INTERNATIONAL MONETARY FUND

IMF Country Report No. 17/220

REPUBLIC OF POLAND

July 2017

2017 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR REPUBLIC OF POLAND

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2017 Article IV consultation with Republic of Poland, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 7, 2017 consideration of the staff report that concluded the Article IV consultation with Republic of Poland.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 7, 2017, following discussions that ended on May 18, 2017, with the officials of Republic of Poland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 23, 2017.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Republic of Poland.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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Press Release No. 17/285
FOR IMMEDIATE RELEASE
July 17, 2017

International Monetary Fund
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Washington, D. C. 20431 USA

IMF Executive Board Concludes 2017 Article IV Consultation with Poland

On July 7, 2017, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV Consultation[1] with Poland.

The near-term growth momentum remains strong, supported by accommodative monetary and fiscal policies and sizeable EU transfers. The economy is operating above potential, with the unemployment rate at a historical low. Growth is projected to accelerate to 3.6 percent in 2017 and remain strong in 2018. Long-term growth, however, will be more subdued, unless adverse demographics and structural constraints on investment and productivity growth are addressed.

Risks to the near-term outlook are broadly balanced. Externally, while stronger-than-expected recovery in advanced economies would be a boon for Poland, on the downside, a faster-than-expected tightening in the global financial conditions, as well as growth, financial or political shocks in Europe, would have a negative impact. Domestically, both growth and inflation can surprise on the upside if the EU funds' absorption and investment rise further or if wage growth accelerates faster than expected. On the downside, a delayed monetary policy response could lead to inflation overshooting its target, while a weakening of institutions or fiscal slippages could dent investor confidence.

Policies have focused on supporting growth, with the central bank aiming to ensure a gradual return of inflation to target. Monetary policy remains accommodative, with policy rate kept at a historically low level since early 2015. The 2017 general government budget deficit of 2.9 percent of GDP represents a pro-cyclical stance and is only marginally below the Excessive Deficit Procedure (EDP) limit. In this regard, the fiscal performance so far this year has been very encouraging, and the authorities intend to resume fiscal consolidation next year with an adjustment in the structural and headline deficits of about half a percent of GDP. The banking sector remains well capitalized, but profitability continues to decline amid low interest rates and rising non-interest costs. The final solution to foreign currency mortgage loans is still pending, but will likely entail further costs to banks. The recently adopted Responsible Development Strategy sets ambitious targets to achieve fast convergence to the EU living standards, but much work lies ahead to translate the strategy into concrete reform plans and to ensure a consistent policy mix.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Board Assessment

Executive Directors commended Poland's very strong policy and institutional frameworks. They noted, however, that maintaining strong and inclusive growth over the medium term would require advancing structural reforms to lift investment and productivity, as well as addressing demographic challenges. Sound institutions and macroeconomic policies would strengthen Poland's resilience against external risks.

Directors agreed that the accommodative monetary policy stance is appropriate for now, but stressed the need to closely monitor domestic inflationary pressures. Given the uncertainties surrounding future wage growth, monetary policy should be data-dependent to ensure a timely response and avoid overshooting the inflation target. A clear state-contingent rather than time-bound communication strategy would help to better guide inflation expectations.

Directors commended the strong fiscal performance and improved tax collection so far this year. They urged the authorities to start consolidation as soon as possible to reverse the pro-cyclical stance, and build a buffer relative to the Excessive Deficit Procedure (EDP) limit already this year, taking advantage of the cyclical upswing and saving any revenue overperformance. Directors welcomed the authorities' intention to reduce the headline and structural deficits by about half a percent of GDP per year during 2018–19, and supported the medium-term objective of cutting the structural deficit to one percent of GDP.

Directors stressed the importance of high quality and permanent measures to underpin a growth-friendly fiscal adjustment. They noted the authorities' efforts to improve tax administration, but suggested conservative budgeting of potential gains. They urged the authorities to consider additional measures to ensure that they achieve their fiscal objectives. Such measures could include eliminating preferential VAT rates and exemptions, rationalizing current spending and improving public expenditure efficiency, and gradually phasing out preferential pension regimes.

Directors stressed the importance of preserving financial sector resilience for future growth. They noted that the banking sector remains sound, but that profitability has continued to decline amid a low-interest rate environment and rising regulatory and tax burden. Directors highlighted the need to monitor the impact of the bank asset tax. They also underscored that the solution to address consumer protection concerns related to foreign-currency mortgages should preserve financial stability and banks' lending capacity, and noted that a case-by-case approach would be preferable. Directors also noted the rising sovereign-bank linkages, and underscored the need to maintain strong and independent financial supervision and macroprudential oversight.

Directors encouraged the authorities to advance structural reforms to boost potential growth. They noted the ambitious targets set by the Responsible Development Strategy, and called for prioritization with the focus on streamlining product market regulations, implementing more effective labor market policies, and improving the efficiency of the EU-funded investment in infrastructure and R&D. Directors also encouraged measures to increase labor force participation and incentivize employees to remain longer in the workforce.

Republic of Poland: Selected Economic Indicators, 2013–22

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
				Est.			Projections			
Activity and prices										
GDP (change in percent) 1/	1.4	3.3	3.9	2.6	3.6	3.3	3.0	2.8	2.7	2.6
Domestic demand	-0.6	4.9	3.3	2.4	4.0	3.8	3.3	2.9	2.8	2.7
Private consumption growth	0.3	2.4	3.0	3.8	4.2	3.5	3.2	2.8	2.6	2.4
Public consumption growth	2.5	4.1	2.4	2.8	2.1	2.3	2.3	2.1	2.0	1.9
Domestic fixed investment growth	-1.1	10.0	6.1	-7.9	5.8	6.0	5.0	4.4	4.4	4.4
Inventories (contribution to growth)	-1.0	0.6	-0.2	1.3	-0.1	0.0	0.0	0.0	0.0	0.0
Net external demand (contribution to growth)	2.0	-1.4	0.6	0.3	-0.2	-0.4	-0.3	-0.1	-0.1	-0.1
Output gap	-1.2	-0.9	0.0	0.1	0.7	0.9	0.9	0.7	0.6	0.4
CPI inflation (percent)										
Average	0.9	0.0	-0.9	-0.6	2.1	2.5	2.5	2.5	2.5	2.5
End of period	0.7	-1.0	-0.5	0.8	2.3	2.6	2.5	2.5	2.5	2.5
Unemployment rate (average, according to LFS)	10.3	9.0	7.5	6.2	5.3	4.5	4.3	4.2	4.2	4.2
Public finances (percent of GDP) 2/										
General government revenues	38.5	38.8	39.0	38.8	39.8	40.3	40.1	40.0	39.9	39.9
General government expenditures	42.6	42.3	41.6	41.3	42.6	42.9	42.8	42.3	42.0	41.8
General government net lending/borrowing	-4.1	-3.5	-2.6	-2.4	-2.8	-2.7	-2.7	-2.3	-2.1	-1.9
General government structural balance	-3.3	-3.1	-2.6	-2.5	-3.1	-3.0	-3.0	-2.6	-2.3	-2.1
General government debt	55.7	50.2	51.1	54.4	54.3	53.9	53.5	53.0	52.3	51.6
National definition 3/	53.3	48.1	48.8	50.1	...	...	...	...	...	...
Money and credit										
Private credit (change in percent, end-period) 4/	4.4	7.5	7.5	5.0	6.8	6.5	6.0	5.9	5.7	5.5
Credit to GDP (percent)	53.5	55.4	56.9	58.0	58.8	59.0	59.2	59.5	59.8	60.0
Deposits (change in percent, end-period)	6.9	8.6	8.8	8.4	8.7	6.2	4.9	4.8	4.7	4.5
Broad money (change in percent, end-period)	6.2	8.2	9.1	9.6	8.3	6.2	5.0	5.0	4.8	4.6
Policy Rate (percent) 5/	2.9	2.4	1.6	1.5	...	...	...	...	...	...
Balance of payments										
Current account balance (billion U.S. dollars)	-6.7	-11.4	-2.9	-1.4	-5.9	-7.3	-8.9	-10.9	-13.2	-15.2
Percent of GDP	-1.3	-2.1	-0.6	-0.3	-1.2	-1.4	-1.6	-1.9	-2.2	-2.4
Exports of Goods (billion U.S. dollars)	198.1	210.6	191.0	195.6	216.5	235.4	255.1	273.5	293.5	312.9
Export volume growth	6.1	6.7	7.7	9.0	7.5	7.1	6.6	6.1	5.7	5.4
Imports of Goods (billion U.S. dollars)	198.6	214.9	188.6	193.4	219.7	241.3	263.3	284.3	307.1	329.5
Import volume growth	1.7	10.0	6.6	8.9	8.4	8.2	7.4	6.5	6.0	5.6
Terms of trade (index 1995=100)	100.6	102.7	105.1	106.1	104.2	104.2	104.3	104.0	103.6	103.1
Official reserves (billion U.S. dollars)	106.2	100.4	94.9	114.4	120.3	125.5	128.8	132.5	135.3	136.8
In percent of short-term debt plus CA deficit	67.4	88.5	88.9	88.7	108.9	115.6	115.6	117.3	116.8	117.0
In percent of IMF ARA metric	105.6	110.6	111.2	128.1						
Total external debt (billion U.S. dollars)	384.1	356.7	330.0	335.9	344.0	348.3	351.9	357.2	363.6	370.5
In percent of GDP	73.2	65.4	69.1	71.6	69.6	66.7	63.8	61.5	59.5	57.7
Exchange rate										
Exchange rate regime					Freely floating					
Zloty per USD, period average	3.2	3.2	3.8	3.9	...	...	...	...	...	...
Zloty per Euro, period average	4.2	4.2	4.2	4.4	...	...	...	...	...	...
Real effective exchange rate (INS, CPI based) 6/	108.2	109.0	105.2	100.7	...	...	...	...	...	...
Appreciation (percent change)	0.7	0.7	-3.4	-4.3	...	...	...	...	...	...
Memorandum item:										
Nominal GDP (billion zloty)	1656.8	1719.7	1799.3	1851.2	1951.1	2069.0	2186.6	2304.1	2424.8	2547.6

Sources: Polish authorities and IMF staff calculations.

1/ Real GDP is calculated at constant 2010 prices, while the authorities' definition is based on prices of the previous year.
2/ According to ESA2010.
3/ The difference from general government debt reflects different sectoral classification of certain units.
4/ Credit defined as in IFS: "Claims on other sectors."
5/ NBP Reference Rate (avg).
6/ Annual average (2000=100).

INTERNATIONAL MONETARY FUND

REPUBLIC OF POLAND

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

June 23, 2017

KEY ISSUES

Context: The near-term growth momentum remains strong, supported by accommodative monetary and fiscal policies and sizable EU transfers. The economy is operating above potential, with the unemployment rate at a historical low. But long-term growth will be more subdued, unless adverse demographics and structural constraints on investment and total factor productivity (TFP) growth are addressed. Some recent policies, notably the reversal of the 2013 retirement age increase, will likely exacerbate the decline in the working-age population and require additional fiscal consolidation efforts. While the external environment has improved, both global and domestic policy uncertainties continue to weigh on sentiment.

Policies: to ensure strong inclusive growth and income convergence with advanced Europe, the government should maintain sound macro policies and advance reforms:

- ***Rebuilding fiscal space*:** With the 2017 budget deficit of just below 3 percent of GDP, the fiscal policy priorities are to avoid breaching the Excessive Deficit Procedure (EDP) limit and to start consolidation as soon as possible, taking advantage of the cyclical upswing, to reach the medium-term objective of a structural deficit of 1 percent of GDP.

- ***Managing reflation*:** Holding the policy rate steady is appropriate for now, but domestic inflationary pressures are rising. Close monitoring and timely actions, supported by a clear communication strategy, are needed to maintain inflation within the target range.

- ***Preserving financial sector resilience*:** Banks are sound, but profitability continues to decline. The final solution for FX mortgage loans should be mindful of the need to preserve banking sector resilience and a case-by-case approach remains preferable. The impact of the bank asset tax and of the overall tax and regulatory burden on the activities and risk profiles of banks should be monitored.

- ***Advancing structural reforms*:** Achieving higher potential growth will require faster productivity growth, stronger private investment and higher labor force participation. The recently adopted Responsible Development Strategy covers many of the structural challenges and sets ambitious targets. Prioritization and implementation are now key—the focus should be on streamlining the product market regulations, implementing more effective labor market policies, and improving efficiency of the EU-funded investment in infrastructure and R&D.

Approved By
Thanos Arvanitis and Vitaliy Kramarenko

Ms. Ilyina (head), Ms. Bi, Ms. Xu (all EUR), Ms. Korniyenko (SPR), and Ms. Ozturk (FIN) visited Warsaw during May 8–18, 2017. The mission met with senior government and central bank officials and representatives from trade unions and the business community. Mr. Bakker (Senior Regional Resident Representative), Mr. Sierhej, and Mr. Krogulski (Resident Representative Office) participated in the discussions. Mr. Jakab (RES), Ms. Jung, and Ms. Nguyen (all EUR) provided support from headquarters. Poland is an Article IV country and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for those solely for the preservation of national or international security (Informational Annex: Fund Relations). Data provision is adequate for surveillance (Informational Annex: Statistical Issues).

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TABLES

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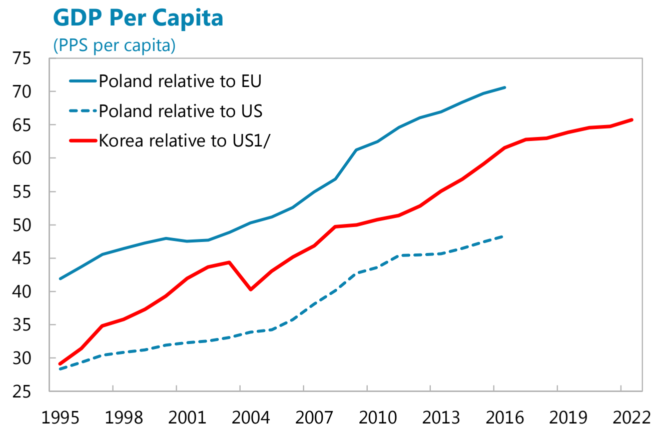
CONTEXT

1. Poland has been one of the fastest growing economies in the European Union (EU). Historically, Poland's performance has not been far off that of the fastest-converging economies (e.g., Korea). Even after the onset of the global financial crisis, Poland continued to grow faster than its regional peers at an average rate of 3¼ percent per year, rapidly closing its income gap with the EU, though its convergence relative to the US has slowed after the crisis. This strong performance reflects dividends from earlier institutional reforms, rapid integration into the European economic and financial systems, as well as sound economic management.



Sources: WEO and IMF staff calculations.
1/ Korea GDP Per capita starts in 1989 relative to Poland's GDP per capita.

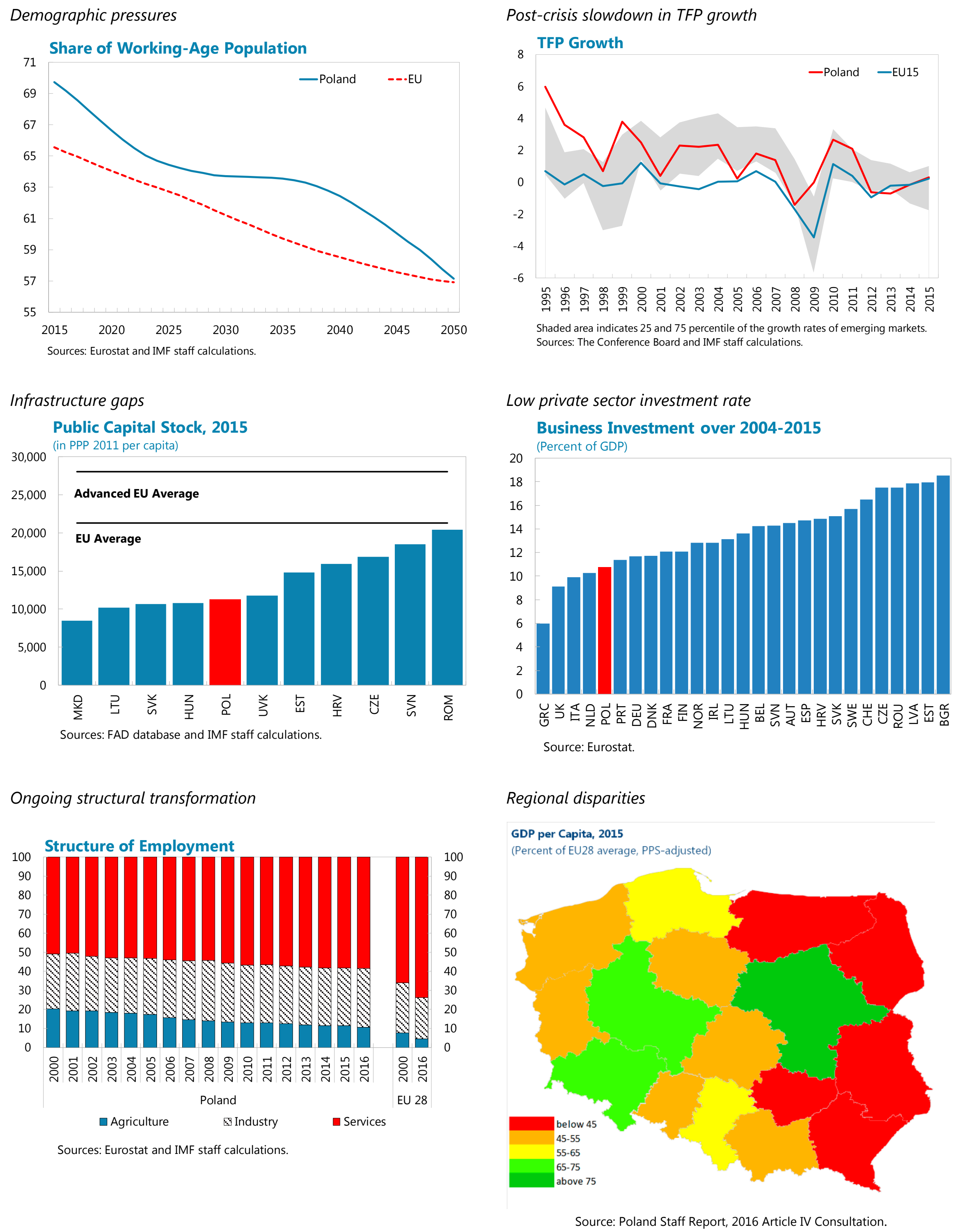
2. The strong growth momentum is expected to continue in the near term. Growth has accelerated to 4 percent in 2017:Q1 from 2.7 percent in 2016, on the back of continued strong consumption and inventory accumulation. Record-low unemployment and a near record-high capacity utilization suggest that the economy is already operating above potential. But the still subdued private investment and lower than pre-crisis total factor productivity (TFP) growth cast a shadow over the medium-term growth prospects.

3. Over the longer-term, growth will be more subdued, if demographic headwinds and structural challenges are not addressed (Figure 1):

- *Shrinking workforce*. With birth rates among the lowest in the EU and persistent emigration, the Polish working-age population has been declining by 1 percent annually since 2012, and is expected to shrink by over a ¼ by 2050, resulting in more than doubling of the old-age dependency ratio. If left unaddressed, these trends will reduce potential growth and increase healthcare and pension-related spending. In addition to the demographic pressures, a relatively low participation rate, persistent labor market segmentation, and skill mismatches point to potential misallocation of labor with adverse effects for productivity.

- *TFP growth slowdown*. In line with global trends, TFP growth in Poland has slowed significantly after the global financial crisis, falling from an average of 2.4 percent over 2003–07 to barely 1 percent on average over 2013–16. Prior to 2008, strong TFP growth was supported by the rapid institutional and structural transformation of the Polish economy and by Poland's integration into the EU economic space and European supply chains. With slower expansion of the technological frontier and technology diffusion, Poland will need to rely more on internal drivers of TFP growth.

Figure 1. Poland's Structural Challenges



- *Infrastructure gaps*. Compared to many EU economies, Poland has sizable infrastructure gaps. Furthermore, Poland relies heavily on the EU Structural and Cohesion Funds to finance public investment—under the 2014–20 EU funds program it can receive up to EUR 86 billion, and over half of the national public investment during 2014–17 was financed by EU funds. An eventual reduction in EU transfers will have to be offset by funding from other sources if public investment were to be maintained at current levels.

- *Low domestic private investment***.** The private investment rate in Poland is among the lowest in the EU, while the public sector continues to play a prominent role in the economy, especially in energy, transportation, and other network sectors. Ensuring a more prominent role of the domestic private sector in the future growth and economic transformation of Poland is another challenge.

- *Regional disparities*. Eastern regions in Poland—with a relatively large share of small-scale farming—have significantly lower per-capita GDP, productivity and education attainment levels, as well as higher poverty and unemployment rates.[1] Ensuring broad-based and inclusive growth requires greater focus on regional development.

4. The current strong growth momentum provides an opportunity to advance structural reforms. The Responsible Development Strategy (RDS), which was formally adopted in February 2017, aims to address structural obstacles to sustainable, strong, and inclusive growth. But much work lies ahead to translate the strategy into concrete reform plans and to ensure that the rest of the policy mix is consistent with the goal of lifting Poland's potential growth, while maintaining fiscal prudence and macro-financial stability.

RECENT DEVELOPMENTS

5. External demand and financial conditions remain supportive (Figure 2). External demand is recovering despite lingering policy uncertainties in major economies. While the expectations of a fiscal stimulus have lifted forecasts of growth and interest rates in the U.S., the external financing conditions have remained supportive for Poland, given low Eurozone interest rates and subdued global market volatility.

6. Domestic financial conditions are still accommodative (Figures 2, 11). The policy interest rate has been held at a historically low level for more than two years. Yields on government bonds are still relatively low, despite a moderate increase from 2.9 percent in September 2016 to 3.2 percent in June 2017. In line with global trends, Polish equities gained more than 30 percent since end-2016, recovering about three quarters of the stock market losses from mid-2015. Meanwhile, the recent REER appreciation and some tightening in bank lending standards, especially on corporate loans, have led to a slight tightening of the overall financial conditions.

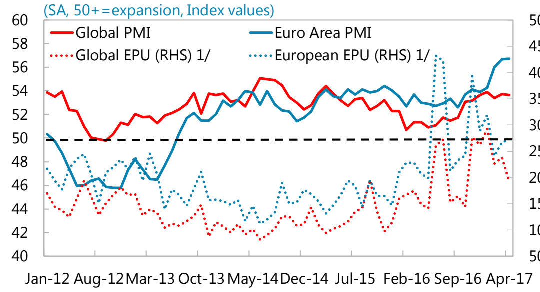
[1] See the 2016 Article IV Staff Report.

Figure 2. Recent Economic and Financial Developments

External demand is recovering despite lingering policy uncertainties.

Composite PMI (Manufacturing & Services) and Economic Policy Uncertainty

(SA, 50+=expansion, Index values)

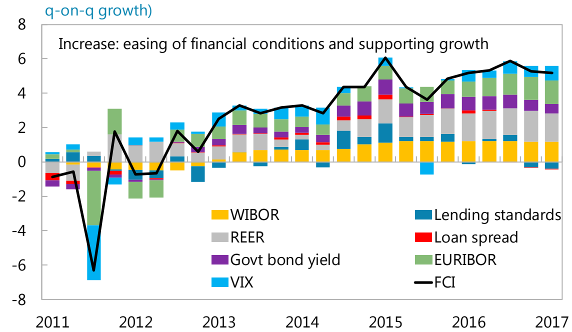


Sources: Bloomberg Finance L.P. and Haver Analytics.
1/ National EPU index values are from www.PolicyUncertainty.com and Baker, Bloom and Davis (2016). Each national EPU Index is renormalized to a mean of 100 from 1997 to 2015 before calculating the Global EPU Index.

Financial conditions remain supportive.

Contributions to Financial Conditions Index (FCI)

(FCI measured as impact on growth, in percentage points of annualized q-on-q growth)

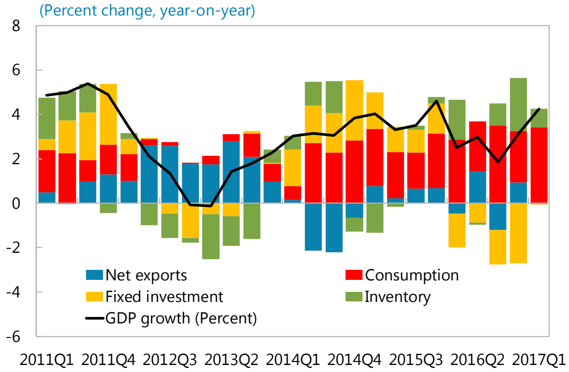


Sources: Datastream, Haver Analytics, JP Morgan, NBP, Reuters, Statistics Poland, and IMF staff calculations.

Private consumption is still the main driver of growth.

Real GDP Growth

(Percent change, year-on-year)

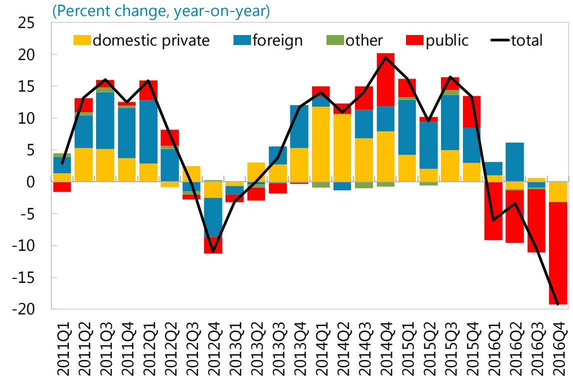


Sources: Poland Statistical Office and IMF staff calculations.

Public investment growth has been weak, reflecting low absorption of EU funds during transition to 2014–20 program...

Investment in Non-Financial Corporations

(Percent change, year-on-year)

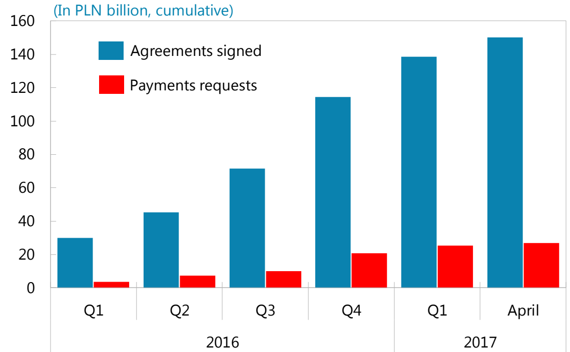


Source: Poland national authorities.

...but the EU funds' absorption is set to pick up, ...

EU Project Agreements

(In PLN billion, cumulative)

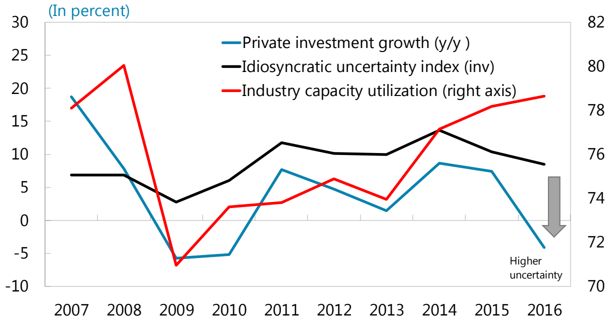


Source: Ministry of Development.

...while private investment is still held back by domestic policy uncertainties, despite record-high capacity utilization.

Investment, Capacity Utilization and Uncertainty

(In percent)



Note: The uncertainty index is measured as the interquartile range of forecasts of Poland-based survey respondents as reported in Consensus Forecasts. All forecasts are at monthly frequency, predicting 12-month ahead growth rates of GDP, consumption, investment, industrial production, and levels of short-term and long-term interest rates. See Ozturk and Sheng (forthcoming) for details.
Sources: Poland Statistical Office, Haver Analytics, and IMF staff calculations.

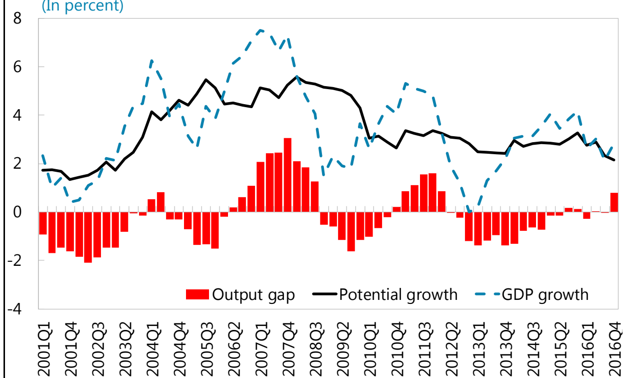
7. The near-term growth momentum is strong (Figures 2, 12). Real GDP growth accelerated to 4 percent in 2017:Q1 after a temporary slowdown to 2.7 percent in 2016 from 3.9 percent in 2015 due to weaker investment. The *public investment* decline last year was driven by a significantly lower absorption of EU funds during the transition to the 2014–20 program, with similar declines observed in other recipients of EU funds.[2] *Private investment* growth has been disappointing as well, with the recent EIB survey pointing to political and regulatory uncertainties as the key factors. However, investment momentum appears to have strengthened in 2017:Q1, with more upbeat PMI and business sentiment indicators, and a pick-up in contracts and disbursement requests for EU-funded projects. Meanwhile, growth is still mainly driven by *private consumption*, which is supported by solid wage growth, minimum wage hike and higher social spending (the child benefits program).

8. The cyclical rebound is in an advanced stage. Different estimation methods consistently show that the negative output gap that opened during the global financial crisis had largely closed by 2015, and a positive output gap opened in 2016. Unemployment is at record low and reflation is gathering pace (Figure 3). Nonetheless, credit growth is moderate at 4.9 percent y-o-y (as of May 2017) and there are no signs of excessive asset price acceleration so far (see charts below).[3]

Business and Financial Cycle Indicators

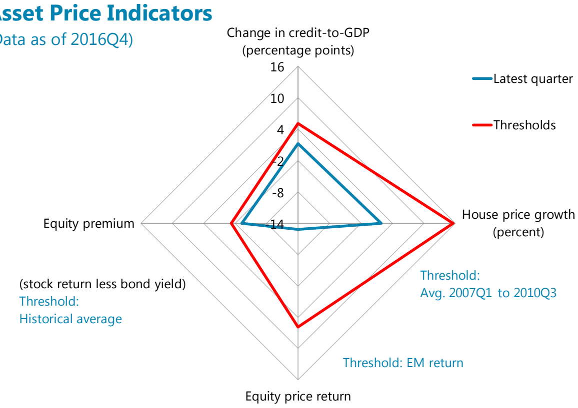
Economy is entering an advanced phase of the business cycle… *… but no signs of asset price bubbles so far.*

Potential Growth and Output Gap
(In percent)



Source: IMF staff calculations.

Asset Price Indicators
(Data as of 2016Q4)



Sources: Country authorities, Datastream, Haver Analytics, and IMF staff calculations.

9. The labor market is increasingly tight (Figure 3, 12). The unemployment rate (seasonally-adjusted, harmonized) dropped to a historical low of 4.8 percent in April 2017. Firms are increasingly experiencing shortages of skilled labor, with about 30 percent of surveyed firms reporting labor shortages as a barrier to growth. A steady decline in the working-age population that started in

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[2] Some of the delay has been due to the new regulatory and operational requirements of the 2014–20 program.

[3] There were no major developments in the household and corporate balance sheets since the [2016 Article IV Consultation](#).

2012 is now felt more acutely amid continued strength of the economy. Compared to the steep fall in unemployment, the very recent acceleration in wage growth (from an annual average of 4 percent to 4.7 percent in the first five months of 2017 in the enterprise sector) seems moderate. A leading explanation of the still relatively restrained wage growth is the large inflow of Ukrainian migrants, reportedly around 1.3 million, many of whom work in Poland on short-term contracts (maximum of 6 months within 12 consecutive months) and at much lower effective wages than local workers.[4] Even at the current rate, the real wage growth is already outpacing the real labor productivity growth (Figure 12).

10. Reflation is gathering pace (Figures 3, 13). Headline inflation accelerated from 0 percent in November 2016 to 1.9 percent in May 2017 on the back of rising food and fuel prices, but is still below the NBP's inflation target of 2.5 percent. A model-based inflation decomposition suggests that the drag from the euro area inflation declined, while the contribution of domestic factors increased (Figure 3, chart 2). Core inflation (headline, excluding food and fuel prices) reached 0.8 percent in May 2017, and other measures of core inflation that capture domestic demand conditions signal even stronger domestic inflationary pressures.

11. The fiscal outcome in 2016 was better than expected. The realized general government fiscal deficit was 2.4 percent of GDP in 2016, the lowest level since the global financial crisis. Revenues outperformed due to a significant increase in the VAT and other tax receipts, reflecting improved compliance. Expenditures were under-executed due to weak public investment associated with low absorption of EU funds. However, with a positive output gap, the improvement in a cyclically-adjusted balance is smaller, likely representing a broadly neutral fiscal stance. Public debt had increased to 54 percent of GDP at end-2016, but remains sustainable under a wide range of shocks (Annex VIII).

12. The external position continued to improve (Figure 14). Poland's current account deficit declined to 0.3 percent of GDP in 2016 (the smallest deficit on record since 1995). This reflects improved terms of trade and more competitive REER, as well as higher exports to the euro area in 2016:Q4 that were supported by the recovery in trade in the global value chains (GVCs).[5] Net financial inflows remained weak in 2016, and the small positive financial account was primarily due to the accumulation of reserves that was partly driven by increased repo transactions of the National Bank of Poland (NBP). Net portfolio inflows turned positive in 2017:Q1 in line with broad EM patterns, leading to both nominal and real appreciation of the PLN following a depreciation streak since mid-2015. The overall external position is broadly consistent with economic fundamentals and desirable policies (Annex I), and gross reserves are adequate, amounting to 128 percent of the IMF's composite reserve adequacy metric as of end-2016.[6]

[4] These temporary migrants are not included in the official employment statistics.

[5] See 2017 April WEO, Chapter 1.

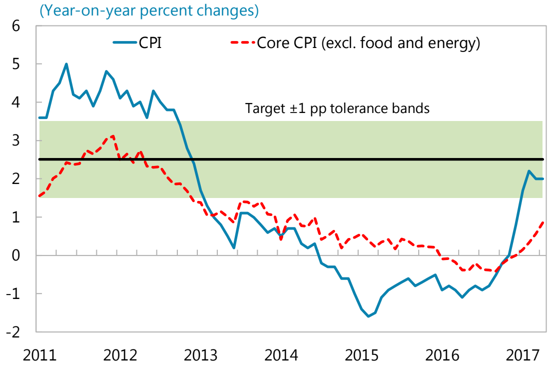
[6] Net reserves were at 103 percent of the IMF's modified composite reserve adequacy metric at end-2016. Compared to end-2015, both net and gross reserves increased significantly, the latter also because of the increase in repo transactions by the NBP.

Figure 3. Inflation and Labor Market Conditions

Reflation is gathering pace, with headline inflation outpacing core inflation on higher fuel and food prices…

CPI Inflation

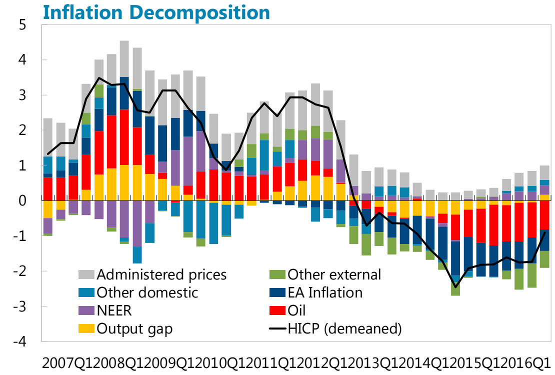
(Year-on-year percent changes)



Sources: Haver Analytics and IMF staff calculations.

