

I. ECONOMIC ENVIRONMENT

(1) BACKGROUND

1. Poland was among the first countries in Central and Eastern Europe to embark on radical economic reform. The reform plan, launched in January 1990, was aimed at stabilizing prices, wages, and the exchange rate. The programme was based on sharp cuts in public spending, devaluation of the currency, wage control and widespread liberalization of the economy. Reforms, continued at a slower pace from the mid-1990s, initially generated a deep recession, followed by a gradual and accelerating recovery, led in the beginning by domestic consumption. The private sector has expanded significantly and is currently the engine for economic growth. It accounted for 59% of GDP in 1997, compared with 18% in 1989, and currently supplies some three quarters of manufacturing output and value added. Real GDP annual growth averaged around 5% between 1992 and 1999. Since 1994, growth has been firmly export- and investment-led, both increasing more rapidly than GDP. By 1995, the Polish economy had recovered its real GDP levels existing prior to the transformation, and currently exceeds these levels by some 25%. The informal (grey) part of the economy, consisting mainly of small private businesses, is estimated to have grown rapidly during the 1990s. According to the authorities, it accounted for between 10% and 20% of GDP in the mid-1990s, providing employment for about 2.4 million people.

2. The transformation from a centrally planned to a market economy has generated substantial changes in the composition of output. Led by strong growth in trade, the services sector has steadily expanded (Table I.1). Between 1993 and 1998, the share of services in GDP rose from 64% to 74%, while that of agriculture (including hunting and forestry) and manufacturing fell from 7% and 25%, respectively, to 4% and 19%. Nevertheless, Poland's rapid expansion during the 1990s has been driven mainly by the manufacturing sector, which contributed to two thirds of the increase in value added.¹ Moreover, despite the modest and declining contribution of agriculture to GDP, farming still employs one quarter of the labour force. The services sector provides most (almost half) of all job opportunities. The share of merchandise trade (exports and imports) in GDP also rose sharply during the 1990s – up from 38% in 1994 to 49% in 1997 – and remains substantially above earlier levels, despite falling to 47% and 44% in 1998 and 1999, respectively.

3. Poland's transition to a market economy has proceeded at a remarkable pace. Wide-ranging macroeconomic and structural reforms continue to be implemented, including trade liberalization; privatization of state-owned enterprises; price deregulation; opening of financial and other important service sectors; and currency and exchange rate liberalization. Regulations facilitating the entry of both foreign and domestic firms and creating a framework for competitive markets based on private investment have also been introduced. Fundamental democratic reforms and changes to the political system accompanied these policy changes.²

4. Poland's impressive economic performance has translated into social progress. Most social indicators, such as life expectancy and child mortality, have improved substantially. Unemployment, which officially did not exist in the statistics prior to 1990, surged during the recession in 1990-91, and peaked at 16% in 1993. It fell continuously, in tandem with the expanding economy, to 10% in 1997, about the EU average, but rose to around 13% at end-1999. The number of poor has gone down. In 1999, GDP per head averaged about US\$4,000.

¹ OECD (2000).

² The success of Poland's economic transition could be illustrated by its membership of the OECD since 1996 and its acceptance by the EU in 1999 as a "functioning market economy".

Table I.1
Main economic and social indicators

Area	312,685 km ²	Urban share of population	62%
Population (1998)	38.7 million	Nominal GDP at current prices (1999, ZI billion)	609.0
		Per capita income (1998 current US\$)	3,982
Annual population growth (1998)	1.8%	Sectoral share of GDP (per cent, 1998)	
		- Agriculture, hunting, forestry & fishing	4.2
		- Mining	2.5
		- Manufacturing	19
		- Services	74.3
Life expectancy at birth (1998)		Sectoral share of formal employment (per cent, 1998):	
- males	68.9 years	- Agriculture, hunting, forestry & fishing	25.8
- females	77.3 years	- Mining	3.2
		- Manufacturing	28.8
		- Services	42.2
Crude birth rate per '000 (1996)	10.2	Enrolment ratio in education (1997)	
		- Primary	99.7
		- Secondary	87.1
Infant mortality rate per '000 (1998)	9.5		

Source: Information provided by the Government of Poland.

5. The reform agenda has been increasingly driven by Poland's goal of accession to the European Union.³ This objective is having a profound impact on its economic and trade-related policies, which are being harmonized to those of the EU. New institutional arrangements and enactment of laws and regulations are required to achieve this objective. The drive towards EU membership is providing a renewed opportunity for Poland to further implement necessary reforms, such as in taxation, investment, trade, agricultural, and industrial policies.

(2) RECENT ECONOMIC PERFORMANCE

6. The Polish economy is performing well, despite reduced growth from mid-1998 to mid-1999 as domestic and external demand for Polish goods weakened, due primarily to the Russian financial crisis and the economic slowdown in the EU, especially Germany. Real growth slowed to 4.8% in 1998 and to 4.1% in 1999 (Table I.2). The contagion effects from the Russian crisis were minimized through easing monetary policy, and the economy rebounded quickly with growth again accelerating from mid-1999. Future growth prospects appear favourable (section (5)). Poland's integration into the world economy in general, and the EU in particular, has been an integral component of the transition process. Poland's robust growth performance reflects an increasingly active private sector and substantial inward foreign investment. International confidence is reflected in growing foreign direct and portfolio investments, which totalled close to US\$7 billion in 1998 (equivalent to 4.3% of GDP). In 1998, foreign direct investment in Poland accounted for 40% of all inflows to Central and Eastern Europe and the Baltic States.⁴

³ Ministry of the Economy (1999a). If Poland meets this plan and is ready by 2003, its membership will still need to be ratified by EU national parliaments. The earliest possible date for Poland's accession to the EU is therefore 1 January 2004 (Bank Handlowy, 1999).

⁴ EBRD (1998).

