POLISH ECONOMIC OUTLOOK
TRENDS • ANALYSES • FORECASTS
CASE
QUARTERLY 2/2009 (41)

Special Feature:
L, U, V or W for The Shape of Recovery to Come

EXECUTIVE SUMMARY

Contrary to our expectations, Polish economy did not enter recession in the 1H2009, defined as two consecutive quarters of GDP decline in quarterly terms, as GDP grew seasonally adjusted 0.3% qoq and 0.5% qoq in the 1Q2009 and the 2Q2009, respectively. However, domestic demand decreased three quarters in a row, starting with the 4Q2008, when it fell by the seasonally-adjusted 0.2% qoq though it still rose unadjusted 3.5% yoy. In the 1Q2009 and 2Q2009, quarterly declines were stronger in quarterly and annual terms. Thus, by this gauge the economy was in a recession in the 1H2009. Domestic demand was supposed to buffer it against the global downturn, but did not. Despite this contraction, GDP grew because exports fell much less than imports did so net exports improved significantly.

The short-term outlook for the economy improved for the first time in a year. The improved prospects for the rest of the year bode better times for Polish exports. Inventory correction is almost complete and subsequent restocking should be at least neutral to economic growth. Financial markets are normalizing and fewer banks report further tightening of credit standards. Business confidence has improved. The structure of growth factors should not change in the 2H2009 from the 1H2009. Private consumption, despite its softness will remain one of its drivers though its growth will probably hover around 2% yoy. Net exports, thanks to the strong competitive edge of Polish companies that had been underpinned by the past depreciation, will remain another.

The better performance of the economy in the 1H2009 than in our previous forecast leads to an upward revision of our growth forecast to 0.5% yoy in the 3Q2009 and, consequently, in the entire of 2009 though we do make any change in the forecast for the 4Q2009 (Table 1). The outlook for 2010 is clouded by the uncertainty regarding the strength of the world-wide recovery, which is based on the inventory adjustment at present. Despite all the headwinds, recovery in Poland should gather strength in 2010, fuelled by the infrastructure investment projects and exports.

A slack in the economy should help ease inflationary pressures once the statistical effects of hikes in regulated prices disappear from the index. CPI inflation grew in the 2Q2009 to 3.7% yoy from 3.2% in the 1Q2009, largely as a result of accelerating prices of gasoline, selected foodstuffs and industrial goods. Most of the increase can be attributed to agricultural supply shocks and the weakness of the Polish currency which, despite the recent strengthening, remains 20-30% weaker than in the same period of 2008. Compared to our previous forecast, we are now expecting a slightly higher consumer inflation and lower producer inflation in 2009. The main factor behind the elevated CPI forecast are more optimistic prospects for the real economy in Poland as well as Poland's main trading partner markets. The exchange rate remains one of the major risks to the forecast as until the end of the year, the currency will remain depreciated on a y-o-y basis. We, therefore, expect the process of passing through some of the costs associated with the depreciation onto consumers to continue – at least until early 2010. Combining these factors together, we expect the CPI inflation rate to remain just above the target range of 1.5-3.5% until the end of 2009 and then gradually decline to 3.1% in the 1Q2010. It should fluctuate between 2 and 3% in the remainder of 2010. On the annual average, the consumer price inflation will reach 3.6% in 2009 and 2.7% in 2010.

Since inflation is mostly caused by the supply-side, NBP continued to conduct expansionary monetary policy in the 2Q2009. It reduced the required reserve ratio to 3.0% from 3.5% in May and it cut its key open market operations rate to 3.50% p. a. in June from 3.75% in March 2009. Since the CPI inflation has been above the target and the core inflation rate, excluding food and energy, continued to creep upward in July while the short-term prospects for the economy slightly improved, the likelihood of more cuts in NBP rates has diminished. If the October inflation report confirms a downward trend in future inflation as the impact of 2009 hikes in administered prices recedes, the MPC may decide to lower the NBP interest rates the last time in its term. Otherwise, they should remain unchanged at least through the 1H2010.

The Labor-Force-Survey employment was still growing in the 2Q2009. The unemployment increase, accompanying it resulted from a dynamic increase of the number of active population in recent period. However, the official unemployment rate did not increase in the 2Q2009, mostly for seasonal reasons,

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

Indicator	Data							CASE forecasts					
	2006	2007	2008	2008		2009		2009		2010		2009	2010
				Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2		
Nominal GDP, PLN bn	1060.0	1176.7	1271.7	314.2	349.0	314.5	326.6	330.1	366.7	328.8	343.2	1337.9	1405.6
(% change, yoy)													
GDP	6.2	6.8	4.9	5.0	2.9	0.8	1.1	1.2	2.0	2.5	3.1	1.0	3.0
Private Consumption	5.0	4.9	5.4	5.1	5.3	3.3	1.9	2.7	2.5	2.3	2.9	2.1	2.9
Fixed Investment	14.9	17.6	8.2	3.5	4.6	1.2	-2.9	-3.8	-2.2	-1.4	1.1	-2.3	1.6
(4Q, % of GDP)													
CA balance	-2.7	-4.7	-5.4	-5.3	-5.5	-3.9	-2.1	-1.1	-0.1	-0.5	-1.1	-0.1	-0.9
(% change, yoy)													
Exports (NBP, EUR)	20.4	13.4	12.7	19.5	-7.5	-22.9	-22.8	-20.3	3.8	9.0	10.0	-16.3	11.5
Imports (NBP,(EUR)	24.0	19.5	14.9	22.6	-4.6	-28.8	-32.0	-25.7	-1.8	8.0	9.0	-22.6	9.9
(% change, yoy)													
Industrial sales	11.2	9.5	3.3	2.2	-6.3	-10.0	-6.7	-4.0	1.0	5.0	3.5	-5.1	4.5
Gross value added	6.0	6.7	4.9	4.9	3.4	1.2	0.8	1.2	1.9	2.3	3.0	1.2	2.9
CPI	1.0	2.5	4.2	4.7	3.7	3.2	3.7	3.8	3.6	3.1	2.2	3.6	2.7
PPI	2.3	2.3	2.5	2.1	2.4	4.9	4.2	3.0	3.6	2.1	2.7	3.9	2.9
Nominal Ave. Wage	4.9	8.7	10.4	9.8	6.8	6.8	4.4	3.0	1.4	3.6	1.8	3.5	2.3
Employment %, LFS	3.1	3.1	3.7	3.6	3.0	1.3	1.0	0.5	0.0	-0.5	-1.0	0.7	-0.5
Registered unemployment rate (%, eop)	14.8	11.4	9.5	8.9	9.5	11.2	10.7	11.3	12.7	14.1	13.3	12.7	14.2
PLN/EUR, eop	3.89	3.78	3.52	3.31	3.77	4.50	4.45	4.17	4.10	4.00	3.95	4.30	3.85
WIBOR 3M, %, ave	4.20	5.68	5.88	6.63	5.88	4.17	4.44	4.15	3.95	3.90	3.90	3.95	4.20
Central bank key rate eop	4.00	5.00	5.00	4.75	5.00	3.75	3.50	3.50	3.25	3.25	3.25	3.25	3.75
(% change, yoy eop)													
Broad Money (M3)	16.0	13.4	18.6	17.3	18.6	17.5	14.4	10.0	7.5	8.0	7.9	7.0	9.5
Loans to HH	33.4	37.9	44.6	33.5	44.6	43.7	35.7	19.0	10.0	7.0	8.0	11.0	9.0
Loans to Firms	13.7	24.1	29.0	24.1	29.0	25.8	15.0	9.5	1.0	- 2.0	-1.0	1.0	5.0
(% GDP)													
Fiscal Balance	-3.9	-1.9	-3.9	n.a.	-3.9	n.a.	n.a.	n.a.	-5.5	n.a.	n.a.	-5.5	-4.5
Public Debt eop	47.7	44.9	47.1	n.a.	47.1	43.6.	n.a.	n.a.	52.0	n.a.	n.a.	52.0	54.5

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

but labor markets proved more flexible than expected as well, since working time was reduced and substantial declines in wage growth occurred. The broad recourse to sickness leaves that temporarily shifted the cost of employment to the Social Insurance Fund from firms was also a factor. We do not significantly alter our unemployment forecasts from the previous PEO issue. It results from the fact that actual labor market developments seem to broadly follow our expectations thus far. Both, registered and LFS unemployment will continue to grow in the rest of 2009. We expect the registered unemployment rate to reach 12.7% at the end of 2009, while the LFS unemployment rate will probably grow to about 8%.

Increasing unemployment has moderated wage demands. Wage dynamics are going down very sharply and real wage dynamics actually fell below zero in the 2Q2009 for the first time since the mid of 2005. We expect this downward trend to last and, hence, we strongly reduce our earlier expectations concerning the nominal wage growth in the quarters to come. On average, nominal wages in 2009 should grow by no more than 3.5% and real wages should stay at the level from 2008. During 2010 nominal wage growth on a y-o-y basis can even fall further to the average of 2% yoy.

Despite the fact that the central budget deficit was in line with projections in the 1H2009, the government decided to revise the 2009 cash shortfall upward to PLN 27 bn or from PLN 18.2 bn. A combination of caps on expenditure and raised dividends should fill the gap in the state revenue. We do not take issue with these estimates. The ESA-95 general government deficit that unexpectedly rose to 3.9% of GDP in 2008 will likely hit 5.5% to 6% this year, but the outlook for 2010 is better in our view because of the conservative macroeconomic assumptions for the state budget draft.

We forecast that a large deficit this year is to cause a rise in the public debt by 5 percent of GDP to about 52%. Risks that the 55% precautionary threshold will be breached in 2010 are elevated, but there is a chance that the ratio will stay below this level under a number of assumptions, out of which high privatization proceeds seem the most important.

On the external side, trends from the 1Q2009 were continued in the 2Q2009. The four quarter rolling current account deficit sharply declined to 2.7% in the 2Q2009 from 5.4% of GDP in the 4Q2009. The huge improvement in the trade balance and a decline in the income deficit were the main factors of this change. The rate of decline in exports bottomed out in the 2Q2009 while the scale of import collapse increased. Since the Polish economy keeps on weakly growing while its partner economies shrink, this is due to the strong depreciation of the zloty. Our qualitative forecast with regard to the tendencies, exhibited by the current account components, remains unchanged. Such a rapid improvement in the current account may result in its position close to balance in 2009 unless the economic growth in Poland unleashes more demand for imports in the 4Q2009.

LATEST DEVELOPMENTS IN THE POLISH ECONOMY

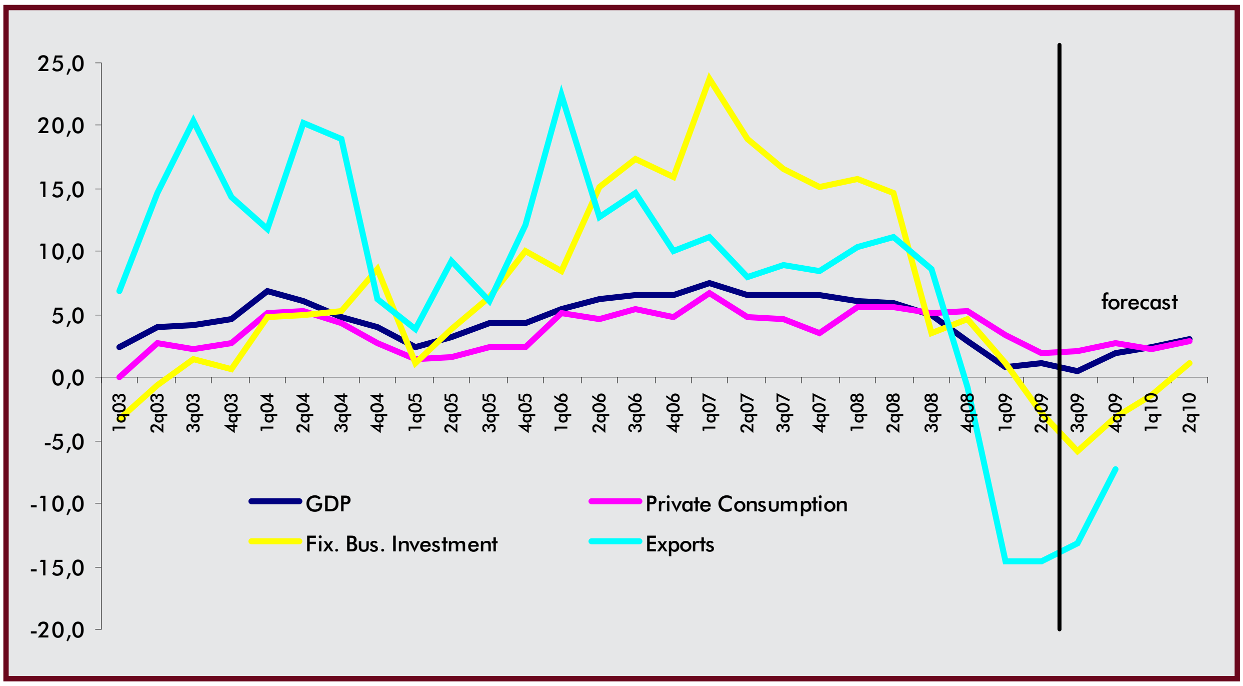
Economic growth

Contrary to our predictions (see PEO 1/2009), the economy did not enter a recession phase in the 1Q2009 and GDP growth was also positive in the 2Q2009, according to the preliminary data on GDP in the 2Q2009. They even point to a slight acceleration. However, recovery may be slow due to softness in consumer expenditure.

