2015 OUTLOOK: POLAND

MACRO, RATES AND FX

December 2014

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Overview – rear-view mirror (2014)

- In the first half of 2014 we saw a continuation of the economic recovery as domestic demand joined exports as the engines of expansion. **After the first phase of the recovery, which started in 2013 and was driven primarily by exports, we expected to see higher consumption and investment**. Simply put, higher expected foreign orders required an increased in production capacity and, thus, led to higher employment and investment. In fact, investment growth turned out to be stronger than we anticipated a year ago. Nevertheless, **when the second phase of the recovery started to be visible, an outside shock appeared on the radar**. These were two, interlinked shocks, as the conflict in Ukraine (which affects Polish trade with Eastern Europe) was accompanied by a slowdown of economic growth in the Euro zone, especially Germany. As a result, in late August we lowered our forecasts for Polish GDP in 2014-15. **The slowdown seems temporary, however, as recent business climate indices suggested that we will see, at most, two quarters of sub-3%YoY GDP growth at the turn of 2014 and 2015**.
- **Inflation surprised on the downside in 2014**, which was the main reason why the central bank continued monetary easing during the year (contrary to expectations of rate hikes, formulated just a few quarters earlier). Although in our outlook for 2014, published a year ago, we were also in the camp opting for monetary tightening, it was not surprising that **the MPC decided to cut rates, given the change in the macroeconomic situation, especially as regards the consumer price index. At the end of the day, their mandate is**: "*The basic objective of the activity of the NBP shall be to maintain price stability, while supporting the economic policy of the government, insofar as this does not constrain the pursuit of the basic objective.*" Given that there were no risks to inflation (in fact, the CPI target of 2.5% was missed again, this time by 3 percentage points), there was even more room for monetary easing, especially when the risk of headline and core inflation exceeding the target in the medium-term was limited (according to most forecasts).
- The downside risk for growth, much-lower inflation and monetary easing combined to support a rally on the Polish fixed income market. In the FX market, the EURPLN rate was relatively stable throughout the year, which we think is a result of forces acting in opposite directions.

Overview – looking through the macro windscreen

- As outlined on the previous page, we expect **the slowdown in GDP (possibly to below 3%YoY) to be temporary**. Most of risks continue to be external, with a number of question marks hanging over the Euro zone economy and considerable difficulty in forecasting further developments in Ukraine. We still assume, however, that Polish export growth will be solid at c6%-7% (lower than the c10% growth we expected before the 2Q shock), which will increase the importance of exports in the economy. Growth should be underpinned by the continuing geographical diversification of exports and gains in Poland's market share in existing export markets (see following pages). This should be supported on the demand side by a moderate recovery in the Euro zone. We assume the slowdown in the Euro zone economy is temporary and our house forecast for Euro zone GDP is for 1.1% growth for 2015 (and 1.5% in Germany). Although the forecasts are similar to 2014, the quarterly profile is quite different, with the weakest YoY growth in 1Q.
- **Domestic demand will continue to be important in 2015**. The improvement in the labour market should continue with job creation and significant growth in real wages (supported by productivity increases). According to the LFS data, in October 2014, for the first time on record, employment exceeded 16 million people. Employment growth amounted to 2.7%YoY (the highest since 2008) in a declining working-age population. Nominal wage growth of c3%-4% should be maintained, but low/no inflation will support disposable incomes in real terms. At the same time, we expect unit labour costs to increase by a mere 1%-2% in 2015. Household budgets should also be supported by favourable rules on indexation for pensioners, higher tax allowances for families with children and low interest rates. **Private consumption should be an important driver of GDP growth in 2015**. The big question mark is over investment, where we expect growth of 8.4%.
- **We do not think inflation will become a problem any time soon (quite the opposite, deflation could last almost 12M).** Although our growth breakdown suggests core inflation may increase throughout 2015, the starting point is extremely low and a long way off the inflation target. We see CPI inflation below zero at least until mid-2015, before increasing gradually to 1% by year-end. This would put pressure on the Monetary Policy Council (MPC) again.

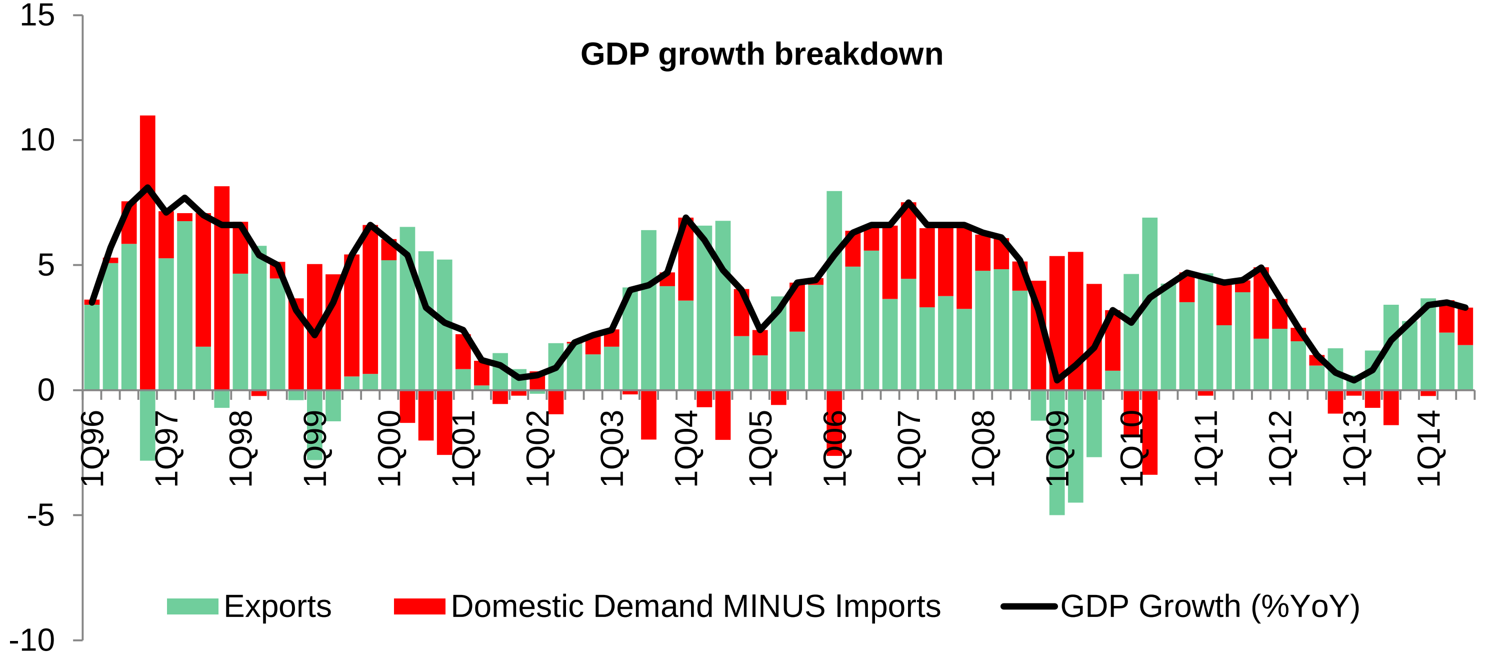
(continues on the next page)

Overview – looking through the markets windscreen

- The downward trend in money market rates has reversed recently, as expectations of further interest rate cuts fade after better-than-expected macro data. The **money market is still assuming one more rate cut over the coming three months, in line with our base scenario**, with a slight chance of more easing in two to three quarters. If investors start to price in additional easing (exceeding 50bp) as was the case in 2014, we would find it unjustified.
- In 2015, the domestic debt market is likely to remain under pressure from several factors, with divergent monetary policy one of the key issues. Hopes for both QE in the Euro zone and a rate cut by the domestic MPC should stabilise yields/rates at low levels at the beginning of 2015. Yields may increase if the hopes are confirmed, in particular at the long end of the curves. **The expected economic recovery, driven mainly by domestic demand should also contribute to higher yields** (although a prolonged period of sub-zero inflation could limit the pace of yield increases, especially at the short end). **A significant pre-financing of 2015 gross borrowing requirements should also provide some support for domestic assets**. We expect a similar structure of local debt financing as in 2014, with domestic commercial banks playing a key role. As regards foreign investors, we forecast their share to increase to PLN8bn from cPLN4bn expected for 2014E.
- As regards the foreign exchange market, **we expect EUR/PLN to decrease slightly in 2015**. The zloty tends to be a cyclical currency, gaining during the periods of economic recovery. The economic slowdown should prove to be relatively short-lived and the Polish economy should continue to outperform not only the Euro zone, but also its CEE peers. Moreover, real interest rates in Poland are relatively high. This should favour the zloty, especially in an environment of highly-accommodative monetary policy globally (particularly in the Euro zone).
- **The Ukraine-Russia conflict seems to be the most important risk factor to our market scenario**. The zloty has remained resilient to the rouble's recent weakness, but any serious political/military tensions are likely to weigh on the Polish market. The possibility of US rate hikes generates an upside risk for the EUR/PLN, as faster-than-expected tightening in the US could trigger cash outflows from emerging markets. However, the market seems to have already factored in the Fed raising rates next year and we think the impact on the Polish market should be less significant than on other emerging economies.

Exports as the main engine of long-term growth

- The graph below shows the breakdown of GDP growth, but not in a standard textbook way (GDP=C+I+G+NX), but dividing it into pure exports (not net exports) and domestic demand minus imports. This shows to what extent exports are the main driver of growth and how much of consumption and investment has been spent on domestically-produced goods. The picture is quite clear: except for the major external shock in 2009 (affecting not only exports, but also imports due to zloty's depreciation), exports of goods and services were the main engine of long-term growth.
- It is interesting that the last two quarters showed that domestic demand joined exports in driving growth and helped mitigate the negative effects of a slowdown abroad.

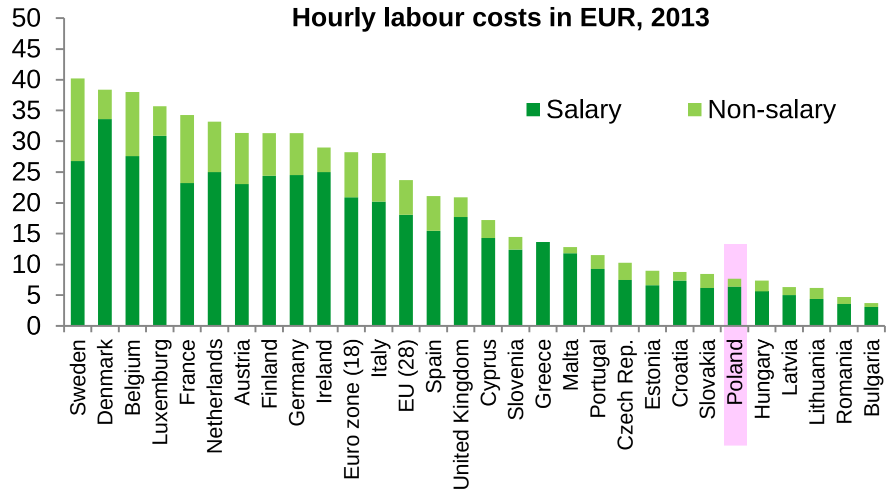


Source: CSO, BZ WBK

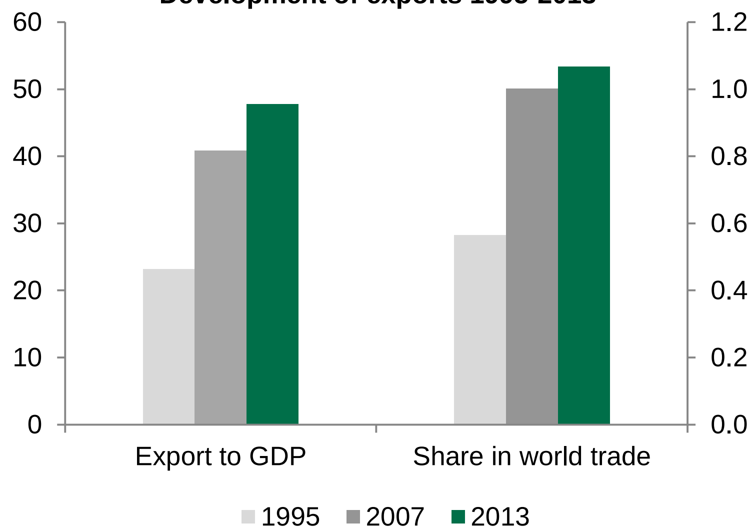
Low labour costs boost Polish exports . . .

- The importance of Polish exports in international trade, as well as openness of the Polish economy, has been rising for many years
- This was mainly due to higher competitiveness in labour costs, but a flexible exchange rate and the flexibility of the private sector played important roles as well.
- Another issue we do not cover here is the difficulty of maintaining this growth in next 20 years, given demographic trends.