… as well as diminishing drag from the euro area inflation.

Inflation Decomposition

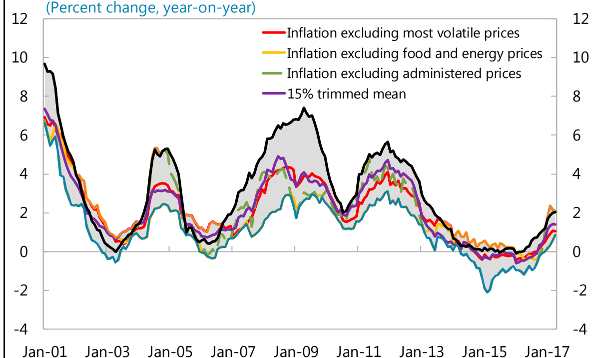


Sources: GAS Database, Kiliand, EIA, Haver Analytics, WEO, and IMF staff calculations.

But domestic inflationary pressures are building up.

Core Inflation Indices

(Percent change, year-on-year)

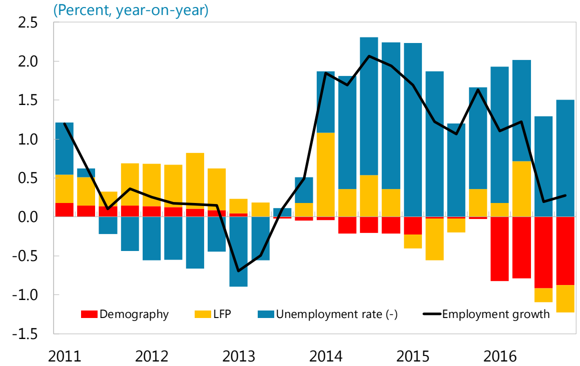


Sources: National Bank of Poland and IMF staff calculations.

Labor market conditions continue to tighten, with unemployment rate falling rapidly.

Employment Growth Decomposition

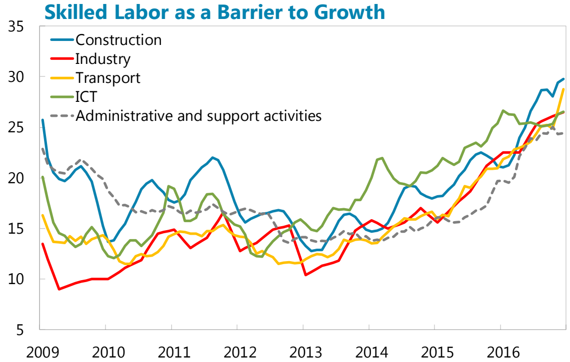
(Percent, year-on-year)



Sources: Statistical Office of Poland and IMF staff calculations.

Firms are increasingly experiencing skilled labor shortages…

Share of Enterprises Reporting Shortage of Skilled Labor as a Barrier to Growth

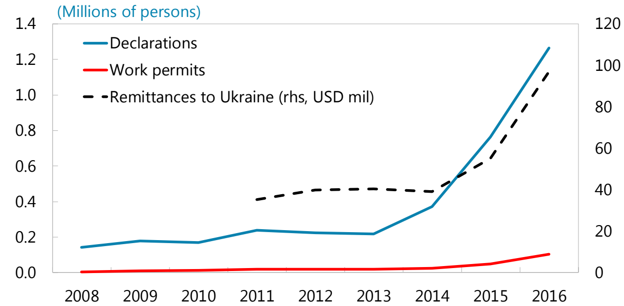


Sources: Statistical Office of Poland and IMF staff calculations.

…despite a surge in temporary migrant inflows from Ukraine.

Ukrainian Workers in Poland

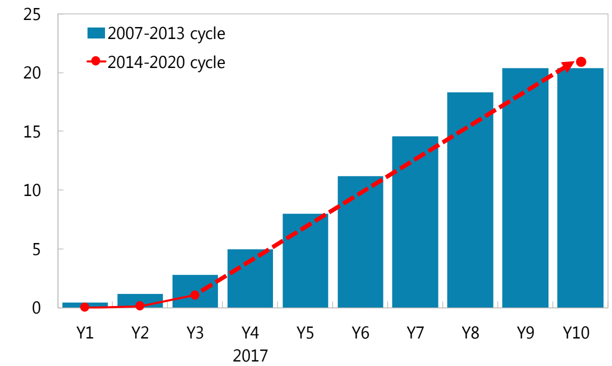
(Millions of persons)



Note: Declaration of intetion allows to hire a foreigner from selected CIS countries for a period not exceeding 6 months within 12 consecutive months.
Sources: Ministry of Family, Labour, and Social Policy, and the National Bank of Ukraine.

OUTLOOK AND RISKS

Public investment is set to pick up on higher absorption of EU funds.



Sources: European Commission, Polish Authorities, and IMF staff calculations.

13. Growth will remain strong in the near term, but longer-term prospects are more subdued. Real GDP growth is projected to accelerate to 3.6 percent in 2017 on the back of stronger EU funds' absorption (see chart), robust private consumption, and modest recovery of private investment amid supportive external demand. But over the medium term, adverse demographics will weigh on employment growth, pulling GDP growth back to its potential rate of around 2.7 percent by 2022, despite moderate improvements in the investment and TFP growth (Annex II). As domestic demand strengthens and commodity prices recover, import growth is likely to outpace export growth, leading to a moderate widening in the current account deficit over the medium term.

14. Headline inflation is expected to reach the mid-point of the target band in early 2018. The impulse from the recent strong growth in food and fuel prices will likely taper off in the second half of 2017. Core inflation, however, is set to accelerate amid an increasingly positive output gap and rising wage pressures in a tight labor market, including an 8 percent minimum wage hike that came into effect in January 2017. As rising domestic inflation offsets the diminishing effects from food and fuel price increases, headline inflation is likely to rise gradually toward the NBP's inflation target of 2.5 percent with limited risks of overshooting in 2017, barring upside surprises on food and fuel price inflation. Assuming a timely monetary policy response, inflation will likely stabilize around the target after 2017.

15. In the near-term, risks to the outlook are broadly balanced (Figure 4 and Annex III):

- *External risks:* The external environment can improve further if global growth accelerates on a stronger-than-expected recovery in advanced economies. The key downside risks for Poland include a faster-than-expected tightening in the global financial conditions, as well as growth, financial, or political shocks in Europe. A faster-than-expected monetary policy normalization in the U.S. would lead to higher external borrowing costs, which would have a negative impact on Poland given its relatively high external financing requirements (Figure 4). Possible growth or financial shocks in Europe would have negative spillovers for Poland through trade, GVC and financial channels (Figure 4). A rise of protectionism globally could reduce cross-border trade, capital and labor flows, but would likely have a moderate impact on Poland.[7]

[7] For more details, see Box 1 of the October 2016 WEO and the April 2017 WEO, Chapter 1.

- *Domestic risks:* Both growth and inflation can surprise on the upside if the EU funds' absorption and investment rise further or if wage growth accelerates faster than expected. On the downside, a delayed monetary policy response to higher-than-expected inflation could lead to inflation overshooting its target, while a weakening of institutions or fiscal slippages could dent investor confidence.

16. Should risks materialize, policy response would depend on circumstances. Poland's flexible exchange rate, high reserve buffers, and a well-diversified foreign investor base should help mitigate adverse financial spillovers. In the event of an economic downturn, fiscal automatic stabilizers should be allowed to fully operate. In the event of significant capital outflows, the NBP should stand ready to provide both zloty and FX liquidity to the banking sector. If capital outflows intensify, interest rate hikes could be used to stem capital outflow pressure. Poland's Flexible Credit Line (FCL) arrangement is an added insurance against adverse external shocks, and could also be used as needed to prevent disorderly market conditions. To safeguard against domestic risks, the authorities should remain focused on maintaining strong policies and institutions.

Authorities' views

17. The authorities broadly agreed with staff's assessment of outlook and risks. The NBP's growth forecast is broadly in line with staff's, with output gap projected to close later this year. The Ministry of Finance (MoF) is more optimistic, forecasting the real GDP growth of 3.8–3.9 percent in 2018–20, on sustained strong investment growth. After a period of deflation, the authorities see domestic inflationary pressures rising slowly, with inflation staying close to the target in the medium term. Higher wage growth is seen as a key driver of future inflation. However, the authorities' wage growth and core inflation forecasts are more benign than staff's. On the external side, the authorities saw further normalization of the monetary policy in the U.S. and earlier-than-expected ECB tapering as the key risks, with Brexit and other political event risks in Europe adding to uncertainties. Nevertheless, they noted that Poland's strong external position, diversified investor base, and flexible exchange rate, supported by the FCL arrangement with the IMF, will help it to withstand external pressures.

POLICY DISCUSSIONS

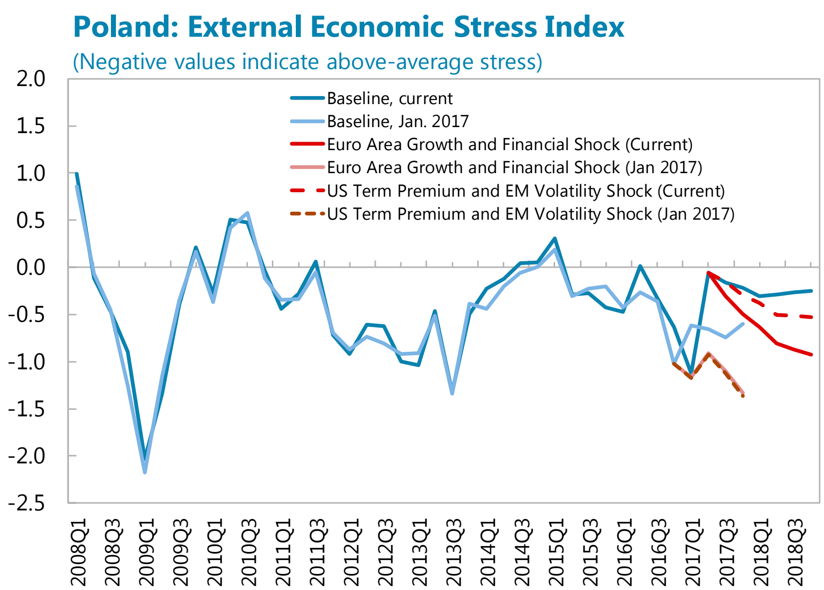
18. The policy mix should reflect the need to rebuild buffers during good times and to address longer-term growth and fiscal challenges. This year's consultation focused on policies to achieve higher potential growth over the long term, a durable structural fiscal consolidation over the medium term, and to maintain macro-financial stability amid the current cyclical upswing. The past policies have been broadly in line with Fund's recommendations (Annex IV), but fiscal consolidation has stalled and the 2013 retirement age increase was reversed, against staff's advice.

Figure 4. External Risks and Vulnerabilities

Selected Vulnerability Indicators: Poland vs other Emerging Markets

	Current Account Balance (Percent of GDP)	External Debt Refinancing Needs in 2017 (Percent of GDP)	Gross International Reserves (Percent of the IMF's Reserve Adequacy Metric)	Loan to Deposit Ratio (Percent)	Cyclically Adjusted Primary Balance (Percent of GDP)	Public Debt (Percent of GDP)	Public gross financing requirement in 2017 (Percent of GDP)
	(I)	(II)	(III)	(IV)	(V)	(VI)	(VII)
Poland	-0.3	21.0	128.1	106.6	-0.8	54.4	9.2
Average emerging Asia	1.8	12.3	156.8	87.0	-1.3	53.6	9.8
Average emerging Europe	-1.8	25.2	116.3	97.9	0.1	51.7	10.6
Average Latin America	-3.2	8.2	122.5	112.6	-2.2	53.0	9.7
Average Middle East & North Africa	-7.6	9.7	142.3	83.3	-2.7	65.7	22.3
Average all EMCs	-3.1	14.1	128.7	97.1	-1.6	55.4	12.6
Median	*-2.5*	*8.9*	*107.0*	*93.0*	*-0.7*	*53.3*	*9.4*
25th percentile	-4.6	5.2	75.4	75.0	-2.0	39.8	5.6
75th percentile	-0.8	17.8	158.1	111.0	0.5	69.3	15.8

Sources: Joint External Debt Hub; IMF Monetary and Financial Statistics; IMF World Economic Outlook; and IMF staff calculations.



Sources: Bloomberg Finance L.P., IMF Monetary and Financial Statistics; IMF World Economic Outlook; and IMF staff calculations.

Note: The External Economic Stress Index (ESI) aims to capture the evolution of external environment as it pertains to Poland. The index is a weighted sum of standardized deviations of the key external risk factors from their means. The risk factors are the same as in the January 2017 FCL report and include real shocks (growth in the euro area) and financial shocks (changes in the European bank equity prices, the 10-year US bond yield, and the emerging market implied volatility (VXEEM)). The weights are based on the time-varying trade and financial exposures, all expressed as shares of GDP and then normalized to add up to one.

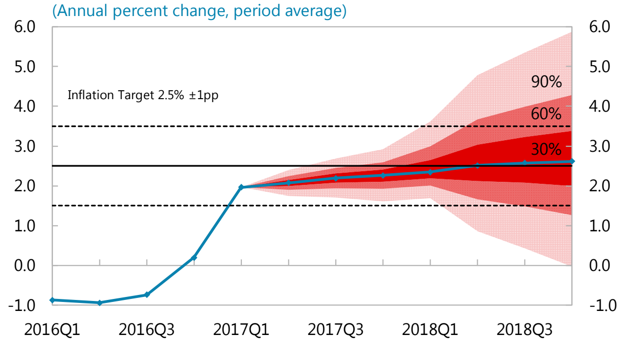
A. Monetary Policy: Managing Reflation

19. The authorities assess the current policy stance as appropriate to keep inflation within the target range over the forecast horizon. The NBP expects the effects of higher oil and food prices to taper off later this year, and the domestic price pressures to remain contained. Thus, the policy rate is expected to be on hold throughout 2017 and well into 2018, though a negative real policy rate is becoming more of a concern.

20. In staff's view, monetary policy tightening will likely be needed in 2018 to stabilize inflation around its target.[8] Staff's baseline assumption is that wage growth will accelerate gradually amid tight labor market conditions[9] with a relatively fast pass-through to core inflation, as suggested by historical patterns. Under these assumptions, headline inflation could reach the upper bound of the target band by end-2018 without monetary tightening (Figure 5). However, there is considerable uncertainty about the wage growth trajectory given the recent disconnect between the unemployment gap[10] and wage growth (Figure 5, chart 1). A continuation of the moderate wage growth of around 4 percent in 2017–18 would bring headline inflation below target by end-2018, while faster wage growth could result in inflation breaching the upper bound of the target band in mid-2018 (Figure 5, chart 2). Other risks to inflation include a weaker-than-expected euro area inflation (downside risk) and the pass-through from potential exchange rate depreciation (upside risk) that could be triggered by bouts of global financial market volatility or policy uncertainties. While the risk of a premature tightening is well internalized, it is also important to recognize that a delayed response could lead to more significant and persistent inflation overshooting (Figure 5, charts 3–4). In recent months, all survey and market-implied inflation expectations have adjusted upward (Figure 13). Survey-based one-year and two-year ahead inflation expectations have risen toward 2 percent or higher, while five-year inflation expectations remain stable. Inflation expectations derived from the long-term inflation-

Inflation is expected to reach the target in early 2018, with risks tilted to the upside.

Inflation Projections 1/
(Annual percent change, period average)



Sources: World Economic Outlook and IMF staff estimates.
1/ The uncertainty interval was calculated based on the annual CPI inflation forecast errors for Poland from the IMF *World Economic Outlook* during April 2006-October 2016, following the methodology described in Elekdag and Kannan (2009).

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[8] Staff's Taylor-rule estimates suggest that with a positive output gap, a gradual acceleration of wage inflation and robust Eurozone inflation under the baseline, inflationary pressures could require monetary tightening as early as end-2017 or early 2018 to avoid significant inflation overshooting. Therefore, an assumption of a moderate rate hike is embedded in staff's baseline inflation projections.

[9] The April 2017 NBP report on "Quick Monitoring Survey" of enterprises shows rising shares of enterprises planning wage hikes and of enterprises reporting rising wage pressures and average planned hikes.

[10] The difference between the non-accelerating inflation rate of unemployment (NAIRU) and the actual unemployment rate.

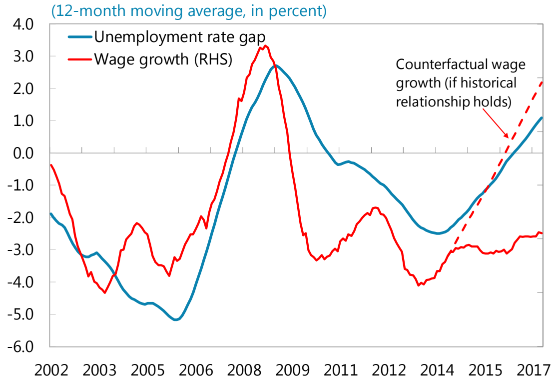
Figure 5. Inflation Risks and Monetary Policy Responses

Given the increasing divergence between the unemployment gap and wage growth, wage inflation could accelerate sharply…

…which could cause the headline inflation to breach the upper limit of inflation tolerance band sometime during 2018 in the absence of monetary tightening.

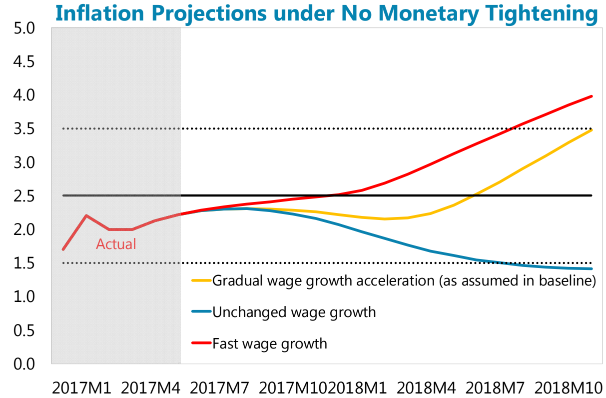
Unemployment Rate Gap and Wage Growth

(12-month moving average, in percent)



Sources: Statistical Office of Poland, and IMF staff calculations.

Inflation Projections under No Monetary Tightening



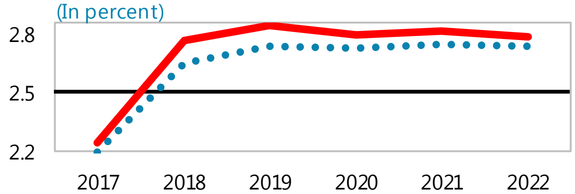
Source: IMF staff calculations.

Scenario 1: a sharp acceleration of wage growth to an average 10 percent year-on-year in 2018 (as in "fast wage growth" scenario above), with a gradual return to baseline in the medium term*. In the charts below, the blue dotted lines correspond to the outcomes with a prompt policy rate hike, and the red lines correspond to the outcomes with a delayed monetary policy response. In this illustrative scenario, the persistent wage growth shock requires moderate tightening starting from 2017. If delayed, the rate hike needed would be larger and inflation would be persistently higher. Note that the 10 percent wage growth is consistent with the current level of unemployment gap and the historical relationship between unemployment gap and wage growth (chart above).*

Scenario 2: a 10 percent nominal depreciation of the zloty in 2017, with a gradual return to the pre-shock level in 2019*. In the charts below, the blue dotted lines correspond to the outcomes with a prompt policy rate hike, and the red lines correspond to the outcomes with a delayed monetary policy response. In the model, the pass-through from depreciation mainly affects food and fuel prices (rather than core inflation), while monetary tightening can only affect core inflation. Hence, in this scenario, a rate hike of 80 basis points would be needed in 2017 to facilitate a faster return to the inflation target.*

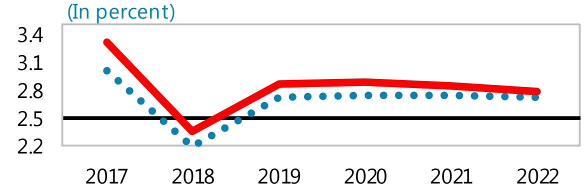
Headline Inflation

(In percent)



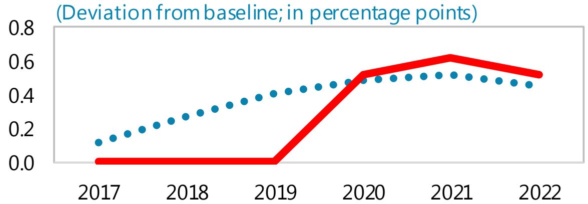
Headline Inflation

(In percent)



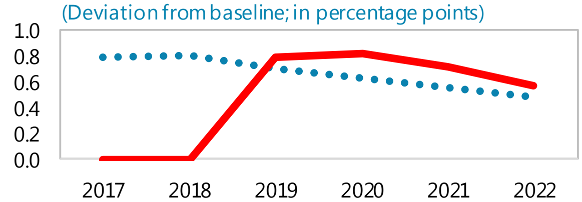
Policy Rate

(Deviation from baseline; in percentage points)



Policy Rate

(Deviation from baseline; in percentage points)



Note: The shock-policy response simulations for scenarios 1 and 2 were carried out by Zoltan Jakab using the semi-structural general equilibrium model (FSGM).

indexed government bonds have increased to the 2.5–3.5 percent range. Consensus forecast of the short-term interest rate suggests that investors expect a rate hike in 2017–18.

21. Overall, the monetary policy should be data dependent and supported by a clear communication strategy. Staff's recommendations are as follows:

- *Holding the policy rate steady is appropriate for now.* Staff does not see a need for immediate tightening, especially as the increase in headline inflation has so far been mainly driven by external factors, such as higher fuel and food prices, which are expected to taper off.
- *Inflationary pressures should be monitored and the authorities should tighten monetary policy if accelerating core inflation threatens the inflation objectives*. The incipient domestic inflationary pressures should be monitored closely, given an opening positive output gap, a pro-cyclical fiscal stance, a negative real interest rate, and a record-low unemployment rate. Because of considerable uncertainty about the future wage growth, monetary policy decisions should be data dependent. When there are clear signs of accelerating core inflation,[11] the authorities should tighten to prevent headline inflation from rising above the upper bound of the target range. Given long lags in the monetary transmission, timely actions will be crucial to avoid inflation overshooting and to maintain credibility.
- *The monetary policy response would also depend on the fiscal stance*. In the absence of sufficient fiscal adjustment (see the fiscal policy section), monetary policy will need to shoulder a greater burden in managing domestic demand pressures.
- *The monetary policy should be supported by a clear communication strategy.* The NBP should provide clear state-contingent rather than time-bound forward guidance based on timely updates of inflation outlook to help guide inflation expectations. The MPC should avoid sending mixed messages that may undermine the credibility of the inflation-targeting framework.

Authorities' views

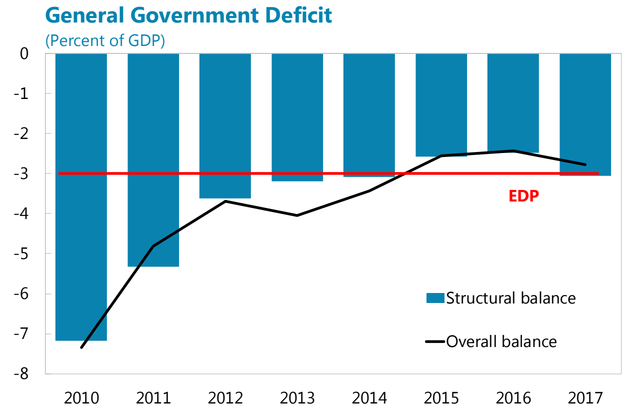
22. The authorities agreed that monetary policy decisions should be data dependent and that clear communication is important, but were not in favor of formal forward guidance. The MoF envisages freezing the wage bill for the central government in 2018 to mitigate wage growth. In the NBP's view, several factors will likely continue to restrain wage growth, including Ukrainian migrants (who earn much lower effective wages), policy-induced switching from the temporary civil law contracts to the labor code contracts (as an alternative to pay raises), and a structural change in labor demand toward less skilled, less experienced, and hence, lower-paid workforce (as the baby-boomers retire). Nonetheless, they noted the uncertainties about future wage growth and hence the risks to inflation outlook. Therefore, they agreed that monetary policy decisions should be data dependent and noted that the current "wait and see" policy is the best option. The NBP reiterated their commitment to timely actions if developments threaten the inflation objectives. However, the NBP was skeptical of a formal forward guidance, fearing that it might trigger market speculation.

[11] As discussed in 2015 Article IV Consultation Selected Issues Paper Chapter 1, domestic demand pressures should not be underestimated—even during the recent deflation episode, low inflation was largely imported.

B. Fiscal Policy: Rebuilding Fiscal Space

23. The 2017 fiscal stance is procyclical. The general government budget deficit of 2.9 percent of GDP is only a shock away from the EDP limit of 3 percent of GDP and represents a relaxation of about 0.5 percent of GDP in structural terms. Compared to the 2016 budget outcome, the 2017 budget accommodates additional expenditures of about 0.6 percent of GDP: the new child benefits program (the full year effect), a lower retirement age (effective from October 2017), lower revenues from an increased PIT tax-free allowance for low-income tax payers, and the co-financing of higher EU-funded capital spending. Part of the spending increase is expected to be offset by revenue gains from tax administration reforms and by postponing the reduction in the VAT rate planned for this year until 2019.

The envisaged 2017 budget deficit is close to the EDP limit and represents a pro-cyclical fiscal stance.



Source: IMF staff calculations.

24. Fiscal performance so far this year has been better than expected, reducing the risk of breaching the EDP limit. In the first four months of 2017, VAT revenue increased by 33 percent (y-o-y), reflecting strong private consumption, improved compliance (due to recently adopted measures to reduce the VAT fraud), and one-off adjustments of the VAT refunds and settlements[12]. Other taxes have increased broadly in line with expectations. The strong revenue collection suggests that the fiscal deficit in 2017 could outperform the budget target of 2.9 percent of GDP, though the stance is still likely to remain pro-cyclical.

25. Fiscal consolidation should start as soon as possible to take advantage of the cyclical upswing. The focus in 2017 should be on avoiding any slippages that could lead to breaching the EDP limit and on saving any revenue over-performance. In case of revenue underperformance, contingency measures could include mobilizing savings by using margins built into the budget expenditure assumptions,[13] and rationalizing part of discretionary government consumption of goods and services, while avoiding public investment cuts. Although Poland may have some fiscal space for discretionary stimulus given its current debt position (Annex VIII), the fiscal space is limited if one takes into account the fiscal rules, including the debt limits and the Stabilizing Expenditure Rule (SER), which is linked to the medium-term objective (MTO). The need to create space to respond to future shocks coupled with the need to accommodate future aging costs and public investment spending imply that fiscal consolidation should start as soon as possible, at the time when the economy is strong (see Annex V

[12] About half of the VAT revenue increase is explained by one-off factors, about a quarter is likely due to the cyclical upswing, while the rest could be attributed to the structural factors.

[13] The contingency reserves built into the budget are relatively low by international standards.

for details). In this regard, the recent reversal of the 2013 retirement age increase, which will add to fiscal pressures through lower social security contributions, higher pension payments, and lower potential growth, is disappointing and goes against the staff's advice (Annex VI).

26. The authorities' 2017 Convergence Program update envisages an ambitious consolidation path over the medium term (Figure 6). Under the 2017 update, the headline deficit is expected to improve to 1.2 percent of GDP by 2020 and hit the MTO (a structural deficit of 1 percent of GDP) by 2021. This path is underpinned by assumptions of strong nominal GDP growth, sizable revenue gains from the tax administration reforms, and conservative projections of social benefits and wages (constant in real terms).[14] Several new initiatives to further improve tax administration are planned for 2017–18, including mandating an online filing of "Standard Audit Files," creating a centralized IT system to tackle tax fraud, and introducing separate VAT accounts under the "Split Payment Mechanism." The authorities also stated their intention to contain spending in line with the SER, though specific cuts remain to be identified. In this regard, they are considering some discretionary measures, including freezing public-sector wages in 2018 and rationalizing spending on active labor market policies.

27. Staff supports the authorities' intention to reduce the structural and headline deficits by about half a percent of GDP each year during 2018–19, in line with the 2017 Convergence Program Update. Such adjustment would help reverse the current pro-cyclical stance and build a "safety buffer" relative to the EDP limit. Beyond 2019, the pace of consolidation could be lower if there is a need to accommodate any direct fiscal costs of growth-enhancing structural reforms (see the structural reforms section).[15] However, the MTO will still need to be reached no later than 2023, given projected aging costs, exacerbated by the retirement age reduction, and in anticipation of the phasing out of the EU funds.

28. Staff recommends a menu of measures that could be used if revenues from tax administration reforms turn out to be insufficient to meet the Convergence Program targets. Staff projects the headline deficit to decline to 2.3 percent of GDP by 2020, given announced policies and assuming: (i) a more conservative budgeting of potential gains from tax administration reforms; (ii) a higher public sector wage bill and social benefits reflecting upward pressures from accelerating private sector wages; and (iii) more conservative growth assumptions. The authorities' efforts to close the VAT compliance gap by tightening regulations and improving the efficiency of tax administration focus on the right areas, and the results achieved so far are very encouraging. However, the expected revenue gains from these measures (1.3 percent of GDP by 2020) appear overly optimistic (Annex VII). International experience shows that revenue gains from tax administration reforms are uncertain, and therefore, should be budgeted conservatively (Figure 6).

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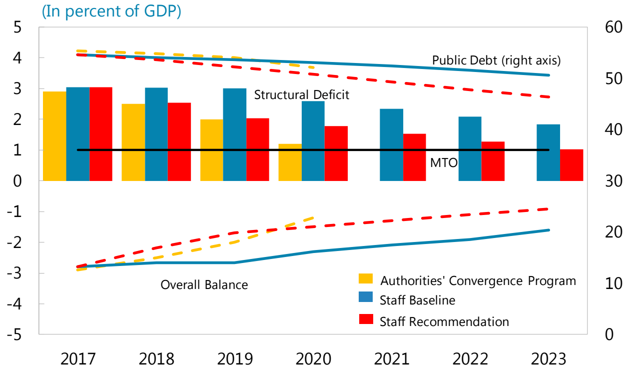
[14] It should be noted that the targets set out under the previous Convergence Program updates were consistently missed. For example, the 2013 update envisaged reaching the MTO by 2016, while the 2016 update envisaged reaching the 1 percent of GDP MTO by 2020.

[15] In a scenario with stronger consolidation efforts, the MTO is achieved by 2022, while the output growth is expected to be lower by 0.1–0.3 percentage points over the medium term (the FSGM model-based simulations).

Figure 6. Fiscal Consolidation: Convergence Program and Staff Recommendations

Public Debt and Deficit Projection

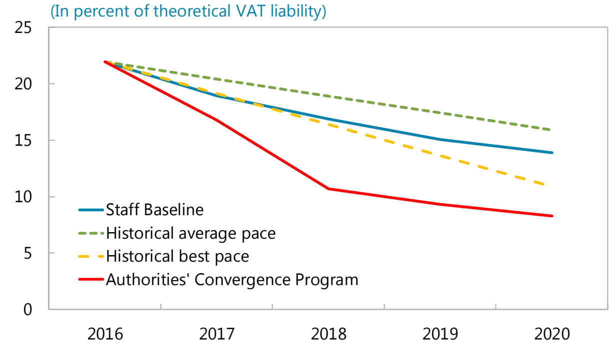
(In percent of GDP)



Source: The Polish authorities and IMF staff projections.
Note: The authorities' convergence program projects higher public debt than staff baseline in 2017-19, mainly reflecting different assumptions on net accumulation of financial assets.

VAT GAP Projections under Difference Scenarios

(In percent of theoretical VAT liability)



Sources: 2016 CASE study of VAT gaps in the EU for EC TAXUD, and Eurostat
Note: Historical average pace is the average gains of 5 EU countries (LVA, CZE, HUN, SVK, EST) during 2010-14 who reduced VAT gap through similar tax administration reforms; Historical best pace refers to the average gains of the best performaning country-Latvia during 2010-14 .

Fiscal Balance Targets and Recommended Measures for 2018-20*

In percent of GDP

	2018	**2019**	**2020**
Authorities' Convergence Program headline deficit	-2.5	-2.0	-1.2
Authorities' Convergence Program structural deficit	-2.5	-2.1	-1.2
o.w. VAT compliance measures	0.5	0.7	0.8
Staff's baseline structural deficit	-3.0	-3.0	-2.6
o.w. VAT compliance measures	0.2	0.4	0.5
Staff's recommended structural deficit	**-2.5**	**-2.0**	**-1.8**
The gap between staff's baseline and recommended deficit	*-0.5*	*-1.0*	*-0.8*
Staff's recommended additional measures to close the gap			
Revenues	**0.2**	**0.7**	**0.7**
Closing part of the VAT policy gap	0.1	0.2	0.2
Closing part of the VAT compliance gap 1/	0.1	0.2	0.2
Maintaining the VAT rate (starting from 2019) 2/	0.0	0.4	0.4
Expenditures	**0.3**	**0.3**	**0.2**
Rationalization of discretionary government consumption	0.2	0.2	0.0
Improving efficiency of social spending	0.2	0.2	0.2

* Staff's estimated impact of each of the additional measures refers to the improvement in the fiscal balance relative to the baseline. The components may not add up to the total due to rounding effects.
1/ In addition to staff's baseline assumptions.
2/ Included in the authorities' convergence program but not in staff's baseline as no budget decisions have been made.

Source: The Convergence Program 2017 Update and IMF staff projections.

29. The medium-term consolidation should be supported by comprehensive fiscal structural reforms. Staff's main recommendations are:

- *Revenue collection*: Efforts should focus on closing not only the tax compliance gaps, but also the tax policy gaps. Until higher revenues from tax administration reforms are realized, the 2011 VAT rate increase should be maintained. Meanwhile, given the large VAT policy gaps (Annex VII), staff encourages the authorities to consider removing some preferential rates and tax exemptions.
- *Expenditure efficiency*: Increasing efficiency of current expenditures, notably on social protection, could generate additional savings without compromising income distribution.[16] There is also some room to improve efficiency of public investment, where there is still a gap of about 20 percent relative to the efficiency frontier. Further improvements in public investment management—notably, in areas of project appraisal and management—could bring tangible efficiency gains as well.[17]
- *Pension system:* Additional fiscal savings can be achieved through reforms of special pension regimes and measures to mitigate the adverse impact of the retirement age reduction. In this regard, the recent pension system review suggested introducing a minimum-years-of-service requirement, reducing incentives for double-dipping (getting a pension and working at the same time), and increasing public awareness of the old age poverty. However, these measures may not fully offset the negative impact of the retirement age reduction (Annex VI).
- *Fiscal institutions:* Staff welcomes the authorities' intention to develop a medium-term budgetary framework starting in the 2018 budget cycle with the IMF's TA support. As a priority, staff urges the authorities to operationalize SER by identifying specific expenditure measures ex ante, underpinned by a well-defined system of medium-term expenditure forecasts for each ministry.

Authorities' views

30. The authorities saw upside risks to fiscal performance in 2017 and underscored their commitment to the medium-term fiscal consolidation. They expected the deficit to outperform the budget target of 2.9 percent of GDP in 2017 on the back of strong revenue collection, and indicated their intention to save revenue overperformance. They agreed with staff's assessment on the need to rebuild fiscal space, which would help increase the capacity to respond to shocks and to accommodate long-term pension expenditures and public investment. They were optimistic on the timing and magnitude of expected gains from tax administration reforms, and thought such revenue gains would be sufficient to achieve the medium-term fiscal objective. The authorities acknowledged that any additional structural adjustment will be politically challenging before the 2019 elections. They concurred that the reversal of the 2013 retirement age increase could entail additional fiscal costs, but noted that the defined contribution pension system and tight labor market conditions could encourage eligible retirees to stay in the work force longer.

