CONCLUDING STATEMENT

Poland: Staff Concluding Statement of the 2023 Article IV Mission

FOR IMMEDIATE RELEASE

Washington, DC – March 24, 2023:

An International Monetary Fund mission visited Warsaw during March 14-24 in the context of the 2023 Article IV consultation.

Following an impressive recovery from the pandemic, the Polish economy has been struck by the effects of Russia's war in Ukraine, which have contributed to high inflation and slowing growth. Poland is graciously hosting 1 million refugees from Ukraine, reflecting the commendable efforts of the authorities and the Polish people. The main policy challenge is to lower inflation back to the target without unduly weakening the economy.

- *In the short run, fiscal policy should support the central bank's efforts to reduce inflation by avoiding a fiscal loosening this year. Future energy support measures, if needed, should be more targeted according to need and allow a greater role for price signals to promote energy conservation.*
- *The authorities' announced intention to reduce the role of off-budget fiscal funds is welcome. Expenditures currently executed through off-budget funds should be moved to the budget to improve transparency and permit parliamentary and societal review.*
- *The authorities should create room within the budget to accommodate a planned increase in defense expenditures. Having ample fiscal space has served Poland well during the pandemic and the energy price shock. Given ongoing uncertainty, it will be important to preserve the fiscal buffers.*
- *Monetary policy should continue to respond to changing data and conditions. The National Bank of Poland (NBP) should be prepared to raise interest rates further if necessary to reduce inflation to the target by the end of 2025.*
- *While banks should proceed with voluntary restructurings of foreign exchange mortgages, the authorities should explore policy options to help resolve the uncertainty that legal risks cast over the banking sector. Financial sector authorities should monitor challenges to banks' ability to provide credit to the economy, and costly untargeted credit holidays should be discontinued.*

As elsewhere in Europe, the Polish economy faces headwinds in the wake of Russia's war in Ukraine. While energy shortages have been avoided, growth slowed significantly in the second half of 2022 as high inflation eroded real wages, monetary tightening slowed housing activity, and external demand weakened. The slowdown will continue in early 2023, before a gradual recovery begins in the second half of the year. Growth in 2023 is projected at 0.3 percent, down from 4.9 percent in 2022.

Despite the current challenges, the medium-term economic growth outlook remains favorable. A cyclical rebound is projected in 2024 and 2025, with growth of 2.4 and 3.7 percent, respectively. Economic growth is projected to exceed 3 percent annually over the medium term, as the negative effects of population aging are offset by stronger investment financed in part by Next Generation EU grants, underscoring the importance of meeting the milestones agreed with the EU. Even after terms of trade normalize, a small current account deficit is projected to persist over the medium term, given Poland's significant investment needs. The central bank's foreign exchange reserves are ample and expected to remain adequate to insulate against external shocks and disorderly market conditions.

Uncertainty to the outlook remains unusually high. An escalation of the war in Ukraine or an intensification of recent banking sector turmoil in advanced economies could trigger greater risk aversion and weaker external demand. Separately, inflation could remain high for longer than expected. On the upside, Poland is well positioned to benefit from a possible increase in nearshoring-related investments. A sustained increase in immigration would also increase Poland's competitiveness and raise medium-term growth.

Following a fiscal expansion in 2022 and amid still-high inflation, the authorities should avoid budgetary loosening in 2023. The general government fiscal deficit increased from 1.9 percent of GDP in 2021 to an estimated 3.1 percent of GDP in 2022. This fiscal loosening was driven by a personal income tax (PIT) reform and the "Anti-Inflation Shield" temporary tax reductions on food and energy. While the looser fiscal stance added to existing inflation pressures, the "Anti-Inflation Shield" tax cuts also helped contain the increase in headline inflation. Looking forward, the deficit is expected to again widen, reaching 4.5 percent of GDP in 2023, due to the slowing economy and higher interest payments. While general government debt is projected to remain stable at about 50 percent of GDP, a tighter fiscal position in 2023 would support the central bank's efforts to lower inflation. At a minimum, further fiscal loosening should be avoided unless major downside risks materialize.

If Poland faces additional energy shocks, policies should be primarily focused on protecting the most vulnerable and encouraging energy conservation. While measures to shield the economy from an extraordinary energy price shock can be appropriate, they should be temporary and move towards greater targeting according to household income and energy poverty. In addition, they should allow a greater role for price signals to improve energy conservation and support the transition to renewable energy. The "Energy Shield" of 2023 is a step in the right direction with respect to electricity, as it introduces block tariffs which allow for greater price increases above a threshold level of consumption.

To accommodate additional defense expenditures, the authorities should find offsetting savings to prevent debt from increasing over the medium term. Ample fiscal space permitted robust support to the economy during both the pandemic and the energy price shock. However, Poland now faces new fiscal pressures in the form of additional defense expenditures, lower PIT revenue, and higher interest rates. Over the medium term, the general government deficit is projected to exceed the approximate 3 percent of GDP level that would stabilize debt around 50 percent of GDP. Keeping debt on a gradual downward path would preserve policy space to address future shocks and prepare for long-term pressures related to population aging and the energy transition. To create fiscal space, the authorities could consider reforming the property tax to raise additional revenues or curb expenditures by enhancing the targeting of social benefits and raising the retirement age. This latter step would also support economic growth by limiting the gradual decline in the labor force. Ending the reliance on extra-budgetary funds and instead requiring all spending to go through the budgetary approval process would also support fiscal scrutiny.

