

International Credit Update

Republic of Poland

Ratings

Foreign Currency

| | |
|-----------------|----------|
| Long-Term..... | BBB+ |
| Short-Term..... | F2 |
| Outlook..... | Positive |

Local Currency

| | |
|----------------|--------|
| Long-Term..... | A |
| Outlook..... | Stable |

| | |
|----------------------|---|
| Country Ceiling..... | A |
|----------------------|---|

Peer Group

| | |
|----|----------------|
| A- | Bahrain |
| | Chile |
| | China |
| | Czech Republic |
| | Hungary |
| | Israel |
| | Latvia |
| | Lithuania |
| | Malaysia |
| | Slovakia |

| | |
|------|---------------|
| BBB+ | Poland |
|------|---------------|

| | |
|-----|--------------|
| BBB | Aruba |
| | South Africa |
| | Thailand |
| | Tunisia |

■ Fiscal Adjustment Awaits Elections

Poland's 'BBB+' sovereign rating is underpinned by strong economic and institutional fundamentals and EU membership. The economy is diverse and integrated with the stable and wealthy EU market. The banking system is essentially sound and two-thirds foreign-owned. Levels of education and skills are high relative to wages, providing good prospects for sustained robust GDP growth.

Public finances are the main constraint on Poland's rating. The budget deficit (ESA basis, excluding private pensions from the general government) has widened from 2.3% of GDP in 2000 to 6.8% in 2004 (4.8% including pensions), while public debt has climbed steadily from 38% of GDP to 48% (ESA) – above the 'BBB' median of 38%. Fitch Ratings expects a narrowing in the deficit to about 5.8% in 2005, but the Hausner Plan has ground to a halt. Comprehensive fiscal reforms will be required, after this year's elections, to stabilise the public debt ratio. The next government is likely to be a coalition led by the centre-right Civic Platform. However, it has yet to clarify its economic policies. The composition and coherence of the coalition is uncertain. And unpopular spending cuts will be required if Poland is to meet its timetable of adopting the euro in 2009, or even 2010.

The current account deficit has narrowed from 7.6% of GDP in 1999 to just 1.5% in 2004, suggesting some secular improvement in trade performance. Poland's external debt ratios are broadly in line with rating peers and its liquidity position is comfortable. The rebound in the zloty (PLN) in 2004 will lower growth somewhat this year, but it does not seem obviously uncompetitive at current levels. Inflation and interest rates are now expected to decline.

Ratings History

| Date | LTFC | LTLC |
|-------------|------|------|
| 6 May 2004 | BBB+ | A |
| 19 Nov 1998 | BBB+ | A+ |
| 06 Jun 1996 | BBB | A- |
| 31 May 1995 | BB+ | - |

■ Credit Outlook

Poland's LTFC rating of 'BBB+' has not changed since late 1998 as latent upward pressure from rising incomes, economic restructuring, EU accession and a stronger balance of payments have been offset by adverse fiscal trends. If, as Fitch expects in its central scenario, Poland sets out credible fiscal reforms after the elections, then it would be likely to upgrade the rating.

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■ Strengths

- Good medium-term growth prospects
- Moderate current account deficits, mainly non-debt financed
- Flexible and transparent monetary and exchange rate policy
- Essentially sound, largely foreign-owned banking system

■ Weaknesses

- Large budget deficit and rising public debt-to-GDP ratio trend
- Political uncertainty poses risk to fiscal consolidation and euro adoption timetable
- High unemployment, large agricultural sector

Key Indicators for Poland

| | |
|--------------------------------------------------------------------------------------------------------------------------|---------------------------------------------------------------------------|
| Population (2004): 38.2m | Population growth rate (1999-2004): -0.3% p.a. |
| GDP (2004^a): USD241.6bn | GDP per head at market exchange rates (2004^a): USD6,325 |
| GNI per head at purchasing power parity (2003): USD11,450 (= 31% of USA level) | |
| Modern sovereign rescheduling history: Paris Club and London Club agreements in 1991 and 1994; 50% NPV reduction. | |

| | 2000 | 2001 | 2002 | 2003 | 2004 ^e | 2005 ^f | 2006 ^f |
|---------------------------------------------------------------------|-------|-------|-------|-------|-------------------|-------------------|-------------------|
| Domestic Economy and Finance | | | | | | | |
| Real GDP growth (%) | 4.0 | 1.0 | 1.4 | 3.8 | 5.3 | 4.3 | 4.5 |
| Unemployment (% of labour force) | 16.4 | 19.4 | 20.0 | 20.0 | 18.8 | 18.0 | 17.0 |
| Consumer prices (annual average % change) | 10.1 | 5.5 | 1.9 | 0.8 | 3.5 | 2.7 | 2.5 |
| Gross domestic savings (% of GDP) | 19.3 | 18.0 | 16.3 | 16.2 | 18.1 | 18.5 | 18.7 |
| Gross domestic investment (% of GDP) | 24.7 | 20.7 | 18.9 | 18.1 | 18.1 | 19.1 | 19.7 |
| Short-term interest rate (%) ⁽¹⁾ | 18.0 | 15.4 | 8.5 | 5.6 | 5.8 | 5.9 | 5.5 |
| Broad money (% change Dec to Dec) | 11.8 | 9.2 | -1.9 | 5.6 | 8.0 | 9.4 | 10.1 |
| PLN per USD (annual average) | 4.3 | 4.1 | 4.1 | 3.9 | 3.7 | 3.1 | 3.1 |
| REER (CPI, 2000=100) | 100.0 | 111.8 | 108.2 | 98.9 | 101.9 | 112.1 | 112.1 |
| REER: % change (+ = appreciation) | 8.4 | 11.8 | -3.2 | -8.6 | 3.0 | 10.0 | 0.0 |
| Public Finances | | | | | | | |
| General government balance (% of GDP) | -2.3 | -5.3 | -5.5 | -5.6 | -6.8 | -5.8 | -5.3 |
| General government debt (% of GDP) | 37.7 | 38.5 | 43.7 | 48.7 | 47.7 | 50.0 | 51.7 |
| General government debt maturities (% of GDP) ⁽²⁾ | 6.7 | 7.9 | 7.0 | 11.7 | 11.9 | 10.0 | 12.8 |
| General government debt/revenue (%) | 100.6 | 100.5 | 113.5 | 122.0 | 122.0 | 121.5 | 125.4 |
| Interest payments/revenue (%) | 5.0 | 6.9 | 6.6 | 6.9 | 6.0 | 6.4 | 6.5 |
| Balance of Payments | | | | | | | |
| Current account balance (USDbn) | -10.0 | -5.4 | -5.0 | -4.6 | -3.6 | -8.1 | -11.0 |
| Current account balance (% of GDP) | -6.0 | -2.9 | -2.6 | -2.2 | -1.5 | -2.6 | -3.4 |
| Current account balance <i>plus</i> net FDI (USDbn) | -0.7 | 0.4 | -1.1 | -0.7 | 0.7 | -2.6 | -5.5 |
| Current account balance <i>plus</i> net FDI (% of GDP) | -0.4 | 0.2 | -0.6 | -0.3 | 0.3 | -0.9 | -1.7 |
| Gross financing requirement (% of official reserves) ⁽³⁾ | 64.6 | 65.5 | 60.2 | 38.4 | 30.7 | 51.4 | 65.1 |
| Current external receipts CXR (USDbn) | 51.6 | 57.8 | 62.9 | 79.6 | 104.6 | 116.9 | 125.4 |
| Current external receipts CXR (annual % change) | 19.5 | 12.1 | 8.9 | 26.5 | 31.4 | 11.8 | 7.2 |
| Current external payments CXP (USDbn) | 61.5 | 63.1 | 67.9 | 84.2 | 108.2 | 125.1 | 136.4 |
| Current external payments CXP (annual % change) | 10.6 | 2.6 | 7.6 | 24.0 | 28.5 | 15.6 | 9.1 |
| External Assets and Liabilities | | | | | | | |
| Gross external debt (USDbn) | 69.5 | 72.0 | 84.9 | 105.7 | 122.8 | 125.5 | 134.8 |
| Gross external debt (% of GDP) | 41.7 | 38.7 | 44.4 | 50.5 | 50.8 | 40.9 | 41.6 |
| Gross external debt (% of CXR) | 134.7 | 124.6 | 134.9 | 132.9 | 117.4 | 107.3 | 107.5 |
| Net external debt (USDbn) | 30.2 | 29.6 | 40.9 | 56.4 | 57.3 | 59.3 | 65.1 |
| Net external debt (% of GDP) | 18.1 | 15.9 | 21.4 | 26.9 | 23.7 | 19.3 | 20.1 |
| Net external debt (% of CXR) | 58.6 | 51.2 | 65.0 | 70.8 | 54.8 | 50.7 | 51.9 |
| Public external debt (USDbn) | 33.4 | 29.7 | 35.8 | 44.2 | 58.7 | 59.7 | 64.5 |
| Public external debt (% of GDP) | 20.1 | 16.0 | 18.7 | 21.1 | 24.3 | 19.4 | 19.9 |
| Net public external debt (% of CXR) | 11.5 | 5.4 | 9.6 | 12.9 | 20.9 | 19.1 | 18.8 |
| Public FC denominated & FC indexed debt (USDbn) | 30.7 | 25.6 | 28.6 | 34.2 | 38.3 | 36.2 | 37.8 |
| Short-term external debt (% of gross external debt) | 13.7 | 15.5 | 16.4 | 19.1 | 17.0 | 16.0 | 15.0 |
| External debt service (% of CXR) | 21.1 | 28.0 | 22.6 | 13.1 | 10.2 | 12.9 | 13.9 |
| External interest service (% of CXR) | 6.2 | 6.2 | 5.2 | 4.5 | 3.8 | 3.7 | 3.3 |
| Liquidity ratio (%) ⁽⁴⁾ | 150.6 | 133.5 | 142.6 | 142.0 | 123.7 | 123.4 | 115.6 |
| Official international reserves including gold (USDbn) | 27.5 | 26.6 | 29.8 | 34.0 | 36.8 | 37.4 | 40.9 |
| Official international reserves in months of CXP cover | 5.4 | 5.0 | 5.3 | 4.8 | 4.1 | 3.6 | 3.6 |
| Official international reserves (% of broad money) | 37.9 | 32.3 | 35.5 | 37.4 | 29.9 | 29.1 | 28.8 |

