



Special Feature

– Is The Zloty Too Strong?

EXECUTIVE SUMMARY

Mildly slowing economy, inflation still on the rise, sound fiscal position despite a lower tax revenue than projected and a widening current account despite solid export growth were the features of Poland's macroeconomic landscape in the 2Q2008. The growth outlook for the 3Q2008 and beyond deteriorated while inflation should reach its peak in the 3Q2008 and then start gradually falling.

Polish economy grew stronger than expected in the 2Q2008 and weathered well the global slowdown. However various surveys of business conditions pointed to their worsening and a coming slowdown in economic activity. The deterioration of export profitability due to the excessive rate of the zloty appreciation and the decline in export orders have become wide-spread. We forecast that GDP growth will fall below its potential rate in the second half of 2008 as the stagnation in the euro zone will affect Polish export performance, lead to lower advances in manufacturing output and produce ripple effects on other sectors. The loss of the momentum arrives later than we expected but the economy will cool stronger than we previously predicted. The reason is that the euro zone slipped in recession in the 2Q2008, dragged by three largest economies. In the case of Germany, much is a reaction to the very robust

1Q2008 but the slippage casts doubts that Eurozone can decouple from the US predicament. This is why we think that Poland will be adversely affected to higher degree than we have estimated so far. We also change our view that GDP will grow stronger in 2009 than in 2008. Since the slowdown comes later, the pickup in activity will also happen later.

Fixed business investment and private consumption will continue to drive GDP expansion but private investment growth will slow considerably due to the uncertain prospects while private consumption only marginally, boosted by high pay rises and PIT reduction. Negative net exports will grow, dented by the appreciated zloty and the Eurozone stagnation.

Inflationary pressures kept on strengthening in the 2Q2008 at a pace slightly higher than we predicted as the crude oil prices rose sharply in that period, domestic prices of energy were raised and their increases spread across goods and services. Since then crude oil prices have retreated by more than 20% but remain highly elevated compared with the same period of 2007. The same can be said about grain prices that fell on prospects of a global good harvest, the first in three years, but are still above their levels from 2007. They have a way to come down before world disinflation renews vigorously. We think that CPI inflation in Poland

reached its peak in the 3Q2008 but the downward trend will be much flatter than we thought. CPI inflation will be at 4.0% yoy in the 2Q2008 and 3.7% in the 2Q2009. Despite higher inflation, we do not change our forecast of flat central bank interest rates through the 1Q2009 since growth is slowing below potential, the zloty is excessively strong and commodity prices are heading rapidly south due to the weaker world-wide demand. The MPC will closely monitor wage growth, which should start slowly declining, affected by the softening of growth, but we doubt that this will prompt another hike.

The rate, at which employment grew, peaked in the 1Q2008. We expect that both employment in the enterprise sector and the overall LFS employment figure will keep rising year on year in the quarters to come, however the pace of growth will be decelerating. It will reflect the expected fall in GDP

dynamics resulting in slower job creation by Polish enterprises. In the 3Q2008, the enterprise sector employment growth should stay above 4.5% yoy, and the LFS employment in the 2Q2008 should stay around 4.5% yoy. The average enterprise sector employment growth for 2008 should stay at a rate of 5.0%, the LFS employment will grow at the average rate 4%-4.5% yoy. Shortages of labor have been lately reported by businesses as less acute so this should also help dampen nominal wage growth.

The state budget revenue came below projections in the 1H2008, while the state expenditure was short of the plan by a substantial amount that dwarfed the missing tax revenue. Therefore the cash shortfall was very low in the 1H2008. Slower GDP growth will likely lead to more tensions on the central government revenue side in the 2H2008 but should not lead to a considerable deterioration in the cash deficit. The

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

Indicator	Data							CASE forecasts					
	2005	2006	2007	2007		2008		2008		2009		2008	2009
				Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2		
Nominal GDP, PLN bn (% change, yoy)	983.3	1060.0	1167.8	288.5	330.1	294.1	309.2*	313.7	359.3	312.6	359.8	1275.6	1386.4
GDP	3.6	6.2	6.6	6.5	6.4	6.1	5.7*	4.4	4.8	4.4	4.6	5.2	4.9
Private Consumption	2.1	5.0	5.0	4.8	3.6	5.6	5.8*	5.4	5.8	4.6	4.8	5.8	5.1
Fixed Investment (4Q, % of GDP)	6.5	14.9	17.6	16.7	15.2	15.7	14.5*	12.4	11.8	4.2	5.0	13.4	8.0
CA balance (% change, yoy)	-1.2	-2.7	-3.7	-3.8	-3.7	-4.1	-4.5*	-4.7	-4.8	-5.0	-4.9	-4.8	-4.6
Exports (NBP, EUR)	17.8	20.4	12.8	13.1	12.0	21.3	20.4	12.5	11.7	10.7	10.0	15.8	11.5
Imports (NBP, EUR) (% change, yoy)	13.4	24.0	17.9	16.6	16.2	21.1	21.9	14.3	10.0	11.6	9.0	16.6	9.9
Industrial sales	3.7	11.2	9.5	8.1	9.6	8.5	8.4	7.1	6.3	6.0	5.5	7.7	7.1
Gross value added	3.3	6.0	6.7	6.3	6.3	5.5	5.5*	4.4	4.7	4.9	4.5	5.0	4.9
CPI	2.1	1.0	2.5	2.0	3.5	4.1	4.3	4.8	4.0	4.0	3.7	4.3	3.9
PPI	0.7	2.3	2.3	1.7	2.3	3.0	2.6	2.9	3.5	3.3	3.2	3.0	3.1
Nominal Ave. Wage	3.8	4.9	8.7	9.7	8.9	10.1	11.6	11.8	9.9	10.1	9.5	11.2	9.0
Employment %, LFS	2.3	3.1	3.1	3.6	4.8	3.5	4.5*	4.2	4.0	3.7	3.0	4.3	2.4
Registered unemployment rate (% eop)	17.6	14.8	11.4	11.6	11.4	11.1	9.6	9.1	9.3	9.3	8.2	9.3	8.8
PLN/EUR, eop	3.86	3.83	3.58	3.78	3.58	3.53	3.35	3.30	3.20	3.25	3.33	3.20	3.30
WIBOR 3M, %, eop	4.60	4.20	5.68	5.10	5.68	6.15	6.65	6.45	6.40	6.35	6.05	6.35	5.72
Central bank key rate eop	4.50	4.00	5.00	4.75	5.00	5.75	6.00	6.00	6.00	6.00	5.75	6.00	5.50
Broad Money (M3) (% change, yoy eop)	13.1	16.0	13.4	14.4	13.4	13.6	16.3	15.0	14.0	13.1	14.4	14.0	12.9
Loans to HH	26.0	33.4	33.4	39.6	37.9	37.4	34.4	31.0	29.0	25.0	23.0	29.0	25.0
Loans to Firms	2.5	13.7	24.1	24.7	24.1	25.2	24.5	23.0	21.2	19.0	15.0	21.1	17.0
Fiscal Balance (% GDP)	-4.3	-3.8	-2.0	n.a.	-2.0.	n.a.	n.a.	n.a.	-2.8	n.a.	n.a.	-2.8	-2.3
Public Debt eop	47.1	47.6	45.2	n.a.	45.2	43.6.	42.9*	n.a.	43.0	n.a.	n.a.	43.0	43.5

(*) means estimates or forecasts in a column with data

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

developments on the revenue side confirmed our strong conviction that tax collection has been projected overoptimistically to finance bloated expenditure. This will become even more visible in the 2H2008. Government spending will pick up in the 2H2008 so the deficit will rapidly grow in the final months of the year but it should stay below the government projections. We do not change our forecast that the ESA-95 deficit will be slightly higher than the government target in 2008 and 2009 since we think that local government spending has been underestimated.

Differential rate of growth between Poland and its partners and the overvalued zloty caused the estimated cumulative four-quarter current account deficit to increase to almost 4.5% of GDP in the 2Q2008 from 3.7% in the 4Q2007 on the back of the

widening trade deficit and a rising income deficit. However exports in euro terms held well in the 2Q2008. A small surplus on the service account disappointed in the 2Q2008 though its negligible size may yet prove to be a one-time phenomenon. This surplus was the factor supposed to offset a further deterioration in the trade balance, when we bravely forecasted the CA flat declining trend through 2009. We are less confident in such developments now so we backtrack from our previous forecast and replace it with a gradual upward trend on the CA.

The rapid appreciation of the zloty and its impact on trade flows has become highly topical. This is why our special text analyzes the question whether the zloty has become overvalued.

LATEST DEVELOPMENTS IN THE POLISH ECONOMY

Economic growth

The effects of the global slowdown on the Polish economy were little discernible in the 2Q2008. Broadly speaking, the supply side in the 2Q2008 did not look worse than in the first quarter as analyzed in year-on-year terms. Sold industrial output grew at about the same rate, construction sales picked up stronger while real retail sales growth slowed a bit, dented by picking up inflation. However, business climate in manufacturing deteriorated rapidly, a sign that a slowdown of economic activity, perhaps of significant proportions, is in the air.

Sold industrial output grew by 8.4% yoy in the 2Q2008, compared with 8.5% yoy in the 1Q2008 and manufacturing output was up by 8.9% yoy, compared with 8.6% yoy in the 1Q2008 so the downtrend since the 1Q2007 was arrested. This is rather temporary, judging by declining export orders. Like in the 1Q2008, monthly figures were erratic and dragged down by calendar, filled with holidays in May but their volatility also suggested that leaner times are ahead. As we wrote in our previous issue output performance in industry should be strong in April 2008 due to two more working days than April 2007, and, indeed, it was the case. However, the following months brought about weaker advances in industrial sales. In particular May figures reopened the discussion about an imminent slowdown in economic activity, transmitted from the Eurozone (and the UK) whose economic performance dramatically deteriorated in the 2Q2008 after the surprisingly strong 1Q2008. Coupled with the impact of the zloty appreciation, this is adversely affecting Polish exports growth and manufacturing output but the effects have been modest so far.

