Morgan Stanley
INVESTMENT MANAGEMENT

Poland's Quiet Convergence

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Thirty-five years ago, following the formation of Poland's first noncommunist government post-World War II, Lawrence Eagleburger, then deputy U.S. secretary of state, sent a note to the American ambassador in Warsaw. He encouraged efforts to ensure economic prosperity in Poland, "full employment, low inflation, high productivity and a Mercedes (or equivalent) in every garage." Though the memo ended on a humorous note, it also foreshadowed the Poland that was to emerge 30 years later.

Generating prosperity after years of central planning required shock therapy. The government's Balcerowicz plan (named after Polish Finance Minister Leszek Balcerowicz) attempted to revamp the economy by introducing wholesale free market reforms. When the Iron Curtain came down in 1989, Poland teetered on the verge of bankruptcy, burdened by inefficient agriculture, outdated infrastructure and a high level of sovereign debt. Yet, defying expectations, the economy flourished after the government took bold actions to implement extensive supply-side reforms, privatize state-owned enterprises and rebuild its institutions, including a free press, democratic accountability and the rule of law. Poland's strong education system continued to produce high-quality graduates, especially in mathematics and science. All were critical building blocks for an economy that would rely on innovation, entrepreneurship and hard work, rather than global commodity prices or financial engineering.

Poland experienced a significant economic boost when it joined the European Union (EU) in 2004, gaining full access to the common market and benefiting from EU development funds to overhaul its aging infrastructure. Since the fall of communism, Poland has seen its gross domestic product (GDP) increase more than tenfold. Today, with an $840 billion economy, Poland is on the cusp of becoming a trillion-dollar economy. Over the last two decades, Poland's GDP per capita has almost quadrupled, achieving a compound annual growth rate (CAGR) of 7%, outperforming all the top 15 emerging markets except China and India *(Display 1)*.

Despite these improvements, last year presented challenges. Private consumption was impacted by the inflationary shocks and fall in confidence following Russia's invasion of Ukraine, leading the economy into a technical recession during the first two quarters of 2023. Inflation has declined following a peak of 18% in February 2023 to less than 4%, benefiting from lower commodity prices and a tighter monetary policy. The outlook has stabilized, and with wage growth outpacing inflation, consumption should return to solid growth in 2024.