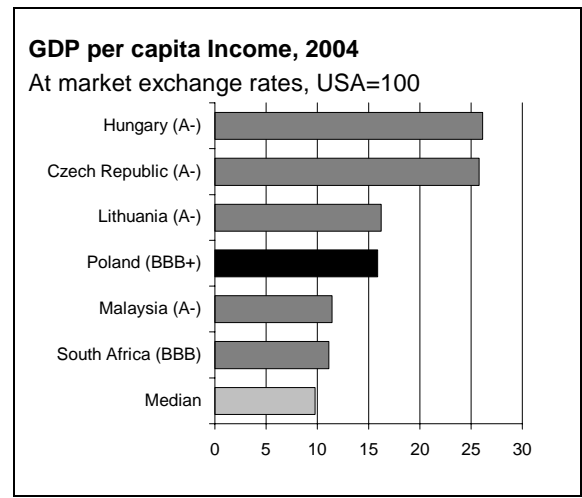
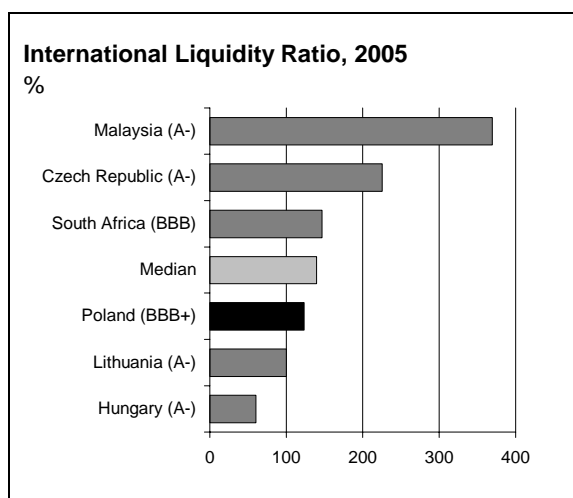
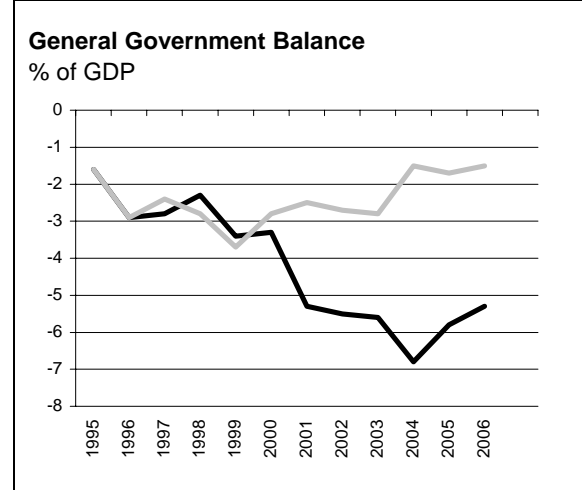
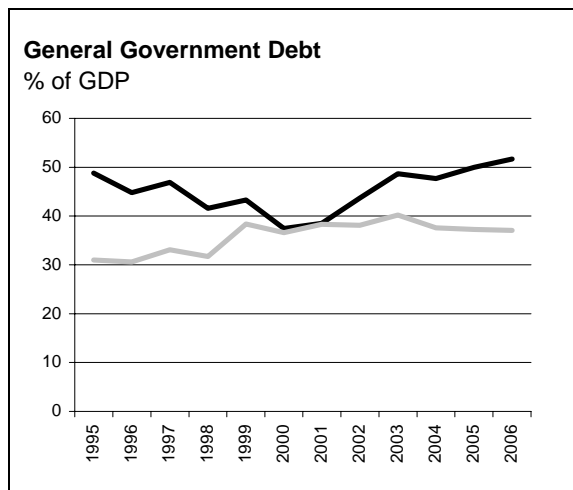
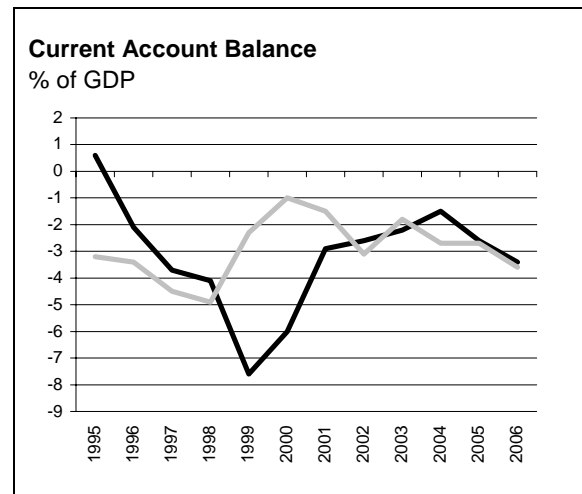
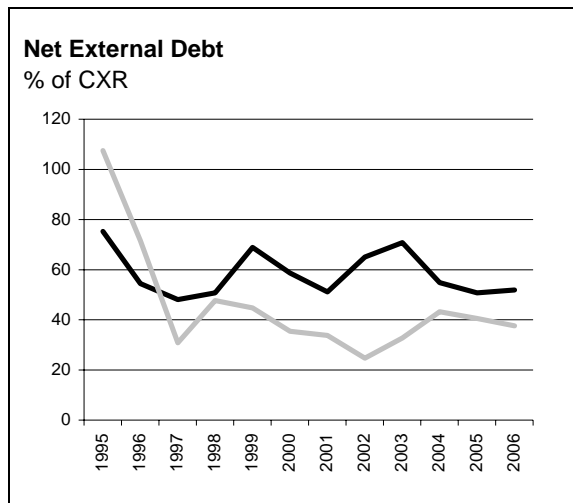
(1) Money market rate 14-day REPO (annual average).

(2) Maturities of medium and long-term debt during year *plus* short-term debt outstanding at the beginning of the year.

(3) Current account balance *plus* amortisation of medium and long-term debt, over official international reserves.

(4) Official reserves incl. gold *plus* banks' foreign assets/ Debt service *plus* liquid external liabilities.

Peer Comparison



— Poland

— BBB Median

Source: Fitch Sovereign Comparator

■ Rationale

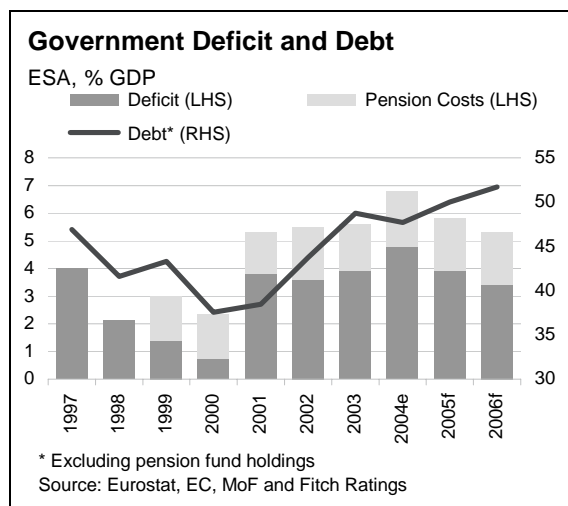
Fitch Ratings has revised the Outlook on Poland's Long-term foreign currency rating of 'BBB+' to Positive from Stable in reflection of a number of encouraging trends, including the impact of previous structural reforms on international trade performance and macroeconomic stability. The 2004 budget outturn was also better than expected and Fitch judges that there is an increased likelihood - though by no means a certainty - of progress with sustained fiscal consolidation after the parliamentary elections this year. In addition, there is now a higher chance of the adoption of the euro in 2009 or 2010, especially in light of the recent decision by the EU Council to take partial account of the fiscal costs of pension reform in assessing the Maastricht fiscal criteria.

Poland's sovereign rating is underpinned by strong economic and institutional fundamentals. It has implemented broad structural reforms and has largely completed the transition to a successful market economy. The economy is diverse and integrated with the stable and wealthy EU market. The banking system is essentially sound and two-thirds foreign-owned. Levels of education and skills are high relative to wages, providing good prospects for sustained healthy GDP growth and "real convergence" with wealthier EU countries. Fundamental political stability is supported by democratic institutions and EU membership.