Table I.2
Economic performance, 1995-99

	1995	1996	1997	1998	1999 ^a
National accounts (constant prices)	<i>(Percentage change)</i>				
Real GDP, market prices	7.0	6.0	6.8	4.8	4.1
Private consumption	3.6	8.7	7.1	..	..
Collective consumption	2.9	3.4	..	4.2	3.5
Gross fixed capital formation	16.9	20.6	20.6	14.1	10.6
Exports, goods and services	23.6	12.5	11.0	1.3	0.5
Imports, goods and services	24.3	28.0	21.4	7.8	6.0
Prices and interest rates	<i>(Per cent)</i>				
Consumer price inflation (period average)	27.8	19.9	15.9	11.8	7.3
Bank lending rate (annual average)	33.5	26.1	25.0	24.5	17.5
Real effective exchange rate ^b	100.0	108.8	111.4	117.7	..
Savings and investment	<i>(Per cent of GDP)</i>				
Gross investment	18.7	20.9	23.6	25.3	27.0
Private consumption	61.2	63.1	63.5	62.3	62.5
Public finance					
State government balance ^c	-2.6	-2.5	-1.3	-2.4	-2.2
Revenues from customs duties	2.0	1.8	1.6	1.1	0.8
Consolidated central government balance ^d	-1.3	-2.3	-1.8	-2.7	..
Total outstanding public debt	55.7	49.4	46.2	42.7	38.9
Monetary sector (end period)	<i>(Percentage change)</i>				
M1	34.7	13.1	18.2	13.0	..
M2 ^e	34.9	31.1	29.1	25.2	15.3
External sector	<i>(Per cent of GDP, unless otherwise specified)</i>				
Trade balance	-1.5	-6.1	-8.3	-9.2	-9.1
Current account balance	-1.9	-6.3	-7.5	-8.5	-9.5
Including unrecorded trade	3.3	-1.0	-3.2	-4.5	-7.6
Capital and financial account balance	2.3	3.6	5.6	7.0	6.1
Foreign direct investment, net	1.0	2.0	2.2	3.9	4.5
Portfolio investment, net	1.0	0.2	1.5	0.4	1.6
Total external debt (end-period)	37.2	32.3	29.4	27.3	27.2
Short-term external debt (STED)	1.8	2.0	2.8	..	..
Debt-service ratio, paid ^f	12.2	7.8	5.8	6.9	7.0
Gross official reserves, US\$ billion ^g	15.0	18.0	20.7	27.4	27.3
Reserve cover (months of GS imports) ^g	6.5	5.8	5.9	6.8	8.0
Merchandise trade (imports plus exports)	40.0	42.4	48.5	46.7	43.9
	<i>(Twelve-month growth rate, end period, per cent)</i>				
Merchandise export growth ^h	35.0	6.7	11.5	10.6	-12.4
Merchandise import growth ^h	38.9	31.9	18.2	13.8	-6.8
Memorandum item:					
Nominal GDP (US\$ billion)	119.1	134.6	135.6	158.4	154.1

.. Not available.

a Preliminary.

b Increase equals zloty appreciation.

c Since 1998, income from privatization does not constitute current income to the state budget but is a source of financing the budget deficit.

d Includes state budget, Social Insurance Fund, Pension Fund and Labour Fund.

e M2 = M1 + interest bearing local-currency deposits and other deposits + treasury bills.

f Debt service as a share of exports of goods and non-factor services in convertible currencies.

g GS = goods and services. Total reserves, including gold.

h Current U.S. dollars.

Source: Data supplied by the Polish authorities; Central Statistics Office (various issues), *Quarterly Statistics*, Warsaw; Central Statistical Office (1998), *Statistical Yearbook of the Republic of Poland*, Warsaw; and IMF (various issues), *International Financial Statistics*.

7. Unemployment has risen since 1997, from 10.3% to 13% at end-1999, due to subdued economic growth and labour market rigidities.⁵ In addition, although annual inflation fell sharply from 12% in 1998 to 7% in 1999, it remains higher than in most of Poland's trading partners. Moreover, inflationary pressures have intensified since mid-1999. Poland continues to have substantial and widening current account deficits, 8.5% of GDP in 1998 and 9.5% in 1999. The adverse effects of the widening current account deficit have been mitigated by financing from private inward FDI and not from public debt, and by substantial unrecorded trade which, if included, would reduce the deficit by about half. Continued prudent macro-stabilization policies are nevertheless needed to sterilize the potentially inflationary effects of capital inflows on the Polish economy and the real exchange rate.⁶

(i) Fiscal policies

8. Poland's fiscal position had steadily improved since 1992, reaching a deficit of 1.3% of GDP in 1997 (Table I.2 and Chart I.1). However, higher fiscal deficits occurred in 1998 and 1999. Inclusion of the Government's Zł 4 billion loan to the Social Security Administration (ZUS), to offset pension losses, raises the Government's 1999 budget deficit to around 4% of GDP, compared with a consolidated deficit in 1998 of 3.4%. This suggests that fiscal policy was more expansionary in 1999. The 2000 Budget, passed by Parliament in December 1999, proposes a deficit of around 2% of GDP. However, the practice of putting more deficit items "below the line or outside" the budget to meet deficit targets appears to be undermining the transparency of fiscal policy.⁷ Budget deficits are largely met from privatization receipts.

9. Transfers to social security funds represent the largest item of public expenditure. In the 2000 Budget these are projected to account for 25% of government expenditure. The Budget also provides for export credit subsidies to be increased by 100%. Since the beginning of Poland's economic transformation, the pension system has worsened financially and had become the main factor contributing to the budget deficit.

10. On the revenue side, the Government has in recent years reduced the overall tax pressure, while, at the same time, moving towards greater reliance on indirect taxes. In 1999, the authorities introduced a major tax reform package.⁸ The company tax rate is to be reduced from 34% in 1999 to 22% in 2004, and several other reforms are being introduced to broaden the tax base, such as eliminating investment incentives and closing loopholes. Indirect taxes, such as VAT, and excise duties are also being amended to harmonize them with EU requirements, including increases on some commodities, and bringing agriculture into the VAT base.

11. The Government's current fiscal strategies were adopted by the Council of Ministers in June 1999 (the "Strategy of Public Finance and Economic Development 2000-2010"). This highlights the importance of accelerating the privatization of state-owned enterprises and the need to control public finances and the budget deficit. Public finances are to be based on gradually reducing public spending as a share of GDP, from 45% to 34-36% over the ten-year period; increasing domestic

⁵ Labour market rigidities include wage indexation and minimum wages legislation.

⁶ For example, the National Bank of Poland has recently established an account to receive foreign currency proceeds of privatization rather than channelling the funds through the exchange market.

