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CONFIDENTIAL

February 17, 1988

To: Members of the Executive Board
From: The Secretary
Subject: Poland - Real Effective Exchange Rate - Information Notice

Attached for the information of the Executive Directors is an information notice on the real effective exchange rate of the Polish zloty.

Mr. Boote (ext. 8801) is available to answer technical or factual questions relating to this paper.

Att: (1)



INTERNATIONAL MONETARY FUND

POLAND

Real Effective Exchange Rate - Information Notice

Prepared by the the European Department and the
Exchange and Trade Relations Department

(In consultation with the Legal Department
and the Research Department)

Approved by Massimo Russo and J. T. Boorman

February 17, 1988

The recent evolution of Poland's real effective exchange rate, as measured by the standard index developed in connection with the information notice system, is set out in the attached table and chart. As measured by this index, the Polish zloty depreciated in real effective terms by 10.2 percent between September and November 1987. ^{1/} The Executive Board last reviewed Poland's exchange rate policy on September 16, 1987 in its discussion concluding the 1987 Article IV consultation (SM/87/219, 8/18/87, Sup. 1, 9/14/87 and Corr. 1, 9/14/87).

The real effective exchange rate for the zloty has fluctuated widely over the past several years. From 1980 to end-1983 the zloty appreciated around 70 percent in real terms as the nominal depreciation of the currency failed, particularly in 1982, to match the surge in domestic inflation. By contrast, since 1983 the nominal rates of depreciation of the zloty have outstripped the increases in domestic consumer prices relative to partner countries, notwithstanding the generally rising trend in the Polish inflation rate--to about 26 percent in 1987. In consequence, in 1984 the zloty depreciated in real effective terms by around 6 percent, in 1985 by 18 percent, in 1986 by 26 percent, and by 34 percent in the first 11 months of 1987.

The authorities generally adjust the exchange rate of the zloty against convertible currencies weekly with a view to maintaining its nominal value in terms of a weighted basket of currencies. They also make periodic, but less frequent, adjustments in the value of the zloty in terms of this basket so as to take account of inflation differentials between Poland and its trading partners and with the broad aim of

^{1/} Since the index does not reflect transactions in transferable rubles, the depreciation measured is primarily against convertible currencies. The bulk of Poland's trade with partner members of the Council for Mutual Economic Assistance (CMEA) is denominated in transferable rubles.

achieving profitability for 80 percent of exports. ^{1/} Adjustments motivated by the latter considerations have been made more active in the last year and a half than previously. In September 1986 and February 1987, there were large discrete devaluations of the zloty--both of almost 20 percent--and smaller adjustments continued to be made in the course of 1987. Part of the reason for the sharp real depreciation of the zloty in 1987, as measured under the information notice system, is that the basket of currencies used by the authorities to manage the exchange rate with convertible currencies differs significantly from the basket underlying the information notice system calculations. In particular, the basket used by the authorities--which is based on the currency composition of current account transactions in convertible currencies--has a much higher weight for the U.S. dollar than the basket used in the information notice system.

Partially matching the depreciation of the zloty against convertible currencies, there has also been a significant depreciation of the zloty against the transferable ruble. From 1983 through 1986 the zloty depreciated by around 28 percent in nominal terms against the transferable ruble (compared to a depreciation of 56 percent against the U.S. dollar) and by a further 32 percent in 1987 (compared to a depreciation of 37 percent against the U.S. dollar).

Reflecting the recovery of the Polish economy from the dislocations of the early 1980s, the current account deficit in convertible currencies was reduced from a peak of US\$3.2 billion in 1981 to about US\$0.6 billion in both 1985 and 1986. Provisional data for 1987 suggest a current deficit of the same order as in the two preceding years. The trade surplus was broadly unchanged at around US\$1 billion for the third consecutive year. A rise in interest payment obligations--to slightly over US\$3 billion according to staff estimates--was offset by a continuing rise in receipts from private transfers, to US\$1.3 billion. Both export and import volumes are estimated to have risen by about 4 percent in 1987. While the growth in export volumes--which had changed little in the two preceding years--partly reflected the real depreciation of the zloty, it also reflected other export incentives, notably tax reliefs and changes in rules governing the use of certain foreign currency accounts by enterprises. ^{2/} Poland has also remained in current account deficit on its transactions in nonconvertible currencies though this deficit fell from the equivalent of around US\$0.5 billion in 1985 to the equivalent of US\$0.3 billion in 1986 and is estimated to have narrowed further in 1987.

