



MACROscope

POLAND: Mid-Year Economic Outlook

June 2017

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- Polish economy has started 2017 on a surprisingly solid note, with GDP growth surging to 4.0% y/y already in the first quarter. The revival in economic activity was driven mainly by the stronger private consumption, boosted by a lagged effect of the 500+ scheme and decent labour income, and the rebound in external trade, catching a tailwind from rising activity in the Euro zone. Fixed investments, after having fallen significantly last year, have remained flat at the start of 2017 (in contrast to many other CEE states), but we expect to see a notable pickup in the coming quarters, amid a rising tide of EU financing and improving business confidence. In sum, we predict GDP growth at nearly 4% this year, fuelled by all three engines: consumption, exports and investments. 2018 may be not as strong as this year, but still solid (GDP growth above 3%), as the EU-financed investments should pick up momentum.
- The inflation rate, after having jumped above 2% y/y at the start of 2017, has stabilised recently just below this level as Brent oil's upward trend has reversed. While rising fruit prices may introduce some CPI volatility in the summer/autumn, the year should end with inflation well below 2% y/y, due to a high base effect in December. Moreover, underlying price pressure remains well contained, and we predict core inflation will pick up only gradually, remaining well below the 2.5% official target not only this year but also in 2018. The slack in the domestic labour market is declining every month and may eventually trigger higher wage pressure, but so far the huge inflow of workers from Ukraine has effectively capped labour cost growth in Polish companies.
- In this environment, the Polish central bank is in no hurry to start thinking about monetary policy tightening, and signalled it was ready to accept negative real interest rates as long as there is no clear threat to the official inflation target in the medium run. We believe that the main interest rates in Poland will remain stable until very late in 2018.
- The fiscal deficit in 2016 was lower than planned (at 2.4% of GDP) and we see growing chances that in 2017 the gap will again be less than budgeted, as solid, consumption-driven economic growth plus higher inflation have boosted tax revenues. 2018 will be more challenging, due to higher costs of lowering the retirement age and possibly no one-offs in revenues, but the government seems determined to keep the general government deficit below 3% of GDP.

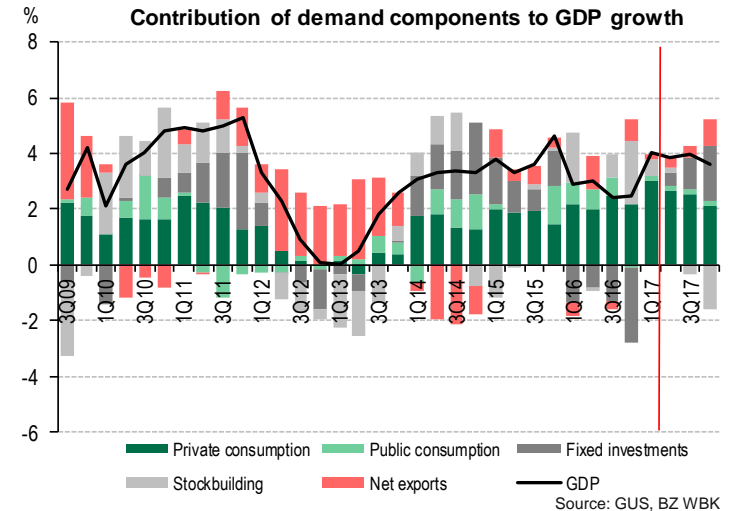
- The Polish zloty has appreciated sharply in the first months of the year, supported by the growing optimism regarding the economic outlook, decreasing external geopolitical risks and lower investor concerns about domestic economic policies. The rally paused in June but we expect the PLN to strengthen again in July and then to depreciate in August due to the seasonal pattern. The Polish currency should approach 4.20 against the euro by the year-end end.
- The Monetary Policy Council managed to convince investors that it is not going to alter its policy for long. As a result, the first 25bp rate hike priced-in by FRAs moved to early 2019. We think that the short end of the yield curve and money market rates will remain anchored at relatively low levels in the coming months, as stable inflation and stronger zloty will give the central bank good excuses to keep policy on hold. The situation may get more interesting at the end of this year, when we expect to see core inflation reach 1.5% (the lower end of the allowed band around the inflation target) and wage growth to accelerate.
- We believe that the MPC will be very slow in changing its rhetoric towards a less dovish tone. As a result, the market may perceive the Polish central bank as being well "behind the curve", which could result in the asset swap widening. Therefore, we think that IRS rates will pick up relatively slowly in the coming quarters, even though the upward move would be justified by the macro situation (correlation between the nominal GDP growth and swap rates was historically quite high).
- Meanwhile, the bond market should remain under the influence of trends abroad. In July the yields of Polish bonds may go down again due to strong seasonal pattern and weakening inflation concerns worldwide. However, our base scenario still assumes that yields in the US and in the Euro zone should go up gradually later this year, amid further monetary tightening by the Fed and possible ECB rhetoric to prepare the market for a gradual exit from its asset purchase programme in late 2017. We assume that Polish bond yields will follow this upward tendency, especially at the long end of the curve.

2017 summary: Our expectations vs reality

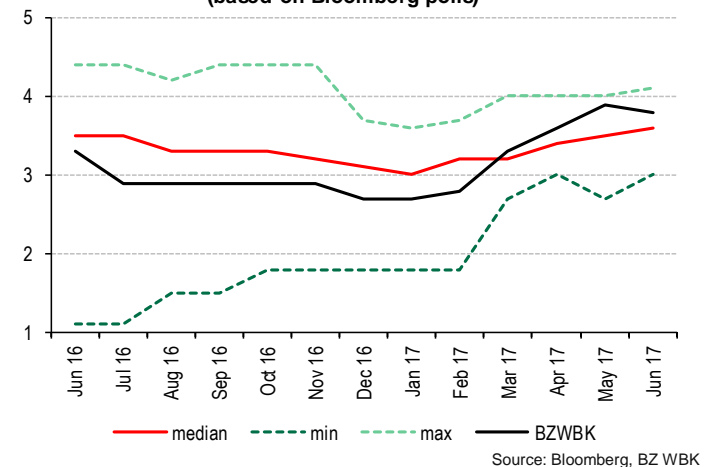
Indicator	Our view (6 months ago)	Outcome / Our revised view
GDP	V-shaped recovery with a dip in Q2 on the working days effect. The scale of recovery depends mostly on investment. We see GDP growth in Q4 again above 3% y/y.	Recovery proved stronger and faster than we expected, with 1Q17 already hitting 4.0% y/y. Recent data show that 2Q17 may be slightly weaker, but we expect average GDP growth near 4% this year.
GDP breakdown	Strong consumption, at least in 1H17. Net exports neutral again, despite recovery in foreign trade. Investments picking up in 2H17 after EU fund absorption speeds up.	Still valid. Consumption proved even stronger, exports and imports already reviving, no rebound in investments yet but it should take place in 2H17.
Labour market	Unemployment already close to natural rate. Job creation limited by available labour supply. Wage acceleration.	Job creation has continued, though at slower pace. Wage pressure still moderate, but may strengthen in the coming quarters.
Inflation	Strong jump in 1Q17 to 1.5% due to spike in commodity prices. Stabilisation later in the year.	CPI peak at the start of the year a bit higher than we expected, but followed by the anticipated stabilisation. Core inflation rising slowly.
Monetary policy	Rates flat throughout the year. MPC under pressure at the turn of 2016/17 amid very low GDP growth, but they are likely to resist.	The MPC took a 'wait-and-see' approach, as expected. Interest rates should remain stable not only in 2017, but also for the better part of 2018.
Fiscal Policy	Central budget deficit at c.3% of GDP is relatively safe amid 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 lower than planned by at least PLN20bn, thanks to the solid growth in tax revenues, and the general government gap should be safely below 3% of GDP.
Interest rate market	In 2017, the front end is starting to price in interest rate hikes (to materialise in 2018). Long-term yields under upward pressure from global markets.	MPC's dovish rhetoric quickly dispelled market speculation about rate hikes before end-2018. Yields in the world debt markets fell in 1H17, but we still expect an upward move in the second year-half.
FX market	Cyclicality of the Polish zloty will not be supportive at the start of 2017, some improvement in sentiment in 2H17.	PLN did rally on improving economic outlook and decreasing geopolitical risks, reaching our year-end target 4.2 vs. EUR in May. Short-term correction likely in the summer.

