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Rating Action

Neuss, 13 August 2021

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. Large, well-diversified, and competitive economy, also reflected in a rising export market share, as well as a long phase of uninterrupted GDP growth prior to the outbreak of the pandemic, pushing Poland's income level closer to the EU average; a relatively mild recession in 2020, also cushioned by swift and targeted government support which helped to maintain low unemployment, is set to be followed by strong growth this year and next, with downside risks persisting due to virus mutations
2. The 'Polish Deal' and - if implemented effectively - reforms and investment as set out in the National Recovery Plan (KPO) should bolster growth in the medium term and strengthen economic resilience further, likely resulting in an accelerated convergence process towards EU-levels, while unfavorable demographic developments pose headwinds; we would also monitor possibly deteriorating cost competitiveness in the face of prospectively strong wage growth
3. The generally high institutional quality, also encompassing the benefits associated with EU membership in terms of markets, standards and financial support is somewhat balanced by recurring and recently intensifying disharmony over selected EU guiding principles
4. Despite a drastic deterioration of fiscal metrics due to the pandemic, the public debt ratio remains at a moderate level by European comparison; fiscal sustainability risks seem limited and mainly stem from foreign-currency-denominated debt and increasing public guarantees; legal risks related to FX mortgage loans, and which potentially constitute a burden for the banking sector, will have to be monitored
5. External vulnerabilities as suggested by a highly negative, although shrinking, NIIP are partly mitigated by its composition; we expect the recent increase in the current account surplus to be partly reversed amid strengthening domestic demand in the near term

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Reasons for the Rating Decision and Latest Developments¹

Macroeconomic Performance

Poland's very strong macroeconomic performance profile rests on a high degree of diversification and competitiveness of the economy, feeding a long streak of uninterrupted growth and enabling the country to continue to accumulate wealth and further converge towards the EU's average income level. In combination with low unemployment and moderate ratios of private sector debt offering space for shock absorption, this reduces vulnerabilities to external shocks. While the economy seems to have weathered the corona crisis fairly well, possible new infection waves amid virus mutations pose downside risks to growth in the short term as long as there is no herd immunity, or if available vaccines prove not to be sufficiently effective. Persisting risks to the medium-term growth outlook stemming from unfavorable demographics and labor shortages will have to be monitored against tentative signs of a reversal of migration flows towards net immigration.

Poland experienced only a mild recession by European comparison last year, with its GDP contracting by 2.7% (EU-27: -6.0%). As a point of reference, Central and Eastern European (CEE) peers such as the Czech Republic, Hungary, and Slovakia suffered GDP declines roughly twice as strong. The fact that Poland is still a less open economy compared to most CEE economies, with a trade-to-GDP ratio of 104.8% in 2020 and featuring a large domestic market that was propped up by swift and comprehensive support measures in this crisis, likely contributed to this relative resilience. In the same vein, the country exhibits comparatively low exposure to tourism and other industries particularly affected by the corona crisis. Moreover, judging by the stringency index compiled by Blavatnik School of Government, the containment measures to suppress the spread of coronavirus have been somewhat less strict than elsewhere.

Last year's fall in economic output put an end to Poland's impressive track record of positive economic growth that had been uninterrupted for three decades. Real GDP averaged 3.7% between 2010 and 2019 (EU-27: 1.6%), pushing Polish GDP per capita to 74.3% of the EU-27 weighted average in 2019 (IMF data, PPP terms), rising further to 77.2% in 2020, thus leaving it in a middle-range position among CEE countries in terms of convergence. Furthermore, at an estimated USD 34,103 in 2020, GDP per capita remained below the median of our A-rated sovereigns (USD 38,392).

Investment posted a strong downturn last year (-9.6%). Significant contractions both in non-residential construction investment and in investment in machinery and equipment contributed to the decline in gross fixed capital formation, which ultimately took 1.8 p.p. off GDP growth in 2020, thus matching the negative contribution from lower private consumption. Household spending declined by 3.1% in 2020, mainly due to the restrictions imposed to protect the population amidst two infection waves. Meanwhile, imports declined by 1.9%, whereas exports only fell rather moderately (-0.2%), highlighting relative resilience to the global downturn and leaving net exports to add positively to GDP growth (+0.8 p.p.).

Poland's quarterly GDP profile has broadly mirrored epidemiological developments. Still, real GDP expanded by 1.1% q-o-q in this year's first quarter (EU-27: -0.1%), while a severe third infection wave built up, peaking in the spring (cumulative 14-day infection rate, 988.8 in week 13)

¹ This rating update takes into account information available until 9 August 2021.

and forcing authorities to increasingly tighten nationwide restrictions. The Q1 outturn thus lifted the Polish economy closer to its pre-crisis level, with a remaining gap of 1.6% versus Q4-19 (EU-27: -4.4%). Exports in particular, dominated by goods exports, have displayed a vivid upswing after collapsing in Q2-20, exceeding their pre-crisis level by 7.5% in Q1-21, which also underscores the economy's favorable competitive stance.

Along with a high degree of diversification, illustrated by a services-to-industry ratio of 2.0 (Q1-21, EU-27: 2.8), a high gross value added (GVA) share of the industrial sector (Q1-21: 25.7%, EU-27: 20.3%) and a non-excessive development of real unit labor costs have been contributing to continued gains in global export market share over recent years. From 1.34% in 2019, this share leapt to 1.51% in 2020 (2016: 1.18%). A minor caveat would be that last year's exceptional circumstances may exaggerate the picture somewhat.

