

COUNTRY REVIEW

Poland



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ANALYST: Dr. Manfred Stamer

EULER HERMES COUNTRY RISK GRADE: BB

Country Risk Grades are on a scale of AA, A, BB, B, C, D
where AA is the lowest and D the highest risk.

Strengths

- EU membership
- Diversified sectoral external trade structure
- Proven resilience of the overall economy to global shocks
- Access to the IMF's Flexible Credit Line which is only offered to strongly performing economies with a solid record of timely and effective economic policy adjustments
- Relatively strong structural business environment

Weaknesses

- Slow structural reform progress
- Fiscal consolidation is not given priority
- Non-diversified regional external trade structure
- Exchange rate volatility and vulnerability to investor sentiment

Country Risk Assessment

| Ratings | Poland | | Median Grade BB | Estonia | Peers Brazil | Israel |
|---------------------------------|------------|------------|--------------------|-----------|-----------------|------------|
| | Latest | Previous | | | | |
| Systemic Political Risk: | P2+ | P2+ | P2- | P1 | P2+ | P2- |
| Systemic Economic Risk: | E3 | E4 | E3 | E3 | E3 | E3 |
| ME rating: | ME3 | ME4 | ME3 | ME3 | ME3 | ME3 |
| <i>Structure</i> | 1.6 | 2.3 | 4.0 | 3.3 | 1.6 | 1.6 |
| <i>Policy</i> | 3.6 | 4.3 | 4.2 | 2.6 | 4.0 | 3.8 |
| <i>Solvency</i> | 2.8 | 3.2 | 1.7 | 4.2 | 3.3 | 2.8 |
| <i>External Liquidity</i> | 4.2 | 6.0 | 2.8 | 3.8 | 2.8 | 4.3 |
| SBE rating: | SBE2 | SBE2 | SBE2 | SBE1 | SBE3 | SBE3 |
| COUNTRY GRADE: | BB | B | | BB | BB | BB |

Nomenclature:
 Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).
 Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).
 ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).
 The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).
 SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).
 Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Economic Studies

ECONOMIC STRUCTURE

| Country Profile | |
|------------------------|--|
| Capital city: | Warsaw |
| Population: | 38.07 mn (2009) |
| GDP: | USD 430782 mn (2009) |
| Currency: | Polish zloty (PLN) |
| Form of state: | Parliamentary republic |
| Head of government: | Prime Minister Donald TUSK (since November 2007) |
| Next elections: | Parliamentary: October 2011 / Presidential: 2015 |

| Major Industries (% of GDP at market prices, 2009) | | Global Assumptions | 2010 | 2011 |
|---|-------|---------------------------|------|------|
| Services | 64.5% | Real GDP grth (% yr/yr) | 3.3 | 2.9 |
| Industry | 31.5% | Inflation (% av) * | 1.2 | 1.4 |
| Agriculture | 4.0% | Dated Brent (USD/b) | 75 | 70 |
| | | * Major economies | | |

| Main Exports (% of total, 2009) | | Main Imports (% of total, 2009) | |
|---|-------|---|-------|
| Machinery & transport equipment | 43.0% | Machinery & transport equipment | 34.5% |
| Manufactures classified by material | 19.5% | Manufactures classified by material | 17.0% |
| Miscellaneous manufactured goods | 13.5% | Chemicals & related products | 13.5% |
| Food & live animals | 9.5% | Miscellaneous manufactured goods | 10.5% |
| Lead Export Markets (% of total exports, 2009) | | Lead Import Markets (% of total imports, 2009) | |
| Germany | 26.5% | Germany | 27.5% |
| Italy | 7.0% | Russia | 8.5% |
| France | 6.8% | Italy | 6.5% |
| UK | 6.5% | France | 5.5% |

