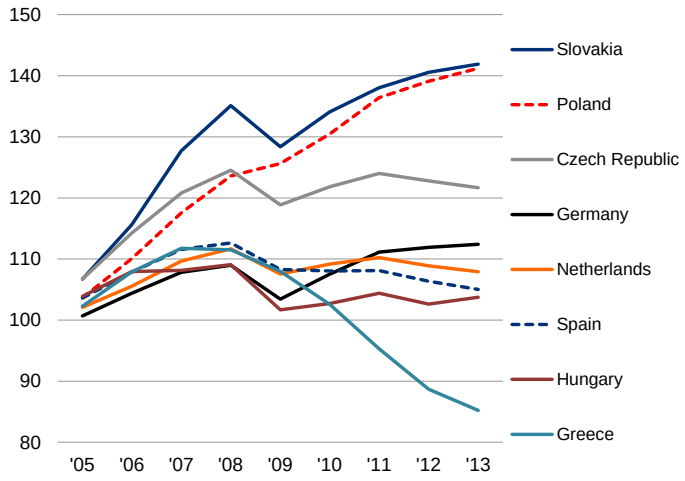
Poland: Leading the CEE pack

- **Poland and Slovakia have been the fastest-growing economies since the Big Bang EU enlargement in May 2004. Polish cumulative GDP grew by 41.2% in 2005-13, second only to Slovakia (41.9%).**
- **Poland and Western Europe both benefited from their closer connections. Demand growth from the EU has created 365,000 jobs in Poland in 1995-2012 while Polish demand growth has created 465,000 jobs in WE in this period.**
- **In this and the coming two years Poland will stay at the top of the list of GDP growth rates of CEE countries.**
- **Increases in capital investments (6.8%) and private consumption (3%) will replace net exports as the main contributor to GDP growth (3.8%) in 2014-15.**
- **Spill-over from the Russia-Ukraine conflict may have a negative impact on Polish economic development, to the tune of 0.4ppt of GDP growth.**
- **Challenges for the Polish economy include remaining red tape and regulatory issues, overly large government influence on the economy, and an ageing population.**
- **Based on its economic performance Poland is very close to qualifying for adoption of the euro. It is now up to Polish politicians to decide.**
- **The Polish manufacturing sector continues to increase its share of high added value products cementing its role in global production chains.**
- **High import growth is expected to occur in office, telecom, and electrical equipment, in industrial machinery, and in pharmaceuticals.**
- **Polish exports of industrial machinery and chemicals are expected to show particularly strong growth.**
- **The Polish economy is running a trade deficit with the Dutch economy. High growth in Polish imports from the Netherlands is expected in road vehicles, industrial machinery, and pharmaceuticals, together with more moderate growth of traditional Dutch exports.**

For 2014 and 2015 we expect 3.7% YoY and 4.1% YoY GDP growth, somewhat below potential, but still very robust in cross-EU comparisons. In 2013, economic acceleration was fuelled by exports, but this year we expect the recovery to broaden to domestic demand. According to our estimates, consumption is growing far more slowly than disposable incomes. This is due to low household confidence, but the gap should close over coming quarters, reflecting the recovery in the labour market. Recent data shows an acceleration of private investments to be continued in the rest of the year. In parallel public investment will show a positive growth as well due to two approaching elections (local government in 2014, general election in 2015). The changes in the pension system should lower debt by about 8% of GDP (or 9% of GDP ESA95) and the deficit by 1.0% of GDP, meaning that the government might comply with the EC recommendation to lower the deficit and simultaneously increase public investment. The absorption of EU money should start in 4Q14 and should have a significant impact on growth in 2015.

Figure 1 GDP level since EU entry in May 2004, 2004=100

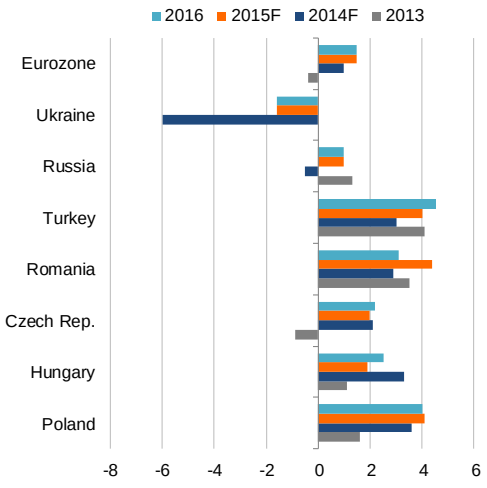


Source: ING

2014 inflation should remain subdued (with the yearly average close to 1% YoY), with low food and stable energy prices as well as the longest ever period of weak domestic demand. This is a background supportive of an interest rate cut decision by the NBP in September. The expected strengthening of the Polish currency (on a 3M horizon PLN could push to close to 4/€ or even below) will act against a rebound in the low inflation rate.

