MACROscope

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Take it easy

Poland: Economic Outlook

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Executive summary (macro)

Despite mounting concerns about global economic slowdown and the main central banks preparing to re-enter emergency easing mode, Polish economy still shows big resilience to global sentiment deterioration. This does not mean, however, that the increasingly challenging external environment will leave us without a scratch. After a very strong first quarter of 2019 and a stunning April, data for May already brought some disappointment and we expect that June's results of output and sales will be even less impressive. As a result, the GDP growth in 2Q19 probably slowed to c.4.5% y/y, and we expect to see a continuing gradual deceleration in the coming quarters, as private consumption alone (even boosted by much higher social transfers) will be not enough to fully offset the impact of looming worsening of net exports and slowing investments. **We keep our GDP growth forecast for this year at a solid 4.3% and expect c.3.5% in 2020.** We still believe that we are not going towards a prolonged stagnation or recession in the euro zone, but if we are, the slowdown in Poland could be even more pronounced. Anyway, we think this is not a good time for upward GDP forecast revisions.

Among domestic challenges the deepening labour shortage is still the biggest one and will not go away quickly, in our view, especially that the inflow of migrant workers is slowing (and may even reverse once Germany opens up their borders in 2020). This is why **we think that the elevated wage growth will not disappear but instead will rather escalate in the coming quarters**. The good thing is that we see some evidence of Polish companies addressing this problem and trying to boost productivity through automation, which was reflected in recent data showing a rebound in private sector investments in machinery and equipment.

As we expected, inflation accelerated visibly, breaching 2.5% official target in June for the first time since 2012. **The upward trend will continue in the coming quarters, in our view, bringing CPI growth to almost 3% by year-end and almost 4% y/y at the beginning of 2020** (with a risk of touching this mark if the spike in food and energy prices exceeds our assumptions). While some part of the inflation pickup is related to transitory factors or level shifts in come price categories (a surge in food prices, higher energy costs and potential introduction of retail tax), it is important to recognise that the revival of core inflation is an important part of the process, and it is unlikely to ease soon, as the persisting cost pressure on companies will keep filtering into prices. As a result, we think that inflation could stay above the target for longer than currently anticipated by the central bank.

Such scenario does not mean, however, that the Monetary Policy Council will change its wait-and-see policy anytime soon. While the local factors would be increasingly supportive for considering policy normalisation, the big shift towards a more dovish approach by the world's main central banks cannot be ignored by local policymakers and, in our view, **takes interest rate hikes off the table at least until the end of 2020**.

Fiscal outlook for 2019-20 remains quite sanguine, in our view. **This year's fiscal gap may reach 1.7% of GDP** and will be considerably higher than the record-low 0.4% of GDP recorded in 2018, but still well below the EU's 3% threshold. Next year's gap also should remain well contained, even below 1% of GDP (mainly due to significant one-off revenues), at least unless economic growth deteriorates significantly.

Executive summary (markets)

FX

In 1H19, the zloty performed better than we had expected with EUR/PLN falling below 4.24 in early-July amid market pricing of a Fed rate cuts. This implies the starting point for 2H19 is lower than we had expected and so we decided to cut our EUR/PLN forecasts for the remainder of the year. Technical analysis suggests that in the short term the zloty could give up part its recent gains but in our view the 2H19 in general should be positive for the Polish currency. The key assumption underlying this scenario is a continuation of dovish tilt in monetary policies of main central banks and only mild deceleration of economic growth in Poland.

FI

Concerns about global economic growth, continuing trade wars and resulting change of rhetoric of main central banks towards much more dovish support significant decline of yields. Among local factors, low supply of POLGBs and persistently dovish NBP rhetoric should be also supportive, even despite climbing inflation. Temporary profit taking on the debt market is possible in the middle of summer holidays, if the FOMC fails to deliver interest rate cut at the meeting in July. However, in the following few months horizon yields may decline further, under influence of new releases of global economic data (which will reveal the negative impact of already imposed higher tariffs), possible re-escalation of trade tensions and ECB policy outlook.

