April 2008
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Republic of Poland: 2007 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the 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 2007 Article IV consultation with the Republic of Poland, the following documents have been released and are included in this package:

- the staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on January 21, 2008, with the officials of the Republic of Poland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on March 19, 2008. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;

- a staff supplement of April 9, 2008 updating information on recent developments;

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its April 16, 2008 discussion of the staff report that concluded the Article IV consultation; and

- a statement by the Alternate Executive Director for the Republic of Poland.

The document listed below has been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF POLAND

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Consultation
with the Republic of Poland

Approved by Michael Deppler and Adnan Mazarei

March 19, 2008

Executive Summary

Growth is slowing and core inflation rising. Supply-side constraints are emerging, with real wages growing well above productivity. GDP growth is set to ease from 6½ to 5 percent in 2008, while inflation is projected to remain outside the upper end of the band in 2008–09.

Policy tightening is warranted. Monetary policy should retain a tightening bias to prevent higher inflation expectations from becoming entrenched and a prolonged tightening bias from causing excessive appreciation in the future. The 2008 budget will, at best, be neutral, but the government plans to cut the structural deficit by about ½ percent of GDP annually over the medium-term. This will help safeguard external sustainability and maintain the zloty within its equilibrium range as the current account deficit otherwise will approach the limit of what is safe. Staff suggest a three-year fiscal framework to protect against pro-cyclical policy and broaden support for fiscal targets.

There is no evidence of the current turmoil spilling over through financial channels. Banks are very profitable, have scant exposure to US sub-prime assets and structured products, and the corporate bond market is small. While systemic vulnerabilities are limited, the unification of supervision comes at a sensitive time and vigilance is needed during the transition period.

Automatic stabilizers should be allowed to work. Downside risks arising from the possibility of stronger-than-expected external spillovers are broadly offset by risks that domestic demand will be more robust than assumed. Should downside risk materialize, monetary tightening should pause and the fiscal stabilizers should be allowed to work.

Boosting labor participation is essential for long-term growth prospects. Participation is low and the scope for increasing utilization is being exhausted. Reforming generous provisions for early retirement and for disability payments is of highest priority, and reducing the tax wedge at lower incomes and reforming the agricultural pension system could also boost participation.

The authorities will set a timetable for euro adoption once they deem that the conditions for success have been established.

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I. INTRODUCTION[1]

1. **Poland is experiencing strong and well-balanced growth, in large part because of rapid financial deepening and an EU accession related investment boom**. So far, the recovery has resulted in only limited upward pressure on core inflation and the external current account deficit. Similarly, the zloty remains within the estimated equilibrium range.

2. **Resource constraints are, however, beginning to emerge, especially in the labor market, where real wage growth has outpaced productivity for some time**. The recent steady increase in core inflation suggests that scope for continuing to absorb unit labor costs (ULCs) by squeezing profit margins is diminishing. And with limited observed spillovers thus far from the slowdown in major industrial countries, GDP growth is set to remain at or above potential, increasing the risk of a wage-price spiral. Cost pressures could also erode competitiveness and lead to a faster deterioration in the current account than seen in recent years.

3. **Against this background, discussions with the newly elected government focused on the dual challenge of containing demand pressures and strengthening the economy's supply response**. As to the former, the main topics included spillovers from the financial market turmoil, the appropriate near-term monetary and fiscal policy stance, and the need for fiscal consolidation over the medium term. On the supply side, the focus was on the role of the financial sector, the scope for boosting Poland's exceptionally low labor participation, and the prospect for accelerating catch-up gains in productivity through liberalization and privatization. Discussions also focused on the frameworks for fiscal policy and financial sector supervision.

