

Investing in Poland: Untapped Potential

The Experience of German Investors



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Foreword



Marcin Diakonowicz

Partner, Audit & Assurance, Leader of the German Desk in Poland and Central Europe, Deloitte

During the 27 years that followed Poland's political transformation, the country has been busy catching up with developed economies in Western Europe, both economically and socially. The task was by no means easy. One reason why Poland is now stable and prosperous is the economic relations it built with Germany, the world's fourth-largest economy

Foreign investments are an important factor in stimulating economic growth and have had a definitive impact on the development of a market economy in Poland. German companies were quick to realise the potential of their eastern neighbour. Although they felt uncertainty surrounding Poland's new economic environment, German companies did not hesitate to move in soon after Poland opened its doors to foreign investments. As of 2015, German companies have invested 135.9 billion zlotys into the Polish economy, constituting 1/5 of all foreign direct investment in the country.

Our western neighbours appreciate Polish workers' high qualifications, productivity and motivation. Moreover, they welcome the improvements that have been made to the country's infrastructure, boosting the investment attractiveness of various regions. German investors also emphasise that Poland's membership in the European Union has made its economy exceptionally resilient to shocks, and its regulatory environment remains stable.

This report provides an analysis of the reasons why Poland, even after a period of rapid economic growth, continues to display advantages that provide opportunities for successful and profitable direct investments.

Michael Kern

Managing Director, Member of the Board, AHK Poland

Summary

The Polish economy has grown consistently since 1991, an achievement that sets it apart from all other EU member states. Moreover, the growth is dynamic: per capita GDP growth (at purchasing power parity) over the last 20 years has averaged 6% per year. This is the best result in Central Europe, and therefore investors often consider it a good reason to branch out into Poland.

The rapid and steady growth of the Polish economy is based on investments and capital. From 2010-2015, the contribution of foreign investments and capital to Poland's GDP was considerably higher than in other Central European countries, excluding Bulgaria. That said, Poland grew at a rate that was two times faster than Bulgaria.

According to numerous indices that measure competitiveness and social progress, Poland is second only to the Czech Republic. That is because the Czech economy is, for the most part, mature and industrialised. The Czech Republic has the lowest investment risk in the region, but potential investors have to keep in mind that Poland's GDP growth is twice as fast (3% compared to 1.5% in 2010-2015).

Even though the Polish economy has grown rapidly over the last 25 years, its potential is far from depleted. This is evidenced by Poland's considerably lower productivity compared with other, more developed EU countries, and its still low capital stock. Poland has managed to double the amount of capital per worker in the last 20 years,

which allowed it to overtake Slovakia and Hungary. Nevertheless, the traditionally industrial economy of the Czech Republic continues to have almost two times as much capital stock.

The relatively low value of production capital in Poland ensures high rates of return on investment. Marginal capital productivity in Poland is almost four times higher than in the Eurozone (the 2006-2016 average), and higher than in Slovakia, the Czech Republic and Hungary.

Manufacturing, which has received approximately 230 billion zlotys of Foreign Direct Investment (FDI), i.e. 1/3 of the total capital invested in Poland, is one of the most attractive sectors for investment. The business services (BPO/SSC) sector, which continues to grow by 20% year-on-year and is predicted to employ 300,000 workers by 2020, is gaining in importance.

Germany is the biggest source of FDI in Poland. As of 2015, German companies had invested 135.9 billion zlotys, or almost 1/5 of all FDI. German investors continue to think highly of Poland's

membership in the EU as it translates into a stable, high-quality regulatory environment. Other factors that encourage German companies to invest in Poland include employee qualifications, productivity and motivation, as well as the high quality and availability of local suppliers.

STEADILY GROWING ECONOMY

- Constant GDP growth since 1991 – unmatched by any other EU country
- Fastest per capita GDP growth in Central Europe, 1995-2016
- The most stable economy in Central Europe

1

POLAND'S COMPETITIVE ADVANTAGES

- Beneficial ratio of worker productivity to employment costs
- Exceptional quality of education, especially in science, technology and IT
- Large percentage of the population speaks English or German

3

FOREIGN DIRECT INVESTMENT IN NUMBERS

- Total value of FDI is 712 billion zlotys, equal to 45% of Poland's GDP
- Almost 230 billion zlotys of FDI went into manufacturing
- Germany is the leading investor in Poland: German companies have invested almost 136 billion zlotys

5





UNTAPPED GROWTH POTENTIAL

- Production capital per worker is just 1/4-1/3 that of highly developed countries
- Low professional activity: 40% of Polish women do not work professionally and are not seeking jobs
- Big potential for improving the quality of regulations and developing alternative sources of financing, e.g. PPP

2

POLAND IN THE EYES OF FOREIGN INVESTORS

- Industrious people with strong work habits
- High worker mobility and flexibility
- Good infrastructure that is constantly being improved

4

MOST ATTRACTIVE SECTORS FOR INVESTMENT

- Manufacturing
- Business services (BPO/SSC), IT and telecommunications
- Real estate

6

DYNAMICS AND CONSISTENCY OF THE ECONOMY

GDP GROWTH RATE
GDP per capita growth at PPP,
1995-2016, CAGR



GDP GROWTH STABILITY
Standard deviation of the GDP
growth rate



QUALITY OF THE INVESTING ENVIRONMENT

COMPETITIVENESS OF THE ECONOMY
Global Competitiveness Index
2016/2017 (rank among 138
countries)



SOCIAL PROGRESS
Social Progress Index 2016
(rank among 130 countries)



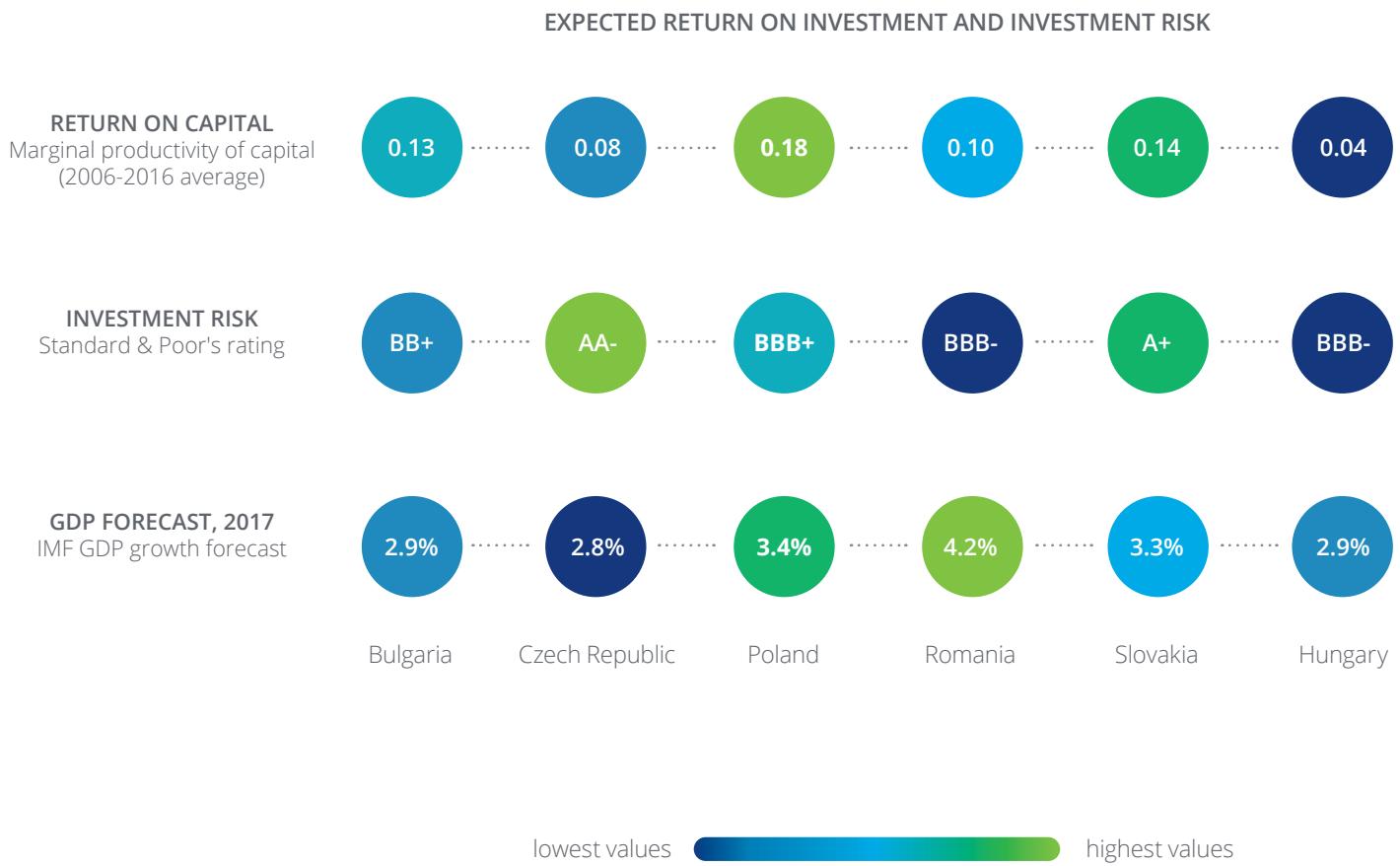
ROLE OF CAPITAL IN THE GROWTH PROCESS

THE IMPORTANCE OF CAPITAL
Contribution of capital to GDP
growth, 1995-2015 average
(percentage points)



CAPITAL STOCK
Net capital per worker
(in thousands of Euros)





Why should you invest in Poland?

The last time Poland went through a recession was in 1991: GDP suffered a 7% year-on-year drop.¹ Since then, the Polish economy has grown continuously, marking one of the longest periods of uninterrupted economic growth around the world in the last few decades.

Australia is the only other OECD country that has had a similar period of continuous GDP growth.² The fact that Poland was the only EU country to avoid the 2009 recession has become common knowledge (the economy grew by 1.7% in that year). Currently, Poland is the 7th biggest economy in the EU (excluding the UK) and ranks 24th in the world.³

The analysis of investment attractiveness presented in this chapter was carried out using a top-down method. It begins with a historical and macroeconomic overview, which serves as the starting point for a deeper look into the breakdown of Poland's GDP growth, the foundations that made this growth possible and an analysis of the conditions for increasing capital stock.

The goals of this chapter are to:

- present a summary of Poland's economic growth over the last 25 years and outline the key factors that made this success possible,
- analyse the GDP growth breakdown in Central European countries with a particular focus on capital expenditures, providing in-depth information about the 2010-2015 period, which was very challenging for investors,
- compare the most important indices of competitiveness, institutional quality and social progress,
- outline the profile of foreign direct investment in Central Europe,
- analyse the capital stock, capital expenditure productivity and expected investment risk on the macroeconomic level.





The Polish economy: 25 years of growth and stability

In 1989, Poland was among Europe's poorest countries, and no one was predicting it would be able to catch up to the affluent EU-15 countries as fast as it did.

Economic growth is never an automatic process, but rather the result of a number of factors, including capital accumulation, improved productivity and human capital development, which

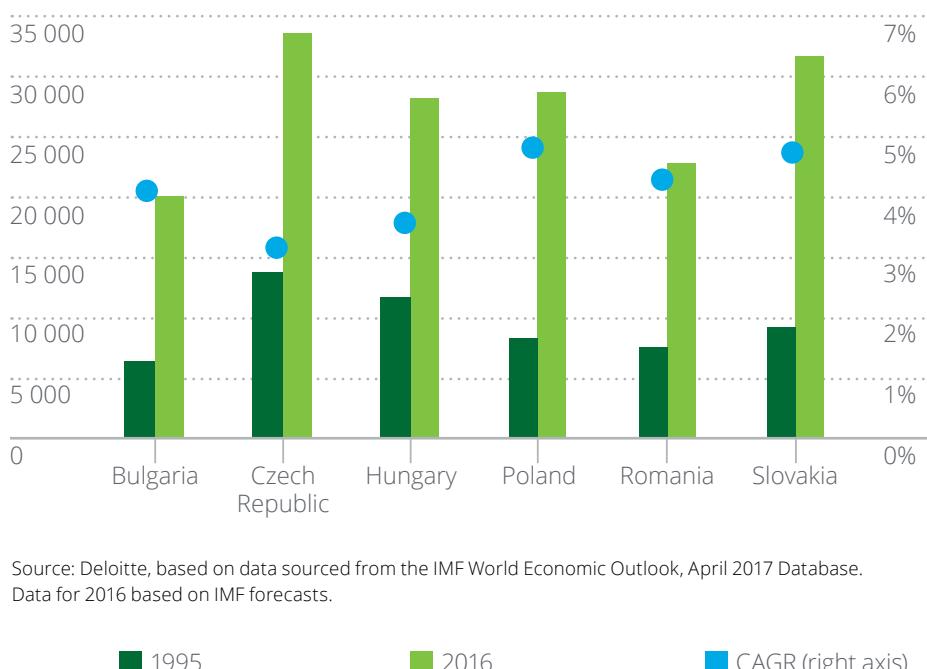
result from millions of decisions made by individual companies, consumers and officials.⁴

"Poland has made great strides in the last 25 years. Poles must have some kind of special, innovative spirit, which has allowed them to achieve this in such a short period of time. Poland has a lot to gain in the near future thanks to Polish society's approach to new technology."

Poles embrace new inventions and actively seek them out. The spirit of innovation is evident in the growing number of Polish tech start-ups, which may contribute to the growth of the country's economy in the coming years."

**Barbara Jacob, CEO,
Komsa Polska**

**Per capita GDP growth at purchasing power parity in 1995 and 2016;
CAGR 1995-2016**



Source: Deloitte, based on data sourced from the IMF World Economic Outlook, April 2017 Database.
Data for 2016 based on IMF forecasts.

It is difficult to provide a thorough analysis of Poland's economic performance during the first few years following the political transformation, due to a lack of reliable data.⁵ An analysis of the 1995-2016 period leads us to conclude that Poland achieved the region's highest

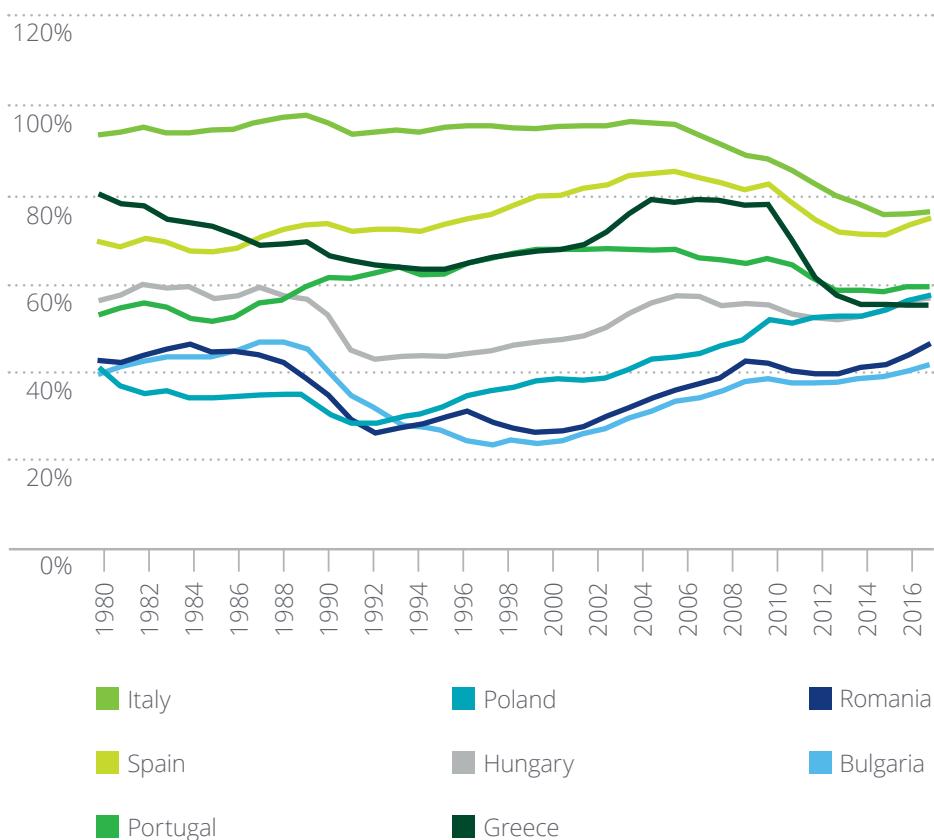
per capita GDP growth rate at purchasing power parity (CAGR⁶ of 6.0%), followed by Slovakia (5.8%), Bulgaria and Romania (5.4% and 5.3% respectively). Hungary and the Czech Republic grew at a considerably slower pace (4.4% and 4.2% respectively).

Fast GDP growth allowed Central European countries to continue closing the development gap for a number of years without any major setbacks.

The end of that prosperous period was brought on by the financial crisis of 2007, which slowed down the convergence process. It took eight years for these economies to pick up steam again in 2015-2016, which was especially evident

in Poland, Hungary and Romania. As a result of these processes, in terms of GDP per capita at PPP the Visegrad Group countries have practically caught up with Greece and Portugal, which since entering the Eurozone have not only failed to close the gap with Germany, but managed to fall even further behind.

