POLISH ECONOMIC OUTLOOK

TRENDS • ANALYSES • FORECASTS

QUARTERLY 4/2009 (43)

EXECUTIVE SUMMARY

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

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

The CPI inflation rate fell slightly in the 4Q09 to 3.3% yoy, down by 0.3 p.p. from the third quarter, benefiting from slowing prices of food, energy and selected services. On the other hand, continuing the trend from previous quarters, prices of industrial goods and fuel kept accelerating reflecting rising global prices of crude oil and other commodities combined with the weak zloty. Since the economy will be growing below its potential and the output gap is widening, the CPI inflation will be on a downward trend. Compared to the previous issue of PEO, we raised our forecast of the CPI slightly and markedly lowered the forecast of the PPI inflation. Our expectation of stronger consumer price growth in 2010 follows from the slightly higher-than-expected price growth in the fourth quarter (+0.1 p.p.) and the combination of a few demand and supply factors. First, higher demand pressures will stem from the better GDP results in the third and fourth quarter combined with a slightly more optimistic outlook for the Polish economy in 2010, including the projection of faster wage growth. Secondly, upbeat economic results in the US and emerging Asia led to the upward revision of price growth for some of the key commodities, such as oil and metals.

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

by 25 basis points in the 4Q10, but if the appreciation of the zloty were sustained such a hike would only be counterproductive to economic growth.

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

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

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

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

Cut-off date: February 28, 2010

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

The central government cash deficit was unexpectedly low in the 4Q09 so the 2009 deficit came below projections as we had expected. However, the performance at the beginning of 1Q010 does not confirm this tendency, which is slightly unsettling. The government preliminary estimated that the ESA-95 general government deficit reached 7.2% of GDP in 2009, which is much more than we had predicted (5.8%). The details are unavailable, but the doubling of the deficit is related among others to the worsening financial situation in the Social Insurance Fund (ZUS) and local governments, the latter posted surpluses in previous years. Our forecast for 2010 is better than that of the government due to a number of factors including economic growth and higher inflation as well as the appreciation of the zloty, but the general government shortfall will stay high in 2010. We assess that the ministry-of-finance reform proposals are piecemeal and will not suffice to put the fiscal finances in order in line with the Stability and Growth Pact, i. e. to cut the deficit below 3% of GDP by the 2012 yearend. The government will avoid a breach of the 55% precautionary threshold by the public debt in 2010 though the risk will be acute in 2011.

The positive effects of the nascent European recovery became discernible in the 4Q09 as the NBP exports of goods grew 1.5% yoy in the terms of the euro after a drop by 20% to 22% yoy in each remaining quarter of 2009. Further, the weak zloty kept on supporting exports throughout the yearend despite the appreciation of the real effective exchange rate since February 2009; the appreciation markedly slowed down in the 3Q09 and the 4Q09, but resumed in the 1Q10. The current account deficit continued to decrease year on year in the 4Q09 though the quarterly deficit was roughly twice as high as in both 2Q09 and 3Q09, a sign of a stronger economy. The balancing act in 2009 was impressive as the shortfall fell to preliminary 1.6% of GDP from 5.1% of GDP in 2008, mostly due to the trade balance improvement as exports decreased much less than imports. Both export and import should exhibit strong upward trends in 2010 with converging dynamics. The current account deficit is predicted to further fall to 1.2% of GDP in 2010 due to the negligent deficit in trade. These developments will further decrease external financing needs of Poland so they will underpin the zloty exchange rate on top of the net capital inflows. Major privatization projects should attract FDI inflows.

LATEST DEVELOPMENTS IN THE POLISH ECONOMY

Economic growth

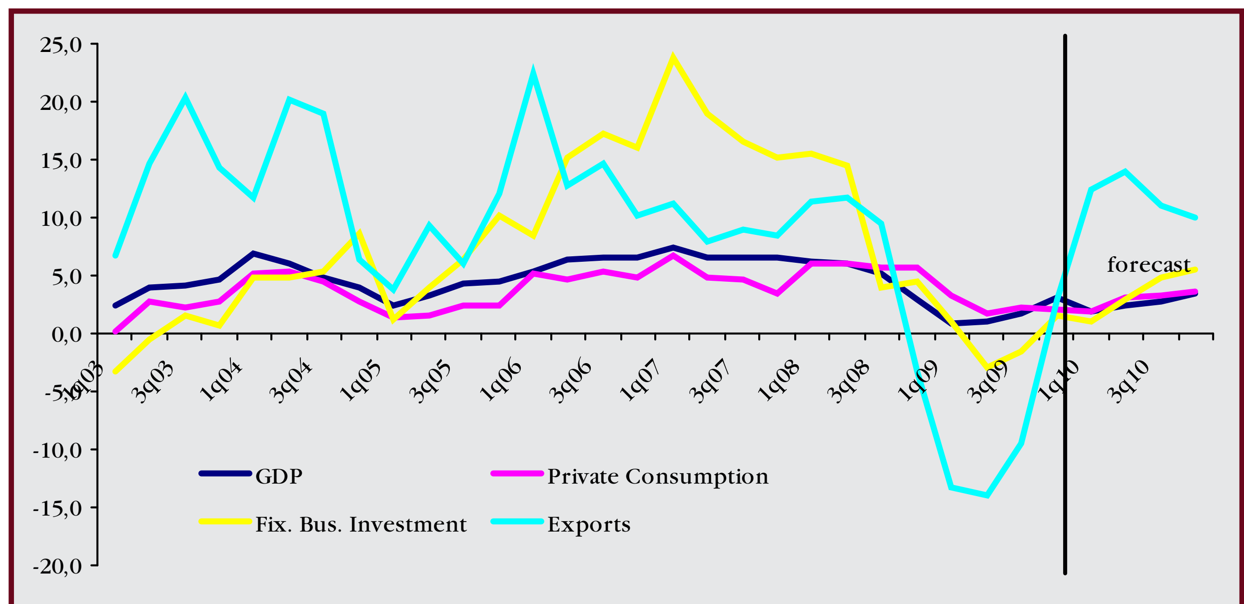
CSO (GUS) has preliminary estimated that GDP grew by 1.7% in 2009, compared with 5.0% in 2008. The Polish economy weathered the global crisis quite well as it was the only economy in the EU to post positive economic growth last year. There was no crisis in Poland, but only a significant slowdown in growth. However, domestic demand recorded a recession as it fell in three straight quarters year on year and quarter on quarter while net exports offset this decline. In this respect, the pattern of the recent slowdown has been similar to the one from 2001-2002. So was its magnitude.

The economy grew at a faster clip of 3.1% yoy in the 4Q09 than we had predicted (2.2% yoy). Despite the picking momentum, as it grew 1.2% qoq in seasonally adjusted terms, we do not change substantially our forecast for 2010 since the recovery in the EU has been soft so far and a key uncertainty remains whether it is sustainable while domestic developments have been broadly in line with our predictions for the last three quarters.

According to the preliminary CSO estimates, GDP, consumer expenditure and fixed business investment grew by 3.1% yoy, 0.8% yoy and 1.6% yoy in the 4Q09, respectively. Domestic demand rebounded by 0.9% yoy. Consumption was dragged down by public consumption as it fell by 2.7% yoy while personal consumption was up by 2.0% yoy, not much different

from 2.2% yoy and 1.7% yoy recorded in the 2Q and 3Q09, respectively. Thus, it upheld quite well in the environment of rising unemployment and low growth in real wages by 1.4% yoy, possibly thanks to the improving confidence for the economy while the government apparently attempted to cut the state budget deficit and it did with a success (see Fiscal Developments). Fixed business investment was in the positive territory thanks to public spending on infrastructure projects. The anemic growth of consumption and gross investment was offset by strong next exports. Since the rise in domestic demand was much lower than GDP, year-on-year net exports kept on contributing strongly to growth in the 4Q09, though this contribution was lower than in the 2Q09 and the 3Q09. The replenishment of inventories was in sync with similar developments in the advanced world. Exports grew 0.6% yoy in the 4Q09, the first such occurrence since 3Q08, while imports continued to decline, but the decrease decelerated compared with the previous three quarters; imports were down by 4.9% yoy compared with declines by 14% to 20% yoy in the first three quarters of 2009. Growth continues to be led by exports, but a pickup in fixed business investment that also stabilized in seasonally adjusted terms quarter on quarter in the 2H09 after two quarters of decline is encouraging because it points to a broadening of the growth base. Domestic factors have started contributing to the expansion of the economy positively after a pause and, in the future, may offset weak foreign demand should the recovery in the UE lose steam. The driving force in the investment aggregate is large infrastructure projects, financed by the EU, and projects related to the European soccer championships to be held in 2012.

Figure 1. GDP Growth Factors, quarterly % yoy



Seasonally adjusted quarterly figures for the 4Q09 exhibit robust GDP growth of 1.2% qoq, the strongest since 1Q08, and domestic demand increase of 0.5% qoq. Both aggregates accelerated considerably compared with the 3Q09. Gross investment and fixed investment posted 2.3% qoq and 0.0% qoq, respectively so the re-stocking of inventories took place, but there was no acceleration in fixed business investment on a quarterly basis. Seasonally adjusted quarterly figures reveal that personal consumption did not grow from the 3Q09 so it lost momentum. This augurs badly for the near future.

The supply side data also confirmed that economic activity accelerated in the final quarter of 2009. Sales of industrial output increased 5.5% yoy and real retail turnover of firms with at least 9 employees was up 4.7% yoy, compared with -1.3% yoy and 3.6% yoy in the 3Q09, respectively. However, construction sales of firms with at least 9 employees slowed considerably year on year in the 4Q09 as they grew by 3.7% in 2009 while they were up by 4.7% yoy in January-September 2009[1]. This decline in overall activity of the construction sector is likely related to a decline in housing construction and subdued investment activity of companies. The rise in fixed business investment in the 4Q09 was due to retooling. There is no pressing need for firms to complete construction of new buildings, not to say to start a construction of new ones, as there are substantial underutilized capacities. Infrastructure projects keep the construction afloat and offset the decline in erecting buildings.

