POLISH ECONOMIC OUTLOOK
TRENDS • ANALYSES • FORECASTS
CASE
QUARTERLY 3/2007 (34)

Special Topic – Economic Consequences of PO

EXECUTIVE SUMMARY

As the data on the supply side indicate, the economy lost a bit of its momentum in the third quarter of 2007. This is mainly due to lower year-on-year growth of construction output and industrial sales. Meanwhile real retail sales came out stronger in year on year terms than in the second quarter. It is likely that the economy continued to churn at a rate of growth greater than its potential. The economy is about to grow at 5.5% plus y-o-y clip in the 4Q2007 (see the Economic Activity section).

The estimates of the potential rate of growth are not particularly reliable in Poland. However, the tendency for the consumer industrial goods inflation to pick up shows that demand pressures are being ignited due to a rapid rise in wages, employment and credit to the economy. Yet inflationary pressures were modest in the third quarter as CPI was up 2.0% yoy. Supply-side factors continued to shape fluctuations in the CPI rate, but there are signs that demand factors will surface soon and add tensions.

The Monetary Policy Council paused since the publication of PEO 2/2007, but we expect a continuation of the tightening cycle in the fourth quarter of 2007 and throughout of 2008 due to the outlined inflationary developments. The rising interest rate differential will push the zloty upward even more so that it is well supported by fundamentals (see Inflationary Developments and Monetary Policy).

The inflationary pressures in the pipeline are only an example of the broader tendency of the macroeconomic equilibrium to deteriorate, albeit at a creeping pace. The current account deficit continued to increase in the third quarter of 2007 compared with the corresponding quarter a year ago. However, exports in terms of the euro grew faster year on year in the first two months of the 3Q2007 than in the 2Q2007 so a declining trend was arrested at least for the time being. The appreciation of the Polish zloty especially vis-a-vis the US dollar is hurting the performance of exporters. The break-even exchange rates, reported by Polish exporters have strengthened as well as firms have adjusted their productivity levels. Thus the rapid increase in the trade deficit year on year cannot be traced to the weakness of exports, at least not yet. Import growth outpaced export growth but this is related to the considerable growth differential between Poland and its trade partners. The current account deficit is comfortably financed by net FDI inflows that are likely to reach record high levels in euro terms this year (see Balance of Payments).

Stronger-than-expected economic growth led to the unexpected improvement in the fiscal position of

Poland; the central government finances were balanced in January-September versus the original government projection of a deficit of nearly 18 bn zlotys (1.6% of currently projected 2007 GDP) in this period. Revenues were higher than projected in the budget bill but expenditures grew even less relative to the plan. State expenditure should accelerate in the remaining months of the year. The 2007 outcome will be close to 20 bn zlotys (1.7% of GDP), much lower than the originally predicted 30 bn zlotys (2.6% of currently projected 2007 GDP). Supported by these trends, the ESA-95 general government deficit will likely fall to anywhere between 3% and 3.2% of GDP in 2007. Since the outgoing government planned to run a loose fiscal policy, its projections for 2008 and beyond do not look reliable. The previous government wanted to finance large expenditure growth, assuming strong economic growth and a large increase in tax collection. The new government will attempt to verify the 2008 budget draft and reduce the 28.6 bn projected deficit, i.e. much higher than the 2007 probable outcome, but deadlines for adoption of the budget law are binding and short. Hence, policymakers may not have enough time to reverse some decisions made by the parliament, which is unfortunate as these changes would be necessary to achieve a better outcome than projected in 2008 (see Fiscal Developments and Policy).

The result of early parliamentary elections is welcome as far as the economy is concerned. Center-right and pro-market PO (Civic Platform) will form a coalition government with centrist PSL (Peasant Party). PO is well positioned to take up economic reforms. It seems to be well aware of the pending priorities such as: reforming the state expenditure and balancing of the fiscal side, completing

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

Indicator	Data							CASE forecasts					
	2004	2005	2006	2006		2007		2007		2008		2007	2008
				Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2		
(% change, yoy)													
GDP	5.3	3.6	6.2	6.6	6.6	7.2	6.4	5.8	5.8	4.8	5.4	6.5	5.0
Private Consumption	4.4	2.0	4.9	5.2	4.7	6.9	5.1	5.8	7.3	5.4	6.8	6.2	5.7
Fixed Investment	6.4	6.5	16.5	18.0	16.6	26.2	20.8	16.7	13.2	1.8	7.2	18.2	10.1
(4Q, % of GDP)													
CA balance	-4.3	-1.6	-3.2	-2.6	-3.2	-3.2	-3.7	-3.9	-3.8	-3.9	-4.6	-3.8	-5.6
(% change, yoy)													
Exports (EUR bn)	22.3	17.8	19.3	19.6	20.5	19.0	19.3	15.3	11.8	9.5	10.0	13.5	10.5
Imports (EUR bn)	19.5	13.3	16.1	18.1	20.7	20.6	16.1	15.8	13.0	12.5	12.9	15.9	13.2
(% change, yoy)													
Industrial sales	12.6	3.7	11.3	12.3	10.8	13.0	8.5	8.1*	6.9	5.8	8.9	9.6	8.0
Gross value added	5.2	3.3	6.2	6.2	6.9	7.6	6.1	5.8	6.0	4.7	5.6	6.3	4.8
CPI	3.5	2.1	1.0	1.4	1.3	2.0	2.4	2.2*	3.1	3.3	2.9	2.4	3.2
PPI	7.0	0.7	2.3	3.5	2.8	3.3	2.0	1.7*	3.4	3.8	3.3	2.6	3.5
Nominal Ave. Wage	4.0	3.8	4.9	5.0	5.3	7.1	8.9	9.8*	9.0	7.0	7.7	8.8	8.0
Employment %, LFS)	2.2	2.3	3.1	3.7	3.9	3.6	4.8	4.5*	4.2	4.0	3.2	4.5	3.3
Registered unemployment rate (%, eop)	19.0	17.6	14.9	15.2	14.9	14.4	12.4	11.6*	11.5	11.7	9.7	11.5	9.8
PLN/EUR, eop	4.08	3.86	3.83	3.98	3.83	3.87	3.77	3.78*	3.65	3.60	3.55	3.60	3.60
WIBOR 3M, %, eop	6.64	4.60	4.20	4.19	4.20	4.40	4.71	5.10*	5.50	5.65	5.80	5.35	6.43
Central bank key rate	6.50	4.50	4.00	4.00	4.00	4.00	4.50	4.75*	5.00	5.25	5.50	5.00	6.25
(% change, yoy eop)													
Broad Money (M3)	9.4	13.1	16.0	13.4	16.0	18.0	14.7	14.4*	16.6	15.9	14.9	16.9	15.3
Loans to HH	13.3	26.0	33.4	31.1	33.4	37.7	37.7	39.6*	33.0	29.0	25.0	33.0	20.0
Loans to Firms	-4.0	2.5	13.7	9.1	13.7	17.1	22.1	24.7*	22.5	17.0	15.0	22.5	15.0
(% GDP)													
Fiscal Balance	-5.7	-4.3	-3.9	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	-3.2	-3.5
Public Debt	45.7	47.1	47.8	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	47.0	48.0

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

privatization, adopting the euro, reducing non-wage labor costs and the tax wedge to improve incentives to work and deregulating (see Special Report).

