Country update **POLAND**

Summary

After growing strongly with 4.3% in 2011, the economy of Poland is expected to slow to a still respectable 2-3% in 2012 – despite the Euro 2012 soccer championship in Poland. Fiscal austerity, elevated unemployment and slowing investment weigh on economic growth. Developments in the eurozone pose a downside risk to the growth outlook. Despite strong fundamentals, the zloty depreciated in the second half of 2011, but has since recovered partly. The volatile zloty adds to the government's challenge to keep its public debt below 55% of GDP, as a third is denominated in foreign currency. The ongoing fiscal consolidation, on the other hand, supports public debt reduction. In 2011, the fiscal deficit was 5.6% of GDP, down from 7.8% in 2010. This year's target is below 3% of GDP, but this seems rather ambitious. The coalition of PO and PSL renewed its term in the October 2011 parliamentary elections and is expected to continue on its path of cautious reform.

Things to watch:

- Fiscal consolidation and constitutional thresholds on public debt
- Economic growth (and impact eurozone developments)

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Poland

National facts	
Type of government	Republic
Capital	Warsaw
Surface area (thousand sq km)	313
Population (millions)	38.2
Main languages	Polish (98%)
	Other (2%)
Main religions	Roman Catholic (90%)
	Eastern Orthodox (1.3%)
	Protestant (0.3%)
Head of State (president)	Bronislaw Komorowski
Head of Government (prime-minister)	Donald Tusk
Monetary unit	zloty (PLN)

Economy	2011	
Economic size	*bn USD*	*% world total*
Nominal GDP	517	0.75
Nominal GDP at PPP	766	0.97
Export value of goods and services	232	1.06
IMF quotum (in mln SDR)	1688	0.78
Economic structure	*2011*	*5-year av.*
Real GDP growth	4.3	4.7
Agriculture (% of GDP)	3	4
Industry (% of GDP)	34	32
Services (% of GDP)	65	65
Standards of living	*USD*	*% world av.*
Nominal GDP per head	13536	126
Nominal GDP per head at PPP	20060	163
Real GDP per head	10456	129

Social and governance indicators	rank / total
Human Development Index (rank)	39 / 187
Ease of doing business (rank)	62 / 183
Economic freedom index (rank)	64 / 179
Corruption perceptions index (rank)	41 / 183
Press freedom index (rank)	24 / 178
Gini index (income distribution)	34.21
Population below $1.25 per day (PPP)	<2

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
Germany	27	Germany	29
France	7	Russia	8
Italy	6	Italy	6
UK	6	France	6

Main export products (%)	
Machinery, transport equipment	42
Manufactured goods classified by material	20
Miscellaneous manufactured goods	13
Food & live animals	9
Main import products (%)	
Machinery & transport equipment	34
Manufactured goods classified by material	18
Chemicals & chemical products	14
Miscellaneous manufactured goods	10
Openness of the economy	
Export value of G&S (% of GDP)	45
Import value of G&S (% of GDP)	47
Inward FDI (% of GDP)	2.3

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Introduction and update

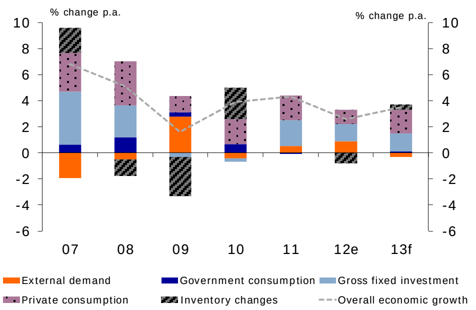
Economic growth in Poland was strong in 2011 at 4.3%. For this year, growth is expected to slow to 2-3%, among others because several large infrastructure projects need to be finished before the European soccer championship, this year hosted by Poland and Ukraine, starts in the summer. An influx of soccer fans will not only support economic growth to some extent, it will likely also give a small boost to the services balance. Still, the overall current account balance is expected to stay in deficit at around 4% of GDP, slightly better than in 2011. External debt is expected to rise to 65% of GDP on account of the current account deficit and debt repayments. Although the stock of foreign debt is substantial and rising, Poland is not expected to face difficulties in refinancing its debt yet. Growing foreign exchange reserves (to USD 93bn end-2011), backed by a USD 29.4bn Flexible Credit Line from the IMF, support the external position of Poland. However, the country could be affected by renewed intensification of the eurozone crisis, especially if Poland would fail to get its fiscal deficit under control. The new government of Donald Tusk and the central bank face an interesting challenge in balancing fiscal consolidation needs, maintaining growth, lowering inflation, reducing volatility of the zloty and, last but not least, rooting for the national soccer team to make it through to the next rounds. More on the first topics below.

