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PANORAMA POLAND INSOLVENCIES

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by Grzegorz Siewicz
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Poland is a headline example of the country that didn't record recession in recent years. However, in micro terms companies insolvencies have been on rise since 2008 and 883 bankruptcies in 2013 is even the highest result in 9 years history. The decreased internal demand caused less contribution to the country's GDP growth and it was directly perceived by Polish companies. This year brought better outlook with the slow recovery of Eurozone which is the main trading

partner of Poland and improved labour market data which should lead to a momentum for private consumption. The constraint came from a stagnation in Russia which was 5th largest receiver of Polish exports triggered then by the Russia-Ukraine conflict and trade disruptions. On the internal side, Polish households have started to increase their consumption modestly, focusing more on daily necessities than durable goods. It proves they are not convinced of the long-term improvement of their financial situation.

Against the backdrop above, has the rising trend of companies insolvencies been stopped? Have companies suffered from a modest improvement of internal demand and will they be harmed by uncertainties on the external side: the stagnation of Russian economy and introduced embargo as well as Eurozone's disappointing recovery? And last but not least, what is the outlook for insolvencies in Poland in the near future?

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WILL THE ECONOMIC SLOWDOWN AND TRADE DIFFICULTIES ON EXPORT MARKETS AFFECT THE NUMBER OF INSOLVENCIES IN POLAND?



BY OUR ECONOMIST

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The insolvency statistics of Polish companies finally bring a relief. The rising trend of bankruptcies initiated in late 2008 seems to be discontinued. Polish companies have had to face in that period volatilities of domestic and external markets after a collapse of the Lehman Brothers, double-dip recession in the Eurozone – their main exports destinations as well as a domestic slowdown with subdued local demand. Then, better prospects of domestic and external situation translated not only to stabilization of insolvencies but even its sizeable decrease.

At the same time, the construction sector has finally stopped to be a long-term negative performer of insolvency statistics. It suffered from a contraction from a previous booming period as well as severe competition and a necessity of accepting low or even negative margins to remain in business.

Currently, brighter prospects include companies' intentions to rebuild investments in fixed assets and a rebounding housing market, both supported by the

« **Uncertainties on external markets will have a negative effect on the level of companies insolvencies in Poland** »

historically low interest rate environment. Nevertheless, the business confidence is constrained currently by uncertainties coming from an external side – prospects for the Eurozone economy and the neighbouring Russian market. Our Panorama focuses on possible external developments of current economic conditions with our assumptions on their impact on the level of companies insolvencies in Poland. But before that, the publication deals with insolvency statistics in the first half of this year with sectorial insights.

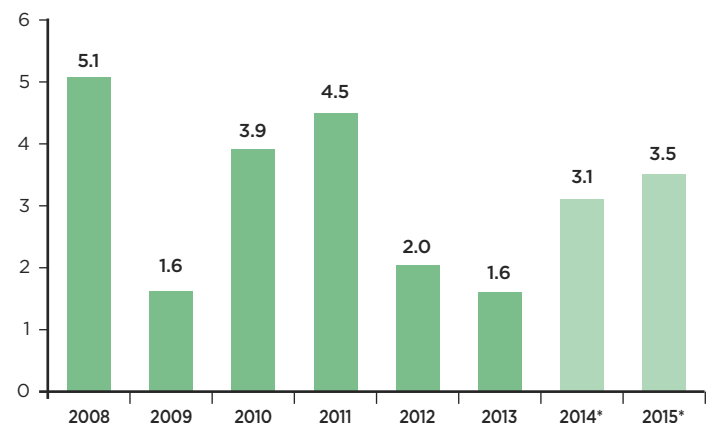
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ON A RECOVERY PATH AMID EXTERNAL RISKS

Many economies across the globe have experienced turbulences in recent years. In that period the Polish economy was stable and it didn't recorded recession either in the first stage of crisis triggered by the collapse of Lehman Brothers bank or its further deepening when the Poland's main trading partner Eurozone fell into double-dip recession. Stable private consumption has been one of the crucial supportive factors and contributed positively to GDP growth. The Polish economy is relatively less open than other economies in the Central and Eastern Europe (CEE) region.

