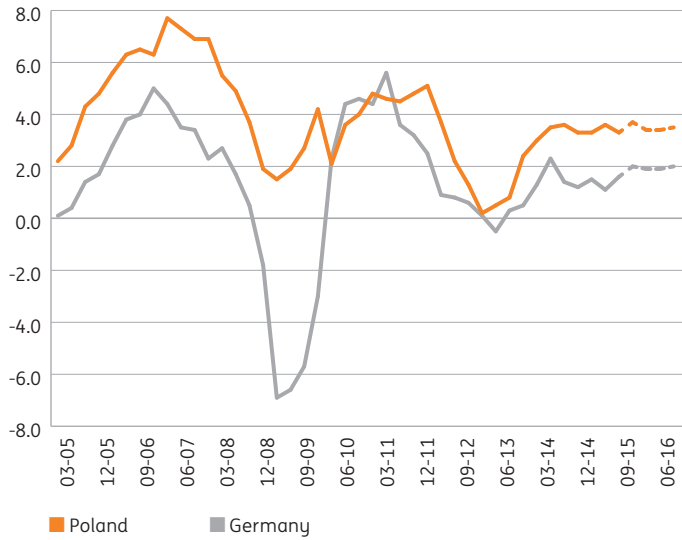


Poland: Still going strong

Highlights

- The Polish economy is doing well, with GDP expected to show a respectable growth of 3.4% this year, driven by both domestic demand and exports. Imbalances are moderate, with Poland exiting the Excessive Deficit Procedure, no substantial credit bubbles, and a small current-account deficit.
- Going forward, a risk from abroad is the indirect impact of slower demand from Asia, while on the domestic front a change of the ruling party in coming elections could result in less predictable economic policy (but still respectful of EU fiscal rules). Still, all in all, the economy is expected to be for a large part insulated from the 'new mediocre' that the IMF foresees in emerging markets.
- Labour costs have been increasing in Poland, but productivity improvements have prevented a large increase in Unit Labour Costs. Overall, low labour costs is in many sectors still a valid reason for production in Poland.
- In terms of sectors, the picture in Poland is one of the traditional growth industries, but with significant diversification. The automotive (parts) industry is still doing well, but also new industries such as business services are showing significant growth.
- As income per capita increases further, consumption patterns shift, and expenditure on homes (decoration and improvement), recreation, and restaurants, is expected to grow further in relative importance.
- In terms of international trade, Polish imports mainly consist of office and telecom equipment, miscellaneous manufactured goods and fuels, originating in Germany, Russia and China, with the Netherlands a respectable fourth. Fast growth is expected in industrial machines, road vehicles, and pharmaceuticals.
- The effects of the disruptions of exports to Russia and Ukraine has been more limited than expected, helped by low oil prices, and acceleration of the economies of other main trading partners.
- Poland exports mainly miscellaneous manufactured goods, road vehicles, car parts, and office, telecom, and electrical equipment mainly to EU countries, with Germany being of crucial importance. Significant growth of Polish exports of road vehicles and industrial machinery is expected, mainly to the UK, CEE neighbours, and China.
- It should be noted, however, that the recent trade slump in China is only partly reflected in the forecasts. The importance of China for the Polish economy is higher than it seems by just looking at the gross trade data: when looking at the value added to meet final demand from other countries, China is the 7th export destination.
- The effect of an ongoing Chinese trade slump would be felt the most in the sectors that cater the most to Chinese final demand, such as basic metals, electrical equipment, machinery and mining. Still, also in terms of value added, fellow EU countries, particularly Germany, remain much more important for the Polish economy.

