

2005-41
December 28, 2005

Poland (the Republic of)

Foreign LT: A-/Stable, Local LT: A/Stable (Affirmed on May 12, 2005)

Main Factors for the Ratings

Positive Factors

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

Negative Factors

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

< Lower house election results >

Political party	Sep. 2001 seats	Sep. 2005 seats	increase/ decrease
Law and Justice	46	155	109
Civic Platform	56	133	77
Samobrona	30	56	26
Democratic Left Alliance(note)	152	55	(97)
League of Polish Families	25	34	9
Polish Peasants' Party	40	25	(15)
others	53	2	(51)
Union of Labour(note)	15	0	(15)
Polish Social Democracy	32	0	(32)
Democratic Party	11	0	(11)
Total	460	460	0

(note) coalition parties prior to the election in September 2005

Updated: from September 2005 to November 2005

Positive Factors

- The new minority government led by Law and Justice (Pis) revised the fiscal deficit target for 2006 to 3.0% of GDP from 3.3% as envisaged in the draft budget prepared by the former government (November 30).
- Real GDP growth in the July-September quarter of 2005 accelerated to 3.7% year-on-year from 2.8% the previous quarter.
- Current account deficit in the first ten months of 2005 narrowed to EUR 2.9 billion from EUR7.6 billion in the same period of last year.
- Unemployment rate in October 2005 improved to 17.3%, down 1.4 percentage points from the year earlier.

Negative Factors

- Following its victories both in the September parliamentary election and the October presidential election, Pis formed a minority government with Kazimierz Marcinkiewicz as prime minister (October 31). The former Warsaw Mayor Lech Kaczynski became new president (December 23).
- Pis showed cautious attitude to early adoption of the euro. Pis said during the election campaign that it would delay the introduction of the euro until after 2010 and that it would take no decision on the participation in the exchange-rate mechanism in the immediate future.

<Prospects and Noticeable Points>

No drastic policy change expected

(1) Both ratings and outlooks retained

The conservative Pis emerged as the winner in the parliamentary election held on September 25, 2005, garnering 155 out of 460 lower house seats at stake. On October 23, former Warsaw Mayor Lech Kaczynski, the Pis candidate, defeated Civic Platform (PO) leader Donald Tusk in the second-round runoff presidential election. Following the collapse of its coalition talks with PO, Pis formed a minority government in early November when the cabinet led by Prime Minister Kazimierz Marcinkiewicz won a vote of confidence with the backing of the populist Samobrona and Catholic nationalist League of Polish Families.

JCR had expected that a coalition government would be formed by Pis and PO, which advocates reforms in preparation for the adoption of the euro. But JCR holds that the formation of a minority government led by Pis will not affect its rating for the present. Unlike the former ex-Communist government, Pis has its roots in the former Solidarity labor movement and strongly advocated conservative policies during the election campaign. New prime minister revealed action programme so-called "A Solidary State" which envisages putting much effort on restoring state function, strengthen securities and social welfare system, economic expansion driven by a rise in employment, and modernization of agriculture. With fiscal stance, it is committed to containing the fiscal deficit as it fixed the fiscal deficit to Zloty 30 billion during 4-year administration. However, JCR considers that a full execution of its policies is

<1/2>

highly unlikely, because the minority government will have to compromise with opposition parties to gain their support in parliament. Moreover, with local elections scheduled for the fall of 2006, there remains the possibility of Pis forming a coalition government with opposition parties including PO. In this situation, Pis is very likely to keep the status quo rather than seek a drastic policy shift.

(2) Economic growth to accelerate on expansion of private demand

The Polish economy grew 3.7% year-on-year in the July-September quarter of 2005, up from 2.8% the previous quarter. As the growth of personal consumption improved to 2.7% from 1.6%, that of gross fixed capital formation accelerated to 5.7% from 3.8%. The latter was given a boost by stronger corporate profit performances and an easy credit policy. Growth of exports declined moderately due to the appreciation of the zloty, but continued outpacing that of imports mainly driven by brisk motor vehicle shipments. JCR forecasts that the economy in 2006 and 2007 will expand around 4% year-on-year on improved domestic demand centering on personal consumption and gross fixed capital formation despite a moderate decline of exports due to the appreciation of the zloty. Consumer price inflation rate rose slightly to 1.6% year-on-year in October 2005 due primarily to higher oil and food prices. But the core inflation rate excluding those temporary factors remained stable at 1.2% in October. The central bank has been keeping its policy rate unchanged at 4.5% since August while maintaining an easy monetary policy bias.

