JCR

JCR Sovereign Quarterly Review

2009-29
October 30, 2009

Poland (the Republic of)

Foreign LT: A-/Stable, Local LT: A/Stable

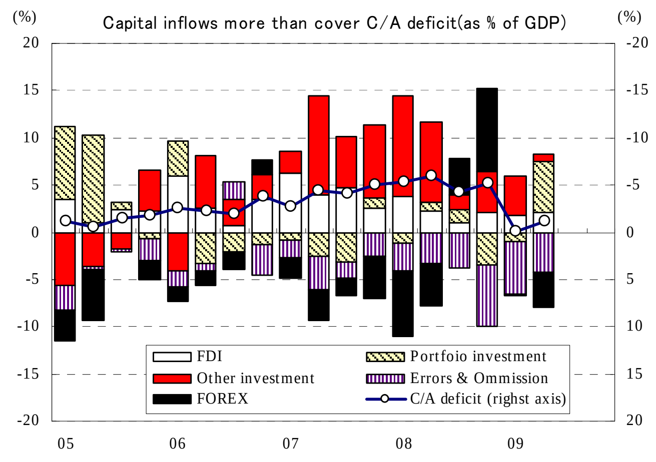
<Rating Perspective>

Positive Factors

- Diversified economic structure with lower dependence on exports
- Expansion of production capacity on the back of growing investment underpinned by massive inflows of FDI and EU subsidies

Negative Factors

- Chronic fiscal deficit
- Relatively heavy external burdens
- Rigid labor market



<Updated: from July 2009 to October 2009>

Positive Factors

- The current account deficit in the January-August period of 2009 improved noticeably to 0.5% of GDP from 3.2% a year earlier
- Net capital inflows into Poland (foreign direct investment, portfolio investment and other investments), which increased to 5.1% of GDP in the January-August period of 2009, sufficiently covered the current account deficit
- Real GDP in the April-June quarter of 2009 kept a positive growth rate at 1.4% year-on-year from 1.7% in the previous quarter
- The total foreign debts outstanding at the end of June 2009 shrank around 5% to EUR 176.6 billion from its peak in September 2008
- The state budget deficit in the first eight months of 2009 remained zloty 15.6 billion (1.2% of GDP), equivalent to 57.5% of the amended full-year plan of zloty 27 billion (2.0% of GDP)

Negative Factors

- In August 2009, the government officially abandoned its aim for Poland to enter the euro zone in 2012
- Ecofin puts Poland under the excessive deficit procedure based on the recommendation issued by the European Commission on July 9, 2009
- In early October, 2009, several government officials including the Interior Minister, Sports Minister and Justice Minister resigned in the wake of an alleged scandal involving lobbying activities in the gaming industry

<Outlook and Points to Watch>

Economy likely to avoid recession

(1) **JCR assigned A- ratings to the upcoming Japanese yen bonds**

JCR has assigned A- preliminary ratings to upcoming the eighth and the ninth Japanese yen bonds to be issued by the Republic of Poland on October 26. The Polish economy, though slowing down rapidly amid slumped exports, is highly likely to avoid a recession, helped by steady domestic demand. Although an increase of general government fiscal deficit is expected to be inevitable in 2009 on revenue shortfalls in the economic downturn, the government will continue to pursue a stringent spending control to reduce the deficit after 2010 in a bid to adopt the euro. JCR will attentively watch the government's announcement expected to be made in the second half of November on the programs of public finance reform for the next two years. The county's external position has improved considerably thanks to its increasing foreign exchange reserves, the IMF's Flexible Credit Line (FCL) amid narrowing current account deficit.

(2) **The country will keep positive economic growth after avoiding a recession with a stable financial system**

Poland is one of the few EU member countries that have averted a recession in the wake of the global economic and financial

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turmoil. The economy grew 6.0% per year on the average in the past three years to 2008 and kept a positive growth rate at 1.6% year-on-year in the first half of 2009. Unlike other Central and Eastern European countries, steady domestic demand has been supporting the whole economy, which is relatively less dependent on exports.

Despite the rising unemployment and credit tightening by the banks, the economy is highly likely to achieve a moderate growth in 2009 and 2010, due mainly to the steady personal consumption supported by tax reduction and an expansion of infrastructure investment underpinned by EU subsidies. Amid the subsiding inflationary pressure and weak economic outlook, the central bank started easing its monetary policy in November 2008, cutting its policy rate by a total 250bps so far to 3.50%.

