POLISH ECONOMIC OUTLOOK
TRENDS • ANALYSES • FORECASTS
CASE
QUARTERLY 2/2007 (33)

Special Topic – Impact of Global Credit Crunch on Poland

EXECUTIVE SUMMARY

Polish economy grew at 7.1% year on year (yoy), i.e. above its potential, in the first half of 2007. Growth was broad-based and was mainly driven by fixed business investment and exports while individual consumption trailed it.

The over-potential pace of expansion was reflected in the gradual worsening of the equilibrium in the economy. Poland's economy is still well-balanced but first signs that growth may be hampered in the future by mounting disequilibria have already appeared. Domestic demand has become the main driver of growth while net exports deteriorated as the differential rate of growth has led to a strong rise in imports. The current account deficit is still low (around 3% of GDP) but the pace of its worsening is rather rapid and reminds the developments in the second half of the 1990s. However, if the deficit is adjusted for the net EU related inflows that are registered on the financial account of the balance of payments but can be treated as unrequited net transfers, then the shortfall is closer to 2% of GDP, a low and safe figure.

Inflation pressures intensified in the 1H07 but core inflation index excluding food and fuels hovered around 1.6% yoy, i.e. close to the lower limit of the central bank inflation target band. The year-on-year CPI was driven up to 2.3% yoy in July 2007 from 1.4% in December 2006 mainly by the supply side factors (fuel and food prices) while few demand pressures were visible. Strong wage rises in the overall economy that exceed labor productivity growth per employee, coupled with fast gains in employment suggest that inflation will continue creeping upward but an outburst of it cannot be excluded, either. Strong monetary expansion that mirrors a booming credit to non-financial sector also suggests that inflationary pressures are in the pipeline.

These developments encouraged the central bank to raise its key interest rate by 75 basis points in three installments, the latest in August, to 4.75% per annum, as its latest inflation projection pointed to growing upside risks. This is not the end of the tightening cycle and at least one hike in interest rates should be expected by the end of 2007. Fiscal position of the central government improved considerably in January-July 2007, when the central budget reached a small surplus due to positive cyclical developments but it was also related to some delays in expenditures. Definitely, the central budget is on track to undershoot the nominal target of 30 bn zlotys or 2.4% of GDP. The wider general government deficit will be positively affected by a lower central government deficit and should come close to the 3% Maastricht ceiling.

The outlook for growth is positive in the short run and medium term yet the economy has likely peaked already and lower GDP rates of growth should be expected. The downside risks to growth outweigh the upside risks. The uncertainty related to the course of global economy, the impact of interest rate hikes and bottlenecks on the labor market suggest that expansion will slow down to 5% next year. The political uncertainties related to the outcome of early parliamentary elections will linger as well. There have been no structural reforms that would have raised the potential rate of growth and enhanced business confidence in the economy. Inflation will continue its upward trend fueled by wage increases above productivity gains and a credit boom. This will prompt the central bank to react to it with preemptive strikes and the cumulative effects of these increases will be to dampen GDP growth.

It is high time that the government tightened its lax fiscal policy in order to achieve a proper mix of the policy: The best period of low inflation and accelerating economic growth has already been wasted. However, the outgoing government was unprepared for a genuine fiscal adjustment in good times. To the contrary, it has expanded social spending, put off even non-ambitious reforms of the state budget and counted on the growth dividend to bring the general government budget in line with the 2006 Convergence Program update that calls for its reduction to 2.9% of GDP by the end of 2009. The expansionary policy has raised the risks of a boom-bust cycle in the economy such as the one that Portugal experienced. This is not to say that a bust is round the corner, to the contrary, it is still a remote prospect. Nevertheless if the government implements a loose fiscal policy in 2008, it may encounter some

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	6.1	6.3	6.6	7.4	6.7	5.9	5.8	4.8	5.4	6.5	5.0
Private Consumption	4.4	2.0	5.2	5.6	5.1	6.9	5.1	5.8	7.3	5.4	6.8	6.2	5.7
Fixed Investment	6.4	6.5	16.5	19.3	19.3	29.6	22.3	16.7	13.2	1.8	7.2	18.2	10.1
(4Q, % of GDP)													
CA balance	-4.3	-1.7	-2.3	-1.9	-2.3	-2.5	-3.0	-3.5	-3.4	-3.9	-4.6	-3.3	-5.6
(% change, yoy)													
Exports (EUR bn)	22.3	17.8	19.3	19.6	20.5	19.0	19.3	15.5	12.3	18.4	20.1	12.2	11.9
Imports (EUR bn)	19.5	13.3	16.1	18.1	20.7	20.6	16.1	19.9	14.2	22.6	22.5	15.0	11.5
(% change, yoy)													
Industrial sales	12.6	3.7	11.3	12.3	10.8	13.0	8.5	9.0	7.3	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	2.8	3.1	2.7	2.3	2.9
PPI	7.0	0.7	2.3	3.5	2.8	3.3	2.0	1.7	3.6	4.0	3.3	2.6	3.6
Nominal Ave. Wage	4.0	3.8	4.9	5.0	5.3	7.1	8.9	9.1	9.0	7.5	7.9	8.6	7.5
Employment %, LFS)	2.2	2.3	3.1	3.7	3.9	3.6	4.8	4.4	4.2	4.0	3.0	4.3	3.4
Registered unemployment rate (%, eop)	19.0	17.6	14.9	15.2	14.9	14.4	12.4	11.7	11.6	11.5	9.9	11.6	9.9
PLN/EUR, eop	4.08	3.86	3.83	3.98	3.83	3.87	3.77	3.85	3.75	3.70	3.80	3.78	3.70
WIBOR 3M, %, eop	6.64	4.60	4.20	4.19	4.20	4.40	4.71	5.10	5.35	5.60	5.85	5.30	6.40
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	15.9	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	35.0	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	21.5	20.5	17.0	15.0	20.5	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	-3.7
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	48.5

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

problems meeting its targets as the state budget revenues are based on very optimistic assumptions of economic growth and tax collection.

