Poland

Trees don't grow to the sky

Economic growth rose to 5.1% in 2018, the highest level since the global financial crisis, with few signs of overheating. In 2019-2020, a less favourable cyclical environment in the eurozone and international trade tensions are bound to strain the Polish economy. Even so, domestic demand will remain relatively solid, bolstered by wage growth driven by labour market pressures as well as by the government's fiscal stimulus measures announced in February in the run up to European elections in May and legislative elections in October. Under these conditions, inflation is likely to accelerate and the twin deficits to widen, albeit without compromising the country's macroeconomic stability.

Past its peak

Poland's macroeconomic track record is impressive in 2018: GDP growth peaked at the highest level since 2007, the unemployment rate is historically low, inflation is tightly controlled, the fiscal and current account deficits are both small and the currency is stable.

Despite the economic slowdown in the eurozone (and in Germany in particular), which absorbs 58% of Polish exports, GDP growth held to a pace of 5% year-on-year (y/y) in the second half of 2018, after H1 growth of 5.2%. This uncoupling with the European economic cycle can be attributed to the strength of domestic demand (+5.5% in 2018, after +4.9% in 2017), while foreign trade continued to make a negative contribution to GDP due to the acceleration of imports (+7%), which outpaced exports (+6.2%).

Household consumption is a solid growth engine (+4.6% in 2018), although it slowed slightly in H2 (+4.4% y/y). Strong wage growth driven up by labour market pressures (see below) have bolstered household confidence, even though it too has dipped slightly in recent months. Lending to households has also accelerated continuously over the year (+7% y/y in 2018, after +2% in 2017).

Investment rebounded by 7.3% in 2018 thanks to a strong second half (+9.9% y/y in Q3 and +6.7% in Q4). According to the Central Statistical Office (GUS), corporate investment was buoyant in all sectors of activity, regardless of company size. Yet it slowed slightly towards the end of the year, notably for the subsidiaries of foreign firms in a more uncertain European environment. After a period of rapid growth, residential investment was not as vigorous in H2 2018. The sector was hit by supply-side constraints linked notably to labour shortages and higher wages in the construction sector. For the past two years, new home prices have shot up by an average of 15% in Poland's 10 biggest cities. Lastly, public investment continues to benefit fully from EU structural funds.

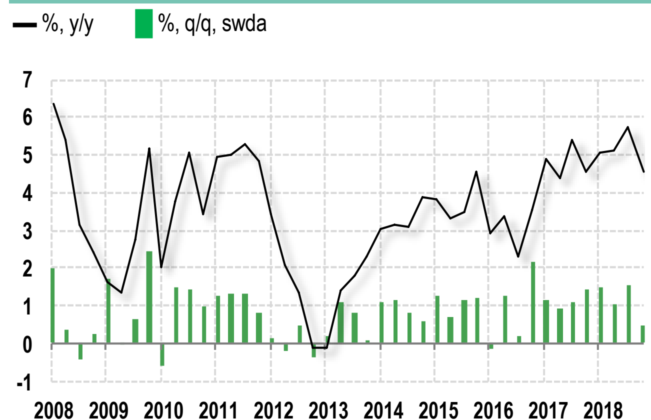
A corollary of the dynamic momentum of domestic demand, services increased strongly through Q3 2018, before dipping thereafter. Industrial output was driven by construction (+17% in 2018) and the manufacturing sector (+5.2% in 2018 and +6.1% y/y in the first two months of 2019). Yet manufacturing PMI has dropped below 50 since November. The production capacity utilisation rate (82%) has declined and exports have slowed, notably for intermediary goods, at a time when the automobile sector was disrupted by new anti-pollution standards. Another factor straining export competitiveness is the zloty, which many Polish companies now consider to be overvalued.

1- Forecasts

	2017	2018	2019e	2020e
Real GDP growth (%)	4.6	5.1	4.0	3.5
Inflation (CPI, year average, %)	2.0	1.7	1.9	2.4
Gen. Gov. balance / GDP (%)	-1.4	-0.9	-1.8	-2.4
Gen. Gov. debt / GDP (%)	50.6	48.7	47.3	46.7
Current account balance / GDP (%)	0.2	-0.7	-1.5	-2.5
External debt / GDP (%)	72.2	61.3	58.9	57.5
Forex reserves (EUR bn)	94.5	102.3	103.8	105.2
Forex reserves, in months of imports	4.8	4.8	4.5	4.3
Exchange rate EURPLN (year end)	4.2	4.3	4.3	4.3

e: BNP Paribas Group Economic Research estimates and forecasts

2- GDP growth



Source: GUS

Yet prospects are still promising

Deteriorating external conditions will strain Polish growth in 2019-2020. Yet buoyant domestic demand, bolstered by the fiscal stimulus measures announced on 23 February and a rather accommodating monetary policy, should help buffer a cyclical downturn. The deterioration of macroeconomic fundamentals is bound to be limited.

