INTERNATIONAL MONETARY FUND

IMF Country Report No.15/182

REPUBLIC OF POLAND

July 2015

2015 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; INFORMATIONAL ANNEX; AND STATEMENT BY THE EXECUTIVE DIRECTOR

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2015 Article IV consultation with Poland, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 10, 2015 consideration of the staff report that concluded the Article IV consultation with Poland.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on July 10, 2015, following discussions that ended on May 18, 2015, 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 22, 2015.
- An **Informational Annex** prepared by the IMF.
- A **Statement by the Executive Director** for the Republic of Poland.

The documents listed below have been or will be separately released.

Republic of Poland—Selected Issues
Country Report on Inflation—Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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INTERNATIONAL MONETARY FUND
COMMUNICATIONS DEPARTMENT

Press Release No. 15/335
FOR IMMEDIATE RELEASE
July 14, 2015

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Concludes 2015 Article IV Consultation with the Republic of Poland

On July 10, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of Poland.

The economy has recovered from the 2012–13 slowdown. Growth accelerated to 3.4 percent in 2014, and further to 3.6 percent in the first quarter of 2015, on the back of buoyant domestic demand, supported by improving labor market and financial conditions. However, inflation has remained negative since July 2014 owing to low commodity prices and weak imported inflation. The current account deficit narrowed from 3.5 percent in 2012 to 1.4 percent in 2014, benefiting from strong exports.

The outlook is for continued robust growth and subdued inflation amid downside risks. Economic expansion is expected to continue, with growth projected at 3.5 percent in 2015 and over the medium term. External downside risks include a surge in global financial market volatility amid asymmetric monetary exit in advanced economies, continued geopolitical tensions in the region, and renewed sovereign stress or protracted low growth in the euro area. Domestically, inflation could fail to pick up owing to external factors or if low inflation expectations become entrenched. On the upside, a stronger-than-expected recovery in the euro area and low oil prices would further lift growth in Poland. Poland's Flexible Credit Line (FCL) arrangement with the IMF helps mitigate external downside risks.

Policies have focused on supporting growth and rebuilding policy buffers. Monetary policy has remained accommodative helped by a cumulative 100 basis points cut in the policy interest rate since October. Fiscal consolidation has advanced further, allowing Poland to exit the Excessive Deficit Procedure (EDP) one year early. The general government deficit, which declined to 3.2 percent of GDP last year, is expected to narrow further over the medium term. The banking sector has remained well-capitalized and resilient to shocks,

[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.

while reliance on foreign funding has declined. However, legacy vulnerabilities remain, including a sizable stock of foreign-currency loans and the still-elevated nonperforming loan (NPL) ratio.

Executive Board Assessment[2]

Executive Directors welcomed Poland's recovery from the 2012–13 slowdown, supported by very strong economic fundamentals and policies, which pave the way for continued robust growth and further integration with European and global markets. Poland's strong policy framework has also increased the economy's resilience. While the outlook is favorable, downside risks remain—including from volatile global financial conditions, geopolitical tensions, and sovereign stress in the euro area. Directors encouraged the authorities to further strengthen policy buffers and advance structural reforms to mitigate risks and ensure a durable and balanced recovery. They noted that the precautionary FCL arrangement continues to provide important temporary insurance against external risks.

Directors welcomed the March policy interest rate cut, which should help limit the risk of prolonged low inflation. While recognizing that low inflation so far did not appear to have negative effects on the real economy, Directors agreed that there may be a need to ease monetary policy further if inflation expectations continue to disappoint. Directors also recommended moderate reserve accumulation to strengthen the resilience to shocks.

Directors commended the continued strong performance of the banking sector, which remains well-capitalized, liquid, and profitable. They welcomed the new bankruptcy and insolvency law and encouraged the authorities to expedite implementation of other key financial sector reforms, including the adoption of comprehensive macroprudential and bank resolution frameworks. Directors recommended continued efforts to address legacy vulnerabilities from still-elevated levels of NPLs and the credit union segment, and supported the authorities' case-by-case approach to restructuring distressed Swiss-franc-denominated mortgages.

Directors commended the authorities' strong fiscal consolidation efforts, which allowed Poland to exit the European Union's EDP one year early. They considered that continued gradual consolidation would create additional policy space to allow for a timely and effective response to shocks without unduly weighing on growth. In this regard, Directors agreed that the medium-term objective of a structural deficit of 1 percent of GDP remains appropriate, and encouraged the authorities to identify specific expenditure savings and reduce the large VAT revenue gap to ensure that this objective will be met. Over the longer run, continued efforts to raise spending efficiency and reform of the special pension schemes would help to address fiscal pressures from population aging.

Directors encouraged the authorities to continue to implement structural reforms to boost productivity, safeguard competitiveness, and allow the economy to move up the value-added

[2] 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.

chain, thereby facilitating income convergence. They welcomed recent steps to streamline the list of regulated professions, reduce labor market segmentation, and ease administrative requirements for business start-ups. Directors advised that continued productivity gains would require promoting innovation, encouraging greenfield investment, and better targeting education and training to employer needs.

Poland: Selected Economic Indicators, 2012–15

	2012	2013	2014	2015
				Proj.
National Income, prices, and unemployment				
Nominal GDP (billion zloty)	1615.9	1662.7	1728.7	1791.1
Real GDP (change in percent)	1.8	1.7	3.4	3.6
CPI inflation (percent, average)	3.7	0.9	0.0	-1.0
CPI inflation (percent, end of period)	2.4	0.7	-1.0	-0.2
Unemployment rate (percent)	10.1	10.3	9.0	7.9
Public finances (percent of GDP) 1/				
General government revenues	39.2	38.2	38.6	39.1
General government expenditures	42.9	42.2	41.8	41.8
General government balance	-3.7	-4.0	-3.2	-2.8
Public debt	54.4	55.7	50.1	51.1
Money and credit				
Private sector credit (change in percent, eop)	2.4	4.5	7.6	7.5
Broad money (change in percent, eop)	4.5	6.2	8.2	7.3
Policy rate (percent) 2/	4.6	2.9	2.4	1.5
Balance of payments				
Current account balance (percent of GDP)	-3.5	-1.3	-1.4	-1.3
Official reserves (billion U.S. dollars)	108.9	106.2	100.4	104.4
Total external debt (percent of GDP)	73.8	72.7	64.3	72.9
Exchange rate				
Exchange rate regime				
Zloty per USD, period average 3/	3.3	3.2	3.7	3.1
Zloty per Euro, period average 3/	4.2	4.2	4.1	4.2
Real effective exchange rate (INS, CPI based) 4/	107.5	108.3	109.1	…

Sources: Polish authorities and IMF staff calculations.
1/ ESA2010 definition.
2/ NBP Reference Rate (avg). For 2015, rate as of June 4.
3/ 2015, exchange rate as of June 4.
4/ Annual average (2000=100).

INTERNATIONAL MONETARY FUND

REPUBLIC OF POLAND

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

June 22, 2015

KEY ISSUES

Context. The economy has recovered from the 2012–13 slowdown, supported by sound policies and improving external conditions. The outlook is for robust growth and subdued inflation but risks, although moderating, are tilted to the downside. Further structural reforms and stronger policy buffers will mitigate risks and ensure that the recovery is durable and balanced.

Interconnectedness. Poland's strong interconnectedness with Europe through both trade and financial linkages has facilitated growth and income convergence and reduced inequality. However, it also exposes Poland to external shocks that can propagate through substantial foreign participation in the government bond market and in the banking system.

Monetary policy. The recent policy interest rate cuts should help gradually return inflation to the target. However, the Monetary Policy Council (MPC) should stand ready to further ease monetary policy if inflation expectations were to disappoint.

Financial sector policy. The financial sector remains profitable, well-capitalized, and liquid. Credit growth is picking up in tandem with activity. Addressing legacy vulnerabilities and completing financial sector reforms would further buttress financial stability and support continued healthy credit expansion.

Fiscal policy. Gradual fiscal consolidation should continue to build policy buffers and address long-term aging-related contingent liabilities. The authorities should identify measures to underpin their fiscal plans.

Structural reforms. Over the past two decades, Poland succeeded in closing a quarter of its per capita income gap with the European Union (EU) average. Further boosting income levels and living standards requires structural reforms to move up the value-added chain and facilitate labor mobility to higher productivity sectors.

Approved By
Thanos Arvanitis and Sanjaya Panth

Ms. Zakharova (Head), Ms. Christiansen, Mr. Ebeke (all EUR), and Ms. Kyobe (SPR) visited Warsaw during May 7–18, 2015. The mission met with senior government and central bank officials and representatives from trade unions and the business community. Mr. Roaf (Senior Regional Resident Representative), Mr. Sierhej, and Mr. Krogulski (Resident Representative Office) participated in the discussions. Mr. Morán Arce, Ms. Nguyen, Ms. Moraes Rego, and Ms. Allison (all EUR) provided support from headquarters. Poland is an Article IV country and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for those solely for the preservation of national or international security (Informational Annex: Fund Relations). Data provision is adequate for surveillance (Informational Annex: Statistical Issues).

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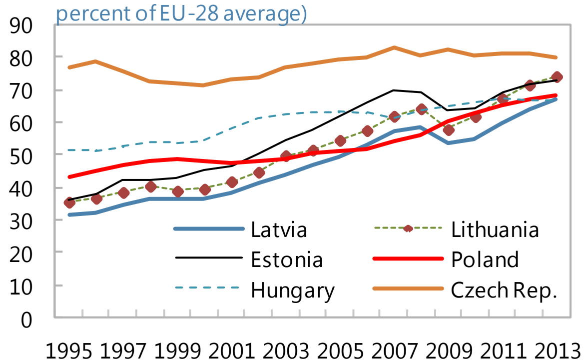
CONTEXT

1. **The economy has recovered from the 2012–13 slowdown.** Growth strengthened to 3.4 percent in 2014 on the back of buoyant domestic demand. Private consumption and investment continue to benefit from higher disposable income, eased financial conditions, and robust credit growth. Nonetheless, inflation has been negative since July 2014.

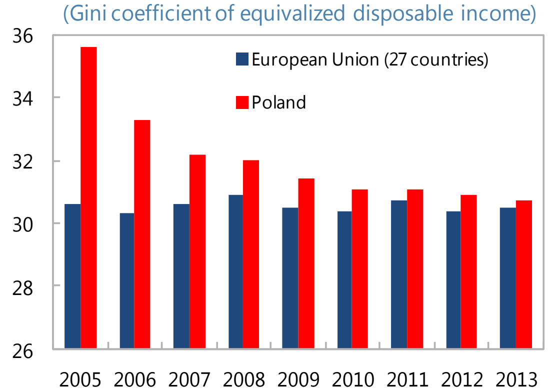
2. **Poland's integration with global markets has facilitated growth and income convergence.** Poland has developed strong trade and financial linkages with the euro area and has become an integral part of the German supply chain (Figure 1). This has led to substantial technological transfers and increased sophistication of domestic value added, with positive implications for productivity, competitiveness, and growth. Foreign investment in the manufacturing sector, stable inflows of intercompany lending, and EU structural funds helped expand the capital stock, further supporting growth. As a result, during the past two decades, Poland gradually closed a quarter of its per capita income gap with the EU average, while income inequality has declined to the EU average (see Appendix I).

Convergence Toward EU Average Income
(Purchasing power parity (PPP) income per capita as a percent of EU-28 average)



Sources: Eurostat and IMF staff calculations.

Income Inequality, 2005–13
(Gini coefficient of equivalized disposable income)

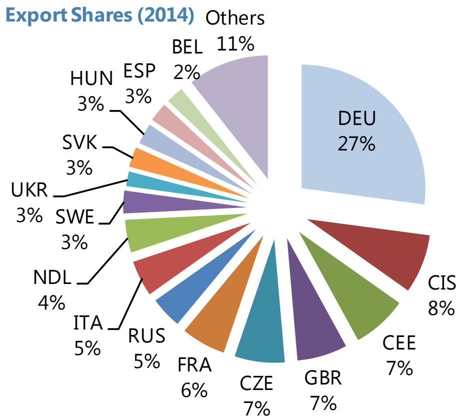


Source: Eurostat.

3. **However, the high degree of trade and financial integration also exposes Poland to external shocks.** Demand shocks in the euro area can propagate through substantial trade linkages. Exports to the EU represent 75 percent of Poland's exports and 65 percent of Poland's domestic value added embodied in exports is finally consumed in Europe. Global financial shocks can affect Poland through the substantial foreign investor presence in the government bond market (40 percent of domestic treasury securities are held by nonresidents) and in the banking system (about 60 percent of banking sector assets are held by foreign banks).

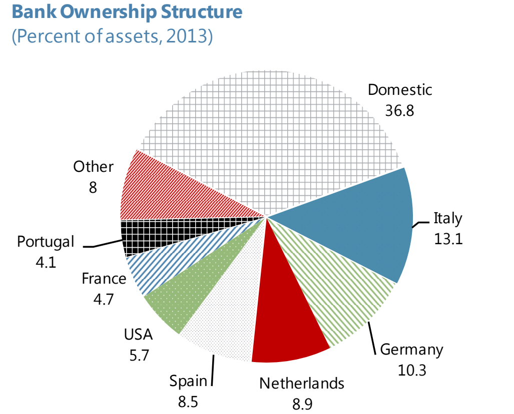
Poland: Trade and Financial Linkages

A large share of trade is with Europe…



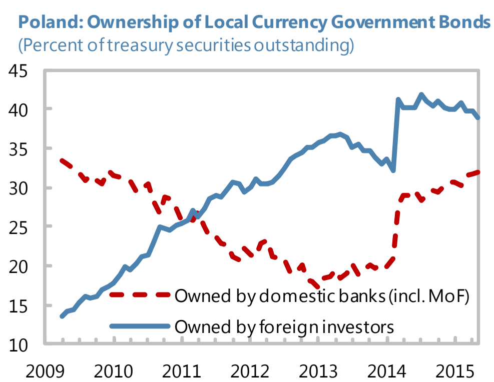
Source: IMF Direction of Trade and Statistics.

…and the banking system is largely foreign owned.



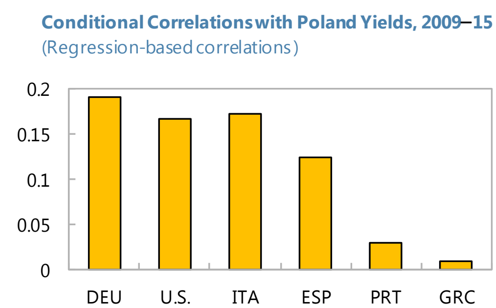
Sources: Polish Financial Supervision Authority (KNF) and IMF staff calculations.

Nonresidents hold a large share of domestic treasuries,…



Sources: Haver Analytics, National Authorities, and IMF staff calculations.

…increasing the comovement of Polish yields with global markets.



Correlations are based on estimates from regressions of weekly changes in Polish yields on changes in other countries' yields. For ITA, ESP, PRT, and GRC, the regression controls for DEU yields.

Sources: Haver analytics and IMF staff calculations.

4. So far, the economy has weathered well several bouts of market turbulence. Poland's very strong fundamentals and policies helped preserve investor confidence in the face of continuing geopolitical tensions in the region and episodes of emerging market volatility (Figure 2). The large share of the relatively stable intercompany loans in corporate debt, reduced reliance on parent bank funding, and a stable and diversified investor base in the domestic government bond market have helped mitigate the risks of capital flow reversals and dampened financial volatility. The Flexible Credit Line (FCL) arrangement with the IMF has provided additional insurance against external shocks.

5. Going forward, it will be important to continue building policy buffers to enhance resilience to shocks and implement structural reforms to complete convergence.

- **Policy buffers.** Much has been achieved in strengthening policy buffers. However, further effort is needed to create additional policy space to better cope with shocks. The fiscal deficit and public debt have declined, and Poland has exited the Excessive Deficit Procedure (EDP) one year earlier than expected. Nonetheless, public debt is still elevated. Continued gradual fiscal consolidation is needed to put it on a robust downward path. International reserves have increased and are broadly adequate on the IMF's modified metric for assessing reserve adequacy (ARA). Nonetheless, reserves continue to fall short on some metrics, including as a share of short-term debt. Effective financial sector oversight promoted strong capitalization in banks but work to adopt the bank resolution and macroprudential frameworks needs to be finalized.

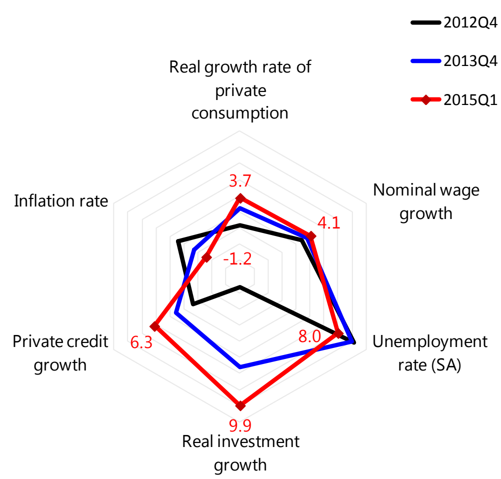
- **Completing convergence.** Accelerating economic convergence will require structural reforms to close productivity gaps, move up the value-added chain, and complete structural transformation of the economy.

6. **The near-term reform momentum is being dampened by political uncertainty.** The presidential elections in May were closely contested and ended with a decisive victory of the opposition, Law and Justice (PiS) party candidate. Parliamentary elections are scheduled to take place in the fall. In the meantime, and given the uncertainty and the ruling coalition's slim parliamentary majority, a slowdown of reform momentum is a risk.

RECENT ECONOMIC DEVELOPMENTS

7. **Growth continues to strengthen.** Real GDP growth reached 3.4 percent in 2014, up from 1.7 percent in 2013, supported by strong domestic demand. Higher disposable income—boosted by accelerating wages, falling unemployment, and declining prices—has buoyed private consumption. Investment has benefited from robust credit growth on the back of eased financial conditions. These trends have continued into the first quarter of 2015, with growth accelerating to 3.6 percent. High frequency indicators, including strong Purchasing Managers Index (PMI) readings, point to continued healthy economic expansion (Figure 3, Table 1).

Poland: Changes in Economic Indicators, 2012–15

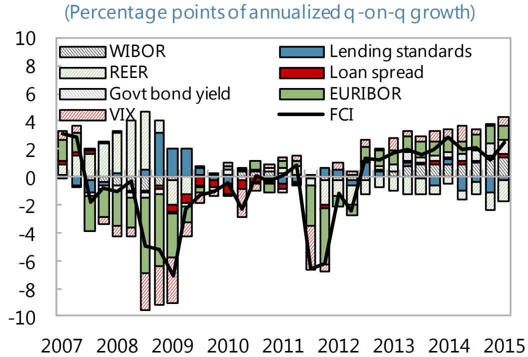


Sources: Polish authorities, Eurostat, and IMF staff calculations.

8. **Financial conditions have eased.** A cumulative 100 basis points (bps) cut in the main policy interest rate between October and March and low yields on local-currency government bonds reduced borrowing costs. In April, Poland became the first emerging market to issue foreign-currency denominated bonds at a negative yield helped by ample market liquidity following the

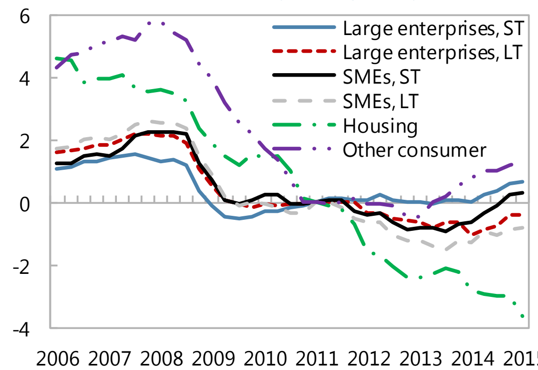
launch of the European Central Bank's quantitative easing (ECB QE) program. Credit expansion has been supported by recent easing of lending standards (except for housing loans, which saw tightening credit terms as loan-to-value (LTV) ratios were lowered), though these remain stricter than in the run-up to the global financial crisis. Equity prices have risen, benefiting from improved economic outlook and stronger equity fund flows. Volatility in international financial markets has recently increased, partly reflecting a correction of stretched bond valuations. Spreads of Polish and CE3 (Czech Republic, Hungary, and Slovakia) long-term government bond yields to German bunds have increased slightly while equity valuations have mainly followed the improved economic conditions.

Contributions to Financial Conditions Index
(Percentage points of annualized q-on-q growth)



Sources: Datastream, Haver Analytics, JP Morgan, NBP, Reuters, Statistics Poland, and IMF staff calculations.

Credit Standards on Loans (Cumulative change in percent balance in quarterly lending survey; 2011Q1 = 0)



Sources: Haver Analytics, NBP, and IMF staff calculations.

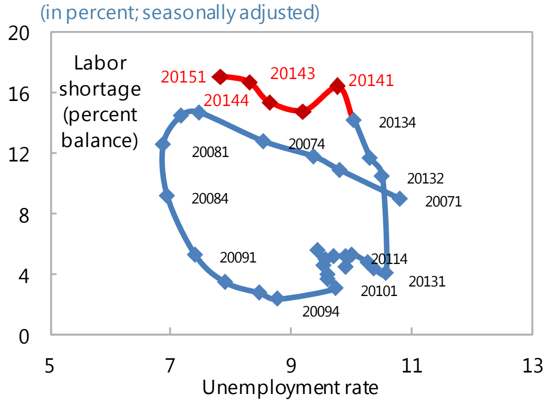
9. Labor market conditions have improved markedly. The seasonally-adjusted harmonized unemployment rate has fallen by about 3 percentage points from its early-2013 peak to 7.9 percent in April on the back of rising employment. Nominal wages accelerated to 4.1 percent in the first quarter along with rising job vacancies. Wage growth outpaced labor productivity growth, pushing up real unit labor costs.

Republic of Poland: Labor Market Developments

High vacancies amid declining unemployment point to continuing economic expansion…

…putting upward pressure on labor costs.

Poland: Beveridge Curve
(in percent; seasonally adjusted)



Source: Eurostat.

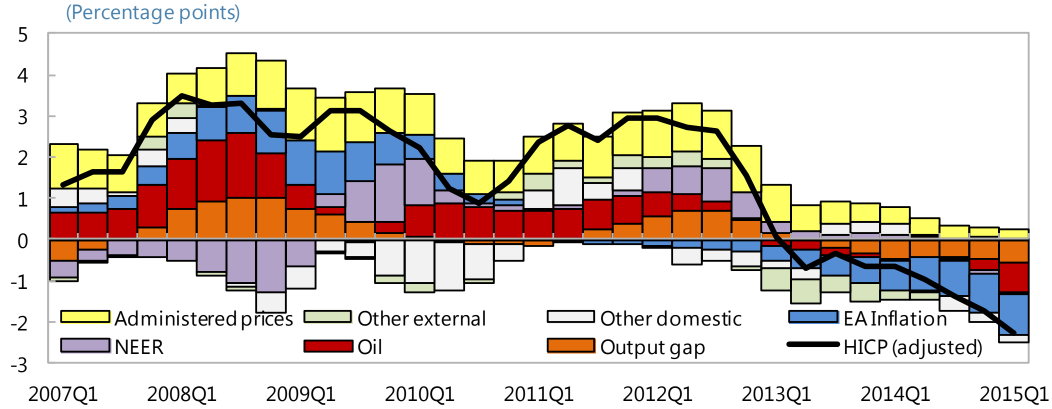
Poland: Labor Productivity and Wages
(year-on-year growth; percent)

Sources: Eurostat and Haver analytics.

10. Inflation remains subdued. Low commodity prices and weak imported inflation, including from the euro area, have kept headline inflation in negative territory. Nonetheless, the rate of deflation slowed from a historic low of -1.6 percent in February to -1.1 percent in April. Core inflation has remained weak and stood at 0.4 percent in April year-on-year, suggesting that negative external price shocks have fed into core inflation despite the rapidly closing output gap (text chart and Cross-Country Selected Issues Paper on Low Inflation in European Inflation Targeters).

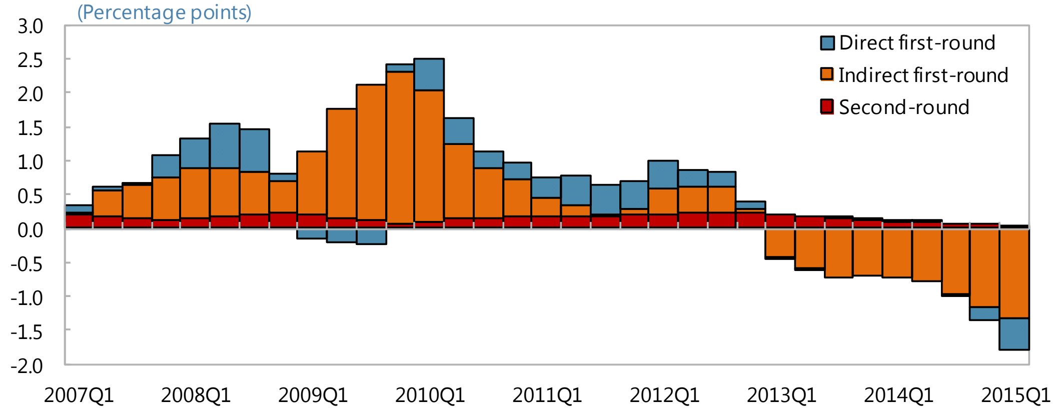
Republic of Poland: Inflation Decomposition

Poland: Inflation Decomposition
(Percentage points)



Source: Cross-Country Selected Issues Paper on Low Inflation in European Inflation Targeters.

Poland: Contributions from Oil, NEER, and Euro Area Inflation to Headline Inflation
(Percentage points)



Source: Cross-Country Selected Issues Paper on Low Inflation in European Inflation Targeters.

11. Poland's external position is consistent with medium-term fundamentals and appropriate policies. The current account deficit declined from 3.5 percent in 2012 to 1.4 percent in 2014, benefiting from strong exports to the euro area and increasing export shares outside Europe (Box 1). While lower oil prices provided a boost to the current account, this was more than offset by higher non-oil imports (Figure 4, Table 2). External debt and gross financing needs are high but vulnerabilities are mitigated by the high share of the relatively stable intercompany debt (Annex I).

Box 1. External Sector Assessment

The external position in 2014 is broadly in line with medium-term fundamentals and appropriate policies, though vulnerabilities exist. As of March 2015, it appears that the positive impact of lower oil prices on the trade balance is being more than offset by strong domestic demand growth and rising import demand, leaving the overall assessment of the external position unaffected.

Current account. The current account deficit declined from around 5 percent of GDP in 2010–11 to 1.4 percent of GDP in 2014. In 2015, the current account is projected to improve only marginally, despite the improvement in the oil trade deficit (3.4 percent of GDP in 2013) which is more than offset by higher non-oil imports due to strong domestic demand. The cyclically-adjusted current account balance is consistent with fundamentals and desirable policies.

Real exchange rate. The real exchange rate is assessed to be broadly in line with fundamentals and desirable policy settings. Alternative approaches suggest a modest undervaluation of between 2 and 11 percent (2 percent using the current account norm; the estimated undervaluation using the external sustainability estimate of the real effective exchange rate (REER) gap is 6 percent; and the estimated undervaluation using the REER index regression approach is 2 percent and 11 percent using the levels approach). Capital inflows following ECB QE action could result in appreciation of the zloty, though the 50 bps policy interest rate cut in March could mitigate the impact.

Capital and financial account. Portfolio inflows into domestic bond and equity markets have weakened in 2014. There has also been a decrease in foreign direct investment (FDI) flows, primarily reflecting high income repatriation, while EU funds—which finance the bulk of the current account—are stable. Although part of the decline in net FDI inflows was associated with one-off factors, going forward, financing of the widening current account could prove challenging should FDI inflows fall significantly below current projections.

Foreign assets and liabilities. Substantial net international investment position (IIP) liabilities have stabilized and stood at 60 percent of GDP in 2014. Associated vulnerabilities are mitigated by the large and diversified share of FDI liabilities and related intercompany lending (over 40 percent of foreign liabilities are FDI investments).

Reserve adequacy. Reserves are broadly adequate at about 114 percent of the IMF's modified composite reserve adequacy metric at end-2014.

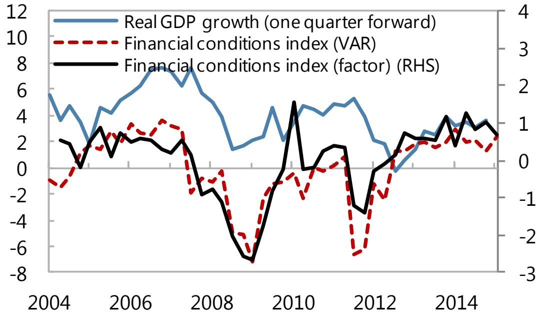
OUTLOOK AND RISKS

12. **The outlook is for continued robust growth and subdued inflation.** Healthy domestic demand is expected to maintain growth at around 3½ percent in 2015. Private consumption and investment will continue driving growth over the medium term, supported by falling unemployment, robust wage growth, and a moderate pick-up in credit growth. On the supply side, given adverse demographic trends, increasing labor participation (including of women), and boosting investment and productivity will be key to sustaining strong growth (see also Section D). Poland should continue to benefit from improved economic conditions in the euro area and higher EU structural funds. The output gap is projected to close in 2016. Nonetheless, continued low commodity prices and still-low imported inflation, combined with subdued inflation expectations, will contain inflation below the target band (1.5 to 3.5 percent) until late-2016 (Chapter I of Selected Issues).

Republic of Poland: Economic Outlook and Macro-Financial Linkages

Improved financial conditions…

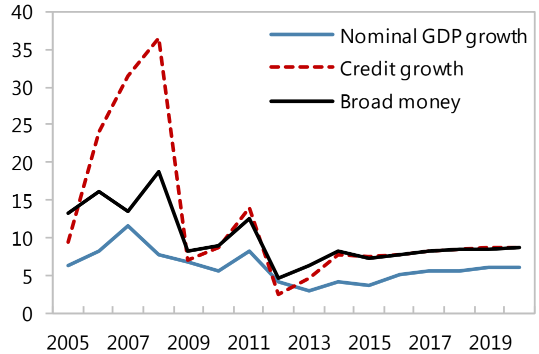
Financial Conditions Index (FCI) and GDP Growth
(Real GDP growth: yoy, percent)



Sources: Datastream, Haver Analytics, JP Morgan, NBP, Reuters, Statistics Poland, and IMF staff calculations based on Ho and Lu (2013), IMF Working Paper WP/13/252.

…and continued moderate credit growth…

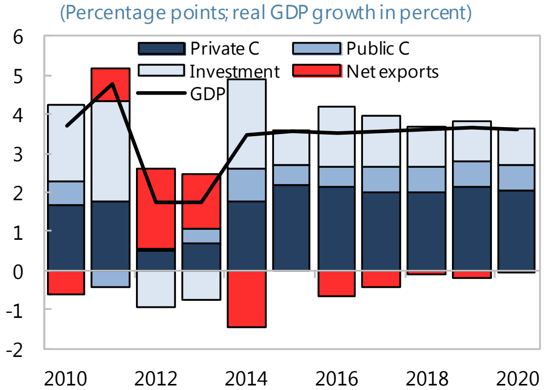
Macro-Financial Linkages in the Medium Term
(Percent)



Sources: IFS, NBP, and IMF staff calculations.

…should support domestic demand going forward.

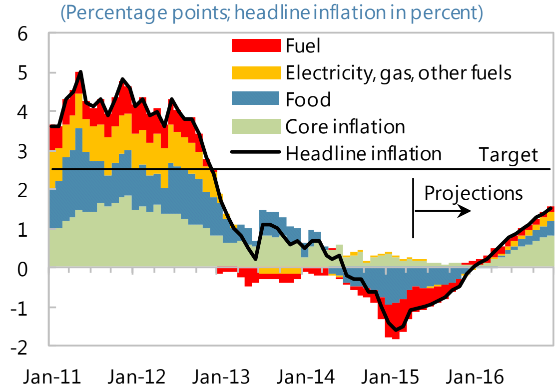
Contribution to Annual Real GDP Growth
(Percentage points; real GDP growth in percent)



Sources: Statistics Poland and IMF staff calculations.

