POLISH ECONOMIC OUTLOOK
TRENDS • ANALYSES • FORECASTS
CASE
QUARTERLY 1/2008 (36)

Special Feature – Latest Convergence Program

EXECUTIVE SUMMARY

The first quarter was marked by a number of surprises, mostly positive, suggesting that the strength of the economy and its resilience to withstand the global slowdown is better than we expected. One of the reasons is that Polish banks are little exposed to US credit markets.

The economy did not lose much traction in the 1Q2008 despite our previous expectations that the statistical-base effects should significantly dampen GDP growth, taken year on year. Expansion was driven by domestic demand. Our estimates point to a continuation of strong business fixed investment growth yoy in the 1Q2008, a bit stronger than in the 4Q2008. This should be coupled by a pickup in the year-on-year private consumption in this period, which surprised on the downside in the 4Q2007. The negative contribution to the year-on-year GDP growth from net exports should increase, compared with the 4Q2008, when it was unexpectedly near zero, the lowest since 2Q2006. This helped keep the pace of GDP expansion over 6% yoy in the 4Q2007 despite the deceleration in private consumption growth. GDP growth surprised us on the upside in the 1Q2008 but we hold to the forecast that it should slow to about 5% yoy in the coming quarters. Weak global economy and the cumulative effects of the interest rate hikes by the central bank will be the main factors of this tempering.

Buoyant growth pushed employment dynamics higher in the 1Q2008, and the unemployment rate continued its steep downward trend year on year. The registered unemployment rate fell by 3.3 percentage points yoy to 11.1% in the 1Q2008 while the Eurostat seasonally adjusted unemployment rate, based on the LFS survey, was down to 7.7% of the labor force, the fourth highest in the EU in March 2008, whereas it was the second highest at the 2007 yearend. Due to more optimistic expectations of GDP growth than a quarter ago our predictions of employment gains and wage growth in 2008 have been revised up. The registered unemployment should decrease to 9.2% in the 2Q2008 and to 9.1% at the end of 2008. The LFS unemployment will also continue to fall as well. It should be at 8.5% in the 1Q2007, and drop to around 6.5% - 7% by the yearend. Wage growth, excessive of labor productivity gains, will tend to exacerbate inflationary pressures.

The year-on-year CPI inflation rate increased to 4.1% in the 1Q2008 from 3.5% in the 4Q2007. Thus, inflationary pressures continued to strengthen and broadened, driven by the supply side factors such as hikes in the energy prices and periodical increases in regulated prices. The year on year food price inflation stabilized while prices of manufactured goods continued to exert disinflationary pressures. The sharp rise in all indices of core inflation, among them the most popular measure that excludes prices of food and fuel, leads to a conclusion that demand pressures were more significant than in the previous quarters. CPI inflation rate should stay at 4% yoy in the 2Q2008, stabilize slightly higher in the 3Q2008, and then decrease to 3.4% in the 4Q2008. This upward revision of the PEO 4/2007 forecast is due to the expectations of a larger magnitude of the energy and fuel price growth as well as the gradual strengthening of demand pressures stemming from the better-than-expected economic growth scenario. It assumes the moderation of food price inflation from the 3Q2008, based on the cautiously optimistic 2008 crop scenario.

The central bank raised its key interest rate by the cumulative 75 basis points in the 1Q2008 (one basis point = 1/100 of a percentage point). The leveling off of the headline inflation rate in the 3Q2008 together with the further appreciation of the zloty will likely induce the central bank to refrain from raising interest rates higher. However one more rise by 25 points in the 2Q2008 is a possibility. Then rates should remain unchanged for a prolonged period of time, i.e. until the 1Q2009, when the CPI inflation rate should decline below 3% yoy.

As expected, further hikes of the interest rates by the NBP in the 1Q2008 increased the interest rate differential between Polish assets and foreign assets, and caused zloty appreciation. This differential may increase further were the ECB to cut its key rate. However, the close end of the tightening cycle should cap the appreciation.

The estimated cumulative four-quarter current account deficit increased to 4.0% of GDP in the

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

Indicator	Data											CASE forecasts	
	2005	2006	2007	2007				2008				2008	2009
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4		
Nominal GDP, PLN bn	983.3	1060.0	1167.8	267.67	281.2	288.2	329.7	296.0*	307.5	312.6	359.8	1275.8	1386.4
(% change, yoy)													
GDP	3.6	6.2	6.6	7.3	6.5	6.5	6.3	6.2*	5.2	4.9	5.2	5.3	5.3
Private Consumption	2.0	4.9	5.2	6.9	5.0	5.1	3.7	6.0*	6.0	6.1	6.8	6.5	5.6
Fixed Investment	6.5	15.6	19.3	26.2	20.8	18.3	16.4	17,0*	11.7	11.2	13.1	13.4	11.1
(4Q, % of GDP)													
CA balance	-1.6	-3.2	-3.6	-3.2	-3.7	-3.6	-3.6	-4.0*	-3.9	-3.7	-3.1	-3.1	-3.0
(% change, yoy)													
Exports (NBP, EUR)	17.8	20.4	12.8	19.0	19.3	13.1	12.0	23.2	17.3	18.7	18.3	19.4	13.5
Imports (NBP,(EUR)	13.4	24.0	17.9	20.6	16.1	16.7	16.2	23.7	20.1	19.6	18.1	20.4	9.9
(% change, yoy)													
Industrial sales	3.7	11.3	9.8	13.0	8.5	8.1	9.6	8.5	8.9	7.6	6.3	7.9	8.0
Gross value added	3.3	6.0	6.7	7.8	6.5	6.3	6.3	6.1*	5.1	4.9	5.0	5.2	5.3
CPI	2.1	1.0	2.5	2.0	2.4	2.0	3.5	4.1	4.1	4.3	3.4	4.0	3.0
PPI	0.7	2.3	2.3	3.3	2.0	1.7	2.3	3.0	2.7	2.9	3.5	3.0	3.1
Nominal Ave. Wage	3.8	4.9	8.7	7.1	8.9	9.7	10.0*	11.5	9.6	11.0	9.8	10.5	7.5
Employment %, LFS	2.3	3.1	3.1	3.6	4.8	3.5	4.2	4.5*	4.0	4.0	3.5	4.0	2.0
Registered unemployment rate (%, eop)	17.6	14.8	11.4	14.3	12.3	11.6	11.4	11.1	9.2	8.8	9.1	9.1	8.0
PLN/EUR, eop	3.86	3.83	3.58	3.87	3.77	3.78	3.58	3.53	3.42	3.39	3.43	3.43	3.35
WIBOR 3M, %, eop	4.60	4.20	5.68	4.24	4.71	5.10	5.68	6.15	6.40	6.35	6.25	6.25	5.70
Central bank key rate eop	4.50	4.00	5.00	4.00	4.50	4.75	5.00	5.75	6.00	6.00	6.00	6.00	5.50
(% change, yoy eop)													
Broad Money (M3)	13.1	16.0	13.4	18.0	14.7	14.4	13.4	13.6	13.2	13.1	13.4	13.4	12.9
Loans to HH	26.0	33.4	33.4	37.7	37.7	39.6	37.9	37.4	35.0	32.4	29.9	29.9	25.0
Loans to Firms	2.5	13.7	24.1	17.1	22.1	24.7	24.1	25.2	24.0	22.0	21.1	21.1	18.0
(% GDP)													
Fiscal Balance	-4.3	-3.8	-2.0	n.a.	n.a.	n.a.	2.0	n.a.	n.a.	n.a.	n.a.	-2.8	-2.3
Public Debt eop	47.1	47.6	44.9	n.a.	n.a.	n.a.	44.9	n.a.	n.a.	n.a.	44.4	44.4	43.5

(*) means estimates or forecasts in a column with data
Sources: CSO (GUS), Eurostat, NBP and CASE own calculations.

1Q2008 from 3.7% in the 4Q2007 on the back of the widening trade deficit and a decrease in the surplus of transfers. However adjusted for inflows on the capital account, which mainly consist of EU unrequited funds, the shortfall was mere 2.5% of GDP. Exports and imports surprised on the upside in the 1Q2008. Export growth at that rate seems unsustainable into the near future amid global slowdown and the zloty appreciation. Though it is expected that the first quarter performance will not be matched in the subsequent quarters, our forecast of the CA path has been changed from an upward trend to a flat declining trend through 2009, as a growing surplus in services should offset the deterioration in the trade balance.

Fiscal position is strong. The central government recorded a small surplus in the 1Q2008 instead of a projected deficit as the tax revenue was higher than expected, whereas the expenditure was lower than planned, a situation similar to that that prevailed in 2008. The ESA-95 general government deficit was only 2% of GDP in 2007. This performance induced a downward revision in our 2008 forecast but the 2009 performance is contingent on the spending reforms as a planned cut in personal income taxes will push the deficit higher.

LATEST DEVELOPMENTS IN THE POLISH ECONOMY

Economic growth

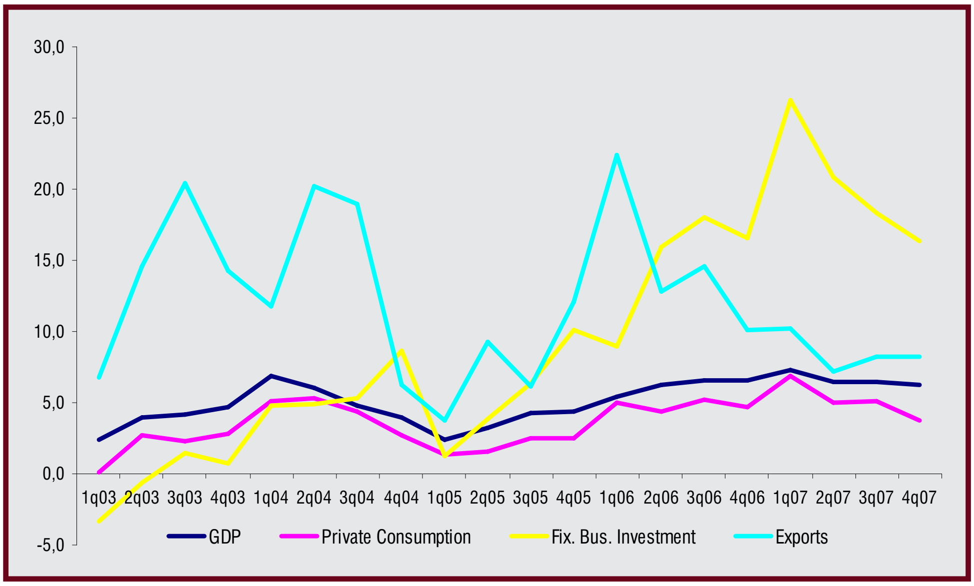
The year-on-year performance of the supply side in the 1Q2008 was mixed, compared to the previous quarter. Sold industrial came weaker while construction and retail sales picked up. The performance was also differential in time: the year-on-year pace of growth of industrial sales and retail turnover was rapid in January - February while it considerably slowed in March, casting doubts whether the economy will maintain its momentum in the coming months. In our assessment, it will but the final jury is still out since the global slowdown is only halfway through.

