POLAND

SOME CHALLENGES FOR THE FUTURE GOVERNMENT

The current government is running for a third term in the general elections on 15th October. Whatever the outcome, the future government will face three major economic challenges: a marked slowdown in growth, a deterioration in budget deficit and an increase in credit risk. However, this increase in risk is not a real cause for concern. There are safeguards against rising public debt. The country also has comfortable external liquidity and the banking sector is strong. The decline in inflation has facilitated the shift in gear in monetary policy, but this seems premature given strong pressure on wages.

A DOWNTURN IN ECONOMIC ACTIVITY IN 2023

Growth in Poland was very erratic from mid-2022 to mid-2023. The trend, however, was a sharp slowdown, followed by a recession at the beginning of 2023. Year-on-year, GDP slowed down from 6% in Q2 2022 to -1.5% in Q2 2023.

This year, economic activity is suffering from the downturn in domestic and external demand, with a negative carry over of -1.3% in Q2. Exports have been less dynamic in recent months and the situation will unlikely improve, given the slowdown in the German economy. Private investment will be affected by weak external demand and a likely postponement of investment projects amidst election uncertainties. Moreover tighter credit conditions alongside with higher credit costs are penalising both investment and household consumption.

However, consumer confidence has recently improved. This bodes well for a rebound in consumption in H2 2023, despite inflation remaining high. From 2024 onwards, we anticipate higher growth prospects as shocks dissipate. The expected recovery of the eurozone economy, the fall in inflation, the return of real wages to positive territory, the expected increase in the minimum wage in 2024 (+19% in 1 year) and the revaluation of child benefits (+60% in 2024) are amongst all the factors contributing to revitalising the economy. In addition, monetary easing should provide support to the credit market. And lastly, public investment will undoubtedly benefit from a possible release of European funds towards 2024/2025.

PREMATURE CHANGE OF DIRECTION IN MONETARY POLICY

Poland embarked on a cycle of monetary easing in September with a cut in the key rate by 75 basis points to 6.00%. Further rate cuts are to be expected in the coming months.

The central bank's action surprised the markets. It is being interpreted as a strong signal regarding the new direction of monetary policy. Meanwhile, the action taken by the monetary authorities is probably taking account of the real interest rate, which is close to shifting into positive territory. Nevertheless, the scale of the policy rate cut, at this stage, seems premature as inflation remains high (8.2% y/y in September), although it has fallen in recent months. On the one hand, the 12% reduction in electricity prices, effective since 19 September, backdated to 1st January 2023, should push disinflation further. On the other hand, the potential impact of *El Niño* and the significant rise in oil prices since June (close to USD 100 per barrel) will have the opposite effect. Furthermore, core inflation is not expected to fall rapidly due to strong pressure on wages. Wages in industry are still showing double-digit growth, although the increase is slightly lower (+10.4% y/y in July, +11.9% in June, +12.2% in May). The central bank does not expect inflation to return to the target range of 1.5%-3.5% before 2025.

FORECASTS

	2020	2021	2022	2023e	2024e
Real GDP growth, %	-2.0	6.9	5.5	0.0	3.0
Inflation, CPI, year average, %	3.4	5.2	14.4	11.8	6.3
Gen. Gov. balance / GDP, %	-6.9	-1.8	-3.7	-5.2	-4.7
Gen. Gov. debt / GDP, %	57.1	53.8	48.3	48.4	48.9
Current account balance / GDP, %	2.4	-1.3	-2.4	-0.1	-0.6
External debt / GDP, %	60.7	56.4	53.0	48.8	45.6
Forex reserves, EUR bn	125.6	146.6	156.5	169.0	174.0
Forex reserves, in months of imports	6.6	6.1	5.2	5.9	5.8

TABLE 1 e: ESTIMATES & FORECASTS
SOURCE: BNP PARIBAS ECONOMIC RESEARCH

POLAND: POLICY RATE, REAL INTEREST RATE AND INFLATION

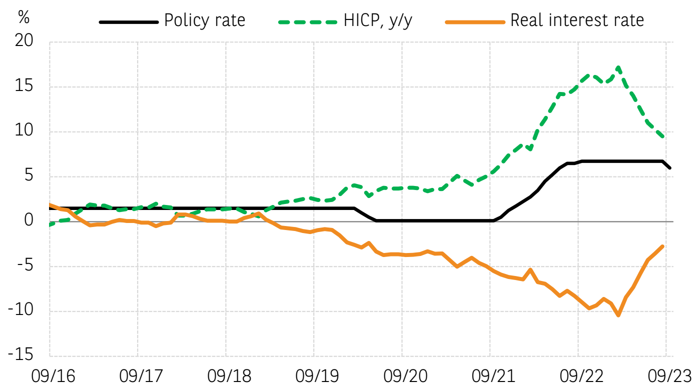

CHART 1 SOURCE: EUROSTAT, CENTRAL BANK OF POLAND, BNP PARIBAS

CREDIT RISK HAS INCREASED BUT REMAINS MANAGEABLE

Household accounts have deteriorated significantly since 2022 due to the impact of higher interest charges on their budgets. In Poland, loans are essentially contracted at a variable rate. Mortgage rates for a 5 year maturity or more rose from an average of 2.4% in 2021 to 5.2% in 2022, then to 6.8% in H1 2023.