Nonetheless, inflation would pick up only gradually.

Baseline Projections: Contributions to CPI Inflation
(Percentage points; headline inflation in percent)



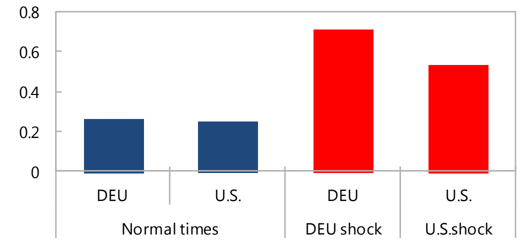
Sources: Haver Analytics, NBP, and IMF staff calculations.

13. Risks have somewhat receded but remain tilted to the downside (Table 3 with the Risk Assessment Matrix (RAM)).

External downside risks

- **Volatile global financial conditions.** Asynchronous monetary policies among major central banks could increase financial market volatility. Both push and pull factors could affect capital flows. On the one hand, ample liquidity in the context of the ongoing ECB QE, combined with strong economic fundamentals in Poland, could attract large capital inflows, potentially fueling asset price bubbles and sharp zloty appreciation, which could weigh on

Poland's Yield Correlations with Germany and U.S.
(Correlations of changes in 10-year gov. yields; Daily data 2013–15)

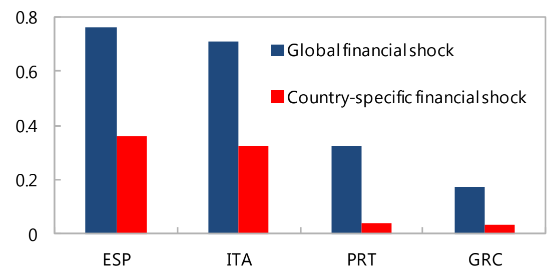


Note: Normal times defined as absolute values of daily changes in yields below 2 standard deviations in DEU and U.S. Shock represents observations greater than 2 standard deviations in each of these countries.
Sources: IMF staff calculations.

inflation. On the other hand, monetary policy tightening in the United States (U.S.) could result in capital outflows, zloty depreciation, and liquidity shortages. Staff analysis (text chart) suggests that the co-movement between Polish and U.S. yields increases sharply during episodes of market stress. However, risks of outflows are mitigated by a stable and diversified investor base, Poland's strong economic fundamentals, flexible exchange rate, and foreign exchange (FX) reserve buffers.

- **Sovereign stress (particularly in Greece) or a protracted slowdown in the euro area.** While direct linkages with Greece are limited, market pressure on the euro area from a protracted turmoil in Greece could spillover into Poland. Nonetheless, contagion to the rest of Europe and Poland could be reduced by strong policy action at the euro area level, including through liquidity support and deployment of existing firewalls. Moreover, correlation of Polish government bond yields with Greece during periods of stress has historically been limited. A protracted growth slowdown in the euro area could adversely affect Poland via strong trade and financial linkages.

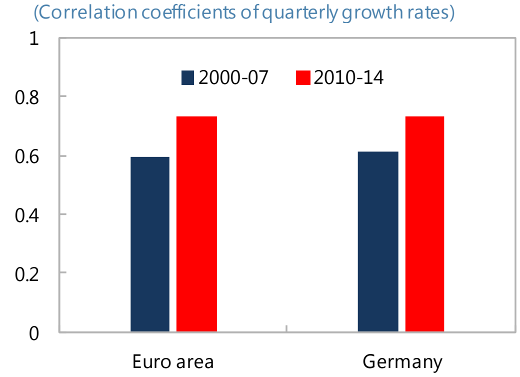
Correlations with Poland Yields during Stress Times, 2013–15
(Regression-based correlations)



Correlations are based on estimates from regressions of daily changes in Polish yields on changes in other countries' yields while controlling for DEU yields. Global and country-specific financial shocks represent periods of changes in yields greater than 2 standard deviations in the U.S. and each respective country.
Sources: Haver analytics and IMF staff calculations.

- **Conflict in Russia and Ukraine.** An intensification of tensions could disrupt imported gas supplies to Poland's heavy industry. While direct financial links are limited, spillovers could materialize through confidence channels, precipitating capital outflows.

Poland: Synchronization of Growth Rates
(Correlation coefficients of quarterly growth rates)



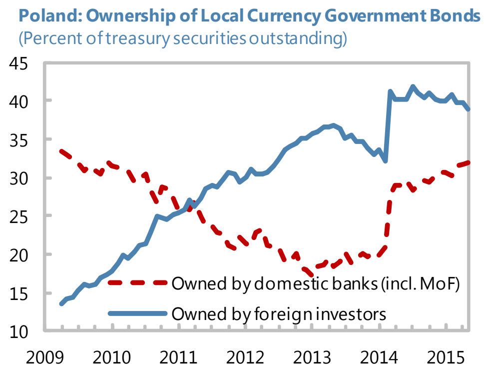
Sources: Haver analytics and IMF staff calculations.

External upside risks

- **Stronger trading partner growth.** A faster-than-expected recovery in the euro area on the back of ECB QE and low oil prices would help lift growth in Poland, given high synchronization of Poland's business cycle with Germany and the euro area.

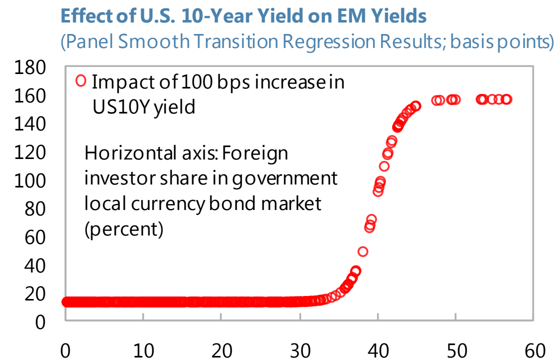
Republic of Poland: The Transmission of Global Shocks to Growth

Nonresidents hold a large share of treasury securities…



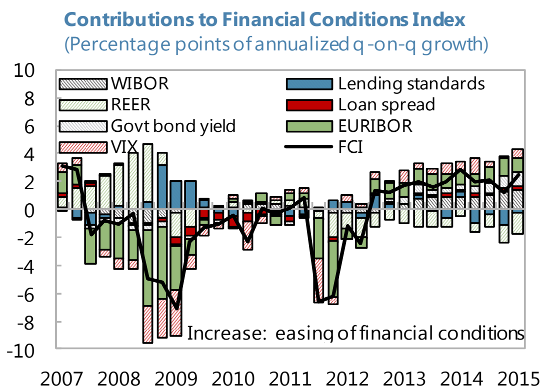
Sources: Haver Analytics, National Authorities, and IMF staff calculations.

…which can amplify the transmission of global financial shocks,..



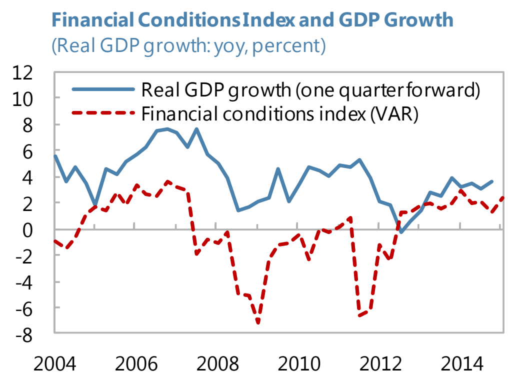
Source: Ebeke and Kyobe, forthcoming, IMF working paper, "Global Financial Spillovers to EM Sovereign Bond Markets; The Role of Foreign Participation and the Investor Base"

…increase interest rates, and tighten financial conditions.



Sources: Datastream, Haver Analytics, JP Morgan, NBP, Reuters, Statistics Poland, and IMF staff calculations.

In turn, this would hamper growth.



Sources: Datastream, Haver Analytics, JP Morgan, NBP, Reuters, Statistics Poland, and IMF staff calculations based on Ho and Lu (2013), IMF Working Paper WP/13/252.

Domestic risks

- **Prolonged low inflation in Poland.** Inflation could fail to pick up owing to external factors or if low inflation expectations become entrenched. Prolonged low inflation could ultimately have adverse balance sheet implications by reducing household debt tolerance, putting a dent in corporate and bank profits, and increasing government deficit and debt. In a tail risk scenario, this could result in an adverse loop of lower demand, higher nonperforming loans (NPLs), lower bank lending, and lower growth (Box 2 and Chapter II of Selected Issues).

- **Weaker impetus for structural reform.** Elections this year could delay some structural and financial sector reforms. Protracted reform delays could undermine potential output growth going forward.

Box 2. Republic of Poland: Balance Sheet Effects from Lowflation

Low inflation has so far had only limited economic impact in Poland. Strong economic activity on the back of healthy domestic demand and robust credit growth suggests that lowflation has so far not fed into the real economy. Private and public sector balance sheets are generally healthy and have weathered well two years of below-target inflation. Household debt has increased, but remains below debt tolerance thresholds. Public sector debt is on a declining path. Nonfinancial corporations and banks remain profitable.

However, prolonged low inflation could have negative economic repercussions. It could exacerbate existing pockets of vulnerability, including the rising household debt burden. In a tail risk adverse scenario, protracted lowflation could reduce household debt tolerance, put a dent in corporate and bank profits, and increase government deficit and debt. Such a scenario could result in an adverse loop of lower household consumption, weaker bank and corporate profits, declining investment, and lower domestic demand pulling inflation down further (Box Figure).

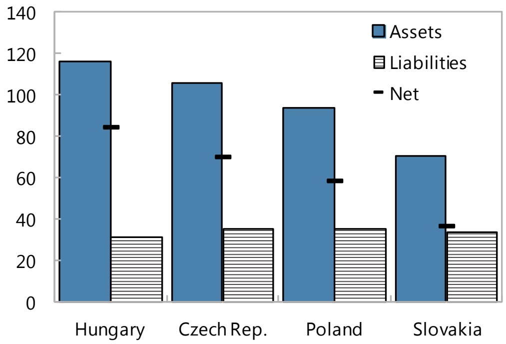
- **Households.** In the near term, low inflation combined with continued healthy wage growth increases disposable income, supporting private consumption. However, protracted lowflation could eventually feed into wages and reduce households' debt servicing capacity, ultimately resulting in lower consumption and higher NPLs.
- **Nonfinancial corporations.** In the short run, low inflation alongside still-sticky wages could reduce corporate profits. In an adverse scenario of prolonged inflation and sluggish disposable income, lower profits would induce firms to postpone investment, further reducing domestic demand.
- **Banks.** In the near term, lower interest rates could squeeze bank interest-rate margins. In an adverse scenario, lower demand for credit and rising NPLs would prompt banks to reduce credit supply.
- **Public sector.** While so far deflation has had limited impact on fiscal revenue, prolonged lowflation could reduce fiscal space and make it more difficult to achieve fiscal targets, potentially triggering procyclical fiscal consolidation. In turn, this could further harm growth.

Box 2. Republic of Poland: Balance Sheet Effects from Lowflation (concluded)

Republic of Poland: Low Inflation and Risks to Balance Sheets

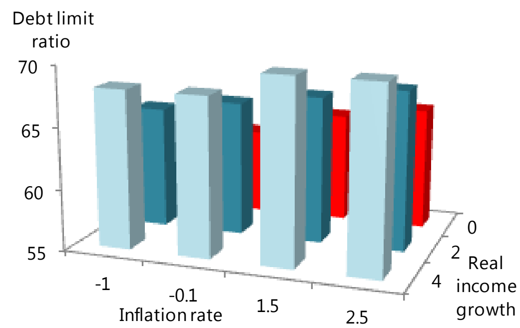
While household balance sheets are generally healthy,...

Household Balance Sheets, 2013
(Stock of financial assets and liabilities, percent of GDP)



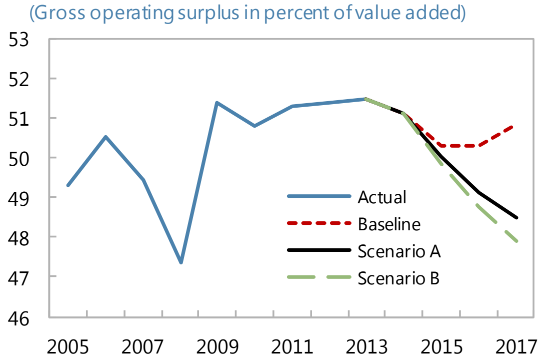
...risks from protracted lowflation include lower debt tolerance.

Household debt limits
(Percent of disposable income)



Corporations could also face reduced profits...

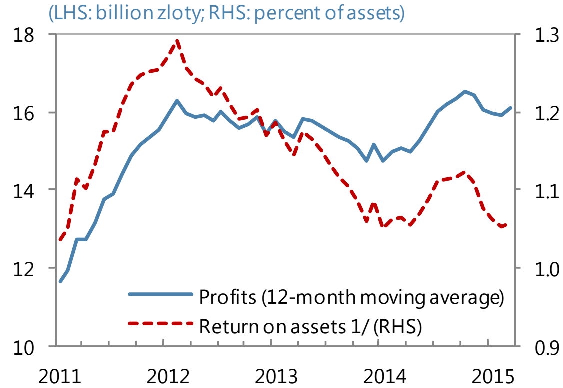
Scenario Analysis: Corporate Profit Share 1/
(Gross operating surplus in percent of value added)



1/ Scenario A: low inflation and robust growth. Scenario B: low inflation and growth.

...as could also banks.

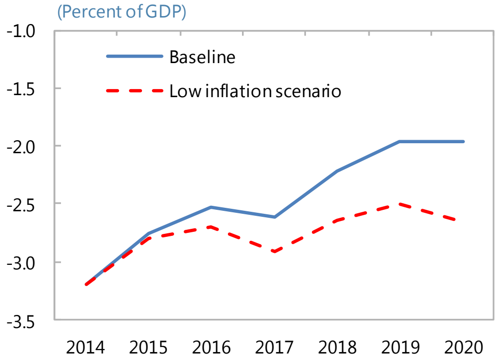
Banking Sector Profits
(LHS: billion zloty; RHS: percent of assets)



1/ 12-month profits in percent of 12-month assets.

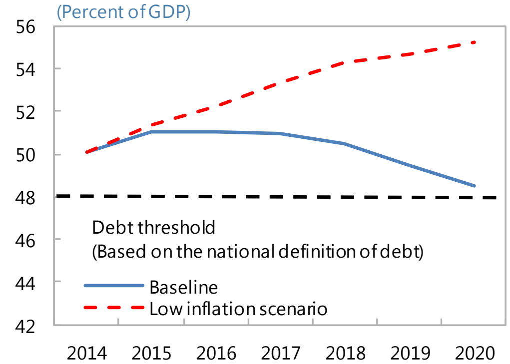
Alongside, there are risks to the public sector deficit...

Fiscal Balance
(Percent of GDP)



...which could result in an increase in debt.

Public Debt
(Percent of GDP)



Sources: Eurostat, Haver Analytics, KNF, NBP, Statistics Poland, and IMF staff calculations. See Chapter II of Selected Issues.

14. Appropriate policy response will depend on the nature of the risks:

- **In the event of severe external pressure, policies should focus on preserving financial stability.** The exchange rate should be allowed to play its cushioning role, while being mindful of the impact on FX denominated debt. Fiscal policy should allow automatic stabilizers to fully operate around the consolidation measures. In the event of significant capital outflows, Narodowy Bank Polski (NBP) should stand ready to provide liquidity, including in FX, to the banking sector as needed. In the event of excessive capital inflows and zloty appreciation, monetary policy should be eased and macroprudential policy should be tightened to manage risks to the financial system, arising from asset price bubbles and excessive credit growth.

- **While prolonged lowflation is still a relatively low risk, its potential impact nonetheless underscores the importance of closely monitoring developments.** If inflation fails to pick up, the NBP has ample policy space to cut rates further to avoid low inflation becoming entrenched in expectations. That said, the potential impact of lowflation on bank profits should be internalized in the authorities' routine stress tests. Fiscal risks from lowflation should be addressed by using conservative inflation projections in budget forecasts and identifying contingency measures to respond to potential inflation surprises.

Authorities' views

15. The authorities broadly shared staff's views on economic outlook and risks. They agreed that domestic demand will remain the primary driver of growth and that inflation will gradually converge to target over the medium term, although the Ministry of Finance (MoF) thought that inflation would pick up somewhat faster than in staff's baseline forecast. On risks, the authorities noted that Poland is well-positioned to manage excessive capital inflows or outflows given its flexible exchange rate, stable and diversified investor base, and strong fundamentals. Risks are further mitigated by a prudent debt management strategy, proactive pre-financing of this year's government external financing needs, and broadly adequate reserves. Contingency plans are in place to ensure timely response to external shocks, including through the use of reserves to curb excessive exchange-rate volatility and via emergency liquidity provision in zloty and FX to the banking system as needed.

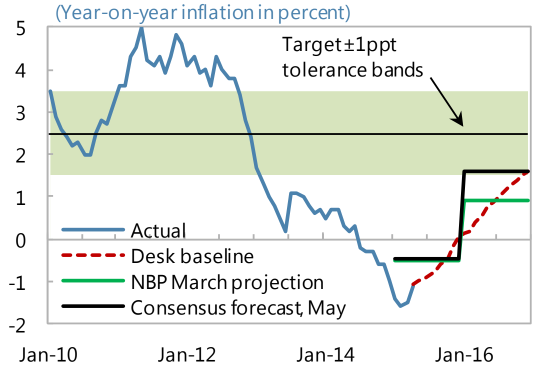
POLICY DISCUSSIONS: ADVANCING REFORMS TO PROMOTE STABILITY AND INCOME CONVERGENCE

16. Maintaining reform momentum is key to ensuring a durable economic recovery. Policies should focus on safeguarding economic stability and advancing structural reforms to encourage continued economic convergence (Table 4).

A. Maintaining Accommodative Monetary Stance to Guide Inflation to Target

17. Monetary policy was eased in March. Monetary policy has been complicated by Poland's tight integration with European and global markets. Inflation has been below the lower bound of the target band for more than two years and in deflation for ten months, largely reflecting declining commodity prices and low imported inflation. This has gradually pushed up real interest rates. The robust domestic demand has yet to lift core inflation and inflation expectations have declined (Figure 5). Against this backdrop, the MPC cut the policy interest rate in March by 50 bps to a historic low of 1.5 percent, bringing the cumulative reduction in the main policy interest rate since October to 100 bps (Figure 6). A draft law on changes to the NBP law, including staggered terms for MPC members, is progressing.

Inflation Projections
(Year-on-year inflation in percent)



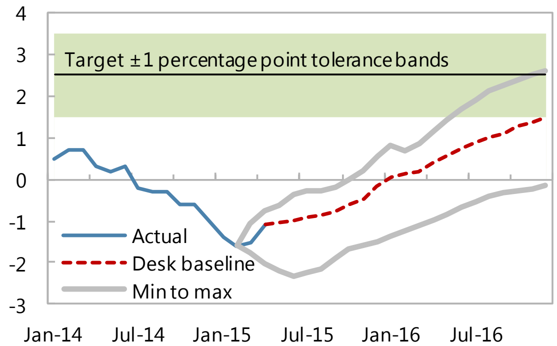
Sources: Concensus Economics, Haver Analytics, NBP, Statistics Poland, and IMF staff calculations.

18. The policy interest rate cut is welcome, but the announcement of the end of the easing cycle was premature. The October and March policy interest rate cuts, alongside continued strong domestic demand and wage growth and ECB QE, should help boost domestic and imported inflation. Taking into account monetary transmission lags (6 to 8 quarters), staff projects inflation to gradually return to the target band by end-2016. Nonetheless, weak inflation expectations point to downside risks to this forecast (Chapter I of Selected Issues).

Republic of Poland: Inflation Forecast and Second-Round Effects

Inflation is projected to remain low…

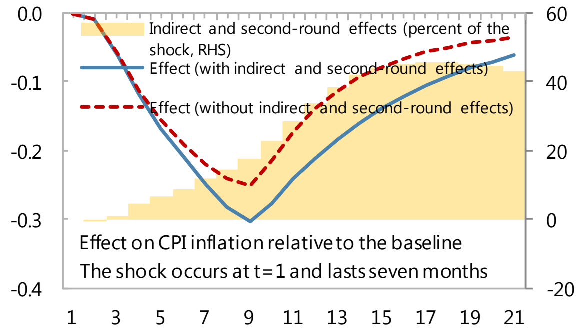
Consumer Price Inflation: Forecast Variation
(Percent, year-on-year)



Sources: Haver Analytics and IMF staff calculations. See Chapter I of Selected Issues for details.

…amid sizeable potential indirect and second-round effects.

Effect on CPI Inflation of Protracted 9 Percentage Point Decline in Oil and Coal Price Inflation (Percentage points)



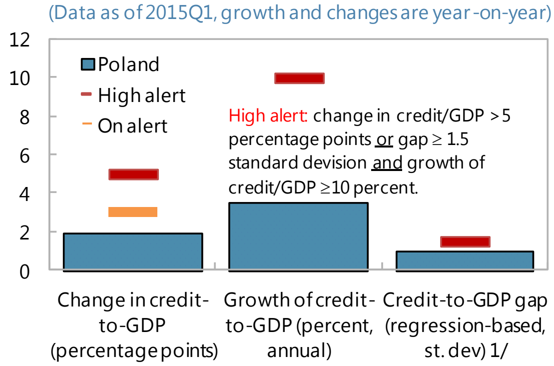
Source: IMF staff calculations. See Chapter I of Selected Issues for details.

19. **An easing bias should be maintained.** The need for further monetary easing should be guided by a data-driven approach, including by monitoring inflation expectations, wage growth, exchange-rate developments, and the outlook for economic activity. Additional policy action would be necessary to return inflation to target if inflation expectations were to disappoint, or if widening interest-rate differentials result in unwarranted upward pressure on the exchange rate, undermining the inflation objective and ultimately competitiveness and growth. Risks related to monetary policy easing appear limited, with no indication of asset price bubbles or excessive credit growth. Nonetheless, close monitoring of bank risk-taking should continue in light of potential search for yield in the low-interest-rate environment.

Republic of Poland: Credit and Asset Price Indicators

Credit growth remains moderate…

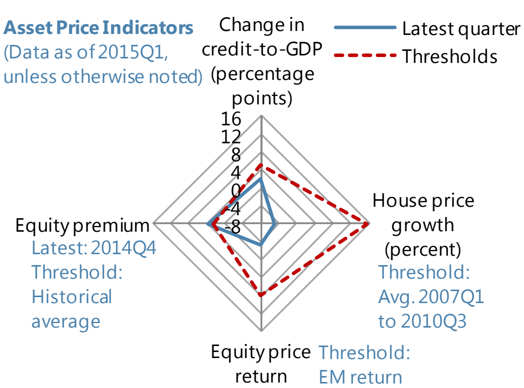
Credit Cycle Indicators
(Data as of 2015Q1, growth and changes are year-on-year)



Sources: Polish authorities and IMF staff calculations.
1/ 2014Q2.

…and there is no sign of asset price bubbles

Asset Price Indicators
(Data as of 2015Q1, unless otherwise noted)



Sources: Country authorities, Datastream, Haver analytics, and IMF staff calculations.

20. Moderate reserve accumulation would be prudent. Reserves increased by 7 percent in euro terms[1] in 2014 and are broadly adequate at about 114 percent of the IMF's modified ARA metric. In light of downside external risks, continued moderate reserve accumulation would help safeguard against external shocks.

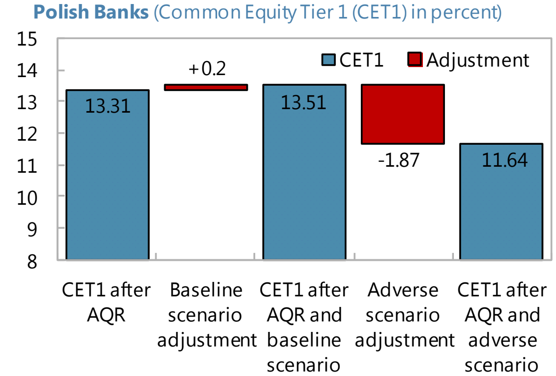
Authorities' views

21. The authorities broadly agreed with staff's assessment. The authorities recognized the downside risks to the inflation forecast. However, they stressed that, so far, low inflation had supported domestic demand and growth and did not appear to have had negative effects on the real economy. Some members of the MPC noted that the March announcement of the end to the easing cycle would not preclude further adjustment should growth significantly underperform. At the same time, the announcement would help maintain financial market stability by limiting uncertainty about monetary policy.

B. Financial Sector Policies and Reforms to Buttress Stability

22. The banking sector is well capitalized and resilient to external shocks. Capital buffers are high and the banking system is liquid, with capital adequacy at 14.7 percent in the fourth quarter, a declining loan-to-deposit ratio, and liquidity above the regulatory minimum (Figure 7, Table 5). The reliance on foreign funding has declined (Figure 8) and the recent Asset Quality Review (AQR) and stress tests by the Financial Supervision Authority (KNF), performed alongside the ECB's Comprehensive Assessment, confirmed the sector's resilience to shocks, including substantial exchange-rate depreciation.

AQR and Stress Tests: Impact on CET1 Changes in Polish Banks (Common Equity Tier 1 (CET1) in percent)



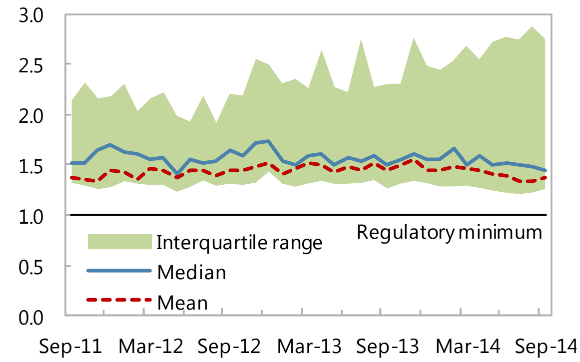
Sources: NBP Financial Stability Report and IMF staff calculations.

[1] The authorities target a gradual increase in reserves in euro terms (rather than in U.S. dollars (US$)), given close integration with the euro area and a large share of external debt denominated in euros.

Nonfinancial Sector Loans to Deposits
(Percent)

Sources: KNF and IMF staff calculations.

Supervisory M2 Liquidity Standard at Commercial Banks
(Ratio)



Source: NBP Financial Stability Report, January 2015.

23. However, some legacy vulnerabilities remain:

- **Foreign-currency mortgages.** While tighter prudential regulation has halted new FX lending, a substantial legacy stock of these loans remains. Close to half of mortgages are denominated in FX (mostly Swiss franc), exposing households and banks to sudden zloty depreciation—as was the case in January when the zloty depreciated around 20 percent against the Swiss franc. As such, the January episode had little macroeconomic impact and high capital buffers in banks mitigated financial stability risks. In addition, the availability of emergency liquidity assistance from the NBP, supported by the swap line with the Swiss National Bank, further mitigated risks (Appendix II).

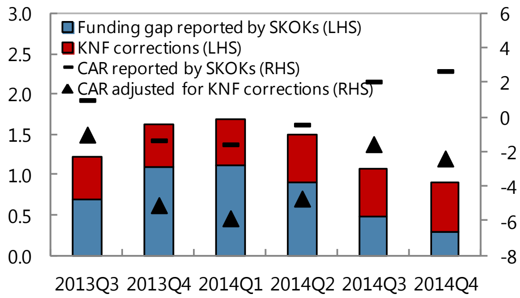
- **Nonperforming loans.** While NPLs have gradually declined during the past two years, they remain elevated at above 8 percent of total loans and are particularly high in the consumer loans and small- and medium-sized enterprise (SME) segments.

- **Credit unions.** Credit unions account for a small segment of the financial sector, with assets corresponding to about 1 percent of banking sector assets. However, the segment is weak and KNF is actively working on its restructuring, including through takeovers and bankruptcy. The restructuring cost the budget about 0.1 percent of GDP in 2014, putting a dent in Bank Guarantee Fund (BFG) resources. Nonetheless, doubled financial sector contributions in 2015 should help replenish BFG funds.

Republic of Poland: Credit Union Capital and Deposits

Credit unions are heavily under-capitalized...

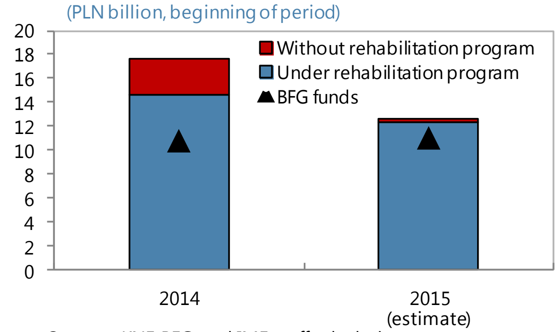
Credit Union (SKOK) Funding Gap and Capital Adequcy 1/
(LHS: PLN billion; RHS: percent)



Sources: NBP, KNF, and IMF staff calculations.
1/ Required capital adequacy for credit unions (SKOKs): 5 percent; Funding gap: capital needed to reach this ratio.

...with the potential for eroding BFG resources.

Credit Union Deposits and BFG Funds 1/
(PLN billion, beginning of period)



Source:s KNF, BFG, and IMF staff calculations.
1/ Ex-ante guarantee funds in BFG; 2015 includes new contributions but excludes valuation changes.

24. Work to strengthen the financial safety net and supervision has continued, albeit with delays. Progress has been made in implementing the 2013 Financial Sector Assessment Program (FSAP) recommendations (Table 6). A draft law empowering the Financial Stability Committee to carry out macroprudential oversight—allowing early detection and prevention of systemic risk—is moving forward. However, preparation of legislation on the bank resolution framework that would also cover credit unions has been delayed by legal challenges related to the role of the judiciary in the resolution process. Elections this year risk delaying the adoption of final legislation.

25. Addressing legacy vulnerabilities will buttress financial stability and promote continued healthy credit expansion.

- **Foreign-currency mortgages.** Given limited macroeconomic or financial stability concerns, staff supported the authorities' approach of case-by-case restructuring of distressed Swiss franc denominated mortgages following the recent Swiss franc appreciation. Implementing the Financial Stability Committee's recommendation for banks to pass on the negative Swiss franc LIBOR rates to customers and not require additional collateral would allow burden sharing between banks and mortgage holders.

- **Nonperforming loans.** Changes in the consumer bankruptcy law have shortened the maximum period to repay debt. A new bankruptcy and insolvency law, which eases restructuring and insolvency procedures to encourage restructuring (instead of liquidation) of viable firms has been finalized and is expected to take effect on January 1, 2016. These measures should help lower the level of NPLs.

- **Credit unions.** Staff supported the authorities' ongoing work to restructure the credit union segment.

26. Implementation of key financial sector reforms should be expedited. Finalizing the macroprudential framework would help manage systemic risks to the financial system, for example related to asset price bubbles or excessive credit expansion, not least associated with accommodative monetary policy. In addition, continued strengthening of macroprudential policies to reduce risks of rapid household debt accumulation would reduce macro-financial risks (Chapter II of Selected Issues). Implementing the bank resolution framework would enhance the effectiveness of crisis response.

Authorities' views

27. The authorities agreed on the importance of finalizing key financial sector reforms. They noted that vulnerabilities associated with Swiss franc mortgages and credit unions do not pose financial stability risks. In the context of ongoing healthy credit expansion, the authorities were not especially concerned about the level of NPLs, which they highlighted were already on a downward trajectory. They concurred that swift completion of the bank resolution framework and implementation of the macroprudential framework would be important to ensure a strong financial safety net and help prevent systemic risks.

C. Continuing Fiscal Consolidation to Reinforce Policy Buffers

28. Fiscal consolidation has advanced further, allowing Poland to exit the EDP one year early. The general government deficit declined to 3.2 percent of GDP last year from 4.0 percent of GDP in 2013 owing to the wage bill freeze, reduced debt servicing costs following changes to the pension system, and a cyclical rebound in tax revenues. When adjusted for the costs of the 1999 pension reform, the deficit declined to 2.8 percent of GDP, allowing Poland to exit the EDP one year ahead of schedule. Public debt also declined by about 5.5 percentage points of GDP to 50.1 percent of GDP, largely on account of changes to the 2013 pension reform (Tables 8 and 9; Annex II). By end-April, about 70 percent of the 2015 gross borrowing needs had been pre-financed.