Sold industrial output advanced by 8.5% yoy in the 1Q2008, compared with 9.6% yoy in the 4Q2007r. The rate of growth manufacturing output was 8.6% and continued a gradual decline since the 1Q2007. This can hardly be traced to either weaker export or domestic demand growth so most likely statistical effects are responsible for this. As mentioned before, March was negatively distinct with regard to industrial sales growth (0.7% yoy), and dragged down the figures. In our view the March year-on-year near-halt in industrial output growth was mostly related to a lower number of working days as Easter moved to March from April. The seasonally adjusted rate of expansion was 6.1% yoy so that it also dropped relative to 11% yoy in January-February 2008 but remained quite solid. To find some reference, in December 2007 the seasonally adjusted rate declined to 6.6% yoy so it was not much higher than in March 2008. Then two months of strong growth in industrial sales followed. Such a pattern of developments cannot be excluded in the nearest future: April 2008 has two more working days than April 2007.

Estimated construction sales of firms with at least 9 employees increased by 17.4% yoy in the 1Q2008 versus 10.2% in the 4Q2007. Thus, the year-on-year construction sales, whose growth peaked in the 1Q2007 and had been downtrending since then, increased much faster than in the 4Q2007. This came as a surprise since the 1Q07 witnessed a huge jump in construction sales due to mild weather conditions and negative statistical effects were expected.

Real retail turnover rose by 16.0% yoy in the 1Q2008 versus 12.2% yoy in the 4Q2007 so it picked up significantly and broke the decreasing trend since the 1Q2007. A relatively slow real increase in retail sales by 11.7% yoy in March 2008, i.e. when Easter set on, should not be treated as an annoying signal because it followed two months of very high increases, in which sales fell much less relative to the December 2007 level than in previous years, a sign that purchases were seasonally advanced. Further, the structure of retail sales growth in March 2007 points to a slowest year-on-year rise in foodstuffs, beverages and tobacco products (by 4.3%). In March 2008, real sales of cars together with spare parts, and consumer electronics together with appliances rose by 16.2% yoy and 23.3% yoy, respectively. The same happened in December 2007. Two explanations come to mind: fast growth in real wages has led to a shift in consumer demand away from food, a sign of growing affluence of the society, and substantial increases of food prices have also led to substitution effects.

Figure 1. GDP growth factors, quarterly % yoy



Based on the much better performance of the supply side than we had previously expected, our estimate of 1Q2008 GDP growth is raised to 6.0% yoy. Our previous forecast from PEO 4/2007 assumed a much lower rise in construction sales due to the statistical base effects and negative cumulative effects of interest rate hikes: Construction sales grew by over 50% yoy in the 1Q2007. The drop in industrial sales growth year on year in the 1Q2008 was likely offset by gains in value added in construction, retail sales and telecommunications, i.e. mostly in market services. The latest revisions of the 2007 GDP statistics by the Central Statistical Office did not point to any loss of momentum in the economy throughout 2007, since seasonally adjusted GDP growth, having slowed to 6.4% yoy in the 3Q2007, picked up to 6.9% in the 4Q2007. The flat trend was likely upheld in the 1Q2008.

On the demand side, fixed business investment continued as the main engine of economic growth in the 1Q2008 since its rate of growth is strongly correlated with the pace of construction expansion, which picked up compared to the 4Q2007. In our previous forecast of GDP growth in the 1Q2008, an assumed weakness in construction should have strongly dragged fixed business investment down in y-o-y terms in the 1Q2008 but, actually, this was not the case. Furthermore, real credit growth for firms did not exhibit any signs of easing despite a series of interest rate hikes. The 2Q2008 NBP business survey reports that mild winter led to moving backward, i.e. to the 1Q2008, some investment projects, which points to elevated fixed investment growth figures in this period. Therefore the year-on-year increase in fixed business investment should be at least similar to that in 4Q2007. Judging by retail sales growth private consumption should expand much faster year on year, i.e. above 5%, than in the 4Q07, when it increased at 3.7% yoy, the slowest pace since 4Q2005. This latter low figure is a puzzle. Strong growth was also underpinned by the rapid consumer credit expansion that did not display any signs of deceleration in real terms in the 1Q2008.

The negative contribution of net exports to GDP growth was almost negligible in the 4Q2008, a pleasant surprise that offset a decline in the rate of growth of personal consumption. In January 2008, the volume of exports of goods as measured by the CSO expanded faster than the volume of imports, and export prices fell the third month in a row despite the appreciation of the zloty. Polish companies apparently did not raise them in order not to lose market shares. If the January pattern prevailed in the remaining months of the quarter then the negative contribution to GDP growth of net exports could be low again. We do not count on it as according to the NBP balance-of-payments statistics imports grew faster than exports in January-February and the surplus of services decreased year on year. Instead, we incorporate a larger negative contribution of net exports into our GDP estimates. However, signaling the upside potential for GDP growth from this source seems appropriate.

The outlook for the remaining part of 2008 and beyond is still uncertain due to the ripple effects of the US near-recession on the global and in particular the European economy. Since the writing of PEO 4/2007 global forecasts of economic growth have been revised downward for 2008 and 2009. Stagflation tendencies are more pronounced now as the prices of commodities stubbornly refuse to drop, inflated by speculation, despite timid expectations of world demand expansion. The aggressive interest rate cuts by the Fed, its pumping of liquidity to financial markets and actions to restore confidence in the financial markets together with other key central banks, and the upcoming effects of the large fiscal stimulus will likely result in a shallow and short recession. However, the US recovery may prove slow because the main ingredients that induced the slowdown such as a crisis on real estate market will still be around. Credit conditions will remain tightened and houses prices depressed so the US consumers will have to raise their savings before they will again be able to go on a shopping binge. Therefore it seems unlikely that the US economy will become a driver of an economic recovery in the world like it did in the past.

The Polish economy has weathered unscathed the global slowdown so far but it is unlikely that it will not feel the adverse effects of diminished growth in Europe. The appreciation of the zloty cushioned the economy against stagflationary tendencies in the 1Q2008. However exporters face a double whammy: the appreciation of the zloty, which has been too rapid in the 1Q2008 according to the NBP survey, and lower demand growth for their produce. The interest rate hikes by the NBP may also become a domestic source of slower growth than hitherto if they were continued. So far the cumulative increase by 175 basis points mostly helped keep the real short-term interest rates unchanged at around 2 percent. However, monetary conditions have been tightened by the strengthening zloty. Then, if inflation dropped and rates stayed put, monetary policy would become automatically tightened. This is why GDP growth should weaken in the coming quarters, however it will be stronger than in our previous forecast and reach 5.3% in 2008. This scenario assumes a slowdown in the euro zone, but no recession. Furthermore, domestic growth risks for 2009 are skewed to the upside were structural reforms entailed and improved the functio0ning of the supply side of the economy. Enhanced confidence coupled with the injection of EU funds could bring in stronger FDI inflows despite a downturn in the global economy.

The start of the 2Q2008 is promising, however it is weaker than the start of the 1Q2008. Business sentiment continues to be positive according to the 2Q2008 NBP survey but demand, new orders, output, fixed investment and employment will rise at a lower pace than in the 1Q2008. Optimism has been tempered but after a strong pickup in the 1Q2008. It is characteristic that optimism suffered mainly because firms with large shares of exports in their revenues became more pessimistic. After seasonal adjustment, capacity utilization fell to 83.5% in the 1Q2008 from a record 84.1% in the 1Q2008. In contrast, consumer confidence improved considerably in April 2008 according to the CSO monthly survey. Both current evaluation and expectations were lifted up suggesting that strong growth in consumer expenditure should be maintained in the coming months.

A pickup in GDP growth in 2009 is predicted for a number of reasons. Structural reforms should start creating results although they typically do so with a considerable delay therefore the sooner they are adopted, the more upward risks there are. Last but not least, the global situation should improve as well.

Inflation and Monetary Policy

Consumer inflation continued to rise in the first quarter of 2008 reaching 4.1% yoy (up from 3.5% yoy in the 4Q2007) mostly on the back of rising prices of energy, fuel and processed foodstuffs. However, in contrast to 2007 when sharp rises in food and energy have been balanced by low or negative price dynamics in other sectors early 2008 saw inflationary pressures spilling over to virtually all sectors of the economy. Growing inflation rates have been registered for home furnishings, vehicles, pharmaceuticals and in most service sectors: healthcare, transportation, postal services, education and catering.

Broadening inflationary pressures are clearly reflected in sharp rises of all core inflation indicators. Net inflation (calculated without food and fuel) rose by 0.9 percentage points qoq up to 2.4% yoy in the 1Q2008, trimmed mean - by 0.8 percentage points to 4%, and core inflation excluding administrative prices - by 0.4 percentage points to 3.8% yoy. This points to the fact that the observed inflation rise can no longer be ascribed to a few supply-side shocks and has gradually spread to many different markets. Furthermore, the equality of the trimmed mean and the headline CPI suggests that inflationary pressures are symmetrically distributed across different goods and services while the near-equality of core inflation excluding administrative items and the headline CPI indicates that administrative prices have ceased to be consumer inflation's main driving force and now register the rates comparable to those of the rest of the basket.

