



Special Feature

– Resilience of the Polish Economy

EXECUTIVE SUMMARY

Gradually slowing economy and a cloudy outlook for economic growth, falling unemployment and growing employment, a turning point in inflation trends, a sound fiscal position and a widening current account deficit characterized the 3Q2008.

As expected, the economy started slowing in the 3Q2008, impacted by the downturn in the euro area, but the slowdown was gradual and did not augur a discontinuity, which occurred in October. The culmination of the global financial crisis in October also hit the Polish economy whose growth prospects, broadly speaking, became uncertain and deteriorated. Outside events overflowed to Poland, leading to a psychological stress and the development of a crisis mindset. Commercial banks became infected by the financial contagion and imported high levels of mutual distrust. In a result, credit markets, well functioning until September, froze in October. Banks tightened lending standards and started rationing credit to the real economy that is leading businesses to reassess their investment plans.

These developments, along with the destabilization of the world economy and prospects of the most severe downturn in the postwar history make reliable predictions hard, therefore we envisage two scenarios. In our baseline scenario, when banks resume lending

to the non-financial sector, the central bank reduces its interest rates to offset the impact of widening spreads on the credit market and the global downturn is moderate, the economy should grow at 3 to 4% next year. In the worse case scenario, when credit is frozen, the world plunges in the worst postwar recession the economy could even stagnate. We still assign a lower probability to the second scenario.

Were the economy to grow in line with our baseline scenario, employment should keep steady while unemployment should not rise. However, a rate slower than 3% is likely to reverse the declining trend in unemployment since labor productivity gains will make some employees redundant as output stagnates.

Inflation passed its peak in the 3Q2008 as we predicted. The supply side factors have receded as the prospects of the global downturn caused an abrupt fall in commodity prices across the board. A good global harvest also reversed inflationary trends of foodstuffs. Stagflation talk shifted to global deflation fears. Since Polish economy will likely grow much below its potential in 2009, demand pressures will likely fade soon as well. Hikes in regulated prices of energy will remain the main inflationary factor as rises in pay will be moderated while the exchange rate should be neutral. We considerably revise our forecast

of the CPI inflation rate down, predicting that it will have dropped within the central bank band by the end of 1Q2009 and in the vicinity of the central bank target of 2.5% yoy by the end of 3Q2009. Since then it may remain stable. Downward surprises are likely should the economy grind to a halt. Easing of inflationary pressures will allow the central bank to reduce its interest rates: we forecast at least three to four cuts by the cumulative 1 percentage point until the summer of 2009.

The state budget position was sound after three quarters of 2008. The lower-than-projected tax revenue was more than offset by the lower-than-planned expenditure so the cash deficit came at 4.2 bn zlotys, much lower than projected. Like in 2007, the deficit will quickly rise in the 4Q2008, as the government steps in expenditure in particular for fixed business investment and EU related projects.

But it will come below the 2008 target of PLN 27.1 bn. The state budget draft for 2009 is based on GDP growth of 4.8% and inflation of 2.9%. Definitely, the former assumption is overly optimistic under current circumstances. In our view, a revision of the GDP growth rate to 3% next year would reduce the tax revenue by some PLN 5 bn and raise the cash deficit to 1.7% instead of 1.3% of GDP, keeping all other things unchanged. This should not cause a breach of the 3% threshold for the general government deficit from the Stability and Growth Pact.

The estimated four-quarter current account deficit reached 5.0% of GDP in the 3Q2008, compared with 4.7% in 2007. Revised NBP data point to a slow upward trend in this ratio in 2008 on the back of the rapidly widening trade deficit. However this deficit did not grow in the euro terms from the 2Q2008. In the 3Q2008, exports in the euro terms did not show

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

Indicator	Data						CASE forecasts						
	2005	2006	2007	2008			2008	2009				2008	2009
				Q1	Q2	Q3		Q4	Q1	Q2	Q3		
Nominal GDP, PLN bn (% change, yoy)	983.3	1060.1	1175.3	295.3	309.9	315.8*	356.3	312.1	328.1	338.0	382.4	1277.5	1360.7
GDP	3.6	6.2	6.7	6.0	5.8	4.5*	3.4	2.2	2.9	4.0	4.4	4.9	3.4
Private Consumption	2.0	5.0	5.0	5.6	5.5	5.3*	5.2	3.0	4.0	3.6	4.1	5.2	3.8
Fixed Investment (4Q, % of GDP)	6.5	14.9	17.6	15.7	15.2	12.5*	6.4	-2.8	-4.7	1.1	3.5	12.8	0.0
CA balance (% change, yoy)	-1.2	-2.7	-4.7	-4.9	-4.9	-5.0*	-4.8	-4.7	-4.5	-4.4	-4.5	-4.8	-4.5
Exports (NBP, EUR)	17.8	20.4	13.4	20.3	20.9	18.7	8.4	1.6	3.5	4.0	4.7	17.4	3.5
Imports (NBP, EUR) (% change, yoy)	13.4	24.0	19.5	20.6	21.5	19.9	9.0	2.2	2.9	3.9	4.4	19.0	3.4
Industrial sales	3.7	11.2	9.5	8.5	8.5	3.4	2.3	0.9	2.2	3.4	7.5	5.6	3.5
Gross value added	3.3	6.0	6.6	5.5	6.1	4.4*	3.6	2.3	2.8	4.0	4.4	4.8	4.8
CPI	2.1	1.0	2.5	4.1	4.3	4.7	3.8	3.5	3.0	2.8	2.9	4.2	3.0
PPI	0.7	2.3	2.3	3.0	2.5	2.1	2.4	1.8	1.5	1.5	1.9	2.5	1.7
Nominal Ave. Wage	3.8	4.9	8.7	11.5	11.7	10.7	8.8	9.5	9.1	7.6	6.7	10.6	8.2
Employment %, LFS	2.3	3.1	3.1	4.6	3.5	2.5	1.5	0.5	0.3	0.0	0.0	3.1	0.2
Registered unemployment rate (% eop)	17.6	14.8	11.4	10.9	9.4	8.9	9.1	9.5	8.8	8.9	9.4	9.1	9.4
PLN/EUR, eop	3.86	3.83	3.58	3.53	3.35	3.41	3.55	3.50	3.47	3.45	3.40	3.55	3.40
WIBOR 3M, %, eop	4.60	4.20	5.68	6.15	6.65	6.63	6.40	5.70	5.40	5.10	5.05	6.40	5.05
Central bank key rate eop	4.50	4.00	5.00	5.75	6.00	6.00	5.75	5.25	4.75	4.50	4.50	5.75	4.50
(% change, yoy eop)													
Broad Money (M3)	13.1	16.0	13.4	13.6	16.3	17.3	16.5	13.4	13.2	13.1	14.0	16.5	9.0
Loans to HH	26.0	33.4	37.9	37.4	34.4	33.5	37.5	34.0	29.5	25.0	18.0	37.5	18.0
Loans to Firms	2.5	13.7	24.1	25.2	24.5	24.1	30.0	25.0	21.0	18.0	13.1	30.0	13.1
(% GDP)													
Fiscal Balance	-4.3	-3.8	-2.0	n.a.	n.a.	n.a.	-2.4	n.a.	n.a.	n.a.	n.a.	-2.4	-2.8
Public Debt eop	47.1	47.7	44.9	n.a.	43.1	n.a.	43.9	n.a.	n.a.	n.a.	n.a.	43.9	44.0

(*) means estimates or forecasts

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

any weakness despite a recession in the euro zone while imports were highly correlated with them as both quantities rose by 18.7% yoy and 19.9% yoy, respectively. We are expecting a slowdown in exports to show up in the statistics in the coming quarters as companies report dwindling orders. But we do not forecast a further considerable deterioration in the trade deficit because the rapid depreciation of zloty restored the competitive edge of Polish companies while imports of commodities will be much cheaper and investment imports will likely decline. Further, Poland will likely use a larger portion of the EU funds than in 2008, which will tend to dampen the current account deficit. That is why we forecast a weak downward trend of the current account deficit in 2009. This deficit should not pose a problem to be

financed even under the low liquidity of international financial markets since its portion to the order of 1.6% of GDP was financed by the capital account inflows, which are EU funds almost entirely, unlikely to be reimbursed for their misuse.

Structural reforms are on the right track though for political reasons they have been delayed and watered. We think that the global crisis environment will lead to their vigorous introduction to enhance the confidence in the economy. One of them is the road map to the euro adoption in 2012, which is ambitious but still realistic.

Since the subject of the resilience of the Polish economy to the financial crisis is highly topical right now, it is tackled in our Special Feature.

