POLISH ECONOMIC OUTLOOK

TRENDS • ANALYSES • FORECASTS

QUARTERLY 1/2007 (32)

Special Topic – Poland, the Euro and the Maastricht Criteria

EXECUTIVE SUMMARY

Growth in the Polish economy in the fourth quarter of 2006 and in the whole of 2006 exceeded expectations reaching the highest yearly rate since 1997. The economy expanded at 6.6% yoy in the fourth quarter and at an annual average of 6.1%.

The growth was driven by a surge in investment, private consumption and exports. Strong demand was met by an acceleration of industrial production growth and contributed to a reduction of registered unemployment to the lowest levels since the late 1990s.

The outlook is positive both in the short and medium term. Forecasts show continued high GDP growth figures in the coming quarters and business sentiment indexes, as well as consumer confidence indexes are at or close to historically high levels. The rapid growth of fixed capital investment adds to the picture of prevailing optimism. The 2006 HICP inflation rate, at an annual average of 1.3%, remained among the EU lowest, while higher GDP growth and tax revenues have led to a smaller-than-expected fiscal deficit in terms of GDP.

Despite the positive perspective there are, however, a number of risks to the downside emerging. First of all, rising demand and credit figures lead to the emergence of some inflationary pressures. On the supply side, despite still high registered unemployment rates, labor supply in some markets seems especially squeezed, in part due to migration. March 2007 inflation exceeded expectations reaching 2.5% and is projected to rise further by the end of 2007.

Government spending needs to be cut back given the growth phase of the economic cycle and unprecedented optimism levels. However, plans for consolidation do not seem ambitious and the postponement of tax reforms constitutes a foregone occasion to reorganize the state budget before a slowdown kicks in. For now, there seems little possibility of meeting the 3% of GDP limit on fiscal deficit and having the EU's excessive deficit procedure lifted in the coming years.

The housing market in the main cities is booming, fueled largely by increased access to mortgage loans. Supply in the entire construction sector is rising, though is curbed in part by problems of tightening labor supply. Poor credit access in the past leads to the expectation that this fast growth is part of a catch-up effect rather than a bubble. If rising inflation pressures are not contained in time and will ultimately require large(r) interest rate hikes the housing market may be vulnerable to a rapid cooling.

Some additional sources of uncertainty in the fourth quarter of 2006 included issues of energy security and rather ambiguous attempts to find a replacement for the outgoing central bank governor.

Finally, mainly due to high demand for exports in the EU, the current account deficit remains moderate; however the most recent figures exceeded expectations because of a larger-than-expected trade deficit.

Therefore, although the economy is certainly doing well, some fears of overheating are emerging, and there is room for both central bank and government action in order to contain the uncertainties and sustain the high growth.

In the new edition of the Polish Economic Outlook we summarize the main macroeconomic developments in the last quarter of 2006 and the first quarter of 2007. We present CASE forecasts for the main variables and introduce a *Special Topic* section in order to focus on broader economic issues. To start we propose *Poland, the Euro and the Maastricht Criteria*.

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

Indicator	2004	2005	2006				2006	CASE Forecasts					
								2007				2007	2008
			Q1	Q2	Q3	Q4		Q1	Q2	Q3	Q4		
(% growth, yoy)													
GDP	5.3	3.6	4.8	5.6	5.9	6.6	6.1	6.9	6.9	6.7	6.1	6.7	5.4
Private Consumption	4.4	2.0	4.4	50.0	5.3	5.1	5.2	5.6	5.7	4.7	5.0	5.3	4.5
Investment	6.4	6.5	13	15	18.7	19.7	16.5	20.8	14.5	11.7	9.0	14	10.1
(% of GDP)													
C.A. Balance	-4.2	-1.7	-1.9	-2.0	-1.8	-2.1	-2.0	-2.6	-2.5	-2.8	-2.9	-2.7	-2.1
(% growth, yoy)													
Exports (EUR)	22.3	17.8	18.1	19.6	20.5	19.0	19.3	14.8	15.4	11.9	13.1	13.8	11.9
Imports (EUR)	19.5	13.3	4.9	18.1	20.7	20.6	16.1	12.1	10.9	9.0	11.7	10.9	11.5
(% growth, yoy)													
Industrial Production	12.4	4.1	12.4	12.1	12.3	10.8	11.9	13.3	13.0	12.9	13.0	13.1	10.5
Gross V.A.	5.2	3.3	6.3	4.7	6.0	6.5	6.2	5.8	5.4	5.2	6.2	5.7	4.8
CPI	4.4	0.7	0.4	0.8	1.4	1.3	1.0	1.8	2.1	2.1	2.7	2.2	2.8
PPI	5.2	0.2	0.9	3.0	3.6	2.8	2.6	3.3	1.4	0.6	2.5	2.0	3.2
Nominal Wages	3.8	3.2	4.9	5.4	5.5	4.7	5.1	4.9	5.4	5.5	7.8	5.9	7.1
Employment (growth, LFS)	2.2	2.3	3.1	3.7	3.9	3.6	3.6	3.5	3.4	3.2	3.0	3.3	2.8
Unemployment (rate, eop)	19.0	17.6	17.8	16.0	15.2	14.9	14.9	14.4	12.3	11.6	11.3	11.3	9.2
(value, eop)													
Exchange rate PLN/EUR	4.1	3.9	3.9	4.1	4.0	3.8	3.8	3.9	3.9	3.7	3.8	3.8	3.7
Interest Rate (WIBOR 3M)	6.7	4.1	4.2	4.2	4.2	4.2	4.2	4.2	4.5	4.7	4.7	4.7	5.0
Interest Rate (C.B. reference)	6.5	4.5	4.0	4.0	4.0	4.0	4.0	4.0	4.25	4.5	4.5	4.5	4.75
(% growth, yoy)													
Broad Money (M3)	8.9	10.4	9.8	11.9	13.0	15.7	12.6	18.0	16.6	15.9	15.4	16.5	15.3
Loans to HH	13.9	22.9	25.4	28.8	31.2	32.5	29.4	29.6	27.5	24.0	22.1	25.8	15.4
Loans to Corporate	-4.0	2.8	3.9	5.2	10.0	12.4	7.9	13.7	14.2	13.2	13.0	13.5	9.6
(% of GDP)													
Fiscal Balance	-4.4	-2.9	(r)	(r)	(r)	(r)	-2.4	(r)	(r)	(r)	(r)	-2.7	-2.7
Public Debt	43.5	45.0					47.9					50.6	52.0

Sources: GUS, CASE, Eurostat.