The data on the first month of 2010 sent mixed signals. Industrial output kept momentum as it was up 8.5% yoy with manufacturing recording even higher growth of 10.1% yoy. New orders in industry were up by 6.2% yoy after 15 consecutive months of a decline. The expansion was broadly based as all sectors with the exception of mining and quarrying registered growth year on year. However, construction was adversely affected by a severe winter as its output decreased by 15.6%, the first such fall since February 2006. By the way, winter in 2006 was harsh as well though less. Retail sales decreased by 1.1% yoy in real terms while sales of transportation services were down by 0.4% yoy. The latter were also affected by climate conditions. Railway services were down, but their decline was almost offset by the rise in other types of transportation services.

Soft data point to a recovery gradually gathering strength. The NBP quarterly business confidence index of current conditions leveled off in the 4Q09, but expectations of economic conditions in the 1Q10 improved considerably. The V-shaped pattern of the index is clearly visible. The monthly issued CSO seasonally adjusted index of the business climate in manufacturing has been systematically uptrending since February 2009 after an earlier collapse and it has remained in the positive territory since November 2009. The output sub-index has displayed the same tendency since February 2009, but it has become positive in February 2010 for the first time since May 2008. New orders in manufacturing have been increasing since the trough in March 2009. The index crossed the zero line in August 2009 and reached the levels in February 2010 that were last seen in May 2008 when the economy was growing at the rate of over 5% yoy. Similar indices in construction and trade give mixed signals and show that these sectors are in a worse shape than manufacturing, but green shoots are visible in construction and transportation, which had to cope with unusually severe winter. Expectations of new orders and output were in the positive territory in February 2010 in contrast to current conditions. Other sectors such as real estate and financial services exhibit improvement in sentiment as well. Indices in the latter are strongly positive. Current confidence and consumer expectations continued to improve in January- February 2010 though they remained at relatively low levels. Both indices have been uptrending since their troughs in the 1Q09. Based on these various gauges of business sentiment and consumer confidence, we think that GDP growth will continue to gradually accelerate in 2010.

We do not see changes to the pattern of growth we highlighted in the previous issue of the PEO. The recovery will be based on two pillars: public fixed investment and net exports. Household consumption will remain soft until unemployment stops rising, which should be the case once GDP growth

[1] GUS exhibits only cumulative data from the beginning of each year through subsequent quarters.

reaches 3.5% yoy, i.e. in the 2Q10. Private fixed investment will probably recover sooner than we had expected, but it should remain subdued through the 2010 yearend due to large underutilized capacities and uncertainty about the sustainability of the global recovery likewise domestic political uncertainties with regard to upcoming presidential and parliamentary elections. The credit constraint for firms will ease in the course of the year so it will be more demand-driven than supply-restricted as in 2009. However, the demand for corporate credit will rise only slowly as firms have scaled their investment plans down and adjusted financing needs. Net exports will not contribute to growth as much as in 2009 because the positive growth differential between Poland and the rest of the EU will finally boost imports, but this should happen gradually. Exports are very competitive despite a strengthening of the zloty since the 2Q09, which has been unable to revert the strong depreciation when the global crisis peaked in the 4Q08 and the 1Q009.

In general however, 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 by the 2010 yearend. The stabilization of global financial markets and return of multinational banks to profitability will help revive credit to companies in Poland, since their parent foreign banks will gradually lift the restrictions on well-capitalized domestic banks. The sustainability of the world-wide recovery in the future will depend on whether private demand will replace government demand once governments and central banks start reversing their expansionary policies. However, this should not have implications for 2010, but for 2011, which is beyond the scope of our forecasts at present. Should the euro zone recovery not gather strength in 2011, it may cause a plateau in economic growth in Poland. However, domestic drivers of growth, related to the completion of large infrastructure projects ahead of the European soccer champs should offset this adverse impact.

Inflation

Current situation

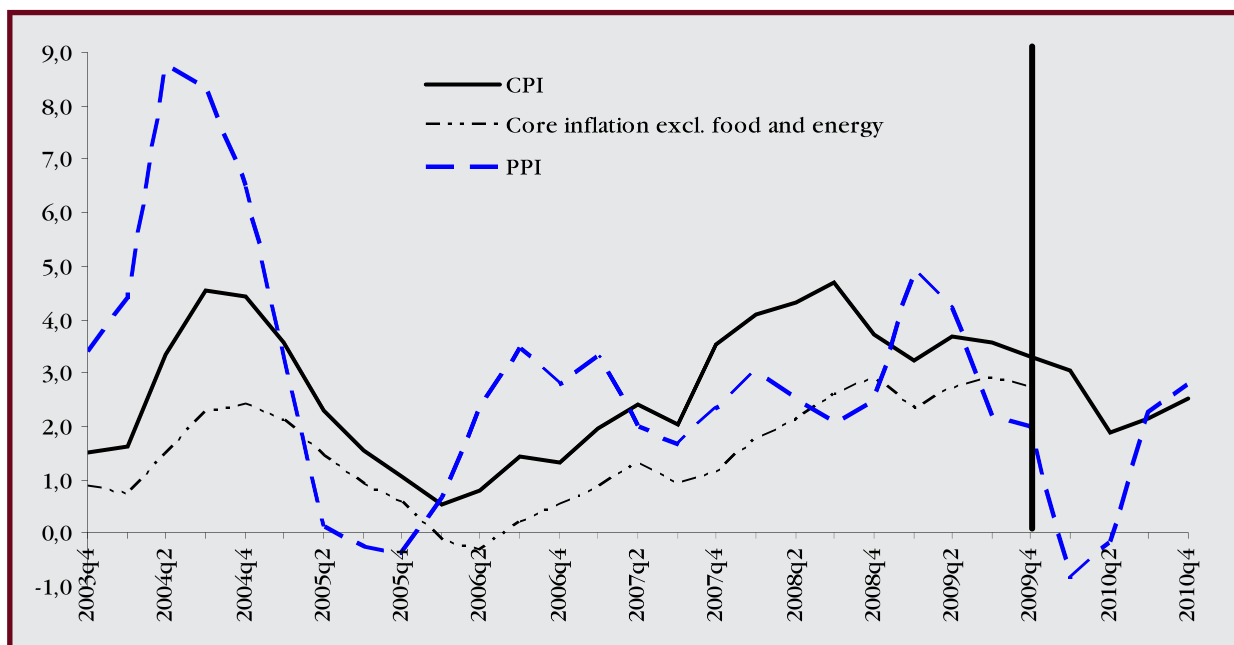
Inflation fell slightly in the fourth quarter 2009 to 3.3% yoy, down by 0.3 p.p. from the third quarter, benefiting from slowing prices of food, energy and selected services. On the other hand, continuing the trend from previous quarters, prices of industrial goods and fuel kept accelerating reflecting rising global prices of crude oil and other commodities combined with the weak zloty.

Core inflation excluding food and energy declined to 2.8% yoy in the 4Q09 (down from 2.9% in the 3Q) and remained half-a-percentage point below headline inflation providing evidence for the inflationary effect of food and energy combined. Inflation of food products moderated markedly over 2009 and reached 3.3% and 3.0% yoy in the 4Q09 and January 2010, respectively. Leading the deceleration were bread and cereals (1.9% yoy in 4Q09 down from 5.7% in 1Q09), meat (6.4% in the 4Q09 down from 10.6% in the 2Q09) and vegetables (-2.2% in the 4Q09 down from 10.8% in the 1Q09). On the other hand, some other foodstuffs saw their inflation increase in the course of 2009, among them dairy products (from -2.5% in the 1Q to 0.3% in the 4Q) and fruits. Procurement milk prices have been rising sharply in recent months and hit 17.9% yoy in December 2009 – the highest since early 2008 and as much as 50 p.p. higher than in December 2008.

The slow-down in inflation of the entire food aggregate coincided with the acceleration of price growth of energy&fuel. Rising energy and fuel price dynamics driven by a combination of the weak zloty and recovery-related growth in prices of oil and other commodities, has been discernible since early 2009. Inflation of fuel for vehicles hit 3.8% year on year in the 4Q09 – the highest since 3Q08 and as many as 18.3 p.p. up from the low in the 1Q09. However, major energy carriers such as electricity, gas and other fuels decelerated somewhat throughout 2009 to a still high 6.4% yoy in the 4Q09.

Non-energy industrial goods in the Polish HICP index posted the highest inflation since 2005, 0.9% yoy in the 4Q09 (somewhat down to 0.7% in January) contrasting with the all-time low of -1.0% yoy in the euro area. The aggregate comprising most consumer durables and non-durables is subject to extreme deflationary pressures in the euro area due to sluggish consumer demand, while in Poland prices of these goods are inflated by the depreciation of the zloty (on a yoy basis until end-2009) and relatively stronger demand conditions.

Figure 2. Annual Inflation in Poland, quarterly, % yoy



Likewise, inflation of services -usually well correlated with local demand pressures – persist well above 4%[2] yoy albeit moderated somewhat in the fourth quarter in comparison to the third and second quarters. Among the services whose prices grew the fastest were out-patient services (5.5% in the 4Q09 and 5.2% in January 2010), railway transportation (5.9% and 7.7% in December 2009 and January 2010, respectively), hairdressing services (4.7% in the 4Q09) and services related to package holidays and accommodation (5.0% and 5.5% in the 4Q09 and January, respectively).

Administrative prices continue to push inflation up, as the core inflation excluding administrative prices remained at 3% yoy in the 4Q09 (unchanged from the 3Q09), 0.3 p.p. below headline inflation. Upward adjustments in prices of railway tickets, electricity, water supply and sewage services as well as social protection were the most significant administrative inflation drivers in the fourth quarter while prices of gas and postal services posted relatively little growth.

