THE VIEW

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POLAND CORPORATES TO FACE HEADWINDS

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EXECUTIVE SUMMARY

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- Over the past five years, Poland experienced rapid economic growth of an average annual rate of +4%, driven by strong foreign demand, an investment boom and a markedly strengthening labor market. However, while the latter two should persist in 2019, foreign demand (notably from the Eurozone) has already begun to weaken. As a result, we expect a slowdown of Poland's growth from +5.1% in 2018 to +4% in 2019 and +3.3% in 2020 amid an increasingly challenging global economic environment.
- Risks in the corporate sector are expected to rise. Even though the Days Sales Outstanding (DSO) of listed companies indicate that large firms are enjoying relatively good payment discipline, the overall non-payment risk has steadily risen over the last three years. This is reflected in the ongoing uptrend in business insolvencies (+10% p.a. on average in 2016-2018). We expect corporate insolvencies to increase by another +10% in 2019, posing particular risks to large-scale suppliers of Polish companies.
- Despite the boom over the past five years, policy choices have led to a deterioration in the attractiveness of doing business in and with Poland. Feuds between the Polish government and the EU may even put future EU funding flows at risk. Thus, the best days in terms of strong economic performance could be behind for Poland. However, there are opportunities and room for maneuvering for the next government to reverse those critical policy moves and improve the overall business and investment climate.

Photo from Unsplash

+10%

Rise in corporate insolvencies expected in 2019

EU IMPETUS AND INVESTMENT GROWTH DROVE THE RECENT BOOM

Poland experienced a strong economic rebound between 2014 and 2018, with real GDP expanding by an average annual +4% and reaching an 11-year peak of +5.1% in 2018. Three key factors drove the strong performance:

- **Strong foreign demand**

Poland's real exports grew by an average annual rate of +7.8% between 2014 and 2018, thanks to the Eurozone recovery, as shipments to the member states of the monetary union, especially Germany, rose much more than those to the rest of the world (see Figure 1). The Eurozone's share in Polish goods exports increased from 51.6% in 2013 to 57.7% in 2018 (Germany's share rose from 25.1% to 28.2% over the same period). Polish companies benefited from the supply-chain structures that were built up over the past two decades.

- **Investment boom**

A strong utilization of EU funds for eligible projects drove growth in investment. As the previous EU research and innovation funding program of 2007-2013 came to an end, Poland was able to get a number of projects accepted, with disbursements being realized in 2014-2015. In addition, this funding attracted substantial private investment. In 2017-2018, Poland was able to increase the use of EU funding again, which accelerated fixed investment growth (+4% in 2017 and +8.7% in 2018) as well as inventory building. The latter contributed an average annual +0.6pp to GDP growth in the two years.

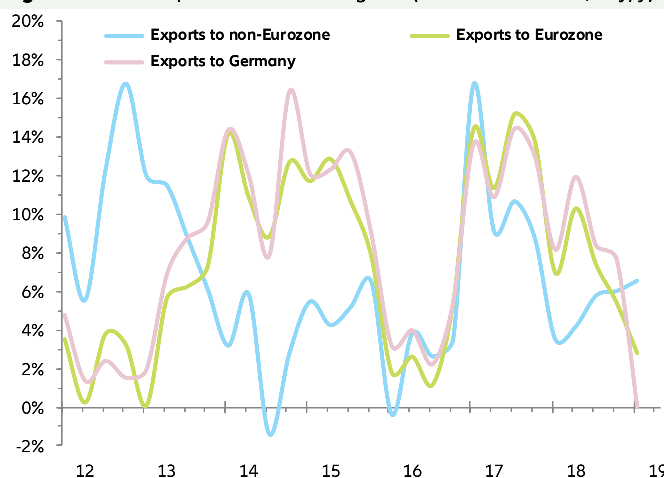
- **Strengthening labor market**

Both the favorite export cycle and the investment boom have had positive effects on the Polish labor market since 2014. The total number of employed persons in the national economy expanded by an average annual +2.1% in 2014-2018. In the private sector the average increase was even +2.8%. As a result, the unemployment rate (national definition) fell rapidly from 13.5% in 2013 to 6.1% in 2018.