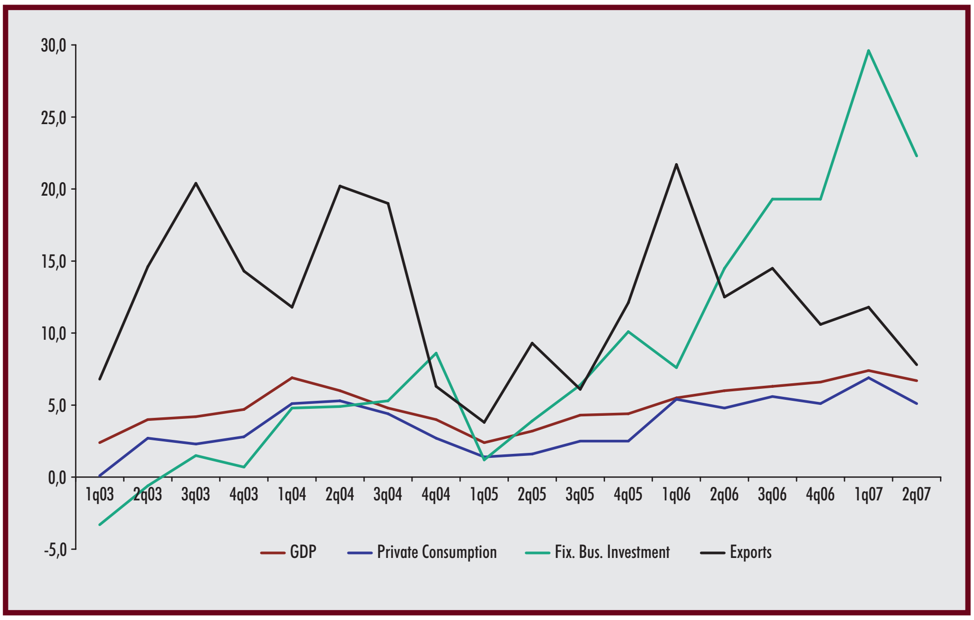
In this issue of the Polish Economic Outlook we discuss the macroeconomic performance of Poland in the second quarter of 2007 and at the beginning of the third quarter. The forecasts of key economic indicators are included as usual. This time our *Special Topic* focuses on the impact of the global credit crunch on the Polish economy.

LATEST DEVELOPMENTS IN THE POLISH ECONOMY

Economic growth

The economy gained momentum in 2Q07 as seasonally adjusted real GDP grew 6.9% year on year (yoy), slightly more than 6.8% yoy in 1q07. In terms of previous year prices, real GDP grew above expectations by 6.7% year on year in 2Q07 compared with 7.4% yoy, according to the preliminary release by the CSO (GUS). The structure of growth factors points to the changing pattern of growth, which has been driven by domestic demand while net exports deteriorated. This shields Poland against a global slowdown but on the other hand its external balance has rapidly started turning in the red.

Figure 1. GDP growth factors, yoy



Personal consumption expenditures – unexpectedly – slowed down to 4.4% yoy in 2q07 from 5.7% yoy in 1q07 despite a stronger rise in retail sales and higher wage increases in the 2Q07 from a year ago than in the 1q07. Its contribution to growth was lower (3.2 percentage points) than that of fixed business investment (3.8 percentage points), which grew by 22.3% yoy in 2q07, down from 29.6% yoy in 1q07. Fixed business investment in the 1q07 was elevated by unseasonably warm winter that caused a jump in construction activity. The quarterly break-down of investment shows that firms invest the least in the first quarter and almost half of total annual investment takes place in the fourth quarter. Therefore the figures on the first quarter should have been treated with caution, but a strong show of investment in the 2q07 suggests that the robust upward trend will be sustained into the second half of the year. It is striking that accumulation of inventories picked up in the 2q07, while most firms reported that they were running out of the stock. Net exports declined as exports and imports picked up 7.8% yoy and 14.2% yoy, respectively. Its negative contribution to growth was 2.6 percentage points in the 2q07 compared to negative 1.1 percentage points in 1q07. Net exports are a mirror image of divergent rate of growth of Poland and its main partners in the EU. Export growth is on a declining trend as output sales are switched to the domestic market while imports are brought to meet high investment and consumer demand. Further, the quarter-on-quarter GDP growth slowed down in the euro zone in 2q07, which may have exerted a negative effect on Polish exports. The real effective zloty exchange rate has not appreciated to the point, where it would hamper exports as the NBP quarterly survey of firms finds.

The data show that the Polish GDP continues to grow well above potential, estimated at 5% to 6% annually, inducing inflationary pressures. Bottlenecks on the labor market are evident and capacity utilization increased in the 2q07 to record levels – the most reliable indicator published by the central bank reached 84% at the end of the second quarter of 2007 while the median value rose to 89% from 85% in the previous quarter. Over time, booming investment should bring new capacities that would ease the constraint but for now, it boosts demand in the economy and leads to rising producer prices. Evidence points to a strong positive correlation between changes in capacity utilization and CPI changes: Changes in capacity utilization lead CPI changes by one quarter, thus the recent developments would suggest mounting underlying inflationary pressures.

The outlook for GDP growth in 3q07 is positive, based on the inertia of economic processes, good supply-side data for July and business confidence indicators that stabilized at high levels or slightly picked up (retail sales). Industrial orders are on the rise and expectations of demand growth across sectors of the economy are positive. Consumer confidence continued its upward trend in August, underpinned by hefty take-home pay increases due to two factors: accelerating wage growth and a cut in the disability premium for employees by 2 percentage points since July. Investment, rising at a 20% clip yoy, should continue to be a key driver of growth but personal consumption should pick up above 5% yoy. This will be accompanied by a further widening of net exports gap. Nevertheless, we downgraded a bit our previous forecasts of year-on-year GDP growth in the third and fourth quarters of 2007 as the economy has evidently become capacity-constrained now (see PG TOP 1/2007). There have not been any reforms enacted that would improve the functioning of the supply side and the supply-side effects of the investment boom should become visible no sooner than in 2008. The forecast that GDP would grow above 5% in 2008 has been maintained. Consumption growth should be underpinned by rising wages and gains in employment, but smaller than gains hitherto due to geographical mismatches and mismatches between qualifications and demand of businesses. Continued investment by businesses, albeit at a slower pace, should also be an engine of economic growth.

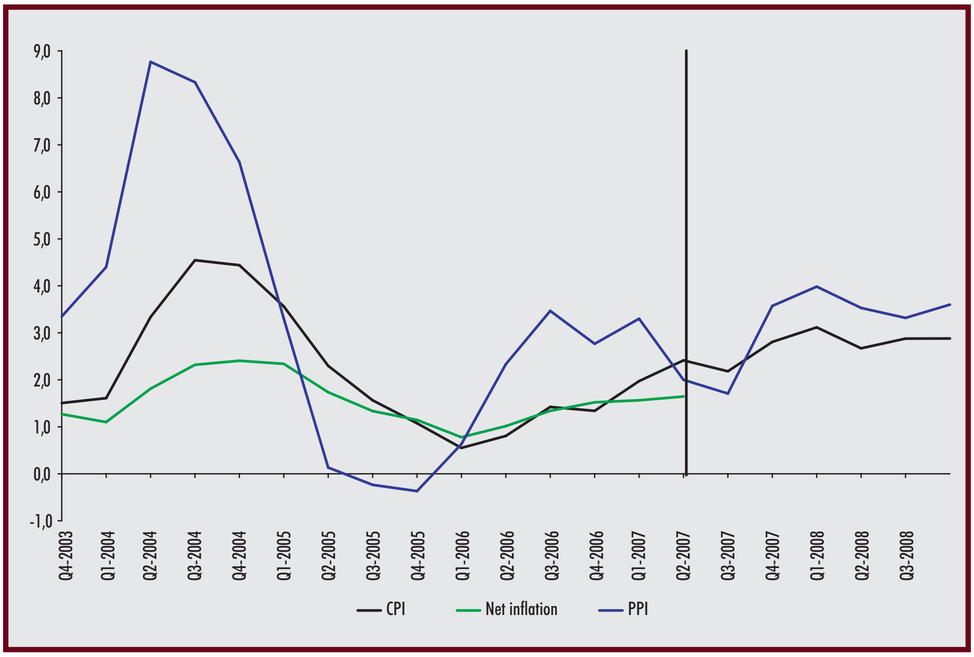
The downside risks for the outlined growth scenario are the following: interest rate hikes stronger than expected, continued turmoil in the financial markets that would cause a credit crunch, US recession leading to the slowdown in the euro zone and political instability. The upside risks are a better use of structural funds from EU to upgrade infrastructure, a better investment climate should possible early elections elevate to power a reform-minded government and a sooner end to the real estate crisis in the USA that would allow the US economy to pull itself out from the mid-cycle slowdown and boost confidence in the world economy.

