



MACROscope

2018 Outlook: Poland

MACRO, RATES AND FX

December 2017

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- GDP growth accelerated much more than we expected in 2017, nearing 5% y/y in 3Q17 and probably around 4.5% on average in the entire year. It was driven by very strong private consumption (first 500+, then healthy labour income and a lower savings rate) and an exceptionally supportive external environment (solid recovery in the Euro zone) boosting Polish exports. The long-awaited revival in investments started to materialise in 2H17, although slowly and mainly in the public sector. We expect economic growth to remain decent in 2018, near 4%, still strongly supported by buoyant external demand and local consumers. While we see reasons to expect a further rise in investments, We also see arguments why a rebound in this area could be only moderate and less significant than in the corresponding period of the previous EU financial framework.
- Unemployment fell to a record-low and the shortage of workers became a major headache for Polish companies and a key barrier for further business expansion. Fortunately, immigration from Ukraine has not slowed and the labour participation rate has been growing until recently, which helped to alleviate the problem. Nevertheless, it was not enough to stop wage pressure from building up and we expect wage growth to accelerate further in the coming year, as the gap between demand for labour and supply is likely to widen.
- The surge in labour costs is very likely to push services prices higher and so we think that core inflation will trend up in 2018, towards 2% y/y. In case of headline CPI, we expect to see ups and downs, with a rise above the 2.5% target mid-year and then a retreat, perhaps even below 2%, due to high base effects in food and energy prices.
- Although several Monetary Policy Council members already see arguments for a policy tightening, we think the NBP president and the majority of the Council will remain patient and the first 25bp rate hike will not take place before 4Q18, when the prospect of inflation persistently exceeding the official target becomes much more tangible.
- The fiscal situation in 2017 not only remained under control, but again proved to be much better than expected. The government's draft budget for 2018 assumes a moderate widening of the deficit, despite the good economic cycle, but as long as economic growth is strong, the fiscal outlook is unlikely to unnerve investors or rating agencies.

- The Polish zloty proved to be one of the best-performing emerging market currencies against the euro and the US dollar in 2017. After more than two years of high volatility, in the last few months EUR/PLN has become much more stable. It seems the market has already digested most of the risk factors, both as regards the global situation (monetary policy normalisation, US tax reforms, Brexit) and Polish internal politics. We think that the PLN exchange rate is likely to fluctuate in a relatively narrow band in the coming year, as it did in 2013-2014.
- In 2018, we expect bond yields to rise across the curve. In our view, the better part of this move will take place in 1H18. Despite the CPI's temporary drop to c2% y/y at the start of the year, stronger wage pressure and mounting core inflation may boost expectations of a rate hike (we do not rule out that a first, unsuccessful, motion to hike rates could be tendered in 1Q18). This process, together with the expected normalisation of monetary policy in the US, should push the whole curve up, particularly at the long end. Higher yields may be also justified by a larger supply of bonds in the first quarter of 2018.
- In 2H18, we expect some recovery at the long end of the yield curve. This should be supported by a slight weakening of business climate indicators in the Euro zone.
- At the same time, we expect the trend of a falling cost-of-credit risk (reflected in the asset swap spreads and yield spreads vs. German Bunds) to continue, owing to a still positive assessment of fiscal indicators.

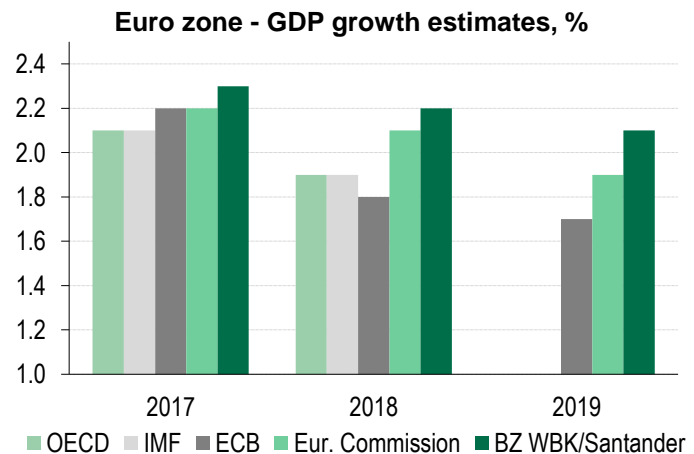
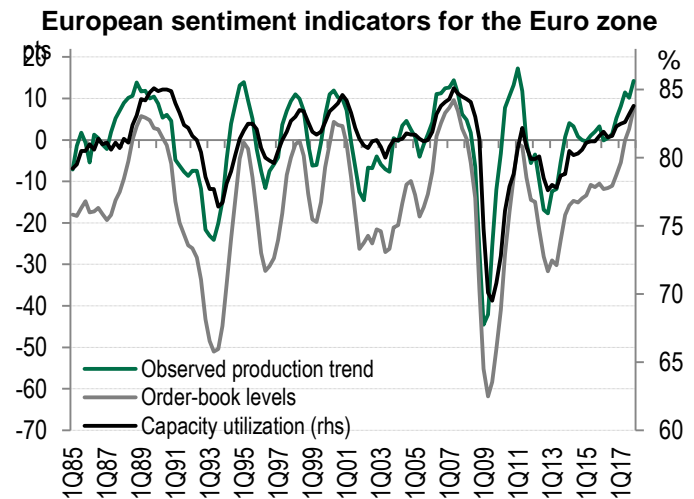


Indicator	Our view (12 months ago)	Outcome
GDP	V-shaped recovery with a blip in Q2 because of the working days effect. The scale of the recovery depends mostly on the performance of investment. We see GDP growth back above 3% y/y in 4Q.	Economic growth has outperformed our forecasts by a wide margin (likely to reach 4.5% vs the expected 2.7%), despite a sluggish investment revival.
GDP breakdown	Strong consumption, at least in 1H17. Net exports neutral again, despite a recovery in foreign trade. Investments picking up in 2H17 after the absorption of EU funds speeds up.	Consumption was even stronger than we had thought and investments indeed started picking up in 2H. The inventory rise surprised on the upside again, while net exports were close to neutral.
Labour market	Unemployment already close to natural rate. Job creation limited by available labour supply. Wage acceleration.	Strong job creation continued, so the unemployment rate fell more than expected and the labour shortage intensified. Wage pressure only strengthened significantly at year-end.
Inflation	Strong jump in 1Q17 to 1.5% due to a spike in commodity prices. Stabilisation later in the year.	Stronger inflation at the start of the year, followed by the expected stabilisation. Higher fuel & food prices caused a spike to 2.5% in November, while core inflation (as expected) did not exceed 1%.
Monetary policy	Rates flat over the year. MPC under pressure at the turn of 2016/17 amid very low GDP growth, but members likely to hold back.	GDP quickly surprised on the upside, but the MPC adopted a 'wait-and-see' mode, declaring interest rates stable until end-2018.
Fiscal policy	A central budget deficit of c.3% of GDP is relatively safe, given the favourable growth breakdown (driven by consumption). General government fiscal deficit slightly above 3%, however, because of deficits at local government level.	State budget deficit may be as little as half the planned level at the year-end. General government balance could even be below 2% of GDP, unless the Ministry of Finance decides to introduce major shifts in revenue/spending to "offload" next year's budget.
Interest rate market	In 2017, front end starting to price in hikes by the MPC (to materialise in 2018). Long-term yields under upward pressure from global markets.	MPC's dovish rhetoric kept rate hike expectations muted. Global pressure on the Polish curve did not happen and the excellent budget performance was very supportive for bonds.
FX market	Cyclicality of the Polish zloty will not be supportive at the start of 2017, some improvement in sentiment in 2H17.	The zloty rallied on the improving economic outlook and decreasing geopolitical risk, with a correction in the second year-half.



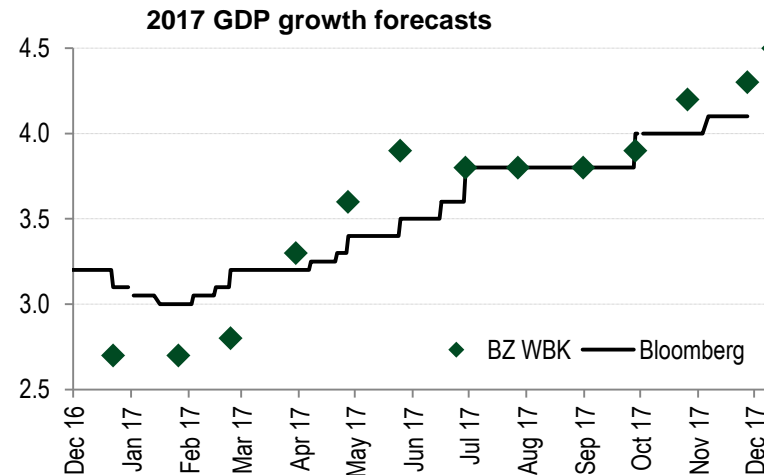
Indicator	Our view (in a nutshell)	Main risks
GDP	Growth has already peaked, but should remain solid, near 4%, supported by a very favourable external environment and accommodative domestic macro policies.	Main risk is external: an unexpected stagnation of solid growth in Europe. Capacity constraint resulting from labour shortages may halt economic expansion, despite strong demand.
GDP breakdown	Consumption is still the main driver of growth, with investments growing moderately, fuelled mainly by local government spending. Net exports close to neutral again and inventories slightly negative.	The biggest uncertainty still concerns the investment outlook, especially in the private sector. Increased tension between the US and North Korea could disrupt international trade, affecting Polish exports.
Labour market	Jobless rate at record low and falling. Labour shortages intensifying across the board, slowing employment growth and triggering further acceleration of wage pressure, but also a rise in labour participation.	If the labour participation rate drops dramatically after the lowering of the retirement age, labour market pressures would be much stronger.
Inflation	CPI topping the inflation target mid-year and retreating to c.2% in 2H due to a high base effect. Higher labour costs and above-potential growth fuelling a gradual pick-up of core inflation towards 2%.	Another strong rise in global commodity and food prices (or severe weather anomalies again) would push the CPI substantially above target.
Monetary policy	Rising inflation and growing wage pressure could deepen the divide in the MPC and trigger an interest rate hike before year-end, most likely in November 2018.	If wage and inflationary pressures strengthen significantly and growth surprises on the upside again, rate hike possible earlier (July 2018).
Fiscal policy	Fiscal budget still under control, even though the scope for further improvement in tax collection seems limited.	Economic slowdown is still a threat, as the sharp improvement in the fiscal situation was partly cyclical in nature. However, better tax collection seems to be a structural improvement to some extent.
Interest rate market	In 2017 the short end should start to price in rate hikes to be delivered in 2018. The long end should be driven by global market mood.	Stronger pressure on Polish curve if monetary policy normalisation pushes global yields up significantly.
FX market	Stabilisation of PLN in a narrow range, as improvement of macro fundamentals and political uncertainty has been already priced-in.	Correction in stock markets could be a risk factor for the zloty.

- At the end of 2017, EU business confidence seems to be high. The European Commission's indicator of the production trend in the manufacturing sector is approaching the level last seen at the peak of 2006-07. Companies have remained optimistic for 49 months, the longest in the history of the survey (started in 1985).
- New order book indices are also approaching the levels of 2006-07. However, the expansion period for order books was much shorter than for production trends. It is worth noting that recently we have observed faster growth in production and orders than we had back in 2006-07. This was accompanied by high capacity utilisation (but lower than in 2006-07). Still, capacity utilisation is growing more slowly than output and orders.
- This data, combined with the fact that GDP growth was mainly fuelled by domestic EU demand without a major acceleration of credit growth (0%-2% y/y), allows us to expect these positive trends will remain in 2018.
- The picture of US economy looks similar, with unemployment at all-time lows and moderate wage growth. Asia seems to be the most unstable element of the global economy. This is because China is changing from an export-driven model to a domestic-demand-driven one, which makes it necessary for policymakers to address numerous tensions in the financial and housing markets.

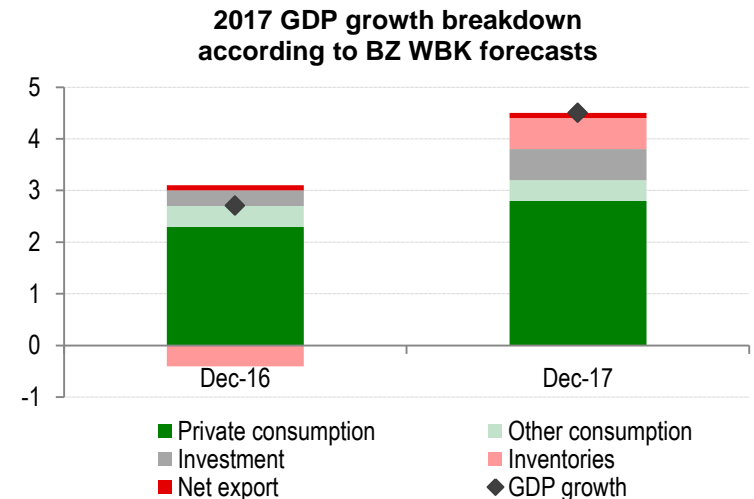


GDP (1) – Huge positive surprise in 2017

- GDP growth in 2017 was probably close to 4.5% y/y, much higher than expected by us and by most market analysts one year ago.
- Our forecasts, along with the Bloomberg consensus, has chased GDP growth throughout the year. Our latest upward revision comes with this report. At the end of last year, we were more pessimistic than the market and expected GDP growth below 3% y/y. In April, we became more optimistic than consensus.
- In our [2017 Outlook for Poland](#), we were expecting GDP growth to bottom out in 4Q16 and take a V-shaped recovery path in 2017, with private consumption the main growth driver and rather weak investment, not recovering until 2H17. While the general direction was correct, we have strongly underestimated the power of the revival.
- In 2017, private consumption is likely to contribute 2.8pp to GDP growth (vs our forecast of 2.3pp in our 2017 Outlook), and investment 0.6pp (vs 0.3pp). We were right about almost neutral contribution of net exports. Inventories proved our biggest missed call, as they are likely to contribute +0.6pp versus our expectations of -0.4pp. We thought that the big rise in inventories in 2016 (+1.2pp contribution to GDP growth) would be reversed as higher demand would make companies destock.



Source: Bloomberg, BZ WBK



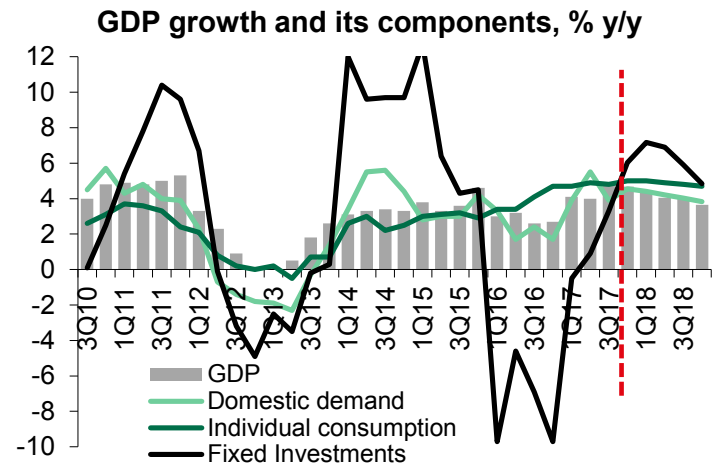
Source: BZ WBK

GDP (2) – 2018 still decent, but the peak is behind us

- In 2018, we expect GDP growth to decelerate slightly and reach 4.0% y/y on average (the current Bloomberg consensus is at 3.7% y/y).
- Strong consumption, driven by a booming labour market and high growth in disposable incomes, should remain the main engine of GDP growth. Investment should show a stronger revival, yet its expansion is likely to be capped by rising capacity constraints in construction. Both exports and imports should post decent growth rates, given the positive global economic outlook, a revival in international trade, and strong domestic demand. The contribution of net exports should again be close to zero on average, in our view. We also forecast a minor drop in inventories.
- The following slides show our scenario for the main components of growth in more detail: investments, consumption and the labour market situation, and exports in a global context.



