POLISH ECONOMIC OUTLOOK
TRENDS • ANALYSES • FORECASTS
QUARTERLY 1/2009 (40)

Special Feature – Deflation Scare – Not in Poland

EXECUTIVE SUMMARY

The economy most likely entered a recession phase in the 1Q2009, defined as at least two quarters of negative quarterly growth, as we forecast that GDP is likely to decline in the y-o-y terms not only in the 1Q2009, but in the 2Q2009 as well. This view is based on the supply side developments in the 1Q2009. Credit to non-financial firms came to a standstill in the 1Q2009 mainly because of a credit crunch, i. e. problems of credit supply, but firms stopped asking for investment credit as well so demand for credits also fell.

Short-term growth prospects for the economy have markedly worsened since writing the previous report. The latest round of downward revisions to global growth forecasts is probably the last one in this slump, but it also drags down our growth forecasts for the Polish economy. Lately, the rate of decline in output in OECD countries hase been slower than in the 4Q2008 and the beginning of 2009, business confidence improved, but the bottom has not been reached yet. This poses a question mark whether the Polish economy will bottom out in the 2Q2009 as we had thought. We forecast a decline in GDP year on year in the 2Q2009, albeit slower than in the 1Q2009, a resumption of slow growth in the 3Q2009 and its pickup in the 4Q2009 above 2% yoy (Table 1). Recovery should gather strength in 2010, fuelled by the infrastructure investment and exports. Potential GDP growth will not be restored until the late 2010, depending on the strength of the world-wide recovery. Despite a slowdown in average real wage growth and rising unemployment throughout the 2009, consumption growth should remain relatively stable, supported by the decline in personal income tax whose positive impact will be more visible with the lapse of time. The government will likely arrest growth in public consumption in the 2H2009, i.e. after the elections to European parlament, because of the precarious state of public finances, but its strong growth in the 1H2009 should keep it at least unchanged, if not in a positive territory, in 2009. Public investment should pick up in the course of the year to offset the decline in the private investment to a higher and higher degree. This will exert some positive ripple effects on business investment, in particular in non-residential construction. Contrary to the previous forecast, the net export contribution to GDP growth should be positive in all quarters of 2009 as the slowly improving economic prospects in the EU will help Polish firms exploit their competitive edge over foreign companies due to the depreciated zloty despite that the zloty should firm in the course of the year.

The labor market situation in the 1Q2009 seriously deteriorated following the fall in economic growth and widely expected recession. Employment in the so-called enterprise sector decreased by 0.2% yoy in the 1Q2009. It was the first employment reduction in y-o-y terms since the 4Q2004. The situation seems to deteriorate most dynamically in the manufacturing. Following the reduction of expected GDP growth, our forecast concerning the employment growth is also more pessimistic than in the previous PEO issue. We expect that in 2009, on average, employment in the enterprise sector will actually fall by 3.6% yoy and the LFS employment will fall by 1.3% yoy. Wage dynamics is still weakening. We expect the downward trend to last, following the continuing economic downturn. On average, nominal wages will grow in 2009 by 4% – 5% and real wages by about 2%. During 2010 real wage growth on a y-o-y basis can even fall to 1.4%-1.5% you, but then it will start to accelerate reaching the average of about 2% yoy. We expect the registered unemployment rate to reach 12.8% at the end of 2009, while the LFS unemployment rate will probably grow to 9%.

Inflation proved more persistent than we forecasted and Poland is an outlier among the EU countries, where inflation has been consistently downtrending. With demand side pressures in check it was the supply-side-triggered price hikes that led the inflationary process in initial months of the year – although this time they are neither high nor likely to be long-lasting. The CPI inflation rate declined to 3.2% year on year in the first quarter of 2009 from 3.7% in the final quarter of 2008, benefiting from falling prices of fuel, transportation, telecommunication and most market services. Prices of foodstuffs that were primarily responsible for the deceleration of inflation in the second half of 2008, rebounded in January 2009 and have been on the rise since then. Adding to inflationary pressures were prices of energy, continuing their upward trend and peaking in the first quarter at the highest level in more than a decade. Compared to the previous issue of PEO, we significantly raised forecasts of both CPI

Table 1. The Polish economy – main macroeconomic indicators and CASE forecasts

Indicator	Data							CASE forecasts					
	2006	2007	2008	2008				2009				2009	2010
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4		
Nominal GDP, PLN bn	1060.0	1176.7	1271.7	297.8	310.6	314.3	349.0	305.7	319.6	322.2	363.1	1310.6	1380.3
(% change, yoy)													
GDP	6.2	6.7	4.9	6.1	6.0	5.0	3.0	-1.3	-0.5	0.1	2.0	0.0	3.0
Private Consumption	5.0	5.0	5.4	5.6	5.6	5.1	5.3	2.0	2.1	2.7	2.9	2.5	2.0
Fixed Investment	14.9	17.6	8.1	15.7	14.7	3.5	4.4	-10.0	-10.9	-6.4	-2.5	-6.9	1.0
(4Q, % of GDP)													
CA balance	-2.7	-4.7	-5.5	-5.0	-5.2	-5.3	-5.5	-4.1	-3.5	-2.9	-2.5	-2.5	-2.6
(% change, yoy)													
Exports (NBP, EUR)	20.4	13.4	12.7	21.2	19.8	19.5	-7.5	-22.9	-19.0	-17.0	4.8	-14.2	7.0
Imports (NBP,(EUR)	24.0	19.5	14.9	22.5	21.7	22.6	-4.4	-28.9	-25.7	-19.5	-0.6	-19.1	5.0
(% change, yoy)													
Industrial sales	11.2	9.5	3.3	8.5	8.5	3.4	-6.3	-10.0	-5.8	-2.0	1.0	-4.3	2.5
Gross value added	6.0	6.6	5.0	5.6	6.3	4.9	3.5	-1.2	-0.6	0.1	1.9	0.1	3.2
CPI	1.0	2.5	4.2	4.1	4.3	4.7	3.7	3.2	3.8	3.5	3.4	3.4	2.3
PPI	2.3	2.3	2.5	3.0	2.5	2.1	2.4	5.0	5.5	5.5	5.6	5.4	3.3
Nominal Ave. Wage	4.9	8.7	10.4	10.1	11.6	10.6	7.7	6.3	5.3	4.0	2.3	4.4	3.2
Employment %, LFS	3.1	3.1	3.7	4.6	3.5	3.6	3.0	0.7	-1.5	-1.9	-2.4	-1.3	0.0
Registered unemployment rate (%, eop)	14.8	11.4	9.5	10.9	9.4	8.9	9.5	11.2	10.9	11.7	12.8	12.8	14.3
PLN/EUR, eop	3.83	3.58	4.17	3.53	3.35	3.41	4.17	4.50	4.40	4.35	4.10	4.33	3.90
WIBOR 3M, %, ave	4.20	5.68	5.88	6.15	6.65	6.63	5.88	4.17	4.00	3.80	3.75	3.65	4.50
Central bank key rate eop	4.00	5.00	5.00	5.75	6.00	6.00	5.00	3.75	3.50	3.25	3.25	3.25	4.00
(% change, yoy eop)													
Broad Money (M3)	16.0	13.4	18.6	13.6	16.3	17.3	18.6	17.5	15.0	10.0	7.0	7.0	8.5
Loans to HH	33.4	37.9	44.6	37.4	34.4	33.5	44.6	43.7	32.5	20.0	11.0	11.0	9.0
Loans to Firms	13.7	24.1	29.0	25.2	24.5	24.1	29.0	25.8	21.0	13.0	6.1	6.0	5.0
(% GDP)													
Fiscal Balance	-3.9	-1.9	-3.9	n.a.	n.a.	n.a.	-3.9	n.a.	n.a.	n.a.	n.a.	-5.5	-3.7
Public Debt eop	47.7	44.9	47.1	n.a.	43.1	n.a.	47.1	n.a.	n.a.	n.a.	n.a.	52.0	54.0

Sources: CSO (GUS), Eurostat, NBP and CASE own calculations.

and PPI inflation. The factors behind this correction include primarily much higher than expected energy price adjustments in January and February that will impact annual inflation until early 2010, combined with a surprising rebound in prices of foodstuffs.

Taking into account all these factors and associated risks we expect the CPI inflation to rise temporarily in the second quarter to 3.8% year on year and then fall to 3.6% in the third quarter entering the NBP target range of 1.5%-3.5% in the summer. Inflation will remain close to the upper bound of the range in the 4Q2009 (3.4%) to fall sharply in early 2010 to below 3%, reflecting the high base from early 2009, and remain just below the mid-point of the range from the second quarter onwards. On the annual level this produces inflation of 3.5% and 2.3% in 2009 and 2010.

A strong rise in state expenditure and a negligible rise in state revenue in the 1Q2009 suggest that fiscal policy became strongly expansionary in the 1Q2009. This is related to the work of automatic stabilizers as well as to a deliberate action of the government that simply moved expenditure to the first months of the year. However, the government projection of the deficit looks increasingly unrealistic under recession as its forecast was based on a much better performance of the economy. The government will have to overhaul its budget in the middle of the year, but this fact has already been discounted by financial markets and it has little economic merit. We forecast the central government cash deficit will grow to 41 bn zlotys in 2009 or 3.1% of GDP, estimated at around 1310 bn zlotys. The public sector deficit may exceed 5%-6% of GDP in 2009. The original 2009 deficit plans were consistent with the intent to adopt the euro in 2012, but this date is beyond reach at present.

Unprecedented drops in exports and imports in the 1Q2009 should not be matched in the coming quarters as conditions will slowly start improving in the external environment of Poland, and the much depreciated zloty will allow Polish companies to exploit their competitive edge. The latter is the main reason why Polish exports fell less than imports despite shallower recession in Poland than in partner countries. The current account was near balance in the 1Q2009 and this augurs its substantial decline in the course of 2009 to 2-3% of GDP from 5.5% of GDP in 2008. These developments will underpin the zloty that is fundamentally undervalued so it will gradually strengthen over 2009 an 2010.

LATEST DEVELOPMENTS IN THE POLISH ECONOMY

Economic growth

The economy most likely entered a recession phase in the 1Q2009, defined as at least two quarters of negative quarterly growth, since GDP is likely to decline in the y-o-y terms not only in the 1Q2009, but in the 2Q2009 as well. This view is based on the supply side developments in the 1Q2009.

