POLISH ECONOMIC OUTLOOK
TRENDS • ANALYSES • FORECASTS
CASE
QUARTERLY 4/2007 (35)

Special Feature – Pending Fiscal Reforms

EXECUTIVE SUMMARY

Polish business cycle peaked in the first half of 2007: Since then year on year economic growth started slowing and this trend should continue at least in the 1Q2008 (see Table 1). Real GDP grew preliminary 6.5% in 2007, i.e. above its potential rate of growth, estimated by us within the range of 5% to 5.5% a year. Domestic demand picked up to offset the rise in a negative contribution of net exports. However exports also grew faster than GDP, albeit at a lower clip than in previous years. This pattern should prevail in 2008 though the differential should continue to narrow. Net exports deteriorated as imports expanded due to the investment boom. Fixed business investment was the main driver of growth advancing by preliminary 20.4% in 2007. In 2008, they should grow at a lower pace of 11% (Table). Private consumption grew slower than GDP most of the year though this pattern may have changed in the 4Q2007, marking another change in the structure of growth. In 2008 private consumption should grow faster than GDP on the back of strong wage increases, further employment gains and pension indexation.

Actual GDP growth above potential should lead to stronger inflationary pressures and, indeed, they mounted above expectations in the 4Q2007, when the CPI rose by 3.5% yoy compared with 2.0% yoy and 1.3% yoy in the 3Q2007 and 4Q2006, respectively. However, these pressures have not increased because of excessive demand as the economic theory would suggest. Most of the inflationary pickup has occurred due to supply side factors so far. The most popular measure of core inflation ex-food and fuels barely budged in 2007: It stood at 1.7% yoy in December 2007 versus 1.5% in the 3Q2007 and 1.6% yoy in December 2007. Demand pressures have been creeping upward for sometime but they have been surprisingly timid. They are likely to replace supply side effects in 2008, assuming that global growth will falter and the global grain crop will be in line with the multi-year average after a dismal one in 2007. This scenario, coupled with the strengthening of the zloty, makes us forecast a declining trend for CPI inflation in 2008 (Table).

Strong growth led to a rapid fall in unemployment rate. The Eurostat seasonally adjusted index dropped to 8.5% in November 2007 from 11.8% in December 2006. The rate still remains the second highest in EU-27 but has come down much closer to the average of 7.2% in the euro area. The fall in unemployment was mostly due to increase in employment: The economy created more than 500 thousand jobs in 2007 and the 4Q2007 did not bring any slowdown in this trend despite seasonal adversities. Another factor was migration to the old EU countries, in particular to UK and Ireland, as unexplained part of the increase in non-active population suggests. Upward trends in employment will persist in 2008 but the gains will be smaller unless Poland opens wide its doors for immigration to ease labor shortages. These shortages in a number of professions and sectors are forcing wage growth above labor productivity gains and public wage demands put inflation risks on the upside. These developments support the view that actual unemployment fell in the vicinity of NAIRU so demand-pull inflation may accelerate in the coming quarters.

The current account shortfall rose moderately to estimated 3.6% of GDP in 2007 from 3.2% in 2006 on the back of a rapidly widening trade deficit in 2007. Nonetheless it remains one of the lowest in the region and was comfortably financed by FDI inflows that covered 97% of it in January-November 2007. Furthermore, the deteriorating trade balance in 2007 did not result from a softness in exports that continued to grow by estimated 13.6% in the euro terms. The 4Q2007 did not stand out negatively in this respect. The deficit widening is mostly related to the much more expensive imported commodities and to the differential rate of growth of the Polish economy and the euro area. In 2008, the deficit should deteriorate further to 4.5% as the euro zone downturn and the zloty appreciation will dent exports.

The strong balance of payments supported the zloty, which appreciated in the 4Q2007, backed by the widening interest rate differentials since the NBP raised its interest rates by a notch whereas the Fed lowered them aggressively and the ECB left them put. The interest rate differential will remain the main factor of a continued appreciation of the zloty in 2008 though this uptrend will be periodically interrupted by waves of bad sentiment against emerging markets due to ongoing financial markets turbulences, related to more disclosures of write-downs of assets and losses of financial institutions around the globe.

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

Indicator	Data								CASE forecasts				
	2004	2005	2006	2006 Q4	2007				2008			2007	2008
					Q1	Q2	Q3	Q4	Q1	Q2	Q3		
Nominal GDP, PLN bn	924.5	983.3	1060.2	300.4	266.7	280.2	286.8	329.3*	289.3	304.4	310.7	1163.0*	1257.8
(% change, yoy)													
GDP	5.3	3.6	6.2	6.6	7.2	6.4	6.4	5.9*	4.9	5.2	5.0	6.5	5.0
Private Consumption	4.4	2.0	4.9	4,7	6,9	5.1	5.2	5,9*	5.1	5.5	6.2	5.2	5.6
Fixed Investment	6.4	6.5	16.5	16.6	26.2	20.8	19.6	17.5*	9.5	10.6	10.3	204	11.1
(4Q, % of GDP)													
CA balance	-4.3	-1.6	-3.2	-3.2	-3.2	-3.7	-3.6	-3.6*	-3.7	-4.0	-4.4	-3.6*	-4.5
(% change, yoy)													
Exports (EUR bn)	22.3	17.8	19.3	20.5	19.0	19.3	14.4	13.3*	11.8	9.5	10.0	13.5*	10.5
Imports (EUR bn)	19.5	13.3	16.1	20.7	20.6	16.1	16.6	11.6*	13.0	12.5	12.9	15.9*	13.2
(% change, yoy)													
Industrial sales	12.6	3.7	11.3	10.8	13.0	8.5	8.1	9.6	6.4	8.9	7.6	9.7	7.5
Gross value added	5.2	3.3	6.2	6.9	7.6	6.4	6.2	5.9*	5.0	4.9	4.8	6.6	4.8
CPI	3.5	2.1	1.0	1.3	2.0	2.4	2.0	3.5	4.0	3.6	3.5	2.5	3.6
PPI	7.0	0.7	2.3	2.8	3.3	2.0	1.70	2.3	2.3	1.8	1.8	2.3	2.2
Nominal Ave. Wage	4.0	3.8	4.9	5.3	7.1	8.9	9.7	10.0*	8.8	9.5	10.9	9.1	9.7
Employment %, LFS	2.2	2.3	3.1	3.9	3.6	4.8	3.5	3.0*	2.6	2.1	2.1	3.8	2.2
Registered unemployment rate (%, eop)	19.0	176	14.8	14.8	14.3	12.3	11.6	11.4	11.2	10.1	9.4	11.4	9.6
PLN/EUR, eop	4.08	3.86	3.83	3.83	3.87	3.77	3.78	3.58	3.57	3.53	3.50	3.58	3.45
WIBOR 3M, %, eop	6.64	4.60	4.20	4.20	4.40	4.71	5.10	5.70	5.80	5.95	5.80	5.70	6.00
Central bank key rate	6.50	4.50	4.00	4.00	4.00	4.50	4.75	5.00	5.50	5.75	5.75	5.00	5.75
(% change, yoy eop)													
Broad Money (M3)	9.4	13.1	16.0	16.0	18.0	14.7	14.4	13.4	13.2	13.1	14.0	13.4	12.9
Loans to HH	13.3	26.0	33.4	33.4	37.7	37.7	39.6	37.9	35.0	32.0	29.5	37.9	25.0
Loans to Firms	-4.0	2.5	13.7	13.7	17.1	22.1	24.7	24.1	22.5	20.9	20.1	24.1	18.0
(% of GDP)													
Fiscal Balance	-5.7	-4.3	-3.9	n.a.	n.a.	n.a.	n.a.	2.9*	n.a.	n.a.	n.a.	-2.9*	-3.4
Public Debt	45.7	47.1	47.8	n.a.	n.a.	n.a.	n.a.	46.5*	n.a.	n.a.	n.a.	46.5*	48.0

(*) means estimates or forecasts

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

Economic growth, much stronger than penciled-in, was one of the reasons, why the central government cash budget deficit came at 16.9 bn zlotys or 1.4% of GDP, i.e. 54% of the 2007 annual plan. Tax revenue was higher than projected by 0.6% of GDP but an unintended restraint in expenditure by 0.5% of GDP played an equal role. The ESA-95 general government deficit (on accruals basis) likely dropped below 3% of GDP for the first time and should encourage Poland to ask the EU Commission to lift its Excessive Deficit Procedure. This plea must be accompanied by reform measures because the improvement in the deficit was one-off and cyclical so it is unsustainable into the future. The new government introduced only cosmetic changes into the former government's state budget draft (see PEO 3/2007). The former government has implemented reforms of the public spending that raised social expenditure. In our view, this increase is not properly accounted for in the state budget, which is based on overly optimistic assumptions with regard to GDP growth and tax collection. Therefore we maintain that the general government deficit will deteriorate to 3.4% of GDP in 2008.

