Country report **POLAND**

Summary
In the coming months, the parliamentary elections of October will take centre stage. The ruling Civic Platform (PO) party of premier Tusk is expected to win the elections again. Therefore, in broad lines no changes are expected in policy. The need for fiscal consolidation will hopefully become more important after the elections. Economic growth is expected to be robust at around 4% this year. However, the risks of economic headwinds are rising – EU slowdown, strong Swiss franc, and fiscal consolidation. Monetary tightening in the first half of 2011 would allow the Central Bank to loosen its policy interest rate if the economy slows. The current account data was recently revised. New data shows a larger deficit in the past years, but it is not shocking and has reduced a long-standing uncertainty. The current account deficit is expected to be around 5% of GDP in 2011.

Things to watch:

- Parliamentary elections (October 2011)
- Fiscal consolidation
- Potential economic headwinds – external (EU) slowdown, strong Swiss franc and fiscal consolidation.

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Poland

National facts		
Type of government	Republic	
Capital	Warsaw	
Surface area (thousand sq km)	312.7	
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		**2010**
Economic size	*bn USD*	*% world total*
Nominal GDP	469	0.75
Nominal GDP at PPP	720	0.97
Export value of goods and services	195	1.05
IMF quotum (in mln SDR)	1369	0.63
Economic structure	*2010*	*5-year av.*
Real GDP growth	3.8	4.7
Agriculture (% of GDP)	3	4
Industry (% of GDP)	33	31
Services (% of GDP)	65	65
Standards of living	*USD*	*% world av.*
Nominal GDP per head	12280	125
Nominal GDP per head at PPP	18843	161
Real GDP per head	10006	125

Social and governance indicators	rank / total
Human Development Index (rank)	41 / 169
Ease of doing business (rank)	70 / 183
Economic freedom index (rank)	68 / 179
Corruption perceptions index (rank)	41 / 178
Press freedom index (rank)	32 / 178
Gini index (income distribution)	34.9
Population below $1.25 per day (PPP)	2%

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
Germany	26	Germany	28
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)			42
Import value of G&S (% of GDP)			43
Inward FDI (% of GDP)			2.1

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

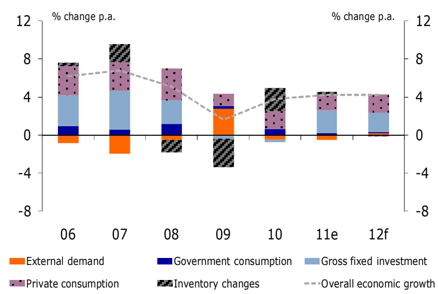
Economic structure and growth

Poland is the largest country of the group that entered the European Union (EU) in 2004. With 38mln inhabitants and a matching domestic market, the country is a regional heavyweight. Income per capita was almost USD 19,000 in 2010, which is around 60% of the EU-27 average. Poland's economic structure is similar to that of developed countries. The services sector accounts for two thirds of the economy and industry for a little more than a third. Retail, wholesale, construction and real estate are the four largest sectors and add up to a little over 30% of the economy. The agricultural sector contributes only 4% to GDP, but employs about 15% of the workforce. The Polish export sector is relatively small compared to the large internal market, but still substantial. Food processing and production of automotive parts are major industrial sectors and are important exports. Germany is by far the single most important trading partner.

Economic growth averaged 4-5% in the pre-crisis years, before it dipped to 1.7% in 2009. Poland was the only country in the EU to avoid a recession, but growth was still well below trend. In 2010, economic growth recovered to 3.8%, mainly on the back of consumer spending. Investment lagged last year, but investment spending seems to have kick started this year. The large influx of EU funds – Poland is the largest net receiver of EU funds – and approaching 2012 euro soccer championship stimulate investment. Full-year economic growth is expected to be around 4% this year. Although Poland is performing robustly, going forward, we expect that the risk of more headwinds is rising. Household spending is squeezed by the strong Swiss franc (see also below), the government will need to curb its fiscal deficit sooner or later and a slump in key export markets across the EU could undermine external demand. On the upside, the soccer fans will boost the

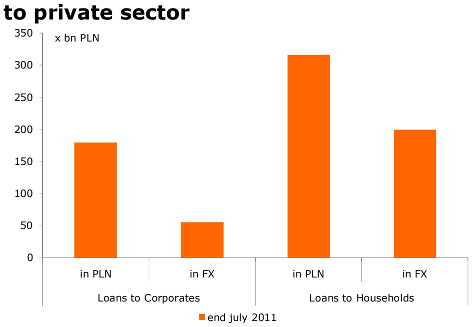
economy next year, which is expected to lead to Poland maintaining a growth rate of around 4% in 2012.
In the medium to long term, economic growth is expected to slow to 2-3% as the working age population will start to shrink from 2013 onward. A boost in productivity growth, a higher participation rate and a decrease in structural unemployment would support structurally higher economic growth rates. However, this is hindered by the lagging business climate, compared to regional competitors. Areas that require attention are bureaucracy and red tape, corruption, and infrastructure.

