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Monetary Policy in Poland in the Conditions of Upheavals in Global Markets and the Change of Internal Business Cycle

Economic Situation in Poland at the Background of the Upheavals in Global Financial Markets in 1997-1998

During the years 1997-98 a set of serious upheavals appeared in financial markets in certain regions of the world. Among those most spectacular in terms of their range and of costs borne in order to bring the economies affected back to stabilisation one should mention financial crises in Asia (Malaysia, South Korea, Thailand), in Europe (Russia, Czech Republic) and in Latin America (Mexico, Brasilia). Since the reasons underlying those crises have been relatively well known and analysed in economic and financial literature, it is not necessary here to go beyond a brief recapitulation of facts. We shall start the concise review of reasons of the recent financial crises with Mexico, due to a high "transparency" of the case, chronological order and a sequence of events that could be called classical in how they caused the deterioration of the business cycle in that country.

It is widely recognised that an improper financial policy had been one of the main reasons of the financial crisis in Mexico. During the early 1990's it featured an excessive credit expansion, causing high inflation. In order to control the inflation the so-called *el Pacto* (a three-way social agreement between the employers, employees and the government) was concluded in Mexico, becoming a basis for obtaining a financial assistance from the IMF and for the change of the hitherto existing monetary policy as well. One of the elements of the above-mentioned former monetary policy in Mexico was binding the peso to American

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dollar through a permanent exchange rate. The restrictive monetary policy, combined with the so-called exchange rate anchor, resulted in reduction of inflation to a single-digit level on the one hand, however, on the other hand, it caused a real appreciation of peso.

As a consequence, a considerable inflow of foreign capital was noticeable. In the years 1989-1994 the inflow of circa US dollar 95 billion to Mexico took place with direct investments accounting for as little as ¼ of that, while the acquisition of shares of Mexican companies equalled to another ¼ and nearly a half of the total amount (*i.e.* US dollar 43 billion) was in bonds and other, mainly short-term investments. This situation wasn't regarded as dangerous, though, and for a relatively long time no major problems were expected. It was rather seen as both a natural symptom and a condition of performance of the so-called nominal exchange anchor, helpful in combating inflation and raising the country's reliability in the international forum, in spite of the fact that the current accounts deficit between 1989 and 1994 rose from 2.8% to c. 7%. However, apart from the trade deficit – large as it was but regarded at that time as one within a capacity to be financed in a smooth way – all the other important indicators of macro-economic development were favourable and encouraged to forecast sound market situation and growth for the future. The most important of those indicators – the status of the public funds, already well consolidated at the time – was seen as the source of particularly optimism, since it was evident basing on the past experiences on the global scale that the State budget deficit had been the single most important reason of currency breakdowns and crises. From that point of view, therefore, Mexican economy seemed a healthy one, both safe and crisis-resistant.

What was the reason of the financial crisis in this country, then? The direct cause of the currency and economic crisis in Mexico was the devaluation of peso carried out in 1994: as evaluated, peso was revalued by circa 20 per cent. As a result of the devaluation a sudden refusal of financial markets to receive new treasury bonds (*tesobonos*) was encountered. Accordingly, it proved impossible to further roll the US dollar denominated short-term public debt, while the reserves had already been depleted at an earlier time in fruitless attempts to defend peso (the level of reserves dropped from US dollar 25 billion in mid-1994 to circa US dollar 7 billion in March of 1995). The breakdown that happened in Mexico basically consisted in the fact that the country, while already having got its budget nearly wholly equalised, nevertheless generated a huge short-term public debt whose dynamics soon went out of control and the hitherto existing creditors (trust funds, collateral funds and other institutional investors) proved to be unexpectedly sceptical in their assessment of fundamental transformations in Mexican economy.

In the case of the Asian crisis (1997-1998) among the main reasons of problems, weakness of the financial institutions, lack of banking supervision, and an excessive liberalisation of capital flow are mentioned. The most peculiar effect of the latter one was, among other things, a huge indebtedness contracted by the private sector abroad as well as an improper exchange rate policy, also basing upon fixed currency exchange rates.

The Russian crisis, as believed by many economic experts, was mainly caused by the deteriorating situation in the field of public funds along with the problems in the execution of taxes by the government of the Russian Federation. In the above mentioned circumstances budgetary expenses that proved far too large could only be financed (if not through an additional generation of money) through the treasury notes issued by the government and located abroad. The budgetary deficit was financed through an inflow of capital. Therefore the financial breakdown experienced by Russia may be included in the Argentinean type (as of the early 1980's).