We see the downside risk to GDP growth related to the Ukraine-Russia crisis at about 0.4ppt. We estimate that each loss of 10% of Polish exports to Russia is worth 0.21ppt of GDP growth in Poland. The food categories that are most sensitive to Russian sanctions (meat, milk, vegetables and fruits) encompass about 10% of Polish exports to this country, so this holds a downside risk to growth. This should materialise in the stabilisation of GDP dynamics in 2H14.

Figure 2 GDP growth in CEE countries and the Eurozone, 2013-16



Source: ING estimates

Challenges for the Polish economy

Anchored by a sound banking system and healthy household and corporate balance sheets, the Polish economy resisted a succession of external shocks without undergoing a contraction, cementing its position as a regional safe haven in CEE. Despite the good performance and strong overall fundamentals, challenges remain for the Polish economy.

The Polish population is ageing fast, with low fertility rates and a steady rise in life expectancy. Poland is broadly in line with the average for developed countries for long-term elderly dependence and pension replacement ratios.

Remaining red tape and regulatory issues

In terms of ease of doing business and the business environment, there has been significant progress. According to the World Bank "Doing Business" survey, in 2012, Poland improved the most on ease of doing business through four reforms:

- Making it easier to register property
- Payment of taxes
- Enforcing contracts, and
- Resolving insolvency.

However, some challenges remain:

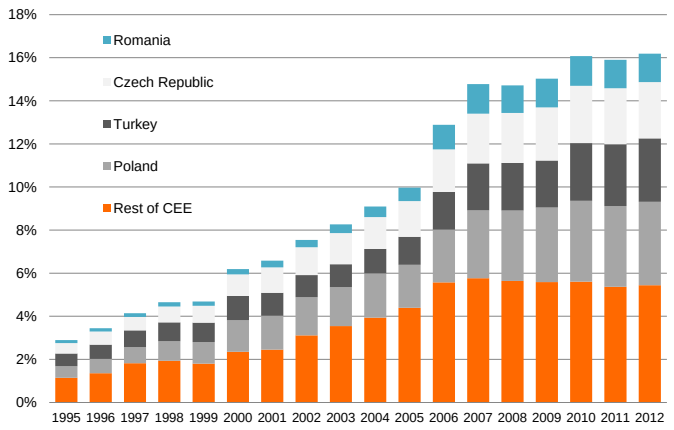
- The administrative and regulatory burden on businesses is still relatively high. Administrative costs imposed by regulations still weigh significantly on firms
- Starting a business appears particularly drawn-out
- Poland still lags behind most OECD countries in the reducing the complexity of the tax system
- Difficulties in resolving insolvency
- Obtaining an electricity connection for a new business.

The government still has a comparatively tight grip on the economy. Reducing this influence would be an improvement as, generally, shifting from public to private ownership tends to increase efficiency and profitability. Poland lags behind other CEE countries in terms of cumulated privatisation since the transition began. As a result, public ownership remains among the most prevalent in the OECD area. Despite the fact that the government has launched ambitious privatisation plans since 2008, and privatisation is still ongoing, government involvement in the economy is likely to remain high. The government has classified almost 50 state-owned enterprises (SOEs) as strategically important and intends to keep them under majority state ownership, or to sell tranches in such a way that it can maintain control due to dispersed ownership. These SOEs operate mostly in the energy, financial, and mining sectors. The government also wants to maintain control over companies in the chemical and mining industries, which are not deemed as strategically important.

The Polish EU connection

Integration at the regional level can be illustrated by the increased flows of goods, foreign direct investments and bank loans. As a consequence, GDP and GDP per capita in Central and Eastern Europe has seen a more rapid increase than in Western Europe. The importance of the overall connection can be expressed as a percentage of Western European GDP. As one of the largest economies in the CEE region, Poland played an important role (3.9%) in the overall connection of 16.6% of Western European GDP in 2012.