Chart 1: Economic growth



Source: EIU

Chart 2: Local and foreign currency loans to private sector



Source: Ecowin

The financial market in Poland is considered to be the main financial centre in Central Europe. The country therefore also attracts foreign capital directed towards the region in general. However, despite its size in the region, the Polish market is still relatively small and shallow compared to developed countries. Private sector loans are about 50% of GDP. The banking sector is characterized by low, but growing usage. Only about half the Poles have a bank account, but this number is expected to increase rapidly in the coming years. The government aims to pay the bulk of social transfers and pensions via the banks rather than via the mail in the next four years.
In the years preceding the global financial crisis, foreign currency (FX) loans were quite popular in the private sector thanks to the interest rate spread. Although the supervisory authority curbed FX lending early, still about a third of all private sector loans (almost 40% for households) are in non-local currency, mostly Swiss franc. With the recent strengthening of the Swiss franc, debt repayments in local currency rose rapidly. Compared to mid-2008, when the zloty was at its peak against the franc, borrowers now need about 90% more zlotys to repay their debt. Early September, the supervisory authority restricted the fees banks can charge for FX loans, but the future repayments remain uncertain and could depress household spending. The number of non-performing loans have increased on the back of a stronger franc to about 6% of FX loans.

Political and social situation

The Civil Platform (PO) of premier Donald Tusk is the senior coalition party. The PO is a centre-right party that favors market- and EU-oriented policies. The PO partnered up with the Polish People's Party (PSL), which is a conservative party with support from the rural community, to form a majority cabinet. The main opposition party is the Law and Justice Party (PiS) of Jaroslaw Kaczynski. This party advocates catholic values and is highly conservative on some issues, while also having some left-wing characteristics, such as opposition to rapid market reforms.
The PO and PiS parties will go head to head in the parliamentary elections on 9 October. At the moment, the PO is taking a lead in the polls, but the PiS will do everything within their means to win. Much attention during the election campaigns still goes to the plane crash that killed president

Lech Kaczynski (twin brother of PiS-leader Jaroslaw Kaczynski), many senior officials and several PiS-members near Smolensk (Russia) in April last year. The Russian investigation report put all blame with the pilots, the Polish version states that the pilots were trained inadequately but that the Russian airport also made mistakes. With the Polish report, which was not published until July 2011, in their hands, the PiS claims that this is a clear example of Tusk's weakness and that the administration cannot even protect its head of state. This will surely bring about some sympathy votes, but it will likely also alienate other parts of the population. The divide within the population, clearly visible in the separate commemoration ceremonies one year after the plane crash, will remain for some time. But except for some political squabbling and heated debates, the division is not expected to lead to troubles.

Assuming that the PO wins the October elections, little change in the policy direction is expected. Some minor changes are likely, depending on the new coalition party, which probably will be the PSL again or the centre-left Democratic Left Alliance (SLD). Poland will stay oriented at the EU, although euro adoption is a far stretch at this moment. Moreover, the government is expected to speed up privatization, also because it needs the proceeds. Improving the general business environment and expanding infrastructure remain important challenges. Unfortunately, the current government does not have a good track record if it comes to structural reforms. Last, but not least, the government will need to address the bloated fiscal deficit (see also next section).

As of the first of July, Poland is president of the EU for the first time in the country's history. Considering the recent developments, the presidency will likely be overshadowed by euro zone issues. Poland's refusal to sign a document on the reduction of CO2-emissions means that climate talks are likely to be frozen until next year. In discussions on the 2014 EU budget, Poland will try to secure sustained support for new member states. Relationships with Russia are slowly improving, despite the differences over the Smolensk plane crash.