Inflation and Monetary Policy

CPI inflation has been on the rise in recent quarters to reach an average of 2.4% y/y in 2Q2007 and 2.3% in July. As evidenced in the stability of net inflation (at around 1.6% y/y) this happened mostly on the back of supply-side factors: increasing price growth of food (from 3.4% in 1Q07 up to 4.4% in April-July) and fuel (from 0% in 1Q07 to 2.3% y/y in April-July). Price dynamics of industrial goods has been on the rise in recent months (a major break from the steady deflation prevailing since mid-2005 until April 2007) but very low (a mere 0.1% y/y in April-July on average) and continue to be a major disinflationary factor in the Polish CPI. Inflation of services remains in check at 2.7% y/y in April-July which represents a slight decline over rates registered in 1Q07 (2.9%) and 4Q06 (3.2%).

Our inflation forecast envisages a continuation of most prevailing trends and the gradual strengthening of the demand-side pull that has been rather limited until now. As the share of food in the Polish consumption basket is about 20%, inflation of foodstuffs is crucial to the future direction of the CPI. The current developments in the global agricultural market point to high likelihood of further price increases despite a good harvest in Poland, especially in the light of the mediocre harvest of major grain cereals in the world and constantly rising world and EU prices of cereals and milk – thus ensuing arbitrage. This leads us to expect the continuation of the current high price upward trend for the remainder of 2007 and the first half of 2008 – triggered by rises in prices of most staple foods including bread and cereals, meat and dairy.

Figure 2. Inflation indices, yoy



Non-energy industrial goods are expected to continue their low inflation trend amid sharp import competition from Asia, coupled with strong zloty and further expansion of cost-cutting retail chains. Prices of fuel carry as usual high substantial risks – currently concentrated on the upper side.

The current situation in the Polish labor market suggests the gradual strengthening of demand-side inflationary factors. Recent massive emigration of Polish workers that also contributed to the rapidly falling unemployment has exacerbated severe shortages in many sectors (e.g.

construction and catering) and forced employers to substantially raise wages. Such increases in disposable income coupled with the demand-effects of the currently observed consistent acceleration of credit to households will be the crucial factor behind the emergence of the demand-driven inflationary pressures in the coming quarters.

Taking into account these assumptions we expect the y-o-y CPI inflation to enter an increasing trend in September to reach 3.2% y/y in December and stay at this level for 3 months to fall somewhat in 2Q08 and stabilize at 2.8-2.9% for the rest of 2008. Our forecast is thus similar to that included in the central bank's July *Inflation Report* until 1Q08. However, it divergences somewhat after 2Q08 when NBP forecasts consistently rising inflation (to just over 3% at end-2008) while we predict its stabilization just below 3%.

The central bank reacted to rising inflationary pressures and started a tightening cycle in April 2007 by raising its key interest rate by 25 basis points to 4.25% per annum. Subsequently rates were hiked by 25 bps in two steps to 4.75%. Since CPI inflation rate is likely to continue rising, GDP is growing stronger than its potential rate, credit is booming, fiscal policy is expansionary and wage rises exceed labor productivity gains per employee the tightening cycle will continue. We expect a hike by 25 bps to 5.00% until the yearend. In 2008, cumulative hikes in the NBP key rate should amount to 100-125 bps. Should inflation burst out, which is not our base-line scenario however, the central bank is likely to counter it with larger increases.

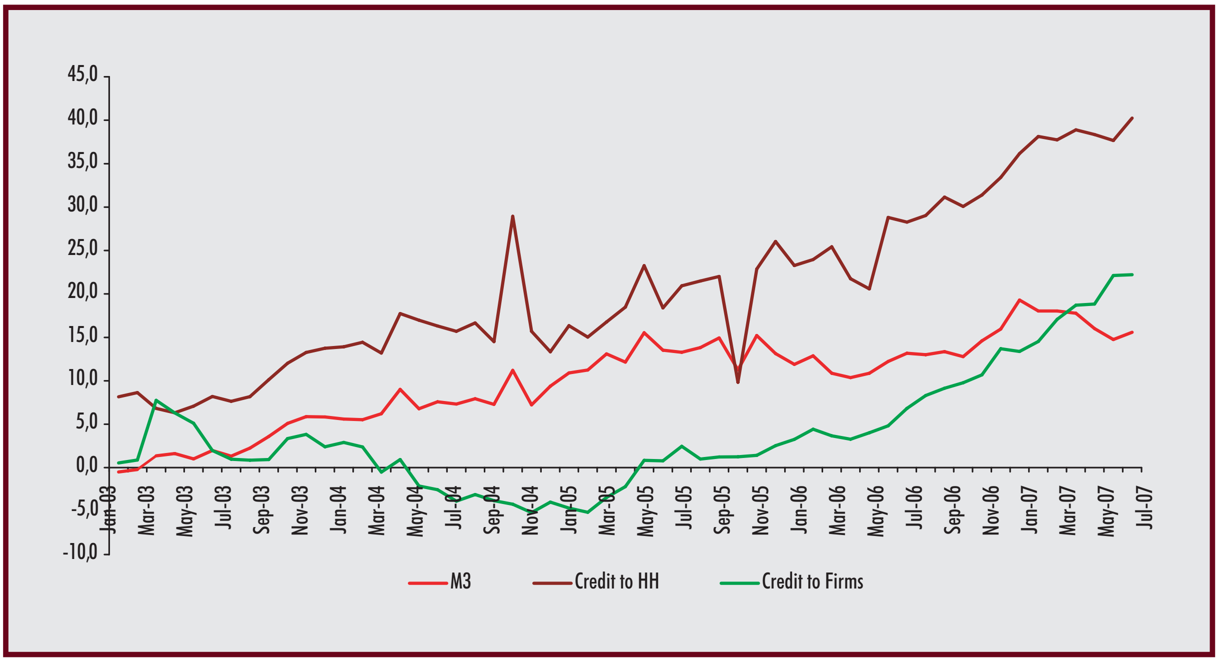
These interest rate hikes should underpin the zloty strength and its stability due to the widening advantageous interest rate differential. However, more fundamentally, the zloty will be supported by Poland's manufacturers productivity gains over its trade partners. The widening current account deficit should be comfortably financed by net direct investment flows and EU transfers that officially appear on the financial account but, in fact should be treated towards a lower current account shortfall.

