



EXECUTIVE SUMMARY

The economy is going through a soft patch. Unemployment increased due to this and seasonal factors, but started rapidly falling in April. Macroeconomic balances mostly improved in the 1Q10. A lot of slack in the economy helped inflationary tensions ease in this period and the CPI inflation rate should remain within the central bank target band for the next four quarters at least. The four quarter rolling current account deficit rose slightly in terms of GDP while the central government deficit came lower than expected.

GDP grew by 3.0% yoy in the 1Q10, in line with our forecast of 2.9% yoy and compared with 3.3% in the 4Q09 and 1.8% in 2009. Growth was driven by consumption, sizable inventory restocking and net exports in the 1Q10. The contribution of domestic demand and net exports to economic growth reversed in magnitude relative to the 4Q09 and earlier quarters of 2009. However, the economy lost momentum in the 1Q10 as seasonally adjusted GDP grew 0.5% qoq, slower than 1.1% in the 4Q09. This softness was related to a significant drop in the fixed business investment that unexpectedly fell 12.4% yoy and seasonally adjusted 5.9% qoq, adversely affected by severe winter that delayed construction. In our view, this drop is a one-off event, but it will weigh on the year-on-year statistics in the coming quarters.

Despite the sudden drop in the fixed business investment the forecast of GDP growth for 2010 has been revised upward as private consumption proved more robust than assumed and unemployment started falling earlier than we had predicted, which leads to the upgrade of our forecast. The soft patch will likely extend into in the 2Q10, but the 2H10 should see accelerating growth buoyed by the public fixed business investment, also related to the post-flood reconstruction, and exports. We still maintain that in 2011, the economy is likely to grow between 4% and 5%, depending on the world

economy developments. The euro depreciation versus the dollar should add some stimulus provided that the euro area public debt problem will not lower confidence in the global recovery.

Inflation moderated to 3.3% yoy on average in the 1Q10, down from 3.6% yoy in the 4Q09, and declined further down to 2.2% yoy in April reflecting decelerating prices of food, electricity, consumer durables and selected services. Countering this trend were prices of fuel and tobacco which rose markedly in early 2010. The downward trend in inflation should be arrested in the 3Q10, but the subsequent upward trend will be flat. Compared to the previous issue of PEO, we slightly raised our forecasts of the CPI inflation and lowered those of the PPI inflation. Expectations of higher CPI growth are motivated by the upward revision of economic growth as well as a small upward correction of the food price growth during the upcoming harvest season due to the impact of the flood. The zloty appreciation should offset increases in commodity prices, should they occur.

The central bank rates stayed flat through May 2010 and, based on our CPI inflation path, we do not expect any changes until 2011 because the acceleration in growth toward the yearend is not going to eliminate the slack in the economy.

Conditions in the labor market stopped deteriorating in the 1Q10 despite a sub-par economic growth and the adverse seasonal factors, suggesting that recovery is making inroads. The overall employment dynamics in the sector of large firms that had already stopped to worsen at the end of the 2009, started to significantly improve at the beginning of 2010 on the back of rising employment in manufacturing. However, the overall employment figures from Labor Force Survey (LFS) were bad and we ascribe this fact to harsh winter, a one-off event. Therefore, our general employment forecast for 2010 is rather optimistic. We expect that the LFS

employment in 2010 will most probably stay at the same level as in 2009 while in 2011 it will rise by 1.2%. In the 1Q2010, unemployment increased to 12.9% so it was below our previous forecast, but it fell rapidly in April, also in seasonally adjusted terms. The seasonally adjusted figures confirm that the 1Q2010 can see a breakthrough in the labor market situation in Poland. We revise down our forecast of registered unemployment that should stabilize at the 2009 level at the end of 2010. In 2011, registered unemployment will continue to fall to around 10%-10.5% at the end of the year. Factoring in that the unexpectedly bad LFS figures for the 1Q2010 resulted mainly from adverse weather conditions, we assess that the LFS unemployment will fall to as low as 9.6% in the 2Q2010. It should stabilize throughout the rest of 2010, reaching 9.7% at the end of the year. In 2011, it will fall to even 8.5%.

Real wage dynamics in the entire economy more or less stabilized in the 1Q10. Since conditions on the labor market have started improving and GDP growth is likely to pick up, growth of average nominal wage will gradually accelerate. Average nominal wage growth in the enterprise sector should stay around 3% yoy in the 2Q10 while in the entire 2010, it should stay below 4%. The average nominal wage in the whole economy should rise about 5% in 2010 that translates in a 2.5% rise in purchasing power. Nominal and real wage growth is expected to accelerate in 2011 on the back of better performance of the economy.

The central government (CG) cash deficit came lower than projected by the government in the 1Q10 and this tendency continued through April. Expenditures were lower while revenues were higher than projected. The latter were supported by economic growth, however it was not strong enough to produce

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

Indicator	Data						CASE forecasts						
	2007	2008	2008	2009			2010	2010			2011	2010	2011
				Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1		
Nominal GDP, PLN bn (% change, yoy)	1176.7	1275.4	1344.0	327.0	331.9	371.4	327.4	344.8	349.2	389.2	349.7	1416.1	1510.0
GDP	6.8	5.1	1.8	1.1	1.8	3.3	3.0	3.1	3.7	4.2	4.2	3.5	4.0
Private Consumption	4.9	5.7	2.3	1.6	2.3	1.7	2.2	3.2	3.1	3.7	3.4	3.1	3.7
Fixed Investment (4Q, % of GDP)	17.6	9.6	-0.8	-3.3	-1.4	1.1	-12.4	-3.0	4.9	5.6	16.5	1.0	10.0
CA balance (% change, yoy)	-4.7	-5.1	-1.6	-2.8	-2.1	-1.6	-1.9	-1.9	-1.4	-1.3	-1.3	-1.3	-2.5
Exports (NBP, EUR)	13.4	14.2	-17.1	-21.8	-19.5	1.5	19.0	23.7	19.5	15.1	12.0	19.2	11.0
Imports (NBP, EUR)	19.5	17.2	-25.4	-29.7	-27.0	-10.3	19.1	24.0	18.5	20.2	11.7	20.4	12.5
Industrial sales (% change, yoy)	10.7	3.6	-4.3	-6.7	-1.3	5.6	9.5	9.9	8.2	4.9	7.0	8.2	9.0
Gross value added	6.7	5.1	1.9	1.0	2.0	3.3	2.8	3.2	3.5	4.1	4.3	3.4	4.1
CPI	2.5	4.2	3.5	3.7	3.5	3.3	3.0	2.2	2.4	2.8	2.7	2.6	2.5
PPI	2.0	2.2	3.4	4.2	2.2	2.0	-1.6	-0.4	2.0	2.5	2.4	0.6	1.4
Nominal Ave. Wage	7.9	10.1	5.5	4.4	4.9	4.7	4.1	3.2	3.6	4.2	3.6	3.5	4.6
Employment %, LFS	3.1	3.7	0.7	1.0	0.5	-0.5	-0.9	-0.4	0.0	0.0	0.5	-0.3	1.2
Registered unemployment rate (% eop)	11.2	9.5	11.9	10.6	10.9	11.9	12.9	11.5	11.3	11.9	12.4	11.9	10.3
PLN/EUR, ave	3.78	3.52	4.33	4.45	4.20	4.17	3.99	3.97	3.87	3.83	3.75	3.85	3.68
WIBOR 3M, %, ave	5.68	5.88	4.27	4.44	4.18	4.27	4.10	3.90	3.90	3.95	4.20	4.20	4.50
Central bank key rate eop	5.00	5.00	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.50	3.75	3.50	4.00
Broad Money (M3) (% change, yoy eop)	13.4	18.6	8.1	14.4	9.6	8.1	5.5	7.0	8.5	9.5	9.0	9.5	12.0
Loans to HH	37.9	44.6	15.5	35.7	26.3	12.0	5.7	8.5	9.5	11.0	12.0	11.0	15.0
Loans to Firms	24.1	29.0	1.0	15.0	6.8	-3.3	-9.0	-6.0	-2.5	0.5	2.0	0.5	9.0
Fiscal Balance (% GDP)	-1.9	-3.7	-7.1	n.a.	n.a.	-7.1	n.a.	n.a.	n.a.	n.a.	n.a.	-5.8	-4.5
Public Debt eop	45.0	47.2	51.0	n.a.	n.a.	51.0	n.a.	n.a.	n.a.	n.a.	n.a.	52.5	54.8

Sources: CSO (GUS), Eurostat, MoF, NBP and CASE own calculations. Cut-off date: May 31, 2010. Data are corrected backwards due GUS and NBP revisions.

a year-on-year growth in the tax revenue in this period. We forecast that in 2010, the CG deficit will be lower by 1% of GDP than forecast by the government. This will help reduce the general government ESA95 shortfall relative to official projections as well. The risk of breaching a 55% threshold for the public debt is negligent in 2010. Our forecast of the public debt ratio in 2010 is lowered and it is also a factor, why we expect that this ratio should not cross the line in 2011, either. Other factors are the appreciation of the zloty, large proceeds from privatization and a large payment from the NBP profits.

The current account deficit is a non-issue. It is predicted to slightly rise to 2-2.5% of GDP in 2010 due to the negligent deficit in trade. Both export and import should continue to post strong upward trends in 2010. Adjusted for the net capital surplus that captures most of the EU aid, the current account shortfall should not exceed 1-1.5% of GDP. These developments will further decrease external financing needs of Poland so they will support the zloty exchange rate on top of the net capital inflows, in particular of FDI. The zloty rate will be quite volatile due to disruptions on the financial markets, but its upward trend will not be compromised.