29. Fiscal adjustment is expected to continue, but is subject to risks.

- **Short term.** The fiscal deficit is expected to decline to around 2¾ percent of GDP in 2015 on the back of increasing revenues, supported by strong growth, and lower expenditures on social benefits as unemployment declines. However, this projection is subject to risks from lower-than-expected inflation, pre-election spending pressures, and higher-than-expected costs from restructuring of the mining sector (currently assumed at about PLN3 billion during 2015–18).

- **Medium term.** Going forward, the authorities' Convergence Program update envisages a decline in the fiscal deficit to 1.2 percent of GDP by 2018, but has yet to identify concrete fiscal measures to do so. Staff estimates that under unchanged policies, including continued revenue gains from the pension changes and the freeze in the income tax thresholds, the deficit would decline to around 2 percent of GDP by 2019—about 1 percentage point above the authorities' medium-term objective (MTO). The recent decision to reform large taxpayer administration and establish a single Large Taxpayer Office, in line with IMF's technical assistance (TA) recommendations, should help enhance domestic revenue mobilization and limit fiscal risks over the medium term.

Poland: 2015 Convergence Program Update

Percent of GDP	2014	2015	2016	2017	2018
Total revenues	**38.6**	**38.8**	**38.5**	**37.9**	**37.8**
Taxes	19.7	19.8	19.9	19.5	19.4
Indirect taxes	12.7	12.8	12.9	12.4	12.3
Direct taxes	7.0	7.0	7.1	7.1	7.1
Social contributions	13.2	13.5	13.4	13.2	13.1
Other revenues	5.7	5.5	5.2	5.2	5.3
Total expenditures	**41.8**	**41.5**	**40.8**	**39.8**	**39.0**
Compensation of employees	10.2	10.0	9.7	9.4	9.0
Intermediate consumption	6.0	6.0	5.9	5.8	5.7
Social benefits	16.3	16.2	16.1	15.8	15.4
Capital investments	4.4	4.5	4.5	4.3	4.2
Other expenditures	4.9	4.8	4.6	4.5	4.7
Net lending (+) / net borrowing (-)	**-3.2**	**-2.7**	**-2.3**	**-1.8**	**-1.2**
Structural balance	-2.7	-2.6	-2.2	-1.8	-1.2

Source: Ministry of Finance.

30. **Staff supported the authorities' fiscal plans but stressed the need to underpin them with specific measures.** The planned fiscal consolidation should create sufficient policy space to allow for timely and effective response to shocks, while putting public debt on a robust downward trajectory.

- **Short term.** The 2015 fiscal stance is appropriate, but contingency planning is needed to mitigate fiscal risks. The planned gradual deficit reduction appropriately addresses the need to put public debt on a robust downward path, while being mindful of not undermining growth. The authorities should identify contingency measures in case risks materialize, including from pre-election spending pressures and lower-than-expected inflation.

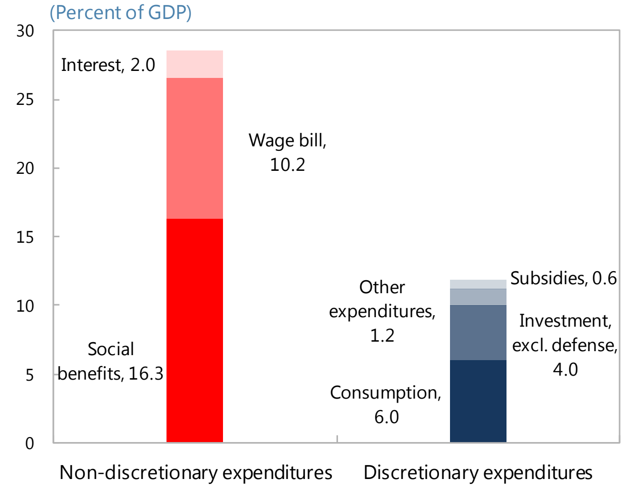
- **Medium term.** Reaching the MTO would require additional effort. The authorities' MTO of 1 percent of GDP structural deficit by 2019 remains an appropriate fiscal anchor, which would further bolster debt sustainability. However, additional measures of about 1 percent of GDP would be needed to reach this objective. Closing a third of the VAT compliance gap could increase revenue by about 0.6 percent of GDP in the medium term (Figure 9). To this end, recent IMF TA has recommended developing industry-based compliance projects and implementing strategies to fight the grey economy. A follow-up TA is planned to support the improvement of VAT administration, including through a VAT gap analysis. Consideration could be given to reducing the number of VAT rates to improve compliance and lower the burden on tax administration. Preventing the 2011 VAT increase from expiring in 2017 would help sustain revenues until tax administration reforms are finalized. On the expenditure side, identifying measures to support implementation of the stabilizing expenditure rule, including by drawing on the ongoing review of selected spending categories, would strengthen its credibility.

- **Over the longer run, additional reforms would lessen the burden of aging-related costs.** Recent estimates by the IMF suggest that health expenditures will rise by some 1.7 percentage points of GDP by 2030.[2] In this context, improving expenditure efficiency would help generate fiscal space to respond to long-term aging-related fiscal pressures (Appendix III). Promoting voluntary savings through the third pillar would help reduce risks of old-age poverty, thereby limiting contingent liabilities. Addressing imbalances in the special occupational pension schemes remains essential.

Authorities' views

31. The authorities broadly shared staff's assessment and underscored the existence of budgetary safeguards to manage fiscal risks. They noted that short-term fiscal risks, including from lower-than-expected inflation, are manageable given upside risks to the growth forecast underpinning the budget. Regarding medium-term fiscal adjustment, they were confident that strict enforcement of the stabilizing expenditure rule would support the achievement of the MTO. They also noted that the large share of discretionary expenditures in the budget (estimated by staff at around one-third of total expenditures) affords sufficient flexibility to cut expenditure over time. On the revenue side, the authorities agreed with the need to reduce the VAT revenue gap and were appreciative of the ongoing IMF TA. They noted that the new tax code recently proposed by the government aims to further strengthen tax compliance. They also acknowledged the need to reform special pension schemes for farmers and miners.

Poland: Budget Flexibility
(Percent of GDP)



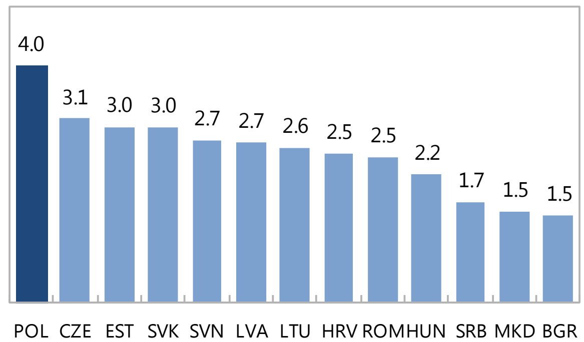
Sources: Ministry of Finance, and IMF staff estimates.

[2] IMF, 2015, Fiscal Monitor: Now Is the Time. Fiscal Policies for Sustainable Growth, April 2015, International Monetary Fund.

D. Structural Reforms to Boost Productivity and Facilitate Convergence

32. Poland's economic convergence with advanced European countries has continued. Ongoing integration with the European supply chains and structural reforms have supported productivity growth and facilitated income convergence. Rising productivity and improvements in the business climate over the past few years have made Poland one of the most attractive investment destinations in Central, Eastern, and Southeastern Europe. Further gains would arise from reforms already in the pipeline:

Investment Attractiveness of Central and Eastern European (CEE) Countries in 2015
(Responses of surveyed foreign firms; 6–very attractive and 1–not attractive)



Sources: Polish-German Chamber of Industry and Commerce, and Interntional Group of Chambers of Commerce in Poland.

- **Labor market policies.** The planned deregulation of professions should further boost job creation. Better alignment of social security contributions on temporary employment contracts with those on regular contracts from 2016, alongside ongoing efforts to limit the duration of consecutive short-term contracts, should help reduce labor market segmentation and support sustainability of the social security system without unduly undermining labor market flexibility. Temporary civil law contracts have often been used by employers to avoid paying employees' social security contributions; they have also been seen as reducing incentives for employers to invest in employee training. Public employment offices were also reformed to increase job-matching efficiency, including by better targeting of services to unemployed and closer cooperation with the private sector.

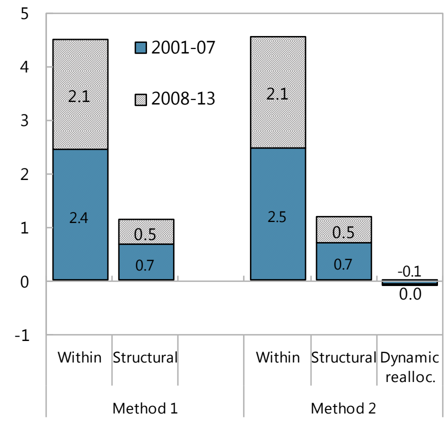
- **Business climate.** Administrative requirements were eased for business start-ups and efforts continued to reduce red tape. Legislative work has been completed to ease regulations for construction permits, starting in June. New consumer insolvency law entered into effect in December 2014. While privatization has slowed and state-ownership remains prevalent in strategic sectors, these sectors appear broadly profitable (Figure 10).

33. Staff stressed the need for additional reforms to facilitate faster convergence. Cross-country research suggests that this would require completing structural transformation of the economy by redeploying resources toward higher-productivity sectors and closing sector-specific productivity gaps by moving up the value-added chain (Box 3 and Chapter III of Selected Issues).

Box 3. Raising Productivity Growth in Poland: The Role of Structural Transformation

Countries that manage to sustain productivity gains enjoy strong and durable growth. Increases in aggregate labor productivity can originate from two main sources: sector-specific productivity gains and reallocation of labor from low-productivity sectors (e.g., agriculture) toward modern economic activities—a process known as structural transformation.

Poland: Decomposing aggregate labor productivity
(Average growth over seven years; in percent)

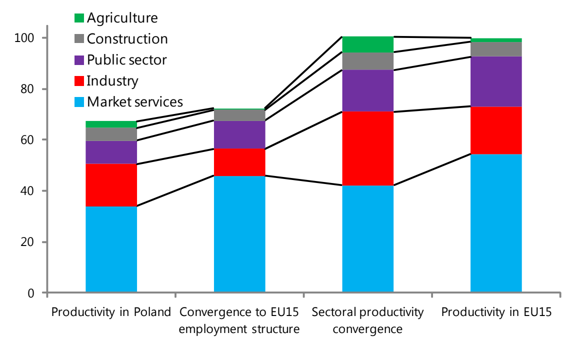


Source: IMF staff estimates.

Poland has benefited from both sector-specific productivity gains and structural transformation. Over the past decade, within-sector productivity gains have accounted for the bulk of aggregate productivity growth, with the remaining one-fifth coming from structural transformation. The manufacturing sector, which has benefited from integration with Europe's supply chains, has been one of the main sources of increased productivity at the sectoral level.

Sustaining productivity improvements would require completing structural transformation, while boosting within-sector productivity.

Illustrative scenarios of productivity convergence
(Productivity decomposition; percent of productivity in EU15)



Note: Convergence to EU15 employment structure assumes adopting EU15 employment structure in Poland with sectoral productivity levelsunchanged. Sectoral productivity convergence assumes increase of sectoral productivities to EU15 levels with employment structure unchanged.

Sources: Eurostat; IMF staff calculations.

- Continued **structural transformation** would require facilitating labor mobility across sectors and promoting economic diversification. Cross-country econometric results show that securing large greenfield investments, improving the business climate, addressing labor market duality, and tackling long-term unemployment are key factors associated with structural change.
- Further **within-sector productivity enhancement** entails moving up the value-added chain. Poland's integration with the German supply chain has resulted in welcome technology transfers and has increased sophistication of domestic value-added embodied in exports. Further advancement along the value-added chain would require encouraging innovation and increasing investment in research and development—an area where Poland still lags behind its peers. Better targeted vocational training would facilitate the absorption of new technologies.

- **Labor market policies.** Labor mobility to higher-productivity sectors can be facilitated by further streamlining the list of regulated professions and better targeting education and training to employer needs—an issue also highlighted by employer groups. Further development of the rental market is needed to ease the geographical mobility of labor. Reducing labor market segmentation would encourage investment in on-the-job training. Encouraging greater female labor force participation is essential for maintaining employment levels in the face of adverse demographic trends.

- **Business climate.** Continued business climate improvements to encourage greenfield investment, including by strengthening contract enforcement, would boost competitiveness.

Advancing along the value-added chain will require efforts to support innovation and research and development.

Authorities' views

34. The authorities acknowledged the importance of structural reform for growth and income convergence and underscored several ongoing initiatives. They highlighted recent measures to reduce labor market segmentation including by better aligning civil law and temporary contracts with regular contracts. Efforts continue to increase female labor force participation, including via affordable child care, subsidized telework, and programs aimed at reintegrating women returning from maternity leave into the workforce. The authorities observed that the new housing rental program financed by the Polish development bank BGK would help develop the rental market and facilitate regional labor mobility. They noted ongoing efforts to promote innovation via increased allocation of EU funds to innovation programs, including for SMEs and via greater research and education synergies between universities and the private sector.

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35. The economy has recovered from the 2012–13 slowdown, and the outlook is for continued robust growth. Growth accelerated in the first quarter of this year on the back of strong domestic demand, supported by improving labor market and financial conditions. Nonetheless, deflation persists amid low commodity prices and weak imported inflation. Economic expansion is expected to continue, with growth projected at around 3½ percent in 2015 and over the medium term. This should help gradually return inflation to the target band by end-2016.

36. Risks have somewhat moderated, but remain elevated. On the external side, an abrupt surge in global financial market volatility could propagate via the substantial foreign participation in the government bond market and in the banking system. Continued geopolitical tensions could also weigh on confidence. Nonetheless, these risks are mitigated by Poland's stable and geographically diversified investor base and declining reliance on foreign bank funding. Domestically, inflation could fail to pick up owing to external factors or if low inflation expectations become entrenched. Prolonged low inflation could ultimately squeeze profit margins with potential negative repercussions for investment, employment, and growth. On the upside, a stronger-than-expected recovery in the euro area and low oil prices could further lift growth in Poland.

37. Policies should continue to focus on preserving stability and supporting income convergence. The economy has weathered well several bouts of market turbulence, benefitting from very strong economic fundamentals and policies and the insurance provided by the FCL arrangement with the IMF. Going forward, it will be important to continue building policy buffers to enhance resilience to shocks and implementing structural reforms to lift income standards further.

38. Additional monetary policy easing could be needed. The March policy interest rate cut is welcome and, alongside quantitative easing by the ECB, should help lift inflation and limit the risk of prolonged low inflation. Additional policy interest rate cuts could be needed if inflation expectations continue to disappoint, or if persistent zloty appreciation jeopardizes the inflation objective. Moderate reserve accumulation would be prudent in light of downside external risks.

39. Financial sector performance is strong but key reforms should be completed. The well-capitalized, liquid, and profitable banking system has remained resilient to shocks. Nonetheless, prompt adoption of the bank resolution framework is essential for a strong and effective financial safety net. Implementing a comprehensive macroprudential framework will help ensure early detection and prevention of systemic risks. Restructuring of the weak but non-systemic credit union segment should continue.

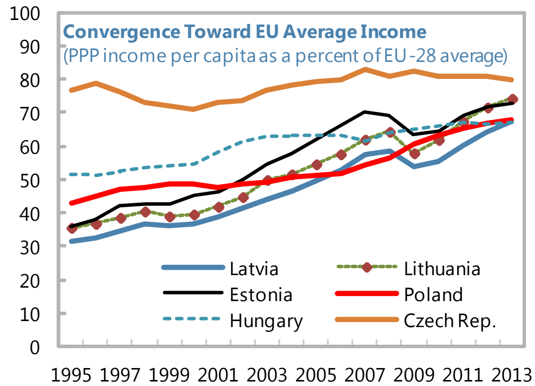
40. Gradual fiscal adjustment should continue. The authorities' strong consolidation efforts in recent years have allowed Poland to exit the EDP one year early—a welcome achievement. The fiscal deficit is expected to decline further to around 2¾ percent of GDP in 2015. The medium-term objective of 1 percent of GDP structural deficit remains an appropriate fiscal anchor to bolster fiscal sustainability and rebuild policy space. Reaching this target would require additional measures of about 1 percent of GDP. Identifying specific expenditure savings to support implementation of the fiscal rule and reducing the large VAT revenue gap would be important measures in this regard.

41. Structural reforms would boost productivity and facilitate income convergence. Reform efforts should continue focusing on moving up the value-added chain and redeploying resources toward higher-productivity sectors. Promoting innovation, encouraging greenfield investment, and better targeting education and training to employer needs would help achieve these goals. Recent actions to reduce red tape, streamline the list of regulated professions, and reduce labor market segmentation by better aligning civil law and regular contracts, are welcome in this regard.

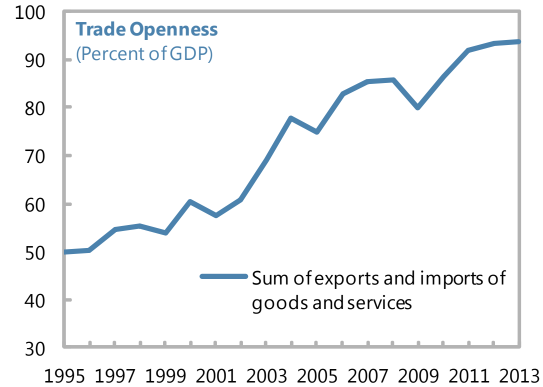
42. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Figure 1. Republic of Poland: Integration with the Global Economy

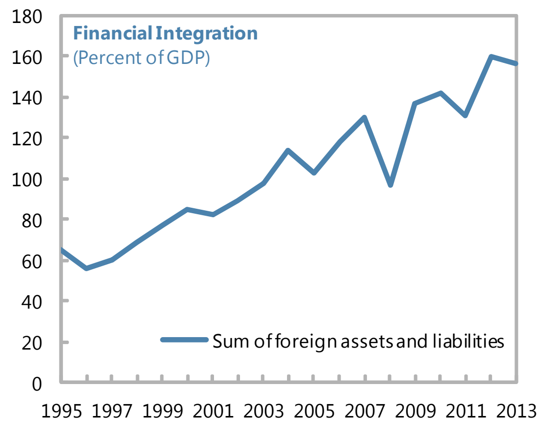
The income convergence process is well underway…



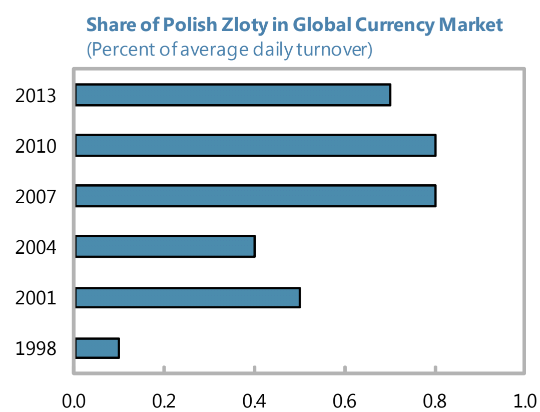
… supported by trade openness via supply-chains…



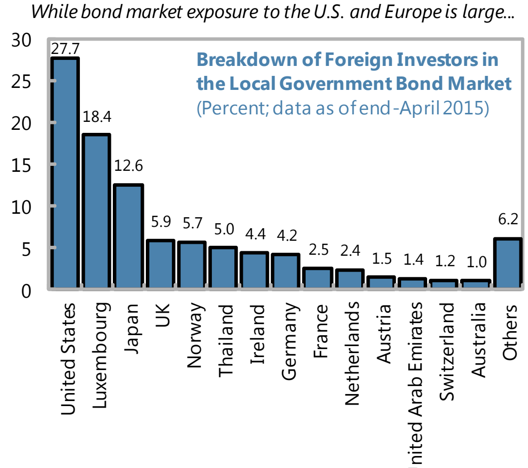
…and financial integration.



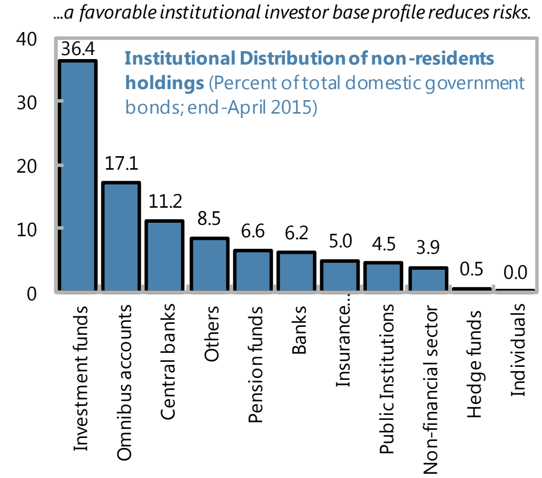
Consequently, zloty trade has become important.



While bond market exposure to the U.S. and Europe is large…



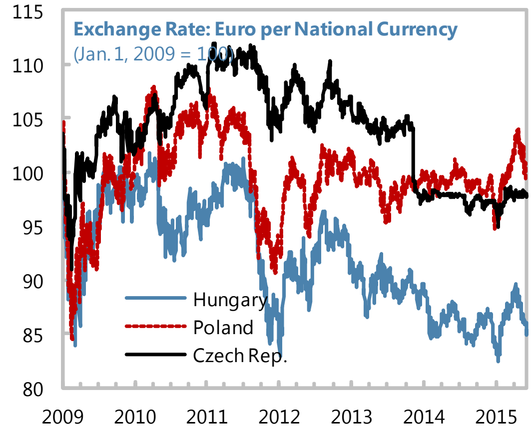
…a favorable institutional investor base profile reduces risks.



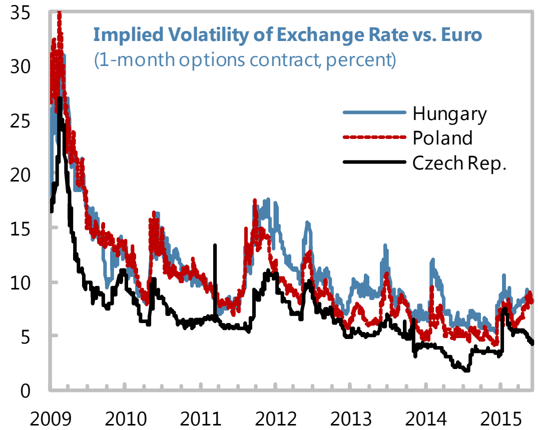
Sources: Polish authorities, IMF World Economic Outlook, Bank for International Settlements Triennial Central Bank Survey, and IMF staff calculations.

Figure 2. Republic of Poland: Financial Market Developments

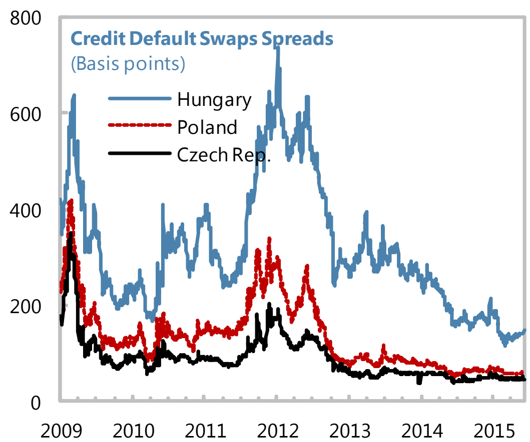
The zloty has generally remained relatively stable despite bouts of turbulence...



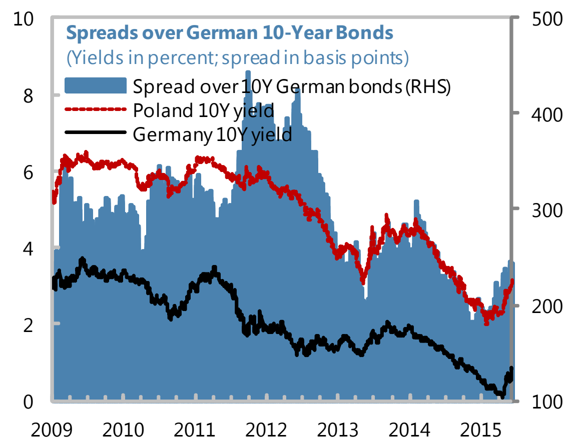
...and implied volatility has remained within recent historical patterns.



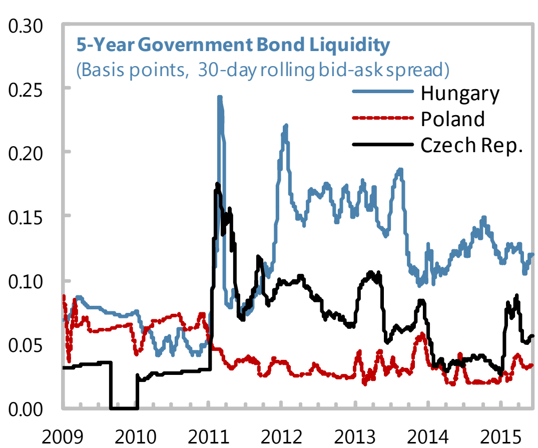
Credit default swap (CDS) spreads remain narrow...



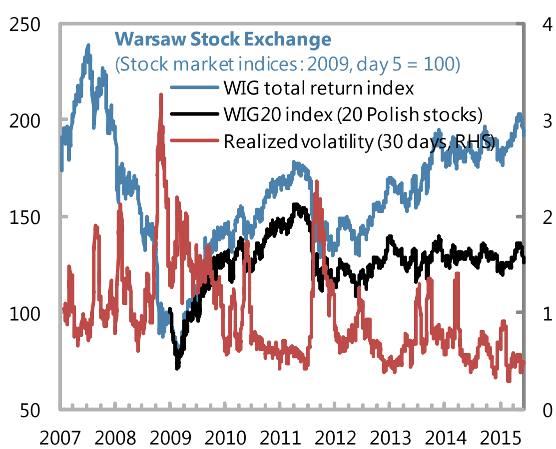
...as do spreads to German yields, despite a recent widening,...



...in a liquid market.

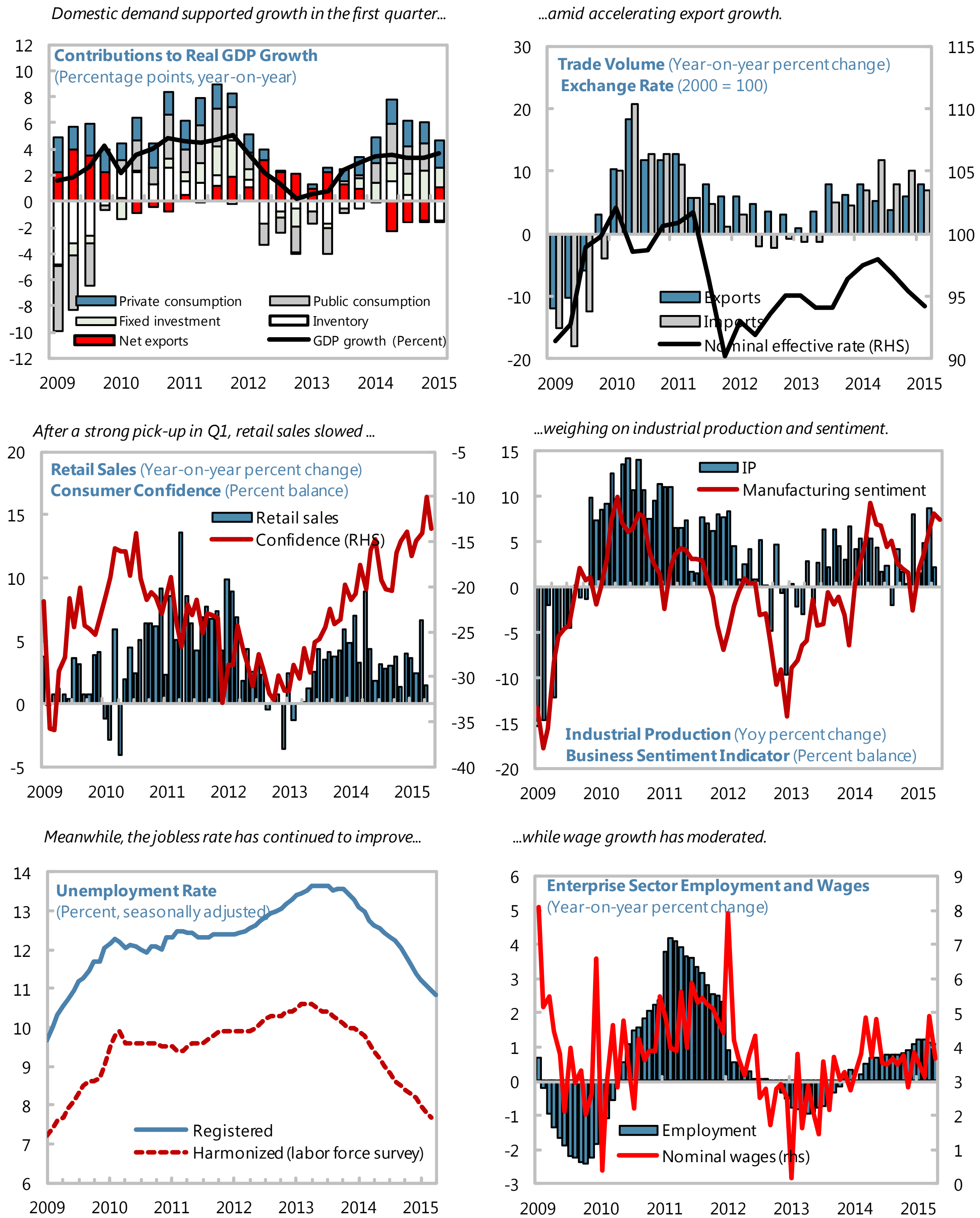


Meanwhile, the stock market has held up well, despite bouts of volatility.



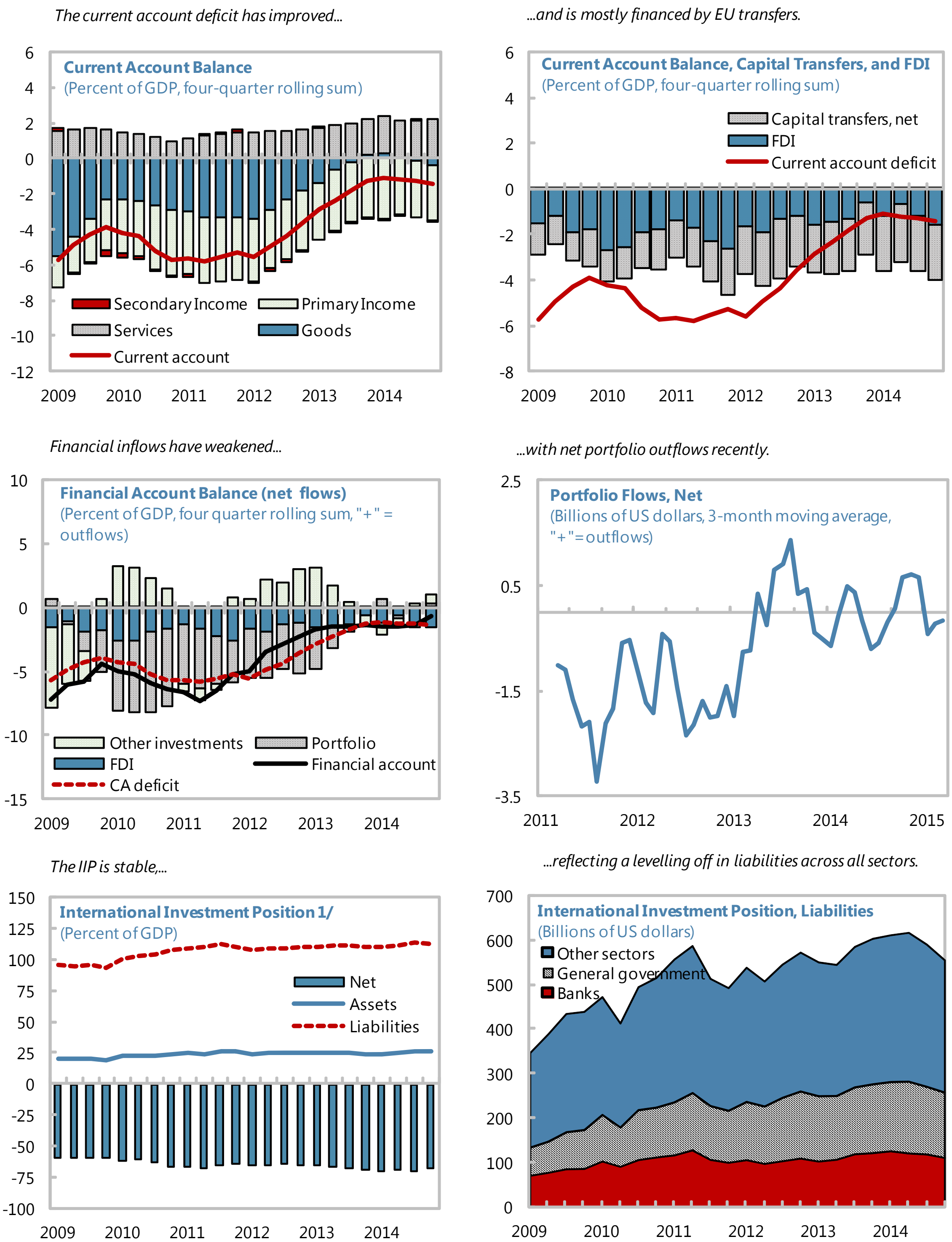
Sources: Bloomberg, Haver Analytics, Polish Ministry of Finance, and IMF staff calculations.

