

# Against the rules

## Poland: Economic Outlook

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# Executive summary (macro)

After three months of this year we see evidence that economic slowdown is underway, but – as we argued in the January’s 2019 Outlook – it will be quite mild in Poland, with **average GDP growth in 2019 at c.4%** (vs. 5.1% in 2018). While the markets are still fretting about economic outlook for Europe, we believe that fundamentals are good, hoping to see higher economic activity in the Euro zone in 2H19. Especially given some early signs of pickup in global trade. The resilience of Polish exports and manufacturing to slowdown in Germany looks impressive and may last for a while, but the net exports is likely to contribute negatively to economic growth due to imports revival. Meanwhile, private consumption will receive a big boost from the newly announced fiscal package, which is reducing the risk of a more pronounced slowdown. Investment growth is likely to continue, supported by the absorption of EU funds and apparently growing companies’ outlays, although our optimism in this regard is slightly smaller than at the start of the year given the recent evidence.

The ruling Law and Justice party launched the election campaign with the set of five promises to be implemented even before the elections, that may cost the budget PLN18bn in 2019 and PLN30bn net in 2020. It implies a **U-turn in fiscal policy, that may bring fiscal deficit to almost 3% of GDP in 2020**, from nearly balanced position in 2018. But the biggest challenge for the Ministry of Finance, in our view, is not the deficit limit, but the stabilising expenditure rule, which in its current shape does not provide room for such spending spree. How the government is going to solve this problem remains unclear, but among obvious options are cuts in other expenses and/or seeking extra revenues. The room for manoeuvre in both cases seems to be not enough, however, and we can only hope it will not lead to dismantling or suspending the fiscal rule. An important warning sign in this regard could be if the current Minister of Finance Teresa Czerwińska quits her office.

The European Parliament elections, to be held in less than two months, will serve as a litmus paper for the ruling party, if the already announced fiscal package has been enough to secure a victory also in the general elections in the autumn. **The worse performance of PiS in May EP elections the bigger might be the possible size of the top-up of election promises in June.** This could be also the make-or-break moment for the coalition of opposition parties. A failure in May could decrease their morale and support, granting an easy win to PiS later on. For now, opinion polls show PiS and the united opposition running neck and neck in the European elections.

Central banks across the globe are turning more dovish amid weakening growth outlook and fading inflation. In Poland, this is not so much the case, as the economy remains strong, inflation is expected to pick up, and the government has just announced the large fiscal stimulus plan, which tilts the overall policy-mix towards more expansive. In fact, **as much as half of the Monetary Policy Council members expressed their concern that rate stability could be undermined by the effects of large fiscal impulse.** However, in our view, as long as inflation stays low (well below the 2.5% target), any significant change in the central bank’s official policy bias is unlikely. And definitely not before the general elections scheduled for the autumn. What seems to be clear is that a discussion about potential monetary easing is off the table.

Meanwhile, **inflation started picking up at the beginning of the year, just as we had expected, and seems to be on track to reach 2.5% by the year-end.** Core non-tradables prices accelerated, mainly due to a strong rise in costs of services, and we expect this trend to continue, as operating costs for companies continue rising relatively quickly, corporate margin compression is advancing, the inflow of migrant workers has slowed, and the new consumption boost is coming.



# Executive summary (markets)

## FX

In early April, EUR/PLN is near the level of 2018-end but when compared to the EM universe, the zloty is the fourth weakest EM currency vs the euro and dollar YTD. We think it would be challenging for the zloty to gain in the current environment. We think there is a risk for the profit taking to start on the equity market. Weaker demand for the risky assets could be caused also by the still persisting Brexit uncertainty. Later in the year, when we expect the signs of an economic revival in the European economy to be more obvious, we expect the Polish currency to gain. Also, we uphold the view that EUR/USD will rise this year and the MPC rhetoric may become less dovish, which should also be zloty-positive.

## FI

In the nearest months we see bond yields declining slightly, amid influence of global environment and trends in core debt markets. However, we think that there is not much room for a long-lasting and strong decline of yields. The tendency may change around the middle of the year, when escalation of the election campaign may negatively affect the domestic sovereign debt market. Between now and the end of the year, we see room for further yield increases in reaction to the expected improvement of economic outlook in Europe. However, the scale of increases should not lead to a significant excess of 3.0% by 10Y yields.



# 2019 Forecasts Revisited

Indicator	Our view in January	Our current view
GDP	The economic cycle has matured and the coming quarters will see GDP growth slowing down moderately, yet still holding somewhat above potential.	Broadly unchanged, although GDP forecast revised up slightly, from 3.8% to 4.1% on average in 2019.
GDP breakdown	Consumption still contributing the most, although slowing down gently amid deceleration of real disposable income. Moderate investment growth continues, fuelled largely by public spending on infrastructure. Net exports slightly negative again.	Consumption will get a boost from the new fiscal measures, so it's unlikely to decelerate. Investments will grow, but probably less than we earlier anticipated (amid looming cuts in central budget and falling optimism of local governments as regards investment plans). Net exports even slightly more negative.
Labour market	Polish economy needs to continue creating jobs to grow c4%, so labour shortages likely to persist. Depleted domestic resources make us dependent on migrants flow. Wage growth will remain elevated, but unlikely to accelerate much amid slowing GDP, corporate profits under pressure, continuing migrants inflow and (later on) introduction of PPK scheme.	Inflow of migrant workers started slowing down earlier than we had assumed. Wage growth acceleration seems even more likely.
Inflation	Once again we expect to see a turning point for inflation as all preconditions for higher price growth are in place. Even though the electricity tariff spike will be muted by the government, other factors will be pushing up corporate costs, which should finally lift core inflation towards 2.5%, in our view, as the process of margin compression is already advanced. However, the inflation pickup will be quite slow.	Unchanged.
Monetary policy	Monetary Policy Council signalled clearly it would have lots of tolerance for inflation's deviation from the target, as long as there is no strong evidence of a persistent upward trend in core inflation. It means that 2019 will be another year of interest rate stabilisation.	Unchanged.
Fiscal policy	No risks on the horizon as long as economic growth is solid. Budget draft is based on realistic assumptions and does not allow for spending spree, despite 2019 being the election year.	PiS election promises imply a U-turn on fiscal consolidation path, with a risk of breaking the fiscal anchor, i.e. stabilising expenditure rule. Big surprise.
Fixed income market	The yields of Polish bonds will remain low over most of 2019, mainly owing to the CPI staying below the NBP inflation target and deceleration of GDP growth, plus the supply of bonds still being not very high.	U-turn in fiscal policy deserves a risk premium, but trends in core debt markets are pushing yields lower. Slight rebound possible later this year if signs of global weakness abate.
FX market	Slowing economic growth and Fed rate hikes would weigh on the zloty in early 2019. Later, PLN could rebound amid euro strengthening vs dollar, among others.	Unchanged.



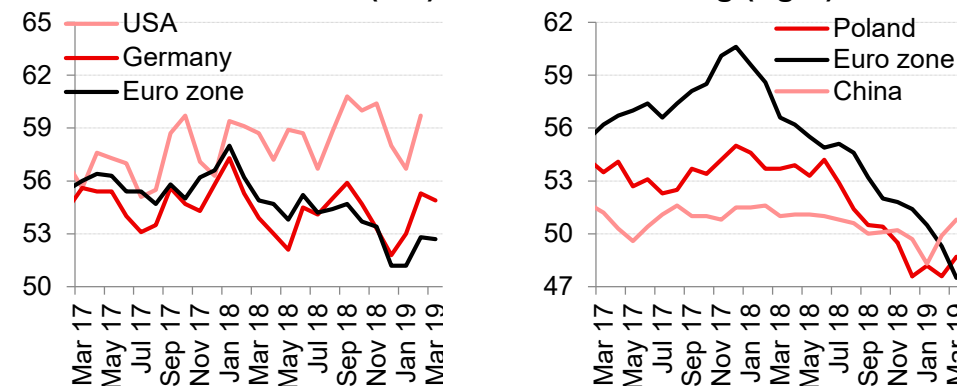
# External environment: nearing the trough?

The global growth outlook kept deteriorating in early 2019, with euro zone as a particular source of worry. In March, OECD made considerable revisions to the euro zone GDP, which is expected to grow by 1% in 2019 (lowered from 1.8% indicated in November) and by 1.2% in 2020 (down from 1.6%), with Germany and Italy observing the largest cuts to forecasts. Trade weakness, plus global and political uncertainty are to blame. Credit growth is weakening. The ECB also slashed its growth forecasts for the euro area in March, decided to postpone its tightening agenda and launched another TLTROs to revive credit. Santander's forecasts for the euro zone GDP have been trimmed as well: to 1.3% in 2019 (previously 1.9%) and 1.7% in 2020 (previously 1.9%).

While many central banks and market investors are turning more and more pessimistic, we believe forecast downgrades will end soon, and some stabilisation should follow. Major trade disputes have not found any solutions (US and China were supposed to end the tariff wars in March, European Parliament has rejected negotiations of a new deal with the US), but the domestic demand of the euro zone seems robust and positive data surprises start to pop out here and there in the European data, including the last readings of German retail sales, export, import, output, of which many were accompanied by positive revisions of the previous releases. New orders for German car manufacturers also picked up. ZEW and Ifo expectations indices seem to be bottoming out. Euro zone manufacturing PMIs remain the scary part.

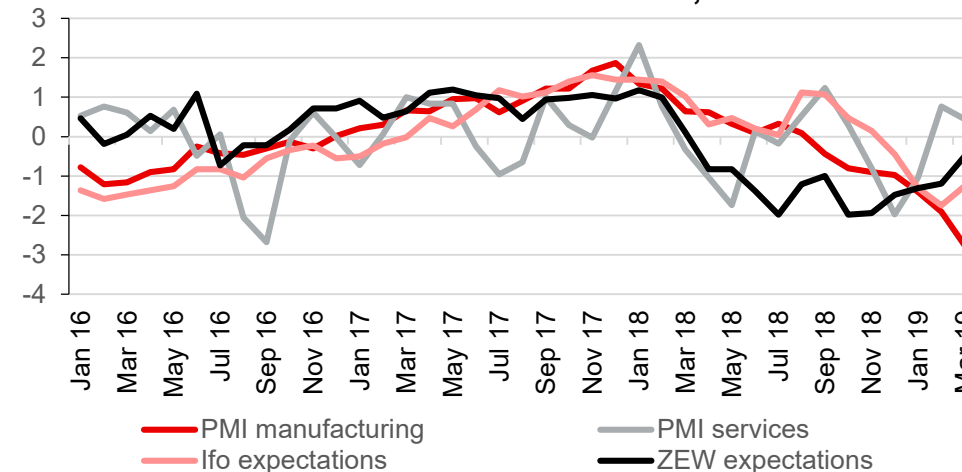
If we also assume that the recent VAT cut by China prevents a severe slowdown in the country, and that the Brexit issue gets kicked down the road for at least a year, we could end up with a relatively stable global growth profile, although weaker than expected a quarter ago. Just keep your fingers crossed.

### PMI/ISM business sentiment indicators in services (left) and manufacturing (right)



Source: Bloomberg, Markit, ISM, Santander

### German business sentiment indices, standardised



Source: Bloomberg, Markit, Santander



# Poland-Germany divergence: can it continue? (1/2)

The paths of Polish and German output and exports have decoupled recently. The gap in output growth has reached historical proportions. What could justify the usual strong correlation in output and exports are strong trade ties between the two countries (Germany is top destination for Polish goods and its top supplier, while Poland receives c4% of German exports and is its fourth largest supplier) making them share a similar business cycle. But their economic activity numbers may deviate substantially, as it is the case now.

