Krzysztof Rybiński: Outlook for Poland's economic and financial situation

Speech by Mr Krzysztof Rybiński, Deputy President of the National Bank of Poland, at the Annual General Meeting of the Association of Chartered Certified Accountants (ACCA), Warsaw, 18 May 2006.

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Ladies and Gentlemen,

Thank you for your invitation to address the Annual General Meeting of the ACCA. Today I am going to speak about prospects of the Polish economy with a special emphasis on the financial situation.

In short, I can say that economic prospects of the Polish economy are good. Let me justify this conclusion by presenting four dimensions of future prospects of the Polish economy: global outlook, financial markets, domestic outlook and public finances prospects.

Global outlook

According to recent IMF and European Commission forecasts[1],[2], the global economy, after recording a growth of above 5 percent in 2004, slowed to an estimated 4.6-4.8 percent in 2005 and is expected to grow at a similar or marginally higher rate this year. Forecasts for 2007 call for a global growth moderation by 0.2-0.3%. If the forecasts come true, the global conditions will remain favorable and conducive to robust growth of the Polish economy. In particular, according to the European Commission, the eurozone, - a destination for more than half of Poland's exports - is expected to grow at 2.1 percent in 2006 and 1.8 percent in 2007, which is significantly above a eurozone average growth rate in the years 2002-2005 when it stood at 1.2 percent per annum.

There are numerous risks to these forecasts and the balance of risks is slanted to the downside. The International Monetary Fund in its World Economic Outlook published in April 2006[3] mentioned four risks: high and volatile oil prices, tightening in financial market conditions, rising global imbalances and an avian flu pandemic.

Let me now comment briefly on three of the risks, and I will address the fourth - financial markets conditions a little later. So far high oil prices have had a remarkably small impact on world growth and world inflation in comparison with previous oil price shocks. For example, in one of the recent speeches[4] titled "Has oil lost ability to shock?" David Walton, member of the Bank of England's Monetary Policy Committee, analyzes five episodes in which oil prices have risen significantly and tries to uncover the reasons for the relatively benign outcome on this occasion. He comes up with two key conclusions: (1) this time the shock has taken longer to unfold and the economy is less dependent on oil; (2) both monetary policy conduct and monetary policy framework focused on stabilizing inflation have anchored inflation expectations well and prevented the second round effects, ie. higher wage claims. Indeed, despite large increases in oil prices inflation in OECD countries oscillated around 3 percent in the past year and core inflation (CPI excluding food and fuel) drifted from 2 percent to 1.8 percent in the same period[5]. However, in my view, further prolonged increases in energy prices, especially those stemming from supply constraints or related to political risk could result in more elevated inflationary pressures in the short term and could seriously harm global growth prospects in the medium term, also because they would contribute to further worsening of global imbalances.

The issue of global imbalances has attracted enormous attention, both from academics, investors, policy-makers and, of course, central-bankers. You may find a detailed description of the issue of

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[1] International Monetary Fund, World Economic Outlook, April 2006.

[2] European Commission, Directorate General For Economic and Financial Affairs, Economic Forecasts, Spring 2006.

[3] See endnote 1.

[4] Walton D. „Has oil lost the ability to shock?", speech to the University of Warwick Graduates' Association Senior Directors' Forum at the Commonwealth Club, London, 23 February 2006.

[5] OECD "OECD Consumer Price Index", various releases.

global imbalances in my earlier speeches posted on the NBP website (www.nbp.pl publications speeches/lectures). Today I will only say that never in a human history has the largest economy run such a high current account deficit reaching 6.5 percent of GDP, not to mention that this economy is a provider of the global reserve currency. Moreover, this deficit is financed in large part by purchases of U.S. debt securities by Asian central banks and by public institutions from oil exporting countries. Some people call it a "revived Bretton Woods" system and claim it could work for years, if not decades6. I agree that temporary constructs often survive much longer than one could expect; just recall the former temporary Syreny military pontoon bridge on the Vistula river in Warsaw built in 1985, that lasted for fifteen years[7]. However, one can be next to certain that without farreaching reforms undertaken by major stakeholders financial markets may experience significant volatility in the not-too-distant future, with potentially harmful consequences for global growth. The third risk to global growth is the avian flu pandemic. Both the risk and the consequences of the worst-case scenario are impossible to assess, but the potential human and economic costs could be enormous.