Monetary Developments

Inflationary pressures are fuelled by a rapid rise in money supply. Broad money as measured by M3 rose by 15.6% yoy in July 2007. Using a simplified rule of thumb that money should grow at the same pace as nominal GDP, it is evident that the rate of M3 expansion exceeds the rate of nominal GDP growth by far. The signs of credit boom are widespread. Domestic credit has been rising faster than 20% a year since November 2006 and it increased by 31.4% yoy in July. Credit to households and non-financial firms rose by 40.2% yoy and 22.2% yoy in July, respectively. Mortgage rose by 56.2% yoy in July and that credit boom has led to the real estate and housing inflation. Appartment and house prices doubled in the last twelve months as the lack of lots for housing construction did not allow the construction output to respond to the surge in demand. Households are vulnerable to exchange rate depreciation since almost 58% of housing loans are denominated in foreign currencies, mostly in the Swiss franc and the euro, due to a favorable interest rate differential. However, the degree of foreign exchange exposure peaked in June 2006 and has down trended since then, as this differential diminished and the central bank instructed commercial banks to tighten their procedures of approving foreign currency loans. While credit to households started advancing in double digits since late 2003, credit to firms remained sluggish and its growth picked up only in the final quarter of 2006, lagging the pickup in fixed business investment that started in the 2q06. Firms have accumulated large bank deposits of 10% of GDP from retained profits that allowed them to fund investment without a recourse to external financing. This has changed in 2007 but firms' high liquidity has not decreased as profits continued to grow strong. 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 a source of financing their investment projects.

This rapid growth of credit aggravates the risks of a boom-bust cycle in the Polish economy though a bust is still a remote prospect since the economy is still well equilibrated. One could argue that this phenomenon is a sign of an adjustment to a new steady state. Households have revalued their permanent incomes upward due to the EU entry and started borrowing more funds, confident that they would afford to repay them. However, the pickup of consumer demand fueled by a borrowing binge, may lead to a sudden slowdown in the future due to two reasons either recession or a relative saturation of households with durables before restitution demand increases.

Figure 3. Broad Money and Credit Expansion, % yoy



Fiscal Developments and Policy

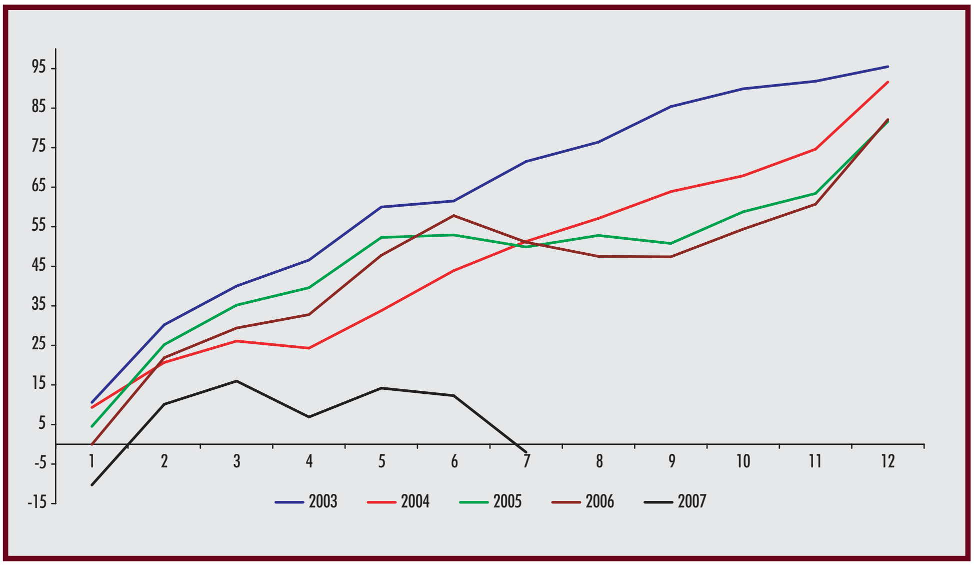
Poland's fiscal position in 2007 is strong as imbalances are declining due to cyclical developments. On the other hand, government plans to step up spending in 2008 will threaten the implementation of the non-ambitious 2006 Convergence Program. Poland is running an expansionary fiscal policy in times when GDP is growing above its potential instead of equilibrating growth by means of a fiscal restraint. This complacency may prove costly for the stability of public finances in the future should growth slow down abruptly. Such a policy makes an entry into ERM2 mechanism unlikely in 2008 and 2009 unless the priorities would be shifted.

The central government cash budget was balanced in January - July 2007: It registered a small surplus of 0.6 bn PLN or 0.05% of GDP. This unseasonably strong position was due to a cyclical upturn in revenues and a restraint in expenditure. Tax collection came at a much faster clip than originally anticipated, related to higher-than-expected GDP growth of 7.1% year on year in the 1h07 but also in 2006. The rise in PIT revenue was correlated with high wage increases and strong gains in employment while CIT revenue was boosted by rapidly rising net incomes of firms. Indirect taxes grew faster than expected as more sales transactions were concluded. It is interesting that state budget revenue was higher than expected only in one month of April, when households settled their tax obligations for 2006. The state budget bill for 2007 assumed very high tax revenue elasticities with respect to GDP (CIT and PIT elasticities) and domestic demand (the VAT revenue elasticity) and a 4.6% rate of GDP growth. The conclusion is that had economic growth in 1h07 not exceeded this projection by far, the tax collection would have come lower than projected because, except for April, it was more or less on schedule in January – July. This also implies that the projection of 4.6% GDP growth and of a strong rise of revenue in the state budget plan for 2007 were incompatible.

Expenditures rose slower than projected as the government spent less than planned on subsidies to the Social Security Fund (the ZUS) that was well funded by increased pension and disability pension premium collection. Most of the savings in the state budget expenditure relative to the 2007 expenditure plan were recorded in the 2q07. These developments suggest that the 2007 cash central government shortfall will come much lower than 30 bn zlotys, originally projected in the state budget bill. Assuming that revenue expenditure would proceed in line with the original 2007 plan, the deficit would reach around 13 bn zlotys or 1.1% of GDP this year. However, expenditure will be stepped up in the final months of the year in particular in December, when bills for public investment are settled. On the other hand, 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 deficit should come at around 15 – 20 bn zlotys or 1.3 – 1.7% of GDP in 2007 much below the plan of 30 bn zlotys.

