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## **Poland: the return of the strong zloty**

Poland's yearly indicators for 2004 are looking quite favourable. GDP grew by 5.4%: more than domestic demand, which increased by 4.9%, with private consumption rising by 3.2% only and gross fixed investment by 5.1%. Foreign trade (goods and non-factor services) added to the overall GDP growth, contributing approximately 0.4 percentage points to the GDP growth rate. Total gross value-added rose by 5% (in industry it was up 9.7%, in construction it fell however, already for the fourth year running). But there was a massive rise in inventories which accounted for about 1.8 percentage points of the overall GDP growth rate. In addition, GDP growth has been slowing down throughout 2004: from 6.9% in the first quarter to about 4.1% in the fourth. The second half of 2004 (and its final months in particular) seems to have brought qualitatively new developments. Quite unexpectedly private consumption, which had kept rising by 3.5-3.9% earlier in the year, grew by approximately only 1.5% in the fourth quarter. The slowdown in the growth of private (and overall) consumption was not compensated by the acceleration in growth of gross fixed investment (from 3.7% in the first three quarters to over 7% in the fourth). In addition, the positive contribution of foreign trade was reduced in the fourth quarter (from about 0.66 percentage points in the first three quarters to 0.4 p.p. in the whole year of 2004). Some signs of a 'structural break' can also be seen in data on industry. Industrial sales, which in the first half of 2004 were about 17.6% higher (in real terms) than in the same period of 2003, rose less dynamically in the second half of 2004. (Overall industrial sales rose by about 11.6% in 2004.) The growth slowdown does not seem to be an 'effect of accession', at least directly. Indirectly, the accession may have played a role through higher inflation which eroded the purchasing power of wages and pensions, thus weakening the rise of consumer demand. (A tighter monetary policy is another indirect effect of accession.)

Whether or not the 'structural break' had some impacts on profits is not yet known. According to available data on the first three quarters of 2004, the non-financial corporate sector made very high profits (amounting to PLN 57.9 billion, up from 24.6 billion in first three quarters of 2003). In the entire year of 2003 gross profits reached PLN 30.2 billion. Net profits grew even faster (also on account of lower corporate tax rates): from PLN 15.1 billion in the first three quarters of 2003 to 46.4 billion in the same period of 2004. Net profitability (the ratio of net profit to revenue) rose from 2% to 5.1%. Profits improved in all major branches and sectors. Exporting firms continued to outperform other firms on profitability. All in all, even if profits and profitability declined somewhat in the last quarter of 2004, the financial standing of the corporate sector must be considered very good. The same applies to commercial banks, whose net profits also rose very strongly, from PLN 2.3 billion in 2003 to 7.3 billion in 2004. The banks' strong profits were

accompanied by an improving quality of banks' assets. Within 2004 the share of 'problematic' assets in banks' credit portfolios fell from 21.2% to 14.8%.

The manifold expansion of corporate profits happened to coincide with a very slow (3.3%) rise in that sector's nominal wage bill. In real terms the average gross wage in that sector rose by 0.6%. In manufacturing the average gross wage rose by 0.9% in real terms, while labour productivity increased by 13.1% – resulting in unit labour costs falling by close to 19%. The stagnation of wages is easily explained by the very high, persistent unemployment and the ensuing weakness of the Trade Unions.

The high profits earned by the corporate sector and the still relatively low levels of investment are consistent with the falling volume of the sector's credit liabilities. On aggregate the corporate sector does not need to borrow. To the contrary, the sector's deposits with commercial banks are rising very fast. In contrast, the volume of households' deposits have been stagnant while their credit liabilities are expanding quite strongly.

The outstanding performance of foreign trade has followed from two developments: the ongoing decline in unit labour costs (strong rise in labour productivity combined with weak increases in wages) and the weak (nominal) exchange rate vs. the euro. On average the PLN/EUR exchange rate was 11% higher (i.e. weaker) in the first half of 2004 than in the same period of 2003. However, the zloty, which had been weakening since the first half of 2002 – together with falling National Bank (NBP) interest rates and amid quite low inflows of both FDI and portfolio investment – has been strengthening since February 2004. By September the zloty had appreciated by close to 11% in nominal terms. In the fourth quarter the zloty strengthened by another 5.6%. Further gains were recorded in early 2005. The strengthening of the zloty can be seen as reflecting the rapid rise in inflows of portfolio capital and the expectations (correct so far) of relatively high interest rates and of the zloty strengthening even further. Indeed, in the first nine months of 2004 there was a massive inflow (equivalent to EUR 6.8 billion) of portfolio investment targeting government debt securities. This is over twice the level recorded in the whole year of 2003. Capital inflows and the strengthening of the zloty may be intimately linked to the correctly anticipated moves of the National Bank of Poland: NBP interest rates were raised twice in 2004, in July and August.