Financial markets

Now let me turn to financial markets. The recent few years are marked by a significant growth in financial transactions, stock exchanges have risen, corporate and emerging markets spreads have tightened, the ratio of non-performing loans has dropped[8],[9]. According to the Bank for International Settlements, private capital flows to emerging markets have reached the level last seen in 1997, before the Asian crisis. Inflows to European emerging markets have reached all-time highs. Factors responsible for a sharp increase in capital flows to emerging markets can be divided into pull factors (local fundamentals) and push factors (global liquidity, global cyclical factors). While pull factors actually improved, and rating upgrades by Moody's outnumbered downgrades by three to one in 2005, they cannot fully account for the magnitude of capital flows to emerging markets in that year. For example, BIS provides a measure of an average sovereign credit rating for emerging markets based on long-term foreign currency Standard & Poors ratings. While credit spreads fell to an all-time low, at the same time emerging markets sovereign ratings remained below their highest levels recorded in 1997. Therefore we may conclude that push factors have been playing an important role in emerging markets. For example, the hedge fund community came to a view that in early 2004 the Polish zloty was an obvious "no-brainer" trade, partly because it had depreciated significantly in previous years and partly because EU accession resulted in a significant and permanent drop in the country's risk premium. In early 2005, hedge funds were telling me that the Brazilian real was another "no-brainer" trade, as the central bank would have to keep high rates to control inflation and a good external balance indicated that the exchange rate could appreciate. In both cases, the Polish zloty in 2004 and the Brazilian real in 2005 were star performing currencies, and hedge funds pursuing carry trade and momentum strategies were important players on these markets.

Such a situation poses a true challenge for many central banks in emerging markets. They have to judge to what extent their local currency strength is a result of solid fundamentals and to what extent it is just another "no-brainer" trade that may last for quite a while but may also end suddenly. Research conducted at the National Bank of Poland and by other institutions indicates that financial markets have become much more integrated in recent years, global factors drive the performance of emerging market currencies much more than just a few years back, that home bias is being reduced and even a well-known Feldstein-Horioka puzzle is almost gone[10], ie the cross-country correlation between saving and investment rates has declined markedly.

Favorable global liquidity conditions, attractive rates of returns and good economic prospects draw global investors to Polish financial markets. Additionally, Poland's accession to the EU and the future

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6 See Dooley M., Folkerts-Landau D., Garber P. „An Essay on the Revived Bretton Woods System", NBER Working Paper 9971, September 2003; and a series of other papers published by these authors in 2004 and 2005.

7 http://www.um.warszawa.pl/v_syrenka/miasto/mosty-9.htm

8 International Monetary Fund "Global Financial Stability Report", March 2006.

9 Bank for International Settlements "BIS Quarterly Review. International banking and financial market developments", March 2006.

10 Feldstein M. "Monetary Policy in a Changing International Environment: The Role of Capital Flows", NBER Working Paper 11856, December 2005.

entry into the euro area have made the Polish T-bond market, with the average daily net turnover of PLN 6 billion (the largest and the most liquid market in the region), more attractive to foreign investors. EU membership has enabled institutional investors, that are allowed to invest in instruments issued within the Community, to increase their exposure to Polish securities. In 2004, non-residents' investments in T-bonds issued in Poland rose by about PLN 20 billion, and in 2005 - by a further PLN 7 billion. The beginning of 2006 was also marked by new records on the Warsaw Stock Exchange amid purchases made by foreign investors and domestic investment funds. In 2005, the number of IPOs amounted to 35 and the market capitalization increased by almost 50%.

However, one should not take these favorable global liquidity conditions for granted. Federal Reserve has already raised the interest rate to 5 percent. The ECB is in the process of normalizing interest rates and the Bank of Japan has announced an end to quantitative easing and markets started to price in first increases of BoJ interest rate. This may expose some emerging markets, which have weak fundamentals to a change in investors' sentiment, may lead to the depreciation of local EM currencies and a significant drop in market liquidity.[11] Some risks are also related to the changing structure of our financial markets. Since the second half of 2004, the liquidity of offshore spot zloty market has increased significantly and average daily turnover reached almost USD 1 billion. In addition, high nominal values of single transactions between non-residents contribute to a segmentation of the zloty foreign exchange market. This phenomenon is even more visible in the case of the zloty option market. At the same time the consolidation of the Polish banking sector, transfer of treasury operations to parent banks and very limited amount of Polish banks' capital, which determines the scope of risk they can take, limits the liquidity of the domestic market.

In the future, financial market for instruments denominated in zlotys could become even more segmented and therefore less effective in absorbing different kinds of risks.[12] This process will accelerate with our accession to the eurozone. Experience of some EMU members, e.g. Finland, indicates that EMU membership will be accompanied by a visible contraction of the domestic market.[13] The introduction of the euro will change banks' internal organisation of risk and liquidity management. Treasury activities will be centralised on a multi-country group level and proprietary trading will be transferred abroad to head offices.

This process might be accelerated by the already observed transformation of subsidiaries into branches of foreign banks.

