POLISH ECONOMIC OUTLOOK
TRENDS • ANALYSES • FORECASTS
CASE
QUARTERLY 3/2009 (42)

Large Fiscal Deficits – Curse #1

EXECUTIVE SUMMARY

It is definite now: Poland has escaped recession though domestic demand declined for three straight quarters. GDP growth is picking up slowly and unemployment is rising slower than predicted. Inflation finally started heading south. The current account deficit is very low and downtrending. The only meaningful disequilibrium is the gaping fiscal deficit, but Poland is not an outlier across the universe in this respect.

The economy experienced a sudden stop in growth and bottomed in the 4Q08, when it was hit by the global crisis, then it meddled through the 1H09, and it started improving in the 3Q09 thanks to the tailwinds from the world economy. Broadly speaking, it behaved along our predictions in the 3Q09. Short-term prospects for the economy are improving. In 2010, the recovery should gain momentum. Our forecast of growth in the 3Q09 and in the 4Q09 is revised upward to 1.5% yoy and 2.2% yoy, respectively. Going forward, we see the recovery gain momentum in 2010, 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% yoy, i. e. in the 2Q10. 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worldwide recovery will gather strength in 2010, based on the effects of macroeconomic stimuli that will not have been withdrawn.

Despite persistent deflation in the euro area the consumer price inflation in Poland remains relatively high fuelled by the depreciation of the currency and the high administrative price increases. It fell slightly in the third quarter 2009 to 3.6% yoy, down by 0.1 p.p. from the second quarter, benefiting from slowing prices of food and energy. Counteracting this trend, prices of industrial goods and fuel continued to accelerate on the back of the weak zloty and progressively rising global prices of crude oil, gas and other commodities. Compared to the previous issue of the PEO we lowered our forecast of the CPI and PPI inflation. In spite of the gradual acceleration of economic growth and domestic consumption in 2010 we do not expect significant demand pressures to resurface in the forecast horizon due to the persisting negative output gap. The steadily strengthening zloty is projected to put an additional downward pressure on prices. Averaged over four quarters these inflation rates translate into the annual inflation declining from 3.5% to 2.1% in 2009 and 2010, respectively.

The central bank did not change its key interest rates in the 3Q09 and in October 2009 as prospects for economic growth improved and the CPI inflation remained on an elevated level relative to the inflation target. However the projected inflation declined in 2010 so in fact monetary policy was tightened in the 3Q09. If the appreciation of the zloty is accounted for, then the so-called monetary conditions tightened quite considerably. The central path of the year-on-year inflation rate in 2010 assumes that the rate will decrease through the 3Q10 falling below the lower target range (1.5% yoy) and would reach the lower bound in 1Q11. Such a projection would call for a cut in interest rates even by 50 basis points immediately since inflationary risks are low and they are skewed to the downside. If to believe the NBP projections the interest rates should remain unchanged through 2010. Our predictions are slightly higher so we do not exclude a first hike in interest rates in the 4Q10, but the probability of it is low.

The conditions in the labor market continued to deteriorate in the 3Q9 due to sluggish economic growth, but the scale of the deterioration was lower than expected and there were some positive signals as well. Due to this and the improvement in the general economic forecast in this PEO our expectations regarding the situation on the labor market are also revised positively. We assess that the LFS employment in the 3Q2009 was still increasing in the y-o-y terms by 0.5%. We expect that in 2009, on average, employment in the enterprise sector will fall by 1.4% and the LFS employment will actually be increasing by 0.5% yoy. Unemployment keeps increasing, although at a slightly slower pace than we expected. It is interesting that the rise in unemployment rate can be explained mainly by an increasing economic activity of the population, which remains a puzzle during a severe slowdown in growth. We revised downward our

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

Indicator	Data						CASE forecasts						
	2006	2007	2008	2008			2009	2010				2009	2010
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4		
Nominal GDP, PLN bn	1060.0	1176.7	1272.8	314.1	326.3	331.4*	369.8	328.8	343.1	349.2	388.4	1341.6	1409.5
(% change, yoy)													
GDP	6.2	6.8	4.9	0.8	1.1	1.5*	2.2	2.5	3.1	3.3	3.5	1.0	3.2
Private Consumption	5.0	4.9	5.4	3.3	1.7	2.5*	2.5	2.3	3.2	2.8	3.4	2.1	2.9
Fixed Investment	14.9	17.6	8.2	1.0	-3.0	-5.6	-2.0	-1.1	1.6	4.9	3.6	-2.5	2.3
(4Q, % of GDP)													
CA balance	-2.7	-4.7	-5.4	-3.9	-2.1	-1.1*	-0.5	-0.6	-1.1	-1.2	-0.9	-0.1	-0.9
(% change, yoy)													
Exports (NBP, EUR)	17.8	20.4	13.4	-22.9	-22.8	-21.8*	3.4	7.0	8.0	7.5	8.9	-16.6	7.8
Imports (NBP,(EUR)	13.4	24.0	19.5	-28.8	-32.0	-27.2*	-2.8	5.0	7.0	6.0	9.5	-22.6	6.8
(% change, yoy)													
Industrial sales	11.2	9.5	3.3	-10.0	-6.7	-1.3	1.0	5.0	3.8	4.5	6.0	-4.3	4.8
Gross value added	6.0	6.7	4.9	1.2	0.8	1.2	1.9	2.4	3.1	3.2	3.5	1.2	3.1
CPI	1.0	2.5	4.2	3.2	3.7	3.6	3.4	2.9	1.7	1.8	2.1	3.5	2.1
PPI	2.3	2.3	2.5	4.9	4.2	2.2	2.3	0.8	1.5	3.3	3.2	3.4	2.2
Nominal Ave. Wage	4.9	8.7	10.4	6.8	4.4	3.0	2.7	3.4	2.5	3.1	3.3	4.0	2.9
Employment %, LFS	3.1	3.1	3.7	1.3	1.0	0.5	0.0	-0.3	-0.8	-0.5	0.0	0.7	-0.4
Registered unemployment rate (%, eop)	14.8	11.4	9.5	11.2	10.7	10.9	11.9	12.5	12.7	12.3	13.0	11.9	13.0
PLN/EUR, eop	3.89	3.78	3.52	4.50	4.45	4.20	4.17	4.10	3.98	3.95	3.75	4.30	3.85
WIBOR 3M, %, ave	4.20	5.68	5.88	6.15	4.17	4.18	4.15	4.10	4.05	3.95	3.85	3.95	4.00
Central bank key rate eop	4.00	5.00	5.00	5.75	3.75	3.50	3.50	3.50	3.50	3.50	3.50	3.25	3.75
(% change, yoy eop)													
Broad Money (M3)	16.0	13.4	18.6	17.5	14.4	9.6	8.1	8.0	7.9	8.5	9.5	8.1	9.5
Loans to HH	33.4	37.9	44.6	43.7	35.7	26.3	15.5	10.0	8.0	8.5	9.0	15.5	9.0
Loans to Firms	13.7	24.1	29.0	25.8	15.0	6.8	1.0	1.5	3.0	4.3	5.0	1.0	5.0
(% GDP)													
Fiscal Balance	-3.9	-1.9	-3.9	n.a.	n.a.	n.a.	-5.8	n.a.	n.a.	n.a.	-5.5	-5.8	-5.5
Public Debt eop	47.7	45.0	47.2	43.6.	n.a.	n.a.	52.0	n.a.	n.a.	n.a.	54.9	52.0	54.9

(*) in the column on the 3Q2009 means CASE estimates or forecasts.
Cut-off date: October 31, 2009.
Sources: CSO (GUS), Eurostat, NBP and CASE own calculations.

projections of the registered unemployment rate to about 13% at the end of 2010, while the LFS unemployment rate will probably grow to about 9-10%.

Nominal wage dynamics stopped falling in the 3Q09. It seems that the improving general economic climate has encouraged firms to stop wage cuts and saved the average real wage level from reductions. However, we do not expect wages to come back to the rising dynamics in the nearest future because of rising unemployment. Average nominal wage growth in the 4Q09 should fall to around 3% yoy and stay there in 2010. This will result in the real wage y-o-y dynamics at the levels close to zero in the 4Q09 and 1% in 2010.

The supplementary budget was implemented without any tensions in the 3Q09 and we do not expect any such in the final quarter of the year. The central government deficit will likely come lower than projected in the supplementary budget. The MF predicted in October 2009 that the general government deficit would reach 6.3% in 2009, which is close to our slightly increased forecast of 5.8% of GDP. Fiscal disequilibrium will increase in 2010 as the government has drafted a budget with a large cash deficit, however, the general deficit should rise only modestly. We think that factors that will tend to lower the state deficit relative to the target prevail over those that would lead to a slippage. Therefore, the government may avoid a breach of the 55% precautionary threshold by the public debt in 2010 though the risk is acute.

Exports were down again, but they continued to be underpinned by the weak zloty despite the appreciation of the real effective exchange rate since February 2009 that accelerated in the 3Q09. The depreciated zloty along with the economic stagnation discouraged imports. The positive effects of the nascent European recovery on nexports were little discernible. An improvement in economic activity in Poland in the 3Q09 along with the zloty strengthening supported imports whose year-on-year declines decreased in the July-August period. Both exports and imports seem to have bottomed in the 2Q09 if the data on September 2009, which were not available as of writing, confirm the trends from July-August 2009. The current account continued to rapidly decrease on the back of the shrinking trade deficit and the four quarter deficit fell to 2.1% of GDP in the 3Q09 according to our forecast. It will fall further in the 4Q09 and start slowly widening in the course of 2010.

The special feature: Large Fiscal Deficits – Curse # 1, suggests how to tackle the recurring large fiscal deficits in Poland. The text proposes two additional institutional arrangements to help cut the fiscal deficit in a sustainable way. One is to adopt a rule capping expenditure growth. Another and, perhaps even a more pertinent idea, is to establish a Fiscal Council of independent experts, which would monitor the fiscal policy of the government and warn were it may lead to.

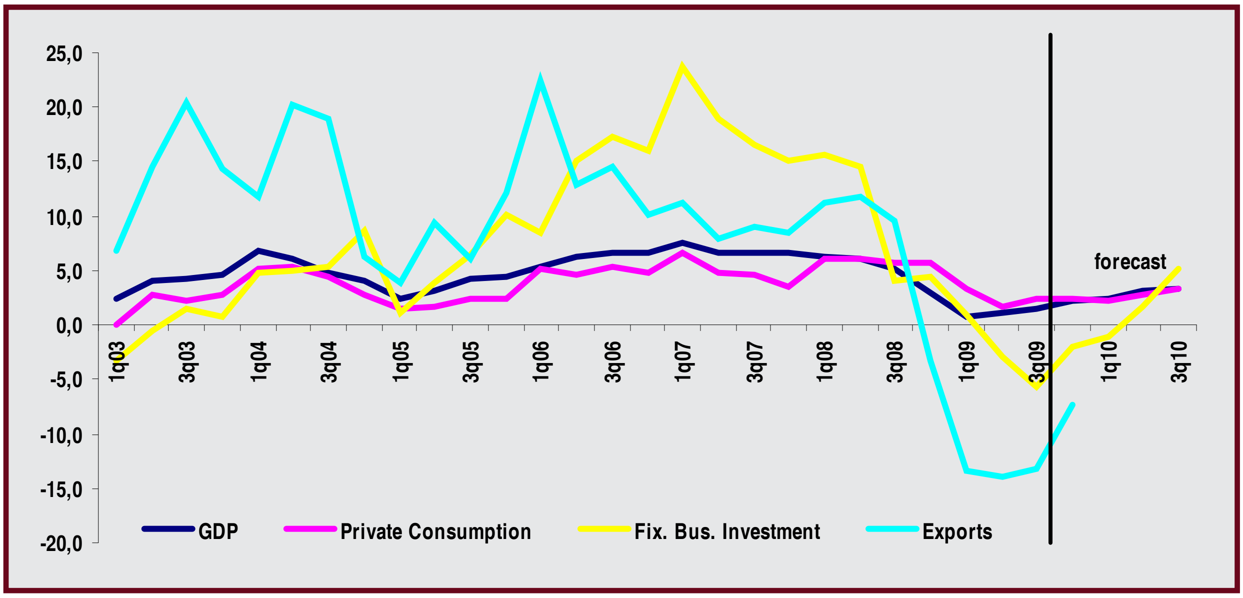
LATEST DEVELOPMENTS IN THE POLISH ECONOMY

Economic growth

The fear of recession is gone for now. The economy experienced a sudden stop in growth and bottomed in the 4Q08, when it was hit by the global crisis, then it meddled through the 1H09, and it started improving in the 3Q09 thanks to the tailwinds from the world economy. Broadly speaking, it behaved along our predictions in the 3Q09. Short-term prospects for the economy are improving. In 2010, the recovery should gain momentum.

