POLISH ECONOMIC OUTLOOK
TRENDS • ANALYSES • FORECASTS
CASE
QUARTERLY 4/2008 (39)

Special Feature – Is There a Room for Fiscal Stimulus?

EXECUTIVE SUMMARY

Poland was hit by the global financial crisis in the 4Q2008 that caused an economic slump of Western economies. These developments spilled over to Poland and growth considerably weakened. Employment continued to grow at a slow pace in the 4Q2008 while the number of unemployed persons started rapidly increasing at the turn of the year. Inflationary pressures eased in the 4Q2008 on the back of falling fuel and food prices (cereals). Despite weak growth, the trade deficit continued to grow because of the collapse in exports. The central government cash deficit came above expectations in the 4Q2008, but the full-year shortfall was below original projections. The most meaningful structural reform was the elimination of early pensions.

Polish economy abruptly entered near-stagnation in the 4Q2008, as seasonally adjusted GDP grew only 0.3% qoq, versus 0.8% in the 3Q2008. GDP grew 2.9% yoy compared with 4.8% in the 3Q2008. A large decline in exports and inventory-unloading were the main factors of this slowdown, compared with the 3Q2008. Private consumption expenditures upheld its strong rate of growth. A new year started with a further worsening of business climate. We outlined two scenarios in the PEO 3/2009. GDP growth in 2009 could reach 3%, contingent on the resumption of lending by commercial banks to the non-financial sector, decisive cuts in the central-bank interest rates and the moderate global downturn. Meantime, banks have further restrained lending while the world economy slipped into the deepest recession since the second world war. Only, the NBP has delivered and cut decisively its interest rates, but their transmission to market interest rates on credits was poor. Since the bad-case scenario is unfolding, we forecast a stagnation in the economy in the 1H2008 and a slow recovery afterwards; GDP should grow less of 1.5% in 2009, consumption will reamain the engine of growth.

GDP growth near zero in the 1H2009 will support further disinflation whose roots have been mainly on the supply side so far. Soft demand will arrest demand inflation while hikes in regulated energy prices, instituted at the beginning of 2009, are counterproductive in this respect. The major risk to disinflation is the strong depreciation of the zloty on the wave of irrationally high risk-aversion vis-a-vis currencies in Central Europe to the levels far off of the fundamentals. In our view, Polish zloty should start gradually firming until the yearend, and assuming this scenario, we forecast a decline the CPI inflation rate to 1.7% yoy in the 4Q2009; the average 2009 rate would drop to 2.1%. A rather quick return of the inflation rate to the middle of the NBP target of 2.5% yoy and the economic stagnation underpin our prediction of more interest rate cuts; the easing cycle will likely end up in the 1H2009 at the rate 3.00-3.25%, the lowest in history.

Favorable trends on the labor market are over. Employment is likely to decline and unemployment to rise for the next 4 to 6 quarters. The registered rate of unemployment increased more in December 2009 and, in particular, in January 2009 than seasonal factors would point to. We forecast that this rate will reach 12.2% at the 2009 yearend and continue increasing in 2010. The expectations of a rapid rise in the cyclical unemployment have already started capping wage demands so the rise in nominal wages will be much lower than in 2008, but the rise in real wages will decelerate less than proportionately due to disinflation.

The current account deficit rose in euro terms in each quarter of 2008 on the back of the widening trade imbalance, but it was quite stable in GDP terms. The 4Q2008 was distinct from previous quarters in a sense that the prices of commodities stopped pushing it upward whereas the collapse in exports that had grown quite fast before, replaced them. Poland should continue to register a positive growth differential versus its main EU and post it even vis-a-vis its East European partners, which would tend to increase the deficit. However, we think that due to the collapse in private business investment in this country and low prices of commodities imports will shrink more than exports in euro terms. The large-scale zloty depreciation that gives Polish companies a strong competitive edge, will also be instrumental in the reversal of the widening trend in the trade deficit and support the decline in the current account shortfall relative to GDP.

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

Indicator	Data							CASE forecasts					
	2005	2006	2007	2008				2009				2008*	2009
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4		
Nominal GDP, PLN bn	983.3	1060.1	1175.3	295.3	309.9	312.1	349.3	304.2	317.6	322.5	364.4	1266.6	1308.7
(% change, yoy)													
GDP	3.6	6.2	6.7	6.0	5.8	4.8	2.9	0.0	0.7	1.6	2.8	4.8	1.4
Private Consumption	2.0	5.0	5.0	5.6	5.5	5.1	5.2	2.2	2.8	3.2	3.7	5.4	3.1
Fixed Investment	6.5	14.9	17.6	15.7	15.2	3.5	3.5	-9.0	-6.1	-3.0	-1.9	7.9	-4.0
(4Q, % of GDP)													
CA balance	-1.2	-2.7	-4.7	-4.9	-5.1	-5.2	-5.4	-5.2	-4.6	-4.4	-4.3	-5.4	-4.3
(% change, yoy)													
Exports (NBP, EUR)	17.8	20.4	13.4	20.3	21.3	17.9	-8.5	-23.1	-17.3	-13.9	4.3	12.1	-13.1
Imports (NBP,(EUR)	13.4	24.0	19.5	21.7	24.2	21.1	-3.2	-22.2	-19.9	-13.7	-1.3	14.1	-14.0
(% change, yoy)													
Industrial sales	3.7	11.2	9.5	8.5	8.5	3.4	-6.3	-12.0	-5.0	-2.0	1.0	3.3	-4.3
Gross value added	3.3	6.0	6.6	5.5	6.1	4.7	3.4	0.1	0.9	1.8	2.7	4.9	1.4
CPI	2.1	1.0	2.5	4.1	4.3	4.7	3.7	2.9	2.1	1.8	1.7	4.2	2.1
PPI	0.7	2.3	2.3	3.0	2.5	2.1	2.4	2.7	2.3	2.4	2.4	2.5	2.4
Nominal Ave. Wage	3.8	4.9	8.7	10.1	11.6	10.6	7.7	6.7	6.5	4.4	2.8	10.4	5.0
Employment %, LFS	2.3	3.1	3.1	4.6	3.5	3.6	3.0	1.2	-1.0	-1.5	-2.0	3.7	-1.0
Registered unemployment rate (%, eop)	17.6	14.8	11.4	10.9	9.4	8.9	9.5	11.2	11.4	11.2	12.2	9.5	12.2
PLN/EUR, eop	3.86	3.83	3.58	3.53	3.35	3.41	4.17	4.70	4.50	4.20	4.00	4.17	4.00
WIBOR 3M, %, eop	4.60	4.20	5.68	6.15	6.65	6.63	5.88	4.40	3.85	3.80	3.75	5.88	3.75
Central bank key rate eop	4.50	4.00	5.00	5.75	6.00	6.00	5.00	3.75	3.25	3.25	3.25	5.00	3.25
(% change, yoy eop)													
Broad Money (M3)	13.1	16.0	13.4	13.6	16.3	17.3	18.6	17.0	15.0	10.0	7.0	18.6	7.0
Loans to HH	26.0	33.4	37.9	37.4	34.4	33.5	44.6	40.0	29.5	20.0	11.0	44.6	11.0
Loans to Firms	2.5	13.7	24.1	25.2	24.5	24.1	29.0	26.0	21.0	13.0	6.1	29.0	6.0
(% GDP)													
Fiscal Balance	-4.3	-3.8	-2.0	n.a.	n.a.	n.a.	-2.8	n.a.	n.a.	n.a.	n.a.	-2.8	-3.5
Public Debt eop	47.1	47.7	44.9	n.a.	43.1	n.a.	46.1	n.a.	n.a.	n.a.	n.a.	46.1	47.0

(*) data or estimates

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

The 4Q2009 witnessed a twice larger increase in the cash central government budget deficit than government expectations. The state revenue was much lower than predicted while a lower-than planned expenditure was unable to offset it. Our forecast from the PEO 3/2008 proved accurate that the 2008 deficit would reach PLN 24 bn, i.e. below the original projection of 27 PLN bn. The government sticks to the deficit projection of PLN 18.1 bn in 2009 despite a downward revision of its growth forecast, planning large expenditure cuts. However, we are skeptical that they will be sufficient since government growth forecasts seem overly optimistic. The work of automatic stabilizers such as income taxes and social security premia will also tend to raise the deficit of local governments and social insurance. Local governments will also speed up their infrastructure outlays. Therefore we forecast that the general government deficit will reach 3.0 - 3.5% of GDP in 2009, compared with the government target of 2.5% of GDP. The breach of 3% could cloud the outlook for the ERM-2 entry.

The deficit plans are consistent with the intent to adopt the euro in 2012, but this date is becoming more and more uncertain because of the soft zloty and its high volatility likewise the lack of political consensus in this country. The necessary amendments of the Constitution hinge on the yes by the main opposition party. Even if the government were able to stick to its deficit target, it is unable to eliminate the political risk before presidential and parliamentary elections due in 2010 and 2011, respectively. This may lead to the excessive volatility of the zloty.

The debate whether Poland should adopt an expansionary fiscal policy to prop its economy like others do, has recently been lively in Poland. The government rejected this possibility, sticking to the "road map to euro". We take the subject in our Special Feature: Is There a Room for Fiscal Stimulus?

LATEST DEVELOPMENTS IN THE POLISH ECONOMY

Economic growth

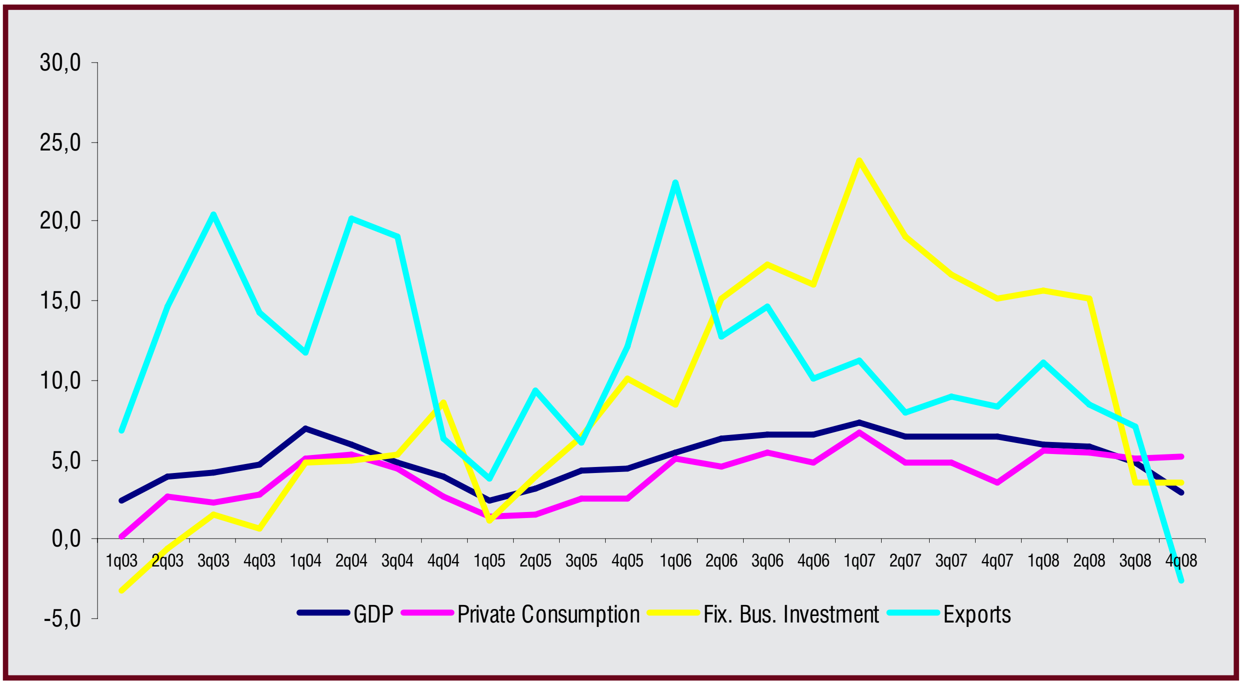
Preliminary data on economic growth in the 4Q208 clearly show that the global crisis affected Poland not only through exports, but also through the financial channel as the poor access to investment credit diminished expectations about profitability of investment projects, cast doubts about a possibility of their financing and instilled pessimism about growth prospects.

