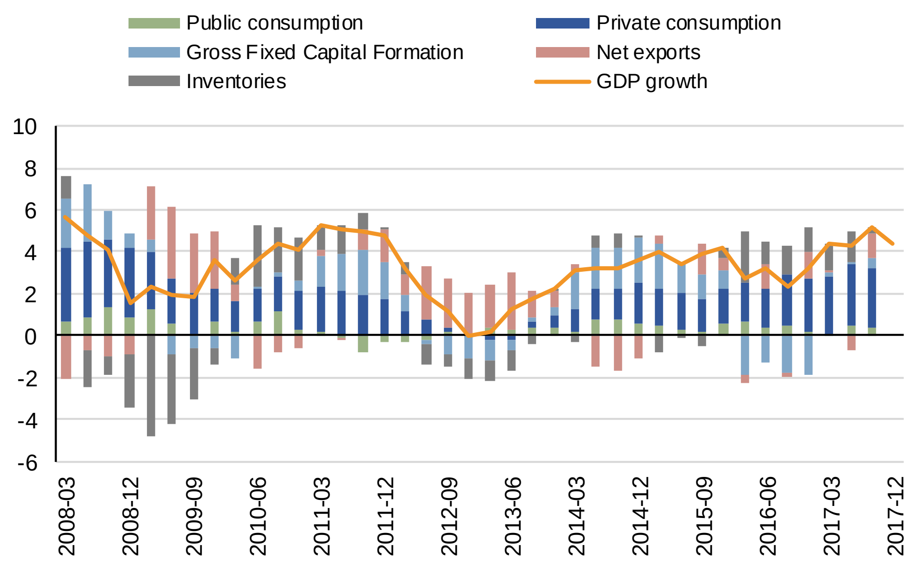
Special Comment: Poland to maintain robust growth, despite threat from Article 7

Poland (A+/Stable Outlook) remains on a path of high growth rates and robust inward foreign direct investment (FDI). In this special comment, Scope argues that Poland's growth and debt sustainability outlook remain robust, despite challenges surrounding the country's Article 7 dispute with the European Union (EU).

Poland grew by about 4.6% in 2017, exceeding earlier expectations. Scope now expects Polish growth to remain strong in 2018 at around 4%, followed by 3.5% in 2019. Going forward, consumption growth will decelerate as the effects of social transfers fade. But, this will be compensated for by rising investment.

However, it is Scope's view that the low level of national savings in Poland and weaknesses in the business investment remain constraints to the country's longer-term growth prospects. These challenges make Poland consequently more reliant on international capital inflows, an ongoing source of risk reflected in Scope's A+ assessment on the sovereign.

Figure 1: GDP growth by contributing component, % Y/Y



Source: Haver Analytics, Scope Ratings GmbH

The European Commission's invocation of Article 7 in December 2017, in relation to Poland's violations of the EU's Rule of Law Framework, has increased pressure on the government. The EU actions respond to reforms which have breached principles on judicial independence, and by default, the application of EU law. It is Scope's view, however, that more significant counter-measures against Poland, like the removal of the nation's voting rights in the European Council or the cutting of EU funds, are unlikely. At the present, Scope expects the impact of Article 7 tensions on Poland's growth environment to be modest.

Poland's ratings (A+/Stable Outlook) are supported by reductions in the budget deficit (to an estimated 2.1% of GDP in 2017 from 2.5% in 2016), underpinned by economic growth. In view of the conservative macroeconomic assumptions underlying Poland's budget for 2018, Scope sees upside to Poland's budgetary execution, with the deficit expected to remain unchanged at close to 2% of GDP in 2018. Acknowledging strong growth and Poland's conservative fiscal framework, Scope forecasts government debt to decline to around 50% of GDP by 2022 (from 52% as of Q3 2017).

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Related Research

Republic of Poland: Rating Report – 28 July 2017

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Poland's growth outlook – opportunities and challenges

