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Research Update:

Poland Foreign Currency Rating Lowered To 'BBB+' On Weakening Institutions; Outlook Negative

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Overview

- Since winning the election in October 2015, Poland’s new government has initiated various legislative measures that we consider weaken the independence and effectiveness of key institutions, as reflected in our institutional assessment.
- We have therefore lowered our long-term foreign currency sovereign credit rating on Poland to 'BBB+' from 'A-' and our long- and short-term term local currency sovereign credit ratings to 'A-/A-2' from 'A/A-1'.
- The negative outlook reflects our view that there is at least a one-in-three likelihood that we could lower the ratings within the next 24 months if monetary policy credibility is undermined or if public finances deteriorate beyond our current expectations.

Rating Action

On Jan. 15, 2016, Standard & Poor's Ratings Services lowered its long-term foreign currency sovereign credit rating on the Republic of Poland to 'BBB+' from 'A-' and its long- and short-term local currency sovereign credit ratings to 'A-/A-2' from 'A/A-1'. The short-term foreign currency sovereign credit rating was affirmed at 'A-2'. The outlook is negative.

We also revised our transfer and convertibility (T&C) assessment on Poland to 'A' from 'AA-' (a T&C assessment reflects our view of the likelihood of the sovereign restricting nonsovereign access to foreign currency needed for debt service).

Rationale

The downgrade reflects our view that Poland's system of institutional checks and balances has been eroded significantly as the independence and effectiveness of key institutions, such as the constitutional court and public broadcasting, is being weakened by various legislative measures initiated since the October 2015 election. Poland's new ruling party Law and Justice (PiS), which holds an absolute majority in the parliament (Sejm) and the senate, has set out to make fundamental changes to Poland's institutions. For example, the constitutional court's ability to work efficiently and independently will likely be undermined, in our view, by changes to the court's composition and decision-making process. The government's new media law, as another example, gives the government extensive powers to appoint and control the directors and supervisory boards of public broadcasters. A third law terminates contracts of all current senior, career civil servants and removes a constraint regarding previous party membership, therefore enabling the new government to change the structure of the civil service. In our view, these measures erode the strength of Poland's institutions and go beyond what we had anticipated regarding policy changes from the general election.

The revision of the T&C assessment to 'A', two notches above the foreign currency rating on Poland, reflects our expectation that the Polish government's overall policy inclination will be more interventionist, which could ultimately also impact the foreign exchange market.

The change in the rating outlook to negative reflects our view that there is potential for further erosion of the independence, credibility, and effectiveness of key institutions, especially the National Bank of Poland (NBP). Moreover, we no longer expect Poland’s fiscal metrics will improve as we previously forecast. We also foresee some reversals in Poland’s sound macroeconomic management of the past years, for instance by targeting certain sectors with new taxes.

The ratings remain supported by Poland's relatively moderate external financing needs and strong growth potential. The economy benefits from a floating exchange rate regime and domestic capital markets that permit the government to finance itself in local currency at long-dated maturities. The ratings are constrained by Poland's still low income levels compared with its Western European peers, especially in light of recent Polish zloty (PLN) depreciation and long-term challenges to public finances, primarily stemming from the pension system.

Since winning the Oct. 25, 2015, parliamentary election, Poland’s new government, led by PiS with an absolute majority, has introduced a number of legislative initiatives. A law that changes the decision-making process of the constitutional court, which in our view would undermine its ability to work effectively and make decisions in a timely fashion, was signed into law by President Andrzej Duda before year-end 2015. Similarly, a law that moves the power to appoint the management and supervisory board of public broadcasters to the Treasury Ministry significantly weakens the independence of these institutions and has the potential to make them political instruments, in our view.

While PiS' absolute majority has removed pre-election concerns about increased political instability resulting from fragile coalition arrangements, we expect significant friction will persist between PiS and the opposition. In addition, we see a risk of internal tensions within PiS between more conservative and moderate forces, especially given the growing public discontent about these new measures. Similarly, taxes on banks, insurers, and large retailers seem to be more focused on sectors that are predominantly foreign owned, thereby raising questions about Poland’s attitude toward growth-driving foreign direct investment. Moreover, pronouncements about, for instance, the refugee crisis, may heighten tensions between Poland and many Western-European EU states.