Figure 1. Economy performed well last year despite Russian embargo on food exports and mediocre Eurozone growth (Real GDP % change YoY)



Source: Macrobond, ING. Dotted line ING forecasts

The economy is expected to grow 3.4% in 2015

Investment continues to perform well, growing 8.9% in 1H15. The positive domestic demand development is expected to continue in the remainder of 2015, thanks to an improving labour market, record-low interest rates, and disinflation. 1Q15. The rebound in exports (10% YoY in 1Q15 in € terms) despite trade disruptions with Russia and Ukraine also helps, while monetary and fiscal policy remains supportive to growth. The external picture looks slightly less positive currently, with external demand from Emerging Asia disappointing and PMIs in both Poland and Germany moderating (figure 2). Still, generally, the Polish economy looks isolated from the ‘new mediocre’ the IMF foresees in the EM space.

Political uncertainty in the runoff to elections

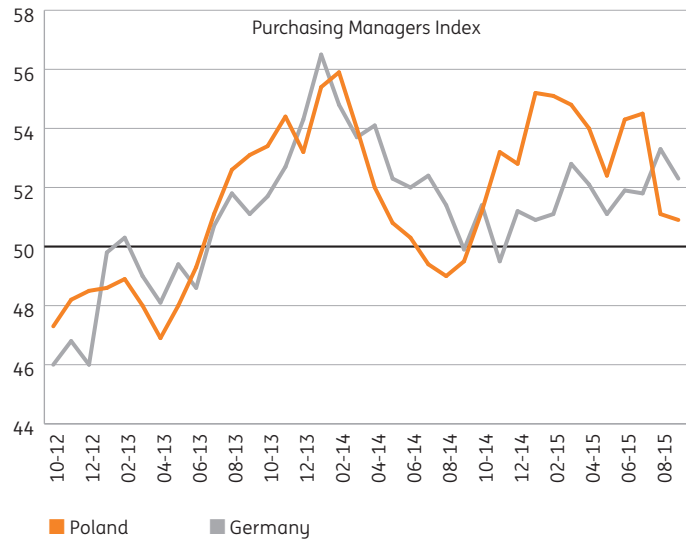
Polls show that the ruling PO would lose to PiS in October general elections. The election campaign provided excessive spending bids from both governing and oppositional party. Still, after the elections rather prudent fiscal policy is expected, with PiS appearing committed to EU fiscal rules.

A PiS-led government may boost short-term economic growth and pursue a more protective stance towards the Polish ‘strategic’ industries (less progress on privatization of state companies in energy, insurance, and financial industry) would result. Currently, the Polish state still has a comparatively tight grip on the economy, with public ownership among the most prevalent in the OECD area.

Imbalances moderate

In June of this year, **the EU Council closed the Excessive Deficit Procedure (EDP) for Poland.** Poland had been in the EDP since 2009. The 2014 deficit was 3.2% but the excess was accounted for by costs of pension reform that ran until end-July 2014. The Commission forecasts 2.8% of GDP this year

Figure 2. Polish PMI moderating, adding some risk



A PMI of more than 50 represents a MoM expansion of the manufacturing sector; a value under 50 represents a contraction.

Source: Macrobond

and 2.6% for 2016, with general government debt at 50-51% of GDP. Government creditworthiness is well-entrenched with very strict government debt thresholds in the Constitution and Public Finance Act. A challenge in this respect, and for the macro economy generally, is the fact that the Polish population is ageing, 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.

With the current-account deficit also moderate at 0.9% of GDP and the economy flexible and diversified, relying not only on export but also on the large domestic market, imbalances appear moderate.

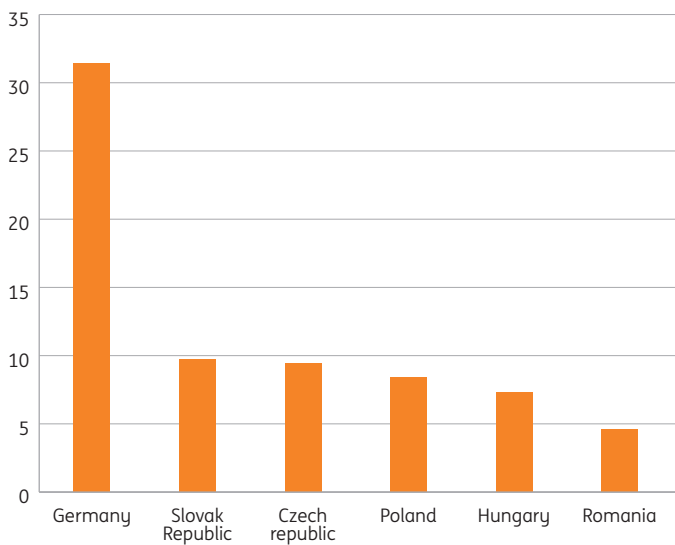
Poland as production location/business climate