Per capita GDP in purchasing power standard, Germany = 100%

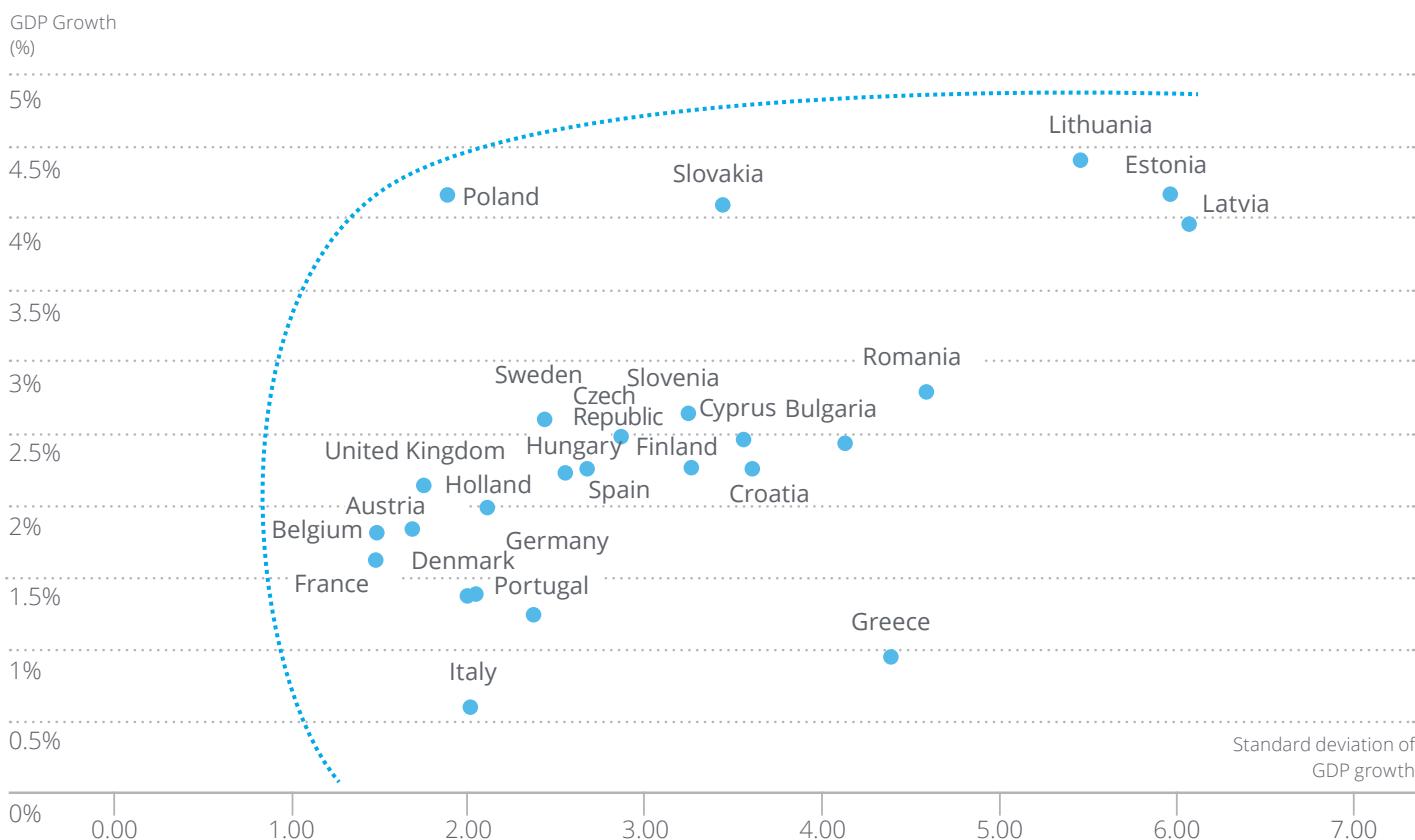


Source: Deloitte, based on data sourced from the IMF World Economic Outlook, April 2017 Database. Data for 2016 based on IMF forecasts.

According to the EBRD Transition Report 2016-2017, Poland's so-called real economy and financial markets are highly resilient to negative external shocks.⁷ **The rapid growth and resilience of the Polish economy are usually attributed to its big internal**

market. However, the importance of this factor is often exaggerated, especially when explaining long-term growth.⁸ The high quality and stability of Poland's institutions and economic policy, which are the basic prerequisites for rapid

Average GDP growth and standard deviation, 1995-2015



Source: Deloitte, based on data sourced from the IMF World Economic Outlook, April 2017 Database.

and balanced GDP growth, have formed the foundation for the country's sustained development.

This conclusion may be drawn on the basis of the extensive literature on economic growth mechanisms, as well as simple observations.^{9,10} The integration of financial markets and capital ties have also contributed to increased stability.

Also, the quality of institutions and economic policy is a crucial factor as it lowers risk in the financial sector and prevents the accumulation of excessive debt.¹¹

"Based on my observations from the last few years, I have to say that Poland is one of the most stable EU countries. It also was the only country that did not go through a recession during the recent financial crisis, and managed to maintain positive GDP growth over that period. Plus, it is the biggest economy in the region. Therefore, I do not think that any other Central European country will be able to take Poland's place as the regional leader."

Peter Baudrexl
CEO, Siemens Group in Poland

Stable GDP growth benefits companies that are already present in the market, as well as potential investors. Let us once again emphasise the crucial role of institutions: **long-term stability may be seen as a proxy for the quality of economic policy and the efficiency of markets and the public sector.**

Two components of economic policy, i.e. fiscal policy (taxes and public expenditure) and **monetary policy**

(central bank interest rates and other instruments), are fundamental for maintaining stability.¹²

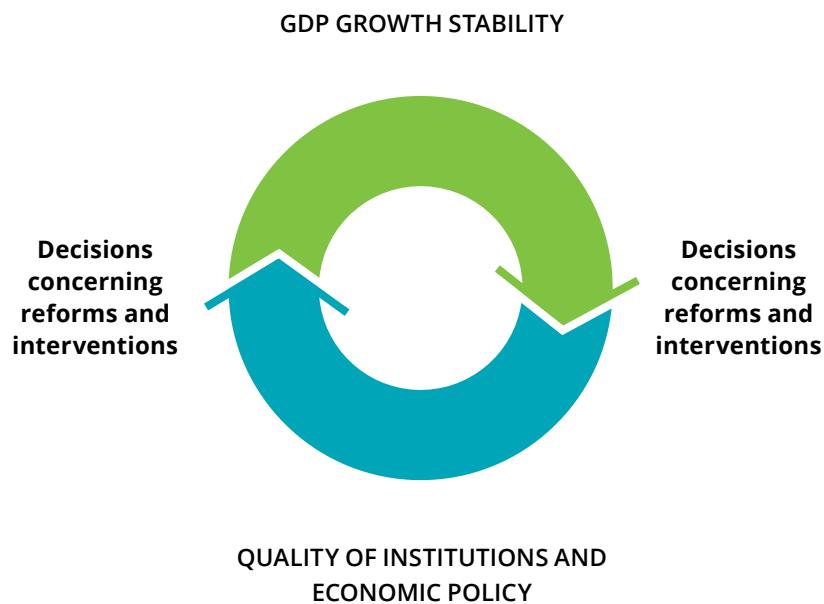
It is often said that Poland's conservative monetary policy and effective financial supervision were the key factors that shielded the country from the boom-bust cycle and the recession that followed in 2009.

According to economist Marcin Piątkowski, Poland's economic growth is based on entrepreneurship and hard work, not on natural resources or "financial steroids". Poland is a net importer of energy and the country's private and public debt levels are well below the EU average.¹³

"We were one of the first German companies to enter the Polish market. We had a total of 10 employees in 1990. Today, our company employs 276 people in our Stargard and Lubartów plants. Our printing plant is currently the world's biggest facility of this type. Based on my 25 years of experience here, I would say that Poland's biggest advantage is the approach that Poles have to doing business. "On the one hand, it is much more similar to the 'old' Europe than to, for example, Southern European countries. On the other hand, Polish businesses are much more resilient and flexible when dealing with crises and sudden shifts in the environment. The changes that took place in Poland in 1989 were so dramatic that the current shifts and crises, which cause panic in Western European markets, leave Poles unimpressed. I think that this is one of the most important factors contributing to the stability of Poland's economy."

Andreas Visser
Managing Director, SchoPa Buchbinderei Sp. z o. o.

The reciprocal relationship between GDP growth rate stability and quality of institutions and economic policy: long-term perspective



Source: Deloitte

Note that the relationship between GDP growth and the quality of economic policy and institutions is mutual. This is because very stable GDP growth lowers the risk of sudden and/or broad changes to fiscal and monetary policies. Consequently, tax hikes or discretionary reductions in public spending, i.e. spending cuts made on-the-go to lower the public finance deficit, are less likely to be introduced.¹⁴

Two processes have contributed to the growth and stability of the Polish economy after 1989:

- **The economic transformation strategy**, which was based on three pillars: macroeconomic stabilisation, macroeconomic liberalisation and institutional reform. The breadth of this reform and its prompt implementation were vital to its success.¹⁵
- **Poland's accession to the European Union**, which lowered the costs of movement of workers, capital, goods and services, and facilitated the reduction of political and regulatory risks (e.g. limiting the use of discriminatory practices in the EU single market).¹⁶



Breakdown of GDP growth in Central European countries

In recent years, Poland has become one of the fastest-growing EU economies and the fastest-growing economy in Central Europe. Between 1995 and 2015, Poland's GDP growth averaged 4.1%.¹⁷

In 2010-2015, the economy expanded at a slightly slower pace of 3%. Nevertheless, Poland still was the fastest-growing economy in Central Europe.

The economies of Central European countries are becoming more dependent on the global economy, and especially the EU economy, in which Germany is a major player. This is because Central European economies are becoming

more open and integrated into global value chains. The biggest benefits from trading with Germany are being reaped by the Visegrad Group (V4) countries, i.e. Poland, the Czech Republic, Hungary and Slovakia. They have used EU cohesion policy funds to improve infrastructure, focusing on Trans-European Networks, railroads and airports.

GDP growth in Poland: contribution of employment, capital and changes in productivity



Source: Deloitte, based on data sourced from The Conference Board Total Economy Database™ (Original version), November 2016.

Although international trade and capital flows are very important for the region, EBRD economists say the impact of national structural barriers is growing.¹⁸

This phenomenon and the effects of the worsening demographic downturn have already affected the composition of GDP growth in Poland and other Central European countries.

The GDP breakdown shows that Poland's post-2010 slowdown was caused mainly by slowing growth of total factor productivity (TFP). In 2010-2015, Poland's average annual TFP growth stood at 0.8%, while in 1995-2015 it had reached almost 1.7%. For comparison, average TFP growth stood at 1.7% in Slovakia and 1.9% in Romania in 2010-2015.

A TFP growth slowdown was observed in developed economies as well, but Poland, due to its relatively low

productivity, has bigger potential for TFP growth (through importing technology and know-how, improving the efficiency of markets, etc.).¹⁹ The reasons that are given for Poland's diminishing productivity growth include: limitations imposed on competition that result in the ineffective allocation of resources;²⁰ a disadvantageous industry structure; the low level of cluster development; and insufficient innovation capacity.²¹ The Responsible Development Strategy prepared by the current government, along with a number of experts, argues that the country's economic inefficiency is a result of the erroneous approach adopted following EU accession in 2004, i.e. decision-makers focused on absorbing EU funds instead of making efforts to allocate them efficiently.²²

The capital expenditure to GDP ratio paints a more favourable picture of Poland's economy. Despite the slower economic growth in the 2010-2015 period, the contribution of capital expenditure remained unchanged at 2.1%. Consequently, accumulation of capital has been the main factor behind Poland's GDP growth since 2012. Growing employment is another factor that had a positive impact on the Polish economy starting in 2014. However, the contribution of employment to GDP growth over the 2010-2015 period was only 0.1%.

GDP growth in Poland: contribution of employment, capital and total factor productivity (averages, 1995-2015 and 2010-2015)²³

Poland	1995-2015 Average	2010-2015 Average
GDP growth	4.1%	3.0%
Contribution of employment (percentage points)	0.3%	0.1%
Contribution of capital (percentage points)	2.1%	2.1%
Contribution of TFP (percentage points)	1.7%	0.8%

Source: Deloitte, based on data sourced from The Conference Board Total Economy Database™ (Original version), November 2016

The continuing high contribution of capital to Poland's GDP growth proves that investments are likely to generate high returns.

because Polish companies are highly competitive and take full advantage of the free movement of capital within the EU.

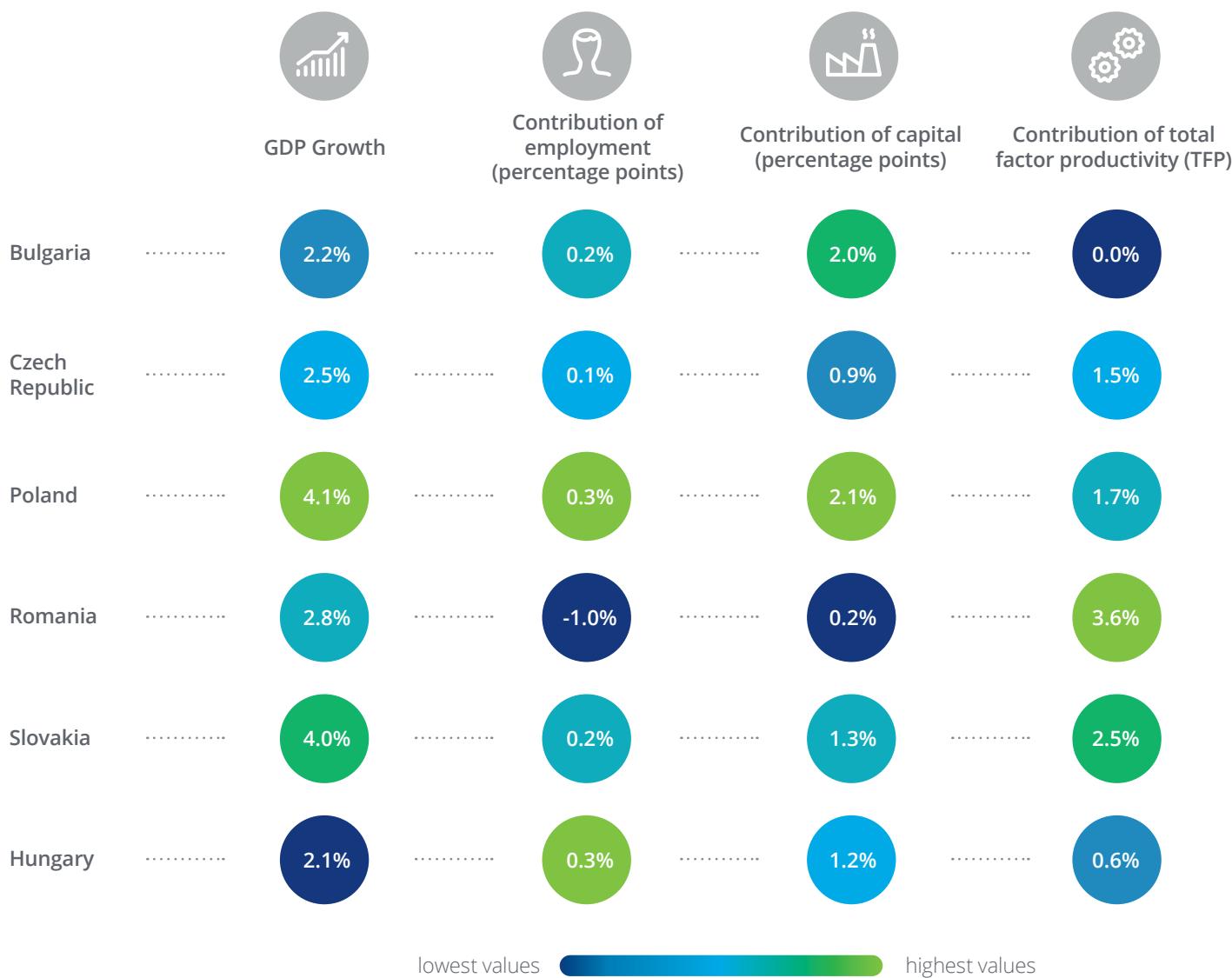
That is because there still is relatively little capital per worker in the economy,

Growth of GDP, employment and labour productivity in Poland (averages, 1995-2015 and 2010-2015)

Poland	1995-2015 Average	2010-2015 Average
GDP Growth (%)	4.1%	3.0%
Employment growth (%)	0.4%	0.2%
Labor productivity growth* (%)	3.8%	3.0%

*Productivity is defined as the relationship between GDP and total hours worked. Source: Deloitte, based on data sourced from The Conference Board Total Economy Database™ (Original version), November 2016.

GDP growth in Central European countries: contributions of employment, capital and changes in productivity, 1995-2015 averages



Source: Deloitte, based on data sourced from The Conference Board Total Economy Database™ (Original version), November 2016.

Bulgaria was the only Central European country that had a comparable contribution of capital to GDP growth over the last 20 years. However, due to stagnating TFP, the Balkan country's GDP growth rate was considerably slower. The GDP growth breakdown of Romania is also worth looking into as the ageing of society and high emigration (resulting in labour shortages) have led to the

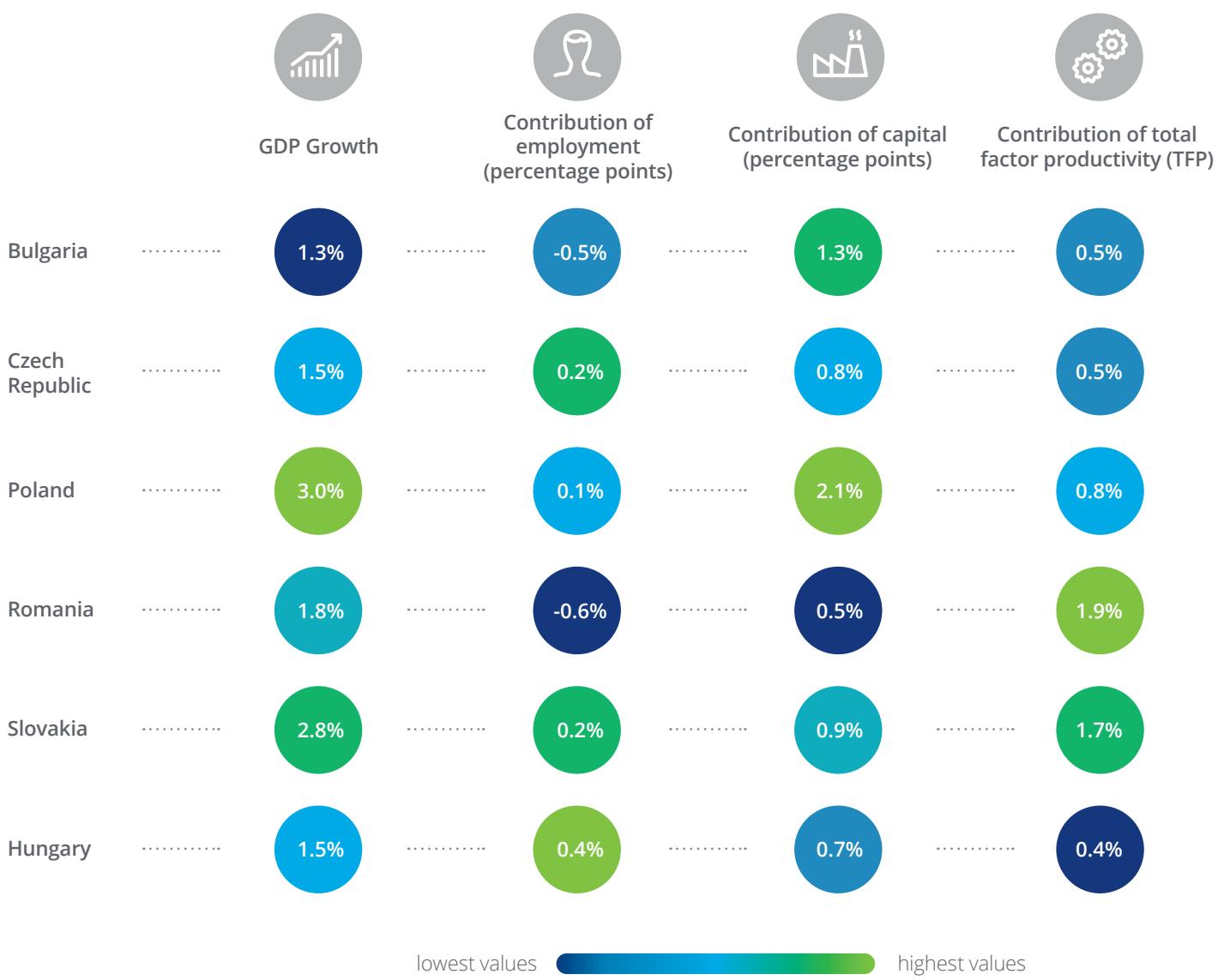
country's GDP growth rate dropping by approximately one percentage point each year. At the same time, Romania's average contribution of capital expenditure was the smallest among the six Central European countries (0.2 percentage points yearly), so the country's GDP growth was driven mostly by TFP growth.

