

# Poland Macro View

## Primer on Poland

- *This note is intended to provide key information on Polish economy, its structure, monetary policy and fiscal framework. We believe this report should be useful mostly to investors who are looking for one source of information on a particular country or for whom Poland is a relatively new market.*
- Poland has relatively large domestic market and is less dependent on exports than other Central European economies. In recent years net exports had significant positive contribution to growth, though both private consumption and fixed investment were also drivers of GDP.
- Being the biggest recipient of aid funds from the European Union, Poland was able to maintain relatively fast economic growth after 2008. EU funds were used to boost investment spending and in particular infrastructure investment ahead of European football championships in 2012.
- Monetary policy is focused on keeping inflation close to the target but the incumbent Monetary Policy Council seems to prefer relatively tight monetary policy and wants to keep real interest rates in positive territory.
- Poland has several fiscal rules that are likely to affect fiscal policy dynamics in the future. In particular the government is committed to keep public debt below 55% of GDP, which seriously limits the room for countercyclical fiscal policy measures. The government also is trying to cut the general government deficit below 3.5% of GDP as failure to achieve this goal could lead to a cut in access to EU funds.
- Political situation remains relatively stable and we believe the risk of early election is not an issue at this stage.

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**See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.**

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## Primer on Poland

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## Basic Information

Figure 1. Poland – basic information

|                                   | Poland       | Rank in EU |
|-----------------------------------|--------------|------------|
| GDP nominal (EUR bn, 2012)        | 381          | #8         |
| GDP nominal in PPS (EUR bn, 2012) | 655          | #6         |
| GDP PPS per capita (in EUR, 2011) | 16200        | #24        |
| Population (mn)                   | 38.5 (2012)  | #7         |
| Next election dates               |              |            |
| Parliamentary                     | Autumn 2015  | -          |
| Presidential                      | June 2015    | -          |
| Other (EU parliament)             | 2014         | -          |
| MPC term expires                  | Jan/Feb 2016 | -          |
| Term of NBP governor expires      | June 16      | -          |

Source: Eurostat, GUS, NBP, Citi Research

Figure 2. How does Polish economy react to shocks?

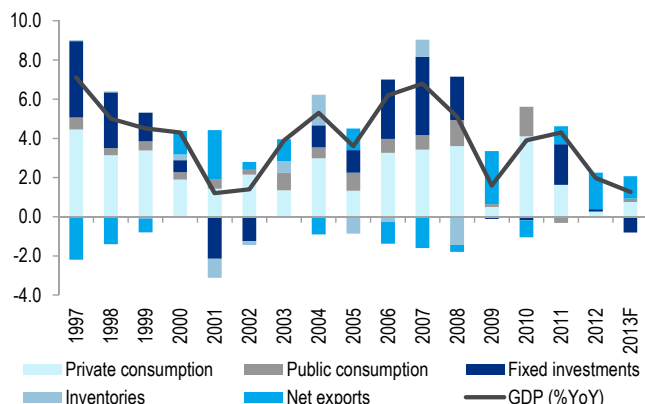
| Type of shock   | Impact on GDP growth<br>(in % points) | Impact on CPI<br>growth (in % points) |
|---|---------------------------------------|---------------------------------------|
| FX shock (10% PLN appreciation)*                            | -1.7 (after 3Q)                       | -2.0 (after 3Q)                       |
| Interest rate shock (increase by 100bps)                    | -0.5 (after 4Q)                       | -0.4 (after 4Q)                       |
| External demand (global growth lower by 1% point)           | -1 (after 3Q)                         | -0.3 (after 4Q)                       |
| Energy prices (10% increase - oil, gas and coal prices)     | -0.2 (after 9Q)                       | +0.3 (after 5Q)                       |
| Agricultural prices (10% increase)                          | -0.05 (after 5Q)                      | +0.2 (after 2Q)                       |
| Fiscal tightening (increase in indirect taxes by 1% of GDP) | -0.1 (in 1st year)                    | -                                     |
| Fiscal tightening (cut in investment spending by 1% of GDP) | - 0.8 (in 1st year)                   | -                                     |

Source: Results from ECMOD model of NBP (2012), OECD, Citi Research. \*Note: FX pass-through is highly cyclical in Poland and in periods of substantial economic slowdown the depreciation has only marginal impact on the CPI.

## Structure of economy and its growth drivers

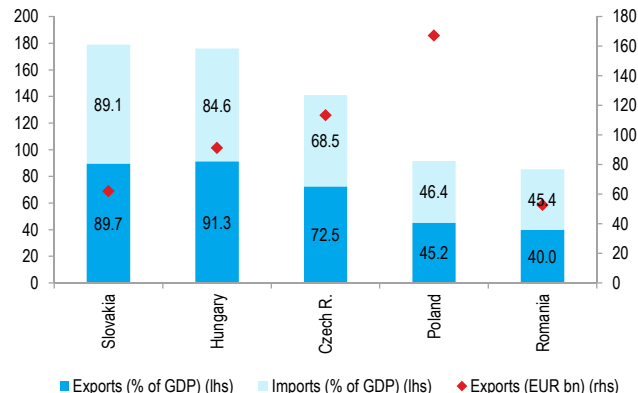
Thanks to its size and structure, the Polish economy has been more protected from external shocks than other Central European economies. Poland is the sixth biggest economy in the European Union (based on nominal GDP in Purchasing Power Standard) and has a relatively large labour market (Figure 1). Due to the size of domestic market, the country is less reliant on exports — for example, the share of exports to GDP in Poland amounts to around 46% of GDP, while in Hungary it is approximately twice bigger. Given the weakness of euro area growth in the past few years, this bigger reliance on the domestic market has proved to be a supportive factor.

Figure 3. Contribution to economic growth in Poland



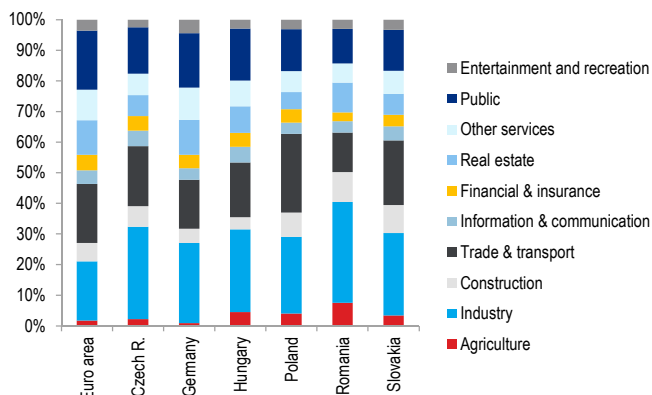
Source: Polish Central Statistical Office, Citi Research

Figure 4. Exports and imports (% of GDP)



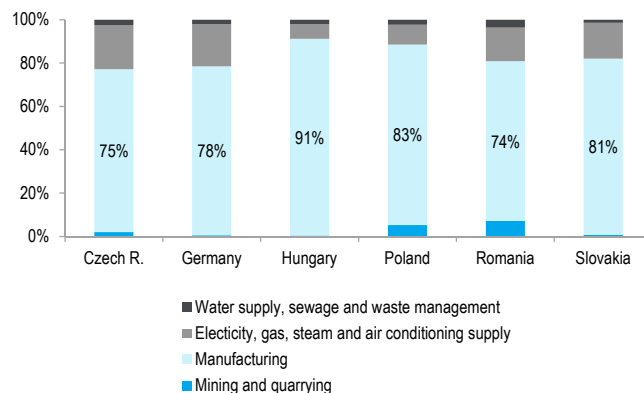
Source: Eurostat, Citi Research

Figure 5. Structure of value added in CEE (2011)



Source: Eurostat, Citi Research

Figure 6. Structure of industrial output in CEE

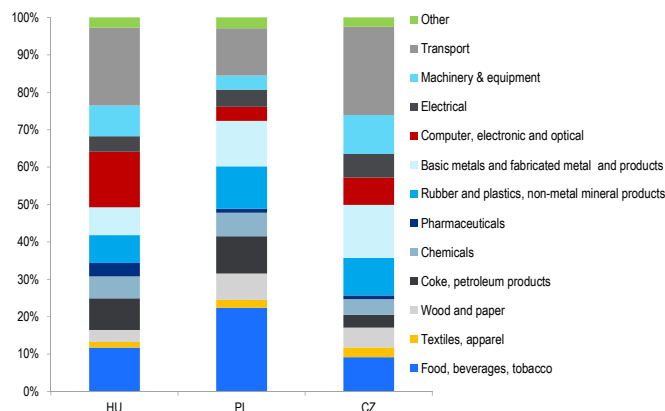


Source: Eurostat, Citi Research

Looking at the breakdown of value added, a large part of Poland's output comes from industry, as well as trade and transport (Figure 5). In terms of manufacturing, it seems Poland has a relatively diversified structure of production as compared to regional peers. Relatively high share of food and agricultural products in manufacturing also makes country less vulnerable to cyclical downturn as demand for food usually holds up well during slowdowns. Car manufacturing industry is relatively large, though smaller than in the Czech Republic or Slovakia. However, even despite having a bigger internal market and more diversified manufacturing structure, Poland's growth remains correlated with that of its trading partners. That is because Polish firms are well integrated into production chains of Western European firms.