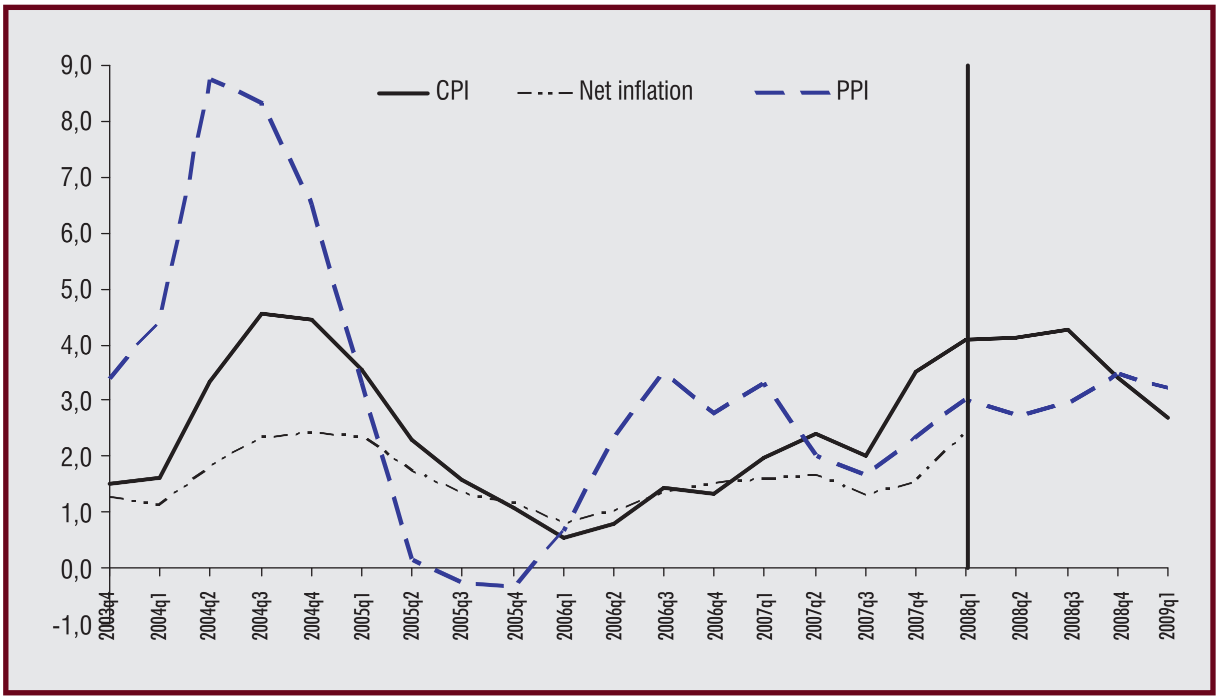
Prices of food have decelerated somewhat in recent months (from 7.9% yoy in December down to 7.0% yoy in March) thanks to the slowing price dynamics of poultry meat and vegetables. Inflation of pork, cereal and dairy products registered a slight rise in the 1Q2008, compared to the 4Q2007, albeit viewed by months, stabilized in the three months of 2008 at around 5.5%, 12% and 15% yoy, respectively.

On the other hand, prices of energy continue to accelerate and have become the primary source of inflationary pressures. The combined inflation of four major energy sources (electricity, gas, furnace fuel and central heating), accounting for 11% of the total household expenditures, rose from

3.4% yoy on average in the 4Q2007 to 6.8% yoy in February and 7.0% yoy in March on the back of rapid hikes in the price of electricity (11% yoy in March) and furnace fuel (10.1%). Furthermore, despite the appreciation of the zloty prices of gasoline continued to rise hitting 13.7% year on year in the 1Q2008 (up from 13% yoy in the 4Q2007 and 1.6% yoy in the 2Q2007) - the highest annual dynamics since mid-2005.

Rising costs including energy and wages are gradually affecting the service sector, which saw its inflation increase to 3.9% yoy in the 1Q2008 (4.2% in March), the highest such growth since 1Q2001[1]. This rise, coinciding with the improvements in the economic situation, can be interpreted through the Harrod-Balassa-Samuelson effect additionally enhanced by the arising cost-push factors. Prices grew across virtually all service sectors with particularly sharp rises posted in residential maintenance services (sewage, garbage disposal etc.), medical services (dental), air transportation, catering, personal care and pre-school child care.

Figure 2. Annual inflation in Poland, quarterly % yoy



On the other hand, prices of manufactured goods continue to exert disinflationary pressures with the HICP non-energy industrial goods aggregate registering a mere 0.3%[2] growth yoy on average in the 1Q2008, down from 0.4% yoy in 4Q2007 and 3Q2007. The prices of manufactured goods were kept low in all-EU including the Euro area (0.8% yoy in the 1Q2008) by cheap Asian imports, and were additionally suppressed in Poland by the sharply appreciating zloty (by 8% yoy in 1Q2008).

Producer prices seem restrained with the all-items PPI inflation in the 1Q2008 at 2.8% yoy, slightly up from 2.5% yoy in the 4Q2007. The sharp rises of world prices of coal and copper in the 1Q2008 translated into a significant acceleration of inflation in mining and quarrying, which hit 13.7% yoy in the 1Q2008, compared to 1.4% yoy in the 4Q2007. The sector of energy, gas and water supply posted an increase in the annual price growth from 3.7% in the 4Q2007 to 4.4% in the 1Q2008, reflecting higher prices of electricity

[1] Data refer to the Harmonized Index of Consumer Prices (HICP) calculated by Eurostat.
[2] Data refer to the Harmonized Index of Consumer Prices (HICP) calculated by Eurostat.

approved by the Agency for Energy Regulation in January and February. Offsetting these increases were manufacturing industries, which saw their inflation decline by 0.2 percentage points to 1.9% yoy in the 1Q2008. Within this sector the oil and tobacco industries continue to register very high price growth of nearly 30% and above 20% yoy, respectively, while small inflation or deflation are posted by other industries.

Compared to the previous issue of PEO we have revised our forecast of consumer and producer price inflation upward. This is motivated by the expectations of a larger magnitude of the energy and fuel price growth as well as the gradual strengthening of demand pressures stemming from the better-than-expected economic growth scenario. We believe that food price inflation will moderate beginning with the third quarter in line with cautiously optimistic 2008 crop scenarios. However, until then, inflation of processed foods will be high reflecting soaring procurement prices of wheat (43% yoy in March) and milk (19%). Furthermore, buoyant economic activity and rising income are expected to continue exerting upward pressures on prices of nontradables (most services). On the other hand consumers are expected to benefit from the competition of cheap manufactured goods and a strong currency putting an additional downward pressures on retail prices.

These effects combined lead us **to expect the stabilization of average quarterly inflation at around 4% yoy in the second and third quarter of 2008 followed by the decline to 3.4% yoy in the fourth quarter and 2.7% yoy in the first quarter of 2009.** The resulting annual average inflation is therefore expected at 4.0% in 2008 and 3.0% in 2009. The PPI inflation will decline to 2.6% yoy in the 2Q2008 and 2.7% yoy in 3Q2008 to rise again to 3.5% yoy in the 4Q2008 and 3.2% yoy in the 1Q2009. At the annual level this will translated into average rates of 3.0% in 2008 and 3.1% in 2009.

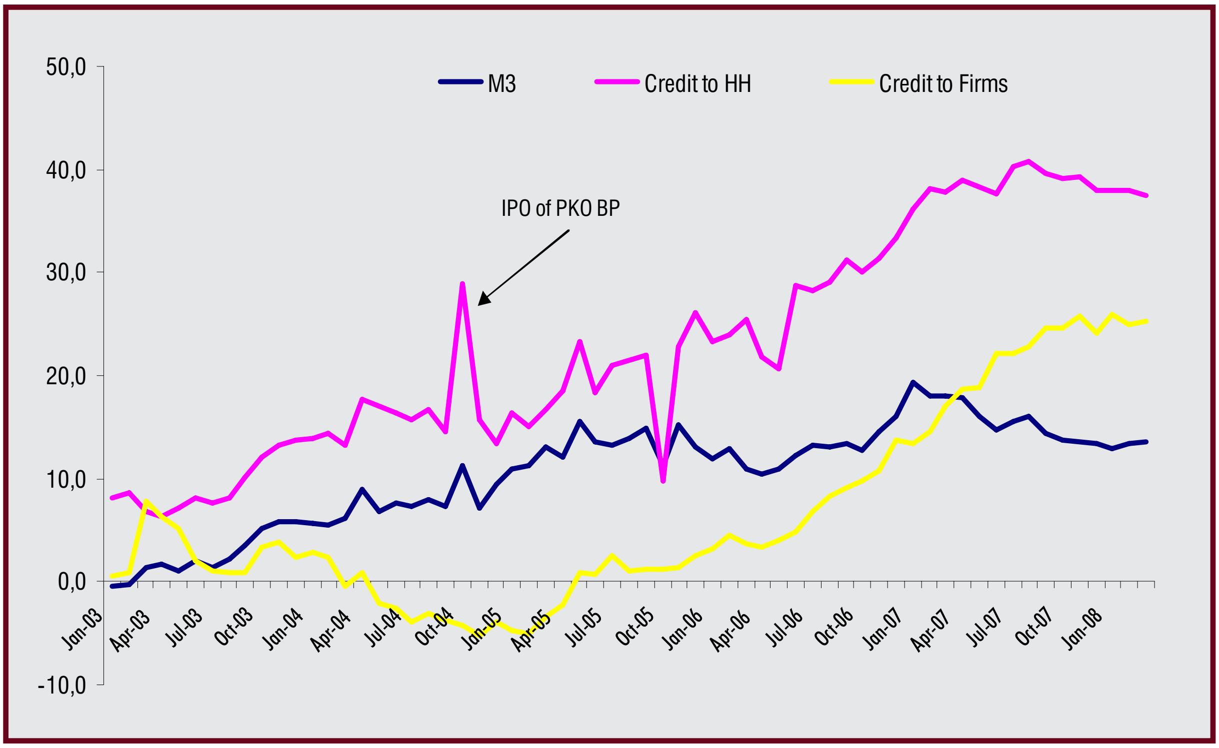
Since inflation rate has nearly peaked and growth is about to slow to the potential rate, the tightening cycle by the central bank is to end soon. The rates were raised slightly faster in the 1Q2008 than we had expected (three hikes instead of two) so a one more interest rate increase cannot be excluded. It should take place in the 2Q2008 as inflation is forecasted to level off.

The rising interest rate differential between the zloty and foreign assets has led to a stronger appreciation of the zloty than we had expected in the 1Q2008. Therefore overall monetary conditions tightened, which encouraged a pause in interest rate hikes after three consecutive increases by 25 basis points in the 1Q2008. A fall in inflation in the 4Q2008 should lead to emerging expectations of prospective cuts in interest rates though we think that the central bank will keep the key rat at 5.75-6.00% through the 1Q2009.The potential hike of the key central bank rate to 6% has already been discounted by the financial markets so we do not think it would revive the appreciation pressure, which may intensify again were the ECB to cut interest rates. The ECB has been preoccupied with inflation tensions in the euro zone up to now but it may "give in" should the sings of the economic slowdown in the euro area become more pronounced. This is why we see the slightly stronger zloty at the end of the 2Q2008 and 3Q2008.

Monetary Developments

Broad money as measured by M3 rose by 13.6% yoy in March 2008, i.e. at the end of the 1Q2008, almost the same as 13.4% in December 2008, however a slow declining trend since January 2007 is discernible. Since inflation has picked up since then, broad real money has been downtrending as well. Were it deflated by the CPI annual change its year-on-year rise would fall from the peak of 17.4% in January 2007 to 9.2% in March 2008. This slightly overstates the change since CPI often rises more than PPI and deposits of firms should rather be deflated by the latter index. The rise in inflation and the appreciation of the zloty were the factors of this deceleration since nominal money growth barely budged down in reaction to interest rate hikes. The data show that the aggregate of M3 stopped rising much faster than nominal GDP that grew by 10.0% in 2007: this comparison is a popular rule of thumb while drawing conclusions about inflationary pressures in the future. Their risk has clearly diminished with regard to monetary developments. Recall that inflation is a purely monetary phenomenon only in the long-term, in which we all die, so other factors matter as well. Due to the differential in GDP and M3 growth rates in 2007, monetization of the economy has continued to gradually increase to almost 50% at the end of 2007.

