Research Report on Poland

6th of November, 2014

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Introduction

Poland is characterized by a stable debt structure, solid growth and a sound financial system. Even though the country has debt levels above 50% of GDP and a fiscal deficit of 4,3% of GDP, new legislation on the pension system will help reduce both of these figures. However, due to current insufficient structural reforms, these new policies could generate future contingent liabilities in the following years. Additionally, Poland's external position is strong with high levels of foreign exchange reserves and a stable free floating currency regime. Despite this, some risks arise due to the interconnectedness with the European Union (EU) and the high level of foreign investors in the PLN denominated government bonds. At the same time, lack of necessary measures in a deficient labor market have contributed to high unemployment rates.

Main Economic Indicators of Poland

Macro indicators	2011	2012	2013
Gross pub. debt, bill PLN	859,2	886,9	934,4
Nominal GDP, bill PLN	1528,1	1596,4	1635,7
Real GDP growth, %	4,8	1,8	1,7
Gross gov. debt/GDP,%	56,2	55,6	57,1
Deficit (surplus)/GDP,%	-5,0	-3,9	-4,3
Inflation rate,%	4,6	2,4	0,7
Curr. Account balance/GDP,%	-4,9	-3,7	-1,4

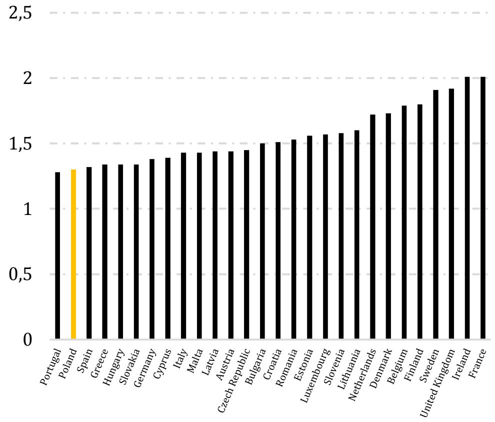
Development indicators	2013
Inequality adj. HDI	0,74
GDP per capita (Thou. of USD)	23,3

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

Government debt structure is solid, though debt levels are slightly high. First of all, short-term debt is low (4,4% of GDP), well covered by budget revenues (11,6%) and by foreign exchange reserves (20,2%). This means that the risk of not fulfilling short-term obligations is very low. In addition, the risk of non-repayment of long-term debt is also considered to be small as the 10Y treasury bond yield stands at 2,6%. Nonetheless, general government debt has been steadily rising up to 57,1% at the end of 2013.

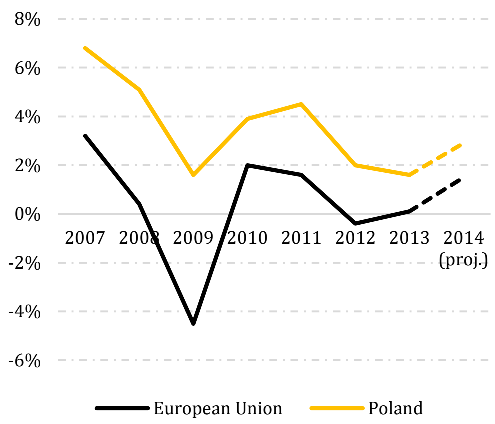
Pension reform provides short-term solutions but long-term challenges. With the new pension reform, an immediate reduction in the general government debt (projected at 49% by the end of 2014) and fiscal deficit (projected to be reduced by 1%) will occur. These reductions will alleviate and further strengthen the debt position of the country. However, two main risks arise: future contingent liabilities and a sudden increase in domestic bond holdings by foreigners. The first risk is due to the transmission of funds from the second pillar (privately managed pension funds) to the first pillar (state-run pension system), which means more government liabilities. In addition, the risk becomes more delicate if Poland's weak fertility rate (see graph 1) and the high aging pace are taken into account. The second risk regards global shocks transmission. High concentration of PLN denominated debt in foreign investors' portfolios

Graph 1: Fertility rate (Number of children per woman, 2012)



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

Graph 2: Real GDP growth rate (%, y-o-y)



Source: RAEX (Europe) calculations based on data from IMF and the European Commission