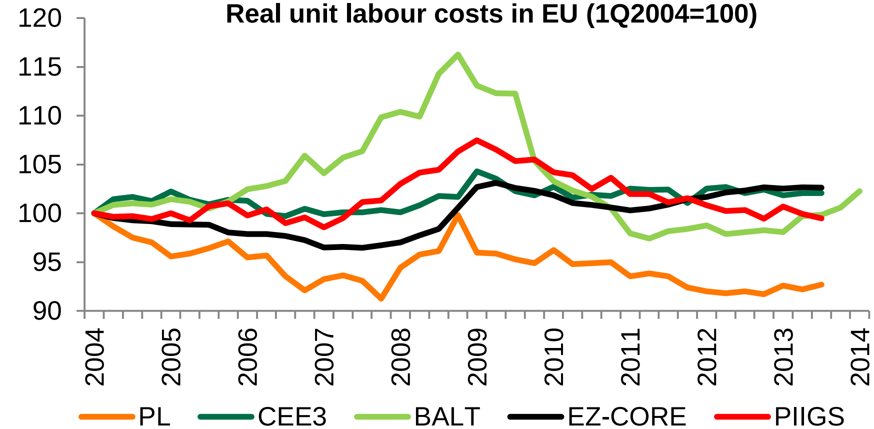
Hourly labour costs in EUR, 2013



Development of exports 1995-2013



Real unit labour costs in EU (1Q2004=100)

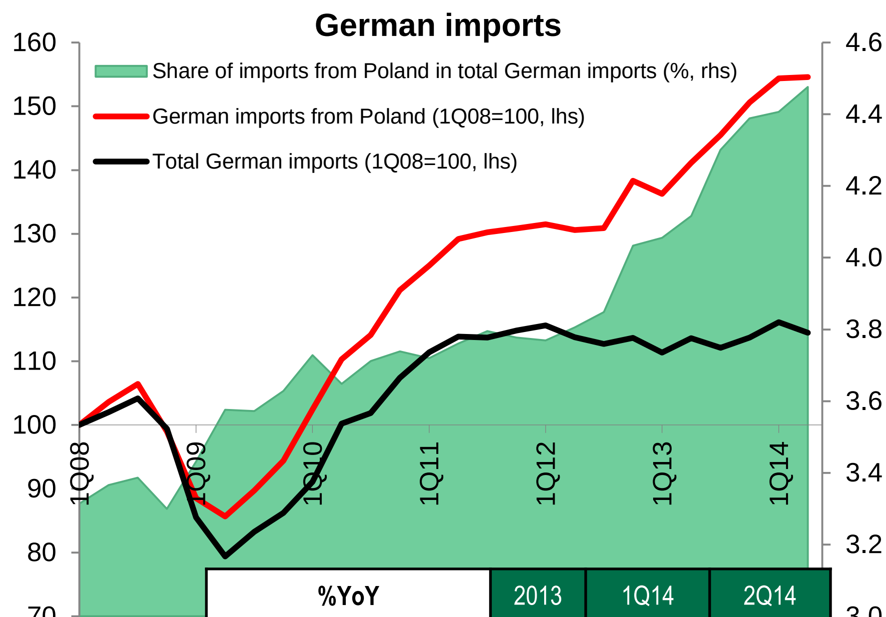


PL - Poland; CEE3 – Czech Rep., Slovakia, Hungary; BALT – Estonia, Lithuania, Latvia; EZ-CORE – Austria, Belgium,, Finland, France, Netherlands, Germany; PIIGS – Greece, Spain, Ireland, Portugal, Italy

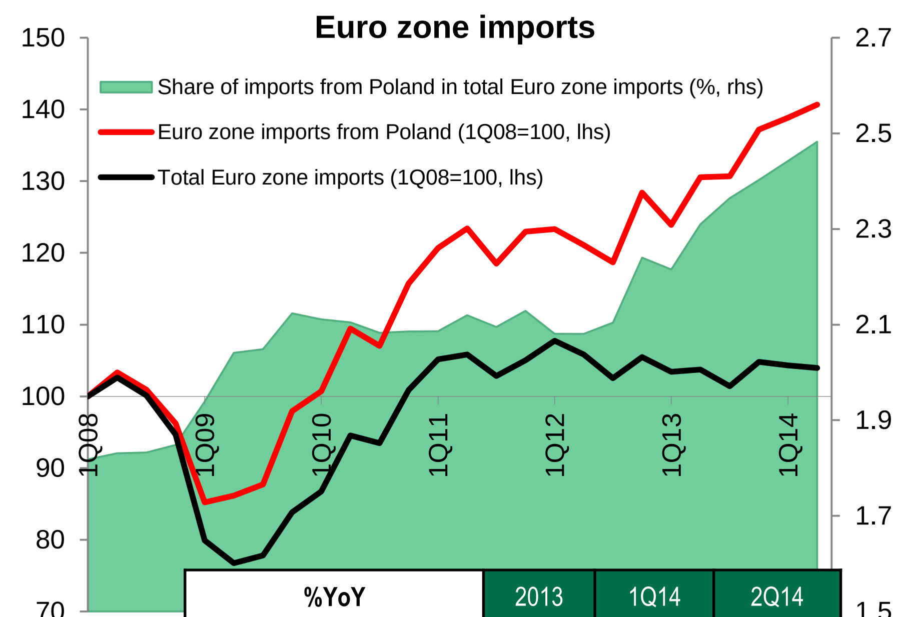
Source: Eurostat, NBP, IMF, BZ WBK

. . . which was key to the substitution effect during the crisis

- Since 2008, Polish export products have gained importance in European markets. The share of Polish products in German imports increased by almost 1 percentage point (or €1.2bn). Figures for the Euro zone show a similar trend, as the charts below indicate (import share up 0.6pp, or €1.9bn, since 2008). If we plot individual charts for Spain, France, Italy or UK, we get similar results.
- This shows that, in a recession, European firms had more incentive to find cheaper but good quality products for their production (we should remember that a c. 30% of Polish exports are intermediate goods). We think this trend will continue, which should support Polish exports going forward.



%YoY	2013	1Q14	2Q14
German imports	-1.1	4.3	0.7
German imports from PL	7.9	13.3	9.6



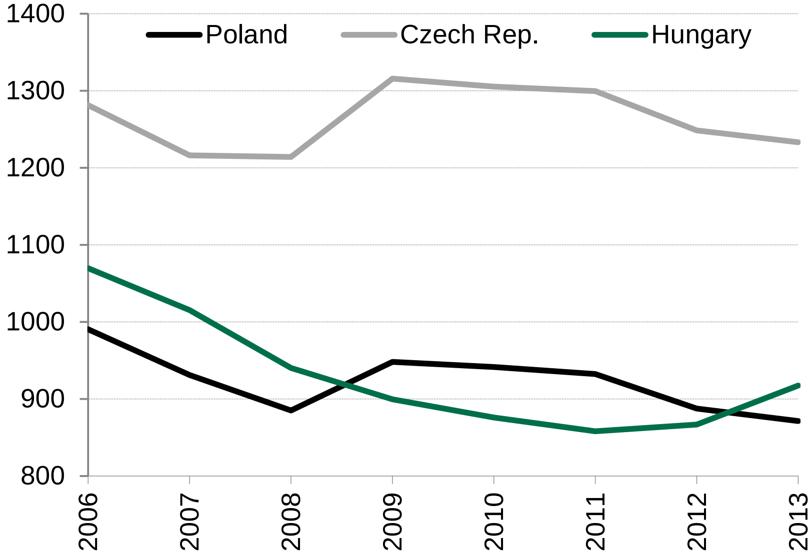
%YoY	2013	1Q14	2Q14
Euro zone imports	-1.9	0.9	0.3
Euro zone imports from PL	6.3	12.1	7.7

Source: Eurostat, BZ WBK

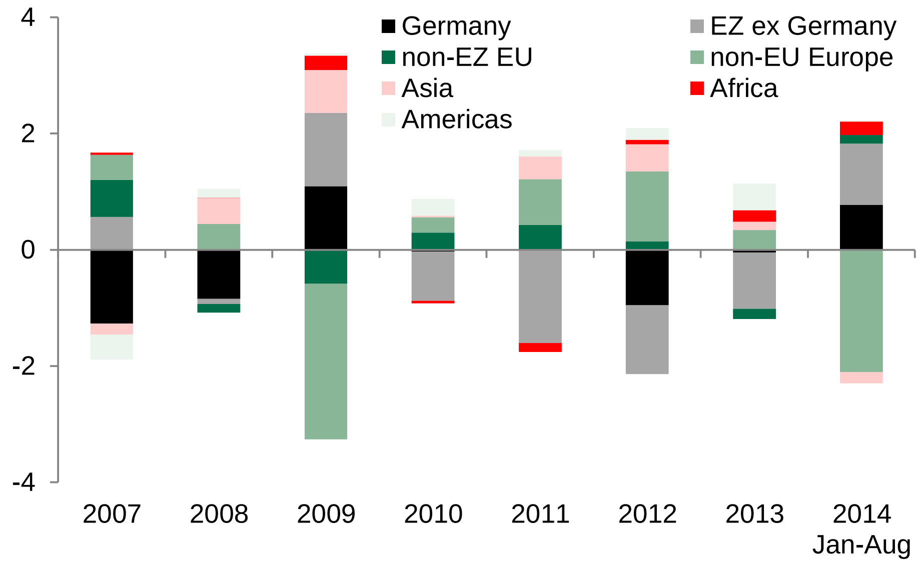
Polish exporters are diversifying geographically

- As well as gaining import market share in the major Euro zone markets, Polish companies are expanding to new markets like Non-euro zone Europe, or Asia, and achieving even faster export growth rates.
- The geographical diversity of Polish exports, as measured by the Herfindahl-Hirschman index*, is lower than in the Czech Republic and similar to Hungary's. At the same time, it is improving steadily, making the Polish economy less vulnerable to shocks.

Geographical concentration of exports – Herfindahl-Hirschman index



Breakdown of changes in shares of Polish exports (%)

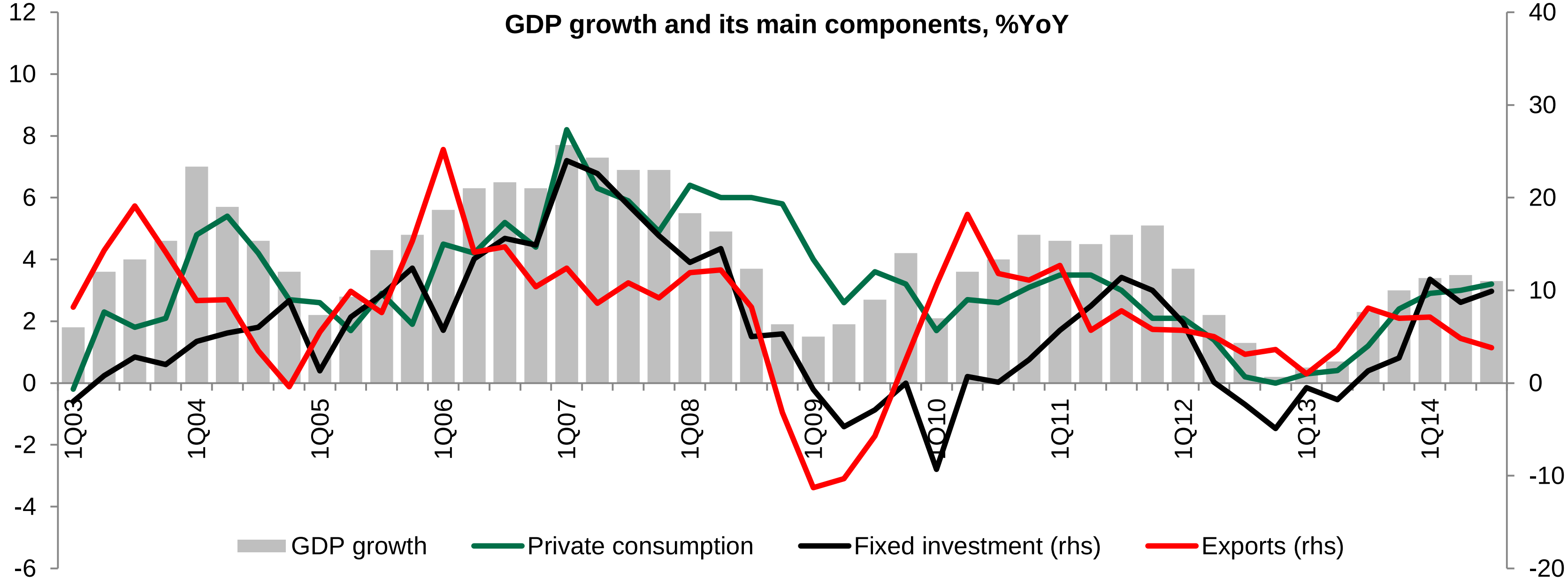


*Value of the Herfindahl-Hirschman index is equal to sum of squared percentage shares of particular countries in Polish exports. Index ranges between 10000/n and 10000, where n stands for the number of countries. Here n=c250 (changing composition). The lower the index, the more diversified are a country's exports.

Source: Eurostat, BZ WBK

From export-led to domestic-demand-led growth

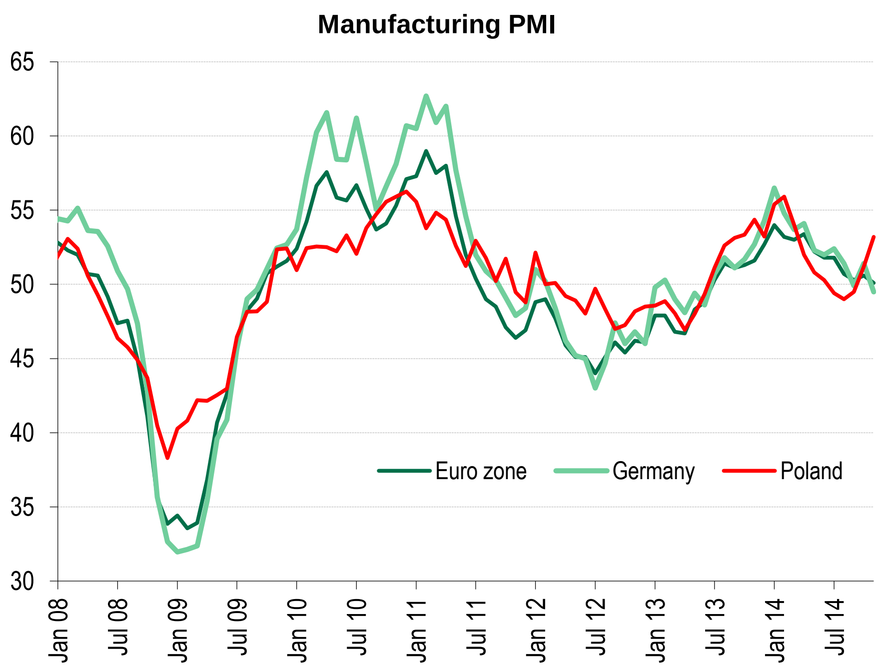
- When the economic recovery in Poland started in 2013, it was driven primarily by export growth, which, in turn, was supported by economic revival in the Euro zone. Growing export orders called for an increase of output capacity and, thus higher investments and employment, so domestic demand started to accelerate as well.
- After a promising start to 2014, two negative surprises hit Polish trade: (1) the Russia-Ukraine conflict and (2) the stagnation of the European economy. Export orders for Polish companies started to decline, which negatively affected industry and trade.
- Meanwhile, consumption and investment growth proved to be surprisingly robust, providing support for the economy to offset the more challenging external conditions.