Exports represent just 48% of the country's GDP in 2013 whereas that ratio was 96% in a case of Hungary and 79% in a case of the Czech Republic. Nevertheless, the latter economies are smaller ones and they cannot benefit from a significant nominal contribution of domestic consumption. Poland with the 38 million inhabitants can rely of that factor and remains quite independent from whims of external demand.

Chart 1: Poland's GDP growth rate (%)



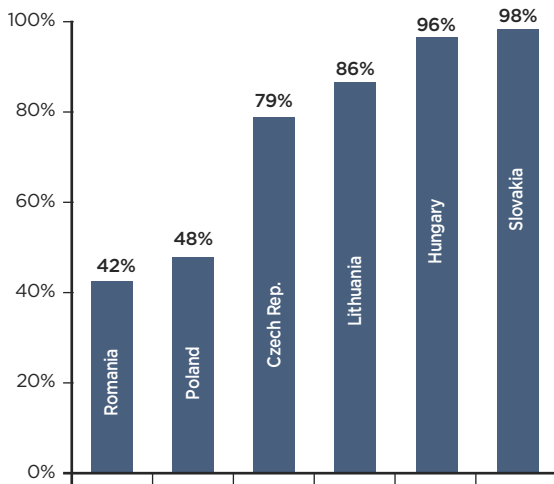
* Coface forecasts

Source: Central Statistical Office, Coface

The year 2013 made a different picture. Households reduced their shopping and focused mainly on daily necessities. Their concerns included not only the level of their wages but also maintaining their jobs in general. The unemployment rate increased from the 2009 average of 8% to nearly 11% recorded in the first half of 2013 (according to Eurostat data)⁽¹⁾. The latter period was the most difficult one since the financial crisis has evolved. The Polish economy experienced flat dynamics of private consumption and contraction of fixed assets investments. Exports remained growing however just by weak 2% facing low demand from the Eurozone area where Poland sends more than half of its exports. Therefore signs of Eurozone recovery indicated in the second half of 2013 made brighter outlook for Poland as well as other CEE economies.

Last months showed that some dark clouds covered a bright sky of Polish recovery. The Polish labour market remains to be supportive with a decreasing unemployment rate and growing wages. However, detailed retail sales data prove that households are still reluctant to significantly increase spending on durable goods. It confirms that their confidence is not at full recovery, especially that credit growth dynamics remain at positive but still at low levels. The external side generates more risks than opportunities. Trade disruptions include a slowdown of neighboring Russian economy and recently implemented embargo on selected products. More to that, the recent performance of the most important trading partner, the Eurozone, shows that the momentum of its recovery has been lost. The German growth contracted by 0.2% q/q in Q2 2014 whereas the French one stagnated in both quarters of this year.

Chart 2: Exports to GDP ratio in selected CEE economies (2013)



Source: Eurostat

Germany remains the most important trading partner in the CEE region. Poland exported to Germany goods worth EUR 39 billion in 2013, i.e. ¼ of total exports. European Union countries are the main receivers of Polish exports (a share of 75% of total exports) however the bottom of top 5 classification took Russia with 5.3% of total Polish exports in 2013.

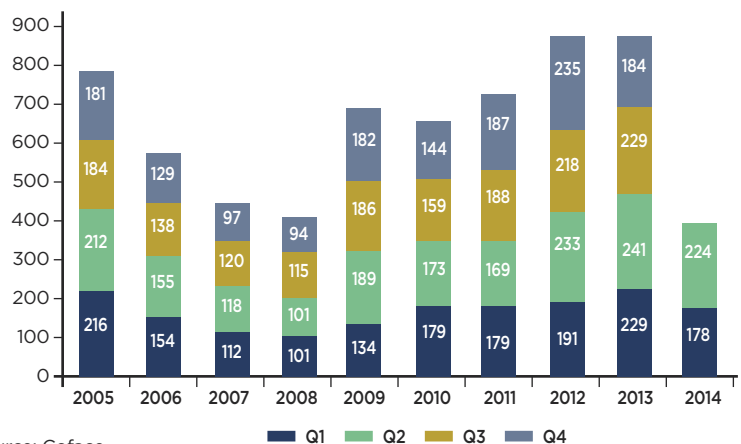
The first half of 2014 brought improvement in the Polish domestic demand. Companies have started to assess better their perspectives facing more demand for their products and services coming from Western Europe. They were willing to make new fixed assets investments (growth of 9.3% y/y in 1H 2014) as well as hire new employees. Households benefited also from growing wages which translated to increased propensity to spending. The Polish economy grew by 3.4% y/y in the first half of 2014 with rebalancing from net exports towards private consumption.