LATEST DEVELOPMENTS IN THE POLISH ECONOMY

Economic growth

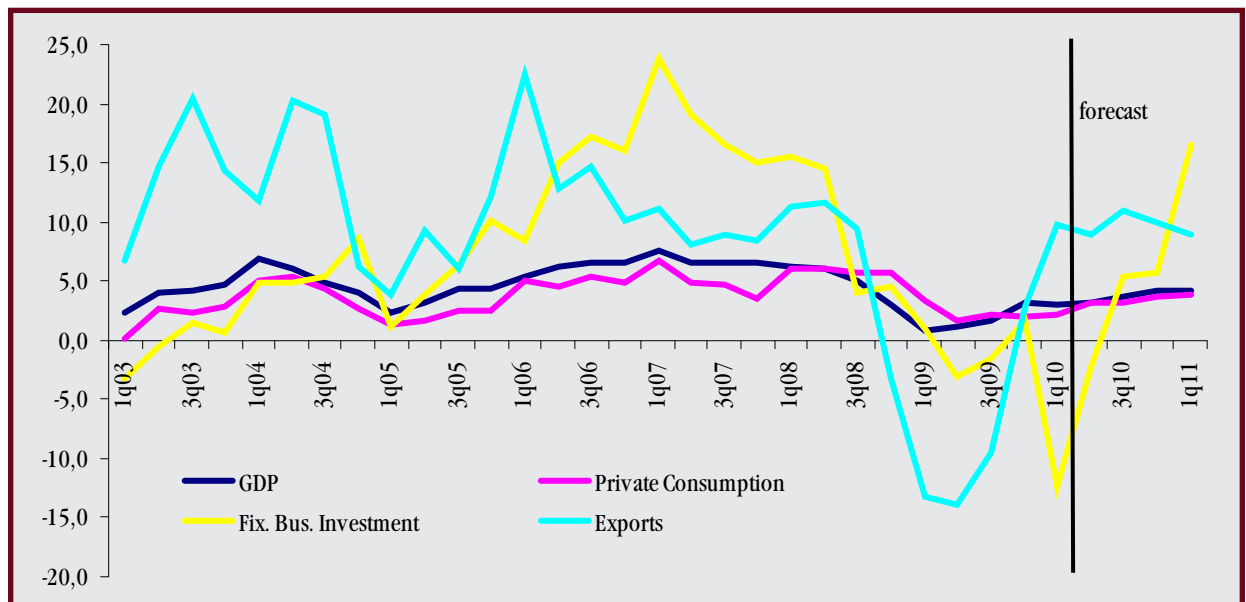
According to the preliminary estimates of the CSO (GUS), GDP grew by 3.0% yoy in the 1Q10, compared with 3.3% in the 4Q09 and 1.8% in 2009. This was in line with our forecast of 2.9% yoy. However, the economy slowed in the first quarter, adversely impacted by severe winter conditions that affected fixed business investment on the demand side and construction, its counterpart, on the supply side. Frozen corporate credit may be a factor as well.

The economy lost momentum in the 1Q10 as seasonally adjusted GDP grew 0.5% qoq, slower than 1.1% in the 4Q09. Domestic demand expanded by 2.2% yoy and seasonally adjusted 0.4% qoq so its quarterly growth was in line with the GDP advance. This softness was related to a significant drop in the fixed business investment that unexpectedly fell 12.4% yoy whereas we had expected a drop of 1% yoy only. It decreased seasonally adjusted 5.9% qoq, the fourth consecutive quarterly drop and the largest as well since the beginning of a downward trend. However, its impact on GDP growth was offset by a rise in gross capital formation that includes changes in inventories. The gross capital formation (gross investment in American lingo) grew by 2.4% yoy while it decreased seasonally adjusted 0.1% qoq only. This is a clear signal that major re-stocking took place, which saved GDP growth in the 1Q10. The inventory accumulation is correlated with the improving business sentiment, rising new orders and anticipation of higher demand. Firms still underutilize capacities (according to the NBP, the index of capacity utilization was below the 10-year moving average in the 1Q10) so they focus on completing the projects rather than starting new ones. By the way, this was also the case in the 4Q09 so the trend has not changed. Since more firms declared they would continue the completion of projects in the 1Q10 than in the 4Q09, this factor cannot explain away the sudden collapse of the fixed business investment in that period. Another negative factor was a difficult access to credit – firms reported that its availability slightly worsened in the 1Q10, compared with the 4Q09. However, Polish firms tend to finance investment projects from retained profits so the downward trend in corporate credit is not only a result of tightened standards, but the effect of weak investment activity as well. On the other hand, business sentiment improved

sharply in the 1Q10 so deteriorating expectations and uncertainty cannot be blamed for the decline in the fixed business investment. Taking into account all these considerations, we think that harsh winter took its toll on it so the acceleration of the downward trend should be a one-off event. Public investment in the infrastructure such as roads that lifted investment figures in previous quarters is usually low in the first quarter of the year

Private consumer expenditure grew by 2.2 yoy in the 1Q10, a bit stronger than 1.9% we had predicted, and it advanced by seasonally adjusted 0.6% qoq, stronger than 0.3% qoq in the 4Q09. Despite rising unemployment and stagnating real wages it kept well. Disposable incomes were boosted by the compensation of pensioners for inflation and wage growth in 2009 so pensions were up 4.2% yoy in the 1Q10 while the economy-wide average real wage rose by 1.1% yoy in real terms. Combined with an improving consumer confidence and stabilizing unemployment at the end of the 1Q10, higher pensions supported consumption growth.

Figure 1. GDP Growth Factors, quarterly % yoy



Exports grew stronger than imports from a year ago and this was the first quarter when both quantities expanded. Both quantities rose 9.8% and 7.9% yoy and seasonally adjusted 3.1% qoq and 5.5% qoq in the 1Q10, respectively. Year-on-year net exports continued to contribute positively to growth in the 1Q10, though this contribution was much lower than in all quarters of 2009. Actually, the shares of domestic demand and net exports in economic growth reversed relative to the 4Q09 and earlier quarters of 2009, suggesting that if growth were to accelerate, this acceleration should rely on domestic demand. A rise in imports was substantially larger than that of exports in seasonally adjusted terms. This rise was most likely related to the inventory restocking when the zloty firmed after a number of quarters when stocks of imported items were depleted in part due to diminished growth prospects and in part due to the zloty depreciation. One quarter does not set a trend, but it may be a sign that a positive contribution of net export to GDP growth may turn to negative in the course of the year should investment activity pick up.

The supply side data confirmed a pickup in manufacturing thanks to the upturn in the global economy. World trade has recovered from the worst post-war collapse, which along with restocking resulted in high growth in industrial output. Sales of industrial output increased by 9.5% yoy in the 1Q10,

compared with 5.5% in the 4Q09 while output of manufacturing, dependent on exports, was up by 10.8% yoy in that period. However, sales of construction firms with at least 9 employees were down 15.2% yoy as they were adversely affected by severe winter. This fall was correlated with the collapse in fixed business investment. Real retail turnover was stagnant in the 1Q10 as it rose by 0.3% yoy. Sales of transportation services as measured in fixed prices were higher by 4.3% yoy in the 1Q10 so they recovered after a drop in January. These changes in activity were not quite correlated with growth of the value added across sectors. It is no surprise that the value added rose the strongest in industry (11.2% yoy) and declined in construction (- 5.8% yoy). The value added slightly decreased in market services (-0.7% yoy), which could be expected on the basis of stagnant real retail turnover, but it was neither related to retail trade, where it grew by 3.7% yoy, nor to transportation and telecommunications where it rose by 4.4% yoy. Apparently, other sectors, on which there is no data available, caused this fall. The remaining sectors include among others financial services, real estate and hotels and restaurants.

The second quarter started with a mixed performance of the supply side. The economy was impacted in April and May by a number of adverse shocks such as the week-long mourning after the president's and his entourage death in an airplane crash. This dampened retail sales and entertainment services. In May, a great flood and the euro zone public debt crisis affected adversely the confidence in the economy. Due to these events, the soft patch will probably continue in the 2Q10. However, industrial production and construction were strong in April, the latter supporting the view that its trend was negatively distorted by weather conditions in winter.

The data show that domestic demand is still weak and the recovery continues to gradually gather strength. The downside risks are related to private fixed business investment should it not recover in the remaining quarters, and to the world economy. The public debt crisis in the euro zone that broke out in May 2010 may derail the nascent recovery in Europe were it prolonged and not contained in time because it would adversely effect business and consumer expectations. Furthermore, turbulences on financial markets may again make access to credit more difficult. These problems are likely to overshadow the global recovery for the rest of 2010 if not longer. The upside risk for GDP growth is the post-flood reconstruction in Poland that should be in full swing by the 3Q10. The May flood, the worst since at least 1997, has done little damage to the supply side of the economy as mostly rural areas were flooded and the output of agriculture is a small fraction of Polish GDP, roughly 3%. This is one of the reasons why we have decided to upgrade our forecast for 2010. There are reasons as well. Unemployment stopped rising faster than we had predicted and high profitability of businesses will also be reflected in higher wage growth so that private consumption should grow a bit stronger than we had forecast. In general, GDP growth should be higher in the 2H10 than we had predicted and stronger than in the 1H10.

In our view, not much has changed with regard to the sustainability of the world-wide recovery beyond 2010 since we published PEO 4/2009 in March 2010. It will depend on whether private demand will replace government demand once governments and central banks start reversing their expansionary policies. The ongoing public debt crisis in the euro area has brought the need for fiscal consolidation to the fore and is forcing a number of governments such as Greek, Italian, Spanish, and Portuguese to bring forward the fiscal adjustment and other high deficit-debt countries such as France and UK may follow. This will tend to dampen aggregate demand in Europe in the near future, but a rise in confidence that the implementation of these steps may bring about should gradually ease the tensions on financial

markets. Despite that more jitters on financial markets will likely happen we endorse a scenario of a slow improvement in growth prospects in the euro zone. Our forecast is not based on a dooms-day scenario, which means the euro zone would fall apart. So far the global recovery has been supportive to growth in Poland through export expansion and higher FDI inflows. Should the euro area recovery not gather strength in 2011, it may cause a plateau in economic growth in Poland. However, domestic drivers of growth, related to the completion of large infrastructure projects ahead of the European soccer champs should offset this adverse impact to much extent. At the moment, we think that GDP growth will gain momentum in the 2H10 and in 2011.

Inflation

Current situation

Inflation moderated to 3.3% yoy on average in the 1Q10, down from 3.6% in the 4Q09, and declined further down to 2.2% yoy in April, reflecting decelerating prices of food, electricity consumer durables and selected services. Countering this trend were prices of fuel and tobacco, which rose markedly in early 2010.