The rising NBP interest rates followed from concerns over inflation, which suddenly accelerated in April, May and June, bringing the 12-month CPI from 1.7% in March to 4.6% in July and August. Despite being sudden, the inflationary acceleration had been generally expected. It reflected higher prices of imported energy carriers and the well anticipated price hikes in the wake of EU accession. Producer prices in coal mining, petroleum processing and metallurgy also accelerated (in March, April and May), partly in response to world market developments. The Spring inflationary acceleration was in fact transient. It is

no small irony that the NBP tightened its policy precisely when consumer prices began to *fall* on their own (in July and August). As it turned out the CPI rose cumulatively by less than 1% over the second half of 2004 (and the index of industrial producer prices by less than 0.5%). Despite this the NBP drags its feet on the interest rates, referring to all kinds of imaginable risks to price stability: a build-up of inflationary expectations, pressures for high wages, lax fiscal policy etc. This certainly serves the goal of NBP's 'reputation building'. Otherwise, under the current conditions, none of these risks seems even remotely real. The real problem is the interest rates being too high, the zloty being too strong, and the portfolio inflows currently taking advantage of that constellation of exchange and interest rates.

High interest rates are unlikely to be conducive to higher fixed investment in the corporate sector. And they are likely to discourage investment in small and medium-size firms. Higher communal and public investment (and also investment in smaller firms) is more likely to be stimulated by the forthcoming EU transfers. But the return of a strong zloty is very likely to prove harmful to the export and import-competing sectors. Of course the actual foreign trade performance need not deteriorate immediately. It may take time to adapt to the new realities, with the zloty much stronger than generally expected not long ago.<sup>1</sup> Nonetheless, even if the volumes of exports continue to rise, profits earned on them, expressed in domestic currency, may be contracting. In addition, the build-up of inventories will eventually be coming to an end. Under these conditions even a quite strong rise in fixed investment may be incapable of generating an overall growth acceleration.

The actions taken by the NBP in Summer 2004 were provoked by the price hikes partly related to Poland's accession to the EU. Otherwise, the accession has done some good – especially to the country's numerous farmers. Farmers have been benefiting not only from sizeable direct payments and other forms of support. Under fully liberalized trade in food and farm products, Poland's agro-food exports to the EU-25 expanded strongly (by more than 30%), pulling up some domestic prices. For the first time in several years prices of farm products rose faster than prices of agricultural production inputs. Farmers, until recently the staunchest opponents of Poland's EU membership, emerge as its clear beneficiaries. Other positive impulses of EU membership are yet to materialize. For the time being one cannot reliably detect or measure e.g. the effects of various non-farm transfer programmes. Also, it is hard to relate the recent FDI inflows to EU membership: quantitatively they do not seem to be any higher than on average in the past several years.

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<sup>1</sup> According to a poll conducted among a large sample of firms in September 2004, it was generally expected that at the end of 2004 the PLN/EUR rate would be about 4.41 and the PLN/USD rate 3.67. The actual rates were 4.08 and 2.99 respectively. Clearly, the firms' expectations were wrong. In September the firms generally believed that exports would cease to be profitable at a PLN/EUR rate of 4.1. Moreover, already the rate of 4.24 was considered harmful for domestic import-competing firms. See NBP's web page at [www.nbp.pl/publikacje/koniunktura](http://www.nbp.pl/publikacje/koniunktura).

Parliamentary as well as presidential elections will be held in 2005, probably in autumn. The ruling liberal-left Social-Democrats, weakened by a number of corruption scandals (overblown by the generally hostile media) and by their own indecisiveness and opportunism, will probably suffer heavy losses. But the likely victorious parties, currently competing with rather radical, if not fundamentalist proclamations, may find it difficult to form a working coalition.