Economic update: GDP growth picked up faster than expected

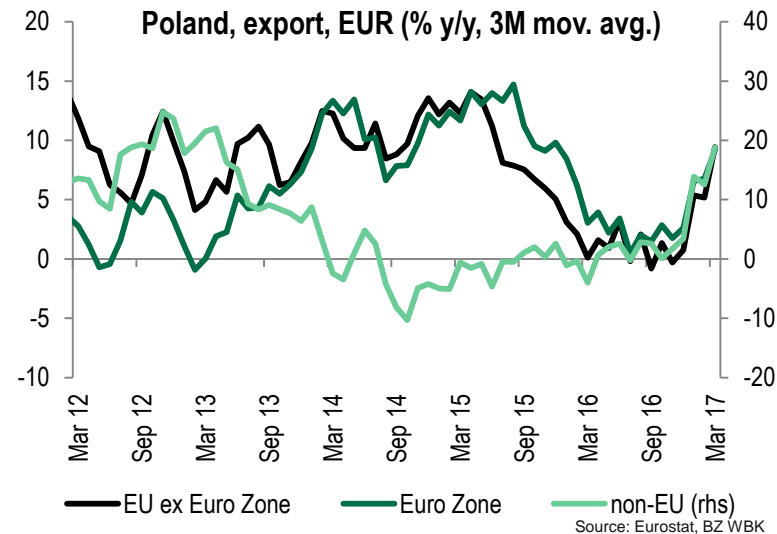
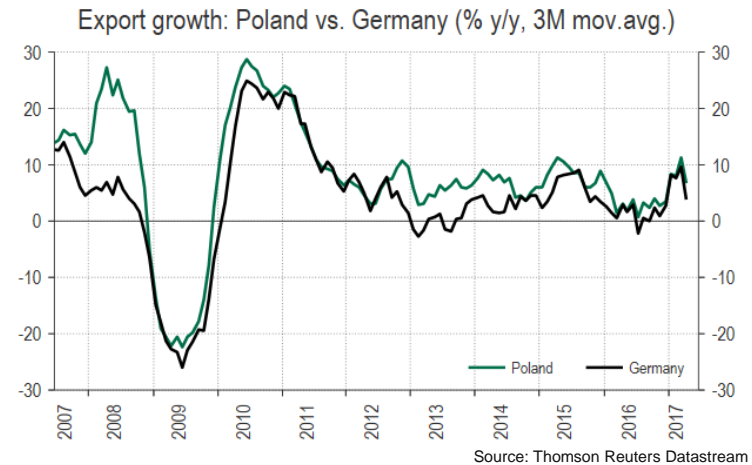
- In our 2017 Outlook released in December we were expecting this year to show a V-shaped recovery yet with the entire year GDP growth at sub-3% levels. Meanwhile, the recovery proved faster and stronger than we had anticipated as growth accelerated to 4% y/y and 1.1% q/q as early as 1Q17.
- 1Q17 surprised us on the upside on almost all fronts: consumption, exports and inventories, with only investments showing virtually no signs of life yet, at least in the private sector. We think the latter should revive gradually during the year.
- While the pace of the economic growth revival at the start of 2017 was a big positive surprise, we think there is not much room for further improvement in the coming quarters. In fact, the most recent high-frequency data suggested that economic growth in the second quarter may decelerate slightly.
- We predict GDP growth this year to stabilise at nearly 4%, fuelled by three main engines: consumption, exports and investments. 2018 may be not as strong as this year, but still solid (GDP growth above 3%), as the EU-financed investments should reach their momentum
- We elaborate more on investment, consumption and the export outlook in the following slides.



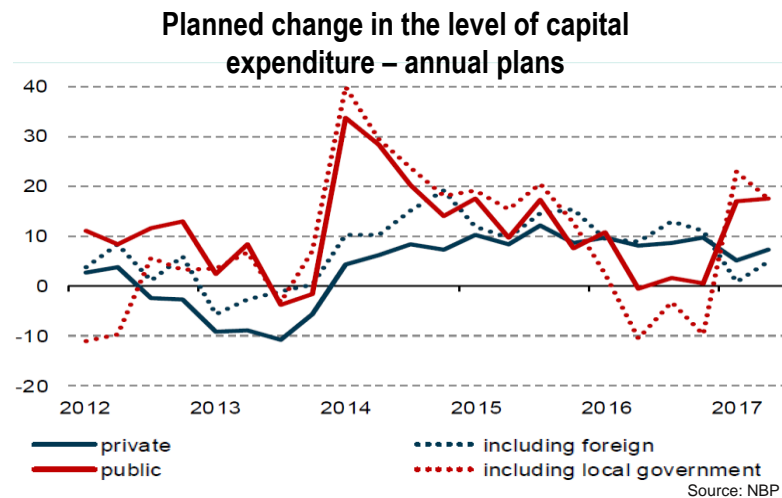
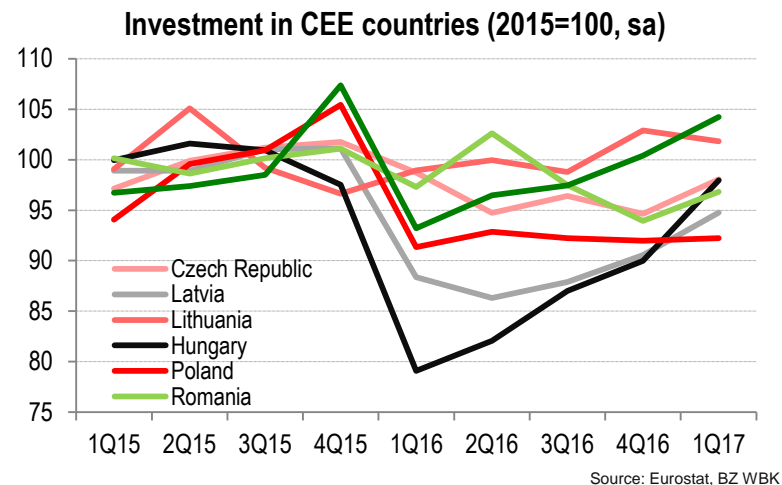
Evolution of GDP forecasts for 2017, % y/y (based on Bloomberg polls)



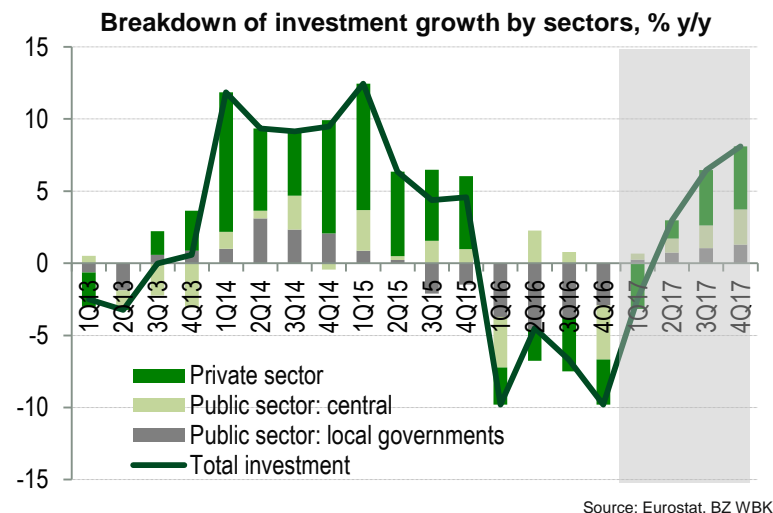
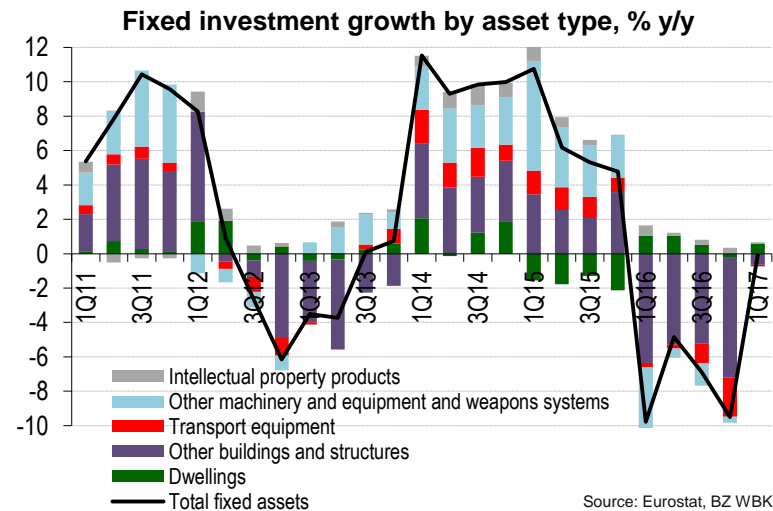
- The Euro zone economy is showing more signs that it has finally overcome its weakness (which was caused in the previous years by the debt crisis, Greek bailout, deleveraging). This has an immediate impact on the performance of Polish exports. The growth of exports in the balance of payments statistics went from 3.4% y/y to 11.3% in 1Q.
- Exports to non-EU countries have also become more dynamic lately after almost three years of stagnation.
- High correlation with German export numbers reminds us that the Polish export sector has two ways to benefit from a rise in global demand – through direct trade links and by supplying the German economy with goods it can add value to and re-export.
- Buoyant private consumption and expectations of an investment rebound from a strong base for imports in Poland. Domestic demand grew 4.1% y/y in 1Q up from 1.7%-3.5% seen in 2016. Imports in EUR increased by 15.1% y/y in this period.
- We assume that the net effect of the improving international trade in Poland will be positive for GDP. Net exports' contribution to economic growth should be neutral in 2Q, but climb to 0.7pp in the final quarter of the year. Moving into 2018, the expected rebound of investments, coupled with consumption remaining strong could lead to net exports weighing on GDP growth, but the impact should be relatively small (-0.1pp).



- 2016 saw a deep slump in investment in Poland and in most CEE countries. However, while other CEE countries have already seen a rebound, Poland is clearly lagging behind.
- The slowdown in investment in Poland was triggered by three factors: 1) low absorption of EU funds, weighing on public infrastructural projects, 2) a freeze in investment in big public companies, especially the utilities sector due to elections and staff changes, 3) suspension of private investment plans due to higher uncertainty about regulations and taxes after the election.
- Other CEE countries did not see a slump in private investment (apart from Latvia) and that is why, in our view, they started to rebound earlier.
- Data from 1Q17 point to the beginning of a rebound in public investment (local governments' capital spending up by 11% y/y), with public companies and the private sector still lagging behind. Data on EU funds suggest an incoming rebound, as do the investment plans of the public sector, while the private sector's plans fell versus 2016, as shown by the NBP report on business conditions (chart on the right).