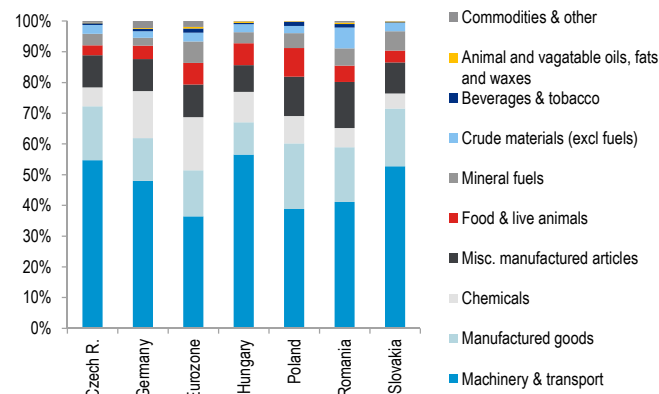
Correlation between growth in Poland and Germany (Figure 8) should not be surprising given the structure of Polish trade. Germany remains the biggest trading partner, accounting for more than 25% of total exports and 21% of imports. To put things into context, the second biggest export market — the United Kingdom — is substantially smaller and accounts for only 6.7% of total exports. Moreover, euro area economies that were most hit by the crisis account for a negligible share of Polish trade (Figure 11). This means that Poland would likely withstand even further deterioration in growth prospects of euro area peripheries if the German economy continued to outperform the eurozone as a whole.

Figure 7. Structure of manufacturing (2012)



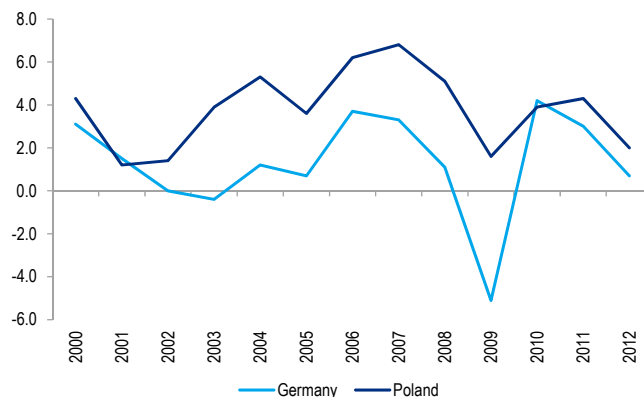
Source: Haver, Eurostat, Citi Research

Figure 9. Export breakdown (2011)



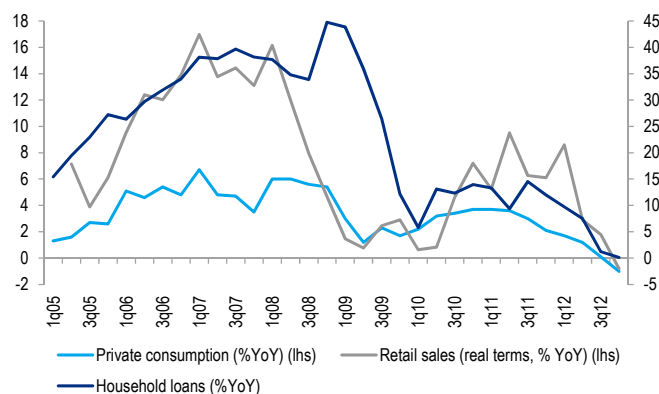
Source: Eurostat, Citi Research

Figure 8. Economic growth in Poland and Germany (YoY)



Source: Eurostat, Citi Research

Figure 10. Private consumption and lending to households



Source: GUS, NBP, Citi Research

Figure 11. Top export markets of Central European economies (2011)

| Poland      |           | Hungary  |           | Czech Republic |           | Slovakia    |           | Romania     |           |
|-------------|-----------|----------|-----------|----------------|-----------|-------------|-----------|-------------|-----------|
| Partner     | % exports | Partner  | % exports | Partner        | % exports | Partner     | % exports | Partner     | % exports |
| Germany     | 26.1      | Germany  | 24.6      | Germany        | 32.2      | Germany     | 20.0      | Germany     | 18.6      |
| UK          | 6.4       | Romania  | 6.1       | Slovakia       | 8.9       | Czech R.    | 14.5      | Italy       | 12.8      |
| Czech R.    | 6.2       | Slovakia | 5.9       | France         | 5.4       | Hungary     | 7.4       | France      | 7.5       |
| France      | 6.1       | Austria  | 5.6       | Austria        | 4.5       | Austria     | 7.1       | Turkey      | 6.2       |
| Italy       | 5.3       | Italy    | 5.0       | UK             | 4.5       | France      | 6.3       | Hungary     | 5.7       |
| Russia      | 4.5       | France   | 4.6       | Italy          | 4.1       | Italy       | 4.9       | Bulgaria    | 3.6       |
| Netherlands | 4.4       | UK       | 4.5       | Netherlands.   | 3.5       | Russia      | 3.6       | UK          | 3.2       |
| Sweden      | 2.9       | Czech R. | 3.7       | Russia         | 3.5       | Netherlands | 3.6       | Netherlands | 3.1       |
| Hungary     | 2.6       | Russia   | 3.2       | Spain          | 2.5       | Sweden      | 2.6       | Spain       | 2.4       |
| Ukraine     | 2.5       | Spain    | 2.6       | Hungary        | 2.2       | Hungary     | 2.4       | Russia      | 2.2       |

Source: Eurostat, Citi Research

Figure 12. Key export sectors of Poland and other Central European economies (2011)

| Poland                                      |              | Hungary                            |              | Czech Republic                        |              | Slovakia                                    |              | Romania                                    |              |
|---|--------------|------------------------------------|--------------|---------------------------------------|--------------|---|--------------|--|--------------|
| Subsector                                   | % in exports | Subsector                          | % in exports | Subsector                             | % in exports | Subsector                                   | % in exports | Subsector                                  | % in exports |
| Road vehicles                               | 13%          | Telecommunications                 | 16%          | Road vehicles                         | 17%          | Road vehicles                               | 21%          | Road vehicles                              | 12%          |
| Electrical machinery                        | 7%           | Electrical machinery               | 11%          | Electrical machinery                  | 10%          | Telecommunications                          | 14%          | Electrical machinery                       | 11%          |
| Furniture & parts                           | 5%           | Road vehicles                      | 9%           | Office machines                       | 8%           | Manufactured products of iron & steel       | 6%           | Telecommunications                         | 7%           |
| Telecommunications                          | 5%           | Power generating machinery         | 8%           | General industrial machinery          | 7%           | Electrical machinery                        | 6%           | Travel goods & handbags                    | 6%           |
| Manufactured products of metals             | 5%           | General industrial machinery       | 4%           | Telecommunications                    | 6%           | General industrial machinery                | 5%           | Manufactured products of iron & steel      | 5%           |
| Power generating machinery                  | 4%           | Medicine, Pharmaceutical           | 4%           | Misc. manufactured articles           | 5%           | Manufactured products of metals             | 4%           | General industrial machinery               | 5%           |
| Manufactured products of non-ferrous metals | 4%           | Office machines                    | 4%           | Manufactured products of metals       | 5%           | Misc. manufactured articles                 | 3%           | Manufactured products of rubber            | 3%           |
| Misc. manufactured articles                 | 4%           | Professional & scientific articles | 3%           | Manufactured products of iron & steel | 4%           | Manufactured products of rubber             | 2%           | Articles of apparel & clothing accessories | 3%           |
| Other transport                             | 3%           | Manufactured products of metals    | 3%           | Power generating machinery            | 3%           | Power generating machinery                  | 2%           | Furniture & parts                          | 3%           |
| General industrial machinery                | 3%           | Misc. manufactured articles        | 2%           | Specialized machinery                 | 3%           | Manufactured products of non-ferrous metals | 2%           | Manufactured products of metals            | 3%           |

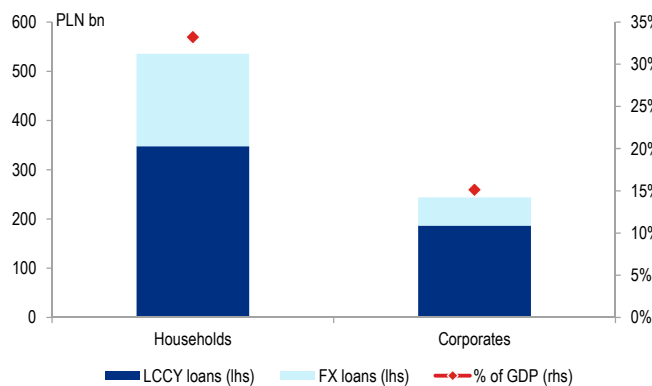
Source: Eurostat, Citi Research

Looking at the key growth drivers in previous years, both private consumption and fixed investment had a substantial positive contribution to GDP (Figure 3). Relatively strong consumer demand growth reflected a catching-up process as households tried to increase consumption towards Western European levels, counting on future increase in incomes. Household spending was also facilitated and fueled by the lending boom, including an increase in cheap foreign currency loans. In Poland, FX loans were mostly used to finance purchases of houses or housing equipment. However, flows of FX loans gradually disappeared after the 2008 crisis and were partially replaced by local currency loans.

Tightening of regulation regarding lending conditions has led to a decline and then stagnation in consumer credit in 2010-2012 (Figure 14). Eventually, the slowdown in lending and weaker labour market contributed to a drop in savings rate and later to a harsh slowdown in consumer spending. In 4Q 2012, for the first time in Poland's history (data go back to 1996), private consumption fell in year-on-year terms.

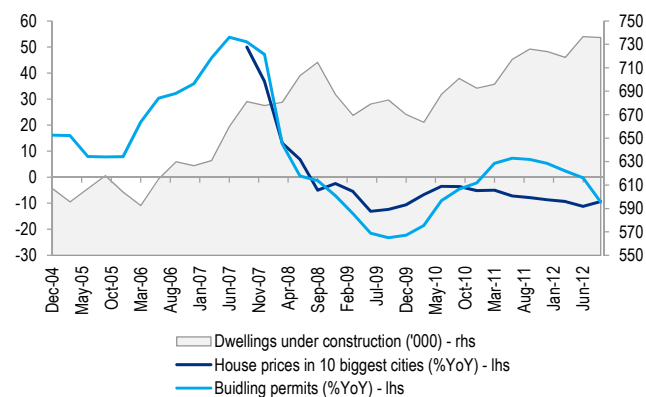
As far as other growth drivers are concerned, after its accession to the European Union in 2004, Poland experienced an investment boom, financed with cohesion and structural funds (see page 8). Even during the 2009-2010 slowdown, the country avoided a deeper contraction in investment. This was mostly thanks to infrastructure investment projects as the government tried to build roads and stadiums ahead of the 2012 European football championships that were co-hosted by Poland. More recently, this public investment boom has ended and 2H 2012 brought a fall in fixed investment in Poland.

