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To: Members of the Executive Board

From: The Acting Secretary

Subject: Poland - Staff Report for the 1988 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1988 Article IV consultation with Poland, which has been tentatively scheduled for discussion on Wednesday, September 14, 1988. A draft decision appears on page 18.

Mr. Wolf (ext. 7413) or Mr. Boote (ext. 8801) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

POLAND

Staff Report for the 1988 Article IV Consultation

Prepared by the Staff Representatives for the Consultation

Approved by Massimo Russo and J. T. Boorman

August 9, 1988

I. Introduction

The 1988 Article IV consultation discussions were held in Warsaw in the period June 1-16. A staff team had previously visited Warsaw in April and the present report also draws on discussions held at that time. ^{1/} Both in April and in June the staff team met with Professor Sadowski, Deputy Prime Minister and Chairman of the State Planning Commission; Professor Baka, President of the National Bank; Mr. Samojlik, Minister of Finance; senior representatives of the Ministry for Foreign Economic Relations; representatives of the Polish United Workers' Party; and with the senior officials of the above and other government ministries and agencies.

Poland rejoined the Fund in June 1986 with a quota of SDR 680 million. Poland has made no use of Fund resources but the authorities have repeatedly expressed interest in receiving a stand-by arrangement from the Fund. Four Fund technical assistance missions have visited Warsaw so far in 1988--from the Central Banking Department (monetary control instruments), the Fiscal Affairs Department (tax reform), the Bureau of Computing Services (computerization of economic forecasting and certain fiscal operations), and the Bureau of Statistics (balance of payments statistics). Poland continues to avail itself of the transitional arrangements of Article XIV.

Poland rejoined the World Bank in June 1986. Extensive work has been carried out in identifying and preparing projects for possible lending but no loan agreements have been concluded. A project preparation facility of US\$1.5 million has, however, been approved.

^{1/} The staff team in April consisted of Messrs. Schmitt (head), Wolf, and Boote (all EUR) and, as secretary, Ms. Birrell (FAD); Messrs. Lav and Milanovic (IBRD) also participated. In June the staff team consisted of Messrs. Prust (head), Wolf, Boote, Ossowski (EP), and, as secretary, Barrington (all EUR), and Ms. Puckahtikom (ETR). Mr. Russo (EUR) also participated in the mission's concluding discussions.

In their discussion concluding the 1987 Article IV consultation, Executive Directors welcomed the Polish authorities' intention to introduce broad systemic reform in 1988. They urged a strongly front-loaded policy package to reduce the administrative allocation of resources, strengthen enterprise financial discipline, and improve the mobility of factors of production and the efficiency of investment. Directors also stressed the need for a determined and substantial tightening of demand management policies. Directors welcomed the authorities' more active exchange rate policy, while stressing the need to keep the level of the exchange rate under close review and to simplify the exchange and trade system. Most Directors believed that more rapid elimination of the current external deficit with the convertible area than envisaged by the authorities was both desirable and possible.

II. Recent Economic Developments

The Polish economy experienced a severe crisis in the late 1970s and early 1980s as a result of a drastic weakening in its external financial position with the convertible area and acute domestic social tensions. The downturn in activity bottomed out in 1982 by which time output had fallen by about 25 percent from its pre-crisis level. Domestic absorption fell by even more with a particularly large drop in fixed investment expenditure, of about 45 percent, on the same basis. Foreign trade with the nonruble area also contracted sharply: by 1981-82 the volumes of imports and exports had fallen, respectively, by 45 percent and 20 percent from their peak pre-crisis levels.

Since 1982 domestic output has expanded at an annual average rate of over 4 percent (Tables 1, 3, and 4). This performance has been assisted by generally favorable weather conditions for agriculture but output has also risen steadily--on average by about 5 percent annually--in the industrial sector where substantial gains in labor productivity have been recorded. As a result the level of output had by 1987 risen to about 95 percent of its pre-crisis peak while per capita consumption has now regained its pre-crisis level.

There has been a progressive increase in the rate of inflation in recent years. The retail price index rose by 25 percent in 1987 compared with about 18 percent in the previous year. Nominal wages, however, increased by only 21 percent in 1987 bringing the first decline in the real wage since 1982. The effects of this fall on real household incomes were more than offset by continuing growth in the real value of social money benefits provided by the Government and of incomes in the nonsocialized sector.

Broadly speaking, domestic financial policies have accommodated the rising trend in inflation (Table 5). Broad money has tended to rise faster or, as in 1987, at about the same rate as nominal incomes. Credit to the socialized sector has generally been the dominant cause of monetary expansion. However, in 1987 it declined by 13 percent in real

terms. The most important expansionary influence in 1987 was the increase in net foreign assets due mainly to the increase in the local currency value of foreign currency deposits with the domestic banking system. The latter development reflected both the underlying rise in such deposits in foreign currency terms as well as the increase in their value in local currency terms because of the depreciation of the zloty. The higher-than-planned deficit on government operations also contributed to the growth in real broad money in 1987.

The deficit on general government operations (including extrabudgetary funds) widened by 0.5 percent of GDP in 1987 (Table 6). This deterioration was mainly attributable to the state budget, the deficit on which rose to Zl 220 billion (1.3 percent of GDP) despite a substantial increase in transfers from extrabudgetary funds which are treated as revenue items in the Polish budgetary accounts. In absolute terms, the largest effect on the state budget was from an increase in consumer subsidies, notably on housing and foodstuffs, the latter reflecting the combination of higher procurement prices for agricultural produce and delayed and less-than-planned rises in administered retail prices. On the revenue side, turnover tax receipts fell in real terms and the effective rate of income tax on enterprise profits declined, partially due to greater income tax relief to exporters.

The convertible currency trade surplus has been constant in nominal terms since 1985 at about US\$1 billion and has thus declined in real terms (Table 7). Imports and exports have risen at similar--and increasing--rates. This pattern continued in the first half of 1988 when in nominal U.S. dollar terms both rose by over 25 percent. The two main influences on changes in the current account balance have been the levels of interest payment obligations and of private transfers. In 1987 there was a rise in interest payment obligations--from US\$2.7 billion to US\$3 billion--largely on account of the effects of exchange rate changes on the U.S. dollar value of the debt and debt service obligations. At the same time, though, private transfers continued to grow rapidly: in 1986 they increased by about one quarter to over US\$0.9 billion and in 1987 they recorded a further appreciable increase to US\$1.4 billion. 1/ As a result, the current account deficit fell in 1987 to US\$0.4 billion (0.6 percent of GDP) which was the lowest level recorded since the early 1970s. Although new capital inflows remained small in 1987, there was sizable debt relief (of US\$4.4 billion compared

1/ In 1987 about 55 percent of net private transfers consisted of sales of products for convertible currency by special state-run retail outlets ("internal exports"); most of the remainder was accounted for by net accruals to foreign currency deposits of the population held with the banking system and pensions received from abroad.

with accrued debt service obligations of US\$6.3 billion), and international reserves increased by about US\$0.8 billion. At end-1987 reserves were equivalent to about four months of convertible imports.

There has been a marked change in merchandise trade performance since 1985 (Table 8). In the early years of the recovery phase (1982-85) the growth in exports was largely attributable to higher deliveries of coal and other primary materials while manufactured exports stagnated. In 1986-87 the opposite was the case: coal exports fell in U.S. dollar terms but manufactured exports rose significantly, particularly to industrial country markets. The improved export performance resulted from a very large real effective depreciation of the zloty (of about 50 percent since mid-1986) compounded by generous tax relief for exporters and, since early 1987, by augmented foreign exchange retention rights for exporters.

Since 1981, Poland has had continuous recourse to debt rescheduling with commercial banks, which hold approximately one quarter of the external debt, and with official (Paris Club) creditors which hold most of the remainder. External debt in convertible currencies at end-1987 was almost US\$40 billion (Table 9). (External debt in nonconvertible currencies is equivalent to only about US\$3 billion.) The debt service ratio in 1987 on an accruals basis was 91 percent while on an actual payments basis (including cash settlements of arrears) it was 27 percent. In December 1987 Poland signed a multilateral agreement with its Paris Club creditors rescheduling maturities totaling about US\$9 billion consisting of most arrears and late interest and most principal and interest due in 1988; negotiation of bilateral agreements is proceeding slowly. An agreement with commercial bank creditors rescheduling principal obligations totaling about US\$8 billion due from 1987 through 1993 was signed in July this year (Table 10).

In 1987 the current deficit on the nonconvertible balance of payments also fell--to US\$0.15 billion--which, like the convertible deficit, was also the lowest level recorded this decade (Table 11). The improvement resulted from a fall in the trade deficit largely reflecting a 6 percent improvement in the terms of trade because of the lower cost of energy imports from the Soviet Union.

III. Economic Reform and Related Policy Initiatives in 1987-88

1. The economic reform program of 1981-82

In 1981-82 the authorities launched a major program of economic reform. The role of the central administration and of the central plan was to be reduced while enterprises were to be given greater autonomy and to be subjected to greater financial discipline. Broadening the scope for market forces necessarily involved not only a greater role for aggregate financial policies but also, if financial magnitudes were

accurately to reflect relative scarcities, a reform of the price structure. The implementation of the reform progressively lost momentum after 1982. Prices continued to embody serious distortions and were subject to extensive controls, and financial discipline remained weak. The central authorities continued to play an active role in guiding the operations of enterprises and the allocation of many commodities as well as foreign trade remained heavily subject to administrative control.

2. The second stage of economic reform

The quinquennial congress of the Polish United Workers' Party, meeting in mid-1986, urged that efforts be made to reinvigorate the reform process. A draft set of proposals for a "second stage of economic reform" was issued in the spring of 1987 and further elaborated later in the year. In essence, the aims and intended instruments of policy were very similar to those envisaged in 1981-82.

In the fall of 1987 the authorities took various steps to streamline the central administration, including a reduction in the number of economic ministries. They also submitted their proposals for economic reform, together with proposals for related changes in the political sphere, to a popular referendum in late November. In the event, less than half the electorate, but about two thirds of those actually voting, supported these proposals. The authorities have nonetheless announced their intention to proceed with the economic reform although, with respect to price reform, at a somewhat slower pace than originally intended.

