INTRODUCTION

On April 10, 2010, a plane crash in Western Russia tragically took the life of Poland’s president, his wife, and a Polish Central Bank governor. A number of other members of Poland’s political and military establishments perished as well. Such a blow at the heart of a country’s leadership should produce uncertainty, an uncertainty that would be reflected in Poland’s currency and sovereign government bond market. While the markets experienced a brief negative reaction, they quickly settled back into patterns reflective of their underlying fundamentals. Why? Poland’s institutional framework remains on sound footing. In accordance with its constitution, the Speaker of the lower house assumed the role of acting President and presidential elections will be scheduled, perhaps, as soon as June. What this tragic event demonstrates is that Poland has created a political and economic foundation that will support its continued movement toward economic liberalization. Poland started down this path two decades ago and the success of that journey allowed its economy to experience strong economic growth and to weather the recent economic storm better than many countries, developed and developing alike.

WHAT MAKES POLAND DIFFERENT?

Back in 1990, Poland started to move away from a centrally-planned economy to one driven by market forces. The government enacted policies that would prevent the Polish economy from experiencing the kind of economic imbalances that afflicted other countries during the recent global recession. As a result of these policies, Poland achieved European Union (“EU”) membership in 2004 and was on the road to adopting the Euro as its currency by 2012. That was before the 2008 global economic recession hit. No country seemed to escape an economic downturn. That is, all countries except Poland.

What attributes did Poland possess that permitted this feat of legerdemain? The International Monetary Fund observed that Poland was the only EU country to avoid recession. While the Euro area economies contracted 4% in 2009 in real terms, the Polish economy managed to eke out positive real growth of 1.7%. During the last quarter of 2009, Poland grew 3.1%, real, while the Czech Republic contracted 3.1%, as an example. Furthermore, Poland was able to maintain access to the credit markets.

Market participants have recognized this superior economic performance in a bleak global economic environment. The Polish equity market has risen some 8% thus far in 2010, while the Euro area stock market (FTSE Euro 100 Index) declined nearly 5.9%, each in US dollar terms. Bond investors concurred with their equity counterparts as the yield on 20-year Polish government bonds fell from around 6.5% at the end of May 2009 to 5.9% most recently. On the other hand, Greek bond yields, as an example, have moved from about 5% to a recent level of 7.2% over the same time period. In fact, the Polish 10-year bond, owned in our Portfolios, produced a total return of 38% during the one-year period ending in March 2010, including currency translation. (We have owned Polish bonds since January 2004 and maintain a positive view of the country’s longer-term prospects).
Nowhere is the distinction clearer than in the cost of insuring Polish bonds against defaulting. The chart below (see Figure 1) depicts a sizeable decline in the credit default swap ("CDS") for Polish debt. The cost of insuring Polish debt has dropped substantially. The current spread for Poland is just over 100, compared to a Western Europe average of 114. Market participants have confidence that the likelihood of a Polish default is decreasing.

**Figure 1** Poland's 5-Year Credit Default Swap (Basis Points)

---

**WHAT FACTORS MIGHT BE DRIVING INVESTORS TO POLAND?**

1. **POLAND ESCAPED THE RECESSION BECAUSE OF ITS GREATER RELIANCE ON DOMESTIC DEMAND, RATHER THAN TRADE.** The Polish economy is more exposed to domestic demand and compared to many economies it has less exposure to trade. It has benefited from a period of rising real income and falling unemployment. As a result, when 70% of its economy continued to grow, Poland avoided the pitfalls of a global contraction in trade that plagued economies more dependent on trade. In fact, its current account deficit actually improved to 1.7% of Gross Domestic Product ("GDP") in 2009, compared to a deficit of 5% of GDP in 2008. As a result of successfully tackling the global downturn, forecasters now think Poland could grow close to 3% in 2010 and over 3% in 2011.

2. **POLAND DID NOT ENTER THE GLOBAL DOWNTURN EXHIBITING ECONOMIC EXCESSES THAT MIGHT HAVE BLUNTED ITS COUNTERCYCLICAL POLICY TOOLS.** As noted, its current account deficit remains relatively low and back in 2007 its budget deficit, at 2% of GDP, was lower than the Maastricht criteria. However, slower economic growth has put some pressure on that public deficit, as automatic fiscal stabilizers kicked in and the country enacted policies to combat the downturn, totaling some 0.7% of GDP. The lack of excesses permitted the Polish government to appropriately stimulate its economy during the global recession.