Source: GUS, BZWBK

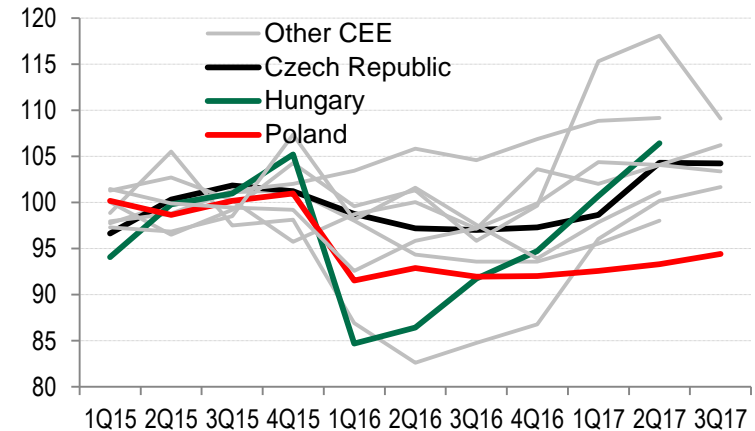


Source: GUS, BZWBK

Investments – Delayed recovery (1)

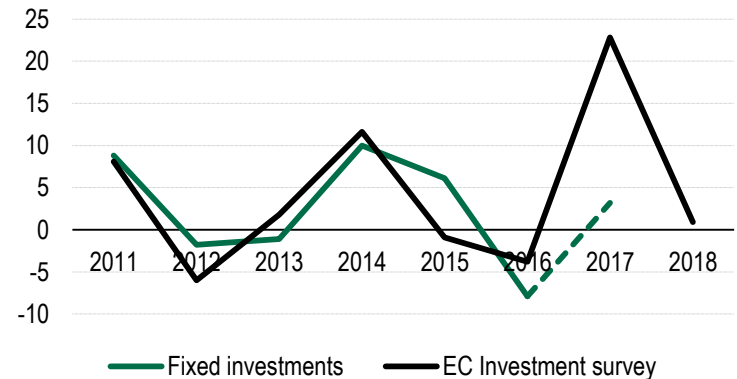
- In 3Q17, investment rose 3.3% y/y, after six quarters of negative or near-zero growth. The recovery is finally here, but is weaker than expected.
- The slump in investment in 2016 was visible in almost all CEE economies. Other CEE countries, however, witnessed a U-shaped investment cycle and their outlays have already returned to 2015 levels. In Poland, we can see an L-shape profile and 3Q17 investment spending (in constant prices) was still about 5%, below the 2015 average.
- The financial situation of Polish companies remains positive, while financing conditions are favourable and banks are reporting rising demand for investment loans. Volumes of EU-financing contracts also accelerated strongly in 2017. Capacity utilisation in the economy is high, so investments are needed to match growing demand. These factors make us believe that the investment recovery will gain strength in the quarters to come.
- However, companies do not plan a major increase in investments in 2018. Moreover, we see only minor upward potential for construction and this will, in our view, limit investment in building in 2018. Also, rising construction costs may lead companies and the government to cut their investment plans. **To sum up, we are expecting the recovery to gain strength and investment to grow by 6.0% y/y in 4Q17 and 5.9% on average in 2018, with a decelerating profile, at least in construction.**

Investment in CEE countries (2015=100, s.a.)



Source: Eurostat, BZWBK

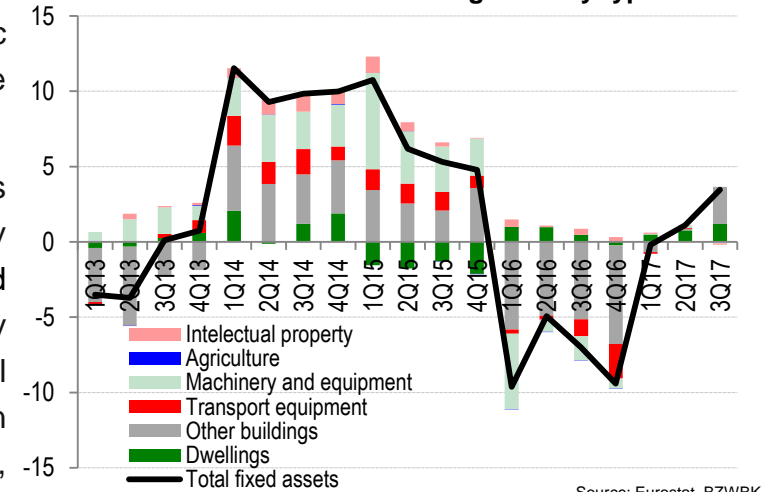
Fixed investment: actual vs expected



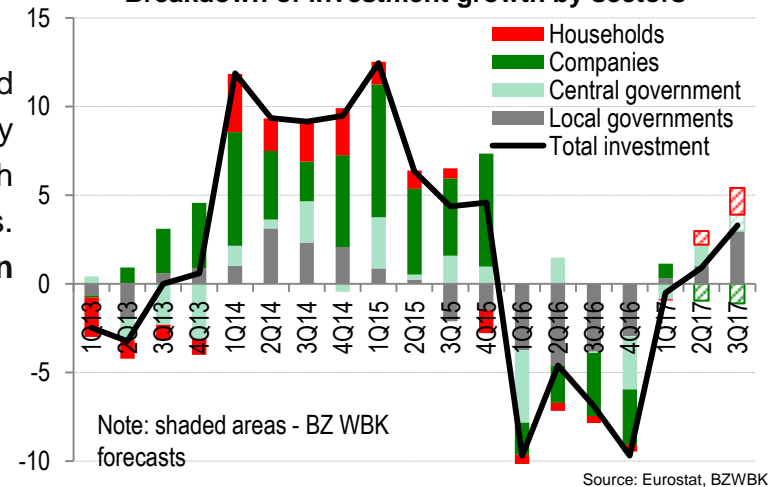
Source: European Commission, GUS, BZWBK

- Slump in CEE investment in 2016 was mostly an effect of the transition period between two EU financing frameworks. This weighed on public investment. Poland lags its CEE peers, mostly due to the fact that private investment fell as well.
- The breakdown by asset type shows that the recovery in 3Q17 was visible only in construction, up 7.1% y/y, while investment in machinery and transport equipment was still sluggish. Non-housing-related construction posted a major upturn and this, is in our view, related mostly to an improvement in public investment, in particular in local governments, where spending increased 44.5% y/y in nominal terms in 3Q17. According to our estimates, private investment remains stagnant, with the exception of households, which are investing heavily in the booming housing market.
- Local governments are the forerunners of the investment recovery and we are expecting other sectors to follow suit. Private investment is highly correlated with local government outlays. The highest correlation is with private investment, which lags local government by two to three quarters. **This suggests that a recovery in private investment should start in 4Q17 and show some real strength in mid-2018.**

Breakdown of investment growth by type

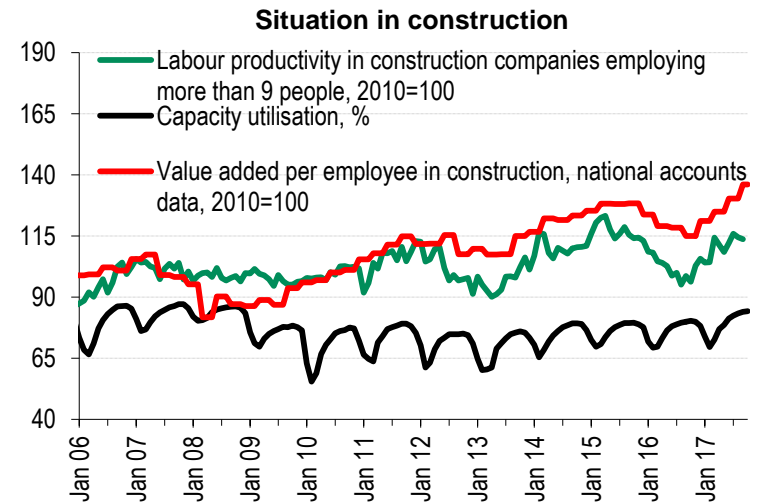


Breakdown of investment growth by sectors

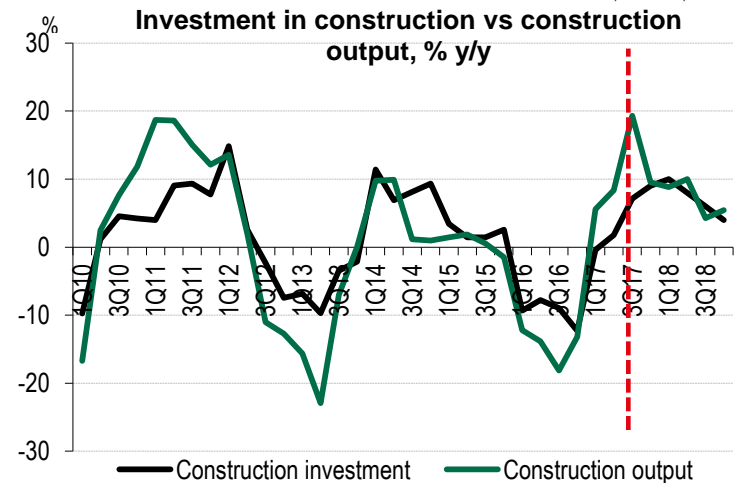


Construction is hitting capacity constraints (1)

- In 2017, construction was a strong driver of GDP and investment, with double-digit growth of output and about 1.0pp contribution to total gross value added growth. Note, however, that such rapid growth was partly the result of the very low base effect, as 2016 saw a big slump in this sector. In our view, 2018 will not be that strong and construction output will slow down as the sector is close to its capacity constraints.
- Construction output in the corporate sector is about 20% lower than in the peak of 2011-2012, and so is the employment in this sector. Labour productivity as measured by output per employee is only 6% below all-time high recorded in early 2015. Value added per employee already at all-time highs. The Statistics Office's reported capacity utilisation in construction sits only 3pp below all-time high recorded in 2007.
- In our view, a strong growth of output in construction would require significant capacity extension. This, however, will be hard to do. First, reported shortages of labour and vacancies in construction are among the highest across sectors and chances for attracting sizeable inflow of more people are slim, at least without significant increase in wages. We are also skeptical about further improvement in labour productivity, given lacklustre investment in machinery and equipment in 2016 and 2017.
- **Therefore, we expect construction output and investment in buildings to slow down from double-digit growth in 1Q18 towards 5% y/y at the year-end.**



Source: GUS, Eurostat, BZWBK

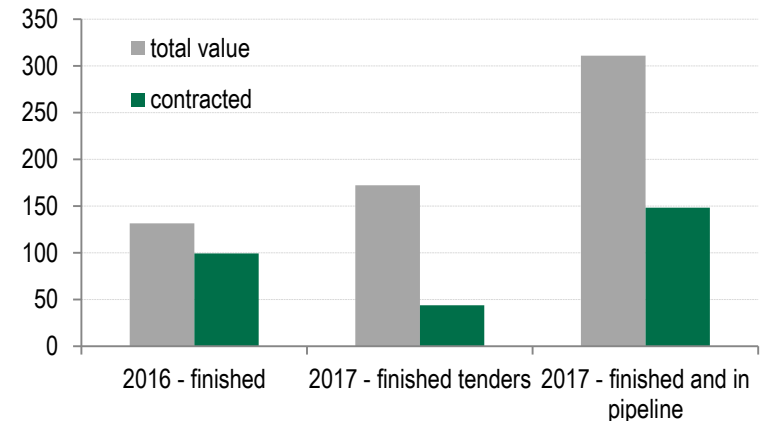


Source: Bloomberg, BZ WBK

Construction is hitting capacity constraints (2)

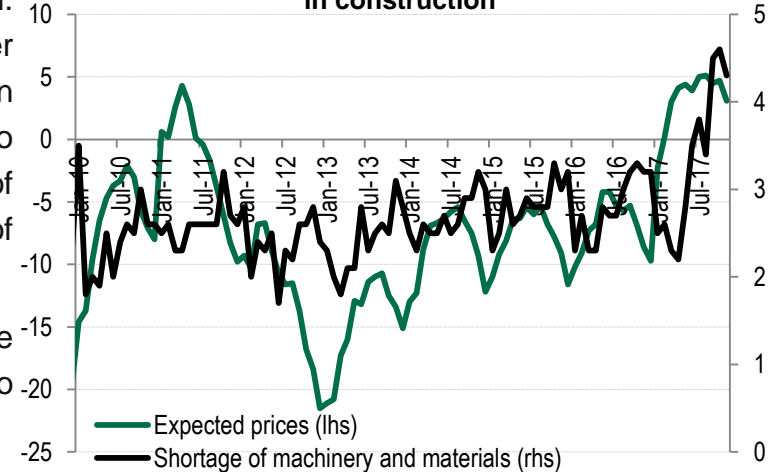
- Problems faced by construction industry are already visible in the hard data. First, big WSE-listed construction companies report rising backlogs and rising costs, which consume margins. Second, tenders by GDDKiA are failing at an increasing rate.
- GDDKiA is a state-owned agency controlling road building in Poland that organises tenders for contractors and secures financing. GDDKiA is also a big user of EU funds: it is the biggest beneficiary of financing contracts, accounting for PLN48.0bn out of PLN242.8bn signed so far (end of November).
- We have analysed GDDKiA completed construction tenders, launched in September and October. We estimate the total value of these tenders at PLN170mn. Surprisingly, only PLN44mn worth (26%) were successful. Other tenders were cancelled as no offers were tabled or the lowest offer was above the budget. In many cases, the lowest offer was more than double the budget. After adding tenders in the pipeline and those likely to be successful (i.e. offers are known), we arrive at total value of PLN310mn and a success rate of 47%. In the corresponding period of 2016, the success rate was close to 75%.
- There are similar signals about problems with tenders for infrastructure investments coming from the local governments, which are now trying to speed up the process of EU fund spending.

GDDKiA tenders, PLNmn



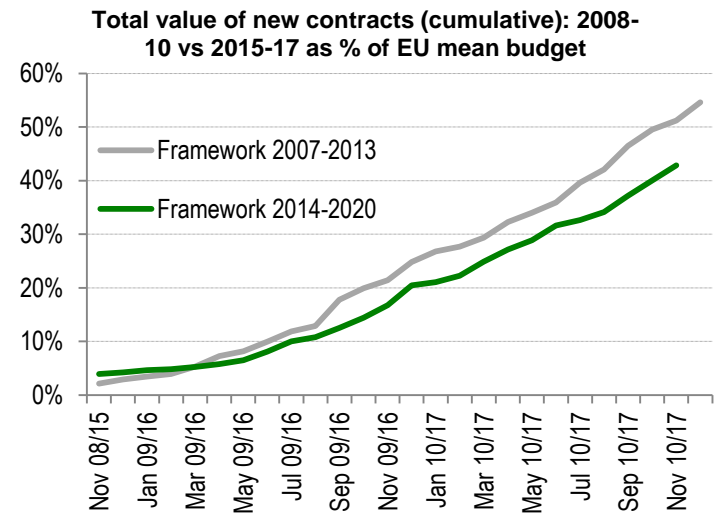
Source: GDDKiA, BZWBK

Statistics Office's business climate indicators in construction

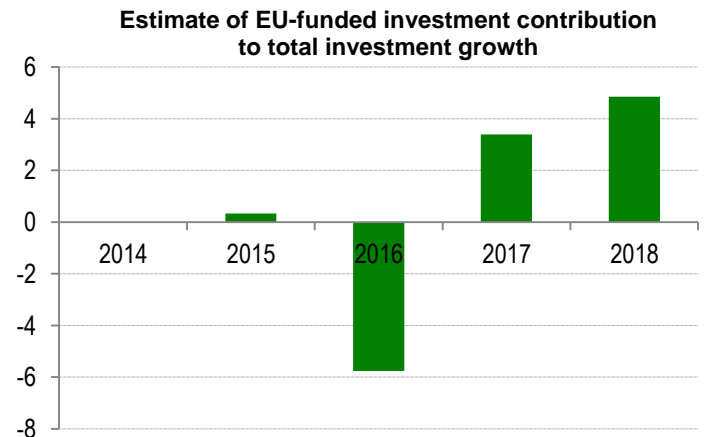


Source: GUS, BZ WBK

- 2017 saw some revival in budgeting of EU funds**, as the value of EU-financing contracts amounted to PLN128.3bn in Jan-Nov 2017 versus PLN89.0bn in Jan-Nov 2016. The total value of new applications fell to PLN188.1bn from PLN189.6bn. In nominal terms, these numbers look better than in the corresponding periods of the 2007-2013 financial framework. However, there is still a lot of slack when we look at the percentage of budget utilisation. At the end of November 2017, contracted funds made up 43% of the budget, compared with 51% in November 2010.
- Our model estimating how applications and contracts are transformed into actual investment suggests a big spike in EU-funded investment in 2018E**, with an impressive 8 percentage point contribution to investment growth and a 1.5pp contribution to GDP growth. In our view, Polish companies will use EU funds to invest in new technology and machinery. However, **given constraints in the construction sector, we are expecting rising backlogs in EU-funded infrastructure investments and have cut our forecast to max 5pp contribution to investment growth and 1.0pp contribution to GDP.**



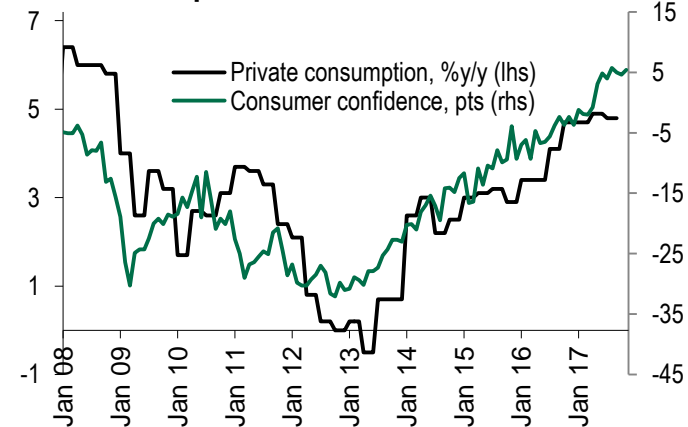
Source: Ministry of Development, BZWBK



Source: Eurostat, BZ WBK

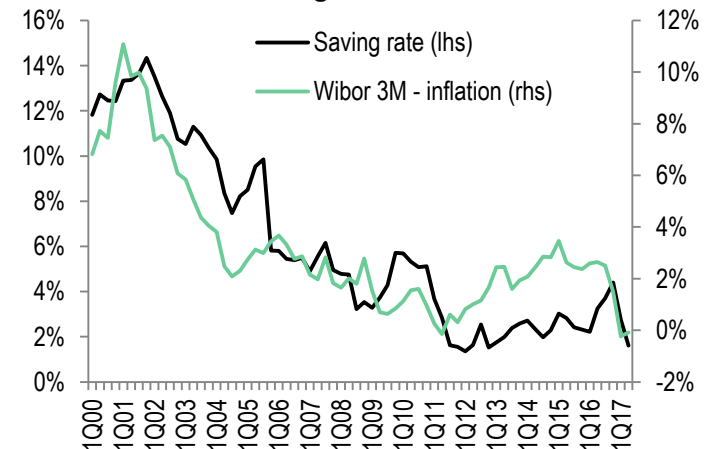
- Record-high consumer sentiment clearly suggests that the current high growth in consumption should continue in 4Q and longer. **Private consumption accelerated to almost 5% y/y over the course of 2017 and looks well positioned to grow at comparable pace in 2018.** Consumers seem to be on a spending spree. A (temporary) decline in real income growth during 2017, due to the CPI rebound and a lesser impact from the 500+ child benefit programme effect, did not harm strong private consumption momentum as people reduced their savings rate and increased consumption. Such a shift of households' stance to a less cautious, more consumption-oriented one should encourage credit demand and is likely to unlock demand for durable goods. This bodes well for private consumption in 2018.
- It seems Polish consumers are on a spending spree again, as in 2007. The 500+ child benefit programme has supported consumption not only directly, by injecting cash to household budgets, but also indirectly, by increasing households' optimism. As the 2.6mn households covered (out of 14.2mn total) started to consider the programme a stable source of income, their approach to the new inflow seems to have switched from cautious to optimistic, lifting their views of their financial outlook. As a result, the savings rate among households recorded an upswing in the early phase of the programme, only to drop below the starting point when inflation dented households' real income growth.