In 2010-2015, a period marked by recurring crises and high uncertainty in the Eurozone, Poland retained a high

contribution of capital to GDP growth, i.e. 2.1 percentage points. Other Central European countries, Bulgaria excluded,

had no more than a 1 percentage point contribution.

GDP growth in Central European countries: contributions of employment, capital and changes in productivity, 2010-2015 averages



Source: Deloitte, based on data sourced from The Conference Board Total Economy Database™ (Original version), November 2016.

German investors emphasise the impact of EU funds on the Polish economy. The cohesion policy has allowed Poland to take advantage of the developed

economy of Germany, which provided funding for the construction of essential infrastructure projects. It should be noted, however, that other Central

European countries had access to a similar amount of EU funds per capita and in relation to GDP.

An analysis of the GDP breakdown of Central European countries leads us to conclude that:

- **There is vast potential to improve productivity in Central European economies, and that creates interesting opportunities for investment.** Poland and its neighbours offer high rates of return on investment, especially considering current conditions in the Eurozone and the ECB's monetary policy.
- **Poland was the country in the region least affected by the global financial crisis and the Eurozone debt crisis.** Meanwhile, Hungary faced a very real threat of a currency crisis and default. Due to the relatively

high stability of Poland's economy, the country's GDP growth was sustained mainly by capital expenditure. This holds true for both 2010-2015 and 1995-2015.

- **During the Eurozone crisis, Central European countries benefitted from the good condition of the German economy.** Increasing German exports, which translated into record-high trade surpluses, were instrumental in boosting demand for goods and services from the V4 countries.



Competitiveness of Central European countries and the inflow of FDI

Competitiveness

An economy's competitiveness may be understood as its ability to continuously improve the quality of life of its population, i.e. ensuring sustained development while taking into consideration economic, social and environmental factors. For the needs of our analysis, we may define the competitiveness of Central European countries as their ability to quickly and permanently close the development gap by taking advantage of internal and external resources. Competitiveness thus defined does not relate only to direct "carriers", such as products and services, but also to specific locations and institutional systems.

Due to globalisation and the complexity of economies, competitiveness is subject to constant changes. It is a variable that describes countries, institutional systems and markets.

Some components of competitiveness, such as institutions that are deeply rooted in society, are relatively impervious to changes in the environment, whereas others, such as economic policy, may undergo rapid shifts.

A fairly wide consensus has been reached in the ongoing public debate about Poland's competitiveness, which may be summed up as follows: the enormous growth reserves that were made available by the economic transformation are slowly being depleted. For wealth to grow further, productivity will need to be improved and more investment needs to be secured, especially if the consequences of the ageing of the population are to be counteracted.^{24 25} We should add that this approach was also presented in the Responsible Development Strategy (RDS), intended to serve as the roadmap for Poland's economic policy in the coming years.²⁶

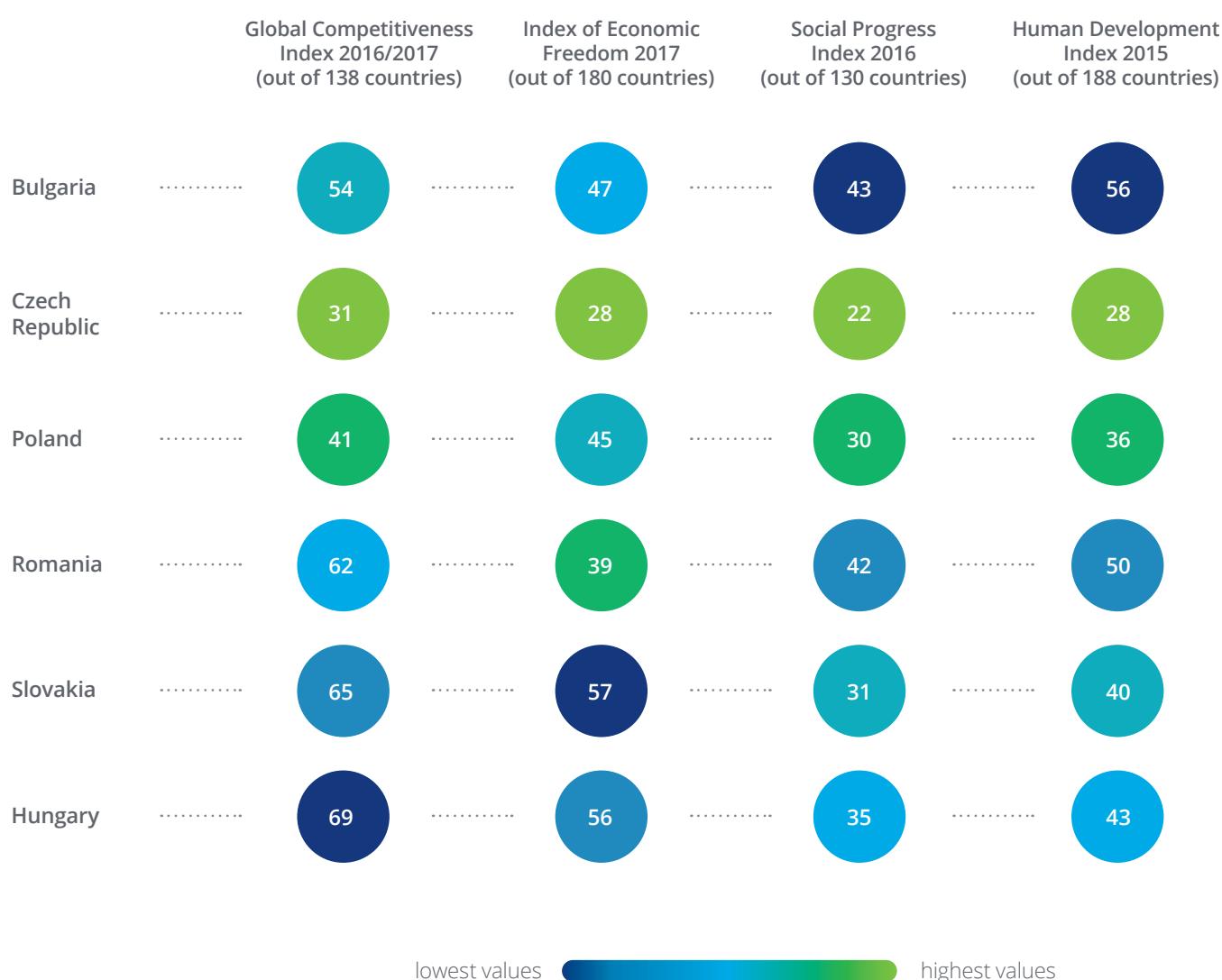
Competitiveness and social progress indices show vast differences among Central European countries.

The Czech Republic is the regional leader in competitiveness and social progress, placing first in the Global Competitiveness Index, Index of Economic Freedom, Social Progress Index and Human Development Index. Poland placed second in the region in three of these rankings. Romania took second place in the Index of Economic Freedom, pushing Poland into third place.

"I think that in the coming years we will continue to witness the growth of the Polish economy as it reaps the benefits of its proximity to and trade with Germany. I consider human capital to be one of Poland's most important advantages, especially due to the country's demographics and the high motivation of Polish workers."

Klaus Böde
Vice-President of the Executive Board, Hochtief Polska S.A.

Rankings of Central European countries in competitiveness, economic freedom and social progress indices



Source: Deloitte, based on data source from Global Competitiveness Index 2016/2017, Index of Economic Freedom 2017, Social Progress Index 2016 and Human Development Index 2015.

"If we take a look at the changes that took place in Poland in recent years, for example in the area of infrastructure, we can undoubtedly say that huge progress has been made. I think that Poland has done really well compared to Eastern European countries and, what is more, still has potential to grow. Poland is a relatively big country compared to its regional neighbours – it is a big economy with an impressive internal market. That is one of its biggest advantages."

Gunnar Günther
CEO, Kaufland Polska Markety Sp. z o. o. Sp. k.



Based on these differences within the region, which were outlined in the 2016/2017 Global Competitiveness Index report, Central European countries were divided into 3 categories according to their level of development and the competitive advantages they offer. The categories are as follows:²⁷

- Economies fuelled by improving efficiency – Bulgaria and Romania;
- Economies in a transition period where the main focus is on moving away from efficiency and towards innovation – Poland and Slovakia;
- Economies fuelled by innovation – Czech Republic.

These categories are based on 12 sub-indices describing the institutions, financial markets and other factors in each country. The complete list of scores of the six Central European countries is presented in the following table.

Central European economies according to the Global Competitiveness Index, 2016-2017



"Poland's main priority after 1989 was achieving stabilisation, followed by growth and only then prosperity. The more prosperous a person becomes, the more they start to think about the future. Will my children be able to enjoy an unspoiled natural environment? Will they have access to wholesome foods? Will they have to breathe polluted air? Will they have to face natural disasters caused by climate change? Such issues are becoming increasingly important for Poles."

Peter Baudrexl
CEO, Siemens Group Poland



Social progress

A broader analysis of the competitiveness of national economies requires consideration of factors such as social progress and the condition of the environment. This may benefit investors by limiting the non-financial risks of investing capital, but also allows them to develop a deeper understanding of the reasons for their investment and consciously manage them.

The growing prosperity of Central Europe has led to changes in people's preferences and social awareness, which is starting to influence the decisions of local and central governments.

In short, citizens and politicians are growing more concerned about the consequences of the inflow of Foreign Direct Investment (FDI). To put it in financial terms, the economic rate of return (ERR) is becoming more important than the financial rate of return, because the former takes into account external outcomes.²⁸ Therefore, investors may wish to familiarise themselves with the Social Progress Index, which provides useful information about social progress in specific countries and regions.

Social Progress Index for Central European countries, 2016

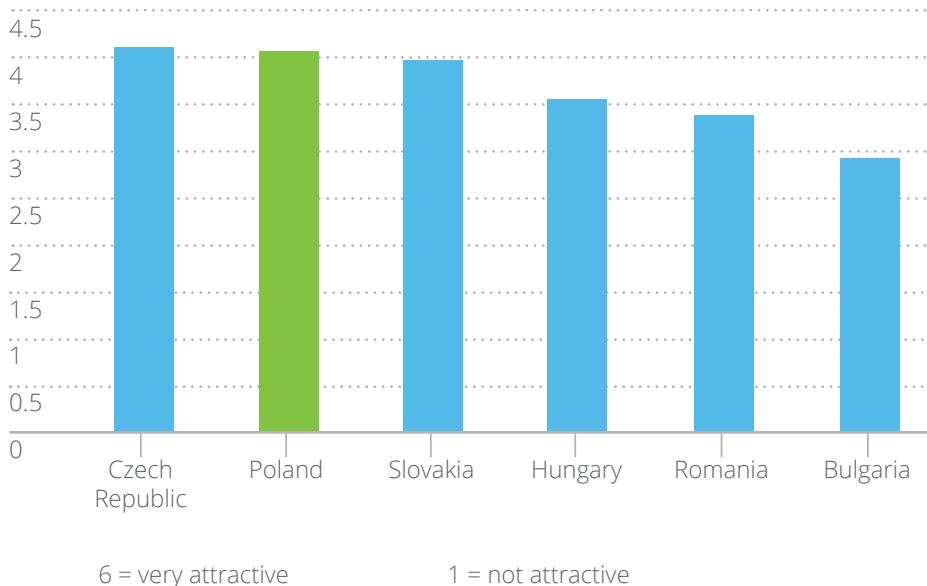


Source: Deloitte, based on data sourced from Social Progress Index 2016

The results of the 2017 Economy Survey of the German-Polish Chamber of Commerce and Industry (AHK Polska) correspond to those of the indices mentioned earlier in this report (Global Competitiveness Index, Index of Economic Freedom, Social Progress Index and Human Development Index).²⁹

According to the Economy Survey, the Czech Republic has become the most attractive country for investment in Central Europe, pushing Poland into second place. It is worth noting, however, that Poland led the ranking until 2015.

Which Central European countries are considered the most attractive by investors in the region – results of the AHK Poland survey

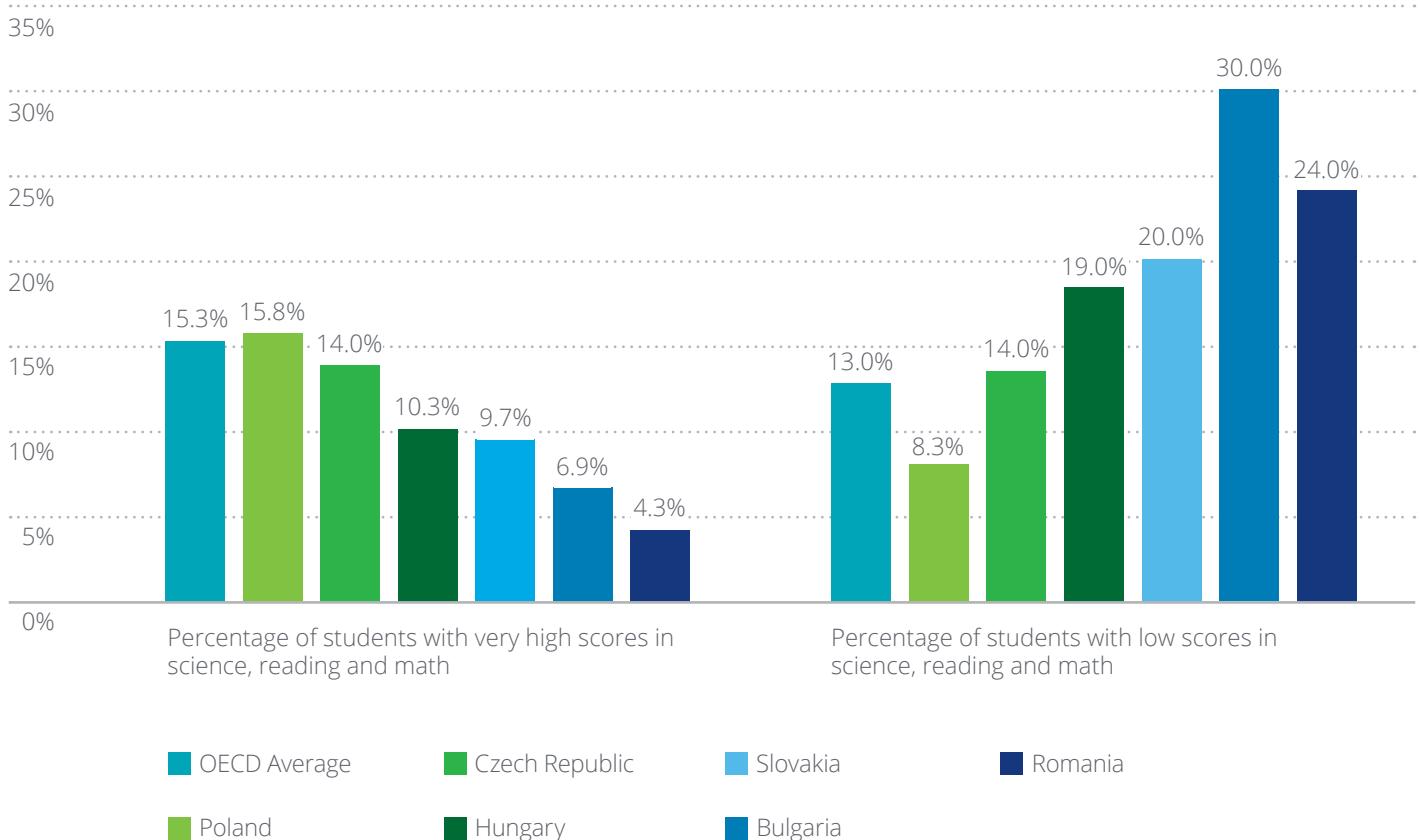


Source: Deloitte, based on data sourced from AHK Polska's 2017 Economy Survey. Poland in the Eyes of Foreign Investors

Apart from its steadily growing economy, Poland's competitive advantages over other countries in the region include its quality of education, especially in the areas of natural sciences and mathematics. In recent years, the number of STEM students and graduates has grown, partly due to the popularisation of those fields and public aid for students.

According to 2015 data, Poland is the Central European leader in the three main categories of the PISA study (mathematics, reading comprehension and science) and the percentage of the highest- and lowest-scoring students. Moreover, Poland has achieved above average scores (among all OECD countries) in each of the three categories.

Results of the Central European student assessment study - PISA 2015



Source: Deloitte based on data sourced from the OECD

Polish graduates and students are also distinguished by their good knowledge of English, which is important for drawing in business services (BPO/SSC) investments. According to the 2015 English Proficiency Index, Poles ranked 9th in Europe for English skills.

