

2005-26
September 27, 2005

Poland (the Republic of)

Foreign LT: A-/Stable, Local LT: A/Stable (Affirmed on May 12, 2005)

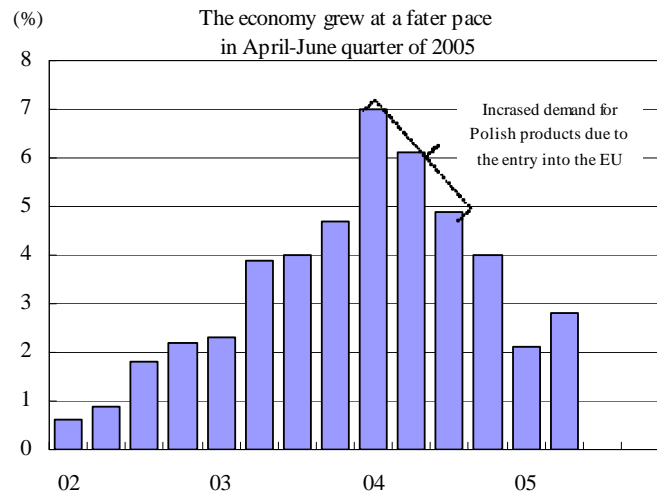
Main Factors for the Ratings

Positive Factors

- A more stable economic structure is likely to be built on progress in various reforms geared for adoption of the euro.
- Increasing exports brought by the expansion of production capacity through inflows of foreign direct investment.

Negative Factors

- Persistent budget deficits.
- High structural unemployment impeding economic flexibility.
- Relatively heavy external burdens



Updated: from June 2005 to August 2005

Positive Factors

- Real GDP growth in the April-June quarter of 2005 accelerated to 2.8% year-on-year from 2.1% the previous quarter (August 29).
- The liberal Civic Platform (PO) and the right-wing Law and Justice (PiS) had their support rates boosted in the opinion poll conducted prior to the parliamentary elections in September 25. Preliminary election results based on the count from 90% of districts, showed PiS winning with 26.8% of the vote and PO with 24.2%. The two parties set to form a coalition with more than 60% of parliamentary seats (September 26).
- The central bank cut its policy rate by a combined 100 bps from June to August and moved back to easy monetary policy bias from neutral in June.
- To fund repayment of its Paris club debt, Poland floated 50-year government bonds totaling EUR500 million for the first time in the emerging countries.
- Current account balance registered a surplus of EUR555 million or 0.3% of GDP in the first six months of 2005.
- Consumer price inflation in the first seven months of 2005 slowed down to 2.7% year-on-year.

Negative Factors

- Parliament approved a bill for revision of the pension system and preserved the preferential pension treatment for the miners (August 17).
- A bill for revision of the minimum wages was also approved by parliament. As a result, the minimum wages are expected to increase even in real terms (June 30).
- Ministry of Economy revised its economic forecast for 2005 downward from 5% to 3.7% (August 17).

<Prospects and Noticeable Points>

Two opposition parties set to form a coalition government

(1) Economy growth is expected to accelerate on investment expansion

The Polish economy grew 2.8% year-on-year in April-June quarter of 2005, up from 2.1% the previous quarter. While the growth of personal consumption slowed slightly to 1.5% from 1.7%, that of gross fixed capital formation accelerated to 3.8% from 1.0%. A stronger financial position of Polish companies and a lower interest rate continued to accelerate investment. Mainly driven by motor vehicles, growth of exports continued outpacing that of imports despite the appreciation of the zloty. Industrial production in April-June quarter grew by 2.6% year-on-year, up from 0.9% the previous quarter. JCR forecasts that the economy will bounce back in the latter half of the year as gross fixed capital formation and exports will continue growing. The growth rate will be 3.5% on a full-year basis. Consumer price inflation rate rose to 4.5% year-on-year in the latter half of 2004 due primarily to temporary factors such as higher food prices caused by strong external demand for Polish foodstuffs. It slowed down to 2.7% year-on-year in the first

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seven months of 2005. These developments have prompted the central bank to cut its policy rate by a combined 100 bps between June and August and moved back to easy monetary policy bias from neutral in June.