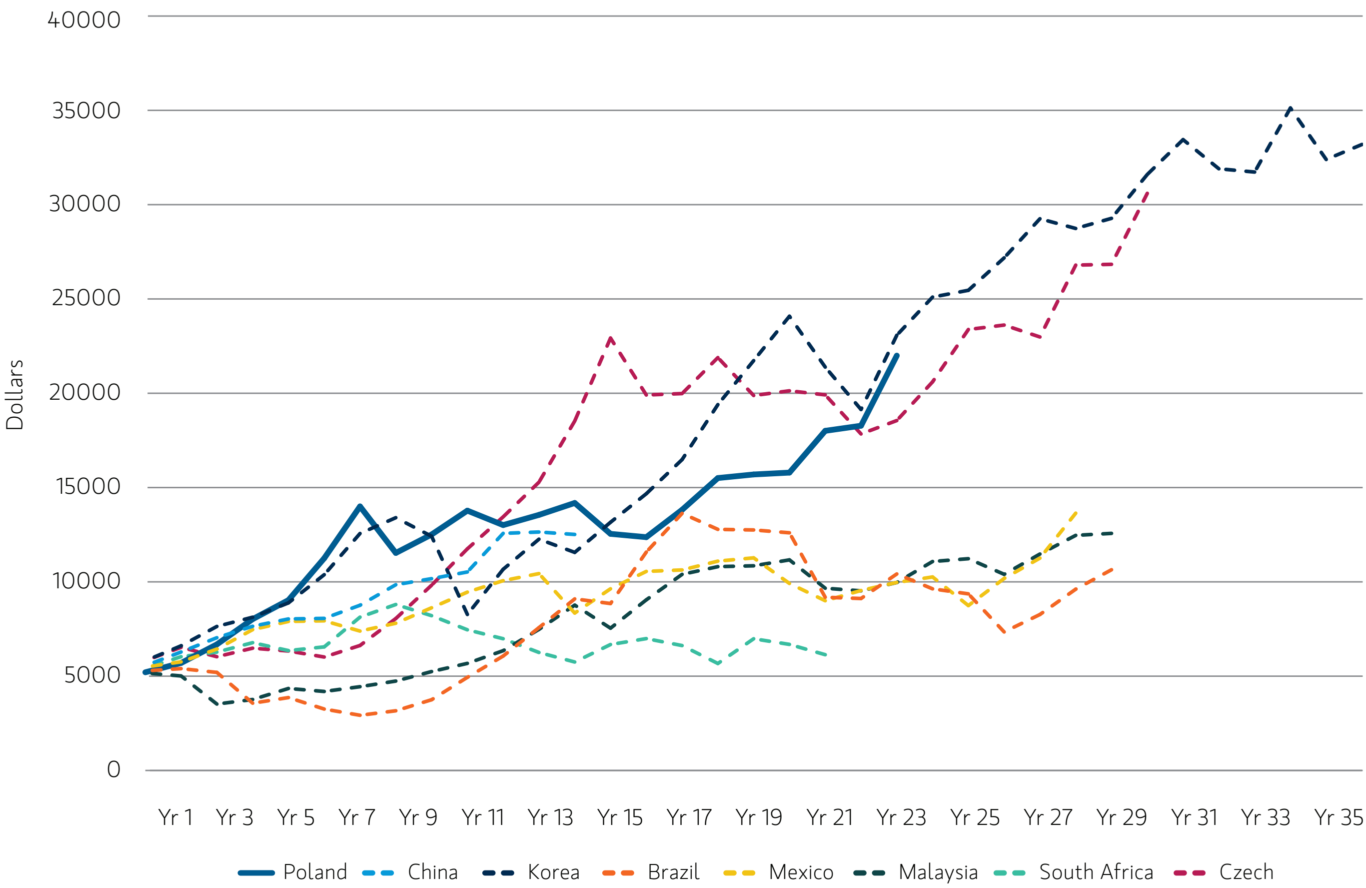
The political news is also positive. Last October, voters turned out in record numbers to eject the ruling populist-nationalist Law and Justice party (PiS) that had run the country for the past eight years. Donald Tusk, a former prime minister who spent four years as president of the European Commission, now heads a coalition of centrist parties. One of Tusk's key tasks will be to mend strained relations with the EU and unlock more than 137 billion euros in funds that had been frozen after PiS tried to limit judicial independence.

The highly divisive political climate under PiS hurt businesses, but since the election, consumer confidence has improved markedly. The new government remains firmly committed to the EU and North Atlantic Treaty Organization (NATO). Poland's competitive labor force, strong institutions and a macroeconomic landscape with no major imbalances should continue to attract foreign investors. The country is now a crucial manufacturing hub for western companies - with 28% of exports heading to Germany - benefiting from a network of supply firms, attractive tax rates and modernized infrastructure. It has also emerged as a key player in "ally-shoring" strategies *(Display 2)*.

The macro picture also looks healthy. We expect the government's fiscal deficit to hover around 5% of GDP this year after hitting a similar level in 2023. Military spending will increase sharply in the next few years, with the military's modernization plan rising to 4% of GDP this year, a record among EU countries. Overall, the economic, political and earnings picture looks rosy, yet investors

DISPLAY 1

GDP per Capita (Once It Crosses $5K)



Source: World Bank

have overlooked the country's progress, with Poland constituting less than 1% of the MSCI EM Index.

A few challenges remain, particularly in productivity and fiscal management. According to the World Bank, an average industrial firm in Poland needs three times more staff than a firm in Germany to produce the same product. The average Polish worker is generating around $30 of GDP per hour worked, almost half of the output of an average German employee.

