MACROscope

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Turning points (still) ahead

Poland: 2019 Outlook

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Executive summary (macro)

We see clouds thickening over the global economic outlook, and although we do not expect a major downturn in Europe in 2019, the worsening external environment will gradually take its toll, further depressing Polish exports and manufacturing (strongly linked with European value chains). The good news is that domestic investments financed by EU structural funds, which have revived in 2018, are likely to continue providing a counter-balance for faltering external demand, as according to our estimate the peak of EU funded-spending in the current seven-year framework is still ahead. Private consumption is likely to remain the strongest growth engine, even though in this area the best days are probably over. As a result, **GDP growth in Poland will slow from around 5% in 2018 to around 4% in 2019, still remaining above potential and among the highest in Europe**.

There is no more slack in the Polish labour market – the unemployment rate is at new lows with deepening shortage of workers being the major obstacle for expanding business in many sectors. The good news is that the inflow of migrant workers has continued, it seems (although visibility in this area is obscured by lack of reliable data), which still creates some breathing space for entrepreneurs. The bad news: even though domestic participation rate has been on the rise, the local supply of labour is unlikely to go up further. Meanwhile, **if the economy is to expand nearly 4 percent, further job creation is needed, which means that wage growth is unlikely to moderate**.

Despite seemingly perfect environment for an inflation pickup (above-potential growth driven by consumption, tightening labour market, low interest rates, decent credit growth), price growth has not only remained muted in Poland, but even underperformed most of European markets in 2018. We believe that part of the answer to this puzzle lies in corporate profits, which have been decent enough to allow companies to absorb costs instead of passing them to customers. However, such situation cannot last forever and we observe growing evidence of margin compression process being already quite advanced. Thus, either we see the pass-through from costs to prices accelerating in the coming quarters, or corporate profits deteriorate much more in the environment of slowing economic activity. **We expect to see a gradual increase of the core inflation in 2019, going towards 2.5% by the end of the year**. The headline CPI is likely to follow almost identical path, after the risk of surge in energy costs has been mitigated by the government.

The Polish central bank has been watching the booming economy with cold blood, and probably rightly so, given scarce evidence of economic imbalances building so far. The core inflation will pick up in 2019, but slowly, so **it is hard to imagine the consensus for monetary policy normalisation building before 2020**, especially in the environment of slowing GDP growth.

It seems that excellent performance of the state budget did part of the job in terms of policy-mix adjustment, as it looks very likely that 2018 will end with almost balanced fiscal position. **2019 budget was planned responsibly, as the room for spending spree was limited by the stabilising expenditure rule**. However, given the election cycle in full swing, it seems more likely that this time the planned deficit will be utilised almost in full, which would imply a counter-cyclical policy adjustment again. With the deficit way below 3% of GDP and public debt remaining on descending path, the room for some fiscal expansion is there, if needed in case of deeper economic slowdown.

Executive summary (markets)

FX

We expect EUR/PLN to rise above the upper end of the 4.26-4.34 range in 1Q19 and ease to 4.30 at the year-end.

The first months of 2019 could bring some zloty depreciation as the hard data will finally show evidence that the economic slowdown in Poland is actually happening. Additionally, the materialisation of two Fed rate hikes in 1H19 (currently not priced-in by the market) could be negative for EM assets. The beginning of 2019 might be a tough period for the zloty also amid Brexit uncertainty as the Polish economy is among the most exposed to the no-deal Brexit. Volatility on the (not only) Polish market is very low and this also makes us cautious as regards the room for stronger zloty in the short term.

"Hard Brexit" is not our base-case scenario and any jump in volatility should be sharp but temporary. Thus, later in the year, the zloty may start benefiting from the rising EUR/USD, pause in the Fed rate hike cycle and market pricing for an improvement of the situation on the emerging markets after a turbulent 2018. However, the pace of EUR/PLN decline may be slow amid no interest rate hikes in Poland this year, continuation of an economic slowdown and markets' uncertainty ahead of the general election planned for autumn.

Our main driver for USD/PLN forecast is the assumption that EUR/USD would rise in 2019. We forecast the economic growth in the US to slow as the impact of the fiscal stimulus would fade prompting the FOMC to end the rate hike cycle in mid-2019. At the same time, the ECB should be on track to deliver first hike for years in late 2019.

FI

We assume Polish bond yields will stay low for the better part of 2019, mainly thanks to the CPI running below the NBP target and deceleration of GDP growth. We could see some (temporary) upside pressure in mid-2019 as the rise of core inflation becomes more evident and due to looming parliamentary elections. The market could worry that ideas to ease fiscal policy could be at the center of attention during the elections campaign while an outstanding budget performance in 2018 was one of the key factors pushing yields down. However, we expect the bond weakening to be only temporary as we do not assume any generous spending to be introduced and as well as we do not expect any interest rate hike in 2019.

2018 Forecasts in rearviewmirror

Indicator	Our view - 12 months ago	Outcome
GDP	Growth has already peaked, but should remain solid, near 4%, supported by a very favourable external environment and accommodative domestic macro policies.	The economy proved much more resilient than we had ever dreamed, with GDP growth running at c5% y/y for already five quarters in a row. External environment deteriorated quickly, but it was offset by strengthening domestic 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.	Consumption confirmed to be the main growth engine and was joined by stronger-than-expected revival in fixed investments, fuelled by pre-election spending spree in local governments. Inventories rose strongly third year in a row.
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.	As expected, jobless rate fell and labour shortages deepened. However, wage growth refused to accelerate much above 7% y/y, possibly due to, among others, continuing inflow of migrant workers and rising labour participation.
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%.	Inflation hugely disappointed once again, remaining below 2% for the better part of the year. Core inflation, instead of accelerating, stayed muted below 1%.
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.	Inflation's underperformance suppressed hawkish voices in the MPC. Despite the first motion for a rate hike being filed in November, the broad consensus in the Council supports no changes in monetary policy not only in 2018 but also in 2019.
Fiscal policy	Fiscal budget still under control, even though the scope for further improvement in tax collection seems limited.	Strong economic growth and progress in tax compliance resulting in excellent fiscal performance. The year is likely to end with the best fiscal balance on record.
Fixed income market	The first half of the year will see the rise of short end of the curve, in reaction to rising inflation. Long end should go up following core markets, more slowly.	Subdued inflation, central bank's 'wait-and-see' approach and scarce debt supply kept short end of the curve low. Long end more closely followed German Bunds than US Treasuries.
FX market	Stabilisation of PLN in a narrow range, as improvement of macro fundamentals and political uncertainty has been already priced-in.	The view was broadly correct, which is reflected in our first rank in Bloomberg's FX forecasts comparison. EURPLN was hovering in a narrow band, although at a slightly higher level than we had initially assumed.

2019 Forecasts and main risks

Indicator	Our view (in a nutshell)	Main risks
GDP	The economic cycle has matured and the coming quarters will see GDP growth slowing moderately, yet still holding somewhat above potential.	We expect slowing global economy, but no major downturn. If external environment deteriorates more, it could have negative implications for Polish economy, either directly or through our links with EU.
GDP breakdown	Consumption still contributing the most, although slowing gently amid deceleration of real disposable income. Moderate investment growth continues, fuelled largely by public spending on infrastructure. Net exports slightly negative again.	Upside: consumption and investment growth may exceed expectations, especially if the inflow of migrant workers accelerates (triggered by Russia’s next incursion in Ukraine, for example). Downside: deeper external shock negative for exports.
Labour market	Polish economy needs to continue creating jobs to grow c4%, so labour shortages likely to persist. Depleted domestic resources make us dependent on migrants flow. Wage growth will remain elevated, but unlikely to accelerate much amid slowing GDP, corporate profits under pressure, continuing migrants inflow and (later on) introduction of PPK scheme.	In case of a significant slowdown in net inward migration, Polish companies may struggle to fill in the resulting vacancies. Fortunately, Germany’s plan to open the labour market to non-EU citizens have been postponed until 2020.
Inflation	Once again we expect to see a turning point for inflation as all preconditions for higher price growth are in place. Even though the electricity tariff spike will be muted by the government, other factors will be pushing up corporate costs, which should finally lift core inflation towards 2.5%, in our view, as the process of margin compression is already advanced. However, the inflation pickup will be quite slow.	If inflation could have disappointed once, why cannot it do the same next year? Perhaps there is some piece of the puzzle we are missing? On the other hand, we find it difficult to justify why inflation in Poland should be persistently among lowest in Europe, so we feel that risks for our (cautious) inflation forecast are skewed to the upside. Once firms start pushing through costs to customers, the scale of rebound may exceed expectations.
Monetary policy	Monetary Policy Council signalled clearly it would have lots of tolerance for inflation’s deviation from the target, as long as there is no strong evidence of a persistent upward trend in core inflation. It means that 2019 will be another year of interest rate stabilisation.	Speculation about monetary tightening could appear back on the radar should inflation pickup prove much stronger, with risk of persistent breach of 2.5% target. In case of deeper economic slowdown and/or another downward inflation surprise the MPC will not hurry to cut rates due to worries about impact on small banks’ stability.
Fiscal policy	No risks on the horizon as long as economic growth is solid. Budget draft is based on realistic assumptions and does not allow for spending spree, despite 2019 being the election year.	Major economic downturn and lack of inflation are the biggest threats for fiscal performance, as budget deficit reduction in the last two years was largely cyclical.
Fixed income market	The yields of Polish bonds will remain low over most of 2019, mainly owing to the CPI staying below the NBP inflation target and a deceleration of GDP growth, plus the supply of bonds still being not very high.	Yields could go higher if global growth outlook proves more positive than currently priced-in by the market and thus expectations for faster / more aggressive monetary policy tightening increase. In the event of much more severe slowdown, long end of the curve may be under pressure of growing credit risk.
FX market	Slowing economic growth and Fed rate hikes would weigh on the zloty in early 2019. Later, PLN could rebound amid euro strengthening vs dolar, among others.	"Hard Brexit" could spur risk aversion sending EURPLN higher than we expect. On the other hand, fewer rate hikes in the US might push the exchange below our target.

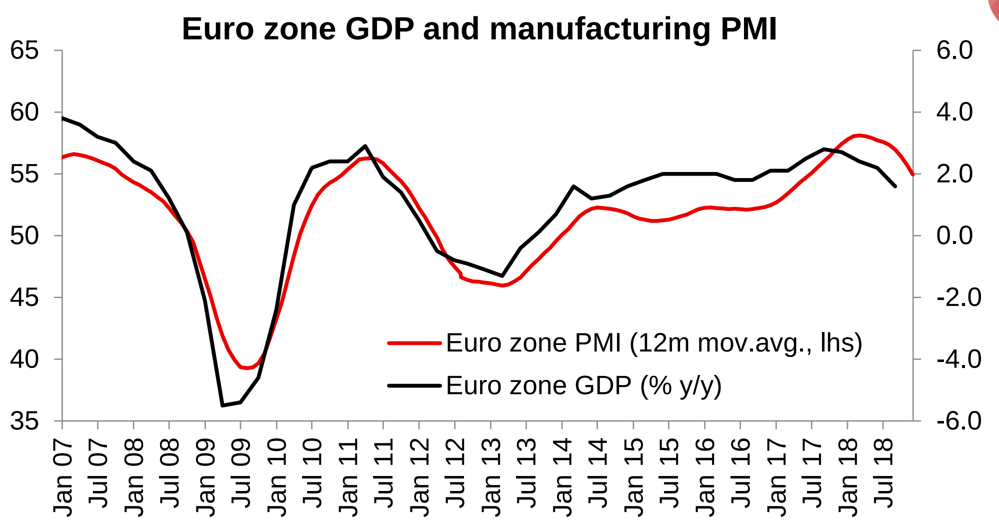
External environment: slowdown, but how deep?

2018 saw European manufacturing PMIs plummeting after their superb performance in the previous year. But as much as leading indicators' surge at the end of 2017 was not a good harbinger of the following change in economic cycle, their recent collapse must not herald economic doomsdays ahead. We still think that euro zone domestic demand has strong fundamentals and the GDP growth slowdown in Europe in 2019 should be only mild. Similar story applies to US economy, where – despite confidence surveys still being high – tighter monetary conditions and gradually wearing off effects of fiscal stimulus will lead to slightly slower GDP growth.

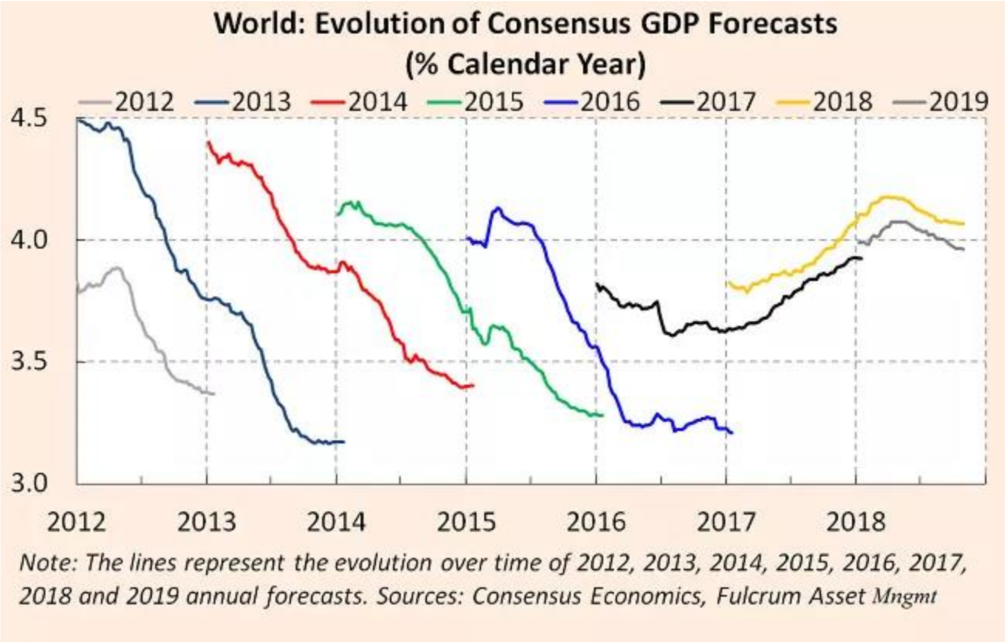
That leaves us with global economic growth still strong enough to allow the main central banks continue / start their monetary policy normalisation. The US Fed may increase main interest rates twice in 2019, in our view, while ECB should start lifting rates before the end of 2019.

There are, of course, many risk factors to this scenario, including Brexit, trade tensions escalation, or political instability in Europe.

It should be noted that in the last couple of years – barring 2017-18 – the evolution of global growth forecasts was quite similar: the initial deterioration of expectations always started very gently, but as the time went by, the reality check proved to be brutal. The last two years showed this is not a universal phenomenon, and we do not expect the pattern to repeat in 2019, but it suggests a risk one should reckon with.



Source: Markit, Santander



Source: FT.com

Leading indicators: mixed evidence

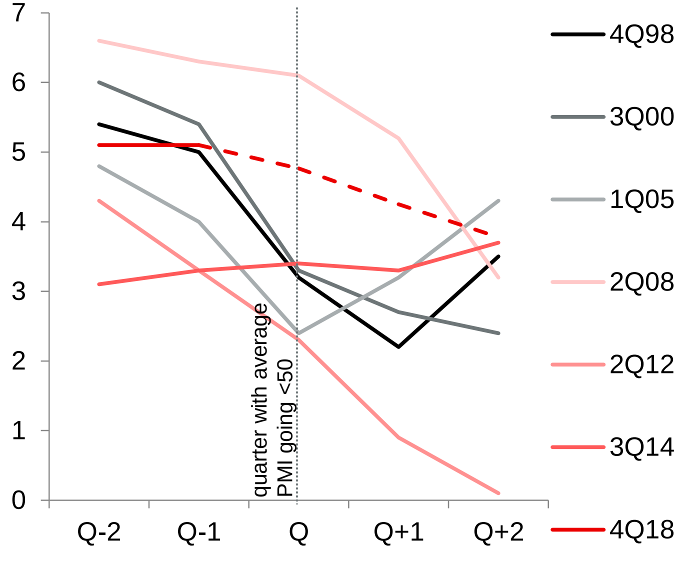
The leading indicators for Polish manufacturing tell two different stories at the same time, depending where you look at.

PMI, after declining throughout 2H18, dropped below the breakeven level of 50 pts in November-December. Historically, when quarterly average of PMI sank below 50 it was followed by GDP growth slowdown of varying intensity. 2014 was an exception, but PMI spent only three months below 50 pts back then. Still, it has to be noticed that in general the PMI is a 'noisy' indicator, signalling too often swings in business sentiment.

In contrast, European Commission's ESI and GUS sentiment indicators signalled a "second wind" among businesses in November and December despite deteriorating euro zone leading indicators. Yet, it should be remembered that those indicators have been overly optimistic earlier in 2018. GUS also showed an acceleration in the value of industrial new orders in late 2018.

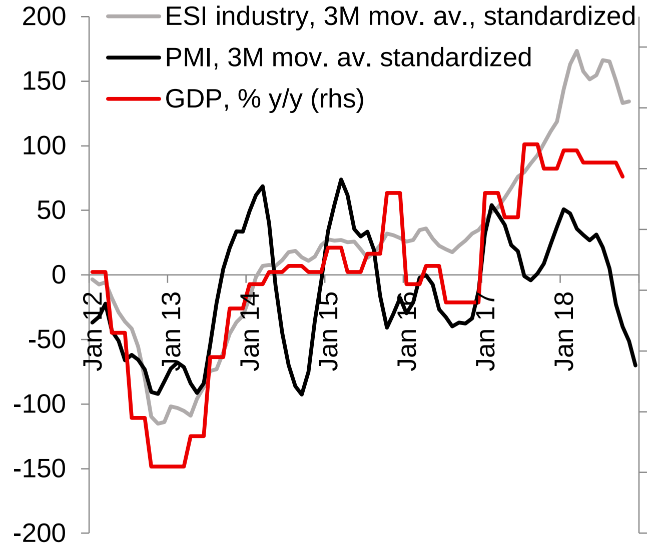
Our take on the diverging signals is that there might be a really gentle, gradual slowdown down the road for the Polish economy.

GDP growth around periods of PMI's sub-50 decline



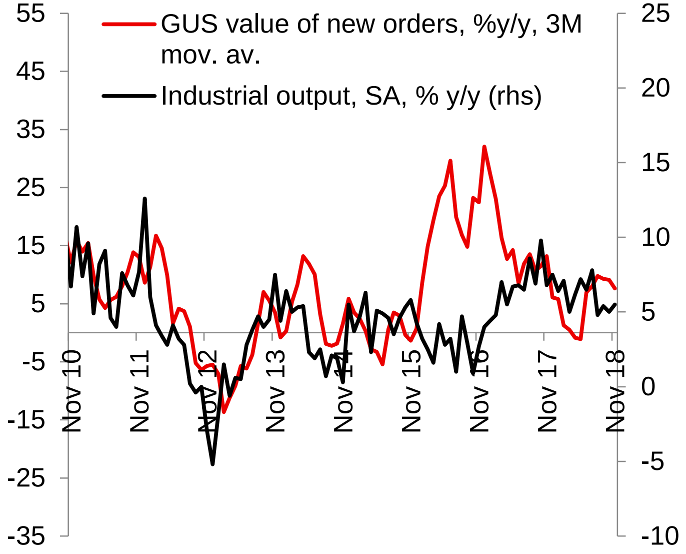
Source: GUS, Markit, Santander

Mixed signals from leading indicators



Source: GUS, Eurostat, Markit, Santander

New orders speak against slowing output



Source: GUS, Santander

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GDP in 2018: defying gravity?

Polish economy has clearly decoupled from the Western European world in terms of economic growth in 2018. Whereas most of the European economies experienced a soft patch at the start of 2018, Poland managed to continue surprising to the upside, with GDP growth running at around 5% y/y for already five quarters in a row.

The deterioration of external environment has been counterbalanced by healthy domestic demand: relatively robust consumption, reviving investments and build-up of inventories.

The positive surprises from domestic economic data and the economy's resilience to business climate deterioration abroad triggered systematic upward revisions of GDP growth forecasts throughout the year, even though forecasts for euro zone economies have been trending in the opposite direction since early 2018.

It has been the second straight year when the performance of domestic economy has clearly surprised us to the upside. Will we be more lucky third time, predicting mild slowdown for 2019? Let's see…

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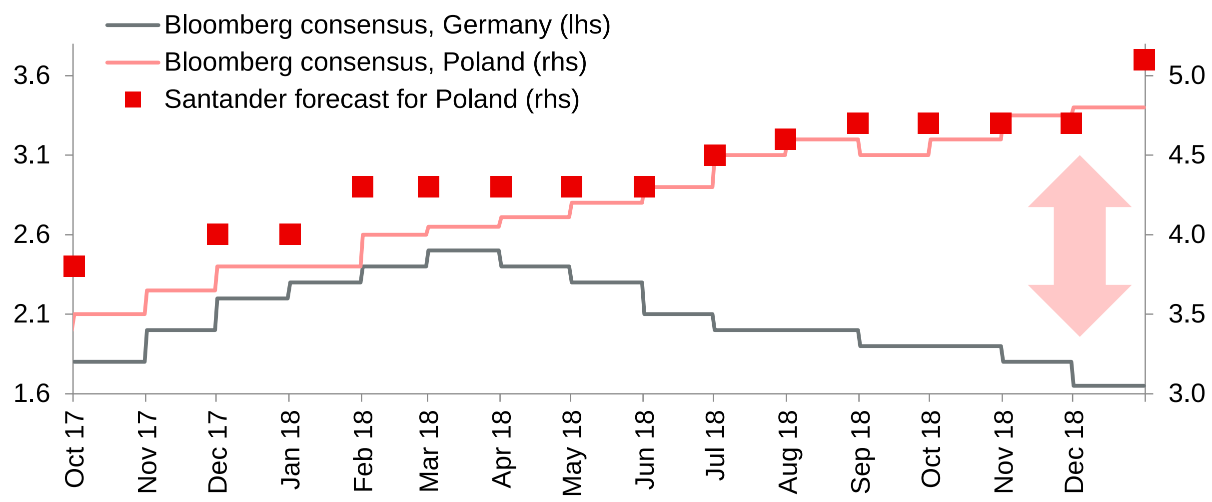
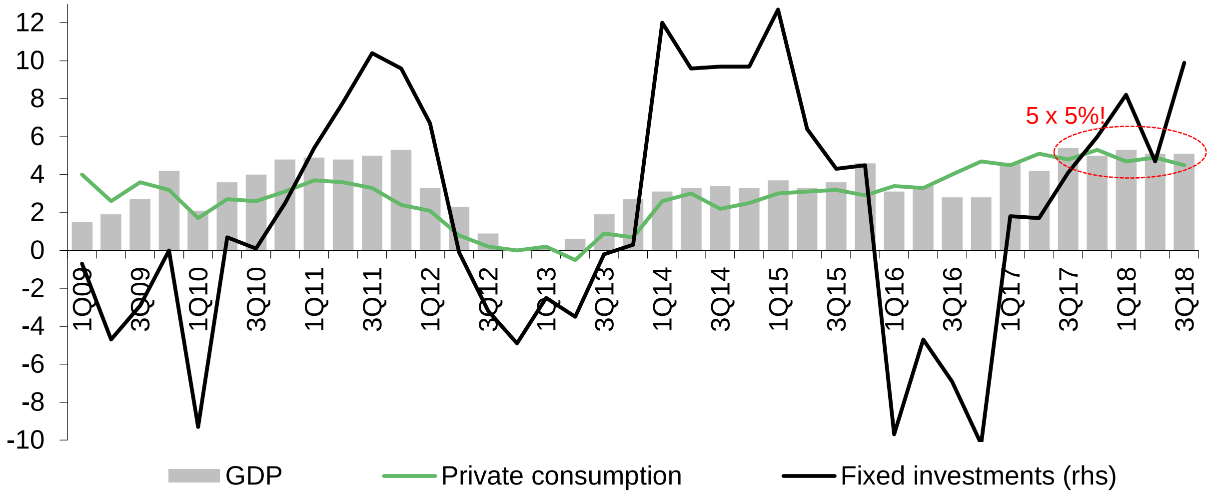
Evolution of 2018 GDP forecasts for Poland and Germany



Source: Bloomberg, Santander

GDP growth and its selected components (%y/y)



Source: GUS

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GDP in 2019: still flying high

The five-percent GDP growth will be hard to sustain much longer, given deteriorating external environment (trade tensions, potential slowdown in economic growth abroad and in international trade) and building domestic challenges (deepening labour shortage, already high capacity use, corporate margin compression). However, the pace of expansion should remain decent in the coming quarters, with the domestic demand playing the first fiddle.

The good news is that domestic investments financed by EU structural funds, which have revived in 2018, are likely to continue providing a counter-balance for faltering external demand, as according to our estimate the peak of EU funded-spending in the current seven-year framework is still ahead. Private consumption is likely to remain the strongest growth engine, even though in this area the best days are probably over.

In general, the structure of economic growth should closely resemble what we saw in 2017-18, although the pace will be slightly smaller. On the following pages we present more details about the growth components.

Source: GUS, Santander

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Consumption: keep calm and carry on

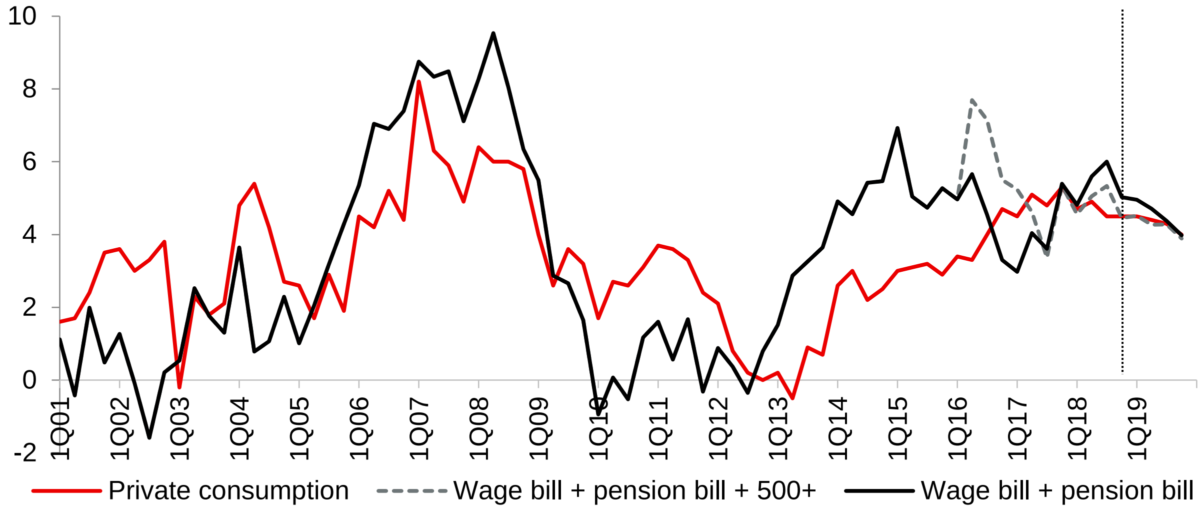
In our view private consumption will remain the backbone of GDP growth in 2019. Even though the peak of the consumer spending cycle is probably behind, growth rate well above 4% y/y should be easy to maintain given predicted trajectory of labour income and social subsidies. Employment should keep rising, wage growth in the private sector should remain elevated, and wages in the public sector (already rising nearly 8% y/y) may even accelerate further, which should prevent any material slowdown. On top of it, households' saving rate might decline some more as real interest rates are unlikely to rise this year.

