14 January 2022

Sovereign and Public Sector

Republic of Poland

Rating Report

SCOPE A+ NEGATIVE OUTLOOK

Credit strengths

- Strong macroeconomic fundamentals
- Liquid, well-capitalised banking system
- Reduction of external-sector risks
- Strong market access, cash cushion and deep capital markets

Credit challenges

- Weakening of governance institutions
- Weakening of public finances since Covid-19 crisis
- Social and environmental risks
- Elevated inflation
- Resolution of Swiss-franc loans

Rating rationale:

Robust macroeconomic fundamentals: Poland's credit rating is anchored by a large, diversified economy and strong macroeconomic fundamentals. The economy is expected to display comparatively robust rates of economic growth over the coming years as well as present comparatively strong longer-run growth potential. Poland's economy has been resilient over the Covid-19 crisis, with the crisis weakening services more than industry.

Profitable, liquid and well-capitalised domestic banking system: Modest rise of non-performing loans (NPLs) since the crisis. Tier 1 capital ratios improved since the crisis, due significantly to temporary suspension of dividend payments and increased holdings of low-risk government bonds; liquidity coverage ratios have likewise significantly improved since the crisis. FX risks remain outstanding in the banking system, including as relates to the resolution of Swiss franc mortgages.

Reductions of external-sector risks: Current account dynamics had improved, although a 2020 surplus has reverted rapidly to deficit amid a domestic demand recovery. Inward foreign direct investment (FDI) flows have accelerated. The net international investment liability position has improved while gross external debt has delevered to a degree. Foreign-exchange reserves have been bolstered, although FX risks in government debt prevail, even if reduced.

Ratings challenges include: i) longer-standing trend of weakening of governance institutions, affecting economic and fiscal outlooks; ii) weakening of Poland's public finances since the Covid-19 crisis; iii) social and environmental transition risks; iv) elevated inflation; and v) resolution of Swiss-franc loans on bank balance sheets.

Poland's sovereign rating drivers

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic Economic Risk		35%	aa+		0	A+
Public Finance Risk		25%	aa-		-1/3	
External Economic Risk		10%	bbb+		0	
Financial Stability Risk		10%	aaa		0	
ESG Risk	Environmental Risk	5%	aa		-1/3	
	Social Risk	5%	bbb		-1/3	
	Governance Risk	10%	bbb-		-1/3	
Overall outcome		aa-		0	-1	

Note: The qualitative scorecard adjustments, capped at one notch per rating pillar, are weighted equally with an aggregate adjustment rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings.

Outlook and rating triggers

The Negative Outlook represents our opinion that risks to the sovereign ratings are skewed to the downside over the forthcoming 12-18 months.

Positive rating-change drivers

- Substantive easing of governance risks and tensions with EU
- Declining debt/GDP trajectory
- Improved external balance sheet

Negative rating-change drivers

- No resolution of governance risk
- Deterioration of debt sustainability
- External shock and/or weakened external-risk profile

Ratings and Outlook

Foreign currency

Long-term issuer rating	A+/Negative
Senior unsecured debt	A+/Negative
Short-term issuer rating	S-1+/Negative

Local currency

Long-term issuer rating	A+/Negative
Senior unsecured debt	A+/Negative
Short-term issuer rating	S-1+/Negative