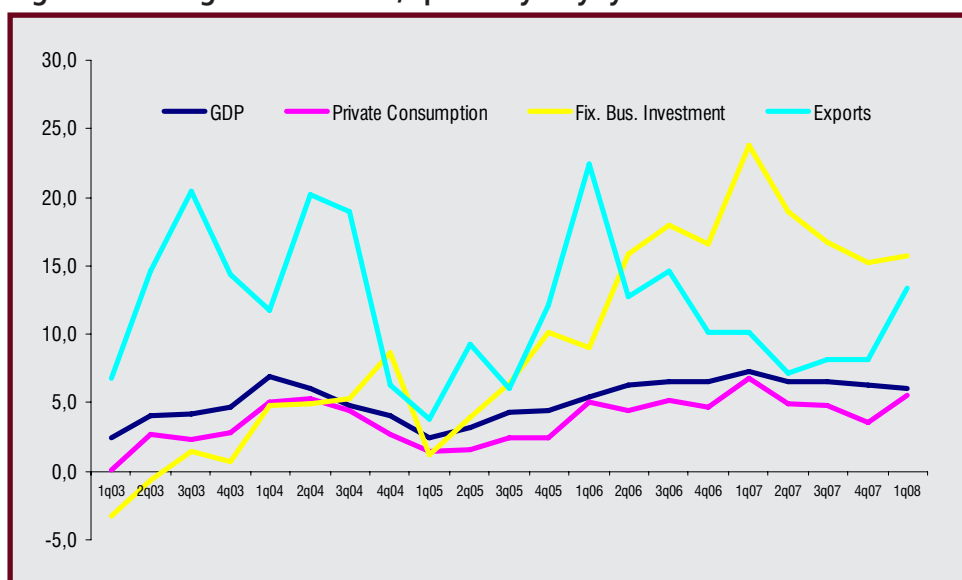
Estimated construction sales increased by 20.2% yoy in the 2Q2008 versus 14.5% yoy in the 1Q2008. This was a second quarter running when their growth accelerated, a sign that investment in fixed assets has remained strong despite earlier signals from firms that the first quarter may have witnessed its peak. Interestingly, high statistical-base effects have been overridden. Estimated real retail turnover rose by 11.8% yoy in the 2Q2008

versus 15.7% yoy in the 1Q2008 as its nominal growth slowed when the CPI inflation accelerated to 4.3% yoy from 4.1% yoy in the 1Q2008.

Based on the better performance of the supply side than we had previously expected, our forecast of 2Q2008 GDP growth has been raised to 5.7% yoy from 5.2% yoy. The y-o-y weaker performance than in the 1Q2008 results from lower growth in domestic demand as inventory accumulation, particularly strong in the 1Q2008, should slow due to the worse near-term outlook for the economy, and due to a further increase in the negative contribution of the external side to GDP.

On the demand side, fixed business investment should have continued as the main driver of economic growth in the 2Q2008, taking into account its tight correlation with the pace of construction output. Firms displayed willingness to continue the started projects and did not report departures from their original plans. Further, real credit growth for firms did not display signs of easing despite a series of interest rate hikes in the 1Q2008. We think that fixed business investments grew only a dash less year on year than in the 1Q2008. Judging by retail sales growth private consumption should have expanded slower year on year than in the 1Q2008. However, average real wage growth in the 2Q2008 was on par with that in the 1Q2008 yoy, despite a pickup in the CPI inflation, and pensions were adjusted for inflation in the 2Q2008 so the real average pension rose by 5.3% yoy in the 2Q2008 while the purchasing power of an average pension eroded 0.2% yoy in the 1Q2008. This compensation should boost consumption. On the other hand, y-o-y employment growth slowed a bit in the 2Q2008, compared with the 1Q2008, when it peaked in this business cycle. The negative contribution of net exports to GDP could have risen gradually in the 2Q2008, based on April-May performance of trade volumes, and provided that June was not a distinct month in this regard. To account for the potential worsening of it, GDP growth yoy in the 2Q2008 is marked down relative to the 1Q2008.

Figure 1. GDP growth factors, quarterly % yoy



The outlook for the second half of 2008 and beyond has become more uncertain than as of writing the previous edition of this quarterly: Judging by the considerable deterioration in business sentiment, the slowdown may be more pronounced than the one we predicted. Perhaps even significant in the worst case scenario, should exports suffer very much and domestic demand growth could not replace it. It is clear that the Polish economy, which has

weathered the global slowdown so far, will begin to feel its adverse effects starting the 3Q2008, a period that seems to be a turning point in this respect. Sound export performance is the first culprit, threatened by the appreciation of the zloty that resumed in the 2Q2008 concomitant with the hampered growth in foreign markets. If to believe the casual reports more and more exporters are under stress as export profitability has dwindled, which is likely to lead to the deterioration in export activity. New export orders waned and exporters have started openly expressing their discontent with the pace of the appreciation and the level of the zloty exchange rate. The elevated inflation readings, compared to the target, tie the hands of the central bank so it is unlikely that it would lower interest rates to induce the zloty depreciation in order to stimulate exports. Such an action of the central bank could be effective, since the recent appreciation is related to much extent to the favorable interest rate differential. The cumulative effects of the increase by 200 basis points in headline interest rates will be felt by the economy to more extent than now once CPI inflation drops and rates stayed put as monetary policy will be automatically tightened. This is a likely scenario in the fall 2008 so it may lead to a further softening in growth in 2009 unless public investment steps in and consumers spend increases in disposable income due to the scheduled personal income tax reduction.

The start of the 3Q2008 pointed to a further deterioration in business sentiment, dragged down mainly by exporters but spreading to other groups of firms as well. On the bright side, business sentiment improved in construction and remained about the same in firms that deliver solely to the domestic market. According to various business surveys one should expect lower growth in demand, output, new orders, fixed investment and employment in the 3Q2008, i.e. the second quarter in a row. In the first three quarters of 2008, the central bank seasonally adjusted prospective index of business sentiment dropped rapidly from the record high levels, recorded at the end of 2007, to the levels last seen in the 1Q2005, thus sending a strong warning signal. After seasonal adjustment, capacity utilization fell to 82.9% at the end of the 2Q2008 from 84.1% in the 4Q2007, when it peaked.

It is too early to judge whether a slowdown in Polish economic activity will be prolonged or short-lived, say, limited to the next two quarters. Much will depend on the developments in the global economy where uncertainties prevail. Global stagflationary tendencies were the strongest in the 2Q2008 when crude oil prices reached their new record highs, and this would bode badly for global growth prospects in the coming quarters. However, crude oil prices have dropped by some 20% since the end of June and if the downward trend is sustained this should improve profit prospects of companies and business confidence likewise let consumers spend more on other items. Yet, these prices have to fall significantly further to exert a positive impact on growth since they still stay at elevated levels, compared with the same period of 2007. Good 2008 global harvest should arrest an upward trend in agricultural commodity prices, and dampen the world-wide inflation. If sustained, these two factors should revive consumer optimism to some extent, currently very much depressed.

Were this positive scenario materialize in the 2H2008, the global economy could start picking up by 1Q2009, and it would improve the 2009 outlook for the Polish economy as well. Nevertheless we backtrack from the forecast that GDP would grow faster in 2009 than in 2008 because economic growth proved much stronger in the 1H2008 than we had originally predicted. The high statistical base from 1H2008 is one factor accounted for in this revision, another one is the lagging structural reforms and delays in the implementation of large infrastructure projects to be financed with the EU

funds. In the optimistic scenario for the world economy Polish GDP in 2009 would grow on par with 2008. For now, however, risks to growth seem to be skewed to the downside both in Poland and the world. Therefore the Polish economy is likely to grow below its potential rate for the next three to four quarters, i.e. below 5% yoy.

Inflation and Monetary Policy

Inflation rose again in the second quarter of 2008 reaching 4.3% yoy up from 4.1% in the 1Q2008, fueled by the accelerating prices of energy and most consumer services. Inflation of foodstuffs fell somewhat in comparison to the second quarter on the back of lower price dynamics of fruits and vegetables and dairy products albeit continues to be significantly higher than the aggregate index (7.1%). With food prices in check, energy became the major inflationary factor as reflected in the soaring consumer energy aggregate, comprising electricity gas and hot water, which peaked at 9% yoy in the second quarter, up from 5.7% in 1Q2008 and the highest since 2001!

Acceleration of energy prices led the central bank to introduce the new broader measure of core inflation excluding food and energy (engine fuel and all energy carriers) in place of the previously calculated narrower "net" inflation which eliminated only food and engine fuel. Not surprisingly, the new core inflation indicator remains low and stable, rising slightly from 2.0% to 2.2% yoy over the last 4 quarters and reflecting the stability of the remainder of the consumption basket. However, this stability masks considerably diverging trends of finer consumption aggregates. Prices of consumer services continue to accelerate sharply¹, suggesting spreading of the effects of higher energy prices and wages around different sectors of the economy. With annual inflation at 4.4% in the second quarter, the highest since early 2001, services are currently mildly outpacing the all-items inflation. Balancing high inflation of energy and services are industrial goods, which actually registered a deflation of -0.1% in the 2Q2008, i.e. -2.7% and -2.9% yoy for durables and semi-durables, respectively. They benefited from the strong zloty and massive imports from Asia. Inflation of industrial goods in Poland has been for a long time consistently lower than in the Euro Area (0.7% and -0.5% yoy for total and durables, respectively) and the lowest among new member states (NMS). This suggests that a well-functioning distribution and retail sector, combined with nominal appreciation of the currency, has been a key to keeping Polish HICP the second lowest in the region (after Slovakia)

The trimmed mean has risen sharply to 4.5% yoy in 2Q2008, up from 4% yoy in the 1Q2008, pointing to persistent inflationary pressures beyond the usually mentioned food and energy supply shocks. At 4.5% the trimmed mean exceeds the headline inflation which suggests that the inner core (70%²) of price changes is actually higher than the combined extremes (highest price falls and increases), confirming the broad-based character of inflationary processes.

