

## 20. POLAND

### Leading the pack in the recovery phase

#### Resilience confirmed

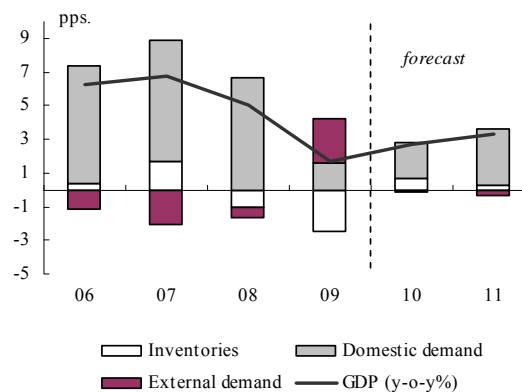
The economic performance of the Polish economy was strong in 2009, with real GDP increasing by 1.7%, only positive growth rate in the EU. Real GDP growth remained positive throughout the year and accelerated in the last quarter of 2009, when it reached 1.2% q-o-q. This exceptional performance during the crisis reflects a constellation of favourable factors including sound fundamentals at the onset of the crisis, a well-capitalised and sound financial sector, the relatively low degree of openness of the economy, a sizeable depreciation of the Polish currency at an early stage of the crisis, the cushioning effect of real-wage adjustment on employment, and timely reactions from monetary and fiscal policies. While some of these factors are temporary in nature – with the worsening of the fiscal position the margin for supportive fiscal policy disappeared, and the exchange rate has been appreciating since the spring – most of them are set to continue to fuel growth in the coming quarters.

In addition, the effects of the global crisis on potential growth are expected to be less pronounced than in other countries of the region. First, the lower dependence of the Polish economy on the financial services, construction and automotive industries has led to a lower incidence of bankruptcies and more limited destruction of capital stock. Second, there are indications that Poland's flexible wage setting mechanism (compared with the previous slowdown of 2000-01) is likely to help limit the increase in structural unemployment through hysteresis. The sharper-than-anticipated adjustment of real wages has indeed mitigated the effects of the downturn on employment leading to a less-pronounced rise in the unemployment rate than was initially expected. Moreover, labour supply will benefit in coming years from recent structural reforms (reduction of the tax wedge, abolition of special early pensions for a majority of beneficiaries, and effects of the pension reform). Finally, the pronounced increase of public investment is also expected to boost potential output.

Another reason for optimism is that the Polish financial system has resisted the global financial crisis well. This owes largely to the conservative behaviour of banks before the crisis in terms of

lending practices and investment strategies. Moreover, prudent financial system supervision and the incentive to build up capital by retaining profits accumulated in the previous year have contributed to reinforcing the robustness of the banking system (the capital adequacy ratio reached 13.3% at the end of 2009). The impact of financial stress on the economy, although reflected in tightened credit conditions, has been limited by the low indebtedness of the private sector, in particular corporates, and the lower-than-expected impact of the slowdown on profitability. All in all, following the moderate decline of credit to enterprises towards the end of 2009,<sup>(78)</sup> the most recent bank-lending survey points to a possible stabilisation in the coming quarters. Credit growth to households could still decelerate in response to the labour-market situation, the increased share of non-performing loans, and the tightened regulatory framework.

Graph II.20.1: Poland - GDP growth and contributions



#### Poland to fully benefit from the improvement in the global economic environment

The outlook features a continued recovery in 2010 and 2011. Real GDP is projected to increase by 2.7% in 2010 and 3.3% in 2011. The main drivers of this recovery are the ongoing rebound in global trade and foreign capital inflows, the latter reflecting the lower risk aversion in international capital markets and the improved perception of the Polish economy among foreign investors. The smooth adjustment of the labour market to the crisis and still-accommodative monetary

<sup>(78)</sup> Nominal lending denominated in PLN to non-financial corporations declined by ca. 3% at the end of 2009.

conditions are also expected to support the recovery.

