

Poland—Concluding Statement of the 2010 Article IV Consultation

Warsaw, March 15, 2010

Poland has weathered the global crisis well compared to other European countries.

1. **Poland is the only EU economy to have escaped a recession in 2009.** Its large domestic market and attendant limited reliance on exports, coupled with a well-capitalized and profitable banking system, limited the negative spill-over from the global crisis through both real and financial channels. Moreover, policy makers took advantage of the room for maneuver afforded by limited pre-crisis imbalances and the flexible exchange rate policy to provide significant monetary and fiscal stimulus.

2. **A large and timely fiscal stimulus was particularly helpful.** Discretionary fiscal relaxation of an estimated 1¾ percent of GDP in 2008 and 2½ percent of GDP in 2009, together with a fall in revenues due to the economic slowdown, increased the general government deficit from under 2 percent of GDP in 2007 to over 7 percent of GDP in 2009. While the Government initially intended to offset revenue shortfalls to the extent needed to maintain the state budget deficit below the limit of Zloty 18 billion in 2009—through what would have been highly pro-cyclical expenditure cuts—it appropriately changed such plans at mid-year, when it increased the deficit limit to Zloty 27 billion. Thus, fiscal policy—through a combination of discretionary relaxation and the work of automatic stabilizers—has provided a much welcomed counter-cyclical stimulus in 2008-09. This was one of the key factors preventing Poland from falling into recession.

We expect a continued but gradual rebound.

3. **The outlook is favorable.** The global environment is improving; the balance-sheet adjustment in the Polish banking system appears to have run its course, with renewed risk appetite suggesting that banks are ready to cautiously expand credit; and, not least, EU funds to Poland are expected to almost triple in the next few years. Against this background, we expect a continued recovery in domestic demand, in particular public investment. As a result, growth is set to gradually increase to around 2¾ percent in 2010 and 3¼ in 2011. With the economy still operating below capacity and wage growth constrained by elevated unemployment, inflation is expected to remain contained.

A neutral monetary stance and a gradual fiscal tightening are thus warranted.

4. **We do not see the case for raising policy interest rates.** The Monetary Policy Council (MPC) appropriately accommodated the economic slowdown by lowering the policy rate by a cumulative 250 basis points. Despite upward pressures on the zloty, the MPC announced last October that the cycle of rate cuts was ending, reflecting renewed concern about inflation. The February Inflation Report has inflation rising above the upper end of the band during the forecast period, and the market consensus is for the MPC to begin raising policy rates later this year. However, in our view, inflation is likely to remain around the mid-point of the band, suggesting that a rise in rates would not be warranted any time soon.

5. **Government plans for fiscal consolidation remain to be fully specified.** The rebound of growth under our baseline scenario suggests that it is time to begin withdrawing the fiscal stimulus, in order to place the debt-to-GDP ratio on a sustainable downward path. While the Government has ambitious targets for deficit reduction, its program for achieving them remains to be fully specified:

- We project the general government deficit to remain at an elevated level of 7¼ to 7½ percent of GDP in 2010. Under current policies, and including announced but not yet approved measures, the deficit will fall only slowly, to just under 7 percent of GDP in 2011 and about 5¾ percent of GDP in 2012. As a result, the general government debt-to-GDP ratio on an ESA95 basis is, in our view, set to continue to increase, peaking at about 62 percent of GDP by 2014 (including debts of the National Road Fund that are excluded from the national definition of debt).

- We believe that the consolidation path should be calibrated with a view to setting the debt-to-GDP ratio on a downward trajectory from 2012-13. This would require additional structural fiscal measures—over and above what already has been announced—of some ½ to 1 percent of GDP annually during the next 4-5 years. With such measures, the deficit would fall below 3 percent of GDP by 2013-14. Reducing it to 3 percent already by 2012 would, in our view, be too ambitious, considering that the economic recovery is incipient and still uncertain. Thus, we believe that our proposal strikes an appropriate balance between short-term cyclical and medium-term sustainability concerns.

- The substantial fiscal adjustment needed over the medium-term will require changes in entitlement programs, given the high share of statutory spending in total expenditures. In our view, a durable expenditure reduction is unlikely to be achieved merely by temporary expenditure rules that limit the real growth of flexible spending to one percent per year, as planned. However, we agree that such rules, reinforced by comprehensive expenditure reviews, could prove very helpful in controlling discretionary spending.
- The medium-term fiscal framework needs to be further strengthened. The recently introduced four-year rolling fiscal plans are useful in providing guidance on medium-term policy goals. However, they are non-binding and remain focused on nominal deficits, maintaining a pro-cyclical bias in fiscal policy. Hence, there is a need to implement a permanent binding expenditure rule consistent with the authorities' medium-term targets and supported by a determined implementation of the ongoing multi-year performance budgeting reforms at all levels of government.
- There is an ongoing debate in Poland on whether to lower transfers to private pension funds. Poland has been ahead of most countries in implementing reforms to ensure the long-term sustainability of its pension system. This is evident from cross-country comparisons by staff using more comprehensive, intertemporal measures of Poland's net worth. Paradoxically, traditional deficit and debt indicators—including the definition of the Maastricht deficit limit and debt limits under Polish legislation—are worse as a result of these important reforms. In view of this, suggestions have been made to lower transfers to private pension funds in order to reduce fiscal costs. We are concerned that this could be seen as a more fundamental reversal of pension reforms at a time when the credibility of Poland's commitment to medium-term fiscal consolidation hinges on political support for further reforms of entitlement programs. As regards pursuing alternative proposals, including redefining the national debt definition and corresponding debt thresholds in the Public Finance law, this should be done in such a way as not to undermine confidence in the fiscal framework and not to encourage spending pressures.