II. STRONG GROWTH CONTINUED IN 2007, BUT BOTTLENECKS HAVE EMERGED

A. Recent Economic Developments

4. **After years of sluggish performance, Poland enjoyed a second year of strong economic growth in 2007** (Table 1). The upturn has been underpinned by robust and well-balanced growth as EU accession has bolstered business confidence and spurred a long-awaited rise in investment. Meanwhile, private consumption has remained strong, driven by rapidly rising real wages, increasing employment, and record-high credit growth, but also tax cuts. The external sector, however, has become an increasing drag on the economy since mid-2006. This, and incipient signs of a gradual slowing in GDP growth, likely reflect emerging capacity constraints.

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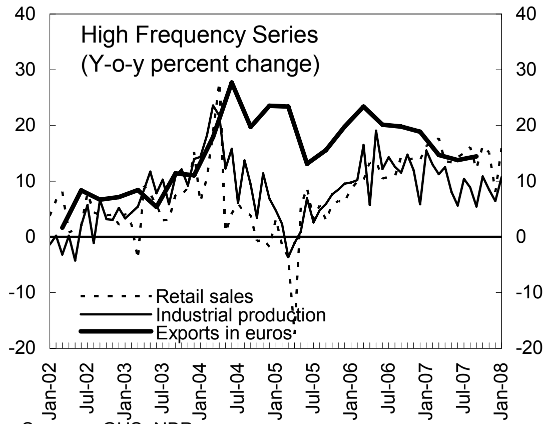
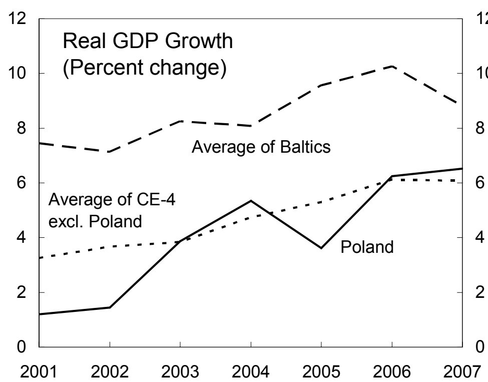
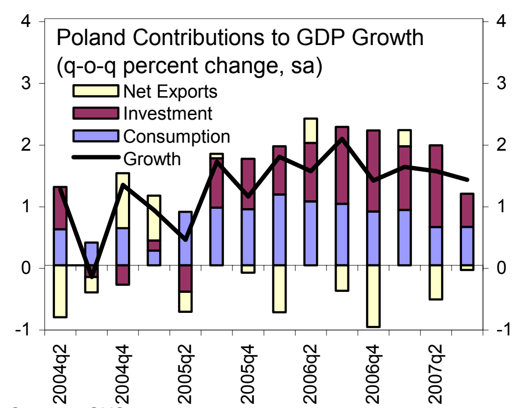
[1] A team comprising of Mr. Thomsen (head), Mr. Hoffmaister, Ms. Allard, and Mr. Annett (all EUR) and Mr. Galizia (MCM) visited Warsaw during January 14–21, 2008; an advance team arrived on January 9. Messrs. Rosenberg and Sierhej, from the Warsaw Regional Office, supported the work of the mission. Poland is an Article VIII country (Appendix I). Data provision is adequate for surveillance (Appendix II).



Sources: GUS; NBP.

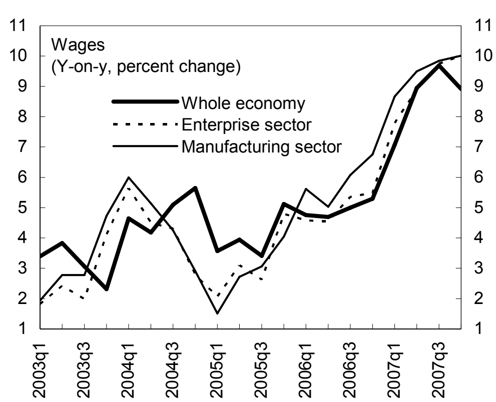


Sources: WEO, IMF; Staff projections.