The monthly profile of inflationary developments reveals a marked decline in February as the y-o-y consumer price inflation fell from 3.5% year on year in December and January to 2.9% in February and continued to fall further to 2.6% yoy and 2.4% yoy in March and April, respectively. This closely mirrored the deceleration of food prices which decreased from 3.3% yoy in December down to 0.5% yoy in April. Such a fast disinflation of foodstuffs in recent months was largely due to a deepening deflation in the meat market, which is currently benefiting from the peak supply (resulting in inflation falling from 5.4% yoy in December to -2.2% yoy in April), sugar (from 1.3% down to -23.7%) and fruits (from 4.9% to -5.6%).

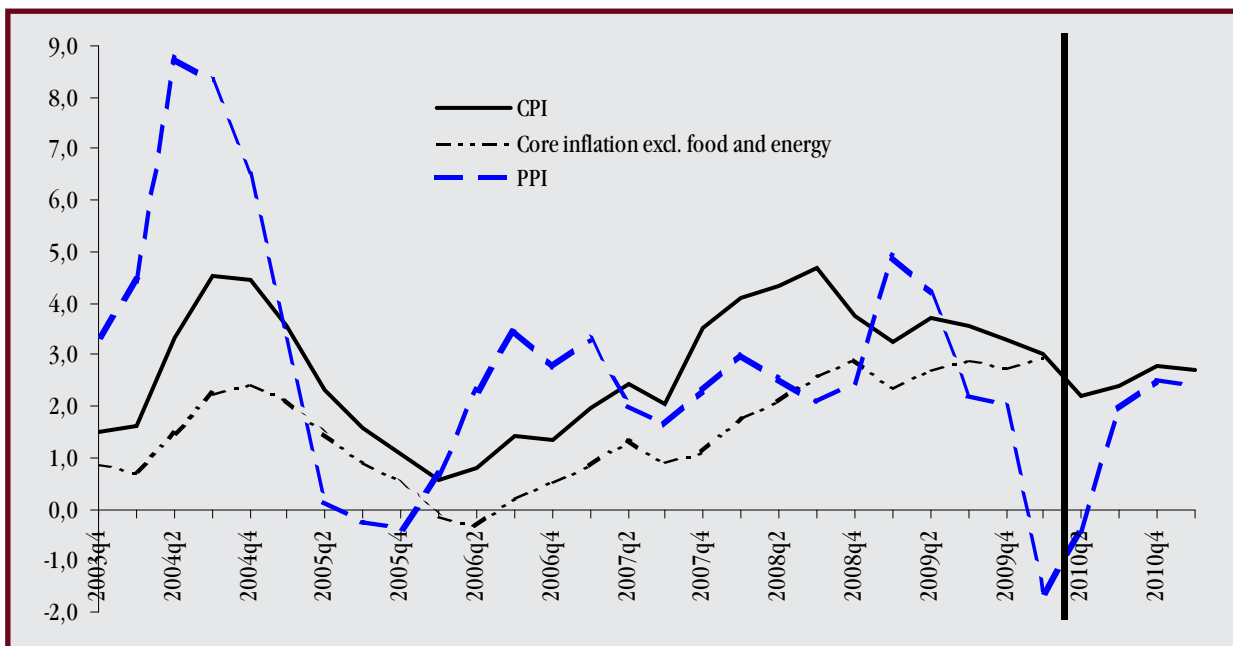
Slowing inflation of selected energy carriers was another factor behind declining inflation. Adjustments of electricity prices in the first quarter of the current year were considerably smaller than in the 1Q2009 (5.4% qoq vs. 10.8%) pulling inflation of the entire energy aggregate down to 3.2% yoy in March and April compared to 5.8% yoy in December. However, rising world prices of crude oil boosted prices of vehicle fuel to 22.3% yoy in January, the highest since November 2000. Fuel price inflation moderated somewhat in the following months but remained high at 17.5% and 17.0% yoy on average in the first quarter 2010 and April, respectively.

The decelerating foodstuffs and electricity prices, combined with the sharp acceleration of fuel prices resulted in a relative stability of core inflation excluding food and energy, which reached 2.9% yoy in the 1Q2010 (almost unchanged from 2.8% yoy in the 4Q2009) and slowed to 2.4% in April. Core inflation, excluding administrative prices, declined smoothly in the initial months of 2010, from 3.5% yoy in January to 2.4% yoy in April – precisely in line with the all-item CPI. This reflects the fact that administrative price adjustments have been neutral to aggregate inflation.

On the other hand, trimmed mean – which eliminates extreme price changes – posted the sharpest decline, from 3.4% yoy in the 4Q09 (0.1 p. points above CPI) down to 2.2% in the 1Q10 (0.8 p. points below CPI). This suggests that inflation of the „inner core“ of price changes slowed markedly more than the combined extreme price changes (extreme high and extreme low price changes). This may be due to the impact of the sharp price increase

of a few components of the consumer basket, i. e. vehicle fuel and tobacco products (17.6% yoy in the 1Q10 vs. 13.7% yoy in the 4Q09), which were not accompanied by commensurate price drops.

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



Following the acceleration in late 2009, industrial goods¹ resumed their disinflationary trend in 2010 with year-on-year price growth declining from 0.8% yoy in December to 0.1% in April. The progressive strengthening of the Polish currency throughout 2009 and the first four months of 2010 brought a reversal of the depreciation trend vis-a-vis the euro on a year-on-year basis and resulted in the zloty appreciation by 11% yoy in the first quarter 2010 and 10.3% yoy in April-May. This strengthening combined with slack consumer demand led to the deflation in prices of consumer durables (-2.1% yoy in April vs. 1.4% yoy in December) and helped sustain deflation in semidurables (-1.3% yoy in the first four months vs. -2.0% yoy in the 4Q09).

Weak demand accompanied by the strengthening currency led to a deceleration of prices of services as well. The year on year growth of the entire services aggregate slowed from the high of 4.7% yoy in the 3Q09 down to 4.3% yoy in the 4Q09 and progressively to 3.7% yoy in the 1Q10 and 3% yoy in April 2010. Health, catering and cultural services were among those which posted the biggest decline in dynamics.

In February producer price inflation (PPI) went into the negative for the first time since 2005. The year-on-year price growth reached -2.4% and deflation continued in March and April reaching -2.6% yoy and -0.5% yoy, respectively. The key factor behind this slow-down was the situation in manufacturing, which has been posting deflation since August 2009 and saw deflation deepen to -3.3% yoy and -2.1% yoy in the 1Q10 and April, respectively (down from -0.7% in the 4Q09). In line with the previous quarter, deflation persisted in most manufacturing industries, with the biggest price drops registered in the production of computers and electronics (-11.5% yoy), basic metals (-9.3%) and vehicles (-8.6%). Manufacture of coke and refined petroleum products was among a handful of sectors that saw increasing price dynamics and hit 24.4% year on year in the first quarter 2010.

¹ Data on aggregated industrial goods and services refer to the Harmonized Index of Consumer Prices (HICP).

Price growth in mining&quarrying and the energy sector slowed down as well. Despite progressively rising world prices of coal, copper and other raw materials, the annual inflation of mining and quarrying slowed to 15.7% and 15.2% in the first quarter and April, respectively, down from the record-high 20% in the 4Q09. This was largely due to the high base in the first three months of 2009 when quarterly growth in the sector exceeded that in 2010 four-fold. Likewise, smaller administrative adjustments of electricity and central heating prices in early 2010 compared to 2009 led to a steep decline of annual inflation in the entire energy sector: from 11.8% yoy in the 4Q09 down to 1.5% yoy and 1.3% yoy in the 1Q10 and April, respectively.

Forecast

Compared to the previous PEO, we slightly raised our forecasts of the CPI inflation (by 0.2-0.3 p.p. in 2010) and lowered those of the PPI inflation (by 0.2-0.3 p.p.). Expectations of higher CPI growth are motivated by the upward revisions of economic growth as well as a small upward correction of the food price growth during the upcoming harvest season.

While we expect demand pressures to be subdued throughout 2010, a slightly more optimistic GDP outlook is likely to provide additional stimulus to domestic demand. The Polish zloty is expected to continue appreciating in the coming quarters with the Greek-crisis-induced weakening in May only a temporary phenomenon. We believe that the quarterly profile of appreciation will not change significantly compared to the previous PEO implying the year-on-year appreciation gradually declining from 10.7% in the 2Q10 to 6.1% in the 1Q11. This should continue to exert sizeable downward pressures on prices of tradables which will gradually resume and reinforce its leading role in keeping inflation in Poland low. This role will be magnified through the progressively increasing weight of non-energy industrial goods in the overall consumer basket. Consumer durables -which historically showed the deepest deflation in the consumer basket- saw their share in total expenditure expand to 7.3% in 2009, double the share in 2003 and the highest ever registered.

The supply outlook of agricultural commodities and quality of the harvest has been relatively positive up until March but deteriorated subsequently owing to adverse weather conditions in April and floods in May and June. It is still too early to estimate the detrimental impact of these conditions, but it is very likely that it will reduce prospective crops in several key markets. However, experts point to the fact that the floods alone are unlikely to impact prices on the domestic level due to their regional character. On the other hand, coupled with bad weather conditions persisting since the beginning of the vegetation period, they may reduce this year's crops and lead to smaller seasonal price decreases. Consequently, our expectations of food price inflation is somewhat less optimistic compared to the previous forecast round.

All these factors combined lead us to expect a mild acceleration of consumer prices in the following four quarters. We expect the year on year change in the CPI index to decline to 2.2% in the 2Q10 and rise subsequently to 2.4% in the 3Q10 and then slightly above the mid-point of the target range, to 2.8% and 2.7% in the 4Q10 and 1Q11, respectively.

Producer prices will rebound in the course of 2010 reflecting progressively rising commodity prices, including copper and coal – both of key importance for the Polish industry. The gradual acceleration will be also driven by the sluggishly reviving global demand, including demand for imports in major

² The weight from 2009 is used in HICP calculations throughout 2010.