In some respects, however, the economy is less advanced than its regional peers. GDP *per capita* (at end-2004 market exchange rates) was only USD7,737, 75% of the average level of the Czech Republic ('A-'), Hungary ('A-') and Slovakia ('A-'). Achieving its growth potential will require greater gross domestic investment, which was only 18% of GDP in 2004, the lowest in Central and Eastern Europe (CEE) – though investment growth increased to over 7% in the year to 4Q04. According to Transparency International, corruption is perceived to be the worst in the EU. Unemployment, at 19%, is the highest in the OECD, while employment is only just over 50% of the labour force and the agricultural sector employs 20% of the workforce. This structure and the weight of disenfranchised groups give succour to extreme political parties and complicate public finance reforms.

Public finances are the main constraint on Poland's rating. The budget deficit (on a European System of Accounts (ESA) basis, excluding mandatory private pensions from the general government) has widened from 2.3% of GDP in 2000 to 6.8% in 2004, while public debt has climbed steadily from 38% of GDP to an estimated 48%. This is above the 'BBB' median of 38%, though less than Hungary ('A-') at

61% and some wealthier 'A' range countries. More positively, Poland has strong debt management skills, a solid revenue base, favourable debt dynamics, and good local and international market access; while long-term solvency is supported by pension reforms. Its public foreign currency and foreign currency-linked debt is estimated at only 12% of GDP at end-2004, below the 'BBB' median of 17%.



Nonetheless, comprehensive fiscal reforms will be required to stabilise the public debt ratio, prevent a potential breach of Poland's 60% constitutional limit and allow the eventual adoption of the euro. Fitch expects a narrowing in the budget deficit to around 5.8% in 2005, helped by some measures in the Hausner Plan. However, only around one-third of the plan has been implemented and no further progress is expected this side of parliamentary elections due by October. Poland's latest EU Convergence Programme (CP) envisages reducing the deficit to 2.2% of GDP in 2007. However, it optimistically assumes strong GDP growth, the full adoption of the Hausner Plan, a full allowance for pension costs and other unexplained improvements in the deficit.

After the elections the new government will need to implement a programme of unpopular fiscal retrenchment. The political situation is, therefore, a relevant rating issue. Opinion polls suggest the next government is most likely to be a coalition comprising the centre-right Civic Platform (PO) and the right-wing Law and Justice (PiS) parties, and probably one other party (see **Political & Social Situation**). If, as Fitch expects in its central scenario, the next government sets out a coherent programme, then it is likely to upgrade Poland's rating.

For now, however, outstanding uncertainties make that premature. The composition, strength and coherence of the government are still in question. The PO has yet to clarify its economic policies, such

as how it will cut the deficit at the same time as introducing radical tax cuts. Fitch estimates that, even following the amendments to the EU rules on “excessive deficits” (see **Public Finance**) it would need to reduce the deficit by 2% of GDP in 2006-07 in order to meet Poland’s current implicit timetable for adopting the euro in 2009. This would still be challenging, but the change in the rules has increased the prospect of Poland adopting the euro in 2009 or 2010. Fitch regards the adoption of the euro as a net positive for the foreign-currency rating.

Poland’s external position has strengthened in recent years and is not a current credit concern. The current account deficit has narrowed every year from 7.6% of GDP in 1999 to just 1.5% in 2004, despite the widening in the budget deficit and weak growth in the EU market. Growth in Poland’s export market share and productivity suggest some structural improvement in trade performance as well as cyclical and temporary competitiveness effects. Fitch expects a moderate widening in the current account deficit in 2005 and 2006, but no “twin deficit” problems to emerge. Moreover, it should be financed primarily by FDI and EU capital inflows.

Poland’s external debt ratios are broadly in line with rating peers. On Fitch’s residency classification, net external debt was 55% of CXR at end-2004, somewhat above the ‘BBB’ median of 43%. But by place of issue Poland’s ratio is 35%, and well over half gross external debt is private sector, much of which is inter-company borrowing. Furthermore, valuation effects should lead to a fall in the ratios this year. Fitch estimates Poland’s external debt service ratio for 2005 at 13% of CXR, just below the ‘BBB’ median of 14%.

In Fitch’s view, Poland’s transparent inflation-targeting regime and freely-floating exchange rate is a rating strength. Exchange rate flexibility has helped to insulate the real economy and balance of payments from political, fiscal and external shocks. At the same time, cost pressures have been contained and inflation is forecast to decline to below 2.5% at end-2005. Interest rates appear to have peaked at 6.5%, with the economy growing close to trend. This represents a huge improvement in policy management compared with the previous cycle when interest rates peaked at 19% in 2000. Nonetheless, potential volatility in the zloty (PLN) is a risk factor. The change in the policy framework necessitated by joining the ERMII – probably in 2006 or 2007 – could also increase uncertainty.

Poland’s LTFC rating of ‘BBB+’ has not changed since late 1998, owing to adverse fiscal trends. Over that time, however, there have been positive

developments such as rising income levels, economic restructuring, EU accession and a stronger balance of payments, which have been exerting latent upward pressure on the rating. If Poland sets out a coherent fiscal reform programme, therefore, the rating would be likely to be upgraded.

■ Political & Social Situation

Poland benefits from fundamental political stability, which is underpinned by democratic institutions and EU membership. However, the political scene has experienced a turbulent 12 months and Poland faces important parliamentary elections by the autumn. This is a credit issue as the country needs a stable government that is willing and able to implement a programme of fiscal consolidation to stabilise the public finances and open the way to the euro. The popularity of extremist parties, corruption and risk of a shock over the EU Constitution are also concerns.

Current Setting

Elections for the Sejm (lower house of parliament) are likely to take place in either June or in September-October. The current government is a centre-left minority coalition led by Prime Minister Marek Belka. It comprises the Democratic Left Alliance (SLD), Labour Union (UP) and Parliamentary Federation Club (FKP). Mr Belka favours early elections may resign in May¹.

Composition of Sejm: March 2005

| | Seats | % Seats |
|-------------------------------------|------------|------------|
| Government Coalition | 182 | 40 |
| Democratic Left Alliance (SLD) | 152 | 33 |
| Labour Union (UP) | 15 | 3 |
| Parliamentary Federation Club (FKP) | 15 | 3 |
| Other | 278 | 60 |
| Civic Platform (PO) | 56 | 12 |
| Law and Justice (PiS) | 46 | 10 |
| Polish People's Party (PSL) | 40 | 9 |
| Social Democracy of Poland (SdPI) | 32 | 7 |
| Self-Defence (Samoobrona) | 30 | 7 |
| League of Polish Families (LPR) | 25 | 5 |
| Other Parties | 17 | 4 |
| Independent | 32 | 7 |
| Total | 460 | 100 |

Source: Sejm and Fitch Ratings

¹ The timing of the election will depend on complex strategic and constitutional issues. Early elections could be triggered by a two-thirds majority vote in the Sejm. A vote is scheduled for 5th May. This would normally appear unlikely as current MPs have an incentive to stretch out their term in office. But elections would also be called if there is a vote of no confidence, or if the PM resigns and the Sejm fails to approve a successor in three attempts, which could prove difficult. June elections would force the next government to draft the 2006 budget, and perhaps adversely affect its prospects at the Presidential election due by late October, but give it more scope to set the timing of the referendum on the EU constitution.

Despite strong political pressures, Mr Belka and Finance Minister Mirosław Gronicki have been able to maintain steady fiscal management. Fitch does not expect any significant progress with public finance reform or populist pump-priming before the election.

However, it has been a turbulent 12 months in Polish politics and further shocks cannot be ruled out. In April 2004, the SLD's declining popularity and internal tensions led 34 MPs to splinter off to form a new party, Social Democracy of Poland (SdPI). The then Prime Minister Leszek Miller resigned on 2nd May. Mr Belka was finally approved by the Sejm to replace him on the third round of voting and survived a no confidence vote in October. Deputy Prime Minister and Minister of Economy Jerzy Hausner resigned from the SLD in February.

The Polish political establishment has been rocked by a series of scandals, which have fuelled public disillusionment with the government. Sejm speaker Józef Oleksy was forced to resign in January over allegations of being an informant for the secret service in the communist era. A Sejm committee is investigating "Orlengate", centring on allegations of Russian espionage and influence on Jan Kulczyk, Poland's wealthiest man, and his alleged influence with President Aleksander Kwaśniewski. Other allegations and shocks are possible. Poland was rated the worst out of the EU25 in Transparency International's 2004 Corruption Perceptions Index, and its score and ranking have worsened every year since 2000, though this may have reflected heightened perceptions more than reality.

Election Prospects

Opinion polls suggest a heavy defeat for the SLD and other centre-left parties, and gains for the centre-right and extremist parties (see table). No single party is likely to win a majority. Uncertainties are heightened by the 5% threshold for representation, with a number of parties close to the hurdle rate.

Opinion Polls

| March 2005 | % Votes ¹ | % Seats |
|------------------------------------|----------------------|---------|
| Civic Platform (PO) | 24 | 28 |
| Law and Justice (PiS) | 15 | 17 |
| Self-Defence (Samoobrona) | 17 | 20 |
| League of Polish Families (LPR) | 11 | 13 |
| Democratic Left Alliance (SLD) | 7 | 8 |
| Democratic Party (PD) ² | 6 | 7 |
| Polish People's Party (PSL) | 6 | 7 |
| Social Democracy of Poland (SdPI) | 4 | - |
| Labour Union (UP) | 2 | - |
| Other, will not vote etc | 8 | - |

¹ Average of PBS, CBOS, OBOP, Ipsos and Pentor

² Includes Freedom Union, if PD not specified

Source: PBS CBOS, OBOP, Ipsos and Pentor and Fitch Ratings

Moreover, the announced formation in February of the centrist Democratic Party (DP) has changed the landscape. It was set up by Mr Hausner and members of the Freedom Union party, and is likely to be joined by Mr Belka. Latest opinion polls suggest it has already attracted 6% popular support – partly at the expense of the PO. There is a gap in the electoral spectrum for it, though it will be difficult for centre-left politicians to rebrand themselves.