Summing it up it can be said that the main direct reasons of upheavals occurring in the financial markets in the 1990's (apart from those mentioned in the first part of the present study) were as follows:

- Strong appreciation of the domestic currency of a given country, caused, among other things, by the firm tying of the domestic currency to US dollar. This, on the one hand, resulted in a worsening of competitiveness of goods and services generated in those countries, making a change for worse in a trade balance and, on the other hand, the so-called peg made private investors remain in their belief that a fixed exchange rate would be maintained in the future as well and therefore that foreign credits denominated in US dollars may still be drawn because a cost of their servicing would not change in the future. An unavoidable change of the exchange rates (a fall of the domestic currencies prices) implied a sudden growth of charge for the private sector, bringing, at the same time, a threat of insolvency – resulting in the end in the escape of capital (Mexico and Asia);
- Lack of consequence in running currency policy, consisting, among other things, in verbal introduction of the exchange rate guarantees while in realty it proved impossible to keep them (Mexico, Russia);
- Convertibility of currencies and liberalisation of capital transactions allowing for a free inflow and outflow of capital (Mexico and Asia);
- Weak financial systems – low level of assets and equity capital, lack of the appropriate regulations and of applicable banking supervision (Asia and Russia);
- Lack of full information regarding the type of assets portfolio of the financial system. As soon as the first signs of a financial crisis manifested

themselves, in many cases it became evident for the first time how large a portion of the financial sector assets portfolio was in bad debts – either dubious or de facto unrecoverable, which should not have had been given or at least which should have had been covered in banks' appropriated reserves in case of a necessity to book them to the debit. Such a crisigenic aspect of an open access to financial market has been strongly marked in Mexican, Far-East, Hungarian (in 1995) and in Czech crises;

- Fiscal problems, consisting in tax collection in the first rank, causing a serious lack of balance in the State budget (Russia);
- A high level of the private sector debts taken abroad as well as short-term capital transfer – mainly initiated by the foreign disposers of funds or taking place as a reaction to a demand on the part of local banks and companies pursuing venture goals. This was manifested in the famous *bubbles* for example in the real estate market and in stock exchanges. Cracking of the bubbles usually marked the beginning of the most intense stage of a crisis soon resulting in companies going bankrupt due to their incapability of paying back their liabilities or to banks crashing as a result of non being able to collect credits given (Asia).

Looking from the Polish perspective it seems important to answer the questions how should one evaluate the influence of the above-described upheavals upon the Polish economy and whether some of the above-mentioned reasons can be observed within the range of Polish economy as well. In order to answer those questions it seems advisable to gather some basic economic data together, regarding the period under analysis. Such data have been presented in the Table 1 below.

Table 1. Selected macroeconomic data for Poland in the period 1997-1999

Year	GDP (%)	Unemployment (%)	Export (%)	Import (%)	Account current (in US dollar million)	Import coverage with reserves*
1997	6.8	10.3	20.3	20.8	-4 298	6.5
1998	4.8	10.3	9.4	14.6	-6 389	7.3
1999	4.9	13.0	-12.4	- 6.8	-11 660	6.8

* import coverage with reserves in foreign currency presented in the number of months

Source: Data provided for the appropriate years by the Central Statistics Office and the National Bank of Poland.

Data provided in the Table 1 above indicate that during the period from 1997-1999 Poland experienced both positive and negative changes in certain macroeconomic ratios. A high rate of the economic growth and the decrease of inflation can be included among successful results of Polish macroeconomic policy, while the fall in export in 1998, aggravating the current accounts deficit as well as the growth of unemployment have to be rated as negative ones. A more detailed analysis of those phenomena leads to a conclusion that, without a doubt, the downfall in export was influenced by a general deterioration of the business cycle in the global markets and by the Russian crisis in particular.

Throughout the period under analysis the reserves in foreign currencies have been maintained on a safe level in spite of the downfall in export and a rise in import which has been rather weak but nevertheless clearly observable, at least by the third quarter of 1998. This indicates that the turning of the business cycle towards the worse has been transmitted on the businesses via real activity *i.e*. via foreign trade rather than via the financial field. Such a conclusion is further confirmed by the fact that the National Bank of Poland has not been forced to intervene on the currency market since July 1998, *i.e*. since the time before the Russian crisis and, furthermore, since August 1998 the official currency reserves have remained on the level above US dollar 27 billion, that is practically unchanged.

Main Reasons for a Limited Influence of Economic Upheavals on International Markets Upon the Status of the Business Cycle in Poland

- **Structure and Geography of Polish Foreign Trade**

The period covering the second half of the 1980's and the early 1990's brought some important changes to basic directions of Polish foreign trade. In 1988 the Soviet Union was still in the double role as the main importer of Polish goods and services, as well as the most important source of raw materials, machines and equipment for Poland. Economic and political transformation taking place in the early nineteen-nineties both in Poland and the Soviet Union resulted – at least during an initial stage – in a dramatic collapse in the bi-lateral trade turnover between both countries. It seems that there was also an additional reason for making decision on considerable changes in directions of the Polish foreign trade, namely the structure of demand in the Polish market, featuring high demand for consumer goods in the first rank – and for low or medium technology and inexpensive goods in particular. Among the producers and exporters of such goods the Far-Eastern and Western European countries were dominant. At the same time the export of Polish goods also grew, mainly to the EC countries. As a result, between 1996-98 circa 67 per cent of Polish export

was directed to the EC countries, while as little as 23 per cent went to the former CMEA (Council for Mutual Economic Aid) countries. Similar situation was observed on the import side, with around 64 per cent of total import between 1996-1998 being that from the EC countries and only around 15 per cent from the former communist countries. Directions of Polish foreign trade in selected years during the 1990's have been presented in more detail in the Table 2.

