

Poland (the Republic of)

Foreign LT: A-/Stable, Local LT: A/Stable (Affirmed on January 9, 2007)

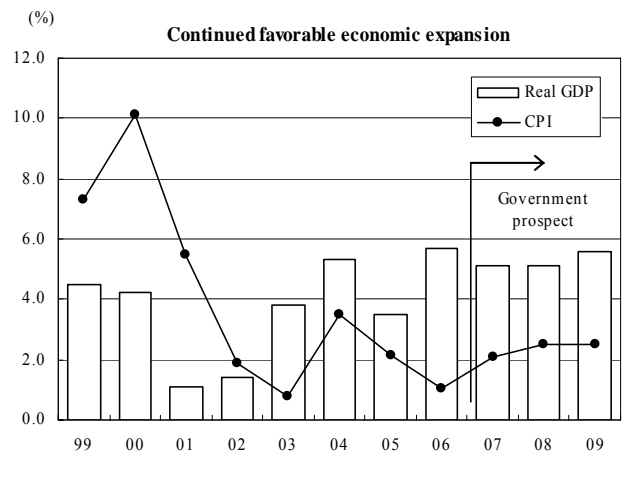
<Rating Perspective>

Positive Factors

- Continued convergence with the euro-zone economy in preparation for the adoption of the euro
- Strong exports brought by the expansion of production capacity through inflows of foreign direct investment

Negative Factors

- Persistent budget deficit
- High structural unemployment impeding economic flexibility
- Relatively heavy external burdens



<Updated: from December 2006 to February 2007>

Positive Factors

- Real GDP growth in 2006 accelerated to 5.8% from 3.4% in 2005
- State budget deficit in 2006 stood at Zloty 25.1 billion (2.4% of GDP), lower than the annual target of Zloty 30.5 billion under the 2006 budget plan.
- The government set its 2007 state budget deficit target at Zloty 30 billion (2.7% of GDP) in line with its commitment to keep the annual deficit at Zloty 30 billion through 2009. The deficit in the first two months of 2007 stood at Zloty 3.9 billion, or 10.4% of the target.
- Foreign direct investment inflows in 2006 reached the highest annual record of EUR 11.7 billion (4.3% of GDP).

Negative Factors

- The European Council adopted its second recommendation to the Polish government on February 27, calling for submission of effective measures to correct what it called as an excessive budget deficit.
- Privatization revenues in 2006 amounted to Zloty 620 million or a bleak 11.3% of the annual target, the lowest since 1991.

<Outlook and Points to Watch>

Favorable economic expansion continuing

(1) JCR has affirmed the ratings in annual review

On January 9, 2007, JCR retained its ratings with stable rating outlooks on foreign and local currency long-term senior debts. The affirmation of the ratings is primarily supported by the country's ongoing convergence with the euro-zone economy, in particular, concerning interest rates and inflation, in preparation for the adoption of the euro and the continued sound economic prospects following constant growth of exports boosted by an expanding production capacity rendered by foreign direct investment (FDI) inflows and increased efficiency brought by progress on corporate restructuring. On the other hand, the ratings are constrained by the country's chronic budget deficit and improving yet still the highest unemployment rate among the EU25, which is impeding the country's further economic growth.

The ratings outlooks are stable. JCR believes that any significant fiscal deterioration seems unlikely as the Jaroslaw Kaczynski government holds fast to its policy commitments to keep the annual budget deficit lower than 30 billion zloty (equivalent to 2.7% of GDP) through 2009. The policy, though unlikely to lead up to fiscal reforms, is expected to stem any significant deterioration of the annual budget deficit. Furthermore, pressure for increased expenditures has eased following the heavy setbacks suffered by the Self-Defense and Polish Families League (LPR) in the November local elections. A continuing favorable economic expansion is also helping to hold back deterioration of the budget deficit.

(2) Political stability regained for the present following return of the three-party coalition and local election results

In September 2006, the three-party coalition formed by the PiS, Self-Defense and LPR collapsed with the departure of the Self-Defense. However, as PiS failed to strike a deal in coalition negotiations with other political parties, it had to return to the original tripartite coalition with the Self-Defense and LPR in October. The renewed coalition, commanding 230 out of 460 seats in

< 1/2 >

parliament, lost a majority as some MPs had bolted from the Self-Defense and LPR. However, it manages to maintain a majority with the support of the National Party, a new party formed by a group of MPs who had left the Self-Defense and LPR, and some individual MPs from other parties.

In the local elections held in November 2006, the main opposition party Civic Platform won the largest number of seats in regional assemblies. In contrast, both the Self-Defense and LPR suffered heavy setbacks while the PiS managed to come second. As a result, the influence of the populist Self-Defense and the nationalist LPR, which had strongly advocated increased expenditures, has receded within the coalition camp. Furthermore, the political base of the Kaczynski government has been strengthened by the replacement of the foreign and interior ministers, who had pursued individualism, in a cabinet reshuffle carried out in February 2007. Thus, the political situation may stay calm for the present. However, there still remains the possibility of a general election scheduled for September 2009 being moved up depending on political developments, such as a breakup of the tripartite coalition.