The 500+ child benefit programme played its role in reviving consumption in 2016-2017, but has already become a drag on total income growth. The flows to households are already shrinking in y/y terms (by 15.7% in 2Q and by 22.9% in 3Q), mainly due to stricter verification of beneficiaries and demographic changes (more children reaching age 18 than entering the pool). Also, the payments are not CPI-linked, so their real value decreases with time.

Consumer confidence (GUS measure) flattened out in 2018 at record high levels, higher than in 2017 when private consumption accelerated to 4.9% on average. Electricity bill uncertainty caused a large drop in December, but it might be reversed as this issue is already solved.

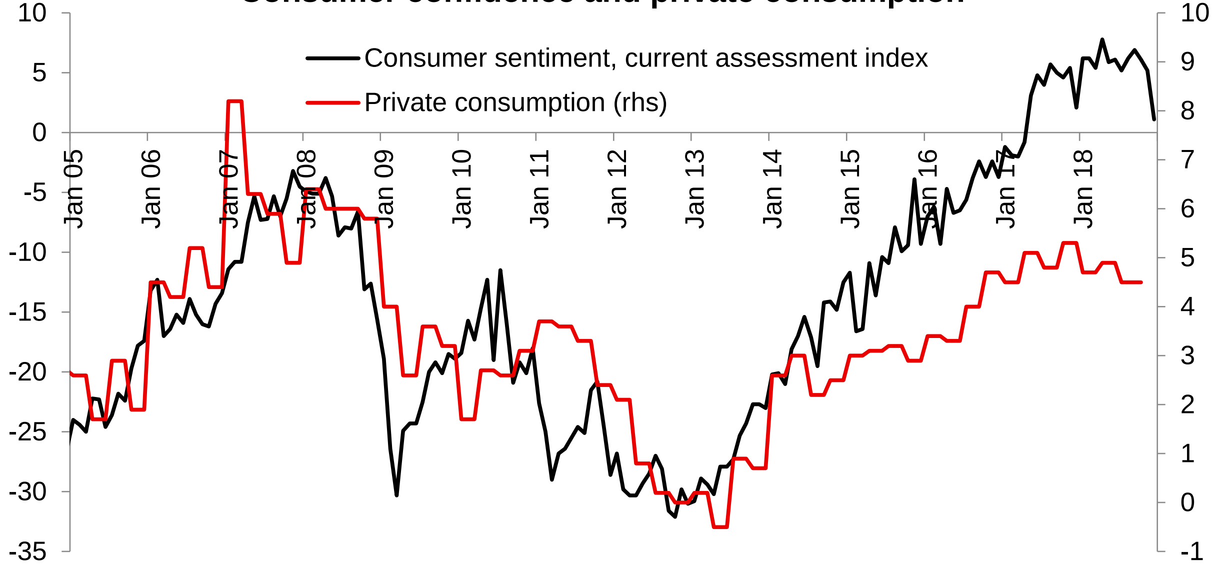
Negative risks to 2019 private consumption are linked to higher cost of living. Rise of electricity bill will be covered by the state, but rise of prices of gas, heating and solid fuels plus extra tax on fuel will not. The gradual introduction of Employee Capital Plans (PPK) from mid-2019 on will be denting disposable incomes as well.

Real growth of households' income measures and private consumption



Source: GUS, Santander

Consumer confidence and private consumption



Source: GUS, Santander

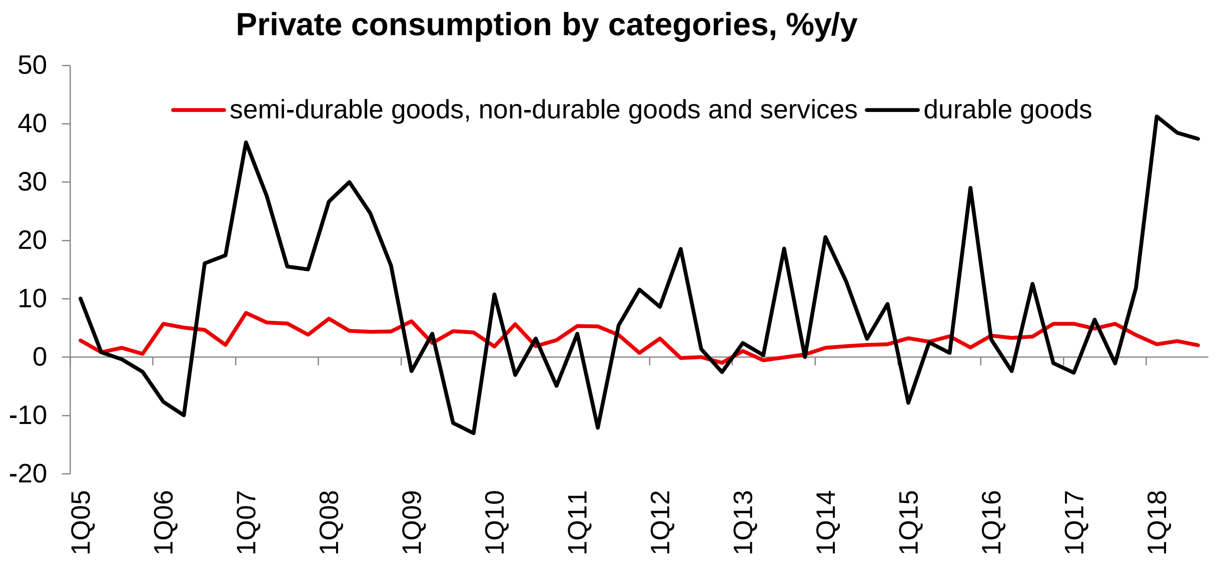
Consumption: how durable?

Eurostat breakdown of household consumption expenditures shows a 35-40% y/y increase of durable goods purchases in the recent quarters – a pace that seems hard to maintain much longer – and relative weakness in the other categories. Consumption of durables is very volatile and its high phase usually occurs late in the cycle.

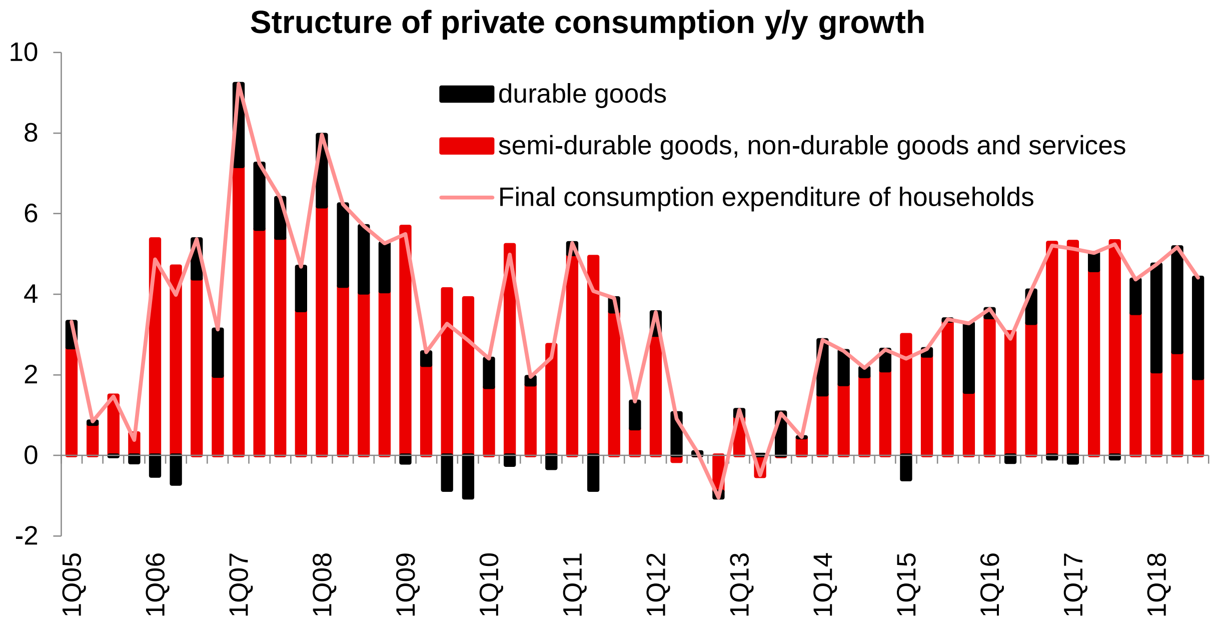
Note also that in 2007-2008 sizeable contribution from durables came on top of strong performance of other consumption components. This time the total consumption growth is stable so far, but consumption of durables is crowding out the remaining categories instead of building on top of their stable pace of growth.

What is more, consumer survey showed in 4Q a decline of attitude towards major purchases with a simultaneous rise of the propensity to save (an alternative use of household budget surplus).

This suggests a slowdown in 2019 when base effect in durables consumption starts to weigh. And yet in 2006-2008 a double-digit growth in durables lasted for 10 quarters. What is more, the deceleration back then was a consequence of the global financial crisis rather than a natural move to another phase of the business cycle. If this time we assume gradual loss of economic momentum, consumers may be able to smooth the consumption path more than during the crisis.



Source: GUS, Santander



Source: GUS, Santander

Consumption: limited room for credit boost?

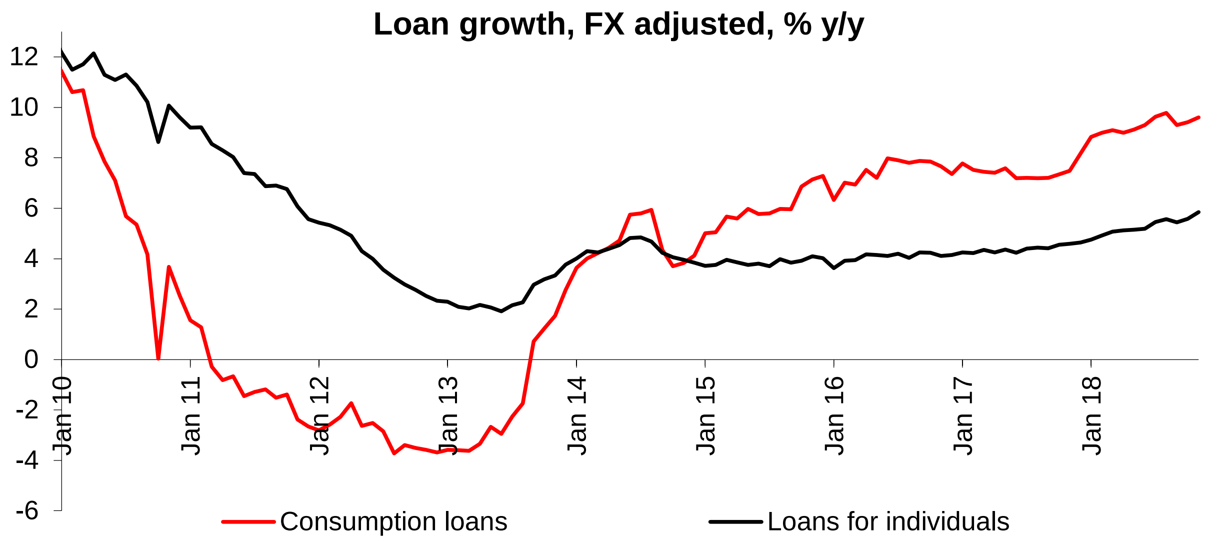
Theoretically, when real income growth decelerates, the credit boost could help to keep consumption growth afloat. However, in our view chances for such scenario in current environment are limited.

Consumer loans are already running at a high 9%+ y/y pace, the strongest in eight years, so what we observe in private consumption is already supported by credit.

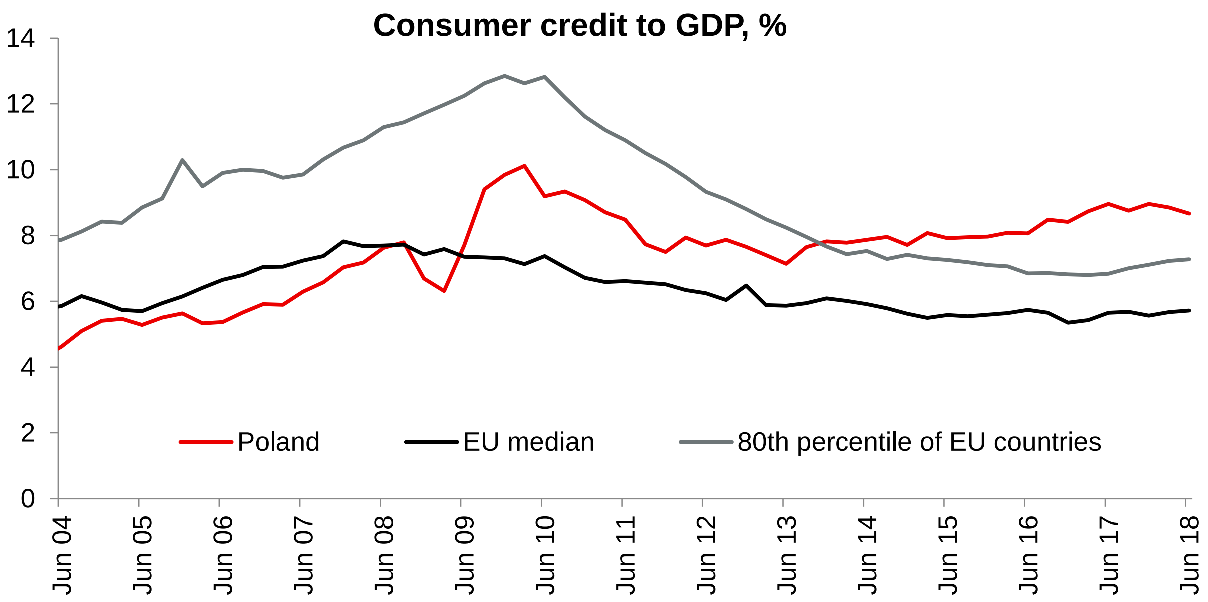
In 3Q senior loan officers' survey banks reported strong demand for financing of durable goods purchases, unlike in the previous periods. Nevertheless, the index of banks' expectations for consumer credit demand in 4Q remained relatively low.

What is more, ESI consumer survey reveals a change of approach towards saving vs using financial leverage. Compared to the peak of the cycle in 2007, the share of households which are running into debt decreased from 9% to 2% while the share of those who are putting aside rose from 17% to 35%. However much of this difference between the shares at the cyclical peaks might come from the rise of disposable income that occurred in the meantime.

Apart from all this, the economy is already relatively saturated with consumer loans compared to the rest of Europe, unlike in other loan categories. The ratio of consumer credit to GDP for Poland is one of the highest in the EU. So, the room for further expansion of consumer loans does not seem to be exceptionally large.



Source: NBP, Santander



Source: NBP, Santander

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Investment: driven by the public sector

In 3Q18 investment grew by almost 10% y/y, posting the highest growth rate since early 2015. About 2/3 of the entire investment growth was achieved by local governments, which were on a pre-election spending spree. In the first half of the year, investment in other economic sectors remained in stagnation, but in our view the private sector may have shown some revival in 3Q18 First, statistics on investment in companies employing 50+ people showed a 15% y/y growth in 3Q18. Second, Breakdown of investment by assets showed a rebound in machinery and equipment (14.3% y/y), which is strongly correlated with investment in companies.

In our view, public investment will remain strong, driven by projects started prior to elections (note that we have other two elections coming in 2019) and by increasing utilisation of EU funds. We see EU-funded investment to peak in 2019, see page 15. Central budget's investment plans for 2019 are actually lower than for 2018: PLN32.4bn versus PLN35.4bn of total property spending and EU projects co-financing. However, 2018 realisation is rather low, at PLN14.9bn after October, so growth in actual numbers is quite probable.

Even with the probable rebound in 3Q18 in mind, the 2019 outlook for private investment is not too positive. Some business sentiment indicators are already going down, investment surveys point either to decline or to just minor growth, firms are witnessing falling margins and are pointing to persisting institutional uncertainty as an important drag to their expansion plans. Thus, in general we are expecting the 2019 investment demand to be still driven mostly by the public sector.

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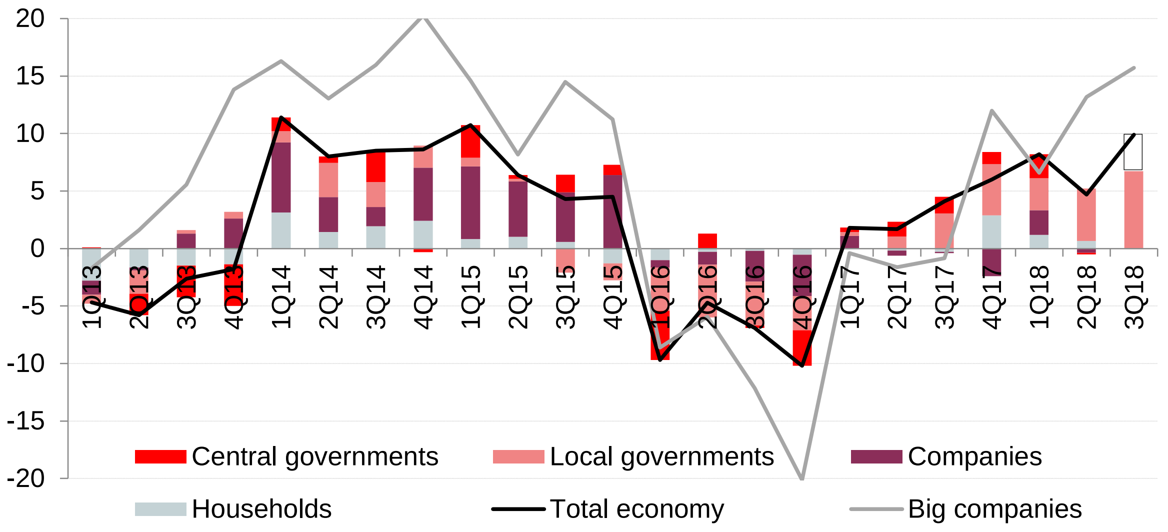
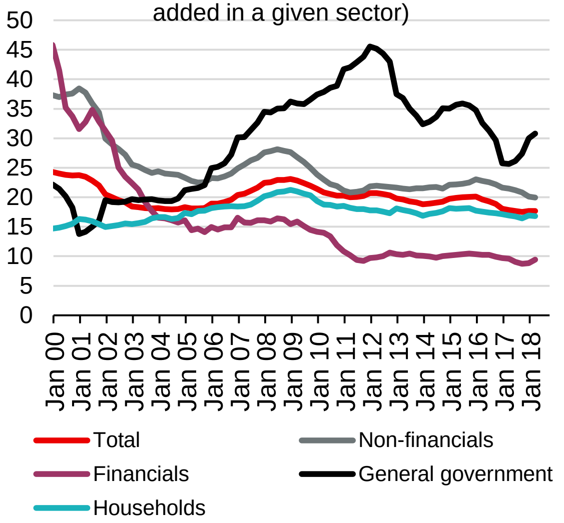
Investment growth breakdown by ownership



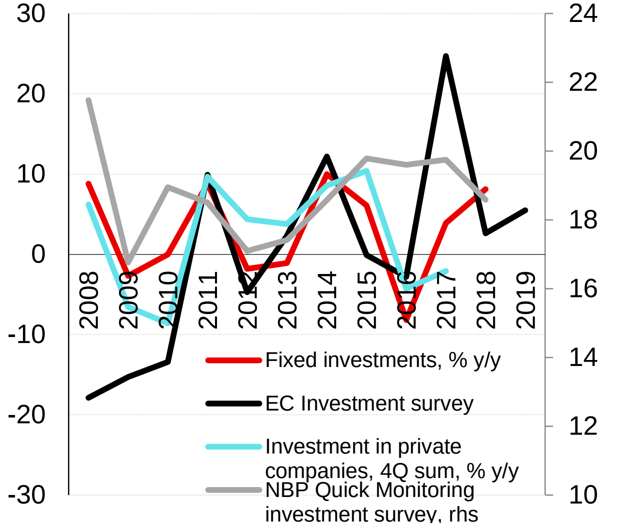
Source: GUS, Eurostat, Santander

Investment rates by sector

(fixed investments in relation to gross value added in a given sector)



Fixed investment: Actual vs Surveys



Source: GUS, European Commission, NBP, Eurostat, Santander

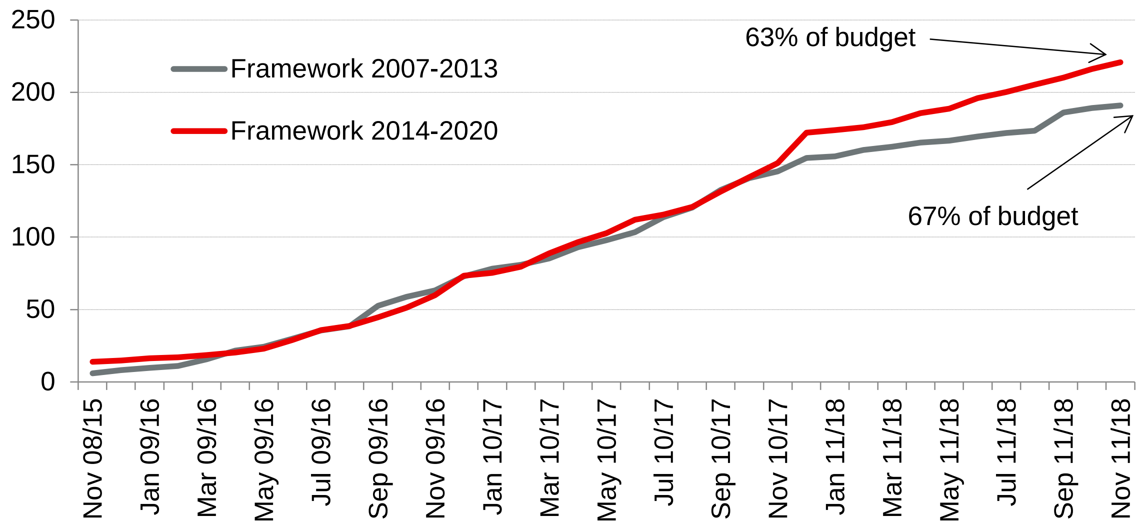
Investment: EU spending to peak in 1H19

Utilisation of EU structural funds from 2014-2020 financial framework was rising steadily throughout the year, surpassing PLN200bn in the middle of the year. Until November, 63% of the total budget for Poland was contracted as compared to 67% for the 2007-2013 framework in November 2011. At the end of 2017 these ratios amounted to 49% for 2014-2020 framework and 55% for 2007-2013 framework, meaning that some slack was cut in 2018.

According to our estimates, EU-financed investments accelerated markedly throughout 2018. That having said, total utilisation in Jan-Nov period in 2018 was way lower than in 2017 (PLN48.7bn vs PLN78bn, respectively). According to our model, contracts become actual investment in six-eight quarters, so we estimate the peak of EU-funded investment to occur in 4Q18-3Q19 period.

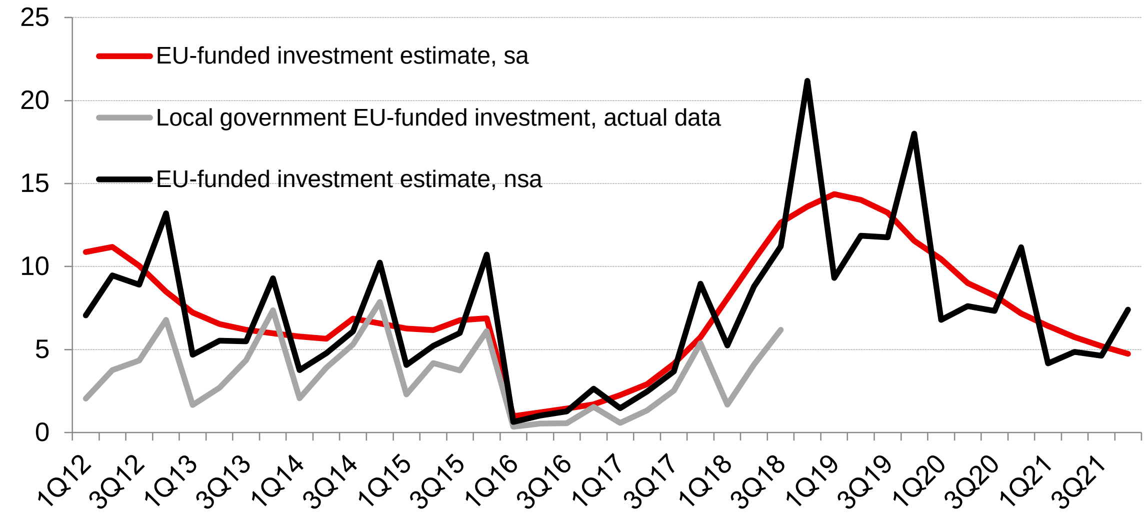
With EU-funded investments peaking in 2019, their contribution to total investment growth will amount to about five percentage points, so it will be similar to contribution in 2018, or even slightly lower. In 2020 the impact of EU-funded investment on total investment growth rate is likely to be negative.

Utilisation of EU funds: 2008-11 vs 2015-18, PLNbn, signed contracts



Source: Ministry of Development, Santander

Estimate of EU-funded investments, PLNbn



Source: Ministry of Development, Ministry of Finance, Santander

Investment: does leasing tell different story?

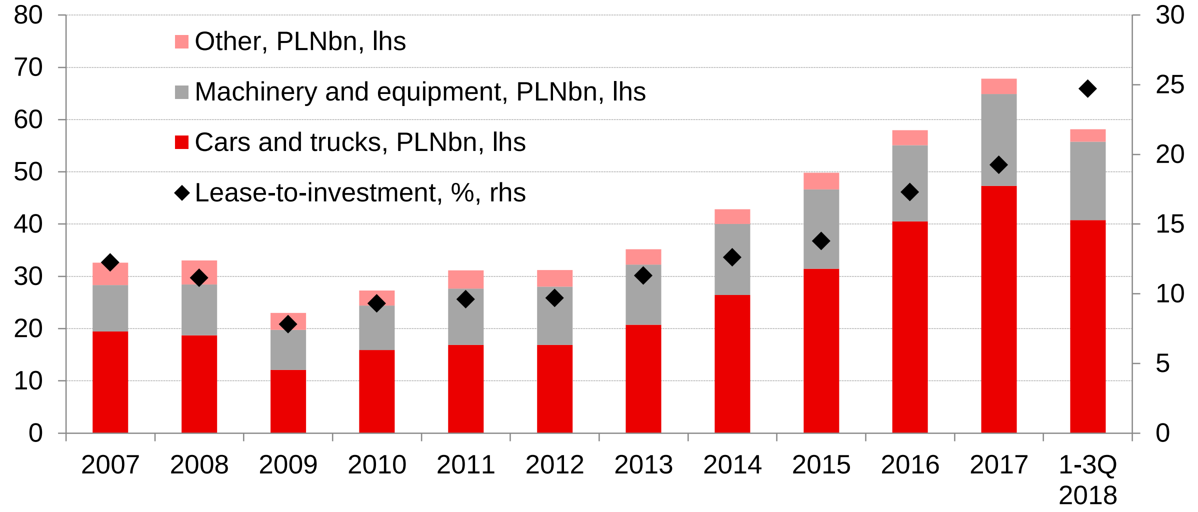
The rather moderate recovery of investment in 2018 provoked speculations that the Statistics Office understates the investment numbers. Such worries were even voiced by the NBP president Adam Glapiński, who announced that the central bank would issue an official enquiry on this matter.