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[16] See the 2016 Article IV consultation.

[17] See the Regional Economic Issues Report on Central Eastern and Southeastern Europe (November 2016).

C. Financial Sector Policies: Preserving Resilience

31. Banks remain sound, but profitability continues to decline (Figures 7, 14). Banks are well capitalized, with the average capital adequacy ratio of 17.7 percent and the average Tier 1 capital ratio of 16.1 percent in 2016:Q4. The banking sector liquidity continued to improve on the back of strong deposit growth from both corporate and household sectors, leading the loan-to-deposit ratio to decline to 106.6 percent in 2016:Q4 (Table 5). The bank asset quality improved as well, with the non-performing loans (NPLs) edging down to 7 percent of total loans. However, profitability continued to decline.[18] The NBP's latest assessment suggests that commercial banks remain resilient to a range of macroeconomic, market and liquidity shocks, albeit lower profitability reduced their buffers, while some of the credit unions and cooperative banks continue to struggle to stay afloat.[19]

32. Falling bank profitability reflects the challenges of operating in a low interest rate environment with rising costs (Figure 7). Interest margins remain squeezed amid low interest rates and stable lending rates. Banks' non-interest expenses have increased, including from the bank asset tax, additional contributions to the Bank Guarantee Fund (for both deposit guarantee and bank resolution funds), as well as changes in tax deductibility. As a result, the aggregate banking sector return on equity has dipped below the cost of equity.

33. Profitability pressures have not affected credit supply yet. Lending standards tightened slightly in recent quarters (especially on corporate loans[20]), but do not appear to have constrained credit growth. A deceleration in corporate credit growth has been driven by weaker demand for working capital, while credit for investment continued to grow at 9.9 percent (as of March 2017). Mortgage lending has been constrained by the macroprudential measures,[21] while consumer credit has seen the fastest growth.

34. The final solution for FX mortgage loans is still pending, but will likely entail further costs for banks. The stock of FX mortgages has been shrinking since March 2012 and now accounts for 7.7 percent of GDP (Figure 8). While these loans are not viewed as a source of systemic risk either by the NBP or by the Financial Supervision Authority (KNF), the solutions proposed by the authorities to address consumer protection concerns related to FX mortgages could entail significant costs to banks. The authorities' approach appears to be two-pronged—legislative and regulatory—with the final solution possibly including both elements:

[18] By 11 percent y-o-y for the first three months of 2017. Excluding a one-off factor (Visa's merger to Visa Europe), which boosted profitability significantly in 2016:Q2, bank profitability has continued to decline since early 2015.

[19] See the NBP's Financial Stability Report (June 2017).

[20] Reportedly related to stronger tax enforcement, which has led banks to increase scrutiny of corporates.

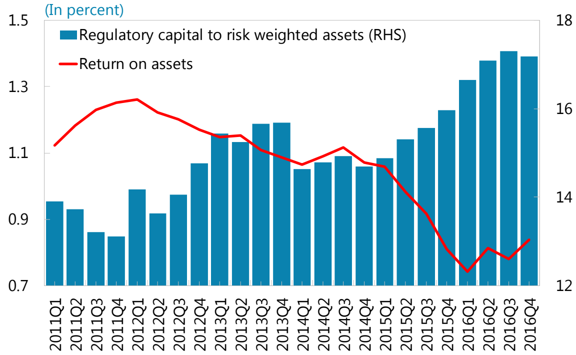
[21] Recommendation *S* on good practices of the management of credit exposures secured by mortgages (effective since January 1, 2017) requires that the loan-to-value ratio for new loans should not exceed 80 or 90 percent, unless the surplus over 80 percent is insured or secured in other forms. See the NBP's Financial Stability Report, June 2017.

Figure 7. Banking Sector and Credit Developments

Bank profitability has continued to weaken…

Banking Sector Profitability and Capital

(In percent)

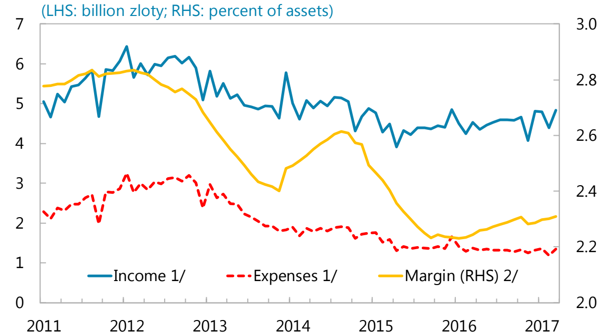


Sources: Polish Financial Supervision Authority and IMF staff Calculations.

…as net interest margins remained compressed…

Interest Income, Expenses, and Margin

(LHS: billion zloty; RHS: percent of assets)

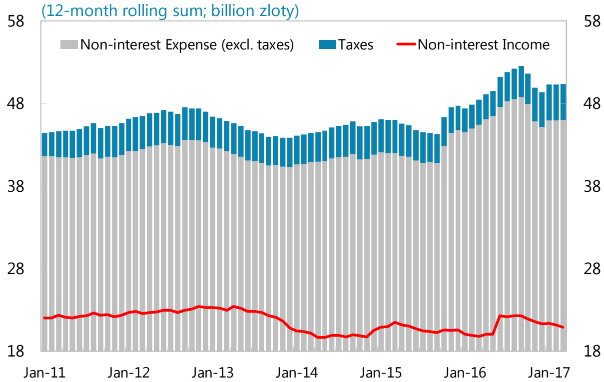


Sources: KNF and IMF staff calculations.
1/ Monthly income and expenses.
2/ 12-month sum in percent of assets.

… and non-interest expenses (incl. taxes) rose considerably.

Non-interest Income and Expenses

(12-month rolling sum; billion zloty)

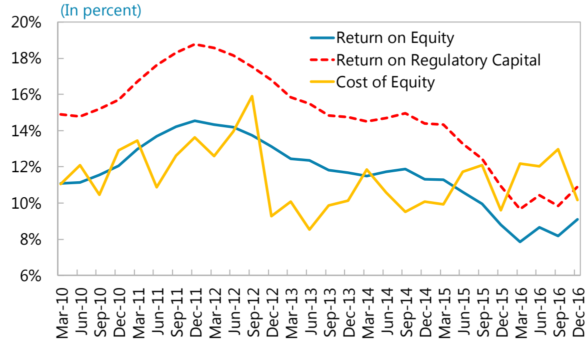


Sources: KNF and IMF staff calculations.

As a result, the return on equity dropped below the cost of equity

Cost of Capital Compared to Return on Equity

(In percent)

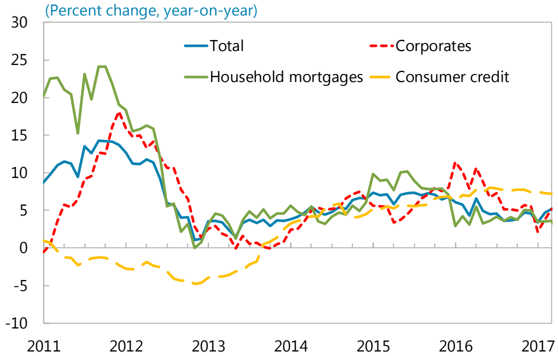


Sources: Bloomberg Finance L.P. and National Bank of Poland.
1/ Based on 11 large banks listed on the Warsaw Stock Exchange. One-off returns are excluded.

Credit expansion has slowed, especially to corporates…

Private Sector Credit Growth

(Percent change, year-on-year)

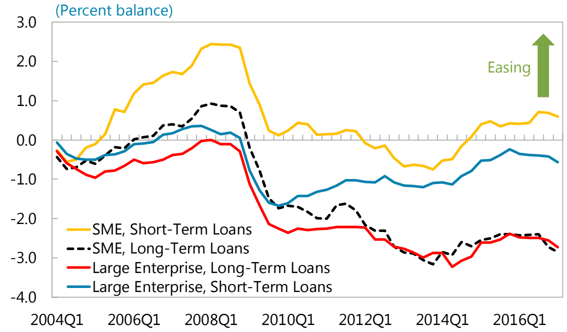


Sources: Haver Analytics and IMF staff calculations.

… while lending standards on corporate loans tightened slightly.

Cumulative Change in Lending Standards to Corporate Loans

(Percent balance)



Sources: Haver Analytics and IMF staff calculations.
1/ An increase in the index value means an easing of credit standards.

- *The legislative solution*: the early-2016 proposal of a mandatory conversion of FX mortgage loans into PLN was replaced in August 2016 by the President's Office (PO) proposal for banks to repay excessive FX spreads unfairly charged to borrowers. The PO proposal is currently under review by the parliamentary Public Finance Committee. Depending on the final decision, expected this summer, the cost could be in the range of PLN 4–9 billion (up to two-thirds of the 2016 banking sector profits).

- *The regulatory solution*: The Financial Stability Committee (KSF) released nine recommendations in January 2017 aimed at encouraging banks to restructure FX mortgages, including through conversion of FX mortgages into PLN (Figure 8). The key measures include higher risk weights on FX mortgage loans (from 100 percent to 150 percent), and broadening the scope of the existing Borrowers' Support Fund (established in 2015) to include a dedicated fund based on contributions by banks with FX mortgage portfolios to cover the costs incurred during voluntary restructurings. The expanded Borrowers' Support Fund is viewed as the key tool to accelerate the restructuring of FX mortgage loans. Most regulations are expected to come into effect by end-2017 or early 2018. Progress on voluntary conversion has been slow so far, as banks are waiting for clarity on the final solution.

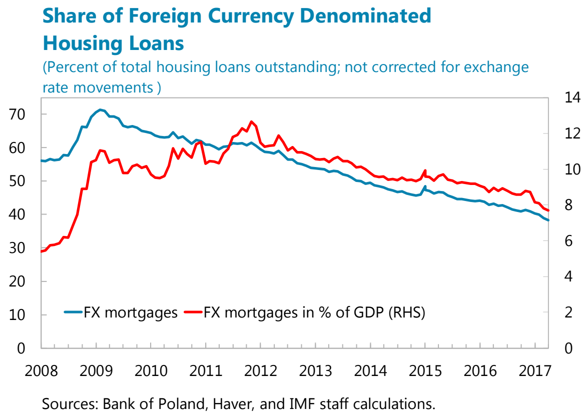
35. Recent polices have contributed to tighter sovereign-bank linkages:

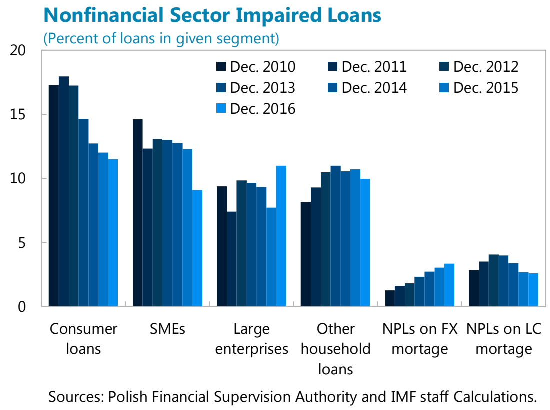
- *Banks' holdings of government bonds*: Banks' holdings of domestic government bonds, which are exempt from the bank asset tax, have seen a sharp step increase in February 2016, the first month when the bank asset tax was calculated and paid, and have continued to rise since then. By April 2017, banks held about 40 percent of total government bonds outstanding, which constituted about 14 percent of banks' total assets. Larger holdings of government bonds imply higher exposure to market risk in the event of capital outflows triggered by global market volatility or a re-assessment of Polish sovereign risk in the event of fiscal slippages.

- *State ownership of financial intermediaries:* With the sale of the UniCredit's remaining share in Pekao S.A. to the state-controlled insurance group PZU and the state-owned Polish Development Fund (PFR), the share of domestic ownership of the banking sector has risen to above 50 percent, and the share of state-controlled banks to 36 percent (in percent of total banking system assets). In addition to increasing financial sector concentration, the latest transaction has also created a systemically important financial conglomerate operating in banking and insurance markets, which entails new prudential and macro-prudential challenges for supervisors.

Figure 8. Foreign-Currency Mortgage Loans

The stock of foreign-currency mortgages continues to decline… *… while the NPLs ratio remains relatively low and stable.*





Sources: Polish Financial Supervision Authority, KNF, NBP, and IMF staff calculations.

Financial Stability Committee's Recommendations to Encourage Conversion of FX mortgages into PLN

1. Increase the *risk weighting for FX mortgages* from 100 percent to 150 percent for banks' standard capital assessment methods. The regulation is being finalized and will come in effect on December 1, 2017.

2. Increase the minimum *Loss Given Default (LGD) parameter* for banks using Internal Ratings Based (IRB) approach to assess capital requirements.

3. Change the operating design of the *Borrowers' Support Fund* to encourage voluntary restructuring, including by linking a bank's contribution to the fund to the value of its FX mortgage portfolio. The amendment to the Law on Support for Borrowers is being finalized, and is expected to be effective from January 1, 2018.

4. Develop adequate solutions to neutralize potential excessive *tax burdens*, which may result from the restructuring of FX mortgages.

5. Impose a 3 percent *systemic risk buffer* (from the current zero percent), the maximum level for which the opinion of the European Commission is not required. This buffer will apply to all banks regardless of the size of their mortgage portfolios, and will replace the 4 percent "discretionary" buffer imposed by the KNF. This is likely to be in effect from January 1, 2018.

6. Modify the methodology used in the annual *Supervisory Review and Evaluation Process* of Commercial, Associating and Cooperative Banks (BION) to allow the KNF to assign additional capital charges to banks by including risk factors related to FX mortgages, such as operational risk, market risk and the collective default risk of borrowers. The methodology has been updated in April 2017 and the BION study will be implemented in November 2017.

7. To complement the Pillar II additional capital requirements, the KNF can impose *additional capital requirements* (the so-called capital surcharges) on banks with FX mortgage portfolios to cover not only credit risks (already in practice), but also other risks associated with these portfolios. The KNF plans to send individual banks the new capital surcharges in 2017:Q4.

8. Issue the supervisory recommendation on *good practices in restructuring FX mortgages*. The recommendations should identify all risks and costs associated with maintaining the FX mortgage portfolios, describe good practices for restructuring, and require banks to prepare restructuring plans. These supervisory recommendations will be presented by the KNF by end-2017.

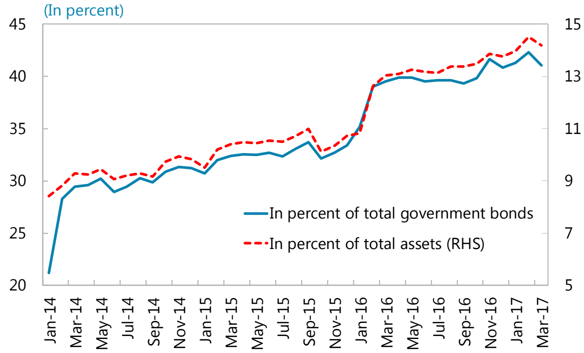
9. Modify individual bank's contributions to the Bank Guarantee Fund to increase the premium paid by banks with FX mortgage portfolios. This was completed in February 2017.

Sovereign-Bank Linkages

Banks' holdings of government bonds have been rising steadily.

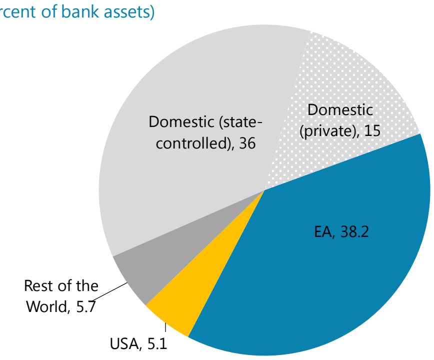
The shares of domestic and state-controlled banks in total banking sector assets increased as well.

Banks' Holdings of Government Bonds
(In percent)



Sources: Ministry of Finance, Polish Financial Supervision Authority, and IMF staff calculations.

Bank Ownership Structure
(Percent of bank assets)



Sources: Polish Financial Supervision Authority (KNF) and IMF staff estimates.

36. **Preserving financial sector resilience is critical to ensuring financial stability and strong growth.** Staff's main recommendations are:

- *Foreign-currency mortgages.* Staff's view remains that a case-by-case approach to FX mortgage restructuring is preferable—that is, only distressed mortgage borrowers would be offered a restructuring. Both the legislative and the regulatory solutions appear to be significantly less costly for banks compared to the mandatory blanket conversion scheme proposed in early 2016. That said, their impact on the sector and on individual banks should be carefully assessed. The drawback of the proposal to repay excessive FX spreads (legislative solution) is that it does not address the stock of FX mortgages. In comparison, the regulatory solution does aim to provide incentives for banks to reduce their FX loan books, but there is a risk that the final package of measures could induce banks to offer overly generous terms to the FX mortgage holders (without due regard to the debt-to-income or loan-to-value ratios) because of pressures to meet the FX loan restructuring targets.

- *Profitability pressures on banks, including from tax burdens:* The authorities should continue to monitor the impact of the bank asset tax on banks' activities and risk profiles, and stand ready to revise its design, if adverse effects become apparent. Staff's view remains that a tax on profits and remuneration (proxying the VAT from which the financial sector is exempt) would be less distortionary than a tax on assets. A more holistic assessment of the impact of rising total costs on banks' profitability, resilience and credit supply would be warranted.

- *Credit unions and cooperative banks*: The difficulties in the credit union and cooperative bank segments should be addressed in a sustainable way, including by encouraging further consolidation/integration and ensuring an orderly market exit of unviable firms.

- *Sovereign-bank linkages:* The increasing sovereign-bank linkages warrant close monitoring, as they may mutually reinforce fiscal and financial vulnerabilities, increase banks' exposure to market risk and affect liquidity in the government bond market. In this regard, maintaining a strong and independent supervision and robust macroprudential framework is critical.

Authorities' views

37. The authorities shared the view that the final solution to FX mortgages should preserve financial stability, but were less concerned about the effects of the bank asset tax. The authorities believed that major risks associated with the introduction of the bank asset tax have not materialized and banks were strong enough to "digest" the bank asset tax without adverse impact on credit supply. While the final solution to address consumer protection concerns related to FX mortgages is still pending, the authorities noted the need to manage total costs to banks to safeguard their resilience and financial stability. The authorities viewed the rising sovereign-bank linkages in a more positive light: they saw the sizable increase in banks' holdings of government bonds as reducing the financing risks for the government without adversely affecting banks' risk profiles, and the acquisition of the subsidiary of UniCredit by the state-controlled insurer and the state-owned PFR as reducing the risk of negative financial spillovers from abroad.

D. Structural Reforms: Upgrading Poland's Growth Model

38. Given demographic pressures and baseline policies, potential growth will likely remain below the pre-crisis level over the medium term. On current policies, staff estimates that the baseline potential growth will likely drift to 2.7 percent (Annex II), well below the pre-crisis average. These estimates already reflect positive spillovers from improving global environment on Poland's TFP growth (Figure 18), without which the estimated potential growth rate would have been 0.2-0.3 percentage points lower.

39. Achieving higher potential growth will require faster productivity growth, stronger private investment, and higher labor force participation. The RDS aims to achieve convergence with the EU average per capita income by 2030 by focusing on re-industrialization, development of innovative firms and SMEs, promoting expansion of Polish companies abroad, mobilizing capital for development and promoting social and regional development (see below). In each of these areas, the RDS sets some quantitative targets and outlines the main programs/projects, but in most cases, the specific action plans, as well as their economic and fiscal impact assessments, are still being prepared. In what follows, staff outlines a menu of policies to boost potential growth (see below, and Selected Issues Paper for details) based on staff's diagnostics of Poland's structural reform gaps and on other studies by the IFIs. These policy options are used as a starting point for identifying reform priorities and constructing illustrative reform scenarios to inform the discussion on the design of structural reforms.

Table 1. Responsible Development Strategy–Key Areas and Selected Quantitative Targets

Objective I – *Sustained economic growth based increasingly on knowledge, data, and organizational excellence*	Indicator	Unit	Baseline (base year)	Target (2020)	Target (2030)
1.1 Reindustrialization *Increase in industry's ability to meet global competition*	Share of net revenue from the sale of products of industrial processing enterprises in the high- and medium-high-tech sectors in net revenue from the sale of products of industrial processing enterprises	%	32.7 (2014)	**34**	**40–45**
	Share of manufacturing in gross value-added	%	19.7 (2015)	**20**	**21**
1.2 Development of Innovative Firms *Increase in innovation of enterprises in domestic and foreign markets*	Spending on R&D activities relative to GDP	%	1.0 (2015)	**1.7**	**2.5**
	Spending by the enterprise sector on R&D activities relative to GDP	%	0.47 (2015)	**0.8**	**1.3**
1.3 Small and Medium-Sized Enterprises *Structural sector changes, new forms of action and cooperation, modern assistance mechanisms*	Poland's position in the NES GEM ranking for the category "Government Policy on Entrepreneurship" (ranked between 10th and 15th)	ranking	16 (2014)	**15**	**13**
1.4 Development Capital *Sustained increase in the investment rate and the quality of investments in the long run, with greater use of domestic resources*	Investment rate	% GDP	20.1 (2015)	**22.0–25.0**	**25**
	Gross household savings relative to GDP	%	1.7 (2014)	**2.2**	**>5.0**
1.5 International Expansion *Increase in the internationalization of the Polish economy. Increase in exports of high-tech goods.*	Average annual growth rate of goods exports	%	6.8 (2009–14)	**7.2 (2015–20)**	**6.8 (2021–30)**
	Share of exports of high-tech products in total exports	%	8.5 (2015)	**10**	**15**

Objective II – Socially and regionally balanced development	Indicator	Unit	Baseline (base year)	Target (2020)	Target (2030)
2.1 Social Cohesion *Reduction of poverty and social exclusion and improved access to services in response to demographic challenges. Increase and improvement in the use of human potential in the labor market.*	Indicator of female employment involving women with the youngest child aged up to 5 years, according to the Labor Force Survey (LFS)	%	64.1 (2015)	**65**	**70**
	Proportion of children aged 0-3 years in various forms of institutional care	%	8.1 (2015)	**10**	**33**
	Employment indicator for people aged 20–64	%	67.8 (2015)	**71**	**73**
2.2 Territorially Sustainable Development *The country's sustainable development using the unique potential of regions. Strengthening of regional competitiveness based on economic specialization and new market niches identified at national and regional levels. Improvement in the efficiency and quality of the implementation of regionally focused policies.*	Share of private-sector investment in total investment: 1) Poland, 2) selected voivodships	%	1) 62.6 2) 51.2 (2014)	closer alignment of the level of selected voivodships with the national average	
	Ratio of the net average annual disposable income per capita in a household in rural areas to the city	%	69.5 (2015)	72	75

Objective III – Effective state and institutions for growth and for social and economic inclusion	Indicator	Unit	Baseline (base year)	Target (2020)	Target (2030)
3.1 Legislation for Citizens and the Economy *Simplification of legislation ensuring better conditions for conducting business and fulfilling the needs of citizens*	Global Competitiveness Index (GCI) – regulatory burden	ranking	122 (2015)	**97**	**80**
	Regulatory Quality Indicator	indicator	1 (2015)	**1.3**	**1.5**
3.2 Pro-development and Strategic Institutions *Inclusive and effective public institutions. Development of an integrated social, economic, and zoning planning system.*	Government Effectiveness Indicator	indicator	0.8 (2015)	**1**	**1.3**
3.3 Public Finance *Stable, efficient, and sustainable public finance*	General government investment rate	% GDP	4.4 (2015)	**above EU average**	**above EU average**
3.4 Effective Use of EU Funds *Use of funds from the EU budget in a way that translates into lasting developmental effects*	Share of repayable assistance in financing projects co-funded with EU funds	%	5 (2014–20)	**7**	**25**
	Share of Polish ventures/projects in the value of programs administered by the European Commission	%	1 (2014)	**2.5**	**5**
3.5 Human and Social Capital *Improved quality of human capital. Increased share of social capital (including civil society organizations) in socio-economic development*	Adults participating in education or training (aged 25–64)	%	3.5 (2015)	**4.2**	**9**

Note: the areas not included in this table, but also covered in the RDS are digitization, transportation, energy, environment, and national security.

Policies to Address Structural Obstacles to Higher Potential Growth

To counter shrinking labor supply

- increase labor force participation (LFP) through more effective labor market policies (e.g., vocational training)
- provide incentives for seniors to remain in the workforce past their retirement age
- improve child-care services to raise female LFP
- address the decline in the working age population (WAP) through immigration policies and policies aimed at increasing fertility

To increase private investment

- streamline the product market regulations (PMR) to reduce regulatory burdens and ensure level playing field
- reduce administrative burdens on startup companies
- improve physical and ditigal infrastructure through efficient public investment
- improve the quality of vocational training

To lift TFP growth

In addition to policies mentioned earlier:

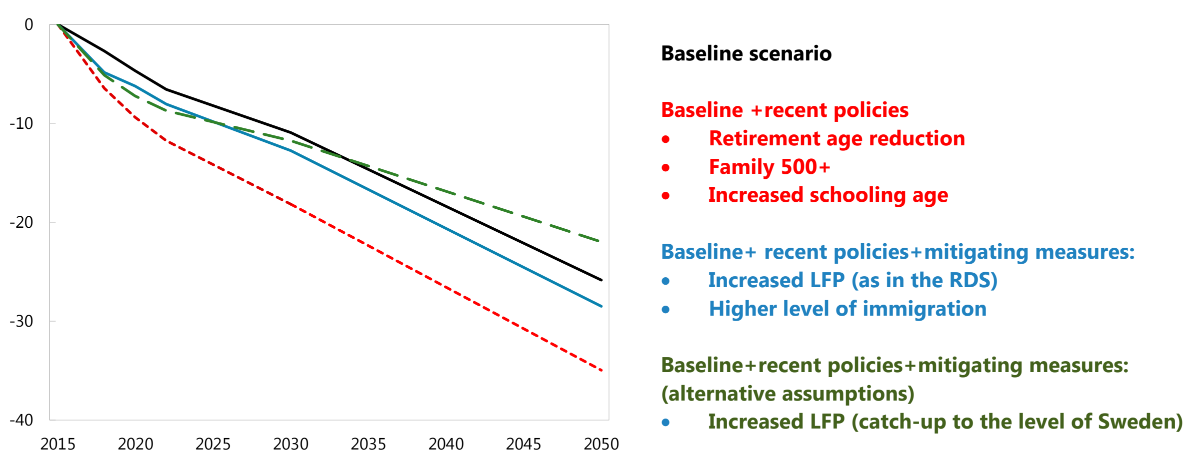
- provide R&D support to private companies
- reduce barriers (incl. labor market rigidities) to resource reallocation across sectors
- enhance institutional and government efficiency

Source: IMF staff analysis

40. Higher labor force participation (LFP) would help counter demographic headwinds. While the need to increase the LFP amid rising demographic pressures is well understood, some recent policies (notably, the reversal of the 2013 retirement age increase) go in the opposite direction and will likely exacerbate the adverse dynamics of labor supply (see chart below and Annex VI). Staff's estimates suggest that, even with strong mitigating policies aimed at increasing the LFP (up to the highest level in the EU) and encouraging immigration, the decline in the working age population (WAP) will be significant. Staff's analysis also shows that the estimated negative impact of the reversal of the 2013 retirement age increase would be difficult to offset even with strong measures (see chart below), which underscores the need to provide incentives for seniors to stay in the labor force longer.

Labor Supply: Demographics and Policies

Cumulative loss of the labor supply (in percent of 2015 WAP) under different scenarios



Source: IMF staff calculations. For more details, see the 2017 Article IV Selected Issues Paper, Chapter 1.

41. Closing the key structural reform gaps and leveraging Poland's comparative strengths would help boost investment and TFP growth. The key reform gaps are identified using quantitative indicators and qualitative assessments (Figure 9):

- Based on a wide range of indicators from the Word Bank, OECD, and World Economic Forum (WEF), the areas where Poland lags the most compared to its peers (OECD countries) include *infrastructure*, *business regulation, labor market efficiency,* and *R&D/innovation.* The Poland specific studies by international institutions further identify shortcomings in *labor market regulation*, *human capital development*, and *institutions/government efficiency*. A still relatively high share of agriculture and relatively low share of services (compared to peers) suggest that there may be scope to re-allocate resources towards higher-productivity sectors.[22]

- But there are also areas where Poland scores well relative to peers: it has market-friendly institutions, low barriers to trade and investment; less regulatory complexity and less regulatory protection of incumbents; as well as relatively high quality of human capital. These strengths should be preserved and better leveraged.

42. Closing the key reform gaps could lead to a significantly higher level of output in the long term. The impact of closing (or partially closing) the structural reform gaps in four key areas—*product market regulation* (*PMR), labor market policies, infrastructure investment,* and *R&D support*—on the level of GDP by 2030 is estimated using the FSGM model calibrated for Poland. For the reforms that entail additional fiscal costs, the calibration of reform efforts reflects fiscal constraints (the baseline deficit projections, and the EDP and debt limits). Staff's estimates suggest that under a range of plausible reform scenarios, the level of output could be lifted by about 7–11 percent by 2030, covering about a third of the distance to the RDS convergence objective (Figure 10). This also means that more will have to be done to achieve the goals set out in the RDS. Other areas not included in the simulations, but where there is scope for improvement (relative to the OECD average), include *human capital development* and *institutions/government efficiency*.

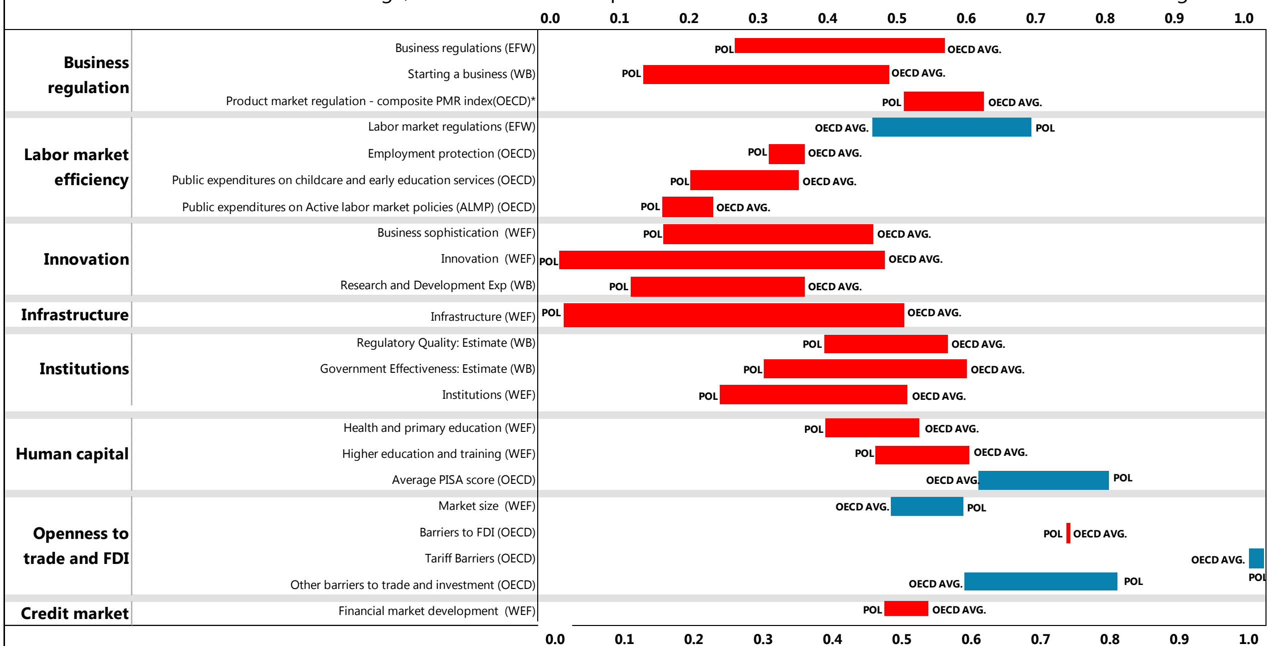
43. Given limited fiscal space, the impact of the RDS on public finances should be carefully assessed and reflected in the authorities' fiscal consolidation strategy. Some of the flagship projects under the RDS point to an increasing role of the state, but the fiscal implications, including possible increase in contingent liabilities, have not yet been fully assessed. Staff's analysis shows that the scope for additional spending on growth-enhancing reforms will remain limited without further structural fiscal adjustment (Figure 10).

[22] See the 2015 Article IV Consultation Selected Issues Paper on structural transformation.

Figure 9. Structural Reforms Gaps and Priorities

Structural Reform Gaps

The table below shows Poland's position vis-à-vis OECD countries on a number of structural indicators. All indicators are normalized to take values between 0 (min) and 1 (max), with higher values indicating better outcomes. The blue bars correspond to indicators where Poland exceeds the OECD average, while red bars correspond to indicators where Poland falls below the OECD average.



Sources: OECD, World Bank (Doing Business Indicators, Worldwide Governance Indicators, and WDI), WEF, EFW and IMF staff calculations.