GDP grew by 2.9% yoy in the 4Q2008, the slowest since the 1Q2005, when the economy unloaded inventories, accumulated during the so-called accession boom before May 2004. At present, conditions are different and inventories are rising due to the lack of demand, in particular, foreign. The positive y-o-y rate of growth masks the fact that the economy barely expanded in this period as the seasonally adjusted GDP expanded by 0.3% qoq only, compared with 0.8% - 1.0% qoq in the previous quarters of the year. Such a low quarterly figure was last seen in the 1Q2002, when the economy stagnated. To recall, GDP grew by 1.2% in 2001 and 1.4% in 2002. Therefore the 4Q2008 performance of the economy augurs badly for the short-term growth prospects.

Domestic demand increased by 3.6% yoy in the final quarter of 2008 so the slowdown of GDP expansion was mainly due to the collapse of exports that decreased by 2.6% yoy in the 4Q2008, but much more in seasonally adjusted terms, i.e. 3.4% qoq. This collapse was not fully offset by imports, which declined by 0.3% yoy and seasonally adjusted 2.1% qoq so net exports contributed negatively to growth after they were positive in the 3Q2008. Moreover this negative contribution was relatively strong.

Domestic demand rose faster than GDP, but gross investment that consists of gross fixed business investment and inventory changes was another factor of the slowdown in the 4Q2008. Its growth rate fell to 1.5% yoy in the 4Q2008 from 5.6% yoy in the 3Q2008, but it is interesting that, in seasonally adjusted terms, a decline was higher in the 3Q2008 than in the 4Q2008, i.e. by 0.9% qoq and 0.1% qoq, respectively. Fixed business investment rose by 3.5% yoy, the same as in the 3Q2008 and compared with over 15.4% yoy in the first half of 2008. Interestingly though, it decreased by 0.7% qoq in seasonally adjusted terms in the 3Q2008 whereas it expanded by 0.8% qoq in the 4Q2008. Firms saw that excessive inventories piled up in the 3Q2008 so they started unloading them in the 4Q2008. Disinventories shaved 0.6% of GDP growth, therefore the gross-investment contribution to GDP growth fell considerably, but, in contrast, fixed business investment actually picked up. A couple of conclusions come to mind. Thus, the slowdown in investment started in the 3Q2008, most likely ignited by the diminishing prospects for the world demand that multinational companies transmitted to their daughter companies in Poland. The figures suggest that the deceleration in fixed business investment preceded the tightening of lending standards by Polish banks and higher spreads on loans in the 4Q2008. Its return to growth in the 4Q2008 is most likely related to the pickup in public fixed investment, as EU funds had to be used up by the yearend, otherwise they would have to be reimbursed.

Figure 1. GDP growth factors, quarterly % yoy



Private consumption, a main driver of growth, kept steady as it consistently rose over 5% yoy in each quarter of 2008, i.e. 5.1% yoy and 5.2% yoy in the 3Q2008 and 4Q2008, respectively. Seasonally adjusted growth on a quarterly basis was stable throughout the year as well (1.2% -1.4% qoq). This happened on the back of rising wages and salaries as well as employment. The y-o-y growth in wages and employment slowed in the 4Q2008, but this did not impact consumption adversely. Consumer confidence started worsening in the 2H2008, but, apparently, did not impact consumer expenditure, either. Was it the final party on Titanic ?

On the supply side, poor performance of exports coincided with a drop in sold industrial output by 6.3% yoy in the 4Q2008, compared with an increase of 2.2% yoy in the 3Q2008 and rates of growth above 7% yoy in the past six consecutive quarters. On the seasonally corrected basis, industrial output fell even more. Thus both series reported consistent results. Starting October 2008, new orders in industry have been decreasing each month on a yearly and monthly basis and export orders have experienced a virtual slump since then.

The domestic side upheld better, but it also felt the brunt of the global recession in the 4Q2008. Estimated construction sales increased by 3.8% yoy in the 4Q2008, compared with 9.4% and 16.5% yoy in the 3Q2008 and the 2Q2008, respectively. Estimated real retail turnover rose by 4.7% yoy in the 4Q2008, compared with 8.0% yoy and in the 3Q2008.

The outlook for the 1Q2009 and beyond has worsened further since the previous issue. The external environment has plunged into the deepest recession in the post-war period and foreign orders have collapsed. The deterioration in the business sentiment indicators to the levels below the ones recorded during the 2001 recession, implies that pessimism is overwhelming. It pervades consumers as well. Firms hoard cash because they have problems to renew or receive working capital from banks while households, scared by the prospects of unemployment, increase their savings. Increased savings may be rational from a microeconomic point of view, but, in aggregate, their massive rise will lead to a fall in domestic demand in the short-run so GDP growth will slow. Therefore the economy will inevitably experience the negative consequences, described by the Keynesian paradox of thrift. Consumers under stress may spend a small fraction of the cut in personal income tax (0.7% of GDP) and pensioners may also save the generous pension compensation for 2008 (a rise by about 6% in nominal terms). Rising unemployment and lower rise in nominal wages in 2009 will also tend to cap the expansion of personal consumption. Consumer credit growth has considerably slowed as banks continue to tighten credit standards and limit a size of loans as well. Despite these qualifications, personal consumption will remain an engine of growth in 2009.

With regard to fixed business investment, the culmination of the financial market crisis in the 4Q2008 led to revisions of numerous investment plans of private firms. Their fixed business investment will significantly decline in 2009 and it remains uncertain to which extent this drop will be offset by the acceleration in public investment into infrastructure, based on the use of the structural funds from the EU. We assume that it will be partially achieved. Nonetheless, domestic demand should remain the engine of GDP growth in 2009, and the higher the public investment will be, the stronger multiplier effects will be spread over the economy.

Foreign demand will likely drag Polish economy down, as Poland's main partners experience a severe recession, but imports should fall in line with exports as well due to the down-sized private fixed investment, cheap commodities and the depreciated zloty. As a result, net exports will likely remain negative, but of the similar order as in 2008, i.e. -0.4% of GDP. The substantial nominal depreciation of the zloty – it lost some 30% in value against the euro since the collapse of an investment bank Lehman Brothers - translated into the real effective depreciation (Figure 10) has improved profitability of Polish exports very much. The previous such episode was in the fall of 2003 and the 1Q2004, when it spurred recovery of the Polish economy after two years of stagnation. However, the world economy was picking up at that time after the recession of 2001-2002. At present, the global economy is shrinking so that external demand is very weak and falling. It is unclear whether Polish companies will be able to increase their share in the declining markets despite their enhanced profitability that should enable them to cut prices in order boost sales.

We stated in the PEO 3/2008 that if commercial banks do not resume lending, the central bank does not cut interest rates and the global economy plunges in the deep recession, Poland would stagnate. This course of events is most likely in the 1H2009, however, due to the ever-deteriorating global environment we cannot exclude a recession in Poland in the 1H2009. A start of a gradual recovery should occur in the 2H2009, but potential GDP growth will not be restored until the late 2010. The pessimistic scenario is materializing since central bank interest rate cuts have not been transmitted to lower market interest rates as commercial banks raised their credit margins and tightened credit standards for customers.

Inflation and Monetary Policy

Current situation

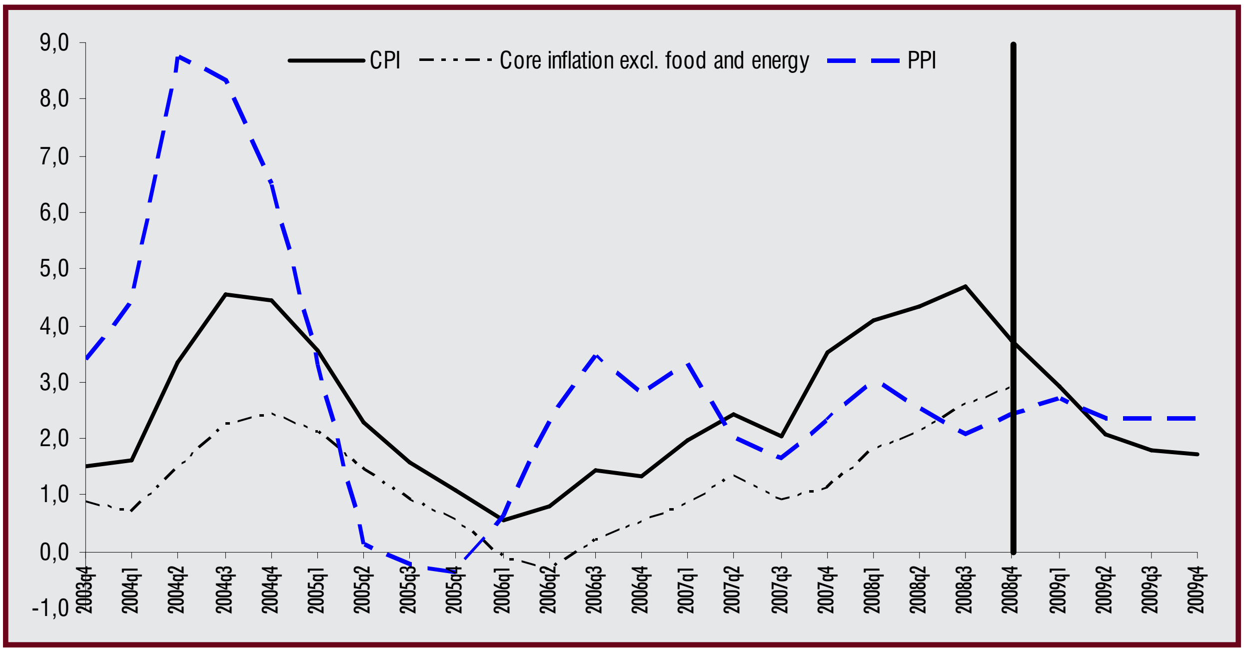
CPI inflation slowed down markedly to 3.7% yoy on average in the fourth quarter – down by a one percentage point compared to the third quarter- and further to 3.1% in January (preliminary estimate). This decline reflected a sharp deceleration of prices of foodstuffs (cereal, dairy and fruits) and fuel - both were responsible for pushing inflation up in late 2007 and 2008. Growth of prices of services remains high while prices of non-energy industrial goods continued to slow down showing in late 2008 the lowest dynamics since early 2007.

Inflation declined thanks to the reversal of food and fuel supply shocks that struck global markets in mid-2007. This is clearly discernible from the behavior of core inflation without food and energy, which has leveled off at 2.7-2.9% yoy since August 2008, providing evidence for the stability of the remainder of the consumer basket. Prices of food are tumbling down at global markets with the IFS index of agricultural raw materials down by 25% year on year in January 2009, including wheat which saw a price cut of 35%. Procurement prices in the Polish market seem to have declined even more with wheat, rye and maize all sold at roughly at half of the last year's price in January. The result are sharply falling inflation rates of retail prices of related foodstuffs: bread and cereals have seen their annual dynamics fall from 13.5% in the third quarter (the highest since early 2001) down to 7.3% in the fourth quarter and 6.6% in January 2009. Likewise, prices of dairy products have seen their dynamics fall to 0.7% year on year in the 4Q2008 and further to -1.2% in January 2009, down from 14.9% in the 1Q2008. Inflation of fruits and vegetables oils has also come down from near 30% and near 15% in the 1Q2008, respectively, to -6% and 3% in the fourth quarter.