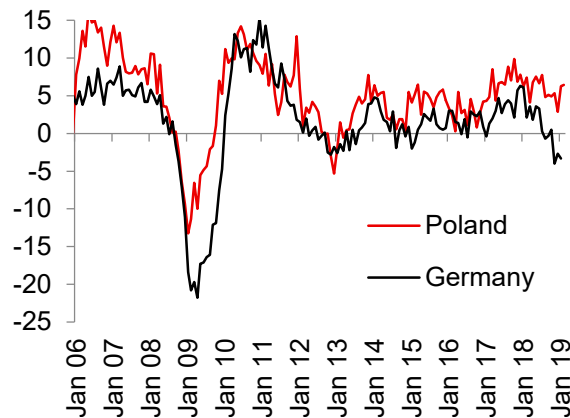
In 2012-2013 Poland's exports managed to avoid being dragged down by the German (and Eurozone) slowdown, as it oriented more towards the CEE region and its Eastern neighbours, leading also to a period of stronger growth of output than in Germany. This time the source of output outperformance seems to be, at least partly, the strength of domestic demand rather than trade diversification (which is also working, but to a lesser extent).

In 2018, for the first time in many years ratio of exports value to output decreased in Poland, signalling a growing significance of the domestic market vs external demand.

What is more, the domestic part of Polish industry's order book is growing at a faster rate than new business from abroad. GUS data show total value of industrial new orders rising more than the index of non-domestic new orders. In March, the difference between ESI indicators of industry's order books and export-order books was the highest on record.

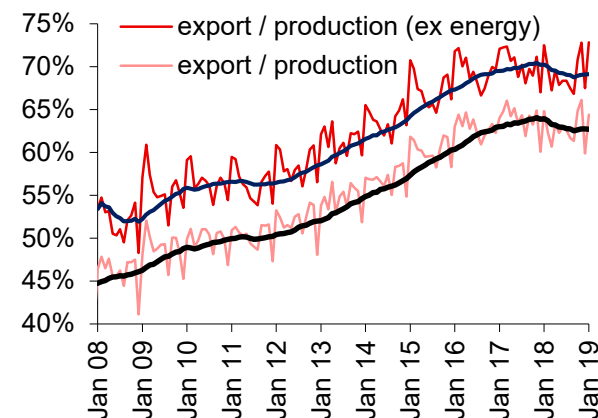
The Poland-Germany economic activity gap thus may hold for another year on robust domestic demand in Poland, getting further stimulus due to fiscal package, hopefully shrinking on some rebound of German output. But there are other reasons for the gap to last.

Production: Germany vs. Poland, %/y WDA



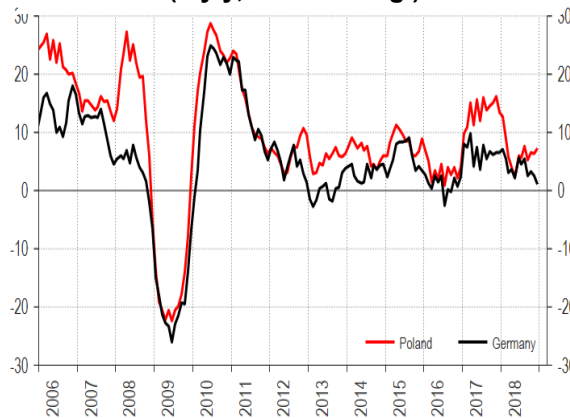
Source: GUS, Eurostat, Santander

Exports-to-output ratio and 12M mov.avg.



Source: GUS, NBP, Santander

Export growth: Poland vs Germany (%/y, 3M mov.avg.)



Source: Thomson Reuters Datastream

Value of new orders in industry, %/y, 3M mov.avg.



Source: GUS, Santander

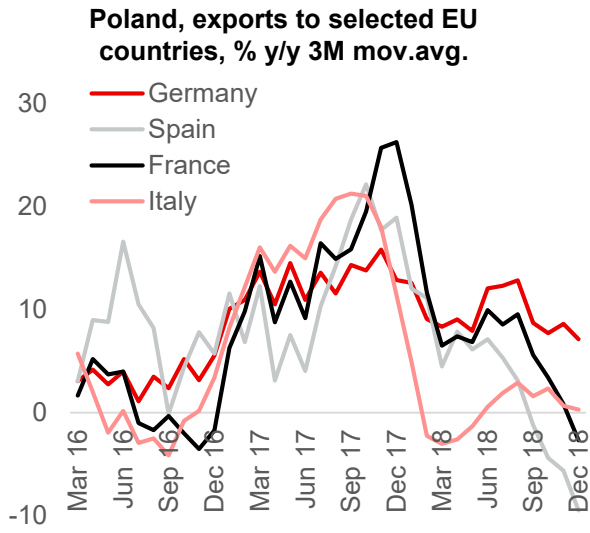


# Poland-Germany divergence: can it continue? (2/2)

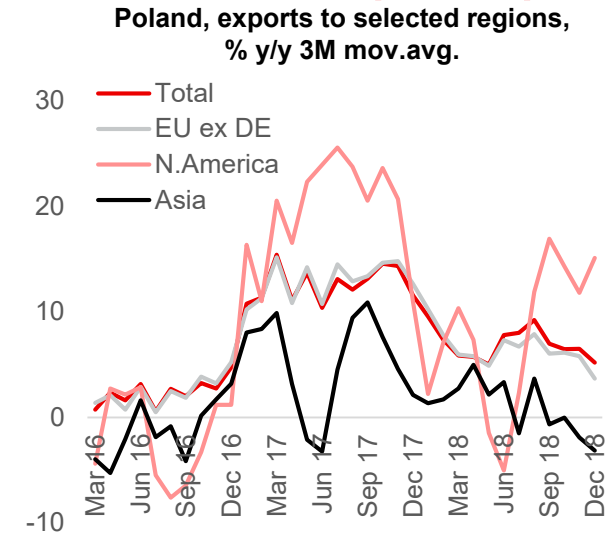
Polish exports growth in the face of the slowdown in Europe and global trade uncertainty looks decent. While Germany saw recently large cuts of growth forecasts, its demand for Polish goods is still quite strong. Germany is shielding Poland from a significant slowdown in exports, other key EU economies are working in the other direction. Support also comes from demand from Americas (c5% of Polish exports) while the flow of goods to Asia is already decreasing y/y.

There is evidence that Polish companies are able to increase their market share in the euro zone and Germany in particular during the time of the slowdown/recession in Europe. Such humps in the share of Poland in German imports are visible most in consumer goods: durable and semi-durable. This may come from substitution with cheaper alternatives in times when there is more focus on economising and when dealing with big-ticket items. In line with this there is a less than proportional response of Polish output of consumer durables to the current euro zone slowdown. This comes on top of a positive trend in the scale of presence of Polish goods in some categories like non-durable consumption goods. What is more, in 2018 there was also a quadruple rise of the share of Poland (from the usual 2-3%) in German imports of industrial vehicles.

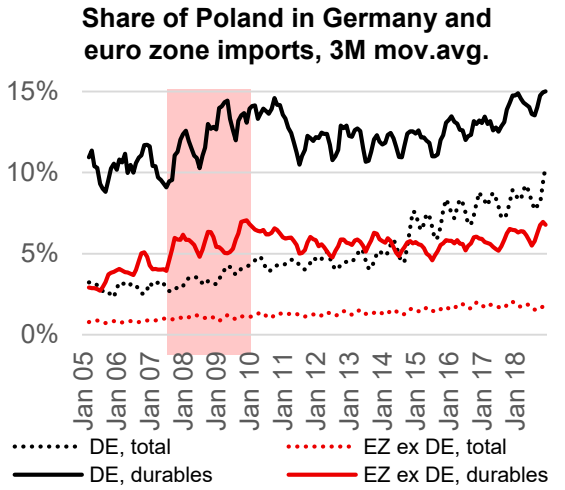
This gives us another hint about the discussed divergence – Germany is suffering from underperforming export sector, but its domestic demand remains relatively strong, leading to stable demand for final products for households, of which Poland is an important European supplier, while intermediate goods are observing proportionately reduced demand.



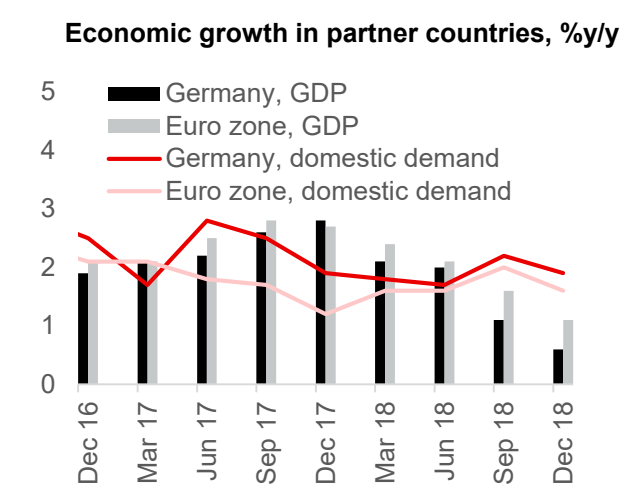
Source: GUS, Eurostat, Markit, Santander



Source: GUS, Santander



Source: GUS, Markit, Santander



Source: Eurostat, Santander



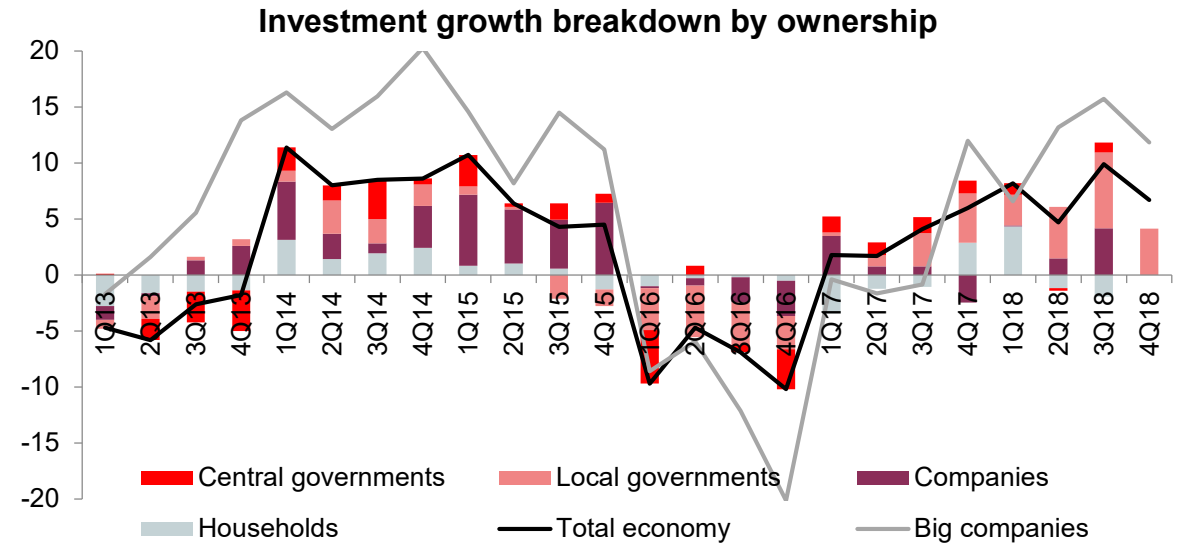


# Investments: a bit slower, but more private

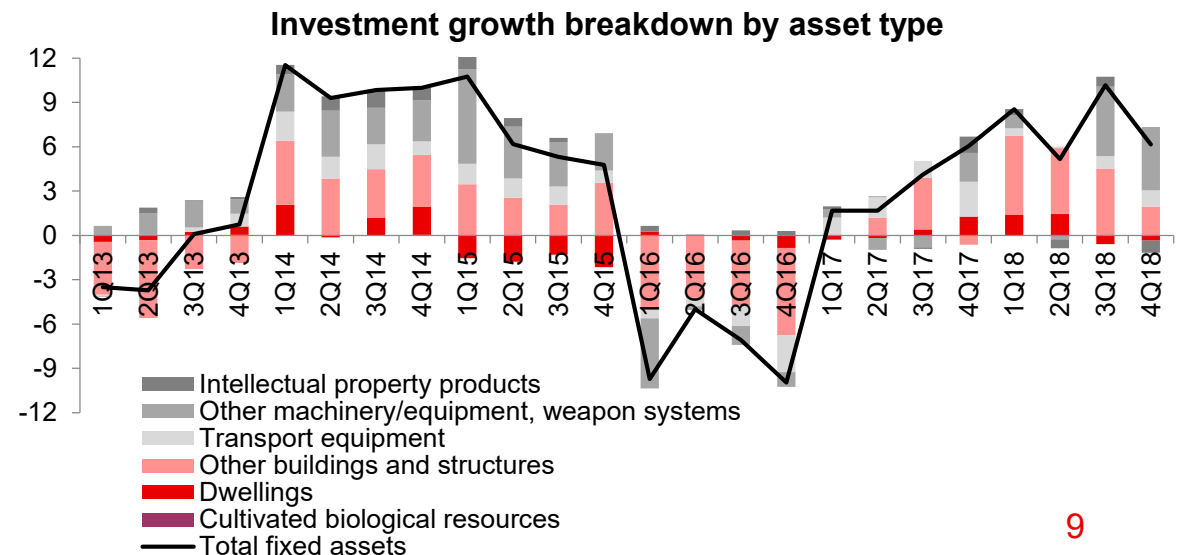
We have revised our forecast of 2019 investment growth slightly down, given weaker reading for 4Q18 and the new social spending package. We maintain our view that strong utilisation of EU funds will be underpinning investment growth in 2019. In our view, 2019 will see a peak in EU funded investment in nominal terms, while its contribution to growth may be a bit lower than in 2018.

