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ACRA assigns LT A to the Republic of Poland, outlook Stable

ACRA has assigned the following ratings to the Government of the Republic of Poland (hereinafter, the Republic of Poland, Poland, or the country) under the international scale:

- **Long-term** foreign currency credit rating at **A** and local currency credit rating at **A**;
- **Short-term** foreign currency credit rating at **S1** and local currency credit rating at **S1**.

The outlook on the long-term foreign currency credit rating is **Stable** and local currency credit rating is **Stable**.

The **Stable outlook** assumes that the rating will most likely stay unchanged within the 12 to 18-month horizon.

Credit rating rationale

The Republic of Poland's A sovereign credit rating is supported by a wealthy, diversified and balanced economy, that has benefited from EU funds. It has a sustainable fiscal position, flexible monetary policy, and a strong banking system. The rating is constrained by the country's poor demographics, tight labor market, prolonged structural deficits, relatively low private investments and moderate external debt level, and limited R&D expenditures compared to the EU average.

Following a 28-year period of strong economic growth, Poland's economy, whose GDP PPP per capita stood at 71.8% of the EU average in 2018, is going to contract in 2020. ACRA expects the country's GDP to decline in the range of 4.0–7.0%. This is mainly due to the economic consequences of the COVID-19 pandemic, which negatively affects Poland's economy and the economies of its key trade partners.

At the same time, the relatively closed nature of the economy, its diversification and a slightly lower share of SMEs in the country's GDP structure could explain the less severe expected GDP contraction compared to its CEE peers. Anti-crisis measures adopted by the National Bank of Poland (NBP) and the government may serve as an important mitigating factor. The government recently announced a gradual lifting of lockdown measures, although the spread of the virus has not started to slow down yet. Should the rate of infection be brought under control, these measures could help the economy to recover; otherwise, the negative impact could be magnified.

The NBP reacted swiftly to the crisis caused by the pandemic by enacting large-scale monetary stimulus. It has employed a set of conventional and unconventional measures including reducing the key rate twice by 100 bp in total to 0.5%, releasing additional funding by lowering reserve requirement rates on funds in local and foreign currency, and launching secondary market operations by buying not only government bonds, but also government guaranteed bonds. Given the previous long-running soft monetary policy, timely unwinding of bond buying operations will be very important when the economy starts to recover.

Poland's fiscal position, which was stable prior to the crisis, is going to weaken in 2020. The country's public debt stood at 46.4% of GDP at the end of 2019, having declined from its peak in 2013. Poland has fiscal space to support the economy in order to fight the economic consequences of the pandemic. However, as a result of using this space the general government's debt-to-GDP ratio will deteriorate and could be around 55.0% of GDP by the end of 2020.

One of the main triggers for elevated public debt is an expanded budget deficit in 2020.The initial expected budget deficit at 1.2% of GDP for the general government is unlikely to be achieved this year. Instead, in ACRA's view, the 2020 budget deficit could amount to 5–6% of GDP with risks tilted to the upside. This deficit will be driven by a loss of revenues due to the GDP decline and the large fiscal package of anti-crisis measures, which total PLN 312 bln (around 14.0% of GDP). Out of this package, according to ACRA's assessment, additional government spending could make up at least 3.0% of GDP. The package includes an increase in healthcare funding, subsidies for struggling companies to pay salaries, deferral of social security payments, a fund to support infrastructure (that could issue government guaranteed bonds, which are eligible for the NBP's secondary market operations), and aid to SMEs and financial companies.

Despite its heightened financing needs and volatile markets, the government is well placed to finance its deficit on affordable terms. As of the end of March 2020, the government had accumulated a cash buffer, which covers around 90% of the initially planned total needs for this year. The NBP's secondary market operations will help contain the cost of new debt. In March, for the first time since 2017, the government started issuing short-term bills at around 1% of total central government debt (PLN 10.0 bln). The size of these bills relative to the outstanding public debt is negligible. There is no risk associated with this amount, but if the government choses to rely on this instrument more, refinancing risks could increase.

Poland's efforts to fight the crisis could be supplemented with EU money from the Coronavirus Response Investment Initiative, which would potentially permit the country to utilize unallocated cohesion funds that are estimated at around EUR 6.0 bln (1.1% of GDP).