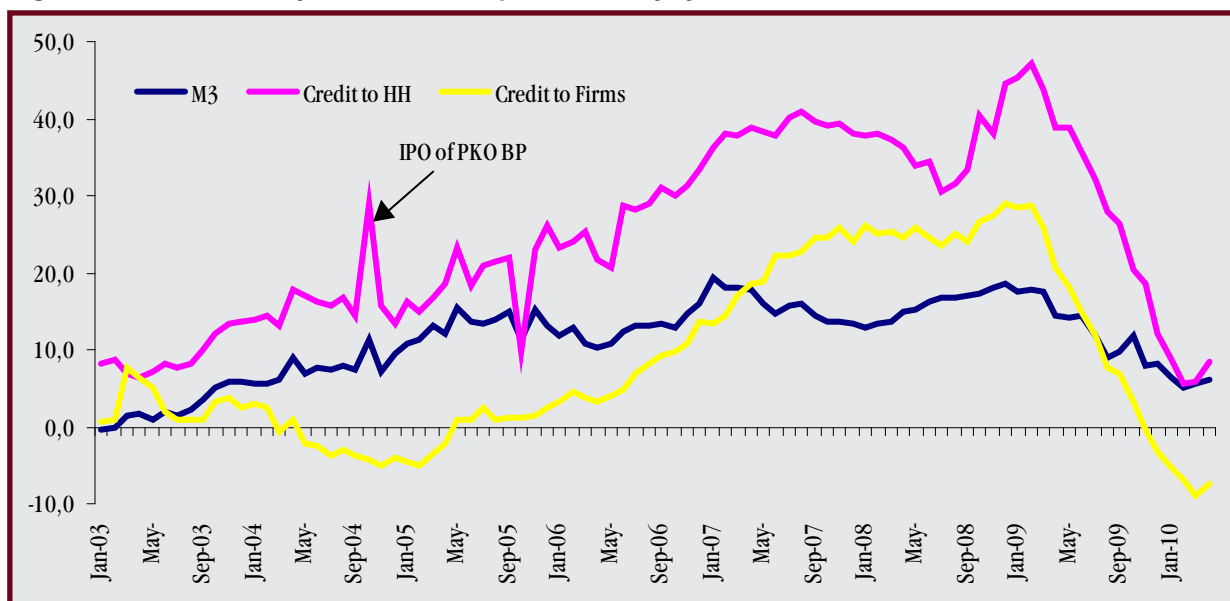
Polish export markets. The quarterly profile of the PPI inflation will directly reflect this acceleration. Producer price inflation will pick up from -1.6% yoy in the 1Q10 to -0.4% yoy in the 2Q10 and then further to 2.0%, 2.5 and 2.4% in the 3Q10, 4Q10 and 1Q11, respectively.

Monetary Developments and Policy

We speculated in the previous edition of our report that the 1Q10 may witness a trough in the downward credit trend. This seems to be the case as the April data suggest that a turning point has been taken. However, the aggregate credit growth masks continued divergent trends of credit to households and firms.

Credit to households kept on rising in the 1Q10 at a decreasing year-on-year rate as it was up by 5.8% yoy at the end of the 1Q10 versus 12.1% in the 4Q09. The quarterly rise was mere 1.0%. Nominal credit to nonfinancial companies continued to fall in the 1Q10 as it was PLN 203.8 bn at the end of 1Q10, compared with PLN 207.4 bn in December 2009. Both zloty and foreign currency loans displayed a downward tendency so the appreciation of the zloty does not change this conclusion qualitatively. In year-on-year terms, nominal credit to non-financial firms fell by 9.8% yoy and 1.7% qoq in the 1Q10, compared with 3.4% qoq in the 4Q09 so the negative trend has lately decelerated³.

Figure 3. Broad Money and Credit Expansion, % yoy



Source: NBP and own calculations.

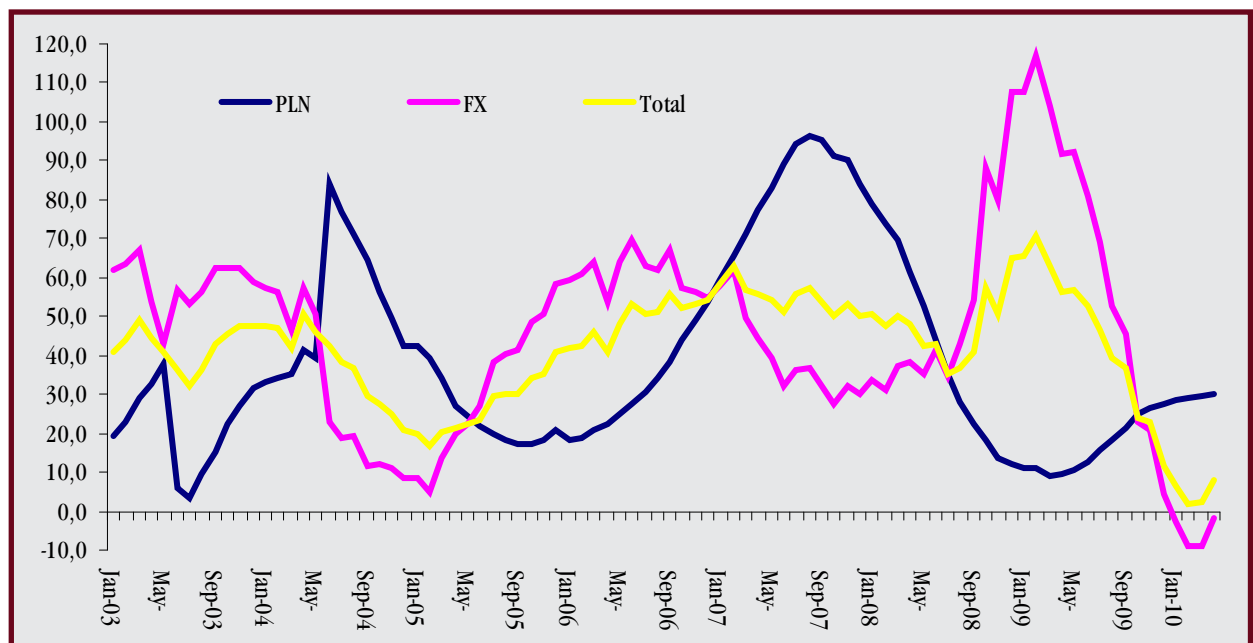
According to the NBP, firms as aggregate continue to express little interest for credit and they want to reduce their bank indebtedness in all sectors but the construction and the public sector. Debt reduction is not planned by the largest employers across sectors, either. Firms experienced fewer approvals of their loan applications in the 1Q10 than in the 4Q09 and these refusals were unrelated to the financials of companies. As we had reported, the credit crunch reduced the share of firms that plan to finance their investment projects by means of a bank loan to the lowest level in the questionnaire

³ Based on NBP statistics on assets and liabilities of the monetary institutions vis-a-vis non-financial firms, May 2010.

history in the 4Q09. This ratio rose a little in the 1Q10, which suggests that the revival of investment credit will be slow.

Nominal broad money (M3) growth continued to decelerate in the 1Q10 as M3 rose by 6.1% yoy in March 2010 versus 8.1% yoy in December 2009. In quarterly terms, M3 increased 0.1%. The upward trend of total deposits was maintained in the 1Q10 as they rose by 6.2% yoy versus 9.8% yoy in the 4Q09. Deposits of households and firms rose by 9.5% yoy and 10.4% yoy, respectively, in that quarter, compared with 15.4% yoy and 10.4% yoy, respectively, in the 4Q09. The upward trend in households deposits has been decelerating since the end of 2008, but the upward trend in demand deposits steepened while the decelerating upward trend in time deposits reached a turning point in the 1Q10 and they started slowly decreasing. This may be related to the growing attractiveness of alternative financial investments such as stocks and investment funds in the environment of low interest rates. The average interest rate on households' time deposits up to 2 years and demand deposits was 4.8% p. a. and 1.8% p.a., respectively, in the 1Q10 versus 5.0% p.a. and 1.7% p.a. in the 4Q09 and 5.6% and 1.7% in the 4Q08, respectively, so it continued to narrow. The beginning of the 2Q10 saw a further drop in time deposit rates for households as expectations of an NBP rate hike receded due to the decreasing CPI inflation trend.

Figure 4. Housing Credit Credit Growth, % yoy



Polish banking sector has weathered the global financial crisis well. The recapitalization of banks in 2009, forced by the Polish Financial Supervision Commission (PFSC), led to the increase in their CAR to 14.1% in the 1Q10 from 11.1% in the 1Q2009. The slowdown in the economy led to an increase in non-performing credits, but their proportion is not even close to the record-high levels they reached in 2001, i.e. during the previous downturn. At the end of 2009, the proportion of irregular loans to the non-financial sector was 7.6% versus 4.5% at the 2008 yearend. This ratio continued to creep upward to 7.9% in the 1Q10, according to our estimates based on the preliminary data from PFSC, but this increase in irregular loans did not stop the profit growth as the net income of the banking sector amounted to PLN 2.5 bn in the 1Q10, compared with 2.1 bn in the 1Q09, a rise by 18.6 % on a year. In our view, banks are well capitalized and in a position to increase

lending to the economy. However, the ripple effects of the Greek public debt crisis may affect their lending adversely as some of their parent companies may have exposure to Greek assets so they may intend not to expand credit until it becomes clear that they will not have to write these assets off. Since Polish banks are well-capitalized their capital ratios may be used toward creating a safety valve for the consolidated financial institution like it happened during the global crisis.

