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Country Profile: Poland

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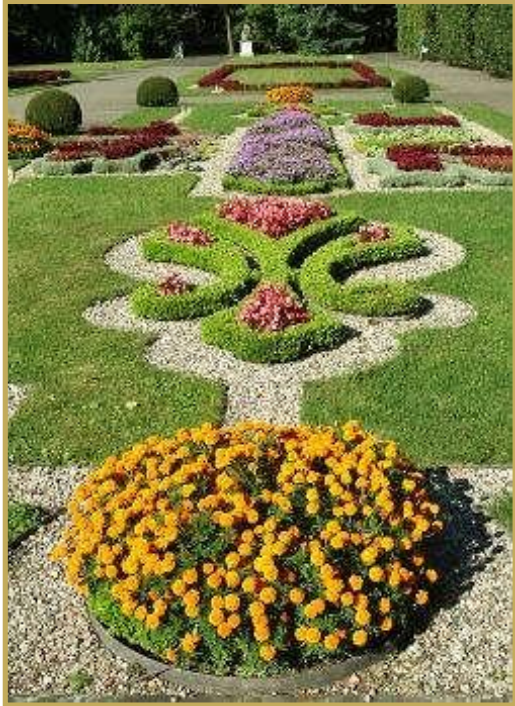
It has never been more important for you to understand what is occurring in the world beyond your country's borders. Whether you realize it or not, we are now all fellow citizens...Global Citizens.

The Thomas White organization was founded in 1992 with the goal of bringing the benefits of globalization to investors around the world. We believed that once investors understood that globalization was a positive force, they would also see the advantages of adding international equities to their portfolios. It only makes common sense that professional investors would begin searching the globe for the most attractive opportunities. Researching a wider universe of companies should improve long-term performance. Moreover, broad diversification typically lowers return volatility. Multinational corporations have been using this global strategy for years; why shouldn't investors do the same?

Now nearly two decades later, our firm growth and strong subsequent portfolio performance has confirmed our investment premise. Currently, Thomas White professionals are performing research and managing over one billion dollars in close to 50 countries. We believe one reason for our success is that the nationalities of these analysts are as globally diverse as our portfolios.

A handwritten signature in dark ink, reading "James S. White, Jr." in a cursive script.

Poland: The Small Wonder of Europe



Surrounding the 17th century Wilanow Palace in Warsaw, the 108-acre Palace garden is a splendid example of the gardening style of the period. The Wilanow Palace, known as the "Polish Versailles", and is a perfect fusion of European and traditional Polish architecture.

*Poland has not yet succumbed,
As long as we remain,
What the foe by force has
seized,
Sword in hand we'll gain*

These first four lines of the Polish national anthem adequately embody this ever so spirited country situated in the heart of Europe. They also reflect the tumultuous past and struggles of a country which has survived a legacy of violence, dominance, and aggression, interspersed with periods of freedom. The geometric center of the European continent, Poland enjoys a strategic location, well connected with cities like London, Paris, Vienna, and Berlin. The boundary between the eastern and western European continental masses also runs through Poland.

This diminutive country occupies 1.4% of the area of the European continent, with a population size 12% of the U.S. Yet, like the long-lived oaks that it has

nurtured for several centuries, Poland has always harbored towering ambitions. Home to 11 Nobel Prize winners including the revered Pope John Paul II, brilliant astronomer Copernicus, musical maestro Chopin, and renowned physicist Maria Curie, the country prides itself on its eclectic contributions to the world. Poland also symbolizes one of the most remarkable transitions from communism to a market-

based economy in modern time.

Turbulent yet triumphant

The genesis of Poland, a country that has endured a strife-laden past, can be traced back to the 10th century. Poland has suffered aggression, division and partition of its territory on numerous occasions by Austrians, Prussians, Russians, and Germans. For nearly a century since 1795, it completely lost its existence as an independent entity. However, the indomitable Poles fought resolutely against foreign dominance throughout the 19th century. Following the Great War, Poland literally emerged from obscurity, regaining its identity as a separate country in 1918. Yet, World War II and German occupation proved to be the harbinger of fresh turmoil and violence in Poland. A case in point was the ghastly incident which left a deep scar on the moral

consciousness of a nation, known as the Katyn massacre. During April-May 1940, the Soviet secret police, on the orders of the politburo and Josef Stalin, murdered some 22,000 Polish nationals in the Katyn forest in Russia. The ensuing wartime struggle culminated in 1945 with the Soviet capture of Poland and a subsequent treaty between the USSR and Poland delimiting the Soviet- Polish frontier.