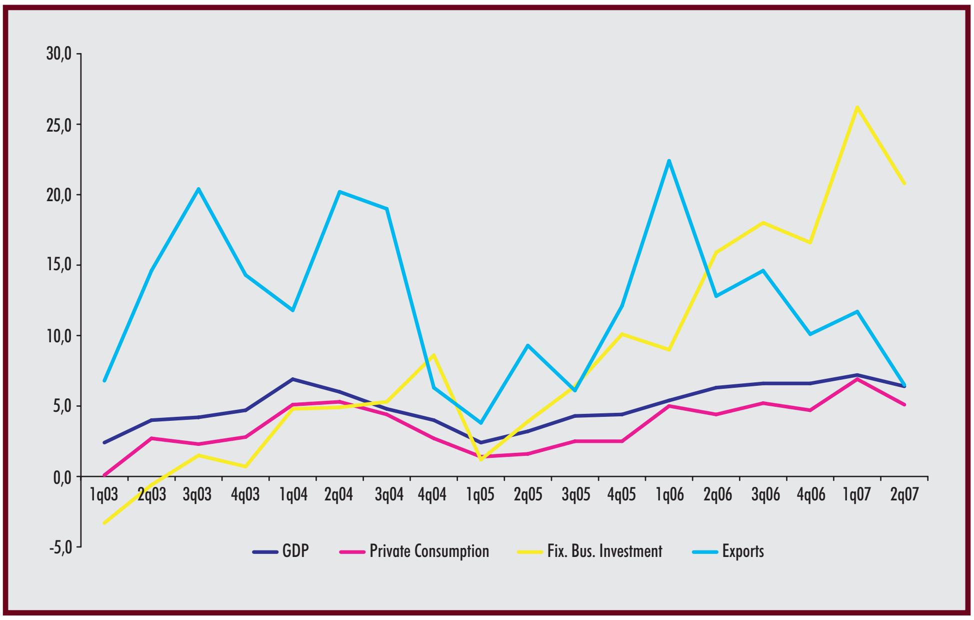
Thanks to the elections outcome domestic risks to growth are skewed to the upside. The prospective hikes in the NBP interest rates would rather remove accommodation of monetary policy. To the contrary, the external risks are on the downside and they involve the fallout of the credit crunch. It is uncertain, whether the slide in performance of the world financial sector will be only short-lived or prolonged and, what impact, along with the US potential slowdown, it will exert on the global real economy. The ongoing hike in crude oil prices may also dampen worldwide growth next year. Domestic and global risks are broadly balanced in our view. Due to this fact our forecast for GDP growth in 2008 remains unchanged but depending on domestic reforms the outlook may improve and offset potentially disadvantageous developments in the world economy should they occur.

LATEST DEVELOPMENTS IN THE POLISH ECONOMY

Economic growth

GDP growth slowed in the third quarter year on year (yoy). This conclusion is based on the weaker expansion of the supply side. Industrial sales and construction output rose by 8.1% yoy and 11.0% yoy, respectively, compared to 8.5% and 19.0% yoy in 2Q2007. Retail trade turnover grew 14.4% yoy in real terms yoy, compared with 13.8% yoy in 2Q2007 yoy. Taking into account value-added shares of different sectors, we do not think that a stronger pace of expansion in retail trade from a year ago in the 3Q2007 offset a lower pace of activity in industry and construction in the same period. Furthermore, the CSO has recently revised GDP growth down to 6.4% yoy in the 2Q2007 from 6.7% yoy due to the slower growth of government consumption and investment than reported originally. Based on the 3Q2007 supply side performance and this revision, we slightly revise down our forecast of GDP growth to 5.8% yoy in the 3Q2007.

Figure 1. GDP growth factors, yoy



This would imply that the economy has lost a bit of its momentum in the third quarter. Stronger retail sales than in 2Q2007 suggest that personal consumption expenditure has picked up in the 3Q2007, supported by a higher rise of the average wage in the economy and further gains in employment. (see Table 1 in PEO 2/21007). The real average wage rose by 8.1% in 3Q2007 versus 6.5% yoy in 2Q2007 in the sector of firms with at least 9 employees. Though its advance in the entire economy was probably slower, the increasing trend in the rest of the economy was maintained as well (the data has not been published as of writing).

Judging by the fact that construction activity slowed along with industrial sales, it is likely that fixed business investment also lost its momentum in the 3Q2007. However, its growth should stay above 15% yoy in this period. The negative contribution to growth of net exports should remain broadly unchanged in the 3Q2007 because the discrepancy between export and import rates of expansion did not increase.

The start of the 4Q2007 is promising. Business sentiment is riding high and so is consumer confidence according to the NBP and CSO quarterly surveys. However, the indicators point to a small decline in the rate of output growth. This is the reason for a marginal downward revision of our predictions of the year-on-year GDP rate of growth to 5.5% in the 4Q2007. With regard to 2008, there are headwinds in the form of the fallout of the global credit crunch that broke out in August and September. The impact of the US slowdown, however, will only be indirect through the deteriorated growth prospects in the euro area. Domestic risks are skewed to the upside after the outcome of parliamentary elections (see our Special Report) as inflationary risks have already been discounted in our forecast. If the new government starts on the structural reforms that have been lagging since 2005, defines a clear path to the euro, and reforms state budget expenditure, then the potential rate of growth should be driven up. Rising confidence in the economy should attract more FDI inflows while structural reforms should enhance the use of structural funds from the EU. Then actual GDP growth could accelerate again to the 6-percent rate without igniting additional inflationary pressures.

Inflation and Monetary Policy

Year-on-year consumer inflation fell in 3Q2007 compared to the preceding quarter and returned to the level registered in 1Q2007, i.e. 2.0% yoy. However, viewed over a longer span of time, CPI inflation has been on the rise. For example, this is confirmed by the EU-wide year-on-year harmonized measure of inflation HICP, which has been increasing both at monthly and quarterly frequency. Higher inflation can be traced back to the mixture of supply-side factors such as hikes in prices of fuels, food and tobacco as well as emerging demand-side factors that are reflected in increasing prices of non-durable industrial goods and services related to housing.

Foodstuffs can be singled out as the biggest contributor to the observed acceleration in inflation. The prevailing global trend of sharp rises in prices of major agricultural commodities has coincided with a relatively good domestic harvest in Poland. However price-arbitrage-induced imports of Polish agricultural products have led to a rise in domestic prices in unison with world prices. This resulted in steadily growing procurement prices of milk (19% yoy on average in 3Q2007) and major grains (rises by 54% yoy for wheat and 56% yoy for rye). Retail prices of processed foodstuffs have gradually followed suit as bread and cereal products, dairy products, oils and fruits in the third quarter hit the highest annual dynamics since the EU-entry shock in 2004. Additionally, large administrative adjustments of excise on tobacco in 3Q2007 in order to align them with the EU requirements pushed the annual inflation of tobacco products to the highest level since 2000 (on average 11% yoy in 3Q2007).

