Creditreform Sovereign Rating

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Rating Object	Rating Information		
REPUBLIC OF POLAND	Assigned Ratings/Outlook: **A /stable**		Type: Follow-up Rating, unsolicited
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	31-03-2017 02-03-2018 “Sovereign Ratings”	

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Rating Action

Neuss, 02 March 2018

Creditreform Rating has affirmed the unsolicited long-term sovereign rating of “A” for the Republic of Poland. Creditreform Rating has also affirmed Poland’s unsolicited ratings for foreign and local currency senior unsecured long-term debt of “A”. The outlook is stable.

Key Rating Drivers

1. Continuing income convergence towards EU-28 levels, driven by solid GDP growth on the back of robust private consumption and recovering public investment; output expansion is set to remain robust in the medium term
2. Track record of spending discipline over the recent years; fiscal deficit in 2016-17 significantly lower than targeted
3. Moderate levels of government debt are balanced against risks stemming from elevated share of FX debt and building expenditure pressure owing to demographics
4. Despite generally strong institutional framework, Poland’s key governance indicators rank below A-rated peers; adoption of a controversial judicial reform in Dec-17 led to intensifying tensions with the EU commission
5. Balanced current account in 2017 due to improving income balance; risks associated with a highly negative NIIP are somewhat tempered by the fact that FDI accounts for the bulk of external liabilities

Reasons for the Rating Decision

Our assessment of the Republic of Poland’s high level of creditworthiness continues to be supported by a diversified, competitive economy, and continued income convergence towards EU-28 levels aided by a strong macroeconomic performance.

Last year, Poland’s real GDP expanded steadily over the course of the year and growth did not show any signs of weakness in light of ongoing political tensions with the EU (see below). In the first three quarters, q-o-q GDP growth was reported at 1.1, 1.0 and 1.2%, respectively. According to a flash estimate by Statistics Poland, growth held up well at the end of the year, posting at 1.0 (Q4), and annual growth came in at 4.6% in 2017, significantly above the 2016 growth rate of 2.9%. The economy’s strong growth performance in

2017 was entirely driven by vibrant domestic demand, which contributed 4.5 p.p. to GDP growth. Growth in household spending accelerated for the fourth consecutive year and came in at 4.8% (2016: 3.9%). Private consumption was buoyed by the rising purchasing power of households, as disposable household income was boosted by additional social benefits (Family 500+), as well as by vividly growing gross wages which outpaced inflation by a wide margin. What is more, investment, which dented economic activity in 2016, turned the corner. After a 7.9% drop due to the transition to the new European Structural and Investment (ESI) funds' 2014-20 funding period, gross fixed capital formation returned to growth last year and expanded by 5.4%. To be sure, the recovery in gross fixed capital formation was primarily led by government investment. While public investment gained momentum in Q2 and Q3-17, posting double-digit y-o-y growth rates, business investment has not picked up so far. Contrary to 2016 (+0.7 p.p.), net exports made no meaningful contribution to GDP growth (+0.1 p.p.). As Eurostat data reveals, nominal y-o-y growth in imports (9.2%) was broadly in line with exports (9.1%) in the first nine months of the year. Export growth was supported by stronger demand from EU partners, but also from Russia and the US, mirroring the cyclical recovery of the world economy.

As regards Poland's near term economic prospects, we expect output growth to decelerate to 4.0% this year. Domestic demand should remain the main driver of GDP expansion, although we believe that household spending will lose some steam. Private consumption will presumably weaken somewhat as the anticipated pick-up in inflation is likely to limit further gains in real disposable income. Taking into account already tight labor market conditions, we also believe that employment growth is set to slow down somewhat. Meanwhile, we expect investment to strengthen in 2018. Our positive outlook on investment is underpinned by EU commission data, according to which the share of ESI-funds allocated to specific investment projects significantly increased to 55% at the end of 2017 (2016: 22%). Against this backdrop, we anticipate a higher drawdown on funds in 2018. Moreover, higher capital expenditures of private enterprises should be conducive to investment this year. Capacity utilization continued to trend upwards throughout 2017, reaching an all-time high in Q1-18. As financing conditions should remain favorable, we expect NFCs to ramp up spending on machinery and equipment. On the other hand, net exports should weigh on Poland's growth performance this year. Driven by robust domestic investment activities, we anticipate import growth to outpace export growth, resulting in a slightly negative growth contribution from net exports.