^{1/} For these purposes, profitability is defined as having been achieved when the ratio of the export price of a given commodity to its domestic price (both expressed in a common currency) is equal to or greater than unity.

^{2/} "ROD" accounts--for an explanation see SM/87/224, 8/27/87, pp. 63-64.

It is reported that Poland's convertible currency debt rose from US\$33.5 billion at end-1986 to around US\$37.6 billion at end-1987. A large part of this rise reflects the currency composition of the debt: at end-1986 around 55 percent of the debt was denominated in European currencies. On December 17, 1987, Poland signed an agreement with its official (Paris Club) creditors which provided for the rescheduling of most payments of principal and interest due in 1988 as well as of most arrears and late interest at end-1987. The total amount of debt consolidated is estimated at US\$9 billion. An agreement with commercial bank creditors rescheduling principal obligations due from 1988 through 1993 was initialed in August 1987 but has not yet been signed. The total amount of debt to be consolidated under this agreement is estimated at around US\$8 billion.

The authorities have adopted some measures, and are continuing to formulate others, under their "second stage of economic reform." As part of this process, various price increases, for both consumer and producer goods, became effective on February 1, 1988 and other increases are expected later in the year. As a result, the rate of price inflation (on an annual average basis) is expected to exceed 40 percent in 1988. Partially in order to prevent this higher rate of inflation from having adverse effects on external competitiveness, the authorities have continued their active exchange rate policy in 1988. On February 1, 1988 there was a 16 percent step devaluation of the zloty against the U.S. dollar to Zl 380 = US\$1, and on the same date the zloty was depreciated by 18 percent against the transferable ruble to Zl 170 = TR 1.

Staff Appraisal

In concluding the 1987 Article IV consultation with Poland on September 16, 1987, Directors welcomed the more active exchange rate policy pursued by the authorities since 1986 but felt that the level of the real exchange rate needed to be kept under close review in light of the evolving trade performance and of the requirements of the debt-servicing situation. The more active exchange rate policy of the recent past has been accompanied by a reversal of the previous declining trend in the volume of exports, particularly manufactures, to convertible currency markets. However, provisional data show the 1987 trade surplus in convertible currencies still below the level in 1984. Given the need to strengthen Poland's external financial situation, the continued real depreciation of the zloty can only be welcomed. However, as was stressed during the last consultation, a more active exchange rate policy needs to be underpinned by a determined and sustained tightening of demand management policies. Otherwise, there is a danger that the effects of a faster depreciation of the zloty may be largely dissipated through higher domestic inflation. The efficacy of exchange rate policy would also be enhanced by a simplification of the exchange and trade system and, in particular, by a reduction in the role of administrative

controls. A reduction in the scope of administrative price controls would promote a closer relationship between domestic and world prices and would allow exchange rate changes to be more fully and rapidly reflected in the structure of domestic prices. There is thus a close link between the effectiveness of exchange rate policy and the pricing and other measures that the authorities intend to introduce as part of their program of economic reform. The staff remains in close contact with the authorities concerning their policy intentions in all these areas. The 1988 Article IV consultation discussions with Poland are scheduled to take place in June 1988.