Figure 13. LCCY and FX loans of households and corporates



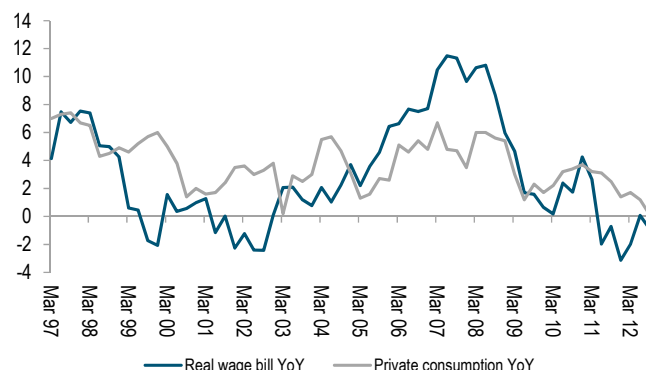
Source: NBP, Citi Research

Figure 15. Apartment prices, building permits, dwellings under construction



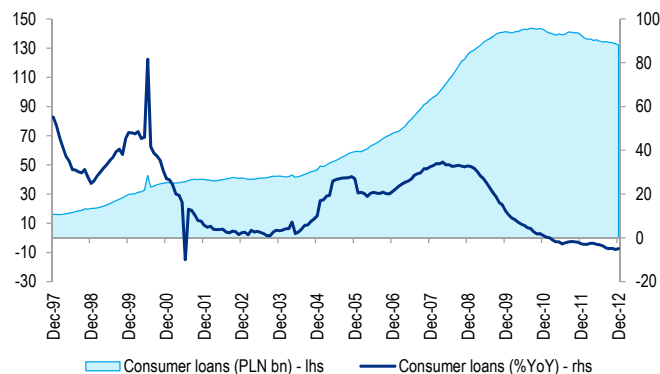
Source: NBP, Citi Research. Apartments' prices are based on hedonic index of NBP that adjusts market prices for the effect of changes in market composition of different quality apartments.

Figure 17. Real wage bill and private consumption



Source: Ministry of Finance, Citi Research

Figure 14. Consumer loans



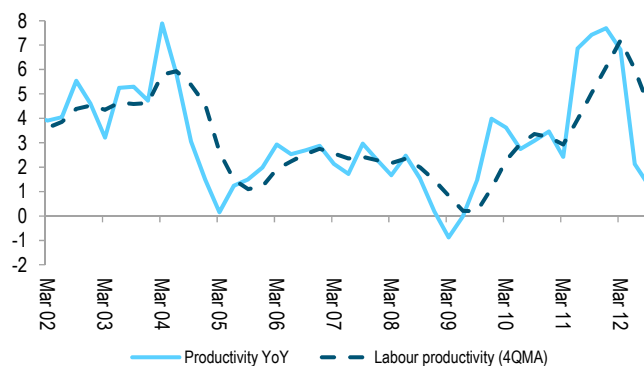
Source: NBP, Citi Research

Figure 16. Unemployment rate



Source: GUS, Citi Research

Figure 18. Labour productivity growth in Poland



Source: GUS, Citi Research

## EU funds

Poland became a member of the European Union (EU) on 1 May 2004, and thanks to this the country started a process of quick integration into Europe's economic structures. EU entry led to elimination of export and import taxes for intra-EU trade and opened Western Europe's labour markets for Polish workers. One of the most visible benefits was related to inflow of structural and cohesion funds from the EU, of which Poland is the biggest beneficiary. These funds are the financial instruments of EU regional policy and they have been designed to narrow the development gaps among EU members. The EU budget allocated EUR 348bn for regional and cohesion policies, out of which Poland received more than EUR 67bn (19% of the total amount), to be used over 2007-2013. In the new EU budget that will cover 2014-2020, the amount of EU funds available for Poland rose to EUR 72.8bn, while the pool of the money for the whole European Union shrank.

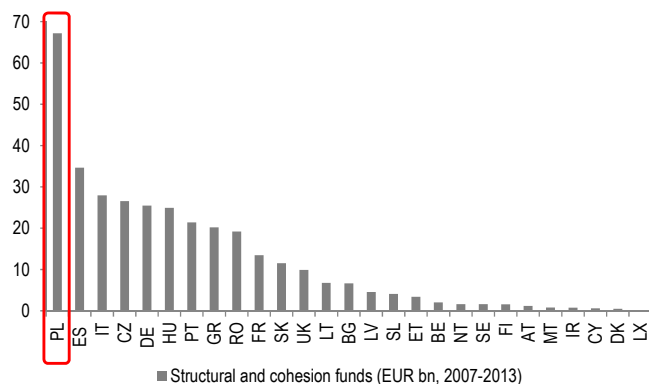
There are two major types of funds:

**1. Structural funds** — supposed to provide support for job-creating and productive investment as well as for improving human capital.

**2. The cohesion fund** — set up to accelerate economic and social convergence of countries with GDP per capita below 90% of EU average. Cohesion funds are usually used to improve transport infrastructure or fund environmental projects. Access to this fund can be suspended if a country shows an excessive fiscal deficit and has not taken appropriate steps to lower the deficit.

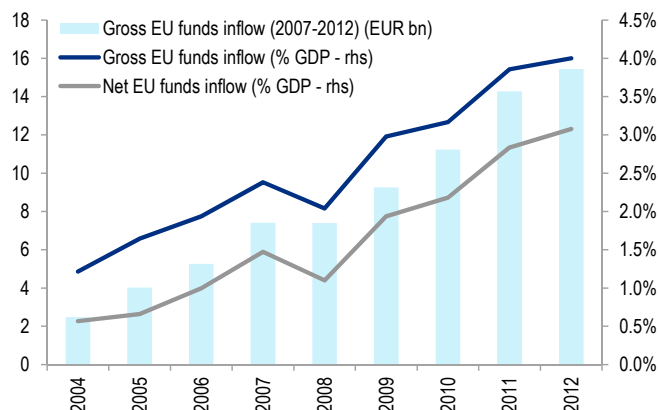
Availability of EU funds was one of the reasons why Poland managed to keep a relatively high and stable growth rate even when the eurozone was hit by sovereign debt crises. However, this also led to some deterioration in fiscal positions of local governments as recipients of EU funds are expected to cover a portion of investment costs. However, after a relatively good 2007-2012 period, we believe 2013-2014 will be probably more challenging as the flow of funds from the 2007-2013 EU budget is slowly coming to an end, while resources from the 2014-2020 budget will probably start flowing at a faster pace only in 2015.

Figure 19. Allocation of structural and cohesion funds by country (EUR bn)



Source: European Commission, Citi Research

Figure 20. Inflow of EU funds to Poland (EUR bn and % of GDP)



Source: Polish Finance Ministry, Eurostat, Citi Research

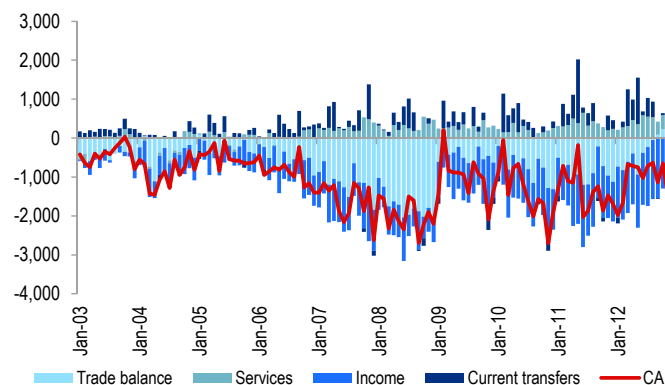


## External imbalances

Poland has been running wide current account deficits in previous years. According to our estimates, the CA gap on average amounted to around 4.6% of GDP over last five years, with the biggest deficits in trade and income balances. A persistently large income deficit reflects large dividend payments or reinvested profits and is a consequence of the fact that Poland has been a recipient of large FDI inflows, while Polish FDI abroad so far has been limited. Over time this might change as Polish firms are planning regional (and sometimes global) expansion, but we don't expect it to happen in the foreseeable future.

An important factor that in the past attracted attention of investors is related to the relatively large net errors and omissions (NEO) component in the balance of payments. This entry reflects potential errors or flows that are hard to classify elsewhere. In 2011 large NEO attracted the attention of investors, leading to some temporary fluctuations in the FX market. Since then the Polish central bank has made progress in cutting NEO, thus making overall balance of payments data more reliable.