LATEST DEVELOPMENTS IN THE POLISH ECONOMY

Economic growth

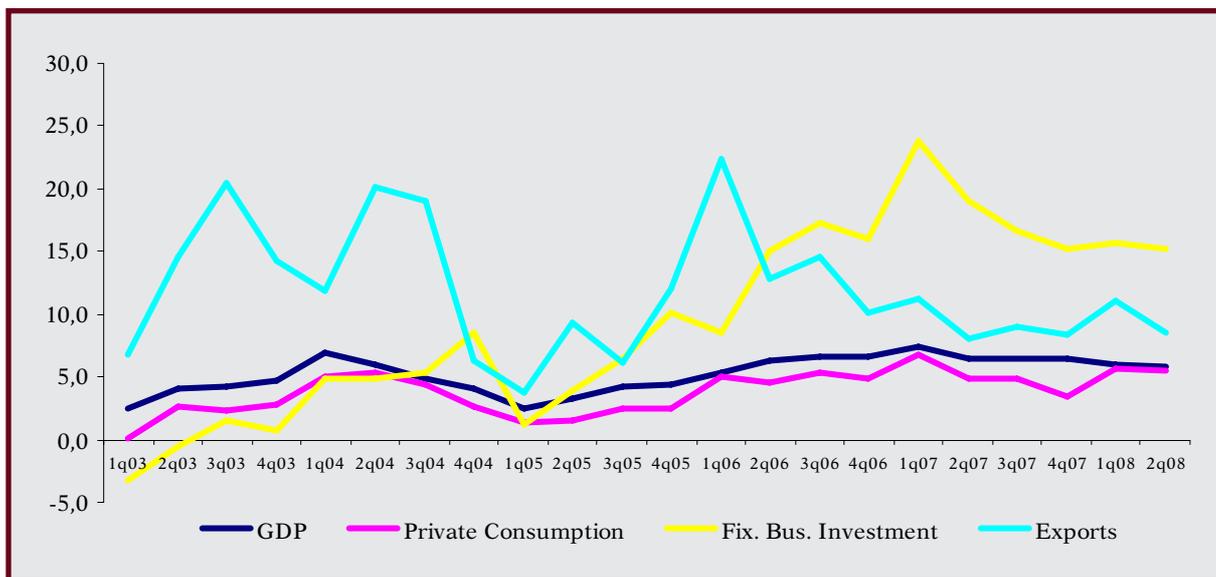
Global economic slowdown due to the ongoing financial crisis that reached its climax after the collapse of an investment bank, Lehman Brothers, started affecting Poland in the 3Q2008. Yet, the financial channel played a rather negligent role, except for the stock exchange market, as the turmoil on global financial markets still left Polish banks rather as observers than participants of the crisis in the 3Q2008. However, the ripple effects of the freeze of world-wide credit markets were felt in October, when emerging markets and Central Europe as well were infected by financial contagion.

In general, there are four major channels of contagion: exports, FDI, financial contagion and psychology. The first three out four affected Polish output in the 3Q2008, with the third channel working mostly in September. First, the slowdown in the Polish economy in the 3Q2008 came from western economies through lower export growth. Year-on-year export growth in euro terms decelerated considerably in August according to the central bank data. This coincided with a drop in sold industrial output by 3.7% yoy in the same month. In effect, industrial sales increased only 3.4% yoy in the 3Q2008, compared with 8.5% yoy in the 2Q2008 and rates of growth within a range from 8.5% yoy to 9.6% yoy in the five previous quarters. This was the weakest quarterly increase year on year since the 2Q2005. On the seasonally corrected basis, industrial output rose by 3.0% yoy in the 3Q2008, compared with 7.4% yoy in the 2Q2008. Thus both series reported consistent results. New orders in industry fell by 1.5% year on year in this period, but after a considerable drop in July they grew month on month in the remaining months of the quarter. The prolonged strong zloty appreciation that was arrested at the beginning of August may have also exerted a negative impact on Polish exports growth and manufacturing output on top of the recession in the euro area and other developed economies in the 3Q2008. The weakening of the zloty in the remaining part of the quarter, however, halted a wave of casual reports how the strong zloty dents export prospects and profitability.

While the external side of the economy was suffering from the euro zone downturn, the domestic side upheld quite well though it also showed signs that worse times lie ahead. Estimated construction sales increased by 11.9% yoy in the 3Q2008, compared with 20.1% yoy in the 2Q2008 and 14.5% yoy in the 1Q2008. The drop in the rate of growth was smaller when seasonally adjusted figures are compared: 14.2% yoy versus 17.1% and 9.6% yoy, respectively. Estimated real retail turnover rose by 7.4% yoy, compared with 11.8% yoy and 15.7% yoy in the 2Q2008 and 1Q2008, respectively. Nominal sales growth decelerated while quarterly CPI inflation picked up and reached its highest levels in 2008, eroding the purchasing power of large nominal rises in pay.

Business climate in manufacturing worsened gradually in the 3Q2008, signaling that it will soon translate into softer output figures but nothing suggested an abrupt shift. October brought a disruption as under the outside pressure of the intensified global credit crunch, the sentiment indicators of the GUS (the central statistical office) declined rapidly. But they still remained in the positive territory (see Figure 2). The indicators beyond the manufacturing sector decreased slowly in the 3Q2008 whereas their performance was mixed across sectors in October. All fell, but business sentiment indicators in construction and retail trade decreased relatively little on a seasonally adjusted basis while these indices dropped considerably in transport, real estate services and financial services, the latter were under stress of mutual distrust in the Polish banking sector. Despite their significant drop financial intermediation indices remained strongly positive since they fell from high levels.

Figure 1. GDP growth factors, quarterly % yoy



On the demand side, fixed business investment should have remained the main driver of economic growth in the 3Q2008. Its tight correlation with the pace of construction output suggests that it grew slower year on year than in the 2Q2008. Firms continued projects started earlier, but became more and more reluctant to launch new ones. Net FDI inflows were lower, compared with the corresponding period of 2007 (see Balance of payments Section). On the other hand, real credit growth for firms including investment credit growth did not ease at all year on year in the 3Q2008. These three factors lead to an estimate of a moderately lower rate of fixed business investment year on year in the 3Q2008 in line with our previous forecast from PEO 2/2008 (12.4% yoy).

Smaller advances in the retail turnover in real terms point to weaker growth in private consumption year on year in the 3Q2008. Other factors also support

this view. Real average wage growth was weaker year on year than in the 2Q2008 because of a further pickup in inflation while employment gains were smaller than in the 2Q2008 so the whole aggregate of wages did not grow in real terms as fast as in the previous quarters. On the other hand the real average pension increased at the same rate. The negative contribution of net exports to GDP likely rose in the 3Q2008, based on July-August performance of trade volumes, and provided that September was not a distinct month in a negative sense in this regard.

The outlook for the 4Q2008 and beyond deteriorated rapidly in October, strongly influenced by the culmination of the global credit crisis. The two other channels: psychology and financial market contagion played a significant role in October 2008, with the financial contagion depressing the mood among economic agents. Judging by the considerable deterioration in the business sentiment, the slowdown in the 4Q2008 may be more pronounced than the one we predicted in PEO 2/2008 since the climax of the financial crisis in October 2008 did a lot of damage to the real economy world-wide and prompted a downward revision of global growth forecasts for 2009 by international institutions. The elevated inflation readings, compared to the target, and the excessive volatility of the Polish zloty make it reluctant to significantly lower interest rates in the 4Q2008 in order to boost the economy. However, with inflationary pressures abating and growth falling below potential, the central bank is likely to start a relaxing cycle in early 2009.

We reiterate the statement from PEO 2/2008 that due to the overwhelming uncertainty, caused by wild gyrations on the global financial market and at least temporary reduced access to credit, it is too early to judge whether a slowdown in Polish economic activity will be prolonged or short-lived. Much will depend on the depth of the recession in the euro zone, with which the Polish business cycle is strongly correlated. The resilience of the Polish economy to the world downturn is discussed in our Special Feature. Our GDP forecasts for 2009 have been revised downward under the pressure of a kaleidoscope of adverse events on the global scene. The baseline scenario assumes two things that Polish banks will resume lending to the non-financial sector or the state will fill this gap to some extent, and that the central bank will cut its interest rates up to 100 basis points in three to four installments. In our baseline scenario, GDP will grow slightly over 3% in the next three quarters, i. e. until the end of 1H2009, and then the economic activity will pick up rather quickly so the economy should restore its potential growth by the end of next year. We do not share the gloom that the slowdown will extend into 2010 because by that time Poland should more aptly use EU aid than now, therefore Poland's increased public investment into infrastructure, financed from the EU structural funds, should boost domestic demand. A number of deregulatory reforms on the product market will also raise the confidence in the economy and take effect by then.

Due to the short history of the market economy in Poland, the only downturn, to which we may refer as a benchmark for estimates of the potential downturn magnitude is the period of 2001-2002, but these parallels can be misleading. During the previous world-wide recession in 2001 and 2002, Polish GDP grew mere 1.2% and 1.4%, respectively, while domestic demand shrank by 1.3% in 2001 and grew mere 0.9% in 2002. Domestic demand fell each quarter year on year in 2001 only to start weakly recovering in 2002 so the data imply that net exports contributed positively to GDP in 2001. Actually, exports grew 3.1% and 4.8% in 2001 and 2002, respectively. The main reason for the stagnation in GDP and recession in domestic demand was a collapse of fixed business investment that dropped 9.7% yoy in 2001 and 6.3% in 2002. In this global slowdown the situation should be different. Domestic demand should keep relatively well

this period. In the previous downturn, it was depressed by the very restrictive policy of the central bank that intended to erase CPI inflation in excess of 10% yoy at its peak in July 2000 and jacked up the interest rates above 20%. Further, that inflation burst was unexpected so pensions dropped considerably in real terms as the compensation did not keep the pace with actual inflation that dampened the growth of personal consumption.