We have upwardly revised our fiscal deficit forecast for 2016 to 3.2% because we consider that various spending-side measures, either planned or announced, are not fully offset by revenue-side measures or expenditure cuts. These measures include a reversal of the previous pension reform so that the retirement age for women will again be lowered to 60 and for men to 65, higher childcare benefits through the Family 500+ program, a higher tax-free allowance and minimum wage, and free medicines for the elderly. Proposals on the revenue side are so far are limited to a 0.44% tax on bank and insurance company assets and a yet-to-be-decided retail turnover tax. In addition, the PiS-led government has decided to amend the expenditure-stabilizing rule, only recently introduced, by substituting actual inflation rates with the 2.5% NBP target, in turn increasing potential expenditure levels. Lastly, the government has decided to amend the 2015 budget to give itself more spending flexibility in 2016, for instance by booking the proceeds of the October LTE (long-term evolution) cell phone network auction (PLN9 billion or 0.5% of 2016 GDP) in 2016 rather than in 2015. Moreover, we do not expect revenue-side measures will be sufficient to compensate for higher spending, and view the macroeconomic assumptions underpinning the 2016 budget as too optimistic. We therefore expect that larger fiscal deficits than we initially forecast will persist in the coming years.

Nonetheless, we expect general government debt will remain broadly stable at about 51% of GDP through to 2018. At the same time, lower debt resulting from last year's pension change and low interest rates continue to contain the government's interest burden, which decreased to 4.6% of general government revenues in 2015. In an environment of changed risk perception and continued political uncertainty, we expect this trend will reverse and push interest costs back up to 5% of general government revenues by 2018. The share of foreign currency debt in total government debt remains somewhat high at 34%, as does the proportion of debt held by nonresidents at 56%. However, the relatively high share of long-term oriented nonresident investors, for instance foreign central banks and public institutions that own around 23% of domestic securities, reduces the risk of sudden large sales of Polish government bonds, in our view.

After a further acceleration over 2015, we expect real GDP growth in Poland will remain strong and average 3.3% over 2016-2018. Stronger domestic demand resulting from income-boosting government policies and a continued recovery in the eurozone, Poland’s main trading partner, bode well for robust economic expansion. Stronger wage growth and subdued inflation will likely continue to boost real incomes further, while a potentially looser monetary policy stance could also help contain household and corporate borrowing costs.

Additional long-term challenges to the Polish economy could arise if the economy fails to move from a growth model relying on cheap labor and labor-intensive industries to higher-value-added and more innovative industries. In that sense, a reform of the loss-making, primarily state-owned coal mining sector might become an important factor, although such reform seems less likely under the PiS government. Similarly, the 2014 change to the pension system, such as the dismantling of its defined contribution pillar, raises questions about the long-term sustainability of the Polish pension system, which will likely be pressured by the government’s decision to revert to a lower retirement age.

We expect the current account deficit will gradually widen over our forecast horizon. Lower import prices and strong exports have helped narrow the deficit, but we expect the import component of Polish exports will remain high and net exports will stay negative. Nevertheless, we think Poland's demonstrated ability to draw on EU funds, and a revival in foreign direct investment, should comfortably finance most of these deficits, despite perpetually high net errors and omissions. However, with tensions between Poland and the EU on the rise, access to EU structural funds may become more difficult. Nonetheless, Poland benefits from some important buffers that we expect will help keep external borrowing costs down. These include a flexible exchange rate regime, which helps the NBP pursue an independent monetary policy, and a flexible credit line with the International Monetary Fund, which was reduced in January 2016 to $18 billion and is expected to be phased out over the coming years.

We anticipate a very gradual reduction of Poland's external debt because the current account deficit will be funded largely through non-debt inflows. We forecast narrow net external debt (external debt net of reserves, plus financial sector assets) will decline to 52% of current account receipts (CARs) in 2019 from about 57% in 2015. Nevertheless, with net external liabilities at 125% of CARs in 2015, a prolonged deterioration of external sentiment or increased volatility on global financial markets could weaken Poland's ability to finance its net external liabilities. Our base case is that gross external financing needs will remain fairly constant at approximately 86% of CARs and usable reserves until 2018.

