POLISH ECONOMIC OUTLOOK

CASE

TRENDS • ANALYSES • FORECASTS

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.

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.

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

Indicator	Data							CASE forecasts					
	2004	2005	2006	2006	2007				2008			2007	2008
				Q4	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.

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