(3) Promotion of expenditure reforms is key to further improvement of budget deficit

Budget deficit continues to improve due mainly to a favorable economic expansion and the government's policy commitments to keep the annual budget deficit lower than Zloty 30 billion (equivalent to 3.0% of GDP in 2005) for four years from 2006. State budget deficit in 2006 came to Zloty 25.1 billion (2.4% of GDP), lower than the Zloty 30.5 billion target.

The government set its 2007 state budget deficit target at Zloty 30 billion (2.7% of GDP) in line with its commitment to keep the annual deficit at Zloty 30 billion through 2009. But the 2007 budget calls for substantial increases in both revenues and expenditures as compared with the initial budget plan. While revenues are highly dependent on economic expansion, expenditures centering on social security expenses are set to grow faster than the nominal GDP growth rate. Therefore, the 2007 budget is susceptible to economic fluctuations. Following its first recommendation in November 2006, the European Council adopted its second recommendation to the Polish government on February 27, calling for submission of effective measures to correct what it saw as an excessive budget deficit. The Council sees the Polish government's ongoing fiscal measures as inadequate and projects a further increase in the budget deficit in 2007.

(4) Economy continues expanding led by domestic demand amid stable inflation

Real GDP growth in 2006 accelerated to 5.8% from 3.4% in 2005. The growth was paced by the expansion of gross fixed capital formation on higher capacity utilization, solid corporate profit underpinned by progress on corporate restructuring and substantial inflows of subsidy from the EU. Consumer spending also remained solid on increased real wages and improved employment. The strong economic expansion has helped to lower the unemployment rate, the highest among the EU25, by 2.2 percentage points to 16.2% in 2006. Inflation continued to decelerate further to 1.0% in 2006 from 2.1% in 2005. The current account deficit widened moderately to 2.1% of GDP in 2006 from 1.7% in 2005 due mainly to increased imports caused by strong domestic demand. There is little concern about external finance as FDI inflows continue to cover most of the deficit. The central bank cut its policy rate to 4% at the beginning of 2006 and has since kept it unchanged.

A favorable economic expansion is expected to continue in 2007 and 2008 though the improving labor market and domestic demand expansion may somewhat accelerate inflation. The current account deficit is likely to widen on increased imports triggered by strong domestic demand, but refinancing risk is highly mitigated by strong FDI inflows.

Main Economic Indicators: The Republic of Poland

	2002	2003	2004	2005	2006(f)	2007(f)	2008(f)
Convergence criteria for adopting the euro (2006)							
1. CPI (annual average)	2.9%	1.9	0.8	3.5	2.1	1.0	2.3
2. 10 year government bond yield	5.4%	7.3	5.8	6.9	5.2	5.2	5.5
3. General gov't fiscal balance/GDP(ESA95)	Below -3.0%	▲5.0	▲6.3	▲5.7	▲4.4	▲3.8	▲3.7
4. General gov't debt/GDP(ESA95)	Below 60%	42.2	47.1	45.9	47.3	49.3	50.5
Real GDP growth rate	(%)	1.4	3.8	5.3	3.4	5.7	5.5
Unemployment rate (year-end)	(%)	19.7	20.0	19.6	18.2	16.2	14.8
Current account balance/GDP	(%)	▲2.6	▲2.1	▲4.3	▲1.7	▲2.1	▲3.0
Trade balance/GDP	(%)	▲3.7	▲2.7	▲2.2	▲0.9	▲1.5	▲2.4
Net FDI/GDP	(%)	2.0	2.0	4.7	2.1	3.1	2.9
Forex reserves (excl. gold)	(EUR mn)	25,504	25,310	25,313	32,797	34,242	36,200
Imports (G&S)/monthly imports	(months)	4.6	4.4	3.8	4.3	3.7	3.2
Forex reserves/short-tem external debt	(times)	1.9	1.6	1.4	1.4	1.3	1.3
Gross external debt/ exports (G&S)	(%)	135.4	133.2	123.8	123.1	114.1	106.0
Gross external debt/ GDP	(%)	38.7	44.3	46.6	45.8	46.5	46.1
Gross public external debt/exports (G&S)	(%)	57.2	56.3	55.4	56.7	50.2	47.2
Debt service ratio	(%)	22.5	24.9	18.0	19.2	19.5	18.2

(Note) Figures for 2006, 2007 and 2008 are based on JCR forecast. Fiscal figures include pension reforms costs

(Source) The European Commission, The Central Bank, and Ministry of Finance

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