While the financial sector is generally profitable and predominantly (63%) deposit funded, and we classify it in group '5' of our Banking Industry Country Risk Assessment (see "Banking Industry Country Risk Assessment: Poland," published June 30, 2015, on RatingsDirect), we nevertheless believe it may experience a period of heightened stress. We expect three factors will affect banks in Poland in 2016. The introduction of a banking sector tax of 0.44% on assets is going through the parliamentary process, while a decision on a conversion of about 570,000 Swiss-franc-denominated mortgage loans (into zloty) has yet to be made. In addition, the government is requiring Polish banks to step up their contributions to the deposit guarantee fund following the bankruptcy of a small lender, SK Bank. Although the issue of a conversion of Swiss franc mortgage loans had moved out of focus since the elections, the President unveiled a proposal on Jan. 15, 2016. While the exact consequences of this proposal for the financial sector remain uncertain, we expect certain institutions will come under more stress. Lastly, PiS will have significant power to shape the future path of monetary policy because the Polish president, parliament, and senate can nominate a total of nine new monetary policy council members, including the governor of the NBP, in 2016.

Outlook

The negative outlook reflects our view that there is at least a one-in-three possibility that we could lower our ratings on Poland in the next 24 months.

We could lower the ratings if we perceived a further weakening in the independence, credibility, and effectiveness of key institutions, most importantly the NBP. In addition, we could lower the ratings if public finances deteriorated beyond our current baseline scenario as the revenue and expenditure balance becomes more negative.

On the other hand, a reversal of the government's efforts to change and control Poland's key institutions, as well as sustained strong external performance, leading to further reductions in net external debt could lead us to revise the outlook to stable.

Key Statistics

Table 1

Republic of Poland Selected Indicators

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
ECONOMIC INDICATORS (%)										
Nominal GDP (bil. LC)	1,445	1,567	1,629	1,656	1,719	1,797	1,893	2,005	2,127	2,256
Nominal GDP (bil. $)	479	529	500	524	545	483	483	514	549	586
GDP per capita (000s $)	12.6	13.9	13.1	13.8	14.3	12.7	12.7	13.6	14.5	15.5
Real GDP growth	3.7	5.0	1.6	1.3	3.3	3.5	3.4	3.3	3.2	3.2
Real GDP per capita growth	4.0	4.9	1.6	1.3	3.5	3.6	3.5	3.4	3.3	3.3
Real investment growth	(0.4)	8.8	(1.8)	(1.1)	9.8	7.2	6.1	6.3	5.9	5.9
Investment/GDP	21.3	22.4	21.0	19.0	20.3	20.4	20.7	21.1	21.4	21.6
Savings/GDP	15.9	17.3	17.3	17.7	18.2	19.5	19.4	19.4	19.6	19.9
Exports/GDP	40.0	42.5	44.4	46.3	47.4	48.8	48.9	49.0	49.5	49.9
Real exports growth	12.9	7.9	4.6	6.1	6.4	7.2	4.9	3.8	3.3	3.0
Unemployment rate	9.7	9.7	10.1	10.3	9.0	8.0	7.9	7.8	7.8	7.7
EXTERNAL INDICATORS (%)										
Current account balance/GDP	(5.4)	(5.2)	(3.7)	(1.3)	(2.0)	(0.9)	(1.3)	(1.7)	(1.8)	(1.8)
Current account balance/CARs	(12.2)	(11.0)	(7.6)	(2.5)	(3.9)	(1.6)	(2.5)	(3.1)	(3.3)	(3.2)
Trade balance/GDP	(3.0)	(3.5)	(2.1)	(0.1)	(0.8)	(0.2)	(0.7)	(0.9)	(1.0)	(1.1)
Net FDI/GDP	1.9	2.6	1.2	0.8	2.0	1.2	1.2	1.2	1.2	1.2
Net portfolio equity inflow/GDP	1.4	0.7	0.6	0.3	0.1	0.1	0.2	0.2	0.2	0.2
Gross external financing needs/CARs plus usable reserves	99.0	96.3	91.4	85.3	88.4	84.8	84.6	86.2	87.7	89.1
Narrow net external debt/CARs	69.1	57.5	67.7	66.0	55.6	56.9	57.9	56.0	53.7	51.8
Net external liabilities/CARs	151.2	116.5	141.4	143.6	119.6	125.1	127.9	123.8	118.7	114.3
Short-term external debt by remaining maturity/CARs	22.8	20.6	19.1	16.7	16.9	15.5	15.2	14.5	13.5	12.8
Reserves/CAPs (months)	3.9	4.0	4.3	4.7	4.2	4.5	4.6	4.2	3.9	3.5
FISCAL INDICATORS (%, General government)										
Balance/GDP	(7.5)	(4.9)	(3.7)	(4.0)	(3.3)	(2.8)	(3.2)	(3.0)	(3.0)	(2.9)
Change in debt/GDP	6.4	5.2	1.7	2.9	(3.5)	3.2	3.1	2.9	2.9	2.9
Primary balance/GDP	(5.0)	(2.3)	(1.0)	(1.5)	(1.4)	(1.1)	(1.4)	(1.1)	(1.1)	(1.0)

