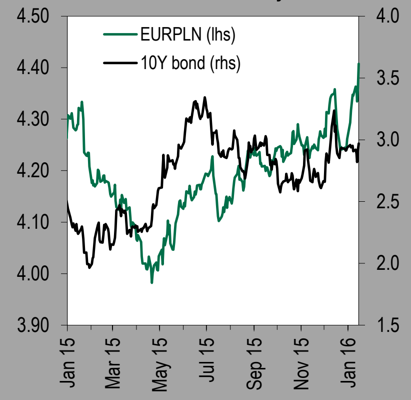
MACROscope

Polish Economy and Financial Markets

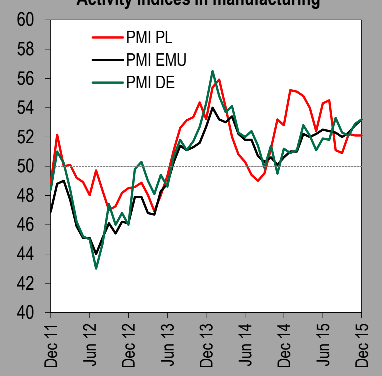
January 2016

Where Are We Now?

EURPLN rate and bond yield



Activity indices in manufacturing



Since we released our 2016 outlook in early December, data have confirmed the strength of GDP and business climate indicators suggest growth is going to stay between 3.0% and 3.5% in the coming quarters. The latest balance of payments figures show 4Q15 might be even above this range (higher net export contribution). Despite high growth, where consumption may prove to be the star performer (thanks to looser fiscal policy), we have lowered our CPI forecast. Although the cut in energy and gas tariffs for households was not a surprise, it seems the inflationary impact of the drought on food prices was shorter-lived in reality than we expected (two months rather than four). Lower commodity prices will also lead to lower inflation across the universe. With the lower starting point, it is little wonder that deflation in 2016 will last longer and we now expect it to continue until September.

Last year, when the market priced-in some monetary policy easing (25-50bp) in the start of 2016, it was mostly due to the expected changes in Monetary Policy Council members (eight new members starting in 1Q16). At the turn of 2015-2016 expectations on rate cuts were scaled back. However, we think the new inflation outlook, which will be reflected in the central bank's projection in March, may support further monetary easing.

The Senate accepted three candidates to join the MPC members. The Sejm is due to accept another two at the end of January, so five of the seven 'old' decision-makers will still participate in the February meeting. One more candidate from Sejm and two from the President will be known in a few weeks and the central bank governor will change mid-year (there are no candidates yet). Not all new members are absolute beginners in monetary policy: among them is one who served five years on the central bank's board and an ex-advisor to the current governor. For others, however, monetary policy appears to be outside their sphere of professional interest.

In March all eight new members will be on board and, if they have a sense of doubt about deflation ending, the MPC might decide the time is right for a cut. After all, annual inflation rate has averaged zero for the last three years (vs a target of 2.5%) and 2016 could see a repetition. This is not America: the new MPC will be under pressure from the lack of inflation and market discussion may soon change from whether a new, politicised MPC will cut rates to 'what is the scope for monetary easing, given inflation well below the target for another year (or more)? All things considered, we still believe that the new MPC will be generally more dovish than the previous one. The case for rate cuts looks solid, but a factor that might shake it is a prolonged weakening of the Polish currency. So far, this year, while almost nothing has changed in the domestic economy, we have seen a significant weakening of the zloty, driven by further turbulence in China at the start of the year and S&P's decision to cut Poland's rating in mid-January. Please see page 6 for our detailed comment on the latter.

In this issue:

Financial market on January 15 2015:

NBP deposit rate	0.50	WIBOR 3M	1.70	EURPLN	4.4075
NBP reference rate	1.50	Yield on 2-year T-bond	1.43	USDPLN	4.0411
NBP lombard rate	2.50	Yield on 5-year T-bond	2.97	CHFPLN	4.0143

This report is based on information available until 10.11.2015.

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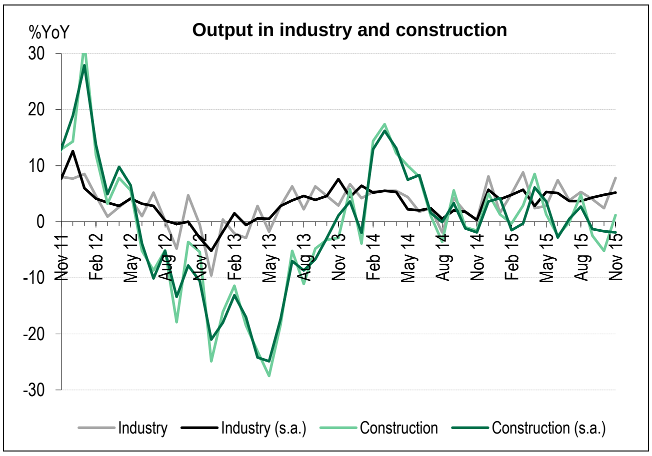
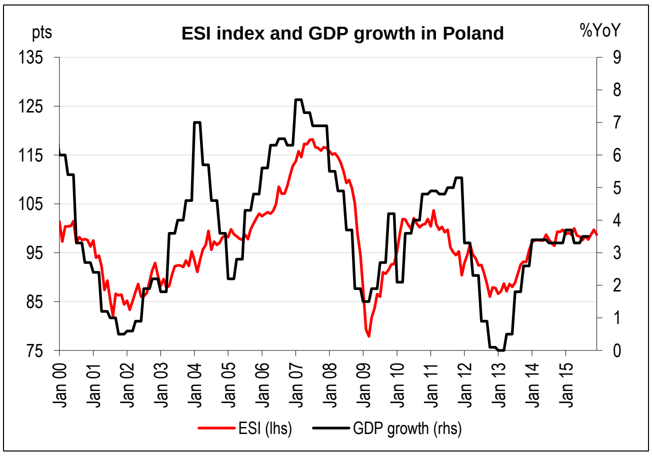
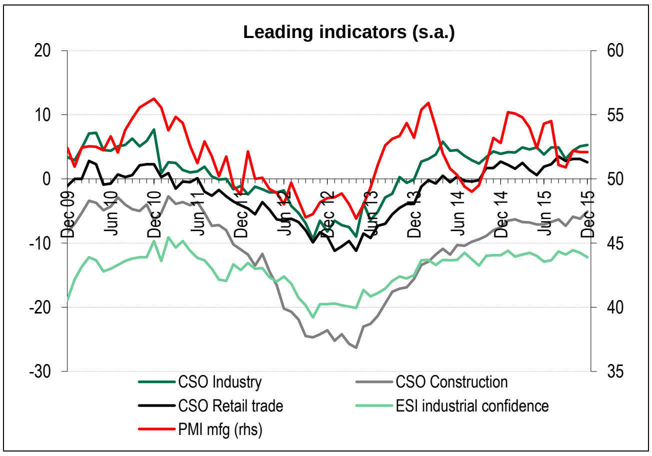
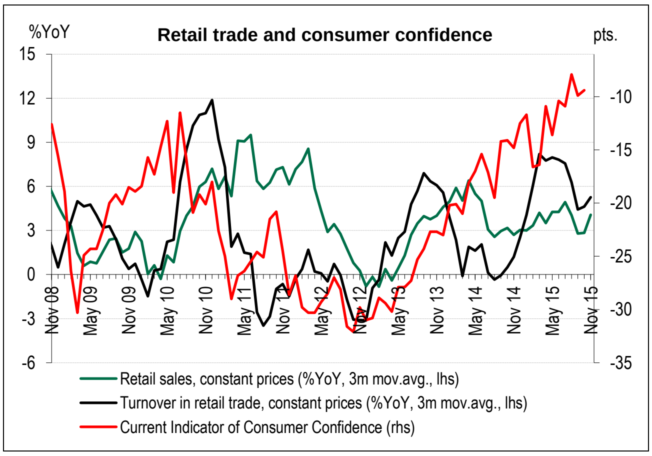
Economic update









Source: CSO, NBP, Eurostat, Markit, European Commission, BZ WBK.

Output boosted by working-day effect

▪ Industrial output rose by 7.8% YoY in November, above forecast. The acceleration versus October (2.4% YoY) was partly due to the positive working day effect, but the seasonally-adjusted data also accelerated to 5.2% YoY vs. 4.4% YoY year to date. Data confirmed that the industrial sector is in a good shape, with the highest growth in industrial manufacturing (9.3% YoY), especially in export-oriented sectors (vehicles, electrical appliances, furniture). There was a surprisingly surge in manufacture of other transport equipment (79.7%YoY), which was probably due to one-off factors and added as much as a percentage point to the overall industrial growth index. Other data confirmed the rise in orders for Polish industry, both domestic and foreign. We are still optimistic about industrial output growth in the coming months.

▪ Construction and assembly output rose 1.2% YoY in November while the market (and we) expected a 3.6% YoY decline. There was a marked rebound in building construction (to 0.9% YoY from -7.3% YoY in October) and civil engineering (+3.5% YoY from -6.2% YoY) while growth in specialized construction remained negative (-2.2% YoY vs. -0.2% YoY in October). Despite the acceleration in annual terms, seasonally-adjusted output slowed vs. October to -1.9% YoY. This may suggest that the market underestimated the impact of differences in the number of working days, implying the jump is only a statistical phenomenon and does not signal an improvement in construction.