In parallel to the above-mentioned supply-side shocks, the recent months saw a gradual resurfacing of demand side pressures as labor market developments have been pushing real wages up and fast credit growth continued to boost the domestic demand. These extra inflationary pressures are predominantly reflected in the acceleration of price growth in several consumption categories. Most notably, prices of industrial goods (non-durables in particular) that have been the major disinflationary factor over the past several years, have registered a consistent rise in dynamics. The annual growth rate of prices of non-durable goods rose faster than the aggregate inflation rate to 3.8% yoy in 3Q2007, up from 3.0% yoy in 2Q2007, 1.2% in 1Q2007 and 0.4% on average in 2006. This rise was also significant for the entire aggregate of industrial goods (non-durables, semi-durables and durables): their rate of inflation reached 0.4% in 3Q2007 compared with -0.5% yoy in the first half of 2007 and -1.7% yoy on average in 2006 (see Figure 2). This can be interpreted as a sign of strengthening demand-side pressures, despite continued nominal appreciation of the exchange rate. The trend is clearly visible in Figure 3 depicting the annual dynamics of industrial goods prices in Poland and the euro area along with the PLN/EUR exchange rate from mid-2005, i.e. in the aftermath of the EU-entry price shock. The figure indicates that the dynamics of industrial goods prices in Poland has been consistently below that in the euro area in recent years (by up to 3 percentage points) as a strong zloty and expansion of retail chains have been pushing prices down. However, since late 2006, inflation of industrial goods prices has picked up in Poland and recently reached the highest level since early 2005 (in absolute terms) causing the difference vis-a-vis the euro area to narrow down to about 0.5 percentage points - in spite of a continued nominal appreciation of the currency.

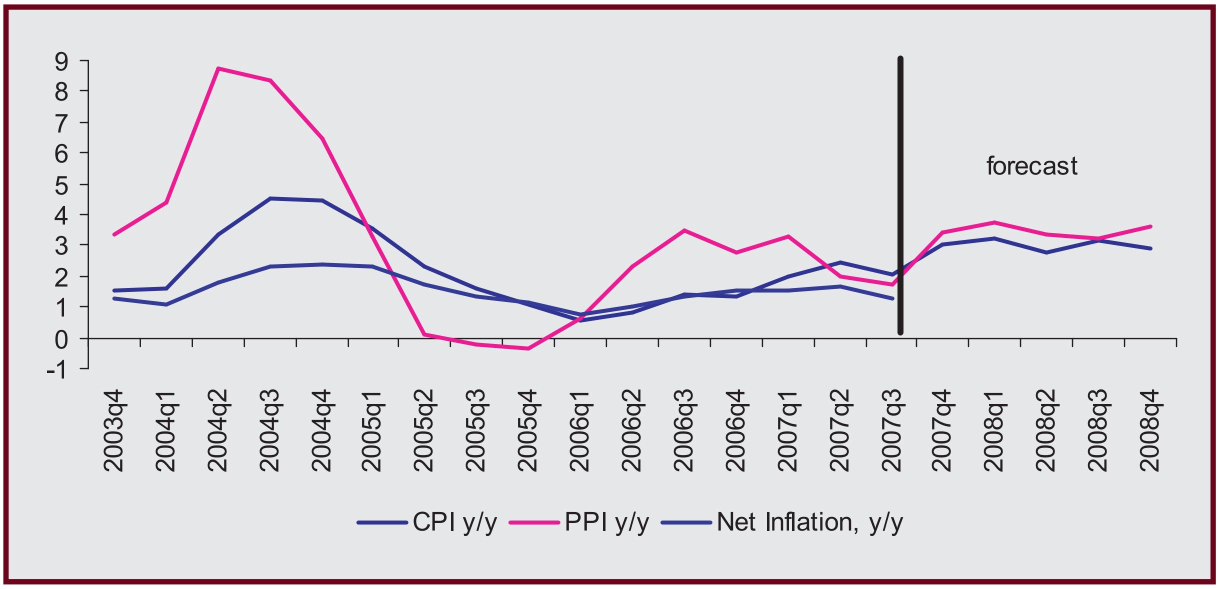
Producer prices, on the other hand, decelerated in recent quarters from 3.3% yoy in 1Q2007 to 1.7% yoy in 3Q2007, as a partial result of the base effect related to the high rise in dynamics in the third quarter of 2006. This decline was underpinned by the sharp drop in price dynamics of mining and quarrying (0.5% yoy in 3Q2007, down from 22.5% in 3Q2006) despite rising world prices of gold and copper. Prices in manufacturing have been rising at a declining rate (1.5% yoy in 3Q2007 versus 1.7% yoy in 2Q2007 and 2.4% yoy in 1Q2007) while those in the supply of electricity, gas and water have remained stable at 3.7% yoy for the last two quarters.

The consumer inflation outlook for the following four quarters has been revised upward from the previous one (see PEO 2/2007). It predicts a gradual rise in dynamics of the CPI to 3.0% yoy in 4Q2007 and then to 3.1% yoy and 3.3% yoy in the first and second half of 2008, respectively. This is higher than the central forecast of the October 2007 inflation projection of the NBP for the period 4Q2007-2Q2008 and in line with the NBP forecast from 3Q2008 onwards (National Bank of Poland, Inflation Report, October 2007). This rise will be underpinned by further acceleration in food price inflation as well as the continued gradual, albeit slow, acceleration of industrial goods and services prices. The latter will occur thanks to expanding domestic demand due to higher real wages and growing consumer credit, despite the predicted strengthening of the zloty. The forecast for producer price inflation has been slightly revised from the previous edition of PEO due to expectations of lower growth of raw material prices in the forecast horizon. The result is the acceleration of the PPI dynamics to 3.4% yoy in 4Q2007 (partly due to the base effect) and fluctuations within the range of 3.2%-3.8% yoy in quarterly levels in 2008.

The Monetary Policy Council paused in September when, surprisingly, y-o-y CPI inflation fell to 1.5%. This was largely due to the monthly deflation caused mainly by a drop in vegetable, transportation and tourism prices. Despite a worsening inflationary outlook - judging by the wording of the October communiqué - the MPC did not raise interest rates in October, either. It reiterated the rhetoric of the previous communiqués, that GDP is likely to continue to grow above its potential rate in the upcoming future; that the relation between wage growth and labor productivity gains has deteriorated and that wage pressures may cause inflationary pressures. Food stuff prices were also mentioned as an item that skews inflationary risks to the upside. On top of it, the decisions made by the outgoing parliament and the government will lead to a significant rise in state expenditures and a drop in revenue growth in 2008, which implies an expansionary fiscal policy. Taking all these factors into account, the communiqué states that the future inflation is more likely to exceed the target of 2.5% yoy than fluctuate below it. In this case, why did the rates remain unchanged? The October quarterly Inflation Report could have served as an argument for staying put because the projection of inflation until mid-2008 was slightly reduced compared with the July Report. MPC interpreted it as sign that its previous hikes had mitigated inflationary pressures. Furthermore, core inflation excluding foodstuffs and fuels is under control. It stood at 1.2% yoy in September despite a jump in the headline figure to 2.3% yoy. Politics may have played a role in this since a new government was in the process of forming during the meeting.