Note: for more details see the 2017 Article IV Selected Issues Paper, Chapter 3

Structural Reform Priorities

	Structural Bottlenecks	Recommendations from International Institutions: IMF Board Paper (2016) 1/	IMF REI (May 2016) 2/	IMF Past AIV Reports 3/	OECD (2015) 4/	EC Country Report (2017) 5/
Most Lagging Areas 6/	**Infrastructure**	√	√	√	√	√
	Business Regulation	√	√		√	√
	R&D and Innovation		√			√
Less Lagging Areas 7/	**Labor Market Regulation**	√	√	√	√	√
	Human Capital		√		√	√
	Institutions and government efficiency			√		√

1/ based on findings for all emerging markets, not Poland-specific. See "Staff Note for the G20—A Guiding Framework for Structural Reforms".
2/ based on the comparisons of institutional indicators for Poland relative to other OECD and CESEE countries, see IMF REI (May 2016) for more details;
3/ based on the IMF staff's recommendations over the past four years, see 2016 Article IV, 2015 Article IV, 2014 Article IV, and 2013 Article IV for more details;
4/ see "Economic Policy Reforms: Going for Growth" Country Note on Poland (2015) for more details.
5/ includes areas, where progress falls short of targets, see EC Country Report (2017) for more details.
6/ areas where most indicators for Poland are below the OECD average.
7/ areas where most indicators for Poland are below the OECD average, but the gaps are relatively small compared to the most lagging reform areas.
Note: For more details see the 2017 Article IV Selected Issues Paper, Chapter 4

Figure 10. Potential Gains from Structural Reforms

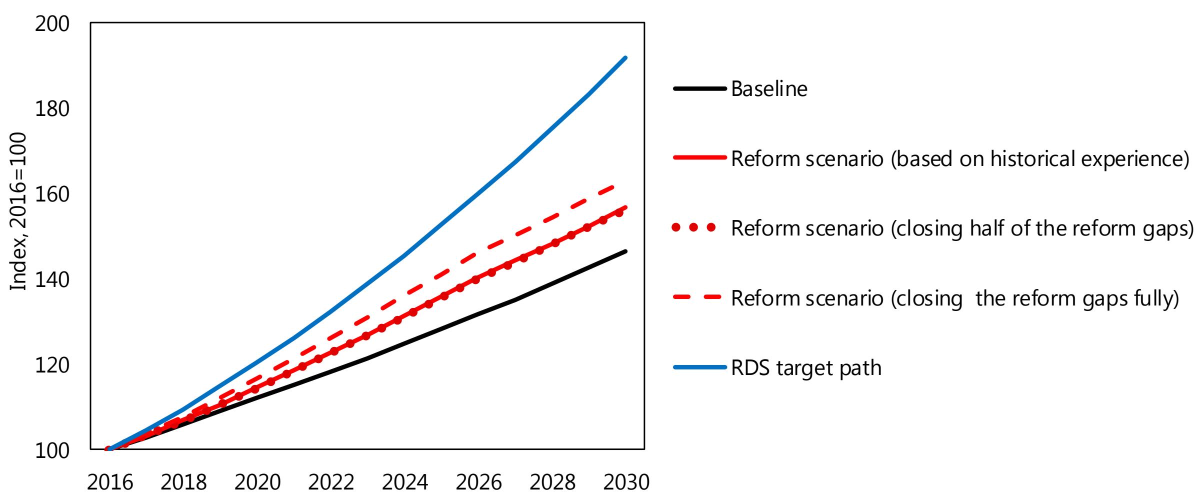
Illustrative Reform Scenarios: Estimated Impact of Specific Structural Reforms on the GDP level by 2030

	Reform scenario based on past experiences of Poland and the best performers		Reform scenario in which Poland **closes half of the reform gaps** relative to the OECD average by 2030		Reform scenario in which Poland **fully closes the reform gaps** relative to the OECD average by 2030	
	Impact on GDP level by 2030 (pp increase)	Impact on Government deficit/GDP (pp increase, avg. per year)	Impact on GDP level by 2030 (pp increase)	Impact on Government deficit/GDP (pp increase, avg. per year)	Impact on potential GDP level by 2030 (pp increase)	Impact on Government deficit/GDP (pp increase, avg. per year)
Relaxing administrative burdens on startups	1.39	-	0.68	-	1.33	-
Relaxing regulations on professional services and retail	0.83	-	0.97	-	1.86	-
Relaxing regulations on gas sector	0.75	-	1.51	-	3.01	-
Relaxing regulations on airlines and road sectors	0.74	-	0.96	-	1.90	-
Relaxing employment protection	0.78	-	0.38	-	0.56	-
Increasing infrastructure spending	1.17	0.36	1.40	0.43	0.78	0.25
Increasing public spending on childcare services	0.49	0.11	0.48	0.11	0.93	0.23
Increasing direct public funding of business R&D	0.49	0.03	0.24	0.01	0.46	0.03
Increasing public spending on ALMP	0.23	0.13	0.09	0.07	0.17	0.13
A combined impact of all reforms	**7.01**	**0.66**	**6.84**	**0.66**	**11.41**	**0.66**
of which fiscally costly reforms	*2.37*		*2.21*		*2.33*	

Note: In the scenario based on the past experiences of Poland and best performers, various structural reform gaps are closed by 25-50 percent. The estimates of the impact on the level of GDP in 2030 are based on the FSGM simulations using elasticities from different OECD studies. The latest OECD indicators are from 2013. The fiscal space used for additional spending in all scenarios reflects fiscal constraints (the baseline deficit projections, the EDP and debt limits). For reforms that require fiscal spending, the impact on output takes into account the effects of the required increase in deficit financing.

For more details on the methodology, see 2017 Article IV Selected Issues Paper, Chapter 4.

Long-run Growth: Baseline, Reform Scenarios, and the RDS Target Growth Path

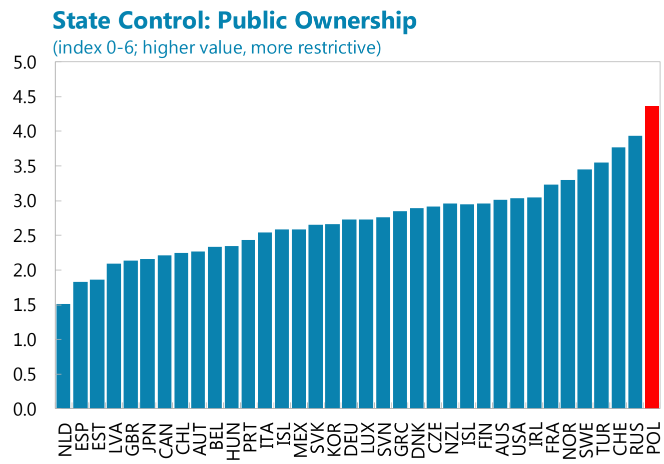


Note: The reform scenarios shown in this chart correspond to the ones detailed in the table above. RDS target path is based on the targets stated on RDS.

For more details, see 2017 Article IV Selected Issues Paper, Chapter 4.

44. **The reforms should focus on creating more efficient institutions and more growth-friendly regulations.** The RDS envisages an important role for the government in promoting growth (e.g., promoting national champions, and active use of development funds). Given that the state footprint in the economy is already significant (see chart), while the business investment as a share of GDP is relatively low, the priority should be given to reforms that make investment more attractive for domestic or foreign private investors. A sound approach would be to ensure the same level playing field for all market participants that would allow resources to be channeled to the most efficient and innovative firms. Also, cross-country experience shows that policies aimed at supporting specific industries and SMEs may not always be as effective as intended.[23] As regards to the state-controlled firms, it is important to maintain strong governance standards and effective oversight of their financial performance and to advance privatization in line with staff's past advice.[24]

Poland ranks above other OECD counties on the extent of public ownership in the economy.



Source: OECD (2013).

45. **Given Poland's structural reform gaps, strong cyclical position, and limited fiscal space, staff's analysis suggests the following structural reform priorities:**[25]

- *Regulations*: Streamlining the PMR—reducing administrative burdens on startups, and deregulating professional services and network industries—could bring substantial benefits without additional fiscal costs. The reform gaps (Figure 9) in these areas and the estimated growth impact from closing these gaps (Figure 10) are consistently higher than for other reforms. Among the PMR reforms, reducing administrative burdens on startups and relaxing the regulations on professional services and retail distribution could have the largest impact, when reform efforts are calibrated based on historical experiences.

[23] See Fiscal Monitor, April 2016 and April 2017.

[24] While the quality of governance in the state-owned enterprises (SOEs) in Poland is generally perceived to be relatively good, SOEs tend to perform slightly worse than their private competitors, most notably in mining, transport and manufacturing (see the EC country report on Poland, 2017). Furthermore, in its 2017 report, the EC expressed concerns about some elements of the SOE governance reform (January 2017), which is meant to pave the way for increasing the role of SOEs in the economy.

[25] Staff's analysis is guided by the conceptual framework developed by the IMF, which has three principal steps: (i) identifying a country's structural policy gaps, (ii) considering the macroeconomic context, including income level, cyclical position, policy space and preferences and trade-offs, and (iii) prioritizing structural reforms. For details, see "Staff Note for the G20—A Guiding Framework for Structural Reforms".

- *Labor-market policies:* The well-targeted *active labor market policies* (ALMPs) (e.g., improving vocational training) could help increase the LFP by addressing skill mismatches of young workers, long-time unemployed women, and seniors, and by helping integrate the less-skilled immigrants. Policies to provide *incentives for seniors* to stay in the workforce past their retirement age could also increase the LFP and help mitigate shortages of skilled labor. *Reforms of the childcare and early education system* should be designed to increase the female LFP, which is currently lagging the most. However, these policies would entail some fiscal costs, which could, in the first instance, be covered by the allocated EU funds. Other elements of the labor market regulation could also be reviewed with the aim of reducing constraints on labor reallocation across sectors. For instance, reducing *labor market protection*, where there is still a gap relative to best practice (Figure 9), could bring long-term growth benefits without adverse short-term economic effects given the economy's strong cyclical position.

- *Infrastructure and R&D*: A more targeted and more efficient public spending on *infrastructure* and *R&D support*, that relies as much as possible on the allocated EU funds, could help lift private investment and TFP, and support the efforts of the Polish firms to move up the value chain (Figure 10).

Authorities' views

46. The authorities reiterated their commitment to the RDS and to advancing structural reforms. They noted that the implementation of some reforms started before the formal adoption of the RDS in February 2017. The authorities acknowledged the need to increase the LFP amid rising demographic pressures and noted several projects in the pipeline such as increasing the number of childcare facilities, changing the school structure to address the needs of businesses and to reduce youth unemployment and emigration to the west, and increasing the adaptability of senior citizens to changing labor market conditions. Moreover, the flagship projects on complex technological products as well as support of SMEs and start-ups are expected to boost the TFP. Finally, the authorities underscored that although the EU funds are an important financing source, state funds are also intended to be actively used for the implementation of the RDS. Nonetheless, they viewed the RDS as broadly fiscally neutral.

SAFEGUARDS ASSESSMENT

47. Safeguards procedures for Poland's FCL arrangement are underway. Staff held discussions with E&Y Audyt Polska, the external auditor of the NBP, and no significant safeguards issues emerged on the 2016 and 2015 external audits. Financial statements continue to be published on a timely basis and the audit opinions remain unqualified.

STAFF APPRAISAL

48. Poland's economic fundamentals and policy frameworks remain very strong. Public debt is moderate. International reserves are adequate, and the external position is broadly in line with macroeconomic fundamentals and desirable policy settings. The financial system is sound, and supported by strong financial regulation and supervision. The institutional settings are appropriate to support the authorities' policy commitments, including a flexible exchange rate to work as an effective shock absorber, an inflation targeting regime to guide monetary policy, and medium-term fiscal targets to anchor fiscal consolidation.

49. Despite the current strong cyclical upswing, longer-term growth prospects are more subdued. Growth is expected to accelerate in 2017, supported by accommodative policies, higher public investment boosted by EU funds, and strong consumption. Labor market conditions continue to tighten, with unemployment at record low. Headline inflation increased rapidly, crossing the lower bound of the central bank's target band. But subdued private investment and lower than pre-crisis TFP growth cast a shadow over the medium-term growth prospects. Thus, the key challenge ahead is to ensure timely and effective implementation of policies and reforms to sustain strong and inclusive growth.

50. While appropriate for now, the monetary policy stance should be tightened if accelerating core inflation threatens the inflation objectives. The incipient domestic inflationary pressures could accelerate amid an opening positive output gap and a pro-cyclical fiscal stance, and should be closely monitored. Wage pressures, though still moderate, are on the rise. Given significant uncertainties about the future pace of wage growth, monetary policy decisions should be data dependent. With lags in the monetary transmission mechanism and adaptive inflation expectations, timely actions are critical to avoid significant overshooting of the inflation target. A clear and consistent communication strategy would help guide expectations by stipulating the circumstances for a rate change rather than providing a time frame for how long the rates are likely to stay on hold.

51. The strong fiscal performance so far this year is welcome, and consolidation should start as soon as possible. Given favorable cyclical conditions and with the budget deficit only a shock away from the EDP limit, policy priorities for 2017 are to avoid breaching the limit and to save any revenue overperformance. Given the economy's cyclical position, the authorities' intention to start fiscal consolidation with about half a percent of GDP annual adjustment in the structural and headline deficits during 2018–19 is appropriate and would help reverse the pro-cyclical stance and build a "safety buffer" relative to the EDP limit. Beyond 2019, the pace of consolidation could be adjusted to accommodate any direct fiscal costs associated with growth-enhancing structural reforms, while still aiming to reach the MTO target no later than 2023, given projected aging costs and in anticipation of some phasing out of the EU funds.

52. The fiscal adjustment should be based on credible growth-friendly measures. In this regard, the authorities' efforts to upgrade the tax administration and the recent improvement in the tax collection are very encouraging, but future gains are uncertain, and therefore, should be budgeted conservatively. To further enhance the quality and credibility of the adjustment, additional measures could include keeping the VAT rate at the current level beyond 2018, eliminating preferential VAT rates and exemptions, rationalizing current spending through expenditure reviews and gradually phasing out preferential pension regimes. Introducing measures to encourage seniors to work longer could help partially mitigate the negative impact of the retirement age reduction, but may not be sufficient to fully offset the negative impact on public finances and the long-term sustainability of the pension system.

53. A resilient financial sector is critical to ensuring strong growth. While banks remain sound, their profitability has continued to decline, reflecting the challenges of operating in a low interest rate environment with rising costs and regulatory burdens. The bank asset tax should be monitored and adjusted if adverse effects on banks' activities and risk profiles become apparent. A tax on banks' profits and remuneration is a less distortionary alternative to the bank asset tax. The final solution to address consumer protection concerns related to FX mortgages should preserve banks' capacity for internal capital generation and lending. A voluntary case-by-case restructuring remains the best approach. Maintaining a strong and independent supervision and robust macroprudential framework is critical given the increasing share of the state-controlled entities in the Polish financial sector and rising bank holdings of sovereign bonds.

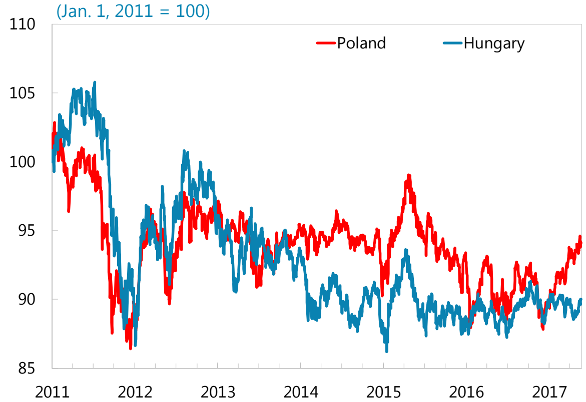
54. Structural reforms should focus on improving institutional and business environment. To have more growth-friendly regulations, there is a scope for reducing administrative burdens on startups and deregulating professional services and network industries. To address shortages of skilled labor and increase labor force participation, more effective and better focused active labor market policies and policies to upgrade the childcare and early education systems can be adopted. Also, better targeted and more efficient public spending on infrastructure and R&D support would help boost productivity and private investment. With limited fiscal space, the priority could be given to reforms that do not require additional public expenditures, while some fiscally costly reforms could, in the first instance, be financed by the allocated EU funds. While many elements of the RDS look promising, much work lies ahead to determine the key priorities and translate them into concrete reform plans, which should be closely coordinated with the authorities' fiscal consolidation strategy.

55. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Figure 11. Financial Market Developments

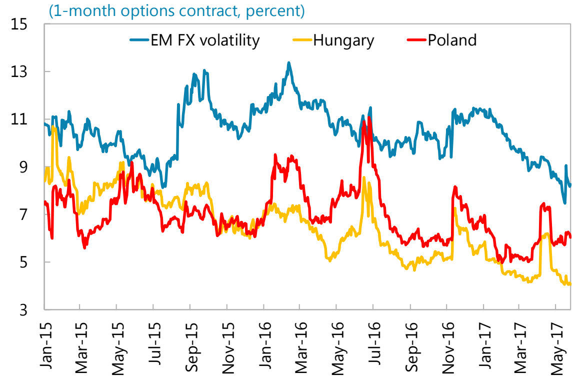
The zloty has appreciated since end-2016…

Exchange Rate: Euro per National Currency
(Jan. 1, 2011 = 100)



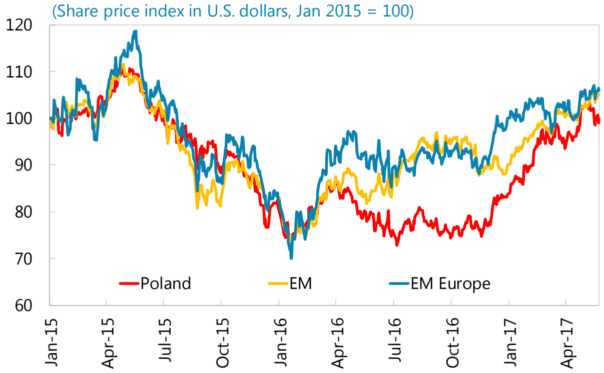
…and implied volatility trended down.

Implied Volatility of Exchange Rate vs. Euro
(1-month options contract, percent)



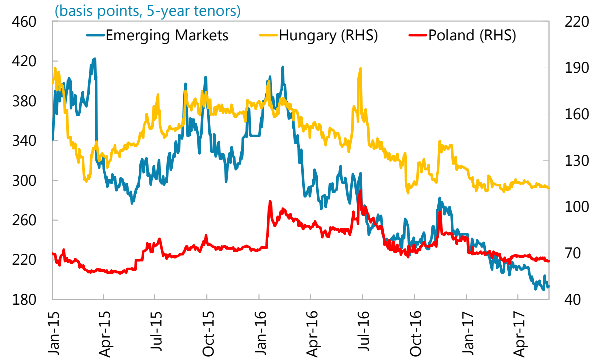
Equity market has gained some value as in regional peers.

MSCI Emerging Market Equity Index
(Share price index in U.S. dollars, Jan 2015 = 100)



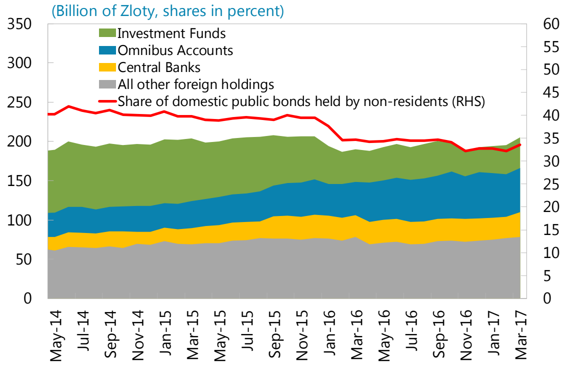
Credit default swap spreads remain narrow.

Sovereign Credit Default Swap Spreads
(basis points, 5-year tenors)



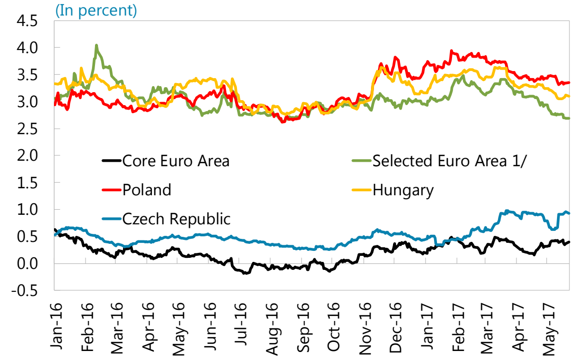
Foreign investors' holdings of domestic government bonds declined since a year ago…

Non-resident Holdings of Government Bonds
(Billion of Zloty, shares in percent)



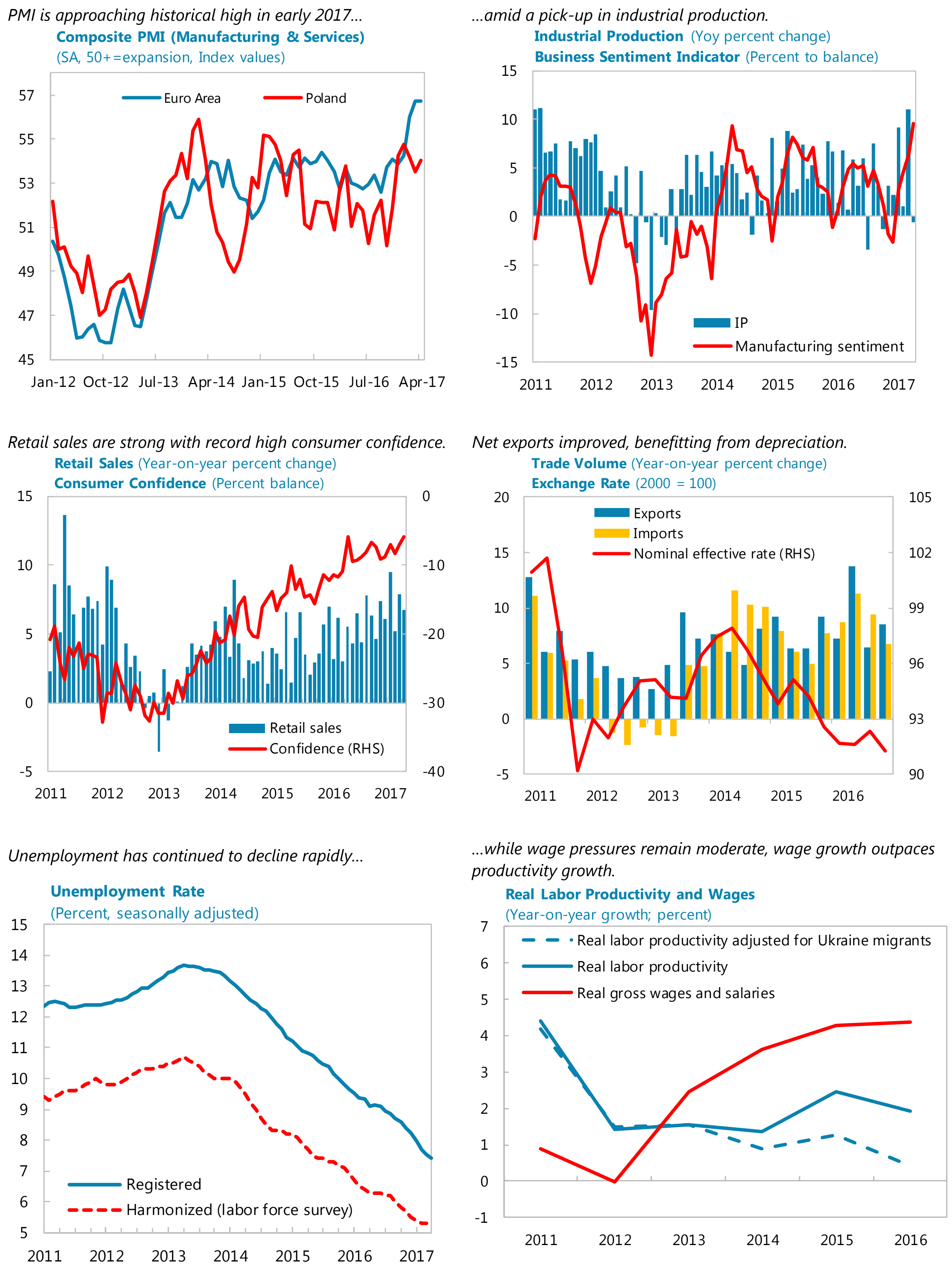
… and government bond yields have increased from late 2016.

Ten-Year Government Bond Yields
(In percent)



Sources: Bloomberg Finance L.P., Haver Analytics, Poland Ministry of Finance, and IMF staff calculations.
1/ Selected Euro Area includes Greece, Portugal, Spain, Ireland, and Italy.

Figure 12. Real Sector Developments, 2011–17

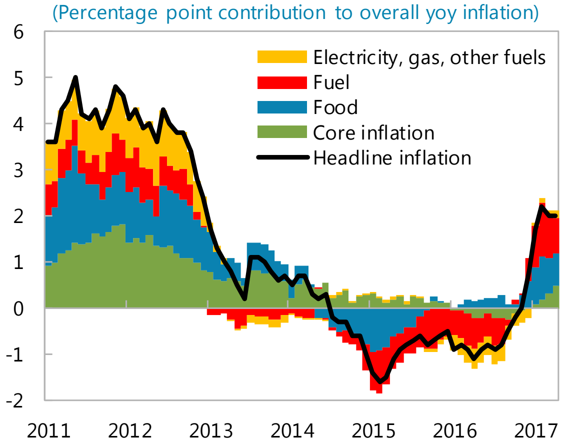


Sources: Haver Analytics, Poland Central Statistical Office, and IMF staff calculations.

Figure 13. Inflation Dynamics and Monetary Developments

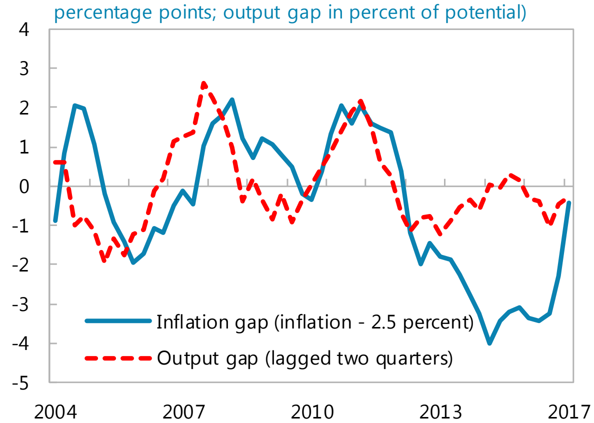
Inflation rose sharply on the back of higher fuel and food prices; core inflation rose as well, though from a low base.

Consumer Price Inflation
(Percentage point contribution to overall yoy inflation)



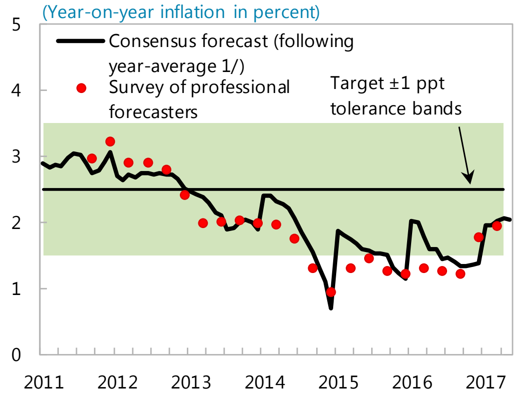
Domestic demand pressures are building up as output gap turned positive.

Inflation and the Output Gap (Inflation gap in percentage points; output gap in percent of potential)



Near-term inflation expectations rose accordingly...

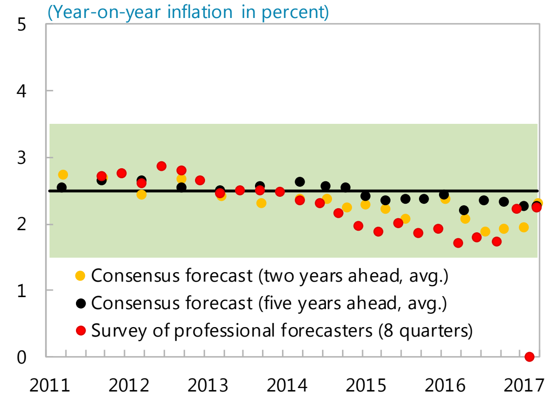
Inflation Expectations, One Year Ahead
(Year-on-year inflation in percent)



1/ Expectations for the following year's average is affected by breaks when the forecast-year changes in January.

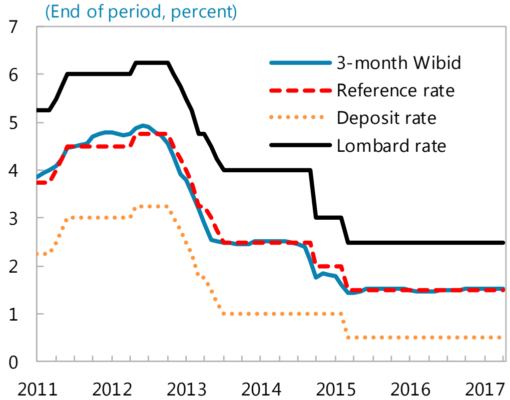
...so did longer-term inflation expectations.

Longer-Term Inflation Expectations
(Year-on-year inflation in percent)



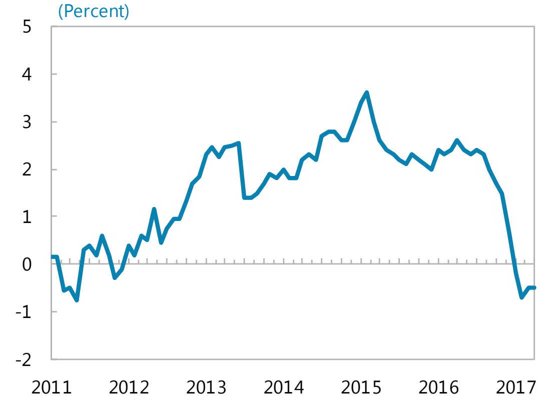
Policy rates remain at historical lows...

Interest Rates
(End of period, percent)



...and real interest rate was much lower as inflation rose.

Real Policy Rate
(Percent)

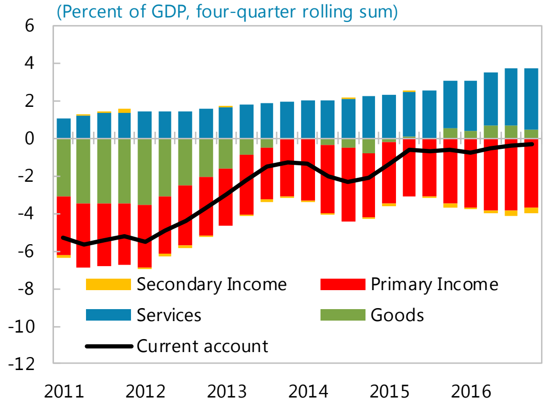


Sources: Consensus Forecast, Haver Analytics, NBP, Statistics Poland, and IMF staff calculations.

Figure 14. Balance of Payments Developments, 2011–16

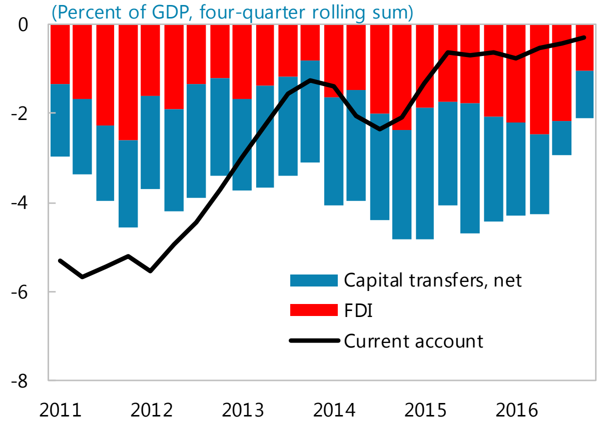
The current account deficit continued to improve on account of lower oil prices, ...

Current Account Balance
(Percent of GDP, four-quarter rolling sum)



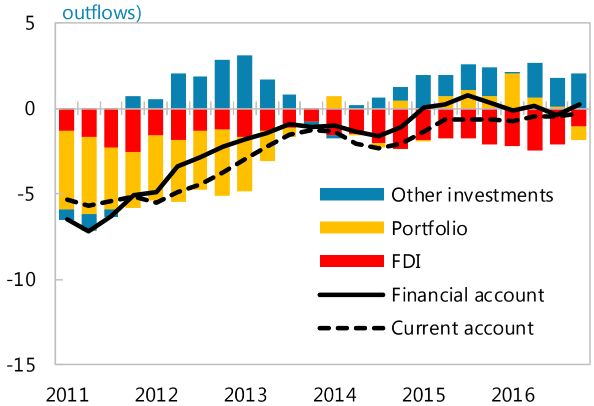
...and was financed primarily by FDI and EU transfers.

Current Account Balance, Capital Transfers, and FDI
(Percent of GDP, four-quarter rolling sum)



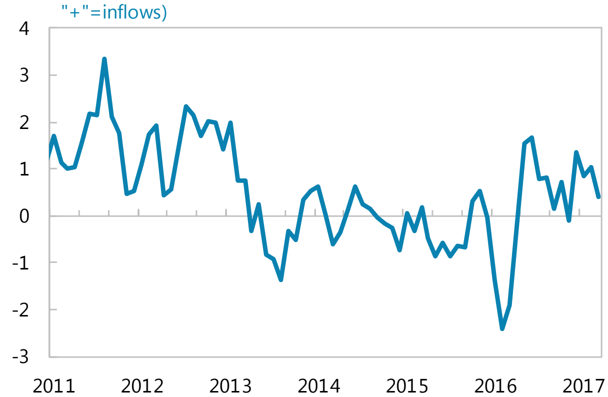
Financial flows remained weak, ...

Financial Account Balance (net outflows)
(Percent of GDP, four quarter rolling sum, "+" = outflows)



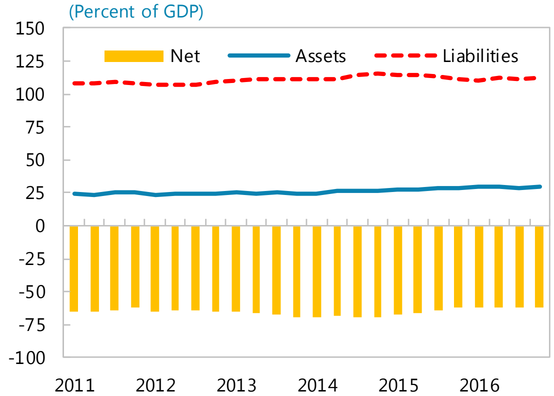
...and net portfolio outflows reversed.

Portfolio Inflows, Net
(Billions of US dollars, 3-month moving average, "+"=inflows)



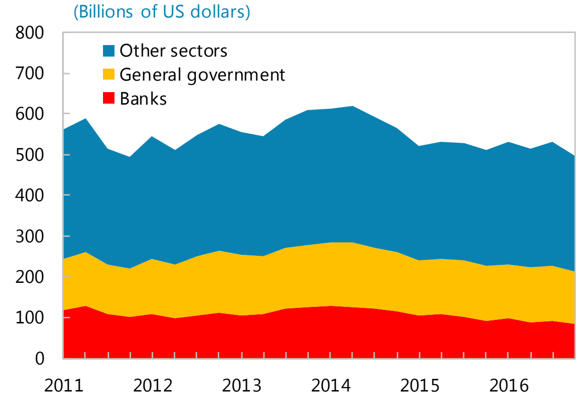
The IIP remained stable, ...

International Investment Position 1/
(Percent of GDP)



...as liabilities leveled off across all sectors.

International Investment Position, Liabilities
(Billions of US dollars)



Sources: NBP and IMF staff calculations.

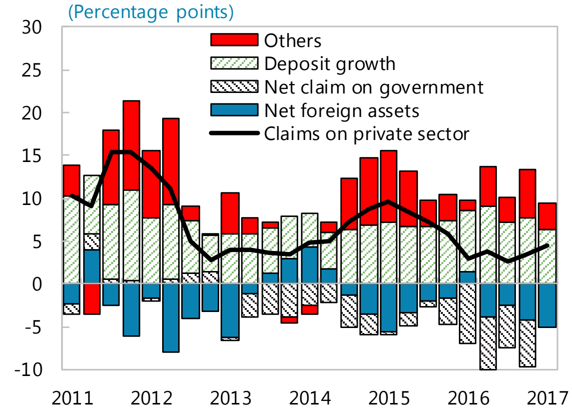
Figure 15. Banking Credit Growth and Funding, 2011–17

Loan-to-deposit ratio has been declining steadily.

Nonfinancial Sector Loans to Deposit
(Percent)

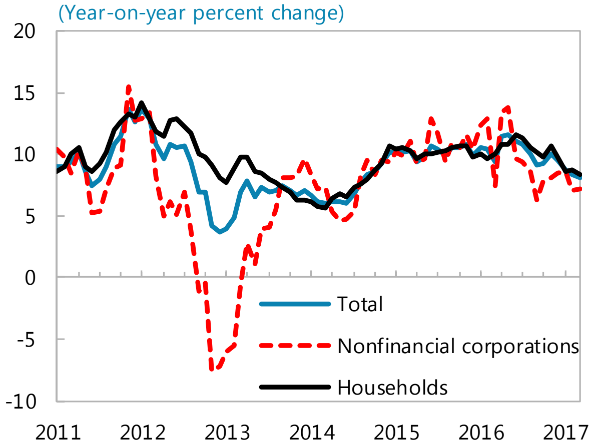
Deposits remain an important funding source...

Contributions to Private Sector Credit Growth
(Percentage points)



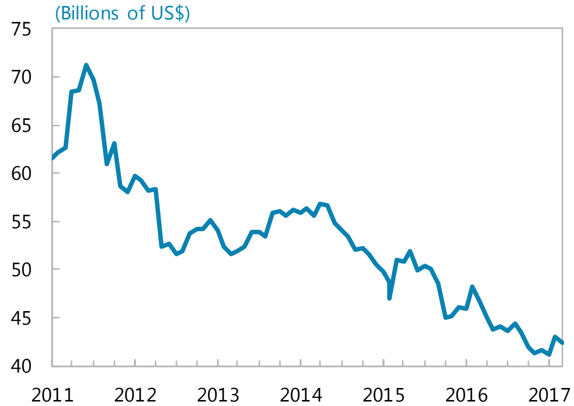
...by both households and nonfinancial corporations.