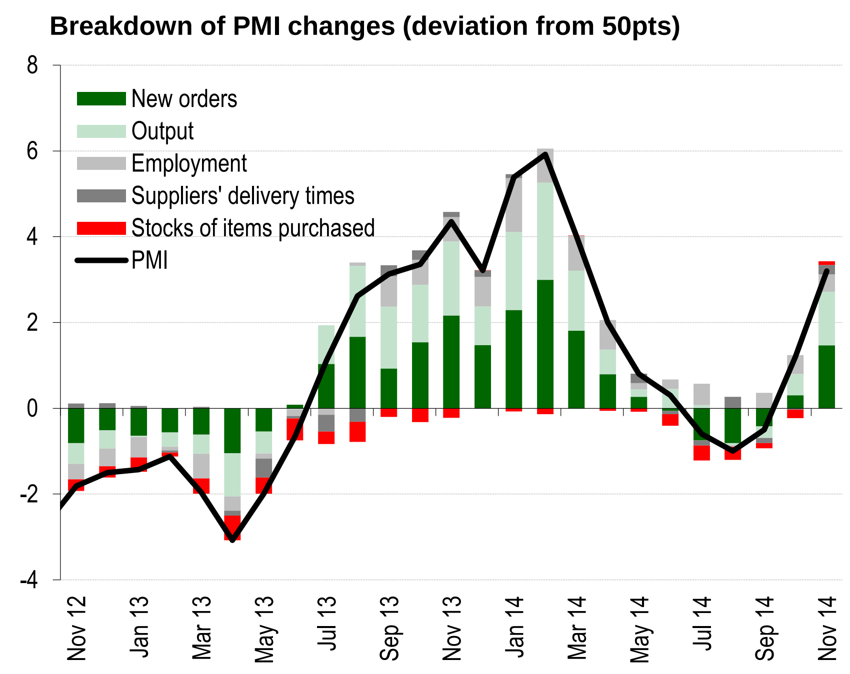


Sources: GUS, BZ WBK.

Worse external environment weighed on the Polish economy

- Falling economic activity abroad, in particular in the Euro zone, weighed on Polish industry.
- A sharp decline in new orders, mainly for export, was one of the main factors behind a significant drop in the Polish manufacturing PMI in the second and third quarters of 2014.
- Interestingly, at the start of 4Q14, not only the PMI but also other business climate surveys showed a clear rebound of manufacturing sentiment. In the PMI survey, companies reported that this was partly due to entering new markets, mainly in Central and Eastern Europe.

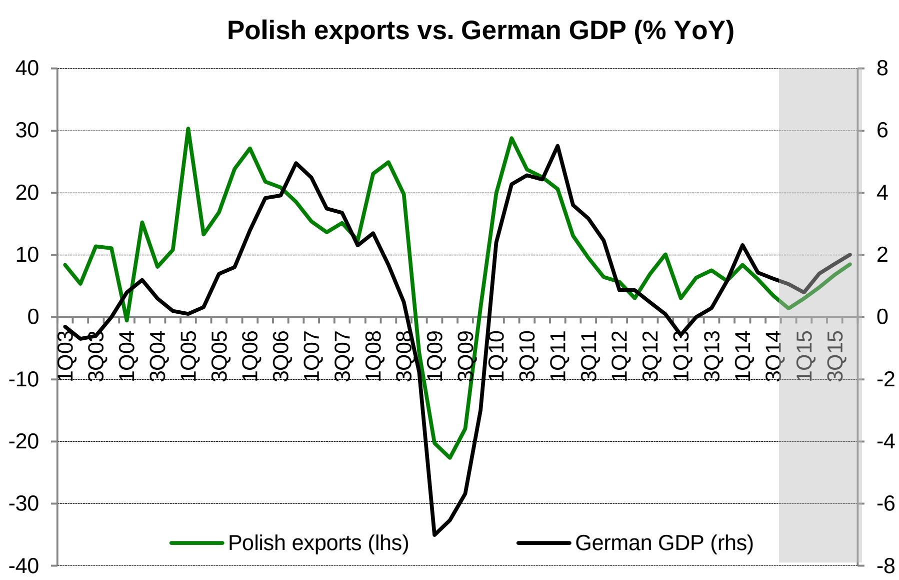


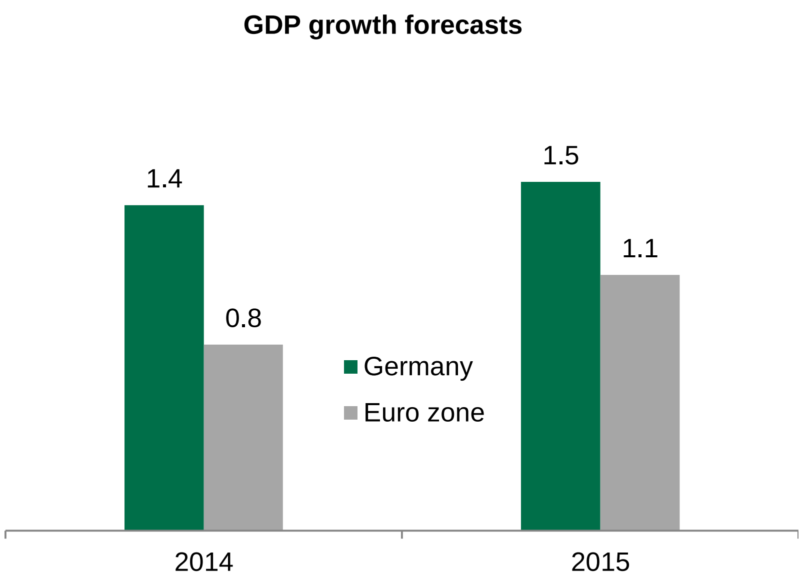


Sources: Markit, BZ WBK.

German growth should recover in 2015

- Trade with the Euro zone represents more than 50% of Polish exports (half of this is Germany), even after exporters' geographical diversification of recent years. This means there is still a high correlation between Polish export growth and German GDP.
- Our forecast for German GDP is similar for 2014 and 2015, but the quarterly profile is quite different and 2015 looks much more solid with a higher contribution from domestic demand. The fundamentals for private consumption are strong, with unemployment decreasing and income gradually increasing and now at an all-time high. We have strong forecasts for both capital goods and construction for 2015 (c3%). We still see Germany as one of the more buoyant economies in the Euro area.



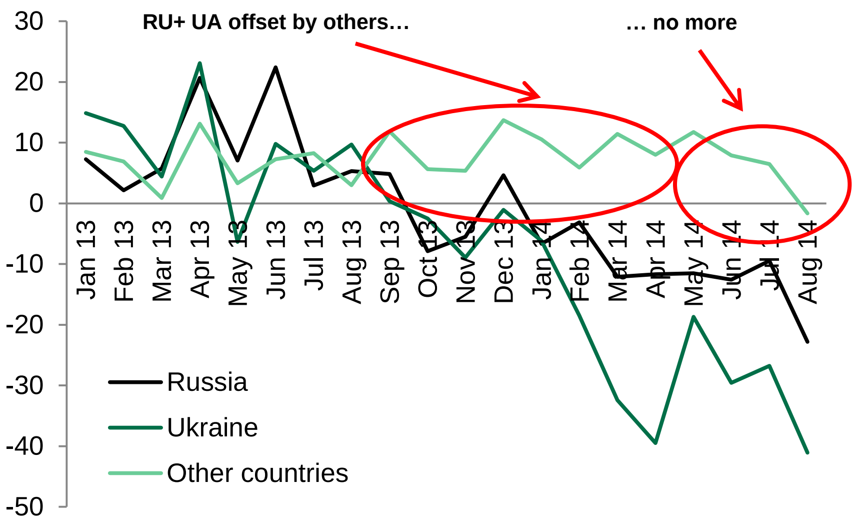


Sources: NBP, Eurostat, Santander, BZ WBK.

But weakness in Eastern markets may persist

- Polish exports to the Ukraine and Russia plunged, due to: (1) the weak economic performance and lower demand in these countries; (2) sanctions, both by the US and EU against Russia, as they weigh on Russian demand, and by Russia against the EU, as this hits food products, which make up c15% of Polish exports to Russia; and (3) the depreciation of other CEE currencies, which undermines Poland's price competitiveness.
- It is worth remembering that poor demand from Russia factor weighed on Polish exports in previous quarters and the weak outlook there led Polish exporters to diversify.
- At the start of 2014, the weakness of exports to the East was offset by strong demand from the Euro zone, but a deteriorating outlook in the latter changed the situation in 2Q.

Polish exports %YoY



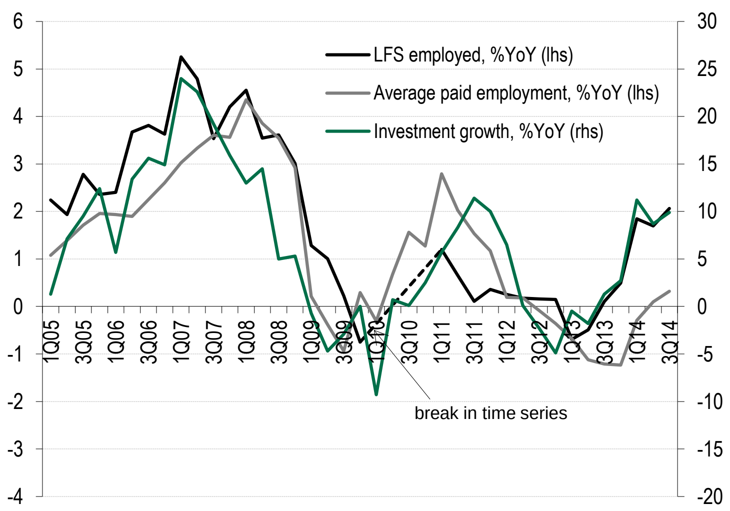
GDP growth (%YoY) in Russia and Ukraine, median market forecast (FocusEconomics)

Sources: Eurostat, FocusEconomics, BZ WBK.

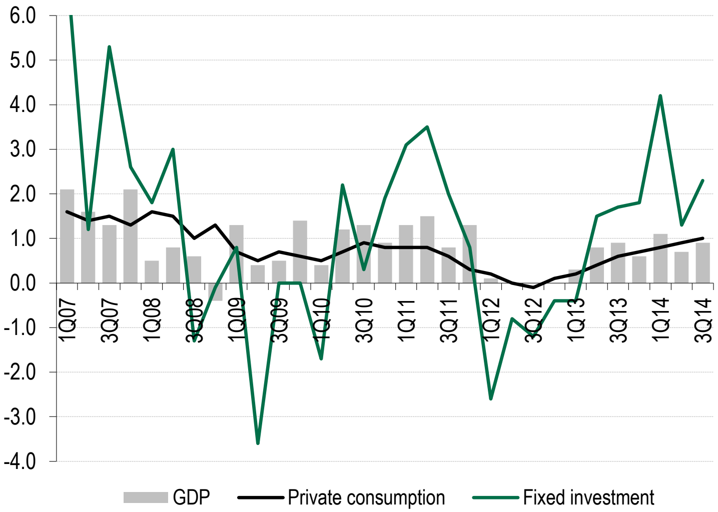
Polish firms perceive Europe's slowdown as temporary

- Recent data show that Polish companies were not overly concerned about the worsening economic climate abroad (probably seeing the European slowdown as temporary). While a surge in fixed investment growth of more than 10%YoY in 1Q14 was, to some extent, boosted by one-off effects (exceptionally good weather, a last chance to use tax allowances for car purchases), the next two quarters saw no significant slowdown of investment activity. Strong investment growth fuelled job creation and this, together with moderate wage growth and declining inflation, supported real growth of household labour income, and, in turn, private consumption.
- The global, and particularly the European, economy is still highly important: if exports suffer significantly, this would have an indirect impact on domestic demand. This is not our base-case scenario, however. Although the current pace of investments and employment growth is probably hard to maintain, we expect their positive impact on the economy to continue in 2015.

Investment growth vs. employment growth



Seasonally adjusted growth, %QoQ



Sources: GUS, Eurostat, BZ WBK.