Producer price inflation (PPI) decelerated to 2.0% yoy in the 4Q09 (from 2.2% in the 3Q) and plummeted further to a mere 0.2% yoy in

[2] Data refer to the HICP index.

January 2010. The January PPI inflation was the lowest since late 2005 and largely reflected the gloomy sentiment in manufacturing industries which continued to lower their prices due to the feeble domestic and external demand. Prices in manufacturing have been declining on a year on year basis since August 2009, but subsequent months saw the deepening of deflation from -0.2% and -0.7% yoy on average in the 3Q09 and 4Q09, respectively, to -1.4% in January. Among the industries most affected by the deflationary trend were clothing and textiles, chemicals, paper, metals and metal products, motor vehicles and furniture. Pharmaceutical, tobacco and petroleum industries are among the few ones that resisted deflation with prices in the latter sector surging to 19.3% and 27.0% yoy in December 2009 and January 2010, respectively (the highest since mid-2008) on the back of rising crude oil prices and weak zloty.

The remaining industrial sectors fared markedly better with progressively rising commodity prices boosting inflation in mining and quarrying and energy. Soaring copper and aluminium prices pushed price dynamics in mining and quarrying to 20% yoy in the 4Q09 and above 23% yoy in December. Inflation in the energy sector slowed to 11.8% yoy in the 4Q09 (down from 21.3% in the 1Q09) and further sharply to 1.5% in January – due to the base effect reflecting missing electricity price adjustment in January 2010 (following a nearly 10% hike in January 2009).

Forecast

Compared to the previous issue of PEO we raised our forecast of the CPI slightly and markedly lowered the forecast of the PPI inflation. Our expectation of stronger consumer price growth in 2010 follows from the slightly higher-than-expected price growth in the fourth quarter (+0.1 p. p.) and the combination of a few demand and supply factors. First, higher demand pressures will stem from the better GDP results in the third and fourth quarter combined with a slightly more optimistic outlook for the Polish economy in 2010 including the projection of faster wage growth. Secondly, upbeat economic results in the US and emerging Asia led to the upward revision of price growth for some of the key commodities, such as oil and metals. Combined with a strengthening of the USD vis-a-vis the euro and other currencies this will mean that the appreciation of the Polish zloty towards the USD will be smaller implying a noticeably faster growth in commodity prices denominated in the Polish currency.

The disinflation of industrial goods fuelled by the appreciating zloty will be the main driving force behind the price deceleration in 2010. Prices of non-energy industrial goods pushed down by cheap imports are likely to revert to deflation in 2010 after rebounding above zero in the May 2009 on the back of the weakened zloty (and following 4 years of zero inflation or deflation). The disinflation impact of this deflationary trend will be further magnified by the growing share of households' expenditures on industrial goods which is reflected in the higher consumption weight of this group in consumer price indices in 2010.

Agricultural commodities are expected to pick up somewhat in 2010 on the back of rebounding global demand, albeit considerably less than oil and metals. Taking into account the appreciation of the zloty this will ensure a very low dynamics of basic food commodities. The domestic supply projections for 2010 are likewise favourable which leads us to expect a relatively low inflation of the entire food aggregate in the range of 1-1.5% for the year as a whole.

All these factors combined lead us to expect a slight deceleration in consumer prices in 2010. We expect the year on year change in the CPI index to decline

to 3.0% in the 1Q10 and further down to 1.9% in the 2Q10 and rebound mildly to 2.2% and 2.5% in the third and fourth quarter, respectively. For the year as a whole the CPI inflation will slow to 2.4% yoy down from 3.5% in 2009.

Producer prices will rebound in the course of 2010 reflecting rising commodity prices, including copper and coal – both of key importance for the Polish industry. The gradual acceleration will be also driven by the sluggishly reviving global demand, including demand for imports in major Polish export markets. The quarterly profile of the PPI inflation will directly reflect this acceleration albeit starting from the very low base-effect-depressed levels in early 2010. Producer price inflation will pick up from -0.8% yoy in the 1Q10 to -0.2% in the 2Q10 and then further to 2.2% and 2.8% in the third and fourth quarter, respectively. However, for the year as a whole this will mean the PPI inflation of 1.0% considerably down from 3.3% in 2009 and the lowest since 2005.

Monetary Developments and Policy

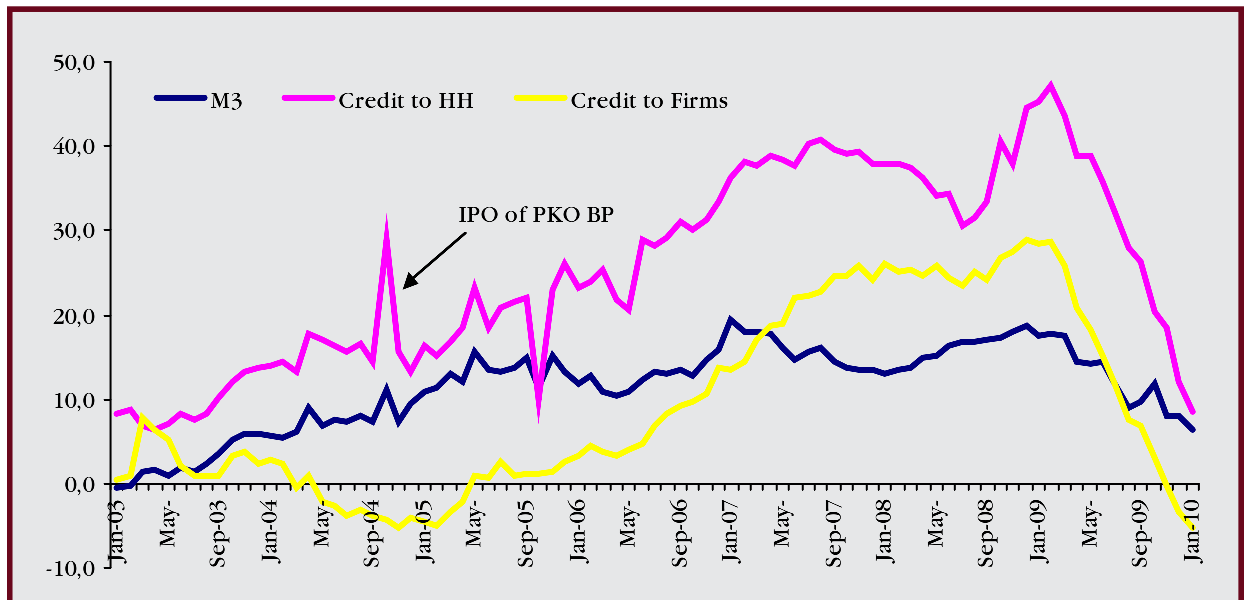
Credit to nonfinancial companies kept on declining in the 4Q09 as it was PLN 207.4 bn at the 2009 yearend, compared with PLN 214.8 bn in September 2009. In year-on-year terms, credit and to non-financial firms fell by 4.0% yoy and 3.4% qoq in the 4Q09. Both local and foreign currency credits downtrended. The declining trend set off in March 2009, but if adjusted for the depreciation of the zloty, it had begun earlier, in December 2008[3]. The 4Q09 was a third straight quarter of a decline and we think that the downward trend will continue in the 1Q10, as surveys of banks and companies suggest. However, the 1Q10 will likely witness the trough as the economy is gradually picking up and the access to credit has notably improved as the number of applications, turned down due to factors non-related to the financials of a company, decreased considerably. According to the NBP survey, the credit crunch peaked in the 2Q09 and has started receding since then. On the other hand, firms express disinterest for credit in all sectors but the construction as their investment activity is low. With regard to construction firms, their increased demand for credit is correlated with liquidity problems. Credit crunch has reduced the share of firms that plan to finance their investment projects by means of a bank loan to the lowest level in the questionnaire history in the 4Q09, but this ratio bounced back in the 1Q10 so the downward trend reversed it must adversely affect the fixed business investment growth.

Credit to households continued to grow in the 4Q09, but at a decreasing year-on-year rate as it was up by 11.9% versus 26.5% yoy in the 3Q09, however it rose 2.0% qoq, compared with 1.5% qoq in the 3Q09. This quarterly increase is seasonal as Christmas season happens in the 4Q09, but it may also be a sign that commercial banks became more willing to loan out funds to households.

Prospects for the credit resumption in the 1Q10 continue to improve not only because the economy is in a better shape at the start of the new than in 2009, but also because adjustment processes in commercial banks such as cost restructuring and recapitalization are well advanced so the supply of credit is going to grow. Since domestic banks have much worse access to foreign funding than before the crisis, this deceleration also puts limits to the credit expansion but this constraint is being slowly eased by the capitalization. Another question is whether it will be matched by the rising demand for it.

[3] Based on NBP statistics on assets and liabilities of the monetary institutions vis-a-vis non-financial firms.