Table 1. Poland: Real Effective Exchange Rate and Related Series

(Indices: 1980 = 100)

	Real Effective Exchange Rate <u>1/</u> <u>2/</u>	Nominal Effective Exchange Rate <u>1/</u>	Relative Consumer Prices (Local Currencies)	Exchange Rate in Terms of U.S. Dollars <u>1/</u>	Consumer Price Index (Seasonally Adjusted)	Consumer Price Index (Not Seasonally Adjusted)
Quarterly						
1982						
I	116.7	69.6	167.6	54.1	207.2	206.0
II	134.3	70.0	191.8	52.6	238.3	246.4
III	145.8	71.7	203.2	51.2	258.4	255.8
IV	154.0	73.5	209.5	50.7	269.7	264.2
1983						
I	162.8	74.5	218.6	51.6	288.4	286.8
II	170.5	76.8	222.0	50.8	298.6	309.0
III	164.9	73.4	224.8	45.9	310.8	308.9
IV	169.8	74.7	227.4	45.5	323.4	316.0
1984						
I	166.9	72.6	230.0	43.4	334.6	332.4
II	160.8	69.2	232.5	40.7	343.8	355.0
III	165.1	69.5	237.7	38.0	362.2	361.7
IV	160.6	67.8	236.8	35.2	368.0	359.6
1985						
I	154.8	65.3	237.1	31.6	377.9	374.6
II	150.1	62.4	240.8	30.8	393.8	405.4
III	136.9	55.2	247.9	28.5	415.4	416.7
IV	134.7	54.2	248.7	29.6	426.1	417.1
1986						
I	120.2	48.2	249.5	27.6	436.1	431.0
II	114.3	45.4	251.9	26.7	445.6	458.0
III	107.8	42.0	256.6	25.5	457.6	460.0
IV	97.4	36.1	269.6	22.1	491.9	482.0
1987						
I	86.3	30.8	280.2	19.8	518.9	512.0
II	80.4	27.6	291.5	17.7	561.5	577.0
III	76.0	26.0	292.4	16.1	576.0	579.6
Monthly						
1987						
Sep. <u>3/</u>	73.0	24.8	294.0	15.5	586.2	
Oct.	71.6	24.2	296.4	15.0	596.4	
Nov.	65.6	22.0	298.2	14.1	606.9	
Percentage change						
Sep. - Nov. 1987	-10.2	-11.4	1.4	-8.6	3.5	