Consumption and consumer confidence



Source: GUS, BZ WBK

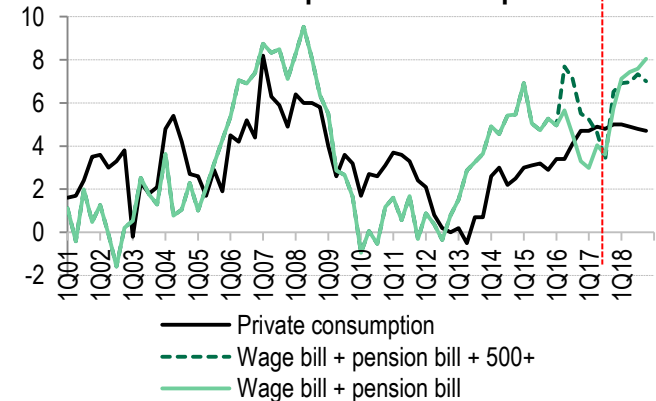
Households' saving rate vs. real interest rate



Source: GUS, Reuters, BZ WBK

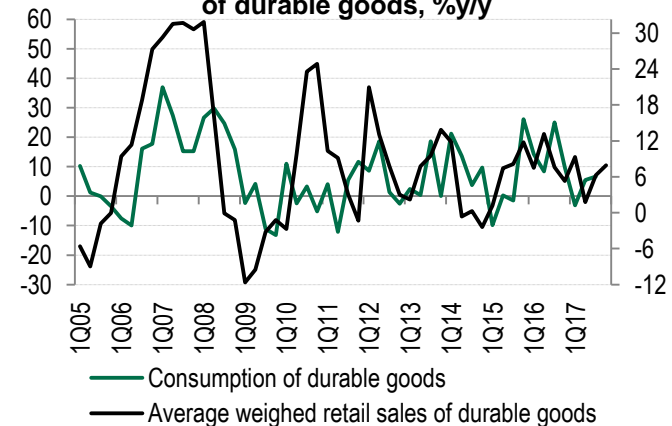
- Household incomes should also support consumer spending next year, on the back of broad wage increases and high indexation of social security transfers.
- Payment of one-off equivalents for coal benefit in 4Q17, worth PLN2.3bn in total, is another material – yet temporary – boost (0.8pp) to household incomes. The wage and pension bill are both growing by c7%-8% y/y in real terms (the latter not only because of indexation, but also because the number of pensioners has risen after the retirement age was reduced, although we think most of the new pensioners will probably return to work after getting their benefits) should support record high consumer confidence and spending power in 2018. Our consumption growth forecast of c5% y/y seems conservative in this context.
- Consumption of durable goods is another reason to expect a high and steady pace of overall consumption. This category so far has not contributed much to the acceleration of total private consumption, while the contribution of other categories (semi-durables, non-durables, services) taken together has already equalled the level at the peak of cycle in 2007-08. A subset of monthly retail sales data covering durable goods already points to some rebound. This indicator has historically worked well in predicting turning points in overall durable goods consumption. The Statistics Office's consumer survey is also showing record-high levels of propensity to make major purchases this year.

Real growth of households' income measures and private consumption



Source: GUS, BZ WBK

Retail sales and consumption of durable goods, %/y

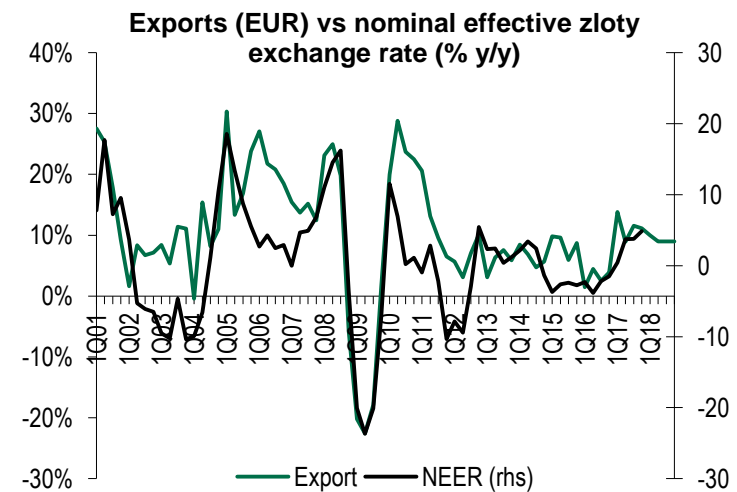


Source: GUS, BZ WBK

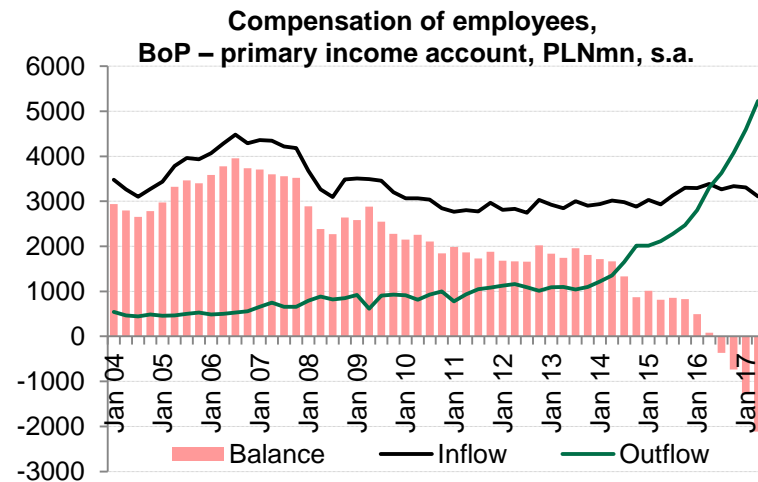
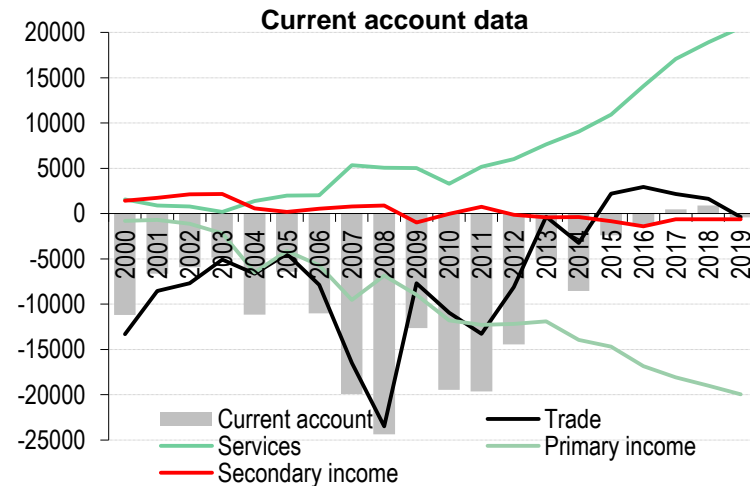
- The outlook for global economic growth in 2018 is quite positive. The export-share-weighted average of Bloomberg forecasts for Poland's trading partners suggests some slowdown to 2.3% in 2018 from 2.5% in 2017, but it will be still one of the best results in the post-2008 period.
- Forecasts for Germany – Poland's biggest trade partner – are particularly positive. German exports are highly correlated with Polish exports. **Hence, we expect Polish exports to grow 6% y/y in 2018 in real terms (9% y/y nominal growth in EUR).**
- While the zloty has appreciated quite significantly in 2017, we are not concerned that this will have significant negative impact on export growth in the coming quarters. Historical data clearly show that the correlation between Polish export growth and local currency strength is surprisingly positive, which simply reflects the fact that exports are much more sensitive to the business climate abroad than to the PLN rate.

Country	GDP growth - data and forecasts			Share in trade
	2016	2017	2018	
Germany	1.9	2.2	2	26.5
UK	1.8	1.5	1.4	6.7
Czech Rep.	2.6	4.3	3.2	5.9
France	1.2	1.8	1.8	5.2
Netherlands	2.2	3.1	2.1	4.7
Italy	0.9	1.5	1.3	4.3
All partners - wghtd avg	2.0	2.5	2.3	100.0

Source: Bloomberg, GUS, NBP, BZWBK

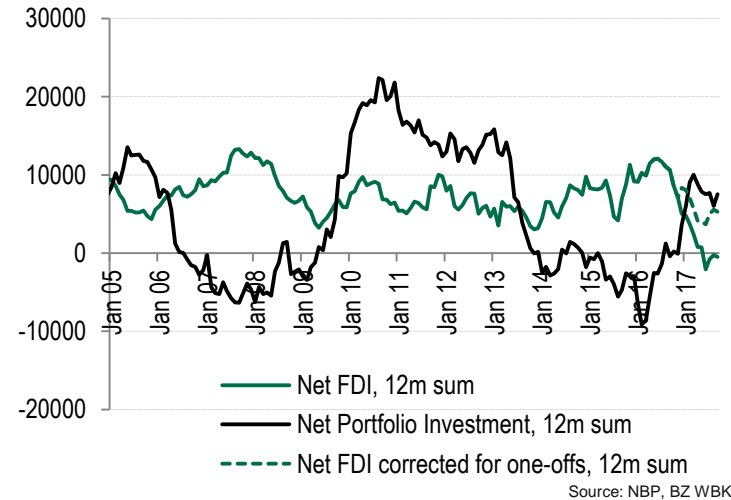


- Poland has run an almost balanced current account in the last three years, despite moderately strong economic growth, which seems to be at odds with the correlations observed in the previous years.
- To large extent, this was possible thanks to a significant improvement in the balance of trade in goods, where an impressive export performance, combined with subdued domestic demand (limiting imports), led to surpluses, unseen since the early 90s. Another reason was the rapid expansion of exports of services, visible since 2011, only partially offset by a growing income deficit.
- Even though exports of goods should remain strong in the coming quarters, we see room for a slight reduction of their surplus in 2018, as rising investments and robust private consumption (with a higher share of durable goods) should boost imports.
- The income balance should deteriorate further, amid growth in dividends paid by foreign-owned companies and due to a worsening of the net compensation of employees – a result of immigration and growing transfers of salaries to Ukraine. Yet, it should be more than offset by further a improvement of the services surplus, as Poland strengthens its position as a European hub for business services.
- As a result, we expect the current account to remain almost balanced.**

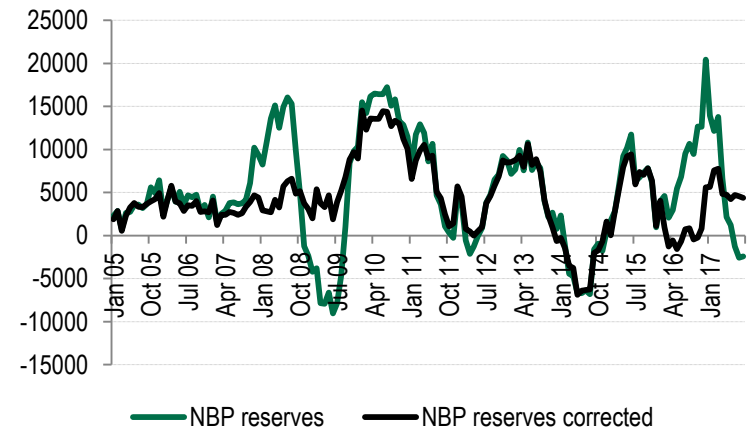


- Last quarters saw a big drop in 12-month rolling net foreign direct investment in Poland: to zero from average €9.0bn in 2015-16.
- Financing account data sheds some light on this: 1) foreign direct investment into Poland fell from €14bn on average in 2015-16 to €7.2bn in September 2017 (12M Rolling avg). However, this number was undermined by the Pekao SA transaction. If we correct for this deal (€2.5bn in June 2017), FDIs look much better (€9.7bn in September 2017). There is some slowdown in FDI inflow to Poland, but has not come to a sudden stop – we witnessed a stronger slowdown in 2012-14; 2) There was a rebalancing between the Polish foreign portfolio and direct investment abroad in December 2016: the former position declined by €3.3bn, while the latter climbed by €6.0bn.
- **If we correct for one-off moves in investment data, net FDIs would not differ much from the levels of recent years.**
- The financing account also saw a decline in the NBP reserve assets after a strong rise in 2016. In 2016, the Central bank was pursuing an investment strategy of closing EUR, GBP and USD reverse repo and repo transactions. This secured a hefty NBP gain in 2016 but also caused a temporary swelling of the NBP's balance sheet. If we correct for this move, we see that official reserves did not actually fall.

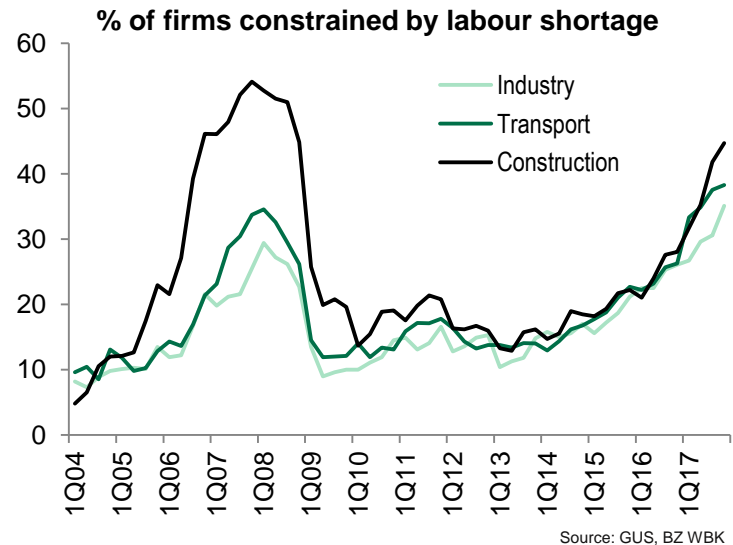
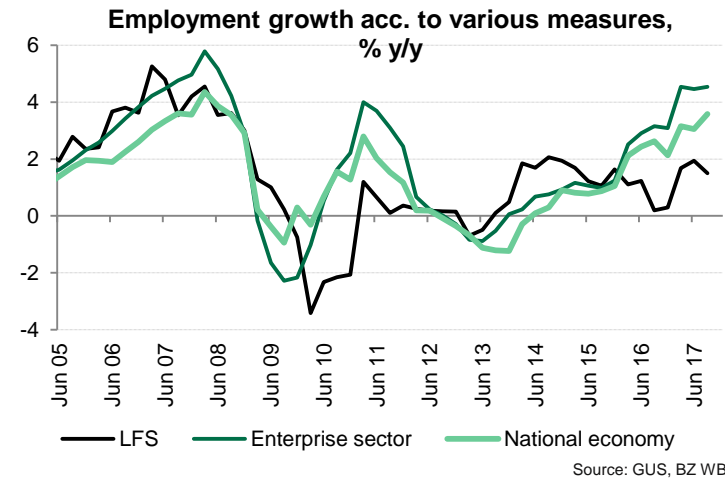
FDI and portfolio investment, PLNmn



