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Research Report on Poland

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Introduction

The general stance of the Polish economy is strong and stable. Downward trends in fiscal deficit and debt figures, alongside a healthy financial system and encouraging growth prospects, have strengthen the state of the economy, and thus, the government's creditworthiness. The new pension reform caused government debt to GDP to decrease by more than 6% and the deficit to get closer to the 3% threshold established by the EU's EDP (Excessive Deficit Procedure). Additionally, sound fiscal and monetary policies have supported economic growth and stability in public finances even when the external economic environment seems unstable and slow. Nevertheless, rising contingent liabilities (due to the pension reform), deflationary pressures, regional geopolitical (Ukrainian conflict) and economic (EU economic slump) concerns, as well as moderate external vulnerabilities, present a slight risk for the current and mid-term prospects of the economy.

Government debt declined substantially, though contingent liabilities present a potential long-term obstacle due to the pension reform. General government debt benefited from the new pension scheme[1] in the country: government debt to GDP was reduced by approximately 7 p.p. from 2013 to 2014. The cancellation of Treasury securities as a result of the new pension reform, reduced the state debt to 48,8% of GDP breaking the 50% to GDP threshold and allowing the Polish government to have more room for indebtedness. However, as mentioned in our previous report[2], the transfer of funds from the second pillar to the first pillar will increase the government's pressure on liabilities. These liabilities are not shown in the debt figures, nonetheless, they will represent a burden for the Polish government, especially taking into account the fact that it is an aging country with low fertility rates. In addition, liabilities in the form of pensions and social insurance, decrease the country's ability to reduce expenditures in times of crisis. Further reforms and measures implemented by the government regarding this issue will be kept on watch by the Agency.

Main Economic Indicators of Poland

Macro indicators	2012	2013	2014
Gross pub. debt, bill PLN	878	926	842
Nominal GDP, bill PLN	1616	1662	1725
Real GDP growth, %	1,8	7,7	3,3
Gross gov. debt/GDP,%	54,4	55,7	48,8
Deficit (surplus)/GDP,%	-3,7	-4,0	-3,5
Inflation rate,%	2,4	0,7	-1,0
Curr. Account balance/GDP,%	-3,6	-1,3	-1,2

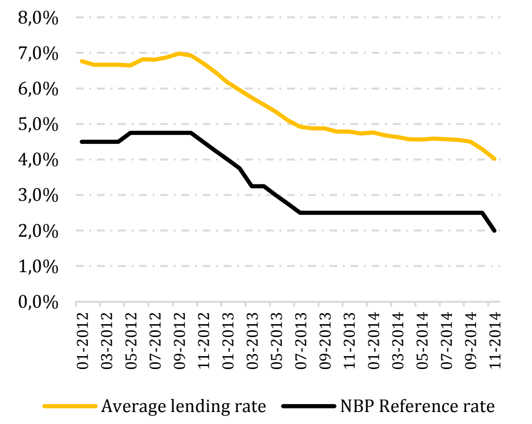
Development indicators	2014
Inequality adj. HDI	0,75
GDP per capita (Thou. of USD)	25,1

Default indicators	30.04.2015
5-Year CDS spread (Bp)	58
10Y Gov Bond Yield, %	2,47

Sources: RAEX (Europe) calculations based on data from World Bank, IMF, Bloomberg

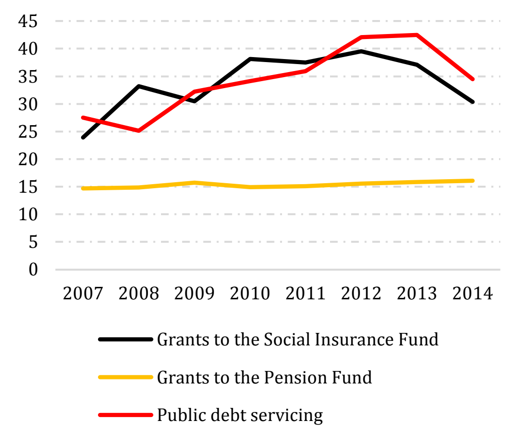
[1] The pension reform consisted of the transmission of funds from the second pillar (privately managed pension funds) to the first pillar (state-run pension system).
[2] Research report on Poland from 6th of November, 2014 (http://raexpert.eu/reports/Research_report_Poland_06.11.2014.pdf)