2019 Forecasts Revisited

Indicator	Our view in January	Our current view
GDP	The economic cycle has matured and the coming quarters will see GDP growth slowing moderately, yet still holding somewhat above potential.	Better-than-expected start of the year and the government's fiscal stimulus allowed us to raise GDP forecast for this year to 4.3%. At the same time, worsening global outlook suggests caution.
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.	Consumption was unimpressive at the start of the year, but will accelerate after the new fiscal transfers boost households' revenue. Investments will slow gradually, as a surge in private spending will not fully offset lower momentum in public investments. Net exports will finally deteriorate after surprisingly strong start of the year.
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.	The labour shortage continues. Wage growth has stabilised in the recent months, but we think the pressure will tend to strengthen over time as the inflow of migrants is still not enough to address companies' needs, and may be even reduced further after Germany opens its borders in 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.	Inflation started accelerating and the trend is likely to continue, pushing CPI to almost 3% by year-end and well above that level in 2020. Persisting cost pressure on companies, end of price wars in several sectors, unfreezing energy tariffs, and looming retail tax introduction – will all contribute to higher inflation in the next two years.
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.	A significant dovish shift in global central bank's policy bias means that it is even more likely that the Polish MPC will overlook increase of domestic inflation, even if it exceeds expectations. Rates likely to remain stable in 2019-2020.
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.	The government found money to finance PiS election promises without breaching the fiscal anchor, at least in 2019-20. The fiscal deficit will rise from record-low 0.4% of GDP in 2018 to c.1.7% in 2019 but should be below 1% again in 2020.
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.	Concerns about global economic growth, continuing trade wars and resulting change of rhetoric of main central banks towards much more dovish support significant decline of yields.
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 dollar, among others.	Lower starting point for 2H19 and dovish turn in global monetary policy convinced us to revise EURPLN forecasts lower for the remainder of the year. We think the rest of 2019 could be positive for the domestic currency.

GDP growth: gradual deceleration under way

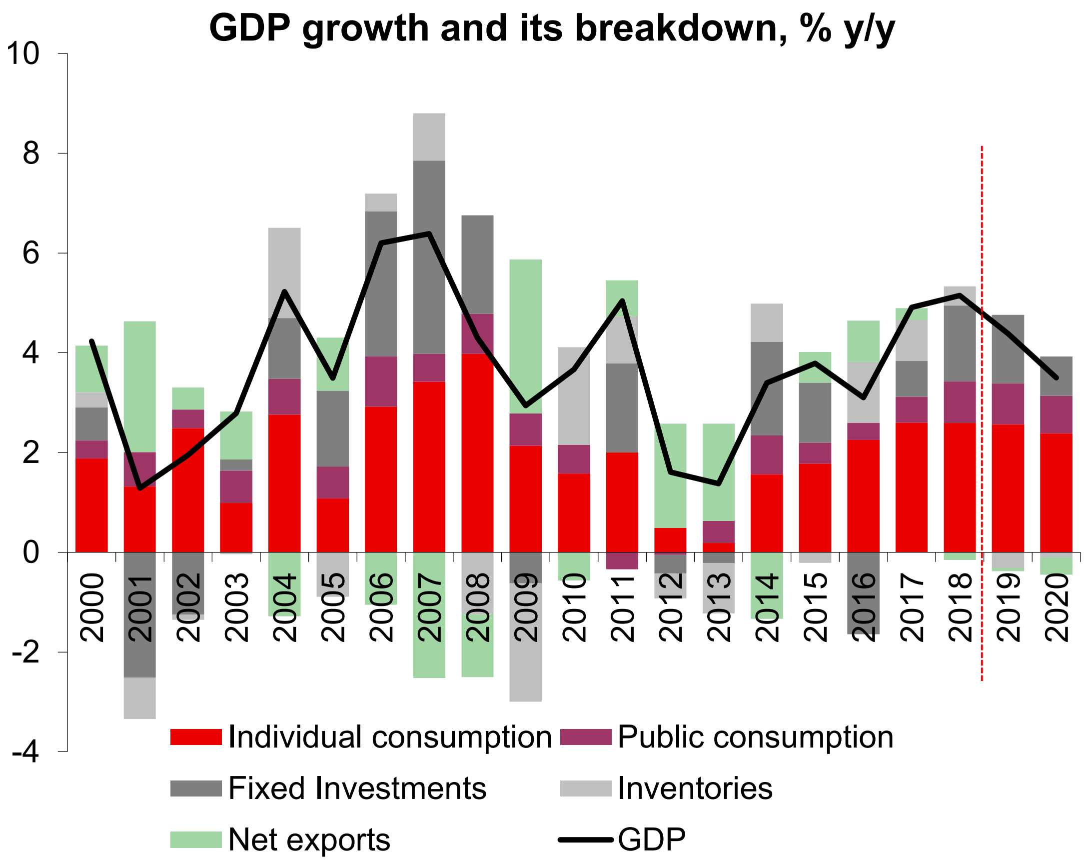
Polish economy is still running at a high gear, showing big resilience to global sentiment deterioration. However, a moderate GDP growth slowdown is already under way, and in our view it will continue in the coming quarters.