Insolvencies Barometer - How much has macro environment impacted insolvency statistics?

The challenging macroeconomic conditions last year have impacted business insolvencies negatively. Companies defined the year 2013 as a difficult period in their business activities as they experienced decreased internal and external demand. The number of insolvencies have peaked in the middle of 2013 – it reached the highest level since 2005 with 470 insolvencies in just the first half of 2013. Then, the improved economic prospects were reflected in companies insolvencies which recorded a sizeable decrease at the end of last year. Nevertheless, it should be noted that December data were affected by a holiday period which due to calendar differences was longer than usual.

The improvement is being continued. First months of 2014 with rising internal demand and growing exports were beneficial for Polish companies. The first half of 2014 brought 402 insolvencies, i.e. 11.5% less than a year before. On the other hand, the number of insolvencies is still twice as high as in the pre-crisis first half of 2008.

Chart 3: Companies insolvencies in Poland



Source: Coface

(1) Labour Force Survey. According to the national methodology the unemployment rate exceeded 14% in the first quarter of 2013.

A Sector Analysis- Insolvencies still on rise in some sectors

Construction

Finally insolvencies of the construction sector, which was a long-time negative performer, have stopped to increase. Moreover, current statistics show that there are less insolvencies of construction companies by 21% than a year ago. Nevertheless, there are less companies active in the market compared to few years ago. They have been decimated by huge insolvency dynamics which started in 2009 (a heat map below). Positive news include also restraining further insolvencies of companies linked with the construction sector. Last year many manufacturers, suppliers and distributors of construction materials, steel and wooden constructions and reinforcing bars as well as machinery manufacturers experienced delays in payment schemes and had to file for insolvency. This 'domino effect' triggered the highest insolvency levels among manufacturing companies in 2013.

Chemicals

The sector generated an increase of insolvencies by 25% in the first half of 2014 however it results from a low number of entities of that sector in statistics. In nominal terms, it equaled to only one more insolvency compared to a previous year. The significant part of the chemicals sector in Poland includes producing of fertilizers with a

strong dependence on gas as the main resource used in production. Current risks relate to an uncertainty of supply from Russia as well as the level of gas prices that Poland will be charged. In the past there have been crucial differences between prices paid by receivers of the Russian gas. Poland tries to diversify sources of gas supply however it will not be possible to abandon imports from Russia completely.

Retail

The households' low propensity to spend contributed to rising insolvencies of retail sector (+27% y/y). The consolidation process of the sector is ongoing with severe competition of companies fighting for profits amid a necessity of accepting low margins. Consumers are still very cautious in their purchasing decisions despite improvement of the labour market. The weak demand for durable goods is confirmed by one of the biggest insolvency this year - Domex, the owner of Avans stores, which included 250 stores with 3,000 employees, was declared insolvent in May. According to estimations the company indebtedness exceeded EUR 106 million and it recorded a loss of EUR 4.8 million at end 2013.