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Bloomberg: RESP SCOP

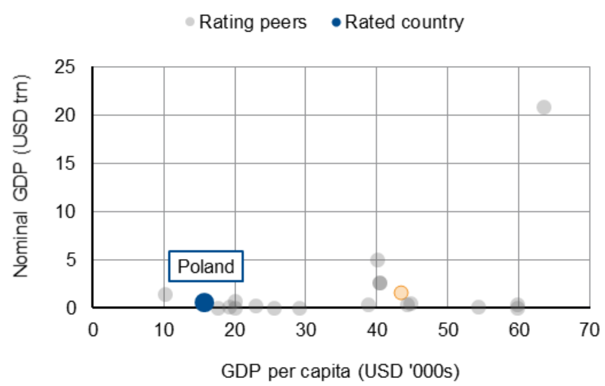
Domestic Economic Risks

- **Growth outlook:** After a comparatively moderate downturn in growth of -2.5% during 2020 Covid-19 crisis peaks, output recovered an estimated 5.6% in 2021. Even considering economic slowdown presumed over Q4-21 and Q1-22 amid winter Covid-19 stresses and renewed economic restrictions introduced since December, economic growth is anticipated to remain robust over 2022 at 4.7% as well as during a 2023 election year (4.1%). Similar to peer economies, the Polish economy has displayed greater resilience during each successive wave of the pandemic – with minimal long-run scarring anticipated from the crisis. Medium-run potential growth is estimated of around 3% a year – higher than that of sovereign rating peers, even acknowledging working-age population decline averaging 0.8% per year over 2022-26.
- **Inflation and monetary policy:** Inflationary pressure is expected to remain significant over 2022, amid evidence of economic overheating. Inflation stood at 8.6% YoY as of December 2021, averaging 5.1% over the year 2021. The IMF estimated in December inflation to average 5.6% over 2022 prior to gradually easing to inside a 2.5% +/- 1% central bank inflation band by 2023 – we see upside risks to this IMF inflation estimate. Additional rate hikes are anticipated with the reference rate reaching at least 3%, after 215bps in rate rises brought the reference rate to 2.25% earlier this month. Inflation may be more pronounced and/or persistent as core inflation remains elevated. Prudently, the National Bank of Poland has suspended a quantitative easing programme given price change dynamics.
- **Labour market:** Fiscal policy has anchored employment dynamics over this pandemic – with unemployment seeing decline to 2.9% in 2022 and 2.8% in 2023, after 3.4% in 2021 – as well as bolstered corporate balance sheets, anchoring private-sector investment. On education, Polish students performed well on a 2018 OECD Programme for International Student Assessment (PISA) study of the scholastic performance of 15-year-old students across mathematics, science and reading, ranking 11th of 77 countries as an aggregate on the three categories; however, skills of the Polish workforce ranked a below-average 92nd of 141 countries under the World Economic Forum's 2019 Global Competitiveness Report.

Overview of Scope's qualitative assessments for Poland's *Domestic Economic Risks*

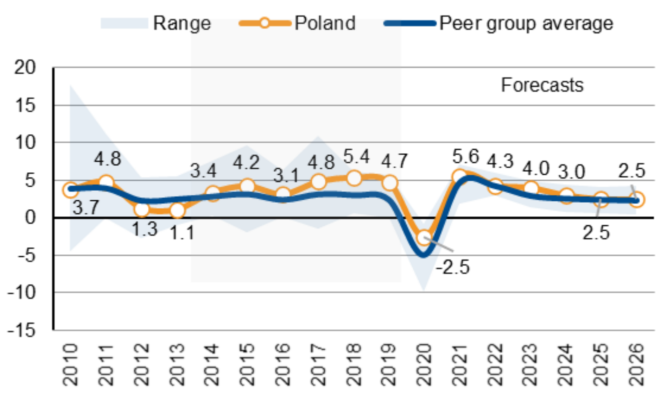
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa+	Growth potential of the economy	Strong	+1/3	High growth potential; long-term growth prospects supported by EU programmes
	Monetary policy framework	Neutral	0	Credible and effective central bank
	Macro-economic stability and sustainability	Weak	-1/3	Diversified economy and competitive export base; reliance on foreign investment; rising labour shortages; comparatively weak labour flexibility