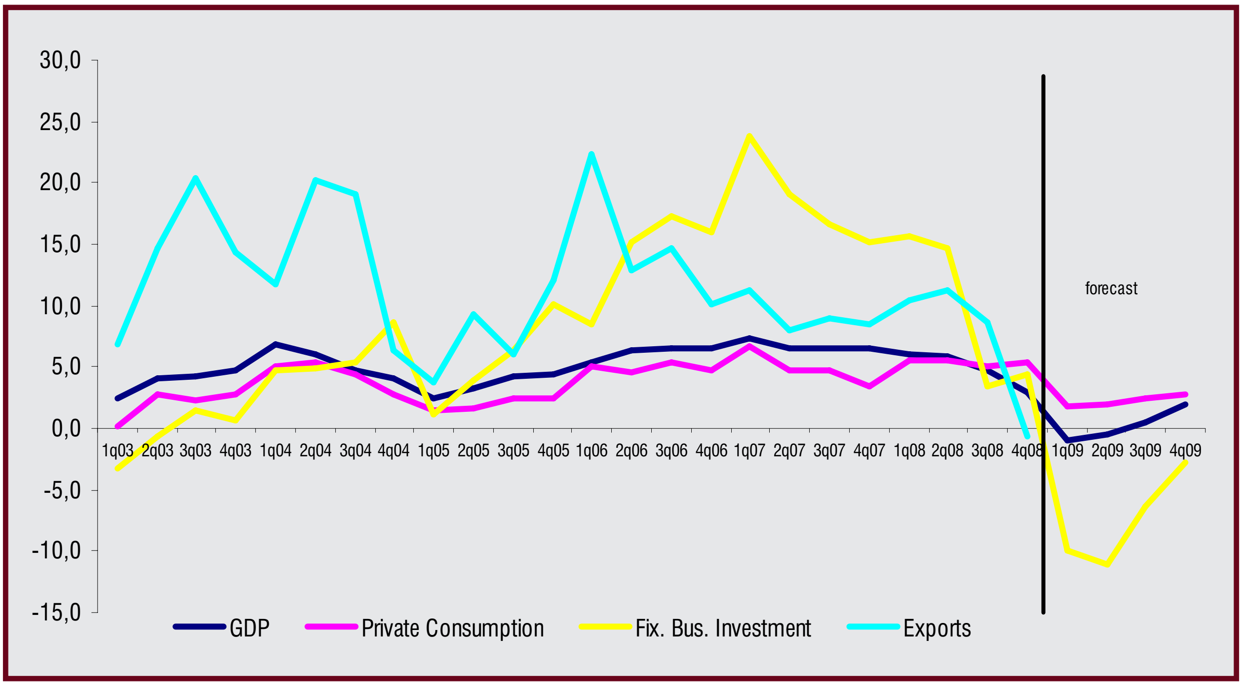
According to the preliminary data, economic activity weakened in the 1Q2009. Industrial output of firms with at least 9 employees fell by 10% yoy in the 1Q2009, dragged down by mining whose output fell by 16.7% yoy, but on par with that of manufacturing, in which sales decreased by 9.9% % yoy, pulled down by dwindling exports. Construction registered a 1.3% yoy drop in its sales. Retail sales fell by 0.9% yoy in stores with at least 9 employees, which translates into a decline in real terms by 1.4% yoy. Wholesale turnover was down by 9.4% yoy in the same period. The quantities of goods shipped declined by over 13% yoy in the 1Q2009. Altogether the abovementioned sectors have a share of 57-58% in the total valued added in the economy. Based on this data, we estimate that GDP decreased by 0.5% to 2.0% yoy in the 1Q2009. Since we have been consistently slightly overoptimistic on growth since the global downturn started, we are tempted to suggest a point forecast at the bottom of this range, i. e. -1.5% yoy, but since we have no probability distribution of hypothetical performance, we stick to the rule of the arithmetic average of two extremes.

The global crisis has been transmitted mainly by two channels: foreign trade (a collapse in foreign demand) and credit markets (frozen). We focus on the first one while the impact of the second channel is discussed in the section on Monetary Developments. Exports of goods and services dropped 13.8% yoy in euro terms, causing a slump in manufacturing. Since imports fell even faster in the 1Q2009, we estimate the overall contribution to growth by the external side of the economy was slightly positive, contrary to the 4Q2008. It is tempting to explain this phenomenon by the significant depreciation of the real exchange rate (see the section on Balance of Payments), as GDP in Poland declined, markedly less than in main partner countries or regions such the euro zone or Russia, UK and Ukraine.

Private consumption was a driver of growth as had been expected and will continue to do so. However, it came likely a bit lower than our previous prediction of 2.2% yoy. This downward revision is not related to lower disposable incomes on a year ago, which rose quite considerably since real pay increases were still around 3% in real terms, personal income taxes were cut and pensioners received a considerable compensation for the 2008 inflation and wage growth though the latter occurred in the final month of the quarter. Adjusted for the rise in unemployment whose average rate was not different in the 1Q2009 from its rate in the 1Q2008 (see section on the Labor Market), there was every reason to expect the private consumption to grow by around 3% yoy. Our previous forecast took into account the adverse impact of the scare about the crisis, but it looks now that the negative impact of the overwhelming fear for unemployment was higher than previously „guesstimated". We forecast, therefore, that private consumption grew by 2.0% yoy instead of 2.2% yoy.

Surprisingly, the newly revised GDP data point to a strong pickup in public consumption in the 4Q2008, contrary to the previous release. It actually grew by 14.1% yoy and by 7.6% yoy, whereas it had originally been reported to increase 3% yoy and 0.0%, respectively. This leads to significant changes in our forecast of it. Judging by a large growth of state budget outlays year on year in the 1Q2009, and taking into account that public sector, in particular administration, did not shed any labor force, strong growth may have continued in the 1Q2009. The share of public consumption in GDP in the first quarter of the year fluctuates around 19% so its rise by 5% yoy – 10% yoy would add almost 1% yoy -2% yoy to economic growth. Such outcome is possible.

Figure 1. GDP Growth Factors, quarterly % yoy



Revised GDP data point as well to a small drop in inventories by PLN 0.9 bn in the 4Q2008, contrary to the previous report when a rise of PLN 8 bn was reported. This correction sheds new light on the business cycles developments as it means that Polish firms started reducing excessive inventories in late 2008 so the inventory cycle should be in full swing in the 1Q2009. Therefore we forecast that gross capital formation in the 1Q2009 (aka gross investment in the USA) will be a strong drag on GDP performance, and fell more than in our previous forecast. It also decreased significantly more than the fixed business investment. In turn, private fixed business investment was mostly driven by the inertia of the process in the 1Q2009, i. e. continued projects and replacement investment, but new projects were in a short supply. Public investment improved somewhat, compared to the 1Q2008, as the data on the use of the EU funds point to, but its size could only partially, if not only fractionally, offset the collapse in business fixed investment.

Short-term growth prospects for the economy are bad and they have markedly worsened since writing the previous report. The latest round of downward revisions to global growth forecasts is probably the last one in this slump, but it also drags down our growth forecasts for the Polish economy. It will likely continue contracting in the 2Q2009, either year on year or quarter on quarter, the slippage exacerbated by the prolonged deep recession in the euro zone and in Eastern Europe. Lately, the rate of decline in output in OECD countries have been slower than in the 4Q2008 and the beginning of 2009, business confidence improved, but the bottom has not been reached yet. This poses a question mark whether the Polish economy will bottom out in the 2Q2009 as we had thought. There is such a possibility because business sentiment and consumer confidence improved somewhat and unemployment will be flat in the 2Q2009. However, we forecast a decline in GDP year on year in the 2Q2009, albeit slower than in the 1Q2009, a resumption of slow growth in the 3Q2009 and its pickup in the 4Q2009 above 2% yoy (Table 1). Recovery should gather strength in 2010, fuelled by the infrastructure investment and exports. Potential GDP growth will not be restored until the late 2010, depending on the strength of the world-wide recovery. Despite a slowdown in average real wage growth and rising unemployment throughout the 2009, consumption growth should remain relatively stable, supported by the decline in personal income tax whose positive impact will be more visible with the lapse of time. Banks are keen to extend consumer credits and if this action succeeds, private consumption will find more support. The government will likely arrest growth in public consumption in the 2H2009, i. e. after the parliamentary elections, because of the precarious state of public finances, but its strong growth in the 1H2009 should keep it at least unchanged, if not in a positive territory, in 2009. Public investment should pick up in the course of the year to offset the decline in the private investment to a higher and higher degree. This will exert some positive ripple effects on business investment, in particular in non-residential construction. Contrary to the previous forecast, the net export contribution to GDP growth should be positive in all quarters of 2009 as the slowly improving economic prospects in the EU will help Polish firms exploit their competitive edge over foreign companies due to the depreciated zloty despite that the zloty should firm in the course of the year.

Inflation and Monetary Policy

Review of 1Q2009

The CPI inflation rate declined to 3.2% year on year in the first quarter of 2009 from 3.7% in the final quarter of 2008, benefiting from falling prices of fuel, transportation, telecommunication and most market services. On the other hand, prices of foodstuffs that were primarily responsible for the deceleration of inflation in the second half of 2008, rebounded in January 2009 and have been on the rise since then. Adding to inflationary pressures were prices of energy, continuing their upward trend and peaking in the first quarter at the highest level in more than a decade. However, on the whole the economic gloom has been so far efficiently depressing prices of goods and services, weakening a pass-through of the marked depreciation onto retail prices.

The downward effect of the sharp deceleration of economic activity on prices was clearly discernible in the initial months of 2009. Tumbling world prices of oil to just above $40 a barrel, the lowest since late 2004, cut the Polish retail price of gasoline by nearly 15% on average in the first quarter, triggering significant declines in prices of all transportation services. Household budgets are gradually beginning to feel the brunt of falling income dynamics and worsening employment prospects. This has led producers and retailers to abstain from raising prices in spite of the markedly increasing import costs related to the weak zloty. The annual depreciation vis-a-vis the euro rose from 11% in December to 17% in January and further up to roughly 30% in February-April, putting a massive strain on the financial situation of producers and importers alike. So far no attempts at passing these costs onto consumers can be discerned as prices of industrial goods, typically anchored by the import cost-competition, show no signs of acceleration with the exception of fuels. Most consumer durables remain on the deflationary path: prices of clothing and footwear fell by 7.5% year on year in the1Q2009 (vs. 6.9% in all 2008), home appliances – by 2.1% (vs. 1.3% in 2008), audiovisual and photographic equipment – by 11.4% (vs. 13.5% in 2008) and cars – by 5.3% (vs. 2.7% in 2008). Deflation or very low inflation in most industrial goods follows, to some extent, from recession-triggered price declines at a global level. However, even accounting for this factor the dynamics of Polish prices of industrial goods is much lower (-0.4%[1] year on year in the 1Q2009) than in the euro zone (+0.8%) despite a prolonged period of sizeable depreciation – indicating harsher demand conditions in the Polish retail market.

Likewise, a gloomy market situation has been keeping prices of most services down. The entire service aggregate1 decelerated to 4.2% year on year in the first quarter from 4.7% in the second half of 2008 amid shrinking demand and falling cost of business (transportation, rents). Declines were registered in catering, health, education and culture but also in postal and telecommunication services as well as the formerly discussed transport services.