LATEST DEVELOPMENTS IN THE POLISH ECONOMY

GDP growth and components

High GDP growth continues, fueled by strong investment figures, exports and private consumption. Industrial production and sales are up while profitability improves.

According to the Central Statistics Office (GUS) in 2006 the Polish GDP grew at 6.1% yoy in real terms, in excess of previous expectations and up from 3.6% in 2005. This was the highest annual growth rate since the late 1990s. The Q4 growth at 6.6% yoy continued a series of seven quarterly growth increases since the end of 2004.

The 2006 annual growth rate was the highest since late 1990s

The main contributor to growth was gross fixed capital expenditure, which grew 16.5% yoy in 2006 (19.7% yoy in Q4), accelerating from 6.5% last year and contributing to the increase of gross investment to GDP from 18.2% to 20%. Private consumption grew by 5.1% yoy in 2006 Q4 and 5.2% in the year as a whole, up from the sluggish growth of 2% in the year before.

Strong domestic demand was accompanied by increasing exports, but the growth of imports continued despite some moderation due to the fall in global oil prices, causing the overall trade balance to unexpectedly deteriorate towards the end of the year.

Industrial production grew 11.9% in 2006, and accelerated further reaching a 13.3% growth rate yoy in 2007Q1. The Q4 increase was mainly due to high growth in the manufacturing sectors, as the sold production of durable consumption goods accelerated strongly, growing 29.6% yoy (up from 7.4% in 2005) and investment goods which grew 18.2% yoy (up from 7.6% in 2005). Both continued at paces above 20% in the first two months of 2007, while the increase in production of non-durable consumption goods was somewhat slower and amounting to 7.5% yoy in 2006, still more than double that of the year before (3.6% yoy) and accelerating to 11.6% in 2007 M1-2.

Industrial production growth strong in durable and investment goods

Total gross value added grew 6.5% in Q4 and 6.2% in the entire 2006, the growth concentrating in the construction sector (19.3% yoy for Q4 2006 and 12.6% in the year 2006) and the industrial sector (7.7% in 2006 relative to 3.9% the year before) while being somewhat slower in market services (4.9% in 2006 relative to 3.6% in 2005).

There was a clear strengthening of financial results of non-financial companies in 2006, bringing both net and gross profitability up to 4.7% and 5.8% respectively in 2006 Q4, as in the previous quarter. Both retail and wholesale growth had their strong contribution. Retail sales in constant prices were up 11.9% yoy in 2006, accelerating from the increase of 1.5% in the previous year, with especially strong growth in the fourth quarter (exceeding 13% on the equivalent period of 2005) and even further at 16.9% in the first two months of 2007. The fastest growth was noticeable in the furniture and household electronics sector, as well as the transport sector. Wholesales were up by 9% yoy increasing from 5.2% growth in 2005, largely due to the increase in wholesale of machinery and other equipment (up 51.2% from 2005). They tended to slow slightly in the fourth quarter, but rebounded to levels above 18% yoy in early 2007.

Companies' financial results strengthened further

This overall growth tendency seems to be expected to continue, as consumer confidence indicators are strengthening and the business confidence indicator calculated by the Statistical Office is on the rise in all industries, particularly in the construction sector.

Finally, the housing market is on the rise, though the growth in 2006 is still rather moderate, as dwellings in construction are up 3.9%, construction begun on new dwellings increased by over 30%, while permits issued also increased by 35.9%. A total of 626,700 houses were in construction at the end of the year. New dwellings started and new permits issued surged further in early 2007 due to mild weather conditions in 2006Q4 and 2007Q1, which may also help reduce the time-to-market of some of the projects. Nevertheless, much of the growth is concentrated in large cities, as average prices per square meter in main cities were up by one-third, to three-quarters in 2006, while overall remaining at single digit levels.

The outlook for the Polish economy remains positive as GDP growth, driven by strong domestic demand, should persist at high levels, albeit slowing slightly in late 2007. GDP will continue to grow at real levels well above 6% yoy in 2007 (about 7% in 2007Q1) and similarly at 5.4% in 2008. The main external forces which pose threats to our forecasts are developments in oil prices, financial market sentiment, political instability and external (EU) demand conditions.

Positive outlook driven by strong domestic demand

As in the recent past, the growth will be driven by the increase in domestic demand, which will grow well above 6% yoy in 2007 and similarly in 2008. Investment growth will prevail in the double-digit figures, remaining strong in the first half of 2007 and slowing somewhat to average around 14% yoy for 2007. In 2008, a slight slowdown is expected, to about 10% yoy. Consumption, mainly private consumption which will continue to be fueled by household disposable income (up 5.3% yoy in 2007) will slowly decelerate to 4.5% growth by the end of 2008.

The effects of current high investment levels should increase the production capacity and help satisfy domestic demand. Industrial production is expected to increase about 13% in 2007, while slowing only slightly in 2008 (still growing above 10%).

Total gross value added will roughly maintain the 2006 pace of growth between 5-6%yoy though tending to be slightly higher. More specifically, in the industrial sector, we still expect acceleration in 2007 and early 2008, as the newly created capacity is utilized, and a moderation, albeit partly due to seasonal factors, towards the end of the period 2008. Value added in the construction sector should remain strong through 2007, in double-digit levels, as Poland remains one of the most "under-housed" economies in the EU. Aside from housing, infrastructure projects, in part EU funded, should constitute an important source of growth in this sector. However, the growth of total gross value added in construction is at risk due to potential problems with the lack of qualified labor force caused by migration which may lead to the squeezing of margins and/or the extension of project duration.