Poland's moderate direct debt is supplemented with a sizable amount of contingent liabilities, which stood at 43.3% of GDP in 2018 (the latest available data), making Poland one of the countries with the largest contingent liabilities in the CEE region. This amount will increase, as the government's fiscal package is tilted towards guarantees. ACRA will closely monitor the extent to which these contingent liabilities materialize on the government's balance sheet and increase the country's direct debt. The latter will depend on the actual amount of guarantees issued and underlining companies' financial resilience, which will be tested by the pandemic.

The crisis will test the resilience of the country's banking sector. Prior to the crisis, the foundations of the banking industry were solid. Poland's banks were well capitalized, had low levels of non-performing loans (4.0% of total gross loans in Q3 2019), and met liquidity requirements. However, banks still keep around 5.0% of GDP in foreign currency mortgages on their books. Recent rulings from the Court of Justice of the European Union (CJEU) allow the annulment of these mortgages, therefore increasing the probability of additional capital needs. Moreover, an abrupt halt in economic activity due to the pandemic has dented household income and the profits of companies. This could result in NPLs increasing in the very near future.

Poland's external resiliency has improved over the last three years thanks to reduced external debt, which accounted for 53.9% of GDP at the end of 2019. However, external debt coverage remains limited. At the end of 2019, the country's foreign currency reserves covered 36.7% of total external debt and 59.1% of external debt in foreign currency. In 2019, the country's net international investment position (NIIP) reached a deficit of 50.5% of GDP and was one of weakest among its CEE peers.

The limited coverage is mitigated by the low volatility of the local currency. The zloty's depreciation has been manageable since the beginning of the crisis (around 6% compared to the euro) and international reserves remain intact. The country's free-floating exchange rate regime is likely to keep the current account balanced as the contraction of exports will be compensated by a fall in imports due to a weaker currency, the country's status as a fuel importer, and constrained consumption. At the same time, the primary deficit will improve as foreign subsidiaries record lower profitability and, as a result, transfer less money abroad.

The country's institutional framework has slightly deteriorated in recent years. Almost all of Poland's World Governance Indicators have weakened since 2015. Recent rulings from the CJEU on lowering the retirement age of judges, as well as the country's refusal to take in migrants, could put pressure on certain governance indicators. At the same time, the Human Capital Index supports Poland's institutional score, ranking the country third among CEE peers.

Sovereign model application results

The core part of the rating model put the Republic of Poland at AA-. The rating committee has decided to use an A+ Indicative credit rating. According to the methodology, this conservative correction was made because of limited data material for rating consideration due to the elevated volatility of the macroeconomic environment.

A number of modifiers in the modifiers part of the model allow the Indicative credit rating to be decreased. These include the following, which are determined by the Methodology for Credit Rating Assignment to Sovereign Entities under the International Scale:

- Potential economic growth;
- Contingent liabilities and the risk of them materializing on the sovereign balance sheet;
- Fiscal policy framework and fiscal flexibility.

Modifiers that could serve as grounds to increase the Indicative credit rating have not been identified.

In view of the abovementioned modifiers, the credit rating of the Republic of Poland has been decreased by one notch. Therefore, a Final credit rating of A has been assigned. There are no extraordinary factors that could adjust the Final rating. In connection with this, the Assigned credit rating remains at A.

Potential rating upgrade factors

- Quick and strong economic recovery;
- Strong rebound in fiscal position after the crisis;
- Further progress in external deleveraging.

Potential rating downgrade factors

- Significant deterioration in fiscal position;
- Increased external exposure;
- Risk of contingent liabilities materializing.

Issue ratings

No outstanding issues have been rated.

Regulatory disclosure

The sovereign credit ratings have been assigned to the Republic of Poland under the international scale based on the Methodology for Credit Rating Assignment to Sovereign Entities under the International Scale and the Key Concepts Used by the Analytical Credit Rating Agency Within the Scope of Its Rating Activities.

Sovereign credit ratings have been assigned to the Republic of Poland for the first time. The sovereign credit ratings and their outlook are expected to be revised within 182 days following the publication date of this press release as per the Calendar of planned sovereign credit rating revisions and publications.

The sovereign credit ratings are based on information from publicly available sources, as well as ACRA's own databases. The sovereign credit ratings are unsolicited. The Government of the Republic of Poland did not participate in the credit rating assignment.

ACRA provided no additional services to the Government of the Republic of Poland. No conflicts of interest were discovered in the course of the sovereign credit rating assignment.

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