MOODY'S
INVESTORS SERVICE

Rating Action: Moody's changes outlook on Poland's A2 rating to negative from stable; affirms rating

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Frankfurt am Main, May 14, 2016 -- Moody's Investors Service, (Moody's) has today changed the outlook on the Government of Poland's A2/P-1 issuer and government bond ratings to negative from stable and affirmed the ratings. At the same time, the government's senior unsecured medium term note (MTN) and senior unsecured shelf programme ratings have been affirmed at (P)A2.

The key drivers for the decision to change the outlook on Poland's A2 government bond ratings to negative from stable are the following:

(1) Fiscal risks related to a substantial increase in current expenditures as well as the intention to lower the retirement age, the latter raising age-related costs over time;

(2) Impairments to the investment climate from a shift towards more unpredictable policies and legislations, as reflected in the ambiguity with respect to the conversion of foreign-currency denominated mortgages and in the prolonged stalemate between the government and the country's constitutional court.

RATINGS RATIONALE

The affirmation of Poland's A2 rating is based on the country's economic resilience as reflected in a large, diversified economy that has shown robust real GDP growth irrespective of external headwinds.

Poland's long-term and short-term foreign-currency bond and deposit ceilings remain at Aa3/P-1 and A2/P-1, respectively. At the same time, the long-term local-currency bond and deposit country ceilings remain at Aa3.

RATIONALE FOR OUTLOOK CHANGE TO NEGATIVE

FIRST DRIVER -- FISCAL RISKS RELATED TO EXPENDITURE INCREASE, LOWERING OF THE RETIREMENT AGE

The first driver of the decision to change the outlook to negative is related to the fiscal risks arising from a substantial increase in current expenditures, uncertainty as to offsetting revenue measures, as well as the government's intention to lower the retirement age.

As one of its first measures in government, the Law and Justice party introduced a child-benefit subsidy, which will increase current expenditure by around PLN 17 billion (0.9% of GDP) in 2016 and PLN 23 billion (1.1% of GDP) in 2017. In 2016, those additional expenditures are covered through additional revenues, including proceeds from the sale of telecom licenses, dividends from the National Bank of Poland (NBP), as well as revenues from new taxes on banks and large retailers. Fiscal risks increase in 2017, however, given the government's reliance on one-off revenues and a more efficient tax collection to fund the child-benefit subsidy.

Concurrently, the government recently indicated that it will increase the free tax allowance in the calculation of personal income tax by PLN 1,000 in each of the coming years until reaching PLN 8,000. The implied shortfall in revenues will be around PLN 4 billion (0.2% of GDP) in 2017, and will progressively increase thereafter. These measures complicate the authorities' commitment to meeting the 3% of GDP budget deficit threshold in coming years.

Poland's fiscal risks are further amplified by the government's intention to lower the retirement age. The proposal reverses the pension reform introduced by the previous government. That reform would have progressively increased the retirement age to 67 by 2020 for men and by 2040 for women, which would have saved PLN 7 billion in 2017 (0.4% of GDP) respectively, and an increasing yearly amount over the subsequent years.

Moody's also notes that amendments to the Spending Expenditure Rule, which caps increases in nominal expenditures, facilitate the surge in nominal expenditure associated with these policies. The amendments mean that spending increases are likely to persist in future years, a credit negative. Based on an increase in the nominal expenditure cap of around PLN 28 billion (1.5% of GDP) and PLN 34 billion (1.7% of GDP) in 2016 and 2017, Moody's expects the general government deficit to widen this year to 2.8%, before exceeding 3% of GDP in 2017.

SECOND DRIVER -- RISK OF A DETERIORATION IN THE INVESTMENT CLIMATE

The second driver of the outlook change is the risk of impairments to the investment climate from a shift towards more unpredictable policies and legislations. This shift is exemplified by the proposal presented by the President's office to implement a law converting foreign-currency denominated mortgages and the prolonged stalemate between the government and the country's constitutional court, with the potential to undermine banks' credit flow and deter inward investment, respectively.