Upside risks: policy challenges from larger capital inflows or a faster domestic rebound.

6. Failure to adjust policies in a timely fashion, if upside risks materialize, could cause excessive upward pressures on the zloty. At this time, we see two possible (but still unlikely) upside risks relative to the slow-but-steady improvement embodied in our baseline: larger-than-expected capital inflows, if ample liquidity and low interest rates in advanced countries, coupled with increased concern about sovereign risks of highly-indebted European countries, were to cause an even stronger demand for assets of good performing emerging market countries like Poland; and a much faster-than-expected recovery in domestic demand, if investor confidence and risk-appetite in the banking system improve more rapidly. The necessary policy corrections would be different in these two cases. But in both cases, failure to adjust policies could eventually cause excessive upward pressures on the zloty, although there is no evidence yet of Poland having become uncompetitive as a result of the appreciation during the last year:

- If foreign demand for Polish assets continues to build up and inflation remains contained, the MPC should consider resuming the reduction in policy rates. Moreover, as mentioned by some policy-makers recently, under these circumstances, the NBP could also consider temporarily undertaking limited pre-announced foreign-exchange intervention. Such intervention should be transparent and well-communicated so as not to compromise the integrity of the inflation-targeting framework. Moreover, the limitations on foreign-currency lending recommended below for prudential reasons could have the auxiliary benefit of slowing capital inflows. Nevertheless, the flexible exchange-rate policy remains the main defense against a sustained surge in capital inflows.
- In the near term, there appears to be little risk of macroeconomic imbalances caused by much stronger-than-expected private sector demand. However, considering that the medium-term fiscal program for lowering the structural fiscal deficit remains to be fully specified even under the baseline scenario, the risk that fiscal policy will be unable to respond in a timely and effective manner to much stronger demand relative to the baseline appears to be increasing as the time horizon is extended. In that case, the burden of adjustment would fall mainly on

monetary policy, with the attendant risk of zloty appreciation. This further highlights the importance of specifying plans for reducing fiscal deficits to a sustainable level.

Downside risks: renewed deterioration in the global environment.

7. Downside risks are likely to arise mainly from external developments. Poland has monetary and fiscal policy space to undertake stimulus measures in case a renewed deterioration in global conditions leads to negative spill-over through real and financial channels. Moreover, during the last year, the availability of FCL resources has provided an important safeguard against negative tail risks. Thus, market participants have stressed that the FCL was an important reason for the reduction in sovereign spreads, not least on zloty bonds, even as the public sector's borrowing need surged. With this need remaining elevated, policy makers—when considering whether to request a renewal of the FCL—should focus in particular on whether there is a need for insurance against pressures in the foreign-exchange and government bond markets in the event of a more general retreat globally from sovereign debt markets.

The authorities should consider limiting foreign-currency exposures.

8. The Polish banking system is well buffered, and credit is set to gradually revive. Capital adequacy ratios are back at pre-crisis levels, helped by the KNF's proactive recommendation to retain the record-high 2008 profits. Moreover, profits remained robust in 2009, reaching about two thirds of the preceding year's levels. While non-performing loans are still rising, their rate of growth is slowing, and such loans are likely to stabilize during 2010. Against this background, banks are expected to begin to expand credit cautiously as investor sentiment begins to recover. In the context of renewed risk appetite, the introduction of Recommendation T constitutes a timely strengthening of what are uneven lending standards for household loans. Moreover, the efforts to bring SKOKs under the KNF's supervision are welcome.

9. The authorities need to guard against the risk of a rapid increase in foreign-exchange exposures. The experience of a number of regional peers during the 2008-09 crisis was that large un-hedged foreign exchange liabilities led to balance-sheet stress and significantly curtailed policy options, exacerbating the recession through pro-cyclical policies. In view of this, and with risk appetite returning, the KNF should, in our view, take forceful steps to prevent a rapid growth of foreign-exchange lending, not least the extension of foreign currency-denominated mortgages. A first useful step is for the KNF to ensure that foreign-exchange lending is funded and hedged on a longer-term basis. Moreover, capital requirements on foreign exchange-denominated mortgages should be raised decisively to reflect higher credit and valuation risks. To ensure the effectiveness of this measure, close cooperation with home supervisors is essential. If such prudential measures were ineffective in slowing foreign currency-denominated mortgages, the Government should consider legislation imposing explicit constraints.

Structural reforms are key to boosting long-run growth.

10. Poland's exceptionally low labor participation continues to represent an obstacle to long-run growth. The authorities have taken important steps to address this concern, including the discretionary measures in 2008-09 to reduce the tax wedge and the tightening of eligibility criteria for early retirement. We are encouraged by the Government's determination to continue to advance labor supply-enhancing reforms. In this regard, we support reforms that have a complementary long-term fiscal impact, such as pension reforms aimed at gradually increasing and equalizing the retirement age between men and women, and including special pension schemes within the general system. Such efforts could usefully be complemented by reducing rigidities in product markets through a continuation of the ambitious privatization agenda and reduction of administrative barriers to business activity.

Euro adoption is an important long-term goal for Poland.

11. The intention to delay Euro adoption is appropriate at the current juncture. In view of the large adjustment needs in the next few years and the continued uncertainty in the economic outlook, early ERM-II entry would be risky. Moreover, in determining when to adopt the Euro, policy-makers should be mindful of the fact that exchange-rate flexibility was an important shock absorber facilitating Poland's adjustment to the global crisis, and that a higher degree of synchronization between external shocks facing Poland and the Euro area should be achieved before giving up the independent exchange-rate policy.

We would like to thank the authorities for their hospitality and a fruitful exchange of views.

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