Table 2. Main trade partners of Poland in 1988-1998

Year	Share of selected Poland's partners (in %) in:			
	Export		Import	
1988	1. Soviet Union	24.5	1. Soviet Union	23.3
	2. West Germany	12.4	2. West Germany	13.0
	3. Czechoslovakia	6.0	3. Czechoslovakia	6.4
1991	1. Germany	29.4	1. Germany	26.5
	2. Former Soviet Union	11.0	2. Former Soviet Union	14.1
	3. United Kingdom	7.1	3. Austria	6.3
1994	1. Germany	35.7	1. Germany	27.4
	2. Netherlands	5.9	2. Italy	8.4
	3. Russia	5.4	3. Russia	6.8
1996	1. Germany	34.4	1. Germany	24.7
	2. Russia	6.8	2. Italy	9.9
	3. Italy	5.3	3. Russia	6.8
1997	1. Germany	31.4	1. Germany	23.9
	2. Netherlands	6.0	2. Russia	8.5
	3. Italy	5.6	3. Italy	6.9
1998	1. Germany	32.9	1. Germany	24.1
	2. Russia	8.4	2. Italy	9.9
	3. Italy	5.9	3. Russia	6.3

Source: The Central Statistics Office, 1999, p.260.

A detailed analysis of the Table 2 explains and confirms the reasons for which upheavals occurring in the Russian market had only a limited influence upon the business cycle in Poland. Putting things simply, it went like this because Russia had relatively little share in total trade with Poland during the first half of the nineteen-nineties.

Polish Economic Policy in 1990's

Reaching a reduction of the inflation level and initiation of the restructuring processes in industry, necessary in the light of the transition from the command economy to market-oriented economy, have been among the fundamental goals of Polish economic policy of the 1990's. There was a general agreement that such goals may be attained, to a large degree, through the implementation of an appropriate (restrictive) monetary, fiscal and currency exchange rate policies. According to monetary policy assumptions, the supply of money, which, if excessive, generates a permanent inflation pressure, could be reduced through application of the open market operations. Such a solution made it possible to replace the excess of the highly liquid financial assets, including in particular monetary aggregate M0 in the economy with the less liquid securities. As a result of such an operation, a certain percentage rate would develop as a market price of money. However, due to the non-existence of the financial market (which began to develop as late as in 1991) prevented such a strategy in financial policy to be implemented. Instead, a reverse solution was adopted, consisting in an imposition of a high interest rate in order to reach the desired goal: a reduction of supply of money.

Establishment of a high interest rate caused the following four direct effects:

1. It forced the businesses which possessed their own resources in cash to pay back their credits at an earlier time, which resulted in the reduction of their most liquid financial assets, limiting, at the same time, the resource of the so-called hot money and leading, in the first rank, to a radical reduction of the consumption demand;
2. It caused a strong burden upon the financial outcome leading even to a financial crash of those businesses which were unable to pay back their credits at an earlier time;
3. It discouraged businesses and households from taking new credits;
4. It started a tendency to save on the part of households since people could observe serious advantages of saving (therefore a level of financial resources in banks grew considerably and at the same time a large portion of savings kept in foreign currencies have been converted to Polish zlotys).

Fiscal policy consisted in, among other things, an introduction of personal income tax, raising the corporate income tax and the introduction of the value-added tax (VAT).

The exchange rate policy, on the other hand, included the introduction, during the first stage of reforms (in 1990), of a fixed exchange rate in relation to US dollar, and later on, a currency basket and a gradual devaluation of Polish zloty within the range of an admissible deviation from the central exchange rate.

It is evident, therefore, that both fiscal and exchange rate policies have been an additional element of a restrictive monetary policy and their fundamental goal

was to assist the monetary policy in the reduction of the inflation level and in bringing the State budget back to the desired balance. There can be no doubt as to whether the goal itself was set properly, however, as usually in similar situations, a degree to which the implemented financial policy was restrictive, had been basically fixed through decisions made by its architects and executors which is always up to debate and dispute. Of course, it is particular economic results that act as ultimate factors verifying the implemented financial policy and such results can be evaluated from several different points of view. In terms of the issues under discussion in the present study there were both positive and negative phenomena resulting from that policy.

From the perspective of a synthetic study, one can distinguish stages of development (and their effects) within the process of bringing Polish economy to stabilisation and fostering its development during the nineties. Such stages have been presented in the Table 3. As can be seen, we have not attempted to state exactly neither when each of those stages began nor when it ended.

The elements marking the distinguished stages are as follows: the rate of the GDP growth, main phenomena in the area of monetary and fiscal policies as well as basic factors influencing economic situation, mainly from the side of demand (with positive impacts upon the business cycle marked with "+" while negative ones – with "-").