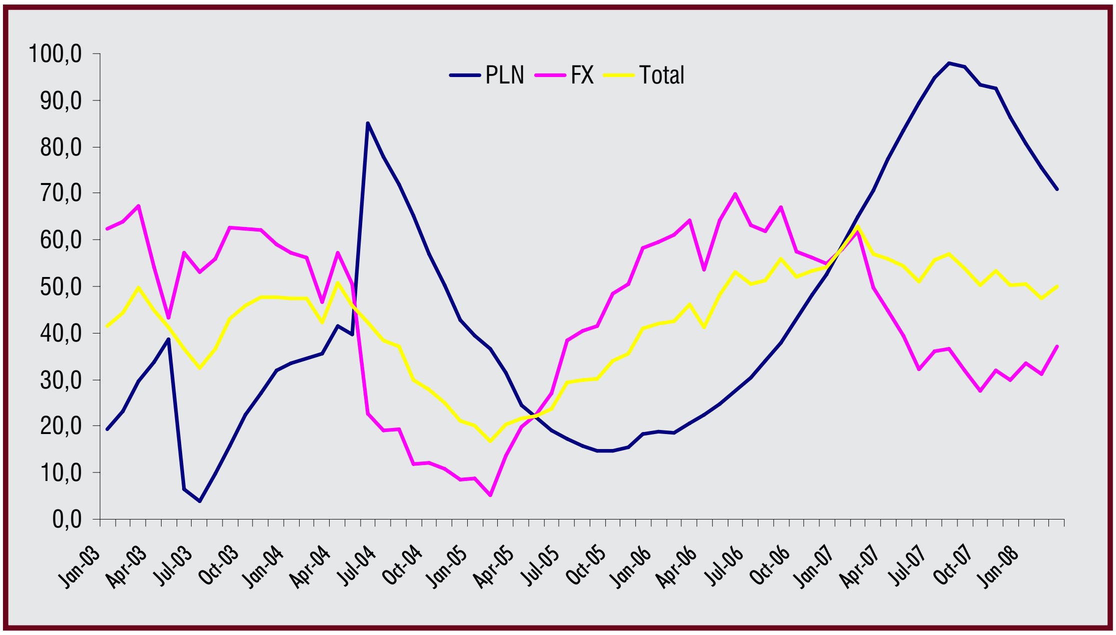
Figure 3. Broad Money and Credit Expansion, % yoy



It is worth noting that real M3 uptrended in the first quarter since household time deposit growth accelerated considerably. These deposits stopped decreasing year on year in January 2008 for the first time since November 2005. The switch in trend is most likely related to a combination of two factors. Average interest rates on time deposits of households have risen since the onset of interest rate hikes by the central bank in April 2007 by approximately 1 percentage point according to the NBP statistics, and households withdrew their funds from investment funds due to declining stock markets, on which uncertainty and volatility increased significantly. Small investors who counted on quick high returns burnt their fingers. New savings by risk-averse persons have been channeled to bank deposits that offer safety of protecting capital in turbulent times. Cash balances growth outside bank tellers continued decelerating in the 1Q2008, and rose at 10.8% yoy in March, i.e. at a slower pace than M3 in the 1Q2008. Growth in demand deposits of private persons increased faster in the 1Q08 than in the 4Q2007, perhaps in response to stronger wage growth and gains in employment.

Firms usually withdraw their deposits, mostly time deposits, at the beginning of the year after having dressed their books at the end of the year. This happened in the 1Q2008 as well but the drop in deposits was much bigger than in previous years. One possible explanation is that businesses advanced their investment projects due to mild winter conditions and needed more funds for purchases of goods and services. The NBP quarterly business survey gives clue to this interpretation. The pickup in fixed business investment is sustaining the credit boom in the Polish economy. Interest rate hikes by cumulative 1.75 percentage points since April 2007 have had little impact, if any, on credit growth for firms, as the pace of its nominal expansion actually rose in the 1Q2008 to the unweighted average of 25.4% yoy versus 24.8% yoy in the 4Q07.

Figure 4. Housing Credit Credit Growth, % yoy



While interest rate increases by the central bank have not exerted a declining impact on the credit action to firms yet, they seem to have affected credit to households. The rate of growth of nominal credit to them peaked at 40.8% yoy in August of 2007. A downward trend set in since then, and the rate of growth was down to 37.4% in March 2008, but this rate barely dropped in the 1Q2008 despite ongoing interest rate increases. The drop is more visible in real terms: Due to a pickup in the CPI inflation, credit to households rose by 32% yoy in March 2008 versus a peak of 38.7% yoy in August 2007. This gradual credit moderation is a result of a deceleration of growth in the housing credit from its peak at 62.9% yoy in February 2007 to 49.9% yoy in March 2008 but the slowdown was small in the 1Q2008. The appreciation of the zloty and the rising interest rate differential between the zloty and the other key currencies such as the euro and the Swiss franc led to the acceleration of the housing credit in the 1Q2008, denominated in foreign currencies. This arrested the decreasing trend in the proportion of foreign currency credits to the total housing credit that had been visible since June 2006. The proportion of such credits rose to 57% in March 2008 from 55.2% in December 2007 thus households became a bit more vulnerable to a hypothetical zloty depreciation than in the 4Q2007.

This exposure has been mystified. At present, the 10% zloty depreciation would raise the amount of outstanding foreign currency housing credits by about 7.3 billion zlotys or 0.6% of GDP. Assuming an average interest rate of 5.5% on these credits, which is probably an overestimate since this rate has been calculated as an arithmetic average of the interest rate in the euro, and the Swiss franc and credits in the latter prevail, this would raise the debt service by 0.4 bn zlotys a year. This amount is so low that it should not lead to a visible rise in delinquent repayments. A one rise in the key interest rate of the NBP by 25 basis points in March 2007 would cause a rise in debt service of households in a year of a similar magnitude (about 370 million zlotys).

Therefore until disposable incomes rise strongly Polish households should not face problems servicing debt as their level of indebtedness is low compared to other countries: housing credits amounted to only 11.2% of GDP in 2007 despite their breath-taking rate of expansion in recent years (e.g. the total housing credit was 64.8% of GDP in Portugal in 2007). There is no wonder that the ratio of irregular bank assets in their total value has been slackening and stood at 4.1% in September 2007, compared with 4.1% in June 2007 according to the most recent available data. There is no evidence that mortgage quality has deteriorated. Irregular housing credits stood at 1.9% in September 2007 of total housing credits versus 2.9% in 2006.

Fiscal Developments and Policy

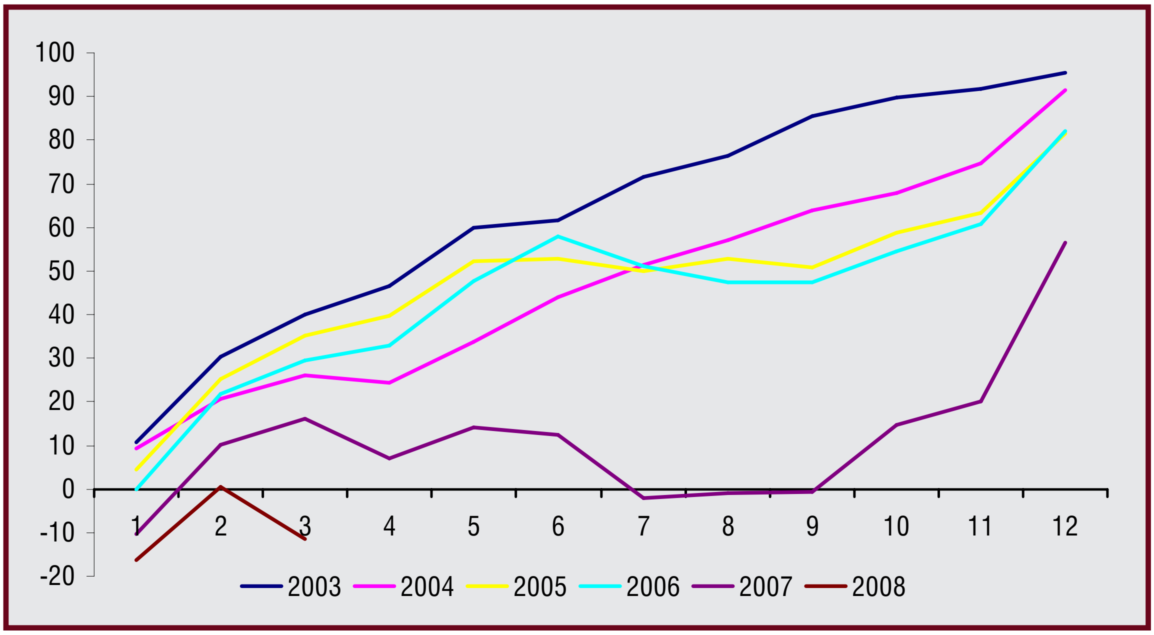
According to the preliminary estimates the central government cash budget registered a surplus of 3.1 bn zlotys in the 1Q2008, compared with the initial government projections of a 6.0 billion deficit or 22.3% of the annual plan of 27.1 billion zlotys. The state revenue came much stronger than expected at 65.9 bn zlotys versus 62.6 bn, i.e. 3.3 bn zlotys more, while the state expenditure was short of the plan of 68.6 bn zlotys by 3.8 bn zlotys.

On the revenue side the strong collection of taxes should be underscored: It was underpinned by the continued expansion of the economy. In particular, the collection of VAT rose by estimated 14.4% yoy, suggesting that domestic demand grew rapidly in the 1Q2008, and the corporate income tax (CIT) collection grew by over 115% yoy so it reached 35.6% of the 2008 government projections, a clear sign that the profitability of businesses kept well in the 1Q2008. The state income from excise rose by 3.9% while PIT revenues increased by 8.9% yoy due to strong gains in employment and hefty increases in remuneration. Comparing these rates of growth to the rates of growth of various taxes that the budget bill provides for the entire 2008, it occurs that the rates of growth of indirect taxes were lower in the 1Q2008 than projected for 2008 while the rates of growth of income taxes in the 1Q2008 exceeded them rather strongly. Thus, the projected increases in the revenues from indirect taxes seem overly optimistic, especially that growth in the 1Q2008 exceeded expectations, and the deteriorating global economy may adversely impact the Polish economy in the remaining part of the year. However, these potential negative effects may become offset by the income taxes.

Altogether the tax revenues reached 25.5% of the 2008 government projections in the 1Q2008. Seasonally, the first quarter brings the lowest revenue out of the four quarters in a year so if this pattern prevailed in 2008, the first quarter performance would bode well for the 2008 revenue projections of the government. Furthermore, the amount of the EU unrequited transfers to the state budget was low 9.1% of the 2008 projections. In particular, the government received a negligible amount of means related to structural funds.