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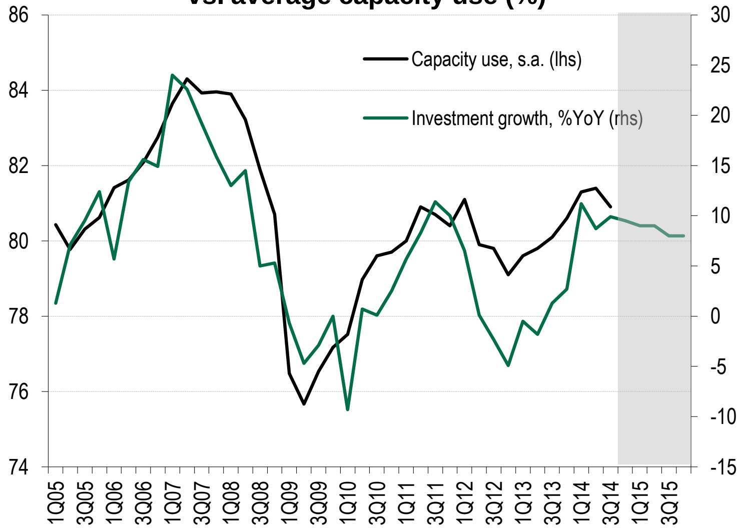
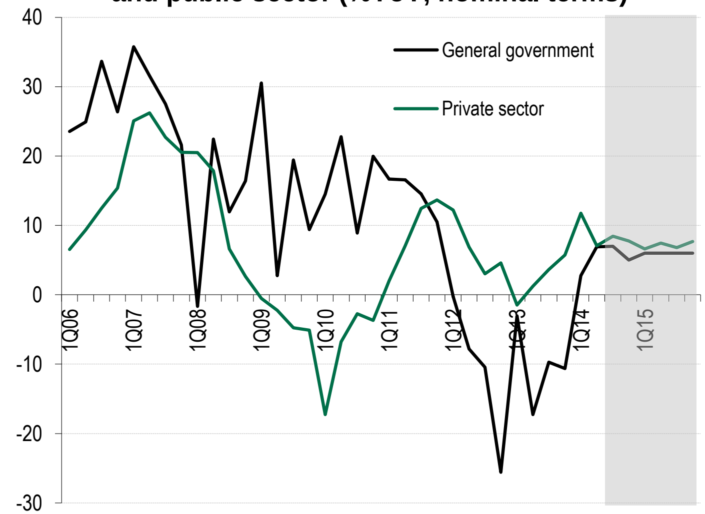
Investment should keep growing

- We expect fixed investments to keep growing at moderate pace in 2015. Average capacity use is above the long-term average and, as long as companies do not anticipate a prolonged and significant collapse of demand, they should keep expanding their production, helped by record-low interest rates. Demand for investment loans remains strong (c.10%YoY growth) and there is no sign of a slowdown.
- We think that the public sector will also contribute strongly to investment growth in the coming quarters. In contrast to the Finance Ministry's earlier assumptions, general government investment spending picked up significantly in 1H14 and we think growth will not wane substantially ahead of a general election in 2015.
- 2015 is the last year when funds from EU financial framework for 2007-13 may be spent and there is still a substantial amount of money in this pool (c.PLN70bn). So, even if the flow of funds from the new EU financial framework (2014-20) is delayed a bit, EU-funded investment spending is likely to be quite strong.

Fixed investment growth (%YoY) vs. average capacity use (%)



Fixed investment growth of the private and public sector (%YoY, nominal terms)



Sources: GUS, NBP, Eurostat, BZ WBK.

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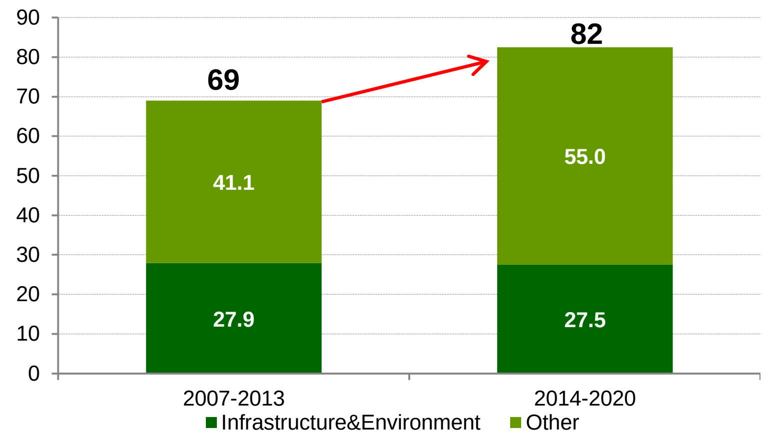
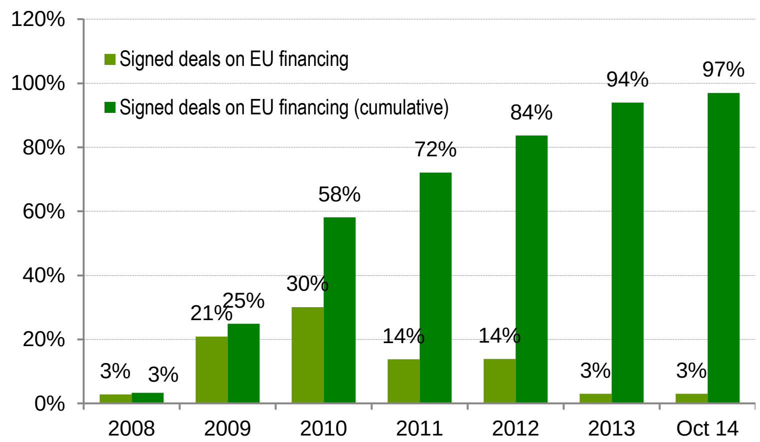
EU funding should boost investment I

- Poland is due to receive EUR82bn in co-funding from the EU in 2014-20, 19% more than the EUR69bn of 2007-13.
- Approximately EUR28bn of this amount is to be spent on infrastructure, broadly the same as in 2007-13.
- Thus far, the absorption of the 2007-13 funds covers almost 100% of the originally allocated amount. Some 60% of the funds were allocated in the first three years of the 2007-13 plan.
- However, cash transfers are lagging behind and only 74% of funding has so far been transferred to the beneficiaries.

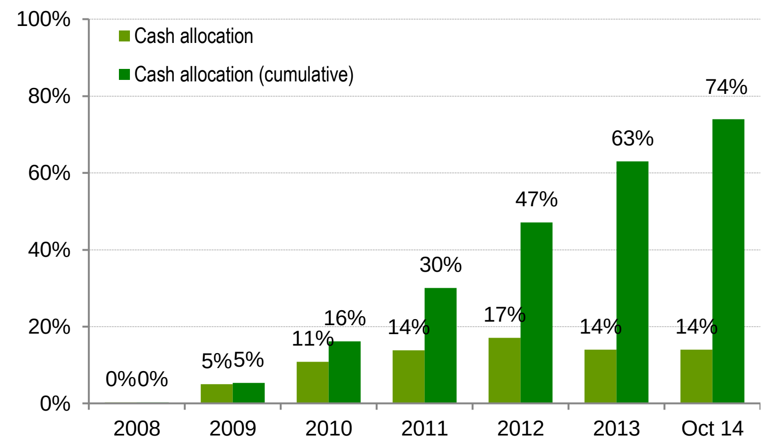
EU funds for Poland in 2007-13 and 2014-20 (EUR bn)



Timeline of 2007-13 EU funds utilization (deals signed)



Cash transfers of 2007-13 EU funds

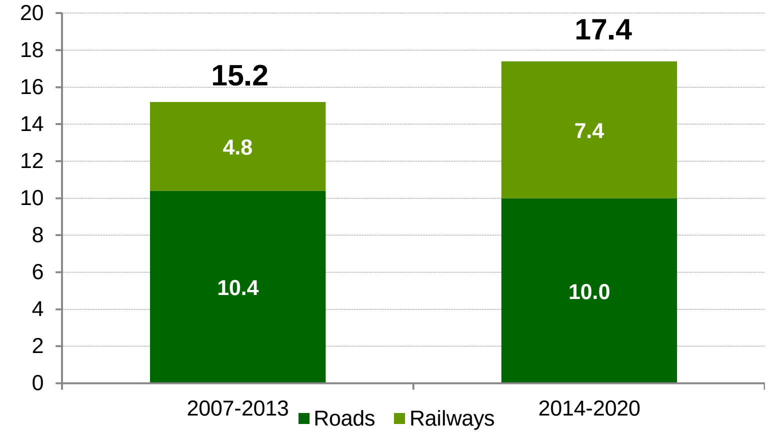


Source: Ministry of Infrastructure and Development, BZ WBK.

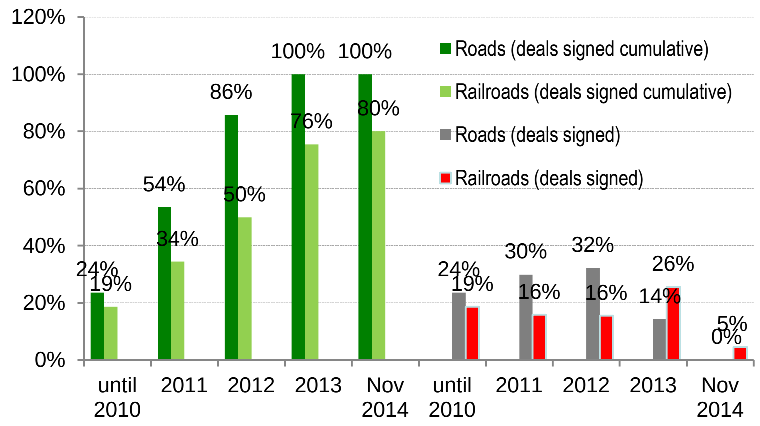
EU funding should boost investment II

- In 2014-20, spending on transport should rise 14% to EUR17.4bn, compared with EUR15.2bn allocated in 2007-13.
- Of this, EUR7.4bn should be earmarked for railway construction, which would be 54% more than in the 2007-13 budget.
- 2007-13 funding for roads has so far been fully absorbed. In contrast, only 80% of funds earmarked for railways have been taken up (and only 23% of the cash has been transferred to the beneficiaries so far).
- Spending in the early years of the 2014-20 plan might lag. For example, only 24% and 19%, respectively, of the amounts earmarked for roads and railways had been used in the first four years (by 2010) of the 2007-13 period.

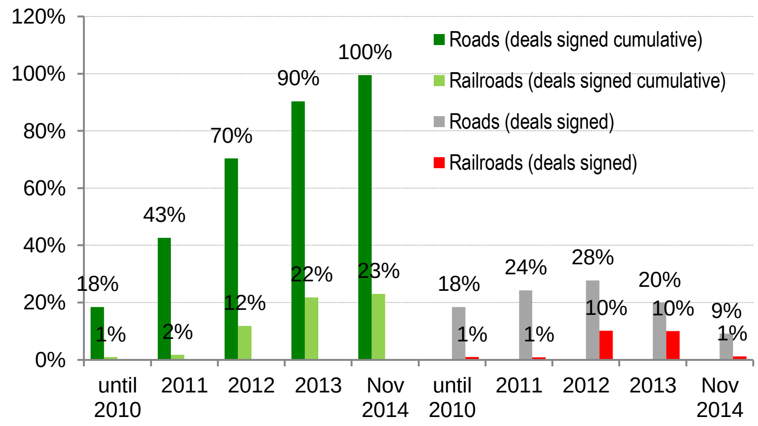
EU funds for roads & railways (EUR bn)



Road and railroad 2007-13 – EU funds utilization



Road and railroad 2007-13 – EU cash transfers

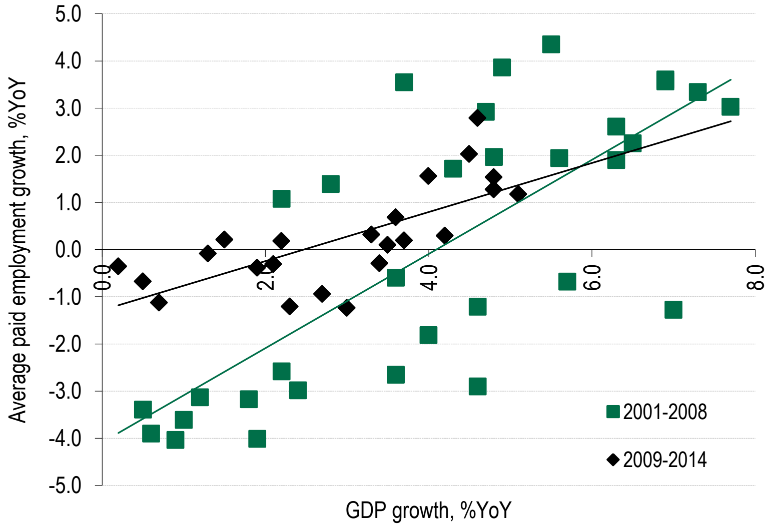


Source: Ministry of Infrastructure and Development, BZ WBK.

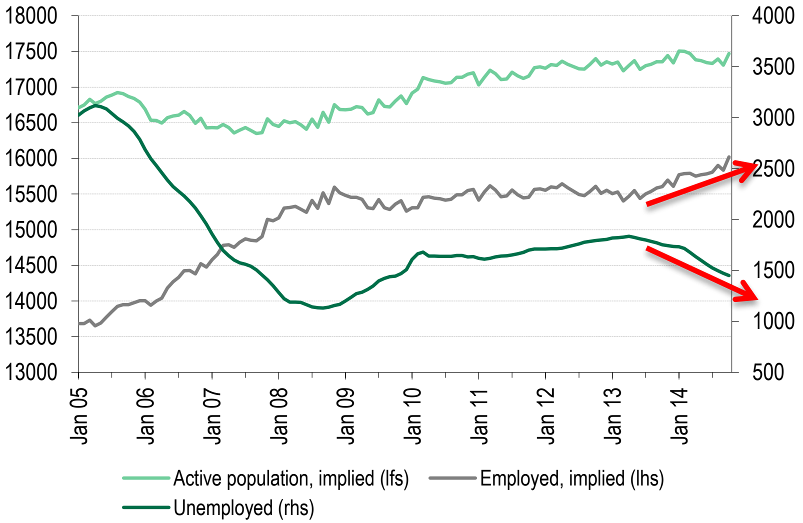
Further labour market improvement ahead

- The labour market has changed its behaviour in recent years. It seems that the GDP growth threshold at which new jobs are created has fallen, as has employment's sensitivity to GDP changes.
- The demand for labour remains strongly correlated with investment activity, so our prediction of further growth in fixed investment should result in a continued pick-up in jobs, although probably a bit slower than in the last few quarters.
- The Labour Force Survey shows much stronger employment growth in recent months (almost 3%YoY) than that indicated by employment data in the corporate sector (under 1%YoY). This may be due to most of the job creation shown in the LFS being in the services sector, which is under-represented in the corporate employment statistics.
- Labour activity has been rising gradually since 2008 and we expect this trend to continue.

