COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 18.2.2009
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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 9 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated convergence programme of Poland, 2008-2011

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. In particular, it introduced greater flexibility in the application of the rules governing the excessive deficit procedure, notably with regard to definition of "exceptional circumstances" and the setting of deadlines for the correction of an excessive deficit.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes.

2. BACKGROUND FOR THE ASSESSMENT OF THE UPDATED PROGRAMME

The Commission has examined the most recent update of the convergence programme of Poland, submitted on 30 December 2008, and has adopted a recommendation for a Council opinion on it.

In order to set the scene against which the budgetary strategy in the updated convergence programme is assessed, the following paragraphs summarise:

(1) the Commission Communication of 26 November 2008 ("A European Economic Recovery Plan").

(2) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the convergence programme).

2.1. The Commission Communication of 26 November 2008 ("A European Economic Recovery Plan")

In view of the unprecedented scale of the global financial and economic crisis, the European Commission has called for a European Economic Recovery Plan (EERP)[2]. The plan proposes a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to € 200 bn. (1.5% of EU GDP), made up of a budgetary expansion by

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1 OJ L 209, 2.8.1997, p. 1. The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

2 Communication from the Commission to the European Council of 26 November 2008 - COM(2008) 800.

Member States of € 170 bn. (around 1.2% of EU GDP) and EU funding in support of immediate actions of the order of € 30 bn. (around 0.3 % of EU GDP); and (ii) a number of priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth. The plan calls for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability of government finances and competitive positions. In particular, for Member States outside the euro area with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008. In this context, Member States were asked to submit an addendum to their updated stability or convergence programme, so as to reflect the measures taken in the context of the Recovery Plan. The examination of how measures (budgetary measures as well as structural measures) contribute to the recovery process in the short term, is made in the opinions of stability and convergence programmes.

2.2. The assessment in the Council opinion on the previous update

In its opinion of 8 July 2008, the Council summarised its assessment of the previous update of the convergence programme, covering the period 2007-2010, as follows: The overall conclusion was that "following the correction of the general government deficit in 2007 and while the deficit and the debt will remain below the reference values of respectively 3% and 60% of GDP, the programme envisages a deterioration of the general government balance by 0.5 percentage point of GDP in 2008 and a back-loaded progress towards the MTO in the following years in a context of favourable growth prospects. In 2008, the projected structural deterioration by almost ½ percentage point of GDP is not in line with the Stability and Growth Pact. Given the risks to the budgetary targets from 2009, mainly due to a lack of specified measures, the MTO may not be achieved by 2011 as planned in the programme. Moreover, should inflationary pressures emerge, a tighter fiscal stance than foreseen in the programme would be required. As regards the long-term sustainability of public finances, Poland appears to be at low risk, but the early retirement system is in need of reform". In view of this assessment and the need to ensure sustainable public finances, the Council invited Poland to "exploit the favourable growth conditions to strengthen the pace of structural adjustment towards the MTO, including in the light of possible inflationary pressures, by using any extra revenue and unspent resources for deficit reduction in 2008 and by specifying and implementing measures, especially on the expenditure side, in the following years".

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On the updated convergence programme of Poland, 2008-2011

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[3], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [10 March 2009] the Council examined the updated convergence programme of Poland, which covers the period 2008 to 2011.

(2) The Commission services' January 2009 interim forecast projects GDP growth to decrease from 5% in 2008 to around 2% in 2009 mainly on account of the global financial crisis. The deterioration in global trade flows affects Polish export-oriented sectors, while the financial crisis hampers FDI activity and limits the availability of external financing to both the financial and non-financial sector. The relatively high share of foreign currency denominated mortgages brings an additional drag on private consumption in times of marked currency depreciation, while the Polish construction sector suffers from falling prices and demand in the housing market. After hiking interest rates in the first half of 2008 (from 5.25% in January 2008 to 6% in June 2008) the National Bank of Poland eased monetary policy by cutting interest rates to 5% in the last two months of 2008. The nominal effective exchange rate of the Polish zloty depreciated by 11.2% during 2008. In view of the economic slowdown the government has adopted a number of expansionary measures (chiefly tax reductions and a surge in public investment) both ahead of the crisis and after its effects became visible. The planned fiscal measures will stimulate both aggregate demand in the short term and strengthen the supply side of the Polish economy in a longer term. A

3 OJ L 209, 2.8.1997, p. 1. The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

deterioration of the general government deficit by about 1 percentage point to 3½% of GDP in 2009 is foreseen in the Commission services' January 2009 interim forecast. In the absence of corrective measures, the deficit will decline only marginally in 2010.