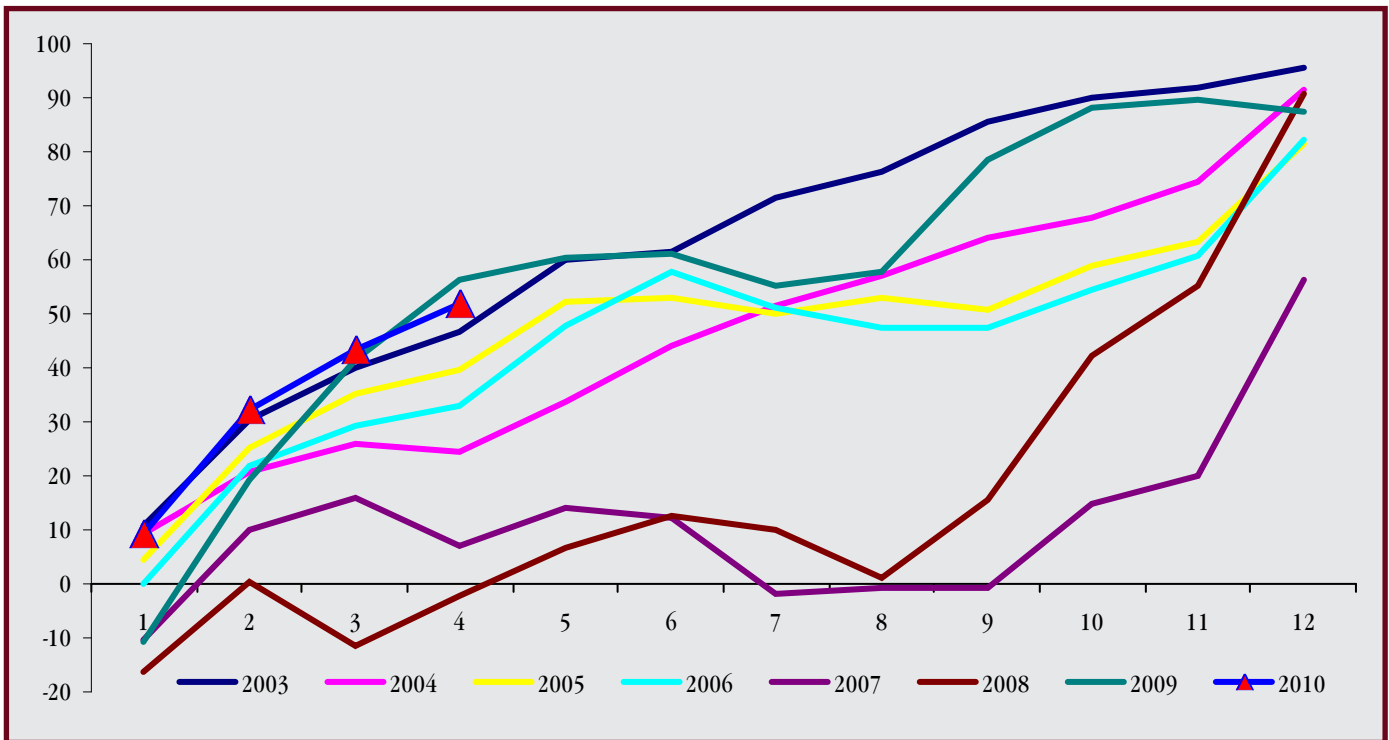
The central bank did not change its key interest rates in the 1Q10 and in the first two months of the 2Q10. The y-o-y CPI inflation declined by a full percentage point since the end of 2009 and fell to the mid-point of the NBP target in April 2010. This path was consistent with the NBP projection from February 2010. The core inflation indices also exhibited a downward trend, which in combination with underutilized capacities and the appreciating zloty created an environment for stable interest rates. Actually, monetary conditions were tightened because of the zloty appreciation. Despite our forecast that the CPI inflation rate should reach its y-o-y trough in the 2Q10 and then start slowly increasing, we do not see any interest rate hikes in the remaining part of the year because there will still be slack in the economy and wage growth should remain below productivity gains while the zloty should appreciate once the elevated risk aversion due to the uncertainty, caused by the euro zone public debt crisis, declines. The MPC has expressed the view that upside and downside risks to inflation are broadly balanced and we do not think that this description will change unfavorably in the near future. A new inflation project from the NBP will cast more light in this respect, but it will be available at the end of June.

Fiscal Developments and Policy

The fiscal position of the central government improved in the first quarter of 2010 on the back of stronger economic growth than assumed by the government in the budget bill. The central government cash budget deficit reached preliminary 27.0 bn zlotys or 51.8% of 2010 target in January – April 2010, compared with the earlier government projections of 62.5%. This better performance was due to the lower expenditure than planned, which amounted to preliminary PLN 106.8 bn against the scheduled PLN 110.5 bn, and the higher revenue that was preliminary PLN 79.7 bn instead of projected PLN 77.9 bn.

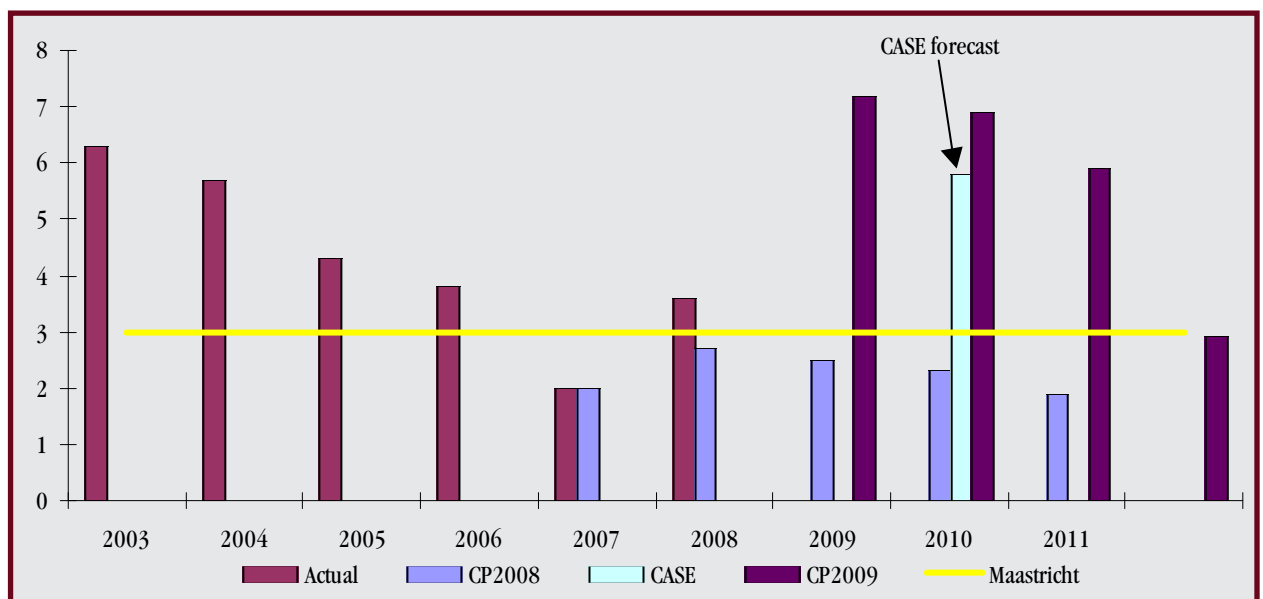
The higher-than-projected revenue was not high enough, however, so that it recovered in year-on-year terms as it was down by 2.6% yoy in January – April 2010. The indirect taxes rose by 3.6% yoy in January-April, but income taxes were lower than a year ago. The revenue from indirect taxes was up despite a drop in the excise tax revenue that decreased by 6.6% year, which is an encouraging sign because the excise tax collection was boosted by one-off payments by the tobacco industry in January 2009. When the 2009 figures are cleaned off this „anomaly“, the excise-tax collection was up year on year. On the other hand, revenues from PIT and CIT were down by 8.5% yoy and 25.9% yoy, respectively. The former were adversely affected by the rise in unemployment over a year while the drop in the latter is hard to explain as net profits of large firms were not lower on a year ago and no meaningful legislation that could lead to their reduction has been adopted. Non-tax revenues were almost the same in January-April 2009 and the corresponding period of 2010.

Figure 5. Central Government Budget Deficit, % annual projection



The expenditure was lower than planned in January-April 2010 due to delays in some spending so this underperformance should not be extrapolated to upcoming quarters. The reversal of the upward unemployment trend could bring some relief to the Social Insurance Fund, but it is uncertain that the government would cut the subsidy to it in case the fund had enough funding from social taxes because the Fund has taken credits and its rising liquidity would allow it to repay them.

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



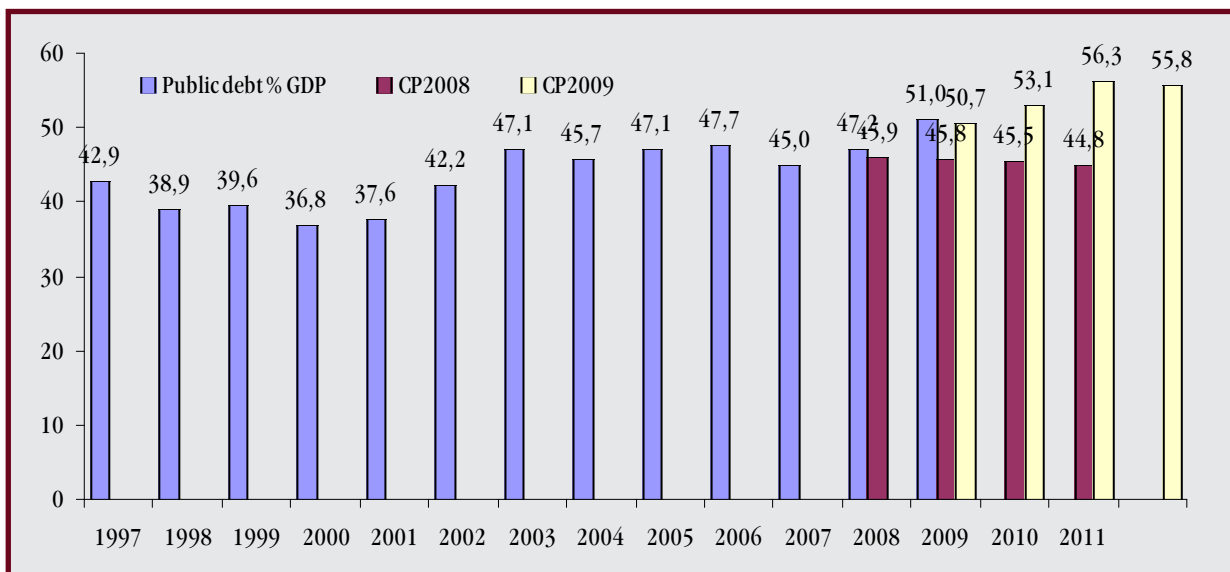
Source: Polish Convergence Programs 2006 and 2007.