(3) Narrowing current account deficit and fiscal deficit

The government pledged to cut the fiscal deficit in 2005 to 3.7% of GDP from 4.6% in 2004. It looks certain that the actual deficit will prove smaller than projected as the deficit in the first nine months of the year shrank 36.6% year-on-year to Zloty21.8 billion (2.3% of GDP) on a substantial gain in tax revenues. Accordingly, the general government budget deficit (ESA 95) in 2005 is projected to improve to 3.9% of GDP from 4.8% in 2004. The new government revised the fiscal deficit target for 2006 downward to 3.0% of GDP from 3.3% as envisaged in the draft budget prepared by the former government. However, it earmarked expenditures slightly bigger than those in the original draft. This seems to suggest that much of the lower deficit would come from increased tax revenues. JCR will watch carefully how the new government will steer its fiscal policy.

The central bank has announced a major revision of the country's balance of payments statistics for 2004, based on an upward revision of profits earned by foreign-owned companies. The revision has led to a wider current account deficit and bigger foreign direct investment. Specifically, the current account deficit has been revised upward from 1.6% of GDP to 4.3% and a net increase in foreign direct investment from 2.2% of GDP to 4.8%. Despite the revision, however, there has been no change in the ongoing trend of improving current account deficit. The current account deficit in the first ten months of 2005 narrowed to EUR2.9 billion (1.3%) from EUR7.6 billion (3.9% of GDP) in the same period of last year on a reduced trade deficit and increased service and transfer account surpluses. There is little concern over financing of the current account deficit as net inflows of foreign direct investment in the same period came to EUR4.9 billion (2.1% of GDP), far surpassing the deficit. The current account deficit may widen slightly in 2006 and 2007 as imports increase amid continuing economic expansion. But the deficit will remain small.

Main Economic Indicators: The Republic of Poland

		2001	2002	2003	2004	2005(f)	2006(f)	2007(f)
Adopting the euro	Criteria							
(Convergence criteria)	(2004)							
1.CPI (annual average)	2.6%	5.5	1.9	0.7	3.5	2.3	2.0	2.2
2.10 year government bond yield	5.6%	10.7	7.4	5.8	6.9	5.3	5.0	4.8
3.General gov't budget deficit/GDP(ESA95)	Below -3%	-3.9	-3.6	-4.5	-4.8	-3.9	-3.5	-4.0
4.General gov't debt/GDP(ESA95)	Below 60%	36.7	41.2	45.4	43.6	46.5	47.3	48.3
Real GDP growth rate	(%)	1.0	1.4	3.8	5.4	3.0	4.0	4.2
Unemployment rate (year-end)	(%)	18.0	19.7	20.0	19.6	18.5	17.5	16.8
Current account balance/GDP	(%)	-2.9	-2.7	-2.2	-4.3	-2.7	-3.5	-4.1
Trade balance/GDP	(%)	-4.2	-3.9	-2.8	-2.3	-1.9	-2.8	-3.8
Net Foreign Direct Investment/GDP	(%)	3.2	2.1	1.9	4.8	2.3	2.2	2.2
Forex reserves (excl. gold)	(EURmn)	26,747	25,504	25,310	25,314	32,000	33,500	34,500
Imports (G&S) coverage	(months)	4.9	4.6	4.4	3.8	4.3	3.8	3.3
Forex reserves/short-term external debt	(times)	2.1	1.9	1.6	1.4	1.7	1.8	1.8
Gross external debt/ exports (G&S)	(%)	141.8	135.3	131.8	122.7	116.2	105.6	96.8
Gross external debt/ GDP	(%)	39.8	40.5	45.6	48.2	44.0	43.3	43.0
Gross public external debt/exports (G&S)	(%)	58.5	57.1	55.0	55.3	56.5	54.3	51.4
Debt service ratio	(%)	27.9	22.4	18.4	17.7	15.4	16.3	17.5

(Note) Figure for 2005, 2006 and 2007 are based on JCR forecast.

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

(Toshihiko Naito, Senior Analyst)