Table PL

## Poland: Selected Economic Indicators

|  | 1998    | 1999    | 2000    | 2001    | 2002    | 2003    | 2004 <sup>1)</sup>     | 2005   | 2006     |
|--|---------|---------|---------|---------|---------|---------|------------------------|--------|----------|
|  |         |         |         |         |         |         |                        |        | forecast |
| Population, th pers., end of period <sup>2)</sup>        | 38667   | 38654   | 38644   | 38633   | 38219   | 38191   | 38175                  | .      | .        |
| Gross domestic product, PLN mn, nom.                     | 589361  | 652517  | 723886  | 760595  | 781112  | 814922  | 884200                 | 951700 | 1024300  |
| annual change in % (real)                                | 4.8     | 4.1     | 4.0     | 1.0     | 1.4     | 3.8     | 5.4                    | 4.5    | 4.5      |
| GDP/capita (EUR at exchange rate)                        | 3885    | 3994    | 4670    | 5366    | 5299    | 4851    | 5110                   | .      | .        |
| GDP/capita (EUR at PPP - WIIW)                           | 7940    | 8450    | 9050    | 9290    | 9660    | 9830    | 10580                  | .      | .        |
| Gross industrial production (sales)                      |         |         |         |         |         |         |                        |        |          |
| annual change in % (real)                                | 3.5     | 3.6     | 6.7     | 0.6     | 1.1     | 8.1     | 11.6                   | 8      | 8        |
| Gross agricultural production                            |         |         |         |         |         |         |                        |        |          |
| annual change in % (real)                                | 5.9     | -5.2    | -5.6    | 5.8     | -1.9    | -0.8    | 7.6                    | .      | .        |
| Construction output total                                |         |         |         |         |         |         |                        |        |          |
| annual change in % (real)                                | 12.4    | 6.2     | 1.0     | -6.4    | -0.3    | 0.9     | .                      | .      | .        |
| Consumption of households, PLN mn, nom.                  | 363074  | 406517  | 455405  | 486504  | 510817  | 530033  | 422774 <sup>I-X</sup>  | .      | .        |
| annual change in % (real)                                | 4.8     | 5.2     | 2.8     | 2.1     | 3.3     | 3.1     | 3.2                    | 3      | .        |
| Gross fixed capital form., PLN mn, nom.                  | 139205  | 156690  | 170430  | 157209  | 148338  | 148962  | 97014 <sup>I-X</sup>   | .      | .        |
| annual change in % (real)                                | 14.2    | 6.8     | 2.7     | -8.8    | -5.8    | -0.5    | 5.1                    | 7      | .        |
| LFS - employed persons, th, avg. <sup>3)</sup>           | 15354.0 | 14757.0 | 14526.0 | 14207.0 | 13782.0 | 13616.8 | 13707.0 <sup>I-X</sup> | .      | .        |
| annual change in %                                       | 1.2     | -3.9    | -1.6    | -2.2    | -3.0    | .       | 0.9 <sup>I-X</sup>     | .      | .        |
| Reg. employees in industry, th pers., avg.               | 3378.7  | 3138.4  | 2955.0  | 2820.6  | 2670.5  | 2656.9  | 2399.4 <sup>5)</sup>   | .      | .        |
| annual change in %                                       | -1.6    | -7.1    | -5.8    | -4.5    | -5.3    | -0.5    | -0.4 <sup>5)</sup>     | .      | .        |
| LFS - unemployed, th pers., average <sup>3)</sup>        | 1816.0  | 2391.0  | 2785.0  | 3170.0  | 3431.0  | 3328.5  | 3280.0 <sup>I-X</sup>  | .      | .        |
| LFS - unemployment rate in %, average <sup>3)</sup>      | 10.6    | 13.9    | 16.1    | 18.2    | 19.9    | 19.6    | 19.3                   | 19     | 18       |
| Reg. unemployment rate in %, end of period <sup>3)</sup> | 10.4    | 13.1    | 15.1    | 17.5    | 20.0    | 20.0    | 19.1                   | 18     | .        |
| Average gross monthly wages, PLN <sup>4)</sup>           | 1232.7  | 1697.1  | 1893.7  | 2045.1  | 2097.8  | 2185.0  | 2289.6                 | .      | .        |
| annual change in % (real, gross)                         | 4.5     | 4.7     | 1.0     | 2.5     | 0.7     | 3.4     | 1.5                    | .      | .        |
| Consumer prices, % p.a.                                  | 11.8    | 7.3     | 10.1    | 5.5     | 1.9     | 0.8     | 3.5                    | 3      | 3        |