The government spending came lower than planned for a number of reasons. Firstly, the subsidy to the social insurance fund (FUS) was much behind the time lapse and amounted to only 11.8% of the 2008 plan. The proportion was 20-25% of the planned annual subsidy in previous years. Secondly, the domestic public debt service was low 9.9% of the 2008 plan. This brought about 1 bn zlotys in savings compared with the 1Q2007. Such comparisons make sense since the total debt service is planned about the same in both years.

Figure 5. Central government budget deficit, % of annual projections

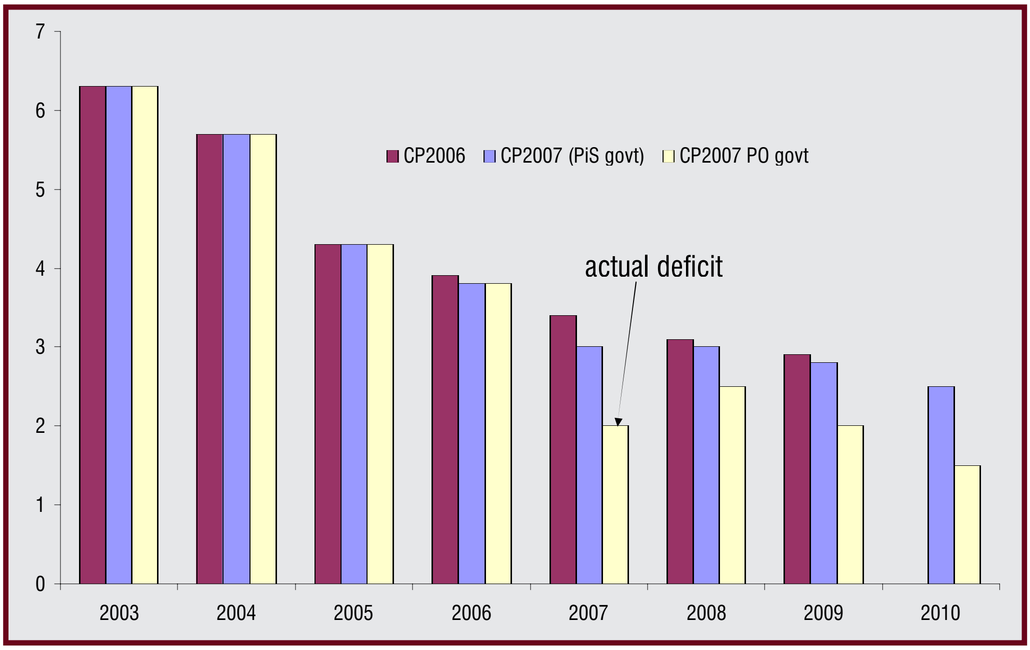


Concluding, the state budget performance beat the plan and projections in the 1Q2008. The risks that the 2008 shortfall will exceed the projections of 27.1 billion due to the large increase in expenditure this year diminished, however they remain.

According to the data published in April 2008, the ESA-95 general government deficit was down to 2.0% of GDP in 2007, compared with 3.8% of GDP in 2006, the 3.4% of GDP projected in the 2006 update of the Convergence Program and later government estimates of 3% of GDP. This was due to the drop in the central government budget deficit by the 1 percentage point of GDP, the improvement of the local governments balance by 0.5% of GDP and the increase in the social security funds surplus by 0.3% of GDP. The government predicts that the ESA-95 deficit will rise to 2.5% of GDP in 2008 as the surplus of the social security funds, equal to 1% of GDP, will practically disappear this year due to the reduction in the disability pension premium and the increased indexation of pensions. On the other hand, local governments should improve their fiscal surplus by 0.4% of GDP to 0.6% of GDP in 2008, which seems overly optimistic, taking into account the fact they will spend money on co-financing of EU related projects. This is the main argument why we expect the general government deficit to come higher than the government projections of 2.5% by some 0.3% of GDP.

The fall in the general government shortfall to 2% of GDP was cyclical to much extent and therefore unsustainable into the future without deep reforms of social expenditure, i.e. early pensions and pensions for farmers likewise a further tightening of supervision over disability pensions. The prospects for such reforms diminished once the deputy finance minister in

Figure 6. Central government budget deficit, % of annual projections



source: Polish Convergence Programs 2006 and 2007.

charge of them resigned early April. Despite these unfavorable signals the European Commission made up a to lift the Excessive Deficit Procedure under which Poland has been since its entry into the EU.

Labor Market

Employment

Employment dynamics are is still on the rise. In the 1Q2008, the number of employed persons in enterprises that have at least nine people on staff (in the so-called enterprise sector) increased by 5.9% yoy (5.0% in the 4Q2007). Employment accelerated most rapidly in construction (12.2% yoy growth in the 1Q2008 as compared to 7.2% in 4Q2007) and in business services (10.3% versus 7.7% yoy). The rise in employment dynamics was shared by all sectors excluding manufacturing where it stabilized at the pace of 4.4% yoy. Since manufacturing is the sector with the biggest share in total employment, continuation of this trend may result in the stabilization of total employment dynamics in the nearest quarters.

Only slightly less optimistic messages, concerning employment creation, come from Public Employment Service (PES) where the number of job offers from enterprises registered at PES seem to have stabilized. The number of job offers in the 1Q2008 was by 0.1% lower than a year ago. However, as we mentioned in the previous issues of PEO, it does not necessarily mirror the actual situation in enterprises. It may be related to the increasing share of unfilled vacancies in PES related to a very low "quality" of the labor force still in the disposal of PES. The only way, in which PES can react to this problem is to actively look for new "clients" among those currently inactive persons, i.e. not looking for jobs.

The Labor Force Survey (LFS) employment figures for the 4Q2007 continue to be optimistic. The number of employed increased year on year by 4.2% so it seems that employment dynamics regained its previous impetus after a short break in the 3Q2007, when it had fallen to "only" 3.5% yoy. The interesting fact about the 4Q2007 is that the level of economic activity of the population seems to have stabilized. The number of economically active population (the sum of those who work and who are unemployed) was exactly the same as in the 4Q2006. This news is worth emphasizing as the number of economically active population had been continuously and rapidly decreasing since the beginning of 2006, most probably as the result of mass emigration. One can only hope that this break of a downward trend is not a one-off phenomenon as falling economic activity was one of the most worrying trends on the Polish labor market in recent times.

We expect that both employment in the enterprise sector and the overall LFS employment figure will keep rising in the quarters to come, taking into account more optimistic expectations of GDP growth than a quarter ago. In the 2Q2008, the enterprise sector employment growth should be higher than 6% yoy and the LFS employment in the 1Q2008 will grow by around 4.5% yoy. The average enterprise sector employment growth for 2008 should stay at the rate of 5.0% - 5.2%, the LFS employment will remain at around 4% yoy.

Wages

As we expected in the previous issue of PEO real wage dynamics in the 1Q2008, after a short break in the 4Q2007 came back to its rising trend. It increased by 7.1% yoy, i.e. by 0.8 of a percentage point more than in the 4Q2007. Nominal wages in the 1Q2008 increased by 11.5% yoy.

Wages grow most rapidly in construction (16.9% yoy) and in business services sectors (13.4% yoy). It is interesting as those are also the sectors experiencing the highest employment growth. It is most probably the result of two parallel processes: increasing demand for labor and deepening shortages of skilled staff additionally reinforced by migration.

One has to observe, however, the pace of wage growth in construction was in the 1Q2008 lower than in the 4Q2007 when it had reached 17.8% yoy. In business services, on the other hand, wage dynamics rapidly accelerated from 10.8% yoy in the 4Q2007. It may mean that in construction sector we may be close to some kind of limit of labor demand growth, on the other hand business services sector seems to be just booming.

As our earlier expectation that the slowdown in real wage dynamics observed in December 2007 was a one-off phenomenon appeared to be correct, and since both labor market and overall economic situation seem to continue their bullish trends we still expect nominal wages to rise rapidly. Nominal wage growth should stay at least above 10% yoy both in the 2Q2008 and in 2008 as a whole.

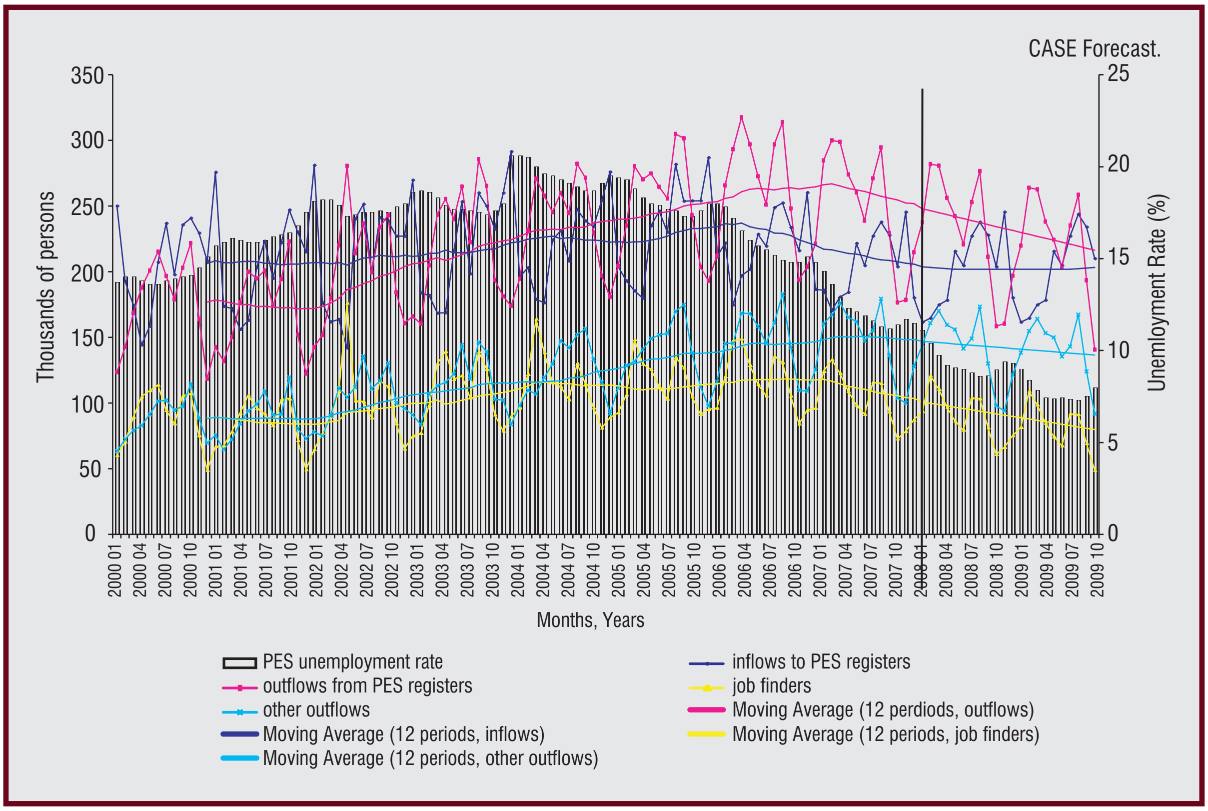
Unemployment

Unemployment keeps rapidly falling. The number of registered unemployed persons fell to 1.7 million in the 1Q2008. This meant a y-o-y reduction of 23.8% (24.2% yoy in the 4Q2007). The registered unemployment rate fell by 3.3 percentage points to 11.1%.