The two most likely scenarios are:

- The centre-right PO and right-wing PiS are able to form a majority government coalition.
- The PO-PiS have to pull in a third party to secure a majority or attempt to govern as a minority, with various informal alliances. The most likely partners are the DP, the agrarian Polish People's Party (PSL) or, perhaps, the League of Polish Families (LPR).

A majority PO-PiS government should be relatively positive for the prospects for fiscal consolidation and creditworthiness. However, so far, the PO has not been very clear about its fiscal policies, such as how it can cut tax rates, potentially delay implementing public expenditure reform until 2007 and still join the euro in 2009 (see **Public Finances**). Moreover, little is known about the fiscal priorities of the PiS, but its talk of reducing the National Bank of Poland (NBP) independence and its euro-scepticism are concerns. A third coalition partner (particularly the PSL or LPR) would further risk policy coherence and the will for expenditure reforms. A minority government would find it difficult to implement unpopular fiscal measures and would run the risk of no confidence votes and early elections.

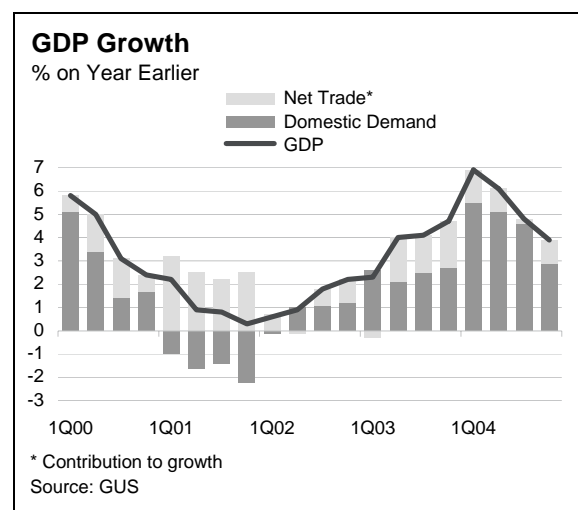
It seems improbable that the extremist parties the Self-Defence (SD) and LPR would form a coalition government because of their mutual antipathy, even if they picked up extra electoral support. Both draw votes from the losers from transition, such as the unemployed, pensioners and rural poor. The SD is economically-populist, left-wing and nationalist. It has lost some popularity since last summer, as farmers have benefited from EU accession. The catholic LPR is right-wing conservative, nationalist and anti-EU. Even if they fail to win power, the popularity of these parties and the large number of disenfranchised voters remain a source of concern.

Elections for the largely ceremonial position of president are due by October. Under the constitution, Mr Kwaśniewski (of the SLD) cannot stand for a third five-year term. Poland must also hold a referendum on the EU constitution. Although the EU is popular amongst the people, most parties are

purportedly against ratifying it. There is a risk of the turnout falling below 50%, which is required for validity, particularly if its timing is divorced from the presidential elections. In that case, the decision would pass to the Sejm, which, post-election, might vote “no”. That could create a political crisis, depending on the voting in other countries.

■ Short-Term Prospects

GDP grew at 5.3% in 2004, its fastest rate of expansion since 1997. The recovery reflects the benefits of private sector restructuring supported by low interest rates, fiscal expansion, a boost to competitiveness from the depreciation of the zloty in 2003 and the fillip from EU accession.



However, the economy has recently lost some momentum. The 12-month growth rate slowed through the course of 2004 from 6.9% in 1Q04 to 3.9% in 4Q04. This reflects the zloty appreciation during 2004, subdued real wage growth and EU base effects. Fiscal and monetary tightening should also act as a touch on the brake in 2005. At the same time, there has been a rebalancing of growth, with the contribution of net exports declining and domestic demand picking up. Export and import growth were both buoyant at 18% in 4Q04. Encouragingly, investment is finally reviving, growing by 7.2% in 4Q04, after languishing in negative territory from 2001-03. Investment prospects are bolstered by strong corporate balance sheets, high capacity utilisation and EU financing. Overall, Fitch forecasts GDP growth of 4.3% in 2005 and 4.5% in 2006.

The main short-term risk to growth and the current account position is an appreciation of the zloty. Other downside risks are a slowdown in the EU, higher oil prices and a tightening of global liquidity. In contrast, the stronger zloty has helped bear down on inflation and short-term interest rates have now peaked. Elections will be a focus of attention this

year and increase uncertainties. Over the medium term, fiscal consolidation will be required to sustain balanced growth.

Economic Performance and Outlook

| | 2004e | 2005f | 2006f |
|-------------------------------|-------|-------|-------|
| Real GDP (%) | 5.3 | 4.3 | 4.5 |
| CPI Inflation (% Annual Avg.) | 3.5 | 2.7 | 2.5 |
| Budget Balance (% GDP) | -6.8 | -5.8 | -5.3 |
| Current Account (% GDP) | -1.5 | -2.6 | -3.4 |

Source: PSP, NBP, MoF and Fitch Ratings

■ Structural Issues

Transition, Growth and EU Convergence

Poland's creditworthiness is supported by strong economic fundamentals and “real convergence” with wealthier EU countries. Good growth prospects are based on ongoing industrial restructuring, low labour costs relative to skills, recovering investment rates, institutional development and trade openness. However, structural challenges include restructuring heavy industry and agriculture, completing privatisations and reducing unemployment.

Real GDP growth *per capita* has averaged 4.4% over the past 10 years, close to trend growth estimates of around 5%. However, Poland's GDP *per capita* was still only around USD7,737 at market exchange rates at end-2004, just 22% of the EU15 average. In terms of purchasing power parity, Poland's 2003 GNI *per capita* was USD11,450, 43% of the EU15 average, up from 37% in 1997. Notwithstanding a recovery last year, Poland's investment rate was low at only 18% of GDP in 2004 (down from 25% in 2000), the lowest in CEE. A pick-up in both public infrastructure (which should be boosted by EU funds) and private sector investment will be required to sustain GDP growth rates.

Privatisation, Industry and Agriculture

Privatisation is important to support industrial restructuring, raise productivity growth, improve corporate governance and strengthen public finances. Some 400 enterprises remain state-owned, constituting around 10%-12% of GDP. The process has been slow under the SLD government, but advanced last year with the sale of a 38.5% stake in bank PKO BP, helping to raise PLN10.3bn. The government hopes to raise PLN5.7bn this year, including insurer PZU, oil and gas distribution company PGNiG, oil refiner Lotos and power distributor ENEA. But the target is at risk from disruption associated with the election and specific legal and contractual issues, not least for PZU.

Further restructuring is required in heavy industries such as coal, chemicals and the railways. The Sejm has yet to pass a long-planned law on the energy sector, which is necessary for liberalisation and the issue of up to PLN15bn of bonds in compensation to energy suppliers for the restructuring of their advantageous long-term contracts with distributors.

A large and unproductive agricultural sector is a significant drag on Poland's standard of living and budget. The sector accounts for around 20% of employment, but only about 3% of GDP. However, output appears to have been boosted by increased market access since joining the EU.

The Labour Market

Unemployment is a serious economic, social and political problem. At 19% of the labour force, it is the highest in the OECD². Around 15% is estimated to be structural. Moreover, 13% of those of working age are on disability pensions, so only just over 50% of the labour force are in employment, the lowest in the OECD bar Turkey ('BB-').



Industrial restructuring, fast productivity growth and the population profile have led to large net inflows into the labour market and significant industry, regional and skills mismatches. These trends were compounded by the downturn in 1998. A large tax wedge, high minimum wage and generous social welfare payments reduce labour mobility and the incentive for active job search, raising the share of long-term unemployment.

Encouragingly, the unemployment rate fell by one percentage point in 2004, helped by the cyclical recovery and some improvements in the labour code. Tax cuts and social welfare reforms in the Hausner Plan should also help somewhat. But more radical

measures to liberalise the labour market, lower the tax wedge and reform social benefits would be needed to reduce unemployment further and faster.

Financial Sector

Fitch does not view the financial sector as a significant risk to sovereign creditworthiness. It is relatively small, with banking assets equivalent to just 50% of GDP, M3 of 42% of GDP and domestic credit to the private sector of 28% of GDP (compared with the EU25 median of 103% and CEE8 median of 36%). This limits systemic risk and contingent sovereign liabilities. In addition, the system is two-thirds foreign-owned. Following some amendments last year, supervision and regulation essentially conform to EU standards.

Nevertheless, there are some concerns. Fitch bank analysts estimate the average Individual bank rating to be 'D' (weak), slightly worse than CEE4 peers. Classified ("irregular") loans are quite high at 14.7% at end-2004, but encouragingly have declined markedly from 21.2% at end-2003, helped by strong corporate profitability³. Non-performing loans (NPLs) were 9.2% at end-2004, and only 4.3% excluding specific provisions. Bank earnings, profitability and capital all improved in 2004.