NBP reserves, 12M rolling flow, PLNmn

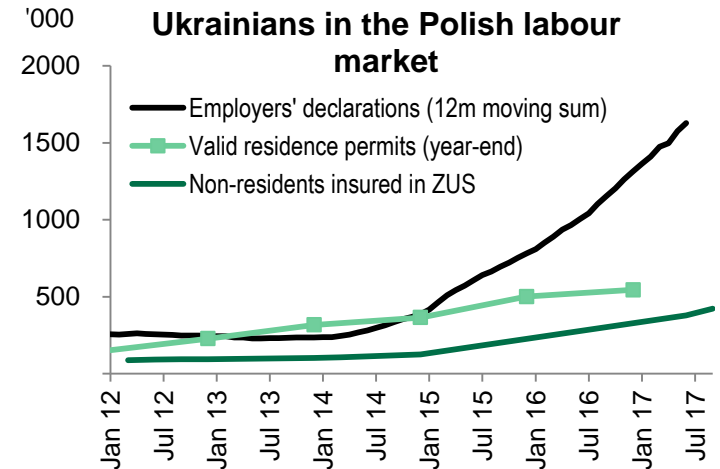


- The Polish labour market is booming, as fast GDP growth is triggering high demand for labour. According to the Labour Force Survey, the number of employed rose to a record-high 16.5mn in 3Q17. In fact, the official data most likely underrepresent the true demand as they do not capture most of the jobs taken by immigrants (mainly from Ukraine). Short-term immigrants are not covered by the LFS survey by definition; moreover, most of them work on civil contracts, some illegally.
- Companies are still planning to create new jobs, which seems natural given the continuing strong demand and the very high level of capacity utilisation (already near, or at, levels observed in the peak cycle in 2007-08, depending on the survey and sector).
- At the same time, there is growing evidence that firms face mounting difficulties in finding new workers. Recruitment problems affect virtually all areas and have become the main obstacle to business development in recent months, according to many surveys.
- Interestingly, despite complaints about growing labour shortages, the pace of employment growth stayed strong throughout 2017, suggesting that the labour market reserves have not been fully depleted yet.
- **We expect employment growth to continue in 2018, although at a slower pace. Mobilising additional workforce will become increasingly difficult and may require bigger wage hikes.**

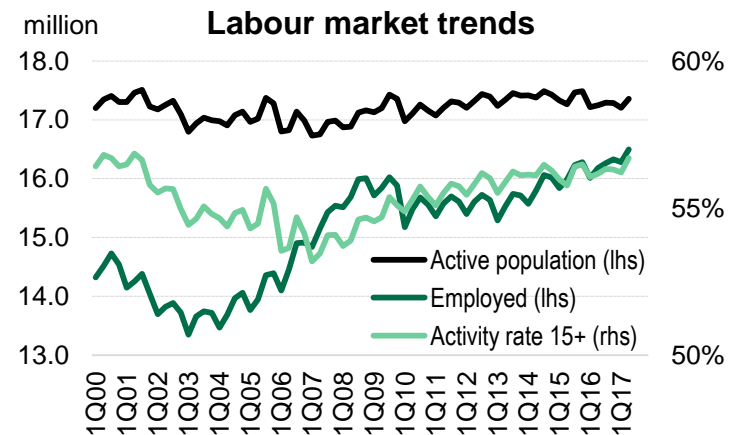


Labour market – Immigration and rising labour participation still create some breathing space

- The inflow of workers from Ukraine has eased the labour market tensions markedly. There are no good data to capture this flow in real time, but the companies' declarations about hiring non-residents, or the number of Ukrainians registered in the Polish social security system, suggest no significant slowdown of work migration from Ukraine in 2017. Apparently, the EU's introduction of visa-free movement for Ukrainian citizens in mid-2017 has not had disruptive consequences yet.
- According to a recent survey*, 68% of Ukrainians aged 18-35 plan to seek work abroad, Poland is the second most popular destination for migration (26% of respondents), behind just Germany (37%).
- At the same time, there is mounting anecdotal evidence that Ukrainian workers' wage expectations are quickly converging with their Polish peers, so this workforce may cease to be a cheaper option for Polish companies.
- Another positive feature of the last few years is the growing labour participation, which has effectively lifted the labour supply in Poland, despite an ageing population (while the population aged 15-64 dropped by 727k in the last two years, the number of active people in the same age group rose by 21k). The lower retirement age implemented in October may halt this positive trend, at least for a while, but we expect labour participation to keep rising in the medium run, as higher wages will incentivise staying in the labour market for longer.



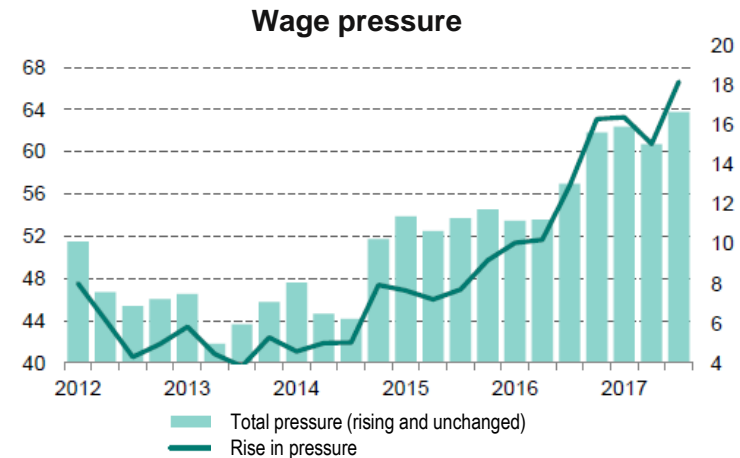
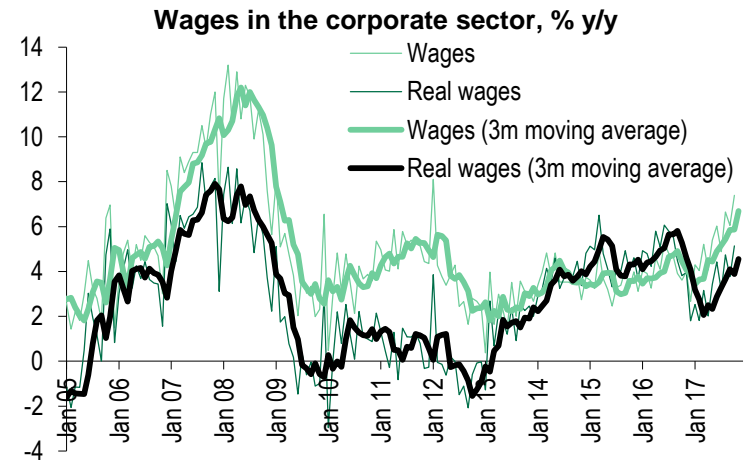
Source: Labour Ministry, ZUS, BZ WBK



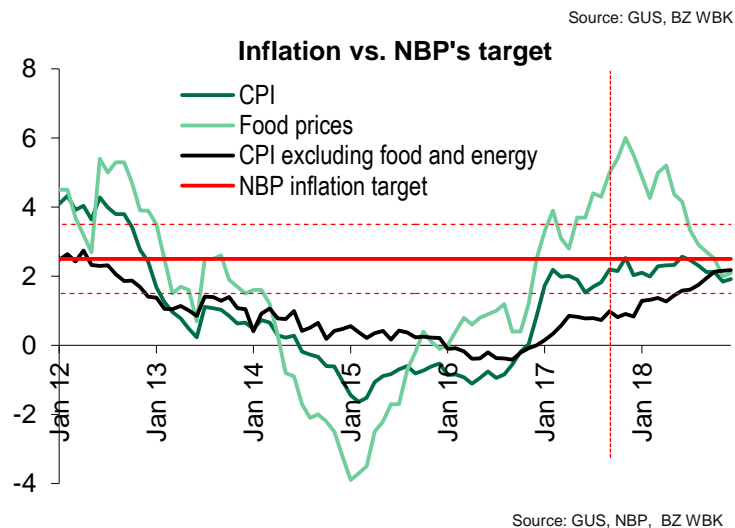
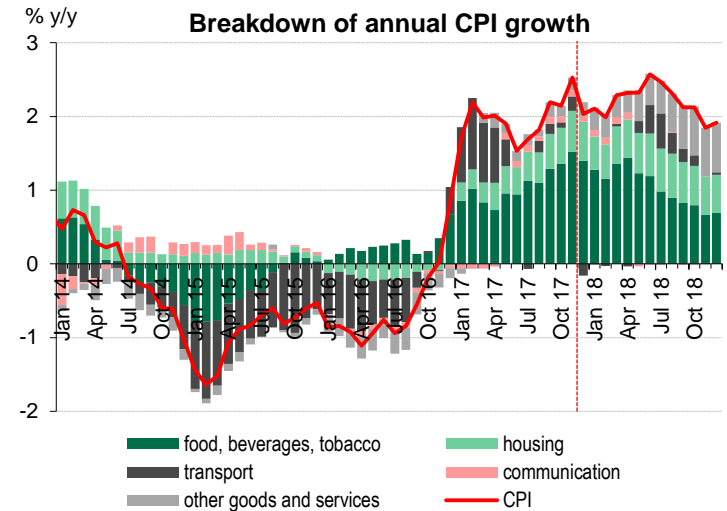
Source: Eurostat, BZ WBK

* Survey by Sociological Group "Rating" made in September 2017

- Despite labour shortages building for quite some time, average wage growth in Poland has been very stable until recently. In fact, real wages even decelerated sharply at the start of 2017, eroded by a surprisingly strong rebound in inflation. However, **recent months have seen a significant upward move in salaries: October average wages rose by almost 8% y/y in manufacturing, by 8.5% y/y in construction and by almost 10% y/y in the retail trade. We see a number of arguments in favour of this trend continuing.**
- First of all, business surveys confirm rising wage pressures, with firms planning to speed up wage hikes.
- The increase in observed inflation (driven by food and energy prices) and inflation expectations is likely to add to this pressure, with the memory of deflation in previous years fading.
- Moreover, the retirement age cut in October is likely to leave a labour market gap that needs to be filled relatively quickly. According to ZUS, almost all eligible citizens (>400k) have already applied for the new earlier retirement. Even if the majority decide to return to work after getting the pension benefit, this is still likely to prevent a rise in labour participation, at least for a while. There is still room for further growth, but those inactive for a long time will need a sufficiently strong incentive to rejoin the labour market, probably in the form of higher wages.

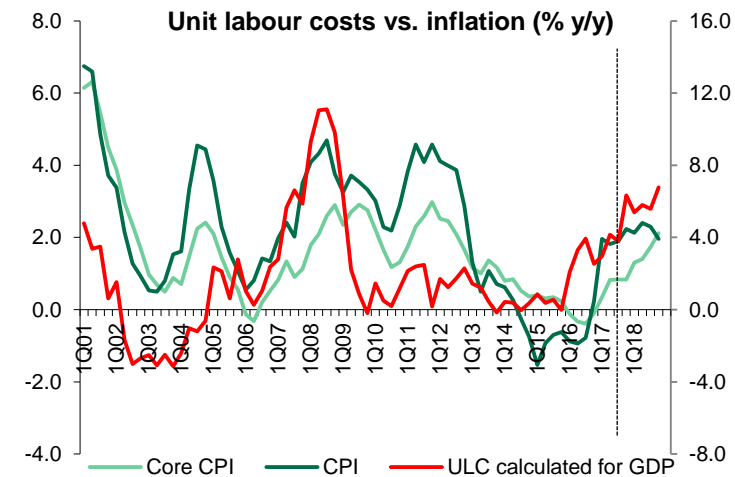
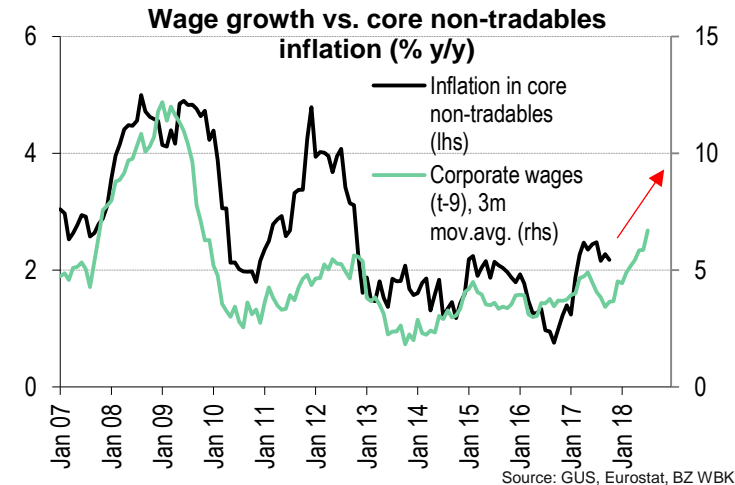


- CPI inflation touched the 2.5% official target in November 2017, which would have been impossible without a boost from food, fuel and energy.
- While food inflation will most likely remain the biggest contributor to CPI inflation in 2018, we expect it to decelerate in the coming quarters, amid global food commodity prices gradually descending from the recent peak and the PLN strengthening slightly in y/y terms.
- We also see limited potential for a further sustained rise in crude oil prices. But, even a scenario with Brent retreating towards \$60 p/b in 2018 would imply a temporary positive shock to domestic inflation from fuel prices because of the low base effect in this component in mid-2017.
- Growth in energy prices should, in our view, stabilise near 2.5% y/y for the best part of the year and ease at year-end. We would not rule out small hikes in electricity and gas tariffs in 1H18, in a lagged response to more expensive coal and oil.
- To sum up, the non-core components of inflation should stop fuelling CPI growth in 2018. At the same time, we think core inflation will accelerate, driven by building wage and cost pressures (see next page). As a result, **we expect CPI growth to drop to around 2% y/y in December 2017 and early 2018, before starting to climb again, and exceeding the 2.5% target mid-year. High base effect should push inflation lower again, towards 2% at the end of 2018.**

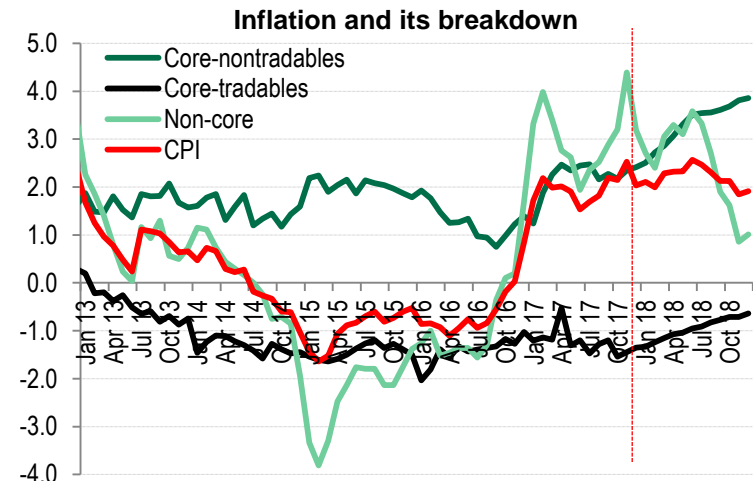


Inflation – Pass-through from higher labour costs about to start

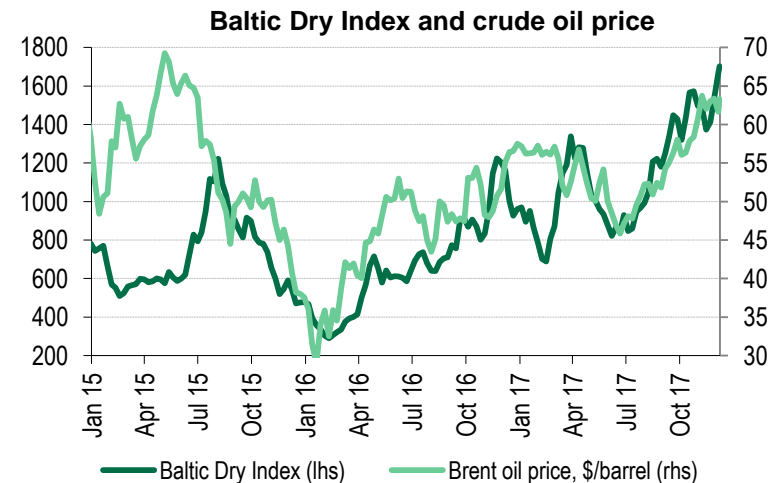
- We think that quick growth in salary costs will start pushing core inflation higher next year. Naturally, services (or, more broadly, the non-tradable core inflation components) prices will be affected the most, as the share of labour costs is relatively high there and exposure to international competition limited.
- Our answer to the frequent question "why haven't we seen this impact yet?" is simply that the pass-through usually comes with a lag of at least 3 quarters (see chart on the right). So, we still have to wait a little longer, as wage growth only started accelerating sharply in 2H17.
- **Our forecast of average corporate wage growth accelerating to around 10% y/y in 2018 seems consistent with non-tradable core inflation picking up to above 4% y/y in a few quarters.**
- Note that unit labour costs already started to pick up in 2016, even before the wage acceleration (amid slowing output), which partly explains core inflation rising to almost 1% y/y at the start of 2017. Now, the surge in labour costs is set to fuel ULC dynamics further, strengthening pressure on companies to start lifting prices, and supporting our forecast of core inflation trending higher in the coming quarters.