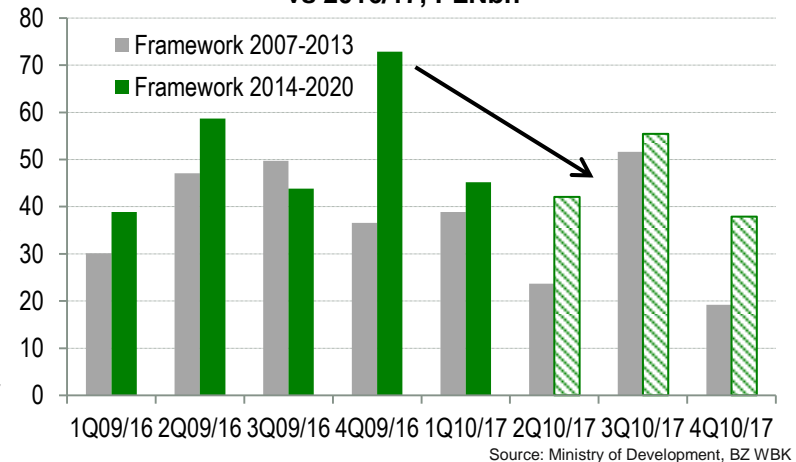


- In our view, private investment will not be as weak as suggested by data from the NBP report on business conditions. The economic environment is quite favourable for investment, given companies' good liquidity position, low financing costs, high capacity utilization and positive sentiment. Moreover, rising public investment and growing labour market tension should encourage the private sector to invest.
- The revision of 2016 investment data was an important factor affecting our 2017 forecasts: the initial reading of -5.5% y/y fell to -7.9% y/y, providing a lower base effect. This affected our y/y path, but our forecasts of investment volume remained roughly stable.
- The downward revision was applied mostly to 1Q16 and investment in "other machinery and equipment" and the public sector, and to 4Q16 investment in "transport equipment" and the private sector.
- To sum up, we expect investment growth to improve gradually and to reach c5% y/y on average. In our view, the recovery in 1H17 will be mostly driven by investment in construction and by the general government sector, while other sectors are likely to join a bit later.



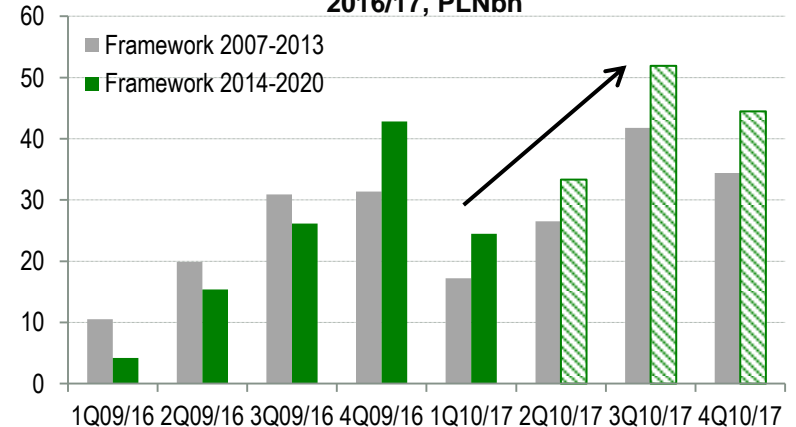
- After a weak start to the financial framework 2014-2020, 2016 saw a gradual acceleration in the number of applications for EU financing. It is worth remembering that there are three phases for EU funds: 1) applications for EU funds; 2) signed contracts for EU financing; and 3) investments. Our analysis implies that applications are transformed into contracts within 1-3 quarters (about 40% in the first quarter). The contract then becomes an actual investment with outlays spread over ten quarters, with a peak between the 6th and 8th quarters.
- In line with our expectations, the "application frenzy in 4Q16" (PLN73bn worth of new applications) was a one-off event. The number of new applications fell to PLN45bn in 1Q17 and PLN34bn in April and May 2017. Signed contracts totalled PLN43bn in 4Q16, PLN24bn in 1Q17 and PLN21bn in April and May 2017. In general, the budget allocation is still lower than in the corresponding period of the 2007-2013 framework. Applications and contracts are at 52% and 24% of the whole budget versus 55% and 32% in the previous framework.
- We are expecting the number of new contracts to rise markedly in 2H17 and reach almost PLN100bn on the back of strong inflows of new applications at the end of 2016. Contracts should transform into investments, fuelling a rebound in 2H17E and 2018E, contributing 3pp to investment growth in 2017E and 8pp in 2018E.

Value of new applications per quarter : 2009/10 vs 2016/17, PLNbn



Source: Ministry of Development, BZ WBK

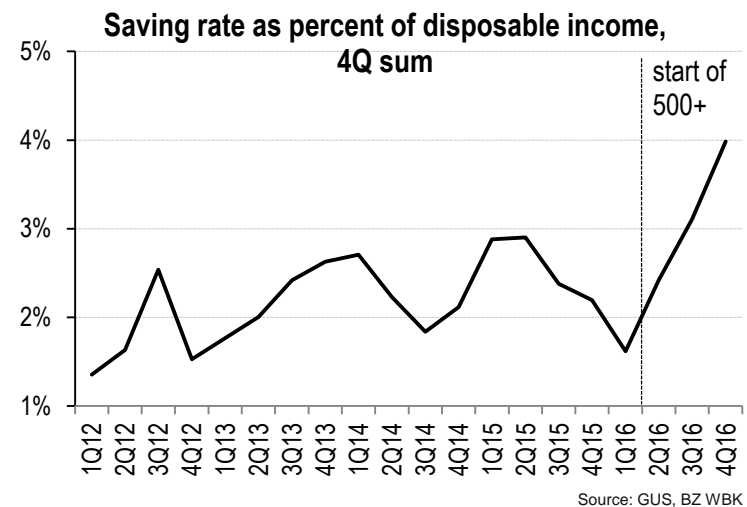
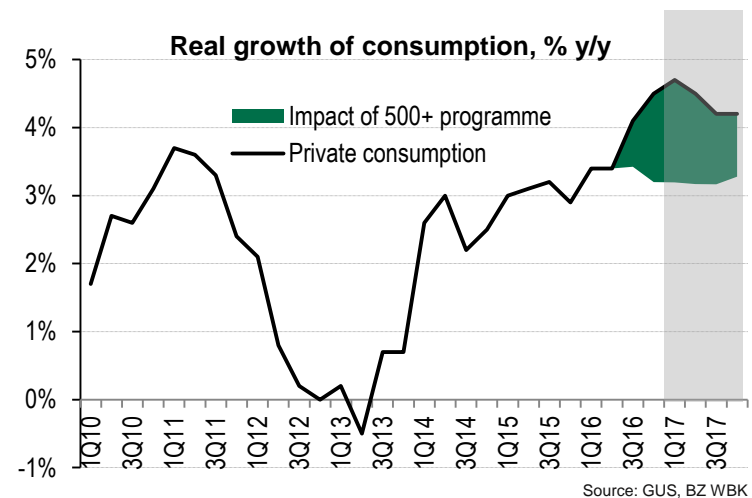
Value of new contracts per quarter : 2009/10 vs 2016/17, PLNbn



Source: Ministry of Development, BZ WBK

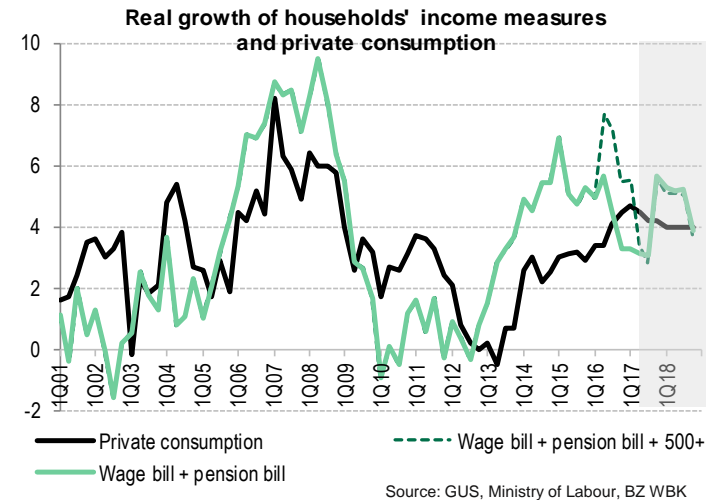
Economic update: 500+ proved a strong pillar of consumption

- PLN24.9bn was spent on the 500+ child subsidy programme during the first year since its introduction in April 2016, the equivalent of 1.3% of GDP recorded in that period. It was widely expected that the programme would translate into higher consumer spending. At the same time, it was not sure how households would treat the new source of income and what level of propensity to consume they would apply. The acceleration of y/y consumption growth came with some delay – in 3Q16 it went from 3.4% to 4.1%, and then to 4.5% in 4Q16 and 4.7% in 1Q17. Our model-based estimate of the 500+ consumption boost pointed to 0.7pp being added in 3Q16, but as much as 1.5pp in 1Q17. We see the full-year effect at c0.27pp in 2016 and c0.94pp in 2017.
- Such delayed transmission of the relatively big new social transfers to household spending is in line with the consumption-smoothing hypothesis; however, according to anecdotal evidence, the money was used in the first place to reduce high-interest, short-term indebtedness.
- The child subsidy program has a positive effect on the savings rate, which has been rising since its launch and is now the highest in five years. We estimate that in 1Q17 about 40% of the value of 500+ transfers received in the last year was spent, while the rest was used to improve the net savings of households. By the end of the year, the propensity to consume the 500+ benefits could go to 80%.