In February 1988 the Parliament endorsed a program of economic reform extending into the 1990s which includes changes in the institutional sphere and in policies. The planned institutional changes include the decentralization of the banking system by creating a network of competing commercial banks; reform of the tax system by, inter alia, introducing a value added tax and a personal income tax and streamlining the system of enterprise taxation; further reducing the share of material inputs subject to central administrative allocation; reducing the incidence of price control; liberalizing the foreign trade system; selectively breaking up monopolistic enterprises and in some cases liquidating inefficient enterprises; and facilitating the formation of new enterprises by state enterprises, foreign investors engaged in joint ventures, and by the private sector.

Regarding macroeconomic policy the primary focus of the approved program was on two key domestic objectives. The first was to reduce price subsidies and forestall a major deterioration in the budget. The second was to reduce imbalances and progressively to ease price controls, i.e., to move closer to a situation in which demand could be met by the available supply at liberalized prices. Both elements were seen as indispensable in creating a propitious environment for the efficient

operation of autonomous enterprises. As previously, plans called for the elimination of the current account deficit in convertible currencies only in 1991.

In line with these objectives the authorities took a number of measures in early 1988. Increases in a wide range of administrative prices were approved, notably for foodstuffs, energy, and rents. The increases in food prices were primarily intended to cover the costs of higher procurement prices paid to farmers while the energy price measures were deliberately intended to raise the relative price of energy. Contract prices, which are subject to less control than administrative prices, were generally allowed to increase substantially. The nominal budget deficit was to be approximately stabilized. The effective rate of taxation of enterprise profits was to be raised, notably by limiting the scale of tax relief for exporters, and the budget was to benefit from increases in the administered prices of subsidized items. The monetary authorities announced credit plans consistent with a rate of monetary expansion significantly below that of nominal incomes; they also raised interest rates. Finally, regulations governing the application of the tax on excessive wage increases were amended partly with a view to securing some further decline in the real wage.

In the event, social pressures, including labor unrest in April and May, have resulted in rates of increase in prices, wages, and other incomes now expected for 1988 as a whole which substantially exceed the original official targets. Real wages are now expected to increase and not to decline as planned. On an annual average basis, prices are expected to rise by some 55 percent and wages by over 60 percent. This compares with an original expectation that prices would rise by 45 percent and wages by about 42 percent. On May 11 the Parliament passed legislation granting the Government extraordinary powers to counteract excessive growth in wages and prices as well as to expedite the reform process (see section IV below).

IV. Policy Issues for 1988 and Beyond

The Polish authorities simultaneously face several key policy issues. A dominant concern at the moment is substantially to reduce the rate of inflation. A second need is to strengthen the convertible balance of payments and lay the basis for a progressive normalization of the country's external financial relations. And a third requirement is to provide a policy environment favorable to the authorities' reform objectives of decentralizing and liberalizing the economic system, while at the same time making the necessary accompanying legal and institutional changes. A central problem affecting the approach to these issues is the current excess demand for the output of the socialized sector at the prevailing price level. This problem, which is the result of lax financial policies combined with pervasive controls over prices and imports, is itself an important reason why the authorities, for fear of adding to open inflation and running down scarce foreign exchange

reserves, have not pushed ahead faster with the liberalization of prices, materials allocation, and foreign trade. Such liberalization, however, is crucial if a more decentralized system is to function efficiently.

1. Domestic issues

a. Prices and wages

The authorities recognize that the emerging relationship between price and income increases represents a serious setback to their original plans for 1988. However, they view these increases as in the nature of once-for-all adjustments and believe that an ongoing inflationary spiral can be avoided. They expect the rate of wage increase to moderate substantially in the remaining months of the year and, in fact, to fall somewhat below the month-by-month increase in prices. For 1989 early official plans are for an approximate halving of the inflation rate. The mission felt greater concern about the dangers of an emerging inflationary spiral and noted that information available during the discussions did not cover the month of May, a month during which labor unrest continued and large wage increases were granted. ^{1/}

The price structure in Poland continues to embody various easily identifiable distortions, notably for energy, certain other key materials, and housing. Although the steps taken in early 1988 brought some improvements in these areas, the desired degree of relative price restructuring was not achieved because price increases for many other goods considerably exceeded the plan. The price structure also embodies other major distortions whose effects, however, on the prices of particular commodities are less precisely measurable. In this category fall the effects of negative real interest rates and of the incomplete passthrough of the exchange rate to the structure of domestic prices (see below). While the authorities recognize the need for further action in these areas, they are concerned that any measures taken should be consistent with a substantial reduction in the rate of inflation.

The authorities agreed that a sustainable lowering of the inflation rate would require extremely tight financial and incomes policies. In addition, the mission urged a strengthening of measures to control nominal income growth directly. It also noted that the room for maneuver on wage policy was limited by the fact that other incomes, notably social benefits provided by the state, had been allowed to rise relatively fast both in 1987 and 1988. The authorities responded that with acceleration of payments of the tax on excessive wage increases--enterprises will now

^{1/} Information which has recently become available shows that the year-on-year rate of growth of wages in the first five months of 1988 (excluding premia distributed from profits) was 5 percentage points higher than in the first four months of the year.

be required to make any payments due monthly--and a reduction in reliefs from this tax, it would become a more effective instrument for wage control.

b. Monetary policy

The authorities recognize that the overrun in the inflation rate in 1988 strengthens the need to restrain the growth of nominal money and credit. They also recognize that this need is further heightened by the prospective decentralization of the banking system and thus intend to retain ceilings on credit growth for a transitional period. However, they rule out the possibility of introducing further increases in nominal interest rates in 1988 and look mainly to the anticipated fall in the inflation rate in 1989 to move interest rates closer to levels that are positive in real terms. The authorities drew attention to the sharp increase in interest rates on both bank credits and deposits in 1988 and to the simplification of the structure of subsidized interest rates. Deposit rates of interest effective in 1988 were raised substantially--for instance, from 10 percent to 25 percent for one year savings deposits. But there were less than matching increases in lending rates with the result that the higher costs to the banks of servicing deposits in 1988--but not thereafter--will be met by a budgetary subsidy to be paid in the period 1989-82. The basic rate of interest on bank credit was raised from 12 percent to 18 percent in addition to which charges ranging from 2-7 percentage points may also be levied with even higher rates for loans in arrears.

In the mission's view further interest rate action is necessary. With higher nominal interest rates on bank credits, the demand for credit and thus monetary growth would be curtailed, and reduced reliance on direct credit controls would be facilitated--an issue that is likely to become increasingly important as the banking system is decentralized. The incentive for speculative and socially unproductive stockholding would be greatly reduced if not eliminated--a vital consideration in an economy which even in a year of growing shortages is expected to devote some 5 percent of its total output to stockbuilding. Higher interest rates would also be an essential underpinning of any strategy to improve the quality of investment that, despite some modest improvements, continues to be characterized by long gestation periods and by continuing substantial expenditure on old projects of dubious viability and on excessive investment in structures as opposed to machinery and equipment. Finally, higher deposit interest rates would raise the demand for household financial savings and help neutralize the unplanned infusion of purchasing power that has occurred in 1988. Moreover, higher deposit rates on zloty deposits would appear to be indispensable if the propensity for holding savings in foreign exchange is to be reduced and,

especially at a time when the exchange rate is depreciating, the authorities' effective control over monetary conditions is to be increased. 1/

c. Fiscal policy

Fiscal policy in Poland is important both for its impact on aggregate demand and as an instrument for affecting financial discipline.

Regarding aggregate demand management, as noted earlier the net borrowing of the government has been relatively small in relation to the growth of credit to enterprises as a source of monetary expansion. Nevertheless, the substantial deterioration of the state budget position in 1987, especially after abstracting from the effects of once-for-all transfers from extrabudgetary funds, is a source of concern. The price increases of early 1988, partly intended to keep consumer subsidies from growing in real terms, and a reduction in tax reliefs, allowing a higher effective rate of taxation of enterprise profits, were introduced to forestall what would otherwise have been a very substantial increase in the state budget deficit in 1988. However, in the course of the year new pressures on the budget have emerged which may entail a need for further measures if the originally targeted deficit is not to be exceeded. Agricultural procurement prices were further raised on July 1 which, in the absence of retail price increases, will increase consumer subsidies on foodstuffs. Other expenditure items will also exceed budgeted levels because of the higher-than-expected increases in prices and wages. The same is true of certain revenue items and the authorities are considering using their extraordinary powers to introduce a stabilization tax on enterprises.

The mission noted that the budgetary accounts, which are kept on a cash basis, gave an incomplete picture of the true budgetary position. In particular, the practice of deferring payments of subsidies to the banking system, which are meant to cover the costs of higher deposit rates and debt service payments, has led to an understatement of the extent to which the budget is accumulating liabilities for the future. This problem could increase over time since the Government's obligations

1/ A large share of the household sector's financial wealth is now held either in foreign currency deposits with Polish banks or, to an extent that is unknown but widely thought to be substantial, in the form of holdings of foreign currency outside the banks.

There exists a broad spectrum of views concerning the appropriate exchange rate for valuing these holdings, ranging from the official exchange rate to the parallel market rate. In April 1988 the official exchange rate was about Zl 400 = US\$1 while the parallel market rate was about Zl 1,400 = US\$1. Using these exchange rates, foreign currency denominated bank deposits (i.e., excluding currency outside banks) were equivalent to 21 percent and 47 percent, respectively, of broad money.

to cover the costs of debt service payments would grow as Poland becomes able to meet an increasing share of its external debt service obligations.

The authorities are aware of the decisive impact of budgetary operations on financial discipline. Explicit subsidies to enterprises as well as implicit subsidies conferred through negotiated tax reliefs are important sources of financial indiscipline. While direct subsidies to enterprises fell by about 15 percent in 1987 in real terms and were budgeted to decline in nominal terms as well in 1988, there remains considerable pressure from enterprises not to cut back on tax reliefs. The authorities intend to address these problems through adaptations in pricing policy and through a standardization of the tax regime for enterprises.

d. Institutional reform

The authorities have been pursuing their program of institutional reform on various fronts. Decentralization of the banking system is proceeding with the aim of reducing the role of the National Bank of Poland (NBP) to that of a classical central bank. An independent national savings bank was set up in November 1987, and from January 1, 1989 nine new commercial banks are to be established which will take over the commercial loan portfolio of the NBP. Draft legislation, which would permit both socialized and privately-owned enterprises to issue bonds through the banking system, has been submitted to the Parliament.