The deputy minister of finance in charge of the state budget has estimated that the cash budget deficit may come 7 billion zlotys (0.5% of GDP) lower than projected 52.2 bn zlotys in 2010 thanks to lower expenditure by PLN 3

billion than assumed and a PLN 4 billion payment to the budget by the NBP from its net income. The state budget has assumed that there will be no such a payment. This means she has not included a potential rise in tax revenue above the government projection. We think that this is a conservative assessment because she has not included a potential rise in tax revenue above the government projection. It is possible that the tax collection will outperform the assumptions and the dividends from corporations, in which the state has its shares will also be higher as the net incomes of corporate sector should be on the rise in sync with economic growth.

The key uncertainty at present is how the great flood in May-June will affect the budget expenditure. Preliminary estimates of damages are of the order of 8 to 12 billion zlotys (2-3 billion euros) or up to 1% of GDP. The previous flood of such proportions happened in 1997 so it gives some clue in this respect. Neither the cash deficit was raised nor expenditure increased in the aftermath of the flood. The government approved a supplementary budget that provided a rescheduling of expenditure, i. e. changed the purpose of provisions, within the same limit so that it could be used for the post-flood reconstruction. In addition, it was granted loans from international institutions: EIB and Worldbank granted USD 300 mn each in cheap credits for the reconstruction of infrastructure.

Figure 7. Public Debt, % of GDP



With regard to the expenditure, the government has a buffer fund for natural disasters and other emergencies included into the state budget, running close to PLN 0.4 billion and without a supplementary budget it was able to assign PLN 2 billion for cleaning the damages. It can also count on the unrequited aid from the European Commission in the range of 110 mn euros (0.45 bn zlotys). Drawing low-interest loans from the international institutions, like in 1997, should the need arise would be another possibility. The government could also use the NBP payment that was not accounted for in the state budget to finance the post-flood reconstruction, but this would require the approval of a supplementary budget. It is likely that the government will submit a supplementary budget in order to tap provisions for the reconstruction, but this will not happen before presidential elections and will require more reliable estimates of damages than available right now. In our view, the flood will not cause the targeted deficit to rise. In an optimistic scenario, in which we assume that the reshuffle of expenditure will suffice to

cover the post-flood cleaning, we estimate that the shortfall in 2010 may come lower by 1 percentage point of GDP than the projected one. This should translate into a lower general government deficit by a slightly higher magnitude because local governments have their stakes in PIT and CIT. However, the emergency spending of these governments on the post-flood reconstruction may offset this gain so it is hard to say whether the general government budget would be reduced by the same proportion.

In 2009, the public debt reached 51% of GDP and it is projected by the government to reach 53.1% of GDP in 2010. We do not think there are meaningful risks that this scenario will not materialize. The ongoing public debt crisis in the euro area has led to increased risk aversion lately, which has caused a depreciation of the zloty. If it persisted through the end of the year the public debt could rise above the projected proportion, but it is unlikely to breach 55% of GDP. The depreciation would have to be substantial 10% from the level of PLN 4.00. We have been of the view for a long time that real risk of breaching this threshold concern in 2011. The government has predicted in its 2010 Convergence Program Update that public debt will peak at 56.3% of GDP in 2011 to start slowly decreasing in 2012. Despite our skepticism that we expressed in PEO 4/2009 with regard to the deficit reduction path, outlined in the 2010 Convergence Program Update in compliance with the Excessive Deficit Procedure, we think that the public debt may not breach 55% of GDP in 2011 provided the general government deficit were sizably lower than projected in 2010.

Labor Market

Employment

In the 1Q2010, employment in the enterprise sector, the companies employing nine and more than 9 workers, fell by only 0.6% yoy, reaching 5,294,000 as compared to the y-o-y decrease of 2.2% registered in the 4Q2009. On the quarterly basis, the number of employed persons increased by 0.6%, compared with 0.2% in the 4Q2009. It means that the overall employment dynamics that had already stopped to worsen at the end of the 2009, started to significantly improve at the beginning of 2010. The pace of this improvement is slightly higher than we expected in the previous PEO issue.

The section-specific trends from the 1Q2010 are also in general optimistic with the notable exception of construction, which recorded a deep worsening of employment dynamics. In 1Q2010, the number of construction employees fell by 0.2% yoy as compared with a 4.6% yoy increase in the 4Q2009. This negative tendency, however, can be explained by exceptionally hard weather conditions in Poland during winter. By the way, we expected this fall in construction employment dynamics in the previous PEO issue. We stick also to our earlier expectations that this negative trend will not continue in the future and the labor situation in construction will start to improve already in 2Q2010.

Employment dynamics continued to improve significantly in manufacturing, where the y-o-y reduction of the number of employees in the 1Q2010 amounted to only 3.6% as compared to 7.6% in 4Q2009. In q-o-q terms employment increased in 1Q2010 by 0.4% as compared to 3.3% decrease in the 4Q2009. Employment still increased in hotels and catering sections – by 3.6% in y-o-y terms, although the pace of employment growth there was lower by 0.9 percentage points than in the 4Q2009. We expect this negative trend can continue also in the 2Q2010, we do not expect, however, that

employment in hotels and catering can start to actually decrease. The beginning of a new tourist season in the 3Q2010 should help in this respect. Employment dynamics in the 1Q2010 also worsened in other consumer services' sections, namely in trade and services, where employment fell in y-o-y terms by 1.1% yoy as compared to 0.2% yoy increase in the 4Q2009. It suggests that the employment cuts have finally spread from the industrial to services sectors. We expect, however, that these negative trends should not last long due to improving domestic demand and worsening of the situation in services sectors will be limited mainly to temporary problems with employment dynamics.

The employment figures from Labor Force Survey are surprisingly bad for the 1Q2010. Employment decreased in y-o-y terms by 0.9% as compared to 0.7% in the 4Q2009. The number of employed persons declined to 15,574,000.

It seems to be related mainly with extremely hard weather conditions and there are numerous facts that seem to back such hypothesis. The jobs were lost mainly in industry, the part of which is construction in the LFS data, where the y-o-y employment reduction amounted to 5% and in agriculture, down by 4.6% yoy. On the other hand, employment in services in the 1Q2009 was up by 2.2% from the 1Q2009. The number of jobs decreased also only among males who dominate in construction (1.7 % of yoy reduction), whereas the number of employed females increased by 0.1%. More jobs were also lost in rural areas (down by 1.8% yoy) than in urban ones (- 0.3% yoy) as plant vegetation was delayed. Therefore although the worse than expected employment situation according to LFS will influence our general employment forecast for 2010 it will not change our general optimistic mood regarding the expected labor market developments.

Employment in the enterprise sector in the 2Q2020 will not change in the y-o-y terms, and it will be equivalent to the q-o-q decrease of 0.1%. We expect that employment in the enterprise sector will start to increase in 2010 – the average employment in 2010 will be by 0.1% higher on the average than in 2009. In 2011, employment in the enterprise sector should start growing by 2.3% yoy. Our forecast for the LFS employment is only slightly less optimistic. We still expect that the LFS employment in 2010 will most probably stay at exactly the same level as in 2009 while in 2011 it will re-start increasing at the average pace of 1.2%.

Wages

In the 1Q2010, wage dynamics recorded a slight fall after a short term stabilization. The average nominal wages in the enterprise sector increased by 2.8% yoy whereas in the 4Q2009, the y-o-y growth rate was 3.8%. It meant that real y-o-y average wage dynamics fell below zero, i. e. in the 1Q2010, real wages were by 0.2% lower than in 1Q2009. It was slightly below our expectations from the previous PEO issue when we expected the nominal wage growth of around 3% yoy. The question is, however, whether the return of the deteriorating wage dynamics after the half-year long stabilization, recorded in late 2009 is the longer term phenomenon or the one-off one only. One can try to answer this question analyzing the wage dynamics in the biggest sections of the enterprise sectors.

Firstly, wage dynamics stabilized in manufacturing section (37% of employment in the enterprise sector), where wages increased yoy by 4.7% in the 1Q2010 as compared to 4.4% in the 4Q2009 and 3.4% in the 3Q2009. Secondly, wage dynamics fell in the trade and repairs section (20% of employment in the enterprise sector) – from 2.3% in the 3Q2009 and 2.7% in

the 4Q2009 to only 1.3% in the 1Q2010. The behavior of wage dynamics in other large sections was very diversified, from a dynamic improvement in transportation and communications, to stability in construction to deep deterioration in business services.

This very diversified behavior of wage dynamics across sections of the enterprise sector and an improving climate in the Polish economy in the 1Q2010 would suggest that the observed fall in the wage dynamics will be a one-off phenomenon so our forecast is based on this assumption.

We do not change significantly our wage forecast from the previous PEO issue. We still expect wage dynamics to creep upward in the nearest future with slight inclinations for growth. Average nominal wage growth in the 2Q2010 should stay around 3% yoy and it will result in the real wage y-o-y dynamics around 0.5% yoy. During the entire 2010, the nominal wage growth on a y-o-y basis should stay below 4%. The situation will most probably start to change in 2011 when we expect wages to grow slightly more dynamically – even around 5% yoy on average.

Unemployment

In the 1Q2010, the number of registered unemployed persons reached 2,076,700 and the unemployment rate was 12.9% so it was below the rate we had forecasted in the previous PEO issue. Unemployment increased by 18.1% yoy, and it means that the rate of unemployment growth slowed down considerably – in the 4Q2009, the number of unemployed was by 28.4% higher than in the 4Q2008. Unemployment dynamics slowed down for the first time since the beginning of 2008. In the q-o-q terms, the number of unemployed persons increased by 9.7%, as compared to the q-o-q increase by 19.3% in 1Q2009.

It all means that the situation on the labor market from the point of view of unemployment is improving surprisingly fast. As of writing this text, we already know that this positive trend also continued in April, when the unemployment rate fell to 12.3% and the number of unemployment decreased by 4.9% qoq as compared to a 2.2% qoq decrease in April 2009.

As usually, we have also cleaned the unemployment figures for the 1Q2009 from a seasonal component⁴. In the 1Q2010, the seasonally adjusted number of unemployed increased by 1.1% qoq while it increased by 4.5% qoq in the 4Q2009. Actually, both seasonally adjusted numbers of unemployed in March and April 2010 already started to decrease in the m-o-m terms by 0.3% and 0.6%, respectively. The estimated seasonally adjusted unemployment rate at the end of the 1Q2010 reached 12.0%, which is an equivalent to the q-o-q increase of 0.1 percentage points (0.4 percentage points in the 4Q2009). The seasonally adjusted figures confirm that the 1Q2010 can become a breakthrough for the labor market situation in Poland and can start a process of stabilization or even reduction of unemployment in Poland already in 2010.