Looking ahead, we believe that the Polish economy will continue to experience robust but somewhat more moderate growth as both consumption and investment should lose some momentum. As a result of weaker domestic demand, net exports should be less of a drag on growth than in 2018. Beyond 2019, we expect GDP to evolve in line with the economy's potential growth of about 3% (EU Commission estimate). As a result, Poland should continue to catch-up with EU-28 income levels. As IMF data reveal, per capita income has more than doubled since Poland entered the European Union. Last year, GDP per capita was reported at USD 29.251 (in PPP terms), up from USD 14.176 in 2004. More importantly, rising per capita income continues to boost income convergence. As measured by EU-28 levels, Polish GDP per capita rose from 50.3% to 71.5% 2004-17. Note-

worthy is that the catching-up process experienced no setbacks. Unlike peers from Central and Eastern European (CEE) countries, the Polish economy experienced no recession during the financial crisis and thus continued to close the income gap even in 2008-10.

Notwithstanding, medium-term growth prospects are challenged by low levels of private investment and a projected decline in labor force. In 2017, Poland’s private investment-to-GDP ratio was estimated at 14.0%, one of the lowest among CEE countries (CZ: 21.7%; HU: 17.0%). At the same time, adverse demographic developments are expected to weigh on labor supply in the medium term. As highlighted by the EU Commission’s 2018 Ageing Report, the share of Poland’s population at working age (15-64y) should decrease from 68.7% in 2016 to 61.1% in 2040, assuming net migration remains negligible. To be sure, trends in labor market participation have been positive in recent years. Over the last decade, the participation rate climbed from 63.2 (2007) to 68.8% (2016) and further increased to 69.8% in Q3-17. Still, participation rates remain well below the EU-28 average of 73.1%. In general, Poland’s labor market continued to perform well in 2017, with unemployment rates falling from 6.2 (2016) to a historically low 4.9%, driven by broad-based employment growth. Concurrently, wage growth in the private sector gained momentum, but can be regarded as relatively moderate against the background of the strong labor market performance, which is mainly explained by the inflow of working immigrants from Ukraine and the dampening effect on compensation. After average monthly gross wages had grown by 3.5 and 3.8% in 2015-16, the respective growth rate posted at 5.9% last year. Going forward, wage growth is likely to accelerate, mainly due to the increasingly tight labor market, with labor shortages becoming more widespread.

On the back of the favorable labor market development and strong domestic demand, higher wages are likely to translate into increasing core inflation – which we expect to be the main driver of inflation going forward. Last year’s recovery in headline inflation was mainly a result of rebounding food and energy prices. After two years of deflation, growth in consumer prices turned the corner in 2017, reaching 2.0% (2016: -0.6%). Taking into account that the National Bank of Poland (NBP) targets a CPI-inflation rate of 2.5% with a fluctuation band of +/- 1 percentage point and consumer prices which NBP forecasts to increase by 2.3 and 2.7% in 2018-19 under current policies, we anticipate a first interest rate hike in the first half of 2019. At its February meeting, the Monetary Policy Council decided to continue with its accommodative policy stance, keeping the reference rate at a historically low 1.5%.

Our credit assessment also factors in moderate levels of government debt and a buoyant fiscal performance in 2016-17, which was partly a result of the successful implementation of tax compliance measures.