Poland has the world's highest number of German learners outside of German-speaking countries. According to a Goethe Institute study, almost 2.3 million Poles are learning German, 2.1 million of whom are doing so in schools.³⁰ Therefore, knowledge of German in Poland is more widespread

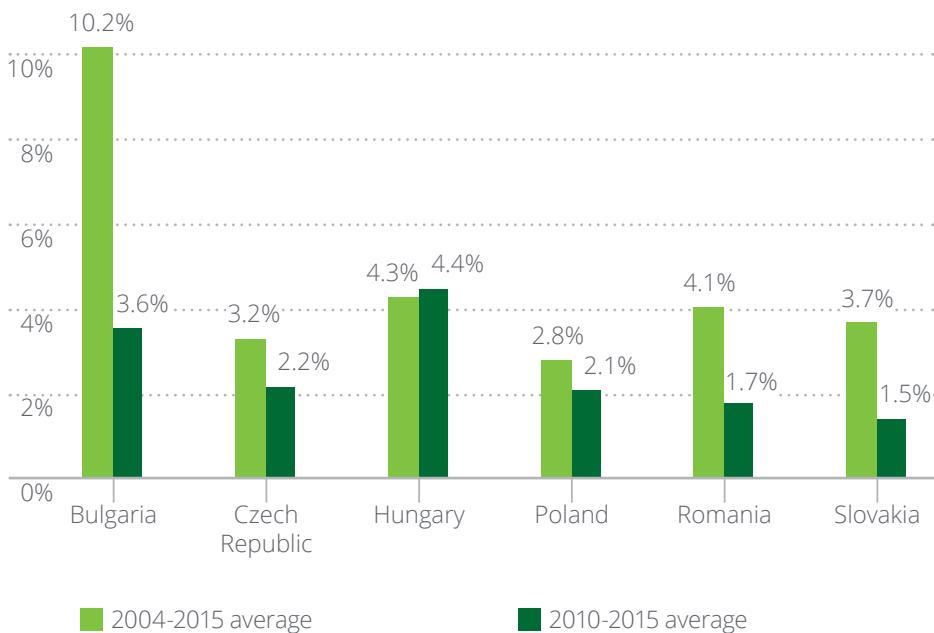
than in any other Central European country. Almost 13.3% of Poles speak the language of their western neighbours, compared with 10.9% of Hungarians, 10% of Slovaks, 8.6% of Czechs, 3.4% of Bulgarians and 2.1% of Romanians.³¹

Inflow of foreign direct investment into Central Europe

The majority of studies show that the inflow of FDI to Central Europe has had a positive impact on GDP growth and exports.³² Most importantly, FDI brings improved efficiency, because of two factors: first, employees are drawn to the more productive FDI; second, technology and know-how are imported. Apart from improved productivity, the capital inflows

themselves and the growing manufacturing potential are also important. At the same time, more and more economists are providing evidence that the extent to which FDI affects a country's economy depends on the sectors that the investments are made in.³³

Foreign direct investment as a percentage of the destination country's GDP



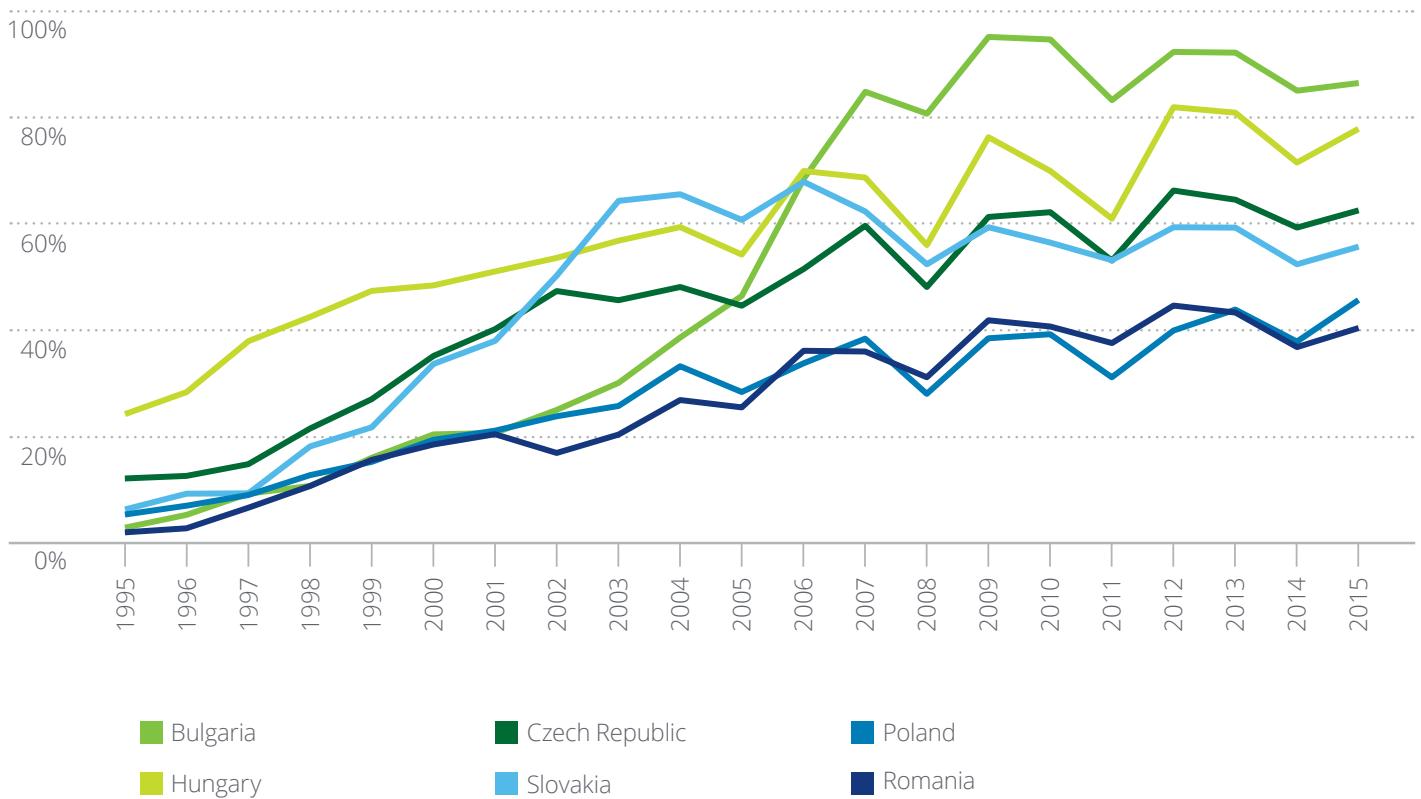
Source: Deloitte, based on data sourced from UNCTAD;
<http://unctadstat.unctad.org/wds/ReportFolders/reportFolders.aspx>

Even though Bulgaria drew in the most FDI in 2004-2015 (in relation to its GDP), the Czech Republic, Poland and Slovakia secured the most beneficial investments.

FDI in the latter three countries was primarily in the manufacturing and business services sectors, which was facilitated by factors including their proximity and similarity to Western

European markets. According to the IMF, labour productivity in Poland in 2000-2013 increased from 49% to 70% of the EU average, due in part to the technology that has been transferred to manufacturing companies.³⁴

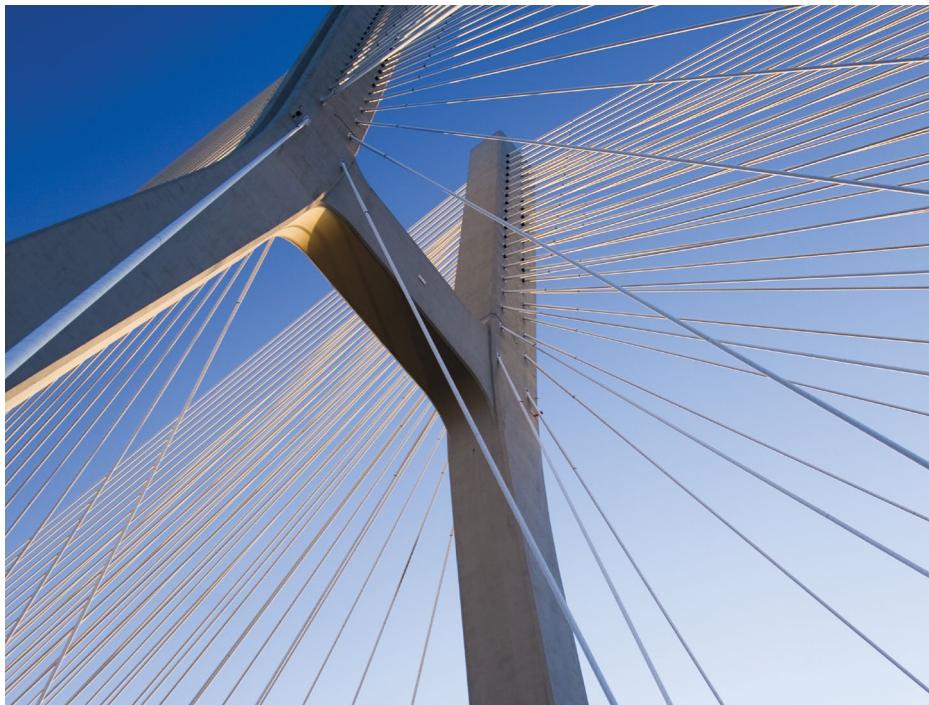
**Foreign direct investment as a percentage of the destination country's GDP,
1995-2015**



Source: Deloitte based on data sourced from UNCTAD;
<http://unctadstat.unctad.org/wds/ReportFolders/reportFolders.aspx>

- Bulgaria drew in the most FDI in 2004-2015, but it was the Czech Republic, Poland and Slovakia that secured the most beneficial investments.** The majority of FDI went into tradables (the manufacturing and services sectors).
- Hungary was the regional FDI leader in 2010-2015 despite its severe economic and currency crises, coupled with deep political changes.** Hungary's FDI inflow in the period stood at 4.4% of GDP, compared with 2.1% in Poland. Poland managed

to draw in relatively big investments at the time, coming third after Hungary and Bulgaria, both of which have much smaller economies. Moreover, Poland's GDP grew consistently throughout the period. Therefore, retaining an FDI inflow of 2.1% of GDP required much larger investments in absolute terms (billions of zlotys).



Investing in Poland: potential gains and risks

Every investment project can be assigned an expected level of risk and return. This allows investors to adopt one of two approaches: maximise expected returns at their selected (acceptable) level of risk, or minimize risk at their selected (acceptable) level of returns.

In the case of foreign direct investments, which usually have longer timeframes than portfolio investments, investors must choose a specific location to invest in. Two identical, complex, long-term investment projects may yield different returns depending on the destination region or city. Therefore, it is necessary to carry out local analyses to determine the local growth rate, development level and competitive advantages; the quality

of available resources (e.g. infrastructure, availability of professionals); and institutions.

The main problem lies in choosing the right proxy variables for investment risk and return on capital in a given country, region or city.

Investment risk

Public ratings and rating forecasts, as well as the spread between the yield on the destination country's bonds and the yield on the highest-rated country's bonds (e.g. Germany) often

serve as the starting point for assessing investment risk in the destination country.

Prime rates and credit ratings of Central European countries, May 2017

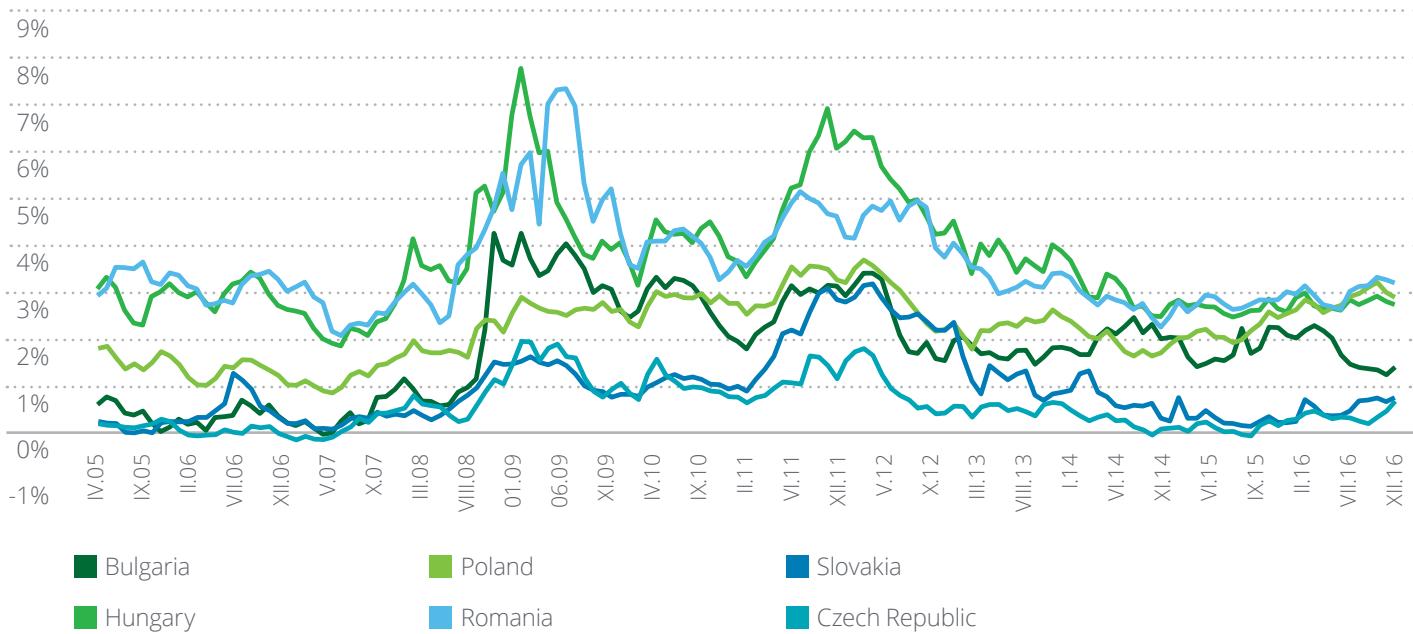


Source: Deloitte, based on data sourced from ECB; Trading Economics, 14 May 2017

Yield spread should be approached with some caution, as it is shaped by a number of factors other than the risk premium itself, such as the differences in interest rates set by central banks, and sentiment on global markets. For example, due to Bulgaria's monetary and

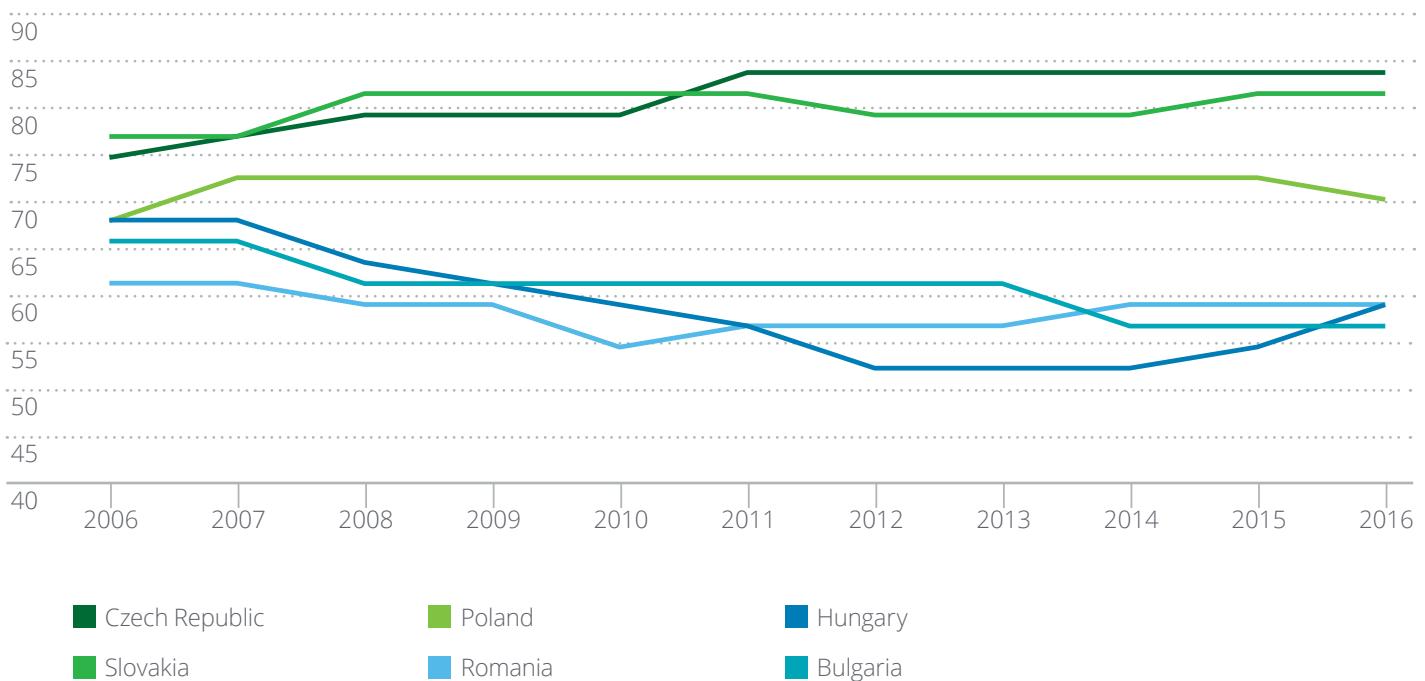
currency policy (the BGN is pegged to the EUR) the country has a lower yield spread than Poland and Hungary, but its investment rating is in fact significantly lower.

Yield spread between Treasury bonds of Central European countries and Germany



Source: Deloitte, based on data sourced from EBC

CE countries' credit ratings (standardised average of Fitch and Standard & Poor's ratings)



Source: Deloitte, based on data from Fitch and S&P

The Czech Republic and Slovakia are the least risky countries for investment in Central Europe, while Poland is considered the third least-risky destination based on sovereign ratings, with a significant lead over Romania, Hungary and Bulgaria.

We should add that the official ratings take into consideration "macro-level" economic, political and social risks, i.e. those that affect the entire country, whereas the choice of a suitable location for an FDI relies on "micro-level" analyses, i.e. those that focus on a single region or specific factors.

Macro-level risk may still have a decisive impact on the choice of destination for an investment, e.g. when the risk could result in catastrophic consequences such as a currency collapse or tax hikes.



"Polish consumers are open to innovations and quickly learn to use new technology. The growth of the finance sector, and especially the banking industry, is a good example of this trend. Poles were quick to embrace electronic banking, contactless payment systems and mobile banking services provided via smartphones. Several of these technologies found widespread use in Poland before regulators allowed them in certain Western European countries. Currently, consumers wish to be able to pay their bills or use telecommunications services with similar ease, regardless of time of day or location.

"Companies that operate on the Polish market do their best to meet the growing needs of consumers. Therefore, they invest in the development of new technologies and seek solutions that may improve operational efficiency as well as increasing customer engagement and satisfaction.

"Poland's potential for innovation is evident in the number of Polish tech start-ups that are prospering in both local and global markets. One of the more interesting investment projects that was recently implemented by financial institutions was the development of loyalty programs based solely on the use of debit cards and requiring no additional effort from customers. Our western neighbours are fully aware of Poland's potential; CVC (Corporate Venture Capital) funds are doing well in the Polish market, as are the accelerators of the biggest German telecom companies and banks, among others. However, new technologies have not yet been implemented in some segments of the Polish market, and that may be a profitable area for future investment."

Daniel Martyniuk
Partner, Head of German Desk, Deloitte Digital

Expected return on investment

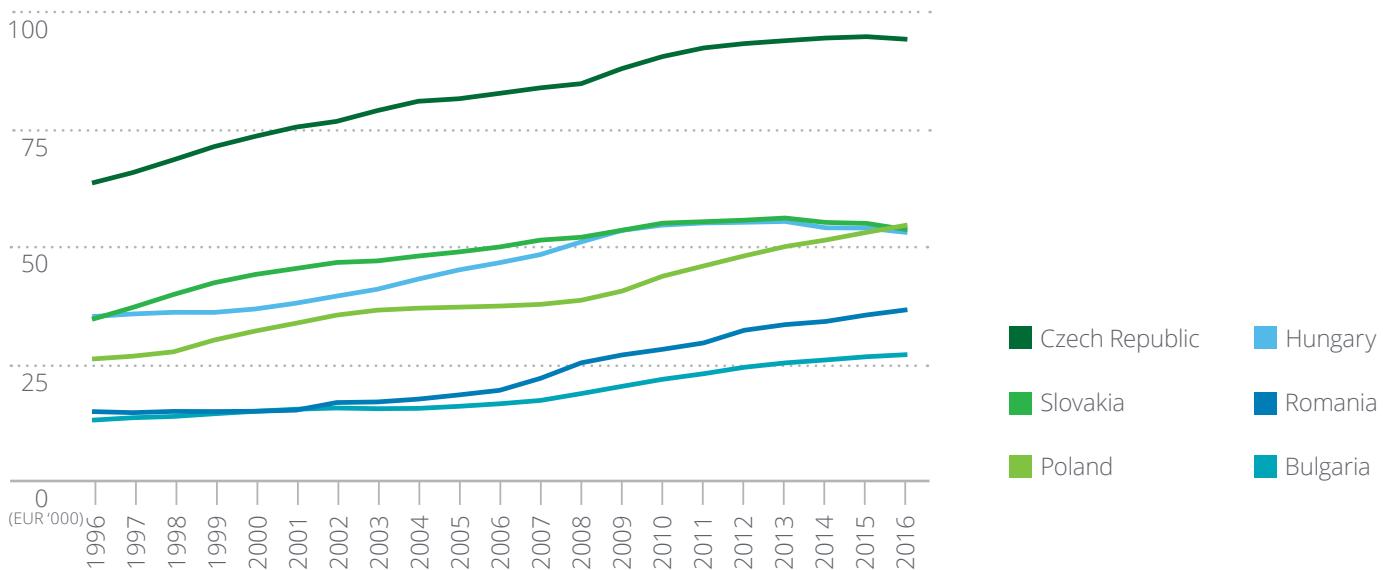
In economics, the **law of diminishing marginal returns** states that the more units of a given factor of production there are (e.g. capital), the lower the returns will be for each additional unit. An example of this may be an investment boom fuelled by cheap loans, resulting in an excessive number of bad capital investments, which in turn inevitably lead to a bust, resulting in losses.

