

2005-59
March 31, 2006

Poland (the Republic of)

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

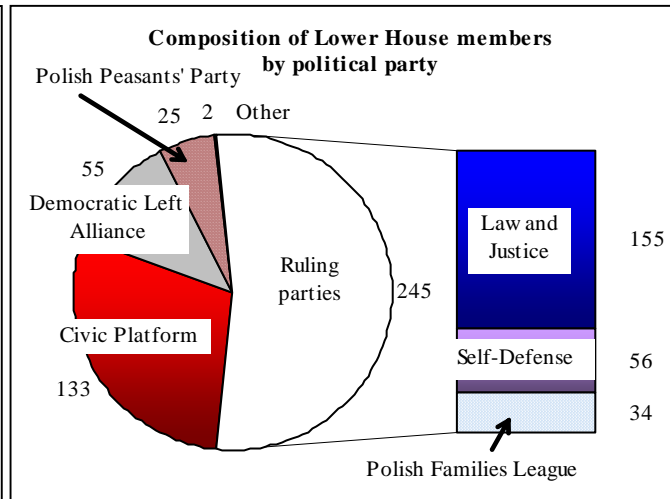
Main Factors for the Ratings

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



Updated: from December 2005 to February 2006

Positive Factors

- Real GDP growth in the October-December quarter of 2005 accelerated to 4.2% year-on-year from 3.7% in the previous quarter.
- Finance Minister Teresa Lubinska was replaced by Zyta Gilowska, a former member of Civic Platform (PO), on January 7.
- The central government budget deficit for 2005 reduced to Zloty 27.5 billion or 2.8% of GDP from Zloty 35 billion in the budget plan. The central government budget plan for 2006, which aims a 2.9% budget deficit, was approved in the parliament on January 24.
- The ruling minority Law and Justice party (PiS) signed a 12 months cooperation agreement with the Self-Defense and the Polish Families League (LPR) on February 2.
- The central bank cuts its policy rate by 25basis points in January and February to 4.0%.
- Current account deficit in 2005 narrowed to 1.6% of GDP (EUR 3.9 billion) from 4.1% in a year earlier.

Negative Factors

- President Lech Kaczynski indicated to have national referendum in 2010 (last year of his presidency) as to when adopting the euro, although he did not rule out the euro adoption.
- With a merger of two local subsidiaries of Italian bank UniCredit, the European Commission gave a warning to Polish government to allow the merger on March 8.
- The European Commission calls on Poland to strengthen the budgetary adjustment in 2006 after having examined Poland's updated convergence programme.

<Prospects and Noticeable Points>

Political stability will not recover temporally amid rapid economic improvement

(1) The ruling PiS submitted a motion to dissolve parliament and call general election in May

Following the general election in September 2005, the ruling right-wing PiS gave up coalition talks with the liberal PO and set up a minority government on its own with the support of the populist Self-Defense and the Catholic nationalist LPR in November 2005. In February 2006, PiS signed a pact with the Self-Defense and LPR to enlist their support from outside the Cabinet. Nonetheless, on March 2006, PiS submitted a motion to dissolve parliament and call general election in May. The motion will be voted by the beginning of April, but it is likely to be disapproved by opposition of PO, the largest opposition party.

(2) The new government has yet to set a target date for euro adoption

Though the former government set a target date for euro adoption in 2009, the new government has yet to specify its own target date. Both Prime Minister Kazimierz Marcinkiewicz and President Lech Kaczynski did not oppose to the adoption of the euro itself, but they have voiced reluctance to adopt the euro during their tenure. In its convergence program revealed in January 2006, the new

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government gave a roadmap to euro adoption, but fell short of specifying target date. JCR sees a country's euro adoption as a very positive factor for its ratings because that would remove risks and costs associated with exchange rate.

(3) 2005 fiscal deficit ended narrower than that of previous year

The 2005 state budget deficit narrowed to 2.8% of GDP from 3.6% of GDP as estimated in the original deficit due primary to larger-than-expected tax revenues brought by economic recovery. The government put the general government fiscal deficit (ESA95) for the year at an estimated 2.9% of GDP (4.7% of GDP if pension reform costs were included). The new government revised the 2006 state budget deficit to 30.6 billion zloty (or 2.9% of GDP) from 32.6 billion zloty (or 3.1% of GDP) in the draft budget prepared by the outgoing government. It made a modest upward revision of expenditures, but the lower deficit estimate was based on a more optimistic revenue projection. The 2006 general government fiscal deficit (ESA95) is expected to decline slightly to 2.6% of GDP (4.6% if pension reform costs were included).

