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Republic of Poland–Staff Report for the 2011 Article IV Consultation

The following documents have been released and are included in this package.

- The staff report, prepared by a staff team of the IMF, following discussions that ended on May 12, 2011, with the officials of Poland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 14, 2011. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A public Information Notice (PIN).
- A statement by the Executive Director for the Republic of Poland.

The document listed below will be separately released.

Republic of Poland–Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF POLAND

Staff Report for the 2011 Article IV Consultation

Prepared by the Staff Representatives for the 2011 Consultation with the Republic of Poland

Approved by Anne-Marie Gulde and Aasim Husain

June 14, 2011

Overview: Poland returned to solid growth in 2010, building on timely and forceful countercyclical policy responses to the global crisis. These responses were permitted by limited macroeconomic imbalances prior to the crisis and access to the Flexible Credit Line (FCL) arrangement with the IMF. With the economy gaining momentum, it is time to normalize macroeconomic policies, further strengthen banking system resilience, and deepen structural reforms.

Key policy recommendations:

- The current substantial fiscal consolidation is welcome. Additional measures will be needed to put government debt firmly on a downward path over the medium term. With capacity constraints tightening, this additional adjustment should begin sooner rather than later, with significant front-loading.
- Revisions to balance of payments data are expected to raise the reported current account deficit, which would indicate that net national saving is lower than previously thought and thus strengthen the case for additional fiscal saving.
- Recent increases in the policy interest rate have been appropriate. Some further gradual increases will be necessary to bring inflation back to target.
- Indicators of banking system soundness are generally sound, though some challenges remain. Financial sector surveillance policies have been effective, but efforts to further strengthen financial sector resilience need to continue.
- Further raising labor participation would boost potential growth.

The authorities broadly shared staff's assessment of the economic situation and the key policy recommendations. They considered that existing plans for fiscal consolidation are sufficiently ambitious for now.

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I. CONTEXT

1. **A solid recovery is underway, driven by domestic demand**. As capacity constraints tighten, inflationary pressures and the current account deficit are expected to rise. The fiscal deficit in 2010 was large and the government debt-to-GDP ratio rose. Indicators of banking system soundness are generally stable, though some challenges remain. The FCL arrangement continues to play an important role in providing insurance against tail risks.

2. **Against this background, the mission focused on the following key policy issues:**[1]

- How would an upward revision to the current account deficit affect external vulnerability?
- How quickly should fiscal policy tighten, given the need to ensure counter-cyclicality and fiscal sustainability?
- What considerations should determine the pace of monetary policy tightening?
- What can be done to further strengthen financial sector policies?
- How should policies respond if capital inflows were to increase sharply?
- How can structural reforms boost potential growth?

3. **Parliamentary elections are expected in October 2011.** The center-right Civic Platform (PO) has governed in a coalition with the agrarian Polish People's Party (PSL) since 2007. Poland will take up the rotating presidency of the EU Council in July 2011.

II. RECENT ECONOMIC DEVELOPMENTS

4. **The economic recovery gained momentum in 2010** (Figure 1 and Table 1). Real GDP growth picked up to 3.8 percent, driven primarily by private consumption—in turn helped by a rebound in employment and wage growth during the second half of the year—and strong inventory accumulation. Fixed investment contracted, as robust EU-financed public investment was more than offset by weak private investment, as firms remained cautious about the outlook. Strengthening domestic demand reduced the contribution to growth from net exports. High-frequency indicators point to continued momentum in the early months of 2011, with strong retail sales and industrial production.

5. **Labor market conditions have strengthened** (Figure 2). Private-sector employment growth increased, largely driven by the service sector. The labor force participation rate also rose, reflecting both improved employment prospects and tighter eligibility requirements for early retirement. The LFS-based unemployment rate declined to 9.3 percent at end-2010.

[1] A mission comprising Mr. Morsink (head), Mr. Epstein, Ms. Lu (all EUR), Mr. Llaudes (SPR), Ms. Nedelescu (MCM), and Mr. Van Wersch (STA) visited Warsaw during May 4–12, 2011. Messrs. Allen and Sierhej (Warsaw Regional Office) supported the work of the mission. Ms. Zajdel-Kurowska (Alternate Executive Director) joined the discussions. Poland is an Article VIII country (Informational Annex, Appendix I). Data provision is adequate for surveillance (Informational Annex, Appendix II).

6. **Inflation rose, mostly reflecting higher commodity prices, a VAT hike, but also some increase in core inflation** (Figure 3). CPI inflation increased to 4.5 percent in April 2011, mostly driven by food and energy prices as well as the one-off effects of the recent hike in VAT rates. At the same time, rising capacity utilization, a closing output gap, and increasing private sector nonfarm wage growth put some upward pressure on core inflation.

7. **The current account deficit widened in 2010, reflecting stronger domestic demand** (Figure 4, Table 2). The current account deficit increased to 3.4 percent of GDP, as a rebound in export growth due to improving conditions in Poland's main trading partners was more than offset by an acceleration of imports. The current account deficit was almost fully financed by capital transfers from the EU and net FDI inflows. The decline in FDI reflected a specific foreign disinvestment in the insurance sector. Financial market turbulence in Europe in May and November 2010 temporarily increased Poland's CDS and government bond spreads (Figure 5). The real exchange rate is broadly in line with fundamentals (Box 1).

8. **The banking sector remained profitable and well capitalized in 2010, but credit quality deteriorated** (Figure 6, Table 5). Improving net interest margins boosted profitability and the average capital adequacy ratio rose to around 14 percent, with Tier 1 capital representing 90 percent of total capital. The nonperforming loan ratio increased to about 9 percent, but now appears to have stabilized. Stress tests by the central bank, reported in the December 2010 *Financial Stability Report*, show that most banks are resilient to adverse shocks. Preliminary analysis by the authorities indicates that banks generally meet the new Basel III requirements. Private sector credit grew by about 9 percent, with mortgage lending remaining strong, consumer lending falling, and corporate lending picking up (Figures 7 and 8).

III. OUTLOOK AND RISKS

9. **Real GDP growth is expected to remain at about 3¾–4 percent in 2011–12, underpinned by domestic demand** (text table, Table 4). Private consumption is projected to continue to grow steadily, supported by stronger labor market conditions that more than offset headwinds from the VAT rate hike and higher energy prices. EU-funded public investment is set to peak in 2011 and then slow in 2012. Private fixed investment should accelerate, given higher profitability and increasing capacity utilization. Inventory accumulation is projected to slow down from a year ago. Employment growth should remain solid, leading to a further fall in the unemployment rate. The full relaxation of German labor market restrictions on Polish workers is not expected to have a major impact on the Polish labor market. CPI inflation is expected to rise through mid-2011 and then gradually decline toward its 2½ target by end-2012.

10. **Based on existing data, the current account deficit is projected to widen to 4.1 percent of GDP in 2012.** While foreign demand should support exports, strengthening domestic demand and high commodity prices will boost imports. Following the temporary

Box 1. Poland: Real Exchange Rate Assessment

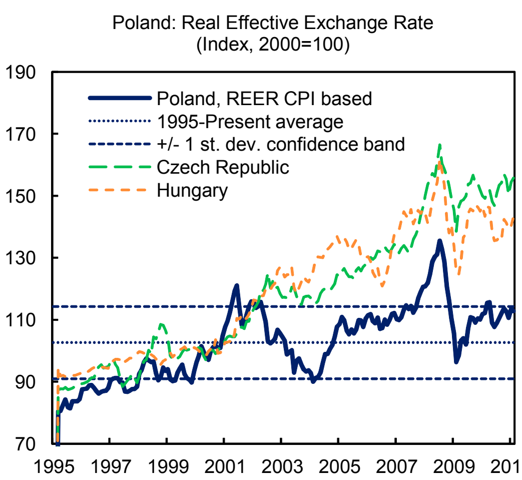
On balance, the evidence suggests that the real exchange rate of the zloty, which is classified as a free float, is broadly in line with fundamentals. Specifically:

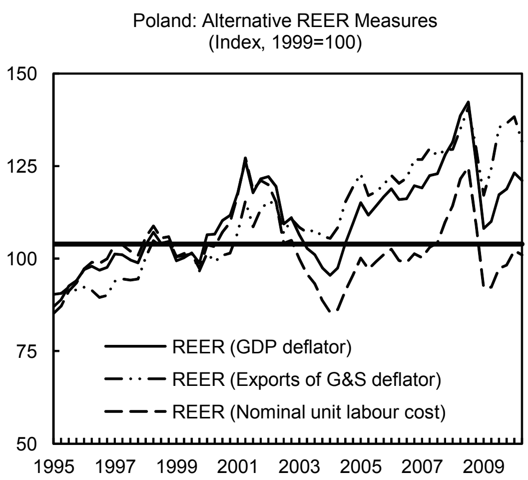
- The actual real exchange rate is less strong than the estimated equilibrium real exchange rate, which has been boosted by improvements in relative productivity. The sum of the current account balance and capital transfers in the medium term is slightly more negative than the current account norm used in the macro-balance approach, but slightly more positive than NFA-stabilizing current account balance used in the external sustainability approach.

CGER Results, 2010-11
(Percent deviation from estimated equilibrium)

	Spring 2010	Spring 2011
Macrobalance approach (MB)	-3	5
ERER approach	-3	-7
External stability approach (ES)	-10	-3
Average	**-5**	**-2**
CA norm	-2.0	-2.2
NFA-stabilizing CA	-3.0	-3.5

- The CPI-based real exchange rate is slightly above its historical average, but Poland's cumulative real exchange rate appreciation since 2000 remains below that of regional peers. ULC-based measures of the REER have picked up over the last year as improving cyclical conditions have contributed to a pick-up in wage pressures.





Sources: National authorities; European Commission; and GDS.

Poland: Real GDP Growth and Inflation Projections, 2011-14
(Percent change)

	2011	2012	2013	2014
GDP	4.0	3.8	3.8	3.7
Domestic demand	3.5	3.8	3.7	3.8
Private consumption	3.2	3.2	3.3	3.3
Public consumption	0.6	1.7	1.6	1.6
Domestic fixed investment	8.5	6.7	6.5	6.5
Inventories (contribution to growth)	-0.2	0.1	0.1	0.1
Net external demand (contribution to growth)	0.5	0.0	0.0	-0.2
Output Gap	0.6	0.6	0.7	0.5
Unemployment rate (average, LFS)	9.4	9.2	9.0	8.8
CPI Inflation				
Average	4.2	2.9	2.6	2.5
End of period	3.8	2.6	2.5	2.5

Sources: Polish authorities; and IMF staff estimates.

slowdown in 2010, net FDI flows are expected to increase in 2011 and then remain stable. Portfolio inflows should decline gradually in line with lower government financing needs. Reserve accumulation is expected to continue, although at a slower pace than in recent years.

11. **Improvements to the BOP compilation system may lower large errors and omissions, but increase the reported current account deficit and external vulnerability.** The authorities are scrutinizing the nonfinancial private sector's external assets, banks' off-balance sheet operations, and various current account items (especially trade in goods and services, and private transfers). The authorities have indicated that imports of used cars may have been under-recorded, and net private sector transfers over-stated. As a result, the forthcoming BOP data release may revise up the 2010 current account deficit by 1–2 percentage points of GDP to 4½–5½ percent of GDP. Revisions to E&O may change the structure of GDP, but are unlikely to change overall growth as any upward revisions to imports are expected to be offset by higher consumption and investment. A higher current account deficit would indicate that net national saving is lower and that vulnerability to external financing shocks is higher than previously thought. Furthermore, it would affect the assessment of the exchange rate and could imply a higher projected path for external debt (Appendix I).

12. **Risks to the growth outlook are balanced, with external risks mainly on the downside and domestic risks mainly on the upside**. While direct exposure to Europe's periphery via trade and financial channels is limited, sovereign financing concerns in the region could spill over to funding pressures in core Europe and in turn increase financing costs for Poland. In addition, Poland is closely integrated into Europe's banking system, making it potentially vulnerable to contagion from financial strains. Poland's FCL arrangement provides insurance against these risks. A sustained rise in global oil prices would represent a risk to GDP growth. On the upside, increased investor appetite for Polish assets could lead to a surge in capital flows. Also, given improved corporate profitability and tightening capacity constraints, private fixed investment could recover more rapidly than currently envisaged.

Authorities' views

13. **The authorities broadly shared staff's views on the outlook and risks.** The central bank's GDP growth projections for 2012–13 are slightly lower than staff's, reflecting the view that fiscal consolidation will have a more negative impact on domestic demand.

14. **The authorities were more sanguine than staff about the implications of a higher current account deficit for external vulnerability,** emphasizing that the past widening of the current account deficit was gradual and fully financed.

IV. The Policy Agenda

A. Narrowing the Fiscal Deficit

15. **The fiscal deficit widened in 2010** (Figure 9, Table 3). Given initial uncertainty about the strength of the recovery, the 2010 budget envisaged a roughly neutral policy stance. In the event, the fiscal deficit widened to 7.9 percent of GDP, mainly reflecting the lagged effects of the 2009 economic slowdown on corporate income tax revenues, as firms continued to deduct earlier losses. Financing needs were comfortably met in financial markets (with nonresident purchases of government bonds reaching an all-time high) and through privatization receipts. With government debt not far from an important threshold under the Public Finance Act, the authorities specified additional corrective actions triggered by the debt threshold.[2]

16. **Substantial fiscal consolidation is under way** (text table). Consolidation measures amounting to 1½–1¾ percent of GDP each year are being implemented in 2011–12, notably tightened eligibility for early retirement, a ceiling of CPI+1 on the growth of discretionary expenditure (which includes a wage bill freeze in 2011), a VAT increase of 1 percentage point, and increases in excise taxes. In addition, some pension contributions are being shifted from the private to the public system and the government intends to further restrain local government deficits. Based on announced policies and tax buoyancy, staff expects the fiscal deficit to fall to 5.6 percent of GDP in 2011 and 3.6 percent of GDP in 2012.

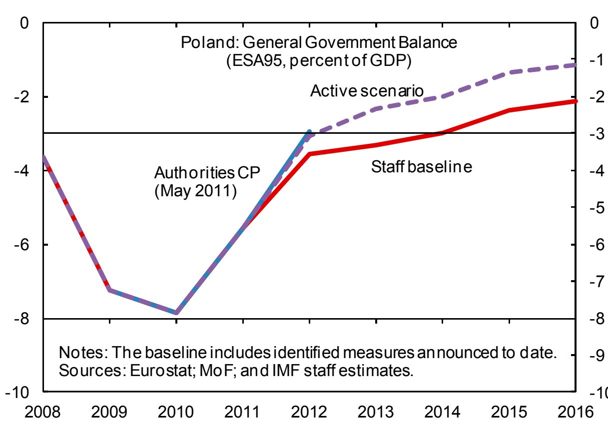
17. **To put government debt firmly on a downward path, additional fiscal consolidation will be needed** (text figures). On staff's baseline projections, the fiscal deficit would fall over the medium term to 2 percent of GDP and government debt would decline slowly to 53 percent of GDP (ESA95 basis). To reduce debt firmly over time, the fiscal deficit should be cut to no more than 1 percent of GDP over the medium term, which is also Poland's medium-term objective (MTO). The MTO ensures long-term sustainability taking into account projected increases in age-related spending. This would require additional permanent measures of a little more than 1 percent of GDP. With such measures, the debt-to-GDP ratio would fall to about 40 percent of GDP by 2021. Given that statutory spending represents about ¾ of total

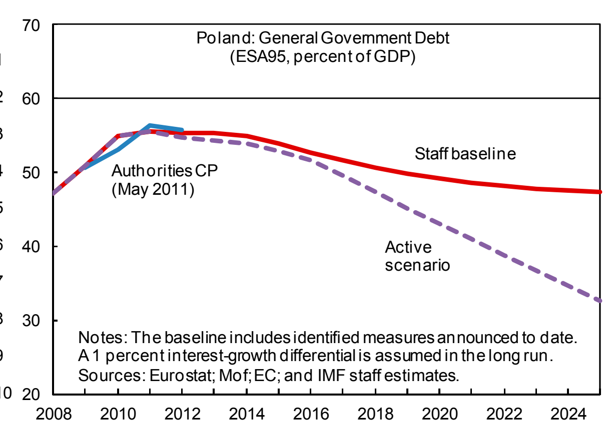
[2] The Public Finance Act establishes debt thresholds that apply to the national definition of debt (excluding debts of the National Road Fund that are included in the ESA95 definition). The 50 percent of GDP threshold serves mainly as a signal. The 55 percent of GDP threshold requires the implementation of measures to curb the increase in debt, including a nominal wage freeze, a limit on pension indexation, and a VAT rate increase. The Constitution limits debt to 60 percent of GDP.

Announced consolidation measures (percent of GDP)	Staff estimates 2011	Staff estimates 2012	Authorities estimates 2011	Authorities estimates 2012
Revenue				
VAT increase	0.4		0.4	
Excise tax increases	0.1	0.1	0.1	0.1
Abolition VAT exemption for cars	0.1		0.1	
Freeze PIT thresholds	0.1	0.1	0.1	0.1
Taxation of profits on O/N deposits		0.0		0.0
Planned measures on coal and CO2 1/		0.2		0.2
Total Revenue Yield	**0.7**	**0.4**	**0.7**	**0.4**
Expenditure				
CPI+1 rule	0.3	0.5	0.5	0.6
Reform of early retirement scheme	0.4	0.4	0.4	0.4
Reduction ALMPs	0.3		0.3	
Reduction in funeral benefits	0.1	0.0	0.1	0.0
Lower interest payments due to pension changes	0.0	0.0	0.0	0.0
Restraint on local government deficits		0.3		0.4
Total Expenditure Yield	**1.0**	**1.1**	**1.2**	**1.4**
Pension contribution changes	0.6	0.5	0.6	0.5
Total Yield	**2.3**	**2.0**	**2.5**	**2.3**
Projected General Government Deficit (percent of GDP)	*5.6*	*3.6*	*5.6*	*2.9*

Sources: MoF and IMF staff estimates and projections.
1/ Due to EU regulations.

expenditures, the authorities could continue their reforms of entitlement programs to attain a durable expenditure reduction. Specific measures that could be considered include tightening pension indexation, aligning disability benefits with the pension formula, improving the targeting of other benefits, increasing the flexibility of the floor on defense spending, streamlining public administration employment, limiting tax reliefs and exemptions, and enhancing VAT yields. Staff suggested that, given the tightening of capacity constraints and increased vulnerabilities associated with an upward revision to the current account deficit, it would be good to front-load this additional adjustment.





18. **The authorities are planning to adopt a permanent fiscal rule.** They are aiming for a fiscal rule that would allow for countercyclical policy responses, be expenditure-based to help constrain the size of government, and be simple to design, implement, and present to the public. Specifically, they are considering a ceiling on nominal expenditure growth equal to historical nominal GDP growth minus 1 percent. Given the importance ensuring fiscal sustainability, staff suggested that the spending rule be anchored by Poland's MTO, so that spending growth would be reduced if the deficit consistently exceeds the MTO (a "debt brake"). Such a rule would be effective in restraining debt while allowing for some counter-cyclicality. Staff also highlighted that the rule should be complemented by strengthening the implementation of the ongoing multi-year budgeting reforms, including through annual spending reviews, moving toward top-down budgeting, and preparing multi-year fiscal forecasts at the general government level.

19. **The shift of some pension contributions from the private to the public system will improve government debt dynamics, but should not be allowed to facilitate higher spending or tax reductions that could weaken fiscal sustainability.** The comprehensive pension reform of the late 1990s improved long-run fiscal sustainability (Appendix II). However, the funding of future pension liabilities in the private second pillar led to higher fiscal deficits and debt than would have otherwise been the case. The recently-implemented shift of some pension contributions from the private to the public pension will reduce the fiscal deficit and projected debt. However, if the shift contributes to delays in structural fiscal reforms, then it could weaken fiscal sustainability. Moreover, given the projected long-term decline in replacement ratios, staff suggested raising national saving once fiscal space allows (i.e. once the MTO is achieved), either by strengthening the fiscal balance target or increasing contributions to the second pillar. Also, a funded second pillar is potentially beneficial from international risk-diversification and capital-market development perspectives. At the same time, the regulation of private pension funds should be improved.