The relation between GDP and employment growth has changed



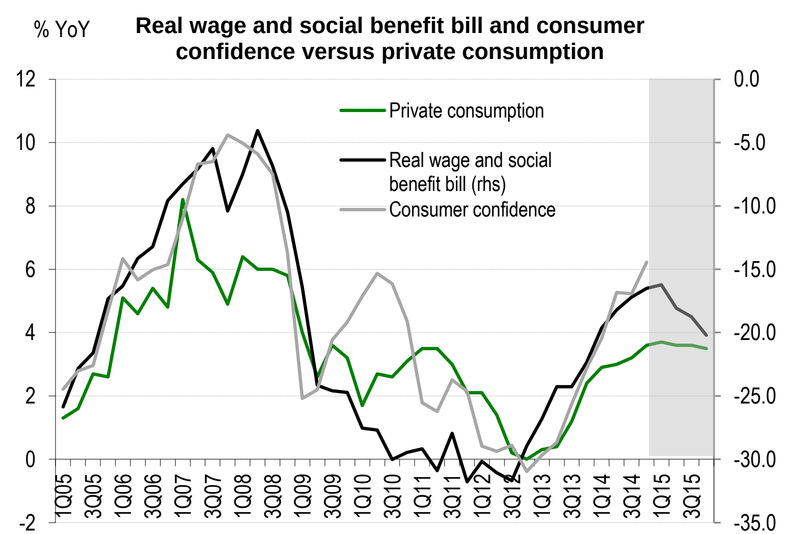
Changes in the labour market according to Labour Force Survey



Sources: GUS, Eurostat, BZ WBK.

Household income and consumption should strengthen

- Continued employment growth is likely to be accompanied by accelerating wage growth. Although the inflation-linked indexation of social benefits is low, the government has introduced a floor for nominal pension indexation (cost PLN1.7bn). This should result in roughly the same nominal indexation as in 2014. There is also a new fiscal stimulus for 2015 in the form of higher tax allowances for families with three or more children (cost PLN1.1bn).
- Lower interest rates will be an additional factor supporting consumption. We estimate the cuts so far lower the cost of households' debt servicing by cPLN4.5bn in annual terms (although lower rates have an adverse effect on incomes from deposits, we think the effect of this on consumption will be small).
- Very low inflation and declining prices of basic goods may also support consumption. We predict that average fuel prices may drop by c.10% in 2015E, which will leave an extra c.PLN6bn a year in household pockets. It may add an extra 0.6pp to real private consumption growth (unless it transforms into higher savings, which is unlikely, given low interest rates).
- The above-mentioned effects will keep real growth in household incomes at a very healthy level. Consumer confidence indices also remain relatively high, showing consumers are eager to spend. We expect private consumption to grow by 3.6% in 2015.

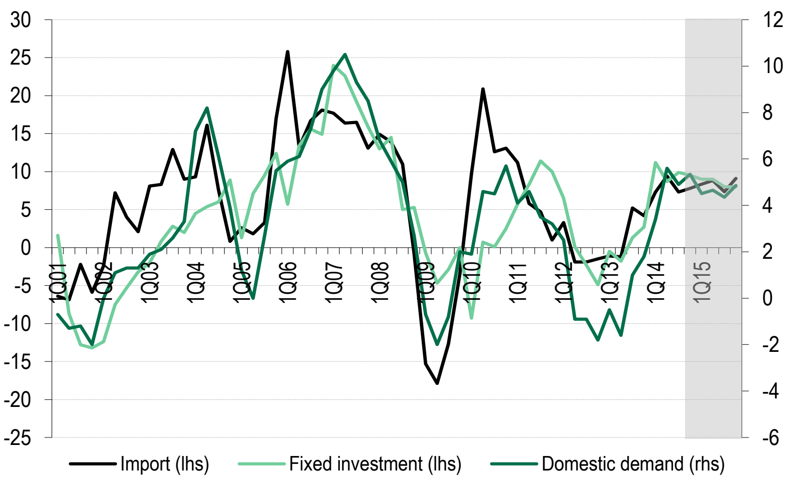


Sources: GUS, BZ WBK.

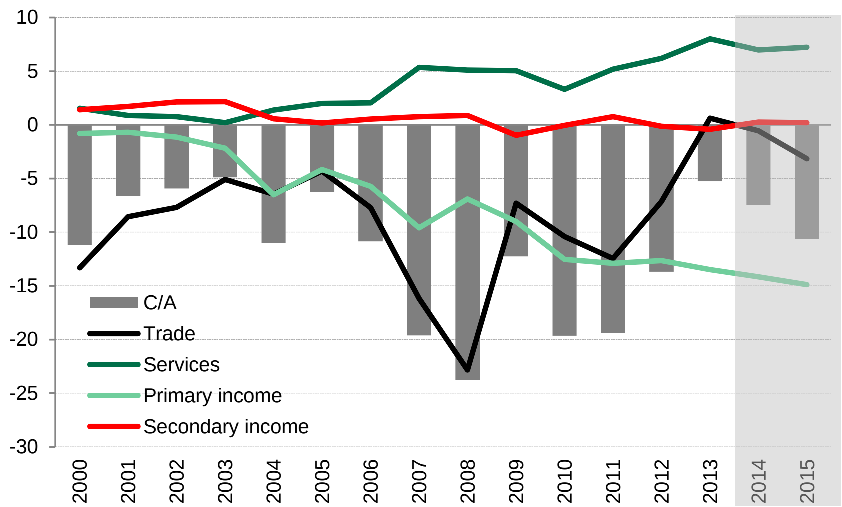
Current account deficit set to widen moderately

- As explained, we expect exports to continue robust growth of c6-7% in 2015E, driven by competitiveness (labour and exchange rate), new markets and a German recovery. At the same time, the improvement in private consumption and solid investment growth should contribute to significant import growth, partly offset by low commodity prices (although the latter have with no impact on net exports' contribution to GDP in real terms). We estimate that the lower oil price will reduce import spending by €1.1bn and €2.1bn in 2014E and 2015E, respectively, (assuming Brent averages US$77 a barrel in 2015E). While we expect the trade account to be roughly balanced in 2014E, we expect it to show a €3.1bn deficit 2015E (-0.7% of GDP).
- The current account deficit should widen moderately from 1.8% to c2.5% of GDP in 2015E, largely financed by long-term capital (FDI + EU funds in the capital account).

Imports, investment and domestic demand (%YoY)



Balance of payments (€ bn)

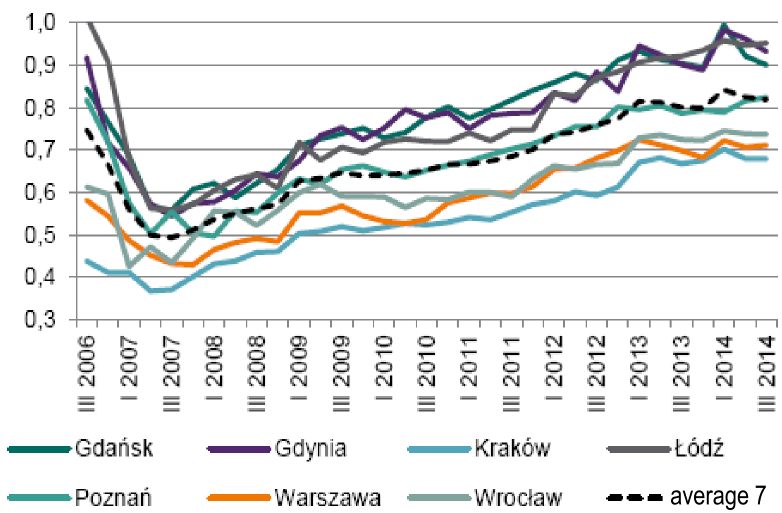


Sources: GUS, NBP, BZ WBK.

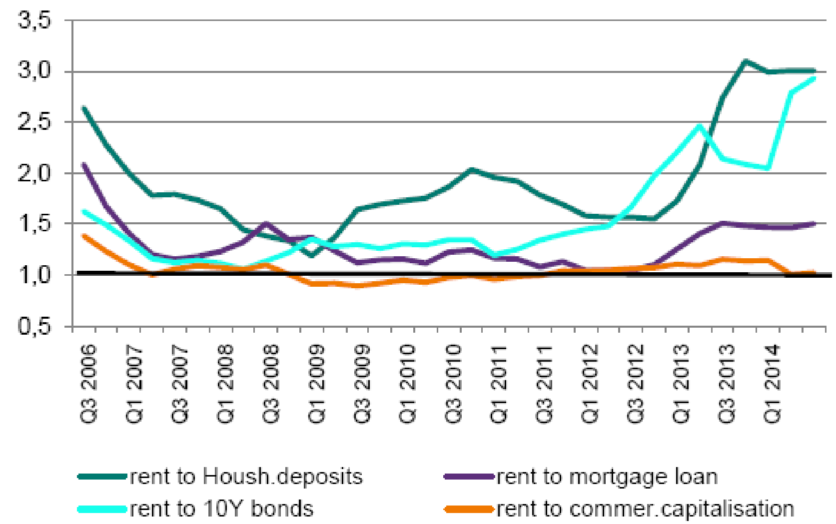
Real estate market should revive

- 2015 could be interesting for the residential market in Poland. Average house prices have been fairly stable in the last few years, while household incomes have grown steadily, which implies a significant increase in housing affordability. The cost of PLN-denominated mortgage loans has dropped to an all-time low, and banks' mortgage credit policy has relaxed. This should result in a gradual increase in demand for houses, especially if the labour market continues to strengthen (although to some extent the effect will be tamed by new supervisory regulations enforcing lower mortgage LTVs). Lower interest rates have triggered a sharp increase in the relative profitability of real estate investment compared with bank deposits or Treasury bonds. As a result, there is a growing incentive for wealthy households to shift some of their savings from the financial markets to real estate. We expect those two effects combined to trigger an increase in average house prices of c.3% in 2015E.

Housing availability in terms of one square meter of housing vs the average wage in the enterprise sector



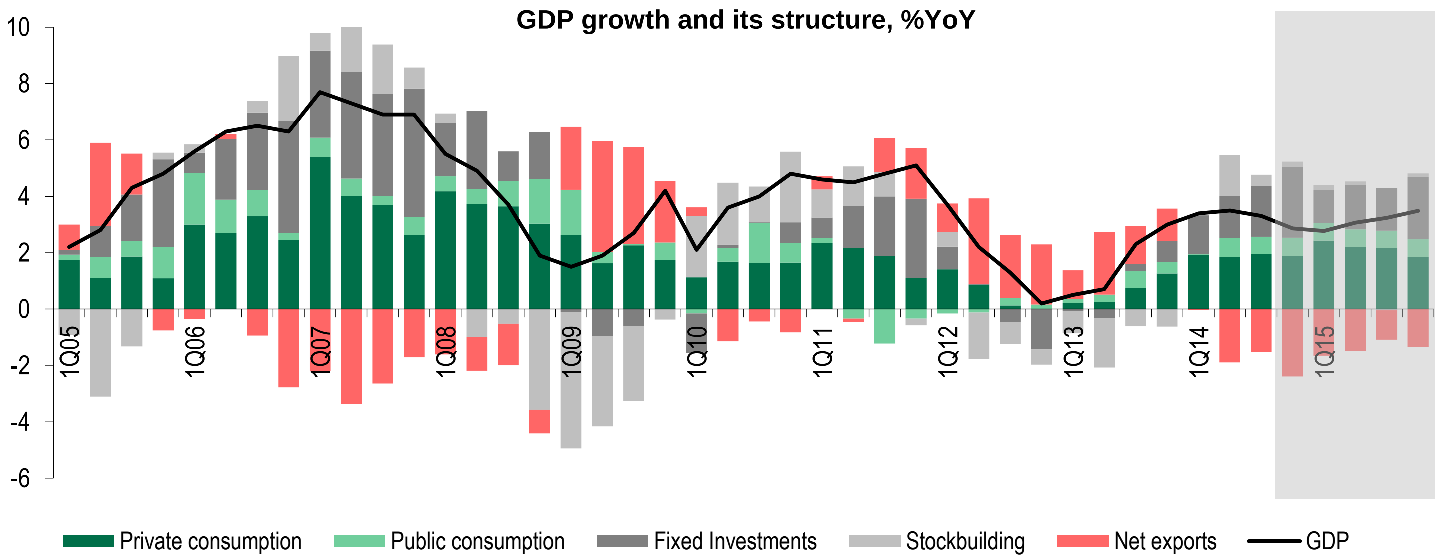
Profitability of home rental (average in eight cities) vs bank deposits and loans, 5-year Treasury bonds and rate of capitalization of commercial property (offices and retail space)



Sources: NBP, BZ WBK.

GDP slowdown: not very strong and not very long

- Summing up, we predict a moderate and short-lived slowdown in Poland's economic growth. While export growth may continue to underperform in the next two or three quarters, it is unlikely to fall sharply unless we see the Euro zone, and Germany in particular, enter a fresh recession, which is not our base-case scenario. Instead, we predict that, after a temporary slowdown, external demand will start to accelerate again in 2015E.
- Meanwhile, robust domestic demand looks set to dampen the impact of a deteriorating external environment. Fixed investment and consumption growth accelerated in the first three quarters of 2014 and should continue to perform well in 2015. They are likely to boost import growth to some extent, so the external balance should deteriorate and net exports' contribution to GDP should be negative.



Sources: GUS, BZ WBK.