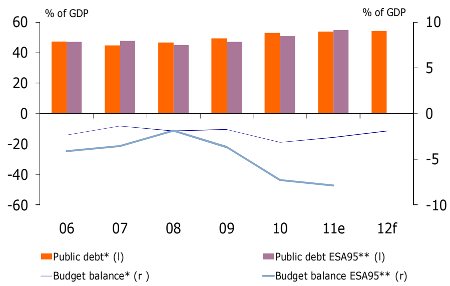
Economic policy

The market has been rather benign towards Poland's fiscal situation, but the figures clearly show that action is needed. During the global economic recession, the Polish government attempted to soften the blow with fiscal stimuli. As a result, the fiscal deficit deteriorated from 1.9% of GDP in 2008 to 3.7% of GDP in 2009 and 7.3% of GDP in 2010 (ESA95 accounting standards). For this year, the government aims for a fiscal deficit of 5.6% of GDP. The performance up to August suggests that they might actually come in below that. However, the 3% of GDP-target for 2012 seems rather ambitious considering the optimistic revenue estimates. With the elections in sight, the government is very reluctant to push through fiscal austerity and reforms, instead it relies strongly on economic growth to reduce the deficit. After the elections this might change, but do not expect bold fiscal reforms. This is a missed chance, especially with regards to the special farmers' social security scheme, early retirement options and low participation rate.

The level of public debt is expected to breach at least the first constitutional threshold at 50% of GDP[1] and probably also the second at 55% of GDP this or next year. This would mean a slight increase from the 53% of GDP in 2010. Although a public debt level around 55% of GDP is substantial but still acceptable, the constitution requires stringent cuts. This provides some comfort. But the government already showed that some creative rerouting of pension contributions will go a long way in avoiding the next threshold.

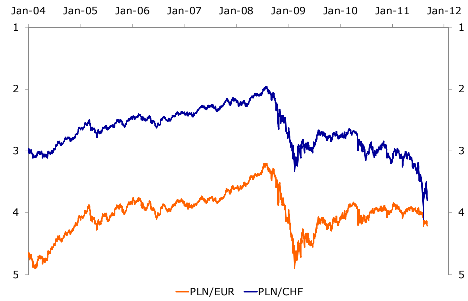
[1] In the Polish constitution, three thresholds are established for public debt (at 50%, 55% and 60% of GDP). The first threshold requires some proposals to cut spending, the second more stringent cuts, while the last hurdle prevents the government from borrowing until the level of public debt as fallen below 60% again. The latter basically means a balance budget in the next budget cycle.

Chart 3: Fiscal situation



Source: EIU, Eurostat
* Definition used by Polish government
** Definition used by Eurostat

Chart 4: Zloty



Source: Ecowin

The zloty-euro exchange rate has been more or less stable since January 2010. The occasional ups and downs were strongly related to news from around the world, including Hungary, Greece and other euro zone countries. The zloty showed a downward trend against the Swiss franc (CHF), with a recent acceleration. The safe heaven effect pushed the CHF up against the euro and thus also against the zloty. This has a significant effect on borrowers with Swiss franc loans, as the debt repayments in local currency increased very rapidly. Between mid-2008 and early September 2011, the zloty depreciated around 90% against the franc, which means that Polish borrowers need 90% more zlotys to repay their debt. Early September, the Swiss central bank decided to peg the franc against the euro, which weakened the CHF by about 10%. However, compared to the complete appreciation path, this is peanuts.

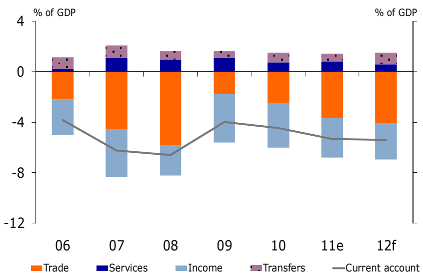
Inflation climbed rapidly in the first half of 2011 on the back of high food and fuel prices and a VAT increase on January 1st. Moreover, the output gap seems to be closed by now and economic growth is robust. In response, the central bank of Poland (NBP) raised its policy interest rate several times in 1H2011 to get inflation back to the 2.5%-target. Helped by the slowdown in global commodity prices and the e.coli outbreak in Germany (which pushed down vegetable prices), inflation peaked in May at 5% and slowed to 4.1% in June. Headline inflation is expected to ease further in the next months. Core inflation was around 2.5% in the period May-July. Looking at the volatile external environment and easing inflation pressure, the NBP is expected to stick to its wait-and-see approach in the next months.