Authorities' views

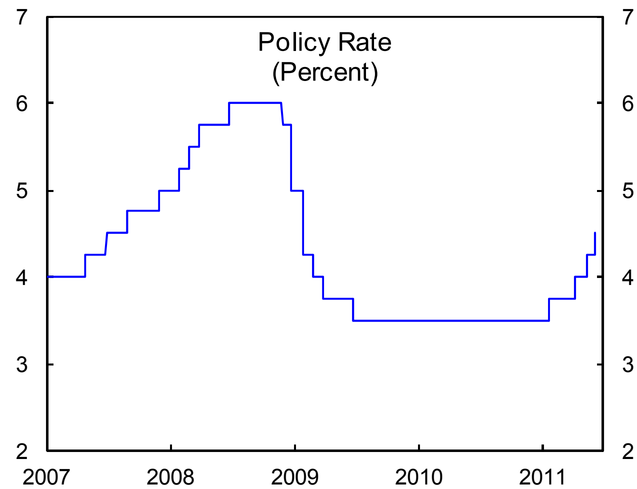
20. **The authorities agreed that additional fiscal measures will be needed over the medium term, but differed on timing**. The authorities are confident that the outlined measures will be sufficient to meet the 2012 target. Nevertheless, they stand ready to adopt additional measures, if necessary.

21. **The authorities saw scope for anchoring the envisaged permanent fiscal rule in the MTO**. They added that the rule would be accompanied by a strengthening of budgetary processes and be governed by either a new Fiscal Responsibility Law or an amendment to the Public Finance Act.

22. **The authorities agreed on the need to increase retirement saving over the long term, but preferred to improve incentives for voluntary private saving (third pillar)**. While they did not exclude a more ambitious fiscal target to create additional fiscal space, they opposed using this space to enhance mandatory private saving under the second pillar.

B. Tightening Monetary Policy

23. **After keeping the policy interest rate unchanged during 2010, the central bank began to raise the rate in January 2011.** As financial conditions normalized, exceptional liquidity facilities were gradually withdrawn during 2010. The central bank has hiked the policy rate since January by a cumulative 1 percentage point to 4½ percent. This puts the policy rate broadly in the neutral range (based on an estimated equilibrium real rate of 2¼ percent plus the 2½ percent inflation target).



24. **Looking forward, core CPI inflation is projected to continue to rise**. Improving labor market conditions and tightening capacity constraints are expected to boost core inflation. Headline inflation should peak at around 4¾ percent in 2011Q3 before starting to fall, as commodity price increases moderate.

25. **Given inflationary pressures, some further increases in the policy rate will be needed.** The appropriate magnitude and pace of tightening will depend on the evidence on capacity constraints, as well as developments in inflation expectations, labor markets, the exchange rate, and possible second-round effects from higher food and fuel prices. In staff's model-based forecast, which incorporates an endogenous interest rate path, further gradual hikes in the policy rate by about a cumulative ½ percentage point over the next 12 months would bring inflation back to the 2½ percent target over the policy horizon (Appendix III). Financial markets are pricing in a similar pace of policy tightening.

26. **Monetary policy communication has been strengthened.** In particular, recent post-MPC meeting communiqués have contained more discussion of the MPC's view of the inflation outlook. There is scope for further elaboration, for example regarding the MPC's views of the balance of risks or the short- versus medium-term dynamics.

27. **The recent decision to convert some EU funds on the foreign exchange market (FX) will lower reserve accumulation**. Hitherto, most EU funds have been exchanged at the central bank; the authorities now plan to convert some EU funds on the foreign exchange market, which—in their view—would limit excess liquidity in the banking system. Market conversion implies a slower buildup of foreign exchange reserves by the central bank, which will contain sterilization costs. Reserves exceed several measures of reserve adequacy, but fall short of short-term debt at remaining maturity plus the current account deficit, suggesting that some additional reserve accumulation would be desirable (Appendix IV). Staff suggested that official sales of foreign exchange ought to be done in a transparent and non-discretionary way, so as to minimize potential exchange rate volatility.

Authorities' views

28. **There was agreement on the need for some further gradual rate hikes, but the authorities took slightly different views on reserve accumulation and FX sales**. The central bank noted that reserves are more than adequate on most measures and thus saw little need for further reserve accumulation. On FX sales, the authorities noted that market reactions are difficult to anticipate, but emphasized that the policy intention is not to influence the exchange rate.

C. Strengthening Financial System Resilience

29. **Financial sector policies have been effective, but there is room to further strengthen resilience.** In early 2010, the Financial Supervision Authority (KNF) introduced Recommendation T, imposing tighter standards on lending to households, including by capping the debt-service-to-income ratio under stressed scenarios at 50 percent (65 percent for above-average earners). More recently, the KNF reinforced the previously-issued Recommendation S—which strengthened standards on mortgage lending to households—by capping the debt-service-to-income ratio for FX loans at 42 percent, with banks having until end-2011 to adjust. KNF recommendations appear to have helped reduce the share of FX mortgages in new mortgage lending since mid-2010, but FX mortgage loans still account for over 60 percent of the stock of total mortgage loans. Depending on the impact of these recommendations, further tightening of the existing prudential requirements or the introduction of other supervisory measures (e.g., increasing capital requirements under a Pillar II approach) could be considered. Staff pointed to the desirability of funding mortgage lending on a longer-term basis and further developing the market for covered bonds (presently issued by a limited number of specialized mortgage banks). Staff noted the importance of remaining alert to the risk of increased lending by non-regulated or less regulated entities, following the recent tightening of banks' lending standards.

30. **Financial supervision should be strengthened further.** Regarding micro-prudential supervision, the preliminary conclusions of the recent Basel Core Principles assessment suggest that more frequent on-site inspections and better coordination between on- and off-site supervision are essential for monitoring compliance with prudential requirements and for a timely identification and containment of risks. Also, to support the enforcement of financial oversight policies, the KNF's independence could be increased, including by enhancing governance arrangements and the legal protection of staff (Appendix V). Regarding macro-prudential supervision, it would be helpful to develop a framework for coordinating policy responses to systemic risks, building on the central bank's analytical framework for identifying systemic risks, the KNF's experience with designing and implementing prudential requirements, and the effective forum for discussion provided by the Financial Stability Committee (which consists of the central bank, the KNF, and the Ministry of Finance). In addition, the bank resolution framework could be strengthened by adopting a broader range of instruments and by increasing the role of the Bank Guarantee Fund.

31. **The introduction of a financial stability contribution is being considered**. The contribution would build a fund that could facilitate the resolution of weak credit institutions. The base for the contribution would be bank liabilities excluding Tier 1 capital and insured

deposits. Operational modalities (notably the tax treatment and the relationship of the new fund with the existing Bank Guarantee Fund) are still being clarified. Over time, the contribution could be refined to reflect the riskiness of different institutions.

Authorities' views

32. **The authorities generally agreed with staff's recommendations, but expressed reservations regarding the need to increase the KNF's independence**. The authorities are committed to closely monitor the implementation of recent prudential requirements and to tighten prudential requirements in the area of liquidity management to ensure that banks build adequate long term funding. The authorities expressed concern about the often-limited powers of host supervisors in the context of the EU supervisory architecture, especially with regard to the oversight of branches. The authorities also agreed on the need to improve the coordination of policy responses to systemic risks and to enhance the resolution framework. However, the authorities considered that the independence of KNF is adequate. Finally, the authorities indicated that they would request an FSAP Update in 2012.

D. Policy Options if Capital Inflows were to Surge

33. **Poland was one of the main recipients of capital flows among emerging economies in 2010**. The primary destination for inflows was government securities, reflecting in part the government's increased financing need. Despite these inflows, the appreciation of the exchange rate was limited. Going forward, gross FDI inflows are projected to rise gradually in line with the upturn in investment, other investment inflows should remain steady, while portfolio inflows are expected to fall gradually given the government's declining financing need. There is a risk that increased investor appetite for Polish assets could lead to a surge in capital flows.

34. **If capital inflows were to increase sharply, monetary policy could be tightened more gradually and fiscal consolidation could be accelerated**. As the exchange rate is not overvalued, some appreciation would be acceptable. This would dampen inflationary pressures, thus reducing the need for increases in the policy interest rate. However, if a surge in capital inflows were to put excessive pressure on the exchange rate, then the pace of reserve accumulation could increase, within the NBP's prevailing monetary policy guidelines, and the already-envisaged fiscal adjustment could be accelerated, which would also reduce the need for interest rate hikes. In addition, targeted macro-prudential measures, such as measures to tighten bank lending standards, could complement the macroeconomic policy response.

Authorities' views

35. **The authorities broadly agreed with staff's recommendations, but did not see a need for additional reserve accumulation**. The authorities concurred that some gradual exchange rate appreciation would be acceptable and that the already-envisaged fiscal adjustment could be accelerated.

E. Enhancing Growth and Flexibility

36. **Despite recent reforms, structural rigidities continue to hamper potential growth**. Poland's labor force participation rate has increased since 2007, due in part to measures that lowered the tax wedge and tightened early retirement entitlements (Figures 10). However, the participation rate is still low compared to the EU average. The government has also tackled administrative and product market rigidities by introducing computerized land registers, one-stop-shop regulations, and e-invoicing of VAT; streamlining documentation and licensing requirements; and stepping up the privatization agenda in 2010–11. Poland's score on the World Economic Forum's Global Competitiveness Index is relatively high, but it lags its peers on the World Bank's ease of doing business index, and a recent OECD study notes weak product market regulations and large state involvement in network sectors such as transport, energy, and communication (Figure 11).

37. **Possible further structural reforms include the following** (Appendix V):

- **Labor market:** Labor force participation could be increased by adopting labor-supply enhancing measures with a complementary long-term fiscal effect, such equalizing and increasing the retirement age and merging special pension schemes, including the farmer's scheme, within the general system. With limited resources for spending on active labor market policies, the efficiency and targeting of existing measures could be reviewed. Finally, existing (but temporary) flexible employment provisions could be extended beyond 2011.
- **Product markets:** Administrative barriers to business could be further reduced, including by simplifying building permit requirements, improving one-stop-shop regulations, eliminating tax reliefs and exemptions, and further streamlining documentation and licensing. Efforts could continue to deregulate network sectors such as energy and transportation and decrease the share of state ownership in the economy through privatization.

Authorities' views

38. **The authorities recognize the importance of structural reforms and remain committed to proceed with the reform agenda.** Improving labor participation remains the authorities' main priority: the goal is to raise the employment rate from 65 percent in 2010 to 71 percent by 2020. To this end, discussions on reforming police pensions are under way, while changes to other special pension schemes, increasing statutory retirement age, or equalizing the age for men and women are under consideration. The authorities are determined to pursue the privatization agenda, with the ultimate goal of reducing state companies' contribution to GDP from 20 percent to 10 percent, implying that only strategic firms, mainly in key infrastructure like power grid or railroads, would remain state-owned.

F. Euro Adoption

39. **Euro adoption remains an important long-term objective.** The authorities are pursuing an appropriate strategy, aiming to achieve sufficient progress toward convergence and fulfilling the entry criteria, especially on the fiscal deficit, before announcing a specific target date. In the meantime, they are working on required changes to the Constitution to permit entry into the euro area.

V. Staff Appraisal

40. **Poland returned to solid growth in 2010, building on timely and forceful countercyclical policy responses to the global crisis**. These responses were permitted by limited macroeconomic imbalances prior to the crisis and access to an FCL arrangement with the Fund, both of which reflected a track record of very strong policies.

41. **With the economy gaining momentum, capacity constraints are tightening, inflationary pressures are rising, and the current account deficit is widening**. Risks to the short-term growth outlook are balanced, with external risks mainly on the downside and domestic risks mainly on the upside. The FCL arrangement provides insurance against external financial risks.

42. **Revisions to BOP data are expected to increase the current account deficit**. A higher current account deficit would indicate that net national saving is lower and that vulnerability to external financing shocks is higher than previously thought, though the impact on the projected path of external debt and the assessment of the exchange rate (which is currently seen as broadly in line with fundamentals) would likely be modest. Given that errors and omissions were not at an acceptable level, the authorities' much-needed efforts to improve BOP data are welcome and should continue.

43. **Given the large fiscal deficit in 2010, the substantial fiscal consolidation already under way is welcome, but additional fiscal consolidation will be needed**. To reduce debt firmly over time, additional permanent measures of a little more than 1 percent of GDP will be needed over the medium term. Given the tightening of capacity constraints and increased external vulnerabilities associated with an upward revision to the current account deficit, it would be good for this additional adjustment to begin sooner rather than later, with significant front-loading.

44. **The recent increases in the policy interest rate are welcome and some further gradual hikes in the policy rate will be needed to bring inflation back to target**. The appropriate magnitude and pace of monetary tightening will depend on developments in aggregate demand pressures and inflation expectations. The increased discussion of the inflation outlook in the post-MPC meeting communiqué is welcome and further elaboration would be desirable. While international reserves are more than adequate on several measures, on balance some additional reserve accumulation would be desirable.

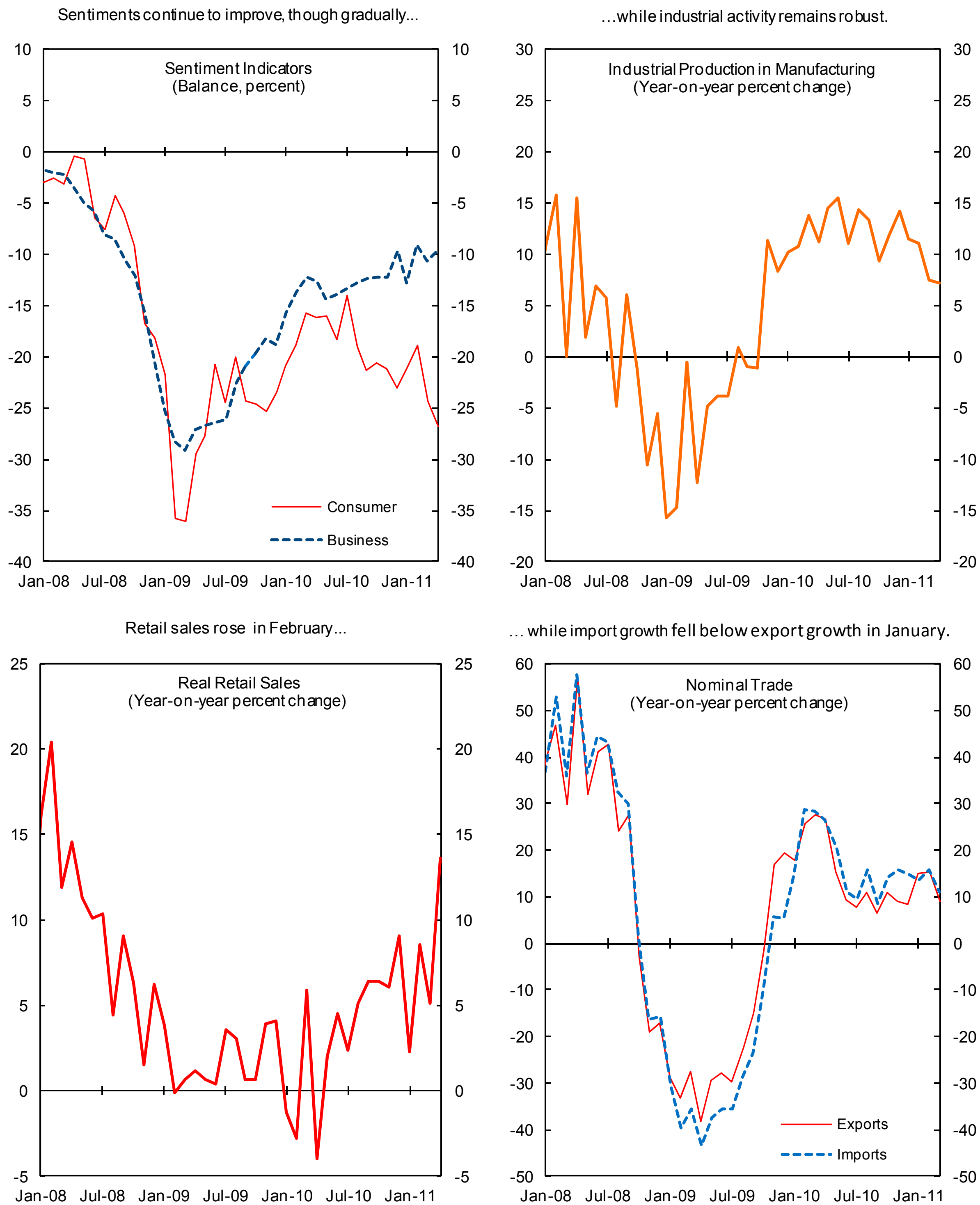
45. **Financial sector surveillance policies in Poland have been effective, but efforts to further strengthen financial sector resilience need to continue**. Depending on the impact of

recent prudential recommendations, further steps could be considered. While financial supervision is already strong, there are areas where it could be further improved, including through more frequent on-site inspections. The independence of the Financial Supervision Authority (KNF) could be increased and it could be given broader authority to issue binding regulations. Regarding macro-prudential issues, a framework for coordinating policy responses to systemic risks, in line with evolving international thinking, could be developed. Finally, to strengthen the bank resolution framework, a broader range of tools is needed.

46. **Further raising labor participation would boost potential growth**. Labor-supply enhancing measures with a complementary long-term fiscal effect, such as raising the retirement age and equalizing it between men and women, and merging special pension schemes within the general system, would be desirable.

47. **It is recommended that the Article IV consultation remain on a 12-month cycle.**

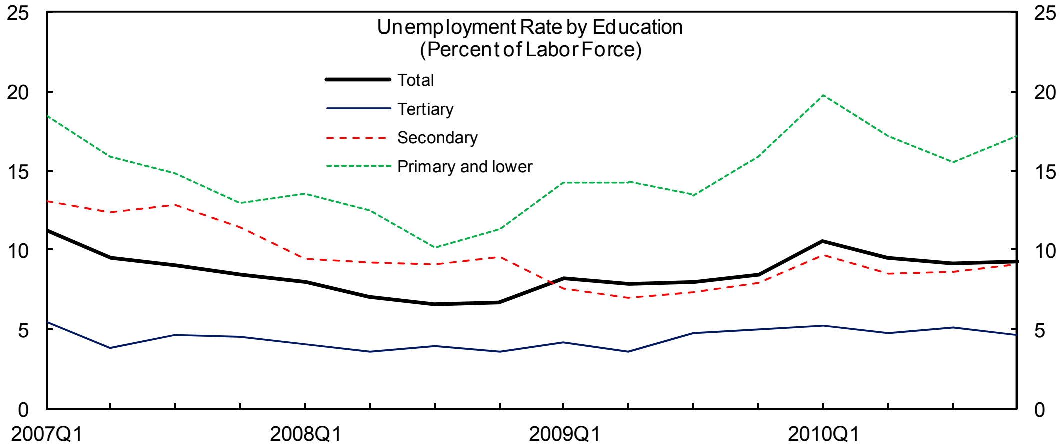
Figure 1. Poland: Recent Economic Developments, 2008-11



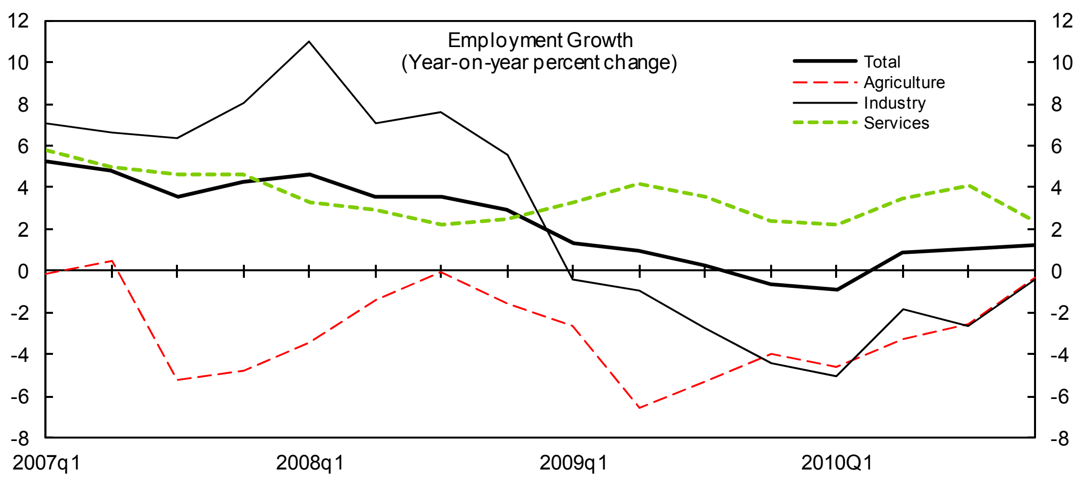
Sources: European Commission; and Polish Statistical Office.

