POLAND

THE STRONG MAN OF CENTRAL EUROPE

Poland is well equipped to deal with the economic consequences of the conflict in Ukraine. Its economy had fully absorbed the shock from Covid-19 by the end of 2021. Output was 5% higher than in late 2019, the recovery was well balanced and the unemployment rate had returned to a frictional level. In addition, Poland's budget deficit fell sharply in 2021 and its public debt/GDP ratio remained well below the Maastricht limit due to a substantial gap between growth and interest rates. The current-account balance is in deficit again, but still comfortably covered by non-debt generating capital flows. The only cloud on the horizon is the acceleration in inflation which has prompted the central bank to tighten monetary policy more aggressively since autumn 2021. Growth will inevitably slow in 2022, but from a high level, and the risk is on the upside given the economy's resilience.

A FIRM, BALANCED RECOVERY

Before the shock caused by the conflict between Russia and Ukraine, Poland's economic recovery was proceeding at a good pace. Real GDP growth accelerated slightly in H2 2021 (2% per quarter) as opposed to 1.7% in H1. The recessionary shock caused by Covid-19 is now a thing of the past, since economic output in Q4 2021 was 5% higher than two years previously. In terms of its recovery, the Polish economy is leading the way in Central and Eastern Europe.

In 2021, growth was driven mainly by domestic demand, since the contribution from net exports of goods and services turned sharply negative. But that was not due to export performance: the 12% rise in exports was much larger than the 9% rise in imports from EU countries, which are Poland's main trading partners. Imports simply rose in line with domestic demand, with an apparent elasticity of 2.

The recovery has been well balanced, with similar growth rates for consumer spending and total investment (respectively 6% and 7%), but also for capital goods investment (excluding transport equipment) and construction investment (6% each). In addition, the increase in public-sector consumption has remained moderate at 2%. Another positive factor is that household borrowing has increased, but not excessively, rising 5.2% year-on-year in February 2022 as opposed to 6% in late 2019. Indeed, growth in consumer loans (up 2.1% year-on-year in February 2022) is particularly low given the 10% increase in wages at end-2021 and a labour market that is almost at full employment: the unemployment rate is only 3%, back to its late-2019 level, with no reduction in the labour force.

TWIN DEFICITS NO LONGER CAUSE FOR CONCERN

Strong growth allowed a marked decline in the central government budget deficit from 3.7% of GDP in 2020 to only 1% in 2021, with lower spending accounting for two thirds of the reduction. The general government deficit (central government, social security and local authorities) has increased by 3.5 points of GDP in the last two years, because some of the measures adopted under the extensive support plan (EUR 74.5 bn budgeted, equal to 14.5% of GDP) was financed off-budget, in particular via the PFR development fund. At the end of 2021, the central government debt-to-GDP ratio was almost back to its pre-crisis level (43.7% versus 42.4% in late 2019). According to OECD estimates, the general government debt, in Maastricht definition, increased by 11.4 points of GDP to 57% at the end of 2021. The difference lies in local authority debt (3.5% of GDP) and, since 2020, the PFR's debt issuance. However, the debt-to-GDP ratio remains under control because Poland's nominal growth rate far exceeds the yield on its sovereign bonds. This means that, assuming a balanced primary budget, the ratio will decrease by at least 2 points per year.

The current-account balance has fallen back into deficit due to faster real growth in imports and the surge in commodity prices. In H2 2021, the deficit amounted to 3.2% of GDP. However, it was still very comfortably covered by net FDI inflows (2.6% of GDP in H2 2021) and EU

FORECASTS

	2019	2020	2021e	2022e	2023e
Real GDP growth, %	4.7	-2.4	5.6	3.6	2.5
Inflation, CPI, year average, %	2.1	3.4	5.1	10.0	8.0
Gen. Gov. balance / GDP, %	-0.7	-7.1	-4.6	-2.5	-2.0
Gen. Gov. debt / GDP, %	45.6	57.4	57.0	53.4	50.3
Current account balance / GDP, %	0.5	3.4	-1.0	-1.7	-1.5
External debt / GDP, %	59.3	61.9	57.0	52.0	50.0
Forex reserves, EUR bn	114.5	125.6	146.9	148.0	150.0
Forex reserves, in months of imports	5.1	5.9	6.0	5.8	5.6

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

POLAND: WAGE BILL AND BANK LOANS TO HOUSEHOLDS

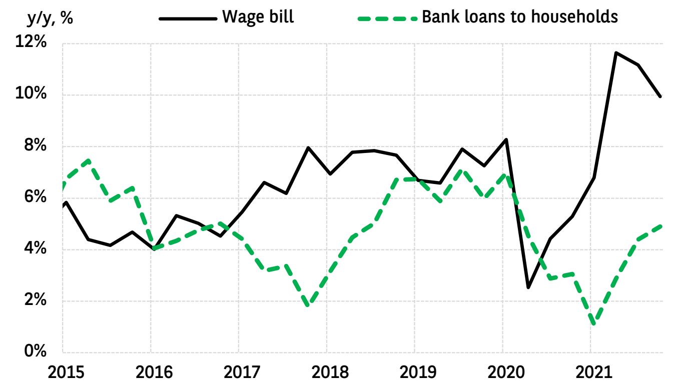

CHART 1 SOURCE: INS, BNR, BNP PARIBAS

funding (equivalent to 2.5% of GDP per year). Central bank reserves have strengthened with no increase in external debt. The latter even fell both absolute and relative terms (i.e., as a percentage of GDP or G&S exports).