A Soviet-backed communist regime came to power in Poland after World War II. Successive agitations by the Poles for greater freedom were throttled by the communist hardliners wielding power. However, winds of change harbored a workers' movement in 1980, resulting in the formation of the Solidarity trade union. The government tried to suppress the movement, but eventually succumbed to the people's will. Partially free elections were held in 1989, which led to the formation of the first non-communist coalition government in Eastern Europe. Widespread success for Solidarity catapulted Lech Walesa, the trade union leader of humble origins, to the position of the first popularly elected President of Poland. Under the Polish constitution, as it stands currently, the President has fewer powers than the Prime Minister, but has a significant say in foreign policy. In the elections held in October 2007, the pro-Europe, Civic Platform party emerged triumphant with Donald Tusk assuming the Prime Minister's position.

Cultural Solidarity

Poland's rich cultural heritage, which has evolved for over 1000 years, is a striking blend of both eastern and western influences. The country's amicable approach to inspirations from other parts of the world is reflected in the versatile character of its own art and culture. Polish traditions, art, dress, and cuisine span the whole spectrum of diverse European styles. While Polish literature dates back to the 14th century, the country also prides its contributions to avante garde literature and theater in the 20th century. At present, more than 98% of the nation's people are Poles, with small groups of Ukrainians, Belorussians, Germans, Slovaks, and Lithuanians. The Polish population is largely urban centric, with 60% of the population living in cities.

Poland and the World	
Nominal GDP (\$)	430.1 billion
GDP Rank	21/193
Per Capita GNI (\$)	12,260
Per Capita GNI Rank	69/213
Population Rank	33/224
Geographical Area Rank	69/250
Global Competitiveness Rank	46/133
Economic Freedom Index Rank	68/179
Human Development Index Rank	41/182
Major Industries	Automotive, Aviation, White Goods, R&D Center, BPO, Copper and Silver

No longer separated

The ushering of market-based reforms and large-scale privatization in 1990 heralded a new era of integration of Poland with the world economy. Despite being a victim of disorderly and fractious politics, Eastern Europe's largest democracy has been gradually but surely transformed into a potent force in the European sub-continent. A country with a painfully turbulent past, Poland secured membership in the North Atlantic Treaty Organization (NATO) in 1999, underscoring its commitment to peace and security in Europe. The country is also a member of the Organization of Economic Co-operation and Development (OECD), a body that is focused on strengthening democracy and the market economy. In 2004, Poland was extended membership in the European Union (EU). From an isolated existence, this little wonder of Europe has now taken momentous strides towards integrating itself into a globalized world.

Emerging Europe's Radical Reformer

The journey of Poland's transition to a market economy since 1990 has been fraught with challenges and tribulations. As it embarked on this path, the erstwhile communist country was riddled with difficult macroeconomic conditions like hyperinflation, high unemployment, unsustainable budget deficits, burgeoning external debt, and an inefficient and archaic state sector. The *Leszek Balcerowicz Plan* of the early 1990s, named after the reformist Polish Finance Minister, ushered in an era of widespread economic reforms both on the domestic, as well as the external fronts of the country. Domestic prices that were earlier administered by the government,



While many European and Asian countries are battling the burden of an aging demographic, Poland boasts that half its population falls below 35 years of age, a distinct advantage for a burgeoning economy.

gradually became market determined and the Polish economy also opened up to the world. The Polish currency, *zloty*, became convertible to other currencies and its value was stabilized against the dollar. Currently, the country has a floating exchange rate regime, which is a step towards the goal of adopting the euro and amalgamating with the European Monetary System between 2012-14. This fundamentally radical approach to reform has qualified Poland as the most dynamically developing European country, worthy of the epithet "*the flying eagle of Europe*".

The structural reforms have slowly but surely borne fruit. The economy, after growing at a reasonable rate of 4% since 1995, has witnessed a remarkable acceleration after accession to the EU. The country grew at 5.8% in 2006 and 6.5% in 2007, the fastest pace in a decade. The economy grew at the rate of 4.8% in 2008. Consumer prices, which hovered around 20% in 1996, had dramatically dropped to 1.3% in 2006. Despite global inflationary pressures, inflation continued to remain at a reasonable annual rate of 4.3% in April 2008. The unemployment rate also substantially declined to around 10% in 2007 compared to 20% in 2005. In addition, the government's fiscal balance showed an upward trend.