Figure 3. Republic of Poland: Recent Economic and Labor Market Developments



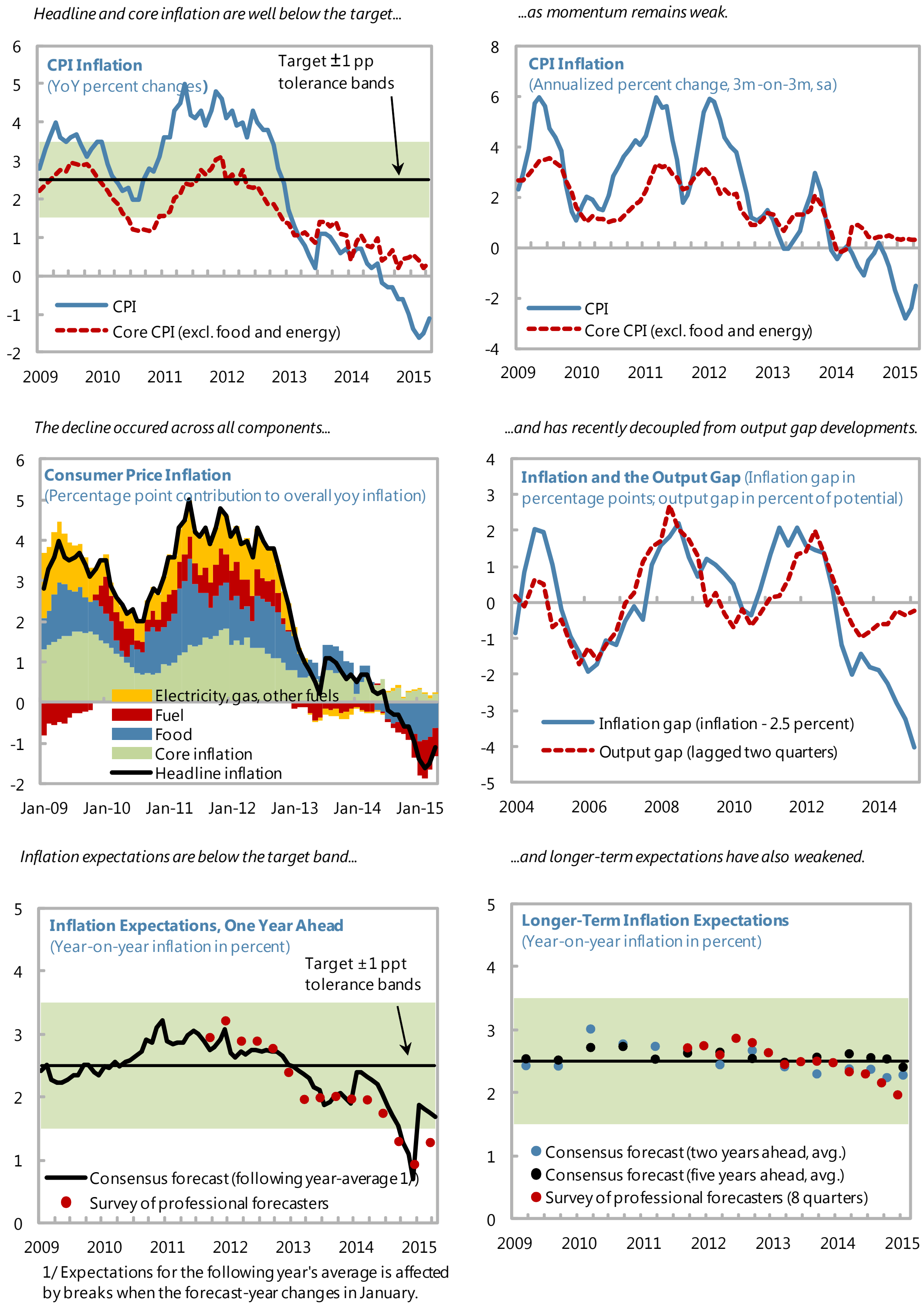
Sources: Haver Analytics, Poland Central Statistical Office, and IMF staff calculations.

Figure 4. Republic of Poland: Balance of Payments



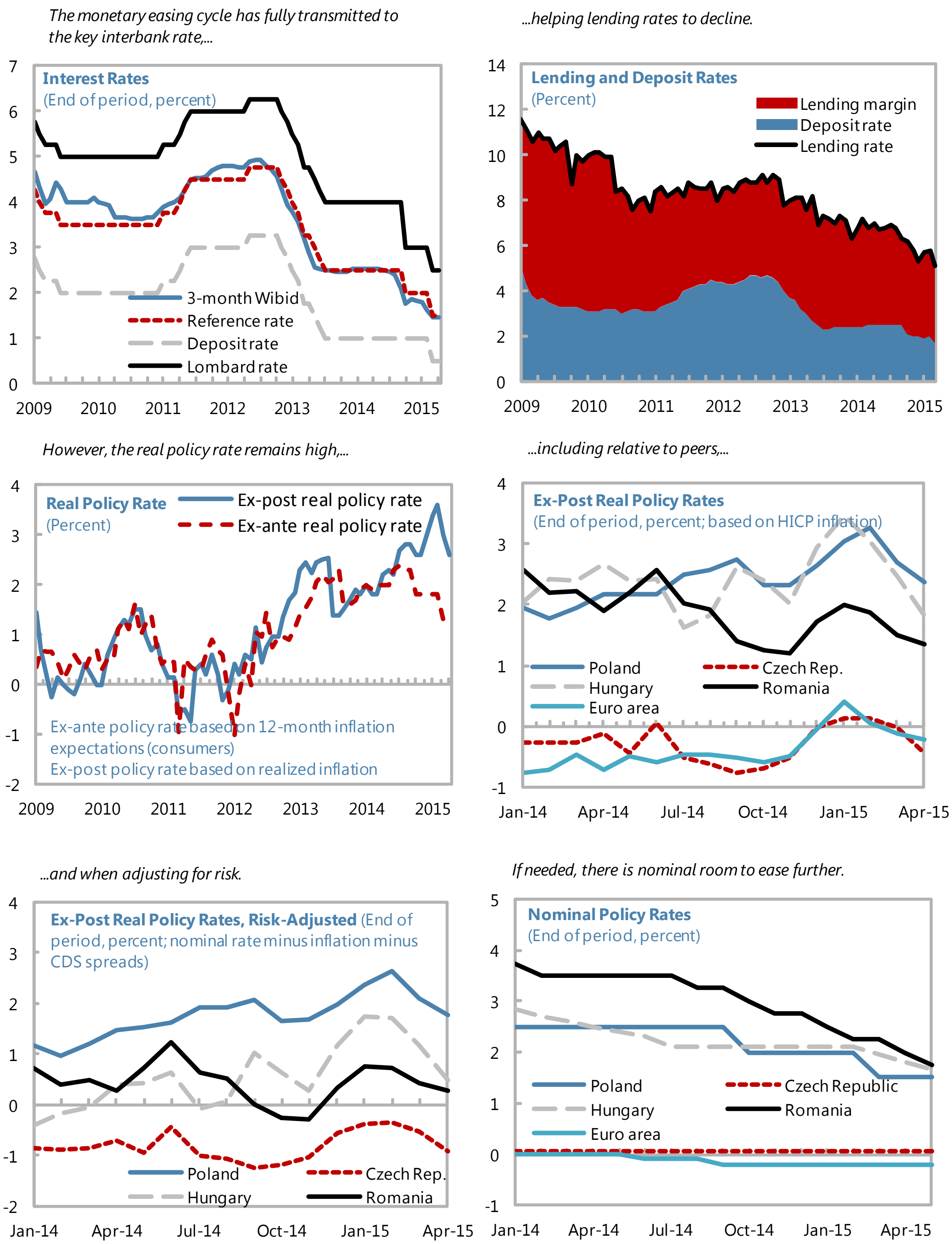
Sources: Narodowy Bank Polski (NBP) and IMF staff calculations.
1/ Excludes NBP.

Figure 5. Republic of Poland: Recent Inflation Developments



Sources: Bloomberg, Datastream, Haver Analytics, JP Morgan, NBP, Reuters, Statistics Poland, and IMF staff calculations.

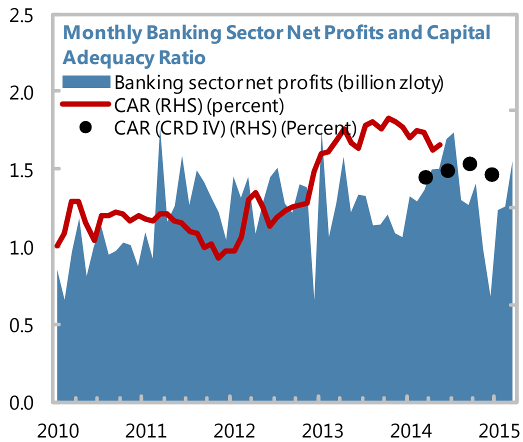
Figure 6. Republic of Poland: Monetary Policy Developments



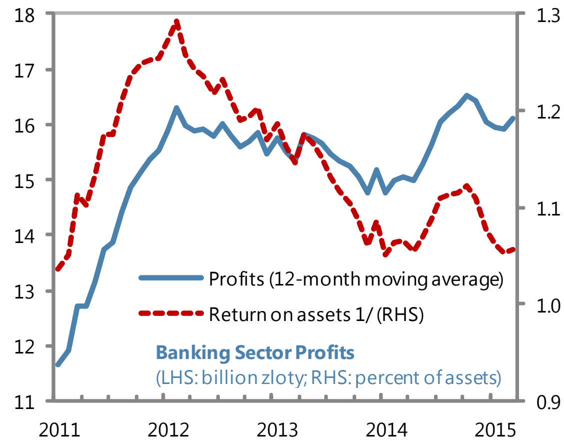
Sources: Bloomberg, Consensus Economics, Datastream, Haver Analytics, JP Morgan, NBP, Reuters, Statistics Poland, and IMF staff calculations.

Figure 7. Republic of Poland: Banking Sector Capital and Asset Quality

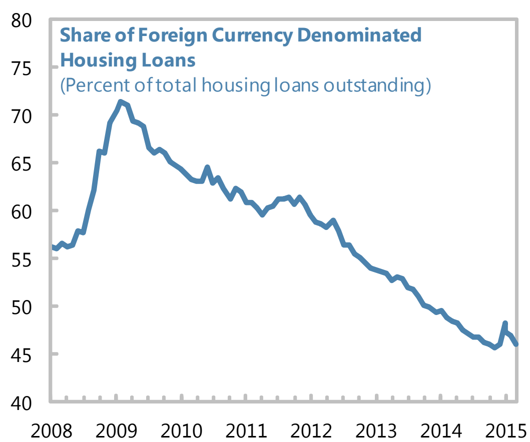
Bank profits remain strong and capital adequacy high,...



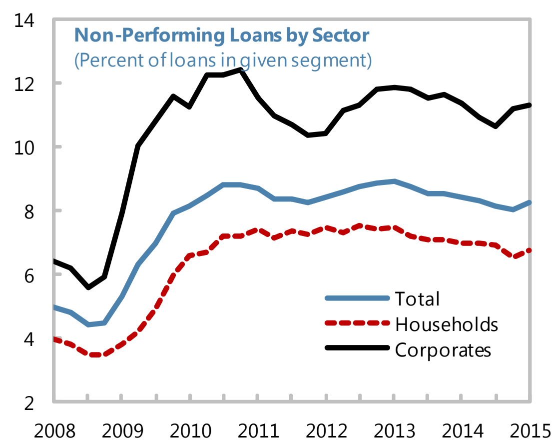
...though profitability has recently weakened.



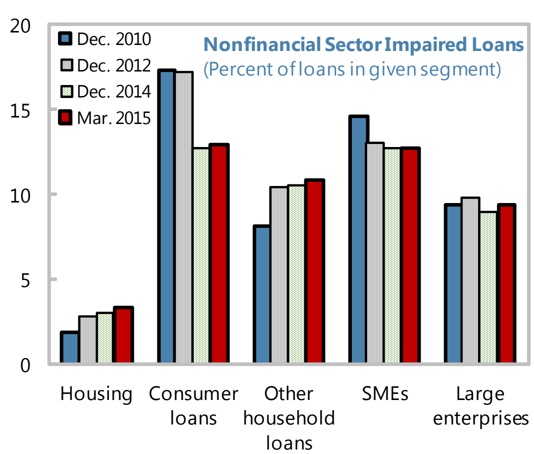
Nonetheless, the foreign currency share of mortgages has declined.



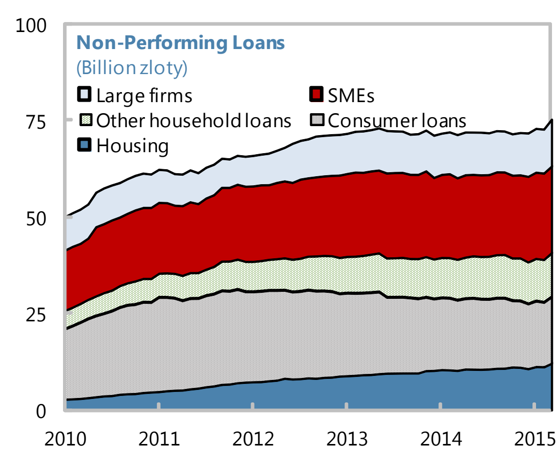
Non-performing loans (NPLs) are sticky...



...and remain high for SMEs and consumer loans,...



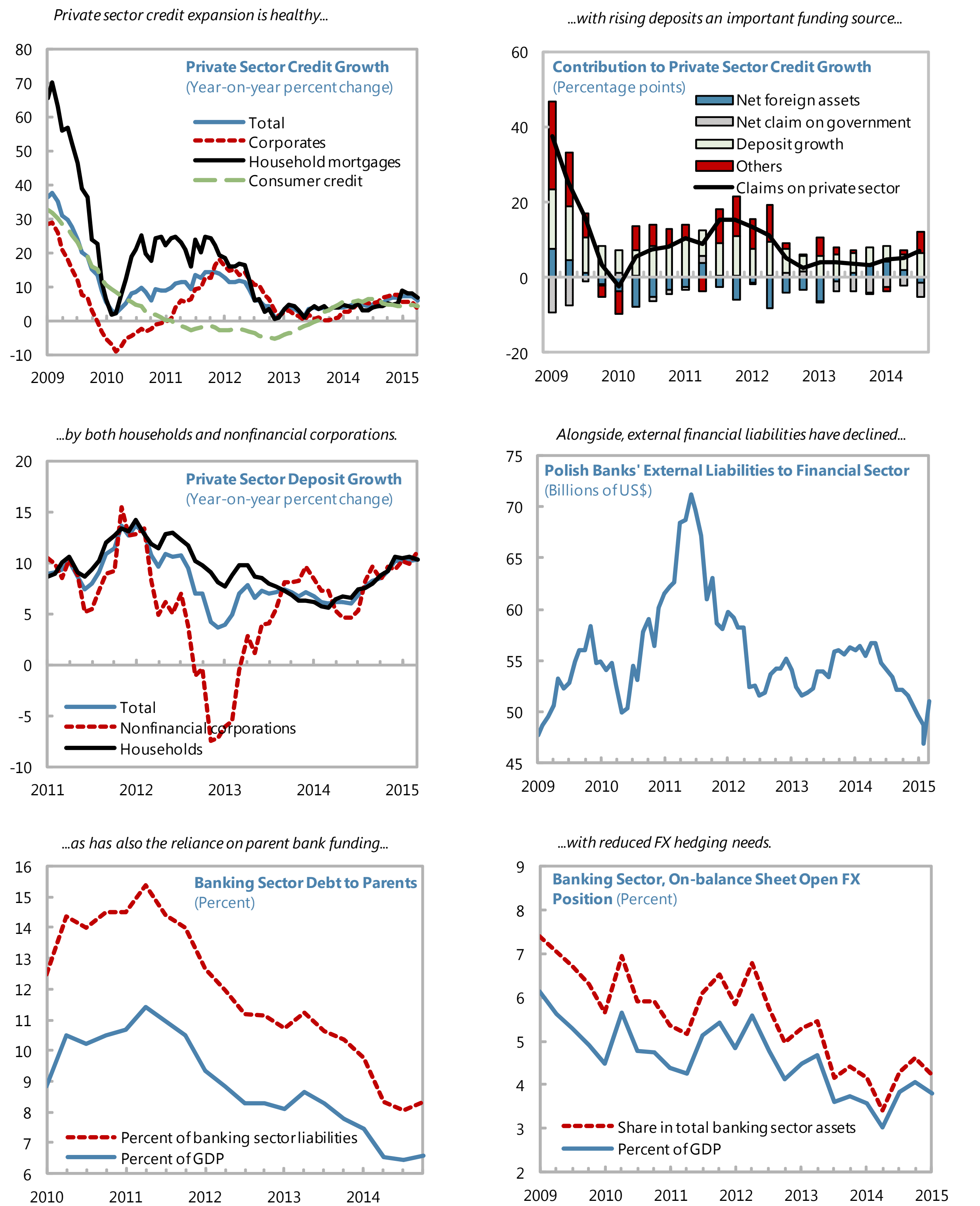
...accounting for the bulk of impaired loans.



Sources: KNF, NBP, and IMF staff calculations.

1/ 12-month profits in percent of 12-month assets.

Figure 8. Republic of Poland: Credit Growth and Banking Sector Funding

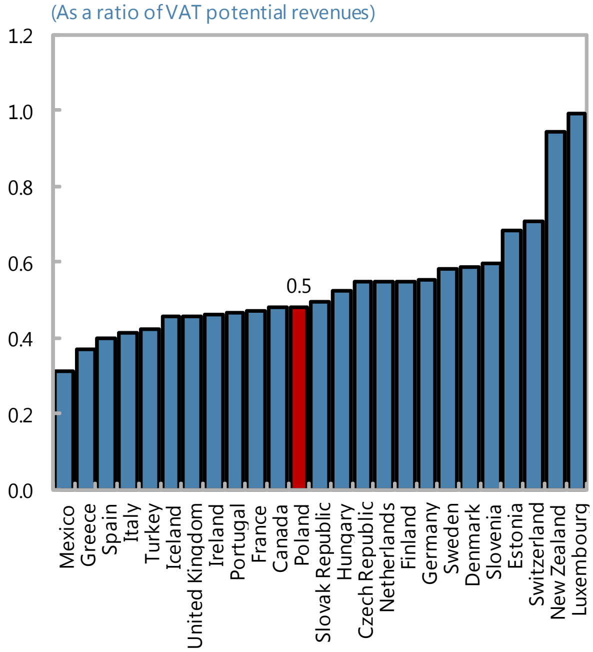


Sources: Haver Analytics, International Financial Statistics, NBP, KNF, and IMF staff calculations.

Figure 9. Republic of Poland: VAT Compliance

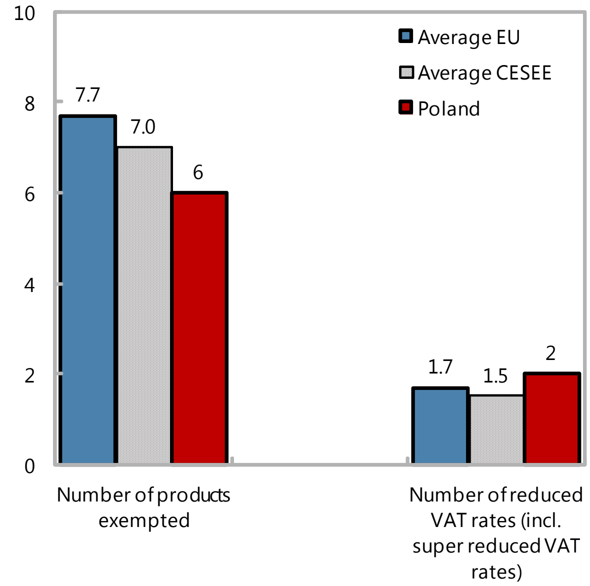
VAT efficiency in Poland is relatively low.

VAT C-Efficiency Ratios in the OECD, 2011
(As a ratio of VAT potential revenues)



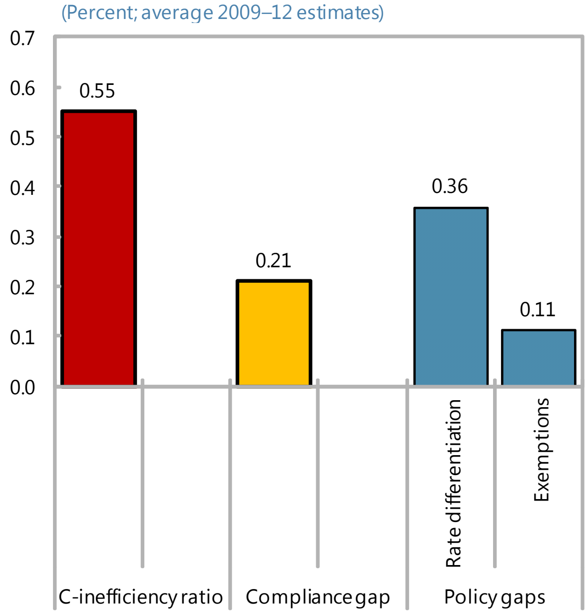
Exemptions are limited but rate differentiation is above average.

VAT Coverage in Europe, 2015
(Unweighted averages)



Compliance gap accounts for over a third of the VAT gap…

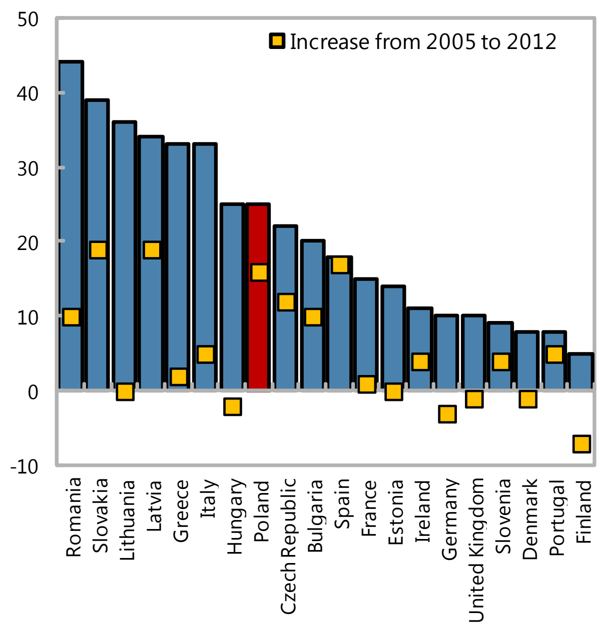
Poland: Decomposition of the C-Inefficiency of the VAT
(Percent; average 2009–12 estimates)



Note: Decomposition follows de Mooij and Keen (2012).

… and has deteriorated more than elsewhere in Europe.

VAT Compliance Gap
(Percent of total VAT revenue liabilities in 2012)

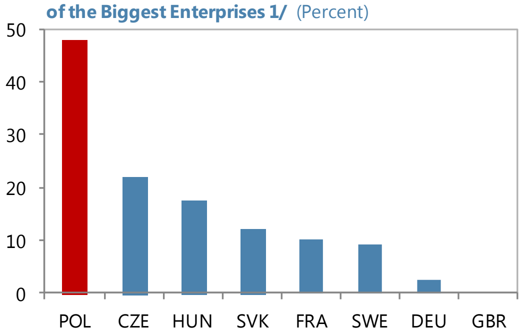


Sources: Organisation for Economic Cooperation and Development (OECD): Consumption Tax trends 2014, European Commission, and IMF staff calculations.

Figure 10. Republic of Poland: Prevalence of State-Owned Enterprises

The share of state-controlled enterprises in Poland is high…

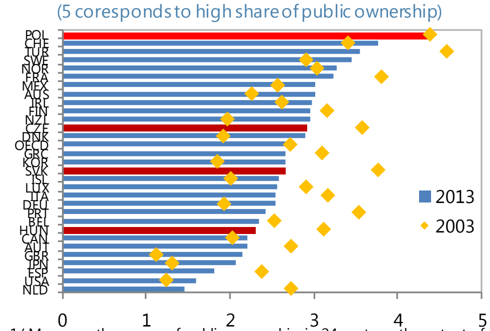
Share of State-Owned Enterprises (SOEs) in Revenues of the Biggest Enterprises 1/ (Percent)



1/ Biggest non-financial companies with cumulative revenues above 50 percent of GDP.

…and has changed very little in the last decade.

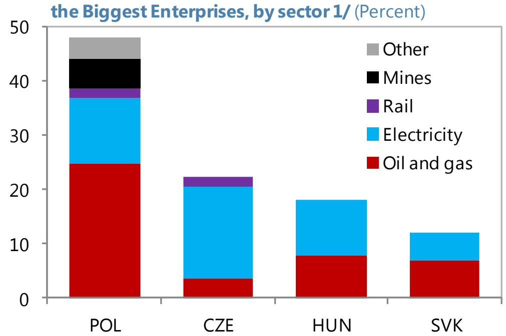
Public Ownership Indicator 1/
(5 coresponds to high share of public ownership)



1/ Measures the scope of public ownership in 24 sectors, the extent of state-ownership in network industries, and the level of public control in enterprises where the state owns shares.

Energy companies have the largest share…

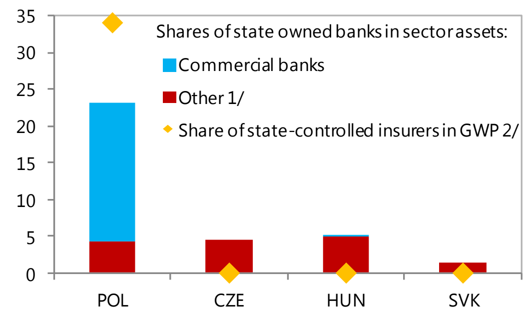
Share of State-Controlled Enterprises in Revenues of the Biggest Enterprises, by sector 1/ (Percent)



1/ Biggest non-financial companies with cumulative revenues to GDP ratio of 50 percent of GDP.

…and state presence in the financial sector stands out.

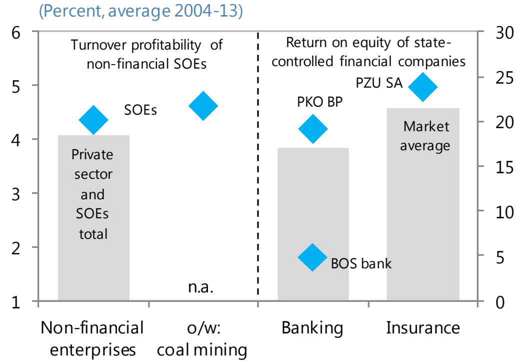
Share of State-Controlled Institutions in Financial Sector (Percent)



1/ Includes development and import-export banks.
2/ GWP denotes Gross Written Premium.

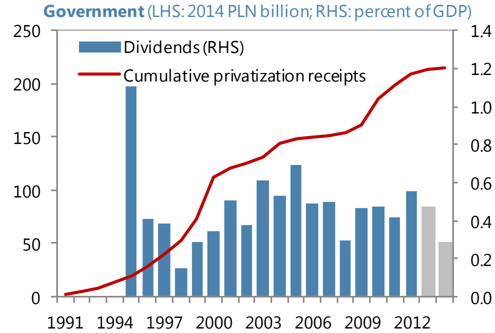
Profitability does not seem to be a concern…

Profitability of SOEs
(Percent, average 2004-13)



…and the state budget continued to benefit from dividend payments and privatization receipts.

Privatization Receipts and Dividends Paid to General Government (LHS: 2014 PLN billion; RHS: percent of GDP)



Note: estimates for 2013 and 2014 dividends.

Sources: Bankscope, Deloitte CE Top 500, Forbes Global 2000, Companies' financial reports, Eurostat, Ministry of Economy and staff calculations.

Table 1. Republic of Poland: Selected Economic Indicators, 2012–20

	2012	2013	2014	2015	2016	2017	2018	2019	2020
				Projections					
Activity and prices									
GDP (change in percent) 1/	1.8	1.7	3.4	3.6	3.5	3.6	3.6	3.6	3.6
Domestic demand	-0.4	0.4	5.0	3.6	4.2	4.0	3.7	3.8	3.6
Private consumption growth	0.9	1.2	3.0	3.7	3.6	3.4	3.4	3.6	3.5
Public consumption growth	0.2	2.1	4.7	3.0	2.9	3.5	3.5	3.5	3.5
Domestic fixed investment growth	-1.5	1.1	9.2	7.8	5.7	6.0	4.5	4.5	4.0
Inventories (contribution to growth)	-0.6	-1.0	0.4	-0.8	0.2	0.0	0.0	0.0	0.0
Net external demand (contribution to growth)	2.1	1.4	-1.5	0.0	-0.7	-0.4	-0.1	-0.2	0.0
Output gap	0.1	-1.0	-0.5	-0.2	0.0	0.0	0.0	0.0	0.0
CPI inflation (percent)									
Average	3.7	0.9	0.0	-1.0	0.8	1.8	2.3	2.5	2.5
End of period	2.4	0.7	-1.0	-0.2	1.5	2.1	2.5	2.5	2.5
Unemployment rate (average, according to LFS)	10.1	10.3	9.0	7.9	7.7	7.6	7.5	7.5	7.5
Public finances (percent of GDP) 2/									
General government revenues	39.2	38.2	38.6	39.1	38.8	38.6	38.7	38.9	39.0
General government expenditures	42.9	42.2	41.8	41.8	41.4	41.2	41.0	40.9	40.9
General government balance	-3.7	-4.0	-3.2	-2.8	-2.5	-2.6	-2.2	-2.0	-2.0
Public debt	54.4	55.7	50.1	51.1	51.0	50.9	50.5	49.5	48.5
National definition 3/	52.0	53.1	47.8	...	...	...	...	...	...
Money and credit									
Private credit (change in percent, end-period)	2.4	4.5	7.6	7.5	7.7	8.1	8.4	8.6	8.7
Deposits (change in percent, end-period)	5.1	5.8	7.8	7.6	7.7	8.1	8.4	8.6	8.6
Broad money (change in percent, end-period)	4.5	6.2	8.2	7.3	7.8	8.1	8.3	8.5	8.6
Policy Rate (percent) 4/	4.6	2.9	2.4	1.5	...	...	...	...	...
Balance of payments									
Current account balance (transactions, billion U.S. dollars)	-17.6	-6.9	-7.6	-6.5	-9.7	-13.6	-16.4	-21.3	-23.3
Percent of GDP	-3.5	-1.3	-1.4	-1.3	-1.9	-2.5	-2.8	-3.4	-3.5
Exports of Goods (billion U.S. dollars)	181.0	197.8	208.8	212.4	228.3	244.8	262.5	281.0	300.7
Export volume growth	4.3	4.8	5.7	7.4	6.8	6.5	6.7	6.6	6.7
Imports of Goods (billion U.S. dollars)	190.2	197.0	211.0	213.9	232.1	252.2	272.4	295.3	317.6
Import volume growth	-0.6	1.8	9.1	7.9	8.0	7.5	7.0	7.0	6.8
Terms of trade (index 1995=100)	98.2	100.5	102.9	103.7	103.8	103.4	102.9	102.0	101.6
Official reserves (billion U.S. dollars)	108.9	106.2	100.4	104.4	106.8	108.2	108.3	108.3	107.8
In percent of short-term debt plus CA deficit	86.9	93.6	102.6	98.0	96.9	94.4	91.5	90.2	88.3
Total external debt (billion U.S. dollars)	366.7	382.8	352.0	352.4	353.7	355.9	360.3	371.9	384.8
In percent of GDP	73.8	72.7	64.3	72.9	69.2	65.2	61.9	59.7	57.4
Exchange rate									
Exchange rate regime					Freely floating				
Zloty per USD, period average 5/	3.3	3.2	3.2	3.7	...	...	...	...	...
Zloty per Euro, period average 5/	4.2	4.2	4.2	4.1	...	...	...	...	...
Real effective exchange rate (INS, CPI based) 6/	107.5	108.3	109.1	...	...	...	...	...	...
Appreciation (percent change)	-2.6	0.7	0.7	...	...	...	...	...	...
Memorandum item:									
Nominal GDP (billion zloty)	1615.9	1662.7	1728.7	1791.1	1882.9	1987.3	2097.6	2225.0	2359.1

Sources: Polish authorities and IMF staff calculations.