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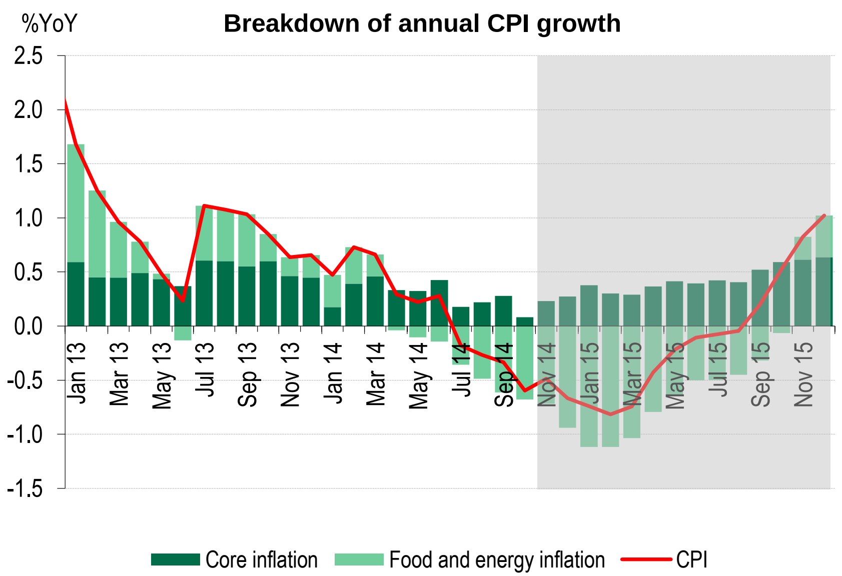
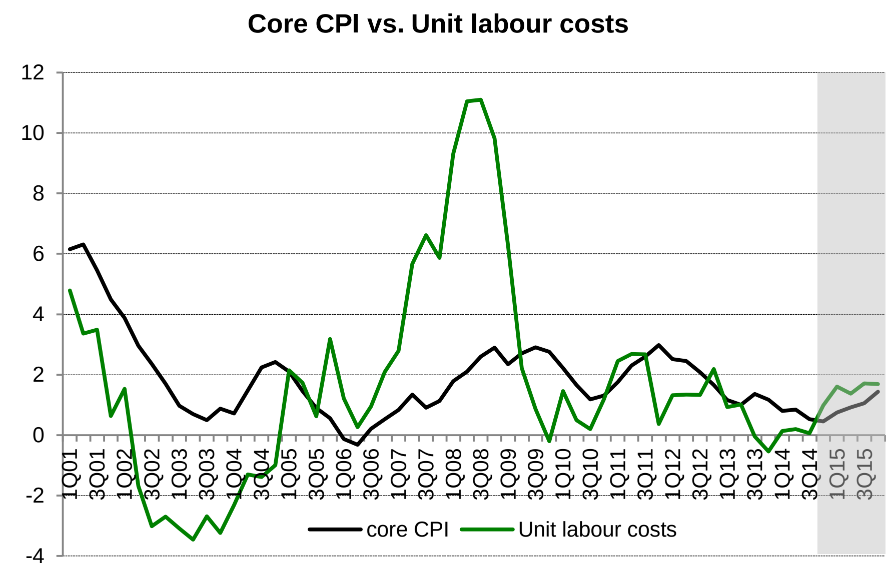
Inflation? What inflation?

- 2014 has been a year of big changes in inflation expectations. Inflation not only surprised to the downside (in headline and core terms), but medium-term prospects also changed substantially. There were a number of reasons behind this: (1) slower closing of the output gap, given negative external shocks, especially from Russia, Ukraine and the Euro zone; (2) supply-side shocks such as sanctions on EU food causing a major oversupply and lower prices, the fall in oil prices, an abundant crop harvest; and (3) low imported core inflation.
- For 2015 we expect a gradual increase in unit labour costs (from a very low level), a still-negative output gap, a disinflationary impact from oil prices (at least in 1H) and a slight zloty appreciation. Overall, 12M CPI should remain negative in 1H15E, core inflation should gradually increase but without creating a risk in the medium-term.



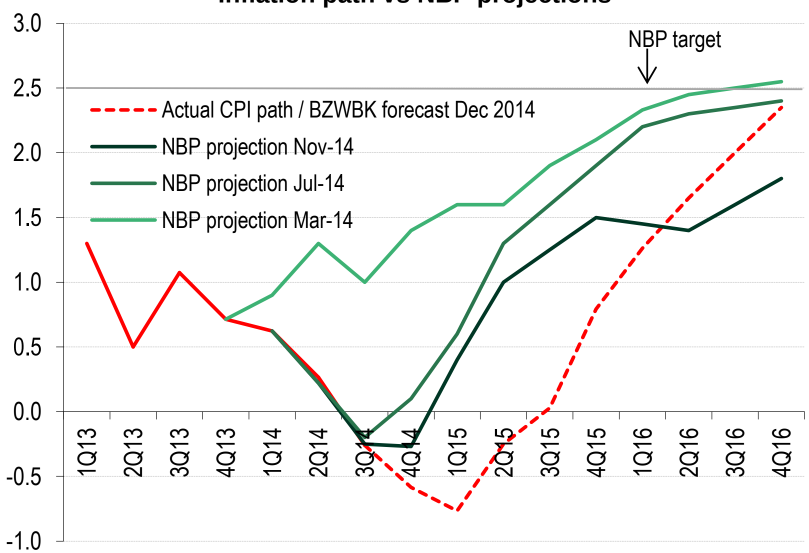


Sources: GUS, NBP, BZ WBK.

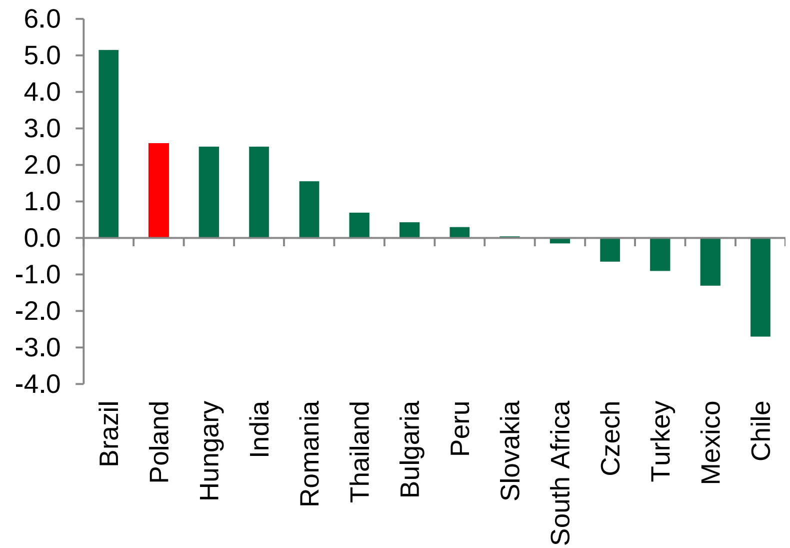
Interest rates: Will the MPC act in the last 12M of its tenure?

- The significant change in the inflation outlook led to a substantial shift in monetary policy. The MPC cut the reference rate by 50bp in October, but, despite very dovish central bank projections for GDP/CPI (inflation reaching just 1.5%, well below the target of 2.5% until end-2016) it kept rates on hold in November and December. Quite surprisingly, the the central bank emphasised the importance of growth (not inflation), disregarding the fact that its primary objective is price stability (specifically, the CPI target, which it sets itself).
- Growth prospects are quite positive, in our opinion, but 2015E inflation will be significantly (3pp) below target, putting pressure on the MPC to carry out more monetary easing, especially if the ECB delivers on quantitative easing. We expect the MPC to trim rates by a further 25bp in 1Q15E.
- MPC members (and possibly the NBP governor) are due to be replaced in 2016 and we would expect a list of candidates to be published in 2H15.

Inflation path vs NBP projections



Real interest rates in emerging markets



Sources: NBP, Eurostat, BZ WBK.

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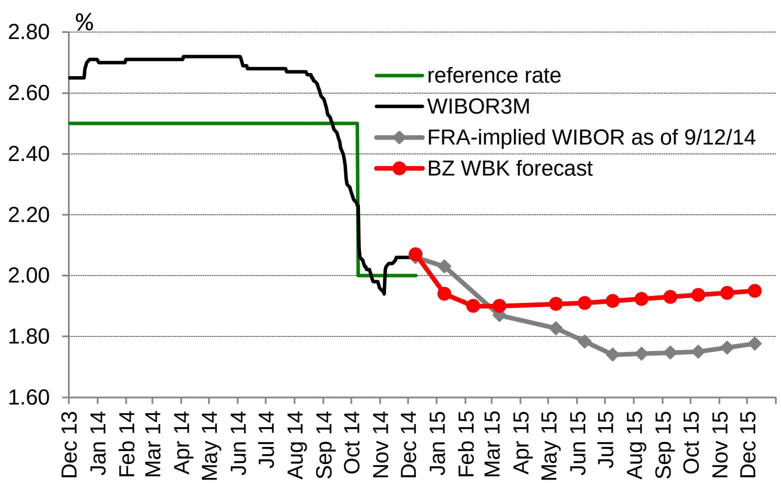
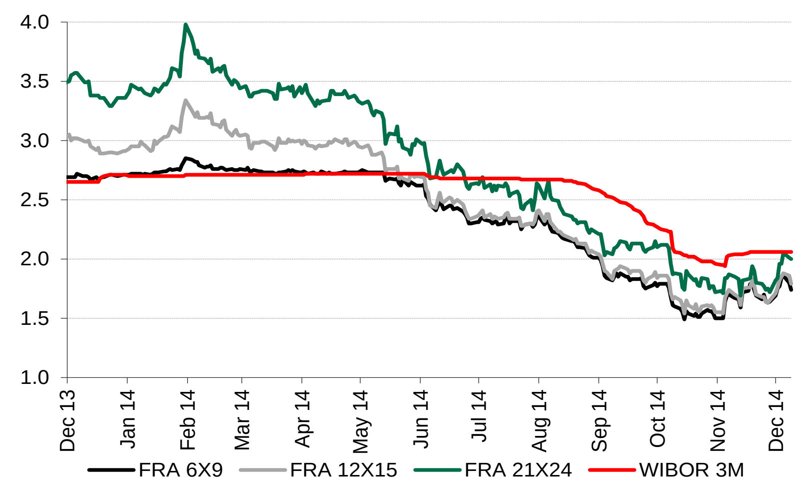
Money market is pricing in just one cut, in line with our view

- Money market rates fell significantly in 2014, in particular in the last quarter, after the official rate cut. However, the downward trend quickly reversed as expectations of more cuts faded after better-than-expected economic data.
- The money market is still looking for one more rate cut in the next three months, in line with our base scenario, with a slight chance of some more easing in two to three quarters. In our view, a slight reduction of the main interest rates in Poland is possible in 1Q15 in reaction to weaker economic data (GDP below 3%YoY), continuation of deflation and a stronger zloty.
- WIBORs should stabilize after that. If investors start to price-in additional easing exceeding 50bp, we would find it unjustified. We forecast 3M WIBOR at around 1.90% (on average) in 1H15E, increasing to around 2% in 2H15E as improving macro data fuel expectations for rate hikes in 2016.

Short-term 3M WIBOR expectations



Money market rates (%)

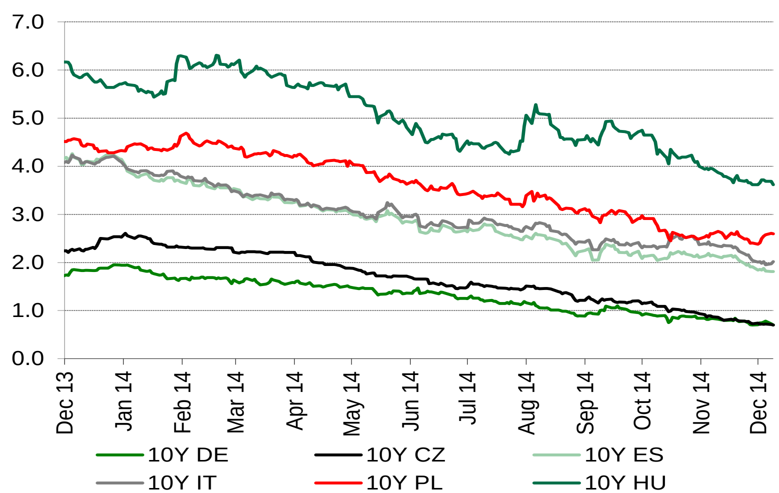


Sources: Reuters, BZ WBK.

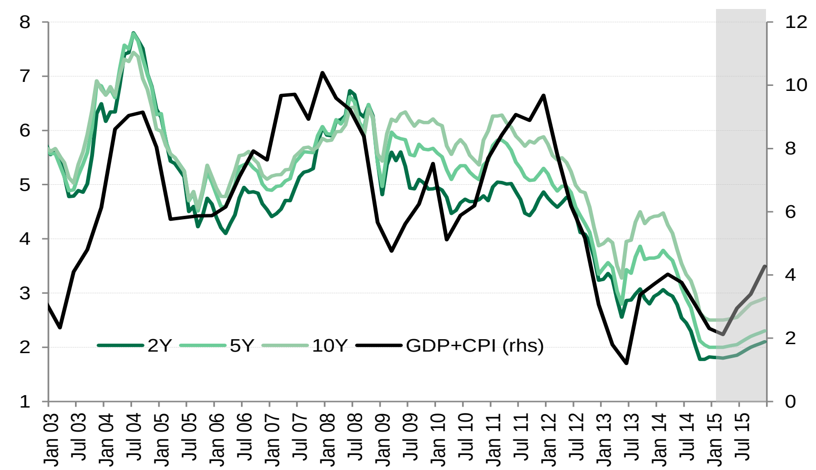
Moderate upward drift in yields/rates

- In 2015, the Polish debt market is likely to remain under pressure from several factors, with divergent monetary policy one of the key issues. Hopes of a Euro zone QE programme and a domestic rate cut should stabilise yields/rates at low levels at the beginning of 2015E, but they could rise, particularly at the long end, once QE or a domestic rate cut actually happens. Moreover, the beginning of the Fed's monetary policy tightening may put additional upward pressure on global yield curves.
- As regards domestic fundamentals, the expected economic recovery driven mainly by domestic demand should also contribute to higher yields. However, a prolonged period of sub-zero inflation could limit the pace of yield growth, mainly in the 2Y sector.
- On the supply side, the fact that the Treasury has pre-financed c 25% of the 2015 gross borrowing requirements should translate into a lower-than-expected supply of Treasury securities next year, which we think should support domestic assets.
- Overall, Poland's market rates should increase gradually in 2015. We are expecting the front end of the curve to perform better than other sectors and the yield curve should steepen as a result. We forecast a 2Y yield slightly above 2% and a 10Y yield of 2.90% at the end of 2015.