Moreover, as the labor market tightened, nominal wage growth accelerated from +3% in 2014 to +6.9% in 2018. And since consumer price inflation was very low over 2014-2018 (average annual +0.4%) real wage growth and households' disposable income rose as well, boosting consumer spending. In real terms, the latter increased from a mere +0.2% in 2013 to +4.5% in 2018.

However, there are now signs that Poland's economic boom is about to abate.

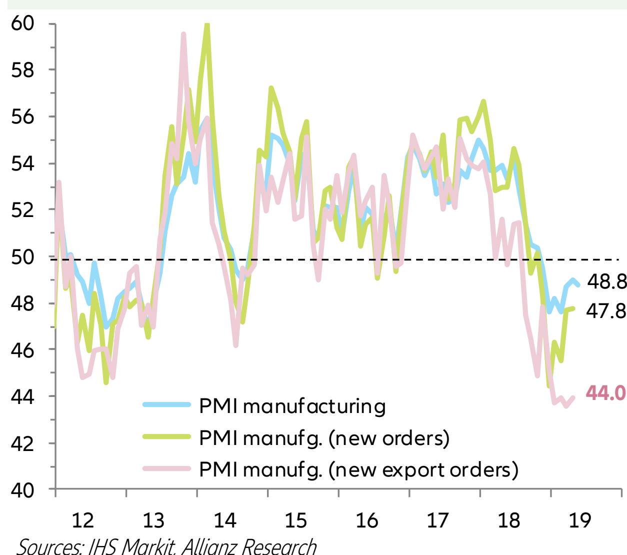
Figure 1 Polish exports to selected regions (EUR-denominated; % y/y)



Sources: National statistics, IMF, IHS Markit, Allianz Research

A DIFFICULT GLOBAL ENVIRONMENT WILL LEAD TO DECELERATION

Figure 2 Manufacturing PMI



Sources: IHS Markit, Allianz Research

We expect a deceleration of Poland's economy in 2019-2020, in line with weaker growth in the Eurozone - the main export destination of Polish goods - as well as the slowdown in global trade. The weakening outlook for Polish exports is supported by some advanced indicators. The manufacturing PMI for Poland has been below the 50.0 mark since November 2018, dragged down to a large extent by new export orders (see Figure 2). And export growth to the Eurozone (and to Germany in particular) decelerated rapidly and fell below the export growth rate of non-Eurozone economies in Q1 2019 (see Figure 1). What is noteworthy is that the uptrend in Polish shipments to countries outside the Eurozone since 2018 was driven by strengthening exports to the UK (thanks to a strong inventory buildup by British companies ahead of the expected Brexit) and the U.S. (thanks to positive effects of the American fiscal stimulus in 2017-2018 on global trade). However, we expect these drivers to fade away in the course of 2019-2020 as Brexit will take effect at some point and the U.S. economy is forecast to markedly decelerate. As a result, overall external demand for Polish goods is projected to slow down further in the next quarters.

For 2019 as a whole, domestic demand is expected to remain broad-based and the main driver of growth, while diminished external demand will act as a brake. Consumer spending will be supported by still solid wage growth, low unemployment and moderate inflation. And investment will benefit from continued loose monetary policies and ongoing EU funding flows, although the impact of the latter should gradually wane. Moreover, public spending is set to rise, thanks to a stimulus package ahead of the legislative election at the end of 2019. This package is expected to add some +0.3pp to annual growth in the next two years, thus (perhaps unintendedly) mitigating the negative impact of global trade tensions on the Polish economy. Overall, real GDP is forecast to grow by a still solid +4% this year before moderating to around +3.3% in 2020.