2017 growth above expectations

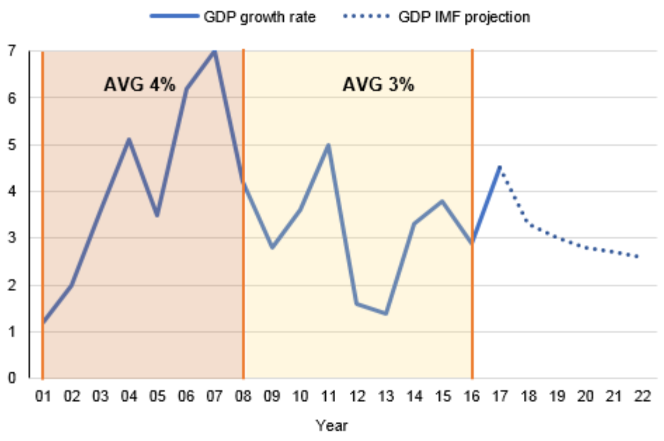
Poland grew by about 4.6% in 2017, according to preliminary estimates from the Central Statistical Office, exceeding earlier expectations of 3.4% in the IMF's April 2017 forecasts. Strong private consumption has supported growth, helped by accelerating wages and higher social transfers. In addition, exports have been boosted by solid growth in the euro area (Poland's main export market). Investments have resumed expansion since the second half of last year, mainly in the public sector, as reflected in rising EU-financing contracts (to PLN 130bn in 2017, from PLN 90bn in 2016).

Growth to remain strong in 2018, with rising investments

Scope expects Poland's economic growth to remain strong at around 4% in 2018 and 3.5% in 2019, supported by a solid external environment and further increases in investment, taking advantage of low interest rates combined with a faster absorption of EU structural funds around the conclusion of the current financing period.

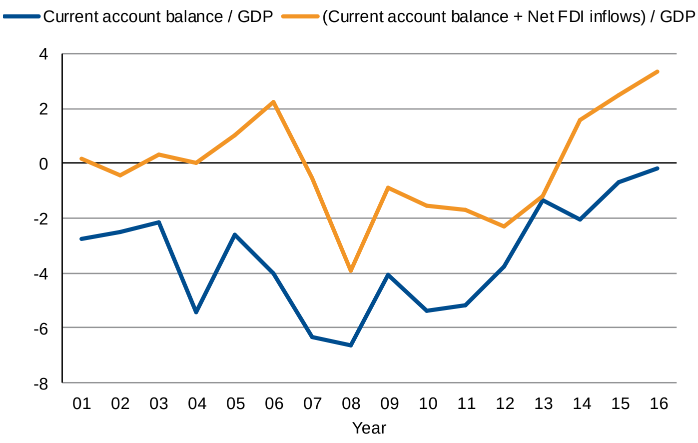
As of the end of 2017, 45% of available EU funds for Poland in the current period to 2020 had been absorbed, a similar ratio to that at the same point of the 2007-2013 financing phase. At the end of the 2007-2013 period, Poland managed a final absorption rate of around 98%, the highest of any Eastern European country that joined the EU since 2004 – signalling a potential pick-up going forward. It is Scope's view that consumption growth will decelerate as the effects of higher social transfers fade going ahead. But, this will be compensated for by an impulse from rising investment.

Figure 2: GDP growth, % change



Source: IMF, Haver Analytics, Scope Ratings GmbH

Figure 3: Current account balance, as a % of GDP



Source: World Bank, Haver Analytics, Scope Ratings GmbH

But, the rate of growth is gradually slowing

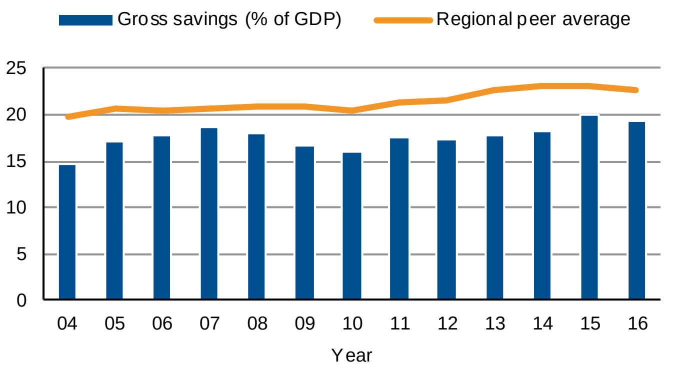
However, Scope notes that Poland's growth rate is gradually declining, reflecting a longer-term transition as living standards converge with those in Western EU countries. This catch-up growth can be divided into three stages to date (**Figure 2**): Poland grew (1) on average 5% p.a. from 1992 – 2000; (2) 4% p.a. from 2001 – 2008 and (3) 3% p.a. from 2009 – 2016. Going forward, the IMF's projections for 2018 – 2022 see a gradual further slow-down, with growth of on average 2.9% p.a., including 2.6% in 2022.

Scope positively notes that, despite strong growth in private consumption, Poland has run nearly balanced current accounts in each of the last three years – a material change from preceding years. This trend reflects Poland's improved competitiveness, shown in gains in export market shares, particularly in business services. Scope expects support to economic growth from Poland's export sector to continue over the medium term.