This time inflation is under check and it is going downward while interest rates are not excessively high and likely to drop. The cut in personal income tax (PIT) is likely to uphold personal consumption. This cut will allow consumers to pocket about 0.6-0.7% of GDP. The generous pension compensation for 2008 that also includes a component related to wage growth will push upward pensions in real terms at least as much as in 2008 when the purchasing power of an average pension rose by at least 3.5%. The time when the compensation will reach pensioners in March, CPI inflation should be lower than the 2008 average inflation rate, on which the indexation scheme is based so pensioners should feel the inflow of purchasing power. Nominal wage increases in 2009 will not match those from 2008 or 2007 as the economy is slowing and firms are reporting that the shortage of skilled labor stopped to be the most annoying barrier to running business, but the PIT cut should offset these smaller gains. Should the world commodity prices fall further, then surprise disinflation may also offset the negative impact of lower nominal increases in wages and salaries on the real gains in purchasing power and increases in prices of energy that are scheduled for the beginning of 2009. On the negative side, consumer credit expansion is likely to slow as banks will continue to tighten credit standards and limit a size of loans as well. However, potential cuts in interest rates and gradual normalization on the global credit markets, instilled by rescue programs of central banks and governments, will tend to keep credit flow to consumers. The rise in real disposable incomes may not lead to increased spending, should the consumer confidence be agitated by ongoing financial markets turmoil and a widespread feeling of uncertainty and convictions that they face a crisis.

With regard to investment, the culmination of the financial market crisis in October led to revisions of many investment plans of private firms. Their fixed business investment may drop in 2009 but to some extent it could be replaced by the public investment into infrastructure provide that the government will step up efforts to fully use the structural funds from the EU. This increase in public investment would support construction sector and exert multiplier effects on the economy. The bottom line is that domestic demand should remain the more supportive for GDP growth in 2009, the higher the public investment will be. In contrast, foreign demand will likely drag Polish economy down. However, there is also a silver lining to this. In the previous global downturn, Polish exports continued to grow despite the fact the zloty experienced a strong real appreciation at that time. Definitely, one reason for this was that companies could not switch their demand to the domestic market because it was not simply there. This time is different, domestic demand should act as a buffer so companies may attempt to redirect sales of their output to Poland. On the other hand, the zloty appreciation is gone and the zloty is not overvalued now so this factor will not act to hurt export profitability. Further, Polish companies still retain their competitive advantage despite the strong rises in wages because most of them were a correction movement toward the equilibrium. The share of labor costs in Poland is the lowest among EU countries (see the section on Labor Market in PEO 2/2008).

In our worse case scenario, when commercial banks lending is not resumed, the central bank does not cut interest rates and the global economy plunges

in the worst post-war recession, Poland would stagnate in the 1H2009 to start a gradual recovery in the 2H2009, but potential GDP growth would not be restored until the middle of 2010.

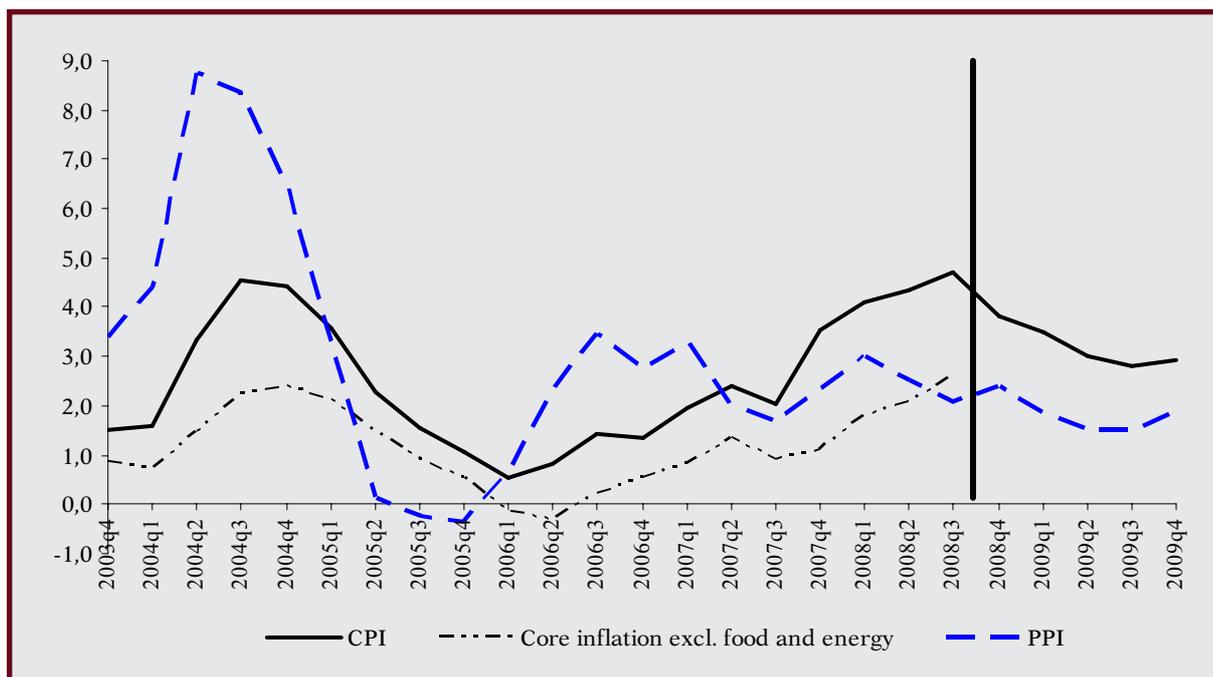
Inflation and Monetary Policy

Current situation

Inflation grew in the third quarter 2008 to 4.7% yoy – the highest since 2001 – largely on the back of rising prices of energy and services. However, viewed by months inflation entered a falling trend after it peaked in July/August at 4.8%. Food inflation fell for the second subsequent quarter to 6.6% yoy in the third quarter, benefiting from significant price declines in the markets for meat, dairy products and fruits. Energy remains the major source of inflationary pressures with all energy carriers posting significant price increases in the third quarter and the total energy aggregate soaring at 11.1% yoy – the highest annual dynamics for more than 10 years.

The net effect of the deceleration of food prices, coupled with the acceleration of energy prices, was neutral and consequently, the core inflation without both components closely followed the developments of the headline CPI – albeit at the level of about 2 percentage points below the CPI (see Figure 2). This measure of core inflation rose to 2.6% yoy in the 3Q2008 (highest since 2002) pointing to rising inflation of the remainder of the consumer basket composed of non-food industrial goods and services. Out of the two components, prices of services have indeed continued accelerating during last couple of quarters peaking at 4.7%¹ yoy in the 3Q2008 – up by more than 2 percentage points since the 3Q2007 and highest since 2001. On the other hand, the component of non-energy industrial goods decelerated markedly in the 3Q2008 to -0.7% yoy, pulled down by competitive imports from Asia whose disinflationary effect in the euro area (0.7% yoy in the 3Q2007) was magnified in Poland by the appreciating zloty against the euro by 13% yoy in the 3Q2008.

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



¹ Based on the Harmonized Index of Consumer Prices, HICP.

Prices of services continued to rise faster than the average inflation as a result of the substantial increase in the cost of business across the economy, including growing wages, energy prices, transportation and other related costs. This cost-push factor coincided with the strengthening demand-pull factor as Polish consumers enjoying rapidly rising disposable income, spend more on a variety of services. This has resulted in a sharp acceleration of inflation in catering (6.7% yoy in the 3Q2008 compared with 3.7% in the 3Q2007), recreation and culture services (0.7% vs. -1.9%), transportation (6.9% vs. 1.3%) and education (3.6% vs. 1.5%).

Other important core inflation measures such as the one excluding administrative prices and the trimmed mean rose as well in the 3Q2008 to 4.3% and 4.7%, respectively, largely converging to the headline inflation. This means that the pro-inflationary role of administrative price increases is wearing out and the free-market share of the consumer basket registers comparable price dynamics. On the other hand, the near-equality of core inflation and the CPI suggests that inner core of the distribution of all price changes does not deviate from that of the group composed of the two extremes: highest rises and sharpest falls. This clearly points to the evening-out of inflationary pressures and spreading of the initial supply shocks across most sectors.

The producer price index, PPI, continued to register very low dynamics dropping further from 2.5% yoy in the 2Q2008 to 2.1% yoy in the 3Q2008 on the back of the sharp decline of inflation in manufacturing which decelerated to 0.6% yoy in the third quarter. Such a low inflation in manufacturing industries was brought about by the combination of a weaker external demand for Polish products as well as marked falls of most raw material prices in recent months (including oil, metals, agricultural raw materials), reinforced by the appreciation of the zloty. This led to zero-inflation or deflation in major Polish manufacturing industries (metal products, machinery&equipment and transportation equipment) and significant deceleration in other important sectors (foodstuffs, coke and oil processing). In line with global developments, prices were growing much faster in mining and quarrying (11.1% yoy in the 3Q2008) and the energy sector, which saw its inflation jump to 9.4% yoy in the 3Q2008, the highest rate of growth since 2001.

Forecast

In comparison to the previous issue of the PEO we lowered our inflation forecast by 0.2 and 1.1 percentage point in the 4Q2008 (for CPI and PPI, respectively), and by 0.8 and 1.4 percentage point on average in 2009 for respective indices. The underlying reasons are the deepening global financial crisis, pushing prices of raw materials down and reducing demand for Polish products both from abroad and from the side of Polish consumers.