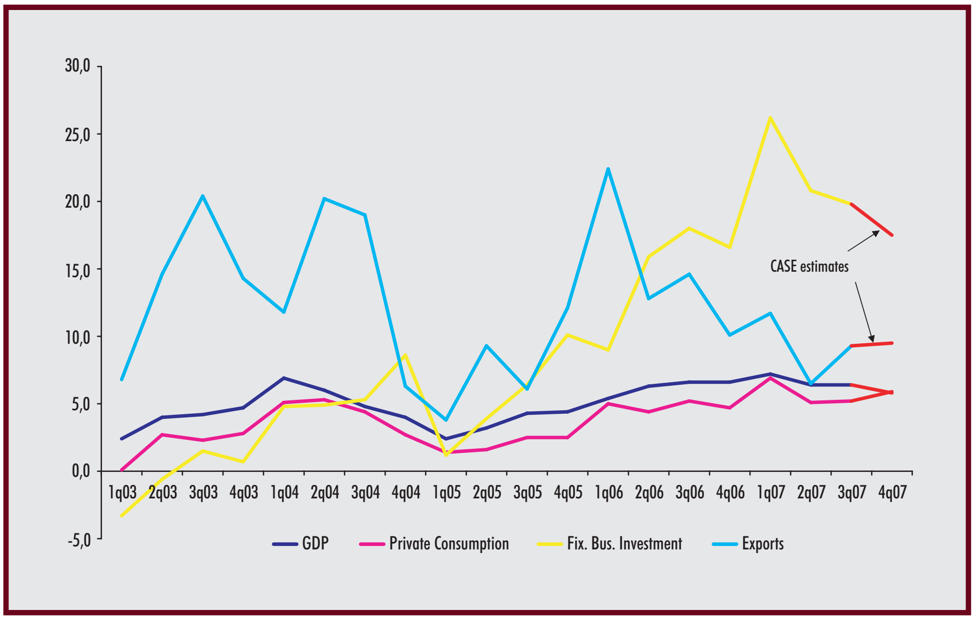
LATEST DEVELOPMENTS IN THE POLISH ECONOMY

Economic growth

Broadly speaking, the supply side became weaker in the 4Q2007 than in the 3Q2007. Sold industrial output advanced by 9.6% yoy, compared with 8.1% yoy in the previous quarter. Manufacturing output growth, however, has been downtrending since the 1Q2007, which is due to weaker exports since domestic demand has picked up in the meantime. The slowdown of manufacturing in the 4Q2007 was offset by a rapid rise in the electric energy, natural gas and water supply. Estimated construction sales increased by 10.2% yoy in the 4Q2007 versus 13.5% in the 3Q2007. Construction sales also peaked in the 1Q2007 and have been downtrending since then. Retail turnover rose by 12.2% yoy in the 4Q2007 versus 12.8% yoy in the 3Q2007 but when we adjust for CPI inflation, it actually slowed down more significantly from 10.6% yoy to 8.4% yoy. In this case, the pace of expansion has been decreasing since the 1Q2007 as well. However, the fall in retail sales growth was almost entirely due to a surprising year-on-year drop in the sales of foodstuffs in December 2007. This, however, may prove to be a one-time outlier. Consumers may have switched to durables during the Christmas season as these items became cheaper relative to foodstuff since prices of the latter rose rapidly in the fall of 2007 while heavy discounts attracted buyers to consumer electronics.

Comparisons of supply trends across sectors lead to a conclusion that GDP growth slowed down in the fourth quarter year on year and the economy lost even further momentum in the fourth quarter of 2007. We use the word "further" because on the seasonally adjusted base GDP, growth slowed to 5.8% yoy in the 3Q2007 versus 6.6% and 6.7% yoy in the 2Q and 1Q2007, respectively. The actual GDP year-on-year rate of growth in the 3Q2007 did not change and stayed the same as it did in the 2Q2007 at 6.4% while we had expected 5.8%. This surprised us because the supply side in the 3Q2007 looked weaker than in the 2Q2007. One explanation for this is that firms were able to raise net incomes despite strong increases in wages. Unfortunately, statistics on incomes, revenue and costs of non-financial firms for the 4Q2007 have not yet been released to date. These statistics will give us some indication as to whether firms were able to improve their profit margins over costs like they did in the 3Q2007 and increase value added. Should this be the case, GDP growth could reach 6% in the 4Q2007 but we do not count on the sustainability of this trend in our baseline scenario because wage rises in the 4Q2007 seem too high in order not to compromise firms' profitability. Therefore, we maintain our estimate that GDP grew by 5.8% yoy in this period.

Figure 1. GDP growth factors, quarterly % yoy



On the demand side, fixed business investment became the main engine of economic growth in the 3Q2007 since its contribution outperformed the contribution of consumption. This pattern is unlikely to have changed in the 4Q2007. Estimated average real wage and consumer credit rose less year on year in the 4Q2007 than in the previous quarter while employment advanced slightly faster. The real wage aggregate probably rose at a similar clip as in the 3Q2007 (the data for the entire economy is not currently available, nevertheless real average wage increased by 6.5% in 4Q2007 versus 8.1% yoy in 3Q2007 in the sector of "firms with at least 9 employees" because of the inflation surge). Year on year, real pensions fell more in the 4Q2007 than in the 3Q2007. These developments altogether suggest that private consumption did not have much capacity to grow faster year on year in the 4Q2007 than in the 3Q2007. The potential boost to private consumption could have come from dissaving, which may have occurred due to withdrawals from mutual funds in the 4Q2007 when the stock market plunged but this impulse is hard to assess. It is evident that overall consumption expenditures were stimulated by public consumption in the final quarter of the year as the central government's deficit increased rapidly. All in all, total consumption expenditures may have risen more in the 4Q2007 than in the 3Q2007. The previous forecast (see PEO 3/2007) has been revised downward to 5.9% because an unexpectedly strong rise in CPI inflation wiped out a significant portion of purchasing power gains due in part to higher wages.

Fixed business investment should have continued to slow since construction sales rose at a lower rate in the 4Q2007. This suggests that investment growth in nonresidential construction declined. On the other hand, a stronger use of credit by corporations and a slower expansion in their bank deposits may signal that they have intensified their retooling efforts. Based on two months of data the negative contribution to growth of net exports should remain broadly unchanged in the 4Q2007 because the discrepancy between export and import rates of expansion did not increase. The improvement in net exports was one of the reasons why GDP advanced more than we had expected in the 3Q2007. This should not be the case in the 4Q2007 if October-November trends are extrapolated to December.

The outlook for 2008 looks more nebulous than it appeared at the time of writing the PEO 3/2007. This is due to the ongoing credit crunch, the onset of the bear market on the global stock exchange and fears of ripple effects on the global and European economies due to a potential US recession. It is unclear whether the aggressive interest rate cuts by the Fed and a planned fiscal stimulus will offer a respite to the slipping US economy. It is also unclear whether US exports, propped up the softening dollar, will continue to make up for the collapse of residential construction in the US as they have managed to do thus far. Our views on the potential impact of a US recession on Poland's economy were outlined in the PEO 2/2007 and they can only be reiterated, albeit putting more emphasis on the negative risks. We still think that the fallout will be limited. Poland's economy continues to grow above its potential so demand-pull inflation, while still mitigated, is likely to become more apparent and constrain the scope for an easing of monetary policy should Polish exports wane. In fact, our hitherto scenario assumed that demand pressures will increase considerably due to excessive wage growth and prompt the central bank to hike its headline rate by at least 125 basis points in 2008. However these pressures have been timid so far and supply shocks (foodstuffs and fuels prices) have taken their place. These shocks, not taking into account some long-term factors, should subside in 2008. A global slowdown and a better harvest around the world should instigate a decline in the Polish CPI year-on-year inflation rate starting late spring. Furthermore, the large interest rate cuts by the Fed and likely declines in the ECB interest rates will support the ongoing zloty appreciation, which will exert counter-inflationary tendencies. Under such circumstances, as long as demand pressures remain low, the Polish central bank could interrupt its tightening cycle in the 1H2008 after increasing rates by a total of 50-75 basis points. We highlight this possibility as a departure from our previous scenario hikes totaling 125 bps in 2008. The potential loss of exports could be offset by the rising domestic demand though at a cost of an increasing trade deficit. The Monetary Policy Council would have more room for accommodation in monetary policy should structural reforms as well as fiscal reforms truly get started. In a nutshell, we maintain the forecast that Polish GDP will grow by 5% in 2008 in a baseline scenario that assumes a slowdown in the euro zone, or 4.5% under a scenario of a mild recession in this area. Furthermore, domestic growth risks are skewed to the upside because pending fiscal and structural reforms should enhance confidence in the economy. Increased confidence coupled with the injection of EU funds should attract more FDI inflows despite a downturn in the global economy. A potential increased rate of growth should follow which will in turn alleviate inflationary pressures.