Like elsewhere in the region, rising external demand is projected to boost exports. However, this demand effect is likely to be partly offset by the impact of the appreciating currency (14% against the euro over February 2009 - February 2010), which may also stimulate imports following the large drop observed in 2009. While it is still forecast to weigh on real disposable income and consumption, the situation of the labour market is less of a concern than initially expected. The prospects of recovery and the recent reforms that reduced labour costs and favoured adjustment of real wages, seem to be mitigating the effects of the downturn on employment. The unemployment rate is now expected to peak at about 9.4% of the labour force, instead of 10% in the autumn forecast. Finally, investment spending is set to be positive in 2010, with the planned acceleration of capital formation in the public sector and higher FDI inflows compensating for the weakness of domestic private investment in the immediate post-crisis environment. Inflation is expected to fall in 2010, reflecting the large negative output gap following the crisis, contained wage pressure, a limited rise in administered prices and the appreciating currency.

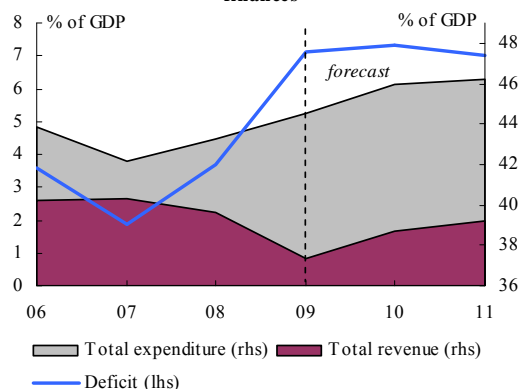
The recovery is expected to gain momentum in 2011. This reflects external factors (continued recovery of the world economy and a further increase in FDI), but also the stabilisation of the situation in the labour market (which will stimulate demand by households), and the improved absorption of EU funds (several projects will need to be finalised ahead of the 2012 European soccer championship). Moreover, with a more sustained recovery, projected loosening of credit conditions and growing capacity utilisation, corporates should start to invest again.

The sizeable current-account deficit of 5% of GDP in 2008 improved to 1.6% of GDP in 2009 amid a sharp contraction in domestic demand for durable and investment goods (which constitute the majority of Polish imports), and a less-pronounced decline in external demand for Polish consumption goods, not least because of a strong zloty depreciation. The current-account deficit is expected to gradually increase to 3.3% of GDP over the forecast horizon, reflecting the rebound in domestic demand, the lagged effects of

appreciating zloty, and improved profitability of foreign-owned companies.

This scenario is subject to both upside and downside risks. On the positive side, a stronger rebound in global demand would boost exports and investments. The steady improvement in growth and employment prospects could also imply lower precautionary savings by households than assumed in the forecast. On the negative side, a delayed loosening of credit conditions could hamper investment and consumption in the quarters ahead. In addition, the public finances' situation, if not addressed, could affect market sentiment adversely, and increase the costs of borrowing also for the private sector.

Graph II.20.2: Poland - General government finances



While the Polish economy has remained surprisingly resilient during the crisis, key challenges for the years ahead will be to secure steady competitiveness gains, continue the catching-up process and maintain macroeconomic stability. Exchange-rate depreciation has played a key role in supporting growth during the crisis, but its role will gradually vanish with the return of foreign capital to emerging markets (this will put upward pressure on the zloty). Thus, the competitive position of the Polish economy will depend on the continuous upgrade of the export structure towards capital-intensive and high-technology industries. To this end, domestic driven productivity improvements, generated by investments in R&D and fostered by more flexible labour and product markets, will have to play an even more important role than in the past. This would also contribute to fostering the sustainable convergence of Polish GDP per capita towards the average EU level.

### Public finances in the red

The headline government deficit, which had been reduced to below 2% of GDP in 2007 after several years of strong growth, widened to 7.1% of GDP in 2009. This very sizeable increase in the deficit reflects the operation of automatic stabilisers during the crisis as well as the impact of stimulus measures of about 2% of GDP, which included a cut in personal income tax and an increase of investment in infrastructure. Despite measures taken to contain the increase in the deficit in 2009 (reduction of administrative expenditure and increase of dividends from state-owned enterprises), the structural balance deteriorated by more than 2 pps., reaching about 7¼% of GDP.