Spending boom in local governments, which was the main driver of investment in 2018, seems to be running out. For 2019, local governments have planned investment outlays lower than those in 2018. Given that realisation is typically lower than initial plans, we would not rule out a decline in local government investment spending by up to 10% y/y. We were hoping until recently that the central budget will offset that and actually January data on central budget investment was quite promising. Now we are less optimistic: the Finance Ministry will be looking for every possible spending cut to make room for the new lavish fiscal package. Investment seems to be an easy call.

Numbers for 3Q18 showed a decent rebound in corporate investment (10% y/y). For 4Q18, breakdown by sectors is not available yet, but breakdown by assets showed a decent performance of outlays on machinery and equipment, which is strongly correlated with companies' investment. Investment in biggest companies slowed down versus 3Q, but still remained strong. Thus, in 2019 private investment may show a bit higher momentum than we assumed previously, even though most investment surveys point to a slowdown.



Source: GUS, Eurostat, Santander



Source: GUS, Eurostat, Santander



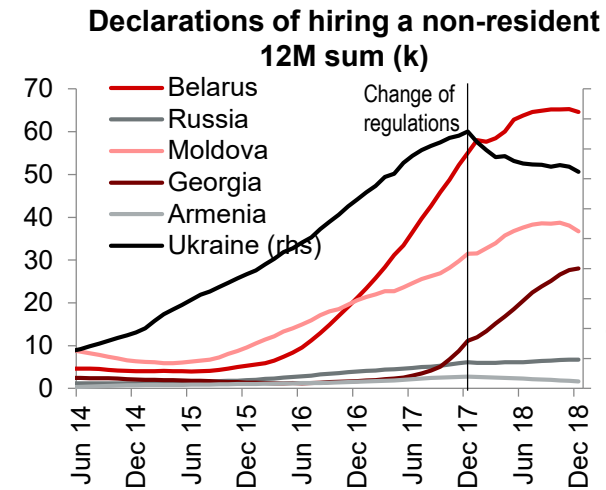
# Labour market: is Poland still attractive to Ukrainians?

Without the Ukrainian migrant workforce Polish labour market would be in far bigger trouble due to lack of spare capacity than it is now. NBP assessed that inflow from Ukraine kept employment rising 1.8-2.7% instead of 0.7-1.9% in the years 2014-2017. The problem was 2018, when the positive result ceased to be applicable. We think further rise of Ukrainian workforce in Poland should not be taken for granted.

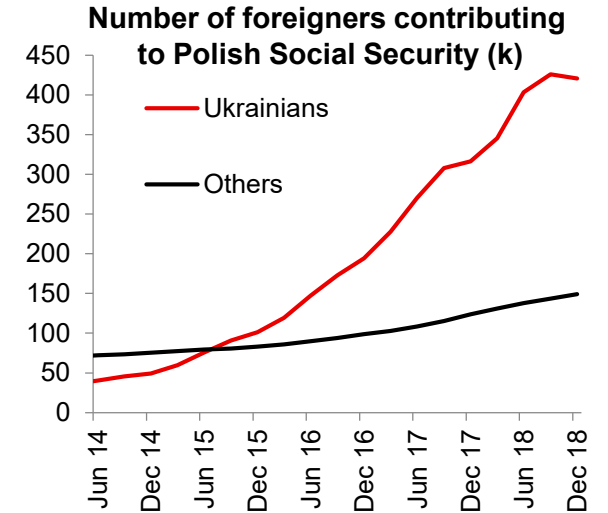
4Q18 was the first quarter in six years without an increase in the number of Ukrainians contributing to Polish Social Security (ZUS), suggesting the massive inflow has weakened. On the other hand, border crossings by Ukrainians are still growing decently and so far there is no evidence they are heading for other EU countries, eg Germany and Czechia (the language barrier and local regulations are working against it).

What we do know is that working in Poland is now less attractive than it used to be back in 2014 and 2015 relative to staying in Ukraine. The neighbour country is out of deep recession and has been granting 10%+ pay rises (in real terms) for the last three years. Two years ago average Polish wage expressed in hryvnias was 4-6 times higher than the Ukrainian counterpart. Now it is 3 times higher, but bear in mind we are talking about attracting new workers, not just making the old ones come again (they are allowed to work visa-free for 9 months per year) – so intuitively the hosting country should be offering more not less. Add to this, that Ukrainians may see prospects of getting double-digit nominal wage hikes at home – they are no longer pushed out of the country because of insufficient labour demand.

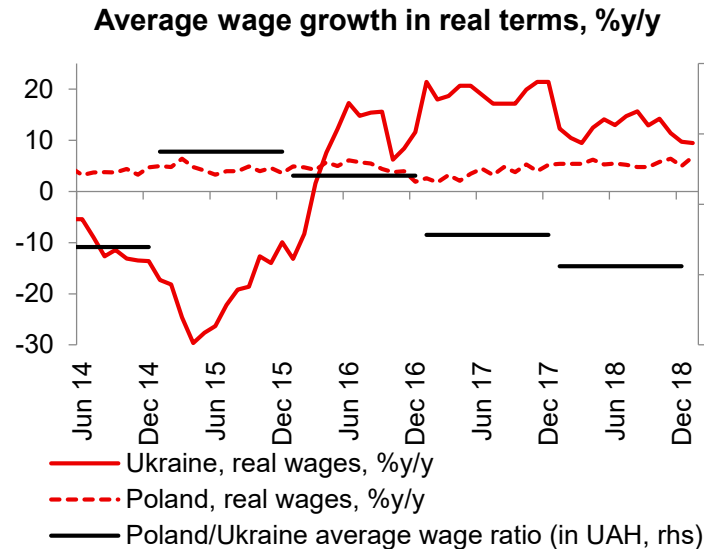
Also, the exchange rate may be becoming a deterrent for migrants. UAHPLN was going down for decades, especially in the period of increased migration since 2014, beefing up Ukrainians' earnings in Poland when transferring them to the home country. But last year the fx pair seems to have bottomed out. A worker coming at the turn of 2017/2018 by the end of the year would get 10% less in UAH terms (assuming flat wage in PLN).



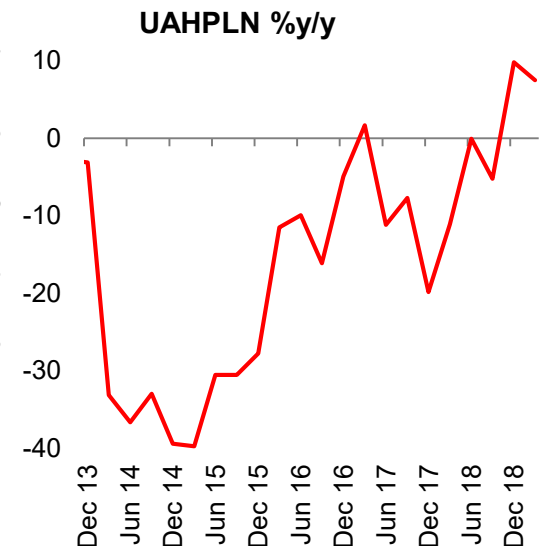
Source: GUS, Santander



Source: ZUS, Santander



Source: Bloomberg, Santander



Source: Bloomberg, Santander



# Inflation: core measures about to pick up

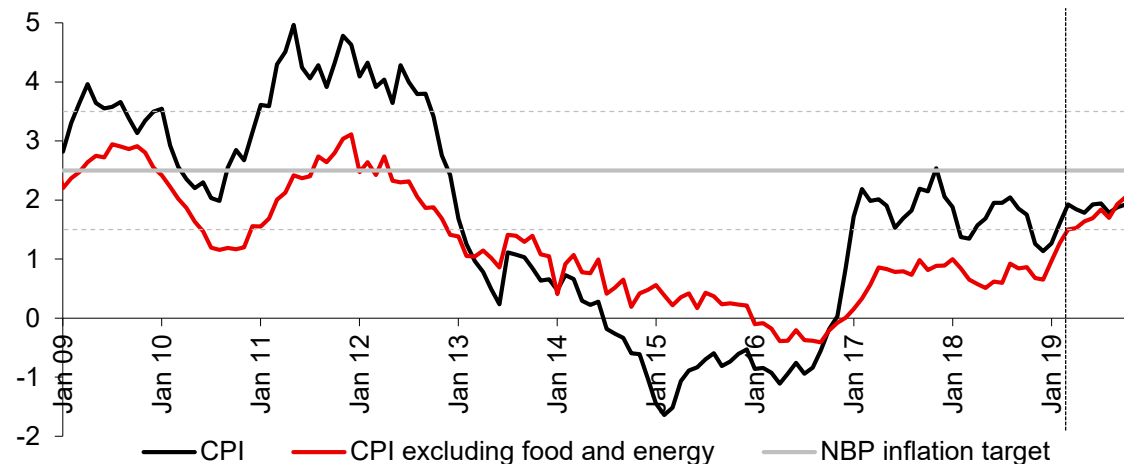
So far, the 2019 inflation is developing in line with our expectations. We assumed an acceleration in core non-tradables due to pressure from the labour market, and this proved even stronger than we expected, as prices in many categories or services went strongly up at the start of 2019. We are expecting the price pressure in this category to continue.

Non-core inflation slumped in January 2019 due to a decline in electricity prices by about 7% m/m due to the government's „freeze act“. As regards food, the year started with upward pressure on vegetable and grains prices due to draught effects, in line with our forecasts. Prices of sugar and poultry were higher than we expected. In our view, growth rate of food prices may still go up in the months to come, but weather conditions this year will be crucial, especially for the two last quarters.

We have revised our path for core tradables' slightly down due to lower readings at the turn of 2018 and 2019 (lower car prices) and lower core inflation forecasts of the ECB. Still, we expect the price growth in this category to stay slightly below zero, which is rather high in historical comparison.

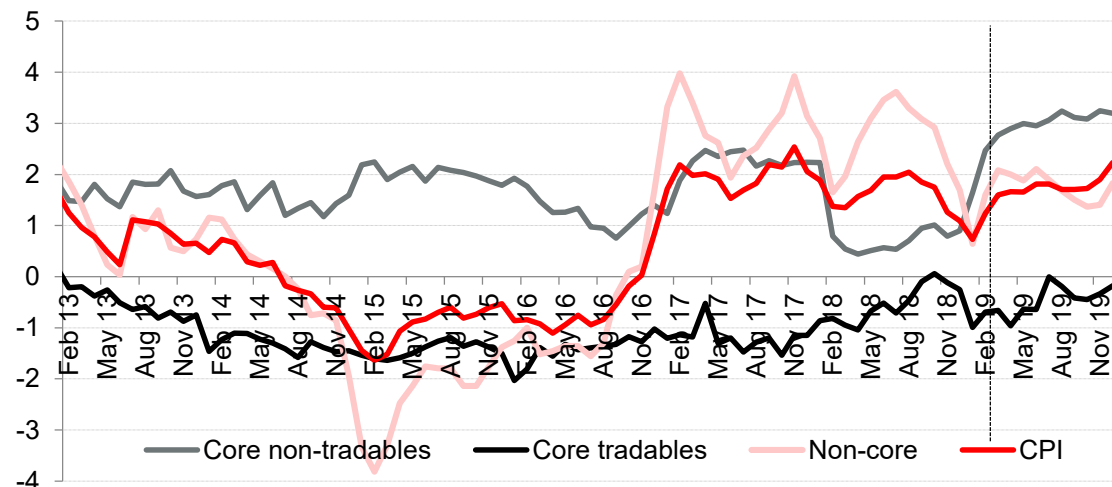
In general, we see inflation approaching 2.5% at the year-end and averaging 1.7% y/y.