The start of the 1Q2008 is promising. Business sentiment continues to be positive according to the NBP comprehensive business sentiment quarterly survey. Consumer confidence is also in line with the CSO monthly survey. It is to be noted that the impact of a global slowdown and uncertainties about its magnitude are not reflected in lower forecasts of export growth and export profitability but rather the strong and fluctuating zloty is pointed to as a culprit. After seasonal adjustment, capacity utilization slightly rose to a record of 84.1% in 4Q2008 while demand forecasts for the 1Q2008 were very optimistic in the NBP quarterly survey. Surveyed firms, in particular large corporations and public sector firms planned more fixed business investment in the 1Q2008 that should instigate an unprecedented number of start-ups. Further strong gains in employment and large wage increases, forced by strikes in the public sector, are predicted that will stimulate demand growth. Reading this makes us uneasy about our GDP forecast of 4.8% yoy in the 1Q2008 but the pattern of growth is heavily influenced by the statistical base effects: A jump in fixed business investment reflected by a spike in non-residential construction in the 1Q2007 will tend to dampen growth figures. Later on, these effects should drag the growth figures less and less until the economy works them out by the end of 2008. A pickup in GDP growth in 2009 is predicted for a number of reasons. Structural reforms should start creating results although they typically do so with a considerable delay therefore the sooner they are adopted, the more upward risks there are. Much will depend on the non-Keynesian effects of the fiscal package, which should be prepared and executed in 2009. Last but not least, the global situation should improve as well.

Inflation and Monetary Policy

Consumer inflation rose sharply by 3.5% yoy and 4% yoy in the final quarter of 2007 and in December 2007, respectively. This is the highest rate since early 2005, when inflation peaked in the aftermath of the EU accession. The current rise was driven to a large extent by prices of food and fuel. Compared to the 3Q2007, these aggregates saw their annual rate of growth increase by 3.5 and 11.4 percentage points up to 7.7% and 13% in 4Q2007, respectively.

The predominance of the supply-side origins of the inflationary rise is clearly evidenced in the behavior of the core inflation, calculated without both components. This measure of core inflation rose marginally from 1.3% in the 3Q2007 to a still very low 1.5% in the 4Q2007 suggesting that prices of industrial goods and services continue to increase at a very moderate rate.

Indeed, prices of non-energy industrial goods have stabilized in the 4Q2007 at 0.4% yoy, the same as in the 3Q2007, and services rose slightly to 2.7% yoy, up by 0.2 pct. points from the 3Q2007 but the same as in the 2Q2007[1]. While the fourth quarter data do not indicate acceleration of inflationary pressures in these aggregates vis-a-vis the previous quarter, they are, however, confirming the general trend of inflation rising across all consumer goods and services over a horizon of several quarters.

This is easily discernible in the dynamics of all measures of core inflation other than the net inflation. So-called trimmed inflation rose by a significant 0.9 pct. points to 3.2% yoy in the fourth quarter - only slightly below the CPI change. As the trimmed mean reflects the behavior of the inner-core of price changes[2] this suggests that the observed rise in inflation has resulted from the price acceleration in numerous rather than few markets and thereby confirms the broadening of inflationary pressures. Sizeable increases exceeding 1 pct. point over the previous quarter have been registered by all other core indicators, including the core inflation excluding the most volatile items and the core inflation without administrative goods and services – up by a sharp 1.6 pct. points and 1.3 pct. points, respectively.

Annual growth rate of producer prices increased by 0.6 pct. points to 2.3% yoy in the 4Q2007, although there seems to be no increasing trend over a longer period: PPI inflation was exactly 2.3% yoy on average in both 2006 and 2007. The relative stability disguises diverse trends within the index: a gradual rise in the price growth in manufacturing by 2.2% yoy in 4Q2007, coupled with falls in energy, gas and water supply by 3.7% yoy, and in mining and quarrying by 1.3% yoy, owing to falling metal ores prices by 15.9% yoy. Viewed across manufacturing branches, prices have visibly accelerated in the

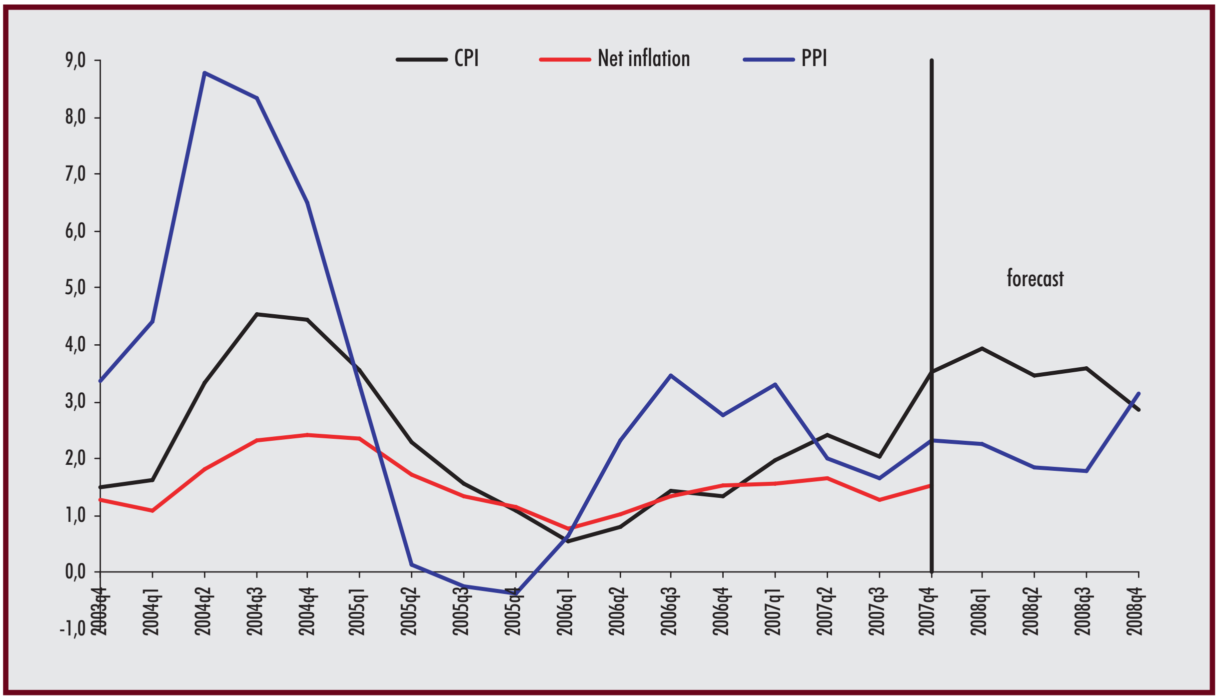
[1] Data refer to HICP (source: Eurostat).
[2] Trimmed mean is calculated by the elimination of the extremes from both ends of the price change distribution (i.e. extremely high and extremely low price changes).

foodstuffs and oil industries while declines have been registered in the metals and machines industries.

The consumer inflation outlook for the following four quarters is significantly higher than in the previous edition of the PEO, owing to sharper-than-predicted rises in food and energy prices in the 4Q2007 as well as higher expectations of food prices in the 1H2008 and strengthening domestic demand side pressures. We expect that the strong zloty will continue to restrain prices of tradables. However, the global trend of food price rises has consolidated over the recent quarter and is bound to have a lasting effect on the Polish foodstuffs market. Nevertheless we assume that the food inflation decline based on a good global crop in 2008 will override the long-term trend, whose main drivers are the growing demand for food in China and India as well as from the bio-fuel industry in the USA and Europe. This hypothesis underpins our decreasing path for the year-on-year CPI inflation in the 2H2008.

These effects combined will be responsible for the increase in inflation to 3.6% yoy on average in 2008 or 1 pct. point above the rate in 2007. Viewed by quarters, inflation will peak in the 1Q2008 at 4.0% yoy on average and then decline gradually throughout the year to 3.5%, 3.6% and 2.8% in the second, third and fourth quarter, respectively. The declines of the PPI in all three months of the 4Q2007 have led us to cut the forecast for 2008 to 2.3% yoy in the 1Q2008, 1.8% yoy in both 2Q2008 and 3Q2008 and 3.1% yoy in the 4Q2008.