Since no official data on GDP growth in the 3Q09 have been published as of writing, the coverage of the developments in this period begins with the high frequency data on the supply side. A look at the Table 2 reveals that the supply side performed a bit better year on year in the 3Q09 than in previous quarters. This suggests that economic growth should have accelerated. Sales of industrial firms with at least 9 persons on staff fell by 1.3% yoy in the 3q09, i.e. the least in any quarter of 2009. Construction sales of firms with at least 9 employees increased by 4.7% yoy in January-September 2009 while they grew 1.4% yoy in the 1H09; the comparison of these figures suggests that construction considerably accelerated during the 3Q09. Our estimate is over 11% yoy[1]. This rise was caused by the large public investment in infrastructure, supported by the EU funds. The data from Ministry of Regional Development point to a pickup in approved applications for aid and the use of funds. The breakdown of the construction output growth confirms this assertion as civil engineering (construction of surface and water facilities), in particular construction of roads and rails, grew by 19.6% yoy in January-September this year while other branches of construction recorded declines. Real sales turnover rose by 3.7% yoy in the 3Q09, compared with 1.4% yoy in the 2Q09. The turnover was much stronger in the summer holiday months than in September, suggesting that purchases increased because Poles chose to spend holidays at home instead of going to southern Europe because of the unfavorable exchange rate. Recall, that the appreciation of the zloty peaked in the summer of 2008. The 40% yoy decline in travels of Poles crossings of the Polish border to countries remaining outside the Schengen group during the first three quarters of 2009 supports this hypothesis[2]. The only sector that registered a considerably lower activity in annual terms in the 3Q09 was telecommunications and postal services, but the earlier data may have been revised downward

Figure 1. GDP Growth Factors, quarterly % yoy



With regard to the demand side, personal consumption should have come slightly stronger as the real wages in the enterprise sector rose by 0.5% yoy in the 3Q09, compared with 0.1% in the 2Q09, consumer credit picked up a bit and the consumer confidence improved in this period as fears of unemployment dissipated somewhat. There was no information available on the growth of wages in the entire economy in the 3Q09 as of writing, but salaries of the employees in the state-budget sector on a year ago should have risen distinctively higher than the wages in the enterprise sector since the former were offered a considerable pay rise in the 1Q09 (by 8.1% yoy in real terms), of which effects should have been carried over to the following quarters. Since there were no layoffs in the public sector, the employees enjoyed higher disposable incomes in the 3Q09 year on year and could spend more without dipping into savings. Usually, as fears of unemployment ease,

[1] There are only cumulative data on the first three quarters.
[2] There are no registrations within the Schengen group of countries.

Table 2. Output growth in various sectors in 2009, % yoy

	1q	2q	3q
industrial sales, % yoy	-10	-6.7	-1.3
o/w manufacturing	-9.9	-6.2	-1
construction sales, % yoy*	-1.3	2.7	11
real trade turnover	0.4	1.4	3.7
transportation, cumulative % yoy	-8.5	-6.4	-4.5
telecommunications and postal services, cum. % yoy	5	5	3.5

***) own estimates based on CSO cumulative data.**

people tend to use their savings to support the living standard. The official rate of unemployment rose in this period by 0.3 of a percentage point at the end of a quarter, but the average rate was up by only 0.1 of a percentage point from the 2Q09 so the rise did not have much negative influence on the nominal aggregate of wages and salaries in the economy. Real gains in pensions were of the same order as in the 2Q09, i. e. 3.7% yoy in the case of non-agricultural pensions, so there should have not been any slowdown in purchases by that social group, the more so that their ranks increased by 0.6% yoy. Therefore, their purchasing power increased by 4.3% yoy in this period. Taking the data into account, we see no reason for a revision of our forecast of the personal consumption rise by 2.7% yoy in the 3Q09. However, the CSO has just revised downward its growth to 1.7% yoy from 1.9% yoy in the 2Q09 so taking this correction into regard, we forecast a 2.5% yoy at present.

Since there was no corporate credit growth fixed business investment in the private sector should have continued to decrease in the 3Q09 in year on year terms. The public investment offset this drop to some extent like in the previous quarters so its positive contribution to economic growth increased. According to the data on the state budget performance, public fixed business investment grew by over 455% yoy in July-August 2009 and by 144% from the 3Q08. This rise amounts to 5.2% of the nominal level of fixed business investment in the economy in the 3Q08 so it is not negligent and may offset quite a substantial drop in the private investment, the more so that the month of September is not accounted for as of yet. This is why we think that our previous forecast does not require any changes. The negative impact of the inventory cycle on gross investment and GDP growth should have gradually diminished due to the almost completed elimination of excessive inventories in the private sector. However, they were still problematic in the public sector, which will tend to dampen growth in this sector in the 4Q09. Net exports were most likely to remain the driver of economic growth in the 3Q09 like in earlier quarters, since the year-on-year rates of decline in exports and imports were about the same as in the 2Q09. The NBP business confidence index has undergone a V-shaped recovery so the 4Q09 should witness stronger economic growth than 4Q09: The index of forecasted output crossed the zero line and is wandering upward. The economy seems to have set the virtuous circle in motion in the 3Q09 though it accelerates rather slowly.

Going forward, we see the recovery gain momentum in 2010, 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% yoy, i.e. in the 2Q10. According to the latest NBP quarterly survey of companies, they plan to start new investment projects more often in the 4Q09 than in the 3Q09 and are less inclined to freeze the completion of investment projects in train. Nevertheless the private fixed investment should remain sluggish, at least until the 2009 yearend, due to a poor access to banking credit, large underutilized capacities and uncertainty about the sustainability of the recovery. This situation should start changing for the better in 2010. Net exports will worsen in the course of 2010, albeit slowly and continue to positively contribute to GDP growth. Exports are very profitable despite a strengthening of the zloty in the 3Q09; the profitability of exporters who conclude contracts in the euro is still at levels comparable only to the period 2H03-1H04. The recovery gaining steam in the global economy bodes better times for Polish exports and it is doubtful that imports growth will outpace its growth by a significant margin until investment activity of the private sector is subdued.

The latest CSO revisions to the quarterly GDP estimates in 2008 and 2009 have some influence on our forecasts as they provide arguments for a cosmetic upward correction. The CSO confirmed that seasonally adjusted GDP fell 0.1% qoq. in the 4Q08 so the economy bottomed then, but GDP growth was negligible 0.1% qoq in the 1Q09 instead of a slightly higher 0.3% qoq that had been reported earlier. However, the pickup in the 2Q09 was stronger than previously reported as GDP grew by 0.7% instead of 0.5% qoq on a seasonally adjusted basis. Despite these changes, the CSO upheld its previous estimates of GDP growth by non-adjusted 0.8% yoy and 1.1% yoy in the 1Q09 and 2Q09, respectively. The collapse in domestic demand proved stronger than it had been reported as it decreased by 0.5% qoq instead of 0.2% qoq in the 4Q08 and its unadjusted growth rate was revised down to 3.1% yoy from 3.5% yoy. The declining trend accelerated in the 1Q09 and the 2Q09 so GDP growth was saved by growth in net exports. It is unlikely that domestic demand recuperates suddenly since the private fixed business investment is low and consumers' disposable incomes grow slowly, therefore net exports will remain the engine of economic expansion. The new data did not bring any material revisions to the data on gross investment and fixed business investment, suggesting that the inventory destocking was a bit more faster in the 2Q08 through the 1Q09 than previously reported. Restocking of inventories in manufacturing, which took off in the 2Q2009 should turn positive for GDP growth yoy in the 4Q2009.

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. The strongly expansionary combination of fiscal and monetary policies in key countries has proven successful in resuscitating global demand for the time being, albeit from very low levels. The progress with stabilizing the global financial markets 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 will not have implications for 2010, but for 2011, which is beyond the scope of our forecasts at present. Should the global recovery not gather strength in 2011, it may cause a plateau in economic growth in Poland. However, domestic developments related to the construction activities ahead of the European soccer champs may offset this adverse impact.

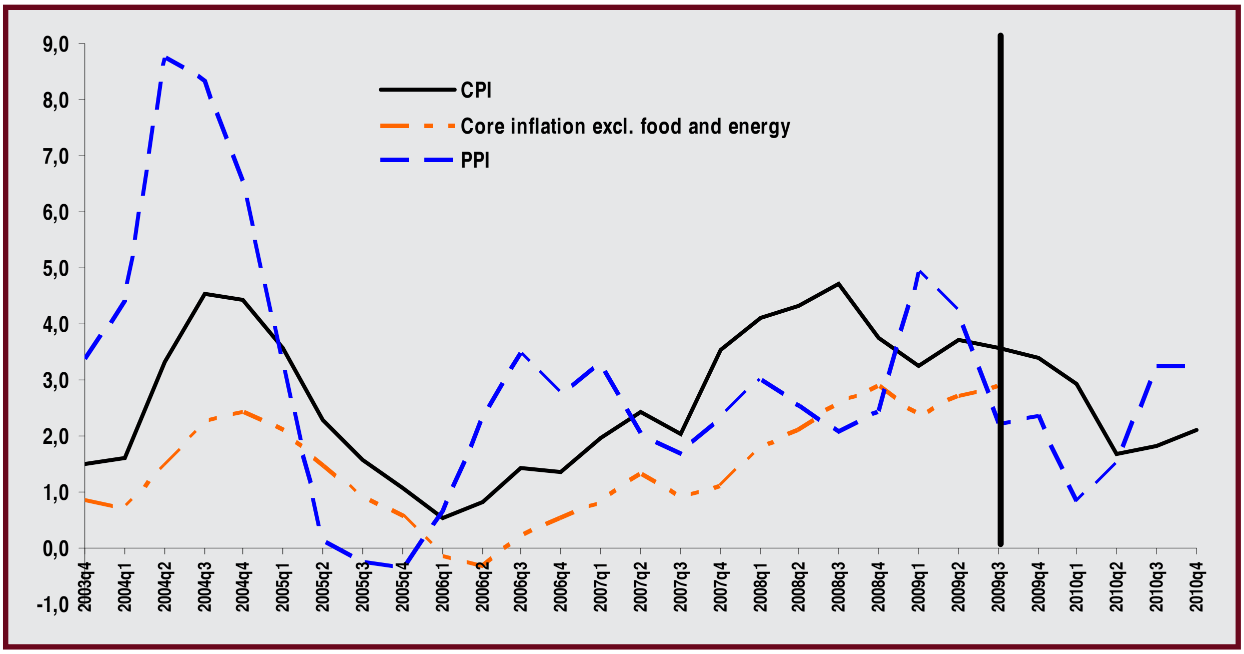
Inflation

Current situation

Inflation fell slightly in the third quarter 2009 to 3.6% yoy, down by 0.1 p. p. from the second quarter, benefiting from slowing prices of food and energy. Counteracting this trend, prices of industrial goods and fuel continued to accelerate on the back of the weak zloty and progressively rising global prices of crude oil, gas and other commodities. Despite persistent deflation in the euro area the consumer price inflation in Poland remains relatively high fuelled by the depreciation of the currency and the high administrative price increases.

