Creditreform Sovereign Rating

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

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Rating Action

Neuss, 31 March 2017

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

Key Rating Drivers

1. Very strong and robust growth performance that has been accompanied by steady convergence progress towards EU income levels; output growth set to pick up on the back of stronger drawdown of EU funds
2. Controversial policy initiatives and policy-making becoming somewhat less predictable, leading to a deterioration in business confidence, but generally high quality of institutional set-up
3. Although debt-to-GDP ratio is on a rising trajectory, public debt is at moderate levels; despite increase in outlays, deficit target as stipulated in 2017 Budget Act expected to be met
4. Elevated external risks, as indicated by high degree of trade openness and external financing needs, balanced against recent renewal of Flexible Credit Line with the IMF

Reasons for the Rating Decision

Our assessment of the Republic of Poland's high creditworthiness is reflected in the economy's convergence with the European Union's income levels on the back of strong economic growth as well as its solid public finances, while mainly constrained by external factors.

Poland's generally strong institutional framework is balanced against rising political uncertainty caused by controversial policy initiatives since late 2015. As regards the quality and efficiency of public administration and the control of corruption, the sovereign has recorded some improvement since it joined the EU. An assessment of the World Bank's government effectiveness index shows that the country is currently ranked 54th out of 209

countries (2015) – up from rank 61 in 2004. Meanwhile, Poland improved its ranking for rule of law from 79 to 50 and also achieved a better scoring on the control of corruption index (2015: rank 62/209, 2004: rank 86/206).

Notwithstanding, it should be noted that Poland still ranks below the EU-28 median on most World Governance Indicators and some actions taken by the current administration raised concerns over a potential weakening of the country's key institutions – in particular the Constitutional Tribunal. The appointment of five new judges by the governing PiS-party (Nov-15) complemented by legislative changes regarding the role and functioning of the Tribunal (Dec-15), prompted the EU Commission to issue two Rule of Law Recommendations (Jul-16 and Dec-16), setting out concerns on the independence and efficiency of the Tribunal under the new legal framework. The Polish Ministry of Foreign Affairs, however, dismissed these concerns in an official response (Feb-17), stressing that all changes implemented to the court are in line with European standards.

Uncertainty was further aggravated by limited public and parliamentary consultation during the legislative process, which eventually resulted in the withdrawal of two major law proposals last year. A draft law proposing the mandatory conversion of FX mortgages had to be withdrawn in view of financial stability risks (see below) which were deemed to be too high by Poland's Financial Supervision Authority (KNF). In the same vein, a tax on retail sales had to be suspended, following doubts whether such as tax is compliant with EU competition rules.

Going forward, we view quality and predictability in policymaking and regulation as key for preserving Poland's favorable business environment, which has been conducive to growth in recent years. In the 2017 World Bank Doing Business report, Poland was placed 24th, up from rank 25 one year before. This improvement can mainly be attributed to measures tackling business impediments related to building permits and insolvency resolution. Amendments to the Bankruptcy and Recovery Law, which came into effect January 2016, have introduced new restructuring mechanisms, allowing creditors greater participation in insolvency proceedings and establishing a Central Reorganization and Bankruptcy Register.

Our credit assessment also factors in the buoyant macroeconomic performance. Poland has displayed a remarkable track record of income convergence towards EU levels. To be sure, Poland's per capita income is somewhat below that of other CEE peers; as measured by IMF data, GDP per capita is estimated to post at USD 27,715 (PPP terms) in 2016 as compared to USD 33,223 in the Czech Republic or USD 29,882 in Lithuania. However, the country is catching up more steadily and rapidly with EU levels than other CEE economies. Thus, Poland's GDP p.c. stood at 69% of the EU average in 2015, 19 p.p. above the level seen ten years before. The fast progress in closing the income gap with the EU is mainly due to the robust and high growth rates of the recent past. Unlike the other members of the EU, Poland did not experience a recession during the last ten years. What is more, Poland's economy recorded the second highest average GDP growth in the EU-28 between 2007 and 2016 (3.6%).