### CPI versus NBP target, % y/y



Source: GUS, NBP, Santander

### Breakdown of inflation, % y/y



Source: GUS, Eurostat, Santander



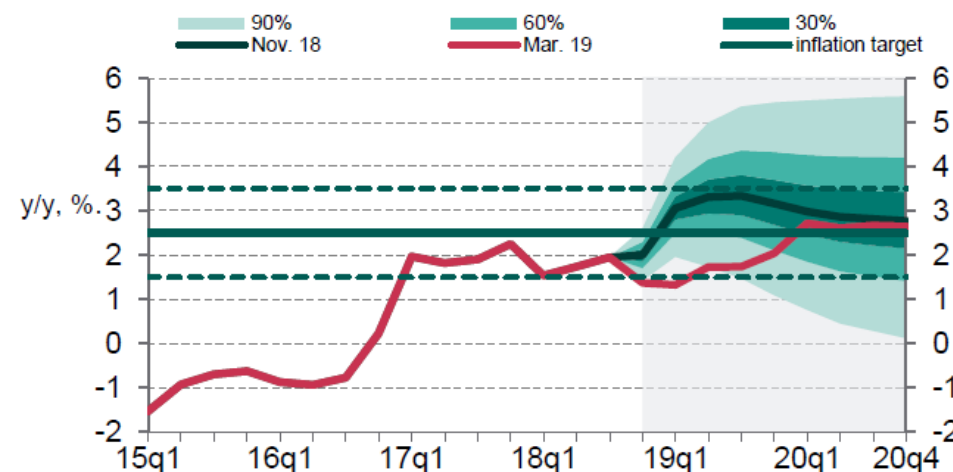
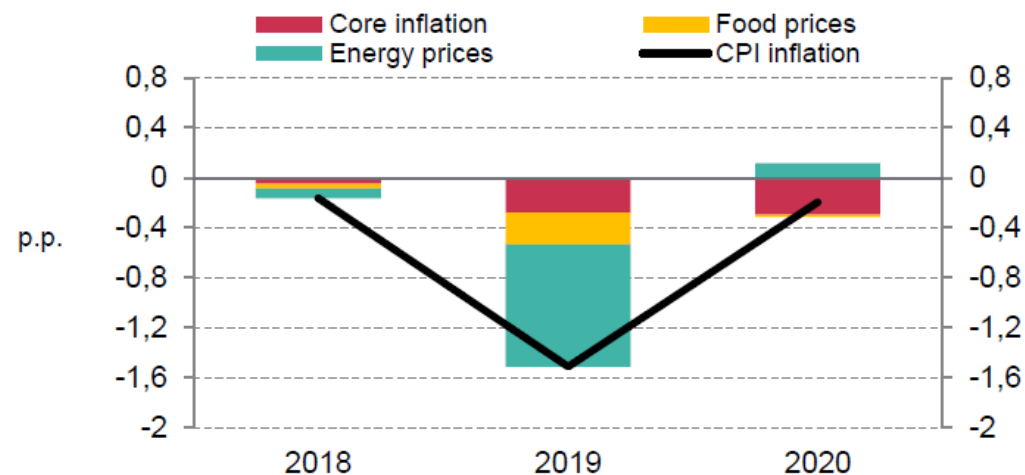
# Monetary policy: haven of stability

Central banks across the globe are turning more dovish amid weakening growth outlook and fading inflation. In Poland, this is not so much the case, as the economy remains healthy, inflation is about to pick up, and the government has just announced the large fiscal stimulus plan, which tilts the overall policy-mix towards more expansive. Yet, the central bank maintains its patient approach, declaring long period of rates stability ahead (even until 2022, according to NBP Governor Adam Glapiński).

The new NBP's projections released in early March show higher GDP growth and lower inflation than in the previous edition. Lower inflation is no surprise, as the November's forecast was based on unrealistic assumption of big surge of energy tariffs, which has not materialised. Meanwhile, higher GDP reflects the impact of PiS election promises, boosting consumption. According to the central bank, the inflationary effects of the fiscal spending spree will be negligible.

The NBP governor underscored at the last press conference that the new fiscal proposals do not affect the monetary policy outlook. However, the recent comments from the MPC members show that the Council is deeply divided on this issue – already half of the members agree that the rates' stability can no longer be warranted after announcement of fiscal stimulus (see the next page for details). In our view, as long as inflation stays low (well below the target), any change in the official MPC rhetoric is unlikely. Definitely not before the general elections scheduled for the autumn. The situation may get more interesting by the end of this year, when we expect both CPI and core inflation to converge to 2.5% target. But for now, stability is the name of the game. What is clear, in our view, is that any serious discussion about rate cuts in Poland is off the table for a while.

### Change of inflation projection – March vs. November



# Monetary policy: the fiscal impulse not so irrelevant?



## MPC members' comments after the release of PiS fiscal package:

### Grażyna Ancyparowicz, 26/03 Bloomberg

I am no longer convinced we will be able to guarantee rates stability in the face of such aggressive fiscal policy. The government's plans make a dangerous accumulation of expenditures in a short period and nobody knows what else will be promised.

### Jerzy Osiatyński, 25/03 PAP

The fiscal package generates a risk that inflation will rise faster than predicted, therefore it cannot be assumed that interest rates will remain unchanged even until the end of this year.

### Kamil Zubelewicz, 25/03 PAP

It is hard to expect that the fiscal package could change the monetary policy outlook, although in my opinion interest rates should be lifted anyway. The package reduces risk of economic stagnation, so speculations about rate cuts in the next three years are now becoming futile.

### Jerzy Żyżyński, 25/03 PAP

Introduction of fiscal package neither rules out a hypothetical interest rate cut, nor makes interest rate hike more likely. Poland has a room to cut rates, but small: 25-50bp max.

### Eugeniusz Gatnar, 21/03 PAP

Taking into account the policy mix, the fiscal package will mobilise us to think about slight monetary tightening at the end of the year. In my view the fiscal impulse closed discussion about rate cuts or using non-standard policy tool.

### Łukasz Hardt, 14/03 Bloomberg

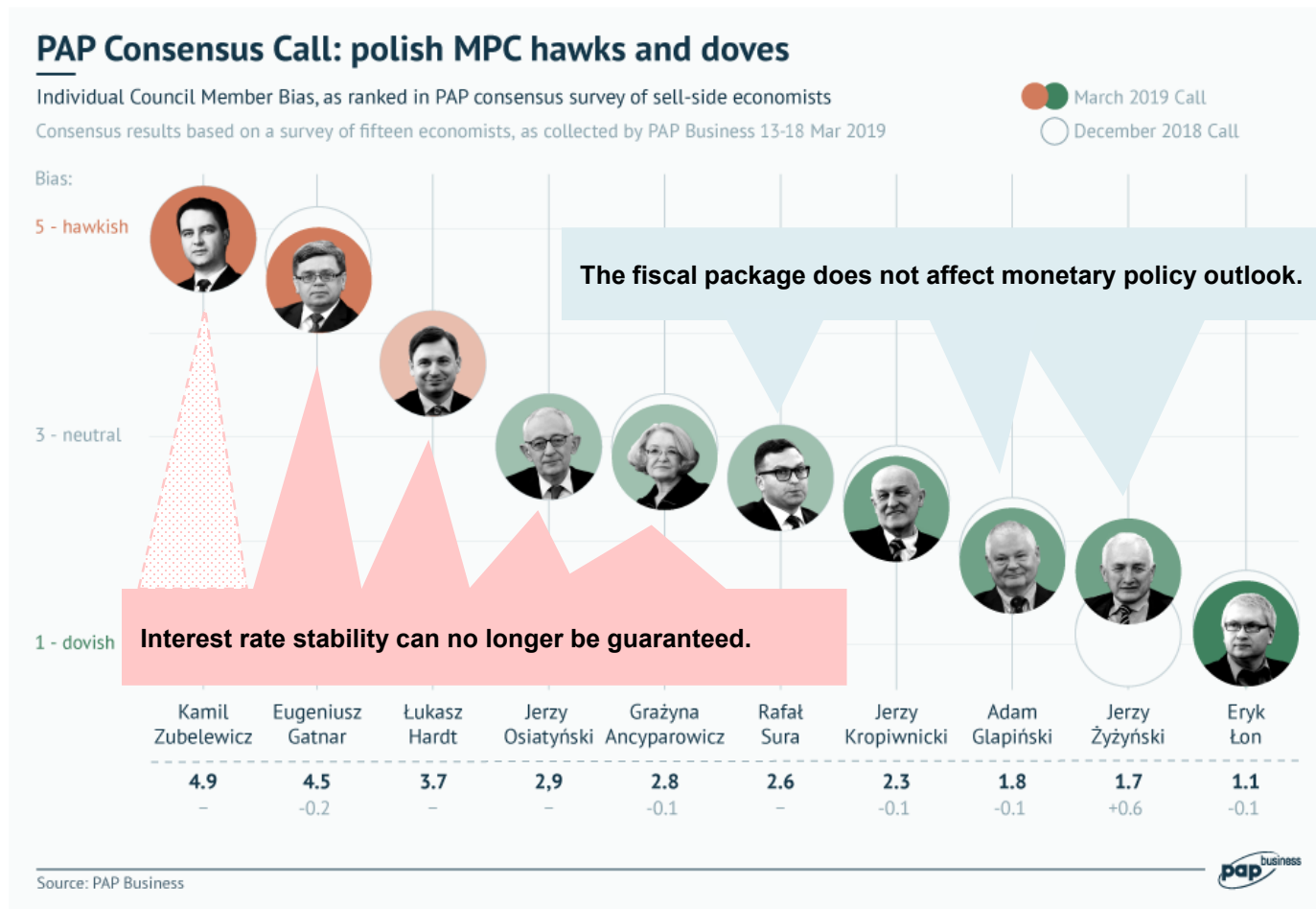
Due to the proposed fiscal impulse, which could boost inflation, it is hard to rule out the need to consider monetary tightening in 2020.

### Adam Glapiński, 13/03, 06/03 PAP

The fiscal package neither has any impact on interest rate path nor does it increase probability of rate hike. (...) It cannot be ruled out that interest rates will remain unchanged until the end of the MPC term in the office, i.e. until 2022. Economic slowdown in the coming years will not require rate changes and there is no need to use non-standard policy tools.

### Rafał Sura, 26/02 Bloomberg

The plan doesn't alter stable-rate view. The plan won't have any significant impact on prices. Economic slowdown in Poland won't require rate cuts, however room for hypothetical monetary easing still exists despite the fiscal plan.





# New fiscal stimulus: boost to consumption

## Cost estimate of pre-election package to public finances, PLNbn

On February 23 the ruling Law and Justice (PiS) held its party congress where it presented its pre-election package. The program includes: (1) Extension of the 500PLN child benefit facility (called 500+) to all first children (currently the benefit is available for some first children meeting a per capita income criterion and to all second and further children), (2) One-off bonus for pensioners worth PLN1100, (3) No personal income tax for employees up to 26 years of age (for incomes falling in the lower 18% tax bracket), (4) Easing the tax burden: lower first PIT tax rate, rise in tax-deductible expenses, (5) Restoring public local bus transport. For details, please see our [special report](#).

The government pledged to disburse the bonus pension in May, 500+ extension in July and to introduce changes in PIT in autumn. In our view, the latter may be approved by autumn, but will be effective since early 2020 due to practical reasons. Important uncertainty concerns the extra pension payment – while theoretically it is a one-off, key PiS politicians have already pledged it will be repeated every year if only they win next elections. The trick is that even before elections the government has to finish 2020 budget draft and in our view it will be hard to explain to the public if money for extra pension is not included.