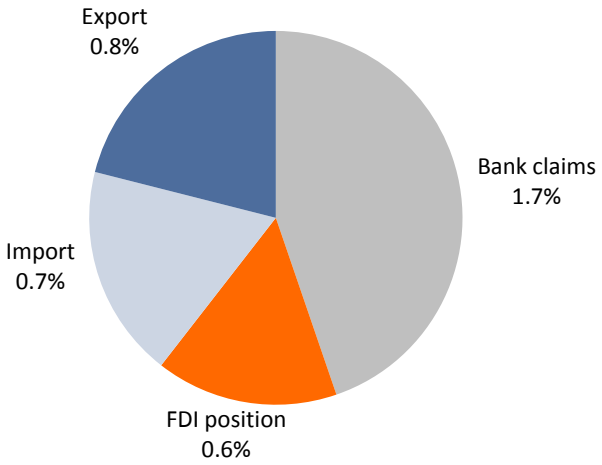
Figure 3 Connection rate of CEE countries, as % of Western European GDP



Source: BIS, UNCTAD, OECD, EIU, ING calculations

Trade flows dominated the connection between Western Europe and Poland in 1995. Due to the need to step up investments, bank financing by international banks started to play an important role soon after. This has been linked to foreign direct investments by western companies establishing greenfield operations and acquiring local companies.

Figure 4 Composition of the connection (sums up to 3.9% of Western Europe GDP) between Poland and Western Europe



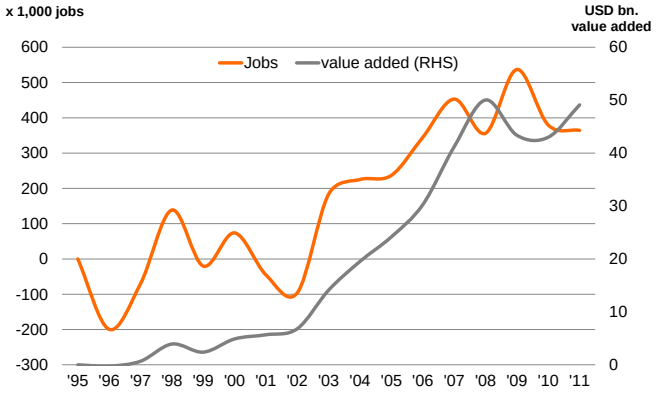
Source: BIS, OECD, UNCTAD, ING calculations

The accession of ten CEE countries to the EU gave a big boost to the connection rate in 2004. Germany, Italy and Austria were able to expand their activities more rapidly due to their long standing relationships even before 1989. Dutch companies, including banks, swiftly followed.

Mutual benefits of the connection

The expansion of production capacity in Poland with the help of foreign investors enabled the country to benefit from the increase in demand from Western Europe. Value added through additional demand from Western Europe generated **USD49bn** in Polish GDP in 1995-2012. This increased demand led to **365,000 more jobs** (see graph below), making Poland the main beneficiary in the region. Additional demand from Poland created USD46bn value added **in Western Europe**, **generating 465,000 jobs**. In Poland most jobs linked to more demand from Western Europe were created in the service sector, especially in the wholesale and retail trade (+194,000 jobs) and in business services (+79,000). An additional 86,000 jobs were created in the manufacture of furniture and other consumer goods. The fact that value added increased in all sectors while the number of additional jobs did not increase in parallel is due to the increase in labour productivity in Poland.

Figure 5 Growth of jobs and value added in Poland, 1995-2012

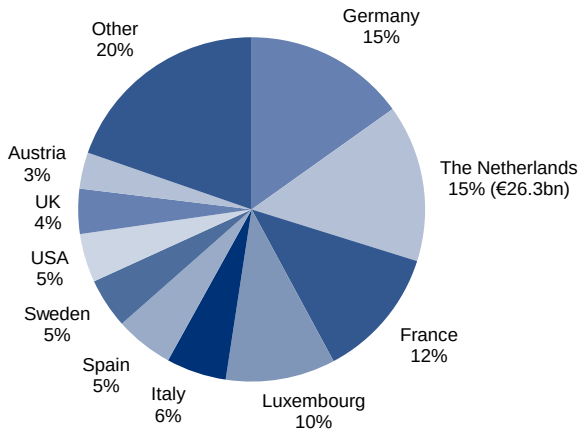


Source: University of Groningen, ING calculations

FDI inflow recovers

Germany and the Netherlands are the most important foreign direct investors in Poland. Total net FDI inflow into Poland showed an outflow of US$1.3bn last year. This year the inflow will probably revive to US$3.7bn and increase even further next year. The fall in 2013 had a lot to do with the poor international investment climate for emerging markets. The negative mood among investors towards emerging markets seems to have been replaced by a more positive mood this year.