(4) Rapid economic improvement and continuing harmonization with euro-zone economy

Poland's real GDP growth rate decelerated to 3.2% in 2005 from 5.2% in 2004. However, the economy began picking up in the latter half of the year, underpinned by strong domestic demand. The trend is seen sure to continue. The economy is projected to grow more than 4% in 2006 and 2007 on robust domestic demand spurred by increases in real wages, an improving labor market, expanding production and lower interest rates. Consumer price inflation slowed down to 2.1% in 2005 from 3.5% in 2004. The inflation rate stood at 0.7% year-on-year in February 2006, significantly lower than the target (2.5% ± 1%) set by the central bank. The favorable inflation development has prompted the central bank to implement a series of cuts in its policy rate since the end of 2004. The rate now stands at a record low 4.0%. Accordingly, long-term interest rates have been falling, coming closer to those in the euro-zone economy. The unemployment rate, the highest among EU25, has been on the moderate decline, improving to 18.0% in January 2006 from 19.4% a year before. Labor flexibility has been improving with a shift of job opportunities from the agriculture sector, which has large potential unemployment, to manufacturing and service sectors amid the growing number of employed persons. The current account deficit fell to 1.6% of GDP in 2005 from 4.1% in 2004 as an increased income balance deficit was more than offset by a reduced trade deficit and an increased transfer account surplus. The current account balance is highly likely to end up with a smaller deficit in both 2006 and 2007. FDI inflows should easily finance a deficit of that order.

(5) JCR has retained the ratings

As PiS submitted a motion to dissolve parliament, political stability will not recover at least in the short-term. Nonetheless, the economy continues to pick up underpinned by strong domestic demand. JCR has retained the ratings, but continues to watch the development of politics and fiscal reforms.

Main Economic Indicators: The Republic of Poland

		2001	2002	2003	2004	2005	2006(f)	2007(f)
Adopting the euro	Criteria							
(Convergence criteria)	(2005)							
1.CPI (annual average)	2.9%	5.5	1.9	0.7	3.5	2.1	2.0	2.2
2.10 year government bond yield	5.4%	10.7	7.4	5.8	6.9	5.2	5.5	5.2
3.General gov't budget deficit/GDP(ESA95)	Below-3.0%	-3.7	-3.2	-4.7	-3.8	-2.9	-3.5	-3.5
4.General gov't debt/GDP(ESA95)	Below 60%	35.9	39.8	43.9	41.9	42.5	45.0	46.3
Real GDP growth rate	(%)	1.0	1.4	3.8	5.3	3.2	4.0	4.2
Unemployment rate (year-end)	(%)	18.0	19.7	20.0	19.6	18.2	17.5	16.8
Current account balance/GDP	(%)	-2.8	-2.6	-2.1	-4.1	-1.6	-2.3	-3.2
Trade balance/GDP	(%)	-4.0	-3.7	-2.7	-2.2	-1.0	-1.7	-2.5
Net FDI/GDP	(%)	3.0	2.0	2.0	4.6	2.5	2.0	2.5
Forex reserves (excl. gold)	(EUR mn)	26,747	25,504	25,310	25,314	32,797	33,500	34,500
Imports (G&S) coverage	(Months)	4.9	4.6	4.4	3.8	4.4	3.8	3.4
Forex reserves/short-tem external debt	(times)	2.1	1.9	1.6	1.4	1.8	1.8	1.8
Gross external debt/ exports (G&S)	(%)	141.9	135.4	133.2	122.6	112.8	103.6	94.9
Gross external debt/ GDP	(%)	38.4	38.7	44.3	46.2	41.6	41.2	40.9
Gross public external debt/exports (G&S)	(%)	58.5	57.2	56.3	55.3	54.9	53.2	50.4
Debt service ratio	(%)	27.9	22.5	24.9	17.7	11.5	12.3	13.3

(Note) Figures for 2006 and 2007 are based on JCR forecast

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

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