Table 3. Stages of changing economic situation in Poland during transformation

Stage	Occurrence	Monetary policy	Fiscal policy	Most important factors influencing the situation
Stage "0" – 1989	Slowing rate of the GDP growth	Abundance of domestic money. Dollarisation of economy	Budgetary deficit covered in whole by the Central Bank	(+) Investments. (-) Market deficits
Stage I 1990-91	Production collapse and a fall of the GDP. Transformation shock	Shortage of money. High interest rate. Both creditors and creditees unfit for the new situation – credit limitations. Beginning of endogenous money (1990)	Shock variations of the public finances – in 1990, and in 1991 a deep budgetary deficit	(-) A fall in the number of investments (-) A fall in consumption (-) Rebuilding of lost savings (+) Growth of export

Stage II 1992-93	Gradual enlivening of economy and a slow GDP growth	Paying jams. Shortage of money due to the budgetary deficit. Exogenous money anew	A serious budgetary deficit, financed in a large portion by commercial banks	(+) Stopping of the fall and renewed little growth in investments (+) A low growth of consumption (-) Decreasing export
Stage III 1994-95	Quick GDP growth	Growth of the currency reserves. Wholly endogenous money. High cost of the sterilisation of the money market by the National Bank of Poland	Decrease of the budgetary deficit	(+) Considerable growth of export (+) Growth in investments (-) Too slow growth of private consumption
Stage IV 1996-97	High rate of the GDP growth	Over-liquidity of the banking system. Endogenous money. Gradual credit expansion	Decreasing deficit and a primary surplus of the budget	(+) Growth in investments gaining momentum (+) Quick growth of consumption (-) Too slow growth of export
Stage V 1998-99	The fall in the rate of the GDP growth. Renewed growth of unemployment	Restrictive monetary policy. Endogenous money. Pressure towards the appreciation of Polish zloty	Deterioration of situation in the public finances. Fiscal sources of inflation	(+) Public finances deficit (+) Consumption credit (-) Fall in export (-) Slowing rate of growth in investments (-) Current account deficit

Source: Data prepared by K.Ryć, Warsaw University School of Management, 2000.

The initial status of the economy at the outset of the system transformation and macroeconomic stabilisation we have marked as the "stage 0". Among its main characteristics there was a disastrous situation in the financial area and within public finances. Abundance of domestic money combined with high inflation resulted in a widespread dollarisation of economy. Bank accounts run in foreign currencies constituted a large portion of financial resources of people and enterprises. Moreover, large amounts of foreign currencies were present in the market in the form of cash.

A crash of the domestic currency took place as an effect of its excessive issue. A high budget deficit was financed almost wholly by a credit given by the

National Bank of Poland. The rate of economic growth was slowing down as a result of the total lack of stabilisation, market pressures and shortages on the side of supply. Among the factors maintaining the economic growth rate one should mention investments made by the State-owned enterprises and by companies from the private sector, stimulated by a negative real interest rate (interest rate on credits was way below the inflation rate).

The shock caused by the restrictive monetary policy implemented from the early 1990 and by its consequences following from the introduction of the convertibility of Polish zloty and its high devaluation, resulted in a fall of domestic demand, a fall of import and a growth of export. A positive situation of the State budget in 1990, attained as a result of price arbitrary made by enterprises (high prices – low wages) turned into a deep deficit as early as in the next year. Therefore, even the expected budgetary deficit failed to maintain demand during the first year of transformation. The process of rebuilding of the lost savings taking place relatively early was a peculiar phenomenon (it seems that this was an example of the so-called Pigou effect, consisting, generally speaking, in a growth of the savings rate under the circumstances of a fall of real income). Domestic money resources kept growing as a consequence of turning the foreign currency reserves into cash (in 1990).

The ensuing enlivening of economy in 1992-93 (stage II) was based upon a gradual rebuilding of consumption and investments, that is of domestic demand. On the other hand, the fall of export was a factor slowing down this growth which was also hindered by the occurrence of strong paying jams. A credit given by the central bank for the budget was again the main exogenous factor behind the accretion of money.

The stage III was a period of largely positive quantity and quality changes in economy. A high rate of the GDP growth was mainly due – looking from the perspective of factors upon which demand depends – to the export and investments made at the time while a slow growth of consumption has to be seen as a factor slowing the process down. The accretion of money – just as during the subsequent stages – was of an endogenous character.

During the stage IV a further quick growth of the GDP was observed, however the factors behind this growth on the side of demand were changing: the importance of investments grew, even compared to the previous stage, and a quick growth of consumption took place. On the other hand, the rate of the GDP growth was slowed down by the slower growth of export. Therefore – unlike in the previous stage – domestic absorption was dominating.

Stage V, *i.e.* the period covering the years 1998-99 was mainly marked by a chain of negative occurrences. Demand was largely shaped by private consumption and the publics finance deficit. Decreasing export as well as a lowering of the rate of investment growth – in relation to two previous stages –

acted as factors turning the business cycle towards the worse. The rate of the GDP growth and in particular of industrial production falls down. Unemployment began to grow again and, beginning in September 1999, a growth of inflation occurred as well. As already mentioned above, among other factors contributing to general worsening of the economy results there were also some international problems such as the Russian crisis in particular. However – as we point it out below – in our opinion the basic reason for that situation was in the lack of consequence in policy mix, that is of fiscal, monetary and the exchange rate policies.