Figure 21. Current account and its components



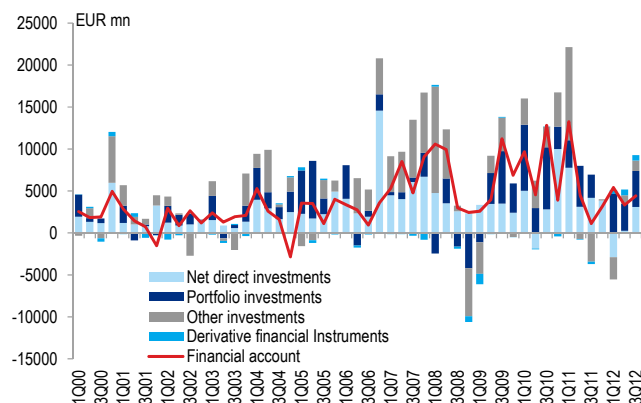
Source: NBP, Eurostat, Citi Research

Figure 22. Net errors and omission of balance of payments



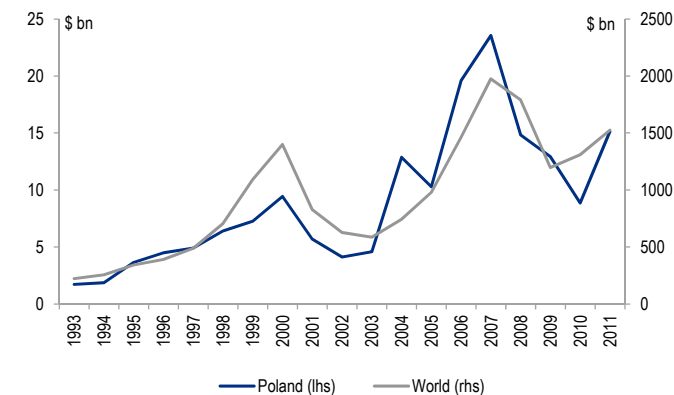
Source: NBP, Eurostat, Citi Research

Figure 23. Financial account and its components



Source: NBP, Citi Research

Figure 24. Inward FDI - Poland vs. world



Source: UNCTAD, Citi Research

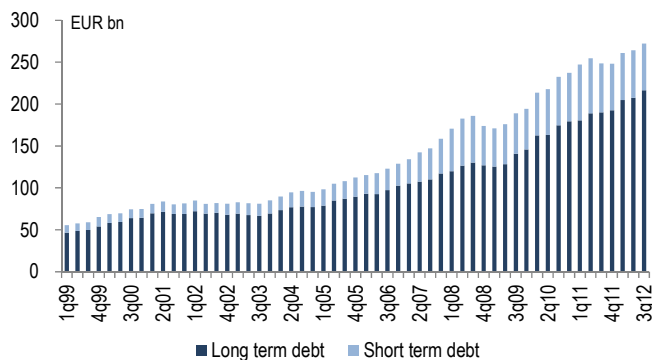
In terms of capital flows, inward FDI inflow slowed substantially in the wake of the 2008-2009 crisis, but this also reflects weaker FDI elsewhere (Figure 24). This shortfall was replaced by large inflows of portfolio capital, especially in 2011-2012,

as foreign investors were eager to buy government bonds. According to our estimates, the inflow to the bond market reached 3.3% of GDP in 2012. Given that the share of foreign investors in domestic debt market has reached 35.7%, one of potential risks is related to a possibility of the outflow of some of this capital, especially if rates in developed markets start rising.

An important component of capital flows is related to bank funding flows. Western European banks are active in the Central European region and for years they have provided funding to their subsidiaries or branches in Poland. However in 2011-2012 this flow was reversed as eurozone banks were obliged to increase capital buffers and reduce assets, which led to some form of deleveraging in the region. A risk of further deleveraging remains (see [Bank Deleveraging – Where Are We Now?](#)) as the loan-to-deposit ratio in Poland exceeds 100% and parent banks put pressure on subsidiaries to become self-funded. This could keep economic growth in the region at levels below the long-term average for some time, though risks of abrupt and disruptive withdrawal of bank funding seems less likely.

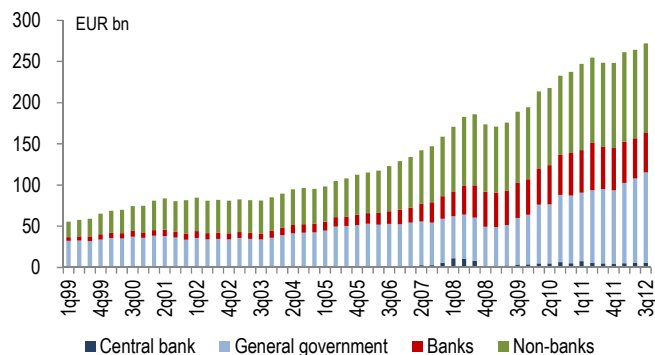
Finally, as compared to countries staying outside the European Union, Poland's balance of payments includes large inflows in the capital account that are related to structural and cohesion funds (see page 8). Given relative stability of EU fund inflow and the fact that they are given for seven-year periods, this component can be treated as an important source of funding for the CA gap. Actually, the Polish central bank and many economists covering Poland tend to look at the evolution of Current + Capital account instead of only the current account.

Figure 25. External debt – short-term vs. long-term (EUR bn)



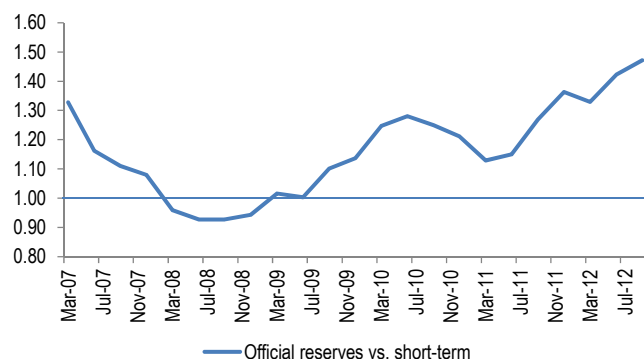
Source: NBP, Citi Research

Figure 26. External debt by sector (EUR bn)



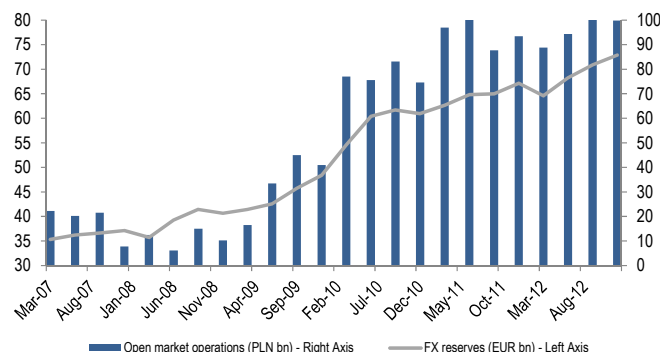
Source: NBP, Citi Research

Figure 27. Ratio of official reserves of NBP to short-term external debt



Source: NBP, Citi Research

Figure 28. Official reserves and size of liquidity absorbing operations of the central bank



Source: NBP, Citi Research

Poland has relatively high external debt, which reached EUR 272bn in 3Q 2012 or approximately 70.8% of GDP. Out of this 20% constitutes short-term external debt, with initial maturity below one year. Short-term debt to foreign reserves ratio amounted to around 68% in 3Q 2012. However, a substantial portion of the external debt reflects loans from parent companies to their Polish subsidiaries, a component that is likely to be rolled over without creating substantial risks to financial stability. Recent increase in external debt reflects large inflows of portfolio capital to Poland's government debt market as Poland's relatively strong economic growth and stable political situation continued to attract foreign investors.

## Fiscal policy

### Fiscal Situation Overview

Poland conducted a relatively loose fiscal policy in previous years and on average its deficit was one of highest among 27 EU countries (#6 based on data starting in 1995). However, an increase in public debt towards 55% of GDP has forced the government to reverse the previously loose fiscal policy and as a result of that since 2010 the fiscal policy has been tightened substantially. According to our estimates the general government deficit (ESA 95) that includes the central government, local governments and social security funds probably fell to around 3.5% of GDP in 2012 (Figure 30).

### Fiscal rules

Polish as well as EU law implies limits on the level of public debt and fiscal deficit dynamics. This is likely to have a meaningful impact on the dynamics of fiscal policy in the coming years.

**Public debt thresholds.** Poland's constitution states that public debt (calculated according to domestic methodology<sup>1</sup>) cannot exceed 60% of GDP, while the Public Finance Act defines certain actions to be taken by the government if 50%, 55% and 60% thresholds are breached. This public debt rule has important implications for the conduct of fiscal policy and suggests that authorities will be committed to avoid breaching 55% of GDP. If the debt exceeded this level, the authorities would be practically forced to balance the budget within next two years — a move that would probably be very costly in terms of GDP growth. This means the room for fiscal easing is relatively limited whenever public debt is hovering close to 55% of GDP and therefore the ability of the government to use countercyclical fiscal policy is limited.

**Expenditure rule.** Starting from 2011, a new temporary expenditure rule is in the force. The rule limits the growth rate of discretionary and new "legally mandated" spending to only 1% annually in real terms. New legally mandated spending includes also current legally mandated expenditure if the act defining them is modified, which means that the coverage of the rule is likely to increase over time due to amendments of the current law<sup>2</sup>. According to Finance Ministry's plans, if the fiscal deficit falls towards 3% of GDP and the Excessive Deficit Procedure (see below for more details of EDP) against Poland is removed, the government will

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<sup>1</sup> Public debt calculated according to domestic methodology is lower than general government debt calculated based on EU methodology (ESA95). The difference amounts to approximately 3% of GDP and is mainly a reflection of debt of so called Road Fund – an off-budget fund used to finance infrastructure projects in Poland.

<sup>2</sup> See: "Convergence Program" (2012), Finance Ministry of Poland

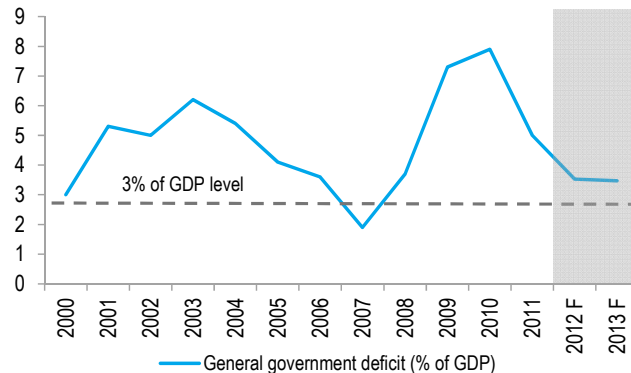
replace the temporary fiscal rule with a new permanent rule that would aim to stabilise the deficit in the medium term at 1% of GDP.