A potential explanation, put forward by market analysts, was that the Office does not fully account leases, which are strongly growing in importance as a source of investment financing. According to Polish Leasing Association (Związek Polskiego Leasingu, ZPL), total value of leases in 2017 amounted to PLN68bn as compared to PLN352bn of total fixed investment in 2017 (19.3%). In 2012, leasing-to-investment ratio stood at 9.7%

We see no reason to doubt the Stat Office's statistics. However, we decided to make some back-of-the-envelope calculations showing what would happen with investment if market doubts proved accurate. We assumed that the Statistics Office completely omits leases in investment data and we added their value by ZPL to arrive at corrected values and growth rates of investment.

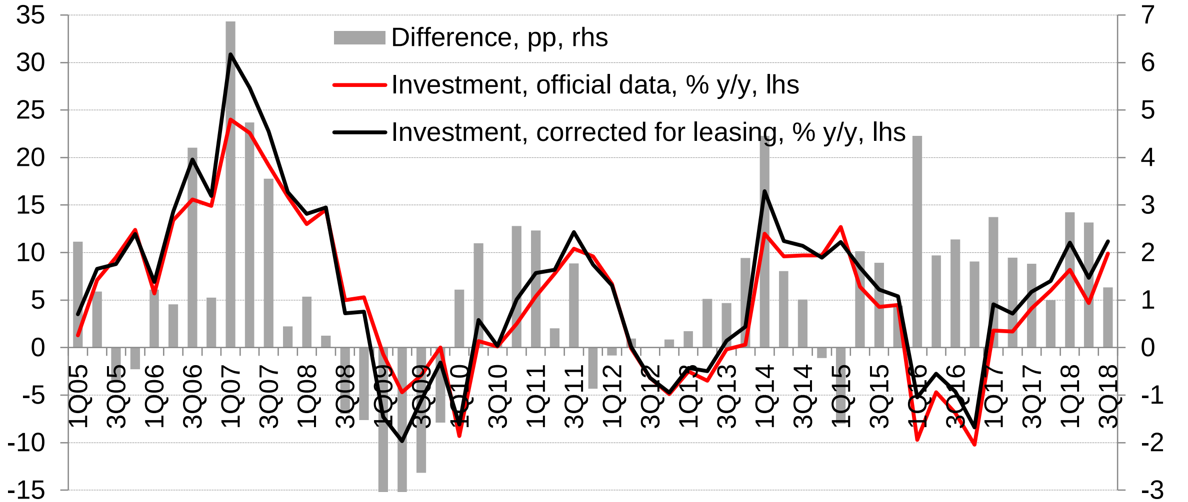
We estimate that the error of omitting leases would result in understating investment growth rate by about 2 percentage points in 2017-2018. Note that adjusting investment for leasing does not change the general trend at any point of time.

Value of leases in Poland



Source: ZPL, GUS, Santander

Investment corrected for leases, % y/y



Source: ZPL, GUS, Santander

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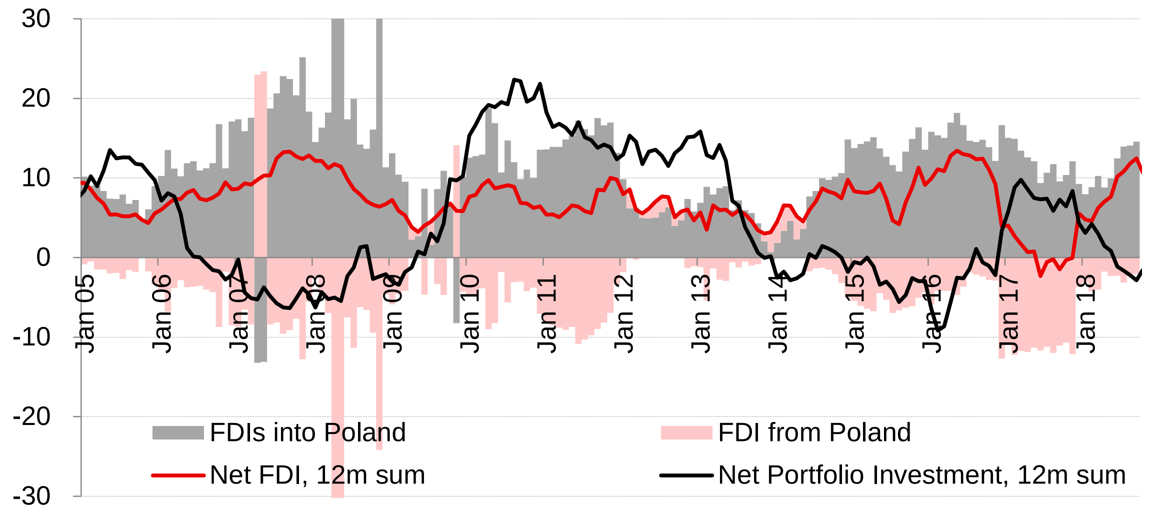
FDIs back on track

2017 saw a major slowdown in net FDI. In our last yearly outlook, we argued that this was a one-off due to one big ticket transaction and rebalancing between portfolio and direct investments. Our call proved true and 2018 saw investment values return to averages, with October 2018 net 12-month FDIs at €10.6bn. We expect this trend to continue in 2019.

In 2017, gross inflow of FDI into Poland amounted to €8.1bn, breaking down into +€8.9bn of reinvested profits, -€0.4bn of change in equity and -€0.4bn change in net debt instruments. Biggest inflow of FDIs came from Germany (€3.0bn), Luxembourg (€2.9bn), Cyprus (€1.3bn) and Austria (€1.2bn), while major outflows were seen in case of Italy (-€2.0bn), Netherlands (-€1.7bn) and France (-€0.9bn). Polish FDIs into other economies grew by €2.4bn and were directed mostly to Sweden (+€1.7bn) and Luxembourg (+€1.0bn), while investment in Cyprus fell by €1.6bn.

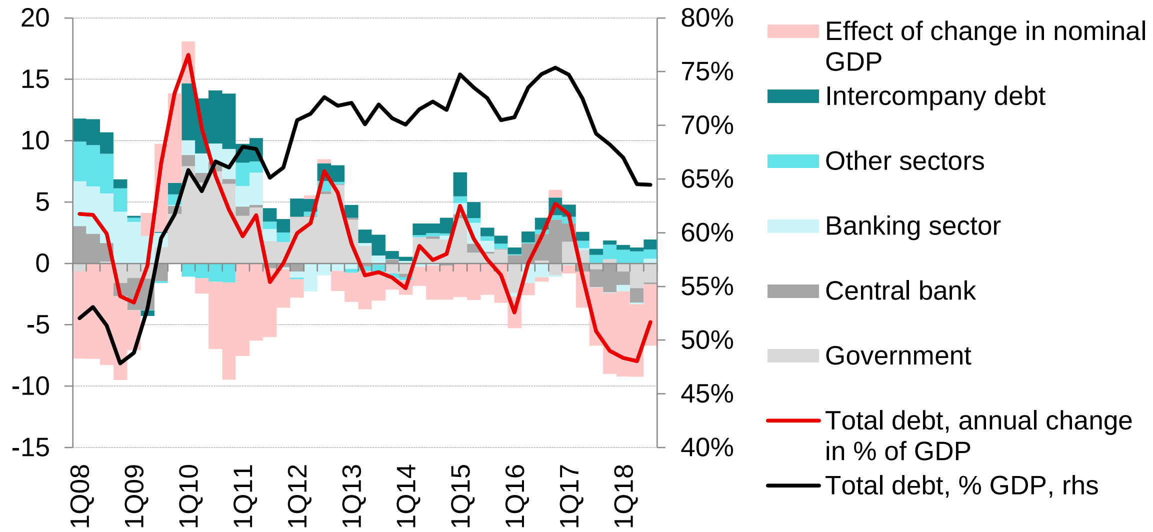
Poland's gross external debt fell to 64.5% of GDP in 3Q18, the lowest since 2Q10. In annual terms, debt fell 4.8% of GDP after a decline by 8.0% of GDP in 2Q18 (this was the most considerable fall since comparable data have been available, i.e. 2004). This decline was achieved primarily thanks to strong GDP growth (over 6.0% y/y in nominal terms), and only a slight growth of nominal indebtedness, and with falling foreign debt of the government. A further decline in gross external debt would be welcomed by rating agencies.

FDI and portfolio investment, PLNbn



Source: NBP, Santander

Gross foreign debt, % of GDP



Source: NBP, Santander

Foreign trade: export unlikely to take off

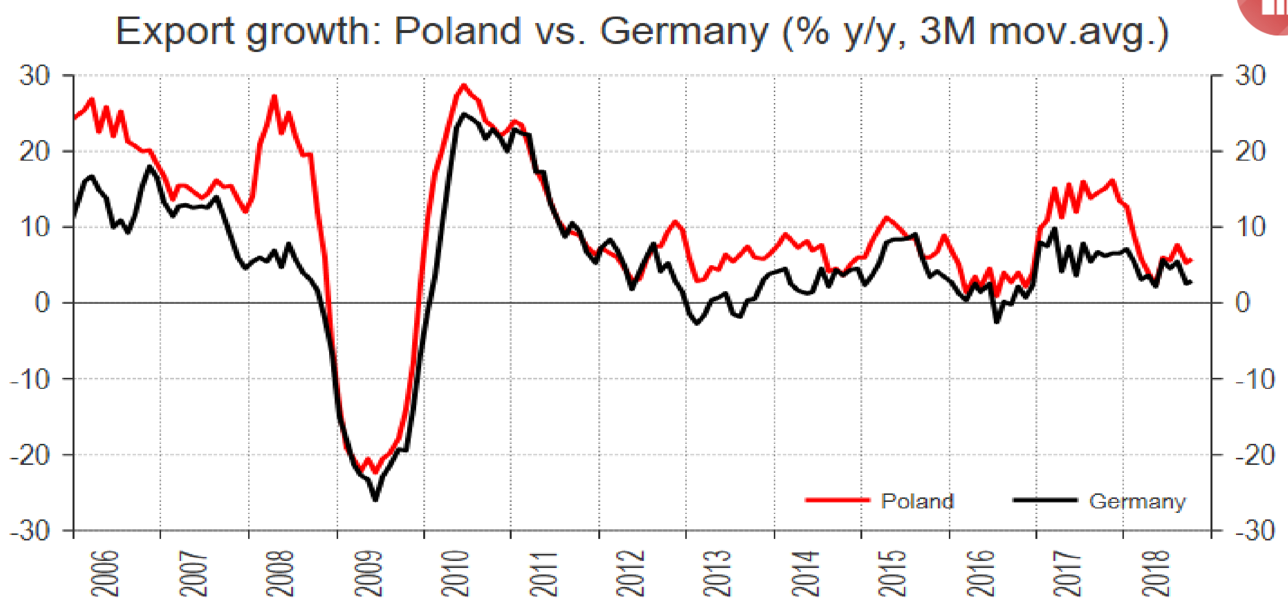
Polish export growth decelerated visibly in 2018, following a similar pattern in German and – more broadly – in global trade. The slowdown was broad-based and affected all major Polish export markets.

The outlook for the coming quarters does not look particularly bright, given the clouded global growth outlook and persisting trade tensions, which may negatively affect the international trade turnover. It is virtually impossible to see a revival in Polish exports without a pickup in EU (or, more specifically, in Germany). Therefore, we expect Polish export growth to slow to about 3.0% y/y in 2019 from 5.5% in 2018.

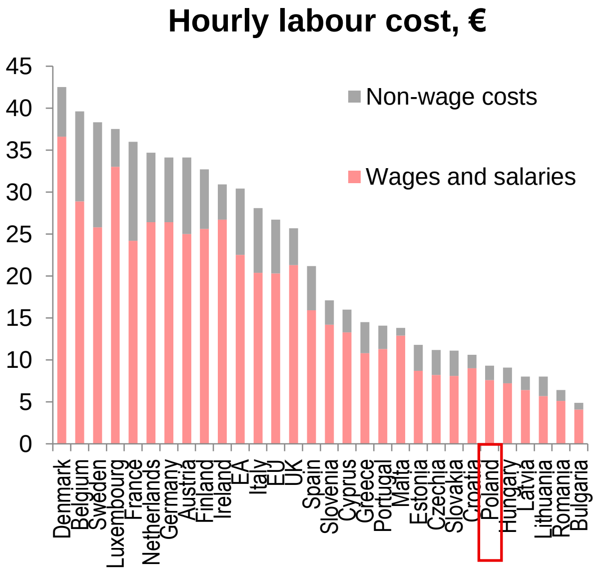
On the flip side, the competitiveness of the Polish exports does not seem to be significantly undermined. The pace of unit labour costs growth has accelerated in the recent quarters, but remains below the most of the CEE peers. And the gap between costs of labour here and in the developed Europe is still huge.

As regards the exchange rate of the zloty, it has trimmed part of the appreciation recorded in 2017 and does not seem to be overvalued (with Real Effective Exchange Rate being only c5% above the trough reached just after the 2008 global economic crisis and 3% below its 20Y average). The NBP survey shows that both EURPLN and USDPLN are well above levels, which secure profitability of Polish exports.

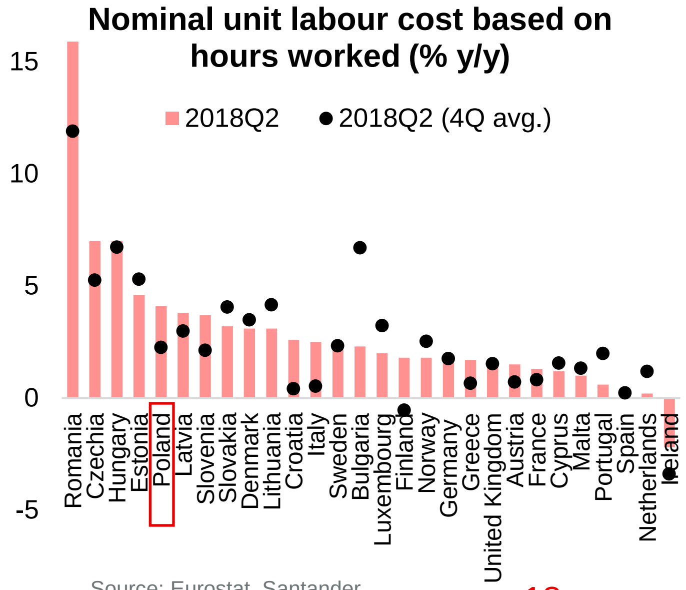
After all, one should remember that historically the strength of external demand always proved to be much more important for Polish export performance that the level of exchange rate.



Source: Thomson Reuters Datastream



Source: Eurostat

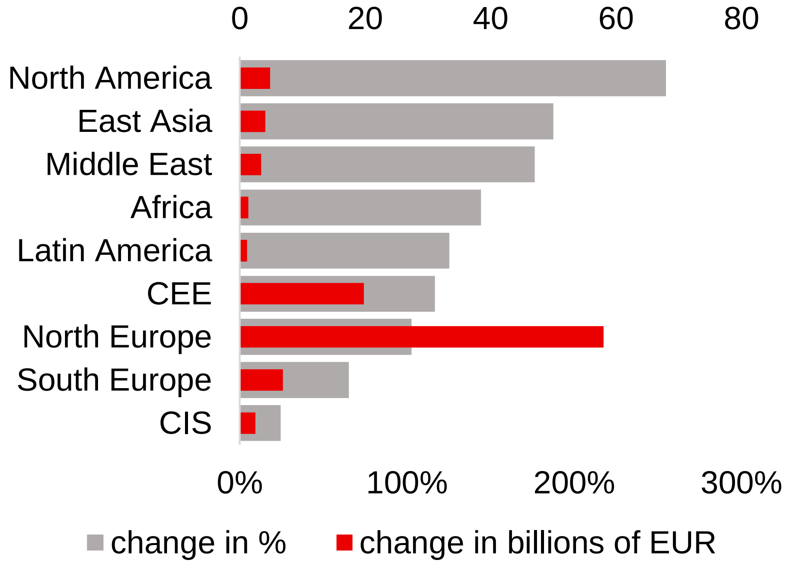


Source: Eurostat, Santander

Foreign trade: expansion beyond Europe continues …
… but it's still only a (growing) margin

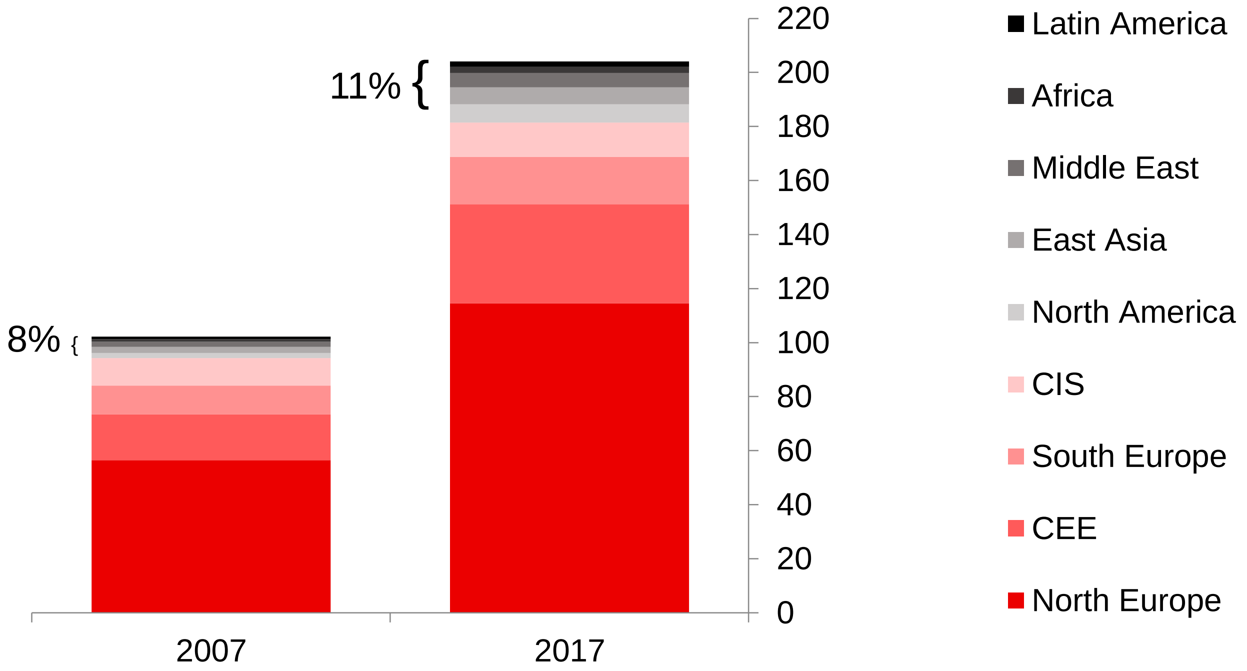
The EU is still the biggest Polish export market, although the process of geographical diversification continues. However, the non-European markets still constitute only a relatively narrow margin of Polish trade. Thus, the potential impact of global trade wars on Polish exports would be felt probably mainly indirectly, through the influence on the German (European) economy.

Change in value of Polish exports 2007-2017 by country groups



Source: Eurostat, Santander

Breakdown of Polish exports, €bn



Source: Eurostat, Santander

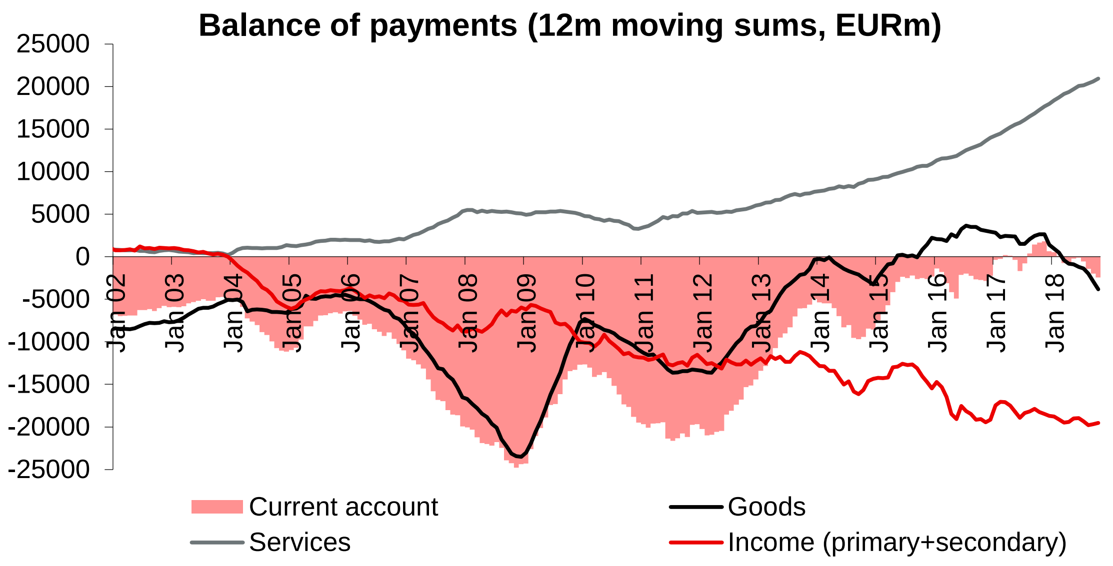
Foreign trade: still no external imbalance

Trade balance started deteriorating in 2018 as exports slowed while imports remained supported by strong domestic demand. However, surplus in services keeps soaring (as Poland attracts more and more business services due to its cost competitiveness, among other factors), while the widening of negative income balance slowed clearly. As a result, current account balance is still close to zero.

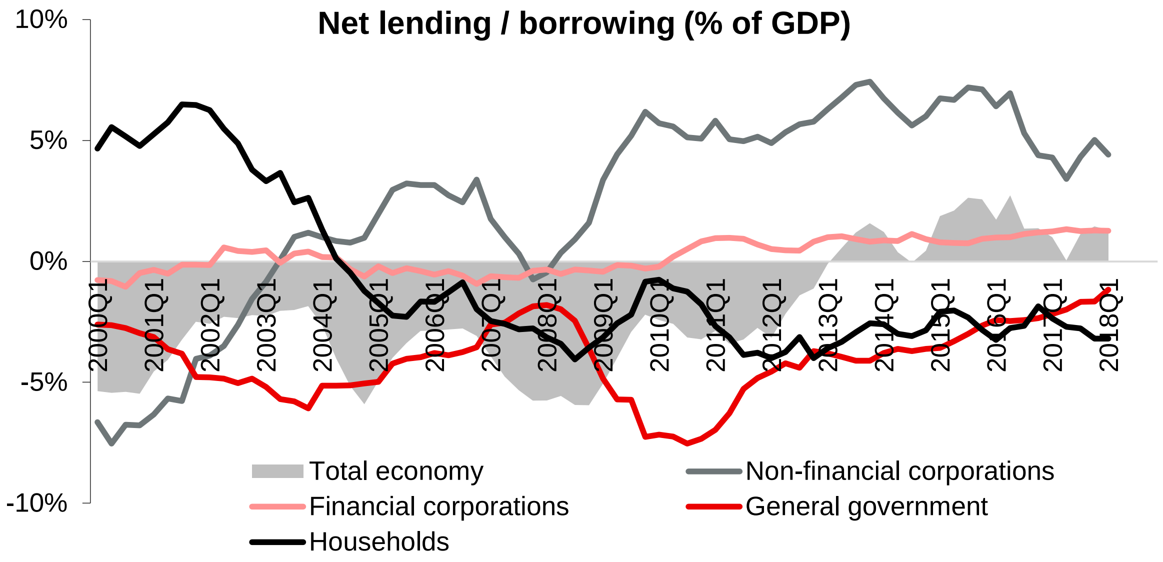
C/A deficit may widen in 2019, but mildly, remaining near 1% of GDP. Bigger gap in trade of goods should be largely offset by rising surplus in services, while income balance should not deteriorate much, given lower financial results of companies and resulting lower dividend payments.

Moreover, the proper measure of Poland's external imbalance is not the current account gap alone, but the sum of the current and the capital accounts (the latter reflects the inflow of capital transfers from EU). Those two taken together correspond to total economy's net lending/ borrowing position, which is currently in surplus at near 1.5% of GDP and should remain positive in 2019, given likely acceleration of EU transfers inflow.

Also, the analysis of sectoral net lending/borrowing positions does not seem to herald major risks for external imbalance. The impressive fiscal consolidation will probably not continue, but unless we see a major revival in households' consumption or corporate investments (which is not our base case scenario), the overall net external position of the economy should remain in surplus.



Source: NBP, Santander



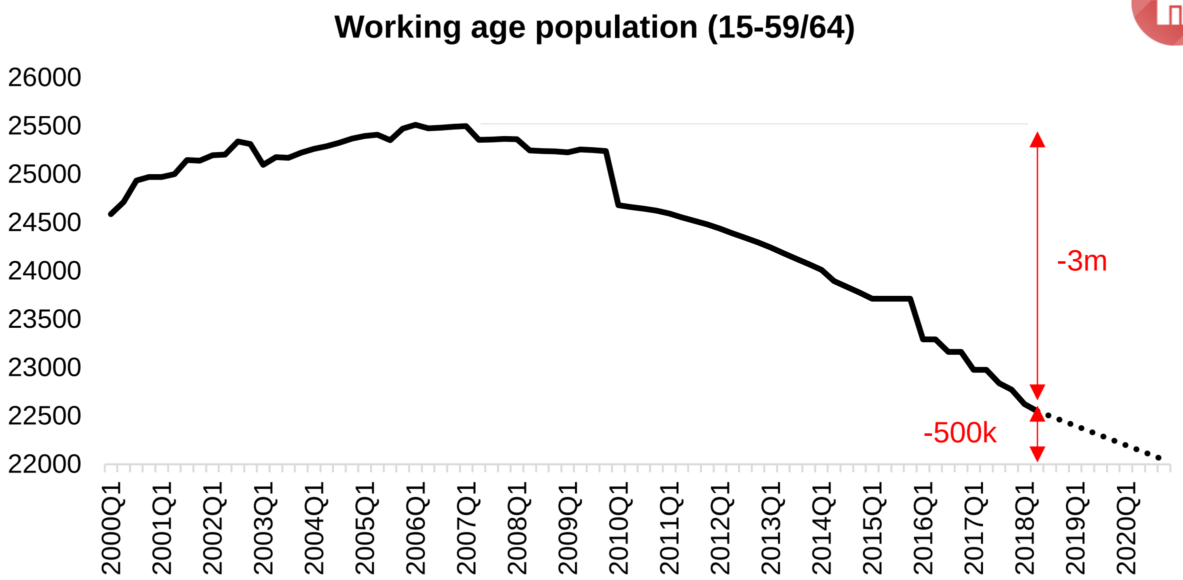
Source: Eurostat, Santander

Labour market: demographics bites

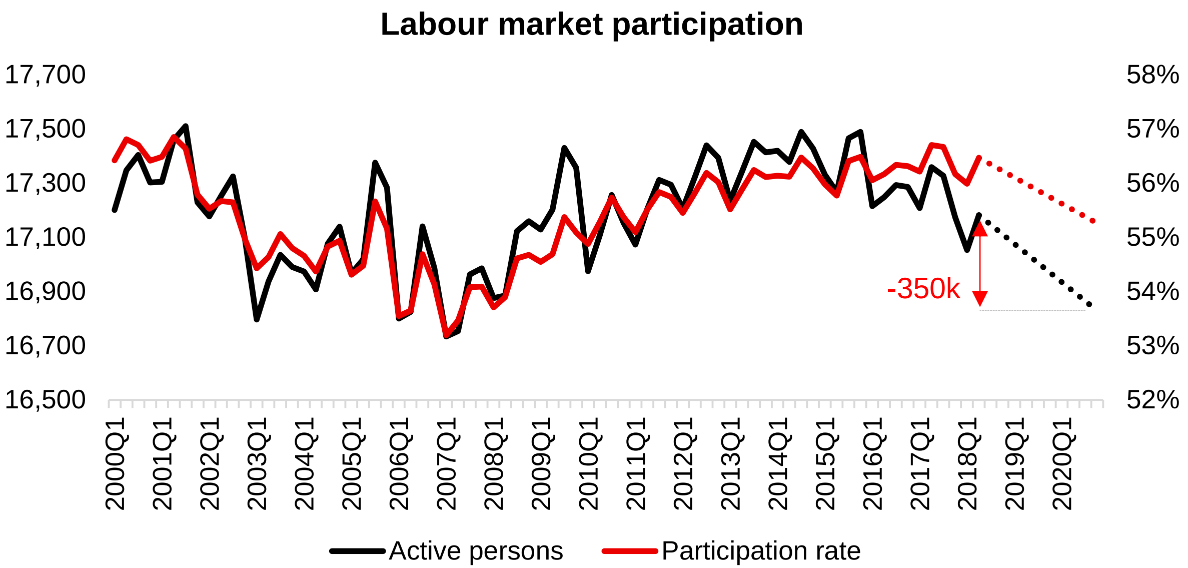
In the last ten years the working age population in Poland has decreased by c.3 million, according to the Labour Force Survey. And yet it did not prevent the economy from growing rapidly. The number of jobs rose in the last decade by almost 2.5m, as there were still available reserves to use: the number of unemployed fell sharply by over 2m (jobless rate down to 3.8%, one of the lowest in EU), and the participation rate increased, lifting the number of active persons by over 380k in the last decade.