Monetary and financial developments

Shocks to food and fuel prices caused a rise in inflation in early 2007, while demand pressures are responsible for higher inflation forecasts for the rest of 2007 and 2008.

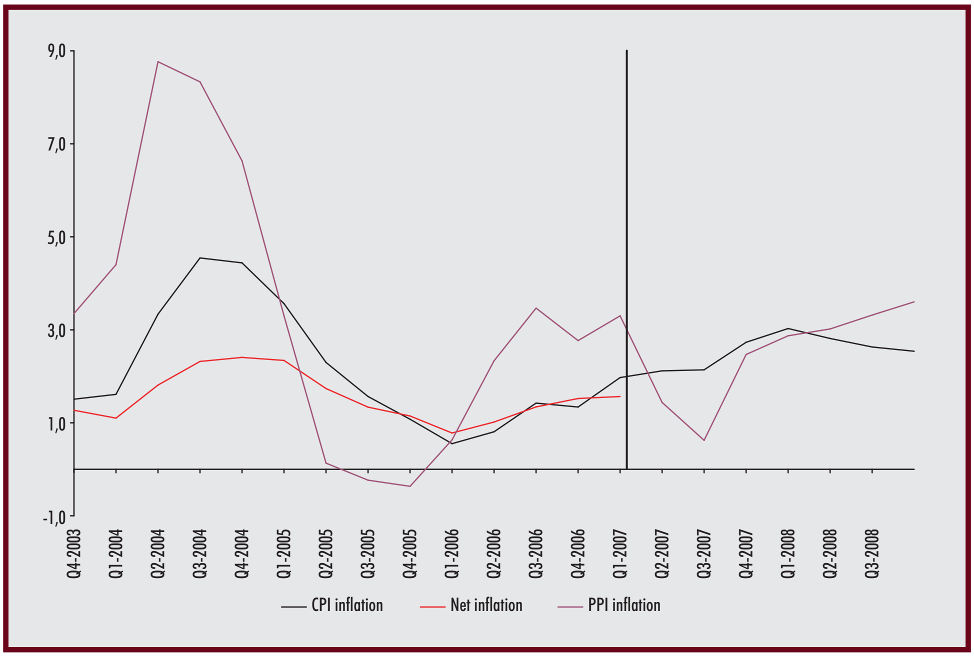
Poland seems to have lost its lead in the lowest EU inflation ranking as inflation rose markedly from 1.3% yoy on average in 2006Q4 up to 2.0% in 2007Q1 with a clear upward monthly trend. Although this increase coincides with the apparent acceleration of real activity symptoms of demand-driven price growth are rather scarce and it can be traced back almost entirely to rising dynamics of food (mostly meat, bread and cereals) and fuel. This is clearly evidenced in the stability (1.5-1.6% yoy in both quarters) of net inflation – a core inflation indicator calculated excluding food and fuel.

Inflation remained among EU lowest in 2006, while upward pressures started to show in 2007Q1

Industrial goods prices continue to register deflation (-1% yoy in 2007Q1) which confirms their role as the most stable disinflationary factor in recent years. Their dynamics, however, are up by 0.5pp from 2006Q4 - entirely a result of the acceleration in the least tradable subcategory of non-durables (which rose from 0.4% 2006Q4 to 1.2% in 2007Q1). On the other hand, prices of both durables and semi-durables remain in the deflationary trend (-2.5% and -5.1% in 2007Q1, respectively) on the back of cheap Asian imports aided by the strong zloty and rising competition among retail chains in Poland.

Inflation in services stands stable at around 3% in spite of a market rise in dynamics of rents and dwelling-related services.

Figure 1. CPI, PPI and net inflation.



The Producer Price Index stabilized in recent months at the level around 3% (3.3% in 2007Q1). The relative stability of the aggregate indicator masks diverging trends within the index: a sharp decline in price dynamics of mining and quarrying (stabilization of copper prices on world markets) accompanied by rising dynamics in manufacturing (mostly due to food industry and refineries).

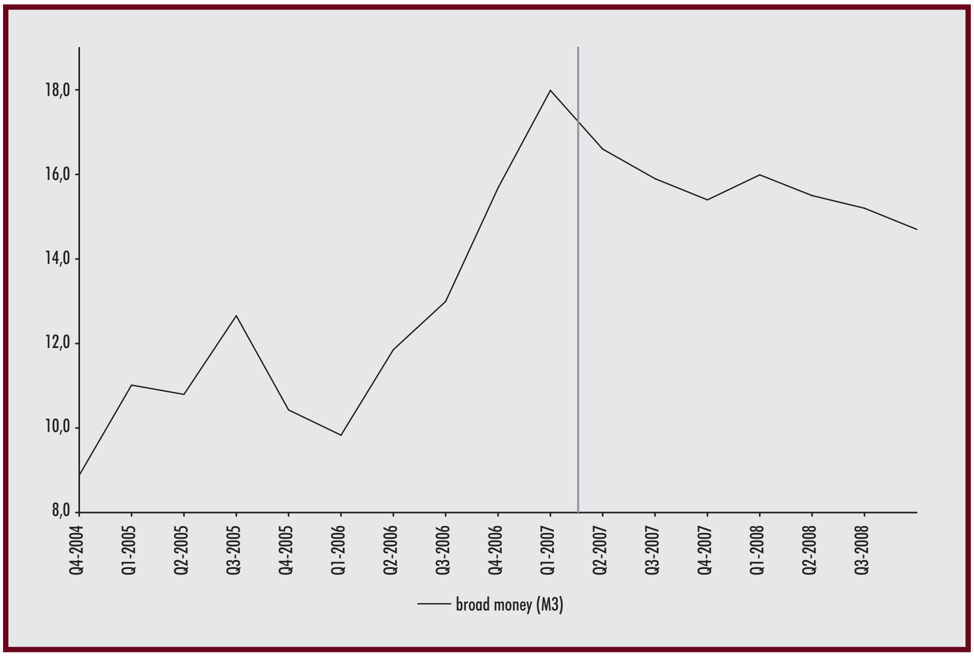
PPI growth is stable around 3% on aggregate with very different behavior of subcomponents

While the recent rise in inflation was supply-shock-driven, our forecast of higher inflation in 2007 and 2008 relies mostly on the gradual strengthening of demand-pull effects. Accelerating economic growth, booming retail sales underpinned by record-high household credit growth lead us to expect an increase in the annual dynamics of the CPI to 2.1% yoy in 2007Q2 and Q3, and then further to 2.7% in Q4 and the average of 2.8% in 2008. We predict producer inflation (PPI) to drop in 2007Q2 and Q3 below 1% yoy due to the base effect to recover in subsequent months and rise gradually to 2% and 3.2%, on average, in 2007 and 2008, respectively.