1/ Real GDP is calculated at constant 2010 prices.

2/ According to ESA2010.

3/ Excluding debts of the National Road Fund.

4/ NBP Reference Rate (avg). For 2015, as of June 4.

5/ For 2015, exchange rate as of June 4.

6/ Annual average (2000=100).

Table 2. Republic of Poland: Balance of Payments on Transaction Basis, 2012–20

(Millions of U.S. dollars, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Projections			
Current account balance	-17,631	-6,856	-7,578	-6,498	-9,668	-13,595	-16,446	-21,332	-23,332
percent of GDP	-3.5	-1.3	-1.4	-1.3	-1.9	-2.5	-2.8	-3.4	-3.5
Trade balance	-1,253	11,328	9,924	10,885	9,081	5,968	3,958	-59	-1,847
percent of GDP	-0.3	2.2	1.8	2.3	1.8	1.1	0.7	0.0	-0.3
Balance on Goods	-9,233	833	-2,133	-1,494	-3,841	-7,341	-9,955	-14,324	-16,855
Merchandise exports f.o.b.	180,985	197,787	208,838	212,413	228,303	244,840	262,493	280,968	300,728
Merchandise imports f.o.b.	190,218	196,954	210,971	213,907	232,144	252,181	272,448	295,292	317,583
Balance on Services	7,980	10,495	12,057	12,379	12,923	13,309	13,912	14,265	15,008
Merchandise exports f.o.b.	41,113	44,899	48,094	48,917	52,577	56,385	60,450	64,705	69,256
Merchandise imports f.o.b.	33,133	34,404	36,037	36,538	39,654	43,076	46,538	50,440	54,248
Exports of goods and services									
percentage change in unit values	-1.3	9.3	5.9	1.7	7.5	7.2	7.2	7.0	7.0
percentage volume growth	4.3	5.0	5.7	7.4	6.8	6.5	6.7	6.6	6.7
Imports of goods and services									
percentage change in unit values	-5.0	3.6	6.8	1.4	8.5	8.6	8.0	8.4	7.5
percentage volume growth	-0.6	1.8	9.1	7.9	8.0	7.5	7.0	7.0	6.8
Terms of trade (percentage change)	-1.0	2.3	2.4	0.8	0.1	-0.3	-0.5	-0.9	-0.4
Primary Income balance	-16,178	-17,644	-16,940	-16,815	-18,176	-18,984	-19,819	-20,682	-20,889
Secondary Income balance	-200	-540	-562	-568	-573	-579	-585	-591	-597
Capital and financial account balance	-322	4,933	9,485	9,409	2,675	3,606	-1,320	-10,412	-14,222
Capital account balance (net)	10,958	11,964	13,309	11,579	10,006	12,698	11,926	10,134	9,585
Financial account balance (net)	-11,280	-7,031	-3,824	-2,169	-7,331	-9,092	-13,246	-20,545	-23,807
Foreign direct investment (net)[+ = outflows]	-5,862	-3,334	-8,786	-8,584	-9,049	-9,537	-10,050	-10,589	-11,155
Assets [Increase = +]	1,327	-3,322	5,374	5,428	5,482	5,537	5,592	5,648	5,705
Liabilities [Increase = +]	7,189	12	14,160	14,012	14,531	15,074	15,642	16,237	16,860
Portfolio investment (net)	-19,655	-125	1,462	-1,065	-1,142	-1,511	-1,759	-6,790	-6,893
Assets	445	2,159	5,692	5,448	4,631	5,765	5,771	5,777	5,783
Liabilities	20,100	2,284	4,230	6,513	5,773	7,277	7,530	12,567	12,675
Other investment (net)	5,766	-3,772	3,211	3,500	500	500	-1,500	-3,200	-5,200
Assets	2,117	294	2,605	1,000	1,000	1,000	2,000	2,500	1,800
Liabilities	-3,649	4,066	-606	-2,500	500	500	3,500	5,700	7,000
Financial derivatives	-2,732	-745	-15	0	0	0	0	0	0
Errors and omissions	-4,607	-12,139	-9,555	-7,250	-7,669	-8,195	-8,725	-9,348	-10,059
Financing									
Reserve assets [Increase = +]	11,203	945	304	3,979	2,359	1,456	63	33	-559
Memorandum items:									
Current plus capital account (percent of GDP)	-1.3	1.0	1.0	1.1	0.1	-0.2	-0.8	-1.8	-2.0
Official reserves	108,914	106,220	100,438	104,417	106,776	108,233	108,296	108,329	107,770
in months of imports	6.9	6.5	5.7	5.9	5.5	5.2	4.8	4.4	4.1
Ratio of reserves to short-term debt 1/	92	100	110	108	111	110	112	112	109
Ratio of reserves to ST debt plus CA deficit 1/	87	94	103	98	97	94	92	90	88
Ratio of reserves to IMF ARA metric	118	109	114	118	118	…	…	…	…
Total external debt (percent of GDP)	74	73	64	73	69	65	62	60	57
Total external debt (percent of exports)	165	158	137	135	126	118	112	108	104
External debt service (percent of exports)	58	52	45	38	37	35	34	32	30

1/Short-term debt is on remaining maturity.

Sources: National Bank of Poland and IMF staff calculations.

Table 3. Republic of Poland: Risk Assessment Matrix[1/]

Risk	Relative Likelihood and Transmission Channels	Expected Impact of Risk	Policy Recommendations
1. Side-effects from global financial conditions	**High** • A surge in financial volatility could occur as investors reassess underlying risk and move to safe-haven assets given slow and uneven growth as well as asymmetric monetary exit. Both push and pull factors will affect capital flows in the months ahead. ▪ **Outflows**: monetary policy tightening in the U.S. could trigger capital outflows with high participation of foreign investors in the domestic bond market entailing a potential transmission channel. Risks are mitigated by prudent public debt management. ▪ **Inflows:** Ample liquidity in the context of the ongoing quantitative easing by the European Central Bank (ECB QE), combined with strong economic fundamentals in Poland, could attract excessively large capital inflows.	**Medium** **Outflows**: ▪ Investors could reallocate assets away from Poland, resulting in capital flow reversals and zloty depreciation. ▪ Liquidity in the FX derivatives market could be adversely affected, increasing banks' hedging costs. Risks are mitigated by strong liquidity positions in the banking sector. **Inflows:** ▪ Excess liquidity could increase exchange market pressure, exacerbate zloty appreciation and fuel asset bubbles.	• The exchange rate should be allowed to float freely, but intervention could be used to dampen excessive volatility. Fiscal policy should allow automatic stabilizers to work as needed. ▪ **Outflows:** interest rate hikes could be used to stem capital outflow pressure. The NBP should provide liquidity support (including in FX) if needed. The FCL arrangement could be used under extreme circumstances. ▪ **Inflows:** monetary policy should be eased to reduce interest-rate differentials and macroprudential policy should be tightened to manage potential risks of asset price bubbles.
2. Protracted period of slower growth in key advanced and emerging economies	**High** • In the euro area and Japan, weak demand and persistently low inflation could lead to "new mediocre" growth.	**Medium** • Significant trade linkages with Europe would weaken growth in Poland through lower exports and adverse confidence effects. • NPLs would increase as a result of the growth slowdown. Risks are mitigated by the banking sector's strong capital position.	• Monetary policy should be further eased. • Fiscal automatic stabilizers should be allowed to operate.
3. Mounting conflict in Russia and Ukraine	**Medium** • The mounting conflict could depress business confidence and heighten risk aversion amid disturbances in global financial, trade, and commodity markets. • Spillovers would materialize through trade, financial, and confidence channels.	**Medium** • Gas supply disruptions would adversely affect Poland, particularly heavy industry (which is more reliant on imported gas). • Financial market/confidence effects could lead to capital flow reversals and pressure on Polish financial markets. Risks are mitigated by Poland's very strong fundamentals and policies.	• In the event of adverse growth effects, monetary policy should be further eased, unless Poland is faced with strong capital outflows, and fiscal automatic stabilizers should be allowed to operate. • The exchange rate should be allowed to float freely, but intervention could be used to dampen excessive volatility.

Table 3. Republic of Poland: Risk Assessment Matrix (concluded)

Risk	Relative Likelihood and Transmission Channels	Expected Impact of Risk	Policy Recommendations
4. Sovereign stress in the euro area re-emerges due to political uncertainty, faltering reforms and political and social upheaval, particularly in Greece	**Medium** • Bank-sovereign-real economy links could re-intensify because of stalled or incomplete delivery of policy commitments at the national or euro area level. • Strong market pressure on euro area economies would likely reverberate across financial markets. • High participation of foreign investors in the domestic bond market entails a potential transmission channel. Risks are mitigated by prudent public debt management.	**Medium** • Poland could face capital flow reversals and exchange rate pressure. • Liquidity in the FX derivatives market could be adversely affected, increasing banks' hedging costs. Risks are mitigated by strong liquidity positions in the banking sector.	• The exchange rate should be allowed to float freely, but intervention could be used to dampen excessive volatility. • The NBP should provide liquidity support (including in FX) if needed. • The FCL arrangement could be used under extreme circumstances.
5. Protracted period of low inflation	**Medium** • Inflation could fail to pick up as envisaged in the baseline—either on account of external factors (low imported inflation) or domestic factors (entrenched low inflation expectations)—and remain low for a protracted period.	**Medium** • Very low inflation would increase (ex-post) real interest rates and weigh on balance sheets, deterring investment and growth. • To the extent that household inflation expectations in Poland are adaptive, breaking out of a protracted low inflation environment could be more difficult than in countries where inflation expectations are well anchored. Risks are mitigated by still-strong domestic demand.	• Monetary policy should be eased further. Forward guidance could help anchor inflation expectations. • The exchange rate should be allowed to float freely.

1/ The RAM shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly.

Table 4. Implementation of Past Fund Advice

Policy implementation has been broadly in line with past Fund advice:

Monetary policy. To counter risks of protracted deflation, the MPC continued the easing cycle by cutting the policy interest rate in March by 50 bps to a historic low of 1.5 percent, bringing the cumulative reduction in policy interest rates since October to 100 bps. However, staff is of the view that announcing the end of the easing cycle was premature given weak inflation expectations and risks of second-round effects.

Fiscal policy. Fiscal consolidation has advanced further, supported by a robust economic recovery, recent changes to the pension system, and the implementation of the stabilizing expenditure rule in the 2015 budget. Meanwhile, the authorities have remained committed to their MTO, which is deemed adequate to rebuild fiscal buffers and preserve fiscal sustainability. However additional measures are needed to reach this objective. The recent decision to reform large taxpayer administration and establish a single Large Taxpayer Office, in line with IMF TA recommendations is a welcome step in strengthening revenue mobilization.

Financial sector. The work is ongoing to restructure the small non-systemic, but weak, credit union segment through takeovers and bankruptcy. Doubled financial sector contributions in 2015 should help mitigate fiscal risks. Work to put in place macroprudential and bank resolution frameworks has continued, though final legislation has been delayed.

Structural reforms. The authorities continued to strengthen labor and product markets. Regarding the labor market, work is ongoing to streamline the number of regulated professions. Measures are being taken to reduce labor market segmentation by better aligning social security contributions on civil law employment contracts with those on regular contracts and limiting the duration of consecutive short-term contracts. Public employment offices have been reformed to increase job-matching efficiency. The business climate is being improved by easing regulations for business start-ups. A new corporate insolvency regime to encourage restructuring (instead of liquidation) of viable firms is to take effect from January 1, 2016.

Table 5. Republic of Poland: Financial Soundness Indicators, 2007–15

	2007	2008	2009	2010	2011	2012	2013	2014	2015Q1
Capital adequacy 1/									
Regulatory capital to risk-weighted assets	12.0	11.1	13.3	13.9	13.1	14.8	15.7	14.7	
Regulatory Tier I capital to risk-weighted assets	11.8	10.0	12.0	12.5	11.7	13.1	14.1	13.5	
NPLs net of provisions to capital	11.4	8.3	13.8	11.5	11.6	12.9	12.1	12.1	
Bank capital to assets	8.0	7.5	8.1	8.2	7.8	8.7	9.1	8.9	
Asset composition and quality									
NPLs to gross loans (nonfinancial sector)	5.2	4.4	7.9	8.8	8.2	8.8	8.5	8.1	8.2
Sectoral distribution of loans to nonfinancial sector									
Loans to households	59.3	62.0	65.3	68.0	66.4	65.7	66.1	65.6	65.8
Loans to non-financial corporations	40.3	37.6	34.3	31.5	33.1	33.7	33.3	33.7	33.6
Earnings and profitability									
Return on average assets (after tax)	1.7	1.5	0.8	1.0	1.3	1.2	1.1	1.1	1.1
Return on average equity (after tax) 1/	22.4	20.7	11.2	13.3	16.1	14.0	12.1	12.4	
Interest margin to gross income	59.4	55.7	51.9	53.0	55.8	55.0	56.1	58.2	57.0
Noninterest expenses to gross income	68.7	58.4	58.5	56.0	54.5	54.5	57.2	54.9	55.0
Liquidity									
Liquid assets to total assets (liquid assets ratio)	17.1	17.0	20.3	20.8	19.5	20.9	21.4	20.6	20.3
Liquid assets to total short-term liabilities	24.2	25.3	29.8	31.2	28.8	31.1	31.7	30.6	30.3
Loans to deposits	98.0	112.6	109.2	114.5	119.8	117.7	115.7	112.9	112.8
Sensitivity to market risk									
Net open positions in FX to capital 1/	0.6	0.0	2.7	0.3	-0.3	0.2	-0.1	0.2	

Sources: NBP and KNF.

Note: Data according to Financial Soundness Indicators (FSI), except for asset composition and quality (indicators not part of FSI reporting template).

1/ Data for domestic banking sector (since 2014: Bank Gospodarstwa Krajowego excluded). Since 2014: data on capital in accordance with CRDIV/CRR (not yet available for 2015Q1 as of May 5, 2015).

Table 6. Republic of Poland: 2013 FSAP Recommendations and Current Status[1/]

Key Recommendations	Status
Addressing impaired loans: (i) intensify oversight of credit risk management and restructuring practices; (ii) standardize and enhance transparency of bank accounting practices; and (iii) standardize debt-to-income (DTI) ratio calculation.	The Polish KNF intensified oversight of credit risk management and restructuring practices through an AQR, following ECB methodology for the euro area AQR. This included on-site credit file review. Following the AQR, KNF addressed a letter to banks, highlighting expectations, including about quality of data used for calculation of impairment charges and use of models for exposure valuation. This aimed at standardizing and enhancing transparency of bank accounting practices. DTI limits are set by the banks. Recommendations specify how DTI ratios should be calculated. The process of determining DTIs by banks is subject to offsite and onsite examinations by KNF.
Strengthening banking supervision: (i) expand the scope for KNF to issue legally binding prudential regulations; (ii) allow KNF's Board to delegate administrative and procedural decisions to its management, increase KNF independence, and address other governance issues; and (iii) increase KNF flexibility to allocate budgetary and staff resources and enhance its analytical capabilities.	Pending. According to the Polish constitution, KNF cannot issue legally binding, general acts (regulations). However, KNF can issue recommendations regarding risk management, specifying how banks should mitigate risk.
Strengthening credit unions: (i) eliminate the dual supervision; require a solvency ratio of 8 percent in 5 years; and clarify the governance of the stabilization fund; (ii) develop an inclusive set of SKOK regulations and apply accounting principles for financial institutions to SKOKs; and (iii) develop capital rehabilitation plans for financially weak SKOKs.	Rehabilitation plans are being developed with 41 of 50 SKOKs obliged to prepare recovery plans. Last year, 2 credit unions went bankrupt, 2 credit unions were taken over by commercial banks, and one merger took place.
Developing sound macroprudential policies: (i) ensure the macroprudential supervisory law provides for Systemic Risk Board's (SRB) independence (with a leading role for NBP), accountability to Parliament, and power to make recommendations coupled with an "act or explain" mechanism; and (ii) develop clear macroprudential policy objectives that are distinct from those of monetary and microprudential supervisory policy.	A law on macroprudential supervision is progressing. According to the draft law, a macroprudential committee (comprising chairpersons of the NBP, the Ministry of Finance, KNF, and Bankowy Fundusz Gwarancyjny (BFG)) will be a designated authority in Poland. The draft entrusts macroprudential supervision to the Financial Stability Committee (FSC) and not to the SRB as previously envisaged. As such, the FSC will combine functions of macroprudential supervision and crisis management.

[1/] See "Republic of Poland: Financial System Stability Assessment," IMF Country Report No. 13/221, 2013.

Table 6. Republic of Poland: 2013 FSAP Recommendations and Current Status (concluded)

Key Recommendations	Status
Improving the bank resolution framework: (i) ensure precedence of administrative powers over corporate insolvency procedures; (ii) ensure that the creditor claims hierarchy protects BFG's claims on resources provided for balance sheet "gap filling" measures; and (iii) include a Tier-1 capital trigger and link the "public interest" trigger to financial stability.	Work is progressing to improve the bank resolution framework. According to the draft law, (i) precedence of administrative powers in the resolution procedure over corporate insolvency procedure will be ensured; (ii) protection of BFG claims will be ensured; and (iii) a Tier-1 trigger and a public interest trigger are included as the triggers for resolution process.
Improving the deposit insurance system: (i) remove the Polish Bank Association from the BFG Council; (ii) ensure adequate funding and capacity, revise and introduce new regulations, and enhance protocols in light of expanded mandate; and (iii) amend code of conduct to restrict employment in member institutions to all employees.	A draft law on BFG is undergoing consultations. BFG is expanding and strengthening staff in accordance with its new tasks. The draft law envisages adequate BFG funds for deposit protection and resolution. Existing BFG funds will be redistributed to the Deposit Guarantee Scheme (DGS) for resolution purposes. The proposed target levels of BFG funds are above those established in DGS and the Bank Recovery and Resolution Directive (BRRD).
Strengthening pension reform and capital markets: (i) allow lifecycle strategies in pension funds, and measure performance of pension funds in relation to the benchmark portfolio; (ii) amend the mortgage covered bond framework to allow broader issuance and adopt a legal framework for mortgage securitization; (iii) strengthen enforcement of security interests and judicial decisions.	The pension system was changed in 2014 with most employees deciding not to contribute to open pension funds but only to the public sector fund. A draft law on covered bonds and mortgage banks is progressing. The draft law eliminates some barriers in Polish tax legislation to the development of covered bonds. Additionally, it aims at facilitating the investment in covered bonds by pension funds and credit unions domiciled in Poland.

Table 7. Republic of Poland: Monetary Accounts, 2008–15

	2008	2009	2010	2011	2012	2013	2014	2015 Proj.
				(Billions of zlotys)				
Central bank								
Net foreign assets	177	212	257	317	321	297	332	362
Official reserve assets	185	228	277	337	337	321	356	386
Net domestic assets	-51	-74	-117	-179	-153	-133	-140	-159
Net claims on government	-21	-23	-12	-19	-16	-7	-19	-19
Claims on banks 1/	9	-25	-74	-93	-100	-117	-85	-103
Other items, net	-38	-26	-31	-67	-37	-9	-36	-36
Base money	126	138	140	138	167	164	192	203
Currency issued	102	100	103	112	113	126	143	150
Bank reserves	25	38	37	26	54	38	49	53
Deposit money banks								
Net foreign assets	-113	-135	-156	-169	-143	-147	-149	-136
Net domestic assets	679	762	842	939	953	1,004	1,072	1,129
Net claims on the central bank 1/	37	75	121	130	167	167	146	168
Net claims on government	153	171	177	191	177	204	242	249
Claims on private sector	633	677	735	838	858	896	964	1,036
Claims on corporates	224	217	215	253	257	259	278	299
Claims on households	376	421	480	537	538	562	593	638
Claims on other	33	40	41	47	63	75	93	100
Other items, net	-143	-161	-191	-219	-248	-263	-280	-325
Deposits	566	627	687	771	810	857	924	993
Consolidated banking system								
Net foreign assets	64	76	101	149	177	150	183	226
Net domestic assets	602	644	683	733	744	829	876	910
Claims on government	131	148	164	172	161	197	222	230
Claims on private sector	633	677	735	838	858	896	964	1,036
Other items, net	-162	-182	-217	-276	-274	-264	-311	-356
Broad money (M3)	666	720	784	882	921	979	1,059	1,136
Memorandum items:				(Percentage change from end of previous year)				
Base money	23.1	8.8	1.6	-1.1	21.0	-1.9	16.8	5.8
Broad money (M3)	18.6	8.1	8.8	12.5	4.5	6.2	8.2	7.3
Net domestic assets	36.6	7.0	6.0	7.4	1.5	11.4	5.7	3.9
Net foreign assets	-46.9	18.8	32.6	46.9	19.4	-15.3	22.1	23.3
Net claim on government	63.4	12.8	11.0	4.5	-6.6	22.5	13.0	3.4
Claims on private sector	36.4	7.0	8.5	13.9	2.4	4.5	7.6	7.5
Deposit growth	18.9	10.6	9.6	12.2	5.1	5.8	7.8	7.6
				(Percent of GDP, unless otherwise noted)				
Broad money (M3)	52.2	52.9	54.5	56.7	57.0	58.9	61.3	63.5
Private sector credit	49.6	49.7	51.2	53.9	53.1	53.9	55.8	57.9
Broad money Velocity (GDP/M3)	1.9	1.9	1.8	1.8	1.8	1.7	1.6	1.6
Money multiplier (M3/base money)	5.3	5.2	5.6	6.4	5.5	6.0	5.5	5.6

Sources: Haver, IFS, NBP, and IMF staff calculations.

1/ The difference between deposit money bank claims on the central bank and central bank claims on banks relates to banks' reserves and currency in vault.

Table 8. Republic of Poland: General Government Statement of Operations, 2012–20

(Percent of GDP, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
				Projections					
Revenue	39.2	38.2	38.6	39.1	38.8	38.6	38.7	38.9	39.0
Taxes	20.0	19.5	19.7	19.8	19.9	19.5	19.6	19.7	19.8
Personal income tax	4.5	4.6	4.5	4.6	4.6	4.6	4.7	4.7	4.6
Corporate income tax	2.1	1.8	1.7	1.8	1.8	1.8	1.8	1.8	1.8
VAT	7.1	7.0	7.1	7.0	7.1	6.8	6.8	6.9	6.9
Excises	3.7	3.7	3.5	3.6	3.6	3.6	3.6	3.6	3.6
Other taxes	2.6	2.5	2.8	2.8	2.8	2.8	2.8	2.8	2.8
Social contributions	13.0	13.2	13.2	13.4	13.4	13.4	13.4	13.4	13.4
Other revenue 1/	6.1	5.5	5.7	5.8	5.6	5.7	5.7	5.8	5.8
Capital revenue	1.3	1.0	1.2	1.2	1.1	1.2	1.2	1.2	1.2
Sales of goods and services	2.4	2.3	2.4	2.4	2.4	2.4	2.4	2.4	2.4
Other current revenue	2.4	2.2	2.1	2.2	2.1	2.1	2.2	2.2	2.2
Expenditure	42.9	42.2	41.8	41.8	41.4	41.2	41.0	40.9	40.9
Expense	38.4	38.5	37.8	37.7	37.5	37.2	37.2	37.1	37.1
Compensation of employees	10.4	10.3	10.2	10.1	10.1	10.1	10.1	10.1	10.1
Use of goods and services	5.9	5.9	6.0	6.1	6.1	6.1	6.1	6.1	6.1
Interest	2.7	2.5	2.0	1.8	1.7	1.5	1.5	1.6	1.6
Subsidies	0.7	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Social benefits	15.9	16.3	16.3	16.3	16.1	16.0	16.0	15.8	15.8
Other expense 2/	2.9	2.9	2.8	2.8	2.8	2.8	2.8	2.8	2.8
Other current expenditure	2.3	2.3	2.2	2.2	2.2	2.2	2.2	2.2	2.2
Capital transfers	0.6	0.5	0.6	0.7	0.6	0.7	0.7	0.7	0.7
Net acquisition of nonfinancial assets	4.5	3.7	4.0	4.1	3.9	4.0	3.8	3.8	3.8
Gross operating balance	0.7	-0.3	0.8	1.3	1.4	1.4	1.6	1.8	1.8
Net lending/borrowing (overall balance)	-3.7	-4.0	-3.2	-2.8	-2.5	-2.6	-2.2	-2.0	-2.0
Net financial transactions	-3.4	-4.1	-3.2	-2.8	-2.5	-2.6	-2.2	-2.0	-2.0
Net acquisition of financial assets	-0.9	-1.1	0.7	0.1	0.1	0.1	0.1	0.1	0.1
Currency and deposits	0.7	-1.0	0.7	0.0	0.0	0.0	0.0	0.0	0.0
Debt securities	0.0	0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Loans	0.0	0.0	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Equity and investment fund shares	-1.0	-0.6	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Other financial assets	0.1	0.4	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Net incurrence of liabilities	2.5	2.9	3.9	2.8	2.6	2.7	2.3	2.1	2.0
Currency and deposits	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt securities	2.4	2.1	-4.8	1.6	1.4	1.6	1.3	1.0	1.1
Loans	0.8	0.7	1.3	1.0	0.9	0.8	0.8	0.8	0.7
Other liabilities	0.3	0.1	7.4	0.2	0.2	0.2	0.2	0.2	0.2
Adjustment and statistical discrepancies	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:									
Cyclically-adjusted balance	-3.8	-3.3	-3.0	-2.7	-2.5	-2.6	-2.2	-2.0	-2.0
Primary balance	-1.1	-1.5	-1.2	-1.0	-0.8	-1.1	-0.7	-0.4	-0.3
Cyclically-adjusted primary balance	-1.1	-0.8	-1.0	-0.9	-0.8	-1.1	-0.7	-0.4	-0.3
General government debt	54.4	55.7	50.1	51.1	51.0	50.9	50.5	49.5	48.5
General government liabilities	62.8	62.9	57.3	58.3	58.2	58.1	57.7	56.7	55.7
General government financial assets	-33.2	-36.0	-31.4	-33.3	-34.3	-35.2	-35.7	-35.7	-35.8
Nominal GDP in billions of zloty	1,616	1,663	1,729	1,791	1,883	1,987	2,098	2,225	2,359

Sources: Eurostat and IMF staff calculations.
1/ According to ESA2010.
2/ Includes grants.

Table 9. Republic of Poland: General Government Financial Balance Sheets, 2012–20

(Millions of zloty, unless otherwise indicated)

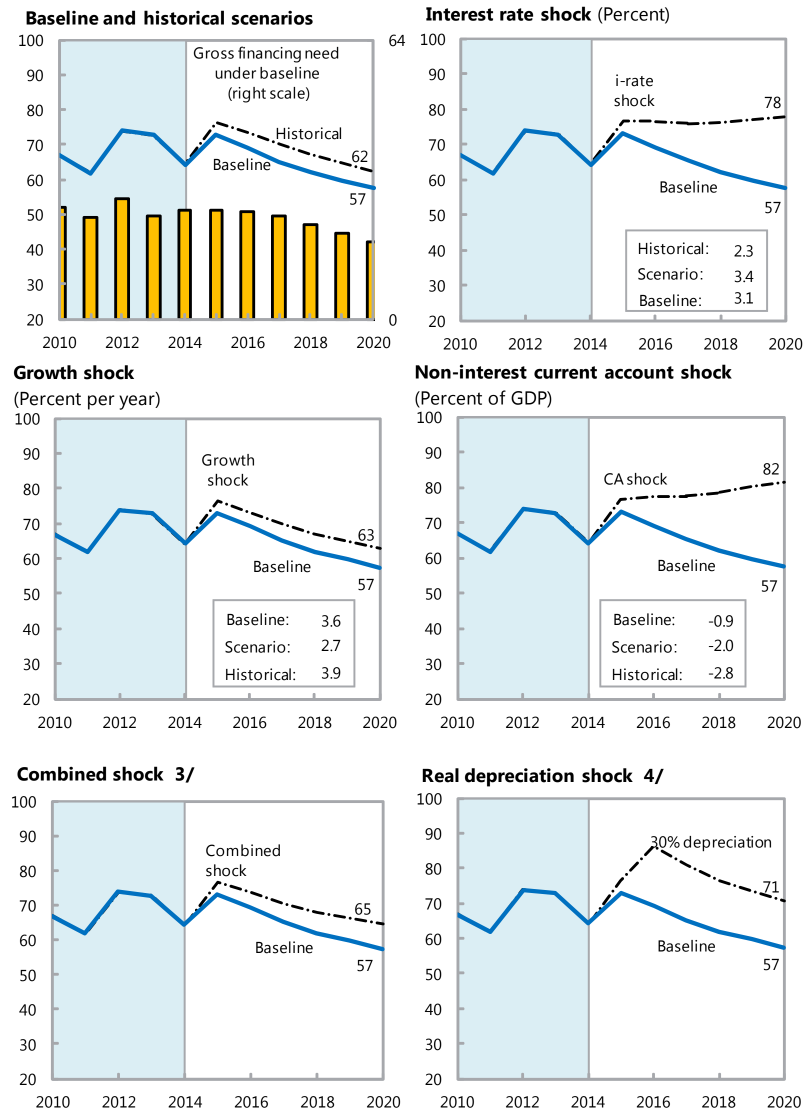
	2012			2013			2014	2015	2016	2017	2018	2019	2020
	Trans-actions	OEF	Closing Opening balance	Trans-actions	OEF	Closing Opening balance	Projections						
Net worth and its changes	....	....	....	....	....	....	....	....	....	....	....	....	....
Nonfinancial Assets	....	....	....	....	....	....	....	....	....	....	....	....	....
Net Financial Worth	-60,235	-28,594	-537,135	-67,369	6,691	-597,814	-541,971	-596,287	-645,092	-698,591	-749,513	-794,408	-843,431
Financial Assets	-3,352	44,443	477,800	-18,523	-10,796	448,480	448,996	447,299	451,398	456,556	460,906	466,648	471,188
Currency and deposits	12,055	793	74,509	-17,088	-1,857	55,564	57,769	59,856	62,924	66,413	70,097	74,354	78,836
Debt securities	105	-896	1,557	2,034	59	3,650	3,795	3,932	4,133	4,362	4,604	4,884	5,179
Loans	-317	117	14,287	4	314	14,605	15,185	15,733	16,540	17,457	18,425	19,544	20,722
Equity and inv. fund shares	-16,825	28,901	274,531	-9,604	-4,599	260,329	253,376	244,614	238,324	231,667	223,542	214,868	204,230
Other financial assets	1,630	15,529	112,915	6,131	-4,713	114,333	118,871	123,164	129,477	136,657	144,238	152,997	162,220
Liabilities	56,883	73,037	1,014,935	48,846	-17,487	1,046,294	990,967	1,043,586	1,096,490	1,155,147	1,210,419	1,261,056	1,314,618
Currency and deposits	0	0	0	0	0	0	0	0	0	0	0	0	0
Debt securities	39,253	-30,193	39,253	34,531	-39,253	34,531	853,681	901,343	946,955	997,320	1,043,838	1,084,358	1,127,268
Loans	12,402	-21,227	12,402	12,332	-12,402	12,332	12,821	13,284	13,965	14,739	15,557	16,502	17,497
Other liabilities	5,228	124,457	963,280	1,983	34,168	999,432	124,465	128,959	135,570	143,088	151,025	160,197	169,854
Memorandum items:													
Net financial worth (percent of GDP)			-33.2			-36.0	-31.4	-33.3	-34.3	-35.2	-35.7	-35.7	-35.8
Financial assets (percent of GDP)			29.6			27.0	26.0	25.0	24.0	23.0	22.0	21.0	20.0
Liabilities (percent of GDP)			62.8			62.9	57.3	58.3	58.2	58.1	57.7	56.7	55.7
GDP nominal prices (billion PLN)			1615.9			1662.7	1728.7	1791.1	1882.9	1987.3	2097.6	2225.0	2359.1

Sources: National authorities and IMF staff calculations.