Business climate indicators confirm uptrend

▪ Poland's manufacturing PMI was unchanged in December at 52.1 while we and the market expected a rebound. The detailed data showed that output was supported by acceleration in new export order growth, while domestic orders decelerated slightly from November. The index confirmed that the labour market is still sound (employment sub-index reached its highest level in five months) and that there is still low price pressure – production costs and the price of finished goods fell sharply.

▪ The December reading was a bit disappointing, which may have been partially due to political uncertainty, but the data confirmed solid, stable year-end growth. This was echoed by the statistics office's business climate indicators: the manufacturing and construction indices reached their highest levels since April 2014 and June 2011, respectively. The trade index declined slightly, but remained relatively high.

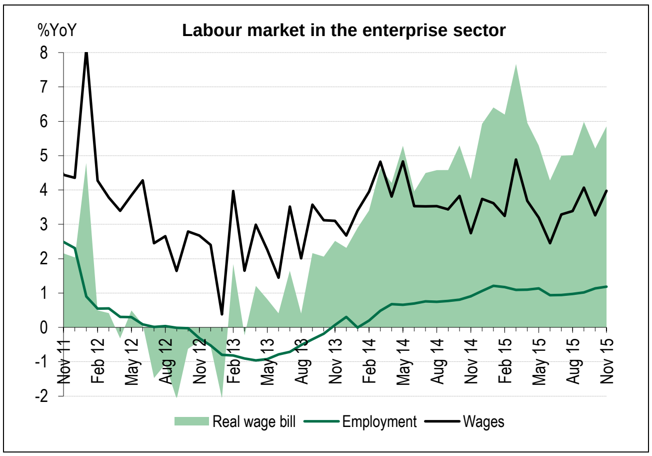
Retail sales surprise on the upside

▪ Retail sales rose 3.3% YoY in nominal terms and 5.7% YoY in real terms in November, well above expectations.

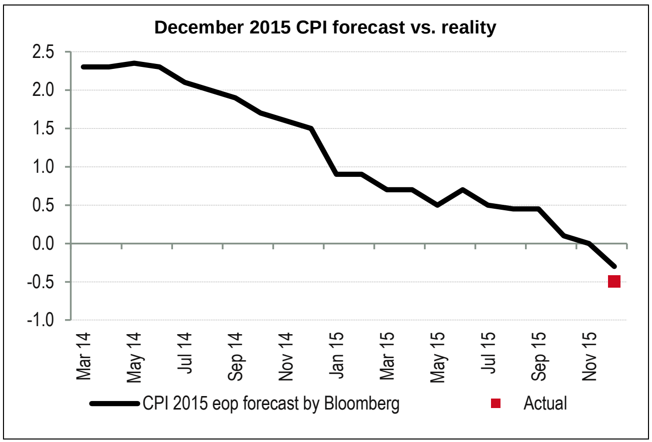
▪ The biggest surprise was in sales of autos, motorcycles and parts, which rose c20% YoY in nominal terms, the fastest pace since February 2014. Household appliances also accelerated (to 6.1% YoY from 3.8% in October, the fastest growth since June) as did pharmaceutical and medical equipment (to 8.4% YoY from 5.6% in October, the fastest growth since May). Sales of food and other non-specialised stores clearly deviated from the trends of previous months (with a surprising drop of 3.1% YoY and a sharp acceleration to 19.5% YoY from c3%, respectively). However, the statistics office said this was to a large extent due to 'organizational change' in the retail market, where some sales classified as food were transferred to 'non-specialized stores'.

▪ Data for retail sales confirm that internal demand remains strong. We expect the positive trends in the labour market to continue to support consumer demand.

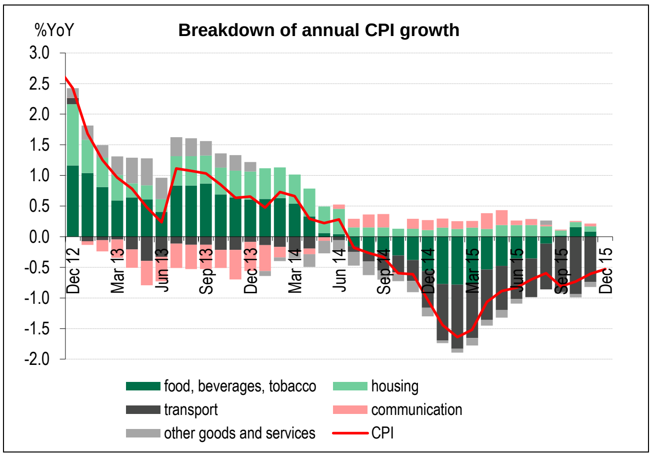
Economic update



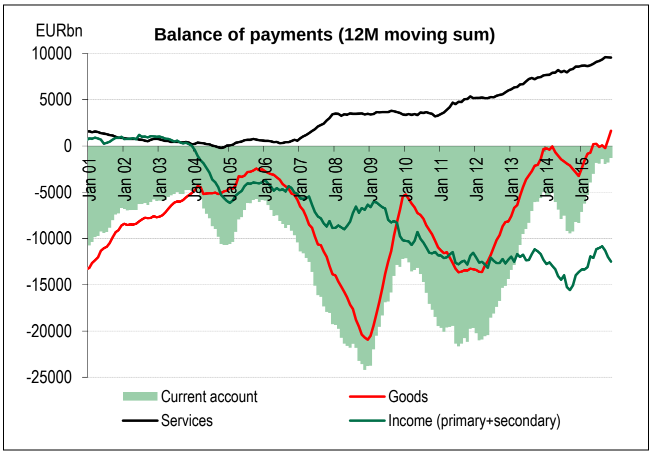
Labour market in the enterprise sector



December 2015 CPI forecast vs. reality



Breakdown of annual CPI growth



Balance of payments (12M moving sum)

Source: CSO, NBP, Eurostat, BZ WBK.

Labour market strengthens

- Employment in the corporate sector rose 1.2% YoY in November. In monthly terms, employment rose 9k, the highest increase for November since 2007. Recall that we have recorded multi-year highs since July and this confirms the strength of demand for labour. Employment is likely to grow fast in the months to come. Labour Ministry data showed the registered unemployment rate at 9.8% in December, the lowest reading since 2008.
- Wages in the corporate sector rose 4.0% YoY in November and the real wage bill was up 5.9% YoY. Robust growth in real incomes will continue to support private consumption in the coming quarters. We think the pace of employment growth could slow in the nearest quarters, as the stock of potential workers dries up, and strong demand for labour could generate upside pressure on wages. Real wage growth should stay high.

Deflation should stay for longer

- CPI inflation for December confirmed flash estimate at -0.5% YoY. In MoM terms prices fell by 0.2% mainly due to declining prices of food and fuels. At the same time, in other categories there were completely no signs of upward pressure on prices. According to our estimate, core inflation excluding prices of food and energy remained at 0.2%YoY, the same as in November.
- The CPI surprised to the downside in 2015, with average prices falling 0.9%. We are expecting inflation to stay below or close to zero in the months to come (with deflation continuing as far ahead as 3Q16) and our expectations are markedly below market consensus. There are a number of reasons for this: (1) weaker-than-expected upward pressure on food prices, as the effects of the drought, while visible, proved shorter than we forecast and low global prices prevailed. (2) low commodity prices, especially a longer-lasting fall in oil prices; and (3) cuts in electricity and gas tariffs in January and our expectations for further price reductions later in the year. All three factors are strongly tied to global commodity prices, so we do not view the deflationary tendencies as threatening economic growth.
- More pronounced price growth (by ‘pronounced’ we actually mean something close to 1% YoY) is possible at year-end, in our view. Core inflation may also accelerate towards 1% in the second half.
- There is some upward risk to inflation implied in the government’s ‘500+’ child benefit programme, will should support consumption, and a tax on retailers, as a squeeze on trade margins may translate into higher prices. However, as the tax is aimed at big companies with strong negotiating positions, it may be transferred to suppliers instead.

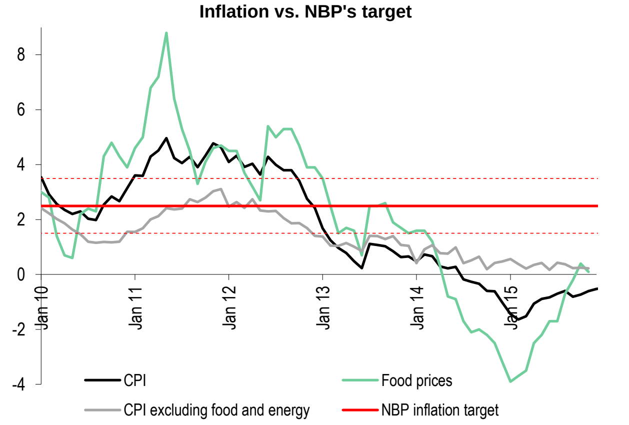
Current account performs better than expected

- Poland’s November balance of payments was much better than expected. The current account showed a €620mn surplus versus widespread expectations of a deficit. The significantly better balance of foreign trade in November implies GDP could exceed forecasts for 4Q15 and accelerate to nearly 4%YoY.
- The main source of the surprise was the trade balance, as export growth surged 12.6% YoY (the strongest since March) while imports grew 5.4% YoY. This points to a revival in foreign demand, which is probably supported by accelerating economic growth in the Euro zone and the weaker zloty. We assume that the positive trend in exports will continue, as economic growth in Europe should remain solid in the months to come. However, imports may accelerate in 2H16, when households start to spend funds under the 500+ child benefit programme.