Figure 2. Poland: Labor Market developments, 2007-10

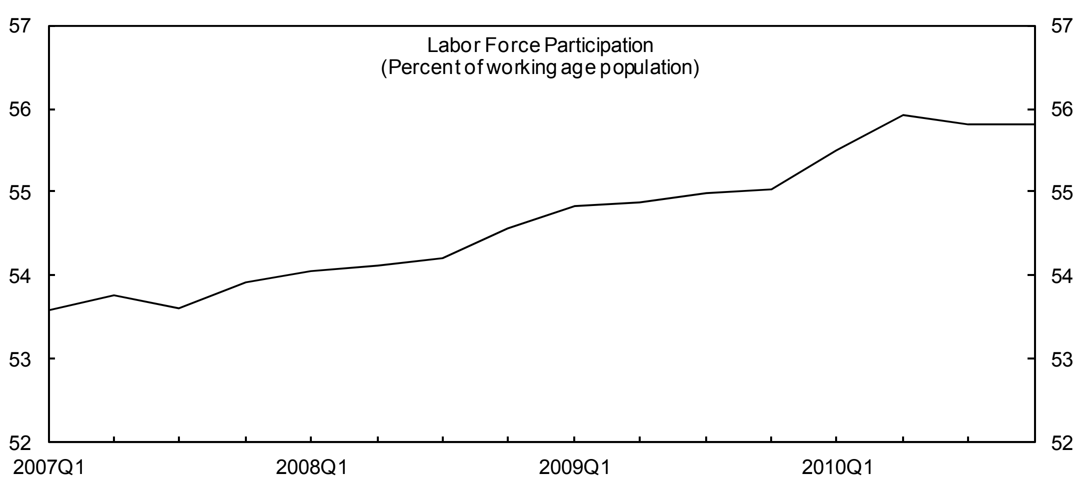
A recent decline in the unemployment rate, albeit gradual and not among low-skilled workers.



A rebound in employment growth, largely driven by the services sector.



Labor participation rates on the rise, but from low levels.

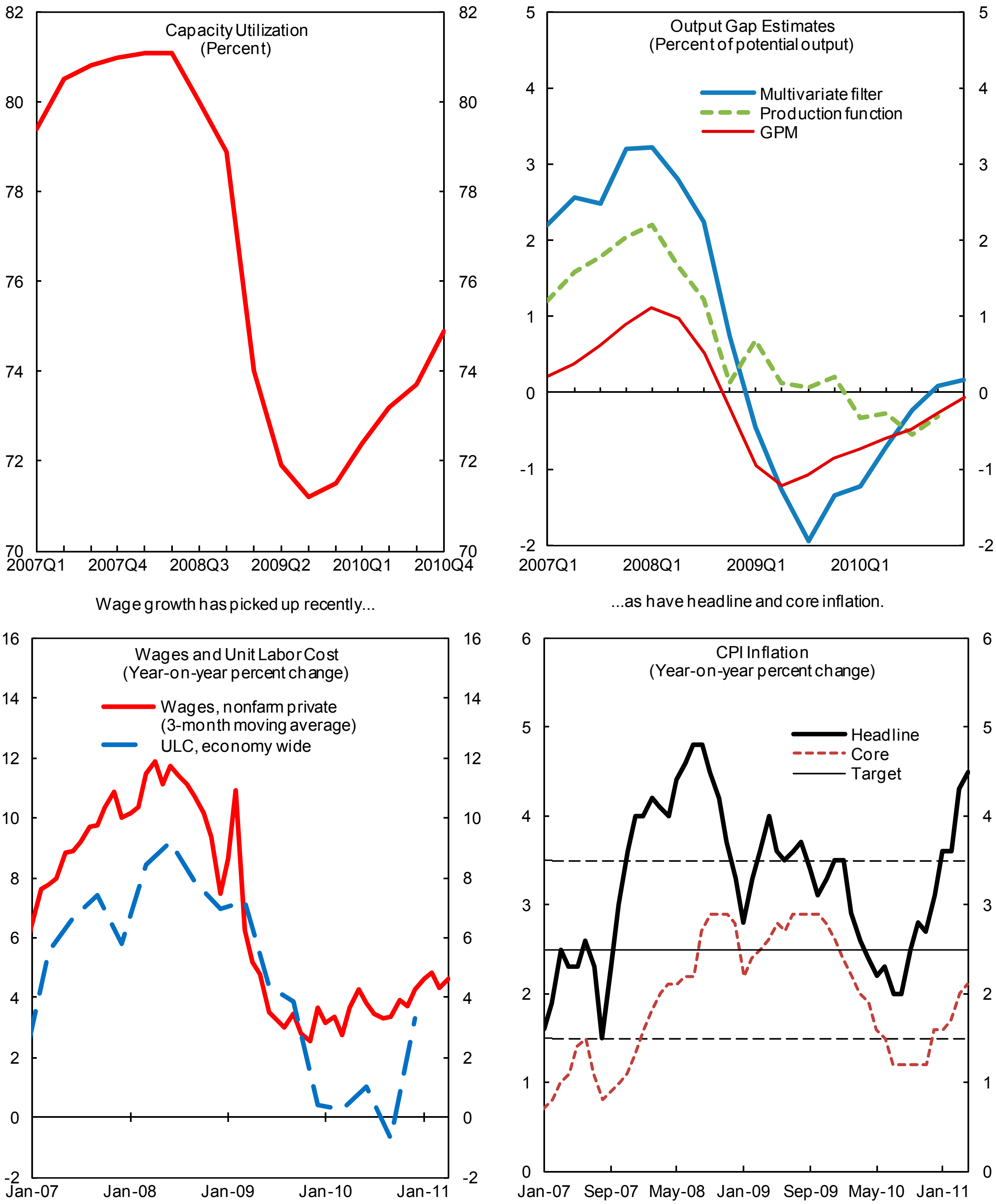


Source: Poland's Statistical Office

Figure 3. Poland: Capacity Utilization, Output, and Inflation, 2007-11

Capacity utilization has rebounded...

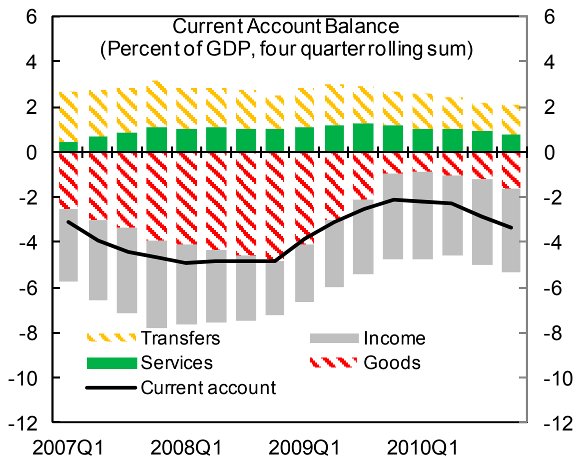
...while the output gap has closed.



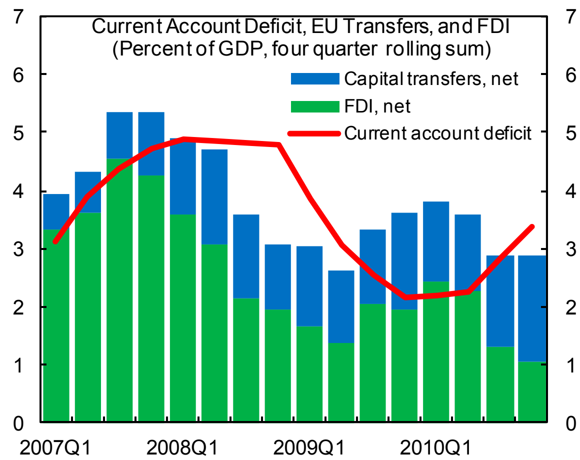
Sources: European Commission; Polish Statistical Office; and IMF staff estimates.

Figure 4. Poland: Balance of Payments Developments, 2007-11

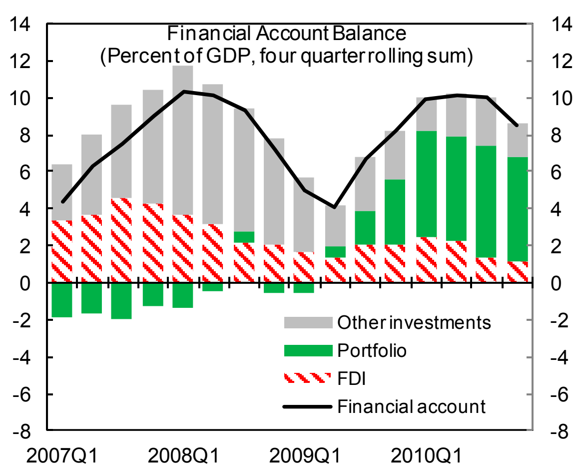
The current account deficit has begun to widen...



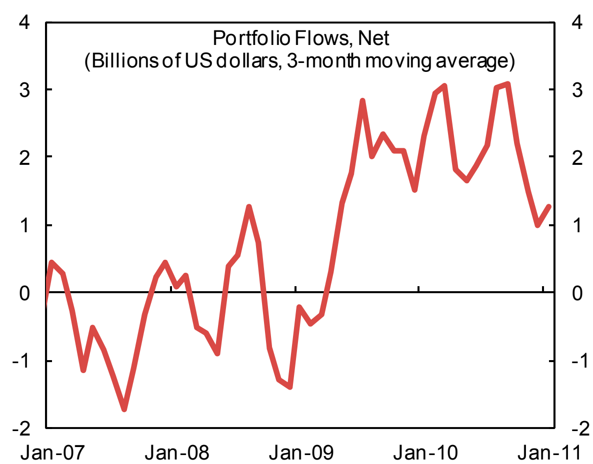
...but is till largely covered by FDI and EU transfers.



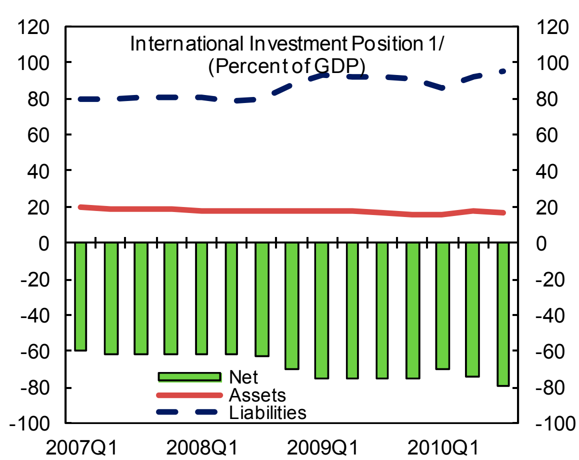
Financial inflows have leveled off...



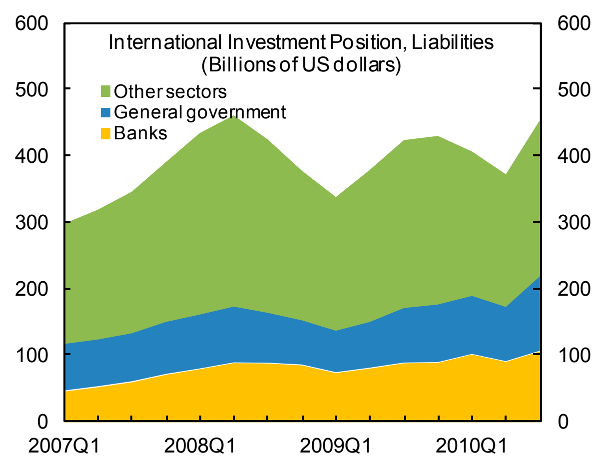
...with portfolio inflows remaining strong.



The IIP has gradually worsened...

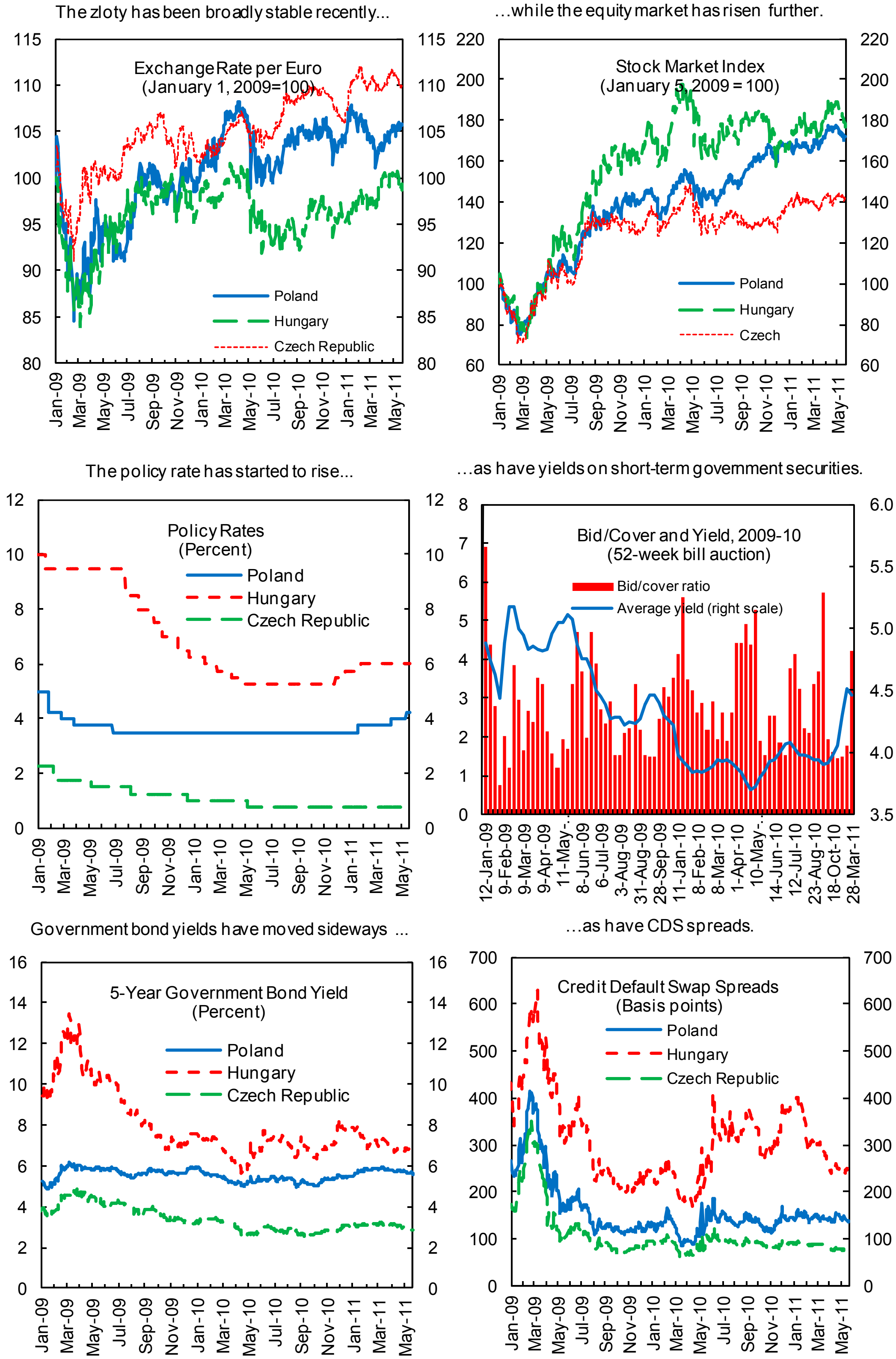


...due to rising liabilities in both public and private sectors.



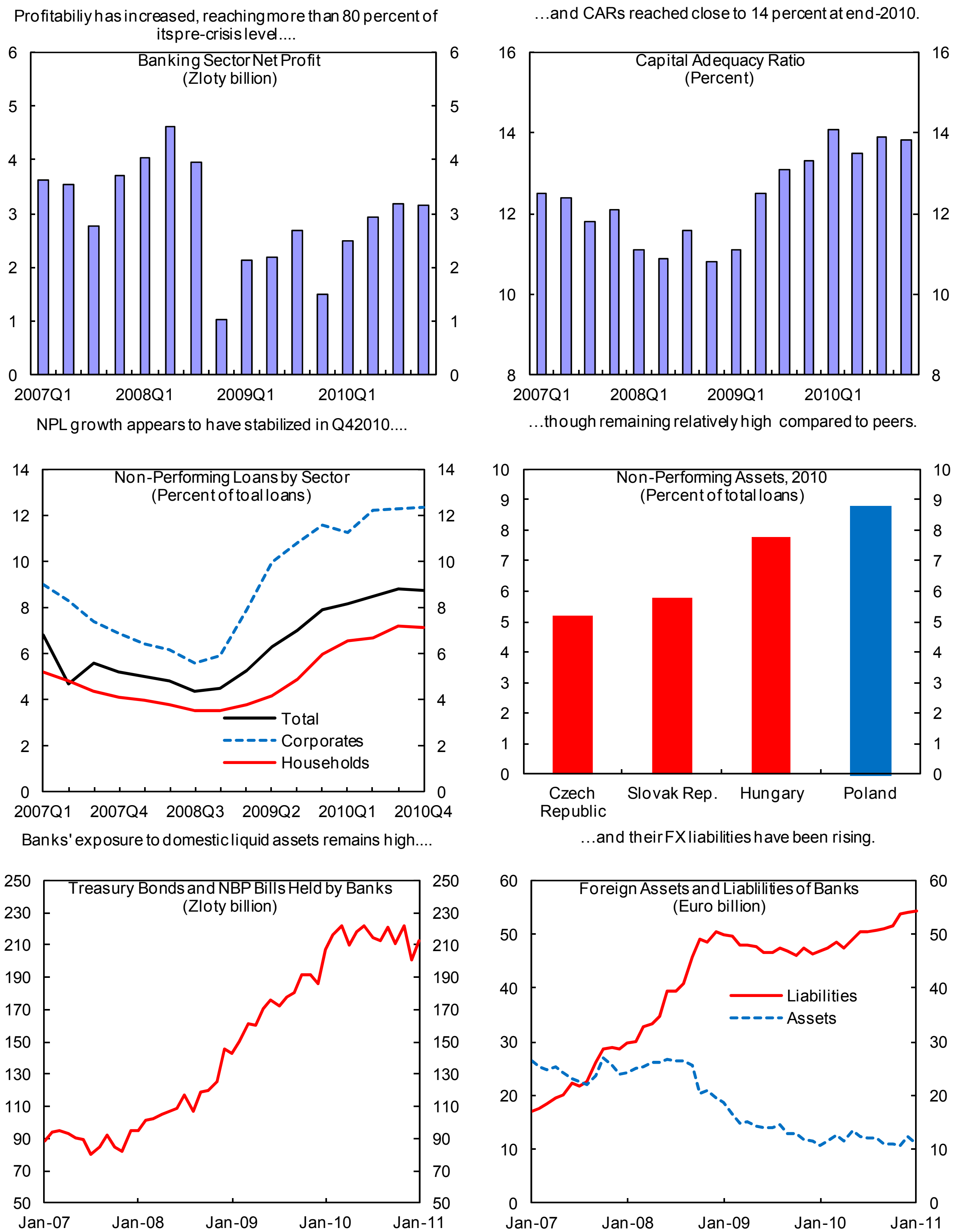
Source: National Bank of Poland.
1/ Excludes NBP.

Figure 5. Poland: Recent Financial Markets Developments
January 2009 - May 2011



Sources: Bloomberg; and Polish Ministry of Finance.