Key Facts: Banking System

End-2004

| | |
|--------------------------------|------|
| M3 (% GDP) | 41.6 |
| NPL Ratio | 9.2 |
| Capital Adequacy Ratio | 14.2 |
| Public Ownership, % of Assets | 20.5 |
| Foreign Ownership, % of Assets | 67.6 |

Source: NBP and Fitch Ratings

Bank lending growth is subdued compared with other new EU member states. Indeed, lending to the corporate sector is still declining, owing to strong corporate balance sheets. Lending to the household sector is expanding at 15%, from a low base. This is a natural part of real convergence, the debt service burden is moderate and loans are well-collateralised. Total property lending is rising at over 30% and now accounts for over 23% of loans, though there is not evidence of a price bubble.

One credit issue is the prevalence, though declining share, of lending in foreign currency, which is 24% of all loans – including to households without foreign currency revenues. Thus a depreciation of the zloty could increase the real debt service burden and NPL ratio. Other issues include the fast-growing

³ Poland changed the definition of classified loans last year to those more than 30 days overdue, from 90 days, in line with international standards. NPLs exclude "substandard" and "doubtful" but which are still performing classified loans.

² "OECD Economic Surveys: Poland": OECD, June 2004

(at around 50%), self-regulated credit union sector, though their total assets are still small at around 1% of bank assets. Banks are quite exposed (around PLN100bn) to the power sector, for which there is some uncertainty over the details of compensation for changes to long-term contracts.

■ Public Finance

Public finances are the main constraint on Poland's sovereign ratings. Budget deficits have widened markedly this decade, from 2.3% in 2000 to an estimated 6.8% (4.8% including pension funds) in 2004, leading to an increase in public debt from 38% of GDP in 2000 to an estimated 48% in 2004⁴. Over the past four years, Poland has seen four finance ministers and the abandonment of several reform plans, Belka (in 2002), Kolodko (2003) and Hausner (2004/05). A comprehensive and sustained reform programme, focused on cutting social benefits will be required after the elections to stabilise public debt and allow the eventual adoption of the euro.

Outturns for 2004 were better than originally feared, helped by the economic recovery, lower debt servicing costs and spending restraint. The state budget deficit (central government, national definitions) was PLN41.5bn (4.7% of GDP), below the target of PLN45.3bn. The state borrowing requirement was PLN11.3bn below target at PLN48.7bn, mainly owing to a faster than expected dispatch of EU financing.

For 2005, the state deficit target is just PLN35bn (3.7% of GDP). Fitch's forecast for the ESA general government deficit is 5.8% (3.9% including pension funds). That would be a significant improvement from 2004. There are some risks. Hausner Plan measures that do not require legislation or have already been passed explain a 1.1 percentage point reduction in the deficit⁵. But some legislation assumed in the budget was not passed (reform of the Farmers' Social Security Fund (KRUS), the Disabled Fund and contributions of the self-employed), while some compensatory costs have been excluded. In addition, the 5% GDP growth assumptions looks a bit optimistic, while public investment (and EU co-financing) spending could rise sharply.

⁴ Unless otherwise stated, figures are based on the European System of Accounts (ESA 95) definition, excluding mandatory private (OFE) pensions from the general government sector (see text and table). Confusingly, the EU is currently allowing them to be included up to 2007, but not thereafter. For consistency and transparency, Fitch excludes them from its base projections, but takes them into consideration when analysing the public finances.

⁵ However, around 0.3% of GDP of these savings are temporary as part of the cost of the indexation of pensions has been *de facto* postponed until 2006.

State Finances: Sources and Uses

| % of GDP | 2004e | 2005f | 2006f |
|----------------------------|-------------|------------|-------------|
| Uses | 12.8 | 9.9 | 12.3 |
| Budget Deficit | 4.7 | 3.7 | 3.2 |
| Amortisation | 6.7 | 5.0 | 7.9 |
| Domestic | 5.6 | 4.0 | 6.6 |
| External | 1.1 | 1.0 | 1.3 |
| Transfers to Pension Funds | 1.2 | 1.2 | 1.2 |
| Other | 0.2 | 0.0 | 0.0 |
| Sources | 12.8 | 9.9 | 12.3 |
| Gross Borrowing | 11.3 | 9.8 | 11.9 |
| Domestic | 9.8 | 8.4 | 10.3 |
| External | 1.5 | 1.4 | 1.6 |
| Privatisation | 0.8 | 0.4 | 0.4 |
| EU Pre-Financing | 0.2 | -0.3 | 0.0 |
| Other | 0.5 | 0.0 | 0.0 |

NB: Borrowing by place of issue

Source: MoF, EC and Fitch Ratings

The Hausner Plan was meant to produce cumulative savings of around PLN54bn over 2004-07, and reduce the deficit by 1.7% of GDP in 2007 relative to the baseline. Around one-third of the savings are estimated to have been implemented (see table overleaf), but Fitch expects no further progress⁶. In March, the Ministry of Finance announced additional deficit-reduction measures, "Plan B" (in the event that there is no change to the EU ruling on the treatment of pension costs for the Maastricht criteria), worth around 0.4% of GDP in 2006 and 1.2% in 2007, lowering the deficit to 2.8% of GDP in 2007. There are three main strands: expenditure rationalisation, efficiency savings and tax reforms. As with the Hausner Plan, however, Fitch takes little comfort from Plan B, as it is light on the details of the savings, the Sejm will not pass new legislation this side of the election and most of the action is back-loaded in 2007 by when there will be a new government with a new plan.

If there are autumn elections, the PO has said that it would stick to the draft 2006 budget being drawn up by the current government, as it says there would be insufficient time to draft a new one. It would then pass (as yet unspecified) reforming legislation in 2006 that would then become effective only in 2007. Thus 2006 could be a "missing year" for fiscal consolidation. Fitch expects only a moderate reduction in the deficit to 5.3% of GDP in 2006.

Moreover, Fitch is not convinced the implementation of public finance reforms in 2006 is unfeasible and views the PO's timetable as a negative signal regarding its policy coherence and political will. It seems a strange political strategy not to get some social pain out of the way early in the electoral term

⁶ The NBP estimates 31% (Inflation Report: February 2005, P.22) and reports government estimates at 44%.

Fiscal Plans and EMU Convergence

| % of GDP | 2004 | 2005 | 2006 | 2007 | 2007-2004 |
|-----------------------------------------------------------------------|------------|------------|------------|------------|-----------|
| EU Convergence Programme | | | | | |
| (a) Budget Deficit (Including Pensions in Govt) | 5.4 | 3.9 | 3.2 | 2.2 | - |
| (b) Transfers to Private Pension Funds | 1.8 | 1.9 | 1.9 | 1.9 | - |
| (c) Budget Deficit (Excluding Pensions in Govt) | 7.2 | 5.8 | 5.1 | 4.1 | - |
| Hausner Plan¹ | | | | | |
| (d) Total Expected Savings (e) + (f) | 0.08 | 1.09 | 0.89 | 1.16 | |
| (e) Not Requiring Legislation | 0.01 | 0.45 | 0.46 | 0.45 | |
| (f) Legislation Approved by Sejm | 0.07 | 0.64 | 0.43 | 0.71 | |
| (g) Legislation not (yet) Approved by Sejm | 0.04 | 0.41 | 0.49 | 0.53 | |
| (h) Change in Budget Deficit (a)t - (a)t-1 | - | -1.5 | -0.7 | -1.0 | -3.2 |
| (i) o/w Explained by Hausner Savings (d)t - (d)t-1 | - | -1.0 | 0.2 | -0.3 | -1.1 |
| (j) Unexplained, Annual (h) - (i) ² | - | -0.5 | -0.9 | -0.7 | -2.1 |
| (k) Unexplained Cumulative | - | -0.5 | -1.4 | -2.1 | -2.1 |
| (l) Budget Deficit Without "Unexplained" Reduction (c) - (k) | 6.8 | 5.7 | 5.9 | 5.6 | |
| (m) "Discounted" pension cost under "excessive deficits" ³ | 2.0 | 1.5 | 1.1 | 0.8 | |
| (n) Implied Maastricht reference rate (3% + (m)) | 5.0 | 4.5 | 4.1 | 3.8 | |
| Implied Additional Required Budget Cuts (l) - (n) | 1.8 | 1.2 | 1.8 | 1.9 | |
| "Plan B" (Deficit Excluding Pensions in Govt) | 6.8 | 5.8 | 4.4 | 2.8 | -4.0 |
| Memo: Fitch forecast (Deficit Excluding Pensions in Govt) | 6.8 | 5.8 | 5.3 | 4.5 | -2.3 |

¹ Relative to 2004 baseline (not previous year)

² Part of reduction could be explained by GDP growth

³ 100% of pension costs (b) in 2004, 80% in 2005, 60% in 2006, 40% in 2007, 20% in 2008 and 0% in 2009

Source: Republic of Poland: Convergence Programme 2004 Update (November 2004) and Fitch Ratings

– as in Slovakia ('A-'). The elongation and phasing of the electoral cycle raise risks to Poland's EU Convergence Programme (CP) and euro timetable.

Poland's latest CP envisages reducing the deficit to 2.2% of GDP in 2007 (around 4% excluding pensions). However, as the European Commission (EC) warns, it is based on optimistic assumptions, including average GDP growth of 5.1% and the full adoption of the Hausner Plan. Moreover, the Hausner Plan only explains about half the 3% of GDP drop in the deficit over 2004-07. If it is not satisfied, the EU could potentially seek the sanction of a suspension of cohesion funds under "excessive deficit procedures". In any case, further fundamental fiscal reforms will be required after the elections, focused on cutting the 7% of GDP deficit on social transfers. Moreover, the PO has pledged to introduce a flat 15% VAT, personal income tax and corporate profit tax, which without compensating measures, would lower revenues.

