2008-10
May 28, 2008

Poland (the Republic of)

Foreign LT: A-/Positive, Local LT: A/Positive

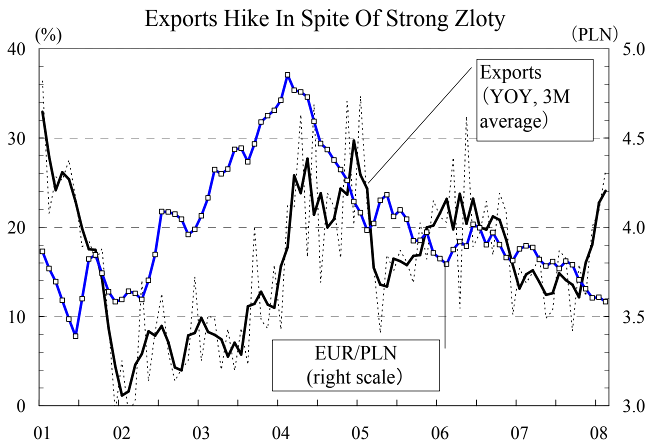
<Rating Perspective>

Positive Factors

- Continued convergence with the euro-zone economy in preparation for the adoption of the euro.
- The expansion of production capacity through massive inflows of foreign direct investment and subsidy from the EU

Negative Factors

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



Source: National Bank of Poland, EUR/PLN cross rate is monthly average

<Updated: from March to May 2008>

Positive Factors

- Remittances from migrant workers amounted to PLN 20.4 billion in 2007, up 16.6% y-o-y (4/8)
- Investment increased a strong 26% y-o-y in 2007 (3/27)
- The European Commission announced an end to the measures taken to correct Poland's excessive fiscal deficit. (4/29)
- Both exports and imports continued to grow robustly in March, up 19.3% and up 20.7% y-o-y, respectively, on a euro basis (4/28)
- The government fiscal balance in the 1st quarter of 2008 was in surplus by PLN1.8 billion. The balance registered an estimated PLN0.6 billion surplus in April 2008.(5/9)

Negative Factors

- Amid continuing appreciation of the Polish zloty and overheating domestic demand, the current account deficit in 2007 widened to 3.6% of GDP. (4/8)
- Consumer price inflation rate has been staying higher than 4.0% since December 2007. (5/8)

<Outlook and Points to Watch>

Some signs of moderation in the hiking economy

(1) Latest economic trends

The economic growth continued to be driven by a steady domestic demand expansion amid steady employment and income growth. Considering the uptrend of consumer confidence, private consumption is likely to stay steady. Gross fixed capital formation kept growing primarily on expansion of private investment. However, there are signs that the economy has started slowing down, as the growth of the industrial production index decelerated to 1.0% year-on-year in March from 10.6% in January and 15.0% in February and the growth of retail sales declined to 11.7% in March from 19.2% in February. Future trends of these indicators need to be monitored as their drops in March might have been a one-off phenomenon caused by the fewer working days due to the Easter holidays. The National Bank of Poland (NBP) tightened its monetary stance by raising its policy rate three times by a total 75bp in the first quarter of 2008. This may have also worked to slow down the economy. In deciding on its future policy options, NBP needs to take into account the facts that the consumer price index growth remains higher than 4% and that the Polish zloty continues appreciating amid the rapid interest rate hike. (The currency rose to 3.4113 zloty per euro on May 26 from 3.6233 zloty at the end of January.) With ECB pegging its rate at 4.00% since June 2007, NBP should also consider the widening rate differential between the EU and Poland. NBP's Monetary Policy Committee in April left its interest rate unchanged. Some members of the committee voiced concern that a stronger zloty may have adverse impact on exporters and the current account while acknowledging that the rise of consumer prices remains way higher than the inflation target. Given the buoyant domestic demand, NBP may consider another rate hike, depending on future developments of the exchange rate.

(2) Tusk administration's economic forecast for 2008-2010

The government estimates the real GDP growth rate in 2008 at 5.5% under its 2008-2010 medium-term plan (Convergence Program Update 2007). The higher growth estimate despite a global economic slowdown is based on a projection that personal consumption will expand around 6% in 2008, even higher than the 5.7% posted the year before. The government expects that the expanding employment and a continuing steep income growth (up 10.1% year-on-year in April 2008) will help boost individual consumption. It also expects that its tax reforms aimed to lower the tax burdens of enterprises and households, which had been heavier than those in other EU countries, and reduce the pension contribution will prove effective in stimulating the economy. Moreover, the government envisages that business investment will stay robust, supported by the favorable evaluation given to the Polish economy both at home and overseas. On the other hand, it is concerned about some negative factors, such as the impact of a continuingly strong zloty on exports and a sharp growth of imports amid strong domestic demand that could boost the current account deficit to around 6.0% of GDP in 2008. As to the continuing uptrend of the inflation rate, the government holds that the main reason is the hike of state-controlled prices such as electricity, gas and other public utility rates and that the price inflation will begin decelerating in the latter half of 2008. The government projects the average inflation rate in 2008 at 3.5%, which is more optimistic than the estimates of around 4.0% given by NBP and private organizations.