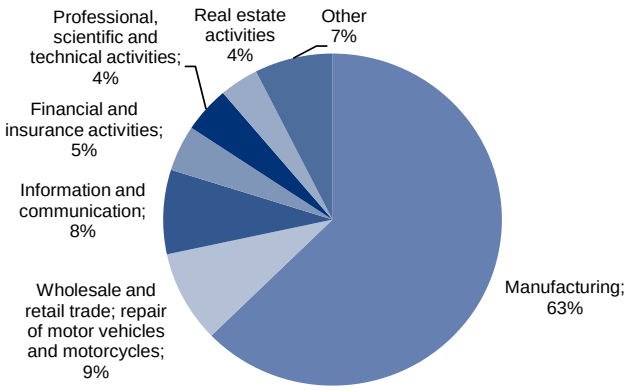
Figure 6 FDI inward position by country, as at end-2012



Source: ING

Dutch FDI is highly concentrated in the manufacturing industry. The Dutch number includes many foreign companies routing FDI via their Dutch finance companies.

Figure 7 Major Dutch FDI by activity



Source: NBP

Polish development as a production location

Foreign direct investment, EU funds and bank loans from western banks helped the country to improve its production base and face competition from European and Asian countries. This financial support, together with western companies introducing new production and management techniques, helped the country to upgrade its production processes. The results can be seen in the development of the production profile and linked to the improvement of the export profile.

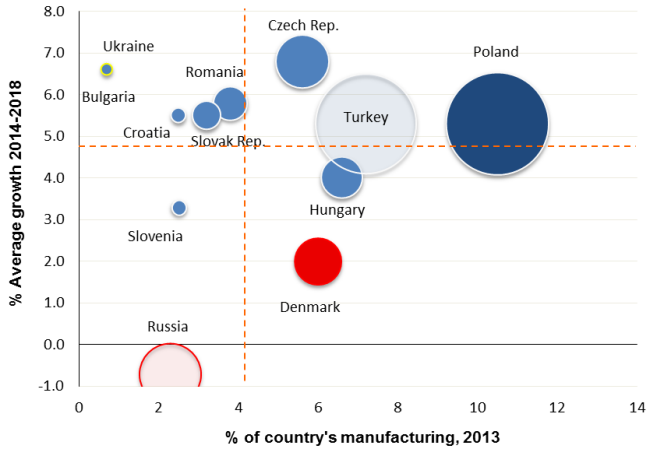
Associated with the activities of western producers, supply chains were created as a result of fragmentation of production processes and relocation of these fragments (mainly comprising manufacturing) to countries with lower labour costs. The relocation of production to Poland was fostered by favourable geographical location, rapid development of transportation and IT infrastructure and also by the integration with the European Union. The objective of global supply chains developing in such circumstances was to boost the competitiveness of products. One of the symptoms of the growing role of Global Supply Chains (GSC) in foreign trade is a decrease in the share of domestic value added in exports

The growth in the role of foreign value added was not the same in all sectors. The sectors currently most internationalised include production of vehicles (NACE 34-35) and electrical machinery and equipment (NACE 30-33,36). In these sectors the strongest growth in foreign value added was recorded in 1995-2009. In Poland, foreign value added amounted to 39% in 2009 of exported production of vehicles (compared to 20% in 1995). An analysis of trends in the exports of domestic and foreign value added in individual sectors indicates that the sectors having posted the highest foreign value added growth were also the ones with the steepest growth in domestic value added. Thus, in 1995-2009, domestic value added in Poland's vehicle exports increased ten times and electric machinery and equipment thirteen times. In the remaining manufacturing sectors, domestic value added in exports increased five-fold in this period. Therefore, it can be stated that the participation in the GSCs has also contributed to an acceleration in the pace of domestic value added growth.