Though the Polish economy still outpaced that of most EU members and stood well above the EU average, growth has edged down in the last year. While Poland's GDP growth came in at rates of 3.3 and 3.9% in 2014 and 2015, respectively, it expanded by 2.8% in 2016 (EU-28: 1.9%). Growth fell short of the strong performance seen in 2014/15 as it was dented by weakening gross fixed capital formation, which decreased by 5.5% as compared to the previous year. As in other CEE countries, the transition to the new 2014-20 programming period and the concurrent delayed absorption of European Structural and Investment (ESI) Funds sent investment outlays plummeting. As of 21 March 2017, EUR 19.2bn have been allocated to concrete investment projects (22.3% of total EU funds available), of which approx. EUR 3.7bn have been spent so far. With an allocation of EUR 86.1bn, the country is the largest beneficiary of the ESI funds in the EU. According to AMECO data, public investment fell by 13.5% while private investment also declined, however to a somewhat lesser degree (-2.8%). Meanwhile, brisk private consumption spending was again the main driver of Polish output growth, increasing by 3.6% y-o-y, underpinned by the strong labor market performance and additional child benefits which translated into rising disposable incomes. The "Family 500+" program was introduced in November 2015 and has been in place since April 2016. It is geared towards increasing the birth rate and supporting large and low-income families, providing families with at least two children with a monthly allowance of PLN 500 per child.

The labor market is in good shape and has been steadily improving. Labor participation has increased over recent years, as the active population made up 68.8% of total population aged of 15-64y in Q3-16 (Q3-13: 67.1%), albeit standing below the EU-28 average of 73.1%. Unemployment rates declined sharply from 10.3% in 2013 to 6.2% in 2016. More recently, the unemployment rate fell to a record low of 5.4% in January 2017 on a monthly average, down from 6.7% a year before. At the same time, average monthly real gross wages and salaries have increased by 4.2%, after 3.2 and 3.5% in 2014 and 2015, respectively. Also, monthly minimum wages have significantly increased, from PLN 1.850 to 2.000 (+8.1%) – the tenth increase since 2007 (PLN 936). Most importantly, the accelerating wage growth does not seem to entail adverse effects on the cost-competitiveness of the Polish economy, as productivity kept pace. Thus, real compensation per employee increased by 10.3% in 2010-16, as compared to an average +2.4% in the EU. However, real labor productivity per person exceeded real compensation growth as it improved by 14.3% over the same period (EU-28: +4.4%).

Looking forward, we expect GDP growth to accelerate significantly in view of a markedly higher absorption rate of ESI Funds. In our baseline scenario, we forecast GDP to expand by 3.3% in 2017 and to average slightly above its potential growth rate at around 3.0% in 2018-20. Although we believe that private household spending will continue to be the main factor in underpinning real GDP growth expansion, investment is set to play a more important role. We expect an allocation of 10 to 15% p.a. for 2017-18, which should foster public investment and have positive repercussions on private investment via co-financed EU projects. While we assume that inventories will not continue to have a substantial growth contribution as in 2016, net exports will likely be curbed by import growth, boosted by strong domestic demand and balancing strong export growth buttressed by

high cost-competitiveness. Private consumption spending is set to remain strong, benefiting from strong wage growth and from the Familiy 500+ program which will impact private consumption for the first full year in 2017. In the medium term, we expect household spending to moderate as rising consumer prices should drag on real disposable income. Though likely to be contained in 2017-18, price pressures should build up, with rising energy, food and import prices being the main drivers. Moreover, rising wages due to a further tightening labor market should add to this.