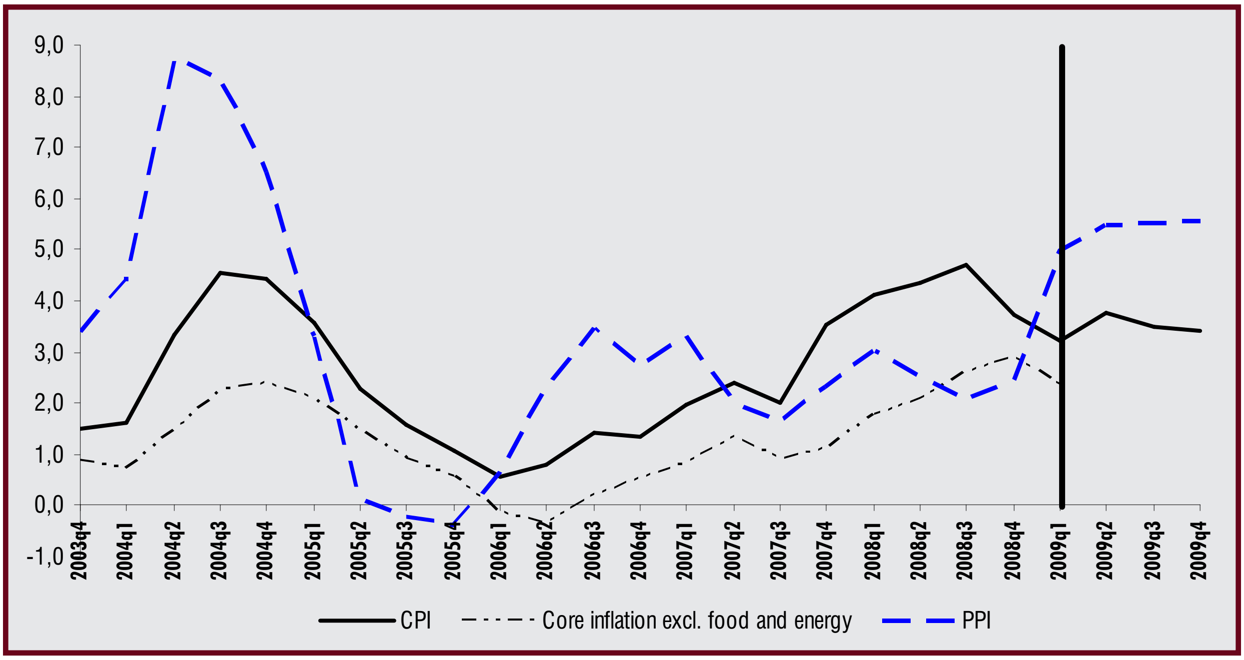
With demand side pressures in check it was the supply-side-triggered price hikes that led the inflationary process in initial months of the year – although this time they are neither high nor likely to be long-lasting. Inflation of foodstuffs grew to 3.8% year on year in the 1Q2009 up from 3.4% in 4Q2008 on the back of a combination of local supply developments and the impact of EU policies. Domestic production cycles and supply fluctuations led to the significant acceleration in prices of various kinds of meat (to 7.6% in the 1Q2009, up by 3 percentage points from the 4Q2008) and vegetables (to 10.8%, up by 3.5 p. pts.) while the EU's Common-Agricultural-

[1] Data related to the Harmonized Index of Consumer Prices – HICP.

Policy-induced output control pushed up the prices of sugar (to 5%, up by 11.2 p. pts.) and related confectionary products. On the hand, prices of cereal and dairy products exhibit continuously slowing dynamics, benefiting from ample domestic and global supply that has been rebounding after last year's demand-induced price surge.

The energy aggregate comprised of electricity, gas, and heating hit a new high of 14.4% year on year on average in the first quarter although began to decelerate from the peak of 14.8 in January to 13.9% in March, suggesting a slight downward trend for future months. January saw administrative adjustments of prices of electricity, heating fuel and hot water by 3.8%, 2.6% and 1.6%, respectively, followed by an additional massive 7.8% hike in electricity prices in February. The fact that these adjustments take place some 2-3 quarters after the peak of world energy commodity prices is a consequence of the lengthy approval process by the Energy Regulation Agency (URE), which exercises direct controls over key energy prices.

Figure 2. Annual Inflation in Poland, quarterly, % yoy



The administrative and supply-side origin of most price increases is best evidenced in the development of core inflation. Core inflation without prices of food and energy as well as core inflation excluding administrative prices stood at 2.3% yoy and 2.2% yoy, respectively, in the first quarter, reflecting that the core non-food and free-market component of the consumer basket exhibits very low inflation.

The first quarter saw a sharp rise in the producer price inflation. Compared to the fourth quarter of 2008 the PPI inflation more than doubled reaching 5.0% year on year on the back of robust increases in January and February 2009 – by 2.3% and 2.6% month on month, respectively. The most direct impulse came from the abovementioned URE-approved hikes in prices of electricity and gas, which pushed overall inflation in the energy sector to 21.3% on average in the first quarter 2009 from 12.4% in 4Q2009. Inflation in this sector fell somewhat in March, i. e. to 20.9%, as a result of changes in the law regulating the conditions of levying the excise tax, but remains the highest in more than a decade.

Prices in manufacturing picked up as well to 2.6% in the first quarter -they were up from 0.8% in the 4Q2008 – owing to substantial price increases in the production of foodstuffs, textiles and clothing, machinery and equipment and electrical machines, car and transportation equipment as well as furniture. Counteracting these tendencies was the deepening deflation in the manufacturing of coke and petroleum products (-19.1% year on year in the first quarter vs. -4.7% in 4Q2008) and sharp disinflation in prices of some of Polish major export commodities: metals and chemicals.

The only sector posting declining producer price inflation was mining and quarrying where annual price growth fell to 8.9% in the 1Q2009 from 9.7% in the 4Q2008. This is a consequence of the continued deceleration of prices of some of Poland's key commodities: coal and copper as well as other materials quarried domestically such as crude petroleum and natural gas.

Forecast

Compared to the previous issue of PEO, we significantly raised forecasts of both CPI and PPI inflation. The factors behind this correction include primarily much higher than expected energy price adjustments in January and February that will impact annual inflation until early 2010, combined with a surprising rebound in prices of foodstuffs.

The supply situation in agricultural markets will depend on the length and severity of the draught that prevailed in April and May. It is certain that some losses will be incurred, but at the same time specialists indicate sizeable excess grain in the market and grain reserves that continue to depress prices: March procurement prices of wheat and rye stood at a mere 50% of last year's level. Prices of pork, accounting for roughly 3 expenditures on meat, are likely to decelerate in view of the swine flue and the ensuing precautionary decline in demand. Moreover there are prospects of increased domestic supply of pork thanks to the upward rebound in the production cycle following the markedly improved production profitability. (konczy sie chyba takze świnski dolek, produkcja jest bardzo opłacalna w ujeciu cena zywca/tona paszy czy coś takeigo – moze wspomnij?). Combining these moderately favorable predictions with forecasts of stable or falling world prices of main agricultural commodities, we expect inflation of foodstuffs to moderate in the summer and slightly decline afterwards.

World prices of oil and other non-food commodities are likely to stabilize or fall slightly in the remainder of the year depending on the magnitude of recession in major global markets.

Exchange rate continues to be one of the major risk factors for inflation forecast. Our exchange rate predictions imply sustained, roughly 30% depreciation vis-a-vis the euro in the 2Q2009 and the 3Q2009 that will fall to around 9% in the 4Q2009. As mentioned earlier recessionary prospects in the first and second quarter, accompanied by the gradually declining disposable income dynamics, should prevent producers and retailers from widespread passing the depreciation-associated costs onto consumers. However, some price increases are inevitable and likely to occur in the case of vehicle fuel (in line with developments in the 1Q) or goods and services closely tied to foreign prices, e.g. tourism services or imported foodstuffs with no domestic substitutes (citrus fruits, coffee, tea). This will effectively balance price declines in many sectors making inflation more persistent than in neighboring countries from the euro area or with currencies tied to the euro.

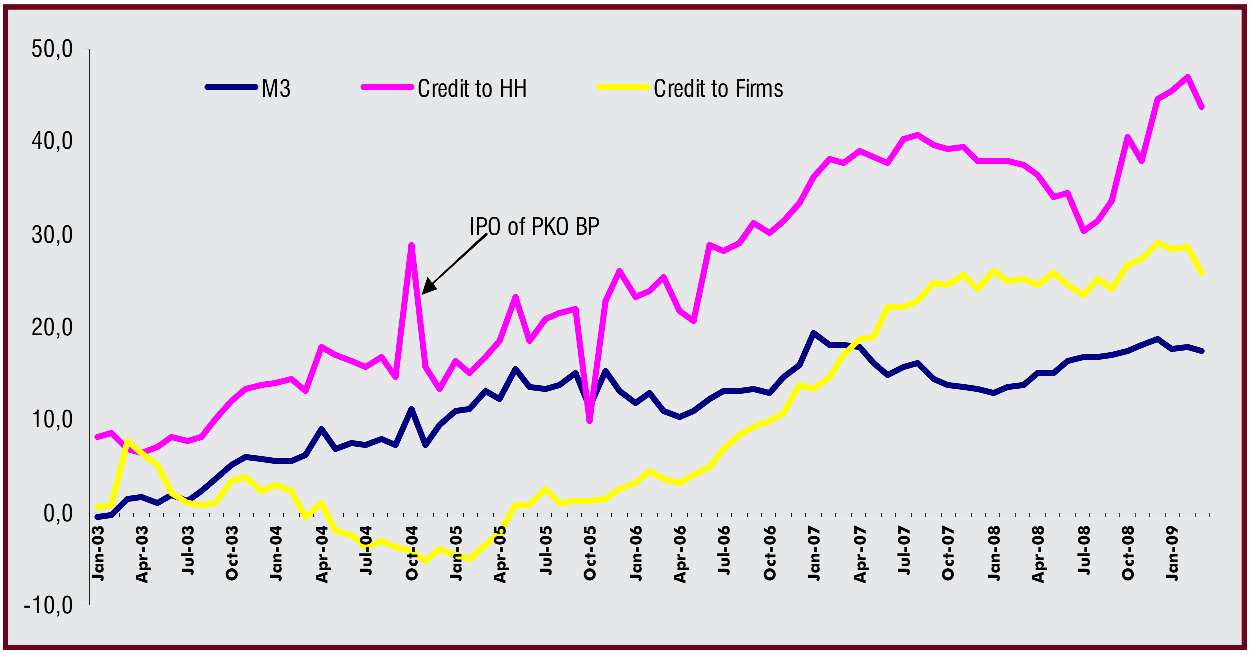
Taking into account all these factors and associated risks we expect the CPI inflation to rise temporarily in the second quarter to 3.8% year on year and then fall to 3.6% in the third quarter entering the NBP target range of 1.5%-3.5% in the summer. Inflation will remain close to the upper bound of the range in the 4Q2009 (3.4%) to fall sharply in early 2010 to below 3%, reflecting the high base from early 2009, and remain just below the mid-point of the range from the second quarter onwards. On the annual level this produces inflation of 3.5% and 2.3% in 2009 and 2010.

Predictions are burdened with much higher risks in the case of the PPI due to the higher impact of unstable commodity prices and the exchange rate. After the sharp increase in late 2008 and early 2009 we expect producer price inflation to stabilize around 5.5% yoy until the end of 2009 and gradually fall throughout 2010 to 3% yoy in the 4Q2010. On the annual basis these developments will result in the average inflation of 5.4% and 3.3% in 2009 and 2010, respectively.

Monetary Developments and Policy

The year-on-year statistics continues pointing to a credit boom, but it is totally misleading. Actually, credit to non-financial firms came to a standstill in the 1Q2009 mainly because of a credit crunch, i. e. problems of credit supply, but firms stopped asking for investment credit as well so demand for credits also fell. Firms report severe difficulties obtaining working capital from banks. According to the NBP April survey, more than 50% of banks tightened loan standards and 80% raised credit margins in the 1Q2009 so the credit crunch escalated though a quarter earlier 80% of banks reported a tightening o credit standards. Firms limited their interest in long-term credits, which is related to the collapse in private fixed investment. The only comforting fact is that interest rates on loans have eventually come down, following significant reductions in the NBP interest rates, but the access to credit is poor (see figure 5).