Yields of 10Y benchmarks (%)



Nominal GDP growth vs T-bond yields (%)

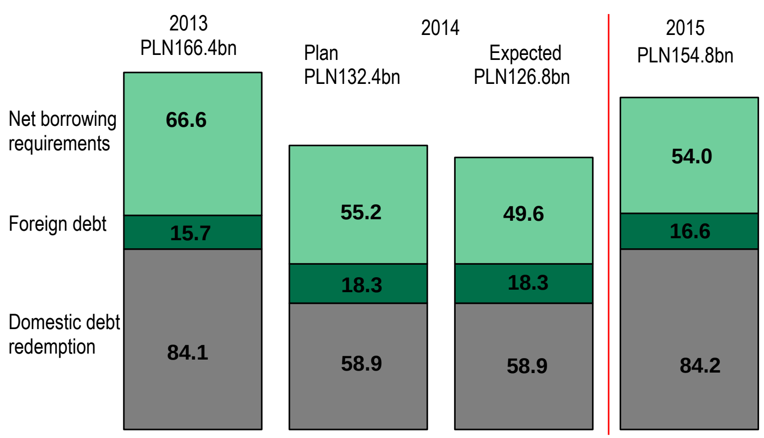


Sources: GUS, Reuters, BZ WBK.

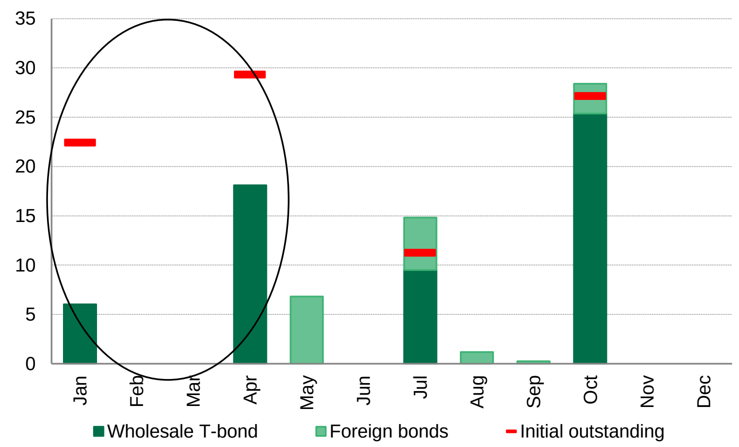
Debt supply may be lower

- The budget draft for 2015 assumes a deficit of PLN46.1bn, net borrowing needs of PLN53.98bn and gross borrowing needs of PLN154.8bn. The increase in the borrowing requirement compared with 2014 is mainly due to the larger budget deficit and a sharp increase in redemptions of domestic debt (see chart).
- We think it possible that next year's spending will be at least PLN5bn below budget. In 2009-13, actual expenditure was c.PLN7bn lower than planned on average. Our forecasts for both GDP growth and inflation for 2015 are below the Finance Ministry’s assumptions, which implies a risk for budget revenues, but, on the other hand, the structure of GDP growth (based on domestic demand) should be favourable for the budget. On balance, we think that both the deficit and net borrowing needs should be close to projected in the 2015 draft budget.
- However, the total supply of debt next year may be lower than suggested by the budget’s gross borrowing requirements, as the latter do not take into account the pre-financing done this year (c.25% of the 2015 borrowing requirements). So, gross borrowing needs to be covered in 2015 should be slightly lower than in 2014.

Gross borrowing requirements



Treasury security redemptions in 2015 including pension fund reform and pre-financing done in 2014



Source: Ministry of Finance, BZ WBK.

More flexible foreign financing

- PLN-denominated securities (mainly fixed-rate T-bonds) will still play the main role in funding the country's net borrowing needs (nearly 80%). The Finance Ministry plans to keep foreign currency bond issues and net foreign loans at similar levels to this year (c.PLN4bn and PLN5bn, respectively). However, the importance of foreign funding is likely to be substantially higher than this year, as the ministry also plans to use liquidity accumulated in the FX account (PLN9.4bn).
- This implies greater flexibility in foreign financing. The ministry will not be under pressure to place debt on the international markets as it will be able to use money from the FX account to repay foreign debt or pay interest.
- Overall 2015 gross FX issuance is projected at PLN18.3bn. We think euro-denominated issues will account for most of this. The rest is likely to be US dollar debt.

Funding net borrowing requirements in 2015 (PLN mn)

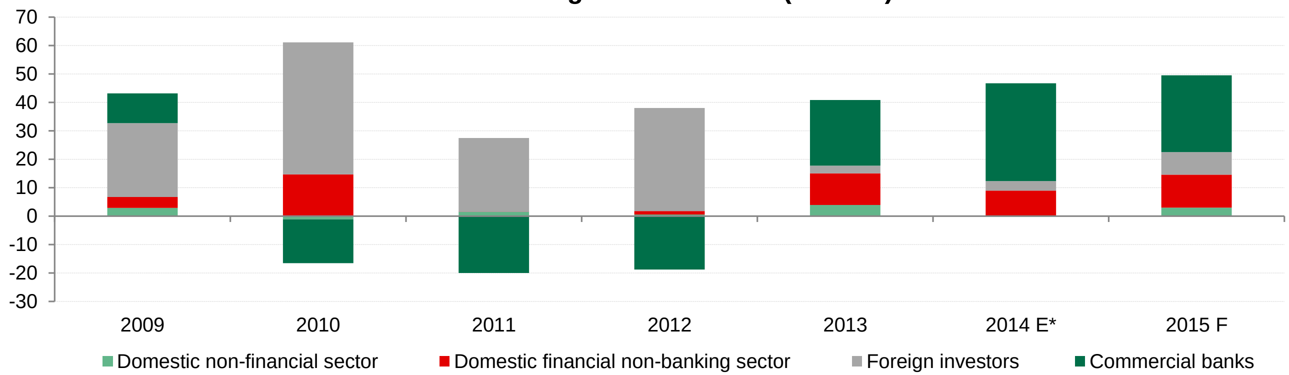
	2014 expected funding	2015E
Net borrowing needs	**47,377.9**	**53,977.4**
Domestic financing	***51,458.1***	***42,517.2***
1. Issuance on the domestic market	47,184.5	42,517.2
2. Funds on the budget account	4,273.6	0.0
Foreign financing	***-4,080.2***	***11,460.2***
1. Issuance on foreign market	3,808.5	3,933.8
2. Loans	4,946.0	5,170.0
3. Management of EU funds	-6,987.5	-7,088.6
4. Flows on FX account	-5,847.3	9,444.2

Source: Finance Ministry, BZ WBK.

Domestic banks are playing a key role

- In 2014, as in 2013, domestic commercial banks played the main role in financing Poland's PLN-denominated borrowing needs. Despite widespread concern, the implementation of the pension fund (OFE) reform did not create waves in the fixed income market as domestic banks took on the role of smoothing market turbulence during risk aversion periods. Consequently, their share of financing borrowing needs increased considerably vs. 2013 (to nearly 75% from c57%), while foreign investors' share was similar to 2013.
- For 2015, we expect the structure of domestic financing to be similar to that in 2014. Domestic commercial banks should remain on the bid-side, contributing most to total financing. Implementation of a new Recommendation P by the Polish Financial Supervision Authority (KNF) to monitor banks' financial liquidity might also lead to commercial banks purchasing government bonds.
- We expect foreign investors' share to increase to PLN8bn in 2015E from cPLN4bn expected in 2014E. The search for returns continues in a context of record-low core bond yields, which makes domestic bond yields look attractive and should limit the increase in yields during the year.
- In our view, the risk of a sharp outflow of foreign capital is limited. The breakdown of the foreign investor base seems to be relatively stable, as medium- and long-term investors (including central banks) remain the dominant players.

Domestic financing – demand side (PLN bn)



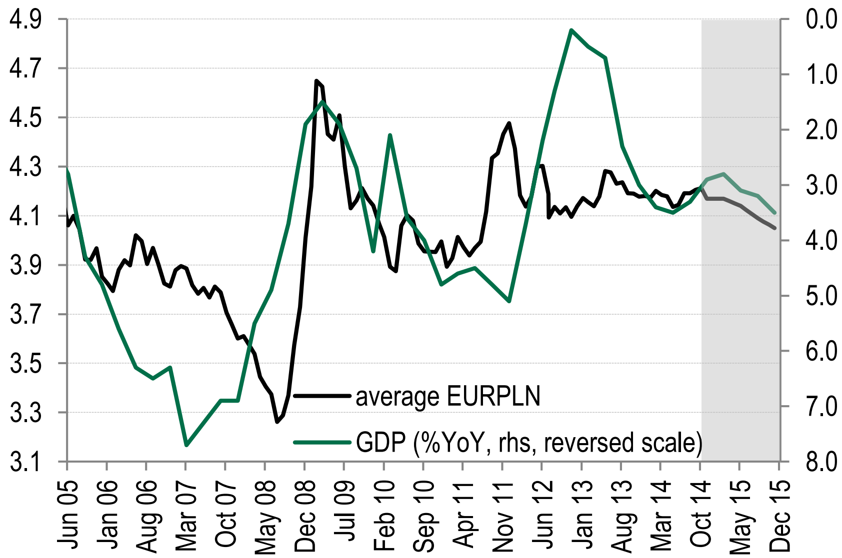
*/ excluding OFE reform

Sources: Ministry of Finance, BZ WBK.

FX: Zloty supported by strong economy and search for yield

- We expect the EUR/PLN rate to decrease slightly in 2015. The zloty tends to be a cyclical currency, gaining during periods of economic recovery. We expect the economic slowdown that started in the second half of 2014 to prove relatively short-lived and Polish GDP growth to accelerate again to above 3% in 2015E. In our view, the Polish economy will continue to outperform not only the Euro zone but also its CEE peers. This should also favour the zloty. With productivity growing faster than in the Euro zone, the real exchange rate is poised for real appreciation (due to the Balassa-Samuelson effect). As inflation in Poland remains extremely low (it is likely to stay below zero at least until mid-2015), this should imply a nominal appreciation of the currency.
- Also, relatively high interest rates and yields on Polish bonds should attract inflows of portfolio capital, especially in an environment of highly accommodative monetary policy in the Euro zone and the ECB pumping liquidity into the European financial system.

Average monthly EUR/PLN vs. Polish GDP



Sources: GUS, Reuters, BZ WBK.

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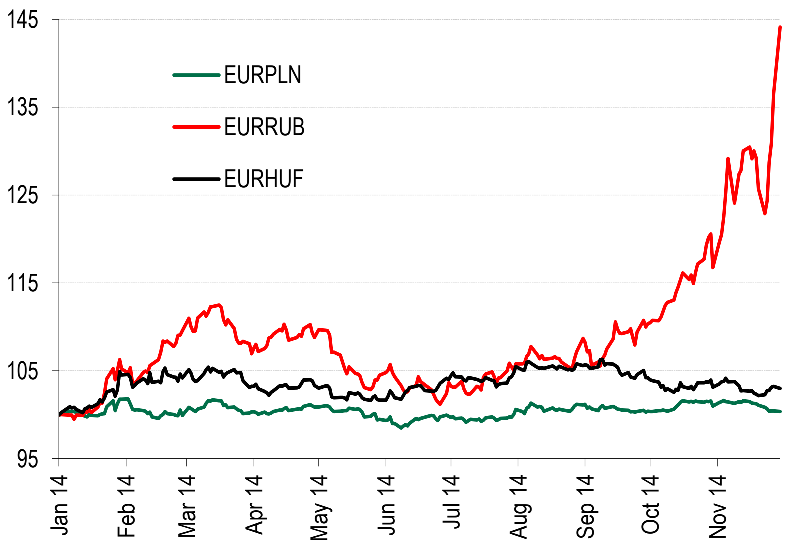
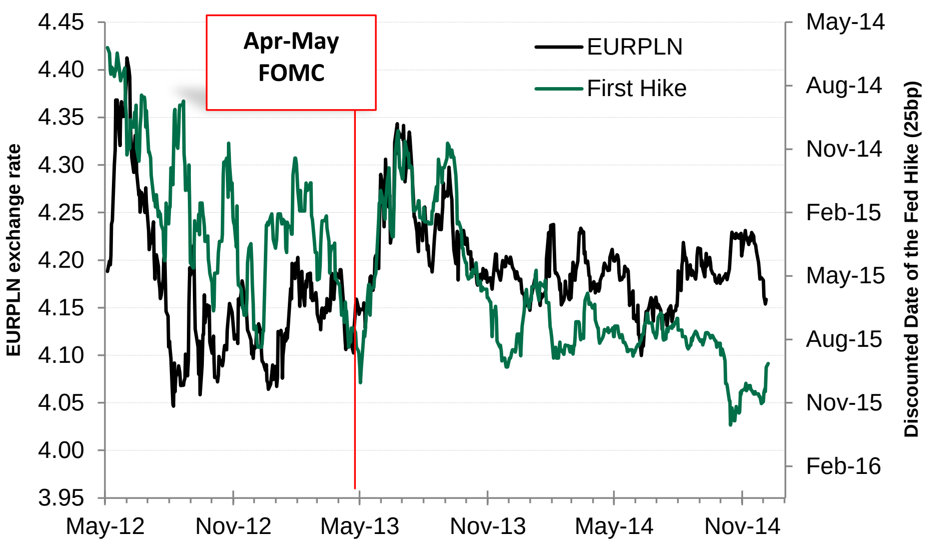
FX: Russia-Ukraine conflict is the main risk

- The Ukraine-Russia conflict seems to be the main risk factor in our scenario. Russian army activity near Ukraine does not bode well for stabilisation of the situation in Eastern Europe, so increased geopolitical risk may limit the pace of the zloty's appreciation. The zloty has remained resilient to the recent sharp fall in the rouble, but any serious political/military tensions are likely to weigh on it.
- Expectations of Fed rate hikes generate an upside risk for the EUR/PLN, as faster-than-expected monetary tightening in the US could trigger cash outflows from emerging markets. However, the market seems to have already factored in the Fed raising rates next year so the impact may be limited. We think the influence on the Polish market should be less significant than on other emerging economies.