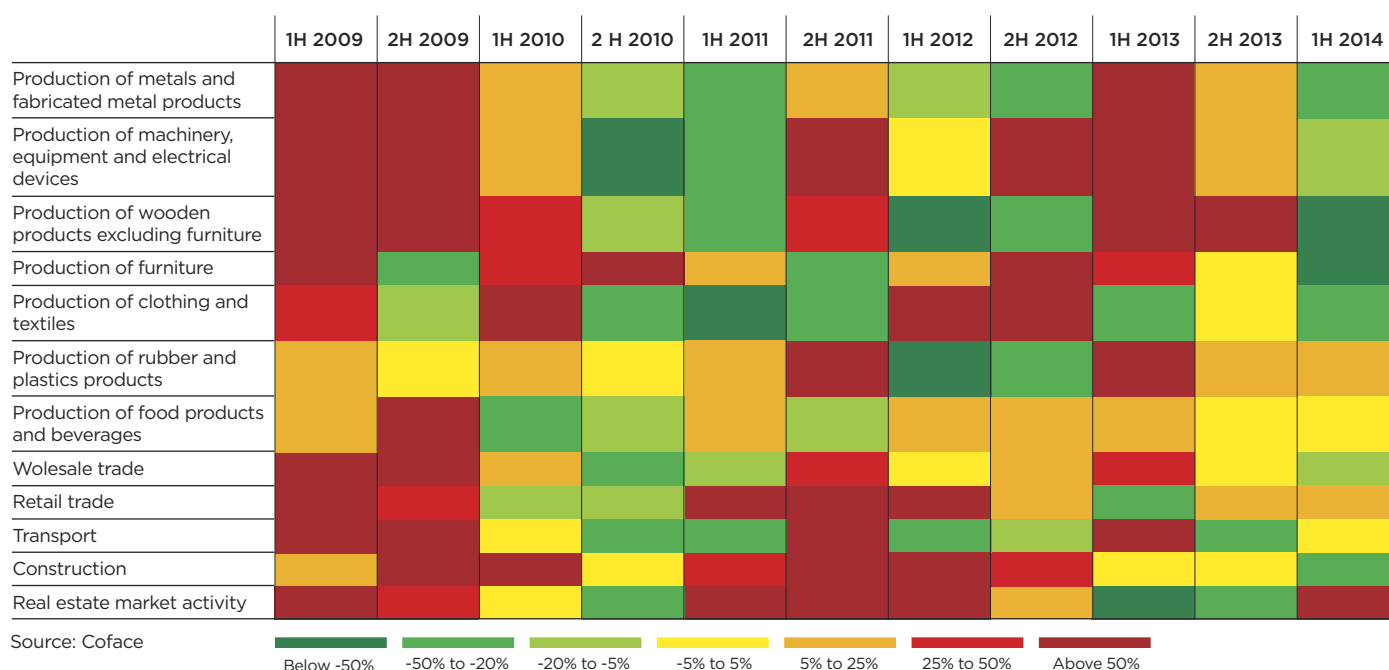
The heat map below confirms that temporary periods of decreased insolvencies were not sufficient to turn into sustainable improvement of the sector.

Chart 4: Companies insolvencies by sectors in 1H 2014

Sector	Insolvencies in 1H 2014	Change y/y	Share
PRODUCTION, including:	112	-25%	27.9%
Manufacturing including, but not limited to:	100	-29%	24.9%
Production of food products and beverages	21	0%	5.2%
Production of metals and fabricated metal products	20	-38%	5.0%
Production of machinery, equipment and electrical devices	14	-7%	3.5%
Production of rubber and plastic products	7	17%	1.7%
Production of chemicals and chemical products	5	25%	1.2%
Production of paper and paper products	5	-50%	1.2%
Production of clothing and textiles	5	-44%	1.2%
Production of furniture	4	-67%	1.0%
Production of wooden products excluding furniture	4	-64%	1.0%
Production of goods from other non-metal natural resources (including construction materials)	3	-50%	0.7%
Other manufacturing	7	-42%	1.7%
TRADE including, but not limited to:	104	-6%	25.9%
Wholesale	62	-13%	15.4%
Retail	33	27%	8.2%
CONSTRUCTION	84	-21%	20.9%
TRANSPORT	18	0%	4.5%
Other sectors	84	18%	20.9%
TOTAL	402	-12%	100.0%

Source: Coface

Chart 5: Heat map of insolvencies by selected sectors in respective semesters (dynamics),



Transport

The insolvencies of transport companies have stood at the same level as a year ago. However the heat map shows that insolvency dynamics of the transport sector have significantly fluctuated in previous periods. The sector's performance is subject to external demand due to a strong exposition of Polish transport companies to providing international services. The current external trade disruptions point to increase of insolvencies in next quarters. Moreover, the competition in that sector is also strong and it imposes the acceptance of lower margins amid stable fixed costs. Moreover, the transport sector requires regular investments, especially in vehicle fleets in the case of road goods transport. This is determined not only by the age of the fleet but also imposed by regularly increased European emission standards, with the current Euro VI standard required for new heavy duty vehicle registrations as of 1 January 2014.