Among positive attainments of the period under consideration the following may certainly be included:

- A decrease of inflation to a one-digit level (8.6% in 1998). Although this success has not been maintained in 1999, when inflation grew again to 9.8%, nevertheless there has still been a chance to put it down again to around 5% in the year 2000.
- Maintaining, for a couple of subsequent years a relatively high (although gradually decreasing) rate of the Gross Domestic Product growth (6.8% in 1997, 4.8% in 1998 and 3.8% in 1999).
- Decreasing the budgetary deficit to the level of –2.7% of the GDP in 1998 and –2.2% in 1999, which made it possible to meet one of the criteria stipulated for in the Maastricht Treaty.
- Decreasing of the rate of unemployment starting from the level of 16.4% in 1993 and maintaining it within the range of 10-12% until 1998, although in 1999 this level was unfortunately exceeded with the unemployment as of the end of that year rising to the level of 12.8%.
- Strengthening of Polish zloty both in the national (a decrease of the economy dollarisation) and in international forum (growth of the level of foreign assets denominated in Polish zlotys).
- Maintaining a public debt at the level below 60% of the GDP, which meets another criterion of the convergence with the Maastricht Treaty.
- Maintaining a safe level of the foreign currency reserves (around US dollar 27 billion as of the end of 1998 and around US dollar 25 billion as of the end of 1999).
- Increasing the level of confidence in Polish economy shown by foreign investors which resulted in a considerable growth of foreign direct investments (c. US dollar 30 billion as of the end of December 1999 which can be calculated as c. US dollar 595 *per capita*).

On the other hand, the following have to be regarded as the most important weaknesses of the so far implemented economic policy:

- Too high level of interest rates both seen from nominal and from real perspective. Real interest on credits in 1998, calculated in relation to the

expected next year inflation amounted to as much as 14% and in 1999 its level was only slightly lower (in the range of 10-12%). Most likely this was the single most important reason for a nearly two-fold growth of the private sector foreign indebtedness in 1998 (up to circa US dollar 14 billion and up to c. 20 billion by the half of 1999 which resulted in total Polish foreign debt increasing in the half of 1999 to around US dollar 57.4 billion). As implies from the earlier consideration in this study – and similarly to situations that have taken place in other countries – such a situation may constitute a threat of a possible crisis. This fact may become particularly dangerous in the case of a depreciation of Polish zloty, made for example in the need to increase competitiveness of Polish goods and services in order to improve the balance of current account. Also in practice such a situation means that cost of service of the foreign currency debt would rise which has been one of the main reasons of financial crises in several countries.

- High cost of service of the domestic debt, caused, among other factors, by the high interest rates. In order to service this debt the government has issued bonds which – as may easily be concluded – has exerted a serious influence upon variations of price of money at the turn of 1999/2000, causing its rise. Such situations have usually resulted in domestic businesses increasing their foreign debt even further.
- A relatively high share of nomadic capital in the securities market – which may not be regarded as dangerous at present, however, combined with the possibility of a new issue of the treasury notes for the need of financing the budgetary outlays, it may become a serious threat of a loss of liquidity.
- A large deficit in foreign trade.
- An improper structure of assets of the banking system. The share of credits in total assets constituting around 70 per cent is standard in the market economy countries, while in Poland that share constitutes at present around 38-42 per cent which, in the light of a low capitalisation of the Warsaw Stock Exchange (c. 8-10% of the GDP) should be seen as a serious problem for Polish companies, making it difficult for them to acquire investment assets. It seems that this is one of the main reasons for two further phenomena: firstly, companies becoming mutually indebted (as shown in the recent studies, companies have financed each other in around 50-60 per cent), and, secondly, the already-mentioned indebtedness of Polish businesses abroad. This situation is dangerous for Polish banks as well as it means that they incapable of competing, to a sufficient degree, against foreign banks not only in terms of capital, but, furthermore, in terms of their credit-giving skills. In other words, while giving credits on a limited scale only, Polish banks fail to gain a sufficient experience in this field.

- **Legal regulations**

Apart from purely economic instruments, introduced as a consequence of the reforms that had been made and aiming at protection, at least within certain limits, of Polish economy from the outside shocks, also some sound legal regulations in the areas of the capital flow, convertibility of Polish currency, banking supervision and in other areas played an important role in such protection. Looking from a very general perspective it can be said that as a result of a very limited, far from full, convertibility of Polish zloty a limited capacity of Polish foreign currency market has acted as a kind of a fuse protecting from the inflow of an excessive amount of foreign venture capital. The fact that Polish financial (capital, monetary and currency) market was very shallow at that time also proved helpful in this respect since any important changes in it have been easily detected by the appropriate supervising bodies thus enabling to give a quick response on the part of the still sensitive central bank or of the Securities Board. It should nevertheless be remembered that, firstly, such operations are relatively expensive and, secondly, in the light of the agreements signed by Poland a considerable liberalisation is going to take place in this area.

- **Financial system**

The attainment of the goals previously set for the economy policy was further facilitated by the two-grade banking system, introduced at the beginning of 1990's. The most important features of this system was separation of the central bank functions from those of commercial banks as well as the imposition of a prohibition of financing the budgetary deficit through the central bank credits. Such a solution made it possible, firstly, to control the amount of money in circulation by the implementation of an appropriate interest rate policy and, during the second half of 1990's, by carrying out operations of the open market, and, secondly, made it possible to take a qualitatively new attitude towards financing the budgetary deficit through the issue of the treasury notes. Maintenance of licences for banking activities both on the part of foreign and domestic businesses was another important feature of the reformed banking system. Such a solution allowed the monetary authorities to control the flow of foreign capital providing them, at the same time, with an opportunity to counteract possible financial upheavals originating in foreign markets and influencing Polish market.