Poland's financial system has restored its stability after experiencing deterioration amid the global financial turmoil. Banks suffered profit setbacks on increased loan-loss provisions, with the ratio of nonperforming loans rising to 6.3% at the end of June 2009 from 4.5% at the end of 2008. Given the slower economic growth, a further increase of nonperforming loans looks inevitable. However, the country's financial system retains sufficient capacity to absorb the increased credit cost, with the capital adequacy ratio improving to 12.5% at the end of June from 11.2% at the end of 2008.

(3) Improved external position on the back of IMF's FCL and increased inflow of foreign capital

The country's external position has improved after it secured a line of credit totaling US$ 20.6 billion in April 2009 under the IMF's Flexible Credit Line (FCL) program. The current account deficit narrowed to 0.5% of GDP in the January-August period from 3.2% a year earlier. The deficit was sufficiently covered by net capital inflows (foreign direct investment, portfolio investment and other investments) which increased during the period to 5.1% of GDP. As a result, the foreign exchange reserves rose to EUR 44.5 billion at the end of August 2009, up 8% from September 2008. The total foreign debts outstanding at the end of June 2009 shrank around 5% to EUR 176.6 billion from their peak in September 2008. Furthermore, the IMF support has helped a great deal to improve the international investors' confidence on Poland. JCR estimates that the total sum of the foreign exchange reserves and the FCL credit line is enough to cover the need of country's external finance for 2009 with narrowing current account deficit.

(4) Government to keep stringent fiscal policy in preparation for euro adoption

Faced with a bleak economic outlook in June 2009, the government revised its general government fiscal deficit estimate to 4.6% of GDP from 3.0%. In the following month, the Ecofin Council of EU put Poland under the *excessive deficit procedures* and called on the country to cut its fiscal deficit to less than 3.0% of GDP by 2012. JCR forecasts the deficit in 2009 to widen to more than 5% of GDP on reduced revenues unless a further spending cut is implemented. The general government debt, which increased to 47.1% of GDP at the end of 2008, is highly likely to increase rapidly in the coming years. However, the latest *Public Debt Management Strategy* published in late September 2009, foresaw that the debt will remain below 55% of GDP in 2010-2012. In order to curb swollen debts, the government plans to raise 25.0 billion zloty (1.9% of GDP) in 2010 through the sale of state-owned assets. If the debt-to-GDP ratio may exceed 55% in 2010, the government would be required to take measures under the public finance laws to compile a balanced budget in the following year. A balanced budget would negatively affect the economy.

The center-right coalition government with a strong political base had to abandon its earlier plan to adopt the euro in 2012. However, it will resume implementing fiscal reforms in 2010 in a bid to prepare for euro adoption. JCR will keep monitoring how the fiscal reforms will be substantiated.

Main Economic Indicators: The Republic of Poland

		2005	2006	2007	2008	2009(f)	2010(f)
Convergence criteria for adopting the euro							
1. CPI (annual average)	3.8%	2.2	1.3	2.6	4.0	3.0	2.5
2. 10 year government bond yield	5.0%	5.2	5.2	5.5	6.0	n.a.	n.a.
3. General gov't fiscal balance/GDP(ESA95)	Below-3.0%	-4.3	-3.9	-1.9	-3.9	-5.8	-5.0
4. General gov't debt/GDP(ESA95)	Below 60%	47.1	47.7	44.9	47.1	50.3	55.0
Real GDP growth rate	(%)	3.6	6.2	6.8	5.0	1.5	2.0
Unemployment rate (year-end)	(%)	17.7	13.8	8.5	9.1	12.0	11.6
Current account balance/GDP	(%)	-1.2	-2.7	-4.7	-5.2	-1.8	-2.5
Trade balance/GDP	(%)	-0.9	-2.0	-4.0	-5.0	-0.4	-2.0
Net FDI/GDP	(%)	2.3	3.2	4.3	2.3	1.4	2.0
Forex reserves (excl. gold)	(EUR mn)	32,797	34,242	37,141	40,637	45,500	50,500
Imports /monthly imports	(months)	4.3	3.6	3.3	3.1	4.5	4.3
Forex reserves/short-tem external debt	(times)	1.4	1.3	0.9	0.9	1.0	1.1
Gross external debt/ exports	(%)	123.7	116.6	125.0	119.8	139.4	137.1
Gross external debt/ GDP	(%)	45.9	47.0	51.0	48.8	55.5	56.8
Gross public external debt/exports	(%)	56.6	47.8	46.9	34.3	40.1	37.0
Debt service ratio	(%)	28.6	17.4	16.4	17.6	20.7	19.3

(Note) Figures for criteria 1 and 2 are annual average between August 2008 and July 2009. Figures for 2009 and 2010 are projection made by JCR
(Source) The European Commission, National Bank of Poland and Ministry of Finance

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