In accordance with a streamlining of the central economic administration, supervision of socialized enterprises not deemed to be of "national importance" is being progressively transferred to local authorities. It is intended that eventually the consolidated Ministry of Industry will only have direct supervision over some 300-400 such enterprises. The number of groups of material inputs subject to formal central allocation was further reduced in 1988, with 22 percent of inputs, by value, still being centrally allocated (1987: 35 percent).

Several initiatives are being taken with respect to increasing competition and promoting structural change. A demonopolization office was established in early 1988 with the task of formulating antimonopolistic policies, investigating complaints of monopolistic practices, and imposing sanctions for such behavior. A draft Law on Economic Undertakings was submitted to the Parliament in June, under which individuals, private firms, and socialized enterprises would be entitled to engage in a wide range of economic activities previously subject to special license. The draft legislation, which is expected to come into effect on January 1, 1989, also liberalizes the number of employees permitted in private firms. Also put before the Parliament in June and expected to come into force at the beginning of 1989 was a proposed new law on joint ventures designed to make them more attractive to foreign investors, including by dropping the requirement that the majority share be held by the Polish partner. An Industrial Restructuring Fund has been

established with the aim of providing credits to selected enterprises undertaking projects consistent with the authorities' objectives for structural change. In foreign trade, the licensing system was amended on July 1, 1988 permitting an estimated 80 percent of turnover to take place on the basis of general as opposed to specific licenses.

Under the extraordinary powers it assumed in May 1988, the Government is seeking to speed up the process of splitting up, merging or liquidating socialized enterprises that are viewed as inefficient. Warnings have been issued to some 900-1,000 poorly performing enterprises and cooperatives and lists have already been published of firms that are to be split up or liquidated, and a comprehensive examination of the economic viability of the metallurgical and shipbuilding industries has been launched. A tax on "unproductive assets" has also been enacted that would encourage firms to make better use of their resources or dispose of them to other enterprises. Under the extraordinary powers the Government can recall or suspend directors of any state enterprise without first obtaining the approval of its workers' council.

Draft legislation has been submitted to the Parliament which would permit enterprise management greater flexibility in wage determination by reducing the number of mandatory payments, such as seniority bonuses. Draft changes in the labor code are meant to increase the autonomy of both enterprise directors and local trade unions in labor relations, and these changes may be enacted by January 1, 1989. For the time being, however, the extraordinary powers limit the right of local unions to strike by requiring them first to obtain the approval of not only their respective labor federations but also of the national alliance of trade union federations (OPZZ).

2. External sector policies and objectives

a. Objectives

Poland's external financial position with the convertible area remains weak. Since the onset of the financial crisis in 1980 new capital inflows to Poland have dwindled to negligible levels. Accordingly, and given the continuing current account deficit, a substantial proportion of debt service obligations have been effectively financed by debt relief and, in periods pending signature of rescheduling agreements, arrears have been incurred. The debt service ratio on an accrued obligations basis in 1988 is estimated to be about 65 percent.

With the convertible currency trade surplus planned to remain at US\$1 billion for the fourth consecutive year, transfers officially expected to decline, and with interest obligations expected to exceed US\$3 billion, the authorities anticipated some deterioration of the current deficit in 1988 from the US\$0.4 billion level of 1987. The staff, however, suggested that a higher trade surplus and a smaller decline in transfers were probably attainable, and that deterioration in the current account could be avoided. Given the cushion provided by a

build-up in international reserves of US\$0.8 billion in 1987, Poland would in this event be fully able to meet in 1988 its payment obligations for nonrescheduled interest (US\$1.7 billion) and nonrescheduled principal (US\$1.0 billion) and avoid the emergence of a financing gap. Currently, nonrescheduled principal repayments will increase to US\$1.7 billion in 1989, however, and from 1990 substantial repayments, of over US\$2 billion per annum, start to fall due to official creditors under the 1982-84 rescheduling agreement.

The mission reiterated the view previously propounded by the staff that an essential first step in the process of normalizing external financial relations is the attainment of current account balance with the convertible area to be followed by a period of moderate current account surplus. The mission also argued that these objectives could be achieved while still allowing imports and output to rise at an acceptable rate. The vastly improved performance of exports since 1985 together with the buoyancy of private transfers has considerably eased the trade-off between adjustment and domestic absorption in a way that would have been hard to imagine even a short while ago. ^{1/} The mission prepared a number of illustrative scenarios (see Appendix IV) indicating that, especially with the effective implementation of reform measures to boost efficiency, the comparatively small shift of resources into net exports needed to eliminate the current deficit and then run a moderate surplus would, under the current import regime, be compatible with acceptable growth rates in imports and output.

The Polish representatives responded that in their view the adjustment proposed by the mission was unrealistically rapid. There was an enormous need for imports from the convertible area to replace an aging capital stock as well as to provide inputs for current production. Moreover, there was a close relationship between import and export growth: it would be hard to sustain the present growth in exports if import growth were curtailed. Current account balance could be approached only gradually and the current surge in exports, while generally welcome, was seen by some as a factor exacerbating domestic shortages. Some officials suggested that the mission took inadequate account of the imperfect substitutability of domestically absorbed output and exports: the achievement of a given increase in exports could require a greater-than-equal cut in domestic absorption.

Some officials expressed concern about the status of negotiations with official creditors. They believed that the fixed interest rates charged under certain previous agreements were excessively high and

1/ On a balance of payments basis, exports to the convertible area in 1987 rose by 16 percent; customs data indicate that volume growth to the convertible area was on the order of 10 percent. Indications are that, so far in 1988, performance has been even stronger with export receipts rising by about 30 percent in the first five and half months in value terms and by about 20 percent in volume terms.

should be reduced. They also believed that it would be appropriate for signature of bilateral agreements to be accompanied by at least informal commitments to grant new official or officially guaranteed credits, at least on a modest scale. But these arguments had generally not met with a very sympathetic response.

b. External policies

The Polish authorities have pursued an active exchange rate policy since mid-1986. Since then the real effective exchange rate of the zloty has depreciated by about 50 percent. Over this period Poland's export prices in industrial country markets have risen less rapidly than those of suppliers to these markets in general, suggesting that Polish exporters have used part of the leeway created by the depreciation to cut prices. Nevertheless, through 1987 prices on export sales in zloty terms rose substantially faster than domestic prices. The resultant incentive effect has been compounded by tax relief for exporters which, through 1987, was based both on the level and on the increase in exports.

The mission urged that the authorities' recent exchange rate policy be maintained so as at least to prevent any real effective appreciation of the zloty from its current level. The need for future rate adjustments would have to be assessed periodically in light of the overall balance of payments situation and trade performance. The staff expressed the view that it would be more effective and transparent to replace the tax relief provisions for exporters--which represent a considerable burden for the budget--by an across-the-board devaluation. The mission also argued that steps should be taken to improve the effectiveness of the exchange rate as a policy instrument. This would involve abandoning the so-called submarginal approach to exchange rate policy which aims to achieve "profitability" ^{1/} for only about 80 percent of exports, as well as moving toward full passthrough of changes in foreign trade prices to the domestic economy. The presumption underlying the current system is that the export price will typically exceed the domestic price for a large proportion of the commodities which Poland exports. Other things being equal, an incentive would be created for exporters to maximize overseas sales and minimize domestic sales. This naturally creates a need for export controls, whether formal or informal, which runs counter to the authorities' desire to raise the economy's export orientation.

The Polish authorities accept that import liberalization is an important goal of policy, not least as a means of mitigating the effects of the highly monopolized structure of industry. They intend to pursue liberalization by reducing the share of imports that are centrally financed (currently over 60 percent) and correspondingly increasing the

^{1/} "Profitability" is considered to be achieved when the ratio of the export price to the comparable domestic price equals or exceeds unity.

share which is financed by foreign exchange retained by exporters and through the expansion of various foreign exchange auction schemes. At the same time, they are in the process of raising and standardizing the retention coefficients applied under the foreign exchange retention scheme--a process which they envisage will take about three years. The mission suggested that it would be preferable to standardize these rates more rapidly. This could be facilitated by a faster rundown in the proportion of imports centrally financed than currently planned by the authorities. A higher proportion of imports could thus be determined on a decentralized basis thereby enhancing the effectiveness of import liberalization in providing competition for domestic producers.

The supply of foreign exchange offered for auction by exporters with retention accounts has been growing, and the authorities have expanded the auction system in 1988 to include sales by the banking system to nonexporting production enterprises as well as domestic trading organizations. As a result, foreign exchange sold through auctions is expected to rise from about 0.2 percent of convertible currency imports in 1987 to about 5 percent in 1988. Also, since June 1988 Polish residents can buy and sell dollar-denominated Bank PKO S.A. coupons through the banking system for zlotys at rates close to those on the free parallel market. These coupons are not officially convertible directly into foreign currency but are convertible into products sold by PEWEX and other designated state-run sales outlets.

V. Staff Appraisal

The Polish economy is at a critical juncture. Important moves toward increasing the economy's market orientation have been started during the past year and others are planned for the future. There is widespread support for and recognition of the need for these moves within official circles in Poland. Supporting macroeconomic policies are essential. Their aims should be, first, to reduce the rate of inflation from its current dangerously high level; secondly, progressively to remove excess demand pressures so that controls on prices and foreign trade can be eased without, respectively, reigniting excessive inflation or worsening the external position; and, thirdly, to achieve early elimination of the current account external deficit in convertible currencies as a first step in normalizing Poland's external economic relations.

Crucial in the achievement of all three objectives is the sustained implementation of tight aggregate demand management policies. Monetary and fiscal restraint will both be important but there will also be at least an interim need for more direct restraint on the growth of nominal incomes. Policy should be aimed at keeping the rate of monetary expansion significantly below that of nominal income growth and holding the growth in nominal incomes below that of nominal expenditures.

The authorities are to be commended for the steps they have taken in early 1988 to raise and simplify the structure of interest rates. Much remains to be done to curb subsidized credits, however, including those for housing. The staff regards further increases in nominal interest rates as an essential ingredient in tightening monetary policy and believes that it would be inappropriate to rely solely on the hoped for decline in inflation to achieve an interest rate structure that is positive in real terms. The benefits of such a structure would be numerous and pervasive.

The deterioration in the budgetary position which became evident in 1987 needs to be reversed and the pressures to allow an accommodation of the deficit in 1988 to the overrun in price and wage increases should be firmly resisted, especially in view of the claims on the budget related to debt service payments that are likely to rise steeply in the future. The budgetary authorities also need to resist pressures from enterprises for ad hoc accommodation to the tensions which the combination of price reform and tight credit policies could create. While the authorities' plans to introduce a value added tax and a personal income tax are welcome, the staff believes that it is equally important to make early progress in standardizing the taxation of enterprise profits which would make a vital contribution to strengthening financial discipline. It will also be important progressively to reduce budgetary subsidies as part of an ongoing process to decrease the redistributive role of the budget: lower expenditures would, in turn, permit a lower tax burden.