Balance of Payments

The current account balance of Poland is generally in moderate deficit and tends to go up and down with the economic cycle. The main culprit of this deficit is the deficit on the trade balance. Important export products for Poland are automotive parts, processed food and several labour-intensive products. On the import bill, you will see a range of products, including semi-finished products and fuel. Another factor of the current account deficit is the income balance. With ample foreign investment in the past, the income balance tends to be in the red. The surplus on the services and transfer balances compensate this to some extent. EU funds and remittances make up the bulk of the transfer balance.

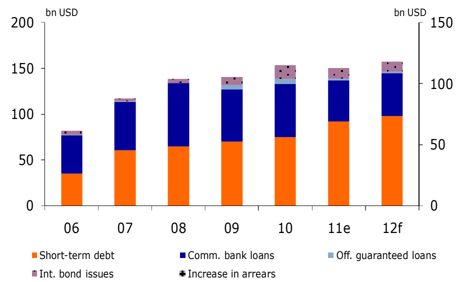
The current account deficit (CAD) was 4.5% of GDP last year, which was an improvement from the pre-crisis years. The CAD is expected to be around 5-5.5% this next year. Investment in infrastructure is expected to push the import bill up in 2011 and 2012. In the summer, the central bank published revised current account data, which showed a higher CAD for the entire 2004-2010 period. For example, the 2010 CAD was changed from 3.4% to 4.5% of GDP. The revision was meant to clarify the net error and omissions, as this balance had risen to heights exceeding the CAD. Especially used car imports and transfers received by Polish households from abroad were understated in the original data. The NBP asked the IMF to assist, which increases the credibility of the revisions. Despite the larger CAD, the revision is not expected to have major consequences. The new data are not shocking and have reduced a long-standing uncertainty.

Chart 5: Current account balance



Source: EIU

Chart 6: Composition of debt financing



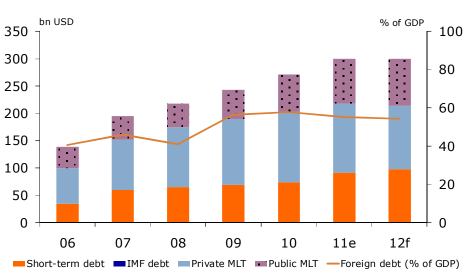
Source: EIU

Debt service costs and the current account deficit create an annual financing requirement. In 2011, this is expected to be around USD 161bn. Next year, it is expected to increase to around USD 180bn. More than 90% of Poland's financing needs is covered by debt financing. The remaining stems from inward foreign direct investment (FDI) and portfolio investment. Debt financing consists out of short-term debt for a continuously increasing part. In 2010, it was about 50%, but it is expected to increase to around 60% in 2011 and 2012. Being seen as a regional star, Poland is currently able to finance its need rather easily. However, if the twin deficits on the current account and fiscal balance really get on the radar of sovereign-debt-worried investors, the costs of borrowing for the government could increase.

External position

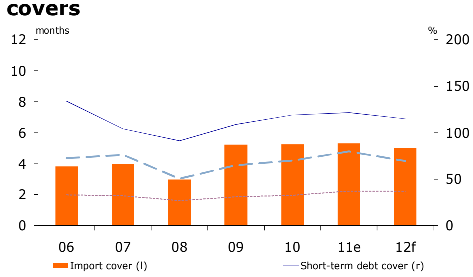
The level of total foreign debt in Poland increased from USD 105bn (41% of GDP) in 2004 to USD 271bn (58% of GDP) in 2010. The influx of foreign credit, largely through foreign-owned banks, explains this rapid increase. EU entry in 2004 provided a boost. In the global financial crisis, the availability of foreign credit was curbed, but not to the extent of most Central European countries. Still, the stock of foreign debt is expected to level off at around USD 300bn in the period 2011-13. Economic growth is expected to push the level of external debt to GDP down from 58% in 2010 to around 55% of GDP in 2011 and 2012.

Chart 7: Foreign debt



Source: EIU

Chart 8: Foreign exchange reserve covers



Source: EIU

Regarding the structure of external debt, about 70% is medium to long term and the bulk is owed by the private sector. In the past years, the percentage of short-term debt has been rising. This is not raising red flags yet, as much short-term is trade related and owed by Polish subsidiaries to their Western parent companies. However, if the Western banks face renewed problems, this could affect Poland as well.
The liquidity position of Poland is good, even though the liquidity ratio, which is expected to be 92% in 2011, is pretty low. The country has adequate access to international financial markets and enjoys the benefits of EU membership and being the regional financial hub. The foreign exchange reserves (FX reserves) are expected to grow to USD 111bn end-2011. This would give the country an import cover of 6 months, which is deemed acceptable.