Graph 1: Monetary policy transmission mechanism



Source: RAEX (Europe) calculations based on data from the NBP

Graph 2: State budget expenditure (Bill. of PLN)



Source: RAEX (Europe) calculations based on data from the Central Statistical Office of Poland

The structure of debt continues to be solid. Short-term debt was reduced to 3,9% of GDP in 2014, half a percentage point down compared to 2013 and to 10,2% of budget revenues, 1 p.p. less than the previous year; and the amount of FX reserves is five times the load of short-term debt. Additionally, the yield on 10Y treasury notes stands at 2,3%, i.e. the cost of financing for the Polish government remains fairly low.

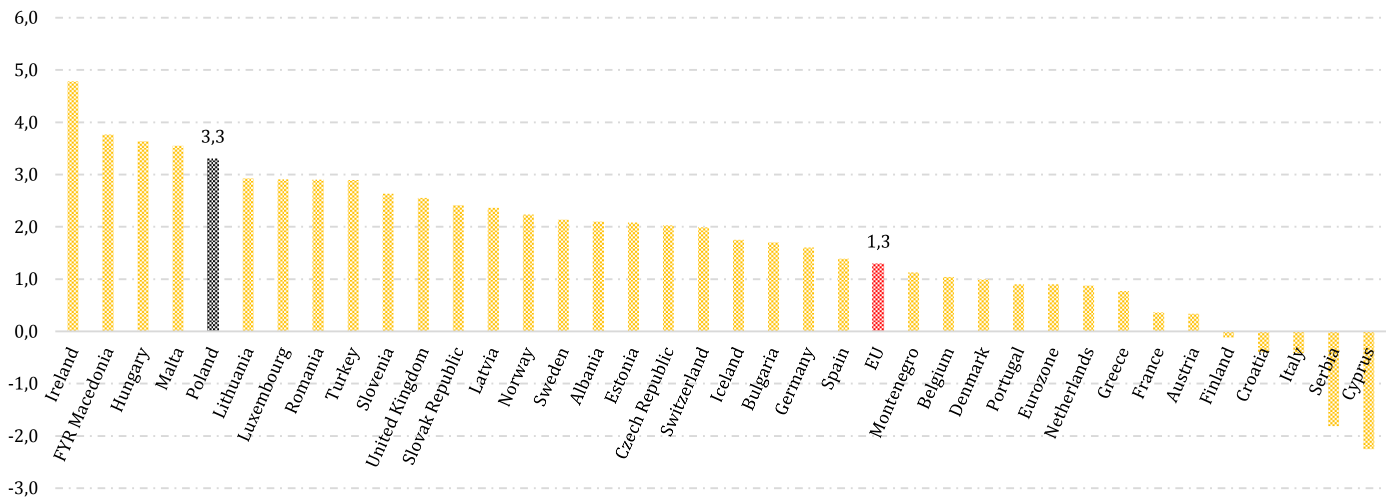
Inflation is moving further away from the NBP (National Bank of Poland) target, however, monetary and fiscal policies have proved to drive economic growth and reduce the fiscal deficit. Last year, consumer prices in Poland started to drop; the country showed a deflation figure of 1% at the end of 2014, moving further away from the Central Bank target of 2,5%. Depressed prices were a result of low imported inflation, mainly falling food and oil prices in the international market. In response, the NBP has reduced the reference rate several times during 2014 and 2015 (standing at 1,5% as of today). These cuts have been positive for the economy. The transmission mechanism of the NBP's reference rate to the overnight rate and, thus, to lending rates, has worked perfectly (see graph 1). However, deflationary pressures continue and further easing is still in the plans of the Central Bank. Regarding fiscal policy, the design of the 2015 budget alongside the adoption of the SER (Stabilizing Expenditure Rule)[3], have benefited public finances. The aforementioned one-off reduction of the government debt due to the new pension scheme resulted in a reduction of debt servicing expenses. Additionally, grants to the social insurance fund also declined (see graph 2). These factors contributed to narrowing the deficit down to 3,5% of GDP, though still above the EU threshold, and compensated the flat revenues due to deflation. However, the fiscal budget for 2015 is set to reduce the deficit as low as 2,6% in order to exit the EU's EDP.