- The tradable components of core inflation have consistently been in negative territory since 2013, being curbed by international competition, the zloty appreciation (10% y/y vs. a basket of trading partners' currencies since January) and a still-benign global inflation environment. This component of core inflation is likely to remain low next year. However, we expect the downward external pressure on Polish inflation to ease gradually and to be weaker than over the last three years.
- The revival of international trade pushed up transport and logistics costs (Baltic Dry Index up almost 200% since mid-2016), commodity prices are higher and production costs in China have risen consistently throughout 2017. Therefore, we would not be surprised to see the deflation in the tradable core components easing gradually.
- **Overall, we expect to see a gradual upward trend in core inflation (CPI ex prices of food and energy) in 2018, to slightly above 2% y/y at year-end.**
- When it comes to the non-core elements, we are rather conservative on food prices, assuming a path of m/m inflation with only a marginal upward correction for supply disruptions in 1H18. As for energy commodities, we used a slightly higher path of Brent oil than the current Bloomberg consensus, which could mean some asymmetric risks to our CPI forecast.

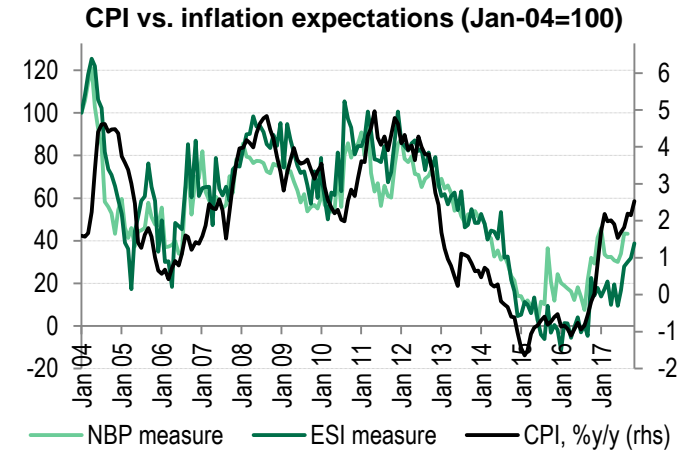


Source: GUS, Eurostat, BZ WBK

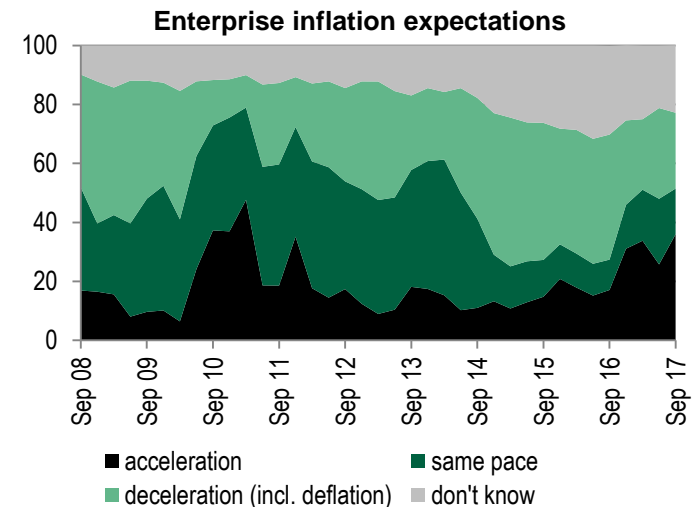


Source: Bloomberg, BZ WBK

- For some months now, the minutes to the MPC meetings have included references to inflation expectations, as one of the areas to which hawkish members would want to turn the Council's attention. **A rise in expectations has been noted, but we doubt this is a reason for alarm.**
- NBP measures of consumer inflation expectations, as well as the European Commission's ESI survey, suggest a slow adjustment to the rise in CPI since 2H16. They do not evidence inflation fears that would make people magnify the observed price changes.
- ESI details confirm that more than two years of deflation have generally lowered households' concerns over a persistent rebound in inflation. We compared the survey results in two periods when CPI moved from almost zero to the 2.5% target relatively quickly: 1Q06-1Q07 (with fresh experience of a post-EU accession CPI spike) and 4Q16-4Q17 (coming after prolonged deflation). We found that, now, **despite a quicker-than-expected rise of inflation this year, c40% of respondents still believe that prices will increase at a slower pace going forward.** Back in March 2007, the percentage was less than 30%.
- Enterprises are more worried that the share of businesses assuming inflation will pick up pace within the next 12M, with it already close to 2011 levels, when CPI accelerated past 4% y/y.



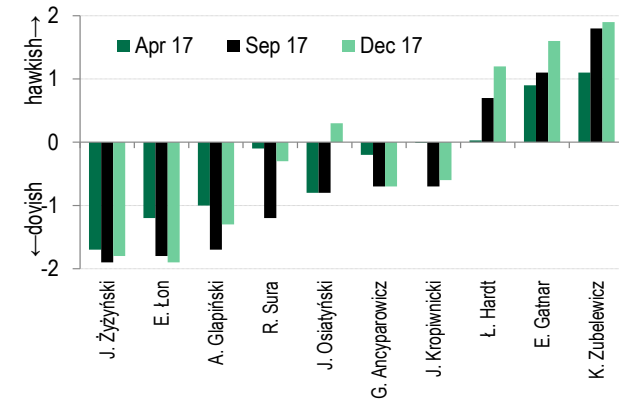
Source: GUS, NBP, European Commission, BZ WBK



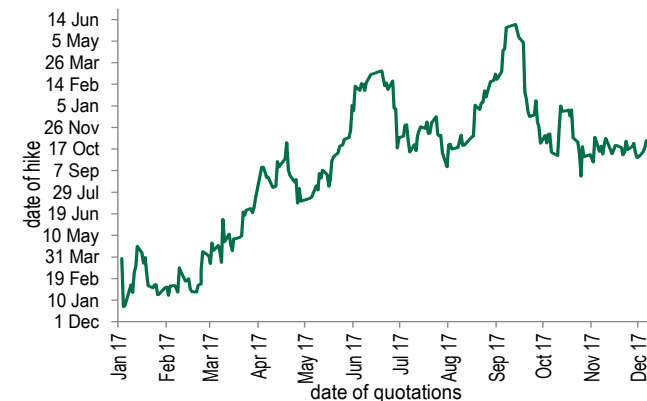
Source: NBP, BZ WBK

- As we projected in the last year's Outlook, the MPC kept the main interest rates unchanged in Poland throughout 2017. The Central bank's slight tweak to its mandatory reserve policy –the reserve requirement ratio for long-term deposits (>2Y) was reduced from 3.5% to zero (effective March 2018), and the interest on the mandatory reserve was cut from 1.35% to 0.5% (effective January 2018)– was a technical move, aimed at promoting long-term deposits.
- The NBP remains in 'wait-and-see' mode and Governor Adam Glapiński strongly believes that no change in monetary policy is needed until the end of 2018.
- Glapiński still firmly controls the majority on the Council, but we note that last year saw some MPC members' views gradually shift towards a more hawkish bias. The chart on the right shows how the assessment of individual MPC members by sell-side analysts has changed over the year, while the table overleaf showing the evolution of MPC members' comments.
- The most hawkish MPC members have already signalled that they see reasons for policy tightening and we would not rule out a motion to hike rates being tabled in early 2018. However, the majority is still on the dovish side and we think that much stronger arguments are needed to significantly change the balance of votes. Therefore, **we still expect Poland's main interest rates to remain unchanged until the final quarter of 2018.**
- Market pricing for the first rate hike is currently fairly in line with our scenario.

MPC members' bias - results of PAP surveys among economists



FRA-implied timing of the 1st 25bp hike by the Polish MPC



Monetary policy – MPC members' heat map

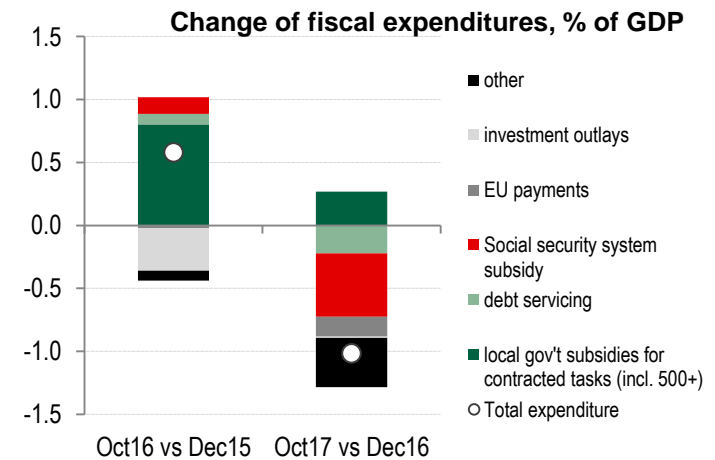
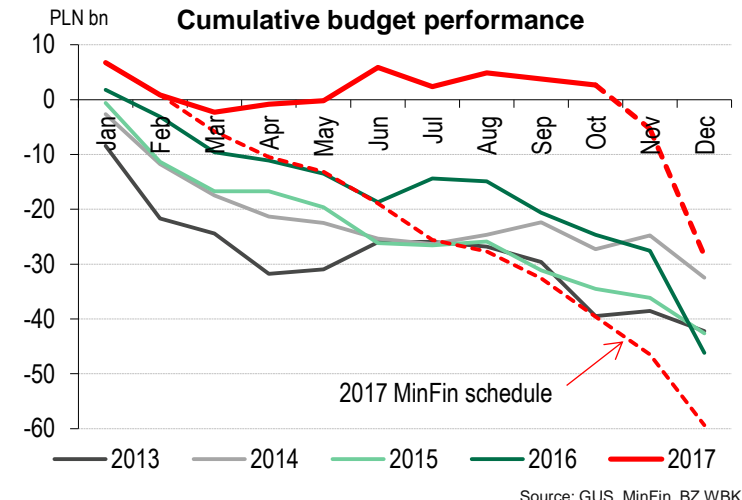


Łon	Żyżyński	Glapiński	Sura	Osiatyński	Ancyparowicz	Kropiwnicki	Hardt	Gatnar	Zubelewicz
<p>It is very important to stick to the expansive monetary policy. If there is a need to cut rates, I will not hesitate (27.01)</p> <p>In general I think that the still low growth rate of investment justifies keeping rates unchanged for a longer time, at least 12 months. This is the optimal policy. Moreover, let me note that core inflation is relatively low, postponing the monetary policy tightening (28.02)</p> <p>There will be no need to hike rates in the upcoming 12 months (16.03)</p> <p>There is no need to change interest rates (10.07)</p> <p>A need to loosen the monetary policy may arise in the coming months. I am considering more and more intensively a 50bp cut (11.09)</p>	<p>We are not expecting CPI to surpass 2.5%. If it does, we may consider hikes (13.02)</p> <p>In my view then, interest rates should stay unchanged until the end of 2018, or longer (14.09)</p>	<p>If economic growth accelerates and triggers price growth, then it will be the time for rate hikes... possibly in 2018, but only in a positive scenario (11.01)</p> <p>The MPC can consider rate hikes only in 2018. But rates can also stay unchanged if the economy does not gain steam in 2017 (25.01.)</p> <p>If current tendencies hold, then rates will remain unchanged until the year-end. There will be no reasons to hike rates – maybe even until the end of 2018 – but this is a distant future (8.03)</p> <p>All available information suggests that rates will stay flat until the end of 2017. (...) In my view, there will be no reason for hike rates in 2018 as well. (5.04)</p> <p>In my view there could be no need for a rate hike even until the end of 2018 (17.05)</p> <p>There are no reasons to discuss changes in interest rates. (6.09)</p> <p>I expect that by the end of 2018 interest rates will stay at the current level if reality is close to projection (5.12)</p>	<p>I do not view interest rate hike necessary in the upcoming quarters (21.02)</p> <p>If CPI stays below 2%, there will be no reason for hike in 2017 or in 1Q18 (11.04)</p> <p>In my view, wage growth will be slowing down. I see no reasons to change our policy (4.10)</p> <p>I would be for beginning the discussion about tightening in mid-2018 if I see further acceleration of inflation after 2019 (13.11)</p>	<p>Overreacting to that data comes in the form of pressure on policy makers, who are urged to (...) raising rates (31.03)</p> <p>I am concerned about the wage pressure. Should wage pressure persist (...), maybe we will have to consider rate hike (...) sooner than in 4Q (20.10)</p> <p>I don't share the confidence of many that Poland may safely navigate with the same (...) interest rate level throughout 2018 (20.11)</p>	<p>There are no reasons to change monetary policy parameters in the months to come. (16.01)</p> <p>Risk, of surpassing 2.5% is small, but if the upward trend holds, we will need some slight corrections of rates, before inflation reaches 3.5% (15.02)</p> <p>Provided there are no extraordinary events, change in monetary policy bias can be considered no earlier than after the July projection (14.03)</p> <p>Forecasts are optimistic and this means a lack of reasons to change the stance in monetary policy at least until the end of this year, and perhaps longer (7.08)</p> <p>Should wages grow stronger than we expect – and there are some external shocks – we should discuss behaviour of inflation in mid-2018 (4.10)</p> <p>The governor may be right in assuming a pause on rates until end-2018. We must not raise the cost of money in the face of such sluggish investment (15.11)</p>	<p>If upward inflation trend holds, then I would consider also data on GDP and unemployment when deciding on rates (13.02)</p> <p>I see no possibility to change monetary policy in 2017 (23.03)</p> <p>We do not see reasons to push for a rate hike (20.06)</p> <p>As long as there is no wage-price spiral in the economy, there are no reasons to worry (6.09)</p> <p>That [rising food prices and wages] may trigger an inflationary spiral. Interest rates should stay unchanged in 1H18 (20.10)</p> <p>I believe rates should remain where they are now. At least for the coming year (16.11)</p>	<p>Any change in monetary policy would be bad for the economic stability (16.01)</p> <p>No rate changes until end of the year is the most probable scenario (13.02)</p> <p>It will be difficult for me to tolerate negative real interest rate if it extends after 2018 (7.06)</p> <p>If the next projections show real rates remaining negative throughout 2018, attempts to tighten policy will be taken even at the beginning of next year (10.07)</p> <p>One cannot exclude that tensions on the labour market supply side (...) will lead to higher inflation. Then a reaction may be needed at the start of 2018 (9.10)</p>	<p>In baseline scenario, we will be stabilizing rates throughout 2017. (25.01)</p> <p>Negative interest rates would be an argument to hike rates in 2017 (13.03)/ Rate hikes in 2017 cannot be ruled out (22.03)</p> <p>If adverse effect of negative real interest rates becomes more visible, it would be an argument for considering hikes even at the end of 2017 (12.07)</p> <p>If wage pressures rise (...) and inflation comes near the target then I would expect interest rates to be raised in 1Q18 (21.09)</p> <p>I have in mind a normalization of monetary policy, which means an increase by 25 basis points (25.10)</p> <p>Polish CPI may reach target in 1Q 2018 and it will be the right moment to raise rates by 25bps (16.11)</p>	<p>Possibility of a hike this year cannot be ruled out (13.02)</p> <p>We should implement a cautious hike this year and the earlier it will be, the better. (17.07)</p> <p>Rates should be increased gently now, as the economic situation is favourable (29.08)</p>

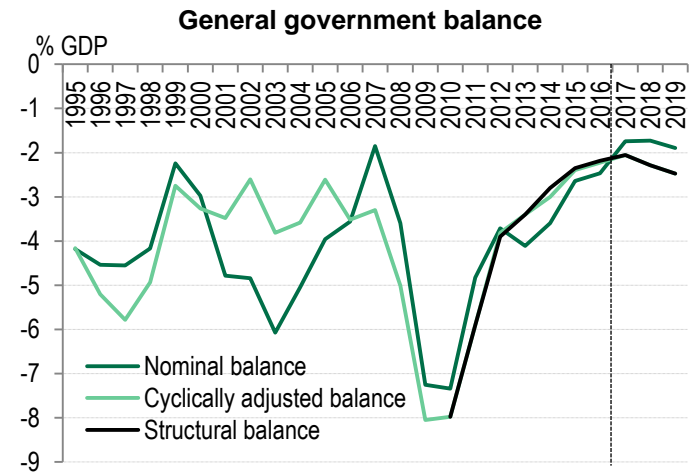
Type of remark:

dovish neutral hawkish

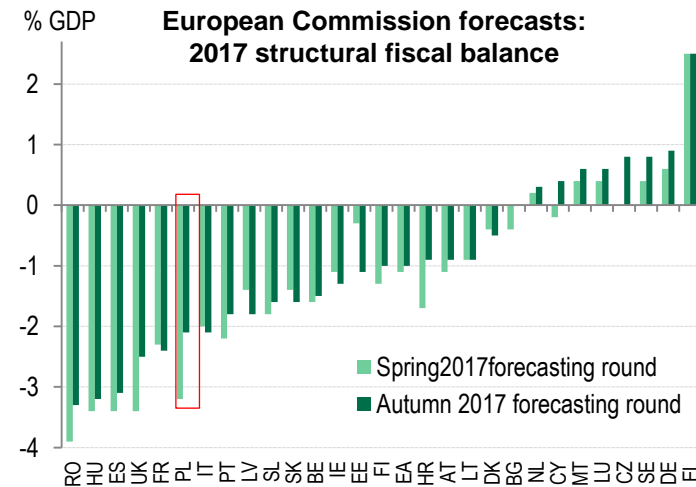
- 2017 so far has witnessed an exceptional budget performance, with the first-ever surplus still after October. The last two months of the year, however, were probably under the spell of massive fiscal spending and the full-year result could be around PLN30bn vs. the planned PLN59.3bn, but, ultimately, that is in the hands of politicians. Some of this deterioration (cPLN15bn) is warranted by the seasonal pattern, some comes from the budget amendment boosting expenditures by cPLN9-11bn. The Ministry of Finance may also advance cPLN5bn of VAT returns, so that they are paid out in FY2017 instead of FY2018. Such a move in late 2016 secured a very positive fiscal start to 2017.
- The fiscal success of 2017 was built on stronger-than-expected economic activity, efforts to improve VAT compliance (PLN11-14bn), transfer of the large NBP profit and advance payment of 1Q VAT returns in late 2016.
- While the higher total spending-to-GDP ratio in 2016 was caused almost entirely by the introduction of the 500+ child benefit programme, the ratio's decrease in 2017 was based on cyclical items like social security system subsidy, debt service costs (lowered by FX appreciation) plus the effect of a smaller contribution to the EU budget due to its less-than-full utilization in 2016.
- In case of worse economic conditions, the listed items would push up the overall spending-to-GDP ratio, while the 500+ programme seems set to continue.