However, we are arriving at the point where those domestic reserves are close to run out: (1) Even with participation rate still on the rise in the recent quarters, active population already started shrinking due to ageing. (2) We see evidence of upward trend in participation rate stalling in most of age groups in the last year, probably at least partly due to reduction of retirement age in October 2017 and introduction of 500+ family subsidy. (3) If we assume participation rates across age groups stabilising at recent highs or even rising slightly, the total participation rate and the total number of active persons will drop in the coming years, according to our estimates, because of population ageing, i.e. large cohorts moving to much less active groups – unless participation rates in those age groups increase sharply.

With unemployment already at record low level, this leaves little room for employment growth in the coming years, at least if we take into account the domestic labour force. We forecast the number of labour market participants to drop to 16.8m by the end of 2020, which is only 1.6% above the current level of employment. That makes Polish economy increasingly dependent on inflow of migrant workers.



Source: Eurostat, Santander



Source: Eurostat, Santander

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Earlier retirement did not hit the labour market

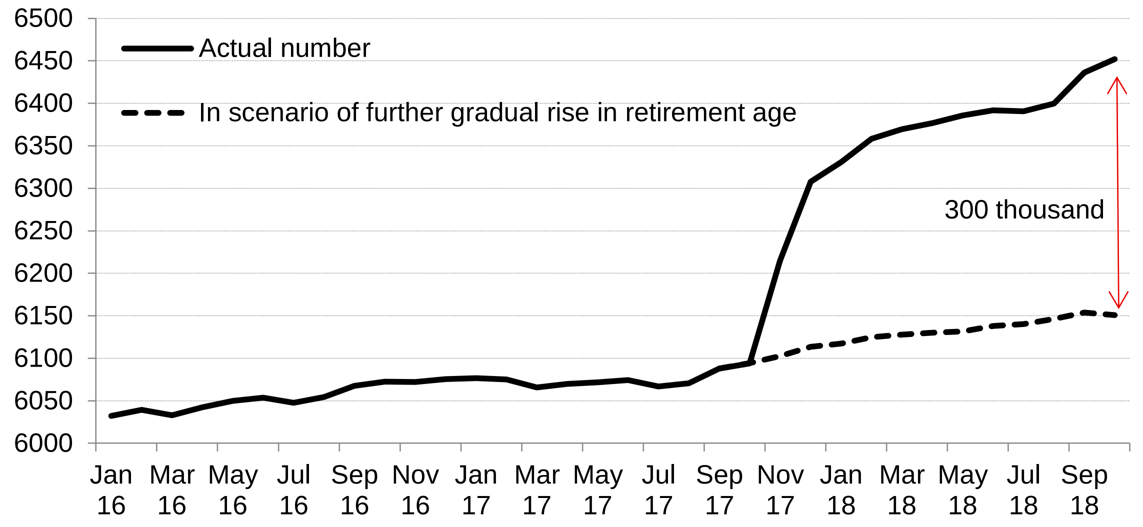
Since the start of 2013, the retirement age had been going gradually up to 67. This decision has had a positive impact on labour market participation – while total population activity rate rose by less than one percentage point in 2012-16, activity of men aged 65-69 rose by 2.5 pp and activity of women aged 60-64 rose by more than 6.0 pp.

Since 1 October 2017, the retirement age was diverted from its upward path back to 65 for men and 60 for women. As we have claimed on numerous occasions, we assess this decision as detrimental for the long-term growth potential of Polish economy. Our analysis shows that almost all eligible people took advantage of the new law, and this did have some negative yet not overly strong effect on employment in the oldest cohorts.

According to our estimates, In October 2018, the number of pensioners was by 300k higher than in counterfactual scenario of continuation of the previous policy. Total number of old-age pensioners rose by 350k, but lowering of retirement age caused a reduction in the number of disability pensioners, so the final number is lower. Still, this figure will be growing in the years to come and is likely to surpass 500k in 2020 or 2021. In fiscal terms, we estimate total costs of higher pensions at PLN7.0bn in 2019.

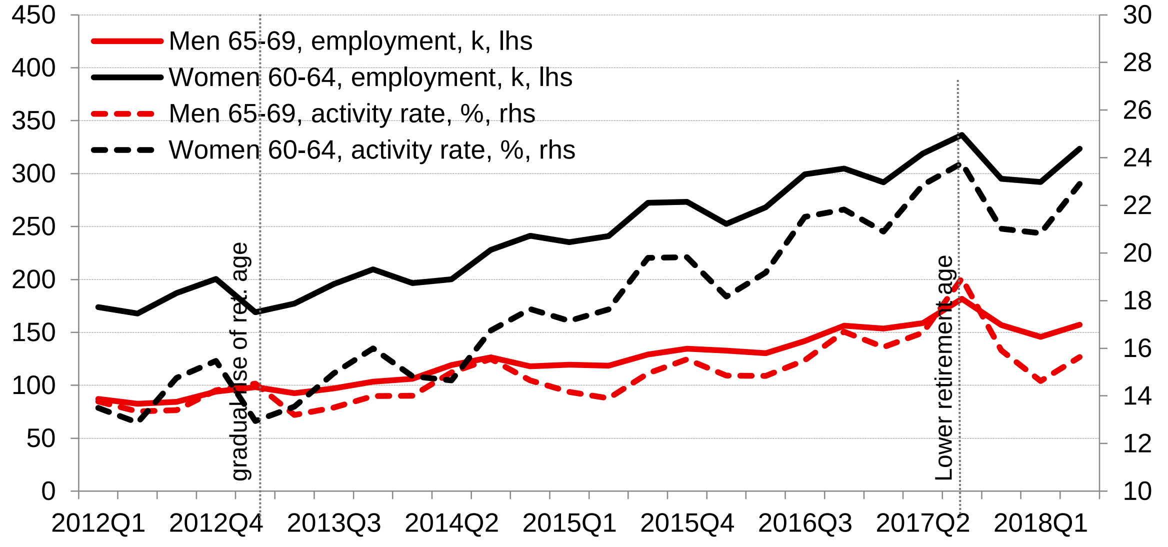
As regards effect on employment: it was not particularly strong. We estimate that the decision decreased the 2Q18 employment of women in the 60-64 age cohort and men in the 65-69 age cohort by 70k in total (vs current employment in these groups at 500k).

Number of pensioners



Source: ZUS, Santander

Employment in older cohorts



Source: Eurostat, Santander

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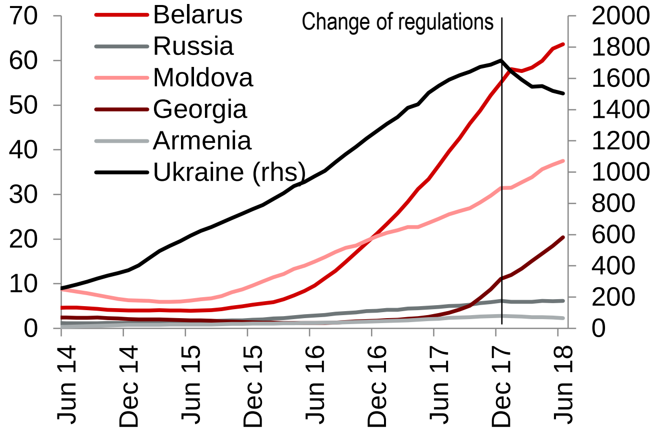
Labour market: immigrants keep coming, it seems

In the last 2-3 years the inflow of migrant workers (mainly from Ukraine) supported greatly the labour supply in Poland. Unfortunately it is hard to track the inflow due to lack of reliable and precise data. Companies' declarations to hire a non-resident suggested a switch to negative trend in 2018, but it coincided with a change of regulations. The number of foreigners contributing to Polish social security shows that positive trend is still in place, and so do the reports from border guards about border crossings with Ukraine (but only if we extract the high-frequency crossings, which distort the picture). Unfortunately, none of these data give a full picture and all of them are flawed to some extent: declarations to hire a foreigner do not translate one-to-one to actual employment and were affected by the change of regulations this year. Numbers on immigrants paying social insurance contributions are delayed and only cover those holding a contract (probably not even a half of the total number). Border crossings will not discriminate between Ukrainians bound for Poland and e.g. Germany, nor between potential workers and tourists. However, all signals taken together seem to suggest, in our view, that migrants keep coming to work in Poland in big numbers (and for now we find little reason for this trend to stop in 2019). This may be the missing piece of puzzle explaining why the corporate wage growth failed to accelerate above 7% y/y in recent quarters.

German plans to ease immigration rules to attract non-EU jobseekers is a risk factor for the inflow of foreign workers to Poland. However the government proposed to introduce changes only in 2020 and not 2019 as initially suggested. Furthermore, they are targeting selected skilled workers, so it need not imply a massive outflow from Poland. Yet, the risk is that, with time, it will drain the local labour supply somehow.

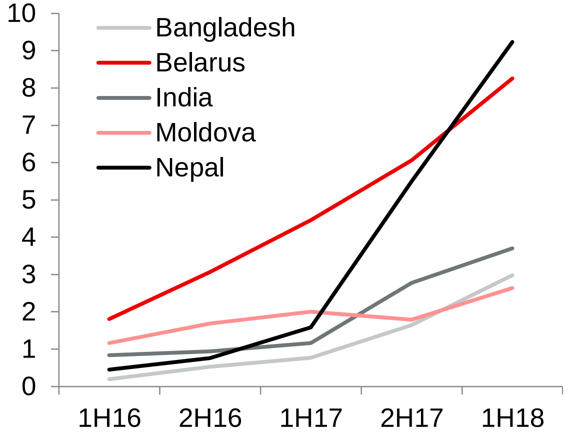
Meanwhile, in Poland works on the government's proposal to ease immigration rules have stalled (they included extending the life span of declarations to hire, the list of eligible countries, making it easier to legalize work and bringing one's spouse to Poland).

Declarations of hiring a non-resident 12M sum (k)



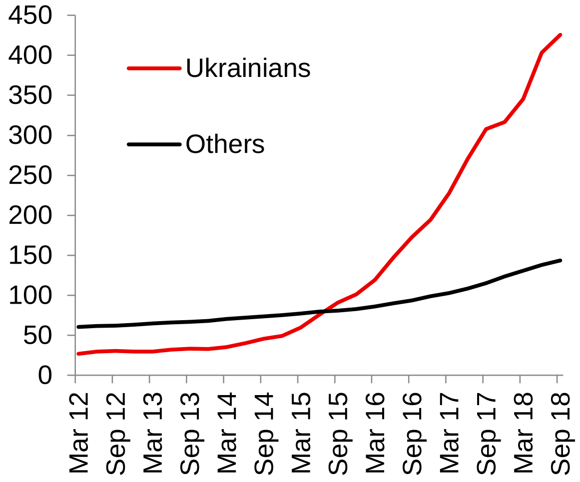
Source: GUS, Santander

Number of work permits



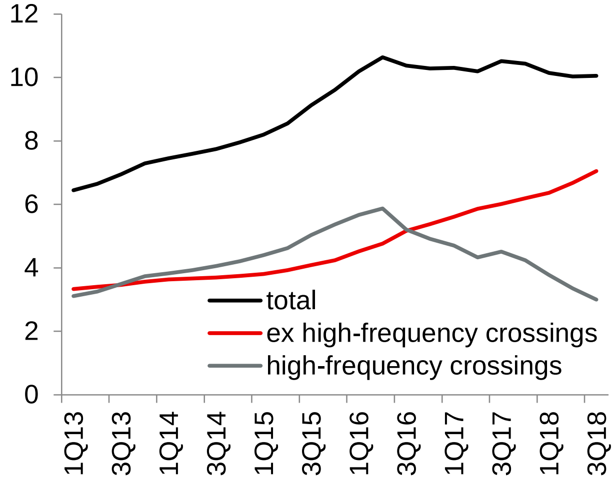
Source: GUS, Santander

Number of foreigners paying contributions to Polish Social Security (k)



Source: ZUS, Santander

Number of crossings of the Ukrainian border, to Poland, by foreigners, 4Q sum (mn)



Source: Straż Graniczna, Santander

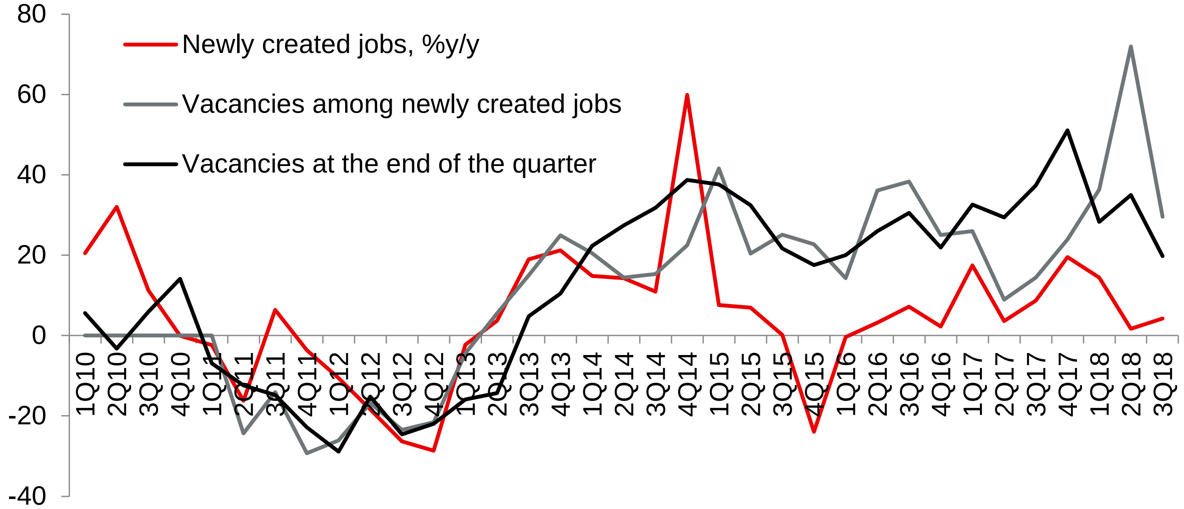
Labour market: uncovered labour demand

In 3Q vacancies kept growing at a high pace (c20% y/y). Employers failed to fill 21.5% of newly created jobs – this is the second highest share of the last decade (after 25.3% in 2Q18). The growth rate of new jobs was still limited (4.3% y/y), compared to 14.4% in 1Q18 and 19.5% in 4Q17. At the same time the pace of job destruction accelerated visibly (to 30.2% y/y). This most likely means that the labour market remains very tight, judging e.g., by the historically high pool of unsatiated labour demand, and the wage pressure is pushing the labour force to jobs where it is more efficiently utilised.

Sentiment indicators show a rebound of employment indices in 4Q18, surprisingly joint with a correction in super-low unemployment expectations of consumers. We treat the ESI indices as a proxy of labour demand by various sectors. The behaviour of the indices is generally in line with what we expect for 2019: slower descent of the unemployment rate, and continued high labour demand clashing with limited supply, keeping wage pressure alive.

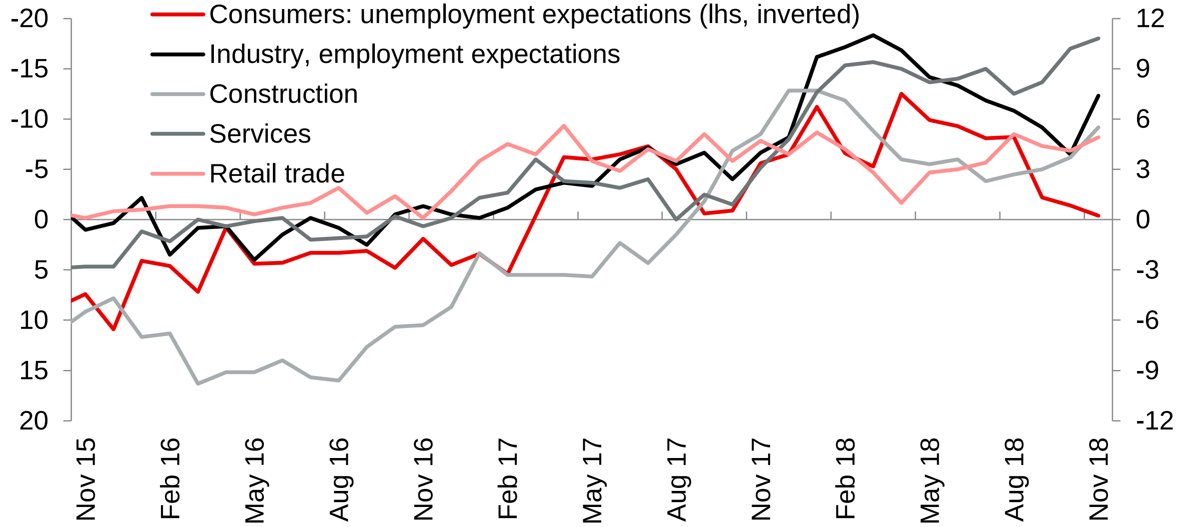
With economic growth most likely still above potential next year, it is hard to argue that labour demand will fade. The less bright outlook does call for its moderation, though. There should also be focus on raising productivity instead of expansion by raising staff levels.

Labour demand and vacancies, % y/y



Source: GUS, Santander

ESI employment indices and consumer unemployment fears



Source: European Commission, Santander

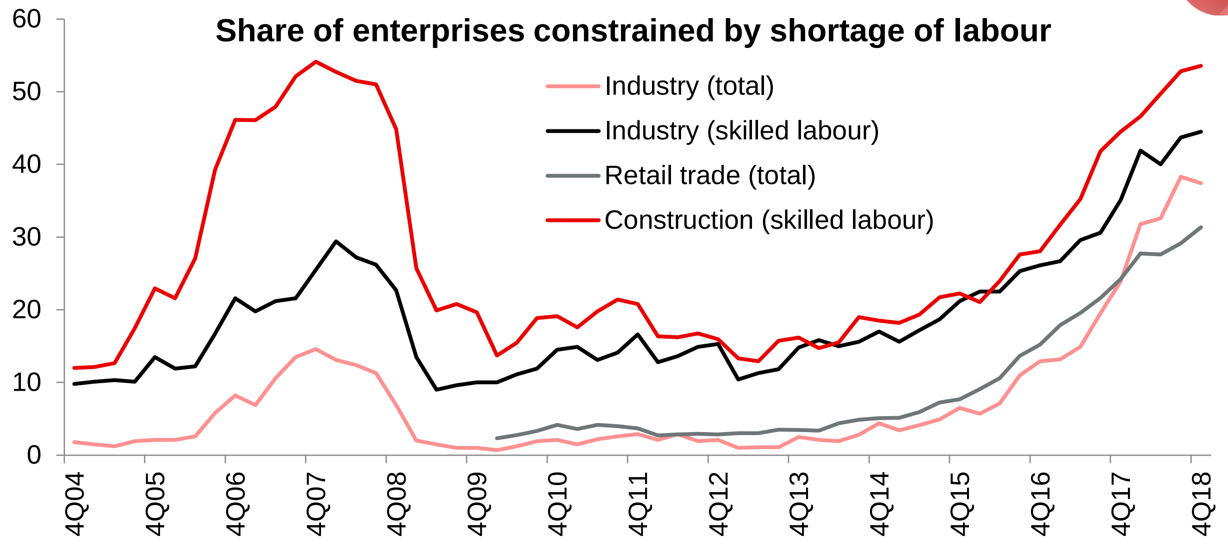
Labour market: wage growth unlikely to slow

2018 did not go as we imagined as far as wage growth is concerned. The pressure was certainly there, with all business sectors reporting historically high difficulties in finding new workers. The pool of available potential employees was systematically shrinking, as the unemployment rate set one new record low after another. But somehow the wage growth in the enterprise sector (a narrow measure, but the only one that can be tracked on a monthly basis) could not climb significantly above 7% y/y in nominal terms.

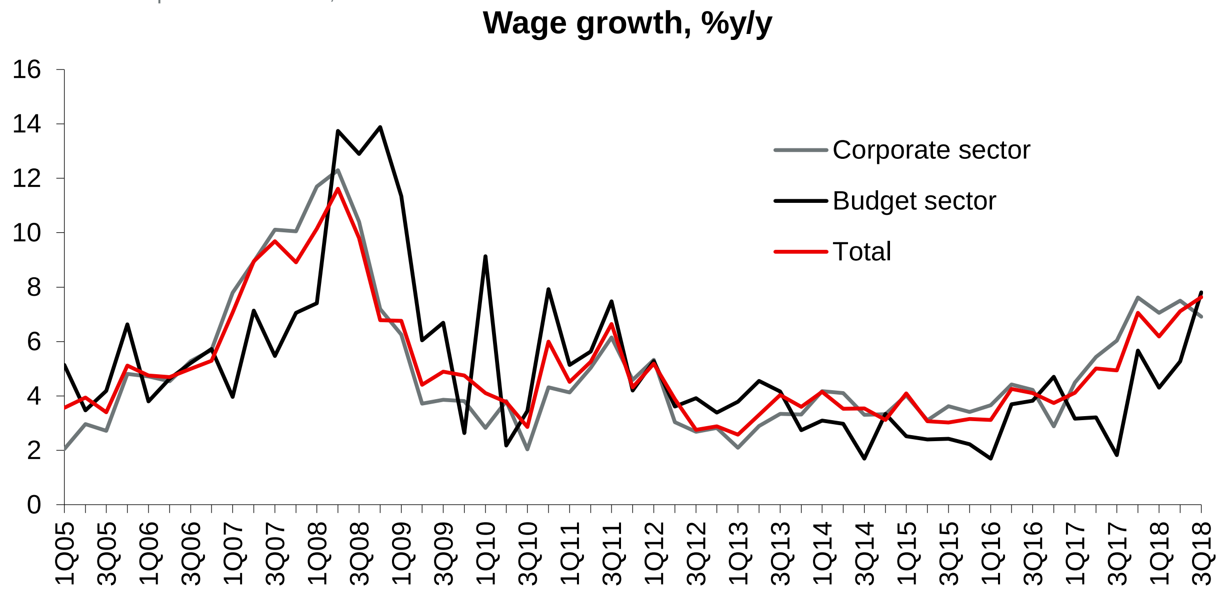
However, the 3Q readings of other wage statistics: economy-wide measure and growth rate of compensation in the budget sector (both coming on a quarterly basis), raise the probability that 7% is not a ceiling that cannot be crossed. Both these measures went above the corporate wage growth, reaching almost 8% in 3Q2018.

The public sector has finally caught up with corporates, and the 3Q print does not look like the top, with several work groups already securing pay rises in 2019 (policemen, soldiers among others). Lawmakers may be under further pressure to hike wages in the budget sector during the year, by groups counting on their generosity ahead of elections (like teachers, unsatisified with the already granted wage hikes).

We believe that in 2019 wage growth in the national economy can stay close to 7% y/y we estimate for 2018, but it is more likely it will accelerate some more rather than slow down this year.



Source: European Commission, Santander



Source: ZUS, Santander

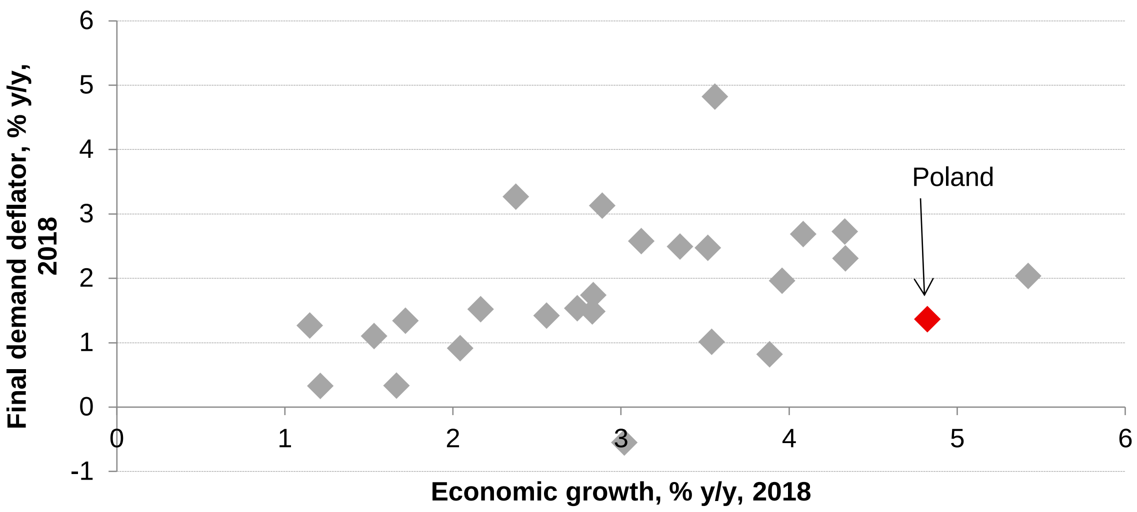
Inflation: so low for so long

Closed output gap, strong consumption demand, rising wage pressure (salaries growing faster than productivity) and other costs mounting – all those factors have been justifying higher inflationary pressure for some time. Meanwhile, core inflation in Poland not only refused to climb, but even underperformed the corresponding measures in other European countries.

Strong international competition and very good financial results of companies (they could have afforded squeezing margins without passing costs onto customers) could be responsible for lack of price acceleration; plus, some one-off effects (price drop in insurance sector and financial services).

