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Poland:
Soft landing ahoy

Fiscal consolidation is likely to slow down growth in Poland in the coming years. The economy still benefits from its size, versatility and relative closeness – as well as from its exchange rate and labour market flexibility. The good financial standing of the business and banking sector should support growth. However, the ambitious nature of the incipient fiscal consolidation programme and the return of restrictive monetary policy will act as brakes on growth.

In the wake of decelerating growth in private consumption (and a decline in the volume of public consumption), overall GDP growth slowed down in the first quarter of 2012. The first quarter's GDP growth rate was the lowest recorded over the past two years, despite the continuing palpable expansion of gross fixed investment and the marked increase in inventories. Foreign trade developments were also favourable; although the volume of both exports and imports grew at a slower rate than in 2011, export growth outstripped that of imports. Net exports contributed positively - by 0.7 percentage points (p.p.) - to overall GDP growth in the first quarter of 2012. Both gross fixed investment and the increase in inventories contributed 0.8 p.p. each, while private consumption contributed 1.4 p.p. The increase in gross value-added, (GVA), [the volume of which rose by 3.2% in toto] was particularly pronounced in the construction sector (close to 10%). GVA in industry increased by 3.4%.

The enterprise sector (non-financial firms operating outside agriculture and employing 49 persons or more) performed quite well in the first quarter of 2012. Although the sector's liquidity and profitability indicators worsened slightly, its net profits overall reached PLN 23.6 billion (roughly equivalent to EUR 5.7 billion): 7% more than the year before. Exporting enterprises perfomed better than their non-exporting counterparts. Although exports grew at a much lower rate than the year previous (in terms of both volume and value), they yielded higher profits. No doubt this reflects the relative weakness of the Polish currency as well as the current gains in unit labour costs (repressed growth in wages). The growth slowdown in the euro area has not yet affected Polish exporters, one factor being that hitherto growth in Germany, Poland's most important export market, has not overly slowed down. In 2011, the enterprise sector's attitude towards the expansion of productive capacities changed. After some two years of pre-emptive accumulation of idle cash balances, the sector started to expand its fixed asset investments quite forcefully. That trend continued during the first quarter of 2012. The sector's outlays for fixed investment (PLN 17.6 billion) rose by more than 12% in real terms over the same period in 2011. The upswing in the propensity to invest is especially visible in mining, market services and manufacturing, yet that same propensity is fast receding in the construction sector. The latter development marks a response to the gradual reduction in public-sector infrastructural (chiefly transportation) investment that has been planned for the next few years[1]. Purchases of machinery and equipment, as well as means of transport, account for close to two thirds of the total investment outlay.

The financial standing of the banking system remains comparatively strong. The capital adequacy ratio (CAR) stood at 13% at the end of November 2011. Although CAR is forecast to decline slightly in 2012, its will surely suffice, even if macroeconomic and/or financial conditions deteriorate quite radically. The share of 'endangered' credits in the total stock of credits (7.5% at the end of September 2011) has dropped (from 7.9% the year previous). During the first quarter of 2012 the banking sector accrued net profits close to PLN 4.3 billion (12% up on the same period in 2011). The high profits earned are likely to continue to increase the banks' own capital base, thereby reinforcing their resilience.

During the first four months of 2012, the stock of loans to the non-financial sector remained flat. In real terms, stock contracted (because the stock of foreign-exchange denominated loans was inflated as a result of the weakening PLN). The sluggishness of lending reflects: (i) the entrenched risk awareness on both sides of the loan market; and (ii) the fact that a large share of the corporate sector does not rely on bank credits at all. On average, the sector's financial means exceeds its needs. Of course, access to credit is still a matter of concern to small and medium enterprises, especially those that have just started up. The sluggishness is also a reflection of the stagnation (both actual and anticipated) of real purchasing power that the economy-wide wage-bill and social benefits have also encountered.

Of course, the relatively high interest rates administered by the National Bank of Poland (NBP), which were raised yet again in May 2012,[2] keep market rates at elevated levels: a

1 The GDP share of the publicly-funded investment rose from 4% in 2006 to 5.8% in 2011. From 2012 that ratio will be progressively reduced, to 2.8% in 2015. Much of the investment in question is directly related to the UEFA European Football Championships (organized jointly by Poland and Ukraine) in June 2012.