Continuing price adjustments are necessary for several reasons, including the need to raise prices for energy and other key materials much closer to world levels and to diffuse throughout the economy the effects of higher interest rates and of the exchange rate. These tasks will only be achievable in conjunction with a general reduction in the scope and intensity of price controls. The scope of administrative pricing and of controls on contract prices should be reduced and an increasing proportion of prices, particularly for nonessentials, should be freed from controls altogether. As experience in 1988 demonstrates, the impact of pricing measures in curtailing aggregate demand and improving the structure of relative prices will be severely circumscribed unless nominal incomes can be controlled. An effective incomes policy is therefore essential. The problem of wage control may be eased by constraining the growth of nonwage incomes to the greatest extent possible consistent with overall social priorities. The trend in recent years for wages to decline in importance relative to state-provided social benefits is surely undesirable at a time when the authorities are seeking to tie earnings more closely to productivity.

The staff continues to believe that rapid elimination of the current account deficit in convertible currencies, and its replacement by a moderate surplus, is a necessary and feasible objective. By creating a situation in which Poland would be able to meet most if not all of its current interest payment obligations from its own resources, conditions for future rescheduling of principal maturities would be considerably

improved. The resumption of the substantial voluntary capital inflows for which the authorities look will not take place until Poland's record in servicing its existing obligations, and prospects for being able to service any obligations acquired in the future, are greatly improved. Moreover, the case, and commercial inducement, for financing higher imports will remain weak until a comprehensive set of policies are in place to ensure their efficient utilization. The staff regrets the slow progress in Poland's bilateral negotiations with official creditors pursuant to the December 1987 multilateral agreement and urges the Polish authorities to make their best effort to conclude these negotiations promptly. A continuing stalemate can only undermine support for Poland's cause in the international community and complicate the chances of success for any future debt rescheduling talks.

Poland's foreign trade performance has improved dramatically in the last two years and the pessimism previously expressed about the exportability of Polish manufactures has proved to be unjustified. The staff does not question that there is a link between import growth, on the one hand, and the behavior of exports and output on the other. But, given the possibilities for improved investment efficiency and for reducing the absorption of resources by industries that are demonstrably inefficient, the staff is convinced that, consistent with adequate growth in imports and output, it should be possible to hold import growth somewhat below export growth. Moreover, the Polish economy's growth performance continues to be buoyant: output is expected to rise by some 4 percent in 1988 and consumption by over 3 percent. With such high growth rates, the external convertible currency deficit can be eliminated while still allowing significant growth in domestic absorption.

For any convertible current account adjustment, the required change in domestic absorption is also dependent on the pace of adjustment with the nonconvertible area. Currently the authorities envisage an early swing into current account surplus with the nonconvertible area. Given the much lower level of debt to the CMEA (around US\$3 billion) there would appear to be scope for a more moderate pace of adjustment with the nonconvertible area, thus reducing the necessary slowdown for domestic absorption.

The staff commends the authorities on their recent active exchange rate policy and urges that it be continued. Exchange rate policy could be made more effective, however, as discussed in section IV, and the level of the exchange rate should be determined in light of the overall balance of payments position and the need to liberalize imports. At the same time, domestic price controls should be eased so that the gap between border transactions prices and domestic prices would be narrowed. The authorities' commitment to simplifying and expanding the foreign exchange retention scheme of exporters is welcome. The staff believes that over time, however, exchange rate policy should be the primary instrument for guiding foreign trade and that the need for special retention arrangements should be eliminated. The introduction

of more uniform retention quotas leads to a greater need for foreign currency auctions to smooth the mismatch between retained amounts and the actual foreign exchange needs of particular enterprises.

Since the previous consultation, steps have been taken to broaden the use of market-related exchange rates. The auction introduced in 1987 for exporters with foreign exchange retention accounts has been supplemented in 1988 by other auctions. In addition, the dollar-denominated coupons used for purchases from state-run hard currency sales outlets have since June 1988 been sold and bought for local currency through the banking system at a market-related rate. The authorities have expressed their intention to move further toward the use of market determination in foreign exchange transactions, with the objective of unifying the exchange rate at a realistic level. The staff welcomes the aims of the authorities in introducing and extending the use of these schemes, and encourages them to unify the different effective exchange rates as soon as possible. In the meantime, the staff proposes that the Executive Board grant approval for the multiple currency practices involved.

The Polish authorities have introduced important policy and institutional reform initiatives in 1987 and 1988. Unfortunately, the policy measures have had much less than their intended impact in reducing imbalances and improving relative prices, essentially because excessive increases in nominal incomes have taken place. This experience argues for the recognition of the limits of social tolerance to price increases. The staff, however, believes that with the policies described above, inflation can be reduced and contained at an acceptable level while the policy environment for economic reform and the external position is strengthened.

It is expected that the next Article IV consultation will be held on the standard 12-month cycle.

VI. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision concerning Poland's exchange practices subject to Article VIII, section 3, and in concluding the 1988 Article XIV consultation with Poland, in the light of the 1988 Article IV consultation with Poland conducted under Decision No. 5392 - (77/63), adopted April 19, 1977, as amended (Surveillance Over Exchange Rate Policies).

2. The restrictions on the making of payments and transfers for current international transactions, and the multiple currency practices which are described in detail in SM/88/..., are maintained by Poland in accordance with Article XIV, except for the multiple currency practices connected with the foreign exchange auctions and the convertible foreign exchange coupon scheme which are subject to approval under Article VIII, section 3. The Fund urges the authorities to take early steps to eliminate or liberalize exchange restrictions evidenced by payments arrears and bilateral payments arrangements, and encourages the authorities to accelerate the process of simplifying and eliminating the very complex multiple currency practices. In the meantime, the Fund grants approval of the practices subject to its approval until December 31, 1988.

Table 1. Poland: Selected Economic Indicators, 1982-88

(Percentage change unless otherwise indicated)

	1982	1983	1984	1985	1986	1987	Official Forecast 1988 ^{1/}
Domestic Indicators							
(In real terms)							
Gross domestic product (SNA basis)	-4.8	5.6	5.6	3.6	4.2	2.0	4 1/2
Net material product	-5.5	6.0	5.6	3.4	4.9	1.7	4
Consumption (material)	-11.5	5.8	4.4	2.9	4.8	2.6	3
Gross fixed investment	-13.7	8.8	9.8	4.4	4.5	4.1	4 1/2
Industrial production (gross)	-2.1	6.4	5.2	4.5	4.7	...	4 1/2
Agricultural production (gross)	-2.8	3.3	5.7	0.7	5.0	-2.8	5
(In nominal terms)							
Consumer prices	100.8	22.1	15.0	15.1	17.7	25.2	53-55
Average monthly wages in the socialized sector	51.3	24.5	16.3	18.8	20.4	21.1	61-62
Household incomes ^{2/}	66.1	22.4	18.3	18.7	22.4	26.0	65
Fiscal Indicators							
State budget revenues	109.4	12.6	25.7	24.1	22.4	19.3	... ^{3/}
State budget expenditures	75.5	11.0	26.1	20.9	22.3	20.2	... ^{3/}
State budget balance (as a percentage of GDP)	-2.9	-2.1	-2.2	-1.2	-1.1	-1.3 ^{4/}	... ^{3/}
Direct subsidies (as a percentage of total expenditures)	44.6	40.0	41.4	39.6	39.7	42.1	... ^{3/}
Monetary Indicators							
Domestic credit (net of general government deposits)	19.7	13.3	12.3	20.1	26.9	14.1	20.0 ^{5/}
Money and quasi-money	36.7	14.5	18.7	24.2	25.1	32.5	40.0 ^{6/}
External Indicators in convertible currencies							
(in terms of U.S. dollars)							
Exports ^{7/}	-8.6	5.8	10.8	-3.8	3.8	15.9	18.5
Imports ^{7/}	-26.2	-9.0	1.4	2.2	6.2	19.7	22.2
Trade balance							
In billions of U.S. dollars	0.27	0.92	1.38	1.09	1.04	1.04	1.04
In percent of GDP ^{8/}	0.4	1.2	1.8	1.5	1.4	1.6	1.6
Current account							
In billions of U.S. dollars	-2.27	-1.41	-0.77	-0.62	-0.67	-0.42	-0.9
In percent of GDP ^{8/}	-3.5	-1.9	-1.0	-0.9	-0.9	-0.6	-1.4
External debt (end of period) ^{9/}							
In billions of U.S. dollars	26.5	26.4	26.9	29.7	33.5	39.7 ^{10/}	41.0
In percent of GDP ^{8/}	40.5	34.9	35.7	41.8	45.4	61.4	63.5
External arrears							
In billions of U.S. dollars	6.8	10.7	12.1	0.8	3.4	0.5	—
Commercial exchange rate depreciation (-) against U.S. dollar	-39.6	-7.4	-19.4	-22.7	-16.0	-33.9	-38.4
External indicators in nonconvertible currencies							
(in terms of U.S. dollars) ^{11/}							
Exports ^{8/}	7.7	4.7	4.6	-11.1	8.3	-12.9	...
Imports ^{8/}	-5.8	4.9	4.9	-8.7	3.6	-14.4	...
Current account balance (in billions of U.S. dollars)	-0.36	-0.35	-0.51	-0.56	-0.28	-0.16	—

Sources: Central Statistical Office, *Rocznik Statystyczny*; and data provided by the authorities.

^{1/} As interpreted by staff.

^{2/} Income accruing from savings bonds issued in 1982 (to provide partial compensation to savers for the large increase in prices in that year) is distributed over the period 1982-85 even though the bonds and accumulated interest income could not be encashed before 1985.

^{3/} Budgeted revenues and expenditures will likely be exceeded as a result of above-plan increases in prices and incomes.

^{4/} If the state budget balance is calculated on a basis strictly comparable to 1986, the deficit would amount to about 2 percent of GDP.

^{5/} To the socialized sector (excluding general government) only.

^{6/} Zloty denominated money only.

^{7/} Balance of payments basis.

^{8/} Gross domestic product in zloty terms is converted into U.S. dollars at the commercial exchange rate.