3. **THE MARCH DOWN THE PATH OF ECONOMIC LIBERALIZATION WAS AIDED BY A CENTRAL BANK SET ON REINING IN INFLATION AND DOGGEDLY PURSUING (AND HITTING) ITS INFLATION TARGET, HELPING TO ANCHOR THE ECONOMY’S INFLATION EXPECTATIONS.** This focus on inflation targeting gained the central bank immense credibility and the support of market participants. As a result during the credit crisis, the central bank engineered a reduction in interest rates from 6% to 3.5% currently.

4. **POLAND’S CURRENCY, THE ZLOTY, IS FREE FLOATING, ITS VALUE DETERMINED BY THE MARKET** As a result the zloty can adjust helping to ameliorate a negative economic environment and improve its global competitiveness. A freely flexible currency was an important factor for Poland during this crisis, in sharp contrast to its Euro-bound neighbors. The chart on the next page (see Figure 2) shows the path of the zloty.
(and its fair value as measured by Purchasing Power Parity) during the recent global economic strain. From its peak in July 2008 to its February 2009 trough the zloty tumbled 48%, while the Euro fell around 21%. Other things being equal such an exchange rate adjustment can potentially produce a sizeable pricing adjustment to Polish firms that export. The zloty is no longer very cheap as measured by Purchasing Power Parity (“PPP”), but it has gotten substantially cheaper compared to early 2008 levels. The independence of the central bank has also provided some support for the currency.

**Figure 2** Polish Zloty (USD Per PLN)

5. **POLAND HAD ACCESS TO OTHER EXTERNAL SOURCES OF FUNDING THAT COULD TAKE SOME PRESSURE OFF ITS FISCAL POLICY.** Not only did Poland’s banks remain well-capitalized (partly a by-product of foreign ownership) but it continued to obtain access to the credit markets. Poland has access to external sources of funding that take some pressure off fiscal policy. Poland has been the recipient of funds under the EU’s so-called Cohesion Policy. Such funding is provided to help countries alleviate regional growth disparities and to help countries improve their transportation infrastructure. It also includes support under the Common Agricultural Policy (“CAP”). Under this program the EU directs funds to countries like Poland. The Organization for Economic Cooperation and Development (“OECD”) estimates that in 2009 these cohesion funds will total 3.3% of GDP. Additionally, Poland was the second participant, following Mexico, in the International Monetary Fund’s Flexible Line of Credit (“FLC”) program. That line of credit totaled $20.5 billion. The line of credit recognizes the policies enacted earlier by the Polish government and provides Poland with a stop gap in the event, for example, that access to the capital markets becomes encumbered. It is purely precautionary in nature, acting as a backstop if needed.

**CONCLUSIONS**

The aftermath of the tragic plane crash has reaffirmed our view that Poland has a healthy, stable economy. Its infrastructure can respond to a potential crisis, political or economic. Its policies have created an economy ready to compete in the 21st Century and beyond. That is not lost on investors. Its recent economic performance owes much to the pursuit of economic liberalization begun 20 years ago. Challenges lie ahead for Poland. Like other countries, Poland’s next challenge will be a gradual withdrawal of fiscal and monetary stimulus necessitated by the downturn. Further the OECD notes that Poland will also have to pursue structural reforms in

As of 4/23/2010
its fiscal policies. Among the suggestions cited: reforming the pension system and broadening the tax base. Nevertheless, if past is prologue, Poland will build on those past economic successes. Investors concur.

1 Data has been obtained by and used with permission of Thomson Datastream, which Brandywine Global believes to be accurate and reliable.

The views expressed herein represent the opinions of Brandywine Global, and are not intended as a forecast or guarantee of future results. This material may not be reproduced or used in any form or medium without express written permission. This information should not be considered a solicitation or an offer to provide any Brandywine Global service in any jurisdiction where it would be unlawful to do so under the laws of that jurisdiction. It should not be assumed that investment in the regions or currencies listed will prove profitable, or that investment decisions we make in the future will be profitable. Fixed income instruments are subject to credit risk and investment rate risk. International securities and ADRs may be subject to market/currency fluctuations, investment risks, and other risks involving foreign economic, political, monetary, taxation, auditing and/or legal factors. There may be additional risks associated with international investments. International investing may not be suitable for everyone. Indices are unmanaged and not available for direct investment. Past performance is no guarantee of future results.

© 2010 Brandywine Global Investment Management, LLC. All rights reserved.