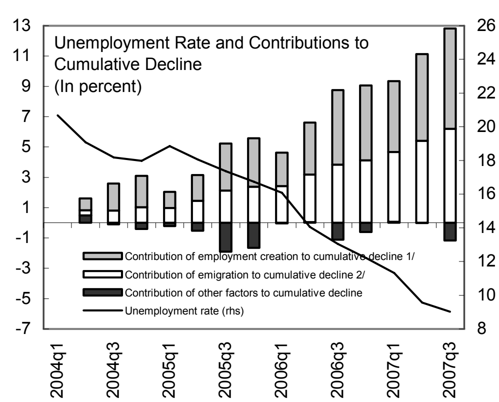


Sources: GUS.

5. **The output gap is closing and labor markets are tightening**. Capacity utilization indicators have reached record-high levels, and staff estimates that GDP growth is still running above potential, despite the rise in investment in recent years. Pressures are particularly evident in labor markets. Driven by plummeting unemployment, wage growth reached close to 10 percent in the fourth quarter (year-on-year), and real wage growth continues to significantly outstrip productivity gains. Labor shortages have been compounded by continuous emigration to Western Europe since EU accession.



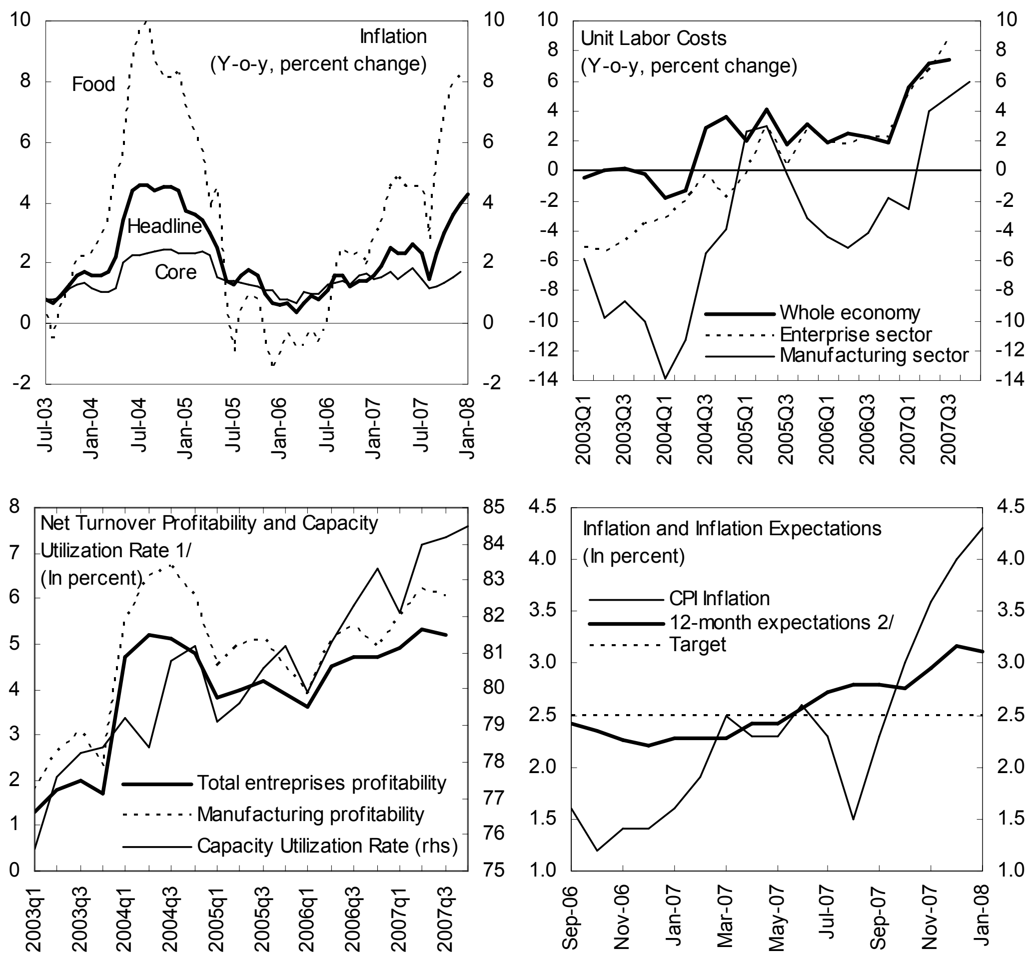
Sources: GUS; and NBP.