Under current policies and growth forecasts, the headline government deficit is set to stabilise over 2009-11. It should deteriorate marginally from 7.1% of GDP in 2009 to about 7½% of GDP in 2010, and advance to 7% of GDP in 2011. The difference of -0.4 pp. in the projected deficit for 2010, compared to the latest projection by the national authorities, is explained mainly by lower projected tax revenues due to a less dynamic growth scenario. The structural deficits are set to decrease moderately from 7¼% to 5¾% of GDP over the period, reflecting favourable growth composition towards end of the forecast horizon

and the impact of consolidation measures announced so far. The foreseen worsening of government finances in 2010 mainly reflects an increase in government expenditure, which is not fully compensated on the revenue side. Both the expenditure and the revenue ratios are forecast to grow in 2010, reflecting the financing by EU structural funds of public investment projects. The projected rise in the revenue ratio also reflects an increase in excise and quasi-excise duties (on cigarettes and fuel). In 2011, the expenditure ratio is projected to grow marginally by 0.2 pp., mainly on the back of rising investment and interest expenditure. Developments in expenditure in 2010 and 2011 may be worse than projected in this forecast, given a possible escalation of spending pressures ahead of and after presidential and general elections.

As a consequence of the high deficits, gross debt is forecast to increase from slightly more than 47% of GDP in 2008 to approximately 59½% in 2011. The projected debt figures are subject to significant uncertainty because of the high volatility of the exchange rate and the ensuing valuation effects of the foreign-denominated part of the debt. Finally, interest expenditure may turn out to be higher than projected, which would further limit the room for manoeuvre on the fiscal side.

Table II.20.1:

#### Main features of country forecast - POLAND

	2008			Annual percentage change						
	bn PLN	Curr. prices	% GDP	92-05	2006	2007	2008	2009	2010	2011
GDP	1272.8		100.0	4.3	6.2	6.8	5.0	1.7	2.7	3.3
Private consumption	785.2		61.7	4.2	5.0	4.9	5.9	2.3	1.5	2.7
Public consumption	236.3		18.6	3.1	6.1	3.7	7.5	1.2	3.0	-0.1
Gross fixed capital formation	280.9		22.1	6.3	14.9	17.6	8.2	-0.3	3.0	8.0
of which : equipment	107.9		8.5	-	17.1	22.3	10.9	-6.9	-1.0	4.5
Exports (goods and services)	508.9		40.0	10.7	14.6	9.1	7.1	-9.1	6.0	5.8
Imports (goods and services)	559.5		44.0	11.2	17.3	13.7	8.0	-14.3	6.3	6.7
GNI (GDP deflator)	1243.8		97.7	4.5	5.5	5.6	6.4	0.7	2.2	3.3
Contribution to GDP growth :										
Domestic demand				4.5	7.0	7.2	6.7	1.6	2.1	3.4
Inventories				0.0	0.4	1.7	-1.1	-2.5	0.7	0.3
Net exports				-0.2	-1.1	-2.1	-0.6	2.7	-0.1	-0.4
Employment				-	3.2	4.4	3.8	0.4	0.0	0.6
Unemployment rate (a)				15.2	13.9	9.6	7.1	8.2	9.2	9.4
Compensation of employees/head				18.0	1.8	4.9	8.1	3.7	3.2	4.4
Unit labour costs whole economy				-	-1.1	2.6	6.9	2.4	0.5	1.7
Real unit labour costs				-	-2.5	-1.3	3.8	-1.2	-1.7	-0.7
Savings rate of households (b)				-	-	9.5	6.3	8.3	8.2	7.8
GDP deflator				13.8	1.5	4.0	3.0	3.7	2.2	2.4
Harmonised index of consumer prices				-	1.3	2.6	4.2	4.0	2.4	2.6
Terms of trade of goods				0.2	-0.3	2.0	-2.1	5.0	-1.0	-0.5
Trade balance (c)				-3.0	-2.0	-4.0	-4.9	-1.0	-1.2	-1.7
Current account balance (c)				-1.9	-3.0	-5.2	-5.0	-1.6	-2.8	-3.3
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-1.2	-2.1	-4.1	-4.2	0.0	-0.8	-1.0
General government balance (c)				-	-3.6	-1.9	-3.7	-7.1	-7.3	-7.0
Cyclically-adjusted budget balance (c)				-	-4.0	-2.8	-4.6	-6.9	-6.5	-5.7
Structural budget balance (c)				-	-4.0	-2.8	-4.6	-7.2	-6.3	-5.7
General government gross debt (c)				-	47.7	45.0	47.2	51.0	53.9	59.3

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.