Figure 3. Broad Money and Credit Expansion, % yoy

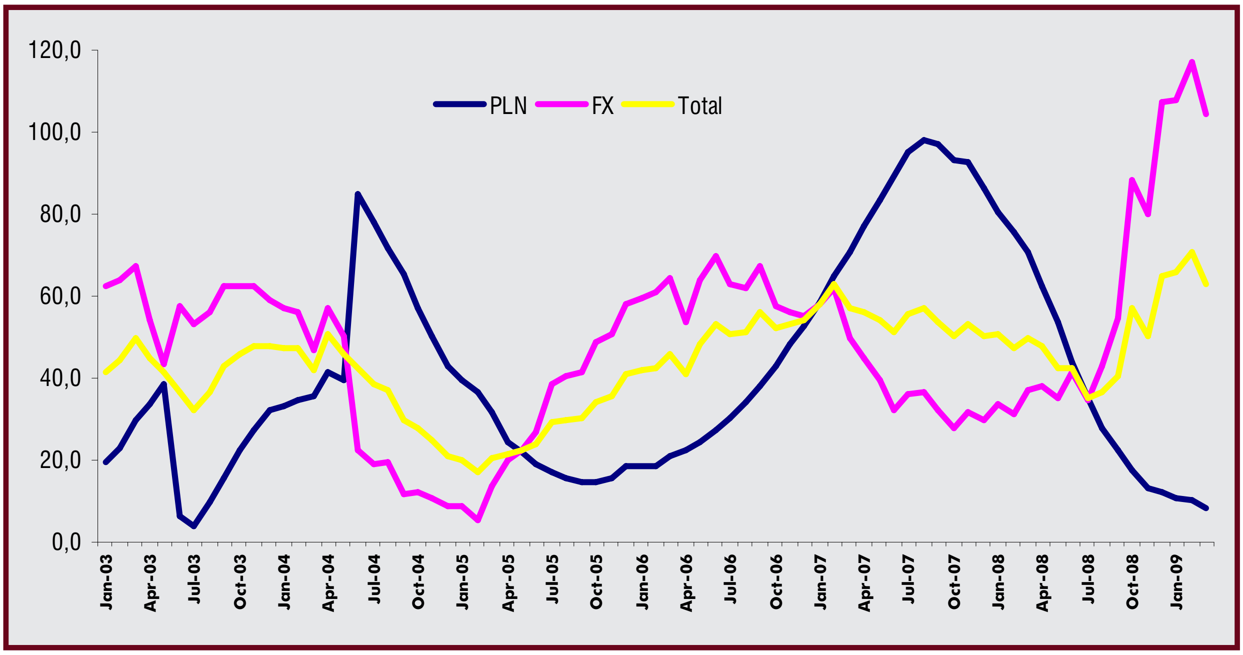


On surface credit to nonfinancial companies grew in the 1Q2009 as it amounted to PLN 225.7 bn end of March 2009 versus PLN 216.2 bn end of December 2008. A rise by 9.5 bn zlotys or by 4.3% in relative terms looks solid, but, when adjusted for the appreciation of the euro by 12.6% between these dates, it shrinks to PLN 2.9 bn or 1.5%[2]. This is the actual amount of new credit for non-financial companies, granted in the 1Q2009, out of

[2] No currency breakdown of credit is available so the euro is taken as a proxy.

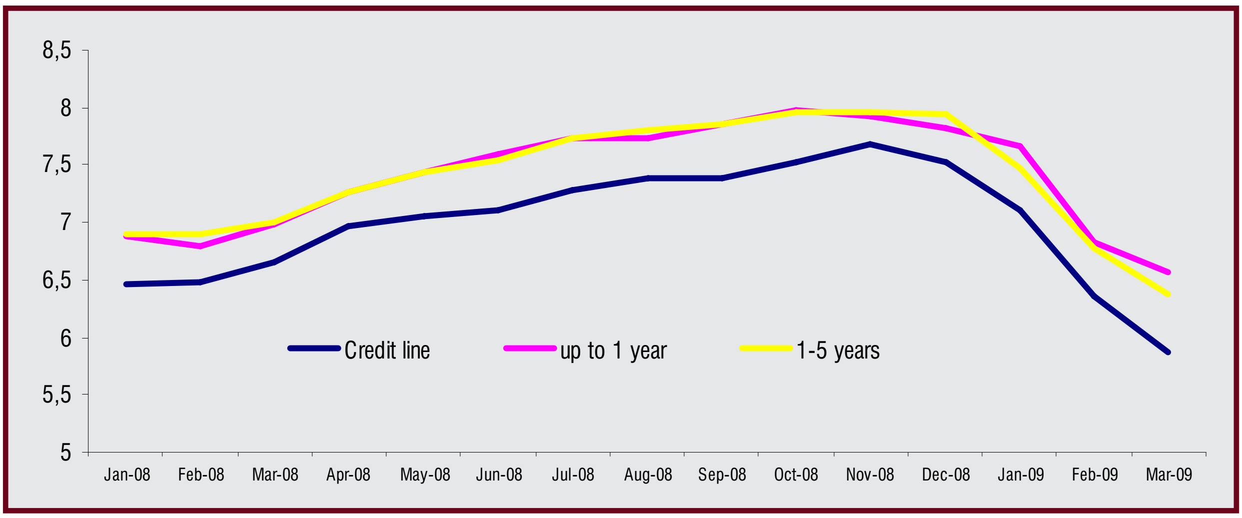
which 1.8 bn zlotys was loaned in foreign currency (FCY). When adjusted for the PPI inflation, „new" credit to non-financial corporations declined by 3.5% qoq in the 1Q2009 as the PPI rose by 5.1% qoq. The zloty depreciation also meant that the share of FCY credits grew to 27.0% end of March 2009 from 24.3% end of December 2008.

Figure 4. Housing Credit Credit Growth, % yoy



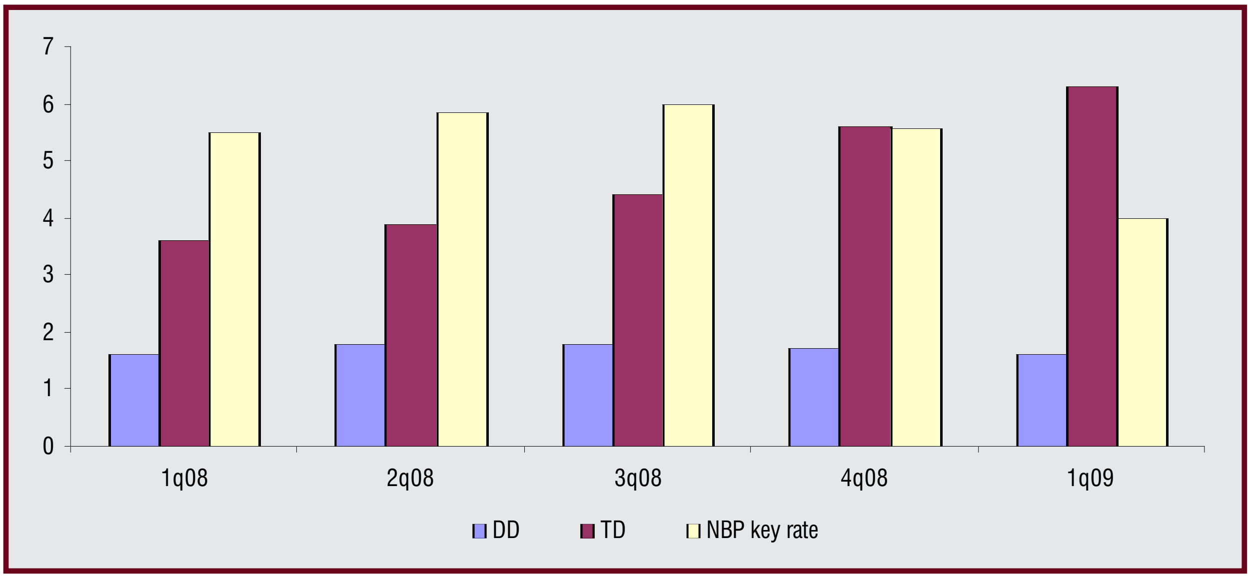
Similar trends are visible with regard to credit to households though this credit holds better as banks make attempts to replace mortgages with consumer credit that pays higher interest rates and matures at shorter periods so, in theory, it carries less risk. Credit to households increased by 25.8 bn zlotys or 6.6% from end-December 2008 to end-March 2009, again at a respectable rate. However, the zloty value of the December volume in FCY grew by PLN 18.7 bn, which implies that new credits rose by 7.1 bn zlotys. This looks somewhat better than in the case of non-financial firms as „new credit" increased by 7.2 bn zlotys or almost 2% from end December 2008 to end March 2009. Yet, it also declined in real terms, albeit slightly, as the CPI inflation reached 2.2%. The share of FCY loans in total credit to households rose to 42.5% end of March 2009 from 40.5% end of December 2008 due to the zloty depreciation.

Figure 5. Household Credit Interest Rates



This short analysis points to the lack of credit in the economy that could support its growth. Trends that were shaped in the 4Q2008, continued to hit the economy. In the 4Q2008 Polish commercial banks, mostly owned by foreign capital, transmitted the credit crunch to Poland as their parent companies cut them credit (swap) lines in foreign currencies, e. g. in the euro and the Swiss franc, which served as a basis of credit expansion.

Figure 6. Household Deposit Interest Rates



Nominal broad money (M3) rose by 17.5% yoy in the 1Q2009 compared with 18.6% yoy in December 2008 so no tendency to decline can be identified. Total deposits grew by 19.4% yoy versus 20.6% yoy in December 2008. The rates of growth in household and company deposits continued to be differential 25.3% yoy and 6.9% yoy in March 2009, respectively, compared with 26.5% and 4.0% yoy in December 2008, respectively, but on a quarterly basis the rates of growth are small. The depreciation of the zloty in January-February 2009 kept on increasing the value of deposits, but high deposit interest rates continued to exert the same impact. The rate of expansion of time deposits of households was 45.8% yoy while the rate of growth of demand deposits was only 6.1% in March 2009. The latter has considerably fallen since September 2008, the first month when commercial banks started aggressively competing for deposits due to liquidity problems, caused by the global crisis in the aftermath of the investment bank Lehman Brothers collapse. The average interest rate on time deposits up to 2 years was 6.3% p. a. and demand deposits was 1.6% p. a. in the 1Q2009, respectively. This discrepancy continued to increase. It is evident that the public switches its demand deposits to time deposits in the environment where alternative investments are treated with suspicion due to the elevated risk aversion despite a recent surge of optimism on the stock market. The rise in state guarantees on household deposits to the equivalent of 50 thousand euro was also instrumental in this respect. The pickup in stock exchanges since March 10 has been too short to change portfolio decisions of households in such a way that it would impact monetary statistics. This coincided with the further central bank interest rate cuts: the NBP key open market operations rate was reduced to 3.75% in March 2009 from 5.00% in December 2008.

The banking sector reported distinctively lower net income in the 1Q2009 than in the 4Q2008, when its profits declined for the first time in 2008, when the sector became the second important channel of the global crunch transmission to the Polish economy. No official data on the first quarter were available as of writing, but only fragmented releases by incorporated institutions, yet the picture is bleak. Net income was only a fraction of the 1Q2008 magnitude. However it is not related to a rise in non-performing assets, the case of parent institutions of Polish banks from the „old" EU countries, but to the drastic cut in access to credit by the non-financial sector and the narrowing of spreads between credit and deposit rates. The sector also raised provisions, forced by the significant depreciation of the zloty, as over 150 bn are denominated in the Swiss franc, and to cushion potential problems settling option contracts concluded with Polish firms (provisions of PLN 1.5 bn) as well as to build a buffer for future non-performing assets, whose upcoming rise is inevitable. For instance, BRE raised its provisions tenfold, compared with the 1Q2008; BHP that reported a loss in the 1Q2009 doubled them on a year ago. Thus the banking sector has become a culprit of its own behavior. Sadly, the economy has suffered badly as well.

The worst for the banking sector is yet to come since irregular credits have only started growing. In December 2008, the latest data available, the share of irregular assets was 3.7%, down from 4% on a year ago while irregular credits consisted 3.5% of the total credit, down from 4.1% on year ago. These indicators should have deteriorated in the 1Q2009, but casual reports did not point to a sudden rise in these credits. Despite a rising unemployment, employment was still slightly up on the 1Q2008 and firms were quite liquid as they have accumulated large deposits relative to GDP.

