Republic of Poland—Concluding Statement of the 2013 Article IV Mission
May 16, 2013

Despite its resilience in recent years and very strong fundamentals, the Polish economy has slowed markedly. Near-term macroeconomic policies should therefore be geared toward supporting the economy, within fiscal constraints. The consolidation measures contained in the 2013 budget remain appropriate and, despite limited fiscal space, automatic stabilizers should be allowed to operate. With inflation in check, monetary policy easing should continue without delay. The financial system appears to be resilient, but it is important to further strengthen credit risk management and financial oversight. Over the medium-term, key priorities include additional fiscal consolidation to reduce the public debt ratio and structural reforms to boost potential growth.

Economic outlook

After weathering the global financial crisis well and staging an impressive recovery in 2010-11, the Polish economy slowed markedly in 2012. The slowdown appears to be cyclical, as weakness in euro area growth spread to Poland's main trading partners, with knock-on effects on Polish consumer and business confidence. As a result, external demand was subdued and private investment and consumption weakened. This, alongside a sharp decline in public investment, pushed growth below 2 percent in 2012. The labor market worsened and credit growth decelerated.

Growth in Poland is expected to moderate further in 2013, as ongoing recession in the euro area weighs on exports and confidence. Nonetheless, a recovery should occur later this year, but this depends on the projected growth improvement in Europe, inventory restocking, and the positive impact of monetary easing on private demand. Overall, growth is expected to slow to 1.2 percent in 2013, rising to 2.2 percent in 2014. A protracted economic slowdown in Europe presents the main risk—this would hamper Poland's medium-term recovery through sustained trade, financial, and confidence effects, possibly lowering potential growth. Other risks relate to shifts in global risk appetite or renewed financial stress in the euro area which could lead to capital outflows, particularly from the government bond market or the banking sector. The Flexible Credit Line arrangement with the IMF, alongside broadly adequate international reserves, provide important insurance against risks.

Fiscal policy

Poland's impressive fiscal consolidation continued in 2012, but the economic slowdown poses challenges going forward. The consolidation has resulted in a decline in the deficit from 7.9 percent of GDP in 2010 to 3.9 percent of GDP in 2012, and the first fall in the public debt ratio since 2007. Nonetheless, fiscal space remains very limited given the

proximity of public debt (national definition) to the 55 percent of GDP legal threshold and the need to further reduce the fiscal deficit over time.

Despite limited fiscal space, there is scope for fiscal policy to balance structural consolidation with support for the economy in 2013. This implies that Poland should maintain the measures contained in the 2013 budget, while allowing automatic stabilizers to operate. Under these assumptions, we expect the general government deficit to reach 4 percent of GDP in 2013, largely as a result of the impact of the growth slowdown on fiscal revenues. The strong credibility of fiscal policy has contributed to favorable financing conditions, and the authorities should continue to pre-fund public sector financing needs.

As the economy recovers, additional fiscal consolidation will be needed to put the public debt ratio firmly on a downward path and rebuild fiscal buffers. Based on measures that have already been identified (including maintaining the current VAT rate through 2016 and limiting discretionary expenditure growth to the CPI growth rate), we expect the deficit to decline to 3.3 percent of GDP in 2014 and to fall gradually in the medium term. Additional measures of about 1 percent of GDP will be needed over 2014-16 to meet the authorities' medium-term objective (MTO) of a 1 percent of GDP structural deficit, which in turn is essential to reduce the debt ratio. These measures should be identified in advance and could include conducting a broad expenditure review to identify areas where non-priority spending can be reduced. Further cuts in public investment should be avoided.

Bolstering the fiscal and pension frameworks remains important. Finalizing the design of a permanent expenditure rule that is simple and transparent, with sufficient counter-cyclical properties and a clear link to the MTO, would help anchor public finances in the medium term. The ongoing review of the pension system is welcome, and the impact of any prospective changes should be carefully considered in terms of the long-term impact on public finances and the ability of the pension system to provide sufficient income to future retirees. Efforts to align the disability formula with the general pension system and continued reforms of the special occupational pensions are also needed.

Monetary policy

We welcome the cuts in policy interest rates since November, and urge the Monetary Policy Council to continue monetary easing without delay. With economic activity below potential, we expect inflation to remain below the target over the policy horizon. At the same time, real policy interest rates in Poland remain high, both historically and when compared with peers, and policy rates adjusted for country risk premia are among the highest in the region (suggesting that further easing would not lead to destabilizing capital outflows). The relatively quick transmission of policy rate cuts to bank lending rates implies that further easing would have immediate effects through lower household and corporate debt servicing costs. Over time, as uncertainty dissipates, easier monetary conditions should help boost

credit to the economy. Under these circumstances, and with limited fiscal space , monetary policy remains the main tool through which macroeconomic policies can support the economy.

Financial sector policies

Poland's financial system appears to be resilient. Risks have been managed well and vulnerabilities contained through effective supervisory measures, including on foreign exchange exposure, capital adequacy, and bank funding. Stress tests conducted as part of the recent IMF-World Bank FSAP update mission confirm the sector's resilience: bank capital and liquidity buffers can withstand large shocks and contagion risks are limited.

Improvements in bank supervision should continue. The frequency of targeted inspections has increased and onsite/offsite coordination has been enhanced. Nonetheless, there is a need to broaden the areas where the Financial Supervision Authority (KNF) can issue binding prudential regulations and to increase the KNF's supervisory resources and budgetary autonomy and flexibility, especially in light of its expanding perimeter and new regulatory and supervisory initiatives at both the global and European levels.

Safeguarding asset quality will be essential. Banks have been addressing the existing stock of impaired assets, but accounting constraints, tax disincentives (deductibility of loan losses and debt relief), and legal obstacles (insolvency regime) will need to be tackled to speed up progress. Looking ahead, the KNF should intensify its oversight over bank credit risk management practices, especially as the slowing economy will add to impaired loans. In this context, the KNF's ongoing thematic review of impaired loans is timely and should help identify other areas where improvements are needed.

The new macroprudential and bank resolution frameworks should be put in place as soon as possible. The authorities should advance legislation to create a Systemic Risk Board and establish a formal and explicit macroprudential framework that will aim to identify, monitor, and contain systemic risks to the financial system. They should take this opportunity to delineate the mandates of the various institutions involved in financial oversight, secure sufficient autonomy and accountability for each, and define coordination arrangements. The envisaged overhaul of the bank resolution framework will provide critical tools for orderly bank resolution, and could be supported by explicit depositor preference.

Boosting potential growth

We welcome the recent steps to improve the business climate and labor market. A comprehensive effort is underway to ease access to a number of regulated professions, which has a welcome focus on removing entry barriers for the youth, the group most affected by unemployment. Given the growing number of bankruptcies, ongoing efforts to modify the

insolvency regime—notably by setting up a framework conducive to restructuring of firms instead of the current bias towards liquidation—are also important.

The new SME lending program and investment support scheme should help boost investment, but safeguards are needed. The former should provide SMEs with needed bank financing, in part to support investment. The latter—which will be operated by a special-purpose company (Polish Development Investments, PIR)—is still in its initial phase. It is crucial that PIR's corporate governance and operations are transparent and accountable, in line with best international practice, and that only commercially viable projects are selected. Ultimately, PIR could play an important role in mobilizing private funds for infrastructure projects.

The mission is grateful for the warm welcome and excellent cooperation from the authorities and all other groups that it met during this visit.