CORPORATE RISK IS SET TO RISE

Days Sales Outstanding (DSO) better than the global average…

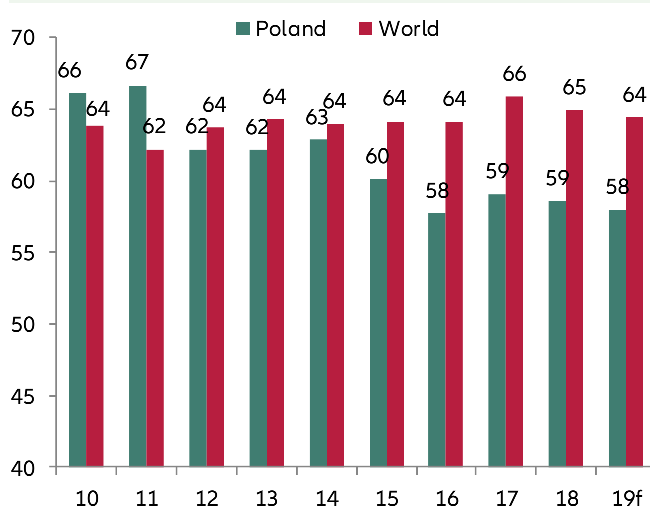
Poland's average DSO fell markedly in 2015-2016 and has been well below the global average since then (see Figure 3). In Poland, slightly less than one in five companies is paid only after three months, whereas this is the case for one in four firms at a global level. Between 2017 and 2018, amid particularly strong economic growth, the average DSO of listed companies in Poland rose by +1 day to 59 days , a sign of firms having greater trust in customers in a period of accelerating growth (see our recent Global DSO Study).
However, as the Polish economy is set to slow in the next two years, the need for payment discipline should rise again. Hence, we expect Polish DSO to fall by -1 day to 58 in 2019.

…yet the uptrend in corporate insolvencies continues

Despite the economic boom and the comparatively favorable DSO over the past few years, Poland's non-payment risk has steadily risen since 2016, as reflected in an ongoing uptrend in business insolvencies. On an annual basis, insolvencies rose for the third consecutive year in 2018, by +10%. On a quarterly basis, a strong increase was recorded in Q4 2018 (+25% q/q and +17% y/y) and Q1 2019 (+8% q/q and +10% y/y) after a temporary moderation in the previous two quarters (see Figure 4).

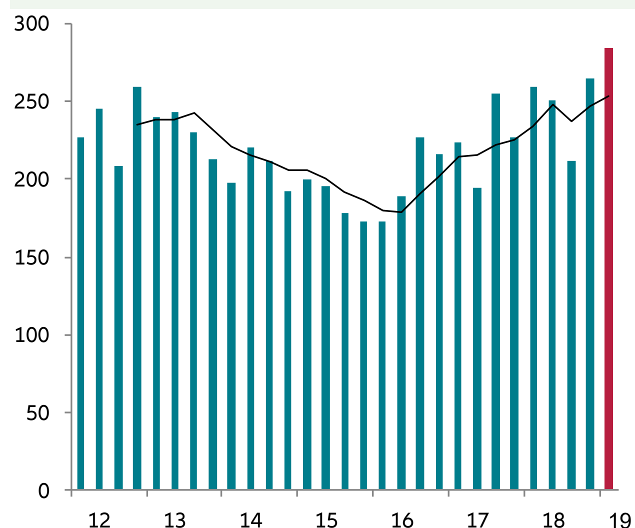
There are three explanations for this: First, at the start of 2016, the new Restructuring Law of 2015 came into effect, along with an amended version of the Bankruptcy Law of 2003. The Restructuring Law aims to facilitate more recovery proceedings instead of outright bankruptcies (liquidations). It has been successful as the number of liquidations has declined somewhat since 2016, while the number of recovery proceedings (which are also counted as insolvencies as creditors are not paid) has risen markedly.