| Producer prices in industry, % p.a.                      | 7.3     | 5.7     | 7.8     | 1.6     | 1.0     | 2.6     | 7.0                    | 4      | 4        |
| General governm. budget, EU-def., % GDP <sup>6)</sup>    |         |         |         |         |         |         |                        |        |          |
| Revenues   | 44.5    | 44.9    | 42.5    | 43.8    | 43.9    | 43.7    | 45.6                   | .      | .        |
| Expenditures   | 46.6    | 47.0    | 44.2    | 47.7    | 48.1    | 47.6    | 51.2                   | .      | .        |
| Deficit (-) / surplus (+)                                | -2.1    | -1.3    | -0.7    | -3.7    | -3.6    | -3.9    | -5.5                   | -4     | -3.1     |
| Public debt, EU-def., % of GDP <sup>6)</sup>             | 39.1    | 40.1    | 36.8    | 36.7    | 41.1    | 45.4    | 47.7                   | 50.3   | .        |
| Discount rate of NB % p.a., end of period                | 18.2    | 19.0    | 21.5    | 14.0    | 7.5     | 5.8     | 7.0                    | .      | .        |
| Current account, EUR mn                                  | -6154   | -11719  | -10789  | -6004   | -5402   | -4109   | -3500                  | -5700  | -6000    |
| Current account in % of GDP                              | -4.1    | -7.6    | -6.0    | -2.9    | -2.7    | -2.2    | -2                     | -2.5   | -2.5     |
| Gross reserves of NB excl. gold, EUR mn                  | 23396   | 26224   | 28555   | 29031   | 27367   | 26000   | 25904                  | .      | .        |
| Gross external debt, EUR mn                              | 50668   | 65121   | 74671   | 81461   | 81046   | 83705   | 94130 <sup>I-X</sup>   | .      | .        |
| FDI inflow, EUR mn                                       | 5676    | 6824    | 10334   | 6372    | 4371    | 3660    | 4400 <sup>7)</sup>     | .      | .        |
| FDI outflow, EUR mn                                      | 282     | 29      | 18      | -97     | 228     | 173     | 300 <sup>7)</sup>      | .      | .        |
| Exports of goods, BOP, EUR mn                            | 28951   | 28215   | 39022   | 46537   | 49338   | 53836   | 64600                  | 69800  | 75400    |
| annual growth rate in %                                  | 6.5     | -2.5    | 38.3    | 19.3    | 6.0     | 9.1     | 20                     | 8      | 8        |
| Imports of goods, BOP, EUR mn                            | 40397   | 42361   | 52349   | 55094   | 57039   | 58913   | 70100                  | 76400  | 84000    |
| annual growth rate in %                                  | 12.6    | 4.9     | 23.6    | 5.2     | 3.5     | 3.3     | 19                     | 9      | 10       |
| Exports of services, BOP, EUR mn                         | 9666    | 7850    | 11320   | 10914   | 10545   | 9850    | 10400                  | 10700  | 11000    |
| annual growth rate in %                                  | 22.5    | -18.8   | 44.2    | -3.6    | -3.4    | -6.6    | 6                      | 3      | 3        |
| Imports of services, BOP, EUR mn                         | 5907    | 6553    | 9773    | 10021   | 9690    | 9408    | 9900                   | 10000  | 10100    |
| annual growth rate in %                                  | 16.2    | 10.9    | 49.1    | 2.5     | -3.3    | -2.9    | 5                      | 1      | 1        |
| Average exchange rate PLN/USD                            | 3.49    | 3.97    | 4.35    | 4.09    | 4.08    | 3.89    | 3.65                   | .      | .        |
| Average exchange rate PLN/EUR (ECU)                      | 3.92    | 4.23    | 4.01    | 3.67    | 3.86    | 4.40    | 4.53                   | 4.2    | 4.2      |
| Purchasing power parity PLN/USD, WIIW                    | 1.65    | 1.75    | 1.82    | 1.85    | 1.83    | 1.85    | 1.83                   | .      | .        |
| Purchasing power parity PLN/EUR, WIIW                    | 1.92    | 2.00    | 2.07    | 2.12    | 2.11    | 2.17    | 2.19                   | .      | .        |

Notes: 1) Preliminary. - 2) From 2002 according to census May 2002. - 3) From 2003 according to census May 2002. - 4) From 1999 including mandatory premium for social security. - 5) Enterprises with more than 9 employees. - 6) According to ESA'95, excessive deficit procedure. - 7) wiiw estimate.

Source: wiiw Database incorporating national statistics; AMECO Database; wiiw forecasts. Source: wiiw Database incorporating national statistics; AMECO Database; wiiw forecasts.