Annex I. External Debt Sustainability Analysis

Republic of Poland: External Debt Sustainability: Bound Tests, 2010–20[1/2/]

(External debt, 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/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2015.

Republic of Poland: External Debt Sustainability Framework, 2010–20

(Percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2010	2011	2012	2013	2014			2015	2016	2017	2018	2019	2020	
								I. Baseline Projections						**Debt-stabilizing non-interest current account 5/**
1 **External debt**	66.8	61.7	73.8	72.7	64.3			**72.9**	**69.2**	**65.2**	**61.9**	**59.7**	**57.4**	**-4.2**
2 Change in external debt	2.6	-5.1	12.1	-1.1	-8.5			8.7	-3.7	-4.0	-3.2	-2.3	-2.3	
3 Identified external debt-creating flows (4+8+9)	-2.5	-3.7	2.2	-2.9	-3.6			1.2	-4.6	-4.2	-3.7	-3.1	-2.9	
4 Current account deficit, excluding interest payments	4.5	4.1	1.8	-0.3	-0.2			-0.2	0.3	0.7	0.9	1.4	1.4	
5 Deficit in balance of goods and services	-82.4	-87.8	-89.7	-90.1	-92.0			-105.9	-108.1	-109.2	-110.4	-110.9	-110.6	
6 Exports	40.2	42.9	44.7	46.1	46.9			54.1	54.9	55.1	55.5	55.5	55.2	
7 Imports	-42.2	-44.9	-45.0	-44.0	-45.1			-51.8	-53.2	-54.0	-54.8	-55.5	-55.4	
8 Net non-debt creating capital inflows (negative)	-3.4	-3.2	-1.9	-1.1	-2.2			-2.5	-2.8	-2.8	-2.9	-2.8	-2.7	
9 Automatic debt dynamics 1/	-3.6	-4.6	2.3	-1.4	-1.2			3.9	-2.1	-2.2	-1.7	-1.7	-1.6	
10 Contribution from nominal interest rate	1.1	1.1	1.7	1.6	1.6			1.6	1.6	1.8	1.9	2.0	2.1	
11 Contribution from real GDP growth	-2.2	-2.9	-1.1	-1.2	-2.4			-2.6	-2.4	-2.3	-2.2	-2.1	-2.0	
12 Contribution from price and exchange rate changes 2/	-2.6	-2.7	1.7	-1.8	-0.4			4.9	-1.3	-1.6	-1.4	-1.7	-1.7	
13 Residual, incl. change in gross foreign assets (2-3)	5.2	-1.5	9.9	1.8	-4.9			7.5	0.8	0.2	0.5	0.8	0.6	
External debt-to-exports ratio (in percent)	166.2	143.7	165.1	157.7	137.0			134.9	125.9	118.2	111.6	107.6	104.0	
Gross external financing need (in billions of US dollars) 3/	123.1	122.0	136.9	125.4	137.1			120.4	127.0	130.1	127.0	123.3	118.1	
in percent of GDP	25.8	23.3	27.6	23.8	25.0	10-Year Historical Average	10-Year Standard Deviation	24.9	24.8	23.8	21.8	19.8	17.6	
Key Macroeconomic Assumptions														
Real GDP growth (in percent)	3.7	4.8	1.8	1.7	3.4	3.9	1.8	3.6	3.5	3.6	3.6	3.6	3.6	
Exchange rate appreciation (US dollar value of local currency, percent)	3.4	1.8	-8.9	3.0	0.1	2.1	11.2	-14.9	0.6	1.2	0.9	1.0	1.5	
GDP deflator in US dollars (change in percent)	5.2	5.0	-6.9	4.1	0.6	4.6	11.6	-14.8	2.2	3.2	2.8	3.4	3.9	
Nominal external interest rate (in percent)	1.9	1.7	2.7	2.3	2.3	2.3	0.6	2.2	2.4	2.7	3.2	3.5	3.7	
Growth of exports (US dollar terms, in percent)	16.6	17.4	-1.3	9.3	5.9	11.3	14.8	1.7	7.5	7.2	7.2	7.0	7.0	
Growth of imports (US dollar terms, in percent)	19.9	17.0	-5.0	3.6	6.8	11.2	18.9	1.4	8.5	8.6	8.0	8.4	7.5	
Current account balance, excluding interest payments	-4.5	-4.1	-1.8	0.3	0.2	-2.8	2.1	0.2	-0.3	-0.7	-0.9	-1.4	-1.4	
Net non-debt creating capital inflows	3.4	3.2	1.9	1.1	2.2	2.5	0.8	2.5	2.8	2.8	2.9	2.8	2.7	
								II. Stress Tests for External Debt Ratio						**Debt-stabilizing non-interest current account 5/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2015-2020 4/								**76.5**	**73.4**	**70.1**	**67.1**	**64.6**	**62.2**	**-5.6**
B. Bound Tests														
B1. Nominal interest rate is at baseline plus one-half standard deviation								76.5	76.4	75.9	76.1	77.0	77.8	-1.2
B2. Real GDP growth is at baseline minus one-half standard deviations								76.5	73.3	69.7	66.9	65.0	63.0	-4.0
B3. Non-interest current account at baseline minus one-half standard deviations								76.5	77.2	77.4	78.4	80.1	81.6	-1.6
B4. Combination of B1-B3 using 1/4 standard deviation shocks								76.5	73.6	70.3	67.9	66.3	64.7	-4.1
B5. One time 30 percent real depreciation in 2016								76.5	86.2	80.8	76.5	73.5	70.5	-5.9

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

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

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

4/ 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.

5/ 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.

Source: IMF staff calculations.

Annex II. Public Sector Debt Sustainability Analysis

Public debt is moderately high but sustainable. Its structure and risk profile in terms of interest, rollover, and foreign currency risks is robust, and contingent liabilities are not deemed material. The main risk to the debt outlook stems from a negative shock to GDP growth. In addition, a large share of foreign investors in the domestic debt market entails a risk, albeit the favorable composition of the investor base dominated by "real money" investors and the low share of debt at floating rates provide some mitigating factors.

A. Baseline and Realism of Projections

Debt levels. The adoption of ESA2010 accounting standards resulted in a 1½ percentage point decline in the recorded ratio of public debt to GDP to 55.7 percent at end-2013. A further one-off drop to 50.1 percent of GDP in 2014 occurred as a result of the recent changes to the pension system. Poland's favorable public debt dynamics are underpinned by a decline in the primary deficit, a favorable differential between projected GDP growth and the real interest rate, and the ongoing effects of the changes to the pension system.

GDP growth. The projections assume continued robust GDP growth of around 3.6 percent during 2015–20. The output gap is expected to close next year. In recent years, staff projections of growth have displayed small forecast errors, with some indication of a pessimistic bias relative to other countries.

Fiscal adjustment. Under the baseline, the primary deficit is expected to decline from 1.2 percent of GDP in 2014 to about balance during 2019–20, reflecting modest fiscal measures already in the pipeline, the changes to the pension system, and the gradual recovery in tax revenue (closer to recent historical levels). In the recent past, staff forecast errors of the primary deficit in Poland have not displayed an apparent bias and have been more conservative than for other countries. Overall, the projected fiscal adjustment seems feasible, as indicated by cross country benchmarks.

Sovereign yields. The effective interest rate on public debt declined from 6.6 percent in 2005 to 5.9 percent in 2009 and further to about 5 percent in 2013, reflecting Poland's strong fundamentals and favorable global financial conditions. It is projected to decline to 3.6 percent by 2015. In recent years, Poland has maintained access to capital markets on favorable terms, even during periods of global financial distress. Yields on 10–year bonds declined by 21 bps year-to-date to 2.31 percent in March 2015, but have recently increased reflecting higher volatility in international market. In turn, spreads over 10–year German bonds reached 238 bps in June, while Emerging Market Bond Index and CDS spreads increased to around 52.3 bps and 65 bps, respectively. While there is uncertainty about the impact of the lift-off of U.S. interest rates on global market conditions, the pass-through from interest increases to the budget would be very gradual, as about 80 percent of debt carries a fixed interest rate and the average duration stands at about 5 years. Increases in Poland's yields could also be dampened by capital inflows in the domestic bond markets on the back of the ECB's quantitative easing. A 100 bps parallel shift in the yield curve will lead to an increase in the interest bill of about 0.1 percent of GDP in the first year.

Changes to the pension system. Public debt projections under the baseline are strongly influenced by changes to the pension system.[1] From the fiscal perspective, these changes generated a large one-off drop in (explicit) public debt in the first quarter of 2014 (with a matching increase in implicit public pension liabilities), and a reduction in public financing needs over the medium term. The latter reflects the combined effect of lower public debt service, a partial redirection of pension contributions from the second pillar to the social security administration, and a gradual transfer of assets to the social security administration ten years before retirement. By contrast, the associated increase in public pension payments will gather pace in the long run. Staff calculations using baseline projections for 2014–60 indicate the pension changes would lead to net positive cash flows to the fiscal sector of 30 percent of GDP in net present value terms.

Maturity and rollover risks. Rollover risks are well managed. The average maturity of outstanding debt is estimated at about 5 years, and the share of short-term debt in total government debt is negligible (there have been no t-bills outstanding since August 2013). In recent years, the authorities have taken advantage of favorable market conditions to actively pre-finance debt. About 70 percent of 2015 gross borrowing needs have already been pre-financed. The pension changes caused a mechanical increase in the share of foreign investors in the domestic market as well as in the share of foreign debt (according to the nationality of the holders): the share of foreign investors in the domestic market increased from about 34 percent in 2013 to about 41 percent in January 2015 and the overall share of external debt in total public debt increased from 51 percent in 2013 to 57 percent in 2014. In addition, the share of foreign currency debt in total debt also increased from 30 percent in 2013 to about 36 percent in 2014. In line with the debt management strategy, the baseline assumes gradual convergence toward the current structure of public debt in terms of the share of foreign currency debt in total debt (about 30 percent) and external debt in total debt (about 50 percent).

Debt sustainability analysis (DSA) risk assessment. The heat map highlights risks associated with the relatively large external financing requirements (about 21 percent of GDP in 2014), plus the share of public debt held by non-residents (about 57 percent at end-2014). The latter is influenced by the large participation of foreign investors in the domestic bond market, which increased sharply following the recent pension reform. In turn, the high share of U.S. investors among them exposes the bond market to liquidity risks in case of interest rate hikes in the U.S. However, risks associated with a sudden pullout by foreign investors are mitigated by a favorable composition of the investor base, which is dominated by “real money” institutional investors. The substantial pre-financing of the 2015 external financing requirements of the public sectors also provides an additional cushion. Moreover, overall external financing requirement are heavily influenced by the financing needs of

[1] In February 2014, the pension funds’ holdings of public debt were transferred to the social security administration (together with the corresponding pension liabilities), causing a one-off drop in public debt of about 9 percent of GDP. In addition, the pension changes entailed the gradual transfer of contributor’s assets from the second to the first pillar, starting 10 years prior to their retirement.

the private sector, which include a substantial share of cross-border, intercompany financing, which tends to ameliorate the risk of a sudden stop.

Fan charts. The symmetric fan charts, which assume symmetric upside and downside risks, show that public debt is more likely to enter a downward trajectory during the projection period. The lower bands indicate that the debt-to-GDP ratio could drop to around 46 percent by 2020 with a 25 percent probability. On the other hand, the upper bands indicate that debt-to-GDP ratios could surpass 60 percent by 2020 with a 10 percent probability. A more stringent exercise, however, combining restrictions to the upside shocks to interest rates and GDP growth (200 bps and 1 percent, respectively), increases the probability of debt-to-GDP surpassing 55 percent in 2020 to 50 percent. This result is still commensurate with a sustainable debt path, but it illustrates the degree of uncertainty around the baseline.

B. Shocks and Stress Tests

Primary balance shock. An assumed deterioration in the primary balance by 0.8 percentage points during 2015–16 pushes up slightly the public debt-to-revenue ratio to about 135 percent during 2017–18 and opens up a gap of about 5 percentage points relative to the baseline. Gross financing needs peak at about 10 percent of GDP in 2016 and converge to the baseline by 2020.

Growth shock. The stress scenario assumes a drop in GDP growth by 1.8 percentage points in two consecutive years (2016–17) relative to the baseline, combined with a 0.5 percent drop in inflation and deterioration in the primary balance by 0.8 percent in 2016 and further by 1.8 percent in 2017. Under these assumptions, public debt increases to about 55.7 percent of GDP in 2017 before trending downward to about 53.2 percent of GDP by 2020. Gross financing needs increase to about 10 percent of GDP during 2016–17, but then converge toward the baseline in the outer years.

Interest rate shock. A permanent 200 bps increase in the nominal interest rate starting in 2016 (equivalent to the difference between the maximum real interest rate during 2004–14 and the average real interest rate over the projection period), leads to an increase in the effective interest rate on debt by 40 bps in 2017 (compared to the baseline) and further gradual increases to 130 bps by 2020. Under this scenario, public debt dynamics deteriorate marginally relative to the baseline, with debt remaining around 50 percent of GDP throughout the projection horizon.

Exchange rate shock: The combined shock also assumes an exchange rate depreciation of about 20 percent in 2016 (from 3.6 PLN/US$ to 4.3 PLN/US$), calibrated to emulate the maximum historic movement of the FX rate over the last 10 years. Under this scenario, gross public debt increases by 1 percentage point to about 52 percent of GDP in 2016 before trending down to about 49 percent by 2020. The resilience reflects the predominance of public debt in local currency.

Combined shock. Under the combined shock, the public-debt-to-GDP ratio jumps to about 59.3 percent in 2018 and declines gradually afterward. In turn, gross financing needs increase to about 10.4 percent of GDP in 2017, and remain around 9 percent of GDP in the outer years.

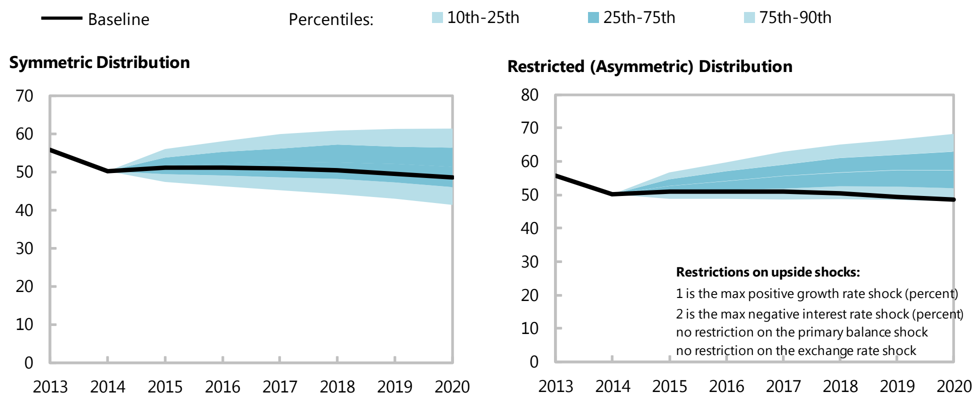
Republic of Poland: Public Sector DSA—Risk Assessment

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

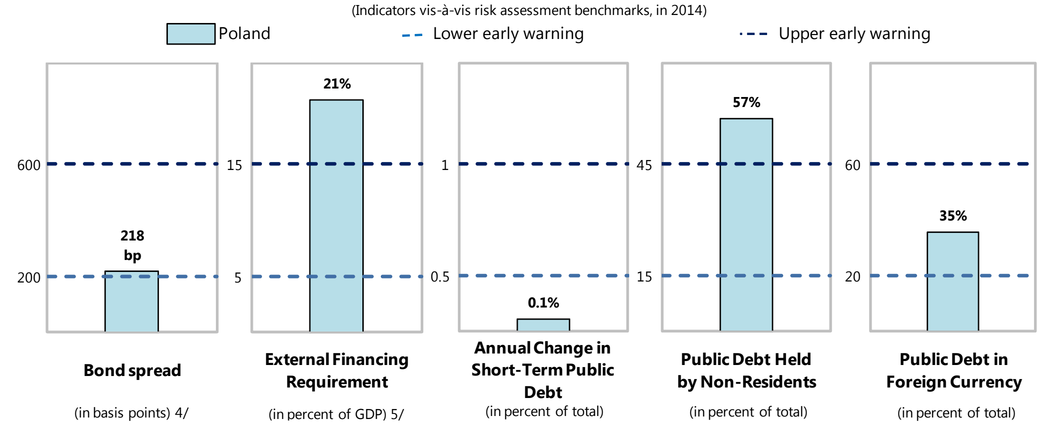
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2014)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

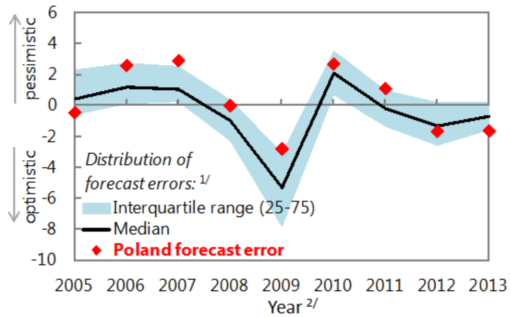
4/ Long-term bond spread over German bonds, an average over the last 3 months, April to-Jun-15.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

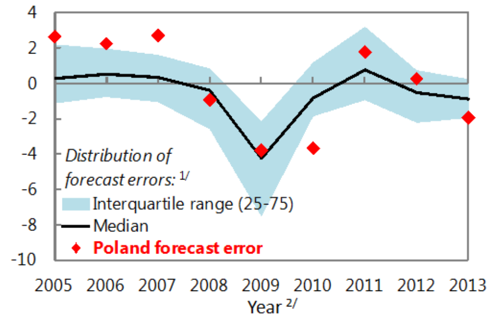
Republic of Poland: Public DSA—Realism of Baseline Assumptions

Forecast Track Record, versus all countries

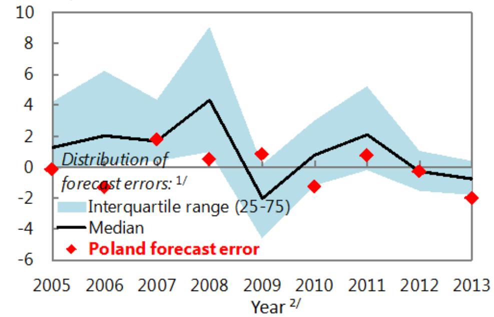
Real GDP Growth
(in percent, actual-projection)
Poland median forecast error, 2005-2013: 0.00
Has a percentile rank of: 55%



Primary Balance
(in percent of GDP, actual-projection)
Poland median forecast error, 2005-2013: 0.26
Has a percentile rank of: 68%

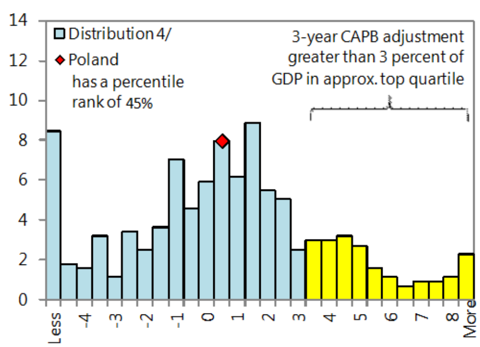


Inflation (Deflator)
(in percent, actual-projection)
Poland median forecast error, 2005-2013: -0.12
Has a percentile rank of: 24%

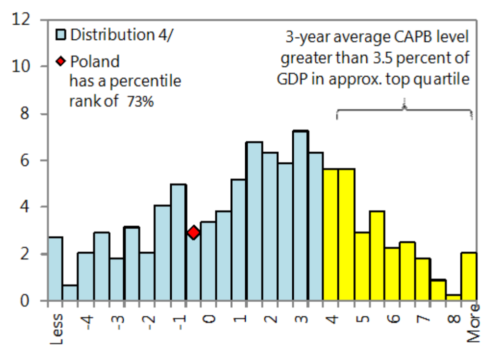


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)

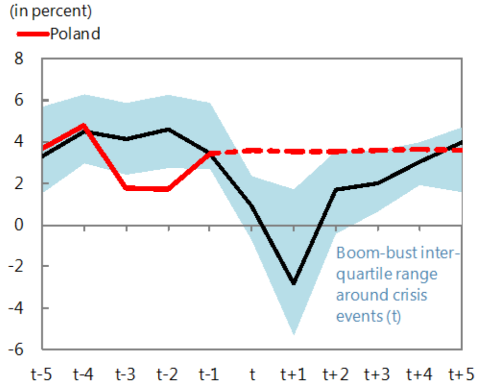


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

Real GDP growth
(in percent)



Source : IMF Staff.
1/ Plotted distribution includes all countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Poland has had a negative output gap for 3 consecutive years, 2012-2014. For Poland, t corresponds to 2015; for the distribution, t corresponds to the first year of the crisis..
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Republic of Poland: Public DSA—Baseline Scenario

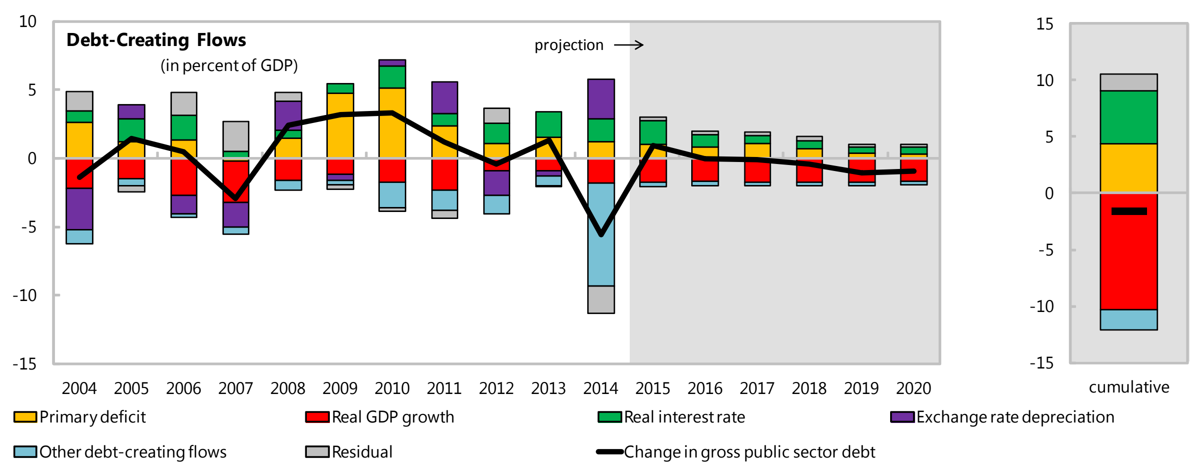
(Percent of GDP, unless otherwise indicated)

Debt, Economic and Market Indicators [1]

	Actual			Projections						As of June 05, 2015		
	2004-2012 [2]	2013	2014	2015	2016	2017	2018	2019	2020	Sovereign Spreads		
Nominal gross public debt	49.4	55.7	50.1	51.1	51.0	50.9	50.5	49.5	48.5	EMBIG (bp) 3/		238
Public gross financing needs	15.1	10.8	8.1	10.0	9.1	7.8	7.8	7.5	6.8	5Y CDS (bp)		66
Real GDP growth (in percent)	4.3	1.7	3.4	3.6	3.5	3.6	3.6	3.6	3.6	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	3.0	1.1	0.5	0.0	1.5	1.9	1.9	2.3	2.3	Moody's	A2	A2
Nominal GDP growth (in percent)	7.5	2.9	4.0	3.6	5.1	5.5	5.5	6.1	6.0	S&Ps	A-	A
Effective interest rate (in percent) [4]	5.6	4.7	3.6	3.6	3.5	3.2	3.2	3.3	3.5	Fitch	A-	A

Contribution to Changes in Public Debt

	Actual			Projections							
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance [10]
Change in gross public sector debt	0.8	1.3	-5.6	0.9	0.0	-0.1	-0.4	-1.0	-1.0	-1.6	
Identified debt-creating flows	0.2	1.4	-3.6	0.7	-0.3	-0.4	-0.7	-1.2	-1.1	-3.0	
Primary deficit	2.2	1.5	1.2	1.0	0.8	1.1	0.7	0.4	0.3	4.3	-1.4
Primary (noninterest) revenue and grants	39.5	38.2	38.6	39.1	38.8	38.6	38.7	38.9	39.0	233.1	
Primary (noninterest) expenditure	41.7	39.7	39.9	40.1	39.7	39.6	39.4	39.3	39.3	237.4	
Automatic debt dynamics [5]	-1.1	0.6	2.7	0.0	-0.8	-1.1	-1.1	-1.3	-1.2	-5.6	
Interest rate/growth differential [6]	-0.8	1.0	-0.2	0.0	-0.8	-1.1	-1.1	-1.3	-1.2	-5.6	
Of which: real interest rate	1.1	1.9	1.7	1.7	0.9	0.6	0.6	0.4	0.5	4.7	
Of which: real GDP growth	-1.9	-0.9	-1.8	-1.7	-1.7	-1.7	-1.7	-1.7	-1.7	-10.3	
Exchange rate depreciation [7]	-0.3	-0.4	2.9	…	…	…	…	…	…	…	
Other identified debt-creating flows	-0.9	-0.7	-7.5	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-1.8	
Privatization (+ reduces financing needs) (negative)	-0.7	-0.6	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.5	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Liabilities not included in debt [8]	-0.2	-0.1	-7.4	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-1.2	
Residual, including asset changes [9]	0.6	-0.1	-2.0	0.3	0.3	0.3	0.3	0.2	0.2	1.4	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

8/ From 2014 onwards, reflects the transfer of pension fund assets and liabilities to the social security administration.

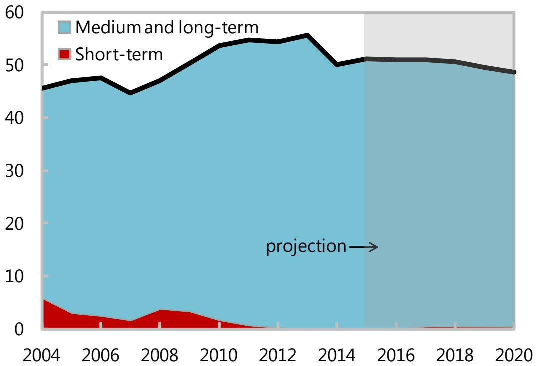
9/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

10/ 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.

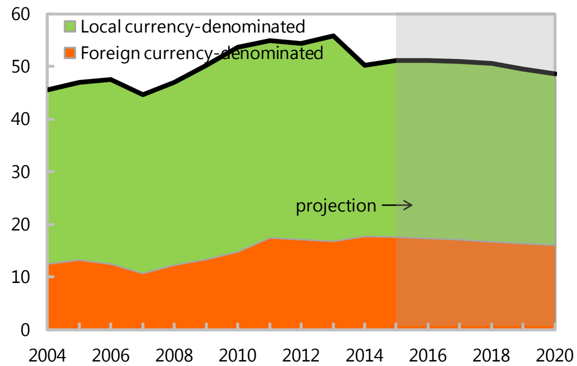
Republic of Poland: Public DSA—Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



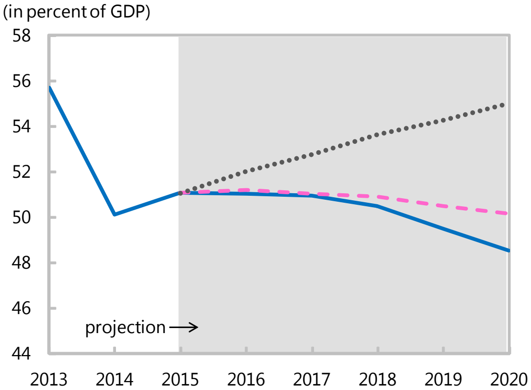
By Currency
(in percent of GDP)



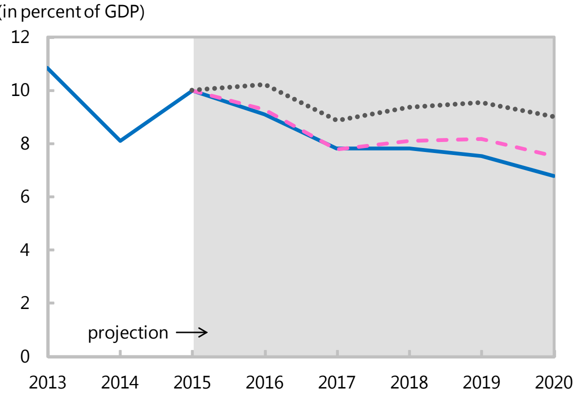
Alternative Scenarios

Baseline Historical Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

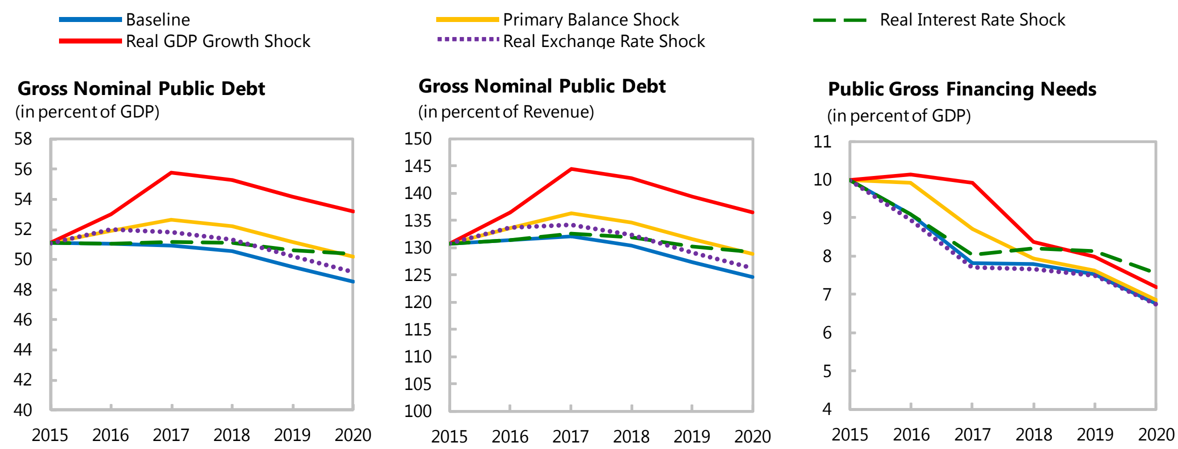
Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	3.6	3.5	3.6	3.6	3.6	3.6
Inflation	0.0	1.5	1.9	1.9	2.3	2.3
Primary Balance	-1.0	-0.8	-1.1	-0.7	-0.4	-0.3
Effective interest rate	3.6	3.5	3.2	3.2	3.3	3.5
Constant Primary Balance Scenario						
Real GDP growth	3.6	3.5	3.6	3.6	3.6	3.6
Inflation	0.0	1.5	1.9	1.9	2.3	2.3
Primary Balance	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Effective interest rate	3.6	3.5	3.2	3.2	3.3	3.5

Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	3.6	3.9	3.9	3.9	3.9	3.9
Inflation	0.0	1.5	1.9	1.9	2.3	2.3
Primary Balance	-1.0	-2.0	-2.0	-2.0	-2.0	-2.0
Effective interest rate	3.6	3.5	3.4	3.6	3.8	4.1

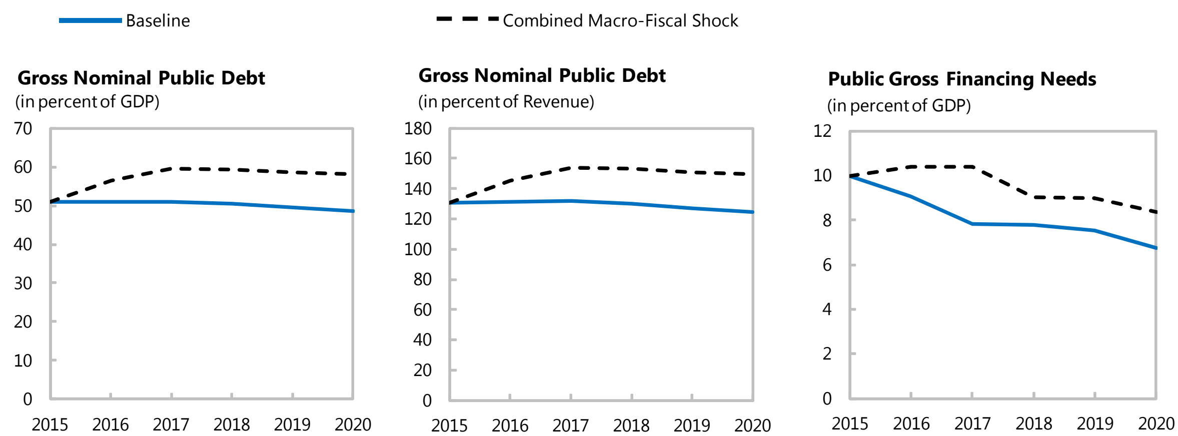
Source: IMF staff.