In light of eased restrictions from late Apr-21 as infection rates came down rapidly, real GDP should have experienced further acceleration in Q2-21. In Jun-21, economic sentiment reached a 22-month-high (European Commission data), sold production registered an increase of 18.4% y-o-y (Statistics Poland) and retail sales were 8.6% above their level in Jun-20 (Statistics Poland), all of which backs our expectation of continued economic expansion.

We anticipate the economic rebound to experience some further acceleration over the remainder of the year and into 2022, chiefly driven by domestic demand, although we would highlight downside risks related to the so-called Delta variant that is already causing renewed disruption in a number of European countries. We notice a somewhat slower progress of the vaccination campaign as compared to EU averages: Whilst the uptake of first vaccination doses seems to be lagging behind numbers registered for the EU as a whole (57.8% vs 72.1%, ECDC, 9-Aug-21), the share of the fully vaccinated population lies only slightly below the EU reading (55.8% vs. 60.6%).

Uncertainty around effectiveness in view of possible further virus mutations remains high, entailing the risk of new restrictions to public life at some point. At the current juncture, however, the number of infections seems to be at a rather low level. In fact, Poland continues to display one of the lowest infection rates in Europe (week 30: 4.2). Apart from the health situation, labor shortages and the supply of various intermediate products such as semi-conductors may prove to be a bottleneck for production.

That being said, we expect real GDP to increase by 4.9% this year, accelerating to 5.3% in 2022. Private consumption should remain well-supported by the comparatively benign labor market development throughout the crisis, which was partly a result of labor hoarding, wage subsidies for firms in order to retain jobs, and fiscal support that has been directed towards families in particular. In this respect, the 'Polish Deal' (Polski Ład) presented this May would add substantial further support if adopted by Parliament. Intended to enter into force from 2022, it includes, among other things, personal income tax relief and assistance in repayment of mortgages linked to the number of children.

Apart from this new stimulus program, the monthly minimum wage continues to rise, having been lifted by 7.7% to PLN 2,800 from 2021, after increases by 7.1% and 15.6% in 2019 and 2020 respectively. We are aware of ongoing negotiations among the Council for Social Dialogue (RDS) over a proposed further rise by 7% to PLN 3,000 from 2022, which in our view would increase pressure on the country's cost competitiveness. In general, wage pressure is likely to remain high in view of Poland's tight labor market. The government expects average wage growth of 6.2% this year and 6.4% next year.

As mentioned above, negative effects to Poland's labor market from the Covid-19 crisis were curbed, with the market having entered the pandemic from a position of strength, including one of the lowest unemployment rates in the EU (2019: 3.3%, EU-27: 6.7%, LFS-adj.). For 2020 as a whole, the unemployment rate even declined slightly, to a new record low of 3.2%, against a rise of 0.4 p.p. to 7.1% in the EU-27. Looking at monthly developments, Polish unemployment stood at 3.6% in Jun-21 (EU-27: 7.1%), slightly down from an intermediate peak at 4.0% in Mar-21, while remaining somewhat higher than before the outbreak of coronavirus.

Employment had fallen slightly prior to the pandemic, contracting by 0.2% in 2019 (EU-27: +1.0%, national accounts, domestic concept), but remained broadly stable last year (0.1% y-o-y), whereas the EU registered a significant decline (-1.5%). In Q1-21, employment in Poland stood 0.2% below the level reached in the same quarter of the preceding year, comparing favorably with the EU-27. We also note that the gap to the EU has narrowed further with respect to the participation rate, standing at 72.1% in Q1-21 (EU-27: 72.9%), although this represents one of the lowest levels among CEE peers.

Perspectives for gross fixed capital formation appear more upbeat at this stage, backed by receding economic uncertainty as suggested by improving business sentiment, firms' sound balance sheets, ongoing favorable financial market conditions, and by planned investment as set out in the national recovery and resilience plan (KPO), which amongst other things foresees investment in transport, energy and digital infrastructure. As evidenced by a strong increase in building permits, residential construction investment should constitute a supportive pillar as well, also bearing in mind envisaged reduced bureaucracy for the construction of single-family houses as hinted at in the 'Polish Deal'.

Overall, Poland is set to receive EUR 23.9bn in grants via the EU's Recovery and Resilience Facility (RRF), and we gather that with the KPO the government has asked for EUR 11.7bn of funding via the RRF loan facility. The absorption of the European Structural and Investment Funds 2014-2020 proceeds according to plans, with the Covid-19 pandemic not having a negative impact on the process according to the Ministry of Finance, and we expect to see the remaining EU funds finding their way into the Polish economy by 2023. Negotiations with the EU over the KPO are ongoing at the time of writing, leading us to expect the absorption of RRF funds to come fully on stream from 2022. From the EU's new Multiannual Financial Framework 2021-2027, Poland can expect to receive EUR 75.0bn (of which EUR 72.2bn within the framework of the Cohesion Policy allocation and EUR 2.8bn under the Connecting Europe Facility) which would be slightly less than in the prior period.

The outlook for exports remains positive given the ongoing global recovery, although the epidemiological situation in the UK and in the euro area - important trading partners - seems to be worsening and could potentially slow the upswing. More generally, the agreement between the UK and the EU over their post-Brexit trade relations last December removed a notable downside risk for the Polish economy. With domestic demand likely to post strong increases, we expect net trade to make a negative contribution to GDP growth this year and next.