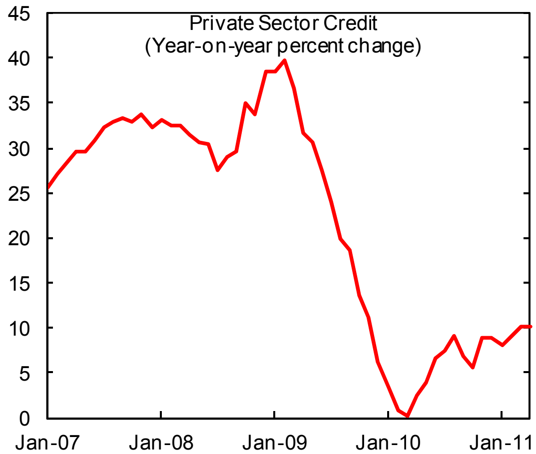
Figure 6. Poland: Banking Sector Developments, 2007-11

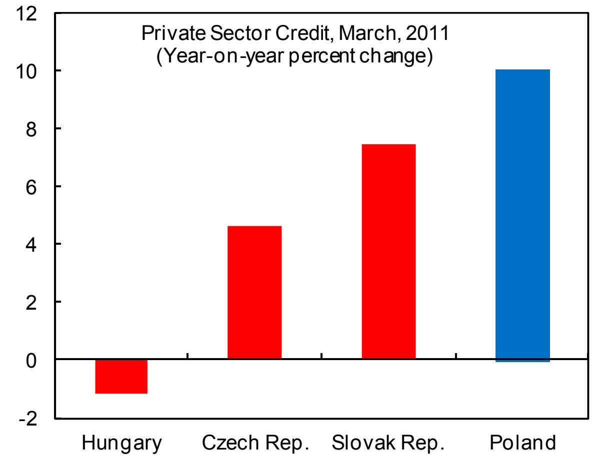


Sources: National Bank of Poland; and IMF staff estimates.

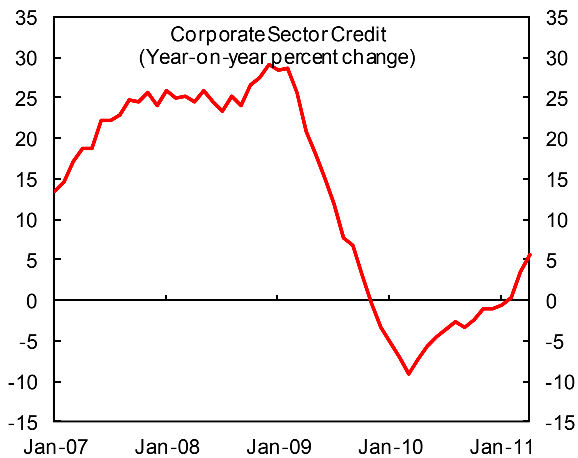
Figure 7. Poland: Credit Developments 2007-11

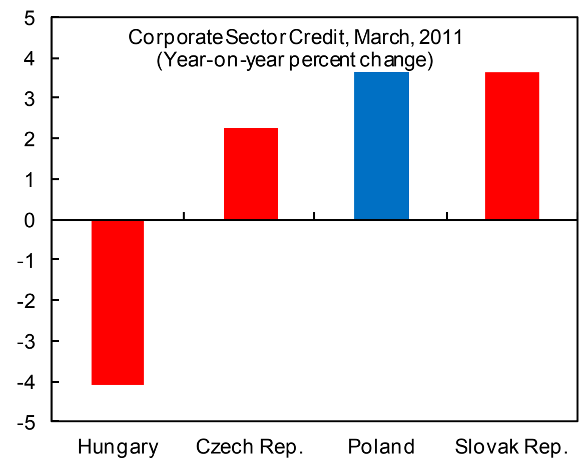
Pivate sector credit remains subdued relative to the past, though it is higher than in regional peers.



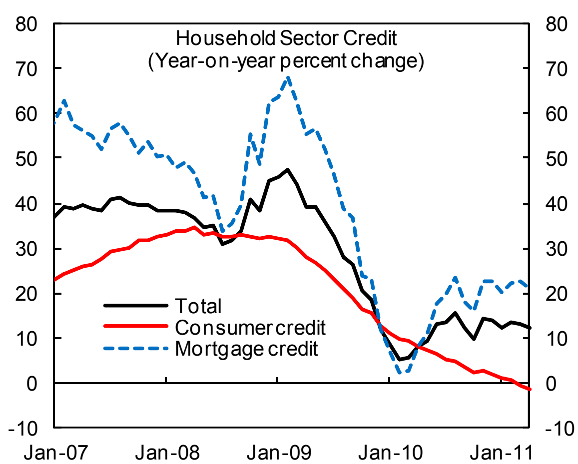


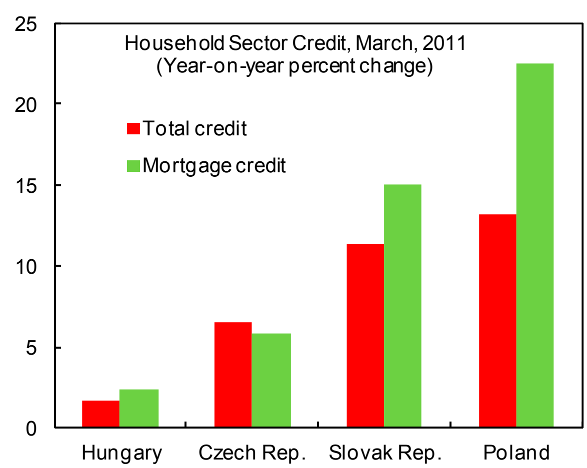
Corporate credit has yet to pick up...





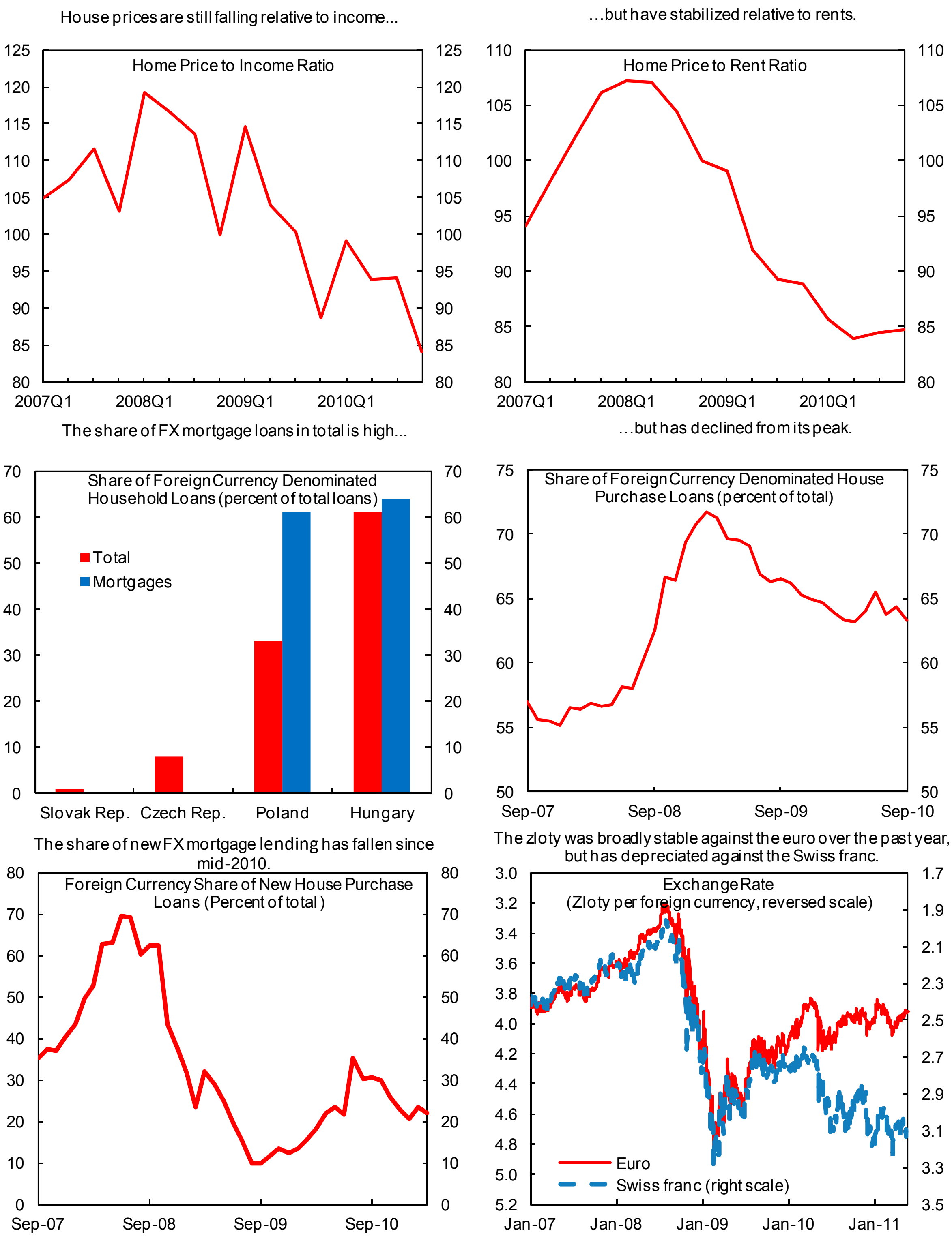
...while household credit has been increasingly driven by mortgages.





Sources: National Bank of Poland; Country Central Banks; and IMF staff estimates.

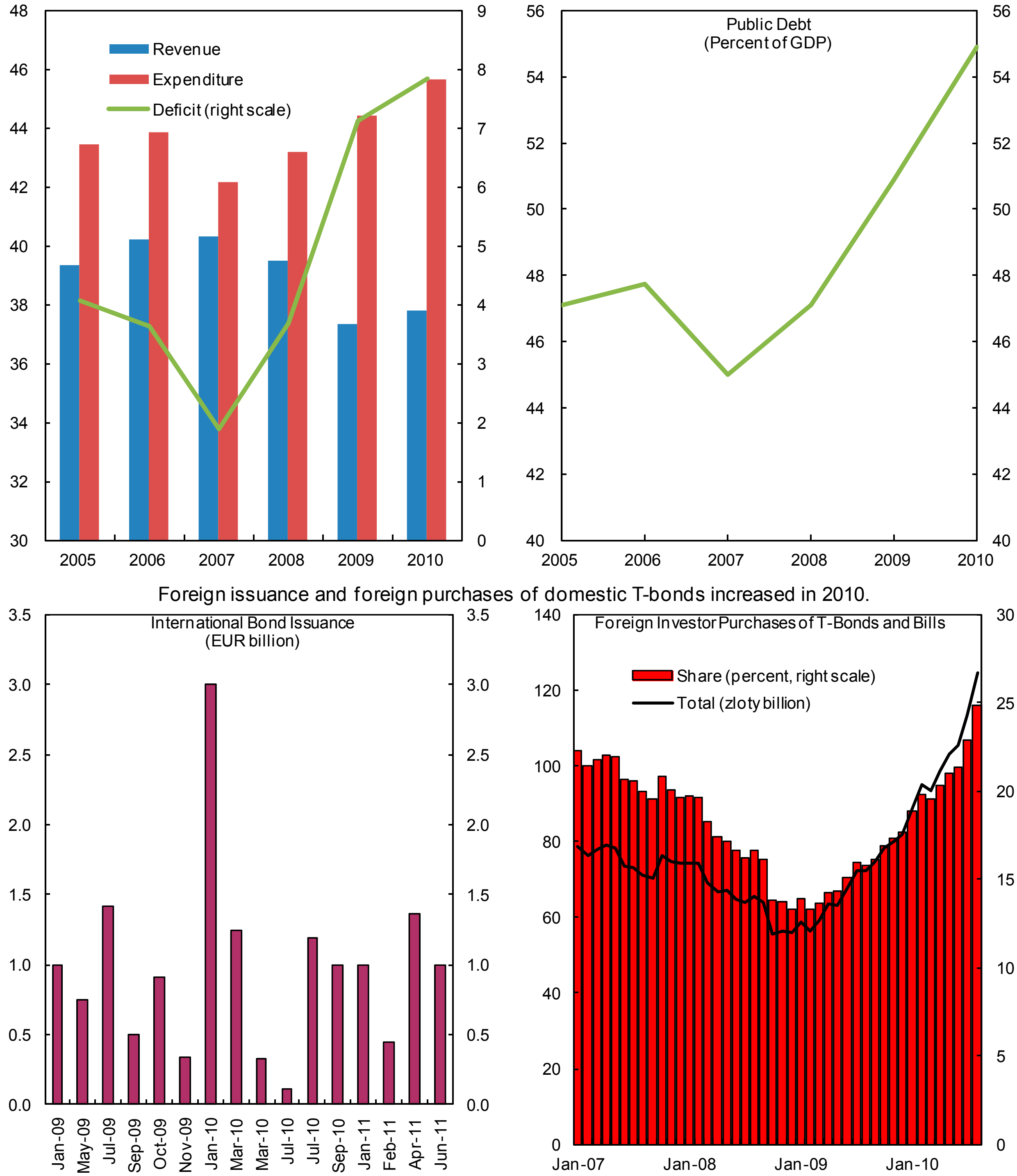
Figure 8. Poland: Residential Real Estate Lending, 2007-11



Sources: National Bank of Poland; Bloomberg; KNF; and IMF staff estimates.

Figure 9. Poland: Recent Fiscal Developments

The general government deficit widened to 7.9 percent of GDP, while debt increased to 54.9 percent of GDP .

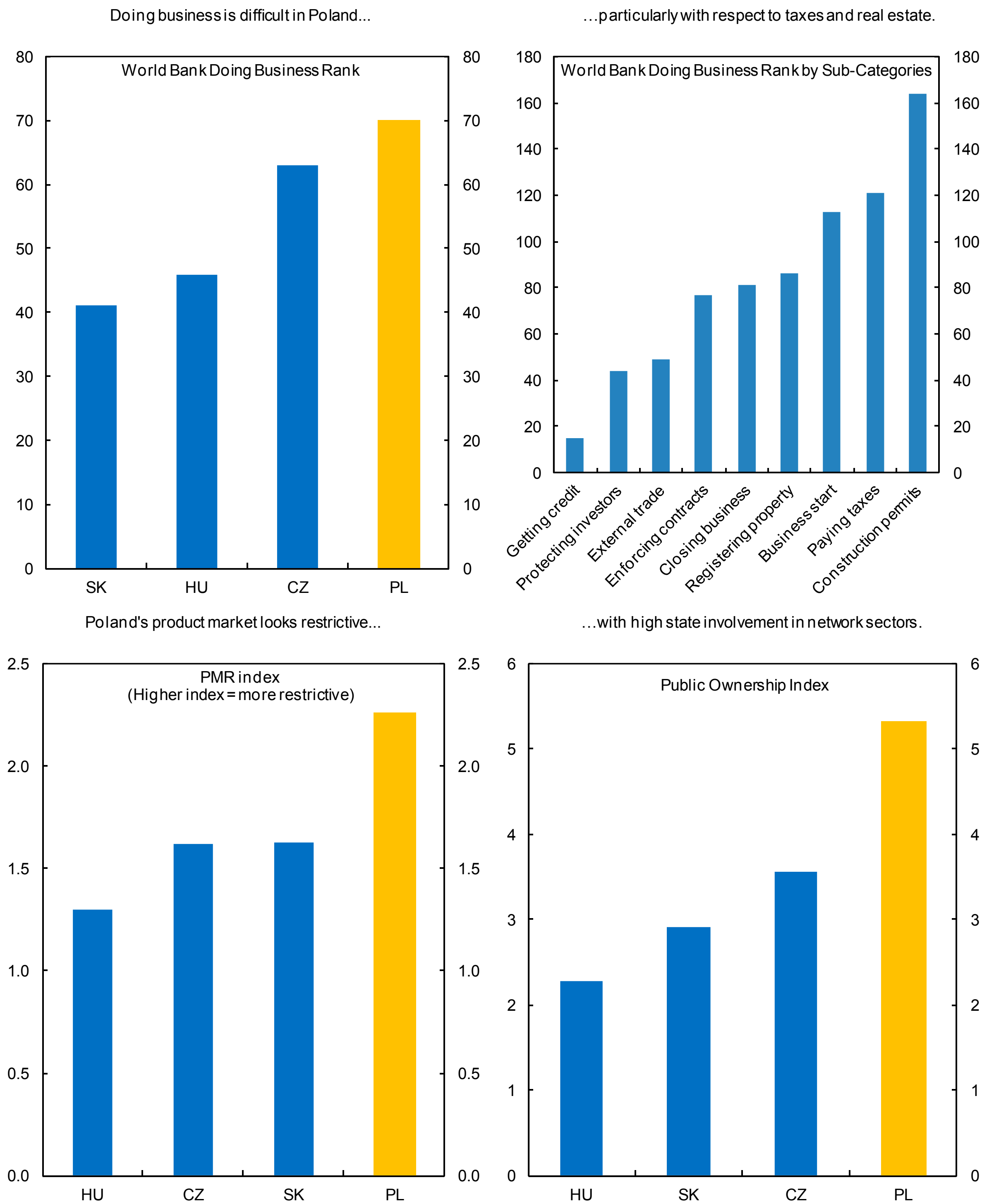


Sources: Polish Ministry of Finance; and IMF staff estimates.

Figure 10. Poland: Labor Market Indicators

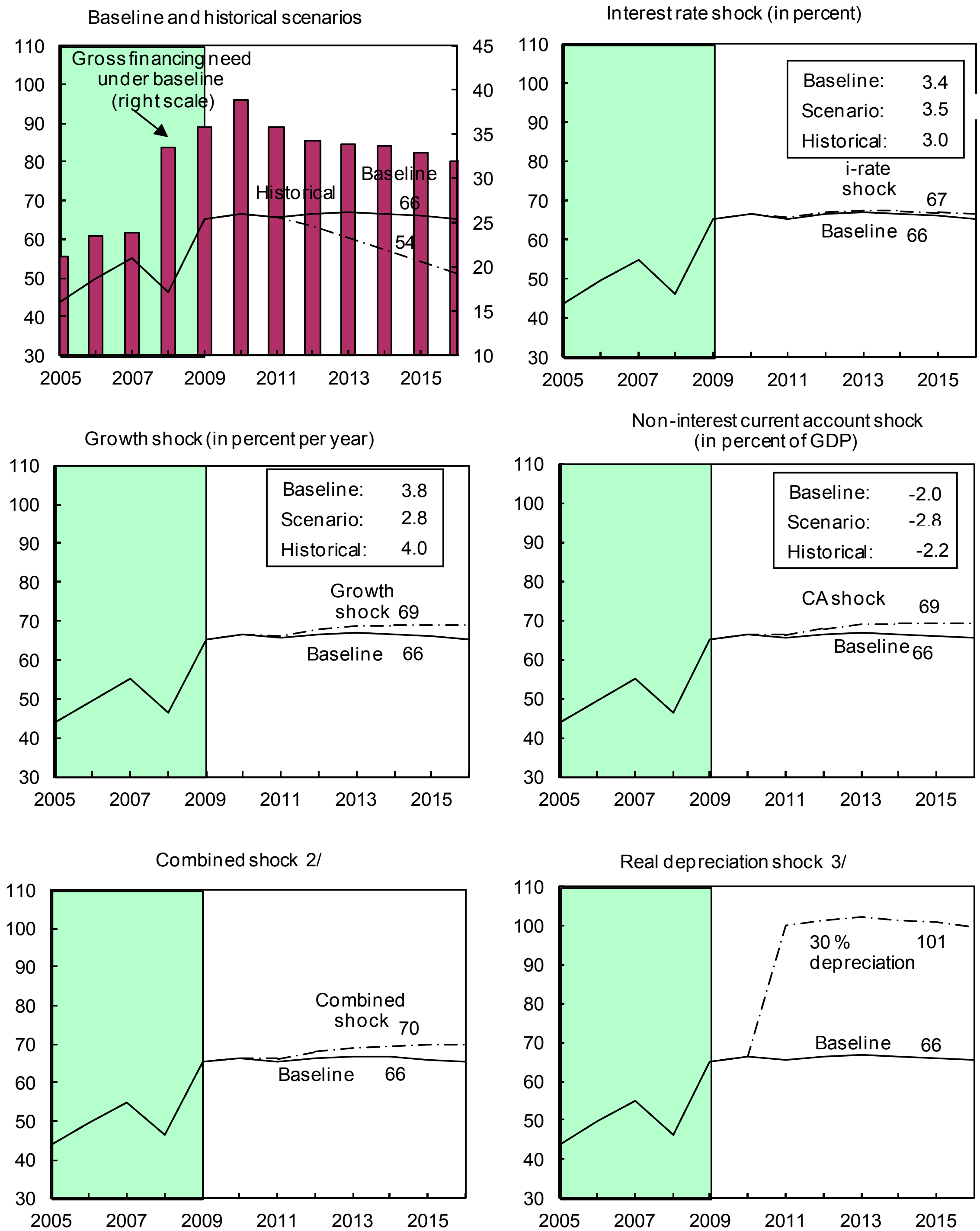
Sources: Eurostat; EU Commission; and OECD.