The principles of economics suggest that markets and high mobility of capital will lead to rates of return (marginal productivity of capital) tending to equalise across countries. A number

of studies prove that this has indeed happened as a result of globalisation and European integration. In the 1970s, the price-adjusted differences in the marginal productivity of capital between developed and developing countries were substantial, but that started changing in the 1980s, and the differences are now minimal.³⁵ The rapid drop in the marginal productivity of capital in developed countries, caused by a decline in the cost of capital and a significant increase in capital per worker, is another interesting phenomenon that happened in the past few decades.³⁶

OECD data show that the amount of capital stock per worker in the majority of the most affluent economies has not increased for several years, in some cases for more than 10 years. This process is evident in the Czech Republic, which has numerous characteristics of a developed economy. Despite the relatively low supply of capital per worker in Slovakia and Hungary, these two countries are also experiencing stagnation in capital stock per worker. That is mainly because the growing number of workers is not accompanied by an increase in capital.³⁷

Net capital per worker in Central European countries



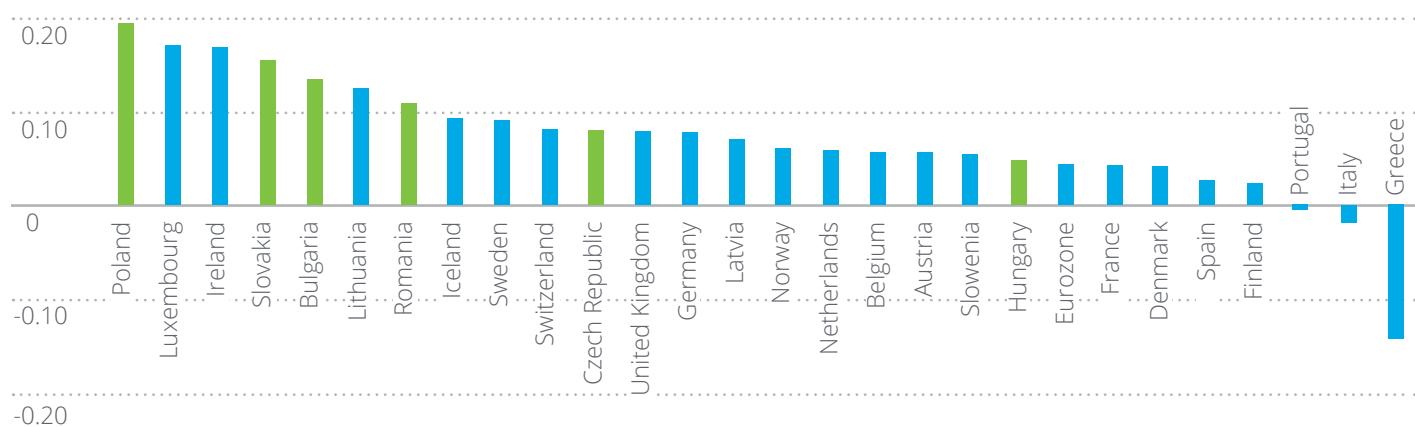
Source: Deloitte, based on data sourced from the European Commission, AMECO Database, https://ec.europa.eu/info/business-economy-euro/indicators-statistics/economic-databases/macro-economic-database-ameco_en

Poland has managed to double the amount of capital per worker over the last 20 years, which allowed it to overtake Slovakia and Hungary. Nevertheless, the traditionally industrial economy of the Czech Republic continues to have almost

two times as much capital stock. This disparity, combined with Poland's well-educated workforce and considerable potential for improving TFP, results in very high marginal productivity of capital. As a result, Poland had the highest average marginal productivity of capital

among all EU countries in 2006-2017.

Marginal productivity of capital in selected EU countries



Source: Deloitte, based on data sourced from the European Commission, AMECO Database, https://ec.europa.eu/info/business-economy-euro/indicators-statistics/economic-databases/macro-economic-database-ameco_en



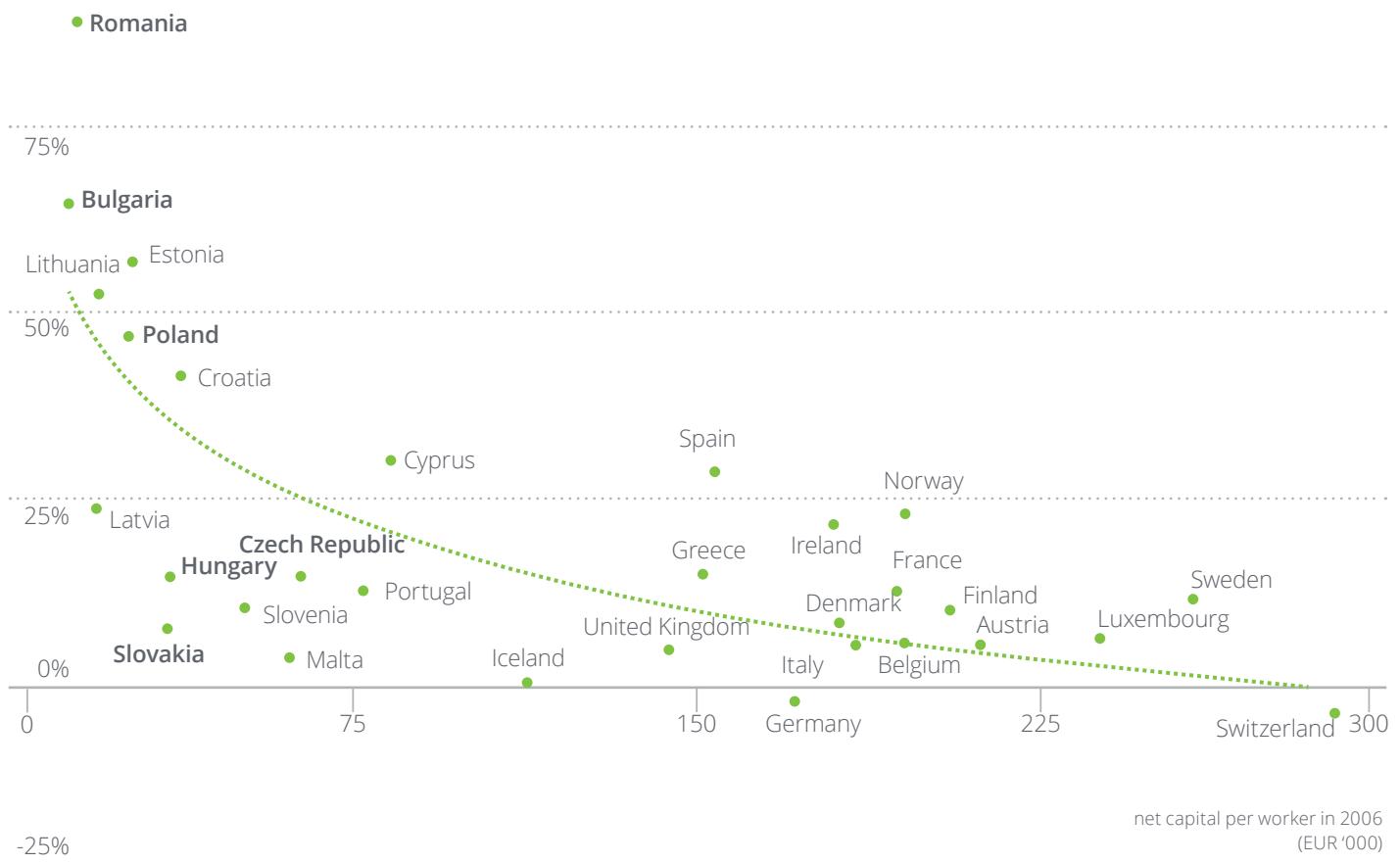
"Interest rates in Western Europe have been at record-lows for over half a decade now. It should be noted, however, that this has been caused not only by the monetary policy of the most important central banks, but also by investor expectations for economic growth in the region. It is only natural for investors to seek the most attractive forms and destinations for investment at an acceptable level of risk. When compared to highly developed countries, Poland still has relatively low capital stock per worker, which ensures a high rate of return for every million Euros invested. Moreover, there are additional untapped resources that may contribute to the long-term profitability of investments in Poland. These include the potential for increasing labour-force participation, especially among women, and the transfer of workers from agriculture to industry and services. For that to happen, however, certain structural reforms have to be put in place."

Julia Patorska
Senior Manager, Sustainability & Economics Team, Deloitte

Growth of net capital per worker, 2006-2016, and net capital per worker in 2006

Growth of net capital per worker,
2006-2016

100%



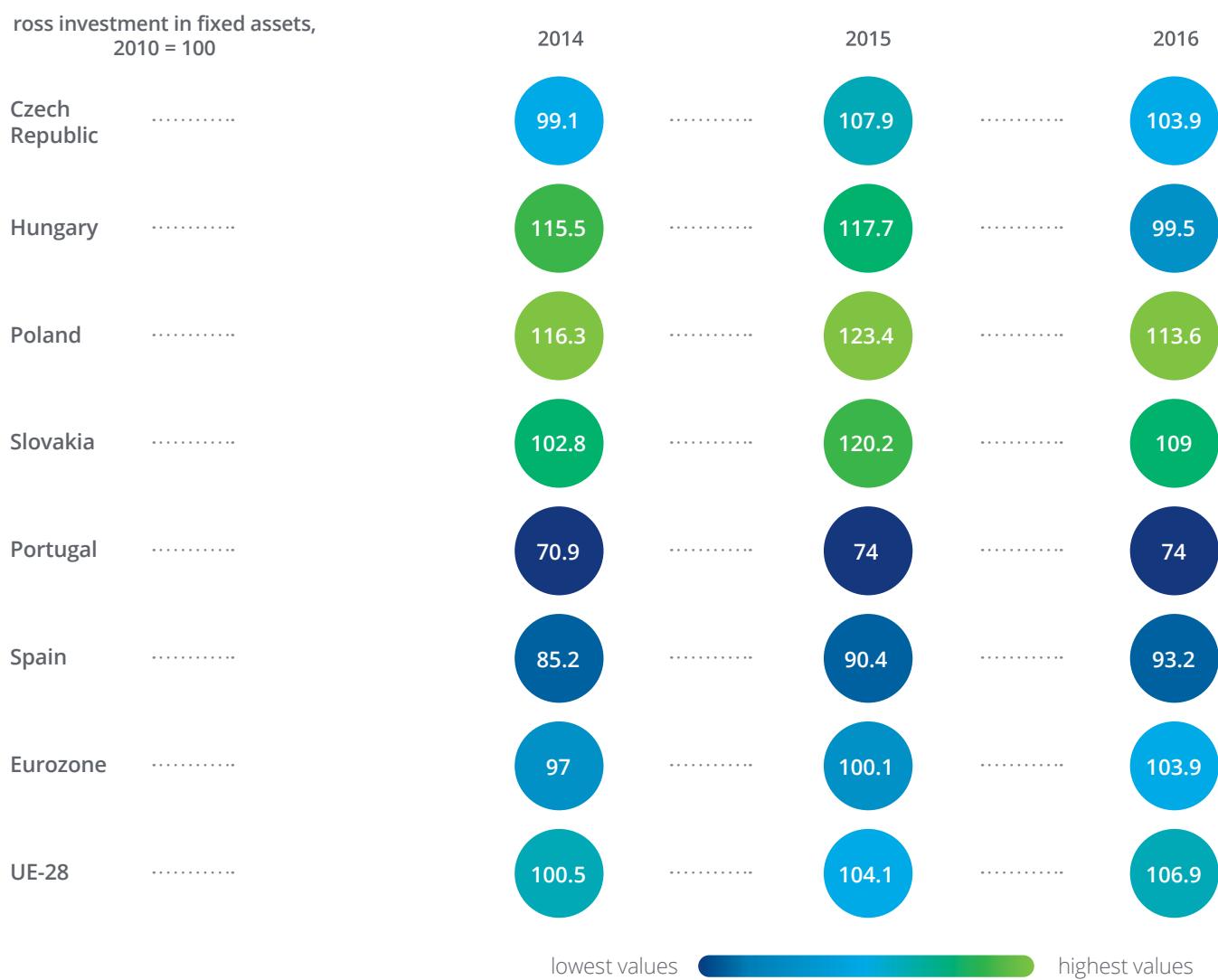
Source: Deloitte, based on data sourced from the European Commission, AMECO Database,
https://ec.europa.eu/info/business-economy-euro/indicators-statistics/economic-databases/macro-economic-database-ameco_en

The vast differences in marginal product of capital (marginal capital efficiency) do not necessarily translate into equally big differences in financial rates of return (FRR). Many studies have proven that capital does not flow to certain undeveloped countries, or to those that have small capital stock in relation to GDP/per worker.³⁸

Poland and other Central European countries are very different from non-European emerging economies, which struggle to draw in both FDI and portfolio investments. There are two reasons for this. First, Central European countries are members of the European Union, which significantly lowers both capital transfer costs (thanks to the single market) and investment risk. Second, they have moderate levels of GDP per capita, labour productivity and TFP.

Therefore, their resources (e.g. educated workers, infrastructure) and efficient markets have a positive impact on the profitability of investments.

Gross investment in fixed assets, 2010 = 100



Source: Deloitte, based on data sourced from the OECD

Because the flow of capital between EU countries is relatively unhindered, the significant differences in capital productivity and investment activity (of both domestic and foreign entities) are caused mainly by the specific characteristics of the individual economies and the quality of their economic policies.

In 2016, investment outlays in Spain remained lower than in 2010 (93.2%), whereas in Portugal they amounted to 74% of the 2010 level. Investment outlays in Poland in 2016 amounted to 113.6% of the 2010 level, following a significant drop in 2015.

Apart from growing uncertainty, the drop was caused by the gap between the 2007-2013 and 2014-2020 EU Financial Frameworks, which had a negative impact on all investments in Poland, Hungary, the Czech Republic and Slovakia.³⁹ Small, open economies may be exposed to macroeconomic risk if they become too dependent on inflows of foreign capital. This includes not only portfolio investments but also FDI, which in turn is highly dependent on the state of the global economy.

Investing in Poland – potential gains and risks: Summary

- Poland has managed to double the amount of capital per worker in the last 20 years, which allowed it to overtake Slovakia and Hungary.** Nevertheless, the traditionally industrial economy of the Czech Republic continues to have almost two times as much capital stock. This disparity, combined with Poland's well-educated workforce and considerable potential for improving TFP, results in very high marginal productivity of capital. **As a result, Poland had the highest average marginal productivity of capital of all EU countries in 2006-2017.**

- Yield spread figures should be approached with some caution, as they are shaped by numerous factors apart from the risk premium itself**, e.g. the differences in the interest rates set by central banks, and sentiment on global markets. For example, due to Bulgaria's monetary and currency policy (the BGN is pegged to the EUR), the country has a lower bond yield spread than Poland and Hungary, but its investment rating is in fact significantly lower.

- 2016 investment outlays in Poland amounted to 113.6% of the 2010 level, following a significant drop in 2015. Nonetheless, Poland still leads the V4 group (Czech Republic, Poland, Slovakia, Hungary) in this regard.** Apart from growing uncertainty, the drop was caused by the gap in the 2007-2013 and 2014-2020 EU Financial Frameworks, which had a negative impact on all investments in Poland, Hungary, the Czech Republic and Slovakia.

- An excessive contribution of FDI to GDP may make the economy vulnerable to external shocks.** In the case of Hungary, FDI constituted one-quarter of all investments in 2010-2014. In Poland the figure was 11%.⁴⁰

How to invest in Poland

Performing competitor analyses and assessing the growth perspectives and stability of Central European economies is merely the starting point for selecting an optimal investment location.

The next steps should involve preparing regional analyses, analyses of the growth of key supplier and client sectors, infrastructure analyses and a thorough examination of the national regulations that could affect the costs of investment and operations.

The goals of this chapter are to:

- present an overview of sectors that have high growth potential and sectors that draw in the most foreign direct investment,

- outline the most important economic policy changes, both planned and implemented, that have an impact on Poland's investment attractiveness,
- share the experience of German investors in Poland, focusing on the most important barriers that affect FDI returns and risk.



"The key move for new foreign investors who plan to invest in our country would be to familiarise themselves with Poland's legal and tax regulations. Choosing the right location, with access to the necessary infrastructure, human resources and public subsidies, is also important. As regards reporting, the availability of finance employees with suitable qualifications and foreign language skills will be crucial for foreign investors. The experience of German investors shows that there is no shortage of qualified finance and financial audit employees with a good knowledge of English or German in most Polish cities."

That makes it possible to prepare all of the reporting packages that the daughter companies of German organisations are required to file in accordance with German GAAP. Because consolidation packages are subject to group auditing, it is crucial for German investors to have access to auditing firms with expertise in both the Polish and the German markets, i.e. having a practical knowledge of legal frameworks, tax obligations and accounting principles."

Ilona Gawrych
Manager, Audit & Assurance Team, Deloitte





Sectors with high growth potential

Accession to the European Union, ongoing structural changes and the global financial crisis have all had an impact, albeit to a different extent, on all sectors of the Polish economy.

In 2005-2016, the following sectors had the quickest growth in gross value added (CAGR based on constant prices):

- Administration and auxiliary activities (8.1%)
- Manufacturing (6.7%)
- Information and communication (5.5%)
- Other services (4.8%)
- Professional, academic and technical activity (4.5).