Poland

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	6.2	6.8	5.1	1.6	3.8	4.2	4.2
Consumer prices (average % change pa)	1.0	2.5	4.2	3.5	2.6	4.2	3.2
Current account balance (% of GDP)	-3.8	-6.2	-6.6	-4.0	-4.5	-5.3	-5.4
Total foreign exchange reserves (mln USD)	46371	62967	59306	75923	88822	111940	112780
Economic growth							
GDP (% real change pa)	6.2	6.8	5.1	1.6	3.8	4.2	4.2
Gross fixed investment (% real change pa)	14.9	17.6	9.6	-1.2	-1.0	9.5	8.0
Private consumption (real % change pa)	5.0	4.9	5.7	2.1	3.2	2.8	3.2
Government consumption (% real change pa)	6.0	3.7	7.4	2.0	4.0	1.5	0.7
Exports of G&S (% real change pa)	14.6	9.1	7.1	-6.8	10.1	6.5	6.6
Imports of G&S (% real change pa)	17.3	13.7	8.0	-12.4	11.5	7.6	6.3
Economic policy							
Budget balance (% of GDP)	-2.4	-1.4	-1.9	-1.8	-3.2	-2.6	-1.9
Public debt (% of GDP)	47	45	47	49	53	54	54
Money market interest rate (%)	4.2	4.7	6.3	4.6	3.9	4.7	5.3
M2 growth (% change pa)	16	14	20	8	8	9	8
Consumer prices (average % change pa)	1.0	2.5	4.2	3.5	2.6	4.2	3.2
Exchange rate LCU to USD (average)	3.1	2.8	2.4	3.1	3.0	2.8	2.9
Recorded unemployment (%)	16.2	12.7	9.8	11.0	12.1	12.0	10.8
Balance of payments (mln USD)							
Current account balance	-13147	-26501	-34957	-17155	-20982	-28920	-30080
Trade balance	-7372	-19066	-30659	-7617	-11414	-20030	-22640
Export value of goods	117468	145337	178427	142085	162267	198810	211270
Import value of goods	124840	164403	209086	149702	173681	218840	233910
Services balance	736	4758	5006	4795	3493	4470	3230
Income balance	-9748	-16387	-12882	-16551	-16703	-16770	-15800
Transfer balance	3237	4194	3578	2218	3642	3400	5140
Net direct investment flows	10727	17987	10365	8696	5204	7000	11000
Net portfolio investment flows	-6158	-8236	-4909	9224	13499	1860	1740
Net debt flows	22550	41133	30184	30056	33643	18180	5430
Other capital flows (negative is flight)	-8059	-7122	-4250	-13412	-17452	25830	11750
Change in international reserves	5913	17260	-3567	17409	13912	23950	-160
External position (mln USD)							
Total foreign debt	139033	195376	218022	243239	271132	300300	300650
Short-term debt	34558	60366	64904	69745	74625	91770	97920
Total debt service due, incl. short-term debt	63536	82526	117554	116891	126265	140080	161400
Total foreign exchange reserves	46371	62967	59306	75923	88822	111940	112780
International investment position	-166360	-241335	-242645	-277507	-300481	n.a.	n.a.
Total assets	117956	156877	136866	156156	181554	n.a.	n.a.
Total liabilities	284316	398212	379511	433663	482035	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-2.2	-4.5	-5.8	-1.8	-2.4	-3.7	-4.1
Current account balance (% of GDP)	-3.8	-6.2	-6.6	-4.0	-4.5	-5.3	-5.4
Inward FDI (% of GDP)	5.8	5.6	2.8	3.2	2.1	2.5	3.0
Foreign debt (% of GDP)	41	46	41	57	58	55	54
Foreign debt (% of XGSIT)	90	100	92	129	128	114	107
International investment position (% of GDP)	-48.7	-56.8	-45.8	-64.5	-64.0	n.a.	n.a.
Debt service ratio (% of XGSIT)	41	42	50	62	60	53	58
Interest service ratio incl. arrears (% of XGSIT)	3	3	4	3	3	3	3
FX-reserves import cover (months)	3.8	4.0	3.0	5.2	5.3	5.3	5.0
FX-reserves debt service cover (%)	73	76	50	65	70	80	70
Liquidity ratio	102	97	83	88	89	92	88

Source: EIU