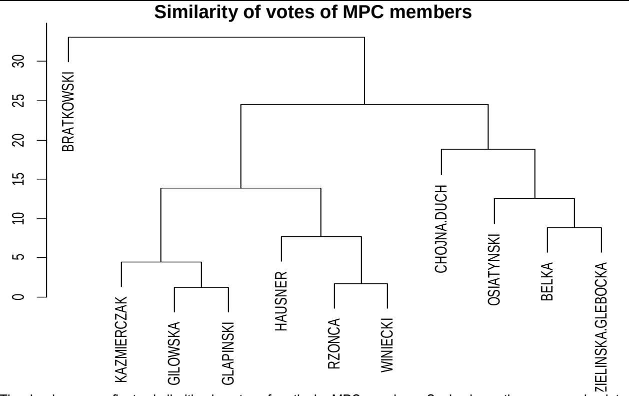
Monetary policy watch

Excerpts from the MPC's communiqué after its January meeting
Due to the sustained negative output gap and only moderate wage growth in the economy there is no inflationary pressure in the economy. The annual growth rates of consumer prices and producer prices remain negative, although the scale of deflation is gradually declining. Falling energy commodity prices in the global markets are the main driver behind continuing deflation. Inflationary expectations are still low.
In the opinion of the Council, consumer price growth will slowly increase in the nearest quarters, yet **due to renewed decline in commodity prices, consumer price growth may be lower than anticipated**. So far, the continuing deflation has not had a negative impact on the decisions of economic agents. Gradual increase in price growth will be supported by closing of the output gap amidst improving economic conditions in the euro area and a tight domestic labour market.
The Council decided to keep the NBP interest rates unchanged, assessing that – given the available data and forecasts – the current level of interest rates helps to keep the Polish economy on a sustainable growth path and ensure macroeconomic balance.

Inflation vs. NBP's target



Similarity of votes of MPC members



The dendrogram reflects similarities in votes of particular MPC members. Scale shows the average absolute distance in basis points between interest rate levels proposed by MPC members during voting meetings. The closer to zero the connection between members/member groups is, the more similar their votes were.

New MPC members appointed by the Senate:

Marek Chrzanowski, (35), is a professor at the Warsaw School of Economics. His publications focus on economic policy and public finance.
Eugeniusz Gatnar. University professor at the Statistics Department of the University of Economy in Katowice, management board member of the NBP since 2010; member of the Polish Academy of Sciences.
Jerzy Kropiwnicki was most recently an advisor to the NBP head Marek Belka. He is a former minister in the right-wing governments of Jan Olszewski and Jerzy Buzek, and head of Governmental Centre for Strategic Studies. Mayor of Lodz in 2002-10.

MPC candidates from the Sejm proposed by PiS:

Grażyna Ancyparowicz, a professor at the Katowice School of Economics.
Eryk Łon, a professor at Poznan University of Economics and Business.
Henryk Wnorowski is dean of Bialystok University's Economics and Management Faculty, specialising in enterprise functioning, foreign trade, macroeconomics, international economic relations and fiscal policy. He also held top managerial positions at one of Poland's major spirits company (Polmos).

Sources: NBP, Reuters, BZ WBK.

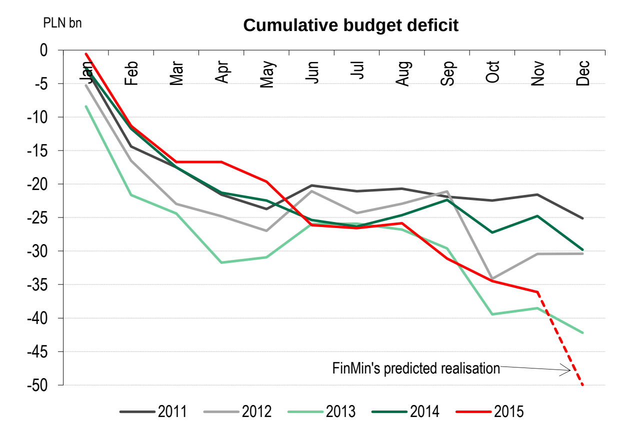
The 'old' MPC concluded its term of office

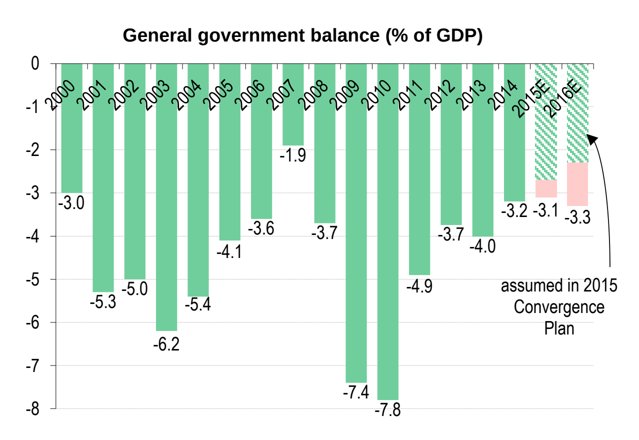
- The Monetary Policy Council kept the main interest rates on hold in January, its last meeting before the change of line-up. The tone of the press conference seemed quite dovish, however, as the Council acknowledged that inflation in the coming quarters may be lower than previously expected due to the renewed decline in commodity prices.
- In December the MPC held a special conference, during which it summarised its six-year term. We accept it has been working in a challenging environment, with turbulent world economic growth, major shocks to global commodity markets (both up and down) and persistent turmoil in financial markets. All these factors were accompanied by unconventional policies by the main central banks. For quite some time the MPC felt it was in the relatively comfortable position of being able to stick to traditional monetary policy.
- Another difficulty (or a justification for sometimes not optimal policy) was the fact that the council was a very heterogeneous body and sometimes struggled to reach a consensus (see chart on left). Nevertheless, overall, we note that average inflation in the six-year period (1.8%)was not far off target (2.5%). We would distinguish two different periods: the first three years, when average 12M CPI was c3.5%, and the second half of MPC's term, with average inflation at zero.
- GDP growth was relatively steady, as was the EURPLN exchange rate, which was high enough to support the competitiveness of Polish exporters. Also, the central bank maintained a high level of public trust.
- The council started its term with a positive commodity shock and a rise in inflation, to which it responded with higher interest rates. While in 2012 inflation was still high, the economic slowdown had started. In these circumstances the MPC delivered one more hike (taking its key rate to 4.75%). A similar move by the ECB was not sufficient to excuse this error, in our view. During the six-year term there was only one period of GDP slowdown and the reaction of the MPC was far from perfect.
- The new council will start out with record-low interest rates, which does not mean there is no room for manoeuvre. Especially as deflation looks set to stay for longer than previously expected. This is likely to be confirmed by the new inflation projection. We hope the new MPC leans heavily on the National Bank of Poland's Economic Institute's analysis.

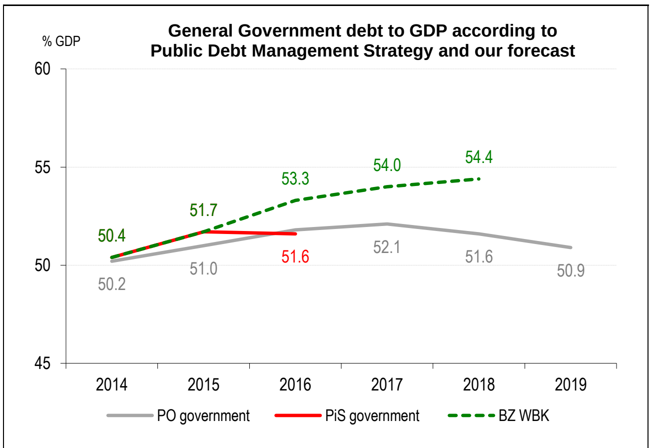
The new MPC in the making

- The Senate appointed three new members of the Monetary Policy Council – Eugeniusz Gatnar, Marek Chrzanowski and Jerzy Kropiwnicki, all proposed by the ruling Law and Justice (PiS).
- When answering questions from senators, Gatnar said that the "current level of the interest rates is good for the economy", but he also added that interest rate instruments can still be used, if needed. He expects the government's new programme of granting PLN500 per child per month could boost inflation due to stronger internal demand. Kropiwnicki said he was sceptical whether monetary policy could support economic growth. In his view, the current level of the interest rates "does a good job" and there should be "the highest caution when changing them". In our view, Chrzanowski (who said earlier that monetary policy could attempt to support growth if the inflation target is not under threat) and Gatnar may support additional monetary easing.
- The Sejm will select two MPC members mid-January and one more, probably in February (or end-January). The president will also pick two new MPC members in February.