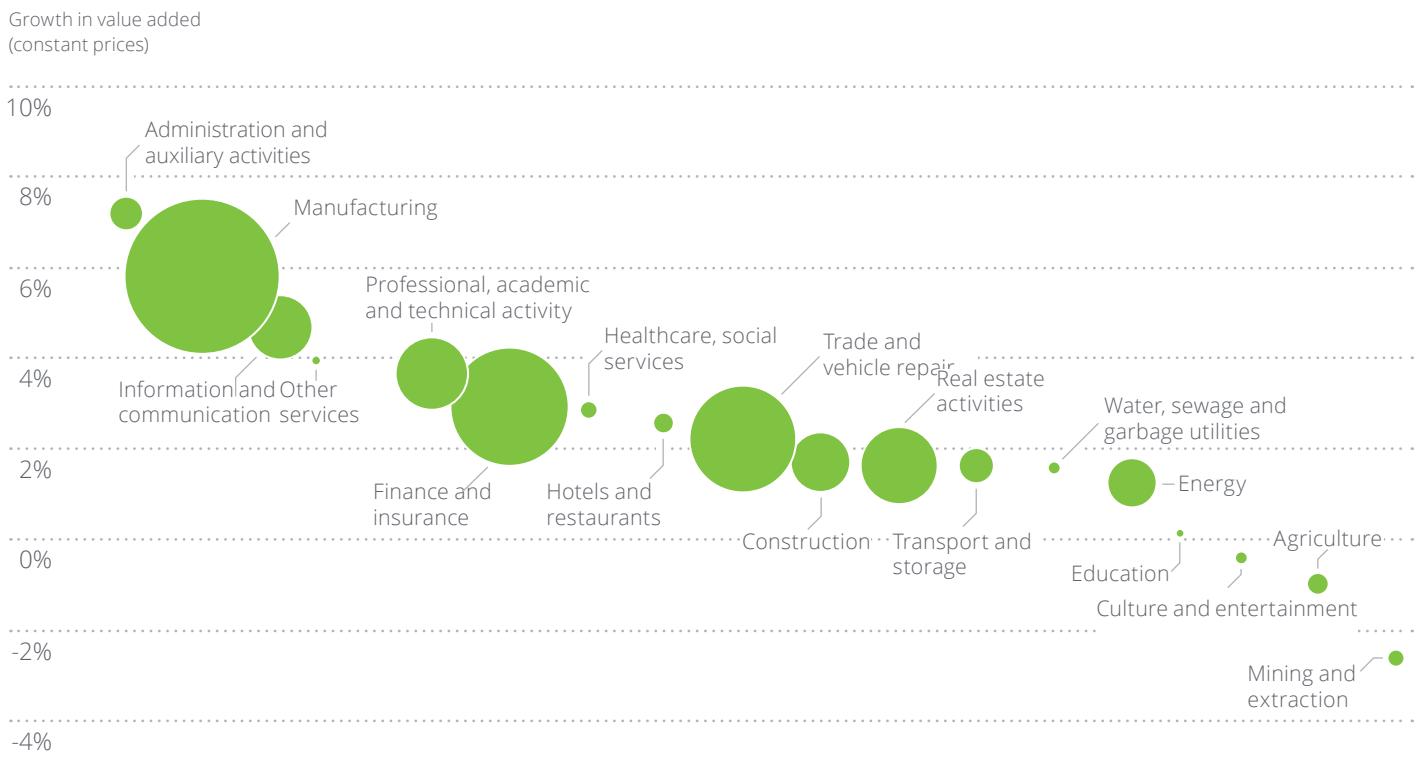
For comparison, total added value in the economy grew at a CAGR of 3.5% in 2005-2016.

The slowest-growing sectors in Poland in that period were:

- Energy (2.0%)
- Education (0.8%)
- Culture, entertainment and recreation (0.3%)

Gross value added decreased in agriculture (-0.3%) and mining and extraction (-1.9%).

Growth in value added (constant prices; CAGR 2005-2016; vertical axis) and total FDI in billions of zlotys



Source: Deloitte, based on data sourced from the Central Statistical Office of Poland and the National Bank of Poland

The inflow of foreign direct investment into Poland was concentrated in certain sectors. According to the National Bank of Poland, two-thirds of FDI went to three sectors:

- Manufacturing (229.6 billion zlotys; 32.2% of all FDI)
- Finance and insurance (133.9 billion zlotys; 18.8%)
- Vehicle trade and repair (108.6 billion zlotys; 15.3%)

The data show that most investors avoided putting capital into the slowest-growing sectors and industries (agriculture; mining and extraction; culture, entertainment; other services).

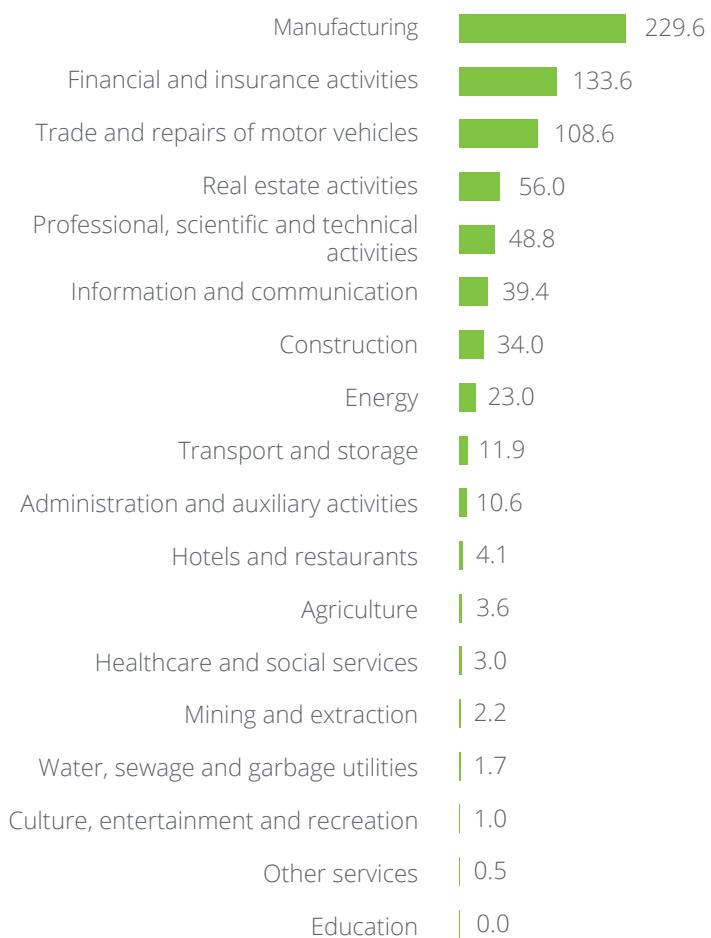
There are two sectors, i.e. manufacturing and business services (BPO/SSC), that will continue to offer short- and long-term investment opportunities in Poland.



"The total value of M&A transactions in Poland reached a record-high of 11.2 billion Euros in 2016. The Polish market, part of the broader Central European market, is seen as an attractive investment destination, both for sector investors and various types of funds, such as private equity. Deloitte research (the Central Europe Private Equity Confidence Survey) shows that almost 70% of funds wish to invest in the region, especially in the manufacturing and food sectors. It should be noted that this trend has existed for almost two years now, which bodes well for the future."

Małgorzata Hess, ACCA
Senior Associate, Financial Advisory, M&A Team, Deloitte

FDI in Poland by sector (2015; billions of zlotys)



Source: Deloitte, based on data sourced from the National Bank of Poland

Manufacturing: Poland more industrialised than the Eurozone

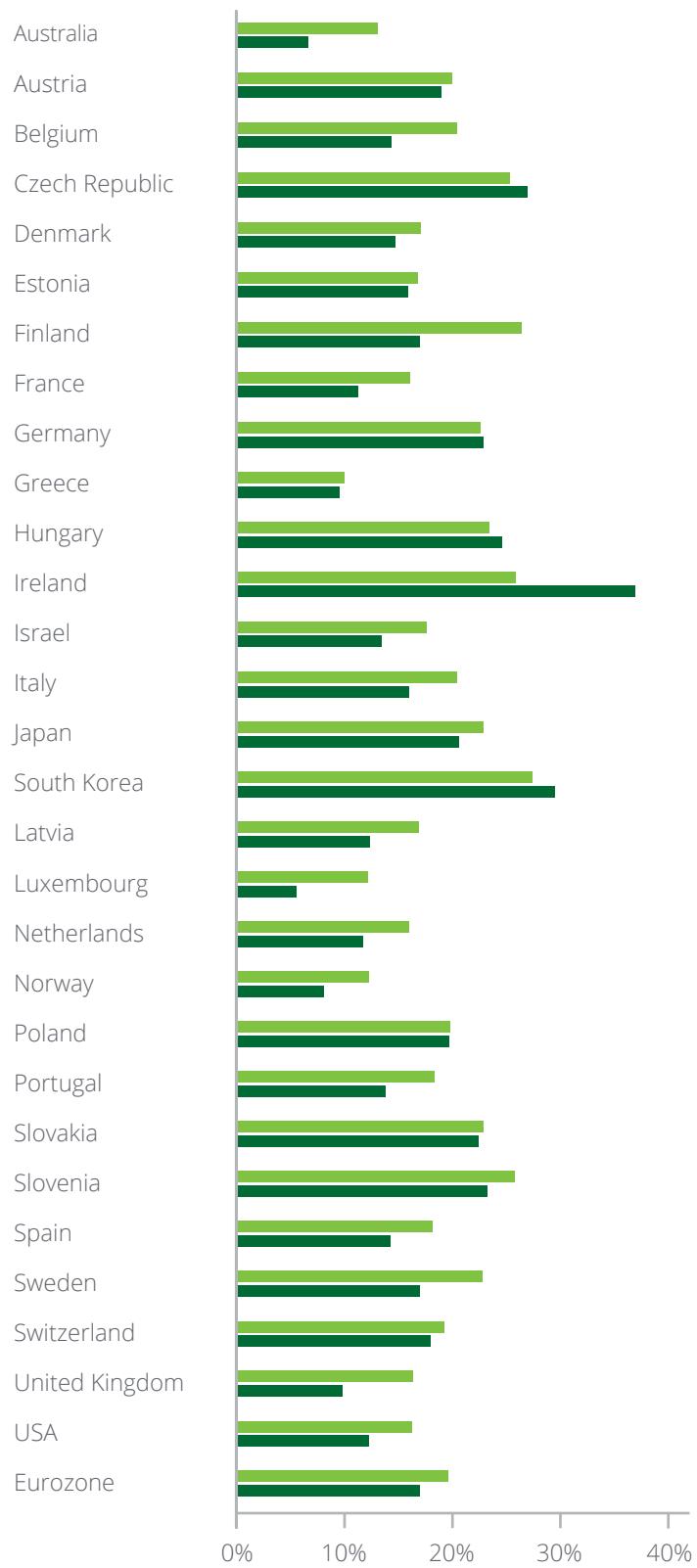
Economists and decision-makers often emphasise the importance of creating good conditions for manufacturing. That is because industry has a positive impact on the economy's overall productivity, not only due to the principle of economies of scale, but also because manufacturing companies invest in R&D projects, draw in technology from abroad and create high-quality jobs (thus having a positive impact on investment and helping keep human capital in the country).

In many developed countries, the prosperity of the 1990s and the first decade of the 21st century was marked by a declining contribution of manufacturing to total value added. This could be observed in economies including the US, France, the UK and the Eurozone as a whole. Germany, where manufacturing continues to account for a large share of added value, is an exception to that trend.

Similar to other Central European countries, Poland has managed to retain the same level of industrialisation as in 1997.

FDI continues to be one of the key factors spurring the growth of the manufacturing sector. The importance of foreign investors is reflected by that fact that FDI amounted to 24% of the total value of fixed and current assets in the manufacturing industry in 2015.

Contribution of manufacturing to total value added (%) in 1997 and 2015.



Source: Deloitte, based on data sourced from OECD

By offering competitive conditions for the manufacturing industry, Poland is opening the door to further productivity growth and job creation for highly qualified workers. The country's innovation potential is growing as well. The automotive sector, with approximately 900 companies and 10% of the country's total manufacturing output, may serve as an example of this. Companies that have opened R&D centres in Poland include: TRW, Tenneco, Valeo, Delphi, Wabco, Faurecia, MBtech and Eaton.⁴¹

German investors say the machinery, home appliance and furniture industries are also growing at a rapid pace. Furthermore, the positive trends are visible across companies of all sizes: small, medium and large. However, the energy sector is stagnating, which is due in part to changes in the renewable energy policy and the unstable energy strategy currently being implemented in Poland.

"It has been known for years that Poland has a stable and rapidly growing economy. Three companies of the RETHMANN group – SARIA, RHENUS and REMONDIS – are present in Poland and have been steadily growing ever since they started operations in the country. We see no signs of that changing in the future. First and foremost, Poland has very well-educated workers. Young Poles are very mobile and are ready to move from Wrocław to Gdańsk or from Warsaw to Kraków. That is mainly because Poland, similar to Germany, is a decentralised country that is not concentrated around a single metropolis. Instead, there are many big cities which are not only attractive from a business perspective, but also pleasant to live in.

Compared to the rest of the region, Poland has a big internal market and very good infrastructure. All of that contributes to the country's attractiveness for investment and gives Poland an advantage over other countries in the region."

Torsten Weber
CEO, Remondis sp. z o. o.

Business services sector – Poland among EU leaders

The business services sector (BPO/SSC) is another important industry that ensures high returns and helps Poland move up in global value chains.

According to 2016 data, there are approximately 1,000 BPO/SSC centres in Polish cities (of which 676 are foreign-owned), employing 200,000 workers. In recent years the sector has grown by 20% annually, and between the first quarter of 2015 and the first quarter of 2016 it grew by an impressive 25%.^{42,43}

If we broaden the category of services to include BPO, SSC, IT and R&D, total employment in the business services sector in 2016 stood at 212,000. More than 83% of employees (177,000) work in foreign-owned centres. ABSL forecasts that by 2020 the total number of employees in the services sector will increase to 300,000.⁴⁴

Due to growing employment and office lease costs in the biggest cities (Warsaw, Kraków, Wrocław), many BPO/SSC centres are being opened in smaller cities. These include mainly university cities with many students and graduates, e.g. Bydgoszcz, Toruń, Rzeszów, Lublin

and Białystok. This process is facilitated by the gradually improving availability and quality of infrastructure in eastern Poland, which is increasing the efficiency of local job markets.

According to the German investors who took part in the Deloitte survey, the government should focus on breaking down the barriers that separate academia from the economy. They point to the fact that, despite the obvious benefits associated with the growth of the BPO/SSC sector, if no major reforms are put in place Poland may be unable to draw in more advanced business services and R&D centres. At the same

time, Poland has not fully capitalised on start-ups, one of its major advantages, due to factors including fragmentary support programmes that are not integrated into a coherent plan.

Some investors say that even the more "traditional" industries, such as food production and retail, still have potential to grow. This is due to factors such as Poles' high aspirations and consumer needs, coupled with relatively low salaries.





Economic policy

Responsible Development Strategy

The Responsible Development Strategy (RDS), adopted by the current government, will lead to an evolution of FDI policy. An analysis of the RDS allows us to conclude that attracting FDI will no longer be a goal in itself: the authors of the strategy argue that this approach shaped Poland's policy in this area since the beginning of the transformation process, but that FDI should rather serve as a means of fostering the growth of domestic companies. We may therefore assume that investment projects leading to the creation of high-value-added jobs, technology transfer and the development of R&D will be prioritised. The total number of new jobs may become a less important criterion,

especially given Poland's record-low unemployment rate.

The strategy assumes that the policy for attracting FDI should form part of a broader regional policy, concentrating on efficiency in exploiting regions' specific advantages. This is to be achieved by introducing systems of National Smart Specialisations and Regional Smart Specialisations. Consequently, the RDS may lead to the adoption of a more selective approach not only to foreign investors, but also to determining which projects will be co-financed by the EU. This move is motivated by the limited effectiveness of EU-funded projects in the least-developed regions of the country: development has not been

boosted, and foreign investment has not increased.⁴⁵

"Until now, the regional policies of local governments have led to improvements being made to infrastructure (e.g. technical, social and environmental) and the quality of social capital and innovation potential, which includes resources allocated to the research and development sector (R&D), but only a few provinces have improved their investment attractiveness to the point where they were able draw in foreign capital in the form of big direct investment projects that serve as a growth accelerator."

Responsible Development Strategy, p. 206

The RDS assumes that the following steps will be taken by 2020 to bolster regional investment systems:

- strengthening export-focused companies and business clusters;
- improving conditions for investors, for example by supporting the development of utilities on land plots designated for investment and creating a system of incentives for investors;
- developing and modernising infrastructure in the vicinity of investment projects, including the construction of a coherent regional transport network, improving public transport in accordance with the Responsible Development Strategy by 2020 (may be prolonged to 2030) and efficiently connecting the regional road and rail transport systems to national and European networks;
- increasing the efficiency and effectiveness of education services and improving the qualifications of officials who work with investors;

- improving regional investment promotion systems, including extensive support for FDI that links the activities of companies in selected areas;
- using investments to strengthen the relationships between businesses, academia and local governments in key regional sectors (while observing the rules for state aid).

Representatives of German companies emphasise how important it is for prospective investors to have access to coherent information about the government's economic policy goals and initiatives. This is particularly true of policy for attracting foreign investors, which depends in part on the country's overall image.

Business and FDI regulations

Poland placed 24th out of 190 countries in the Doing Business 2017 ranking (up one place from 2016).

The biggest improvements were in the areas of dealing with construction permits and resolving insolvency (up six places), while the process of starting a new business suffered the biggest drop (down six places).

Impact of 2016 regulatory changes on conditions of doing business in Poland, according to the 2016 and 2017 Doing Business ranking



Source: Deloitte, based on data sourced from the World Bank, Doing Business 2016 and 2017



"When making long-term plans, investors should bear in mind that Polish tax regulations change rapidly. For example, the introduction of the so-called tax avoidance clause, which entered into force in July 2016, has significantly increased the risk of restructuring in Poland. Therefore, most reorganisations (e.g. combining entities, or dividing them by delegating certain functions to outside entities) require careful planning, and documents that explain the entire process from a business perspective."

But it is also worth remembering that choosing the right business structure in Poland (especially in the form of partnerships, e.g. limited partnerships) makes it possible to considerably lower tax obligations in Germany (preventing taxable income earned in Poland from being taxed again in Germany when distributing profits to shareholders). Despite the possibilities that exist, most German companies still retain a non-optimal structure."