Nominal GDP and GDP per capita



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH

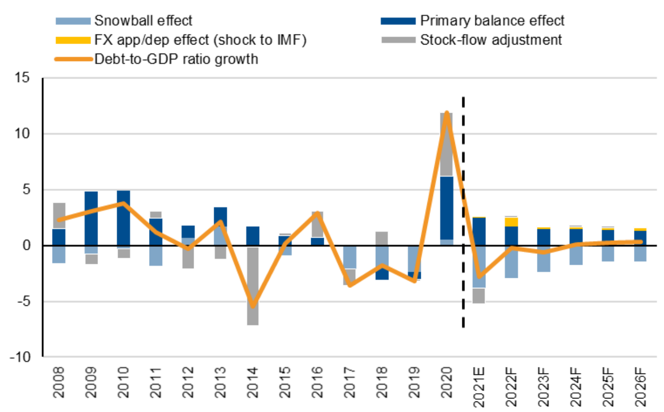
Public Finance Risks

- **Fiscal outlook:** The economic contraction and sizeable emergency budgetary actions widened the general government deficit to 7.1% of GDP in 2020, before correction to an estimated 3.6% during 2021 – the latter less than a previous government assumption as regards the 2021 deficit of 5.3%. The government sees a budget deficit of 2022 of 2.9% of GDP – under a 3% Maastricht criterion. Although budget deficits are expected to further ease this year as policy stimulus is rolled back and revenue continues recovery, spending pressures in view of upcoming parliamentary elections by 2023 and social spending programmes are likely to hold debt levels at somewhat more elevated ratios after this crisis than before the crisis.
- **Debt trajectory:** Poland's general government debt ratio was 57.4% of GDP as of Q2 2021, representing an increase from a 45.6% ratio as of Q4 2019 pre-crisis. We estimate the debt ratio concluding a forecast horizon to 2026 at a still elevated 54.3% with the debt trajectory being anchored by a robust nominal economic growth outlook but challenged by rising financing rates as well as continued primary deficits. Given a more elevated government debt stock, annual gross government financing requirements are seen averaging a moderate 7.4% of GDP per year over 2022-26, nevertheless above a 5.2% average pre-crisis (over 2015-19).
- **Debt profile & market access:** A comparatively short average maturity of treasury debt (4.9 years) and foreign-exchange risks, given 13.3% of GDP in foreign-exchange-denominated general government debt, representing 24.3% of outstanding treasury debt as of Q3 2021 (although trimmed from 34.4% in 2016), are, respectively, credit negative. Credit strengths of Poland incorporate strong market access, a sizeable cash cushion and deep domestic capital markets. Rule of law contentions cast doubt as regards EU balance of payments assistance under any adverse economic scenarios that may require lender of last resort functionalities.

Overview of Scope's qualitative assessments for Poland's *Public Finance Risks*

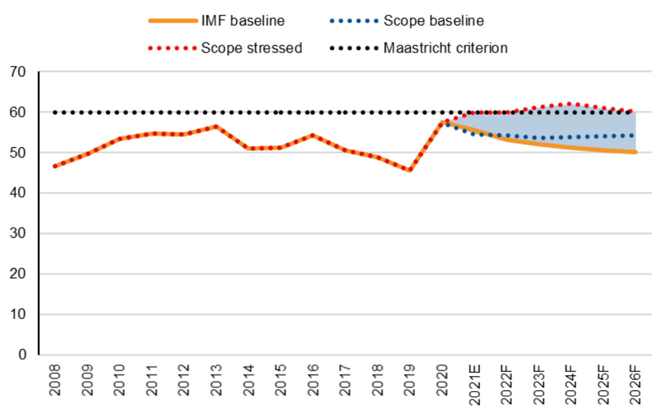
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aa-	Fiscal policy framework	Neutral	0	Credible fiscal framework although suspended during Covid crisis; current risk of overheating due partly to expansionary policy
	Debt sustainability	Neutral	0	Contingent liabilities and rising ageing-related costs coupled with substantive social spending programmes pose medium-run fiscal challenges; risk from FX share of public debt
	Debt profile and market access	Weak	-1/3	Below-average debt maturity, FX risk in debt profile, interest rates have risen although low average cost of outstanding debt portfolio, deep domestic capital markets and strong market access, tension with the EU questions contingent support