Figure 2. Annual inflation in Poland, quarterly % yoy

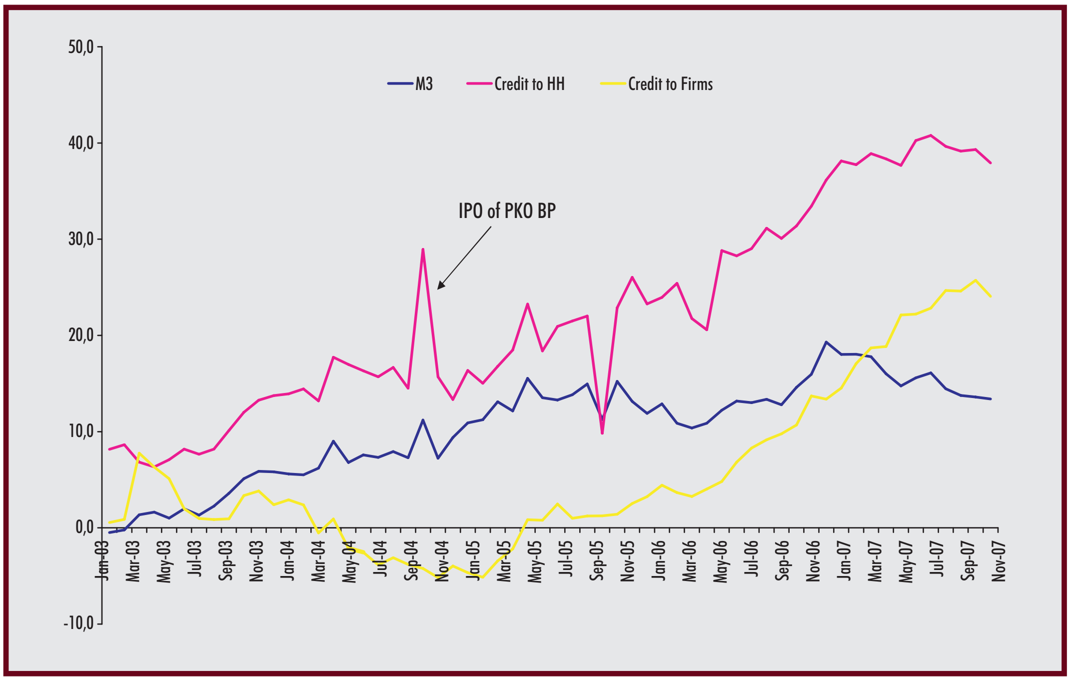


A declining trend for CPI inflation in 2008 prompts us to change our view on the monetary policy of the central bank. Summing up, demand pressures have been surprisingly low so far but due to wage increases above labor productivity gains, hefty pension indexation and expansionary fiscal policy they will come to the fore while supply side factors will subside in 2008. However these demand pressures should be offset by moderate declines in food-price inflation due to a solid global crop after a dismal 2007 one and a deceleration in fuel and commodity prices, dampened by the global downturn. Furthermore, the interest rate differential between Poland and the key financial markets has risen substantially on the back of moderate tightening in Poland while the Fed reduced its rates aggressively and ECB did not change them at all. Yet, due to downturn risks ECB is likely to follow suit soon. This differential should be the main factor of a stronger zloty appreciation than the one we had forecasted in PEO 3/2007. The strengthening will exert stronger counter-inflationary effects than had been perceived before. Therefore the path of interest rate hikes in 2008 is revised downward to only two to three 25 basis point increases from 125 basis points. These hikes should be concentrated in the 1H2008. The tightening cycle will likely be resumed in 2009.

Monetary Developments

Broad money as measured by M3 rose by 13.4% yoy in December 2007, down from its rate of 14.4% yoy at the end of the 2Q2007. Growth of M3 peaked in 1Q2007 and then decreased. Since the inflation rate has been increasing for most of the year, the M3 year-on-year growth in real terms dropped even faster than in nominal terms. When M3 expansion was corrected for CPI inflation, it amounted to 9.0% yoy in December 2007, compared to 14.4% yoy in December 2006 and continued to have an even faster rise in 1Q2007. Thus, at the end of the year, the rate of real M3 expansion exceeded the rate of growth in real GDP growth by a much smaller margin than at the onset of 2007. This augurs less inflationary pressures in the future than was previously predicted.

Figure 3. Broad Money and Credit Expansion, % yoy



Due to the differential in GDP and M3 growth rates, monetization of the economy has continued to gradually increase: It reached 48.3% of GDP in the 2H2007. Narrow money M1, cash balances and demand deposits are the most liquid forms of money because they may be directly exchanged into goods and services. Like in the 2Q2007, cash balances rose, broadly speaking, at a similar pace as M3 with a 13.5% yoy on average in the 4Q2007 while demand deposits increased at a much faster rate amounting to 21.8% yoy on average. This latter trend can be linked to rapidly rising wages and strong gains in employment. However, these deposits grew less year on year in the 4Q2007 than in the previous quarter and the slowest since the 2Q2006. The rising interest rates in the fall encouraged households to switch their money balances to time deposits that rose the fastest in the 4Q2007 since the 3Q2005. The long-term decline in time deposits of households was arrested in the 4Q2007 due to a combination of turmoil on the global stock exchange as well as in Poland and rising domestic interest rates which led risk-averse individuals to redeem shares in investment funds and switch to safer instruments of saving. Time deposits hit rock bottom in July 2007, when the first signs of a credit market crisis appeared to which stock exchanges reacted negatively. However this rise in time deposits of households was not strong enough to prevent them from falling year on year by 2.4% in December 2007 compared to a drop by 6.5% and 7.8% in September and June 2007, respectively. Firms continued to increase their deposits but their ratio to a rolling four-quarter nominal GDP had been gradually falling and stood roughly at 10% in December last year, compared to 11.9% in December 2006. This downward trend may be related to increased investment activity.

It is evident that the pickup in fixed business investment is sustaining the credit boom in the Polish economy. Interest rate hikes by a full percentage point have not impacted domestic credit adversely, yet the pace of expansion has started to slightly slow down since domestic credit rose 29.5% yoy in December 2007 versus 30.5% in September 2007. Due to accelerating inflation, the fall in real terms was more pronounced. Thus, the turning point has been passed. This faint decrease in the rate of growth can be traced to a slowdown in the credit rise for households to 37.9% yoy in December 2007 versus 39.6% in September 2007. Credit to non-financial firms stopped rapidly accelerating in the 4Q2007 as it also had in the 3Q2007 but on average its year-on-year pickup was stronger in this period than in 3Q2007. Full capacity utilization, labor shortages in conjunction with positive expectations of demand and profit continue to encourage firms to use credit as an external source of financing their investment projects. Since more hikes in interest rates are broadly expected, it means that firms do not think that the rising cost of outside financing will compromise their net incomes.

Such a rapid growth in credit always poses questions about the quality of loans especially if a downturn should ensue. However such an event is not expected to happen in the near future. Likewise, there are no statistical and casual reports of rising credit delinquencies. The ratio of irregular loans in their total value has been slackening and stood at 4.6% in June 2007 according to the most recent available data.

Mortgage rose by 50.3% yoy in December 2007 against 53.8% yoy in September so it continues to be at the forefront in terms of rates of growth of credit to private persons. The pace of expansion peaked at 62.9% yoy in February 2007 and has started erratically declining since then. A combination of factors could be at work. First of all, rising interest rates in Poland and abroad (in Switzerland) probably discouraged some individuals from applying for credit. Second of all, housing price inflation slowed considerably following a rapid rise when the former government announced its proposals to remove some of the barriers for housing construction. This proposal raised expectations of a decline in real estate prices so that some households may have delayed their decisions about purchasing a new home. It is worth mentioning, however, that the new government has not introduced these changes yet. Third of all, banks reported that they tightened their standards of granting mortgages as their capital adequacy declined due to rapid credit expansion earlier in the year. This may have also been due to the fact that they were psychologically impacted by the housing crisis in the USA. However this impact has been modest so far. There is no evidence that mortgage quality has deteriorated. Polish mortgages are not securitized as in the USA so any analogies are misplaced. Therefore the Polish banking sector has no direct or indirect exposure to the risk connected to investments into collateralized debt obligations supported by US subprime mortgages. Furthermore, mortgages in Poland have never been given to "ninjas" (persons with no income, job or assets) like in the USA and credit history is always screened.

The vulnerability of Polish households to the zloty depreciation continues to decrease. In the 4Q2007, 55.2% of mortgages were denominated in foreign currencies, compared with 57% in the 3Q2007 and a record of 67.1% in June 2006, when the Central Bank instructed commercial banks to tighten their procedures of approving foreign currency loans. In 2007 zloty and foreign-exchange denominated mortgages rose by 86% and 30% so the currency risk is diminishing. Zloty denominated mortgage almost doubled in the last twelve months whereas foreign exchange denominated mortgage rose by 32.1% yoy.

Fiscal Developments and Policy

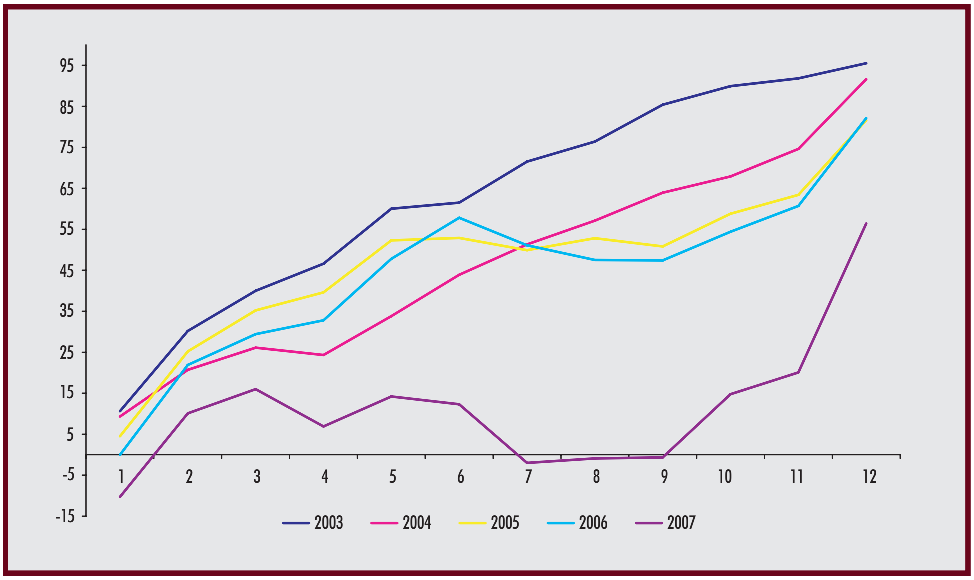
The central government cash budget deficit was 17.1 bn zlotys in the 4Q2007, turning a small cumulative surplus in the first three quarters of the year into a 16.9 billion deficit for the whole year or 1.4% of estimated 2007 GDP. This amounted to 56.4% of the annual plan of 30 billion zlotys. The actual shortfalls in October and November were lower than originally projected by the government so the bulk of the fourth quarter deficit occurred in December 2007. Precisely, it reached 10.9 bn zlotys and resulted from a large rise in expenditure. This does not signal any relaxation of the fiscal policy, however. Polish government typically settles its bills, in particular for public investment, in the last month of the year so December deficits are usually an outlier but this time delays in settling the bills were longer and concentrated at the very end of the year. Last year state financing for a number of EU related projects was probably released in December, when various institutions rushed to cash co-financing from the state budget before deadlines.

