

## Poland (the Republic of)

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

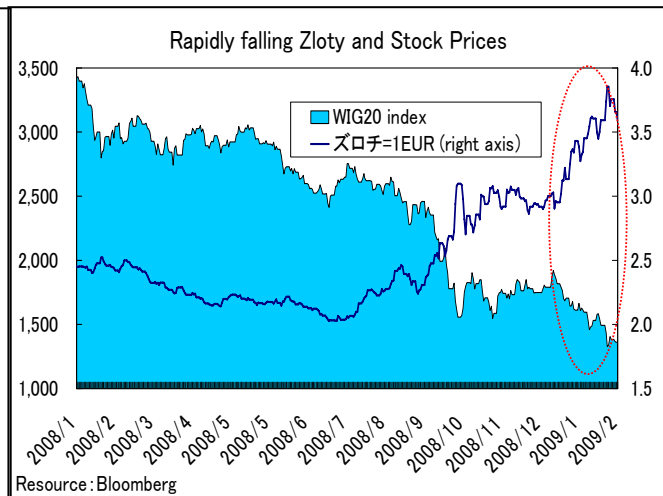
### <Rating Perspective>

#### Positive Factors

- Continued convergence with the eurozone 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

- High structural unemployment impeding economic flexibility
- Relatively heavy external burdens



### <Updated: from December 2008 to February 2009>

#### Positive Factors

- The government decided to cut expenditures by 19.7 billion zloty in the 2009 budget (2/4).
- The state budget registered a 2.9 billion zloty surplus [770m dollars] in January (2/16).
- Monetary Policy Council decided to lower NBP interest rate by 25bps to 4.00% (reference rate) (2/26) .

#### Negative Factors

- Real GDP growth ratio sharply declined to 2.5% in the 4Q of 2008 from 4.8% in the 3Q of 2008 (2/3).
- The Polish Auto Association forecast car sales in 2009 to decrease by 10-15 % from the year before (2/13).
- Exports in 2008 decreased by 16% from 2007(2/13).
- The Polish zlotv fell to the lowest level since May 2004 (2/16).

## <Outlook and Points to Watch>

### *Putting an end to the Zloty depreciation?*

#### (1) Economic forecast to be lowered further

Poland's real GDP growth rate in 2008 decelerated to 4.8% from 6.7% in 2007. The growth of domestic demand declined to 4.8% from 8.6%, with that of gross fixed capital formation sharply falling to 7.9% from 17.6%. Although the pace of the slowdown in 2008 as a whole looks relatively small, the economy was sinking faster than it would appear. In the 4<sup>th</sup> quarter of 2008, the industrial production index dropped 4.5% year-on-year, the steepest setback in 10 years. According to the latest government forecast, the economy will grow only by 1.7% in 2009. National Bank of Poland (NBP) forecasted that the annual GDP growth will be between 0.3 to 1.9%, substantially down from the forecast in the last October (1.9 to 3.7%). Some economists in the private sector forecast that the current account deficit will widen to around 6% of GDP in 2009 from the current 4.3%.

#### (2) Falling zloty

Foreign capital outflows are accelerating amid concerns over an economic slowdown, interest rate cuts for stimulus purposes and growing worries about the soundness of the banking sector. As a result, the Polish zloty fell in February 2009 to the lowest level since May 2004. Stock prices also declined by 24% from the beginning of 2009 as of February 24. NBP started lowering the interest rate in November. The policy interest rate has since been cut by a total 200 bps and currently stands at 4.00%. NBP suggested a further cut as part of the economic stimulus measures. However, the central bank may find it impractical unless the depreciation of the zloty comes to a halt, thereby losing the flexibility in implementing its monetary policy. The zloty has depreciated 13.2% since the beginning of 2009, the largest fall among the currencies of the emerging countries. A weaker zloty could have two negative impacts on the economy. First, it would expand write-offs for the currency option deals made so far by banks. Secondly, it could put