Broad money growth will slow but remain at two-digit levels

In the same time, broad money (measured by the M3 aggregate) will continue to grow at two-digit levels, though we expect a turnaround as growth will decelerate throughout both 2007 and 2008 to reach 14.7% yoy in nominal terms.

Figure 2. M3 growth.



The interest rates set by the central bank (Narodowy Bank Polski) remained unchanged within the 2006Q4 and 2007Q1. The reference rate prevailed at 4%, and the rediscount rate at 4.25%. Average market rates on PLN loans either continued to decline or remained at historically low levels, dropping below 6% annually on short term mortgage loans for individuals and longer term loans for corporate clients. However some increase in the long-term fixed interest rate on newly issued loans to both corporate clients and individuals was visible. Market rates on medium to long term PLN deposits generally remained at historically low levels for both individuals and corporate clients. The interest rate on newly issued loans nudged up slightly in the fourth quarter, in response to an increase in inflation expectations.

The newly elected central bank (NBP) President Sławomir Skrzypek replaced Professor Leszek Balcerowicz in January 2007. Despite some initial preoccupation, the markets seem to have hardly responded to the change. Notably the Monetary Policy Council in an attempt to increase transparency decided to release *minutes* from its decision-making meetings starting May 2007.

The Polish zloty continued strengthening steadily against the euro for the first half of 2006Q4 and stabilized subsequently. The end-of-month exchange rate strengthened from 3.98 PLN per euro (2006M9) to 3.83 PLN per euro (2006M12) exhibiting a 3.8% appreciation, compared to the previous quarter and a 6.8% change from the 2006 trough in June. The first quarter of 2007 saw the rate rather stable reaching 3.87. The exchange rate against the U.S. dollar reflected euro/dollar movements, hence, the zloty appreciated, reaching the 2006 high of 2.86PLN per USD in early December; and dropped slightly to 2.91 PLN per USD. At the end of the quarter, a 7.4% appreciation relative to the end of the previous quarter was recorded. In Q1 2007, the rate was rather stable and closed at 2.91 PLN. We expect the PLN/EUR to stabilize in the region of 3.7-3.8 particularly if inflation picks up.

In 2006 C.B. interest rates unchanged while the exchange rate appreciated. Interest rate raised in April 2007, further hikes expected

Monetary financial institutions (MFI) credit to households has been booming, as 2006 saw a 34.5% nominal increase in loans outstanding (the first 2 months of 2007 another 4.6% rise). Growth was especially high in foreign currency denominated (FCD) loans which grew 47.1% in nominal domestic currency terms (6.6% in 2007M1-2) while the stock of domestic currency denominated (DCD) loans increased 29.3%.

As end of 2006, FCD loans constituted 32% of the outstanding loan stock, which may prove a source of vulnerability to exchange rate movements, as households generally do not hedge their liabilities.

Foreign currency denominated loans constitute a third of household loans

Household deposits failed to keep up with loans, growing 8.4% in nominal terms in 2006, accelerating in the final quarter to reach 3.2% growth (2.5% in 2007M1-2). Moreover the increase was visible in DCD deposits while FCD deposits actually fell slightly. That said, most of the growth was in demand deposits, which increased by 33% (11.3% in Q4 and 7.5% in 2007M1-2) while most other categories saw a decrease, reflecting a shift to shorter term deposits.

As for loans to the corporate sector, these increased somewhat slower, at 14.5% in nominal terms, (3.8% in Q4 and 3.1% in 2007M1-2) and in a more equilibrated fashion – DCD loans grew by 16% in 2006 (2.2% in 2007M1-2), amounting up to 78% of the total corporate loan stock. Corporate deposits grew by 26% in 2006, half of which occurred in the fourth quarter, while no shift to shorter term deposits was visible - demand deposits grew at 21%.

Though the above developments are in nominal terms, the prevailing low rate of inflation facilitates the conclusion for real values. Moreover, both types of loans increased sharply relative to GDP.

As for the credit market, we expect continued high growth, though lending to households should grow at a slower pace, as rising interest rates take effect. New loans should shift more to domestic currency denomination, especially if the PLN starts depreciating. However, double-digit annual growth will be maintained both in 2007 and 2008, in the case of credit to households, while falling to single-digit figures in 2008 for loans to the corporate sector. Total deposits should continue to increase at a slower rate than lending, however, they will grow at two-digit values for the corporate sector.

Credit is still on the rise and expected to continue further

The Warsaw Stock Exchange boomed throughout the whole of 2006, experiencing a stock market capitalization increase of 50% in nominal terms (in 2006) to 685.9 bln. PLN, of which 437.7 bln. were domestic stocks. Total trading in the year was up 83% on the equity market, where 38 new companies were listed and 59% on the futures market. Through the year the main WIG index rose 42% in PLN terms (43% in euro terms, among the highest in emerging markets), while the WIG-20 largest companies' index rose 24%. The equivalent figures for the fourth quarter were 14.5% and 12.5%, pushing both indexes to record highs. In 2007Q1 the stock market continued high growth, recording a 14% increase of the WIG (on previous quarter, PLN) and 7% in WIG20. The markets were hit by a global hiccup in late February, but recovered within a few days.

