S&P changes outlook to positive on Poland

The surprise change in outlook comes on the back of strong GDP, a lower deficit, better budget performance and limited impact of institutional deterioration on capital flows

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What's behind the change?

The rating agency, Standard & Poor has changed Poland's sovereign outlook to positive for both local and foreign debt, but it still maintains the lowest rating among the three main rating agencies.

Currently, it has BBB+ for long-term foreign currency debt and A- for long-term local currency debt while Fitch's rating is a notch higher and Moody's two notches higher.

The main reasons behind the outlook change are:

1. Positive surprise with the economic growth of Polish economy in 2017 (4.6% of GDP), as well as the expectations this is sustainable.
2. Strong GDP growth, as well as a surge in tax collection as so far tax tightening has added 0.5% of GDP in new revenues.

3. Better relations with the EU despite negligible amendments of the controversially judicial "reforms," which lowers the risk that EU funds may be suspended or constrained.
4. Expectations that policy mix should properly address the risk of an overheating economy.

In the comment, the agency elaborates about the ongoing institutional deterioration. We share similar concerns but simultaneously point out that its impact on investors sentiment, especially foreign direct investment and portfolio inflows have been moderate so far.

After the elections in 2015, S&P was the first and the only agency to downgrade Poland's sovereign rating backed by worries that strong institutional deterioration initiated by the PiS government may negatively affect FDI and portfolio flows. As well as risk the for banking sector associated with Presidents Duda proposal to convert all CHF-loans into PLN at the expense of banks.

Next Steps

Theoretically, after a change in outlook, an upgraded rating may follow within 24 months, but the bar for an upgrade is very high.

The conditions are that the public debt to GDP should keep decreasing under a scenario of budget surplus. Moreover, Poland needs to prepare for new long-term fiscal burdens caused by population ageing.

We think the PiS government can satisfy 1/3 of the requirements next year as debt as a percentage of GDP should keep decreasing below 50% of GDP as it dropped to 50.6% of GDP in 2017, but simultaneously reaching a budget surplus is unlikely. It is because of expected higher spending on the co-financing of EU-backed projects, as well as some (still much lower than in the previous campaign) spending pledges before 2018 local and 2019 general elections. Moreover preparing the budget for the long-term challenge of an ageing population seems to be outside the policy horizon of this government.

In our opinion, the S&P forecast of 2018 general deficit is excessively pessimistic. It sees deficit at 2% of GDP in 2018, while we expect 1.3% and 1.9% in 2019 including new spending pledges mentioned by Prime Minister Morawiecki this weekend. But we expect that rising tax collection may surprise again on the upside this year, which should be seen positively by the agency.

Bottom line

Based on the recent and expected improvement of the fiscal side of things, we think this calls for a rating upgrade, but the agency is unlikely to do that as local elections approach in 2018 and general elections in 2019. Marketwise, the outlook upgrade is already largely priced in.

For over a month we called for further compression of risk premium in Polish 10y bonds and much of that has already happened, i.e. last weeks spread to Bunds in 10y Polish government bonds compressed by another 20bp. Out of 150bp post elections risk premium, only 1/5 still exists. Further compression is possible.

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