Republic of Poland—Concluding Statement of the 2014 Article IV Mission

May 15, 2014

The economy is steadily recovering from a substantial slowdown in 2012-13, helped by supportive economic policies and improving conditions in main trading partners. Going forward, growth is expected to continue to gradually strengthen, though external risks remain on the downside. Macroeconomic policies should focus on continued fiscal consolidation, while maintaining supportive monetary policy. The financial sector has been resilient, but more needs to be done to address obstacles to nonperforming loan (NPL) resolution, establish a macroprudential framework, and revamp the bank resolution framework. Over the medium term, boosting potential growth will require pressing ahead with reforms of the labor market and the business environment.

Economic outlook

After a growth deceleration in 2012-13, an economic rebound is underway. The economy grew by 1.6 percent in 2013 as the slowdown in core euro area countries had knock-on effects on consumer and investor confidence in Poland. A steady recovery is now under way with growth expected to reach 3.1 percent in 2014, rising to 3.4 percent in 2015, on the back of strengthening domestic demand and falling unemployment. Inflation remains very low, partly reflecting external factors, and is projected to average only around 1 percent this year. Looking forward, it is expected to rise toward the 2.5 percent target as the output gap closes, but there are downside risks to this projection.

External risks are firmly on the downside. Poland's strong trade and financial linkages with core euro area countries and significant energy imports from Russia make it vulnerable to growth shocks or a sharp increase in geopolitical tensions surrounding Russia/Ukraine, which could hamper the recovery. Although the US exit from unconventional monetary policy has so far had only limited impact on Polish financial markets, a further tightening of global financial conditions could result in bouts of financial market volatility or capital outflows. Poland's Flexible Credit Line (FCL) arrangement with the IMF, along with its strong fundamentals and sound policy frameworks, helps mitigate these risks.

Fiscal policy

The structural fiscal consolidation planned this year is appropriate at this stage of the economic cycle. The fiscal deficit widened by 0.4 percentage point to 4.3 percent of GDP in 2013, as the economic slowdown took a toll on tax collections and the authorities allowed automatic stabilizers to operate. However, in 2014, the deficit is projected to drop to 3.3 percent of GDP on account of modest consolidation measures, the effects of pension changes, and a cyclical recovery in tax revenue. Reflecting the authorities' sound public debt management strategy, financing is comfortable with over three-quarters of government financing needs for 2014 already covered.

The recent changes to the pension system will improve the fiscal aggregates, but legacy flaws and risks of increasing old-age poverty still need to be addressed. The changes to the pension system—which entail a downsizing of the second pillar—are estimated to deliver an improvement in the fiscal accounts of around 30 percent of GDP in net present value terms during 2014–60, matched by an increase in gross implicit pension liabilities. However, liquidity in the government bond and equity markets could be adversely affected by the reduced presence of the pension funds. Moreover, legacy flaws in the pension system—notably relating to the indexation of the notional pension accounts and imbalances in special occupational pension schemes—continue to present long-term fiscal risks. The key challenges therefore relate to addressing these flaws and tackling risks of increasing old-age poverty:

- While Poland's (public) first pillar is a notional defined contribution scheme that is financially sustainable, its actuarial soundness could be eroded by adverse economic shocks. Better aligning the indexation mechanism of the notional pension accounts with wage and growth outcomes would help protect the financial sustainability of the first pillar.

- Closer alignment of the disability pension formula with regular old-age benefits and addressing imbalances in the special occupational pension schemes (which contribute to the deficit in the social security system) would ameliorate fiscal risks.

- The projected sharp drop in replacement rates will need to be addressed, as it raises risks of old-age poverty in the future. The planned extension of pension coverage to workers on temporary contracts is an important first step. Other alternatives to help ensure socially sustainable pensions going forward should also be considered, including policies to help boost voluntary private savings. In this regard, recently introduced tax incentives for the third pillar are a step in the right direction.

Over the medium term, despite the improvement in the fiscal accounts associated with the pension changes, further fiscal consolidation will be necessary. After an initial drop in 2014, the public debt ratio is projected to decline further to around 43 percent of GDP by 2019, helped by the pension changes. However, additional consolidation measures of about ½ percent of GDP per year during 2015–16 would be needed to reach the authorities' medium-term objective (MTO) of a 1 percent of GDP structural fiscal deficit by 2016 and put public debt on a stronger downward path. Strict enforcement of the new permanent fiscal rule should help ensure that fiscal policy remains prudent. In this regard, the recent lowering of the public debt thresholds contained in the fiscal rule is welcome.

Monetary policy

Monetary policy has appropriately supported the economy, but rate cuts would be needed if the recovery falters or inflation fails to pick up. Monetary policy is at a challenging juncture. Inflation is very low, but this partly reflects external factors. At the same time, the domestic demand-led recovery is continuing, monetary conditions appear supportive, and credit growth is rising. The Monetary Policy Council has kept rates on hold since July 2013, but should stand ready to reduce rates if the recovery falters or projections indicate that inflation would remain well below target for a protracted period, taking into account monetary policy transmission lags. Although international reserves remain broadly adequate, moderate reserve accumulation would be prudent in light of downside external risks.

Financial sector policies

Poland's financial system has remained resilient. The banking system is well-capitalized, liquid, and profitable. Effective supervisory measures have halted foreign currency mortgage lending, on-balance sheet open foreign currency positions have narrowed, and reliance on parent funding has declined. Nonetheless, the share of foreign currency mortgages, although falling, remains high at around 50 percent of housing loans. The NPL ratio, while starting to edge down, has remained sticky at around 8½ percent.

Supervisory measures to further bolster financial sector resilience should continue. To prevent NPLs from potentially constraining credit expansion, and ultimately economic growth, tax disincentives and legal obstacles to NPL resolution should be addressed. Work to restructure the weak, but small, credit union segment is welcome and should continue.

Meanwhile, the easing of regulatory guidelines on consumer loans will require continued careful oversight of lending practices, not least considering the high level of NPLs in this segment. Looking ahead, the development of additional sources for long-term funding would also help banks prepare for Basel III liquidity requirements concerning the net stable funding ratio.

The macroprudential and bank resolution frameworks should be implemented expeditiously. Establishment of a Systemic Risk Board is essential for macroprudential supervision. Legislation should therefore be finalized, creating an independent body with responsibility for systemic risk identification and analysis and with powers to issue directives and recommendations regarding the use of tools. Concerted efforts are needed to overcome the protracted delays on legislation to overhaul the bank resolution framework.

Boosting potential growth

Recent reforms to improve the functioning of the labor market and the business climate are welcome. The authorities adopted a law to improve the efficiency of public employment services, with a view to better targeting these services at particular groups, such as youth unemployed. They have also continued liberalizing access to regulated professions, which has helped improve the business environment.

Additional reforms, notably in the labor market, are nonetheless needed. Labor market segmentation is exceedingly high in Poland, largely because of differences in the tax treatment of contracts under the civil code vs. the labor code. Work continues to reduce segmentation by increasing the coverage of social contributions and capping the duration of temporary work contracts. Further efforts in this area are warranted.

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