Private Sector Deposit Growth
(Year-on-year percent change)



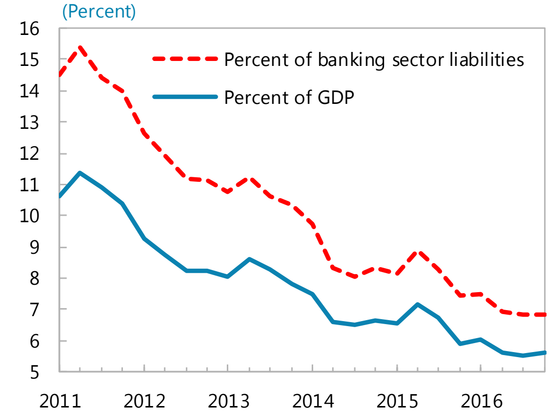
Alongside, external financial liabilities have declined...

Polish Banks' External Liabilities to Financial Sector
(Billions of US$)



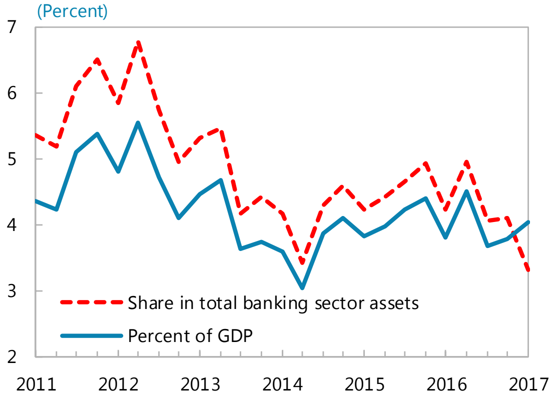
...as has also the reliance on parent bank funding.

Banking Sector Debt to Parents
(Percent)



FX hedging needs remain below recent levels.

Banking Sector, On-balance Sheet Open FX Position
(Percent)



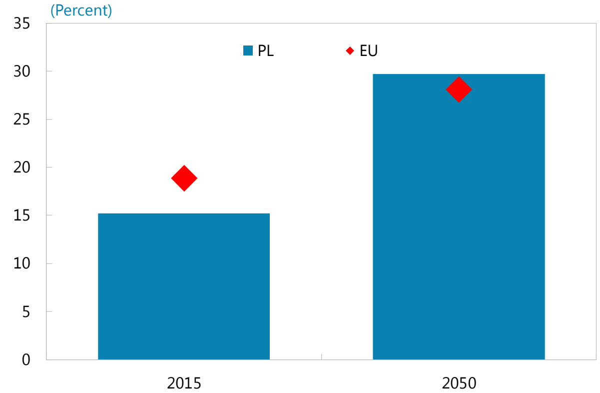
Sources: Haver Analytics, International Financial Statistics, NBP, KNF, and IMF staff calculations.

Figure 16. Coping with Demographic Headwinds[1]

Population aging is underway…

Share of population 65+

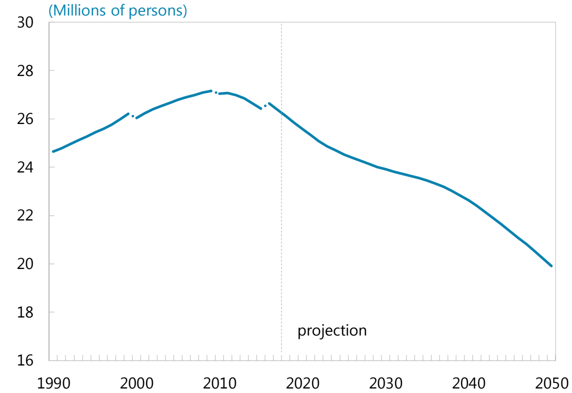
(Percent)



…and the number of working-age persons is set to decline…

Working-age Population

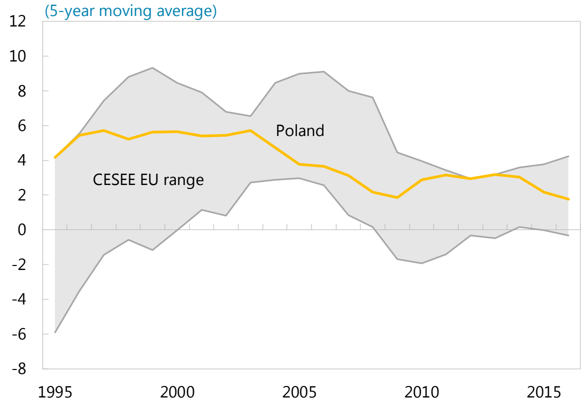
(Millions of persons)



…which combined with productivity downtrend…

Labor Productivity

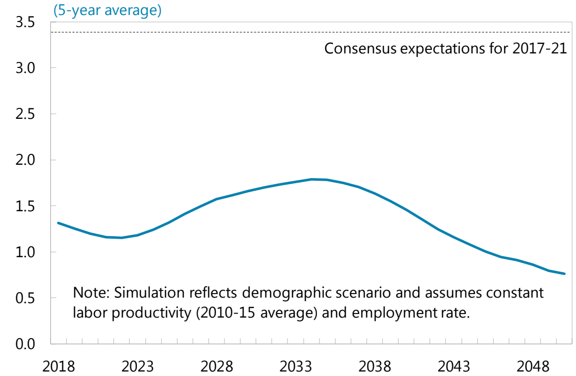
(5-year moving average)



…could lead to subdued GDP growth.

Real GDP growth simulation

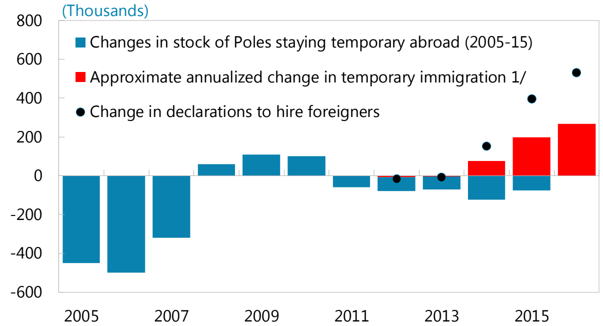
(5-year average)



Migrants may help mitigating adverse demographic trends,…

Temporary Migrations

(Thousands)

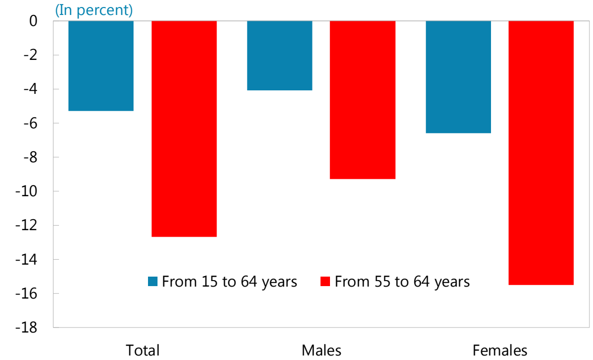


Note: Declarations allow to hire foreigners for a period not exceeding 6 months within 12 consecutive months, hence approximate impact on employment is 1/2 of the change in declararations.

…but policies to increase participation rates are also needed.

Differences between labor force participation rates in Poland and EU15, 2015

(In percent)



Sources: Eurostat, GUS, Ministry of Family, Labor and Social Policy, Total Economy Database, and IMF staff calculations.

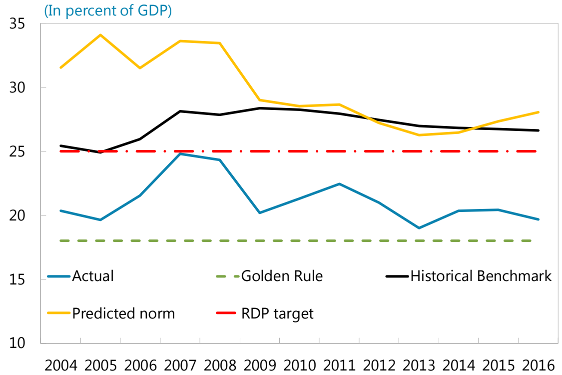
1/ For more details see 2017 Article IV Selected Issues Paper, Chapter 1

Figure 17. Investment Challenge[1]

Poland's actual investment rate is below the estimated optimal investment benchmarks, given its fundamentals and its level of development.

Poland Investment Rate and Benchmarks

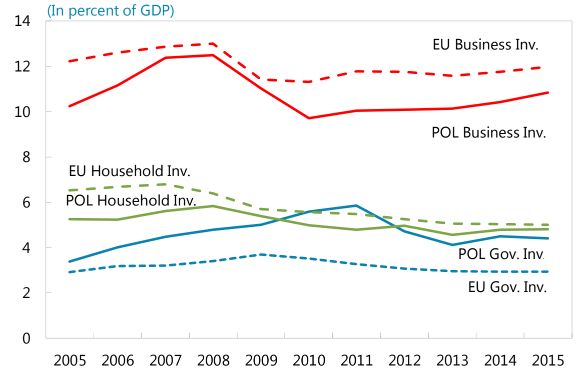
(In percent of GDP)



Low business investment post-crisis is the main drag, while public investment has been boosted by the EU funds.

Investment in Poland and EU

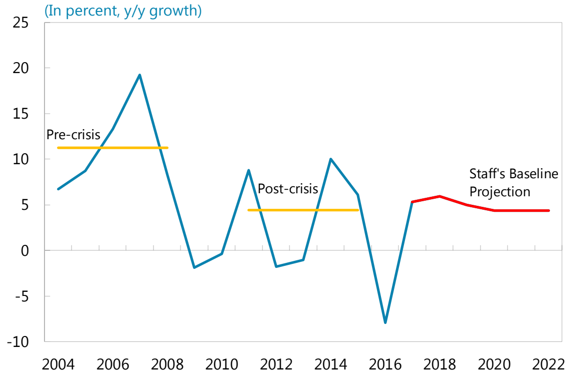
(In percent of GDP)



Without reforms to address barriers to investment, the private investment rate will likely remain at a modest level,...

Gross Fixed Captial Formation

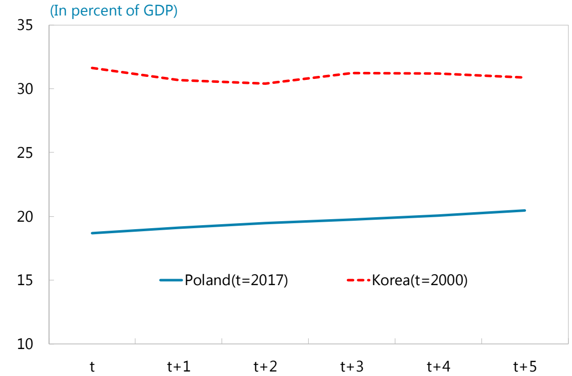
(In percent, y/y growth)



...which is well below the rate observed in the fast converging economies of the past.

Gross Fixed Capital Formation

(In percent of GDP)

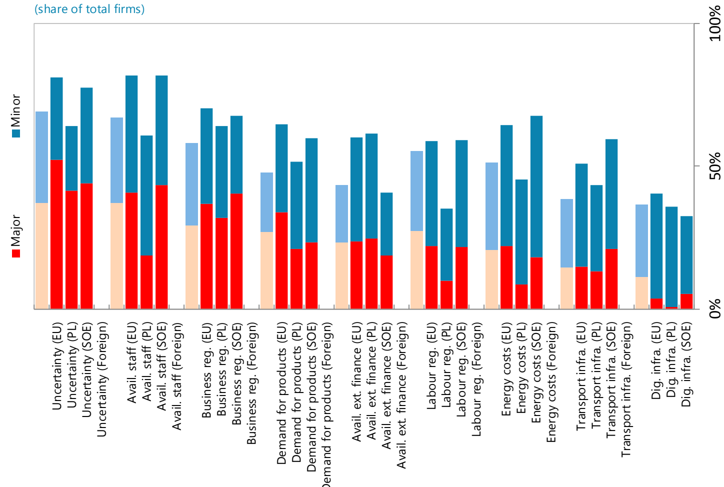


Note: GDP per capita (PPP) in Korea in 2000 was like in Poland in 2017

Based on the recent EIB survey, financing availability does not seem to be a key constraint, while uncertainty, business regulation and labor shortages are cited by

Long Term Investment Barriers

(share of total firms)



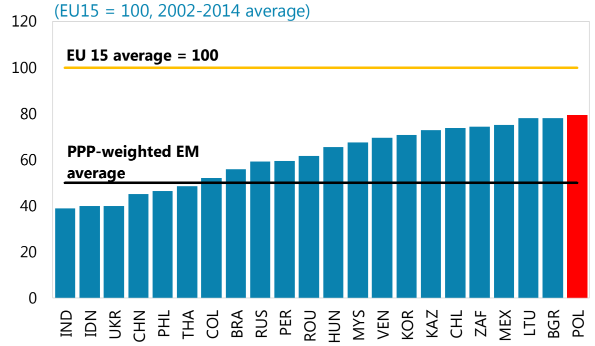
Sources: The Polish authorities, EIB and IMF staff calculations.

1/ For details see Article IV 2017 Selected Issues Paper Chapter 2

Figure 18. Total Factor Productivity[1]

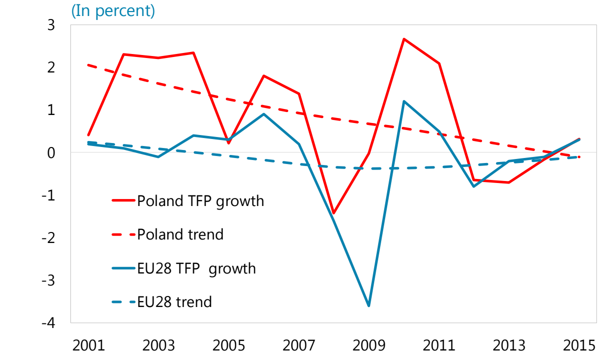
Poland's average TFP level has been higher than other EMs…

Average Total Factor Productivity Levels: Emerging Markets
(EU15 = 100, 2002-2014 average)



… but the trend has been declining

Cyclically Adjusted TFP Growth
(In percent)

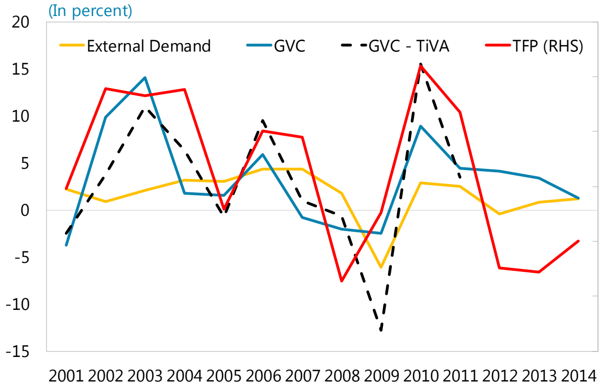


1/ Trend TFP growth is calculated using the HP filter.

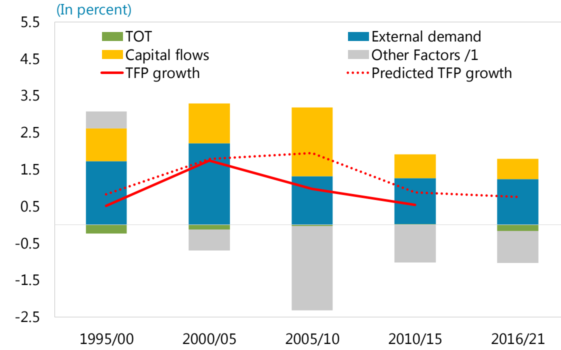
Poland's TFP growth has been strongly correlated with GVC participation and external demand…

… which are expected to provide limited support to TFP growth going forward.

Growth in External demand, GVC participation and TFP
(In percent)



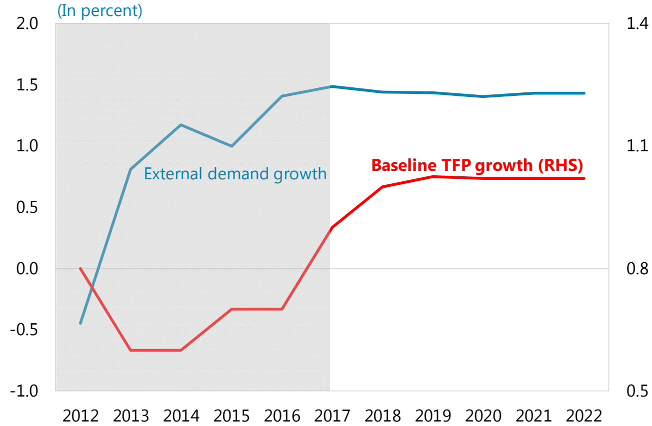
Contribution of External Factors to the TFP Growth in Poland
(In percent)



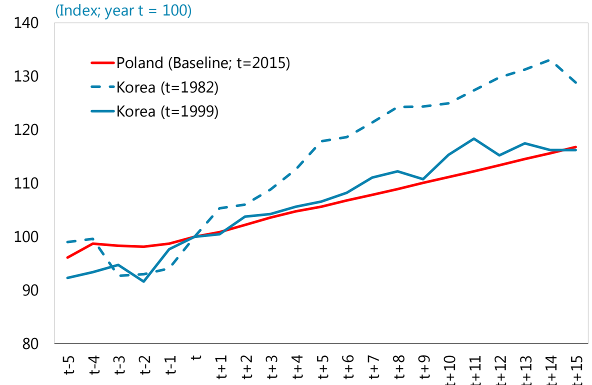
Without structural reforms, the TFP growth will likely remain around 1 percent per year over the medium term…

… falling short of Korea's performance during its fast convergence episode (from the 1980s).

Baseline TFP Growth Projection
(In percent)



TFP Level: Poland Baseline *vs.* Korea Experiences
(Index; year t = 100)



Sources: Penn World Table 9.0, WEO, Conference Board, ORBIS, TiVA database, and IMF staff calculations.
1/ For more details see Article IV 2017 Selected Issues Paper Chapter 3.

Table 2. Selected Economic Indicators, 2013–22

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
				Est.			Projections			
Activity and prices										
GDP (change in percent) 1/	1.4	3.3	3.9	2.6	3.6	3.3	3.0	2.8	2.7	2.6
Domestic demand	-0.6	4.9	3.3	2.4	4.0	3.8	3.3	2.9	2.8	2.7
Private consumption growth	0.3	2.4	3.0	3.8	4.2	3.5	3.2	2.8	2.6	2.4
Public consumption growth	2.5	4.1	2.4	2.8	2.1	2.3	2.3	2.1	2.0	1.9
Domestic fixed investment growth	-1.1	10.0	6.1	-7.9	5.8	6.0	5.0	4.4	4.4	4.4
Inventories (contribution to growth)	-1.0	0.6	-0.2	1.3	-0.1	0.0	0.0	0.0	0.0	0.0
Net external demand (contribution to growth)	2.0	-1.4	0.6	0.3	-0.2	-0.4	-0.3	-0.1	-0.1	-0.1
Output gap	-1.2	-0.9	0.0	0.1	0.7	0.9	0.9	0.7	0.6	0.4
CPI inflation (percent)										
Average	0.9	0.0	-0.9	-0.6	2.1	2.5	2.5	2.5	2.5	2.5
End of period	0.7	-1.0	-0.5	0.8	2.3	2.6	2.5	2.5	2.5	2.5
Unemployment rate (average, according to LFS)	10.3	9.0	7.5	6.2	5.3	4.5	4.3	4.2	4.2	4.2
Public finances (percent of GDP) 2/										
General government revenues	38.5	38.8	39.0	38.8	39.8	40.3	40.1	40.0	39.9	39.9
General government expenditures	42.6	42.3	41.6	41.3	42.6	42.9	42.8	42.3	42.0	41.8
General government net lending/borrowing	-4.1	-3.5	-2.6	-2.4	-2.8	-2.7	-2.7	-2.3	-2.1	-1.9
General government structural balance	-3.3	-3.1	-2.6	-2.5	-3.1	-3.0	-3.0	-2.6	-2.3	-2.1
General government debt	55.7	50.2	51.1	54.4	54.3	53.9	53.5	53.0	52.3	51.6
National definition 3/	53.3	48.1	48.8	50.1	...	...	...	...	...	...
Money and credit										
Private credit (change in percent, end-period) 4/	4.4	7.5	7.5	5.0	6.8	6.5	6.0	5.9	5.7	5.5
Credit to GDP (percent)	53.5	55.4	56.9	58.0	58.8	59.0	59.2	59.5	59.8	60.0
Deposits (change in percent, end-period)	6.9	8.6	8.8	8.4	8.7	6.2	4.9	4.8	4.7	4.5
Broad money (change in percent, end-period)	6.2	8.2	9.1	9.6	8.3	6.2	5.0	5.0	4.8	4.6
Policy Rate (percent) 5/	2.9	2.4	1.6	1.5	...	...	...	...	...	...
Balance of payments										
Current account balance (transactions, billion U.S. dollars)	-6.7	-11.4	-2.9	-1.4	-5.9	-7.3	-8.9	-10.9	-13.2	-15.2
Percent of GDP	-1.3	-2.1	-0.6	-0.3	-1.2	-1.4	-1.6	-1.9	-2.2	-2.4
Exports of Goods (billion U.S. dollars)	198.1	210.6	191.0	195.6	216.5	235.4	255.1	273.5	293.5	312.9
Export volume growth	6.1	6.7	7.7	9.0	7.5	7.1	6.6	6.1	5.7	5.4
Imports of Goods (billion U.S. dollars)	198.6	214.9	188.6	193.4	219.7	241.3	263.3	284.3	307.1	329.5
Import volume growth	1.7	10.0	6.6	8.9	8.4	8.2	7.4	6.5	6.0	5.6
Terms of trade (index 1995=100)	100.6	102.7	105.1	106.1	104.2	104.2	104.3	104.0	103.6	103.1
Official reserves (billion U.S. dollars)	106.2	100.4	94.9	114.4	120.3	125.5	128.8	132.5	135.3	136.8
In percent of short-term debt plus CA deficit	67.4	88.5	88.9	88.7	108.9	115.6	115.6	117.3	116.8	117.0
In percent of IMF ARA metric	105.6	110.6	111.2	128.1						
Total external debt (billion U.S. dollars)	384.1	356.7	330.0	335.9	344.0	348.3	351.9	357.2	363.6	370.5
In percent of GDP	73.2	65.4	69.1	71.6	69.6	66.7	63.8	61.5	59.5	57.7
Exchange rate										
Exchange rate regime				Freely floating						
Zloty per USD, period average	3.2	3.2	3.8	3.9	...	...	...	...	...	...
Zloty per Euro, period average	4.2	4.2	4.2	4.4	...	...	...	...	...	...
Real effective exchange rate (INS, CPI based) 6/	108.2	109.0	105.2	100.7	...	...	...	...	...	...
Appreciation (percent change)	0.7	0.7	-3.4	-4.3	...	...	...	...	...	...
Memorandum item:										
Nominal GDP (billion zloty)	1656.8	1719.7	1799.3	1851.2	1951.1	2069.0	2186.6	2304.1	2424.8	2547.6

Sources: Polish authorities and IMF staff calculations.

1/ Real GDP is calculated at constant 2010 prices, while the authorities' definition is based on prices of the previous year.

2/ According to ESA2010.

3/ The difference from general government debt reflects different sectoral classification of certain units.

4/ Credit defined as in IFS: "Claims on other sectors."

5/ NBP Reference Rate (avg).

6/ Annual average (2000=100).

Table 3. Balance of Payments, 2013–22

(Millions of U.S. dollars, unless otherwise indicated)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
				Est.	Projections					
Current account balance	-6,744	-11,444	-2,932	-1,395	-5,863	-7,310	-8,947	-10,906	-13,178	-15,224
percent of GDP	-1.3	-2.1	-0.6	-0.3	-1.2	-1.4	-1.6	-1.9	-2.2	-2.4
Trade balance	9,692	7,755	14,577	17,344	12,522	10,816	9,593	8,005	6,253	4,730
percent of GDP	1.8	1.4	3.1	3.7	2.5	2.1	1.7	1.4	1.0	0.7
Balance on Goods	-453	-4,291	2,464	2,179	-3,269	-5,940	-8,248	-10,786	-13,563	-16,600
Merchandise exports f.o.b.	198,107	210,628	191,023	195,568	216,453	235,392	255,086	273,522	293,496	312,942
Merchandise imports f.o.b.	198,560	214,919	188,559	193,389	219,722	241,333	263,333	284,308	307,059	329,542
Balance on Services	10,145	12,046	12,113	15,165	15,791	16,756	17,841	18,791	19,816	21,331
Merchandise exports f.o.b.	44,629	48,723	45,096	48,976	54,206	58,949	63,881	68,498	73,500	78,370
Merchandise imports f.o.b.	34,484	36,677	32,983	33,811	38,415	42,193	46,040	49,707	53,684	57,039
Exports of goods and services										
percentage change in unit values	9.2	6.8	-9.0	3.6	10.7	8.7	8.4	7.2	7.3	6.6
percentage volume growth	6.1	6.7	7.7	9.0	7.5	7.1	6.6	6.1	5.7	5.4
Imports of goods and services										
percentage change in unit values	3.5	8.0	-11.9	2.6	13.6	9.8	9.1	8.0	8.0	7.3
percentage volume growth	1.7	10.0	6.6	8.9	8.4	8.2	7.4	6.5	6.0	5.6
Terms of trade (percentage change)	1.1	2.1	2.4	0.9	-1.8	0.0	0.1	-0.3	-0.4	-0.5
Primary Income balance	-15,896	-18,649	-16,559	-17,571	-17,747	-18,053	-18,501	-18,871	-19,480	-20,087
Secondary Income balance	-540	-550	-950	-1,168	-637	-72	-39	-40	48	133
Capital and financial account balance	5,947	6,954	12,850	5,879	4,917	5,792	3,163	381	-3,492	-6,974
Capital account balance (net)	11,964	13,305	11,331	4,926	6,679	7,840	7,344	6,932	6,132	5,414
Financial account balance (net)	-6,017	-6,351	1,519	953	-1,762	-2,048	-4,181	-6,551	-9,624	-12,388
Foreign direct investment (net)[+ = outflows]	-4,206	-12,977	-9,815	-4,999	-6,499	-9,635	-10,282	-10,964	-11,684	-12,444
Assets [Increase = +]	-3,411	6,799	4,252	9,186	5,391	5,499	5,609	5,721	5,835	5,952
Liabilities [Increase = +]	795	19,776	14,067	14,185	11,890	15,134	15,891	16,685	17,520	18,396
Portfolio investment (net)	-237	2,250	3,289	-3,804	901	2,220	2,480	921	267	119
Assets	2,162	5,866	11,049	-6,026	5,036	5,086	5,137	5,189	5,240	5,280
Liabilities	2,399	3,616	7,760	-2,222	4,135	2,866	2,657	4,267	4,974	5,161
Other investment (net)	-1,809	4,136	7,859	-13,054	-2,070	130	318	-184	-948	-1,607
Assets	1,559	4,453	5,324	2,255	3,300	3,140	2,924	2,770	2,490	2,309
Liabilities	3,368	317	-2,535	15,309	5,370	3,010	2,606	2,954	3,438	3,917
Financial derivatives	-710	-64	-949	149	0	0	0	0	0	0
Errors and omissions	-11,237	-8,212	-6,880	-2,578	-2,578	-2,578	-2,578	-2,578	-2,578	-2,578
Financing										
Reserve assets [Increase = +]	945	304	1,135	22,661	5,906	5,237	3,302	3,675	2,742	1,543
Memorandum items:										
Current plus capital account (percent of GDP)	1.0	0.3	1.8	0.8	0.2	0.1	-0.3	-0.7	-1.2	-1.5
Gross official Reserve	106,220	100,438	94,922	114,391	120,297	125,534	128,836	132,512	135,254	136,797
in months of imports	6.4	5.6	6.0	7.1	6.6	6.2	5.9	5.6	5.3	5.0
Gross official Reserve (euro)	77,144	82,645	86,894	108,064	...	...	...	...	...	...
Net Reserves (USD) 1/	95,535	93,050	86,805	91,820	97,726	102,963	106,266	109,941	112,683	114,226
Ratio of gross official reserves to short-term debt 2/	72.7	90.8	90.1	92.9	116.6	126.0	128.1	132.8	134.5	134.5
Ratio of gross official reserves to ST debt plus CA deficit 2/	67.4	88.5	88.9	88.7	108.9	115.6	115.6	117.3	116.8	117.0
Ratio of gross ofiicial reserves to IMF ARA metric	105.6	110.6	111.2	128.1	...	...	...	...	...	...
Ratio of net official reserves to IMF ARA metric	95.0	102.5	101.7	102.8						
Total external debt (percent of GDP)	73.2	65.4	69.1	71.6	69.6	66.7	63.8	61.5	59.5	57.7
Total external debt (percent of exports)	158.2	137.5	139.7	137.4	127.1	118.3	110.3	104.5	99.1	94.7
External debt service (percent of exports)	57.0	56.2	48.1	52.2	48.6	38.2	34.7	32.9	30.7	29.2

Sources: National Bank of Poland and IMF staff calculations.

1/ Net reserves are calculated as a difference between gross reserves (official and other FX reserves) and FX liabilities.

2/ Short-term debt is on remaining maturity.

Table 4. Monetary Accounts, 2010–17

	2010	2011	2012	2013	2014	2015	2016	2017 Proj.
	(Billions of zlotys)							
Central bank								
Net foreign assets	257	317	321	297	332	349	390	387
Official reserve assets	277	338	338	320	352	370	478	476
Net domestic assets	-119	-180	-154	-134	-142	-139	-171	-151
Net claims on government	-14	-20	-17	-8	-21	-15	-28	-28
Claims on banks 1/	-75	-93	-100	-117	-85	-74	-81	-59
Other items, net	-31	-67	-37	-9	-36	-50	-62	-65
Base money	140	138	167	164	192	212	220	236
Currency issued	103	112	113	126	143	163	187	200
Bank reserves	37	26	54	38	49	49	33	36
Deposit money banks								
Net foreign assets	-167	-177	-151	-154	-159	-162	-156	-164
Net domestic assets	830	923	934	990	1,067	1,150	1,226	1,327
Net claims on the central bank 1/	38	27	56	40	49	51	36	17
Net claims on government	150	167	151	178	216	241	297	262
Claims on private sector	730	831	849	886	952	1,023	1,074	1,147
Claims on corporates	219	261	270	275	298	324	340	363
Claims on households	480	537	538	562	593	633	665	710
Claims on other	31	32	40	49	61	67	69	74
Other items, net	-88	-101	-123	-113	-150	-165	-181	-98
Deposits	663	746	782	836	908	988	1,070	1,163
Consolidated banking system								
Net foreign assets	90	140	169	143	173	187	234	223
Net domestic assets	693	741	752	836	886	968	1,032	1,148
Claims on government	137	147	134	170	195	226	269	234
Claims on private sector	730	831	849	886	952	1,023	1,074	1,147
Other items, net	-173	-236	-231	-220	-261	-281	-312	-233
Broad money (M3)	784	881	921	979	1,059	1,155	1,266	1,371
Memorandum items:	(Percentage change from end of previous year)							
Base money	1.6	-1.1	21.0	-1.9	16.8	10.7	3.9	6.9
Broad money (M3)	8.8	12.5	4.5	6.2	8.2	9.1	9.6	8.3
Net domestic assets	6.4	6.9	1.5	11.1	6.0	9.2	6.6	11.3
Net foreign assets	31.9	55.2	20.7	-15.5	20.9	8.2	25.1	-4.8
Net claim on government	15.3	7.4	-8.4	26.6	14.9	15.8	19.2	-13.1
Claims on private sector	8.6	13.8	2.2	4.4	7.5	7.5	5.0	6.8
Deposit growth	9.8	12.4	4.9	6.9	8.6	8.8	8.4	8.7
	(Percent of GDP, unless otherwise noted)							
Broad money (M3)	54.2	56.3	56.5	59.1	61.6	64.2	68.4	70.3
Private sector credit	50.5	53.0	52.1	53.5	55.4	56.9	58.0	58.8
Broad money Velocity (GDP/M3)	1.8	1.8	1.8	1.7	1.6	1.6	1.5	1.4
Money multiplier (M3/base money)	5.6	6.4	5.5	6.0	5.5	5.4	5.7	5.8

Sources: Haver, IFS, NBP, and IMF staff calculations.

1/ The difference between deposit money bank claims on the central bank and central bank claims on banks relates to banks' reserves and currency in vault.

Table 5. Financial Soundness Indicators, 2010–16

(Percent)

	2010	2011	2012	2013	2014	2015	2016Q1	2016Q2	2016Q3	2016Q4
Capital adequacy 1/										
Regulatory capital to risk-weighted assets	13.9	13.1	14.8	15.7	15.2	16.5	17.1	17.4	17.5	17.7
Regulatory Tier I capital to risk-weighted assets	12.5	11.7	13.1	14.1	14.0	15.2	15.7	15.7	16.0	16.1
NPLs net of provisions to capital	11.5	11.6	12.9	12.1	12.1	10.2	10.0	9.8	9.7	9.2
Bank capital to assets	8.2	7.8	8.7	9.1	8.9	9.4	9.6	9.6	9.8	9.5
Asset composition and quality										
NPLs to gross loans (nonfinancial sector)	8.8	8.2	8.8	8.5	8.1	7.5	7.4	7.3	7.3	7.0
Provisioning coverage for nonperforming loans (nonfinancial sector)	54.6	55.0	54.3	55.0	54.8	54.3	54.6	54.9	54.6	53.5
Sectoral distribution of loans to nonfinancial sector										
Loans to households	68.0	66.4	65.7	66.1	65.7	65.3	64.8	65.1	64.7	65.1
Loans to non-financial corporations	31.5	33.1	33.7	33.3	33.7	34.1	34.5	34.3	34.6	34.2
Earnings and profitability										
Return on average assets (after tax)	1.0	1.3	1.2	1.1	1.1	0.8	0.7	0.8	0.8	0.8
Return on average equity (after tax) 1/	13.3	16.1	14.0	12.1	12.3	9.1	8.2	9.0	8.4	9.0
Interest margin to gross income	53.0	55.8	55.0	56.1	58.2	57.2	57.9	56.1	56.5	57.4
Noninterest expenses to gross income	56.0	54.5	54.5	57.2	54.9	61.9	62.9	61.4	62.2	59.5
Liquidity										
Liquid assets to total assets (liquid assets ratio)	20.8	19.5	20.9	21.4	20.6	20.1	22.3	21.5	21.4	21.6
Liquid assets to total short-term liabilities	31.2	28.8	31.1	31.7	30.6	29.6	32.3	31.1	31.0	31.1
Loans to deposits	114.5	119.8	117.7	115.7	112.9	112.1	108.8	108.3	107.9	106.6
Sensitivity to market risk										
Net open positions in FX to capital 1/	0.3	-0.3	0.1	-0.1	0.1	1.0	0.6	0.6	0.5	0.3

Sources: NBP and KNF.

Note: Data according to Financial Soundness Indicators (FSI), except for asset composition and quality (indicators not part of FSI reporting template).

1/ Data for domestic banking sector (Bank Gospodarstwa Krajowego excluded). Since 2014: data on capital in accordance with CRDIV/CRR.