^{9/} Including arrears.

^{10/} Includes an estimated US\$0.5 billion of late interest due on certain rescheduled debt.

^{11/} Transactions in nonconvertible currencies were converted from transferable rubles into zlotys at the TR/Zl commercial rate, and then into U.S. dollars at the Zl/US\$ commercial rate.

Table 2. Selected Social and Demographic Indicators

Area

Size: 312.7 thousand sq. km.
Agricultural land (in percent of total area): 60
Population per sq. km: 120

Population characteristics

Total population (end-1987): 37.8 million
Population of working age (end-1987): 21.9 million
Average annual rate of growth in 1986-87 (percentage change): 0.6
Life expectancy at birth (1986):
 Male: 66.8 years
 Female: 75.1 years
Population death rate (1987; in percent): 1

Per capita income (1986): US\$1,716

Health (1987)

Population per physician: 488
Population per hospital bed: 152

Education (1987)

Population between the ages of 15-18 that are in school
(in percent): 86

Source: Rocznik Statystyczny; various issues; Maly Rocznik Statystyczny, (1988).

Table 3. Poland: Development of Selected Indices, 1971-87

	(1970 = 100) 1978	(1978 = 100) 1982	(1978 = 100) 1987 <u>1/</u>	(1982 = 100) 1986	(1982 = 100) 1987 <u>1/</u>
Real net material product	184.1	76.5	94.4	121.3	123.4
Industry	201.0	76.9	96.2	121.2	125.1
Agriculture	115.5	84.9	90.4	117.9	106.5
Construction	192.3	49.7	64.3	126.6	129.4
Consumption <u>2/</u>	179.0	88.8	108.7	119.4	122.4
(Consumption per capita) <u>2/</u>	(167.3)	(85.7)	(101.0)	(115.5)	(117.9)
Gross fixed investment <u>2/</u>	227.3	56.8	77.1	130.5	135.7
Real household disposable incomes <u>3/</u>	188.5	94.1	106.0	111.2	112.6
Real wages in the socialized sector <u>4/</u>	162.9	83.5	88.0	108.9	105.4
Retail prices	134.2	284.9	678.5	190.2	238.2
Employment	112.7	99.4	101.2	101.4	101.9
Exports (in volume terms) <u>5/</u>					
To nonsocialist countries	178.0	84.3	105.0	116.3	124.6
To socialist countries	208.6	96.0	136.8	138.6	142.5
Imports (in volume terms) <u>5/</u>					
From nonsocialist countries	319.6	46.0	64.8	127.2	140.9
From socialist countries	186.9	92.1	120.7	130.5	131.1

Sources: Data provided by the authorities.

1/ Provisional.

2/ In volume terms.

3/ Includes income in kind; deflated by the retail price index.

4/ Includes premia distributed from profits for the entire period; deflated by the retail price index.

5/ Customs basis.

Table 4. Poland: Demand and Supply

(Percentage change at constant prices)

	Annual Average			1985	1986	1987	Official
	1971-78	1979-82	1983-87				Forecast 1988
Net material product <u>1/</u>							
Consumption	7.5	-2.9	4.1	2.9	4.8	2.6	3
Of which: private	7.3	-3.6	3.9	2.2	5.0	2.5	...
Investment	10.1	-21.2	4.5	7.2	5.4	-2.2	5
Of which:							
Fixed investment	11.5	-21.3	7.5	4.9	5.9	5.1	...
Domestic expenditure	8.3	-7.6	4.2	3.8	5.0	1.6	3 1/2
Exports <u>3/</u>	9.0	-1.8	6.0	0.3	4.2	4.8	8 4/
Imports <u>3/</u>	12.0	-9.2	6.4	6.9	5.4	4.5	9 4/
Net material product	7.9	-6.5	4.3	3.4	4.9	1.7	4
Of which:							
Industry	9.1	-6.4	4.6	4.0	4.5	3.2	4
Agriculture	1.8	-3.4	1.7	0.2	6.3	-8.6	5
Construction	8.5	-16.0	5.3	4.3	4.3	2.2	1
GDP (SNA basis)							
Gross domestic expenditure	...	...	4.0	3.9	4.1	1.7	...
GDP	...	...	4.2	3.6	4.2	2.0	4 1/2

Sources: Data provided by the authorities; and staff estimates.

1/ Net material production is equivalent to GDP less depreciation and the value added of nonmaterial services, plus nonmaterial services used as inputs in material production.

2/ Expressed in terms of contributions to growth of NMP.

3/ Of goods and material services through 1986; for 1987-88, trade in goods only.

4/ Staff estimates; trade in convertible and nonconvertible currencies weighted by 1987 value shares.

Table 5. Poland: Selected Data on Money and Credit, 1982-87

	1982	1983	1984	1985	1986	1987
	(Percent change)					
Domestic credit	19.7	13.3	12.3	20.1	26.9	14.1
Socialized sector	14.6	9.4	9.5	16.6	18.9	14.6
Working capital credits	(17.6)	(7.7)	(6.8)	(21.0)	(18.3)	(10.3)
Investment credits	(11.7)	(11.3)	(12.2)	(12.3)	(19.6)	(19.2)
Nonsocialized entities and households	35.2	31.8	23.5	26.5	25.2	27.7
Net claims on government <u>1/</u>	...	...	110.5	95.7	149.8	1.3
Money (M1)	39.1	10.0	16.3	21.4	19.7	25.9
Socialized sector	(31.8)	(4.4)	(16.0)	(18.1)	(22.0)	(32.4)
Nonsocialized sector	(51.1)	(18.1)	(16.6)	(25.6)	(17.0)	(14.4)
Broad money (M2)	36.7	14.5	18.7	24.2	25.1	32.5
Socialized sector	(34.4)	(5.6)	(18.7)	(7.8)	(20.5)	(37.3)
Nonsocialized sector	(38.4)	(20.7)	(18.8)	(34.2)	(27.3)	(30.8)
Broad money (in real terms) <u>2/</u>	-21.9	-3.1	3.9	6.4	6.8	1.1
	(Contribution in percentage points to growth in broad money)					
Credit to the socialized sector	25.7	13.9	13.3	21.5	23.1	17.0
Credit to nonsocialized entities and households	3.2	2.8	2.4	2.8	2.7	3.0
Credit to government, net <u>1/</u>	6.2	3.9	3.2	4.9	12.0	0.2
Credit to government, excluding settlements with state budget	(6.5)	(-0.4)	(0.1)	(-0.7)	(-0.5)	(2.3)
Settlements with state budget	(-0.4)	(4.4)	(3.1)	(5.6)	(12.5)	(-2.1)
Total domestic credit	35.0	20.7	18.9	29.2	37.8	20.2
Foreign assets, net	-1.2	-1.3	-1.8	0.1	2.6	9.7
Other liabilities, net	2.9	-4.9	1.6	-5.2	-15.4	2.6
Rate of change of broad money	36.7	14.5	18.7	24.2	25.1	32.5
	(Ratio)					
Income velocity of broad money						
Held by the socialized sector <u>3/</u>	4.12	4.37	4.77	5.08	5.54	5.71
Held by nonsocialized entities and households <u>4/</u>	2.46	2.35	2.32	2.25	2.06	2.01
Held by nonsocialized entities and households but excluding foreign currency deposits	2.57	2.46	2.46	2.44	2.31	2.44
	(In percent)					
Average interest rates						
Deposits of the socialized sector	2.7	2.4	2.8	2.1	2.1	3.0
Deposits of the nonsocialized sector	8.1	8.2	8.4	7.8	8.2	8.7
Credits to the socialized sector	5.4	6.0	5.9	6.4	6.4	6.7

Source: Staff compilation from data provided by the authorities.

1/ Includes state budget, local governments and extrabudgetary funds and includes settlements with the state budget. In 1982 and 1983 percentage growth figures are not calculated due to a change in the sign of the stock of net claims on government.

2/ Deflated by the December-on-December retail price index.

3/ Ratio of NMP of the socialized sector to the average stock of broad money held by the socialized sector.

4/ Ratio of disposable household income to the average stock of broad money held by the nonsocialized sector.

Table 6. Poland: Major Budgetary Aggregates, 1982-88

(In percent of GDP at current prices)

	1982	1983	1984	1985	1986	1987	Budget 1/ 1988
Total state budget revenue	<u>43.4</u>	<u>39.1</u>	<u>39.7</u>	<u>40.4</u>	<u>39.9</u>	<u>36.0</u>	<u>34.6</u>
Of which:							
Turnover tax 2/	11.5	13.8	13.6	12.3	11.6	10.5	10.3
Income tax 2/	13.8	9.1	8.8	10.7	11.0	11.8	14.6
Total state budget expenditure	<u>46.3</u>	<u>41.2</u>	<u>41.9</u>	<u>41.6</u>	<u>41.0</u>	<u>37.3</u>	<u>35.6</u>
Of which:							
Purchases of goods and services and payments of wages	7.3	7.0	7.0	7.0	7.0	6.5	7.5
Subsidies to the population	10.3	8.3	8.7	8.2	9.1	9.9	9.4
Subsidies to enterprises	10.3	8.1	8.6	8.2	7.1	5.8	3.8
Investment	4.8	5.5	5.3	5.7	5.9	5.5	5.2
State budget balance	<u>-2.9</u>	<u>-2.1</u>	<u>-2.2</u>	<u>-1.2</u>	<u>-1.1</u>	<u>-1.3</u> 3/	<u>-1.0</u>
Extrabudgetary funds balance	0.4	1.3	1.7	1.2	0.8	0.5	1.0
General government balance	<u>-2.5</u>	<u>-0.8</u>	<u>-0.5</u>	<u>—</u>	<u>-0.3</u>	<u>-0.8</u>	<u>0.1</u>

Source: Staff compilation from data provided by the authorities.

1/ Based on the budget plan and original official projections of real output growth and inflation. Budgeted revenues and expenditures as well as original projections for GDP in nominal terms are likely to be exceeded as a result of above-plan increases in prices and incomes.

2/ On the socialized sector.

3/ Approximately -1.6 percent of GDP if calculated on a basis strictly comparable to 1986.