The strong position of the state budget in 2007 is due to higher-than-expected economic growth and an unintended expenditure restraint. Tax collection continued to come ahead of projections in the 4Q2007: Actual revenues outperformed projections by 2.9 bn zlotys. In the entire 2007 revenues that neared PLN 236 bn were up PLN 7.0 bn relative to original projections or 0.6% of 2007 GDP.

The rise in indirect tax, PIT and CIT revenues by 5.7%, 11.4% and 11.4% relative to 2007 plan, respectively, was caused by a much stronger GDP expansion than projected in the state budget. However, the cash state budget would not have recorded such a small deficit in 2007 had not expenditures dropped much behind the original schedule, either. State expenditures rose much slower than projected in this period and amounted to 252.9 bn zlotys versus the projected 259.0 bn zlotys, i.e. they were lower by 6.1 bn or 0.5% of GDP than planned.

The new PO-led government did not go for a major overhaul of the 2008 state budget draft, prepared by the former government, in order not to risk breaching the constitutional deadlines. It introduced only minor changes that do not upgrade a general poor review of the draft because its major flaws have not been deleted. The state revenue, expenditure and deficit have been changed to 281.8 bn, 308.9 bn (both including settlements with the EU) and 27.1 bn zlotys, respectively, compared with the original draft that called for a deficit of 28.6 bn zlotys. Thus the government will run an expansionary fiscal policy in 2008. This is rather disappointing. GDP growth assumptions of 5.5% are too optimistic while CPI inflation at 2.3% is too low: Both most likely are neutral for tax revenue. The rise in the state revenue is overly optimistic since increases in tax collection assume high levels of tax revenue elasticities with respect to GDP and domestic demand from 2006-2007. Such assumptions are supposed to justify a much larger rate of state revenue growth than nominal GDP. In turn, this strong rise in state revenues should fund a big increase in expenditure, mostly social, without enforcing a significant rise in the central government deficit. An augmented indexation of pensions and a huge increase in a subsidy to the Social Insurance Fund (FUS) due to a reduction in non-wage costs will boost expenditures whereas an increased tax credit for each child in a family will lead to a decline in state budget revenues by 0.5% of GDP. When assessed against the 2007 performance of PLN 16.9 bn the PLN 27 billion deficit looks excessive. The new government has not used the opportunity to cancel or to postpone the second stage of the costly reduction in disability pension premium for at least a year. This cancellation would have saved the government some 10 billion zlotys or 0.8% of GDP and could have been directed toward the deficit reduction. Slashing of the premium is untimely when the economy is growing above its potential rate and its benefits have benefited mostly consumers instead of firms.

Figure 4. Central government budget deficit, % of plan



Our forecast of the ESA-95 general government deficit of 3.4% of GDP remains practically unchanged since we do not endorse the government optimism that the revenue will rise so much as projected by the state budget bill; local governments will continue to enjoy low shortfalls and social funds will continue to record surpluses. In our view the tax credit for families with children that will approximately cost the budget 0.5% of GDP in lost revenue is not properly accounted for. We share EU Commission's opinion that the drop in the general government shortfall below 3% of GDP is cyclical to much extent and unsustainable into the future without radical reforms of social expenditure, i.e. early pensions and pensions for farmers likewise further tightening of supervision over disability pensions. Under these circumstances lifting of the Excessive Deficit Procedure in 2008 look fairly unlikely.

Labor Market

Employment

Employment dynamics is still on the rise although the situation does not look clear in all sectors. In the 4Q2007, the number of employed persons in enterprises that have at least nine people on staff (in the so-called enterprise sector) increased by 5.0% yoy (4.8% in 3Q2007). This rise in dynamics however took place only due to rapidly rising employment in two sections: business & property services (a 7.7% increase yoy in the 4Q2007 in comparison to 5.9% yoy in the 3Q2007) and trade (7.7% versus 7.4%). In all other sections, employment dynamics either slightly deteriorated (as in transport by 0.2%) or stabilized (as in the biggest section - manufacturing). The 4Q2007 was also the first one since the beginning of 2007, when construction was not the leader of employment growth (7.2% yoy).

The only discouraging news concerning employment creation continues to come from the Public Employment Service (PES). The number of job finders still continues to decrease; In the 4Q2007 only 281,300 registered unemployed persons found new jobs meaning a 12.2% yoy decrease.

Unfortunately, we still do not have detailed information on structure of job finders in the 4Q2007. We do not know how many of them were able to find new jobs due to their own activities and how many of them got the subsidized jobs within the framework of PES activation programs. The partial data we have, cover October and November only and indicate that the share of subsidized jobs in total job-related outflows keeps on rising.

The dynamics of the number of job offers from enterprises registered at PES seem to have stabilized on the relatively low level. The number of job offers in 4Q2007 was up by 4.6% from a year ago (it was 3.2% in 3Q2007, 12.4% in 2Q2007 and 26.8% in 1Q2007).

What seems more interesting however, is the increasing share of unfilled vacancies at PES. In the 4Q2007, there were 72% of leftover vacancies at PES, whereas the average for the rest of 2007 was 61% and for 2006 - 49%. It means that it becomes more and more difficult for employers to fill their vacancies through PES. The phenomenon started to be visible in PES data since the beginning of 2005, however in last several months it became more dramatic. It is obviously related to a very low "quality" of the labor force at the disposal of PES. The only way PES can react is to actively look for new "clients" among those currently inactive (job non-seekers).

The LFS employment figures for the 3Q2007 continued to be optimistic, but also with a bit of caution. The number of employed increased yoy by 3.5% (4.8% in 2Q2007), so it seems that employment dynamics lost its previous impetus. The number of employed increased more rapidly in industry (6.3% yoy) than in services (4.6% yoy) but in both cases the pace of growth was slower than 8.2% and 6.0% a year ago, respectively. The number of employed in agriculture continues to fall: It was down by 5.2% yoy in the 3Q2007. It seems that there are mainly so called assisting family members (mainly farmers' families), who either look for other jobs or choose inactivity.

We expect that employment in the enterprise sector and the overall LFS figure will keep rising in the quarters to come, however we still expect the growth rates to slow down. In the 1Q2008, the enterprise sector employment will grow by 4.5% yoy and the LFS employment in the 4Q2007 will grow by around 3% yoy. The average enterprise sector employment growth for 2008 should stay at a rate of 4.0%-4.2%, the LFS employment will stay at around 2%-2.5% yoy.

Wages

Wages in the enterprise sector continue to rise rapidly, although December, partly due to the statistical base effect and partly due to shifting the payout of bonuses forward to November, witnessed the most acute reduction in nominal wages dynamics since the end of 2005. Anyway, average gross wages increased by 10% yoy in the 4Q2007 and it was "only" by 0.2 pct. point higher than in the 3Q2007. The average annual growth rate of nominal wages in 2007 reached 9.1% yoy compared with a rise by 5.1% in 2006.

Real wage dynamics decelerated to 6.3% yoy in the 4Q2007 due to rising inflation, i.e. so the wages rose by 1.3 pct. point less than in the 3Q2007, marking the first reduction of real wage dynamics since the 3Q2006. Real wages grew by 6.5% in 2007 versus 4.1% in 2006.

Although year-on-year nominal wage dynamics in December decelerated in almost all sectors, the quarterly y-o-y growth rates are still on the rise. In the 4Q2007 wages were still growing most rapidly in construction. However it was also the only sector, where wage growth significantly slowed down as compared to the 3Q2007 (16% yoy in the 4Q2007 as compared to 17.8% in 4Q2007). In manufacturing and in trade and repairs, wage growth stabilized at around 10% yoy and at 11.5% in the 4Q2007, respectively. Wages accelerated most rapidly in mining growing 9.2% yoy in the 4Q2007 as compared to 6% in the 3Q2007, and in hotels&restaurants (10.5% versus 8.6%).