GDP growth is expected to slow to 4% this year and 3.5% in 2020, but should remain above the average for the other Central European countries (~3%). The fiscal stimulus, estimated at

between 1.5% and 2% of GDP over the next two years (PLN 40 bn a year), should bolster consumption via three key measures: 1) the Family 500+ programme, a family benefit of PLN 500 (around EUR 116) per child as of the second child, which will be expanded to include the first child, with no means testing, 2) a premium of PLN 1100 (around EUR 256) for pension holders, and 3) income tax cuts, including the exemption of taxes for the under-26 age group.

An expansionist fiscal policy will widen the general government deficit. Faced with concerns about public finance overruns, the government reiterated its commitment to maintaining the deficit below the threshold of 3% of GDP and thus may reign in public investment spending. Public debt is therefore expected to hold to a favourable trajectory in 2019-2020. With the approach of the European and legislative elections, the government seems to have arbitrated in favour of social welfare spending, which political benefits in the short term are stronger than those resulting from public investment spending. Yet the latter theoretically has a higher multiplier effect on economic growth than the former. As a result, the residual windfall of European structural funds in the last two years of the 2014-2020 programme (estimated at more than EUR 36 bn) might not be totally absorbed. All in all, total investment is expected to slow, even though corporate investment should remain buoyant.

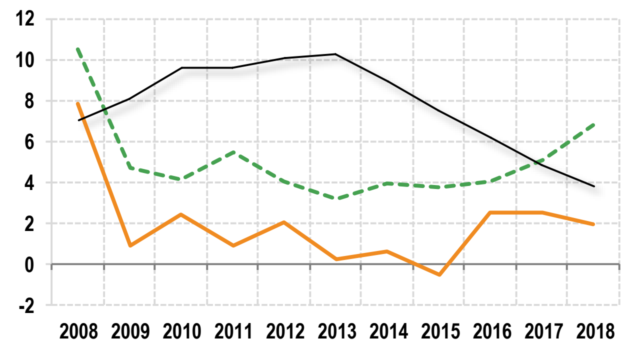
Limited external imbalances and inflationary pressures

Poland's external accounts are not a real source of concern, even though the current account surplus evaporated in H2 2018 and the deficit is expected to widen in 2019-2020. The trade deficit will remain moderate and the services balance will continue to show a major surplus. Moreover, assuming foreign direct investment in Poland generates fewer profits, the large deficit on the income balance would diminish slightly. Foreign reserves provide a comfortable safety mattress covering nearly 5 months of imports and all of the country's short-term debt. At a time of persistently accommodating monetary policies in Europe and the United States, Poland is expected to remain attractive for non-resident investors, and the exchange rate should remain relatively stable despite certain (geo)political risks.

Inflation is expected to accelerate gradually after holding below 2% in 2017-2018 due to the decline in NAWRU, the non-accelerating wage rate of unemployment (see below), and to the decline in commodity prices in late 2018. The output gap, the difference between the potential GDP growth rate (estimated at 3.5%) and the actual GDP growth rate, will remain positive in the quarters ahead, while wages should continue to rise significantly in both nominal and real terms. Headline and core inflation will converge on the target rate of 2.5% in 2020. The Central Bank (NBP) might begin to raise its key policy rate moderately, after holding it at 1.5% since March 2015. However, NBP governor Adam Glapinski stated in early April that he did not expect a change in key rates before the end of the current monetary policy committee's mandate in 2022.

3- Labour market

— Nominal wages (%, y/y) — Unit labour costs (%, y/y)
— Unemployment rate (% of labour force)



Source: Eurostat, European Commission

Demographics, labour supply, wages and productivity: squaring the circle

The jobless rate has declined from 9% in 2014 to 3.8% in 2018 (Eurostat data). Full employment has resulted in a shortage of labour that is restricting production capacity, notably in construction and industry. However, productivity gains and the inflow of foreign workers, notably Ukrainians (about 1 million since 2014 thanks to simplified procedures for obtaining work permits for six non-EU countries) has limited the increase in unit labour costs and reduced NAWRU. In real terms, wage growth accelerated from 2.5% a year between 2010 and 2016 to 5.5% in 2018. Over the same period, labour productivity gains followed similar trends, rising from 4.5% a year in 2010-2016 to 6.5% in 2018 (IMF, *Country Report 19/38, Selected Issues*, February 2019). Yet the 12-month delay in reporting non-resident workers in official employment statistics has tended to play down productivity gains in recent years.

With European competition to attract skilled workers likely to intensify in the years ahead (especially with Germany), innovation and automation are seen as solutions for the shortages of labour supply and the search for productivity gains. Yet to curb Poland's slow demographic decline over the past two decades, strong-willed family and emigrant policies (including incentives for Polish emigrants to return home) will be crucial for boosting the country's growth potential and macroeconomic prospects in the medium to long term.

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