While some institutions have recently started raising their GDP growth forecasts for Poland after a few positive data surprises and the announcement of government's fiscal stimulus, we are not going to chase this trend, as we see factors that would offset the positive impact of much higher social transfers and (temporarily) booming consumption.

Our GDP growth forecast for 2019 is at 4.3%, with every consecutive quarter getting a bit lower. The tendency should be similar in 2020, with average growth at c.3.5%. The main engine fuelling expansion will be private consumption, with fixed investments still playing positive (yet diminishing) role, amid stalling public sector spending, and both net exports and inventories change contributing slightly negatively to growth.

On the following slides we provide more detailed outlook for the main components of the aggregate demand.

A potential prolonged stagnation/recession in the euro zone (which we still think is unlikely to happen) remains the main risk factor for Poland. Among domestic challenges the most significant is the deepening labour shortage, which may eventually start limiting future GDP growth.



Source: GUS, Santander

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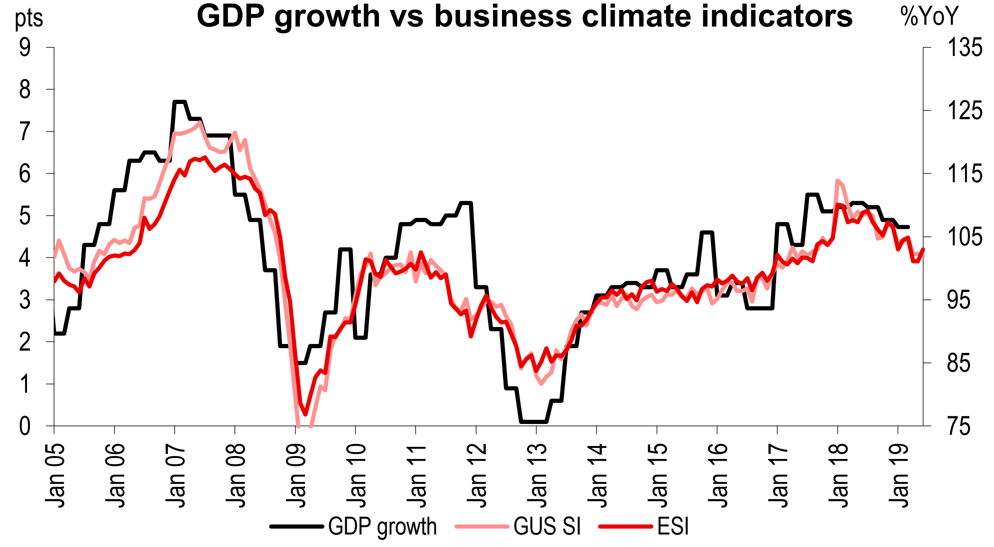
Surveys point slightly to the south

The second quarter of 2019 started on a very strong note, with April's data about activity in manufacturing, construction and retail trade significantly beating market expectations. However, the data for May already brought some disappointment and we expect that June's results of output and sales will be even less impressive (partly due to the negative calendar effect). As a result, we estimate that the GDP growth in 2Q19 slowed to c.4.5% y/y.