Prices of agricultural raw materials have ceased to be a major inflation risk as a good harvest coupled with a global slowdown brought them down to levels prevailing in 2006/07 and is likely to depress them further in 2009. The Polish market mirrors these processes with most procurement prices registering sharp declines in recent months (wheat, corn and milk were down by 38%, 30% and 18.5% yoy, respectively, in September), bound to reflect in retail prices of related foodstuffs in the near future.

Likewise, prices of oil and gas halved since their peak in July this year with the current gloomy global economic outlook pushing them further down and making it likely for both energy sources to reach their levels from 2005/2006. However, somewhat detached from the global trends, end-2008 and early 2009 will be marked by increases, rather than falls of retail prices of

electricity and gas in Poland in line with the formal approval by the Agency for Energy Regulation of the previously submitted rate increase requests by major energy generation and distribution companies.

The exchange rate became one of the major risks related to the inflation forecasts for 2008-2009. The sudden depreciation of the zloty in the third decade of October triggered by the financial crisis in Hungary and increasing global instability raises questions about the durability of this trend and hence its effect on the price level. Zloty bounced back somewhat towards the end of the month but a minor risk about its behavior in the short and medium run remains. In case of the prolonged depreciation of the zloty prices of industrial goods – a major disinflationary factor for a long time- will visibly increase their dynamics adding to inflationary pressures across the economy. A major risk is the magnitude and length of the global and European economic slowdown that will inevitably work in the opposite direction, putting a downward pressure on prices as producers will be struggling to sell their products both abroad and in the domestic market and will therefore be forced to cut prices.

We believe that the balance of all those risks coupled with sharp declines in the world prices of raw materials will translate into a significant slowing of inflation in Poland. Inflation will fall sharply in the fourth quarter of the current year to 3.8% yoy, partly as a result of the „base effect”, and decline even more in 2009 to about 3.0% on average. The annual growth rate of the PPI will fall even more as global recession is expected to depress producers prices sharply amid rapidly declining commodities prices. In line with these trends we slashed our forecast to 2.5% in 4Q2008 and 1.7 % on average in 2009.

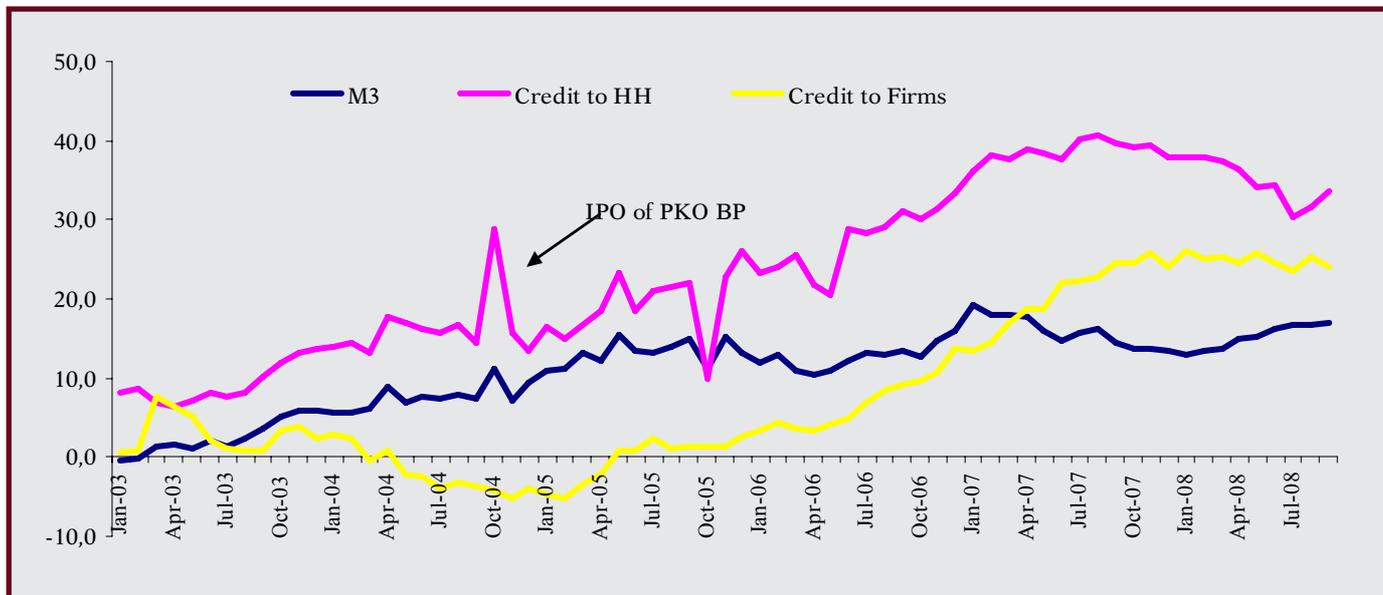
Monetary Developments

Nominal monetary expansion as measured by broad money continued to accelerate in the 3Q2008 as M3 rose by 17.3% yoy in September compared with 16.3% yoy in June and 13.6% yoy in March 2008. One could think that in real terms money growth declined due to the increase in inflationary tensions. However, in similarity to the 2Q2008, the monetary pickup in the 3Q2008 more than offset the simultaneous increase in the inflation rate so M3 grew by 12.3% yoy in real terms at the end of this period versus 11.2% yoy in real terms at the end of the 2Q2008 in June. On average it rose by 11.7% yoy in the 3Q2008, compared with 10.7% yoy and 9.2% yoy on average in the 2Q2008 and 1Q2008, respectively. Due to this trend, monetization of the economy has kept on increasing quite sharply.

Stronger growth in M3 in the 3Q2008 than in the first two quarters of the year resulted from a further increase in household deposits due to rising deposit interest rates in the environment of collapsing and volatile stock markets; household deposits grew by 23.9% yoy in September 2008 while they increased at the rate of 8.1% yoy in September 2007, i. e. about the time when the global financial markets turmoil broke out. Households continued to withdraw assets from investment funds and directly from the stock market, and deposited them with banks as time deposits, which rose 26,4% yoy in September 2008, at the highest rate since December 2000. In September 2008, households most likely started switching demand deposits into time deposits as well since the former declined quite rapidly. Deposits of firms grew by 3% in the 3Q2008 from the 2Q2008 but their rate of growth was moderate 7.1% yoy, close to the average rate in the first nine months of 2008. Deposits of firms continued

to grow at the slowest year-on-year pace since 2002. It is still premature to say whether a strong pickup in demand deposits was a sign of hoarding money by firms after the collapse of an investment bank Lehman Brothers because liquidity dried up. Monthly increases of such magnitude occurred in the past, e.g. in May 2008 or June 2007, and may be related to the fluctuations of cash flows.

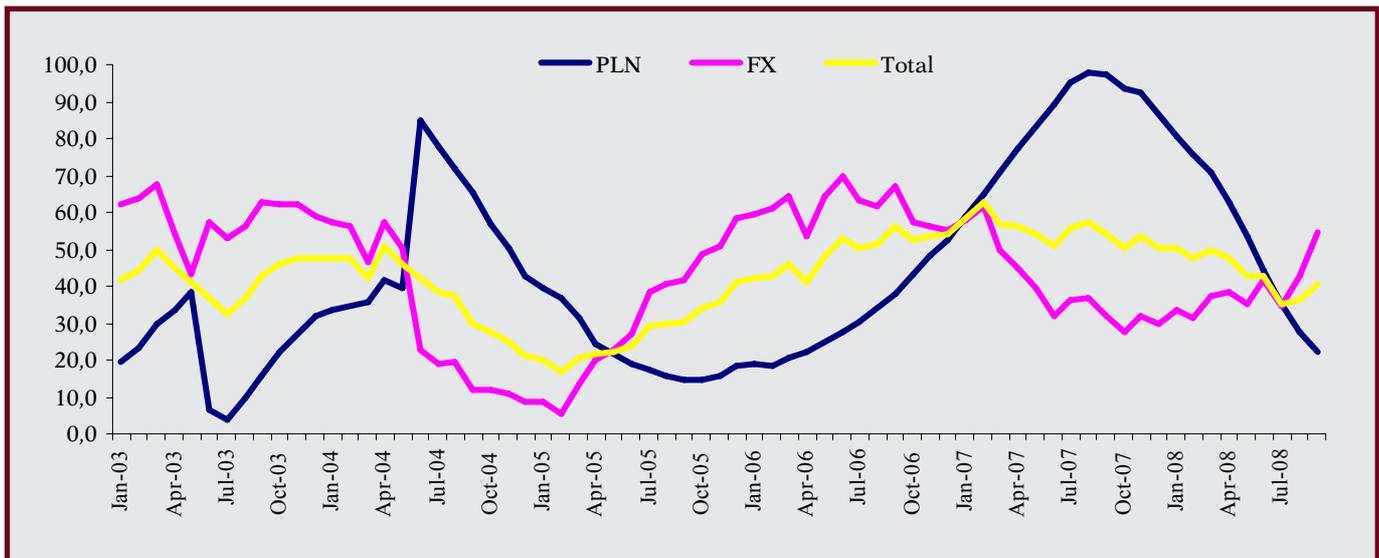
Figure 3. Broad Money and Credit Expansion, % yoy



The global financial crisis did no harm to credit volumes in Poland even at the end of the 3Q2008, i. e. in September 2008 as figures point to; despite ongoing moderation, the credit was still booming. Polish interbank market did not feel any disruptions until October 2008 and all the talk and efforts to tighten credit standards by banks did not exert a visible impact on credit dynamics. After an initial year-on-year drop in July, credit to households started accelerating again year on year in nominal and real terms in the 3Q2008. Its rate of growth was 33.5% yoy in September versus 34.4% and 37.4% in June and March, respectively, so the pace of a slowdown decelerated (Figure 3). The break in moderation is likely related to effects of the zloty appreciation that offset the impact of slightly higher interest rates in the 3Q2008 and encouraged households to apply for more mortgages. It is true that growth in housing credits decelerated further to 40.6% yoy in September from 42.5% yoy in June 2008 and 53.8% yoy a year ago but the decline slowed as foreign currency denominated housing credits, mostly denominated in the Swiss franc, grew 54.4% yoy in September, the strongest rate since January 2007.