Republic of Poland: Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	3.6	3.5	3.6	3.6	3.6	3.6
Inflation	0.0	1.5	1.9	1.9	2.3	2.3
Primary balance	-1.0	-1.7	-1.9	-0.7	-0.4	-0.3
Effective interest rate	3.6	3.5	3.2	3.3	3.4	3.6
Real Interest Rate Shock						
Real GDP growth	3.6	3.5	3.6	3.6	3.6	3.6
Inflation	0.0	1.5	1.9	1.9	2.3	2.3
Primary balance	-1.0	-0.8	-1.1	-0.7	-0.4	-0.3
Effective interest rate	3.6	3.5	3.6	4.0	4.4	4.9
Combined Shock						
Real GDP growth	3.6	1.8	1.8	3.6	3.6	3.6
Inflation	0.0	1.1	1.5	1.9	2.3	2.3
Primary balance	-1.0	-1.7	-2.8	-0.7	-0.4	-0.3
Effective interest rate	3.6	3.7	3.6	4.0	4.4	4.9

Real GDP Growth Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	3.6	1.8	1.8	3.6	3.6	3.6
Inflation	0.0	1.1	1.5	1.9	2.3	2.3
Primary balance	-1.0	-1.7	-2.8	-0.7	-0.4	-0.3
Effective interest rate	3.6	3.5	3.2	3.3	3.4	3.6
Real Exchange Rate Shock						
Real GDP growth	3.6	3.5	3.6	3.6	3.6	3.6
Inflation	0.0	6.6	1.9	1.9	2.3	2.3
Primary balance	-1.0	-0.8	-1.1	-0.7	-0.4	-0.3
Effective interest rate	3.6	3.7	3.1	3.1	3.2	3.4

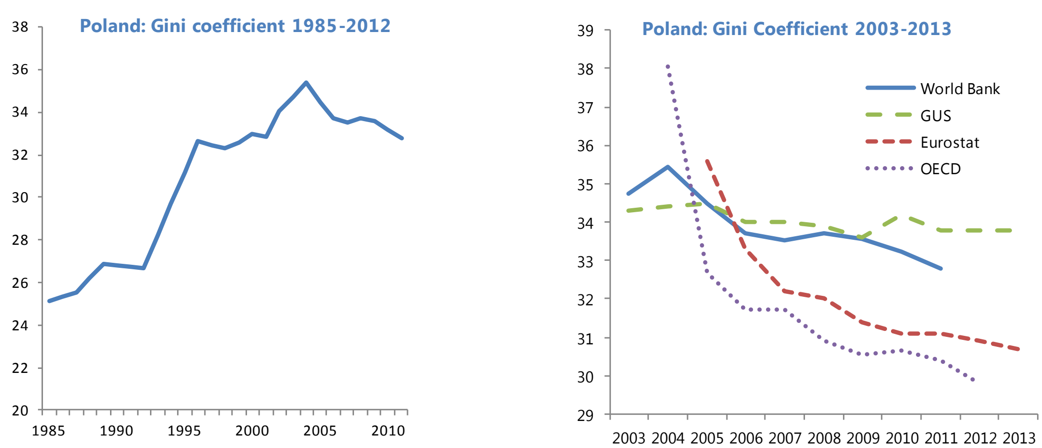
Source: IMF staff.

Appendix I. Evolution of Income Inequality Following EU Accession[1]

Following accession to the EU, Poland experienced a notable reversal in the uptrend in income inequality, with the Gini coefficient[2] gradually declining to levels consistent with the EU average. EU common agricultural policy appears to have played a role in this process by elevating incomes of farmers, the poorest household group, relative to wealthier households. While social transfers help to mitigate income inequality, their role is minor, and their efficiency could be enhanced without increasing their size. Cross-country data show that pay discrimination of women in Poland is below levels prevailing in most EU countries.

1. **Income inequality trended up in the course of economic transformation, but this trend was reversed after EU accession.** Income inequality rose during the first fifteen years of economic transformation (Figure AI.1). This is not surprising, given that the transformation implied a switch from full employment and a relatively flat wage structure to a market system, where entrepreneurship and skills are rewarded, but open unemployment emerges as well. This uptrend reversed after Poland's accession to the EU in 2004, although the degree of turnaround differs, depending on data source. National statistics suggest a mild drop in inequality, while data from international institutions point to a larger decline.[3]

Figure AI.1. Republic of Poland: Trends in Income Inequality



Sources: World Bank, GUS, Eurostat, and OECD.

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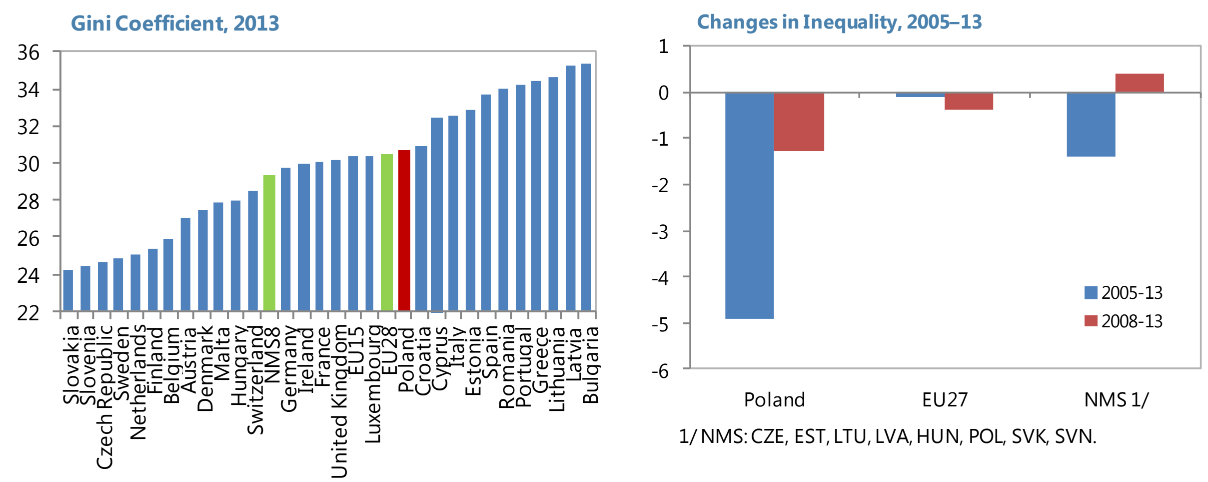
[1] Prepared by Robert Sierhej (Resident Representative Office in Warsaw).

[2] In this note, we measure income inequality with Gini coefficients published by Central Statistical Office (GUS), Eurostat, OECD, and World Bank, the latter consumption-based and others income-based.

[3] Eurostat and OECD statistics start only in 2004–05, and data for the early years may suffer from a bias related to initial problems with launching such surveys, which could exaggerate post-accession inequality decline.

2. Relative to other new member states (NMS) post-accession inequality decline was the largest in Poland, bringing it down close to EU average. In an international perspective, inequality in Poland is broadly in line with the EU average (Figure AI.2). Compared to regional peers, Poland's inequality is below the Baltics, Romania, and Bulgaria, but remains above Slovakia, Slovenia, Czech Republic, and Hungary, the first three countries from the latter group being most equitable in the EU. While inequality has diminished in all NMS which joined the EU in 2004, this drop was the largest in Poland. Moreover, the downward trend has continued in recent years, unlike other NMS where some pickup in inequality took place.

Figure AI.2. Income Inequality in the EU



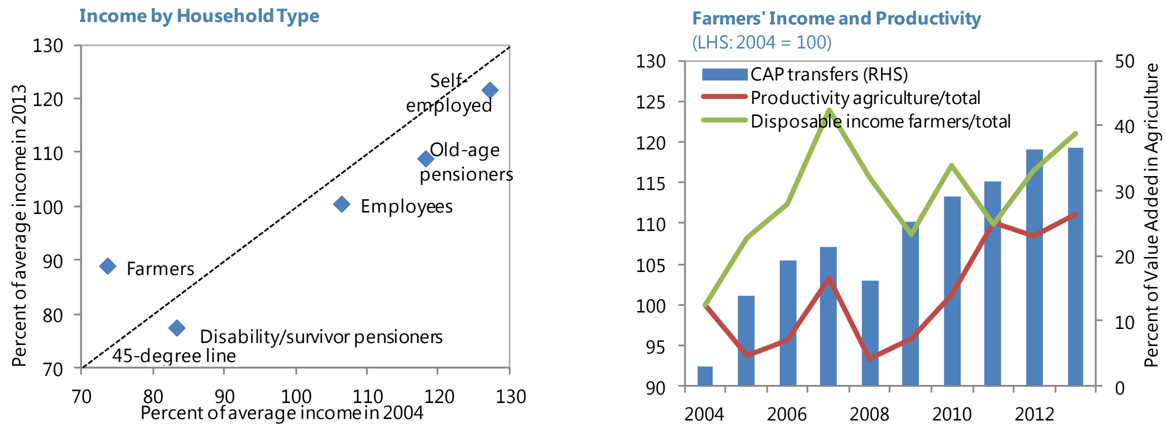
Source: Eurostat.

3. EU agricultural policy appears to have contributed to the post-accession reduction in inequality. Looking at post-accession income developments by household type, farmers stand out as those gaining most relative to other groups. During 2004–13, disposable income in farmer households went up from slightly above 70 percent to almost 90 percent of the average for all households (Figure AI.3). Since farmers have been the poorest households, such a convergence helped to diminish overall income inequality. Notably, this increase in income has outpaced relative productivity growth in agriculture, particularly in the early post-accession years. At the same time, it coincided with growing transfers under EU agricultural policy (CAP), which went up from close to zero in 2004 to almost 40 percent of gross value added in agriculture by 2013 (Figure AI.3). This suggests that EU agricultural policy played a role in elevating incomes of farmers in the last decade, thus helping to make the overall income structure more equitable.[4] Since the EU accession agreement envisaged that the CAP transfers would increase gradually to reach their target level in 2013, their potential to further flatten income distribution appears limited. At the same time, by potentially discouraging labor mobility from agriculture to more

[4] Given the relatively large share of agriculture relative to other NMS, this factor could also help to explain why inequality decline in Poland was deeper than elsewhere in the region. Estimating the extent to which CAP transfers could have dampened income inequality would require individual household-level data.

productive sectors, the transfers could impede structural labor market transformation and dampen overall productivity growth (see also Chapter III of the Selected Issues Paper).

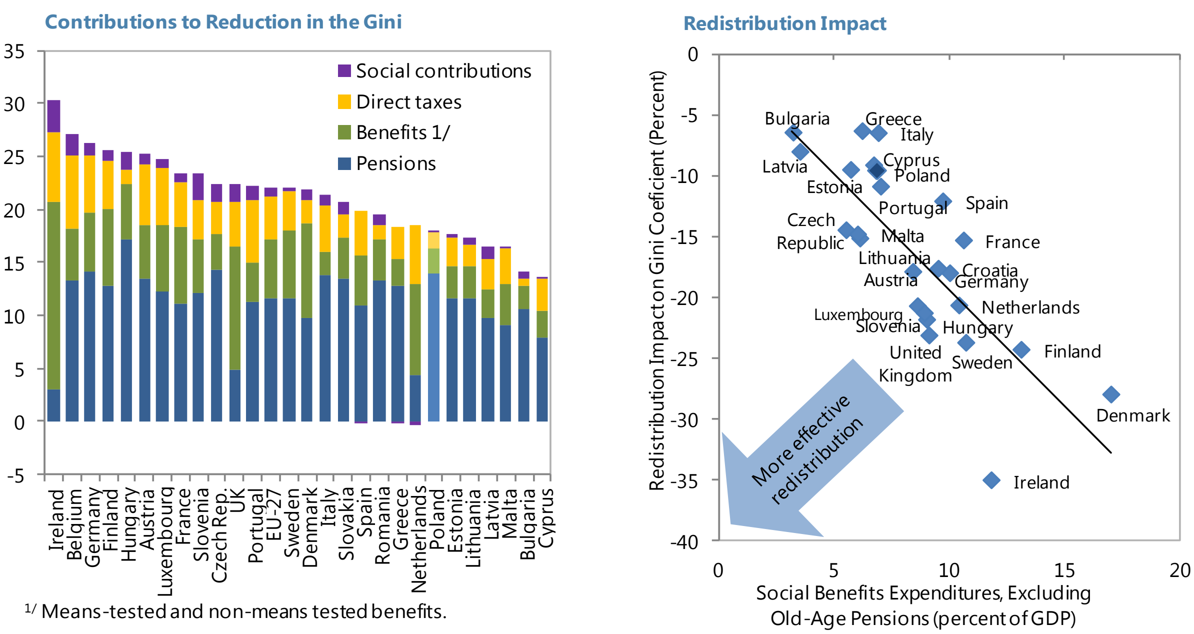
Figure AI.3. Evolution and Farmers Income, Agricultural Productivity, and CAP



Sources: GUS and MoF.

4. **Social transfers could be made more efficient in mitigating inequality**. Compared to other EU countries, social benefits, social contributions, and direct taxes contribute relatively little to reducing income inequality in Poland, with pensions playing the largest role (Figure AI.4). Excluding pensions, which underwent radical reform in recent years, significance of other social benefits in making incomes more equitable appears minor and has been diminishing over time. Cross-country comparison suggests that there is still some room to increase their efficiency by better targeting them to the needy (right panel of Figure AI.4).

Figure AI.4. Role of Social Transfers in Reducing Income Inequality

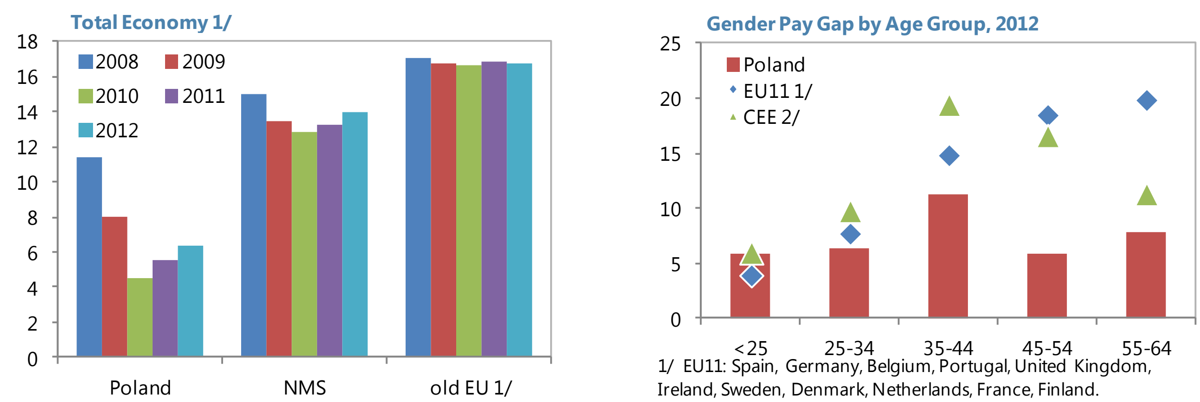


1/ Means-tested and non-means tested benefits.

Source: Eurostat.

5. Earning differences between males and females are lower than those prevailing in the EU. While the overall income inequality is slightly above EU average, differences between male and female hourly earnings, so called *gender pay gap*,[5] are well below levels prevailing in the EU (Figure AI.5). The only exception is the youngest age group, where the pay gap slightly exceeds EU average. Despite some uptick in recent years, the gap between female and male hourly earnings almost halved since 2008, unlike in other EU or NMS countries, where this gap remained flat. Notably, differences between male and female average monthly wages are larger than those for hourly earnings, reflecting lower number of hours worked by women.[6] Nevertheless, the gender-specific gap in average monthly wages declined in recent years, from 23 percent in 2008 to 17 percent in 2012.

Figure AI.5. Gender Pay Gap



1/ Except agriculture, public administration, defense, and compulsory social security.

1/ EU11: Spain, Germany, Belgium, Portugal, United Kingdom, Ireland, Sweden, Denmark, Netherlands, France, Finland.
2/ CEE: Bulgaria, Czech Rep., Lithuania, Hungary, Poland, Slovenia, Slovakia.

Source: Eurostat.

[5] *Gender pay gap* reflects the difference between male and female hourly earnings, expressed as a percent of male earnings.

[6] According to GUS, women worked more than four hours per week less than men in 2013.

Appendix II. Republic of Poland: Foreign Currency Mortgages[1]

1. The Swiss National Bank (SNB) decision on January 15, 2015 to remove the cap on the value of the Swiss franc resulted in a 20 percent depreciation of the zloty against the Swiss franc. While the zloty has regained some ground since then, it remains some 10 percent below its value before the SNB move. The SNB also lowered the marginal interest rate on central bank deposits by 50 bps to -0.75 percent and the target range for the three-month Libor to between -1.25 and -0.25 percent.

2. The depreciation of the zloty has raised concerns about foreign currency (FX) exposure on household and bank balance sheets. For a given interest rate, the zloty depreciation increased debt-servicing costs for more than half a million Polish households holding Swiss franc-denominated mortgages. Although the tightening of prudential regulations in recent years (including by requiring household FX earnings for FX mortgage eligibility and increasing risk weights on FX mortgages) has brought Swiss franc-denominated mortgages down from around 11 percent of GDP at the peak in November 2011 to 8.3 percent of 2014 GDP in March, they still account for close to 40 percent of the mortgage portfolio (all foreign currency mortgages accounted for around 47 percent of the portfolio in March). And while NPL ratios for these mortgages are relatively low at around 3.5 percent in March, many mortgages issued in the run-up to the crisis carry LTV ratios above 100 percent (Figure AII.1). The high LTVs, combined with FX mismatches on household balance sheets, pose credit risk to banks. And hedging of the bank open FX position partly through short-term FX swaps presents liquidity risk.

3. The economic impact of the zloty depreciation appears to be limited:

Macroeconomic implications. Given that most Swiss franc-denominated mortgages have been contracted at floating rates, the increase in debt servicing costs for households will be mitigated by lower Swiss LIBOR rates, provided that it is passed on to mortgage holders. Furthermore, real wages have increased by more than 10 percent since the beginning of 2008 when many mortgages were issued, and the unemployment rate has declined markedly since its crisis peak. Overall, any impact on consumption and economic growth would therefore be small.

Financial stability implications. Recent stress tests conducted by the KNF showed that bank capital and liquidity buffers are sufficient to prevent a significant increase in systemic risk, even in the event of zloty depreciation well beyond the recent shock.

4. Given limited macro or financial stability concerns, the authorities' response focused on mitigating the impact on distressed households. The FSC recommended that banks pass on the negative Swiss franc interest rates to customers, narrow foreign-currency spreads, give potential maturity extensions or payment holidays, offer provision-free conversions, do not require additional

[1] Prepared by Lone Christiansen (EUR).

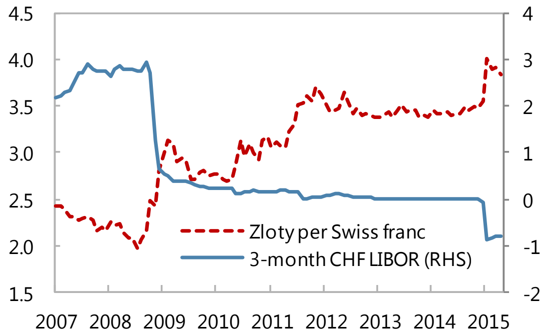
collateral, and take a case-by-case approach to the restructuring of distressed mortgages. This has been supported by the banking association. The Polish authorities, including the Office of Competition and Consumer Protection (UOKiK), are closely monitoring banks' response. To increase incentives to mitigate risks from distressed mortgages, the Ministry of Finance recently signed regulation to exempt gains from mortgage credit restructuring and negative interest rates from income taxation. Correspondingly, banks would be allowed to deduct these amounts from taxable income.

Figure AII.1. Republic of Poland: Foreign Currency Mortgages

Republic of Poland: Swiss Franc Appreciation and Housing Loans

The SNB decision led to an abrupt zloty depreciation,...

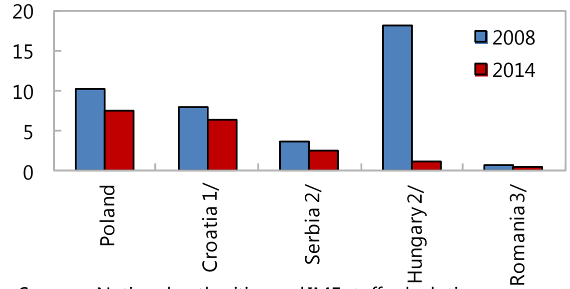
Exchange Rate and Interest Rate
(Interest rate in percent)



Sources: British Bankers' Associations, Haver Analytics, NBP, and IMF staff calculations.

...which put pressure on Swiss franc mortgages.

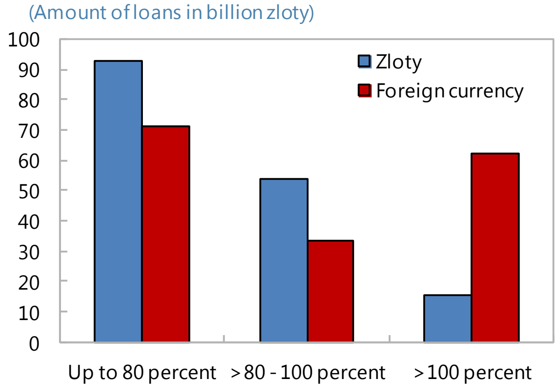
Swiss Franc Household Mortgage Exposure
(Percent of GDP)



Sources: National authorities and IMF staff calculations.
1/ 2010 instead of 2008.
2/ Total household loans in Swiss franc.
3/ Loans in currencies other than domestic currency or euro.

In Poland, many have high LTV ratios,...

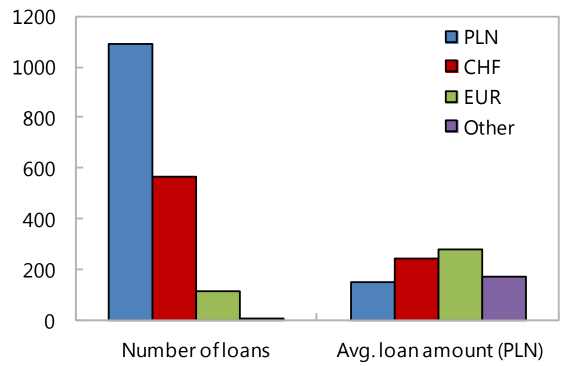
Loan-to-Value Ratio Structure of Loan Portfolio, 2013
(Amount of loans in billion zloty)



Sources: KNF and IMF staff calculations.

...with potential impact on many borrowers.

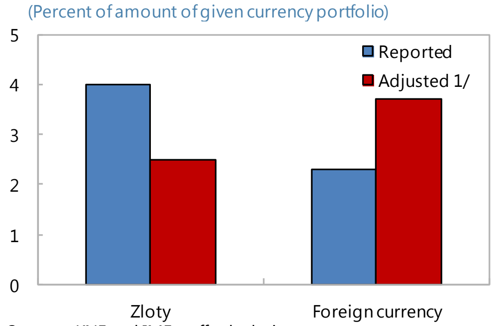
Number and Average Loan Amount, 2013
(Thousands)



Sources: KNF and IMF staff calculations.

However, housing NPLs are still manageable...

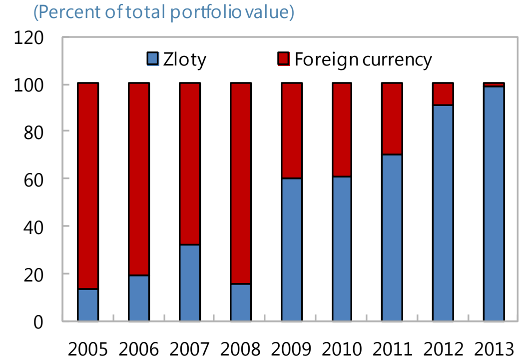
Nonperforming Loans, 2013
(Percent of amount of given currency portfolio)



Sources: KNF and IMF staff calculations.
1/ Adjusted for foreign currency loan conversion into zloty loans.

...and prudential regulations have halted new FX lending.

Currency Distribution of New Loans Granted
(Percent of total portfolio value)



Sources: KNF and IMF staff calculations.

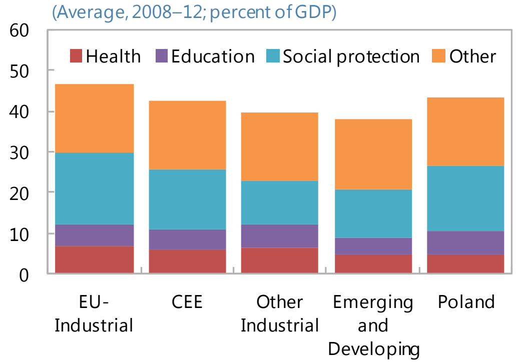
Appendix III. Efficiency of Public Expenditure[1]

Poland's public expenditure has declined in recent years and stands below the EU average, but fiscal consolidation remains incomplete. Going forward, seeking further efficiency in the use of public resources would be critical to facilitate the implementation of the stabilizing expenditure rule and support sustainable growth. A cross-country analysis indicates that Poland's efficiency in the provision of public services, particularly in social protection and health, could be improved, potentially generating modest expenditure savings over time.

1. **During 2011–14, Poland accomplished substantial expenditure-based fiscal consolidation**. Since the start of the Excessive Deficit Procedure in 2011, the headline deficit was reduced by about 1.7 percentage points to 3.2 percent of GDP in 2014. Against lackluster tax collection, the adjustment was driven by cuts in current expenditure and a moderation of public investment toward its historic average. Going forward, changes in the pension system implemented in 2014 should further improve the fiscal aggregates, but additional consolidation of about 1 percent of GDP will be necessary to achieve the MTO. Part of this adjustment will have to come from the expenditure side, reflecting the design of the stabilizing fiscal rule implemented in 2013.

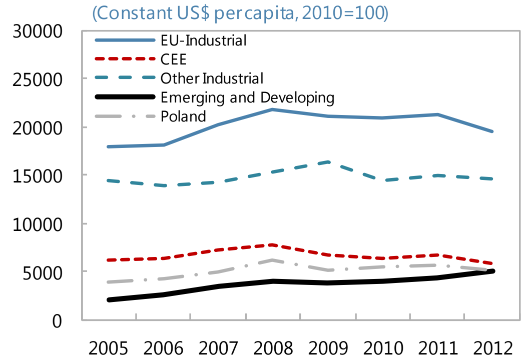
2. **From a cross-country perspective, Poland's public sector size is moderate**. Poland's public expenditure averaged 43¼ percent of GDP during 2008–13, which stands close to the Central and Eastern Europe (CEE) average but below the public sector size in industrial EU countries. In per capita terms, public expenditure in Poland is about one-fourth of the average for industrial EU countries, reflecting differences in income levels. Across categories, Poland's combined expenditure in health, education, and social protection accounts for about 60 percent of total expenditure, and its share in GDP has declined in recent years to about 26 percent, which stands well below the average for industrial EU countries (30 percent).

Public Expenditures in Selected Categories
(Average, 2008–12; percent of GDP)



Sources: Eurostat OECD. and IMF staff calculations.

Evolution of Public Expenditures
(Constant US$ per capita, 2010=100)



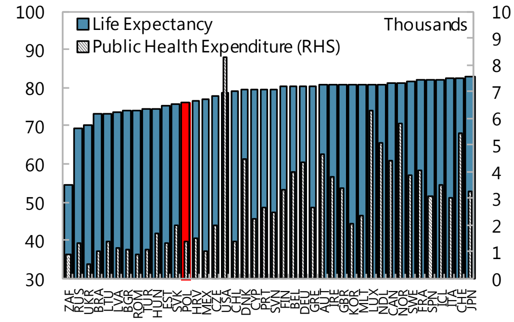
Sources: Eurostat, OECD, and IMF staff calculations.

[1] Prepared by Francisco Vazquez (ICD).

3. The quality of Poland's public services in health, education, and social protection has improved over time, but there is room for further improvement in some areas (Figure AIII.1).

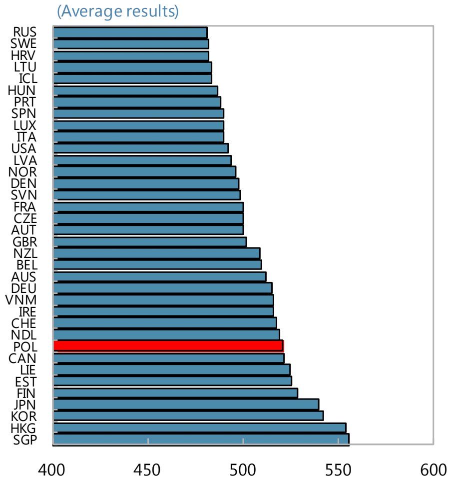
Health. Over the last two decades, Poland has achieved substantial improvements in health outcomes: infant mortality rates have declined and life expectancy has increased to almost 77 years, which is still below the EU average (80½ years). At the same time, comparator countries based on similar per capita income, such as Mexico, Chile, and Korea have achieved higher life expectancy than Poland with lower public health expenditures.

Life Expectancy and Public Health Expenditure
(Constant PPP USD per capita, average 2008–12)



Sources: World Bank and IMF staff calculations.

PISA Scores of Top Performers, 2012
(Average results)



Sources: OECD and IMF staff calculations.

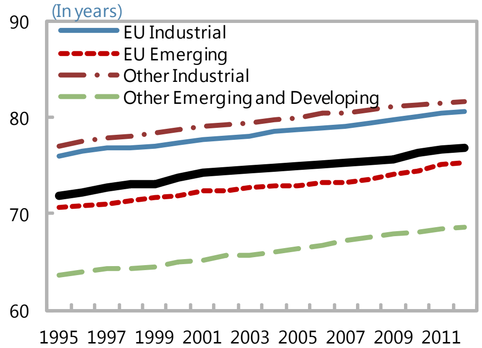
Education. Poland stands among the countries with the highest literacy ratios worldwide. Performance in the Program for International Student Assessment (PISA) exams has improved considerably over time and compares favorably to peers (Poland ranked 9 among the 62 countries covered in the 2012 assessment).[2] At the same time, school enrollment and completion rates in primary school remain low compared to other countries, and the number of repeaters in primary and secondary schools is relatively large despite small class sizes. Poland also lags peer countries on adult participation in lifelong learning, as well as in employability, signaling potential mismatches between the education system and employer's needs.