Figure 3. Broad Money and Credit Expansion, % yoy



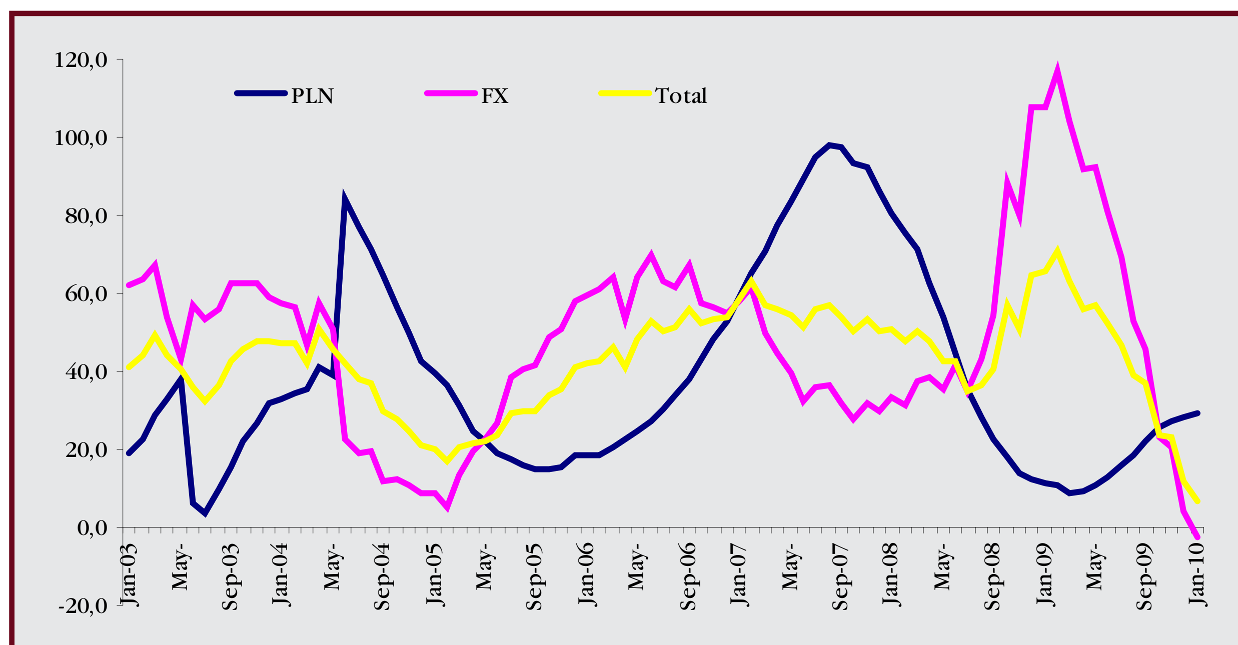
Source: NBP and own calculations.

Because stronger economic growth should make banks start rethinking their prudent loan policy as the financial standing of firms will likely not deteriorate. In fact, it is not bad, either, since the aggregate net income rose quickly in the 2Q09, compared with the 1Q09 and it probably matched the level in the 3Q09 from a year ago. When this report was written, there were no data on the bank sector performance in the 3Q09, in particular on irregular loans in the economy, but their amount likely rose due to economic stagnation. However, this rise was not strong as casual reports point to. Banks are in the position to loan out more, but they are simply afraid to do so after a period of excessive expansion in 2007-2008. Their capital adequacy levels are high due to retained 2008 profits. They are much less leveraged than their foreign parent companies and these relatively high capital adequacy ratios continue to be used to support consolidated group capital ratios, limiting credit expansion in Poland. In October 2009, the Supervision Financial Commission expanded the range of instruments to some debt instruments that can be accounted for as principal capital in order to limit the need of offering new stock that would involve a risk that the ownership structure of an institution would have to be altered. These instruments include issued convertible bonds with maturity of 5 years at least or bonds with maturities between 10 and 30 years. This should help revive credit though the quality of principal capital of Polish banks may deteriorate since due to stringent regulations no hybrid instruments have been included so far. A mechanical increase in capital adequacy ratios may not reduce the risks enough if the bonds, treated as a part of capital, were illiquid.

Nominal broad money (M3) growth continued to decelerate in the 4Q09 as M3 rose by 8.1%% yoy in December 2009, compared to 9.6% yoy in the 3Q09 and 18.6% yoy in December 2008. In quarterly terms, M3 increased by 2.9% versus a drop of 0.3% in the 3Q2009 and a rise of 5.7% in the 4Q08. Comparison of the same quarters cleans the seasonality so a slowdown is clear. The upward trend of total deposits continued to accelerate to 16.1% yoy versus 10.9% yoy in the 3Q09. Deposits of firms rose rapidly in the 4Q09, i.e. by 21.2%. The nominal value of the increase in December 2009, the month when deposits usually grow strongly, amounted to twice the rise in December 2008. This may reflect a rise in net income due to improved economic conditions. Polish firms are liquid though the aggregate of their deposits equal to 11% of GDP masks disparities across sectors.

Time deposits of households expanded by 5.4% yoy in December 2009, compared with the rate of 26.1% yoy in the 3Q09 due to the effects of a high statistical base from the 4Q08 when commercial banks attracted depositors offering high deposit rates in order to ease problems with liquidity. However, the slowdown may be related to a lower rise in disposable incomes and increasing confidence in the economy that is inducing a gradual portfolio shift toward riskier assets such as stocks. Demand deposits of households rose at the rate of 28.5% yoy in December 2009 versus 13.5% yoy in September 2009. This acceleration in growth also reflects the low statistical base from the 2008 yearend, when households switched from demand deposits to time deposits, but this growth may also be the effect of a high rise in wages and salaries in December 2009. The interest rate differential between these two types of deposits is still attractive despite the reductions in deposit rates. The average interest rate on time deposits up to 2 years and demand deposits was 5.0% p. a. and 1.7% p. a. in the 4Q09 versus 5.2% p. a. and 1.6% p. a. in the 3Q09 or 5.6% and 1.7% in the 4Q08, respectively, so it continued to narrow.

Figure 4. Housing Credit Credit Growth, % yoy



The central bank did not change its key interest rates in the 4Q09 and in the first two months of 2010 as prospects for economic growth continued to improve and the CPI inflation remained on an elevated level relative to the 2.5% inflation target (see section on Inflation in this report). After a drop to 3.1% yoy in October, CPI rise gradually increased to 3.6% yoy in December 2009, but it was viewed as temporary. In the 4Q09, monetary policy was consistent with the projection of inflation from October 2009, in which the predicted range of the CPI inflation rate in 2010 shifted down to 0.8% to 2.2% yoy from 1.1% to 3.2% yoy. The central projection was revised down to 1.5% from 2.1% in 2010 so expected real interest rates rose when nominal rates stayed put[4]. If the appreciation of the zloty is accounted for, then the so-called monetary conditions tightened quite considerably. We maintained in the PEO 3/2009 that such a projection would call for a cut in interest rates even by 50 basis points immediately as inflationary risks were low and they were skewed to the downside as presented in the October 2009 Inflation Report.

[4] Inflation Report, NBP, October 2009.

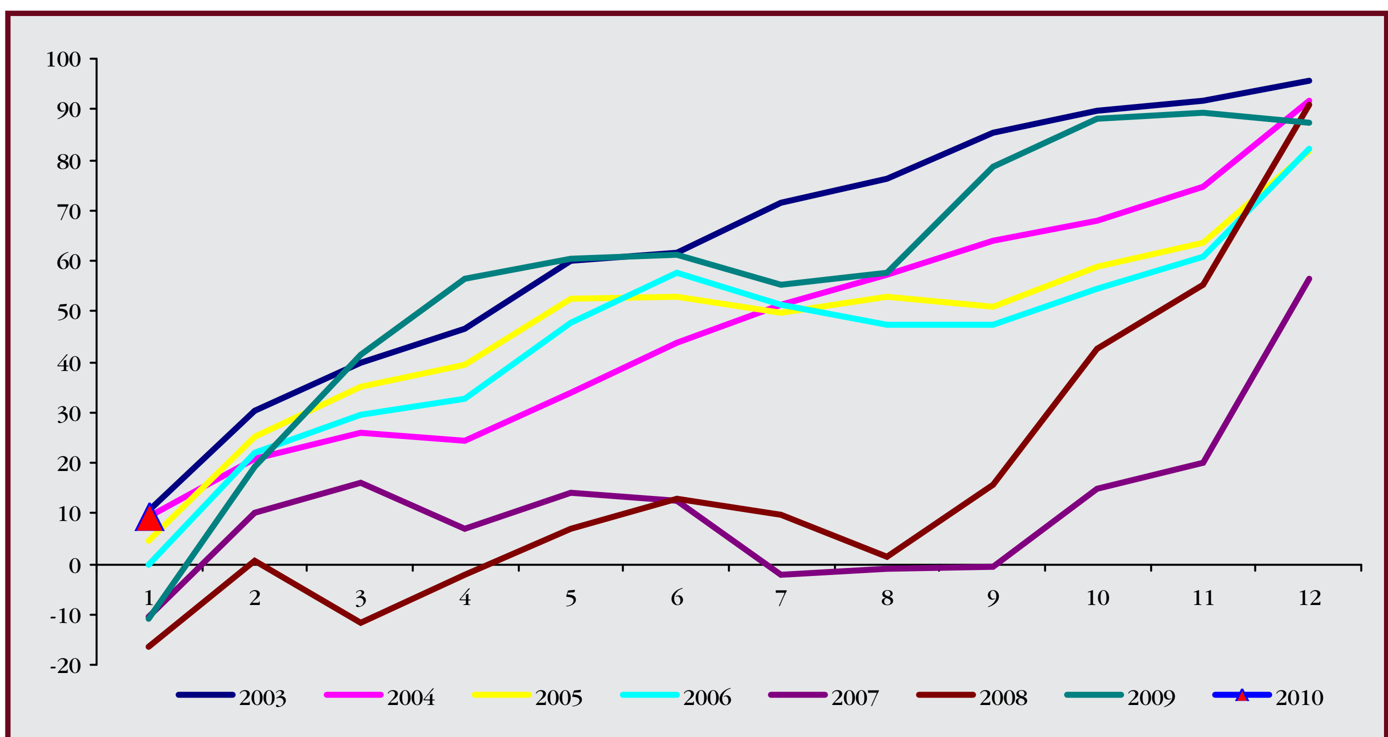
However, the central bank rates stayed put throughout the 4Q09. We claimed that this was caused by an upcoming change of the guard in the MPC. Possibly, the outgoing MPC did not want to make a rate cut decision during the one of its final meetings. A new MPC has been elected and it made its first rate decision in February 2010. It left the key rates unchanged. The MPC members knew the latest NBP inflation projection at the meeting, which is not markedly different from the October 2009 forecast. The CPI inflation rate would be in the range of 1.3% to 2.2% yoy in 2010 and 1.7% to 3.1% in 2011[5]. However, the new central projection for 2010 was revised upward to 1.8% from 1.5% yoy. This explains, why the MPC did not make any decision to cut the interest rates despite the widening output gap and low inflationary risks whose balance, in our view, is skewed to the downside, like in the October report.