Although these are very good trends one has to take into account signals warning that this pace in unemployment reduction may be unsustainable soon. The number of unemployed persons that find new jobs, continues to fall rapidly from quarter to quarter, being accompanied by an increasing number of unfilled vacancies. It suggests the rising mismatch between the skill structure of job offers and actual skills of those still in unemployment registers. It all shows off in the slightly falling dynamics of unemployment reduction. Polish actual unemployment rate seems to be already below its natural level.

The LFS figures for the 4Q2007 were also very positive. The number of unemployed fell by 30.2% yoy, as compared to 31.6% in 3Q2007, reaching 1,448,000, and the unemployment rate fell yoy by 3.7 percentage points, reaching a record low of 8.5%. Here, however, we can also observe that the dynamics of unemployment reduction has slightly decelerated.

Figure 7. Registered unemployment rate, outflows from and inflows to PES registers in 2000-2007 and CASE forecast for 2008-2009



Anyway, we still expect that the registered unemployment will decrease in the 2Q2008 to 9.2%, and only then it will stabilize. We expect it to reach 9.0% - 9.5% at the end of 2008. The LFS unemployment will also continue to fall. It should stay at around 8.5% in the 1Q2007, and fall to around 6.5% - 7% by the yearend. Both the registered and the LFS unemployment will probably continue to fall also in 2009, however much slower than in 2008. We expect the registered unemployment rate and the LFS unemployment rate to decline at the end of 2009 to around 8% and to 5.5% - 6%, respectively.

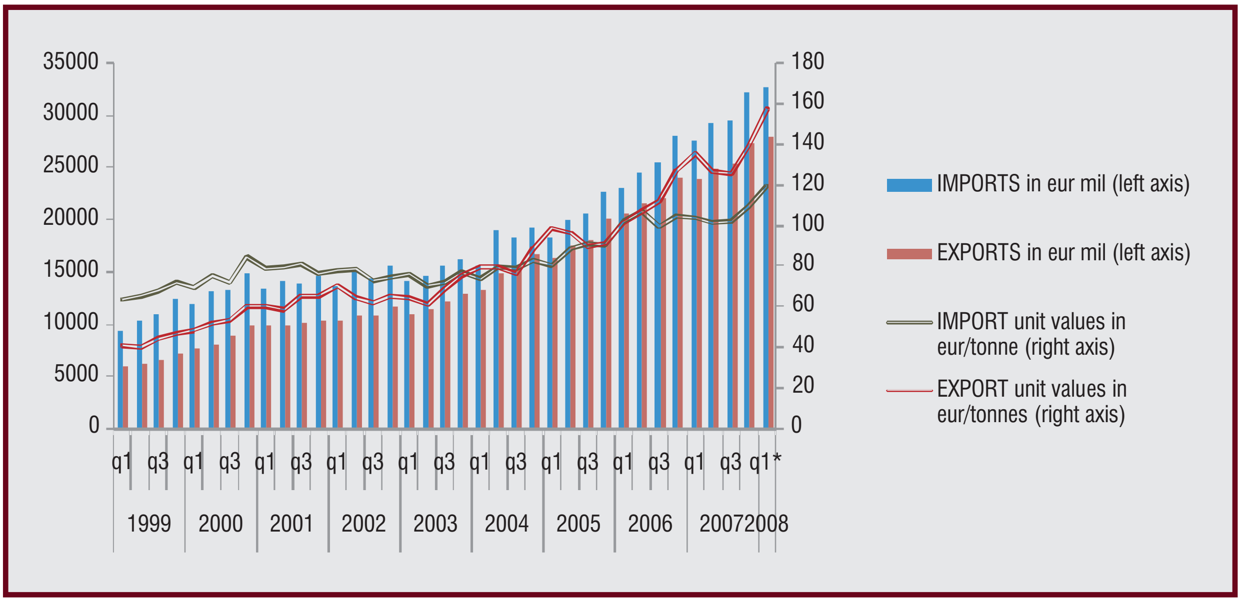
Foreign Trade and Balance of Payments

- **Growing trade flows**
- **CA deficit rose to 4% of GDP**

At the beginning of 2008, growth of merchandise exports accelerated. According to the CSO (GUS) data, sales of Poland-made produce increased in nominal zloty terms by about 11% yoy in January-March of 2008 (and about 18% yoy when expressed in the euro). The fastest growing export markets were developing countries and Eastern European states, mainly Russia and Ukraine. Sales to the EU maintained its earlier pace of 5% yoy in the zloty and 12% yoy in the euro in the 1Q2008, notwithstanding the economic slowdown in the euro area and in the global economy. The average euro prices for a unit of exported good kept on mounting fast (see Figure 8).

Imports have been on the upward path too, and expanded marginally faster than exports. Value of imports rose in nominal zloty terms and in euro terms by about 12% yoy and 20% in the 1Q2008, respectively. In January-March 2008, similarly as before, merchandise trade deficit was mainly due to trade with developing countries (China) and to some extent due to trade with Russia. Trade with the EU ended with a surplus in the 1Q2008, although the balance of trade with the euro zone was negative. Prices of imports broke the earlier downward trend and began to rise rapidly, even when expressed in the Polish currency, a phenomenon most likely related to the rapid increases in commodity prices. The annual dynamics of euro unit values (see Figure 8) was significantly higher than the appreciation of the exchange rate. Nevertheless the relation between the levels of import and export unit values remains favorable, and suggests that imported goods are on average of a lower quality (or less-processed) than the exported ones. This relation showed for the first time in mid-2006, and has been prevalent since then.

Figure 8. Values and prices of Polish merchandise trade, 2002-2008



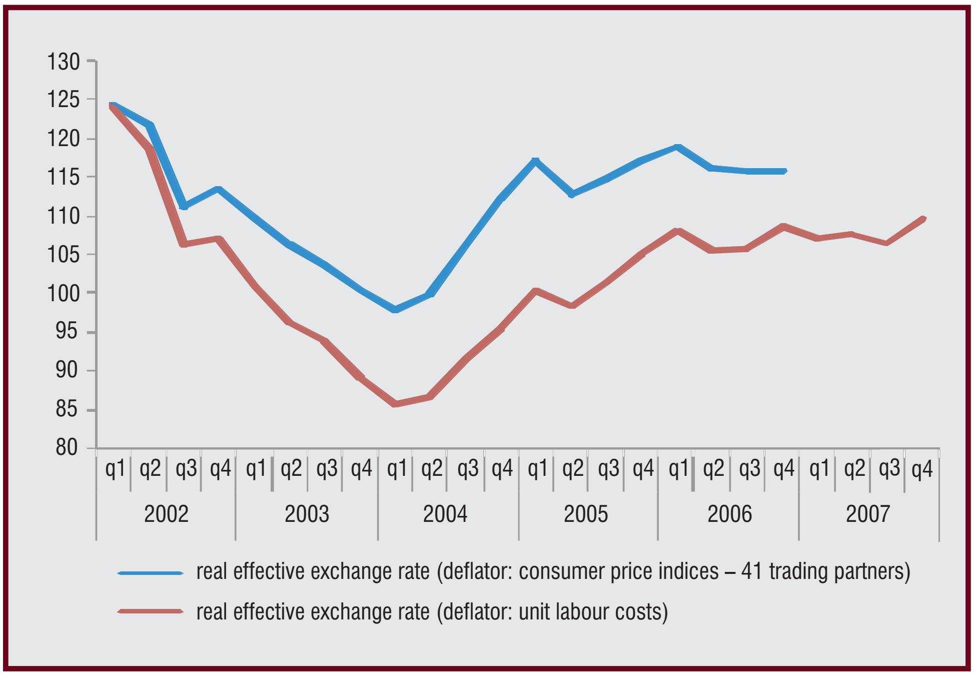
Note: 4Q2008 – estimate
Source: Eurostat and own calculations

The volume of exports expanded 12% yoy in January 2008, which suggests unchanged dynamics with respect to the situation at the end of 2007. The volume of imports tended to grow at the similar speed - at 11% yoy in January - also relatively unchanged when compared to the end of 2007. It is most likely that the primary cause for the growth of imports was high and stable domestic demand. However, appreciating real exchange rate of the zloty vis-a-vis the euro and the dollar throughout the whole 1Q2008 might also be a factor (for real effective rates see Figure 9). Economic growth in the EU27 continued, albeit at slower pace, and it was the primary factor behind the growth of Polish exports.

It is forecasted that exports will continue to expand in real terms by above 10% yoy in 2008-2009. The real growth of imports will be lower, at 5-6% yoy in 2008-2009. This is for the reason that forecasts are made on the basis of past relations, where the real exchange rate was estimated as insignificant for real dynamics of merchandise trade flows. The forecasts are based mostly on the estimate that exports are much more responsive to changes in the growth of the EU countries than imports are to the changes in Polish domestic demand. When one combines assumed future growth of the EU27 demand and Polish domestic demand, the result is that real dynamics of exports is forecasted to be higher than that of imports.

It is difficult to say with the significant degree of confidence what will be the time path of future nominal values of merchandise exports and imports. They depend very much on changes of terms of trade, and those are hard to predict. We forecast, nevertheless, that the dynamics of merchandise exports and imports, expressed in the euro, will be much higher than the real changes, predominantly due to the strengthening of zloty. We think that the unit values of exports will grow less dynamically in 2008 than in 2007. We also forecast that merchandise trade balance will widen in 2008, and then again in 2009.