Table 6. General Government Statement of Operations, 2013–22

(Percent of GDP)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
				Est.			Projections			
Revenue	38.5	38.8	39.0	38.8	39.8	40.3	40.1	40.0	39.9	39.9
Taxes	19.6	19.6	19.8	20.3	20.8	21.1	20.8	21.0	21.1	21.3
Personal income tax	4.6	4.6	4.7	4.8	4.9	4.9	4.9	4.9	4.8	4.8
Corporate income tax	1.8	1.7	1.8	1.8	1.9	1.9	2.0	2.1	2.1	2.1
VAT	7.0	7.1	7.0	7.1	7.4	7.6	7.3	7.4	7.5	7.6
Excises	3.7	3.6	3.5	3.6	3.6	3.6	3.6	3.6	3.6	3.6
Other taxes	2.5	2.6	2.8	3.0	3.1	3.1	3.1	3.1	3.1	3.1
Social contributions	13.4	13.3	13.6	14.0	14.0	14.0	13.9	13.8	13.7	13.6
Other revenue	5.5	5.8	5.6	4.3	5.0	5.2	5.4	5.2	5.1	5.0
Capital revenue	0.9	1.2	1.1	0.4	1.1	1.3	1.5	1.3	1.2	1.1
Sales of goods and services	2.4	2.5	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4
Other current revenue	2.2	2.1	2.1	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Expenditure	42.6	42.3	41.6	41.3	42.6	42.9	42.8	42.3	42.0	41.8
Expense	38.8	38.1	37.4	38.0	38.3	38.4	38.2	37.9	37.7	37.6
Compensation of employees	10.4	10.4	10.2	10.3	10.1	10.1	10.0	9.9	9.8	9.8
Use of goods and services	5.8	5.9	5.9	5.8	5.8	5.8	5.8	5.8	5.8	5.8
Interest	2.5	1.9	1.8	1.7	1.8	1.8	1.8	1.8	1.8	1.8
Subsidies	0.7	0.7	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Social benefits	16.4	16.3	16.2	17.2	17.6	17.7	17.6	17.4	17.3	17.3
Other expense 1/	3.0	2.9	2.8	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Other current expenditure	2.3	2.1	2.2	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Capital transfers	0.6	0.7	0.6	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Net acquisition of nonfinancial assets	3.8	4.2	4.2	3.3	4.2	4.5	4.6	4.4	4.2	4.2
Gross operating balance	-0.3	0.7	1.6	0.8	1.5	1.8	1.9	2.1	2.2	2.3
Net lending/borrowing	-4.1	-3.5	-2.6	-2.4	-2.8	-2.7	-2.7	-2.3	-2.1	-1.9
Structural fiscal balance	-3.3	-3.1	-2.6	-2.5	-3.1	-3.0	-3.0	-2.6	-2.3	-2.1
Net financial transactions	-4.2	-3.5	-2.6	-2.4	-2.8	-2.7	-2.7	-2.3	-2.1	-1.9
Net acquisition of financial assets	-0.5	10.0	0.6	2.3	0.1	0.0	0.0	0.0	0.0	0.0
Currency and deposits	-1.2	0.6	-0.7	1.1	-0.7	-0.8	-0.8	-0.8	-0.7	-0.7
Debt securities	0.1	8.3	0.0	0.4	0.2	0.2	0.2	0.2	0.2	0.2
Loans	0.7	0.7	0.3	0.1	0.3	0.3	0.3	0.2	0.2	0.2
Equity and investment fund shares	-0.6	0.2	-0.1	-0.3	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Other financial assets	0.4	0.1	1.1	1.0	0.5	0.5	0.6	0.6	0.5	0.5
Net incurrence of liabilities	3.6	13.5	3.2	4.8	2.8	2.7	2.7	2.4	2.1	2.0
Currency and deposits	0.0	0.0	0.5	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Debt securities	2.0	2.7	1.7	4.1	1.6	1.6	1.7	1.5	1.4	1.1
Loans	1.5	1.4	0.9	0.0	0.8	0.8	0.7	0.5	0.5	0.6
Other liabilities	0.1	9.3	0.1	0.6	0.2	0.2	0.2	0.2	0.2	0.2
Adjustment and statistical discrepancies	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:										
Cyclically-adjusted balance	-3.3	-3.1	-2.6	-2.5	-3.1	-3.0	-3.0	-2.6	-2.3	-2.1
Primary balance	-1.6	-1.5	-0.8	-0.7	-1.0	-0.9	-0.9	-0.5	-0.3	-0.2
Cyclically-adjusted primary balance	-0.7	-1.2	-0.8	-0.8	-1.2	-1.2	-1.2	-0.8	-0.6	-0.3
General government debt	55.7	50.2	51.1	54.4	54.3	53.9	53.5	53.0	52.3	51.6
General government liabilities	71.5	77.6	77.1	80.0	72.2	71.8	71.4	70.9	70.2	69.5
General government financial assets	33.9	35.6	35.2	36.9	33.2	32.2	31.2	30.2	29.2	28.2
Nominal GDP in billions of zloty	1,657	1,720	1,799	1,851	1,951	2,069	2,187	2,304	2,425	2,548

Sources: Eurostat and IMF staff calculations.

1/ Includes grants.

Table 7. General Government Financial Balance Sheets, 2013–22

(Millions of zloty)

	2013			2014			2015	2016	2017	2018	2019	2020	2021	2022
	Trans-actions	OEF	Closing Opening balance	Trans-actions	OEF	Closing Opening balance	Closing Opening balance	Projections						
Net Financial Worth	-67,366	17,475	-622,244	-59,415	-52,562	-734,220	-754,971	-797,765	-762,200	-819,710	-880,033	-937,981	-995,055	-1,052,436
Financial Assets	-7,956	-1,789	561,783	172,383	-122,332	611,834	633,018	683,004	647,405	665,813	681,812	695,399	707,566	717,928
Currency and deposits	-19,212	-356	85,774	10,836	8,645	105,255	96,168	121,957	104,282	110,580	116,869	123,147	129,596	136,160
Debt securities	2,275	554	38,013	143,444	-134,083	47,374	47,328	55,693	51,321	54,421	57,516	60,605	63,779	67,009
Loans	12,180	433	51,865	12,177	717	64,759	69,106	72,819	74,936	79,462	83,981	88,492	93,126	97,843
Equity and inv. fund shares	-9,569	149	262,345	3,525	790	266,660	267,362	262,846	250,897	245,360	237,447	227,162	214,810	200,214
Other financial assets	6,370	-2,569	123,786	2,401	1,599	127,786	153,054	169,689	165,968	175,991	186,000	195,992	206,255	216,701
Liabilities	59,410	-19,264	1,184,027	231,798	-69,770	1,346,055	1,387,989	1,480,769	1,409,605	1,485,523	1,561,845	1,633,380	1,702,621	1,770,364
Currency and deposits	-358	-6	28,028	517	11,410	39,955	36,846	39,826	39,955	42,368	44,777	47,183	49,653	52,168
Debt securities	33,394	-19,827	835,116	46,388	-90,827	790,677	814,831	891,332	788,088	826,472	865,313	899,430	930,237	958,859
Loans	24,578	741	199,768	24,829	8,222	232,819	250,641	254,292	271,788	288,202	304,592	320,955	337,762	354,870
Other liabilities	1,796	-172	121,115	160,064	1,425	282,604	285,671	295,319	309,774	328,481	347,163	365,813	384,969	404,467
Memorandum items:														
Net financial worth (percent of GDP)			-37.6			-42.7	-42.0	-43.1	-39.1	-39.6	-40.2	-40.7	-41.0	-41.3
Financial assets (percent of GDP)			33.9			35.6	35.2	36.9	33.2	32.2	31.2	30.2	29.2	28.2
Liabilities (percent of GDP)			71.5			78.3	77.1	80.0	72.2	71.8	71.4	70.9	70.2	69.5
GDP nominal prices (billion PLN)			1656.8			1719.7	1799.3	1851.2	1951.1	2069.0	2186.6	2304.1	2424.8	2547.6

Sources: National authorities and IMF staff calculations.

Table 8. 2013 FSAP Recommendations and Current Status[1]

Key Recommendations	Status
Addressing impaired loans: (i) intensify oversight of credit risk management and restructuring practices; (ii) standardize and enhance transparency of bank accounting practices; and (iii) standardize debt-to-income (DTI) ratio calculation.	The in-depth analyses of impaired loans (including credit file review) were conducted under the cross-sector inspections in 2013 and the Asset Quality Review (AQR) in 2014. Following the AQR, the KNF clarified expectations to banks to standardize and enhance the transparency of bank accounting practices. A follow-up was conducted in 2015 to verify the implementation of the individual recommendations issued in 2013 and 2014. Meanwhile, all 15 banks included in the AQR were requested to provide information on the quantitative impact of the implementation of recommendations on impairment charges. The KNF found that the AQR, through recommendations to banks, had a significant measurable impact on the level of impairment losses in banks, and contributed to developing the new standards. In 2016, the priority areas were other aspects of credit risks in commercial banks (as covered within the cross-sector inspections). The issues of impaired loans were analyzed, and the verification of the implementation of KNF recommendations is being conducted in 2017. Also, the biggest banks are being examined on their progress in implementing IFRS 9.
Strengthening banking supervision: (i) expand the scope for the Polish Financial Supervision Authority (KNF) to issue legally binding prudential regulations; (ii) allow KNF's Board to delegate administrative and procedural decisions to its management, increase KNF independence, and address other governance issues; and (iii) increase KNF flexibility to allocate budgetary and staff resources and enhance its analytical capabilities.	In line with the stipulations of the Polish constitution, the KNF cannot issue legally binding, general acts (regulations). However, the KNF can issue recommendations to banks regarding risk management, specifying how banks should mitigate risk. Now that many regulatory provisions are from the EU, in particular the CRR, it is less of an issue as to which authority is entitled to issue regulations. The KNF management has increased flexibility to allocate budgetary and staff resources to the extent possible, subject to the budget constraint from the government.
Strengthening credit unions: (i) eliminate the dual supervision; require a solvency ratio of 8 percent in 5 years; and clarify the governance of the stabilization fund; (ii) develop an inclusive set of SKOK regulations and apply accounting principles for financial institutions to SKOKs; and (iii) develop capital rehabilitation plans for financially weak SKOKs.	The dual supervision problem has been solved and the KNF is the only supervisor of the credit union sector. The KNF has continued work to address vulnerabilities, with 33 of 42 credit unions obliged to prepare capital rehabilitation plans. Restructuring has also involved bankruptcy and take-overs by banks. The draft law on the bank resolution framework is awaiting the President's signature, and it covers credit unions. Applying accounting principles for financial institutions to SKOKs has been an ongoing process. The current version of the regulation came into force on January 1, 2015.
Developing sound macroprudential policies: (i) ensure the macroprudential supervisory law provides for Systemic Risk Board's (SRB's) independence (with a leading role for the NBP, accountability to Parliament, and power to make recommendations coupled with an "act or	The Act on Macroprudential Supervision over the Financial System and on Crisis Management took effect in 2015. The Financial Stability Committee (KSF) was designated with dual functions: (a) the macroprudential authority, and (b) the authority responsible for crisis management in the financial system. The KSF is chaired by the Governor of the NBP and comprises of the Minister of Finance, the Chairman of the KNF and the President of the Bank

Table 8. Poland: 2013 FSAP Recommendations and Current Status (concluded)

explain" mechanism; and (ii) develop clear macroprudential policy objectives that are distinct from those of monetary and microprudential supervisory policy.	Guarantee Fund. The KSF is fully operational and press releases are published following each meeting. In August 2016, the KSF adopted opinions on the identification of other systemically important institutions and on imposing on them other systemically important institution buffer (O-SII buffer). Subsequently, based on individual administrative decisions of the KNF, 12 O-SIIs were identified and appropriate O-SIIs buffers were imposed on these institutions. In January 2017, the KSF passed a resolution on the recommendations to restructure the FX housing loans portfolio. In June 2017, the KSF was informed about the progress in implementing these recommendations.
Improving the bank resolution framework: (i) ensure precedence of administrative powers over corporate insolvency procedures; (ii) ensure that the creditor claims hierarchy protects BFG's claims on resources provided for balance sheet "gap filling" measures; and (iii) include a Tier-1 capital trigger and link the "public interest" trigger to financial stability.	The Act on the Bank Guarantee Fund (BFG), Deposit Guarantee Scheme and Resolution (the Act on the BFG) came into effect in October 2016. The Act covers issues (i), (ii), and (iii) as in the FSAP recommendations.
Improving the deposit insurance system: (i) remove the Polish Bank Association (PBA) from the BFG Council; (ii) ensure adequate funding and capacity, revise and introduce new regulations, and enhance protocols in light of expanded mandate; and (iii) amend code of conduct to restrict employment in member institutions to all employees.	The Act on the BFG and the relevant implementing acts cover issues (i), (ii) and (iii) as in the FSAP recommendations.
Strengthening pension reform and capital markets: (i) allow lifecycle strategies in pension funds, and measure performance of pension funds in relation to the benchmark portfolio; (ii) amend the mortgage covered bond framework to allow broader issuance and adopt a legal framework for mortgage securitization; (iii) strengthen enforcement of security interests and judicial decisions.	Currently, pension funds do not offer lifecycle strategies. To protect pension fund assets in the last period of saving before retirement, assets are transferred gradually to the Social Security Fund managed by the Social Insurance Institution (ZUS), starting 10 years before reaching retirement age. The performance of pension funds is measured relative to an external benchmark.

[1] See "Republic of Poland: Financial System Stability Assessment," IMF Country Report No. 13/221, 2013.

Annex I. External Sector Assessment

Foreign asset and liability position and trajectory	**Background.** A large negative net international investment position (NIIP) has remained broadly stable around 60 percent of GDP over the last five years, with both assets and liabilities growing in 2016, to 52 percent and 111 percent of GDP, respectively. The NIIP is projected to improve towards -49 percent of GDP over the medium term as nominal GDP grows faster than the current account (CA) deficit, which is financed largely by non-debt creating FDI and EU fund flows. In the near term, both domestic and external policy uncertainties point to the risk of further depreciation of the zloty, which, combined with the potential strengthening of the US dollar vis-à-vis the euro (due to policy divergence in the US and the euro area), may lead to large valuation effects. **Assessment.** Vulnerabilities exist, but sustainability concerns surrounding the large negative NIIP are mitigated by diversified FDI liabilities and associated intra-company lending (over 40 percent of foreign liabilities are FDI), and the projected improvement of the NIIP under the baseline. Adequate reserves and the FCL arrangement also help mitigate liquidity risks (ST debt is about 23 percent of the total) that may arise from the large negative NIIP.
Current account	**Background.** Poland's current account deficit was broadly unchanged at 0.3 percent of GDP in 2016, with improvements in trade balance (by 0.6 percent of GDP) offset by a larger income deficit. The higher trade surplus reflected improved terms of trade, stronger export performance on the back of continued demand recovery in the euro area, and subdued non-oil import growth as domestic demand remained relatively weak. In 2017, the CA deficit is projected to widen on the back of a pickup in domestic demand, and a deterioration in the terms of trade. **Assessment.** The CA level is broadly consistent with fundamentals and desirable policies. The ES model gives a CA gap of 1 percent. The CA approach estimates a gap between cyclically-adjusted CA (-0.1 percent of GDP) and the CA norm (-0.7 percent of GDP) of around 0.6 percent of GDP, reflecting the sum of offsetting domestic and partners' policy gaps and a residual. The staff assessment is similar, with a CA gap range for 2016 centered on 0.9 (plus or minus 1) percent of GDP. 1,2/
Real exchange rate	**Background.** The annual average real effective exchange rate (REER) depreciated 7¾ percent cumulatively over 2014-16 (weakening by around 4 percent in 2016 relative to the 2015 average), largely explained by nominal depreciation vis-à-vis the US dollar and the Swiss Franc. The depreciation was a result of NBP policy rate cuts in response to deflationary pressures, as well as domestic policy uncertainties in the run-up and after the 2015 elections. The REER has been on a depreciation trend since mid-2015, but has appreciated slightly in 2017:Q1. As of May 2017, the REER is up by 2.5 percent relative to the 2016 average. **Assessment.** The EBA models suggest undervaluation between 1 and 10 percent for 2016. The REER gap implied by the CA EBA model is -1 percent. Other approaches suggest a larger undervaluation: the ES EBA estimates a REER gap of -2.6 percent; the REER index model shows a gap of -9.6 percent. 3/ Overall, staff assesses Poland's real exchange rate in 2016 to have been close to a level consistent with fundamentals and desirable policy settings, with a range for the REER gap of -10 to 0.
Capital and financial accounts: flows and policy measures	**Background.** The capital account is dominated by EU structural fund inflows, even though there was a temporary slowdown in EU funds absorption in 2016 due to transition to the new EU funds cycle. In recent years, inflows in the financial account were particularly volatile and centered on portfolio and FDI flows. Net capital inflows remained weak in 2016, with the largest net inflows driven by the repo transactions of the NBP as part of their reserve management strategy. **Assessment.** High foreign holdings (around 40 percent) of government bonds indicate potential vulnerabilities, but the ratio has declined recently as domestic banks are increasing their holdings in response to the new bank asset tax, which excludes government bonds. The diversified foreign investor base is another mitigating factor.
FX intervention and reserves level	**Background.** Gross Reserves have increased from USD 95 billion at end-2015 to 114 billion at end-2016, partly due to a significant increase in NBP's repo transactions. Based on staff calculation, net reserves have increased from USD 87 billion at end-2015 to about 92 billion at end-2016. 4/ The zloty has floated freely. **Assessment.** Gross Reserves are adequate, standing at about 128 percent of the IMF's composite reserve adequacy (ARA) metric in 2016 (net reserves stood at 103 percent of the IMF's ARA metric). The recently approved FCL arrangement of SDR 6.5 billion also provides insurance against external tail risks.
Technical Background Note	1/ Poland's EBA CA gap (including residual) 0.6 percent of GDP. The contribution of identified policy gaps is 0.9 percent. The domestic fiscal policy gap is -0.7 percent, but is offset by fiscal gaps in trading partners that result in 0.2 percent net contribution of fiscal policies to the current account gap. The domestic credit gaps contribute 0.2 percent to the total CA gap, with health spending, domestic capital controls and reserves also contribute positively. 2/ Staff assesses the mid-point CA norm to be slightly lower (by 0.2 percent of GDP), but well within the 90 percent confidence interval of [-2.3, 0.9] percent of GDP suggested by the EBA CA model, possibly due to somewhat higher-than-estimated medium term investment needs. 3/ The level REER model for Poland suggests an undervaluation of 18.2 percent, however has large residuals of 14.0 percent, and may not be adequately capturing the dynamics over the estimated period. 4/ Net reserves are calculated as a difference between gross reserves (official and other FX reserves) and FX liabilities, based on IFS data.

Overall Assessment

The external position in 2016 was broadly consistent with medium-term fundamentals and desirable policies.

Improvements in the CA balance in 2016 have been driven mostly by stronger demand in the euro area, and supported by a weaker currency and marginally better terms of trade. A widening of the CA deficit is expected in 2017 on the back of stronger domestic demand and investment as well as a rebound in oil prices.

Reserves are adequate, while the FCL arrangement continues to provide an added buffer in the event of external shocks.

Potential Policy Responses

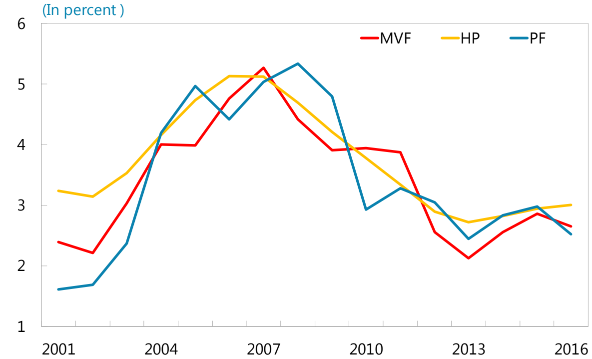
The current policy settings—with an accommodative monetary policy stance and a frontloaded, but gradual, fiscal consolidation—are broadly appropriate under the baseline, given Poland's cyclical position and the need to maintain fiscal sustainability in the longer term. Domestic policy gaps could be closed in the medium term by fiscal consolidation and supportive credit growth. In the event of external shocks, flexible exchange rate should be the first line of defense, while more hawkish monetary tightening could be warranted if inflationary pressures (from the exchange rate depreciation and domestic demand pressures) lead to inflation overshooting the target. Vigilance with respect to bank funding (including foreign exchange swaps) is also important, including by standing ready to extend FX liquidity. In the medium term, risks of fiscal slippages and monetary policy being too loose for too long (to support growth) should be properly managed. The macro-prudential and bank resolution frameworks need to be implemented to address any systemic risks. Structural reforms are crucial to boost potential growth

Annex II. Poland's Potential Growth Revisited[1]

1. **This annex presents estimates of potential output and output gap for Poland based on a range of methods.** These include: (i) a Hodrick-Prescott (HP) filter; (ii) a multivariate filter (MVF); and (iii) a production function approach (PF). While each method has its own merits and limitations, taken together they can provide a good gauge of Poland's cyclical position (see the Selected Issues Paper, Chapter 4 for details).

2. **All three methods point to a post-crisis slowdown in potential growth and a slightly positive output gap in 2016.** The estimated potential growth has declined significantly from the pre-crisis peak of above 5 percent to 2.5–3 percent in 2016, suggesting that the post-crisis growth slowdown has been largely structural. The negative output gap experienced during the global financial crisis and the euro area crisis was largely closed by 2015, with a slightly positive output gap opening in 2016. The differences across the three approaches are small, especially in the most recent period.

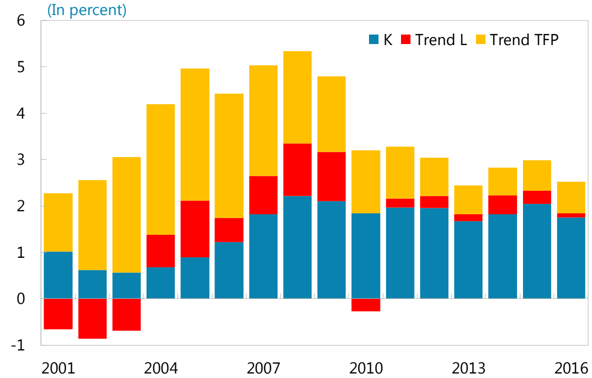
Poland Potential Growth Estimate
(In percent)



Sources: Poland Statistical Office and IMF staff calculations.

3. **The decline in potential growth has been largely due to the TFP growth slowdown, followed by a falling labor contribution.** A PF-based decomposition suggests that the post-crisis potential growth was mainly dragged down by stagnant TFP growth and to a lesser extent, by a shrinking labor contribution. The reduced labor contribution largely reflects negative demographics, as the working age population has been on a declining trend since 2012. The post-crisis investment growth has been very volatile with some temporary rebounds, but the capacity utilization has been rising quickly and is now approaching the pre-crisis peak. Thus, capital accumulation has become the main growth driver.

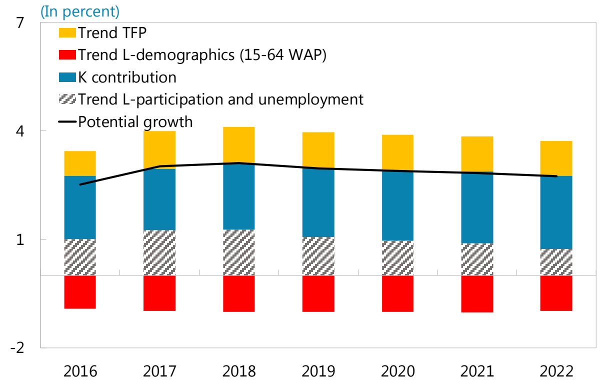
Potential Growth Decompositon
(In percent)



Source: IMF staff calculations.

4. **Over the medium term, on current policies, potential growth will likely remain below 3 percent.** The impact of unfavorable demographics will become more pronounced (Figure 16). TFP growth is expected to recover somewhat reflecting an improvement in the external environment (Figure 18). The contribution from capital accumulation will also increase, as investment gradually picks up (Figure 17). However, on current policies, the baseline potential growth is likely to stabilize around 2.7–3.0 percent, which is well below the pre-crisis average.

Contribution to MT Potential Growth
(In percent)



Source: IMF staff calculations.

[1] Prepared by Xin Cindy Xu.

Annex III. Risk Assessment Matrix[1]

Source of Risk	Relative Likelihood	Time Horizon	Expected Impact	Policy response
EXTERNAL				
Policy, political and geopolitical uncertainties: **Retreat from cross-border integration**. A fraying consensus about the benefits of globalization could lead to protectionism, reduced global and regional policy collaboration with negative consequences for trade, capital and labor flows, sentiment, and growth.	**High**	**Short to Medium Term**	**Medium** Potential damage to global supply chains, reduced global trade and FDI, and increased capital flow volatility would adversely impact the Polish economy.	• Flexible exchange rate should serve as a first line of defense. • Fiscal policy should allow automatic stabilizers to work as needed, while continuing a growth-friendly fiscal consolidation in the medium term. • The NBP should provide liquidity support (including in FX) if needed. • The FCL arrangement could be used if necessary. • Strong progress on structural reforms (including active labor market policies) should support competitiveness.
Policy uncertainty and divergence. Two-sided risks to U.S. growth with difficult-to-predict policies and global spillovers. In Europe, uncertainty associated with negotiating post-Brexit arrangements and with upcoming major elections. Policy divergence could lead to rising global imbalances and exacerbate exchange rate and capital flow volatility.	**High**	**Short to Medium Term**	**Medium** Uncertainty can weigh on market sentiment and dampen investment outlook. *Mitigating factors:* • Banking system is funded mainly domestically; • Sufficient reserve buffers; • FCL	
Financial conditions: **Significant further strengthening of the US dollar and/or higher rates.** As investors reassess policy fundamentals, as term premia decompress, or if there is a more rapid Fed normalization, leveraged firms, lower-rated sovereigns and those with un-hedged dollar exposures could come under stress. Could also result in capital account pressures for some economies.	**High**	**Short Term**	**High/Medium** • Investors could reallocate assets away from Poland, resulting in capital flow reversals and zloty depreciation. • Sovereign's and banks' borrowing costs can go up. Mitigating factors: • Banking system is liquid and funded mainly domestically; • Sufficient reserves buffers; • FCL	• Flexible exchange rate would serve as a first line of defense. • Fiscal automatic stabilizers should be allowed to operate. • The NBP should provide liquidity support (including in FX) if needed. • Maintaining accommodative monetary conditions, while enhancing public debt management would increase resilience to shocks. *If risks intensify*, interest rate hikes could be used to stem capital outflow pressures. The FCL arrangement could be used if necessary.
European bank distress: Strained bank balance sheets amid a weak profitability outlook could lead to financial distress in one or more major banks with possible knock-on effects on the broader financial sector and for sovereign yields in vulnerable economies.	**Medium**	**Short-term**	**Medium /Low** About half of the banking sector is owned by euro-area banks. Banks are prudent, liquid, and well capitalized, reliant primarily on domestic funding.	

Weaker-than-expected global growth: **Significant China slowdown and its spillovers:** Key near-term risks are disruptive drying up of liquidity for weaker borrowers in the interbank market and increasing pressure on the Renminbi, which could lead to overcorrection. Weak domestic demand further suppresses commodity prices, roils global financial markets, and reduces global growth (Likelihood: low in short-term, medium thereafter).	Low/ Medium	Short to Medium Term	Medium • Indirect trade linkages to China through the German supply chain would lower Polish exports to Germany and other CEE countries. • Financial volatility raises risk aversion and could trigger capital outflows from emerging markets, including Poland.	*Near term:* • Monetary policy should be eased further. • Fiscal automatic stabilizers should be allowed to operate. • The FCL arrangement could be used if necessary. *Medium-term:* • Policies supporting domestic demand, as well as diversifying trade partners and specialization, could help cushion the impact on the economy.
Structurally weak growth in key advanced and emerging economies: Low productivity growth (U.S., the Euro Area, and Japan), a failure to fully address crisis legacies and undertake structural reforms, and persistently low inflation (the Euro Area, and Japan) undermine medium-term growth in advanced economies (high likelihood). Resource misallocation and policy missteps, including insufficient reforms, exacerbate declining productivity growth in emerging markets (medium likelihood).	High/ Medium	Medium Term	High/Medium • Significant trade linkages with Europe would weaken growth in Poland through lower exports and adverse confidence effects. • NPLs would increase as growth slows. • Risks are mitigated by relatively stable investor base and the banking sector's strong capital position.	• Maintain strong policies and institutions and refrain from introducing destabilizing policies. • Ensure that structural transformation is on track. Facilitate structural reforms, focusing on product and labor market reforms, improving education and vocational training, and boosting infrastructure investment and R&D support, to raise productivity and investment (including FDI).
DOMESTIC				
Domestic policy uncertainty and slippages • Fiscal slippages, with a breach of the EDP limit • Monetary policy mistakes • Inaction or mis-prioritization of structural reforms • Weakening of key institutions	Medium	Short to Medium Term	High • Ratings downgrades could push up financing costs. Increased policy uncertainty would make Poland less attractive to foreign investors. • Interaction of fiscal and financial sector policy mis-steps could result in a vicious cycle of weaker public finances and financial sector health and lower growth. • Convergence was already set back by the financial crisis. The demographic outlook is worsening and productivity growth has stalled. No action on structural reforms would dampen competitiveness and productivity further.	• Maintain strong policies and institutions, including a credible fiscal policy and an independent central bank, as these are prerequisites for durable and sustainable growth. • Continue the gradual fiscal consolidation. • Refrain from introducing destabilizing policies. • Ensure that structural transformation is on track. Facilitate structural reforms, focusing on product and labor market reforms, improving education and vocational training, and boosting infrastructure investment and R&D support, to raise productivity and investment (including FDI).

[1] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. "Short term" and "medium term" are meant to indicate that the risk could materialize within 1 year and 3 years, respectively.

Annex IV. Implementation of Past Fund Advice

Policy implementation has been broadly in line with past Fund recommendations, but fiscal consolidation has stalled and the 2013 retirement age increase was reversed, against staff's advice.

1. Monetary policy. In line with staff recommendations, the Monetary Policy Council has kept the policy interest rate on hold at a historically low level since March 2015 against prolonged deflationary pressures. Moderate buildup of international reserves has continued.

2. Fiscal policy. While the 2016 fiscal outturn was better than expected, the fiscal stance was broadly neutral amid an opening positive output gap. The 2017 budget represents a procyclical stance, against staff's advice that fiscal policy should take advantage of strong growth to resume consolidation already in 2017. Moreover, the 2013 increase in the retirement age has been reversed without any mitigating measures, against Fund advice. On the other hand, reforms to improve tax administration, supported by Fund Technical Assistance, have been progressing well.

3. Financial sector policy. The macroprudential and bank resolution frameworks have been finalized, and restructuring of the small non-systemic credit union segment has continued, though at a slow pace. While the final solution to address consumer protection concerns related to the FX mortgages is still pending, the draft law to require banks to repay excessive FX spreads charged and the more recent recommendations from the Financial Stability Committee are much less costly than the original proposal of a mandatory blanket conversion of the FX mortgages into zloty.

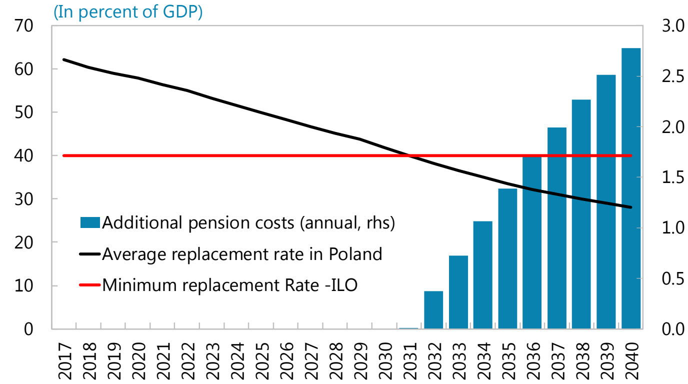
4. Structural reforms. The authorities continued to reduce labor market duality by encouraging the switch from civil law employment contracts to labor code contracts, which provide better protection to employees, and by limiting the duration of temporary contracts. A package of regulations has been implemented to improve the business climate. A comprehensive and ambitious Responsible Development Strategy was approved in early 2017, covering all the key areas where structural reforms are needed, but the strategy has yet to be translated into concrete action plans.

Annex V. The Fiscal Space and the Medium-Term Objective[1]

Although Poland may have some fiscal space given its moderate debt level, the fiscal space becomes limited once the need to comply with fiscal rules is taken into account. That said, the current level of structural deficit coupled with the need to accommodate future aging costs and public investment spending provide a strong economic rationale for adhering to these rules in order to achieve the structural deficit target of 1 percent of GDP over the medium-term.

1. Both the fiscal deficit and debt levels are close to their legal limits. The 2017 general government budget deficit is 2.9 percent of GDP, which is only slightly below 3 percent of GDP—the Excessive Deficit Procedure (EDP) limit set by the EU. Public debt (based on the national definition) is around 52 percent of GDP and is assessed as sustainable under a wide range of shocks (see Annex VIII). However, the public debt-to-GDP ratio is not too far from the 55 percent limit set in Poland's Public Finance Act as a threshold requiring fiscal consolidation if breached, though it is still well below the constitutional debt limit of 60 percent of GDP.

Aging-Related Fiscal Costs
(In percent of GDP)



Source: IMF staff calculations.
Note: Additional pension costs refers to fiscal expenditure to maintain pension replacement rate at or above 40 percent - minimum recommended by International Labor Organization.

2. Unfavorable demographics imply significant additional fiscal outlays to sustain the pension system at a reasonable replacement rate over the long term. Under the baseline demographic trends, with the recent reversal of the 2013 retirement age increase, the average pension replacement rate (average pension-to-wage ratio) is projected to decline by more than a half to below 30 percent in 2040, one of the lowest in the EU, implying a high risk of old-age poverty. To keep the average replacement rate at 40 percent—the minimum recommended by the International Labor Organization—pension expenditures would have to increase by over 2.7 percent of GDP per year by 2040.

3. To maintain the current level of public investment over the long term, the EU funding will eventually need to be replaced with other sources of financing. The EU Structural and Cohesion Funds have been an important source of financing public investment in Poland. In the context of the 2014–20 EU funds program, Poland can receive up to EUR 86 billion. However, Poland— which currently accounts for about 19 percent of the total EU funds'

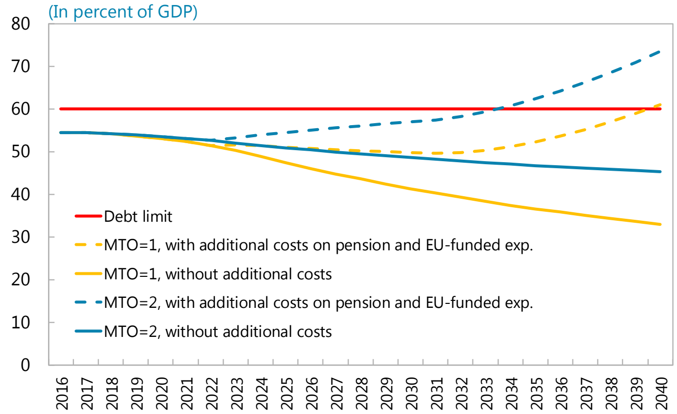
[1] Prepared by Xin Cindy Xu.

allocation—may see a decline in EU funding in the next cycle, i.e., after 2023, especially if the size or the structure of the EU budget is revised following Brexit. Hence, some additional fiscal space may be needed to offset lower EU fund inflows in the future.

4. In view of the looming structural challenges, the medium term structural deficit target (MTO) of 1 percent of GDP is an appropriate long term fiscal anchor. In a scenario where the government needs to accommodate additional pension expenditures (starting from 2031) and replace much of the EU-funded public spending (starting from 2023), achieving the MTO before 2025 and sustaining it afterwards will keep public debt within 60 percent of GDP until 2040. Furthermore, if either a larger share of EU funding would need to be replaced from 2023 onwards or if infrastructure spending would be increased in line with the RDS, the MTO would need to be reached sooner to keep the debt within the 60 percent limit. In comparison, if the deficit is maintained at 2 percent of GDP over the long term, with additional pension and public investment funding requirements, debt will breach the 60 percent of GDP limit in 2034 and continue to rise in the outer years. That said, keeping debt firmly on a declining path beyond 2040 may require additional parametric changes of the pension system in both scenarios (discussed above), given current demographic projections.