Contributions to change in debt levels, pps of GDP



Source: IMF, Scope Ratings GmbH forecasts

Debt-to-GDP forecasts, % of GDP



Source: IMF, Scope Ratings GmbH forecasts

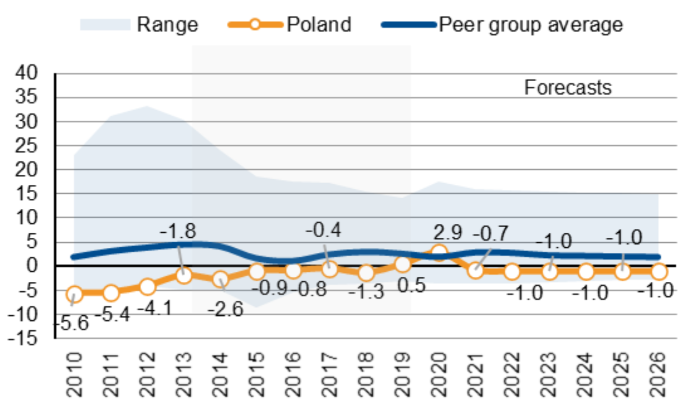
External Economic Risks

- **Current account:** Current account dynamics had improved, from a deficit of 6.9% of GDP in 2008 to a 0.5% of GDP surplus by 2019. Amid increasing external competitiveness, Poland's share of world exports increased from 0.6% in 2001 to 1.5% by 2020. During the Covid-19 crisis, the current account balance temporarily reached a surplus of 2.9% of GDP in 2020 but had reverted sharply to -0.2% in the year to November 2021 amid a recent rapid pick-up of domestic demand, imports as well as in dividend payments to international investors. Moving ahead, the current account is likely to remain in modest deficit on annual basis.
- **External position:** Poland's external sector is bolstered by a capital account surplus that includes structural EU fund inflows, reflecting a high quality of external funding sources, with FDI liabilities constituting a high 50% of gross external liabilities as of Q3 2021. Inward FDI accelerated to 5.2% of GDP in the year to November 2021, from a 3% average over 2015-19. The net international investment position has improved to -40.8% of GDP in Q3 2021, from lows of -69.9% in Q3 2014; gross foreign debt had been trimmed to 58.4% of GDP in Q3 2021, from 2016 peaks of 76.3%.
- **Resilience to external shocks:** Foreign-exchange reserves have been enhanced to USD 145bn in December 2021, from USD 116bn pre-crisis as of end-2019, aided by the IMF's global SDR programme allocation of USD 5.6bn in August 2021, with reserves representing currently an adequate 87% coverage of external debt maturing under one year – reducing vulnerabilities to external shocks and periods of emerging-market FX instability.

Overview of Scope's qualitative assessments for Poland's *External Economic Risks*

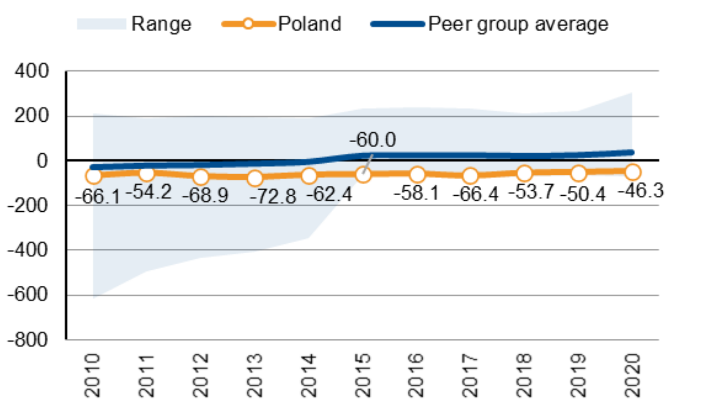
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Current account resilience	Neutral	0	Recent deterioration of the current account, returning to a deficit, but strong financing resilience via foreign direct investment
	External debt structure	Neutral	0	Poland's external debt stock has been reduced over past years
	Resilience to short-term shocks	Neutral	0	Enhanced stock of foreign-exchange reserves mitigates short-run external vulnerabilities