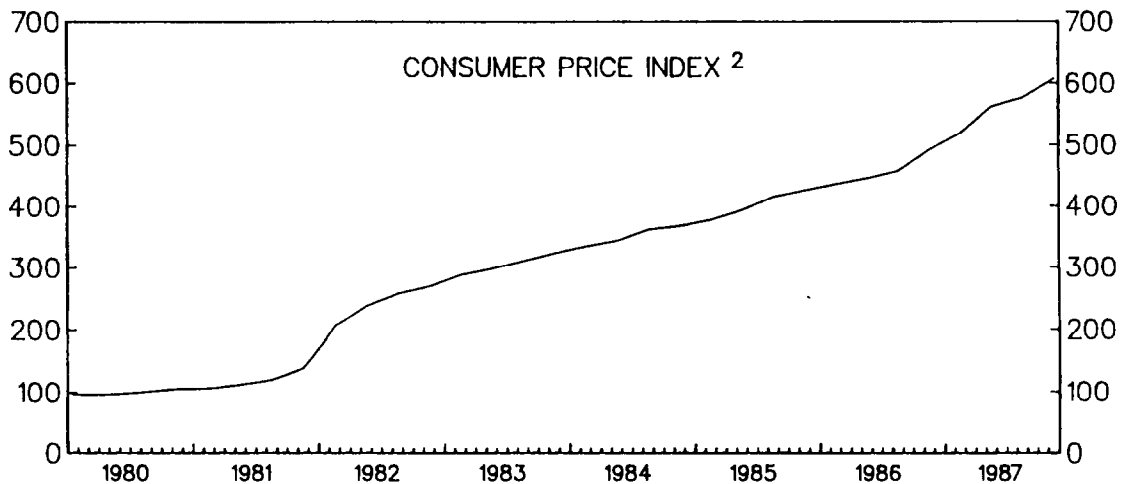
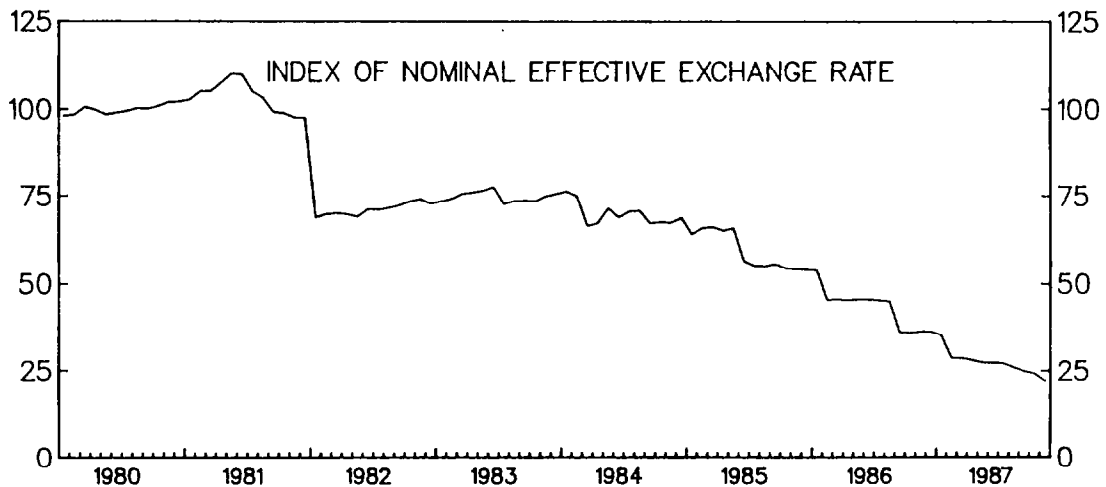
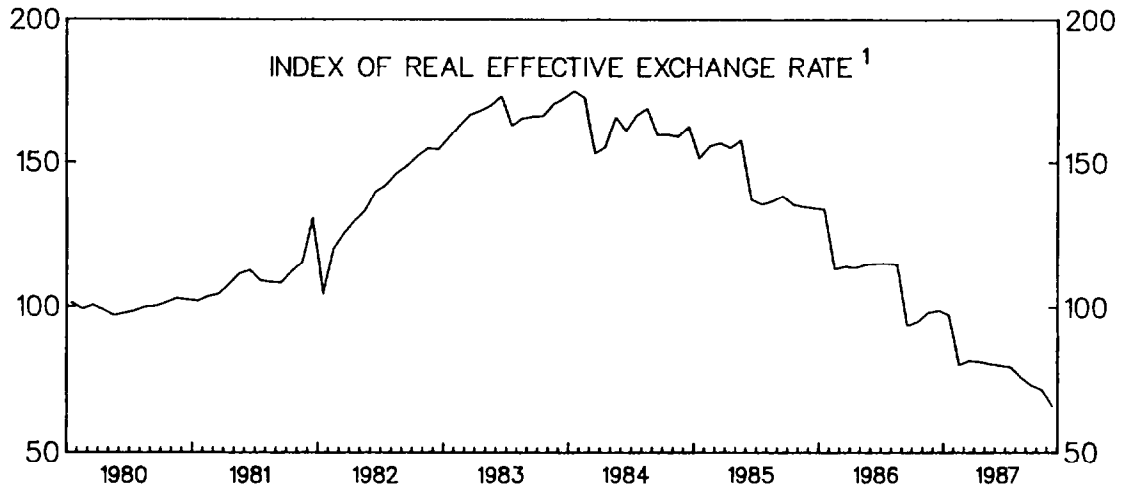
Source: Information Notice System.

1/ Increases mean appreciation.

2/ Using seasonally adjusted price indices.

3/ Date of latest consideration by Executive Board.

CHART 1
POLAND
INFORMATION NOTICE SYSTEM INDEX OF
EFFECTIVE EXCHANGE RATE
(1980=100)



Source: Information Notice System.

¹Trade weighted index of nominal exchange rate deflated by seasonally adjusted relative consumer prices; Increases mean appreciation.

²Seasonally adjusted.