We reiterate our forecast from PEO 3/2009 that the interest rates should remain unchanged for the most of 2010, if not for all 2010. We hold a small probability of a first rate hike by 25 basis points in the 4Q10, but if the appreciation of the zloty were sustained such a hike would only be counterproductive to economic growth.

Fiscal Developments and Policy

The central government cash budget deficit was preliminary 23.7 bn zlotys in 2009 or 1.8% of GDP, i. e. less than the supplementary budget target of 27.2 bn zlotys. The shortfall in 2009 reached 87.5% of the government projection. This better performance was due to the lower expenditure than planned, which amounted to preliminary PLN 298.2 bn instead of PLN 300.1 bn and the revenue that was preliminary PLN 274.4 bn, i. e. higher than projected PLN 272.9 bn by near 1.5 bn zlotys. Indirect taxes and income taxes outperformed the projections from the supplementary budget by margins in the single digits.

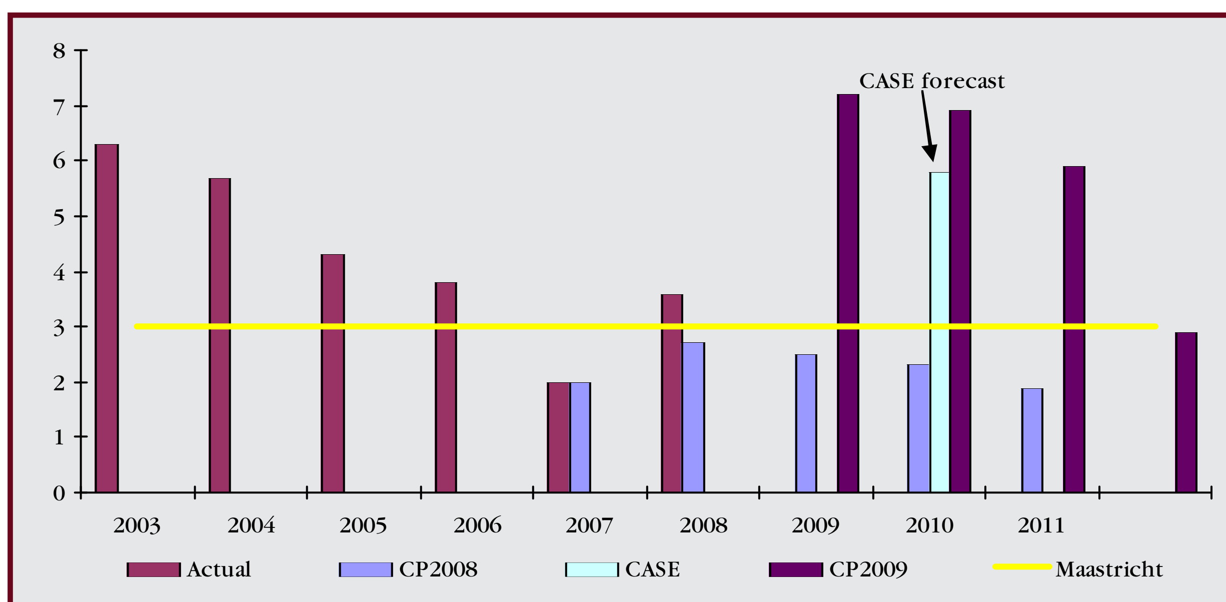
Figure 5. Central Government Budget Deficit, % annual projection



[5] Inflation Report, NBP February 2010.

The improvement in the central government finances occurred in the 4Q09, when the economy picked up, as the cash deficit amounted to 2.4 bn zlotys (0.2% of GDP) only instead of projected PLN 5.4 bn by the government and compared to 21.3 bn (1.6% of GDP) in January – September of 2009. A swift rise in the revenue, which was up by 17.4% yoy in the 4Q09, slightly outperformed the projection; the revenue in the quarter was PLN 71.8 bn versus projected 71.3 bn. It is interesting that the impact of the recovering economy, in particular a steadying of the domestic demand, did not show much impact on the revenue relative to the government forecast, which did not rely on the pickup of the economic activity in the 4Q09. Perhaps, this forecast was too optimistic and the MoF was simply lucky to have seen its forecast saved by the unexpected rise in GDP. On the other hand, exports continued as the main driver of economic growth so the improvement in the VAT collection could not be large because exports are exempted from the VAT.

Figure 6. General Government Deficit versus Maastricht criterion, % GDP



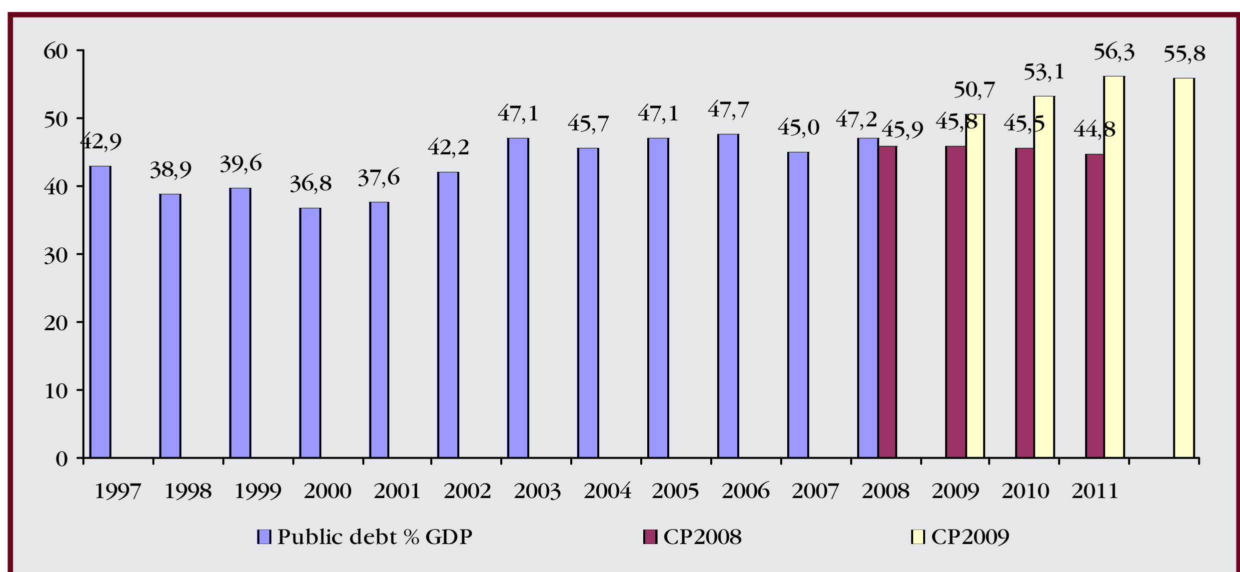
Source: Polish Convergence Porgrams 2006 and 2007.

These are bygones. In January 2009, the central government recorded a cash deficit amounted to 9.3% of the 2010 plan, which looks bad in the light of surpluses that were recorded in the previous years (Figure 5). However, in January 2009, the government collected a large amount of the excise from the tobacco industry (i.e. it amassed more than a double amount from January 2008 at the peak of the domestic demand decline), which positively distorted the figure. When one compares how the collection of various kinds of taxes progressed in January 2010 with the collection in 2008, when no recessionary tendencies were in place, then there are few reasons to worry about. The proportions of different kinds of revenue in January 2010 to annual figures are similar to those from January 2008 though they are slightly lower across the board. As concerns the expenditure side, the striking difference was in the item of subsidy to the Social Insurance Fund (FUS). This fund needed a very low subsidy in January 2008 thanks to the low and falling unemployment, but has been in need for a replenishment of its revenues by the government in 2009 and at the start of 2010, as unemployment rose sharply in these months. One month does not make a trend so it would be premature to extrapolate the January underperformance for the following months, especially that economic growth is likely to stay in the region of 3%

yoy while the government constructed the budget based on the 1.2% GDP growth in 2010. We expect pleasant surprises in the coming months, but, meantime, the state budget situation should be carefully monitored.

The cash budget is only a part of the general government deficit, which is the single factor, threatening with macroeconomic instability in the medium-term. The 2009 update of the government Convergence Program (CP2009), published in February 2010, estimated that the general government deficit in ESA-95 terms reached 7.2% of GDP in 2009 from 3.6% of GDP in 2008 and this rising gap led to a rise in the public debt to 50.7% of GDP from 47.2% in 2008. The latter breached the first warning threshold, inscribed in the public finance bill, but this is inconsequential for the government policy. Nominal GDP used for these calculations by the ministry of finance was PLN 1345.3, but the CSO reported lower GDP of 1341.9 billion zlotys so both ratios may actually prove slightly higher. On the other hand, government preliminary estimates are not entirely reliable as the subsequent announcements of the 2008 figures revealed so there is a possibility that the public debt came below the 50% line. In 2010, public debt is to reach 53.1% of GDP so it should not breach the 55% threshold as had been feared by many analysts in the course of 2009. We consequently maintained the opposite view that this would not be the case and the real danger lies in 2011 so we are vindicated. The government forecast confirms our predictions for 2011 as well since it is forecasting that public debt will peak at 56.3% of GDP in 2011 to start slowly decreasing in 2012. The breach of this threshold in 2011 would have serious fiscal policy implications in 2013 such as the freeze of the civil servants' salaries and the elimination of the wage coefficient in the formula for indexing pensions for past inflation. In general, an austerity package would have to be enacted. This would happen after parliamentary elections to be held in the Fall of 2012. Since we do not expect a hung parliament or a victory by a populist opposition, a new government should have enough political clout to finally cleanse public finances of excess expenditure and put the public finance on firm footing, i. e. to reduce the structural deficit considerably so that it would turn into a surplus during an economic boom.

