

Poland (the Republic of)

Foreign LT: A-/Stable, Local LT: A/Stable (Affirmed on April 12, 2006)

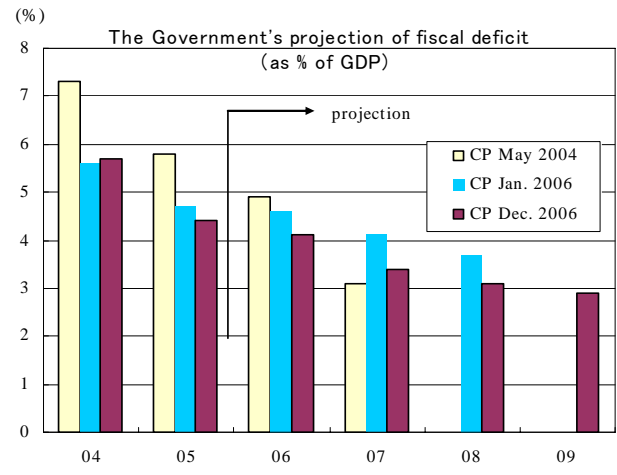
Main Factors for the Ratings

Positive Factors

- Continued harmonization with the euro-zone economy in preparation for the adoption of the euro
- Strong exports brought by the expansion of production capacity through inflows of foreign direct investment

Negative Factors

- Persistent fiscal deficit
- High structural unemployment impeding economic flexibility
- Relatively heavy external burdens



Updated: from September 2006 to November 2006

Positive Factors

- New Convergence Program, which envisages bringing down the fiscal deficit to below 3% of GDP by 2009, was made public on December 1.
- On October 16, the three-party coalition secured a parliamentary majority with the return of Self-Defense to the coalition and the support of a new political party, the National Party, from outside the Cabinet.
- Real GDP growth in the July-September quarter of 2006 accelerated to 5.8% year-on-year from 5.5% the previous quarter, mainly due to a surge in gross fixed capital investment.
- State budget deficit in the first ten months of 2006 stood at Zloty 16.6 billion, or 54.4% of the annual target under the 2006 budget plan.
- On December 1, the government announced the redemption of Brady bonds worth USD588 million in November.

Negative Factors

- The European Commission voiced concern that Poland has not taken sufficient measures to correct its budget deficit (November 14).
- Privatization revenues in the first ten months of 2006 amounted to Zloty 571.1 million or 10.4% of annual target.

<Prospects and Noticeable Points>

Continued political stability remains uncertain

(1) Political stability regained for the present following return of Self-Defense to coalition and local elections

In September, the three-party coalition formed by the Law and Justice (PiS), Self-Defense and Polish Families League (LPR) collapsed with the departure of Self-Defense. However, as PiS failed to strike a deal in coalition negotiations with other political parties, it had to return to the original tripartite coalition with the Self-Defense and LPR in October. The renewed coalition only counts on 230 seats in the 460-member parliament because some MPs had bolted from the Self-Defense and LPR. This forced it to secure a parliamentary majority with the support of the National Party, a new political party formed by a group of MPs who had left the Self-Defense and LPR, and individual MPs from other parties. In the local elections held in November, the main opposition party Civic Platform won the largest number of seats in regional assemblies. In contrast, both the Self-Defense and LPR suffered heavy setbacks although the PiS managed to come second. As a result, the political situation may stay calm for the present as the balance of power within the coalition will shift to the PiS from its junior coalition partners, the Self-Defense and LPR, which had strongly advocated increased expenditures. However, given the minority status of the coalition and the stagnant approval rating of the ruling PiS, the current political stability is unlikely to continue until the next parliamentary election in 2009.

(2) The government plans the continued improvement of fiscal deficit in the New Convergence Program

The continued political instability has had little impact on the fiscal policy. The state budget deficit in the first ten months of 2006 came to Zloty 16.6 billion on increased tax revenues and curbed expenditures, or 54.4% of the annual

target set under the 2006 budget plan. As a result, the annual deficit is highly likely to be lower than annual target of Zloty 30.5 million (equivalent to 2.9% of GGP). The 2007 budget plan foresees continued gradual reduction of the fiscal deficit to 2.7% of GDP. But it calls for substantial increases in both revenues and expenditures as compared with the initial budget plan. While revenues are highly dependent on economic expansion, expenditures centering on social security expenses are set to grow faster than the nominal GDP growth rate. Therefore, the 2007 budget plan is susceptible to economic fluctuations.