Current account balance, % of GDP



Source: IMF, Scope Ratings GmbH forecasts

Net international investment position, % of GDP



Source: IMF, Scope Ratings GmbH

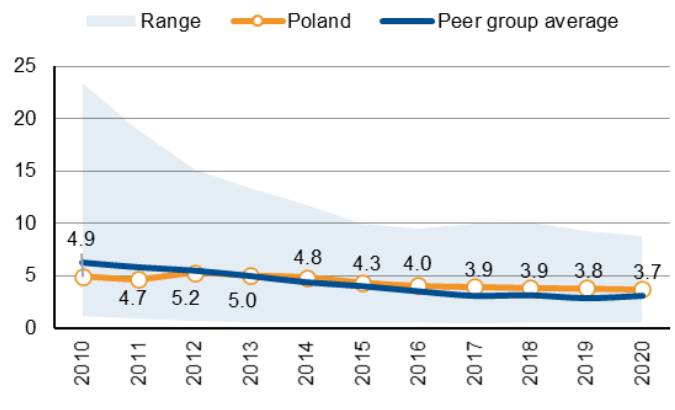
Financial Stability Risks

- **Banking sector:** A stable banking system, with resilient asset quality through the pandemic crisis allowing for gradual removal of crisis-phase regulatory relief. NPLs have only modestly risen to 5.0% of aggregate loans as of Q3 2021, from 4.8% before the crisis, and loan performance has not deteriorated even after conclusion of pandemic payment holidays. Tier 1 capital ratios improved to 17.3% of risk-weighted assets as of Q3 2021, from 16% pre-crisis, due significantly to the temporary suspension of dividend payments and increased holdings of low-risk government bonds; liquidity coverage ratios have likewise improved.
- **Private debt:** While removal of monetary stimulus discourages excesses in fresh borrowing, some borrowers could face payment difficulty as interest rates rise although lowered debt service ratios since 2013 provide the private sector a degree of cushion. Credit growth to private sector picked up to 5.1% YoY by November 2021. Aggregate non-financial private debt stood around a moderate 77.8% of GDP as of Q2 2021.
- **Financial imbalances:** Robust housing market conditions represent one area to monitor. The legal risk from FX loans represents a risk to the banking system, with 15% of banking-system loans (though down from 42% as of 2009) and 12% of banking-system deposits (compared with 9% a decade before) denominated in foreign currency. Specifically, the severity of risk from EUR 21bn of Swiss franc-denominated mortgages to exposed banks has moderated over recent months, however, as key legal guidance suggests a reduced likelihood of the most adverse court outcomes with legal costs likely to be spread over time, while profitability of banks has improved.

Overview of Scope's qualitative assessments for Poland's *Financial Stability Risks*

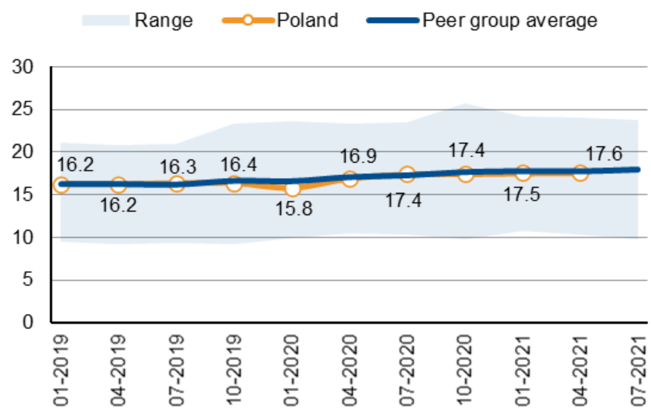
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Profitable, liquid and well-capitalised banking system. Modest rise of NPLs since the crisis. FX risks, incl. from the resolution of Swiss franc mortgages.
	Banking sector oversight	Neutral	0	Effective financial-sector oversight
	Financial imbalances	Neutral	0	Low private-sector debt level; pick-up of credit growth

Non-performing loans, % of total loans



Source: IMF, Scope Ratings GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