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more foreign currency-denominated debts in arrears due to heavier debt burden. The country's financial authority has estimated losses to be incurred by companies at Z115-20 billion. Polish commercial banks, which have put up provisions equivalent to 10-15% of their currency option deals, have estimated their possible write-offs at about Z12 billion. Poland's outstanding balance of foreign currency-denominated credits stood at around 26% of the total bank credit balance, which is relatively lower than that in other Central and Eastern European countries. However, the zloty's depreciation could have a serious impact on the household economy since about 60% of housing loans are dominated in foreign currency. In order to avoid further currency depreciation, it will be necessary not to damage the attractiveness of the zloty for foreign investors with additional rate cuts. In addition, the government needs to carry out aggressive economic stimulus measures to stem further economic downturn, which is evident from several negative factors such as an expanding current account deficit and sharply contracting industrial production. Since February 23, depreciation of zloty has peaked out gradually reflecting the government's intention to join the Exchange Rate Mechanism (ERM2) in the first half of 2009. However, the government is expected to carefully consider the possible impacts in the longer term, such as appropriate exchange rate level or the recovery of the economy, in case that Poland will join ERM2 under the current severe economic conditions

### (3) The government starts preparations to join ERM2 in 2009

Even as the economy began slowing down in the latter half of 2008, Prime Minister Donald Tusk remained committed to his policy to aim for the adoption of the euro in 2012. However, there are a number of issues to be resolved. Euro adoption requires a constitutional amendment. The opposition party has opposed adopting the euro in 2012 and requested a national referendum. Opinion polls have indicated that chances of the government getting a two-thirds referendum approval needed for constitutional amendment would be rather slim. However, media reports said that the government started negotiations with the EC, convinced that Poland should aim to join ERM2 in 2009 before resolving the constitution issue. On the other hand, NBP said in its report on euro adoption that joining ERM2 amid the ongoing global financial woes is not preferable to the Polish economy. The report said that in the long run, adopting the euro will help reduce the foreign exchange volatility risk and lower nominal interest rates, expanding exports by 12% and boosting the real GDP growth rate by 0.7%. NBP added, however, that it would be difficult to expect such effects under the current volatile economic situation. JCR holds that accession to ERM2 in 2009 may have a possibility that it could cause the delay of economic recovery as it might put restrictions on its fiscal and monetary policies. At this moment, the zloty seems to stop falling. However, the government should reconsider its time schedule for euro introduction should the zloty continue the volatile movements.

#### Main Economic Indicators: The Republic of Poland

		2004	2005	2006	2007	2008	2009(f)	2010(f)
<b>Convergence criteria for adopting the euro</b>								
1. CPI (annual average)	2.8%	3.5	2.1	1.0	2.6	4.8	1.2	2.2
2. 10 year government bond yield	6.4%	6.9	5.2	6.2	6.5	5.4	5.3	5.5
3. General gov't fiscal balance/GDP(ESA95)	Below-3.0%	-5.7	-4.3	-3.8	-2.0	-2.7	-2.5	-2.3
4. General gov't debt/GDP(ESA95)	Below 60%	45.7	47.1	47.6	44.9	45.9	45.8	45.5
Real GDP growth rate	(%)	5.3	3.5	6.1	6.5	4.8	1.2	3.0
Unemployment rate (year-end)	(%)	19.0	16.7	11.9	8.2	7.1	10.5	11.4
Current account balance/GDP	(%)	-4.3	-1.7	-2.3	-3.4	-4.3	-6.0	-5.5
Trade balance/GDP	(%)	-2.2	-0.9	-1.4	-2.9	-3.5	-5.0	-4.5
Net FDI/GDP	(%)	4.8	2.3	3.0	3.8	3.9	2.6	3.0
Forex reserves (excl. gold)	(EUR mn)	25,313	32,797	34,242	37,800	43,930	48,323	50,000
Imports (G&S)/monthly imports	(months)	3.8	4.3	3.7	3.4	3.5	3.5	3.5
Forex reserves/short-tem external debt	(times)	1.4	1.4	1.3	1.1	0.6	0.6	0.9
Gross external debt/ exports (G&S)	(%)	124.1	123.8	116.8	125.7	150.6	130.8	140.0
Gross external debt/ GDP	(%)	37.6	36.9	37.5	38.7	43.3	41.0	39.0
Gross public external debt/exports (G&S)	(%)	55.4	56.7	47.8	44.7	42.9	42.2	42.2
Debt service ratio	(%)	34.6	28.7	19.5	18.2	17.5	18.5	18.5

(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

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