The revised data, published end of August 2009, showed that seasonally adjusted GDP fell 0.1% qoq in the 4Q2008, whereas GUS had previously reported 0.0% qoq in that period. Thus, the 4Q2008 has been the trough in GDP growth. Since then, GDP has resumed quarterly growth at a slightly increasing pace, as it grew seasonally adjusted 0.3% qoq and 0.5% qoq in the 1Q2009 and the 2Q2009, respectively. GDP data would suggest that the economy came to a halt directly after the collapse of financial markets in late September and October 2008, when the confidence in the global economy dived and demand imploded. It grew non-adjusted 0.8% yoy and 1.1% yoy in these quarters, respectively.

Interestingly, the seasonally-adjusted domestic demand fell in three consecutive quarters, starting the 4Q2008, when it decreased by 0.2% qoq though it still rose unadjusted 3.5% yoy. It was contrary to expectations since domestic demand had been believed to be a buffer against the weakness in the world economy. Actually, the softness in domestic demand caused that the economy came to a halt and the slowdown started in the 3Q2008. This sequence in time of quarterly rates of growth and decline suggests that domestic demand begun dragging down GDP growth due to accelerated destocking that started in the 2Q2008 and this process intensified in the 4Q2008. The collapse of demand in the global economy in the 4Q2008 reinforced the stagnation when net exports decreased faster than in previous quarters due to a collapse in exports. Imports reacted with a lag to a decline in domestic demand and its dramatic decline in the 1Q2009 offset the drop in exports. In a result, net exports increased considerably in this period and in the 2Q2009 as well, therefore, GDP continued to grow in quarterly and yearly terms. The process of eliminating excessive inventories was completed in the 2Q2009, according to the seasonally adjusted data on gross investment (gross capital formation), and seasonally adjusted imports increased a little in quarterly terms. However, growth in seasonally adjusted personal consumption continued to slow to 0.5% qoq, the weakest since 1Q2005. A rise in private consumption by less in the 2Q2009 than in the 1Q2009 came as no surprise because real rise in the wage aggregate was smaller than in the 1Q2009, consumer confidence was low and consumer credit was hard to come by.

Figure 1. GDP Growth Factors, quarterly % yoy



According to the data on the supply side of the economy, economic activity continued to weaken in the 2Q2009, but rates of decline were lower than in the 1Q2009. These developments were in sync with the developments in the advanced world. Industrial output of firms with at least 9 employees fell by 6.7% in the 2Q2009 versus 10.0% yoy in the 1Q2009. It was again dragged down by mining whose output fell by 18.1% yoy versus 12.3% yoy in the 1Q2009, whereas sales in manufacturing decreased by 6.1 % yoy, compared with 9.9% yoy in the 1Q2009. Branches of manufacturing, dependent on exports, such as machines and equipment or automobiles and parts likewise raw materials were the most severely affected. For example, sold output of machines and equipment, and autos fell by 12.5% yoy and 16.0% yoy, respectively, in the 2Q2009. Sales of metals collapsed by 32.8% yoy while sales of coke and refined petroleum products decreased by 15.8% yoy. Each rate of decline is much higher than the average for the whole industry.

The CSO has not published the data on construction output in the 2Q2009 yet, but only the cumulative data on output of firms with at least 9 employees in the 1H2009. A look at them reveals that construction sales must have grown year on year in the 2Q2009, as it fell by 1.3% yoy in the 1Q2009 while it increased by 1.4% yoy in the 1H2009, mainly thanks to the construction of infrastructure. Real retail sales fell by 0.1% yoy in stores with at least 9 employees in the 2Q2009, compared with a drop by 1.4% yoy in the 1Q2009. Retail sales were dragged down by sales of autos, motorcycles and parts, and sales of fuel. Nominal wholesale turnover was down by 9.7% yoy in the 1H2009, so, in the 2Q2009, it declined at the rate similar to the 1Q2009 that had previously been reported as 9.4% yoy. The quantities of goods shipped declined by 11.7% yoy in the 1H2009, compared with a previously reported drop of 13% yoy in the 1Q2009, but the sales of their services declined less, i. e. by 6.4% yoy in real terms in the 1H2009 versus a drop by 8.5% yoy in the 1Q2009, implying improvement in the 2Q2009. Telecommunications, courier and post-office services enjoyed a rise by approximate 5% yoy in real terms in the 1H2009, compared with 5% yoy in the 1Q2009 so the rate of growth in the 2Q209 was similar.

Short-term growth prospects for the economy improved for the first time in a year thanks to a number of external and domestic factors. The bottoming of the global economy and its better prospects for the rest of the year bode better times for Polish exports. The strongly expansionary combination of fiscal and monetary policies in key countries is proving successful in arresting the depression and resuscitating global demand. Another factor is the progress with stabilizing the financial markets that results in a gradual return of confidence, underpinned by the rising stock markets as well. Long-term credit continues to be scarce, but gradual normalization on global markets is taking place. There is little doubt that the global financial conditions are the key to resumption of credit expansion by banks in Poland, since it is the parent companies that transmitted the credit crunch to this country.

With regard to domestic factors, business sentiment and consumer confidence have improved since the 1Q2009 while unemployment was flat in the 2Q2009. The better sentiment kept in the first two months of the 2Q2009. Surprisingly, non-financial firms recorded much larger profits in the 2Q2009 than in the 1Q2009 so a downward trend in net income that took three quarters has been arrested. The year-on-year profits in the 1H2009 were down by over 16.3%, but they were up by 13.8% yoy in the 2Q2009. This shift in net income trend points to a successful restructuring of costs by enterprises, a positive harbinger of their improved finances. They managed to reduce increases in pay in nominal terms, but elevated inflation helped erode a part of their purchasing power as well. To exemplify, nominal average wage in the so-called enterprise sector rose by 3.7% in the 2Q2009 yoy, compared with 10.3% yoy in 2008. Inflation reduced the gain in purchasing power to mere 0.2% yoy in the 2Q2009. Liquidity of companies has remained very high as firms started hoarding cash and limited investment activities so commercial banks should not see a large increase in irregular corporate credit soon. If, contrary to fears, these risks do not materialize, banks may rethink their lending strategies and become more supportive for growth. Further, the newly introduced system of state guarantees, in which the state-owned bank BGK is instrumental, should also help revive credit to firms. Therefore, stagnation in the economy should end in the 3Q2009 and growth should start picking up in the 4Q2009 (Table 1).

The structure of growth factors should not change in the 2H2009 from the 1H2009. Private consumption, despite rising unemployment, lower growth of disposable income and tight credit will remain one of its drivers though its growth will probably hover around 2% yoy. Net exports, thanks to the strong competitive edge of Polish companies that had been underpinned by the weak zloty due to the past depreciation, will remain another. Public consumption will contribute to growth less and less and may even shrink year on year in the 4Q2009 as the government will make efforts to cap state budget expenditure. Public investment into infrastructure will partly offset a decline in fixed business investment. Restocking of inventories in manufacturing, which took off in the 2Q2009 should be broadly neutral GDP growth yoy in the 3Q2009 and support the year-on-year growth in the 4Q2009. The better performance of the economy in the 1H2009 than in our previous forecast, in particular the astonishing strength of net exports, leads to an upward revision of our growth forecast to 0.5% yoy in the 3Q2009 and, consequently, in the entire of 2009 though we do make any change in the forecast for the 4Q2009.

The outlook for 2010 is clouded by the uncertainty regarding the strength of the world-wide recovery. The global recovery is based on the inventory adjustment at present. Inventories will have likely been replenished by 2010 while the weakness in demand on the part of US consumers due to high unemployment, high indebtedness and their lower financial wealth will drag on mid-term prospects for growth of the world economy. A likely withdrawal of the fiscal and monetary stimuli at some point due to inflationary risks and high public indebtedness will also dampen these prospects, but this should happen no sooner than late 2010 or after. Despite all the downside risks on the part of the global economy, recovery in Poland should gather strength in 2010, fuelled by the infrastructure investment projects and exports. Household consumption will gradually pick up in the course of the year as unemployment peaks, firms begin to hire people and offer higher wage increases amid lower inflationary pressures. Finally, fixed business investment should revive when capacity utilization returns to a long-term average and it occurs that demand is there to stay.

Inflation

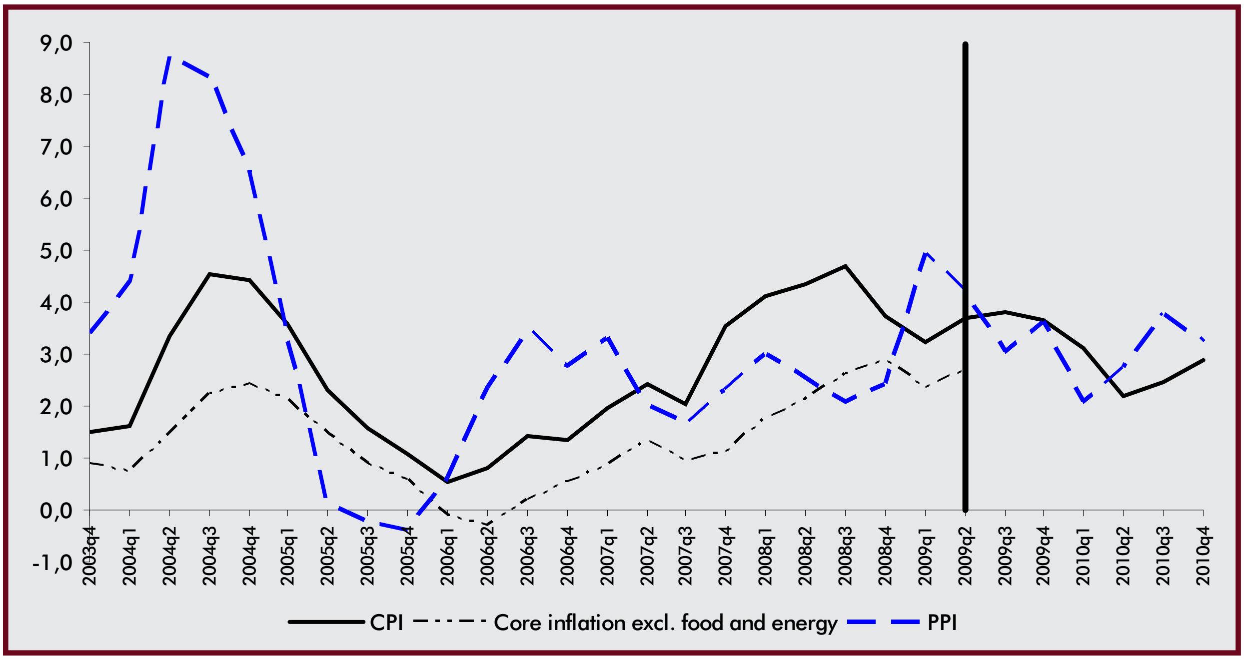
Review of 1Q2009

CPI Inflation grew in the second quarter to 3.7% yoy from 3.2% in the first quarter largely as a result of accelerating prices of gasoline, selected foodstuffs and industrial goods. Most of the increase can be attributed to agricultural supply shocks and the weakness of the Polish currency which, despite the recent strengthening, remains 20-30% weaker than in the same period of 2008.