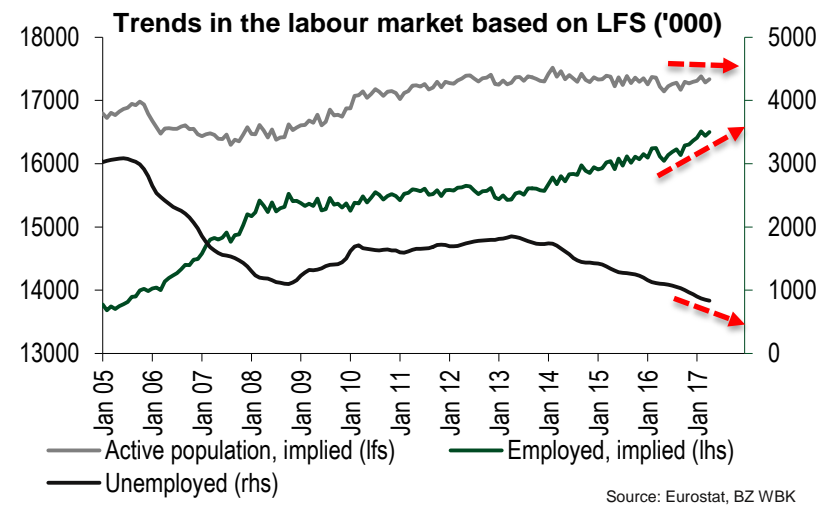
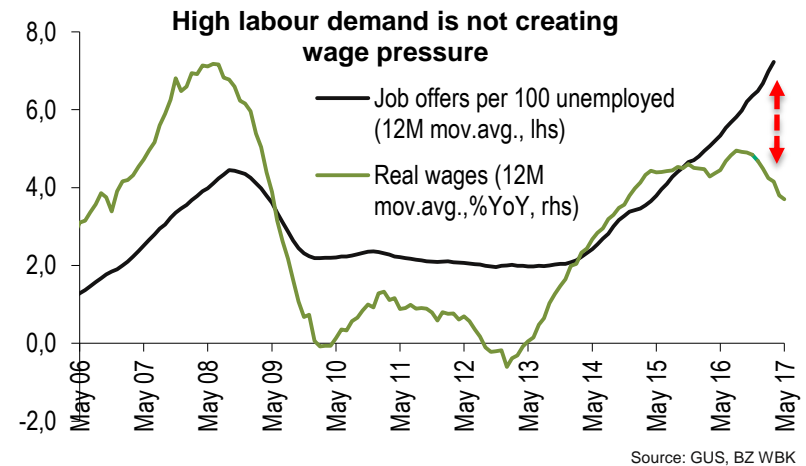
Economic update: Consumption heading for the strongest year since 2008

- The child benefit programme was an important element boosting households' revenues just when labour income growth started decelerating in real terms (as the nominal wage growth stabilised and was eroded by the rising inflation).
- While the effect of the 500+ programme on private consumption will gradually fade, this process is likely to be delayed by the rising propensity to spend the money from the programme as mentioned on the previous page.
- Moreover, we expect to see another boost to households' disposable income before the end of this year, resulting from the reduction of retirement age. We estimate that, due to the retirement age cut in October, as many as 480k people may apply for pension benefits – the vast majority of entitled people will opt to retire almost immediately, in our view, even though most of them may choose to continue their labour activity after retirement. As a result, the pension bill, which has recently decelerated sharply due to low pension indexation would accelerate to around 8% y/y in 4Q17. And if we add the likely more generous pension indexation in 2018, the pension bill could accelerate above 10% y/y (in nominal terms) at the end of 1Q18.
- Therefore, we think private consumption growth will remain strong in the coming quarters. In 1Q17 consumption accelerated to 4.7% y/y and recorded the best result since 4Q08; we expect it to remain one of the main engines of economic growth, rising by c4% y/y not only this year but also in 2018E.



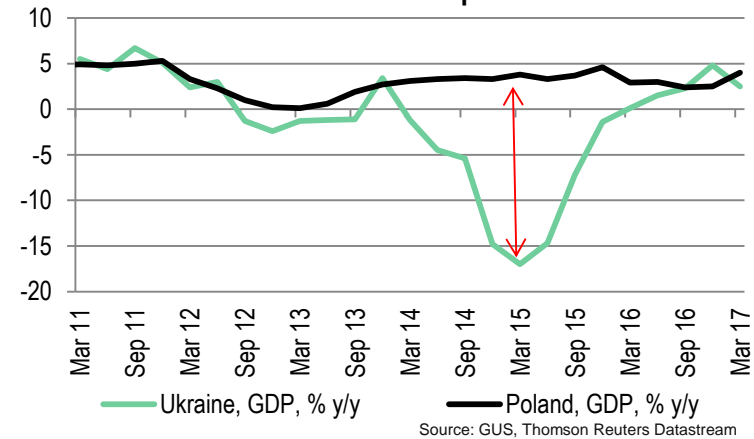
Economic update: Labour market gets tighter, but where is the wage pressure?

- The job offers count keeps increasing and the unemployment rate is hitting a new record low with almost every monthly release. Such a tightening of the labour market should theoretically lead to a build-up of wage pressure. Enterprise sector wages are still growing at about 4% y/y in nominal terms, which is actually considered a disappointment as a similar pace was observed in 2016 and the perception of labour shortages has increased since then. Meanwhile, the higher inflation decreased the purchasing power of the average wage but has not yet triggered substantially higher wage hike claims.
- The labour market could be seen as running into a wall. Please note that, while the levels at which the unemployment rate has dropped are surprisingly low (7.5% registered rate, 4.8% LFS-based rate), the number of jobseekers in May saw the lowest decline since 2009. It seems the remaining stock of unemployed does not meet employers' needs.
- The NBP's quarterly report on enterprises signalled that wage pressure is elevated, but not growing despite the scarcity of available labour resources, which is explained by pointing out that the economy is creating low-paid jobs and offers employment to social groups that are unable to generate wage pressure (like immigrants). The inflow of Ukrainians is seen as a blessing for the Polish labour market, but its full scale is not captured by official statistics.

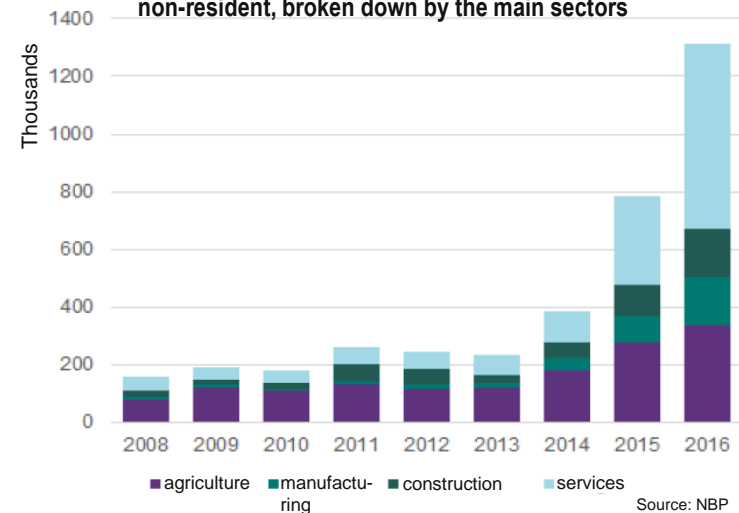


- Statistics on registered employers' declarations about plans to hire non-residents show a c60% y/y increase in 2016, with the count of offers for foreigners reaching 1.3mn. Almost half of this number was added in Jan-Apr 2017, which suggests that the inflow even accelerated at the start of this year. However, this important inflow of jobseekers from Ukraine may soon reach its limits. Ukrainian citizens have just acquired the right to travel visa-free to the EU and Schengen Area, and even though this is only valid for tourist visits (without granting a work permit), it may slow their inflow to Poland. Another reason to expect a slower inflow of Ukrainians is the economic rebound in their homeland, with real wages rising about 20% y/y. While the conflict with Russia that has caused the recession and the wave of migration have not ended, the reasons for mass migration now seem to be smaller than in the last two years.
- Another risk for the Polish labour market coming this autumn is the decrease in the retirement age to 60 for women and 65 for men. Just how many will quit their jobs after the change is a big unknown, but we estimate the domestic labour force could shrink by 150k people in the first year after the reform is implemented. The details of the government's incentives to keep people in the market longer are not known yet.
- Poland still has "demographic reserves" in the form of low labour activity and overemployment in agriculture, but we would probably need to see notably higher wages to see those reserves activated.