Acting as a further element of macroeconomic stability, Poland continues to boast moderate levels of private indebtedness which have not risen during the crisis, thus continuing to provide vital risk-bearing capacities. Debt of non-financial corporations (NFC) stood at 42.0% of GDP as of Q1-21 (Q1-20: 42.5% of GDP), suggesting a stabilization after trending downward from an intermediate peak at 47.1% in Q4-16. At this level, Poland displays one of the lowest ratios in the

EU. A similar picture can be observed for household debt, which in Q4-20 stood at 55.5% of disposable income (Q4-19: 58.45%), having edged down slightly since 2016.

With regard to the medium-term outlook for real GDP, the recovery plan along with the recent 'Polish Deal' back our main scenario of robust underlying growth if the deal is adopted by parliament and envisaged measures are implemented effectively and timely. Domestic demand – in particular private consumption – thus seems set to act as a major driver, and we note that the recent stimulus program harbors the ambition for Poland to match average EU GDP per capita levels by 2030. Polish authorities estimate that their recovery plan should boost real GDP by 1.3% in 2025. Employment is estimated to increase by 0.4% by 2025.

Drawing on AMECO data, potential growth has remained strong and above that of the narrower Visegrad peer group (V4, incl. HU, CZ, SK) over the last years, and is expected to rise by 3.2% this year and slightly strengthen to 3.4% in 2022 (EU-27: 1.3% and 1.6%), largely driven by estimated TFP growth, further supporting our favorable medium-term expectations. TFP growth has exceeded that of the EU and V4 since 2016, and is projected to increase by 2.8% this year and by 4.1% in the next, thus surpassing its 2019 level by 4.1% (EU: 3.1%). This being said, we note a rather distinct productivity gap between Polish SMEs and the larger companies in the country, as suggested by OECD data (2020). According to these findings, SMEs in Poland only reach 48.4% of the real value added per employee in large companies, as compared to 63.8% in the OECD and 53.3% in V4 peers. We would monitor these developments going forward, as we expect to see improvement on the back of investments to foster digitalization among SMEs. In this vein, we also expect positive spillover effects for private investment, which, set against GDP, averaged only 13.7% in the period 2016-20, corresponding to one of the lowest ratios in the EU.

Risks associated with the pandemic should start to fade in the medium term, in light of continued vaccination progress and adapted behavior on the part of businesses and households, although setbacks linked to virus mutations remain on the cards (see above). As regards structural risk factors affecting the sovereign's macro profile, we would stress that upskilling of labor and reallocation towards areas dominated by new technology could present challenges. As a case in point, Poland was placed at rank 23 out of 27 EU members plus UK in the 2020 European Commission (EC) DESI ranking, with integration of digital technology and use of internet technology comparing rather unfavorably. In this respect, we understand that the Operational Program Digital Poland for 2021-27 is underway with a view to tackling respective deficiencies.

Moreover, we would flag a less favorable development as regards real unit labor costs, as real compensation per employee rose markedly between 2015 and 2019 (+21.8%), exceeding respective gains in real labor productivity per person (+16.5%) and comparing unfavorably against main European trading partners. Against the backdrop of ongoing wage pressure, risks regarding the country's cost competitiveness may mount. This being said, in the crisis year 2020, real unit labor costs rose by 3.3% against 2019, broadly in line with main European trading partners. What is more, we acknowledge that Poland's convergence process inevitably involves advancing on the wage scale, not least in order to attract and retain highly qualified workers amid an already shrinking working-age population and disadvantageous demographic prospects. Moreover, the higher compensation level to some extent reflects progress already made in knowledge transfer and the associated creation of generally more specialized and hence higher-paid jobs.

In this respect, further downside risks for the medium-term growth outlook emanate from a shortage of skilled staff in some areas. As far as production is concerned, a recent survey by the

EC sees Poland coming top in the EU with regard to this perceived limiting factor. Further highlighting the importance of securing highly qualified labor, the World Economic Forum (WEF) places Poland at rank 33 out of 37 countries in its recent assessment (Dec-20) focusing on economic transformation readiness. Maintaining a competitive position on the way to a more digitalized and environmentally more sustainable economic growth model will involve stiff competition for respective talent that could enhance the innovation potential of the country. We observe that at least migration trends seem to point into the right direction, as in 2019 Poland recorded net international immigration for a fourth consecutive year, after decades of net emigration. While the latest EU Ageing Report (2021) suggests increasing, although moderate, net migration inflows over the next few decades, it also projects the working-age population to shrink to 58.6% by 2030 (2020: 61.6%).

Institutional Structure

A generally high-quality institutional framework continues to buttress Poland's credit ratings, also encompassing the benefits associated with EU membership, which include access to the large single market, common standards, as well as being able to tap broad and deep capital markets. Credible and accountable monetary policy in the hands of National Bank of Poland (NBP) constitutes a further significant pillar of the institutional framework, as does financial supervision under KNF, whereas we would reiterate the absence of a fiscal council. Recurring and recently intensifying differences with the EU over adherence to rule of law balance the generally positive assessment to some extent. While not being our baseline scenario, we think that further escalation over this issue would carry a risk of fading policy predictability and associated reputational damage.