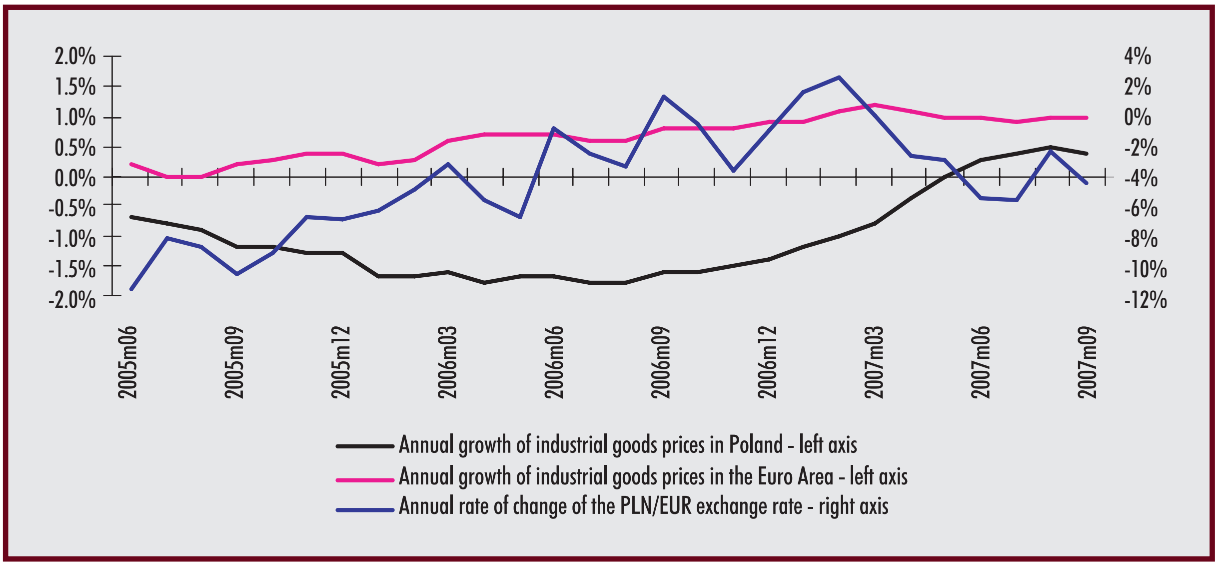
Further interest rate hikes are inevitable in light of mounting inflationary pressures and we expect the next move in November this year. So far inflationary factors have surfaced mostly on the supply side. Our coverage of inflationary developments points to the pressures mounting on the demand side (industrial goods prices) and they will tend to prompt more interest rate hikes in 2008. We maintain our forecast that the tightening cycle will continue in 2008 and the key NBP interest rate will be raised by at least 1.25 percentage points in four installments next year to reach 6.25%. Only a worldwide slowdown could correct the scenario of Poland's growth weakening decisively, but it does not seem to be the case now.

Figure 2. Annual CPI and PPI inflation and Net inflation in Poland



Source: *GUS and NBP.*

Figure 2. Year-on-year growth of industrial goods prices in Poland and the euro area and annual rate of change of the PLN/EUR exchange rate, in percent per annum



Source: *Eurostat (HICP data).*

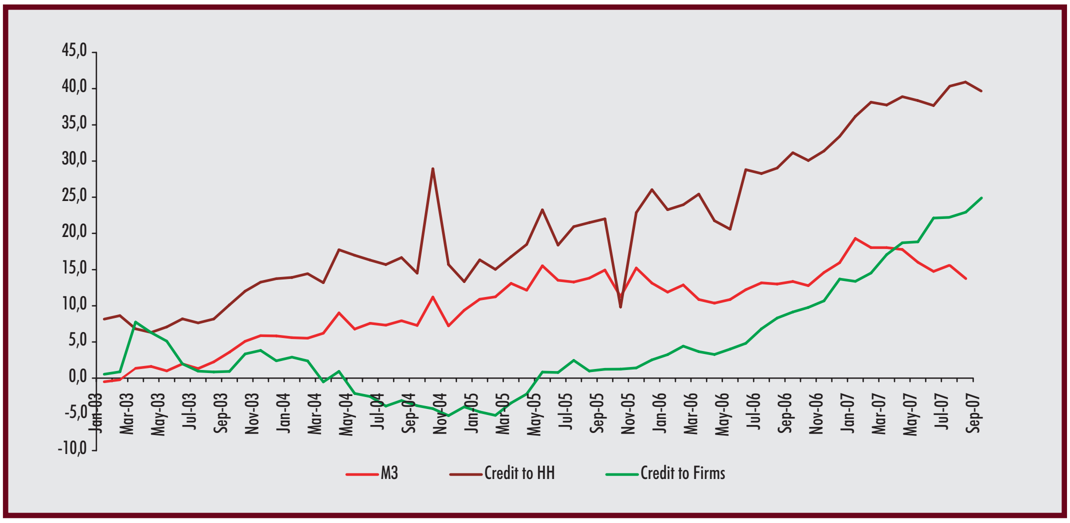
Monetary Developments

Broad money as measured by M3 rose by 14.5% yoy in September 2007, slightly less than at the end of the 2Q2007. It amounted to 48.3% of GDP in 2H2007 so the relatively low monetization of the economy has continued gradually increasing. However, the rate of M3 expansion exceeds the rate of nominal GDP growth by a large margin: This discrepancy may cause inflationary pressures in the future. Cash balances rose at the same pace as M3 in the 3Q2007 while demand deposits increased at the rate of 25.1% yoy. This is connected with rapidly rising wages and strong gains in employment. Households cut their time deposits by 6.5% yoy switching the composition of their saving portfolios to investments in mutual funds that offer higher rates of return. These deposits declined by 28.2% since the peak reached in October 2001, an illustration how developments of financial instruments changed the structure of household portfolio investment in Poland.

The evidence of a continued credit boom is widespread. Domestic credit has been rising faster than 20% a year since November 2006 and it increased by 31.1% yoy in September with no signs of abating. Credit to private persons and non-financial firms rose by 41.6% yoy and 24.7% yoy in September, respectively. Thus credit to non-financial firms continued to visibly accelerate in the 3Q2007 while growth of credit to private persons accelerated only slightly in the same period. Mortgage rose by 53.8% yoy in September so it leads the rate of growth of credit to private persons. No sings of global credit crunch on mortgage growth were discernible. Apartment and house prices doubled since the onset of 2006, as the supply side constraints did not allow the housing construction to respond to the surge in demand. Dwelling construction grew by 13.9% yoy in January-September 2007. In theory, Polish households are vulnerable to an exchange rate depreciation since 57% of housing loans, due to a favorable interest rate differential, are denominated in foreign currencies, mostly in Swiss franc and the euro. However, the recent appreciation of the zloty against the euro and the Swiss franc cushions households against adverse developments on the foreign exchange market. Assuming that households made their decisions about taking credit with due regard to their financial standing, they penciled a higher zloty rate than the recent one. Furthermore, the degree of foreign exchange exposure, which peaked in June 2006, has been downtrending since then as the interest rate differential has gradually diminished and the central bank instructed commercial banks to tighten their procedures of approving foreign currency loans. Zloty denominated mortgage almost doubled in the last twelve months whereas foreign exchange denominated mortgage rose by 32.1% yoy.

Credit to firms is picking up despite rising interest rates so these rates do not seem to be at prohibitive levels after three hikes by the central bank. This is rather no surprise since the tightening cycle has started from record low levels of interest rates in the transition history. The environment of low interest rates despite their recent hikes, full capacity utilization in conjunction with positive expectations of demand and profit encourage firms to use credit as an external source of financing their investment projects.