Foreign capital inflows have substituted for low national savings

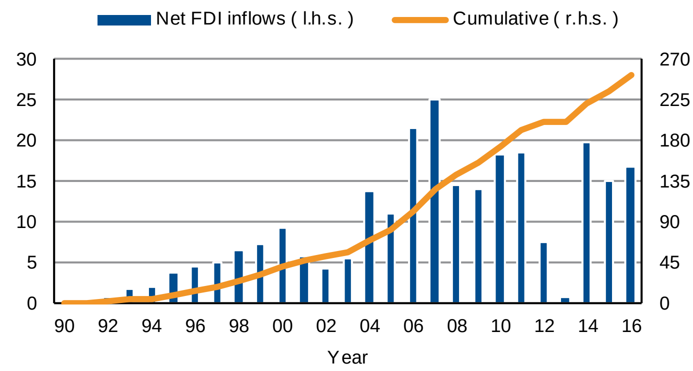
It is Scope's view that the low level of national savings is an important constraint to Poland's long-term growth prospects. However, Scope notes that Poland has nonetheless been successful in attracting FDI and EU structural fund inflows. As such, despite low domestic savings, Poland has benefitted from a transfer of *external savings* to sustain robust economic growth.

Figure 4: Gross savings as a % of GDP



Source: World Bank, Scope Ratings GmbH

Figure 5: Net FDI inflows, 1990 – 2016 (in USD bn)



Source: World Bank, Scope Ratings GmbH

Low Polish investment rate due to non-financial corporate sector

Low national savings and weak business investment are typical in economies in Central and Eastern Europe. But, Poland's savings and investment rates have been lower even than the average of its regional peer group[1] (**Figure 4**). In principle, this reflects the low investment rate of the Polish non-financial corporate sector, acknowledging that small- and medium-sized enterprises in Poland account for 99.8% of non-financial businesses, and are typically more labour intensive, rather than capital intensive.

To maintain growth rates of 3-4% p.a. over the longer term, Poland requires robust external funding. As EU structural funds will be slowly reduced in step with economic convergence, the main investment burden will fall with foreign companies.

Poland will remain an attractive destination for foreign capital

It is Scope's view that Poland will remain an attractive destination for foreign private capital, due to the size of its domestic market, its skilled labour force, geography, and government incentives for FDI. For example, the "Programme for supporting investments of major importance to the Polish economy for years 2011-2023" includes the provision of government grants to investors in priority sectors like automotive and biotechnology, underpinning high returns on FDI. Scope believes this will support rising investment.

Poland's political row with the EU

Invoking Article 7 sends a clear warning to Poland…

By invoking Article 7 of the Treaty of Lisbon in December 2017, the European Commission issued a formal warning to the Polish government. The EU concerns relate to a lack of independent constitutional review and judicial independence, owing to laws adopted by the Law and Justice (PiS) government since 2015. The laws in question concern the functioning of the Constitutional Tribunal, Supreme Court and ordinary courts. In response, Poland argues that the changes were necessary as the existing system lent itself to '*nepotism and corruption*'.

… but sanctions against Poland are unlikely.

According to the EU procedure, a vote by EU states on whether to back the Commission's action will now follow. However, it is Scope's view that drastic measures like the elimination of EU voting rights or the cutting of EU funds for Poland are unlikely. Here, Scope highlights six points:

[1] The regional peer group for Poland includes: Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Romania, Slovak Republic, Slovenia

(1) Sanctions on Poland require the unanimous decision of the European Council, where Hungary and Romania have repeatedly assured that were such a Council vote to occur, they would veto sanctions;

(2) It is 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 strategic importance;

(3) Timing inconsistencies, in that the EU must secure an agreement and transition to the forthcoming post-2020 EU budget, requiring European Council decisions during 2018 (the scheduled vote for the Article 7 procedure does not occur until 2019);

(4) Sanctions risk sparking deeper divisions between the EU's longer-standing member states and new-joiners, and could heighten accusations of a double standard, as some Western EU countries also allow the executive to have influence on the selection of judges, which is one of the criticisms of the Polish reforms;

(5) From a cost-benefit perspective, EU funds allocated to one member-state in reality 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 nations;