What counts for the assessment whether Poland complies with its 2006 Convergence Program (CP) update, is a general government deficit, measured in ESA-95 terms. According to the update of Convergence Program from November 2006, the shortfall should come at 3.4% of GDP, down from 3.9% of GDP in 2006. The hitherto developments suggest that the central government deficit will come lower than previously anticipated but the assumption that local governments will register a surplus of 0.3% of GDP looks too optimistic. Local governments' finances were in surplus in 1h07 but their spending will likely pick up in the fall, since these governments seem to be on a steep learning curve, how to get the access to EU structural funds. They have accumulated savings in order to pre-finance and co-finance the projects that will be dominantly funded by the EU handouts. Thus it is likely that the surplus will turn into a deficit at the yearend, perhaps of 0.3% - 0.4% of GDP similar to the previous years. This happened, for example, in 2006: It was estimated in the updated CP that local governments would register a surplus of 0.2% of GDP in 2006 but eventually they had a deficit of 0.4% as the government report (published in June 2007) on the implementation of 2006 state budget revealed. Adding the local governments deficit, the central government deficit and the cost of pension system reform (2% of GDP) one comes up with the estimate of a general government deficit equal to 3.6% to 4.1% of GDP. This result should be adjusted for a surplus of the social security funds. In 2006, this surplus amounted to 0.5% of GDP and it should take a similar proportion in 2007 or even slightly higher due to the increased revenue of social security funds. Adjusting for this surplus, the ESA-95 general government deficit should be 3.0% to 3.5% of GDP, i.e. in line with the projected amount in the 2006 CP update.

Figure 4. Central government budget deficit, % of plan



In case, the deficit were close to the 3% threshold, the government could ask the European Commission to apply the procedure of the reformed Stability and Growth Pact that calls for a partial deduction of pension reform costs from general government deficits. Provided that the deficit is close to 3% of GDP and the downward trend is sustainable a country that has reformed its pension system is allowed to deduct portions of annual costs at a diminishing scale by 20 percentage points each year, starting with 100% in 2005, 80% in 2006 and finally zero in 2010. Should the Commission accept the fall in the deficit as sustainable it were to deduct 60% of the pension reform cost in 2007 so the deficit that counts for the Excessive Deficit Procedure calculations would be in fact lower by 1.2% of GDP. This would imply that the Commission should terminate the procedure in the Polish case.

However, the Commission may take 2008 government budget draft in its evaluation. As of writing, only macroeconomic assumptions for the 2008 state budget draft are known. They show optimism on the part of the Ministry of Finance: GDP is projected to grow by 5.7% and CPI inflation will stand at 2.3% though the MoF has already signaled it may revise the growth projection downward. On a comparable basis (excluding spending related to EU flows of funds), the state budget expenditure is to rise by 12.1% so it would exceed the rate of growth of nominal GDP of 8.1% in 2008. The government intends to pursue costly social programs that would raise the state expenditure (the cost-of-living compensation for pensioners, a rise in salaries of state employees, tax deductions for families with children) and will have to supplement the Social Security Fund with the amount that will cover the loss of the fund's revenue due to the cut in the disability premium by 7 percentage points that alone may cost the budget 1.5% of GDP. Altogether, the cost of these measures is likely to amount to over 3% of projected GDP. Besides these measures, there are other entitlements to increased expenditure. The projected rise in the state budget revenue by 12.8%, i.e. by 2.2% of GDP in 2008, may not cover the rise in expenditure. In this case the 30 bn zloty cap for the state budget deficit could be in jeopardy and it would imply negative repercussions for the general government deficit as well.

Labor Market

Employment still grows but first signs of slower gains appear. Although unemployment keeps falling the number of job finders goes down. Wages are still on the strong rise.

Employment

In 2007Q2 employment was still growing rapidly but first signs of slower growth showed up. In the so called enterprise sector it increased by 4.5% yoy (4.1% yoy in 2007Q1). Construction sector was still a leader of employment growth (8.7% yoy) but for the first time since the middle of 2005 employment dynamics in this sector started to decrease on a monthly basis. Employment growth started to stabilize also in manufacturing, transport, communal services and real estate sectors. It all may mean that 2007Q2 was the last year of accelerating overall employment rate of growth.

First sings that employment growth may slow are also visible in outflows data from Public Employment Service (PES), (see Figure 5). Since the beginning of 2007 the number of job finders keeps decreasing. In 2007Q2 only 364.400 unemployed persons found jobs, i.e. 14.3% less than a year ago. One becomes even more cautious looking at a changing structure of job finders. Since the beginning of 2006 the total number of job finders has been increasing only due to a growing number of those who have been able to find their new jobs "on the market" – i.e. not as an element of a job activation program subsidized by PES. This trend was arrested in 2007Q2, when the number of the unsubsidized job finders decreased in yoy terms by 18.5%. It was also the first period since the beginning of 2006, when the number of subsidized job finders increased (by 14.3% in yoy terms). Decreasing dynamics of a number of jobs offered monthly in PES offices by employers (a 12.4% yoy increase in 2007Q2, compared to 126.8% in 2007Q1) is the last piece of information testifying to a possibility that the reduction of employment rate of growth is in the pipeline.

These somewhat pessimistic signals from the enterprise sector and PES are not fully proven by Labor Force Survey (LFS) data. Employment growth in the sector strengthened in 2007Q2 to 4.8% yoy after a pickup in 2007Q1 to 4.6% yoy that followed the short term seasonal slowdown in 2006Q4 to 3.6% yoy. Employment grew in all sectors and employment rates rose for all age groups but the oldest one 65+, all education levels and in all regions but two, where it was stable.

On the other hand however, similarly as in previous periods, growing employment is not reflected in economic activity growth. The size of active population (active population is the sum of those employed and unemployed) still keeps decreasing, (by 1.5% yoy in 2007Q2).

Based on signals coming from both enterprise sectors and employment offices we keep our employment forecast for the next several months unchanged, although it appeared excessively pessimistic in the short run. We still expect that employment both in the enterprise sector and the overall LFS figure will keep rising in the quarters to come. However, the employment dynamics will stop rising and a turning point will be reached. In 2007Q3, we expect that enterprise employment will grow by 4.3%-4.4% yoy and the LFS employment in 2007Q3 will grow by 4.5% yoy. The average employment growth for 2007 should stay at similar levels. In 2008 employment growth should decelerate to the average of around 3% yoy, still a strong figure despite the slowdown.

Wages

Wages keep booming and it may have already resulted in negative phenomena in employment dynamics we described above. In 2007Q2 wages increased by 8.9% yoy, (by 8.3% yoy since the beginning of 2007). Real wages increased by 6.3%.

Wage growth keeps on accelerating in all main sectors. The highest wage growth is visible in construction (15.5% yoy), where labor shortages are most felt. In the remaining sectors wages rise at the annual rate of between 8% and 10%. In manufacturing wages grew by 9.5% yoy.

Since the beginning of 2007 wages in manufacturing increased by 9.1% yoy, whereas labor productivity of a worker, using overall sales as a production measure, increased by "only" 8.2%. It means that actually manufacturing wages grow faster then productivity increasing Unit Labor Costs. This factor my play a major role in decreasing the employment dynamics in the periods to come.

Notwithstanding the negative relationship between labor productivity and wages we still expect wages to grow rapidly till the end of this year. Wage pressures will still be strong due to the improving labor market conditions (still increasing employment and falling unemployment) and a visible lack of qualified labor in some sectors.

The last decision to increase sharply (by 20.3%) the minimum wage in Poland since the beginning of 2008 may create additional tensions despite its relatively limited direct effects for the country as a whole. Although according to our estimates the share of employees earning minimum or close to (+20% in this case) minimum wage is about 3% it may result in increased wage demands from other groups of employees.