2006 a record year for the Warsaw Stock Exchange, bullish growth continued in early 2007

Labor market

Employment is still growing, but is accompanied by dangerously falling economic activity, while wages keep booming.

Strong employment growth, especially in construction

In 2007Q1, employment was still on the rise. We estimate that in the enterprise sector it further increased by 4.2% yoy (3.8% in 2006Q4). The highest employment dynamics (8.3% yoy) in construction have been recorded, which has continued to boom for several months. Employment dynamics, however, are on the rise in other sectors as well, including the largest sector – manufacturing, which recorded employment growth almost equal to the overall figure (4.1% yoy).

Improving employment figures for enterprises are positively influencing overall employment dynamics as recorded by Labor Force Survey (LFS), although here the result are slightly less encouraging. In 2006Q4 (the most recent period for which this data is accessible) the number of employed persons increased by 3.6% yoy (3.9% in 2006Q3) and it was the first period since 2005Q4 of falling employment growth.

To make the picture even less optimistic employment growth is still accompanied by falling economic activity. The number of active population in 2006Q4 was 1.7% lower than one year earlier (1.2% yoy decrease was recorded in 2006Q3) and the negative dynamics continue accelerating. The reasons for this quite awkward mixture of rising employment and falling activity are still unknown. It may be related to ongoing out-migration (reflected in the decreasing number of new unemployed registered by Public Employment Service) flows or to the increasing number of old unemployed, quitting their job search due to discouragement, (reflected by an increasing number of unemployment registry leaves not related to job finding).

We expect that employment both in the enterprise sector, and overall LFS figure, will keep rising in periods to come. However, the employment dynamics will stop accelerating and employment growth will stabilize. In 2007Q2 we expect that enterprise employment will grow by 4.2%-4.3% yoy and the LFS employment in 2007Q1 will grow by 3.5% yoy. The average employment growths for 2007 should stay at similar levels. In 2008, employment dynamics should decelerate to the average of 2%-3% yoy. This will be the result of large wage dynamics limiting the number of employees demanded.

In 2007Q1 wages accelerated again, after some stabilization in 2006Q4, reaching, according to our estimations, the growth rate of at least 7.8% yoy. Even in rising inflation environment it meant the average annual increase of real wage in the range of 5.2% yoy (4.1% in 2006Q4).

Dynamic growth of wages in all sectors, especially construction

Wages accelerated in all main sectors including manufacturing recording the average growth of 8.7% yoy. Similarly, as in previous periods, wages grew most dynamically in construction recording the yoy figures of 13.5%.

We believe that wages in 2007 will continue to grow rapidly. We expect that in 2007Q2 wages will grow by at least 7.5% yoy in nominal terms. Such wage dynamics should continue till the end of this year. In 2008, nominal wages should slow down overall, with average dynamics falling below 7% yoy.

Wage dynamics may begin to fall earlier if economic activity improves. This will lead to faster employment growth and it will be a much more optimistic scenario for the economy. Paradoxically, current high wage dynamics can help in this respect.

Registered unemployment continues to fall more and more vigorously, but here the message is mixed. In 2007Q1, the number of unemployed (2.2 million) was by more than 20% lower than a year earlier. The unemployment rate fell to 14.4%, a 3.4pp yoy decrease.

However, as mentioned earlier, this is not driven by job related outflows (only 1.1% yoy increase compared to 12% yoy decrease in inflows), although the number of vacancies registered by PES seems to increase very fast (27% yoy). Also, the changing structure of the unemployment pool may indicate some dangerous phenomena, with a decreasing share of young unemployed and increased shares of the elderly (50+) and unskilled. This means that further reduction of unemployment may still involve further decrease in economic activity, since the average employability of those still unemployed continues to worsen.

Job creation was not the main driver in of the fall in unemployment

Unemployment continues to fall more drastically according to the LFS figures. In 2006Q4 the number of unemployed according to this survey fell to 2076 thd. – 28% less in yoy terms – and unemployment rate fell to 12.2%.

Both registered and LFS unemployment will keep falling, however, the process should slow down. In 2007Q2, the registered unemployment rate should fall to around 12.4%, by the end of the year reaching 11%. The level of LFS unemployment will be even lower falling significantly below 10% by the end of 2007. In 2008, unemployment will keep falling but slightly more slowly. The registered unemployment by the end of the year should fall to 8%-9% and the LFS unemployment to 7%-8%.

Registered unemployment to fall to single digit levels by 2008

The fiscal sector

Strong GDP growth and tax revenue improved the fiscal balance. Budget reforms postponed despite high growth.

The growth of the economy led to an increase in government revenue in 2006 by about 9% in constant prices. The growth was due to direct income tax revenues which increased 17.5% in total and 22.8% in the case of legal persons, reflecting the increase in profits. Revenue from income taxes constituted 24.1 % of total revenue, up by 1.7pp. Revenue from the VAT tax on goods and services was up by 9.3% in constant prices, constituting 43.2% of total revenues. On the expenditure side, large growth was visible in social security expenditure (11.4% yoy in the year to November) which constituted 23.7% of total expenditure. As expenditure grew slower than revenue, at 6%, the fiscal balance improved resulting in 25bln PLN according to preliminary estimates, well within the government's advertised nominal anchor of 30bln. Generally, high growth of the economy caused the revenue figures to exceed expectations and the fiscal deficit for 2006 to reach 2.4% of GDP, lower than the 3.3% approved in the budget plan and the 3.0% in the approved correction.

Deficit relative to GDP was lower than planned

The positive figures had the effect of facilitating the postponement of serious fiscal reforms. The determination to implement consolidation is somewhat unconvincing given that one of the proposed dates (2009) that is most often cited is an election year. Some plans of fiscal reform have recently (March/April 2007) resurged, but they tend to be regarded as insufficient, albeit a step in the right direction. Next, the above analysis concerns the Polish methodology, which differs from the European Commission approach in terms of the treatment of the costs of pension reform. According to the latter, the deficit would result in about 4.3% of GDP.

