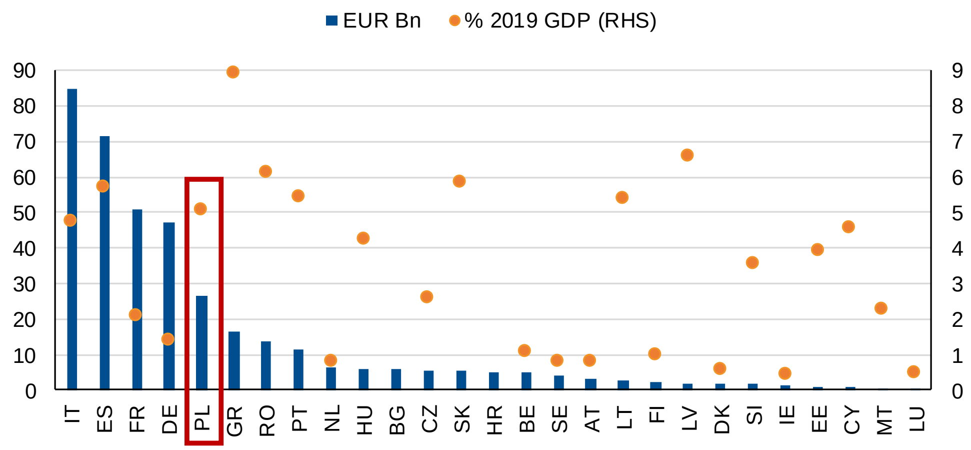
Poland and Covid-19: a resilient economy yet institutional challenges set to continue

Poland (A+/Stable), in robust economic shape as it entered the global economic crisis caused by the Covid-19 pandemic, has used its available fiscal and monetary policy space to respond forcefully to the crisis. The country's economic resilience to the unprecedented shock contrasts with concerns over weakening institutions and ongoing tensions with the EU, posing challenges to medium-term growth prospects.

Poland is set to register the smallest decline in 2020 output among the Central and Eastern European (CEE) members of the EU. Under our baseline scenario, we expect a 4.2% contraction of real GDP in 2020 versus -7.2% in CEE and -9.1% in the Euro area, before a 4.5% rebound in 2021, with the pandemic outbreak disproportionately hitting services, ahead of industry, construction and retail.

Poland's relative resilience in face of the Covid-19 economic shock mainly derives from the unprecedented EU-wide and national fiscal and monetary stimulus in response to the crisis with Poland being eligible for a similar amount of funding in form of EU recovery grants in relation to GDP as hard-hit economies Italy or Spain (see **Figure 1**) and the country's large and diversified economic base with low exposure to the pandemic's disruption of global supply chains. Poland benefits from solid public finances, providing space for a large and effective set of fiscal and monetary intervention to support the healthcare sector, businesses and households to cushion the economy from the pandemic's impact. We expect a fiscal deficit of 8.5% of GDP this year, while public debt will increase to around 56% of GDP.

Figure 1: EU Recovery grants, EUR bn and % of 2019 GDP



Source: Bruegel, Scope Ratings GmbH

However, Poland has structural economic weaknesses in the form of capacity constraints which reinforce the country's reliance on foreign capital, constrain its economic potential and could amplify the pandemic's adverse impact on growth. Contrary to previous anticipations of a material decline in EU funding before the pandemic, we expect Poland will be eligible for a similar amount of funding in relation to GDP as in the current EU multi-year financial framework, though the precise allocation of grants and loans has not been published yet.

The tight race in recent presidential elections has confirmed that the country continues to be deeply divided. Incumbent president Andrzej Duda was re-elected with a narrow five-seat majority in parliament. With no other elections scheduled until 2022, the ruling party can focus on its political agenda. Poland's long-running disagreements with the EU over the 'Rule of Law' procedures are unlikely to subside. We expect that Poland will find some caveats tied to the new the deployment of EU funds. However, proposals to make EU funding conditional on respect for the rule of law have been watered down recently, with such conditionality remaining imprecise in the final agreement reached at the European Parliament.