- In the autumn round of forecasts the European Commission decreased this and next year's general government deficit in Poland from 2.9% GDP to 1.7%, while 2019 was shown at 1.9%. It was the largest positive change recorded among all the 33 countries for which the Commission showed forecasts, for both 2017 and 2018 fiscal balance. The structural deficit forecast was lowered greatly and it is now expected by the EC at 2.1% GDP for this year, 2.3% in 2018 and 2.5% in 2019 (the previous forecasts were 3.2% for 2017 and 3.1% for 2018). This means that the structural measure is to remain close to the average from the last three years (2.2% for 2016, 2.3% for 2015, 2.8% for 2014), which seems a surprisingly good result given the new expenditures linked to government actions like the 500+ programme and the lowering of the retirement age. It seems the EC has become convinced that government efforts to improve tax compliance were successful and should be counted as a permanent improvement if the structural deficit is no longer shown rising quickly.
- Despite the large positive correction in general government forecasts, Poland still looks poor compared to the rest of EU (sixth highest structural deficit vs fifth highest in the previous round).



Source: AMECO, BZ WBK



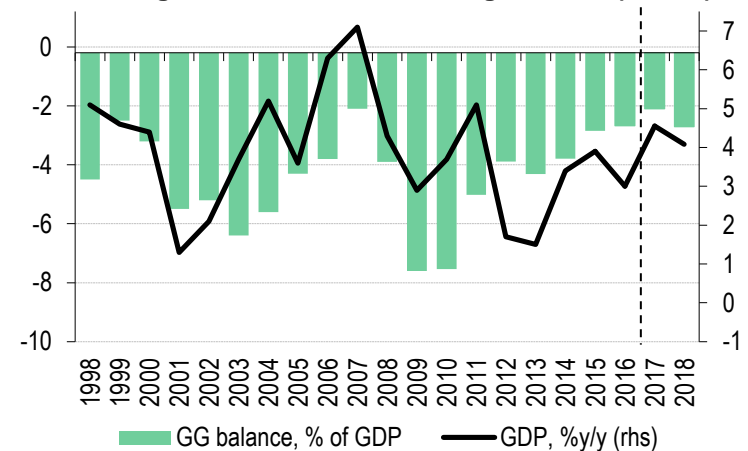
Source: European Commission, BZ WBK

- The 2018 Budget assumes a fiscal deficit of PLN41.5bn, based on macroeconomic assumptions that look conservative and relatively easy to meet. We are more optimistic about private consumption (we forecast 4.9% y/y growth, the budget assumption is 3.5%) and wages (8.9% y/y vs. 5.3%), which are items that could meaningfully increase budget revenues. Still, we are less confident about investments.
- The government expects additional gains of cPLN10bn in 2018 from greater tax compliance. The 2017 ratio of VAT returns to gross VAT revenues was already close to its historical low and, in our view, smaller VAT returns was the main source of extra money from tax collection (apart from the increase due to a higher tax base). So, some of the assumed revenues may prove hard to achieve. However, the high probability of positive surprises vs the underlying macroeconomic assumptions should make up for the less-certain improvement in tax compliance flows.
- Some government projects are already in the pipeline, like one-off transfers to retirees, which will be implemented if the early months of 2018 show a sound budget performance. This means next year's deficit is likely to be realised in full, while 2017's is expected to be around half of the planned value.
- In general government terms, we think the deficit is likely to drop to, or below, 2% of GDP in 2017 and could stay close to 2% of GDP in 2018.

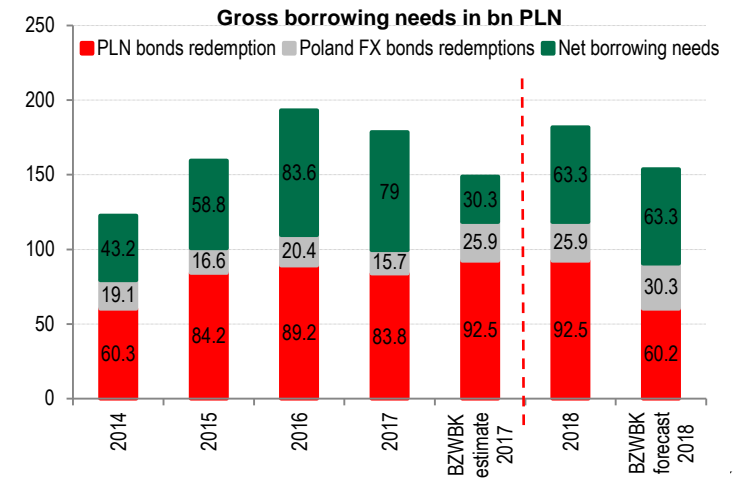
VAT refunds to gross VAT revenues



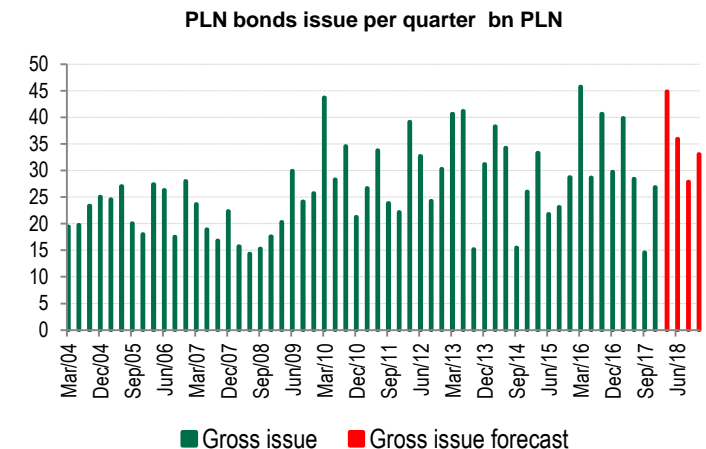
General government debt and budget deficit (%GDP)



- In line with the 2018 budget assumptions, net borrowing needs will amount to PLN63.3bn (with PLN57.9bn raised on the Polish market) while gross needs are planned to reach PLN181.7bn (vs PLN178.5bn initially planned for in the 2017 budget and the revised plan's PLN143.1bn). The Ministry of Finance said that by the end of November it had already covered 13.8% of 2018's gross borrowing needs (that is cPLN25bn). According to our estimates, at the end of this year, 2018's gross borrowing needs could be c20% covered.
- We think that in 2018, as in 2017, the ministry will have to issue less debt than planned in the budget bill. According to our estimates, **the total amount of new issuance on the Polish market will reach PLN140bn vs PLN120bn estimated for 2017**. We assume that in 2018 the ministry will repurchase bonds worth PLN20bn instead of the planned PLN40bn as a result of higher repurchases at the end of 2017 compared with when it was preparing the 2018 budget bill and a higher liquidity cushion. **We think the ministry will try to cover the majority of needs in 1H18, with total debt issuance reaching PLN45bn in 1Q18 alone.**
- The ministry does not plan to increase issuance of foreign-currency denominated bonds compared with previous years.

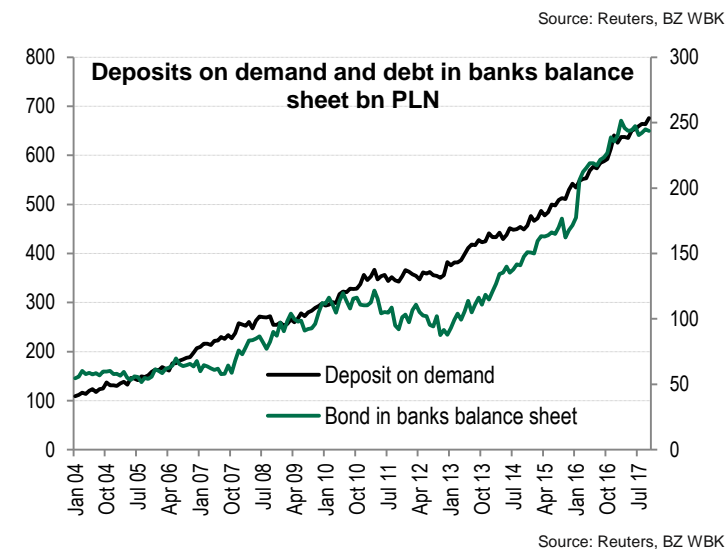
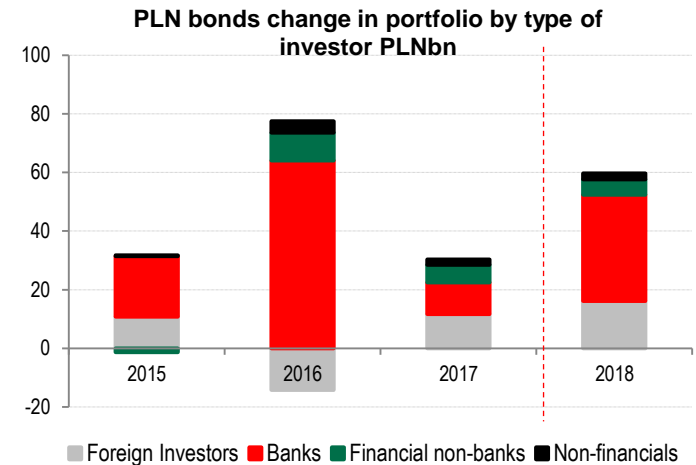


Source: Ministerstwo Finansów, BZ WBK



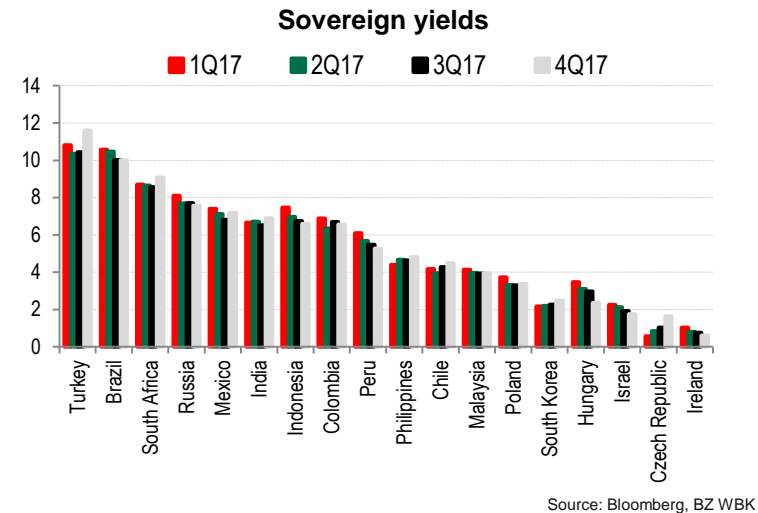
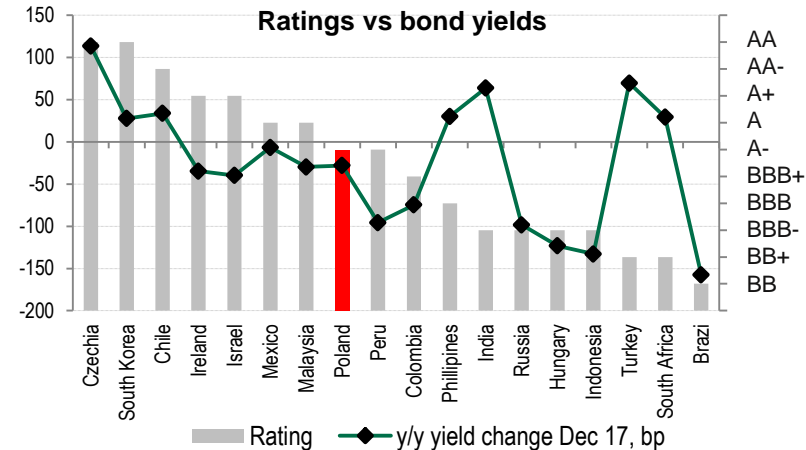
Source: Ministerstwo Finansów, BZ WBK

- We think that solid GDP growth, which is reflected in the robust labour market, will be favourable to an increase in money supply. Assuming the current share of sovereign bonds in short-term banking sector deposits remains stable (at 50%) and assuming money supply growth in 2018 is 8%-9% y/y, **the banking sector will be able to finance a maximum PLN45bn new debt** (of the total PLN57.9bn). We assume that the **banking sector will finance cPLN35bn debt**.
- As in previous years, we expect that low nominal and real interest rates will lead to a higher share of short-term deposits on the banking sector's balance sheet. That should generate additional demand for liquid assets (i.e. T-bonds). As usual, the demand for T-bonds will be supported by tax incentives that exempt them from asset taxes.
- With this scale of a contribution from the banking sector, we would expect international investors to finance cPLN15bn of debt, and other sectors PLN7bn. The relatively high yields of Polish bonds (compared with other CEE countries like the Czech Republic or Hungary) should encourage investors to buy Polish debt.

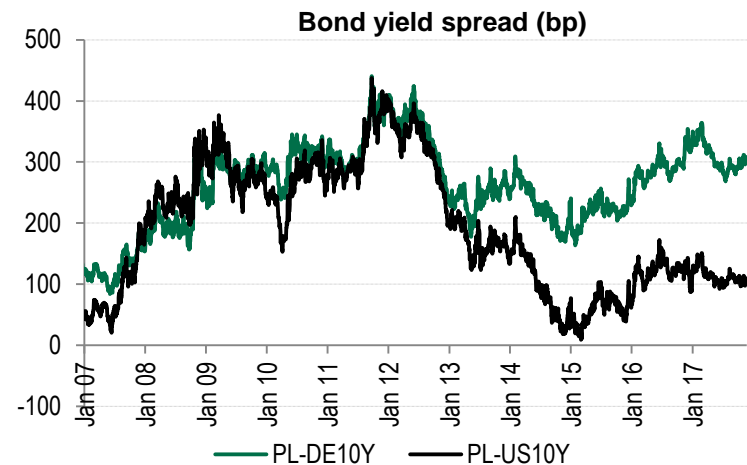


Source: Reuters, BZ WBK

- In 2017, Polish 10Y bond yields fell c30bp, in line with most countries with similar S&P credit ratings (A+, A, A-). (A comparable drop in the cost of financing was recorded for Peru, Malaysia, Chile and Israel, for example).
- The biggest declines in bond yields happened in Brazil, Indonesia and Russia. However, these countries have lower ratings (BBB or lower) and, a year or two ago, were perceived as teetering on the edge of a debt or political crisis. Among these countries, there is a pretty large group that suffered significant yield jumps of c100bp, like Turkey or South Africa.
- It is worth noting that the cost of financing for developed countries with an A or higher rating (the Czech Republic or South Korea) rose at a similar scale to those with BBB or lower.



- If we assume Polish CPI rises to around the inflation target in 1H18 and GDP growth remains high, this should support the market pricing in a rate hike in the first part of 2018. **As a result, we expect 2Y yields to rise gradually to c2.0%** until mid-2018 and stay there later in the year, with rising core CPI. Additional pressure on the front end could be generated by a higher supply of short-term bonds at the auctions, which we think is likely.
- **In the case of the long end, we anticipate a somewhat stronger upside move of c40-50bp.** The ECB adjusted the size of its asset purchase program for the planned rise of public debt in 2018 and cut its monthly bond buying. This should keep short-term yields low in the Euro zone and excess liquidity high. As a result, we think that investors will use any upward move in yields to purchase bonds.
- Furthermore, we think that economic activity indexes in Europe and the US are now at their peak and the next year could see some downward correction, which should ease any upward pressure on yields.