We estimate that the impact of the new program on GDP growth would be 0.2 pp in 2019 and 2020, respectively. Private consumption will be boosted by 0.6 pp in 2019 and 0.4 pp in 2020. Those are cautious estimates, based on the assumption that the new transfers will be at least partly offset by spending cuts in other areas.

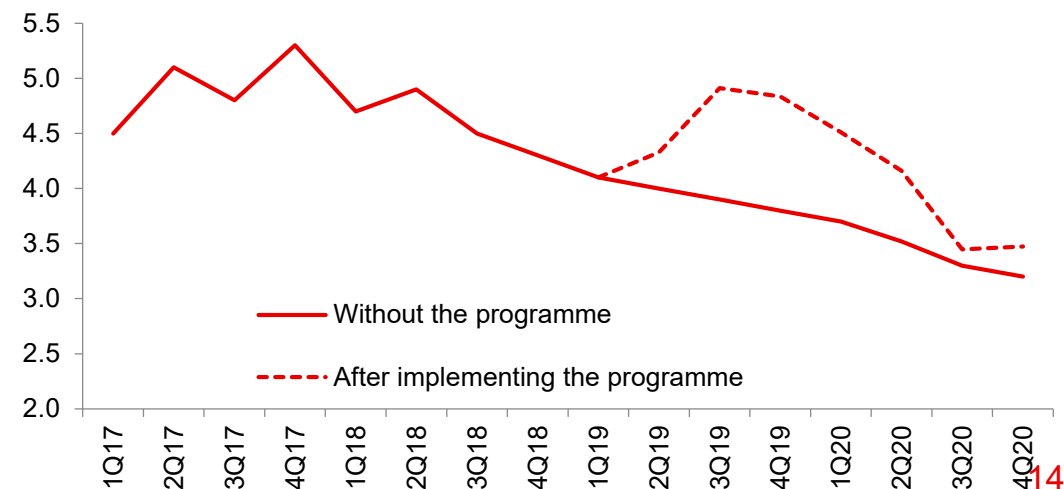
	Base case*		Maximum case**	
	2019	2020	2019	2020
<b>Extension of 500+</b>	9.2	18.5	9.2	18.5
<b>13th pension</b>	10.2	-	10.2	10.5
<b>No PIT for the young</b>	-	2.5	1.2	2.5
<b>PIT 17%</b>	-	8.0	3.0	8.0
<b>Higher tax-deductible costs</b>	1.7	3.5	1.7	3.5
<b>Local buses</b>	-	1.0	0.5	1.0
<b>Gross total</b>	<b>21.1</b>	<b>33.5</b>	<b>25.8</b>	<b>44.0</b>
<b>To return in taxes</b>	3.0	4.0	4.0	6.0
<b>Net total (PLN bn)</b>	18.1	29.5	22.0	38.0
<b>Net total (% GDP)</b>	0.8%	1.3%	1.0%	1.6%

\* base case is what we consider the most likely implementation

\*\* In the maximum case we assume all promises to be delivered by mid-2019, and in 2020 the 13th pension will be paid again.

Source: Chancellery of the Prime Minister (KPRM), Santander

## Consumption – effect of the new fiscal stimulus, % y/y



Source: GUS, Eurostat, Santander

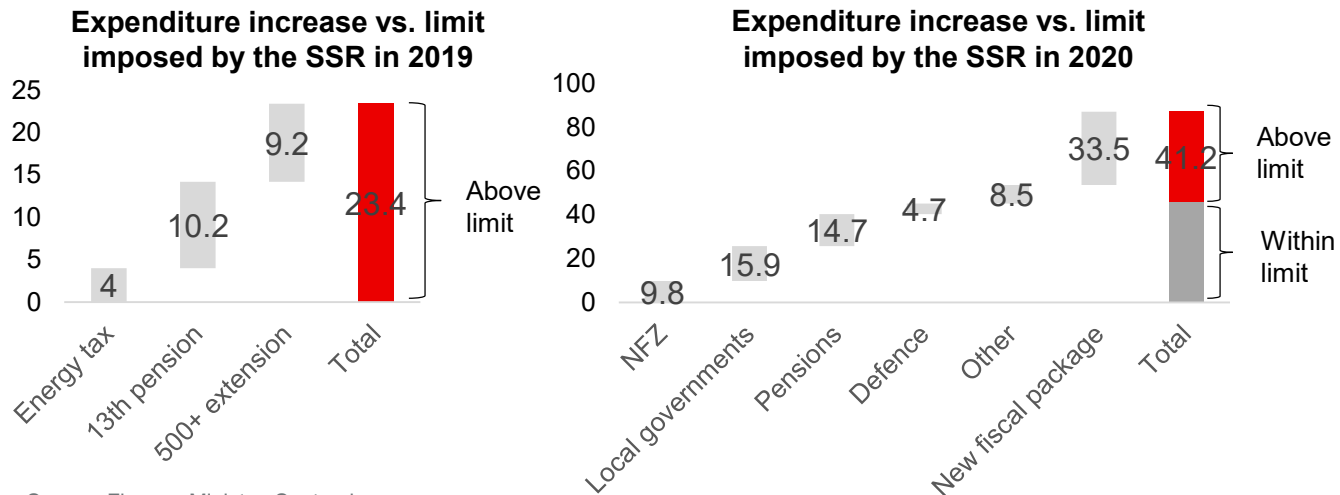


# New fiscal stimulus: U-turn in fiscal policy?

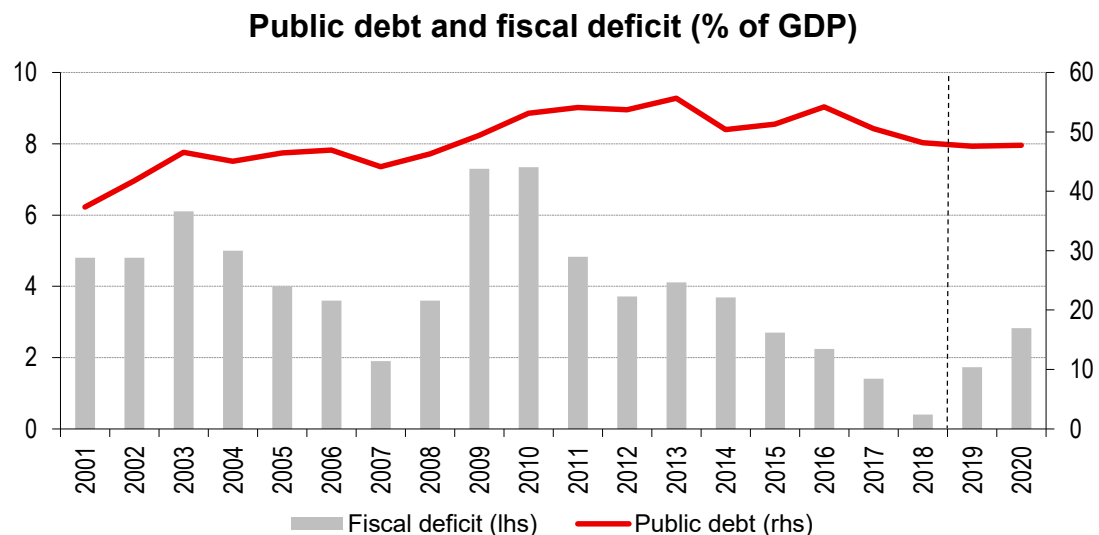
In total, we estimate that the new proposals from PiS will cost public finances some PLN18bn net in 2019 and PLN30bn net in 2020. In our view it will be possible to fit the new package into the PLN28.5bn central deficit limit thanks to higher than planned tax revenues, extra NBP profit (possibly c.PLN5bn), cutting some other spending and streaming the bonus pension to Social Security Fund budget. Still, the General Government balance may deteriorate to c.1.7% of GDP in 2019 and slightly below 3% of GDP in 2020, which implies a U-turn in the Poland's fiscal consolidation path.

However, in our view the biggest problem is not the higher deficit but the stabilising spending rule (SSR), which sets strict limits on expenditures. The 2019 budget prepared last year already used all available room for spending growth, and on top of it the government still has to squeeze in PLN4.0bn resulting from cut in energy taxes. If we assume that only the 13. pension and the 500+ extension are introduced this year, the government has to fit PLN23.4bn into the rule. In 2020, the rule will allow for a rise in spending by c.PLN46bn, according to our estimate, but it will hardly enough to cover even the already enacted hikes in other spending categories, not to mention the additional fiscal package. According to our estimates, the SSR gap is at PLN41.2bn in 2020.

The government signals it wants to obey the spending rule limits by cutting expenses in other areas, maximising dividends from state-owned companies and further increase of tax compliance. In our view, this may not be enough and there is a significant risk that the SSR will lose its importance as a credible anchor for fiscal policy in Poland.



Source: Finance Ministry, Santander



Source: GUS, Eurostat, Santander



# New fiscal stimulus: what does the Fitch say?

A few weeks after PiS presented its costly election promises, Fitch Ratings confirmed Poland's credit score at A- with the stable outlook, pointing to strong economic fundamentals. What is important, the agency said it believes that the government will comply with the stabilising expenditure rule and the EU's fiscal convergence rules, although it has lifted forecasted fiscal deficit for 2019-20.

Two other major rating agencies will follow in April with the Poland's rating review. Taking into account what the agencies have said after the previous reviews, and given the lack of clarity on how the government is going to match the large spending spree with the stabilising expenditure rule, we do not expect any action to be taken this time. The situation could change later this year if (when) it becomes clear that the new fiscal impulse is impossible to implement without a breach to the expenditure rule.

Also, in April Poland will have to send the updated convergence programme to the European Commission. The document should include FinMin's calculations what the new proposals imply for the fiscal path. Please recall that even without the new spending package Poland had one of the highest structural deficits in the EU.

<b>Fitch</b> Next review: September 27 Last review: March 29, 2019 A-, stable outlook	<b>S&amp;P</b> Next review: April 12 Last review: October, 2018 A-, stable outlook	<b>Moody's</b> Next review: April 19 Last review: September 19, 2018 A2, stable outlook
<u>Positive rating action factors:</u> - Further sustained reduction in net external debt/GDP towards the 'A' category median. - Fiscal consolidation that leads to a sustained decline in public debt/GDP. - GDP growth that supports faster income convergence towards the 'A' category median.	<u>Positive rating action factors:</u> - Further rise of the real income at a faster pace than in Poland's main trading partners that will not cause any external imbalances. - Budget surplus leading to lower public debt in nominal terms. - New Employee Capital Plans (PPK) will boost private savings leading to smaller Poland liabilities that would emerge as a result of the demographic and falling number of economically active population	<u>What could move rating up?</u> - Fiscal consolidation that would bring about a sustainable reduction in the structural budget deficit - Improvements in the sustainability of the social security system as well as in the institutional framework - Structural reforms that would increase medium term growth prospects and labour productivity
<u>Negative rating action factors:</u> - Weaker commitment to adhering to the 3% of GDP EU deficit ceiling, or failure to stabilise the debt/GDP ratio in the medium term. - Weaker macro-economic policy framework, potentially resulting in lower GDP growth. - Deterioration in governance standards or the business climate leading to an adverse impact on the economy.	<u>Negative rating action factors:</u> - Significant deterioration of fiscal performance - Rapid wage growth leading to a faster-than-expected increase in net external borrowing, a potential sign of eroding competitiveness.	<u>What could move the rating down?</u> - A permanent deterioration in the government's fiscal position - A material impairment in the investment climate, potentially including substantial capital outflows - The lack of progress with structural reforms that would stall innovation and/or deter FDI and hence hamper growth - The risk of significantly lower EU funds in the future
<u>Key rating Drivers:</u> Poland's 'A-' rating reflects its diversified economy and strong macroeconomic fundamentals, supported by a sound economic policy framework, and strong banking sector. These are balanced against weak GDP per capita and high net external debt compared with the peer median. <b>Fitch expects the government to comply with its own expenditure and European Commission (EC) convergence rules, in line with historical performance.</b>	The upgrade reflects Poland's strong track record of balanced economic growth and fiscal prudence. We think it will likely achieve next year's 1.8% of GDP deficit target, even against a background of slowing growth.	<u>Key rating Drivers:</u> + Economic resilience based on scale and competitiveness of its economy + Sound macroeconomic framework, underpinned by inflation targeting, national fiscal rules and flexible exchange rate + Stability of Poland's financial sector - Elevated general government debt-to-GDP ratio compared to peers - External vulnerabilities stemming from high external debt - Persistent social divides and regional inequalities that elevate domestic political risks