Acceleration in food prices contributed the most to rising inflation (1.3 percentage points), with the entire food aggregate in the second quarter 5.4% more expensive than in the analogous period of 2008, up by 1.5 percentage points from the 1Q2009. The temporary trough in the swine production cycle lifted the pork meat inflation to 11.1% yoy in the second quarter – the highest quarterly growth since late 2004 – although the monthly profile suggests that prices began to decelerate in the summer to 9 – 10% yoy in June and July. World prices of sugar have been growing gradually since 2008 to reach the highest level in 25 years in early summer. This surge pushed up the year on year dynamics of retail prices in Poland to 27% yoy on average in the 2Q2009 – the level unregistered since the accession related high of 2004. The price peak, resulting from the combination of bad global crops (e.g. India) and the EU-reform-induced reduction in production capacities has been raising prices in many related food industries: confectionary, fruit processing and dairy, thus contributing to an overall increase in the food inflation.

Other key consumer foods benefited from increased supply and posted declining inflation rates. Most importantly- good harvest of grains, in particular wheat and rye, led to sustaining deflation in procurement prices and insured falling dynamics of consumer prices of bread and cereals (4% yoy and 2.8% yoy in the 2Q2009 and July, respectively, vs. 5.7% yoy in the 1Q2009). Likewise, high supply of milk suppresses consumer prices in the dairy sector where deflation on an annual level has persisted for the second quarter in a row (-1.6% and -2.5% in the second and first quarter, respectively). Fruits and vegetables have also had a generally good crop this year which translated into the decline in inflation in both markets in July.

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



Prices of crude oil, in line with the trend in most commodity markets, have been going up gradually since the beginning of 2009 to reach a 10-month high of US$75 a barrel in late August. This trend, together with the weak zloty exchange rate vis-a-vis the dollar, have boosted retail prices of fuel which saw a marked increase in the y-o-y dynamics from -18.2% in the January to -6% in July. Other energy carriers combined (electricity, gas, heating and coal) posted a moderate decline in the growth rate from the record high 14.4% in the 1Q2009 down to 11.8% in the 2Q2009 and further down to 10.1% in July – largely as a result of the marked deceleration in gas prices. The overall net effect of food and energy on consumer prices continues to be pro-inflationary as indicated by the core inflation excluding food and energy – which has remained below the headline CPI for a number of years now. Reversing the trend from past few quarters, this indicator of core inflation rose from 2.3% yoy in the 1Q2009 to 2.7% and 2.9% in the 2Q2009 and July, respectively.

An even bigger increase was registered by the core inflation, excluding administered prices. The revised index published since March 2009 follows the Eurostat's definition of administered prices, which compared to the previously applied list, does not include products controlled through excise taxes (alcohol, tobacco and fuel), road transportation, telecommunication and insurance, but instead covers rents, water supply, sewage collection and elementary schools[1]. Although this measure of core inflation rose markedly from 2.2% in the 1Q2009 to 3.0% in the 2Q2009, it still remains significantly below the CPI, indicating that administered prices continue to exert strong upward inflationary pressures. Among the prices with the highest influence on the general prices level, are the previously mentioned component of energy carriers, but also rents and housing services. Several items, previously eliminated from this index as they had been included on the list of administered prices, such as tobacco and fuel saw marked increases in recent months as a result of the excise hike (tobacco in July) and the continued rise of global prices (fuel since early 2009). Now, included in the index, these hikes contribute to the gradual climb of the core inflation in administrated prices.

The trimmed mean rose slightly from 3.4% in January to 3.9-4.1% in March-May to fall back to 3.6% in June-July reflecting the moderate increase in fundamental inflationary pressures in the first five months of the year. The most important factor behind this increase has been the continued acceleration in prices of industrial goods, fueled by the depreciating zloty. Tumbling retail sales have pushed consumer durables in the Euro zone into the deepest deflation since the initiation of the HICP index (-0.7% yoy in the 1Q2009 and 2Q2009 and -0.8% in July), but inflation in the same product group has been on the rise in Poland as importers decided to pass through some of the cost related to the weakened currency onto consumers. As a result, the deflation of consumer durables' prices shrank to -0.5% yoy in the 2Q2009, the lowest since early 2005, and turned into inflation in July (+0.7% yoy) for the first time since January 2005. The recently observed strengthening of the zloty may lead to a resumption of the falling trend, however, there will certainly be a lag in the response of businesses, which have had to cope with deteriorating profitability of production and imports for a few quarters now.

The developments in producer prices in Poland have been reflecting the combination of plummeting domestic and external demand, weak zloty and rising commodity prices. All these factors combined led to the decline of annual PPI inflation from 4.9% yoy in the 1Q2009 to 4.2% yoy in the 2Q2009, and further down to 3% in July. Manufacturing was the hardest hit of all industrial sectors with producer inflation gradually down from 3.4% yoy in February to 0.9% yoy in July and quarterly inflation plunging from 2.5% in the first quarter to 1.8% in the second. Despite the rising trend in related commodities, the year-on-year price dynamics fell in the production of basic metals (-10% in the 2Q2009 vs. 4.6% in the 1Q2009) and coke and oil processing (-20.4% vs. -18.8%). The crisis continues to depress prices in key large industries manufacturing intermediate and capital goods: chemicals saw prices decelerate from 7.8% yoy in the first quarter to 3.8% yoy in the second, while prices of metal products slowed down from 7.2% yoy to 5.3% yoy between the second and first quarter. Among those industries that posted rising inflation were foodstuffs (2.7% yoy in the 2Q2009 vs. 0.9% yoy in the 1Q2009), tobacco (15.5% vs. -3.2%) and most industries producing machinery and equipment, electrical appliances, transportation equipment (incl. cars) and furniture.

Price indices in mining and quarrying accelerated in the second quarter (to 12.3% yoy, up by 3.5 percentage points on the first quarter), reflecting global trends in the commodity exchanges. Prices of both coal and copper – most important commodities for the Polish industry, have been rising gradually since early year and contributing to growing price dynamics in the entire sector. July saw a sharp decline in inflation (to 8.6% yoy) despite the

[1] The total weight of the administered component of the consumer basket in 2008 was 12.4% vs. 26.5%, according to the previously applied definition of the controlled prices.

continuation of the trend of rising commodity prices- predominately as a result of the high base in the summer of 2008 when most commodities peaked in the pre-crisis boom. The price growth in the energy sector moderated somewhat reaching 16.9% yoy and 14.3% yoy in the second quarter and in July – down from the high of 21.3% in the first quarter, in line with slowing prices of gas and other energy carriers.

Forecast

Compared to our previous forecast we are now expecting a slightly higher consumer inflation and lower producer inflation in 2009. The main factor behind the elevated CPI forecast are more optimistic prospects for the real economy in Poland as well as Poland's main trading partner markets. This optimism boosts expectations of domestic and external demand for the Polish industry, but also drives up prices of key industrial commodities including crude oil, steel, copper as well as those of agricultural raw materials, including key grains and oils. We believe that a more favorable labor market conditions implied by the better real sector prospects will have a positive -if slow – effect on disposable incomes of households and gradually also on the credit action benefiting both households and firms. This will ensure sustaining moderate demand pressures over the forecast horizon.

Exchange rate remains one of the major risks to the forecast. The sudden appreciation in July and August strengthened the currency faster than we expected in the third quarter, however, we leave our fourth-quarter prediction at 4.10 PLN to the euro – unchanged from the previous forecast. This means that until the end of the year the currency will remain depreciated on a y-o-y basis and only in the 1Q2010 the zloty will gradually start to appreciate vis-?-vis the preceding year. We therefore expect the continuation of the process of passing through some of the costs associated with the depreciation onto consumers – at least until early 2010.

Despite the recent acceleration of the food aggregate prices we expect inflation of foodstuffs to moderate in the coming months and fall below 3% in the short-to-medium horizon. Good crops for most key agricultural commodities in Poland and globally should hold prices restrained even amid the upcoming acceleration of the economic activity. We believe that shocks to individual markets (sugar, swine meat) will be either isolated or short-lived and reversed so will not be impact the overall food price level significantly.

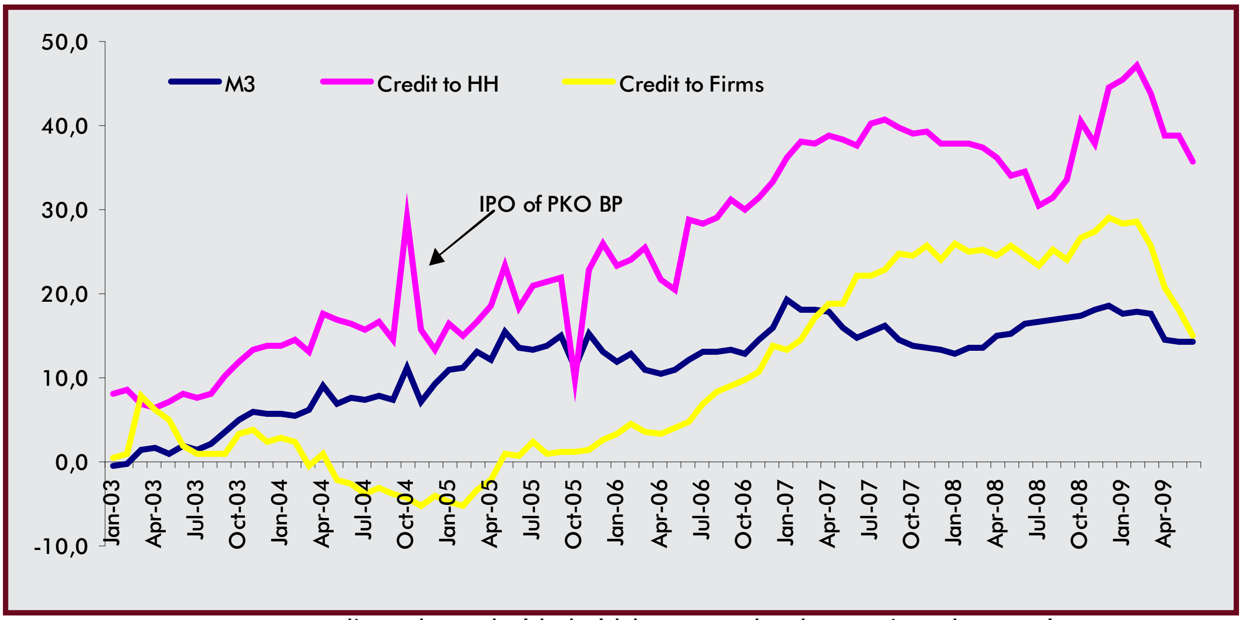
Combining these factors together we expect the CPI inflation to remain just above the target range of 1.5-3.5% until the end of 2009 – at 3.8% and 3.6% in the third and fourth quarter, respectively, and then gradually decline to 3.1% in the 1Q2010 and fluctuate between 2 and 3% in the remainder of 2010. On the annual average level the consumer price inflation will reach 3.6% in 2009 and 2.7% in 2010. The PPI inflation will decelerate to 3% in the 3Q2009, pick up to 3.6% in the 4Q2009 and then fall to 2.1% and 2.7% in the first and second quarter of 2010, respectively. The annual average PPI inflation will amount to 3.9% in 2009 and 2.9% in 2010.

Monetary Developments and Policy

The year-on-year statistics continues to point to a strong upward trend in credit growth, but it also keeps on misleading.