At the general government level, we expect the headline deficit to narrow from 2.5% to 1.6% of GDP in 2016-17, significantly lower than the targeted 2.9% projected in the administration’s 2017 convergence program. Our expectation is underpinned by quarterly data, according to which the government accounts reported a surplus of PLN 2.4bn, up to the third quarter of 2017 (Q1-Q3-16: PLN -18.4bn). The improved fiscal position mainly resulted from strong economic activity which translated into higher revenues. According

to Eurostat, total government receipts increased by 8.5% y-o-y between January and September 2017. VAT-revenue leapt by 21.2% in the first nine months of 2017 as compared to the same period one year before. Although VAT receipts were partly boosted by a shift in refunds which was recorded in Q1-17, double-digit y-o-y growth rates in Q2- and Q3-17 point to a robust expansion of the underlying tax base and some progress in VAT-enforcement. In 2016-17, Poland launched a range of anti-VAT-fraud measures, which seem to be bearing fruit. Among the measures taken was the introduction of a reverse charge in the construction sector, lower thresholds for cash transactions, and the merging of tax and customs authorities. According to the NBP's estimates, Poland's VAT gap – which was one of the highest in the EU in 2015 at 24.5% of GDP – should have significantly narrowed in 2016-17. Despite policies which had a dampening effect on revenue, such as a rate cut from 19 to 15% for small businesses and a higher tax free allowance for low-income individuals, tax revenue also surprised on the upside last year.

Turning to the expenditure side of the budget, spending increased by 4.4% y-o-y in the months up to Sep-17. Above all, expenditure growth was driven by the gradual recovery of public investment. Growth in government investment, which had been negative in the first quarter (-2.8% y-o-y) turned positive in mid-2017, expanding by 13.1 and 22.2% in Q2 and Q3 respectively. In total, spending on investment projects increased by 13.9% in the period of Jan-Sep-17. The implementation of several social policy initiatives in the recent past have not resulted in significantly higher levels of spending as yet. Social benefit payments grew by a moderate 3.9% in the first three quarters of 2017. This appears noteworthy, as 2017 was the first year in which the new child benefit scheme "family 500+" fully impacted the state budget. Implemented in late 2016, the program is providing 2.6 million families with income support.

With regard to 2018, the Polish government should maintain its current fiscal stance, which can be regarded as procyclical, as the output gap was closed in 2017 and is expected to widen going forward (NBP estimates). While public investment should be boosted by increasing co-financing needs related to a stronger drawdown on EU structural funds in the run-up to the local elections in 2018, spending on pensions will likely increase in 2018 as pension eligibility criteria were eased in Q4-17. Rolling back the previous government's pension reform, which increased the retirement age to 67 years, the statutory retirement age was lowered to 65 and 60 years for men and women, respectively. At the same time, we expect growth in tax receipts and social security contributions to benefit from robust GDP growth and further improvements in the labor market. The implementation of additional tax compliance measures could provide some tailwinds to revenues, but taking into account that tax collection has already seen a remarkable improvement in the recent past, the revenue-enhancing effect of additional measures is hard to predict. Tax compliance measures which enter into effect in 2018 include an obligation for all companies to file Standard Audit File for Tax (SAF-T) electronically and the introduction of a VAT split-payment regime. On the whole, we anticipate the government deficit to stabilize at current levels, well below the EDP threshold of 3% GDP.

In the medium term, however, rising spending needs on infrastructure and pensions could hamper fiscal consolidation. As of now, Poland is the largest beneficiary of ESI funds.

The EU commission estimates that total fund allocations in 2014-20 will make up for about half of the country's public investment budget. Given that the size of the EU's next multiannual budget is yet unknown, we see the risk of a cut in structural funds allocations in 2021-27. Replacing ESI funds could prove challenging, especially in the light of recent pension policy decisions, which are expected to weigh on the state budget in the medium term. After the government has already lowered the statutory retirement age in Okt-17, additional costs could result from the introduction of a universal minimum pension of PLN 1.000, as proposed by the social insurance board (ZUS). To be sure, the government is aware of the need to overhaul the existing pension system in order to safeguard sustainability and adequacy of future pension payments. In Feb-18, the government released a draft bill, which aims to strengthen the take-up of occupational pension schemes (PPK). According to the law proposal, employees would be automatically enrolled but with the right to opt out. The draft law has been submitted for public consultation.