More detailed information, coming from the Public Employment Service, are also in general optimistic. Firstly, the growth rate of the inflow of newly unemployed persons into registers also continued to decelerate. In the 1Q2010, this number was only by 0.1% higher than in the 1Q2009, whereas the y-o-y growth rate amounted to 16.0% in the 4Q2009 and to 22.8% in the 3Q2009. Secondly, the number of unemployed who found new jobs, increased in the y-o-y terms by 23.6% in the 1Q2010, as compared to 12.9% in the 4Q2009. It is even more encouraging that the number of

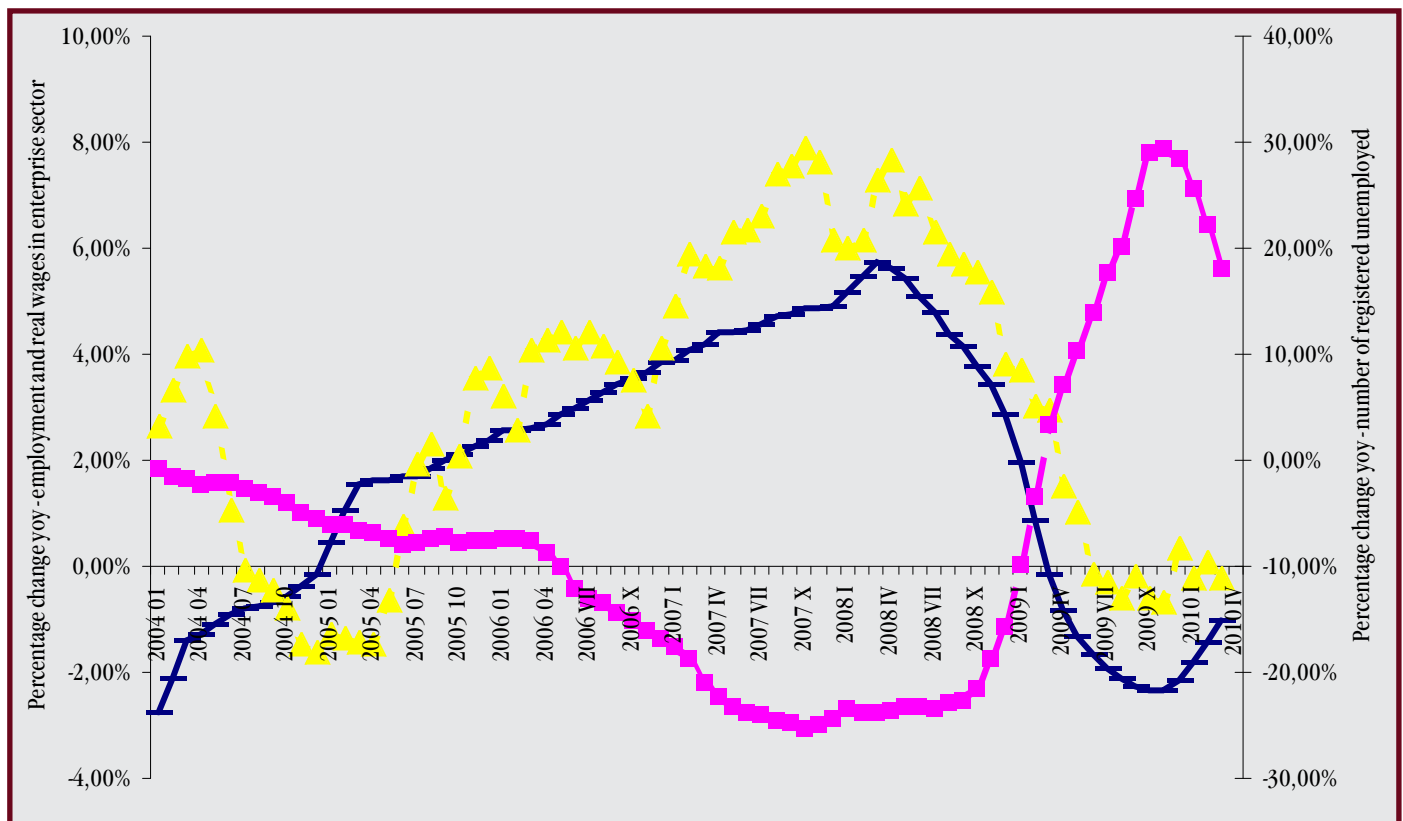
⁴ De-seasoning performed using the DEMETRA 2.2 software and Tramo/Seats methodology.

those who found unsubsidized jobs increased by 20.1% yoy as compared 10% yoy in the 4Q2009.

On the other hand, however, the more detailed analysis of PES data does not allow for an excessive optimism. A growing number of unemployed persons, finding unsubsidized jobs, alone would not be enough to lead to the observed dynamic increase of the total number of job finders among the unemployment. Job placements subsidized by the Public Employment Services, the number of which increased in the 1Q2010 by 48.7% yoy, are also of growing importance.

The other important factor, determining the dynamic decrease of the number of unemployed in the 1Q2010, was the growing number of unemployed leaving the registers due to other reasons than finding new job, be it subsidized or not. In the 1Q2010, the number of such persons increased in the y-o-y terms by 17.7%, ie. by 57 000 persons. As much as 44% of this increase was related to training and apprenticeship programs. The number of participants of these types of programs increased in the y-o-y terms by 34.6% in the 1Q2010.

Figure 8. Employment and real wage dynamics in enterprise sector; and registered unemployment dynamics in Poland 2004-2010.



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

This analysis boils down to the conclusion that the breakthrough we observed in the unemployment figures in the Q2010 was only partially „a natural one“. It was actually strongly „pumped up“ by the Public Employment Service. In order to better understand the meaning of this PES activity for the observed unemployment figures, one can calculate that if the number of those who left unemployment registers without finding a job had been similar in the 1Q2010 as in the 1Q2009, the unemployment rate would have reached 13.3%, so it would have been very close to the number we projected in the previous PEO issue.

The LFS unemployment figures from the 1Q2009 followed the unexpectedly bad employment figures. The number of LFS unemployed

increased in the 1Q2010 by 30.1% yoy, reaching 1,839,000. The LFS unemployment rate reached 10.6% and it was much more than we expected in the previous PEO issue. However, as we have already commented we assess that this worsening of the labor market situation, staying in contradiction with optimistic developments observed in the PES data and in employment data from the enterprise sector, is mostly related to bad weather conditions that caused numerous job losses in construction and agriculture. Therefore, although it will shift our LFS unemployment forecast upwards it will not change the expected direction of trend.

We expect that the registered unemployment rate in 2010 will maintain the falling trend that started at the beginning of the year, although not as dynamically as the figures from the first quarter could suggest. In the 2Q2010, it should fall to around 11.5%, but the seasonal factors will start then to work against the falling trend and at the end of the year the registered unemployment should reach 11.9%. It means that we expect registered unemployment to generally stabilize on the 2009 level in 2010, and it makes our forecast more optimistic than in the previous PEO issue. In 2011, registered unemployment will continue to fall, reaching around 10% – 10.5% at the end of the year. Believing that the unexpectedly bad LFS figures for the 1Q2010 resulted mainly from adverse weather conditions, we assess that the LFS unemployment will fall to as low as 9.6% in the 2Q2010. It should stabilize throughout the rest of 2010, reaching 9.7% at the end of the year. In 2011, it will fall to even 8.5%.

External Trade and Balance of Payments

A surge in the world trade in the aftermath of the strongest decline in the post-war history was reflected also in Polish trade figures for the 1Q10 (Figure 10). Despite the real appreciation of the zloty in the 1Q10, mainly caused by the nominal appreciation, exports remained highly profitable, according to business surveys of exporters, conducted by the NBP. The financial standing of firms that recorded financial losses on currency options in the fall of 2008, when the zloty fell rapidly in value while they wagered on its appreciation, improved considerably. The cumulative appreciation since March 2009 has not undone the earlier depreciation during the peak of the global crisis yet (Figure 9). The May 2010 turbulence on the financial markets that raised the risk aversion and weakened the zloty is unlikely to be sustained in our view and, therefore, impact positively the competitiveness. Leaving it aside, the zloty has remained at competitive levels, in particular against the euro, as the latest NBP quarterly survey of companies pointed out⁵.

In the 1Q10, the NBP exports of goods and services grew by 19.0% yoy and 9.8% yoy in the euro terms, respectively, after a fall by 17.1% and 14.5% in 2009. Imports also recovered strong on the back of solid domestic demand. Imports of goods and services in euro terms increased by 19.2% yoy and 14.2% yoy in the 1Q10 compared to a fall by 25.4% and 16.8%, respectively, in 2009. According to our estimates, growth in NBP export volumes that recovered in the 4Q09, accelerated to 10.0% yoy while import volume dynamics reached 3.2% yoy, the first such increase after five quarters of a decline. The rebound of exports and imports has been faster than we had expected. The rise in the euro imports came stronger than the rise in the euro exports, a sign that companies replenished their stocks after a long period when imports fell more than exports due to the substantial depreciation of

⁵ Information on business conditions in the second quarter 2010, NBP, April 2010.