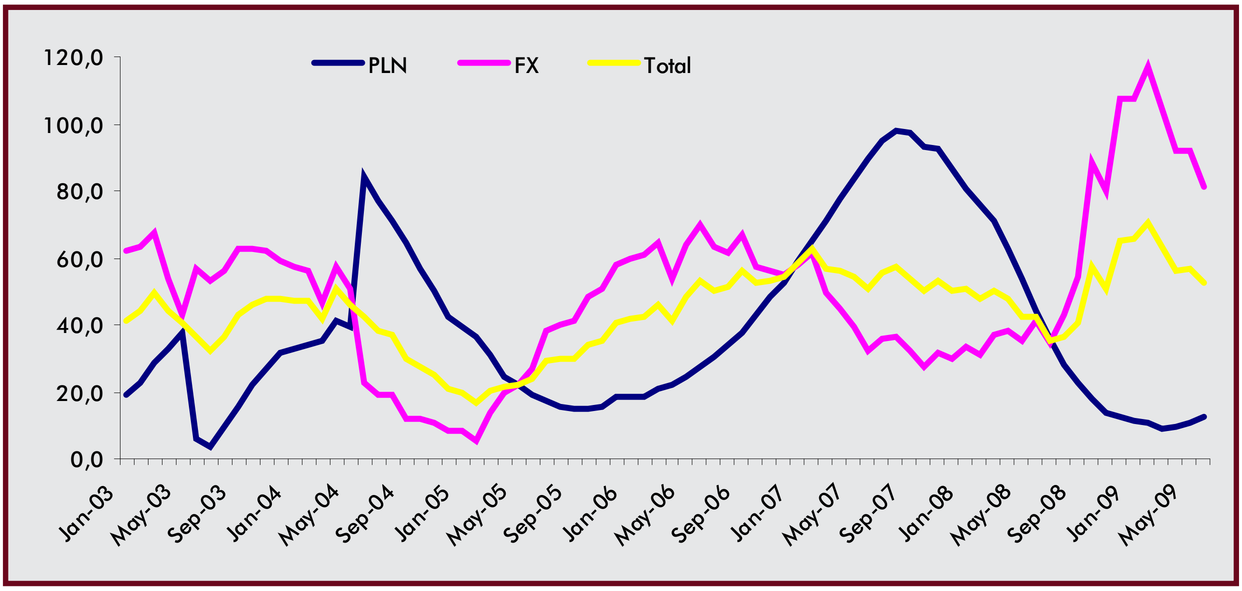
Credit to nonfinancial companies fell in the 2Q2009 as it amounted to PLN 218.8 bn end of June 2009 versus PLN 225.7 bn end of March 2009, down by 3.1%. Supply-side problems such as low liquidity or capital, tightening of credit standards due to a fear by banks of a potential rise in irregular credits due to the economic stagnation were the cause of this decline. It is interesting that the role of inadequate capital as a factor constraining credit eased in the 2Q2009 after banks had retained 2008 profits along the guidelines of the Polish Financial Supervisory Authority (FSA). Stabilization of the zloty exchange rate was helpful as well. In year-on-year terms credit to non-financial firms grew by 15.0%. Growth of both the zloty and foreign currency credits displayed a decreasing trend.

Figure 3. Broad Money and Credit Expansion, % yoy



Credit to households held better as banks continued to replace mortgages with consumer credit that pays higher interest rates and matures at shorter periods so, in theory, it carries less risk. In the 2Q2009, credit to households increased by 1% qoq or PLN 4.1 bn, compared with 6.6% or 25.8 bn zlotys from end-December 2008 to end-March 2009. However, the zloty depreciation in the 1Q2009 inflated the zloty value of foreign currency loans whereas such effects were absent in the 2Q2009, when the zloty exchange rate was stable. Credit to households rose by 36.1% yoy in June 2009.

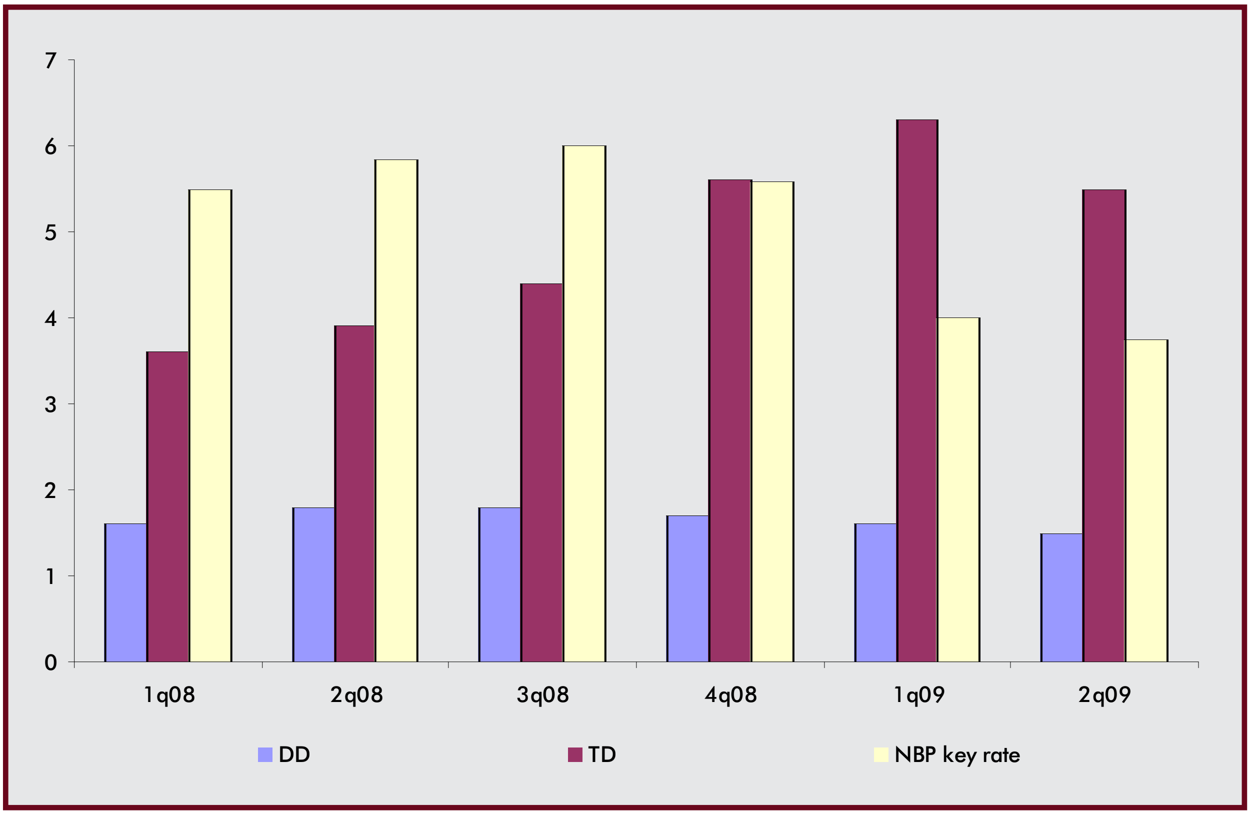
Figure 4. Housing Credit Credit Growth, % yoy



Prospects for the resumption of credit expansion were better in the 3Q2009 than in the previous three quarters. Steps, taken by the NBP, eased problems with liquidity while the FSA's recommendation to banks to retain profits from 2008 that were at record highs helped raise the capital adequacy ratios or maintain them unchanged; the amount of 11.2 bn zloty of undistributed profits from 2008 has increased their tier one capital. The capital adequacy ratio increased to 12.5% in June from 10.8% in March 2009, a level registered in the middle of 2007. If the improvement is sustained this should gradually lead to more credit once macroeconomic risks are contained and confidence among financial institutions is higher. However, some banks still have to raise more capital, as they are in a different position. This means they should issue new shares, but this action could imply changes in their ownership structure, and it is time consuming as well while the problem should be resolved rather quickly. Therefore, FSA has prepared a decision, based on the banking law, that would allow banks to treat long-term bonds of maturities from 10 to 30 years, including the convertible ones, as principal capital. FSA would approve, which bonds can be accounted for and withdrawn as tier one capital. The issue is controversial since 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.

Polish banks are much less leveraged than their parent companies so they could, in theory, lend more, but these relatively high capital adequacy ratios support consolidated group ratios, which are low, therefore, capitals of Polish daughters help manage the risk on the level of the entire banking group. The result is that parent companies may advise their daughter institutions in Poland to freeze credit expansion. Commercial banks also point to the scarcity of long-term financing and risks they run. A number of banks took short-term deposits or inter-bank loans to finance mortgage expansion so they have to rebalance their portfolios.

Figure 5. Household Deposit Interest Rates



Nominal broad money (M3) rose by 14.4% yoy in the 2Q2009 compared with 17.5% yoy in March 2009 so a downward trend has finally set in. In quarterly terms, M3 grew by 1.5% in the 2Q2009, which is little as compared with a number of past quarters. Total deposits increased by 15.9% yoy in June 2009 versus 20.6% yoy in December 2008. The rates of growth in household and company deposits continued to be differential 24.7% yoy and 7.2% yoy in June 2009, respectively, compared with 26.5% and 4.0% yoy in December 2008. Time deposits of households expanded at the rate of 41.9% yoy while demand deposits rose at the rate of 9.2% yoy in June 2009, however time deposits declined while demand deposits rose in the 2Q2009. 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 5.6% p. a. and 1.5% p. a. in the 2Q2009, respectively versus 6.3% and 1.6% in the 1Q2009. The pickup in stock exchanges since March 2009 has not impacted monetary statistics yet as the risk-averse public mostly ignored it.

Like in the 1Q20099, the NBP conducted expansionary monetary policy in the 2Q2009. It reduced the required reserve ratio to 3.0% from 3.5% in May in order to ease supply-side constraints on bank credits and it cut its key open market operations rate to 3.50% p. a. in June from 3.75% in March 2009 to support the economy. The main argument for the latter reduction was based on the distribution of inflationary risks. The likelihood that the CPI inflation rate would trend above the target of 2.5% yoy in two years' time was lower than the probability that it would trend below since weak domestic demand is likely to further ease inflationary pressures. The MPC expressed its conviction in the June communiqué that inflation remained above the target range of 1.5% to 3.5% yoy mainly for the reasons beyond the control of the central bank, i. e. due to the dragging effect of the rise in regulated prices in particular energy carriers and past increases in food prices. However, the decision was a close call as inflation is still elevated relative to the NBP target. Since the CPI inflation is persistently above the 1.5% to 3.5% target and the core inflation rate, excluding food and energy, continued to creep upward in July while the short-term prospects for the economy slightly improved, supported by the bottoming of the global economy, the likelihood of a next reduction in NBP rates any time soon has diminished. The July appreciation of the zloty, if it is sustained, may improve the balance of inflationary risks as an earlier depreciation pushed prices of imported goods upward, among them commodities that have become more expensive as they discount better prospects for the world economy. In our view, the room for one more interest rate cut is contingent on the content of the next inflation report that will be available to the MPC in October 2009. In the 1H2010, the impact of hikes in regulated prices from the beginning of 2009 on the year-on-year price index will disappear and we should see quite a significant drop in the CPI inflation rate while demand pressures should be weak. If the report confirms such a course for future inflation, the MPC may make a decision to lower the NBP interest rates.

The banking sector performance deteriorated considerably in the 1Q12009 as it reported a decline in net income by 49.3% yoy in the 1Q2009, i. e. 2.1 bn zlotys. One reason for this was a rise in provisions for irregular credits that grew from 0.5 bn to 1.6 bn zlotys in the 1Q2009. Much of this rise was related to the problem of currency options contracts that firms issued to banks, wagering on a further appreciation of the zloty. However, when the zloty depreciated significantly, firms incurred losses and could not settle its dues with the banks. The amount of irregular loans rose in the 4Q2008 for the first time since the middle of 2003. This tendency continued in the 1Q2009, when the ratio of irregular loans to firms rose to 7.9% from the record low of 5.8% in 2008 and that of loans to households rose to 3.8% from 3.5%. At the end of 2Q2009, the overall ratio of irregular loans amounted to 6.3%, up from 4.5% at the end of 2008.