The latest set of Worldwide Governance Indicators (WGIs), provided by the World Bank and concerning the year 2019, broadly underpins Poland's generally high institutional quality. Having said that, the sovereign remains well behind the median of the A-rated peers in our rating universe and the EU-27 median as regards the WGIs we consider, with the exception of control of corruption. When it comes to the perception of the extent to which public power is exercised for private gain, we observe that the sovereign has slipped to a relative rank 61 out of 209 (from rank 54 of 209 in the previous vintage), now corresponding to the median of our A-rated sovereigns. We also note a slight deterioration in government effectiveness, where Poland moves at a relative rank 57, down from 53/209, while relative positions were broadly stable as far as voice and accountability (rank 60) and rule of law (rank 71) are concerned.

With regard to commitment to EU rule of law, we are monitoring ongoing controversy between the sovereign and the EC, with the latter having expressed deep concern over a recent decision by the Polish Constitutional Tribunal. On 14 July 2021, the Polish Tribunal stated that interim measures ordered by the European Court of Justice (ECJ) on the functioning of the Disciplinary Chamber of the Supreme Court were inconsistent with the Polish Constitution. The ECJ on 15 July confirmed that the disciplinary regime for judges in Poland is not compatible with EU law, causing the EC to set a deadline (16 August) for Poland to comply with EU law or else ask the ECJ to impose financial penalties on Poland.

Against this background, we would interpret the latest signals by Polish authorities as signs of accommodation. Whilst the Chief Justice of the Polish Supreme Court suspended the work of the court's Disciplinary Chamber in early August, we understand that the Vice PM has signaled the preparation of adjustments to the questioned regime. We think that this would essentially be a sign of responsiveness to EU policies after all, and we will follow developments vigilantly.

These latest tensions tie in with a number of controversial issues between the EC and Poland pertaining to reforms of the Polish justice system and rising concerns on the part of the EC over the independence of Poland's judiciary in particular. To this end, we recall that the Article 7(1) procedure of the Treaty on European Union (TEU) against Poland has been under consideration since 2017. Further to this subject, we note that a compromise found among the EU members regarding the linking of NGEU aid to the perceived adhering to EU rule of law principles is currently before the ECJ to clarify whether possible sanctions against Poland (and Hungary) in the event of a stated violation of the principles would be lawful. However, a decision on this is reportedly not expected until 2022 at the earliest.

While we noticed progress as regards the combat of money laundering and the financing of terrorism, as underscored by a new amendment to the Anti-Money Laundering and Terrorist Financing Act which was signed into law in Apr-21, we took note of the EC's concerns over the independence of the main institutions responsible for prevention of and fight against corruption. We also pay attention to the expected changes in the legal framework that is to strengthen the statutory safeguards for the independence of the media regulator, which would continue to the process of transposing the Audiovisual Media Services Directive.

Turning to the domestic political situation, a snap election ahead of the 2023 parliamentary election may not be ruled out. The stability of the current governing coalition seems to partly hinge on the continued support of the leading PiS by Kukiz '15, a parliamentary group with which PiS signed a cooperation deal in May-21. Last September, a new coalition agreement apparently aiming to firm cohesion among the three parties constituting the informal 'United Right' alliance led by PiS was signed, but was put to the test by diverting opinions over the EU's pandemic relief program, among other things. Having said this, the government's 'Polish Deal', presented in May-21, points to broad agreement over spending and investment priorities as set out in the latest program to support and extend the economic recovery, with substantial income tax relief at its core.

In terms of greening the economy, we note that Poland remains committed to reducing carbon emissions, whilst not having formally agreed to the aim of becoming carbon neutral by 2050. Judging by the EC's Eco-innovation Index, which places Poland in second-to-last position among the EU members in 2021, the transformation towards greater use of renewable energy sources presents challenges. The latter is underscored by the level of greenhouse gas emissions per capita, which, at 10.4 tons of CO₂ equivalent in 2019, was among the higher ones in the EU, having come down from 11.0 tons in 2017, which constituted a peak in the period 2010-19 (Eurostat data). Moreover, the overall share of energy from renewable sources compares low against the EU-27 average (12.2% vs. 19.7% in 2019), but has been on an upward trend and nearly doubled since joining the EU. In its KPO, Poland stresses the goal to achieve a 32%-share of renewable sources in electricity generation by 2030, based on energy strategies as set out in its National Energy and Climate Plan 2021-30 and Poland's Energy Policy until 2040 (PEP2040).

Fiscal Sustainability

Despite a drastic deterioration of Poland's fiscal metrics on account of the pandemic, we consider fiscal sustainability risks as limited. Poland's favorable initial position in terms of public finances allowed for a forceful response to the crisis, whilst still leaving the public debt ratio at a relatively moderate level by European comparison. A convincing track record of prudent fiscal planning and the

expectation of ongoing high debt affordability add to our generally benign assessment of fiscal perspectives, while foreign-currency-denominated debt, albeit further shrinking, constitutes some balancing element. Legal risks related to FX mortgage loans could present a burden for the banking sector, which will have to be monitored. The same applies to contingent liabilities, which have risen sharply in the wake of the corona crisis.