As mentioned above the food market stabilized in recent months with inflation at a high 7.1% yoy. The significant decline in procurement prices of milk and a relatively high supply of seasonal fruits and vegetables have brought prices down in respective segments of consumer foodstuffs. On the other hand, inflation of cereals, meat and oils and fats continues to rise with this year's harvest giving moderate grounds for expectations of subsequent

¹ Based on the Harmonized Index of Consumer Prices (HICP).

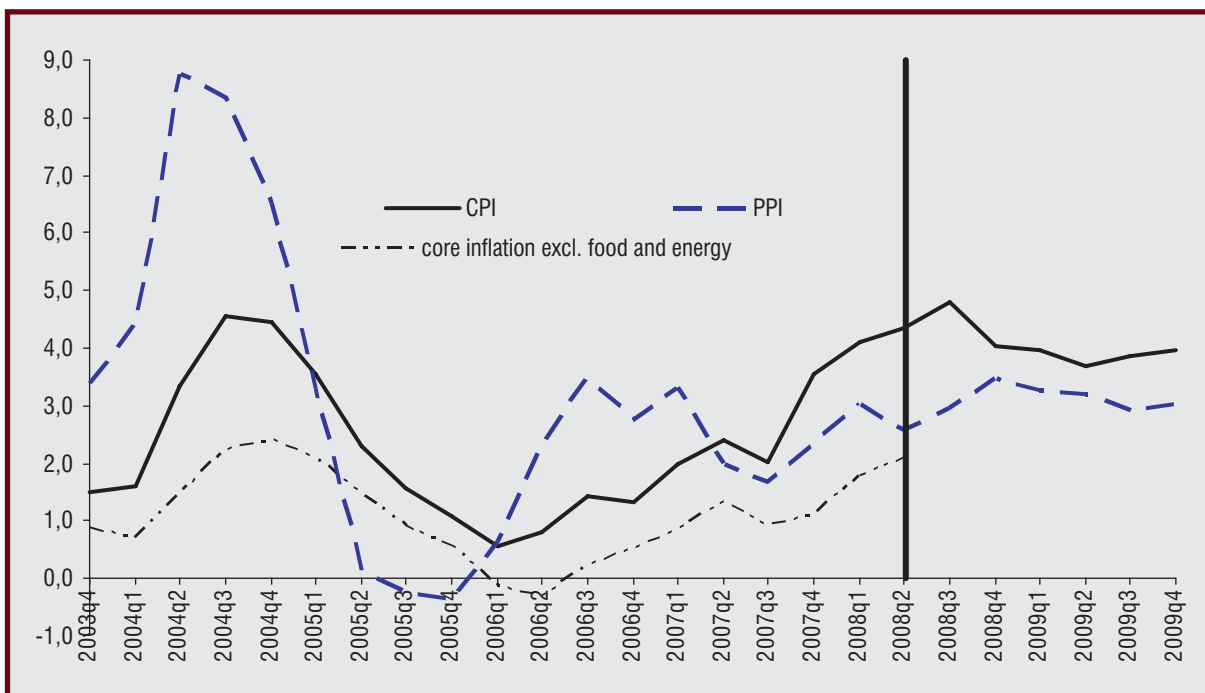
² Percentage refers to the weight in the consumption basket.

declines. Nevertheless food inflation in the second quarter in Poland was the lowest among NMS and one of the lowest in the whole EU.

The PPI inflation fell in the second quarter to 2.6% yoy from 3% yoy in the first quarter. This decline was a result of a large quarterly drop in price dynamics in both mining and quarrying (9.1% in the 2Q2008 vs. 13.6% yoy in the 1Q2008) and manufacturing (from 2.1% to 1.4% yoy) that offset the sharp acceleration in the energy sector (from 4.4% to 8.1% yoy) due to the 3.3% mom rise of prices of energy carriers in May.

Compared to the previous issue of PEO we have revised our forecast of consumer price inflation upward - slightly in 2008 and somewhat more in 2009. This is primarily the effect of the larger-than-expected increases in prices of energy with crude oil and gas hitting new highs in July, making the third quarter most likely to see the highest quarterly prices in history despite recent price drops unless crude oil prices fall below 100 dollars a barrel. The Energy Regulatory Agency is likely to gradually allow the Polish energy sector firms to transmit those prices to final consumers. Although the process will take some time with the magnitude of official hikes moderated somewhat by the strong zloty, we can certainly expect additional sizeable increases in the course of the future months and quarters.

Figure 2. Annual inflation in Poland, quarterly % yoy



Sentiments in the global food markets have improved in line with good harvest predictions, although this has so far not brought down prices considerably. Drought in June and July has reduced the domestic crop of major grains which keeps procurement price dynamics very high (38% yoy for wheat in June) and raises the prices of pork. The projections for both markets are moderately optimistic with imports expected to be the main price restraining factor in future months.

Furthermore, economic activity, still strong despite a slowdown, and soaring income are expected to contribute to inflationary pressures, especially in the area of nontradables (most services). With the appreciation trend of zloty reversed recently, the demand pressures might be expected to gradually feed into the goods market as well.

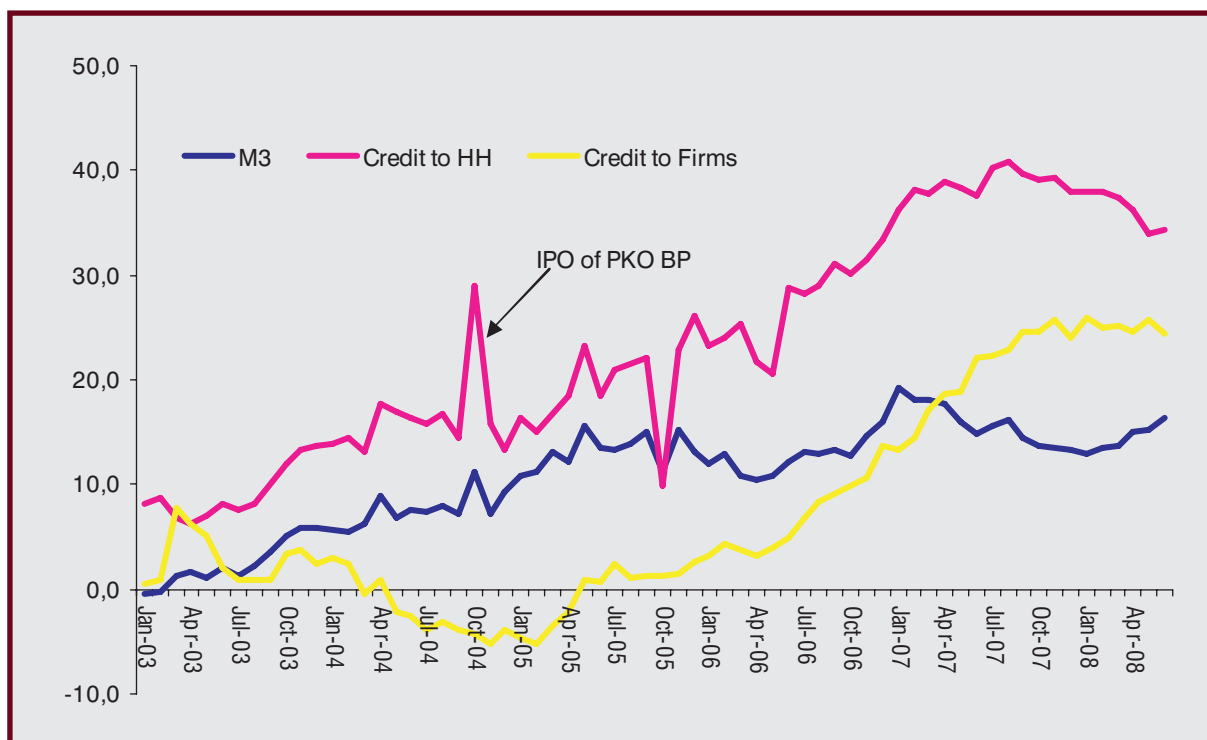
These effects combined lead us to expect the peak of quarterly inflation in the third quarter at 4.8% yoy followed by the subsequent decline to 4% yoy in the fourth quarter and stabilization in the range of 3.7%-4.0% yoy in the four quarters of 2008. The PPI inflation will slowly trend upwards reaching 2.9% yoy in the 3Q2008 and 3.5% yoy in the 4Q2008. The year 2009 will see the stabilization of the quarterly PPI inflation in the range 2.9-3.3% yoy.

Monetary Developments

Broad money (M3) expansion accelerated in the 2Q2008 as it rose by 16.3% yoy in June, compared with 13.6% yoy in March 2008. Thus, a flat declining trend since January 2007 has been arrested, however a prospective slowdown in the economy is likely to bring about its resumption. This pickup more than offset the simultaneous increase in the inflation rate so broad money, M3, grew by 11.2% yoy in real terms in June 2008 and 10.7% yoy on average in the 2Q2008 versus 9.2% yoy in March and 8.9% yoy on average in the 1Q2008, respectively. The long-term upward trend in the relatively low monetization of the economy has steepened in the second quarter since the discrepancy between money growth rate and nominal GDP growth rate widened.

