

20. POLAND

Mild recession knocking at the door

Strong growth continued in 2008 on the back of domestic demand

Economic activity continued to be relatively robust in 2008. Driven by domestic demand, real GDP growth eased to 4.8% from 6.6% in 2007. Growth was fuelled by private consumption (5.3%) and investment (7.9%). Export and import growth decreased to 5.8% and 6.2% in real terms, respectively. Net exports contributed negatively to GDP growth (-0.3 percentage points) on account of strong private consumption and a deteriorating external environment.

Strong consumption activity in the second half of the year was backed by rising employment and wages. However investment activity decelerated as business confidence and industrial output stalled. In consequence, quarterly data indicate a further GDP growth deceleration in the fourth quarter of 2008 to 3.1% year-on-year.

The Polish financial sector, which is dominated by foreign universal banks, has witnessed a deterioration in funding opportunities, while the strong depreciation of the Polish currency has somewhat negatively affected the situation of households indebted in foreign currencies and even more severely some companies involved in FX options operations.

Lower degree of openness and public investment will cushion the effects of external developments

GDP is expected to contract by 1.4% in 2009. Compared with other countries in the region this is

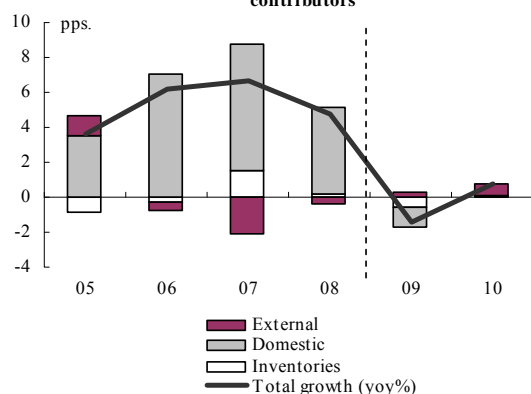
a relatively mild recession thanks, among other factors, to the lower share of trade in GDP. Exports are expected to plummet by 11% in 2009 due to low external demand in the EU – the main trading partner. While the fall in exports is considerable, it is forecast to remain relatively constrained because of the currency depreciation. In addition, the structure and cost competitiveness of the Polish export industry, specialised in mid-tech, relatively low priced goods, should prove to be an advantage in these times.

The contribution of domestic demand will be negative in 2009 as investment is set to fall by around 6¼%. Investment in equipment will be badly hit because of restricted access to credit, worsening company results and decelerating FDI. Infrastructure investment will benefit from the strong inflow of EU funds and increased public spending, but housing outlays are forecast to contract sharply throughout 2009, as tight access to mortgages will limit demand.

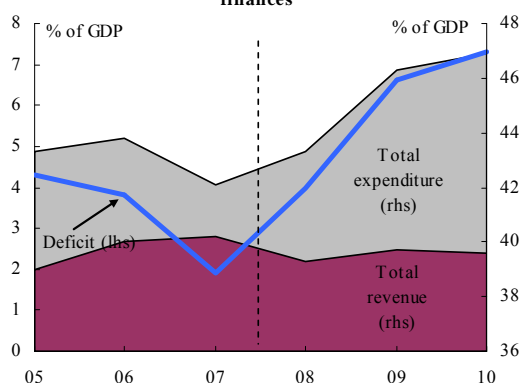
Private consumption growth is expected to slow abruptly to around ½% in 2009. This relatively negative outlook is based on a strong fall in consumer confidence, a sharp increase in unemployment and a reduced availability of credit, as well as on lower wage growth and rising costs of mortgages. Falling investment and exports, decelerating private consumption growth and increasing import prices are set to influence imports which will decrease by 10¾% in 2009.