Despite marked weakening of the zloty in recent months prices of industrial goods continue to exhibit very low inflation, reflecting shrinking domestic and foreign demand. The Polish currency depreciated by 22% in the fourth quarter alone (end-quarter values) and by further 11% in the first two months of 2009, but transmission to prices of tradables has been rather limited so far. The aggregate of non-energy industrial goods picked up marginally from 0.7% yoy in the 3Q2009 to 0.9% in the 4Q2009, solely as a result of slight acceleration in the group of semi-durables and non-durables while the most intensely traded durables have actually seen their dynamics decline from -0.4% to -0.5% yoy in the third and fourth quarters, respectively[1]. The developments of CPI groups confirm that no significant change in key industrial goods can be discerned. Clothing&footwear continue their deflationary trend (-6.5% yoy in the 4Q2008 and January 2009) as does electronics (-13.4% in the 4Q2008 and -12.9% in January 2009) and home appliances while inflation of home furnishings remained very low, well below 2% in the same period.

[1] Eurostat data referring to the Harmonized Index of Consumer Prices – HICP.

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



Core inflation excluding administrative prices declined markedly in the fourth quarter to 3.5% yoy (from 4.3% in the 3Q2009) and got very close to the headline inflation. This signals that the effect of administrative price adjustments has been neutral in the fourth quarter and suggests the gradual convergence of growth of administrative price to that of free-market prices. The major impact on the developments of the administrative component of the CPI basket was due to fuel whose price decelerated from 6.2% in 3Q2008 to -6.5% in 4Q and -15% in January 2009, reflecting sharp declines of global prices of crude oil, traded in February 2009 at a mere one-third of the peak July 2008 price. On the other hand, inflation of all other energy carriers combined (electricity, gas, furnace fuels, heating and hot water) continues to rise with the 4Q2008 and January 2009, setting new record highs in a decade at 13.5% and 13.8% yoy, respectively, markedly up from 11.1% yoy in the third quarter and 7.4% on average in the first half of 2008. This divergence in trends of retail prices of vehicle fuel and other energy carriers appears to be a result of the lower deceleration of world prices of gas and coal compared to crude oil and, perhaps more importantly, of a significantly higher rigidity of retail prices of electricity, gas, central heating and hot water. These prices -unlike the one of fuel- are subject to direct price controls of the Energy Regulation Agency. The price-approval process by the Agency is quite complex and accounts for a variety of factors such as EC-imposed environment policies, ensuing eco-investment needs and individual firm specificities - making resulting price developments more persistent and much less correlated with corresponding shifts in world prices.

Producer price inflation picked up to 2.4% in the 4Q2008 and 3.0% in January 2009 from 1.7% in the 3Q2008, mostly on the back of rising prices of energy and in selected manufacturing industries. Sizeable adjustments of prices of electricity, hot water and heating occurred in November (by 2.7%) and January (by 8.3%), lifting the annual price growth in the energy sector sharply from -2% on average in the first three quarters of 2008 to 1.4% in the fourth quarter and a record high 20% year on year in January - not registered since 1996.

In addition to rising energy prices several manufacturing industries have seen their annual price growth rise in the fourth quarter. This trend was largely observed in selected heavy industries (production of metals, machinery and equipment, electronics as well as transport equipment) while other industries continue to see their prices decelerate (e.g. chemicals, foodstuffs). In total, inflation of manufacturing industries increased to 0.8% in 4Q2008 (up from 0.0%) in 3Q to decline again to 0.5% in January 2009.

Mining and quarrying registered a drop in annual price growth to 9.7% yoy in the 4Q2008 and further down to 6.9% in January from 11.1% in the 3Q2009 – largely on the back of falling prices of coal and copper.

Forecast

In spite of accurate forecasts of fourth-quarter CPI and PPI inflation, we have revised significantly our predictions for 2009. We forecast average annual CPI inflation in 2009 to be 0.9 percentage point lower than previously predicted while for the PPI our expectations are now 0.8 percentage point higher compared with previous PEO.

Lower CPI inflation follows directly from the marked worsening of Poland's economic outlook in the course of past 3-4 months. Key economic institutions (including big international financial institutions) have significantly reduced GDP forecasts for Poland, new member states and the UE alike by as much as several percentage points since last autumn. This directly limits demand for goods and services both at a global and domestic level, pushing world prices of commodities down (including the key ones such as oil, wheat and metals) and reducing prices of all goods and services in line with consumers' shrinking budgets.

Decelerating demand of Polish consumers is likely to put considerable pressure on domestic producers and cutting prices may prove to be the only method of retaining market shares. These pressures are expected to be particularly severe in sectors producing goods with high income-elasticity of demand, i.e. those that may suffer the sharpest decline in demand in response to decelerating disposable income of consumers. This group typically includes most services and industrial goods such as electronics, clothing, footwear, home appliances and furnishings and culture-related goods (books, regular publications). On the other hand foodstuffs typically thought to be relatively insensitive to income fluctuations may not experience such a profound decline in demand - however, with sharply falling agricultural commodities they too are expected to exhibit very low price dynamics in the future quarters.

Additional deflationary pressures may come from sectors producing construction materials (not directly covered in the CPI) and many sectors manufacturing home furnishings, decoration and appliances. Drastic demand cuts are expected as a result of sharp deceleration of mortgage dynamics (see chapter on money and credit) as well as other types of consumer loans.

The behavior of the exchange rate carries the biggest risk for future inflation forecast. The sudden depreciation of zloty in the fourth quarter of 2008, continuing in initial months of 2009 appears to have not been transmitted to consumer prices yet. However, if the currency will not rebound soon this may mean that some sectors with relatively weaker competition will gradually pass some of the depreciation burden onto consumers. This is already the case in the gasoline market where larger price declines (commensurate with the global price fall) are thwarted by the depreciating zloty. Therefore the current forecast of low inflation in 2009 is strongly conditioned on the expectation of the gradual rebound of the currency. Should the rebound be weaker, occur later or not occur at all - this will directly translate into higher inflation.

We believe that the balance of all those factors and risks, coupled with the underlying declines in the world prices of commodities, will translate into a significant slowing of inflation in Poland. Inflation will fall sharply in the first quarter of 2009 to 2.9% yoy and decline further 2.1%, 1.8% and 1.7% in subsequent quarters of 2009 averaging 2.1% in 2009 as a whole - precisely half of the 4.2% registered in 2008.

The PPI inflation forecast is 0.8% higher than previously predicted, solely as a result of the massive adjustment of energy prices in January 2009, resulting in a 1.7% hike of PPI on a monthly level. Increases in subsequent months are expected to be markedly lower which coupled with otherwise negative price trends throughout manufacturing and mining&querrying results in a forecast of 2.4% on average in 2009 - compared with 2.4% in 2008.

Monetary Policy

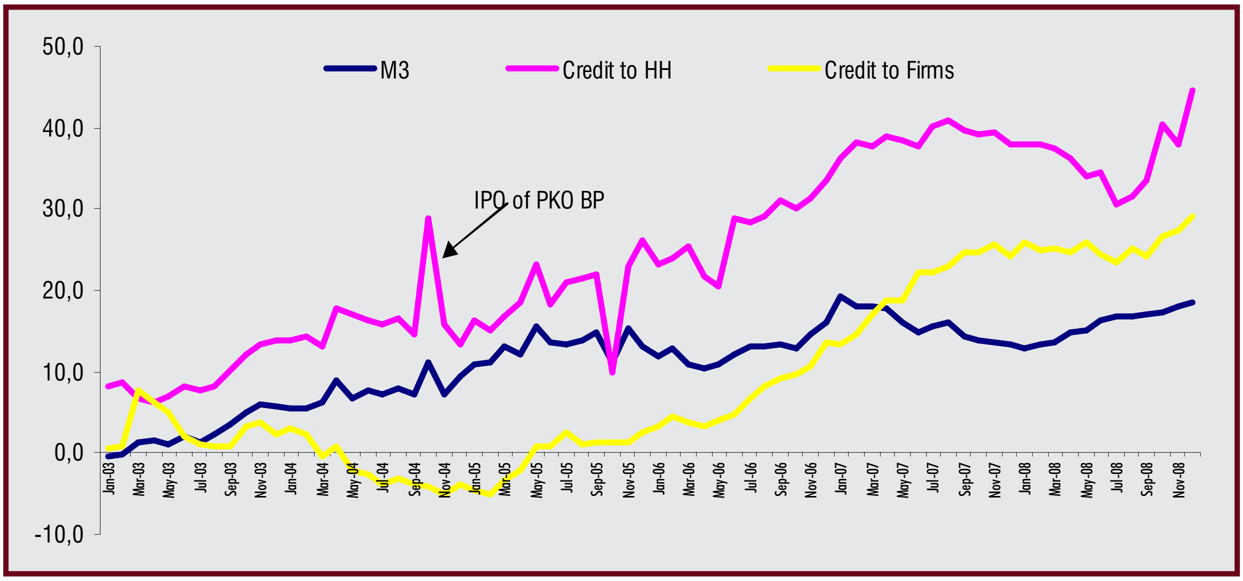
The rapidly deteriorating outlook for economic growth and visible easing of inflationary pressures prompted the Monetary Policy Council (MPC) to reduce interest rates in the 4Q2008 and January-February 2009 by the total of 2 percentage points so they dropped to the lowest level, recorded in transition. The seriousness of the situation was emphasized by a large cut in December 2008, the first cut in December ever. Since inflationary pressures are likely to weaken further and the economy will enter a stagnation phase for at least two quarters, according to our predictions, the MPC is forecast to continue interest rate cuts in the 1H2009. The key interest rate will likely fall to 3 - 3.25% by the end of 1H2009. The cuts could be larger, but the strong zloty depreciation has become a major risk to inflationary developments in 2009 so the MPC will likely trim the cuts as the monetary conditions, which take both the real depreciation and real interest rates into account have considerably eased. NBP interest rates should remain put in the 2H2009 as the economy will start slowly recovering and the gradual appreciation of the zloty will help soften inflationary pressures. Hikes in interest rates seem unlikely before the end of 1H2010 because the economy will not achieve its potential rate of growth by then so demand pressures will not resurface while the supply side inflationary impulses could only come in case of a bad global harvest in 2009.

Monetary Developments

The climax of the global financial crisis led to distinctive monetary trends in the 4Q2008 as compared with the previous quarters. The substantial depreciation of the zloty inflated monetary aggregates, creating a false impression of an accelerated money and credit expansion. However credit was frozen.

Nominal monetary expansion as measured by the broad money aggregate M3 accelerated in the whole of 2008. M3 rose by 18.6% yoy in December 2008, compared with 17.3%, 16.3% and 13.6% yoy in September, June and March of 2008, respectively. This coincided with a pickup in real terms as well despite the increase in inflationary tensions during the first nine months of the year while disinflation in the 4Q2008 reinforced the upward trend in real money. Deposits grew by 20.6% yoy in this period, but this aggregate figure masks distinct trends with regard to household and company deposit that grew by 26.5% and 4.0% yoy, respectively. The depreciation of the zloty elevated the pace of deposit expansion, but households also placed their savings with banks, drawn by aggressive hikes in deposit rates by several of banks as well. Alternative investments, offering positive rates of return on capital, were rare under the circumstances of a bear market. In addition to depositing new savings or redeemed assets at investment funds, households withdrew their demand deposits and switched to time deposits. According to the NBP data, the average zloty deposit rate on time deposits up to 2 years increased to 6.1% per annum in December 2008 versus 4.6% in September 2008. This coincided with the central bank interest rate cuts.