The supply chains, in which enterprises from Poland participate, focus heavily on links with other European countries (in particular Germany). It means that the GSCs are mainly of a regional nature. In 2009, 71% of foreign value added used in Poland's exports originated from the countries of Europe (compared to 77% in 1995). The lower share of Europe resulted mainly from the growth in the role

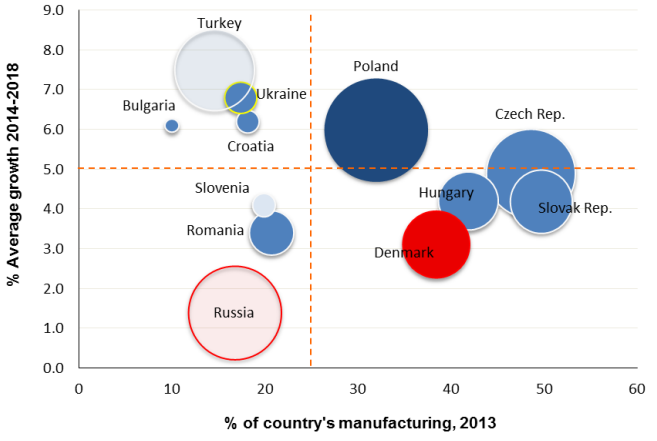
of value added originating from the countries of South Eastern Asia, from 7% in 1995 to 14% in 2009. This probably results from the fact that enterprises located in Germany are the main organisers of the global supply chains in the region.

Figure 8 Growth of production of consumer durable goods, 2014-18, Size of circle represents value in US$bn in 2013



Source: Oxford Economics

Figure 9 Growth in production of investment goods, 2014-18, Size of circle represents value in US$bn in 2013



Source: Oxford Economics

Note: Consumer durable goods comprise domestic appliances, consumer electronics, furniture manufacturing, and other manufacturing

Note: Investment goods include metal products n.e.c, general purpose machinery, special purpose machinery, computers & office equipment, motors, generators & transformers, telecom equipment, precision & optical instruments, motor vehicles & parts, other means of transport.

Poland has become an important producer of investment goods and durable consumer goods and is among the largest producers in the region. Since the production growth rate for both product categories is expected to be among the highest of the region, Poland shows to be very well linked to the development of GSC in these sectors of industry. Poland will become even more dominant in future, not only in its own region but also globally.

Figure 10 Change in share of global production, 2003-13, in % points

	Czech Republic	Hungary	Poland	Romania
Agriculture, forestry & fisheries	-0.1	0.0	-0.3	-0.2
Basic metals	-0.1	-0.1	0.0	-0.2
Chemicals	0.0	0.0	0.1	-0.1
Electric machinery & apparatus	0.4	-0.3	0.9	0.2
Food, beverages & tobacco	0.0	-0.1	0.2	0.4
High-tech goods	0.0	-0.1	0.2	0.0
Mechanical engineering	0.2	0.1	0.1	0.0
Pharmaceuticals	0.1	0.0	0.1	0.0
Rubber & plastics	0.4	0.0	0.3	0.1
Transport equipment	0.5	0.1	0.4	0.1

Source: Oxford Economics

Poland improved its share in of global high added value production in 2003-13. As shown in the figure, Polish performance was better than that of neighbouring countries. Production of electric machinery and apparatus, rubber and plastics and transport equipment show the highest increases in its share in global production.

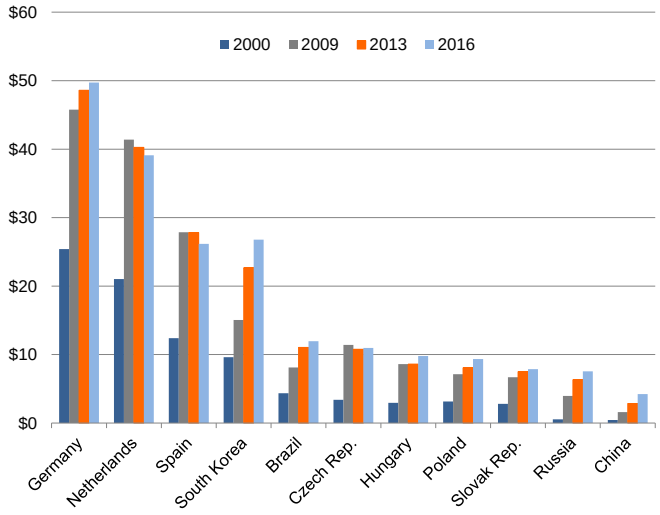
In 2013-2018 Poland is expected to increase its share in global production in the main sectors other than basic metals and agriculture, forestry and fishing. Capital investments and increases in productivity support the favourable development of Polish industrial production.