The large Polish market, the good infrastructure in a broad sense, including availability and quality of financial services, in combination with well-educated but cheap labor, make Poland an attractive place to do business.

In the 2015 Ease of Doing Business ranking of the World Bank, Poland is ranked 32th out of 189 (1 is best), comparable to France and Spain and somewhat better than Czech Republic (44th) and Slovak Republic (37th). For a benchmark outside Emerging Europe, China is ranked significantly lower, at 90th place. Relative strong points of Poland are getting credit, registering property, and protecting minority investors. Relative weaknesses center around getting construction permits, starting a business, and paying taxes.

Labour costs in Poland are slightly higher than one quarter of German labour costs. Compared to other Central and Eastern European countries hourly labour costs are clearly lower than

Figure 3. Moderate wage costs (Wage costs in euro per hour)



Source: Eurostat

Table 1. Labour costs increase, but productivity improvements compensate large part

	Labour cost, % change YoY, 2014	Unit Labour Costs, % change YoY, 2014
Czech Republic	-3.8%	1.2%
Germany	1.5%	1.9%
Hungary	-0.5%	4.0%
Poland	3.8%	1.4%
Romania	5.5%	n.a.
Slovakia	5.2%	2.1%

Source: Eurostat, OECD

in the Czech Republic and Slovakia, but higher than in Hungary and Romania (figure 3).

Over the past year, labour costs increased 3.8% (table 1), which seems substantial. However, due to productivity improvements the increase in unit labour costs was only 1.4%. This is less than the German increase of 1.9%, slightly more than the 1.2% ULC increase of Czech Republic, less than Slovak Republic and much less than Hungary.

Given the increasing labour costs, Poland needs to look higher up the value chain in comparison to countries such as Romania and Turkey. Still, all in all, it is fair to say that **low labour costs is still a valid argument for production in Poland.**

Growth sectors

In terms of sector developments, the picture in Poland is one of the 'old growth model' – but with significant diversification within the manufacturing sector. Fast growth is expected to continue in the automotive sectors and the motor vehicle parts industry (see next paragraph). Fast growth is also

expected in industries involved in producing computers, consumer electronics, and electric components and boards. The disappointing import demand from China could hamper the realisation of the growth expectations in particularly the electronics and electric components industry, as a substantial portion of this production is aimed at meeting final demand in China.

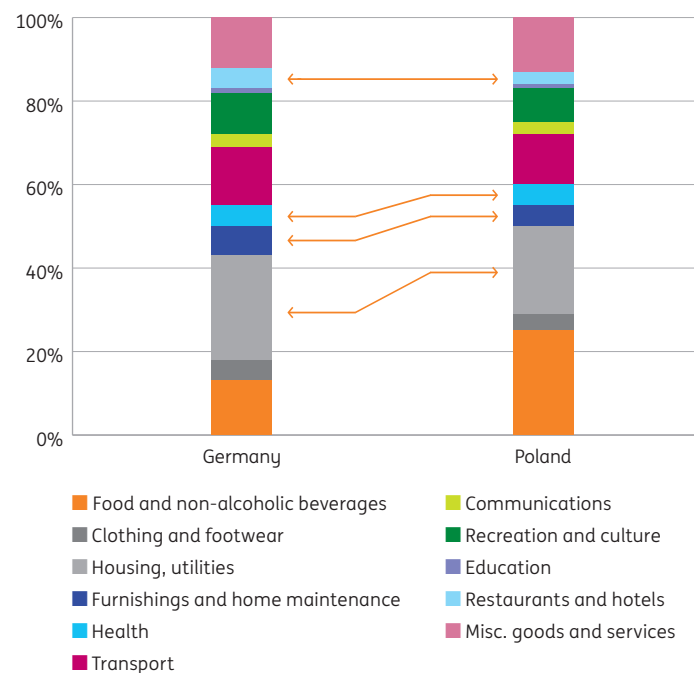
Given the availability of a well-educated and still relatively cheap labour force, the business services sector is also doing very well. Western companies outsource for instance their IT helpdesk, accountancy and HR processes to centers in Poland, gratefully taking advantage of the technical and language skills of the labour force. As a sector, business services is still small, but it is showing impressive double-digit growth.