(3) The government announces further cut of fiscal deficit in updated Convergence Program

In its updated Convergence Program, the government has projected the general government fiscal deficit (ESA95) in 2008 at 2.5% of GDP, substantially lower than the 3.0% envisaged by the former administration. In the medium term, it estimated the deficit/GDP ratio at 2.0% in 2009 and 1.5% in 2010, which should clear the convergence criteria for euro adoption. The fiscal reforms envisaged under the program will center on expenditure cuts. On an item-by-item basis, bearing the brunt will be administrative expenses, which will be cut by 0.8% in GDP terms from 2006 to 2010. The government will take the following specific measures: (1) further rationalization through elimination and consolidation of some public entities, (2) introduction of a three-year budget system, (3) legislation to change the debt limits for local governments that will contain tougher penalty when the debt/GDP ratio exceeds the upper limits. The government also plans to cut the ratio of social protection spending to GDP to 15.1% in 2010 from 16.9% in 2006. On the revenue side, the government plans: (1) a reduction of social security payments and an increased tax allowance for families with children, (2) a higher excise tax rate for tobacco and (3) a higher per-liter excise tax rate for gasoline and diesel oil. One of the major aims of the tax reforms is promotion of employment through reduction of the labor cost. The reforms will lower the tax burdens of both enterprises and households. A full implementation of the updated program should make the planned fiscal consolidation solid. However, some people question the government ability to carry it out. In April, a deputy finance minister resigned, citing the lack of support for the government's proposed spending cuts. With the presidential election scheduled for 2010, Prime Minister Donald Tusk looks keen not to lose the current higher support rate in opinion polls. How far his government can push ahead with its reform initiatives needs to be watched.

Main Economic Indicators: The Republic of Poland

		2003	2004	2005	2006	2007	2008(f)	2009(f)
Convergence criteria for adopting the euro								
1. CPI (annual average)	2.4%	0.8	3.5	2.1	1.0	2.6	4.0	3.0
2. 10 year government bond yield	5.5%	5.8	6.9	5.2	6.2	6.5	7.5	5.5
3. General gov't fiscal balance/GDP(ESA95)	Below-3.0%	-6.3	-5.7	-4.3	-3.8	-2.0	-2.5	-2.0
4. General gov't debt/GDP(ESA95)	Below 60%	47.1	45.7	47.1	47.6	44.9	44.2	43.3
Real GDP growth rate	(%)	3.8	5.3	3.5	6.1	6.5	5.5	5.0
Unemployment rate (year-end)	(%)	19.6	19.0	16.7	11.9	8.2	7.0	6.0
Current account balance/GDP	(%)	▲2.1	▲4.3	▲1.7	▲2.3	▲3.4	▲4.3	▲4.8
Trade balance/GDP	(%)	▲2.7	▲2.2	▲0.9	▲1.4	▲2.9	▲3.5	▲4.0
Net FDI/GDP	(%)	2.0	4.8	2.3	3.0	3.8	3.9	2.6
Forex reserves (excl. gold)	(EUR mn)	25,310	25,313	32,797	34,242	37,800	41,580	45,783
Imports (G&S)/monthly imports	(months)	4.4	3.8	4.3	3.7	3.4	3.3	3.3
Forex reserves/short-tem external debt	(times)	1.6	1.4	1.4	1.3	1.1	1.0	1.0
Gross external debt/ exports (G&S)	(%)	133.2	124.1	123.8	116.8	115.3	121.5	123.2
Gross external debt/ GDP	(%)	44.3	46.7	46.0	47.0	48.0	49.2	49.6
Gross public external debt/exports (G&S)	(%)	56.3	55.4	56.7	47.8	44.7	42.9	42.2
Debt service ratio	(%)	24.9	34.6	28.7	19.5	18.2	17.5	17.5

(Note) Figures for criteria 1 and 2 are annual average of 2007. Figures for 2007, 2008 and 2009 are projection made by JCR
(Source) The European Commission, National Bank of Poland and Ministry of Finance

(Atsuko Kajiwara, Analyst)