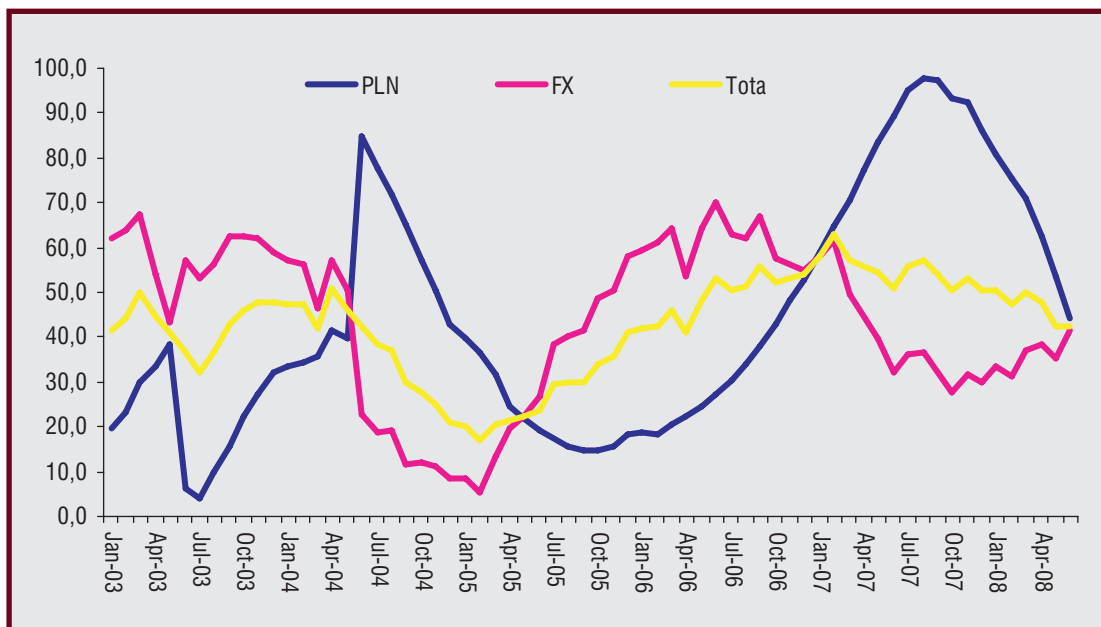
Stronger growth in M3 in the 2Q2008 than in the 1Q2008 resulted from a further pickup in household deposits due to rising interest rates in the environment of declining and volatile stock markets and hefty rises in pay. Households kept on withdrawing assets from investment funds, contributing to declines in the stock market and placed them on bank accounts. Broadly speaking, deposits of firms were stable in the 2Q2008 as they liquidated deposits with maturities up to two years but increased current deposits. This may be in line with vigorous investment activity of firms that need more liquidity to finance their projects.

Figure 3. Broad Money and Credit Expansion, % yoy



The global financial crisis has little affected credit volumes in Poland up to now. Credit to households continued to gradually slow in the 2Q2008 but it responded to higher interest rates. Its rate of growth was 34.4% yoy in June versus 37.4% in March, hardly a sign of subdued credit expansion. Since CPI inflation picked up in the 2Q2008, deceleration was stronger in real terms than in nominal terms, nevertheless the rate of growth was close to 29% yoy. The moderation in credit growth to households can be traced to slower growth in housing credits whose growth decelerated to 42.5% yoy in June 2008, compared with 49.9% yoy in March 2008 and 51.0% yoy a year ago. Loans to firms grew by 24.5% yoy in June 2008 versus 25.2% yoy in March 2008. Since the year-on-year producer price index slightly dropped in the 2Q2008, real credit expansion to firms was unchanged in real terms, a sign that firms did not downsize their plans due to more expensive cost of credit or a gloomier outlook for the world economy and prospects of its adverse impact on the Polish economy. This rapid pace of credit growth augurs well for sustaining strong expansion of the real economy in the coming quarters, suggesting that the slowdown should be mild. On the other hand its gradual slowing is helpful in reducing prospects of a credit bubble in the economy. One could claim that the global crunch has exerted a positive psychological impact on bank managers because it pointed to the accumulating risks of a rapid broadening of the access to credit for less affluent segments of the population, and encouraged Polish banks to review and tighten, sometimes excessively easy, standards of housing credit. This credit has risen at breath-taking pace in the recent years, albeit from a very low base. The restraint will also help cool off the real estate market that was subject to a speculative bubble in the 1H2007, when housing prices and real estate prices reached their peaks. Since then the prices have retreated.

Figure 4. Housing Credit Credit Growth, % yoy



The appreciation of the zloty and the rising interest rate differential between the zloty and the other key currencies such as the euro and the Swiss franc led to the acceleration of the housing credit in the 1Q2008, denominated in foreign currencies. This tendency strengthened in the 2Q2008 as the proportion of such credits rose to 58.2% in June 2008 from the recent trough of 55.2% in December 2007. Hence households became a bit more vulnerable to a hypothetical zloty depreciation than in the 4Q2007. At present, the 10% zloty

depreciation across the board would raise the amount of outstanding foreign currency housing credits by about 8 billion zlotys or 0.6% of GDP. Assuming an average interest rate of 6.0% on these credits, which is probably an overestimate since this rate has been calculated as an arithmetic average of the interest rate in the euro and the Swiss franc while credits in the latter currency prevail, this would raise the debt service by 0.5 bn zlotys a year. This amount is rather low so it is unlikely that the additional burden would lead to a significant disruption in regular debt service by households who experience large increases in disposable incomes. A modest rise in the key interest rate of the NBP by 25 basis points would cause a rise in the debt service of households during a year of a comparable magnitude.

The lack of a direct exposure of Polish banks to mortgage-backed securities and in particular, to the subprime mortgage market in the US is instrumental, together with strong economic growth and inflation in check, to their stable financial performance. Contrary to the global trends, ROE of the Polish banking sector rose in the 1Q2008, the latest when statistics are available, to 23.5% from 22.0% in the whole of 2007. Provisions for irregular credits were 0.21% of average assets held, slightly higher than 0.20% in 2007. Irregular credits stood at 5.2% of the total credit in the 1Q2008, the same as in the entire 2007. The ratio of non-performing loans for the households is even lower (4%) and continued downtrending.

Fiscal Developments and Policy

According to the monthly report on the central government cash budget, the central government budget recorded a small deficit of 3.4 bn zlotys (0.6% of GDP in the 1H2008) in the 1H2008, compared with the initial government projections of a 15.4 billion deficit, equivalent of 57.0% of the annual plan of 27.1 billion zlotys. The state revenue came at 127.7 bn zlotys, below expected 130.3 bn, while the state expenditure at almost 131.1 bn was short of the plan of 145.7 bn zlotys by 14.6 bn zlotys.

This performance reflects diverse trends on the revenue side in the 1Q2008 and the 2Q2008. The state revenue fell short of projections by 4.6 bn zlotys in the 2Q2008 whereas it beat them by 2.1 bn zlotys in the 1Q08 (see PEO 1/2008). Each month since March 2008, the state revenue has been below Ministry-of-Finance projections, confirming the assessment shared by many economists that the 2008 assumptions were overly optimistic. The former government whose budget has been taken over by the present government, constructed the elections state budget, in which it proposed a large rise in state expenditure related to: a cut in non-wage labor costs, tax credits for each child in the family and a new, wage-based formula for indexation of pensions. Since the former government wanted to show a smaller deficit than in 2007, it adopted very optimistic assumptions with regard to tax revenue. Now this is visible in the underperformance of tax collection as details reveal.

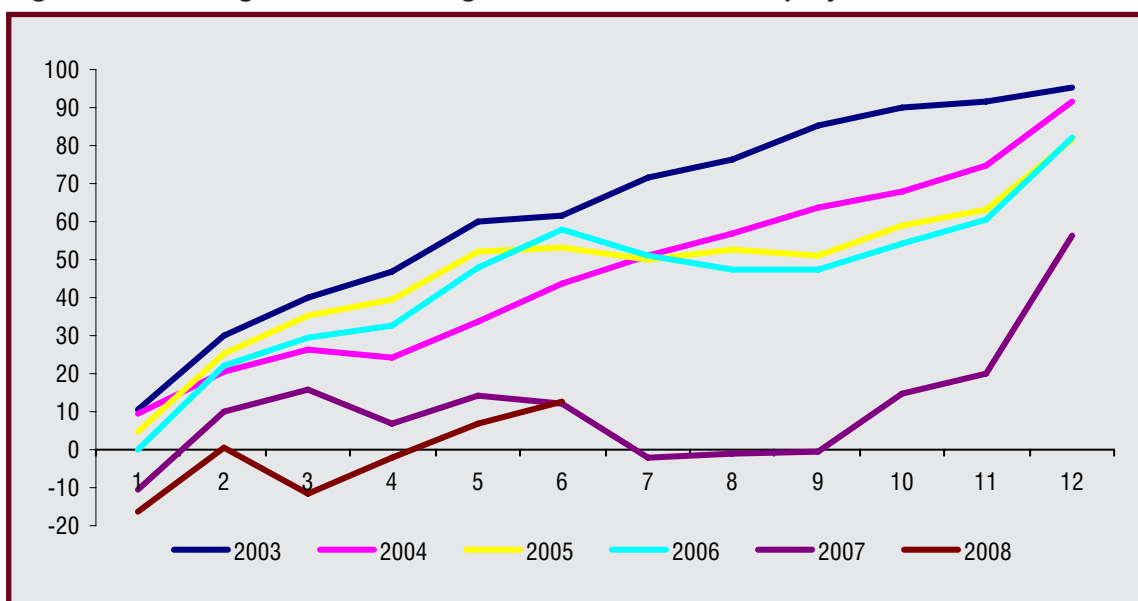
In particular, the collection of VAT rose by estimated 11.5% yoy in 1H2008 while the 2008 budget bill provides for a rise of 22% yoy. The state income from excise taxes rose by 4.8% yoy in the 1H2008 so the rate of growth picked up slightly in the 2Q2008 but it remained far from the projected 15.5% in 2008. The corporate income tax (CIT) collection, which grew close to 100% in 1Q2008 yoy as firms paid large advances for 2008 to state coffers, increased at a lower clip in 2Q2008, pointing to a slower profits growth. Revenue from CIT rose by 19.8% yoy in the 1H2008 versus a 23% annual projection. Continued strong gains in employment and increases in pay helped little to

boost the rate of growth PIT revenue to the annual projection of 14.4% in the whole of 2008 as it was actual 5.7% yoy in the 1H2008. All this occurred despite strong growth in domestic demand in the 2Q2008 so the discrepancies between actual and projected rates of growth in various taxes show how much the previous government overestimated the revenue. Due to a lagged transmission of the global slowdown to Poland, economic expansion will rather weaken in the 2H2008 therefore it would be overly optimistic to count on a pick up in tax collection growth rates in the remaining part of 2008.