Figure 7. Public Debt, % of GDP



Three factors mainly are to work to dampen the public debt dynamics according to the CP2009: the appreciation of the zloty, privatization and robust economic growth in 2011-2012. Otherwise, public debt would rise much faster than assumed. We endorse this scenario as we pointed to these

positive factors before while explaining our view that the general government deficit would not breach the 55% threshold in 2010 (see PEO 2 and 3/2009). The zloty will appreciate due to the differential growth prospects in Poland and the euro zone so foreign capital will flow in due to long-term considerations, but a cyclical difference between interest rates will also make Polish assets attractive so portfolio capital will flow into this country as well. Further, the low current account deficit will also cap the foreign currency needs of Poland. As regards economic growth, contrary to a number of institutions such as OECD and NBP, we do not think that potential GDP growth in Poland has suffered much due to the global crisis. There is no space to outline our counter-arguments, but a number of factors make us think different: an expected rise in labor productivity due to the well-educated baby-boom generation, reaching its primary working age in 2010-2020, enhancements in labor market activity of the older generations and females, a boost to growth from the EU aid funds, invested into infrastructure and, last but not least, reaping growth benefits of the euro adoption, starting 2016, underpin our estimates that potential growth will remain in the range of 4% to 5% in 2010-2020. We also predict that the outcome of presidential and parliamentary elections will be favorable for fostering medium term growth prospects in Poland. The path of the deficit reduction is subordinated to the political calendar. The deficit is to remain practically unchanged at a high level through 2011. The government is planning a modest fiscal stimulus in 2011 since the structural deficit is forecast to fall by 0.8 percentage points of GDP while the headline deficit should decrease by a one percentage point due to the growth dividend. The main effort to cut the deficit in order to reverse the public debt ratio upward trend is scheduled for 2012, that is after parliamentary elections. A fiscal adjustment by 3 percentage points of GDP in one year is large and bold, in particular by Polish standards. It never happened before. Therefore we express serious doubts about the political will to do so. Much will depend on the elections outcome that should produce a clear majority of the ruling party in order to make it possible.

Not only politics, but also the content of consolidation efforts underpins our skepticism. They are estimated to bring cumulative savings through 2012 of less than 0.9% of 2009 GDP so it is impossible to call them meaningful in the medium-term though their positive impact on the public finances will increase over time and the savings are forecast to become substantial over…50 years. The main thrust of them is to cut growth of discretionary expenditure by means of a rule that discretionary spending could not rise by more than 1% in real terms each year. An additional rule would impose a drop in the ratio of public expenditure to GDP each year until the ratio falls below 40% of GDP. This goal should be reached over the maximum of 8 years. Discretionary spending covers about 25% of the total government expenditure so such a cap on it will not produce substantial improvement in the deficit. It was entitlements that grew the fastest in 2007-2008 and their growth alongside with social insurance premium cuts derailed the state budget, starting late 2008. The government would like to reduce the share of expenditure determined by the law. However, this requires not only the political majority in the parliament to change the bills, but also the presidential signature, not a veto. Except for the general postulates, the only well-defined proposal in the reform package is to eliminate the rule that the share of expenditure on the military amounts to 1.95% of GDP each year. The government would like to make this kind of expenditure dependent on legitimate needs of the national defense and scrutinize it by means-tests and efficiency tests. The reform package includes the gradual phasing out of a number of special pension systems such as for the military and police and covering them by the general

pension system. However, the meaningful savings in the state expenditure would show up after 2020 so this measure would be inconsequential for the reduction in the general government deficit below 3% in 2012. The same regards an attempt to decrease in the spending on disability pensions.

Labor Market

Employment

In the 4Q2009, employment level in the enterprise sector, the companies employing more than 9 workers, fell by 2.2% yoy reaching 5,255,000 as compared to the y-o-y decrease of 2.3% registered in the 3Q2009. On the quarterly basis, the number of employed persons fell by 0.2%, i. e. by 0.3 percentage points less than in the 3Q2009. It means that the overall employment dynamics stopped to worsen, a continuation of the positive trend we wrote about in the previous PEO issue.

The section-specific trends from the 3Q2009 also continued. The situation is still difficult, but dynamics in manufacturing is improving, where the y-o-y reduction of number of employees in the 4Q2009 amounted to 7.1% as compared to 7.9% in 3Q2009. Employment still increased in construction and in hotels and catering sections, by 4.6% yoy in both cases, but in the former it meant the stabilization of employment dynamics from previous quarters and in the latter it meant continuation of negative dynamic trend. Employment dynamics worsened also in trade section where employment grew by only 0.2% in the 4Q2009, as compared to 1.1% increase recorded in the 3Q2009.

As we have already mentioned in the previous PEO issue, the falling rate of employment dynamics in services sections (trade, hotels and catering) suggests that the employment cuts have finally spread from the industrial to services sector. One can also expect that due to seasonal factors reinforced by exceptionally snowy and cold winter one will also observe the weakening of employment dynamics in construction section. It may result in a short-term deterioration of overall figures in the 1Q2010, but one should not expect that this negative trend will continue in the longer run so it is not taken into account in our forecast.

The LFS figures are a little bit worse than we expected. Employment started to decrease in y-o-y terms for the first time since the 1Q2003. In the 4Q2009, the number of working persons in the economy was 0.7% lower than in the 4Q2008. The number of employed persons declined to 15,855,000.

As the general economic forecast in this PEO indicates an improving macroeconomic environment in this country so do our expectations, regarding the situation on the labor market. We expect that employment in the enterprise sector will decrease in yoy terms by only 1.5% in the 1Q2010, being an equivalent to the q-o-q increase by 0.1%. We expect that employment in the enterprise sector will practically stop falling till the end of 2010; it should be only 0.3% lower on average during this year than in 2009. In 2011, employment in the enterprise sector should start growing by 2.3% yoy. The average LFS employment in 2010 will most probably stay at exactly the same level as in 2009, in 2011 it will re-start to increase at the average pace of 1.5%.

Wages

Wage dynamics stabilized in the 4Q2009. The nominal wages in the enterprise sector increased by 3.8% yoy whereas in the 3Q2009 the yoy growth rate was 3.9%. Real y-o-y wage growth also stayed at exactly the same rate as in the 3Q2009 as it was equal to 0.5%. It means that the stabilization of the nominal and real wage dynamics we observed in the 3Q2009 after the one-year long period of a systematic fall was not the one-off phenomenon. It can be explained by an improving situation in enterprises and by a generally more optimistic mood in the Polish economy that started to emerge in the recent months. On the other hand, however, it can be treated as a surprise taking into account that the overall situation on the labor market is still difficult.

It seems even more surprising that the improvement of wage dynamics was driven mainly by the developments in manufacturing, which continued to be the section with the most negative, although improving at present, employment dynamics. Wages in this section increased by 4.4% yoy in the 4Q2009 as compared to 3.4% in the 3Q2009. This may indicate that wages in this section, being strongly unionized, are simply less elastic than in services and construction, and that this weak wage elasticity has been one of the reasons of deep employment reduction experienced there. Such a view can be backed by an observation that communal services, being also strongly unionized and relatively frequently public-owned, where the second section experiencing an improvement of the wage dynamics in the 4Q2009 (from 3.5% yoy in the 3Q2009 to 5.8% yoy in the 4Q2009), which was also accompanied by actual employment reductions.

In all the other sections, wage dynamics deteriorated or at most stabilized in the 4Q2009 as compared to the 3Q2009, i. e. in construction from 2% to 1.4% yoy and in hotels and catering from 3.1% to 1.1% yoy. Transport was the only section in the 4Q2009 which experienced the actual reduction of nominal wages – by 0.9% yoy. In trade section wage dynamics were relatively stable as it reached 2.7% in the 4Q2009, compared with 2.2% yoy in 3Q2009. It is worth to underscore that in all of these sections such weak nominal wage dynamics meant actual decrease of the real pay.

The general situation on the labor market starts improving, and the overall economic forecast is rather optimistic. On the other hand, the unemployment level will still be increasing in 2010. As a result, we do expect wage dynamics to stabilize in the nearest future, and afterwards one may expect a flat increasing tendency. Average nominal wage growth in the 1Q2010 should stay around 3% yoy and it will result in the real wage y-o-y dynamics, stabilized at the levels close to zero. During the entire 2010, the average nominal wage growth on a y-o-y basis should not go significantly above 4%. The situation will most probably start to change in 2011 when we expect wages to grow slightly more dynamically, 5% to 6% yoy on average.