Figure 3. Broad Money and Credit Expansion, % yoy

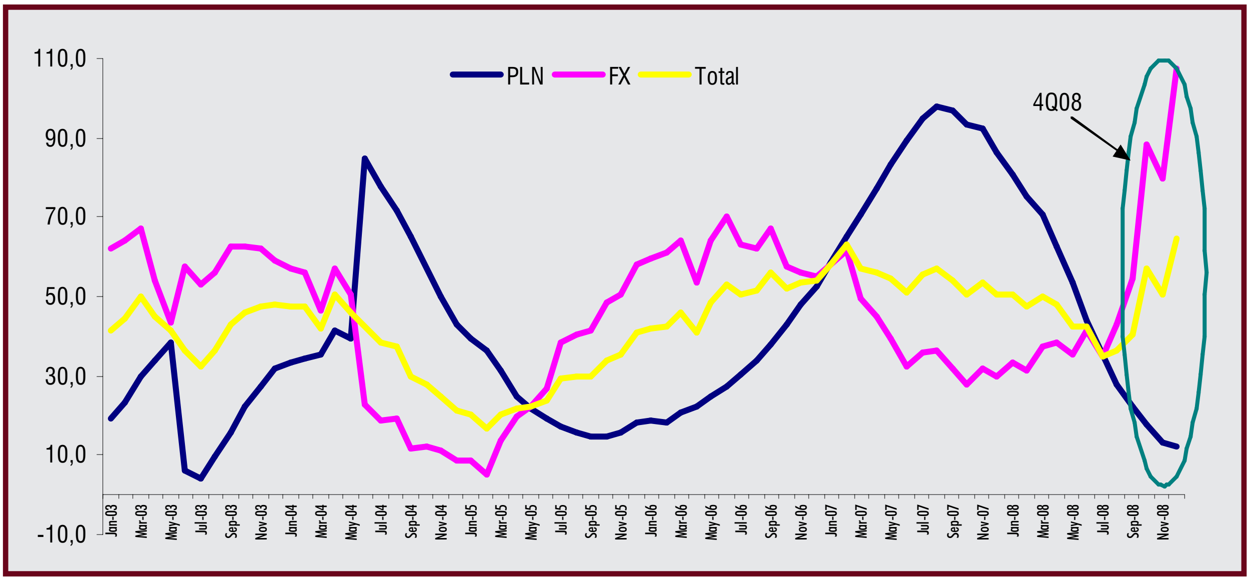


When global financial markets seized in the 4Q2008, foreign parent companies limited the access of their Polish subsidiaries to credit lines. There were even reports of a drainage of funds by loss-making and liquidity-craving parent banks so Polish banks could no longer support the credit action that was based on the foreign currency lending. Therefore they responded to the lack of capital by raising deposit rates to non-bank customers despite a drop in the central bank rates. In a number of cases, the competition among banks drove temporarily these rates above credit rates, showing how desperate they were to keep liquidity, when the inter-bank market dried up, but questioning their responsibility.

Under these circumstances, the fourth quarter of 2008 was distinct from earlier quarters of the year because of a collapse in bank lending to the economy. Polish commercial banks, mostly owned by foreign capital, transmitted the credit crunch to Poland after the failure of an investment bank Lehman Brothers 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. Polish banks stopped lending each other first and then started tightening lending standards to non-financial enterprises. The seizure of financial markets also led to a substantial rise in the cost of credit.

In December 2008, credit to households was up 44.6% yoy versus 36.1% yoy in September 2008. Credit to non-financial firms increased by 29.0% yoy in December while it was up 24.1% in September (Figure 3). How can we square the two facts that money supply and credit grew faster in year-on-year terms in the 4Q2009 than earlier ? A massive depreciation of the zloty in the 4Q2008 comes as an explanation. The euro gained 22.4% against the zloty between the beginning and the end of the fourth quarter of 2008, inflating the value of foreign currency deposits that are included into the money supply likewise the value of the foreign currency stock of credit. The strong depreciation of the zloty also caused the share of foreign currency mortgages to rise substantially Figure 4).

Figure 4. Housing Credit Credit Growth, % yoy



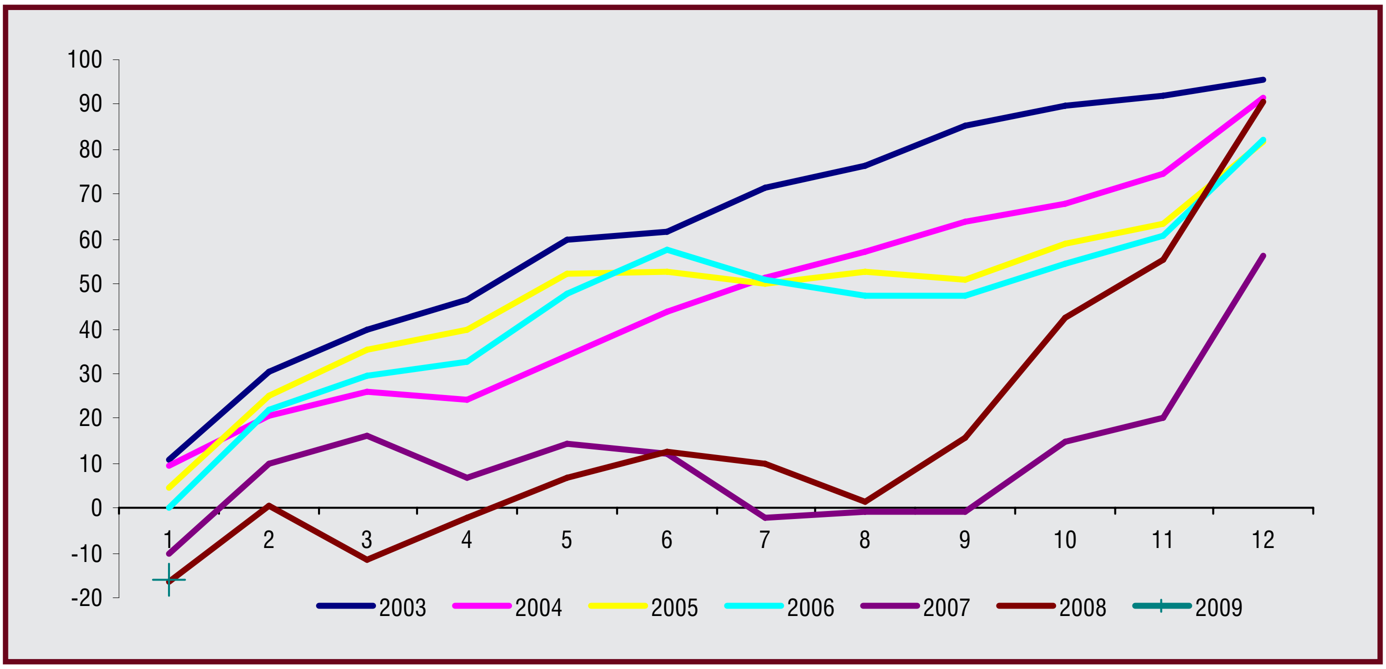
Therefore annual rates of growth of credit aggregates are misleading, when they suggest that credit growth was particularly strong in the 4Q2008. To give an example, all foreign currency assets of financial institutions vis-a-vis the non-financial sector were worth 148.5 billion zlotys at the end of September 2008 or equivalently 43.6 bn euros. The same euro amount was valued 181.7 bn zlotys at the end of December 2008, i.e. 33.2 bn zlotys more. (A word of caution is necessary that a large portion of the foreign exchange bank assets is denominated in the Swiss franc so our estimates are rough. The currency breakdown is not published.). Assets of banks vis-a-vis the nonfinancial sector rose by 63.4 bn zlotys in the 4Q2009 so more than a half of this growth was related to the depreciation of the zloty. Loans, denominated in the zloty, increased by 7.5 billion zlotys only in this period, compared with 14.5 billion zlotys in the 3Q2008, a drop by almost 50%. The amount of new credits, denominated in the foreign currencies, amounted to the zloty equivalent of 21.7 bn in the 4Q2009, compared with 23.2 billion in the 3Q2009, a fall by 1.5 bn zlotys or 6.5%. However, this implies a lower amount of the foreign currency equivalent due to the depreciation of the zloty.

The banking sector was worse off in the 4Q2008, when it disseminated the global crunch to the Polish market, than in previous quarters of 2008. Its net income was approximately half of the quarterly net income, recorded in each of the first three quarters of 2008, i.e. PLN 2.1 bn in the 4Q2008 versus 4.0 bn in the 3Q2008. Numerous banks revealed that they raised their provisions for irregular credits in this period that diminished profits. The data of Polish Financial Supervision Authority show that these provisions and valuation allowances rose by almost 80% in the 4Q2008 as banks anticipated that a slowdown in the economy will lead to a substantial worsening of the quality of their credit portfolio. However, the share of irregular claims on nonfinancial customers did not budge up as it remained the same 4.4% in the 4Q2008 as in the 3Q2008, the lowest in history. The worst is yet to come. Perhaps, in the 1Q2009, but banks still seem to be well capitalized as their risk-weighted capital ratio stood at 10.8% in the 4Q2008, however down from 11.8% in the 3Q2008. Polish banks do not own US toxic assets, but they are likely to incur losses on commercial loans and mortgages due to the low-growth environment and rising unemployment.

Fiscal Developments and Policy

In 2008, according to the preliminary data, the central government cash budget registered a deficit of 24.6 bn zlotys or 90.8% of the 27.1 bn zlotys targeted in the state budget. The shortfall amounted to approximately 1.9% of preliminary GDP, equal to 1266 bn zlotys. The state revenue came at 254.1 bn zlotys or 9.9% less than originally projected. This gap amounted to approximately 2.2% of 2008 GDP. The state expenditure at 278.6 bn zlotys in 2008 was short of the planned 309.0 bn by 30.3 bn zlotys or 9.8%, an equivalent of almost 2.4% of 2008 GDP.

Figure 5. Cumulative central government budget deficit, % of annual projections

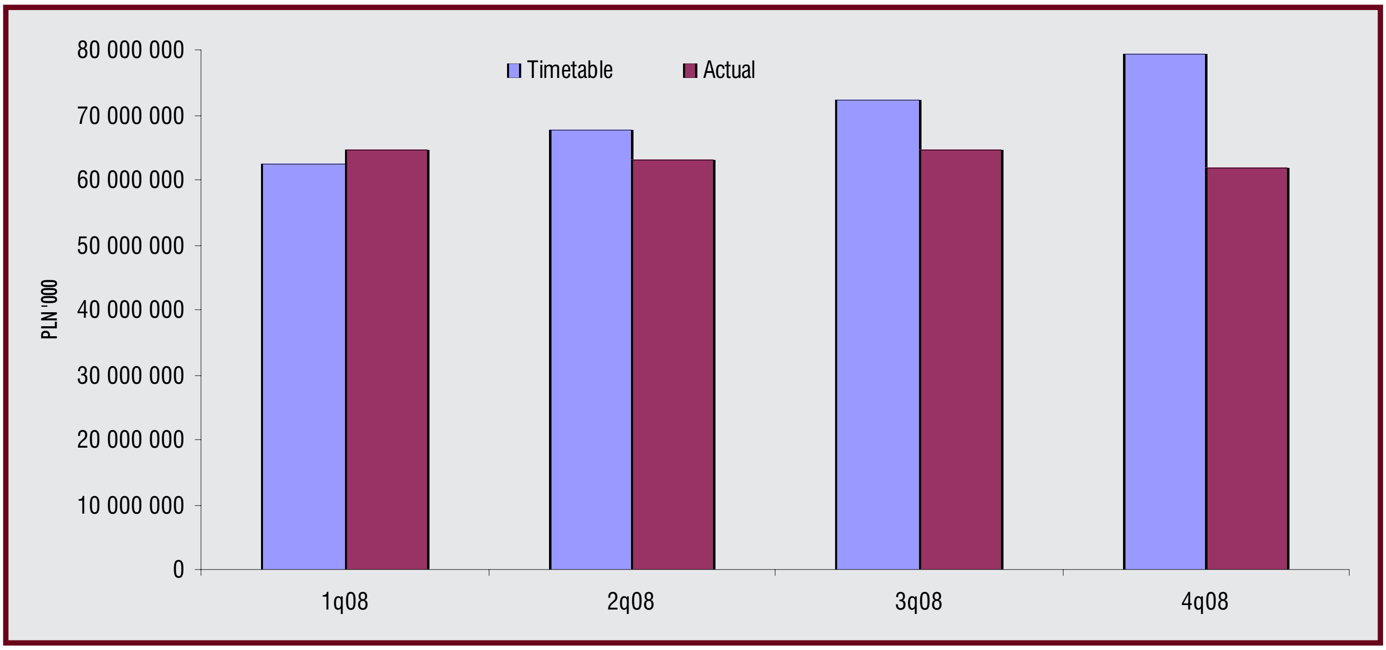


With the exception of the 1Q2008, the state budget revenue came lower each quarter than projected by MoF. This discrepancy had been growing over the year, but it rose considerably in the 4Q2008 (Figure 6). Such a visible deterioration in performance was related to a considerable slowdown in economic growth in this period (see the section on GDP growth). The central government revenue rose about 7.5% in 2008 versus the projected 19.3% so the loss of revenue relative to the projections can be estimated as 0.9% of GDP[2]. In the 4Q2008, like in the first three quarters of 2008, tax revenue projections were missed in the case of indirect taxes whereas income taxes over-performed projections. In particular, the collection of VAT increased 6.0% yoy in 2008 versus 9.5% in the first three quarters while the state budget bill provided for a rise of 15.9% in 2008 against the actual collection in 2007. The government income from excise taxes rose by 3.0% in 2008 (4.9% yoy in the first three quarters of 2008) versus the projection of 6.5% for the entire year. These figures point to a worsening of performance in the 4Q2008 on the back of much slower quarter-on-quarter economic growth. The corporate income tax (CIT) collection also showed signs of deterioration as the revenue grew by 10.7% in 2008, compared with 16.6% yoy in January-September 2008, but it matched a 10.6% projection for the whole year. According to the data on