Altogether tax revenues reached 45.3% of the 2008 government projections in the 1H2008, down from 50.4% and 47.3% in the corresponding periods of 2007 and 2006, respectively. We wrote in PEO 1/2008 that "the first quarter brings the lowest revenue out of the four quarters in a year so if this pattern prevailed in 2008, so the first quarter performance would bode well for the 2008 revenue projections of the government". These revenues kept on rising at a solid pace in the 2Q2008 but this pace cannot match the overblown projections from the budget bill. The amount of the EU unrequited transfers that the central government received in the 1H2008 was low 24.4% of the 2008 projections. Thus most of them will likely add to the revenue in the 2H2008 and improve the balance but it is safe to forecast that the 2008 central government cash revenue will under perform the budget bill, a sad evidence of the overoptimistic projections due to political reasons.

The burden of keeping the deficit in check in the 2Q2008 fell on the expenditure side. The central government spending amounted to 42.4% of the 2008 annual plan in the 1H2008, down from 46.0% and 48.7% in the corresponding periods of 2007 and 2006, respectively. The central government expenditure rose by 10.2% yoy in the 1H08 versus the 2008 annual plan of In absolute terms, savings in expenditures relative to the 2008 plan were higher in the 2Q2008 than in the 1Q2008: 68.2 bn zlotys was actually spent versus the plan of 77.1 bn zlotys.

Figure 5. Central government budget deficit, % of annual projections



Trends from the 1Q2008 continued. The subsidy to the social insurance fund (FUS) was behind the time lapse and amounted to 38.7% of the 2008 plan, a lower proportion than in 2007 and 2006. The domestic public debt service was also low (37.9% of the 2008 plan). The state contribution to financing of the EU-related projects at 28.8% of the annual plan came also much behind

the time lapse. This fact is very instrumental in achieving a small state deficit in the 1H2008 but it also testifies to the administration ineptness to earmark large-scale infrastructure projects such as freeways.

Concluding, the state budget performance beat the plan and projections in the 1H2008 thanks to the expenditure restraint, mostly unintended. One could also claim that this overestimation of expenditure is not entirely politically driven but it results from bad planning as well.

It is unlikely that the inevitable acceleration in expenditure in the 2H2008 will cause that they will come close to the plan. However there are clear signs that revenues are not going to meet projections in 2008, and the question is by how much since lower expenditures than planned may not offset this relative shortfall. Extrapolating the results of the 2Q2008, the missing revenue could reach 9 bn zlotys in the 2H2008, bringing the missing total to 11.5 bn zlotys or about 0.9% of GDP. Since signs that the economy will feel the brunt of the global slowdown appear, such a result is the more likely the more exporters feel the adverse impact of the zloty appreciation. The savings in the central government spending relative to the 2008 plan may prove sufficient to cover this gap but some risks to the deficit projection remain valid despite an outstanding result in the 1H2008.

The MoF has signaled that it may revise its macroeconomic assumptions of the 2009 state budget draft. A potential downward revision of GDP growth rate projection from 5% and an upward correction of the 3% CPI inflation projection should broadly be neutral to the revenue and deficit outcome in 2009.

Labor Market

Employment

Employment in the so-called enterprise sector (the companies employing more than 9 workers) increased by 5.2% yoy in the 2Q2008 as compared to 5.8% in 1Q2008, reaching 5391 thousand persons. It means, however, that the pace of employment growth in this sector started to decrease in y-o-y terms for the first time since the beginning of 2003.

It seems that the observed worsening of employment dynamics does not need to be a one-off phenomenon. It is related to the deterioration in the business environment: softening of demand growth and rising costs of raw materials. Employment growth decelerated in almost all important sectors with most notable declines registered in construction, where it decelerated from the record figure of 12.2% yoy in the 1Q2008 to current, still remarkable, 9.5% yoy. Smaller slowdowns were also observed in manufacturing (from 4.4% to 3.6% yoy), trade (from 8.6% to 8% yoy) and business services (from 10.3% to 9.7% yoy). Employment growth figures in other sectors stabilized or only slightly increased.

Labor Force Survey (LFS) Figures for the 1Q2008 were still positive. Total employment in the economy increased by 4.6% yoy, compared to 4.2% yoy in the 4Q2007, reaching 15 515 thousand persons. The employment rate - the share of the total number of employed in the working age (15-64) population - reached 58.0%, as compared to 55.4% a year earlier.

The most positive information, however, is the increase of economic activity in the population. In the 1Q2008 the number of active population (the sum of those employed and those unemployed) increased by 0,9% yoy, and it was the first increase in y-o-y terms since the end of 2005. It is a very important piece

of information for the Polish tight labor market as the number of active population is the actual size of the labor supply. Deficiency of effective labor supply is one of the main bottlenecks for the development of the Polish economy as very often indicated by companies. It is one of the reasons for the recently observed rapid wage growth excessive of labor productivity gains that could seriously hamper the further job creation. It is also crucial that economic activity increased most rapidly among the older part of the population (aged 45-60/65), as this is the least active part of the Polish labor force as compared to the other EU countries (29% are active versus the EU average of 45%).

We expect that both employment in the enterprise sector and the overall LFS employment figure will keep rising year on year in the quarters to come, however the pace of growth will be decelerating. It will reflect the expected fall in GDP dynamics resulting in slower job creation by Polish enterprises. In the 3Q2008, the enterprise sector employment growth should stay about 5% yoy and the LFS employment in the 2Q2008 stay around 4.5% yoy. The average enterprise sector employment growth for 2008 should stay at a rate of 5.0%, the LFS employment will grow at the average rate 4%-4.5% yoy.

Wages

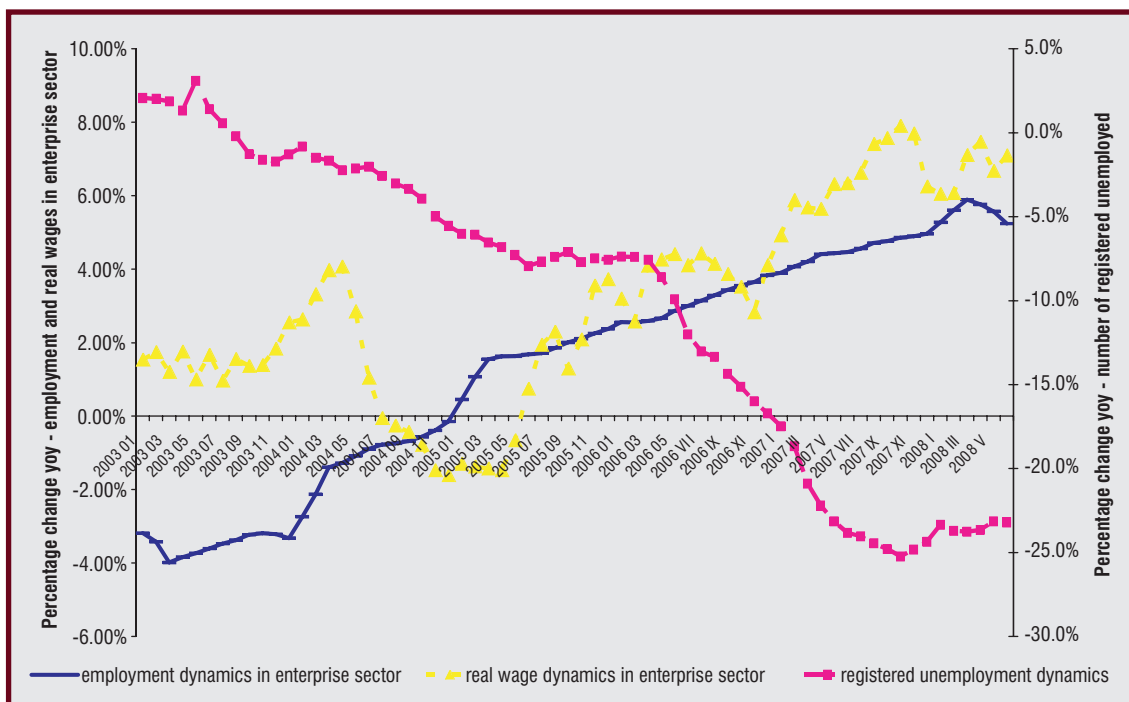
Nominal wages keep rapidly increasing. In the 2Q2008 the average nominal wage in the enterprise sector was by 11.7% higher than in the 2Q2007, while in 1Q2008 the yoy increase was 11.5% yoy. The average gross wage in the overall economy rose by 11.6% yoy in the same period, a sign that the state sector has caught up with the enterprise sector. Nominal wages still accelerated, although the rate of y-o-y growth seems to have stabilized at a high rate that threatens with the inflationary pressures. Real wage dynamics in the 2Q2008 also stabilized at the y-o-y rate of 7.1%.

Nominal wages are still rising most dynamically in construction (15.9% yoy in the 2Q2008) and business services (14.2% yoy). In the 2Q2008 wages grew also very rapidly in mining (16.9% yoy). In mining, however, the variance of quarterly growth rates is very high and, in general, wages in this sector are in line with the economy-wide trend. The nominal wage increase in the biggest sector of industry - manufacturing - very closely mirrors the general figure, with y-o-y growth of 11.3% in the 2Q2008.

It is quite often claimed that increases in wages in Poland seriously hamper the competitiveness of Polish goods exported to international markets. One has to take into account, however, that due to a very tough situation on the Polish labor market in years 1999-2005 wages in Poland have not been rising rapidly (on average below 2% yoy in real terms), and at the same time Poland experienced a dynamic increase in labor productivity - 8% yoy on average, according to Eurostat. According to the Eurostat estimations the index of Unit Labor Costs (ULC) in Poland in 2008 will still be by 20% lower than in 1999. If one compares the level of total labor costs in Poland, measured as a share of total labor costs in GDP, with other European countries it appears that Polish labor is still relatively cheap and competitive (see Figure XX). It is worth to emphasize that Polish labor stays competitive not only vis-a-vis the EU15, but also in comparison to the group of Central and Eastern European countries that joined EU in years 2004 - 2007. It means that, although the further dynamic increase of wages in Poland can harm job creation, it should not bring about serious problems for Polish exporters. It seems that Polish zloty, rapidly appreciating at the same time, can result in much more harm.