Sources: GUS; and Staff calculations.

1/ Assuming half of the new jobs are filled with previously unemployed people.
2/ Assuming 1.5 million Poles emigrated since May 2004, out of which 60 percent were previously unemployed.

6. **Demand pressures are beginning to affect inflation**. Headline CPI inflation has been increasing since 2006, reaching 4¼ percent (year-on-year) in January 2008, despite some appreciation of the zloty. This lies not only well above the National Bank of Poland's (NBP's) inflation target of 2½ percent, but also above the 1½–3½ percent band. Until the Fall of 2007, this increase almost entirely reflected soaring food and energy prices, and core inflation remained stable as rising ULCs were absorbed by lower profit margins, which had been boosted by wage restraint in the first half of the decade. Core inflation has edged up during the last six months, suggesting that the scope for squeezing profit margins is narrowing. Consistent with this, market-based indicators suggest that inflation expectations remained well-anchored through most of 2007, but began to pick up toward the end of the year.



Sources: GUS; NBP; Bloomberg; Staff calculations.

1/ Net profit in percent of turnover.

2/ Derived from inflation-indexed Treasury.

7. **Despite demand pressures, the current account deficit is still relatively low and the zloty is within the estimated equilibrium range**. Buoyant imports have resulted in a slight widening of the deficit—to about 3¾ percent of GDP in 2007—even as Poland has continued to gain export market share and remittances have grown. However, the deficit has remained fully financed by record levels of FDI, and the estimated underlying deficit of 4½ to 6 percent of GDP in 2007 is consistent with external sustainability inasmuch as it remains below the estimated debt-stabilizing level of 6 percent of GDP (Tables 2, 3, and 4).[2] Furthermore, staff estimates of the equilibrium real exchange rate do not point to misalignment, despite the real appreciation that has taken place since mid-2006.[3]

Poland: Export Margin, 2003–07
(Year-on-year rate of change)

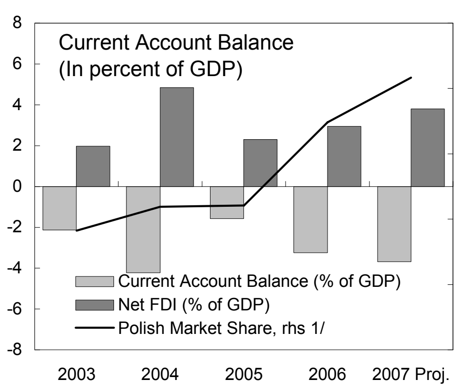
	2003	2004	2005	2006	2007 proj.
Export margin	6.3	7.5	-5.3	0.2	-2.6
Exports deflator	6.2	8.3	-2.5	2.3	3.8
Unit labor cost	-0.1	0.7	2.7	2.1	6.4
Relative profitability of exports 1/	5.9	4.2	-5.2	0.8	1.0
Exports deflator	6.2	8.3	-2.5	2.3	3.8
GDP deflator	0.4	4.1	2.6	1.5	2.8

Source: IMF, *World Economic Outlook.*
1/ Assumes a common unit labor cost for the economy.

Balance of Payments, 2005-07
(In billions of US $)

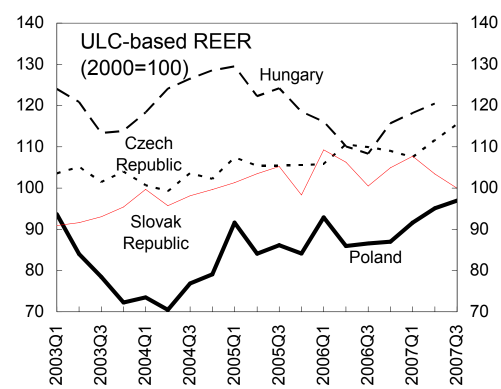
	2005	2006	2007 Proj.
Current Account Balance	-5	-11	-15
Capital and Financial Account Balance	16	14	35
Net FDI	7	10	16
Other Net Flows	9	4	19
Errors and Omissions	-3	-1	-6
Reserve Accumulation	8	2	13
Memo item:			
Current Account in percent of GDP	-1.6	-3.2	-3.7

Sources: NBP, Staff projections.