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

net income of nonfinancial firms with nine and more employees for the first three quarters, these firms stopped generating positive profits in the 3Q2008. To the contrary, strong wage growth that continued in the 4Q2008, albeit at a slightly lower pace, helped boost the personal income tax (PIT) collection. It grew 8.7% in 2008 versus 7.3% yoy in the first three quarters of 2008 and the projection of 2.2% for the entire year. The 2008 budget balance was also improved by the better-than-expected performance of non-tax revenue, but its share in the sum of tax and the non-tax revenue is about 7.5% so its positive impact was only moderate.

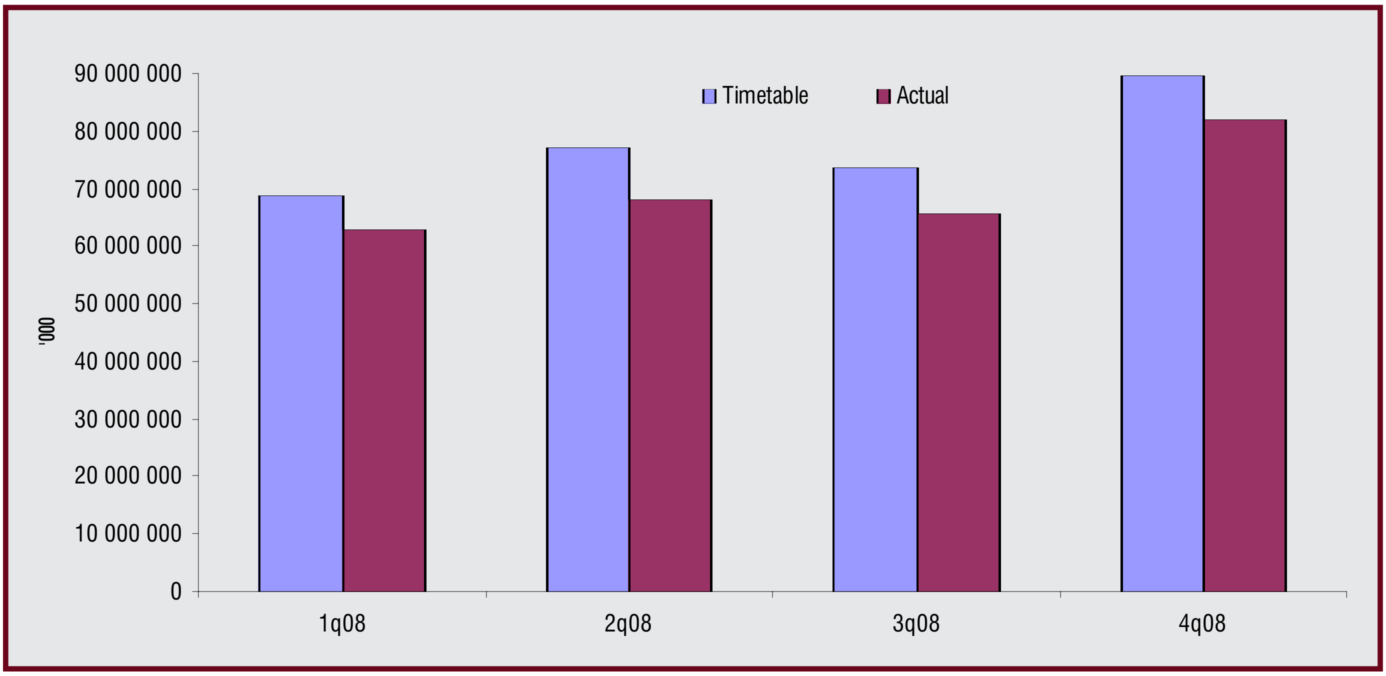
Figure 6. Actual state revenue and projections, PLN mn



The amount of the EU unrequited transfers that the central government received in 2008 reached mere 43.2% of the 2008 projections of 35.3 billion zlotys. This was the main source of the revenue underperformance relative to the MoF projections for 2008, along with the indirect taxes. In particular, only 25.7% of structural funds were received, a signal that the implementation of the EU related projects encountered serious obstacles. In this way the central government cash budget lost 20.1 bn zlotys in revenue or estimated 1.6% of GDP in 2008.

The mirror image of this is the lower expenditure on EU related projects than planned in 2008. As of writing, the figures on the entire 2008 were not available, but in January – November these outlays were 25.4 bn zlotys or 55.9% short of the amended 2008 plan. With the slippage on the revenue side, the burden of keeping the deficit in check in 2008 fell on the expenditure side in 2008 as we emphasized in previous issues of the PEO. Expenditure increased by 10.4% in 2008, compared with 12.5% yoy in the first three quarters of the year and the annual plan of 22.5% so its growth in the 4Q2008 was weaker than in the remaining part of the year. Public debt service came lower than projected by 2.6 bn zlotys or 0.2% of estimated 2008 GDP. There were no overruns in important state budget positions on the expenditure side in 2008. Subsidies to social security funds and to local governments were fully provided, but this is the usual course of events. After the first eleven months of 2008, the expenditure on fixed investment projects was mere 51.5% of the plan. If 2007 were to be a guide in this respect this proportion probably increased close to 100% in the fourth quarter, when the government usually pays the bills, however small savings in this position cannot be excluded.

Figure 7. Actual sate expenditure and plan, PLN mn



Since the previous PEO was written, the economic growth prospects in this country have deteriorated considerably and the MoF has revised down the main macroeconomic projections for 2008, but it sticks to the cash deficit of 18.2 billion zlotys in 2009 despite that the original budget draft was based on the assumption of a 4.8% GDP growth in 2009. We pointed in the previous issue of the PEO to major risks of overruns should economic growth fall to 3%, not to say when it plunges to the lower end of the present government range forecast of 1.7% to 3.7%. We recall that it was assumed in our simple simulation that GDP and GDP deflator would grow 3% and 2.9% in 2009, respectively. The same elasticities of tax revenue with respect to domestic demand in the case of indirect taxes and the same elasticities with respect to GDP in the case of income taxes as in the state budget draft were also assumed. The result was that the tax revenue would fall by 5 billion zlotys or 0.4% of 2009 GDP, projected at 1357 billion zlotys. Assuming that all other revenue and expenditure would be in line with the state budget draft, the cash deficit would stand at 23.2 billion zlotys or 1.7% of GDP. However, we do not endorse such a benign growth scenario this year any longer (see section on GDP growth). Assuming a hypothetical scenario of zero economic growth as the worst case and the same tax elasticities, but lower GDP deflator of 2% in 2009, we forecast that the tax revenue would be some 32 billion zlotys (2.4% of GDP) 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. The government pledged to revise the state budget should things go wrong in the course of the year. It has pledged to reduce expenditure of ministries by 10 billion zlotys. Expenditure on roads, equal to additional 9.7 billion, has been moved outside the central government budget as it will be financed by EIB loans and bond issues. It will however raise the general government deficit. This debt will be repaid after the investment projects are completed by means of the EU structural funds. When the total amount of 19 bn zlotys is excluded from the state budget, our worst-case central government cash deficit would fall to 31 bn zlotys or 2.4% of GDP. This does not look excessive in times of economic stagnation or creeping growth, at best.

The general government deficit in ESA-95 terms will likely breach the 3% threshold in 2009 as the automatic stabilizers such as income taxes and social security premia will tend to raise the deficit of local governments and social insurance funds. Local governments intend to speed up their infrastructure outlays. Therefore we forecast that the general government deficit will reach 3.2 – 3.5% of GDP in 2009, compared with the government target of 2.5% of GDP. The breach of 3% could cloud the outlook for the ERM-2 entry.

So far, the deficit plans are consistent with the intent to adopt the euro in 2012, but this date is becoming more and more uncertain because of the soft zloty and its high volatility, likewise the lack of political consensus in this country. The necessary amendments of the Constitution hinge on the yes by the main opposition party. Even if the government were able to stick to its deficit target, it would not be able to eliminate the political risk before presidential and parliamentary elections due in 2010 and 2011, respectively. This may lead to the excessive volatility of the zloty in the ERM-2 framework, which could jeopardize the compliance with exchange rate criterion.

Labor Market

Employment

The symptoms of the world crisis have already become visible on the Polish labor market. Although employment in the so-called enterprise sector (the companies employing more than 9 workers) still increased by 3% yoy in the 4Q2008, reaching 5,278,000, but the pace of growth was much slower than 4.3% yoy in the 3Q2008, not to mention the 5.2% yoy in the 2Q2008. In the 4Q2008 the number of employees fell by 0.3% on a quarterly basis and it was the first q-o-q employment decrease since the 2Q2004. It all means further deepening of the downward trend that started in the 2Q2008.

Employment growth decelerated in all major industries, but the growth figures dived most deeply in the manufacturing. The number of employees in this industry virtually stopped growing, reaching exactly 0% yoy growth in the 4Q2008. A quarter earlier it grew by as much as 2.0% yoy and by 3.6% yoy in the 2Q2008.

Employment growth also decreased in all other industries, except for communal services and mining. In construction, it fell from 8.4% yoy in the 3Q2008 to 7.4% yoy in the 4Q2008, in retail trade and consumer services from 7.7% to 6.6% yoy, in business services from 8.5% to 5.7% yoy and in transport and communications 3.8% to 3.3% yoy.

Labor Force Survey (LFS) figures for the 4Q2008 were still positive, but the first signs of deterioration were already visible. Although the total employment in the economy increased by 3.0% yoy (0.1% qoq), it grew more slowly than in previous quarters: 3.6% in the 3Q2008 and 3.5% in the 2Q2008.

The total number of working persons reached 16,005,000 in the 4Q2008. The employment rate – the share of the total number of employed in the working age population (15-64) – reached 60%, as compared to 58.1% a year earlier. The level of economic activity of the population was still increasing in the 4Q2008. The number of active population (those who are either employed or are looking for a job) increased by 1% yoy, and the economic activity rate for working age population (15-64) reached 64.3%

We expect that in the months to come the negative influence of the world's turmoil on the Polish labor market will strengthen and hence we are less optimistic than in the previous PEO issue. In the 1Q2009, the enterprise sector employment growth should stop in y-o-y terms, and fall in q-o-q terms by 0.4% We also expect that the LFS figures will start to deteriorate in 2009. Employment growth in the 1Q2009 will fall to about 1.2% yoy, equivalent to the q-o-q decrease of 2%. We expect that in 2009, on average, the employment in enterprise sector will actually fall by 1.4% yoy and LFS employment will fall by 0.5% – 1% yoy.