The deflationary effect of commodity and energy prices is mirrored in the development of headline consumer price inflation which had remained below 0% from mid-2014 to October 2016 and picked up sharply since then, coming in at 2.19% in Feb-17, thus returning into the National Bank of Poland's (NBP) inflation target band at 2.5% +/-1 p.p. The Monetary Policy Council of the NBP decided to leave the key interest rates unchanged on 8 March 2017. The reference rate has been kept unchanged since March-2015, when it was lowered from 2.0 to 1.5%. Yet, core inflation remains at very low levels. Inflation net of food and energy prices has rebounded into positive territory only as recently as January 2017, when the y-o-y rate increased to 0.15%, followed by another modest rise to 0.33% in February after moving within a range of between 0 and -0.4% y-o-y in 2016. Against this backdrop and based on our expectation that output growth is likely to evolve closely with potential growth, we assume that the NBP will keep key interest rates at its current levels this year. In general, we believe that the inflation targeting framework and the NBP's sound monetary policy implementation contributed positively to Poland's macroeconomic performance and is set to support robust and sustainable growth in the medium term.

On the back of strong output growth, Poland should have outperformed the deficit target of -2.6% of GDP outlined in its Budget Act 2016. Based on latest data, we believe that Poland's budget deficit should have amounted to 2.2% of GDP last year. On the revenue side, the state budget benefited from the implementation of measures to improve VAT compliance (e.g. "fuel package") as well as from the new tax imposed on bank assets above PLN 4bn and a sizeable one-off item related to the sale of mobile internet frequencies (0.5% of GDP). According to State Budget Department data as of end-2016, non-tax revenue in January to November 2016 amounted to almost PLN 38.8bn, exceeding the figure envisaged in the Budget Act for the whole year by some 8%. At the same time, government expenditures were lower than originally budgeted during the first eleven months of the year, mainly due to the sluggish absorption of EU-Funds. As a result, we estimate that lower-than-expected co-financing needs for investment projects with EU participation had a positive budgetary impact of approximately 0.2% of GDP.

With regard to 2017, various policy measures which entered into effect this year point to an easing of the fiscal policy stance. Firstly, amendments to the corporate (CIT) and personal income (PIT) tax passed in Sep-16 should prompt lower tax revenue than under a no-policy-change scenario. Under the revised CIT law, newly-established and small companies will benefit from lower tax rates. Effective from Jan-17, the CIT rate applicable to these businesses was cut from 19 to 15%. Moreover, low-income individuals will experience some tax relief, as the new PIT legislation increases the tax-free allowance for this

income group while decreasing it for higher income groups. The Ministry of Finance estimates that under the new tax law revenue will be lowered by about PLN 1bn. Secondly, 2017 will be the first year in which the new child benefit scheme will fully impact the government budget (see above). According to the Ministry of Family, Labor and Social Policy, the annual costs of the program should amount to at least PLN 22bn, equivalent to approximately 1.2% of Poland's 2016 GDP. Looking beyond 2017, further spending pressure could arise from the pension reform which will become effective in Q4-17. The gradual increase of the retirement age to 67 years, which was part of the previous government's 2013 pension reform, was repealed. Under the new pension law, the statutory retirement age will be lowered to 65 and 60 years for men and women, respectively. In addition, rolling back the previous government's pension reform may aggravate Poland's demographic challenges. According to the EU commission, Poland's working age population will drop by 16.4 p.p. in 2013-60 – the second largest decline of all EU-28 members. What is more, the higher absorption of EU funds is likely to raise government expenditure.

As the rise in budgetary outlays will be covered only partially by measures targeted towards increasing state revenue (e.g. postponing VAT reduction, sustaining efforts to enhance tax compliance), we expect Poland's budget deficit to widen but to remain below the EDP threshold and in accordance with the 2017 Budget Act (2.9% of GDP). As a result, public debt, which amounted to 53.2% of GDP in Q3-16, is set to increase this year before it should peak in 2018-19 well below 60% of GDP. In terms of fiscal sustainability, we view the fiscal rules defined in the Act on Public Finance as credit positive, although these have been subject to some discretionary adjustments.