Figure 11. Poland: Product Market Indicators



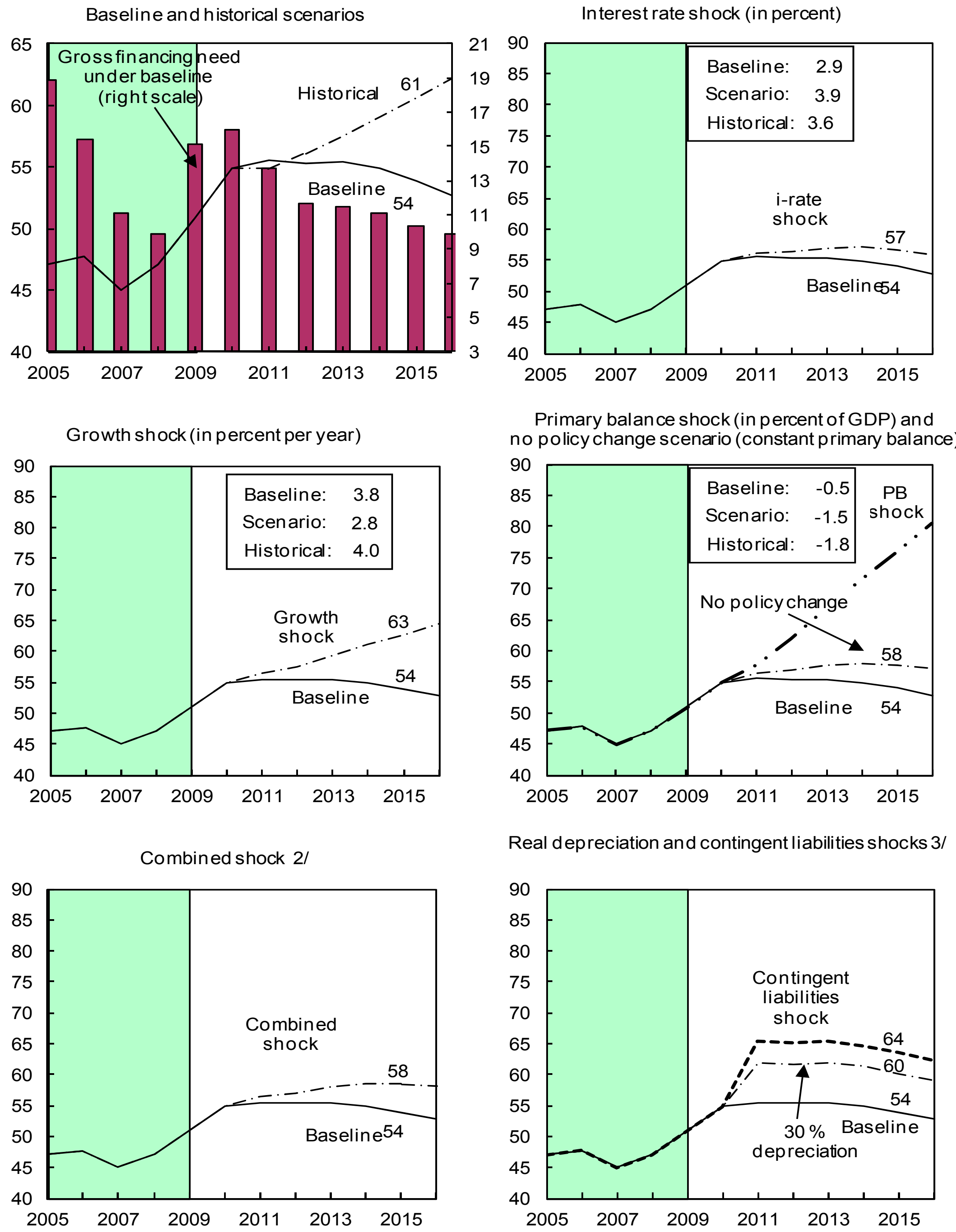
Sources: World Bank Doing Business; and OECD.

Figure 12. Poland: External Debt Sustainability: Bound Tests, 2005-16 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2010.

Figure 13. Poland: Public Debt Sustainability: Bound Tests, 2005-16 1/
(Public debt in percent of GDP)



Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2010, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 1. Poland: Selected Economic Indicators, 2009-13

	2009	2010 Est.	2011 Proj.	2012 Proj.	2013 Proj.
Activity and prices					
GDP (change in percent) 1/	1.6	3.8	4.0	3.8	3.8
Domestic demand	-1.1	4.4	3.5	3.8	3.7
Private consumption growth	2.0	3.1	3.2	3.2	3.3
Public consumption growth	2.0	4.0	0.6	1.7	1.6
Domestic fixed investment growth	-1.2	-1.0	8.5	6.7	6.5
Inventories (contribution to growth)	-2.5	1.9	-0.2	0.1	0.1
Net external demand (contribution to growth)	2.7	-0.6	0.5	0.0	0.0
Output gap	-1.2	-0.4	0.6	0.6	0.7
CPI inflation (change in percent)					
Average	3.5	2.6	4.2	2.9	2.6
End of period	3.5	3.1	3.8	2.6	2.5
Unemployment rate (average, according to LFS)	8.2	9.6	9.4	9.2	9.0
Public finances (percent of GDP) 2/					
General government revenues	37.2	37.8	40.0	40.6	41.0
General government expenditures	44.4	45.7	45.6	44.1	44.4
General government balance	-7.2	-7.9	-5.6	-3.6	-3.3
Structural primary balance adjusted for pension changes	-4.1	-5.2	-4.2	-2.7	-1.9
Public debt	50.9	54.9	55.5	55.3	55.4
national definition 3/	49.9	52.8	…	…	…
Money and credit					
Private credit (12-month change)	8.0	9.1	. . .	. . .	. . .
Broad money (12-month change)	8.1	8.6	. . .	. . .	. . .
Policy Rate 4/	3.8	3.5	4.5	. . .	. . .
Balance of payments					
Current account balance (transactions, millions U.S. dollars)	-9,598	-15,899	-20,135	-22,134	-24,532
Percent of GDP	-2.2	-3.4	-3.9	-4.1	-4.3
Exports of Goods (millions U.S. dollars)	142,085	162,267	190,421	203,785	215,321
Export volume growth	-6.8	10.1	7.8	6.4	6.4
Imports of Goods (millions U.S. dollars)	146,440	170,238	202,959	217,644	231,786
Import volume growth	-12.4	11.5	6.4	6.2	6.2
Net oil imports (millions U.S. dollars)	12,468	16,555	23,167	23,807	24,767
Terms of trade (index 1995=100)	100.7	99.5	96.7	96.3	95.4
FDI, net (in percent of GDP)	2.0	1.1	1.8	1.9	1.9
Official reserves (millions U.S. dollars)	79,591	94,725	100,668	104,592	107,951
In percent of short-term debt	79.1	82.7	102.5	110.7	111.9
Total external debt (millions U.S. dollars)	281,094	312,214	338,904	361,429	383,140
Percent of GDP	65.3	66.5	65.5	66.5	66.9
Exchange rate					
Exchange rate regime	Floating				
Zloty per US$, period average 5/	3.12	3.02	2.72	. . .	. . .
Zloty per Euro, period average 5/	4.33	3.99	3.93	. . .	. . .
Real effective exchange rate (INS, CPI based) 6/	105.5	112.1	. . .	. . .	. . .
percent change	-15.1	6.3			

Sources: Polish authorities; and IMF staff estimates.

1/ Real GDP is calculated at constant avergae prices of previous year.
2/ According to ESA95 (inc. pension reform costs). Including the 2011 budget and all announced measure as of March 2011.
3/ Excluding debts of the National Road Fund.
4/ NBP Reference Rate (avg). For 2011, as of June, 2011.
5/ For 2011, exchange rate as of June 14.
6/ Annual average (2000=100); for 2010, January-October average.

Table 2. Poland: Balance of Payments on Transaction Basis, 2009-16
(Millions of US dollars)

	2009	2010 Prelim.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.
Current account balance	**-9,598**	**-15,899**	**-20,135**	**-22,134**	**-24,532**	**-25,472**	**-27,280**	**-28,842**
percent of GDP	-2.2	-3.4	-3.9	-4.1	-4.3	-4.2	-4.2	-4.2
Trade balance	-4,355	-7,971	-12,537	-13,858	-16,466	-16,040	-17,010	-18,098
percent of GDP	-1.0	-1.7	-2.4	-2.6	-2.9	-2.6	-2.6	-2.7
Exports								
percentage change in unit values	-20.1	13.8	17.4	7.0	5.7	6.2	5.9	5.8
percentage volume growth	-6.8	10.1	7.8	6.4	6.4	6.4	6.4	6.4
growth in foreign demand	-17.7	14.9	7.7	5.1	5.3	5.2	5.2	5.2
Imports								
percentage change in unit values	-27.4	16.8	19.2	7.2	6.5	5.6	5.9	5.8
percentage volume growth	-12.4	11.5	6.4	6.2	6.2	6.5	6.7	6.7
growth in domestic demand	-1.1	4.4	3.5	3.8	3.7	3.8	4.0	4.0
Terms of trade percentage change	3.4	-1.2	-2.8	-0.4	-1.0	0.6	0.2	0.2
Services balance	4,795	3,489	4,252	4,476	4,419	4,937	5,221	5,503
Credit	28,986	32,480	38,815	41,540	43,891	46,602	49,331	52,168
Debit	24,191	28,991	34,563	37,064	39,472	41,665	44,110	46,666
Net Income	-16,575	-17,379	-18,036	-18,660	-19,201	-20,786	-22,805	-23,633
Net transfers	6,537	5,962	6,186	5,908	6,716	6,417	7,313	7,386
o/w EU receipts	4,610	5,150	5,279	5,918	6,756	6,508	7,029	7,099
o/w payment to EU	-5,194	-4,637	-5,241	-5,255	-5,207	-5,161	-5,119	-5,079
Capital and financial account balance	**43,475**	**48,524**	**43,569**	**43,550**	**45,382**	**45,693**	**47,079**	**48,469**
Capital account balance	7,040	8,668	9,059	10,163	11,614	11,172	10,319	10,216
o/w net EU transfers	6,911	7,688	8,761	9,821	11,212	10,800	9,999	9,899
Financial account balance	36,435	39,856	34,509	33,386	33,768	34,522	36,759	38,253
Foreign direct investment (net)	8,696	5,204	9,415	10,271	11,145	12,122	13,271	14,803
by nonresidents	13,796	9,947	11,165	12,271	13,395	14,622	16,021	17,553
o/w privatization	1,263	2,699	409	135	134	134	133	132
Portfolio investment (net)	16,051	26,617	21,587	18,573	17,090	16,216	15,399	15,358
by non-residents	16,315	27,536	22,543	19,566	18,120	17,284	16,507	16,451
o/w equities	1,579	7,739	7,246	6,769	6,323	5,900	5,512	5,150
Other investment (net)	13,380	8,759	3,507	4,543	5,534	6,183	8,090	8,092
Assets	5,275	-4,216	-7,886	-5,185	-4,381	-3,543	-1,678	-1,742
Liabilities	8,105	12,975	11,393	9,728	9,915	9,726	9,768	9,834
Financial derivatives	-1,692	-724	0	0	0	0	0	0
Errors and omissions	**-19,135**	**-17,491**	**-17,491**	**-17,491**	**-17,491**	**-17,491**	**-17,491**	**-17,491**
Overall balance	**14,742**	**15,134**	**5,943**	**3,925**	**3,359**	**2,730**	**2,308**	**2,135**
Financing								
Reserve assets	-14,742	-15,134	-5,943	-3,925	-3,359	-2,730	-2,308	-2,135
Memorandum items:								
Current plus capital account (percent of GDP)	-0.6	-1.5	-2.1	-2.2	-2.3	-2.4	-2.6	-2.7
Official reserves	79,591	94,725	100,668	104,592	107,951	110,682	112,989	115,125
in months of imports	6.5	6.7	6.0	5.8	5.6	5.4	5.2	5.0
Ratio of reserves to short-term debt 1/	79.1	82.7	102.5	110.7	111.9	109.5	108.7	107.1
Ratio of reserves to ST debt plus CA deficit 1/	70.5	71.0	84.1	89.0	88.7	87.0	85.8	84.1
Total external debt (percent of GDP)	65.3	66.5	65.5	66.5	66.9	66.6	66.0	65.4
Total external debt (percent of exports) 2/	164.3	160.3	147.8	147.3	147.8	146.9	145.9	144.8
External debt service (percent of exports) 2/ 3/	48.5	51.3	43.0	40.8	40.6	41.1	40.8	40.7
Gross FDI inflows (percent of GDP)	3.2	2.1	2.2	2.3	2.3	2.4	2.5	2.6
Net FDI inflows (percent of GDP)	2.0	1.1	1.8	1.9	1.9	2.0	2.1	2.2

Sources: National Bank of Poland; and IMF staff estimates.
1/ Reserve level at end of previous year over short-term debt by remaining maturity.
2/ Exports of goods and services.
3/ Excluding repurchase of debt and including deposits.

Table 3. Poland: General Government Revenues and Expenditures, 2009-16
(In percent of GDP, ESA95 basis)

	2009	2010 Proj.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.
General government revenue	37.2	37.8	40.0	40.6	41.0	40.8	40.9	41.1
Taxes	20.3	20.5	21.1	21.5	21.6	21.4	21.6	21.7
Indirect taxes	12.8	13.5	14.0	14.2	14.1	13.8	13.8	13.8
Direct taxes	7.4	6.9	7.1	7.3	7.5	7.6	7.7	7.9
Capital taxes	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social contributions	11.3	11.1	11.7	12.3	12.4	12.4	12.4	12.4
Other current revenue	4.9	5.0	5.3	4.9	4.9	4.9	4.9	4.9
Capital revenue	0.6	1.3	1.8	1.8	2.1	2.1	2.0	2.0
General government expenditure	44.4	45.7	45.6	44.1	44.3	43.8	43.3	43.2
Goods and services	5.6	6.2	5.8	5.8	5.8	5.7	5.7	5.7
Compensation of employees	10.2	10.1	10.1	9.8	9.6	9.3	9.0	9.0
Interest payments	2.5	2.7	2.7	2.8	2.9	2.9	2.9	2.9
Subsidies	0.6	0.5	0.5	0.2	0.2	0.2	0.2	0.2
Social benefits	16.9	17.0	16.7	16.1	16.2	16.1	16.0	16.0
Other current expenditure	2.3	2.8	2.7	2.5	2.4	2.3	2.3	2.3
Capital transfers and investment	6.2	6.4	7.1	7.0	7.3	7.2	7.2	7.2
General government balance	-7.2	-7.9	-5.6	-3.6	-3.3	-3.0	-2.4	-2.1
Memorandum items:								
Cyclically-adjusted balance	-6.8	-7.7	-5.8	-3.8	-3.6	-3.2	-2.5	-2.2
Primary balance	-4.7	-5.2	-2.8	-0.8	-0.5	-0.1	0.5	0.7
Cyclically-adjusted primary balance	-4.2	-5.1	-4.1	-2.2	-1.9	-1.4	-0.6	-0.2
Public debt	50.9	54.9	55.5	55.3	55.4	54.9	53.9	52.7

Sources: Eurostat; and IMF staff estimates.

Notes: The projections include measures announced to date.

Table 4. Poland: Medium-Term Scenario, 2008-16

	2008	2009	2010 Est.	2011 Proj.	2012 Proj.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.
Activity and prices									
GDP (change in percent)	5.1	1.6	3.8	4.0	3.8	3.8	3.7	3.8	3.8
Domestic demand growth	5.6	-1.1	4.4	3.5	3.8	3.7	3.8	4.0	4.0
Private consumption growth	5.7	2.0	3.1	3.2	3.2	3.3	3.3	3.3	3.3
Public consumption growth	7.4	2.0	4.0	0.6	1.7	1.6	1.6	1.6	1.8
Domestic fixed investment growth	9.6	-1.2	-1.0	8.5	6.7	6.5	6.5	7.0	7.0
Nominal GDP (zloty millions)	1,275	1,343	1,415	1,507	1,607	1,702	1,816	1,935	2,062
CPI inflation (average change in percent)	4.2	3.5	2.6	4.2	2.9	2.6	2.5	2.5	2.5
CPI inflation (end of period change in percent)	3.3	3.5	3.1	3.8	2.6	2.5	2.5	2.5	2.5
Unemployment rate	7.1	8.2	9.6	9.4	9.2	9.0	8.8	8.8	8.8
Gross domestic saving (ratio to GDP) 1/	19.1	18.1	17.4	17.7	18.2	18.7	19.4	20.1	20.9
Private savings	18.2	20.2	19.7	16.9	15.6	15.6	16.0	16.1	16.6
Public savings	0.9	-2.0	-2.3	0.7	2.6	3.2	3.5	4.0	4.3
Gross domestic investment (ratio to GDP)	23.9	20.4	20.8	21.6	22.3	23.0	23.6	24.4	25.1
Public finances (percent of GDP, ESA95) 2/									
General government revenues	39.5	37.2	37.8	40.0	40.6	41.0	40.8	40.9	41.1
General government expenditures	43.2	44.4	45.7	45.6	44.1	44.4	43.8	43.3	43.2
General government primary balance	-1.5	-4.7	-5.2	-2.8	-0.8	-0.5	-0.1	0.5	0.7
General government balance	-3.7	-7.2	-7.9	-5.6	-3.6	-3.3	-3.0	-2.4	-2.1
Public debt	47.1	50.9	54.9	55.5	55.3	55.4	54.9	53.9	52.7
Balance of payments (percent of GDP)									
Current account balance	-4.8	-2.2	-3.4	-3.9	-4.1	-4.3	-4.2	-4.2	-4.2
Capital account, net	1.2	1.6	1.8	1.8	1.9	2.0	1.8	1.6	1.5
Financial account, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total external debt	46.4	65.3	66.5	65.5	66.5	66.9	66.6	66.0	65.4

Sources: Polish authorities; and IMF staff estimates.

1/ Derived as total savings minus the current account minus capital transfers.

2/ The projections include consolidation measures that have beeen announced but not yet implemented. They do not inlcude additional measures that would be triggered under the Public Finance Act if debt (national definition) exceeds the 55 percent-of-GDP threshold.

Table 5. Poland: Financial Soundness Indicators, 2005-11

(In percent)

	2005	2006	2007	2008	2009	2010	2011Q1
Capital adequacy							
Regulatory capital to risk-weighted assets	14.5	13.2	12.0	11.2	13.3	13.8	13.7
Regulatory Tier I capital to risk-weighted assets	14.4	12.9	11.8	10.1	12.0	12.4	12.4
NPLs net of provisions to capital	11.9	11.6	11.4	12.8	25.8	29.8	30.4
Bank Capital to Assets	7.9	7.8	8.1	7.9	8.5	8.5	8.2
Asset composition and quality							
NPLs to gross loans	11.0	7.4	5.2	4.4	7.9	8.8	8.7
Sectoral distribution of loans to total loans							
Loans to households	52.6	56.7	59.3	61.4	65.2	68.4	67.9
Loans to non-financial corporations	47.1	43.0	40.4	38.2	34.8	31.6	32.1
Earnings and profitability							
Return on average assets (after-tax)	1.6	1.7	1.7	1.5	0.8	1.0	1.3
Return on average equity (after-tax) 1/	20.6	22.5	22.4	20.7	9.2	12.0	14.9
Interest margin to gross income	57.7	58.9	59.4	61.8	53.2	58.2	59.7
Noninterest expenses to gross income	72.3	69.6	68.7	60.6	62.8	59.7	57.4
Liquidity							
Liquid assets to total assets (liquid assets ratio)	21.2	20.1	17.1	17.0	20.5	21.4	23.4
Liquid assets to total short-term liabilities	29.6	28.1	24.2	24.7	28.2	29.0	30.5
Sensitivity to market risk							
Net open positions in FX to capital 1/	2.0	-0.1	0.6	0.0	4.1	0.3	0.2

Sources: National Bank of Poland; KNF; and IMF staff

1/ Data for domestic banking sector.