Source: Fitch, S&P, Moody's, Bloomberg, Santander

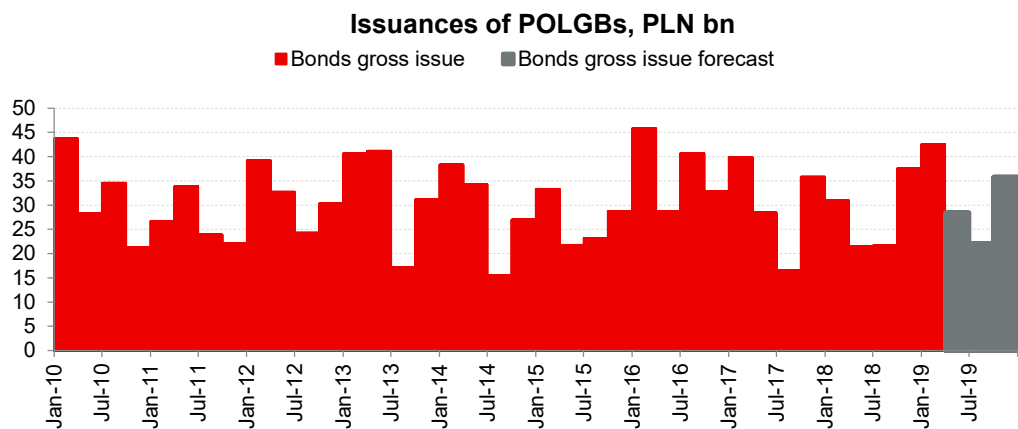




# Bond issuance: over half-way through

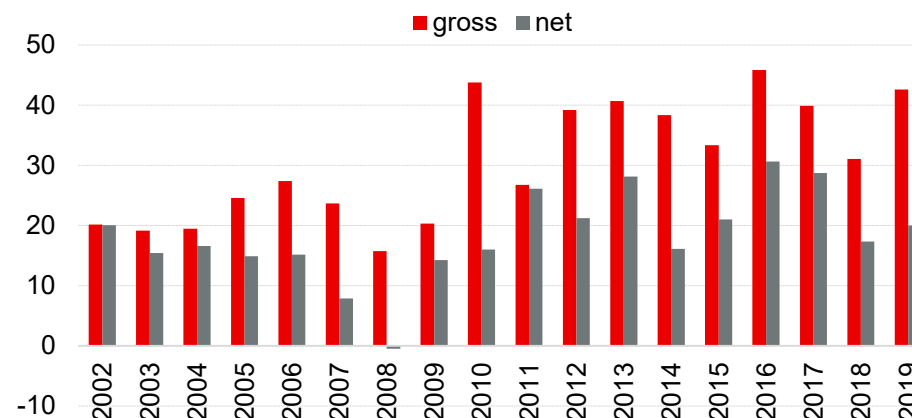
Poland has already financed over 60% of this year's gross borrowing needs. Assuming that this year's budget deficit will not rise above the planned PLN28.5bn, we estimate that by the end of this year the Ministry of Finance will need to issue c.PLN50-55bn worth of bonds to finance 2019 budget, which will imply PLN15-20bn net supply. Adding to that the likely pre-financing of 2020 (at approximately PLN27bn), we end up with c.PLN83-88bn gross debt issuance until the end of the year.

We think that most of the planned supply will take place in the second half of the year. Earlier funding seems less likely, owing to the high budgetary liquidity (at the end of February the balances on government accounts amounted to PLN52bn) and the concentration of redemptions in the second half of the year. We think that the FinMin's willingness to frontload financing of the deficit could be reduced by the last year's opinion of NIK (Supreme Chamber of Control) that has criticised the excessive accumulation of liquidity.



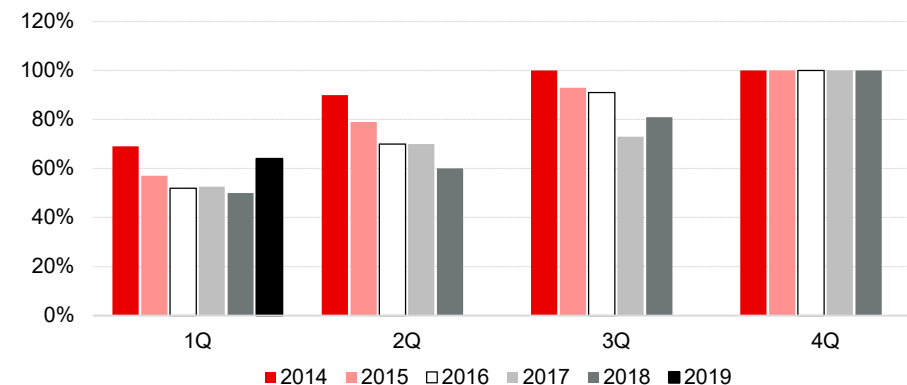
Source: Ministry of Finance, Santander

### Gross and net debt issuances in 1Q in PLN bn



Source: Ministry of Finance, Santander

### Covering of gross annual borrowing needs (%)



Source: Ministry of Finance, Santander

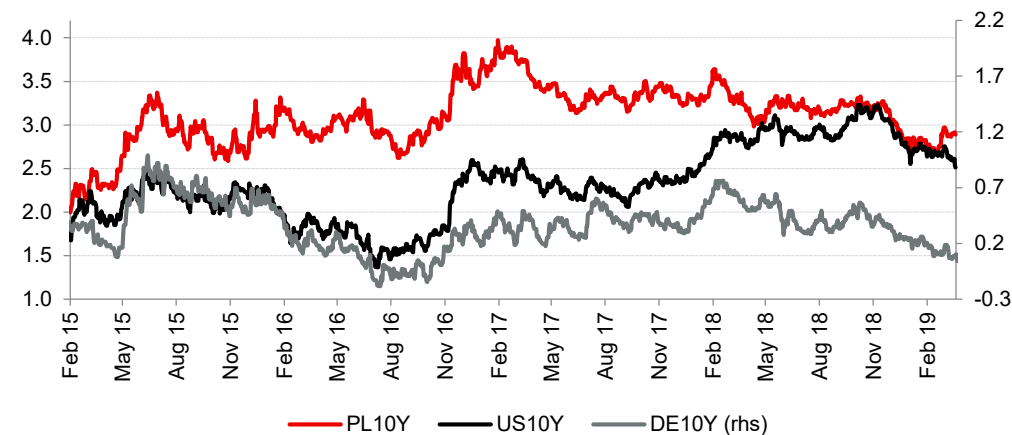


# Debt market: yields slightly up in H2

The market reacted negatively at February to the presentation of the new PiS election promises, discounting the looming fiscal easing, although we think that probably not all risks have been already fully priced-in (for example, the risk of abandoning the spending rule). Still, in the near term the trends in fixed income market are likely to be determined by global factors. We think that the new Fed projection, leaving no room for rates hikes, will support a gradual decline in yields on the long end of the domestic curve in subsequent months of Q2. Lower yields should be additionally supported by domestic data confirming still solid economic growth, which in our opinion will translate into lower credit risk pricing. We do not think that the ratings reviews planned for April (S&P, Moody's) will bring any change in credit score and thus they should not have a negative impact on debt. The short end and the middle of the curve should continue benefiting from domestic banks' purchases effected to meet the liquidity limits (we estimate their capacity to increase POLGBs portfolio in the whole 2019 at PLN30bn minimum). At the long end, we expect non-residents to increase their exposure after recent portfolio reduction (see next page).

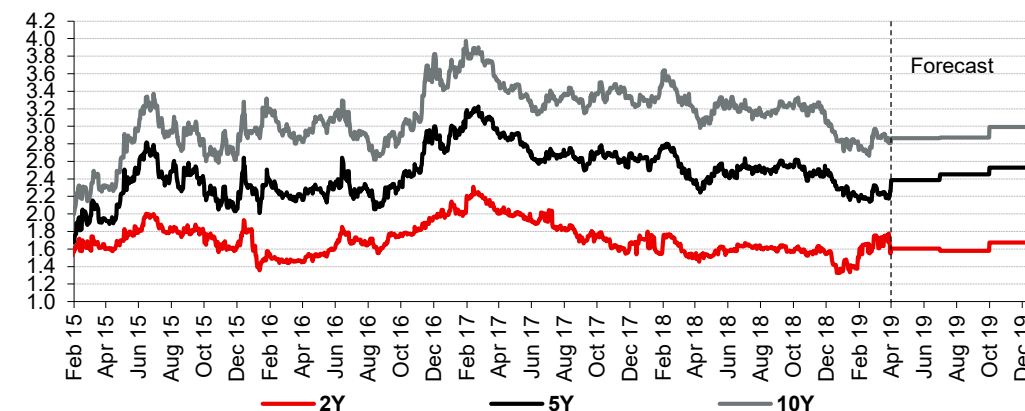
Looking ahead to Q3, will still expect a slight repricing of debt, related to the escalation of the election campaign. However, given that debt yields on core markets will remain low (Fed's announcement of no planned hikes and stop to balance sheet normalisation, and ECB's announcement of TLTRO-III), this effect will not be significant. A more marked upward shift in yields can only happen in Q4, after economic recovery in Europe becomes more visible, which may translate into higher yields of European papers and, as a result, of the domestic 10Y ones.

Yields of POLGBs, UST and Bund 10Y



Source: Thomson Reuters, Santander

POLGBs, yields and yield forecast (quarterly average)



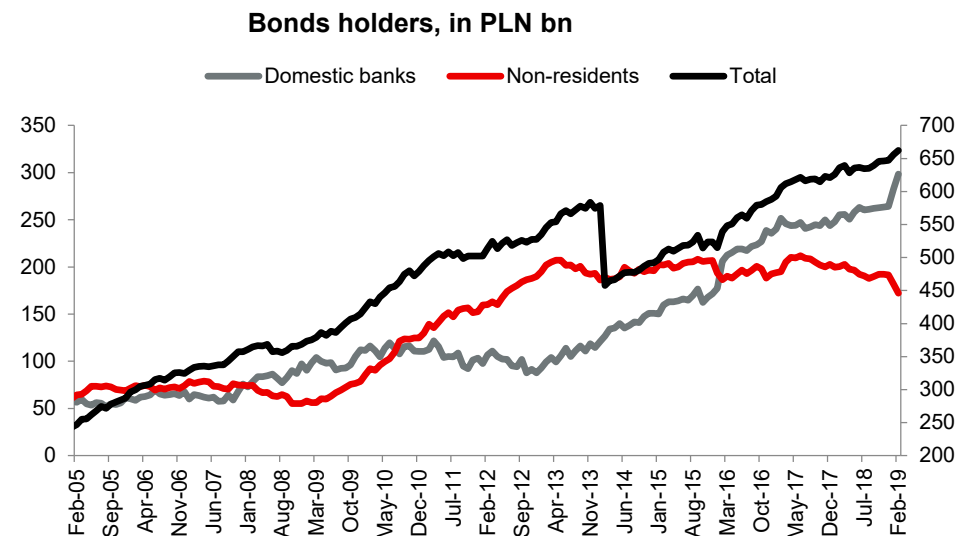
Source: Thomson Reuters, Santander



# 2019 funding: (temporarily) less external

The February data on foreign investors' exposure in the Polish debt market shows a significant decrease (cPLN20bn vs. December) in the exposure of this class of investors into PLN government debt. The main underlying reason is the sell-off of the shortest fixed- and zero-coupon papers (up to 1 year) by foreign financial institutions, coupled with the lack of supply of adequate papers from the 8-10Y segment. In our opinion, such behaviour is caused by certain liquidity requirements related to issues taken up by a part of foreign financial institutions. We estimate the threshold beyond which those institutions do not take up and/or dispose of individual issues at PLN 10-12 billion. This process is particularly visible in the case of short bonds subject to earlier redemptions.