The Covid-19 crisis reversed Poland's downward-trending general government deficit, which leapt from 0.7% of GDP in 2019 to 7.0% of GDP in 2020. The corona-induced recession was combatted with supporting measures to maintain employment, ensure liquidity of companies, and protect vulnerable parts of society as well as industries particularly hard-hit by the required social distancing. Despite the dramatic increase in the deficit, last year's turnout was ultimately less grave than estimated in our last review (-10.5% of GDP), and even less negative than in the aftermath of the global financial crisis (2010: -7.4% of GDP).

In light of the measures taken to cushion the blow from required social distancing and trade disruptions, total government expenditure swelled by 18.0% last year (2019: 8.7%), propelled by subsidies (+3.3% of GDP), but also by vividly expanding public wages (+0.6% of GDP). Social spending had already been increasing before the onset of the pandemic and continued to do so in 2020. Accordingly, the expenditure-to-GDP ratio rose from 41.8% to 48.7%. Against the backdrop of the comparatively shallow recession and anti-crisis initiatives, total government revenue rose by 2.9% y-o-y (2019: +7.5%), thus contrasting with developments in many other European countries. Net social contributions even posted a rather strong increase of 5.1%, while taxes on production and imports (+3.1%) and income and wealth taxes (+1.8%) expanded more moderately.

Discretionary budgetary measures in support of the economy came to roughly 4.3% of GDP in 2020, whereas liquidity support in the form of tax deferrals and guarantees amounted to about 10.5% of GDP. The so-called PFR 1.0 Financial Shield had disbursed about PLN 61bn to MSMEs by the end of 2020, while a new scheme targeted at industries most affected by the pandemic and related restrictions (PFR Shield 2.0), introduced in Jan-21, had paid out roughly PLN 7bn by 26 Feb-21 (NBP data).

Provided the Covid-19 pandemic does not call for any further anti-crisis measures, which is very uncertain at this stage, and assuming that initiatives under the Polish Deal will only be accounted for from 2022, we expect Poland's headline deficit to narrow this year, given that most supporting measures have expired by now. Drawing on the Convergence Program 2021, the estimated budgetary impact from discretionary measures could amount to about 2.0% of GDP, although we understand that this assumption does not take into account the impact of RRF on the economy.

Apart from fading support via the Financial Shields and expired wage subsidies, in particular the introduction of a power fee would add to some tightening compared to 2020. This said, we are aware that parts of the subsidies under both Financial Shields are subject to write-offs as per resolution of the Council of Ministers in Jan-21, which even allows for up to 100% write-off of subsidies under Financial Shield 1.0 for the most affected sectors. Further measures affecting the budget include a boost to social benefits, e.g. by payment of a 14th pension, which would burden the expenditure side. Moreover, the adoption of the so-called Estonian CIT model, according to which limited liability companies and joint-stock companies can opt for lump sum taxation, could lead to a temporary decline in revenue in the short term.

At the same time, the 'Polish Deal', which would imply a substantial income tax relief and further financial help, e.g. regarding mortgages for private households, as well as increased spending on healthcare and investment in transport and cultural infrastructure, is estimated to come at a cost of about PLN 651.6bn over the period 2021-30 (~3.1% of 2020 GDP p.a.). Having said that, many of the proposed programs will have to be fleshed out, signaling that this is likely a rough estimate at this stage.

While the net effects of the tax reform are rather unclear at this stage, the reform measures (i.e. increase of the tax-free allowance and the higher rate threshold) should present a considerable burden to public finances at least in the short term. As spending on healthcare looks set to be financed via higher social contributions, this item may eventually turn out broadly budget neutral. We gather that the measures foreseen in the stimulus program are meant to enter into force from 2022, thus presumably affecting budgets beyond 2021. As mentioned in the recent Convergence Program (CP21), public investment-to-GDP is to be kept around 4.5% (2010-19 avg.: 4.6% of GDP), with the National Road Construction Program and the National Railway Program among major infrastructure projects. The key measures of the Polish Deal are to be adopted by the Council of Ministers by September 2021.

Bearing all this in mind, we currently pencil in a headline deficit to the tune of 4.4% for 2021, which should decline further to 3.5% in the following year, also assuming that the strong pick-up in economic activity (see above) will result in a marked increase in the tax intake. Drawing on monthly state budget execution data covering the first half of this year, we note that expenditure stood at just 42.3% of the plan for 2021 as a whole, while revenue posted at an impressive 57.8% of the plan, suggesting that public finances, in particular tax revenues, are on a favorable course. However, persisting uncertainty over new infection waves also adds to difficulties as regards current forecasts for fiscal metrics.

With its stabilizing expenditure rule temporarily suspended, we note that the government expects to reduce the deficit from 2023 onwards, possibly reaching 2.5% of GDP by 2024. More generally, we assess as positive authorities' pursuit of a budget system reform, among others with the aim of introducing a medium-term budgetary framework and commensurate planning process, a new budget classification, and a spending review.

Amid the recession and the ballooning deficit, Poland's debt-to-GDP ratio soared by 11.9 p.p. to 57.5% of GDP in 2020, still comparing rather favorably against the EU overall (90.7% of GDP). In light of the prospective strong recovery in combination with a narrowing deficit, we expect the public debt ratio to moderate to 57.1% of GDP in 2021 before continuing to decline gradually over the next few years.