Figure 3 Average DSO in Poland vs. the world (days)



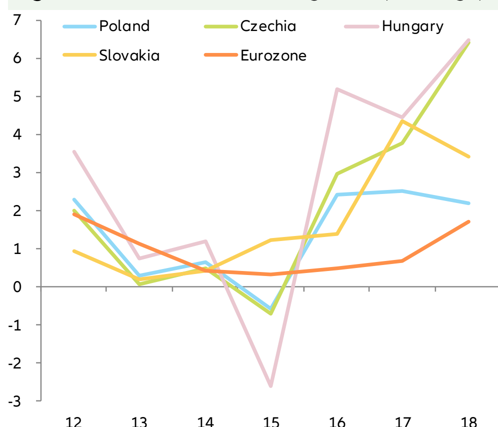
Sources: Bloomberg, Allianz Research

Figure 4 Quarterly number of corporate insolvencies



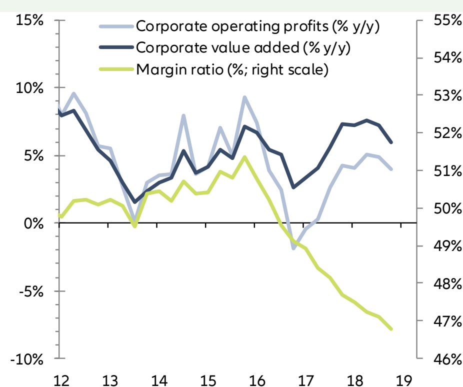
Sources: National statistics, Euler Hermes

Figure 5 Annual unit labor cost growth (% change)



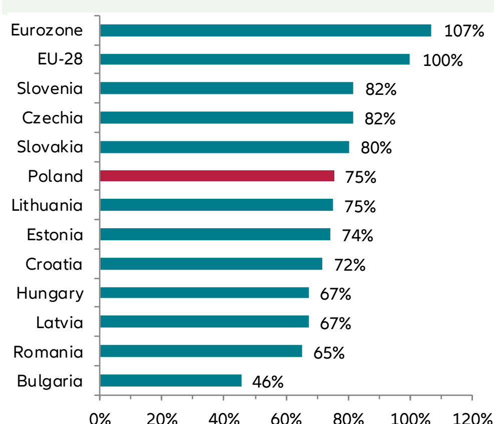
Sources: OECD, Allianz Research

Figure 6 Operating profits, value added and profit margins of NFC (moving 4 qtrs cumulated)



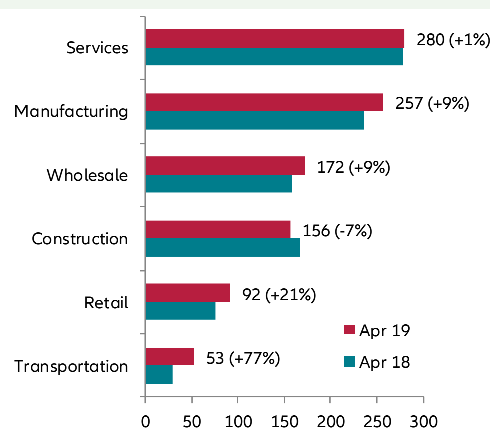
Sources: Eurostat, Allianz Research

Figure 7 Labor productivity per person employed



Sources: Eurostat, Allianz Research

Figure 8 Corporate insolvencies in key sectors (12-month sum, y/y change)



Sources: National statistics, Euler Hermes

Second is the earlier mentioned rapid nominal wage growth that has exceeded productivity growth. This is reflected in a firm increase in unit labor costs by an average annual +2.4% in 2016-2018, which was well above the Eurozone average, though lower than in the other Visegrad countries[1] (see Figure 5). But Polish firms have absorbed higher wage costs by accepting smaller profit margins rather than raising their prices (CPI inflation remained low). As a result, profit margins have dropped from a record high of 51.4% in Q4 2015 to a 10-year low of 47% at end-2018, despite improving operating profits in 2017-2018 (see Figure 6).

Third, outdated business models in some sectors are a further explanation, according to Euler Hermes analysis, resulting in an overall comparatively low level of productivity. Eurostat data show that labor productivity in Poland amounted to only 75% of the EU average in 2017, placing the economy behind Slovenia, Czechia and Slovakia amongst the Central European EU member countries (see Figure 7).