The banking sector is over-liquid in aggregate so the shortage of liquidity does not seem to be the main problem any longer, as it was in the 4Q2008. However, liquidity is unevenly distributed so a few banks still suffer from the stress despite that new NBP credit facilities and the overall thaw on the global financial markets have managed to ease it somewhat. It seems that the next problem to be solved is the recapitalization of a number of banks. The capital adequacy ratio (CAR) stood at 10.8% at the 2008 yearend, down from 11.8% in the 3Q2008 and 12.8% in December 2007. It likely kept on downtrending in the 1Q2009. Even if it were unchanged, the 10%, recommended by the Polish FSA as a minimum, looks low by the current financial crisis standards, when depositors/customers seem to demand ratios in the range of 13% -15% because of the tarnished bank reputation. To reach this level banks would probably have to raise about 20 bn zlotys of new capital, i. e. increase it by about 20-25%. This seems a substantial amount. Two Polish banks due to reputation problems of their parent companies have already been recapitalized, but these amounts may prove insufficient. We forecast that the 2009 net income of the banking sector will downsize to a third of more than 14 bn zlotys in 2008. Despite likely losses at a number of banks and even in the sector as whole in the coming quarters, it is unlikely that a major institution were threatened by a bankruptcy. Anyhow, the government and the NBP will have ready a law by this time that would allow the state to take over such an institution should its foreign owners not deliver a rescue. Therefore such an occurrence should lead to only temporary disruptions in the functioning of the financial system at worst. Instead, mergers and takeover are possible, but they will be driven by the shakeup of the financial sector in the countries of foreign owners. Polish Financial Supervisory Commission recommends banks not to distribute 2009 profits to shareholders or owners so that they raise the capital base, but whether this „moral suasion' will work remains unclear. Polish banks are rather good assets due to the potential growth prospects so their mother institutions, in need of capital, may spin

[2] The actual performance in 2008 is compared to the results of 2007.

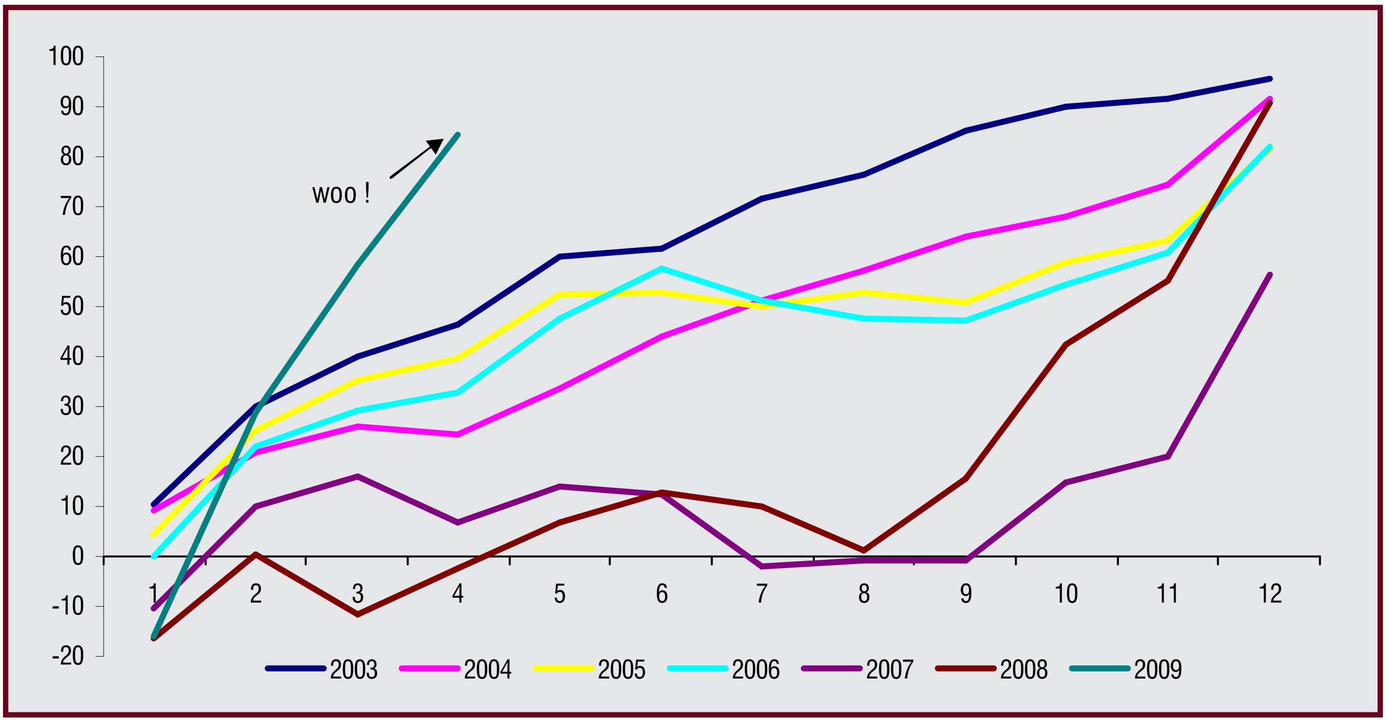
them off to replenish their capital base. One should not forget that the stock capitalization of Citibank Handlowy was on one day in February 2009 larger than its mother company's Citigroup and so is WBK's capitalization relative to its parent Allied Irish Bank.

Fiscal Developments and Policy

According to the preliminary data, the central government cash budget registered a deficit of 10.6 bn zlotys in the 1Q2009, lower than projected by the MoF. This is equivalent to 58.3% of the 18.2 bn zlotys, targeted by the state budget in 2009. The state revenue came at 66.3 bn zlotys, just a dash lower than the MoF projections of 65.9 bn, while the state expenditure at 76.9 bn zlotys was short of the planned 78.2 bn by a bit larger amount.

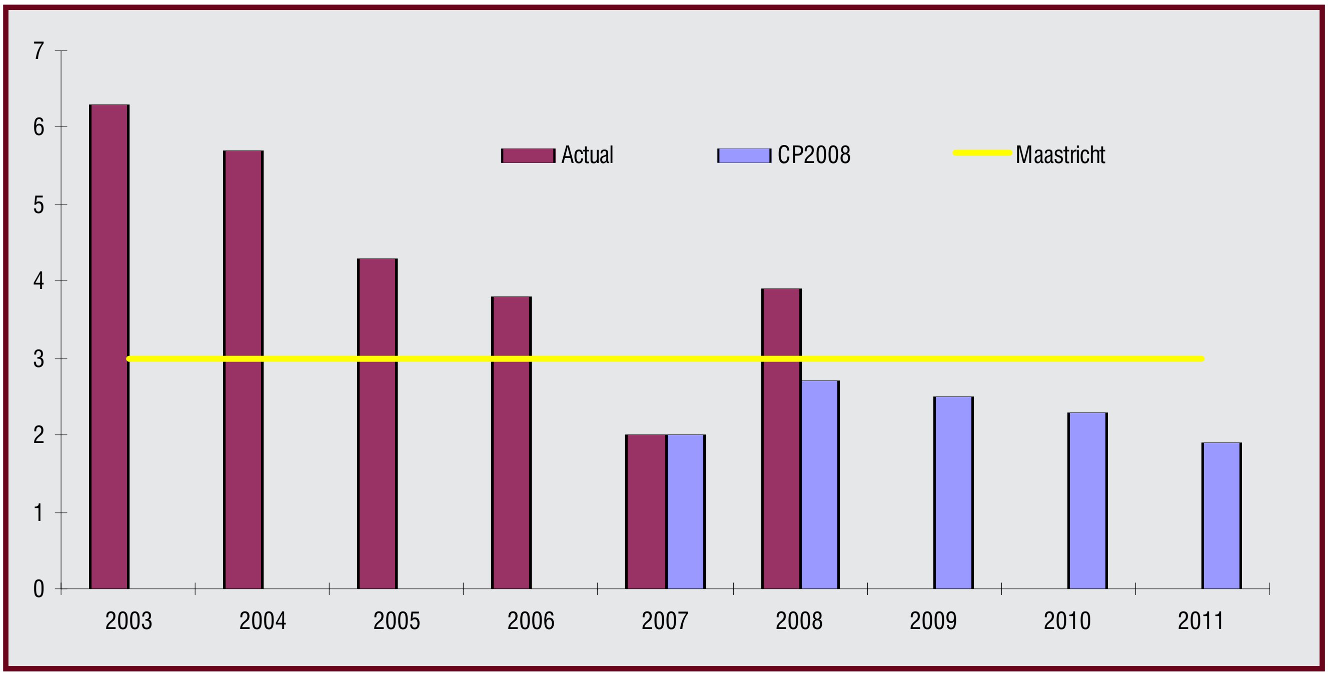
The rise in the central government revenue and expenditure was about 2.5% yoy and 22.3% yoy in the 1Q2009, respectively, implying that the increase in expenditure was substantial in absolute as well as in relative terms to the growth in the revenue. These tendencies suggest that fiscal policy became strongly expansionary in the 1Q2009. The fact that the state budget recorded a small surplus in the 1Q2008 whereas it fell into a quite substantial deficit in the 1Q2009 also seems to confirm this. However, the conclusion should be qualified for the fact that expenditure may have risen due to the work of automatic stabilizers, when GDP probably declined in the y-o-y terms so fiscal expansion may not have been so strong as the raw figures suggest. Instead, a structural budget should be considered, but have only partial information, which des not allow us to estimate it in quarters.

Figure 7. Central Government Budget Deficit, % annual projection



The forecast about declining GDP finds support in figures on tax collection in the 1Q2009. The revenue from personal and corporate income taxes was up by 3.5% yoy and down by 2.0% yoy, respectively. The former reflects the fact that despite a rising trend in unemployment, employment in the economy was still higher than in the 1Q2008 and average wage increased by some 6%-7% yoy in this period while the cuts in PIT rates did not produce a strong offsetting effects (see Labor Market section)[3]. The latter reflects decrease in profits of enterprises due to the decline in economic activity. The indirect tax collection came lower by 1.7% yoy, reflecting a decline in the amount of transactions. Since exports are exempt from the VAT, this implies that a decline in domestic sales was responsible for this drop. The VAT collection fell by some 10%-11% yoy. On the other hand the excise-tax revenue rose by 14.0% yoy despite a fall in prices of fuels, but this was due to a booking-keeping trick, i. e. a one-time shift of the revenue from 2008 to January 2009, and a rise in tax rates on tobacco, to much lesser extent. The rise in one kind of revenue should be comforting: these are unrequited EU structural funds that amounted to 2.0 bn zlotys in the 1Q2009 versus 0.3 bn zlotys in the 1Q2008. Their six-fold rise implies that the public investment, fuelled by the EU money, is picking up though this rise is still too modest to offset the collapse of private fixed business investment.

Figure 8. General Government Budget Deficit, % annual projection



Source: Convergence Program Update January 2009.