In response to fears that a rapid depreciation in the zloty relative to Swiss franc could impair households' repayment capacity, the President's office indicated earlier this year that foreign-currency mortgage loans should be converted into PLN-denominated mortgages at unfavourable terms for banks. According to an assessment of the Polish Financial Supervision Authority (PFSA), under the most likely scenario the proposal, if becomes a law, would result in a total one-off cost of PLN66.9 billion to the banking sector (3.7% of 2015 GDP), or around 4.5 times the system's 2015 pre-tax profit.

To mitigate the risks of capitalization of the banking system, this year PFSA has introduced a foreign-currency mortgage risk buffer and maintained stringent requirements on banks' dividend payouts. However, the proposed conversion at highly unfavourable terms for banks could also have a significant impact on credit supply, with consequences for private consumption and investment. Banks have already started adjusting their balance sheet by gradually reducing lending after the introduction of the tax on bank assets. Varying proposals with respect to the mechanism and the terms of conversion have generated concerns in the market.

Poland's constitutional crisis was triggered by a struggle over the appointment of constitutional court judges and by controversial new legislation that limits the court's powers. Though the implications of the constitutional changes for the independence of the Polish judiciary and therefore for the sovereign's institutional strength remain unclear at this juncture, the crisis has the potential to impair investors' perception of the rule of law and thereby their propensity to invest.

In January, Poland registered net portfolio outflows of $2.3 billion (PLN 9.4 billion, 0.5% of GDP), followed by $3.8 billion (PLN 15 billion, 0.8% of GDP) in February. According to the NBP, the fall in foreign holdings in February were mostly in Treasury bonds issued on external markets. The portfolio outflows are relevant for Poland given its reliance on foreign investment, particularly on inward portfolio flows: in 2015, external debt was at 69.2% of GDP in US dollar terms and 129.8% of current account receipts.

RATIONALE FOR AFFIRMATION OF POLAND's A2 RATING

The affirmation of Poland's A2 rating reflects the country's economic resilience. Poland has a large, diversified economy that has shown robust real GDP growth in recent years, despite being exposed to significant external headwinds at the time of the global financial and euro area debt crises. Poland's real GDP growth has significantly exceeded the EU average over the past five years: 2.9% in 2011-15, compared to the EU's 1.0%. Moreover, real GDP growth accelerated to 3.6% in 2015 from 3.3% in 2014, as net trade turned to positive and private consumption remained strong.

Moody's expects real GDP growth to remain around 3.5% in 2016 and 2017, with net trade progressively driving growth as investment and private consumption are constrained by lower confidence and access to credit. That said, over the longer term, low regional and occupational mobility, a suppressed female participation rate, market segmentation and high youth unemployment have the potential to impair Poland's growth trajectory.

WHAT COULD CHANGE THE RATING DOWN/UP

A deterioration in the government's fiscal position and/or material impairment in the investment climate following the implementation of the government's proposed measures could generate downward pressure on the rating and lead to a downgrade. Concurrently, a protracted (or escalation in) the conflict between the government and the constitutional court that leads to substantial capital outflows could also exert downward pressure on the rating.

Fiscal consolidation that leads to a decrease of the structural budget deficit , and improvements in the long-term sustainability of the social security system as well as in the institutional framework would exert upward pressure on the outlook.

GDP per capita (PPP basis, US$): 25,997 (2015 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 3.6% (2015 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): -0.5% (2015 Actual)

Gen. Gov. Financial Balance/GDP: -2.6% (2015 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -0.2% (2015 Actual) (also known as External Balance)

External debt/GDP: 69.2% (2015 Actual)

Level of economic development: High level of economic resilience

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 11 May 2016, a rating committee was called to discuss the rating of the Poland, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has not materially changed. Other views raised included: The issuer's institutional strength/framework, have materially decreased. The issuer's governance and/or management, have materially decreased.

The principal methodology used in these ratings was Sovereign Bond Ratings published in December 2015. Please see the Ratings Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

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