Nevertheless, while indicating a positive role of the banking system in the process of bringing Polish economy during 1990's to stabilisation, one should also mention some of its weak points which soon in the future can occur a serious hindrance making it more difficult to attain goals of a stable and smart

economic growth. Generally speaking, the following can be regarded as the most important problems of the banking system in Poland:

1. A low degree of capital concentration. The biggest Polish banks: PKO bp, PeKaO S.A., BGŻ and BH have controlled less then 50 per cent of the banking sector capital, while seven banks having mainly Polish capital and assets in excess of PLN 10 billion possessed, in July 1998, around 66 per cent of total assets. In most Western European countries four or five banks control as much as 75-80 per cent of total capital in the banking system; such a situation being illustrated by Germany, United Kingdom, Spain etc. One of the basic strengths of a high capital concentration in the banking system is the fact that it can exert an influence upon the development of the monetary policy of a given country. There is a common belief that strong banks have been the best examiners of the country's financial policy and, at the same time, they are the best partners in developing a strategy of such policy.

2. A low degree of capitalisation as compared to developed countries. Only three Polish banks are ranked among the world's 1000 largest banks in terms of amount of capital (namely: BH, PKO bp and PeKaO S.A.) and all of them are in very far places in this ranking. For example, PeKaO SA is in the 347th place with the assets valued at c. US dollars 14.2 billion, while HSBC Holdings, the largest bank in the world as of the end of 1997, had the assets valued at US dollars 473.6 billion. As indicated in the World Bank Report published at the end of 1997, the assets of Polish banking system accounted for only 5 per cent of total assets of the banking system in Spain.

3. Technological backwardness and still a small number and low quality of bank products. Although it should be stressed very firmly that progress taking place in the field of computerisation of the banking sector in Poland has been really huge during the last couple of years, nevertheless it still remains very far to the level of development of the banking systems in the well-developed Western European countries including, in particular, those of the European Union. In Poland it still happens that clearings and information systems even in the largest and most esteemed banks "collapse" and, as a result, carrying out simple operations requiring from the bank customers few minutes under normal conditions, lasts a couple of hours or even days. The number and quality of products, compared to that offered by well-developed banking systems, also is still far less than satisfying. Some of those objections can certainly be explained and even regarded as justifiable, in the light of, among other things, the non-existence for several dozens of years, of firm connections between Polish banks and the outside world. Therefore there were no practical possibilities to have a share in creating events occurring in international financial markets and, in some cases, even the lack of opportunity to closely observe such events. This is particularly true in the case of changes taking place in the field of the world

banking, resulting *e.g.* in connection with a deregulation of turnover in international financial markets, an increase of the amount of financial assets in circulation as a consequence of the introduction of the so-called derivative instruments, among other factors. However, that also consists in a problem that could be seen as trivial, but in fact is serious in Polish conditions, namely, the procedures of giving credits by Polish banks. Due to that problem, the process of obtaining a credit, even by a sound company, lasts for not a few weeks but several months. This prompts good customers to leave Polish banks and opt for a better service in foreign banks where a similar credit can be prepared and obtained within two weeks or even in a couple of days. As an effect, Polish banks loose their clients and their skills of giving credits and thus, in the process of integration, they become not only less competitive due to a low level of their assets and own capital, but also due to the level of their skills.

4. A low "credit power", regarded as a relation between credits that can be given and the GDP. It follows from empirical studies that if we take under consideration own capitals of German banking system, in the amount comparable to that existing in Poland, then, basing upon the same capital basis the German system would prove to be four times more efficient than the Polish one. Basing on similar assumptions, the Spanish banking system would occur to be three times more efficient and the Czech one – twice as efficient as the Polish one. Therefore one can go as far as to say that Polish banks express a kind of dislike for giving credits. An analysis of the assets of Polish commercial banks indicates that in some respect their attitude of avoiding giving credits to the non-financial sector has been mainly caused by a high profitability of investments made in bonds issued by the government and in the treasury notes. Such situation additionally distorts the structure of assets of the banking system and decreases its competitiveness.

5. An excess employment combined with a low labour effectiveness. The relation of costs to income is in Poland at 0.84 while the average for the European Union countries is at 0.69. Moreover, also the relation of the labour costs to assets in Poland (1.29) is worse than in most European Union countries (0.78 in France; 0.80 in Germany).