As concerns the state expenditure in the 1Q2009, a rise in subsidies to the Social Insurance Fund and the Social Fund of Farmers by 80.8% and 23%, respectively, is striking. This is supposedly connected to a prepayment of the subsidy for the remaining part of the year, which may, in turn, be linked to the annual compensation of pensioners for inflation and real wage growth in 2008. This hypothesis is supported by the doubling of the subsidy in March, when it grew by over 3 bn zlotys. The largest monthly increase in the subsidy to Farmers' Social Fund also occurred in March. On the other hand, a rise in the subsidy could signal that the social insurance funds suffer from a shortage of premiums in the recession period. Well, this is was not the case in the 1Q2009 since employment did not fall and wage aggregates rose in real terms. However, such developments cannot be excluded in the upcoming quarters should economy slip further. A rise in public debt service in the 1Q2009 versus the 1Q2008 as a percentage of the annual schedule should

[3] The actual performance in 2008 is compared to the results of 2007.

not be interpreted as a signal that the government has started incurring unexpectedly higher costs due to a rise in the risk premium. The government has assumed that the average NBP key interest rate will be 6.2% in 2009 while it is 3.75% as of writing. It is unlikely, therefore, that when the applicable risk premium is added, the cost of debt service exceeds the plan. Actually, a 10 year government benchmark bond yields around 6.00%. By the way, it is just 0.5 percentage point more than the worst performer's, Greece's, in the euro zone. The bottom line is that the relative rise in the cost service is linked to the timetable. The mirror image of a better absorption of EU funds is a considerable increase in public fixed investment. The central government spent 2.8 bn zlotys or 15% of the yearly plan on it in January-February 2009 versus 0.7 bn or 4% of the annual plan in the 1Q2008.

The 2009 budget assumes that the central government revenue and expenditure will rise by 19.3% and 15.3% relative to the actual performance in 2008, respectively. Such a substantial rise in cash revenue looks highly unrealistic when these figures are compared to the corresponding figures on the 1Q2009, as the economy has come to a halt. Even assuming a pickup in growth in the 2H2009, as we do, will not change the situation that revenue growth will strongly underperform the 2009 budget draft while expenditure will come on target, at best, but it is likely to overrun it despite the efforts of the government to avoid it. The government will have to overhaul its budget in the middle of the year, but this fact has already been discounted by financial markets and it has little economic merit, but is a legal act that will certainly excite press and opposition politicians for a while without any economic consequences.

We pointed in the previous issue of the PEO to major risks of overruns should economic growth fall to the lower end of the present government range forecast, which is still 1.7% to 3.7% with unofficial statements of 0.5% to 1.0%, i.e. still a positive territory. We estimated that, assuming a hypothetical scenario of zero economic growth and the same tax elasticities as in the budget bill, but a lower GDP deflator of 2% in 2009, we forecast that the tax revenue would be some 32 billion zlotys short of 251.4 bn zlotys, projected in the state budget. This would cause the cash budget deficit to reach about PLN 50 billion or 3.8% of GDP, provided that all other revenue and expenditure remain unchanged as in the state budget bill, i. e. ceteris paribus. When the total amount of announced expenditure savings of 10 bn zlotys is accounted for, the central government cash deficit would grow to 41 bn zlotys or 3.1% of GDP, estimated at around 1310 bn zlotys.

The general government deficit in ESA-95 terms surprisingly rose to 3.9% of GDP in 2008, i. e. it breached the 3% threshold as it occurred in April, but no details are available why it happened in times when the cash central government deficit was low 1.8% of GDP. Apparently, social security funds an local government added much to the shortfall. If their deficit were the same in 2009, then the public sector deficit may exceed 5%-6% of GDP in 2009. The European Commission is likely to restart the Excessive Deficit Procedure (EDP) not for the reason of bad prospects, since many countries will have nothing to brag about in 2009, but because the deficit breached the threshold when growth was 4.9%, i. e. close to potential.

The 2009 deficit plans were consistent with the intent to adopt the euro in 2012, but this date is beyond reach right now. Poland meets only one convergence criterion of the public debt below 60% of GDP and 6% deficits will cause a rapid rise in the public debt though we do not forecast a breach of the criterion any time soon. The entry to the ERM-2 is not contingent on meeting Maastricht criteria and, for instance, Slovakia has been under the EDP along with Poland since 2004 until it was removed in 2008. However, the high volatility of the zloty jeopardizes the entry to the ERM-2 since the zloty can depreciate more than 15% from the parity. On the other hand, the currency is depreciated so its downside potential is small, but, to be on a safe side, the government would have to fix a parity rate that is way from fundamentals and then systematically revalue the zloty. This is unappealing and can lead to speculative runs.

Labor Market

Employment

As we expected in the previous PEO issue the labor market situation in the 1Q2009 seriously deteriorated following the fall in economic growth and widely expected recession. Employment in the so-called enterprise sector (the companies employing more than 9 workers) decreased by 0.2% yoy in the 1Q2009, reaching 5,350,000. It was the first employment reduction in y-o-y terms since the 4Q2004. On the quarterly basis, the number of employed fell by 0.5% in 1Q2009, by 0.3 percentage point more than in the 4Q2008. For comparison, employment increased on the quarterly basis by 2.5% in the 1Q2008.

The analysis of employment dynamics in specific industries is complicated. Since the beginning of 2009, the CSO changed the classification of economic activities, used in monthly reports from the enterprise sector. The same applies to wage data. Although the data has been recalculated back to November 2007 one cannot monitor the industry specific developments backwards more than one year.

The picture is mixed, with some sectors recording employment reductions and others still expanding. The situation seems to deteriorate most dynamically in the manufacturing. In the 1Q2009 the number of employees in this industry fell by 5.2% yoy and 3.3% qoq. It is equivalent to the y-o-y reduction of 113,000 jobs, whereas the total employment fell by 9,000 persons. It means that in other sectors altogether the number of employees actually grew in yoy terms by 104,000.

Employment growth was the most dynamic in hotels and restaurants where the number of employees increased by 7.9% yoy. Employment grew also relatively strong in construction (by 4.6% yoy) and in retail trade sections (by 4.1%) In other industries, the y-o-y growth rate was 2% – 3%. The only sections, not accounting for manufacturing, where employment actually contracted in y-o-y terms in the1Q2009 was property management (by 2.2%) and other administrations and support services, (by 0.4% yoy). By the way, it had been treated as one section till 2008 that has been divided since the beginning of 2009.

Unfortunately, due to changes in the classification, one is not able to directly compare sector specific employment dynamics in the 1Q2009 with earlier periods. It seems, however, that in most of the sections, with the exception of hotels and restaurants, the employment dynamics is weaker than in previous quarters.

Labor Force Survey (LFS) figures for the 4Q2008 were presented in the previous PEO issue. They were still positive, but the first signs of deterioration were visible as employment grew by 3% yoy i. e. by 0.6 percentage points less than in the 3Q2008. Unfortunately, the LFS employment data for the 1Q2009 are still not available. One may, however, assess it, taking into account the employment dynamics induced by the current registered number of unemployed and the registered unemployment rate[4]. The LFS y-o-y employment dynamics in the 1Q2009 should not exceed 0.5%-1%.

Following the reduction of expected GDP growth, our forecast concerning the employment growth is also more pessimistic than in the previous PEO issue. In the 2Q2009, the enterprise sector employment growth should fall in y-o-y terms by 3% and by 2.5% qoq. We also expect that the LFS figures will start to deteriorate in 2009 more quickly that we forecasted in the previous PEO issue. The LFS employment in the 2Q2009 will fall by 0.8%, an equivalent to the q-o-q decrease of 2.3%. We expect that in 2009, on average, employment in the enterprise sector will actually fall by 3.6% yoy and the LFS employment will fall by 1.3% yoy.

Wages

Wage dynamics are still weakening. In the 1Q2009, the average nominal wage in the enterprise sector was up by 6.3% yoy, while in the 4Q2008, the y-o-y increase was 7.7%. Real wage dynamics in the 1Q2009 also decreased to the 3.0% yoy from 3.8% in the 4Q2008.

Similarly, as in case of employment figures for the enterprise sector we are not able to compare current wage dynamics in specific industries with those from earlier periods. It seems, however, that wage growth slowed down in all important sections. The lowest wage growth in the 1Q2009 was recorded in hotels and restaurants (4.3% yoy) and the highest in administrative and support service activities (the new section – earlier part of real estate and business services), where it reached 8.5% yoy. A relatively high wage growth rate was still seen in construction with the y-o-y change of 7.2%.

The wage data confirm also the severity of situation in manufacturing. Employers in this section do not only reduce employment, but they also reduce wage increases, which in the 1Q2009 fell to 5% yoy from about 7% yoy in the 4Q2008. By the way, the wage data from this section seem to be comparable between 2008 and 2009, also some differences in overlapping figures can also be observed.

We expect the downward trend to last, following the continuing economic downturn. Average nominal wage growth in the 2Q2009 should fall to around 5.2%-5.3% yoy. It will result in real wages growing at about 2% yoy. On average, nominal wages will grow in 2009 by 4% – 5% and real wages by about 2%. During 2010 real wage growth on a y-o-y basis can even fall to 1.4%-1.5% you, but then it will start to accelerate reaching the average of about 2% yoy.

Unemployment

Unemployment is increasing, following the general negative trends in the economy. In the 1Q2009, number of registered unemployed persons reached 1,730,000 and the unemployment rate 11.2%, which was exactly the number we forecasted in the previous PEO issue. It means that the number of unemployed increased by 3.3% yoy, and it was the first increase of the registered unemployment since the 2Q2003. The growth of unemployment in the q-o-q terms reached 19.3%. To compare, in the1Q2008 the number of unemployed actually decreased by 2.5% yoy.

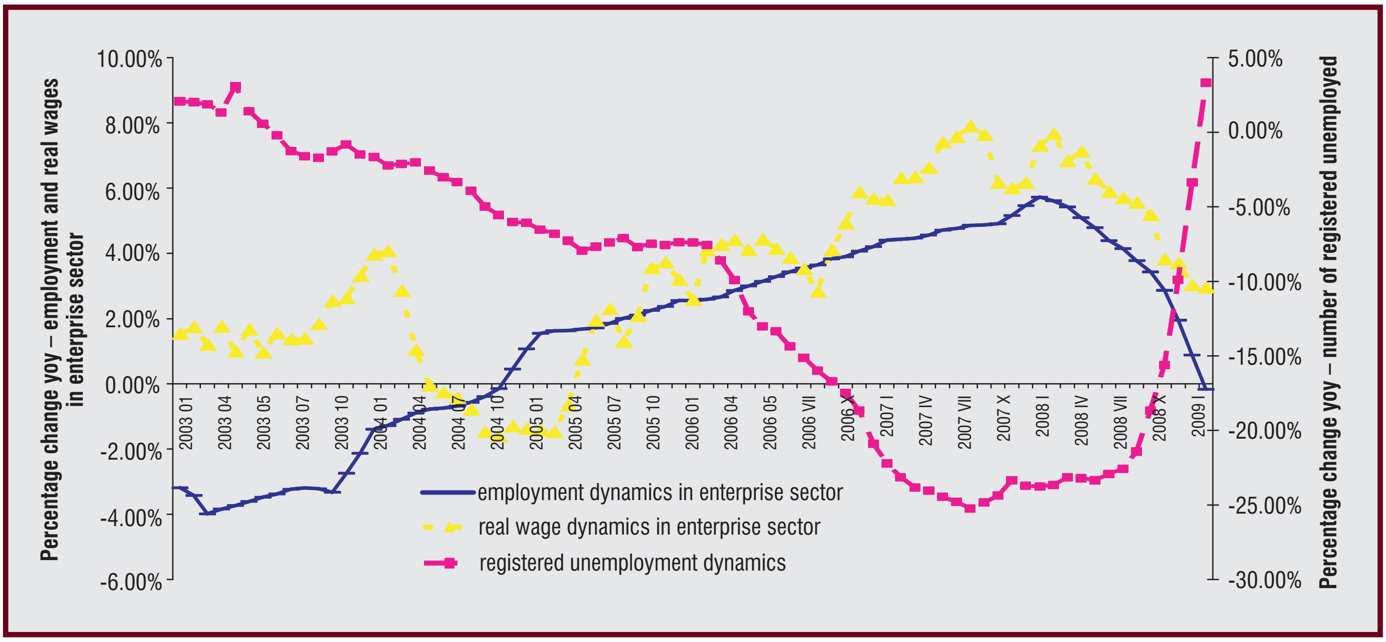
[4] It is the employment figure used by CSO to calculate the registered unemployment rate, where the unemployment rate equals to the number of unemployed, divided by the sum of number of unemployed and the number of employed. This employment figure is quite well correlated with the LFS employment.