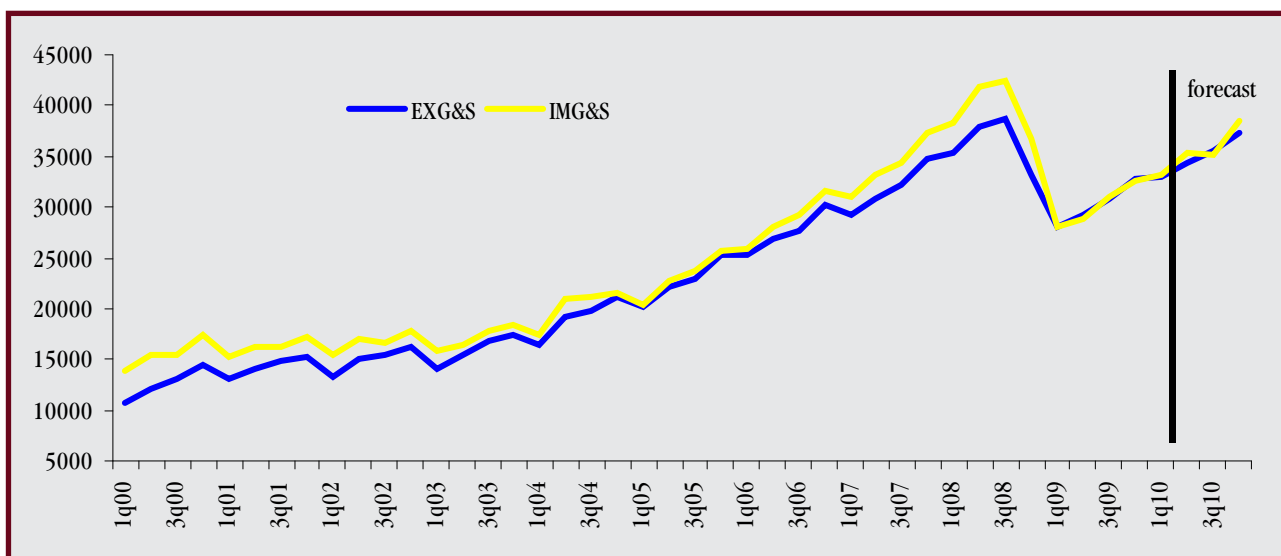
the zloty during the 4Q08 and 1Q09. These trends caused the trade deficit to rise to 952 million euros in the 1Q10 compared with the 764 million euros in the 1Q09. A rise in intermediate imports relative to investment and consumer imports is related to the recovery of the economy.

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



Source: ECB

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



Source: NBP

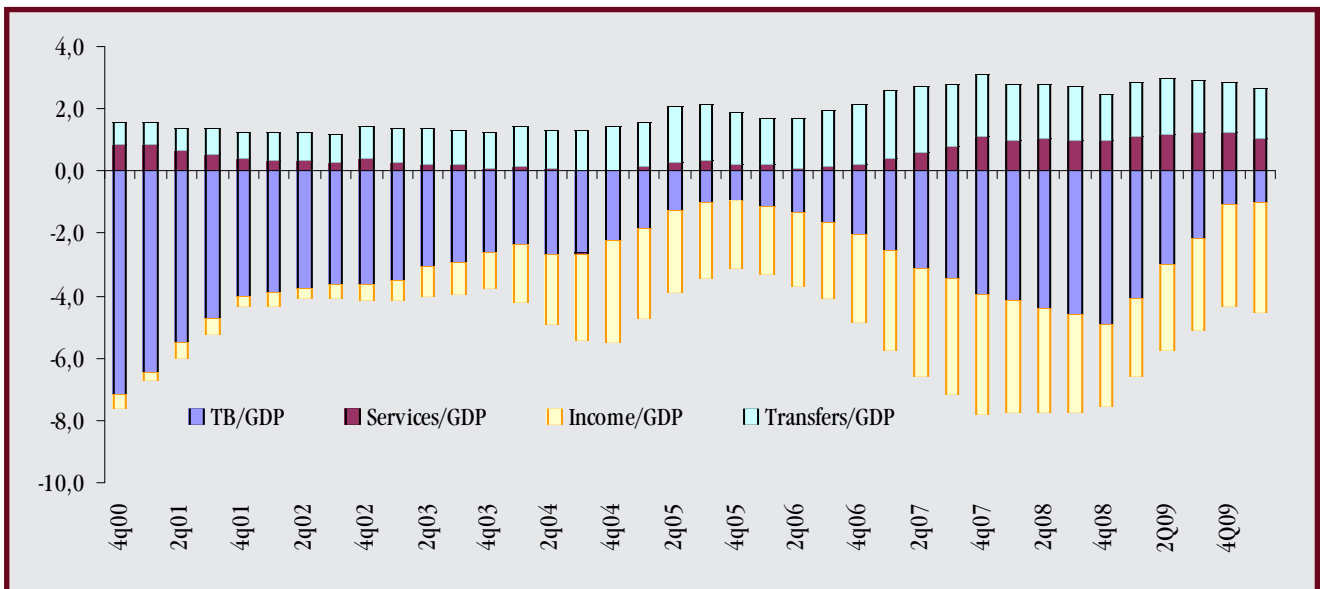
Terms of trade declined in January-February 2010, reflecting mostly the rise in commodity prices. Export and import volumes, computed by the CSO, increased preliminary 10.2% yoy and 5.5% yoy in January-February 2010, respectively.

The geographical breakdown of trends in the 1Q10, points to the most rapid growth in exports to developing countries and the strongest growth in imports from Central and Eastern Europe, in particular from Russia. The latter was related to a pick-up in commodity prices as well. The changes in the geographical structure of exports seem to follow the pattern of the worldwide recovery. The share of the EU countries in total exports of goods fell by 1.8

percentage points yoy to 79.2% in the 1Q10 while the share of developing countries and other advanced economies, including the USA, increased by 0.9 and 0.8 percentage points, respectively. It is premature to draw firm conclusion based on these shifts, but they suggest tentatively that Polish exporters are capable of capturing new markets. The breakdown of exports by SITC sections in 1Q10 reveals slower growth in exports of machines, equipment and transportation means (by 3.3% yoy) than that of total exports (by 3.6% yoy) in zloty terms, which is consistent with the fact that investment activity is still subdued in the advanced world and in Eastern Europe. The share of exports of machines, equipment and transportation is over 42% in the totals.

According to the NBP monthly data, the current account deficit rose to 1207 million euros in the 1Q10 compared with only 30 million in the 1Q09 and EUR 5.0 bn in 2009. The rise was mainly caused by an increase in the income deficit to 2.7 bn euros in the 1Q10 from 1.6 bn euros in the 1Q09, which reflected an improvement in net profits of companies. The rise in the surplus of transfers practically offset a small increase in the trade deficit and a small decrease in the services surplus from a year ago. The rolling four-quarter current account reached 1.9% of GDP in the 1Q10 because of these developments, but the trade deficit slightly decreased in terms of GDP to estimated 1.0% whereas the net income deficit rose to 3.5% of GDP. (Figure 11).

Figure 11. Current Account Breakdown, as % of GDP

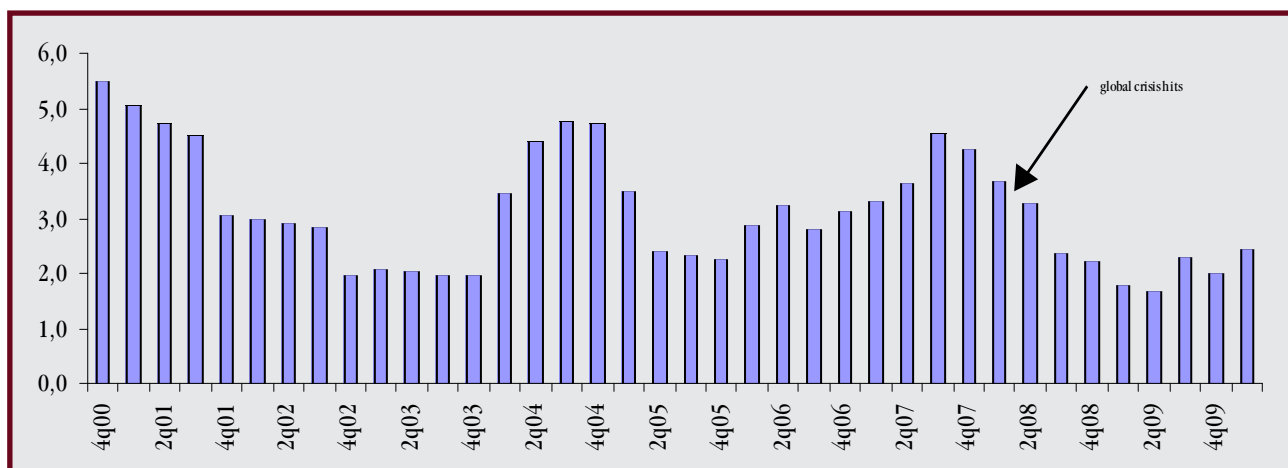


Our qualitative forecast with regard to the tendencies, exhibited by the current account components, is unchanged from the previous edition of PEO 4/2009. Exports and imports of goods should recover faster in 2010 than we have predicted up to now. Exports grew slightly less than imports year on year in the 1Q10, contrary to our predictions, but we still maintain that export dynamics should overpass the import dynamics in the near-term as the weakening euro will positively affect German exports (Germany sells about 40% of its exports to non-euro countries) and Polish exports are often components of German final products – a case of intra-industrial trade. After a first push to restock materials and intermediate products import growth should ease as private fixed investment and consumption demand are still subdued. Therefore, we forecast that trade deficit will not rise considerably during 2010. Income account will be the only item to drag down the current account while transfers and services surpluses should increase. Uncertain fortunes of the euro area recovery continue to be the main downside risk

factor to our forecast of export growth. Poland should maintain its competitive edge due to increases in labor productivity and persistent low rise in real unit costs helping it increase its world market share.

The current account deficit is predicted to rise to 2.5% of GDP in 2010 from 1.6% of GDP in 2009 due to a rise in the trade deficit and the income deficit as well. This should be partly offset by higher services and transfers surpluses. When the current account is adjusted for the net capital inflows that mainly comprise of the EU transfers, the shortfall amounted to 0.5% of GDP in the 1Q10, widening from a surplus of 0.1% of GDP in the 4Q09. The capital account surplus was much smaller in the 1Q10 than in 1Q09 so we expect it will rise in the remaining quarters of the year as public investment will become more vigorous after the harsh winter. Therefore the adjusted current account should not rise to more than 1% of GDP. These developments will tend to support the Polish zloty exchange rate as the net capital inflows should be higher than the current account deficit. Net FDI inflows are expected to increase considerably in 2010, supported by privatization efforts of the government, in particular in the energy sector (Figure 12).

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



POLISH ECONOMIC OUTLOOK

TRENDS • ANALYSES • FORECASTS



QUARTERLY 1/2010 (44)

Polish Economic Outlook 1/2010 (44)
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