Furthermore, there are some risks associated with the composition of the sovereign's state debt, though we consider Poland's debt levels to be moderate. With regard to its investor base, the country shows sufficient diversification but the share of domestic debt securities held by non-resident investors is comparably large at 34.4% (Jun-16), and a significant portion of treasury debt is denominated in foreign currencies (Jun-16: 34.1%). Thus, Poland is left with some susceptibility to FX volatility and sudden changes in international investor sentiment.

As regards the Polish banking sector, we believe that risks which could adversely affect public finances are limited at the moment. Uncertainty with regard to a solution of foreign currency mortgages remains in place, but has recently dissipated somewhat. After the Financial Stability Committee estimated the costs to banks at PLN 38 to 44bn (Feb-16), the government rolled back on its initial plan for a one-off mandatory conversion of Swiss franc-denominated mortgage loans into Zloty to prevent financial stability risks. A revised draft law (Aug-16) is taking a more cautious approach. The law under discussion would force banks to compensate their customers for excessive exchange rate spreads (costs approx. PLN 4bn), pushing them to a voluntary conversion via regulatory incentives. Although details of the draft under consideration could be modified again, we believe that any final legislation will be committed to preserve the soundness of the banking sector.

In general, Polish banks exhibit favorable trends in terms of capital adequacy and asset quality. Compared to the same period in 2015, the NPL ratio as well as regulatory Tier I

capital to RWA further improved to 4.3 and 15.7% in Q3-16 (Q3-15: 4.7; 14.3%). Meanwhile, the loan-to-deposit-ratio fell from 110.3 (Jan-16) to 104.4% (Dec-16) over the course of the year, reflecting improvement in the banks' liquidity. We believe that the low exposure to market funding would largely mitigate funding risks in the event of financial market distress. According to EBA data of Q3-16, 84.7% of total banking sector liabilities were funded by customer deposits.

Turning to Poland's external balance, we believe that the country is exposed to heightened external risks resulting from a high degree of trade openness (2016: 100.3% of GDP) and sizeable external liabilities (2016: 75.4% of GDP), although we acknowledge that risks have abated somewhat in the recent past, in particular with regard to Poland's current account balance. On the back of improving cost competitiveness (real unit labor costs: -9.1% in 2010-15) Poland's current account has significantly improved. Standing at 5.4% of GDP in 2010, the country's current account deficit narrowed to 0.6% of GDP in 2015. While the surplus of trade in services more than doubled from 0.9 to 2.5% of GDP, the turnaround of the trade in goods balance from -3.0 to +0.5% of GDP explains the bulk of external rebalancing seen in 2010-15. At the same time, the economy displays a large and persistent negative primary income balance (2004-15 avg.: -2.9% of GDP) mirroring profit repatriation of foreign corporate subsidiaries.

With regard to 2016, favorable exchange rate dynamics – namely a slight devaluation of the Zloty against the Euro (-3.4%) – should have contributed to a balanced current account (-0.1% of GDP). However, driven by accelerating imports due to the projected pick-up of investment, we expect Poland to report a modest external deficit again this year and a widening thereafter. As a result, Poland's net international investment position (NIIP), which had stabilized in 2014-16, should resume its downward trend. As most other transition economies, Poland is an international net debtor, indicated by a comparatively large and negative NIIP (Q3-16: -63.2% of GDP). In the event of global financial turmoil, strong reliance on external funding can pose a risk to the liquidity of the domestic economy. Nevertheless, in the case of Poland, risks are somewhat tempered by the composition of the country's NIIP. Foreign direct investment (FDI), which we regard as a less volatile funding source compared to portfolio investment, accounts for a large and growing share of Poland's NIIP. As of Q3-16, net FDI contributed 59.2% to the country's NIIP, up from 51.1% in Q1-12. Moreover, reserve coverage as measured by the reserves-to-imports ratio has also improved in 2015-16. Standing at 6.3 months in Jan-15, reserve coverage went up to 7.1 months in Jan-17.