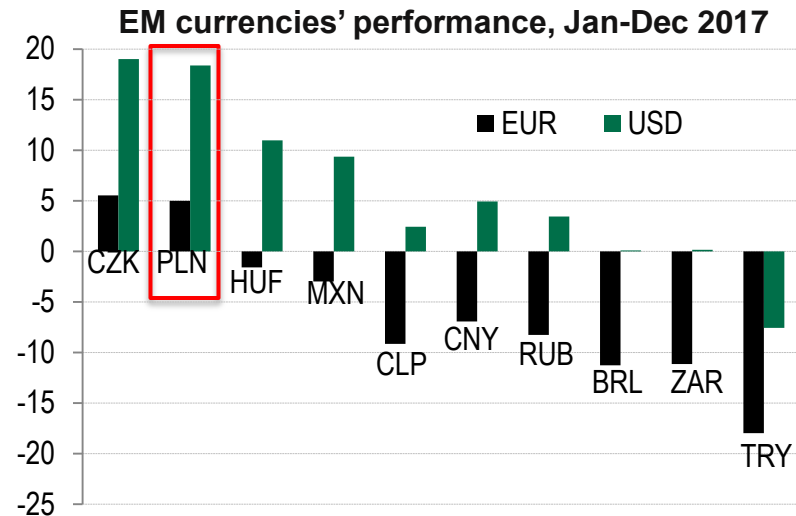
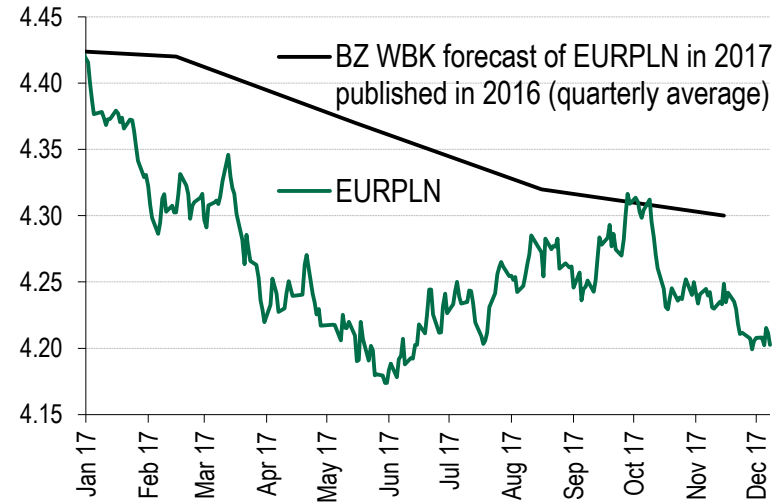


Source: Bloomberg, BZ WBK

	Yields and IRS rates			
	1Q17	2Q17	3Q17	4Q17
Bonds				
2Y	1.70	1.90	2.04	2.04
5Y	2.71	2.84	2.91	3.08
10Y	3.28	3.44	3.64	3.70
IRS				
2Y	2.02	2.24	2.42	2.39
5Y	2.51	2.66	2.79	2.98
10Y	2.93	3.17	3.41	3.50

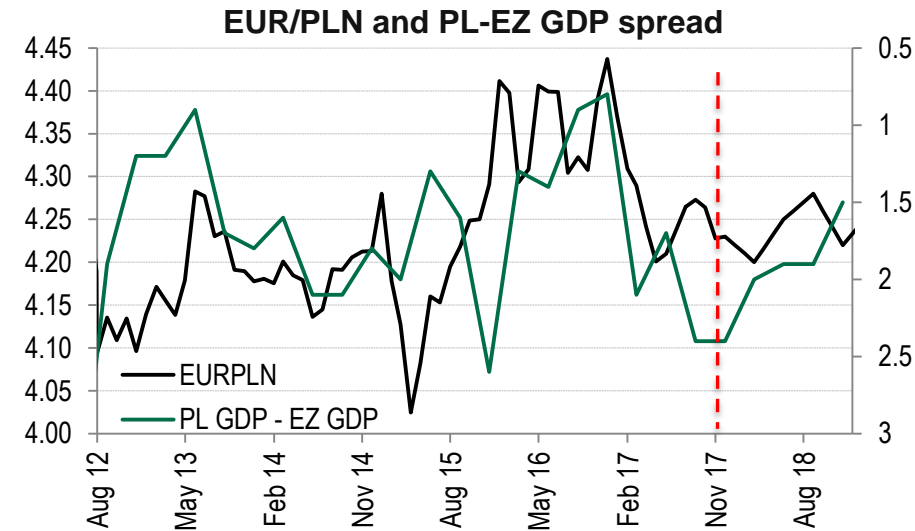
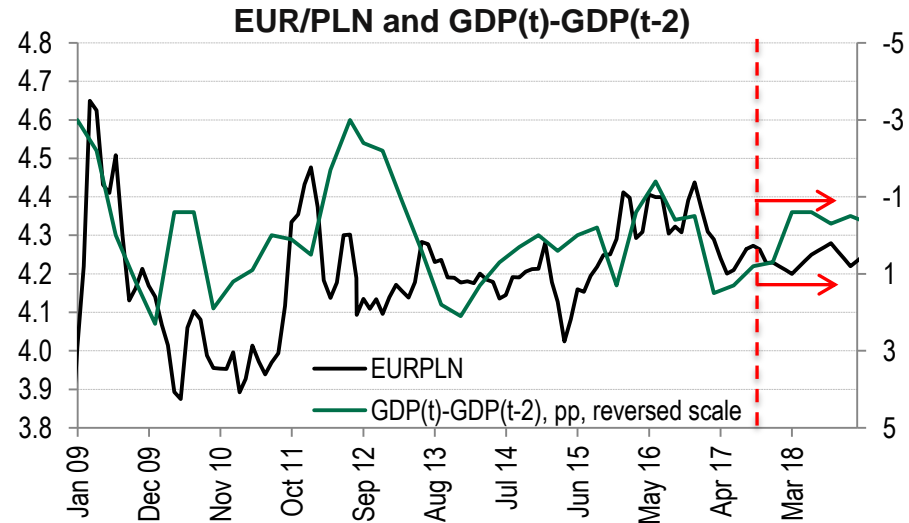
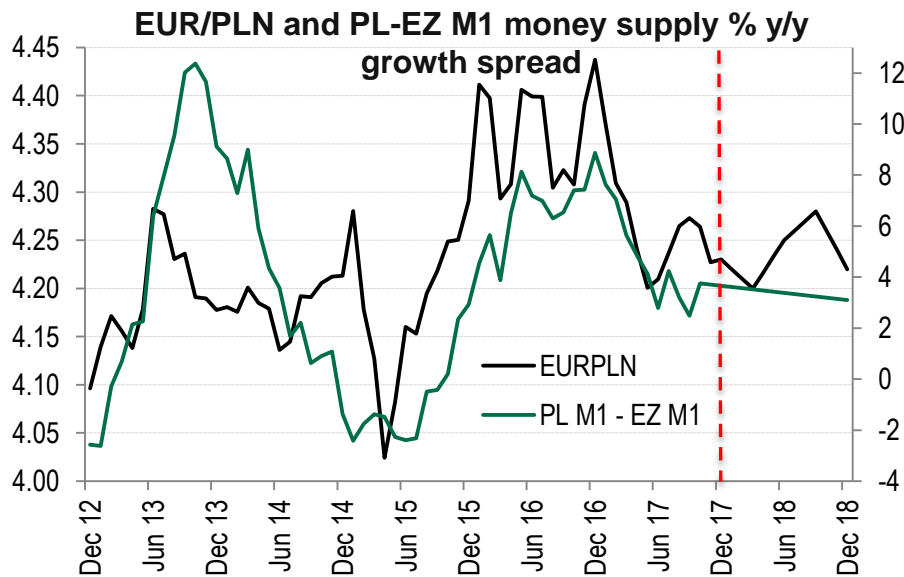
Source : Bloomberg, BZ WBK

- In our 2017 Outlook released in late 2016, we said we expected a gradual zloty appreciation versus the euro, fuelled by an economic recovery. We also thought that Fed rate hikes would not weigh on the Polish currency.
- While our general assumptions proved correct, the scale of EUR/PLN decline was even bigger than we had expected, particularly in 1H17 when the market was pricing-in a revival of economic growth very aggressively.
- As well as the domestic economic cycle, the currency was also supported by a decline of geopolitical risks abroad (market-friendly results of elections in France and the Netherlands) and the fact that investors' worries about the Polish government's policies have eased significantly amid evidence they have had a very limited impact on the country's economic performance and fiscal position. Even the conflict with the European Commission about the rule of law and the threat to launch Article 7 of the EU Treaty had only a limited and temporary impact on the FX market, as the risk of material financial sanctions for Poland was assessed as low.



Source: Reuters, Bloomberg, BZ WBK

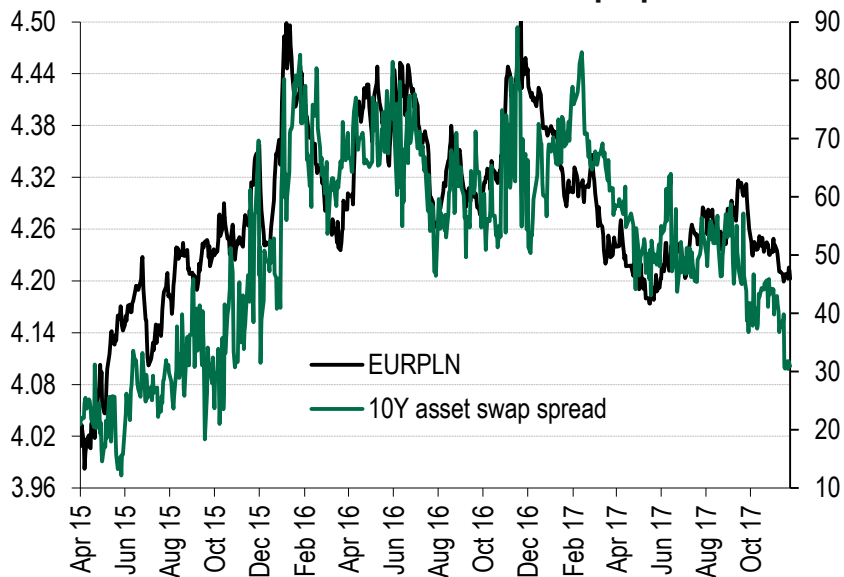
- It seems that the recent zloty appreciation has already priced-in faster economic growth. In 2018, we expect Polish GDP growth to remain decent at around 4%, which implies little scope for further currency appreciation. Also, the spread between Polish and Euro zone pace growth looks set to narrow versus previous years.
- Our forecast of EUR/PLN stabilisation is also supported by the predicted trend in narrow money growth in Poland and the Euro zone (see chart below).



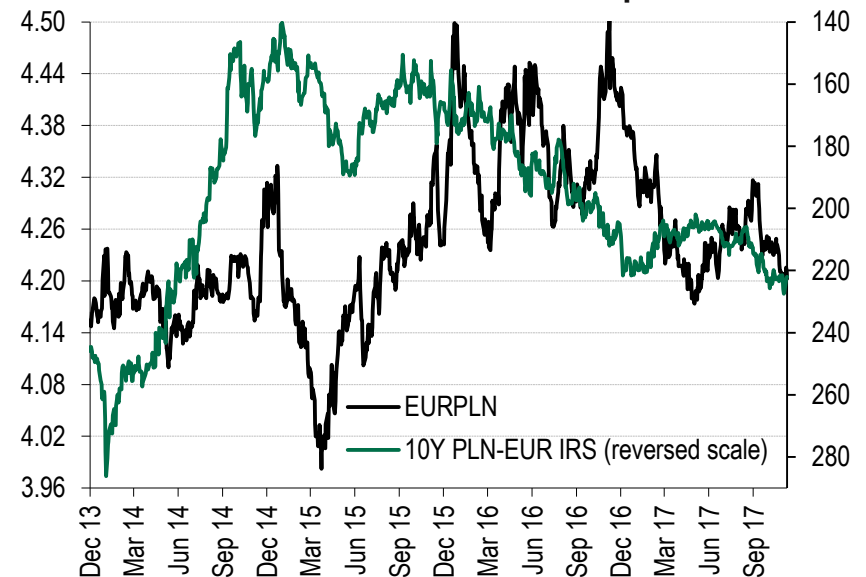
Source: Reuters, Bloomberg, BZ WBK

- Although there is unlikely to be a further acceleration of economic growth to fuel a zloty appreciation, we think that support for the Polish currency may come from a very good fiscal performance and expectations of an interest rate hike.
- As mentioned, this year Poland's budget performance is outstandingly good and this is reflected in falling credit risk measures (see the EUR/PLN and asset swap spread chart). An improved fiscal assessment could make Polish bonds attractive to non-residents, leading to demand for the zloty.
- Also, we think market expectations of an interest rate hike should rise after a further acceleration of wage growth and inflation topping the 2.5% target in mid-2018. While we still expect the MPC to deliver a 25bp rate hike in late 2018, growing market speculation about a possible earlier move should work in favour of the zloty.

EUR/PLN and 10Y asset swap spread



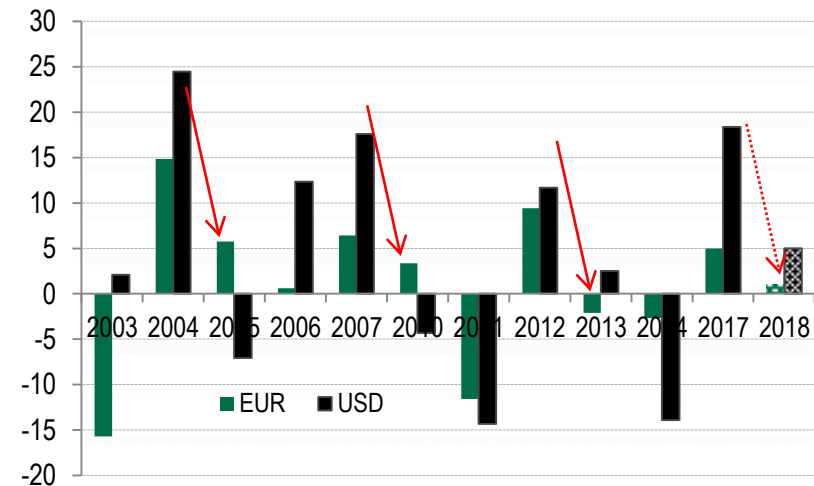
EUR/PLN and PL-EZ 10Y IRS spread



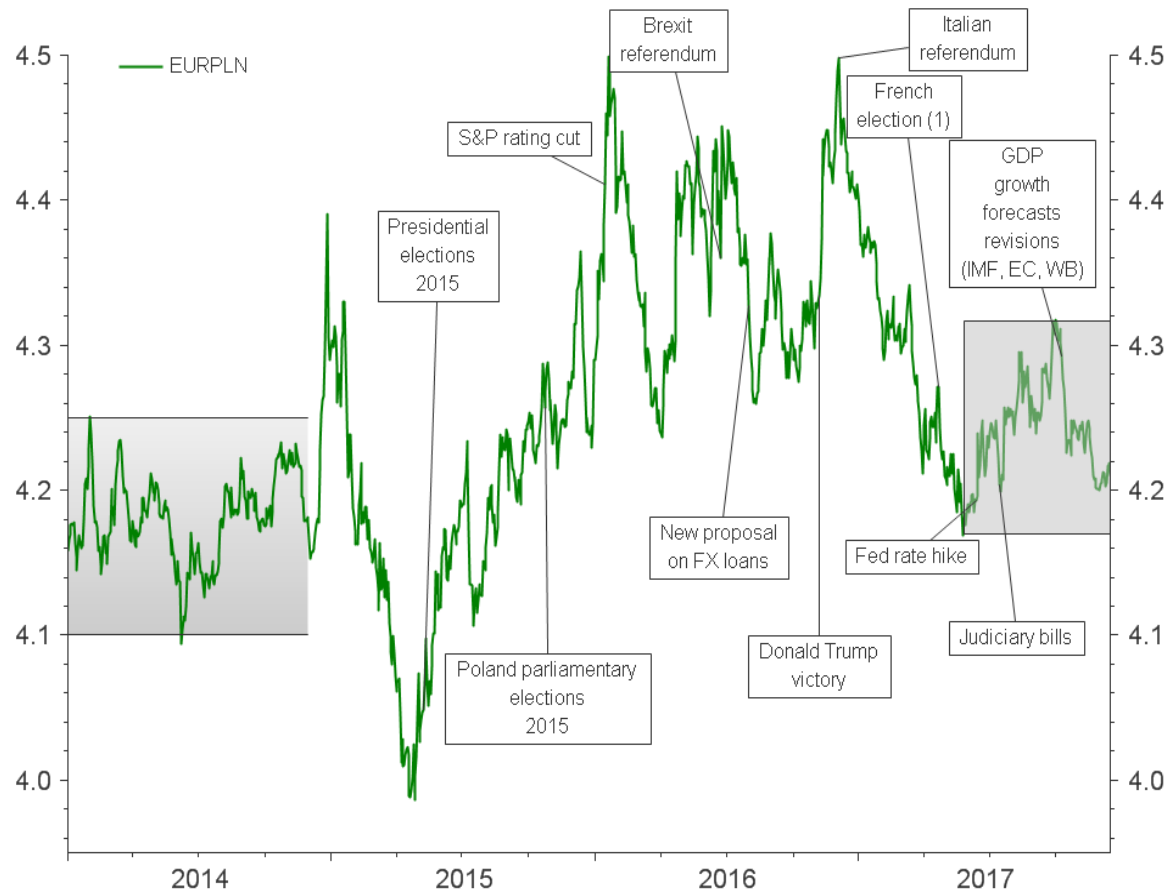
Source: Reuters, Bloomberg, BZ WBK

- We have analysed the average performance of 24 EM currencies in 2000-16, choosing two-year periods when the pace of GDP growth was above the rolling average and there was no significant slowdown during these two years in a bid to replicate the current situation, when 2017 was strong and growth is expected to continue at a similar pace in 2018. We found that a strong currency performance in a given year was almost always followed by a less impressive performance in the second year (with one exception – 2006-07).
- Looking at EUR/PLN and USD/PLN only, when the zloty gained in the first year, it never performed better in the second year, except for 2006-07 (when the global economy was booming and stocks were at record high levels) and 2003-04 (vs the dollar only, owing to a rising EUR/USD).
- Although next year we should see still solid economic growth in Poland, the pace of the GDP will not accelerate and so the zloty is unlikely to gain more than it probably will in 2017. It seems that only an interest rate hike in Poland could push EUR/PLN slightly lower vs the expected end-2017 level.
- In 2018 – when global economic growth is expected to keep up its the pace – investors may turn to currencies that have underperformed and look cheaper than the zloty.