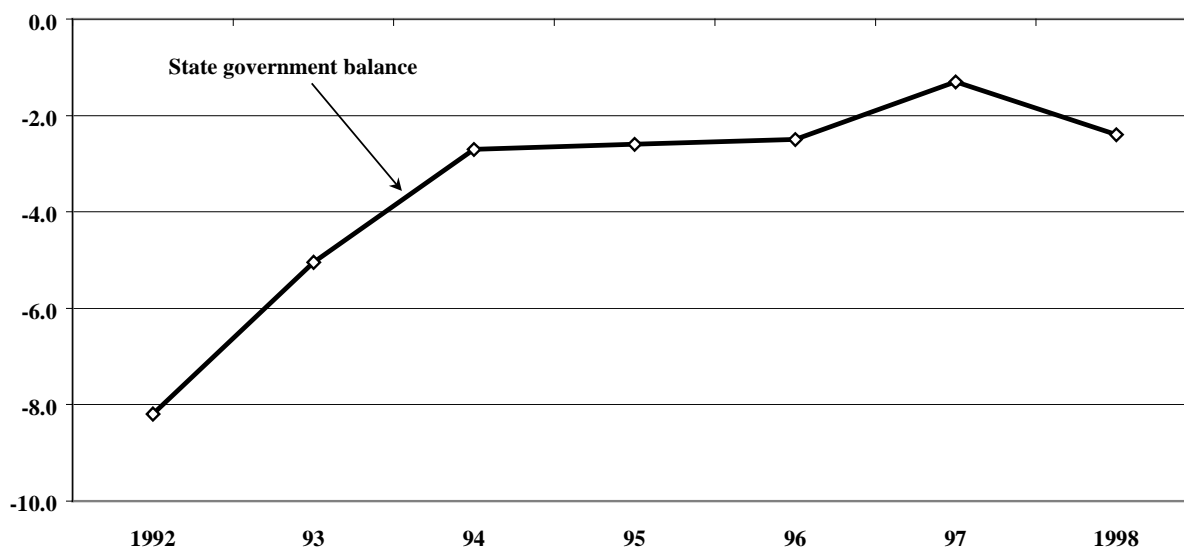
⁷ Polish State Budget for 2000 – Synthesis, Foreign Policy Department, Ministry of Finance, 28 December 1999. It has been estimated that extra-budgetary funds amounted to 12% of total government spending in 1998 (OECD, 2000).

⁸ Proposed cuts in personal income tax rates were not implemented.

savings from around 20% of GDP to 27-28% and foreign savings to 6-7%; and raising the contribution of the private sector to 90% of GDP by 2005.

Chart I.1
Fiscal position, 1992-98

Per cent of GDP



Source: Central Statistical Office (various issues), *Statistical Yearbook of the Republic of Poland*, Warsaw.

(ii) Exchange rate and monetary policies

12. The National Bank of Poland is responsible, under the Constitution, for safeguarding the value of the currency. In February 1998, an independent ten-member Monetary Policy Council (RPP), chaired by the Bank's president, was established to strengthen the Bank's independence in setting the required policies.⁹ The Bank's main legislative objective is to "maintain price stability while also acting in support of government economic policies, insofar as the latter does not constrain pursuit of that objective". The Council sets annual monetary policy guidelines for parliamentary approval and makes decisions on key instruments including interest rates, mandatory reserves, open-market operations, and obligations resulting from loans and exchange rate policy.¹⁰

13. During the review period, the zloty has appreciated in real terms, causing concerns about potential loss of export competitiveness (Table I.2).¹¹ Real exchange rate appreciation has been a

⁹ In 1998, the National Bank of Poland was granted *de jure* independence within the terms of the 1997 Constitution. Other members of the RPP are appointed in equal proportions by the President and both houses of Parliament.

¹⁰ Warsaw School of Economics (1999).

¹¹ A crawling-peg system replaced a fixed exchange rate system in October 1991. In 1995 the system's flexibility was enhanced through the introduction of an exchange rate band of plus and minus 7% around the crawling mid-value. Several further adjustments have been made to the crawling-peg mechanism. The currency has traded since March 1999 within a band of plus and minus 15% on either side of the parity (its central fixing

common experience in most transition economies following structural reforms, privatization, and liberalization of foreign investment. Moreover, in an effort to slow the growth in domestic demand for credits, high real interest rates were maintained, thereby attracting substantial foreign investment. These inflows have caused the domestic currency to appreciate in real terms. Exporters, and domestic producers competing with imports, have been penalized by these movements, since nominal depreciations of the zloty have been insufficient to offset Poland's much higher inflation rate compared with its trading partners. This has undermined the international competitiveness of the Polish economy. However, during 1999, the real effective exchange rate stabilized, partly due to substantial nominal depreciation of the zloty and reduced inflation in Poland.¹²

14. Disciplined monetary policy has been geared to containing inflation. Targeting money supply (M2 including foreign exchange deposits) was until recently the intermediate objective of monetary policy. The target set for M2 was exceeded by a wide margin between 1994-97, with real M2 increasing, on average, at double-digit annual rates. The expansion of monetary aggregates was largely driven by acceleration of credit to enterprises and households.¹³

15. In 1998, the Bank abandoned monetary targeting and adopted a new monetary policy framework of direct inflation targeting.¹⁴ The sole objective of monetary policy is now to achieve an annual inflation rate of below 4% by 2003. The Polish authorities intend to apply for EMU membership in 2006. Poland intends to join the new exchange rate mechanism (ERM2) in 2004 and would have to peg the zloty against the euro within the prevailing fluctuation margins (currently + or – 15%).¹⁵ The Government intends to move to a floating exchange rate in 2000 to let the zloty find an equilibrium level before entering ERM2. Recent changes in the exchange rate system to move to a wide fluctuating band with a slowly crawling central parity pegged to a currency basket have added greater flexibility to the exchange rate mechanism.

(iii) Inflation and interest rate developments

16. Inflation has fallen steadily, although it remains relatively high. Supported by disciplined fiscal policies, average inflation has fallen, though more slowly than expected, from 43% in 1992 to almost 12% in 1998 and 7% in 1999. This is still well above the Bank's adopted target of not more than 4% by 2003. Recent falls in inflation have been helped substantially by international developments – commodity prices have eased (except for oil) and the collapse in exports of food products to Russia and Ukraine has led to intense price competition in the domestic market.¹⁶

17. Although Poland made significant progress in cooling its overheated economy in 1997 and the beginning of 1998, this was achieved at the expense of exceptionally high real interest rates. The

point), and the rate of crawl of the parity rate reduced progressively by 1% per month from early 1997 to, currently, 0.3% per month since March 1999. The parity rate is set against a U.S. dollar/euro basket (40% U.S. dollar and 60% euro). The increased flexibility is aimed at maintaining the exchange rate as a nominal anchor for price inflation and as a mechanism to prevent excessive appreciation that could erode external competitiveness.

¹² OECD (2000). During the last quarter of 1999, the zloty declined in value to reach its lowest level in two years.

¹³ OECD (1998).

¹⁴ National Bank of Poland (1998).

¹⁵ A period of two years in the ERM2 without devaluing against another currency would be needed before joining the third stage of the EMU. According to the OECD, such a strategy is not without risk as it would entail a loss of autonomy in monetary and exchange rate policy at a time when more independence might be necessary to mitigate against unexpected shocks (OECD, 2000).

¹⁶ EIU (1998).

National Bank of Poland, which influences short-term rates mainly by issuing money-market bills on the interbank deposit market, raised the intervention rate several times, to a maximum of 24% by end-February 1998. In response to a slowdown in GDP growth and a weakening of wage and credit growth following the Russian financial crisis, monetary policy was eased and the intervention rate lowered progressively from 24% to 13% in January 1999. It was again increased to 14% in September 1999 in response to growing inflationary pressures.

