POLAND

Highlights

- **Private consumption has propelled GDP growth.** The collapse in investment was the main factor behind the GDP slow-down in 2016, but household consumption strengthened further, underpinned by rising wages and generous social programmes. GDP growth is expected to accelerate this year and next, backed by recovering investment.
- **The new laws on renewables discourage new investments and may jeopardise the existence of the current renewable energy producers.** The law, which establishes a new way to calculate the replacement fee for Poland's green energy producers, follows earlier legislation that sharply restricts inland wind farm placements.
- **The lowering of the retirement age weighs on Poland's growth potential.** The labour force is projected to shrink substantially as the population ages. By 2025 the working-age population is estimated to fall by more than 10 per cent. The process of labour supply decline will likely accelerate due to the lowering of the retirement age in 2017 and will likely exacerbate age-related fiscal and labour market problems.

Key priorities for 2018

- **The government should look at a wider range of clean energy sources, such as renewables, in order to lower emissions and improve air quality.** Air pollution is linked to coal-fired installations and the growing use of private vehicles.
- **There needs to be wider participation in a well-functioning third pillar pension system to help develop capital markets and potentially ease long-term public finance pressure.** Development of the capital markets has faced a number of hurdles, such as people's low propensity to save, an already-high burden on employers and relatively high charges in individual schemes (IKE and IKZE).
- **State-owned enterprises (SOEs) need to be more transparent and improve corporate governance.** There is limited transparency as to the extent of state ownership, while ownership roles are split between several ministries. Evaluation of boards is irregular and targets unclear. Higher transparency is especially important in the context of a government strategy that envisages a stronger role for the state in the economy.

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	1.4	3.3	3.8	2.9	4.1
Inflation (average)	0.8	0.1	-0.7	-0.2	2.0
Government balance/GDP	-4.1	-3.6	-2.6	-2.5	-1.8
Current account balance/GDP	-1.3	-2.1	-0.6	-0.3	-0.8
Net FDI/GDP [neg. sign = inflows]	-0.8	-2.4	-2.1	-1.2	-0.4
External debt/GDP	69.8	72.7	71.8	76.2	n.a.
Gross reserves/GDP	20.2	18.4	19.9	24.4	n.a.
Credit to private sector/GDP	50.4	49.8	51.1	52.7	n.a.

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Macroeconomic performance

Strong household consumption has upheld GDP growth but investment remains slow. In 2016 economic growth decelerated to 2.9 per cent, largely dragged down by a sharp decrease in investment. The slow start of the EU 2014-20 funds utilisation and persistent regulatory uncertainty were the key reasons behind the weak investment in 2016. In contrast, household spending remained strong, and its dynamics strengthened even further at the beginning of 2017, backed by vigorous wage growth and deferred effects of higher social spending. As a result, GDP growth accelerated to 4.3 per cent year-on-year (2010 prices) in the first half of 2017.

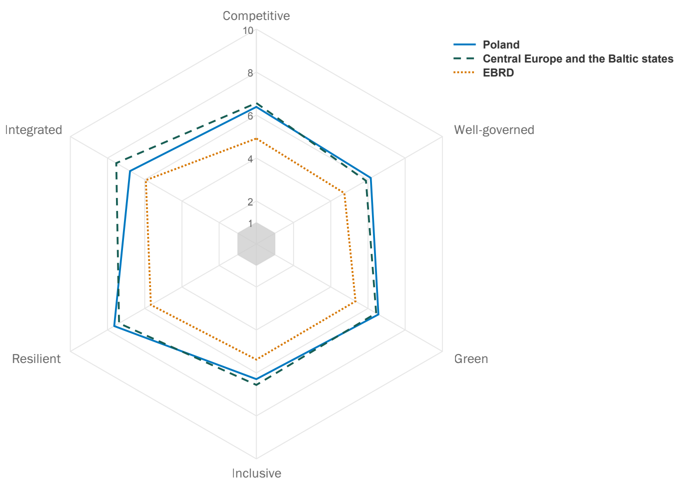
The EU co-financed investment is set to rebound. In 2016 investment dropped by 7.9 per cent. Weak public investment was largely affected by the delays in moving towards the new regulatory and operational requirements of the EU 2014-20 budget, whereas private investment was largely hit by legislative uncertainty. Public sector investment is set to rebound from the second half of 2017, additionally boosted by the approaching local government elections in 2018. Private investment is fragile and still constitutes a higher risk to growth. The investment-to-GDP ratio, which dipped below 18 per cent in mid-2017, has registered its lowest level since 1996.

Labour productivity growth is strong amid net immigration and low unemployment. In June 2017 the unemployment rate dropped to an historic low, reaching 4.7 per cent. The tightening labour market has driven faster wage growth, which reached 4.2 per cent in real terms in 2016. Yet, a potentially higher growth in wages has been prevented by an inflow of additional labour from Ukraine, estimated at about half a million at any given time. While labour productivity growth remains moderate, at about 2.0 per cent in 2016, the approaching adverse demographics and the reversal of the statutory retirement age, effective from October 2017, may hold back potential economic growth.