Sources: NBP; IMF Direction of Trade.

1/ Data as of 2007q3.



Sources: NBP for Poland, IMF for other countries.

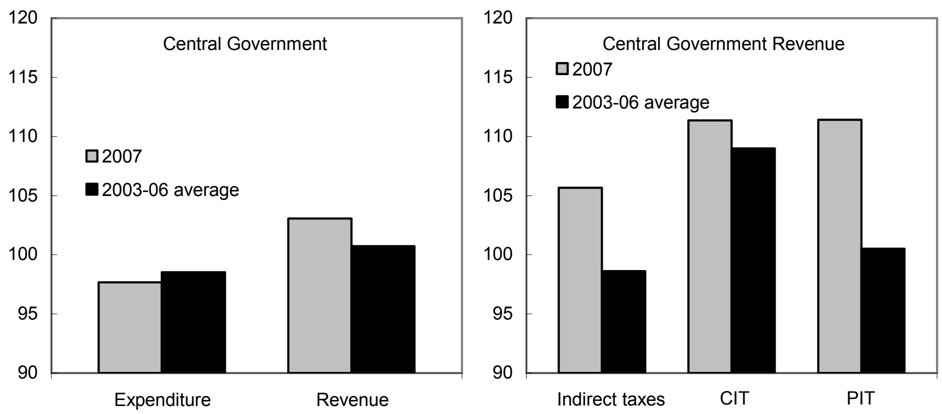
[2] The underlying current account balance is defined as the balance that would result, at prevailing market exchange rates, if all countries were operating at their respective potential output levels. It is estimated using trade equations. The methodology is described in Bayoumi and Faruquee, 1998, Chapter V of "Exchange Rate Assessment, Extensions of the Macroeconomic Balance Approach," IMF Occasional Paper 167.

[3] This assessment draws on preliminary CGER estimates suggesting that the estimated deviations from the equilibrium real exchange rate are within the margin of error of the estimation.

B. Economic Policies

8. **Adjusting for cyclical factors, there was a fiscal tightening of about ¾ percent of GDP in 2007** (Table 5). Expenditures were below budgeted limits at both state and local levels, an under-execution that largely reflected difficulties in carrying out public investments, including those related to EU funds. At the same time, strong cyclically-driven tax collections contributed to a substantially lower-than-budgeted general government deficit of 2½ percent of GDP, a full ½ percent of GDP below the 2007 Convergence Program target.

Poland: State Budget Outcome, 2007
(Percent of budget)



Source: Ministry of Finance.

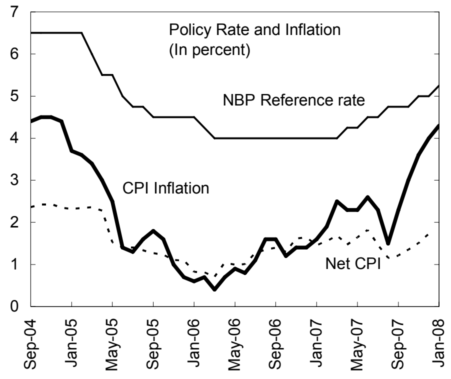
Poland: Summary General Government Balance, 2006-07
(In percent of GDP)