End of economic slump in Ukraine

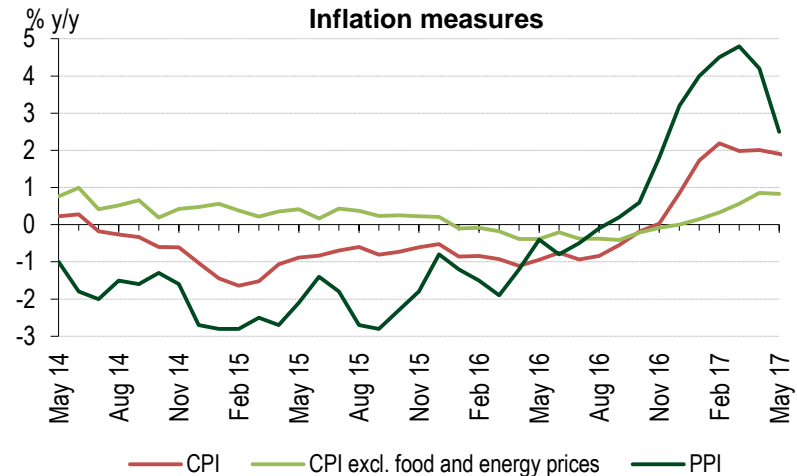


Registered employers' declarations about plans to hire non-resident, broken down by the main sectors



Economic update: Inflation uptrend has stalled, but things may still get more interesting...

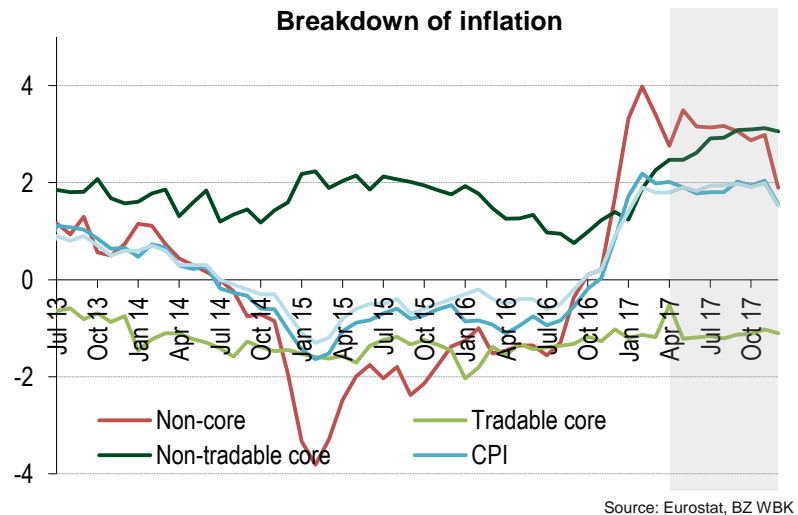
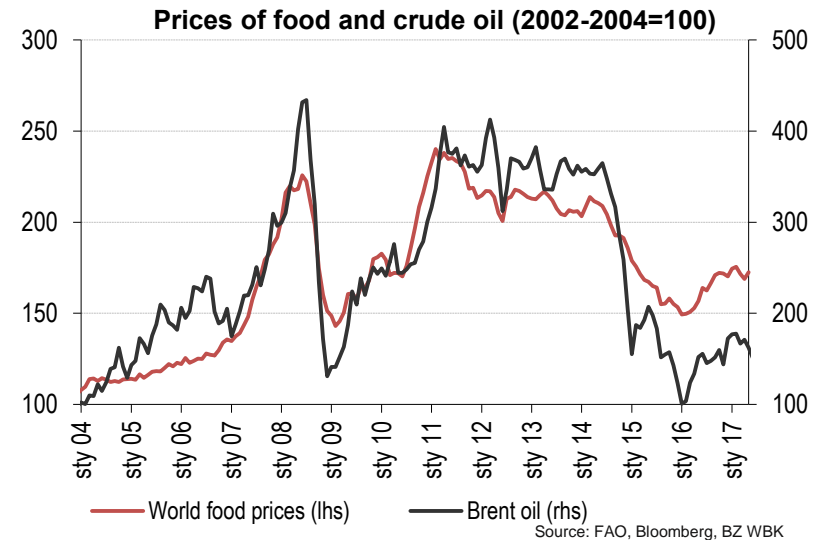
- CPI inflation rebounded faster than expected at the start of 2017, rising from zero to 2.2% y/y in just three months. However, after reaching its peak in February, price growth has stabilised and even decelerated in the following months, as the upward trends in global prices of crude oil and food have stalled.
- In the short run, food prices may add some volatility to CPI growth this year, as the cold temperatures in April/May caused damage to fruit production across Poland, and the final effect on prices is still hard to assess. There has also been an unexpected significant rise in pork prices across Europe in recent months, which –if it continues– could contribute to higher inflation.
- On the other hand, those factors should be offset, at least partly, by a decline in fuel prices and the appreciation of the PLN (c10% vs USD ytd).
- Additional risk for inflation comes from the labour market shortages, which could spark upward pressure on wages and, consequently, also on prices. However, we see it as a medium-term (not a short-term) risk.
- So far, the underlying price pressure remains muted, and core inflation is picking up quite slowly: it increased to 0.9% y/y in April and should converge towards 1.5% by the end of this year, according to our estimates. Moreover, the cost pressure on producers has eased recently due to lower commodity prices and the stronger PLN.



Source: GUS, NBP, BZ WBK

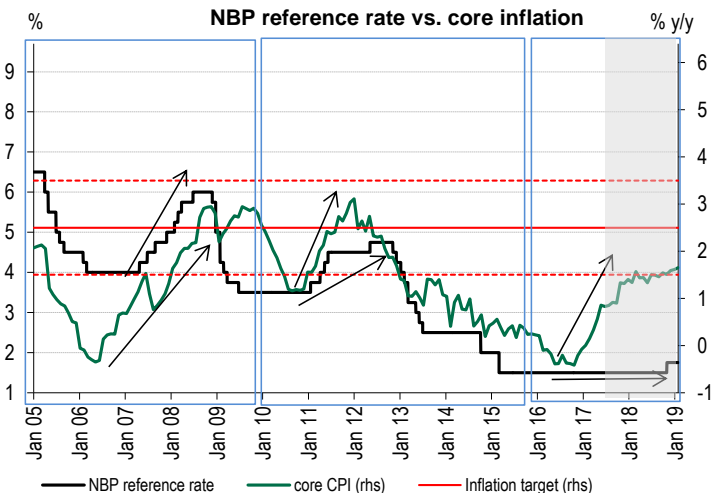
Economic update: Inflation stable, but with a different structure

- In our view, CPI inflation will stay close to 2% y/y throughout 2017E and then fall a bit at year-end due to the high base effect. Even though "stable inflation" seems to be a rather boring concept, much is actually changing beneath the surface.
- The rebound in CPI from deflationary territory to c2% in early 2017 was mainly driven by non-core categories (food and energy). The effect of these categories should fade throughout the year given stable or falling oil prices. There is not much going on in core tradables, as this category stays in deflationary territory and should remain there in 2017, in our view. The visible uptick in April 2017 was due to a jump in passenger transport by air and was only temporary. Additionally, the PLN strengthening by 5% in NEER terms in the December-May period may put some downward pressure on core and non-core tradables (by about 0.25pp on a 2Q horizon, according to NBP research).
- Core non-tradables witnessed an important change in trend, as price dynamics in this category went up quickly from 0.8% y/y in September 2016 (the lowest level in years) to 2.5% y/y in April 2017 (the highest level since October 2012). Moreover, the upward trend was actually quite broad-based among sub-categories. In our view, the strengthening of private consumption should drive non-tradables' prices up further, making this category the main driver of inflation at the end of 2017.



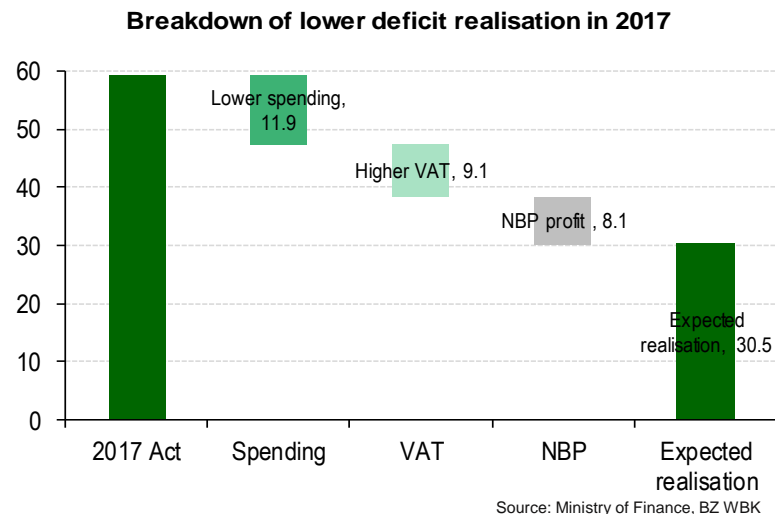
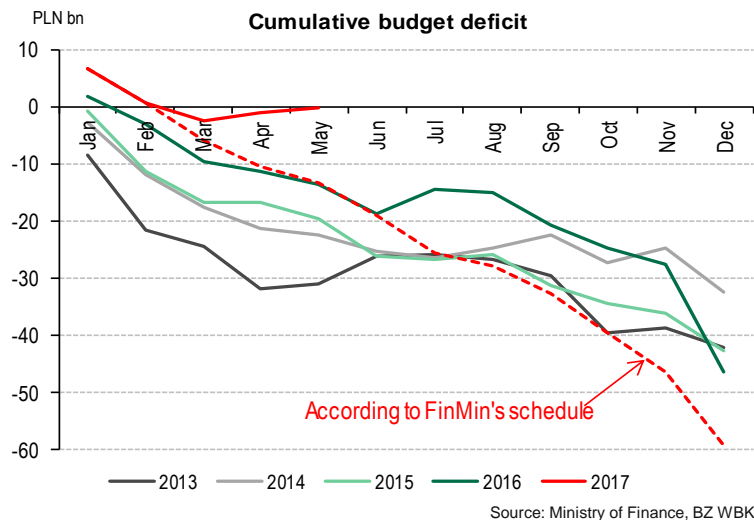
- The recent meetings of the Monetary Policy Council were shows of dovishness, and the central bank managed to convince investors that it is not going to alter its policy for long. As a result, the first 25bp rate hike priced-in by the FRAs was moved back until early 2019.
- The decline of headline inflation since February, the lack of strong wage pressure, and the strong appreciation of the PLN all make the case for a prolonged period of stable rates even stronger. One thing that could disturb this setting is the rise in core CPI towards 1.5% y/y, which we expect to see in late 2017. This could be a crucial moment for monetary policy.
- We found out that, in the past, the trigger for interest rate hikes that worked effectively in the two previous Monetary Policy Councils was headline CPI crossing the 2.5% target and, more importantly, core CPI going above 1.5% y/y. It seems that the CPI exceeding 2.5% is getting less likely as the last prints confirmed that the inflation surge had stopped. But we still see core inflation reaching the historically important level by the end of the year.
- We think that the current MPC will stick to its "wait-and-see" approach as long as possible, and we do not expect to see an interest rate hike in Poland before very late 2018E.