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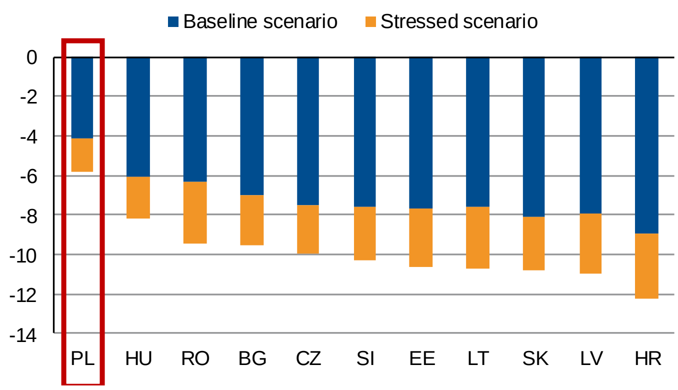
Poland's relative resilience to the Covid-19 economic shock

Real GDP growth forecast:
- 4.2% in 2020
+ 4.5% in 2021

Among CEE economies in the EU, we continue to expect the smallest 2020 output decline in Poland (see **Figure 2**). Under our baseline scenario, we expect a 4.2% contraction of real GDP in 2020 before a 4.5% rebound in 2021, with the pandemic outbreak disproportionately hitting services, more than industry, construction and retail trade. Poland's economy proved relatively resilient in the first half this year, signalling a more V-shaped rebound than in many developed countries. Production has accelerated since June, mostly in export-oriented industries, with the seasonally adjusted output in industry remaining around 10% below the pre-pandemic level.

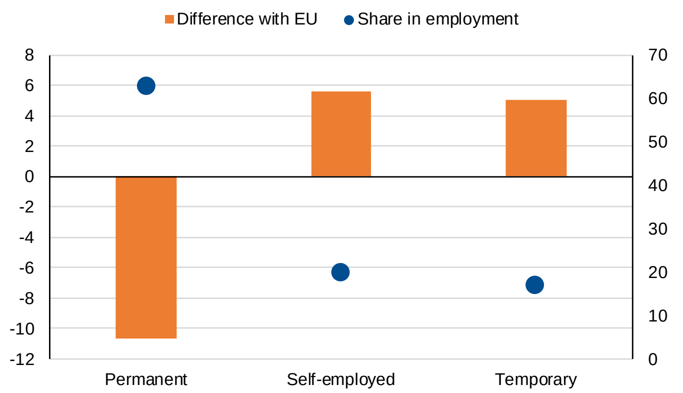
Under more adverse conditions, assuming a second material wave of contagion this year and consequent reintroduction of lockdown measures, we expect Poland's output could plummet by around 6% in 2020. The high proportion of temporary and self-employed workers in total employment, at around 17% and 20% respectively (see **Figure 3**) may amplify adverse effects on growth, also given that 40% of the work force is employed at small companies (employing less than 10 people), which are less likely to have sufficient liquidity buffers to withstand a prolonged economic standstill once furlough programme have run their course.

Figure 2: Real GDP projections across CEEs for 2020



Source: Scope Ratings GmbH

Figure 3: Employment, by contract type, % of total



Source: Eurostat, Scope Ratings GmbH

Main factors behind Poland's relative resistance to the Covid-19 economic shock include:

Robust macro fundamentals and fiscal and monetary stimuli underpin recovery prospects

- *the unprecedented EU-wide and national fiscal and monetary stimulus in response to the crisis* (see next section) with rapid implementation of measures to protect jobs, as part of the "Anti-Crisis Shield" package, providing short-time working schemes, wage support and relief for employers on their social contributions;
- *the country's large and diversified economic base*, with low exposure to coronavirus-related disruptions of global supply chains, notably automotive production and output of other durable goods. Poland's less developed tourism sector ensures that the country is less exposed to travel restrictions;
- *strong macroeconomic fundamentals* with annual GDP growth averaging above 4% in the past five years and the economy's growth potential twice the EU's average; and
- *low levels of private debt together with a well-capitalized, liquid and profitable banking sector*, contributing to the financial resilience of companies and households.

Effective monetary and fiscal measure support resilience

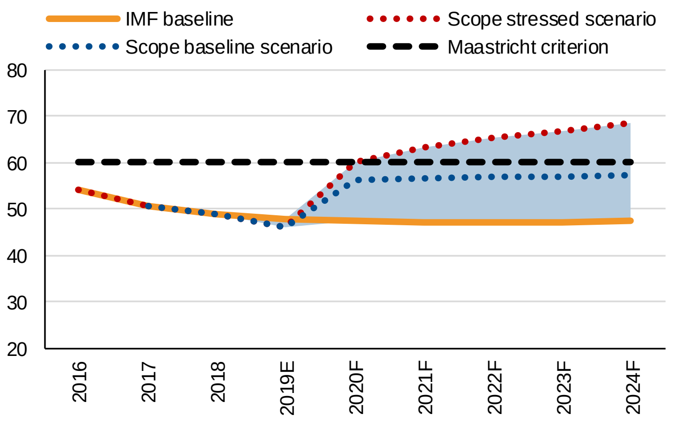
Robust public finances before the crisis