Figure 4. Broad Money and Credit Expansion, % yoy

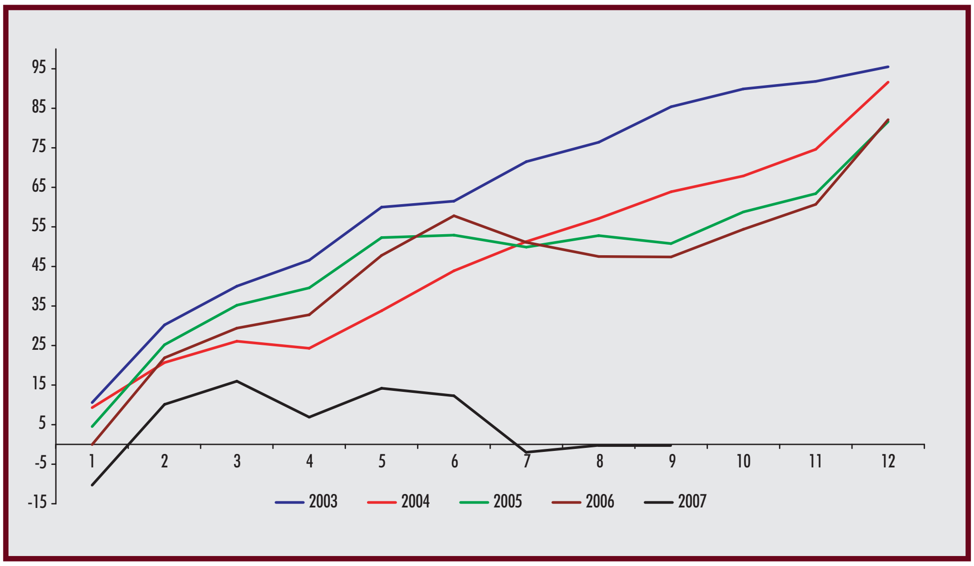


Fiscal Developments and Policy

The central government cash budget was balanced in the period of January - September 2007, contrary to original government projections that the shortfall would reach 17.8 bn zlotys or 1.6% of 2007 GDP (see Figure 4). The state budget registered a large surplus in July that turned the lower-than-projected deficit in the 1H2007 into a small surplus after seven months of the year (see PEO 2/2007). The monthly deficits were negligible in the remaining months of the third quarter of 2007. The strong position of the state budget is due to a cyclical upturn in revenues and an expenditure restraint.

Tax collection was ahead of projections from January to September 2007, thanks to stronger-than-anticipated GDP growth: Actual revenues outperformed projections by 4.2 bn zlotys (0.4% of GDP). However, monthly revenues in the third quarter were much higher than originally predicted only in July, but lower than predicted in August and September. This exemplifies how optimistic these latter projections were, as they had been based on a 4.6% GDP growth rate in 2007 while the economy grew at 6% plus clip year on year in the first three quarters of 2007. The rise in PIT revenue by over 31% yoy in January-September was correlated with high wage increases and strong gains in employment (see section on labor market). CIT revenue grew by 25.3% yoy in this period as it was boosted by rapidly rising net incomes of firms. Indirect taxes grew faster than expected as more sales transactions were concluded: VAT and excise taxes advanced by 16.4% yoy and 14.4% yoy, respectively, from January to September 2007. These figures are much higher than projected in the state budget bill for 2007.

Figure 5. Central government budget deficit, % of plan



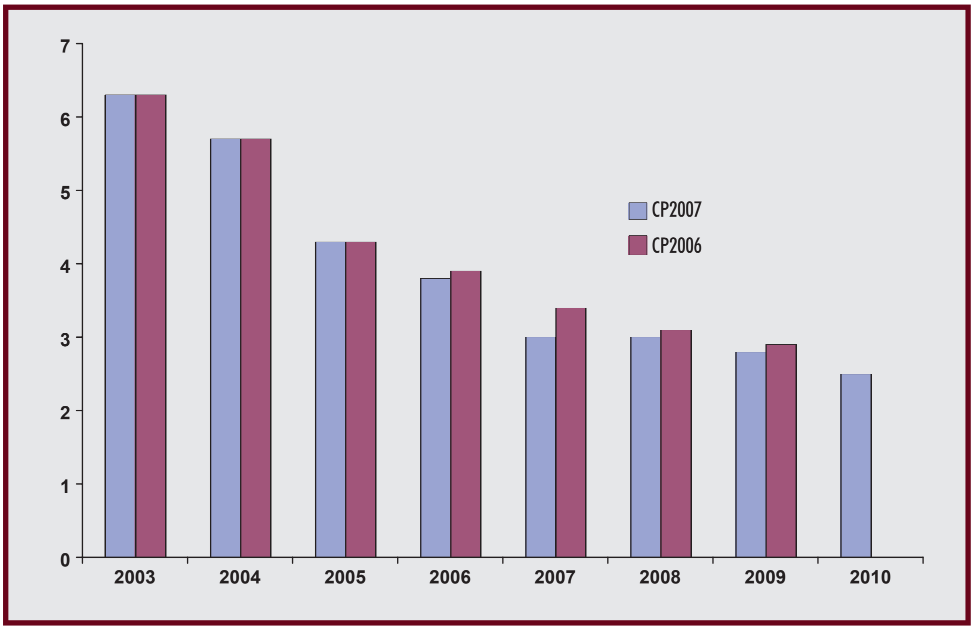
However, the cash state budget would not have been balanced in the first three quarters of 2007 had not expenditures fallen much behind the original schedule. State expenditures rose much slower than projected in this period and amounted to 174.7 bn zlotys versus the projected 189.2 bn zlotys. These developments suggest that the 2007 central government cash shortfall will be much lower than 30 bn zlotys, as originally projected in the 2007 state budget bill. One should bear in mind that the cash deficit masks the fact that transactions may have already been concluded while cash flows will be recorded later. Invoicing for investment expenses usually takes place in the fourth quarter. Furthermore, a number of EU related projects will probably receive financial support from the state budget in 4Q2007 when various institutions rush to cash co-financing from the state budget before deadlines for the use of EU funds. Therefore it is rather certain that the state budget will rapidly turn into a deficit before the year ends.

Assuming that revenues and expenditures would proceed in line with the approved 2007 plan in the fourth quarter, the cash deficit would reach around 11.3 bn zlotys, or less than 1% of GDP this year. Since the expenditure will be stepped up in the final months by larger amounts than those predicted in the original spending timetable, the shortfall is likely to be higher than this amount. On the other hand, the revenue will likely continue to increase ahead of projections due to stronger economic growth than assumed in the 2007 budget plan. Summing up, the central government cash deficit should come to around 16-20 bn zlotys or 1.3-1.7% of GDP in 2007, much below the plan of 30 bn zlotys. In October 2007, the ministry of finance estimated a 20 bn deficit in 2007.

The cash deficit is only a part of a general government deficit. The latter includes costs of the pension reform, balances of local government, state agencies and funds. Furthermore, it is presented using the EU ESA-95 methodology, based on the transactions approach. In its latest notification to Eurostat in October 2007, the Polish Ministry of Finance predicted that the general government deficit will be around 3% of GDP in 2007 or 34.2 bn zlotys, down from 3.8% of GDP in 2006 and better than the CP2006 projected 3.4% of GDP. One could only cheer at this performance were it not a result of strong economic growth only but also due to reforms of the expenditure side. The latter are none. The non-ambitious plan to consolidate public finances was shelved by the outgoing government. 2007 is the fourth straight year in which the deficit is going to decline: In 2003 it reached 6.3% of GDP.