In 2010, GDP growth is expected to increase marginally by 0.8%, as external demand will positively affect GDP growth, while domestic

Graph 2.20.1: Poland - GDP growth and its contributors



Graph 2.20.2: Poland - General government finances



demand is forecast to be broadly neutral. Equipment investment is set to rebound slightly supported by the improved results of enterprises and FDI inflows, while construction investment will continue to benefit from strong public spending, despite a further contraction in housing outlays.

Private consumption growth is expected to slow to ¼% in 2010 because of a worsening labour market situation. Decelerating private consumption growth and increasing import prices are set to influence imports which will decrease further, by 1½% in 2010. Exports are expected to grow by ¼% in 2010 supported by rebounding external demand and the lagged effects of the recent depreciation.

External imbalances will subdue slightly, with the current account deficit shrinking in 2009 to below 5% of GDP and around 4% in 2010. Thanks to higher transfers from the EU, the external deficit will be limited to around 2¼% of GDP in 2010, which still represents a moderate widening compared with the previous years.

The main downside risk to the forecast results from the depreciation of the Polish currency; this could hamper consumption by foreign-currency-indebted households, increase the financial costs of companies and affect also the inflation outlook.

Employment expected to fall sharply

In the course of 2008 an impressive improvement was seen in the labour market, continuing the trend seen since 2006, as the average annual unemployment rate fell to 7% from 9½% in 2007. Total employment increased by around 600,000 in 2008, but as the participation rate increased the drop in the number of unemployed was limited to 400,000. As economic activity is expected to weaken, employment should fall by 2¼% in 2009 and a further 1½% in 2010, while a return of emigrants, less generous early retirement rules and a reduction of taxes on labour should increase the activity rate. The number of unemployed is projected to reach some 1.7 million in 2009 – close to 10% of the labour force – and to increase in 2010 by about ½ a million, leaving the unemployment rate at around 12%.

Inflationary pressures limited by weakening economic outlook

Annual HICP inflation increased from 2½% in 2007 to 4.2% in 2008, boosted by strong wage pressure and elevated energy and food prices. It is likely to fall sharply, on the back of favourable base effects, stabilising fuel and food prices and weakening growth, to 2.6% in 2009; it should decrease further, to 1.9% in 2010, which remains within the Polish central bank's medium-term target range of 2.5% ± 1 p.p.

Unit labour costs are projected to have increased by about 7% in 2008, as a result of strong wage growth combined with modest productivity increases. In 2009 nominal unit labour costs are likely to continue to rise, albeit at a slower pace, as productivity growth recovers slightly supported by falling employment, especially among the least skilled, while the rise in wages is expected to remain subdued. In 2010 nominal unit labour costs are expected to fall in line with rising productivity and decelerating wage growth.

Fiscal deficit increasing due to automatic stabilisers and discretionary measures

Due to the reduction of social contributions, an increase in personal income tax reliefs for families, a generous indexation of pensions and social benefits and a deterioration of the economic situation towards the end of the year, the general government deficit was expected to widen in 2008. It increased by about 2 percentage points to 3.9% of GDP in 2008, significantly more than estimated in the December 2008 convergence programme (2.7%) and in the Commission services' January 2009 interim forecast (2.5%). In particular, non-tax revenues were much lower (mainly capital transfers due to underexecution of EU funds at the regional level) and intermediate consumption (e.g. military expenditure) much higher than presented in the programme.

Despite an additional reduction of central government expenditure of ¾% of GDP, introduced after the adoption of the 2009 budget, the general government deficit is forecast to deteriorate to about 6½% of GDP in 2009. This is the expected outcome of the recession and discretionary measures. Automatic stabilisers will contribute to an increase in social transfers on top of high statutory growth under new indexation rules referring to high inflation and wages in 2008. Among the stimulus measures, a rise in public

investment, a personal income tax reform and a reduction of the tax burden for businesses are to be costly for the Polish public finances. An increase in excise duties, a reduction in subsidies and the replacement of early pensions with less costly “bridge pensions” will be insufficient to offset the effects of the rapid deterioration of the economic situation and the deficit-increasing measures.