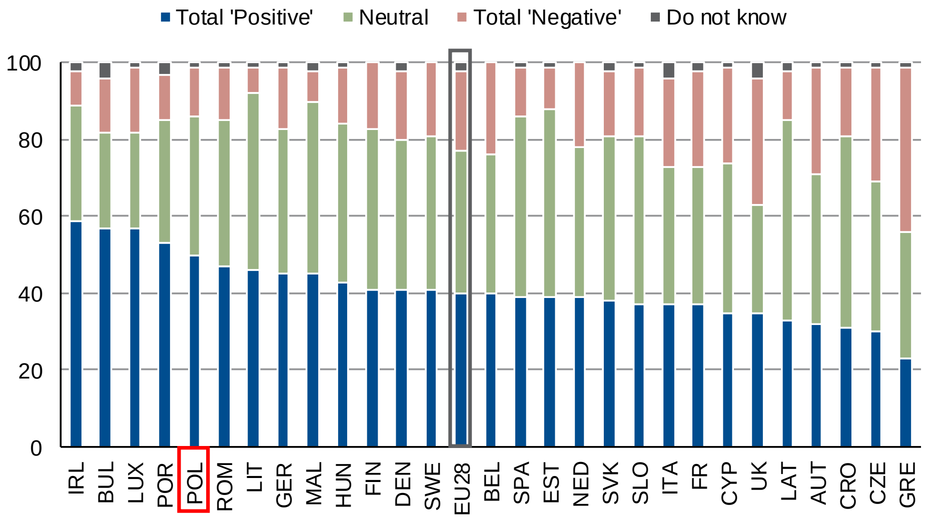
(6) The link between EU funding and the respect for the EU's fundamental values would need to be made legally watertight, considering the impact of breaches of fundamental values or the rule of law on individual beneficiaries of EU funding, such as Erasmus students, researchers or civic organisations.

The dispute with the European Union has forced the Polish government to soften its stance in certain areas. To prevent an excessive political, economic or reputational price, Jarosław Kaczyński, the leader of PiS, reshuffled the cabinet including dismissal of the prime minister, foreign minister and defence minister, individuals known for tense relationships with European leaders.

Over the longer term, the European Union retains considerable support within Polish society, as shown in the latest Eurobarometer survey of November 2017: Poland was ranked fifth among the 28 member-states with 50% of respondents having a positive image of the EU. Given this, Scope sees it as highly unlikely that PiS would allow the conflict with the EU to greatly degenerate, thereby risking greater isolation or the nation's EU membership rights. Instead, Scope believes certain corrective measures would be taken by Polish authorities in advance, should the threat of sanctions become more concrete.

At the present, Scope does not expect Article 7 threats to materially impact Poland's economic growth environment and public finances. This is reflected in Scope's rating assessment on Poland of A+/Stable.

Figure 6: In general, does the EU conjure up for you a very positive, fairly positive, neutral, fairly negative or very negative image?



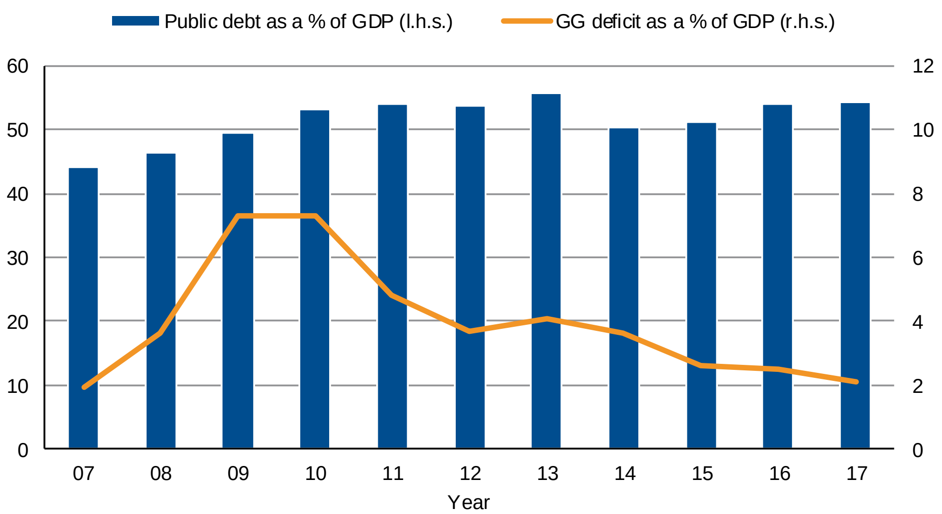
Source: European Commission

Improving public finances

Good budget execution, strong revenue growth

Supported by robust growth, Poland reduced its budget deficit to an estimated 2.1% of GDP in 2017 from 2.5% in 2016, a better-than-budgeted result. On a cash basis, Poland's deficit was reduced to PLN 26bn in 2017 from PLN 56bn in 2016 as state expenditures remained 2% under budgeted levels while revenue execution exceeded expectations by 7.7%.