Loans to firms increased by 24.1% yoy at the end of the 3Q2008, compared with 24.5% yoy in June 2008 and 24.7% yoy in September 2007. Broadly speaking, the real credit expansion to firms was little changed in the 3Q2008 as the producer price index increase stabilized. a sign that firms did not downsize their plans due to more expensive cost of credit or a gloomier outlook for the world economy and prospects of its adverse impact on the Polish economy.

The lack of a direct exposure of Polish banks to asset-backed securities and in particular, to the subprime mortgage market in the US has been instrumental, together with strong economic growth and inflation in check, to their stable financial performance. The after-tax income of Polish banks rose

Figure 4. Housing Credit Credit Growth, % yoy


by 20.5% yoy in the 1H2008, contrary to global trends. ROE of the Polish banking sector at 22.9% was the same as in the 1H2008 as in the 1H2007. Irregular credits stood at a record low of 4.8% of the total credits at the end of the 1H2008. The ratio of non-performing loans for the households was even lower at 3.8% and the non-performing foreign currency credits amounted only to 0.7%. Total irregular credits less provisions stood at 12.2% of bank capital. However, the volume of irregular credits showed a steep upward trend in the 1H2008 though this observation is related to the zloty ones only.

Fiscal Developments and Policy

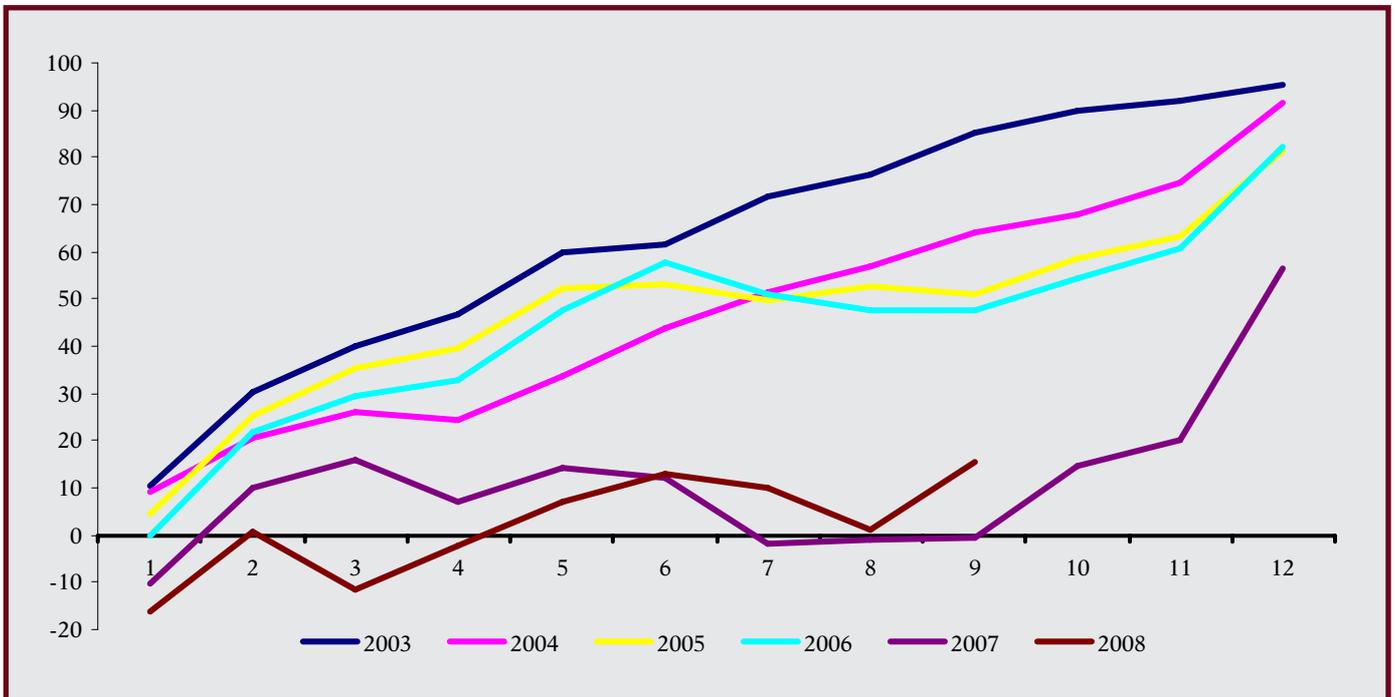
The central government cash budget registered a deficit of 4.2 bn zlotys or 15.6% of the 2008 plan in the first three quarters of 2008, compared with the initial Ministry of Finance (MoF) projections of a 16.7 billion deficit, equivalent to 61.7% of the 2008 plan. This plan amounts to 27.1 billion zlotys. The state revenue came close to 192.4 bn zlotys in January-September 2008, below expected 202.7 bn, projected by MoF in its 2009 state budget draft. This gap amounted to approximately 0.6% of 2008 GDP, projected by MoF. The state expenditure at 196.6 bn zlotys in January-September 2008 was short of the planned 219.4 bn in this period by 22.8 bn zlotys or almost 1.8% of 2008 GDP. This explains, why the three quarter deficit was so low, just 0.3% of 2008 GDP.

Each month since March 2008, the state budget revenue has come lower than projected by MoF, with the exception of July, when the outcome matched projections. This occurred despite that economic growth was stronger than expected, a piece of evidence that the revenue was overoptimistically projected in the 2008 budget bill. The discrepancy between plan and the actual performance tended to increase each month in the 3Q2008.

The central government revenue rose about 10% yoy in January-September 2008 versus the planned 15.9%. Tax revenue projections were missed in the case of indirect taxes whereas they were met in the case of income taxes. In particular, the collection of VAT

increased 9.2% yoy in January-September while the state budget bill provides for a rise of 15.9% in 2008 versus the actual collection in 2007. The state income from excise taxes rose by 4.9% yoy in the first three quarters of 2008 versus the projection of 6.5% for the entire year, using the same benchmark. The revenue from corporate income tax (CIT) grew by 16.6% yoy in January-September 2008, compared with a 10.6% projection for 2008. MoF blamed the payouts of tax credits for children for the relatively soft performance of the personal income tax collection (PIT) in the 1H2008. The end of them brought a moderate increase in the dynamics of the PIT collection, which reached 7.3% yoy in the first three quarters of 2008, compared with the projection of 2.2% for 2008. Due to the fact that the global slowdown was finally transmitted to Poland in October, when the world-wide financial crisis peaked, economic expansion will likely deteriorate in the 4Q2008, therefore it would be overly optimistic to count on a pick up in tax collection growth rates in this period.

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



Altogether tax revenues reached 71.8% of the 2008 government projections in January-September 2008, down from 78.3% in the corresponding period of 2007, but on par with same period of 2006. The amount of the EU unrequited transfers that the central government received in the first three quarters was low 37.5% of the 2008 projections of 35.3 billion zlotys. Thus, a large rise of them, especially of inflows related to Common Agricultural Policy, should be expected in the 4Q2008, which will help improve the balance. If the rates of growth of tax revenues from January-September are extrapolated to the 4Q2008 then the tax revenue for the whole year would underperform the projections by 3.6 billion or 0.3% of GDP. Yet, it may prove too optimistic to forecast that taxes will grow at the same pace in the 4Q2008 as in the first three quarters of 2008 since the economy is slowing, impacted by the worldwide downturn.

It is evident that the burden of keeping the deficit in check in 2008 fell on the expenditure side. The central government spending amounted to 63.6% of the 2008 annual plan in January – September of 2008, down

from 67.5% and 70.3% in the corresponding periods of 2007 and 2006, respectively. It rose by 12.5% yoy in the first three quarter of the year, compared with the 2008 annual plan of 22.5% despite the moderate acceleration in the 3Q2008.

Much of this restraint was not on purpose as the data point to: the government spent only 35% of means, earmarked for funding projects with EU financing, through September 2008. Spending on the EU related projects amounted to 15.9 billion zlotys. Had these funds been spent in line with the lapse of time, the central government expenditure would have been higher by some 17 billion zlotys through September 2008. Further, expenditure on fixed investment projects was mere 34.7% of the 2008 plan through September. There had not been any overruns in other important positions in the first three quarters of 2008. Subsidies to social security funds were only a bit higher relative to the 2008 plan than in the same period of 2007. The proportion of the general subsidy for local governments to plan was the same in January-September 2008 as in the corresponding period of 2007 while the ratio of public debt service to plan was lower than in the corresponding period of 2007.