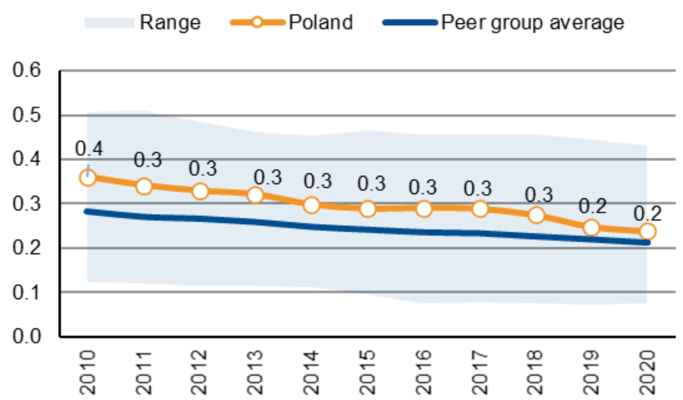
ESG Risks

- **Environment:** Poland adopted an energy policy strategy in 2021 that pledged to significantly curtail coal-fired power by the 2040s, with the main contribution to coal-based emissions stemming from the power sector. Poland participates under the European Emissions Trading System, creating incentives to reduce emissions. Poland's energy transition strategy targets a 30% reduction in emissions by 2030 relative to 1990 levels. This transition will demand substantive investment, however, mostly in power generation, over more than a decade.
- **Social:** The working-age population has been declining around 1% annually over the last decade, creating a steadily increasing skilled-labour shortage. However, large-scale inflow of migrant workers has helped contain wage pressures and eased adverse demographic dynamics. While a net present value of expected pension spending changes is benign at -1.8% of GDP from 2020-50 under IMF projections, the net present value of health care spending care spending changes is more material at 24.2% of GDP over the same period. Poland exhibits weak social and transport infrastructure relative to peer economies and low digitalisation. Authorities' plans to modernise government job search assistance services and strengthen access to training, with a concentration on digital skills, ought to support progress in the future.
- **Governance:** In past years, the Polish government has put forward a series of reforms to the judicial system. The weakening of governance institutions affects economic and fiscal outlooks – with such governance risk under the methodology's ESG rating pillar representing an important driver of this Outlook revision. At the same time, PiS has positively presented Poland as a constructive member of the union, and prudently de-coupled disagreements over issues such as the rule of law from objectives of developing closer economic ties with EU partners and a normal working relationship.

Overview of Scope's qualitative assessments for Poland's *ESG Risks*

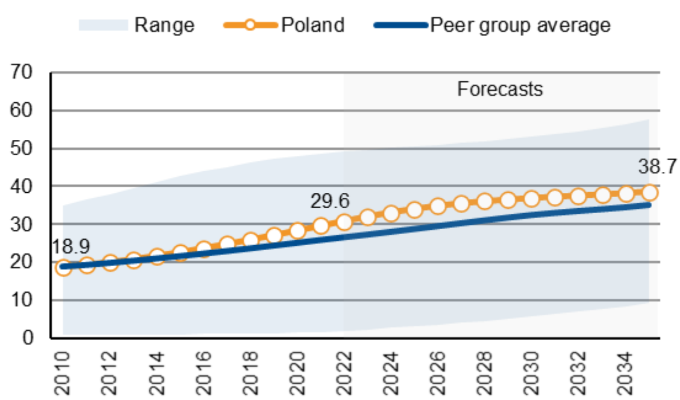
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bbb+	Environmental risks	Weak	-1/3	Structural challenges relating to transition risks to green economy due to phasing out coal dependency in power generation
	Social risks	Weak	-1/3	Adverse demographics result in declining working-age population; significant health care spending changes; below-average skills of workforce; inadequate social and transport infrastructure
	Institutional and political risks	Weak	-1/3	Ongoing institutional challenges and tensions with the EU; polarised political conditions

CO_2 emissions per GDP, $mtCO_2e$



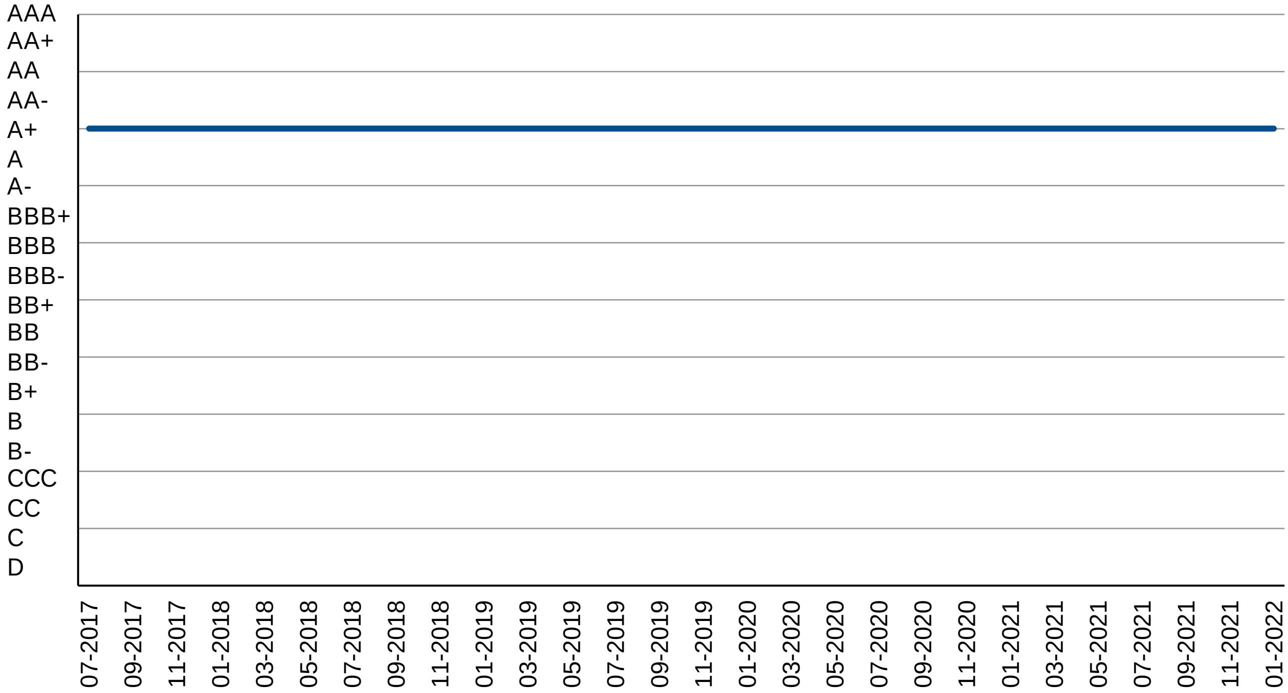
Source: European Commission, Scope Ratings GmbH