Hence we expect wages to grow on average by 8.5%-9% in 2007. In 2008, the wages 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 message for future developments is not so optimistic. The number of registered unemployed in 2007Q2 fell to 1.856 thou. persons meaning a yoy reduction of 22.4% (17.% in 2007Q1). The registered unemployment rate fell by 3.6 percentage points to 12.4% at the end of June (see Figure 5).

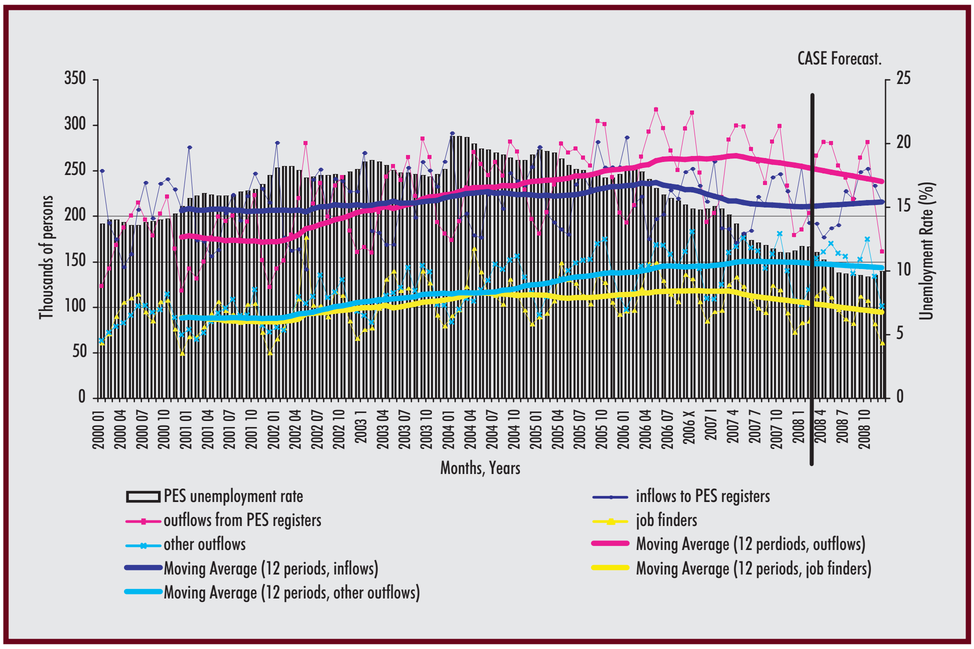
On the other hand the situation does not look so nice anymore if one analyses the labor flows. As it has already been mentioned, the outflows started to fall, especially those related to unsubsidized jobs being found by unemployed. The dynamics of job offers is also slowing down. Apart from that, the number of those leaving the registers due to other reasons than a new job is also stabilizing and we expect it will start to decrease soon, (see Figure 5).

Quarterly inflows of new unemployed persons to employment offices are still falling (by 6.6% yoy in 2007Q2 as compared to 12.1% in 2007Q1). It seems however that these trend is about to reverse (see Figure 5).

LFS unemployment figures still look optimistic and one is not able to discern any warning signs yet. The number of jobless persons in 2007Q2 was 1.602.000 – a 32.6% reduction in yoy terms. The unemployment rate fell below 10% for the first time in this century, reaching 9.6% and close to the minimum recorded during the whole transition to the market economy. Unemployment rates kept falling in all population subgroups and in all regions. The only category of unemployed, whose ranks increased in 2007Q2, were those waiting for their work contracts to start – i.e. those already practically employed. The average duration of unemployment spell decreased as well as the share of long-term unemployed in the total poll.

Signals from the PES data that job creation may start decelerating lead us to a certain caution in our projections of unemployment figures in next year. We expect the registered unemployment rate to fall to around 11.7% in 2007Q3 and to 11.6% by the end of this year (see Figure 5). In the course of 2008 the registered unemployment rate should fall below 10%. Our projection is that, it will stick to this number at the year end. LFS unemployment will continue to fall, although much less dynamically that it has been thus far. It will reach around 8% by the end of 2007 and 7% by the end of 2008.

Figure 5. Registered unemployment rate, outflows from and inflows to PES registers in 2000-2007



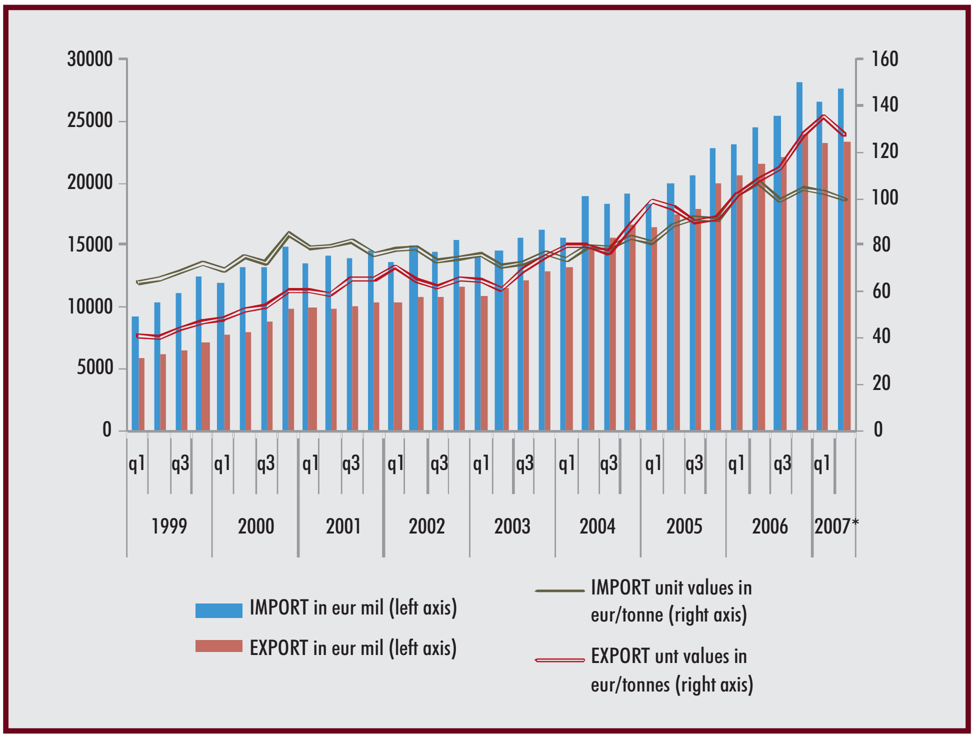
Foreign Trade and Balance of Payments

Growth of imports have been outpacing growth of exports since the onset of 2007. The current account deficit has been mounting on the back of it and higher outflows of retained profits by foreign investors.

Merchandise exports have continued to grow, albeit at a slower rate in 2Q2007. Sales of Poland-made produce increased in nominal euro and zloty terms by about 7-10% yoy in 2Q2007 (15% yoy in 1Q2007). The fastest growing export markets were new member countries and those of Eastern Europe (mainly Russia and Ukraine), i.e. close-by and rapidly developing regions. The average euro prices for a unit of exported good kept on increasing.