Finally total public debt rose to above 47.9% of GDP by the end of 2006, with the increase falling on domestic debt, while foreign debt decreased.

A slowdown in growth may obstruct the delayed fiscal reforms

The 2007 budget plans revenues at 20.6% of GDP, 1.6pp higher than the revised plan for 2006 and expenditures at 23.4%, also up by 1.6pp. This would result in an increase in the deficit to 30 bln PLN, in nominal terms, and thus 2.7% of GDP according to the Polish methodology. Government declarations foresee the reduction of the fiscal deficit to below the Maastricht requirement of 3% GDP in 2009. This would require a deficit of below 1.6% according to the Polish methodology.

However, two key risks make this target difficult to fulfill. First, GDP growth will moderate slightly and more importantly; unless the current parliament term is terminated ahead of schedule, 2009 is set to be the year of parliamentary elections, which will certainly not work in favor of the target's feasibility. We forecast minor improvements in the fiscal position, but hardly see the deficit dropping below 2.6% both in 2007 and 2008. Consequently, we expect government revenue and expenditure to remain more or less stable in terms of GDP.

No prospects for significant reduction of deficit relative to GDP

Continued deficits will lead to the surpassing of the debt to GDP ratio of 50% in late 2007 in accordance with the budget plan.

Finally, the recent decision to grant the hosting of the European Cup 2012 to Poland and Ukraine will certainly have an effect on the expenditure side, which by now is hard to assess; however, we expect the major effect to come after 2008. Nevertheless, it will pose yet another challenge to efforts aimed at reducing spending.

External Sector

Strong surge in exports continues, while C.A. gradually deteriorates.

Merchandise export has continued to grow strongly. The EU still accounts for the largest share of Polish export (around 81% in 2007M1-2). These higher sales to the EU made a continuous surge in exports possible. Also, booming CIS (Commonwealth of Independent States) economies have been exhibiting strong demand for Polish products. As a result, sales of Poland-made produce to those countries (mainly Russia and Ukraine) increased in nominal euro and zloty terms by nearly 40% yoy during the first two months of 2007. It should be noted that since 2004, exported products have been being sold at higher and higher prices.

Prices of export goods rising since 2004

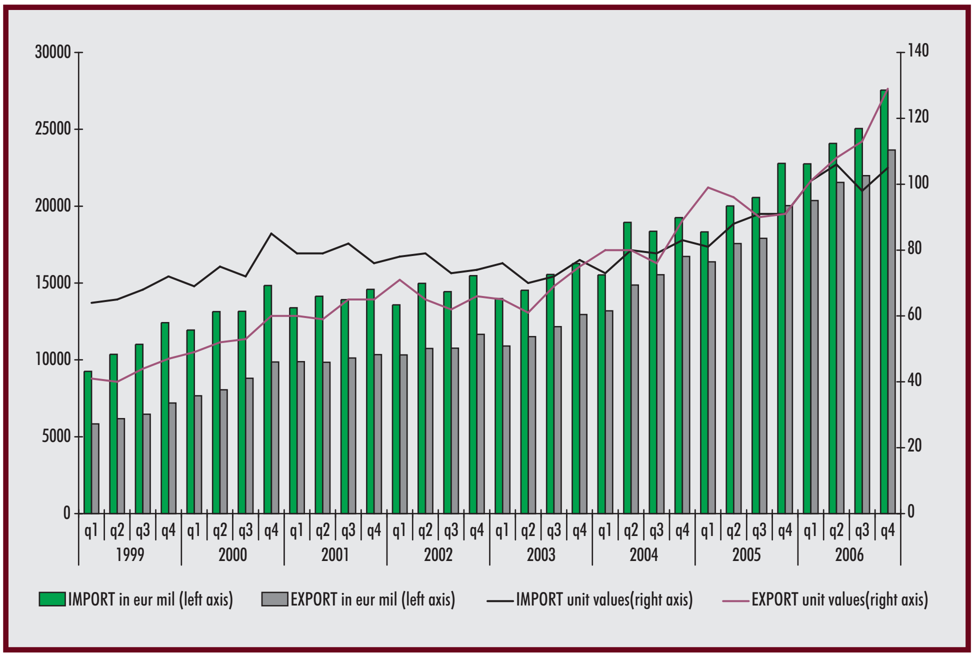
This is depicted as constantly rising prices (unit vales) of exports on Figure 3. The average euro price for a unit of exported goods more than doubled in 2004-2006. Most probably, this also reflected an upward shift in the quality of products produced and exported from Poland.

Imports have been on the upward path too, although growing a bit slower in nominal terms. The strongest surge in imports on a yearly basis was recorded for goods bought from the EU countries. Overall, the EU accounted for around 65% of all Polish imports in January-February 2007. Imports from developing countries are growing too, but their contribution is lower, as developing countries account only for 17% of all imports (7% of which are imports from China). The merchandise trade deficit of EUR1.6 billion, recorded at the beginning of the year (January-February) was basically due to the negative balance of trade with developing countries and with countries of Eastern Europe (increased sales to Russia and Ukraine do not balance imports of Russian oil). A positive trade balance was recorded in trade with the EU.

Real dynamics looked a bit different. It is estimated that export of goods and services expanded by 12% yoy in 2007Q1 in real (volume) terms, while imports grew by 15% yoy, following still strong domestic demand. This is to say that the zloty was still appreciating in yoy terms at the beginning of the year. It is forecasted that similar dynamics of foreign trade will prevail during the whole of 2007. In 2007, export in national accounts is expected to grow by 11% yoy, while imports should grow by 14% yoy. In 2008, both import and export volumes are still predicted to grow strongly, by 12% yoy.

Further strong growth of exports and imports in 2007 and 2008

Figure 3. Values and prices of Polish merchandise trade (1999-2006).



Notwithstanding the small trade deficit, the current account balance has been negative and growing. This has been due to the fact that earnings of foreign investors are accounted for in the current income account and, at present, they have been the primary contributor to the CA deficit. In February 2007, the CA deficit for the last 12 months was around 2.5% of GDP. In the meantime, inflows of FDI continue. New FDI in 2007M1-2 was at EUR1.8 billion.