Figure 9. Real effective exchange rate, 2002-2007

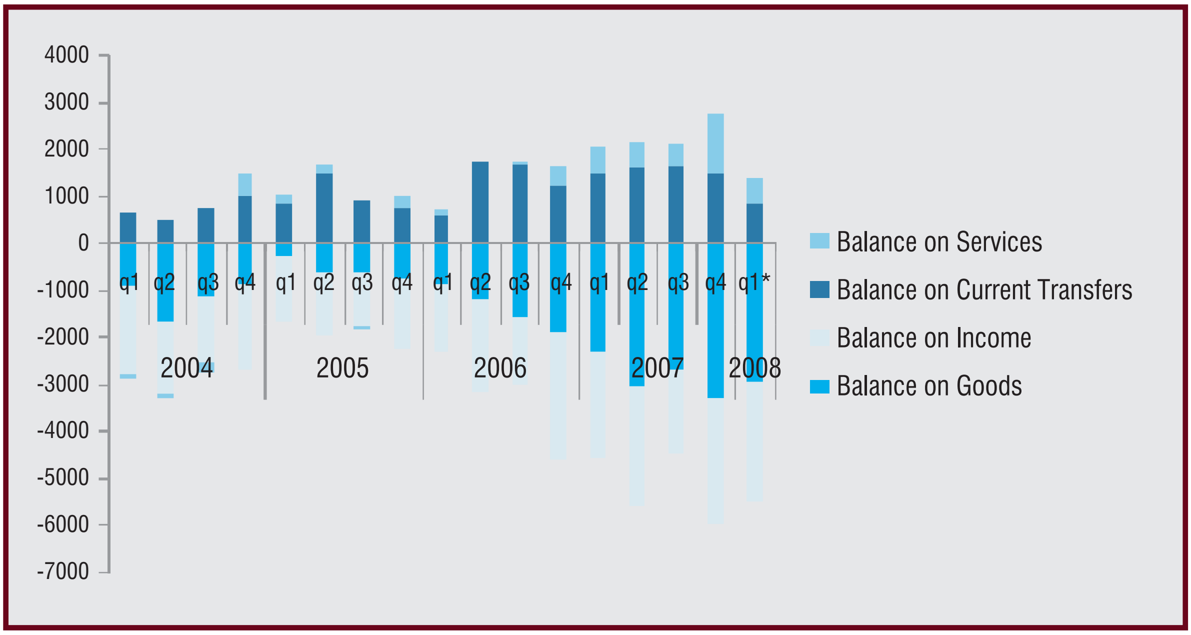


Note: indices, 1999=100
Source: Eurostat

The current account (CA) balance has been negative and around of -3.7% of GDP in 2007. We estimate that the 1Q2008 saw an increase in the CA deficit to 4% of GDP. At the moment, a relatively high and negative CA balance, though still one of the lowest among the new member states in the EU, is influenced by the large merchandise trade deficit, of almost EUR 3 billion in 1Q2008, and by the negative balance on the income account of EUR -2.5 billion in the1Q2008 (see Figure 10). Trade in services in the 1Q2008 closed with a surplus of EUR 0.6 billion. Current transfers - out of which a significant part is composed of transfers to and from the EU budget also recorded a positive balance of EUR 1 billion.

The latest developments lead us to revise our previous forecast, in which we predicted an upward trend of the CA deficit relative to GDP in 2008. At present, we forecast that the CA balance will close in 2008 with a slightly lower deficit of around 3.4% of GDP than in 2007, and the deficit will be even lower in 2009. This is mainly for the reason that we expect the trade in services to result in significant and growing surpluses both in 2008 and in 2009, to the extent that they will offset the increasing deficit in the trade in goods.

Figure 10. Current account in millions of euro, 2004-2008



Note: * – own estimate
Source: NBP.

FDI inflows closed at EUR 3.2 billion in the 1Q2008, while outflows were slightly below EUR 1 billion. The proportion of the CA deficit that is financed by the net FDI inflows deteriorated compared with 2007 but it was still relatively high (58% versus 91%).

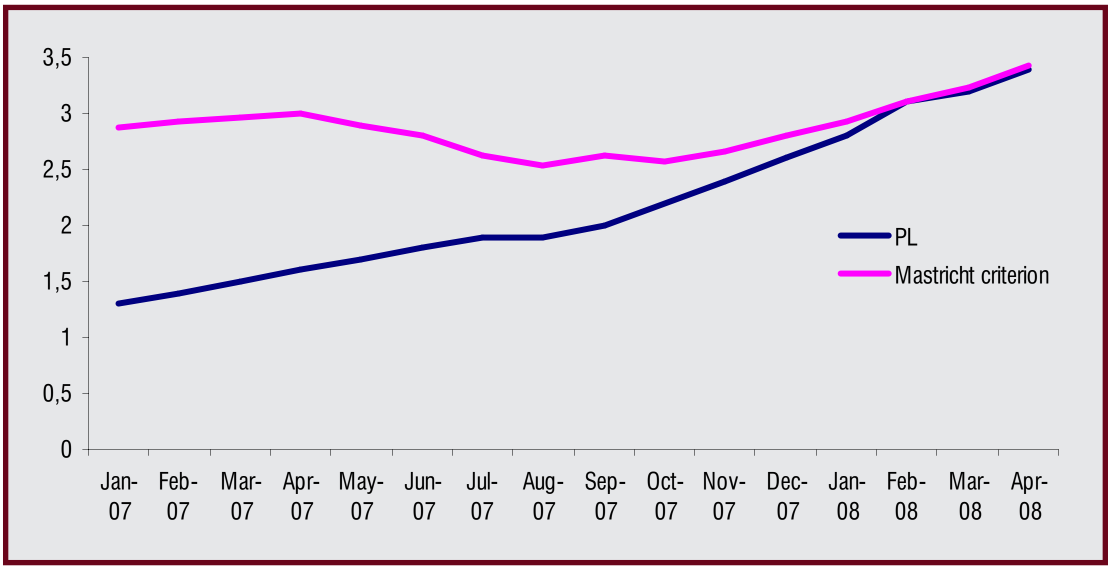
Latest Convergence Program – little hurry to euro adoption

This is the first time when Poland meets all Maastricht criteria. However it continues to contemplate when to adopt the euro. The earliest possible date is 2011 now. Those cautiously optimistic would point to 2012 that coincides with the European soccer championships but the latter date is also uncertain.

The inflation criterion specifies that the average inflation rate should not be higher than 1.5 percentage points from the arithmetic average of HICP inflation rates in three least inflationary countries in the EU. It is well known that a catching-up country should have an inflation rate higher than the reference area so it is no wonder that Polish inflation rate is higher than the one in the euro zone at present though it was not always the case in the past. Poland even used to be a reference country for establishing the value of the inflation criterion in a number of months, most recently in January - April 2007. The world-wide commodity price inflation and food price inflation coupled with GDP growth over its potential rate in Poland has tended to increase the inflation differential between Poland and the euro zone. Nevertheless Poland meets the inflation criterion. It may be violated in the months to come because inflation in this country is on the border but our forecasts of the CPI inflation rate heading south from the 3Q2008 on, should help restore the compliance with this criterion (see chart 11).

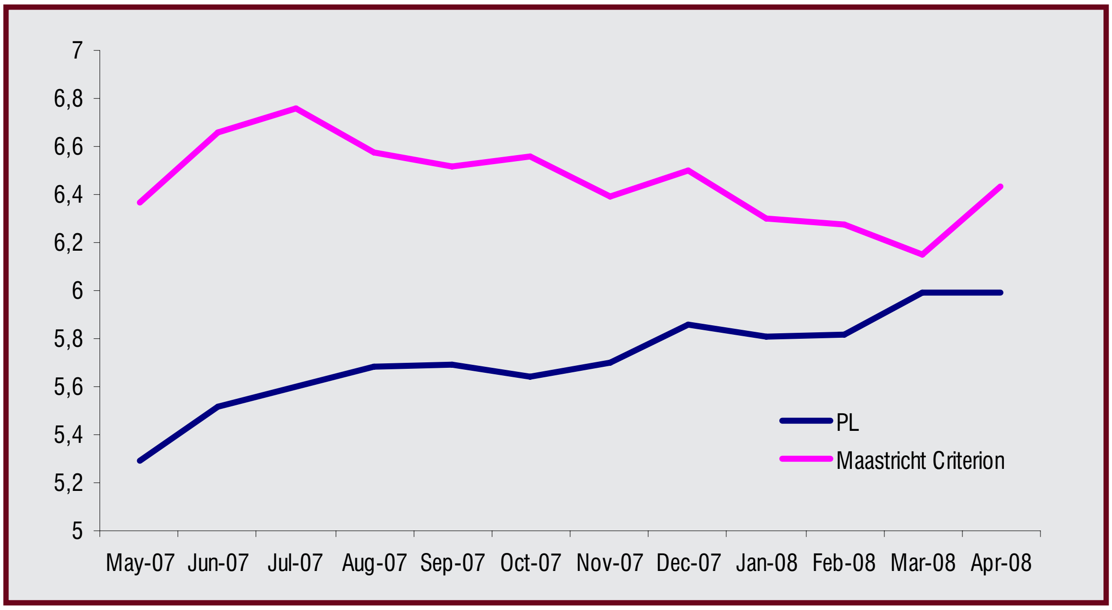
A country could dampen its inflation rate in the very last moment to sneak into the common currency area and then relax its policy or raise regulated prices afterwards, when this action is long overdue. The long-term interest

Figure 11. HICP Inflation Rate yoy: Poland versus Maastricht Criterion



rate criterion, which serves double purpose, is supposed to hold off such behavior. Second, it is also related to prospects that the public debt rises without a bound so financial markets start demanding a higher risk premium. The criterion specifies that the long-term, in practice the 10-year government bond yield, should not exceed the average rates seen in the three lowest inflation countries by more than 2 percentage points. The increasing inflation differential and financial markets turmoil led to a widening of the 10 year government bond spread over the euro zone one. However, Poland still continues to satisfy this fiscal criterion (chart 12).