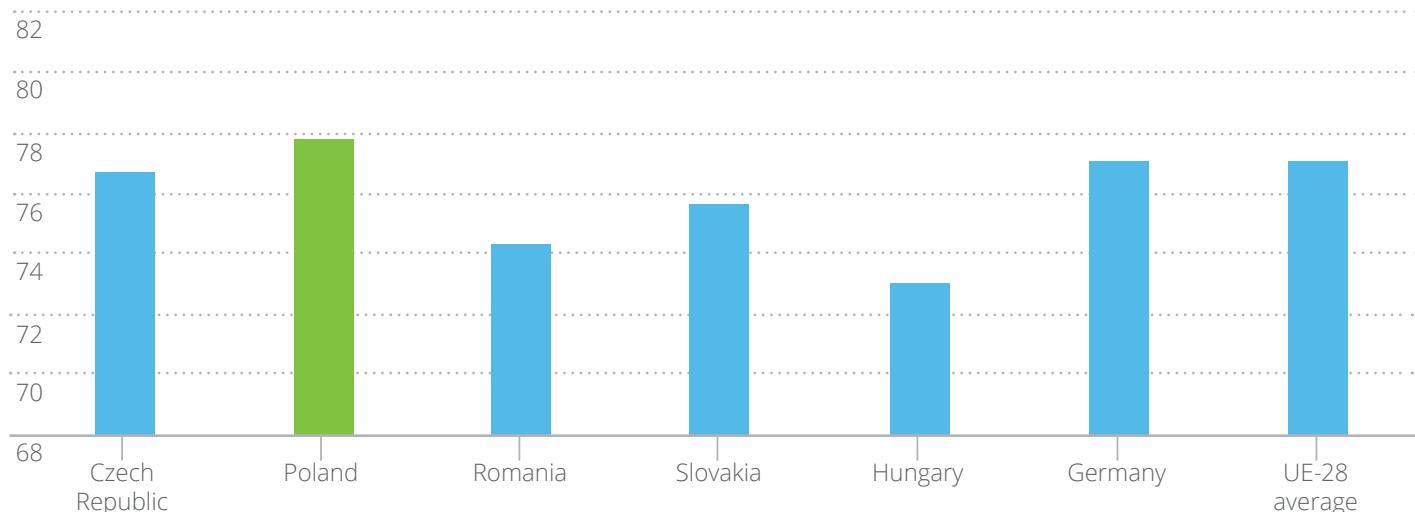
Arkadiusz Bakowski
Senior Manager, Tax Advisory Team, Deloitte

According to Doing Business 2017, there is a pressing need for far-reaching changes to the regulations that govern the registration of new businesses. The Ministry of Development has commenced public consultations on a package of bills – the "Constitution for Business" – that aims to improve and deregulate the business environment. For the most part, the package has been received positively by experts and employers' associations, but lawyers from the government's Legislative Commission say the regulations require further work.⁴⁶

Overall, the regulatory changes introduced in recent years have allowed Poland to achieve considerable progress when gauged by the Doing Business rankings. In 2017, the overall conditions of doing business in Poland were better than the EU-28 average, beating the Czech Republic, Romania, Slovakia and Hungary.

German investors who do business in Poland have seen an increase in regulatory barriers and red tape in 2016, which at first glance seems to contradict the results of the Doing Business 2017 ranking. When looking at individual categories, however, we realize that this is not the case. The two categories that suffered the most were taxes (partly related to the VAT reverse charge mechanism) and the requirements for obtaining permits and starting a business.

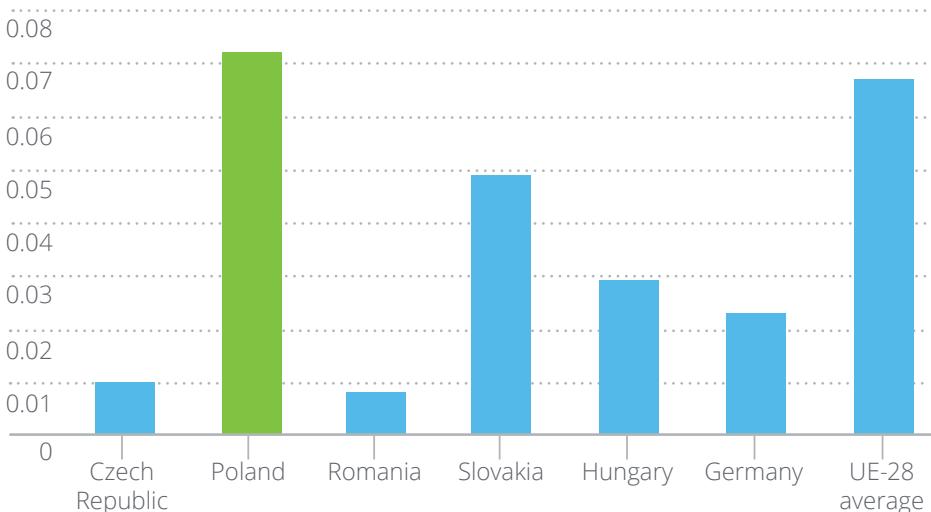
Doing Business 2017 rankings of Central European countries, Germany and the EU-28 average



"Investors, especially those in the construction sector, have very high hopes for public-private partnerships. There are a lot of signs that PPP projects in Poland will really take off soon. We predict, however, that it will be another year or two before the Polish government announces the first big public tenders for road and public infrastructure projects. This may push both Polish and foreign companies to invest."

Klaus Böde
Vice-President of the Executive Board, HOCHTIEF Polska S.A.

OECD's FDI regulatory restrictiveness index, 2015



Source: Deloitte, based on data sourced from the OECD

Poland's foreign direct investment regulations are one of the country's weaknesses. They are broader and more restrictive than the OECD average and, in the Central European region, more complex than in the Czech Republic and Romania.

One of the issues that is often mentioned by investors are the unstable legal regulations, which is reflected by the large number of amendments and new laws that are being passed.

The legal framework for doing business in Poland remains stable due to the safeguarding mechanisms guaranteed by the EU. However, if the fast pace of regulatory changes continues, the stability and quality of the regulatory environment may suffer.

Special Economic Zones

According to the most recent data, 125.3 billion zlotys were invested in Special Economic Zones, leading to the creation of almost 313,000 jobs. Below are the SEZs that have drawn in the most

investment:

- Katowice SEZ (25.6 billion zlotys, 20.4% of total investment in SEZs),
- Wałbrzych SEZ (23.5 billion zlotys, 18.8% of the total),
- Łódź SEZ (14.4 billion zlotys, 11.5% of the total),

Basic data on Special Economic Zones in Poland

Special Economic Zone (SEZ)	Total FDI (in billions of zlotys)	Number of jobs	Total area (in hectares)	Area remaining for development (in hectares)	As of
Kamienna Góra SEZ for Medium Business	2.2	7 083	373.83	157.85	05.2016
Katowice SEZ	25.6	60 000	2614	1200	03.2017
Kostrzyn-Słubice SEZ	6.9	32 000	1868	869	02.2017
Kraków SEZ	4.5	23 000	866	256	03.2017
Legnica SEZ	7.7	13 500	1300	443	11.2016
Łódź SEZ	14.44	36 000	1339	342	02.2017
SEZ EURO-PARK MIELEC	9.4	32 800	1643	494	03.2017
Pomeranian SEZ	11.4	22 160	2246	810.6	09.2016
Słupsk SEZ	1.5	5 800	910	603	02.2016
„Starachowice” SEZ	2.18	7127	644.5	216.8	05.2016
Suwalski SEZ	3	10 000	635	250	02.2017
Tarnobrzeg SEZ EURO-PARK WISŁOSAN	8.45	5884	1868	545	01.2017
Wałbrzych SEZ „INVEST-PARK”	23.5	48 000	3550	1716	12.2016
Warmia and Mazury SEZ	4.5	9469	1390	451	01.2017
Total	125.3	312.8 K	21.3 K	8.4 K	

Source: Deloitte study based on SSE and PAIH data.



"The complex and lengthy procedure of shifting the borders of Special Economic Zones used to be the Achilles heel of the Polish system. A recent example of that could be the Katowice zone which took one and a half years to expand. The new model, in which a company chooses a location and receives subsidies when all of the required criteria are met, will surely be more efficient. It is important, however, for the change to be introduced gradually. Otherwise we could end up in a situation where the old procedures are no longer being used and the new ones are not yet implemented."

Marek Sienkiewicz

Director in the Tax Advisory Department, Head of the SEZ Team, Deloitte

The FDI policy changes that are outlined in the RDS will mostly rely on modifying the SEZ incentive systems. Specific regulations are being prepared, and representatives of the government say support for both investors and the areas where they locate operations will be better targeted.

The planned changes to SEZ policy will also lead to the development of a more flexible support system, which will attract more investment projects to regions that currently lie outside of SEZs.

The main instrument that the Ministry of Development wishes to implement is CIT exemptions for development investments in all regions of Poland. The exact conditions and timeframes of the exemptions have not yet been disclosed, but they will certainly not be offered to all prospective investors.⁴⁸

"Special Economic Zones in Poland still allow investors to receive very, very good support in terms of production costs and investment costs. The very generous support that we receive here is unequalled by any other country that we operate in. Looking forward, however, I think that programmes should be put in place that would support research and development investment projects, as that is Poland's biggest untapped potential."

Michael Kobriger

CEO, MAN Bus Sp. z o. o., Senior Vice President Production Bus, MAN Truck & Bus AG

The representatives of German companies who took part in the Deloitte and AHK Polska survey also point out that certain barriers may have a different impact on the operations of those companies, for example large automotive

companies, whose needs are prioritised by the central and local governments. Investors understand that SEZ policy changes (which are explained in the RDS) will result in a more selective approach to providing support for FDI.

Polish Development Fund and Polish Investment and Trade Agency

The Polish Development Fund Group (PFR) was founded in April 2016 as a replacement for Polish Development Investments, a state-owned company. PFR coordinates development policies and programmes that earlier were supervised by a number of institutions.

This is how Development and Finance Minister Mateusz Morawiecki described PFR's mission: *"We wish to integrate the activities of a number of institutions, including PAED (the Polish Agency For Enterprise Development), IDA (Industrial Development Agency), PITA (Polish Investment and Trade Agency), ECIC (Export Credit Insurance Company) and BGK (National Development Bank), which lead important development initiatives. The end goal is to provide support for small and medium enterprises, foster innovation, increase investments, including foreign investments, and help Polish companies expand onto global markets.*

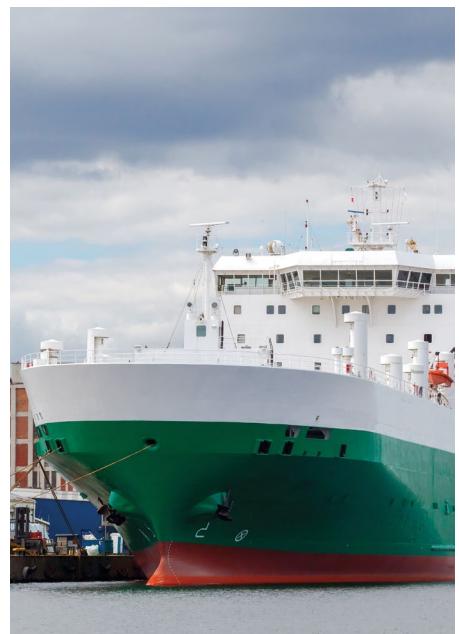
*"All of these institutions do that, but each of them has a different focus. Therefore, the aim of the Polish Development Fund is to integrate all of the functions and activities of these institutions."*⁴⁹

The PFR Group also provides the following services to foreign investors:⁵⁰

- Analysis of the regulatory and business environment,
- Advising on the choice of location,
- Investment incentives,
- Business advocacy,
- Bespoke services

The founding of the Polish Investment and Trade Agency (PITA) coincided with a number of institutional shifts and changes to the economic and foreign policies introduced by the new Polish government after 2015. The government has emphasised in the RDS that the lack of geographical diversity of exports, i.e. the excessive share of trade with EU member states, is a major issue. Therefore, the fundamental goal of Polish

trade diplomacy will be to establish business relationships with non-European markets.⁵¹ Moreover, the PITA budget is three times as big as that of its predecessor, the Polish Information and Foreign Investment Agency.

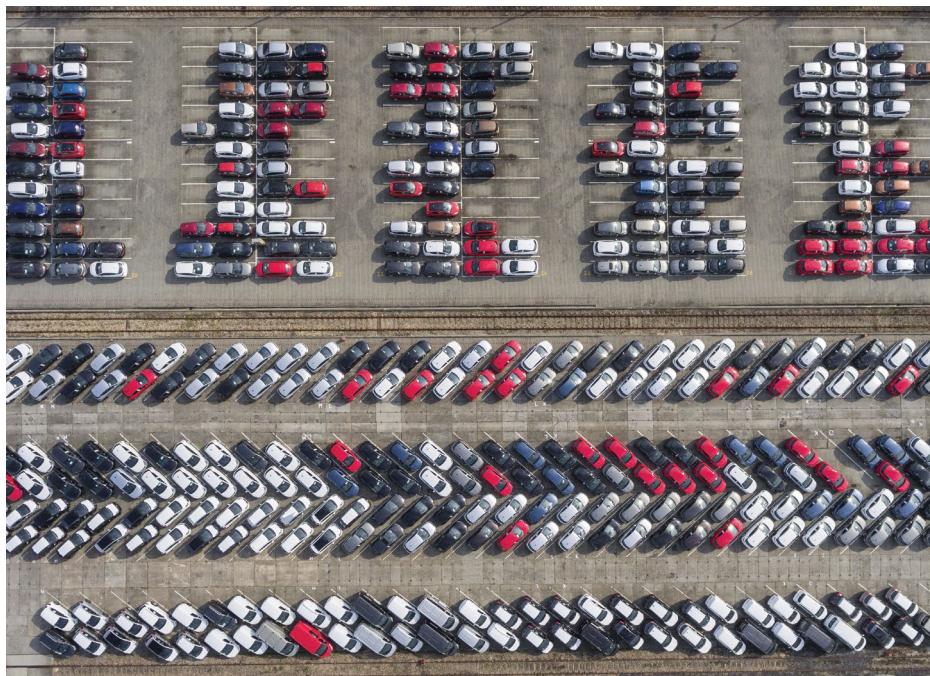


"The time is right for setting up high value-added operations in Poland. Over the next 5 years, Polish and foreign companies will be granted over 10 billion euros in non-repayable grants to open new R&D centers (CAPEX subsidies) and carry out research and development activities (OPEX) in Poland. Currently, foreign investors have access to a system of grants supplemented by SEZ and R&D tax credits, as well as Horizon 2020 programs available across the entire EU. Poland has improved the availability and attractiveness of R&D&I incentives, but obtaining them requires a more specialized approach from investors. If a company wishes to receive subsidies for an R&D project, it is necessary to engage engineers and academics in

preparing the implementation plan. Polish R&D aid programs (including both grants and tax credits) lower the risk of setting up R&D activities by not holding investors accountable for the results of their research. The institutions and experts who assess R&D project proposals are aware that their outcomes are hard to predict and, therefore, do not expect businesses to take on unrealistic obligations.

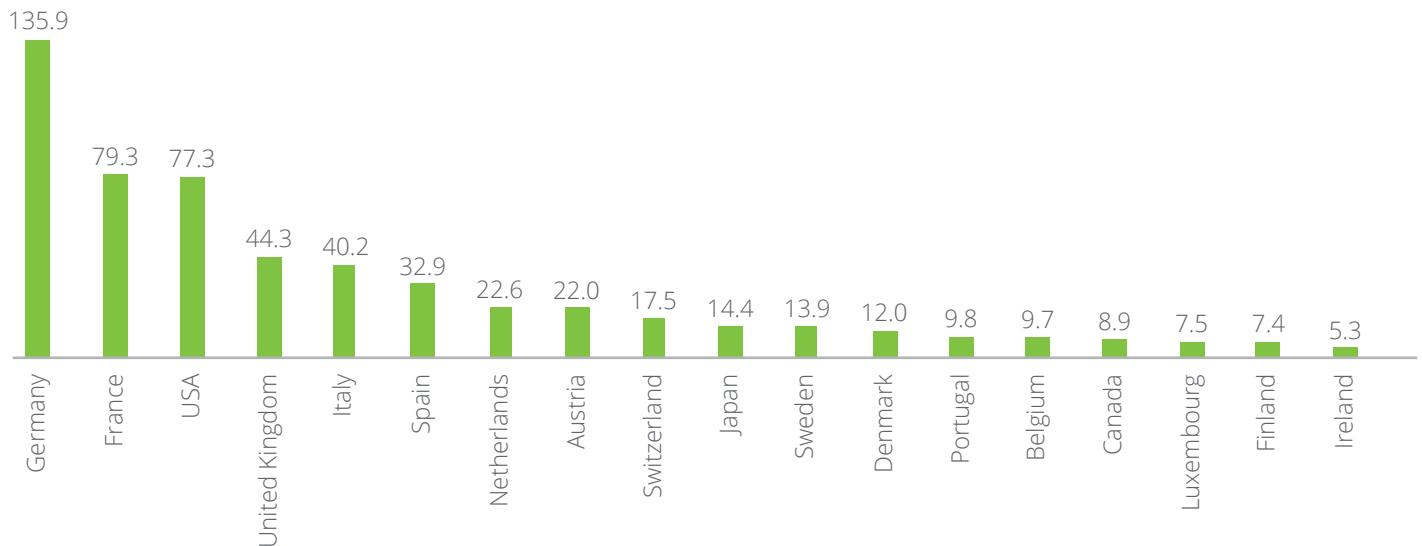
Dominika Orzołek

Senior Manager, Global Investment and Innovation Incentives (Gi3), Deloitte



The experience of German investors in Poland

Germany is the biggest source of foreign direct investment in Poland.⁵² As of 2015, German companies had invested 135.9 billion zlotys. Other major investors include France (79.3 billion zlotys), the US (77.3 billion zlotys), the UK (44.3 billion zlotys) and Italy (40.2 billion zlotys).

Cumulative FDI in Poland by country of ultimate origin (as of 2015, billions of zlotys)

Source: Deloitte, based on data sourced from the OECD

The vast majority (95.6%) of respondents in the AHK Polska survey stated that they would be willing to invest in Poland again. The percentage of "yes" and "no" answers has remained practically unchanged since 2011.

This demonstrates that once the consequences of the 2007-2009 global finance crisis were mitigated, the Eurozone debt crisis that followed did not raise any doubts about the stability of the Polish economy, and FDI continued

to be seen as profitable.

**German investors in Poland - answers to the question:
"Would you be willing to invest in Poland again?"**



Source: Deloitte, based on the AHK survey. The 2017 survey included 369 companies operating in Poland. www.ahk.pl/pl/media/newsy-ekonomiczne/informacje-prasowe/artikel/badanie-konjunktury-edycja-2017

German investors continue to think highly of Poland's membership in the EU, and consider it the key factor in the country's investment attractiveness. The average rating of the EU's importance increased from 2016 despite the Union having suffered setbacks, e.g. Brexit.

The second most important factor listed by representatives of German companies was worker qualifications, followed by the quality and availability of local suppliers and the quality of higher education. The productivity and motivation of workers were also very highly rated. Interestingly, all of the above factors were rated lower than in 2016.

The decline in the rating of workers may be attributed to increasing difficulties in attracting qualified personnel, which is a result of Poland's record-low unemployment rate.⁵³



"Over the years we have seen that German companies have no difficulty navigating the Polish legal environment, especially the commercial law company regulations, due to the similarities between Polish and German commercial law. Nevertheless, foreign investors who are planning to branch out into Poland should focus on several important regulatory aspects. First of all, they should start by choosing an appropriate legal structure for their business. This choice will determine the tax effects and the investor's responsibility for the liabilities of the company, and therefore determine who bears the economic risk. Choosing the right location is equally important. When making this decision, the investor should take into consideration the legal possibilities of purchasing property for the investment. You should keep in mind that agricultural land, despite being conveniently located and attractively priced, is practically impossible to purchase for a foreign investment. Also, the property should be included in the local land-use plan; otherwise it will be necessary to engage in lengthy planning procedures, which could delay the project. All of this means that during the planning stage, it is very important to conduct an audit of the property with regard to the investment's legal aspects, to streamline the entire process."