Fiscal policy watch







	Spread vs. Bunds (10Y) in bp			CDS (5Y USD)		
	15.01	change since 15.12.15	change since 31.12.15	15.01	change since 15.12.15	change since 31.12.15
Poland	249	3	19	83	10	8
Czech	23	26	27	50	0	0
Hungary	289	-23	11	167	2	3
Greece	825	33	54	1037	5	46
Spain	126	15	11	91	14	-6
Ireland	65	16	12	38	1	1
Portugal	223	32	34	179	16	19
Italy	106	3	9	95	6	4
France	39	5	5	24	1	0
Germany				12	0	0

Source: Ministry of Finance, Reuters, BZ WBK.

Budget 2015 – amendment that wasn't necessary

- In mid-December the parliament approved an amendment to the 2015 budget, raising the deficit by PLN3.9bn, to PLN49.98bn. The revenue forecast was cut by PLN10.5bn, to PLN286.7bn, and spending limit was reduced by PLN6.6bn.
- In our view, the amendment was not really needed, as after 11 months of the year the deficit reached cPLN36.1bn, or 78.4% of the plan before the amendment. While tax collection was lower than planned, spending was also lower and the deficit was under control.

Budget 2016 – higher spending and revenues

- The government approved the modified 2016 budget draft, lifting the spending limit to PLN368.5bn (+PLN16.9bn) as compared to previous government's proposal) and revenues to PLN313.8bn (+PLN17bn). The budget deficit was planned at PLN54.74bn.
- The budget draft assumes implementation of the key PiS election promise – the "500+" programme (monthly allowance of PLN500 per child), which is expected to be launched in April-May, and its costs have been estimated at PLN17.5bn (although the final shape of the programme is still under discussion). Other election promises (lower retirement age, higher tax-free income, free drugs for the elderly, etc.) have been postponed until at least next year.
- We think achieving the planned deficit in 2016 may not be easy, as the macro assumptions (GDP growth of 3.8%, average inflation 1.7%) seem over-optimistic (we have cut our average CPI forecast to nearly 0%), and revenues from new sector taxes (on banks, insurers, retailers) may fall short of expectations. On the other hand, the inflow from NBP profits will be higher (PLN8bn instead of PLN3.2bn assumed in the draft budget). The government declared that the general government balance will reach c. -2.8% of GDP in 2016, but we see a risk it will be slightly above 3%.
- It seems that budgets for 2017 and subsequent years will be more challenging, as the cost of PiS's election promises will mount (new measures are to be implemented) and one-off revenues (such as the LTE auction, NBP profit) may not be repeated.

More risks to the medium-term fiscal outlook

- Recent comments suggest the new government plans to depart from Poland's medium-term fiscal objective (structural deficit of 1% of GDP) and instead will aim to keep the fiscal deficit 'on average near 3% of GDP'. We see this as a risky strategy, as it would imply a high probability of incurring an excessive deficit when the economy slows.
- This risk is amplified by a recent change in the fiscal spending rule, approved by parliament in December. The amendment changed the formula that determines the ceiling of public spending growth, by using the NBP's inflation target instead of actual and expected inflation, and by allowing for higher one-off spending if financed by one-off revenues. Effectively, it generated room for extra spending of cPLN15bn (1% of GDP) in 2016, according to our estimates.
- The proposal to lower the retirement age may be another key negative factor for Poland's medium-term economic and fiscal outlook. The government seems to have postponed the move until 2017.

Monetary policy divergence trade has continued to dominate

- As expected, December brought further monetary easing by the ECB and the start of tightening by the Federal Reserve.
- The increasing monetary policy divergence between the US and Euro zone is a key factor for the debt market's direction in the coming weeks/months. January, February are unlikely to bring changes in monetary conditions from either the ECB or the Fed. We think that peripheral bonds should benefit more than core debt markets from an improvement in the global mood as investors will search for yield and because their fundamentals are better. As a result, peripheral spreads over bunds could tighten further in the coming weeks.

Fiscal policy watch

Sovereign ratings

	S&P		Moody's		Fitch	
	rating	outlook	rating	outlook	rating	outlook
Poland	BBB+	negative	A2	stable	A-	stable
Czech	AA	stable	A1	stable	A+	stable
Hungary	BB+	stable	Ba1	stable	BB+	positive
Germany	AAA	stable	Aaa	stable	AAA	stable
France	AA	negative	Aa2	stable	AA	stable
UK	AAA	negative	Aa1	stable	AA+	stable
Greece	CCC+	stable	Caa3	stable	CCC	stable
Ireland	A+	stable	Baa1	positive	A-	positive
Italy	BBB	stable	Baa2	stable	BBB+	stable
Portugal	BB+	stable	Ba1	stable	BB+	positive
Spain	BBB+	stable	Baa2	positive	BBB+	stable

S&P economic forecasts for Poland

	2014	2015	2016	2017	2018	2019
GDP growth	3.3	3.5	3.4	3.3	3.2	3.2
CPI growth	0.1	-0.4	1.2	2.1	2.5	2.5
C/A balance/GDP	-2.0	-0.9	-1.3	-1.7	-1.8	-1.8
GG balance/GDP	-3.3	-2.8	-3.2	-3.0	-3.0	-2.9
Revenue/GDP	38.8	38.6	38.2	38.2	38.2	38.2
Expenditure/GDP	42.1	41.4	41.4	41.2	41.2	41.1
Debt/GDP	50.4	51.4	51.9	52.0	51.9	51.7

Key fragments of the S&P's Research Update:

The downgrade reflects our view that Poland's system of institutional checks and balances has been eroded significantly as the independence and effectiveness of key institutions, such as the constitutional court and public broadcasting, is being weakened by various legislative measures initiated since the October 2015 election. Poland's new ruling party Law and Justice (PiS), which holds an absolute majority in the parliament (Sejm) and the senate, has set out to make fundamental changes to Poland's institutions. For example, the constitutional court's ability to work efficiently and independently will likely be undermined, in our view, by changes to the court's composition and decision-making process. The government's new media law, as another example, gives the government extensive powers to appoint and control the directors and supervisory boards of public broadcasters. A third law terminates contracts of all current senior, career civil servants and removes a constraint regarding previous party membership, therefore enabling the new government to change the structure of the civil service. In our view, these measures erode the strength of Poland's institutions and go beyond what we had anticipated regarding policy changes from the general election.

The change in the rating outlook to negative reflects our view that there is potential for further erosion of the independence, credibility, and effectiveness of key institutions, especially the National Bank of Poland (NBP). Moreover, we no longer expect Poland's fiscal metrics will improve as we previously forecast. We also foresee some reversals in Poland's sound macroeconomic management of the past years, for instance by targeting certain sectors with new taxes.

The negative outlook reflects our view that there is at least a one-in-three possibility that we could lower our ratings on Poland in the next 24 months.

We could lower the ratings if we perceived a further weakening in the independence, credibility, and effectiveness of key institutions, most importantly the NBP. In addition, we could lower the ratings if public finances deteriorated beyond our current baseline scenario as the revenue and expenditure balance becomes more negative.

On the other hand, a reversal of the government's efforts to change and control Poland's key institutions, as well as sustained strong external performance, leading to further reductions in net external debt could lead us to revise the outlook to stable.

Source: S&P, Fitch, Moody's, Reuters, BZ WBK.

Rating decisions – politics vs. the economy

- S&P decided to lower Poland's long-term sovereign foreign currency rating from A- (outlook positive) to BBB+ (outlook negative) on Friday. We were among a minority of market economists in a Reuters' poll, who expected a change in the positive outlook, as the chance of a rating upgrade was minimal. Even so, the decision was a shock. S&P's justification for its decision was also quite surprising. The main reason for the change in its assessment was a view that "system of institutional checks and balances has been eroded significantly, as the independence of key institutions, such as the constitutional court and public broadcasting, is being weakened". While there is no doubt that the institutional framework is important, in our view the main question should be to what extent this affects a country's ability (or willingness) to repay its debt.

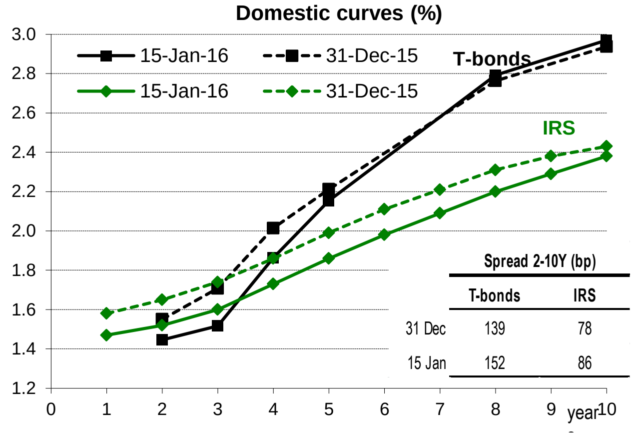
- Analysing S&P's assessment of Poland's current and expected fiscal stance, it is hard to find any change in forecasts to imply a significant deterioration of the country's credibility. Firstly, up to 2019 S&P expects public debt to remain stable at 51%-52% of GDP and sees the expenditure/GDP ratio steady at c41%. As regards the fiscal deficit, it increased its forecast for 2016 by a mere 0.3pp to 3.2% (and cut 2015 by 0.2pp at the same time) and raised its 2017 estimate by a similar amount. For 2017-19 the general government deficit is not expected to exceed 3% of GDP. Secondly, S&P expects the economy to continue to grow at 3.0%-3.5% in 2016-19. So the actual forecasts do not indicate a sharp deterioration in fiscal and economic conditions due to institutional changes. Moreover, there are currently no clear signs of attacks on central bank independence or credibility, which is another factor S&P cites as a possible reason for a further rating downgrade.