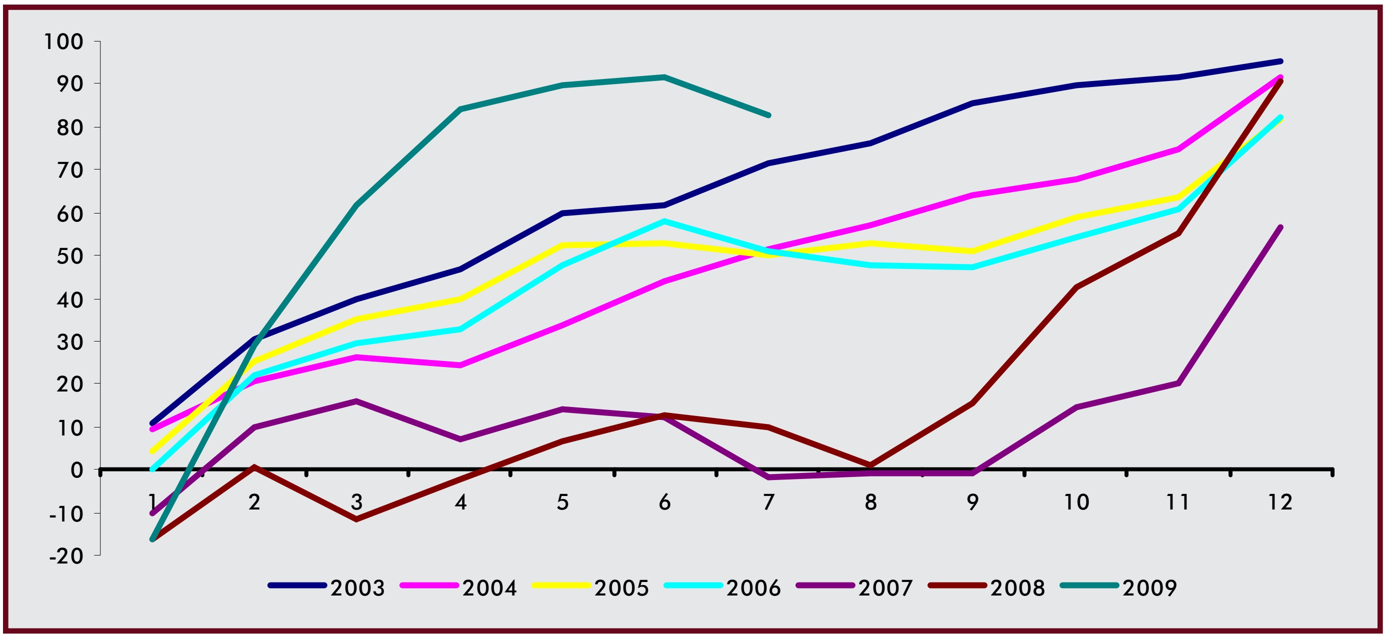
In the 2Q2009, the negative trends continued though no official data on the entire sector were available as of writing. The net income of ten banks that are listed on the Warsaw Stock Exchange declined by 40% yoy to 1.7 bn zlotys. ROE of these banks declined considerably as a result: four of them reported ROE less than 10 whereas a year earlier only one bank showed ROE below 10. Yet, there are some positive trends. The overall impact of the problem of currency options on the bank sector performance was lower in the 2Q2009 thanks to the appreciation of the zloty, but in some cases led to increase in provisions. High cost of funding due to the stiff competition for retail deposits among these banks that suffered from liquidity problems in the 4Q2008 was likely to adversely affect the financial results of the sector as well. To counter reduced revenue, banks started slashing costs and announced lay-offs. In a few cases this process is advanced. Looking ahead, prolonged economic stagnation, in particular a substantial rise in unemployment poses a threat to the quality of the bank credit portfolio. By historical standards, the ratio of irregular credits is still low. During the downturn in 2000-2002, this ratio doubled over two years. It reached almost 27% and 14% in the case of firms and households, respectively, but regulations were more stringent than now so these figures are not directly comparable with the current ones. Polish firms have considerably improved their financials since the stagnation phase in 2001-2002; their liquidity ratio and profitability of turnover in 2006-2008 were roughly double that of the values during an upswing in 1995-2000 so they may weather the slowdown without a massive recourse to non-servicing debts due to liquidity problems. However, a further rise in the ratio of irregular credits is inevitable as unemployment is bound to rise further. Since margins on housing loans during the boom years were low, they may not cover the losses on the loans that would not be serviced due to a large increase in unemployment should it happen. In conclusion, we reiterate the statement that the worst for the banking sector is yet to come since irregular credits have only started growing. Nevertheless, bank failures are unlikely though losses in 2009 cannot be entirely excluded in a few cases. Banks seem to be well capitalized to absorb them. Whereas failures are unlikely due to a relatively good shape of the Polish banking sector, mergers and acquisitions have started and they will likely continue through 2010.

Fiscal Developments and Policy

The central government cash budget recorded a deficit of 16.6 bn zlotys in the 1H2009, an equivalent of 91.4% of the 18.2 bn zlotys that was originally targeted by the state budget in 2009 and slightly less than projected by the MoF. The state revenue reached 134.4 bn zlotys, lower than the MoF projections of 137.2 bn, while the state expenditure that stood at 151.0 bn zlotys was short of the planned 154.1 bn.

Central government revenue and expenditure increased by 5.2% yoy and 15.2% yoy in the 1H2009, respectively, while the 2009 state budget assumes that the central government revenue and expenditure will rise by 19.5% and 15.6% relative to the actual performance in 2008. These tendencies suggest that fiscal policy was expansionary in the 1H2009 due to the work of automatic stabilizers during the downturn, but it was much less so in the 2Q2009 than in the 1Q2009, in which revenue rose at a faster pace than expenditure, 8.9% and 8.5% yoy, respectively. The revenue dynamics has been distinctively lower than projected in the state budget bill so far, therefore, the government has decided to revise the cash shortfall upward to 27 bn zlotys or 2.1% of its projected 2009 GDP (1305.5 bn zlotys) despite the deficit performance close to the original projections in January-June[2]. This revision was broadly expected so it had no negative impact on the functioning of financial markets for the Polish public debt. The scale of an 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. In particular, a risk of breaching a 55% threshold by the public debt relative to GDP has recently risen. This breach would force the government to reduce the deficit abruptly, since it would require to lower the ratio to the 55% level. Such developments would threaten with a recession and instability in markets for Polish debt, where spreads would widen markedly. The zloty would also weaken and the volatility of the exchange rate would increase considerably.

Figure 6. Central Government Budget Deficit, % annual projection



The MoF has estimated that its revenue will be lower by 37 bn zlotys than projected in the 2009 budget bill[3]. Earlier announced savings in expenditure, contingent on the bad-case scenario with regard to GDP growth that has materialized, are supposed to offset 19.7 bn out of the missing amount, newly added savings in the state budget expenditure will offset about PLN 3 bn zlotys while a rise in the dividend income, collected from firms, in which the state holds stakes, will bring about extra revenue of about 5.3 bn zlotys.

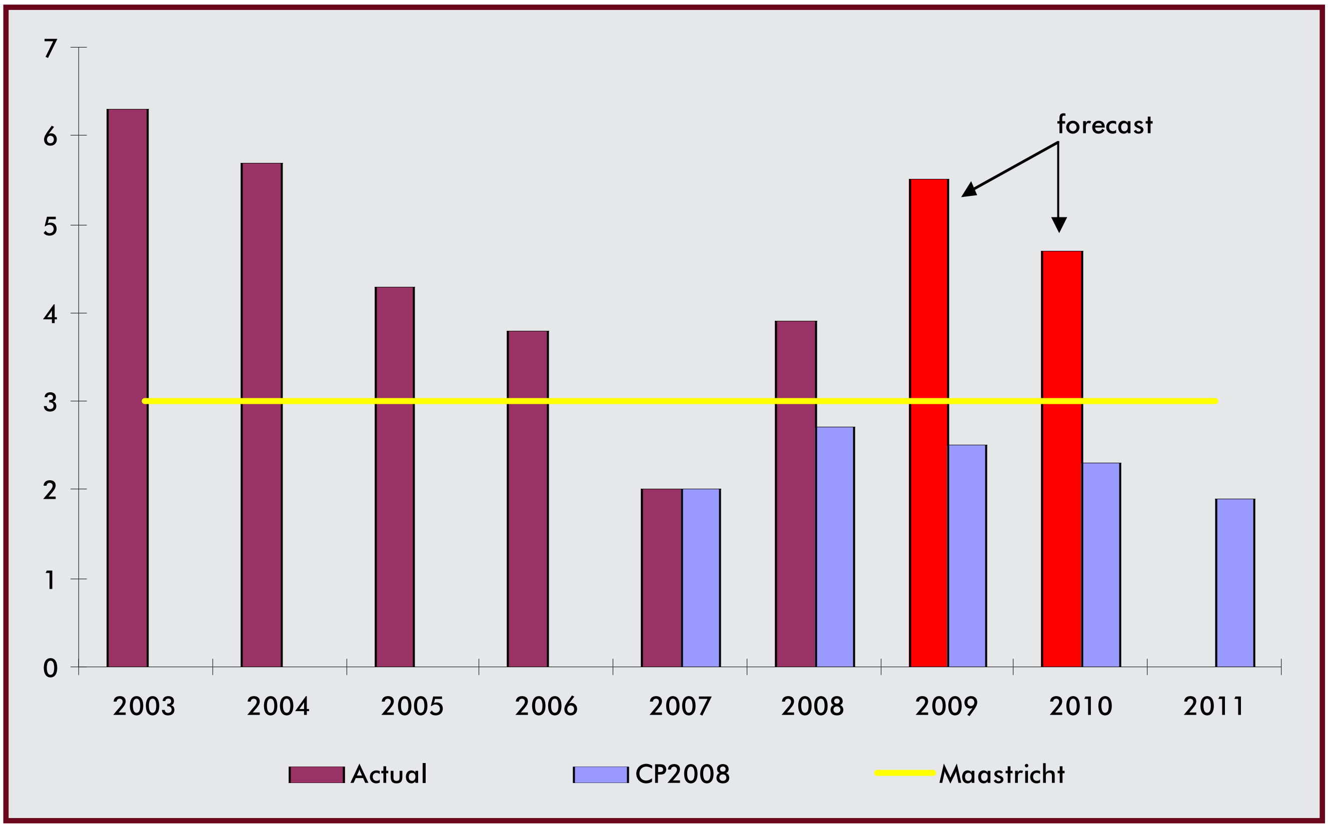
In earlier issues, assuming a hypothetical scenario of zero economic growth and the same tax elasticities as in the 2009 state budget bill, but a lower GDP deflator of 2% in 2009, we forecast that the tax revenue would be some 32 billion zlotys short of 251.4 bn zlotys, projected in the state budget. This would cause the cash budget deficit to reach about PLN 50 billion or 3.8% of GDP, provided that all other revenue and expenditure remain unchanged as in the state budget bill, i. e. ceteris paribus. When the total amount of announced expenditure savings of 10 bn zlotys is accounted for, the central government cash deficit would amount to 41 bn zlotys or 3.1% of GDP, then-estimated at

[2] CASE current forecast of GDP is higher, see Table 1.

[3] Informacja o sytuacji makroekonomicznej i stanie budżetu państwa w 2009 r., Ministerstwo Finansów, czerwiec 2009.

around 1310 bn zlotys. Now, we are raising our nominal GDP forecast to approximately 1333 bn zlotys for two reasons: real economic growth should be slightly positive in 2009 and, more important, GDP deflator will be much higher than projected due to a large rise in export prices, caused by the large depreciation of the zloty. These changes in assumptions lead to a lower shortfall in the tax revenue, which will approximately be 25 bn zlotys. The missing amount, holding all other revenue unchanged and subtracting 19.4 bn zlotys in savings that have already been pledged, boils down to 5 to 6 bn zlotys. In this light, the budget amendment looks sufficient to take care of the gap.

Figure 7. General Government Budget Deficit, % annual projection



Source: Polish Convergence Porgrams 2006 and 2007

We were not able to report more details in the PEO 1/2009 on the unexpected rise in the general government deficit in ESA-95 terms (based on transactions) to 3.9% of GDP in 2008 versus the originally projected 2.6% of GDP. They are available now. Table 2 shows that the shortfall increased in each position. The overruns relative to the 2009 Convergence Program Update occurred in the positions of the central government and local governments. The government explained that they were mostly related to the reduction in the non-wage labor costs (a cut in the disability premium) and lower revenue in the 4Q2008, when the economy slowed considerably after the peak in the global financial crisis. The European Commission has restarted the Excessive Deficit Procedure (EDP) not for the reason of bad prospects for the deficit, since many countries will breach the 3% threshold in 2009, but because the deficit rose above 3% of GDP in 2008 when economic growth was solid 4.9%, i. e. close to the potential. Poland has until 2012 to reduce the fiscal deficit below 3% of GDP. Prospects for 2009 do not look good, either. The rising unemployment leads to tensions in the financial balance of the social insurance fund, which will likely report no surplus or even a low deficit, financed by the loans from commercial banks. The ESA-95 central government budget deficit that includes the subsidy to the open pension funds and state agency for freeway construction, may increase to 5.0% of GDP while the deficits of local governments may double as their revenue is lower and they attempt to continue infrastructure projects, financed by the EU aid. The sum of these deficits would reach near 6.0% of GDP, according to our estimates.