The state expenditure will likely be stepped up in the final months by larger amounts than those predicted in the original spending timetable, so the budget expenditure and the shortfall will rise more than this amount. If 2007 were to be a guide in this respect, one should add some PLN 8-9 billion to the original schedule of expenditure in the 4Q2008. Assuming as well that the tax revenue will grow at the same rate in the 4Q2008 as in January-September the cash deficit would reach 24 billion zlotys or 1.9% of GDP in 2008. MoF expected at the beginning of November that the cash deficit would be 23 billion in 2008.

The 2009 state budget draft provides for revenues and expenditure of 269.9 billion and 288.1 billion zlotys (excluding EU related items), respectively, resulting in a deficit of 18.2 billion zlotys or 1.3% of GDP in 2009. This draft assumes that GDP growth would be 4.8% while CPI inflation would not exceed 3%. The former assumption, which MoF has refused to revise down so far, seems overly optimistic in the light of a rapidly deteriorating world economy, shaken by the financial crisis, and emerging signs of a slowdown in this country because of that. MoF has signaled that it will likely revise its macroeconomic assumptions of the 2009 state budget draft once financial markets calm down and the situation in the world economy stabilizes to allow for a credible revision. Assuming 3% GDP growth rate in 2009, 2.9% growth of the GDP deflator, the same elasticities of tax revenue with respect to domestic demand in the case of indirect taxes and the same elasticities with respect to GDP in the case of income taxes as in the state budget draft, the tax revenue would fall by 5 billion zlotys or less than 0.4% of 2009 GDP, projected at 1357 billion zlotys. Assuming that all other revenue and expenditure would fall in line with the state budget draft, the cash deficit would stand at 23.2 billion zlotys or 1.7% of GDP. This should not lead to a breach of the 3% Maastricht criterion for the broad deficit.

Labor Market

Employment

Employment in the so-called enterprise sector (the companies employing more than 9 workers) increased by 4.3% yoy in the 3Q2008 as compared to 5.2% in the 2Q2008 and reached 5404 thousand persons. It is the continuation of the reversed trend that started in the 2Q2008, when employment growth stopped to accelerate and started to decelerate.

In the previous issue of PEO, we expected that this worsening of employment dynamics did not need to be a one-off phenomenon. At first, it is related to the deterioration in the business environment. Now, this trend will most probably strengthen even further due to the critical situation in the world finances, which is expected to harm also the real economy in Poland.

Employment growth decelerated in all important sectors, including manufacturing. The number of employees in this sector grew by 3.6% yoy in the 2Q2008 and only by 2.0% yoy in the 3Q2008. Employment growth decreased also in construction (from 9.5% yoy to 8.4% yoy), retail trade and consumer services (from 8.0% to 7.7%), business services (from 9.7% to 8.5%) and transport and communications (from 4.1% to 3.8%).

Labor Force Survey (LFS) figures for the 2Q2008 were still positive, although they also indicated a slight decrease in the job creation. Total employment in the economy increased by 3.5% yoy, compared to 4.5% yoy in the 1Q2008, reaching 15689 thousand persons. The employment rate – the share of the total number of employed in the working age population (15-64) – reached 58.9%, as compared to 58.0% a year earlier.

The good news is that the level of economic activity of the population, which has started rising only lately, is still increasing. The number of active population in the 2Q2008 increased by 0.8% yoy and reached 53.9%. It seems also very important that the level of economic activity increases mainly among the older part of the labor force (45-59/64) – by a 1 percentage point yoy from 60.8% in the 2Q2007 to 61.8% in the 2Q2008). It gives a preliminary piece of evidence on the effectiveness of recent policy changes such as limiting the number of new disability pensioners, aiming specifically at increasing the level of economic activity among the elderly. Activity increases for other age groups are much smaller (0.2-0.3 percentage points) and the level of economic activity for the youth (15-24 years) actually decreases, (from 32.4% in the 2Q2007 to 32.2% in the 2Q2008).

Despite the last turmoil in the world economy and expected slowing down of GDP growth in Poland, we still expect that both employment in the enterprise sector and the overall LFS employment figure will keep rising, albeit slowly or, at least, will not start decreasing in the near future. The pace of growth, however, will decelerate more than we expected in the previous PEO issue. In the 4Q2008, the enterprise sector employment growth should fall to about 3-3.5% yoy. We estimate that the LFS employment growth in the 3Q2008 fell to 2-2.5% yoy. In 2008, employment in the enterprise sector will grow on average by 4.5%, the LFS employment will grow at the average rate 3-3.1% yoy. We expect that in 2009, the employment in enterprise sector will grow on average by only 0.9% yoy and LFS employment even less – by 0.2-1% yoy.

Wages

Nominal wages are still increasing rapidly, although it seems that observed reduction of labor demand growth and expected economic slowdown slightly

eased the wage pressure. In the 3Q2008, the average nominal wage in the enterprise sector was by 10.7% higher than in the 3Q2007, while in the 2Q2008 the y-o-y increase was 11.7% yoy. The rate of y-o-y growth of nominal wages actually decreased for the first time since the beginning of 2006. Real wage dynamics in the 3Q2008 also decreased to the y-o-y rate of 5,8% (from 7,1% in 2Q2008).

The growth rate of nominal wages decreased in all sector except for communal services where it increased from 7.4% to 12.6% yoy in the 3Q2008. The wage dynamics in manufacturing decreased from 11.3% in the 2Q2008 to 10.1% in the 3Q2008. The deepest reduction was recorded in construction, the sector with the fastest growing wages for last 2 years. In the 3Q2008, nominal wages in construction grew by "only" 12.8% yoy as compared to 15.9% yoy in the previous quarter. It seems to be related to the general worsening of situation in construction and property businesses in countries hosting the most of Polish emigrants – UK and Ireland and following returns of migrants. This tendency should even strengthen as the result of financial crisis.

We expect that the gradual easing in the tightness of labor markets will result in a serious slowdown of wage dynamics, although one can not expect that nominal wages in Poland will stop rising in the near future. Average nominal wage growth in the 4Q2008 should fall to around 8.8%-8.9% yoy. It will result in real wages growing at 4.6% yoy. On average, nominal wages will grow in 2008 by 10.6% and real wages by 6.1%, whereas in 2007 the corresponding growth rates were: 9.1% and 6.5% respectively. In 2009 the nominal wages can still grow on average by 8.2% yoy.

Unemployment

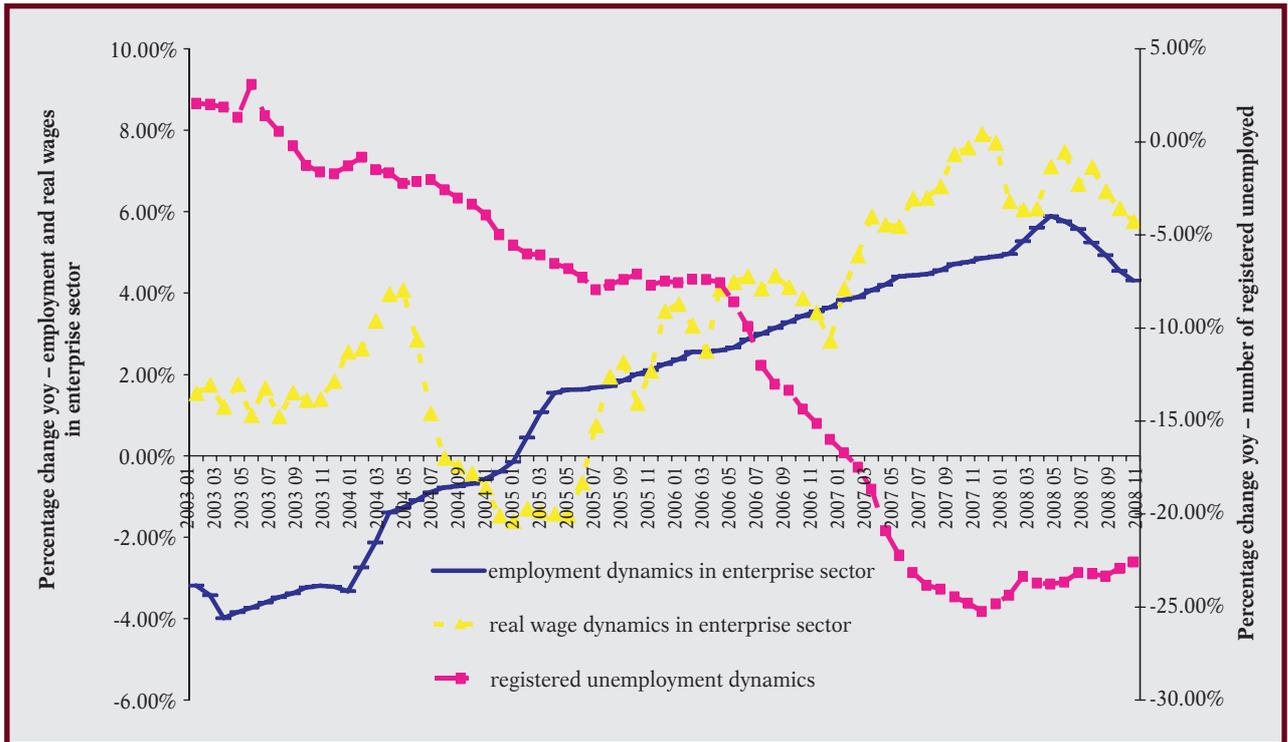
The pace of unemployment reduction decreases. In the 3Q2008 number of registered unemployed persons fell to 1.38 million. This meant a y-o-y reduction of 22.6%, compared with a 23.2% yoy reduction in the 2Q2008 and 23.8% in the 1Q2008. The registered unemployment rate fell by 2.7 percentage points yoy to 8,9%.