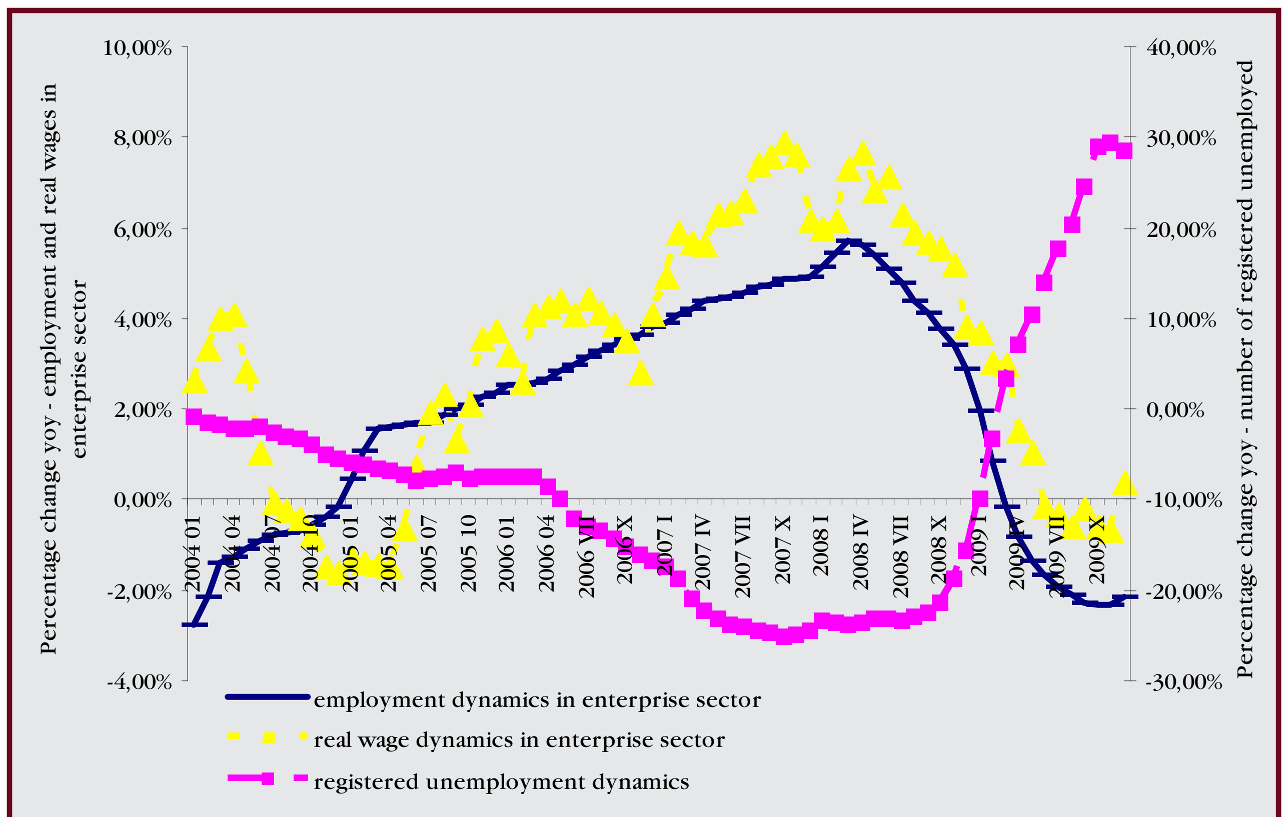
Unemployment

In the 4Q2009, the number of registered unemployed persons reached 1,893,000 and the unemployment rate was 11.9%, which was exactly the rate we had forecasted in the previous PEO issue. Unemployment increased by 28.4% yoy, and it means that the rate of unemployment growth still keeps accelerating, although much slower than in the previous quarters: in the 3Q2009, the number of unemployed increased by 24.6% whereas in the 2Q2009, the y-o-y unemployment increase was 14% and in the 1Q2009 it was only 3.3%. In the q-o-q terms, the number of unemployed persons increased by 10.3%, as compared to the q-o-q increase by 7.1% in 4Q2008.

As usually, we have also cleaned the unemployment figures for the 4Q2009 from a seasonal component[6]. In the 4Q2009, the seasonally adjusted number of unemployed increased by 5.8% q-o-q while in the 3Q2009 it increased by 5.6%. The estimated seasonally adjusted unemployment rate at the end of the 4Q2009 reached 12.1%, which is an equivalent to the q-o-q increase of 0.6 percentage points (0.5 percentage points in the 3Q2009). According to these figures, the pace of growth of unemployment in the latest quarters stabilized at around 5.5%-6% in q-o-q terms (it was also 5.6% in the 2Q2009). It is an optimistic message as the seasonally adjusted qoq growth rate of unemployment was higher in 1Q2009 when it stood at 9.3%.

More detailed information, coming from the Public Employment Service, seems to support relatively optimistic expectations with regard to the labor market situation in Poland in the coming months. In the 4Q2009, the number of unemployed who found new jobs, increased in the y-o-y terms by 12.9% as compared to 5.9% in the 3Q2009. The growth rate of number of those who found unsubsidized jobs also increased in the 4Q2009 – to 10% yoy as compared to only 4.1% in the 3Q2009.

Figure 8. Employment and real wage dynamics in enterprise sector; and registered unemployment dynamics in Poland 2004-2009.



Source: Own calculations based on Statistical Bulletins of Polish CSO (GUS).

This market tendency is also reinforced by successful job placements, supported by public funds. The number of those who found subsidized jobs increased by 24.5% in the y-o-y terms, (13% in the 3Q2009). Most probably, it does not only mean that more funds are directed to these measures, but also that an improving overall situation facilitates successful job placements. The only warning is that while public works is the jobs subsidy program that has been developing most rapidly in the recent period (37% yoy growth in the 4Q2009), this type of a program is the least effective one – i. e. most of

[6] De-seasoning performed using the DEMETRA 2.2 software and Tramo/Seats methodology.

those who participate in public works come back to the unemployment registers immediately after the program ends.

The growth rate of the inflow of newly unemployed persons into registers also continued to decelerate. In the 4Q2009, this number was 16% higher than in the 4Q2008, whereas in the 3Q2009 the y-o-y growth rate amounted to 22.8% and in the 2Q2009 to 25,6%.

The LFS unemployment figures from the 4Q2009 are less optimistic. The number of LFS unemployed increased in the 4Q2009 by 27.5% yoy reaching 1,471,000. The LFS unemployment rate reached 8.5% and it was slightly more than we expected in the previous PEO issue. It is worth to mention, that the increase in the LFS unemployment in the 4Q2009 was still partially the result of an increase in the economic activity of the population. We commented widely on this phenomenon in the previous issue of PEO. The activity rate of 15+ population in the 4Q2009 reached 55.1% and it was by 0.4 percentage points more than in the 4Q2008.

The registered unemployment perfectly followed our expectations from the previous PEO issue. Our expectations regarding GDP do not change significantly, either. Therefore we decided to keep our unemployment forecast for 2010 at similar level as in the previous PEO issue, only slightly correcting it downwards due to the better than earlier expected employment data from the enterprise sector. The registered unemployment rate for the 1Q2010 will most probably, mainly due to seasonal factors reach 13.5% but till the end of the year it will fall to about 12.8%. It means that we expect that the unemployment rate will still be increasing although obviously much more slowly than in 2009.

We assess that the LFS unemployment will reach 9.9% in the 1Q2010, increasing in yoy terms by 1.6 percentage points. In 2010 it should stabilize reaching 9.5% at the end of the year.

We expect that both registered and LFS unemployment will start to fall in 2011, but, obviously, it is strictly dependent on the expected „V-shaped" path of recovery after the crisis. We expect the registered unemployment rate to fall to about 11% at the end of 2011, while the LFS unemployment rate will probably fall back to about 8.0%.

External Trade and Balance of Payments

The weak zloty kept on supporting exports throughout the yearend despite the appreciation of the real effective exchange rate since February 2009, however the appreciation slowed down in the 3Q09 and the 4Q09 (Figure 9). The cumulative appreciation has only partially unwound the depreciation during the peak of the global crisis so far. The zloty was still at very competitive levels, in particular against the euro, as the latest NBP quarterly survey of companies pointed out[1]. The 1Q10 has experienced a second wave of the post-crisis strengthening of the zloty as of writing this piece, but its impact on trade flows cannot be evaluated for obvious reasons that the trade data are not available, but the scale of the strengthening should not dent the export competitiveness too much.

The positive effects of the nascent European recovery became discernible in the 4Q09 as the NBP exports of goods grew 1.5% yoy in the terms of the euro after a drop by 20% to 22% yoy in each remaining quarter of 2009 (Figure 10). Exports of services continued to fall year on year, but the rate of decline decelerated to 6.3% yoy in the 4Q09 from 16.3% yoy in the 3Q09.

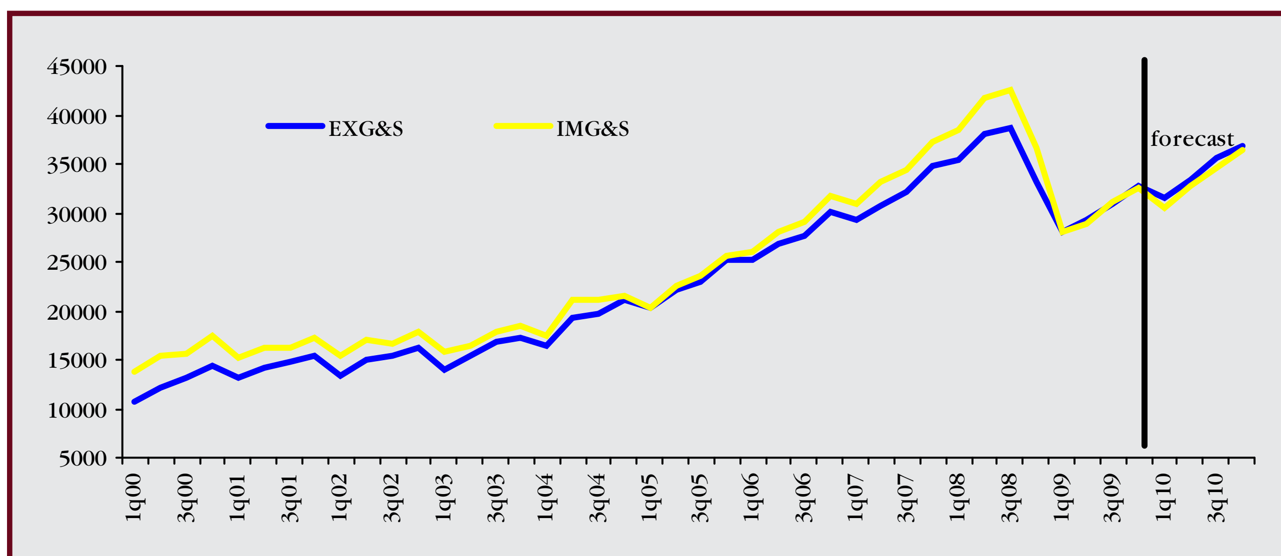
[7] Information on business conditions in the fourth quarter 2009 , NBP, January 2010.