- Interestingly, on the same evening, Fitch released a statement on Poland's rating. While it also noticed a change in checks and balances in Poland, which might raise concerns, it affirmed Poland's long-term foreign currency rating at A- with a stable outlook. Its main arguments were the strong macro performance, resilient banking system and governance indicators. Fitch said a negative rating action could be triggered by: (1) a relaxation of the fiscal stance that increases debt; or (2) a weakening of policy credibility or economic performance.

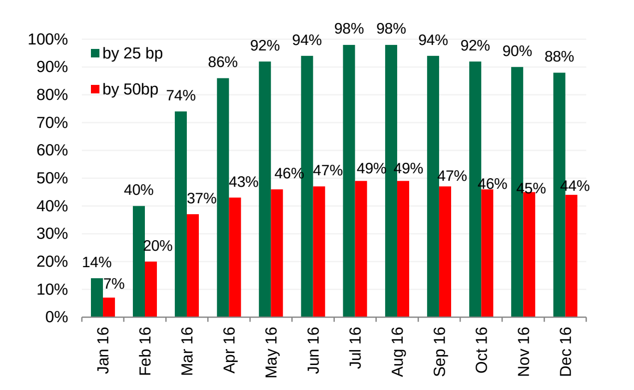
- Overall, the changes the new government has made in economic policy in the last few months justify a more careful approach by both investors and rating agencies. We have commented before on the change in the medium-term approach to fiscal consolidation (current target of a 3% deficit against the previous medium-term objective of 1% of GDP), a change in the so-called spending rule or higher expenditure, partly financed by one-off revenues. As a result of these and possible further policy changes, we cannot rule out Fitch or Moody's deciding to cut Poland's outlook to negative as a next step. That said, in our view, S&P's rating downgrade is too aggressive and overdone at this stage.

Interest rate market

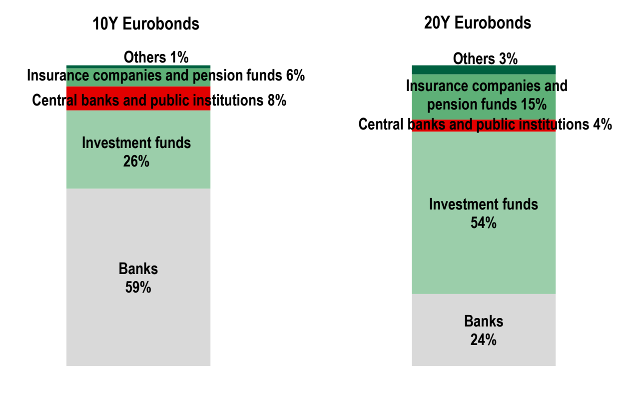
Domestic curves (%)



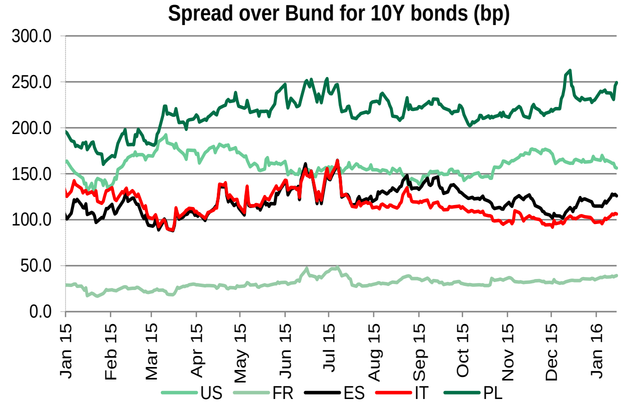
Probability of rate cuts implied by FRA rates



The structure of Eurbonds buyers by type of investors



Spread over Bund for 10Y bonds (bp)



Source: Finance Ministry, Reuters, Bloomberg, BZ WBK.

Significant weakening after unexpected S&P decision

- The key event of early 2016 was the unexpected S&P decision to lower Poland's credit rating. As a result, both IRS and yield curves shifted up significantly. The front and the belly of T-bonds and IRS trimmed earlier gains, with yields/rates returning to levels of the end of 2015, while the long ends of the curves lost the ground and the 10Y benchmark yield slipped back towards December's maximum of 3.24%.
- Both curves steepened markedly as long-term assets underperformed short-term ones. After the rating announcement, the 2-10Y spread widened to over 160bp for T-bonds and to almost 100bp for IRS. The risk premium for Poland, and also other CEE and peripheral debt, rose quite significantly in December, as shown by the further widening in the spread over Bunds in the 10Y sector. This trend has continued at the beginning of the new year.
- In the money market, WIBORs were stable in December, while FRAs remained highly volatile. Investors scaled back their expectations for quick and significant monetary easing in early 2016. This was mainly because of a deterioration in investor confidence in the IRS market. Early 2016 has remained volatile. FRA rates inched higher after the S&P decision, from local minimum levels at the start of the year. As a result, market players revised their expectations of a 50bp rate cut and now see over 90% odds of a 25bp reduction on a six-month horizon, according to FRA market pricing.

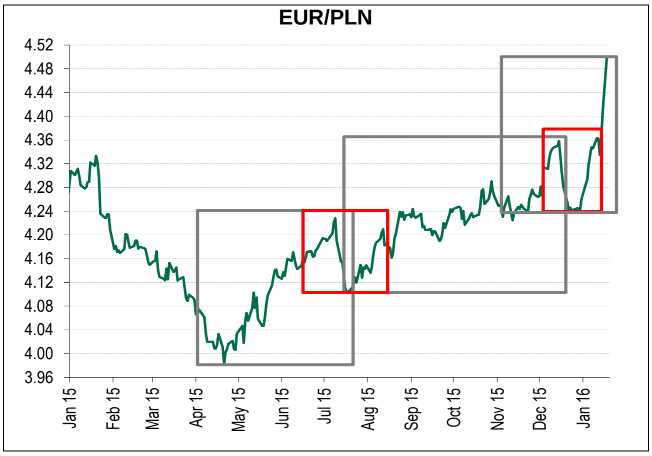
Ministry wants to finance 50% of 2016 target by end 1Q16

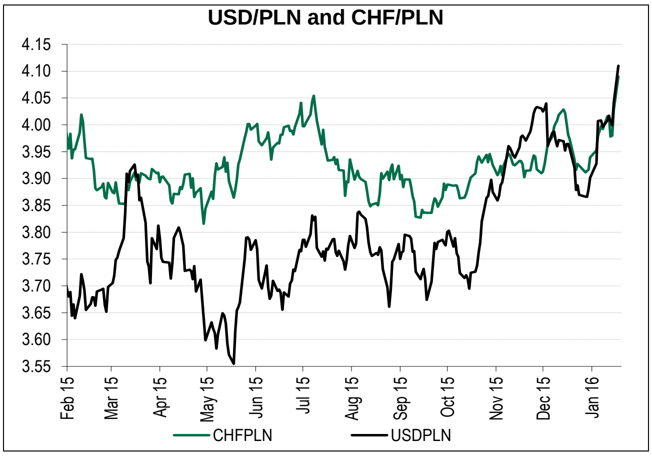
- The start of 2016 was busy for Poland's Finance Ministry: In January it tapped both the domestic and foreign primary debt markets. On the domestic market it sold PLN4.56bn of the 5Y benchmark PS0421 at a yield of 2.382%, slightly more than the upper limit originally planned for the offer (PLN2.5-4.5bn).
- Poland also launched long-term (10Y and 20Y) eurobonds worth €1.75bn in January. It placed the 10Y bonds at 65bp above mid-swaps (with an average yield at 1.542%) and 20Y at 100bp above mid-swaps at an average 2.471%.
- The ministry wants to build up a liquidity cushion and finance 50% of its 2016 gross borrowing needs by the end of 1Q16. While this looks an ambitious plan, we think the liquidity situation should support it. 1Q16 inflows will reach nearly PLN15bn from domestic T-bond redemptions and interest rate payments and c€3bn from eurobond redemptions.