(iv) Balance of payments

(a) Current account developments

18. The trade deficit has widened since 1994 as growth in import demand has outpaced export growth. The trade deficit amounted to 8.3% of GDP in 1997 compared with 0.9% in 1994 (excluding unrecorded trade).¹⁷ In 1998 it widened further to 9.2% of GDP and remained at about that level in 1999. The impact of the Russian financial crisis was greater than anticipated; exports to Russia fell substantially more than imports. Moreover, overall import growth has exceeded export growth throughout the 1990s. In 1999, exports fell by more than 12%, much more than the 7% decline in imports. Consequently, Poland's current account deficit has continued to widen, accentuated by a rise in the deficit on services. The trade balance has, in recent years, been partly offset by the positive balance on unclassified transactions (amounting to US\$6 billion in 1998 and US\$4 billion in 1999).

(b) Capital flows and foreign debt developments

19. The debt restructuring deals of the early 1990s have helped Poland's rapid growth. A debt forgiveness plan was agreed with official Paris Club creditors in 1991. This was followed in 1994 by a similar arrangement with the private London Club banks (the Brady debt reduction plan). In each case, about half of the debts were written off, with the reduced debts to be repaid to the Paris Club by 2014 and to the London Club by 2024. As a result, external debt has continued to drop, from 37% of GDP in 1995 to 27% in 1999. The debt-service ratio (paid) has also fallen substantially, from 12% of GDP in 1995 to 7% in 1998 and 1999, after bottoming at 6% in 1997. Short-term external debt accounts only for about one tenth of total external debt, equivalent to less than 20% of external reserves.

20. Aided by these debt-rescheduling arrangements, Poland has regained access to international private financing – international bonds, syndicated loans, foreign direct investment, and investment from abroad in the form of purchases of domestic debt securities and equities – and no longer relies on official flows in financing its current account deficits. Favourable investment ratings from international agencies have enabled Poland to obtain funds on increasingly attractive terms, including lower interest margins and longer maturities.¹⁸

21. A surge in fixed capital inflows has been evident since 1995. Capital inflows have been dominated by direct investment, and portfolio flows into equity and treasury bills. Foreign direct

¹⁷ The official statistics on merchandise trade seriously underestimate the amount of trade due to illicit trade and under-reporting of the value of imports. It is estimated that some 25% of trade on the eastern borders, and 15-20% of trade on the border with the EU, is unrecorded. The National Bank of Poland makes adjustment for cross-border trade in its external accounts, estimating its net contribution to be US\$6.1 billion or 4.5% of GDP in 1997, down from US\$7.2 billion in 1996 (EU, 1998; and EIU, 1998).

¹⁸ In mid-1995 Poland received its first sovereign debt rating when Moody's awarded it a grade of Baa 3.

investment has accelerated sharply in recent years. FDI inflows roughly matched the current account deficit in 1998.

22. Despite the trade and current account deficits, reserves have continued to increase strongly. At the end of 1998 and 1999 reserves (including gold) amounted to US\$27 billion, equivalent to around six to eight months of imports, compared with US\$15 billion at the end of 1995.

(3) POLAND'S ECONOMIC REFORMS

23. Almost all sectors have been touched by the Government's reform agenda during the period under review (1992-2000). Average tariffs have been reduced, albeit much faster for imports from bilateral trading partners, such as the EU, than from MFN sources. Apart from major on-going structural reforms, a number of macroeconomic reforms have been implemented recently, mainly directed at complying with EU requirements.

Public-finance-related reforms

24. A number of fiscal reforms have been implemented. The Constitution has banned, since October 1998, direct lending to the Government by the National Bank of Poland to finance deficits. The Polish President also no longer has the power to veto the Budget. Furthermore, a new Public Finance Act was adopted by Parliament in November 1998. It is aimed at improving public finance transparency and preparing for EU accession. The legislation establishes procedures to be taken if total public debt, including state guarantees, exceeds 50% of GDP, and also sets a public debt ceiling of 60% (coinciding with one Maastricht condition required for EMU membership). The Government is also required to prepare a public debt medium-term strategy. This legislation should provide a useful framework for fiscal consolidation.¹⁹

25. In recent years, Poland has embarked on impressive social reforms, including to pensions, health, education and decentralization of public finances. Early retirement, easy eligibility, and generous pay-out rates as well as the ageing population structure have given Poland a large and growing public pension bill. The pension payments have escalated, thereby requiring substantial funding from the government budget. In early 1999, Poland introduced a comprehensive reform of the pension system, which now consists of three pillars: the existing under-funded pay-as-you-go (PAYG) system; a new funded scheme; and voluntary individual retirement schemes. The reform implies considerable transitional costs, but over time should alleviate the pressure on the budget. Moreover, the pension reform may improve Poland's relatively low private savings rate and boost capital markets.

26. Poland has also decentralized public finances by reforming regional administration arrangements in 1999 and establishing a smaller number of more powerful regions (Box I.1).

¹⁹ OECD (2000).

Box I.1 The new system of local governments and fiscal devolution

In January 1999 a third tier of local government was created along with devolution of both public authority and control of some public services over public finances from higher to lower levels of government. These reforms enhance a citizen's ability to control and monitor public institutions, and the new system is also likely to better reflect local preferences. By creating a middle level of government it could more efficiently provide public services that have spillovers extending beyond individual localities. Another advantage with the reform is that local governments are crucial to the on-going social reforms because many social service functions will be managed at the local level. It is also significant for Poland's preparation for entry into the EU, which places great emphasis on regional self-government. However, local governments, in principle, are allowed to incur debt. To control the country's overall debt situation formal constraints on these borrowings may be needed.

A Communist-era network of 49 centrally administered regions (voivodship) was replaced by 16 self-governing authorities, subdivided into 308 new districts (powiat) and 2,489 community councils (gmina); gminas have been in function since 1990. This new structure recreates Poland's pre-1939 local government structure.

Expenditure assignments: The regions are responsible for regional development as well as region-wide services including higher education, specialized medical services, ambulance services, culture, road networks, and water management. Districts are responsible for local services, including secondary education and most hospitals. The community councils continue to run primary schools and health centers and local infrastructure. They also produce local development plans, including those for land use. The changes affect foreign and domestic investors, because the regions have been made responsible for regional economic development. Unlike the regions and the districts, which are responsible only for the tasks they are assigned, community councils can tackle any local issue as long as they have the financial resources.

Revenue assignments: The revenues of the local governments consist of

- own revenues, understood as property taxes, shared personal and corporate income taxes;
- statutory incomes (fees and taxes), which may be utilized for any purpose;
- general subsidies, which although calculated for specific purposes such as education and roads, may also be spent freely or carried over as surpluses from year to year;
- specific state budget grants, given for a specific purpose (unutilized funds have to be returned to the state budget); and
- revenues obtained from their own assets, mainly concerning the community councils, which are especially equipped with ground, housing and commercial properties.