The recent decision by the EcoFin EU Council to take partial account of the fiscal costs of pension reform in "excessive deficit procedures" and, therefore, in assessing the Maastricht fiscal criteria is positive for Poland's euro adoption timetable⁷. It should mean that Poland could meet the deficit criterion with a deficit of as much as 3.8% of GDP in 2007, if there was a credible plan for reducing it to

⁷ See Fitch: "Fitch sees Relaxation of SGP as Positive for CEE's EMU Adoption Timetable" 23 March 2005.

3% over the subsequent two years. Fitch now estimates that Poland would need to cut the budget deficit by around 2% of GDP in 2006-07 to meet its implicit target date of 2009 for adopting the euro (see **Monetary & Exchange Rate Policy**).

Debt Management and Financing

Poland's public debt to GDP ratio remains on an upward trajectory, though less steep than feared last year, owing to a lower than expected deficit, astute debt management and the zloty appreciation. Nevertheless, it was 47.7% of GDP at end-2004, (43.6% consolidating pension funds and, Fitch estimates, 51% on Polish definitions (including 1% of risk weighted guarantees⁸)). By any measure, it has been trending up steeply (though not in 2004, owing to the zloty appreciation) and is above the 'BBB' range median of 38%. However, its debt to revenue ratio of 127% is only a little above the 'BBB' median of 114%, and pension reforms strengthen its long-term solvency relative to most rating peers and EU member states.

The 60% of GDP Maastricht reference rate is unlikely to be a constraint provided the deficit criteria can be met. The risk of exceeding the 55% of GDP (Polish definitions) prudential standard of its

⁸ Total guarantees were 3.6% of GDP at end-2004. Poland also has some contingent liabilities, including property restitution claims from World War II (which could cost PLN8bn) and debts in the healthcare system. Compensation for the annulment of long-term energy contracts are likely to be in bonds from an SPV (financed from electricity bills) outside the government sector.

Public Finance Act and breaching the 60% constitutional limit has also diminished – in that event, Poland would be bound to implement an abrupt fiscal adjustment or a credibility-eroding shift in the goal posts. Debt dynamics analysis suggests that if Poland fulfils its CP, then the debt to GDP ratio should decline back towards 40% by 2010; but with no fiscal tightening and slightly lower GDP growth and higher interest rates, it would climb relentlessly to over 70% by 2010 (putting aside the possible effect of the constitutional limit).

Large cash deficits and amortisation add up to a substantial gross financing requirement (see table). The government's debt strategy is to refinance external amortisation in the international market, while restricting net borrowing to the domestic market. At end-2004, external debt (by place of issue) declined to 25% of public debt. By residency, foreign debt has been rising as non-residents purchased a net PLN21.2bn of local debt in 2004, taking their holdings to PLN62.3bn (21% of domestically-issued state debt). Poland has a strong debt management capacity and is able to issue at low spreads – its 15-year EUR3bn Eurobond was issued in January at a spread of 27 basis points over mid-swaps. It keeps a liquidity reserve equivalent to about 2-3 months gross financing needs, which was PLN6bn at end-2004.

Paris Club Pre-Payment

The Paris Club has agreed in principle that Poland can pre-pay its EUR12.3bn debt in 2005 (EUR2.1bn was already due). But it is subject to creditor participation, and take-up could be lower, perhaps closer to EUR5bn. Poland hopes to make the first payments on the 31st March coupon date.

The payment will not significantly reduce public debt as it will ultimately be financed by issuing new market debt in 2005 to 2006. Initially, Poland has secured a EUR6bn bridging loan. The debt management operation should bring benefits in terms of removing a 2005-09 amortisation hump, lengthening average maturity and some net present value (NPV) savings. But it will not, in itself, trigger a rating upgrade.

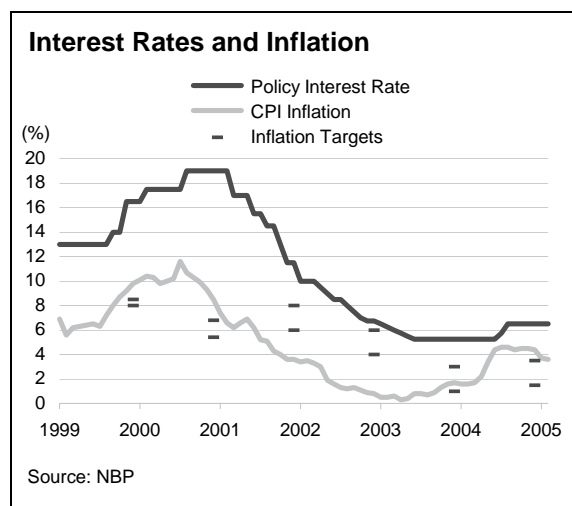
Brady Bonds: Poland has USD1.2bn in Brady bonds outstanding. It could call or buy them back if there were compelling NPV gains.

■ Monetary & Exchange Rate Policy

The NBP operates an inflation-targeting regime and freely-floating exchange rate. In Fitch's view, the transparent monetary policy framework is a rating strength. Exchange rate flexibility has insulated the

real economy and balance of payments from severe strains emanating from political and fiscal shocks that might have occurred under a more rigid regime.

In early 2004, the wholesale change of the nine outside members of the Monetary Policy Council (MPC) of the NBP (who are appointed by politicians) raised concerns that the new MPC might be overtly "dovish". Notwithstanding some market surprises, overall, the MPC has acted judiciously, raising the key 14-day intervention interest rate from 5.25% in June to 6.5% in August. With inflation on a downward path and the economy close to trend, the MPC changed its policy bias to "easing" in February, signalling that rates have peaked. This represents a marked improvement in monetary policy management compared with the previous cycle when interest rates peaked at 19% in 2000.



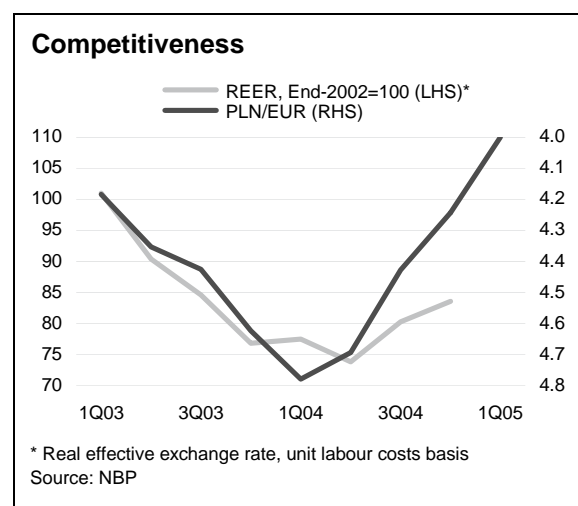
Consumer price inflation increased from an average of 0.8% in 2003 to 4.4% in 4Q04 owing to the cyclical recovery and strong cost pressures from food and fuel prices, earlier zloty weakness, EU accession-related factors and tax and regulated price increases. But it has since fallen to 3.6% in February and is on a clear downward trend as cost pressures have waned, helped by the appreciation of the zloty during 2004. Underlying inflationary pressures are muted. Net inflation (excluding food and fuel prices) was only 2.3% in February, broad money (M3) growth was 9.4% in February and whole economy wage growth was moderate at 5.6% in 4Q04. Fitch expects headline consumer price inflation to fall back to around 2.3% at end-2005, below the centre of the NBP's target range of 2.5% ±1%.

The Zloty and Competitiveness

The zloty has appreciated sharply from PLN/EUR4.72 at end-2003 to around PLN/EUR 4.05, a rise of 14% against the euro (despite some reversal in March related to global liquidity

concerns). The rebound reflects Poland's strong balance of payments, the "carry trade" and some reduction in the fiscal and political risk premium. The zloty's strength has raised some concerns about competitiveness and growth.

Nevertheless, in Fitch's view, the zloty does not look obviously overvalued. The rise still leaves the nominal rate below its level at end-2002, whilst in 4Q04 the real effective exchange rate (based on relative unit labour costs) was around 15% lower, owing to strong productivity growth as private sector companies restructured and shifted to higher value-added products and wage growth was muted. The current account position, export growth and gains in EU market share all suggest the zloty was significantly undervalued before its rebound last year. NBP survey evidence suggests that exports start to become unprofitable at around PLN/EUR4, but the rate is path-dependent, graduated and dynamic rather than on a cliff edge. On the positive side, the appreciation of the zloty has lowered debt servicing costs and the public debt to GDP ratio.



In any case, the authorities' policy options appear limited. The MPC can cut interest rates in the context of overall "monetary conditions" to the extent that it views the stronger zloty as suppressing underlying inflationary pressures. The NBP will change its long-standing policy of non-intervention in the foreign exchange market at some stage before ERMII entry, but Fitch does not expect this to be in the near future.