The sovereign's debt-to-GDP ratio, which totaled at 52.0% of GDP in Q3-17, should remain close to this level in 2018-19, before gradually declining thereafter. Although the government's debt burden is moderate by European standards (EU-28: 82.5% of GDP), the composition of the debt stock points to an elevated exposure to FX risks, as a comparatively large share of treasury debt is denominated in foreign currencies. As of Nov-17, foreign currency debt, which is dominated by EUR and USD borrowing, accounted for one third (30.9%) of the state's total debt stock, implying the risks of unfavorable foreign exchange developments.

With regard to the financial sector, we believe that there are no imminent risks which could have an adverse impact on public finances in the near term. Financial soundness indicators signal that the Polish banking sector is in good shape. In general, Polish banks are characterized by a stable funding base, sound asset quality, and strong capital buffers. While the CET1 ratio was reported at 16.5% (Q3-17), which compares favorably with an EU-28 average of 14.3%, the NPL ratio dropped from 6.5 to 6.0% between Q3-16 and Q3-17. However, banks' relatively high reliance on net interest income appears to be detrimental to profitability in the current low-interest-rate environment. As of Q3-17, net interest income accounted for 68% of total operating income of Polish banks (EU-28: 56.5%). Going forward, the solution for foreign currency mortgages may put additional strain on bank earnings. In August 2017, President Duda submitted a modified draft law to parliament. The bill envisages the creation of a fund which provides assistance to distressed FX borrowers. Quarterly contributions to the fund, amounting to 0.5% of the respective FX mortgage portfolio size, would be financed by payments from banks. After the president's proposal has been approved by the government, legislation is currently being finalized by a parliamentary commission. Assuming no major changes to the draft law, we expect that additional costs for the banking sector will be manageable. Taking the volume of FX mortgages on bank balance sheets in Dec-17, which amounted to PLN 135.2bn, we calculate annual fund contributions to total at about PLN 2.7bn – an amount which is unlikely to curtail banks' lending capacity.

Our institutional assessment balances Poland's economic and political integration in the European Union, prudent and credible monetary policies, and generally high levels of

government effectiveness against increasing concerns related to a weakening of judicial independence.

Although Poland features a generally high institutional quality, we note that the country scores below average on all of the World Bank's World Governance Indicators (WGI) as compared with its A-rated peers. Furthermore, we observed some deterioration in 2014-16 regarding the quality of public services and the legal framework. Currently, Poland ranks 56th and 54th out of 209 countries on the WGI indices government effectiveness and rule of law, down from rank 54 and 48 in the World Bank's 2014 assessment. Against this backdrop, it has to be mentioned that the Polish government pushed ahead with the implementation of controversial judicial reforms last year. Legislation passed in Aug-17 provided the justice minister with the authority to dismiss judges. After having vetoed two additional reform bills in June, president Duda finally approved a new legislative proposal of the government on 20 Dec 2017. One law allows politicians to choose the members of the National Judiciary Council (KRS), which appoints judges, while the other lowers the retirement age for Supreme Court judges. The EU commission stated that there was a serious threat to the rule of law and triggered Article 7 of the Lisbon treaty. Ultimately, sanctions under Article 7 could lead to a suspension of Poland's voting rights at EU summits. Poland has been given three months to address the aforementioned concerns before EU leaders vote on the procedure in March 2018. To be sure, a suspension of voting rights is not our base-case scenario, as this would require the unanimously approval of all member states. Notwithstanding our expectation that an imposition of sanctions is unlikely in the near term, the Article 7 process could play an important role when EU members begin their negotiations on the EU's 2021-27 budget cycle.

Turning to the economy's external performance, Poland achieved an albeit moderate current account surplus (PLN 1.85bn) in 2017 for the first time since it entered the European Union – mainly due to an improving secondary income balance. At the same time, the primary income deficit stabilized at PLN 76.2bn, mirroring employee compensation of the large Ukrainian workforce in Poland. Turning to trade, a rising services surplus compensated for a somewhat weaker trade in goods balance. Last year, Poland's trade in services surplus increased for the fourth consecutive year. Looking forward, we expect a deterioration of the current account which is likely to come on the back of strengthening domestic demand.

