



# Large Fiscal Deficits – Curse #1

## EXECUTIVE SUMMARY

It is definite now: Poland has escaped recession though domestic demand declined for three straight quarters. GDP growth is picking up slowly and unemployment is rising slower than predicted. Inflation finally started heading south. The current account deficit is very low and downtrending. The only meaningful disequilibrium is the gaping fiscal deficit, but Poland is not an outlier across the universe in this respect.

The economy experienced a sudden stop in growth and bottomed in the 4Q08, when it was hit by the global crisis, then it meddled through the 1H09, and it started improving in the 3Q09 thanks to the tailwinds from the world economy. Broadly speaking, it behaved along our predictions in the 3Q09. Short-term prospects for the economy are improving. In 2010, the recovery should gain momentum. Our forecast of growth in the 3Q09 and in the 4Q09 is revised upward to 1.5% yoy and 2.2% yoy, respectively. Going forward, we see the recovery gain momentum in 2010, 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% yoy, i. e. in the 2Q10. There is no reason for a meaningful upward revision of our growth forecasts in 2010 because they have assumed since their first release in PEO 1/2009 that the worldwide recovery will gather strength in 2010, based on the effects of macroeconomic stimuli that will not have been withdrawn.

Despite persistent deflation in the euro area the consumer price inflation in Poland remains relatively high fuelled by the depreciation of the currency and the high administrative price increases. It fell slightly in the third quarter 2009 to 3.6% yoy, down by 0.1 p.p. from the second quarter, benefiting from slowing prices of food and energy. Counteracting this trend, prices of industrial goods and fuel continued to accelerate on the back of the weak zloty and progressively rising global prices of crude oil, gas and other commodities. Compared to the previous issue of the PEO we lowered our forecast of the CPI and PPI inflation. In spite of the gradual acceleration of economic growth and domestic consumption in 2010 we do not expect significant demand pressures to resurface in the forecast horizon due to the persisting negative output gap. The steadily strengthening zloty is projected to put an additional downward pressure on prices. Averaged over four quarters these inflation rates translate into the annual inflation declining from 3.5% to 2.1% in 2009 and 2010, respectively.

The central bank did not change its key interest rates in the 3Q09 and in October 2009 as prospects for economic growth improved and the CPI inflation remained on an elevated level relative to the inflation target. However the projected inflation declined in 2010 so in fact monetary policy was tightened in the 3Q09. If the appreciation of the zloty is accounted for, then the so-called monetary conditions tightened quite considerably. The central path of the year-on-year inflation rate in 2010 assumes that the rate will decrease through the 3Q10 falling below the lower target range (1.5% yoy) and would reach the lower bound in 1Q11. Such a projection would call for a cut in interest rates even by 50 basis points immediately since inflationary risks are low and they are skewed to the downside. If to believe the NBP projections the interest rates should remain unchanged through 2010. Our predictions are slightly higher so we do not exclude a first hike in interest rates in the 4Q10, but the probability of it is low.

The conditions in the labor market continued to deteriorate in the 3Q9 due to sluggish economic growth, but the scale of the deterioration was lower than expected and there were some positive signals as well. Due to this and the improvement in the general economic forecast in this PEO our expectations regarding the situation on the labor market are also revised positively. We assess that the LFS employment in the 3Q2009 was still increasing in the y-o-y terms by 0.5%. We expect that in 2009, on average, employment in the enterprise sector will fall by 1.4% and the LFS employment will actually be increasing by 0.5% yoy. Unemployment keeps increasing, although at a slightly slower pace than we expected. It is interesting that the rise in unemployment rate can be explained mainly by an increasing economic activity of the population, which remains a puzzle during a severe slowdown in growth. We revised downward our projections of the registered unemployment rate to about 13% at the end of 2010, while the LFS unemployment rate will probably grow to about 9-10%.

Nominal wage dynamics stopped falling in the 3Q09. It seems that the improving general economic climate has encouraged firms to stop wage cuts and saved the average real wage level from reductions. However, we do not expect wages to come back to the rising dynamics in the nearest future because of rising unemployment. Average nominal wage growth in the 4Q09 should fall to around 3% yoy and stay there in 2010. This will result in the real wage y-o-y dynamics at the levels close to zero in the 4Q09 and 1% in 2010.

The supplementary budget was implemented without any tensions in the 3Q09 and we do not expect any such in the final quarter of the year. The central government deficit will likely come lower than projected in the supplementary budget. The MF predicted in October 2009 that the general government deficit would reach 6.3% in 2009, which is close to our slightly increased forecast of 5.8% of GDP. Fiscal disequilibrium will increase in 2010 as the government has drafted a budget with a large cash deficit, however, the general deficit should rise only modestly. We think that factors that will tend to lower the state deficit relative to the target prevail over those that would lead to a slippage. Therefore, the government may avoid a breach of the 55% precautionary threshold by the public debt in 2010 though the risk is acute.