Wages

Nominal wages are still increasing, but it seems that general deterioration of the economic situation influenced also the wage setting process in enterprises. In the 4Q2008, the average nominal wage in the enterprise sector was by 8.2% higher than in the 4Q2007, while in the 3Q2008 the y-o-y increase was 10.7% yoy. It was the second quarter in row of the falling y-o-y wage dynamics, but this time, the reduction of the pace of the growth was even stronger. Real wage dynamics in the 4Q2008 also decreased to the y-o-y rate of 3.7% from 5.8% in the 3Q2008.

The growth rate of nominal wages decreased in all industries. In manufacturing, it decreased to 7.1% yoy from 10.1% in the 3Q2008. This seems to be a significant drop, taking into account the historical stability of wage dynamics in this industry, where the quarter to quarter volatility has not even reached 2 percentage points for the last 5 years. It is a serious indication of a trend reversal. The pace of growth also decreased rapidly in other sectors. In construction, it fell to 8.9% yoy in the 4Q2008 from 12.8% in the 3Q2008; in trade to 6.0% from 9.3% and in business services to 8.7% from 13.0%.

We expect this downtrend to strengthen as the economic slowdown continues. Average nominal wage growth in the 1Q2009 should fall to around 5.5%-6% yoy. It will result in real wages growing at 3.5% yoy. On average, nominal wages will grow in 2009 by 4%-5% and real wages by about 3%. In 2010 the real wages can still grow on average by about 2% yoy.

Unemployment

Following the other negative trends in the economy, unemployment has definitely stopped to decrease. In the 4Q2008, number of registered unemployed persons reached 1.47 million. This still meant a y-o-y reduction of 15.6%, but it also meant the q-o-q increase of 7.1%. To compare, in the same period of the last year the number of unemployed fell q-o-q by 7.8%. The registered unemployment rate fell by 1.9 percentage points yoy to 9.5% in the 4Q2008. It meant, however, the q-o-q increase by 0.6 percentage points.

In order to have a more clear picture of the unemployment figures from the final months of 2008 we have cleaned the numbers from a seasonal component[3]. It appeared that in the 4Q2008, the seasonally adjusted number of unemployed actually increased by 0.9% as compared to the 3Q2008. The estimated seasonally adjusted unemployment rate in the end of the 4Q2008 was exactly the same as the registered one (9.5%), and it meant the seasonally adjusted increase of 0.1 percentage points. This implies that the

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

unemployment increase in the 4Q2008 was not only resulting from seasonal factors, but reflected the real deterioration of the labor market.

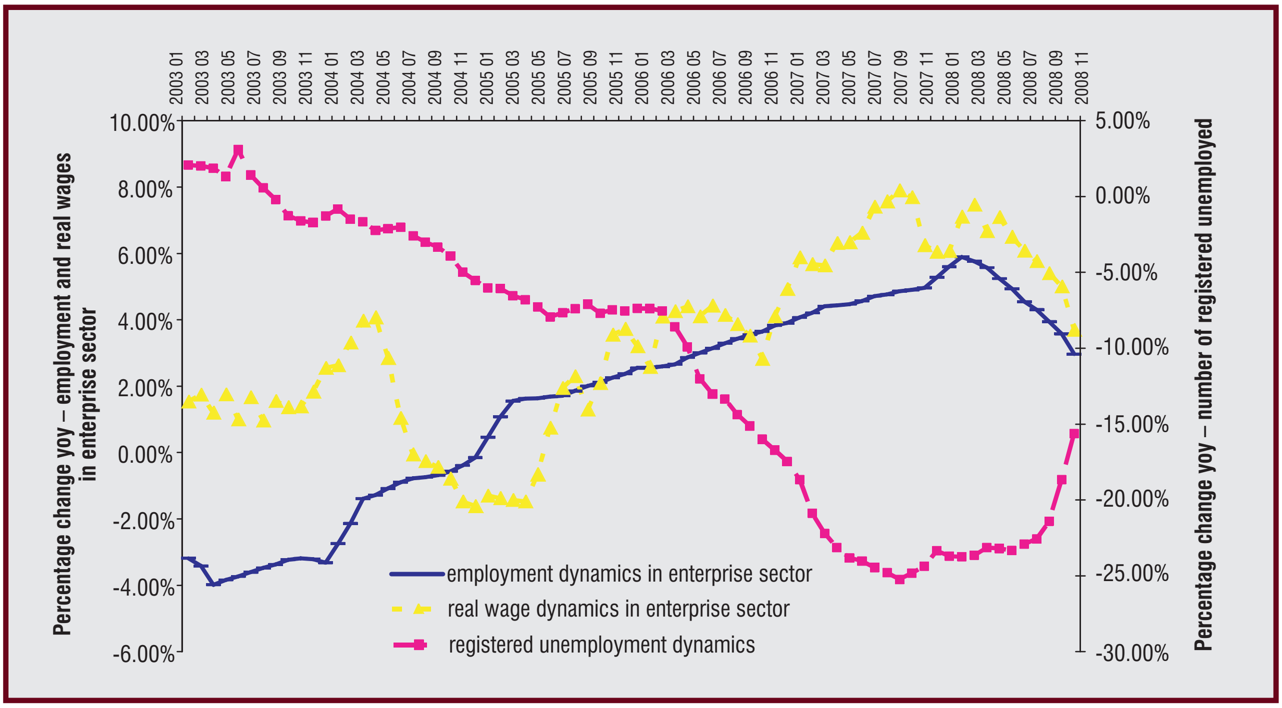
The other information coming for PES is also alarming. The number of unemployed finding new jobs continued to fall, i. e. by 17.9% yoy in the 4Q2008, and the number of those finding unsubsidized jobs dropped even more quickly (by 20.6% yoy in the 4Q2008). On the other hand, one records stronger increases of newly unemployed persons in registers. In the 4Q2009 the number of the new unemployed increased by 7.1% yoy.

The economic slowdown can already be noticed in LFS unemployment figures for the 4Q2008 Although the number of unemployed fell by 20% yoy, reaching 1,154,000, but it meant the q-o-q increase of 1.9%. It was the first q-o-q increase recorded between the third and the fourth quarter of the year since 2001, being one of the worst periods on the Polish labor market ever. The unemployment rate still fell yoy by 1.8 percentage points reaching 6.6%, but it was higher by 0.1 percentage point than in the 3Q2009, also for the first time since 2001.

The other data based on LFS can be found in EUROSTAT publishing monthly so called harmonized unemployment rate for all EU members. According to this (seasonally adjusted) data the unemployment rate in Poland in December 2008 was 6.5%, i.e. by 0.1 percentage point less than in September 2008. It means that although the unemployment rate in Poland according to this measure still kept falling, the pace of this reduction decelerated.

We expect the registered unemployment rate to increase in the first quarter of 2009 to 11.2%. The LFS unemployment should continue to increase in the 1Q2009 and will reach 7.4%. Both, registered and LFS unemployment will further grow in 2009. We expect the registered unemployment rate to reach 12.2% at the end of 2009, while the LFS unemployment rate will probably reach 8.5%-9%. Thus we have significantly corrected our last forecasts upward. This correction results from our generally pessimistic expectations concerning the economic growth in 2009.

Figure 8. Employment and real wage dynamics in enterprise sector; and registered unemployment dynamics in Poland 2003-2008

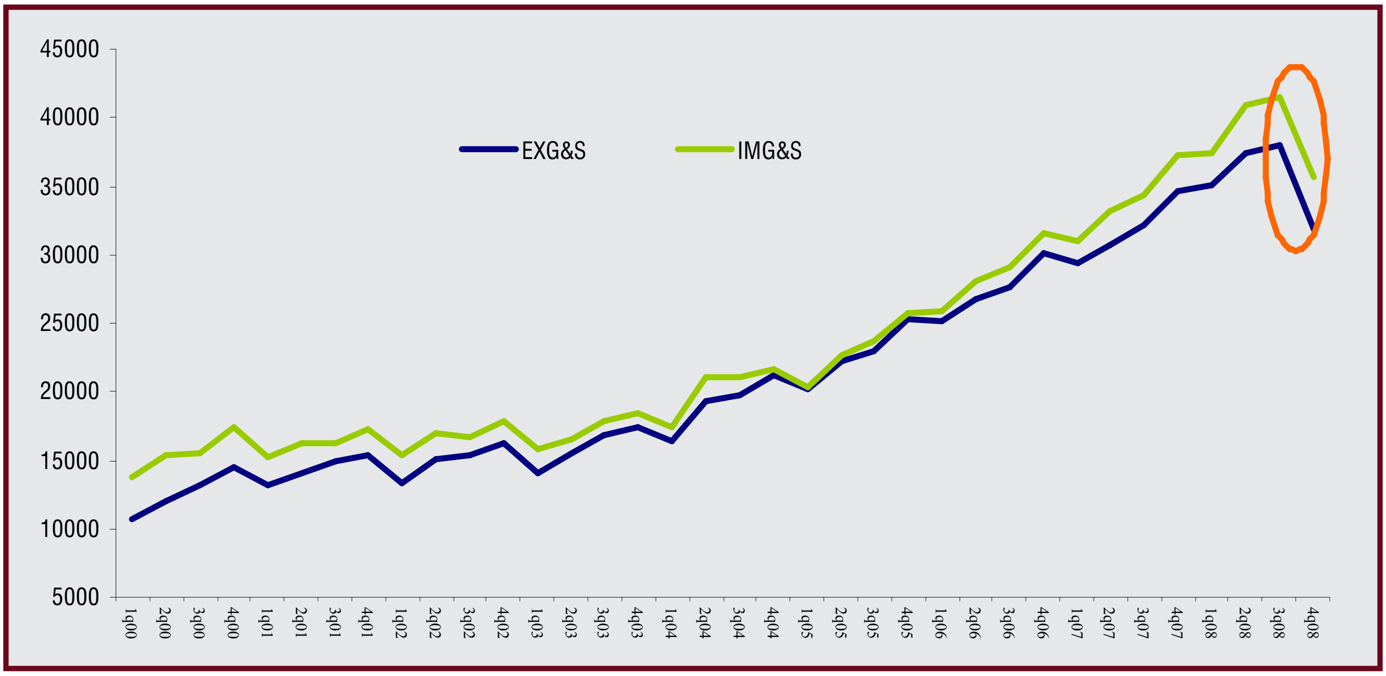


Source: Own calculations based on Statistical Bulletins of Polish CSO (GUS).

External Trade and Balance of Payments

Foreign trade rose fast in terms of the euro in the first three quarters of 2008. However the 4Q2008 brought about a break of these trends: exports and imports of goods collapsed in the 4Q2008 (Figure 9). According to the ever-revised NBP data, they fell by 8.6% yoy and 5.3% yoy, respectively, compared with growth of 19.8% yoy and 21.4% for the first three quarters of 2008. In the same period, the zloty exports and imports of goods decreased by 6.3% yoy and 2.9% yoy, respectively while in the first three quarters of 2008, they increased by 7.4% yoy and 8.8% yoy, respectively. Export and import changes in the zloty are reported as well because they seem to be better approximations of the changes in trade volumes due to wide fluctuations in the exchange rates in 2008; volume data are not available from the CSO as of writing. Exports and imports of services in euro terms did not fare well, either. Exports fell by 4.9% yoy whereas imports grew by 1.7% yoy, compared with 12.5% and 21.5% in the entire 2008, respectively. The collapse of the upward trends clearly shows how the economic slump in the EU and Eastern Europe adversely affected Polish foreign trade and by its channel spread into the Polish economy. This was a strong demand shock that is likely to persist for the several quarters and will likely strengthen in the 1Q2009. Very bad figures on manufacturing sales in January strongly support this statement. Distinctively higher economic growth in Poland than in the EU on average has led to the differential rate of growth in exports and imports: This has not changed in the 4Q2008, when the Eurozone recorded its worst growth performance since its inception.