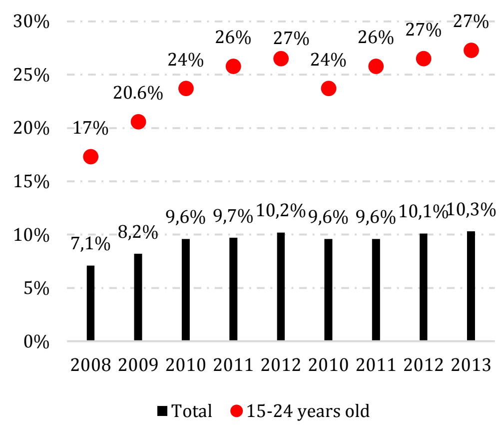
represent a risk due to a potential selloff if geopolitical tensions or market volatility were to emerge.

Strong GDP growth was evidenced in the past years, nevertheless, external risks exist due to dependence on the EU's performance and trade links with Russia. Poland stands out as one of the EU countries that did not have a recession in the aftermath of the 2008 financial crisis and the 2012 general slowdown in the European economy. Although Poland has had actual growth in the previous years, its growth is highly correlated with that of the EU (see graph 2). Therefore, the interconnectedness with the EU, and especially Germany, will have an impact in Poland's economy if slow economic activity were to continue in the region. Moreover, imports from Russia account for 57% of gas consumption (heavily used by the industry) and 94% of crude oil consumption. In this case, the country mitigates this risk by having signed a long-term contract with Gazprom for the supply of these hydrocarbons; also, most of Poland's primary energy supply is produced with coal. In addition, 7% of food exports go to Russia and recent bans could hurt the agricultural sector in the country.

Sound fiscal and monetary policy, however, inflation still well below target. Fiscal consolidation is one of the mid-term objectives of the Polish government. One of the main factors that will contribute to achieve this goal is the pension reform, as previously explained, and the permanent expenditure rule, which links public expenditure with GDP growth. Regarding monetary policy, this has worked correctly in recent years as a transmission mechanism to manage interbank rates and, in consequence, reducing lending rates contributing to real GDP growth. However, due to low imported inflation and low inflation expectations, this indicator has remained well below the 2,5% target (currently 0,7%). In response to the slow pick up of inflation, the Central Bank recently reduced further the policy rate. A potential risk of extremely low inflation may be the impact in fiscal policy by reducing estimated budget revenue, i.e. if prices don't hike, there is less tax revenue.

Strong financial sector. The financial sector in general appears to be strong. Banks are profitable and private lending has picked up in recent years. At the same time, the lending-deposit spread has remained steady and real interest rates have been positive and stable. In addition, recent stress tests demonstrate the stability and readiness of the banking system in case of internal or external shock scenarios. Furthermore, the stock and bond markets are well developed with a wide range of financial instruments. However, non-performing loans (NPLs) among SMEs are quite high reaching around 14% of total loans in the sector.

Graph 3: Unemployment rates



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

Unemployment has been declining recently, but it remains high among the youth. Unemployment in Poland remains above 10%. Insufficient policies along with labor market inefficiencies, contribute to the high level of unemployment especially among the young (see graph 3), which has been rising in previous years. Almost 30% of the contracts are part time contracts, which are given to young employees but do not serve as a bridge for full time employment. At the same time, the lack of vocational training opportunities harms the preparation of young apprentices to enroll in the labor market.

Conclusion

Poland has a well-structured debt framework with low short-term debt ratios to GDP and budget revenues. The new pension scheme contributes to strengthen the debt burden by reducing the budget deficit and general government debt. However, special attention must be focused in future actions by the authorities in the pension system to contain potential contingent liabilities going forward. At the same time, the high level of reserves along with a stable and free floating exchange rate, consolidate the current strong external position for the country. Also regarding the external position, potential risks may arise due to the large foreign investor base in local currency debt as well as the contagion effect from the EU economies. In addition, a more efficient workforce and less segmented market, will contribute to mitigate the high levels of unemployment. Moreover, sound monetary and fiscal policies should contribute to achieve short and long-term objectives. Finally, a strong financial system underpins the base for further growth and investment in the country.