Figure 29. Average general government deficit (1995-2011, % of GDP)



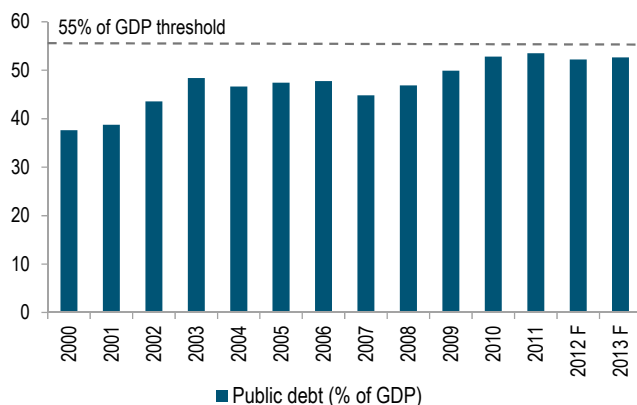
Source: Eurostat, Citi Research

Figure 30. General government deficit in Poland



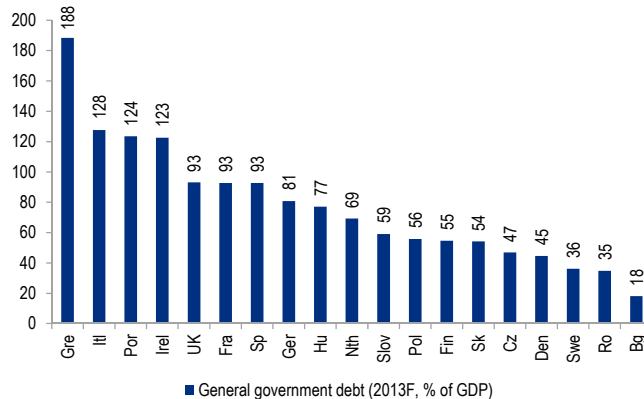
Source: Eurostat, Citi Research

Figure 31. Public debt in Poland (domestic methodology)



Source: Finance Ministry, Citi Research

Figure 32. General government debt (% of GDP)



Source: European Commission forecast from Nov 2012, Citi Research

**Local government rule.** Starting from 2011, local governments are obliged to balance the current balance. This allows municipalities to continue investment projects but puts limits on their ability to increase current spending.

**European fiscal limits.** Due to EU regulations, Poland is obliged to keep the general government deficit below 3% of GDP and if this threshold is breached, the European Commission can start Excessive Deficit Procedure (EDP) against the country. Given the recent focus of EU authorities on fiscal prudence, the importance of the 3% deficit threshold has increased and its existence is one of factors affecting the conduct of fiscal policy. From Poland's point of view, one of most important sanctions for countries remaining in Excessive Deficit Procedure is the possibility of cancellation of EU cohesion funds. These funds have been one of sources of relatively fast growth in Poland in previous years and their cancellation would be a scenario the government would like to avoid. Apart from keeping deficit below 3% of GDP, members of the European Union are supposed to maintain the general government debt below 60% of GDP.

## Ability to use countercyclical fiscal policy

As signaled earlier, the need to keep public debt below 55% of GDP is limiting room for counter-cyclical fiscal easing. In our view in case of a large unexpected shock that would justify fiscal easing, the authorities could theoretically try to avoid these consequences either by suspending some of fiscal rules written in the public finance law or by changing the definition of public debt (for example by excluding from public debt the amount of debt related to pension reform).

In 1999 Poland introduced a new defined contribution pension system consisting of three pillars: (1) a compulsory pay-as-you-go pillar, (2) a compulsory funded private pension fund pillar, and (3) voluntary funded pillar. The defined contribution system helped to improve long-term fiscal sustainability but this has had a short-term unfavourable impact on fiscal accounts. That is because under the new system the pension contribution paid by workers is split between private pension system and public Social Insurance Institution (ZUS). The transfer of contributions to the private system creates a shortfall in ZUS that needs to be reimbursed by the state budget, increasing the fiscal deficit and generating borrowing needs. To show the size of the problem, assets of private Open Pension Funds at the end of 2012 amounted to PLN 269.6bn or 16.7% of GDP, out of which 7.6% of GDP was invested in government bonds.

We would expect that in case of a large unfavourable shock, the government might want to change the law so that fiscal rules apply to public debt after deduction of the size of pension assets (16.7% of GDP), or at least after deducting the amount of pension assets held in bonds (7.6%). Alternatively the government might try to shift some of contributions held in the second pillar to ZUS and by doing this to redeem a corresponding portion of bonds. However, these are only potential possibilities and so far the government has not shown any signs of being in a hurry to implement such measures.

## Budget setting process

The government needs to submit the Budget Draft as well as the debt Management Strategy to the Parliament by the end of September. This means that August and September are usually months when market participants receive important information on future fiscal policy. The Parliament has four months to finish work on the budget and send the Budget Law to President. If it fails to meet the deadline, the President has the right to dissolve the Parliament within 14 days.

An important factor that should be taken into account is that although the Parliament is allowed to change revenue and spending plans, it is not allowed to change the budget deficit limit<sup>3</sup> as compared to the government's draft. Nevertheless, it is possible for the Parliament to increase spending and at the same time increase revenues even if such revenues are not realistic.

Polish law doesn't allow the government to exceed the state budget deficit limit during a fiscal year. This means that usually the budget bill is prepared cautiously, with revenues and spending assumed at levels that leave room for positive surprises. However, if economic growth slows substantially and the deficit cannot be held within limits, the Finance Ministry needs to go through the full process of budget amendment and the new budget limit needs to be approved by the parliament. Such changes are relatively rare in Poland because the budget

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<sup>3</sup> This refers to the budget deficit that reflects difference between central government spending and revenues. These limits do not apply to general government deficit.

amendment process can be costly in political terms (giving opposition easy arguments to be used to criticise the government).

## Impact of FX fluctuations on debt

Since approximately 32% of central government debt is denominated in foreign currencies, PLN depreciation can be one of key drivers affecting the level of public debt. According to Finance Ministry estimates, zloty depreciation by 10% against other currencies would increase government debt by more than 1.5% of GDP in 2013. Existence of fiscal rules that introduced an important threshold at 55% of GDP creates a risk that temporary FX fluctuations could push the debt above this level and trigger substantial fiscal adjustment. Fears of such a scenario were actually one of factors behind rising depreciation pressure in late 2011.

In response to these risks, Poland has changed its law in order to minimise the possibility of such a forced fiscal adjustment. According to current rules if the public debt rises above 55% of GDP, the debt level is recalculated based on annual average FX rate and then the amount of liquid assets (held for debt prefunding purpose) is deducted from the debt level. Fiscal tightening is triggered only if such an adjusted debt level is still above 55% of GDP. Such a solution ensures that fiscal rules will hold in the medium term, but it also makes the government less dependent on short-term market fluctuations.

## Monetary Policy

### Monetary policy framework

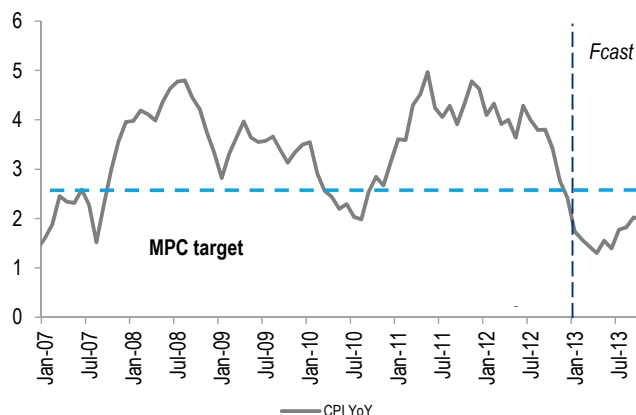
According to Polish law *'the basic objective of the activity of the NBP shall be to maintain price stability, while supporting the economic policy of the Government, insofar as this does not constrain the pursuit of the basic objective of the NBP'*<sup>4</sup>. The NBP has pursued the direct inflation targeting strategy since 1999 and currently the ongoing inflation target is 2.5% for the headline CPI. However, the central bank has also +/-1% point band of permissible fluctuations around the target. In order to meet the inflation target, the NBP adjusts the level of reference rate (Figure 34) and by doing this it tries to affect money market rates as well as lending rates.

Inflation has been volatile in Poland and the CPI has rarely fluctuated close to the 2.5% target (Figure 33). The overshoot of the target in recent years can be, however, attributed mostly to energy and food prices (due to high weight of these categories in the inflation basket). The core inflation rate excluding these two components generally remained lower than headline CPI. Based on recent comments of central bank officials, we believe policymakers treat the target seriously and don't want markets to think the central bank allows for persistent deviation of the CPI from the target. Also, in our view the MPC treats the target literally, focusing mostly on current rather than forecasted inflation. In our opinion the MPC as a whole generally prefers to err on the side of being too hawkish than too dovish, though in the future this behaviour might depend on the incoming data.

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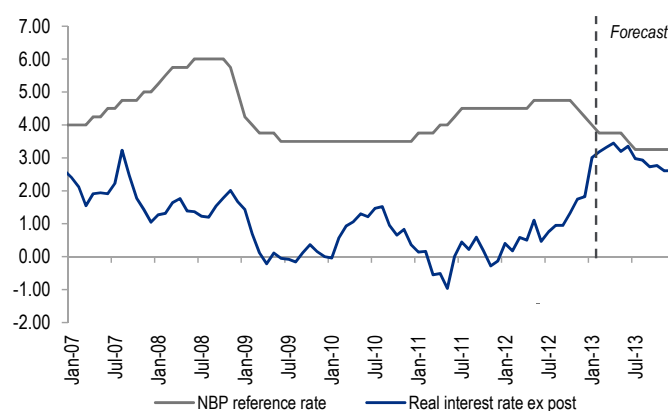
<sup>4</sup> The Act on the National Bank of Poland, 29 August 1997.