Poland presents solid economic growth prospects, nonetheless, the external position of the country is moderately weak and currency risks may arise. Underpinned by higher income, solid real GDP growth and lower unemployment, Poland's growth prospects seem to be well positioned for the future. In 2014, GDP per capita in PPP terms was 25 105 USD (5% higher than 2013) and the economy grew 3,3% in real terms (1,7% in 2013) outperforming most of the EU countries (see graph 3). Furthermore, unemployment figures, albeit still high, showed an important reduction from 2013 standing at 8,9% for 2014. The rate of national savings in the country also rose up to 19,0% of GDP. Despite all

[3] According to the Ministry of Finance of the Republic of Poland, the rule states that "about 90% of central government expenditure will grow in line with the real medium-term GDP, or slower if there is excessive debt or deficit, or the balance does not meet the medium-term objective."

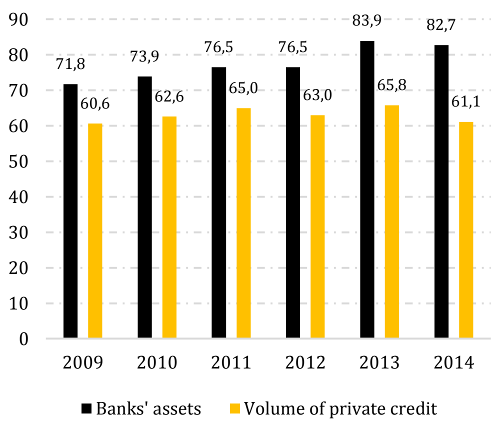
of the above indicators showing a stable and robust economy, the external position is not as solid. First of all, external economic and geopolitical conditions (which will be discussed later in this report) affect Poland directly. On top of this, the amount of FX denominated government debt (45% of total government debt), the high amount of securities in non-residents hands (58% of total debt), the dependence on funding from international organizations, the moderate amount of FX reserves as a percentage of debt (42,5%) and the large number of foreign-owned banks, introduce a bearable currency risk for the country.

Graph 3: Real GDP growth rate in the Europe in 2014 (%, y-o-y)



Source: RAEX (Europe) calculations based on data from IMF and Eurostat

Graph 4: Banks' assets and private debt (% of GDP)



Source: RAEX (Europe) calculations based on data from WB

Private lending decreased slightly and the CHF appreciation took a toll on the financial system in 2014, however, it is still resilient and stable. The banking sector showed positive profitability figures (ROA for the sector was 1,1%) and capital levels (capital adequacy ratio increased up to 9,7% in 2014). Despite these positive figures, the amount of banks' assets fell along with private debt in 2014 (see graph 4). In addition to this, while the banks (moderately exposed to CHF denominated loans and derivatives) suffered when this currency appreciated earlier in the year, the sector is well covered to cushion the credit risk. Confirming conclusions from the previous report for Poland, stress tests have shown that banks are well prepared to absorb internal and external shocks. In contrast to banks, credit unions have not been performing positively. Recent reports show that a large amount of credit unions are on the brink of bankruptcy and two already defaulted. These bankruptcies used up to 25% of the banking guarantee fund.

Potential adverse effects due to the Ukrainian crisis and the economic performance in the EU are still latent. The Polish economy had a solid growth of 3,3% in real terms last year. This means that the country was not strongly affected by the slowdown of the rest of the European economies. However, since Poland's export destinations are countries within the EU, slow economic activity in the region may slowdown growth. In the same sense, the Ukrainian conflict with Russia could further affect the trade with this country due to the bans imposed on fruit and vegetable imports (Poland's biggest export market for these goods is Russia).

Conclusion

During 2014 the Polish economy performed well compared to its regional peers even when adverse macroeconomic and geopolitical conditions in Europe took place. This, hand in hand with healthy and improving public finances, low government debt, stable financial system and sound fiscal and monetary policies, support the fact that the economic conditions in Poland are stable. At the same time, this performance gives Poland clout to weather current and mid-term unfavorable internal and external risks. Nonetheless, as mentioned in this report, there are factors such as the new pension reform, deflation and external pressures that will challenge the country along 2015 and beyond.