Local governments have some authority to borrow money, which may raise concern about the future overall public debt situation. Under the old two-tier government system, local governments faced a limit whereby the sum of interest, principal, and payments for debt guarantees could not exceed 15% of total revenues, including intergovernmental grants. At the end of 1996, although no local government had yet reached its limit, the outstanding amount of municipal debt had almost doubled, from Zl 447 million in 1995 to Zl 897 million (but still only 0.25% of GDP).

Source: Chancellery of the Prime Minister of the Republic of Poland (1998), *Effectiveness, Openness, Subsidiarity: A New Poland for New Challenges*, Warsaw, December; OECD (1996), *Transition at the Local Level: the Czech Republic, Hungary, Poland and the Slovak Republic*, Paris; and *Financial Times*, 30 March 1999.

Currency reforms

27. Reforms have continued since 1990 when the zloty was made convertible internally, making foreign currencies freely purchasable domestically for current international transactions. The Foreign Exchange Law of 1994 introduced full current account convertibility of the currency.²⁰ In October 1995 the Law was amended, enabling Polish exporters to open bank accounts in foreign countries. In 1996, the Government eliminated the requirement for Polish firms to convert their foreign currency receipts into zlotys.

28. When Poland acceded to the OECD, in 1996, it made commitments to liberalize capital movements, including eliminating all inconsistent restrictions by 1 January 2000. Poland implemented a new Foreign Exchange Law in January 1999 aimed at meeting these obligations. The zloty is now an externally convertible currency and off-shore accounts in zlotys are allowed. Some exceptions were retained, such as on transactions in debt instruments with maturities of under one year and derivatives. From 2000, the only restrictions on capital movements, apart from FDI and short-term capital flows, are on real estate purchases abroad and at home.

(4) TRADE AND FOREIGN INVESTMENT PERFORMANCE

(i) Trade patterns

(a) Geographic pattern of merchandise trade

29. The geographic pattern of Poland's trade has altered significantly since the beginning of the economic transformation process, with the EU replacing the former COMECON area as Poland's main trading partner. The EU is now Poland's main source of imports (66% of merchandise imports in 1998) and its principal market for exports (68%) – partly as a result of their trade agreement (Tables I.3 and I.4). Germany is Poland's largest single trading partner, accounting for around 30% of total merchandise trade in 1998. However, Polish exports to Central and Eastern Europe and Russia have rapidly expanded. In 1997, for example, the Russian Federation ranked second in exports and third in imports. The Russian financial crisis in 1998, however, reduced its importance as an outlet for Polish exports. Trade with CEFTA member countries has also expanded slightly, aided by the liberalization of bilateral trade.

(b) Commodity pattern of merchandise trade

30. The changes in the geographic pattern of trade have been accompanied by shifts in the structure of products traded. The share of manufactured products in Poland's exports has increased during the review period, from 59% in 1992 to 77% in 1998, while primary products decreased from 40% to 23% (Table I.5). Exports of machinery and transport equipment and other consumer goods have grown significantly, while the export share of iron and steel and chemicals has declined. Poland's ability to attract foreign direct investment has enabled it to export cars and other products from plants established with foreign capital and technology.

²⁰ In June 1995 Poland formally accepted the obligations of Article VIII, Sections 2, 3 and 4 of the Articles of Agreement of the IMF.

Table I.3
Exports by destination, 1980-98
 (US\$ billion and per cent)

	1980	1990	1991	1992	1993	1994	1995	1996	1997	1998
Total (US\$ billion)	17.0	13.6	14.9	13.2	14.0	17.2	22.9	24.4	25.7	28.2
	(Per cent of total)									
America	4.7	4.7	4.2	5.0	4.7	6.0	4.4	3.8	3.9	4.0
United States	2.5	2.8	2.5	2.3	2.9	3.4	2.7	2.3	2.6	2.7
Canada	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Other America	1.9	1.4	1.3	2.4	1.5	2.2	1.4	1.1	0.9	1.0
Europe	85.2	85.4	88.5	85.4	85.7	84.0	89.8	90.0	90.8	92.0
EU15	34.4	54.8	64.1	65.6	69.5	68.3	70.1	66.6	64.3	68.4
Germany	15.5	25.1	29.3	31.4	36.4	35.6	38.4	34.5	33.0	36.3
Italy	2.9	2.9	4.1	5.5	5.3	4.9	4.9	5.5	5.9	5.9
Netherlands	1.0	3.1	5.2	6.0	5.9	5.8	5.6	4.8	4.7	4.8
France	2.9	3.2	3.8	3.6	4.2	3.9	3.6	4.4	4.4	4.7
United Kingdom	3.2	7.1	7.1	4.3	4.3	4.5	4.0	3.9	3.8	3.9
EFTA	3.0	5.7	5.5	2.7	1.9	1.6	1.6	2.2	1.5	1.7
East Europe	45.5	22.1	16.8	15.4	13.3	13.5	17.3	20.4	24.1	20.9
Former USSR	31.2	15.3	11.0	9.3	7.8	8.6	11.4	13.9	17.2	13.6
Russian Federation	..	..	..	5.5	4.6	5.3	5.6	6.8	8.4	5.7
Ukraine	..	..	..	1.4	1.3	1.5	3.2	4.0	4.7	3.9
Other Europe	2.2	2.8	2.1	1.7	1.0	0.6	0.8	0.9	0.9	1.0
Asia	5.2	6.3	4.4	6.7	6.6	5.7	4.4	4.8	3.8	2.7
Middle East	2.3	2.1	2.0	2.1	1.2	1.7	1.2	1.2	0.9	1.3
East Asia	2.2	3.4	1.9	4.0	5.0	3.6	2.6	3.2	2.5	1.2
South Asia	0.6	0.8	0.4	0.5	0.4	0.4	0.6	0.3	0.3	0.3
Africa	2.8	2.3	2.0	2.7	2.7	1.7	1.3	1.4	1.3	1.1
Other	2.1	1.4	0.9	0.2	0.2	2.6	0.1	0.1	0.2	0.3

.. Not available.

Source: UNSD Comtrade database (SITC Rev.1).