The deficit will be lower than the one projected in the 2006 update of the Convergence Program (CP2006). However, the 2007 update of the Convergence Program (CP2007), issued in October this year, assumes that the general government shortfall will remain the same in 2008, and then drop to 2.8% of GDP in 2009 (see Figure 6). This means only a negligible reduction with regard to CP2006, which projected these deficits to be 3.1% and 2.9% of GDP, respectively.

Figure 6. General government deficits in Convergence Programs of 2006 and 2007, % of GDP



Source: *Polish Convergence Programs 2006 and 2007.*

Such an outcome is the result of the expansionary fiscal policy that the outgoing government decided to conduct in 2008. The projected state budget shortfall in the state budget draft that was submitted to the parliament in September is 28.6 bn zlotys (2.2% of GDP) despite the then-estimated deficit of 23 bn zlotys (1.9% of GDP) in 2007 and the assumption of 5.5% real GDP growth in 2008. This results from a large rise in expenditure (not accounting for expenditures related to the EU), which would rise by 11.4% yoy, i.e. more than nominal GDP, related to an increased indexation of pensions and a huge increase in a subsidy to the Social Insurance Fund (FUS) due to a planned reduction in non-wage costs. An increased tax credit for each child in a family will lead to a decline in state budget revenues.

In theory, the new government may write its own budget draft but in practice it is likely to merely attempt to revise it due to time constraints. According to the Polish constitution, the government is obliged to turn in the state budget draft for the next calendar year to the Sejm by September 30. If the Sejm and the Senate do not submit the approved budget to the president for a signature in four months' time after its submission, then the president has the right to dissolve the parliament and announce new elections. The outgoing government turned in the state budget draft on September 27, 2007. This implies that the budget bill has to be approved before January 28, 2008 (January 27 is a Sunday). The new government will likely attempt to revise the state budget in order to achieve a better outcome in 2008 (see our Special Report). However it is constrained by the approved bills by the parliament and time will press it to amend the budget before constitutional deadlines. It may cancel the second stage of reduction in the non-wage labor costs as the most promising venue to cut the state budget deficit. This reduction is untimely as the economy is growing at its potential rate and its benefits will fall on consumers instead of on firms. Otherwise the government will have limited room for maneuver. If it does not run out of reformist zeal, 2009 should see decisive expenditure reforms, particularly those of early pensions and the pension fund for farmers.

Labor Market

Employment was still on the rise but signals auguring a turning point in trends continue to come from Public Employment Service (PES). Wages continue to rise due to a mixture of structural and cyclical factors. The Labor Force Survey (LFS) unemployment rate fell below 10%

Employment

Despite warning signals that appeared in the previous quarter, employment is still on the rise. In the 3Q2007, the number of employed persons in enterprises that have at least nine people on staff (in the so-called enterprise sector) increased by 4.8% (4.5% in 2Q2007). The construction sector, despite the fall in dynamics, is still a leader in employment growth as it grew 7.5% yoy in this period (8.7 % yoy in 2Q2007). The trade sector is catching up with a yoy figure of 7.4%. Impressive growth was also recorded in hotels and restaurants - 7.4% yoy (5.1% yoy in 2Q2007). In other sectors, employment growth also accelerated.

The slowdown in employment dynamics in the construction sector was one of the leading signals that we focused on a quarter ago when we pointed to an upcoming turning point in overall employment trends. However we did not expect other sectors to outweigh it. It appeared actually that construction was the only sector that experienced a fall in employment dynamics in 3Q2007.

On the other hand, slightly discouraging news concerning employment creation continues to pour in from PES. The number of job finders continues to decrease; In 3Q2007 only 305,800 registered unemployed persons found new jobs, 14% less than a year ago. The number of those who found non-subsidized jobs decreased even more dramatically - by 19% yoy. The number of job offers in PES offices also grew slower. In 3Q2007, the number of job offers increased by only 3.2% yoy - whereas in 2Q2007 it was 12.4% and in 1Q2007 – 26.8%.

Unfortunately we still do not have LFS data on 3Q2007 and the information on 2Q2007 was analyzed in PEO 2/2007. Please recall that the LFS employment figure in 2Q2007 increased by 4.8% (4.6% in 1Q2007). The total employment rate (according to the Eurostat definition, i.e. as a share of those aged 15-64, increased to 56.8% - by 2.9 percentage points yoy.

We expect that employment in the enterprise sector and the overall LFS figure will keep rising in the quarters to come, however we still expect the growth rates to slow down. In 4Q2007, the enterprise sector employment will grow by 4.4% - 4.5% yoy and the LFS employment in 3Q2007 will grow by 4.6% yoy. The average employment growth for 2007 should stay at a similar rate of 4.5% - 4.6%. In 2008, employment dynamics should decelerate to an average of around 3.5% yoy.

Wages

Wages continue to boom: In 3Q2007 average gross wages increased by 9.8% yoy, (by 8.8% yoy since the beginning of 2007). Real average wages increased by 7.6%.

Wages continue to accelerate most rapidly in the construction sector (an increase of 17.8% yoy in 3Q2007 versus 15.6% yoy in 2Q2007). Wages are also steadily accelerating in trade (from 10.1% yoy in 2Q2007 to 11.6% in 3Q2007) and in business services (from 7.8% yoy to 9.9% yoy). In the other sectors wages do not follow a stable trend, however annual rates of growth are higher than 5% yoy across all sectors.

As we mentioned in the last edition (PEO2/2007), such dynamic wage increases, which are causing an increase in unit labor costs, should have led to problems with job creation. Yet this is not visible in employment figures, although one can already notice it in Public Employment Services data. On the other hand, one has to remember that labor productivity in Poland had been growing much faster than wages for the last few years (up until mid-2006). Hence the observed catch-up can be considered a natural phenomenon, i.e. mostly a reaction of labor whose bargaining power has solidified due to a rapid cyclical pickup and shortages of skilled labor. It is also related to structural features of the Polish labor market: The improving skill structure of the Polish labor force plus increasing returns to education. Then it is additionally reinforced by the "exogenous shock" of opening of western EU labor market to Polish workers.

We expect nominal (and real) wages to grow quickly in the nearest future: Their growth should remain within 8.5% - 9% yoy in 2007. In 2008, the wage rate of growth should stabilize, yet not significantly weaken, staying on average at the level of 8% or slightly below.

Unemployment

Although the unemployment figures are still vigorously falling, the preliminary message for future developments continues to be cautiously optimistic. The number of registered unemployed persons fell to 1,777.8 thousand in 3Q2007. This meant a y-o-y reduction of 24.8% (23.8% yoy in 2Q2007). The registered unemployment rate fell by 3.6 percentage points to 11.6% at the end of September (see Figure 7).