2 The NBP reference rate currently stands at 4.75% and its deposit rate at 3.25%. The National Bank has resumed its old deplorable habit of combating inflation due to higher indirect taxes and the increase in the cost of imported crude oil by raising interest rates.

further disincentive to expand lending. At the end of March 2012, the average interest rate on loans to firms stood at 6.4% and the average interest on PLN-denominated housing credit (to households) at 7.4%. Given the recent hikes in official rates, commercial interest rates on new loans are likely to follow suit.

Despite the overall good standing of the banking system, some risks persist. At the end of April 2012, the banks' foreign-exchange assets accounted for 24.7% of their balance sheets, whereas their foreign-exchange liabilities accounted for only 17%. This continuing and ever-growing misalignment that is partly due to the weakening PLN points to a more profound structural problem. The non-financial (domestic) sector's deposits in domestic banking at present cover merely 85.5% of the banks' loans and credits to the domestic non-financial sector. The remaining 15.5% of the backing of the banks' stock of loans come from the financial sector – primarily from foreign parent-organisations. An abrupt withdrawal of a sizeable portion of those foreign resources would certainly affect the domestic banks' stability. However, the likelihood of that happening does not seem very high, given the high profit margins (offering over 15% return on equity) still to be earned on banking activities in Poland. More likely, some foreign banking groups facing difficulties outside Poland may have to sell off their local 'daughters' to other parties – including 'native' Polish banks or other financial groups. In any event, the authorities (both the National Bank of Poland and the Financial Supervision Office) are well aware of the potential fragility created by the lack of balance between the stocks of domestic loans and deposits and the presence of foreign-owned banks.

The budget law for 2012 lays down some new restrictions on public-sector spending (especially in relation to social expenditures and local government outlays on the public health service). Public spending on infrastructural investment is already starting to contract. Taxation (mainly in the form of a 2 percentage-point hike in social security contributions that employers have had to absorb, as well as higher indirect tax rates on certain items) has also gone up. Overall, the additional measures introduced by the government should draw in extra budgetary revenues of about 1.5% of the GDP in 2012 (and reduce spending by 0.6% of the GDP). In effect, the fiscal deficit should drop from about 5.1% of the GDP in 2011 to less than 3% in 2012. Fiscal consolidation will continue throughout 2013 and beyond. However, the changes currently legislated will shift the proportions between increases in revenues and cuts in expenditures, since cuts in spending in 2013 will be greater than increases in revenues. In 2015 revenues should account for 37.6% of the GDP (down from about 38.5% in 2011) and expenditures for 38.6% (as against 43.6% in

2011)[3]. In 2015 the public sector deficit should drop to less than 1% of the GDP. The ratio of public sector debt to GDP should fall from 56.4% in 2011 to less than 50% in 2015. The share of debt denominated in foreign currencies will remain unchanged at about 30% of the total, while the average effective interest on the public debt thus reduced will none the less remain constant at slightly over 5% per annum.

The ambitions of the current fiscal consolidation measures extend well beyond 2015. The government is launching a major reform of the pension system, whereby the age of retirement will be progressively (up until 2040) raised to 67 for both sexes; in 2011 men could still retire at the age of 65 and women at the age of 60. According to the government, the pension system reform will not only stabilise the share of public spending on senior citizens (at a level of less than 20% of the GDP) up until at least 2060, it is also expected to contribute to a higher level of overall employment - and hence to more rapid economic growth. Of course, it is rather hard to square expectations of higher employment among an ever-larger number of older people intent upon finding jobs with such manifest empirical facts as the persistently high overall rate of unemployment among the elderly. The rate of unemployment for persons aged 50 or more is 23% - twice the overall unemployment rate. Furthermore, the assumption that output growth will accelerate given a higher rate of employment among senior citizens borders closely on wishful thinking. Of course, increasing the retirement age is not irrational on purely fiscal grounds, as it will obviously permit ‘economisation’ in terms of pension expenses being covered from the public purse (possibly through higher tax levies on income-earners in the future). Those fiscal gains, however, will be secured at the cost of impoverishing large segments of the future professionally inactive (or unemployed) population. Unable to find any work, older women, will be singularly hard hit [4].