Figure 7: Poland's general government (GG) deficit and debt ratios



Source: IMF, Haver Analytics, Scope Ratings GmbH

Scope estimates that Poland's general government debt (according to the Maastricht definition) remained fairly unchanged at 54% of GDP in 2017, reflecting a conservative fiscal framework including debt limits, e.g. a constitutional ban on incurring loans and granting guarantees that could cause the public debt ratio to exceed 60% of GDP and institutionalised budget consolidation processes should public debt rise above 55% of GDP (according to the domestic definition[2]).

Poland's debt ratio to decline to 50% of GDP

Stable public debt, below constitutionally defined limits

Scope undertook a public debt sustainability analysis, by assessing the impact of changes in assumptions to the IMF's baseline scenario.

The IMF baseline assumes moderate economic growth (of on average 2.9% p.a. to 2022) and a primary deficit of 0.5% of GDP for the forecast period, resulting in a gradually decreasing debt-to-GDP ratio to 51.3% of GDP by 2022. Alternatively, Scope's optimistic scenario assumes stronger GDP growth and better fiscal performance, reflecting strengthening market reforms and rising investment rates, sustaining Poland's growth and leading to a faster reduction in the debt-to-GDP ratio to 45.9% of GDP (**Figure 8**). Scope's negative scenario assumes that institutional challenges deter FDI, reduce the investment rate, undermining economic growth and supporting increasing government debt to 56.3% of GDP by 2022.

Table 1: Debt sustainability assumptions

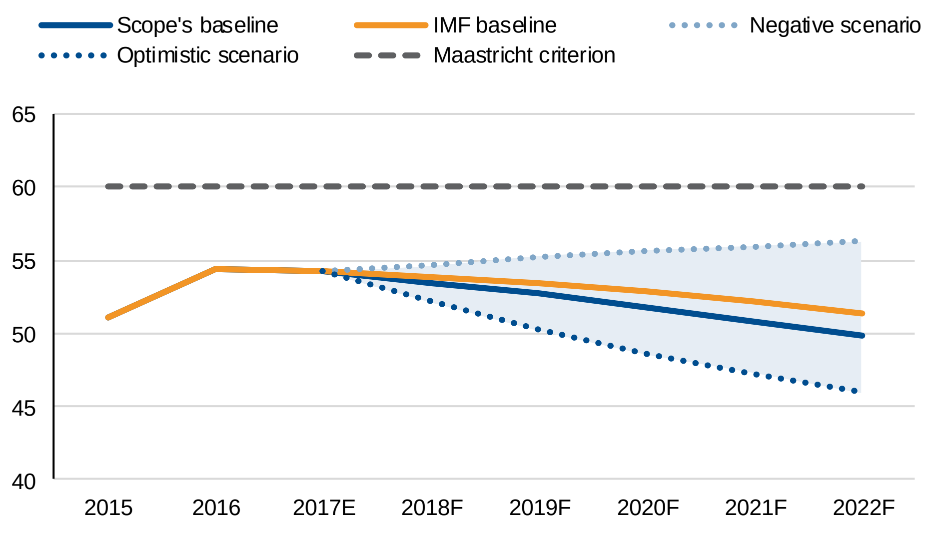
Scenarios for 2018 – 2022	Avg. real GDP growth (%)	Avg. primary bal. (% of GDP)	Avg. real eff. int. rate (%)	Debt, end period (% of GDP)
IMF baseline	2.9	-0.5	0.9	51.3
Optimistic scenario	3.5	0.3	0.9	45.9
Negative scenario	2.4	-0.8	1.7	56.3
Scope's baseline	3.1	-0.1	1.3	49.9

Source: IMF, Haver Analytics, Scope Ratings GmbH

Scope's baseline sees debt declining to 50% of GDP

Scope's baseline, reflecting overall robust growth dynamics and a strong public finance framework, is somewhat more optimistic than the IMF's baseline and sees Polish government debt declining to around 50% of GDP by 2022 (**Figure 8**).

Figure 8: Poland's debt-to-GDP ratio, forecasts to 2022



Source: IMF, Haver Analytics, Scope Ratings GmbH

[2] As of Q3 2017, differences between public debt of PLN 972,207m (according to the domestic methodology) and general government debt of PLN 1,010,855m mainly concern the scope of the sector, in particular the exclusion of debt of the National Round Fund (a vehicle to finance infrastructure) under the domestic methodology

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