If the December tendency to slow down wage growth upheld in 2008 the expected gradual deterioration of labor market dynamics might delay. On the other hand however, one has to remember that the lack of qualified labor and a large inactive population are currently the main bottlenecks of the Polish labor market. The rapid wage growth observed for last several months, notwithstanding all its possible negative consequences for competitiveness of the Polish economy is a reaction to the supply side problems plus it could be important part of the solution since higher wages improve incentives to work and older people may re-enter the labor market.

However, we believe that December slowdown of wage growth was only a one-off phenomenon. Nominal wages will continue to rise rapidly due to strong pressures from unionized labor that goes on or threatens with strikes in the public sector, and due to real supply side bottlenecks on the Polish labor market. We expect nominal wage growth to stay at around 9% yoy in the 1Q2008 and 9.5% for 2008 as a whole.

Unemployment

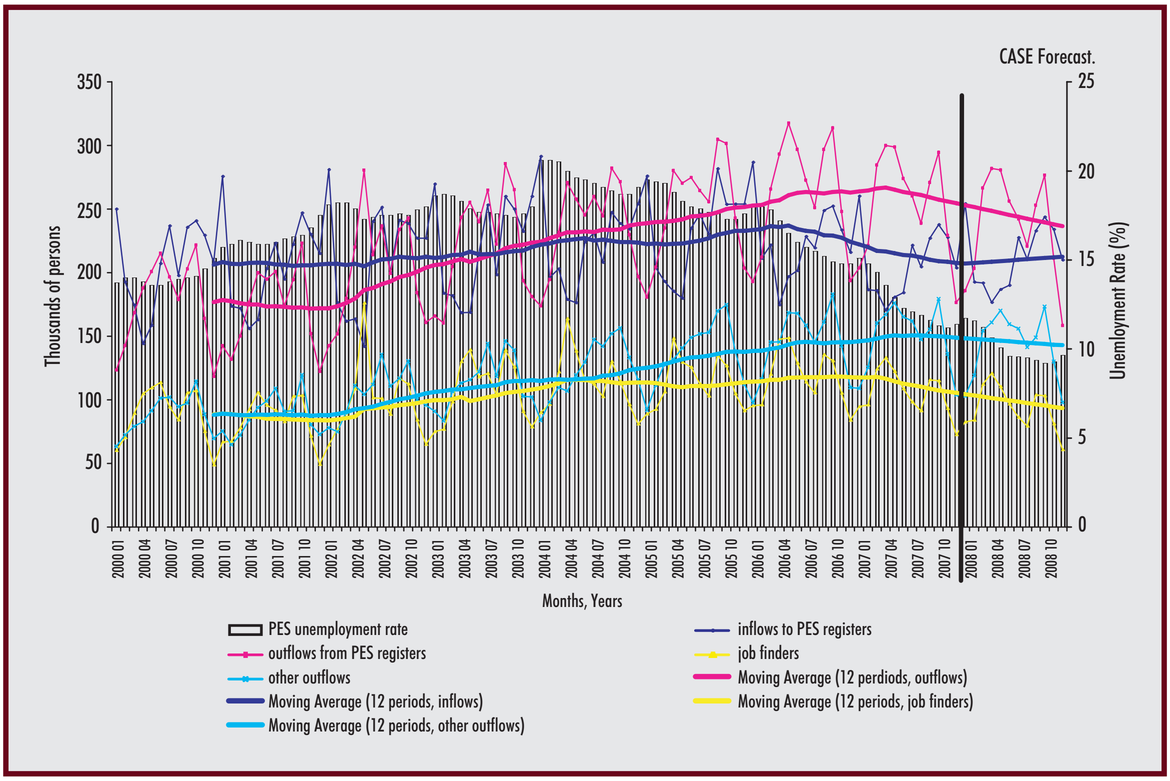
Unemployment is still falling rapidly but the pace of unemployment reduction ceased to accelerate. The number of registered unemployed persons fell to 1,746.6 thousand in the 4Q2007. This meant a y-o-y reduction of 24.4% (24.8% yoy in the 3Q2007). The registered unemployment rate fell by 3.4 percentage points to 11.4% at the yearend (see Figure ??).

As we described it in the employment section, the number of those leaving the PES registers keeps falling. However, it happened not only due to a falling number of job finders in the 4Q2007 but also due to other reasons, not related to employment. On the other hand although the number of those registering in PES (newcomers) still decreases, the rate of this fall is decreasing. The number of newcomers in the 4Q2007 and in the 3Q2007 decreased by 4.6% and 6.3%, respectively. It all indicates that 2008 will witness the slowing down of unemployment reduction in Poland.

The LFS figures for the 3Q2007 are still optimistic but the data signal that unemployment decline will continue at a decreasing rate. The number of unemployed fell by 31.6% yoy reaching 1,531,000 and the unemployment rate fell yoy by 4 pct. Points, reaching the record law of 9.0%. It meant however that in comparison to the 2Q2007 the rate of unemployment reduction decreased by 0.7 pct point. Thus the 3Q2007 marked a turning point as the first quarter since the 3Q2005, when the rate of unemployment reduction did not accelerate.

We expect that registered unemployment will stabilize in the1Q2008 at 11.2%. Then it will resume falling but slower than in 2007. We expect it to reach 9.5%-10% at the end of 2008. The LFS unemployment will also continue to fall. It should stay at around 8.5%-9% in the 4Q2007 and drop to around 7% by the 2008 yearend.

Figure 5. Registered unemployment rate, outflows from and inflows to PES registers in 2000-2007 and CASE forecast for 2008



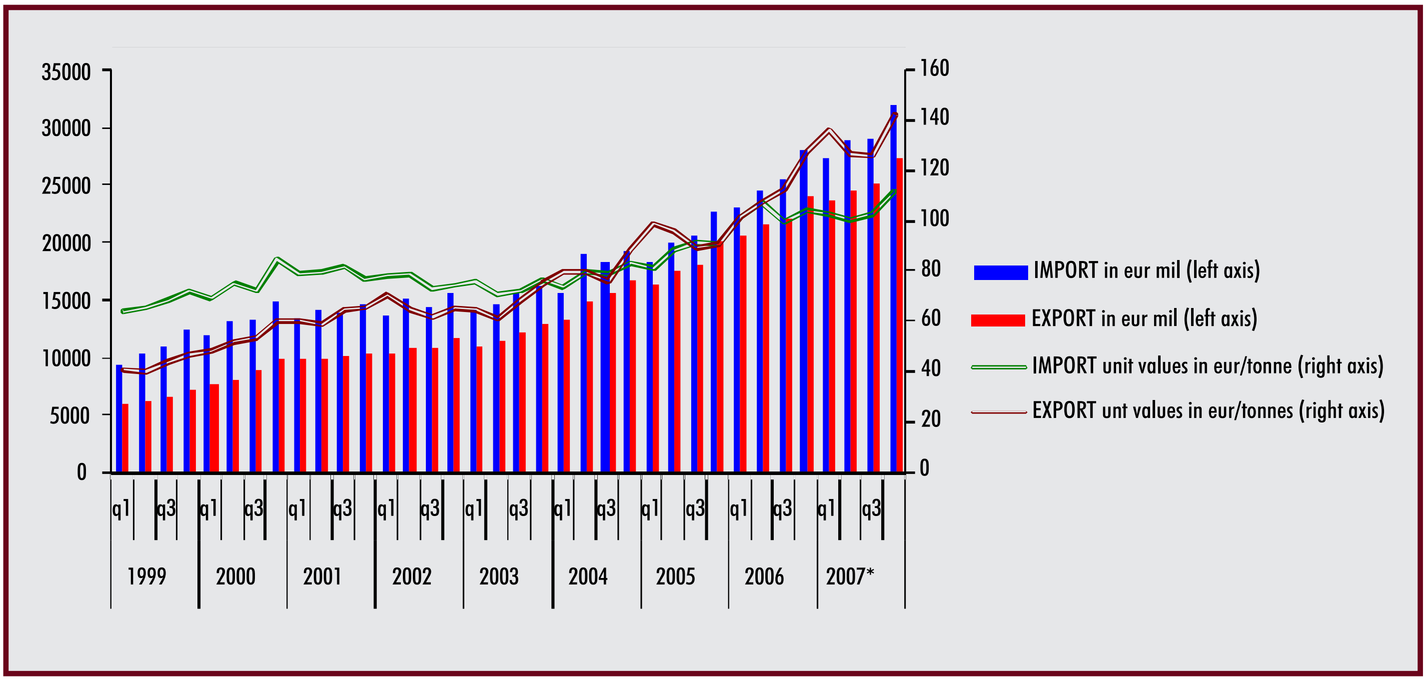
Foreign Trade and Balance of Payments

- **Exports and imports growing at similar rates**
- **CA deficit stable at 3.6% of GDP**

Towards the year end, merchandise exports continued to grow at a similar rate as a quarter earlier. Sales of Poland-made produce increased in nominal zloty terms by about 7-9% yoy in October-November of 2007. The fastest growing export markets were developing countries, while sales to Eastern Europe, mainly Russia and Ukraine, stagnated yoy. Sales to the EU maintained its earlier pace (10% yoy in zloty terms and 16% yoy in the euro in October-November 2007. The average euro prices for a unit of exported goods kept on mounting.