Insolvencies by business legal form

If we look at different legal forms of insolvencies, it can be noticed that all forms recorded a decrease of insolvencies, except of limited partnerships (a business form in which partners are liable only to the extent of invested money) and cooperatives (association owned and operated by members). On the other hand, the limited liability companies (a legal form that provides limited liability to its owners) were going bankrupt the most frequently, what was already experienced in previous statistics; however their share decreased to 55% compared to 66% in 2011. There were less insolvencies of sole traders but their share has been rising from 16% in 2011 to one quarter of total currently. The same phenomenon is experienced by joint-stock companies which constituted 1 out of 10 all insolvent companies.

Chart 6: Insolvencies by business legal form

Legal form	Number of bankruptcies in 1H 2014	Change y/y	Share in total
Ltd.	221	-15%	55%
Sole trader	100	-9%	25%
Joint-stock company	40	-11%	10%
Registered partnership	19	-14%	5%
Limited partnership	12	+50%	3%
Cooperative	9	+80%	2%
Other forms	1	-83%	0.2%
Total	402	-11.5%	100%

Source: Coface

2 WILL CURRENT EXTERNAL TURBULANCES AFFECT THE NUMBER OF INSOLVENCIES IN POLAND?

The current external situation generates risks for the Polish economy. In August 2014 Russia introduced embargo on meat, fish, fruit, vegetables, milk products from EU, US, Australia, Canada and Norway as retaliation measures for US/EU sanctions. The Russian embargo makes a constraint on a part of Polish exports. It includes just 0.5% of Polish total exports but more than 10% of its exports to Russia. Going further 80% of Polish agro-food exports to Russia are currently banned. Many Polish companies which focused on trading with Russia are forced now to look for other markets.

Chart 7: Poland's top 5 trading partners (by exports in 2013)

Trading partner	Share
Germany	25.1%
UK	6.5%
Czech Republic	6.2%
France	5.6%
Russia	5.3%

Source: Central Statistical Office

Before the introduction of retaliation measures by Russia, Poland has already experienced periodic difficulties in trade with its eastern neighbor. Temporary bans for particular products have been already implemented in the past and made many companies ready somehow for such trade disruptions. Nevertheless, the current measure is a wide embargo with one-year validity, if not waived before. The slowdown of the Russian economy already brought a contraction of Polish exports. In EUR terms they slumped by 10.5% y/y in the period of January-July 2014, moving Russia from 5th to 6th rank in Poland's top trading partners by exports. In macro terms, such contraction of Polish exports is not dangerous. Polish external trade to Russia decreased by EUR 500 million in January-July 2014 compared to a corresponding period of a year before.

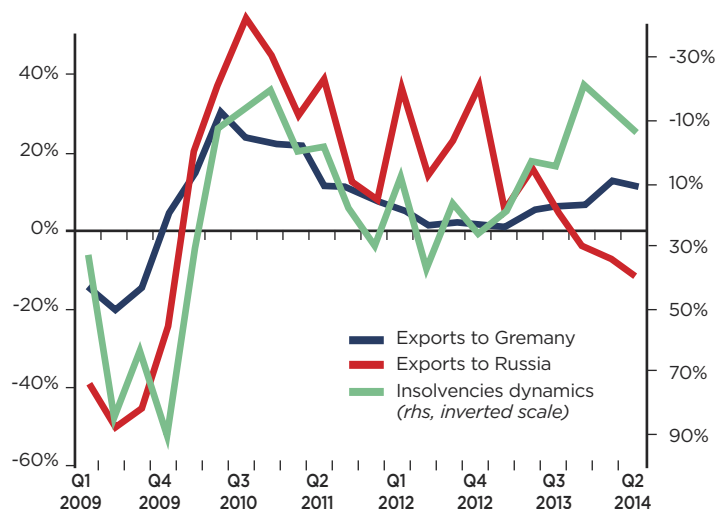
However facing increased demand coming from the Eurozone, Polish exports to Germany were higher by EUR 1.9 billion in the same period making nearly four times compensation of contraction of Russian exports. That optimistic picture turns into pessimistic ones when concluded in micro terms. Many Polish companies have had ongoing trade relations with Russian counterparties for several years. If the slowdown of Russian economy is extended by embargo actions, it translates to closing a sizeable market for Polish entities. Alternative markets cannot be defined and targeted day by day, especially it concerns a huge neighboring market.