A total of 147 thousand people were employed in Polish banks in 1999, which should be regarded as a serious overmanning from the point of view of relation of the number of those employed to the amount of assets in comparison to the Western countries. It is noteworthy that such an excess in employment would be fully justifiable if the so-called ubankowienie?? in Poland was increased (meaning the share of commercial banks in financial clearings between non-financial businesses). However, this problem is connected with the increase of monetarisation of the economy, that is with the increase of the amount of money in relation to the GDP which accounted for around 38 per cent

in Poland in 1996, while for instance in Germany similar share was above 200%. Furthermore, the above-mentioned luck of banking services in Poland has been a consequence of the existence of a number of niches which have not yet been reached by banks. According to an inquiry carried out by Pentor in 1996 only 46 per cent of people in Poland were the customers of banking services. Although a constant growth is observed in this respect (by 6 percentage points in 1996) but this still remains very little if compared to the Western European countries. Looking upon this situation in real terms this means that around 13.5 million Poles takes no advantage of banking services at all.

Conditions and Dilemmas of Polish Economic Policy at the End of 1990's

In the light of the above analysis of the present status of the economy and the reasons of financial crises taking place at a recent time in different regions of the world one can say that in virtually all cases – perhaps with the exception of Russia – main economic indicators (*i.e.* the GDP growth rate, levels of domestic and foreign investment, of employment and of consumption, the status of the budget, etc.) featured, soon before a crisis occurred, a situation that has been generally regarded in the literature as satisfactory or even good. In all the cases under analysis basic weaknesses were those of foreign trade deficit, maintenance of the fixed currency exchange rates (mainly as an instrument of the arbitrary anchor, high cost of service of domestic debt and underdeveloped banking systems. The latter weakness mainly consisted either in low capitalisation or in underdevelopment of the institution of banking supervision or in the combination of both elements.

Unfortunately, a closer analysis of Polish economy indicates similar situation in Poland in some of the above listed areas, except problems relating to banking supervision to which no objections can be made so far. Of course, there are also some clear differences between Poland and countries affected with financial crises and they are to the advantage of Polish situation. Among the most important differences one should mention a healthier structure of the capital flowing in from abroad and in particular a high share of direct investments in it. Furthermore, the indebtedness of companies is low although recently it has begun to grow quickly, as mentioned above. Also, the public debt is at a relatively low level as is national foreign debt. All those factors make Polish economy less sensitive to financial crisis but still it is far from being wholly slump-resistant. The deficit in the foreign trade balance, which has been visible recently, as well as the high costs of service of the domestic debt and a downfall, at the turn of 1998 and 1999, of production in 20 of 29 sectors of national economy combined with the growth of unemployment perhaps don't

have to be regarded as full symptoms of an imminent crisis but nevertheless such information should be given serious consideration before decisions on the economic policy for the next couple of years are made. Therefore, weakening of the real area of economy took place in Poland without occurrence of a true financial crisis.

Following the downfall in industrial production at the turn of 1998/99, in the second half of 1999 industrial production began to grow again, however, despite optimistic expectations, the early in 2000 the rate of its growth decreased again. Also the situation upon the labour market seriously aggravated at a recent time. In January 1999 the growth of unemployment was experienced, rated as the largest since mid-1997, reaching the level of 11.4 per cent compared to 10.4 per cent in December 1998. At the end of 1999 the level of unemployment in Poland peaked at 13 per cent and as the first data for the year 2000 indicate, an even further growth of unemployment is likely.

Apart from the above-listed factors, which can be described as internal conditions, there also exists a set of external conditions resulting from international agreements signed by the Polish government over the period of recent years. Among those having particular importance one should mention agreements concluded between Poland and the OECD and the European Union in the areas regarding freedom of capital flow, external convertibility of Polish currency, principles on ruling an exchange rate, freedom of establishment and operation in Poland of financial institutions from the European Union member states, etc. In the light of those agreements Poland should have removed most of the limitations in those areas by the end of 1999. While on the one hand doing so can undeniably contribute to improvement of the quality of financial services offered in the Polish market, but, on the other hand, it is going to limit the autonomy of the internal economic policy and render Poland at least partially dependant on the flows of foreign capital. This is another very important issue which should be settled: which sources of financing of the economic growth should be stressed: domestic or foreign ones? Additionally, in giving answer to that question, one should keep in mind that, beginning from the year 2001, Poland will have to start the repayment of its debt (postponed for several years) towards both the Paris Club and the London Club and that debt amounts to around US dollar 7-8 billion *per annum*.

Does Poland, under those circumstances, need an expansive or a restrictive financial policy? Or perhaps just a sound, reasonable financial policy? Can one say, modifying what A. Greenspan, the head of the Federal Reserves once said, that as a result of a well-reasoned policy mix Poland can remain a peaceful island on a raging sea? This set of questions is of major importance and answers thereupon should incessantly be searched for. It seems that in an attempt to perform this task at least partially a question should be asked once more,

whether an implementation of the hitherto exercised, restrictive financial policy has brought the expected results; in other words, whether the goals set for that policy have been fully attained. It further seems that it is not possible to give an equivocal answer to that question, for a couple of reasons.