Table 7. Poland: Balance of Payments in Convertible Currencies, 1982-87 ^{1/}
(In millions of U.S. dollars)

	1982	1983	1984	1985	1986	1987
A. Current account	-2,272	-1,412	-774	-618	-665	-417
Merchandise exports, f.o.b.	4,543	4,806	5,324	5,120	5,316	6,163
Merchandise imports, f.o.b.	4,275	3,890	3,944	4,032	4,281	5,123
Trade balance	268	916	1,380	1,088	1,035	1,040
Services: credit	557	772	713	722	773	914
Shipment and other transportation	256	388	262	270	275	299
Travel	59	69	81	86	96	138
Interest receipts	84	153	180	165	177	197
Other	158	162	190	201	225	280
Services: debit	3,415	3,475	3,329	3,192	3,417	3,780
Shipment and other transportation	224	425	411	393	399	470
Travel	23	24	25	31	37	48
Interest payment obligations (before debt relief)	3,031	2,889	2,729	2,609	2,734	3,012
Paid	(1,830)	(1,587)	(1,245)	(1,231)	(1,147)	(920)
Rescheduled	(--)	(--)	(--)	(828)	(87)	(2,067)
In arrears	(1,201)	(1,302)	(1,484)	(550)	(1,500)	(25)
Other	137	137	164	159	247	250
Unrequited transfers (net)	318	375	462	764	944	1,409
Private	318	375	462	764	944	1,409
Official	--	--	--	--	--	--
B. Medium- and long-term capital account (net)	-5,229	-3,680	-2,584	-2,168	-3,394	-3,202
Drawings on loans	1,474	565	218	261	294	317
Loan repayment obligations (before debt relief) ^{2/}	6,701	4,242	2,719	2,417	3,472	3,241
Paid	(368)	(508)	(364)	(765)	(715)	(646)
Rescheduled	(2,208)	(1,154)	(740)	(1,576)	(1,457)	(2,283)
In arrears	(4,125)	(2,580)	(1,615)	(76)	(1,300)	(312) ^{3/}
Export credits extended (net)	-1	-5	-85	-13	-211	-280
Other capital (net)	-1	2	2	1	-5	2
C. Short-term capital and other items (net)	336	175	-141	108	-367	-5
Of which: revolving credits	(196)	(338)	(240)	(-2)	(139)	(106)
D. Overall balance (Items A through C)	-7,165	-4,917	-3,499	-2,678	-4,426	-3,624
E. Change in reserves (-, increase)	-369	-119	-340	236	173	-797
F. Debt relief ^{2/} ^{4/}	2,208	1,154	740	2,404	1,544	4,350 ^{5/}
Principal	(2,208)	(1,154)	(740)	(1,576)	(1,457)	(2,283) ^{5/}
Interest	(--)	(--)	(--)	(828)	(87)	(2,067)
G. Change in arrears ^{4/}	5,326	3,882	3,099	38	2,709	71
Incurrence of new arrears	5,326	3,882	3,099	626	2,800	337 ^{3/}
Cash settlement of arrears	--	--	--	588	91	266
Memorandum items:						
Stock of arrears (end of period)	6,778	10,660	12,072	847	3,412	502
Regularization of arrears through rescheduling ^{4/}	2,150	--	1,687	10,933	144	3,134 ^{5/}
Valuation and other adjustments	...	...	...	-330	--	153

Source: Staff compilation from data provided by the Polish authorities.

^{1/} Transactions within swing limits under bilateral payments agreements with non-CMEA countries are excluded.

^{2/} Does not include the rescheduling of arrears which is shown as a memorandum item. Where multiyear agreements have been signed, including maturities due in the year of signature and later years, debt relief has been attributed to the years in which the rescheduled maturities were originally due.

^{3/} Of which US\$200 million relates to loans covered by the draft agreement with commercial banks which was not finalized in 1987.

^{4/} For Paris club creditors debt relief is recorded (and arrears regularized) on the signature of the relevant multilateral agreement. Debt relief (and arrears) for 1987 therefore reflect the 1987 Paris Club agreement.

^{5/} Excludes the effect of the draft agreement with commercial banks since this was not finalized in 1987.

Table 8. Poland: External Trade

(Percentage change)

	Annual Average							Jan.-Apr. 1/ 1988
	1971-75	1976-79	1980-82	1983-84	1985	1986	1987	
Nonruble trade								
Volume of exports	9	4	-7	14	-4	2	4	17
Volume of imports	26	-1	-20	10	11	3	5	18
Terms of trade	3	--	1	-4	5	1	1	1
Ruble trade								
Volume of exports	11	8	-4	7	7	9	5	14
Volume of imports	8	7	-4	4	6	6	5	11
Terms of trade	--	-1	-4	-2	-1	1	6	6
		1970-71	1976-78	1980	1981	1985	1986	
		to	to	to	to	to	to	
		1976-78	1979-80	1981	1986	1986	1987	
Change in export market shares 2/ (in percent)		+15	-18	-33	+4	+4	-7	

Sources: Data provided by the Polish authorities; and IMF, Direction of Trade.

1/ Over first four months of 1987.

2/ Share of Polish exports in total world imports (excluding imports of CMEA area) from non-oil developing and CMEA countries, in current prices.

Table 9. Poland: External Debt
(In billions of U.S. dollars; end-period)

	1982	1983	1984	1985	1986	1987
In convertible currencies						
Short-term	1.3	1.3	1.3	1.4	1.4	1.5
Medium- and long-term	23.6	22.4	21.5	23.9	28.8	32.6
By maturity:						
1-5 years	10.7	8.5	7.2	6.7	5.2	4.2
Over 5 years	12.9	13.9	14.3	17.2	23.6	28.4
By type and by creditor						
Guaranteed	12.2	13.6	14.0	15.7	18.9	21.8
Countries participating in the Paris Club	(10.7)	(11.3)	(10.7)	(12.0)	(15.9)	(19.8)
CMEA countries and institutions	(0.1)	(1.0)	(1.3)	(1.3)	(1.4)	(1.5)
Commercial credits ^{1/}	(1.3)	(1.1)	(1.3)	(1.6)	(1.4)	(0.3)
Other	(0.1)	(0.2)	(0.7)	(0.8)	(0.2)	(0.2)
Nonguaranteed	11.4	8.8	7.5	8.2	9.9	10.8
Commercial banks participating in rescheduling arrangements	(8.0)	(6.5)	(6.1)	(6.6)	(7.5)	(8.3)
CMEA countries and institutions	(1.8)	(0.8)	(0.9)	(1.0)	(1.1)	(1.2)
Commercial credits ^{1/}	(0.6)	(0.5)	(0.1)	(0.2)	(0.2)	(0.2)
Other	(1.0)	(1.0)	(0.4)	(0.4)	(1.1)	(1.1)
Interest arrears ^{2/}	1.6	2.7	4.1	4.4	3.3	5.6 ^{3/}
Total	<u>26.5</u>	<u>26.4</u>	<u>26.9</u>	<u>29.7</u>	<u>33.5</u>	<u>39.7</u> ^{3/} ^{4/}
In nonconvertible currencies ^{5/}						
Short-term	0.5	0.2	0.6	—	0.1	—
Medium- and long-term	2.4	2.5	2.2	3.4	3.0	2.9
Of which:						
1-5 years	(0.7)	(0.6)	(0.3)	(1.0)	(0.6)	(0.4)
Over 5 years	(1.7)	(1.9)	(1.9)	(2.4)	(2.5)	(2.5)
Total	<u>2.9</u>	<u>2.7</u>	<u>2.8</u>	<u>3.4</u>	<u>3.1</u>	<u>2.9</u>
Memorandum item:						
Ratio of average debt stock in convertible currencies to exports of goods in convertible currencies	5.8	5.5	5.0	5.5	5.9	5.9

Source: Staff compilation from data supplied by the Polish authorities.

^{1/} Commercial credits guaranteed and nonguaranteed include credit extended to Polish foreign trade enterprises by foreign banks as well as by foreign exporters. The guaranteed portion is due to Paris Club creditors.

^{2/} Estimate. Includes amounts that are covered by multilateral rescheduling agreements (and which therefore are not shown as arrears in Table 8) but for which bilateral agreements have yet to be signed.

^{3/} Includes an estimated US\$0.5 billion of late interest due on certain rescheduled debt. Excluding this estimated item, total convertible currency debt at end-1987 was US\$39.2 billion.

^{4/} The currency composition of the convertible debt at end of 1987 was U.S. dollar, 34.9 percent; deutsche mark, 24.4 percent; Swiss franc, 13.0 percent; French franc, 8.7 percent; Austrian schilling, 7.3 percent; pound sterling, 3.3 percent; Japanese yen, 3.1 percent; Canadian dollar, 2.3 percent; other currencies 3.0 percent.

^{5/} The external debt in nonconvertible currencies was converted from transferable rubles into U.S. dollars using cross rates derived from the commercial rates of the zloty vis-à-vis the transferable ruble and U.S. dollar; prior to 1982 the period average exchange rate was used.

Table 10. Poland: Maturity Schedule of Medium- and Long-Term External Debt in Convertible Currencies Outstanding at End-1987

(In millions of U.S. dollars)

	Debt Out- standing at End-1987 <u>1/</u>	1988	1989	1990	1991	1992	1993	1994	Later Years	Delayed
Paris Club creditors	26,862 <u>2/</u>	315	1,165	2,576	2,756	2,845	4,462	4,454	8,140	149
Previously rescheduled debt <u>3/</u>	24,791	146	682	2,245	2,593	2,593	4,368	4,370	7,794	—
Nonrescheduled debt	2,071	169	483	331	163	252	94	94	346	149
Commercial banks participating in rescheduling agreements <u>4/</u>	9,828 <u>5/</u>	129	127	131	1,121 <u>5/</u>	158	158	432	7,572	—
QMEA	2,287	146	67	50	323	374	317	238	772	—
Commercial credits	210	102	65	23	13	6	1	—	—	—
Other	<u>1,476</u>	<u>262</u>	<u>271</u>	<u>359</u>	<u>165</u>	<u>140</u>	<u>28</u>	<u>49</u>	<u>182</u>	<u>20</u>
Total	40,663 <u>6/</u>	954	1,695	3,139	4,378	3,523	4,966	5,173	16,666	169

Source: Staff compilation based on data supplied by the Polish authorities.