Exports were down again, but they continued to be underpinned by the weak zloty despite the appreciation of the real effective exchange rate since February 2009 that accelerated in the 3Q09. The depreciated zloty along with the economic stagnation discouraged imports. The positive effects of the nascent European recovery

on exports were little discernible. An improvement in economic activity in Poland in the 3Q09 along with the zloty strengthening supported imports whose year-on-year declines decreased in the July-August period. Both exports and imports seem to have bottomed in the 2Q09 if the data on September 2009, which were not available as of writing, confirm the trends from July-August 2009. The current account continued to rapidly decrease on the back of the shrinking trade deficit and the four quarter deficit fell to 2.1% of GDP in the 3Q09 according to our forecast. It will fall further in the 4Q09 and start slowly widening in the course of 2010.

The special feature: Large Fiscal Deficits – Curse # 1, suggests how to tackle the recurring large fiscal deficits in Poland. The text proposes two additional institutional arrangements to help cut the fiscal deficit in a sustainable way. One is to adopt a rule capping expenditure growth. Another and, perhaps even a more pertinent idea, is to establish a Fiscal Council of independent experts, which would monitor the fiscal policy of the government and warn were it may lead to.

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

Indicator	Data						CASE forecasts						
	2006	2007	2008	2008			2009	2010				2009	2010
				Q1	Q2	Q3		Q1	Q2	Q3	Q4		
Nominal GDP, PLN bn (% change, yoy)	1060.0	1176.7	1272.8	314.1	326.3	331.4*	369.8	328.8	343.1	349.2	388.4	1341.6	1409.5
GDP	6.2	6.8	4.9	0.8	1.1	1.5*	2.2	2.5	3.1	3.3	3.5	1.0	3.2
Private Consumption	5.0	4.9	5.4	3.3	1.7	2.5*	2.5	2.3	3.2	2.8	3.4	2.1	2.9
Fixed Investment (4Q, % of GDP)	14.9	17.6	8.2	1.0	-3.0	-5.6	-2.0	-1.1	1.6	4.9	3.6	-2.5	2.3
CA balance (% change, yoy)	-2.7	-4.7	-5.4	-3.9	-2.1	-1.1*	-0.5	-0.6	-1.1	-1.2	-0.9	-0.1	-0.9
Exports (NBP, EUR)	17.8	20.4	13.4	-22.9	-22.8	-21.8*	3.4	7.0	8.0	7.5	8.9	-16.6	7.8
Imports (NBP, EUR) (% change, yoy)	13.4	24.0	19.5	-28.8	-32.0	-27.2*	-2.8	5.0	7.0	6.0	9.5	-22.6	6.8
Industrial sales	11.2	9.5	3.3	-10.0	-6.7	-1.3	1.0	5.0	3.8	4.5	6.0	-4.3	4.8
Gross value added	6.0	6.7	4.9	1.2	0.8	1.2	1.9	2.4	3.1	3.2	3.5	1.2	3.1
CPI	1.0	2.5	4.2	3.2	3.7	3.6	3.4	2.9	1.7	1.8	2.1	3.5	2.1
PPI	2.3	2.3	2.5	4.9	4.2	2.2	2.3	0.8	1.5	3.3	3.2	3.4	2.2
Nominal Ave. Wage	4.9	8.7	10.4	6.8	4.4	3.0	2.7	3.4	2.5	3.1	3.3	4.0	2.9
Employment %, LFS	3.1	3.1	3.7	1.3	1.0	0.5	0.0	-0.3	-0.8	-0.5	0.0	0.7	-0.4
Registered unemployment rate (% eop)	14.8	11.4	9.5	11.2	10.7	10.9	11.9	12.5	12.7	12.3	13.0	11.9	13.0
PLN/EUR, eop	3.89	3.78	3.52	4.50	4.45	4.20	4.17	4.10	3.98	3.95	3.75	4.30	3.85
WIBOR 3M, %, ave	4.20	5.68	5.88	6.15	4.17	4.18	4.15	4.10	4.05	3.95	3.85	3.95	4.00
Central bank key rate eop	4.00	5.00	5.00	5.75	3.75	3.50	3.50	3.50	3.50	3.50	3.50	3.25	3.75
(% change, yoy eop)													
Broad Money (M3)	16.0	13.4	18.6	17.5	14.4	9.6	8.1	8.0	7.9	8.5	9.5	8.1	9.5
Loans to HH	33.4	37.9	44.6	43.7	35.7	26.3	15.5	10.0	8.0	8.5	9.0	15.5	9.0
Loans to Firms	13.7	24.1	29.0	25.8	15.0	6.8	1.0	1.5	3.0	4.3	5.0	1.0	5.0
(% GDP)													
Fiscal Balance	-3.9	-1.9	-3.9	n.a.	n.a.	n.a.	-5.8	n.a.	n.a.	n.a.	-5.5	-5.8	-5.5
Public Debt eop	47.7	45.0	47.2	43.6.	n.a.	n.a.	52.0	n.a.	n.a.	n.a.	54.9	52.0	54.9

(\* in the column on the 3Q2009 means CASE estimates or forecasts.

Cut-off date: October 31, 2009.

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

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