FRA-implied timing of the first 25bp rate hike by the Polish MPC



Fiscal policy: 2017 central deficit significantly below the plan

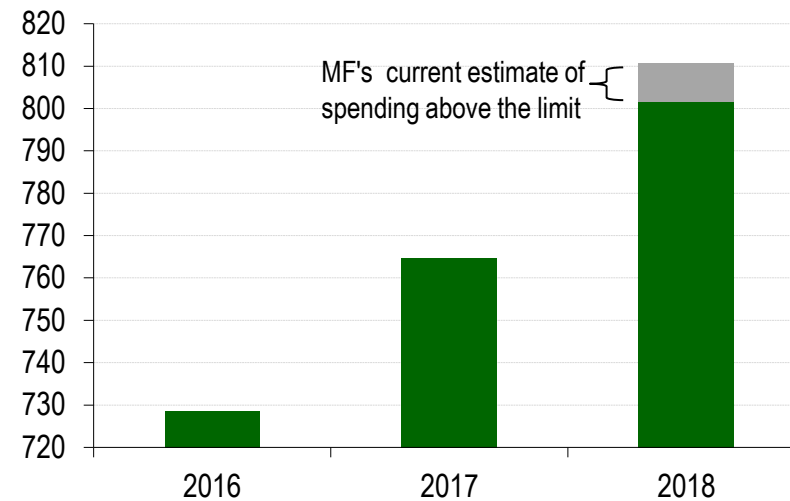
- According to the Ministry of Finance, in January-May the central budget deficit amounted to cPLN200mn, well below the plan, which assumed cPLN13.2bn at the end of May. Revenues were higher than expected (105.5% realisation in April), while spending was lower (96.3% realisation). VAT revenues grew by a surprising 31% y/y in the first five months of the year. This acceleration can be attributed to high consumption and improved tax collection, and about 10pp were added thanks to a shift in VAT refunds. CIT revenues rose by 14.3% y/y, PIT by 7.4% y/y.
- 2017 revenues will also be supported by the NBP's profit, which will bring PLN8.7bn to the central budget (versus PLN0.6bn assumed in the budget act).
- The total planned 2017 deficit was cPLN59bn, but the first months of the year support expectations that the performance will be much better. In our opinion, the deficit could be as low as PLN30bn. Recall, however, that in the final months of the last year the government decided to accelerate spending, leading to higher deficit at the end of 2016 and lower 2017 expenses. One could reasonably expect that this year the story will be the same, placing the final central budget deficit above PLN30bn.



Fiscal policy: Deficit well below 3% of GDP in 2018

- Work on 2018 is in progress, with not many details revealed yet. Still, in our view, the government will be determined to keep the general government budget below 3% of GDP.
- In 2018, the fiscal spending rule will allow general government spending to grow by c5% (to cPLN800bn). Deputy Finance Minister Leszek Skiba said recently that this growth will be consumed by the cost of lowering the retirement age, higher financing of EU projects and higher spending by local governments, leaving no room for growth in central budget spending. According to unofficial information from the ministry, cited by the daily Dziennik Gazeta Prawna, the government will have to cut non-essential spending by PLN9bn in order not to exceed the limit. This may mostly affect investment spending.
- In our view, if the economic situation remains intact and budget revenues grow at a healthy rate in 2018, securing a low risk of deficit exceeding 3% of GDP, the government might be tempted to increase its spending above the spending rule limit. This would, of course, need a change in the spending rule. We remind readers that the government already amended the rule in December 2015, effectively allowing an additional PLN15bn rise in spending in 2016. At that time, this change did not draw much market attention as investors were focused on other issues. This time, however, such a change would be assessed negatively by the market, in our view.

Spending limit according to the fiscal rule

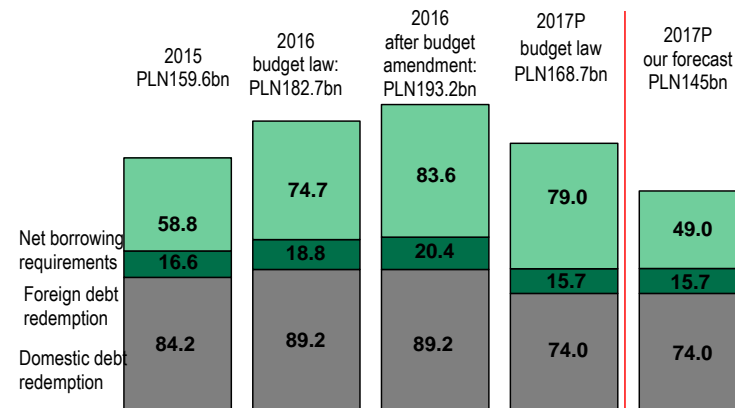


Source: Ministry of Finance, BZ WBK

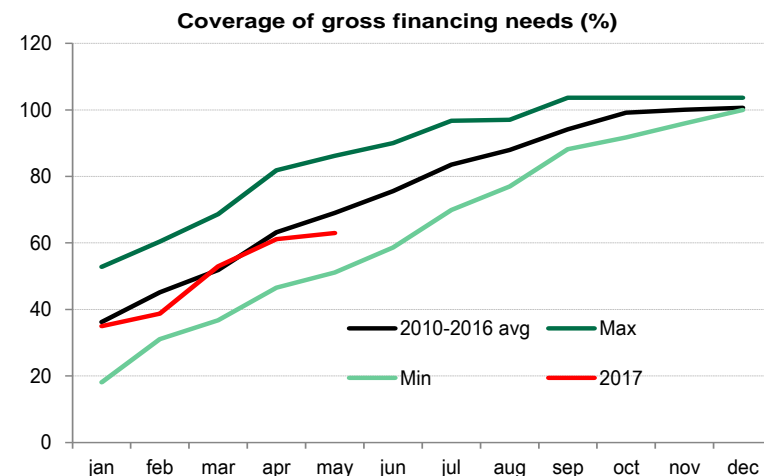
- The government's plans to reshape the 2nd pillar of the pension scheme were released a year ago (covered in [July-August 2016 edition of MACROscope](#)) and are supposed to be implemented at the turn of this year. The legislation is not ready yet, but the main idea has remained unchanged. It affects a pool of PLN176bn of assets.
- 75% of the open pension funds (OFE) holdings will be transferred to individual, privately-owned pension accounts IKZE (part of the voluntary 3rd pillar). These theoretically allow withdrawal of savings before retirement age, albeit at a big tax disadvantage. Some 85% of OFE portfolios are in Polish shares so this transfer could be all equity.
- 25% of OFE assets will go to the government-run Demographic Reserve Fund (FRD) and will be recorded in individual sub-accounts within ZUS, the 1st pillar of the pension system. The FRD is an entity securing funds for future pension payments to mitigate the rise in the demographic burden/dependency ratio and but it may freely choose when to transfer money to the central budget.
- The pension contributions will no longer be divided between OFE and ZUS, so the latter will be much less heavily subsidised by the central budget. Another difference is the investment policy covering the assets to be transferred from OFE. Since the 2013 overhaul, OFE cannot invest in Polish government bonds, but it still holds PLN2bn. The 75% part is allowed a 7-year transition period with a gradually declining limit of share holdings (and possibly withdrawal limitations) and no restrictions after that. The 25% will be managed by the public Polish Development Fund (PFR) without asset class restrictions.
- This means that there is around PLN44bn of pension money which currently cannot be invested in the government debt, but the reform will instantly open a possibility of conversion to bonds. The bill introducing FRD sets a guideline that assets have to be the lowest risk. Most of the assets the fund is allowed to invest in are general government assets (eg sovereign, municipal and state agencies' debt, road bonds, a deposit at the Ministry of Finance).