We would continue to flag risks stemming from a rather high share of foreign-currency-denominated debt, acknowledging that this share diminished further to 23.4% of GDP in 2020. While the government aims to maintain the share of FX debt below 25% of GDP, we note that the Convergence Program envisaged this ratio to shrink to 18.3% by 2024. Furthermore, we have to stress that the pandemic was met with maximum amount of guarantees totaling 15.9% of GDP for the period 2020-21, of which a comparatively high 8.9% of GDP (CP21) have been taken up until 18 March 2021. This comes on top of an otherwise moderate level of public guarantees unrelated to the Covid-19 crisis, which amounted to 6.7% in 2020, of which an estimated 5.1% have been taken up so far.

Despite the aforementioned risks and assumed spending pressure, we continue to think that fiscal sustainability will not be jeopardized in the medium term, given the relatively moderate level from a European perspective, a track record of prudent fiscal planning, as well as low debt servicing costs. Measured against GDP, interest outlays reached their lowest level on Eurostat records in 2020 (1.33%) and we expect them to dwindle further. The government projects interest expenditure to amount to 0.75% of GDP in 2024.

In this context, we have to point out that 23.2% of outstanding state treasury debt consisted of floating rate instruments (Apr-21), thus exposing a noticeable part of debt to interest rate risks. Considering that at the Jul-21 meeting some members of the NBP's Monetary Policy Council had expressed their preference to raise the NBP reference rate on this occasion in light of inflationary pressure, and given speculation on US tapering for similar reasons, we would follow developments here.

HICP inflation, driven by base effects regarding energy prices, but also due to administrative factors such as higher electricity and waste disposal prices, and a sugar tax, reached a peak at 5.1% in Apr-21, and at 4.1% in Jun-21 remained the highest rate in the EU (Jun-21: 2.2%, Eurostat). To what extent a shortage of intermediate products will prove more persistent will have to be monitored. As far as the exchange rate is concerned, the Polish economy's relative resilience and prospects of continued recovery may at least support the zloty at current levels, while a strengthening tendency could rein in price pressure to some extent. The expected acceleration of domestic demand, along with robust wage increases, could add to upward pressure.

In our base scenario, we would expect the inflation rate to moderate somewhat due to reversing base effects next year, but to remain at elevated levels, relative to the EU overall. We expect a first interest rate hike by NBP in the first half of next year at this stage. In any case, our main scenario remains one of ongoing high debt affordability.

As of 23 July, the yield on Polish 10-year government bonds stood at 1.56% (weekly quote), still close to historical lows reached around the turn of the year. A possibly changing tide as regards monetary policy appears also relevant, as the share of (domestic) government bonds held by Polish banks is rather high, standing at 48.2% (May-21, Finance Ministry), thus increasing the banking sector's sensitivity to bond price volatility. However, the NBP's asset purchase program remains in place for the time being, constituting a buffer in this regard. We gather that as of end Jun-21, NBP purchased PLN 135.8bn, or about 5.8% of GDP, in Treasury and government-guaranteed bonds.

Taking a closer look at the Polish banking sector, which counts among the smallest in the EU (assets-to-GDP: 98.5% in Q4-20) and which is state-owned to a large extent (45% of total assets as of May-21), we note that asset quality has deteriorated somewhat. The NPL ratio went up from 4.8% to 5.3% in the year to Q1-21 (EBA data), widening the gap to the EU average (2.5%) and constituting one of the highest NPL ratios among CEE economies. To be sure, NBP data, covering the whole Polish banking sector, does not show any rise in NPLs. In addition, the share of stage 2 loans and advances at amortized cost increased by 4.5 p.p. to 12.6% from Q1-20 to Q4-20 (EU: 9.1% in Q4-20). What is more, stage 2 loans with non-expired moratoria have seen an increase by 15.4 p.p. to 33.8% over this period, signaling looming risks on the horizon.

At the same time, Poland's CET1 ratio compares favorably against the EU as a whole (Q1-21: 18.1% vs. 15.9%), providing risk-absorbing potential against deterioration in some segments. Banks' profitability has been affected by this crisis, but also by lower interest income preceding

the Covid-19 pandemic, as well as by provision for legal risks relating to FX loans (see below). This notwithstanding, profitability as measured by return on assets remains positive and roughly in line with peers.

As mentioned further above, private sector debt is at moderate levels, as are current lending dynamics, with lending to households for housing purchases proving the most robust. Outstanding mortgage loans were at 3.7% y-o-y in Jun-21, having been at 3.4% y-o-y and 8.7% y-o-y in Jun-20 and Jun-19, respectively. In this regard, it seems worth pointing out that house price dynamics remain high, with the 3-year rate of change inching towards 30% (Q1-21: 28.9%), while the annual rate of change slowed to 7.2% in the first quarter of this year (Q1-20: 11.3%). Given the announced fiscal support and reduced red tape concerning housing, demand looks set to remain high, while envisaged additional residential construction could help to cool the market.

While we judge risks to the banking sector from possibly rising insolvencies or debt servicing capacities as manageable overall, they could be compounded significantly by potential charges to provisions related to mortgage loans denominated in foreign currency. According to NBP, the value of the relevant loan portfolio has been constantly in decline, although still totaling PLN 114bn at the end of 2020, corresponding to about 4.9% of GDP (2009: 10.0%), with the majority denominated in CHF. The number of lawsuits filed by borrowers on this issue has risen significantly over the last few years.

Given a pending ruling of the Civil Chamber of the Supreme Court in this respect, legal risks seem high, as also emphasized by NBP in its recent Financial Stability Report, which even considers this a threat to financial stability in a worst case scenario. We will thus monitor developments here closely. A recent case in point as regards negative reverberations to profitability seems to be PKO BP's establishment of a special fund covering effects of settlements with consumers on the issue of FX mortgage loans.