A look at insolvency figures in the six main sub-sectors of the Polish economy provides further insight (see Figure 8). It shows that services (280) and manufacturing (257) have recorded the most cases in the 12 months up to April 2019, followed by wholesale trade (172) and construction (156). Manufacturing has faced volatile and in trend rising energy costs over the past three years, while the rapid wage growth has had the strongest impact on services and construction, sectors in which labor accounts for the highest share in companies' cost structure. Meanwhile, retail trade (92) and transportation (53) have seen the least insolvency cases, however, they have posted the highest growth rates (21% and 77%, respectively). Traditional retailers are facing the typical pressures from online competition as elsewhere. Meanwhile, Polish transportation companies, which have dominated EU international road transportation for more than a decade, are currently faced with a number of challenges: (i) higher energy prices; (ii) increasing (price) competition from Romania, Lithuania, Hungary and Bulgaria; (iii) outdated business models (many small family businesses which do not want to consolidate) and (iv) lack of capital (despite rapid growth in the past, little capital was accumulated).

Based on data for the first four months of this year, we expect total corporate insolvencies to rise by another +10% in 2019 as a whole. This poses a particular risk to suppliers of Polish companies, which also face declining turnover and profit growth against the background of the slowing global economy.

[1] Poland, Czechia, Hungary and Slovakia

REMOVING STRUCTURAL WEAKNESSES WOULD IMPROVE LONG-TERM PROSPECTS

Our analysis suggests that Poland's best days in terms of strong economic performance are perhaps behind it. Several structural factors also pose considerable risks to the country's long-term growth potential, especially if the global economic and political environment remains challenging for longer.

First, although Poland's openness to trade, as measured by the ratio of exports to GDP, has increased over the past five years, its export-oriented businesses have remained largely involved in supply chains, i.e. they have not significantly climbed up the value added ladder. For example, the MIT Economic Complexity Index (ECI) shows that Poland's knowledge intensity of exports has increased by +6% from 2010 to 2017; nevertheless the country slid from rank 22 in 2010 to rank 23 in 2017 (out of 125 economies) and remained behind its regional peers Czechia (rank 9), Hungary (15) and Slovakia (16).

Second, policy choices over the past five years have led to a deterioration of the business environment in Poland. A range of measures implemented by the incumbent government since 2015 have impacted the independence and effectiveness of key state institutions, such as the constitutional court, public broad-casting, the civil service and the central bank. The EU has launched probes into some of these measures and threatened to cut funding flows in the future. Altogether this has altered the attractiveness of doing (new) business in and with Poland. This is well reflected in a number of international business climate surveys[2].

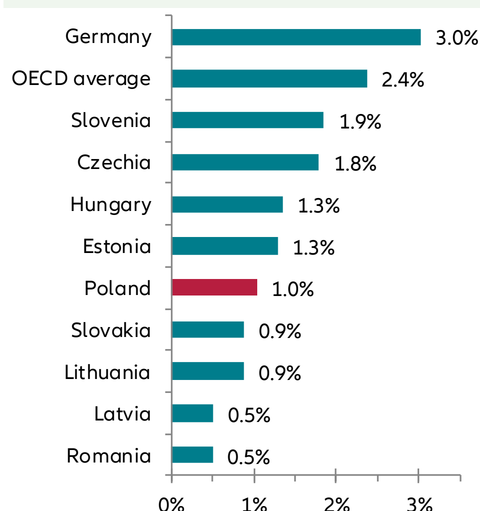
Nevertheless, there are opportunities for policy action that could improve the country's product and export quality, as well as its general attractiveness more substantially and thus enhance its medium-term growth perspectives.