Wage costs make a difference

Hourly wage costs in Polish manufacturing (US$8.1) were six times less than in Germany (US$48.6) in 2013. Even compared with neighbouring countries, such as the Czech Republic and Hungary, hourly wage costs were 25% and 6% less in Poland. Compared with euro country Slovakia, Polish hourly wages were 8% higher. Wage cost level is an important indicator for producers in the manufacturing industry. The development of the wage cost per unit indicates whether a country is becoming more competitive compared with producers in other countries. In 2000-13, the Polish wage cost per unit in US$ declined by 36% and in the Czech Republic by 3.5%. Hungary and Spain showed an increase of almost 18%, while Dutch unit wage cost

increased by 8%. In Germany, the unit wage cost in the manufacturing industry was almost unchanged (an increase of 1%) in the same period. The favourable wage cost development in Poland is the result of an increase in productivity due to the shift in production towards higher added value production and a weaking of the zloty against the US dollar. This year and next year Polish capital investments should continue to see the highest growth rates of the region and productivity increases are expected to keep wage cost under control, even while wage rises are likely to be more generous this year and next.

Figure 11 Hourly wage costs manufacturing industry, 2000, 2009, 2013 and 2016



Source: Oxford Economics

Impact of Russia-Ukraine conflict on the Polish economy

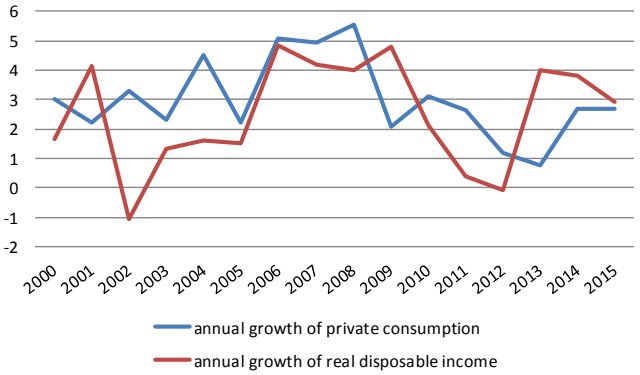
If the confrontation between Russia and Ukraine continues for several months, including sanctions and disruption of gas transit during that period, this could have a serious impact on the Polish economy. Poland depends on supply from Russia for 12.5% of its energy consumption. Closing the tap for Ukraine could have an impact on deliveries to many countries in Europe including Poland. On the export side, Russia accounts for 5.3% of total Polish exports. The Netherlands is responsible for 4% of Polish exports. The most important Polish export products to Russia are mechanical equipment, electrical equipment, road vehicles and plastics. The most fragile components of exports to Russia (meat, dairy products, fruits and vegetables) comprise 10% of the total.

Every 10% loss in exports to Russia will cost Poland 0.22ppt GDP growth. A complete ban on exports to Russia will cost Poland 2.2ppt of GDP growth. The Ukraine accounts for only 2.8% of total Polish exports. A 10% loss of exports to Ukraine will cost Poland 0.12ppt of GDP growth. A complete ban will cost Poland 1.2ppt of GDP growth. In total, the loss could be 3.4%, close to the overall GDP growth forecast for 2014/2015. A scenario of a slow-paced escalation where Russia and Ukraine fail to find a legislative solution for the Eastern Region is possible and tensions between Russia and Western countries could continue for several months. There might be a disruption in gas transit during that period.

An attractive consumer market

Regained consumer confidence, improved prospects for the development of income, and a decline in unemployment will support growth in consumer spending in 2014-15.

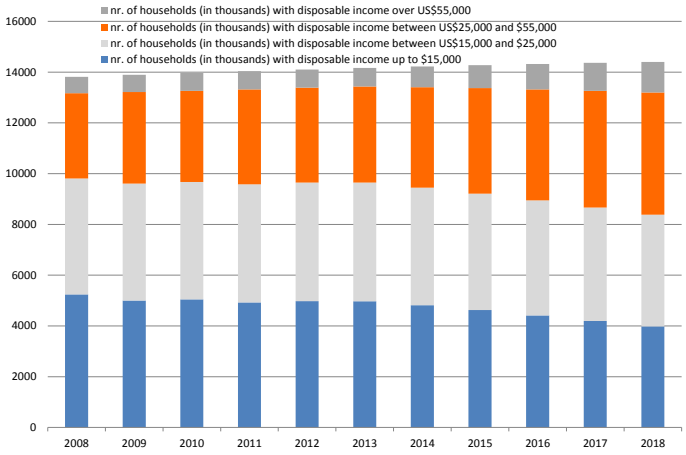
Figure 12 Disposable income grew faster than consumption in 2013, but gap to narrow as confidence improves



Source: EIU

The number of households with an income of over US$25,000 will continue to increase, from 4.7 million in 2014 to 6 million in 2018. The catching up process of the Polish economy has already given a big boost to the development of GDP per capita. Still, the gap between the Western European average per capita GDP (US$40,699 in 2013) and Polish GDP per head (US$13,394) remains large.

