## Economic Research

Athens, June 25, 2008

# Trip Notes: Poland

## Key notes from our recent trip to Warsaw: June $10^{th}$- $11^{th}$

*On June 10-$11^{th}$ we travelled to Warsaw, where we met with prominent officials from the Central Bank, the Ministry of Finance, the Ministry of Economy, the IMF office, prestigious market participants and several renowned academics. In addition, we attended the press conference for the latest OECD survey on Poland.*

*The main focus of our discussions was the response of the Polish economy to the international credit crunch and the world commodities' rally. We also identified potential threats to the economic outlook going on forward.*

*Topics in our discussions included the strengthening of the Zloty, the potential Euro area entry date, the ongoing structural reforms, the pending privatizations and the latest developments in the flourishing banking sector.*

**Poland: Macroeconomic Indicators**

| | 2006 | 2007 | 2008 |
|---|---|---|---|
| GDP growth (%,yoy) | 6.2 | 6.5 | 5.5 |
| Current Account (% of GDP) | -3.2 | -3.7 | -4.6 |
| Net FDI Inflows (% of GDP) | 3.0 | 3.8 | 4.0 |
| HICP (avg, % yoy) | 1.3 | 2.6 | 4.3 |
| Unemployment rate (%,Eurostat definition) | 13.8 | 9.6 | 7.1 |
| General Government Deficit (% of GDP) | -3.8 | -2.0 | -2.5 |
| General Government Debt (% of GDP) | 47.6 | 44.9 | 44.2 |

*Source: Eurostat & New Europe Quarterly Economic Review*

***Source: Official Projections & New Europe Quarterly Economic Review***

**Written by:**

Ioannis Gkionis
Research Economist
igkionis@eurobank.gr

Stella Kanellopoulou
Research Economist
skanellopoulou@eurobank.gr

### I. Assessment

Poland today is in the best position since the late 90s. In contrast other New Europe countries, Poland enjoys a robust growth rate which balances well between consumption and investment, without excessive current account deficits and with low inflation. GDP growth exceeded 6% on average in 2006-2007, while it is projected to slow down only modestly in 2008-2009. The current account deficit, although widening to 3.7% of GDP in 2007 is still the lowest in the region. The inflation hike to the level of 4% is not serious, given the substantial increases in food and oil prices taking place globally.

Nevertheless, the economy is growing close or above its potential, exhausting its capacity limits. Demand for labor is strong. This combined with relatively small labor force participation rates have resulted in wages rallying. The unemployment rate slumped to historical lows. In addition, the country urgently needs an infrastructure upgrading, because infrastructure bottlenecks constrain the economy's production capacity.

Monetary policy has been tightened in an attempt to address exactly those signs of overheating but so far with limited success. Our discussants believe that an even tighter monetary policy is required to address inflationary pressures that origintate in the labor market. Procyclical and expansionary fiscal policy does not help to that end either, even though the fiscal deficit stands safely below the 3% of GDP Maastricht threshold.

The large domestic Polish market provides scope for ample business opportunities. A healthy domestic corporate sector scores well in profitability. Corporates reinvest their profits and start to leverage. Credit and banking penetration is low even when compared to other New Europe peers with lower living standards. Growth in Poland has been less credit –growth-based than in other countries in the region. That is one reason why Poland has not felt the impact of the international financial turbulence. Overall, Poland looks much less at risk than other NE economies.

## II. Economic Outlook: Main risks

### 1. Inflation is climbing quickly, yet Zloty is to stay strong throughout 2008.

The downside of this vivid economic performance is the reappearance of inflation. Headline inflation climbed from approximately 1% in autumn 2006 to 4% at the end of 2007, a rate above the 1.5-3.5% Central Bank target. From the Maastricht criteria perspective, the latest inflation reading of 4.4% in May classifies Poland among the countries which do not meet the inflation criterion.

Demand pressures appeared before last summer. Core inflation had started climbing before that time, driven by strong wage growth, a consequence of labor market shortages. The upward inflation trend was bolstered by the increased food and oil prices which dominate inflation developments since the last quarter of 2007. Ever since, the supply side contribution to inflation is stronger than the demand side one.

The Central Bank expects that this will be the case until the third quarter of 2008. Thereafter, the crisis-related supply side pressures are hoped to fade out. On the other hand, increased production costs have already started passing through to core inflation gradually. The second round effect is expected to reach a peak in the fourth quarter of 2008. Headline inflation is expected to surpass the 4.2% Central Bank forecast in 2008.

To address inflationary pressures, the Central Bank hiked interest rates to 6.0%, a total of 200 bps since April 2007. The greatest fear shared among most of our discussants is that the recent monetary policy tightening may not be successful in bringing down inflation in the short-term. A concern was expressed that the monetary policy transmission mechanism is relatively weak. It usually takes 6-8 quarters since the interest rate hikes become fully effective.

Financial market participants appear convinced that the monetary policy tightening cycle has not ended. The question is how many more interest rate increases are in the pipeline. Our discussants were conveying the message that the roof for the central bank rate is not one more 25 bps hike as the majority of the market believes. They thought that even further monetary policy tightening was desirable. Our contacts based their arguments on the rationale that the risks to the inflation projection are skewed to the upside.