The other information coming for PES is not encouraging, either. The number of unemployed finding new jobs continues to fall (by 14.6% yoy in the 3Q2008). So does the number of new vacancies, it dropped by 3,3% yoy. The numbers of unsubsidized placements (ie. jobs that are not co-financed by PES) and unsubsidized offers fell even more – respectively by 18.3% yoy and 8.7% yoy.

The LFS (Labor Force Survey) figures for the 2Q2008 were still optimistic. The number of unemployed fell by 25.3% yoy, as compared to 28.1% in the 1Q2008, reaching 1196 thousand and the unemployment rate fell by 2.5 percentage points yoy, reaching the record low of 7.1%. According to the new EUROSTAT data the seasonally adjusted unemployment rate in Poland (also based on LFS) fell in September to 6.5% – it is not only below the euro area average rate, but also below the average rate for EU27. On the other hand, the dynamics of unemployment reduction continues to slightly decelerate as it did in the 1Q2008.

We expect the registered unemployment to increase till the yearend to the level of 8.9%. It will result both from a general worsening of the economic situation in Poland and from cyclical phenomena. The LFS unemployment will continue to fall in the 3Q2008, reaching 7.0%, but it should also increase to 7.3%-7.5% by the end of the year. Both, registered and LFS unemployment will stabilize or grow slightly in 2009. We expect the registered unemployment rate to reach 9.3-9.5% at the end of 2009, while the LFS unemployment rate should stabilize at 7.5%.

Figure 6. Employment, unemployment and real wage dynamics in enterprise sector, % yoy



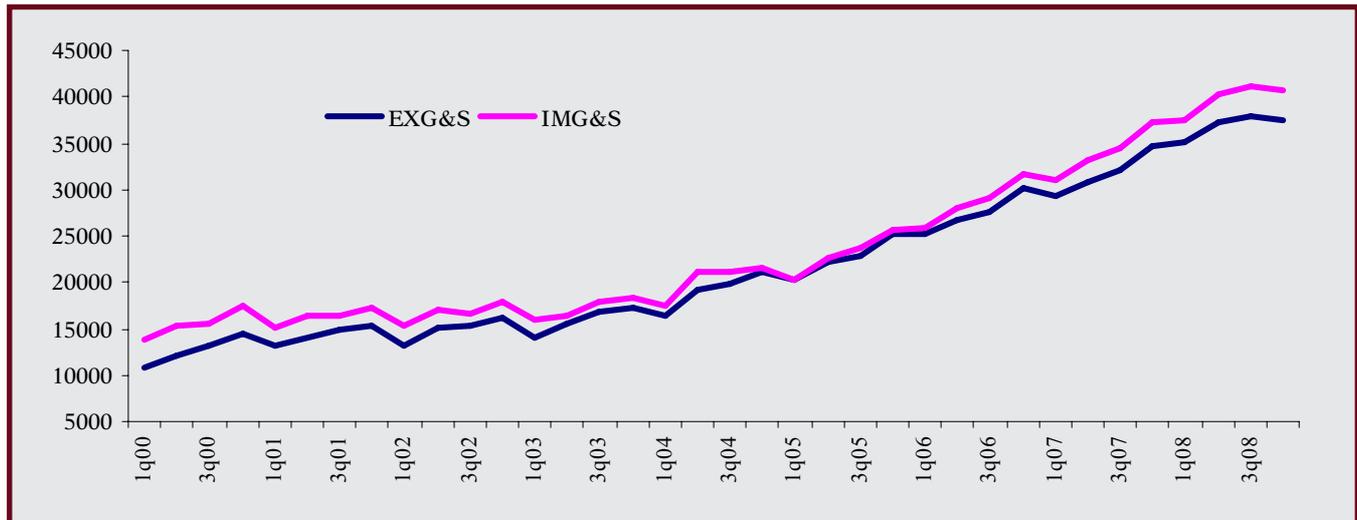
Source: Own calculations based on Statistical Bulletins of Polish CSO (GUS).

Foreign trade and balance of payments

Exports and imports continued to slow in the 3Q2008. As reported by the NBP, the zloty exports and imports grew by 3.6% yoy and 4.7% yoy in the 3Q2008, respectively, compared with the respective growth rates of 8.4% and 8.9% yoy in the 2Q2008. We report export and import growth in the zloty since they seem to be the closest approximations of the changes in trade volumes, which are not available. The zloty appreciated against the euro and the dollar yoy so the statistics, expressed in these currencies, capture this phenomenon and overstate volumes. Deceleration is much smaller, when the euro terms are considered – exports and imports increased by 18.7% and 19.9% yoy, respectively, in the 3Q2008 versus 20.9% and 21.5% yoy in the 2Q2008. The continuity of exports and imports to rise in a lockstep is striking.

When one turns to the CSO data on the merchandise trade, one can trace the geographical breakdown of trends. Unfortunately, only the data on July and August were available as of writing. In the zloty terms, exports were the fastest growing to the developing countries and Eastern Europe while they grew the slowest to the euro zone so the tendencies were highly correlated with the rates of economic growth in the main destination regions. The euro area has been continually losing its share in total exports of Poland: this share fell to 51.1% in January- August 2008 from 52.8% in the corresponding period of 2007. The fastest growing markets continued to be Russia and Ukraine, but this was before these countries experienced financial markets turmoil.

The estimated four-quarter current account deficit reached 5.0% of GDP in the 3Q2008, compared with 4.9% in the 2Q2008 and 4.7% at the 2007 yearend. Revised NBP data point to a rapid increase in the deficit in 2007 whereas they show a slow upward trend in the ratio in 2008 on the back of the rapidly widening trade deficit from a year ago. On the quarterly basis the

Figure 7. Exports and Imports of Goods and Services, quarterly, EUR million


*) forecast

Source: NBP

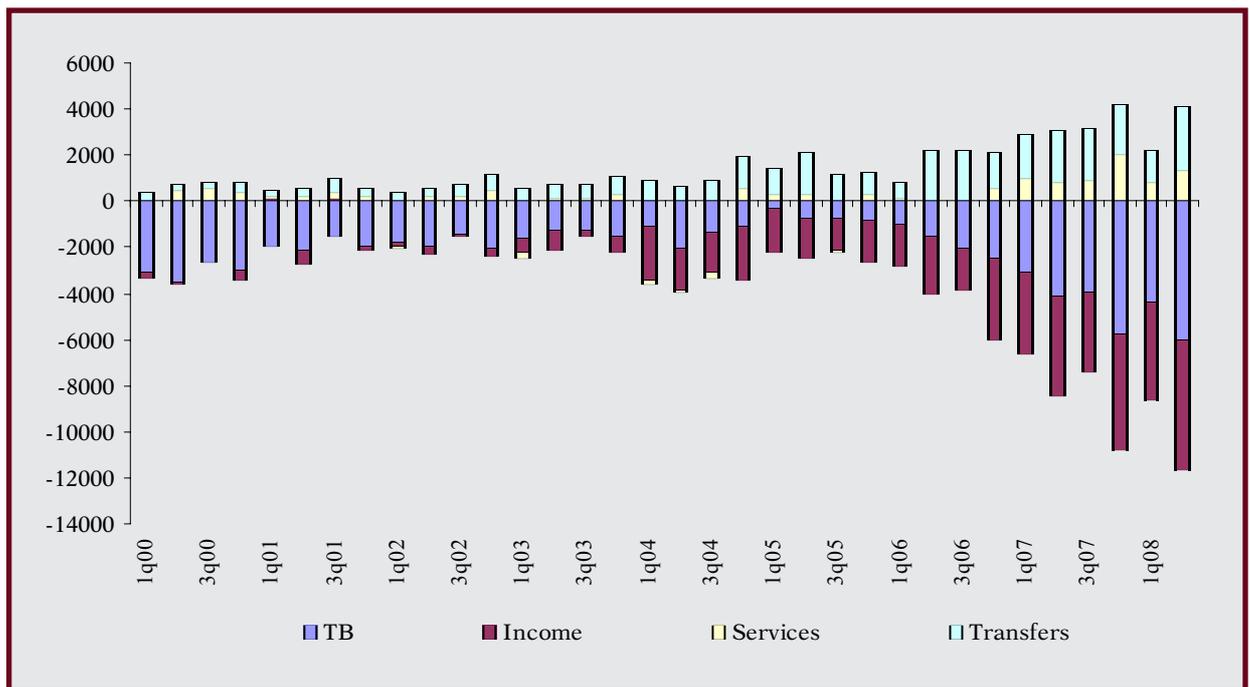
trade deficit did not grow in the 3Q2008, but it would be premature to draw any conclusions from this fact. In this period, NBP exports in the euro terms did not show any weakness despite a recession in the euro zone while imports were highly correlated with them. We are expecting a slowdown in exports to show up in the statistics in the coming quarters as companies have been reporting dwindling external orders for a few months. But we do not forecast a further considerable deterioration in the trade deficit because the rapid depreciation of zloty on the back of the financial crisis restored the competitive edge of Polish companies while imports of commodities will be much cheaper and investment imports will likely decline as many projects will be postponed until better times. Further, Poland will likely use a larger portion of the EU funds than in 2008, which will tend to improve the current account deficit. Taking all factors into consideration, we now forecast a weak downward trend of the current account deficit in 2009.