On the other hand, the recent external risks include also a disappointing recovery of the Eurozone where Poland sends more than half of its exports. The second quarter of this year brought a slowdown of the main Eurozone economies affecting also other economies cooperating with it. Four out of five Poland's top exports destina-

tions recorded flat GDP growth at most in quarter-on-quarter terms: Germany -0.2%, the Czech Republic 0%, France 0%, Italy -0.2%. As a consequence, Polish exports dynamics were lower in a case of those markets in the second quarter of 2014. Prospects of a continued slowdown of the Eurozone put a pressure on the Polish economy and many companies trading and cooperating with western entities. Since trade relations with Eurozone, especially exports to Germany are so significant, how does it impact companies insolvencies? Is deterioration in external trade to Russia affect the level of bankruptcies in Poland? In order to measure it we will calculate a correlation coefficient⁽²⁾ to analyze links between Polish exports to Germany and Russia and dynamics of companies insolvencies in Poland. The sample of data includes data starting Q1 2009 till Q2 2014.

Not surprisingly, Polish total exports correlate strongly with exports to Germany. The correlation coefficient equals to 0.96 if analysed from 2009 till Q2 2014. However, the correlation coefficient in a case of exports to Russia in the same period is relatively strong as well and it equals to 0.84. Does it mean that fluctuations of exports contribute to the level of insolvencies in Poland? The most impact still comes from internal consumption as Poland is a country with a significant consumer base and it is not exposed to international trade as much as most of other CEE economies. However, external business activities of Polish companies remain significant for their overall performance. The correlation coefficient of Polish exports dynamics to Germany and the level of companies insolvencies reached -0.69 whereas in a case of exports to Russia it amounted to -0.65 in the analysed period. Polish companies are willing to take more exposition on foreign markets diversifying their consumer base between domestic and external markets.

Chart 8: Yearly dynamics of Polish exports to Germany and Russia and companies insolvencies



Source: Eurostat, Coface

(2) The correlation coefficient is a measure that determines the degree to which two variable's movements are associated. It varies from -1 to +1 whereas -1 indicates perfect negative correlation and +1 indicates perfect positive correlation.

Nevertheless, it results in higher dependence on the performance of economies abroad. If trading partners have to face deteriorated economic conditions, such a slowdown also affects Polish companies leading even to a serious decrease of their payment solvency. Indeed, the coefficient of determination confirms that exports from Poland contribute considerably to dynamics of local insolvencies⁽³⁾. In a case of exports to Germany it was 0.48 and in a case of exports to Russia it was 0.42 in the analyzed period. Concluding, the performance of the German economy is an important factor for Poland. Those links are visible not only in macroeconomic terms but also within companies. Polish insolvencies are sensitive for exports coming from Poland to Germany as it is the most important destination of Polish exports. However, the external trade links with Russia, which is the Poland's 6th biggest trading partner by exports volume recently, make a relatively sizeable effect on Polish insolvencies as well. Even in a case of less open economies like Poland, the deterioration of external trade can trigger the number of insolvencies. The contraction of exports increases risk of many local companies to some extent, especially if they are directly cooperating with their counterparties which suffer from the economic slowdown.