We expect the average wage growth to stabilize. Average nominal wage growth in the 3Q2008 should stay at around 11.7%-11.8% yoy. Taking into

Figure 6. Employment and real wage dynamics in enterprise sector; and registered unemployment dynamics in Poland 2003-2008



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

account the expected increase in inflation in this period it will limit the growth of real wage to 6.7% yoy. We expect that nominal wage growth will fall slightly below 10% yoy till the year-end. On average, nominal wages will grow in 2008 by 11.2% and real wages by 6.6% (Mateusz przeliczyłem przy Przemka CPI 4.3%) , whereas in 2007 the corresponding growth rates were: 9.1% and 6.5% respectively.

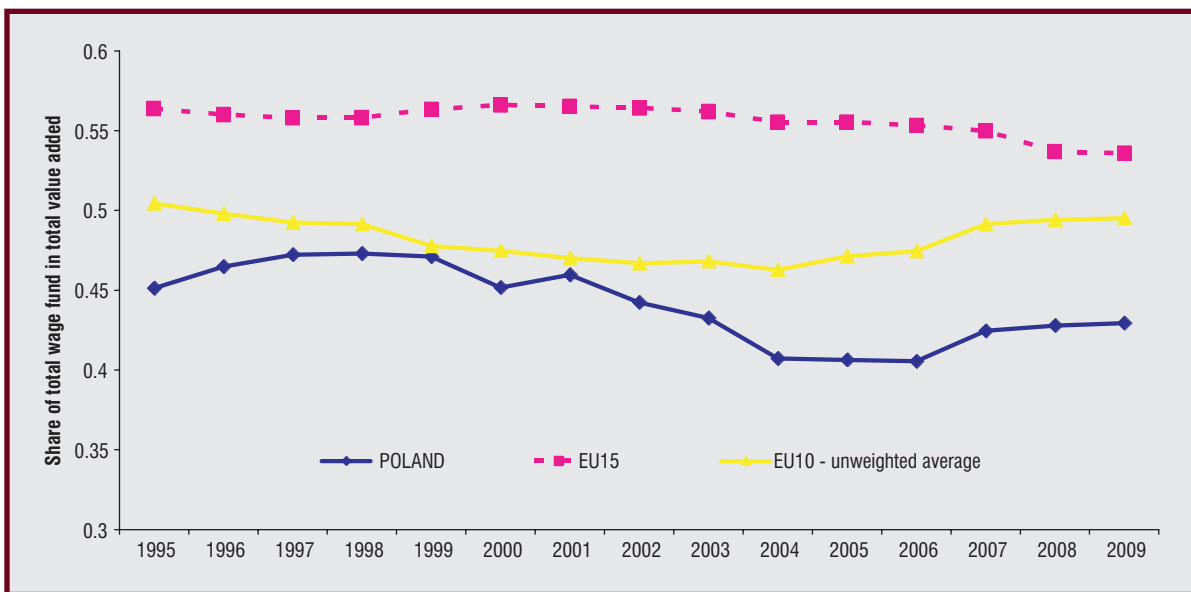
Unemployment

Unemployment keeps falling. The number of registered unemployed persons fell to 1.45 million in the 2Q2008. This meant a y-o-y reduction of 23.2%, compared with 23.8% yoy in the 1Q2008. The registered unemployment rate fell by 2.7 percentage points yoy to 9.6%.

Although these are still very good trends one has to take into account that registered unemployment seems to decline much more slowly than in previous quarters. Additionally, the number of unemployed finding new jobs continues to fall (by 17.5% yoy in the 2Q2008), being accompanied in the 2Q2008 by a decreasing number of new vacancies by 9% yoy. The number of new vacancies offered by PES fell yoy for the first time since 2004.

The LFS figures for the 1Q2008 were still positive. The number of unemployed fell by 28.1% yoy, as compared to 30.2% in the 4Q2007, reaching 1,361,000, and the unemployment rate fell yoy by 3.2 percentage points reaching for the next time a record low of 8.1%. Here, however, we can also observe that the dynamics of unemployment reduction continued to slightly decelerate (as they did in 4Q2007). The falling dynamics of unemployment reduction is also confirmed by seasonally adjusted EUROSTAT data on unemployment rate in Poland (also coming from LFS). According to this data unemployment rate in 2Q2008 fell to 7.5% from 7.8% in 1q2008, i.e. only by 0.3 percentage points. In previous quarters this unemployment figure was decelerating much faster: by 0.8 percentage points in 1Q2008 and 0.7 percentage points in 4Q2007.

Figure 7. The share of wage fund in total value added in Poland, EU15 and EU10* in years 1995-2007 and EUROSTAT forecast for years 2008 and 2009



EU10 = Poland, Czech Rep. Bulgaria, Romania, Hungary, Slovakia, Slovenia, Latvia, Lithuania, Estonia

Source: EUROSTAT

We expect that the registered unemployment will decrease in the 3Q2008 to 9.1% and then it will stabilize reaching 9.3% at the end of 2008. The LFS unemployment will continue to fall. In the 2Q2008 it should fall to 7.8%, then to around 7% by the year end. Both registered and LFS unemployment will probably continue to fall also in 2009, however much slower than in 2008. We expect the registered unemployment rate to stay above 8.5% at the end of 2009, while LFS unemployment rate will not fall below 6%.

Foreign trade and balance of payments

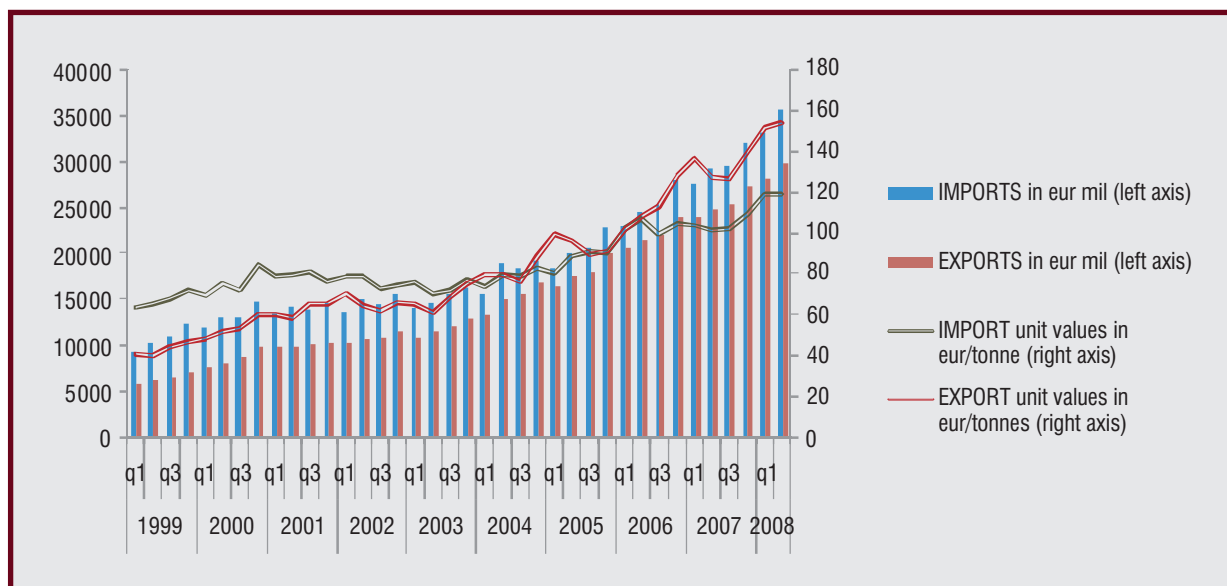
- Strong growth of trade volumes continues
- CA deficit rose further to almost 4.5% of GDP

Growth of merchandise exports slowed down a bit in the 2Q2008. As reported by the CSO (GUS), sales of Poland-made produce increased in nominal zloty terms by about 6% yoy in April-June of 2008 (17% yoy in euro), after 8% yoy in 1Q2008. The fastest growing export markets were again developing countries and Eastern European states, mainly Russia and Ukraine. Sales to the EU slowed down significantly from 6% yoy in the 1Q2008 to 3% yoy in the 2Q2008, affected by the stagnation in the euro zone in this period, where GDP fell by 0.2% quarter on quarter. However, the average euro prices for a unit of exported good kept on mounting (see Figure 8).

The expansion of imports slowed down too. According to the CSO, value of imports rose in nominal zloty terms by about 8% yoy in the 2Q2008 (20% yoy in the euro terms in the same period), after expanding by 10% yoy in 1Q2008. In April-June 2008, similarly as before, merchandise trade deficit was mainly due to trade with developing countries, in particular with China and Russia. Trade with the EU ended with a surplus in the 2Q2008, although the balance of trade with the euro zone was again slightly negative. Prices of imports

remained constant qoq. The relation between import and export unit values remains favorable and suggests that imported goods are on average cheaper and probably of lower quality than the exported ones. This relation showed for the first time in mid-2006, and has been strengthening since then.