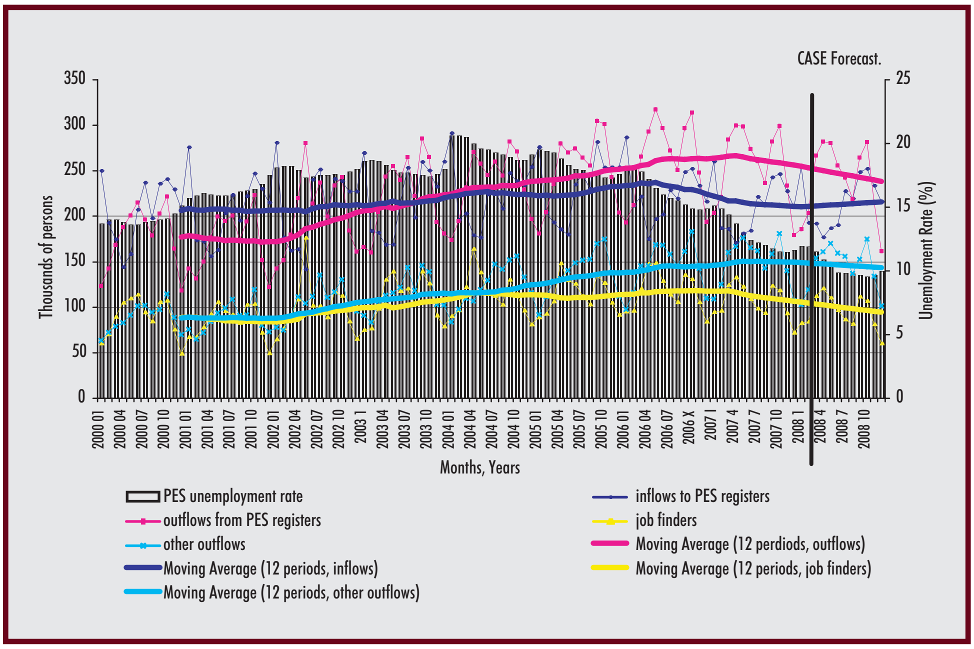
The situation looks less optimistic if one analyzes the labor flows. As already mentioned, the outflows continued to fall, especially those related to unsubsidized jobs found by the unemployed. The dynamics of job offers also continues to slow. Inflows to employment offices are still falling (by 6.3% yoy in 3Q2007 as compared to 6.6% yoy in 2Q2007Q2 (see Figure 7).

Please recall that according to LFS figures, the number of jobless people in 2Q2007 was 1.602 thousand - a 32.6% reduction in y-o-y terms. The unemployment rate fell below 10% for the first time in this century, reaching 9.6%. It was close to the lowest rate recorded during the entire transition period.

Some experts estimate that the "actual" unemployment in Poland is much lower than the "official" one, meaning the data from registers or even LFS. In an attempt to test this hypothesis, we decided to run short calculations based on the individual LFS micro-data set for 2006 (the latest available). In order to calculate "actual unemployment," we excluded all unemployed persons that indicated they had registered at the PES offices and that this was their only employment search method. This idea is based on a simple observation that being registered in PES is not a job search method, it is an administrative action required to obtain unemployment and other benefits and to have public health insurance. Surprisingly enough, applying such a filter reduces the number of unemployed people by only 3% with a negligible effect on the unemployment rate. This means that LFS unemployed numbers are very close to reality and one can consider them "actual figures".

We expect the registered unemployment rate to fall to around 11.5% by the end of 2007 (see Figure 7). In the course of 2008, the registered unemployment rate should fall to single digits, i.e. to 9.8% by the end of the year. LFS unemployment will continue to fall as well, although much less dynamically than thus far. It will reach around 8% by the end of 2007 and 7% by the end of 2008. In each year, unemployment will be at a record low within the entire transition period.

Figure 7. Registered unemployment rate, outflows from and inflows to PES registers in 2000-2007



Foreign Trade and Balance of Payments

Expressed in euro, exports of goods from Poland grew at a faster clip year on year (17.1%) in the first two months of the 3Q2007 than in 2Q2007, suggesting that Polish firms cope well with the creeping appreciation of the zloty and an apparent loss of momentum in the Eurozone. The real effective exchange rate of the zloty did not strengthen in the 3Q2007 compared with the 2Q2007, according to our preliminary estimates. In the latest NBP quarterly business survey, Polish companies signaled that the threshold exchange rates, i.e. the ones below which exports become non-profitable, appreciated along with the actual exchange rates of the zloty in the 3Q2007. Therefore the competitiveness of Polish produce did not deteriorate in this period. In the first eight months of the year, the strongest expansion of merchandise exports was recorded to Russia, Italy, the Czech Republic, Ukraine and the United Kingdom.

Imports of goods, denominated in euro, continued to grow faster than exports in the first two months of the 3Q2007 (18,2% yoy). This discrepancy is mostly related to the differential rate of GDP growth in Poland and its main partners. However, strong inflows of FDI also tend to boost imports. Interestingly, imports did not grow much faster than exports year on year in July-August 2007. If we switch to CSO statistics, which offer a geographical breakdown of Poland's main trade destinations, we find that the bulk of the trade deficit is concentrated in trade with just two countries: China and Russia. They accounted for over 9 bn out of a 10.1 bn deficit, recorded by CSO in first eight months of 2007.

The rising trade imbalance is the main reason why the Polish current account deficit continued to widen rapidly. The cumulative deficit was close to 7.8 bn euros in the first eight months of 2007 versus 5.6 bn euros in the corresponding period of last year. The shortfall amounted to nearly 2.1 bn euros in July-August of 2007, compared with 1.6 bn euros in the corresponding period of 2006. Another factor is the growing deficit in the income account. In a sense, this reflects Poland's success because this rise is mainly caused by growing retained profits, paid out to foreign owners of capital, who enjoy high rates of return in the booming economy. Hence, like imports, they are cyclical to a large extent. It is worth emphasizing that the income deficit was larger than the trade deficit in January-August 2007. The two deficit items are partly offset by services and transfer accounts that are in surplus and both surpluses are growing (see Table XX for the breakdown of the current account deficit). Despite its fast growth in 2006 and 2007, the current account deficit is still relatively low in terms of GDP (3.7% of GDP in 2Q2007) in particular when compared to deficits in other Central and East European members of EU.

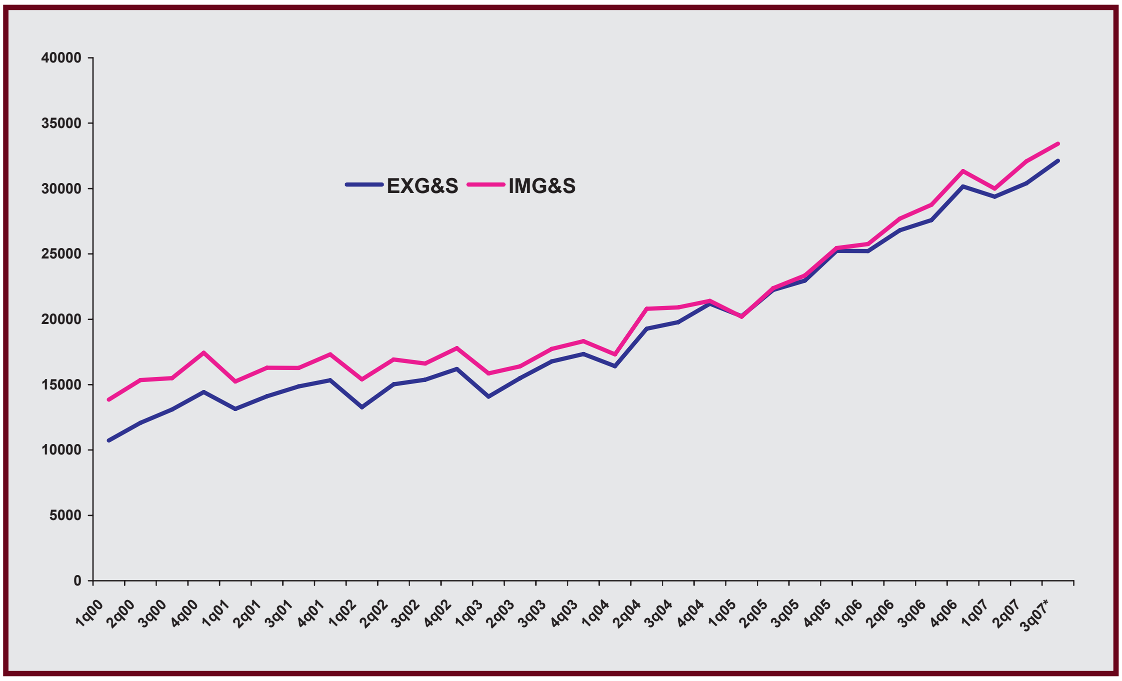
The pace of widening looks less worrisome if one adjusts the current account deficit for inflows on the capital account. These inflows are made up almost entirely of unrequited aid from the EU that is registered on the capital account in line with the EU methodology. Since these flows are not subject to the influence of exchange rates and interest rates, they can be treated as transfers. After this adjustment, the current account deficit was lower by 1.7 bn euros than the official figure in January - August 2007 (see Table). In terms of GDP, the adjusted four-quarter current account deficit was equal to 2.8% of four-quarter GDP in the 2Q2007.