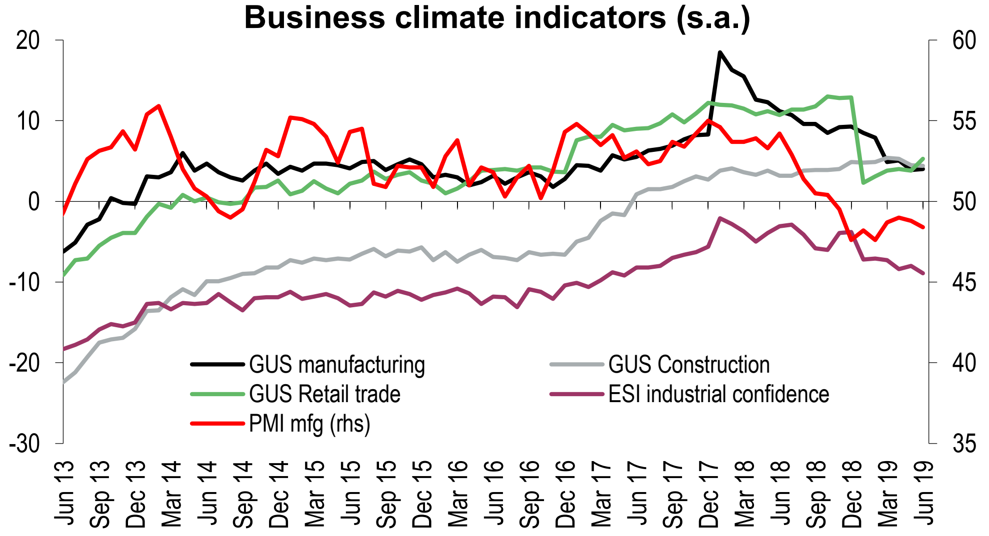
The synthetic indicators of economic climate (ESI, GUS), which usually correlate well with the actual business cycle, are consistent with the moderate economic slowdown underway in the second quarter.

Looking closer into the sectors, the most apparent deterioration of sentiment took place in manufacturing, which is exposed to the erosion of foreign demand. However, at the same time it should be noted that so far Polish export growth has been performing surprisingly well, given the external slowdown and we see some arguments that this relative resilience may continue (see page 13). Moreover, the most recent surveys have suggested some recovery in non-domestic orders, following their visible deterioration in the previous months, which we treat as a signal that the economic growth in the euro zone is not as dead yet as some say.

While the outlook for retail trade and services seems very bright, given the healthy growth in households' disposable income, the construction sector, which has been performing strongly to date, may now enter the slowdown phase as well, as we see growing evidence of large infrastructural investments stalling.



Source: GUS, EC, Santander



Source: GUS, Markit, EC, Santander

New consumption boom round the corner

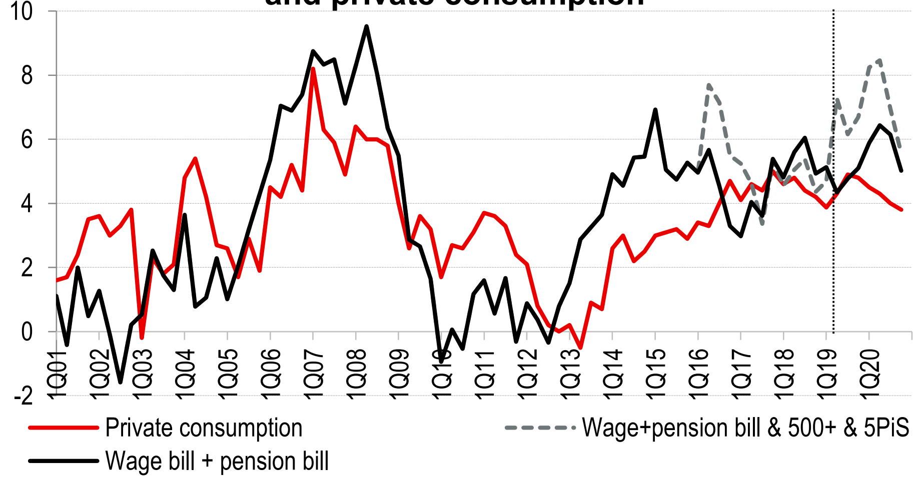
Private consumption was gradually losing pace from 4.8% y/y in 2Q18 to 3.9% in 1Q19. We believe this is where the slowdown ends and a rebound should follow thanks to new large social transfers. The transfers, which are part of this year's fiscal stimulus, include: the extra pension in May, the extension of child benefit program (500+) to all first-born children since July (effective payment in September-October), changes in PIT since September-October (designed to have an instant impact on incomes).

The background of private consumption looks solid. Labour market conditions remain very supportive with wage bill still rising almost 9% y/y in 1Q and c8% in April-May (vs 9% average in 2018). What is more, consumers are super-optimistic. GUS consumer sentiment indexes of current conditions and expectations have just set new records, beating April 2018 values, assessment of own financial situation is also record-high as are expectations about the future financial standing of households. On top of that, the major purchases index remains above the top levels from the booming 2008 since spring 2017, and its last reading was the second highest on record. In such circumstances a fiscal impulse should translate into improved consumption.