Figure 8. Values and prices of Polish merchandise trade, 2002-2008



Note: 2Q2008 – estimate

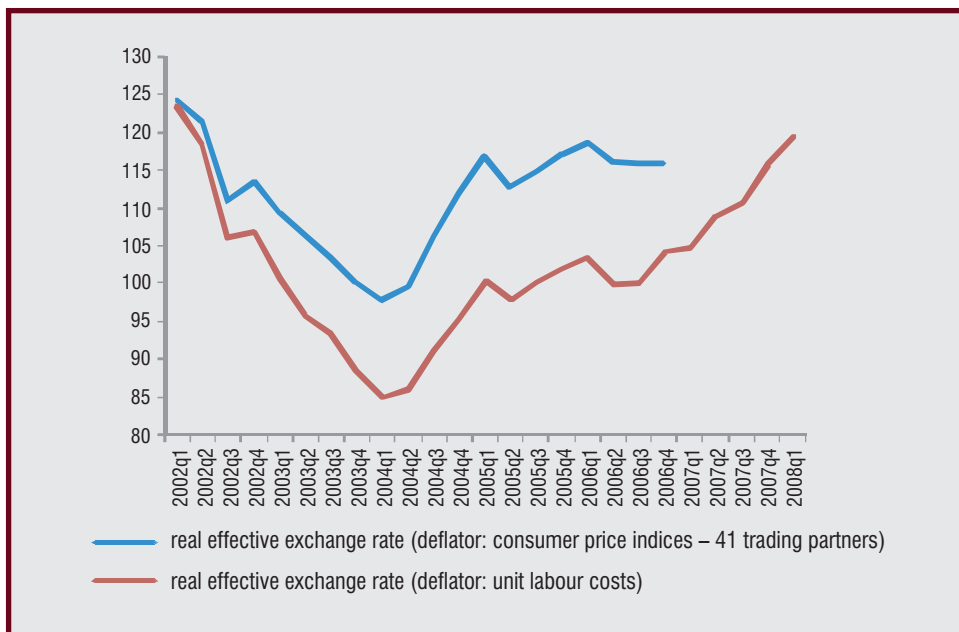
Source: Eurostat and own calculations

The data on trade volumes were available only for April as of writing. The volume of exports expanded 21% yoy in April 2008, which is higher than at the beginning of the year. The volume of imports tends to grow at the similar speed - at 21% yoy in April - and also higher when compared to the 1Q2008. It is most likely that the primary cause for the growth of imports was, still, high and stable domestic demand. However, the appreciating real exchange rate of the zloty vis-a-vis the euro and the US dollar throughout the whole 1H2008 might also be a factor (for real effective rates see Figure 8). Economic growth in the EU27 continued (albeit at much slower pace), and it was primary factor behind the growth of Polish exports. When one separates growth of exports to new and old member states, it is evident that exports to the new EU members grow much faster, which also reflects differences in the dynamics of domestic demand in the old and in the new EU members.

It is forecasted that exports will continue to expand in real terms, by above 10% yoy in 2008-2009. The real growth of imports will be similar in 2008, although lower in 2009.

It is difficult to say with the significant degree of confidence what will be the time path of future values of merchandise exports and imports. They depend very much on changes of terms of trade, and those are hard to predict. We forecast, nevertheless, that the dynamics of merchandise exports and imports, expressed in the euro, will be much higher than the real changes, predominantly due to strengthening of zloty (at least until mid-2009). We think that the unit values of export will grow less dynamically in the 2H2008. We also forecast that merchandise trade balance will worsen in 2008, and then in 2009.

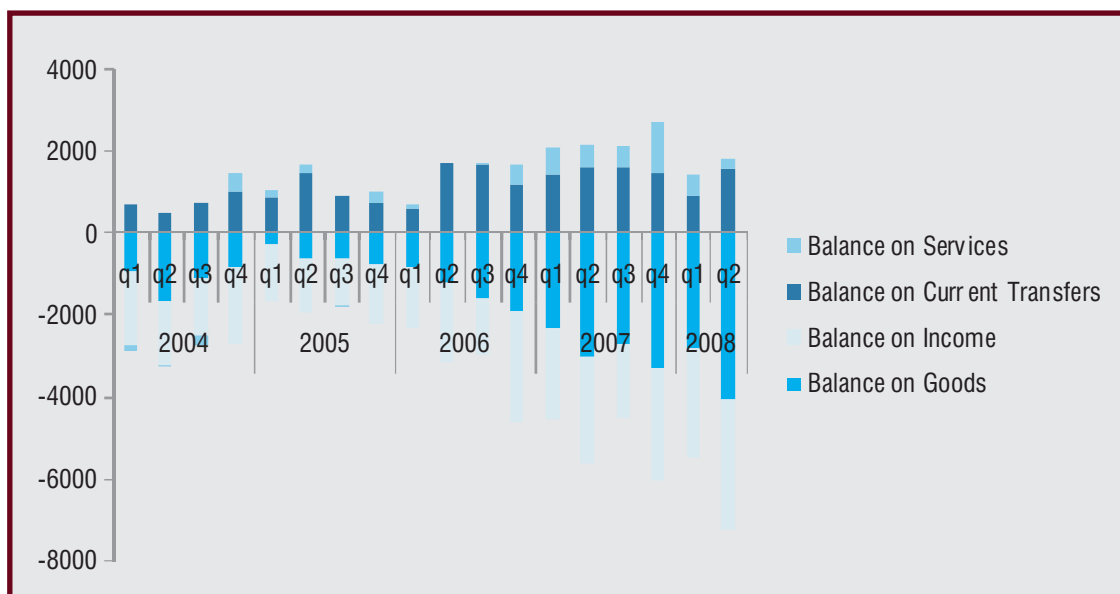
The current account (CA) balance increased to almost -4.5% of GDP in 2Q2008, after -4% of GDP in the 1Q2008. At the moment the high and negative CA balance is influenced by the growing merchandise trade deficit, estimated at almost EUR -4.1 billion in the 2Q2008, and by the negative

Figure 9. Real effective exchange rate, 2002-2007


Note: indices, 1999=100

Source: Eurostat

balance on the current income account that reached almost EUR -3.2 billion in the 2Q2008 (Figure 10). Trade in services in the 2Q2008 closed with a small surplus of EUR 0.3 billion. It is too early to assess whether the smaller surplus of trade in services is a one-quarter phenomenon, or whether it is a change of earlier increasing trend. The low surplus is due to the result for June, when trade in services was balanced. Current transfers - out of which a significant part is composed of transfers to and from the EU budget - recorded a positive balance of EUR 1.6 bn in the 2Q2008. Contrary to our previous issue of the PEO, we now see the possibility that the CA balance in relation to GDP will increase further to reach close to -5% of GDP at the end of this year, and will start to decrease gradually over the course of the following quarters. The primary reason for this is changed forecasts of the dynamics of export and import prices and less optimistic prediction as to the magnitude of the surplus of services.

Figure 10. Current account in millions of euro, 2004-2008


Source: NBP.

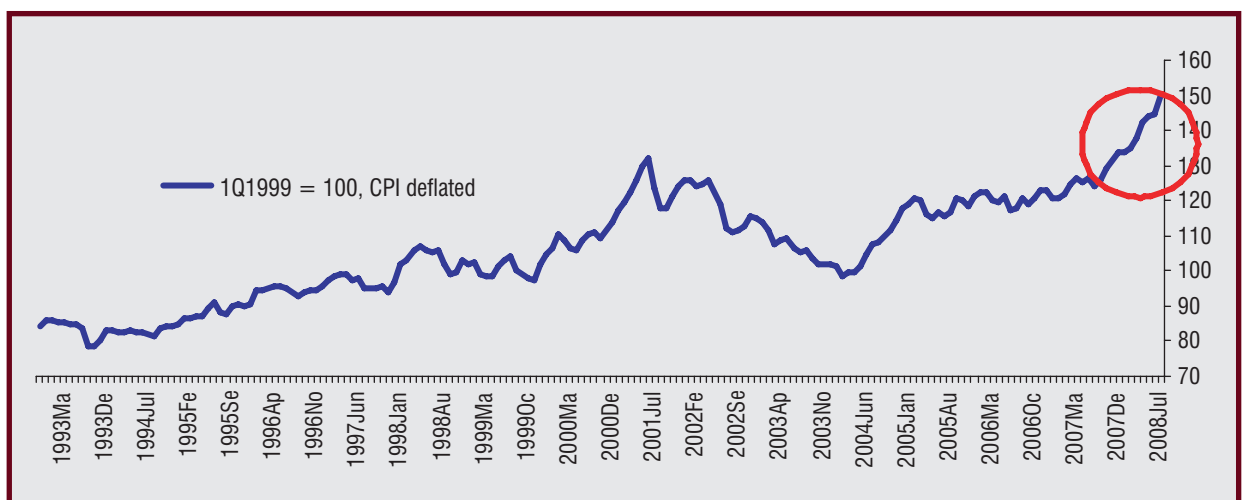
Net inflows of FDI from April to June 2008 were lower than on average in the 1Q2008. Preliminary data indicate that net incoming FDI closed at EUR 0.9 billion in the 2Q2008. For the last 12 months, net inflows of FDI have financed on average 70% of the negative balance on the current account. This is clearly a worsening of the structure of financing, since for the whole 2007 net FDI inflows financed roughly the whole CA deficit, a slight decrease was recorded in the 1Q2008, and the significant one in 2Q2008. We can expect that along with the projected growth of the CA deficit in the close future, and rather stable net inflows of FDI, a lower proportion of the CA deficit will be financed through FDI inflows. Another reason can be the ongoing world-wide slowdown that tends to dampen international capital flows. On the other hand, we do not expect that FDI inflows will finance less than 50% of CA deficit in 2008-2009.

Is the Zloty too Strong?

There are numerous casual reports from exporters, who complain that the profitability of exports has dramatically declined. Even some lay-offs of personnel and bankruptcies have been reported by the press. Small firms are mostly affected.

Since the fourth quarter of 2007 the zloty has appreciated rapidly in nominal terms while the CPI inflation differential between Poland and its main trade partners has been small in the same period, no more than 1 percentage point. Therefore this nominal appreciation translates almost one for one into real appreciation. Real effective exchange rates (REER) are broadly used as a proxy for international competitiveness. The CPI deflated real effective exchange rate of the zloty, calculated by the ECB, appreciated by almost 18.9% from September 2007, the month when the appreciation started, to July 2008 (Figure 11). We also reproduce the NBP chart from its June issue of Inflation Report that confirms the rapid appreciation in real terms, applying various gauges: unit labor costs (the green line), CPI and PPI (Figure 12)³.

Figure 11. Real Effective Exchange Rate of PLN



Source: ECB.