Core inflation excluding food and energy rose to 2.9% yoy in the 3Q09 narrowing the distance from headline inflation to 0.7 p.p. – the lowest in 4 years. The gradual closing of this gap points to the disappearance of pro-inflationary shocks stemming from the peaking prices of agricultural and energy commodities in 2007-2008. Inflation of food declined to 4% yoy in the 3Q09, sharply down from 5.2% yoy in the second reflecting robust supply following a good harvest combined with easing demand pressures both domestically and in Poland's key food export markets. Inflation of bread and cereals plummeted to 2.5% year on year, the lowest since 2006, thanks to globally declining prices of major grains accompanied by good domestic crop. While the Polish procurement prices of wheat and rye rebounded somewhat in the 3Q09 – they are still, respectively, 18.7% and 36.4% lower than in the same period last year, compared to 40% yoy and 48% yoy in the 2Q09. Prices of meat slowed down to 9.3% after peaking at 10.6% yoy in the second quarter reflecting cheaper pork and poultry. Price growth of dairy products rebounded somewhat in the third quarter but remained negative (-1.1% yoy) amid low procurement prices of milk (-9.3% yoy in the 3Q09). Robust crop of fruit and vegetables ensured near-zero inflation on a y-o-y basis in the third quarter. Following gradual increases since late 2008, prices of sugar fell in the 3Q09 to a still high 22.5% yoy.

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



Inflation of energy carriers moderated to 9.6% year on year, down from 11.8% yoy and 14.4% yoy in the second and first quarter, respectively, reflecting a broad-based decline in the dynamics of prices of electricity, gas and heating fuels. The biggest deceleration was registered for gas whose prices slowed to 2.6% yoy in the third quarter – the lowest since the 1Q08 – on the back of fast declining world prices of gas, which fell by 61% in the first nine months of 2009[3]. On the other hand, prices of fuel for vehicles rose by 4.5% qoq in the third quarter bringing the annual dynamics from -10.5% yoy in the 2Q09 to -5.6% yoy in the 3Q09. This reflects a steady increase in world prices of crude oil which grew by 17-20% qoq in the third quarter following a surge by over 30% qoq in the second quarter.

Prices of industrial goods continued to accelerate in the third quarter fuelled by depreciation pressures that have accumulated since late 2008. Despite rebounding slightly in the summer months, the zloty exchange rate was still respectively 23.5% and 17.4% weaker in September and October than in same months of 2008. Consequently, the annual price change of non-energy industrial goods[4] rose to 0.5% in the 3Q09, the highest since 2005. Inflation of consumer durables grew to 1.1% yoy, up from -0.5% yoy in the 2Q09. turning positive for the first time since 2004. This is more than two percentage points above the euro area inflation which plummeted to -0.9% yoy in the third quarter (and -1.1% yoy in September alone), marking the lowest ever monthly and quarterly price change on an annual level in this product group. The acceleration in the year-on-year inflation of consumer goods prices has been discernible in various categories, such as home appliances (+0.8 and +1.9 p.p. compared to the second and first quarter, respectively), home electronics (+2.7 and +7.5 p.p.), hygienic supplies (+0.5 and +1.7 p.p.) and cars (+3.0 and +6.1 p.p.)[5].

Core inflation excluding administered prices fell to 2.9% yoy, i.e. 0.1 p.p. down compared to the second quarter and remained below the headline inflation indicating the moderate pro-inflationary effect of the administrative component. However, while prices of most administered prices continue to grow faster than the overall inflation index, they decelerated significantly in comparison to the third quarter, e.g. energy, rents, railway and postal services. At the same time. many non-administered, but previously included in the group of controlled prices, post accelerating dynamics, e.g. tobacco, which is up by 3.5 p.p. qoq to 18.4% yoy in the 3Q09 or fuel.

Trimmed mean core inflation indicator fell by 0.3 p.p. to 3.6% yoy in the 3Q09 – identical with the headline inflation – suggesting that inner core price changes are in line with those at the extreme ends combined (extreme price hikes and declines). This indicates that headline inflation has gradually become less sensitive to extreme supply shocks and instead reflects the broad-based price trends common for most of product and service markets.

The Producer Price Index (PPI) fell sharply from 4.2% in the 2Q09 to 2.2% in the 3Q09 on the back of a deceleration in mining&quarrying and the energy sector. Inflation in mining&quarrying fell by 3.7 p.p. qoq to 8.6% yoy in the 3Q09 reflecting a sharp drop in the annual inflation in coal mining from 19.6% yoy in the second to 10.1% yoy in the third quarter due to a very high base in the 3Q08. The electricity and gas sector saw its year-on-year price dynamics decline to 15.3% in the 3Q09 from 16.9% yoy in the 2Q09 while prices in the water supply and sewage collection rose by 4.5% yoy in the 3Q09, up from 1.9% yoy in the 2Q09, on the back of marked increases in the sewage collection and waste management.

The overall inflation in manufacturing was largely unchanged from the previous quarter at 1.9% yoy. This stability masks important shifts within the

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[3] Natural gas from Russia, USD terms, source: International Financial Statistics.
[4] The analysis in this paragraph refers to the Harmonized Index of Consumer Prices (HICP).
[5] Based on the CPI data.

index as deflationary trends on a year-on-year level deepened in a number of sectors (metals, metal products, chemicals, paper) while in others the price growth accelerated in comparison to previous quarters (coke and petroleum, pharmaceuticals).

Forecast

Compared to the previous issue of PEO we lowered our forecast of the CPI and PPI inflation. Our expectation of lower consumer inflation in the 4Q09 and in 2010 follows from a slightly smaller-than-expected price growth in the third quarter (-0.2 p.p.) and a more optimistic outlook of the supply and price trends in the agricultural markets. Furthermore in spite of the gradual acceleration of economic growth and domestic consumption in 2010 we do not expect significant demand pressures to resurface in the forecast horizon due to the persisting negative output gap. The steadily strengthening zloty is projected to put an additional downward pressure on prices.

Inflation of food is falling somewhat faster than we predicted in late summer due to a very favourable harvest of major grains, fruits and vegetables combined with a robust supply from major world producers. Major grains and oilseeds are projected to start rising mildly in late 2009 – in line with progressively growing demand from recovering China, India, the US, the EU as well as from the bio-fuels industry – and continue this trend throughout 2010. However, we expect the impact of these increases on retail prices of food to be restrained in the coming quarters and project the overall inflation of food products to stabilize at around 4% yoy in the remainder of 2009 and in 2010.

An additional curb to price growth will come from the stronger zloty which is expected to enter an appreciation trend in the 4Q09 and continue to strengthen throughout 2010. This trend shift will push the PLN/EUR exchange rate up from the depreciation of 27% and 9.9% yoy in the third and fourth quarter of 2009, respectively, gradually to an appreciation of 6-10% in individual quarters of 2010. While some lagged effects of the weak zloty are expected to continue fuelling price increases in tradable goods and services (durables in particular) this effect will gradually wear off in the course of 2010 bringing inflation of industrial goods back towards or even below zero.

Prices of industrial commodities, such as metals, fibres and rubber are set to continue rising moderately in the 4Q09 until 2Q10 and then grow much slowly from 3Q10 onwards reflecting rising demand from rebounding major world economies. Following a fast increase in copper and coal prices in the first three quarters of 2009, the prices of these key domestic commodities are expected to stabilize in 2010. World prices of crude oil are forecast to rise moderately until mid-2010 (to US$80/barrel) and then decline slowly until 2011.

The joint effect of the moderation of commodity prices, gradually strengthening zloty combined with a slowly accelerating domestic absorption and exports will produce the declining PPI inflation, from 3.4% to 2.2% on average in 2009 and 2010, respectively. The PPI will fall sharply in the first two quarters of 2010 to 0.8% yoy and 1.5% yoy, respectively) reflecting a strong base effect related to massive hikes in energy prices in early 2009.

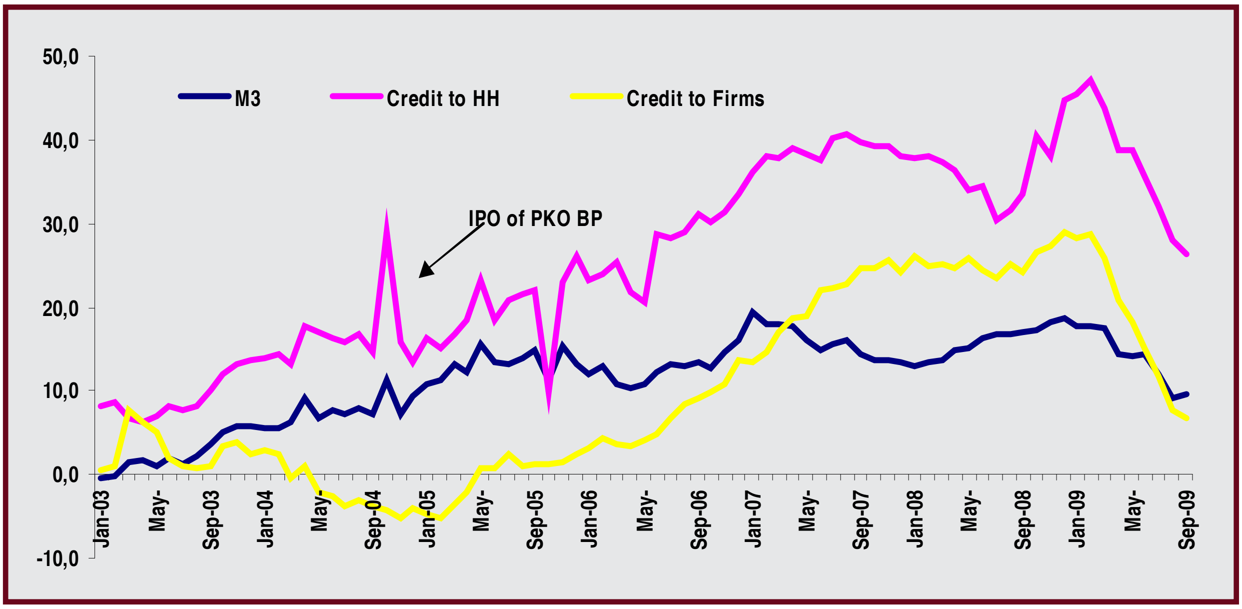
The consumer price inflation is projected to fall to 3.4% yoy in the 4Q2009 remaining in the upper region of the central bank's target zone (2.5% yoy plus/minus 1%) and continue falling to 1.7% yoy in the first half of 2010 on the back of decelerating energy prices and stronger zloty as well as a high early-2009 base. Inflation will rebound to 1.8% yoy and 2.1% yoy in the third and fourth quarter of 2010. Averaged over four quarters these inflation rates translate into the annual inflation declining from 3.5% to 2.1% in 2009 and 2010, respectively.

Monetary Developments and Policy

The year-on-year statistics on household credit growth remained impressive in the 3Q09, but figures on credit growth of non-financial companies were less so, finally reflecting the impact of the ongoing global crisis.