Figure 33. Headline inflation and the central bank's target



Source: GUS, NBP, Citi Research

Figure 34. Central bank's reference rate – nominal and real



Source: NBP, GUS, Citi Research

**Monetary policy reaction function.** Although it is difficult to describe all the drivers of interest rate decisions, below we try to summarise the most important factors that could play a role:

- **Current inflation** — In our view, the incumbent MPC is generally backward looking and pays much more attention to current inflation than to CPI forecasts. Economic activity is a less important factor for the MPC than the current inflation.
- **ECB decisions** — Although Poland's economic cycle is correlated with Germany's, the MPC in Poland usually doesn't blindly follow interest rate decisions of the ECB.
- **Currency** — FX changes usually don't have immediate impact on interest rate decisions in Poland. Only large and lasting PLN moves seem to have significant impact on MPC decisions.

## Who takes decisions on rates?

The institution responsible for conducting monetary policy is the Monetary Policy Council (MPC). The Council consists of 10 members who are appointed for six-year terms: NBP governor and 9 other members. Polish constitution gives the MPC independence from the government and the Parliament. Although nine members are elected and appointed by the President, Lower and Upper House of Parliament (3 members by each) these institutions have no direct influence on monetary policy decisions. Sporadically government officials express critical views regarding the monetary policy stance, usually calling for faster rate cuts or slower, but this doesn't seem to have much impact on actual rate decisions.

All nine 'external' MPC members are elected for six years at the same time and there are no rotating/overlapping terms. This has had a substantial impact on the conduct of monetary policy as changes in the central bank imply lack of continuity in policymaking and imply that all members are new to the job and need to learn it from the scratch. In our view, this might be an explanation for sometimes surprising swings in central bank communication or surprising policy moves after the change of the MPC. So far there has been no serious attempt to change the way MPC members are elected.



**How do they vote?** MPC takes decisions based on a simple majority but in case of a draw, the governor has a casting vote. Generally the incumbent governor (Marek Belka) has tried not to use this right too often and instead he attempted to build a bigger coalition to justify a rate change. The by-product of this strategy was that usually it took a lot of time for the MPC to change the course of monetary policy as building a bigger coalition takes more time.

**Figure 35. Members of Polish Monetary Policy Council and their views**

| Name of MPC member    | Hawk/Moderate/Dove | Characteristics and key views  |
|-----------------------|--------------------|--|
| A. Kaźmierczak        | Hawk               | Backward looking; focused on the level of real rates - real rates should be positive to boost growth in bank deposits to ensure banks will have sufficient resources to fund lending growth even in case of deleveraging by foreign parent banks                                     |
| J. Winiecki           | Hawk               | Wants to keep the real interest rate above 0%; believes that interest rates in developing countries like Poland should be kept on average at a higher level than in most EU countries  |
| A. Rzońca             | Hawk               | Believes the monetary policy response should be asymmetric – responding to unfavorable external shocks that contribute to higher CPI but not reacting to favorable shocks; Mr. Rzońca is also focused on keeping rates close to the natural rate                                     |
| A. Glapiński          | Hawk               | Backward looking approach; believes long period of inflation staying above the target undermines credibility of the monetary policy and justifies relatively high real rates   |
| Z. Gilowska           | Hawk               | Focuses on keeping inflation close to the target and emphasises low level of real rates (very little comments available)   |
| J. Hausner            | Moderate           | Wants to keep positive real interest rates in order to make Polish companies to become "more efficient and to create structural competitiveness"; believes the monetary policy can do little to reverse the 2012/2013 slowdown - this should be addressed by the government, not NBP |
| A. Zielińska-Głębocka | Moderate           | Emphasises various factors but appears to focus on whether current CPI is above the target or not; generally Mrs Zielińska-Głębocka tends to vote in line with governor Belka  |
| M. Belka              | Dove               | Forward looking approach, ready to accept temporarily higher inflation to avoid deeper slowdown, seeking consensus   |
| A. Bratkowski         | Dove               | Forward looking approach, ready to accept temporarily higher inflation to avoid deeper slowdown  |
| E. Chojna-Duch        | Dove               | Forward looking approach, ready to accept temporarily higher inflation to avoid deeper slowdown  |

Source: Citi Research

## FX interventions.

Since April 2000, the zloty (PLN) has been a floating currency and for years the Polish central bank preferred to stay away from the FX market while most policymakers expressed the view that the exchange rate should be a reflection of market forces. This changed in 2011 when the central bank adopted a somewhat more active role in the market and intervened several times in order to limit currency volatility in a period of rising depreciation pressures due to intensification of the euro area crisis. In 2012 there were no central bank interventions we would be aware of.

Central bank officials claim there is no target FX rate they would like to defend and interventions aim to decrease currency volatility, especially in periods when FX moves are large and are not caused by fundamental factors (for more on FX interventions see: [FX Interventions – Either Big or None](#))

Although decisions on interest rates are taken by the MPC, the FX interventions decisions are taken by senior management of the NBP. The central bank is not obliged to publish data on the size of interventions and therefore usually the NBP informs only that it conducted an FX operation on the market. Analysis of changes in the stock of FX reserves of the central bank is of limited use as the increase in reserves in previous years reflected mostly inflow of EU structural and cohesion funds to Poland, most of which were exchanged in the central bank.

Official currency reserves in Poland amounted to EUR 82.6bn (or USD 108.9bn) at the end of 2012. According to most measures, this level of FX reserves is adequate. In case of larger market pressures, Poland has also access to approximately USD 33.8bn from IMF Flexible Credit Line (FCL). The FCL has been designed as a credit line targeted only for countries with strong economic fundamentals and a



good economic policy track record, and there is no conditionality attached to it. This means the FCL can be drawn by Poland whenever such a need arises without meeting any additional conditions. However, Polish authorities declared they would like to treat the FCL as precautionary. The two-year access to FCL has been renewed in January 2013.

## Finance Ministry on the FX market

Apart from central bank interventions, the Finance Ministry can also be active on the market, usually using state owned bank BGK as its agent. The Finance Ministry does not have FX reserves but is responsible for exchanging EU funds into zlotys and given that annual inflow of such funds to Poland amounted to around EUR 16bn in 2012, it potentially could have some impact on the market. Before 2011 these funds were exchanged in the central bank, thus leading to substantial buildup of FX reserves, but having no direct impact on the market. In 2011 the Ministry started to exchange the vast majority of these funds on the market in order to counteract depreciation pressure related to rising risk aversion. In 2012 decisions on when and how much should be exchanged on the market and how much in the central bank probably became more tactical and given relative strength of the zloty, we believe the Ministry preferred to exchange the vast majority of funds either in the central bank or on the market through a different agent than BGK (in order not to send a signal to the market that could strengthen the zloty too much).

## Euro Adoption

As a member of the European Union, Poland is obliged to adopt the euro at some stage, though there is no fixed date by which it should happen. Polish governments used to set target dates for entry to the eurozone but they were systematically delayed. Currently Poland has no target date and official comments of key policymakers — central bank governor, Finance Minister and Prime Minister — suggest the authorities have no intention to hurry up with euro adoption. This is because the authorities want to wait with strategic decisions about EMU membership until the situation in the eurozone stabilises and the new institutional structure of the bloc is decided.

Figure 36. Maastricht criteria fulfillment

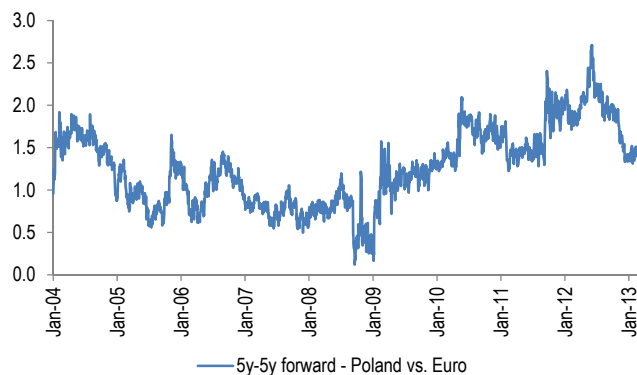
|                      | HICP | Interest rates | General government balance (% GDP) | General government debt (% GDP) |
|----------------------|------|----------------|------------------------------------|---------------------------------|
| Czech Republic       | 3.6  | 2.9            | -3.4                               | 46.9                            |
| Hungary              | 5.6  | 8.1            | -2.9                               | 77.1                            |
| Poland               | 3.9  | 5.2            | -3.1                               | 55.8                            |
| Romania              | 3.3  | 6.7            | -2.4                               | 34.8                            |
| Convergence criteria | 2.8  | 3.6            | -3.0                               | 60.0                            |

Source: Polish Finance Ministry, Eurostat, European Commission, Citi Research. Note: Deficit and debt forecasts based on European Commission's forecasts published in Autumn 2012.

Countries planning to adopt the euro need to fulfill several macroeconomic conditions. In particular they need to keep average inflation and long-term inflation low as compared to other EU countries, maintain general government fiscal deficit below 3% of GDP and keep general government debt below 60% of GDP. Additionally a country planning to enter the eurozone is expected to keep for at least two years the currency in ERM-2 mechanism that limits FX fluctuations to a range around a set parity. Although the European Commission and the ECB that assess fulfillment of Maastricht criteria are open to accept appreciation beyond the limit of

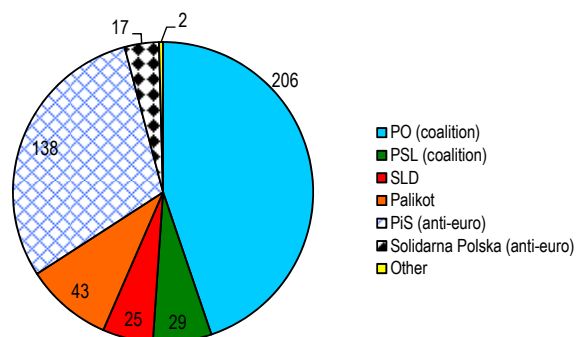
the ERM-2, excessive depreciation probably would be treated as a sign of lack of compliance with Maastricht criteria. All in all, Poland doesn't meet any criteria except for the one related to the general government debt level (Figure 36).