Chart 9: Coefficients of relations of Polish exports to insolvencies

Indicator	Correlation coefficient (R)	Coefficient of determination (R ²)
Total exports / Exports to Germany	0,96	0.92
Exports to Germany / Polish insolvencies	-0.69	0.48
Total exports / Exports to Russia	0.84	0.70
Exports to Russia / Polish insolvencies	-0.65	0.42

Source: Coface

If exports contribute to dynamics of insolvencies in Poland, what level of companies bankruptcies can be expected as a result of implications coming from the external side? First of all, the current macroeconomic outlook for Poland's crucial trading partners is mixed.

Chart 10: Coface growth forecasts

	Coface GDP growth forecast	
	2014	2015
Eurozone	0.9%	1.3%
Germany	1.6%	1.8%
Russia	0.0%	1.0%
Poland	3.1%	3.5%

Source: Coface

The sluggish recovery of Eurozone which can be even defined as a temporary slowdown was experienced in the second quarter of 2014. The third quarter was still challenging however Coface forecasts that the whole this year brings improvement with the Euro-zone growth rising from -0.4% in 2013 to 0.9% in 2014. In the same period the Russian slowdown will cause that the growth rate of 2014 will not rise from 1.3% recorded last year.

Theoretical considerations of relations between Polish insolvencies and economic performance of exports markets lead to calculating how much a decrease of GDP growth of main trading partners will affect the level of bankruptcies in Poland. As Germany is Poland's crucial trading partner such relation is much higher than in a case of the outcome of Russian economy. A decrease of 1 p.p. of growth in Germany would lead to increase of Polish insolvencies by 4% whereas the same decrease of Russian growth would lead to insolvencies in Poland higher by 1.3%.

What dynamics of insolvencies can be anticipated in Poland due to performance of main exports markets? As recent developments in economies of Poland's main trading partners generate mixed signals regarding their future progress let us assume three external scenarios and then check which one is the most likely:

1) Recession

The Eurozone does not come back on the recovery track and falls into recession. Industry indicators record weaker results, households are reluctant to increase their consumption as they are afraid about losing jobs. The ongoing presence of Russian army in eastern Ukraine makes EU/USA to implement further sanctions. Russia implements further retaliation measures. The slowdown in Russia turns into recession. The deteriorated economic conditions on crucial exports markets result in an increase of insolvencies in Poland by 21%.

2) Stagnation

The economy of Eurozone including Germany is not improving and it generates flat growth. German exports grow but at weak levels. The slowdown in Russia is anticipated to remain over next quarters. The conditions above would make insolvencies in Poland growing by 8%.

3) Strong recovery

The German exports benefit from strong demand on worldwide markets as well as internal demand. Other Eurozone economies come back on the sustainable recovery track. Russia moves back its military troops from Ukraine what makes EU/USA to waive sanctions. As a consequence Russia waives embargos. The Russian economy escapes from a slowdown. The improved economic conditions on crucial exports markets result in a decrease of insolvencies in Poland by 19%.

(3) The coefficient of determination indicates how much of the variability of a factor can be caused or explained by its relationship to another factor. It varies from 0 to 1 whereas a higher value indicates the stronger relationship between two factors.

Chart 11: Scenarios affecting the level of companies insolvencies in Poland

Scenario for external side	Details	Forecasted increase (+) / decrease (-) of insolvencies in Poland
1) Recession	Eurozone incl. Germany falls into recession, Russian recession	+21%
2) Stagnation	Germany and Russia generates flat growth	+8%
3) Strong recovery	EU/USA waves sanctions, Germany boosts Eurozone growth, Russia waves embargo	+19%

Source: Coface

Assuming the current Coface forecasts of GDP growth presented in chart 10, the scenario of stagnation of the external side is the most likely. The slowdown of Russian economy is already confirmed in hard data whereas deterioration in trade with western economies and introduced embargo will extend the stagnation period. At the same time a disappointing recovery of the Eurozone with a weak progress of its main engine – the German economy makes a down-side risk for current forecasts, if a positive rebound is not recorded in next months. As such tensions on the external side will cause companies insolvencies in Poland rising by 8% which will be visible in insolvencies statistics in the first quarter of 2015 assuming a delay of implications of macroeconomic conditions for the level of bankruptcies. On the other hand, the

scenario of deterioration of Eurozone and Russian economies cannot be rejected. The ongoing presence of Russian army in eastern Ukraine can trigger introducing further sanctions by the EU and US. If so, additional Russian retaliation measures are likely to be implemented with a negative impact on several sectors of economies of all parties. Then the stagnation period would transform to recession in economies crucial for Polish companies.