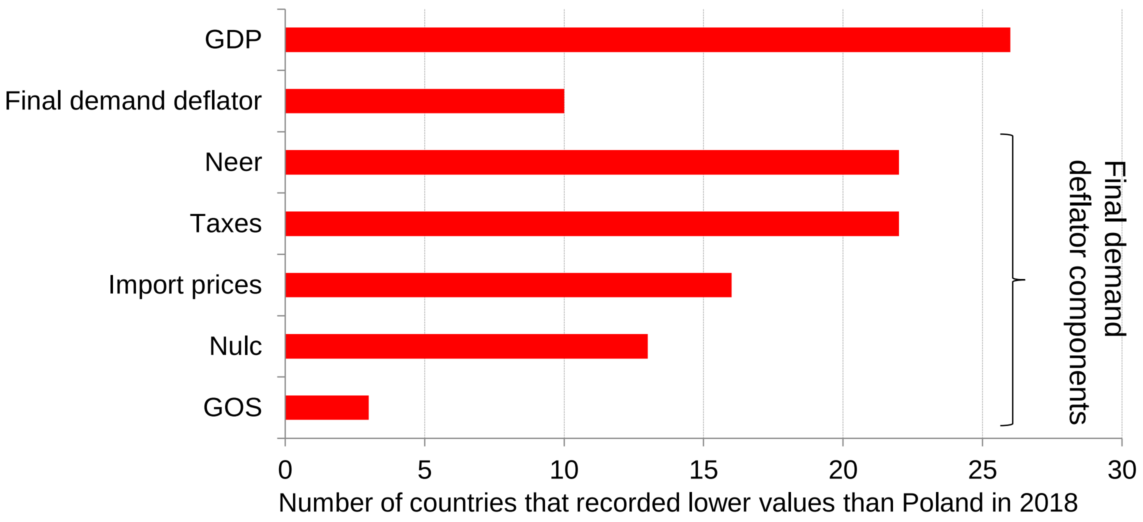
Poland's inflation is very low in comparison to other countries with similar economic growth rates, both in EU and in the world. To put it differently: Polish GDP growth in 2018 is higher than in 26 of EU-28 countries, but the final demand deflator is higher than in 10 of them. If we decompose the deflator into impacts of nominal effective exchange rate, indirect taxes, import prices, nominal unit labour costs and gross operating surplus, it becomes pretty obvious that contribution of gross operating surplus is among the lowest in the EU-28 (only three countries rank lower). This means that inflation is low mostly due to the fact that companies accept lower margins.

Economic growth and inflation in the EU



Source: European Commission, Santander. Note: the chart omits two outliers: UK and Ireland

2018 economic growth and final demand deflator components compared to EU-28



Source: European Commission, Santander

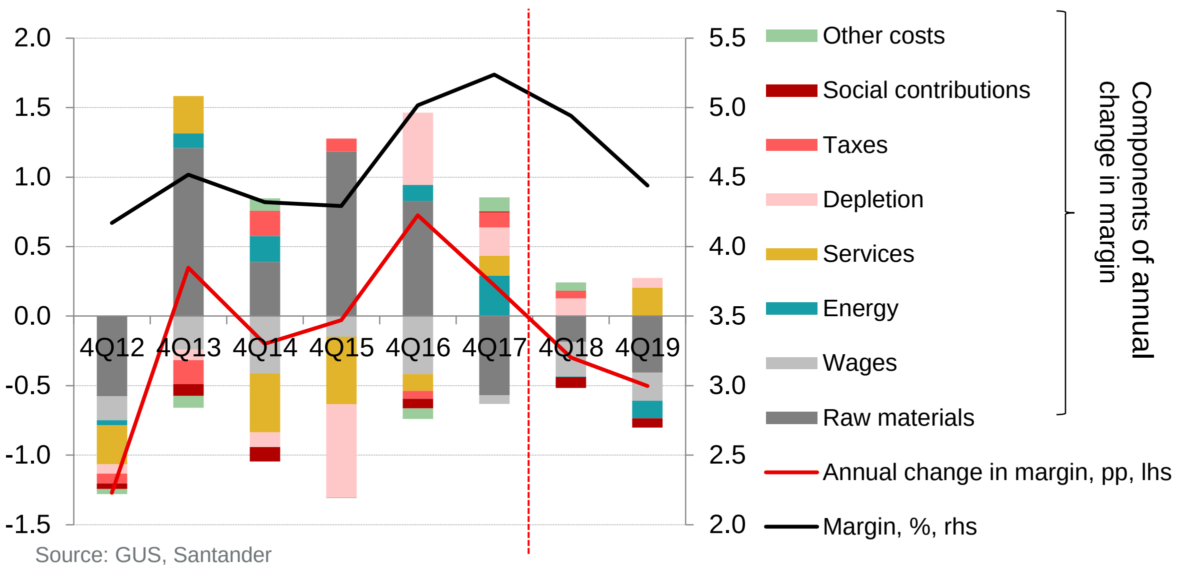
Corporate margins: further compression?

In our view, development of corporate margins is able to explain the behaviour of prices and wages in the Polish economy. In our Economic Comment released in June 2018, we argued that improving financial results of Polish companies made it possible to accommodate high wage growth without pressure on prices. We also claimed that deterioration of profits in 2018 will not be strong enough to make companies hike prices.

In 2019, this situation may change, as margins will be further under pressure of rising wages, energy prices (most notably gas, as electricity prices are not likely to go up), materials and the introduction of PPK. At the same time, revenues will grow slower than in 2018 due to a weaker economic growth. In our view, this will bring margins close to the lows seen in 2012 and might eventually encourage some companies to raise prices.

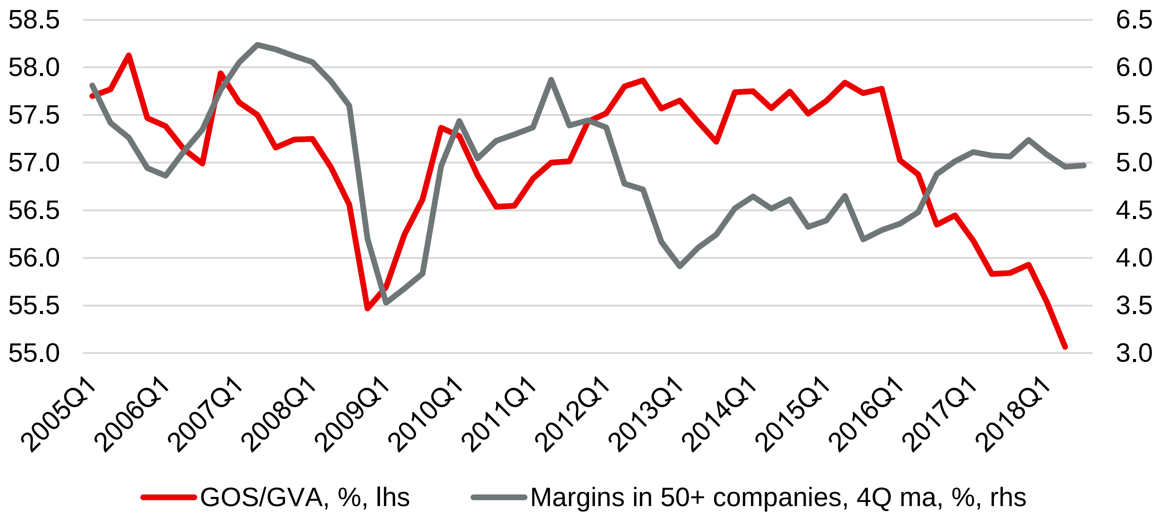
Here we use gross financial results as % of revenues in companies employing 50+ as our proxy of corporate margins. If we extend this metric also to companies employing 10-49, the story does not change. We prefer the 50+ statistics, as it is distributed quarterly, while the 10-49 data are released twice a year. We also have another measure: gross operating surplus as % of gross value added, which should be capturing the whole economy. Interestingly, this measure is going down since early 2016. There are some differences in the methodology (like the accounting of fixed assets depletion), but in our view this may suggest that small companies are way worse off than the big ones.

Margins in 50+ companies – breakdown of changes



Source: GUS, Santander

Corporate margins – different measures



Source: GUS, Santander

Inflation: no energy price hike before elections

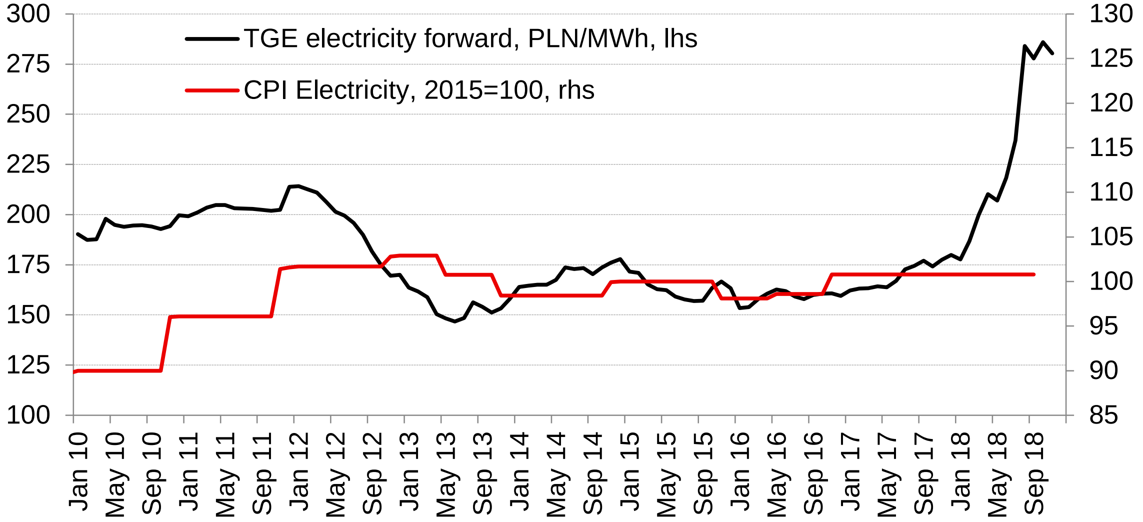
Costs of energy production went up significantly in the recent months, mainly due to higher prices of coal and CO_2 emission permits. This could have added as much as 1.0 pp to CPI in case of no government reaction. It seems that the government will limit the transmission of higher wholesale energy prices to the economy to almost zero.

After a long period of uncertainty, the government enacted a bill, earmarking PLN9.0bn to halt the electric energy price hikes. The act assumes lowering the excise duty to PLN 5 per MWh from PLN 20 per MWh (cost of PLN1.85bn) and the so-called transitory charge by 95% (this charge varies among energy consumers, cost of PLN2.24bn) as well as introducing subsidies for the energy sector (PLN5.0bn). Subsidies will be financed via a special fund, supplied with means from sales of undistributed CO_2 permits from 2013-2017 period.

The regulations should imply there will be no major impact of higher electricity prices on the economy. However, some impact on CPI prints (especially flash releases for Jan-Feb) could be still visible, as some energy companies have already sent out new increased tariffs to customers. Additionally, there is still some risk that the European Commission may question the subsidies for the energy sector – it has already asked for the government notification.

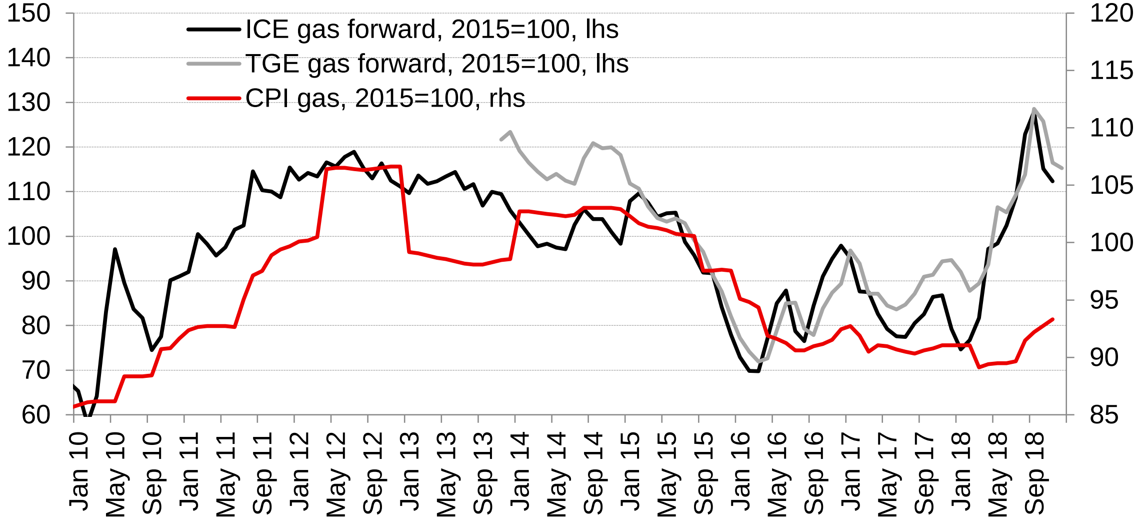
That having said, there is more in store than just higher electricity tariffs. We also saw upward tendencies in gas, heating, solid fuels and there is an additional tax on fuel starting from 2019. Thus, in our view energy will be a moderately positive contributor to inflation.

Electricity prices: wholesale vs households' prices



Source: TGE, GUS, Santander

Gas prices: wholesale vs households' prices



Source: TGE, Bloomberg, GUS, Santander

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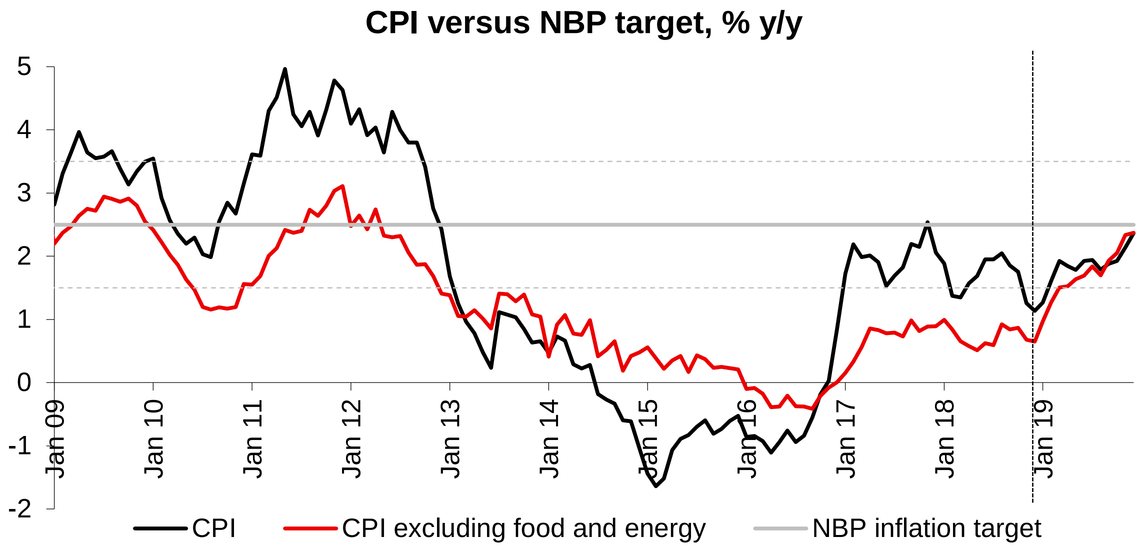
Inflation: core measures about to pick up

We are expecting the 2019 non-core inflation (food and energy) to be lower than in 2018. In case of energy, it will be the result of government's intervention, as explained on the previous slide. As regards food, in the first half of the year we will witness oversupply of poultry and fruit and undersupply of vegetables and bread/grains, with rather weak upward price tendencies as an outcome, as at the end of 2018. In the 2H19, we are expecting an oversupply of dairy products and a possible rise in pork prices. Still, weather conditions this year will be key for food prices in 2H19.

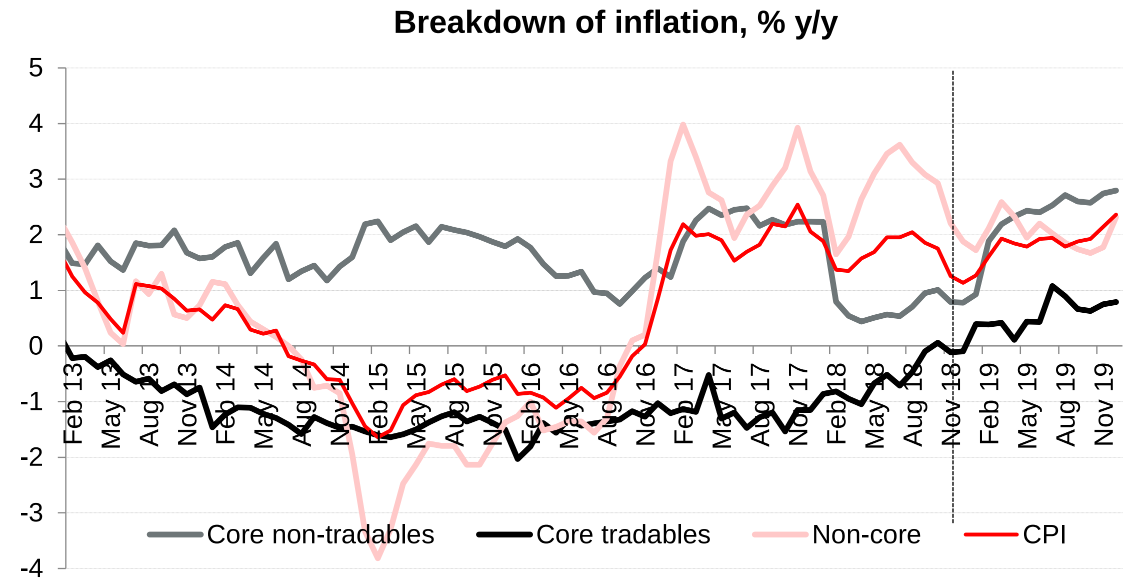
Core tradables saw some upward tendencies in 2018 mostly due to a bit higher growth (or lower decline) of prices of clothing, furnishing, household appliances and cars. The trend should continue as we expect the core inflation in Europe to gradually trend higher (which is in line with ECB forecasts).

Core non-tradables will, in our view, feel the rising pressure from higher labour costs. In 2018, inflation in this segment was low but that happened due to a strong one-off drop in prices of financial services. But the underlying trend was pointing upwards. Thus, in early 2019 the low base effect will send this measure towards 1.5% y/y and then it will be approaching 2% y/y.

In general, we see inflation approaching the inflation target of 2.5% at the year-end and averaging 1.9% y/y.



Source: GUS, NBP, Santander



Source: GUS, Eurostat, Santander

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Loans and deposits to grow slightly slower

Data from the banking sector show continuation of solid loan growth for both individuals and companies.

PLN denominated mortgage loans and consumption loans are rising over 10% y/y – the highest pace in many years, and accelerating. We are expecting strong tendencies in mortgage loans to continue into 2019, given still strong housing market and rising disposable income. As we argued on page 13**,** we are expecting some slight deceleration in consumer loans, so, in total, loans for individuals may rise a bit slower than in 2018.

Loans for companies decelerated slightly (to 6% y/y vs. c10% y/y at the start of the year), but still rising at a decent pace. In general the demand for financing is slightly rising, mainly from SMEs. Much depends on private investment demand in 2019, but in our view, a bit slower economic activity will be negative for the loan growth, which we expect to be somewhat lower than in 2018.

Slightly lower loan growth will translate into slightly lower deposit growth. Low interest rates still will be favouring demand deposits; however, the recent upward tendency in interest on deposits will decrease the gap between demand and term depos.

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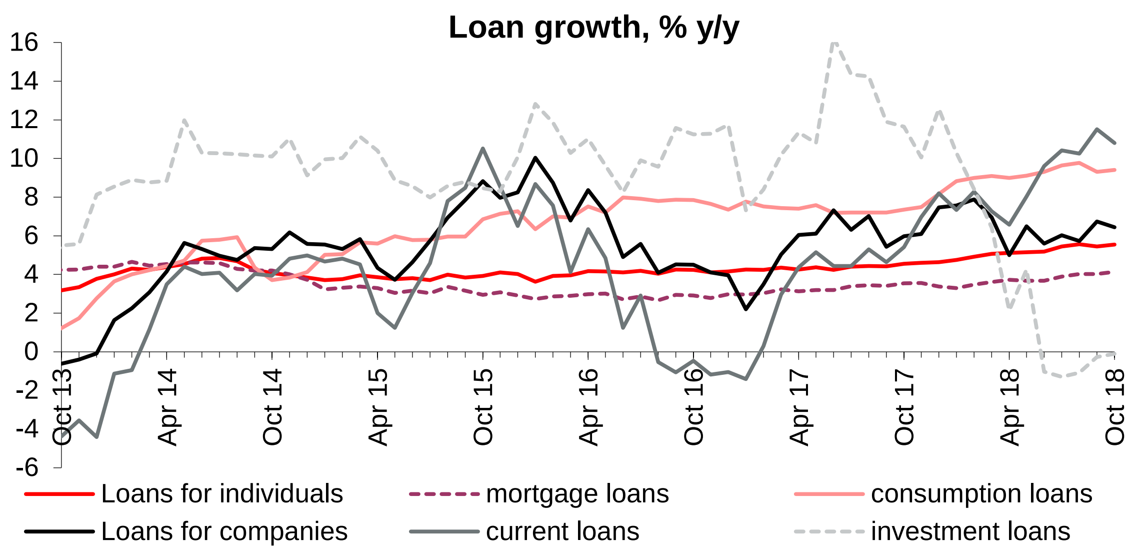
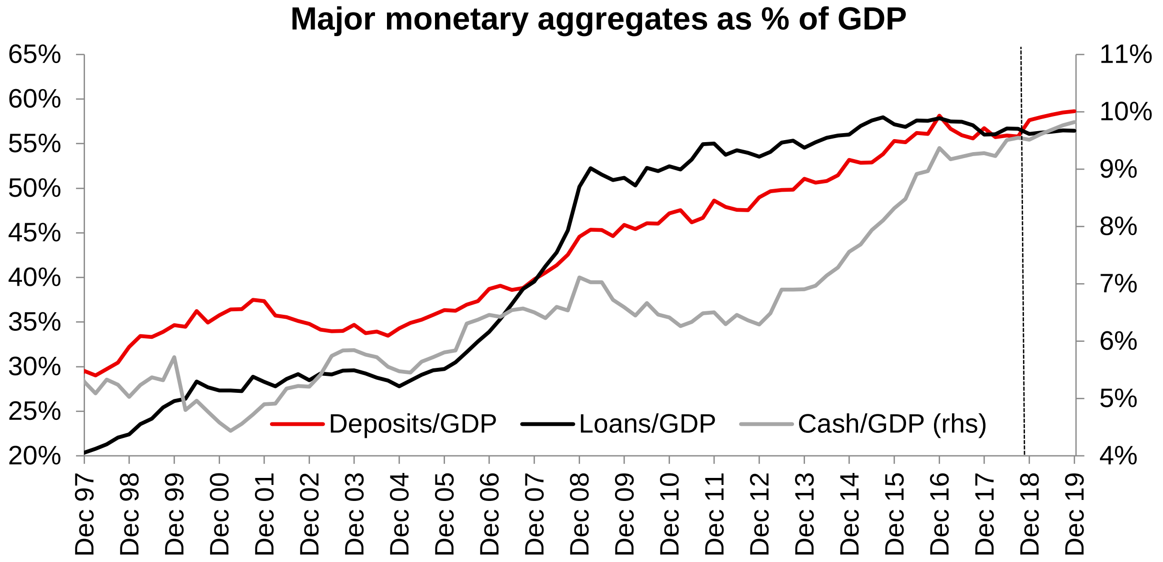


Source: NBP, Santander



Source: NBP, GUS, Santander

Santander

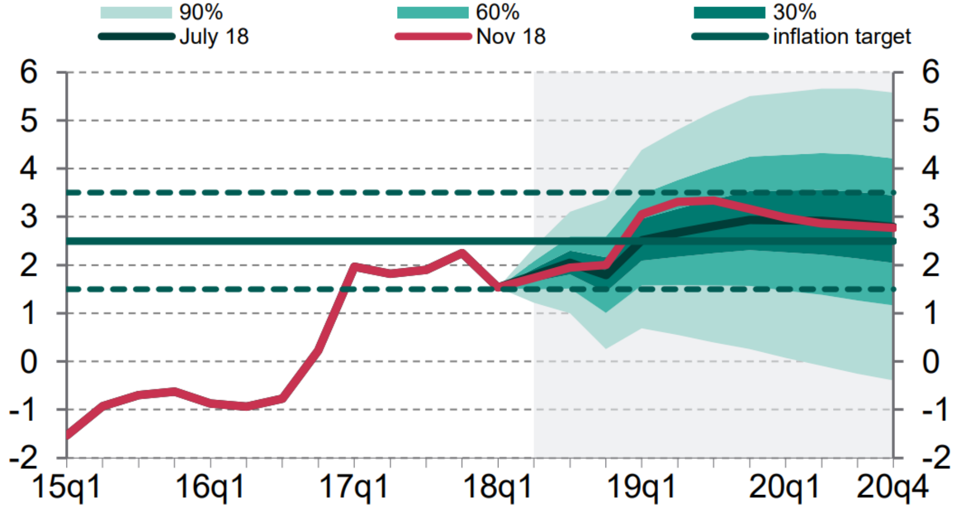
Monetary policy: extremely patient

The Polish central bank has been watching the booming economy with cold blood, and probably rightly so, given scarce evidence of economic imbalances building so far. Some members of the Monetary Policy Council made it clear they would prefer to risk being behind the curve than to act too early, given the disappointing inflation performance to date and the experience of other central banks that were not successful in reviving inflation even with negative interest rates and non-conventional measures.

The November central bank's inflation showed CPI rising to almost 3.5% in 2019, upon assumption of significant spike in energy tariffs (which are unlikely to materialise, as it turns out). Faced with such inflation forecast the MPC did not change the opinion that keeping rates stable at least until the end of 2019 is the optimal strategy. The central bank openly declares it will have big tolerance for inflation deviating from the official 2.5% target, as long as it believes that reasons of the deviation are of temporary nature and the probability of second round effects is low.

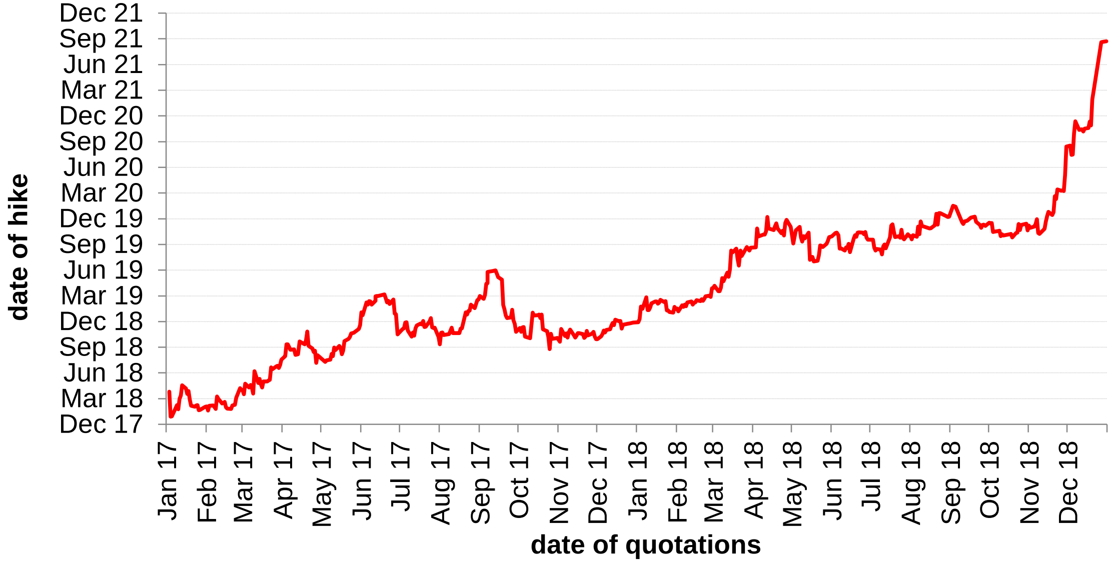
Meanwhile, it looks like inflation is going to be well below, not above the target for the better part of 2019 (if not all). Therefore, we think that any serious talk about monetary tightening in 2019 is highly unlikely. For a rate hike to happen, the central bank would need to see strong evidence of not only observed inflation rising above the official target but also forecasts pointing further up in the subsequent quarters.