Summary

The overall prospects for the Polish economy remain favorable, as most positive tendencies should be sustained, even if growth slows slightly in the medium term. Among the main internal risks is the failure to contain inflationary pressures, which could lead to a loss of competitiveness and a deterioration of the current account. Moreover, given the high growth, the relatively large fiscal deficit may prove a nuisance once the economy slows. The recent decision concerning Euro 2012 will bring large infrastructure investments, which will most likely have a positive effect on growth that is hard to assess at the moment. However it will certainly put pressure on wages and prices, thus challenging attempts to contain fiscal spending.

SPECIAL TOPIC: POLAND, THE EURO AND THE MAASTRICHT CRITERIA

The Polish economy seems capable to fulfill the convergence criteria required to enter the Eurozone. In fact, it is obliged to aim to do so.

Upon joining the European Union in May 2004, Poland, as all other New Member States, has committed to join the Economic and Monetary Union „as soon as it is ready". Although this clause certainly leaves some degree of freedom on the choice of when to enter, in order to do so, the subject countries must aim to gradually fulfill the convergence criteria specified in the Treaty of Maastricht. The five criteria include fixed caps on public debt, fiscal deficit and exchange rate volatility, and EU-adjusted restrictions on inflation and interests rates. In the case of exchange rate volatility, the evaluation horizon is two years, while in the case of the other four criteria, one year. For the fiscal criteria some leeway was given for countries with excess, but „converging" values.

Since 2004, it has become clear that joining the euro is not as easy or as desired as it seemed. Only Slovenia managed to join in 2007 and some of the countries which seemed most determined were forced to postpone due to excessive inflation. Polish officials never gave a target date for euro entry, although some point to 2012 as a possibility.

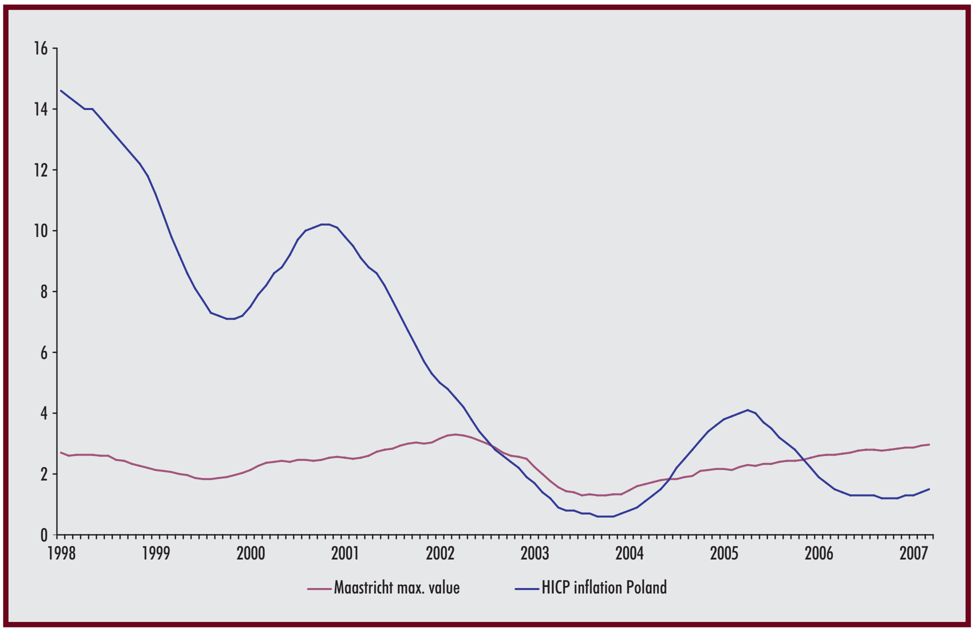
In the Polish Economic Outlook, we will monitor the performance of Polish economic indicators relative to the benchmark criteria, in order to assess how the Polish economy ranks on the criteria which it ultimately will be bound to meet. In this quarter's edition, we discuss the criteria in more detail and in the future, the situation will be summarized in a table, similar to Table 2.

Inflation

Criterion: No higher than the average of annual inflation rates in the 3 EU states with most stable price (i.e. lowest inflation) + 1.5 percentage points.

Poland: The 12-month average of yoy HICP (not CPI) inflation stood at 1.3% in 2006Q4 and 1.5% in 2007Q1. This made it one of the lowest in the EU, and in fact for the past 13 months it was among the 3 low inflation countries forming the benchmark. However, through a surge in demand signs of inflationary pressures seem to be surfacing and further performance will depend on the actions of the central bank.

Figure 4. Polish inflation rate (HICP, black line) versus the Maastricht benchmark inflation (red line), monthly, yoy, 12 month moving average.



Source: Eurostat.

Interest rate

Criterion: Nominal long-term interest rate no higher than the average of interest rates in the 3 EU states performing "best" on the inflation criterion + 2 percentage points.

