Poland

Welcome to Europe's top table!

With Donald Tusk taking over as President of the European Council, the country has moved up to the next level. To consolidate its prominent role within Europe, the country now needs to find ways of showing economic leadership by re-orienting its growth model based on a low-cost approach. While the slowdown is increasingly evident almost right across the EU, Poland has held up remarkably well. With elections due in 2015, fiscal consolidation is set to go on hold. But the anticipated easing is not likely to compromise the credibility of its economic policy.

Welcome to Europe's top table!

With Donald Tusk taking over as President of the European Council, the country has moved up to the next level. After being granted EU membership just 10 years ago, Poland has become the most prominent of the "new members" despite staying outside the euro zone, it has gained access to an equally high level of political representation.

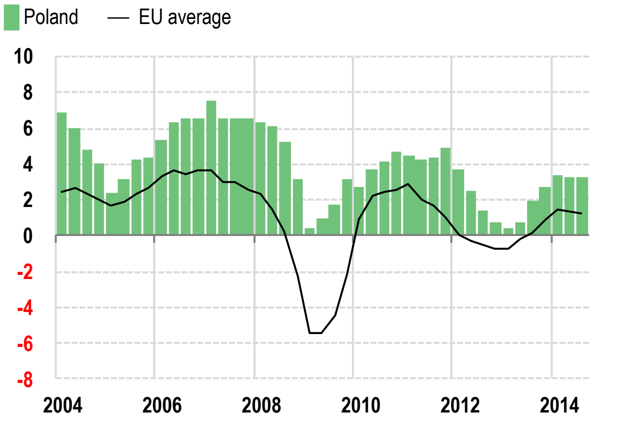
Since joining the EU, Poland has been able to build a robust economy that has weathered shocks. It was one of the few countries to have escaped the recession in 2009. Between 2004 and 2013, the country posted growth averaging 4.1% despite having the lowest volatility in growth and inflation of all the central and eastern European countries. Wage costs remain relatively low for a highly qualified workforce, and the business environment is favourable for foreign investors (and in particular those from Europe). The substantial domestic market is a draw for investors. Economic success has shored up the population's faith in the virtues of European values, providing a stable political situation despite structurally high unemployment.

To consolidate its prominent role within Europe, the country now needs to find ways of showing economic leadership. A growth model based on low costs and technology imports will no longer suffice. The development of new technologies needs to be the next step. As things stand, R&D spending remains insufficient (0.9% of GDP vs. an EU average of 2.08%). Smart use of European loans (EUR82.5 billion have been set aside in the EU budget for the 2014-2020 period) could give fresh impetus to this development, which, if successful, will help to build an economy commensurate with the country's political ambitions.

Year of elections looming

A busy political agenda lies ahead in 2015, with Poland set to elect its President in the spring and then to vote for the Sejm and Senate in the autumn[1]. Donald Tusk's replacement by his ally Ewa Kopacz as prime minister in September 2014 reflects a decision to maintain the political status quo. The new prime minister will have to work on keeping the party together, giving

1- Growth
Year-on-year change



Source: Eurostat

her little scope on the reform front. In all likelihood, most of her effort will have to focus on making smart and full use of the European funds (especially in the form of infrastructure investment projects) while providing reassurance to families and pensioners, who are hoping for a concession from the government.

Despite fairly healthy economic performance and successful European integration marked by Donald Tusk's appointment to the EU's top post, the Civic Platform party cannot be certain of victory in the 2015 polls. At least, that is what the results of the November 2014 local elections suggest. Although the party held onto a majority of seats, it won fewer votes than its opponents.

Another resilience test

While economies have been slowing down almost right across Europe, Poland has held its own. GDP grew by 3.3% year-on-year (0.9% q/q) in the third quarter of 2014. The Polish economy remains one of the top performers in the EU. There has been no let-up in domestic demand, with growth running at almost 5% y/y. The two main components have displayed momentum that would be the envy of most countries. Consumer spending has risen by 3.3% y/y, while investment is rising at close to a double-digit rate (9.9% y/y). The slowdown in external demand, feared by many as a result of the crisis between the EU and Russia over Ukraine, has been

[1] *Since October 2011, the centre-right "Civic Platform" has dominated political life with President Bronislaw Komorowski (elected in 2010). The government is formed from a coalition between the centre-right "Civic Platform" party and its ally representing rural interests, the Polish People's Party. The opposition consists of the conservative Law and Justice party, the Democratic Left Alliance and Janusz Palikot's liberal movement.*

modest so far, with exports growing by 3.8% y/y in Q3 (vs. 4.8% increase in Q2).