Figure 8. Real Effective Exchange Rate of the Zloty, CPI deflated


Source: ECB

The deficit should not pose a problem to be financed even under the circumstances of low liquidity of international financial markets, since its portion of roughly 1.6% of GDP was financed by the capital account inflows in the four quarters running through the 3Q2008. These inflows almost entirely consist of the EU funds that, in theory, may be subject to a reimbursement if rules of their use were breached. This explains, why they are not classified as unrequited transfers, registered on the current account. In practice, this mishap is highly unlikely so they cushion the current account deficit and financing needs from market sources are much lower. If the four-quarter current account deficit were adjusted for the capital account inflows, it stood at 3.4% of GDP in the 3Q2008.

Figure 9. Current Account Breakdown, EUR billion



Like in the 1Q2008 and the 2Q2008, net FDI inflows were lower in the 3Q2008 than in the corresponding quarter of 2007. However, no declining tendency from quarter to quarter could be detected, an encouraging sign that the inflows steadied after a drop to lower levels at the beginning of 2008, caused by the diminished growth prospects in the source countries. Net FDI inflows were down by 31% yoy in January-September 2008, but, interestingly, the outward investment that grew by almost 160% or 1.6 billion euros is more responsible for this than the lower inward FDI, which declined by 13.1% or 1.5 billion euros. The role of financing the current account by the net incoming flows of FDI decreased considerably in 2008, since they financed roughly the total deficit in the whole 2007. In the 3Q2008, these flows covered only about 56% of the four-quarter current account deficit and about 55% in the 3Q2008 alone. This would suggest that they stabilized. However, a rapidly degrading outlook for 2009 in the global economy may induce a further decrease in these inflows since many projects are related to exports either of goods or services. On the other hand, Polish companies may also cut their outward FDI since growth prospects in the EU countries and Eastern Europe are deteriorating. This would mitigate the decline in the net incoming FDI.

Resilience of the Polish Economy to the Global Credit Crunch and Downturn

Blind panic that spread on financial markets in October 2008 seems to be abating as the disastrous collapse of the global banking system has been averted, but the volatility of asset prices remains wild, in particular on stock exchanges. In October, contagion spread to emerging markets and Central Europe as well. This time ECB, national central banks and IMF acted promptly to assure liquidity to vulnerable countries such as Hungary and Ukraine so risks of country defaults have eased while the selloff of assets has been arrested and their prices partially recovered. The financial contagion reached Poland as well despite its solid macroeconomic fundamentals; banks were infected by the lack of confidence so the interbank market was temporarily paralyzed, the zloty depreciated rapidly, when investors withdrew their funds while the stock exchange indices dived along with world-wide trends. These events are the reason that we discuss the resilience of Polish economy to the financial crisis.

In sum, Polish economy should cope rather well with the impact. With regard to the banking sector, its sound financials should be emphasized; banks had record profits, they remained well capitalized after the inception of Basel 2 capital standards and the share of irregular credits was the lowest in the transition history in the 2Q2008, the last quarter for which the figures are available (see section Monetary Developments for more detail). Therefore they had no reason to stop lending to the nonfinancial sector. The main channel of contagion in emerging markets was the withdrawals of funds by investors and the lack of access to foreign currency by domestic banks. Poland's needs for foreign currency are one of the lowest among Central European Countries. Except for the largest bank, PKO BP, all other large banks are owned by banks from the euro area with the exception of one bank that is owned by Citi Group from the USA. In theory, this ownership structure should give Polish banks the access to foreign currency swaps should they need the euros or the dollars to fund their credit expansion. After the Lehman Brothers failure, parent companies of Polish banks have been hoarding cash so they could supply their affiliates with liquidity if they wanted. On the other hand, one cannot exclude a situation, in which battered parent banking companies will ask their daughter banks to fetch liquidity to the detriment of liquidity of the Polish banking system. This risk is hard to evaluate. The NBP staff writes in its latest report on financial stability from October 2008 that this risk is limited due to the supervision of banks and the legal responsibility of management boards of Polish banks. A potential reduction in the credit limits among parent banking companies due to mutual distrust, may affect capabilities of Polish banks to hedge their exposition to the currency and interest rate risk.

The issue of foreign currency credit has been a matter of concern, but this issue seems to be overblown. Foreign currency credits amounted to 28% of the total credit outstanding at the end of September 2008. Most of them are long-term credits so massive withdrawals, which could shake the Polish currency for good, are unlikely. The economy is rather little leveraged despite strong rates of credit growth in the recent years since credit started growing from a low base (Table 2). In September 2008, total credit to the economy was about 40.7% of 2008 GDP, projected by CASE in 2008, and the foreign currency credit stood at 11.4% of it. This rather low monetization of the Polish economy acts as a buffer. It is true that the access to cheaper foreign credit may become much more difficult right now, as foreign parent banking

companies are hoarding cash, but relatively small needs of domestic banks could be met by the central bank from its foreign currency reserves in emergency and foreign currency swaps, arranged with foreign central banks in particular with the Swiss National Bank. Further, domestic companies seeking new credit could switch to the zloty credits instead of FX credits.

Should commercial banks refuse to credit the economy, the central bank or the government through bank BGK could temporarily replace them under emergency conditions, and start granting credits directly to firms. Thanks to easing inflationary tensions in the near future, the NBP could likely issue enough central bank money to accommodate the needs of firms without risking the resumption of inflation. The potential action to accept commercial paper by the central bank, a route chosen by the USA, would not work since the market for commercial paper in Poland is only nascent and its size is very small (1% of GDP versus some 10% of GDP in the USA). However, this solution could be also used to help the largest domestic corporations with established ratings.

The needs of Polish firms for credit are unevenly distributed, the largest firms are the most leveraged while the smallest are the least. Total credit to firms amounted to 15.8% of GDP in September 2008 (Table 2). According to surveys, 64% of small and medium size firms (SMEs) do not use bank loans at all, but SMEs produce a considerable chunk of Polish output so the tightening of credit standards should not result in significant disruptions in their production as their credit needs are rather small. Further, Polish firms are very liquid on average. They hold total deposits that are close to 10% of GDP. This means that should credit be scant for a number of months they could still cope with this situation, running down their deposits. The ratio of short term assets to short term liabilities, at over 31.9% in the 1H2008, was still high despite its drop from a record high 35.4% in 2006. Therefore calling in short-term assets could be another channel of covering urgent financial needs of firms. Own funds of firms are a major source of financing investment projects, which should limit the risk of freezing them due to the potential lack of external financing should firms want to continue them.

During the panic on financial markets, countries that had higher current account deficits experienced stronger depreciation of their currencies. Poland's current account deficit has been trending up, albeit slowly as of recent, so the question whether it can be financed in a sustainable manner under current circumstances, is rightly posed. In our judgment, financing of the deficit should not be problematic in 2009. As we forecast, the deficit should stop rising in 2009 (see Balance of Payments Section) and, perhaps, start falling as a ratio to GDP on slower economic growth, in particular that of fixed business investment, and on increased transfers. This stabilization should raise confidence in the Polish economy. Net FDI inflows will most likely fall further as a cover of the deficit (they financed over 56% of the shortfall in January-September 2008, compared with almost 100% of it in 2007) so this gap should be filled by another kinds of financial flows. Since the largest part of the current account deficit is due to the trade deficit, the most important is the access of companies to export credit. This should be available for them as usual, provided that the normalization of credit markets continues. The rise in risk premia may only raise the cost of this credit. If confidence were restored to a reasonable level and risk-aversion declined, the attractive interest rate differential should keep net portfolio inflows at higher level in 2008. However, more important is the potential rise in the flow of EU funds to Poland. It usually skips attention that a large portion (one third) of the current account deficit is financed by the capital account surplus that

Table 2. Credits to nonfinancial sector, Sep 2008 (million zlotys)

	PLN	FCY	Total	FCY/Total %	total/GDP %	FX/GDP %
households	211 589	106 826	318 415	33.5	24.9	8.3
companies	163 569	39 299	202 868	19.4	15.8	3.1
total	375 158	146 125	521 283	28.0	40.7	11.4

FCY = foreign currency credits

dominantly consists of EU funds, which means financing outside of financial markets. The likely rise in the Poland's capability to use these funds will protect Poland against illiquidity of these markets in 2009. This issue is discussed in more detail in the section on the balance of payments.

The bottom line is that Poland is well positioned to weather the storm on financial markets and avoid a slippage into recession due to a relatively low leverage of the economy and moderate foreign currency needs.

POLISH ECONOMIC OUTLOOK

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 CASE – Center for Social and Economic Research,
 ul. Sienkiewicza 12,
 00-010 Warszawa, Poland
www.case-research.eu

Maciej Krzak (all other texts, Head of Forecasting Unit)
 Przemysław Woźniak (Inflation)
 Mateusz Walewski (Labor Market)

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