Debt Dynamics Under Fiscal Scenarios

(In percent of GDP)



Source: IMF staff calculations.

5. Thus, the fiscal space is limited. Although Poland may have some fiscal space with its moderate debt level, given that both debt and deficit are close to the constitutional and EDP limits, respectively, as well as the need to create space for aging costs and public investment, there is limited room for discretionary fiscal stimulus over the medium term. Furthermore, a positive output gap, relatively flexible labor market, high trade openness and flexible exchange rate regime all point to a low fiscal multiplier[2] in Poland, suggesting limited growth benefits from expansionary fiscal policies. Hence, it would be appropriate to take advantage of the current favorable cyclical position of the economy to rebuild fiscal space. As the aging costs and the public investment needs rise over the long term, this additional fiscal space could be used to accommodate growth-enhancing reforms and to preserve the social sustainability of the pension system.

[2] Batini, et. al, "Fiscal Multipliers: Size, Determinants, and Use in Macroeconomic Projections" IMF FAD Note, 2014.

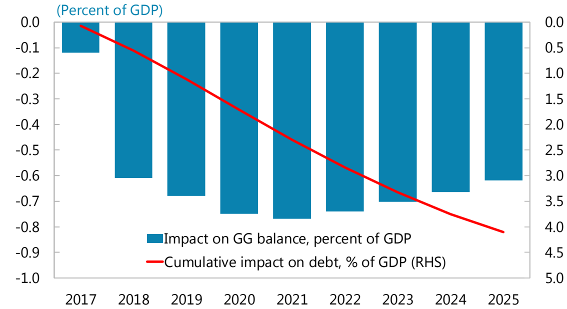
Annex VI. Implications of Lower Retirement Age[1]

The authorities decided to reduce the statutory retirement age to 60 years for women and to 65 years for men as of October 2017, reversing the ongoing gradual increase to an equalized retirement age of 67 years. This decision will likely to have several adverse implications:

1. Public finances: If all eligible persons retire at the lower age, public finances will be hit by less social security contributions and more pension payments. The maximum combined effect will exceed ½ percent of GDP annually, with some 5 percent of GDP cumulative negative impact by 2025[2]. The effect on public debt would be lower by 1pp of GDP due to accelerated below-the-line asset transfer from the 2nd pillar pension funds.

Retirement Age Reversal Impact on General Government

(Percent of GDP)

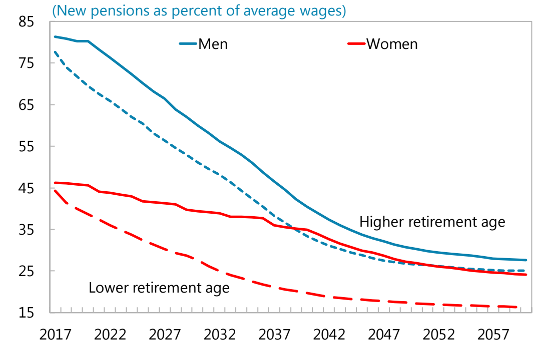


Sources: Social Insurance Institution (ZUS) and IMF staff calculations.

2. Pension benefits: Since the pension system is mostly defined-contribution, the reduced retirement age will imply lower benefits. While the "no-policy-change" scenario also yields declining replacement rates, earlier retirement age would depress them even further, particularly for women. By 2060, women's pensions would be 30 percent lower if they retire at 60 rather than at 67. This will also yield a growing number of people with benefits below the guaranteed minimum pension. Assuming that the minimum pension is indexed by the wage growth, about half of the pensioners may fall below this threshold by 2060, adding to the fiscal cost.

Replacement Rates

(New pensions as percent of average wages)

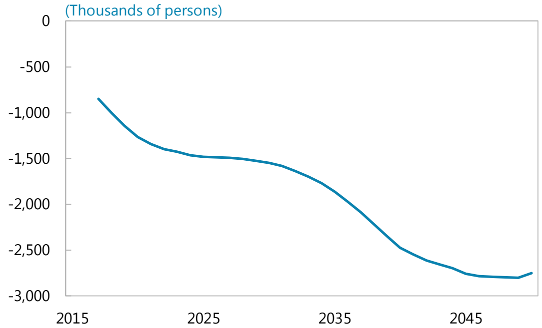


Sources: Social Insurance Institution (ZUS) and IMF staff calculations.

3. Labor market: Reversing the increase and equalization of retirement age will reduce the working age population by some 2½ million by 2050. This will further exacerbate the already adverse demographic outlook, unless people choose to work after reaching the retirement age. However, incentivizing longer working years would likely imply additional fiscal costs.

Change in Working Age Population Due to Lower Retirement Age

(Thousands of persons)



Sources: Eurostat and IMF staff calculations.

4. Potential Growth: The reversal of the 2013 retirement age increase may result in an estimated decline in potential output of 0.6–0.9 percent over the medium term and of about 0.8–1.2 percent over the long run, based on the simulations using the IMF's FSGM model[3].

[1] Prepared by Robert Sierhej and Krzysztof Krogulski, with input from Zoltan Jakab on the FSGM simulations.

[2] Original projections by the Social Insurance Institution (ZUS) assumed reversal of the retirement age as of January 2017. The full-year effect was divided by four to get a proxy for Q4, yielding a value corresponding to the 2017 budget allocation.

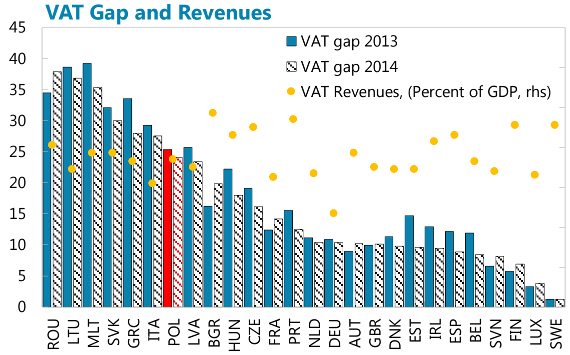
[3] The simulations include two scenarios: i) assuming a 70 percent drop-out rate of the eligible retirees from the labor market and ii) assuming a 100 percent drop-out rate, which gives a maximum potential impact.

Annex VII. Tax Administration Reforms[1]

Poland's relatively large VAT gaps suggest a significant scope for revenue gains from tax administration reforms. Ongoing institutional and compliance management measures aim to close the VAT compliance gap within an ambitious time frame, which requires strong sustained efforts and further structural changes.

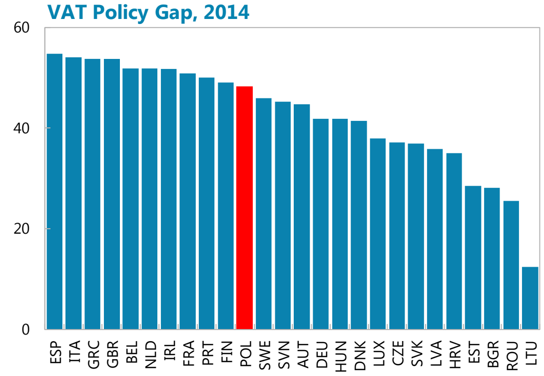
1. **Poland's VAT revenue-to-GDP ratio is below the EU average due to sizable policy and compliance gaps.** Both the VAT compliance and policy gaps in Poland are higher than those in many other EU countries, reflecting extensive non-compliance and broad coverage of reduced VAT rates and exemptions.

VAT Gap and Revenues



Source: European Commission (2016)
Note: Estimates for 2014. The VAT gap is the difference between actual VAT collections and those that could be obtained if the existing VAT laws were perfectly enforced. VAT revenues are expressed as percent of GDP.

VAT Policy Gap, 2014



Source: 2016 CASE Study of VAT Gaps in EU member states (EC TAXUD).

2. **The authorities are implementing institutional and compliance management measures, mainly targeting the VAT compliance gap**. On the institutional front, tax administration, customs and fiscal control operations are merged into single operational offices at regional and local levels. In the Ministry of Finance, all departments related to these areas are concentrated under a single undersecretary. The Ministry of Finance has also improved governance and procurement processes for major IT projects. Several compliance measures are being implemented, for example: targeted actions to tackle VAT fraud in fuels and other sectors; mandatory online filing of standard audit files and invoice transaction logs; process automation; required monthly submission of the VAT record; the creation of a centralized data warehouse for automated risk detection; and a General Anti-Avoidance Rule for corporate income tax (CIT). Additional new initiatives are under preparation, notably the introduction of "split payment mechanism" to create separate VAT accounts, which needs to be considered carefully and targeted appropriately to avoid unnecessary compliance costs.

3. **The authorities' goal of reducing the VAT compliance gap significantly and increasing revenues by 1.3 percent of GDP by 2020 appears ambitious given cross-country experience.** The 2016 CASE study of EU VAT gaps reported that the VAT gap in Poland was 24 percent of potential VAT in 2014, compared to the EU average of 14 percent. This represents a reduction in the compliance gap of 1 percentage point in 2013 and 2014. It is not yet possible to

[1] Prepared by Mick Thackray and Xin Cindy Xu.

see the impact of measures introduced since 2014 in revenue aggregates, and IMF's Fiscal Affair Department (FAD) is initiating a technical assistance program (RA_GAP) to help the authorities estimate the VAT gap in recent years. The authorities expect gains of 1.3 percent of GDP during 2017–20, implying a reduction of the VAT compliance gap by 14 percentage points. These expected gains are much higher that what was achieved by best performers in the region that had implemented similar reforms in the past (see below table), and would bring Poland's compliance gap well below the EU average. Staff's baseline projections of total gains of about 0.8 percent of GDP, equivalent to reducing the VAT compliance gap to the EU average level of 14 percent by 2020, are more in line with historical experiences.

4. **While there is scope for further revenue gains, there are implementation risks as well.** There is a risk that the administrative reorganization and merger could distract efforts from the fight against tax evasion and fraud. In terms of institutional reform, FAD advised on creating a single national tax administration, with a strong headquarter, and with greater autonomy from the Ministry of Finance. At the same time, strong strategic management will be required to ensure the best use of compliance resources, to avoid unnecessary compliance costs for taxpayers, and sustained effort to close the compliance gap.

Improvements in VAT Compliance: Poland and Selected EU Countries

Country Experience	Improvements (In percentage points, i.e. ppts)	Key Measures
Historical experience of five EU countries (LVA, CZE, HUN, SVK, EST), which successfully reduced the VAT gap during 2010-14.	3-11 ppts reduction of VAT gap during 2010-14	Countries' initial conditions and structural characteristics were different, but all five countries undertook similar measures to tackle tax fraud and evasions.
Historical best performance	LVA: 11 ppts in four years; EST: 5 ppts in one year	Though high gains were achieved in LVA and EST, the two countries are smaller economies compared to Poland, and had already implemented major compliance management reforms earlier.
Poland's own historical experience	2 ppts in two years during 2013-14	The decrease in the gap coincided with the introduction of measures to improve both tax compliance and efficiency. Among other measures, the government consolidated organisational functions and introduced a single database of tax identification numbers.

Source: 2016 CASE study of VAT gaps in the EU for EC TAXUD.

Annex VIII. Public Sector Debt Sustainability Analysis

Public debt is moderately high, but remains sustainable. The profile of public debt appears robust to interest, rollover, and foreign currency risks. A negative real GDP growth shock represents the largest risk to the debt outlook. In addition, a large share of foreign investors in the domestic debt market entails a risk, although the well-diversified investor base is a mitigating factor.

A. Baseline and Realism of Projections

1. Debt levels. General government debt rose to 54 percent of GDP in 2016, mainly owing to fiscal deficit and the government's debt management strategy to pre-finance future borrowing needs, taking advantage of the favorable market conditions. With the projected deficit path, public debt is expected to gradually decline to about 52 percent of GDP by 2022. Debt dynamics are mainly driven by the primary deficit, which rises in 2017 before a gradual decline over the medium term. A favorable differential between the projected GDP growth and the real interest rate also contributes to a decline in debt levels over the medium term.

2. GDP growth. Real GDP growth has accelerated to 4 percent in 2017:Q1 from 2.7 percent in 2016. The projections assume a pickup in growth to 3.6 percent in 2017 with a positive output gap, followed by a gradual slowdown to 2.6 percent by 2022 as output trends back toward potential. In recent years, staff's growth projections have had small forecast errors, with some indication of a pessimistic bias relative to other countries.

3. Fiscal adjustment. Under the baseline, the primary deficit is expected to increase to 1 percent of GDP by 2017, before declining to 0.1 percent of GDP by 2022. The dynamics reflect the government's pro-cyclical fiscal stance indicated in the 2017 budget, and thereafter fiscal consolidation measures to improve revenue collection and contain expenditure over the medium term. In the recent past, staff forecast errors of the primary deficit in Poland do not point to any significant bias and the projections of the primary deficit have been more conservative than for other countries. Overall, the projected fiscal adjustment seems feasible, as indicated by cross-country benchmarks.

4. Sovereign yields. The effective interest rate on public debt has been on a declining path since the global financial crisis, reflecting Poland's strong fundamentals and favorable external financial conditions. The effective interest rate is projected at 3.5 percent in 2017, and remains at a similar level in the medium term as most debt is long-term borrowing with a fixed rate. Yields on 10–year bonds have dropped by 47 basis points year-to-date close to 3.2 percent, and spreads of Polish euro-denominated bonds over 10–year German bonds have also declined by 54 basis points, reflecting lower market risk. CDS spreads reduced marginally by 19 basis points year-to-date to 61 basis points.

5. Maturity and rollover risks. Rollover risks are well managed. The average maturity of the outstanding debt is estimated at 5.3 years, and the share of short-term debt in total government debt is under 1 percent. T-bill issuance resumed in January 2016, following a period since August 2013 when there were no outstanding T-bills. As of end-May 2017, 66 percent of gross borrowing requirements for 2017 have been financed. Domestic banks have further increased holding of treasury securities, which are exempt from the new bank asset tax, by about 3.5 percent of GDP during 2016. The overall share of external debt in total public debt has reduced from 57 percent in 2015 to 53 percent in 2016. In addition, the share of foreign currency debt in state debt is about 34 percent as of end-2016. In line with the new debt management strategy, the baseline assumes gradual convergence toward the current structure of public debt in terms of the share of foreign currency debt in total debt (about 30 percent) and external debt in total debt (about 50 percent).

6. **Debt sustainability analysis (DSA) risk assessment**. The heat map highlights risks associated with the relatively large external financing requirements (about 22 percent of GDP in 2016), and the share of public debt held by non-residents (about 53 percent at end-2016). The latter is influenced by the large participation of foreign investors in the domestic bond market. However, the well-diversified foreign investor base, dominated by institutional investors (over 50 percent are long-term investors), is a mitigating factor.

7. **Fan charts**. The symmetric fan chart, which assumes symmetric upside and downside risks, indicates that the debt-to-GDP ratio could drop to below 50 percent by 2020 with a 25 percent probability. On the upper side, the debt-to-GDP ratio could surpass 60 percent by 2020 with a 25 percent probability. A more stringent exercise, combining restrictions to the upside shocks to interest rates and GDP growth, however, increases the probability of debt-to-GDP surpassing 60 percent in 2020 to 50 percent. This result illustrates the degree of uncertainty around the baseline.

B. Shocks and Stress Tests

8. **Primary balance shock**. An assumed deterioration in the primary balance by 0.9 percentage points relative to the baseline during 2018–19 pushes the public debt-to-revenue ratio up to about 138 percent in 2019. Gross financing needs peak at about 10 percent of GDP in 2019 and converge to the baseline in the outer years.

9. **Growth shock**. The stress scenario assumes a drop in GDP growth by about 1.7 percentage points in two consecutive years (2018–19) relative to the baseline, combined with a 0.4 percentage points drop in inflation and deterioration in the primary balance by 0.9 percentage points in 2018 and further by 1.7 percentage points in 2019. Under these assumptions, public debt increases to about 59 percent of GDP in 2019 before trending downward to about 56 percent of GDP by 2022. Gross financing needs increase to about 11 percent of GDP in 2019, but then converge toward the baseline in the outer years.

10. **Interest rate shock**. A permanent 260 bps increase in the nominal interest rate starting in 2018 leads to an increase in the effective interest rate on debt by 36 bps in 2019 (compared to the baseline) and further gradual increases to 133 bps by 2022. Under this scenario, public debt is 2 percent of GDP higher than under the baseline by 2022.

11. **Exchange rate shock.** This scenario assumes a nominal exchange rate depreciation of about 26 percent in 2018 (from 3.95 PLN/US$ to 5.0 PLN/US$), calibrated to emulate the maximum historical movement of the FX rate over the last 10 years. Under this scenario, gross public debt increases by 1 percentage point to 55 percent of GDP in 2018 before trending down to about 53 percent by 2022. The resilience reflects the predominance of public debt in local currency.

12. **Combined shock**. Under the combined shock, the public debt-to-GDP ratio jumps to 64 percent in 2019 and gradually reduces to 63 percent in 2022. In turn, gross financing needs increase to 12 percent of GDP in 2018 before trending down to around 7 percent of GDP by 2022.

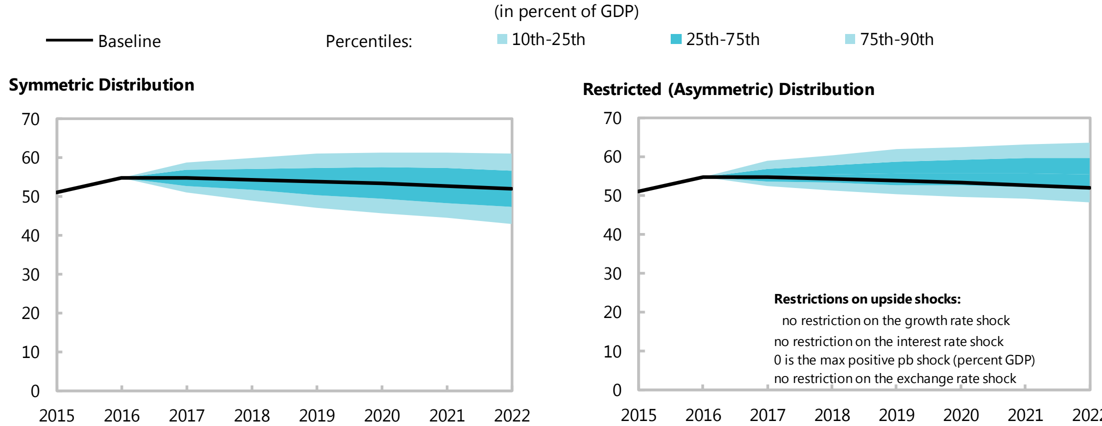
Public Sector Debt Sustainability Analysis (DSA)—Risk Assessment

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

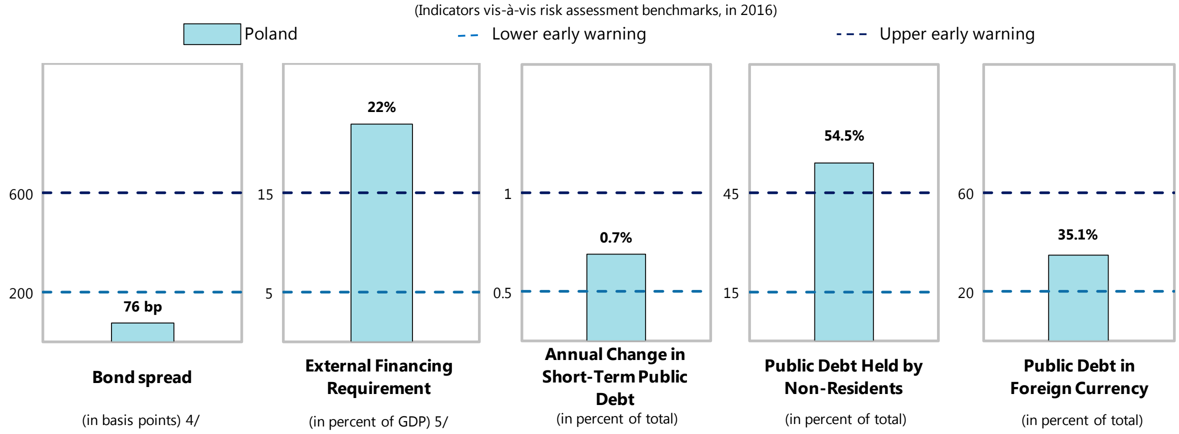
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2016)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

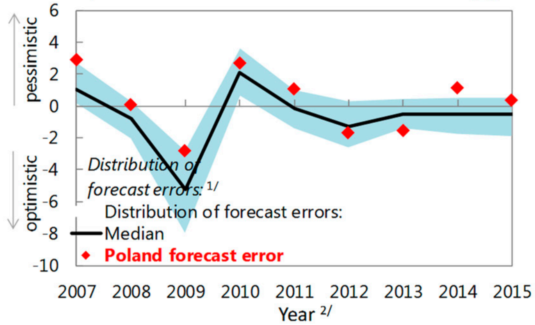
4/ Long-term bond spread over German bonds, an average over the last 3 months, 24-Mar-17 through 22-Jun-17.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

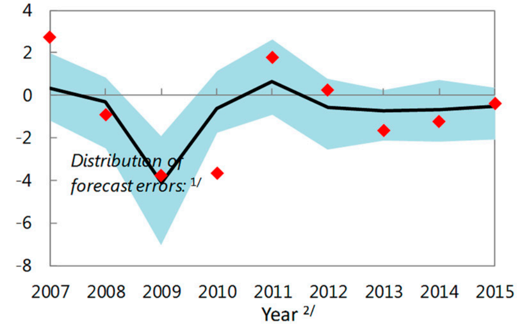
Public DSA—Realism of Baseline Assumptions

Forecast Track Record, versus all countries

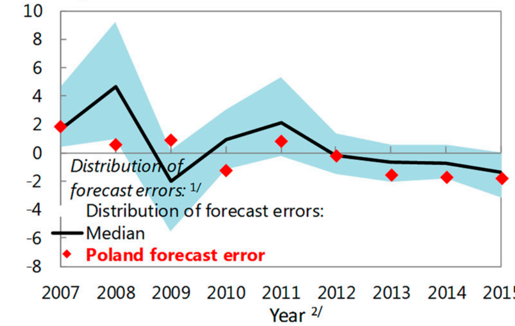
Real GDP Growth
(in percent, actual-projection)
Poland median forecast error, 2007-2015: **0.34**
Has a percentile rank of: **82%**



Primary Balance
(in percent of GDP, actual-projection)
Poland median forecast error, 2007-2015: **-0.93**
Has a percentile rank of: **40%**

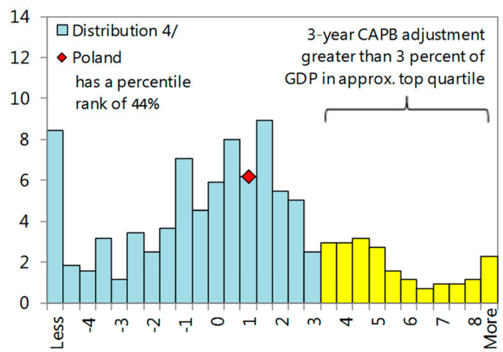


Inflation (Deflator)
(in percent, actual-projection)
Poland median forecast error, 2007-2015: **-0.26**
Has a percentile rank of: **40%**

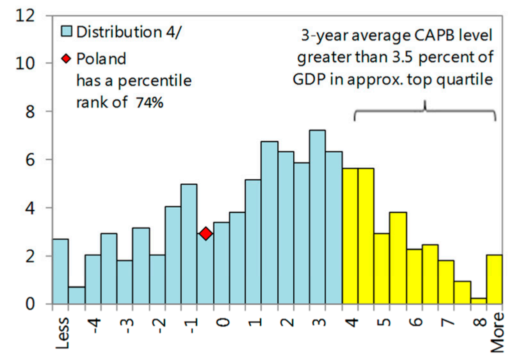


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)

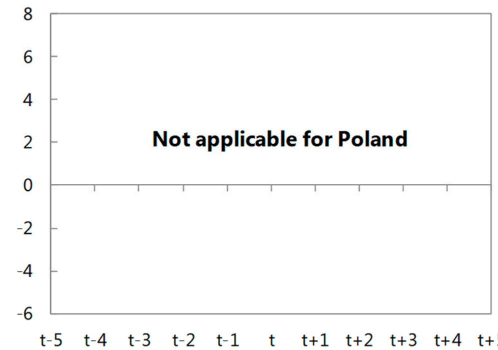


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

Real GDP growth
(in percent)



Source : IMF Staff.
1/ Plotted distribution includes all countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Poland, as it meets neither the positive output gap criterion nor the private credit growth criterion.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Public DSA—Baseline Scenario

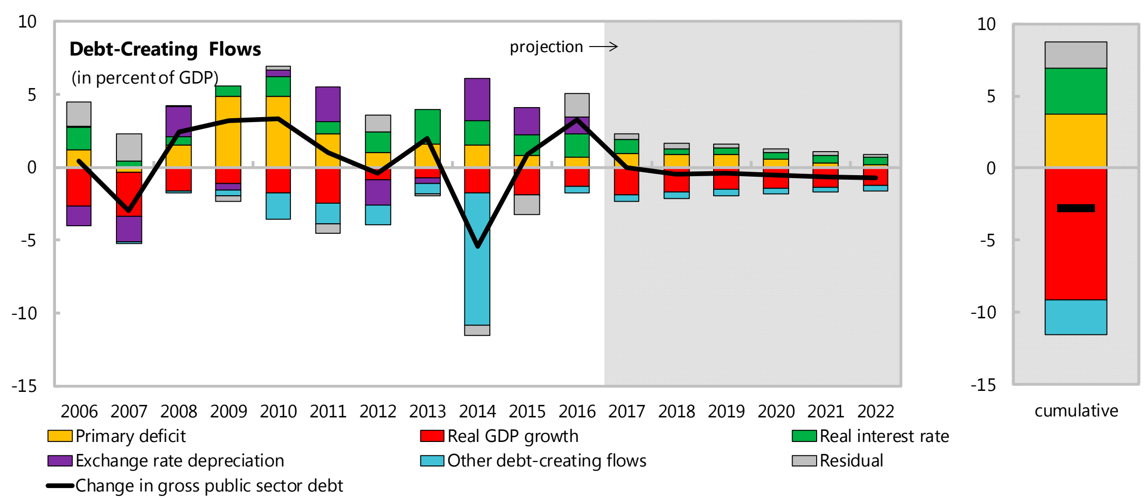
(Percent of GDP, unless otherwise indicated)

Debt, Economic and Market Indicators [1]

	Actual			Projections						As of June 22, 2017		
	2006-2014 [2]	2015	2016	2017	2018	2019	2020	2021	2022	Sovereign Spreads		
Nominal gross public debt	50.5	51.1	54.4	54.3	53.9	53.5	53.0	52.3	51.5	EMBIG (bp) 3/		87
Public gross financing needs	12.5	7.7	4.1	9.2	8.4	8.8	7.8	7.1	5.6	5Y CDS (bp)		62
Net public debt	51.5	51.1	54.4	54.3	53.9	53.5	53.0	52.3	51.5			
Real GDP growth (in percent)	3.9	3.9	2.6	3.6	3.3	3.0	2.8	2.7	2.6	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	2.4	0.7	0.2	1.7	2.6	2.6	2.5	2.5	2.4	Moody's	A2	A2
Nominal GDP growth (in percent)	6.4	4.6	2.9	5.4	6.0	5.7	5.4	5.2	5.1	S&Ps	BBB+	A-
Effective interest rate (in percent) [4]	5.0	3.7	3.4	3.5	3.5	3.5	3.5	3.5	3.5	Fitch	A-	A-

Contribution to Changes in Public Debt

	Actual			Projections							
	2006-2014	2015	2016	2017	2018	2019	2020	2021	2022	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	0.4	0.9	3.3	0.0	-0.5	-0.4	-0.5	-0.7	-0.7	-2.8	
Identified debt-creating flows	0.0	2.2	1.7	-0.5	-0.9	-0.6	-0.8	-0.9	-1.0	-4.6	
Primary deficit	2.1	0.8	0.7	1.0	0.9	0.9	0.5	0.3	0.2	3.7	-1.1
Primary (noninterest) revenue and gra	39.5	39.0	38.8	39.8	40.3	40.1	40.0	39.9	39.9	239.9	
Primary (noninterest) expenditure	41.5	39.8	39.6	40.7	41.1	41.0	40.5	40.2	40.0	243.6	
Automatic debt dynamics [5]	-0.3	1.4	1.5	-1.0	-1.3	-1.1	-0.9	-0.9	-0.8	-5.9	
Interest rate/growth differential [6]	-0.6	-0.5	0.3	-1.0	-1.3	-1.1	-0.9	-0.9	-0.8	-5.9	
Of which: real interest rate	1.2	1.4	1.6	0.9	0.4	0.4	0.5	0.5	0.5	3.2	
Of which: real GDP growth	-1.8	-1.9	-1.3	-1.9	-1.7	-1.5	-1.4	-1.4	-1.3	-9.2	
Exchange rate depreciation [7]	0.2	1.9	1.2	…	…	…	…	…	…	…	
Other identified debt-creating flows	-1.7	-0.1	-0.5	-0.5	-0.4	-0.4	-0.4	-0.4	-0.4	-2.4	
Privatization (+ reduces financing ne	-0.6	-0.1	-0.3	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-1.3	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Incurrence in liabilities not included	-1.1	0.0	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-1.2	
Residual, including asset changes [8]	0.4	-1.3	1.6	0.4	0.4	0.3	0.2	0.2	0.2	1.8	



Sources: Bloomberg Financial L.P. and IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

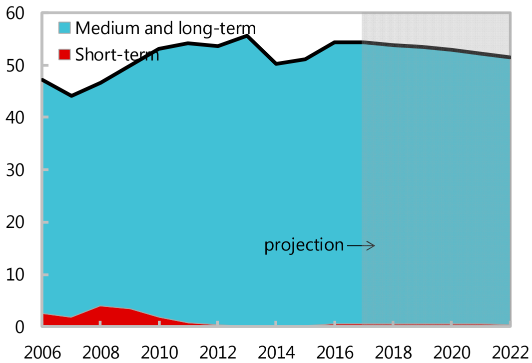
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

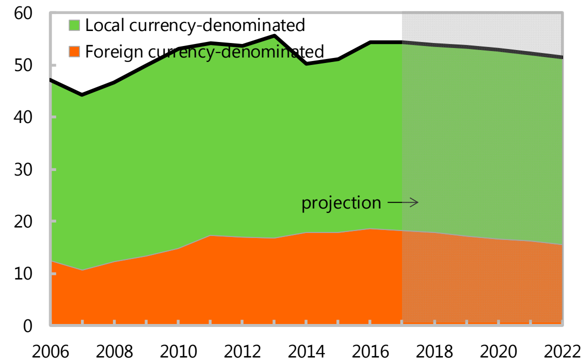
Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



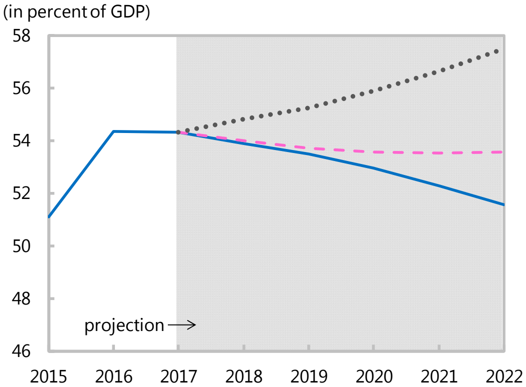
By Currency
(in percent of GDP)



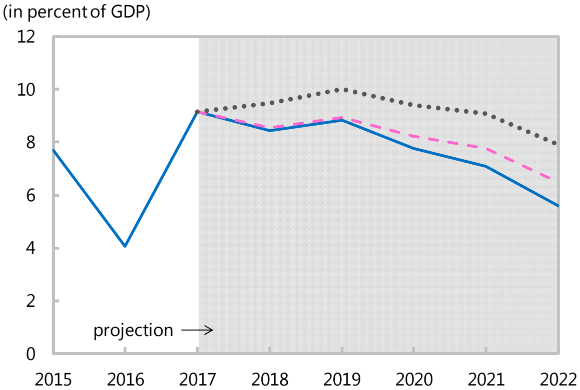
Alternative Scenarios

Baseline ········ Historical – – Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



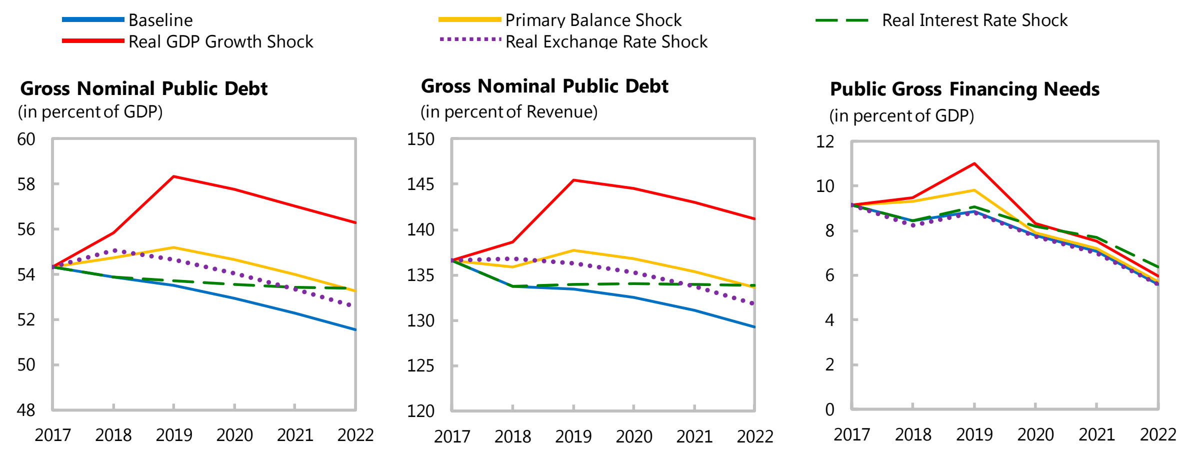
Underlying Assumptions
(in percent)

Baseline Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	3.6	3.3	3.0	2.8	2.7	2.6
Inflation	1.7	2.6	2.6	2.5	2.5	2.4
Primary Balance	-1.0	-0.9	-0.9	-0.5	-0.3	-0.2
Effective interest rate	3.5	3.5	3.5	3.5	3.5	3.5
Constant Primary Balance Scenario						
Real GDP growth	3.6	3.3	3.0	2.8	2.7	2.6
Inflation	1.7	2.6	2.6	2.5	2.5	2.4
Primary Balance	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Effective interest rate	3.5	3.5	3.5	3.5	3.5	3.5