It has to be emphasized, though, that Poland has extended its Flexible Credit Line (FCL) with the IMF by two more years. Under the new arrangement Poland is eligible to draw on funds worth approx. USD 8.24bn, which is only half of the amount available under the previous FCL – mirroring waning external risks. Although our baseline scenario does not incorporate any need to draw on this backstop facility in 2017-19, we see the renewal of the FCL as credit positive. In our opinion, the FCL is an effective instrument to strengthen international investor confidence in the ability of Poland's economy to service its external debt – even under adverse conditions.

Rating Outlook and Sensitivity

Our Rating outlook on the long-term sovereign rating of A 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 near term.

We could lower our rating if the Polish economy experienced lower-than-expected medium-term growth. If growth in the EU-28 fell short of our expectations or financial unrest in the euro area surfaced, Poland's growth prospects might be substantially impacted via the country's strong trade and financial linkages with its European partners. With an FDI stock held by EU-28 investors totaling at PLN 654.1bn (2016: 36.4% of GDP) and a large presence of foreign banking subsidiaries in the domestic financial market, the Polish economy is highly exposed to the economic development in the EU-28.

Poland's vulnerability to external shocks is further aggravated by the country's dependence on a relatively small number of export markets. Taken together, the country's Top-5 export destinations (DE: 27.4%, CZ: 6.6%, UK: 6.6%, FR: 5.6%, IT: 4.9%) make up for 51.1% of total exports. Against this background, Brexit consequences and, in particular, negotiations about the future trade relationship between the UK and the EU have to be closely monitored.

Moreover, risks to Poland's medium-term growth could arise if policy measures bearing the potential to negatively impact the institutional setup were to be implemented. In particular, we believe that the independence of the country's major monetary and judicial institutions should be maintained. An erosion of trust in the country's institutional framework, as well as deeper state involvement in the economy, could negatively affect investor confidence and in turn impede corporate investment and employment.

Further downside risks to our rating relate to a significant deterioration of Poland's fiscal metrics. Refinancing costs – which have been trending upward from 2.831 (Mar-16) to 3.719% (Mar-17) – could further increase if the interest rate trajectory in the United States turns out to be steeper than projected. In the same vein, rising doubts related to the strength of Polish institutions could lead to increasing risk premia on Polish treasuries with negative repercussions on budgetary performance.

On the other hand, we may raise our rating if the Polish economy achieves higher-than-expected and sustainable growth, e.g. resulting from faster-than-expected absorption of ESI funds, or if reforms should be 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

[in %, otherwise indicated]	2011	2012	2013	2014	2015	2016	2017e
Real GDP growth	5.0	1.6	1.4	3.3	3.9	2.8	3.3
GDP per capita (PPP, USD)	22,571	23,345	24,023	25,286	26,499	27,715	29,268
Inflation rate, y-o-y change	3.9	3.7	0.8	0.1	-0.7	-0.2	2.0
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	76.7	77.0	77.3	n.a.	n.a.	n.a.
Fiscal balance/GDP	-4.8	-3.7	-4.1	-3.4	-2.6	-2.2	-2.9
Current account balance/GDP	-5.2	-3.7	-1.3	-2.1	-0.6	-0.1(e)	n.a.
External debt/GDP	61.4	73.7	73.3	65.5	69.5	75.4(e)	n.a.

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 Creditreform Rating´s “Sovereign Ratings” methodology. Creditreform Rating AG 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 Creditreform Rating´s rating methodologies is published on the following internet page: www.creditreform-rating.de.

A Rating Committee was called consisting of highly qualified analysts of Creditreform Rating AG. The quality 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 quali-

tative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in Creditreform Rating´s "Sovereign Ratings" methodology. The main arguments that were raised in the discussion are summarized in the "Reasons for the Rating Decision".

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