Basic indicators

| Selected economic indicators | 2007 | 2008 | 2009 | 2010f | 2011f |
|---|---------|---------|---------|---------|---------|
| Nominal GDP (USD mn) | 424,816 | 529,224 | 430,782 | 472,789 | 500,461 |
| Population (mn) | 38.13 | 38.10 | 38.07 | 38.04 | 38.01 |
| GDP per capita (USD) | 11,141 | 13,890 | 11,316 | 12,429 | 13,167 |
| Real GDP growth (% yr/yr) | 6.8 | 5.1 | 1.7 | 3.6 | 3.3 |
| Inflation (% eop) | 4.0 | 3.3 | 3.5 | 3.0 | 3.0 |
| Fiscal balance (% of GDP; ESA-95 Basis) | -1.9 | -3.7 | -7.1 | -6.9 | -6.5 |
| Current account balance (% of GDP) | -4.8 | -4.8 | -2.2 | -2.5 | -3.1 |
| External debt/GDP (%) | 55.1 | 46.4 | 65.3 | 58.2 | 59.9 |
| External debt/Exports of goods & services (%) | 134.3 | 114.7 | 164.3 | 149.5 | 155.8 |
| Debt-service ratio (%) | 26.3 | 16.3 | 18.2 | 14.7 | 13.5 |
| Foreign exchange reserves (USD mn) | 62,720 | 58,931 | 73,394 | 88,000 | 95,000 |
| Import cover (months) | 4.0 | 3.0 | 5.2 | 5.6 | 5.7 |
| Exchange rate assumption, PLN:USD (av) | 2.77 | 2.41 | 3.12 | 3.02 | 3.04 |
| Exchange rate assumption, PLN:EUR (av) | 3.78 | 3.51 | 4.33 | 4.00 | 3.80 |
| f: CRU central forecast | | | | | |

Sources: National figures, IMF, ECB, World Bank, Euler Hermes Economic Studies

Political Stability

Poland is a well-established democracy and a member of NATO, OECD and the EU. Systemic political risk is low and political reliability has improved under the coalition government of the liberal Civic Platform (PO) and the rural-based Polish Peasants' Party (PSL) which took office in late-2007.

The PO-PSL government is less nationalistic than its predecessor and has been rebuilding relations with the EU, particularly Germany, which deteriorated as a result of the confrontational approach to EU and Polish-German issues adopted by the previous government. The PO-led government also has a more market-friendly approach than its predecessor. Nonetheless it has proceeded cautiously with economic reform and a sharp reduction of the fiscal deficit—which ballooned in the wake of the economic slowdown in 2009—is unlikely until late 2011 when the next parliamentary election is scheduled to be held.

Economic Stability

The structure of the economy is broadly in line with that of developed countries. Services account for around 64% of GDP, industry (including construction) 32% and agriculture 4%. The export structure is favourable with regard to sectoral diversification, though not regarding regional diversification as Western Europe accounts for the bulk of Polish exports. However, with an export-to-GDP ratio of about 40%, the economy is less open than its regional peers. As a result, it was less affected by the global economic slump via trade linkages, though Poland has not de-coupled and the global financial crisis had a significant impact, mainly via the external financing route. A sizeable depreciation of the local currency, the zloty, against major currencies caused per capita income to fall sharply in USD terms, from almost USD14,000 achieved in 2008 to USD11,300 in 2009. But the economy had not overheated prior to the global crisis—in contrast to the Baltic and most Balkan economies—and turned out to be exceptionally resilient. Indeed it was the only one in the EU to avoid a recession in 2009.

Real GDP growth remained positive throughout 2009 and posted a comparatively strong 1.7% overall. Growth accelerated to 3.2% yr/yr in H1 2010. A 6.2% drop in investment was balanced by solid increases of private and public consumption (2.6% and 2.2%) and strong inventory re-stocking which contributed 2pps to growth. Exports and imports increased by 13.5% and 13.1%, respectively, resulting in a meagre contribution of net trade to overall growth. Preliminary estimates show that Q3 GDP growth accelerated to 4.2% yr/yr, driven by an upturn in domestic demand. Private consumption grew by 3.5% yr/yr in Q3, public consumption by 4.3% and investment shifted to modest growth of 0.4%. Inventory re-stocking added 1.2pps to Q3 growth while the contribution of net trade was neutral as exports expanded by 9.6% and imports by 9.5%. We expect a slight moderation of economic activity in the forthcoming quarters and full-year growth of about 3.6% in 2010 and 3.3% in 2011.