The outlook for 2010 looks better as the government intends to base its revenue projections on growth near zero (0.5%) while nominal GDP will amount to 1325 bn zlotys and forecast CPI inflation rate is 1%. First of all, nominal GDP in 2009 will be higher than the preliminary forecast for 2010 so it will help reduce the deficit ratio next year. Second, conservative projections of real economic growth and inflation will be translated into low increases in state budget revenue, which, in turn, should temper appetites for a material rise in expenditure by various ministries and social groups. Third, we think that GDP growth will surprise the government on the upside and the central and general government deficits will come lower than projected by the government. Further, temporary increases in indirect taxes cannot be excluded. The government will also attempt to put a lid on growth of government expenditure, some cuts in administration have already been announced. Reignited privatization efforts may also reduce the net borrowing requirements for 2010, which would lead to a decrease in the risk premium and could help reduce the public debt service cost.

In our view, a large deficit this year is likely to cause a rise in the public debt by 5 percentage points of GDP to about 52%, which is dangerously close to the precautionary threshold of 55% of GDP. Risks that this ceiling will be breached in 2010 are elevated, but there is a chance that the ratio will stay below this level under a number of assumptions. The political calendar, filled with presidential elections in 2010 and parliamentary elections in 2011, and uncertain growth prospects complicate the issue. Upcoming elections discourage the government to take bold reforms on the expenditure side, and a presidential veto is likely as well. A rise in taxes is not a popular option when the economy narrowly escapes recession. The government will resort to it on a modest scale so it is not going to fix the problem. Therefore, the government will hope that economic growth and privatization of state assets will help limit the rise in the public debt ratio and move the problem forward after elections. Nevertheless, we forecast that the 5.5 to 6 percent ESA-95 deficit in 2009 will be slashed by 1 to 1.5 percentage points of GDP in 2010 due to an increase in public revenue thanks to stronger economic growth and low increase in expenditure. To prevent the debt ratio from rising the government intends to step in privatization and counts on the revenue in the region of 2.5% of GDP. This may be too optimistic, but sales of state-owned firms, in particular in energy generation and distribution, should bring about 1.5% of GDP that would ease the borrowing needs of the government. A possible further appreciation of the zloty should help reduce the zloty value of the foreign currency public debt by another 0.5 to 1% of GDP. The foreign currency component of public debt is around 30% of the total value or less than 15% of GDP, therefore, a 5% appreciation of the zloty would reduce the value of the FCY public debt by some 0.8% of GDP. Assuming this scenario, we come to the ratio of public debt to GDP at 54% to 55% at the end of 2010. Then the precautionary threshold of 55% of GDP would not be breached. However, serious risks would remain that the public debt would rise to over 55% of GDP in 2011 unless strong economic growth resumed and the government dealt with the deficit vigorously. The zloty should continue to firm. A decisive action is unlikely in 2011 for political reasons, as it would result in recessionary tendencies in the year of parliamentary elections and could jeopardize the government chance of reelection. The official data on the public debt in 2011 will not be known until the middle of 2012 so the procedures, listed in the bill on public finance, will have to be applied in 2013. In this case, Poland would have to adopt a state budget bill that would ensure that the ratio of Treasury debt to GDP would remain at 2011 level, which could mean a large reduction in the deficit.

Plans to adopt the euro in 2012 have been shelved by the government due to fiscal problems and the excessive volatility in the foreign exchange markets that rendered fixing the parity of the zloty against the euro an impossible task. Under current circumstances, it is unlikely that Poland will attempt to enter the ERM-2 before the fiscal deficit is on a viable downward path. The government will most likely outline such a scenario in its update of the convergence program late 2009, but then deeds will have to follow to establish the credibility of the program. It could pave the way for an entry into the ERM-2 in the middle of 2010. Then Poland could adopt the euro in 2013, but this is a very optimistic scenario. In a more realistic scenario, Poland would become member of the ERM-2 in 2012, when political consensus will be more likely, and then adopt the euro in 2015. Financial markets do not discount the euro adoption at any date right now.

Table 2. Breakdown of General Government Deficit, % of GDP

	2007	2008	2008 proj.
central govt deficit	3,1	4,2	3,6
local govts deficit	-0,1	0,2	-0,4
social security funds deficit	-1,1	-0,5	-0,5

2008 projections: Convergence Program Update, January 2009

Labor Market

Employment

In the 2Q2009, the labor market situation continued to deteriorate following the overall economic slowdown. Employment in the so-called enterprise sector (the companies employing more than 9 workers) decreased by 1.7% yoy in the 2Q2009, reaching 5,294,000. On the quarterly basis, the number of employed fell by 1.1% in 2Q2009, i. e. by 0.6 percentage point more than in the 1Q2009.

The picture of employment dynamics in specific sectors is mixed. Most of the sectors still record employment growth, but it seems to be more and more sluggish. The situation seems to deteriorate most dynamically in the manufacturing, which is the biggest sector with a 38 percent share in total employment. It drags down the entire employment figure. In the 2Q2009, the number of employees in manufacturing fell by 7.4% yoy and 2.4% qoq.

The y-o-y reduction in a number of jobs in manufacturing only reached 161,000, whereas the total employment fell by 89,000 persons. In other sectors altogether the number of employees actually grew in y-o-y terms by 72,000. It still, however, means that the situation in other sectors deteriorated, as in the 1Q2009, the total employment in „other sectors" grew by 107,000 persons.

Employment growth was still relatively vivid in hotels and restaurants where the number of employees increased by 6.3% yoy. Employment grew also relatively strongly in construction (by 4.4% yoy). In retail trade, employment was still growing in the 2Q2009 (by 2.6%), but much more slowly than in the 1Q2009 when it grew by 4.1%. In other industries, the y-o-y employment growth rate was between 1% and -2.2% and it did not change significantly as compared to the 1Q2009.

The LFS (Labor Force Survey) employment figure was still growing in the 2Q2009. Total LFS employment in that period reached 15,847,000 persons and it was by 1.0% more than in the 2Q2008. In q-o-q terms, LFS employment also increased by 0.8%,. Disregarding the deteriorating situation on the labor market, the indicator of economic activity of population still keep increasing. The number of active population, i. e. those who are either employed or unemployed, increased by 1.9% yoy in the 2Q2009 and the economic activity rate, i. e. the share of active population in total adult population, increased from 53.9% in the 2Q2008 to 54.7% in the 2Q2009.

As the employment reduction in the 2Q2009 was slightly weaker then we expected in the previous PEO issue, we are correcting our employment forecasts upwards. In the 3Q2009, the enterprise sector employment growth should fall in y-o-y terms by 3.0% and by 1.2% qoq. The LFS employment in the 3Q2009 will still be increasing by 0.5%, an equivalent to the q-o-q, mainly seasonal, increase of 1.4%. We expect that in 2009, on average, employment in the enterprise sector will actually fall by 1.6% yoy but the LFS employment will actually keep increasing by 0.5% yoy.

Slightly more optimistic expectations, concerning the employment developments, are also related to the significant reduction in nominal and real wage growth in the enterprise sector observed in the 2Q2009.

Wages

Wage dynamics are going down very sharply. In the 2Q2009, the average nominal wage in the enterprise sector increased by 3.6% yoy, while in the 1Q2009, the y-o-y growth was 6.3%. Real wage dynamics actually fell below zero for the first time since the mid of 2005. In the 2Q2009, real wages fell in y-o-y terms by 0.1%, whereas they increased by 3% yoy in the 1Q2009.

Wage dynamics fell dramatically in all most meaningful sectors. In manufacturing, the y-o-y wage growth fell from 5% in the 1Q2009 to 2.3% in the 2Q2009, similar reductions were recorded in hotels and restaurants section (from 4.3% to 2%) and in retail trade and repairs (from 5.4% to 2.3%).

The strongest fall of the wage growth was recorded in the construction sector, where wages were up by 7.2% yoy in the 1Q2009, whereas in the 2Q2009, wage yoy increase reached only 2.1% yoy. Such a deep reduction of wage dynamics in construction could be one of the reasons for which the employment growth in this sector is still relatively vivid, as we have described it in the previous section.

We consider this dynamic reduction of nominal wage growth, leading even to actual reduction of real wages, as a „healthy" economic reaction to more and more complicated situation on the Polish labor market. This significant wage restraint should limit the employment reduction and then it should also let employment to come back to the growth path as soon as the overall economic situation improves.

We expect this dynamic downward trend to last and, hence, we strongly reduce our earlier expectations concerning the nominal wage growth in the quarters to come. Average nominal wage growth in the 3Q2009 should fall to around 3% yoy and it will result in real wages not growing at all or even slightly falling in y-o-y terms, depending on the actual inflation rate. On average, nominal wages in 2009 should grow by no more than 3.5% and real wages should stay at the level from 2008. During 2010 nominal wage growth on a y-o-y basis can even fall further to the average of 2% yoy.

Unemployment

Unemployment is still increasing. In the 2Q2009, the number of registered unemployed persons reached 1,660,000 and the unemployment rate was 10.7%, which was slightly below the number we forecasted in the previous PEO issue. Unemployment increased by 14% yoy, and it means that unemployment growth rate accelerated as compared to the 1Q2009, when the y-o-y unemployment increase was only 3.3%. In the q-o-q terms, the number of unemployed persons actually decreased by 6%, but it was fully related to the seasonal phenomena. To compare, in the 2Q2008, when the economy was still growing rapidly, the number of unemployed persons decreased by as much as 15% in q-o-q terms.

In order to better disentangle seasonal from actual unemployment variability, similarly as in the previous PEO issue, we have cleaned the unemployment figures for the 2Q2009 from a seasonal component[4]. In the 2Q2009, the seasonally adjusted number of unemployed increased by 5.9% as compared to the 1Q2009. The estimated seasonally adjusted unemployment rate in the end of the 2Q2009 reached 11%, which is equivalent to the seasonally adjusted increase of 0.6 percentage points. As the number of unemployed in seasonally adjusted series increased qoq by 95,000 and in unadjusted series actually fell by 100,000, it means that the total seasonal effect amounted to 195,000, or about 12%.

The other piece of information coming from Public Employment Service, however, is slightly better than in the 1Q2009. The number of unemployed finding new jobs was by only 5% lower than in the 1Q2009, whereas in the 1Q2009 this difference reached 26.8%. The number of those finding unsubsidized jobs also dropped more slowly that in the previous quarter – by 7.8% yoy as compared to 27.7% yoy in the 1Q2009. Additionally, the employment offices were able to increase the number of subsidized jobs they offer by 5.7% yoy. For the first time since the 2Q2007, the employment offices were also able to increase the number of persons participating in other active labor market programs such as training or apprenticeships. The number of unemployed who started such programs in the 2Q2009 was by 16% higher than in 2Q2008.

Unfortunately, one still records a high growth rate of inflow of newly unemployed persons into registers. In the 2Q2009, the number of the new unemployed increased by 25.6% yoy. The slightly optimistic part of that is, that the growth rate in the 1Q2009 was higher, reaching almost 36% yoy.

The LFS data from the 2Q2009 are still not as pessimistic as those coming from the registers of Public Employment Services, although they also indicate a serious worsening of the labor market conditions. 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 y-o-y unemployment growth amounted to 3.9%. The LFS unemployment rate reached 7.9%, i. e. 0.8 percentage points more than in the 2Q2008.