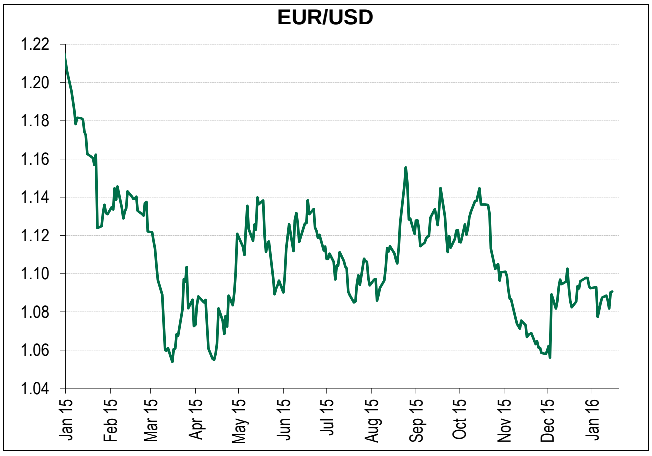
Central banks set the direction for the coming months

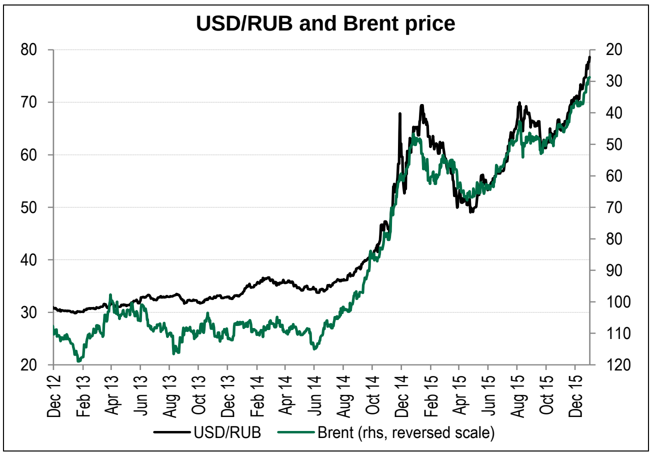
- We maintain our baseline scenario, which assumes that the new MPC is likely to ease monetary conditions in 1Q16. However, in our view, the WIBOR rate is not likely to decline much in the coming weeks and we expect more significant fall closer to the Council's March meeting.
- We remain still mildly bullish on the front end of the curve, as we believe parliament's decision to exclude Polish government bonds from tax (contrary to NBP bills) should shift domestic commercial banks' interest towards the front end of the yield curve. We also think that leaving deflation behind will be a slower process than we had previously expected, allowing the new MPC to deliver one rate cut (of 25bp) in 1Q16. Given these factors, we expect the front end of the curve to return to a downward trend after weakening due to the S&P decision. The main risk to the rate cut is a weak zloty.
- The belly and long end of the curve will remain more vulnerable to global factors. Investors are likely to keep a close eye on China and global central banks (ECB, Fed). An improvement in the global mood might bring some revival in 5Y and 10Y benchmark yields. However, we think sentiment is still fragile and, therefore, potential for strengthening is rather limited. We expect the 10Y yield to stay above 3.0% in the coming weeks. What is more, the curve steepening scenario is still valid.

Foreign exchange market









Sources: Reuters, Bloomberg, BZ WBK.

Volatile zloty

▪ EUR/PLN jumped to 4.50 in recent weeks on the disappointing ECB decision, global risk aversion triggered by worries about China looming NBP rate cuts, concerns about the Polish banking sector (banking tax and proposals on FX loan conversion) and the S&P downgrade. USD/PLN rose to 4.12 (its highest since late 2002) and CHF/PLN to 4.10 (its highest since early 2015). The Polish currency had recovered after the FOMC delivered a 'dovish' 25bp rate hike in December but this proved temporary.

▪ The beginning of 2016 showed that internal issues may be quite an important factor driving the zloty later in the year. We do not see the S&P decision as justified, but it may attract market attention and make foreign investors follow the situation in Poland even more carefully with a focus on the budget performance.

▪ The president's office has made a proposal on how to deal with the FX loans and a draft will now be passed to the Financial Supervisory Authority and a discussion will follow. This could take several months and, in our view, uncertainty related to the final shape of the bill could weigh on the zloty and limit its appreciation potential when global market sentiment improves.

▪ Another risk for the Polish currency is dovish rhetoric from the new MPC, despite the recent depreciation of the zloty. A weaker currency fuels inflation and the market may become more cautious about the scale of the interest rate easing. If the new MPC signals rate cuts are still likely, this may prevent the zloty from appreciating.

▪ After the zloty's sharp fall, we have raised our EUR/PLN forecast for 2016. We do not expect the exchange rate to rise in the short term, but the room for the zloty to gain in the months to come looks limited. EUR/PLN could correct to 4.35 in 1Q after the recent jump. In our base scenario, global market sentiment will be positive enough to allow the Fed to continue with its rate hikes, but the zloty may not advance much after reaching 4.30, due to perceived risks related to Poland's internal situation.

EUR/USD driven by central banks

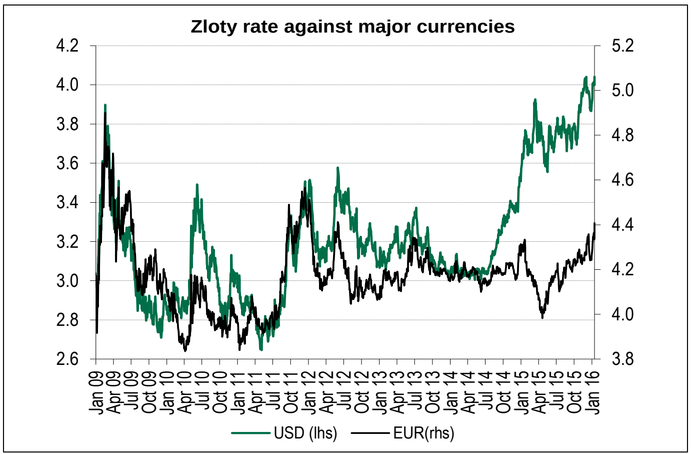
▪ In early December the ECB disappointed markets by extending its asset purchase programme by less than expected pushing EUR/USD above 1.10 from 1.05. However, in the following weeks the dollar firmed gradually thanks to the Fed's rate hike, while the euro was pressured by low oil prices. As a result, EUR/USD broke the local bottom of 1.08 and temporarily reached 1.07 early this year. Still, concern about China weakened market expectations of quicker rate hikes by the Fed and EUR/USD rose to c1.08.

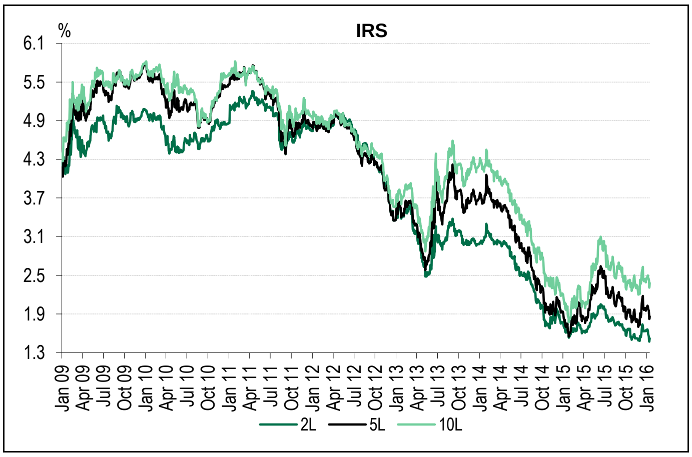
▪ The December US non-farm payrolls data surprised well to the upside and the market sees c27% odds of a Fed rate hike in March and c30% odds of a hike in April. We do not expect any action from the ECB in the months to come, so US monetary policy is likely to be the core factor driving EUR/USD. Should concerns about China ease, the dollar could gain more as the stable global environment would make Fed rate hikes more likely.

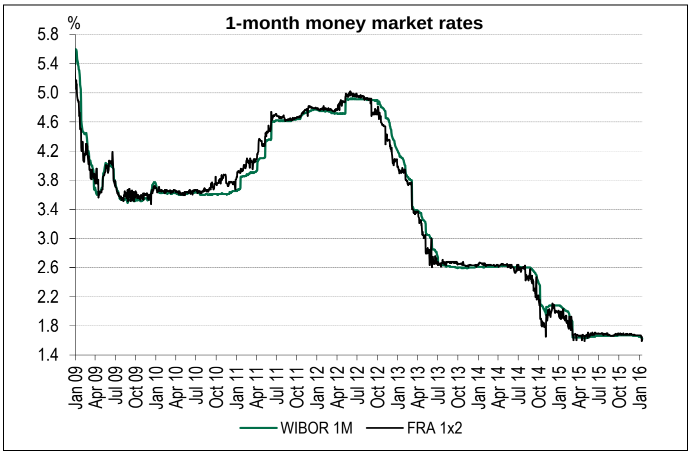
Falling oil price pressures the ruble

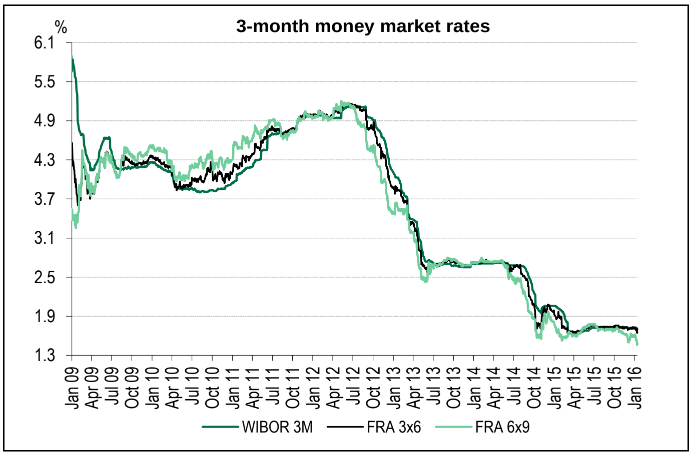
▪ The Brent oil price drop to its lowest since late 2003 had a very negative impact on the ruble. USD/RUB surged above 78 and established its all-time weekly closing high at c77. We think that commodity prices will remain the core drivers of USD/RUB in the near term. The downtrend is being supported by rising supply from Middle Eastern countries and by the US lifting its oil export ban. It might be difficult for the ruble to recover noticeably unless long-term concerns about China fade and the oil price starts to recover.