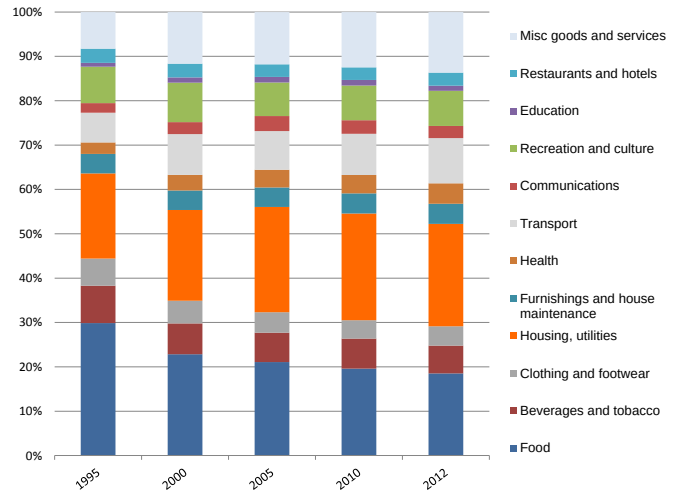
Figure 13 Development of disposable income



Source: Euromonitor

The increase in disposable income will change the distribution in expenditures on the different categories. Figure 14 shows the changes in the expenditure profile between 1995 and 2012. The highest consumption growth since EU accession in 2004 has occurred in expenditures on transport, restaurants and hotels, health, furnishings and house maintenance, and recreation and culture. The reduced proportion of consumption on “basic food” has also demonstrated shifting consumption patterns as the population has grown wealthier. This trend is likely to continue as disposable incomes increase further. The Polish consumer market will be an attractive growth market for local producers of consumer products and for foreign producers of brand products.

Figure 14 Polish consumer expenditure by product group, as % of total expenditure



Source: OECD

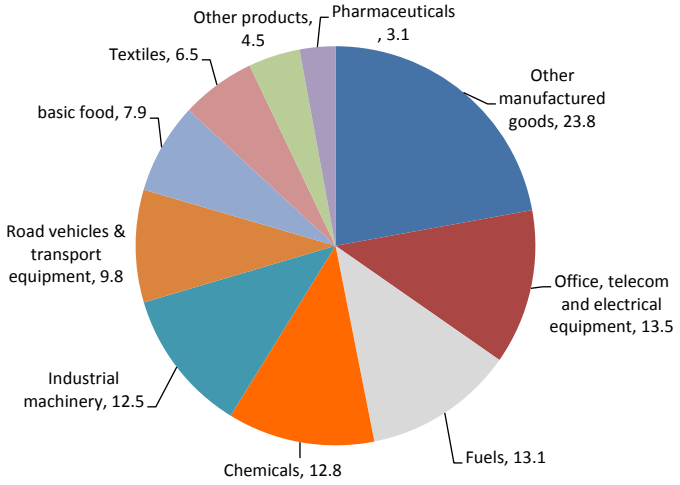
Polish trade flows

Polish imports are expected to grow by almost 10% annually in the coming years (2014-18), about in line with the global average rate. Exports are expected to increase slightly less, at almost 9% annually, resulting in some (modest) widening of the trade deficit.

Most **Polish imports** are in the product groups of office, telecom, electrical equipment, other manufactured goods (metal and paper manufactures mostly), and textiles. Going forward, highest growth is expected to occur in office, telecom and electrical equipment, industrial machinery, and pharmaceuticals.

Germany is by far the most important origin of Polish imports, with €40bn coming from that country annually. These are mostly metal and paper manufactured goods and office, telecom, and electrical equipment.