Social protection. When it comes to social transfers, the coverage and targeting of unemployment and social assistance benefits could be improved, while spending on pensions remains high, partly due to unreformed pension schemes for farmers and miners.

[2] The PISA is a triennial OECD test of knowledge and skills of 15 year-old students. The PISA ranks countries according to student's performance in mathematics, reading, and science, using their mean scores in each area.

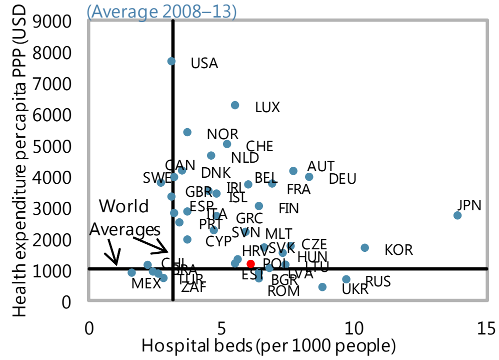
Figure AIII.1. Republic of Poland: Selected Social Outcomes

Evolution of Life Expectancy
(In years)



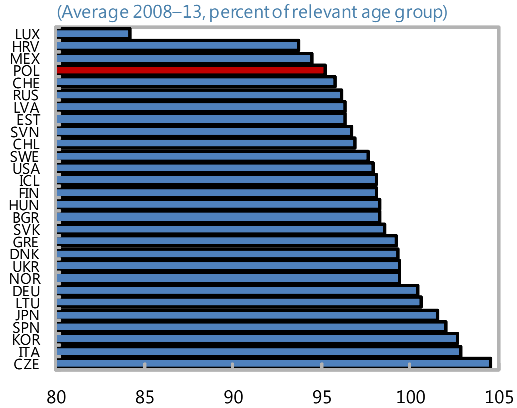
Sources: World Bank,and IMF staff calculations.

Health Expenditure and Hospital Services
(Average 2008–13)



Sources: Eurostat, OECD, World Bank and IMF staff calculations.

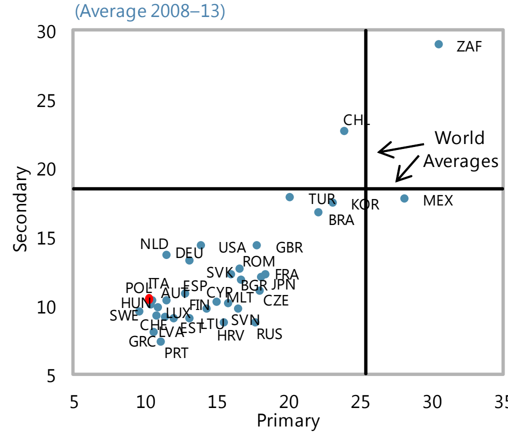
Primary Education Completion Rates 1/
(Average 2008–13, percent of relevant age group)



Sources: World Bank and IMF staff calculations.

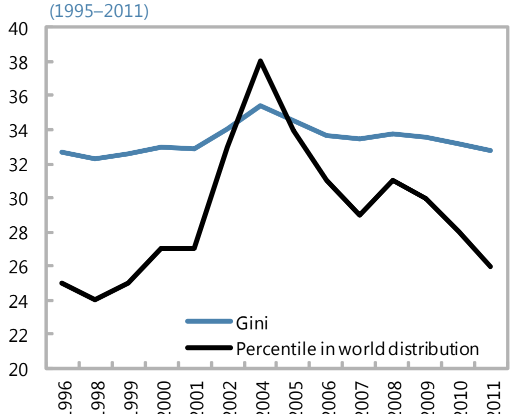
1/ Primary completion rate is measured as the gross intake ratio to the last grade of primary education. It is calculated by taking the total number of students in the last grade of primary school, minus the number of repeaters in that grade, divided by the total number of children of official graduation age.

Education, Pupils per Teacher
(Average 2008–13)



Sources: World Bank and IMF staff calculations.

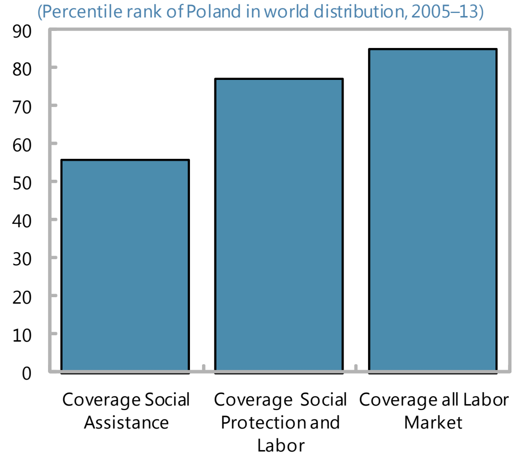
Poland: Income Distribution 1/
(1995–2011)



Sources: World Bank and IMF staff calculations.

1/ The percentile in the World distribution indicates the percent of countries that have a more egalitarian income distribution than Poland (measured by the Gini coefficient).

Poland: Coverage of Social Safety Net
(Percentile rank of Poland in world distribution, 2005–13)



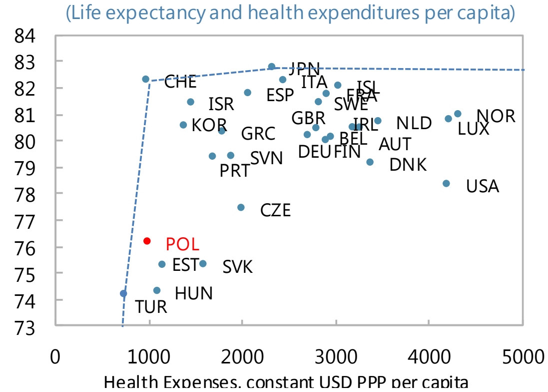
Sources: World Bank and IMF staff calculations.

4. A cross-country analysis indicates that the efficiency of Poland's public spending can be increased. The assessment is carried out by applying Data Envelopment Analysis (DEA) to cross-country data on public resources devoted to education, health, and social protection, and a set of measurable outcomes in these sectors. In particular, DEA uses the actual input-output conversion rates of the sample countries to estimate the most efficient use of resources to produce measurable outcome (i.e., an *efficiency frontier* in a technical sense).[3] Each frontier determines the best outcome that can be attained with a given set of inputs (or, alternatively, the minimum set of inputs required to attain a target set of outputs). The relative efficiency of Poland's public expenditures is then determined by comparing its observed conversion rates with those attained by the countries on the frontier. The distance to the frontier provides a first order estimate of the size of potential fiscal savings while maintaining the observed quality of the public service.

Health. Poland spends around 4½ percent of GDP on health care, which stands below the average for industrial EU countries (6.6 percent) and CEE countries (6.3 percent). In the analysis, the input is measured using public health expenditures per capita (average 2008–12 measured in constant purchasing power parity (PPP) US$ to minimize possible price distortions. In turn, the social outcomes are measured by three indicators: life expectancy at birth and mortality rates of both neonatal and children under 5 years. The text figure shows the scatter plot of life expectancy versus public health expenditures. The efficient frontier is determined by Turkey, Switzerland, and Japan. The analysis suggests that Poland is more efficient than CEE countries but substantially less efficient than industrial countries. Overall, the DEA suggests that there is room to improve Poland's technical efficiency in the provision of health services. Bridging half of the efficiency gap between Poland and the group of countries on the efficiency frontier could, over time, generate some 0.4 percent of GDP in savings, without compromising health outcomes. However, these results should be interpreted with caution, since countries on the efficiency frontier operate different health care systems and rely on different division of public-private responsibility for health care. Moreover, other factors, such as per capita income, also play a role.

Efficiency of Health Expenditures

(Life expectancy and health expenditures per capita)

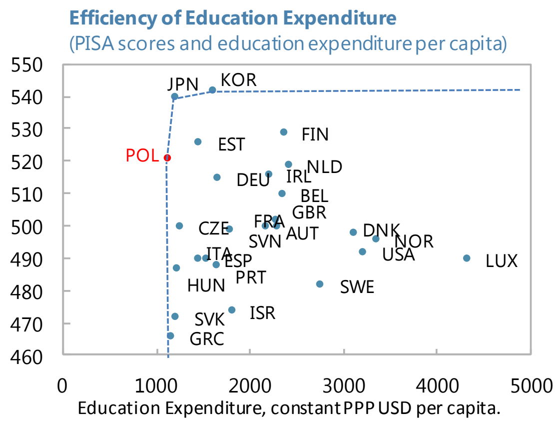


Sources: Eurostat, World Bank, OECD and IMF staff calculations.

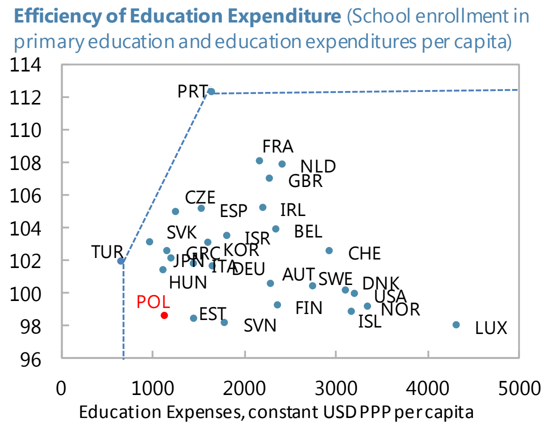
Education. Poland spends around 5½ percent of GDP on education, which stands close to the average of industrial EU countries (5.6 percent) but above CEE countries (4.8 percent). In recent years, Poland has made substantial efforts to improve the quality of education and modernize the curricula. A reform of the vocational education system is also underway. Based on average data for 2008–12, Poland stands on the efficiency frontier if the public outcome is based on PISA scores only. However,

[3] DEA is a linear-programming technique for frontier estimation that uses input-output data for individual decision making units—in this case countries—to construct a piecewise-linear convex set encompassing the data. Similar analyses have been carried out recently in the context of Fund's surveillance for Slovakia (2012), Iceland (2013), and Slovenia (2014).

other indicators, such as primary and secondary school enrollment, and primary completion rates still fall short in cross-country comparison.

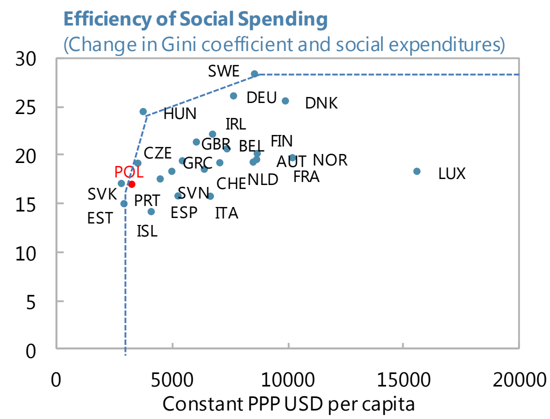


Sources: Eurostat, World Bank and IMF staff calculations.



Sources: Eurostat, World Bank, and IMF staff calculations.

Social protection. Poland's expenditure on social protection amounts to 15¾ percent of GDP, which stands below the mean for industrial EU countries (17¾ percent of GDP) but well above CEE countries (12¼ percent of GDP). Poland's income distribution has improved since 2004 (with a short-lived reversion at the onset of the global financial crisis), and compares well to other countries: Poland ranks in lowest 30 percentile worldwide in terms of income inequality, as measured by the Gini coefficient. Yet, Poland lags peer countries in terms of the coverage of social programs. The DEA analysis uses social expenditures per capita as an encompassing input (measured in constant, PPP-adjusted US$) and the change in the Gini coefficient attributable to social expenditures as an output measure.[4] The frontier is defined by Slovakia, Hungary, and Sweden. The distributive impact of social expenditure in Poland is comparable to that of Slovakia, but Poland spends slightly more in this area. This suggests that Poland could achieve its income redistribution objectives more efficiently, while potentially also generating modest expenditure savings over time. The DEA suggests that bridging half of the efficiency gap between Poland and countries on the efficiency frontier could over time generate some 0.4 percent of GDP in savings, without compromising income distribution outcomes.



Sources: Eurostat and IMF staff calculations.

[4] This variable, published by Eurostat, measures the difference in the Gini coefficient before and after social transfers (including pensions).

5. Overall, there seems to be room to improve the efficiency of public expenditure in the three areas under analysis and potentially generate expenditure savings over time:

Health. Recent reforms aimed at increasing managerial and financial accountability in the hospital system were a step in the right direction. These need to be complemented, *inter alia*, with the introduction of a robust costing system and a top-down assessment of infrastructure needs to help guide investment and optimize the organization of health care providers, including hospitals. Countries with well-performing health systems, have managed to balance market-based incentives with strong regulations, monitoring mechanisms, and institutions to facilitate coordination and help improve efficiency, while ensuring the delivery of high-quality health services (World Bank, 2014).

Education. There is scope for some consolidation of schools and classrooms, as the student population in primary and secondary schools continues to fall in line with demographic trends. In parallel, further efforts are needed to increase school enrollment and improve the matching between the educational and vocational systems and the job market. Seeking a better alignment of lifelong learning programs with labor market needs is also important to increase participation among the adult population and the low-skilled workers.

Social protection. In turn, the efficiency of social expenditures can be increased by broadening the coverage and adequacy of social assistance and improving targeting by reducing the leakage of benefits to non-poor groups. Tackling reform in the special pension schemes for farmers and miners—notably by seeking better alignment of benefits with those of the core pension system—would also contribute to improving the efficiency of social expenditures.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF POLAND

June 22, 2015

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By	The European Department

CONTENTS

FUND RELATIONS

(As of May 31, 2015)

Membership Status: Joined 6/12/1986; Article VIII

General Resources Account:

	SDR Million	Percent Quota
Quota	1,688.40	100.00
Fund Holdings of Currency	1,417.37	83.95
Reserve Tranche Position	271.04	16.05
Lending to the Fund		
New Arrangement to Borrow	257.07	

SDR Department:

	SDR Million	Percent Allocation
Net Cumulative Allocation	1,304.64	100.00
Holdings	946.65	72.56

Outstanding Purchases and Loans: None

Latest Financial Arrangements:

In Millions of SDR

Type	Approval Date	Expiration Date	Amount Approved	Amount Drawn
FCL	1/14/2015	1/13/2017	15,500.00	0.00
FCL	1/18/2013	1/17/2015	22,000.00	0.00
FCL	1/21/2011	1/17/2013	19,166.00	0.00
FCL	7/02/2010	1/20/2011	13,690.00	0.00

Projected Payments to Fund (SDR Million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2015	2016	2017	2018	2019
Principal					
Charges/Interest	0.09	0.20	0.20	0.20	0.20
Total	0.09	0.20	0.20	0.20	0.20

Exchange Arrangements:

The zloty is freely floating.

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 (EU) 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/index_en.htm.

Article IV Consultation:

The last Article IV consultation was concluded on June 23, 2014. In concluding the consultation, Directors emphasized that Poland's very strong fundamentals and economic policies had helped it weather turmoil in financial markets and paved the way for the economic recovery. They noted that the Precautionary Flexible Credit Line (FCL) arrangement has provided important insurance against external risks. At the same time, they observed that external risks remained elevated. Directors advised a measured pace for fiscal consolidation over the medium term to reduce the fiscal deficit and preserve growth. They agreed that the medium-term objective of a structural deficit of 1 percent of GDP remains appropriate and could be achieved through better expenditure prioritization, following a review of public expenditures, and improved tax compliance and efficiency of tax administration. Directors urged the authorities to address legacy flaws in the pension system and consider measures to deal with the sharp drop in future replacement rates. They also advised continued monitoring of liquidity in the government bond and equity markets, given the reduced presence of pension funds. On monetary policy, Directors concurred that the monetary stance was broadly appropriate within the context of limited inflationary pressures and subdued euro area inflation. However, a number of Directors called for heightened vigilance, as policy interest rates could be further reduced if the recovery falters or if revised projections indicate below-target inflation for a protracted period. In light of external risks, Directors concurred that moderate reserve accumulation would be prudent. Directors commended the resilience of the banking system, which remains well capitalized, profitable, and liquid. However, they called for enhanced financial sector supervision by expediting the completion of the macroprudential and bank resolution frameworks—including legislation to create a Systemic Risk Board. Directors encouraged the authorities to deepen structural reforms to achieve more inclusive sustainable growth.

Resident Representative:

Mr. James Roaf replaced Mr. Mark Allen as the Senior Regional Resident Representative for Central and Eastern Europe, effective August 8, 2013.

Republic of Poland: Technical Assistance from the Fund, 1992–2014

Department	Subject/Identified Need	Action	Date	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	October 1992	NBP
MAE	Resident expert-Advisor to President of NBP		November 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	November 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	Expert visits	Late 1995	NBP
FAD	Tax administration (VAT)	Nine short-term assign-ments of field experts	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

Republic of Poland: Technical Assistance from the Fund, 1992–2014 (continued)

Department	Subject/Identified Need	Action	Date	Counterpart
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	Follow-up mission	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

Republic of Poland: Technical Assistance from the Fund, 1992–2014 (concluded)

Department	Subject/Identified Need	Action	Date	Counterpart
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
MCM	Detailed assessment of observance of BCP for effective banking supervision	Mission	Feb/March 2011	KNF
STA	Errors and omissions in balance of payments accounts	Mission	June 2011	NBP
FAD	Developing the fiscal regime for oil and gas	Mission	April 2012	MoF
MCM	Macroprudential framework	Mission	May 2012	NBP
IMF/WB	FSAP update	Mission	Feb/March 2013	MoF/ KNF/NBP
FAD	Tax administration—Modernization challenges and strategic priorities	Mission	November 2014	MoF

STATISTICAL ISSUES

Poland—Statistical Issues Appendix
(As of May 2015)

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 by production and expenditure approaches, both at current and previous year's prices following the *2008 SNA* and *ESA 2010*. A supply and use table is only available for the year 2010. Annual and quarterly financial accounts by institutional sectors are compiled by Narodowy Bank Polski (NBP) following the *ESA 2010* standards and disseminated regularly on its website according to an advance release calendar: the annual financial accounts on the 20th of October the following year and quarterly financial accounts on the 20th calendar day of the 4th month following the end of the reference quarter, i.e., on the 20th of January, April, July, and October.

Price Statistics: The consumer price index does not cover imputed rents of owner-occupied dwellings. The scope of the index covers all resident households, except those in some rural areas. The producer price index does not include any estimation for missing prices; quality and seasonal adjustment techniques are also not implemented.

Government Finance Statistics: The Ministry of Finance (MoF) is responsible for compiling monthly and annual data. The data are compiled in accordance with the IMF's Government Finance Statistics Manual 2001. Monthly cash data cover "core" central government. The annual reports cover a detailed presentation of comprehensive fiscal data on operations of the general government sector divided by central government (breakdown between budgetary, extra-budgetary, and social security accounts) and local government. Revenue and expense are divided by economic type. Financing is classified by sector and by type of debt instrument. Furthermore, for compiling outlays by function of government, classification of the functions of government, UN, 2000 is used. Starting in 2015 (annual data for 2014) GUS will assume responsibilities for collecting, processing, and disseminating annual government finance statistics. Additionally, general government data are released on a quarterly basis, derived from detailed ESA (European System of Accounts) data.

Monetary and Financial Statistics: Beginning with data for January 2004, the NBP provides the European Central Bank (ECB) with monetary accounts in accordance with the ECB's framework for monetary statistics using the national residency approach. An earlier Report on the Observance of Standards and Codes (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.

I. Assessment of Data Adequacy for Surveillance (concluded)
Financial Sector Surveillance: In November 2009, NBP in cooperation with GUS, the Polish Financial Supervision Authority (KNF) and MoF began reporting financial soundness indicators based on the IMF's *Financial Soundness Indicators Compilation Guide*. Data are reported on a quarterly basis with a lag of approximately one quarter. NBP also implemented EU regulation 680/2014 which covers supervisory reporting defined by the Implementing Technical Standards (ITS) prepared by the European Banking Authority. The first data was collected for March 2014 for own funds and liquidity related reporting. Financial reporting on a consolidated basis according to the ITS scheme was reported for the first time for September 2014.
External Sector Statistics: Largely to improve data accuracy, the NBP fully depend on survey-based source data, starting in the first quarter of 2010. STA undertook an evaluation mission to Poland in July 2009, and followed up in June 2011 to assess further data improvements and anticipated revisions in the external sector accounts. Due to the comprehensive work on improving the data sources, the errors and omissions reduced from 4 percent of GDP in 2004 to around 2 percent of GDP in recent years, which is comparable to the level in other European countries. Authorities are committed to further improving the compilation system for the external sector statistics. Poland, as all other EU countries, started disseminating balance of payments data in accordance with the sixth edition of the *IMF's Balance of Payments and International Investment Position Manual (BPM6)* and external debt statistics in line with the 2013 *External Debt Statistics: Guide for Compilers and Users* (2013 *EDS Guide*). Poland reports Coordinated Direct Investment Survey and Coordinated Portfolio Investment Survey data to the IMF.

II. Data Standards and Quality	
Subscriber to the Fund's Special Data Dissemination Standard (SDDS) since April 17, 1996. Uses SDDS flexibility option on the timeliness of the data on general government and central government operations.	Data ROSC was published in 2003.

Republic of Poland: Table of Common Indicators Required for Surveillance–as of May 29, 2015

	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	5/29/2015	5/29/2015	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	4/2015	5/7/2015	M	M	M		
Reserve/Base Money	4/2015	5/14/2015	M	M	M	O, LO, O, LO	O, O, O, O, O
Broad Money	4/2015	5/14/2015	M	M	M		
Central Bank Balance Sheet	4/2015	5/7/2015	M	M	M		
Consolidated Balance Sheet of the Banking System	4/2015	5/14/2015	M	M	M		
Interest Rates[2]	5/29/2015	5/29/2015	D	D	D		
Consumer Price Index	4/2015	5/14/2015	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance, and Composition of Financing[3] – General Government[4]	Q4/2014	5/20/2015	A	A	A	LO, O, O, O	O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	3/2015	5/20/2015	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	3/2015	5/20/2015	M	M	M		
External Current Account Balance	3/2015	5/15/2015	M	M	M	O, O, O, LO	O, O, O, O, LO
Exports and Imports of Goods and Services	3/2015	5/15/2015	M	M	M		
GDP/GNP	Q1/2015	5/29/2015	Q	Q	Q	O, LO, O, O	LO, LO, O, O, LO
Gross External Debt	Q4/2014	3/31/2015	Q	Q	Q		
International Investment Position[6]	Q4/2014	3/31/2015	Q	Q	Q		

[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 (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC published on November 6, 2001, and based on the findings of the respective missions that took place during May 10–18, 2001 for the dataset corresponding to the variable in each row. For fiscal data, also takes account of the 2009 Fiscal Transparency ROSC. 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), or not observed (NO).
[8] Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation, and revision studies.
[9] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

Statement by Mr. Dominik Radziwill, Alternate Executive Director for Poland and Ms. Joanna Osinska, Advisor to the Executive Director
July 10, 2015

The Polish economy has recovered from the temporary slowdown in 2012-13 and has continued the progress in rebuilding policy buffers. Economic growth last year slightly exceeded expectations, while continued fiscal consolidation efforts resulted in Poland's exit from the EU's Excessive Deficit Procedure (EDP) one year ahead of schedule. External position is consistent with fundamentals and appropriate policies. Financial sector remains sound and resilient. Similarly to the developments in the rest of Europe, inflationary pressures had subsided and in the second half of last year inflation turned negative. Implementation of structural reforms has continued. Overall, the outlook is for robust growth and gradual return of inflation towards the target over the medium term. At the same time, risks remain tilted to the downside and dominated by external factors.

On behalf of our Polish authorities, we would like to thank staff for the constructive consultations held in Warsaw and the timely and policy-relevant set of papers. The authorities broadly agree with staff's assessment and policy recommendations.

Economic Outlook

Last year, real GDP growth was solid and amounted to 3.4 percent—twice as much as in 2013. The key factor behind this acceleration was domestic demand, which effectively replaced net exports as the main growth engine (the latter was characteristic for periods of weaker domestic demand, as in 2009 and 2012-13). Domestic demand was driven by higher growth rate of private consumption and a boost in investment. Consumption was spurred by rising employment, higher wages and low inflation, which translated into higher disposable income. Investment benefitted from robust recovery in the credit growth on the back of eased financial conditions. Relatively high competitiveness of Polish companies along with high capacity utilization drove up investment demand.

Poland continues to rank among top EU growth performers. In the first quarter of 2015, real GDP growth surprised on the upside by accelerating to 1.0 percent (q-o-q, sa) and its level was 3.5 percent higher than a year ago. Domestic demand is expected to remain the main growth driver this year, with overall economic growth performance in 2015 forecast to reach at least 3.4 percent, before gradually rising to 4 percent in 2018. Looking ahead, economic growth will be supported, among others, by increased inflow of the EU structural funds. Poland is set to be the biggest beneficiary of the European multi-annual financial framework for the years 2014-2020.

Along with economic growth, the labor market conditions have also been gradually improving since mid-2013. Employment and activity rates have been increasing, while unemployment has continued its downward trend, reaching 7.8 percent in May—well below the EU average. This has been accompanied by steady growth in labor productivity.

External Sector

The current account (CA) deficit has been narrowing over the recent years. After reaching its lowest level in over a decade at 1.3 percent of GDP in 2013, it remained unchanged last year. In April, according to preliminary data, the CA deficit decreased to 0.6 percent of 12-month GDP. Generally, since Q2 2013 exports have been supported by the rebound in the euro area activity. The negative impact on the Polish trade from Russia/Ukraine crisis has been to a large extent counterbalanced by redirection of exports towards other, more dynamic markets as well as gains in price competitiveness. At the same time, imports have recently strengthened due to the rapid acceleration of domestic demand. This has only partially been mitigated by the positive effect of lower oil prices. The CA deficit continues to be comfortably covered by the capital account surplus, driven mainly by stable inflow of the EU funds.

External debt remains relatively stable at around 70 percent of GDP. Around two-thirds of corporate external debt is either intercompany or trade credit, which substantially reduces the roll-over risk. The official foreign reserves remain broadly adequate at about 114 percent of the IMF's modified composite reserve adequacy metric, as of end-2014. Their level has slightly increased since the beginning of the year, in both EUR and USD-terms, to around 94 and 103 billion, respectively. In addition, Poland continues to benefit from the precautionary Flexible Credit Line (FCL) arrangement with the Fund, since January this year with a substantially lowered level of access—in line with the authorities' request and their exit strategy. The FCL provides an additional reserve buffer against external shocks and helps strengthen investor confidence.

Fiscal Policy

The general government deficit last year was reduced to 3.2 percent of GDP—significantly below the 3.9 percent level recommended for that year by the EU Council under the EDP rules. In addition, taking into account the costs of the 1999 pension reform (still incurred in the first half of 2014, despite the last year's systemic changes), amounting to 0.4 percent of GDP, the deficit was effectively reduced below the 3.0 percent of GDP reference value. Consequently, it reached a level that enabled exit from the EDP—one year ahead of the deadline set by the EU Council, and six years after the procedure for Poland had been launched. General government debt also declined last year, to 50.1 percent of GDP, mainly on account of the earlier changes in the pension system.[1]

[1] Cf. our last year's Buff statement for the Article IV consultation.

The correction of the excessive deficit creates some room for fiscal policy reflecting better current economic situation. However, the authorities are committed to further reducing the remaining imbalance in public finances, in a manner which would not pose a threat to Poland's medium-term growth prospects. Going forward, fiscal policy will be guided by progressing towards the medium-term objective (MTO) of a structural deficit of 1 percent of GDP. Achieving the MTO and keeping the government debt significantly below the Maastricht reference value of 60 percent of GDP will, in particular, be ensured by full compliance with the new stabilizing expenditure rule.[2] Among structural fiscal measures, an action plan aimed at improving tax compliance and effectiveness of tax administration has been implemented since last year, which should help foster budget revenues already in the near term.

Monetary Policy

Monetary policy in 2014 and early 2015 was conducted in an environment of low growth in Poland's main trading partners and falling commodity prices globally. Core inflation was continuously low on the back of still negative output gap and moderate wage pressures. All these factors have led to deflationary developments in the Polish economy. Average CPI inflation for 2014 remained constant (0.0 percent).

Amid challenging external conditions, the Narodowy Bank Polski (NBP) strived to maintain price stability, in line with its mandate, while at the same time supporting balanced economic growth. Thus, the NBP cut the reference rate by 50 bps in 2014 and by another 50 bps in 2015, bringing its main policy rate to a new all-time low of 1.50 percent in March 2015. In result, the policy rate has come down by a cumulative 325 bps since the onset of the easing cycle in late 2012. Monetary policy easing has facilitated the gradual pick-up in economic growth and continued improvement in labor market conditions.

Although CPI inflation has been negative since July 2014, deflation has eased somewhat over the past few months. The Monetary Policy Council (MPC) expects that the gradual acceleration of economic growth and good situation in the domestic labor market should bring inflation back to the NBP's target in the medium term. The MPC considers the current level of NBP interest rates as consistent with ensuring price stability, while discouraging a build-up of macroeconomic imbalances.

Financial Sector

The Polish financial sector has remained stable and resilient, supported by the economic recovery. Banks maintain low leverage ratios, remain liquid, well-capitalized and highly profitable. Despite record-low interest rates, the net profits of Polish banks have been stable at the record high level since 2011. In line with recommendations issued by the Financial

[2] Cf. our last year's Buff statement for the Review under the FCL.

Supervisory Authority, banks maintained their capital buffers with the capital adequacy ratio reaching 14.9 percent at the end of Q1 2015 and Tier 1 capital representing around 90 percent of total capital. At the same time, the liability structure of Polish banks has improved as deposits have been growing faster than loans, reducing banks' use of other sources of funding. The reliance on parent bank funding has declined alongside the reduction in the outstanding FX loans.

Credit flow to the economy has been growing at a steady pace, close to the nominal GDP growth rate. As of May 2015, overall credit to the non-financial sector grew by 3.5 percent (y-o-y, after exchange rate adjustment). This pace of credit growth does not create imbalances in the economy, but also does not unnecessarily restrain economic growth.

Work is further progressing on measures to strengthen the financial sector and improve supervision, including macroprudential and bank resolution frameworks. Regulatory and supervisory actions to reduce the share of FX loans in new mortgage lending proved successful with the FX mortgage portfolio in runoff mode since mid-2012. The effects of the recent Swiss franc appreciation have been counterbalanced by lower Swiss interest rates, thereby limiting the impact on debt service costs for borrowers. The authorities do not see the remaining FX mortgage portfolio as a systemic problem, as both the banks and borrowers have strong capital and income buffers to absorb shocks.

Loan-to-value limits for housing and commercial real estate loans, which came into force in early 2014 and will be gradually tightened until 2017, should contribute to strong loan quality going forward. While still high, the share of NPLs in non-financial sector have slightly decreased over the past three years, on account of improving economic conditions and sales of NPLs by some banks. The coverage of NPLs by provisions remains at a comfortable level.

Structural Reforms

The authorities have continued to implement their structural reforms agenda. Based on a number of integrated strategies, measures have been implemented to enhance growth potential of the economy. These measures are aimed, among others, at improving the access of companies to capital, stimulating entrepreneurship, strengthening business climate as well as counteracting the adverse effects of progressing demographic changes on the labor market and public finances. Among labor and product market policies: (i) the process of deregulation of professions has continued; (ii) measures have been taken to reduce labor market segmentation, including by better aligning civil law and temporary contracts with regular contracts as well as limiting excessive use of fixed-term contracts; (iii) efforts have continued to reduce the youth unemployment; (iv) a new housing rental program is in the pipeline to help develop the rental market and facilitate regional labor mobility. Also, a pro-family package—combining different benefits for families with children—is being carried out, along measures to increase female labor force participation. This is expected to increase the fertility rate and growth of labor supply in the long term. In addition, measures have also been undertaken to further improve business environment and promote R&D and innovation.