Inflation is the only cloud on the horizon, rising by 6.5 points over the course of 2021, i.e., from 2.3% in December 2020 to 8.8% in December 2021. Energy and food prices accounted for 4.4 points of the increase, since official core inflation (slightly different from inflation excluding energy and food) rose by only 1.6 points. The smaller increase in core inflation is due to the fact that there is no strong evidence of a price-wage spiral, given i/ wages growing at a double-digit rate and ii/ very low unemployment. The central bank was also fairly slow to raise official interest rates, only starting in the fourth quarter of 2021 and raising them by a total of 165 bp over the year.

HIGHLY RESILIENT TO THE UKRAINIAN SHOCK

In late 2021, therefore, Poland's economy was looking good, with strong growth and limited imbalances. In January and February 2022, economic indicators – PMI, industrial production, exports and retail sales – remained well oriented. The only negatives were a fall in consumer confidence caused by rising Covid-19 case numbers, rising inflation and the central bank's much more aggressive monetary tightening, with a further 275 bp of rate hikes since the end of 2021 taking the official interest rate to 4.5%.

The outbreak of the conflict in Ukraine, along with Russia's threats to the whole international community if its invasion is hampered, has affected confidence among businesses and consumers. The zloty has fallen 3% against the euro since mid-February. So far, however, the bond market has held out well given i) the extent of monetary tightening (since mid-February, bond yields have increased by 1.1 times the increase in official interest rates, as opposed to a ratio of 2 or more for comparable emerging-market countries that have delayed monetary tightening for as long as possible) and ii) the fact that Poland, like most countries in the former Soviet bloc, is regarded as vulnerable to this new external shock.

Industrial output is likely to suffer a supply-side shock, if not because of supply -chain problems or shortages, then at least due to higher prices of intermediate goods. Like other Central European countries, Poland imports oil, gas, agricultural products and fertilisers from Russia and Ukraine. In late March, the Polish government urged its European partners to impose an embargo on imports of Russian oil, gas and even coal: Russia supplies 75% of Poland's coal, which is a major source of energy for the Polish economy, covering 20% of its needs. So far, the EU has only adopted an embargo on coal.

Households will suffer a further rise in inflation, because food and energy make up 40% of the consumer basket. However, households' real income has risen very substantially in recent years, including in 2020 and 2021. Between 2015 and 2021, real wage growth averaged 4% per year. In addition, households have since January benefited from redistributive fiscal measures: the personal income tax threshold has been raised and exemptions have been introduced for retired people and large families, along with the reduction in VAT on energy and food products until July. Inflation has also stabilised at 9% since January.

The consensus is that the war in Ukraine will reduce Polish growth by 1-1.5 points in 2022. This is probably on the pessimistic side, because fiscal support for households should offset the decline in real incomes, and households can dip into their savings. In addition, funding to support refugees – of whom there have been 4 million since the start of the conflict according to the UNHCR – is expected to total between EUR 2.2 bn (official estimate) and EUR 5.2 bn (Bank Pekao estimate), i.e., between 0.4% and 1% of GDP. As a result, consumer spending may not slow at all.

The defence budget has been increased, although the impact of higher public-sector demand on output will be felt more in 2023 than in 2022.

The main drag on growth is likely to come from exports, and indirectly from investment. Sales to Russia and Ukraine account for 3.4% of Poland's total exports. However, the Polish economy is less dependent on foreign trade than those of its neighbours: its openness rate – i.e., exports plus imports, divided by two, as a proportion of GDP – was 52% in 2019 as opposed to 80% for the Czech Republic and 95% for Hungary and Slovakia. An export shock could have a significant potential but under extremely pessimistic assumptions. If exports to the warring countries fell to zero, it would also require growth in exports to the eurozone and the rest of the world (excluding Russia and Ukraine) to fall by a third to produce a negative multiplier effect equal to 2 percentage points of GDP. In addition, that impact could be mitigated by market share gains. Since 2015, Poland's export performance has been much better than that of its close competitors (including Turkey), both in the European market and in other geographical zones. One of the reasons for this is the relatively moderate increase in unit labour costs as a result of firm productivity growth (4% per year on average between 2015 and 2020).

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