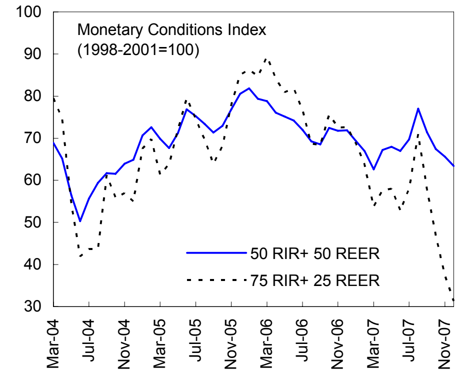
	2006	2007 Est.
General government revenue	39.8	41.3
General government expenditure 1/	43.8	43.9
General government balance 1/	-4.0	-2.6
Memorandum items:		
Structural balance 2/	-3.2	-2.4

Sources: Polish authorities; and IMF staff estimates and projections.
1/ Fund definition (including the cost of the pension reform).
2/ Actual balance corrected for economic cycle.

9. **A monetary tightening cycle is underway**. Reflecting the Monetary Policy Council's (MPC)'s concern about rising inflation, policy interest rates have been raised six times since April 2007 and now stand at 5½ percent. Simultaneously, the zloty has appreciated in response to a widening spread of domestic interest rates over euro and dollar interest rates. Nonetheless, monetary conditions have loosened, as the increase in nominal rates have not prevented real interest rates from falling in the face of accelerating inflation. Besides liquidity management operations (including repos), the NBP has continued

to refrain from directly intervening in foreign exchange markets although international reserves have increased since 2004 as a result of EU transfers and re-evaluation.





Sources: GUS; NBP; Staff calculations.

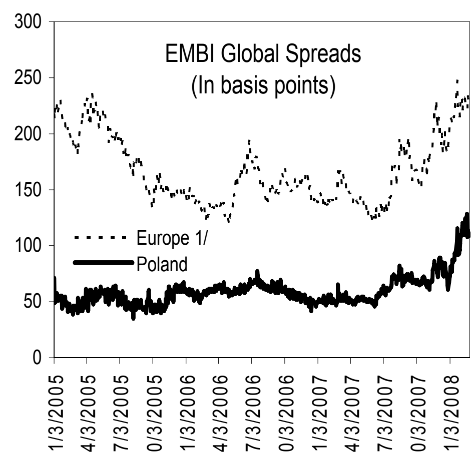
C. Financial Sector Developments

10. **The impact of the international capital market turmoil has been limited so far**. The banking sector's profitability has remained high and it has little, if any, exposure to U.S. sub-prime mortgage assets. Foreign capital inflows have held up well, and the increases in both credit default swap and bond spreads have been limited, especially in relation to other European emerging markets. In contrast, the stock market retrenchment in Poland has been more severe, following substantially larger gains than elsewhere in the region since 2006.

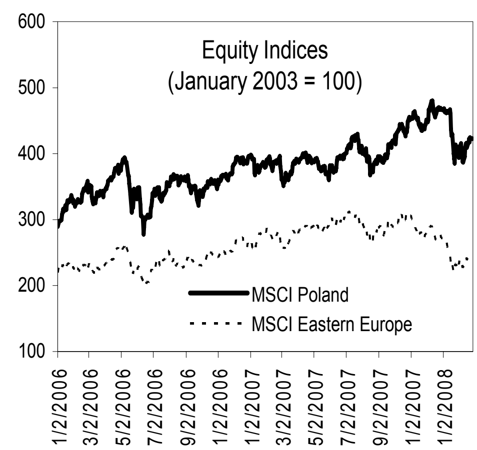
Selected Financial Indicators

	Poland (2007)	Czech Republic (2006)	Hungary (2006)	Western Europe 1/ (2006)
Return on equity	23.7	23.1	22.9	7.5 - 15.6
Return on assets	1.8	1.3	1.8	0.3 - 0.8
Foreign currency denominated liabilities to total liabilities	17.1	n.a.	39.3	n.a.

1/ Western Europe comprises, France, Germany, Italy, and the UK.
Sources: GFSR, IMF; and country authorities.



Source: J.P. Morgan
1/ Comprises Bulgaria, Hungary, Kazakhstan, Poland, Russia, Serbia, Turkey, and Ukraine.



Source: Bloomberg