We therefore believe the lower exposure of foreign investors in domestic debt recorded in February to be temporary (beyond the structural change that is the gradually declining reliance on foreign engagement). In our view, in the coming months the increasing total volume of long fixed-coupon bonds will support the recovery in a part of foreign investors' portfolio. Additional support will be provided by the lower yields of USD-denominated debt.

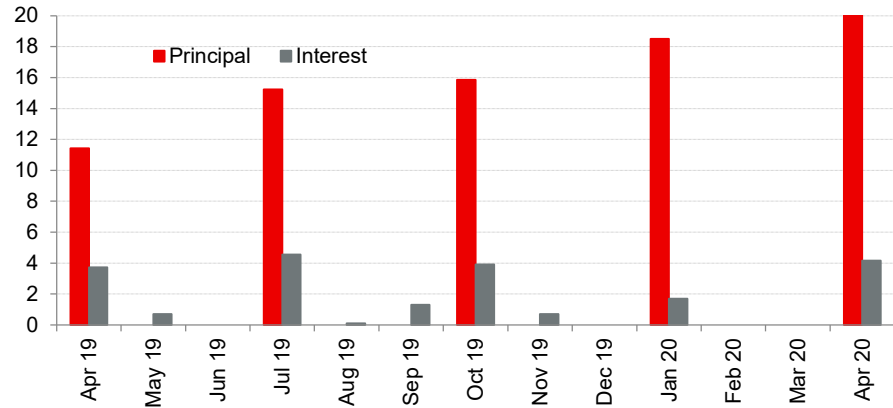


Source: Ministry of Finance, Santander



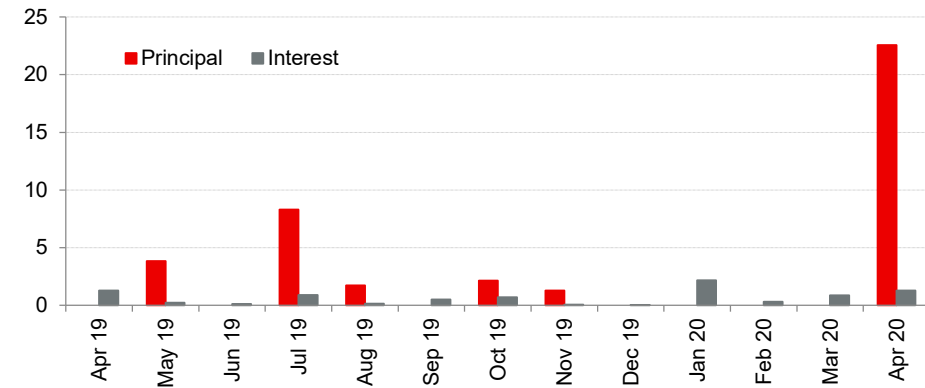
# Debt redemptions, money market pricing

PLN-denominated bond redemptions and interest payments, PLN bn



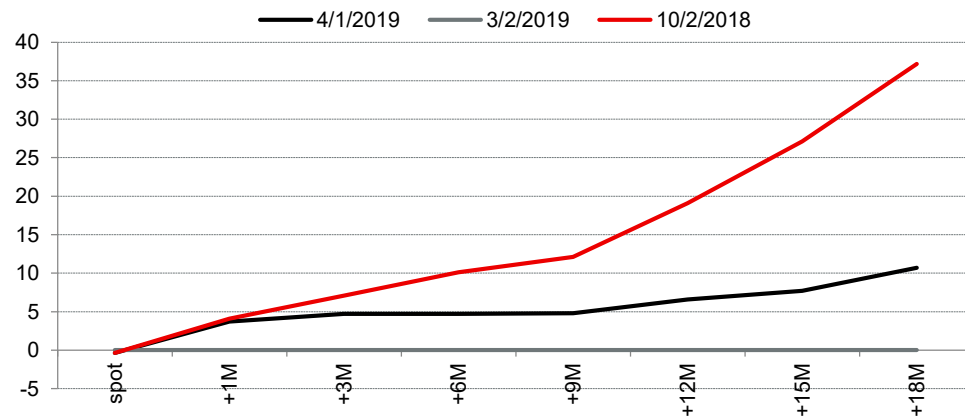
Source: Ministry of Finance, Santander

Foreign currency denominated bond redemptions and interest payments, PLN bn



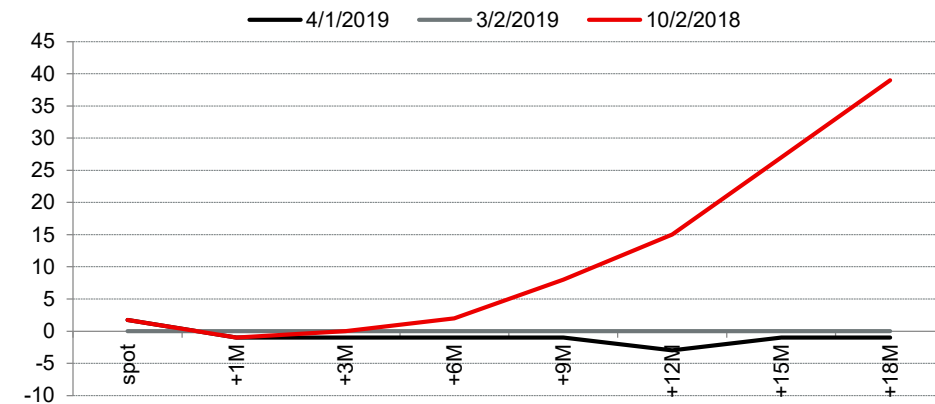
Source: Ministry of Finance, Santander

Change in Euribor3M in the coming months priced-in by the market (pb)



Source: Thomson Reuters, Santander

Change in Wibor3M in the coming months priced-in by the market (pb)



Source: Thomson Reuters, Santander



# FX Market: The zloty underperforms in early 2019...

In our 2019 Outlook, we expected the zloty to be under pressure in early months of this year. In early April, EUR/PLN is near the level of 2018-end but when compared to the EM universe, the zloty is the fourth weakest EM currency vs the euro and dollar YTD, only after the Argentine peso, Turkish lira and Romanian leu.

The domestic currency missed the developing currencies rally fuelled by the rising stock indexes (pricing an economic revival) and commodity prices. This might have been due to high uncertainty related to Brexit, stronger dollar and Polish lawmakers plans to resume work on the FX loans bill.

Nevertheless, the 1Q19 did not bring any breaking changes on the Polish FX market and so we are adjusting marginally our EUR/PLN 2Q forecast. We now expect smaller decline of USD/PLN through the year as EUR/USD is likely to rise less than we expected in December.

## FX forecasts (aop)

	2Q19	3Q19	4Q19
EUR/PLN	4.32	4.35	4.32
USD/PLN	3.76	3.77	3.67
EUR/USD	1.15	1.16	1.18

Source: Santander

## EM currencies performance

	31.12.18-29.03.19 (%)	
	vs EUR	vs USD
RUB	8.44	6.22
THB	4.68	2.55
CNY	4.62	2.48
CLP	4.17	2.05
COP	4.13	2.00
UAH	3.64	1.52
PEN	3.62	1.51
MYR	3.37	1.26
MXN	3.34	1.23
IDR	3.15	1.05
INR	3.00	0.90
SGD	2.64	0.54
HKD	1.85	-0.23
ZAR	1.24	-0.83
BRL	0.89	-1.17
HUF	-0.08	-2.12
CZK	-0.34	-2.37
PLN	-0.35	-2.38
RON	-2.41	-4.41
TRY	-3.03	-5.02
ARS	-11.23	-13.05

Source: Bloomberg



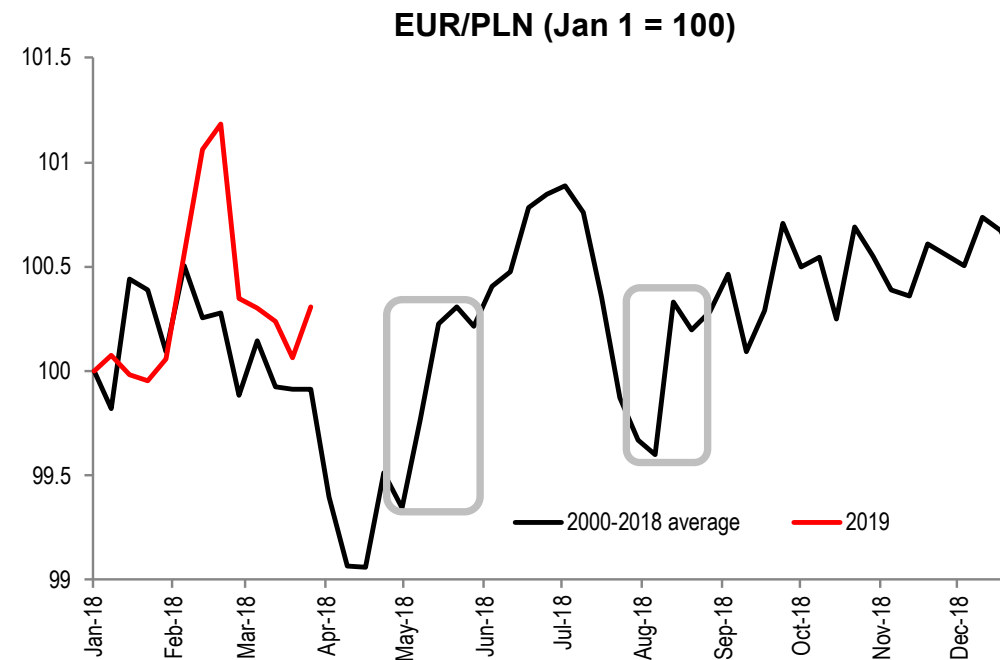
# FX Market: ... and this may hold in mid-year

Until now, EUR/PLN has been tracking its 2000-2018 average performance pretty well. **However, we think it would be challenging for the zloty to add gains in the current environment.**

Global stocks started the year with a noticeable upside move pricing that an economic slowdown in the euro zone is nearing to an end but the recent data still do not give a convincing evidence that the growth has reached the bottom. As a result, we think there is a risk for the profit taking to start on the equity market. In our annual report, we mentioned that trends on the equity markets are more important for the zloty than changes of the bond yields. As a result, any correction of the global stock indexes might weigh on the zloty. Weaker demand for the risky assets could be caused also by the still persisting Brexit uncertainty.

In May, elections to the European Parliament (EP) will be held and as regards Poland, results could be an important determinant for the election campaign ahead of the Poland's general elections. If the ruling PiS is not satisfied with the result, this could encourage the government to come up with even more costly ideas that could be negatively received by investors. Currently, the PiS is running neck and neck with the coalition of opposition parties, as polls before the EP elections show.

Around mid-year, we have two strong seasonal patterns – zloty tends to depreciate in May and August. Since we do not expect any zloty appreciation in March-April, the May-effect could be less pronounced than in the previous years.



Source: Santander, Reuters



# FX Market: higher EUR/USD and less dovish MPC

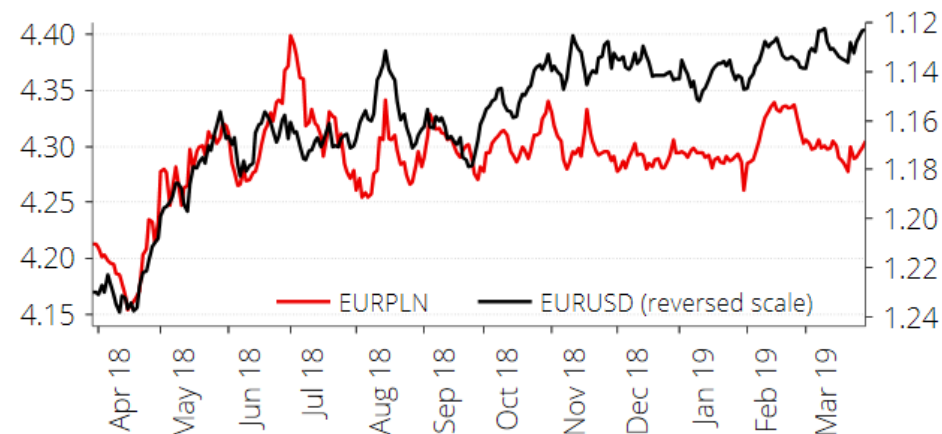
Later in the year, when we expect the signs of an economic revival in the European economy to be more obvious, we expect the Polish currency to gain. Also, we uphold the view that EUR/USD will rise this year which should also be zloty-positive.