In addition to robust growth rates, what sets Poland apart from its peers in Central Europe is the sound macroeconomic fundamentals the economy clearly enjoys. The country now boasts of moderate inflation rates, a restrained current account deficit, and fiscal balance.

A polish-ed destination

An upper middle-income country, which ranks high on human development as well, Poland touts one of the most youthful and best educated societies in Europe. While many European countries are battling the burden of an aging demographic, Poland boasts that half its population falls below 35 years of age. Moreover, a large proportion of this young population has an inclination towards higher education. Augmenting its geographical natural advantage, Poland has successfully created a skilled human resources base, and has devised investor-friendly economic policies.

Hence it is not surprising that Poland offers a fertile ground for global corporations to set up their research and development centers, as well as manufacturing units. International corporations also view Poland as an excellent location for transferring non-production functions, resulting in Poland becoming the European center of modern Business Process Offshoring (BPO) services. This has helped Poland tackle the critical problem of unemployment. Given this, the economy is powered by its services sector, which contributes to about 64% of the gross domestic product (GDP).

The bulk of the country's remaining output is devoted to industry. Located in the southeastern region of the nation, Poland's *Aviation Valley* is famous for its aerospace industry and pilot training centers. The *Aviation Valley* produces 90% of Polish aerospace industry output, and highlights Poland's 100-year experience in the aviation industry. Exporting to over 11 countries the world over, Poland aspires to transform this southeastern outpost into one of Europe's leading aerospace regions.

The Polish automotive industry is also playing an increasingly important role in the emerging economy, accounting for 10.2% of industrial production and 16% of total exports in 2006. One of the first sectors to be privatized in the early 1990s, the industry exports around 95% of its

output, and specializes in the production of spare parts and accessories. The sector is also a magnet for global auto majors. Poland is luring these auto behemoths with low-cost, highly skilled labor, as well as a comprehensive network of subcontractors, many of them holding the highest certificates of quality.



Low-cost, highly skilled labor is the major factor driving the automotive industry in Poland.

In addition, Poland has proved to be an excellent location for foreign companies manufacturing domestic household appliances. Foreign investments have been pouring into this sector in the special economic zone (SEZ) at Lodz, the second largest centrally located city in Poland. Lodz has earned its title as the largest white goods production center in Europe.

Coal is the most abundant, as well as the cheapest fossil fuel in Poland, and is used predominantly for power production and energy generation in the country. Though not richly blessed with oil resources, Poland is home to a major European oil refiner, as well as a petroleum retailer who has the distinction of being Central Europe's largest publicly traded company. In the metals and mining sector too, Poland touts the second largest producer of silver and the sixth largest producer of copper in the world, exporting the world over. The country is also a pioneer in organic agriculture and a leading exporter of milk, meat, fruits and vegetables to EU members. In addition, Poland boasts of a globally recognized and flourishing yacht building industry, and is a favored destination for health tourism in Europe.



The Warsaw Stock Exchange, which had its humble beginnings in 1991, currently has a market capitalization of €113 billion and a daily turnover of about €680 million.

Poland is evolving as a leader in the capital markets, with Warsaw developing as the financial center in central and Eastern Europe. The Warsaw Stock Exchange had its humble beginnings in 1991, when it used to operate out of the old building which housed the Communist Party headquarters. Currently, the exchange has a market capitalization of €113 billion and a daily turnover of about €680 million. In a remarkable triumph for Polish capitalism, the Warsaw Stock Exchange was privatized by the government in December 2010. The

initial public offering brought down the government's stake to 35% from 98% earlier. The

exchange has now become the biggest in central Europe, and is only behind Turkey and Russia in market capitalization. The shares performed well on debut, unlike some of the other recent IPOs. Moreover, the spate of IPOs and stake sales toward the end of 2010 have helped expand Poland's base of individual investors.

GDP growth more than doubles in 2010

The Polish government under Prime Minister Donald Tusk was basking in the growth rate seen during 2006-2008 when the global financial crisis struck. The country escaped relatively unhurt by the crisis, making it the only EU member technically not in recession when it managed to grow moderately in 2009. However, unemployment rose due to the large number of migrant laborers returning from Western European nations hit hard by recession. Industrial production and exports stalled as demand slumped from many of Poland's trade partners. The Polish government stepped in immediately to control the damage, rolling out a \$31 billion stimulus program, which included loan guarantees and infrastructure spending. Notably, Poland, like South Korea, let its currency slide, while it discarded the deficit-swelling policies of the U.K. and the U.S.