Imports have been on the upward path too and expanded faster than exports. They rose in nominal euro and zloty terms by about 10-12% yoy in 2Q2007 (17-18% yoy in 1Q2007). In 2Q2007, similarly as before, almost all merchandise trade deficit was due to trade with developing countries (China) and Russia. It should be noted that imports have been become cheaper and cheaper both in zloty and in euro terms (for euro unit values see Figure 6).

Figure 6. Values and prices of Polish merchandise trade, 2002-2007



Note: 2Q2007 - estimate
Source: *Eurostat and own calculations*

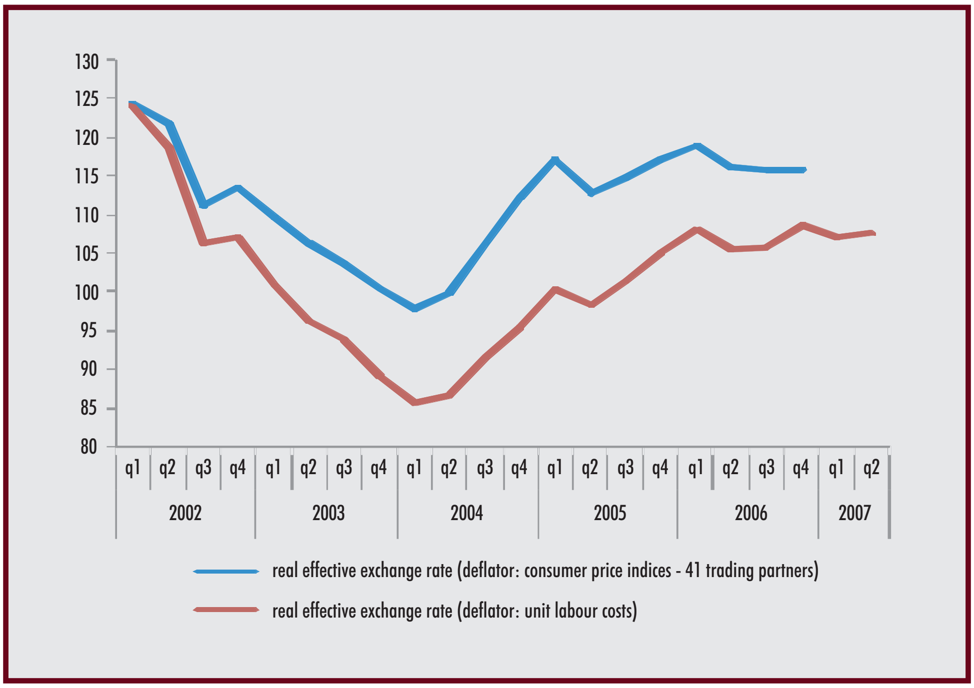
Real growth rates tell the same story. It is estimated that exports and imports of goods and services expanded by 8% yoy and 14% yoy in real (volume) terms in 2Q2007, respectively. While the growth of the volume of exports has recently slowed down a bit (from 11% yoy in 1Q2007), the rate of growth of import volumes remained the same. It is the upturn in the domestic and external markets that have been driving real dynamics of exports and imports in recent months. The real exchange rate, after having appreciated slightly in 2006, has been rather stable throughout 1H2007 (see Figure 7) while, at the same time, robust economic growth in the euro zone continued, although at a slightly slower rate in 2Q2007 than in 1Q2006. On the contrary, the growth of domestic demand that drove imports, increased yoy in 2Q2007, when compared with a quarter earlier.

It is forecasted that similar dynamics of foreign trade will prevail during the whole 2007. In 2007, exports in national accounts are expected to grow by 9% yoy, while imports by 14% yoy. In 2008, the divergent expansion paths of both import and export volumes should continue but both are still predicted to grow strongly, by 12-13% yoy.

The current account (CA) balance has been negative and growing in terms of GDP for the last three quarters. In June 2007, CA deficit for the last 12 months was around 3% of GDP (2.5% of GDP a quarter earlier). The CA deficit in 2Q2007 was primarily caused by large and negative balance on the current income account (EUR -3.5 billion, see Figure 8), and secondly – by the deficit at the goods account (of EUR -1.2 billion). Trade in services closed with a small surplus (EUR 0.6 billion in 2Q2006). Current transfers – out of which significant part is composed of transfers to and from the EU budget – recorded a positive balance (EUR 1.8 billion).

This is to say that higher CA deficits in recent months are caused to much extent by external factors, i.e. by outflows of higher incomes of foreign investors. These factors are nevertheless linked to robust growth of the domestic economy and a concomitant rise in corporate, but are not directly subject to domestic economic policies. They should also not be treated as a source of concern – at least for now – since investors income contains reinvested earnings, which at present constitute about half of the total current income of foreign investors. A large part of these profits is then reinvested into the economy so they appear on the financial account of the balance of payments. Thus in a sense the income account of the CA is self-financed.

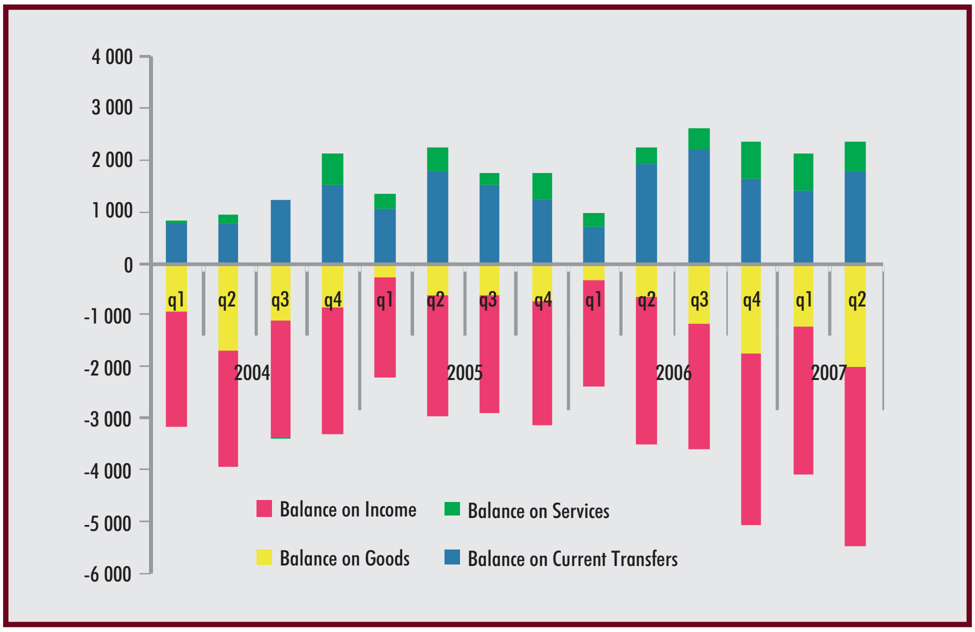
Figure 7. Real effective exchange rate, 2002-2007



Note: indices, 1999=100
Source: *Eurostat*

FDI inflows in 2Q2007 were low. Moreover, they were not much higher from Polish investments abroad, which resulted in unusually low net FDI inflows.

