



EXECUTIVE SUMMARY

Economic growth picked up considerably in the 4Q09 while unemployment kept on gradually rising as GDP growth was below the potential. Recovery was driven by net exports like in previous quarters, but domestic demand supported the year-on-year growth for the first time in a year. Inflation remained elevated, buoyed by the upward trend in commodity prices, but the CPI rate hovered near the upper bound of the central bank range so no rate hikes happened or were in the pipeline. The current account deficit continued its steep downward trend in year-on-year terms thanks to the European recovery and the strong competitiveness of Polish companies underpinned by the earlier sizable depreciation of the zloty. The central government fiscal deficit fell in the 4Q09, a result of a recovering economy, but the public finances ended up the year with a gaping shortfall of 7.2% of GDP, according to the estimate. This deficit and the resulting increase in the public debt, possibly breaching a 55% of GDP threshold in 2011 that automatically would trigger austerity measures, is the sole reason threatening the macroeconomic stability and growth prospects in Poland.

We see no reason for a meaningful upward revision of our growth forecasts for 2010. In our view, a gradual acceleration in the economic activity will continue in 2010 as domestic demand whose recession terminated in the 4Q09, will strengthen as a growth factor. The major uncertainty is related to the external environment, whether the withdrawal of strong state stimuli in the world economy will be offset by an invigoration of private demand in order to make the recovery sustainable in 2011, in particular in the euro area where it has been anemic so far. Polish recovery will be based on two pillars: public fixed investment and net exports. Household consumption will remain soft until unemployment stops rising, which should be the case once GDP growth reaches 3.5% yoy, i. e. in the 2H10. In 2011, the economy is likely to grow between 4% and 5%, depending on the world economy fortunes.

The CPI inflation rate fell slightly in the 4Q09 to 3.3% yoy, down by 0.3 p. p. from the third quarter, benefiting from slowing prices of food, energy and selected services. On the other hand, continuing the trend from previous quarters, prices of industrial goods and fuel kept accelerating reflecting rising global prices of crude oil and other commodities combined with the weak zloty. Since the economy will be growing below its potential and the output gap is widening, the CPI inflation will be on a downward trend. Compared to the previous issue of PEO, we raised our forecast of the CPI slightly and markedly lowered the forecast of the PPI inflation. Our expectation of stronger consumer price growth in 2010 follows from the slightly higher-than-expected price growth in the fourth quarter (+0.1 p. p.) and the combination of a few demand and supply factors. First, higher

demand pressures will stem from the better GDP results in the third and fourth quarter combined with a slightly more optimistic outlook for the Polish economy in 2010, including the projection of faster wage growth. Secondly, upbeat economic results in the US and emerging Asia led to the upward revision of price growth for some of the key commodities, such as oil and metals.

The central bank did not change its key interest rates in the 4Q09 and in the first two months of 2010 as the output gap is large and increasing, effects of administrative prices hikes have receded, the zloty has firmed and a newly projected inflation range for 2010 has been broadly unchanged though the central path for inflation in 2010 is higher than in the October 2009 report (1.8% yoy versus 1.5% yoy). We reiterate our forecast from PEO 3/2009 that the interest rates should remain unchanged for the most of 2010, if not for all 2010. We hold a small probability of a first rate hike by 25 basis points in the 4Q10, but if the appreciation of the zloty were sustained such a hike would only be counterproductive to economic growth.

Conditions in the labor market continued to deteriorate in the 4Q9 due to sub-par economic growth, but the scale of the deterioration was lower than expected as the economy picked up and there were some positive signals as well. Due to this and the more optimistic economic forecast in this PEO, our projections regarding the situation on the labor market are also revised positively. We expect that the average LFS employment in 2010 will most likely stay at exactly the same level as in 2009, in 2011 it will re-start to increase at the average pace of 1.5%. The LFS unemployment will reach 9.9% in the 1Q2010, increasing in y-o-y terms by 1.6 percentage points. In 2010, it should stabilize reaching 9.5% at the end of the year. We expect that both registered and LFS unemployment will start falling in 2011: The registered unemployment rate should fall to about 11% at the end of 2011, while the LFS unemployment rate will probably fall back to about 8.0%.

Wage growth will be a result of two countervailing forces. On one hand, the general conditions on the labor market have started improving, and the overall economic forecast is relatively optimistic, but on the other hand, the unemployment level will still be increasing in 2010 as companies increase the work load of insiders first. As a result, we do expect wage dynamics to stabilize in the nearest future, and afterwards one may expect a flat increasing tendency. During the entire 2010, the average nominal wage growth on a y-o-y basis should not go significantly above 4% so the real gross wage will rise about 2%. Nominal wage growth should accelerate to 5% to 6% yoy on average in 2011, on the back of strengthening economic growth.

The central government cash deficit was unexpectedly low in the 4Q09 so the 2009 deficit came below projections as we had expected. However, the performance at the beginning of 1Q010

does not confirm this tendency, which is slightly unsettling. The government preliminary estimated that the ESA-95 general government deficit reached 7.2% of GDP in 2009, which is much more than we had predicted (5.8%). The details are unavailable, but the doubling of the deficit is related among others to the worsening financial situation in the Social Insurance Fund (ZUS) and local governments, the latter posted surpluses in previous years. Our forecast for 2010 is better than that of the government due to a number of factors including economic growth and higher inflation as well as the appreciation of the zloty, but the general government shortfall will stay high in 2010. We assess that the ministry-of-finance reform proposals are piecemeal and will not suffice to put the fiscal finances in order in line with the Stability and Growth Pact, i. e. to cut the deficit below 3% of GDP by the 2012 yearend. The government will avoid a breach of the 55% precautionary threshold by the public debt in 2010 though the risk will be acute in 2011.