Figure 37. 5y5y forward rate – Poland vs. EUR



Source: Reuters, Citi Research

Figure 38. Distribution of seats in the Polish parliament



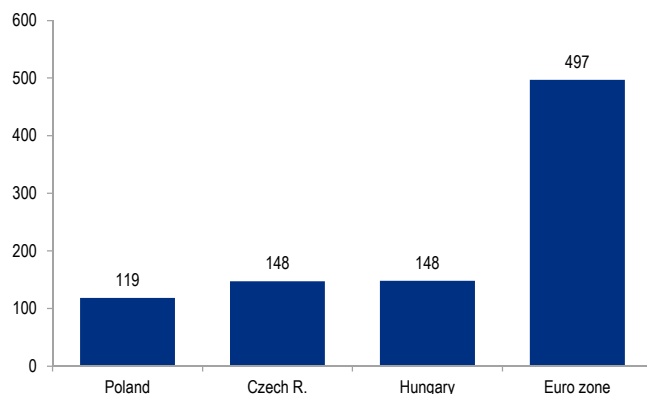
Source: Sejm, Citi Research

Apart from macroeconomic criteria, before euro adoption Poland needs to fulfill legal conditions also, that is to adjust law so that adoption of the common currency is possible. In our view, this seems to be the most serious obstacle for euro entry at the moment. That is because one of key changes in Polish law includes an amendment to the constitution in order to allow the ECB to have rights that are currently reserved only for the National Bank of Poland. For a constitutional amendment, the pro-euro coalition would need to have at least 2/3 majority in the lower house of the parliament (Sejm). However, the current split of seats in the Parliament (Figure 41) shows that euro-sceptical opposition should be able to block such amendments. The next parliamentary elections are scheduled for autumn 2015, but it is uncertain if this will change anything in this respect.

Having said that, we think the euro adoption by Poland is unlikely anytime soon and if anything we believe this could happen closer to the end of this decade or later. At this stage, the government and central bank are planning to start a public debate on costs and benefits of the euro for Poland in order to assess whether the eurozone crisis and resulting institutional changes in the European Union change the case for euro adoption.

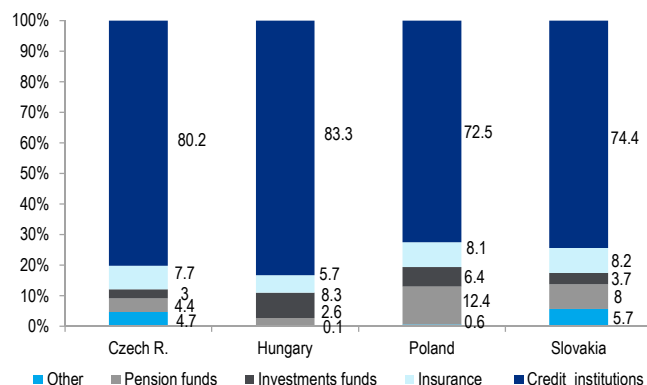
## Financial system in numbers

Figure 39. Total financial system assets in 2011 (% GDP)



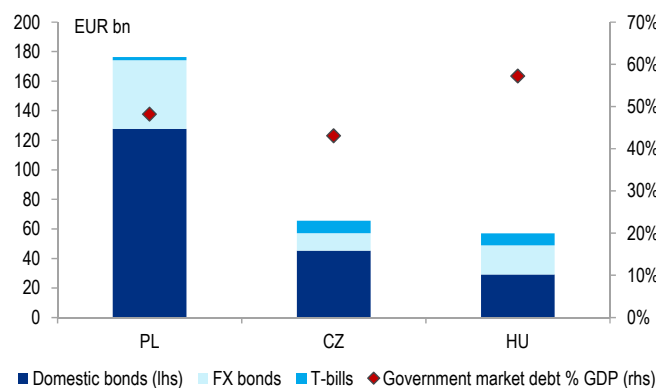
Source: NBP, Citi Research

Figure 40. Financial system structure in CEE (2011, in %)



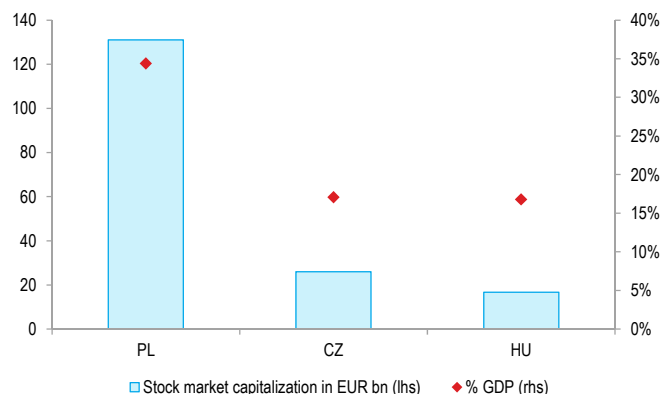
Source: NBP, Citi Research

Figure 41. Government debt market in CEE (Feb 2013)



Source: Bloomberg, Feb 2013, Citi Research

Figure 42. Equity market capitalisation in CEE (Jan 2013)



Source: FESE, Citi Research

Figure 43. Size of financial market by type of instrument in Poland (PLN bn)

|                           | 2008  | 2009  | 2010  | 2011  |
|---------------------------|-------|-------|-------|-------|
| Debt instruments          | 399.4 | 444.2 | 523.7 | 570.2 |
| Treasury bonds            | 360.8 | 405.4 | 471.3 | 495.2 |
| BGK bonds                 | 0     | 7.9   | 13.9  | 21.7  |
| Longterm corporate bonds  | 16    | 15.5  | 19.9  | 26.6  |
| Municipal bonds           | 4.5   | 6.9   | 10.9  | 14.4  |
| Longterm banks' bonds     | 7.4   | 5.5   | 5.2   | 10.4  |
| Mortgage bonds            | 2.9   | 3     | 2.5   | 2.9   |
| NBP bonds                 | 7.8   | 0     | 0     | 0     |
| Listed equity instruments | 466.5 | 718.3 | 801.6 | 651.4 |
| Stocks at WSE             | 465.1 | 715.8 | 796.5 | 642.9 |
| Stocks at NewConnect      | 1.4   | 2.5   | 5.1   | 8.5   |

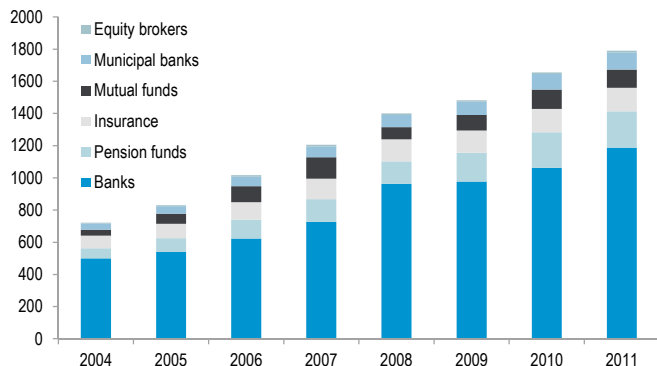
Source: NBP, Citi Research

Figure 44. Daily market turnover in Poland (PLN mn)

|                           | 2008   | 2009   | 2010   | 2011   |
|---------------------------|--------|--------|--------|--------|
| Treasury bonds            | 17,155 | 13,828 | 23,924 | 29,555 |
| FX swap                   | 10,709 | 9,386  | 10,855 | 12,928 |
| Wholesale market deposits | 10,264 | 7,260  | 7,025  | 6,195  |
| FRA                       | 7,626  | 2,399  | 3,505  | 5,573  |
| FX spot                   | 4,236  | 3,907  | 4,280  | 5,219  |
| IRS                       | 1,827  | 683    | 1,353  | 2,219  |
| WIG futures               | 1,199  | 995    | 1,320  | 1,382  |
| FX forward                | 1,494  | 1,222  | 1,318  | 1,380  |
| T-bills                   | 1,245  | 2,455  | 2,110  | 1,250  |
| OIS                       | 1,913  | 868    | 964    | 1,215  |
| Stocks                    | 662    | 701    | 933    | 1,076  |
| FX options                | 1,833  | 580    | 342    | 322    |
| CIRS                      | 117    | 156    | 154    | 113    |

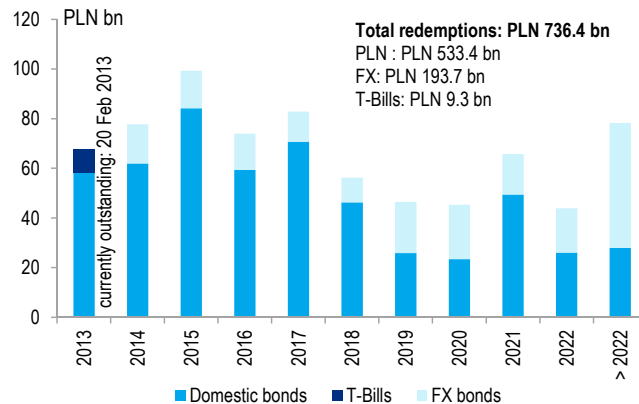
Source: NBP, Citi Research

Figure 45. Assets of financial institutions in Poland (PLN bn)