Table 6. Poland: External Debt Sustainability Framework, 2005-16
(In percent of GDP, unless otherwise indicated)

	Actual			Estimate		Projections							
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	43.7	49.6	55.0	46.4	65.3	**66.5**	**65.5**	**66.5**	**66.9**	**66.6**	**66.0**	**65.4**	**-4.2**
Change in external debt	-7.6	5.9	5.4	-8.7	18.9	1.2	-1.0	1.0	0.4	-0.4	-0.5	-0.6	
Identified external debt-creating flows (4+8+9)	-11.2	-7.3	-10.5	-8.9	9.2	-2.7	-2.1	-1.8	-1.6	-1.5	-1.5	-1.5	
Current account deficit, excluding interest payments	0.1	1.6	3.6	3.6	1.2	2.6	2.7	2.4	2.2	1.8	1.5	1.3	
Deficit in balance of goods and services	0.7	1.8	2.9	4.0	-0.1	1.0	1.6	1.7	2.1	1.8	1.8	1.8	
Exports	37.1	40.4	41.0	40.4	39.7	41.5	44.3	45.2	45.3	45.3	45.3	45.2	
Imports	37.7	42.2	43.9	44.4	39.6	42.4	45.9	46.9	47.4	47.1	47.1	47.0	
Net non-debt creating capital inflows (negative)	-3.8	-5.2	-5.5	-2.9	-3.6	-3.8	-3.6	-3.5	-3.5	-3.4	-3.4	-3.3	
Automatic debt dynamics 1/	-7.5	-3.6	-8.6	-9.6	11.6	-1.5	-1.2	-0.6	-0.3	0.1	0.3	0.5	
Contribution from nominal interest rate	1.1	1.2	1.2	1.2	1.0	0.8	1.2	1.7	2.1	2.4	2.7	2.9	
Contribution from real GDP growth	-1.5	-2.4	-2.7	-2.3	-0.9	-2.3	-2.4	-2.3	-2.4	-2.3	-2.4	-2.4	
Contribution from price and exchange rate changes 2/	-7.1	-2.4	-7.1	-8.6	11.5	...	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	3.6	13.2	15.8	0.3	9.7	3.9	1.2	2.8	2.0	1.2	1.0	0.9	
External debt-to-exports ratio (in percent)	118.0	122.9	134.3	114.7	164.3	160.3	147.8	147.3	147.8	146.9	145.9	144.8	
Gross external financing need (in billions of US dollars) 4/	64.7	80.2	101.8	177.3	154.1	182.2	185.6	186.0	194.5	204.1	211.5	217.5	
in percent of GDP	21.3	23.5	23.9	33.5	35.8	38.8	35.9	34.2	34.0	33.6	32.8	31.9	
Scenario with key variables at their historical averages 5/						**66.5**	**65.6**	**63.3**	**60.4**	**57.4**	**54.2**	**51.0**	**-7.2**
Key Macroeconomic Assumptions Underlying Baseline													
Real GDP growth (in percent)	3.6	6.2	6.8	5.1	1.7	3.8	4.0	3.8	3.8	3.7	3.8	3.8	
GDP deflator in US dollars (change in percent)	15.9	5.8	16.6	18.4	-20.0	5.0	5.9	1.3	1.5	2.3	2.1	2.1	
Nominal external interest rate (in percent)	2.5	3.0	3.0	2.8	1.8	1.3	2.0	2.7	3.3	3.8	4.2	4.7	
Growth of exports (US dollar terms, in percent)	18.2	22.6	26.2	22.8	-20.1	13.8	17.7	7.0	5.7	6.2	5.9	5.8	
Growth of imports (US dollar terms, in percent)	13.7	25.9	29.3	25.9	-27.4	16.8	19.2	7.2	6.5	5.5	5.8	5.8	
Current account balance, excluding interest payments	-0.1	-1.6	-3.6	-3.6	-1.2	-2.6	-2.7	-2.4	-2.2	-1.8	-1.5	-1.3	
Net non-debt creating capital inflows	3.8	5.2	5.5	2.9	3.6	3.8	3.6	3.5	3.5	3.4	3.4	3.3	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 7. Poland: Public Sector Debt Sustainability Framework, 2005-16
(In percent of GDP, unless otherwise indicated)

	Actual					Projections							
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	47.1	47.7	45.0	47.1	50.9	**54.9**	**55.5**	**55.3**	**55.4**	**54.9**	**53.9**	**52.7**	**-0.3**
o/w foreign-currency denominated	10.6	10.1	10.3	11.2	11.4	12.9	12.4	12.2	12.0	11.7	11.4	11.2	
Change in public sector debt	1.4	0.6	-2.8	2.1	3.8	4.0	0.6	-0.2	0.1	-0.5	-1.0	-1.2	
Identified debt-creating flows (4+7+12)	2.2	-0.9	-4.4	2.3	4.0	3.6	0.6	-0.2	0.1	-0.5	-1.0	-1.1	
Primary deficit	1.3	1.0	-0.4	1.5	4.7	5.2	2.8	0.8	0.5	0.1	-0.5	-0.7	
Revenue and grants	39.4	40.2	40.3	39.5	37.2	37.8	40.0	40.6	41.0	40.8	40.9	41.1	
Primary (noninterest) expenditure	40.6	41.2	39.9	41.0	41.8	43.0	42.8	41.3	41.5	40.9	40.4	40.3	
Automatic debt dynamics 2/	1.0	-1.9	-4.0	0.9	-0.3	0.1	-0.6	-0.7	-0.2	-0.6	-0.5	-0.5	
Contribution from interest rate/growth differential 3/	0.1	-0.8	-2.4	-1.3	0.2	0.1	-0.6	-0.7	-0.2	-0.6	-0.5	-0.5	
Of which contribution from real interest rate	1.6	2.0	0.5	0.9	0.9	2.0	1.5	1.3	1.7	1.4	1.4	1.5	
Of which contribution from real GDP growth	-1.6	-2.7	-2.9	-2.1	-0.7	-1.8	-2.1	-2.0	-2.0	-1.9	-2.0	-1.9	
Contribution from exchange rate depreciation 4/	0.9	-1.1	-1.5	2.1	-0.4	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	-0.4	-1.7	-1.6	-0.3	-0.2	0.0	0.0	0.1	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	-0.4	-1.7	-1.6	-0.3	-0.2	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	-0.8	1.5	1.6	-0.2	-0.2	0.4	0.0	0.0	0.0	0.0	0.0	-0.1	
Public sector debt-to-revenue ratio 1/	119.6	118.6	111.6	119.2	137.0	145.0	138.8	136.4	135.0	134.5	131.7	128.4	
Gross financing need 6/	18.9	15.4	11.1	9.9	15.2	15.9	13.7	11.7	11.5	11.1	10.3	9.9	
in billions of U.S. dollars	57.5	52.6	47.3	52.6	65.3	74.8	71.0	63.6	65.7	67.3	66.4	67.6	
Scenario with key variables at their historical averages 7/						**54.9**	**54.9**	**56.1**	**57.6**	**59.1**	**60.7**	**62.2**	**-0.1**
Scenario with no policy change (constant primary balance) in 2010-2015						**54.9**	**57.9**	**62.0**	**66.8**	**71.3**	**75.8**	**80.4**	**-0.5**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline													
Real GDP growth (in percent)	3.6	6.2	6.8	5.1	1.7	3.8	4.0	3.8	3.8	3.7	3.8	3.8	
Average nominal interest rate on public debt (in percent) 8/	6.5	6.1	5.4	5.4	5.7	5.6	5.3	5.4	5.5	5.6	5.6	5.7	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	3.9	4.6	1.4	2.3	2.1	4.1	2.9	2.6	3.4	2.7	2.9	3.0	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-8.3	12.1	19.5	-17.8	3.9	...	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	2.6	1.5	4.0	3.1	3.6	1.5	2.4	2.7	2.1	2.9	2.7	2.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	5.6	7.7	3.3	8.0	3.8	6.7	3.6	0.1	4.2	2.3	2.5	3.6	
Primary deficit	1.3	1.0	-0.4	1.5	4.7	5.2	2.8	0.8	0.5	0.1	-0.5	-0.7	

1/ General government gross debt, ESA95 definition.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Appendix I. Implications of Potential BOP Data Revisions for External Vulnerability[1]

Background. In their ongoing effort to reduce the large errors and omissions in the balance of payments, the Polish authorities have indicated that some of these errors may stem from items in the current account. In particular, preliminary analysis suggests the likelihood of large errors from two sources: under-reported imports of used cars, and over-stated private sector transfers. Revisions to these items could increase the reported current account deficit in 2010 by about 1–2 percentage points of GDP and by similar amounts in previous years. As a result, the current account deficit in 2010 could rise from 3.4 percent of GDP to about 4½–5½ percent of GDP, while errors and omission could decline by a corresponding amount. These revisions may occur as soon as the June 2011 BOP release.[2]

Implications for the medium-term BOP projections. Two alternative scenarios are developed to illustrate the impact of potential BOP data revisions on the BOP projections. These illustrative scenarios assume a 2 percentage point of GDP revision to the 2010 current account deficit, at the high end of the expected range:

Scenario 1: Adjustment factors are applied to the current account deficit and the errors and omissions item so that the current account deficit is 2 percentage points of GDP higher in 2010 and the errors and omissions are lower by the same amount on that year. Equal nominal adjustment factors are applied over the projection horizon.

Implications: The 2016 current account deficit is revised up from 4.2 percent of GDP in the baseline to 5.5 percent of GDP. Given that the nominal change in the current account is exactly offset by the change in errors and omissions, the overall balance in the BOP remains the same.

Scenario 2: In this scenario, imports in 2010 are revised up so that the current account deficit increases by 1 percentage point of GDP; for 2011 and beyond, imports are assumed to grow as in the baseline scenario. Net current transfers in 2010 are revised down by 1 percentage point of GDP and by equal nominal amounts over the projection horizon. Errors and omissions are revised down by 2 percentage points of GDP in 2010 and kept at the new nominal level in the projection years.

Implications: The medium-term current account deficit is revised up from 4.2 percent of GDP in the baseline to 6 percent. The higher current account deficit (compared to Scenario 1) is due to the impact of applying growth rates to a higher stock of imports in 2010. The higher current account deficit (as a percent of GDP) combined with the revised flat profile for errors and omissions (in nominal terms) would imply a smaller overall balance in the BOP. To maintain the same overall balance in the BOP as in the baseline, additional portfolio and other flows are assumed.

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[1] Prepared by Ricardo Llaudes.

[2] A recent STA technical assistance mission found that the methodology underlying the intended BOP revisions is based on appropriate compilation techniques and will improve Poland's BOP data (Informational Annex, Appendix II). The mission identified a few areas where research may prove useful in further improving BOP data.

Implications for the exchange rate assessment. A higher current account deficit in the medium term affects the exchange rate assessment under the macro-balance (MB) and external stability (ES) approaches, but not under the equilibrium real exchange rate (ERER) approach. Trade elasticities suggest that, for every 1 percentage point of GDP increase in the medium-term current account deficit, the level of misalignment under these two approaches increases by 3.4 percentage points. With the exchange rate assessed to be broadly in line with fundamentals based on existing data, the upward revision to the current account deficit in the medium term discussed above would have only a modest impact on the exchange rate assessment. Specifically, the zloty would go from being slightly on the undervalued side to being slightly on the overvalued side. Uncertainty about the trade elasticities implies that the impact of a higher current account deficit on the exchange rate assessment could be larger.

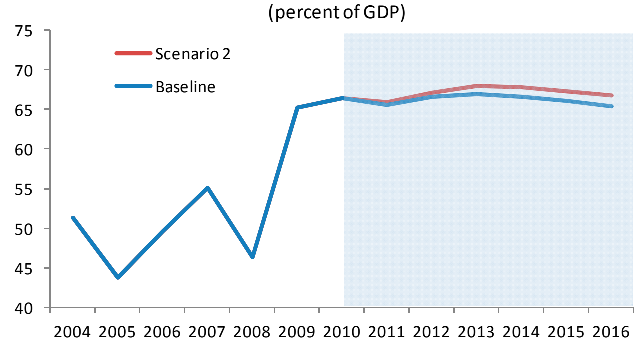
CGER Results, 2011
(Percent deviation from estimated equilibrium)

	Spring '11 baseline	Scenario 1	Scenario 2
Macrobalance approach (MB)	**5**	9	11
ERER approach	**-7**	-7	-7
External stability approach (ES)	**-3**	2	3
Average	**-2**	1	2
Adjusted MT Current Account[1]	**-2.7**	-4.0	-4.5
CA norm	**-2.2**	-2.2	-2.2

[1] Adjusted MT current account is the sum of the MT current account and the capital account. The CGER assessment incorporates this adjustment to reflect the availability of stable EU transfers to finance the current account deficit.

Implications for external debt sustainability. If the revised BOP projections imply a need for additional external financing (as under Scenario 2), the external debt projections will rise. Specifically, under Scenario 2, external debt would peak at around 68 percent of GDP instead of 67 percent of GDP (from 66.5 percent in 2010). Thus, the outlook for external debt would worsen only slightly.

Poland Gross External Debt
(percent of GDP)



Implications for gross external financing needs. A larger current account deficit would imply that Poland's gross external financing needs will be greater by an equivalent amount. An increase in the current account deficit by 2 percentage points of GDP would bring gross external financing needs from an average of around 110 percent of reserves over 2011–12 to around 120 percent of reserves over the same period.

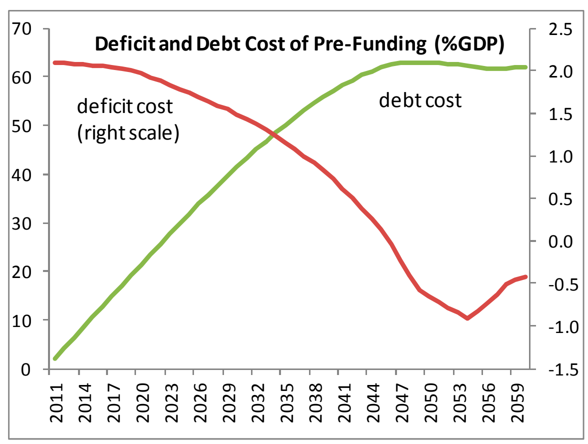
Appendix II. Pension Reform and Options for the Future[1]

Poland undertook a comprehensive pension reform in 1999 that resulted in the implementation of a multi-pillar pension system. The system is comprised of a first pillar pay-as-you-go notional defined-contribution public system; a private, mandatory, defined contribution, fully-funded second pillar system; and a voluntary private third pillar system. The overall social security contribution rate was unchanged, with more than half going to the public system, and the remainder directed to the second pillar. The reforms aimed to improve long-run sustainability, lead to better risk diversification, promote higher labor force participation and saving rates, and help with capital market development.

However, pre-funding entails large fiscal costs. Pre-funding of the private pension system resulted in a yearly deficit of about 2 percent of GDP in the public pension system. In the absence of fiscal consolidation, this deficit was financed by debt issuance, leading to an increase in debt of about 15 percentage points of GDP between 1999 and 2010. With continued debt financing of pension gaps, these costs would likely persist and add an estimated 60 percent of GDP to public debt during 2011–60.

Against this background, the government decided to shift about two-thirds of the contributions going to the private pension system back to the public system. The contributions to the private pension system would remain permanently lower (about half of their original size). These changes were motivated in part by the deterioration of public finances during the recent economic downturn, which, in Poland's case, contributed to the fiscal deficit exceeding the Maastricht limit and government debt (on the national definition) approaching the 55 percent of GDP debt threshold under the Public Finance Act.

To the extent that the pension shift improves government debt dynamics over the medium term, this may weaken the incentive to undertake needed fiscal adjustment. Also, if the second pillar system is significantly diminished, the potential benefits in terms of labor market incentives, international risk diversification, capital market development, and ultimately growth, would be forgone.



[1] Prepared by Delia Velculescu. See also forthcoming SIP entitled, "*Private Pension Systems in Emerging Europe: The Uncertain Road Ahead*."

Consequently, preserving the second pillar and supporting it with appropriate policies remain desirable. To realize the long-run benefits of a multi-pillar pension system, the second pillar should be preserved and complemented with policies that improve its efficiency:

- Pre-funding future liabilities will need to shift from full debt financing to a combination of fiscal consolidation measures and debt issuance, with the share of the two depending on available fiscal space. This will be essential to contain reform costs going forward, achieve inter-generational burden sharing of reform costs, and facilitate an eventual increase in the national saving rate.

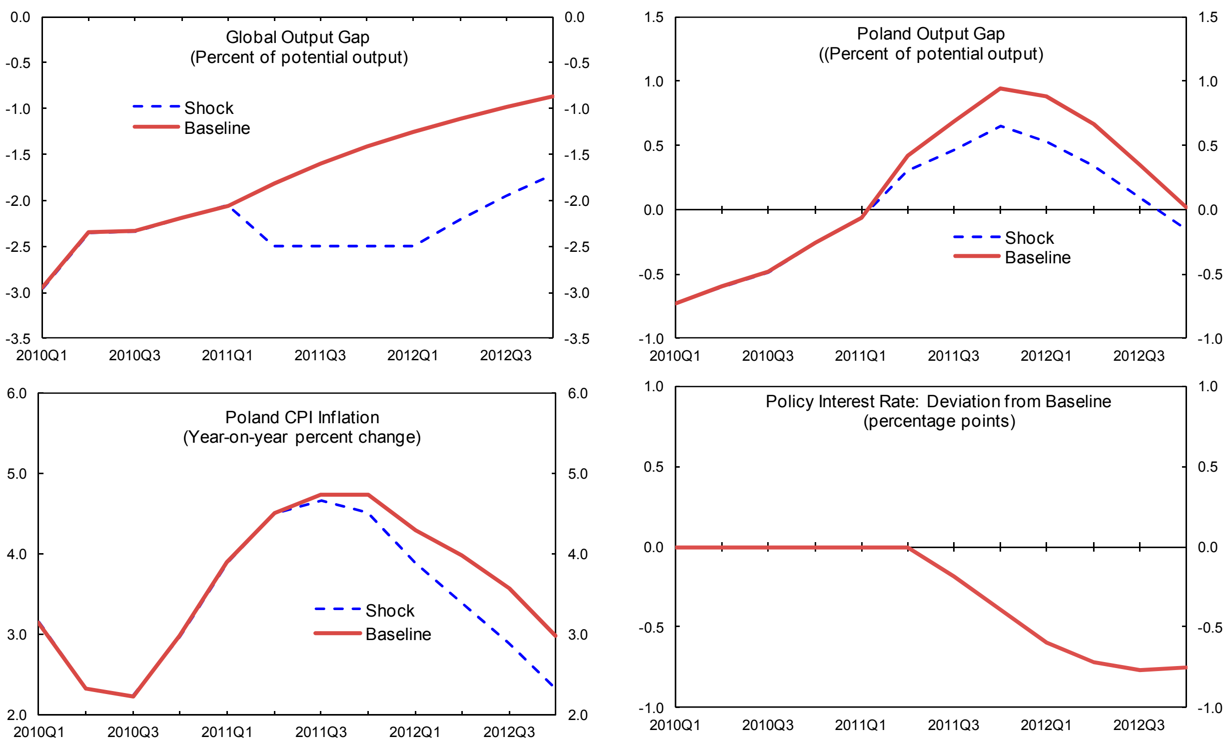
- Pension fund regulations and supervision need to be strengthened to ensure that fees and administrative costs are contained, while investments can be diversified and life-cycle portfolios developed. Moreover, solutions should be developed for the decumulation phase and for improving risk sharing arrangements for longevity and inflation risk.

Appendix III. Inflation Forecasting in Poland: A GPM Application[1]

Small projection models have become important in inflation forecasting and policy analysis in central banks in both advanced and emerging economies. Small models are relatively easy to implement and comprehensible to policy makers. The Fund's Global Projection Model (GPM) is one such model. Two key advantages of the GPM are that it produces an endogenous path for the policy interest rate and that it has a multi-country structure, which makes it well-suited to the analysis of global shocks.

Under the central model-based scenario, the policy interest rate in Poland is projected to increase by about ½ percentage point over the next four quarters. Inflation is projected to continue rise through 2011Q3 and then decline back toward the target next year. The output gap is expected to remain positive over the policy horizon.

If external demand from Poland's trading partners were to surprise on the downside, inflationary pressures in Poland would ease and the need for increases in the policy rate would diminish. Specifically, a negative 1 percent shock to the global output gap would lead to in a decline in Poland's output gap. As a result, inflation would fall more quickly and the policy rate could fall slightly from the current level.