Table I.4
Imports by origin, 1980-98
 (US\$ billion and per cent)

	1980	1990	1991	1992	1993	1994	1995	1996	1997	1998
Total (US\$ billion)	19.1	8.2	15.5	15.9	18.8	21.4	29.0	37.1	42.3	47.0
	(Per cent of total)									
America	9.2	2.7	3.2	5.0	6.7	5.3	5.8	6.8	6.6	5.7
United States	4.0	1.6	2.3	3.4	5.3	3.5	3.9	4.4	4.5	3.8
Canada	1.4	0.1	0.2	0.4	0.4	0.3	0.4	0.5	0.4	0.5
Other America	3.8	0.9	0.7	1.2	1.0	1.5	1.5	1.9	1.6	1.4
Europe	81.4	87.2	85.4	83.7	82.9	82.2	84.1	82.5	81.8	82.1
EU15	30.9	51.4	59.0	62.0	64.8	64.0	64.7	64.0	63.9	66.0
Germany	13.4	20.1	26.5	23.9	28.1	27.3	26.7	24.7	24.1	26.5
Italy	2.0	7.5	4.5	6.9	7.8	8.3	8.6	9.9	9.9	9.4
France	4.2	3.0	3.6	4.4	4.3	4.4	4.9	5.5	5.9	6.5
United Kingdom	3.5	5.7	4.0	6.6	5.8	5.1	5.2	5.9	5.5	4.9
Netherlands	1.1	2.6	4.9	4.8	4.7	4.5	4.5	3.8	3.6	3.8
Sweden	1.3	2.0	1.8	1.9	2.2	2.7	3.1	2.7	3.0	2.9
EFTA	2.3	7.9	5.5	4.2	3.6	3.4	3.1	2.5	2.5	2.2
East Europe	46.3	25.2	19.0	16.3	13.4	13.8	15.4	15.2	14.6	12.9
Former USSR	33.1	19.8	14.1	11.8	9.6	9.6	9.6	9.5	8.6	6.9
Russian Federation	..	..	..	8.5	6.7	6.7	6.8	6.8	6.4	5.0
Other Europe	1.9	2.7	1.9	1.3	1.0	1.0	0.8	0.8	0.9	1.0

Table I.4 (cont'd)

	1980	1990	1991	1992	1993	1994	1995	1996	1997	1998
Asia	5.5	8.5	10.7	10.1	8.9	7.9	8.4	9.2	10.2	11.0
Middle East	2.6	3.1	4.0	3.1	1.9	1.0	0.8	0.3	0.4	0.4
East Asia	2.5	4.8	6.1	6.4	6.4	6.3	7.0	8.3	9.3	10.1
South Asia	0.5	0.6	0.6	0.5	0.6	0.5	0.5	0.5	0.5	0.5
Africa	1.9	0.5	0.4	1.2	1.4	1.4	1.6	1.3	1.2	1.1
Other	1.9	1.0	0.3	0.1	0.2	3.2	0.1	0.2	0.2	0.1

.. Not available.

Source: UNSD, Comtrade database (SITC Rev.1).

Table I.5
Exports by groups of products, 1980-98
(US\$ billion and per cent)

Commodity	1980	1990	1991	1992	1993	1994	1995	1996	1997	1998
Total (US\$ billion)	17.0	13.6	14.9	13.2	14.0	17.2	22.9	24.4	25.7	28.2
(Per cent of total)										
Total primary products	29.4	35.8	39.6	40.0	32.1	31.8	28.5	25.7	27.0	22.6
Agriculture	8.9	15.8	20.0	18.1	14.3	14.8	13.2	13.1	14.5	12.6
Food	6.4	12.7	14.7	13.9	11.1	11.6	10.4	10.8	12.3	10.6
Mining	20.4	20.0	19.7	21.9	17.8	17.0	15.3	12.6	12.4	10.0
Ores and other minerals	2.4	2.6	2.9	4.0	2.2	1.4	1.3	1.1	1.0	0.7
Non-ferrous metals	4.8	6.7	6.1	7.3	6.7	6.6	6.0	4.8	4.9	3.9
Fuels	13.2	10.7	10.7	10.6	8.8	8.9	8.0	6.8	6.6	5.4
Coal, excluding briquettes	9.2	7.1	6.2	6.9	6.8	6.1	5.4	4.7	4.4	3.4
Manufactures	60.7	59.1	55.4	59.1	66.1	67.9	71.1	74.2	72.9	77.2
Iron and steel	3.7	6.9	7.3	7.6	7.2	7.1	6.2	5.5	5.7	4.5
Chemicals	5.2	9.1	9.2	8.7	6.7	6.8	7.8	7.7	7.8	6.7
Other semi-manufactures	3.9	7.3	9.5	10.4	10.9	12.1	13.6	13.8	13.9	14.6
Machinery and transport equipment	36.0	26.1	18.5	19.2	20.6	19.8	21.1	23.5	21.6	28.4
Power generating machines	1.5	2.0	1.7	0.7	0.5	0.4	0.7	0.7	0.5	0.5
Other non-electrical machinery	15.8	7.7	4.3	4.4	4.0	4.2	4.5	4.8	5.0	5.3
Office machines & telecommunications equipment	2.4	2.3	0.8	0.7	1.0	1.3	1.8	2.3	3.1	4.0
Other electrical machines	4.4	3.7	3.2	4.4	4.0	3.8	4.0	4.7	5.1	5.9
Automotive products	4.9	2.7	1.2	3.8	5.2	4.4	4.8	5.4	5.9	7.0
Passenger motor vehicle excluding buses	..	..	..	2.0	3.9	3.0	2.9	3.2	3.0	3.6
Other transport equipment	7.1	4.2	3.9	4.9	5.9	5.8	5.3	5.6	2.0	5.6
Textiles	2.7	2.0	1.6	2.0	2.1	2.2	2.1	2.2	2.5	2.6
Clothing	3.8	2.7	3.4	5.0	11.3	10.8	10.1	9.8	8.7	8.6
Other consumer goods	5.3	4.9	5.9	6.2	7.3	9.1	10.1	11.7	12.7	11.9
Furniture	1.0	1.5	2.4	3.1	4.1	5.2	5.9	6.6	6.9	6.8
Other	0.1	5.1	5.0	0.9	0.2	0.3	0.4	0.1	0.1	0.2

.. Not available.

Source: UNSD, Comtrade database (SITC Rev.1).

31. Manufactured products also dominate Poland's imports, accounting for more than three quarters of total merchandise imports in 1998. Machinery and transport equipment and chemicals are the most important import items (Table I.6). In 1998, imports of transport equipment, including components and CKD kits, reflected an expanding local automotive sector, and again recorded the largest increase. Agricultural imports have continued to decline since 1992.