Domestic outlook

Let me turn to domestic outlook of the Polish economy. The NBP projection released in April - which assumes unchanged interest rates at 4 percent - points to economic growth within the range of 4.5 to 5.5 percent in the years 2006-2008 and inflation gradually returning to 2.5 percent target sometime in 2008. The statement issued after the April Monetary Policy meeting stated, and I quote[14]:

"The Council maintains its assessment that with large probability inflation will in 2006 Q2 and maybe Q3 remain below the inflation target mainly due to short-term factors. If the developments in the economy were consistent with the April NBP inflation projection, then the current level of the reference rate of the central bank would support a gradual return of inflation to the target over the projection horizon and would also be conducive to keeping economic growth at a pace, which is consistent with the potential output growth, determined by the structural features of the Polish economy.

The fact that inflation and core inflation has stayed below the previous forecasts for a relatively long period may be an indication that the impact of the factors which may slow down the returning of inflation to the target in relation to that accounted for in the projection is stronger than previously assumed. Factors which could potentially accelerate the return of inflation back to the target include a higher wage growth than assumed in the projection, provided it would not be accompanied by

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[11] National Bank of Poland "Financial Stability Review Report", Warsaw, September 2005

[12] National Bank of Poland "Financial System Development in Poland 2004", Warsaw, November 2005

[13] H. Koskenkylä, Ed. "Finnish Financial Markets 2002", Bank of Finland, 2003

[14] Monetary Policy Committee statement, 26 April 2006

sufficiently fast increase of productivity, further oil price hikes or a deterioration of the public finance situation in relation to that envisaged in the Convergence Programme.

The Council maintains its belief that the most favourable scenario for Poland would be to implement an economic strategy focused on creating conditions which would ensure the introduction of the euro at the earliest possible date, which would be conducive to a higher long-term economic growth.", end quote.

Public finances prospects

This brings me to the developments in public finances.

The fiscal outlook over the medium-term future would be broadly positive, if it were not for substantial risks, mainly political, surrounding the deficit path.

In 2005, Poland recorded an ESA'95 deficit of 2.5% of GDP. This corresponds to a deficit of 4.4% of GDP with the pension funds classified outside the general government sector, which will be the binding methodology from next year onwards and which is therefore the relevant methodology for assessing Poland's future compliance with the European fiscal rules. This implies that Poland is 1.4 percentage points away from meeting the Maastricht fiscal criteria. It is not a demanding medium-term consolidation target for an economy with an expected real GDP growth of close to 5 percent, providing a very good environment to reduce the ratio of public spending to GDP. It is worth noting that Germany may achieve consolidation of this magnitude over the 2006-2008 period, without such a favorable growth environment.

However, the Convergence Programme[15] presented by the government in January of this year, does not foresee fulfilment of the deficit criterion in the programme horizon; in 2008 the deficit is to stand at 3.7% of GDP. Such a slow pace of deficit reduction has been criticized by the Council of the European Union[16], which pointed out that Poland would be failing to comply with the required annual fiscal adjustment of 0.5 percentage points of GDP in cyclically adjusted terms.

NBP projections confirm that the deficit path is not an ambitious one. In case of a favorable macroeconomic scenario, particularly one in which the job-rich growth observed in 2004 and 2005 continues over the period 2006-2008, the deficit could decline more than set forth in the Convergence Programme, even in the absence of consolidation measures but also without the introduction of new, deficit-increasing legislation. A stronger deficit reduction could be additionally supported by the implementation of the new Public Finance Act, which should contribute to more efficient fiscal management. Unfortunately, these upside risks to deficit targets in the Convergence Programme are far outweighed by downside risks in the form of new deficit-increasing legislation. This includes the recently proposed 4.5 point cut in social contribution rates. While this measure would bring about the much needed reduction of the tax wedge on labour income, it would cost the budget more than 1% of GDP in foregone revenue. Therefore it is essential that it should be accompanied by cuts in spending. Instead, it is more likely that spending will increase, with, among other measures, salary hikes promised to various groups of public employees, as well as more generous social assistance and pension indexation formulas.

To sum up, in the medium-term horizon, Poland should be in a position to achieve a general government balance in line with the Maastricht fiscal criteria. This would require moderate discipline in public spending, which unfortunately does not appear very likely at the present moment.

Conclusions

Global growth has been very strong in the last few years and global financial conditions have been very favorable for emerging markets. This prosperous period has been used in some countries to improve public finances, while certain countries have not made much of a progress. If some of the risks mentioned today materialize, global growth and global risk appetite may decline and many emerging markets will find it harder to maintain a high growth rate. It is therefore of utmost importance

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[15] Convergence Programme. 2005 Update, January 2006.

[16] Council Opinion of 14 March 2006 on the updated convergence programme of Poland, 2005-2008 (2006/C 82/12).

that necessary reforms are introduced as early as possible to get ready for a possible global headwind.

Thank you for your attention.