There is one more side effect from the monetary policy tightening in Poland. The Zloty has appreciated against the Euro by 6.5% since the beginning of 2008.

Even though interest rates increases did not follow the inflation upswing, real interest rates are still positive by a safe margin. Strong Zloty is a trend to stay throughout 2008. It mirrors the convergence dynamics of Poland to the rest of EU. Demand for Zloty will be strong as FDI inflows and EU funds will pour in the country. Summing up, a rising Zloty, even at a slower pace than in the past should not come as a surprise.

## 2. Labor market shortages put a constraint on the economy.

One of the prime concerns in Poland is labor shortages. The phenomenon is driven by the excess demand for labor, generated by above potential GDP growth (600.000 jobs created in 2007 only), coupled with skill mismatches. Unemployment has fallen sharply, from 18% at the end of 2005 to 8.5% in the last quarter of 2007 – in Warsaw unemployment rates stand only at 2%.

Labor shortages are aggravated by the low participation rate, which stands at 26% in the age group 55-65. This is largely attributable to the early retirement scheme with at least 900 job-categories and around 1.3 million workers enjoying a privileged status.

Furthermore, Polish emigration contributes to labor shortages. Since Poland joined the EU, 2 million Poles (corresponding to 15% of the country's labor force) have immigrated to other EU states, with the UK attracting the largest number of immigrants. Although it is widely believed that there is a reverse migration trend, In addition, while a large number of Poles are prepared to move abroad in search of more favorable job opportunities, the geographical mobility of workers within Poland has been low. This is not so much a cultural phenomenon but rather the result of endogenous obstacles, such as limited access to affordable housing in fast-growing areas or lack of sufficient transportation infrastructure, which makes commuting difficult.

Substantial labor shortages result in strong wage growth, especially in sectors such as construction and household services. Moreover, labor productivity does not grow by the same rate as wages, leading to an increase in unit labor costs.

As it was suggested during the OECD Economic Survey press conference, in order to ease labor shortages, policies should be implemented with a view to lifting the barriers hindering labor mobility within Poland. Regarding the low participation rate, the government plans are to shorten the list of workers eligible for an early retirement scheme by the end of 2008, thereby reducing their number to only 130 thousand. This could save up to 17bn zloty.

Additional reforms on personal income tax, to be implemented in 2009, on top of recent reductions in the tax wedge on labor income should bolster work incentives. A countervailing factor to labor shortages is the presence of Russian and Ukrainian workers, especially in construction and service sectors. In addition, in face of the Euro 2012 football championship, which will be hosted in Poland, a great number of Chinese workers are active in stadium constructions.

### 3. The fiscal side is improving, but structural adjustment is postponed until 2010.

Poland was subject to the excessive deficit procedure of the EU. The strong economic performance improved the revenue side. This combined with under-spending especially in EU funds related projects, resulted in the reduction of the fiscal deficit below the 3% of GDP threshold in 2007. Our discussants claim there is no reason for concern about the fiscal side in the medium term. Their forecast is that the general government deficit will exceed slightly the target of 2.5% of GDP set in the Convergence Program in 2008.

Public finances are vulnerable to an economic slowdown. The new government has created expectations in the beginning of its term, that fiscal consolidation was a top priority. Ever since, political sensitivities arising from the Presidential elections in 2010 are likely to delay fiscal reforms.

On the positive side, the initiative to abolish privileges for early retirement, if fully implemented, will increase the low participation rate and reduce the current expenditure. The tax wedge reduction (both for personal income taxation and social security contributions) may act as a positive growth stimulus to the economy, although at the cost of not reducing the structural balance until 2010.

## II. Market Intelligence

- **Moderate growth slowdown in H2-2008-The international financial turbulence impact.**

Poland reached the peak of its economic cycle in 2007. Moderation of GDP growth is now expected for 2008 to around 5.5% yoy against 6.6% yoy in 2007, which is still strong growth. The data to be published for Q2-2008 will bring overall GDP growth to 6% in the first half.

Domestic demand will remain fairly resilient throughout 2008-2009. This time, private consumption will take the lead as the main growth driver. The tight labor market maintains wage growth speedy, while consumer sentiment is high. The wage improvement offsets the negative impact of monetary policy tightening and the erosion of consumption power by inflation.

Investment is expected to slow down but still maintain a significant contribution to GDP growth. Capacity utilization is still at high levels. The world financial turmoil pushed up financing costs. Relatively lower debt leverage for household and corporate balance sheets absorb that impact. On the other hand, local companies have maintained a high level of profitability, reinvest their profits and have started to leverage too.

Polish exports remained fairly resilient despite the Zloty appreciation so far. This is about to change in the second half of 2008. Export orders from Euro Area provide a strong signal that export data will be weaker. Nevertheless, we anticipate that the trade channel impact will be less negative than in the past. Polish exports are a value adding manufacturing component to German exports to Asia and they benefit as well. Finally, exporters have invested on capital intensive technologies trying to implement cheaper methods of production.