Imports have been on an upward path too and expanded marginally faster than exports. Value of imports rose in nominal zloty terms by about 10% yoy and 15% yoy in the euro terms in October-November 2007. In the same period, similarly as before, merchandise trade deficit was mainly due to trade with developing countries (China) and to some extent due to trade with Russia. Trade with the EU ended with a small surplus in the two autumn months of 2007. It should be noted that imports have been becoming cheaper and cheaper both in zloty and in euro terms (for euro unit values see Figure 6).

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



Note: 4Q2007 – estimate
Source: Eurostat and own calculations

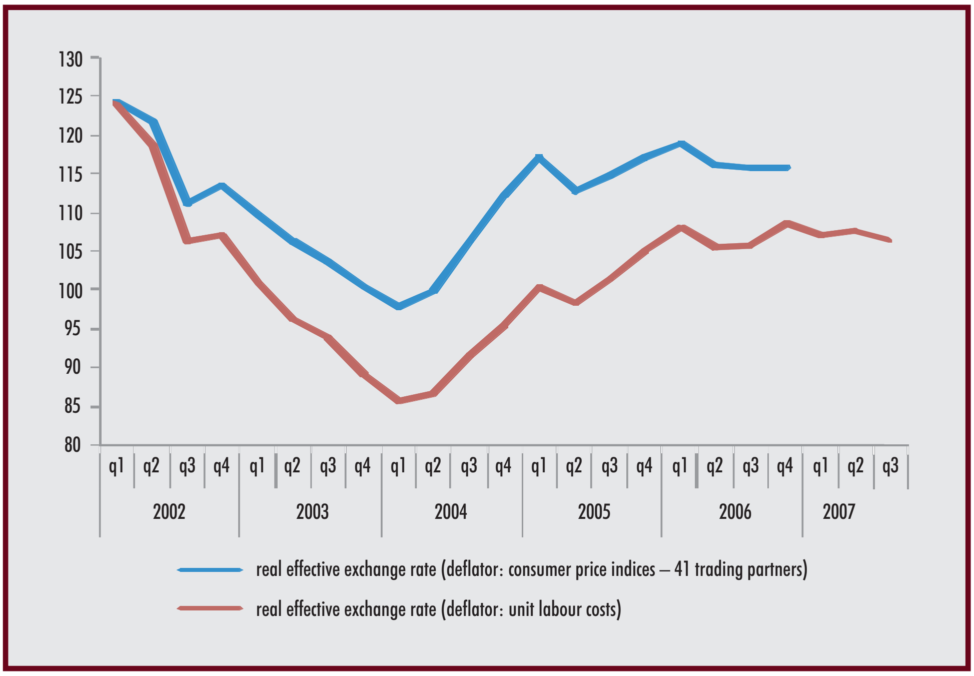
As imports become cheaper, their volumes grow faster export volumes. The volume of imports of goods and services in October 2007 expanded 13% yoy. In the same month, exports of goods and services grew in real terms 6% yoy only. The primary cause for rapid growth of imports was high and stable domestic demand. However, the appreciating real exchange rate of zloty vis-a-vis the euro and the dollar (throughout the whole 4Q2007; for earlier data see Figure 7) might also be a factor. Economic growth in the EU27 continued, albeit at slower pace, and it was a primary factor behind growth of Polish exports.

It is forecasted that both exports and imports will grow at about 10-11% yoy in real terms in 2008. In 2009, exports in national accounts are expected to accelerate and grow by 12%, while growth of imports will be lower, i.e. around 9% yoy.

It is difficult to say with a significant degree of confidence what will be the time path of future values of merchandise exports and imports. They depend very much on changes of terms of trade, and those are hard to predict. We forecast, nevertheless, that the dynamics of merchandise exports and imports (expressed in the euro) will be higher than the real changes, predominantly due to a strengthening of the zloty. We think that the unit values of export will grow less dynamically in 2008. We also forecast that the merchandise trade balance will worsen in 2008, yet improve again in 2009.

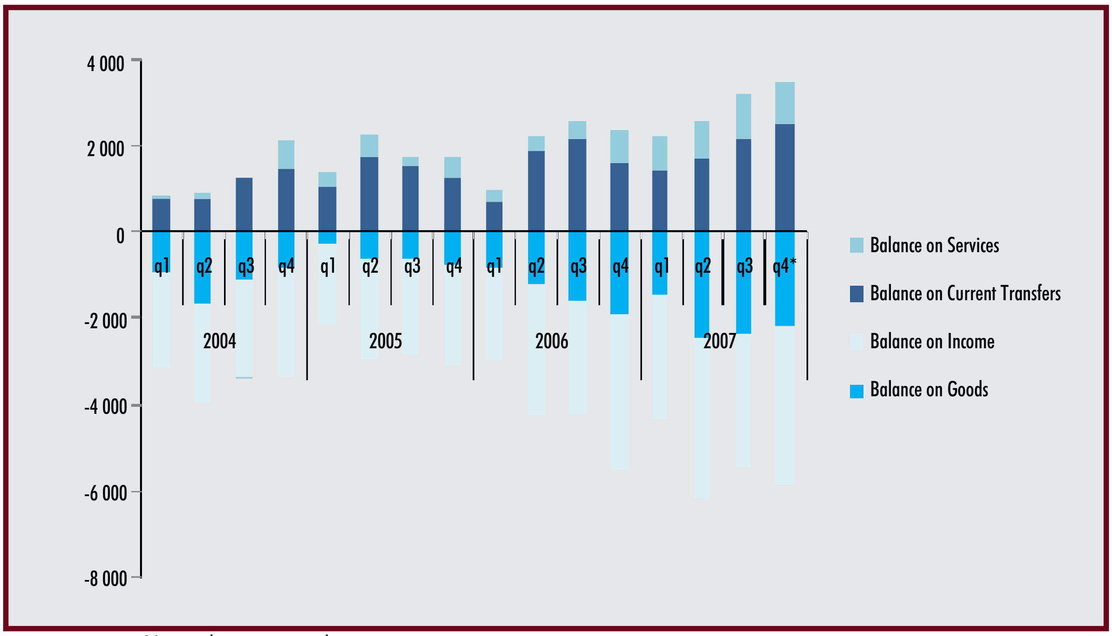
The current account (CA) balance has been negative and around of 3.5% of GDP in the 3Q2007. It seems that the 4Q2007 will not bring any change, and the year 2007 will end in with CA deficit of this range. The CA deficit in the 4Q2007 was probably most influenced by a large and negative balance on the current income account (for October-November 2007 EUR -2.5 billion, if trends were preserved in December, over EUR -3.5 billion for the whole 4Q2007; see Figure 8). The second negative factor affecting CA balance was merchandise trade deficit, which should have closed at around EUR -2.2 billion for the 4Q2007 (estimate based on October and November data). Trade in services probably closed with a small surplus. Current transfers – out of which significant part is composed of transfers to and from the EU budget – most likely recorded a positive balance in the 4Q2007.

Figure 7. Real effective exchange rate, 2002-2007



Note: 4Q2007 – estimate
Source: Eurostat and own calculations

Figure 8. Current account, 2004-2007, quarterly, euro mn.



Note: * – own estimate
Source: NBP

This is to say that higher CA deficits in recent quarters are caused to much extent by external factors, i.e. by outflows of higher incomes of foreign investors. These factors are nevertheless linked to the growth of the domestic economy, but are not directly subject to domestic economic policies. They should also not be treated as a source of concern – at least now – since investors income contains reinvested earnings, and for example in October-November 2007 they constituted over half of the total current income of foreign investors.

FDI inflows in October and November 2007 were higher than on average in the 1H2007. Probably, 2007 closed with FDI inflows totalling EUR 13-14 billion, a result close to that for 2006.

Pending Fiscal Reforms

The state budget outperformed expectations in 2007. The cash central government came at 1.4% of GDP (see section on Fiscal Developments). This was a third year in a row, when the cash deficit was lower than original projections. This led to a quite significant drop in the general government deficit, calculated along the ESA-95 methodology of the EU that uses accruals basis (Figure 9). However, the business cycle peaked in Poland in the 1H2008 and at this juncture the country should have boasted a general government surplus. This is not the case.

Most of the reduction in the state deficit over the years occurred due to higher-than-expected economic growth that boosted tax revenue. This is purely cyclical and unsustainable into the future. The structural deficit barely improved. The former government, in fact, wasted the most advantageous period to come to grips with the expenditure side of public finances. This was the period when inflation rate was low and/or falling (2006-2007) so various indexation schemes, binding by the law, did not enforce automatically more expenditure. The period also coincided with accelerating GDP growth combined with strong gains in employment in Poland and a booming world economy. Counter to decent economics, the high tide of the market encouraged the government to raise costly social expenditures that is causing the cash state budget deficit to rise in 2008 relative to 2007. The central government expenditure is to rise by 11.4%, i.e. above the rate of nominal GDP of 9.4% (barring EU related expenditure). Running expansionary fiscal policy is irresponsible, when it coincides with GDP growth that is above or close to the potential rate of growth of the economy.