November inflation projection, % y/y



Source: NBP

Timing of the first rate hike by NBP implied from FRAs



Source: Thomson Reuters, Santander

2019 Budget: no spending spree

The 2019 budget was planned responsibly, in our view, with the deficit at PLN28.5bn – the lowest planned budget deficit in the last decade – despite 2019 being the election year.

The planned spending growth is moderate, due to the limit imposed by the stabilising expenditure rule. The increase in expenditures due to “inelastic items” and those pre-set by other regulations consumes a big enough part of the quota that comes from the spending rule that there is virtually no room for pre-election gifts. Budget expenditures are to grow not much faster than the nominal GDP and their share in GDP should be at 18.6%, one of the lowest levels since 2015.

Budget revenues in 2019 are to grow by PLN19.5bn, or by c.3% vs. the currently expected outcome for this year. When compared to the nominal GDP growth (near 6% in 2018 and in 2019), it seems to be a conservative assumption. Even the assumed increase in VAT revenues, which initially looked quite ambitious, now seems to be easily achievable, unless economy slows much more than we currently predict. Additionally, VAT revenues are expected to be supported by a further reduction of the tax gap. It is planned to yield additional PLN7.5bn of revenues in 2019.

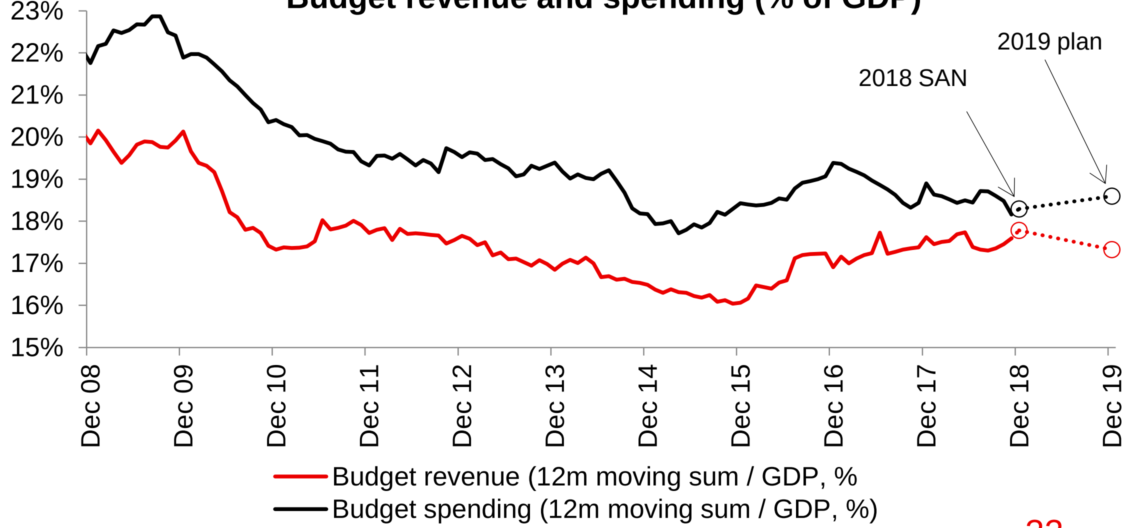
Main Parameters of 2019 Budget (in PLN bn)

	2018 plan	2018 E*	2018 SAN*	2019 plan	change
	1	2	3	4	(4) / (3)
Total revenues	**355.717**	**367.436**	**375.369**	**386.915**	***3.1%***
Tax revenues	331.673	340.589	345.494	359.731	*4.1%*
VAT	166.000	167.310	174.000	179.600	*3.2%*
CIT	32.400	34.000	34.652	34.800	*0.4%*
PIT	55.500	60.320	59.932	64.300	*7.3%*
Excise	70.000	71.000	71.451	73.000	*2.2%*
Bank tax	4.569	4.445	4.500	4.551	*1.1%*
Non-tax revenues	21.923	24.739	28.106	24.987	*-11.1%*
Total expenditures	**397.209**	**391.197**	**386.222**	**415.415**	***7.6%***
Balance	**-41.492**	**-23.761**	**-10.853**	**-28.500**	

* E = MoF estimate from 2019 budget draft; SAN = Santander estimate

Source: Ministry of Finance, Santander

Budget revenue and spending (% of GDP)



Source: Ministry of Finance, Santander

Santander

2019 Budget: realistic assumptions

The macroeconomic assumptions on which the budget draft is based seem to be safe enough from the budget planning perspective. 3.8% GDP growth is close to our forecast. As regards GDP components, the forecast of next year's investments seems realistic, while the forecast of private consumption seems too conservative. Wage growth can turn out to be significantly higher than assumed, in our view, due to the growing labour shortage. Taken together, the macroeconomic assumptions imply that the tax base may be higher, creating a safety margin for planned budget revenues. On the other hand, inflation may be slightly lower than planned. The biggest risk for the assumed macroeconomic scenario is the possibility of a deeper economic slowdown abroad, stemming from, among others, the geopolitical situation and changes in international trade relations.

The new bill aimed at freezing electricity prices in 2019 is the additional challenge to the budget, with the total cost estimated at PLN9bn. However, it looks like the biggest part of those expenditures will be covered by the extra revenues from the selling of carbon permits by the government (those revenues were not included in 2019 budget bill). We estimate current value of carbon permits at cPLN7.7bn (the government priced the permits at cPLN5bn), which is a slightly lower than the total estimated cost of hike of energy prices (PLN8-9bn).

Macroeconomic assumptions of draft budget

	2018 plan	2018 E	2019 plan	2019 SAN
GDP in current prices, PLN bn	2057.2	2104.6	2233.7	2225.1
GDP, % y/y	3.8	3.8	3.8	3.8
Private consumption	3.5	3.8	3.5	4.6
Fixed investments	7.6	9.1	8.4	7.3
Inflation, avg., % y/y	2.3	2.3	2.3	1.9
Wages, national economy, % y/y	4.7	5.7	5.6	7.0
Employment, national economy, % y/y	0.8	1.7	0.5	0.8

E = outcome expected by MF in 2019 budget draft
plan = assumptions from the budget draft/bill
SAN = Santander estimates
Source: Ministry of Finance, Santander

2019 Budget: deficit may be lower, again

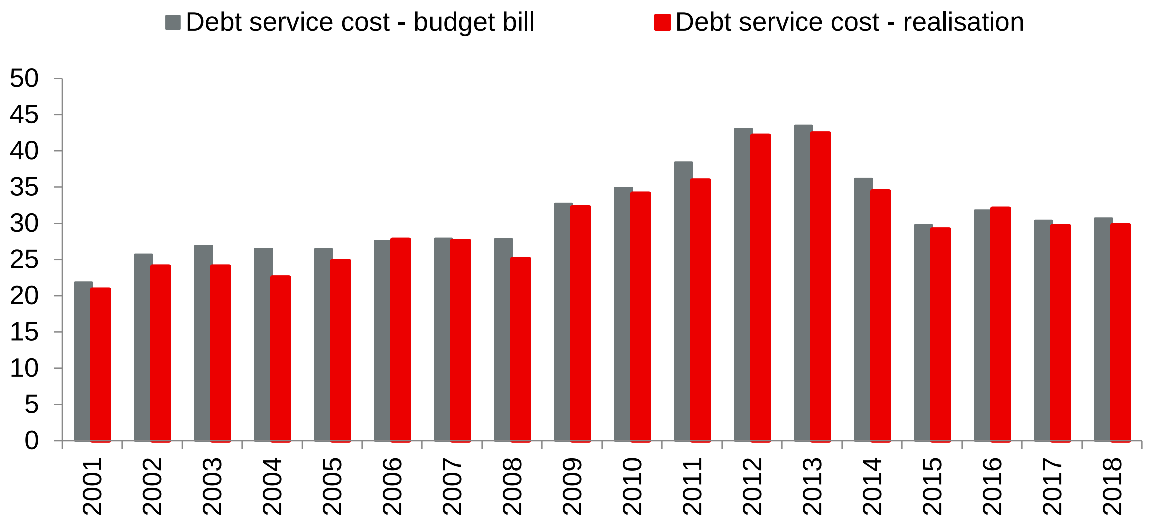
In our opinion, in 2019 the taxes revenue may turn out higher than in the budget draft by PLN10bn, owing to a higher nominal base of 2018 (we estimate the household consumption at cPLN1296bn). We forecasted a faster private consumption growth in 2019 than assumed by budget draft (4.6% y/y vs. government's assumptions of 3.5% y/y).

A better budget realisation should be supported by some hidden pockets on the expenditure side. As in the previous years the budget is likely to have some savings on the debt service cost (usually they amount to PLN0.5-1bn). We estimate that 2019 the savings on the service cost are likely to amount to cPLN1bn.

Simultaneously, we believe that the good budgetary performance in the previous year has allowed the MoF to "save" some money (for example the money allocated to the Demographics Reserve Fund assets). In case of a dramatic deceleration of growth this money could be used for fiscal stimulation without deteriorating the fiscal figures.

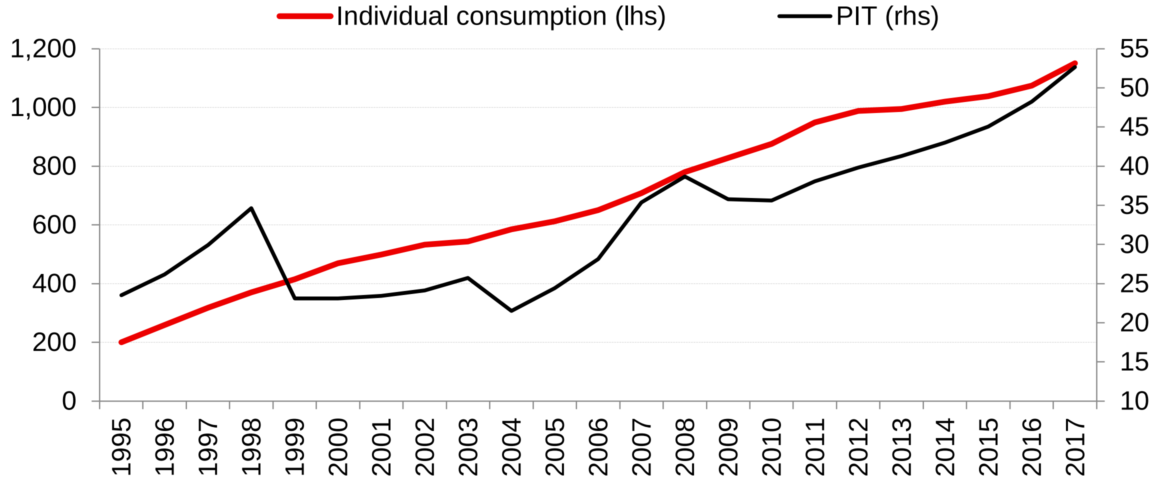
Accordingly, we think that the budget deficit in 2019 will be lower by PLN5-7bn than assumed in the draft budget, while the deficit of the public finance sector will reach 1.3% GDP.

Debt service cost in PLN bn



Source: Ministry of Finance, Santander

PIT revenue and individual consumption in PLN bn



Source: Ministry of Finance, Santander

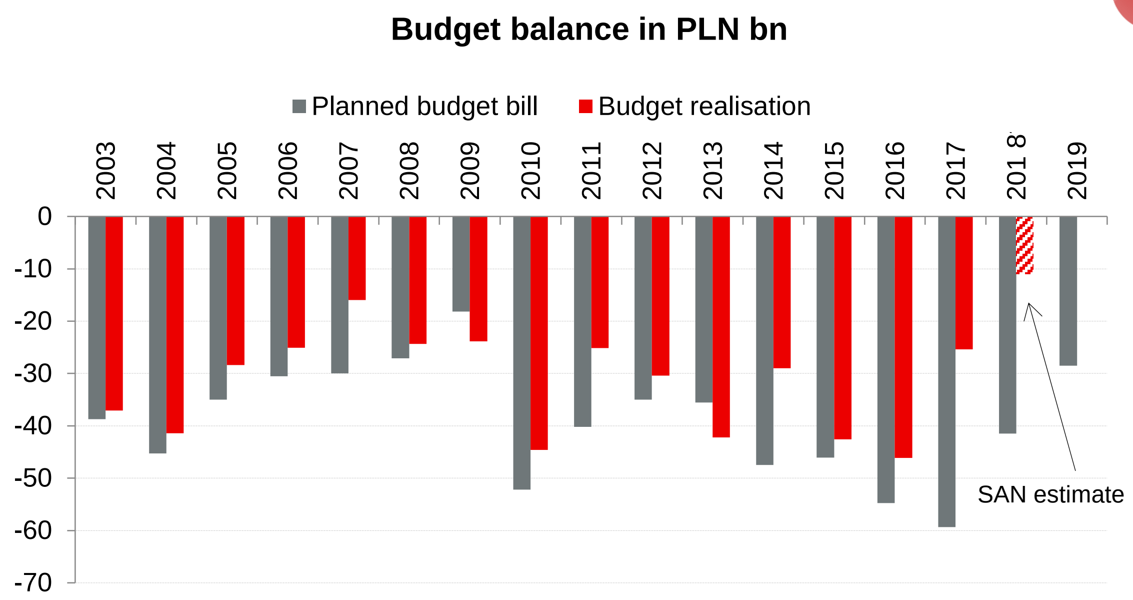
Santander

2018 Budget: 0.5% GDP deficit for a good start

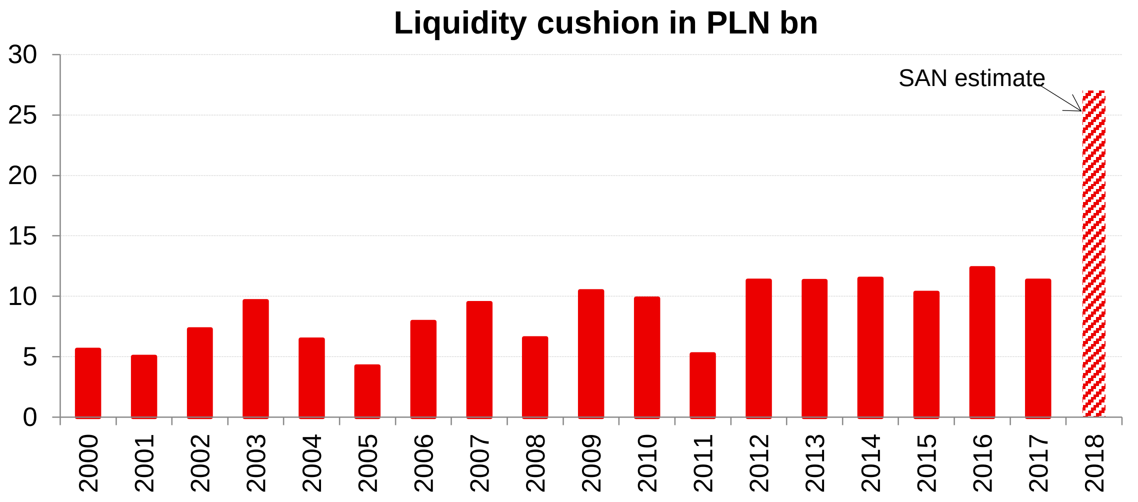
The expected 2018 budget deficit results should provide a good basis for the realisation of the 2019 budget deficit. According to the MoF suggestions, in 2018 the budget deficit will reach c0.5% GDP (cPLN11bn). It should be noted that the budget balance for Jan-Nov 2018 shows a surplus of PLN11.06bn, so the budget realisation for 2018 may have been better than the MoF had declared (in fact, even the surplus cannot be ruled out, although in baseline scenario we assume a slight deficit).

In our opinion the MoF will enter 2019 with a liquidity cushion of cPLN27bn. Furthermore, the budget position will be improved by a lower realisation of net borrowing needs than assumed by the MoF for 2019 in August 2018. In the course of 2018 the debt rose by PLN23bn vs. assumed PLN39.7bn.

It's worth noting that part of recently passed by parliament additional budget expenditures are neutral from the debt point of view. For example, Demographic Reserve Fund and the Fund of Early Retirement assets , managed by ZUS, were uploaded by 3PLNbn (over the whole year by PLN6.5bn).



Source: Ministry of Finance, Santander



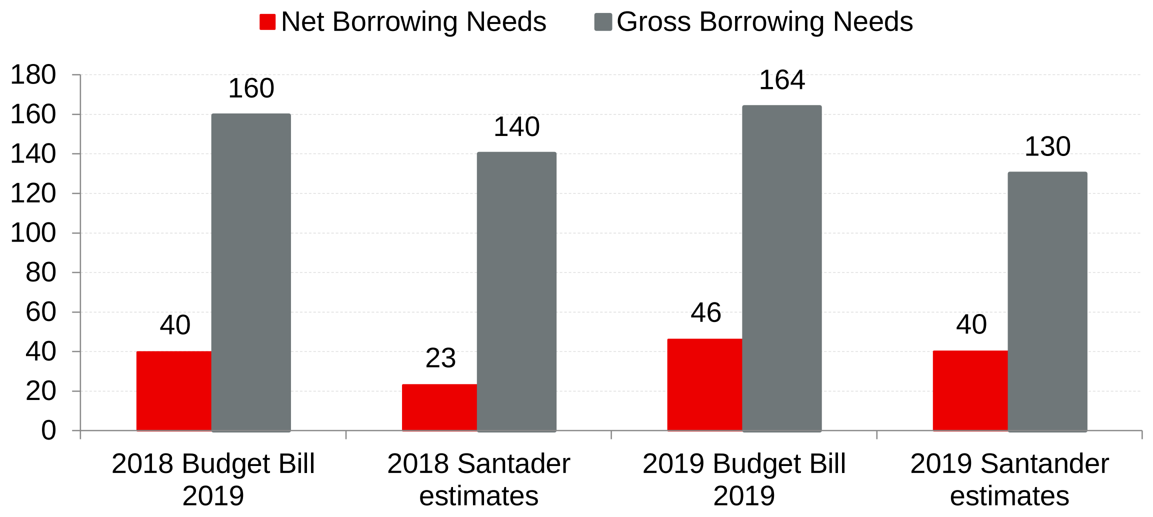
Source: Ministry of Finance, Santander

2019 Financing: borrowing needs a bit lower

In our opinion, in 2019 the gross borrowing needs will amount to cPLN130bn (with PLN120bn raised on the Polish market). We have built these estimates based on the assumption of a slightly lower level of financing of gross borrowing needs for 2020 at the end of 2019 than we saw at the end of 2018. Moreover, we assume that the liquidity cushion at the end of 2018 will amount to PLN27bn. We expect that the net borrowing needs realised on the domestic market will amount to PLN40bn.

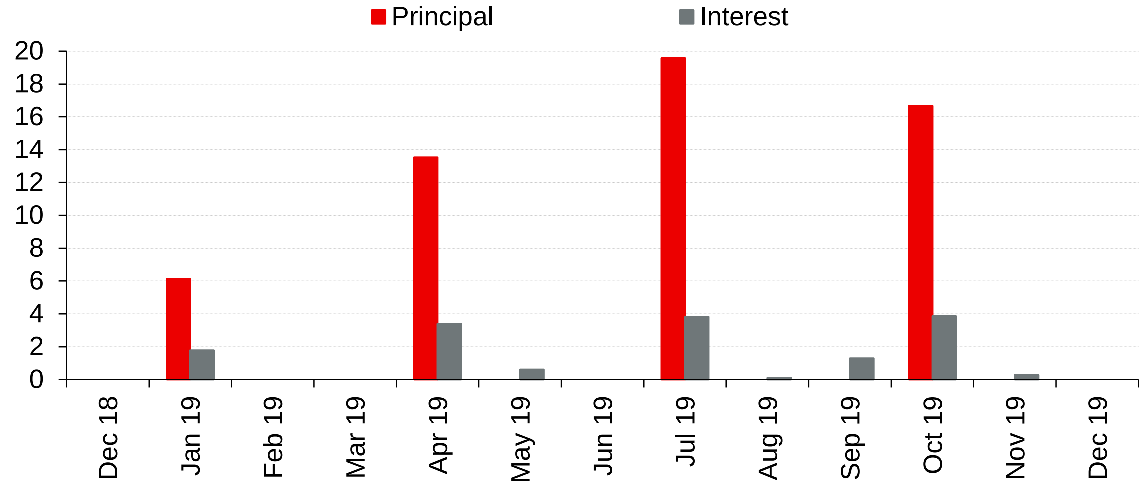
The lower level of gross borrowing needs estimated by us for 2019 (comparing to the MoF assumptions) is mainly a consequence of earlier bonds and credits rolling (cPLN28bn). The rest is a result of lower than the MoF assumed budget deficit (we expect in 2019 the budget deficit to show lower realisation by about PLN5-7bn).

Borrowing needs PLN bn



Source: Ministry of Finance, Santander

Zloty-denominated bond redemption and interest payments, PLN bn



Source: Ministry of Finance, Santander

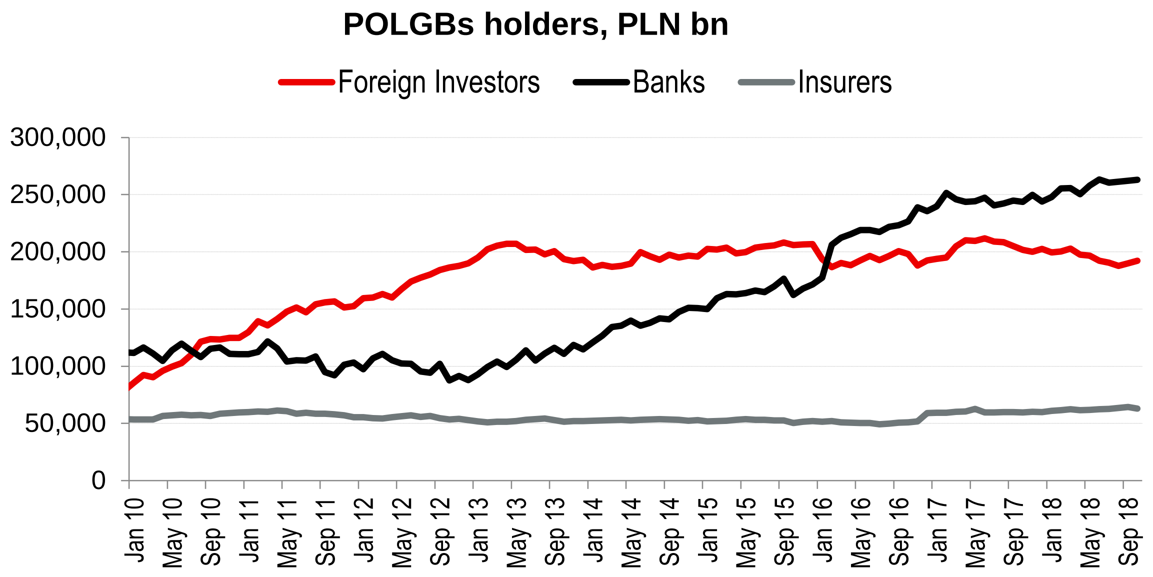
2019 Financing: demand from banks still high

We believe that – as in the recent years – the demand for POLGBs will be driven mainly by the domestic banks (due to the regulatory regime). According to our estimates, domestic banks may buy the biggest part of POLGBs in 2019 (thanks to a solid growth of on-demand or short-maturity deposit in the banking sector, low interest rates and risk aversion among the retail clients).

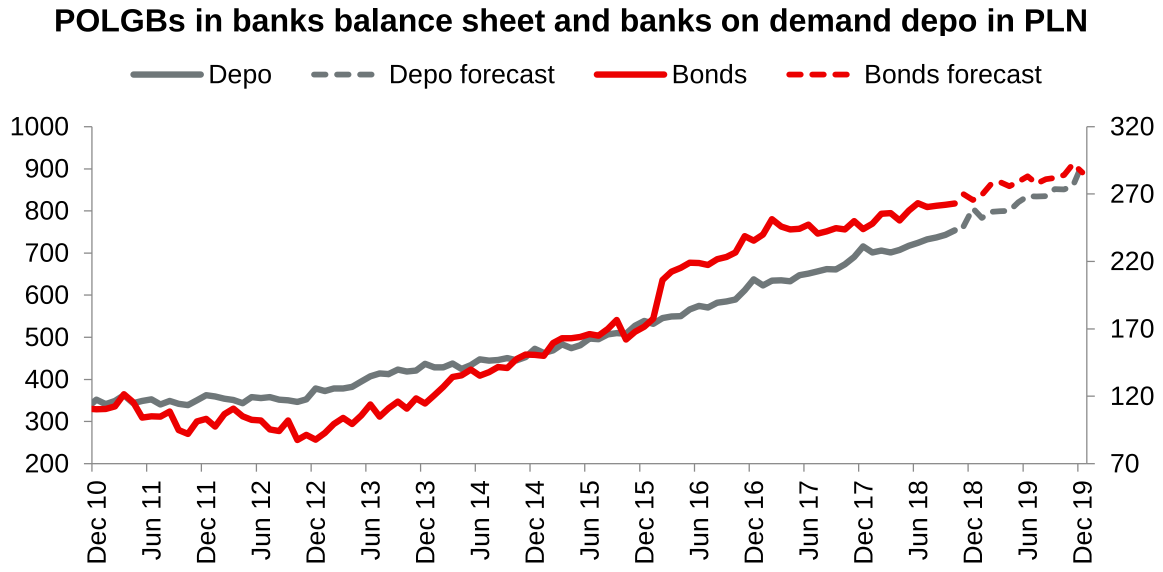
Non-financial institutions are likely to be the second biggest group (in terms of engagement) consuming the extra supply. Moreover, the sovereign bonds in investment funds' and insurers' assets are likely to benefit from the 2018 sell-off of risky assets. Finally, we expect the outstanding volume of saving bonds to increase by cPLN4bn.