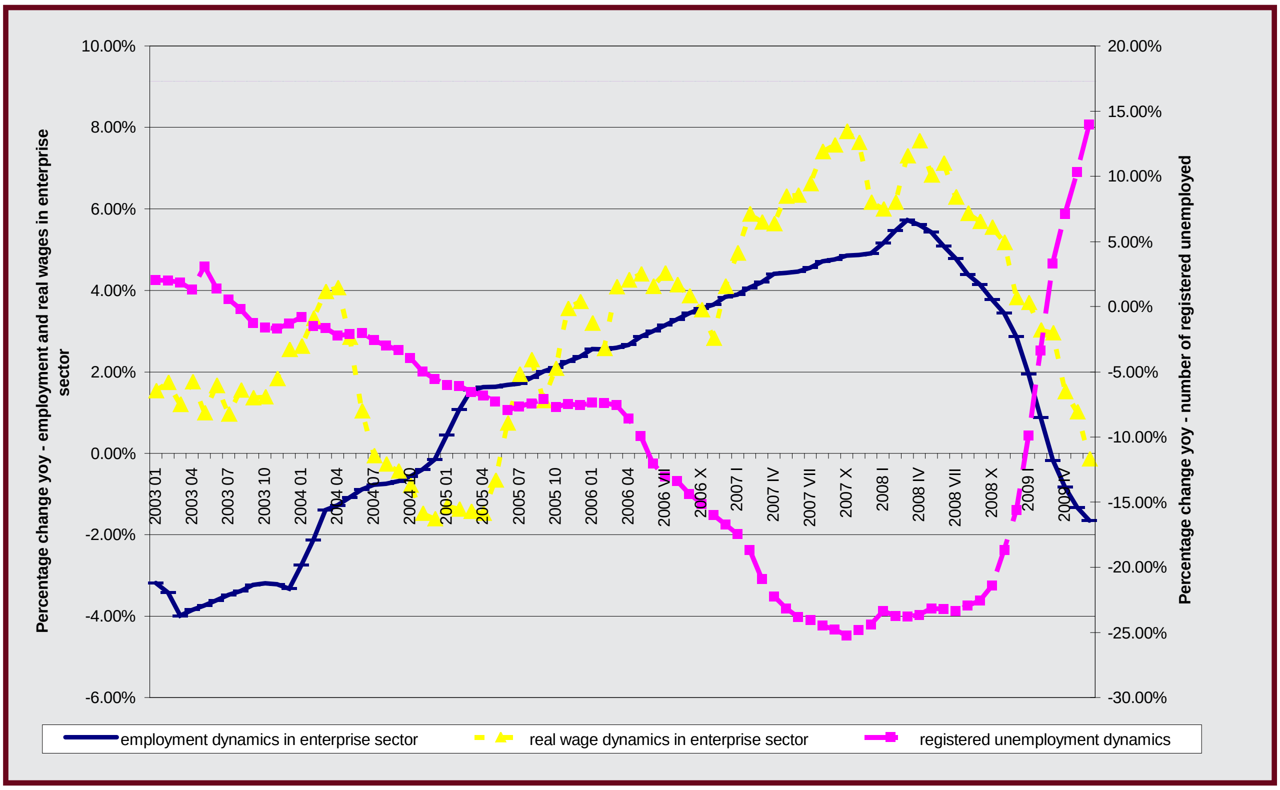
The unemployment increase, accompanying still growing employment results from a dynamic increase of the number of active population in recent period. We will be able to tell more about this phenomena as soon as detailed LFS information is be published by the Central Statistical Office. We will then come back to this subject in the next PEO issue.

We expect the registered unemployment rate to increase to 11.3% in the 3Q2009 so it will be by 0.6 percentage point more than in 2Q2009 and by 2.4 percentage point more than in 3Q2008. The LFS unemployment should also continue to grow at the increasing pace. In the 3Q2009, it should reach 7.5%, increasing in yoy terms by 0.9 percentage points. Both, registered and LFS unemployment will continue to grow in the rest of 2009. We expect the registered unemployment rate to reach 12.7% at the end of 2009, while

[4] De-seasoning performed using the DEMETRA 2.1 software and Tramo/Seats methodology.

the LFS unemployment rate will probably grow to about 8%. It means we do not significantly alter our unemployment forecasts from the previous PEO issue. It results from the fact that actual labor market developments seem to broadly follow our expectations thus far.

Figure 8. Employment and real wage dynamics in enterprise sector; and registered unemployment dynamics in Poland 2003-2008.



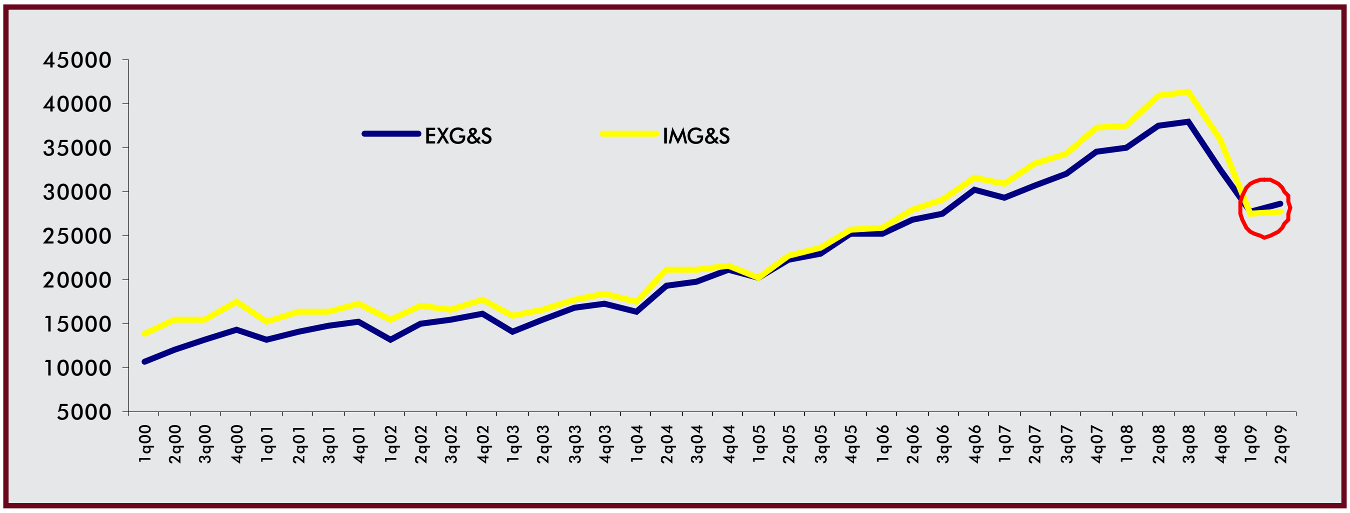
Source: Own calculations based on Statistical Bulletins of Polish CSO (GUS)

External Trade and Balance of Payments

The rate of decline in exports bottomed out in the 2Q2009 while the scale of import collapse increased. According to the NBP monthly data, exports and imports of goods in the euro terms decreased by 22.8% and 32.0% on a year ago in the 2Q2009, respectively. In the same period, the zloty exports and imports of goods decreased by???? yoy and???? yoy, respectively. We continue to report export and import changes in zloty terms, because they seem to better approximate changes in trade volumes due to wide fluctuations in the exchange rates in 2008 and the 1Q2009; volume data on the 2Q2009 were not available from the CSO as of writing.

Exports and imports of services, expressed in euro terms, held better than exports of goods in the 1Q2009, but the declines were similar in the 2Q2009, when exports and imports of services decreased by 22.4% yoy and 31.2% yoy, respectively, so they did not prove more immune to the crisis than flows of goods. Like in the 1Q2009, exports of goods and services were higher than imports of them in the 2Q2009. This turnaround in the foreign trade balance continues to surprise because of a positive differential in GDP growth between Poland and its main partners, in particular in the EU whose economies strongly shrank. Apparently, the huge shock of the zloty depreciation for the Polish companies caused a collapse in imports that more than offsets the differential rates of growth. This would suggest that imports should rather quickly recover once growth, optimism are restored against the back drop of the zloty strengthening. Yet, it is unlikely to happen before 2010 because confidence is still shaky.

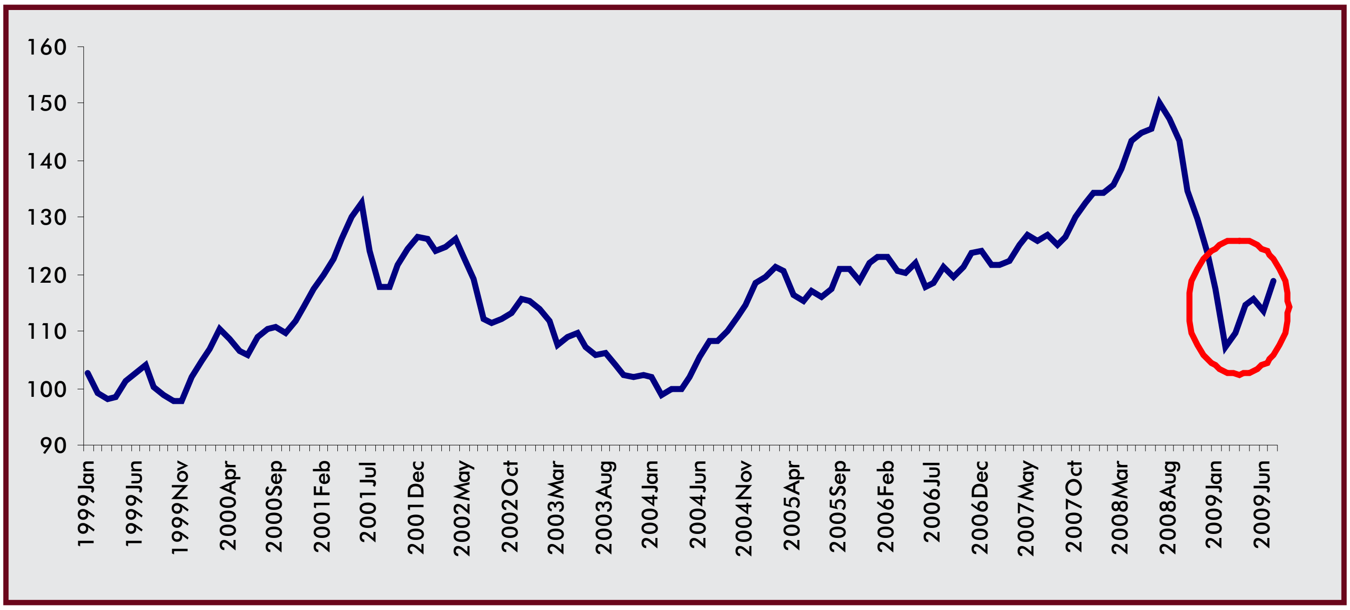
Figure 9. Exports and Imports of Goods and Services, quarterly, EUR million



Source: NBP

These trends induced a very sharp decline in the foreign trade deficit that came almost balanced in the 1H2009, i. e. it amounted to -538 million euros in the 1H2009 versus -7573 million euros in the 1H2008. In GDP terms, it dropped to 2.7% of the estimated GDP in the 2Q2009 from 4.6% in the 4Q2008. This decline was the main cause, why the rolling four-quarter current account deficit halved rapidly, i. e. it fell to estimated 2.7% of GDP in the 2Q2009 from 5.4% of GDP in 2009. A significant decrease in the income deficit was another reason: it decreased to estimated 2.4% of GDP in the 2Q2009 from 3.3% of GDP in the 4Q2008 on the back of lower profits of Polish corporates. Meantime, service and transfer surpluses increased slightly. Such a rapid improvement in the current account may result in its position close to balance in 2009 unless the economic growth in Poland unleashes more import growth in the 4Q2009.

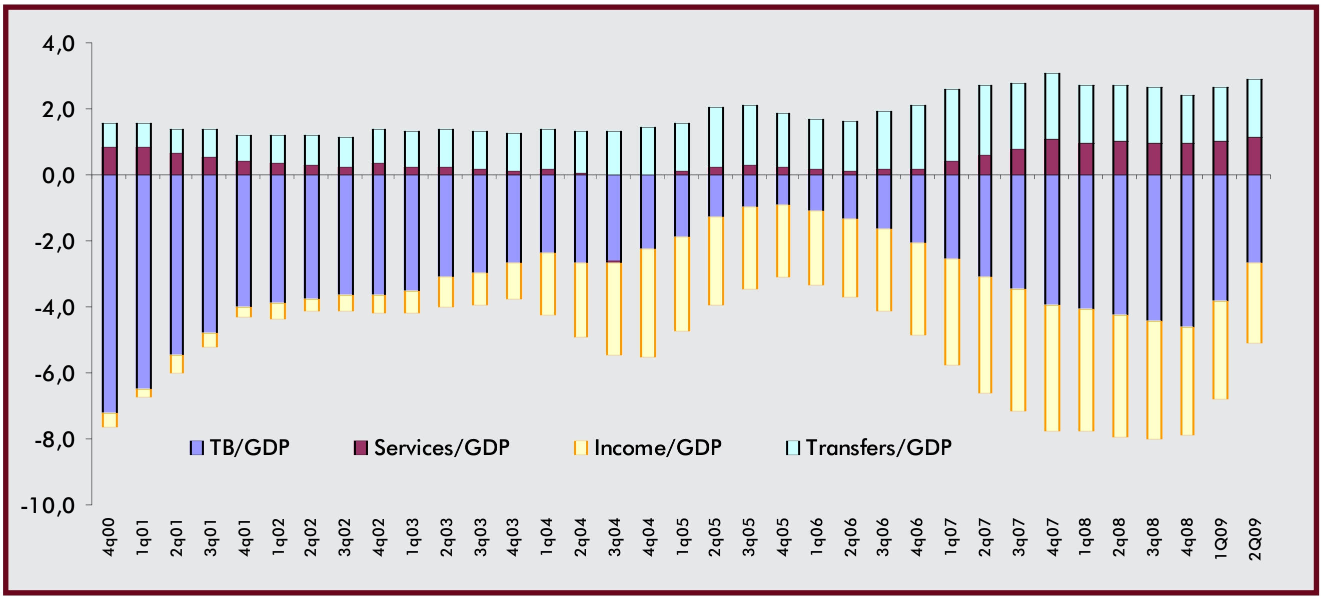
Figure 10. Real Effective Exchange rate of Poland, CPI deflated



Source: ECB

Our qualitative forecast with regard to the tendencies, exhibited by the current account components, remains unchanged. Restoration of growth in the European economy in the 2H2009 should help arrest a further slide in Polish exports in euro terms since they are highly competitive despite the recent appreciation of the zloty across the board of currencies. Growth in exports year on year should resume in the 4Q2009. Import will react only with a lag to the recovery in GDP growth so the trade balance should continue improve through 2009. The trade deficit should shrink to 1.0% – 1.5% of GDP. Net income deficit will continue to decline to about 2.0% of GDP while net transfers should be around 1.8% of GDP.