1/ Including arrears.2/ Including delayed obligations and obligations originally due in 1988 consolidated under the 1987 framework Paris Club agreement.3/ Includes debt covered by the 1987 Paris Club multilateral agreement.4/ After taking account of the rescheduling agreement signed in July 1988.5/ Includes obligations under revolving credit facilities currently due to be repaid in 1991. This accounts for US\$990 million of the total for 1991; excluding this item US\$131 million is due in 1991.6/ The difference between this figure and the total for medium- and long-term debt at end of 1987 in Table 7 (including interest arrears) of US\$38.2 billion is accounted for by interest rescheduled in 1988 under the 1987 framework Paris Club agreement (US\$1.4 billion) and the inclusion of revolving credits from commercial banks (US\$1 billion) in medium- and long-term debt above as this is repayable in 1991: in Table 7 this latter item is included in short-term debt.

Table 11. Poland: Balance of Payments in Nonconvertible Currencies, 1982-87 ^{1/} ^{2/}

(In millions of U.S. dollars)

	1982	1983	1984	1985	1986	1987
Current account	-356	-348	-505	-558	-283	-161
Merchandise exports, f.o.b.	5,914	6,194	6,476	5,762	6,242	5,439
Merchandise imports, f.o.b.	6,379	6,692	7,018	6,404	6,633	5,680
Trade balance	-465	-498	-542	-642	-391	-241
Services: credit	519	590	517	548	587	565
Shipment and other transportation	373	384	319	293	305	232
Travel	9	12	17	27	35	55
Interest receipts	8	31	15	11	11	20
Others	129	163	166	217	236	258
Services: debit	415	445	485	468	481	489
Shipment and other transportation	73	76	81	85	93	87
Travel	110	168	196	143	139	153
Interest payments	125	85	104	121	117	120
Others	107	116	104	119	132	129
Unrequited transfers (private)	5	5	5	4	2	4
Medium- and long-term capital, net	18	-110	-67	72	176	77
Credits received	-63	-77	-8	63	187	31
Drawings	1,114	446	409	462	818	342
Repayments	1,177	523	417	399	631	311
Credits extended	70	-46	-73	-4	-22	-44
Repayments	147	66	60	52	59	17
Drawings	77	112	133	56	81	61
Other capital, net	11	13	14	13	11	2
Short-term capital, net	279	463	551	385	129	103
Credits received	561	148	633	396	284	-6
Credits extended	-	-	-	-	-	6
Payments agreement assets and liabilities	-282	315	-82	-11	-155	103
Financial items, net	59	-5	21	101	-22	-19
Total	-	-	-	-	-	-

Source: Staff compilation from data supplied by the Polish authorities.

^{1/} Data have been converted from transferable rubles into U.S. dollars using the ratio of the Polish commercial exchange rates for the two currencies.

^{2/} Including transactions within swing limits under bilateral payments agreements with non-CMEA countries.

Poland - Fund Relations

(As of June 30, 1988)

(a) Date of membership: Poland was an original member of the Fund but withdrew from membership in March 1950. Poland rejoined the Fund on June 12, 1986.

(b) Status: Article XIV.

A. Financial Relations

II. General Department (General Resources Account)

(a) Quota: SDR 680 million

(b) Total Fund holdings of currency: SDR 680 million
(100 percent of quota).

(c) Fund credit: none

(d) Reserve tranche position: none

III. Stand-by or Extended Arrangements and Special Facilities

No history of use of Fund credit.

IV. SDR Department

(a) Net cumulative allocation: none

(b) Holdings: SDR 85,151

V. Financial Obligations due to the Fund

None.

B. Nonfinancial Relations

VI. Exchange rate arrangements

The currency of Poland is the zloty. Commercial transactions in convertible currencies are carried out at a single exchange rate which is determined on the basis of a weighted basket of currencies, each of which accounts for at least 1 percent of Poland's external current account settlements. The value of the zloty in terms of the basket is periodically adjusted to reflect differences between changes in foreign and domestic prices with a view to ensuring that, for the majority of exports, the export price is equal to or greater than the

domestic price. The currency composition of the basket and the currency weights are defined on a monthly basis in light of current account transactions in convertible currency during the previous months of the calendar year. Buying and selling rates are set with margins of 0.5 percent about the middle rate (except for notes and coins for which the margins are 2 percent), which on June 30, 1988 was Zl 440 = US\$1. Rates are generally set at least once a week, normally on Thursdays, to become effective when they are published on the following Monday.

A single exchange rate similarly applies to commercial transactions denominated in transferable rubles and is generally fixed for extended periods; the middle rate on June 30, 1988 was Zl 200 = TR 1. Exchange rates are also quoted for the zloty against the currencies of CMEA member countries, Albania, and the Democratic People's Republic of Korea for the purpose of noncommercial transactions; these rates are based on multilateral and supplemental bilateral agreements.

VII. The last Article IV consultation was concluded at EBM/87/139 (9/16/87). Poland is on a 12-month consultation cycle. The following decision was taken by the Board on September 16, 1987:

"1. The Fund takes this decision in concluding the 1987 Article XIV consultation with Poland, in light of the 1987 Article IV consultation with Poland concluded under Decision No. 5392-(77/63), adopted April 19, 1977 (Surveillance Over Exchange Rate Policies).

2. The restrictions on the making of payments and transfers for current international transactions, and the multiple currency practices which are described in detail in SM/87/224, Chapter VI, are maintained by Poland in accordance with Article XIV. The Fund notes the complexity of Poland's exchange system and urges the authorities to take early steps to relax exchange restrictions evidenced by payments arrears and bilateral payments arrangements, and encourages the authorities to eliminate the restrictive multiple currency practices in the near future."

VIII. Technical Assistance

Bureau of Statistics: Missions visited Poland in June-July 1987 to discuss government finance statistics and in June 1988 to discuss balance of payments statistics.

Central Banking Department: A mission visited Poland in May 1988 to discuss the reform of the banking system.

Fiscal Affairs Department: A mission visited Poland in May-June 1988 to discuss the establishment of a universal personal income tax system.

Poland - Exchange Practices Subject to Fund Jurisdiction

The following aspects of Poland's exchange and trade system, which were in effect on July 1, 1988, constitute restrictions on payments and transfers for current international transactions or multiple currency practices:

1. The multiple currency practices which arise with respect to the currencies of Fund members that are also members of the CMEA (viz., Hungary, Romania, and Viet Nam) as a result of the broken cross rates that may be associated with quotations for the transferable ruble.
2. The multiple currency practices which may arise with respect to the currencies of countries that are considered by Poland as market economies from the possibility that broken cross rates may emerge as a consequence of the system of weekly quotations for the exchange rates of these currencies.
3. The multiple currency practices which arise from (a) the 200 percent surcharge applied on the sale to Polish tourists traveling abroad of the currencies of countries considered as market economies; and (b) surcharges of from 30 percent to 150 percent applied on the sale to Polish tourists traveling abroad of the currencies of certain Fund member countries considered by Poland as socialist economies (namely, Democratic Kampuchea, Hungary, Romania, and Viet Nam).
4. The multiple currency practice which arises in the event that the advance import deposit required under the system of effectiveness bids for foreign exchange results in an opportunity cost of more than 2 percent.
5. The multiple currency practices that arise from (a) the exchange rate obtaining in the auctions of rights to surplus foreign exchange retained by exporters in the ROD accounts; (b) the exchange rates applying to auctions of foreign exchange to producers of targeted commodities; (c) the exchange rates in auctions of foreign exchange, obtained from "internal exports," to domestic trade organizations; and (d) the exchange rate at which Bank PKO S.A. coupons may be bought and sold for zlotys through the banking system.
6. Poland's bilateral clearing arrangements with Fund members, namely Bangladesh, Brazil, the People's Republic of China, Colombia, Ecuador, India, the Islamic Republic of Iran, Democratic Kampuchea, Lao People's Democratic Republic, Lebanon, and Nepal. Also, Poland's trade agreements with bilateral payments features for certain commodities with Argentina, Bangladesh, Malta, Pakistan, and Yugoslavia.
7. The joint exchange and import license, under which the decision on the granting of the license to import may be decided on the basis of the value of transaction.

8. The restriction imposed on the amount of tourist and business travel allowances.
9. The restriction imposed on the amount of education allowances for study abroad.
10. The restriction imposed on the transfer of income abroad by nonresident workers in Poland.
11. The restriction imposed on the remittance abroad of investment income (including profits).
12. The restriction in the form of a foreign exchange budget fixing the amount of exchange available for external debt service. This procedure, which is comprehensive in that it applies to debt service on the financial obligations of which the obligor is the Government, governmental entity or other resident of Poland, gives rise to payments arrears which on December 31, 1987 were estimated to total US\$502 million.

Poland - Statistical Issues

1. Outstanding issues

a. Monetary accounts

There are significant discrepancies between the monetary and fiscal data reported for inclusion on the IFS country page. A technical assistance mission has been scheduled for the last quarter of 1988 to effect a reconciliation of these two sets of data.

b. Government finance statistics

Provisional data on central government operations are published in IFS and the 1987 Government Finance Statistics Yearbook. The presentation in the Yearbook also includes provisional 1986 data for local and general government. The inclusion of government finance data in Fund publications followed a technical assistance mission in June 1987, which recommended the compilation of the functional classifications of expenditure and lending, further improvements in the economic classification of expenditure and the expansion of the institutional coverage of the statistics. The report also stressed the need to resolve discrepancies between fiscal and monetary data, as noted above.

c. Balance of payments

The authorities compile and report data to the Bureau of Statistics on two different bases. Quarterly data are prepared on the basis of cash transactions while the annual statements are prepared on an accrual basis; there are also differences of coverage between the two series. A staff member from the Bureau of Statistics visited Poland at the same time as the Article IV consultation mission and concluded that the objective of the preparing quarterly data comparable in methodology and coverage with annual data is attainable. The authorities are planning to experiment with compiling quarterly data on an accrual basis beginning with the third quarter of 1988 and reporting to the Fund beginning with the first quarter of 1989.

The recording of balance of payments transactions arising from the Polish debt rescheduling agreement with the Paris Club in December 1987 was reviewed during this mission and agreement was reached with the authorities on the uniform treatment of these transactions.

d. Real sector

In a cable dated May 24, 1988, the authorities agreed to the publication of effective exchange rate indices for Poland in IFS beginning with the July 1988 issue.

Export and import value data in U.S. dollars are reported to the Bureau of Statistics on a monthly basis through May 1988. However, data in national currency that are published in IFS are reported on an annual, or at most, quarterly basis and are uncurrent.

2. Coverage, currentness, and reporting of data in IFS

The table below shows the currentness and coverage of data published in the country page for Poland in the July 1988 issue of IFS. The data are based mostly on reports sent to the Fund's Bureau of Statistics by the Ministry of Finance which, during the past year, have been provided on an irregular basis.