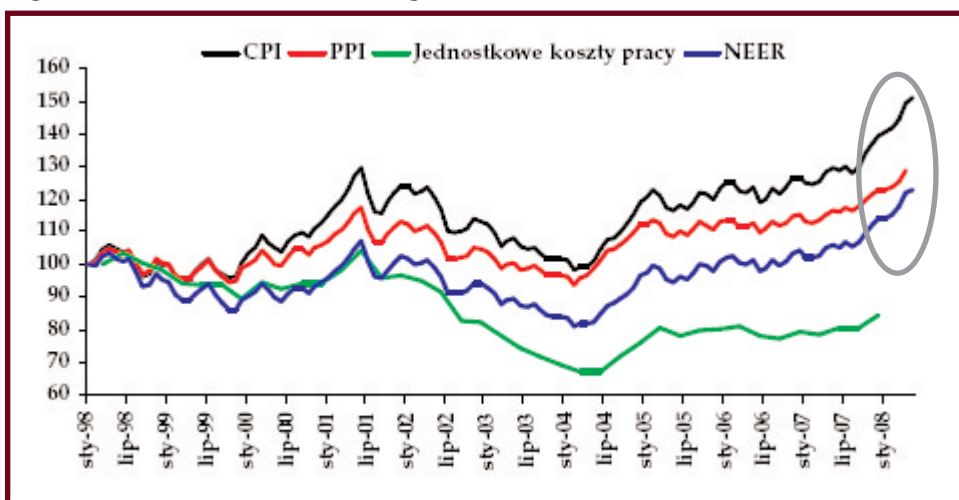
Such a quick pace of strengthening of the zloty could be justified by fundamentals, were the Polish currency particularly weak before that period. Then the strengthening could be treated as an adjustment to correct the disequilibrium.

³ NBP does not publish the chart underlying data.

However, this is not the case as both charts show: the zloty fluctuated in a rather narrow range for a prolonged period before it began to firm significantly in the fall of 2007. Therefore this rate of appreciation is equivalent on balance to an adverse demand shock to the economy. By the way such a movement toward equilibrium occurred in the second half of 2004 and most of 2005 after a significant weakening of the zloty due to the fiscal and political risks earlier.

CPI deflated REERs suffer from the deficiency that they include non-traded goods and indirect taxes so ULC-based REERs are thought to have more merit. Unfortunately, the statistics available from various quarterly Reports on Inflation of the NBP staff, end up in the 4Q2007 so they cover only half of the period examined. Based on this indicator, the appreciation streak starts in the 2Q2007, the REER stabilizes in the 3Q2007 but the appreciation accelerates in the 4Q2007 again.

Figure 12. Real Effective Exchange Rates of Poland, CPI,PPI and ULC Deflated



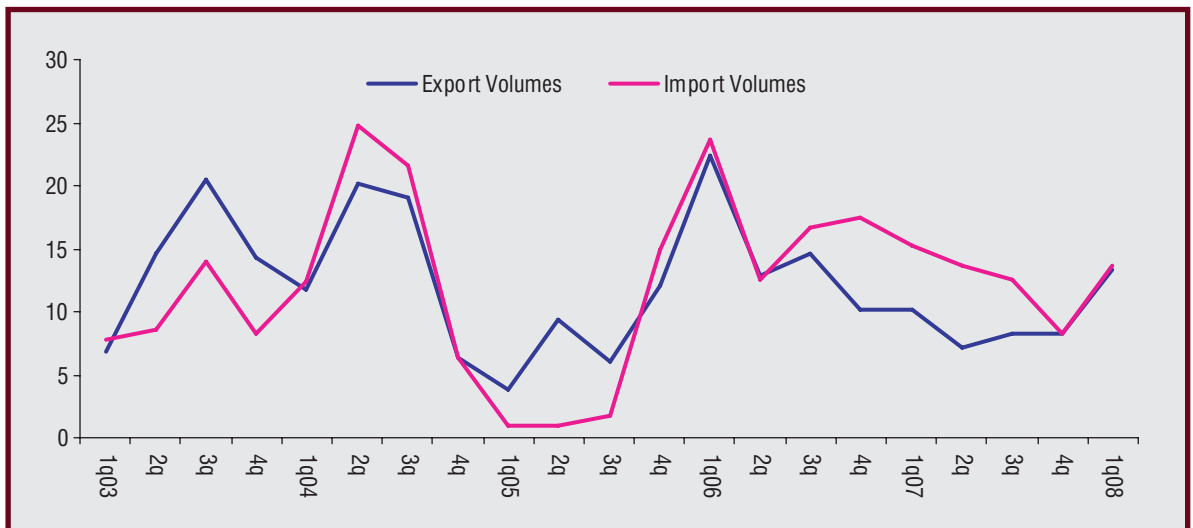
Source: NBP, Inflation Report, June 2008.

It is a tricky question whether the currency is overvalued or not since there are no precise ways to judge it. The most advanced methodology is to estimate so called Fundamental Equilibrium Exchange Rates (FEER) or Behavioral Equilibrium Exchange Rates (BEER). The fundamental external equilibrium occurs when the size of the current account deficit is sustainable in the long-run, i.e. can be financed without disruptions, when the economy operates at an internal equilibrium of full employment and low inflation. In contrast, the BEER methodology uses actual values of fundamental quantities and then attempts to decompose the estimates of the exchange rate into temporary and long-term elements. The latter serves as an indicator of the equilibrium exchange rate. We do not have such models for the zloty, therefore we have to base our judgment on other methods. The consolation is that FEER and BEER methods usually give rise to wide intervals of equilibrium exchange rates so they cease to be operational when one wants to pinpoint a single number or narrow range as they leave the answer open.

Both methodologies emphasize the importance of the current account deficits that should not be too high, i.e. sustainable to use the jargon. Therefore it is sensible to look at the developments on the current account, what its trend is and see what the underlying causes of it are. It is clear that Polish current account deficit has been widening since 2005 and the pace accelerated in 2008 on the back of the yawning trade deficit. On top of it the deficit on the income account has been gradually rising as well. The current account shortfall jumped from 3.7% of GDP at the 2007 yearend to the preliminary 4.4% in the 2Q2008.

However, it is much less clear whether it has happened due to the real appreciation of the exchange rate or due to the differential rates of growth of the Polish and Eurozone economies in particular, whether the current economic slowdown in the euro area was a factor. Most likely both factors have taken their toll on the widening imbalance. The differential rate of growth between Poland and its partners induces a cyclical rise in the current account due to increasing imports but a slowdown in the euro area dampens Polish exports as well. The excessive strength of the domestic currency would show up in the deteriorating performance of exports but also manifest itself in rising imports as they become cheaper. Therefore it is hard to discriminate between the two. Polish trade statistics point to the declining growth in the export volumes (Figure 13) but the trend is not so clear-cut. Relatively strong export volume growth year on year in the 1Q2008 coincided with the appreciation of the zloty but sound economic growth in the Eurozone tended to offset its impact in the 1Q2008. Further import volumes do not exhibit a tendency to rapidly increase; a strong pick-up in import flows could be ascribed to a jump in the value of the zloty. To the contrary, they also tend to fall, suggesting that imports and exports are tightly correlated. One cannot exclude that the J-curve effect is operating: Trade flows usually react to the exchange rate swings with a lag of one to two quarters so the full impact of the appreciation may materialize in the second half of 2008. This would imply an even faster pace of the trade deficit widening. The bottom line of these considerations is that the developments on the current account do not give an unequivocal answer to the question posed. At least not yet. However, broad signals about the falling profitability of exports and declining export orders, a sort of leading indicators, where the trade deficit may go, suggest that the good export performance may suddenly collapse.

Figure 13. Export and Import Volumes Growth, % yoy



Source: CSO, National Accounts.

Another way to fix whether the currency is overvalued or not, is to look at the purchasing power parity (PPP) exchange rates, and compare the market exchange rates to them. A comprehensive International Comparisons Project from 2005, sponsored by the World Bank, that attempts to establish GDP per head and a number of other quantities, based on the purchasing power concept, calculated the PPP rate of the zloty at 1.90 to the US dollar in 2005. The most up-to date index of PPP is BigMac Index, compiled by the Economist with a wink

⁴ The Economist July 26, 2008 page 76.

of an eye, but this surprisingly simple gauge has seldom been far off the mark. Now it stands at 1.96⁴. This would suggest the zloty exchange rate of 2 versus the dollar is about right. However, it does not say anything about the euro rate. The caveats of this measure have been thoroughly described in the literature on the subject. The most troublesome is that the PPP exchange rates take into account non-tradables, of which services are a dominant part. Their prices deviate from the prices that would respect the so-called law of one price, which prices of tradables should obey, at least under theoretical assumptions. These departures are the more significant the larger are the differences in economic standard of living among countries. Usually, non-tradables prices are much lower in less developed countries than in advanced economies when converted at the market exchange rates as these prices reflect domestic conditions of demand and supply. This is the case of Poland as well. The well-known Balassa-Samuelson phenomenon explains, how prices of non-tradables in low-income countries converge over time to the prices of high-income countries. Skipping the details, the catch-up process in prices of non-tradables is related to the faster growth in labor productivity, mainly in tradables sector, in low income countries. However, leaps in productivity growth are rare so this process is usually gradual and takes years. No leap in labor productivity growth in Poland was recorded over the last twelve months. These gains are gradual, therefore the latest episode of the zloty strong appreciation has been detrimental to the profitability of Polish exports. The catch-up process in price levels as explained by the Balassa-Samuelson phenomenon is an equilibrium process so it should not cause any worsening of the export performance.

Concluding this piece, the presented arguments support the view that the zloty is overvalued, which hampers export growth. Under the current global worsened demand conditions this may lead to a considerable slowdown in Polish export performance and considerably affect GDP growth prospects. The situation starts resembling a bit 2001-2002 period when half of exports were reported by firms as unprofitable due to the strong appreciation of zloty, caused by the enormously high interest rate differential between Poland and key financial markets. At that time, however, Polish economy stagnated while domestic demand even fell so it could not be helpful. This time domestic demand is buoyant. Nevertheless, *toutes proportions gardeés*, this is a warning signal that should not be neglected.

POLISH ECONOMIC OUTLOOK

TRENDS • ANALYSES • FORECASTS



QUARTERLY 2/2008 (37)

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Center for Social and Economic Analysis (CASE),
ul. Sienkiewicza 12,
00-010 Warszawa, Poland
www.case-research.eu

Małgorzata Jakubiak (External Sector)
Maciej Krzak (all other texts, Head of Forecasting Unit)
Przemysław Woźniak (Inflation)
Mateusz Walewski (Labor Market)

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