Poland benefits from a solid public finance position, allowing substantial fiscal space for Warsaw to provide significant fiscal support to the healthcare sector, businesses and households. Public debt levels have gradually declined in recent years to 46% of GDP by end-2019. Around 70% of debt is issued in national currency, while the remaining part mainly in euro. Similarly, gross financing needs remained low at 7% of GDP in 2019.

A large fiscal stimulus package to support the economy

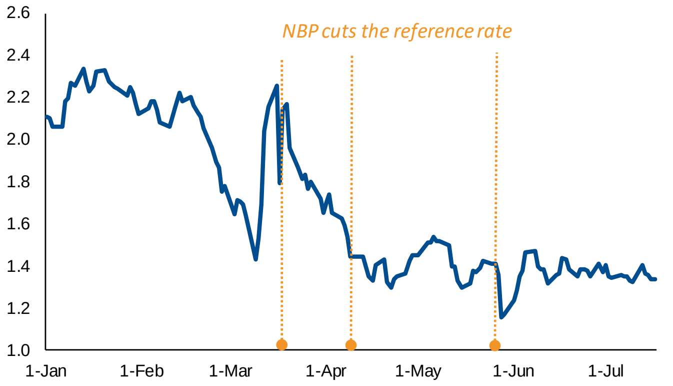
The Polish government legislated a substantial fiscal package of around PLN 100bn, in addition to PLN 75bn in guarantees and micro loans for entrepreneurs and a PLN 100bn liquidity programme for businesses financed by the Polish Development Fund with up to 60% of the latter may be converted to direct grants. Overall, direct budgetary measures count for close to 5% of GDP, while public guarantees total around 8% of GDP.

Figure 4: Government debt, % of GDP



Source: ECB, Eurostat, IMF, Scope Ratings GmbH

Figure 5: 10-year government bond yield, %



Source: IMF, Scope Ratings GmbH

Public debt to jump to close, but below, the 60% Maastricht threshold, in our baseline scenario…

Accounting for both the cyclical deterioration in the budget due to the economic recession and the large discretionary spending implemented by the Polish government, we expect a fiscal deficit of 8.5% of GDP this year, while debt-to-GDP would increase to around 56%. Assuming economic growth returning to its potential in the medium term and a gradual recovery in fiscal flow variables, we expect public debt to stabilise at around 57% of GDP by 2024 (**Figure 4**, see Annex II for more details). The statistical treatment of EU loans needs to be clarified yet, i.e. if those loans will be added to Poland's public debt or consolidated with an impact on EU-debt only. Gross financing needs would double to 13% of GDP in 2020, still below the IMF "high scrutiny threshold", at 15% of GDP for emerging economies, and remain close to pre-crisis levels afterwards, thus manageable.

Monetary policy response: a toolkit of conventional and unorthodox measures

Poland's central bank's response, together with the fiscal stimulus, involving targeted interventions was an effective response to the pandemic. Given that most loans in Poland carry a variable rate, borrowers will soon benefit from lower interest costs following three rate cuts of the key reference rate by 140bps in total, bringing it down from 1.5% in March to 0.1% in June.

The Narodowy Bank Polski (NBP) has also activated a quantitative easing-like program, allowing the unlimited purchase of Polish government bonds on the secondary market. By the beginning of July, the NPB had purchased around 4% of GDP in Treasury and government guaranteed securities in the secondary market. The actions of the NBP will benefit public finances, since cutting rates and assets purchases have translated into lower government financing costs (see **Figure 5**). In addition, the NBP can absorb part of the additional gross financing needs for this year, at around 11% of GDP in total.

The central bank has introduced additional liquidity support measures, such as lowering the required reserve ratio from 3.5% to 0.5% and a programme to provide funding for bank lending to the non-financial private enterprises, like the ECB's TLTRO. The Ministry of Finance has also lowered the systemic risk buffer related to banks' capital requirements.