Growth, zloty and hawkish central bank

At 4.3%, economic growth was stronger in 2011 than in 2010 (3.9%). Investment growth returned in 2011, while domestic consumption stayed strong despite headwinds from fiscal austerity measures (e.g. VAT increase) and increased debt repayments on Swiss franc loans. Export demand benefitted from the weakening zloty in the second half of 2011. The zloty reacted strongly to the increased risk-aversion among investors when the eurozone debt crisis made headlines day after day in the third quarter of 2011. Early 2012, the zloty partly recovered, as the markets cooled again. While this will be a relief to the households with foreign currency loans (about 40% of household loans) and to the government, whose public debt is partly denominated in euros, the export sector will not rejoice about the strengthening zloty. The stronger zloty did help to take the sharp edges of the oil and food price increases in the first quarter of 2012. However, food and fuel prices still put pressure on inflation, which has been above the 2.5% +/- 1% target range of the Polish central bank since late 2010. Headline inflation was 4.3% yoy in February 2012. Although core inflation is within range (2.7% yoy in February), the monetary policy council has been rather hawkish lately. A policy rate hike is therefore possible in the coming quarters, unless developments in the eurozone push growth off track substantially.

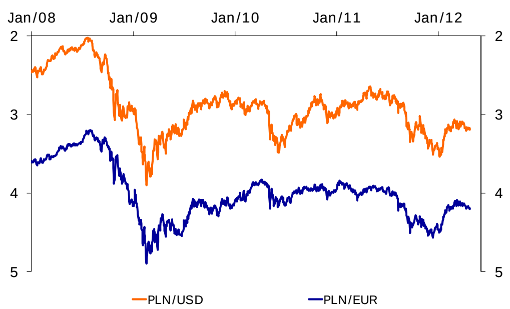
Economic growth is forecast to slow to around 2-3% in 2012, with the government optimistically expecting growth figures above 3%. Elevated unemployment, austerity measures, a strong Swiss franc and hawkish monetary policy are expected to keep consumption growth subdued. Unemployment in Poland has been on the rise since the financial crisis and was 9.9% in 4Q2011 (up from 6.9% in 4Q2008). While this requires attention, more worrying are the data for the group aged 15-34 years, as almost 14% of this group is jobless. External demand is affected by the stagnation in the eurozone and potentially by a strengthening zloty. And investment growth is expected to slow in 2012, as the majority of infrastructure projects are nearing completion. This will especially be the case in the second half of 2012, because several large projects will need to be finished before the Euro 2012 soccer championship starts. Although headwinds are abound, an economic growth of 2-3% should be considered respectable compared to other EU countries.