Credit to nonfinancial companies amounted to PLN 214.8 billion at the end of the 3Q09 and it fell by 1.8% qoq, compared with 3.1% qoq in the 2Q09[6]. This was a second straight quarter of a decline. Both domestic currency and foreign currency credits displayed a negative tendency. The lack of credit has become a significant obstacle to economic growth though according to the NBP surveys the intensity of this barrier eased somewhat in the 3Q09 from the record high level, but is above the index in 4Q08. One third of the questioned firms replied that their applications for credit had been rejected. They cited the lack of a quality collateral and financial situation as main reasons for disapproval. However, even firms with a good financial standing encounter difficulties obtaining credit. Credit crunch has reduced the share of firms that plan to finance their investment projects by means of a loan to the lowest level in the questionnaire history so it must adversely affect the fixed business investment growth. In year-on-year terms credit to non-financial firms grew by 5.9%, compared with 14.5% in the 2Q09.

Figure 3. Broad Money and Credit Expansion, % yoy



Source: NBP and own calculations.

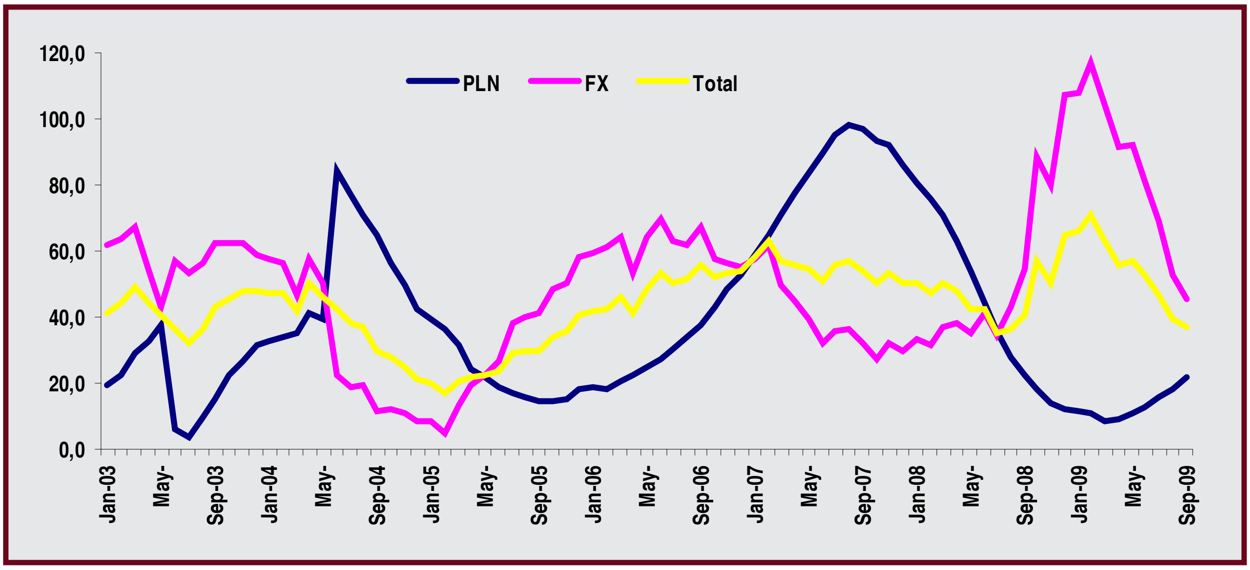
Credit to households continued to grow in the 3Q09, albeit at a snail's pace: it increased by 1.4% qoq, compared with 1.1% qoq in the 2Q09. However, the appreciation of the zloty led to a decline in the zloty value of the stock of foreign currency credits and masked the flat upward trend in the domestic currency credit, which grew by 5% qoq in the third and the second quarter of 2009. Credit to households rose by 26.5% yoy in September 2009.

The credit conditions did not change for the better in the 3Q09 from the 2Q09, based on the NBP statistics and surveys, despite that the prospects seemed more favorable at the beginning of the quarter. However, prospects for the credit resumption in the 4Q09 continue to improve because stronger economic growth should make banks start rethinking their prudent loan policy

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

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.

Figure 4. Housing Credit Credit Growth, % yoy



Nominal broad money (M3) growth continued to decelerate: it rose by 9.6% yoy in the 3Q09, compared to14.4% yoy in the 2Q2009. In quarterly terms, M3 declined by 0.3% versus a rise of 1.5% in the 2Q2009. Total deposits increased by 10.9% yoy, compared with 15.9% yoy in June 2009. Since domestic banks have much worse access to foreign funding than before the crisis, this deceleration also puts limits to the credit expansion. In previous quarters, household and firm deposits used to grow at different rates. In the 3Q09 deposits of firms rose nothing while household deposits increased at the rate of 19.6% yoy. The stagnation in deposits is a mixture of two opposite undercurrents; demand deposits decreased 5.1% yoy while time deposits rose by 13.2% yoy. Polish firms remain liquid, but due to the lack of new credit they simply use their deposits as working capital. Time deposits of households expanded at the rate of 26.1% yoy in the 3Q09, compared to 41.9% yoy in 2Q09. The slowdown may be related to a lower rise in disposable incomes, a gradual reduction in time deposit rates by banks and a rising popularity of alternative financial investments in the environment of uptrending stock markets though this switch, which has started from the trough is slow as the memory of a huge decline in stock values is fresh and investors have become strongly risk averse. Demand deposits of households rose at the rate of 13.5% yoy in September 2009 so the discrepancy between the rate of growth of time deposits and demand deposits has narrowed. 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 5.2% p. a. and 1.6% p. a. in the 3Q09 versus 5.3% p. a. and 1.5% p. a. in the 2Q09, respectively so it continued to narrow.

The central bank did not change its key interest rates in the 3Q09 and in October 2009 as prospects for economic growth improved and the CPI inflation remained on an elevated level relative to the inflation target (see section on Inflation). Effectively, it tightened monetary policy because its own projected 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[7]. If the appreciation of the zloty is accounted for, then the so-called monetary conditions tightened quite considerably. The central path of the year-on-year inflation rate in 2010 assumes that the rate will decrease through the 3Q10 falling below the lower target range (1.5% yoy) and would reach the lower bound in 1Q11, assuming no changes in the central bank interest rates.

Such a projection would call for a cut in interest rates even by 50 basis points immediately since inflationary risks are low and they are skewed to the downside. The world recovery is uncertain. A possible breach of alarm thresholds by the public debt would induce recessionary tendencies as cuts in expenditure and, possibly, tax hikes would be necessary. The credit crunch may be prolonged and firms, deprived of credit financing may increase investing only modestly. A rise in unemployment may further dampen domestic demand. The main inflationary risk is connected with a sustained strong depreciation of the zloty if the public debt breached the feasible threshold, triggering automatic procedures to reduce the debt and the fiscal deficit. However, the central bank rates stayed put in October. Possibly, the MPC did not want to make a rate cut decision during the one of its final meetings. The 6-year terms of its members will start expiring in January 2010 through March 2010. The lower house, the upper house of the parliament and the president of Poland will each elect 3 members of the new MPC. If to believe the NBP projections the interest rates should remain unchanged through 2010. Our predictions are slightly higher so we do not exclude a first hike in interest rates in the 4Q10, but the probability of it is low.

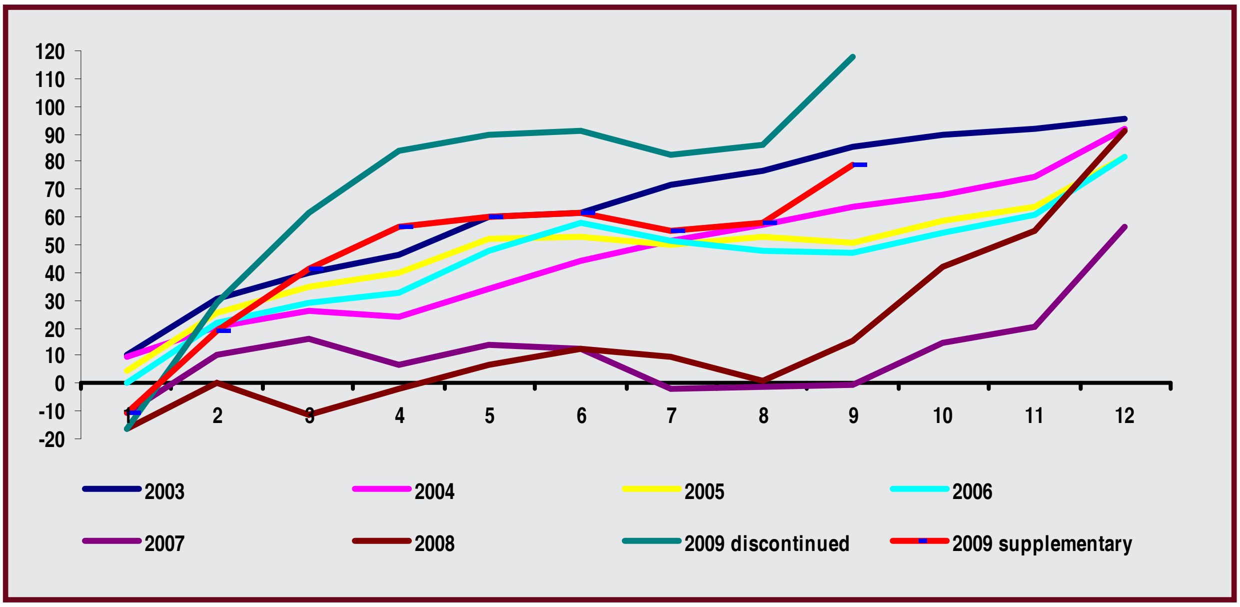
Fiscal Developments and Policy

As signaled in the PEO 2/2009, expecting a performance slippage, the government adopted a supplementary budget for 2009, which specified the state revenues, expenditure and the deficit at PLN 272.9 bn, 300.1 bn and 27.2 bn, respectively. Table xx displays major differences between the supplementary and original budgets. The drop in tax revenue by PLN 45.6 bn or 18.1% is much bigger than the rise in the deficit by PLN 9 bn. This is

[7] Inflation Report, NBP, October 2009.

possible because the government has raised its non-tax income by 7.3 bn, non-reimbursable funding from the EU has been upped by 8.2 bn, manly thanks to the depreciation of the zloty, and the state expenditure has been cut by 21.1 bn. The largest position within the non-tax revenue increment is the additional dividend income of PLN 4.3 bn. The largest cuts pertain to subsidies across the board, public fixed investment and financing of the EU related projects, but spending on the EU related projects will be much higher than in 2008 anyhow. The original plan was simply too optimistic as the absorption capacity is concerned. The scale of the amendment is a compromise between negative effects of a tightening the fiscal policy, when the economy is stagnating, and the negative effects of a larger deficit that could threaten the stability of public finances going forward.