The Euro and ERMII

The policy of the NBP is that Poland should adopt the euro as soon as possible, subject to meeting the Maastricht criteria. The most difficult of which is the budget deficit criterion (see **Public Finances**). The current government has no explicit target date, but its CP implies a goal of 2009. The amendment to the

Stability and Growth Pact regarding the treatment of pension costs makes 2009 more feasible, but still challenging. Fitch still views 2010 as a more central expectation, therefore. The risk of a material delay beyond 2010 has diminished. The ambivalence if not outright hostility of the PiS to the euro is an additional risk. Slippage in the timetable could lead to an adverse reaction in financial markets and the build-up of exchange rate risks in the banking sector.

Maastricht Watch: 2004

| Criteria | Reference | Poland | Met |
|----------------------------------------|-----------|--------|-----|
| Inflation (%) ¹ | 2.2 | 4.4 | x |
| Interest Rates (%) ¹ | 5.7 | 6.0 | x |
| Budget Deficit (% of GDP) ² | 3.0 | 6.8 | x |
| Public Debt (% of GDP) ² | 60.0 | 47.7 | ✓ |
| ERMII | - | - | x |

¹ HICP, end-2004

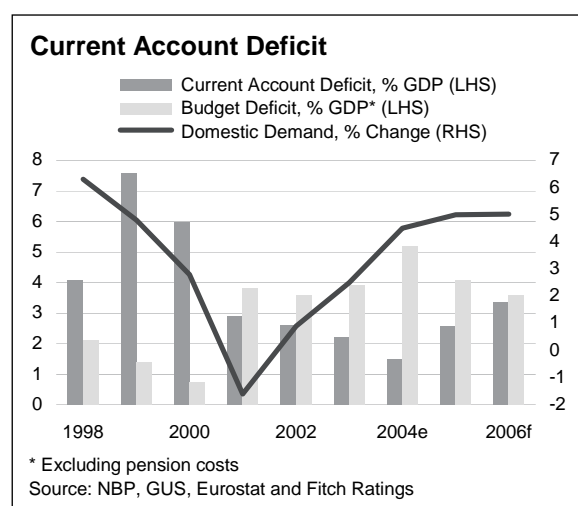
² 2004 average, excluding private pension funds
Source: Eurostat and Fitch Ratings

The Polish authorities intend to minimise the zloty's stay in the ERMII, which is consistent with their euro entry timetable. They see potential risks to monetary developments and the financial sector from "imprisonment" in a quasi-fixed exchange rate system. In practice, that would probably mean the minimum two years specified in the Maastricht Treaty plus around six months to allow for EC and European Central Bank (ECB) assessments and a decision by the Ecofin EU Council. This would imply possible ERMII entry in 2006-07.

External Finance

Poland's external financing position is comfortable and not a current rating concern. The current account deficit has narrowed from 7.6% of GDP in 1999 to just 1.5% in 2004, the smallest since 1995. In Fitch's view this reflects both cyclical and secular trends. It expects the deficit to increase to 2.6% of GDP in 2005 and 3.4% in 2006, as import-intensive investment accelerates, the appreciation of the zloty moderates competitiveness and EU funds boost demand and distort the figures¹⁰.

¹⁰ Polish contributions to the EU, which could be around 1% of GDP, will largely appear as transfers, increasing the current account deficit. But these will be more than financed by EU payments to Poland, which will largely appear in the capital account. Depending on absorption rates these could be around 2.5% of GDP, though some will leak out as imports.



Nevertheless, Fitch believes there has been some structural improvement in Poland's trade performance and does not expect a large "twin deficit" problem to emerge. The current account deficit is significantly lower than in the past, particularly relative to domestic demand, the budget deficit and despite relatively weak demand in Germany, Poland's largest export market.

External Finances: Sources and Uses

| (USDbn) | 2004e | 2005f | 2006f |
|--------------------------------------|-------------|-------------|-------------|
| Uses | 10.4 | 18.9 | 24.4 |
| Current Account Balance | -3.6 | -8.1 | -11.0 |
| MLT Amortisation | 6.8 | 10.8 | 13.3 |
| Sources | 10.4 | 18.9 | 24.4 |
| Gross MLT Borrowing | 12.8 | 18.7 | 23.0 |
| Net FDI | 3.8 | 4.8 | 4.5 |
| Portfolio Equity, Net | 1.9 | 0.5 | 0.5 |
| Net Lending Abroad | -10.6 | -6.2 | -4.2 |
| Capital Account | 1.0 | 3.0 | 3.5 |
| Other Capital, Net | -0.9 | -0.5 | 0.0 |
| Net Errors & Omissions | 2.8 | 0.0 | 0.0 |
| Change in FX Reserves (- = Increase) | -0.5 | -1.4 | -3.0 |

Source: IMF, NBP and Fitch Ratings

The financing mix for the deficit is relatively favourable. Fitch expects net equity FDI of nearly USD5bn in 2005, covering about 60% of the deficit. Moreover, EU financing could pick-up to around 2.5% of GDP. Nevertheless, public sector gross borrowing is expected to be sizeable at around USD15bn in 2005 as the government refinances amortising debt, and could be substantially higher if Paris Club creditors' take-up of Poland's offer to pre-pay its debt is greater than expected.

Poland's gross external debt (GXD) was USD123bn at end-2004, equivalent to 51% of GDP and 117% of CXR. Valuation changes related to the volatile zloty have dominated underlying factors in recent years, and Fitch expects exchange rate effects to lead to a decline in the ratios this year. Fitch estimates net external debt (NXD) was USD57bn at end-2004, equivalent to 24% of GDP and 55% of CXR. These are somewhat above the 'BBB' range medians of 18% and 43%, respectively. But Fitch's classification of debt by residency is relatively unfavourable for Poland, as non-residents' holdings of domestically-issued debt, equivalent to 7% of GDP, is counted as "external".

External Debt Ratios



Source: NBP, IMF and Fitch Ratings

Poland's financing position is relatively strong. Fitch forecasts a debt service to CXR ratio of just 13% in 2005, below the 'BBB' median of 14%. Fitch's liquidity ratio, which measures the ratio of liquid assets to liabilities falling due over the next 12 months, is estimated to be a comfortable 123% for 2005. In any case, as its Paris Club pre-payment proposal plan shows, Poland has strong international capital market access and financing risk is currently extremely low.

Non-bank private sector external debt has exceeded public sector debt since 2000. Of private debt, Fitch estimates 32% is inter-company lending (we deduct the associated inflows to derive equity-only FDI statistics in the balance of payments). Banks' net foreign asset position is positive, and there are no discernable risks to the sovereign from private sector debt.

Fiscal Accounts Summary

| % of GDP | 2001 | 2002 | 2003 | 2004e | 2005f | 2006f |
|-------------------------------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|
| General Government ESA Definitions | | | | | | |
| Revenue | 43.8 | 44.0 | 44.3 | 43.5 | 45.6 | 45.6 |
| Expenditure | 47.6 | 48.9 | 48.1 | 48.3 | 49.5 | 49.0 |
| o/w Interest | 3.0 | 2.9 | 3.1 | 2.6 | 2.9 | 3.0 |
| Primary Balance | -0.8 | -0.7 | -0.8 | -2.2 | -1.0 | -0.4 |
| Balance | -5.3 | -5.5 | -5.6 | -6.8 | -5.8 | -5.3 |
| Balance Including OFE Private Pensions in Govt Sector | -3.8 | -3.6 | -3.9 | -4.8 | -3.9 | -3.4 |
| General Government National Definitions | | | | | | |
| Revenue | 38.3 | 38.5 | 39.9 | 39.2 | 41.2 | 41.2 |
| o/w State Taxes | 16.2 | 17.0 | 17.0 | 15.7 | 16.9 | 16.9 |
| Social Insurance Funds | 13.1 | 13.4 | 13.3 | 13.7 | 13.7 | 13.7 |
| Expenditure | 43.3 | 44.4 | 45.3 | 44.6 | 45.7 | 45.2 |
| o/w State Government | 22.7 | 23.4 | 23.2 | 22.2 | 22.2 | 21.7 |
| o/w Debt Service | 2.9 | 3.2 | 3.3 | 2.9 | 2.9 | 3.0 |
| Social Security Fund | 12.6 | 12.6 | 12.5 | 12.9 | 12.9 | 12.9 |
| Local Government | 10.9 | 10.7 | 9.9 | 10.3 | 10.3 | 10.3 |
| Primary Balance | -2.2 | -2.7 | -2.1 | -1.6 | -2.3 | -1.8 |
| Balance | -5.0 | -5.9 | -5.4 | -5.4 | -4.5 | -4.4 |
| Central 'State' Government Balance | | | | | | |
| | -4.3 | -5.0 | -4.5 | -4.7 | -3.7 | -3.2 |
| Central Government Financing | 4.3 | 5.0 | 4.5 | 4.7 | 3.7 | 3.2 |
| Domestic | 4.8 | 4.1 | 3.6 | 4.2 | 4.4 | 3.7 |
| External | -1.4 | 0.4 | 0.5 | 0.4 | 0.4 | 0.3 |
| Privatisation Receipts | 0.9 | 0.5 | 0.4 | 0.8 | 0.4 | 0.4 |
| Other* | 0.0 | 0.0 | 0.0 | -0.7 | -1.5 | -1.2 |
| General Government Debt - ESA Basis | | | | | | |
| Total | 38.5 | 43.7 | 48.7 | 47.7 | 50.0 | 51.7 |
| Total Including OFE Pensions in Govt Sector | 36.7 | 41.2 | 45.4 | 43.6 | 45.1 | 45.9 |
| General Government Debt - National Definitions | | | | | | |
| Total | 39.7 | 45.2 | 50.1 | 49.6 | 51.9 | 53.5 |
| Domestic | 24.3 | 27.5 | 29.8 | 30.3 | 32.2 | 33.6 |
| External | 15.4 | 17.7 | 20.3 | 19.3 | 19.7 | 19.9 |
| o/w Non-Residents' Domestic Holdings | 2.7 | 4.0 | 5.0 | 7.1 | 7.9 | 8.4 |
| General Govt Debt/Revenue (%) | 103.6 | 117.3 | 125.6 | 126.6 | 125.9 | 129.9 |
| Memo: Gen Govt Debt + Risk-Weighted Guarantees** | 41.0 | 46.7 | 51.5 | 50.9 | 53.1 | 54.6 |
| Memo | | | | | | |
| Transfers to Open Pension FUNDS | 1.5 | 1.9 | 1.7 | 2.0 | 1.9 | 1.9 |
| Government Deposits at NBP | 0.4 | 0.7 | 1.0 | 0.7 | | |