EUR/PLN annual performance vs EUR and USD (%)



- After more than two years of high volatility, in the last few months EUR/PLN has become much more stable.
- It seems the market has already digested most of the risk factors, both as regards global situation (monetary policy normalization, US tax reforms, Brexit) and Polish internal politics.
- We think that the PLN exchange rate may stay in a relatively narrow corridor in the months to come, as it did in 2013-14.
- Also, when looking at implied volatilities, we see there is still room for EUR/PLN to stay relatively stable in the broader time horizon. For Oct 2003 – June 2007 (just before the US financial crisis broke out), EUR/PLN 25 delta risk reversal was trading at 1.25, on average. The average for Jan 2013 – Dec 2017 is 1.45, showing that an assumption that EUR/PLN will remain more stable than in previous years is reasonable.

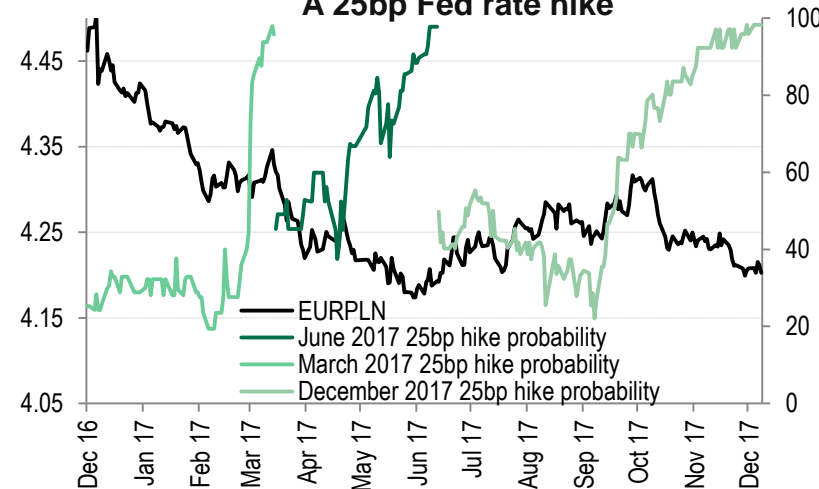


Source: Thomson Reuters Datastream

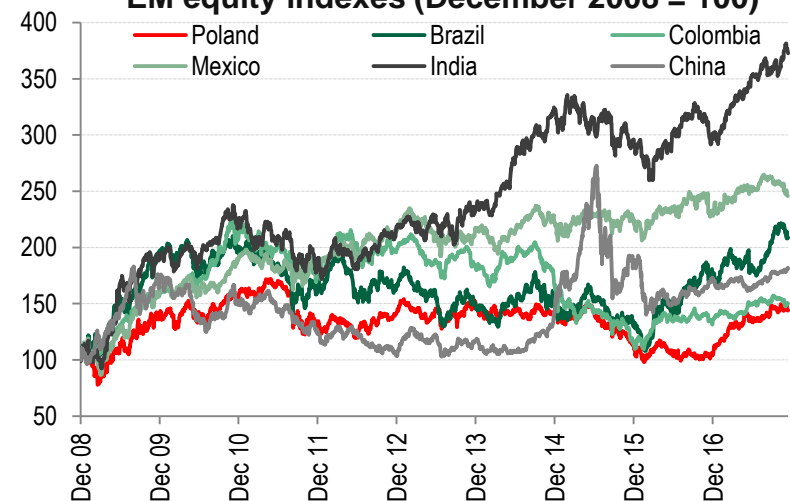
Source: Thomson Datastream, BZ WBK

- The FOMC is on track to deliver a third 25bp rate hike this year in December. We expect the pace of monetary policy normalization in the US to continue in 2018, with three more 25bp hikes announced in 2Q, 3Q and 4Q.
- The top chart shows how, according to Bloomberg, the market-priced probability of a 25bp rate increase was changing before each hike in 2017. We see that there is hardly any evidence that monetary policy normalization in the US (and market expectations of it) was the core driver for EUR/PLN this year. We observe some zloty depreciation versus the euro in the final weeks before a decision but these were only short-term swings.
- The lower chart shows the main national stock indexes' performance since the Fed started QE1 in late 2008, with Poland's WIG20 stock index obviously not benefiting from the injection of extra liquidity. Hence, the outlook for a gradual withdrawal of cheap cash should not trigger a significant capital outflow that would hit the zloty.

EUR/PLN and market implied probabilities of A 25bp Fed rate hike

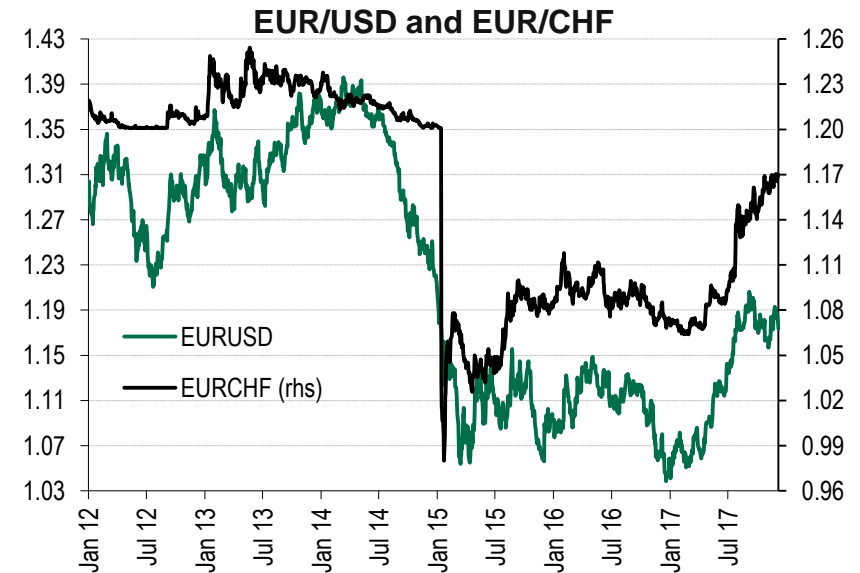
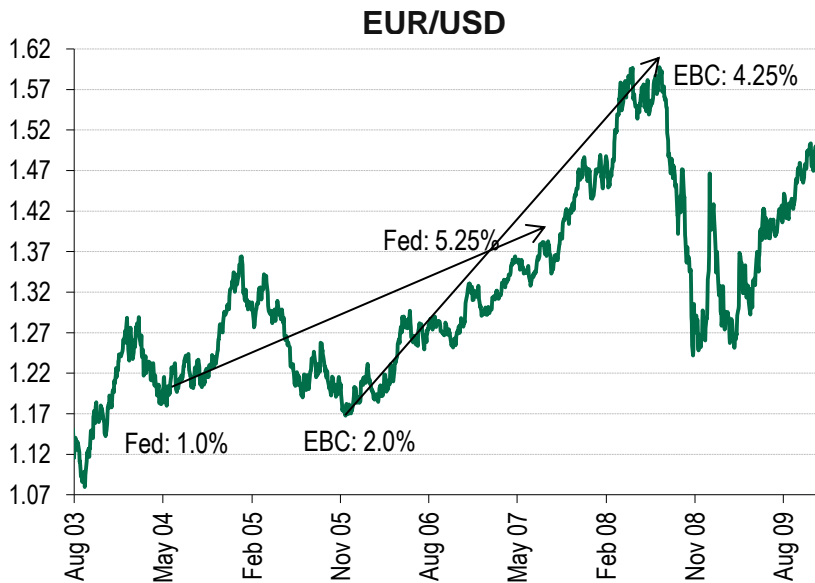


EM equity indexes (December 2008 = 100)



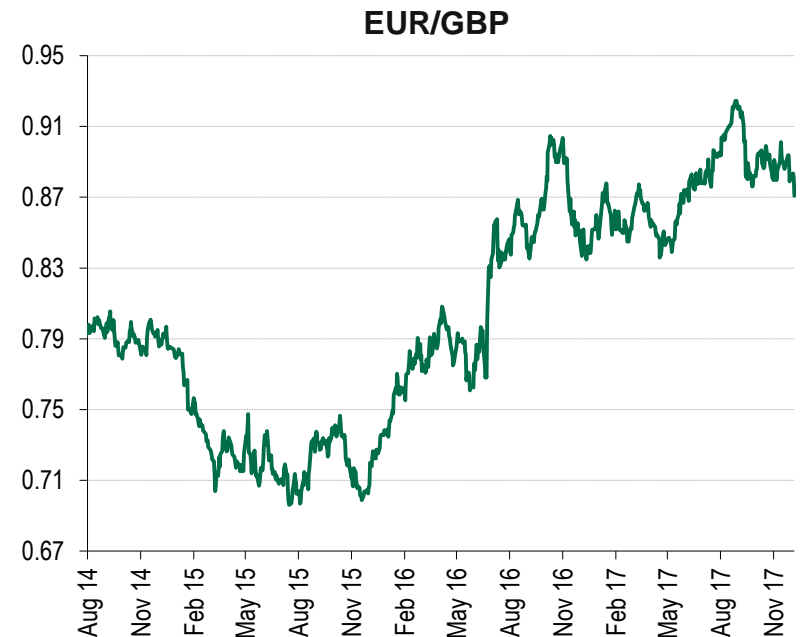
Source: Bloomberg, BZ WBK

- The Fed will be a few steps ahead of the ECB on the path of monetary policy normalization. This would be the same as in the previous cycle, when it did not prevent EUR/USD from rising.
- In June 2004, the FOMC started to hike rates, taking the main refi rate from 1% to 5.25%. Rate hikes in the Euro zone started to rise in late 2005, from 2% to 2.45%, just before the financial crisis broke in 2007. This divergence did not prevent EUR/USD from rising to 1.60 from 1.20 (with a correction to 1.16 in 2005). Positive global market sentiment was key.
- EUR/CHF should strengthen as the demand for safe assets should be low in a context of a sound global economic performance. Also, the SNB still perceives the franc as overvalued, so Swiss monetary policy is likely to remain highly accommodative. We think the Swiss economy could underperform the Euro zone.
- At the same time, the ECB is expected to reduce its stimulus, which should be positive for the euro.



Source: Reuters, Bloomberg, BZ WBK

- In our view, the uncertainty related to the conditions of the UK leaving the EU should weigh on the pound in 2018.
- Brexit negotiations have progressed enough to move on to the second stage, i.e. to the discussion about the 'transition deal' and the bilateral EU-UK trade relations after the UK leaves. This should support the pound on the year-end horizon. Still, the political uncertainty is likely to affect the currency throughout 2018. The upcoming stage of the negotiations is likely to be harder in the light of the British Parliament's decision to oblige the prime minister to obtain the approval of the legislative authority for the final negotiated terms. Additionally, the EU suggests that talks may not start until March.
- The UK economy is expected to underperform, with GDP growing 1.4% y/y in 2018 vs 2.2% y/y in the Euro zone.
- The BoE hiked rates by 0.25bp to 0.50% in November but, in our view, this was not a start of a cycle. We think inflation could ease in 2018, giving no reason for the BoE to continue with its monetary policy normalization. At the same time, the ECB should reduce monetary stimulus and the FOMC is likely to deliver three more rate hikes in 2018.



	1Q18E	2Q18E	3Q18E	4Q18E
EUR/USD	1.15	1.16	1.18	1.19
EUR/CHF	1.14	1.17	1.18	1.19
EUR/GBP	0.88	0.90	0.93	0.95

Source: BZ WBK, Santander, average in quarter

Poland		2015	2016	2017	2018	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18
GDP	mld PLN	1,798.3	1,858.6	1,980.8	2,105.1	456.0	476.2	487.4	561.2	486.8	507.3	518.4	592.7
GDP	% r/r	3.8	2.9	4.5	4.0	4.1	4.0	4.9	4.7	4.3	4.1	4.0	3.6
Domestic demand	% r/r	3.3	2.2	4.5	4.1	3.9	5.5	3.9	4.6	4.4	4.2	4.0	3.8
Private consumption	% r/r	3.0	3.9	4.8	4.9	4.7	4.9	4.8	5.0	5.0	4.9	4.8	4.7
Fixed investment	% r/r	6.1	-7.9	3.2	5.9	-0.5	0.9	3.3	6.0	7.2	6.9	5.9	4.8
Unemployment rate *	%	9.7	8.2	6.7	5.9	8.0	7.0	6.8	6.7	6.8	6.0	5.8	5.9
Current account balance	mIn EUR	-2,405	-1,254	479	893	1,659	-951	-671	442	2,103	-1,007	-675	472
Current account balance	% PKB	-0.6	-0.3	0.1	0.2	0.1	-0.5	0.0	0.1	0.2	0.2	0.2	0.2
General government balance	% PKB	-2.6	-2.5	-1.9	-2.5	-	-	-	-	-	-	-	-
CPI	% r/r	-0.9	-0.6	2.0	2.2	2.0	1.8	1.9	2.2	2.1	2.4	2.3	2.0
CPI *	% r/r	-0.5	0.8	2.0	2.0	2.0	1.5	2.2	2.0	2.1	2.4	2.3	2.0
CPI excluding food and energy prices	% r/r	0.3	-0.2	0.7	1.6	0.3	0.8	0.8	0.8	1.3	1.4	1.7	2.1

Source: GUS, NBP, Ministry of Finance, BZ WBK.

* end of period

Poland		2015	2016	2017	2018	1Q17	2Q17	3Q17	4Q17	1Q18	2Q18	3Q18	4Q18
Reference rate *	%	1.50	1.50	1.50	1.75	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.75
WIBOR 3M	%	1.75	1.70	1.73	1.76	1.73	1.73	1.73	1.73	1.73	1.73	1.73	1.87
Yield on 2-year T-bonds	%	1.70	1.63	1.88	1.92	2.10	1.96	1.81	1.64	1.70	1.90	2.04	2.04
Yield on 5-year T-bonds	%	2.21	2.35	2.77	2.88	3.03	2.76	2.64	2.66	2.71	2.84	2.91	3.08
Yield on 10-year T-bonds	%	2.69	3.04	3.43	3.51	3.72	3.32	3.30	3.36	3.28	3.44	3.64	3.70
2-year IRS	%	1.72	1.68	1.93	2.26	2.02	1.90	1.86	1.96	2.02	2.24	2.42	2.39
5-year IRS	%	2.02	1.96	2.41	2.73	2.53	2.32	2.31	2.48	2.51	2.66	2.79	2.98
10-year IRS	%	2.41	2.39	2.87	3.25	3.02	2.76	2.77	2.93	2.93	3.17	3.41	3.50
EUR/PLN	PLN	4.18	4.36	4.26	4.24	4.32	4.22	4.26	4.24	4.21	4.23	4.27	4.24
USD/PLN	PLN	3.77	3.95	3.79	3.63	4.06	3.83	3.63	3.62	3.68	3.65	3.63	3.57
CHF/PLN	PLN	3.92	4.00	3.84	3.63	4.04	3.89	3.77	3.67	3.69	3.63	3.63	3.56
GBP/PLN	PLN	5.77	5.35	4.87	4.65	5.03	4.90	4.75	4.79	4.81	4.73	4.62	4.46

Source: GUS, NBP, Ministry of Finance, BZ WBK.

* end of period

This analysis is based on information available until 12.12.2017 has been prepared by:

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EXPLANATION OF THE RECOMMENDATION SYSTEM

DIRECTIONAL RECOMMENDATIONS IN BONDS		DIRECTIONAL RECOMMENDATIONS IN SWAPS	
	Definition		Definition
Long / Buy	Buy the bond for an expected average return of at least 10bp in 3 months (decline in the yield rate), assuming a directional risk.	Long / Receive fixed rate	Enter a swap receiving the fixed rate for an expected average return of at least 10bp in 3 months (decline in the swap rate), assuming a directional risk.
Short / Sell	Sell the bond for an expected average return of at least 10bp in 3 months (increase in the yield rate), assuming a directional risk.	Short / Pay fixed rate	Enter a swap paying the fixed rate for an expected average return of at least 10bp in 3 months (increase in the swap rate), assuming a directional risk.
RELATIVE VALUE RECOMMENDATIONS			
	Definition		
Long a spread / Play steepeners	Enter a long position in a given instrument vs a short position in another instrument (with a longer maturity for steepeners) for an expected average return of at least 5bp in 3 months (increase in the spread between both rates).		
Short a spread / Play flatteners	Enter a long position in a given instrument vs a short position in other instrument (with a shorter maturity for flatteners) for an expected average return of at least 5bp in 3 months (decline in the spread between both rates).		
FX RECOMMENDATIONS			
	Definition		
Long / Buy	Appreciation of a given currency with an expected return of at least 5% in 3 months.		
Short / Sell	Depreciation of a given currency with an expected return of at least 5% in 3 months.		

NOTE: Given the current volatility in the financial markets, the recommendation definitions are only indicative until further notice.

We generally review our Rates/FX recommendations monthly, in the regular MACROscope and FX Compass publications, and when market events/moves so warrant.

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