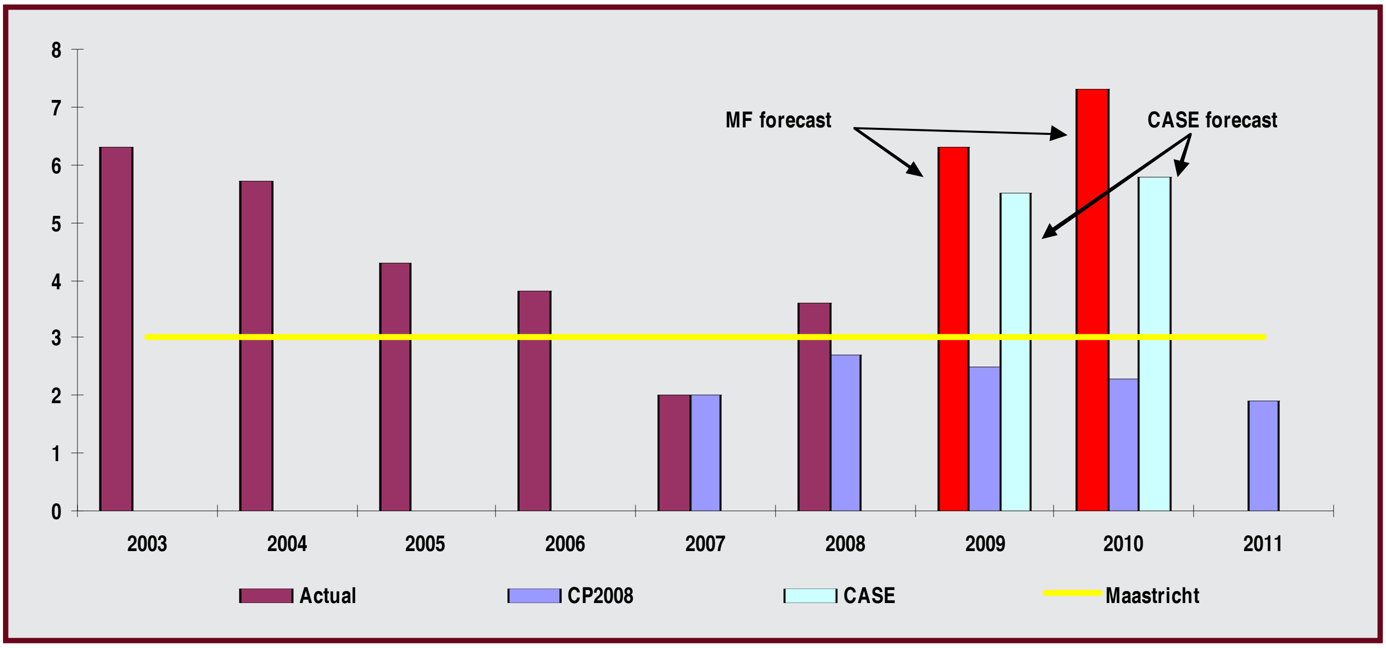
Figure 5. Central Government Budget Deficit, % annual projection



The supplementary budget was implemented without any tensions in the 3Q2009. The central government cash budget recorded a deficit of 21.5 bn zlotys in January – September of 2009, an equivalent of 79% of the 2009 target of the supplementary budget that calls for a cash deficit of 2.1% of 2009 GDP, projected by the Ministry of Finance. The shortfall reached about 118% of the originally targeted amount of 18.2 bn in 2009. Originally, the deficit was to reach 13.6 bn or 75% of the shelved target after three quarters of 2009.

The state revenue reached 202.4 bn zlotys, a dash higher than the MoF projections in its supplementary monthly breakdown of the revenue and expenditure for 2009 and the state expenditure that stood at 223.9 bn zlotys came also close to the plan. The central government revenue and expenditure increased by 6.0% yoy and 11.0% yoy in January-September so the revenue growth accelerated slightly as it rose by 5.2% in the 1H09 while the expenditure growth slowed in the 3Q09 as it grew by 15% yoy in the 1H09. Thus, the fiscal policy has lately taken a less loose stance. To recall, the 2009 original state budget assumed that the central government revenue and expenditure would rise by 19.5% and 15.6% relative to the actual performance in 2008 whereas the supplementary budget assumes that budget revenue will fall by 3.2% while expenditure will be unchanged. The government estimated in the 2010 budget draft that the actual rise in its 2009 revenue may be lower than projected, i.e. 1.2% relative to the 2008 performance. A drop in the revenue by less than PLN 3.9 billion zlotys would be less than the estimated loss due to the personal income tax reduction, but adjusting for a differential amount of collected dividends the drop is close to 8 to 10 billion zlotys.

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

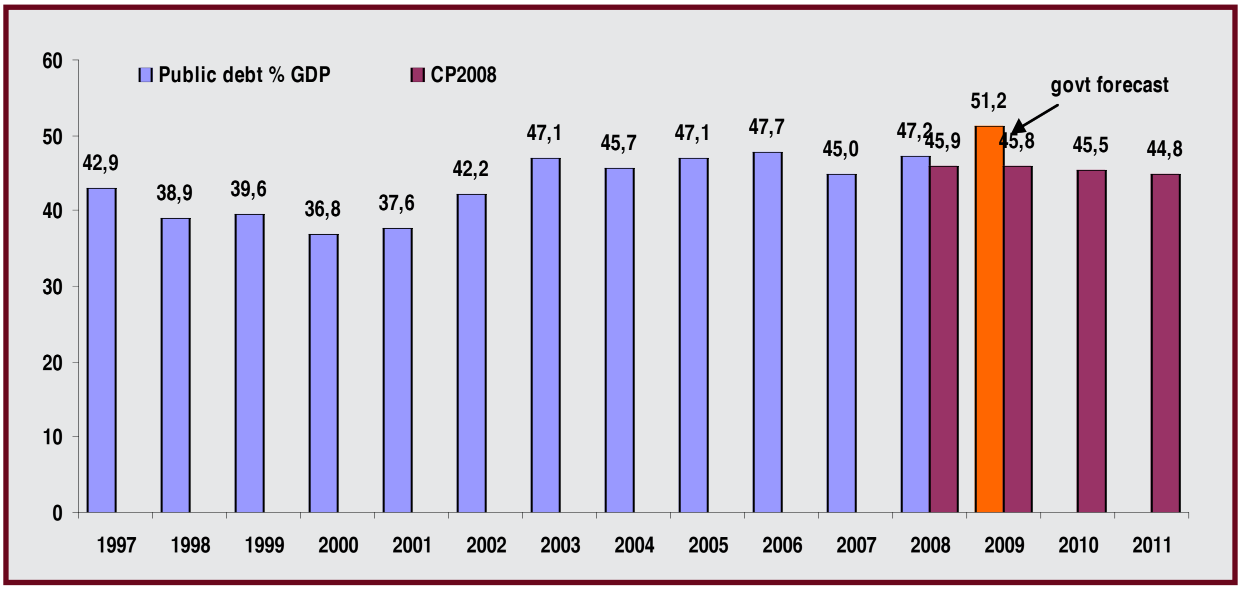


The tendencies suggest that the government should meet its cash deficit target in 2009. Unemployment is rising slower than forecasted by the MF and economic growth is slightly above its projections, which should stabilize the revenue. Despite of this social insurance funds (FUS) face the hard budget constraint due to the loss of income, caused by higher unemployment, and higher expenditure on pensions related to the high compensation for the rise in the cost of living. A relatively large increase in the number pensioners who chose an early retirement before the changes in regulations will limit the access to it. Should the FUS take credits to finance the gap in its finances, then it would add to the general government deficit and debt. The MF predicted in October 2009 that this deficit would reach 6.3% in 2009, which is close to our slightly increased forecast of 5.8% of GDP. However, since nominal GDP will likely be higher than the Ministry's forecast of 1322.3 billion zlotys the forecasted shortfall of PLN 83 billion would amount to 6.2% of GDP. The knowledge of developments in the public sector beyond the central government is only fragmentary and, therefore, these forecasts are unreliable.

The 2010 state budget draft assumes a significantly larger cash deficit than in 2009. It would almost double to PLN 52.2 billion, but the 2009 and 2010 deficits are not directly comparable, since the 2009 budget does not distinguish between the budget of EU funds and the „domestic" budget, which will be the case in 2010. Most likely, the deficit in 2009, when the net balance of EU flows ere deducted, would be much higher though it is impossible to figure out by how much due to the missing data. In 2010, the deficit of EU flows is estimated as additional PLN 15 billion.

In our view the distribution of risks is skewed toward a better deficit performance than projected. The main downside risk is a large increase in the tax collection by 6% in 2010, which does not seem consistent with the assumption of the economic stagnation. The government penciled in an 8.9 % and 9.6% rise in the VAT and the CIT revenue, respectively. With regard to the VAT, it apparently counts on the phasing down of the impact of the shortening of the refund period that reduced VAT revenue in 2009 and a pickup in now depressed imports. The rates of growth in the PIT and excise tax collection are modest 3.3% and 0.7%, respectively. Otherwise, the risks point to a lower deficit than projected. The government has adopted a cautious assumption on GDP growth (1.2%) and consumption expenditure (1.1%) as well as a very low rate of inflation (1%) in 2010. Should our forecast of 3% GDP growth materialize and/or inflation come at 2% then the tax revenue will be higher. Then the reservation of an imprudent projection for the VAT collection would be invalid. We also forecast a stronger appreciation of the zloty than the finance ministry; this should reduce cost of the debt service and, more importantly, the size of the foreign currency share of the public debt. The government has not incorporated any revenue from the 2009 central bank net income into its budget, but it is likely that the NBP will pay in a few billions of zlotys to the state budget. The dividend revenue is modestly projected, compared with 2009, but the settlement of the government dispute with Eureko about PZU, the flagship domestic insurance company, opens a way for a huge payout of a dividend from the past years to the owners that could be as much as 12 billion zlotys. The government could count on another few billions in these circumstances. A rise in the central government expenditure by PLN 8.9% in 2010 looks big, but it is consistent with the assumption about economic stagnation[8]. It is caused by the predetermined expenditure growth due to the parliamentary bills, passed in the past, that the government is unwilling to change before the upcoming presidential and parliamentary elections in 2010 and 2011, respectively. The government avoided any unpopular measures, e. g. it did not stop a pledged rise in salaries of teachers and did not introduce a freeze of a pay rise in administration. Automatic stabilizers will be allowed to work with a full impact. This rise is consistent with the government prediction of rising unemployment, low wage growth and substantially increased pensions because of the elevated inflation in 2009.

Figure 7. Public Debt, % of GDP



Contrary to the central government deficit, the ESA-95 deficit is projected not to increase rapidly in 2010. No details on the general government deficit have been disclosed in the state budget draft, but minister of finance predicted it would be in the region of 7% of GDP so it would increase by 1% of GDP compared with 2009[9]. Large deficits are a rule during the crisis so Poland does

[8] In which we do not believe as you know.
[9] At a press conference on September 7, 2009.

Table 3. Comparison of 2010 Budget Draft with 2009 Budget

	2009 supplementary	2009	% change	absolute ch.	2010 draft	% ch 2010*
Revenue	272.9	303	-9.9	-30.1	245.5	-10.0
Expenditure	300.1	321.2	-6.6	-21.1	297.7	-0.8
Deficit	27.2	18.2	49.5	9.0	52.2	91.9
Tax revenue	205.8	251.4	-18.1	-45.6	223.1	8.4
o/w VAT	94	118.6	-20.7	-24.6	106.2	13.0
excise taxes	51.9	58.1	-10.7	-6.2	53.1	2.3
PIT	34.4	40.3	-14.6	-5.9	36.0	4.7
CIT	24	33.1	-27.5	-9.1	26.3	9.6
Non-tax revenue	25.3	18	40.6	7.3	22.4	-11.5
o/w dividends	7.7	3.4	126.5	4.3	4.2	-45.5

Source: Ministry of Finance.

not seem to be an outlier in this respect. However, countries whose deficit have risen to similar proportions usually have fallen into deep recession, which is not the case of Poland. This underscores that the general government deficit is more a structural problem than a cyclical one. The talk in Poland is about a possible breach of the 55%-of-GDP warning threshold by the public debt that would trigger automatic savings in expenditure. This risk is high, but we think that it relates more to 2011 than to 2010 and we explained in the PEO 2/2009 why we think so. The PEO 2/2009 was published before the government issued the 2010 state budget draft. We thought that the government would plan a modest rise in the state expenditure in 2010, but the contrary is going to happen, there will be a massive increase in privatization proceeds, the zloty will appreciate by at least 5% and the state revenue will rise as GDP growth will pick up considerably. The remaining assumptions are still valid, but the increase in state expenditure will to an upward revision of our 2010 forecast for the general government deficit. It will probably stay at the same level as in 2009, i.e. close to 6% of GDP instead of 4.5% of GDP. This change may cause a rise in the public debt above 55% of GDP. If the government is able to increase its revenue from sales of state-owned companies relative to plan, it may avoid the breach of the threshold.