Figure 9. Exports and Imports of Goods and Services, quarterly, EUR mn

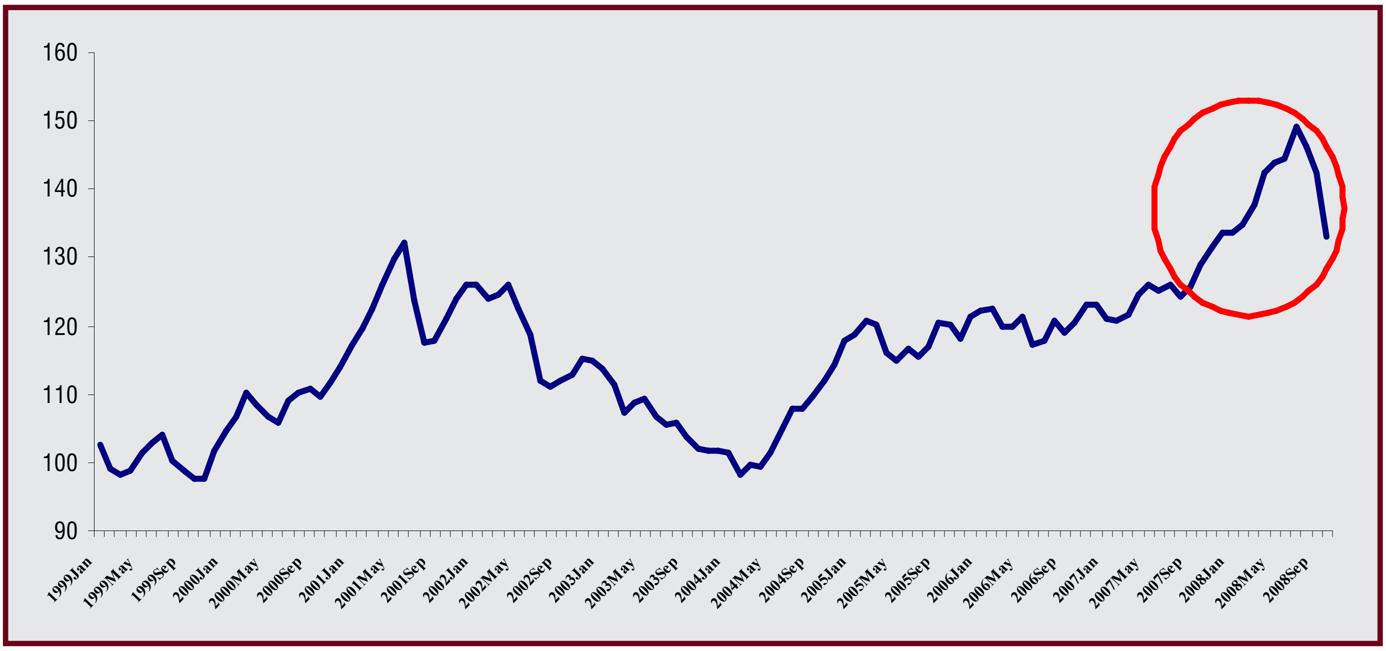


When one looks at the geographical breakdown of CSO preliminary foreign trade data, it is evident that they-o-y export rates of growth fell across the board in the 4Q2008, be it developing countries, Eastern Europe or the euro zone. The largest drop in exports was registered with Eastern Europe, which includes Belarus, Russia and Ukraine. These countries experienced a deep downturn: Ukraine and Belarus were granted IMF aid in order to avoid a macroeconomic destabilization while Russia had to grapple with the effects of a dramatic fall in commodity prices. Russia and Ukraine were the fastest growing markets for Polish exports during the first nine months of 2008, but this occurred before these countries experienced the financial markets turmoil. Russia kept its share in Polish exports at 5.3% in the 4Q2008, but Ukraine's share fell to 3.8% in the entire 2008 from 4.0% in the first three quarters[4].

The CSO has already reported data on the merchandise trade for January – November 2008 in fixed prices. According to them, volumes of exports and imports were up 6.8% yoy and 7.9%, respectively, compared with 9.2% yoy and 10.1% yoy in January- September 2008. The comparison of these data suggests a strong decline in export volumes in the 4Q2008, another piece of evidence that the severe recession in Western Europe has become a major demand shock for the Polish economy.

The rolling four-quarter current account deficit increased to 5.4% of GDP in the 4Q2008 from 5.2% of GDP in the 3Q2008 and compared with 4.7% at the 2007 yearend, according to the revised NBP data. Thus, a steep upward trend in the deficit in 2007, which stood at 2.7% of GDP in 2006, flattened in 2008. Despite a collapse in exports stronger than a decline in imports, the fourth quarter did not bring a larger rise in the ratio than the previous quarters of the year. The quarterly trade shortfall rose the least year on year in the 4Q2008 while the negative balance on the income account decreased considerably as profits of Polish companies dwindled.

Figure 10. Real Effective Exchange Rate of the Zloty, CPI deflated, 1999=100



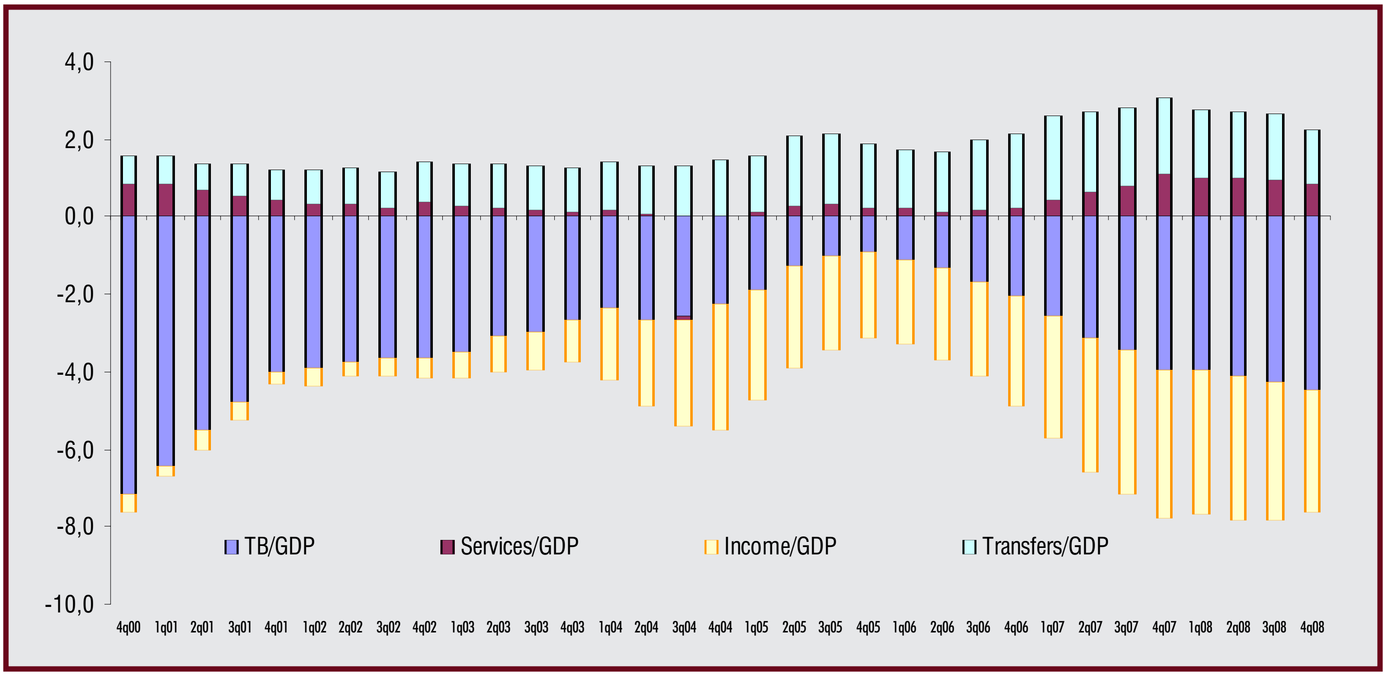
Source: ECB appreciation (+).

The fourth quarter data and a further slump in the export orders bode bad for exports in the near future. However, 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 (Figure 10). Actually, we forecast a reversal of the trade deficit-widening trend. A continued positive growth differential should be offset by two other factors. Imports of commodities have

[4] Only cumulative data are published. The data on single quarters are unavailable.

become much cheaper (natural gas prices have already peaked) and investment imports should decline substantially as many private projects have been be put off or scaled down until the recovery starts. The deficit on the income account should be reduced as the corporate sector will post significantly lower profits in 2009 than in 2008. The first signs were visible in the 4Q2008 (see Figure 11). Further, Poland should use a much larger portion of the EU funds than in 2008, which will also tend to improve the current account deficit. We think that net transfers will slightly improve though private remittances from abroad can decrease due to the rapidly increasing unemployment in the EU countries that have become the main destinations of Polish emigration such as Ireland, Spain and UK. Taking all the factors into consideration, however, we do not see the reason for a revision of our previous forecast of a weak downward trend in the current account deficit in 2009.

Figure 11. Current Account Breakdown, % of GDP



A low liquidity of international financial markets prompts a question whether the current account shortfall of 4% of GDP, i. e. our prediction, can be financed without inducing a further bumpy depreciation of the currency. EU funds that come through the capital account should finance the deficit of the order of 1-1.5% of GDP so the actual needs for financing on the market are lower than the total current account deficit. Net FDI inflows stood at 2.3%% of GDP in 2008, down from 4.3% in 2007 so they funded less than 50% of the 2008 deficit. Incoming FDI fell dramatically in the 4Q2008 because of an outflow in December. Prospects for FDI look bad under the circumstances of the ever-worsening outlook for growth in the global economy and worries of investors that the situation in East Europe has rapidly deteriorated. It is unclear whether these investors will discern countries with sound fundamentals. Since retained profits are a significant part of the net FDI inflows in Poland and the profitability of companies has deteriorated, this will adversely affect FDI figures in 2009. In our view, net FDI inflows will decrease to 1.6% of GDP in 2009. This leaves a portion of the current account deficit that should be financed by net portfolio and credit inflows of the magnitude of 1-1.5% of GDP. This does not seem excessive should GDP growth resume in the 2H2009.

Is There a Room for Fiscal Stimulus?

A primer on fiscal policy

Discretionary fiscal policy is back in fashion after years of neglect during the global crisis. There are two main reasons. Monetary policy is has proved little efficient in times when banks have started rationing credit. Aggressive reductions in interest rates by central banks have only fractionally been passed to creditors as banks have tightened loan standards and started discriminating borrowers.

Another reason is the depth of the current global crisis that is unparallel to any recession after the second world war. In the 1960s and 1970s, the abuses of fiscal expansions led either to accelerating inflations or large public debts or a combination thereof. Based on that experience, that also showed that reality is far away from the „activist paradise", i.e. a hypothetical world in which especially fiscal policy, but monetary policy as well, achieves almost a perfect control over aggregate demand, the economic literature is suggesting now that during a typical recession fiscal policy should be conducted by means of automatic stabilizers. These are institutional arrangements that lead to the smoothing of a business cycle such as (progressive) income taxes, unemployment benefits and social benefits. In times of downturns (upturns), disposable incomes of people fall less than GDP, therefore the aggregate demand declines (increases) less than GDP. The stabilizers are automatic because once the intuitional arrangements are made, the stabilizers work without any deliberate decision of the government. However, this downturn is unprecedented, the worst in 60 years, so discretionary government policy is justified because automatic stabilizers are too weak, in particular in the USA, where taxes are less progressive and unemployment and social benefits less generous than in Europe.

There are a number of caveats of fiscal policy. One problem with discretionary fiscal policy is that its effectiveness is impaired by a long legislative lag. Decisions about additional spending or tax cuts in democracies require a parliamentary debate, which can extend forever. Prolonged discussions may imply that decisions by the legislature will be badly synchronized with the business cycle, and the stimulus may raise the aggregate demand by the time, when the economy has already started recovering. An overheating will be a result of this. Further, these debates are highly politicized as various factions try to pursue vested interests. They attempt to add measures to the „stimulus package" that maximize votes, but not necessarily the extra output per additional government spending or tax (rate) cuts. Monetary policy does not suffer from such problems, and it is not politicized when the central bank is independent.