Table 1

Republic of Poland Selected Indicators (cont.)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Revenue/GDP	38.1	38.8	38.9	38.4	38.8	38.6	38.2	38.2	38.2	38.2
Expenditures/GDP	45.6	43.6	42.6	42.4	42.1	41.4	41.4	41.2	41.2	41.1
Interest /revenues	6.5	6.5	6.8	6.5	5.0	4.6	4.7	4.9	5.0	5.1
Debt/GDP	53.3	54.4	54.0	55.9	50.4	51.4	51.9	52.0	51.9	51.7
Net debt/GDP	49.9	51.1	50.4	53.4	46.9	47.6	48.3	48.5	48.6	48.7
Liquid assets/GDP	3.4	3.3	3.6	2.6	3.6	3.9	3.7	3.5	3.3	3.1
MONETARY INDICATORS (%)										
CPI growth	2.7	3.9	3.7	0.8	0.1	(0.4)	1.2	2.1	2.5	2.5
GDP deflator growth	2.3	3.2	2.4	0.4	0.4	1.0	1.9	2.5	2.8	2.8
Banks' claims on resident non-gov't sector growth	6.8	15.9	3.8	3.6	10.9	8.0	5.4	5.9	6.1	6.1
Banks' claims on resident non-gov't sector/GDP	57.7	61.7	61.6	62.8	67.0	69.3	69.3	69.3	69.3	69.3
Foreign currency share of claims by banks on residents	21.3	22.7	19.8	18.5	17.6	23.9	N/A	N/A	N/A	N/A

Savings is defined as investment plus the current account surplus (deficit). Investment is defined as expenditure on capital goods, including plant, equipment, and housing, plus the change in inventories. Banks are other depository corporations other than the central bank, whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private- sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. LC--Local currency. CARs--Current account receipts. FDI--Foreign direct investment. CAPs--Current account payments. N/A--Not applicable. The data and ratios above result from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

Republic of Poland Ratings Score Snapshot	
Key rating factors	
Institutional assessment	Neutral
Economic assessment	Neutral
External assessment	Neutral
Fiscal assessment: flexibility and performance	Neutral
Fiscal assessment: debt burden	Neutral
Monetary assessment	Strength

Standard & Poor's analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional assessment; (ii) economic assessment; (iii) external assessment; (iv) the average of fiscal flexibility and performance, and debt burden; and (v) monetary assessment. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of Standard & Poor's "Sovereign Rating Methodology," published on Dec. 23, 2014, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with Standard & Poor's sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- Criteria - Governments - Sovereigns: Sovereign Rating Methodology - December 23, 2014
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Methodology: Criteria For Determining Transfer And Convertibility Assessments - May 18, 2009

Related Research

- Sovereign Risk Indicators, Dec. 14, 2015. An interactive version is available at www.spratings.com/sri
- Central, Eastern, and Southeastern Europe Sovereign Rating Trends Mid-Year 2015, July 13, 2015
- The Emerging Market Sovereign Outlook: What's Gone Wrong?, Oct. 20, 2015
- Why Politics Matters To Sovereign Ratings, Nov. 6, 2015
- The Heat Is On: How Climate Change Can Impact Sovereign Ratings, Nov. 25, 2015
- Who's At Risk? Emerging Market Sovereigns Are Facing Adverse Global Trends, Sept. 29, 2015
- Global Sovereign Rating Trends 2016, Jan. 6, 2016
- Default, Transition, and Recovery: 2014 Annual Sovereign Default Study And Rating Transitions, May 18, 2015
- Credit FAQ: What's Ahead For Emerging Market Sovereigns In 2016, Dec. 10, 2015

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision. After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that the institutional assessment has deteriorated. All other key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria and Research').

Ratings List

	Rating	
	To	From
Poland (Republic of)		
Sovereign credit rating		
Foreign Currency	BBB+/Negative/A-2	A-/Positive/A-2
Local Currency	A-/Negative/A-2	A/Positive/A-1
Transfer & Convertibility Assessment	A	AA-
Senior Unsecured		
Foreign Currency	BBB+	A-
Local Currency	A-	A
Short-Term Debt		
Foreign Currency	A-2	A-2
Local Currency	A-2	A-1

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495)

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