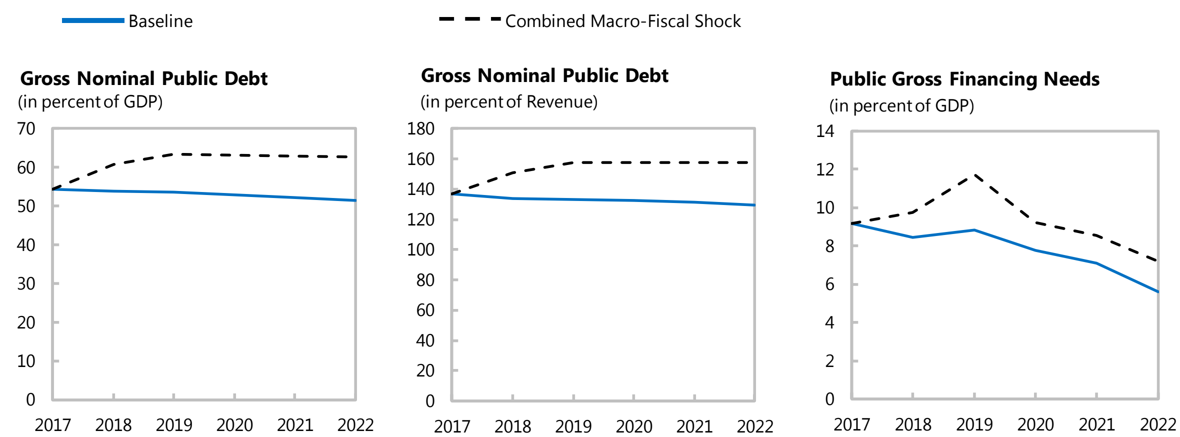
Historical Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	3.6	3.5	3.5	3.5	3.5	3.5
Inflation	1.7	2.6	2.6	2.5	2.5	2.4
Primary Balance	-1.0	-1.9	-1.9	-1.9	-1.9	-1.9
Effective interest rate	3.5	3.5	3.8	4.0	4.2	4.3

Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

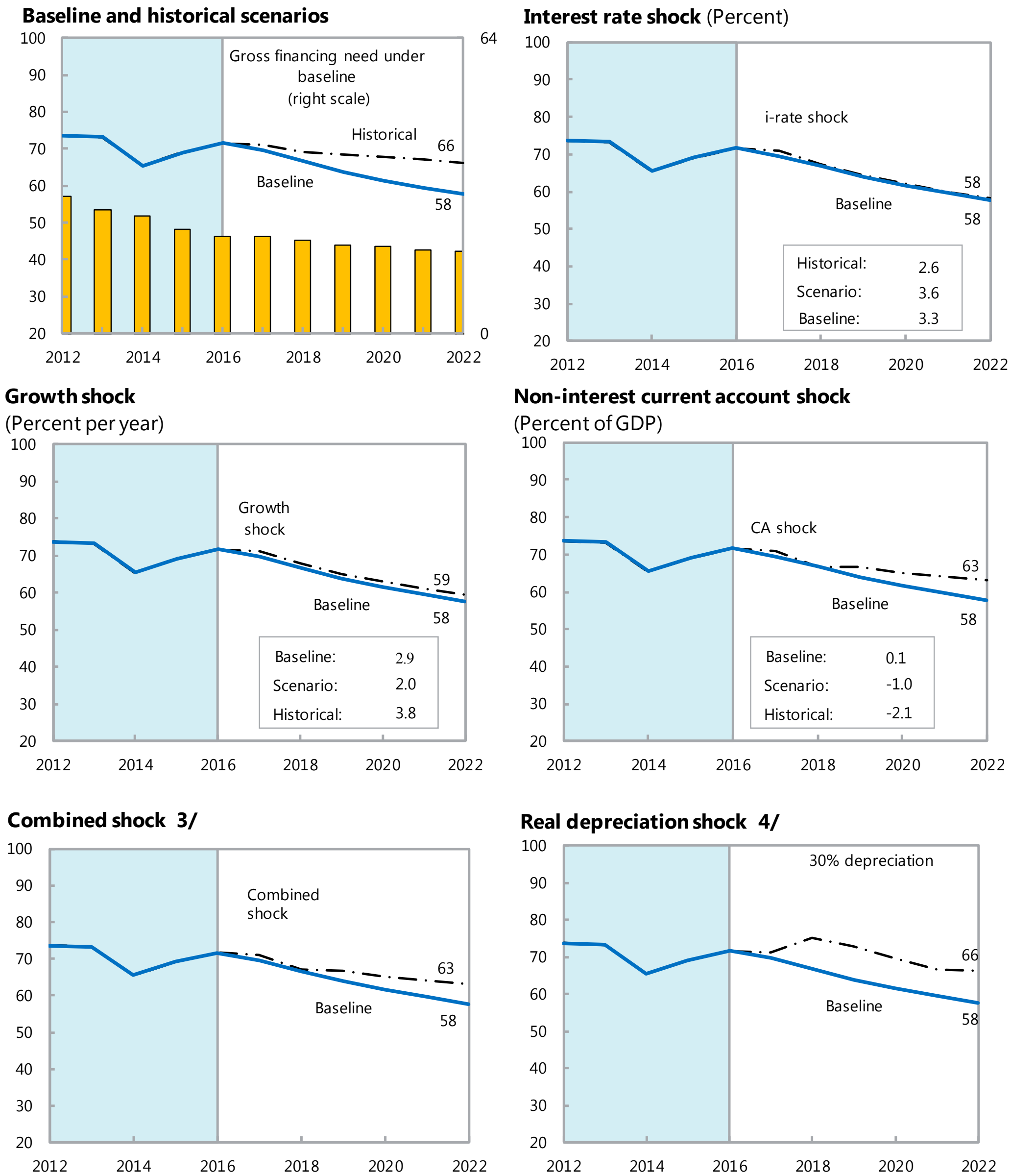
Primary Balance Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	3.6	3.3	3.0	2.8	2.7	2.6
Inflation	1.7	2.6	2.6	2.5	2.5	2.4
Primary balance	-1.0	-1.7	-1.7	-0.5	-0.3	-0.2
Effective interest rate	3.5	3.5	3.6	3.6	3.6	3.6
Real Interest Rate Shock						
Real GDP growth	3.6	3.3	3.0	2.8	2.7	2.6
Inflation	1.7	2.6	2.6	2.5	2.5	2.4
Primary balance	-1.0	-0.9	-0.9	-0.5	-0.3	-0.2
Effective interest rate	3.5	3.5	3.9	4.3	4.6	4.9
Combined Shock						
Real GDP growth	3.6	1.6	1.3	2.8	2.7	2.6
Inflation	1.7	2.2	2.2	2.5	2.5	2.4
Primary balance	-1.0	-1.7	-2.6	-0.5	-0.3	-0.2
Effective interest rate	3.5	3.7	3.8	4.3	4.6	4.9

Real GDP Growth Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	3.6	1.6	1.3	2.8	2.7	2.6
Inflation	1.7	2.2	2.2	2.5	2.5	2.4
Primary balance	-1.0	-1.7	-2.6	-0.5	-0.3	-0.2
Effective interest rate	3.5	3.5	3.6	3.6	3.6	3.6
Real Exchange Rate Shock						
Real GDP growth	3.6	3.3	3.0	2.8	2.7	2.6
Inflation	1.7	9.3	2.6	2.5	2.5	2.4
Primary balance	-1.0	-0.9	-0.9	-0.5	-0.3	-0.2
Effective interest rate	3.5	3.7	3.4	3.5	3.5	3.5

Annex IX. External Debt Sustainability Analysis, 2014–22

External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2018.

External Debt Sustainability Framework, 2014–22

(In percent of GDP, unless otherwise indicated)

	Actual					Projections							
	2014	2015	2016			2017	2018	2019	2020	2021	2022		
						I. Baseline Projections							Debt-stabilizing non-interest current account 5/
External debt	65.4	69.1	71.6			**69.6**	**66.7**	**63.8**	**61.5**	**59.5**	**57.7**	**0.0**	**-2.8**
Change in external debt	-7.8	3.7	2.5			-2.0	-4.9	-2.9	-2.3	-2.0	-1.8	0.0	
Identified external debt-creating flows (4+8+9)	-3.6	0.0	-1.1			-2.9	-4.1	-4.0	-3.4	-3.0	-2.6	0.0	
Current account deficit, excluding interest payments	0.5	-0.8	-1.1			-0.5	-0.4	-0.4	-0.2	0.0	0.2	2.8	
Deficit in balance of goods and services	-1.4	-3.1	-3.7			-2.5	-2.1	-1.7	-1.4	-1.0	-0.7		
Exports	47.6	49.5	52.1			54.8	56.4	57.9	58.9	60.1	61.0		
Imports	46.2	46.4	48.4			52.2	54.3	56.1	57.5	59.1	60.2		
Net non-debt creating capital inflows (negative)	-3.0	-2.9	-0.5			-0.5	-1.5	-2.0	-2.1	-2.1	-2.1	-2.1	
Automatic debt dynamics 1/	-1.1	3.8	0.5			-1.9	-2.2	-1.6	-1.2	-0.9	-0.7	-0.7	
Contribution from nominal interest rate	1.6	1.5	1.4			1.6	1.9	2.0	2.1	2.1	2.2	2.1	
Contribution from real GDP growth	-2.3	-2.9	-1.9			-2.4	-2.2	-1.9	-1.7	-1.6	-1.5	-1.4	
Contribution from price and exchange rate changes 2/	-0.4	5.2	0.9			-1.1	-1.8	-1.7	-1.6	-1.5	-1.4	-1.4	
Residual, incl. change in gross foreign assets (2-3)	-4.2	3.7	3.6			0.9	-0.8	1.1	1.1	1.0	0.8	0.0	
External debt-to-exports ratio (in percent)	137.5	139.7	137.4			127.1	118.3	110.3	104.5	99.1	94.7		
Gross external financing need (in billions of US dollars) 3/	139.6	108.7	99.6			103.8	105.4	106.1	109.9	111.9	115.0		
in percent of GDP	25.6	22.8	21.2	10-Year Historical Average	10-Year Standard Deviation	21.0	20.2	19.2	18.9	18.3	17.9	For debt stabilization	
Key Macroeconomic Assumptions													
Real GDP growth (in percent)	3.3	3.9	2.6	3.8	1.8	3.6	3.3	3.0	2.8	2.7	2.6	2.6	
Exchange rate appreciation (US dollar value of local currency, percent)	0.1	-16.3	-4.4	-1.2	11.3	-0.1	-0.4	-0.1	0.0	0.0	0.0	0.0	
GDP deflator in US dollars (change in percent)	0.6	-15.7	-4.2	0.9	12.0	1.6	2.3	2.5	2.5	2.4	2.4	2.4	
Nominal external interest rate (in percent)	2.3	1.9	1.9	2.6	0.4	2.5	2.7	3.1	3.4	3.6	3.8	3.8	
Growth of exports (US dollar terms, in percent)	6.8	-9.0	3.6	7.4	14.6	10.7	8.7	8.4	7.2	7.3	6.6	6.6	
Growth of imports (US dollar terms, in percent)	8.0	-11.9	2.6	6.6	18.3	13.6	9.8	9.1	8.0	8.0	7.2	7.2	
Current account balance, excluding interest payments	-0.5	0.8	1.1	-2.1	2.3	0.5	0.4	0.4	0.2	0.0	-0.2	-0.2	
Net non-debt creating capital inflows	3.0	2.9	0.5	2.4	1.0	0.5	1.5	2.0	2.1	2.1	2.1	2.1	
						II. Stress Tests for External Debt Ratio							Debt-stabilizing non-interest current account 5/
A. Alternative Scenarios													
A1. Key variables are at their historical averages in 2017-2022 4/						**71.0**	**69.1**	**68.5**	**67.9**	**67.2**	**66.3**	**0.0**	**-3.8**
B. Bound Tests													
B1. Nominal interest rate is at baseline plus one-half standard deviation						71.0	67.4	64.5	62.1	60.0	58.1	0.0	-2.9
B2. Real GDP growth is at baseline minus one-half standard deviations						71.0	67.8	65.0	62.8	61.0	59.4	0.0	-2.6
B3. Non-interest current account at baseline minus one-half standard deviations						71.0	66.7	66.6	65.1	64.0	63.1	0.0	-3.0
B4. Combination of B1-B3 using 1/4 standard deviation shocks						71.0	67.1	66.8	65.3	64.0	63.0	0.0	-2.6
B5. One time 30 percent real depreciation in 2018						71.0	75.0	73.0	69.6	66.4	66.2	0.0	-1.1

Source: IMF staff calculations.

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ Defined as current account deficit, plus amortization on short-term and medium- and long-term debt.

4/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

5/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

INTERNATIONAL MONETARY FUND

REPUBLIC OF POLAND

June 23, 2017

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By European Department

CONTENTS

FUND RELATIONS

(As of May 31, 2017)

Membership Status: Joined 6/12/1986; Article VIII

General Resources Account:

	SDR Million	Percent Quota
Quota	4,095.40	100.00
Fund Holdings of Currency	3,865.82	94.39
Reserve Tranche Position	229.59	5.61
Lending to the Fund		
New Arrangement to Borrow	217.25	

SDR Department:

	SDR Million	Percent Allocation
Net Cumulative Allocation	1,304.64	100.00
Holdings	299.49	22.96

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

In Millions of SDR

Type	Approval Date	Expiration Date	Amount Approved	Amount Drawn
FCL	1/12/2017	1/12/2019	6,500.00	0.00
FCL	1/14/2015	1/13/2017	13,000.00	0.00
FCL	1/18/2013	1/13/2015	22,000.00	0.00
FCL	1/21/2011	1/17/2013	19,166.00	0.00
FCL	7/02/2010	1/20/2011	13,690.00	0.00

Projected Payments to Fund (SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2017	2018	2019	2020	2021
Principal					
Charges/Interest	2.75	5.57	5.57	5.57	5.56
Total	2.75	5.57	5.57	5.57	5.56

Exchange Arrangements:

The zloty is freely floating.

Poland accepted the obligation of Article VIII, Sections 2, 3, and 4 on June 1, 1995. Poland maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for the exchange restrictions imposed by Poland solely for the preservation of national or international security as introduced by the European Union (EU) within the framework of the Common Foreign and Security Policy. The consolidated list of such sanctions is available at: http://eeas.europa.eu/cfsp/sanctions/consol-list/index_en.htm.

Article IV Consultation:

The last Article IV consultation was concluded on June 27, 2016. Directors noted that Poland enjoyed a strong economic expansion, reflecting progress in building strong fundamentals and policy buffers. They cautioned against a weakening of institutions and policies and encouraged the authorities to advance structural reforms to support inclusive growth. Specifically:

- *Monetary policy.* Directors noted that the accommodative monetary policy stance was appropriate but urged the authorities to remain vigilant if inflation expectations were to disappoint or if growth were to slow down sharply.

- *Financial sector policy.* Directors welcomed the strengthened financial sector frameworks. They expressed concerns about the new bank asset tax, which could undermine credit expansion and growth, and encouraged the authorities to consider a more growth-friendly tax. They noted that a case-by-case approach to restructuring foreign exchange-denominated mortgages rather than a blanket conversion would avoid destabilizing the financial sector.

- *Fiscal policy*. Directors concurred with the authorities' medium-term objective of 1 percent of GDP structural deficit. Most Directors considered it necessary to resume fiscal consolidation without delay to take advantage of the favorable cyclical conditions. They recommended maintaining the 2011 VAT increase, rationalizing discretionary government consumption, and reducing sizable VAT policy and compliance gaps. They welcomed the authorities' plans to strengthen tax administration, and encouraged the authorities to maintain the legislated retirement age increases, which would reduce the risk of old-age poverty, avoid adversely impacting the budget and improve labor force participation.

- *Structural reforms.* Directors encouraged the authorities to continue structural reforms to boost productivity and promote inclusive growth. They welcomed the authorities' plans to increase access to vocational training and to promote innovation. Directors advised that reducing regional disparities would require improving educational attainment in Poland's east, scaling up public infrastructure to attract investment to poorer regions, and facilitating labor mobility.

Resident Representative:

Mr. Bas Bakker is the Senior Regional Resident Representative for Central and Eastern Europe.

Republic of Poland: Technical Assistance from the Fund, 1992–2017

Department	Subject/Identified Need	Action	Date	Counterpart
MAE-Coordinated	Periodic visits by experts from central banks cooperating in providing technical assistance to the NBP under the coordination of MAE	Experts' visits	1992–94	NBP
MAE	Payments system, banking supervision, monetary research and analysis	Mission	May 1992	NBP
MAE	Review of progress in the modernization of operational functions	Mission	October 1992	NBP
MAE	Resident expert-Advisor to President of NBP		November 1991–92	NBP
MAE	Additional steps in the modernization process of the NBP	Mission	April 1993	NBP
MAE	Monetary programming and operations, and payments system	Mission	November 1993	NBP
MAE	Central bank modernization	Mission	August 1994	NBP
MAE/LEG	Review of the exchange and payments system	Mission	February 1995	NBP/MoF
MAE	Exchange rate system	Mission	March 1995	NBP
MAE	Review of government securities market, payments system and public debt management	Mission	August 1995	NBP/MoF
MAE	Asset consolidation exercise	Expert visits	Late 1995	NBP
FAD	Tax administration (VAT)	Nine short-term assignments of field experts	August 1992–October 1994	MoF
FAD	Tax administration	Mission	November 1992	MoF
STA	Framework for monetary statistics	Mission	February 1993	NBP
STA	Framework for monetary statistics (follow-up)	Mission	November 1993	NBP

Republic of Poland: Technical Assistance from the Fund, 1992–2017 (continued)

Department	Subject/Identified Need	Action	Date	Counterpart
STA	Government finance statistics	Mission	August 1995	NBP/MoF
STA	Money and banking statistics	Mission	January 1996	NBP
STA	Government finance statistics	Mission	July 1996	NBP/MoF
STA	Balance of payments statistics	Mission	November 1996	NBP/MoF
STA	Balance of payments statistics	Follow-up mission	April 1997	NBP/MoF
STA	Review of progress in implementing the SDDS	Visit	February 1998	
FAD	Public expenditure management	Mission	April 1998	MoF
MAE	Operational aspects of monetary and exchange rate policy	Mission	September 1998	NBP
FAD	Tax administration	Mission	October 1998	MoF
FAD	Examination of impact on revenues of proposed tax reform	Mission	November 1998	MoF
FAD	Discussion of tax administration	Mission	March 1999	MoF
FAD	Tax administration seminar	Mission	April 1999	MoF
STA	Government Finance Statistics	Mission	October 1999	MoF/Local
FAD	Tax administration—Introduction of expert	Mission	November 1999	MoF
FAD	Administering Social Security	Mission	March 2000	MoF
IMF/IBRD	FSAP	Mission	May/Sept 2000	MoF/NBP
MAE	Monetary Operations	Mission	July 2001	NBP
FAD	Expenditure restructuring	Mission	December 2001	MoF
MAE	Stress testing	Mission	January 2002	NBP
STA	Data ROSC	Mission	January 2003	CSO/MoF/NBP
STA	Government finance statistics (GFSM 2001)	Mission	October 2003	MoF
STA	Government finance statistics (GFSM 2001)	Mission	January 2005	MoF

Republic of Poland: Technical Assistance from the Fund, 1992–2017 (concluded)

Department	Subject/Identified Need	Action	Date	Counterpart
IMF/IBRD	FSAP Update	Mission	April/May 2006	MoF/NBP
FAD	Developing a multi-annual fiscal framework	Mission	June 2008	MoF
STA	Errors and omissions in balance of payments accounts	Mission	July 2009	NBP
FAD	Medium-term fiscal framework	Mission	April 2010	MoF
MCM	Detailed assessment of observance of BCP for effective banking supervision	Mission	Feb/March 2011	KNF
STA	Errors and omissions in balance of payments accounts	Mission	June 2011	NBP
FAD	Developing the fiscal regime for oil and gas	Mission	April 2012	MoF
MCM	Macroprudential framework	Mission	May 2012	NBP
IMF/WB	FSAP update	Mission	Feb/March 2013	MoF/ KNF/NBP
FAD	Tax administration—Modernization challenges and strategic priorities	Mission	November 2014	MoF
MCM	Bank Resolution	Mission	March 2016	BFG
FAD	Medium-term budget framework	Mission	January 2017	MoF
FAD	Tax administration	Mission	April 2017	MoF

STATISTICAL ISSUES

(As of May 31, 2017)

Assessment of Data Adequacy for Surveillance

General: Data provision is adequate for surveillance.

National Accounts: The Central Statistical Office (GUS) compiles and disseminates annual and quarterly GDP by production and expenditure approaches, both at current and previous year's prices following the *2008 SNA* and *ESA 2010*. A supply and use table is only available for the year 2010. Quarterly financial accounts of general government sector are compiled by the Central Statistical Office (GUS). Annual and quarterly financial accounts by institutional sectors are compiled by Narodowy Bank Polski (NBP) following the *ESA 2010* standards and disseminated regularly on its website according to an advance release calendar: the annual financial accounts on the 20th of October the following year and quarterly financial accounts on the 20th calendar day of the 4th month following the end of the reference quarter (i.e., on the 20th of January, April, July, and October).

Price Statistics: The consumer price index does not cover imputed rents of owner-occupied dwellings. The scope of the index covers all resident households, except those in some rural areas. The producer price index does not include any estimation for missing prices; quality and seasonal adjustment techniques are also not implemented.

Government Finance Statistics: The Ministry of Finance (MoF) is responsible for compiling monthly data. The data are compiled in accordance with the IMF's Government Finance Statistics Manual 2001 (GFSM 2001). Monthly cash data cover "core" central government. Revenue and expense are divided by economic type. Financing is classified by sector and by type of debt instrument.

Starting in 2015 (annual data for 2014), GUS is responsible for collecting, processing, and disseminating annual government finance statistics. The data are compiled according to European System of Accounts (ESA2010) and adjusted to GFS Manual 2014. The annual reports cover presentation of fiscal data on operations of the general government sector divided by central government, local government, and social security funds. Revenue and expense are divided by transactions. Financing is classified by sector and by type of debt instrument. General government data are released on a quarterly basis, derived from detailed ESA data. Monthly and annual data are regularly disseminated on the SDDS website. Data for 2013 were prepared by the Ministry of Finance according to GFS2001, while data for 2014 were prepared by the Central Statistical Office according to GFSM2014.

Monetary and Financial Statistics: Beginning with data for January 2004, the NBP provides the European Central Bank (ECB) with monetary accounts in accordance with the ECB's framework for monetary statistics using the national residency approach. Data on other financial corporations (OFC) are currently not available. An earlier Report on the Observance of Standards and Codes (ROSC) mission recommended that the NBP, in cooperation with the MoF, reconcile monetary and government finance statistics and carry out a reconciliation exercise on a regular basis.

Financial Sector Surveillance: In November 2009, NBP in cooperation with GUS, the Polish Financial Supervision Authority (KNF) and MoF began reporting financial soundness indicators (FSI) based on the IMF's *Financial Soundness Indicators Compilation Guide*. Poland is currently reporting all core FSIs and 21 of the 28 encouraged FSIs on a quarterly basis with a lag of approximately one quarter. NBP also implemented EU regulation 680/2014, which covers supervisory reporting defined by the Implementing Technical Standards (ITS) prepared by the European Banking Authority. The first data was collected for March 2014 for own funds and liquidity related reporting. Financial reporting on a consolidated basis according to the ITS scheme was reported for the first time for September 2014.

External Sector Statistics: Largely to improve data accuracy, the NBP fully depends on survey-based source data, starting in the first quarter of 2010. STA undertook an evaluation mission to Poland in July 2009, and followed up in June 2011 to assess further data improvements and anticipated revisions in the external sector accounts. Due to the comprehensive work on improving the data sources, the errors and omissions reduced from 4 percent of GDP in 2004 to around 1 percent of GDP in recent years, which is comparable to the level in other European countries. Authorities are committed to further improving the compilation system for the external sector statistics.

Poland, as all other EU countries, started disseminating balance of payments data in accordance with the sixth edition of the *IMF's Balance of Payments and International Investment Position Manual (BPM6)* and external debt statistics in line with the 2013 *External Debt Statistics: Guide for Compilers and Users* (2013 *EDS Guide*).

Poland reports Coordinated Direct Investment Survey and Coordinated Portfolio Investment Survey data to the IMF.

Data Standards and Quality

Subscriber to the Fund's Special Data Dissemination Standard (SDDS) since April 17, 1996. Uses SDDS flexibility option on the timeliness of the data on general government and central government operations.

Data ROSC was published in 2003.

Republic of Poland: Table of Common Indicators Required for Surveillance–as of May 31, 2016

	Date of latest observation	Date received	Frequency of data[7]	Frequency of reporting[7]	Frequency of publication[7]	Memo Items: Data Quality – Methodological soundness[8]	Memo Items: Data Quality Accuracy and reliability[9]
Exchange Rates	5/31/2017	5/31/2017	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	4/2017	5/19/2017	M	M	M		
Reserve/Base Money	4/2017	5/5/2017	M	M	M	O, LO, O, LO	O, O, O, O, O
Broad Money	4/2017	5/12/2017	M	M	M		
Central Bank Balance Sheet	4/2017	5/5/2017	M	M	M		
Consolidated Balance Sheet of the Banking System	4/2017	5/12/2017	M	M	M		
Interest Rates[2]	5/31/2017	5/31/2017	D	D	D		
Consumer Price Index	4/2017	5/12/2017	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance, and Composition of Financing[3] – General Government[4]	Q4/2016	5/20/2017	A	A	A	LO, O, O, O	O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	3/2017	5/20/2017	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	3/2017	5/20/2017	M	M	M		
External Current Account Balance	3/2017	5/15/2017	M	M	M	O, O, O, LO	O, O, O, O, LO
Exports and Imports of Goods and Services	3/2017	5/16/2017	M	M	M		
GDP/GNP	Q1/2017	5/31/2017	Q	Q	Q	O, LO, O, O	LO, LO, O, O, LO
Gross External Debt	Q4/2016	3/31/2017	Q	Q	Q		
International Investment Position[6]	Q4/2016	3/31/2017	Q	Q	Q		

1 Any reserve assets that are pledged of otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

2 Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

3 Foreign, domestic bank, and domestic nonbank financing.

4 The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

5 Including currency and maturity composition.

6 Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).

7 Reflects the assessment provided in the data ROSC published on November 6, 2001, and based on the findings of the respective missions that took place during May 10–18, 2001 for the dataset corresponding to the variable in each row. For fiscal data, also takes account of the 2009 Fiscal Transparency ROSC. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

8 Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation, and revision studies.

9 Includes external gross financial asset and liability positions vis-à-vis nonresidents.

Statement by Miroslaw Panek, Executive Director for Republic of Poland
And Piotr Trabinski, Alternate Executive Director
July 7, 2017

On behalf of the Polish authorities, we would like to thank staff for a detailed and well-focused report on the Polish economy. Our authorities are grateful for an open and insightful discussion during the Article IV mission in Warsaw, and largely agree with the assessment enclosed in the report.

Economic outlook

Poland enjoys a continued strong economic growth. In 2016 real GDP grew by 2.7 percent, i.e. broadly in line with potential output, yet somewhat slower than in the previous year, which was mainly due to temporarily lower absorption of EU funds after the expiration of the previous EU financial framework, a pattern shared by other EU member states. By the first quarter of 2017 GDP growth has already accelerated to 4 percent, driven mainly by increasing private consumption, supported by growth in employment and wages as well as child benefit payments (*"Family 500 plus"*). At the same time, improvement of consumers' sentiment and better business confidence indicators boosted manufacturing and construction output and stabilized investment spending.

The economic growth in 2017 is expected to be broadly in line with potential output and to reach at least 3.6 percent, allowing for a gradual closing of the output gap. On the back of strengthening economic growth and firming labor market, the unemployment rate declined to a new historically low level of 4.8 percent in April 2017, and is expected to remain well below the EU average of 7.8 percent[1].

The government is focused on supporting a strong and inclusive growth while maintaining fiscal sustainability. The 2016 fiscal outcome was better than projected: the fiscal deficit declined to the lowest level since the global financial crises (GFC), reaching 2.4 percent of GDP. Revenues were higher than expected, driven by improved tax compliance, while expenditures underperformed due to weaker public investment. The financial sector remains sound with well capitalized institutions, and the level of non-performing loans (NPLs) has decreased further to 7 percent. Finally, headline inflation picked up last year to reach 1.9 percent in May 2017.

External Sector

External imbalance of the Polish economy is currently at a low level in historical terms. The current account (CA) deficit decreased in 2016 for the second consecutive year, to 0.3 percent of GDP, from 0.6 percent in 2015. This was among others due to improved terms

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[1] According to Eurostat: http://ec.europa.eu/eurostat/statistics-explained/index.php/File:Unemployment_rates,_seasonally_adjusted,_April_2017_(%25)_F2.png

of trade, and thanks to them the nominal surplus in trade of goods and services reached 3.7 percent of GDP. Polish exports benefit from economic revival of the euro area, especially at our main trade partner – Germany. In the last quarter of 2016, stronger exports to the euro area were additionally supported by a weaker currency. At the same time the transition from the 2007-13 to the 2014-20 EU financial perspective contributed – through lower inflow of funds – to a decrease in the capital account surplus.

The external position is consistent with medium-term policies and fundamentals. The gross reserves have increased further in 2016 to about 128 percent of ARA metric. Their level increased in USD-terms from 95 to about 114 billion, at end of 2016. The access to the precautionary Flexible Credit Line (FCL) offers additional protection against potential adverse risks. It has recently been lowered in consistence with the authorities' exit strategy.

Fiscal Policy

The government's strategic objective concentrates on supporting long-term, inclusive economic growth while maintaining sustainability of public finance and complying with domestic and EU fiscal rules. The government aims to mobilize more revenue through better tax compliance. Recently implemented or planned measures aimed at limiting tax fraud include i.a.:

- The *General Anti-Avoidance Rule* – in force since 2016;
- The *Fuel Package* – set of measures aimed at preventing tax fraud in intra-EU liquid fuel trade - in force since August 2016;
- Merging the tax and customs administration into the National Tax Administration – in force since March 2017;
- A detailed automated analysis of tax books (*Standard Audit File*) – in force;
- A system for monitoring of the road freight transport of certain sensitive goods (e.g. fuel, tobacco);
- A split VAT payment mechanism – planned from 2018.

Higher tax revenues gathered through these measures allow for financing new items on the expenditure side. They include the flagship family support program *"Family 500 plus,"* and lowering of the retirement age (planned from October 2017), with fiscal impact to be limited by stronger incentives for employees to remain longer in the labor market.

Moreover, in June 2016, the government adopted the "Assumptions to Budgetary System Reform". The planned reform is aimed at inter alia strengthening medium- term budgetary framework, integrating annual and multiannual planning processes and institutionalization of spending reviews and other instruments supporting the efficiency of public spending.

In 2016, the general government deficit decreased further from 2.6 percent of GDP in 2015 to 2.4 percent of GDP (according to ESA 2010) reflecting higher tax revenues and an improved outturn in the local government and social security accounts. Tax revenues increased by 0.8 percent of GDP to 20.6 percent. It was the fourth highest improvement of the tax revenues in the EU. The general government debt amounted to 54.4 percent of GDP.

In 2017, the budget deficit is expected to reach 2.9 percent of GDP, mainly due to an increase in public investment. However, the government is planning to reduce the structural deficit gradually beginning from 2018, so as to reach the medium-term objective (MTO) – a structural deficit of 1 percent of GDP – just after 2020. The pace of consolidation will be determined by the automatic correction mechanism of the expenditure rule that requires a dynamic of expenditure by 1.5-2.0 percentage points lower than average GDP growth until the MTO will have been achieved and the public debt will have been reduced below 43 percent of GDP. Achieving the MTO will be supported by further initiatives aimed at improving tax administration.

Monetary Policy

From July 2014 to October 2016, Poland experienced a CPI deflation caused mainly by the drop in global commodity prices (energy and food). The average level of consumer prices in 2016 was 0.6 percent lower than in 2015. With the global rebound of commodity prices, inflation in Poland increased to 1.9 percent in the first quarter of 2017. Despite falling unemployment and faster economic growth, core inflation remains low (0.8 percent as of May), indicating a low demand pressure and limited pass-through from tightening labor market to wage and price dynamics. Inflation is forecast to reach 1.8 percent in 2017; and gradually move towards the central bank target of 2.5 percent over the next two years.

The central bank has left its main policy interest rate unchanged since March 2015, at 1.5 percent. Keeping interest rates stable, yet markedly higher than in other EU countries, has supported macroeconomic balance and price stability. The authorities perceive holding the policy rate on hold as appropriate at least until the end of 2017; they agreed with the staff that the policy decisions should be data driven and inflationary pressures should be monitored. They underline their commitment to timely actions in the event of any changes that would jeopardize the inflation objectives.

Financial Sector

Financial sector in Poland remains resilient and stable, with solvency ratios well-exceeding regulatory minimum. Financial institutions are well-capitalized and liquid. Banks continued to strengthen by increasing capital adequacy ratio from 16 percent in 2015: Q4 to 17.2 percent in 2016: Q4 and the average Tier 1 capital ratio by 1 percentage point (from 14.6 to 15.6 percent in the same period). This further increases the level of resiliency in case of adverse shocks and is in line with recommendations from the Financial Supervisory Authority (KNF). The liquidity of banks also improved, due to higher household and corporate deposit growth. Finally, the non-performing loans (NPLs) dropped to 7 percent of total loans.

Financial institutions' position reflects the current low interest rate environment, with operating costs rising. Despite gradual strengthening of the lending standards, credit supply continued to grow. The growth of housing and consumer loans was mainly driven by further improvement in the labor market and rising incomes, while decrease of the growth rate of corporate loans was underpinned by a slowdown in the segment of loans to large enterprises. Increased economic growth, further improvement on the labor market and an increase in individual consumption point to the credit cycle in Poland moving through the juncture of recovery and expansion phases in 2017. Growth of lending should also be supported by expected higher utilization of the EU funds.

The authorities are reviewing possible options to address the issue of the FX mortgage loans. While the FX mortgage portfolio does not generate systemic risks and such loans are being serviced on time, the authorities are seeking the most efficient solution to address consumer protection concerns. There is agreement among the authorities that no solution implemented should endanger financial stability. The appreciation of the Swiss franc led to initiatives of legislative intervention into contractual provisions arising from FX mortgages. Three such bills are now being proceeded in the Parliament, these include a proposal of refunding a part of FX spreads prepared by the Chancellery of the President, and a Parliament's draft on a statutory conversion of FX mortgages. In addition, the Financial Stability Committee (KSF) in January 2017 stated that any restructuring should be on a voluntary basis and statutory conversions are not a proper course of action. The Committee released nine recommendations, which aim to encourage banks to convert FX mortgages into Polish zloty denominated ones, by providing measures facilitating voluntary restructuring. Work on solutions is ongoing and final decisions and implementation of the package of measures to address FX mortgages are expected to be concluded by the end of 2017 or in early 2018.

Government declared a strategy to increase share of domestic ownership in the banking sector, to strengthen its stability and capacity to absorb external shocks. In December 2016, the major Polish insurance company, PZU, together with Polish Development Fund (PFR), signed the agreement to purchase a 32.8 percent stake in Bank Pekao from UniCredit, and the transaction was completed in June 2017.

Structural Reforms

The authorities are strongly committed to the implementation of structural reforms. This attitude is best expressed by the introduction of the Responsible Development Strategy (RDS), the first comprehensive initiative aimed at addressing structural reform gaps. The main objective of the RDS is to provide sustained and inclusive economic, social, environmental and regionally-spread growth. Strategy is presenting a set of strategic objectives, supplemented by the flagship projects and monitoring tools. It provides *inter alia* for increasing the potential of the economy through re-industrialization, fostering innovative companies, promoting sustained regional development, international expansion of domestic firms, creating more high-quality jobs and achieving convergence with the EU average per capita income. Currently the RDS encompasses 185 legal, investment or organizational initiatives, and some of them were already implemented, like the Business Constitution (a set of 100 pro-business legal rationalization initiatives aimed at improving business climate) or creation of the Polish Development Fund, that is intended to coordinate and to finance key development initiatives.

One of top priorities of the RDS is to promote innovation. The PFR and other institutions offer a range of investment initiatives addressed to startups and innovative companies. Increase in the R&D spending and support for innovative companies at different stages of maturity is perceived by the authorities, as a way to achieve more technologically advanced economy.