Government measures to support households should provide some relief. In July 2022, the Polish government introduced a moratorium on mortgage loans in zlotys. Households were therefore able to suspend their repayments free of charge four times in 2022 and four times in 2023.

One of the election promises is to extend this measure in 2024. Also, first-time buyers under the age of 45 have benefited from a new programme since July. According to this scheme, a family can contract a loan at a fixed rate of 2% for 10 years for an amount of PLN 600,000 (i.e. approximately EUR 130,000). Monetary policy has also helped. The cycle of easing should be reflected in mortgage rates and reduce the burden of loan repayments.

Another area of caution relates to the case of mortgages denominated in Swiss Francs (CHF) which remain open, despite a lengthy debt reduction process. These mortgage loans accounted for 7.2% of the total in July 2023, compared to 51.2% in 2011. The latest development is the decision of the European Court of Justice in June 2023 on bank charges linked to this type of loan in CHF, which incurs an additional cost for banks (estimated at PLN 100 billion, i.e. EUR 21.6 billion, by the authorities).

The Polish banking system remains well capitalised with an equity ratio of 17.3% on average in Q1 2023. The Covid-19 crisis has had little impact on non performing loans, which has remained at 2.4% since 2021. The moratorium could potentially lead to an increase in this ratio once loans start maturing. However, credit risk remains moderate for now, given the many measures aimed at supporting households. Similarly, the increase in the cost of risk has probably already been provisioned by banks, which are well capitalised.

THE BUDGET DEFICIT IS WORSENING BUT DEBT IS SUSTAINABLE

The government is anticipating a budget deficit of almost 5% of GDP in 2023 and of 4.5% in 2024, well above the 3% target set by the Maastricht criteria. In fact, several factors will affect government accounts in the short term. Firstly, military spending will increase sharply in the next few years, due to the military's modernisation plan. This item of expenditure should probably reach 4% of GDP in 2023 and 2024, a record among EU countries, and should stand at around 2-3% in the following years. Secondly, the interest burden has increased with the rise in the rate of Government bonds since 2022. Interest payments compared to government's revenue amounted to 4.1% in H1 2023, after reaching 3.6% in 2022 and 2.8% in 2021. And lastly, measures linked to the energy shock, the increase in social welfare expenditure (+60% in 2024 for child benefit, revaluation of civil servants' wages, free healthcare expenditure for the elderly), as well as an expected drop in revenues caused by the slowdown in growth, will significantly affect the budget. Funding requirements will also increase in the next two years: more than 90% of the PLN 290 billion estimated in 2023 has already been funded. In 2024, these requirements are likely to reach PLN 400 billion, including around PLN 200 billion in maturing debt repayments. This means that the government is increasingly using external funding.

As a result, the ratio of public debt to GDP will inevitably increase in the medium term, although it will probably remain below 60%.

However, public finances are not a cause for concern. The debt profile is strong as most debt was contracted at a fixed rate and is mainly composed of an average maturity of 5 years. Similarly, fiscal discipline is reflected in the country's constitution, whereby public debt should not exceed 60% of GDP. In addition, Poland has to comply with the Stability and Growth Pact as part of its commitments towards the EU.

POLAND: GOVERNMENT INTEREST PAYMENT TO REVENUE

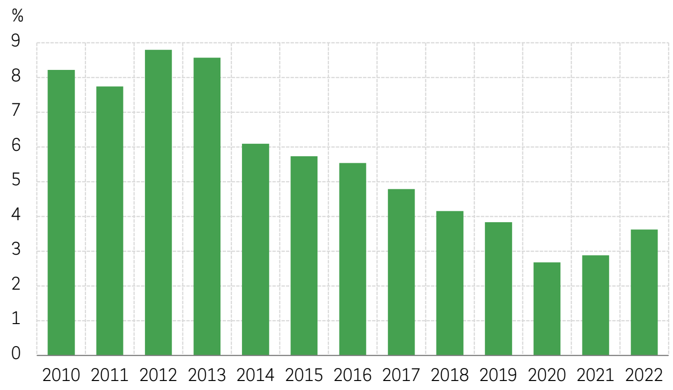

CHART 2 SOURCE: MINISTRY OF FINANCE, BNP PARIBAS

The escape clause from the budgetary framework, activated by the EU during the pandemic, will no longer be in force from 2024. Consolidation measures therefore need to be implemented quickly.

Government debt remains sustainable, according to IMF scenarios (central and stress). Measures to increase revenue or to contain certain expenditures will be necessary in the medium/long term, in order for government accounts to have necessary buffers in the event of a future shock.

THE CURRENT ACCOUNT BALANCE IS IMPROVING

The current account reverted to a large surplus, at EUR 6.9 billion cumulatively over the first seven months of the year, after a deficit of EUR 15.7 billion in 2022 (2.4% of GDP). Poland's current account balance is expected to improve significantly this year due to lower energy bills and an expected drop in domestic demand. But this will probably be temporary. The expected increase in military spending and major investment plans in the next few years will increase imports in the short term, and no doubt push the external accounts back into the red in 2024 and 2025.

As for the exchange rate, the trend was more towards appreciation over the first eight months of the year, owing to an improvement in the current account balance and a strong momentum of capital inflows. The change in monetary policy has led to a recent depreciation of the zloty (respectively, 5.6% and 3.4% against the dollar and the euro since early September). In the short term, the zloty is likely to come under downward pressure due to further monetary easing.

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