Monetary policy is based on inflation targeting (2.5% +/-1%) under a floating exchange rate regime which does not rule out foreign exchange (FX) interventions should they be deemed necessary for the inflation target implementation. Headline annual inflation trended down from 3.5% at end-2009 to 2% in August 2010, but has picked up to 2.8% in October. We expect inflation to remain within the target range in 2010-2011. Private sector credit growth was not very excessive in recent years and has fallen to 7.4% yr/yr in Q2 2010 which was roughly in line with the median of about 150 emerging economies. The freely floating zloty was hit hard at an early stage of the global financial crisis, depreciating by 52% from its all-time high against the euro at end-July 2008 to a more recent low in mid-February 2009. The currency has recovered roughly half of those losses, but a bout of weakness in Q2 2010 reflects continued exchange rate volatility and underscores still high vulnerability to external shocks and market sentiment towards Emerging Europe. Exchange rate risk is particularly a problem for banks, companies and households that have not hedged their foreign currency-denominated loans. At the current rate of about 4.00 zloty/euro the real effective exchange rate appears roughly balanced, i.e. not yet overvalued. Concerned about the weakening economy and tightening credit conditions, the Monetary Policy Council (MPC) cut its benchmark policy interest rate six times between November 2008 and June 2009 by a total of 250 bps to 3.5%, notwithstanding the sharp zloty depreciation at the same time. Since then the policy rate has been kept unchanged, but the MPC may soon adopt modest monetary tightening.

The fiscal position is a cause of some concern. Lower tax revenues resulting from the economic slowdown and fiscal stimulus measures pushed up the fiscal deficit to 7.1% of GDP (ESA-95 basis) in 2009. The government itself forecasts only a small contraction of the deficit to 6.9% in 2010, with a small further reduction forecast in 2011. As a result, public debt has risen from 47% of GDP at end-2008 to 51% in 2009 and could reach about 55% in 2011. While this would still be below the EU average and the 60% Maastricht criterion for euro adoption, a rise to 55% would trigger constitutional

spending curbs. It should also be noted that about 30% of public debt is denominated in foreign currencies.

The current account deficit narrowed to 2.2% of GDP in 2009 but is forecast to increase modestly to 2.5-3.5% of GDP in 2010-2011. Such a ratio would still be adequate, even though the coverage of the external deficit through net foreign direct investment (FDI) inflows has declined from 90% in 2009 to 42% in the first nine months of 2010. Official FX reserves have recovered rapidly—after falling to a recent low of USD56bn in January 2009—and stood at USD93bn in October 2010. This is sufficient to cover more than five months of import, though they fall 5% short of all short-term debt and principal repayments falling due in 2011.

The external debt burden is adequate overall. Gross external debt is estimated at about 60% of GDP and 150% of export earnings in 2010. Thanks to a favourable maturity structure, the debt-service ratio is forecast at a manageable 13-15% in 2010-2011. However, this does not rule out that individual companies may face significant refinancing risk, in particular if global credit conditions were to tighten again.

It should be noted that in May 2009, against the backdrop of the global economic and financial crisis, Poland was granted access to a one-year USD20bn arrangement under the IMF's Flexible Credit Line (FCL) which was renewed for another year in July 2010. The FCL is being offered to strongly performing economies with a solid record of timely and effective economic policy adjustments. No drawings have been made under the FCL arrangements so far and the Polish authorities intend to continue to treat the arrangement as precautionary. Given the large stock of FX reserves, it is unlikely that Poland will draw on the FCL, but the arrangement helps to safeguard the economy against downside risks.

Structural Business Environment

The Structural Business Environment is fairly strong. Poland is placed in the second highest category in our assessment overall, ranking 61st out of 212 countries, slightly behind the Czech Republic (rank 56) but ahead of the Slovak Republic (62) and Italy (64). The economy is market-oriented and open to FDI, although some sectors (notably broadcasting, insurance, aviation services) as well as capital transactions with residents outside the EU, the European Economic Area and the OECD continue to face restrictions. Legal conditions are generally pro-investment though the judicial system remains slow and occasionally unpredictable. The infrastructure is good, payment habits and corporate data transparency are adequate and the banking system is robust. Remaining weaknesses include considerable government intervention in the economy and administrative red tape.

The Polish financial system has been resilient to the global financial crisis, despite the sizeable depreciation of the zloty at an early stage of the crisis and a large share of FX-denominated lending to the private sector. The regulatory framework has proven to be strong and was effectively tightened by the Financial Supervision Commission during the crisis. Although credit has been curtailed and the share of non-performing loans in total loans increased to 7.9% in Q1 2010 from 4.5% in 2008, the banking system has remained liquid, well-capitalised and profitable. According to the IMF, there are currently no bank solvency problems that pose significant systemic risk.

Dr. Manfred Stamer

Hamburg: +49 (0)40 8834 3607

Charts