Poland is becoming the European center of modern Business Process Offshoring (BPO) services. Given this, the economy is powered by its services sector, which contributes to about 64% of the gross domestic product (GDP).

A report from *The Economist* says if Poland found itself better-off vis-à-vis some of the Euro-zone countries, it had better thank luck. The report says a tight monetary policy implemented in the beginning of the decade kept an asset-price bubble under control, while the property boom was kept under check by a bureaucratic government. Moreover, tough banking regulation restrained the borrowing, especially in foreign currency, which bogged down Hungary during the financial crisis. Needless to say, Polish banks survived the crisis well, with most of the banks ending 2009 with profits. Thanks to the decrease in provisions for bad debts and an increase in interest

income and fees, profits of Polish banks are projected to increase by 30% in 2010. Moreover, FDI inflow into Poland fell by only 16% year-on-year in 2009 to €8.4 billion, while recovering significantly in 2010. The downslide is noteworthy when compared to the global capital flows, which tumbled about 40% during the year. As well, Poland's competitors, the Czech Republic and Hungary, witnessed big drops in FDI flow during the year.

Poland did approach the IMF for a US\$20.5 billion loan in April 2009 despite a firm stance that its public finances were in robust health along with some of its neighbors such as the Czech Republic, Slovenia, and Slovakia. All these countries had relatively low levels of public debt, under-control debt repayment options, and reasonably healthy banking systems. However, the point to be noted is that the no-strings attached IMF credit line is generally offered to the most stable emerging-market states. Moreover, the size of the loan amounted to just 3.8% of Poland's 2008 GDP. Poland's decision to approach the IMF was likely driven by the need to strengthen the position of the zloty by boosting the central bank's reserves and as a fallback option if the country found it difficult to tap credit markets later in the year.

The economy expanded at the rate of 3.8% in 2010 after managing to grow 1.7% in 2009, thanks to strong domestic demand and a revival in Germany, which boosts Polish exports. Attracted by the economy's growth potential, foreign inflows to the tune of \$34 billion poured into the economy during 2010, as they did in 2008 when the flow had reached a peak. However, unlike in 2008 when the bulk of these inflows were channeled into industrial investments such as building factories or buying real estate, the majority of the current flow is earmarked for portfolio investment.

Still, the rising fiscal deficit remains a serious concern. The budget deficit, which reached about 7.9% of GDP in 2010, is projected to remain at 6.6% in 2011, which is much higher than the European Union stipulation of 3% for its member states. Prime Minister Donald Tusk is banking on the country's economic growth and a stronger currency to keep public debt under check. As per the Polish law, if public debt crosses 55% of GDP, it would automatically unleash austerity measures.

Breaking Bread with Russia

According to reports from Reuters, the center-right Polish government has also made good progress in improving bilateral ties with neighbors. Russia is a case in point. The decades-old frosty bilateral ties between Poland and Russia date back to the Katyn massacre of 1940 in which some 22,000 Polish officers were killed under the orders of Josef Stalin. However, the strained relationship between the two countries seems to show signs of thawing in the aftermath of the April 2010 plane crash in Russia in which most of Poland's



The plane crash which killed the Polish president and the country's top brass may mark a new beginning in the relationship between Poland and Russia.

political top brass, including its president Lech Kaczynski were killed. Russia empathized with its neighbor in its hour of grief, which also opened up new vistas in trade relations between the two nations, such as the increase in the quota of natural gas imported by Poland. Poland, on its part, reciprocated the gesture by allowing the prominent state-owned Russian oil company Gazprom Neft to bid for stakes in Polish refiner Lotos Group in 2011. Poland, which has the distinction of being the sixth-largest nation in the EU, also maintains excellent relations with Germany, its biggest trading partner.