In November 2014, the sentiment indicator settled at its highest level since 2011. The PMI index also rose (51.2 in October, up from 49.5 in September): the composite index has received a boost from the strength of domestic demand drivers, while new export orders have shown signs of weakening and the effects of the dispute between Russia and the EU are starting to show up.

The strength of the economy is helping employment. The unemployment rate fell back 0.2 points in a month to 11.3% in October based on the official definition (8.3% based on the EU-wide definition). Wages are moving higher, rising by 3.8% y/y in October. This increase is underpinning consumer spending and has (to date at least) not had any impact on inflation.

Temporary bout of deflation

Consumer prices remained unchanged between August and October. Inflation remains in negative territory on a year-on-year comparison (-0.3% y/y in October). The Russian embargo imposed on Polish fruit and vegetable growers when the harvest was in full swing played a role in bringing down food prices. The fall in oil prices that kicked in subsequently and the deflationary conditions seen in the EU are likely to take a heavier toll on prices over the coming months.

Even though the inflation rate has stayed down below the target rate (2.5%+/-1%) for 22 months in a row, the central bank left its benchmark rate unchanged at 2% in November. It expects deflation's hold to be short-lived. Given the growth in wages and public spending to come, it may again opt to leave benchmark rates unchanged.

Elections bound to lead to a slight relaxation of the fiscal stance

The Polish budget deficit has held above the 3% of GDP mark since 2009, It is also expected to remain there over 2014 as a whole (adjusted for exceptional income arising from the transfer of pension fund assets to the state in 2014). The goal for 2015 is to cut it below this level, which would put an end to the excessive deficit procedure (in place since 2009). The deficit is expected to narrow from 3.3% of GDP in 2015 to 2.6% of GDP in 2016, thereby halting the procedure. The constraints of the spending rule, which caps annual growth in spending to 2 points below the increase in GDP in order to reduce the ratio of public debt to 43% of GDP (from 50% at present), will be harder to satisfy because they will require a major drive to cut spending in the medium term, which is hard to deliver in a low-inflation environment.

The budget bill for 2015 is based on growth of 3.4% and an inflation rate of 1.2%. Revenue will increase by just 1%, while a 5% nominal increase in spending is planned. With elections looming large, social security spending will be given top priority. The plan is for an increase in pensions (of around EUR4 per month for every pensioner). Families with children will get a reduction in their tax bill as a result of a 20% tax credit. To control spending, the government still intends to curb public sector pay increases. Public investment is expected to continue reaping the benefit of European funds.

The loosening of the fiscal grip in the run-up to the elections is unlikely to jeopardise the sustainability of the Polish public finances. That said, significant measures will have to be taken to comply with the fiscal rules and halt the excessive deficit procedure during 2016 and 2017 because a prudent fiscal policy holds the key to the credibility of Polish economic policy.

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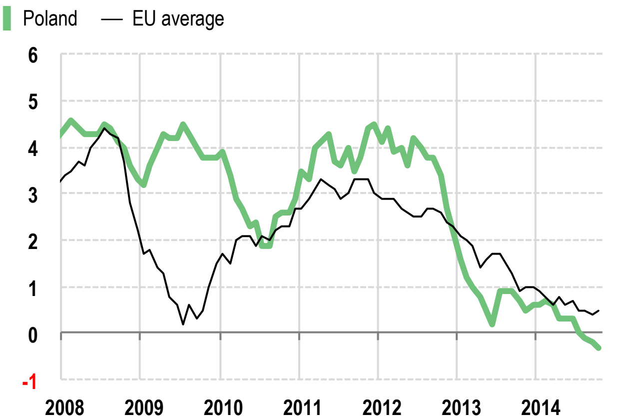
1- Inflation trends
Year-on-year change



Source: Eurostat

Forecasts

	2012	2013f	2014f	2015f
Real GDP growth (%)	1.7	3.3	3.0	3.5
Inflation (CPI, year average, %)	0.9	0.0	1.0	2.0
Gen. Gov. balance / GDP (%)	-4.3	4.2	-3.3	-2.6
Gen. Gov. debt / GDP (%)	57.1	50.5	51.0	50.6
Current account balance / GDP (%)	-1.4	-1.2	-1.1	-1.8
External debt / GDP (%)	74.4	73.0	71.6	66.9
Forex reserves (USD bn)	102	95	97	110
Forex reserves, in months of imports	7.0	6.2	5.8	5.8
Exchange rate EUR:PLN (year end)	4.15	4.25	4.00	4.10

f: BNP Paribas forecasts