POLAND

Executive Briefing

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Capital Market Dynamics

Foreign Exchange ► The Polish zloty (PLN) remains supported by the country's strong economic and policy foundations, credible management of public finances, investment-grade sovereign credit rating and precautionary credit line with the International Monetary Fund (IMF). The currency was the best-performer in the emerging-market universe vis-à-vis the euro (EUR) in 2012, with a gain of 9.4%. Nevertheless, the nation's considerable links to the euro area and large external financing needs leave the zloty vulnerable to adverse developments in the euro crisis, the global economy and major central bank policy. We envision an underlying trend of appreciation for the PLN over the forecast horizon, with expected year-end EURPLN rates of around 4.02 and 3.92 in 2013 and 2014, respectively.

Sovereign Debt & Credit Ratings ► Poland has enjoyed full investment-grade credit rating status for more than fifteen years. In fact, the nation's long-term foreign-currency sovereign rating has never been downgraded, and each of the major international rating agencies currently maintains a "stable" outlook on their respective ratings (Standard & Poor's "A-", Moody's "A2" and Fitch "A-"). Following a prolonged slide driven largely by the improvement in the global risk environment in the latter half of 2012, both the yield on the government's 10-year bond (currently 4.0%) and the nation's credit default swap rate (91 basis points) reached multi-year lows around the turn of the year.

Economic Outlook

Growth ► Despite a sharp deceleration in the pace of growth last year (to 2.0% from 4.3% in 2011), Poland's real GDP continues to expand. We anticipate that the growth rate will dip slightly lower to around 1⅔% in 2013, but that the large domestic base, stable macroeconomic policy framework and gradual recovery in the global economy will then support a re-acceleration. We expect to see a 2½% advance in 2014, guided by an improvement in labour market conditions (the unemployment rate is currently elevated at 11.3%) and growth-enhancing structural reforms. The resilience of the Polish economy, with around 38.5 million inhabitants, has been demonstrated before; the nation was the only in the EU to avoid a recession during the period of global financial stress in 2008-09. In view of potential external shocks, the Polish authorities obtained a new two-year Flexible Credit Line (FCL) arrangement with the IMF early this year, worth US$33.8 billion. The FCL is intended as a precautionary buffer only (and is not expected to be drawn upon). The country's deep and relatively developed local banking and capital markets render it particularly vulnerable to sudden swings in investor sentiment. The main downside risks relate to developments in the euro area, including economic growth in Germany (on which Poland's manufacturing industry is heavily reliant) and possible deleveraging by European parent banks (two thirds of Poland's banking sector is foreign-owned).

Inflation & Monetary Context ► Inflation has trended lower in Poland since mid-2011 thanks to a credible inflation-targeting monetary policy regime, flexible exchange rate and, more recently, the moderation in domestic demand pressures. The headline rate reached 2.4% y/y in December, and is expected to remain within safe distance of the central bank's 2.5% target over the forecast horizon. The central bank is likely approaching the bottom of the easing cycle initiated late last year, having reduced the reference interest rate by a cumulative 100 basis points since November.

Fiscal & Current Account Balance ► Poland has maintained a countercyclical fiscal stance since 2009, with a large stimulus injection followed by a gradual consolidation program. The general government deficit is estimated at 3½% of GDP in 2012, and is expected to decrease to below the EU-mandated level of 3% by 2014. Budget revenues have benefited greatly from the privatization of state-owned enterprises, which raised roughly US$20 billion in 2008-12 (another $1.6 billion is expected in 2013). The government plans to make permanent a set of fiscal rules, including a public debt ceiling (currently set at 60% of GDP, according to the national definition) and automatic fiscal restraint when the ratio exceeds certain thresholds. The IMF assesses that gross debt will stabilize around 56% of GDP in 2013-14 before turning down. On the external front, Poland has suffered from the downturn in Europe (56% of exports were sent to the euro area in 2011). However, imports also slowed sharply in 2012, allowing the current account deficit to narrow from almost 5% of GDP in 2011 to roughly 3½% in 2012. We expect the deficit to stay around this level in 2013-14.

Institutional Framework & Political Environment

Governance ► The coalition government under Prime Minister Donald Tusk of the centre-right Civic Platform party was re-elected for a second term in 2011. With a slight majority in parliament, the administration is moving ahead on important structural reform plans that were delayed in its first term (among them, pension, tax and labour market reforms). According to the World Bank's Ease of Doing Business report, Poland is the highest improving nation in the OECD across measures of regulatory efficiency since 2005, and is currently ranked 55th of 185 surveyed countries.

Financial Sector ► The Polish banking sector has maintained profitability and capital adequacy through the recent period of external financial turbulence, though it remains subject to changing banking conditions in Europe, given the substantial portion of foreign-owned banks. The Tier 1 capital ratio was 12.8% as of the third quarter of 2012. The non-performing loans ratio has ticked up, however, reaching 8.8% in December, while the pace of private sector credit growth has slowed due to tighter lending conditions (consumer loan growth has been negative since early 2011).

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