Government spending crowds out private investment as fiscal expansion tends to push interest rates up when it is financed by treasury bonds so marginal investment projects may become unprofitable. Interest rates rise as higher income due to higher government expenditure raises the demand for money while the money supply remains constant. Then the money market is in disequilibrium. To reduce the excess money demand, interest rates must rise, but this rise reduces intended consumer expenditures for durables and investment. This basic result obtained from the IS-LM model, the workhorse model of macroeconomics. There would be no crowding out only if the interest responsiveness of planned spending were zero (the IS curve is vertical) or when the interest responsiveness of the money demand were infinite, i. e. the interest rate were fixed (the LM curve is horizontal). In this case, there would be no upward pressure on interest rates when the IS curve shifted rightward in the model. Other theoretical possibilities include accommodation of the excess demand for money by monetary expansion or a situation when demand for money does not depend on GDP (income).

Crowding out can be either partial or complete. There is complete crowding out of a fiscal stimulus when the interest rate responsiveness of money demand is zero, i. e. if the LM curve is vertical in the model. The private agents hold on to their money balances, which are not reduced to the unchanged level of money supply since we are assuming no shift in the monetary policy. The only effect of a fiscal stimulus is to raise the interest rate in the economy. It means that the increase in government spending is offset by a drop in private spending by exactly the same amount. Otherwise, crowding out is partial. Fiscal policy is potent when the demand for money is highly interest-responsive. Empirical evidence supports the case for partial crowding out so there is effects of fiscal expansion are real.

It is a truism that discretionary fiscal stimuli should be timely, targeted and temporary. The issue of timeliness has been discussed in the paragraph above. The term „targeted" means that a stimulus should bring the most of an additional zloty or euro of spending or tax reductions in terms of GDP. In this respect, the estimates of multipliers of various kinds of spending are important. Unfortunately, the so-called multiplier uncertainty is overwhelming as we are, at best, likely to specify ranges within which the values of different multipliers can lie (see table below). Nevertheless, the theory tells us that government spending is more efficient than tax cuts or transfers to the population provided this spending is designed in an efficient way. The reason is that the government spending is a part of the aggregate demand in the economy whereas tax (rate) declines or transfer increases directly raise disposable income and only through it – aggregate demand so a part of these cuts or transfers leaks as additional savings. With regard to „targeted" stimuli, we know that different kinds of spending or tax cuts make a difference. We are not in a model world from macroeconomic textbooks where there is a single multiplier of autonomous demand or one marginal propensity to consume. Public investment expenditure on road and railway infrastructure, education and health care renewable energy sources can lift the economy's growth potential over time while consumer expenditure will have only short-lived effects. We know that households in lower-income brackets have a higher propensity to consume than better-off households. Therefore tax cuts should be geared to bringing additional disposable income to low-income groups. Further, households under stress that asset prices have dived and full of fear that they may lose job, may not spend the cuts in taxes.

Another advantage of a government spending over taxes, beside the fact that it is an element of domestic demand whereas taxes are not, is that, relative to tax changes, it should be easier stopped since investment projects should be completed in a given time frame. Income tax cuts are hard to unwind after the economy recovers because they rare politically unpopular while tax rises, sometimes necessary to cool down the overheating economy, are hard to institute for the same reason that they will anger the electorate. Therefore government expenditure better fits the ideal of a temporary stimulus.

So far the discussion has been static, though the problem of a targeted stimulus is also a dynamic nature. Tax cuts are deficient, relative to government spending, because of a phenomenon called Barro-Ricardo (B-R) equivalence. The B-R equivalence means that people treat as equivalent the ways of financing government expenditure; they do not care, whether it is by raised taxes or by contracting more public debt (bond issuance). When government finances spending by issuing debt, people do not treat acquired bonds as net wealth, but as a harbinger of future tax hikes in order to repay the debt. Therefore they do not raise their spending. If the government raises taxes to finance its additional expenditure, people do not adjust their consumption spending either because. The implications are devastating for the effects of expansionary fiscal policy. Fortunately though, there are theoretical arguments that qualify the conclusions the B-R equivalence.

Expansionary fiscal policy results in deficits. Cumulative government deficits add up to the public debt. Governments have to observe the intertemporal budget constraint that simply tells that debts have to be eventually repaid. Simplifying models, the present discount value of a stream of tax receipts over many years has to be equal to the present value of government spending over the same period. Translated into a plain language, this means that debts cannot grow without bound. At a certain period, government deficits have to be replaced with surpluses. In practice, financial investors can fret when the government debt-to-GDP ratio becomes too large as they have doubts whether the government will honor its obligations and suspect that it may use the option to default on the debt since it cannot or does not want to raise taxes to stop the accumulation of debts. They see that the debt dynamics is explosive, the debt continues increasing because the interest is so high that the government has to draw more debt to repay it. Otherwise, it would have to reduce its budget deficit sharply that would induce recession, a politically unpalatable option in many cases. In countries, where central banks are not independent, there is also an exit way in the form of a runaway inflation, which is ignited by a large increase in the money supply that causes an erosion of the purchasing power of public debt since it is stated in nominal terms. The central bank buys directly any amount of government bonds in exchange for money that is used by the government to redeem its obligations vis-a-vis private investors.

Leaving aside the option of the debt monetization, the stabilization of public debt levels either in absolute terms or as a given ratio to GDP becomes crucial. The model analysis concludes that a primary budget surplus has to be equal to the debt service, in order to stabilize the level of the public debt[5]. In order to stabilize the debt-to-GDP ratio, the government should run a primary surplus if the average real interest rate on debt is higher than the rate of real GDP growth. If this interest rate is lower than rate of real GDP growth, a country can run primary budget deficits (in each case, the model gives a precise formula for the size of a minimal surplus or a maximal deficit). In the latter case a balanced primary budget is sufficient to induce a downward trend in the debt-to-GDP ratio. Thus, rapidly growing economies can grow out of their public debts.

The bottom line is that the deficit size matters. Countries with large public debts and large deficits should barely use any fiscal stimulus because they risk a fiscal destabilization. In the case of large public debts and small government deficits or surpluses, the room for maneuver is rather small so these countries have to be cautious. These countries should probably announce how they will return on the path to fiscal prudence once recession is over. Countries with small public debts can temporarily raise their deficit spending without risks.

Case of Poland

Poland will be analyzed against this backdrop. The government of Poland has rejected an idea of a discretionary fiscal stimulus and sticks to the plan of a cash central government deficit of 18.2 bn zlotys despite the deteriorating growth forecasts.

The public sector deficit was about 2.8% of GDP in 2008, just a dash below the Maastricht threshold. In the January update of Convergence Program, the

[5] Primary budget surplus excludes the cost of debt service, i.e. interest rate payments.

government assumes that the structural deficit will be 2.6% of GDP in 2009 while the actual deficit of the general government is projected at 2.5%. Since the potential rate of growth is estimated at 4.8% of GDP, and the government has projected a 3.7% GDP growth rate for 2009, these numbers would suggest that the government intends to run a procyclical fiscal policy, i. e. to reduce aggregate demand when the economy is considerably slowing. Despite all the uncertainty, the 3.7% is definitely overly optimistic so were the government to stick to its deficit target its policy would be even more procyclical. Actually, the lower bracket for the government GDP growth projections is 1.7%, which due to the ever-deteriorating outlook for the world economy, seems on the optimistic side as well. If the government kept its target it would negatively influence the aggregate demand even more. The government manifests its commitment to the target by its emergency plan to reduce the central government expenditure by some 10 bn zlotys (0.8 % of GDP) in 2009, should growth not meet its forecast. This is done as it aims to enter the ERM-2 mechanism and wants to avoid the uncertainty that the deficit criterion may not be met in time to get to the Eurozone in 2012, which could trigger the currency speculation.

A citation from the Stability and Growth Pact (S&GP) would form an additional frame. „Adherence to the objective of sound budgetary positions close to balance or in surplus will allow all Member States to deal with normal cyclical fluctuations while keeping the government deficit within the reference value of 3 % of GDP", reads the resolution of European Commission's on the S&GP from 1997. Poland missed the opportunity to balance its public finances during a period of strong economic growth in 2006-2007 so the room for maneuver is limited, as it should not breach the 3% of GDP threshold unless it finds itself in a deep recession.

Definitely, should GDP growth slow hypothetically to 3.7% only, it could not be treated as a recession at all, not to mention a deep recession that would justify a breach of the 3%-of-GDP threshold, but 1.7% GDP growth or lower, down from 4.8% in 2008 and over 6% in 2007, could possibly pass the test. This would represent a decline in the GDP rate of growth by at least three to four percentage points in one year. „A severe economic downturn" justifies a breach of the Maastricht deficit criterion, according to the Stability and Growth Pact, which defines it as „a negative annual GDP volume growth rate or an accumulated loss of output during a protracted period of very low annual GDP volume growth relative to its potential." A drop in the growth rate to 1% in one year in Poland is like a major recession. One could claim that it would be an equivalent of Eurozone economies, shifting from a 2% growth to a 1-2% contraction. From this point of view, a fiscal stimulus would unlikely provoke the criticism of the European Commission and a reimposition of the Excessive Deficit Procedure on Poland that was lifted in 2008, especially were this stimulus accompanied by a credible plan how to reach a balance in the fiscal position once potential growth is restored. The bottom line is that the actual level of a deficit allows for a modest stimulus.

Deficits accumulate in debts. The IMF study from 2003 suggested that „the sustainable level of public debt varies between countries-depending on the characteristics of each country-for the typical emerging market economy it is often quite low. The analysis of overborrowing suggested that, based on past fiscal performance, the sustainable public debt level for a typical emerging market economy may only be about 25 percent of GDP, while the estimates of the fiscal policy reaction functions indicated that emerging market economies as a group have failed in the past to respond in a manner consistent with ensuring fiscal sustainability once public debt exceeds 50 percent of GDP[6]. Thus the size of Polish public debt at around 46% of GDP is not very low by emerging market standards, but it is far below the Maastricht 60% of GDP threshold. Further, Poland is an in-between case as its pier country group is concerned, and it has gained some credibility in keeping the public debt and deficits in check. The increase in the deficit under the circumstances of a near-stagnation that we predict for 2009 in this report will certainly raise this ratio by a few points. However, it is unlikely that this ratio would approach 55% of GDP, the level that would trigger the government corrective steps to keep the debt ratio from rising as specified by the Polish law. These measures would require a very restrictive fiscal policy that would induce recessionary tendencies. Had the government to resort to them, it could lead to the periodical instability in financial markets like in 2003-2004, when risks of such a breach were taken into account and its recessionary effects on the economy that could undermine social cohesion. Likewise the deficit levels, the debt ratio suggests that a modest discretionary stimulus, say 0.5% of GDP, would be absorbed by financial markets without causing disruptions.

Fiscal deficits have to be financed and increased deficits are harder to get funding. We claim that a moderate rise in the deficit would be justified from the point of view of a downturn that Poland is experiencing at present. However, Poland may have problems financing the deficit under the circumstances of the global severe recession, as key economies such as the USA, UK and Germany are going to launch large expansionary packages that will result in huge fiscal deficits. Their issuance of government bonds is going to crowd out countries with lower rating under the conditions of widespread risk-aversion. The USA is forecast to borrow 1.75 bn dollars in the fiscal year 2009 while European large economies may add 1 bn dollars to cover fiscal deficits and the cost of bank bail-outs. the Poland that has quite large net borrowing requirements may find the debt service costs inhibitive. This looks as the most serious argument that goes against the discretionary fiscal stimulus right now. However, Greece whose sovereign credit rating is similar to Poland's after a downgrade to A-/A2 with a stable outlook by S&P has managed to successfully place a number of issues on the eurobond market through a syndicate instead of auctions[7]. It tapped the market for almost half of its borrowing needs this year. Perhaps, this is a recipe for Poland as well.

[6] IMF, World Economic Outlook, Chapter 3: Public Debt In Emerging Markets: Is It Too High, September 2003
[7] The Economist March 7th, 2009.

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