The dollar positive factors appear to fade – FOMC removed rate hikes from this year’s agenda, the pace of US GDP growth is expected to ease – and should the economic growth in Europe pick up, this could allow the euro to gain vs the dollar even if the ECB postponed rate hikes.

Also, the most recent comments of the Polish MPC members showed some more hawkish bias indicating scenario of stable rates could be questioned in light of the generous stimulus announced by the government. Should there be some noticeable impact on the GDP and inflation from the fiscal impulse, the market could start pricing rate hikes in Poland, supporting the zloty.

While we see only some shift of the Polish MPC members view, in Czech Republic and Hungary central banks have already taken some action. The Czech central bank’s main interest rate is already above Polish one (1.75% vs 1.50%) and the Hungarian central bank hiked the deposit rate. In case of the former, we think the hiking cycle is nearing to an end while the latter stated the move was a one-off adjustment for now. However, when the data show that the situation in the euro zone starts to improve – which is our base scenario – Czech and Hungarian central banks could resume their monetary policy tightening/normalization process. At the same time, Polish MPC could stay behind again leading to a situation when the zloty could underperform vs its CEE peers.

EUR/PLN and EUR/USD



Source: Thomson Reuters Datastream, Santander Bank Polska



# European elections: important test before autumn

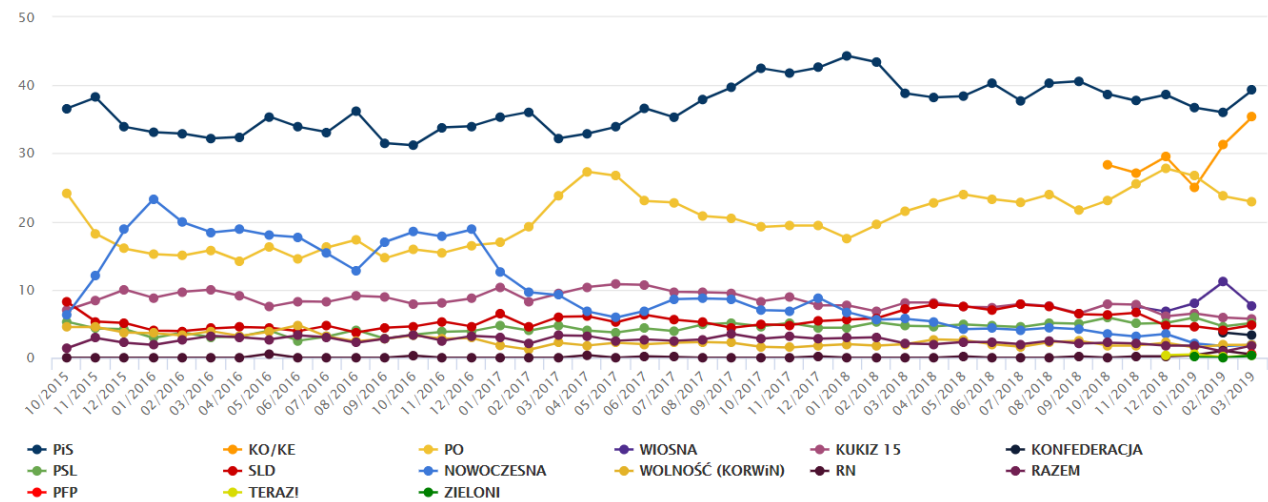
The ruling PiS is still in the lead in the opinion polls, but the support has been gradually fading until recently and the alliance of the opposition parties (KO/KE) has been catching up. Moreover, before the general elections in the autumn there is still one hurdle to go: the European Parliament elections in May, which could potentially be problematic for the ruling party (the turnout in those elections traditionally tends to be higher in urban than in rural areas, which is not supportive for PiS). This was probably one of reasons why PiS came up with such a big spending spree in February.

For the ruling party the European elections will serve as a litmus paper if the already announced fiscal package has been enough to secure a victory also in the general elections later on. The worse performance of PiS in May EP elections the bigger might be the possible size of the top-up of election promises in June. This could be also the make-or-break moment for the coalition of opposition parties. A failure in May could decrease their morale and support, granting an easy win to PiS later on.

Judging by the most recent opinion polls, it seems that some influence of the new spending spree already can be seen, also by toning down negative publicity after several scandals including people linked to the ruling party. The media attention switched to the issue of feasibility of the proposed measures given the current fiscal framework. Nevertheless, the PiS lead over the opposition keeps shrinking.

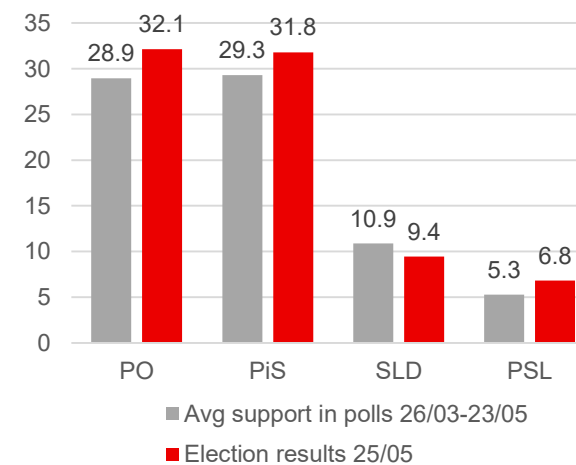
But the general public seems to like the idea of more social transfers despite the financing issues. A recent poll by CBOS had 73% of respondents approving the fiscal package, despite the fact that only 2% agree to a large negative fiscal balance (25% do not mind a small deficit if there is important social reason for it, 60% would want no deficit at all). What is more, only 45% believe Poland can afford the fiscal package while 38% think the opposite. Consumer confidence set new records after the announcement of the package.

Average support for parties in a given month, based on available polls (%)



Source: ewybory.eu

European Elections 2014 – polls vs. results (top four parties)



Source: pollsters, PKW

European Elections 2019 – recent polls (top four parties/alliances)

Opinion poll	Date	PI S	KE	WIOSNA	KUKIZ'15
IBSP	1.04	38.76	41.51	8.63	4.46
Estymator	24.03	42.2	39.3	6.1	5.2
IBSP	21.03	39.35	41.82	7.49	5.04
IBRIS	19.03	41	37.2	6	2.9
CBOS	19.03	41.8	26.4	4.5	4.6
IBRIS	14.03	40	38	7	5
Kantar MB	13.03	33	35	11	7
IBRIS	7.03	39.7	38.5	6.2	5.1
Pollster	1.03	38	32	12	8
Estymator	23.02	38.5	38.5	10.2	7
IBRIS	21.02	34.7	38.5	8.9	6.6
IPSOS	17.02	33.9	33.2	12	7.9

Source: ewybory.eu







# Economic Forecasts

		2016	2017	2018	2019E	1Q18	2Q18	3Q18E	4Q18	1Q19E	2Q19E	3Q19E	4Q19E
GDP	PLNbn	1,861.1	1,988.7	2,116.4	2,224.2	486.5	507.1	525.3	597.5	513.6	532.2	551.9	626.4
GDP	% y/y	3.1	4.8	5.1	4.1	5.3	5.1	5.1	4.9	4.5	4.0	4.0	3.8
Domestic demand	% y/y	2.3	4.9	5.5	4.3	6.6	4.4	6.2	4.8	4.0	4.4	4.5	4.4
Private consumption	% y/y	3.9	4.9	4.6	4.6	4.7	4.9	4.5	4.3	4.2	4.3	4.9	4.8
Fixed investment	% y/y	-8.2	3.9	7.2	6.0	8.2	4.7	9.9	6.7	7.2	6.8	6.3	5.0
Industrial output	% y/y	2.9	6.5	5.9	5.5	5.5	7.0	5.3	5.4	5.6	5.5	6.4	4.4
Construction output	% y/y	-14.5	13.7	19.7	9.7	25.6	21.9	18.3	16.8	9.8	13.6	9.4	7.1
Retail sales (real terms)	% y/y	5.2	7.1	6.5	5.6	8.1	5.5	5.6	5.8	4.2	7.4	8.8	7.5
Gross wages in national economy	% y/y	3.8	5.3	7.2	8.0	6.2	7.1	7.6	7.7	7.1	8.1	8.2	8.6
Employment in national economy	% y/y	2.3	3.3	2.6	1.8	2.8	3.0	2.3	2.2	2.1	1.9	1.7	1.6
Unemployment rate *	%	8.2	6.6	5.8	5.4	6.6	5.8	5.7	5.8	5.9	5.3	5.3	5.4
Current account balance	EURmn	-2,248	715	-3,449	-6,796	535	400	-2,631	-1,753	1,167	-466	-3,679	-3,818
Current account balance	% GDP	-0.5	0.2	-0.7	-1.3	-0.2	-0.1	-0.6	-0.7	-0.6	-0.7	-0.9	-1.3
General government balance (ESA 2010)	% GDP	-2.2	-1.4	-0.4	-1.7	-	-	-	-	-	-	-	0.0
CPI	% y/y	-0.6	2.0	1.6	1.7	1.5	1.7	1.9	1.4	1.2	1.8	1.9	2.0
CPI *	% y/y	0.8	2.1	1.1	2.3	1.3	2.0	1.9	1.1	1.7	1.9	1.8	2.3
CPI excluding food and energy prices	% y/y	-0.2	0.7	0.7	1.7	0.8	0.6	0.8	0.7	1.0	1.6	1.8	2.3

\* End of period; other variables – average in period

Source: GUS, NBP, Santander



# Market Forecasts

		2016	2017	2018	2019E	1Q18	2Q18	3Q18	4Q18	1Q19	2Q19E	3Q19E	4Q19E
Reference rate *	%	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
WIBOR 3M	%	1.70	1.73	1.71	1.72	1.72	1.70	1.71	1.72	1.72	1.72	1.72	1.72
Yield on 2-year T-bonds	%	1.66	1.89	1.59	1.62	1.64	1.57	1.61	1.53	1.61	1.59	1.59	1.67
Yield on 5-year T-bonds	%	2.37	2.78	2.51	2.42	2.61	2.43	2.53	2.45	2.26	2.40	2.47	2.55
Yield on 10-year T-bonds	%	3.05	3.44	3.21	2.90	3.37	3.18	3.19	3.12	2.86	2.85	2.90	3.00
2-year IRS	%	1.62	1.90	1.89	1.85	1.93	1.83	1.89	1.90	1.72	1.84	1.87	1.97
5-year IRS	%	1.94	2.40	2.43	2.21	2.50	2.39	2.45	2.40	2.06	2.18	2.25	2.36
10-year IRS	%	2.37	2.86	2.89	2.57	2.96	2.89	2.92	2.80	2.42	2.50	2.60	2.76
EUR/PLN	PLN	4.36	4.26	4.26	4.32	4.18	4.26	4.30	4.30	4.30	4.32	4.35	4.32
USD/PLN	PLN	3.95	3.78	3.61	3.75	3.40	3.58	3.70	3.77	3.79	3.78	3.77	3.67
CHF/PLN	PLN	4.00	3.84	3.69	3.70	3.59	3.63	3.76	3.79	3.80	3.76	3.66	3.60
GBP/PLN	PLN	5.35	4.86	4.81	4.99	4.73	4.86	4.81	4.85	4.93	5.02	5.06	4.96

\* End of period; other variables – average in period

Source: NBP, Bloomberg, Santander

This analysis is based on information available until 01.04.2019 and has been prepared by:

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