CONCLUDING STATEMENT

Poland: Staff Concluding Statement of the 2024 Article IV Mission

FOR IMMEDIATE RELEASE

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An International Monetary Fund mission visited Warsaw during October 8-17 in the context of the 2024 Article IV consultation.

Poland's near-term outlook is positive and has improved relative to last year despite ongoing sluggish growth across Europe and Russia's war in Ukraine. A consumption-led recovery is underway, and the outlook is further supported by recently unlocked NextGen EU Funds (NGEU). Inflation has declined helped by a tight monetary stance, and its descent to the target range by close to end-2025 is on track, provided prudent policies are maintained. Policy priorities for the near- and medium-term include balancing the mix of monetary and fiscal policy , preserving debt sustainability, while strengthening the economy to face longer-term challenges. Specifically:

- *Monetary policy is appropriately tight and interest rate cuts should commence only when there is clear evidence that wage growth is decelerating, and inflation is firmly on track towards the target.*
- *The medium-term Fiscal Structural Plan is welcome and it targets sufficient cumulative fiscal consolidation by 2028, meeting the EU's new fiscal rules. The full set of measures to achieve this is yet to be identified.*
- *Bringing more of the authorities' medium-term deficit reduction plans up front in 2025 would build more resilience against future shocks, reduce debt, and support more rapid interest rate reductions, which would foster private sector investment and growth while still bringing inflation to target.*
- *Population ageing, diminishing cost-competitiveness, and climate transition present significant challenges to Poland's export-driven growth model. Thus, medium-term growth*

is expected to decline, unless structural reforms are deepened and progress on the energy transition accelerates.

Economic growth is accelerating in 2024 led by recovering domestic demand. Private consumption has picked up as strong nominal wage growth coupled with lower inflation led to a sharp rebound in real wages. Fixed investment also continued its gradual recovery though remaining as a share of GDP below pre-pandemic levels. Net exports, however, are imposing some drag as imports recovered on the back of higher consumption while exports are held back by weak demand from the Euro Area. As a result, growth is expected at 3 percent in 2024 up from around 0 in 2023.

The near-term outlook is positive due to the ongoing cyclical recovery in consumption and investment, and the absorption of EU funds. Growth is expected to accelerate to 3.5 percent in 2025 and 3.4 percent in 2026. Real and nominal wage growth are expected to gradually decelerate, while profits are expected to continue declining as firms have limited capacity to pass-through increases in wage costs into prices given that the output gap remains negative. Stronger consumption, normalization of inventories, lagged impact of the appreciation of the real exchange rate, and release of EU funds are expected to support imports and with it a narrowing in the current account surplus.

Over the medium term, growth is expected to moderate and converge to potential as the support from rebounding consumption and NGEU funds subside. Growth will decelerate to slightly below 3 percent by 2029 as EU-financed investments decline and the population ages. Productivity is expected to modestly recover from the impact of recent labor hoarding. However, productivity growth is not expected to return to pre-pandemic levels given that much of the productivity gap with advanced economies has already been closed.

Amidst high uncertainty, risks remain elevated and tilted towards lower growth and higher inflation. A slower-than-expected recovery in the Euro Area, delayed absorption of EU funds, and heightened geopolitical tensions could dampen the recovery. At the same time, risks to inflation remain elevated from the tight labor market against the backdrop of accelerating domestic demand and potential supply-side shocks. There are also upside risks to growth including a stronger-than-expected catalytic role from EU funds on private investment and productivity, a larger-than-expected workforce from higher immigration, and potential nearshoring as a result of geoeconomic fragmentation. Risks are well mitigated by ample foreign exchange reserves, a flexible exchange rate, modest debt levels, and robust financial sector buffers.

Monetary policy is appropriately tight. While the policy rate was kept on hold at 5.75 percent since November 2023, the monetary stance has tightened as inflation expectations declined. This is appropriate because inflation is well above the central bank inflation target. The momentum of core inflation is elevated in the context of strong wages growth amid still-tight labor market and substantial wage increases in the public sector.

Monetary policy should remain tight at least through 2025 with rate cuts commencing only when data and forecasts confirm that inflation is on a clear downward path towards the target. Absent surprises, both core and headline inflation should peak in year-on-year terms before mid-2025, significantly above the target, before moderating around the upper end of the target range of 2.5±1 percent by end-2025. However, uncertainty on the inflation trajectory is substantial, including due to uncertainty regarding energy prices, developments in the labor market, and the pace of economic recovery. While, monetary policy should remain both data-dependent and forward-looking, the current context warrants placing significant weight on realized inflation declining towards the target over several months on the back of decelerating wages. On this basis, there may be scope for limited and gradual policy rate cuts to start around mid-2025.