Building roads to prosperity

Notwithstanding Poland's economic progress, the country has a bad reputation for development of infrastructure, although recently there have been some giant strides made to correct this. A report from *The Financial Times* observes that Poland's notoriously bad roads are receiving a major makeover, thanks to the free flow of European Union funds ahead of the 2012 European soccer championship to be jointly hosted by Poland and Ukraine. Specifically, the EU is pumping in structural funds to the tune of \$94 billion during 2007-2013 to help the country develop its roads and railway network. Moreover, the hectic construction activity in Poland has caught the attention of Chinese infrastructure companies such as China Overseas Engineering Group, which has won the contract to construct two segments of the Berlin-Warsaw highway. In a progressive step, the Polish government launched a system of filing taxes online, sparing taxpayers the hassle of going through the previous expensive and cumbersome process.

But the icing on the cake was the privatization of some of the state-owned firms, which was aimed at plugging the widening budget deficit. Reports from Reuters say that the program has already exceeded the government's target of \$8.8 billion in privatization revenues by the end of 2010. Though the process of selling shares in these companies was initiated in 2008, it gained momentum during 2010, the most prominent among them being the IPO worth \$2.5 billion from Powszechny Zaklad Ubezpieczen (PZU), the biggest insurer in Poland. Stakes in copper miner KGHM Polska Miedz S.A., oil refiner Grupa Lotos S.A., as well as Telekom Polska S.A. are also being offered to investors, and the process is expected to be completed by the end of 2011. Some of the big government-owned electric utilities such as Enea, Tauron, PGE, and Energea have also been put on the block, though the stake sales have not made much headway so far. Recently, the government said it is planning to put up for sale the majority stake in rail operator PKP Cargo in 2011.

The Million Euro Question

Ever since it became a member of the European Union in 2004, the world changed for Poland. The economy has been able to clock a growth rate of 5% annually until 2009, helped by the liberal flow of EU structural funds into the country. According to a report from the Organization

for Economic Development and Co-operation (OECD), the EU membership is seen helping the country in more ways than one. The entry into the EU has opened up the larger European market for Polish wares, besides the huge funds to develop the country's infrastructure. Moreover, Poland is slated to preside over the EU in the latter half of 2011 in recognition of its growing clout in the comity of European nations. A recent study showed that state-owned Polish firms such as Polish State Railways and natural gas monopoly PGNiG benefited the most from the European Union subsidies allotted during the last three years.

Prime Minister Donald Tusk has been advocating the country's adoption of the euro as its currency, setting 2011 as the target date some two years back. However, the ground situation has changed so much so that the government has now declared 2015 as the new date. The political situation was also not conducive, with the late president Lech Kaczynski opposed to the common currency. Recently, Poland moved a step closer to the adoption of the euro when news reports quoted President Bronislaw Komorowski saying that the parliament would amend the constitution to facilitate its entry into the Euro-zone. The proposed amendments would redefine the Polish central bank's role as the sole issuer of money and formulator of monetary policy. However, the reports pointed out that the lag in implementing reforms and a widening deficit, which is far above the stipulated EU norms, make Poland's goal of adopting the euro difficult to accomplish.




Fundamental and far-reaching economic reforms have earned Poland the distinction of being one of the fastest growing economies in emerging Europe. The TPS tower in Warsaw is one of the many modern offices that represent the dynamically progressive face of Poland.

Future Looks Bright

Witness to a troubled economic and political existence, Poland has indeed come a long way since 1990 when it commenced its transition to a democratic and market-based economy. Its growth performance after the EU accession in 2004 has seen a remarkable acceleration, and the process of catch-up with the higher-income countries seems to have gained fresh momentum. Today, Poland enjoys a well-balanced growth and robust demand, with only limited pressures on core inflation and the current account deficit. Yet, this aggressively expanding country is not exempt from challenges.

A report from the Organization for Economic Co-operation and Development (OECD) notes that the country has to counter emerging resource constraints, in particular, skilled labor shortages. The unusually high capacity utilization rates and the increasing labor costs may impede the country's external competitiveness as well as its price stability.

Moreover, Tusk's efforts at reforming Poland's notorious bureaucratic red tape has not produced any tangible results, with Poland relegated to the 72nd place in a World Bank rating for the ease of doing business, behind the rest of its peers in the region. News reports indicate that though strong fiscal reforms are lacking, Poland seems to have everything going for it. Despite the 13.1% unemployment rate, Poles are spending. Banks have resumed lending, albeit cautiously, while the real estate market looks stable after the crash in the latter half of 2008. The overall popular support enjoyed by the ruling coalition completes the rosy picture. Still, as Poland races ahead, it could do with another stroke of good luck, which partly helped it escape the recession unscathed. 

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