(3) The macroeconomic scenario underlying the programme envisages that real GDP growth will slow down from 5.1% in 2008 to 3.7% in 2009 before recovering to an average rate of 4.2% over the rest of the programme period. Assessed against currently available information[4], this scenario appears to be based on markedly favourable growth assumptions for 2009 and thereafter, as it is based on an optimistic assessment of export market growth and does not take fully into account more recent information pointing to a further deterioration in the economic situation. In particular, little attention is paid to the situation of foreign currency denominated loans and housing market developments, while the programme appears to downplay the effect of a decreasing credit growth on private investment. The programme's projections for inflation are realistic.

(4) For 2008, the general government deficit is estimated at 2.5% of GDP in the Commission services' January 2009 interim forecast, as targeted in the previous update of the convergence programme. This is basically the result of lower revenue growth in 2008 (consistent with the lower estimated GDP growth), offset by less dynamic expenditure.

(5) The general government deficit is planned to improve to 2½% of GDP in 2009 according to the December 2008 convergence programme, compared to a deterioration to 3½% projected in the Commission services' interim forecast based on a less favourable macroeconomic scenario. The estimated net expansionary effect on the budget from discretionary measures exceeds 1 percentage point, including specific measures adopted in response to the economic downturn ("Stability and Development Plan" announced on 30 November 2008). The deterioration projected in the Commission services' forecast, results mainly from automatic stabilisers, as the structural deterioration is estimated at about ⅓ percentage point. Having in mind the uncertainty around the real-time output gap estimation and the estimation of the budgetary sensitivity to the output gap, the relatively low structural deterioration results from a changing composition of tax revenues in Poland, which will resist better to the economic slowdown than suggested by average budgetary sensitivities.

(6) The medium term goal of the December 2008 convergence programme is to keep general government balances below 3% of GDP in a sustainable way, reducing them gradually in the programme period, with a headline general government balance target of −1.9% in 2011. Due to the significant deterioration in the macroeconomic scenario, the achievement of the medium-term budgetary objective consistent with the nominal deficit targets, which is a general government structural balance (cyclically-adjusted balance net of one-off and other temporary measures) of −1% of GDP, is postponed beyond 2011, the target year in the previous update. The adjustment path is based on sizeable expenditure reductions, by 1.5 percentage points of GDP, while the revenue ratio is decreasing by 1 percentage point. However, the expenditure-reducing measures are not specified in the programme. The programme projects a reduction of the debt ratio from almost 46% of GDP in 2008 to less than 45% in 2011 (with a 0.7

[4] The assessment notably takes into account the Commission services' January 2009 forecast, but also other information that has become available since then.

percentage point decrease in the last year of the programme). This contrasts with the Commission services' interim forecast which projects a steep increase of the gross debt ratio from 45½% in 2008 to slightly less than 50% in 2010. The differences are mainly explained by different forecasts for the evolution of the primary deficit.

(7) The budgetary outcomes projected in the programme are subject to downside risks. The favourable assumptions regarding GDP growth lead to an optimistic estimate of revenue growth throughout the programme period. In particular, the expected revenues from direct taxes and revenues other than taxes, social contributions or property income in 2009 are on the high side. The macroeconomic scenario of the programme appears to assume that the fiscal stimulus measures in 2009 (personal income tax reduction and a surge in public investment) are very effective in fuelling growth. This may not fully materialise because high-income households with a comparatively high propensity to save benefit most from the tax reform and there may be an underexecution of investment as in previous years. In addition, certain expenditure such as social transfers and subsidies may rise more than expected in 2009. For the outer years, the planned spending restraint is subject to risks in view of (i) the electoral cycle and (ii) the lack of information on concrete reform measures.

(8) Although, based on the convergence programme, the budgetary position in 2008 includes a small structural primary deficit, the long-term budgetary impact of ageing is among the lowest in the EU according to the projections made in 2005, which are based on the common methodology. Recent reforms, however, tend to raise expenditure in the long-term. Maintaining high primary surpluses over the medium term would contribute to limiting the risks to the sustainability of public finances, which are currently at a low level.