As most other transition economies, Poland is an international net debtor, indicated by a comparatively large and negative NIIP, which continued to stabilize last year (Q3-17: -64.7% of GDP). Although this implies elevated external vulnerabilities, we believe that risks associated with a high level of externally held liabilities are somewhat mitigated by the composition of the NIIP. As NBP data reveals, foreign direct investment accounted for almost half (44.6%) of external liabilities in Q3-17. What is more, the Ministry of Finance announced it would quit its precautionary USD 9.2bn IMF credit line in Oct-17. We view this action as a sign of confidence towards international capital markets. Accounting for healthy corporate balance sheets (debt-to-GDP ratio: 86.3% in Q3-17), moderate government debt levels and official reserve assets, which covered imports by factor 5.3 in

Nov-17, we believe that the Polish economy should be able to service its external debt even in the event of a sharp economic downturn.

Rating Outlook and Sensitivity

Our Rating outlook on the long-term sovereign rating is stable, as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – will remain fundamentally unchanged in the next twelve months.

Our A rating could be lowered if adverse developments lead to substantially lower-than-expected medium-term growth. Given the economy's strong trade linkages with its neighboring countries, a pronounced slowdown in economic activity in the euro area would likely dampen Polish GDP growth. We could also consider a downgrade if we observe a significant deterioration of public finances, or if the Polish government implements additional institutional reforms, which raise concerns about the independence of the judiciary. Weakening the country's institutional framework could lead to an erosion of international investor confidence as well as to a lower allocation of ESI funds in the EU's next multiannual budget. As public investment is characterized by a high reliance on structural funds, significantly lower fund inflows could be detrimental to the economy's medium-term growth trajectory.

By contrast, our rating could be raised if the Polish economy grows at higher-than-expected rates over the medium term, e.g. resulting from a faster-than-expected absorption of ESI funds or if policy measures are implemented, which put general government debt on a steeper downward trajectory.

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Ratings*

Long-term sovereign rating	A /stable
Foreign currency senior unsecured long-term debt	A /stable
Local currency senior unsecured long-term debt	A /stable

*) Unsolicited

Economic Data

	2012	2013	2014	2015	2016	2017e	2018e
Real GDP growth	1.6	1.4	3.3	3.8	2.9	4.6	4.0
GDP per capita (PPP, USD)	23,360	24,068	25,334	26,613	27,690	29,251	30,827
Inflation rate, y-o-y change	3.7	0.9	0.0	-0.9	-0.6	2.0	2.3
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a	n.a
Life expectancy at birth (years)	76.7	77.0	77.6	78.2	n.a.	n.a	n.a
Fiscal balance/GDP	-3.7	-4.1	-3.6	-2.6	-2.5	-1.6	-1.7
Current account balance/GDP	-3.7	-1.3	-2.1	-0.6	-0.3	n.a	n.a
External debt/GDP	73.7	73.2	65.4	69.4	71.9	n.a	n.a

Source: International Monetary Fund, World Bank, Eurostat, own estimates

Appendix

Regulatory Requirements

This sovereign rating is an unsolicited credit rating. Neither the rated sovereign nor a related third party participated in the credit rating process. Creditreform Rating AG had no access to the accounts, representatives or other relevant internal documents for the rated entity or a related third party.

The rating was conducted on the basis of CRAG´s “Sovereign Ratings” methodology. CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG´s rating methodologies is published on the following internet page: www.creditreform-rating.de.

To prepare this credit rating, CRAG has used following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, Central Bank of Poland, Republic of Poland - Ministry of Finance, Statistics Poland.

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with and that the rating action was and is free of any existing or potential conflicts of interest. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG´s “Sovereign Ratings” methodology. The main arguments that were raised in the discussion are summarized in the “Reasons for the Rating Decision”.

In the case of a rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In regard to the rated entity CRAG regarded available historical data as sufficient.

In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

In accordance to Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit

ratings issued in the past and on their changes. Requested data are available on the ESMA website: https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

An explanatory statement of the meaning of CRAG`s default rates are available in the credit rating methodologies disclosed on the website.

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