EURPLN, EURRUB, EURHUF (Jan 2, 2014 = 100)



EUR/PLN vs. expectations for first US rate hike

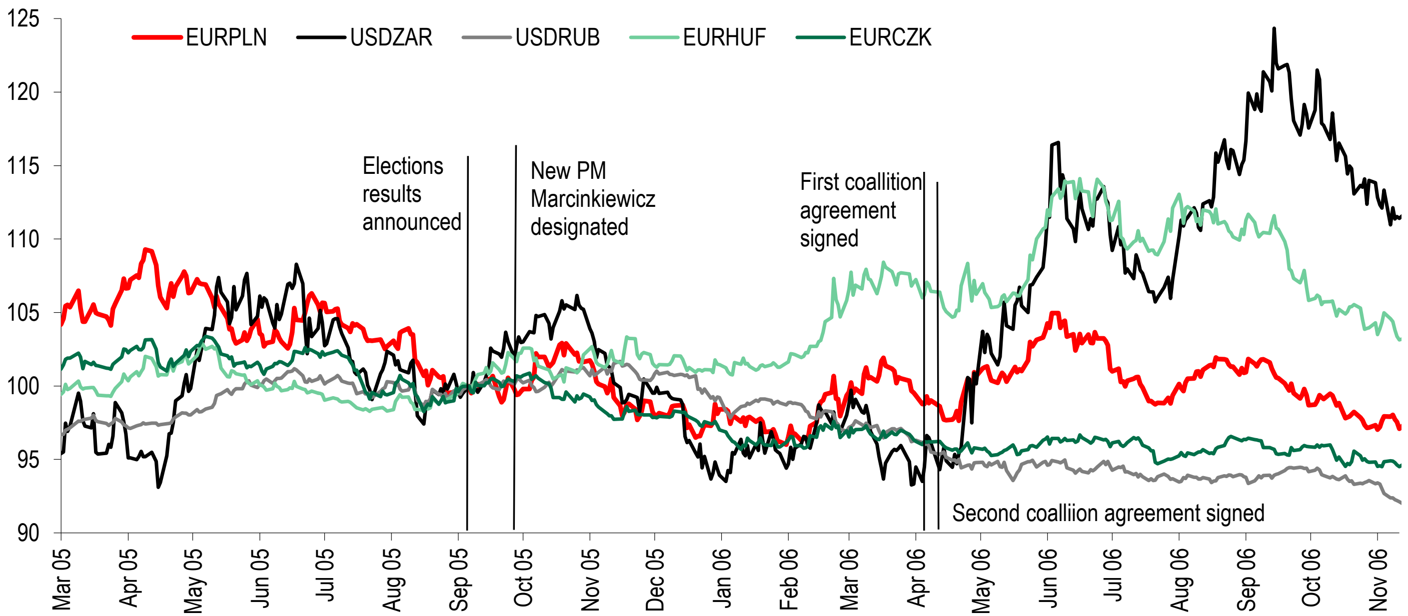


Sources: Reuters, Santander, BZ WBK

FX: Zloty should be relatively immune to elections

- Polish politics (presidential elections scheduled for spring and general elections in autumn 2015) could be a focus of investor attention next year. In the municipal elections held in November 2014, the ruling Civic Platform (PO), won the most seats in the Voivodship Councils, but support for the opposition Law and Justice party (PiS) was the highest among political parties and greater than suggested by the opinion polls.
- This generates uncertainty about the result of the parliamentary election and points to possible difficulties in forming a government afterwards. However, analysis of market reaction to the 2005/2006 parliamentary election, when the Law and Justice party won and was forced to form a coalition with populist parties, does not prove that politics had a decisive impact on the zloty at that time. Thus, we would expect a limited effect this time round.

EURPLN and other EM currencies (September 28, 2005 = 100)

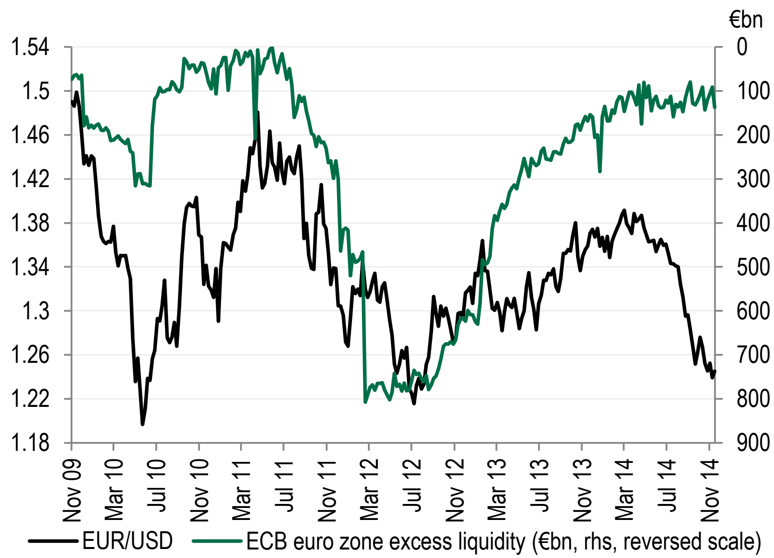


Sources: Reuters, BZ WBK

FX: Volatile year ahead for EUR/USD*

- The combination of looming Fed rate hikes (we expect the first in July 2015), a strong US economy and high expectations for an extension of the ECB asset purchase programme implies a lower EUR/USD rate, at least in 1H15E when it may fall as low at 1.20. However, the second half of next year could bring a rebound if there is an economic recovery and a rise in inflation in the Euro zone. Also, the market seems to have already priced in much of the expected divergent moves of the Fed and the ECB (net long USD positions are close to a record high). We forecast a EUR/USD rate of c. 1.28 at the end of 2015.
- The market may be sensitive to any signs of the Euro zone doing better than expected and/or the US not performing as well as anticipated (the strong dollar may hit exports that account for 13% of US GDP).
- These EUR/USD expectations imply high volatility for the USD/PLN. We think the exchange rate could surge to 3.44 in 1H15E before falling back to c.3.20.

EUR/USD and ECB Euro zone excess liquidity



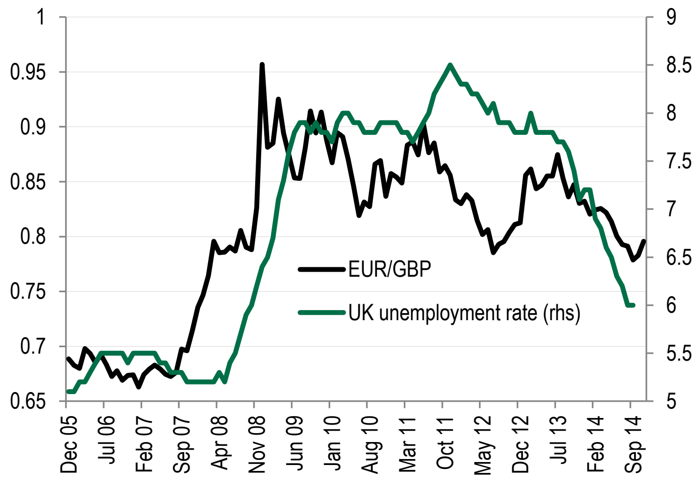
Sources: BZ WBK, Bloomberg

* based on the Santander Global FX Strategy FX Compass published on November 27, 2014

FX – EUR/GBP to follow EUR/USD, EUR/CHF higher*

- EUR/GBP is expected to follow the EUR/USD swings. The pound should appreciate vs. the single currency to 0.76 in 1H15E based on monetary policy easing in the Euro zone and a strong performance from the British economy and looming rate hikes in the UK (the first one is possible in February). This means that the zloty may depreciate vs. the pound to c.5.40 in 1H15E. However, as the euro starts to recover vs. the dollar, it should also gain vs. the pound. We expect EUR/GBP at 0.79 at the end of 2015E and this would drag GBP/PLN to 5.10 at year end. Risks to the pound's strength include a delay in rate hikes and general elections in May when the anti-EU party UKIP could do well.
- We expect EUR/CHF to stay close to the 1.20 floor during 1H15 amid euro weakness vs. the main currencies. The SNB is not expected to lift the floor during 2015 and the single currency should gain vs. the Swiss franc in 2H15E (like the dollar and the pound). The CHF may come under pressure should the SNB introduce additional measures to push inflation up (such as negative interest rates). We expect the zloty to appreciate slightly to 3.30 per franc as EUR/CHF rebounds to 1.23.

EUR/GBP and the UK unemployment rate



Sources: BZ WBK, Bloomberg

* based on the Santander Global FX Strategy FX Compass published on November 27, 2014

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Macroeconomic Forecasts

Poland		2012	2013	2014E	2015E	1Q14	2Q14	3Q14	4Q14E	1Q15E	2Q15E	3Q15E	4Q15E
GDP	PLNbn	1,615.9	1,662.1	1,725.1	1,790.8	403.1	418.4	426.8	476.8	415.2	433.3	443.2	499.1
GDP	%YoY	1.8	1.7	3.2	3.2	3.4	3.5	3.3	2.9	2.8	3.1	3.2	3.5
Domestic demand	%YoY	-0.4	0.2	4.9	4.6	3.4	5.6	4.9	5.3	4.5	4.7	4.4	4.9
Private consumption	%YoY	1.0	1.1	3.2	3.6	2.9	3.0	3.2	3.6	3.7	3.6	3.6	3.5
Fixed investment	%YoY	-1.5	0.9	9.7	8.4	11.2	8.7	9.9	9.5	9.0	9.0	8.0	8.0
Unemployment rate [a]	%	13.4	13.4	11.5	10.9	13.5	12.0	11.5	11.5	11.7	10.4	10.3	10.9
Current account balance	EURmn	-13,697	-5,245	-7,482	-10,628	-1,403	-553.0	-1,803	-3,723	-2,374	-1,041	-3,021	-4,192
Current account balance	% GDP	-3.5	-1.3	-1.8	-2.4	-1.1	-1.2	-1.2	-1.8	-2.0	-2.1	-2.4	-2.4
CPI	%YoY	3.7	0.9	0.0	0.0	0.6	0.3	-0.3	-0.6	-0.8	-0.3	0.0	0.8
CPI [a]	%YoY	2.4	0.7	-0.7	1.0	0.7	0.3	-0.3	-0.7	-0.7	-0.1	0.2	1.0
CPI excluding food and energy prices	%YoY	2.2	1.2	0.7	1.0	0.8	0.8	0.5	0.5	0.8	0.9	1.1	1.4

Source: CSO, NBP, Finance Ministry, BZ WBK estimates. [a] at the end of the period

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Interest Rate and FX Forecasts

Poland		2012	2013	2014E	2015E	1Q14	2Q14	3Q14	4Q14E	1Q15E	2Q15E	3Q15E	4Q15E
Reference rate [a]	%	4.25	2.50	2.00	1.75	2.50	2.50	2.50	2.00	1.75	1.75	1.75	1.75
WIBOR 3M	%	4.91	3.02	2.52	1.92	2.71	2.71	2.59	2.06	1.91	1.91	1.92	1.94
Yield on 2-year T-bonds	%	4.30	2.98	2.45	1.91	3.01	2.76	2.26	1.79	1.81	1.83	1.95	2.07
Yield on 5-year T-bonds	%	4.53	3.46	2.95	2.11	3.71	3.35	2.67	2.05	2.00	2.03	2.15	2.27
Yield on 10-year T-bonds	%	5.02	4.04	3.49	2.65	4.38	3.82	3.18	2.56	2.50	2.53	2.72	2.87
2-year IRS	%	4.52	3.10	2.51	1.97	3.07	2.82	2.32	1.83	1.86	1.88	2.00	2.13
5-year IRS	%	4.47	3.51	2.91	2.13	3.70	3.31	2.63	1.99	2.03	2.08	2.13	2.25
10-year IRS	%	4.56	3.86	3.34	2.57	4.16	3.73	3.07	2.39	2.38	2.51	2.63	2.76
EUR/PLN	PLN	4.19	4.20	4.18	4.12	4.19	4.17	4.18	4.20	4.17	4.15	4.11	4.06
USD/PLN	PLN	3.26	3.16	3.15	3.34	3.06	3.04	3.15	3.35	3.38	3.42	3.35	3.21
CHF/PLN	PLN	3.47	3.41	3.44	3.40	3.42	3.42	3.45	3.48	3.45	3.43	3.38	3.32
GBP/PLN	PLN	5.16	4.94	5.19	5.31	5.06	5.11	5.26	5.32	5.35	5.39	5.33	5.18

Source: CSO, NBP, Finance Ministry, BZ WBK estimates. [a] at the end of period

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The views expressed in this report accurately reflect the personal views of the undersigned analyst(s). In addition, the undersigned analyst(s) have not and will not receive any compensation for providing a specific recommendation or view in this report: **Maciej Reluga*, Piotr Bielski*, Agnieszka Decewicz*, Marcin Luziński*, Marcin Sulewski*.**

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