Poland's year-on-year consumer price inflation rate dropped to 3.1% in July from 3.3% in June, due to a sharp decline in food prices, offsetting higher fuel prices and core inflation. The absence of upward pressure on prices means there is no immediate need to slow the growth of Poland's central-bank balance-sheet or to raise short-term interest rates from their floor around zero.

Reliance on foreign capital is a key economic vulnerability

Poland's structural weaknesses in the form of capacity constraints are weighing on its economic potential and make the country reliant on foreign capital, among other constraints:

- *low national savings and weak business investment*, typical of CEE economies, but in Poland's case are particularly challenging: savings, at 20% of GDP in 2019, were lower than its neighbours';
- *weak business investment:* low investment rates are typical of Poland's non-financial corporate sector, which is dominated by labour-intensive rather than capital-intensive small- and medium-sized enterprises;
- capacity constraints in form of labour force shortages, ensuring wages growth exceeds labour-productivity growth, indicating that Poland's labour cost competitiveness advantages have gradually reduced in recent years;
- low degree of digitalisation, with Poland ranking 23rd out of 28 EU member states in the Digital Economy and Society Index (DESI)[1], also reflecting a high share of people with poor digital skills (nearly 50%) and not online (15%).

Deteriorating governance quality may undermine recovery prospects

Recent controversial judicial reforms weaken institutions

In past years, the Polish government has put forward a series of controversial reforms to the judicial system, that have polarised public opinion and heightened confrontations in Poland's relationships within the EU. The European Court of Justice is scheduled to rule 22 September on whether the Polish Supreme Court fulfils the criteria of an independent chamber. **Figure 6** reveals how Polish governance metrics, as defined by the World Bank, have deteriorated over time, and - in five out of six categories - are below the CEE average.

Presidential election results show political polarisation

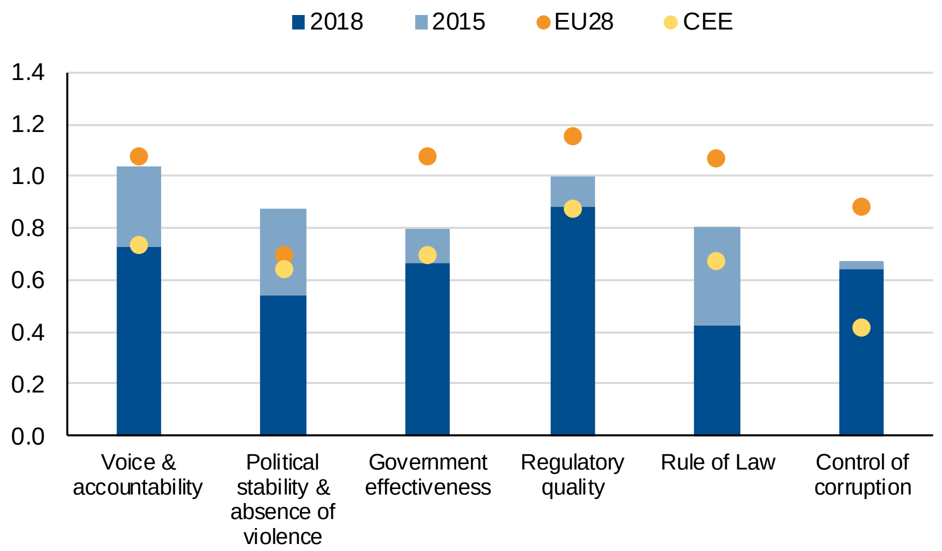
The incumbent president Andrzej Duda won the election run-off on 12 July, beating Rafal Trzaskowski, Warsaw's liberal mayor, by 51% to 49%. The election went to a run-off after no candidate received over 50% of the vote in the first round in June. The tight race has confirmed that the country remains politically deeply divided. The turnout in the election was high at 68%, with Trzaskowski strongly supported in the country's western regions and performing well among the young (winning two-thirds of the under-30 vote) and Duda winning in the more rural, socially conservative east, and in the south and backed by more than 60% in the over-60 age group.

Ruling party has a narrow majority, with no more elections until 2022

Given that the president can veto laws and the ruling party (PiS) lacks the three-fifths legislative majority in the Sejm (the more powerful lower house of the Polish parliament) required to over-turn a presidential veto, a victory for Trzaskowski would have materially limited the ruling party's ability to push forward with reforms. With Duda re-elected and a narrow five-seat majority and no more elections scheduled until 2022, the ruling party can focus on its political agenda. Poland's second chamber, with 51 out of 100 Senators currently aligned with the opposition can delay legislation to some extent (typically 30 days) and block some key appointments. In addition, half of the country's 16 regional councils, which play a major role in distributing EU funds, are currently controlled by the opposition.