During the global financial crisis, the Polish economy performed well, despite adverse external and internal circumstances (massive floods and other disasters). The country’s GDP rose by 15.6% cumulatively over the period 2007 - 2011, without recording a single quarter with negative growth. In comparison, the cumulative change in output for the entire EU-27 was negative (-0.6%). No other EU country managed to escape deep and prolonged recession of varying degrees. This success had many sources, some certainly

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3 According to the Governmental Convergence Programme, dated April 2012 (accessible, for example, on the website of the Polish Finance Minstry).

4 The actual consequences of the pension reforms will, sooner or later, be well understood by the young (especially those unable to find any work). It will then be fully rational for them to seek residence outside the country – i.e. in places where they can find work now and look forward to something better than outright misery in old age. The unfavourable demographic trend (ageing) is the primary justification for the reform put forward by the government. Ironically, the reform could strengthen that very trend by inducing a higher rate of emigration among the young and able.

beyond governmental control. Governmental inaction, however, may well have been a decisive factor. During its first term, the Tusk government launched but one reform worth mentioning (yet it only entered into effect in 2011). More importantly perhaps, for all its hawkish rhetoric, the government did not address the issue of a rising public-sector deficit as much as it could have. On the contrary, despite continuing GDP growth, public-sector revenues fell from 40.3% of the GDP in 2007 to 37.2% in 2009. Public spending, however, rose from 42.2% to 44.5% over the same period. Consequently, the public sector deficit rose from 1.9% of the GDP to 7.4% in 2009. As was to be expected, the public debt rose from 45% of the GDP in 2007 to 56.3% in 2011. Arguably, the increase in public debt was the price paid for maintaining growth which otherwise could have been negative – as was the case throughout the rest of Europe. By allowing the automatic stabilisers to take effect during the difficult period, the Polish economy has sailed through dangerous waters with flying colours. It is quite possible that the reverse process now being set in motion – that of fiscal consolidation with expectations of the debt/GDP ratios being swiftly reduced – will also bolster Poland's growth. Such a providential outcome, however, need not necessarily materialise. It is much more likely that fiscal consolidation – especially as currently executed under generally worsening external conditions – might slow down growth. That growth slowdown is then likely to result in failure to reach the fiscal consoldation targets envisaged.

Certainly, even if fiscal consolidation proceeds as planned in 2012-13 and generates the usual Keynesian recessionary impulses, the country can still continue growing, albeit at a somewhat slower pace. In the near term, private export-oriented investment (sustained by prospects of handsome profits to be made) can still drive overall growth. Later on, that role could be passed on to net exports (the dynamics of which could be supported by further gains in unit labour costs owing to depressed wages and depreciating currency). Of course, this moderately positive scenario for Poland assumes reasonably stable developments in the euro area – most particularly in Germany.