The positive effects of the nascent European recovery became discernible in the 4Q09 as the NBP exports of goods grew 1.5%

yoy in the terms of the euro after a drop by 20% to 22% yoy in each remaining quarter of 2009. Further, the weak zloty kept on supporting exports throughout the yearend despite the appreciation of the real effective exchange rate since February 2009; the appreciation markedly slowed down in the 3Q09 and the 4Q09, but resumed in the 1Q10. The current account deficit continued to decrease year on year in the 4Q09 though the quarterly deficit was roughly twice as high as in both 2Q09 and 3Q09, a sign of a stronger economy. The balancing act in 2009 was impressive as the shortfall fell to preliminary 1.6% of GDP from 5.1% of GDP in 2008, mostly due to the trade balance improvement as exports decreased much less than imports. Both export and import should exhibit strong upward trends in 2010 with converging dynamics. The current account deficit is predicted to further fall to 1.2% of GDP in 2010 due to the negligent deficit in trade. These developments will further decrease external financing needs of Poland so they will underpin the zloty exchange rate on top of the net capital inflows. Major privatization projects should attract FDI inflows.

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

Indicator	Data								CASE forecasts				
	2006	2007	2008	2009				2009	2010			Q4	2010
				Q1	Q2	Q3	Q4		Q1	Q2	Q3		
Nominal GDP, PLN bn (% change, yoy)	1060.0	1176.7	1272.8	314.1	326.3	331.5	370.0	1341.9	332.9	344.8	349.2	389.2	1416.1
GDP	6.2	6.8	4.9	0.8	1.1	1.7	3.1	1.7	2.9	3.1	3.3	3.7	3.2
Private Consumption	5.0	4.9	5.4	3.3	1.7	2.2	2.0	2.3	1.9	2.5	2.8	3.4	2.3
Fixed Investment (4Q, % of GDP)	14.9	17.6	8.2	1.0	-3.0	-1.5	1.6	-0.3	-1.1	3.0	4.9	5.6	3.0
CA balance (% change, yoy)	-2.7	-4.7	-5.1	-3.8	-2.8	-2.2	-1.6	-1.6	-1.7	-1.6	-1.3	-1.2	-1.2
Exports (NBP, EUR)	20.4	13.4	12.7	-22.1	-21.8	-20.5	1.5	-16.3	13.8	15.2	17.5	13.2	15.0
Imports (NBP, EUR)	24.0	19.5	14.9	-27.4	-29.7	-27.2	-10.3	-24.0	8.2	13.6	11.0	14.2	11.8
Industrial sales (% change, yoy)	11.6	10.7	3.6	-10.0	-6.7	-1.3	5.5	-4.3	7.0	6.5	7.5	8.0	7.2
Gross value added	6.0	6.7	5.0	1.1	0.8	1.8	3.0	1.7	2.8	3.1	3.2	3.5	3.1
CPI	1.0	2.5	4.2	3.2	3.7	3.6	3.4	3.5	3.0	1.9	2.2	2.5	2.4
PPI	2.3	2.3	2.5	4.9	4.2	2.2	2.0	3.3	-0.8	-0.2	2.2	2.8	1.0
Nominal Ave. Wage	4.9	8.7	10.4	6.8	4.4	3.0	2.7	4.0	3.0	3.9	4.6	5.1	4.2
Employment %, LFS	3.1	3.1	3.7	1.3	1.0	0.5	-0.5	0.7	-0.3	-0.1	0.1	0.3	0.0
Registered unemployment rate (% eop)	14.8	11.4	9.5	11.2	10.7	10.9	11.9	11.9	13.3	12.9	12.6	12.8	12.8
PLN/EUR, eop	3.89	3.78	3.52	4.50	4.45	4.20	4.17	4.33	4.01	3.95	3.95	3.75	3.85
WIBOR 3M, %, ave	4.20	5.68	5.88	4.17	4.44	4.18	4.27	4.27	4.10	4.05	4.00	3.95	4.05
Central bank key rate eop	4.00	5.00	5.00	3.75	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50
Broad Money (M3) (% change, yoy eop)	16.0	13.4	18.6	17.5	14.4	9.6	8.1	8.1	6.5	7.9	8.5	9.5	9.5
Loans to HH	33.4	37.9	44.6	43.7	35.7	26.3	12.0	15.5	5.0	7.0	8.5	9.0	9.0
Loans to Firms (% GDP)	13.7	24.1	29.0	25.8	15.0	6.8	-3.3	1.0	-5.0	-1.0	4.3	5.0	5.0
Fiscal Balance	-3.9	-1.9	-3.9	n.a.	n.a.	n.a.	-7.2	-7.2	n.a.	n.a.	n.a.	-5.5	-5.5
Public Debt eop	47.7	45.0	47.2	43.6	n.a.	n.a.	50.7	50.7	n.a.	n.a.	n.a.	53.5	53.5

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