(9) The overall track record of the budgetary framework is good when it comes to respecting the budgetary targets. However, this is largely the result of strong growth and sizable windfall revenues in recent years as well as an unintended underexecution of expenditure plans (mainly investment). The convergence programme refers to a planned amendment of the public finance law, which includes a reduction of the amount of autonomous public funds not directly controlled by central or local authorities, obligatory multiannual budgetary plans for the central state budget and local authorities as well as modified fiscal rules. In addition, the programme confirms the planned implementation of performance budgeting with a gradually increasing institutional coverage. These are steps in the right direction although the expected impact is limited.

(10) In response to the financial crisis, the Polish government adopted a number of measures to ensure the stability of the financial sector. The guarantees for bank deposits have been significantly increased, with € 50 thousands as a new threshold. The main measure, which is the increase in the ceiling for guarantees for inter-bank and corporate loans (by almost 2% of GDP), are envisaged for 2009 only and therefore planned to be temporary. In addition, the government planned capital injection (about 0.15% of GDP) to the state-owned BGK bank, intended for increasing loans to small and medium-sized enterprises.

(11) In line with the EERP agreed in December by the European Council, the fiscal stimulus measures planned by the Polish government aiming at aggregate demand stimulation through increased public investment in infrastructure, should also be

beneficial for long-term potential growth and thus public finances. The personal income tax cut reduces the tax wedge, though mainly for high-income tax-payers. These stimulus measures are not temporary. Given the risk of a high fiscal deficit, but still relatively resilient growth, as indicated by the Commission services' interim forecast, the fiscal stimulus package for 2009 adopted by Poland is an adequate response to the economic downturn. However, all the planned measures need timely adoption by the government and parliament and implementation. As regards the structural measures, the sustainability of public finances will be improved by the replacement of early pensions with less costly "bridge pensions". Poland has also taken measures to improve the quality of public finances (a new public finance law strengthening budgetary rules and the control over autonomous funds, and further implementation of performance budgeting). These measures are related to the medium-term reform agenda and the country-specific recommendations proposed by the Commission on 28 January 2009 under the Lisbon Strategy for Growth and Jobs.

(12) The projected fiscal stance is mildly expansionary for 2009 and restrictive for 2010. A too expansionary stance in 2009 could result in higher interest expenditure because of risk aversion towards emerging markets. The planned measures may be insufficient to ensure the accomplishment of the envisaged adjustment after 2009. Moreover, the budgetary strategy should be backed up with specific deficit-reducing measures in 2010 and 2011.

(13) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides all required and most of the optional data[5].

The overall conclusion is that Poland is planning adequate fiscal stimulus measures, some of which are not temporary. The planned measures will stimulate both aggregate demand in the short term and strengthen the supply side of the Polish economy in a longer term. Given the optimistic GDP growth forecasts, the budgetary outcomes projected in the programme are subject to downside risks, according to the Commission forecasts, throughout the whole period covered by the current update. In addition, for the outer years, the planned spending restraint will have to be backed up with specified measures, as appropriate.

[5] In particular, the projections on employment in hours worked or labour productivity in hours worked are missing. The table on cyclical developments does not include a split in the contributions from labour, capital and total factor productivity to potential growth. This gap results from the national method used for estimating potential GDP (HP filter rather than production function). The table on long-term sustainability of public finances does not contain projections for total expenditure, occupational pensions in general government, total revenue, property income, and pension reserve fund assets. The table with sectoral balances does not include the statistical discrepancy. In addition, the presented non-compulsory estimation of the pension reform cost is not consistent with the difference between the general government deficit as reported until March 2007 (when the funded pension schemes were included in the general government) and after that date (when the funded pension funds were excluded from the general government). The cost reported in the current programme appears overestimated due to the inclusion of foregone revenues and extra expenditure not directly related to the pension reform.

In view of the above assessment and also given the need to ensure sustainable convergence, Poland is invited to:

(i) implement the stimulus measures in line with the EERP as planned, while ensuring that the deficit remains below 3% of GDP in 2009;

(ii) back up the budgetary strategy with specific deficit-reducing measures for 2010 and 2011;

(iii) reinforce the budgetary framework through better control over expenditure, including the swift implementation of the amended public finance act and performance budgeting.