Automotive sector: still doing well

The automotive sector has been an important part of the Polish economy for many years now. It remains important and doing well. Demand for cars has been increasing in the Eurozone in line with general upturn in domestic demand. Recently, however, various car builders have been reducing their turnover targets due to stagnating or even falling demand in China.

It is not only the assembly of cars that is important for Poland. Production of automotive parts, both for domestic car assembly as for assembly abroad, carries about the same weight. Over the past few years a number of new plants have opened. In 2014, 15% of total goods exports of Poland consisted of road vehicles and transport equipment. The Polish

Figure 4. As incomes grow, more of this income is spent on homes and recreation (Final consumption expenditure of households)



Source: OECD

automotive sector is still competitive in terms of wage costs, with the average wage bill €8.90 per hour, while the cost is a bit higher in Slovak Republic at €10.30.

Consumer expenditure patterns change

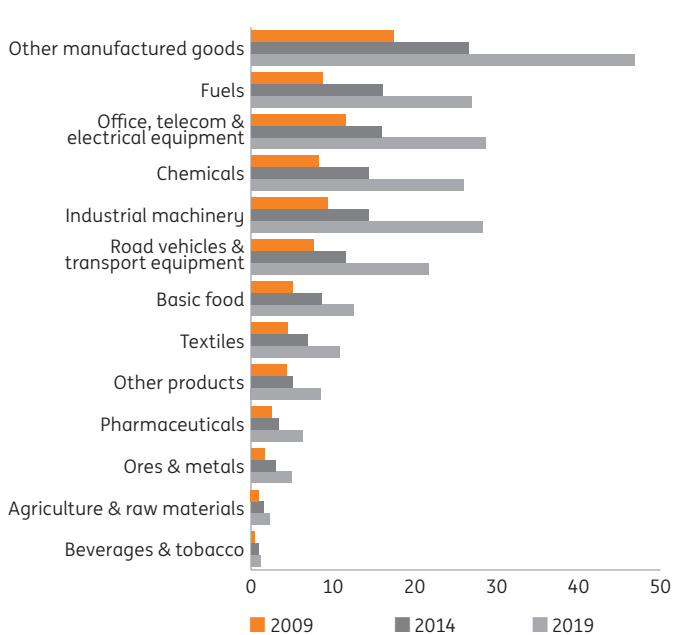
The Polish income per capita has increased by 60% since 2005. The number of households with an income of over US\$25,000 was 4.7 million in 2014 and is expected to grow to 6 million in 2018. As Polish incomes increased, consumptive patterns have been changing. Over the past few years, consumer expenditure on health, clothing and footwear, and restaurants and hotels increased the fastest, while the proportion of incomes spent on food and beverages declined. The shift in consumption patterns probably still has some way to go: when comparing to Germany (figure 4), it is to be expected that as incomes rise, expenditure on homes, recreation, and restaurants, grows further in relative importance. The gap between the German per capita GDP (US\$47,590 in 2014) and Polish GDP per head (US\$14,379) remains large.

Trade

For such a large economy, Poland is quite open, with exports at 38% of GDP. Poland runs a small trade deficit of about 0.5% of GDP.