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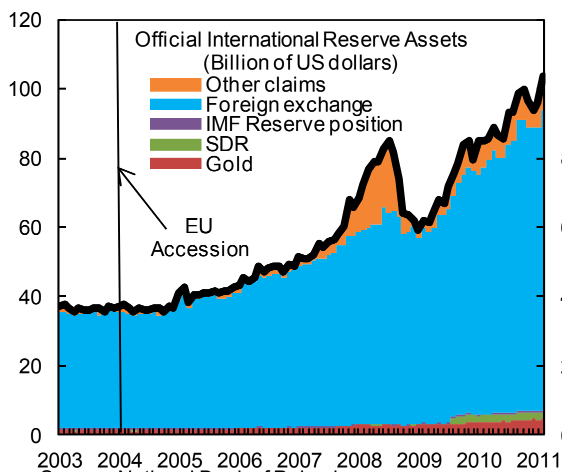
[1] Prepared by Natan Epstein. See also forthcoming SIP entitled, "*Inflation Forecasting in Poland: A Global Projection Model Approach*."

Appendix IV. Reserve Adequacy[1]

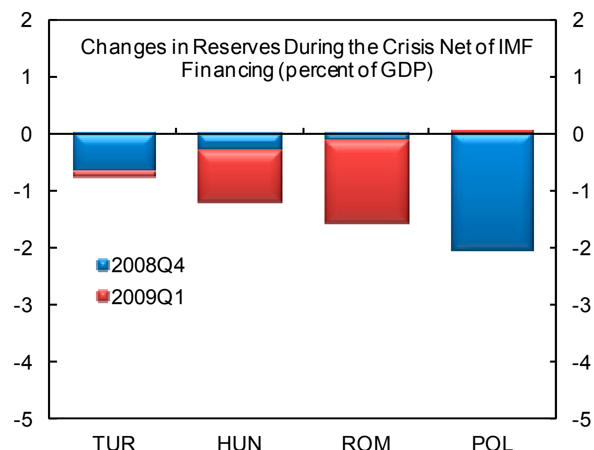
Using a variety of approaches to assessing reserve adequacy, staff considers that the balance of the evidence suggests that some additional reserve accumulation would be desirable. Indeed, reserves are projected to continue to increase.

Poland's international reserve assets increased from about $40 billion in 2004 to about $100 billion in 2010. Reserves have been on a steady upward path, except for the decline in reserves experienced during 2008–09. Stron

g inflows in the financial and capital accounts have contributed to the increase in reserves: (i) FDI inflows averaged about 5 percent of GDP during the 2004–07 period versus 3 percent in the preceding eight years; (ii) portfolio inflows have surged since the global crisis; and (iii) sustained and robust EU-related capital transfers now average about 1½ percent of GDP versus ½ percent of GDP in the years immediately after EU accession. During the peak of the global crisis, the decline in reserves in Poland (measured by the change in reserves as percent of GDP during 2008Q4-2009Q1) was about 2 percentage points of GDP, compared to an average of 1 percent of GDP in other emerging economies in Europe with flexible exchange rate regimes.



Source: National Bank of Poland.

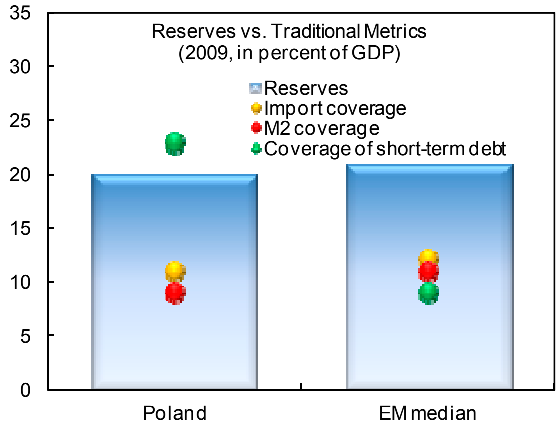


Source: "Assessing Reserve Adequacy" (SM/11/31).

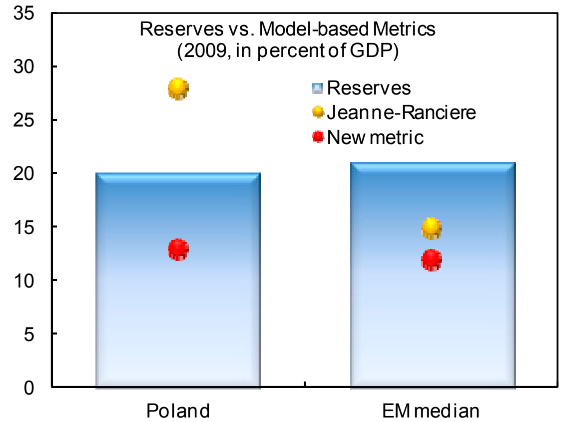
Poland meets some but not all of the benchmarks of reserve adequacy. At end-2010, reserves in Poland stood at about 20 percent of GDP, in line with the median for emerging economies.

Traditional metrics: Reserves amounted to about six month of imports and about 40 percent of broad money. However, reserves fell a little short of 100 percent of short-term external debt (the "Greenspan-Guidotti" rule), reflecting Poland's higher level of short-term debt compared to other emerging economies. Looking forward, reserves are projected to increase to 100 percent of short-term debt by end-2011.

[1] Prepared by Ricardo Llaudes. This appendix draws on "*Assessing Reserve Adequacy*".



Source: WEO, IFS and staff calculations.



Source: "Assessing Reserve Adequacy."

Model-based approach: The most widely-used model to assess reserve adequacy was developed by Jeanne and Ranciere (2006). In this model, reserves are assumed to cushion the fall in output when a sudden stop in capital inflows occurs. The optimal reserves level is determined by the size and probability of a sudden stop, the potential loss in output and consumption, the opportunity cost of holding reserves, and the degree of risk aversion. On this basis, Poland's reserves fell short of their optimal level by around 8 percent of GDP or about $35 billion as of end-2009.

New methodology developed by Fund staff: This new framework determines optimal reserve holdings on the basis of the capital outflows typically observed during periods of exchange market pressure and each country's vulnerabilities based on (i) their current export earnings (representing potential losses from a drop in external demand), (ii) stocks of external liabilities, and (iii) broad money (for capital flight risk). On this basis, Poland's reserves exceeded their optimal level by around 7 percent of GDP or around $33 billion.

Other considerations also suggest the need for additional reserve accumulation. Poland has strong trade links with the euro area and is also closely integrated into Europe's banking system. According to the BIS consolidated debt data, the euro area banking system holds about 75 percent of total external claims on Polish banks, with 25 percent of the total coming from Europe periphery's banks. Given this exposure to Europe's core and periphery, Poland's financial sector is vulnerable to contagion from financial strains and sudden changes in market sentiment. In this context, Poland's reserves cover around 30 percent of the country's liabilities with foreign banks. This is at the low end in relation to regional peers. Another source of potential vulnerability stems from the fact that Poland's relatively deep financial markets allow global investors to take a regional view by buying or selling Polish securities. The level of nonresident portfolio exposures has substantially increased over the past two years. Non-resident holdings of government debt are now at an all-time high of around 26 percent of the outstanding stock. This ratio is considerably larger than that in other countries that have also experienced a surge in capital inflows following the crisis, such as Brazil, Korea, or Thailand. In light of these potential risks and vulnerabilities, the Polish authorities have availed themselves of a Flexible Credit Line (FCL) with the IMF, an insurance-like arrangement that provides an additional line of defense should external pressures develop.

Appendix V. Improving the Banking Supervision Framework[1]

The Polish Financial Supervision Authority (the KNF) took over in January 2008 the banking supervision responsibilities from the Commission for Banking Supervision which functioned under the auspices of the National Bank of Poland. The KNF played an important role in preserving the banking system's stability through the financial crisis by persuading banks to retain 2009 profits and pro-actively issuing recommendations, including on tightening lending standards for consumer credits in 2010 and for FX mortgage lending in 2011. Nevertheless, the preliminary conclusions of the recent Basel Core Principles assessment suggest that the supervisory framework should be improved:

- ***Strengthening the supervisory approach through more frequent on-site inspections and a closer coordination between on-site and off-site supervision.*** KNF should perform annual on-site inspections in the largest banks as well as in other banks where particularly risky areas are identified. Also, KNF should improve the involvement of on-site supervisors in following up with post-examination recommendations and enhance supervisory methodologies to enable forward-looking bank interventions.

- ***Improving the communication with supervisory board members, external and internal auditors, and home supervisors.*** Frequent interaction with the banks' supervisory boards, as well as regular individual meetings with the internal and external auditors would provide KNF with additional insights into the changing risk profiles of banks between regular inspections and serve as a validation of supervisory findings. Taking part in supervisory colleges would need to be supplemented by more active participation in joint inspections and integration of home supervisory findings and risk assessments in the supervisory plan.

- ***Improving the Polish legislation to provide a formal foundation for sound and consistent requirements*** in a number of areas, including corporate governance (i.e. by introducing fit and proper criteria for members of the bank's supervisory board), major acquisitions by domestic banks, banks' holdings in nonfinancial entities, and bank resolution.

- ***Increasing the KNF's independence and enhancing its supervisory resources***. Moving to a system with full-time, remunerated external commissioners, appointed for cascading fixed terms, would improve the KNF's governance, which has seen high turnover since inception. Also, it is necessary to enhance the legal protection of supervisors, and broaden the power of KNF to issue binding resolutions. Finally, the KNF supervisory resources need to be enhanced to cope with additional pressures stemming from enlarging the scope of the oversight (i.e., bringing credit unions under the KNF's supervision, advancing consolidated supervision, putting in place Basel III); increasing the frequency of on-site inspections, and the implementation of more sophisticated supervisory methods (i.e. the new risk-based SREP process for off-site bank supervision).

[1] Prepared by Oana Nedelescu.

Appendix VI. Structural Reforms in Poland[1]

A. Product Markets

Potential growth could be boosted with product market reforms and continued privatization. Despite some recent progress, Poland lags regional peers in the World Bank's *Doing Business* index, with obstacles to construction permits, paying taxes, and starting a business looking particularly cumbersome (Figure 11). Similarly, the OECD's recent study of structural barriers to growth points to the detrimental impact of weak product market regulations, including large state involvement in network sectors like transport, energy, or communication.[2] Quantitative estimates by the OECD suggest that productivity gains from product market reforms would be the highest in Poland among OECD countries.

Key product market reforms include the following:

- *State ownership*: Privatization was accelerated in 2010, with receipts more than tripling on 2009. However, in a number of cases (e.g. energy and financial firms), the government retained control after selling minority stakes. The authorities also intend to reduce public control in the transport sector by selling the cargo part of railways and the national air carrier (see below).
- *Real estate*: The introduction of computerized land registers eased property registration, but building permits remain a bottleneck. The law replacing permits with notifications was enacted in 2009, but it was questioned by the Constitutional Tribunal and needs to be modified.
- *Starting a business*: One-stop-shop regulations did not accelerate business starts; plans to improve the regulations are not clear.
- *Tax payments*: The scope for electronic settlements has been significantly expanded, including e-invoicing of VAT starting in January 2011. At the same time, a recent MOF report on tax expenditures suggests that the tax system remains plagued with exemptions and reliefs, with a substantial room for improvement.
- *Ease of doing business*: The government has submitted to parliament a "de-regulation *package*" to ease business activity and lower its cost by, inter alia, limiting documentation and licensing requirements. However, the authorities recognize that further changes are necessary, and the Ministry of Economy is working on a second de-regulation package.

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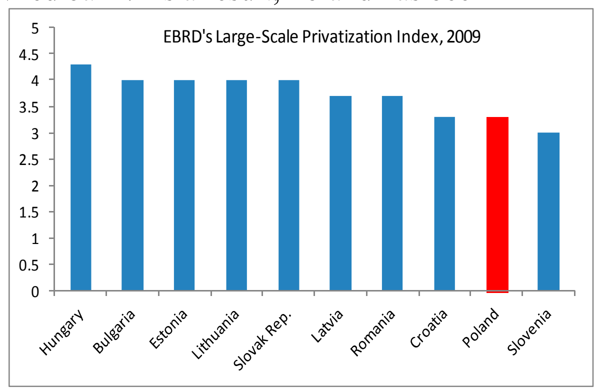
[1] Prepared by Robert Sierhej.

[2].See Bouis and Duval, "*A Quantitative assessment of the potential gains from various structural reforms in the OECD area and Beyond*", OECD, 2011.

Privatization in Poland

Early privatization efforts were significant, but tapered off subsequently. After an initial push in the 1990s—when over 70 percent of state-owned enterprises were fully or partially privatized in the process of transition to a market economy—the momentum slowed. Privatization remained limited during 2001–08, except for a few transactions in the financial sector, including a public issue of shares of PKO BP, the country's largest state-owned bank. As a result, Poland has been lagging its peers on privatization, according to the EBRD. A new and ambitious four-year privatization plan, envisaging the privatization of about 800 state companies from several business sectors, was adopted by the Council of Ministers in mid-2008. However, the start of the global crisis in late 2008 slowed implementation. Consequently, only modest revenues amounting to PLN 2.37bn and PLN 6.6bn were achieved in 2008 and 2009, respectively.



The government has recently revived its privatization agenda. Last year, privatization receipts amounted to PLN 22bn (1.6 percent of GDP), comprising almost 90 percent of the PLN 25bn target. In addition, the sale of an 84 percent stake in power group Energa to the state-controlled PGE (PLN 7.5bn expected revenues) was completed but did not receive approval from the competition regulator, though PGE appealed the decision. While about ½ of privatization receipts flow to special state funds—including the Demographic Reserve Fund—the rest goes directly to the budget. The privatization target set for 2011 is PLN 15bn.

Notable privatization operations in 2010

Firm name	Privatization method	Revenues
Power firm PGE	10 percent stake sale	PLN 4bn
Warsaw Stock Exchange	Floating on stock exchange	PLN 1.2bn
KGHM copper company	10 percent stake sale	PLN 2.2bn
Insurance group PZU	IPO	PLN 1.6bn
Power group Tauron	IPO (sale of 53 percent stake)	PLN 4.2bn

Privatization is expected to help reduce the government's borrowing needs in the short run, with efficiency gains expected to be limited. The broad goal of privatization of state-owned enterprises generally is to increase economic efficiency through increased competition, which, over time, leads to lower prices, improved quality, more choices, less corruption, and less red tape. It is also expected to attract FDI, and, with it, useful technology and know-how. In Poland's recent case, however, this motivation appears more limited, given that the state has continued to retain significant shares in the privatized enterprises and, in some cases, privatization entailed the purchase of shares in one state enterprise by another state enterprise (such as the pending Energa sale), which may result in a larger state monopoly. In this context, the recent acceleration of the privatization agenda has been partly associated with the government's general strategy to reduce its growing borrowing needs. While using privatization proceeds to finance the deficit is appropriate, the authorities should aim for reducing the share of state ownership in the economy in order to achieve full efficiency gains and improve its long-run potential growth.

B. Labor Markets

Despite recent improvement, low labor participation remains an obstacle to growth. The labor participation rate has increased since 2007, but remains below the level in neighboring countries.

Several measures have been implemented in recent years to boost labor participation:

- *Tax wedge*: Disability contributions were reduced from 13 percent to 6 percent of wages in 2007–08, followed by PIT rate cut in 2009. This lowered the tax wedge, but it still remains relatively high for low-income groups (Figure 10A).

- *Early retirement*: Overly generous early retirement provisions were reformed in 2009 (Figure 10B). First, the reform curtailed occupational privileges, with number of people eligible for early retirement declining by ¾ (to about 250,000). Second, the reform closed the window that allowed retiring five years before the statutory age (at 55 for women and 60 for men). Labor participation rates have already increased, especially among women.

- *Flexibility of employment:* While Poland's regulations on temporary employment appear restrictive compared to regional peers, the share of short-term job contracts is high (Figure 10B). In response to the crisis, the authorities further increased flexibility of temporary employment. The anti-crisis package, approved in 2009, allows unlimited number of temporary contracts if their total duration does not exceed 2 years. Available data suggest that it may have had positive impact on the labor market, although seasonal effects may have also played a role. This provision is set to expire at end-2011.

- *Unemployment benefits:* In 2010, the authorities introduced degressive unemployment benefits, which are higher in the first months and lower afterward. This measure is aimed to encourage more active job-seeking.

Looking forward, the policy challenge is to extend labor market gains without imposing a large burden on public finances. Such a strategy could be pursued on several fronts:

- *Deepening pension reforms*: A number of professions remain eligible for generous early retirement, including miners, military, police, and judiciary. They should be gradually brought into the regular pension system, which would not only improve activity rates, but also generate fiscal savings. Given the increasing life expectancy, the authorities could consider increasing the statutory retirement age, especially for women which retire at 60 (compared to 65 for men). Finally, agricultural employment in Poland is large (15 percent of the total at end-2009), with productivity in this sector being very low. Reforms of the special pension system for farmers should be tailored in a way that would encourage them to move to more productive sectors of the economy.

- *Active labor market measures*: As a part of fiscal consolidation, the government has reduced spending on active labor market measures from PLN7 billion in 2010 to PLN3 billion in 2011. The need for fiscal consolidation underlines the importance of reviewing the efficiency of various measures and improving their targeting.

- *Flexible employment regulations:* Finally, the authorities could also consider extending provisions of the anti-crisis package beyond 2011.

INTERNATIONAL MONETARY FUND

REPUBLIC OF POLAND

Staff Report for the 2011 Article IV Consultation—Informational Annex

Prepared by the European Department

June 15, 2011

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Appendixes

APPENDIX I. POLAND: FUND RELATIONS
(As of May 31, 2011)

I. **Membership Status**: Joined 6/12/1986; Article VIII

II. **General Resources Account**:

	SDR Million	Percent Quota
Quota	1,688.40	100.0
Fund holdings of currency	1,197.43	70.92
Reserve Tranche Position	490.98	29.08

III. **SDR Department**

	SDR Million	Percent Allocation
Net cumulative allocation	1,304.64	100.00
Holdings	1,170.14	89.69

IV. **Outstanding Purchases and Loans**: None

V. **Latest Financial Arrangements**:

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
FCL	1/21/2011	1/20/2013	19,166.00	0.00
FCL	7/02/2010	1/20/2011	13,690.00	0.00
FCL	5/06/2009	5/05/2010	13,690.00	0.00

VI. **Projected Obligations to Fund (SDR Million; based on existing use of resources and present holdings of SDRs):**

	Forthcoming				
	2011	2012	2013	2014	2015
Principal					
Charges/Interest	0.35	0.72	0.72	0.72	0.72
Total	0.35	0.72	0.72	0.72	0.72

VII. **Exchange Rate Arrangement**:

The zloty has floated freely since April 12, 2000.

Poland accepted the obligation of Article VIII, Sections 2, 3, and 4 on June 1, 1995. Poland maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for the exchange restrictions imposed by Poland solely for the preservation of national or international security as introduced by the European Union within the framework of the Common Foreign and

Security Policy. The consolidated list of such sanctions is available at: http://eeas.europa.eu/cfsp/sanctions/consol-list_en.htm.

VIII. **Article IV Consultation:**

The last Article IV consultation was concluded on May 7, 2010. In concluding the consultation, Directors commended the authorities for their swift and timely response to the global crisis. Directors considered that policy interest rates should not be raised at this stage, in view of the contained outlook for inflation and the excess capacity in the economy. On fiscal policy, Directors stressed the need to gradually start withdrawing the fiscal stimulus while carefully balancing short-term cyclical priorities and longer-term objectives. Directors recommended introducing a permanent fiscal rule with a deficit or debt anchor consistent with the authorities' medium-term targets. Directors considered that, although the financial sector has been well buffered, continued vigilance is necessary. Directors stressed that despite Poland's strong fundamentals, raising its exceptionally low labor participation rate remains critical to boosting long-term growth. They encouraged labor supply-enhancing reforms with complementary measures such as equalizing and gradually increasing the retirement age and merging special pension schemes with the general scheme.