Table I.6
Imports by groups of products, 1980-98
(US\$ billion and per cent)

Commodity	1980	1990	1991	1992	1993	1994	1995	1996	1997	1998
Total (US\$ billion)	19.1	8.2	15.5	15.9	18.8	21.4	29.0	37.1	42.3	47.0
(Per cent of total)										
Total primary products	43.0	37.2	37.1	34.2	28.8	26.9	25.2	24.7	22.2	18.6
Agriculture	19.1	10.8	15.7	14.2	13.5	13.5	12.8	12.8	10.7	9.7
Food	14.0	7.7	13.1	11.5	11.2	10.6	9.6	10.1	8.3	7.7
Agricultural raw material	5.1	3.2	2.7	2.6	2.3	2.9	3.2	2.6	2.4	2.0
Mining	23.8	26.4	21.4	20.0	15.3	13.4	12.4	11.9	11.5	8.9
Ores and other minerals	4.3	3.3	2.0	2.5	1.9	1.9	1.9	1.6	1.5	1.3
Non-ferrous metals	1.4	1.1	0.5	0.8	1.0	1.0	1.3	1.2	1.2	1.3
Fuels	18.1	21.9	18.9	16.8	12.4	10.5	9.2	9.2	8.7	6.3
Manufactures	51.0	62.8	62.6	64.7	69.6	73.1	74.4	75.0	77.6	80.4
Iron and steel	6.2	4.2	1.3	2.0	2.3	2.6	3.2	2.9	2.7	3.2
Chemicals	7.6	8.6	9.5	13.2	12.9	14.5	14.6	13.4	13.5	13.3
Other semi-manufactures	4.0	4.0	6.2	7.2	7.7	8.8	9.7	9.8	10.1	10.5
Machinery and transport equipment	27.4	34.5	32.7	29.7	29.4	29.2	30.1	33.2	36.1	38.1
Power generating machines	0.7	0.9	0.7	0.3	0.4	0.5	0.5	0.4	0.4	0.4
Other non-electrical machinery	13.8	16.0	9.5	12.7	10.7	11.4	11.2	11.6	11.8	12.2
Agricultural machinery and tractors	2.0	1.1	0.5	0.4	0.3	0.4	0.5	0.8	0.8	0.5
Office machines & telecommunications equipment	2.2	5.3	8.6	6.6	6.8	5.9	6.1	6.7	7.1	7.9
Other electrical machines	2.2	2.7	2.5	4.1	4.7	5.0	5.3	5.6	5.6	5.9
Automotive products	6.2	3.5	6.4	5.0	6.2	5.7	6.2	7.9	9.7	10.5
Other transport equipment	2.3	1.3	1.1	0.7	0.5	0.8	0.8	1.0	1.6	1.0
Textiles	1.6	2.1	1.7	1.9	7.2	7.9	7.4	6.3	5.7	5.8
Clothing	0.8	1.8	2.6	1.2	1.3	1.2	1.1	1.2	1.2	1.3
Other consumer goods	3.4	7.5	8.7	9.4	8.7	8.8	8.3	8.1	8.2	8.2
Other	0.1	0.0	0.3	1.1	0.1	0.0	0.5	0.1	0.3	1.1

Source: UNSD, Comtrade database (SITC Rev.1).

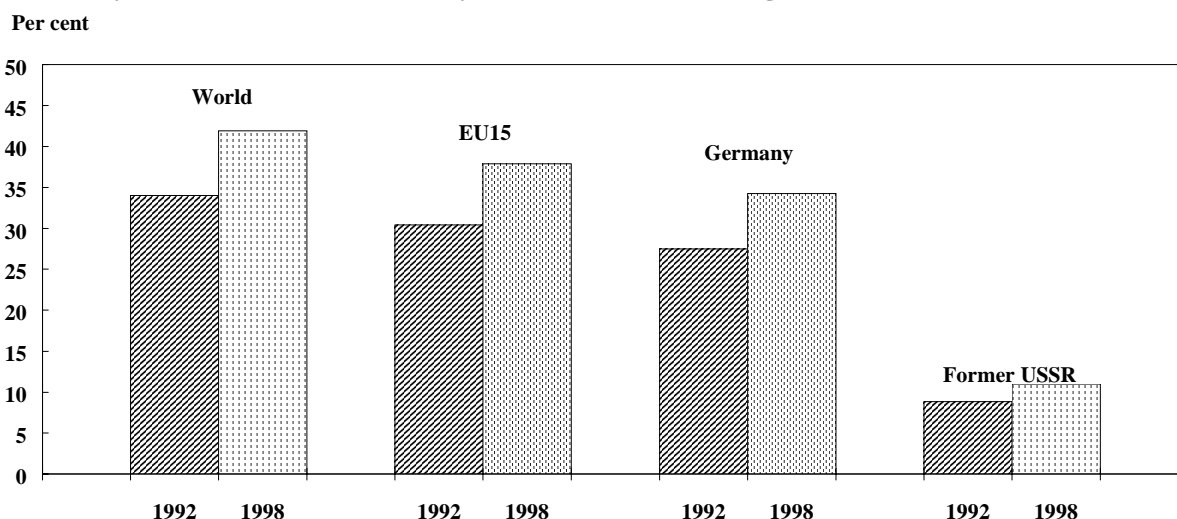
(c) Intra-industry trade

32. Poland's intra-industry trade, which refers to imports and exports of goods in the same product category, has increased since 1992, as measured by the Grubel-Lloyd index (Chart I.2). In 1998 it amounted to 41% of Poland's total merchandise trade, up from 34% in 1992. Factors underlying this rise may reflect greater specialization by firms in differentiated products to gain economies of scale. Another reason may be that firms in the early stages of transition to a market economy have established linkages with countries having higher levels of development to obtain access to know-how, working capital and distribution channels.²¹

²¹ Hoekman, and Djankov (1996).

Chart I.2

Intensity of Poland's intra-industry trade with selected regions, 1992 and 1998



Source : WTO Secretariat based on UNSD, Comtrade database (SITC Rev.1).

(d) Trade in services

33. Poland's receipts of services have exceeded payments during the review period, except in 1998. Receipts increased from US\$1.6 billion in 1992 (equivalent to 1.9% of GDP) to US\$3.7 billion (2.7% of GDP) in 1997. In 1997, freight and transportation accounted for some 29% of total receipts and tourism for another 16%. The major items on the debit account, which amounted to some US\$3.4 billion in 1997, are travel (20% of debits in 1997), and freight and transportation (12%).

(ii) Foreign direct and portfolio investment

34. Foreign investment is viewed as an important element in Poland's transformation process. It has played a leading role in the privatization process, and the country's success in attracting relatively large amounts of foreign investment has been crucial to its successful transition. Foreign investment has assisted Poland by introducing modern technology and management techniques; improving the supply of quality products; reducing production costs; and upgrading social infrastructure, such as through the construction of roads, housing estates and electricity-supply networks.²² Foreign investment has largely financed Poland's current account deficits. In 1998, foreign investment (direct and portfolio) amounted to over 4% of GDP.

35. FDI has accelerated rapidly since 1995, while portfolio investment has shown a more volatile pattern (Table I.7). Between 1992 and 1998, the stock of foreign capital grew some 18-fold and reached US\$31 billion. Labour productivity is said to be higher in companies with foreign participation; in 1996, it was almost double the national average.²³ While FDI initially focused on serving the domestic market, this is changing, and companies with foreign participation have a higher export orientation. This reflects their better product quality and enhanced international competitiveness, as well as access to foreign distribution channels and state-of-the-art marketing strategies. Such firms also tend to have higher import intensity.