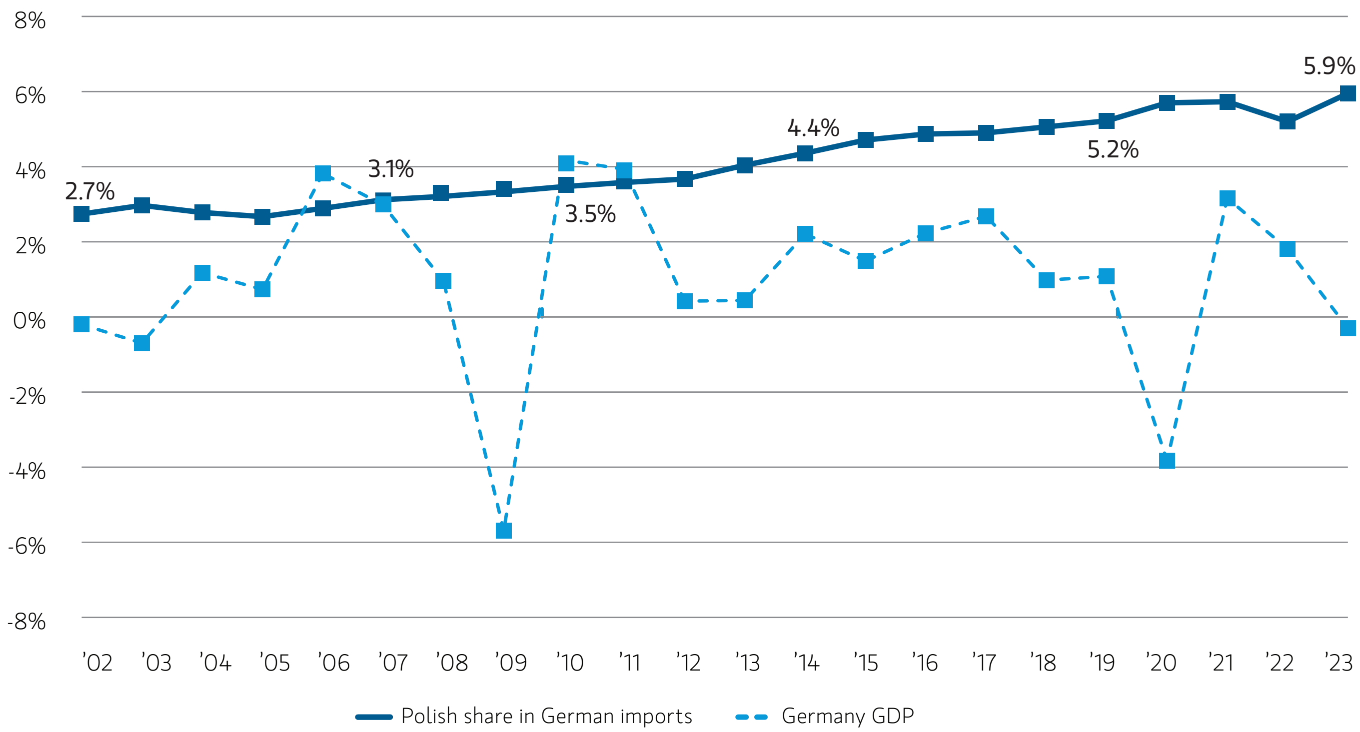
In time, productivity should improve. A thriving equity culture and deep capital markets allow Polish entrepreneurs to raise capital at home. Poland has more than 450 listed companies, on par with Brazil, and many more than Mexico. Foreign direct investment (FDI) is still strong at 3% of GDP, and the country will continue to be an attractive destination for future investments. Poland's geographical location, historically a liability, is now a positive. Given political, economic and financial linkages to Europe, and longer-term opportunities from rebuilding war-torn Ukraine once the fighting stops.

What about Eagleburger's aspirations for a Mercedes in every Polish garage? Car ownership in Poland has tripled since 1989, bringing the country in line with France or Germany. With so much going for it, we think investors are well advised to look at one of the most successful economies to emerge from the former Soviet bloc.

DISPLAY 2

Slow But Steady Climb

Polish Share of German Imports



Source: Germany Federal Statistical Office, Bloomberg. Period to 12/31/2023.

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DEFINITIONS

Compound Annual Growth Rate (CAGR) is the year-over-year growth rate of an investment over a specified period. **Gross Domestic Product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. It includes all private and public consumption, government outlays, investments and net exports.

INDEX DEFINITIONS

The **MSCI Emerging Markets Index (EM)** is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets.

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