Fiscal consolidation has stalled despite high domestic demand. At 2.5 per cent of GDP in 2016, the general government balance saw the lowest deficit since 2007, a result likely to be improved on in 2017. These outcomes were largely driven by improved tax compliance, increased consumption-driven VAT receipts and a slow-down in public investment. The 2018 draft budget envisages a fiscal loosening, despite a very strong economy. Compared with 2016, it needs to accommodate the full year effect of the child benefits programme, the lowered retirement age, and higher public capital spending. While some of the expenditures are expected to be financed by revenue gains from tax administration reforms and the postponed VAT rate reduction, further improvement in tax compliance will be more difficult. Overall, the pro-cyclical fiscal stance will limit the room for manoeuvre in subsequent economic slow-downs.

Short-term growth will be strong. Household consumption, boosted by accommodative policies and the tightening labour market, along with recovering investment, are expected to accelerate GDP growth to 4.1 per cent this year and to 3.4 per cent next year. Nevertheless, a weaker-than-expected recovery in investment and lower external demand constitute potential risks to that scenario.

Assessment of transition qualities (1-10)



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Major structural reform developments

Previous measures to raise the retirement age have been reversed. Under the new law, which entered into force in October 2017, the government has reversed plans to raise the retirement age to 67 from 60 and 65 years for women and men, respectively. This measure may exacerbate age-related fiscal and labour market problems. At the same time, the government plans to strengthen the voluntary retirement pillar from mid-2018. The changes, not yet legislated, could include automatic enrolment and eventual privatisation of a part of the assets of the current obligatory and privately managed second pillar.

The broad push for higher tax compliance is bringing results. Electronic reporting, stricter penalties, a general anti-abuse rule, which is aimed at eliminating transactions made explicitly to avoid taxes, have all contributed to better revenues in 2017. The side effect, however, is lower corporate liquidity. The tax on certain financial institutions, introduced in February 2016, brought PLN 1.1 billion, of which PLN 0.9 billion (about €0.2 billion) was paid by commercial banks to the government in the first quarter of 2017. As a result, it has translated to 50 basis points-higher loan costs, prompting bigger firms to use foreign creditors. The introduction of a retail tax, which was deemed to be violating EU state aid rules, was postponed until 2018.

Business environment indicators are mixed. Poland remained the best central European country in the 2016 Corruption Perception Index (29th out of 176 countries overall). It has, however, fallen by six spots to 45th place in the 2017 Economic Freedom Index, by three spots in the World Bank *Doing Business 2018* report, to 27th position, and by seven spots to 54th in the 2017 World Press Freedom Index.

The Polish Development Fund (PFR) is being strengthened. A new bill on state development institutions, which is expected to be approved by the cabinet by the end of 2017, would give the PFR over PLN 150 billion (8 per cent of GDP) under management. Its investments include direct equity, venture capital investments, corporate loan guarantees, real estate financing and financing foreign expansion of Polish firms.

The state is increasing its share in the financial and energy sectors. The government continued its domestication strategy with the opportunistic purchase of Bank Pekao from Unicredit by state-controlled institutions in June 2017. Also, the state-controlled power firm PGE agreed to buy French utility EDF's Polish assets in a conditional agreement. The latter deal is expected to be finalised by January 2018.

New legislation may deter renewable energy investments. In August 2017 the president signed a new law on renewable energy, which establishes a new way to calculate the replacement fee for Poland's green energy producers. The new legislation will benefit only particular energy distributors, which will be able to renegotiate lower substitution fees that they pay as an alternative to the obligation to buy green certificates. As a result, the income of renewable energy producers, which includes subsidies, will be reduced further, which may discourage new investments and could jeopardise the existence of the current renewable energy producers. The law follows earlier legislation that sharply restricts inland wind farm placements. In 2015 Poland's share of energy from renewable sources was 11.8 per cent, which is still far below the 2020 target of 15.0 per cent, and these recent developments have reduced the probability of meeting that target on time. On a positive note, the government issued an important air quality directive restricting the production and use of polluting heating installations.

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Energy supply diversification continues. In July 2017 an agreement was reached between the United States of America and Poland for supplying US liquefied natural gas (LNG) as an alternative to Russia-sourced gas. Renegotiation of the contract for the latter is due in 2019. Poland wants to increase energy sector resilience and reduce its energy dependence on Russia through alternative sources such as the planned pipeline with Norway, to be ready in autumn 2022, as well as through shipping the LNG from Qatar and the United States of America via its LNG terminal on the Baltic Sea.

EU co-funded public investment is picking up. Poland reached 38.2 per cent in absorption of EU funds (measured by funds contracted) by early August 2017. At €4.2 billion, payments are far lower, below 10 per cent of the allocated envelope. However, the amount still constitutes over one-third of the EU total.