Figure 8. Current account, 2004-2007



Source: *NBP*

August Turbulences on the Global Financial Markets and the Polish Economy

The temporary credit crunch that happened in August had at its root the crisis on the sub-prime mortgage market that had been a by-product of increased US interest rates as fed funds were raised from 1% to 5.25% in the course of 2004-2006. This rise most severely hit sub-prime mortgages with adjustable rates and led to elevated proportion of delinquencies in credit servicing. The dissemination of the crisis has been possible due to the changes in housing financing that the US system has undergone for the last 20 years. This is no longer a market where mortgage (a long-term credit) providers finance themselves with short-term deposits and they bear directly the cost of delinquencies in payments if they arise.

Deregulation of US financial services in the early 1980s that ended with a savings and loans crisis of the late 1980s induced a drive to securitization of mortgages that led to a separation between mortgage lending and investing in mortgage-based securities Mortgages are packed together into collateralized debt obligations (CDOs) and sold to investors almost like commodities. Most of them are constructed in such a way that rating agencies have rated them with high investment grades (triple A on S&P's scale). They appealed to them because of their higher yield than that of treasury bonds. In this way risk spread out and banks took off mortgages of their balance sheets. The crisis unfolded, when rating agencies drastically downgraded some of these CDOs in July, sometimes to a junk-bond status from a high investment grade at one scoop. Investors en masse wanted to get rid of these papers but there were no buyers around. Suddenly, it occurred that financial institutions in Europe, Australia and even in China kept CDOs as their assets and had to assume losses related to delinquent US subprime mortgages. Ten years ago only a local bank would have gone down under the burden of these non-serviced mortgages, but globalization has changed this. Reports of losses and suspicions that any financial institution may have bad CDOs in its portfolio led to a credit crunch. Credit spreads for a variety of instruments jumped. Investor uncertainty rose as structured products have complex payoffs and their risk is hard to assess under the circumstances of financial stress. The flight to quality further aggravated the situation, stock markets experienced wild swings and investors liquidated well performing assets to make up for the losses or satisfy margin calls elsewhere.

The crisis has been aborted so far by a resolute action by central banks, which pumped liquidity to the markets and pledged to deliver it as needed to assure smooth functioning of the credit markets. In particular, the Fed lowered its discount rate by 50 bps, at which it directly lends funds to banks, and Bank of Japan put off the long overdue rise in its key rate. President Bush administration announced measures to guarantee payments on loans that are 90 days overdue, which also brought some relief.

However the US subprime mortgage crisis is not over. In the coming months, many borrowers will be facing their first interest-rate resets whereas house prices are likely to decrease. The housing market collapse may prove more prolonged and deeper than it is estimated. Potentially large losses of financial institutions would trim their appetite for risk and a credit crunch could resurrect. These developments may induce adverse effects outside the financial world. If they decisively dampen consumer spending, they may trigger even recession in the US economy. The latest data on the second quarter and on July suggest that the US economy continued to expand at a moderate pace, despite the drag on growth exercised by the housing market. August consumer confidence indicators sharply dropped, affected by the financial markets tumult. If they do not rebound in the fall, they may herald the upcoming period of softness in consumer spending and risks of a downturn would increase.

Up to now the global economy has coped well with the US slowdown as domestic demand in Europe and Asia became stronger. It has been said that the US housing sector is not import-prone so that European and Asian exports did not suffer much after it had collapsed. However, there is more evidence now than six months ago that the spill-over effects from the housing sector to the rest of the economy are becoming stronger and downside risks to US growth mounted.

Polish economy is not dependent on the US fortunes directly – trade and financial connections are marginal. Polish exports to US were mere 1.9% of total exports in 2006. Going to the extreme, if they suddenly vanished Polish economy would barely felt the impact as their lack would shave less than 0.8% of Polish GDP, all other things equal. But things are not equal as this country's exports in terms of national accounts rose by 9.7% yoy in 1H07, by far more than the US share in total outflows of goods and services from Poland. Thus, the trade impact on the economy would be negligible, especially that exports to US would not decline to zero during the US downturn. Furthermore, Polish companies have negligible investments in the US so their net incomes would not suffer from the low tide of business in the US. Hence, the US slowdown would have no direct impact on fixed business investment in Poland. A stronger-than-expected slowdown or an open recession would likely lead to declining prices of US financial assets, but Poles hold negligible amounts of them in proportion to their total financial wealth. Therefore one should not expect any dire effects through this channel, either.

The adverse impact would come indirectly if euro zone economy slowed and this adversely affected Polish exports to this region. The above-mentioned types of linkages would have distinctly stronger effects on the euro zone than in Polish case. However, US recession would likely mitigate import prices of commodities leaving room for interest rate cuts in the euro zone to stimulate domestic demand, which has gradually replaced exports as the primary engine of growth: favorable financing conditions, employment growth, faster growth of real disposable incomes and higher profitability should sustain robust expansion of domestic demand in the coming year. The relative importance of the USA for the euro zone exporters has declined in recent years. In 2000, 17.2% of euro-area exports were destined to the US and this share fell to 14.4% in 2006 below the share of new member states (NMS) that entered the EU in 2004 (18.5%). The 5+ percentage point rates of growth in NMS may at least partially make up for the loss of exports to the USA should recession unfold there. Structural reforms, despite their piece-meal pace have likely raised the potential rate of growth in the euro zone and its resilience to unfavorable external shocks. Assuming that European economy would keep relatively well during the US recession, Poland's GDP growth should not suffer much as it would be underpinned by domestic demand supported not only by gains in employment and real incomes but also by the inflow of structural funds from EU whose usage should improve.

As Polish financial markets are concerned, the impact of the US subprime mortgage market crisis should be very limited. The US developments may encourage banks to evaluate their mortgage portfolios and slightly tighten the procedures but this should not have significant influence on the rate of growth of the housing credit in Poland. Polish market is not as sophisticated as the US one. It is still in the phase, when banks fund mortgages with short-term deposits. Housing credits are overwhelmingly issued by commercial banks and they carry adjustable interest rates. Since unlike in the US, Polish commercial banks keep the housing loans on their own books, they have strong incentives to screen their customers with proper caution, i.e. to try to overcome the problem of asymmetry of information and invest in information collection. Despite some signs that lending standards have been somewhat relaxed during the mortgage boom (e.g. introduction of 50-year maturities, no downpayment), they are quite stringent. It is inconceivable that a jobless person or customers without a check of their credit history would obtain a housing loan. Housing loans are about 10% of GDP, much lower than in developed countries and even in countries at the similar level of GDP per head in purchasing power terms. Irregular housing loans are less than 1% of total housing loans. On the other hand, the history of housing credit is too short to verify, whether the current margins are high enough to cover the risk of a hypothetical worsening of credit servicing and repayments, should a slowdown start. Provisions by banks for housing loans may be underfunded for rainy days but they have had record profits in recent years so the cost of increasing them would not be excessive. If they did so this would be a positive impact of the global credit market crunch.

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