[1] The European Commission has been monitoring Member States' digital progress through the Digital Economy and Society Index (DESI) reports since 2014.

Figure 6: Poland: governance indicators



Source: WB, Scope Ratings GmbH

EU Recovery Fund can be a game-changer for the Polish economy

EU Recovery Fund is providing an extra boost for the economy

Contrary to previous anticipations of a material decline in EU funding before the pandemic, we expect Poland to be eligible for a similar amount of funding relative to GDP as in the current EU multi-year financial framework, though the precise allocation of grants and loans has not been published yet. Together with the 'classic' EU budgets for 2021-27, we estimate that Poland will be eligible for around EUR 150bn, equivalent to a yearly inflow of of around 3% of GDP vs. 3.5% in 2014-20. The large fiscal impulse should translate into a higher potential GDP growth for Poland and support a further decline in foreign debt and help the maintenance of balanced external accounts.

Some caveats will be tied to the new EU funds absorption

Poland will likely find some caveats tied to the new deployment of EU funds. Proposals to make EU funding conditional on respect for the rule of law have been watered down recently, with a lack of precision in the final agreement reached at the European Parliament about such conditionality. In principle, the European Council has delegated to the European Commission the task of creating a financial sanction mechanism to stop EU funding going to countries in the event of rule-of-law breaches.

Practical hurdles in establishing a stronger link between EU funding and rule-of-law breaches

A stronger link between EU funding and the respect for the EU's fundamental values would need to be made legally watertight, considering the impact of breaches of the rule of law on individual beneficiaries of EU funding, such as Erasmus students, researchers or civic organisations. It is also in the interests of the EU to distribute certain EU funds to Poland, including, for example, EU funds for the pan-European road and rail routes, in view of Poland's geographic and economic strategic importance. From a cost-benefit perspective, EU funds allocated to one member-state benefit others by creating market opportunities, reflected in European Commission estimates that a quarter of additional growth in non-cohesion countries derives from indirect benefits from increased sales to and trade with cohesion nation. Finally, sanctions would also risk sparking deeper divisions between the EU's longer-standing member states and new-joiners. Consequently, while Poland's long-running disagreements with the EU over the 'Rule of Law' procedures are unlikely to subside, compromises between net beneficiary and net contributor countries are indispensable.

Annex I: Economic growth forecasting assumptions

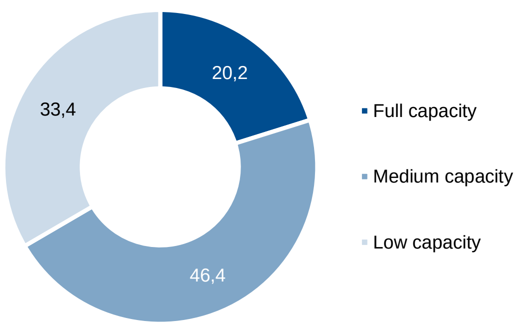
For 2020, we use a model based on a gross value-added calculation of GDP and run two scenarios (baseline and stressed), defined by the timing and shape of recovery in activities of various industry sectors. We classify industry sectors as operating during the crisis at either i) near-full capacity; ii) medium capacity; or iii) low capacity. This assessment is based on the severity of the synchronised demand and supply shocks in 2020.

Impact of demand/supply shock		
Low	**Medium**	**High**
• Agriculture, forestry and fishing • Information and communication • Public administration, education and social work	• Industry • Construction • Financial and insurance • Professional services, science and technology	• Trade, travel, accommodation and food • Arts, entertainment and recreation • Real estate

We thereafter assume monthly losses in productive output compared with pre-crisis levels for each of the three high-level impact classifications and for the industries that are assigned and fall under each of the three classifications. The assumptions also account for the growth-positive effects of fiscal countermeasures announced by the government to date.