Downside risks though exist for the forecasted period. Our contacts identified the ongoing commodities and oil rally as the main risk to the economy. They thought this is more threatening than the credit crunch. In terms of country specific issues, our contacts focused their concerns on the government decisiveness to push for the delayed privatization program.

## ▪ The EU funds role

One of the issues that will make the difference for Poland in the near future is the EU funds. Poland has already been a recipient of EU funds in 2004-2006, but the biggest part is to come. EU funds provide not only for a growth boost of approximately 1% to the economy, but also improve macroeconomic fundamentals such as labor productivity. Poland has spent around 7 bn Euros so far, which is ten times less the amount coming in 2007-2013 (70 bn Euros). In fact, Poland will be entitled to use funds from both the 2004-2006 and 2007-2013 periods in 2008. The government projects that the EU funds absorption rate will exceed 70% by 2010.

## ▪ Prospective Euro Area entry.

The current government is more positive about Poland's Euro-area entry than its predecessor. It has set 2012 as a tentative Euro area entry date, but there is not a firm commitment to that. According to the government point of view, Poland should be ready by 2012 from a fiscal consolidation and structural reforms completion perspective. However, this is going to be a political decision based upon the balance of power between the current ruling party and the opposition.

Poland derogates from EU requirements regarding the independence of its central bank. The constitution has to change in order to meet this requirement. Taking into consideration the opposition skeptical stance to Euro adoption and the presidential and parliamentary elections on2010 and 2011 respectively, in our view, Euro adoption in 2012 is under question.

Our contacts are divided over the desirable date of Euro-area entry. In principle, Poland should adopt the Euro at a time when the economy is well prepared and competitive compared to other Euro area members.

Those who are optimistic, argue that the circumstances are still conducive to the Euro adoption despite the rising inflation pressures. In their view, a country could dampen its inflation rate in the very last moment to sneak into the common currency area and then relax its policy or raise regulated prices.

The more prudent argue the opposite. They believe that is more reasonable to adopt the Euro with a lower inflation. Poland should enter ERM II when it is absolutely certain that all Maastricht criteria can be met.

Another advocating argument for a later Euro adoption emerges from the ongoing global financial turmoil. Poland will benefit from Euro area membership more if the world economic environment is less volatile. Those who are in favor of early entry, point to 2010 as the decisive year with a tentative Euro-area entry of 2013 or 2014. By then, inflation is expected to have eased and projects linked to the Euro 2012 football championship, which contribute to inflation pressures, will be completed.

## ▪ Privatizations program.

The current Polish government is bent on privatization. The Ministry of the Treasury has announced an ambitious privatization program to be implemented in 2008-2011. The overall targeted privatization revenues are budgeted to be more than 20bn PLN. However, the collection over the first 5 months in 2008 was only 0.4bn PLN. Taking into consideration the downside risks emerging by the international financial markets turmoil, there is great uncertainty about the privatization path.

The privatization process is planned to take place mainly through the Stock Exchange, so as to secure transparency. The government plans to sell stakes of 740 state-owned or co-owned companies.

Two state-owned power groups, namely Enea and Energa, will be fully privatized by 2011. The government intents to retain stakes in PGE and Tauron power groups. This year's largest privatization deals are expected to include also the sale of LOT, the national airline; Tarnow-Moscise and Kedzierzyn, the chemical producers~ and minority stakes in other banks such as PKO Bank, the largest Polish bank institution.

The Ministry of Treasury has identified a list of so called strategic companies, not earmarked for privatization. These include gas producer PGNiG, oil concern PKN Orlen, PAP Press Agency and railroad operator PKP PLK.

## ▪ Real estate market: Heading to a temporary cool-off.

After a flourishing period of time, it seems like that the real estate sector is cooling off. Our contacts agreed that real estate prices had climbed to unaffordable levels. On the negative side, the propensity of banks giving out mortgages is about to change at least for the short-term. Global liquidity conditions and the increased risk aversion for the mortgage market force banks to put a temporary break on mortgage growth in Poland. In addition, constructors have less access to financing than before. Slow progress in infrastructure projects because of the governmental change in late 2007 is recorded as well. Stabilization or some correction is expected in the real estate prices, but not dramatic fall as demand for housing is still strong.

**Eurobank EFG, Division of Economic Research & Forecasting**
**Research Team**

**Editor:Prof. Gikas Hardouvelis,**
**Chief Economist & Director of Research**

**Dimitris Malliaropulos: Economic Research Advisor**
**Costas E. Vorlow: Senior Economist**
**Tassos Anastasatos: Senior Economist**
**Ioannis Gkionis: Research Economist**
**Stella Kanellopoulou: Research Economist**
**Theodosios Sampaniotis: Senior Economic Analyst**
**Olga Kosma: Economic Analyst**
**Costas Lambrinoudakis: Economic Analyst**
**Maria Prandeka: Economic Analyst**
**Panagiota Chioti: Junior Economic Analyst**

**Eurobank EFG, 20 Amalias & 5 Souri Str., 10557 Athens, tel: +30.210.333.7365, Fax: +30.210.333.7687,**
**web: http://www.eurobank.gr/research , Contact email: Research@eurobank.gr**