Most Polish imports are in the product groups office, telecom and electrical equipment, other manufactured goods (metal and paper manufactures mostly), fuels, chemicals, industrial machinery, and road vehicles & transport equipment (figure 5). Over the past 5 years, particularly fast growth (in value terms) took place in fuels, ores and beverages. Going forward, imports of industrial machinery, road vehicles, and pharmaceuticals are expected to show fast growth.

Figure 5. Fast growth expected in imports of industrial machinery, and road vehicles and transport equipment (Imports of goods in billions of euros)



Source: Oxford Economics, ING calculations

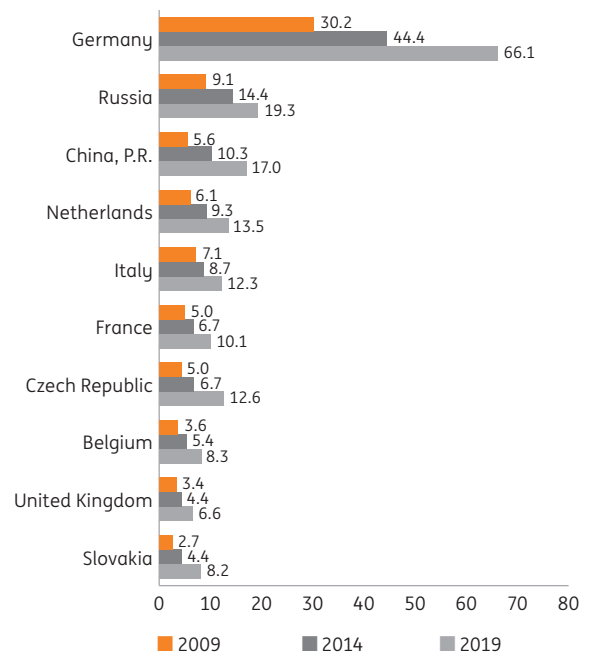
Most of Poland's imports come from Germany, Russia and China, with the Netherlands a respectable fourth (figure 6). Over the past few years, significant growth in imports from China and Russia took place. Going forward, strong growth in imports from fellow CEE countries such as the Czech Republic and Slovakia is expected, while imports from China are expected to continue to grow strongly.

Damage of crisis in Ukraine and Russian ban less than expected

Just after the start of the crisis in the Ukraine, exports to Russia and Ukraine collapsed by 20-30%. As a result, total Polish exports stagnated, where an expansion was expected initially. Overall, some local oversupply of food occurred as a result of the Russian food imports ban. However, most food exports managed to find new markets - with or without facilitation by the authorities. All in all, the effect on the Polish economy has been more limited than initially expected, helped by low oil prices and acceleration of the economies of other main trading partners of Poland.

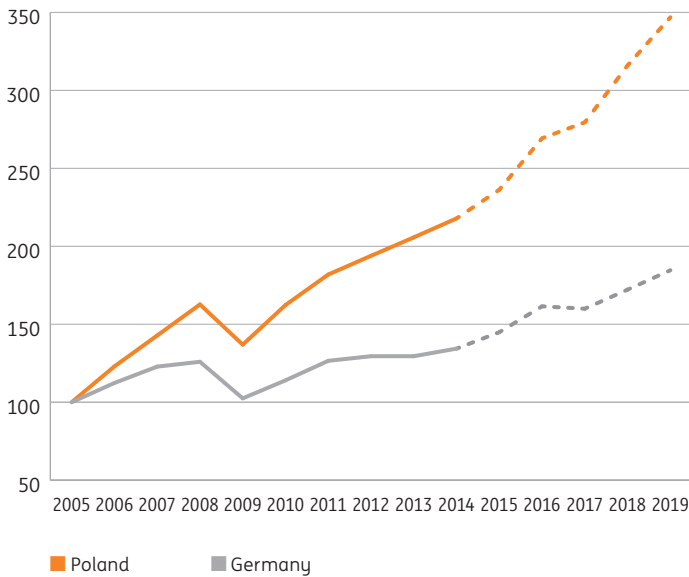
The above-mentioned Russian import ban on EU foods is the largest influence on Polish exports when looking at **trade barriers and restrictions**. Of other important export destinations, trade barriers still play a significant role in the US (on meat, dairy, egg and plant products) and China (restrictions regarding imports such as meat, pharmaceuticals and cosmetic products). In the case of the US, the ongoing TTIP negotiations may offer the opportunity to advance on settling these issues. With regards to intra-EU trade, which makes up the large majority of Polish exports, Poland falls into the single EU market, where goods, services, capital and people can circulate freely.