While inflation is likely to decline significantly in 2023, it is projected to reach the top of the tolerance range of the target only at the end of 2025. The large increase in inflation was mostly driven by external energy and food prices. The stabilization of these prices will drive the projected near-term fall in inflation from 16.6 percent at end-2022 to 7.2 percent at end-2023, while remaining high at 11.9 percent on average in 2023. However, a further decline in inflation to the target will require an easing of core inflation, which is more domestically driven. Given the tight labor market, the IMF mission projects that the decline in core inflation will be protracted, averaging nearly 11 percent in 2023 and more than 7 percent in 2024. Headline inflation is projected to decline to 3.6 percent at end-2025, near the top of the tolerance range of the target.

The NBP should continue to respond to changing conditions and, in particular, be prepared to raise interest rates further, if necessary to reduce inflation to the target by end-2025. The Monetary Policy Council (MPC) appropriately raised rates during 2021-22 before holding the policy rate at 6.75 percent since October 2022. This policy tightening has been effective in dampening economic activity through the interest rate and credit channel. However, the impact of tightening already delivered and the resulting pace of disinflation are difficult to predict. As a result, monetary policy should continue to respond to changing data and conditions. Given the structural labor shortage in Poland, a reduction in wage growth may be slower than projected, hampering the pace of core disinflation. Even if food and energy price inflation persistently declines, the MPC should resume monetary policy tightening if key indicators - core inflation momentum, wage growth, and the economy - fail to slow as projected. A new fiscal expansion may also necessitate additional monetary policy tightening. Accordingly, the MPC should consistently communicate that its current focus remains on the maintenance of a tight policy stance, making clear that discussion of rate cuts is premature.

While the banking sector remains stable and well capitalized, legal and regulatory challenges could hamper the ability of banks to support the economy. Non-performing loan rates remain low, sector-wide capital remains strong, and higher interest rates have supported earnings. Nonetheless, the sector continues to face challenges that reduce profitability and could limit its ability to provide credit to the economy over the medium term. First, mortgage credit holidays made available to all borrowers – regardless of income or actual distress – have led to significant costs for banks and should not be extended. Instead, if needed, the authorities could scale up existing programs which provide effective support to truly distressed borrowers. Second, adverse market conditions have complicated the ability of some banks to issue instruments available for bail-in in the event of resolution, in line with MREL requirements. Absent an improvement in market access, these banks may need to meet the requirement with own funds in early 2024. Finally, foreign exchange (FX) mortgage legal risks continue to cast a high level of uncertainty over the banking sector. While progress in voluntary conversion of FX mortgages to local currency has been encouraging and should continue, the authorities should explore policy options that help resolve this uncertainty.

The energy strategy should reflect the need for decarbonization while safeguarding Poland's energy security. Meeting energy transition targets will require substantial effort, especially in the power sector. The forthcoming update of the energy strategy is expected to propose a strong increase in renewable energy and a reduced role for natural gas as a transition fuel. Unlocking the growth of renewables hinges on a reduction in regulatory barriers and a level playing field to attract private investors. Phasing out the use of coal in electricity generation and directly by households should also be a priority. Meeting decarbonization targets under EU policies will be supported by EU funds, but additional policy instruments may be needed, and the authorities are encouraged to consider a role for carbon taxation.

The authorities' successful efforts to promote the integration of Ukrainian refugees should continue. Refugees have benefited from the existing Ukrainian diaspora in Poland and the generosity of the Polish people. The authorities have also implemented effective policies to support refugees, including financial support and direct access to the health and education systems. In addition, refugees have been granted full rights to work, and Ukrainian businesses have been given operational rights in Poland. Going forward, the authorities could provide refugees with further training opportunities for reskilling and upskilling, Polish language training, and access to affordable childcare. Efforts to facilitate the recognition of Ukrainian professional licenses in Poland would also support the further integration of skilled workers.

The mission thanks the authorities and other counterparts for excellent discussions.

Republic of Poland: Selected Economic Indicators, 2022–28

	2022	2023	2024	2025	2026	2027	2028
	Est.	Projections					
Activity and Prices							
GDP (change in percent) 1/	4.9	0.3	2.4	3.7	3.4	3.1	3.1
Output gap (percent of potential GDP)	1.9	-0.8	-1.3	-0.7	-0.2	-0.1	0.0
CPI inflation (percent)							
Average	14.4	11.9	6.1	4.1	3.4	2.9	2.5
End of period	16.6	7.2	5.0	3.6	3.3	2.5	2.5
Unemployment rate (average, according to LFS)	2.9	3.2	3.5	3.4	3.4	3.4	3.4
Public Finances (percent of GDP) 2/							
General government net lending/borrowing	-3.1	-4.5	-3.8	-4.0	-4.2	-3.9	-3.5
General government cyclically adjusted overall balance	-4.1	-4.0	-3.2	-3.6	-4.1	-3.8	-3.5
General government primary balance	-1.7	-2.7	-2.0	-2.0	-2.1	-1.7	-1.3
General government debt	49.6	50.7	51.7	52.4	53.6	54.1	54.5
Balance of Payments							
Current account balance, percent of GDP	-3.2	-2.4	-2.1	-2.0	-2.0	-2.0	-2.0
Total external debt, percent of GDP	48.4	45.7	43.4	41.1	39.6	38.6	38.4
Memorandum item:							
Nominal GDP (billion zloty)	3067.7	3440.7	3745.5	4053.8	4343.6	4616.4	4891.0

Sources: Polish authorities; and IMF staff calculations.
1/ Real GDP according to 2015 base year.
2/ According to ESA2010.