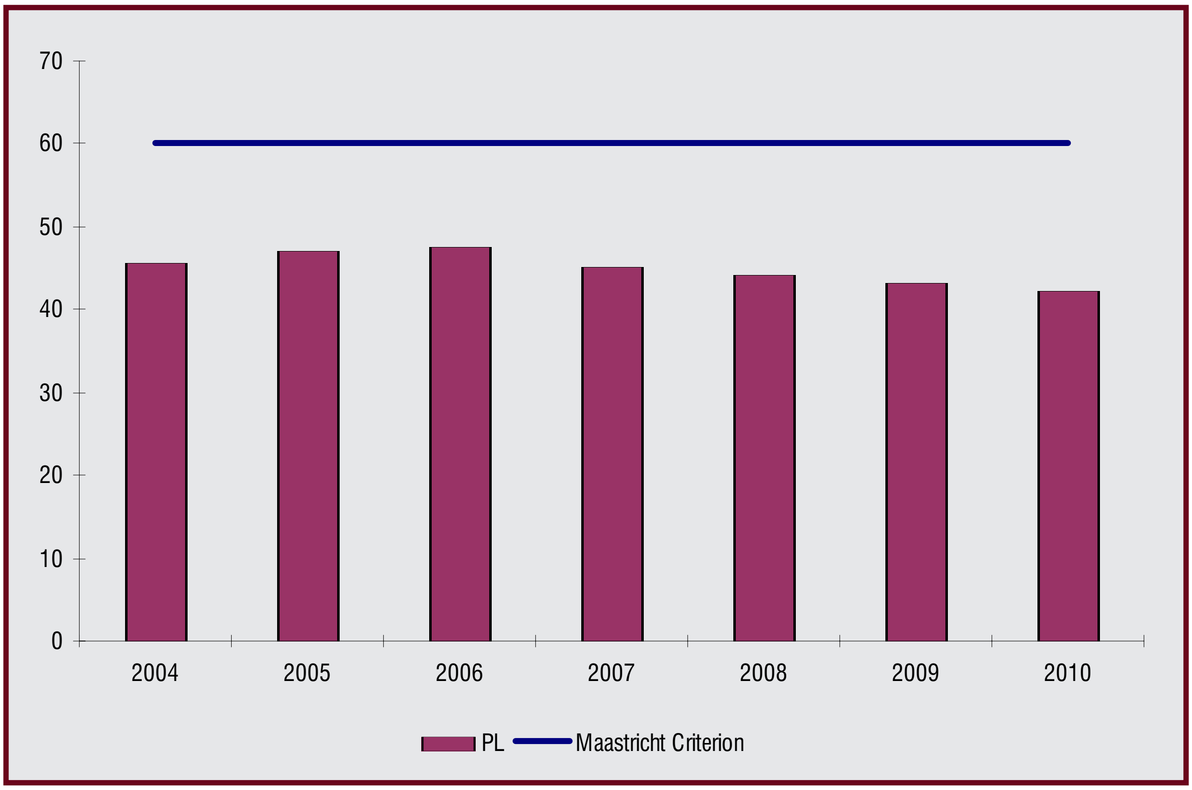
Figure 12. Long-term Interest Rate : Poland versus Maastricht Criterion



The general government deficit has been falling for the last five years, mainly thanks to the advantageous cyclical developments but also due to the lower expenditures than planned because of inept use of the EU aid funds. Its drop to 2.0% of GDP in 2007 has prompted the European Commission to lift the Excessive Deficit Procedure, which had been applied to Poland since its entry to the EU in May 2004. At present, the consensus is that the general government deficit will not rise above the three-percent-of-GDP threshold in the horizon covered by the latest Convergence Program despite its temporary rise in 2008 (chart 6).

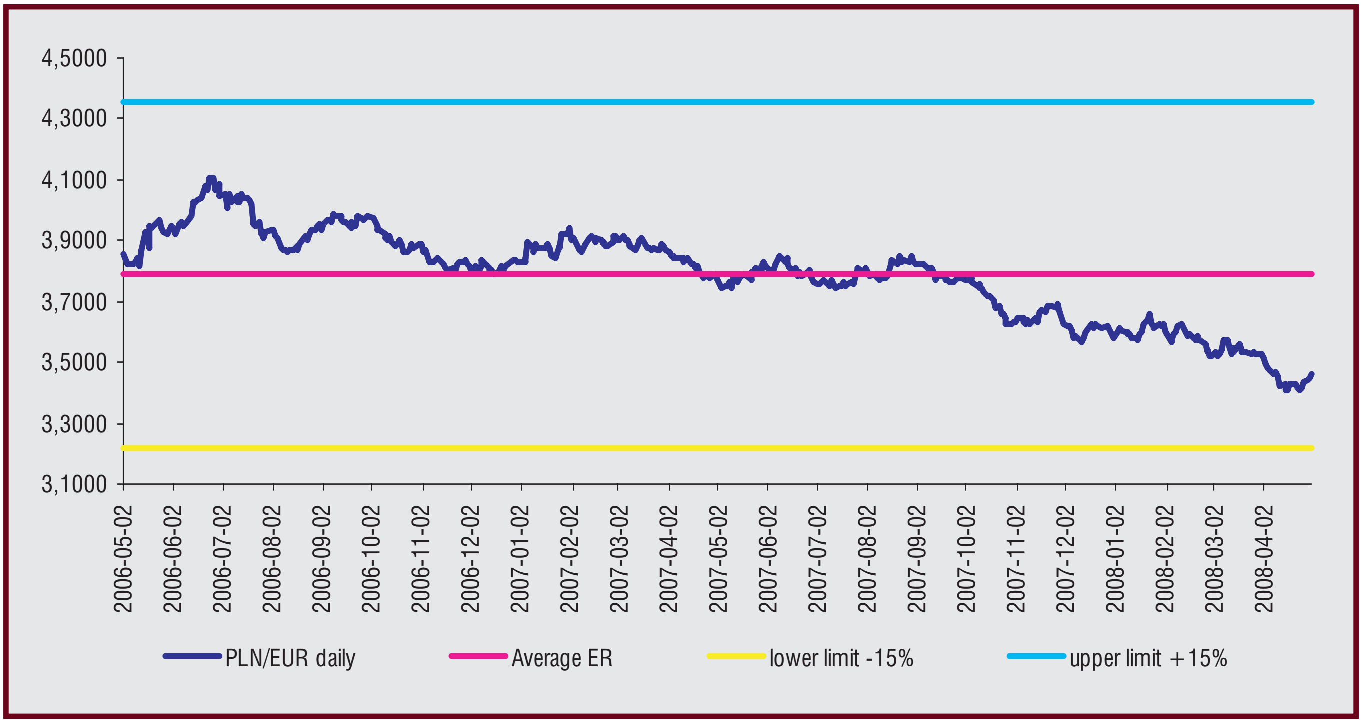
Another fiscal criterion, the ratio of the public debt to GDP below 60%, has been comfortably satisfied since the figures were published for the first time many years ago, and there are no risks that it could be violated in the years to come. The ratio fell in 2007 due to strong economic growth, the lower deficit than expected and the appreciation of the zloty that diminished the foreign portion of the debt (chart 13).

Figure 13. Public debt: Poland versus Maastricht Criterion, % GDP



The final criterion regards fluctuations of the exchange rate against the euro. Poland is not a member of the ERM-2 mechanism so it has not been subject to the restrictions imposed by this criterion. There is no central parity rate against the euro from which the gyrations of the currency could be measured. The rule is that it should not deviate by more than 15% from the parity on either side during a minimum two-year stay in the 'waiting room". The criterion is coupled with a requirement that the exchange rate stays close to the parity level in the reference period. This requirement has never been formalized despite some trial balloons to use the narrow bands of the former European Monetary System so the judgment remains quite subjective. Chart 14 has been constructed assuming that the average of daily exchange rates from May 2 ,2006 through April 30, 2008 is taken as a parity rate. If one takes this time frame as a reference period, it occurs that the zloty fluctuated within a 15% band. The volatility of the zloty can hardly be treated as excessive since the PLN clearly exhibited a tendency to appreciate in the examined period. The European Commission said in the past that the nominal appreciation of a currency will not be considered against a country when evaluating the exchange rate criterion, since it may reflect the ongoing catch-up process. In another words the appreciation would be fundamental and sustainable.

Figure 14. PLN Exchange Rate versus Maastricht Criterion



The circumstances are still conducive to the euro adoption despite the rising inflation pressures and interest rate differential. However, the 2007 Convergence Program update stops shy of specifying the date of the prospective entry into the ERM-2 mechanism that is a prerequisite for the euro adoption, not to mention the date for the euro adoption itself. This program, willy-nilly, reveals that the government does not intend to conduct a policy of bold economic reforms but rather will follow a gradual path. This conclusion is based on the fact that the general government deficit is projected to decrease to 1.5% of GDP in 2010, i.e. by a mere 0.5% of GDP from 2009 through 2010 despite projected 5% GDP growth in this period. 2008 will see an increase in the shortfall to 2.5% according to the Program update. The medium-term objective for the deficit of 1% of GDP, set by the European Commission, a so-called MTO, is projected to be reached beyond the horizon of the Program in 2011. It is evident that a reduction in the non-wage labor costs (the disability premium) and increases in social expenditure (augmented cost-of-living adjustments for pensioners, tax credits for each child totaling 1% of GDP a year), approved in 2007 by the previous government, dent the prospects of equilibrating public finance. The government estimates that the costs of reducing the tax wedge will reach 1.3% of GDP in 2008 and around 2% of GDP in 2009-2010. Adjusting for these costs, the projected general government finances would be balanced in 2009 and reached a small surplus in 2010.

The new government did not use the opportunity to stop the second stage of the reduction in the non-wage costs before it submitted the 2008 state budget draft to the parliament. It also intends to reduce the personal income tax marginal brackets that will likely cost 0.8% of GDP in lost revenues in 2009. These plans lead to a conclusion that the deficit elimination in times of prosperity is not a priority of this government but it prefers a gradual reduction, the minimum that would be in compliance with the rules of the European Commission. Instead, the government has a predilection to supply-side policies. It intends to boost economic growth by reducing the tax burden, dismantling red-tape and introducing incentives to increase employment especially of the 55+ generations.

This is controversial because an international experience with such a sequence of measures suggests that deficits rise first, then they have to be rectified. This happened to president Reagan's administration after tax cuts in the 1980s when the US fiscal deficits reached records in the times of peace, and to the outgoing George Bush's administration where tax cuts have not paid off for themselves so they will likely be unwound by a new administration. Perhaps the overall tax burden in Poland, a medium-developed country, is excessive but it is doubtful that state tax revenues are located on the downward sloping segment of the U-shaped Laffer curve so that the cut in tax rates will produce higher revenues. The government does not seem to count on it either, at least in the time frame of the Convergence Program, since the cost of the tax-wedge reduction is projected to rise in 2010 to 2.1% of GDP from 2% in 2009 and 1.3% in 2008.

The loss of state budget revenue due to the reduction in the tax wedge should prompt the government to enact reforms of expenditure, especially of social expenditure that would compensate it. Yet, the Convergence Program is unspecific with regard to these measures, the declaration about their reforms is only cursory. A reference to a "rise in justified social expenditure" on one page is disturbing. After years of prolific growth at a pace above the rate of growth of nominal GDP, the state budget expenditure should be frozen in real terms or grow at a rate only slightly higher than the inflation rate but definitely below the rate of growth of nominal GDP. This would be easiest done by introducing a rule for the expenditure but the government's Convergence Program does not mention any.

Due to all these reasons the Convergence Program is disappointing. It is a point in case that the government cares more about its popularity than about reforms that could agitate different groups of interest but improve growth prospects of the country. Latest surveys of the public reveal that half of the society is disappointed with the government indecisiveness regarding the health care and public finance reforms. Piece-meal reforms are not going to rapidly raise the potential rate of GDP growth in Poland to, say, 7 percent a year that would allow it to achieve 75% of the EU average in terms of GDP per person in terms of purchasing power in a decade of years. This level can be treated as a goal worth to pursue, since it would mean that most of the catch-up has already occurred by 2020. Later Polish workforce will start declining according to the long-term demographic forecasts, which may complicate a leap to the advanced world.

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