<u>Status of IFS Data</u>		<u>Latest Data in July 1988 IFS</u>
Real sector	- National accounts	1986
	- Prices: Producer (industry)	December 1987
	Consumer	Q2 1987
	- Production: industrial	December 1987
	- Employment: industrial	December 1987
	- Earnings: Average	December 1987
Government finance	- Deficit/surplus	1986
	- Financing	1986
	- Debt	n.a.
Monetary accounts	- Monetary authorities	June 1987
	- Deposit money banks	June 1987
	- Other banking institutions	n.a.
Interest rates	- Discount rate	June 1987
	- Bank lending/deposit rates	June 1987
	- Bond yields	n.a.
External sector	- Merchandise trade: Values:	
	Exports:	1987
	Imports:	Q3 1987
	Prices:	February 1988
	- Balance of payments	Q1 1988
	- International reserves	April 1988
	- Exchange rates	May 1988

Poland: Illustrative Medium-Term Scenarios

To provide a framework for considering the relationship between domestic and external targets, the staff has prepared certain medium-term scenarios. They are designed for illustrative purposes only and in no sense are the results to be seen as forecasts.

In the first two scenarios, the 1988 convertible current account is assumed to be held close to the 1987 level, with balance achieved in 1989 and a US\$500 million surplus thereafter. The first scenario illustrates the effects of relatively slow convertible currency export growth, while scenario 2 assumes faster export growth with some terms of trade loss. Scenarios 3 and 4 assume a slower current account adjustment path, with balance achieved in 1991 and illustrate the impact of slower and faster convertible export growth respectively. Under both adjustment paths, the growth of merchandise imports from the convertible currency area is derived as a residual to achieve the assumed current account balance.

1. General

The main assumptions are:

a. The rate of growth of real output (GDP) is assumed to be equal to a constant term plus a term relating the change in real GDP to the change in the volume of total (convertible plus nonconvertible) merchandise imports. This formulation has been chosen so as to separate what may be regarded as the "underlying" rate of growth of the economy (reflecting changes in the supply of domestic factors of production and their productivity) from the growth that is dependent on changes in imports. The coefficients postulated are not inconsistent with the limited econometric evidence that is available. The equation is:

$$\hat{Y} = a + b.\hat{M}$$

where

\hat{Y} = rate of growth of real GDP

\hat{M} = rate of growth of the volume of total merchandise imports

a = a constant term

b = the elasticity of output with respect to the volume of total merchandise imports

The values of the terms "a" and "b" change as between different scenarios.

b. Assumed changes in foreign trade prices are based on price projections taken from the World Economic Outlook exercise.

c. The average interest rate on the external debt is assumed to be 8.25 percent from 1988 onward.

d. In line with the authorities' projections, nonconvertible trade is assumed to be in balance in 1988, resulting from an improvement in the terms of trade. In 1989 and thereafter, nonconvertible trade is assumed to remain in US\$50 million surplus with no further terms of trade changes.

e. In the convertible balance of payments, a deficit of US\$100 million is assumed for nonfactor services in 1988. In subsequent years, receipts and payments are converted into real terms by the respective price deflator for exports and imports. Interest receipts have been assumed at US\$250 million in 1988, with in subsequent years levels taking into account the assumed rise in reserves and net credit extended.

2. Methodology

Two different assumptions are made about the pace of convertible currency export growth and the elasticity of GDP growth to import growth. In scenarios 1 and 3, the volume of convertible currency exports of goods and nonfactor services and imports of nonfactor services from 1989 is assumed to rise by 5 percent annually with no change in the terms of trade. The rate of GDP growth is given by:

$$\hat{Y} = 0.5 + 0.4\hat{M}.$$

Under scenarios 2 and 4 a more dynamic growth of convertible currency exports and domestic output is assumed to reflect a more rapid and effective implementation of reform measures. Export volumes to the convertible area are assumed to grow by 12 percent annually from 1989 to 1991 with a 10 percent annual growth thereafter, with a terms of trade loss of 2 percentage points annually from 1989 to 1991. Exports of nonfactor services are assumed to grow by two thirds the volume of exports of goods, while imports of nonfactor services grow by 5 percent in volume terms per annum. The rate of growth of real GDP is given by:

$$\hat{Y} = 1 + 0.5\hat{M}$$

Under all the scenarios the growth in domestic expenditure is derived as a residual from the national accounts identity equation. Compared with the scenarios prepared for the 1987 consultation, two major changes have been introduced. Higher growth of convertible currency exports is assumed under both the slow and the fast export growth paths in view of Poland's rapid export growth in 1987 and the first half of 1988. Second, a lower value of the constant term "a" relating GDP to the growth of import volumes has been assumed for both paths in response to the emphasis by the Polish authorities on the need for import growth--particularly from the convertible currency area--to sustain the growth of GDP.

3. Results

A summary of the main results is given in Table 12.

In Scenario 1 the combination of faster adjustment in the convertible currency account and slow export growth produces stagnation in output growth in 1989 and 1990 with low growth thereafter. Both convertible currency imports and domestic expenditure fall in 1989 and rise only gradually in 1990.

In Scenario 2 faster current account adjustment is combined with faster growth in convertible currency exports. The result is a slight slowdown in GDP growth in 1989 with a rapid rise in output growth thereafter. Even in 1989--when output growth is at its slowest--domestic expenditure rises 1 1/2 percent in volume terms with convertible currency imports of goods rising by more than 3 percent. By 1994, GDP is 15 percent higher in real terms and, as a result of the faster export growth, the debt service ratio is 14 percentage points lower than under Scenario 1.

In Scenario 3 slow export growth is combined with a slower path of current account adjustment. Compared to Scenario 1, the rate of GDP and domestic expenditure growth is marginally higher in 1990. But by 1994, the position is reversed and domestic expenditure is 1 percent lower than under Scenario 1 and GDP is also lower. The result of a slower current account adjustment is that external debt is over US\$2 1/2 billion (6 1/2 percent) higher in 1994 than under Scenario 1.

In Scenario 4 faster export growth is combined with a slower path of current account adjustment. Compared to Scenario 3, output growth is much more dynamic, with real GDP 15 percent higher in 1994, and the debt service ratio 15 percentage points lower. Compared to Scenario 2, output and expenditure growth is faster in 1988, though by 1994 domestic expenditure is nearly 1 1/2 percent lower than under Scenario 2 and GDP 1 percent lower. The price of slower adjustment, compared to Scenario 2, is higher external debt in 1994--over US\$2 1/2 billion larger, higher interest payments by around US\$200 million a year, and a higher debt service ratio.

Table 12. Poland: Medium-Term Scenarios, 1988-1994 ^{1/}

(Percentage change, unless otherwise stated)

	1988	1989	1990	1991	1992	1993	1994
Scenario 1							
(Convertible currency current account balance in 1989, with US\$500 million surplus thereafter; convertible export volume growth by 5 percent per year from 1989; no terms of trade loss)							
GDP (1987 = 100)	103.2	103.8	105.0	107.6	110.5	113.5	116.5
GDP growth	3.2	0.6	1.1	2.5	2.7	2.7	2.6
Growth rate of domestic expenditure	4.0	-0.2	0.6	2.6	3.0	2.9	2.8
Convertible import volume growth rate	8.4	-2.7	-0.1	7.3	8.5	8.1	7.8
External debt (in billions of U.S. dollars)	41.1	41.4	41.3	41.1	41.0	40.8	40.7
Debt service ratio ^{2/} (in percent)	35.1	57.6	68.2	64.0	61.1	68.0	64.1
Scenario 2							
(Convertible currency current account balance in 1989, with US\$500 million surplus thereafter; convertible export growth 12 percent per year 1989-1991, 10 percent thereafter; 2 percent terms of trade loss 1989-1991)							
GDP (1987 = 100)	103.2	105.8	109.4	114.9	121.3	127.9	134.9
GDP growth	3.2	2.6	3.4	5.1	5.5	5.5	5.4
Growth rate of domestic expenditure	4.0	1.6	2.6	4.9	5.8	5.7	5.6
Convertible import volume growth rate	8.4	3.3	6.5	13.6	14.7	14.0	13.3
External debt (in billions of U.S. dollars)	41.1	41.4	41.3	41.1	41.0	40.8	40.7
Debt service ratio ^{2/} (in percent)	35.1	55.3	62.9	56.7	51.7	55.1	49.8
Scenario 3							
(Convertible current account balance in 1991, US\$500 million surplus in 1993-1994; convertible export volume growth by 5 percent per year from 1989; no terms of trade loss)							
GDP (1987 = 100)	104.5	105.1	106.5	108.3	110.4	112.7	115.7
GDP growth	4.5	0.6	1.3	1.7	2.0	2.1	2.7
Growth rate of domestic expenditure	5.9	-0.3	0.9	1.4	1.8	2.0	2.9
Convertible import volume growth rate	15.4	-2.7	1.1	2.9	4.3	4.9	8.2
External debt (in billions of U.S. dollars)	41.5	42.5	43.2	43.5	43.6	43.5	43.3
Debt service ratio ^{2/} (in percent)	35.4	58.3	69.5	65.7	62.9	69.8	65.8
Scenario 4							
(Convertible current account balance in 1991, US\$500 million surplus in 1993 and 1994; convertible export volume growth 12 percent per year 1989-1991, 10 percent thereafter; 2 percent terms of trade loss 1989-1991)							
GDP (1987 = 100)	104.5	107.1	110.9	115.4	120.7	126.5	133.5
GDP growth	4.5	2.5	3.6	4.1	4.6	4.8	5.5
Growth rate of domestic expenditure	5.9	1.5	2.9	3.5	4.5	4.7	5.8
Convertible import volume growth rate	15.4	2.9	7.3	9.2	11.0	11.4	13.8
External debt (in billions of U.S. dollars)	41.5	42.5	43.2	43.5	43.6	43.5	43.3
Debt service ratio ^{2/} (in percent)	35.4	56.0	64.1	58.2	53.3	56.6	51.0

Source: Staff estimates.

^{1/} The current account path is predetermined. Other exogenous variables include the external balance with the nonconvertible area, export volumes with the convertible currency area, and the interest rate on the external debt. Imports from the convertible currency area are derived as the residual in the external accounts. The growth of GDP is based on an exogenously given "underlying" rate of growth and an elasticity of output with respect to imports. The growth in domestic expenditure is the residual in the national accounts.

^{2/} Excluding arrears.