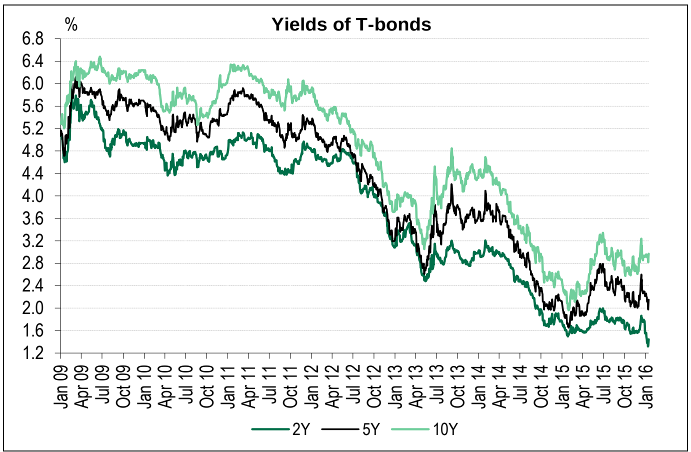
Market monitor

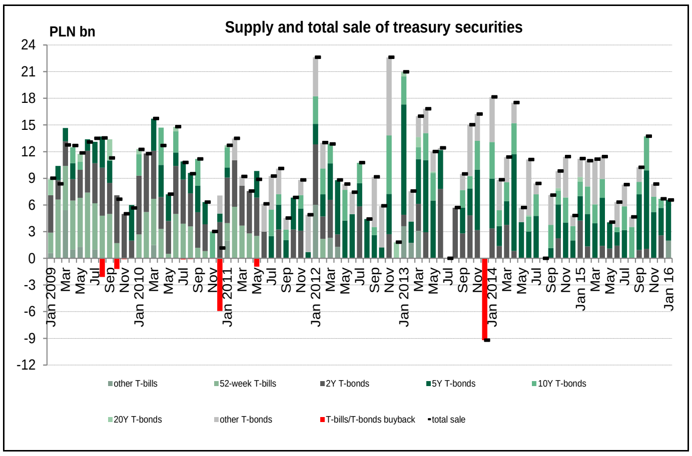












Treasury bond auctions in 2015/2016 (PLN mn)

month	First auction				Second auction				Switch auction		
	date	T-bonds	offer		date	T-bonds	offer		date	T-bonds	offer
January '15	15.01	WZ/DS/WS	3000-5000	4198.5	22.01	OK0717/PS0420	5000-7000	7005.2			
February	5.02	WZ/DS/WS	3000-5000	5980.0	12.02	OK0717/PS0420	3000-5000	5000.0			
March	5.03	USD20150716/	up to	$400.6m	12.03	WZ0124/DS0725/WS0428	3000-4000	4639.0	26.03	PS0415/OK0715/DS1015	WZ0120/PS0420
April	9.04	WZ0124/DS0725	2500-4500	3788.0	23.04	OK0717/WZ0120/PS0420	5000-7000	7654.3			
May	7.05	OK/WZ	3000-5000	Call off	21.05	OK0717/PS0420	2000-4000	4056.0			
June	11.06	OK0717/WZ0120	2000-4000	4236.5					25.06	OK0715/DS1015	PS0420/DS0725
July	9.07	WZ0120/WZ0124	1000-2000	2430.3	23.07	PS0420/DS0725	3000-6000	5852.7			
August	6.08	DS0725/WZ0126	1000-4000	4655.9							
September	10.09	WZ0126/DS0726	2000-4000	3019.0	24.09	OK0717/PS0420	4000-6000	7214.0			
October	29.10	OK/PS/DS	5000-8000	8082.0					8.10	DS1015/OK0116	PS0421/DS0726
November	26.11	EUR20160201**	Up to €1bn	€730m					19.11	OK0116/PS0416	WZ0120/PS0421/DS0726
December									10.12	OK0116/PS0416	OK0717/PS0421/DS0726
January '16	07.01	PS0421	2500-4500	4555.0	28.01	To be announced	4000-8000				

** with supplementary auction, ** buy-back auction, *** demand/sale.*

Source: MoF, Reuters, BZ WBK.

Economic calendar

MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY
18 ***PL: Core inflation (Dec)***	**19** DE: ZEW index (Jan)	**20** ***PL: Wages and employment (Dec)*** US: CPI (Dec) US: House starts (Dec) US: Building permits (Dec)	**21** ***PL: Industrial output (Dec)*** ***PL: PPI (Dec)*** ***PL: Retail sales (Dec)*** EZ: ECB decision EZ: HICP (Dec) US: Philly Fed index (Jan)	**22** CN: Flash PMI – manufacturing (Jan) DE: Flash PMI – manufacturing (Jan) EZ: Flash PMI – manufacturing (Jan) US: Home sales (Dec)
25 DE: Ifo index (Jan)	**26** ***PL: Unemployment rate (Dec)*** HU: Central bank decision US: Consumer confidence index (Jan)	**27** US: New home sales (Dec) US: Decyzja FOMC	**28** ***PL: MPC minutes*** US: Durable goods orders (Dec) US: Pending home sales (Dec)	**29** ***PL: Inflation expectations (Jan)*** EZ: Flash HICP (Jan) US: Advance GDP (Q4) US: Michigan index (Jan)
1 February ***PL: PMI – manufacturing (Jan)*** CN: PMI – manufacturing (Jan) DE: PMI – manufacturing (Jan) EZ: PMI – manufacturing (Jan) US: ISM – manufacturing (Jan) US: Personal income (Dec) US: Consumer spending (Dec)	**2**	**3** ***PL: MPC decision*** DE: PMI – services (Jan) EZ: PMI – services (Jan) US: ISM – services (Jan) US: ADP report (Jan)	**4** CZ: Central bank decision US: Industrial orders (Dec)	**5** DE: Industrial orders (Dec) US: Non-farm payrolls (Jan) US: Unemployment rate (Jan)
8 DE: Industrial output (Dec) CZ: Industrial output (Dec)	**9** DE: Exports (Dec)	**10**	**11** HU: CPI (Jan)	**12** ***PL: Advance GDP (Q4)*** ***PL: CPI (Jan)*** DE. HU: Advance GDP (Q4) CZ: CPI (Jan) EZ: Industrial output (Dec) US: Retail sales (Jan) US: Flash Michigan (Feb)
15 ***PL: Balance of payments (Dec)***	**16** ***PL: Wages and employment (Jan)*** CZ: Advance GDP (Q4) DE: ZEW index (Feb)	**17** ***PL: Industrial output (Jan)*** ***PL: PPI (Jan)*** ***PL: Retail sales (Jan)*** US: House starts (Jan) US: Building permits (Jan) US: Industrial output (Jan) US: FOMC minutes	**18** ***PL: MPC minutes*** US: Philly Fed index (Feb)	**19** US: CPI (Jan)

Source: CSO, NBP, Bloomberg

Calendar of MPC meetings and data releases for 2016

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
ECB meeting	21	-	10	21	-	2	21	-	8	20	-	8
MPC meeting	13-14	2-3	8-9	5-6	12-13	7-8	5-6	-	6-7	4-5	8-9	6-7
MPC minutes	28	18	17	21	27	23	-	25	22	20	24	22
Flash GDP*		12			13			12			15	
GDP*	-	29	-	-	31	-	-	30	-	-	30	-
CPI	15	12[a]	15[b]	11	12	13	11	12	12	11	14	12
Core inflation	18		16	12	13	14	12	16	13	12	15	13
PPI	21	17	17	19	19	17	19	18	19	19	21	19
Industrial output	21	17	17	19	19	17	19	18	19	19	21	19
Retail sales	21	17	17	19	19	17	19	18	19	19	21	19
Gross wages,employment	20	16	16	18	18	16	18	17	16	18	18	16
Foreign trade					about 50 working days after reported period							
Balance of payments*			31									
Balance of payments	13	15	15	13								
Money supply	14	12	14	14								