Similarly, as in the previous PEO issue, we have cleaned the unemployment figures for the 1Q2009 from a seasonal component[5]. In the 1Q2009, the seasonally adjusted number of unemployed increased by 9.8% as compared to the 4Q2008. The estimated seasonally adjusted unemployment rate in the end of the 1Q2009 reached 10.5%, i. e. an equivalent of the seasonally adjusted increase of 0.8 percentage points. It means that about half of the unemployment increase in q-o-q terms in the 1Q2009 was due to seasonal factors and half resulted from the actual worsening of labor market situation.

The other information coming from PES is not reassuring, either. The number of unemployed finding new jobs fell rapidly by 26.8% yoy in the 1Q2009 as compared to 17.9% in 4Q2008. The number of those finding unsubsidized jobs dropped even more quickly by 27.7% yoy in the 4Q2008 as compared to 20.6% in 4Q2008. The employment offices are not able to find subsidized jobs for the unemployed, either. In the 1Q2009, the number of persons, placed to subsidized workplaces, also decreased substantially, i.e. by 19.5% yoy) whereas in the 4Q2008, it was only 5.2% lower than a year earlier, and in the 3Q2008, it actually increased by 5.6% yoy.

In addition, one records extremely high increases of newly unemployed persons in registers. In the 1Q2009 the number of the new unemployed increased by 35.9% yoy. Such extremely rapid increases of inflow of new unemployed into the registers has not been recorded since the 1Q1999 when it peaked to almost 50%.

Figure 9. Employment and real wage dynamics in enterprise sector; and registered unemployment dynamics in Poland 2003-2008.



Source: Own calculations based on Statistical Bulletins of Polish CSO (GUS)

The only LFS-based data for the 1Q2009 can be found in EUROSTAT, publishing monthly a so-called harmonized unemployment rate for all EU members. According to these seasonally- adjusted data, the unemployment rate in Poland in March 2009 was 7.7%, i. e. by 0.7 percentage point more than in December 2008. It is still below the EU27 average (8.3%) which increased since December 2008 also by 0.7 percentage points. The highest unemployment rate in Europe was in Spain (17.4% in March 2009, where it rose by 3 percentage points since December 2009) and the lowest in

[4] De-seasoning performed using the DEMETRA 2.1 software and Tramo/Seats methodology.

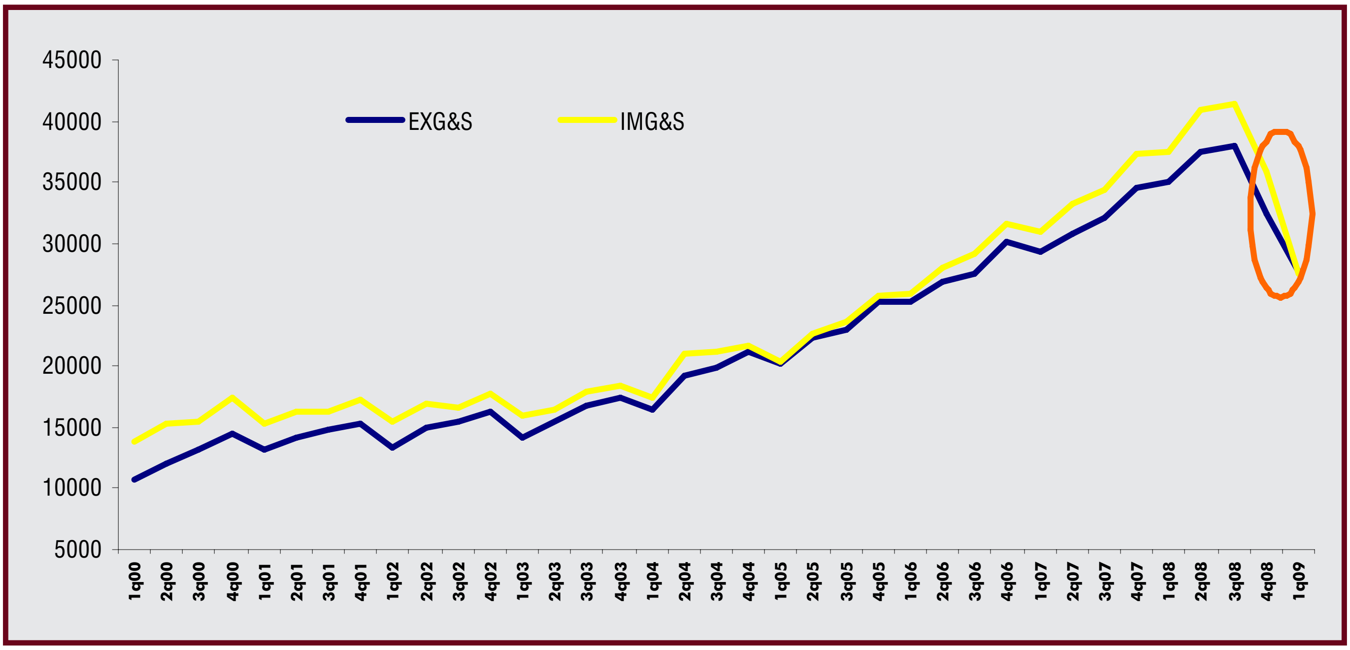
Netherlands (2.8%, an increase 2008 by 0., 1 percentage point since December). One can conclude that the magnitude of the observed increase in the unemployment rate in Poland is similar to the „European average rate".

We expect the registered unemployment rate to actually fall in the 2Q2009 to 10.9% but this fall will result only from seasonal phenomena – actually, it will be by 1.5 percentage points higher than in the 2Q2008. The LFS unemployment should continue to increase and in the 1Q2009 it will reach 7.8%. Both, registered and LFS unemployment will further grow in 2009. We expect the registered unemployment rate to reach 12.8% at the end of 2009, while the LFS unemployment rate will probably grow to 9%. Thus we have slightly corrected our last forecasts upwards. This correction results from our generally more pessimistic expectations concerning the economic growth in 2009.

External Trade and Balance of Payments

Declines in exports and imports growth steepened in the 1Q2009. According to the NBP monthly data, exports and imports of goods in the euro terms decreased by 22.9% and 28.9% on a year ago in the 1Q2009, respectively (Figure 11). The trough in decline rates was in February. In the same period, the zloty exports and imports of goods decreased by 2.1% yoy and 9.0% yoy, respectively. We continue to report export and import changes in the zloty, because they seem to better approximate changes in trade volumes due to wide fluctuations in the exchange rates in 2008 and the 1Q2009; volume data on the 1Q2009 are not available from the CSO as of writing.

Figure 10. Exports and Imports of Goods and Services, quarterly, EUR million



Source: NBP

Exports and imports of services, expressed in euro terms, held better than exports of goods as they fell by 13.8% yoy in the 1Q2009 while imports of services decreased by 16.4% yoy. The collapse of the upward trends that were arrested in the 4Q2008 shows the impact of the deep of the economic slump in the EU and Eastern Europe on Polish foreign trade; demand is simply not there. Based on seasonally adjusted data, GDP in the eurozone fell by 4.6% yoy in the 1Q2009, and in the main countries of Central Europe: the Czech

Republic, Slovakia and Hungary – by 3.4% yoy, 5.4% yoy and 4.7% yoy, respectively, according to the preliminary data by the Eurostat. Even if GDP in Poland dropped 1.5% yoy, the low of our range estimate, the decline would be distinctively less in Poland. This would suggest that Polish exports should decrease faster than imports whereas the opposite trends are developing. In our view, the significant depreciation of the zloty that occurred in the 4Q2008 and deepened in the 1Q2009, caused a dampening of imports and restored a strong competitive edge to Polish companies so exports suffered from the lack of foreign demand less than imports did from the lack of Polish demand. Other factors on the import side are much cheaper commodities than a year ago and the collapse of business fixed investment in Poland that also influenced imports adversely. It worth-while to underscore that combined exports of goods and services were slightly higher than imports of goods and services in the 1Q2009, the first such occurrence since the 1Q2005.

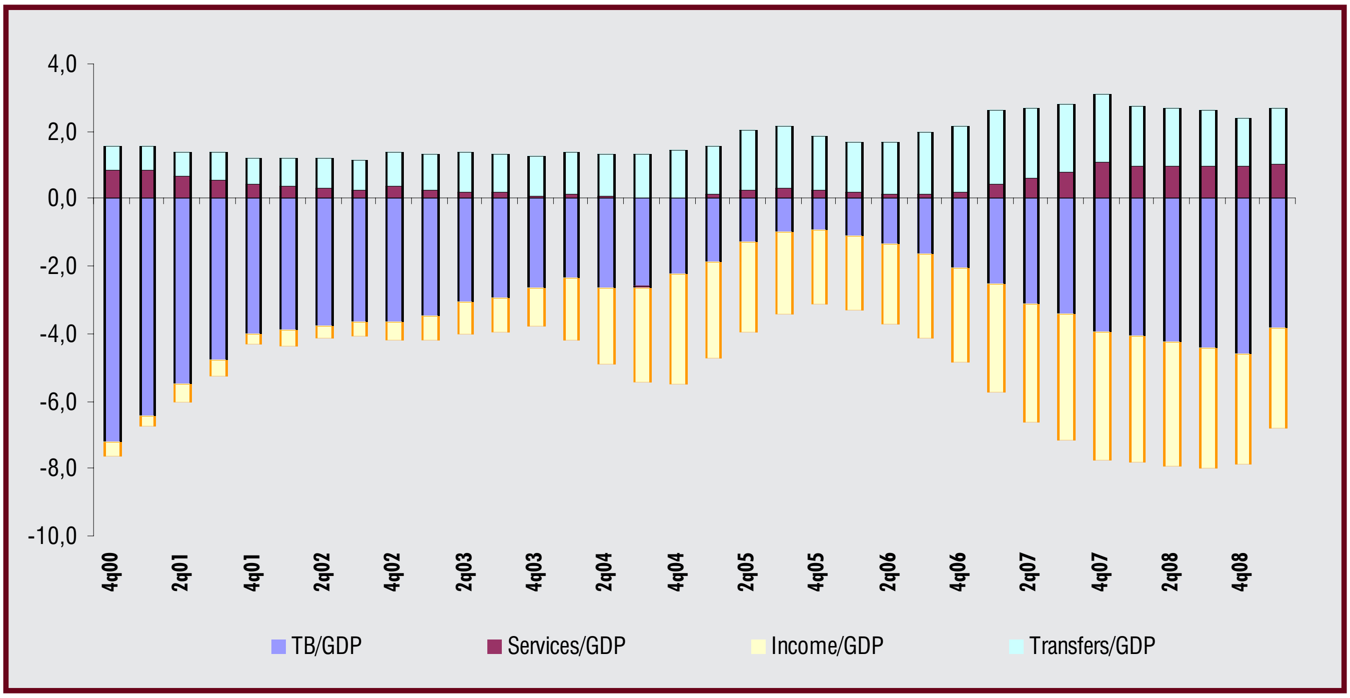
Figure 11. Real Effective Exchange rate of Poland, CPI deflated

The geographical breakdown of CSO preliminary foreign trade data, points to a collapse in foreign trade volumes across the board in the 1Q2009, be it developing countries, Eastern Europe or the euro zone. However, exports to the Eurozone dropped distinctively less than exports to Eastern Europe, which includes Belarus, Russia and Ukraine, i. e. the countries that experience a very severe downturn with the expected GDP declines in the order of 6 to 10% in 2009. Exports to the euro area, expressed in the euro, were down by 16.9% yoy while exports to Eastern Europe fell by 38.7% yoy in this period. On the other hand, such a differential performance cannot be noted in the case of imports. Imports from the euro zone and Eastern Europe decreased by 31.2% yoy and 31.0 % yoy. In our view, Polish companies that faced the shock of a sudden depreciation of the zloty of considerable proportions, but were used to the strongly appreciating zloty in 2008 reacted aggressively and clamped down on imports when its costs became excessively high. We have no data on the real depreciation of zloty in the 1Q2009, but the zloty must have become much softer year on year due to the significant nominal depreciation in January-February that was only fractionally reversed in March. Recall that in the 4Q2008, the zloty weakened by 5.3% yoy and 12.2% qoq in real effective terms vis-a-vis 42 currencies and deflated by the CPI. The nominal depreciation in the 1Q2009 was at least of the same proportions so it likely exceeded 10% yoy in the 1Q2009.