Debt management: Supply could be lower in 2H17

- The Finance Ministry plans to issue bonds in 2H17 at 9 standard auctions. The deputy finance minister Piotr Nowak announced that due to good liquidity situation of the state budget and NBP profit of cPLN9.2bn the debt supply in 3Q will be limited to only PLN10bn. On June switch auction the MinFin started pre-financing 2018 borrowing needs with buyback of WZ0118. The 2017 outstanding debt amounts now to PLN22.8bn. .
- In our view this year's deficit may be lower even by PLN30bn than assumed in the budget plan (see page 18), and so the gross financing needs for 2017 will amount to cPLN140bn vs PLN168.7bn in budget bill.
- The Ministry of Finance said that this year's borrowing needs are covered in 68%, slightly below the pattern seen in the previous years. But if we assume that true borrowing needs could be lower, the actual coverage goes up to above 80% (one of the highest in recent years).
- Lower budget deficit would theoretically allow the MinFin to cut the debt supply in 2H17 to c.PLN25bn. However, the Ministry may start pre-financing its 2018 borrowing needs in October if market conditions are favourable, and thus effectively the debt supply at the end of this year may not be reduced substantially.
- In 2017 only 10Y and 20Y EUR-denominated bonds of total value PLN1.5bn were offered. In May 2017 FX funding amounted to 31.8% of gross borrowing needs, but the MinFin aims to reduce its share to 30%.



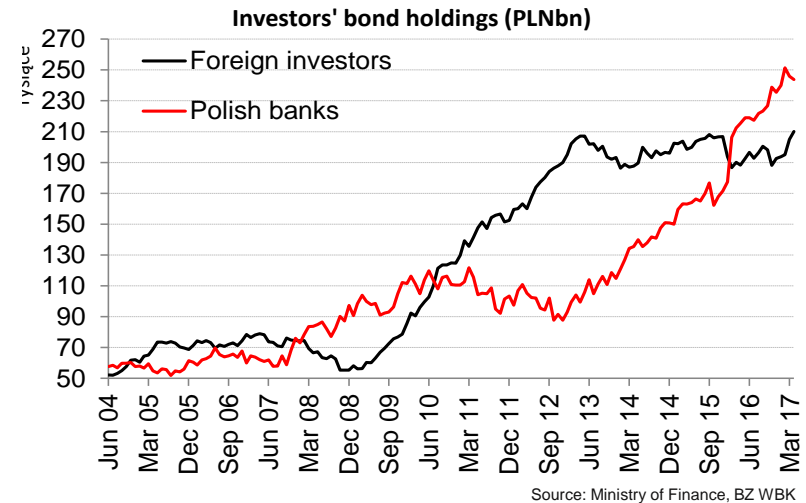
Source: Ministry of Finance, BZ WBK



Source: Ministry of Finance, BZ WBK

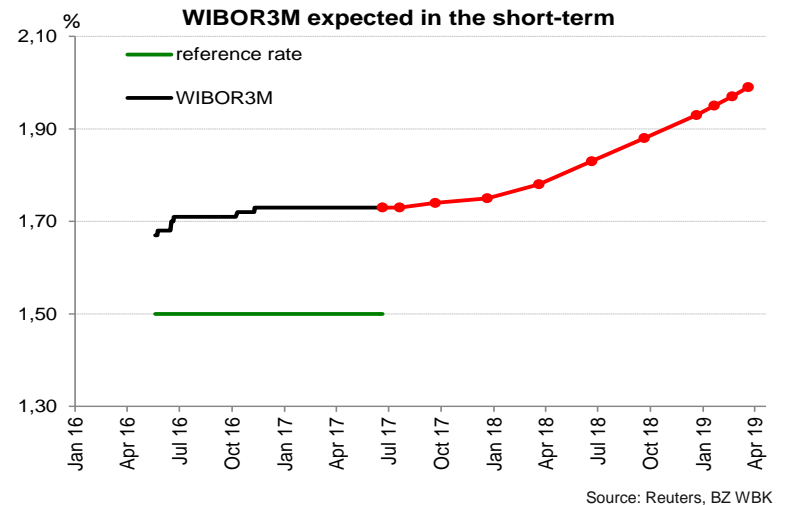
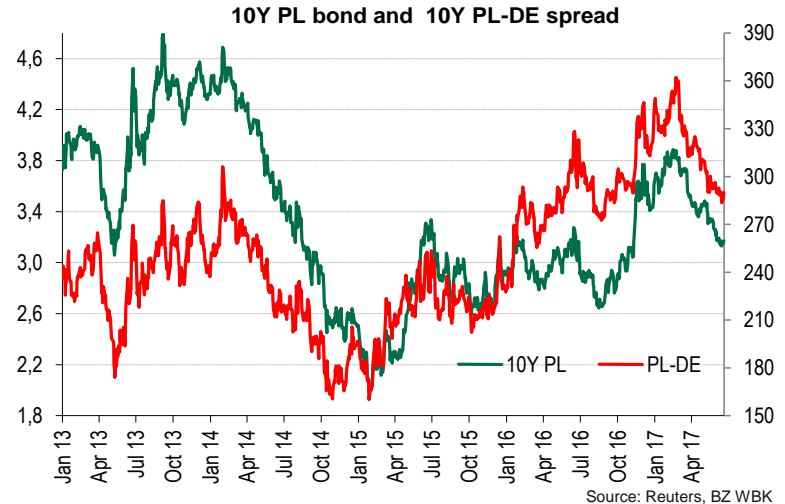
Debt management : Foreign investors buying POLGBs again

- In our 2017 Outlook we had expected that Polish banks would be the biggest buyers of domestic debt this year, followed by foreign investors. Meanwhile, in January-April the main buyers of domestic bonds were non-residents (+PLN17.6bn), among which mutual funds invested the most (+PLN8bn). The weighted average duration of their portfolio rose to 4.84 years (from 4.7 years at end-2016). The exposure of non-residents to the risk of Polish market rates measured by DV01 also increased to 25.5 from 20.6 at the end of 2016.
- Domestic commercial banks bought bonds worth PLN8.2bn, which is significantly below purchases in the comparable period last year (cPLN44bn).
- The loan-to-deposit ratio in the Polish banking system fell throughout 2016, increasing bank's capacity to invest in government bonds, but it rebounded in the last two quarters. We expect to see a revival in loan growth in the coming quarters amid rising corporate investment activity, which may limit further the banks' appetite for accumulating government debt.
- In this environment, foreign investor demand may remain the most important in financing the government's domestic borrowing needs, lured by the improved economic outlook and a lower perception of political and fiscal risk.



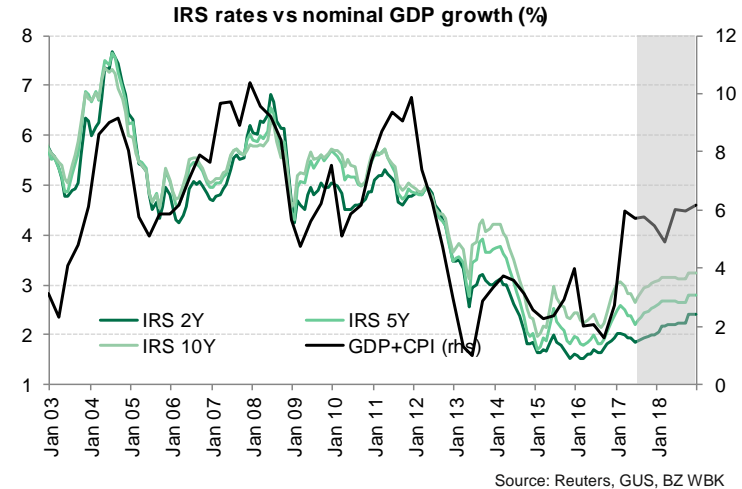
Interest rate market: Significant strengthening in 1H17

- In the first half of 2017 Polish bonds strengthened significantly with the strongest decrease at the long end of the curve (-30bp), although volatility was quite high with a 10Y range of more than 65bp.
- The downward move in yields was, to large extent, triggered by a similar move in the core markets (reversing the "Trump trade" due to falling belief that the new US president will be able to deliver on his promises, and fading concerns about the global inflation outlook based on retreating commodity prices).
- At the same time, the risk premium for Polish assets has decreased due to several factors: (a) lower geopolitical risk in Europe after market-friendly election results in the Netherlands and France, (b) the improving economic and fiscal outlook for Poland, (c) decreasing investor concern about Polish government policies. This was reflected in the narrowing of the asset swap spread (10Y ASW tightened to 50bp at the end of May) or the PL-DE 10Y bond spread (below 290bp).
- The Monetary Policy Council managed to convince investors that it is not going to alter its policy for a long time. As a result, the first 25bp rate hike priced-in by FRAs moved to very late 2018/early 2019.