Therefore radical reforms are pending and they cannot be postponed because the time has passed and Poland is closer to a cyclical downturn than it was at the beginning of 2006 or 2007, even when a slowdown seems a rather medium-term prospect. The blueprint for reforms is rather well-known. They must trim growth of the social expenditure. These reforms will have a gradual impact on the improvement in the structural position of the public sector finances through the state budget.

First of all, the government should cap the rise in state expenditure by introducing a rule for its growth, aka, an anchor in colloquial parlance. A number of possibilities are handy. The optimal would be to freeze the overblown public sector spending in real terms, i.e. to constrain growth of it to the rise in the CPI inflation rate. To be honest, this would imply that the spending would slightly increase in real terms because CPI usually rises faster than GDP deflator. The second best rule would be to limit state expenditure growth to the inflation rate and add some slack for growth in real terms however low. The rule would be formulated as CPI change plus one or two percentage points. The third best rule would be to allow for the expenditure increase in line with nominal GDP.

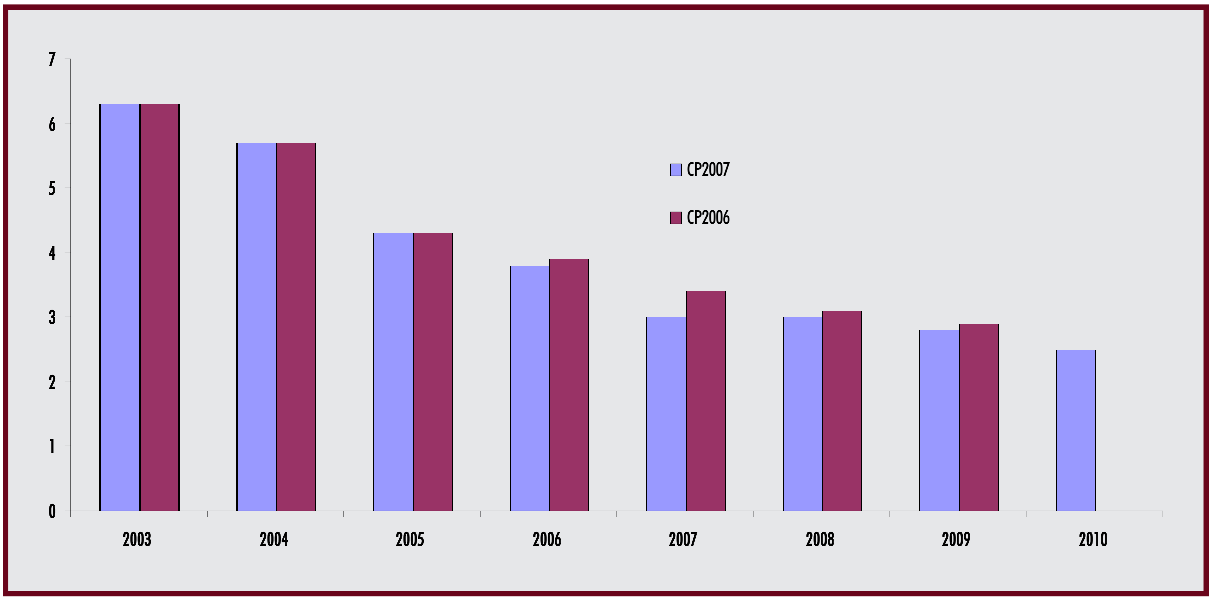
This should be a general framework in order to bring the structural deficit into a small surplus over two to three years. The detailed measures are primarily related to the labor market and also to product markets. The most promising venue for reforms is to drastically limit the access to early pensions. In 2006, the employment rate was 54.5% in this country whereas it stood at 64.8% in EU-25 and 66.2% in the EU-15. Average exit age from the labor force was 59.5% in Poland compared with 61.0% and 61.4% in EU-25 and EU-15, respectively. Only 28.1% of those aged 55 to 64 were employed in Poland in 2006 while the EU-25 and EU-15 averages were 43.5% and 45.3%, respectively.

The spending on early pensions costs 19-20 bn zlotys a year, i.e. about 1.7% of 2007 estimated GDP. There are approximately 4.2 million people aged 55-64 years in Poland, thus raising the number of those working in this generation to the EU average would return roughly 600 thousand people to employment. There are almost 1.1 million early pensioners in Poland and about 0.4 million of those who receive a kind of bridging benefits before they are eligible for pensions, altogether 1.5 million persons. Assuming that 600 thousand persons that would reenter job market claim average benefits, the state expenditure on early pensions would be reduced by 40% or 1% percent of 2007 GDP to 8 billion zlotys or to 0.7% of GDP. Recall this is a half of the central government deficit in 2007. These estimates do not take into regard the revenue side of the budget: These people would pay taxes and assuming that they earned an average wage in the economy in 2007 (we estimate it at 2720 zlotys) and paid an average PIT rate of 16%, the state coffers would be filled with 3.1 bn zlotys or 0.2%-0.3% of 2007 GDP. Hence the combined effect would reach approximately 1% of GDP.

Poland is also subject to society aging and the fertility rate in Poland is one of the lowest in Europe despite one of the harshest abortion laws and predominantly catholic population. On the other hand average life expectancy has been rising for years and a 60 year-old female, i.e. the one at a nominal pension age, can expect to survive almost 23 years more. However, women leave labor force at the age of 54 on average and can expect additional 28 years to live so they spent on pension one third of her life! Is this rational? Taking all these factors into consideration a desirable long-term step would be to raise nominal pension age to 67 years in two stages. The first stage would be to equalize the pension age of females with the pension age of males at 65. This could be done in one step by adopting the law that would immediately allow women work until they reach the age of 65 but did not force them to. The economic rationale is that a female, who goes on pension at the nominal age of 60 can count on a much lower pension than males, who continue to accumulate funds until the age of 65. The second stage would lead to a rise in pension age for both sexes to 67 years, say once the average life expectancy of males at birth reaches 72 years (It is slightly more than 70 years now), to let them enjoy pension benefits for five years like nowadays. This is likely to happen in 5 years.

Another direction of fiscal reforms is to make farmers pay higher contributions to their pension fund, managed by KRUS. At present their premia cover mere 8% of the total cost of farmers' pensions and health care insurance. The state fetches 1.3% of GDP in subsidies to KRUS. Doubling the farmers' contributions would bring additional state revenue of 0.1% of GDP so the amount is small but a path should be tailored to gradually increase these contributions to equalize them with the pension insurance and health care premia paid by non-farmers. The imbalance is not only of economic significance but a matter of social unfairness as well, since non-farmers pay much larger contributions than farmers do, i.e. the latter should triple in fact. Switching to the revenue side, an income tax system for farmers is long overdue. This would also ease the burden of state subsidies to farmers' pension fund.

Figure 9. General government deficits in 2007-2010



Source: Polish Convergence Programs 2006 and 2007

Despite a considerable progress in tightening very lax procedures of legibility for disability pensions that substituted for unemployment benefits at the initial stages of transition, Poland continues to spend too much on them in terms of GDP: The amount was close to 2.9% while the OECD average was 1.4% of GDP in 2005, when the latest data is available. Disability benefits amounted to estimated 10.5% of the total social benefits in Poland versus 7.9% in EU-15 and EU-25 in 2005. The burden will ease over the years, since it has recently become more a problem of a large stock of benefit recipients, accumulated in the past, than a one of an inflow to this pool. Nevertheless further steps to bring disability pensioners back to work should be welcome. Lowering the expenditure permanently by 1% of GDP below 2% of GDP would be welcome and realistic in a few years.

Last but not least the new government should neither shelve the draft of the general government consolidation prepared by the former government nor delay the implementation of a task-performance budget. These reforms would bring about additional savings. The consolidation drive was supposed to eliminate numerous funds and state agencies and incorporate their budgets into the state budget while some of their tasks should be sourced out in order to introduce more competition and efficiency. Thus this would be in fact a reform of product markets. The ministry of finance claimed that the specified consolidation efforts in the draft would allow to save expenditures of about 10 bn zlotys or 0.8% of GDP after two years have passed since putting the reform into force. Even though this figure looks overly optimistic because a number of tasks will have to be implemented by the state administration, savings would be material.

As outlined the broad reform agenda would predominantly touch the expenditure side. Minor measures can be devised on the revenue side because the overall tax burden looks relatively high, when social contributions are properly accounted for. The promising policy with regard to product markets would be to complete privatization of the infrastructure sectors of the economy such as energy generation and distribution, railways etc., in order to cut down subsidies to these sectors and improve their efficiency as they would be subject to competition and have to offer required returns to capital to their owners. Then the state budget would capitalize in terms of increased tax collection as well.

This list of suggested moves shows that a potential to eliminate the structural deficit in Poland is enormous and exceeds 3% of GDP provided that politicians will live up to the occasion. These reforms would eliminate not only the excessive deficits but offer room for counter-cyclical policy during a major recession without a risk of destabilizing public finances.

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