Supply of Bonds	PLN bn
MF 2019 draft budget POLGBs	46
MF 2019 draft budget foreign currencies bonds	11
Demand for POLGBs	**PLN bn**
Total	52
Banks	23
Non financial institutions	9
Investment funds + Insurances	7
Savings bonds/individuals	4

Source: MoF, Santander Bank Polska



Source: Ministry of Finance, Santander



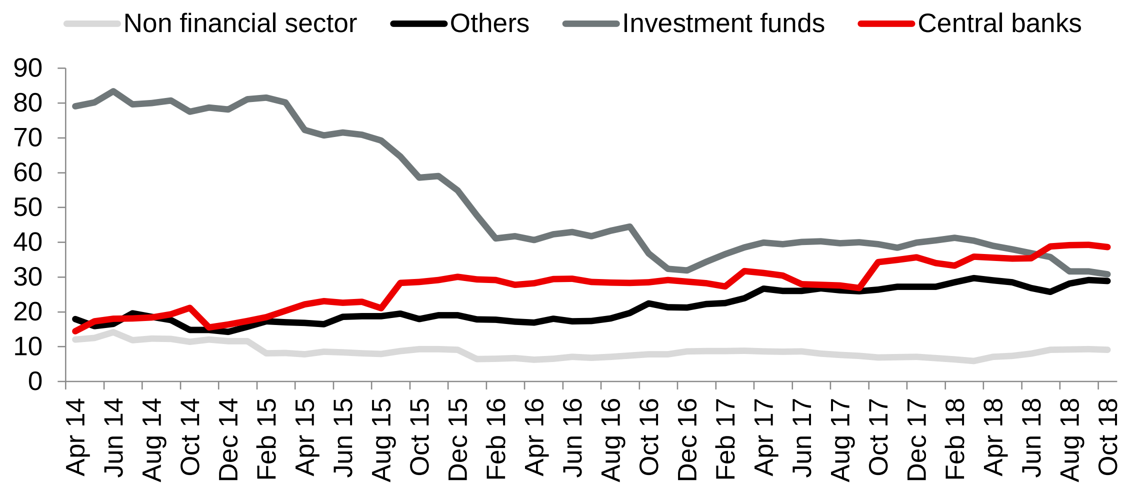
Source: Ministry of Finance, Santander

2019 Financing: foreign investors still in play

We anticipate a reversal of the negative trend of foreign investors' engagement in POLGBs, mainly owing to the breaking of the growth trends in core markets yields. It is worth to noting that in 2018 the DV01 of non-residents' portfolio stayed roughly at the same level over the entire year (c4.4), about 0.2pp lower comparing to the beginning of 2017. We expect that the strong demand from Asian investors will be maintained in 2019 due to the expected slowdown in Asian economy (resulting from a worsening of growth in China) and the related drop in Asian yields. Furthermore, we expect that the sell-off of POLGBs by US investors (the main driver of decreases in foreign debt holders' share over the last three years) will stop as prospects of aggressive rates hikes vanish.

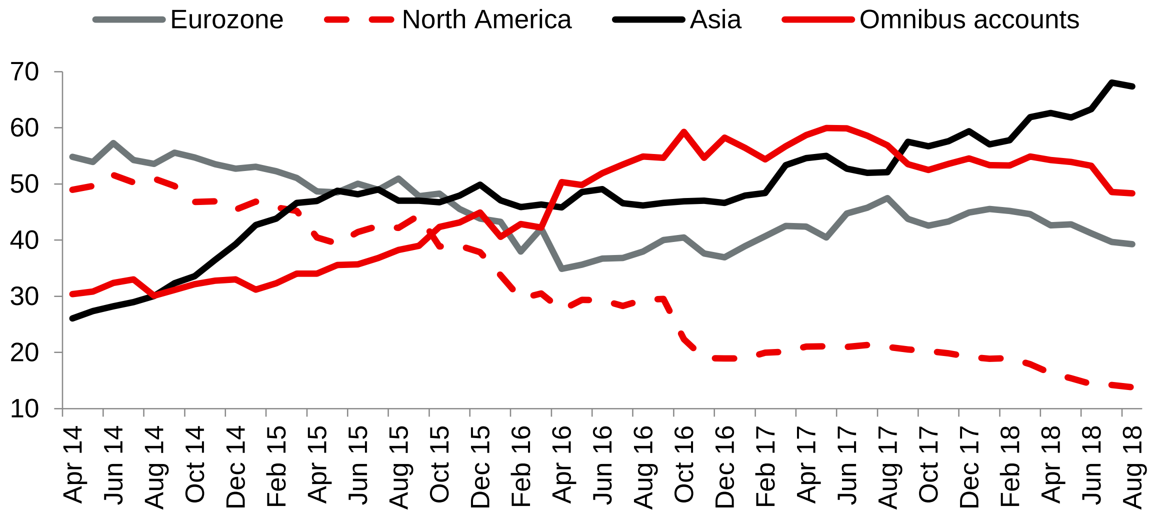
We expect an issue of new EUR denominated series (2.5bn), to replace 1.68bn EUR bonds maturing in January, and a 1bn CHF issue, which will mature in May. We believe that the Ministry of Finance will decide to offer the new EUR bonds in 1Q19 because of the favourable market condition. The rest of foreign currency bonds maturing in 2019 will be replaced by POLGBs issue.

Foreign POLGBs holders by type PLN bn



Source: Ministry of Finance, Santander

Foreign POLGBs holders by region PLN bn



Source: Ministry of Finance, Santander

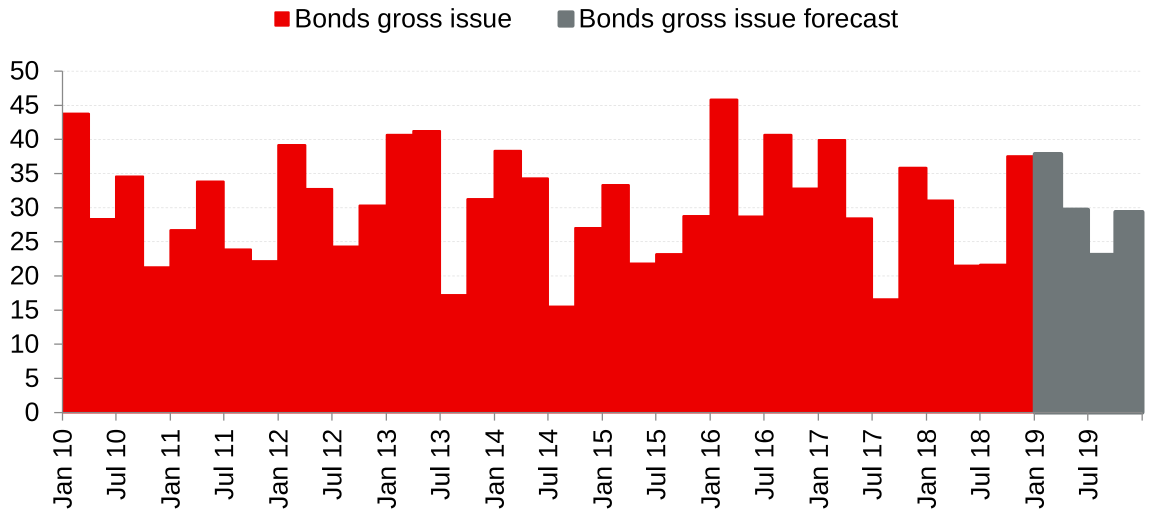
2019 Debt supply schedule

For 2019 we anticipate a slightly higher POLGBs gross issuance than sold by the Ministry of Finance in 2018 (PLN120bn in 2019 vs. cPLN118bn in 2018). We think that the issue calendar will be similar to the 2018 calendar. In our opinion, the largest increase in debt will take place in 1Q19, then gradually falling to almost zero levels in 3Q19 and rising slightly at the end of the year. The gross bonds issues will start from a high level in 1Q19, then gradually decrease until the end of 3Q19. The Ministry of Finance offer should rise again in 4Q19 close to the 2Q19 level.

According to the draft budget, the Ministry of Finance has planned the debt services cost at PLN29.2bn. The cost of the domestic debt service will amount to PLN20.8bn. According to our estimates, the cost of POLGBs coupon payment will amount to PLN15.1bn, while the coupon payments on bonds denominated in foreign currencies will be PLN6.3bn.

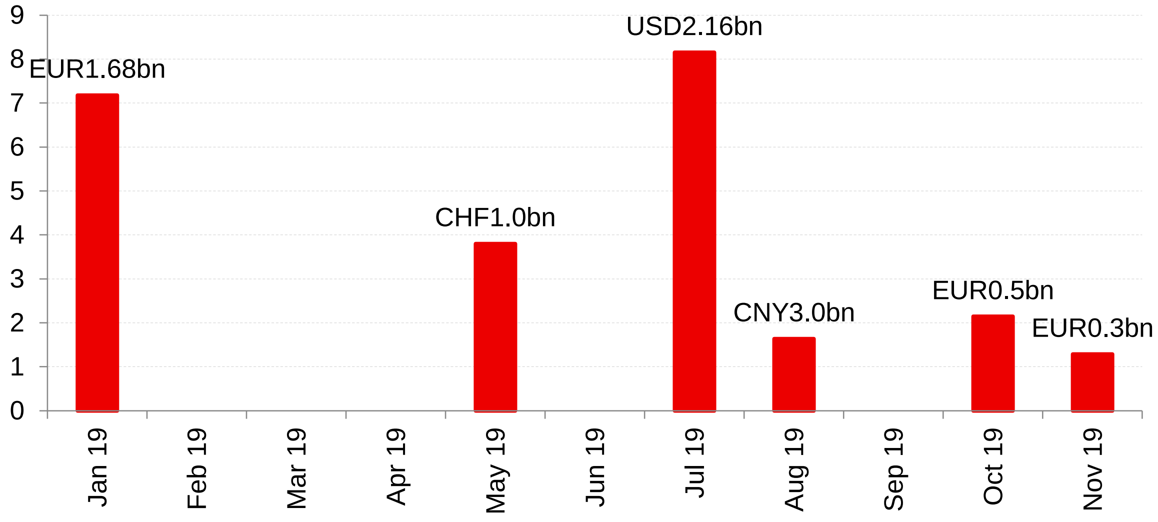
Coupon payments in PLN will be more or less evenly distributed over the quarters (except for a slightly "lighter" 1Q19). In the case of the coupon payments of foreign currency-denominated bonds, most of them will be realised by the end of April.

POLGBs issue by quarter PLN bn



Source: Ministry of Finance, Santander

Foreign bonds redemption calendar PLN bn



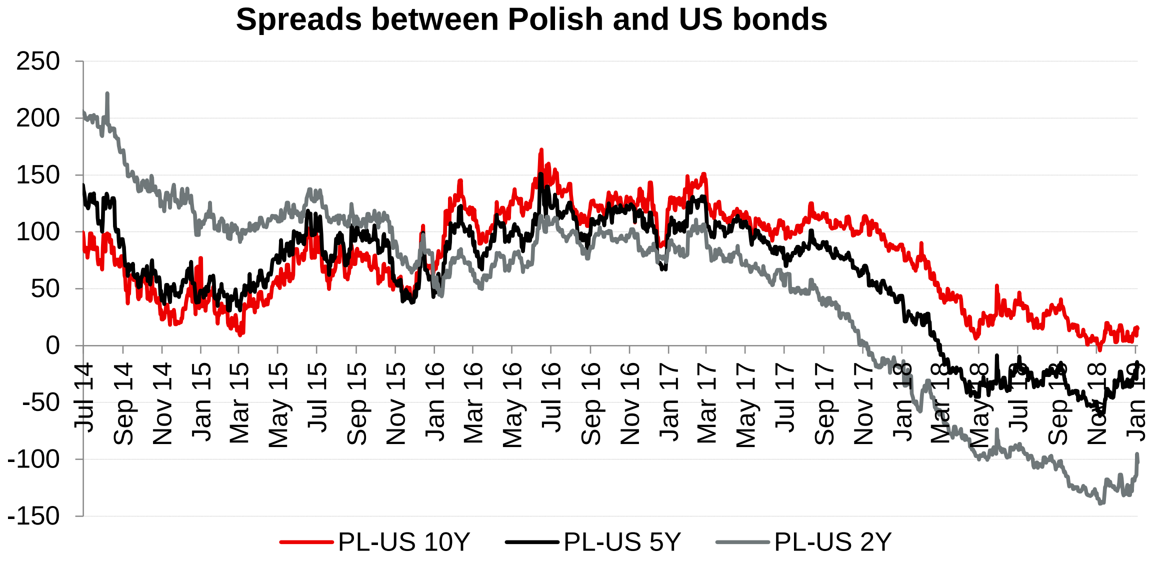
Source: Ministry of Finance, Santander

FI: Yields and rates forecast

In our opinion, the yields of Polish bonds will remain low over most of 2019, mainly owing to the CPI staying below the NBP inflation target and a deceleration of GDP growth over the whole of 2019.

In 2Q19 and 3Q19 we expect some upward shift across the yield curve. This move will be a reaction to a gradual rise of core and headline inflation and the possible resulting rise in market speculation of a looming interest rates hike. As a result, we forecast the yields of 2Y bonds to increase temporary to 1.60%, with a simultaneous temporary upward shift of 5Y and 10Y yields to 2.55% and 3.10%, respectively. The mid-year temporary upward shift in the 5-10Y segment could be supported by investors' pre-election concerns about potential additional fiscal stimulation in the coming years.

We think that the upward shift of the belly and the long end of the curve will be only temporary, owing to the still strong fiscal position and central bank persistently maintaining its dovish rhetoric. As a consequence, we anticipate that the yields of 5Y bonds will return to 2.45% and 10Y yields to 2.85% at the end of the year. The ASW spread should remain low.



Source: Thomson Reuters, Santander

IRS and yields forecasts (end of period)

Bonds	1Q19	2Q19	3Q19	4Q19
2Y	1.4	1.55	1.60	1.45
5Y	2.35	2.45	2.55	2.45
10Y	2.85	2.95	3.1	2.85
IRS	**1Q19**	**2Q19**	**3Q19**	**4Q19**
2Y	1.9	2.15	2.2	2.25
5Y	2.45	2.45	2.5	2.35
10Y	2.55	2.6	2.6	2.6

Source: Santander

FX Market: zloty under pressure in 2018

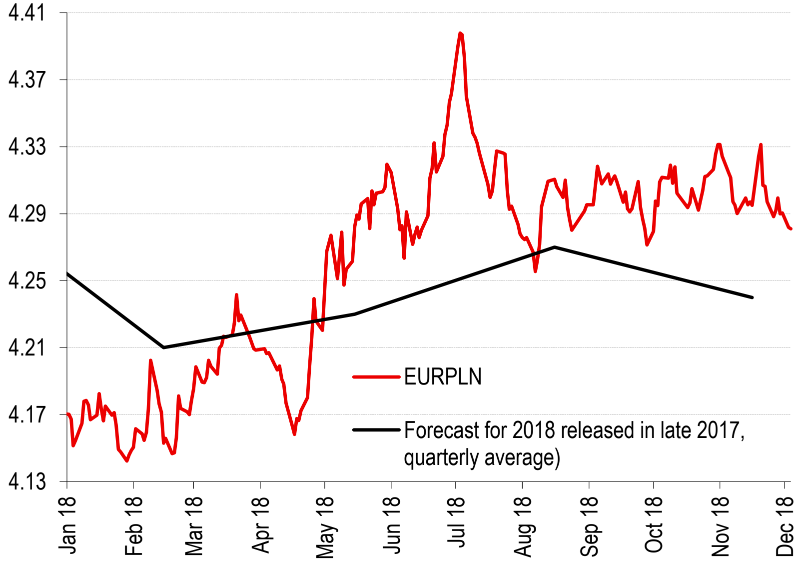
In our previous annual report issued in December 2017, we pointed that there was a limited room for the zloty to appreciate in 2018 after its outstanding performance in 2017. We outlined that the Polish currency became expensive vs its EM peers and it might be difficult to continue appreciation at the same pace given the outlook for a slower economic growth. In 2018, nearly all major EM currencies depreciated vs the dollar and half of them vs the euro vs 2017 ending levels with the zloty in the middle of the table.

Our assumption proved correct but we have underestimated the scale of the zloty depreciation in the middle of the year and so EUR/PLN ended 2018 above the 2017 closing level. It seems that the main drivers of the zloty weakening were the dollar appreciation, concerns about the global economic growth and shaky sentiment on the EM currency market. On the domestic side, low inflation and dovish MPC rhetoric also played their role.

Our call for a gradual deceleration of the pace of the GDP growth did not materialize and it seems that robust economic expansion together with the falling bond yields was the factor that prevented the zloty from a bigger depreciation.

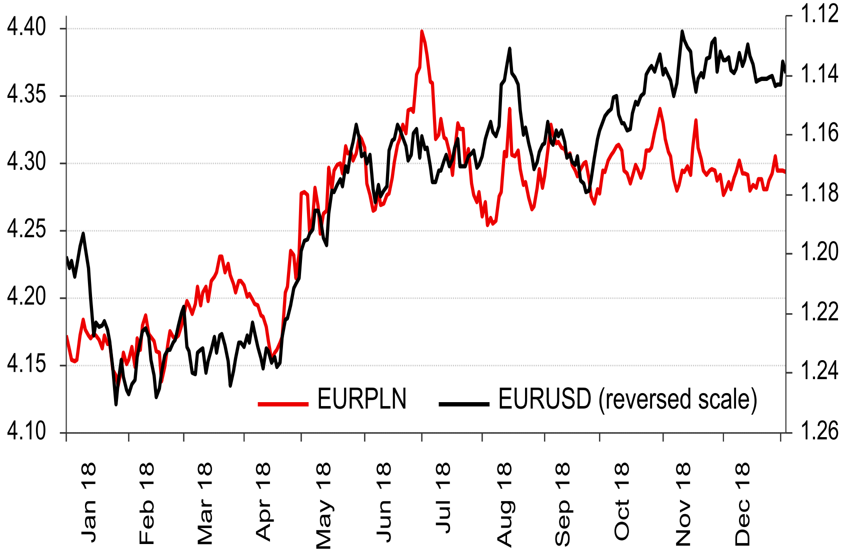
Overall, our EURPLN forecasts proved pretty good when compared to the rest of the surveyed entities. **In 1Q18, 2Q18 and 3Q18 we ranked first in the Bloomberg FX forecasts contest in the EUR/PLN category.**

EURPLN



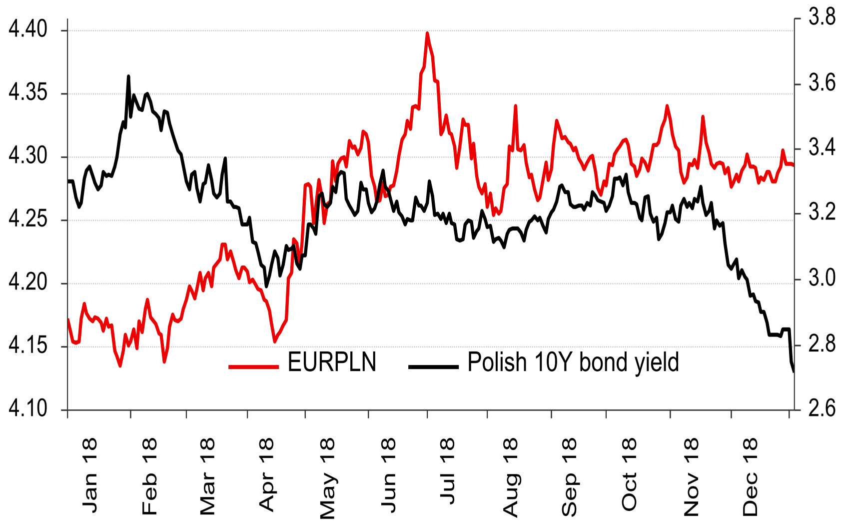
Source: Reuters, Santander

EURPLN and EURUSD



Source: Thomson Reuters Datastream, Santander Bank Polska

EURPLN and Poland 10Y bond yield



Source: Thomson Reuters Datastream, Santander Bank Polska

FX Market: tough start of the year

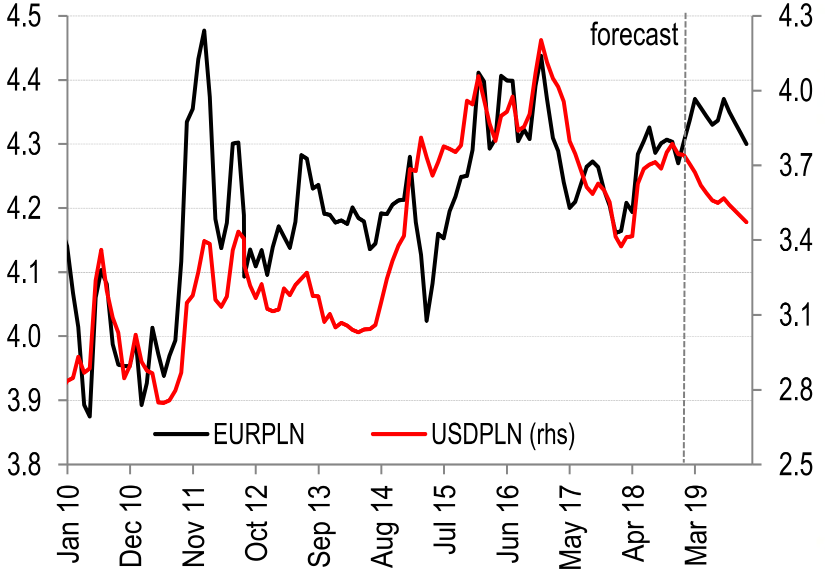
We expect the zloty to depreciate vs the euro in early 2019 and a gradual recovery of Polish currency later in the year.

The first months of 2019 could bring some zloty depreciation as the hard data will finally show evidence that the economic slowdown in Poland is actually happening. Additionally, the materialisation of two Fed rate hikes in 1H19 (currently not priced-in by the market) could be negative for EM assets. The beginning of 2019 might be a tough period for the zloty also amid Brexit uncertainty as the Polish economy is among the most exposed to the no-deal Brexit. Volatility on the (not only) Polish market is very low and this also makes us cautious as regards the room for stronger zloty in the short term.

„Hard Brexit" is not our base-case scenario and any jump in volatility should be sharp but temporary. Thus, later in the year, the zloty may start benefiting from the rising EUR/USD (see slide 47 for details), pause in the Fed rate hike cycle and market pricing for an improvement of the situation on the emerging markets after a turbulent 2018. Euro's appreciation vs the dollar should lead to **markedly lower USD/PLN throughout 2019**.

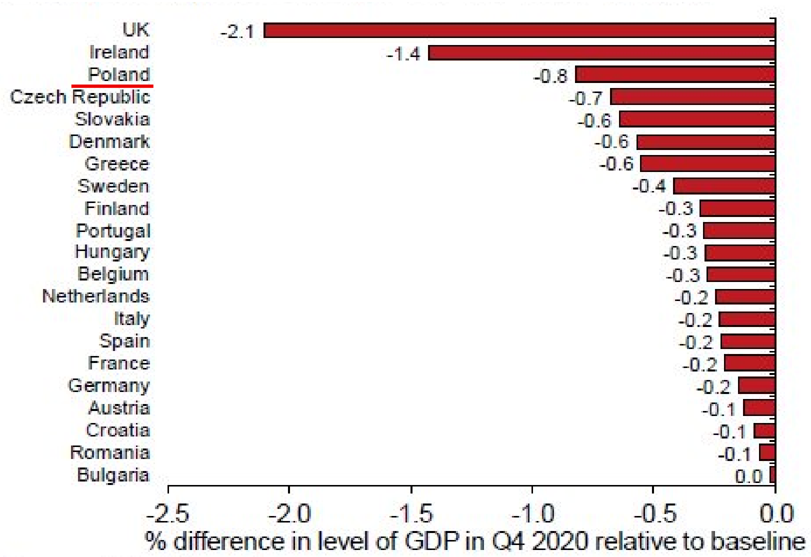
However, the pace of EUR/PLN decline may be slow amid no interest rate hikes in Poland this year, continuation of an economic slowdown and markets' uncertainty ahead of the general election planned for autumn.

EUR/PLN and USD/PLN



Source: Santander

„Hard Brexit" impact on GDP



Source: Oxford Economics

FX forecasts

	1Q19	2Q19	3Q19	4Q19
EUR/PLN	4.34	4.34	4.35	4.32
USD/PLN	3.71	3.59	3.55	3.50
CHF/PLN	3.72	3.67	3.64	3.60
GBP/PLN	4.82	4.75	4.76	4.74

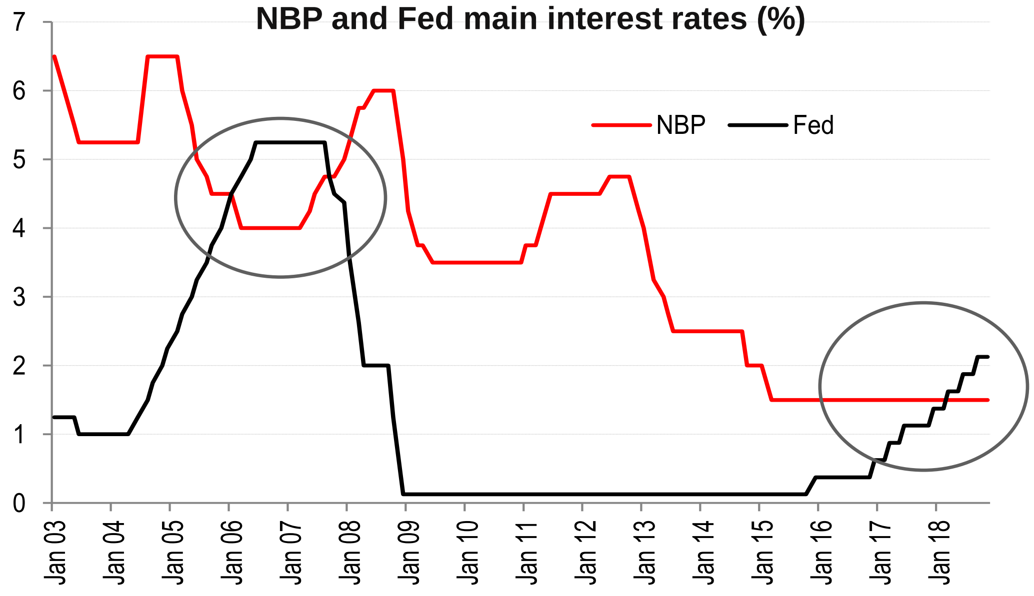
Source: Santander; quarterly averages

FX Market – Higher interest rate disparity to weigh on the zloty

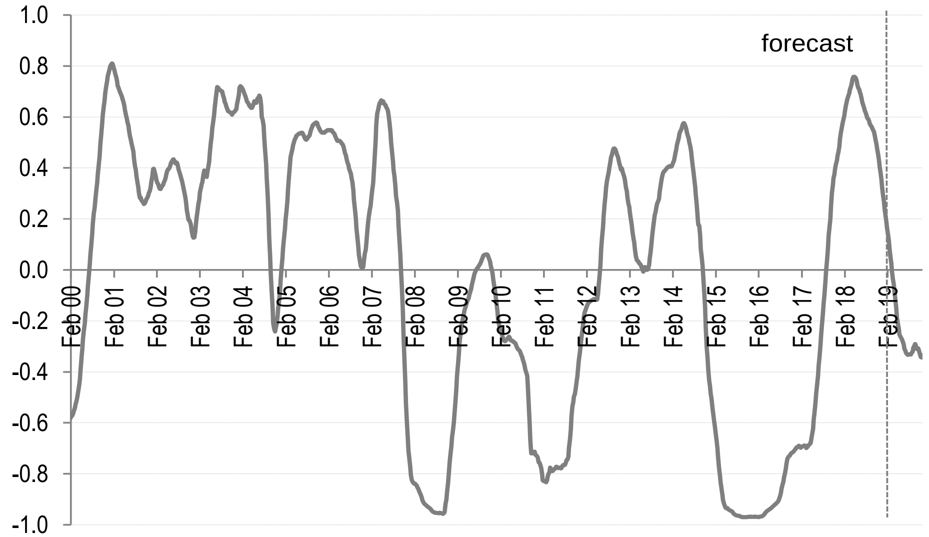
The 25bp rate hike delivered by the FOMC in March 2018 brought the upper-end of the Fed Target Rate above the Poland central bank refi rate for the first time since 2007. Back then, the maximum interest rate disparity reached 125bp. Currently, it stands at 100bp after the December hike.