Old age dependency ratio, %



Source: United Nations, Scope Ratings GmbH

Appendix I. Ratings history



Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard after the reserve-currency adjustment.

Peer group
Austria
Belgium
Czech Republic
Denmark
Estonia
Finland
Germany
Ireland
Lithuania
Luxembourg
Netherlands
Norway
Slovenia
Sweden
Switzerland

Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 29 – with the governance indicator reflecting a composite of six indicators) used in Scope's quantitative model, the Core Variable Scorecard.

	2016	2017	2018	2019	2020	2021E	2022F
Domestic Economic Risk							
GDP per capita, USD '000s	12.4	13.9	15.5	15.7	15.7	17.3	19.1
Nominal GDP, USD bn	472.3	526.6	587.4	597.2	595.9	655.3	720.4
Real growth, %[1]	3.1	4.8	5.4	4.7	-2.5	5.6	4.7
CPI inflation, %	-0.6	2.0	1.6	2.3	3.4	5.1	5.6
Unemployment rate, %[1]	6.2	4.9	3.8	3.3	3.2	3.4	2.9
Public debt, % of GDP[1]	54.2	50.6	48.8	45.6	57.4	54.6	54.3
Interest payment, % of government revenue	4.4	3.9	3.5	3.3	3.0	2.7	2.5
Primary balance, % of GDP[1]	-0.7	0.1	1.2	0.7	-5.8	-2.4	-1.7
External Economic Risk							
Current account balance, % of GDP[1]	-0.8	-0.4	-1.3	0.5	2.9	-0.7	-1.0
Total reserves, months of imports	5.3	4.5	4.1	4.5	5.6	-	-
NIIP, % of GDP	-58.1	-66.4	-53.7	-50.4	-46.3	-	-
Financial Stability Risk							
NPL ratio, % of total loans	4.0	3.9	3.9	3.8	3.7	-	-
Tier 1 ratio, % of risk-weighted assets	15.6	16.2	16.3	16.4	17.4	17.6	-
Credit to private sector, % of GDP	54.4	52.5	52.5	50.7	50.0	-	-
ESG Risk							
CO_2 per EUR 1,000 of GDP, mtCO_2e	291.1	289.4	275.0	248.9	239.1	-	-
Income quintile share ratio (S80/S20), x	4.9	4.6	4.7	-	-	-	-
Labour force participation rate, %	69.1	69.9	70.4	70.9	-	-	-
Old age dependency ratio, %	23.7	24.8	26.0	27.2	28.4	29.6	30.9
Composite governance indicator[2]	0.7	0.7	0.6	0.6	0.6	-	-

[1] Forecasted values are produced by Scope
[2] Average of the six World Bank Worldwide Governance Indicators
Source: European Commission, IMF, World Bank, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Emerging Market and Developing Economies
5y USD CDS spread (bps) as of 14 January 2022	40.7

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