

Change of power in Poland should unlock investment potential of the economy

Exit polls suggest an opposition coalition is set for an overall majority. But forming a new government could take more than two months as the incumbents are likely to try to form a cabinet first. Restoring institutional order could unlock the potential of the economy and EU funds. And that, along with more foreign investment, is positive for PLN



Poland's Sejm
Parliament building

The opposition wins the election

Exit polls suggest the Law and Justice (PiS) party got the most votes in Poland's elections, but at 36.6% support, it's failed to gain a majority in the Lower House of Parliament. With 198 MPs out of 460, they're expected now to be in opposition. Their rivals, Civic Coalition, came second with 31% (161 MPs), but they should be able to form a government with their declared coalition partners, the Third Way (which got 13.5% and 57 MPs), and the Left (which polled 8.6% gaining 30 MPs). The far-right Confederation party received just 6.4% and 14 MPs.

The biggest positive surprise of the elections is the record-high turnout of 72.9%, the highest since the Polish political and economic transition started in 1989. Support for the Third Way surprised to the upside, as it likely took over centrist votes from the Law and Justice party, while the Confederation received much weaker backing than had been expected.

The next steps are not without concerns

The Constitution provides for three steps in forming a new government. According to the President's declaration and outgoing Prime Minister Morawiecki's statement, the incumbent Law and Justice party will attempt to form a government despite lacking a majority in Parliament and having little to no chance of forming a government. This step should last maximum two months.

In the second step, the mission of forming a government will be transferred to Parliament. The Civic Coalition, the Third Way and the Left can potentially count on 248 votes in the Lower House, so they are almost certain to form a government.

However, it will take about two months for the first scenario to materialise and another two weeks for the second.

Concerns are being raised as to whether the transfer of power will be peaceful and in accordance with the rules. We think it should be. The proximity of three other elections: local, European and the most important presidential elections means that if Law and Justice were to hinder the process, it could reduce its chances in those other polls.

A stronger role for the President

The new balance of power in the lower Chamber means a stronger role for President Andrzej Duda. Today's opposition failed to win a majority of the 278 seats required to overturn the president's veto. In addition, the Law and Justice Party, with its 200 seats, will be a very strong opposition; don't forget it also has its representatives in the National Bank of Poland, the Constitutional Court, the National Media Council, and so on.

However, our expectation is that the transfer of power will be a rather smooth but lengthy process. And the first prime minister, at least for a couple of quarters, will likely be Donald Tusk. Restoring institutional order, improving relations with the European Union, and unlocking funds from the Recovery Fund are likely to be the new government's priorities.

Conclusions for financial markets

Markets are breathing a sigh of relief that the threat of a stalled parliament and further snap elections has declined.

The opposition's advantage, at least according to the exit polls, is big enough that instability is unlikely. Prime Minister Morawiecki has announced that he will attempt to form a government, but the arithmetic indicates that an opposition government is likely to be formed in the second step, and that will be the one who'll be in power.

The outcome of the elections suggests that it will be easier to finance the budget's high borrowing needs next year. Financial markets assumed that an opposition win would mean a rapid unlocking of the EU funds, and all opposition parties agree that this is a priority.

These factors point to a strengthening of the zloty

We assume a return of foreign investors to the Polish debt market (after many years of underweighting POLGBs), which has been bypassed by foreign capital in recent years. The possibility of an opposition government also means a potential increase in Foreign Direct Investment (FDI) on top of the already significant inflows (over 4% of GDP in 2022) we have seen recently. These factors point to a strengthening of the zloty.

We expect fiscal policy to remain expansionary, given a series of three more elections - local, EU and presidential - still to come. The incumbent government planned 2024 net borrowing needs at PLN225bn vs PLN143bn in 2023. We estimate that local savings may cover a third of them in 2024, down from two-thirds in 2023. We expect that those spending plans to remain in place after any change of power.

We see potential additional PLN20-30bn new spending from the opposition programmes, which may be implemented in the coming year, but they could be offset by lower defence spending. Given that many EM bond investors have remained underweight in POLGBs for many years, and there's now a more optimistic PLN picture, we expect covering these borrowing needs should be easier.

In the near term, the results of the country's parliamentary elections will be decisive for the zloty's behaviour. If the exit polls are confirmed, the strengthening of the PLN should prove to be permanent. This is because investors are counting on the new coalition to resolve the conflict with the EU, which will allow for the rapid unblocking of funds from the Recovery Fund; a larger FDI inflow than already solid is possible. We see a return of the €/PLN closer to 4.40.

There will still be a few risks towards the end of the year, but we assume they will be less significant than the election result, given the expected inflow of portfolio capital into the debt market and increased foreign direct investment.

That said, it's worth noting a few risks for PLN. These include high 2024 borrowing needs and the continuation of expansionary fiscal policy expected by the rating agencies, and any deterioration in the domestic balance of payments, which has recently been improving.

At the end of the year, we see €/PLN between 4.40-4.50.

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