Table PL

Poland: Selected Economic Indicators

	2008	2009	2010	2011 1)	2011 1st quarter	2012 1st quarter	2012 Forecast	2013 Forecast	2014 Forecast
Population, th pers., average 2)	38126	38152	38184	38230	38204	38207	38217	38204	38185
Gross domestic product, PLN bn, nom.	1275.4	1344.4	1416.4	1524.7	349.4	370.5	1620	1700	1790
annual change in % (real)	5.1	1.6	3.9	4.3	4.6	3.5	2.3	2.4	2.6
GDP/capita (EUR at exchange rate)	9500	8100	9300	9700	.	.	.	.	.
GDP/capita (EUR at PPP)	14100	14300	15300	16200	.	.	.	.	.
Consumption of households, PLN bn, nom.	773.8	809.7	856.2	921.9	233.6	247.6	.	.	.
annual change in % (real)	5.7	2.1	3.1	3.2	3.2	2.1	1.7	2	2.5
Gross fixed capital form., PLN bn, nom.	283.9	284.6	281.3	307.9	42.3	46.6	.	.	.
annual change in % (real)	9.7	-1.3	-0.4	8.1	4.0	6.7	6	5	6
Gross industrial production (sales) 3)									
annual change in % (real)	2.6	-3.7	11.1	6.9	9.1	4.7	4	5	6
Gross agricultural production (EAA)									
annual change in % (real)	0.4	5.9	23.9	1.2	.	.	.	.	.
Construction industry 3)									
annual change in % (real)	9.8	4.7	3.9	15.5	18.7	13.8	.	.	.
Employed persons - LFS, th, average	15799.8	15868.0	15960.5	16130.5	15875.0	15981.0	16210	16370	16530
annual change in %	3.7	0.4	0.6	1.1	1.9	0.7	0.5	1	1
Unemployed persons - LFS, th, average	1210.7	1411.1	1699.3	1722.6	1771.0	1883.0	.	.	.
Unemployment rate - LFS, in %, average	7.1	8.2	9.6	9.7	10.0	10.5	10	9.5	9
Reg. unemployment rate, in %, end of period	9.5	11.9	12.3	12.5	13.3	13.3	13	13	12.5
Average gross monthly wages, PLN 4)	2942.2	3101.7	3224.1	3399.5	3478.9	3668.5	3560	3690	3900
annual change in % (real, gross) 4)	5.9	2.0	1.4	1.2	0.4	1.3	1	1	3
Consumer prices (HICP), % p.a.	4.2	4.0	2.7	3.9	3.6	4.2	3.8	2.5	2.5
Producer prices in industry, % p.a.	2.4	3.9	2.3	7.5	7.7	5.8	4	3	2.5
General governm.budget, EU-def., % GDP									
Revenues	39.5	37.2	37.5	38.5	.	.	.	.	.
Expenditures	43.2	44.5	45.4	43.6	.	.	.	.	.
Net lending (+) / net borrowing (-)	-3.7	-7.4	-7.9	-5.1	.	.	-3.5	-3.0	-3
Public debt, EU-def., in % of GDP	47.1	50.9	54.8	56.3	.	.	55	54	53.5
Central bank policy rate, % p.a., end of period 5)	5.0	3.5	3.5	4.5	3.8	4.5	4.5	4.3	4.0
Current account, EUR mn 6)	-23818	-12153	-16486	-15914	3134	-3623	-15500	-18000	-18700
Current account in % of GDP 6)	-6.6	-3.9	-4.6	-4.3	3.5	-4.1	-4.0	-4.4	-4.3
Exports of goods, BOP, EUR mn 6)	120953	101715	124998	139209	33780	35900	149600	160800	173700
annual growth rate in %	14.2	-15.9	22.9	11.4	16.7	6.3	7.5	7.5	8
Imports of goods, BOP, EUR mn 6)	141896	107140	133893	149317	35673	37973	160500	173300	187200
annual growth rate in %	18.5	-24.5	25.0	11.5	17.4	6.4	7.5	8	8
Exports of services, BOP, EUR mn 6)	24207	20717	24718	26573	5754	5905	27900	30100	32500
annual growth rate in %	15.2	-14.4	19.3	7.5	19.2	2.6	5	8	8
Imports of services, BOP, EUR mn 6)	20729	17294	22381	22233	4901	4965	23300	25600	27600
annual growth rate in %	17.9	-16.6	29.4	-0.7	11.8	1.3	5	10	8
FDI inflow, EUR mn 6)	10135	9339	6699	10333	3829	-2770	.	.	.
FDI outflow, EUR mn 6)	3071	3331	4149	3723	1983	-1186	.	.	.
Gross reserves of NB excl. gold, EUR mn	42299	52734	66253	71028	71720	70626	.	.	.
Gross external debt, EUR mn	173736	194396	236018	249072	245344	.	.	.	.
Gross external debt in % of GDP	47.8	62.6	66.6	67.3	66.3	.	.	.	.
Average exchange rate PLN/EUR	3.5121	4.3276	3.9947	4.1206	3.9435	4.2322	4.15	4.15	4.15
Purchasing power parity PLN/EUR	2.3746	2.4703	2.4247	2.4654	.	.	.	.	.

Note: Gross industrial production, construction output and producer prices refer to NACE Rev. 2. Gross agricultural production refers to Economic Accounts for Agriculture (EAA).

1) Preliminary. - 2) From 2011 according to census March 2011. - 3) Enterprises with 10 and more employees. - 4) Quarterly data refer to enterprises with 10 and more employees. - 5) Reference rate (7-day open market operation rate). - 6) Including Special Purpose Entities (SPEs).

Source: wiiw Database incorporating Eurostat and national statistics. Forecasts by wiiw.