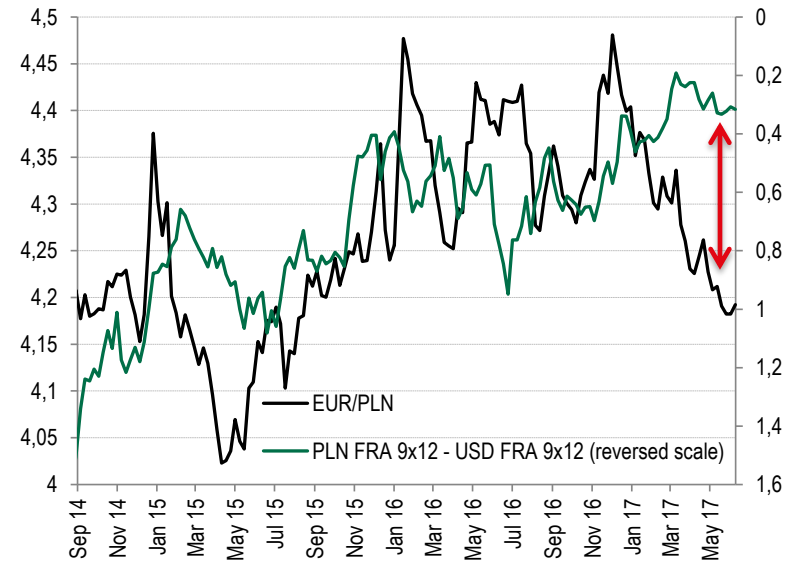
Interest rate market: Rates under the influence of global trends and domestic monetary policy

- We think that the short end of the yield curve and money market rates will remain anchored at relatively low levels in the nearest months, as stable inflation and a stronger zloty will give the central bank good reasons to keep policy on hold.
- The situation may get more interesting at the end of the year, when we expect to see core inflation reach 1.5% and wage growth to accelerate. We believe that the MPC will be very slow to change to less dovish rhetoric. As a result, the market may perceive the Polish central bank as being well "behind the curve", which may result in the asset swap widening.
- We think that IRS rates will pick up relatively slowly in the coming quarters, even though an upward move would be justified by the macro situation (correlation between the nominal GDP growth and swap rates has historically been quite high).
- Meanwhile, the bond market could be under the influence of trends abroad. In July the yields may go down again due to strong seasonal pattern and weakening inflation concerns worldwide. But our base scenario still assumes that yields in the US and in the Euro zone should rise gradually later this year, amid further monetary tightening by the Fed and possible ECB rhetoric to prepare the market for a gradual exit from its asset purchase programme in late 2017. We assume that Polish bond yields will follow this upward tendency, especially at the long end of the curve.



- In our 2017 Outlook, we were expecting the zloty to stay under pressure in the first half of the year and then gain in 2H17 when the economic growth re-accelerated. However, the zloty appreciated substantially in the first five months of 2017, with EUR/PLN reaching 4.18, its lowest level since August 2015.
- The Polish currency was boosted by growing optimism regarding the economic outlook, the dovish stance of the ECB, and the decrease of geopolitical risks in Europe, as elections in the Netherlands and France produced market-friendly results. Furthermore, the Polish currency remained resilient to monetary policy tightening in the US, thanks to the dovish stance of the domestic Monetary Policy Council.
- As a result, so far this year the zloty is the second-strongest EM currency (behind the Mexican peso) vs euro, US dollar, Swiss franc and British pound.
- The rally has paused in June but we expect the PLN to strengthen again in July and then to depreciate in August due to the seasonal pattern. Our current EUR/PLN forecasts are well below those presented in our 2017 Outlook. The zloty tends to be a cyclical currency and, in our view, faster than expected economic growth justifies a stronger PLN.

EUR/PLN and PL-US FRA spread



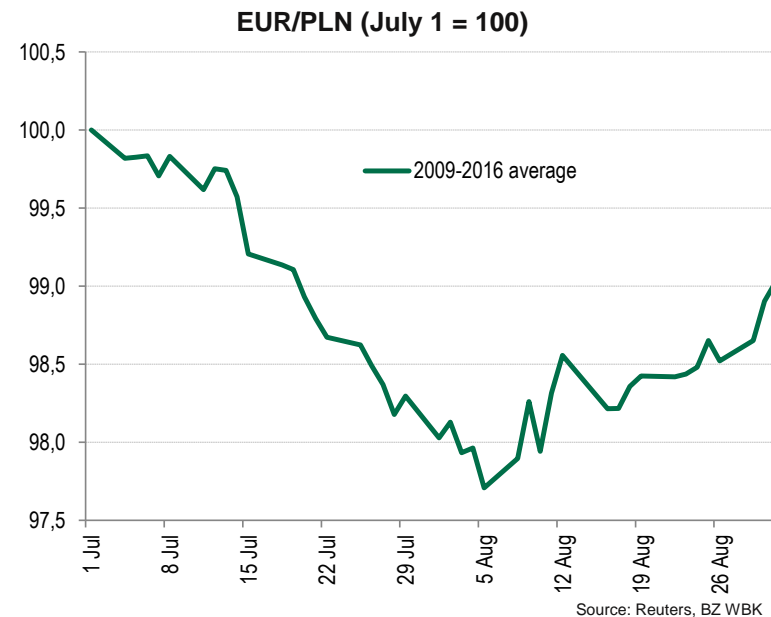
EUR/PLN forecasts vs actual

	1Q17	2Q17E	3Q18E	4Q18E
December 2016 forecasts	4.42	4.37	4.32	4.30
Realization / Current forecast	4.32	4.21	4.25	4.23

Source: BZ WBK

FX market: Short-term correction likely in the summer

- While the zloty's earlier rally was largely fuelled by the improving economic outlook, in our view this factor may stop working as we do not expect further acceleration of GDP growth in the coming quarters.
- Another argument against the PLN appreciation is the dovish Polish central bank, which may keep interest rates stable even until the end of 2018. At the same time, the US Fed remains hawkish and is likely to continue its monetary tightening, which will result in narrowing of the PL-US interest rate differential and may weigh on the Polish currency later this year.
- Seasonal factors will affect the PLN in the summer. The Polish currency usually depreciates in August after strengthening in July. In August many foreign-owned companies pay dividends to their owners, which temporarily boosts the demand for hard currencies. This year, dividends paid by banks will be much lower than in the past, due to the restrictive recommendations of the financial regulator (KNF). However, the share of banks' dividends in total dividends paid by Polish companies to their foreign owners in 2016 was only c7%. Meanwhile, the net profit of non-financial companies operating in Poland rose 20% y/y in 2016. Therefore, we think that lower bank dividends are unlikely to disrupt the seasonal pattern in the FX market.



Poland		2015	2016	2017E	2018E	1Q17	2Q17E	3Q17E	4Q17E	1Q18E	2Q18E	3Q18E	4Q18E
GDP	PLNbn	1,798.3	1,851.2	1,953.0	2,066.5	453.8	474.4	477.7	547.2	474.1	503.3	507.0	582.2
GDP	%YoY	3.8	2.7	3.8	3.5	4.0	3.8	4.0	3.6	2.9	3.7	3.6	3.8
Domestic demand	%YoY	3.3	2.4	3.5	3.8	4.1	3.7	3.6	2.8	3.4	3.9	3.9	4.0
Private consumption	%YoY	3.0	3.8	4.4	4.0	4.7	4.5	4.2	4.2	4.0	4.0	4.0	4.0
Fixed investment	%YoY	6.1	-7.9	5.2	7.0	-0.4	3.0	6.5	8.1	7.0	7.0	7.0	7.0
Unemployment rate ^a	%	9.7	8.3	7.0	6.2	8.1	7.1	6.9	7.0	7.1	6.3	6.1	6.2
Current account balance	EURmn	-2,653	-1,273	-472	-1,699	1,013	521	-2,199	192	928	249	-2,740	-136
Current account balance	% GDP	-0.6	-0.3	-0.1	-0.3	0.0	-0.2	-0.2	-0.1	-0.1	-0.2	-0.3	-0.3
General government balance	% GDP	-2.6	-2.4	-2.5	-2.6	-	-	-	-	-	-	-	-
CPI	%YoY	-0.9	-0.6	1.8	2.2	2.0	1.9	1.7	1.7	1.8	2.2	2.4	2.4
CPI ^a	%YoY	-0.5	0.8	1.4	2.4	2.0	1.7	1.9	1.4	1.8	2.2	2.4	2.4
CPI excluding food and energy prices	%YoY	0.3	-0.2	0.8	1.4	0.3	0.8	0.8	1.1	1.3	1.3	1.5	1.6

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

Interest rate and FX forecasts

Poland		2015	2016	2017E	2018E	1Q17	2Q17E	3Q17E	4Q17E	1Q18E	2Q18E	3Q18E	4Q18E
Reference rate ^a	%	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	1.77	1.73	1.73	1.73	1.73	1.73	1.73	1.73	1.90
Yield on 2-year T-bonds	%	1.70	1.63	2.02	2.35	2.10	1.94	1.94	2.10	2.25	2.32	2.32	2.50
Yield on 5-year T-bonds	%	2.21	2.35	2.85	3.14	3.03	2.75	2.65	2.98	3.12	3.12	3.10	3.24
Yield on 10-year T-bonds	%	2.69	3.04	3.48	3.81	3.72	3.31	3.27	3.63	3.78	3.80	3.77	3.90
2-year IRS	%	1.72	1.68	1.95	2.25	2.02	1.90	1.89	1.98	2.14	2.22	2.22	2.40
5-year IRS	%	2.02	1.96	2.41	2.69	2.53	2.31	2.26	2.52	2.66	2.67	2.65	2.79
10-year IRS	%	2.41	2.39	2.88	3.16	3.02	2.77	2.73	3.02	3.13	3.15	3.12	3.25
EUR/PLN	PLN	4.18	4.36	4.25	4.22	4.32	4.21	4.23	4.22	4.20	4.23	4.23	4.22
USD/PLN	PLN	3.77	3.95	3.84	3.61	4.06	3.83	3.76	3.72	3.67	3.64	3.59	3.55
CHF/PLN	PLN	3.92	4.00	3.89	3.68	4.04	3.89	3.85	3.78	3.72	3.71	3.68	3.61
GBP/PLN	PLN	5.77	5.35	4.84	4.70	5.03	4.92	4.73	4.69	4.67	4.67	4.64	4.64

Source: CSO, NBP, Finance Ministry, BZ WBK estimates.

^a at the end of period

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