Figure 6. Main import origins Germany, Russia, and China (Imports of goods in billions of euro)



Source: Oxford Economics, ING calculations

Figure 7. Polish exports quite stable through Russian export ban (Cumulative developments in exports, nominal euro terms, 2005=100. Dotted line is forecast)



Source: Oxford Economics, calculations ING.

Poland's main export destinations are practically all EU countries, with Germany being of crucial importance (figure 8). In recent years, fast growth of Polish exports took place to CEE countries, Russia, Germany and Sweden. Going forward, given the ongoing trade restrictions with Russia, this country is expected to drop out of the list of fast growers, with significant growth predicted to CEE neighbours and main trading partners Germany and the UK.

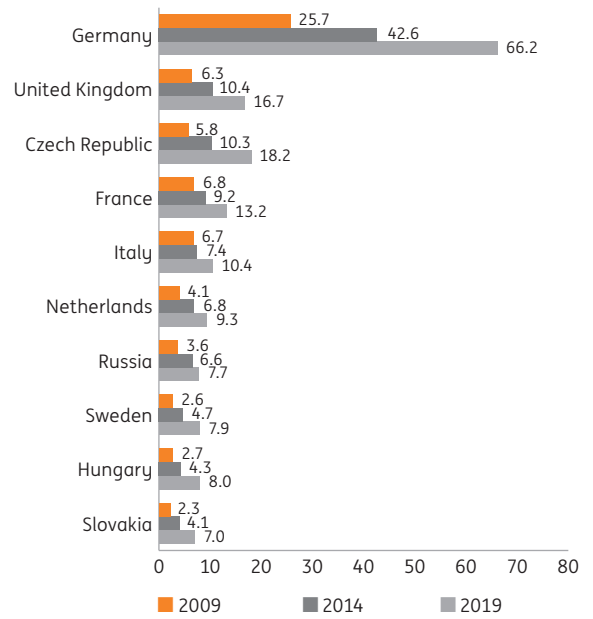
Concerning forecasted Polish exports to Germany, it should be noted that the trade slump in China is only partly reflected in the numbers. As Germany benefited more than other countries in Europe from the rise of China, given its comparative advantage in machinery, transport equipment and other manufactured goods, it is likely that Germany would also be above-average hit by a slowdown in China. Therefore, German import demand could disappoint.

The largest product groups that Poland exports are miscellaneous manufactured goods (mainly furniture and metals manufactures), road vehicles and transport equipment, and office, telecom and electrical equipment (figure 9).

Fast growth over the past few years (in value terms) took place in exports of chemicals, ores and metals, pharmaceuticals, and industrial machinery. Going forward, rapid growth is expected in exports of road vehicles, industrial machinery, other manufactured goods, and pharmaceuticals.