²² Ladyka, Stanislaw (1995).

²³ Foreign Trade Research Institute (1998), p. 37.

Table I.7
Foreign investment by source and activity, 1993-98
 (US\$ million and per cent)

	1993	1994	1995	1996	1997	1998
Foreign direct investment, net (US\$ million)	580	542	1,134	2,741	3,041	6,164
Portfolio investment, net (US\$ million)	0	-624	1,171	241	2,098	636
Total (US\$ million)	580	-82	2,305	2,982	5,139	6,800
Total as a per cent of GDP	0.7	-0.1	1.9	2.2	3.8	4.3
Foreign direct investment inflows by country (per cent of total):^a						
European Union (15)	48.1	42.6	48.1	53.6	55.3	60.4
Germany	7.5	8.9	10.0	12.7	11.9	18.8
France	6.3	6.2	8.4	7.5	9.1	8.8
Italy	9.5	8.5	6.7	10.2	9.2	7.5
United Kingdom	2.4	2.6	5.4	4.2	5.7	7.1
Netherlands	8.2	5.6	6.0	7.9	6.9	6.9
Austria	6.9	3.7	3.6	2.6	3.7	2.8
United States	36.3	32.7	24.9	24.7	22.5	18.0
International companies ^b	10.2	18.7	16.1	12.4	9.3	6.6
Korea, Rep. of	0.2	0.1	1.0	1.5	6.1	5.2
Russia	0.7	0.5	0.3	0.2	0.1	3.5
Foreign direct investment inflows by activity (per cent of total):^{a, c}						
Agriculture	0.3	0.2	0.1	0.1	0.1	0.1
Mining and quarrying	0.0	0.0	0.0	0.0	0.1	0.0
Manufacturing, including	52.9	53.7	58.1	58.2	62.4	58.3
- food products, beverages and tobacco ^d	15.1	16.6	19.9	21.1	18.5	16.4
- transport equipment	..	..	..	..	14.2	13.3
- pulp, paper and paper products, publishing and printing ^e	7.7	3.0	6.5	5.1	6.5	5.0
- chemicals and chemical products ^f	7.9	5.9	7.8	5.3	6.1	4.7
Power, gas and water supply ^g	7.2	6.2	5.2	4.0	0.5	0.9
Services, including	39.6	39.9	36.6	37.7	36.9	40.7
- construction	13.3	8.8	7.3	5.0	3.1	6.2
- financial intermediation ^h	13.2	19.0	19.0	21.2	17.7	17.6
- wholesale and retail trade, repairs ⁱ	4.9	5.5	5.3	5.9	8.0	10.8

.. Not available.

a Data only include foreign direct investment over US\$1 million. Data are not available prior to 1993.

b Includes the European Bank for Reconstruction and Development (EBRD).

c Data were reclassified in 1997 using the European Classification of Activities (NACE). Therefore, the data prior to 1996 are not fully comparable with data of 1997 and onwards.

d For data prior to 1997, classification group was named food processing.

e For data prior to 1997, classification group was named wood and paper.

f For data prior to 1997, classification group was named chemical.

g For data prior to 1997, classification group was named light, fuel and power.

h For data prior to 1997, classification group was named finance and insurance.

i For data prior to 1997, classification group was named trade.

Note: Data are on a cash basis from the balance of payments.

Source: WTO Secretariat, based on data from Polish Agency for Foreign Investment (www.paiz.gov.invest98.htm), Foreign Trade Research Institute (1998), *Foreign Investments in Poland*, Warsaw (by country and by origin), and the National Bank of Poland.

36. The major investors in Poland are EU companies, their share in total foreign direct investment inflows amounted to 60% in 1998, substantially up from 1993. Germany, the United States and France were the most important sources of foreign direct investment in 1998. Investments undertaken by nationals from Russia and some Asian countries have shown strong growth in recent years, albeit from low levels.

37. During the review period, the share of manufacturing industry in total investment in Poland has grown steadily, albeit slowly, at the expense of other sectors. Manufacturing activities accounted for more than half (58%) of inward FDI in 1998, while services accounted for 41%. In 1998, the largest recipient subsectors were financial intermediation (17.6%) and food, beverages and tobacco (16%).

38. Net inflows of portfolio investment peaked at US\$2.1 billion in 1997, and dropped to US\$0.6 billion in 1998. The importance of long-term treasury bonds increased considerably in 1997, partly due to increased real returns and expectations of a long-term appreciation of the currency.²⁴ At end-1997, the nominal value of treasury bonds held by foreign investors amounted to approximately Zł 4.5 billion (or about US\$1.3 billion). In 1997, foreign interest in Polish non-treasury debt instruments also increased substantially, especially for banking debt instruments. Foreigners also invest via the Warsaw Stock Exchange (WSE); the share of investment in the WSE held abroad was estimated at some US\$5 billion at end-1997.

(5) OUTLOOK

39. Poland's reforms have underpinned an impressive economic performance. In the past decade, it has been transformed from a socialist centrally planned economy to a market-based one that is increasingly being integrated into global markets. EU membership should bring further advantages as remaining trade barriers are removed and movement of services, capital and labour are further liberalized. This should enhance Poland's economic efficiency. However, meeting the goal of EU membership poses tremendous challenges, requiring huge restructuring and modernization of most sectors. As important as EU accession is for Poland, care is needed to ensure that concerns over EU membership do not distract from implementing other economic reforms needed if it is to maximize the benefits of trade liberalization.

40. Care is also required to ensure that business uncertainty is not overly increased by frequent changes in Poland's laws and regulations, including in the foreign trade area.²⁵ Between end-1994 and end-1996, 128 amendments were made to 76 legal acts regulating business activity, frequently with short notice and in a few cases with retroactive power.²⁶

41. The short-term outlook for Poland appears to be favourable. The economy's recovery is expected to gather momentum in 2000 and 2001, but the pace will hinge crucially on export growth to Western Europe, as well as to other markets such as the United States, Japan and East Asia. It also requires prudent macroeconomic policies to control the effects of a widening current account deficit and threats of rising inflation. Real GDP is projected to grow by around 5% in 2000 and to approach 6% in 2001. Exports are expected to return to double-digit growth by 2001, and unemployment to fall from 2000. Inflation is forecast to rise to 7% in 2000, partly due to excise and VAT increases, but to fall to 5% by 2001 provided appropriate monetary policies are maintained. The current account deficit is expected to decline as a share of GDP.

²⁴ Foreign Trade Research Institute (1998).

²⁵ Ladyka, Stanislaw (1997); OECD (1998); and Kaminski and Stefanowicz (1997).

²⁶ OECD (1998).