POLAND

RUNNING TEMPORARILY OUT OF STEAM

The Polish economy has to smooth the impact of the Covid-19 pandemic, which hit not only through the decline in foreign demand but also through the lockdown's impact on domestic consumption. Yet the country has enough policy leeway to do so, thanks notably to a reasonable level of public debt before the slowdown began. GDP is unlikely to return to pre-crisis levels before mid-2021, which is bound to curb investment. Thereafter, Poland is expected to return to its robust growth trajectory since its strengths remain intact (competitiveness, labour supply, low wage costs and productivity gains), which have transformed the country into the European Union's 5th biggest industrial sector.

SHARP RECESSION IN Q2

Poland is one of the EU member countries whose GDP contracted the least in Q1, a sign of the vitality of Polish growth, which has not faltered for nearly the past 15 years. Poland accounted for 4.5% of Europe's manufacturing industry in 2019, up from 2.2% in 2004. Yet Poland will not avoid its first full-year contraction in GDP since 1991, with a 3% decline in 2020.

The country managed to keep a lower level of Covid-19 cases, with only 900 cases per 1 million inhabitants. Yet this was achieved through a lockdown that began in mid-March and was tightened in the weeks that followed. Beginning in early May, most of these restrictions were gradually lifted.

Manufacturing output in Poland contracted by 27% year on year (y/y) in April 2020, which is close to the EU average, but not as bad as in the other Central European countries, where openness to foreign trade is higher. In May, the easing of lockdown restrictions has helped output to recover, but still 17% below pre-crisis level. A further recovery is expected in June, but again not to full capacity.

Poland was hit by a double shock in Q2: the 30% decline in Polish exports in April (y/y) was coupled with a contraction in domestic demand. However, the latter recovered quite quickly, since after a -10% decline in April (y/y), it was back to the pre-crisis level in May. Although the decline in demand was significant, it was not as severe as in the rest of Central Europe.

The Polish economy began to show signs of recovering in Q3, with expectations in the surveys of a rebound in industrial output and a slight upturn in household confidence as fears of inflation gradually ease. Yet the crisis is expected to have a more lasting impact on investment prospects.

The severe economic shock has not called into question the convergence of Poland's standard of living with the European average: It reached 76% of the EU average at year-end 2019, up from 61% ten years earlier.

Other virtuous circles are also expected to facilitate the recovery from recession. The current account surplus is expected to rise to 2.2% of GDP (from 0.5% in 2019) due to the decline in oil prices, which fell to an average of USD 38 a barrel in 2020 year-to-date from USD 64 in 2019. The resulting decline in inflation is expected to persist, with an average inflation rate below 2% in Q4 2020, after peaking at 4.6% in Q1. This should bolster household purchasing power.

Poland's relative stability and a rather advantageous yield spread (compared to the Eurozone) should continue to attract capital inflows. This should nurture a moderate appreciation of the Polish zloty to PLN 3.35 per EUR, despite current monetary easing measures.

FORECASTS

	2018	2019	2020e	2021e
Real GDP growth (%)	5.2	4.1	-3.0	3.5
Inflation (CPI, year average, %)	1.8	2.2	3.0	2.6
Gen. Gov. balance / GDP (%)	-0.2	-0.7	-7.0	-5.0
Gen. Gov. debt / GDP (%)	48.8	46.4	56.0	57.5
Current account balance / GDP (%)	-1.0	0.5	2.2	1.5

TABLE 1

e: ESTIMATES AND FORECAST
SOURCE: BNP PARIBAS GROUP ECONOMIC RESEARCH

MANUFACTURING PRODUCTION AND PRODUCTION EXPECTATIONS

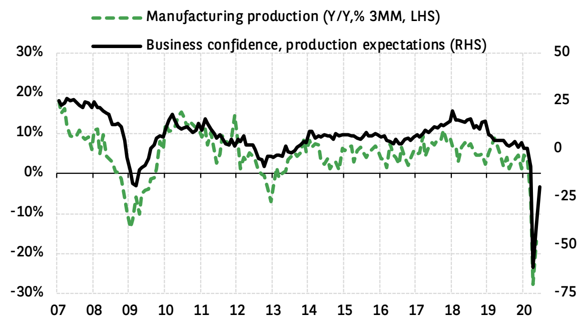

CHART 1

SOURCE: CEIC, DG ECFIN

STRONG SUPPORT FROM THE POLICY MIX

Poland had the advantage of entering the Covid-19 crisis with some leeway in terms of both fiscal and monetary policies. Public debt has fallen constantly since 2016, to 46% of GDP in 2019.