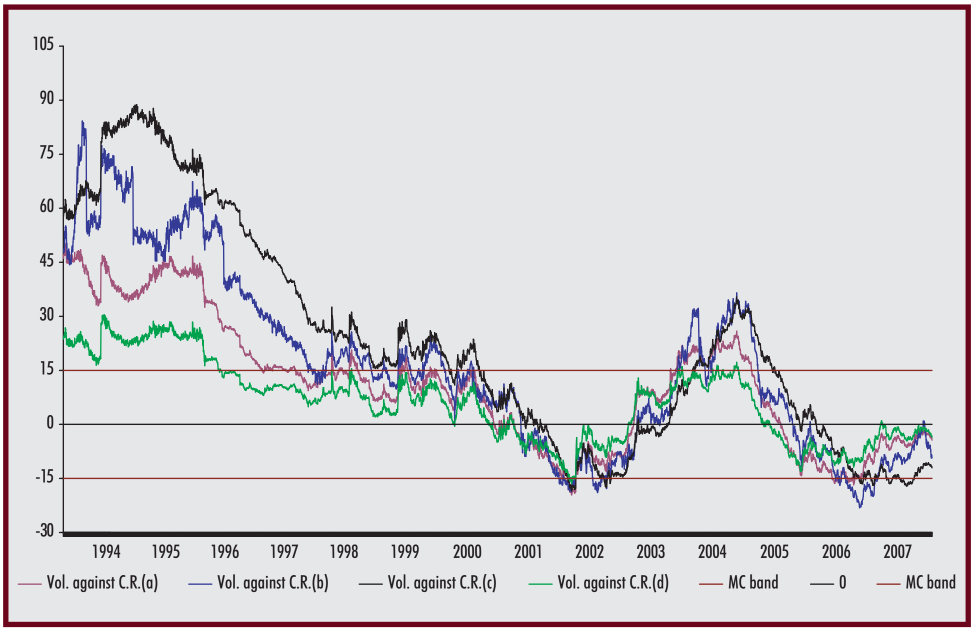
Poland: The interest rate used for the purpose of evaluating this criterion is well within the bound. As mentioned in the previous point, rising inflation pressures may urge the central bank to raise interest rates; however there still seems some room for maneuver.

Exchange rate

Criterion: Exchange rate against the euro within +/-15% bounds of a pre-established central rate, with no devaluation of this rate.

Poland: Not having joined the Exchange Rate Mechanism II (ERM II), the Polish zloty does not have an established central rate as such. We choose proxies for this rate, such as the average rate for the past 2 years. Since mid-2006, maximum deviations over 2 year moving windows were below 15% of the proxy central rate, and even the difference between the maximum and minimum PLN/EUR rates over the two year period has been below 15% of the average rate in 2006Q4.

Figure 5. Exchange rate volatility relative to proxy central rate over time (%). Proxy central rate definitions: (a) average rate over the year t-1, (b) single rate at t-2, (c) average rate over t-1 to t-3 and (d) average rate over t to t-2. Dotted horizontal lines at -15%, 0 and 15%



Fiscal deficit

Criterion: No higher than 3% of GDP.

Poland: This is arguably the most problematic of the five. First, because of a dispute on the classification of pension reform costs, the methodologies differ between the Polish authorities and the European Commission. Adopting EC methodology, which excludes payments to pension funds from government revenue, adds an estimated 1.5 to 2 percent of GDP to the deficit, causing it to exceed the Maastricht criterion. Though Polish officials managed to secure special treatment of pension reform costs, for the assessment in terms of convergence to the euro area, the Commission definition will be used and we regard this criterion as not fulfilled at the moment.

Public debt

Criterion: No higher than 60% of GDP.

Poland: Generally Polish public debt levels, although increasing, fulfill this criterion.

The purpose of this analysis is to capture the performance of the Polish economy with respect to the indicators, in a broad picture, at a certain point in time. Due to the shortcomings arising from the arguable endogeneity of the Maastricht criteria, they cannot be strictly judged in order to assess the capability to join the euro.

Euro Readiness Index

Finally, we also introduce a 'Euro Readiness' index which incorporates countries performance in all five dimensions scaled into one variable in order to facilitate comparison between the New Member States.

It is a very simplified indicator as it does not, for instance, take into account that countries with a currency board exchange rate regime have little possibility to contain inflation; however, it does constitute straightforward comparison - across time and countries. In broad comparison, Poland remained among the countries close to fulfilling the criteria. In terms of inflation, exchange rate volatility and even fiscal deficit, the positions improved relative to the previous year. The primary barrier, aside the lack of determination to enter soon, remains the fiscal deficit, roughly in line with that of other flexible-exchange rate EU countries in the region. At the moment, only one of the Central Eastern European countries qualifies in terms of all five criteria, and Hungary is clearly lagging furthest behind, with problems on almost all the criteria. Overall, according to these simple comparative statistics, Poland does not seem significantly less capable of fulfilling the criteria than other countries in the region.

Table 2. Poland and other CEECs according to the Maastricht Treaty criteria. Data for 2006Q4 (in brackets for 2005Q4)

	ERM II	Inflation	Interest Rate	Exchange Rate	Fiscal Balance	Public Debt	Index
Bulgaria	N	**7.3 (5)**	4.2 (3.5)	0.6 (0.5)	3.3 (1.9)	22.8 (28.2)	94 (63)
Czech R.	N	2.1 (1.6)	3.8 (3.5)	7.9 (9.5)	**-2.9 (-3.5)**	30.4 (30.4)	58 (70)
Estonia	Y	**4.4 (4.1)**	4.2 (4)	0 (0)	3.8 (2.3)	4.1 (4.4)	62 (55)
Hungary	N	**4 (3.5)**	**7.1 (6.6)**	14.2 (7.4)	**-9.2 (-7.8)**	**66 (61.7)**	131 (108)
Latvia	Y	**6.6 (6.9)**	4.1 (3.9)	1 (7.9)	0.4 (-0.3)	10 (12)	84 (86)
Lithuania	Y	**3.8 (2.7)**	4.1 (3.7)	0 (0)	-0.3 (-0.5)	18.2 (18.6)	59 (48)
Poland	N	1.3 (2.2)	5.2 (5.2)	6.6 (15.5)	**-3.9 (-4.3)**	47.8 (47.1)	75 (96)
Romania	N	**6.6 (9.1)**	**7.4 (7.1)**	8.3 (15.5)	-1.9 (-1.4)	12.4 (15.8)	108 (130)
Slovakia	Y	**4.3 (2.8)**	4.4 (3.5)	10.7 (7)	**-3.4 (-2.8)**	30,7 (34.5)	76 (70)
Maastricht	Y	2.9 (2.5)	6.2 (5.4)	15	-3	60	100

Notes: Details of the construction of the Index are available in the Methodological Notes available on the CASE website. Higher values generally indicate lower readiness to fulfill entry requirements for the Eurozone.
Source: own calculations based on Eurostat, IMF(IFS), GUS and NBP.

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