* Includes transfers to OFE pension funds and EU pre-financing

** As defined in Public Finance Laws

Source: Ministry of Finance, Eurostat, EC and Fitch Ratings estimates and forecasts

Amortisation Schedule on Medium- and Long-Term Public Debt

| (USDm) | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|------------------------|--------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Total | 2,719 | 3,060 | 4,147 | 4,034 | 4,587 | 5,364 | 2,489 |
| Paris Club | 2,061 | 2,786 | 3,259 | 3,784 | 4,317 | 2,270 | 21 |
| Brady Bonds | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Eurobonds | 300 | 0 | 663 | 0 | 0 | 2824 | 2196 |
| Multilateral and Other | 358 | 274 | 225 | 250 | 270 | 270 | 272 |

Sources: Ministry of Finance

Balance of Payments

| (USDm) | 2001 | 2002 | 2003 | 2004e | 2005f | 2006f |
|----------------------------------------------------|---------------|---------------|---------------|----------------|---------------|----------------|
| Current Account Balance | -5,371 | -5,007 | -4,635 | -3,637 | -8,127 | -11,039 |
| % of GDP | -2.9 | -2.6 | -2.2 | -1.5 | -2.6 | -3.4 |
| % of CXR | -9.3 | -8.0 | -5.8 | -3.5 | -6.9 | -8.8 |
| Trade Balance | -7,661 | -7,249 | -5,742 | -6,147 | -8,749 | -11,468 |
| Exports, fob | 41,663 | 46,742 | 60,973 | 80,911 | 92,239 | 99,618 |
| Imports, fob | 49,324 | 53,991 | 66,715 | 87,058 | 100,987 | 111,086 |
| Services, Net | 793 | 849 | 512 | 1,307 | 1,438 | 1,538 |
| Services, Credit | 9,753 | 10,035 | 11,180 | 13,372 | 14,709 | 15,739 |
| Services, Debit | 8,960 | 9,186 | 10,668 | 12,065 | 13,272 | 14,201 |
| Income, Net | -1,391 | -1,887 | -3,639 | -4,584 | -4,816 | -4,609 |
| Income, Credit | 2,624 | 1,950 | 2,112 | 1,806 | 2,000 | 2,000 |
| Income, Debit | 4,015 | 3,837 | 5,751 | 6,390 | 6,816 | 6,609 |
| o/w: Interest Payments | 3,589 | 3,267 | 3,601 | 3,926 | 4,352 | 4,154 |
| Current Transfers, Net | 2,888 | 3,280 | 4,234 | 5,787 | 4,000 | 3,500 |
| Current Transfers, Credit | 3,737 | 4,182 | 5,315 | 8,471 | 8,000 | 8,000 |
| Current Transfers, Debit | 849 | 902 | 1,081 | 2,684 | 4,000 | 4,500 |
| Capital & Financial Account, Net | 3,249 | 7,173 | 8,765 | 1,375 | 8,791 | 14,590 |
| Capital Account | 76 | -7 | -46 | 1,025 | 3,000 | 3,500 |
| Non-Debt Creating Flows, Net | 4,011 | 2,058 | 3,457 | 5,762 | 5,341 | 5,000 |
| Direct Investment, Net, Equity Only | 4,385 | 2,871 | 4,109 | 3,827 | 4,841 | 4,500 |
| Portfolio Equity Investment, Net | -374 | -813 | -652 | 1,935 | 500 | 500 |
| External Borrowing, Net | 3,455 | 5,022 | 9,488 | 6,044 | 7,150 | 10,290 |
| Portfolio Debt Securities, Liabilities | 1,374 | 3,596 | 4,601 | 9,185 | 12,150 | 8,290 |
| Other Investment, Liabilities | 2,081 | 1,426 | 4,887 | -3,141 | -5,000 | 2,000 |
| Net Resident Lending Abroad | -3,957 | 998 | -3,265 | -10,587 | -6,200 | -4,200 |
| Portfolio Debt Securities, Assets | 115 | -889 | -1,477 | -1,175 | -1200 | -1,200 |
| Other Investment Assets | -4,072 | 1,887 | -1,788 | -9,412 | -5000 | -3,000 |
| Capital Nes, Net | -336 | -898 | -869 | -869 | -500 | 0 |
| Net Errors and Omissions | 1,695 | -1,518 | -2,890 | 2,789 | 0 | 0 |
| Overall Balance = Chg in Reserves (- =Incr) | 427 | -648 | -1,240 | -527 | -664 | -3,551 |
| Memo | | | | | | |
| Gross Borrowing (Incl. Short-Term) | 25,614 | 27,137 | 30,191 | 33,014 | 38,794 | 43,691 |
| Gross External Financing Requirement | 17,980 | 15,985 | 11,440 | 10,418 | 18,895 | 24,362 |
| Stock of International Reserves, Excl. Gold | 25,648 | 28,650 | 32,579 | 35,324 | 35,988 | 39,539 |

Sources: IMF, NBP, Fitch Ratings estimates and forecasts

External Debt and Debt Service

| (USDbn) | 2001 | 2002 | 2003 | 2004e | 2005f | 2006f |
|------------------------------------------------|--------------|--------------|--------------|--------------|--------------|--------------|
| Gross External Debt | 72.0 | 84.9 | 105.7 | 122.8 | 125.5 | 134.8 |
| % of GDP | 38.7 | 44.4 | 50.5 | 50.8 | 40.9 | 41.6 |
| % of CXR | 124.6 | 134.9 | 132.9 | 117.4 | 107.3 | 107.5 |
| By Maturity | | | | | | |
| Medium and Long-Term | 60.8 | 71.0 | 85.6 | 101.9 | 105.4 | 114.5 |
| Short –Term | 11.1 | 13.9 | 20.2 | 20.9 | 20.1 | 20.2 |
| % of Total Debt | 15.5 | 16.4 | 19.1 | 17.0 | 16.0 | 15.0 |
| By Debtor | | | | | | |
| Public Sector | 29.7 | 35.8 | 44.2 | 58.7 | 59.7 | 64.5 |
| o/w Paris Club | 16.3 | 17.2 | 17.9 | 16.8 | 7.4 | 4.1 |
| Non-Res. Holdings of Dom. Debt | 5.2 | 8.2 | 11.0 | 20.8 | 24.1 | 27.2 |
| Brady Bonds | 4.0 | 2.7 | 1.2 | 1.2 | 1.2 | 1.2 |
| Eurobonds | 1.8 | 4.9 | 10.6 | 15.0 | 24.0 | 29.0 |
| Non-Bank Private Sector | 35.6 | 41.5 | 50.5 | 51.6 | 52.8 | 56.2 |
| o/w Inter-Company Loans | 10.3 | 12.2 | 18.6 | 18.7 | 19.0 | 19.5 |
| Banks | 6.7 | 7.5 | 11.0 | 12.5 | 13.0 | 14.0 |
| Gross External Assets* | 42.4 | 44.0 | 49.4 | 65.5 | 66.2 | 69.7 |
| International Reserves, Incl. Gold | 26.6 | 29.8 | 34.0 | 36.8 | 37.4 | 40.9 |
| Brady Collateral | 0.5 | 0.5 | 0.5 | 0.6 | 0.6 | 0.6 |
| Deposit Money Banks' Foreign Assets | 15.3 | 13.7 | 14.9 | 28.1 | 28.2 | 28.2 |
| Net External Debt | 29.6 | 40.9 | 56.4 | 57.3 | 59.3 | 65.1 |
| % of GDP | 15.9 | 21.4 | 26.9 | 23.7 | 19.3 | 20.1 |
| % of CXR | 51.2 | 65.0 | 70.8 | 54.8 | 50.7 | 51.9 |
| Debt Service (Principal & Interest) | 16.2 | 14.2 | 10.4 | 10.7 | 15.1 | 17.5 |
| Debt Service (% of CXR) | 28.0 | 22.6 | 13.1 | 10.2 | 12.9 | 13.9 |
| Interest (% of CXR) | 6.2 | 5.2 | 4.5 | 3.8 | 3.7 | 3.3 |
| Liquidity Ratio (%) | 133.5 | 142.6 | 142.0 | 123.7 | 123.4 | 115.5 |
| Excl. Banks' Foreign Assets | 94.6 | 90.5 | 97.2 | 85.9 | 69.9 | 66.5 |

* Non-bank private sector external assets are not taken into account
Sources: NBP, IMF, World Bank and Fitch Ratings estimates and forecasts

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