Foreign Exposure

We continue to assess external vulnerabilities as limited, partly due to the favorable composition of Poland's highly negative NIIP, characterized by a relatively high share of net FDI and reserves. The improving trend in the NIIP witnessed over recent years remains in place, whereas the leap in the current account surplus should be partly reversed amid strengthening domestic demand in the near term.

After exhibiting a surplus for the first time since its 2004 accession to the EU in 2019 (0.5% of GDP; average 2010-19: -2.2% of GDP), hinting at improving competitiveness, Poland's current account balance widened to 3.5% of GDP last year, owing to a swelling goods surplus (+2.2 p.p. to 2.4% of GDP) on the back of declining imports. By contrast, the surplus in services trade was little changed, posting at 4.5% (2019: 4.4%), whereas the shrinking deficit in the primary balance added positively to the current account's surplus (+0.7 p.p.).

Latest available data show that the current account surplus declined slightly to 3.1% of GDP as of Q1-21 (4-quarter moving sum). While we expect the Polish current account to remain in surplus this year and next, it should narrow amid strong domestic demand.

Poland remains an external debtor in view of its highly negative NIIP, although we note that this negative position has been shrinking for some time, coming from -69.4% of GDP in 2014. More-

over, we view risks emanating from the overall external stance as partly mitigated by its composition, among other things a relatively large share of FDI in external liabilities and a significant share of intercompany debt.

Last year, Poland's NIIP narrowed by 5.1 p.p. to -44.2% of GDP, mainly driven by an increase in reserves (+3.7 p.p. to 24.9% of GDP), which have been pursuing an upward trend over the last years. Whilst changes in net positions as to portfolio investment and other investment contributed to the narrowing overall position as well, a widening negative position in foreign direct investment (FDI) exerted the opposite effect (-1.4 p.p. to -36.2% of GDP). In the first quarter of the current year, the NIIP narrowed further to -43.0% of GDP, with a SURE loan granted by the EU boosting the reserves balance further, among other things.

Rating Outlook and Sensitivity

Our rating outlook on Poland's long-term credit ratings is stable. We consider the economic resilience on the back of a strong macroeconomic performance profile and contained risks to fiscal sustainability as offsetting still considerable risks entailed by the pandemic, whilst taking a somewhat cautious stance as regards policy predictability. We continue to emphasize that the assessment and interpretation of economic developments remains more challenging than under normal circumstances, as is the case for other indicators, in particular from the fiscal realm.

We could raise Poland's credit ratings or outlook if its economy continues to recover faster than expected, and against a backdrop of firming positive medium-term growth expectations if the sovereign quickly embarks on implementing envisaged measures and investment as set out in the Polish Deal and the KPO. Reassurance over perceivably high institutional quality when it comes to predictable policymaking, in particular with regard to recent tensions with the EU, would be conducive to such a scenario. Upward pressure would also result from a faster-than-expected decline in the sovereign's debt-to-GDP ratio, as well as from a further improving trend in Poland's NIIP.

By contrast, we could consider lowering the sovereign's credit ratings or the outlook if medium-term growth falls significantly short of our current expectations, entailing adverse ramifications for income convergence. Downward pressure on the rating or the outlook could also arise from continued deterioration of fiscal developments, contrary to our expectations, and/or in the event of further deterioration of perceived institutional quality that might result in some reputational damage, adversely affecting e.g. foreign direct investment and financial support via the EU's fiscal transfers.

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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

ESG Factors

While there is no universal and commonly agreed typology or definition of environment, social, and governance (ESG) criteria, Creditreform Rating views ESG factors as an essential yardstick for assessing the sustainability of a state. Creditreform Rating thus takes account of ESG factors in its decision-making process before arriving at a sovereign credit rating. In the following, we explain how and to what degree any of the key drivers behind the credit rating or the related outlook is associated with what we understand to be an ESG factor, and outline why these ESG factors were material to the credit rating or rating outlook. For further information on the conceptual approach pertaining to ESG factors in public finance and the relevance of ESG factors to sovereign credit ratings and to Creditreform Rating credit ratings more generally, we refer to the basic documentation, which lays down key principles of the impact of ESG factors on credit ratings.

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ESG Factor Box

Environmental Quality	Ecological Risks	Ressource Management	Education	Health	Demo-graphics	
Labor	Equality	Technology & Infrastructure	Safety & Security	Judicial System	Quality of Public Services	
Integrity of Public Officials	Quality and Efficacy of Regulations	Civil Liberties/ Political Participation	Market Access	Business Environment	Data Transparency	
Environment	Social	Governance	Highly significant	Significant	Less significant	Hardly significant

The governance dimension plays a pivotal role in forming our opinion on the creditworthiness of the sovereign. As the World Bank’s Worldwide Governance Indicators Rule of Law, Government Effectiveness, Voice and Accountability, and Control of corruption have a material impact on Creditreform Rating’s assessment of the sovereign’s institutional set-up, which we regard as a key rating driver, we consider the ESG factors ‘Judicial System and Property Rights’, ‘Quality of Public Services and Policies’, ‘Civil Liberties and Political Participation’, and ‘Integrity of Public Officials’ as highly significant to the credit rating.