Near-term growth acceleration presents an opportunity to rebuild buffers and help complete the disinflation process by tightening fiscal policies. The general government (GG) deficit is projected to widen from 5.1 percent of GDP in 2023 to 5.7 percent of GDP in 2024, due to expansionary policies resulting in a fiscal impulse of 0.4 percent of GDP. The 2025 budget targets a slightly lower GG deficit of 5.5 percent of GDP largely owing to higher growth. Staff recommends a tighter fiscal stance by around 0.5 percent of GDP. This can be still achievable within the 2025 budget by saving possible revenue overperformance and limiting non-priority spending. Such a shift would lower debt, thereby rebuilding fiscal space to mitigate against future shocks. It would also lift some of the burden from tight monetary policies to rein in inflation, potentially freeing space for additional policy rate cuts.

Fiscal consolidation should be anchored in a clear medium-term plan to stabilize debt. The recently published *Fiscal Structural Plan* is an important and welcome step in this regard as it targets appropriate fiscal balances by 2028 – entailing an adjustment of about 2½ percent of GDP from 2024 in terms of the structural fiscal balance – that would allow exiting the EU's Excessive Deficit Procedure while stabilizing debt at levels close to 60 percent of GDP notwithstanding large increases in spending on defense. Fully identifying the necessary fiscal measures now and bringing more of the planned fiscal consolidation upfront into 2025 would help strengthen its credibility.

Potential measures that would support consolidation while also further reducing inequality include: i) raising Personal Income Tax revenues by increasing progressivity to bring them more in line with EU peers , ii) addressing the preferential and regressive treatment of the self-employed, iii) better targeting of social benefits to more effectively support the vulnerable, iv) raising property tax revenues closer to EU comparators, and v) taxing more non-essential items at the standard VAT rate. In this context, raising the PIT tax-exempt threshold, which is under consideration, would require even stronger consolidation measures to offset the fiscal cost. Finally, aligning the retirement age for men and women and then adjusting it over time in line with longevity would help limit the expected shortfall in pensions' adequacy over the longer-term.

The authorities have made commendable progress in strengthening the fiscal framework. They have expanded the coverage of the stabilizing expenditure rule and improved oversight over extrabudgetary funds. Establishing a fiscal council as planned would further strengthen accountability and governance.

Financial sector policies should safeguard the nascent credit recovery, building on a robust banking system. Systemic risks to the financial sector have moderated, with the banking sector being well-capitalized and liquid. Past prudential policies have focused on buttressing stability through regulatory tightening. At the same time banks had to face large costs of legal risks and regulatory burdens such as mortgage credit holidays. Together with weak credit demand and serious legal and regulatory uncertainties, this has created further headwinds for new credit resulting in one of the steepest declines in private sector credit-to-GDP in the EU. Moving forward, policy makers should: (i) take into account the impact of possible further tightening of regulations on the nascent credit recovery, while enhancing regulatory stability; (ii) proactively reduce legal risks to financial sector stability, including by exploring legislative solutions; (iii) even the playing field for private sector credit by replacing the bank asset tax in a manner that eliminates the preferential treatment of public debt`   and (iv) allow the mortgage credit holiday to expire.

After two decades of impressive income convergence, Poland's growth model needs to adjust to new economic conditions. Exports, especially to the EU, have played a significant role in Poland's success. However, sizable real appreciation over the past two years weighs on cost-competitiveness. Meanwhile, the regional growth outlook remains subdued, and geopolitical conflicts and geoeconomic fragmentation present headwinds to penetrating new markets. In addition, shallow domestic capital markets and low savings weigh on investment, with population ageing posing a substantial drag on the future size of the workforce. To sustain growth, policies should focus on: i) deepening capital markets (including steps towards a capital market union within the EU), ii) lowering barriers to resource reallocation (for example by strengthening re-skilling programs for adults), iii) fostering innovation capacity (including by promoting private equity and venture capital), and iv) supporting higher labor participation especially for women (by ensuring adequate child and elderly care). The new program supporting young parents' return to the labor market aims to address this gap. Building on the successful absorption of refugees from Ukraine into the Polish labor market, ongoing efforts to enhance the integration of immigrants can further help contain labor shortages.

The government's new decarbonization targets are appropriate; meeting these while safeguarding competitiveness and social cohesion will require strong measures. Significant progress has been made on climate mitigation, but more is needed given Poland's costly dependence on coal, which also undercuts competitiveness. The recent draft energy strategy update outlines additional policy targets and measures for bringing emissions in line with EU climate goals. Its success will be supported by EU funds, and depends on removing barriers to private investment in renewable energy, including by adopting EU legislation on faster permitting for green projects, liberalizing regulations for onshore windfarms, and prioritizing NextGen EU funds for expanding electricity grids. Extending carbon pricing to transportation and heating would also be important for reducing emissions; an early and gradual introduction would help limit adjustment costs. The authorities must address social challenges from the climate transition by cushioning the social impact on coal mining regions and reducing energy poverty.

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