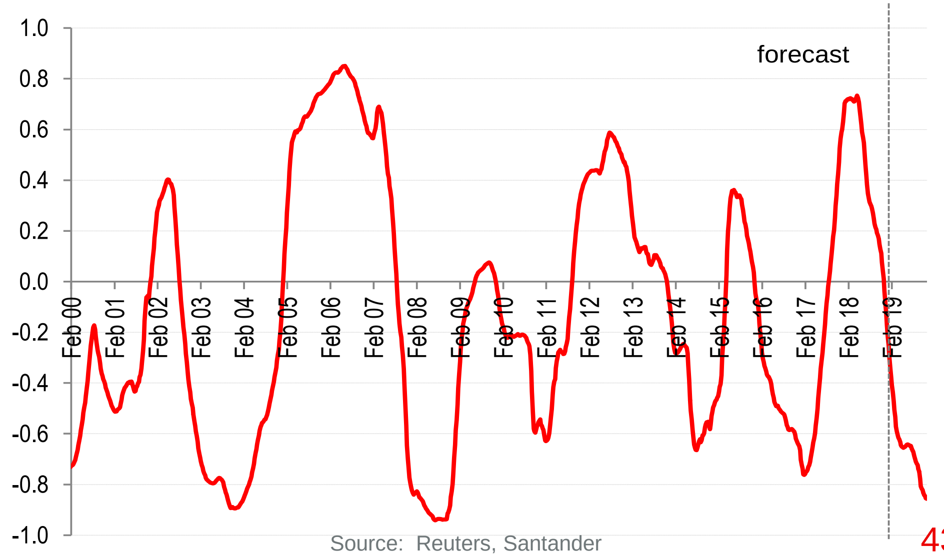
The 2-year weekly EUR/PLN and USD/PLN correlations with the 6M WIBOR-LIBOR spread reached their cyclical peaks and started to decline. We expect the money market spread to become even more negative until mid-2019 which implies higher EUR/PLN if the correlation continues to fall. Only in late 2019 the spread may rise slightly as the Polish market could start pricing NBP rate hikes.

We expect a pause in the Fed rate hikes to take place in 2H19 and no change in rates in Poland this year.



Source: Reuters, Santander





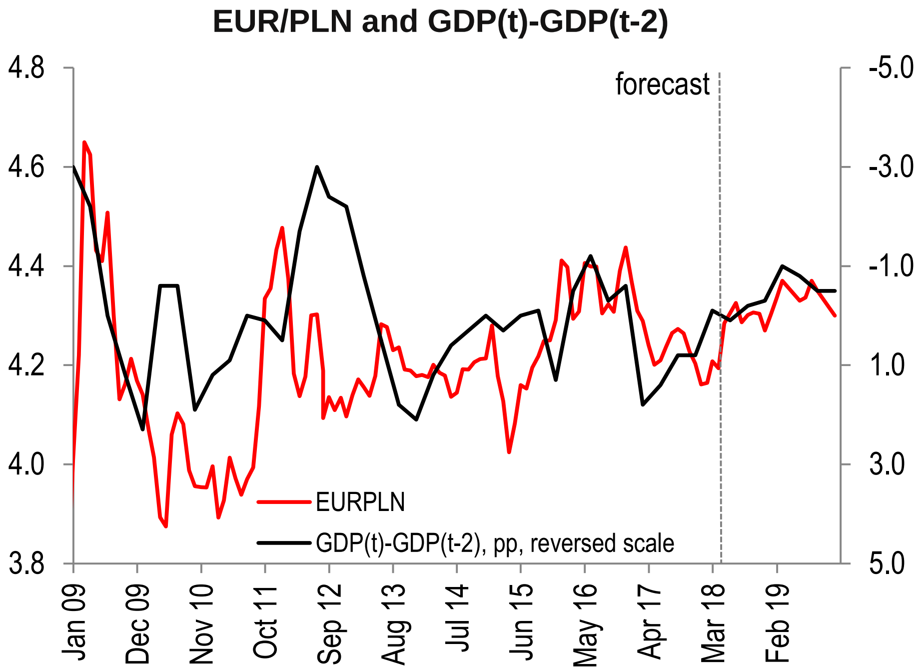
Source: Reuters, Santander

FX Market: slower GDP growth, less premium vs euro zone

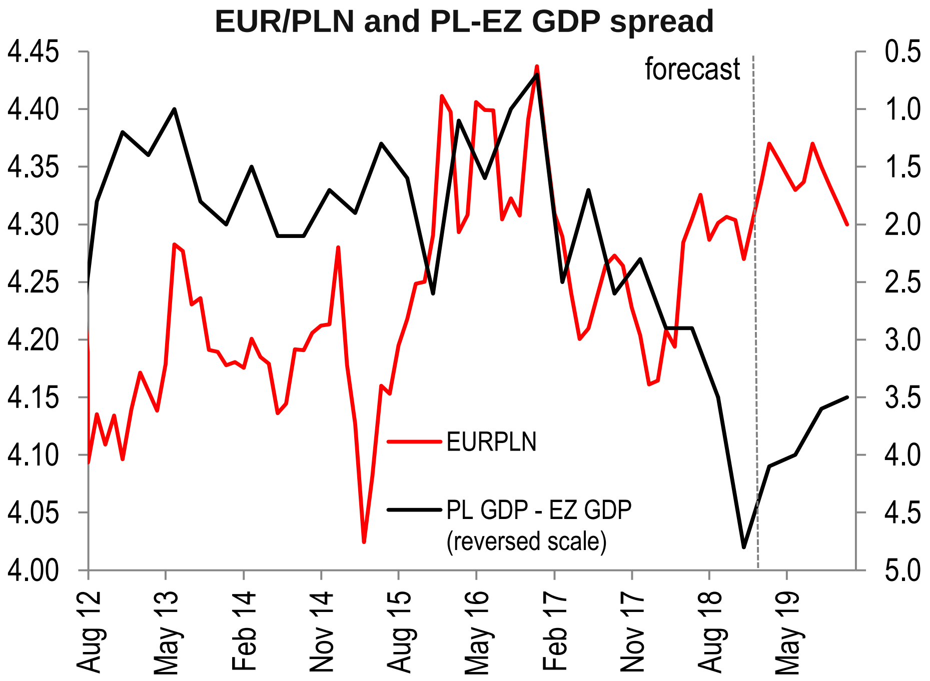
We update the charts included last year that show that it is the change in the pace of the GDP growth that matters in the long run (not only the level of growth itself). Also, the spread vs the euro zone economic growth is a proxy for the zloty's attractiveness.

Like we elaborate on the economic pages, we forecast Poland's GDP pace of growth to decelerate in each consecutive quarter of 2019. As we expect the euro zone GDP to keep growing c2%, the spread vs Polish headline growth would fall markedly next year. Although there has been some divergence between EUR/PLN and the growth spread in mid-2018, the falling growth premium should limit the room for the zloty strengthening in early 2019.

We think that the bond and stock markets have to some extent already priced-in the scenario of a slower growth in Poland and so we do not expect this phenomenon to have a persistent negative impact on the zloty.



Source: Reuters, Santander



Source: Reuters, Santander

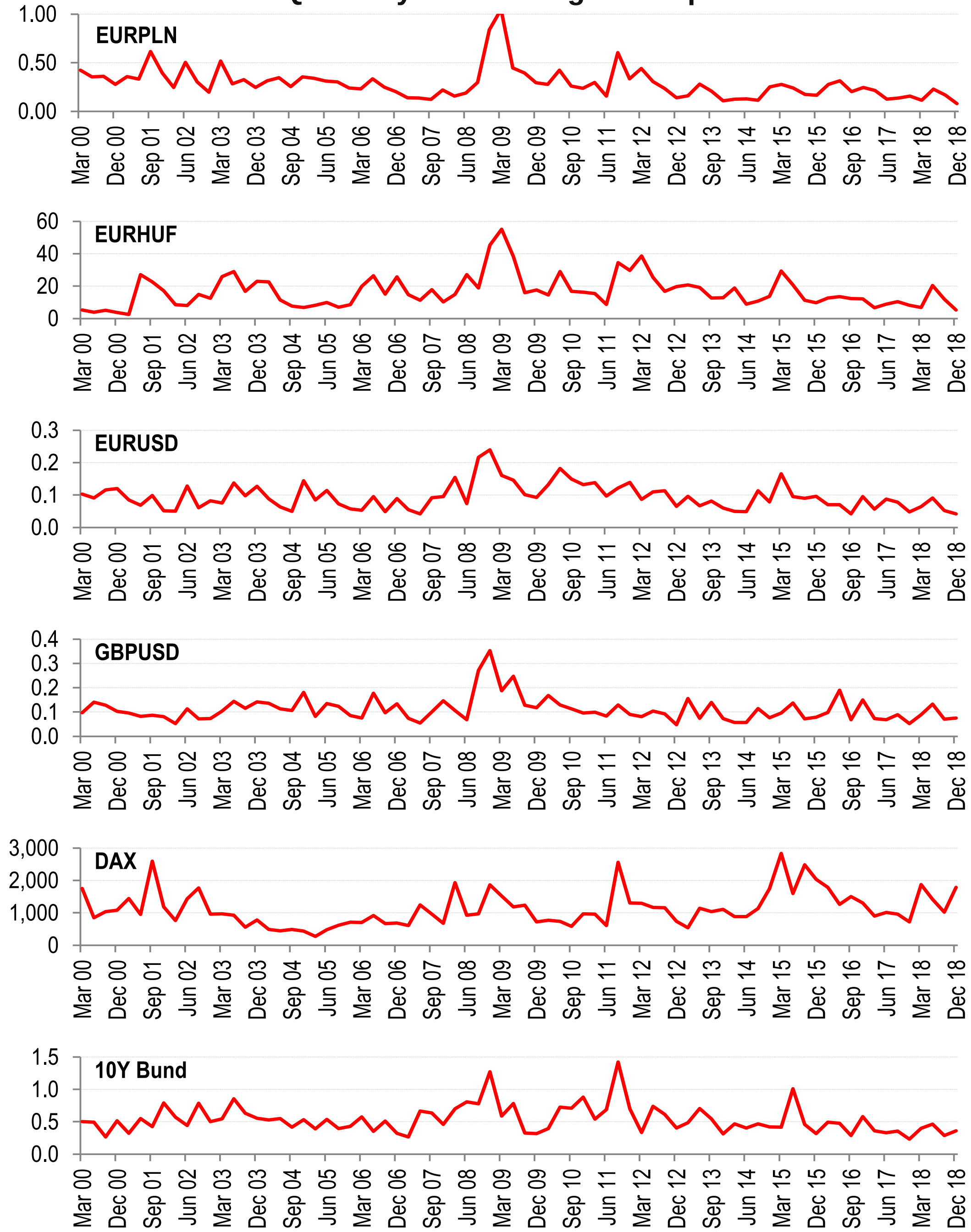
FX Market: dull period

Since August, EUR/PLN has been moving in a very narrow range and the 4Q18 high-low spread was the lowest quarterly range since 2Q93, according to Reuters data. Low volatility, measured as quarterly high-low spread, is recorded also on the CEE and developed market exchange rates (even the pound) or bond yields. Only stock markets and LatAm currencies seem to keep proper volatility.

Periods of a very low volatility are often followed by sharp jumps of price changes. The chart shows that last time when we saw a real rise in volatility was in 2008 when the financial crisis broke out in the US.

We do not expect any such event to take place in the foreseeable future but we think it would be difficult for the low volatility to stay that low undisturbed in the months to come. Recall that rise in volatility is usually a negative phenomenon for the EM currencies and this makes us cautious in assessing chances for a significant zloty appreciation in the short term.

Quarterly nominal high-low spreads



Source: Reuters, Santander

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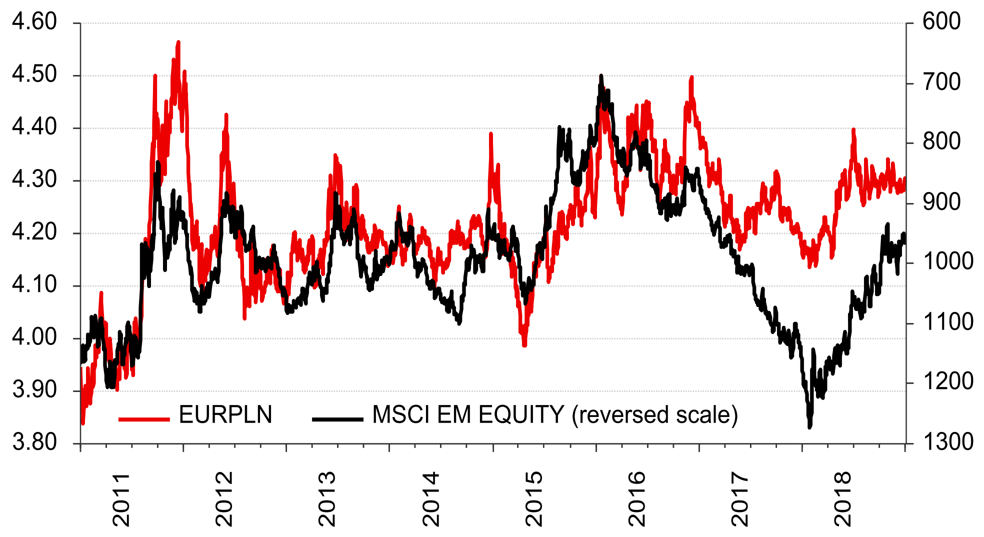
FX Market: watch the equity market

Bond yield changes are not very significant for the zloty which can be reflected in low EUR/PLN correlation with Polish 10Y bond yield (-33% for daily observations for the last eight years, whereas a positive correlation should be expected). At the same time, correlations for the respective period with WIG20 and MSCI EM Equity index are quite high with a logic direction at -60% and -78%, respectively.

Zloty's higher dependence on the risky assets performance is coherent with the fact, that it appears the PLN is a cyclical currency. Solid economic growth boosts companies earnings making them attractive to foreign investors, among others.

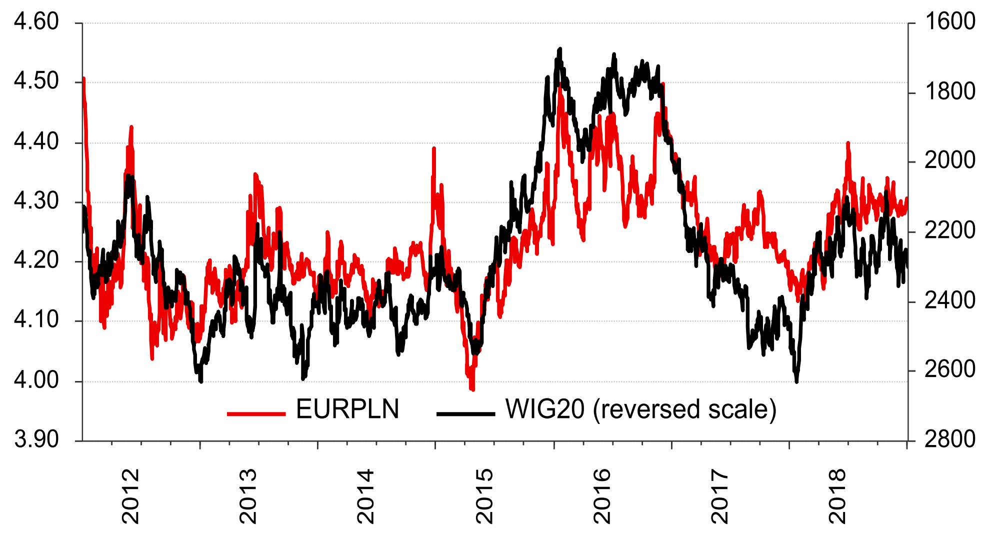
2018 has been a tough period for the EM equity market and it seems that much of the negative factors have already been priced in. At the same time, according to the October edition of the IMF's World Economic Outlook, in 2019 emerging and developing economies are expected to keep the 4.7% pace of growth forecasted for 2018 creating a positive environment for the risky assets this year. Thus, when the appetite for the EM risky assets rises, this should be supportive for the zloty once the 1Q negative factors recede.

EURPLN and MSCI EM Equity index



Source: Thomson Reuters Datastream, Santander Bank Polska

EURPLN and WIG20 index



Source: Thomson Reuters Datastream, Santander Bank Polska

FX Market: EUR, USD, GBP, CHF *

We expect the euro to gain vs the dollar and Swiss franc in 2019.

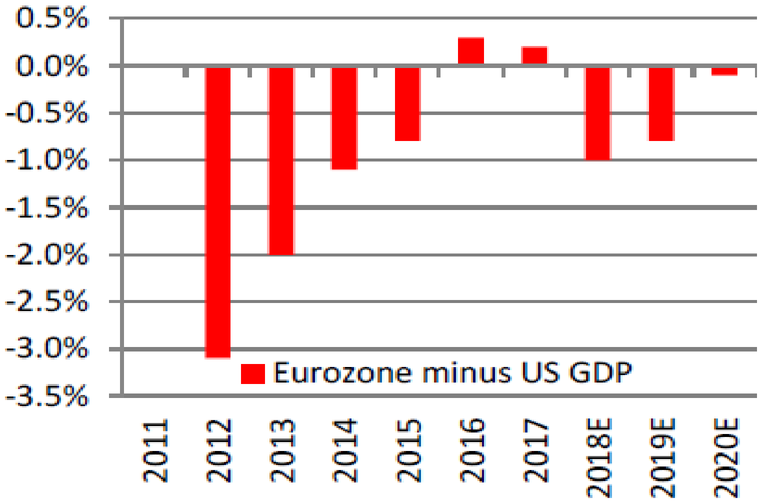
Slower economic growth in the US (amid fading impact of the fiscal stimulus and low chances for more of thereof) and looming end of the Fed interest rate hikes cycle imply there is little that could boost the dollar in 2019.

The Swiss central bank is expected to hold highly accommodative monetary policy longer than the ECB favoring weaker franc. Low inflation should allow to refrain from hiking interest rates.

The British economy might underperform its peers but it is the Brexit that shall largely determine the trend for the pound. We expect the final Withdrawal Agreement to be approved by the UK parliament allowing the UK to enter the transition period after it leaves the EU in late March. In such a scenario, the market could start pricing in rate hikes by the BoE. In effect, we expect the pound to gain vs the dollar and depreciate slightly vs the euro in 2019.

The single currency should benefit from the market pricing a change in the monetary policy stance in the euro zone with the rate hike delivered by the ECB in the final quarter of 2019. Also, the euro zone economy will catch up the US, according to our forecasts.

Difference in pace of the GDP growth



Source: Bloomberg, Santander

FX forecasts (eop)

	1Q19	2Q19	3Q19	4Q19
EUR/USD	1.17	1.21	1.23	1.24
EUR/CHF	1.17	1.19	1.20	1.20
EUR/GBP	0.90	0.92	0.92	0.91

Source: Santander

* based on the Santander G-10 Macro, Rates & FX: 2019 Year Ahead published on December 14, 2018

Political update: election cycle started

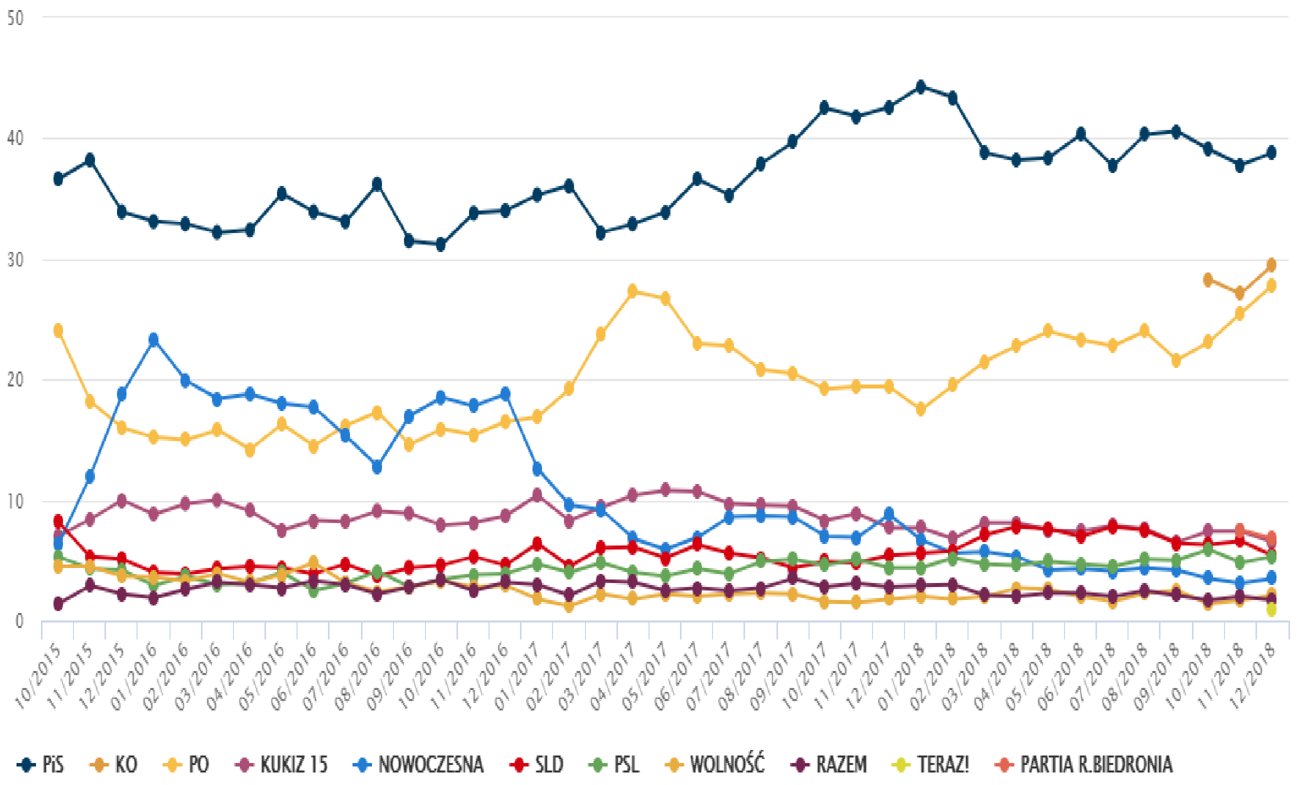
Poland has entered the election cycle that started in October 2018 with the local elections, and will end in late 2020 with presidential elections. In between, we will have European elections in May 2019 and parliamentary elections in October 2019.

The 2018 local elections ended with the ruling party Law and Justice (PiS) winning clearly on a country level, but also revealed that the society is very much divided, with urban population mostly rejecting the government's policies and countryside being in favour of the ruling party. The European elections could be another important challenge for PiS, as it would probably try to grab the centrist electorate and the far-right voters at the same time.

The opinion polls until now have been showing very stable and strong support for PiS, well ahead of the opposition, although the latter started regaining ground recently. The ruling party's popularity did not suffer much from the controversies related to judiciary reform or ongoing conflicts with EU. Even the recent KNF scandal seems to have had very limited impact on public opinion, although it might be still too early to judge the full consequences. It is also too early to say if the general elections in the autumn will bring a significant reshuffle on the political scene, as many scenarios are still possible, including another clear victory of PiS, their slim victory resulting in minority government, or even a landslide defeat.

When the election campaign intensifies, the rhetoric may turn towards more populistic, with new costly promises in the air, but it is worth remembering that there was usually a large gap between measures promised in the campaign and implemented after elections.

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



Source: ewybory.eu

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Economic Forecasts

		2016	2017	2018E	2019E	1Q18	2Q18	3Q18E	4Q18E	1Q19E	2Q19E	3Q19E	4Q19E
GDP	PLNbn	1,861.1	1,988.7	2,111.5	2,225.1	486.5	507.1	525.3	592.7	513.2	534.1	553.3	624.4
GDP	% y/y	3.1	4.8	5.1	3.8	5.3	5.1	5.1	4.8	4.3	3.8	3.7	3.5
Domestic demand	% y/y	2.3	4.9	5.7	4.6	6.6	4.4	6.2	5.6	4.9	4.6	4.4	4.3
Private consumption	% y/y	3.9	4.9	4.6	4.3	4.7	4.9	4.5	4.5	4.5	4.4	4.3	4.0
Fixed investment	% y/y	-8.2	3.9	8.1	7.3	8.2	4.7	9.9	9.0	8.8	8.0	7.0	6.5
Unemployment rate *	%	8.2	6.6	5.9	5.5	6.6	5.8	5.7	5.9	6.0	5.4	5.4	5.5
Current account balance	EURmn	-2,248	715	-3,478	-7,164	569	670	-2,532	-2,185	-246	-354	-3,274	-3,289
Current account balance	% GDP	-0.5	0.2	-0.7	-1.4	-0.2	0.0	-0.5	-0.7	-0.9	-1.1	-1.2	-1.4
General government balance (ESA 2010)	% GDP	-2.2	-1.4	-0.5	-1.3	-	-	-	-	-	-	-	-
CPI	% y/y	-0.6	2.0	1.7	1.9	1.5	1.7	1.9	1.4	1.6	1.9	1.9	2.1
CPI *	% y/y	0.8	2.1	1.1	2.4	1.3	2.0	1.9	1.1	1.9	1.9	1.9	2.4
CPI excluding food and energy prices	% y/y	-0.2	0.7	0.7	1.7	0.8	0.6	0.8	0.7	1.2	1.6	1.8	2.3

* End of period; other variables – average in period

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Market Forecasts

		2016	2017	2018	2019E	1Q18	2Q18	3Q18	4Q18	1Q19E	2Q19E	3Q19E	4Q19E
Reference rate *	%	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
WIBOR 3M	%	1.70	1.73	1.71	1.71	1.72	1.70	1.71	1.72	1.71	1.71	1.71	1.71
Yield on 2-year T-bonds	%	1.66	1.89	1.60	1.51	1.64	1.57	1.61	1.56	1.41	1.50	1.58	1.53
Yield on 5-year T-bonds	%	2.37	2.78	2.51	2.44	2.61	2.43	2.53	2.49	2.35	2.43	2.50	2.47
Yield on 10-year T-bonds	%	3.05	3.44	3.23	2.94	3.37	3.18	3.19	3.17	2.83	2.93	3.02	2.97
2-year IRS	%	1.62	1.90	1.90	2.01	1.93	1.83	1.89	1.94	1.86	1.98	2.17	2.02
5-year IRS	%	1.94	2.40	2.45	2.42	2.50	2.39	2.45	2.46	2.31	2.45	2.47	2.47
10-year IRS	%	2.37	2.86	2.91	2.57	2.96	2.89	2.92	2.88	2.53	2.57	2.58	2.60
EUR/PLN	PLN	4.36	4.26	4.26	4.34	4.18	4.26	4.30	4.30	4.34	4.34	4.35	4.32
USD/PLN	PLN	3.95	3.78	3.61	3.58	3.40	3.58	3.70	3.77	3.71	3.59	3.55	3.50
CHF/PLN	PLN	4.00	3.84	3.69	3.66	3.59	3.63	3.76	3.79	3.72	3.67	3.64	3.60
GBP/PLN	PLN	5.35	4.86	4.81	4.77	4.73	4.86	4.81	4.85	4.82	4.75	4.76	4.74

* End of period; other variables – average in period

This analysis is based on information available until 08.01.2019 has been prepared by:

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