Since indicators relating to the competitive stance of the sovereign such as the World Bank’s Ease of Doing Business index and the World Economic Forum’s Global Competitiveness Indicator add further input to our rating or adjustments thereof, we judge the ESG factor ‘Business Environment’ as significant.

While Covid-19 may have significant adverse effects on several components in our ESG factor framework in the medium to long term, it has not been visible in the relevant metrics we consider in the context of ESG factors – though it has a significant bearing concerning economic prospects and public finances. To be sure, we will follow ESG dynamics closely in this regard.

Economic Data

[in %, otherwise noted]	2015	2016	2017	2018	2019	2020	2021e
Macroeconomic Performance							
Real GDP growth	4.2	3.1	4.8	5.4	4.7	-2.7	4.9
GDP per capita (PPP, USD)	26,856	28,321	30,162	32,536	34,624	34,103	35,957
Credit to the private sector/GDP	55.8	57.0	56.9	55.5	54.9	53.9	n/a
Unemployment rate	7.5	6.2	4.9	3.9	3.3	3.2	n/a
Real unit labor costs (index 2015=100)	100.0	102.1	102.5	104.5	104.6	108.0	n/a
Ease of doing business (score)	76.9	77.7	77.9	76.9	76.4	n/a	n/a
Life expectancy at birth (years)	77.5	78.0	77.8	77.7	78.0	76.6	n/a
Institutional Structure							
WGI Rule of Law (score)	0.8	0.6	0.5	0.4	0.5	n/a	n/a
WGI Control of Corruption (score)	0.7	0.7	0.7	0.6	0.6	n/a	n/a
WGI Voice and Accountability (score)	1.0	0.8	0.8	0.7	0.7	n/a	n/a
WGI Government Effectiveness (score)	0.8	0.7	0.6	0.7	0.6	n/a	n/a
HICP inflation rate, y-o-y change	-0.7	-0.2	1.6	1.2	2.1	3.7	4.0
GHG emissions (tons of CO2 equivalent p.c.)	10.3	10.6	11.0	10.9	10.4	n/a	n/a
Default history (years since default)	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Fiscal Sustainability							
Fiscal balance/GDP	-2.6	-2.4	-1.5	-0.2	-0.7	-7.0	-4.4
General government gross debt/GDP	51.3	54.2	50.6	48.8	45.6	57.5	57.1
Interest/revenue	4.5	4.4	3.9	3.5	3.3	3.0	n/a
Debt/revenue	131.2	140.0	127.2	118.2	111.0	137.8	n/a
Weighted average maturity of debt (years)	4.8	4.9	4.9	4.8	4.8	4.5	n/a
Foreign exposure							
Current account balance/GDP	-0.9	-0.8	-0.3	-1.3	0.5	3.5	n/a
International reserves/imports	0.5	0.6	0.5	0.4	0.5	0.6	n/a
NIIP/GDP	-62.1	-61.5	-61.2	-55.9	-49.3	-44.2	n/a
External debt/GDP	71.7	76.3	67.0	64.2	58.6	60.3	n/a

Sources: IMF, World Bank, Eurostat, AMECO, ECB, Statistics Poland, own estimates

Appendix

Rating History

Event	Publication Date	Rating /Outlook
Initial Rating	31.03.2017	A /stable
Monitoring	02.03.2018	A /stable
Monitoring	01.03.2019	A /stable
Monitoring	21.02.2020	A /positive
Monitoring	21.08.2020	A /stable
Monitoring	13.08.2021	A /stable

Regulatory Requirements

In 2011 Creditreform Rating AG (CRAG) was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG is allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation. The rating was not endorsed by Creditreform Rating AG from a third country as defined in Article 4 (3) of the CRA-Regulation.

This sovereign rating is an unsolicited credit rating. The Polish Ministry of Finance participated in the credit rating process as it provided additional information and commented on a draft version of the rating report. Thus, this report represents an updated version, which was augmented in response to the factual remarks of the Ministry during their review. However, the rating outcome as well as the related outlook remained unchanged.

Unsolicited Credit Rating	
With Rated Entity or Related Third Party Participation	YES
With Access to Internal Documents	NO
With Access to Management	NO

The rating was conducted on the basis of CRAG's ["Sovereign Ratings" methodology](#) (v1.2, July 2016) in conjunction with its basic document ["Rating Criteria and Definitions"](#) (v1.3, January 2018). 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 and basic document "Rating Criteria and Definitions" is published on our [website](#).

To prepare this credit rating, CRAG has used the following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, World Economic Forum, European Center for Disease Prevention and Control (ECDC), Blavatnik School of Government, UNCTAD, National Bank of Poland, Republic of Poland - Ministry of Finance, Statistics Poland, KNF.

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. No conflicts of interest were identified during the rating process that might influence the analyses and judgements of the rating analysts involved or any other natural person whose services are placed at the disposal or under the control of Creditreform Rating AG and who are directly involved in credit rating activities or approving credit ratings and rating outlooks. 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".

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

The date at which the credit rating was released for distribution for the first time and when it was last updated including any rating outlooks is indicated clearly and prominently in the rating report; the first release is indicated as “initial rating”; other updates are indicated as an “update”, “upgrade or downgrade”, “not rated”, “affirmed”, “selective default” or “default”.

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An explanatory statement of the meaning of each rating category and the definition of default are available in the credit rating methodologies disclosed on the website.

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