Public debt was 47.2% of GDP in 2008, practically unchanged from the 47.1%, previously reported in the April notification to the European Commission. The MF forecasted that it would reach 51.2% of GDP in 2009; this is slightly lower than our original forecast of 52.0%, which we uphold.

Labor Market

Employment

In the 3Q2009 employment level in the so-called enterprise sector, the companies employing more than 9 workers, decreased by 2.3% yoy reaching 5,267,000. On the quarterly basis, the number of employed fell by 0.5%, i. e. by 0.6 percentage less than in the 2Q2009. It means that the overall employment dynamics stopped to worsen as rapidly as before so the news might be read as an optimistic signal.

Similarly as in previous quarters, employment in a number of sectors continued to grow. It kept growing in more or less stable manner in construction (by 4.8% yoy) and in hotels and restaurants (5.5%). It grew, although at a falling pace, in trade – by 1.1% yoy in 3Q2009 as compared to 2.6% in 2Q2009 and 4.1% in the 1Q2009. On the other hand employment dynamics seem to improve in business services where the y-o-y growth of 1.7% was recorded in the 3Q2009 as compared to 0.1% in the 2Q2009.

Unfortunately, the falling rate of employment growth in trade, being the second biggest section after manufacturing, suggests that the employment cuts have finally spread from the industrial to services sector. On the other hand however, the negative dynamics in manufacturing as such seem to have been weaker in the 3Q2009. Employment in this section decreased in y-o-y terms by 7.9% which is only slightly more than in the 2Q2009 when they decreased by 7.4%.

We did not have employment data from Labor Force Survey from the 3Q2009 as of writing and the general numbers from the 2Q2009 have already been discussed in the previous PEO issue. We may remind that the LFS employment reached 15,847,000 persons in the 2Q2009 and it was by 1.0% more than in the 2Q2008. In q-o-q terms, LFS employment also increased by 0.8%. The number of active population, i. e. those who are either employed or unemployed, also increased by 1.9% yoy in the 2Q2009 and the economic activity rate, i. e. the share of active population in the total adult population, increased from 53.9% in the 2Q2008 to 54.7% in the 2Q2009.

We can, however, take this opportunity and comment more deeply on some other interesting figures from the Polish LFS in the 2Q2009. There is a widely spread view in the most of media that the employment situation deteriorates particularly among the youngest part of the labor force (15-24 years of age). This information is partially confirmed by the LFS employment data from the 2Q2009, but it brings both bad and good news about the behavior of the Polish young labor force.

The total number of employed in the youngest age group fell in y-o-y terms by 3.6%; it was the only age group that recorded the employment reduction. On the other hand, however, one has to take into account that the total number of persons in this age group fell in the same period by 3.2%, hence the employment reduction was only slightly more than proportional.

It means that the rapid increase in the unemployment rate among the youngest (from 17% in the 2Q2008 to 19.1% in 2Q2009) resulted more from their increasing economic labor market activity than from massive job losses. Young people want simply to start their economic activity earlier than their older colleagues but, due to economic downturn, they are not able to find jobs. The economic activity rate among the youth increased since the 2Q2008 from 32.2% to 32.9%. If the economic activity rate of this group had not increased during the last year (i. e. stayed at 32.2%) the unemployment rate would have reached only 17.3% in 2Q2009 and it would have been only slightly worse than in the 2Q2008.

As the general economic forecast in this PEO improves so do our expectation regarding the situation on the labor market. We expect that in the 4Q2009 the employment in the enterprise sector will decrease in yoy terms 2.4% being equivalent to the q-o-q reduction of 0.4%. We also assess that the LFS employment in the 3Q2009 was still increasing in the y-o-y terms by 0.5%. We expect that in 2009, on average, employment in the enterprise sector will fall by 1.4% and the LFS employment will actually be increasing by 0.5% yoy.

Wages

Nominal wage dynamics stopped falling. In the 3Q2009, the nominal wages in the enterprise sector increased by 3.9% yoy whereas in the 2Q2009 the growth rate was lower 3.7% yoy. Real wage growth also improved from 0.2% in the 2Q2009 to 0.5% in the 3Q2009. It seems that the improving general economic climate has encouraged the firms to stop wage cuts and saved the average real wage level from reductions.

Wage dynamics stopped peaking down in almost all sectors. In manufacturing, the y-o-y wage growth rate recorded an increase to 3,4% in the 3Q2009 from 2.6% in the 2Q2009. The nominal wage dynamics improved also in the same period in the hotels and restaurants' section (from 2% to 3.1% yoy) and in transport and communications (from 2.1% to 3.8% yoy).

In the construction sector, where the strongest fall of wage dynamics had been recorded in the 2Q2009, wage dynamics stabilized around the y-o-y growth rate of 2.1%. Stabilization at similar levels as in the 2Q2009 was also observed in trade and repairs and business services sections.

Communal services was the only sector that experienced the strong reduction of wage dynamics in the 3Q2009. However, in this strongly regulated and unionized sector wages were dynamically increasing yet in the 2Q2009, when the y-o-y growth rate was 10.8%. In the 3Q2009, it fell to 3.5% yoy, and one can simply interpret it as the late catch-up with the general trend.

Our earlier expectations of a continuing rapid reduction of nominal wage growth has not come true. On the other hand, however, despite some encouraging news, the labor market situation will not be improving in terms of falling unemployment till at least the middle of of 2010. As a result, we do not expect wages to come back to rising dynamics in the nearest future. Average nominal wage growth in the 4Q2009 should fall to around 3% yoy and it will result in the real wage y-o-y dynamics stabilized at the levels close to zero, depending on the actual inflation rate. On average, nominal wages in 2009 should grow by no more than 4% and real wages should stay close to the level from 2008, recording the maximum growth rate of about 0.5%. During 2010 the average nominal wage growth on a y-o-y basis should not significantly go above 3%.

Unemployment

Unemployment keeps increasing, although at a slightly slower pace than we have expected. In the 3Q2009, the number of registered unemployed persons reached 1,715,000 and the unemployment rate was 10.9%, which was 0.4 percentage points below the number we forecasted in the previous PEO issue. Unemployment increased by 24.6% yoy, and it means that the unemployment growth rate keeps accelerating – in the 2Q2009 the y-o-y unemployment increase was only 14% and in the 1Q2009 it was only 3.3%. In the q-o-q terms, the number of unemployed persons increased by 3.5%, whereas in the same period of previous year unemployment actually decreased by 5.4%. Hence, although the situation in the 3Q2009 looks generally better then we have expected it is still rapidly deteriorating.

Similarly as in the previous PEO issues, we have cleaned the unemployment figures for the 3Q2009 from a seasonal component[10]. Seasonally adjusted figures confirm a still increasing pace of unemployment growth. In the 3Q2009, the seasonally adjusted number of unemployed increased by 6.3% q-o-q, in 2Q2009 the unemployment increased by 5.7%. The estimated seasonally adjusted unemployment rate in the end of the 3Q2009 reached 11.5%, which is equivalent to the seasonally adjusted q-o-q increase of 0.7 percentage points (0.6 percentage points in 2Q2009).

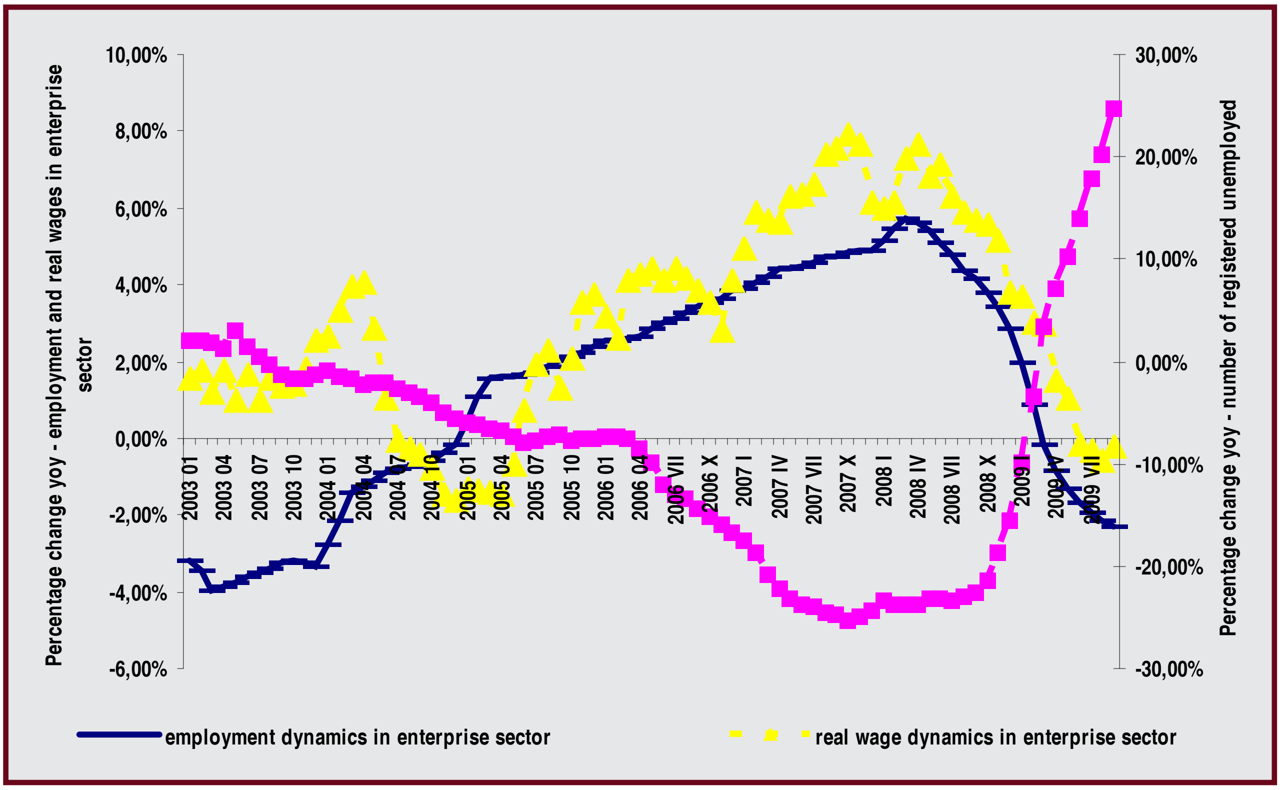
Some more detailed information, coming from the Public Employment Service, is slightly more optimistic than the general figures. In the 3Q2009, the number of unemployed who found new jobs, increased in the y-o-y terms by 5,9%, and it was the first increase in the number of successful job matches since the 1Q2007. What is even more important, the number of those who

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

found unsubsidized jobs also increased in the 3Q2009, i.e. by 4.1% yoy. It means that the increasing number of job matches is not only the result of subsidized jobs programs, but also expresses the actual improvement of the labor demand in enterprises. The number of those who found subsidized jobs also increased by 13%, meaning that the employment offices are more and more effective in subsidized jobs creation.

Although one still records a high growth rate of the inflow of newly unemployed persons into registers it is slightly less dynamic than in previous quarters. In the 3Q2009, this number was by 22.8% higher than in the 3Q2008, whereas in the 2Q2009 the y-o-y growth rate amounted to 25.6% and in 1Q2009 to 35,9%.

Figure 8. Employment and real wage dynamics in enterprise sector; and registered unemployment dynamics in Poland 2003-2009.