IX. **Technical Assistance, 1992–2011**

Department	**Subject/Identified Need**	**Action**	**Timing**	**Counterpart**
MAE-Coordinated	Periodic visits by experts from central banks cooperating in providing technical assistance to the NBP under the coordination of MAE	Experts' visits	1992–94	NBP
MAE	Payments system, banking supervision, monetary research and analysis	Mission	May 1992	NBP
MAE	Review of progress in the modernization of operational functions	Mission	Oct. 1992	NBP
MAE	Resident expert-Advisor to President of NBP		Nov. 1991–92	NBP
MAE	Additional steps in the modernization process of the NBP	Mission	April 1993	NBP
MAE	Monetary programming and operations, and payments system	Mission	Nov. 1993	NBP

MAE	Central bank modernization	Mission	August 1994	NBP
MAE/LEG	Review of the exchange and payments system	Mission	February 1995	NBP/ MoF
MAE	Exchange rate system	Mission	March 1995	NBP
MAE	Review of government securities market, payments system and public debt management	Mission	August 1995	NBP/ MoF
MAE	Asset consolidation exercise visits	Expert	Late 1995	NBP
FAD	Tax administration (VAT) short-term assignments of field experts	Nine	August 1992– October 1994	MoF
FAD	Tax administration	Mission	November 1992	MoF
STA	Framework for monetary statistics	Mission	February 1993	NBP
STA	Framework for monetary statistics (follow-up)	Mission	November 1993	NBP
STA	Government finance Statistics	Mission	August 1995	NBP/ MoF
STA	Money and banking statistics	Mission	January 1996	NBP
STA	Government finance statistics	Mission	July 1996	NBP/ MoF
STA	Balance of payments statistics	Mission	November 1996	NBP/ MoF
STA	Balance of payments statistics Mission	Follow-up	April 1997	NBP/ MoF
STA	Review of progress in implementing the SDDS	Visit	February 1998	
FAD	Public expenditure management	Mission	April 1998	MoF
MAE	Operational aspects of monetary and exchange rate policy	Mission	September 1998	NBP
FAD	Tax administration	Mission	October 1998	MoF
FAD	Examination of impact on revenues of proposed tax reform	Mission	November 1998	MoF

FAD	Discussion of tax administration	Mission	March 1999	MoF
FAD	Tax administration seminar	Mission	April 1999	MoF
STA	Government Finance Statistics	Mission	October 1999	MoF/Local
FAD	Tax administration— Introduction of expert	Mission	November 1999	MoF
FAD	Administering Social Security	Mission	March 2000	MoF
IMF/IBRD	FSAP	Mission	May & Sept 2000	MoF NBP
MAE	Monetary Operations	Mission	July 2001	NBP
FAD	Expenditure restructuring	Mission	December 2001	MoF
MAE	Stress testing	Mission	January 2002	NBP
STA	Data ROSC	Mission	January 2003	CSO/ MoF/ NBP
STA	Government finance Statistics (GFSM 2001)	Mission	October 2003	MoF
STA	Government finance Statistics (GFSM 2001)	Mission	January 2005	MoF
IMF/IBRD	FSAP Update	Mission	April/May 2006	MoF NBP
FAD	Developing a Multi-annual Fiscal Framework	Mission	June 2008	MoF
STA	Errors and Omissions in Balance of Payments Accounts	Mission	July 2009	NBP
FAD	Medium-term fiscal framework	Mission	April 2010	MoF
STA	Errors and Omissions in Balance of Payments Accounts	Mission	June 2011	NBP

X. Resident Representative

Mr. Mark Allen, the Senior Regional Resident Representative for central and eastern Europe, took up his duties in Warsaw in June 2009.

APPENDIX II. POLAND—STATISTICAL ISSUES

As of June 14, 2011

I. Assessment of Data Adequacy for Surveillance
General: Data provision is adequate for surveillance.
National Accounts: The Central Statistical Office (GUS) compiles and disseminates annual and quarterly GDP at current and constant prices following 1993 SNA and ESA 1995. Moreover, a full set of accounts, including financial accounts by institutional sectors are compiled too. There are inconsistencies between annual and higher frequency data reflecting differences in weights and in coverage. Electronic retrieval of the data is challenging. The sub-annual data are collected on a cumulative rather than on a discrete basis, and plans to introduce proper benchmarking have been delayed. Seasonal adjustment on relatively short interval leads to frequent and large backward revisions. **Price Statistics:** The CPI does not cover the imputed rents of owner-occupied dwellings. The scope of the index covers all resident households, except those in some rural areas. The PPI does not include any estimation for missing prices or quality and seasonal adjustments.
Government Finance Statistics: General government data are released on a quarterly basis, and compiled on the same basis as the annual general government data, i.e. derived from detailed ESA accounts (ESA = European System of Accounts). Revenue and expense are available according to the full economic classification and, in addition, expense is also available according to COFOG (Classification of the Functions of Government). Further significant enhancements to government sources of data are necessary to comply with the accrual basis of reporting, and to compile full information on financial and nonfinancial asset stock data for general government.
Monetary Statistics: Beginning with data for January 2004, the NBP compiles monetary accounts in accordance with the ECB's framework for monetary statistics using the national residency approach. An earlier ROSC mission recommended that the NBP, in cooperation with the MoF, reconcile monetary and government finance statistics and carry out a reconciliation exercise on a regular basis.
Balance of Payments: Largely to improve data accuracy, the NBP reduced its reliance on International Transactions Reporting System (ITRS) data and increased its reliance on survey-based source data, starting in the first quarter of 2010; however, the size of errors and omissions remained unacceptably high. In 2009 and 2010, errors and omissions were larger than the current account deficit. STA undertook an evaluation mission to Poland in July 2009 (prior to the implementation of the new compilation system) to examine possible causes of the large and growing net errors and omissions. Among those potential sources were financial account transactions (by banks and nonbanks), goods imports, and weaknesses in data capture through the ITRS. During the 2011 IMF Spring Meetings, the NBP informed of data improvements work that the NBP and GUS had undertaken, and revisions that it anticipated incorporating in the external sector accounts at end-June 2011. A STA mission followed up on these issues during June 6-10, 2011. The mission concluded that the intended revisions to the Polish data are based on appropriate compilation techniques. The revisions would affect the estimates from 2004 forward. Poland has conducted much research into trade in used cars (imports of used cars from Germany may have been missed); remittances (incoming private transfers may be overstated and outgoing private transfers may be understated); repurchase agreements (a limited amount of double counting of financial transactions in repos may have occurred); and overseas assets of non-financial corporations (these may be misreported or missed). Further, the NBP's new survey-based compilation system has had an overall positive impact on data quality. The mission also advised that research may usefully be conducted into the valuation of exports and imports of goods and the coverage of derivatives transactions.

II. Data Standards and Quality	
Subscriber to the Fund's Special Data Dissemination Standard since April 17, 1996. Uses timeliness flexibility options for general and central government operations.	Data ROSC published on September 15, 2003.
III. Reporting to STA (Optional)	
Data for inclusion in the *Government Finance Statistics Yearbook* are reported to the Fund on a regular basis and, since 2004, according to the framework of *GFSM 2001*. Monthly cash data on consolidated core operations of the central government are reported in the *GFSM 2001* cash flow statement for the IFS.	

POLAND: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

AS OF JUNE 14, 2011

	Date of latest observation	Date received	Frequency of data[7]	Frequency of reporting[7]	Frequency of publication[7]	Memo Items:	
						Data Quality – Methodological soundness[8]	Data Quality Accuracy and reliability[9]
Exchange Rates	5/2011	6/7/2011	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	4/2011	5/20/2011	M	M	M		
Reserve/Base Money	4/2011	6/9/2011	M	M	M	O, LO, O, LO	O, O, O, O, O
Broad Money	4/2011	6/9/2011	M	M	M		
Central Bank Balance Sheet	4/2011	6/9/2011	M	M	M		
Consolidated Balance Sheet of the Banking System	4/2011	6/9/2011	M	M	M		
Interest Rates[2]	5/2011	6/6/2011	D	D	D		
Consumer Price Index	4/2011	5/13/2011	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q4/2010	5/5/2011	A	A	A	LO, O, O, O	O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	3/2011	5/24/2011	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	5/2009	6/15/2009	M	M	M		
External Current Account Balance	Q4/2010	4/6/2011	M	M	M	O, O, O, LO	O, O, O, O, LO
Exports and Imports of Goods and Services	Q4/2010	4/6/2011	M	M	M		
GDP/GNP	Q4/2010	3/3/2011	Q	Q	Q	O, LO, O, O	LO, LO, O, O, LO
Gross External Debt	Q1/2009	6/30/2009	Q	Q	Q		
International Investment Position[6]	Q4/2010	5/10/2011					

[1]Any reserve assets that are pledged of otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (state, budgetary funds, extra budgetary funds, and social security funds) and local governments.
[5] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[8] Reflects the assessment provided in the data ROSC or the Substantive Update published on September 15, 2003, and based on the findings of the mission that took place during January 8–22, 2003. for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[9] Same as footnote 8, except referring to international standards concerning (respectively) source data, assessment of source data, statistical techniques, assessment and validation of intermediate data and statistical outputs, and revision studies.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 11/86
FOR IMMEDIATE RELEASE
July 8, 2011

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2011 Article IV Consultation with the Republic of Poland

On July 1, 2011 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Poland.[1]

Background

The economic recovery gained momentum in 2010. Real GDP growth picked up to 3.8 percent, driven primarily by private consumption—in turn helped by a rebound in employment and wage growth during the second half of the year—and strong inventory accumulation. Fixed investment contracted, as robust EU-financed public investment was more than offset by weak private investment, as firms remained cautious about the outlook. Strengthening domestic demand reduced the contribution to growth from net exports, while the current account deficit increased to 3.4 percent of GDP. Recent improvements to the Balance of Payments compilation system lowered large errors and omissions, but increased the reported current account deficit.

The fiscal deficit widened to 7.9 percent of GDP, mainly reflecting the lagged effects of the economic slowdown on corporate income tax revenues, as firms continued to deduct earlier

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

losses. Government's financing needs were comfortably met in financial markets (with nonresident purchases of government bonds reaching an all-time high) and through privatization receipts. Substantial fiscal consolidation is under way, with consolidation measures amounting to 1½–1¾ percent of GDP per year planned for 2011–12.

CPI inflation increased to 5 percent in May-2011, well above the National Bank of Poland's (NBP) 2½ percent target. Inflation has been driven primarily by higher commodity prices, though core inflation (excluding food and energy) has been rising in recent months. In response to inflationary pressures, the NBP has hiked the policy rate since January-2011 by a cumulative 1 percentage point to 4½ percent. This puts the policy rate broadly in the neutral range (based on an estimated equilibrium real rate of 2¼ percent plus the 2½ percent inflation target).

The banking sector remained profitable and well capitalized in 2010, but credit quality deteriorated. Improving net interest margins boosted profitability and the average capital adequacy ratio rose to around 14 percent. Private sector credit grew by about 9 percent, with mortgage lending remaining strong, consumer lending falling, and corporate lending picking up. The nonperforming loan ratio rose to about 9 percent, but now appears to have stabilized. Recent stress tests by the NBP show that most banks are resilient to adverse shocks.

Executive Board Assessment

Executive Directors welcomed the return of Poland's economy to solid growth in 2010, supported by timely and forceful countercyclical policy responses to the global crisis. Directors observed that, with the economy gaining momentum, capacity constraints are emerging, inflationary pressures are rising, and the current account deficit is widening. At the same time, Poland remains vulnerable to contagion from regional financial strains. In this context, while agreeing that the Flexible Credit Line arrangement with the Fund continues to provide insurance against external financial risks, Directors highlighted the importance of maintaining disciplined macroeconomic policies and advancing growth-enhancing structural reforms.

Directors welcomed the substantial fiscal consolidation that is already under way. Given the narrowing output gap and increased external vulnerabilities associated with the upward revision to the current account deficit, they considered that additional front-loaded measures will be necessary to lessen the burden of monetary policy and put debt firmly on a downward path over the medium term. Directors supported the authorities' plan to adopt an expenditure-based fiscal rule, complemented by efforts to strengthen budgetary processes, tighten entitlement programs, and streamline the public administration.

Directors welcomed the recent increases in the policy interest rate. They noted that some further gradual hikes in the policy rate are warranted to bring inflation back to target, while efforts should continue to improve monetary policy communication. Directors encouraged the authorities to remain vigilant to developments in aggregate demand pressures and inflation expectations. A gradual exchange rate appreciation could be considered as part of the policy mix to deal with a potential surge in capital inflows. With international reserves still below short-term debt at remaining maturity plus the current account deficit, most Directors considered that some additional reserve accumulation would be desirable.

Directors commended the Polish authorities for the steps already taken to improve the effectiveness of financial sector surveillance policies. They encouraged further efforts to strengthen the resilience of the financial sector, including by further improving bank supervision, increasing the independence of the Financial Supervision Authority, developing a framework for coordinating policy responses to systemic risks, and strengthening the bank resolution framework. Directors looked forward to a Financial Sector Assessment Program update planned for next year.

Directors underscored that a further increase in labor participation and a reduction in product market rigidities are key to boosting potential growth. They recommended measures to improve labor supply with a complementary long-term fiscal effect, such as raising the retirement age and merging special pension schemes within the general system. Improving the business climate and advancing the privatization agenda remain priorities.

Directors welcomed recent improvements to the balance of payments compilation system, which have reduced errors and omissions. They encouraged the authorities to continue to build on this progress.

Poland: Selected Economic Indicators, 2007–11
(Data and projections as of June 14, 2011)

	2007	2008	2009	2010 Est.	2011 Proj.
Real economy (change in percent)					
Real GDP	6.8	5.1	1.6	3.8	4.0
CPI (average)	2.5	4.2	3.5	2.6	4.2
Unemployment rate (in percent)	9.6	7.1	8.2	9.6	9.4
Public finances (percent of GDP)					
General government balance 2/	-1.9	-3.7	-7.2	-7.9	-5.6
Public debt 3/	44.8	46.9	49.9	52.8	. . .
Money and credit					
Private sector credit (12-month change)	29.5	36.3	8.0	9.1	. . .
Broad money (12-month change)	13.4	18.6	8.1	8.6	. . .
Policy rate 4/	4.4	5.7	3.8	3.5	4.5
Balance of payments					
Current account balance (percent of GDP)	-4.8	-4.8	-2.2	-3.4	-3.9
Official reserves (billion U.S. dollars)	65.7	62.2	79.6	94.7	100.7
Total external debt (percent of GDP)	55.0	46.4	65.3	66.5	65.5
Exchange rate					
Exchange rate regime			Floating		
Present exchange rate			PLN 2.72 = US$1		
Zloty per US$, period average	2.77	2.41	3.12	3.02	. . .
Zloty per Euro, period average	3.79	3.55	4.09	3.94	. . .
Real effective exchange rate (INS, CPI based) 5/	113.2	124.2	105.5	112.1	. . .

Sources: Polish authorities; and IMF staff estimates.
1/ Derived as total savings minus the current account minus capital transfers.
2/ ESA95 definition.
3/ National definition.
4/ NBP Reference Rate (avg). For 2011, as of June.
5/ Annual average (1995=100).

Statement by Katarzyna Zajdel-Kurowska, Alternate Executive Director for the Republic of Poland and Beata Jajko, Advisor to the Executive Director
July 1, 2011

On behalf of the Polish authorities, we would like to thank staff for the constructive consultations held in Warsaw and the comprehensive set of papers. Our authorities broadly agree with the staff assessment and policy recommendations.

Economic Outlook

The economic recovery is gaining momentum, mainly due to robust domestic demand. Since mid-2010, the GDP growth rates (year-on-year) have been exceeding 4 percent, outpacing both market and authorities expectations. The main drivers of the economy remain private consumption stimulated by positive developments in the labor market, and EU-financed public investments. The external sector is benefiting from a rebound in Poland's main trading partners. The situation in the financial sector continues to be sound and investor confidence remains strong, attributable in part to the Flexible Credit Line arrangement with the Fund.

Fiscal Policy

Reducing fiscal imbalance and ensuring long-term fiscal sustainability remain the key priorities for the Polish authorities. The authorities are determined to reduce the general government deficit in line with the Excessive Deficit Procedure (EDP) by 2012 and committed to narrow the structural deficit towards meeting the medium-term objective, which would put the public debt firmly on the downward trend.

To this end, an ambitious fiscal consolidation package, which is mainly expenditure-driven, is being implemented aiming at reducing the structural deficit and enhancing the efficiency and structure of public spending. The fiscal measures for 2011–2012 amount to a total of 4.6 percent of GDP, of which 0.8 percent of GDP accounts to changes on the revenue side. The pace of consolidation and range of measures were designed to minimize possible adverse effects on economic growth.

The main measures under the fiscal consolidation package cover an implementation (effective since 2010) of an expenditure rule limiting the real annual growth rate of discretionary expenditure and new statutory expenditure to 1 percent. This temporary measure, in force until the EDP procedure is abrogated, will be replaced by a permanent expenditure-based rule allowing for counter-cyclical policy responses. The new rule will be at the core of changes in the fiscal framework, which also include strengthening the budgetary processes. Moreover, the already implemented amendments to the fiscal law have strengthened fiscal discipline in local governments and enhanced central government liquidity management. In addition, a portion of the pension contributions was shifted (effective May 2011) from the private to the public pillar of the pension system. Savings resulting from this shift should contribute to improvements in the general government balance by 0.6 percent of GDP in 2011 and an additional 0.5 percent in 2012. The implemented changes in the pension system will not cause delays in structural fiscal reforms which remain the priority of the authorities. These measures were supported by a reduction in a public wage bill; i.e. a freeze in public wages (except local governments) and a reduction of employment in the public administration.

Fiscal consolidation is at the core of the draft Budget Act for 2012 that was already adopted by the government in May 2011. The Polish authorities are strongly convinced that the implementation of the ambitious fiscal consolidation package will not only ensure long-term fiscal sustainability but also benefit the quality of public finances in Poland.

Monetary Policy

Recent CPI developments in Poland have been mainly influenced by external factors such as higher food and commodity prices but also one-offs, like the increase in VAT rate (January 2011) and statistical changes[1]. In May, headline CPI inflation reached 5 percent year-on-year, while the core inflation increased to 2.4 percent year-on-year.

In order to contain inflationary pressure and limit second-round effects, the Monetary Policy Council (MPC) has increased the reference rate by a cumulative 1 percentage point to 4.5 percent since the beginning of 2011. The MPC considers that the significant tightening of the monetary policy should bring the CPI inflation rate back to the target of 2.5 percent over the medium-term. The NBP forecasts indicate that the inflation rate would stay above the upper bound of the MPC target until the end of this year and move close to the target in 2012. The MPC continues to vigilantly monitor the economic and price developments and stands ready to act accordingly.

Balance of Payment

Significant progress has been made to address the long-standing problem of large errors and omission (E&O) in the balance of payments (BoP) statistics. An introduction of a new BoP reporting system and comprehensive work on possible sources of the E&O (supported by the Fund's TA mission) revealed that part of the E&O should in fact be reflected in the current account and financial account. The revised BoP data will be published on June 29, 2011. The major corrections would comprise an upward revision of the imports of used cars and a downward revision of private transfers (remittances and

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[1] Starting from January 2011 the Central Statistical Office changed the weights of items that are vulnerable to seasonal price changes (mainly fruit and vegetables) in the CPI basket to comply with the European Union standards.

compensation of employees). Although the revisions are unlikely to have any substantial impact on the GDP growth, they may influence the GDP structure.

Financial Market

The banking sector remains stable and profitable. Economic recovery and adequately enforced liquidity and capital standards, helped strengthen the capital base and stabilize the pace of deterioration in the quality of loans. The short-term liquidity position remains favorable; however, it is diversified among individual banks. The top-down stress-tests performed by the National Bank of Poland (NBP) and a bottom-up test by the Polish Financial Supervision Authority (KNF) proved that banks hold sufficient capital to absorb potential losses. Adequate capitalization and liquidity position, as well as efficient regulatory and supervision framework provide the financial sector with sufficient buffers against the sovereign debt crisis.

Further strengthening of financial stability is underway. In 2010 and 2011, the KNF tightened the regulations regarding both FX and domestic currency lending for households. Recently endorsed measures include among others a 50 percent limit for the share of exposures open to FX risk in a bank's portfolio of retail credit exposures to real estate; and a limit on the borrower's exposure to FX risk by ensuring conformity of the currency of exposure with the currency of income.

Prudential regulations imposed by the KNF contributed to a shift in the currency structure of mortgage lending. The share of domestic currency loans in new mortgage lending has increased substantially from about 20 percent in mid-2008 to about 80 percent end-2010. Preliminary data confirm that this upward trend continues in 2011.

The ROSCs of the Basil Core Principles and IAIS Insurance Core Principles took place in March 2011 and the FSAP update is planned for 2012. The authorities broadly agreed with the main findings of the draft ROSCs but at the same time expressed their reservations with regard to some of the conclusions and recommendations.