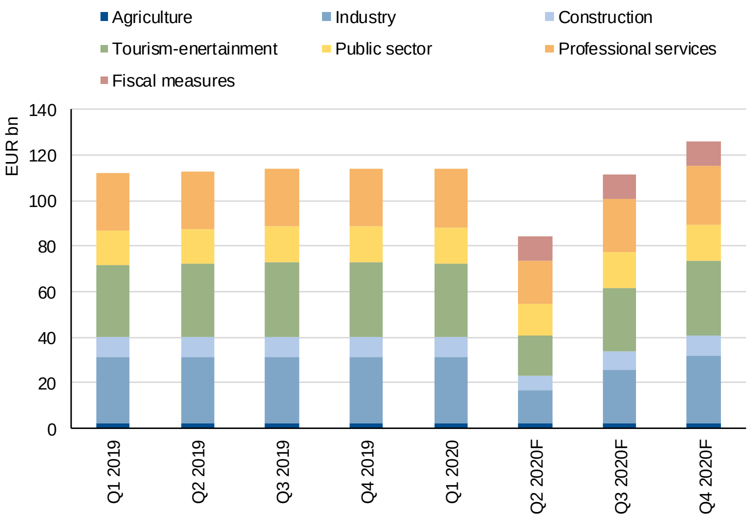
Our baseline scenario entails a gradual recovery into 2021 after containment measures were relaxed. Throughout 2020, we assume declines in monthly productive capacities of around 0-20% for low-hit sectors, 10-25% for medium-hit sectors, and 10-50% for hard-hit sectors in the case of Poland. We then adjust for the impact of announced fiscal stimulus measures, differentiating between various types of government spending and liquidity assistance.

Figure 12: Sectors' share in total GVA, by capacity



Source: Eurostat, Scope Ratings GmbH

Figure 13: Real GVA, Scope baseline forecasts



Source: Eurostat, Scope Ratings GmbH

We also estimate a downside economic scenario, which considers a possible second wave of contagion in the autumn and the consequent re-introduction of containment measures in the fourth quarter, which also causes a much slower recovery in 2021. The results for real GDP growth in 2020-21 are presented as follows:

Scenarios	2020	2021
Baseline	-4.2	4.5
Stressed	-5.8	3.5

Annex II: Debt sustainability assumptions

Our **baseline** debt projections derive from the following assumptions:

Factor	2015-19	2020	2021	2022	2023	2024
Real GDP, %YoY	4.2	-4.2	4.5	3.5	3.5	3.5
GDP deflator, %YoY	1.3	2.4	2.7	2.8	2.8	2.7
Primary balance, % GDP	-0.1	-7.0	-2.7	-2.2	-2.0	-1.8
Interest payments, % GDP	1.6	1.4	1.6	1.6	1.6	1.7
General government debt, % GDP	*46.0*	*56.2*	56.7	57.0	57.1	57.1

- -4.2% growth in 2020 followed by +4.5% in 2021, then convergence to Poland's growth potential of 3.5%;
- Budget deficit of 8.4% of GDP in 2020, followed by 4.3% in 2021 and gradual deficit reductions thereafter;
- Weaker annual increases in the GDP deflator, especially in 2020, to reflect weak economic conditions;
- 0-60bps lower financing rates vis-à-vis IMF pre-shock baseline, reflecting results of monetary policy interventions;
- 3% exchange rate depreciation, impacting on foreign currency denominated debt; and
- Crystallisation onto the sovereign balance sheet of contingent liabilities from government guarantees: 0.1-0.5% of GDP per year vis-à-vis IMF pre-shock baseline.

Our **stressed** debt projections derive from the following assumptions:

Factor	2015-19	2020	2021	2022	2023	2024
Real GDP, %YoY	4.2	-5.8	3.5	2.5	2.5	2.5
GDP deflator, %YoY	1.3	1.7	2.4	2.8	2.8	2.7
Primary balance, % GDP	-0.1	-8.9	-4.0	-3.3	-3.1	-3.5
Interest payments, % GDP	1.6	1.6	1.8	1.9	1.9	2.0
General government debt, % GDP	*46.0*	*60.1*	*63.2*	*65.4*	*67.0*	*69.0*

- -5.8% growth in 2020 followed by +3.5% in 2021, then convergence around a permanently lower growth potential of 2.5%;
- Budget deficit of 10.5% of GDP in 2020, followed by 5.8% in 2021 and gradual reductions thereafter;
- Weaker annual increases in the GDP deflator, especially in 2020, to reflect weak economic conditions;
- 5% and 2.5% exchange rate depreciation in 2020 and 2021, impacting on foreign currency denominated debt; and
- Crystallisation onto the sovereign balance sheet of contingent liabilities from government guarantees: 0.5-1% of GDP per year vis-à-vis IMF pre-shock baseline.

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