At the beginning of December, the government unveiled its New Convergence Program, providing a roadmap to the adoption of the euro. The Program projects that the economy will grow more than 5% annually amid stable inflation. The government will keep the policy to maintain the annual fiscal deficit below Zloty 30 billion from 2006 through 2009 and plan to reduce the deficit from 4.4% (including pension reform costs) in 2005 to 2.9% of GDP in 2009. It approves of euro adoption and commits itself to an early fulfillment of the Maastricht criteria. However, the government has yet to set a specific target date for euro adoption. JCR considers that the Program is rather realistic and likely to be achieved. In order to ensure the fiscal deficit to be cut to less than 3% of GDP by 2009, however, the government needs to promote its belated expenditure reforms.

(3) Economy continues expanding led by domestic demand amid stable inflation

The economy, though slightly slowdown toward 2008 due to a rise in imports spurred by stronger domestic demand, continues growing led by private-sector demand and is projected to expand more than 5% annually in 2006 and 2007. Real GDP growth in the July-September quarter of 2006 accelerated to 5.8% year-on-year from 5.5% the previous quarter. The growth was paced by gross fixed capital formation on higher capacity utilization and solid corporate profit performances. Consumer spending also remained solid on increased real wages and improved employment. Exports kept growing on expanding production capacity and increased demand for Polish products in other European countries. But net exports began to contribute negatively as the growth of imports outpaced that of exports on increased domestic demand. Improved productivity resulting from substantial corporate restructuring and massive EU subsidy push up the economic growth. The strong economic expansion has helped to lower the unemployment rate, the highest among the EU25, to 14.8% in November 2006, the lowest since 2001. Inflation stayed stable as improvement on productivity outpaced wage increases. Consumer price inflation stood at 1.2% year-on-year in October 2006. The central bank cut its policy rate to 4% at the beginning of the year and has since kept it unchanged. The improving labor market and domestic demand expansion may accelerate inflation. But inflation will be modest at around 2% each in 2006 and 2007. The financial system remains stable. Bank lending is on the rise due to improved intermediary functions of financial institutions, but bad loans have been kept at minimum levels under their strict supervision.

(4) External debt burden reduced despite continuing current account deficit

The current account deficit continues to grow on a rise in imports spurred by strong domestic demand and is likely to increase more than 2.0% of GDP in 2006. There is little concern about external finance as FDI inflows continue to cover most of the deficit. This structure of external financing is likely to continue, although the current account deficit may increase moderately as imports are spurred by strong domestic demand. External debt tended to grow moderately, but strong exports helped to reduce the debt burden, with the ratio of external debt to exports falling to 108.8% in June 2006 from 117.3% the year earlier. The government external debt burden also remained low, with the ratio of its external debt to exports falling below 50% in June 2006. The Polish government prepaid USD 588 million worth of Brady bonds in November following the prepayment of its Paris club debt.

Main Economic Indicators: The Republic of Poland

	2002	2003	2004	2005	2006(f)	2007(f)	2008(f)
Convergence criteria for adopting the euro (2005)							
1. CPI (annual average)	2.9%	1.9	0.8	3.5	2.1	1.1	2.5
2. 10 year government bond yield	5.4%	7.3	5.8	6.9	5.2	5.3	5.6
3. General gov't fiscal balance/GDP(ESA95)	Below -3.0%	-5.0	-6.3	-5.7	-4.4	-4.0	-3.6
4. General gov't debt/GDP(ESA95)	Below 60%	42.2	47.1	45.8	47.2	49.3	51.8
Real GDP growth rate	(%)	1.4	3.8	5.3	3.4	5.5	5.0
Unemployment rate (year-end)	(%)	19.7	20.0	19.6	18.2	16.5	14.8
Current account balance/GDP	(%)	-2.6	-2.1	-4.3	-1.7	-2.5	-3.3
Trade balance/GDP	(%)	-3.7	-2.7	-2.2	-0.9	-1.8	-2.7
Net FDI/GDP	(%)	2.0	2.0	4.7	2.1	2.4	2.9
Forex reserves (excl. gold)	(EUR mn)	25,504	25,310	25,313	32,797	36,500	40,500
Imports (G&S)/monthly imports	(months)	4.6	4.4	3.8	4.3	3.9	3.6
Forex reserves/short-tem external debt	(times)	1.9	1.6	1.4	1.4	1.4	1.4
Gross external debt/ exports (G&S)	(%)	135.4	133.2	123.8	123.1	109.8	106.7
Gross external debt/ GDP	(%)	38.7	44.3	46.6	45.8	45.0	46.7
Gross public external debt/exports (G&S)	(%)	57.2	56.3	55.4	56.7	50.3	47.1
Debt service ratio	(%)	22.5	24.9	18.0	19.2	19.5	18.2

(Note) Figures for 2006, 2007 and 2008 are based on JCR forecast. Fiscal figures include pension reforms costs

(Source) The European Commission, The Central Bank, and Ministry of Finance

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