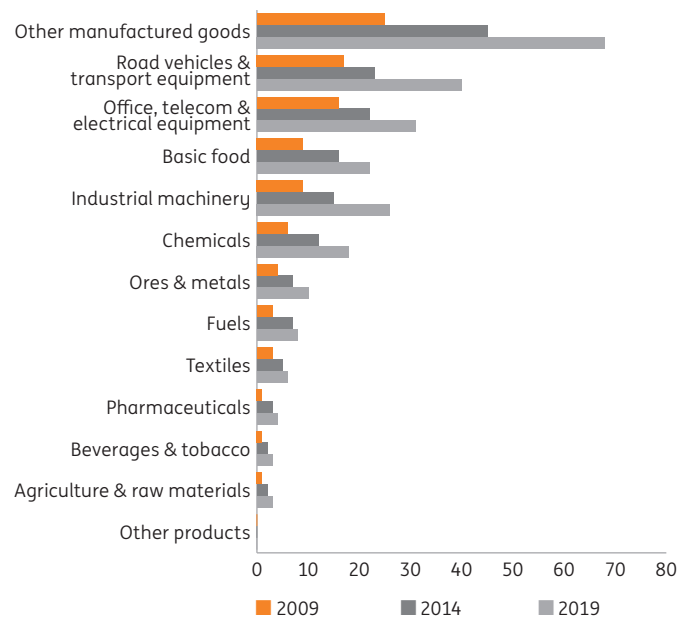
When looking at the current year, 1H15 goods exports grew by 9.4% YoY. In 2H15, the volume of exports of the automotive sector may slightly improve, as in September a new assembly line of car manufacturing was launched and a 2nd one shall also start at the end of 2015, contributing to export figures in 2H15. Importantly, Poland has lower exposure than other

Figure 8. Poland's main export destinations are practically all EU countries (Exports of goods in billions of euro)



Source: Oxford Economics, ING calculations

Figure 9. Polish exports of road vehicles and industrial machinery expected to grow fast (Exports of goods in billions of euro)



Source: Oxford Economics, ING calculations

CEE economies to problems of VW (the share of that brand in total industrial production is only 2.8%). The main risk to the positive development of exports is uncertain growth of the German economy given escalating problems in large emerging economies like Russia and Brazil and the cooling off in China.

Another, more accurate way of looking at the importance of different export destinations is calculating how much value is

Table 2. More trade links with China than appears when looking at the traditional numbers

Rank in terms of VA		Export share in VA terms*	Traditional export share, 2014
1	Germany	16.8%	27.2%
2	UK	6.8%	6.6%
3	Russia	6.2%	4.2%
4	France	5.8%	5.8%
5	US	5.8%	1.8%
6	Italy	5.1%	4.7%
7	China	3.6%	1.0%
8	Czech Republic	2.6%	6.6%
9	Spain	2.6%	2.5%
10	Netherlands	2.4%	4.3%

* % of total Value Added as a result of foreign demand for Polish products, by final destination. 2011 data

added in a certain export product (to correct for re-exports), while also taking into consideration the indirect exports to other countries. Many export products do not end up in the first destination but are used in that country as input for the production of the final product that is consumed in another country. Taking these factors into account changes the ranking of the relative importance of different export destinations. Please see this calculation of Poland's export shares in table 2.

When comparing the value added data with the gross exports data, Russia and the US become more important as a destination for Polish exports while the Netherlands, as a well-known trade hub, becomes less important. China is also clearly more important than it appears initially when looking at the gross exports data. While China is only in 22nd place when looking at gross exports, it is the 7th export destination when looking at value added and final destination. An example of this difference would be for instance, when car parts are exported to Germany, which are assembled in a car which is then exported to China. Thus, although the 3.6% share of China is still limited, the trade slump currently going on in China could thus have a bigger effect on Poland's exports and economy than one would think from the gross trade data.

This would be most felt in the sectors that cater the most to Chinese final demand. This would apply to sectors such as basic metals, electrical equipment, machinery, and mining (please see table 3). For these sectors, around 3-4% of their value added depends on Chinese final demand.

Table 3. Chinese final demand especially important in basic metals and electrical equipment

Sector	% of VA going to China*
Basic metals and fabricated metal	4.3%
Electrical and optical equipment	3.9%
Machinery	3.1%
Mining and quarrying	3.1%
Chemicals and chemical products	2.5%
Rubber and plastics	2.5%

* % of total value added produced in this sector with final destination China (2011 data)

When looking at the share in terms of value added production to meet final demand abroad, the construction sector is also quite heavily involved in China. Still, also in terms of value added, fellow EU countries, particularly Germany, and how their economies develop remains much more important for the Polish economy.

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