Since export growth trend collapsed in the 4Q08, the low statistical base underpinned the relatively good performance as well, but a further rise of exports of goods by 12.3% yoy in January 2010 and that of services by 4.7% yoy seem to support the view of the rippling positive effects of the European recovery. The NBP imports of goods fell by 10.3% yoy in the euro terms in the 4Q09 while in each of the preceding quarters of 2009, this aggregate fell by 27% to 29% yoy. Imports of services decreased by 6.6% yoy in the 4Q09, compared with a drop of the order of 20% yoy in the three preceding quarters of 2009. Like in the case of exports, the factor of a low statistical base from the 4Q08 played a significant role in capping these declines, but the Polish economy picking up probably contributed to the much lower decrease in imports in the 4Q09 along with the stronger zloty.

Figure 9. Real Effective Exchange Rate of the Zloty, CPI deflated, 1Q1999 = 100

Source: ECB

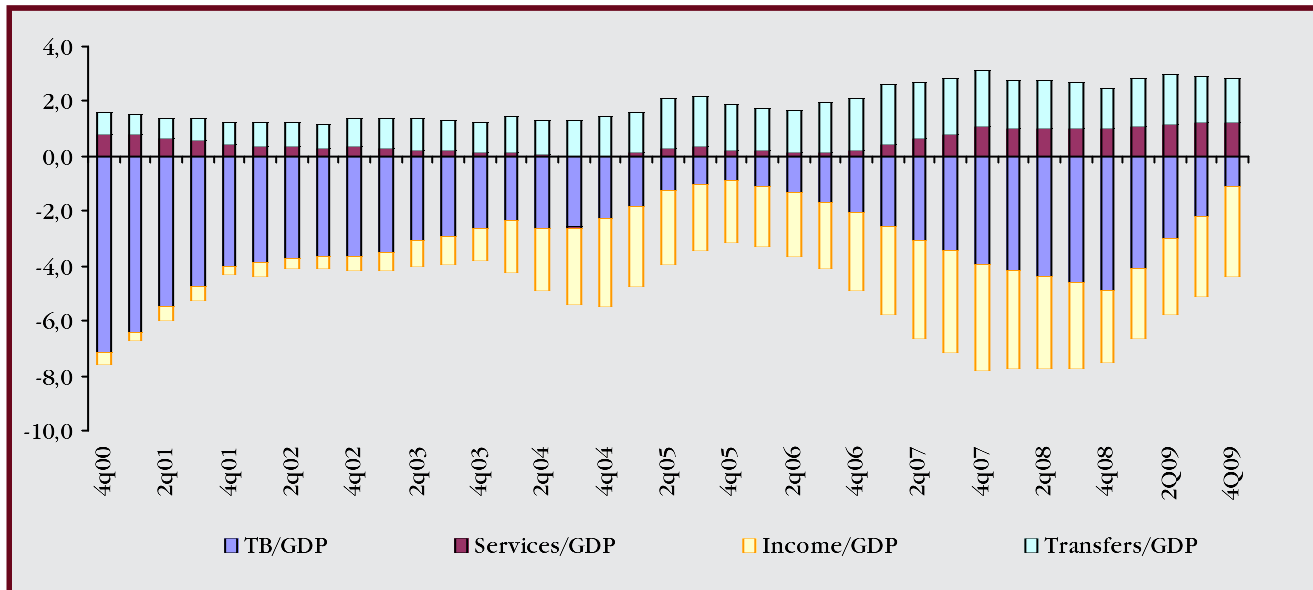
Figure 10. Exports and Imports of Goods and Services, quarterly, EUR million



Source: NBP

Export and import volumes, computed by the CSO, declined preliminary 10.7% yoy and 16.7% yoy in January-November 2009, respectively. In January-September 2009, both aggregates dropped by 13.4% yoy and 19.1%, respectively, so these incomplete data on the 4Q09 suggest a considerable improvement in this period, which is also consistent with the NBP data in current prices.

Figure 11. Current Account Breakdown, as % of GDP



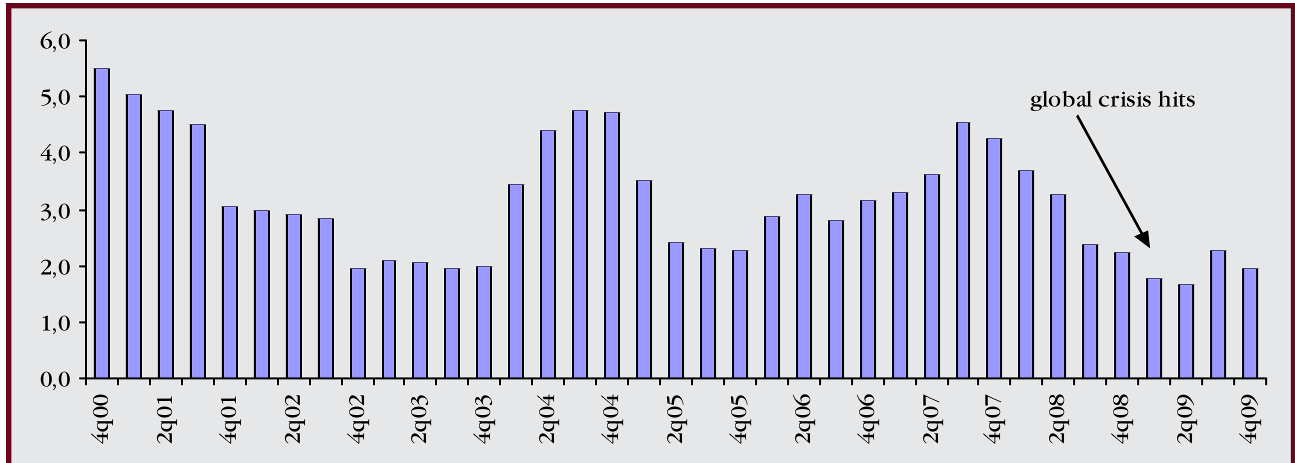
The geographical breakdown of trends, available from the CSO, points to a lower decline in the euro exports to the euro zone than the average fall in 2009, i. e. by 13.4% yoy, compared with a fall of total exports by 17.1% yoy. Exports to crisis-hit Eastern European countries declined by 39% yoy. Imports from the euro area declined by 27.2% yoy in 2009, compared with a fall in total imports by 26.3% yoy. Imports from Eastern Europe fell even more, by 35.4% yoy while imports from developing countries decreased by 18.7% yoy. The latter include imports from China that dropped much less in the euro terms so that China replaced Russia as the second position on the list of the ten most important import partners with a share of 9.3%. The preliminary CSO data on January 2010 show a rebound in the euro exports to Eastern Europe as they rose by 14.8% yoy versus a rise in total exports by 1.8% yoy. Exports to the euro zone declined by 3.6% yoy. One month does not make a trend, but the turning point was in the 4Q09 so there is a possibility that exports to eastern Europe will continue to invigorate Polish exports in 2010.

The current account deficit continued to decrease year on year in the 4Q09 (by almost 45%) though the quarterly deficit was roughly twice as high as in both 2Q09 and 3Q09. The latter rise was higher than we had expected. This increase was mainly caused by a rise in the income account from the 3Q09 as well as the decrease in the net transfers that fell from EUR 1300 to 1600 million in the preceding quarters of 2009 to about EUR 400 million. However, the trade imbalance slightly widened on the quarterly basis as well. The current account shortfall was three times larger in the 2H09 than in the 1H09. At preliminary 3961 million euros, it was equivalent to 1.6% of GDP in 2009, compared with 5.1% of GDP in 2008. The rebalancing act was driven by a significant drop in the trade deficit that fell from 4.9% of GDP in 2008 to 1.1% in 2009 (see Figure 11). Net income deficit that declined relative to

[11] The euro strengthened by 27.0% yoy in the 3Q09, i.e. 3.3065 to 4.1999.

GDP in the 4Q08 and 1Q09, i. e. in the middle of the global crisis, played a considerable role in the current account deficit decline only then. It started recuperating in the following quarters once the profitability of companies improved. A slight increase in the services surplus relative to GDP was offset by a decline in net transfers of the same magnitude in 2009.

Figure 12. Net FDI Flows to Poland, 4Quarter Moving Average, % GDP



Our qualitative forecast with regard to the tendencies, exhibited by the current account components, is revised on the basis of the 4Q09 and January 2010 data. Exports and imports of goods will recover faster in 2010 than we have predicted up to now. We continued to maintain that exports and imports will post divergent dynamics in the 1H10 despite the strengthening zloty since the private fixed business investment will exhibit little to moderate vigor, private consumption expenditure will grow slowly and, in general, the pace of output recovery will be gradual so imports of raw materials and components will not increase rapidly. The 2H10 should bring a further pickup in imports as GDP growth becomes more robust, but export growth may suffer at the yearend from a uncertainties related to the sustainability of the European recovery due to the exit from strongly expansionary policies. Despite the appreciation of the zloty, Poland should maintain its competitive edge due to increases in labor productivity and low rise in real unit costs.

The current account deficit is predicted to further fall to 1.2% of GDP in 2010 from 1.6% of GDP in 2009 due to almost equilibrated trade balance which should come in the red, but below 1 bn euro. The income deficit should rise while we predict that services and net transfers will post lower surpluses. These developments will further decrease external financing needs of Poland so they will underpin the zloty exchange rate on top the net capital inflows. Net FDI inflows are expected to increase considerably in 2010, supported by privatization efforts of the government, in particular in the energy sector (Figure 12).

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