The government rapidly launched fiscal measures for about 4.5% of GDP, mainly through direct subsidies, tax holidays for companies and wage subsidies. Government-backed loans were also granted for a total of nearly 3 points of GDP through the BGK (public bank), with a capped amount of 4.5% of GDP. Lastly, Polish development funds will finance this support for up to 4.5% of GDP through bond issuance with a public guarantee.

Public finances will likely have to support the economy for longer, since activity is not expected to be back to full capacity before mid-2021. As a result, the fiscal deficit should remain significant at 5% of GDP in 2021, after 7% in 2020.

Public debt is expected to rise sharply, by 11 percentage points by year-end 2021. Yet monetary stimulus measures have helped erase fears about the market's capacity to absorb new debt issuances. The Central Bank launched a securities purchasing programme and purchased nearly PLN 100 bn in securities between mid-March and the end of May (15% of the Central Bank's total assets).

This covers a little over half of government bond issues. Ongoing securities purchases, which are not limited in size, have sharply reduced the government's residual needs. At the same time, the Central Bank lowered its key policy rates, which are now near the zero lower bound (0.1%).

As a result, fiscal stimulus measures implemented to cope with the Covid-19 crisis did not prevent 10-year government bond yields from declining to 1.35% at the end of June, from more than 2% at the end of February. The prospects of 'lower for longer inflation' is an anchor for low long-term rates in the medium-run.

At the same time, several measures involved the banks, including the conditional 3-month deferral of loan payments for households and companies requesting relief. Prior to the outbreak of Covid-19, the banks were relatively flush with capital, with a CET1 ratio of 16.3% at Q3 2019. It allowed a number of bank regulations to be repealed (including the 3-point systemic risk buffer) and the range of eligible collateral was expanded.

THE GROWTH POTENTIAL REMAINS SOLID

Looking beyond the underutilisation of production capacity, which is expected to extend through mid-2021, Poland has numerous strengths that will help it get back on the growth path. The job market is structurally vibrant, with strong productivity gains and job creations. It helped to fix a structural unemployment problem, since the unemployment rate went below 10% only in 2015, for the first time since 2008.

The competitive advantage of the manufacturing sector (25% of the economy) has increased during the last years, fuelled by productivity gains larger than European average (30% compared to 9%) between 2019 and a stable real effective exchange rate over the same period.

There has also been an upmarket shift in production. Poland has risen in export complexity rankings (the greater the complexity, the fewer the foreign competitors), and now trails right behind Slovakia, which had a considerable advance just a few years ago. In the automotive sector, nearly 60% of the value of exports are created in Poland, which is the highest proportion among the Visegrad group (which also comprises Hungary, Slovakia and the Czech Republic).

Looking beyond these factors, at some point Poland's ongoing industrial development could be hampered by a labour shortage. Yet agriculture still accounts for a relatively high share of employment. With expected productivity gains, it is estimated that just over a million jobs could be freed up once farm employment reaches the same proportions seen in the other countries that have already completed this transition.

The energy transition is another milestone that Poland will have to make to maintain its industrial future. The country must face two challenges: the weight of industry (especially the metal industries) and the weight of coal in energy consumption (70%). Unlike the other Central European countries, Polish consumers represent the major part of industrial outlets.

CENTRAL BANK DOMESTIC ASSETS (PLN BN)

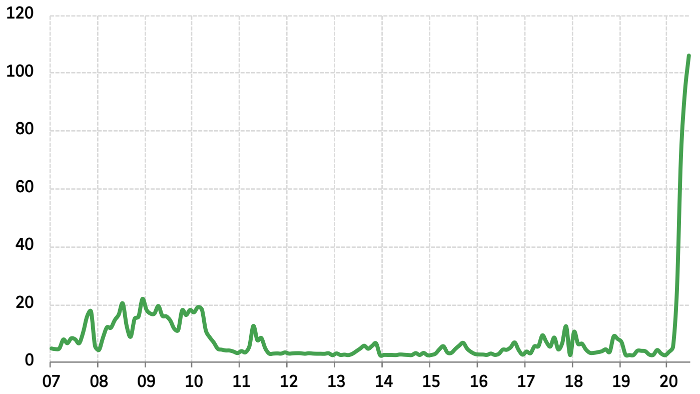

CHART 2

SOURCE: NBP, BNP PARIBAS

The transformation of Poland's industrial sector will have to be mirrored by a change in consumer behaviour. The electromobility and alternative fuel law passed in 2018 helped trigger a catch-up movement, and local carmakers are beginning to produce electric vehicles. A plan to promote renewal energy sources is targeting a 65% increase in production capacity by 2024.

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