Comparison of key macroeconomic and budgetary projections

		2007	2008	2009	2010	2011
Real GDP (% change)	**CP Dec 2008**	**6.7**	**5.1**	**3.7**	**4.0**	**4.5**
	COM Jan 2009	6.7	5.0	2.0	2.4	n.a.
	CP Mar 2008	*6.5*	*5.3*	*5.0*	*5.0*	*n.a.*
HICP inflation (%)	**CP Dec 2008**	**2.6**	**4.2**	**2.9**	**2.5**	**2.5**
	COM Jan 2009	2.6	4.2	2.9	2.5	n.a.
	CP Mar 2008	*2.6*	*3.5*	*2.9*	*2.5*	*n.a.*
Output gap[1] (% of potential GDP)	**CP Dec 2008**	**1.3**	**1.0**	**−0.1**	**−0.6**	**−0.5**
	COM Jan 2009[2]	2.2	2.2	0.1	−1.1	n.a.
	CP Mar 2008	*1.1*	*0.7*	*−0.2*	*−0.9*	*n.a.*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**CP Dec 2008**	**−3.6**	**−4.0**	**−1.8**	**−1.3**	**1.5**
	COM Jan 2009	−3.6	−4.1	−3.5	−2.9	n.a.
	CP Mar 2008	*−2.6*	*−3.5*	*−4.2*	*−4.6*	*n.a.*
General government revenue (% of GDP)	**CP Dec 2008**	**40.0**	**39.8**	**40.7**	**40.0**	**39.7**
	COM Jan 2009	40.0	39.6	40.2	40.3	n.a.
	CP Mar 2008	*40.0*	*40.0*	*39.2*	*38.7*	*n.a.*
General government expenditure (% of GDP)	**CP Dec 2008**	**42.0**	**42.6**	**43.2**	**42.4**	**41.7**
	COM Jan 2009	42.0	42.1	43.8	43.7	n.a.
	CP Mar 2008	*42.0*	*42.5*	*41.2*	*40.1*	*n.a.*
General government balance (% of GDP)	**CP Dec 2008**	**−2.0**	**−2.7**	**−2.5**	**−2.3**	**−1.9**
	COM Jan 2009	−2.0	−2.5	−3.6	−3.5	n.a.
	CP Mar 2008	*−2.0*	*−2.5*	*−2.0*	*−1.5*	*n.a.*
Primary balance (% of GDP)	**CP Dec 2008**	**0.5**	**−0.3**	**0.1**	**0.2**	**0.5**
	COM Jan 2009	0.5	−0.2	−1.2	−1.3	n.a.
	CP Mar 2008	*0.2*	*−0.2*	*0.3*	*0.8*	*n.a.*
Cyclically-adjusted balance[1] (% of GDP)	**CP Dec 2008**	**−2.5**	**−3.1**	**−2.5**	**−2.1**	**−1.7**
	COM Jan 2009	−2.8	−3.4	−3.7	−3.0	n.a.
	CP Mar 2008	*0.6*	*0.5*	*0.1*	*−0.1*	*n.a.*
Structural balance[3] (% of GDP)	**CP Dec 2008**	**−2.5**	**−3.1**	**−2.5**	**−2.3**	**−1.7**
	COM Jan 2009	−2.8	−3.4	−3.7	−2.9	n.a.
	CP Mar 2008	*−2.2*	*−2.7*	*−2.1*	*−1.4*	*n.a.*
Government gross debt (% of GDP)	**CP Dec 2008**	**44.9**	**45.9**	**45.8**	**45.5**	**44.8**
	COM Jan 2009	44.9	45.5	47.7	49.7	n.a.
	CP Mar 2008	*44.9*	*44.2*	*43.3*	*42.3*	*n.a.*

Notes:

[1] Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2] Based on estimated potential growth of 5.2%, 4.9%, 4.2% and 3.7% respectively in the period 2007-2010.

[3] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.2% in 2010, deficit-increasing, and zero for other years according to the most recent programme and the Commission services' January 2009 interim forecast.

Source:

Convergence programme (CP); Commission services' January 2009 interim forecasts (COM); Commission services' calculations.