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

Similarly as in the case of employment data, we did not have the LFS unemployment figures on the 3Q2009 as of writing, and those from the 2Q2009 were commented on in the previous PEO issue. Just to remind, in the 2Q2009 the number of unemployed increased by 13.3% yoy, reaching 1,355,000. It was a much stronger increase than recorded in the 1Q2009 when the y-o-y unemployment growth rate amounted to 3.9%. The LFS unemployment rate reached 7.9%, i.e. 0.8 percentage points more than in the 2Q2008.

Similarly as in the case of youth unemployment, the general unemployment rate can be explained mainly by an increasing economic activity of the population. Assuming the same employment dynamics, had the total activity rate stayed at the same level as in the 2Q2008, the unemployment rate would have actually decreased to 6.7% in the 2Q2009. The most dynamic increases of the activity rate have been recorded among the youngest and among the oldest at the retirement age. In the oldest group of the labor force, the number of active persons (i. e. either working or looking for jobs) has increased since the 2Q2008 by 6.9%.

As it has already been mentioned, although the growth rate of unemployment is still relatively high, it seems to increase more slowly than we expected. Additionally, the pieces of news from the PES records seem to convey quite optimistic messages, and they are accompanied by stabilizing employment dynamics in the enterprise sector. It altogether leads us to correct our unemployment expectations downward. We expect now the registered unemployment rate to increase to 11.9% at the end of 2009 so it will be by 1 percentage point more than in the 3Q2009 and by 2.4 percentage points more at the end of 2008. The LFS unemployment should also continue to grow. We assess that it reached 7.5% in the 3Q2009,, increasing in yoy terms by 0.9 percentage points. At the end of 2009, the LFS unemployment will most probably hit 8%.

Both, registered and LFS unemployment should also continue to grow in 2010, but our expectations are also corrected downwards from the previous PEO. We expect the registered unemployment rate to reach about 13% at the end of 2010, while the LFS unemployment rate will probably grow to about 9-10%.

External Trade and Balance of Payments

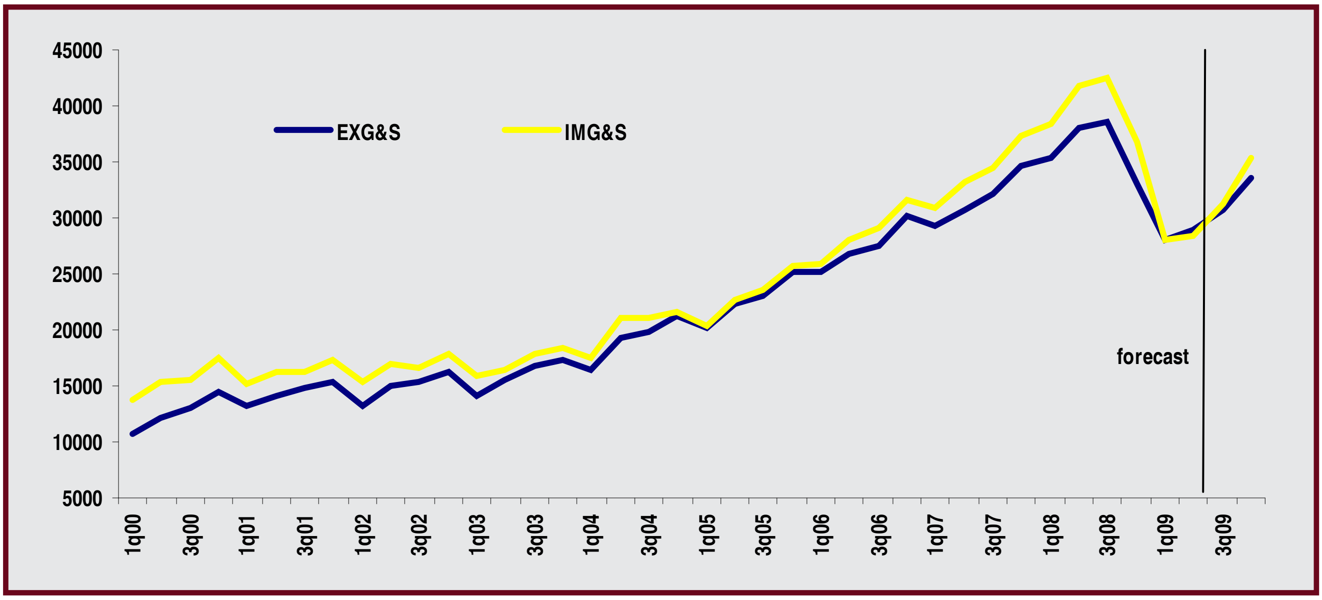
Exports continued to be underpinned by the weak zloty despite the appreciation of the real effective exchange rate since February 2009 (Figure 9) that accelerated in the 3Q09. The positive effects of the nascent European recovery were little discernible. An improvement in economic activity in Poland in the 3Q09 along with the zloty strengthening supported imports whose year-on-year declines decreased in the July-August period. Both exports and imports seem to have bottomed yoy in the 2Q09 if the data on September 2009, which were not available as of writing, confirm the trends from July-August 2009. The current account continued to rapidly decrease and the four quarter deficit fell to 2.1% of GDP in the 3Q09 according to our forecast.

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

Source: ECB

The y-o-y rate of decline in the NBP exports of goods, expressed in the euro, slightly decreased while the scale of import collapse decreased more markedly than that of exports in the 3Q09, according to our forecast, after they had bottomed out in the 2Q09 (-21.8% yoy and -27.2% yoy, respectively). In the same period, the zloty exports and imports of goods decreased much less year on year as the zloty weakened by 21.3% yoy (Figure 10)[11]. The geographical breakdown of trends, available from the CSO, points to a lower decline in exports to the euro zone than average, i.e. by 18.9% yoy in January – August, if to take euro terms, compared with a fall of total exports by 22.5% yoy. Exports to crisis-hit Eastern European countries declined by 42.8% yoy. Imports from the euro area are down 31.9% yoy in January – August, compared with a fall in total imports by 29.9% yoy. Imports from Eastern Europe fell even more, by 39.6% yoy in this period, but imports from developing countries decreased by 18.3% yoy. The latter include imports from China that dropped by 12.7% yoy in euro terms so that China advanced to the second position on the list of the ten most important import partners with a share of 9.9%. Apparently, imports from other countries are substituted by imports from cheaper China.

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



Source: NBP

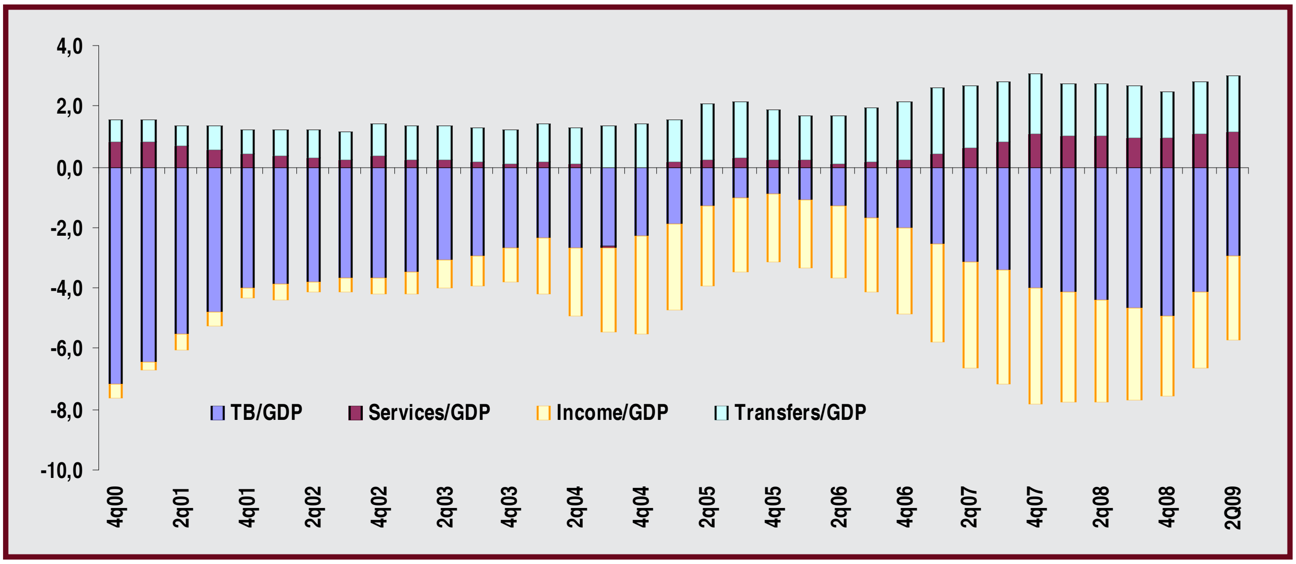
According to the NBP data, exports of goods, expressed in the zloty, fell by 0.6% yoy in July-August 2009 while imports decreased by 13.4% yoy. The zloty appreciated in that period, which offset the decline in real terms. We forecast that NBP exports and imports of services, expressed in the euro, dropped by 12.8% yoy and 22.4% yoy in the 3Q09, respectively, compared with falls of 18% yoy and 22.2% yoy in the 2Q09, respectively. These data suggest that exports and imports of services, also bottomed out in the 2Q09. A much smaller decline in exports of services in the 3Q09 than in the 2Q09 may be a sign that external market has started improving.

Together, exports of goods and services were lower than imports of them in the 3Q2009, contrary to the situation in the 1Q09 and 2Q09, but in each quarter these flows were almost balanced. A sharp decline in the trade deficit due to a much stronger collapse in imports than of exports continues to be the main factor of the current account improvement.

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

Despite a considerable revision of the NBP data on the balance of payments in the 1H09 that show larger imbalances than previously reported, the current account deficit remained low. It was 1593 million euros in January-August 2009 versus 11436 million euros in the corresponding period of 2008. The first two months of the 3Q09 saw a further decline in it. The main reason was a significant drop in the trade deficit, which decreased to 2093 million euros from 11293 million euros; its value was completely offset by a surplus on the services account that increased in January-August 2009 compared with the same period of 2008. The income deficit was another factor of the current account deficit improvement in January-August, but a modest one as the revised data reveal. Actually, the income deficit increased in July-August 2009 versus the deficit in the corresponding months of 2008, perhaps a sign that corporations have returned to higher profitability. The transfer surplus fell in January-August versus the corresponding period of 2008, but this fall almost exactly matched the fall in the income deficit. We estimate that the four-quarter rolling current account deficit fell to 2.1% of GDP in the 3Q09. We expect that it will drop to 0,5% GDP at the yearend on the back of the improving trade and services balances. The transfer surplus should also grow.