Figure 1: Economic growth



Source: EIU

Figure 2: Zloty



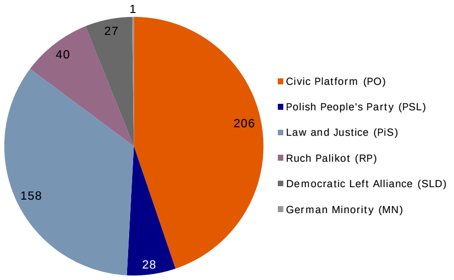
Source: Reuters Ecowin

Tusk remains prime minister

The ruling Civic Platform (PO) party won the parliamentary elections in October 2011 with 39% of the votes, against 30% for the main opposition party Law and Justice (PiS). Although this was expected, the victory was more decisive than polls suggested. Moreover, it was the first time in modern Poland that a ruling party won the elections and that a prime minister, Donald Tusk, was re-appointed. This suggests that public support for the current liberal, pro-EU, consensus-based policy direction is broad. And the PO party was able to bank on the solid economic performance during the financial crisis. A new party, Ruch Palikot (Palikot's Movement, RP), surprisingly won 41 (out of 460) seats. RP was registered only a few months before the elections by several ex-PO members, among which the flamboyant Mr. Palikot. The party is seen as liberal and anti-clerical and draws support from the younger generation with statements about a secular state, legalisation of abortion and more liberal drugs policy.

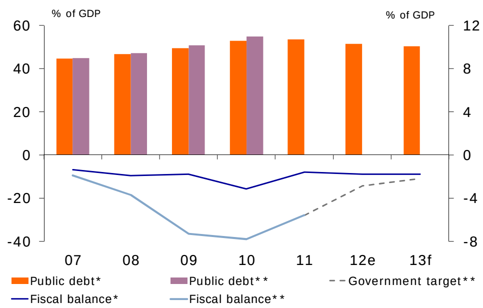
Tusk chooses to work with the People's Party (PSL) as junior coalition party again. With Tusk's focus on policy stability, continuing this coalition seems a rational, but not always easy choice. While it bodes well for predictability, the PO-PSL coalition has shown in the past to be cautious reformers. The privatization drive, for example, has been tediously slow and fiscal consolidation focuses on increasing taxes rather than structurally cutting spending. However, fiscal consolidation is ongoing and, recently, the two parties agreed to increase the pension age to 67 years in 2020 for men and in 2040 for women. Although Poland has little problems with financing pensions in long term, unlike several other EU members, it does have very extensive early retirement options that reduce the participation rate. Increasing the official pension age is expected to push the effective pension age up as well, which would support economic growth in the medium to long term.

Figure 2: Seats in parliament



Source: IHS Global Insight

Figure 1: Fiscal balance and public debt



Source: EIU, Eurostat (dotted line is government target)
* local definition ** Eurostat definition

In the short term, the government faces the challenge of fiscal consolidation. The public deficit deteriorated during the global financial crisis and hit 7.8% of GDP in 2010. As part of the EU excessive deficit procedure, Poland committed to bringing the fiscal deficit back to below 3% of GDP in 2012. In 2011, the fiscal deficit was brought back to 5.6% of GDP, on the back of a VAT increase, strong economic growth, cuts in the public sector wage bill, reduced pension contributions and higher-than-expected inflation. Although the 2011 results were lower than budgeted, the below 3% of GDP target for 2012 seems challenging. For one, the budget is based on 2.5% growth, which could be challenging if the eurozone problems escalate again. However, even a slightly higher fiscal deficit will likely be sufficient for Poland to exit the excessive deficit procedure, as the European Commission is expected to subtract the costs of the 1999 pension reforms (about 2% of GDP in 2012).

Besides the EU regulation, the government is likely even more motivated to rein in the fiscal deficit to avoid breaching the constitutional thresholds for public debt and to keep the sovereign-debt-sensitive market comfortable with Poland. In 2011, public debt rose to 53.5% of GDP, which was still below the 55% threshold that would trigger compulsory budget cuts – this could lead to rushed fiscal tightening that Tusk is so eager to avoid as he wants to protect economic growth. If the 2012 budget target is reached, the public debt level will stay below 55% of GDP in 2012 as well. A weakening zloty could thwart the government's plans, as a little under a third of public debt is denominated in foreign currency, mainly euros. Regarding refinancing needs, in the first quarter of 2012, the government was able to secure more than 40% of its financing requirements for this year, suggesting that the market appreciates the solid economic growth and regards the fiscal consolidation path as credible.