Table 2. The Current account breakdown, eur millions

	Jan-Aug 2007	Jan-Aug 2006	% change yoy
trade balance	-5619	-3244	-73,2
income balance	-8710	-6993	-24,6
services	2161	878	146,1
transfers	4381	3764	16,4
current account	**-7787**	**-5595**	**-39,2**
capital account	1746	964	81,1
adjusted CA	-6041	-4631	-30,4

The net FDI inflows came at 7.7 bn euros in January-August compared with 4.5 bn euros in the same period of 2006, i.e. they rose by 72.2%. This implies that they continue to almost entirely finance the current account deficit, contributing to the strength of the zloty. There is no question that net FDI inflows will reach record levels either in absolute terms or GDP terms in 2007.

Figure 8. Exports and imports of goods and services in euro terms, mn



* forecast

Source: NBP.

Economic Consequences of PO Rule

The center-right PO (Civic Platform) party won early parliamentary elections by a landslide. It collected 41.5% votes while the ruling right and PiS (Law and Justice) managed to collect 32.1% votes, which gives them 166 seats. With 209 seats out of the total of 460 seats, PO is short of a majority in the Sejm so it is going to form a coalition with the centrist PSL (Polish Peasant Party) which won 31 seats (8.9%). One more party only broke the 5% threshold: the center-left LiD (Left and Democrats) that placed 53 parliamentarians in the lower house (13.2%). LiD will likely become a supportive opposition in a united front against PiS. Except for the state budget, the president of Poland, the twin brother of the outgoing prime minister, can veto bills and will probably use it frequently. It is broadly held in public that the former prime minister will attempt to steer the president. The coalition of PO, PSL and LiD will be able to override the veto but the procedure will tend to delay reforms. The PO and PSL programs are incompatible in some respects such as a the flat tax, the date of euro adoption and pension funds for farmers, but these differences should be bridged during negotiations. However they will potentially lead to periodic tensions within the future ruling coalition.

The Civic Platform also won the Senatorial elections, in which it took 60 seats, compared with 39 for PiS. The last seat goes to an independent candidate, the former Social Democratic Prime Minister, Wlodzimierz Cimoszewicz.

The turnout rate was the highest since the fall of Communism at 53.9% (+14.7 percentage points in comparison with the last elections on September 25, 2005). The high turnout surprised the Polish Electoral Commission that had to announce a three hour extension to voting in some Warsaw constituencies since some stations ran out of ballot slips. The mobilization of the youngest electorate was visible (18-24 year olds). PiS won only among those persons who live in the countryside, those with vocational and elementary schooling and among pensioners. It came first in voivodships situated along the Polish eastern border: These voivodships are mostly rural, devout Catholic and poorly educated. In short, a drive to modernization has prevailed in Poland.

In general, PO has a liberal economic platform and believes in the tri-division of state powers. It intends to eliminate state excesses in the economy, promote free competition, eliminate a straitjacket of licenses and permissions, privatize state-owned firms and equilibrate public finances. It is pro-European and will strive to improve relations with EU partners, particularly Germany, which suffered from the divisive policy of the Kaczynskis.

In its electoral program, PO promised to limit the state share in output to 10 per cent, down from the current 20+ per cent. In contrast to the previous government, it will not only use IPOs but also sales to strategic investors as a method of privatization.

PO is aware that fiscal imbalances have improved thanks to a strong cyclical upturn whereas expenditure reforms have been stopped or even reversed (such as a shift from bi-annual to annual compensation for pensioners for past inflation). It pledges to impose a limit on nominal growth of the state budget expenditure (an "expenditure anchor") that should not rise faster than nominal GDP in order to reduce the fiscal deficit and its share in GDP. However the program is short in specifics: It is not clear how this will be implemented.

With regard to the 2008 state budget draft, PO has sent signals that it aims to revise the draft in order to cut the deficit from the projected 28 bn zlotys (2,2 % of GDP in 2008). A reduction to 20 bn zlotys has been mentioned if the second stage of a reduction in disability pension premium were stopped. In nominal terms, this would be about the same as this year's probable outcome but the shortfall would fall to 1.6% of projected GDP for 2008. However the measure could be costly in political terms as it would require a cancellation of the approved bill. PO is short of time to overhaul the state budget draft before the constitutional deadline for approving it so it may have to postpone reforms until 2009. The party would like to equilibrate the state finance in four years' time. The performance-based budgeting that PiS once promised should be implemented. PO will also attempt to introduce a multi-year framework for state budgets that would allow for the shifting of the expenditure of funds into the future until the year n+2. It intends to take on the consolidation of public finances that calls for the liquidation of numerous state budget units, agencies and funds.

The gradual decline in the fiscal deficit should support Poland's entry into ERM2 mechanism in 2009 with prospects of adopting the euro in 2012, of which PO is in favor.

PO believes in a flat tax and the simplification of the tax system. It wants to eliminate the division between PIT and CIT that should be replaced by one tax at the rate of 15 per cent. The introduction of a flat tax should be accompanied by the phasing out of tax rebates and credits. Joint returns would be phased out as well. But tax credits for children would be upheld and the tax-free amount of gross income would rise in order not to increase the tax burden of low-income households. A capital gains tax of 19% would be replaced by the general flat tax. The gross profits of firms would taxed at the source but dividends would not be re-taxed. PO intends to pass a new bill on VAT that is based on the EU directive in this, which should ease the bureaucratic burdens imposed on firms. Discount rates would be still applicable for medicines and food stuffs.

PO would like to further reduce non-wage labor costs and lower the tax wedge for young new entrants to the job market. They would either eliminate the disability pension premium or reduce it to 3% of gross income for the first people taking the first jobs.

In general, the PO program appears promising and should address the most important reform areas: privatization, public finances (the expenditure side), adoption of the euro and deregulation. PO is well positioned to tackle these issues. The greatest risks to the execution of the program lie in the negotiations with PSL, which may attempt to water down reforms. It is also unclear how conflicting goals of reducing the expenditure growth and the pledge to raise public sector wages and to reduce the tax wedge for new entrants on the job market will be resolved.

POLISH ECONOMIC OUTLOOK

TRENDS • ANALYSES • FORECASTS

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