Figure 11. Current Account Breakdown, as % of GDP

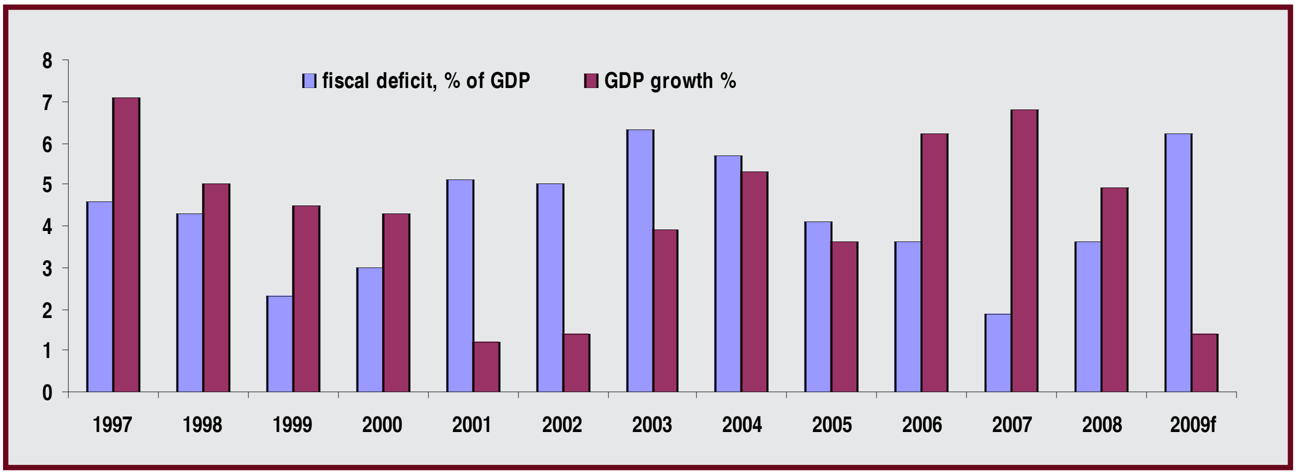


Our qualitative forecast with regard to the tendencies, exhibited by the current account components, remains unchanged from the previous issues as the current developments confirm it. The resumption of growth in the European economy along with the competitive edge of Polish companies due to the depreciated zloty should stop a further slide in exports in the euro terms. Since exports of goods collapsed by 7.5% yoy in the 4Q08 after three quarters of 20% growth year on year, we forecast that they may increase slightly year on year in the 4Q09. Imports will display a much lower decline, i.e. in low single digits year on year, in the 4Q09. We think that export and import will post divergent trends since the fixed business investment will exhibit little vigor and a pickup in output growth will be gradual.

Large Fiscal Deficits in Poland – Perennial Curse

Poland has had fiscal deficits the entire post-communist period[12]. Boom periods coincided with lower deficit thanks to growth dividend that boosted tax revenue, but little effort was done to reduce the deficit regardless the stage of the business cycle. Figure 12 produces evidence on it; high deficits accompany strong GDP growth though cyclicality is also present. This implies that Poland has had a structural deficit problem for years, i. e. the high deficit remains, adjusting the figures for the cyclical component. Poland wasted periods of strong expansion in the second half of 1990s and in the 2000s to tackle the problem. The 1990s are a history now, and Poland, undergoing rapid structural changes was a different economy, but the 2000s boom is a recent episode. Instead of using economic growth to put its public finances on a firm footing, the government went on a spending spree and gave handouts to the population. Figure 12 shows that general government expenditure did not fall during the 2006-2008 strong expansion. The global crisis that hit in late 2008 revealed the scale of the deficit problem.

Figure 12. Fiscal deficits and GDP growth

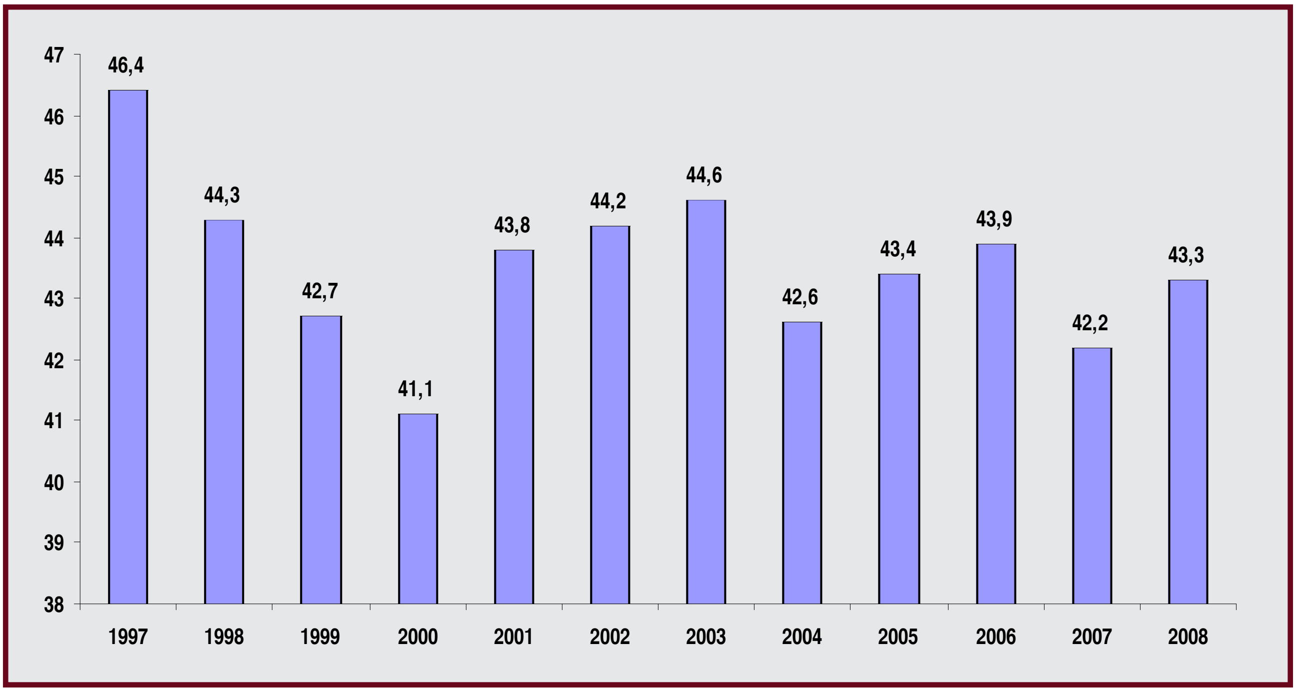


Fiscal deficits in other countries have also reached a high proportion to GDP. This helps Poland to retain its rating because it occurs that the fiscal deficit in this country is not an outlier. However, in a number of countries the structural fiscal position was stronger than in Poland before the crisis so their deficits are more of a cyclical nature and may drop once potential economic growth is restored. This will rather not be the case of Poland. Further, the deficit has become a major obstacle to the adoption of the euro. In theory, Poland could enter the ERM-2 with a deficit higher than 3% of GDP, but then it would risk wider fluctuations of the exchange rate should the markets doubt that the deficit would be reduced to comply with the Maastricht criterion. Delays in the euro adoption deprive Poland of a material increase in its potential growth rate in a number of years so fixing the deficit problem would be beneficial from this standpoint. This text argues that Poland needs to introduce an independent body that would monitor the fiscal policy of the government along gaining popularity international practice in this area.

[12] A kind reminder: terms general government and fiscal deficit are used interchangeably. Central government and state deficits – as well.

Changes in the conduct of fiscal policy have their roots in the evolution of the framework for monetary policy. Modern monetary policy is conducted by independent central banks or, one should say, by a group of independent experts who have a clear mandate, for which they are held accountable. Such a mandate usually takes a form of an inflation target these days. Transparency of the policy is its key ingredient as well. It is built mainly by communiqués after rate-setting meetings and periodical „inflation reports" about the central bank policy assumptions such as inflation forecasts. Together with the accountability of policymakers for deviations from the target it fosters credibility of central banks policy (rate) announcements and helps cut inflationary expectations of the public. It is still sometimes debated whether inflation targeting is a triumph of rules or „constrained discretion" (Frederic Mishkin), but this seems to be more a question of semantics than a real problem. Long terms of members of a rate-setting body should protect them against infringements of their independence.

Figure 13. General Government Expenditure, % GDP



Fiscal policy cannot be conducted in such a way because it is much more complicated than monetary policy and it would suffer from the democratic deficit if politicians were deprived of important decisions for the society that voted for them. There is one interest rate to be set whereas tax rates are many and there are many kinds of expenditure. However, the ideas from monetary policy have pervaded to the realms of fiscal policy as well. Rules for fiscal policy have been introduced in numerous countries around the globe. They are supposed to constrain appetites of politicians for spending. They usually take the form of a ceiling on the fiscal deficit and/or public debt or on public expenditure growth. A good example is the Stability and Growth Pact in the European Union. The problem with it is that its ownership is fuzzy so breaches of it are often. In addition, many European countries have their own warning and alarm thresholds. This is the case of Poland that enshrined some of them in its Constitution Bill from 1997[13]. In addition, Poland has automatic procedures that should be launched if the public debt exceeded 50%, 55% and 60% of GDP thresholds. They are a part of the law on public finance. However, there are no domestic rules on fiscal deficits, the Stability and Growth Pact is the only law in this respect. The 2000s episode clearly shows that Polish politicians are ready to spend any growth dividend before they start thinking about the size of fiscal imbalance and its potentially dire effects. Despite its numerous rules, Poland definitely has a problem with spending growth as the data show. Therefore the introduction of a spending growth rule would make sense. Tried by one of the past governments in the form of inflation plus 1% percentage point, it was quickly breached, but it does not mean it could not be tried again.

The rules can be faulty, either too stringent and call for a premature tightening of the policy or too loose and call for too easy policy for too long, but this can be corrected. However, even such a revision may not result in an improvement of the fiscal conduct as the international experience points to because the ministry of finance is subject to a strong political pressure. The minister is usually a member of the ruling party or coalition. Perennial deficits in countries like Poland suggest that these rules are not sufficient and call for emulating other solutions from monetary policy, namely, some role for independent experts. It would make sense to appoint independent monitors of fiscal policy. Such independent bodies, call it a Fiscal Council or a Council of Fiscal Responsibility, would review fiscal plans of the government and run simulations of alternative fiscal paths. Their role would be to keep the government honest. Every year Monetary Policy Council (MPC) in Poland is compelled to issue its opinion on the state budget draft for the next year, but this body is a part of the central bank so it cannot be treated as impartial. MPC should lose this task and be replaced by an independent group of experts in the Fiscal Council that would monitor how the government complies with a budget target and issue warnings, if necessary. If the analyses and reviews of the state budget performance are to make sense and not be ridiculed as out of touch with reality, then enhanced transparency of general government accounts is required. In Poland, the information on the central government budget performance is published every month by the ministry of finance, but little is known about the part outside it in a timely manner. And this part exceeded 50% of the general government revenue and almost 25% of expenditure, excluding intra-sectoral transfers in 2008. The corrections in the general government deficit in 2008 exemplify the imperfect state of knowledge. The public sector deficit was first announced as 2.8% of GDP, then it was raised to the unexpected 3.9% GDP that triggered the Excessive Deficit Procedure, and finally it was revised down to 3.6% of GDP. This should be improved because financial investors may come to wrong conclusions regarding the public debt prospects, causing undesired volatility in the financial markets. The separation of the budget related to the transactions with the EU and the „domestic" part of the budget, effective the 2010 state budget, is a step in the right direction as the size of the deficit will not be masked by the inflow of EU funds. Information on all state budget commitments such as pension costs, the impact of demographics, i. e. society ageing should also be easy available. The information on the sustainability of the general government finances in the future appears in the updates of the convergence program each year, but should be more emphasized as a separate regular publication of the ministry of finance.

Since such a body would not have a decision mandate its activities would unlikely lead to a democratic deficiency. Politicians as the elected representatives of the society would continue to make tax and spending decisions. However, a Fiscal Council could bring more arguments for the minister of finance when he faces angry politicians and, in this way, could instill more confidence in fiscal policy.

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[13] One of them says that the Sejm cannot raise the state deficit that is proposed in the budget draft. Another bans the government borrowing from the central bank.(article 220). Article 216 introduces a 60%-of-GDP ceiling for the public debt.

The bottom line of this text is that the ways fiscal policy has been conducted in Poland have not eliminated structural fiscal deficits since at least 15 years. This suggest that this framework should be overhauled because it does not bode well for the future. Governments change and their followers usually feel free not to respect the commitments of their predecessors. This text proposes two additional institutional arrangements to help cut the fiscal deficit in a sustainable way. One is to adopt a rule capping expenditure growth. Another and, perhaps even more pertinent idea, is to establish a Fiscal Council of independent experts, which would monitor the fiscal policy of the government and point were it may lead to as a warning.

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