Grzegorz Gajda

Partner Associate, Head of German Desk at Deloitte Legal

German companies that operate in Poland have a good opinion of the country's infrastructure (although they ranked it lower than in 2016), payment ethics, R&D conditions, access to public and EU subsidies and steps to fight corruption and crime.

The rating in this last category showed the greatest increase in relation to 2016. The ratings of the transparency of the public tender system and R&D conditions have also improved significantly.

Apart from the "availability of qualified employees" category, the biggest decline was in the legal security category (an 8.3% drop from 2016). German investors also gave lower ratings to Poland's political and social stability (a 4.4% decline), flexibility of labour laws (-3.6%) and predictability of economic policy (-2.6%). However, Poland's growing political and regulatory instability is mitigated by its membership in the EU, which guarantees the free movement of people, capital, goods and services.

We have also arrived at some interesting conclusions when comparing the most important barriers for businesses in Germany and Poland as outlined in the 2016/2017 Global Competitiveness Index. The main barriers for Polish companies are tax regulations, followed by, in descending order, labour laws, political instability and tax rates. Therefore, the results of the 2016/2017 Global Competitiveness Index study are consistent with those of the AHK economy survey and the Deloitte survey.

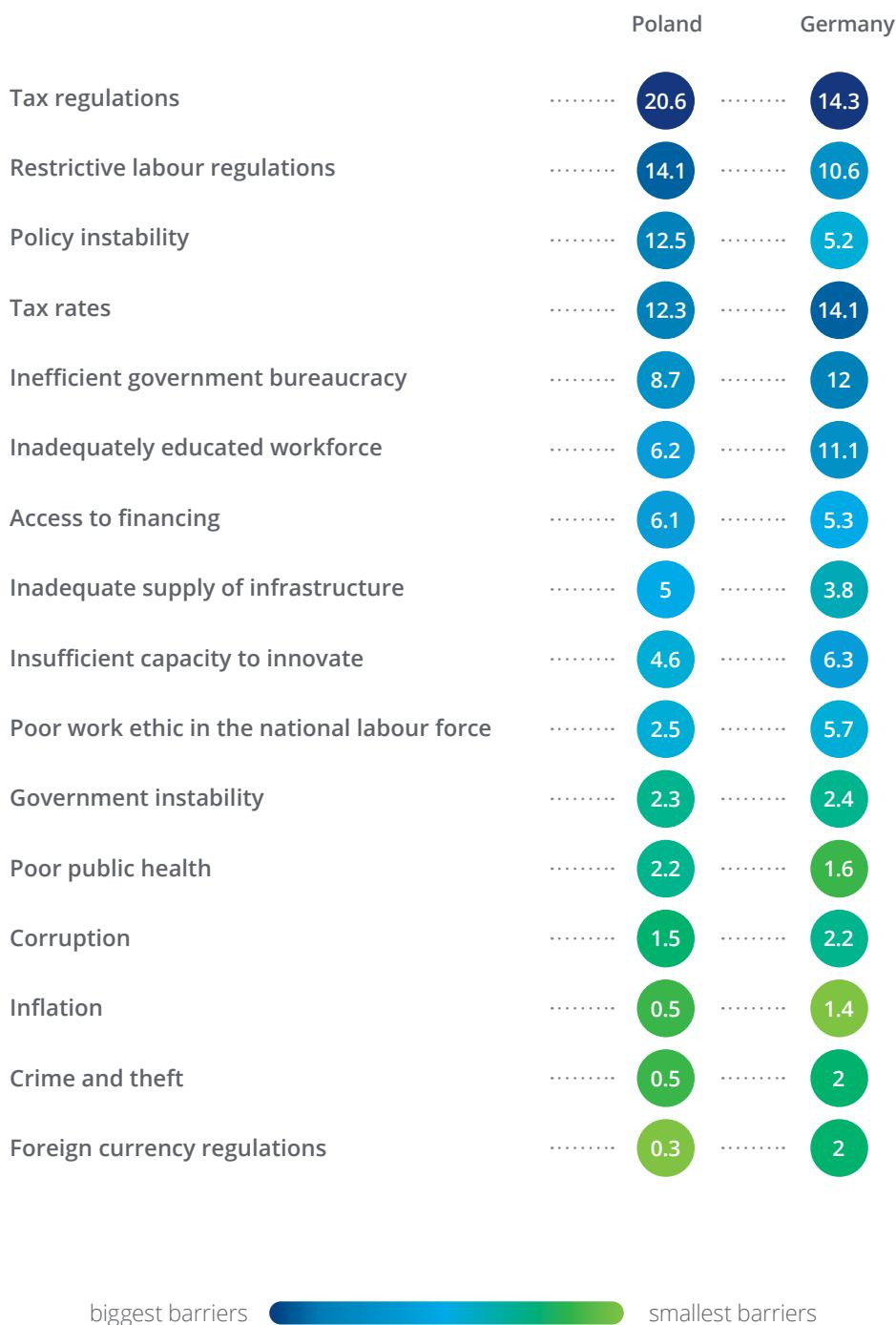
Rating of factors that contribute to Poland's investment attractiveness
- AHK Business Survey Poland 2017



Source: Deloitte, based on data sourced from AHK Poland survey,
<http://ahk.pl/pl/media/newsy-ekonomiczne/informacje-prasowe/artykuly/badanie-konjunktury-edycja-2017>

lowest values  highest values

The most important barriers encountered by businesses in Poland and Germany according to the Global Competitiveness Index 2016/2017



Source: Deloitte, based on data sourced from Global Competitiveness Index 2016/2017

"We have been running studies on German investors in Poland for the last 12 years. In addition to Poland's membership in the European Union, which guarantees that Poland will be included in the European legal system, German investors also think highly of the human capital, including the qualifications and commitment of Polish workers, that is available in the country. Despite rising labour costs, the human factor has been Poland's big advantage for years. Another one of Poland's undisputed strengths is its local networks of professional suppliers who work with foreign companies. Improvements to the country's infrastructure, including transport, energy, IT and environmental solutions, have also been noticed and are appreciated.

When observing the latest economic trends, we may conclude that Poland will try to reclaim its position as the most attractive country for investment in Central Europe. Poland was the regional leader in 2013-2015, but was pushed into second place by the Czech Republic in 2016. Poland's openness to innovations and growing start-up scene will definitely be its strong suits. We are keeping a close eye on the start-up scene and take part in many events during which innovative Polish business ventures are pitched to foreign investors."

Michael Kern
Managing Director, Member of the Board AHK Poland

The results of the 2016/2017 Global Competitiveness Index demonstrate that poor tax regulations, not tax rates themselves, are Poland's biggest issue, a point that has been raised by certain experts and employers' representatives. Complicated German tax regulations and the size of the government's role in the economy are considered to be an almost equally serious barrier to doing business. However, respondents say the inefficient central administration and the mismatch between the vocational education system and the needs of the job market

are even bigger barriers for German businesses.

When assessing all of the changes that are taking place in Poland, German investors still emphasise the strong motivation of workers and employers, as well as the ongoing modernisation of the country. At the same time, they are aware of a gradual change in social attitudes.

Summary

- **The Polish economy has grown consistently since 1991, an achievement that sets it apart from all other EU member states. Moreover, the growth is dynamic: per capita GDP growth (at purchasing power parity) over the last 20 years has averaged 6% per year. That is the best result in Central Europe.** Poland has mostly avoided the consequences of the global financial crisis and the Eurozone debt crisis. The size of Poland's internal market contributed to this stabilisation, but was not as important as the country's responsible monetary policy, efficient supervision of financial markets and flexible exchange-rate regime. Growth was also stimulated by the tax cuts of 2007 and 2008 and the inflow of EU funds.
- **The rapid and stable growth of the Polish economy is based on investments and capital. In 2010-2015, their contribution to Poland's GDP was considerably higher than in other Central European countries, excluding Bulgaria.** The investment slowdown that affected the entire region in 2016 was caused mainly by delays in allocating EU funds and increased uncertainty. Leading financial institutions predict that investments will pick up steam again in 2017.
- **According to numerous indices that measure competitiveness and social progress, Poland is second only to the Czech Republic.** That is because the Czech economy is, for the most part, mature and industrialised. The Czech Republic has the lowest investment risk in the region, but potential investors have to keep in mind that Poland's GDP growth is twice as fast (3% compared to 1.5% in 2010-2015). Poland's institutions, regulations and social progress are rated much higher than their Bulgarian and Romanian counterparts.

- **Even though the Polish economy has grown rapidly over the last 25 years, the potential of the EU's seventh-largest economy (excluding the UK) is far from depleted.** This is evidenced by Poland's considerably lower productivity compared to more developed EU countries and its still low capital stock. Poland has managed to double the amount of capital per worker in the last 20 years, which allowed it to overtake Slovakia and Hungary. Nevertheless, the traditionally industrial economy of the Czech Republic still has almost two times as much capital stock.

- **The relatively low value of production capital in Poland ensures high rates of return on investment.** Marginal capital productivity in Poland is almost 4 times higher than in the Eurozone (based on the 2006-2016 average),

and higher than in Slovakia, the Czech Republic and Hungary. There are vast reserves for improving productivity and, consequently, opportunities for profitable investments in neighbouring countries as well, especially considering current conditions in the Eurozone and the ECB's monetary policy.

- **Manufacturing, which has received approximately 230 billion zlotys of FDI, i.e. 1/3 of the total capital invested in Poland, is one of the most attractive sectors for investment.** The business services (BPO/SSC) sector, which continues to grow by 20% year-on-year and is predicted to employ 300,000 workers by 2020, is gaining in importance.

- **Germany is the biggest source of foreign direct investment in Poland. As of 2015, German companies invested 135.9 billion zlotys in the country, accounting for almost 1/5 of all FDI.** German investors continue to think highly of Poland's membership in the EU, as it translates into a stable, high-quality regulatory environment. Other factors that encourage German companies to invest in Poland include employee qualifications, productivity and motivation, as well as the high quality and availability of local suppliers.



Appendix: Overview of forecasts for the Polish economy

In the first quarter of 2017, Poland was the second-fastest growing EU economy (along with Lithuania). Seasonally adjusted annual GDP growth stood at 4.1%.⁵⁴ Romania took the lead, with growth of 5.6%. Other Central European countries, i.e. Hungary (3.7%), Bulgaria (3.4%), Slovakia (3.1%) and the Czech Republic (2.9%), also did well. Average GDP growth in the EU-28 stood at 2% (1.7% in Germany).

According to forecasts from leading financial institutions, Poland's annual GDP growth will be lower than the 4.1% it achieved in the first quarter. The lowest estimate is 3.2% (EBRD); the highest is 3.7% (NBP). It is also worth noting that the Ministry of Finance is the only institution to predict that Poland's GDP growth will accelerate in 2018 and 2019.

The International Monetary Fund forecasts that the Slovakian and Romanian economies will grow faster than Poland in 2017-2019. Slower GDP growth is expected in Bulgaria, the Czech Republic and Hungary.

Leading institutions' forecasts for Polish GDP growth, 2017-2019

	2017	2018	2019
Ministry of Finance	3.6%	3.8%	3.9%
National Bank of Poland	3.7%	3.3%	3.2%
World Bank	3.3%	3.2%	3.2%
European Bank for Reconstruction and Development	3.2%	3.2%	-
European Commission	3.5%	3.2%	-
International Monetary Fund	3.4%	3.2%	3.0%

Source: Convergence Program. 2017 Update, National Bank of Poland, Current Inflation and GDP forecasts (published on 13 March 2017), www.ec.europa.eu/info/business-economy-euro/economic-performance-and-forecasts/economic-performance-country/poland/economic-forecast-poland_en, World Bank, Global Economic Prospects.2017

The IMF's annual GDP growth forecasts for 2017-2019, CE countries and Germany

	2017	2018	2019
Bulgaria	2.9%	2.7%	2.5%
Czech Republic	2.8%	2.2%	2.2%
Hungary	2.9%	3.0%	2.6%
Poland	3.4%	3.2%	3.0%
Romania	4.2%	3.4%	3.3%
Slovakia	3.3%	3.7%	3.2%
Germany	1.6%	1.5%	1.4%

Source: MFW, World Economic Outlook, updated in April 2017

Endnotes

1. GDP in constant prices, data sourced from IMF – World Economic Outlook.
2. World Bank, World Development Indicators.
3. Ibid.
4. Ukraine, where no major reforms were put in place after 1989, is one of the best examples of a lack of convergence despite enormous potential (e.g. to increase productivity). Despite being at a similar level of development as Poland in 1989, the country is now lagging far behind despite its considerable growth potential. According to the IMF, countries that promptly introduced comprehensive reforms were "rewarded" with rapid economic growth. Moreover, those countries were able to start catching up to developed countries. Cf. IMF, 25 Years of Transition: Post- Communist Europe and the IMF, 2014.
5. The issue of a lack of credible data or any data at all mostly concerns the 1989-1993 period, as many countries in the region were struggling with high inflation or even hyperinflation, and the national statistics offices were not yet able to correctly measure such phenomena in a free-market environment.
6. Compound Annual Growth Rate (CAGR)
7. According to EBRD estimates, a 1 percentage point drop in GDP in the Eurozone results in an 0.8 percentage point drop in transitional economies. Poland, which proved to be resilient to economic slowdowns in external markets, is an exception to this rule. Cf. EBRD Transition Report 2016-2017.
8. The size of the economy and internal demand in relation to GDP can increase stability in the short term. Poland's foreign-trade-to-GDP ratio stands at 33%, whereas in the Czech Republic, Slovakia and Hungary it ranges from 60% to 75%. Source: Deloitte, Investing in Central Europe, Your Move in the Right Direction, December 2016
9. The fundamental role of institutions (and the rule of law as the overarching institution) has been the subject of countless studies since the time of the fathers of modern economics, i.e. Adam Smith and John Stuart Mill. Some of the more recent empirical studies on the topic include: Fischer S., The role of macroeconomic factors in growth, 1993; Hall R. E., Jones Ch. I., Why Do Some Countries Produce So Much More Output per Worker than Others?, 1999; Rodrik D. et al., Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development, 2002.
10. For example, the US is the world's biggest economy, with the biggest internal market, therefore it does not rely on exports (it is definitely less dependent on exports than smaller economies, such as Slovakia and Hungary), but it has nevertheless gone through several recessions in the last few decades.
11. Literature proves that recessions caused by financial instability are longer and more severe. Cf. Claessens et al., 2011.
12. In short, economic policy can contribute to increased stability if it lowers (rather than increasing) cyclical GDP fluctuations and no trade-offs are made in other areas (e.g. the real estate market, the loan market, etc.) for the sake of stability.
13. Piątkowski M., How Poland Became Europe's Growth Champion: Insights from the Successful Post-Socialist Transition, Wednesday, February 11, 2015
14. Obviously, political processes are important risk factors (e.g. the election calendar) and may lead to changes in economic policy, especially with the aim of "stimulating" GDP growth.
15. MFWIMF, 25 Years of Transition: Post-Communist Europe and the IMF, 2014
16. Poland's decision not to adopt the Euro and its impact on the economy sparked a more heated discussion among economists. On the one hand, retaining the Polish złoty allows it the currency to be used as a "shock absorber" that mitigates the effects of stresses in the global economy and makes exports more profitable. On the other hand, the decision not to adopt the Euro meant that the Polish government was not pushed to introduce additional structural reforms that would have made public finances more stable and the job market more efficient.
17. GDP by country (not taking into account purchasing power parity).
18. According to the EBRD report, these barriers include the economy's reliance on unfavourable sources of financing: in the past Poland was overly dependent on foreign-currency loans. At the same time, stock and bond markets provide relatively little financing when compared to bank loans. EBRD, Transition Report 2015-16, Rebalancing Finance.
19. According to the EBRD, the slower productivity growth is a result of the stagnation in implementing structural reforms, which still affects the entire Central European region following accession to the EU. EBRD, Transition Report 2013, Stuck in Transition?
20. Lewandowska-Kalina M. (2012), Productivity dispersion and misallocation of resources: evidence from Polish industries, Warsaw School of Economics
21. Stanilko J. F., Jak zbudować potencjał przemysłowej rywalizacji? Determinanty konkurencyjności polskiego przemysłu w kontekście wdrażania perspektywy finansowej 2014-2020.
22. Geodecki T. et al (2012), Kurs na innowacje. Jak wyprowadzić Polskę z rozwijowego dryfu?
23. The long-term (1995-2015) and recent (2010-2015) timeframes were outlined to determine which, if any, structural changes in Central European economies could have been caused by the financial crisis of 2007 and the Eurozone crisis that followed. As relatively small and open economies, they are very dependent on importing capital (in the form of FDI, but also public and private debt financing), exporting goods and services and importing technology.
24. Polish society is still young when compared to other EU member states, but it is ageing at a rapid pace.
25. FOR, Następne 25 lat. Jakie reformy musimy przeprowadzić, by dogonić Zachód?, 2015
26. According to the RDS, the biggest issue in the coming years will be the diminishing ability to compete using low labour costs, which will not be counterbalanced, at least initially, by innovation and value added per unit.
27. World Economic Forum, Global Competitiveness Index 2016/2017.
28. External effects are "a phenomenon in which some expenses or benefits that are result of the activity of an entity are transferred on to third entities with the former entity failing to account for their impacts." Source: Online Economics Education Website of the National Bank of Poland
29. 1,734 companies took part in the survey, of which 396 were from Poland, 230 from Hungary, 138 from the Czech Republic, 176 from Slovakia, 102 from Bulgaria and 120 from Romania. AHK Polska, Ankieta koniunkturalna 2017. Polska w ocenie inwestorów zagranicznych.
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33. P. Bogumił's (2014) analysis concludes that FDI in the manufacturing and tradables sectors have has the biggest influence on the economy of the destination country, as they have it has a positive impact on exports and manufacturing capabilities.
34. MFWIMF, Republic of Poland. Selected issues, 2015
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37. This is visible in the GDP growth breakdown.
38. It is theoretically possible to reach a high level of marginal productivity in poor countries, but the costs of sourcing capital, qualified workers and all other expenses, e.g. transaction costs, may lead to the financial rate of return being the same as in developed countries (or marginally higher). Additionally, investment risk should also be taken into consideration. Cf. Lucas, R. E. Jr., Why Doesn't Capital Flow from Rich to Poor Countries?, 1990
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50. Puls Biznesu, <https://www.pfr.pl/pl/oferta/#firmy-zagraniczne/14/219>
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52. According to OECD statistics by partner country.
53. The availability of workers with technological or vocational education and the number of graduates with STEM degrees is becoming an increasingly important factor in drawing FDI to Poland. The increasing cost and time required to recruit employees has probably contributed to Poland's lower ratings in categories tied to the job market and education.
54. Eurostat data.

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