Figure 11. Current Account Breakdown, as % of GDP



The question how the deficit could be financed under the crisis conditions on the global financial markets has become irrelevant as the current account should be near equilibrium in 2009. Hypothetically, it is still interesting. The current account deficit, adjusted for the capital account inflow, was 0.8% of estimated GDP in the 2Q2009 and is likely to turn to a surplus at the end of the year so the surplus can cover shortfall of 1.5 to 2.0% of GDP. The rolling four quarter net FDI inflows stood at 2.1% of GDP in the 1Q2009, but dropped to about 1.1% of GDP in the 2Q2009 as these inflows were negative in the 2Q2009. They probably reached a trough, but the world-wide short-term outlook for FDI is still bad. If Poland's growth prospects improve, we should see a turnaround in FDI inflows by the end of the 3Q2009, but this is uncertain. Much will depend on renewed privatization efforts by the government. Let us say that they would be conservatively estimated at 1% of GDP. Portfolio capital inflows turned strongly positive in the 2Q2009 after two quarters of a decline. This augurs well for financing the current account deficit should there need be, but they are erratic so let us assume that they would be close to zero over a year. All this suggests that Poland could comfortably finance a deficit of 2 to 3% of GDP with a recourse to bank loans. However, for now the cash flows balance points to their surplus in 2009. The July appreciation of the zloty was a result of it, but the strengthening trend should continue.

L, U, V or W – the Shape of the Recovery to Come

The world economy has most likely bottomed out and the recovery has started. Most economic data have been positive in the past few months. The advanced world economies were close to the bottom in the 2Q2009 while South East Asia and China began to grow vigorously. The EU economy declined only seasonally adjusted 0.2% qoq in this period versus 2.4% qoq in the 1Q2009 while US GDP decreased 0.3% versus 1.6%. According to OECD estimates, GDP in China grew at the seasonally adjusted and annualized rate by 14% in the 2Q2009. A number of other economies recorded annualized rates close to or of more than 10% in the 2Q2009 as well: South Korea, Thailand, Hong Kong and Singapore. Thanks to China, with its heavy weight, industrial output in emerging Asia revived so rapidly in the 2Q2009 that it bounced back to its level before the crisis.

The resumption of growth is driven by the accumulation of inventories that were abruptly shed when the global demand collapsed in the 4Q2009. The near-term prospects for the world trade are better as the world economy is stabilizing. Overall financial conditions improved as the cost of money market funding fell, corporate bond spreads narrowed, commercial banks moderated the pace of tightening loan standards and equity markets surged. The US housing market, where the crisis began shows first signs of stabilization as sales of existing and new homes rose and prices stopped declining. Favorable developments are also visible in the housing market in UK.

Economists have lively debated for some time how the future recovery will look like. Most of them are convinced that global economic growth will be weaker in the years to come than it was in the preceding recovery. The post-crisis world will likely look different since the economic crisis was ignited by the global financial crisis and such crises tend to make downturns more prolong. The reason is that the access to capital will be more difficult as risk aversion has permanently risen, which will raise the cost of capital. Financing conditions are unlikely to revert to the low interest rates and narrow credit spreads during the credit boom of 2003-07. The prospective unwinding of big monetary and fiscal stimuli will tend to dampen aggregate demand as private demand may not step in to replace the governments.

This piece briefly discusses prospects for different shapes of world-wide recovery and how these types of recovery would impact Poland.

L shape

There were widespread fears at the climax of the financial crisis in the 4Q2008 that the world economy may remain depressed for a number of years like it was during the Great Depression. The basic Keynesian model, which shows how an economy can become stuck at an equilibrium with a low use of capacity was at the foundation of this scare. At present, this does not seem the case as the current economic data point to a solid pickup in economic activity. The scenario of a non-growth world cannot be entirely dismissed at this juncture, but the potential of emerging world to grow will counter the stagnation tendencies in the advanced countries.

U or V shape

We are watching a V-shaped recovery in South-East Asia and China, i. e. in the emerging markets that were not directly involved in the global financial crisis. This has taken many observers by surprise because the developed economies remain weak, which means that demand for export-dependent Asian economies should remain weak as well and hamper their recovery. However, Asia has become a driving force of the world-wide recovery. The reason is that the downturn was severe, but it was only partly caused by the collapse of demand in the developed world. Domestic demand was also softened by tight monetary policies when prices of commodities, mostly imported, and prices of foodstuffs reached their cyclical peaks in 2008, threatening with high inflation. Since the slump also had domestic roots, Asian economies have been propped by aggressive fiscal stimuli that are worth at least 4% of GDP, and easy monetary policy that became possible when commodity prices fell. These countries could afford highly expansionary policies because their public finances were in a better shape than in many western economies. Further their debt-to-GDP ratios are still relatively low, unlikely to hit 50% this year. The bottom line is that a global rebalancing, with an increase in domestic demand from countries with a current-account surpluses, should continue to make this recovery sustainable.

It remains unclear whether the V-shaped recovery is sustainable once the stimulus is withdrawn and when Asia cannot rely on a strong revival of US imports. It has to switch to domestic sources of growth. This is possible as households are modestly indebted so domestic consumption has a capacity to grow when taxes are cut. Financial systems have not been destabilized by investments in „toxic assets" so banks do not refuse loans, for which demand has grown thanks to reduced interest rates. If public investment into infrastructure is coupled with private investment, the strong recovery will be sustained. However, the side-effect of very easy monetary policies are stock market booms that feed bubbles with their potential to destabilize economies when they burst.

Paradoxically, it is Asia that can help pull Europe and US out of recession and not vice versa, but both regions will most likely experience a U-shaped recovery anyway. Asia's positive impact on the advanced world cannot replace domestic sources of growth in Europe and the USA since its imports are too small. American consumers cannot go on a shopping spree any longer. Massive unemployment will not decrease quickly so it will depress consumer spending for a couple of years. US households are too indebted and their wealth has been reduced by a collapse in real estate and stock market prices. Further, regulators will demand from banks that they raise more capital so they will have lower capacities to lend even if they wanted to. At some point the fiscal and monetary stimuli will have to be withdrawn. Large fiscal deficit will have to be reduced in order to reverse the course of public debts to grow relative to GDP. Monetary policy will have to be tightened in order to avoid a pickup in inflation. What needs to happen for this recovery to become self-sustaining is that private demand will step in for public demand. Because it will take time to rebuild activity, the recovery will be sluggish.

Double dip

There are fears that the second round effects of the crisis will derail the world economy once more. This time the story is standard and based on a feedback loop. The collapse of the global financial system has triggered an economic slump, but this, in turn, will cause balance sheets of financial institutions to deteriorate further so they will clamp on lending once again, causing a deeper downturn. It is true that the deepest recession since the WW2 has left many firms with low capacity to service debts and, since recovery will be gradual, revenues of firms will rise only gradually as well. Commercial real estate will lose in value as a collateral. Consumers will also report more ill-serviced credits as unemployment will continue to rise into 2010. In this scenario, banks will see their quality of loan portfolios to deteriorate further and they will have to cope with more losses. Consequently, they will tighten credit standards once again. This will lead to another downturn. Double dips are very rare in the world history. The previous such an episode in the US happened in 1980, but then it was not triggered by the weakness in the financial sector. The second dip was due to the tightening of monetary policy when high inflation reached double digits after the second oil shock and inflationary expectations were ratcheted up. The Fed decided to break with the past and switched to monetary targeting from interest rate targeting in 1979-1982. This led to high levels and volatility of short-term interest rates. Tight monetary policy caused the deepest after-the-war recession.

Poland

This short discussion points to serious doubts whether the world will have the same potential to grow in the post-crisis period as before. Let us quote the recent OECD report taking stock of the literature how recessions impact potential growth. „Recent OECD research also finds evidence of persistent output losses from financial crises. Furceri and Mourougane (2009) estimate that financial crises permanently lower potential output level by 11 to 21 per cent on average, and by up to 4% for severe crises. Fewer studies find evidence of a permanent effect of financial crises on potential output growth, although clearly this is inherently difficult to identify. Haugh et al. (2009) examine OECD estimates of potential output growth and their components around severe banking crises, but find little evidence of long-lasting effects on potential growth, although there are differences across episodes."

The debate is not conclusive, but this suggests that Poland's potential growth rate should not decline due to the crisis. However, intuition tells hat depending on the shape of the world recovery Polish economy will expand at a differential medium-term rate. Nonetheless, there are a number of domestic factors that may offset the slower expansion of the world economy. With these ingredients in place, the difference may be between the midterm annual growth rate of 4% and 5%, not between 2% and 5%.

The following factors will tend to dampen potential growth in Poland. Poland has the strongest trade and capital ties with the EU countries, where it send about 79% of its exports of goods. If growth in the EU and, in particular in Eurozone, were sluggish in the years to come this would adversely affect the expansion of Polish exports. When only foreign trade is considered, the second most important region is Eastern Europe: Belarus, Russia and Ukraine, where 10% of exports is sent. Eastern European countries belong to the most affected economies by the crisis as they are dependent on exports of commodities and inflows of foreign capital. If the crisis is prolonged in Eastern Europe that will constrain the export expansion as well.

Slow growth in Eurozone means that less capital, in particular in the form of FDI, may flow into this country. This can be a self-reinforcing process as diminished expectations of future demand for Polish exports can lead to a downscaling of investment projects by international corporations that would target the EU market with their produce. This means that fixed business investment in Poland would suffer. The increased cost of capital in the post-crisis world may also affect the dynamics of investment in Poland. However, were Poland to launch a credible program of the euro adoption, these spreads would tend to decline and this would offset the impact of the current global crisis so the effect is ambiguous in the future.

There exists an argument that global growth would also suffer in the post-crisis world from the cuts of the R&D spending by multinational corporations. Poland does not risk too much in this respect since it is not on the innovation frontier and, at this stage of development, its main task is still to emulate the best technologies and management practices. Adverse influence on total factor productivity from this factor will rather be negligible.

Even if the global recovery were U-shaped, Poland should be capable of growing relatively fast, say, return to 5% GDP growth, provided it will enact proper structural reforms. The main thrust despite recent considerable progress (substantial reduction in the number of early pensioners, lower non-wage costs) should be to raise labor force participation that is among the lowest in Europe. Product markets should also be reformed and privatization is the most crucial of them. The state-owned sector of firms produces around 30% of the total value added in the economy. Much more than in the advanced world where it is downscaled to between 5% and 15%. Its productivity is markedly lower than that of the private sector. Energy generation and distribution, chemical industry, coal mining, shipyards insurance company PZU, Warsaw Stock Exchange, the bank PKO BP should be all destined for sale to enhance the efficiency of the economy. The third ingredient of strong growth should be the absorption of the available EU structural funds that are estimated between 3% to 4% of GDP in 2007 – 2013. The decrepit road and rail infrastructure is a hindrance to boost economic growth in Poland. If these elements are in place Poland should weather well a possible mid-term slowdown of the global growth and even accelerate its pace of catching up.

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