(2) Budget deficit is likely to widen due to election measures adopted by the current coalition government

The government has pledged to cut the fiscal deficit in 2005 to 3.6% of GDP from 4.6% in 2004. The projected improvement is based on the prospect that roughly one half of the medium-term reform program (2004-2007) devised by former Deputy Prime Minister Jerzy Hausner will be implemented in 2005. The program envisages cutting social security and administrative expenses by zloty 54.6 billion (equivalent to 6.7% of GDP). JCR had held that the deficit would be gradually reduced through the implementation of the medium-term reform program. However, JCR now sees the possibility of the deficit deteriorating once again, given the parliamentary approval of the bills for revision of the pension system and minimum wages. In fact, the central government budget deficit in the first six months of 2005 has already exceeded that for the same period of last year.

(3) Current account balance turns into surplus in 1H of 2005

The current account deficit improved to 1.6% of GDP in 2004 as the trade deficit narrowed on a strong export growth although the income balance deficit widened. The current account balance in the first six months of 2005 turned into a surplus equivalent to 0.5% of GDP on increased trade and transfer account surpluses. It is highly likely that the current account balance will end up with a smaller deficit in both 2005 and 2006. The trade deficit will widen slightly as stronger investment demand sucks in more imports, but a larger transfer balance surplus will more than offset an increased income balance deficit. In 2004, income balance deficit widened to 2.0% of GDP due primarily to increased profits earned by foreign-owned enterprises in Poland. But this was counterbalanced by a bigger transfer account surplus (equivalent to 2.4% of GDP) on increased remittances from Poles working abroad and transfers from the EU budget. The capital account balance remained in surplus in 2004, though its size narrowed drastically. Inflows of net portfolio investment and FDI more than offset outflows of other investments such as bank deposits. However, capital movement began to grow steeply in the latter half of 2003, with both net inflows of portfolio investment and net outflows of other investments climbing to record high in 2004. Poland is now more susceptible to market developments as it integrated into the international financial market.

(4) Ratings and outlooks have been retained. Two opposition parties set to form a coalition government

Preliminary election results based on the count from 90% of districts, showed PiS winning with 26.8% of the vote and PO with 24.2%. There is no chance of winning the ruling current center-left coalition government led by the Democratic Left Alliance. Recent opinion polls had suggested liberal PO would win the election. Unexpectedly, rather conservative PiS gained more supports with a slight margin. The two parties set to form a coalition with more than 60% of parliamentary seats. Should this happen, the two-party coalition would have a parliamentary majority with a wider political base and is likely to adopt more aggressive toward fiscal reforms, though there remains unresolved policy consensus on economic issues, in particular tax cut rates.

Main Economic Indicators: The Republic of Poland

		2000	2001	2002	2003	2004	2005(f)	2006(f)
(Convergence criteria)	Criteria (2004)							
1.CPI (annual average)	2.6%	10.1	5.5	1.9	0.7	3.5	2.5	3.0
2.10 year government bond yield	5.6%	11.8	10.7	7.4	5.8	6.9	5.6	5.8
3.General gov't budget deficit/GDP(ESA95)	Below -3%	-2.8	-3.9	-3.6	-4.5	-4.8	-4.2	-3.5
4.General gov't debt/GDP(ESA95)	Below 60%	51.3	36.7	41.2	45.4	43.6	45.2	47.6
Real GDP growth rate	(%)	4.0	1.0	1.4	3.8	5.4	3.5	4.2
Unemployment rate (year-end)	(%)	14.0	18.0	19.7	20.0	19.6	18.7	18.0
Current account balance/GDP	(%)	-6.1	-2.9	-2.7	-2.2	-1.6	-0.8	-1.4
Trade balance/GDP	(%)	-7.5	-4.2	-3.9	-2.8	-2.6	-1.5	-2.3
Net Foreign Direct Investment/GDP	(%)	5.8	3.2	2.1	1.9	2.2	2.7	1.9
Forex reserves (excl. gold)	(EURmn)	27,215	26,747	25,504	25,310	25,313	28,500	31,000
Imports (G&S) coverage	(months)	5.3	4.9	4.6	4.4	3.8	3.9	3.7
Forex reserves/short-tem external debt	(times)	2.7	2.1	1.9	1.6	1.5	1.7	1.9
Gross external debt/ exports (G&S)	(%)	148.3	141.8	135.3	131.8	122.4	119.9	113.2
Gross external debt/ GDP	(%)	42.0	39.8	40.5	45.6	49.0	50.9	52.4
Gross public external debt/exports (G&S)	(%)	71.3	58.5	57.1	55.0	55.8	57.0	57.6
Debt service ratio	(%)	20.7	27.9	22.4	18.4	15.0	15.4	16.3

(Note) Figure for 2005 and 2006 are based on JCR forecast.

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

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