1. Improve the business environment. Regardless of the election outcome in fall 2019, the next government should have room to maneuver to tackle the deterioration of the business and investment climate in recent years. Moreover, it should implement measures that reduce the length of legal procedures, improve the protection of investors and property rights and ease business registrations and credit availability for SMEs.
2. Boost innovation to reduce dependence on supply chains. In the Global Innovation Index 2018 survey of the WEF, Poland trails other EU member countries in Central and Eastern Europe (rank 39 out of 126 economies overall). Similarly, Poland is ranked 34th out of 115 countries in the Euler Hermes Enabling Digitalization Index 2018[3]. To climb up the value added ladder, investment in research and development (R&D) should be increased - it accounts for just 1% of GDP in Poland, which is well below the 1.8% recorded in Czechia and 1.9% in Slovenia, let alone the OECD average of 2.4% or the 3% share in Germany (see Figure 9). Another example for Poland's trailing position in terms of innovation is its share of researchers in the workforce. At 5.9 out of 1000 employees, Poland is only ranked sixth out of seven EU members in CEE for which these data are available (see Figure 10).

[2] Poland has slid down from rank 25 in 2016 to rank 33 in 2019 out of 190 economies in the World Bank's annual Doing Business survey. The country also deteriorated in the World Bank Institute's annual *Worldwide Governance Indicators* survey, the Fraser Institute's annual *Economic Freedom of the World* report and The Heritage Foundation's annual *Index of Economic Freedom* survey.

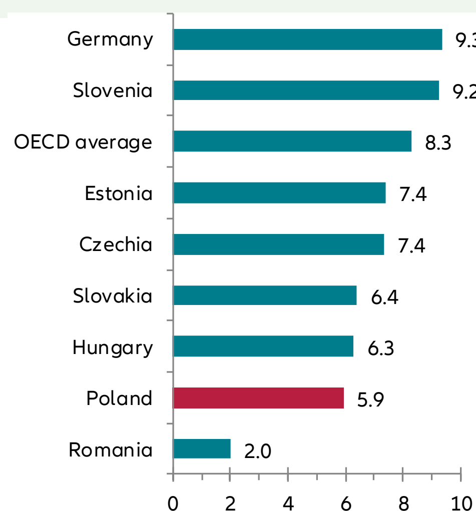
[3] The Euler Hermes Enabling Digitalization Index measures the ability – and agility – of countries to help digital companies thrive and traditional business harness the digital dividend. Based on five components – regulation, knowledge, connectivity, infrastructure and size – the index is a score between 0=worst and 100=best.

Figure 9 R&D investment in % of GDP



Sources: OECD, Allianz Research

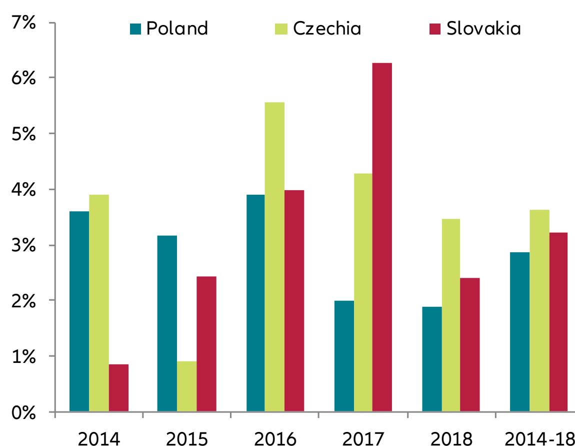
Figure 10 Share of researchers in the workforce



Sources: OECD, Allianz Research

3. Support the recovery of FDI inflows. Foreign direct investment (FDI) inflows into Poland have considerably declined in the past two years. They amounted to about 2% of GDP in 2017-2018 which was down from an average 3.6% in the previous three years. Since 2016, FDI inflows in relation to GDP has also been markedly lower than in neighboring Czechia and Slovakia, indicating that Poland has become less attractive for foreign investors (see Figure 11). The more interventionist economic policy stance since 2015, as well as a gradual deterioration of the business environment, are likely to have discouraged some foreign investors from channeling money into Poland. Improving the investment climate for foreigners to recover FDI inflows would be beneficial for long-term growth.

Figure 11 FDI inflows in % of GDP



Sources: National Statistics, Allianz Research

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