** quarterly data. a preliminary data for January. b January and February.*
Source: CSO, NBP

Economic data and forecasts for Poland

Monthly economic indicators

		Dec 14	Jan 15	Feb 15	Mar 15	Apr 15	May 15E	Jun 15	Jul 15	Aug 15	Sep 15	Oct 15	Nov 15	Dec 15E	Jan 16E
PMI	pts	52.8	55.2	55.1	54.8	54.0	52.4	54.3	54.5	51.1	50.9	52.2	52.1	52.1	52.0
Industrial production	% YoY	8.1	1.6	5.0	8.8	2.4	2.8	7.4	3.8	5.3	4.0	2.4	7.8	6.8	0.5
Construction production	% YoY	5.0	1.3	-0.3	2.9	8.5	1.3	-2.5	-0.1	4.8	-2.5	-5.2	1.2	3.0	3.0
Retail sales [a]	% YoY	1.8	0.1	-1.3	3.0	-1.5	1.8	3.8	1.2	-0.3	0.1	0.8	3.3	2.9	3.9
Unemployment rate	%	11.4	11.9	11.9	11.5	11.1	10.7	10.2	10.0	9.9	9.7	9.6	9.6	9.8	10.4
Gross wages in corporate sector	% YoY	3.7	3.6	3.2	4.9	3.7	3.2	2.5	3.3	3.4	4.1	3.3	4.0	3.6	3.6
Employment in corporate sector	% YoY	1.1	1.2	1.2	1.1	1.1	1.1	0.9	0.9	1.0	1.0	1.1	1.2	1.2	1.2
Exports (€)	% YoY	9.8	4.4	10.9	14.3	8.6	7.8	10.6	5.2	8.1	3.0	3.0	12.6	12.9	15.2
Imports (€)	% YoY	13.1	-2.1	3.9	8.7	7.7	0.5	10.3	7.3	6.7	5.2	-2.9	5.4	7.9	21.5
Trade balance	EUR mn	-629	639	526	485	-117	500	-165	-726	-150	19	499	756	-57	-63
Current account balance	EUR mn	-1,011	-228	93	1,054	929	928	-963	-1,110	-654	-768	-163	620	-439	-589
Current account balance	% GDP	-2.0	-1.7	-1.5	-1.3	-0.9	-0.7	-0.4	-0.5	-0.3	-0.5	-0.4	-0.3	-0.2	-0.2
Budget deficit (cumulative)	PLN bn	-29.8	-0.6	-11.3	-16.7	-16.7	-19.6	-26.1	-26.6	-25.9	-31.1	-34.5	-36.1	-50.0	-2.2
Budget deficit (cumulative)	% of FY plan	62.7	1.3	24.6	36.2	36.2	42.6	56.7	57.7	56.1	67.6	74.8	78.4	108.5	4.0
CPI	% YoY	-1.0	-1.4	-1.6	-1.5	-1.1	-0.9	-0.8	-0.7	-0.6	-0.8	-0.7	-0.6	-0.5	-0.5
CPI excluding food and energy	% YoY	0.5	0.6	0.4	0.2	0.4	0.4	0.2	0.4	0.4	0.2	0.3	0.2	0.2	0.3
PPI	% YoY	-2.7	-2.8	-2.8	-2.5	-2.7	-2.1	-1.4	-1.8	-2.7	-2.8	-2.3	-1.8	-0.8	-0.3
Broad money (M3)	% YoY	8.2	8.6	8.7	8.9	7.2	7.6	8.3	8.6	7.3	8.4	9.1	9.4	9.1	9.4
Deposits	%YoY	9.0	9.1	9.0	9.2	7.8	7.8	8.7	8.8	7.7	8.9	9.2	10.0	9.3	9.7
Loans	%YoY	7.2	8.0	7.7	7.8	6.4	7.7	7.9	7.9	7.6	7.9	7.7	7.2	7.3	6.9
EUR/PLN	PLN	4.21	4.28	4.18	4.13	4.02	4.08	4.16	4.15	4.19	4.22	4.25	4.25	4.29	4.38
USD/PLN	PLN	3.42	3.68	3.68	3.81	3.73	3.66	3.71	3.78	3.77	3.75	3.78	3.96	3.95	4.02
CHF/PLN	PLN	3.50	3.96	3.93	3.89	3.88	3.93	3.98	3.96	3.89	3.86	3.91	3.92	3.96	4.01
Reference rate [b]	%	2.00	2.00	2.00	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
3M WIBOR	%	2.06	2.03	1.92	1.67	1.65	1.67	1.70	1.72	1.72	1.72	1.73	1.73	1.72	1.71
Yield on 2-year T-bonds	%	1.84	1.60	1.60	1.62	1.60	1.74	1.91	1.82	1.79	1.79	1.65	1.58	1.71	1.45
Yield on 5-year T-bonds	%	2.16	1.82	1.88	1.99	1.98	2.38	2.68	2.45	2.40	2.43	2.18	2.10	2.28	2.23
Yield on 10-year T-bonds	%	2.55	2.21	2.20	2.32	2.36	2.83	3.20	3.00	2.88	2.91	2.66	2.73	2.93	3.05

Note: [a] in nominal terms, [b] at the end of the period.
Source: CSO, NBP, Finance Ministry, BZ WBK estimates.

Quarterly and annual economic indicators

		2013	2014	2015E	2016E	1Q15	2Q15	3Q15	4Q15E	1Q16E	2Q16E	3Q16E	4Q16E
GDP	PLN bn	1,656.3	1,719.1	1,783.0	1,839.5	414.6	432.2	438.6	497.7	425.4	444.7	451.4	518.0
GDP	% YoY	1.3	3.3	3.6	3.5	3.7	3.3	3.5	3.7	3.2	3.4	3.6	3.9
Domestic demand	% YoY	-0.7	4.9	3.0	3.9	2.9	3.1	3.2	2.9	4.6	3.7	3.6	3.9
Private consumption	% YoY	0.2	2.6	3.1	3.2	3.1	3.1	3.1	3.1	3.1	3.2	3.4	3.3
Fixed investments	% YoY	-1.1	9.8	5.9	5.7	11.5	6.1	4.6	4.3	4.0	6.0	6.0	6.0
Industrial production	% YoY	2.3	3.4	4.8	4.5	5.3	3.9	4.3	5.5	3.7	5.6	5.4	3.4
Construction production	% YoY	-10.3	4.3	0.7	4.7	1.4	1.9	0.5	-0.2	3.0	5.2	5.0	5.0
Retail sales [a]	% YoY	2.6	3.1	1.3	6.7	0.7	1.4	0.4	2.4	4.5	4.6	8.2	9.0
Unemployment rate [b]	%	13.4	11.4	9.8	9.0	11.5	10.2	9.7	9.8	10.1	9.2	8.8	9.0
Gross wages in the national economy [a]	% YoY	3.4	3.6	3.4	4.9	4.1	3.1	3.0	3.4	3.7	5.1	5.0	5.8
Employment in the national economy	% YoY	-1.1	0.2	0.8	0.7	0.8	0.8	0.7	0.8	0.8	0.7	0.6	0.5
Exports (€)	% YoY	5.7	6.4	8.3	9.2	9.8	9.0	5.3	9.2	7.5	9.0	10.0	10.3
Imports (€)	% YoY	0.2	8.3	4.8	10.5	3.5	6.2	6.4	3.2	11.0	10.0	10.0	11.0
Trade balance	EUR mn	-335	-3,255	2,214	235	1,651	216	-851	1,198	345	-189	-936	1,016
Current account balance	EUR mn	-5,031	-8,303	-745	-2,504	900	864	-2,527	18	-380	362	-2,566	80
Current account balance	% GDP	-1.3	-2.0	-0.2	-0.6	-1.3	-0.4	-0.5	-0.2	-0.5	-0.6	-0.6	-0.6
General government balance	% GDP	-4.0	-3.2	-3.1	-3.3	-	-	-	-	-	-	-	-
CPI	% YoY	0.9	0.0	-0.9	0.0	-1.5	-0.9	-0.7	-0.6	-0.4	-0.3	-0.2	0.7
CPI [b]	% YoY	0.7	-1.0	-0.5	1.1	-1.5	-0.8	-0.8	-0.5	-0.4	-0.2	0.1	1.1
CPI excluding food and energy	% YoY	1.2	0.6	0.3	0.5	0.4	0.3	0.3	0.2	0.4	0.5	0.5	0.8
PPI	% YoY	-1.3	-1.5	-2.2	0.3	-2.7	-2.1	-2.4	-1.6	-0.4	-0.5	0.8	1.3
Broad money (M3) [b]	% oY	6.2	8.2	9.1	4.3	8.9	8.3	8.4	9.1	7.9	6.7	5.5	4.3
Deposits [b]	%YoY	6.6	9.0	9.3	3.5	9.2	8.7	8.9	9.3	7.9	6.4	5.0	3.5
Loans [b]	%YoY	3.5	7.2	7.3	4.7	7.8	7.9	7.9	7.3	6.6	6.0	5.4	4.7
EUR/PLN	PLN	4.20	4.18	4.18	4.34	4.20	4.09	4.19	4.26	4.35	4.31	4.36	4.32
USD/PLN	PLN	3.16	3.15	3.77	3.83	3.72	3.70	3.77	3.90	3.94	3.83	3.84	3.73
CHF/PLN	PLN	3.41	3.45	3.92	3.76	3.93	3.93	3.90	3.93	3.95	3.80	3.73	3.57
Reference rate [b]	%	2.50	2.00	1.50	1.25	1.50	1.50	1.50	1.50	1.25	1.25	1.25	1.25
3M WIBOR	%	3.02	2.52	1.75	1.50	1.87	1.67	1.72	1.73	1.62	1.45	1.45	1.46
Yield on 2-year T-bonds	%	2.98	2.46	1.70	1.46	1.61	1.75	1.80	1.65	1.42	1.43	1.45	1.55
Yield on 5-year T-bonds	%	3.46	2.96	2.21	2.45	1.90	2.35	2.43	2.19	2.24	2.35	2.53	2.67
Yield on 10-year T-bonds	%	4.04	3.49	2.69	3.26	2.24	2.79	2.93	2.77	3.09	3.20	3.32	3.45

Note: [a] in nominal terms, [b] at the end of period. Source: CSO, NBP, Finance Ministry, BZ WBK estimates.

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