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Poland

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	6.8	5.1	1.6	3.9	4.3	2.6	3.5
Consumer prices (average % change pa)	2.5	4.2	3.5	2.6	4.3	3.4	2.8
Current account balance (% of GDP)	-6.2	-6.6	-4.0	-4.5	-4.2	-3.8	-3.6
Total foreign exchange reserves (mln USD)	62967	59306	75923	88848	92656	89670	93860
Economic growth							
GDP (% real change pa)	6.8	5.1	1.6	3.9	4.3	2.6	3.5
Gross fixed investment (% real change pa)	17.6	9.6	-1.2	-1.0	8.2	5.0	5.5
Private consumption (real % change pa)	4.9	5.7	2.1	3.2	3.1	1.9	3.1
Government consumption (% real change pa)	3.7	7.4	2.0	4.0	-0.7	0.0	0.4
Exports of G&S (% real change pa)	9.1	7.1	-6.8	10.1	6.5	4.1	4.8
Imports of G&S (% real change pa)	13.7	8.0	-12.4	11.5	5.5	2.1	5.7
Economic policy							
Budget balance (% of GDP)	-1.4	-1.9	-1.8	-3.2	-1.6	-1.8	-1.8
Public debt (% of GDP)	45	47	49	53	52	51	50
Money market interest rate (%)	4.7	6.3	4.6	3.9	4.9	4.8	4.8
M2 growth (% change pa)	14	20	8	8	12	6	5
Consumer prices (average % change pa)	2.5	4.2	3.5	2.6	4.3	3.4	2.8
Exchange rate LCU to USD (average)	2.8	2.4	3.1	3.0	3.0	3.4	3.2
Recorded unemployment (%)	12.7	9.8	11.0	12.1	12.4	11.8	11.6
Balance of payments (mln USD)							
Current account balance	-26501	-34957	-17155	-20982	-21775	-18170	-18960
Trade balance	-19066	-30659	-7617	-11414	-14888	-11540	-14740
Export value of goods	145337	178427	142085	162267	194997	194290	208350
Import value of goods	164403	209086	149702	173681	209885	205840	223090
Services balance	4758	5006	4795	3493	5207	5050	5420
Income balance	-16387	-12882	-16551	-16703	-15589	-15410	-13740
Transfer balance	4194	3578	2218	3642	3495	3720	4110
Net direct investment flows	17987	10365	8460	3574	5500	4000	6500
Net portfolio investment flows	-9048	-5177	7927	12437	1864	1730	4490
Net debt flows	41133	30184	31689	38969	33114	3600	7020
Other capital flows (negative is flight)	-6310	-3982	-13512	-20060	-14351	5150	3630
Change in international reserves	17260	-3567	17409	13938	4352	-3690	2690
External position (mln USD)							
Total foreign debt	195376	218022	244880	278214	321196	309660	310890
Short-term debt	60366	64904	69721	73978	88847	84280	85570
Total debt service due, incl. short-term debt	82526	117554	115211	120331	134241	155270	151220
Total foreign exchange reserves	62967	59306	75923	88848	92656	89670	93860
International investment position	-241335	-242645	-277507	-305381	n.a.	n.a.	n.a.
Total assets	156877	136866	156156	181113	n.a.	n.a.	n.a.
Total liabilities	398212	379511	433663	486494	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-4.5	-5.8	-1.8	-2.4	-2.9	-2.4	-2.8
Current account balance (% of GDP)	-6.2	-6.6	-4.0	-4.5	-4.2	-3.8	-3.6
Inward FDI (% of GDP)	5.6	2.8	3.0	1.9	2.3	1.7	2.1
Foreign debt (% of GDP)	46	41	57	59	62	65	59
Foreign debt (% of XGSIT)	100	92	130	131	125	121	115
International investment position (% of GDP)	-56.8	-45.8	-64.5	-65.1	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	42	50	61	57	52	61	56
Interest service ratio incl. arrears (% of XGSIT)	3	4	3	3	3	3	3
FX-reserves import cover (months)	4.0	3.0	5.2	5.3	4.6	4.5	4.4
FX-reserves debt service cover (%)	76	50	66	74	69	58	62
Liquidity ratio	97	83	88	91	90	86	88

Source: EIU