As a consequence of high deficits and still slow privatisation, gross debt is projected to increase sharply from more than 47% of GDP in 2008 to only slightly less than 60% in 2010. The debt projections 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.

In 2010, the general government deficit is expected to further deteriorate to more than 7% of GDP on the back of still weak growth and a further weakening of the labour market as well as a one-off measure (debt cancellation). Also the assumption of no policy change has been applied. In particular, nominal expenditure targets presented in the latest convergence programme are included in the forecast, contributing to an increase of the general government expenditure ratio of about $\frac{2}{3}$ percentage point. This comprises a further increase in social expenditure, due to rising unemployment, and ambitious investment plans which, however, may be revised. Higher risk aversion towards emerging markets and quickly mounting debt are expected to result in an increase in interest expenditure. Finally, possible changes on the revenue side, e.g. raising healthcare contributions, are not considered.

Table 2.20.1:

Main features of country forecast - POLAND

	2007		Annual percentage change							
	bn PLN	Curr. prices	% GDP	92-04	2005	2006	2007	2008	2009	2010
GDP at previous year prices	1175.3	100.0		4.4	3.6	6.2	6.6	4.8	-1.4	0.8
Private consumption	711.8	60.6		4.4	2.1	5.0	5.0	5.3	0.6	0.2
Public consumption	211.0	18.0		2.9	5.2	6.1	3.7	0.0	-0.3	0.7
Gross fixed capital formation	253.8	21.6		6.2	6.5	14.9	17.6	7.9	-6.2	-0.8
of which : equipment	100.3	8.5		-	9.9	17.1	22.7	14.8	-9.2	1.0
Exports (goods and services)	479.6	40.8		10.9	8.0	14.6	9.1	5.8	-11.0	0.2
Imports (goods and services)	512.8	43.6		11.7	4.7	17.3	13.6	6.2	-10.8	-1.5
GNI at previous year prices (GDP deflator)	1130.6	96.2		4.5	4.5	5.5	5.5	5.3	-0.8	0.8
Contribution to GDP growth :										
Domestic demand				4.6	3.4	7.0	7.2	4.9	-1.1	0.1
Stockbuilding				0.1	-0.9	0.4	1.5	0.2	-0.6	0.0
Foreign balance				-0.3	1.1	-1.1	-2.1	-0.3	0.3	0.7
Employment				-	2.3	3.3	4.1	4.0	-2.3	-1.4
Unemployment rate (a)				15.0	17.8	13.9	9.6	7.1	9.9	12.1
Compensation of employees/head				19.4	1.5	1.8	3.7	7.6	3.4	2.1
Unit labour costs whole economy				-	0.3	-1.1	1.2	6.9	2.4	-0.2
Real unit labour costs				-	-2.3	-2.5	-2.7	3.9	0.5	-1.7
Savings rate of households (b)				-	-	5.8	8.1	7.0	9.1	9.8
GDP deflator				14.7	2.6	1.5	4.0	2.9	1.9	1.6
Harmonised index of consumer prices				-	2.2	1.3	2.6	4.2	2.6	1.9
Terms of trade of goods				0.2	1.0	-0.3	2.0	-1.5	-0.4	0.1
Trade balance (c)				-3.1	-0.9	-2.0	-4.0	-4.3	-4.6	-3.9
Current account balance (c)				-1.9	-1.2	-3.0	-5.1	-5.3	-4.7	-3.7
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-1.2	-0.9	-2.4	-4.3	-4.3	-3.1	-2.2
General government balance (c)				-	-4.3	-3.9	-1.9	-3.9	-6.6	-7.3
Cyclically-adjusted budget balance (c)				-	-4.4	-4.6	-3.2	-5.3	-6.0	-5.8
Structural budget balance (c)				-	-4.4	-4.6	-3.2	-5.3	-6.0	-5.6
General government gross debt (c)				-	47.1	47.7	44.9	47.1	53.6	59.7

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