Firstly, the rate of the GDP growth although relatively high as compared top other well developed countries, showed a downward tendency recently. This seems to put into doubt the previous expectations according to which the process of equalisation of the level of economic development between Poland and the EU countries would be a prompt one. Why does it happen like this? Did the above-analysed financial crises exert a fundamental influence upon Polish economy, causing the rate of its development to slow down? Have the restrictive monetary and fiscal policies, exercised as an attempt to protect Polish economy from a similar crisis, caused the downfall of the economic growth rate, causing further negative effects as well, in the form of the dangerous growth of unemployment and a renewed increase of inflation, while giving back practically no guarantee that such a crisis would be avoided? Unfortunately, it seems that the answer to those questions has to be positive, since as the statistic data indicate, Poland's economic co-operation with the countries affected by the crises accounts for only a small portion of its international economic co-operation as a whole. The largest part of Poland's foreign trade is that with the European Union countries where not only no crises have taken place but, to the opposite, the economic growth rate was higher than expected back in 1997. For example, in the European Union in the years 1996-98 the growth ratio reached 1.7%, 2.6% and 2.7% respectively. Therefore we may assume that the excessively restrictive financial policy, which, as put forth in the official statements, was the policy aiming at cooling of the economy, in fact proved to be one of the factors hindering economic growth.

Generally speaking, its restrictiveness consisted in the maintenance of high interest rates, high obligatory reserve rates and relatively high tax rates. This not only resulted in slowing down the rate of the economic growth but also caused an increase of internal debt of businesses and of the private sector foreign debt. Additionally, slowing down the rate of the economic growth caused the growth of unemployment. The latter situation seems particularly negative if we look at it together with the necessity to carry out structural changes in the agricultural and food industry sectors which is going to result in a further increase of unemployment.

The appreciation of the Polish zloty, being the effect of maintaining high interest rates, weakened the Polish export and contributed to the fact that a high level of import was maintained, having further negative influence on the level of employment.

Secondly, a low level of inflation has been attained, at least in 1998, through the practice of purposeful maintaining of prices of agricultural products on a low level rather than through the implementation of a sound monetary policy. For example, prices for hogs in January 1999 were as much as nearly 40 per cent lower than in January 1998. Also lower were the prices of rye (by 22%), wheat (by 17%), poultry (by nearly 10%) and milk (by 5%). Since it is known that expenses for food account for around 35-38% of total expenses of an average household in Poland it is easy to explain what was the main reason of weakening the inflation pressure. Another argument confirming such a statement is provided by the fact that during the last four years there never was a positive correlation between the growth of the amount of money in circulation and the inflation. According to the data presented by the National Bank of Poland, the amount of money in the period of the last four years grew by circa 25-30 per cent per annum that is by several percentage points more than previously assumed and the inflation was falling down. This phenomenon leads us to seek other, non-monetary sources of inflation. There is a lot of evidence that what we have experienced in Poland for some time already is – at least partially – a cost inflation and a fiscal inflation, resulting from the high price of capital, while purely monetary instruments have still been used to counteract it.

Thirdly, the balancing of the budget has been attained, at least in part, at the cost of imposing limits on the budgetary outlays appropriated for the weakest portion of the budgetary area, *i.e.* on education, health care etc. One should add in this place that the State budget expenses on education and scientific and scholar research in Poland account for as little as 0.4 per cent of the total outlays. Poland should no longer keep expenses for these areas on such a low level, especially as it intends to access the European Union and to meet other development challenges present at the end of the 20th Century. Thus, the country has to cope with a two-fold task: how not to reduce such expenses and, furthermore, how to increase its income. Additional income could be earned through an increase of the tax base and through prosperity of that base, that is of businesses and households. This, however, is dependant, to a large degree, on whether a proper financial policy is in place, aiming in the first rank at assisting the high rate of the economic growth. Of course, we are not going to suggest a financial policy which is too expansive and which could result in a renewal of inflation. What we have in mind is rather a sensible policy mix either consisting in a more restrictive monetary policy and more expansive fiscal policy or – conversely – depending on particular situation. The fiscal policy proved successful to a certain degree in 1988, however the success wasn't repeated in 1999. Due to a renewed loss of transparency of the public finance it became difficult to univocally assess the real level of the public finance deficit.

Fourthly, stabilisation as well as the appreciation of Polish zloty contributed, on the one hand, to an increase of the level of confidence to the Polish currency, which eventually resulted in a relatively large inflow to Poland of both long-term and nomadic capital (the latter one occurs dangerous in many cases due to its high mobility). On the other hand, however – as already mentioned – a relative appreciation of the Polish zloty deteriorated the current account balance and the trade balance. Much has already been written on the threats appearing as a consequence of the negative trade balance; one should possibly add only one thing: that the negative trade balance can be justified if the import of investment goods prevails, since in such a case one may assume that those goods are going to cause machinery renewal soon in the future as well as contribute to the quality improvement of products leading eventually to almost classic process of bringing the trade balance back into the right order. However, as the recent studies and data indicate, in the case of Poland consumption and supply goods account for a large portion of the total import. It should furthermore be stressed that the exchange rate policy in the Polish case will play a major role in the near future as well. Coming to the right relation between the Polish zloty and the euro and providing a right answer to the question on whether the range of variations within the zloty-euro relation should be small or large are among most important issues in this area. As follows from the initial consideration in this respect, the latter one should be relatively large because this way the Polish monetary authorities would acquire at least a certain margin enabling them to utilise the foreign currency exchange rate in order to improve the competitiveness of Polish economy. Therefore, that issue should be reflected already during at the stage of negotiation on conditions of Poland's accession to the European Union.

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