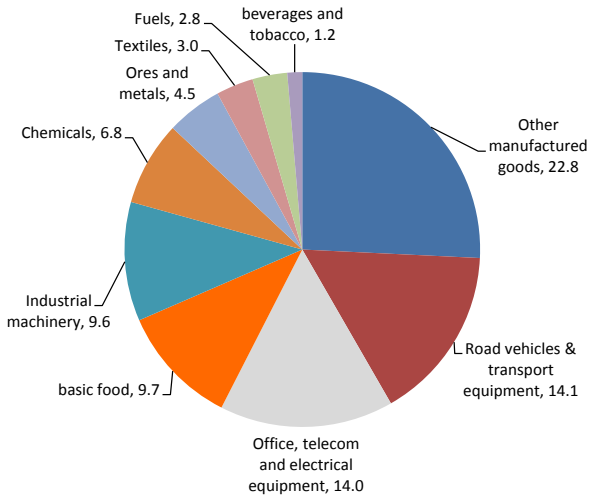
Figure 15 Poland: imports by product group, €bn



Source: Oxford Economics

The largest product groups that Poland **exports** are miscellaneous manufactured goods (mainly furniture and metal manufactures), textiles, and office, telecom, and electrical equipment. Basic food and office, telecom and electrical equipment exports have grown fastest since 2004. For 2014-18, high growth rates are expected to occur in some smaller product groups, such as industrial machinery and chemicals. In terms of export destinations, there is some evidence of export diversification away from the eurozone in 2008-13, at the time of the Eurozone crisis. Germany remains the dominant destination by far.

Figure 16 Poland: exports by product group, €bn

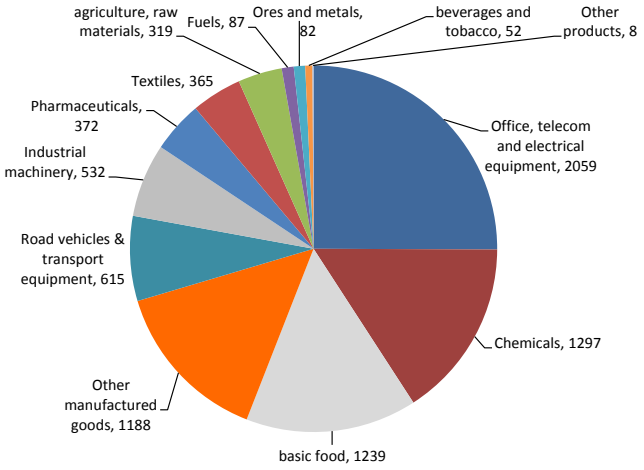


Source: Oxford Economics

Trade flows between Poland and the Netherlands

Poland exported products worth €5.5bn to the Netherlands in 2013. Poland imported Dutch products to the tune of €9.2bn in 2013. Thus, the Polish economy is running a trade deficit towards the Netherlands of 1% of Polish GDP.

Figure 17 Polish imports from the Netherlands, 2013, €m

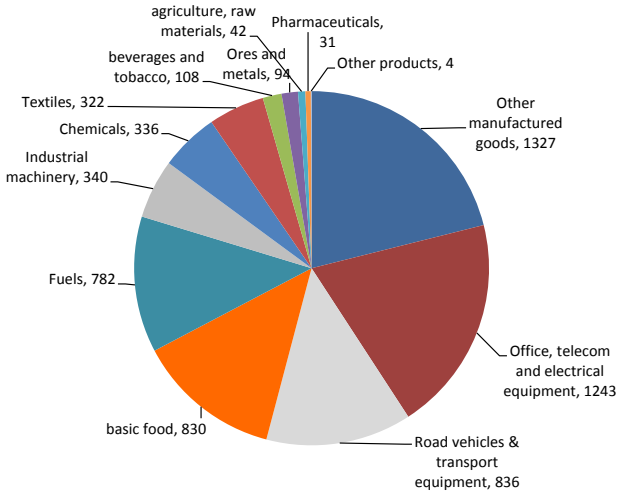


Source: Oxford Economics

Most of the **imports of Poland from the Netherlands** fall in the product groups of office, telecom, electrical equipment, chemicals, and basic food. The highest **growth** of Polish imports from the Netherlands since Poland's EU accession in 2004 has taken place in fuels, beverages and tobacco, basic food and raw materials. Going forward, high growth is expected in road vehicles, industrial machinery, and pharmaceuticals.

Large **export categories to the Netherlands** are other manufactured goods (in this case largely furniture, metals and paper manufactures), office, telecom and electrical equipment, and road vehicles. High growth is expected to take place in road vehicles and industrial machinery.

Figure 18 Polish exports to the Netherlands, 2013, €m



Source: Oxford Economics

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The final text was completed on 19 June 2014