Exports to Germany dropped less than overall exports so Germany, the number one partner of Poland, gained the share in total exports for the first time in many years. France, Italy and UK also increased their shares at the expense of Eastern European countries. On the import side, China continued to gain in share as it rose to 10.2% from 7.5% in the 1Q2008. Imports from China fell only 1.9% yoy in euro terms, compared with a 27% drop of the total imports as reported by the CSO. This shows how competitive Chinese goods are. Another country among the first ten partner-countries, whose share in total imports was elevated in the crisis times, is South Korea.

According to our forecast the rolling four-quarter current account deficit decreased to 4.1% of GDP in the 1Q2009 from the revised 5.5% of GDP in the 4Q2008. We forecasted in the previous issue that the upward trend in the current account would be reversed in 2009, but we did not expect that it would happen so fast and on a such scale as we saw the ratio at 4.3% of GDP by the 2009 yearend. We were too timid, perhaps, but time will tell. This rapid change stems from the near-balance on the current account in the 1Q2009 that, in turn, resulted from a sharp drop in the trade deficit and net income deficit while net transfers increased. We pointed in PEO 1/2009 that „a further deterioration in the trade deficit should stop at latest in the 2Q2009 because the rapid real depreciation of zloty by over 20% on the back of the financial crisis has given Polish companies a strong competitive edge". We also said that „the deficit on the income account should be reduced as the corporate sector will post significantly lower profits in 2009 than in 2008" and transfers from EU should pick up and offset the impact of lower private transfers from abroad due to harsh labor market conditions there. Actually, all the factors played a role in the improvement of the balance of payments in the 1Q2009. According to our estimates, the rolling four quarter trade deficit dropped to 3.8% of GDP from 4.6% of GDP in the 4Q2008, net income deficit declined to 3.0% of GDP from 3.3% of GDP and net transfers increased to 1.7% of GDP from 1.4% of GDP in the final quarter of 2008. Net services contribute the same 1% of GDP (Figure 12).

Figure 12. Current Account Breakdown, as % of GDP



We do not change our qualitative forecast so the tendencies, outlined above, will likely continue to prevail throughout the year. The slowly improving fortunes of the European economy in late 2008 should be instrumental in allowing for the exploitation of the restored powerful competitive edge by Polish companies so the y-o-y exports should start declining less and less over the year with a possible increase in the 4Q2009. Imports will remain depressed and its dynamics will continue to trail the dynamics of exports. The trade deficit should shrink to 3% of GDP. Net income deficit will continue to decline to about 2.5% of GDP while net transfers should reach 2% of GDP. Thus, the current account deficit will likely decline to 2.5%-3% of GDP in the 4Q2009.

Were it to happen the question how the deficit could be financed under the present unfriendly conditions to borrowers becomes a non-issue. We forecast such a course of events so the zloty is fundamentally undervalued right now and will gradually strengthen over 2009 an 2010. The EU funds that come through the capital account show the signs of growing and will most likely cover at least 1%-1.5% of GDP. Net FDI inflows stood at 2.0%% of GDP in the 1Q2009, and it is unlikely that they will drop to less than 1% of GDP in 2009 despite that global prospects for FDI still look bad. However, it seems that we have just witnessed the final round of downward revisions of global growth forecasts by the international institutions so this outlook will probably start improving in the 2H2009. If Poland's growth prospects do not deteriorate further, we should see a turnaround in FDI inflows by the end of the 3Q2009. This leaves a portion of the current account deficit that should be financed by net portfolio and credit inflows of the magnitude of 0.5%-1.0% of GDP. This is less than in our previous forecast of 1% to 1.5% of GDP and it should not pose problems on the international financial markets that seem to be gradually coming back to their senses, i. e. in the environment of narrowing credit spreads and trickling loans, after a period of the risk-aversion going through the roof.

Deflation Scare – Not in Poland

The plunge in consumer price inflation below zero raised the specter of deflation and revived memories of the Japanese experience in the 1990s. US and Japanese CPI declined by 0.4% yoy and 0.3% yoy, respectively in March 2009. A year ago the CPI index rose by 4.0% yoy and 1.2% yoy in these countries, respectively. The USA has not experienced a y-o-y drop in the CPI since 1955. In the Euro area, CPI increased only 0.6% yoy in March 2009 while it stood at 3.3% yoy a year ago. A few countries such as Ireland, Portugal and Spain registered drops in the index. Outside the Eurozone, Switzerland flirts with deflation as well.

These developments cause that deflation is being hotly debated among economists now. They are divided between those who expound the danger of deflation and those who warn against the future inflation, caused by a huge increase in monetary bases by central banks during the ongoing global financial and economic crisis.

A bit of theory and history

There are two basic cases of deflation, distinguished by the economic theory. The first one is benign as caused by the changes in relative prices due to advances in labor productivity. The overall price level drops because it is pulled down by lower prices of these goods that become cheaper thanks to progress and is not related to economic weakness. This kind of deflation was experienced by the world economy in the late 19th century. Michael Bordo [1] points to the episode of 1873 -1896 in the USA, when prices fell by 2% per year under the environment of solid economic growth.

However, there is another case of deflation that finds its roots in an economic collapse when demand is weak and households and firms are highly indebted. A continual fall in the price level leads to expectations that prices will keep on dropping so economic agents delay their purchases for the future, consumers do not buy durables while firms postpone investment decisions, which in turn exacerbates the aggregate demand weakness. Further, debts are fixed in money, i. e. their nominal values remains the same while prices, profits and wages fall. Therefore the real burden of debts increases, depressing spending of borrowers as they have to service their debts. Those who find the debt service excessive, default, causing more problems for banks that have to write off loaned assets. Collaterals suddenly lose value so banks are forced to adjust their portfolios downward so they start tightening credit standards. The financial system is under stress and the recession deepens. A deflationary spiral may start.

Figure 13. Inflationary Expectations of the Public

The scale of the current crisis evokes the memory of the Great Depression during which, i. e. in 1929-1993, the world price level declined by 27%. Bordo and Filardo[5] calculate that, over this period in the United States, annual output declined by 7.6 percent and prices at a rate of 6.8 percent per year. After the asset price bubble burst in early 1990, when the central bank raised its interest rates to cool the economy, Japanese growth gradually deteriorated through the first half of the 1990s, rebounded briefly at mid-decade, but was generally weak until 2003, when it rebounded again on the back of rising exports. This long spell of sub-par growth gave a rise to the term of lost decade. Consumer

[5] Michael Bordo and Andrew Filardo, „Deflation and Monetary Policy in a Historical Perspective: Remembering the Past or Being Condemned to Repeat It?" NBER Working Paper No. 10833 (Cambridge, Massachusetts: National Bureau of Economic Research).

price inflation followed the economy downward, falling below zero in 1995, but its rate was around 1% already at the end of 1993. In response, Japanese short-term interest rates were lowered nearly to zero by late 1995, i. e. from their peak of 8.2% in March 1991 to 2% in March 1995 and 0.5% in October 1995. They have stayed close to zero ever since. However, with prices declining, real interest rates have remained positive, restraining growth.

During the current economic slump the threat of deflation may be still overblown as indices of core inflation excluding food and energy hover much above the zero line. The rapid drops in indices were due to the bursting of commodity price bubbles and these plunges in energy prices are rather temporary. The US core inflation was 1.8% yoy in March 2009 while the Euro area core inflation was 1.5% yoy. More annoying was the pace of the decline. In March 2008, these indices rose?? and by 2.7% yoy, respectively.

Another argument counter the threat is the well entrenched inflationary expectations of the broad public. ECB publishes results of a survey of professional forecasters four times a year in its monthly bulletin. The February release showed that expectations were substantially revised downward to average inflation of 0.9% in 2009 and 1.4% yoy in December 2009. The previous SPF forecasted 2009 CPI inflation at 2.2%. Should these forecasts depend much on current inflation readings then the drop in. The US

Despite of the evidence that deflation is not imminent risk, the downward evolution of indices sends a warning since complacency may result in enormous growth and employment costs as the historical examples illustrate. Deflation in Japan was widely unexpected so the proper policy responses came with a considerable delay when it was well entrenched in the economy, therefore harder to break.

Non-issue in Poland

Whether deflation fears in the advanced world are justified, they are a non-issue in Poland at present. The CPI inflation rate at 4.0% yoy in April was well above zero while the core inflation rate, excluding energy and foodstuffs, was 2.5% yoy in March this year. The section on inflationary developments in this report, however, points to a rapid decline in prices of market driven prices of goods and services amid economic slowdown. One such piece of evidence is that, except for fuels, the pass-thru of the zloty depreciation on import prices is negligible. Most durables prices are on the deflationary path, year on year. If households, which started to feel the pinch of the global crisis in the 1Q2009, see it, they may further delay their previously planned purchases, expecting further drops. In fact, inflation of industrial goods switched to deflation as the index stood at -0.4% yoy in the 1Q2009, and its further decline is likely. By the way, this was less than in the euro area. Inflation of prices of market services also displays a strong downward tendency. The conclusion is that deflationary tendencies may be delayed in comparison to the euro zone or the United States since the crisis hit Poland also with a delay of at least two quarters, but they are an undercurrent.

The fact that inflationary expectations are „well anchored" above zero should not be taken as too much comfort, either (see graph 13). The population expectations have been displaying a steep downward trend since October 2008 despite a gradual and erratic downward trend in inflation. These expectations are almost perfectly correlated with the most recent inflation rate that was known to respondents at the time of the survey so the hypothetical fall in the CPI inflation rate toward zero will likely induce the same drop in expectations. Therefore, the conclusions about the absence of deflationary pressures, based on them, should be treated with caution. The yields on long-term government bonds do not exhibit any deflationary expectations, either. These yields have gone up due to the increase in risk premium, caused by the global financial crisis, but even adjusted for this surge by approximate 150 basis points, the 10-year government bond would still yield about 4.5%. This provides more comfort.

The bottom line is that deflationary tendencies may yet to show in the economy once the combined effects of the rise in regulated prices and the considerable exchange rate depreciation wane. The critical time will come in the 4Q2008 and in particular in the 1Q2009. The central bank should stay alert should the economic slump continue because a rapid fall in inflation, when the key interest rate will be around 3.25%, according to our prediction, may lead to high real interest rates in the economy that would exacerbate the recession or economic growth in its infancy, if to take our predicted GDP expansion rate into account. To put it bluntly, a lagged response by the central bank to deflationary pressures could kill the recovery in its infancy.

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