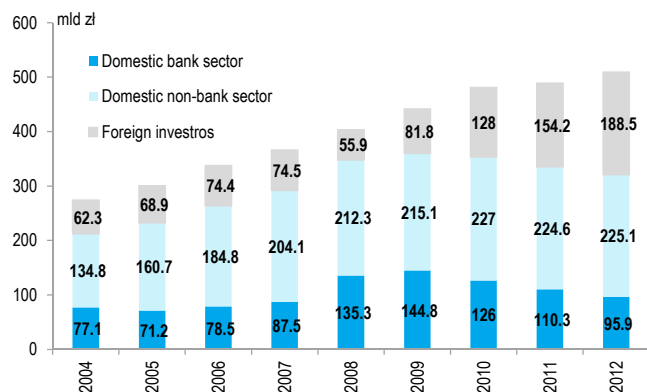
Source: NBP, Citi Research

Figure 46. Government marketable debt redemptions



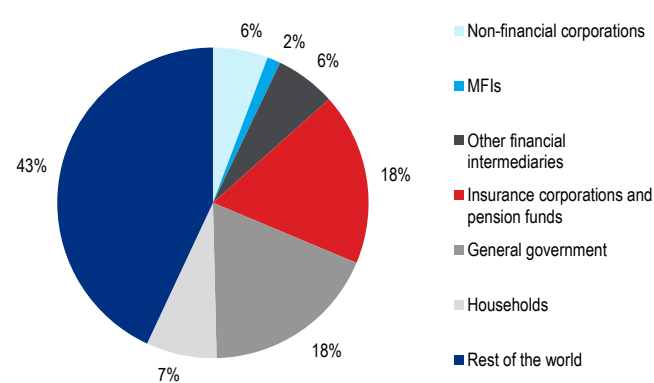
Source: Ministry of Finance, Citi Research

Figure 47. Domestic bonds holdings by type of investor in Poland



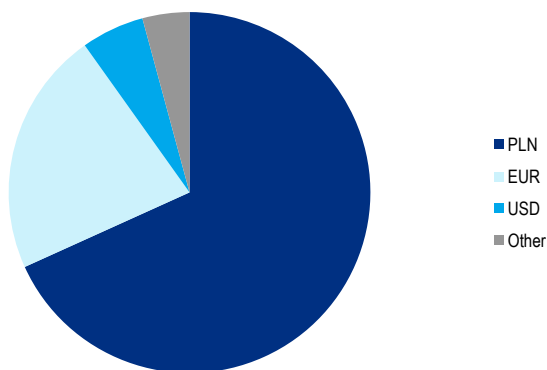
Source: NBP, Citi Research

Figure 48. Stock holdings by type of investor (3Q 2012)



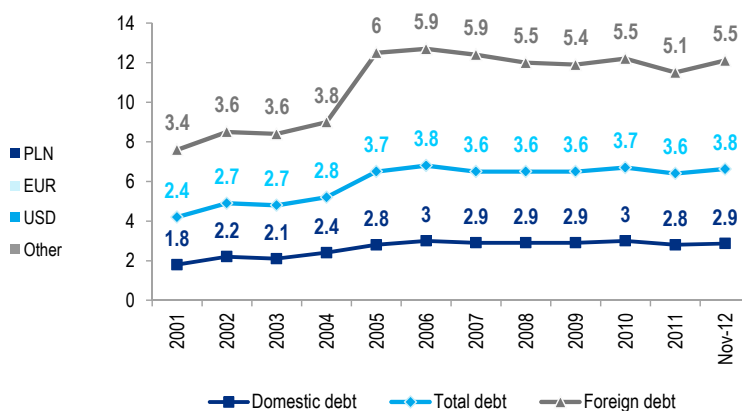
Source: NBP, Citi Research

Figure 49. Government debt FX breakdown (Nov 2012)



Source: Ministry of Finance, Citi Research

Figure 50. Duration of government debt (Nov 2012)



Source: Ministry of Finance, Citi Research

## Appendix: Political situation

### Political structure

Poland is a republic with a President as a head of state and a Prime Minister as head of the government. The President is elected in general elections for a maximum of two five-year terms and currently this position is held by Bronisław Komorowski (appointed in 2011). According to Polish constitution, the President's role is mostly representative and although he/she has right to veto legislation, the Parliament can reject this with a 3/5 majority.

Prime Minister (currently Donald Tusk) is head of the government and usually is a representative of the party that formed the ruling coalition. The government coordinates works of the country's administration but has also the right to propose new legislation that needs to be approved by the parliament.

The lower house of the parliament (Sejm) has 460 members that are elected for four-year terms in general elections. Parties enter the Sejm if they get more than 5% of votes. The upper house of parliament (Senat) consists of 100 members that are also elected for four year terms.

Although in the past Poland saw frequent changes of governments and early elections, more recently the political situation has become much more stable. Parties that formed the government in 2007 (Civic Platform and Polish Peasant Party) were reelected in 2011 and the government remained in power with some minor reshuffles. The main coalition party Civic Platform has been the leader of opinion polls and although the gap versus the biggest opposition party (PiS) narrowed, we believe the risk of a collapse of the incumbent government is small.

### Who is who and who thinks what in Polish politics?

(for more on Polish politics, see: [Poland Macro View](#))

**Civic Platform (PO)** is a centre-right party that has been a member of the ruling coalition in Poland since the 2007 parliamentary elections. Party leader Donald Tusk is also the Prime Minister while one of PO's former politicians Bronisław Komorowski was elected President in 2010. The PO wants to be perceived as a business-friendly party, determined to continue the privatisation process, favouring relatively low and stable taxes and respecting the independence of the central bank. However, the PO government is also pragmatic and decided not to push for full privatisation of companies in strategic sectors, in particular in the energy sector.

The government approved a fiscal tightening plan that assumed an ambitious decline in fiscal deficit in 2011 and 2012, albeit this partly relied on the government's prior decision to cut transfers to the private sector pension system. The party abandoned its previous proposals to introduce a flat 15% tax rate for PIT, CIT and VAT. Instead it approved an increase in VAT rate.

Given the challenges faced by the euro area, the PO leaders suggest Poland should not be in a hurry to adopt the common currency but reiterate a commitment to do it at some future point.

**Law and Justice (PiS)** is a right wing and conservative party (with some nationalist tendencies) that unexpectedly won the 2005 parliamentary elections but lost power two years later after 2007 snap polls. The party's programme puts emphasis on fighting corruption, is against a quick privatisation process, against quick euro

adoption and favours an active role of the state in the economy. Although this was not a point on the party's agenda, in the run-up to the global financial crisis the PiS reduced personal income taxes, a move that increased disposable income of high earners and helped to smooth consumption during the global slowdown. The party appeals to an electorate that has been disappointed by economic transformation after the collapse of communism in 1989 and the results from previous elections suggest the PiS electorate — on average — comes from smaller cities and rural areas, with relatively lower income levels.

**Palikot Movement** is a party formed by Janusz Palikot, ex-businessman and ex-member of the Civic Platform. The party is relatively new to the Polish political scene and most of its MPs are not well known. The programme of the party is usually described as anti-clerical, liberal or libertarian.

**Left Democratic Alliance (SLD)** is a social-democratic party initially formed by ex-members of the communist era PZPR party. SLD has remained out of power since 2005 and is now the third-biggest opposition party on the Polish political stage. The economic program published by the Left Democratic Alliance (SLD) ahead of 2011 elections unsurprisingly highlights the need to diminish inequalities in income levels and standards of living of Poles.

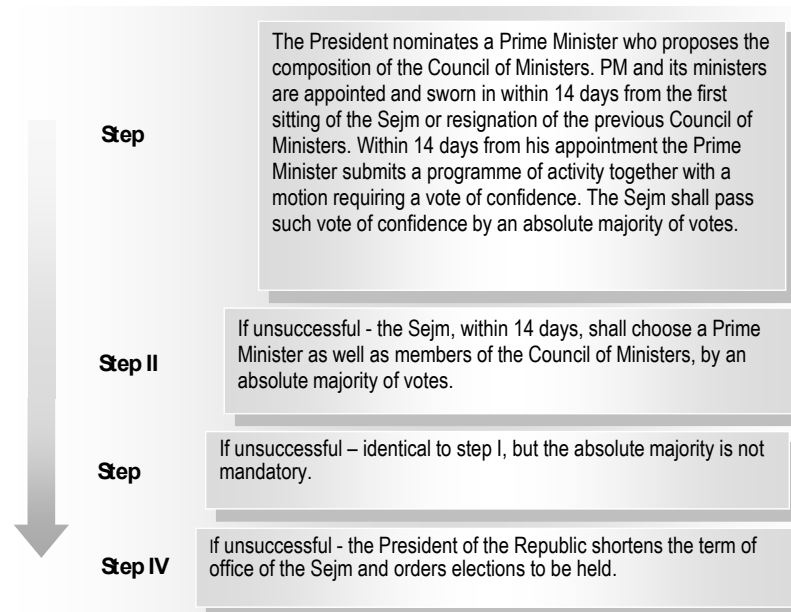
**Polish Peasants' Party (PSL)** is an agrarian, centrist party that has been a junior coalition partner in the government since 2007. The party favours state interventions, somewhat slower privatisation and is moderately euro optimistic (emphasising benefits of large EU payments to farmers). Its former deputy Prime Minister Waldemar Pawlak was one of politicians calling for cancellation of FX option contracts that contributed to losses of several Polish companies during the 2008-2009 zloty depreciation. PSL ministers were also architects of the government's decision to redirect pension contributions to the public pension system from private pension funds. Although opinion polls usually suggest the support for the party is hovering close to the 5% threshold, previous election outcomes suggest polls may understate support for the PSL.

## How is the government formed?

**The process of government formation in Poland can be long and split into several steps** (Figure 54). The whole process begins with the first sitting of the new parliament that should take place no later than 30 days after elections.

President first nominates a new prime minister and then — within 14 days of the first sitting — appoints a PM and ministers. The head of the newly appointed government has another 14 days from his appointment to submit a programme of activity together with a motion requiring a vote of confidence. The Sejm (Lower House) shall pass such vote of confidence by an absolute majority of votes.

Figure 51. Government formation process



Source: Citi Research

If unsuccessful, the second stage begins and the initiative is passed to the Parliament. The Lower House shall, within 14 days, choose a Prime Minister as well as members of the Council of Ministers, by an absolute majority of votes.

If this attempt also proves unsuccessful, the initiative returns to the President. Just like in the first stage, the President has 14 days to appoint a new Prime Minister. If within the next 14 days the Premier is unable to win a confidence vote (with an ordinary majority of votes), the President dissolves Parliament.

All in all this means that the whole process to form a new government can take 1.5-2 months if the process is smooth or could take up to 3 months or more if the whole process is problematic.

## Appendix A-1

### Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

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