Predictions above on dynamics of insolvencies in Poland assume only the impact of external side on bankruptcies with all other things being equal. As such the influence of domestic side (consumption, fixed asset investments, interest rate changes etc.) is excluded from the analysis.

4 CONCLUSION

Companies insolvencies in Poland has finally stopped rising since the trend was initiated in 2008. The number of insolvencies is still high – bankruptcies of 402 companies were announced only in the first half of 2014. On the other hand, such level of insolvencies has to be compared to the 1.8 million active companies in Poland. Nevertheless, official insolvencies are just a tip of an iceberg. In Poland the insolvency procedure is still not used widely. Lots of companies are just going out of business, liquidating or acquiring by other entities. Therefore it makes more sense to analyse dynamics of insolvencies which reflect changes of companies situation in Poland over time. The improved economic conditions have been beneficial for Polish companies which recorded a decrease of insolvencies by 11.5% in the first half of 2014 compared to a corresponding period of last year.

The initiated recovery of the Eurozone in the second half of last year and then improvement of the domestic market was supportive for Polish companies. According to Coface analysis the changes of macroeconomic situation are visible in insolvency statistics with a delay of one or two quarters. As such a decreased number of insolvencies was experienced at the end of 2013 and then in the course of first months of this year. Polish companies could not only benefit from rising consumption of households but also higher demand coming from its main external trading partner Eurozone.

Nevertheless, the households' increased propensity to spend has not recovered fully so far. Although the labour market generates positive performance with a decreasing unemployment rate and growing wages, demand for durable goods is still relatively low. Households are focusing more on their daily necessities and such phenomenon points they are not convinced of the long-term recovery of the economy. As such the retail sector remains to be a subject to ongoing consolidation processes, intense competition and a necessity of accepting low margins. Those challenging market conditions were harmful for a number of companies of the retail sector which generated the highest dynamics of insolvencies in the first half of 2014.

Better prospects came for manufacturing companies with insolvencies falling by nearly 30% in the first six months of this year compared to a

year before. The outlook for them becomes less optimistic concluding recent performance on external markets crucial for Polish companies: it includes mostly a slowdown of Eurozone with the Poland's main trading partner Germany recording a growth rate of -0.2% q/q in the second quarter of this year. Polish exports to Russia have already contracted due to a slowdown of Russian economy. Moreover, the Russia-Ukraine conflict puts a pressure not only on business and consumer confidence as it concerns neighboring countries but it also results in deteriorated trade volumes with the official embargo introduced by Russia on selected merchandise. The latter issue will impact even companies exposed just to a local market as there will be an oversupply of some agro-food products domestically affecting prices downwards. Poland already recorded a first time deflation since the collapse of communism in July this year which is highly probable to be kept in the following months due to oversupplies and continued stabilization of commodity global prices.

The modest recovery of the internal situation on the one hand and turbulences on external markets on the other hand have an effect on Polish companies. According to Coface analyses the most likely scenario of impact of the external side for Polish insolvencies assumes bankruptcies rising by 8% due to the stagnation of Poland's crucial exports markets. However, if tensions between the EU and Russia escalates and/or the Eurozone slowdown deepens, it will be reflected in further deterioration of companies situation triggering an additional negative impact to insolvencies in Poland. Whereas external vulnerabilities affect negatively the level of companies insolvencies, it should be noted that the main influence comes from the performance of Polish domestic economy, especially its internal demand. Nevertheless, decreased demand coming from external trading partners will hamper the domestic recovery by lower orders for Polish industry and services. As a consequence, it will affect companies business development and their willingness for increasing capacities and new investments in fixed assets. The rising companies insolvencies in Poland in a medium term would be emphasized more if companies experience also a slow improvement of internal demand resulting from cautious spending of money by local households.