May retail sales disappointed slightly, despite the first transfer payments (13th pension payout), but the April reading was well above forecast, so we cannot rule out that some pensioners have spent the extra money in advance. Overall, we think there is no reason to be pessimistic, the consumption boom is coming – it's just a matter of time.

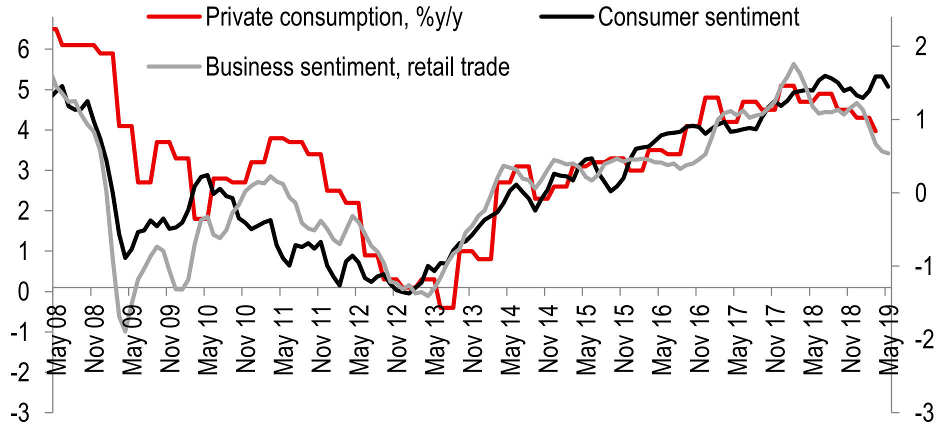
It is worth noting that there is a historically high contribution of durable goods to consumption and retail sales growth while other items are slowing down. This might result in possibly more volatile outcomes as purchases of durables can show big swings. However, the income boost should help maintain high consumer spending in this category.

Real growth of households' income measures and private consumption



Source: GUS, Santander

Consumer confidence, business sentiment in retail, private consumption



Source: GUS, Santander

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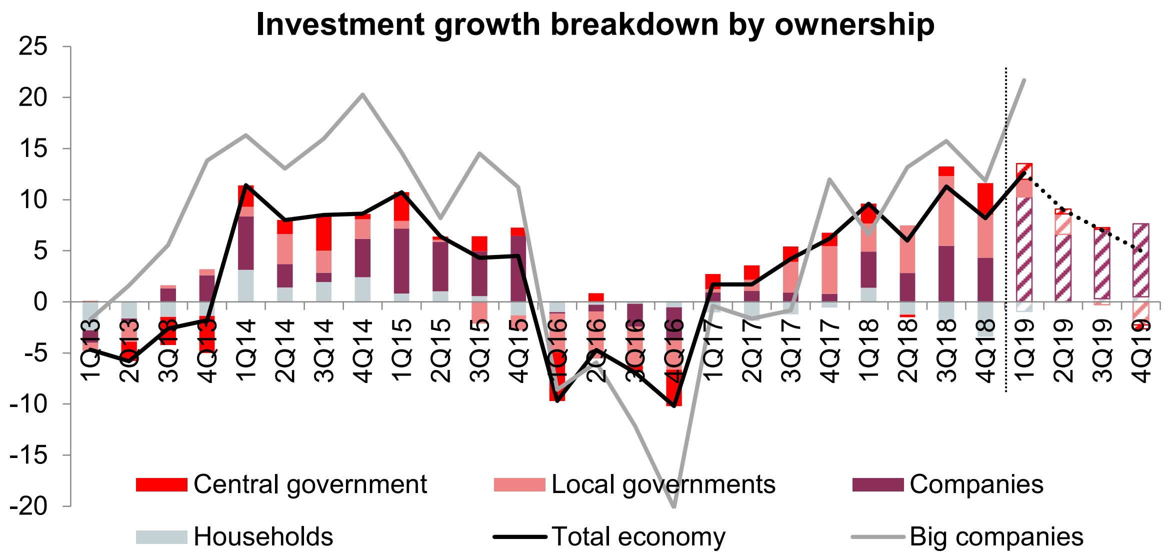
Investment up.. But how persistent is that?

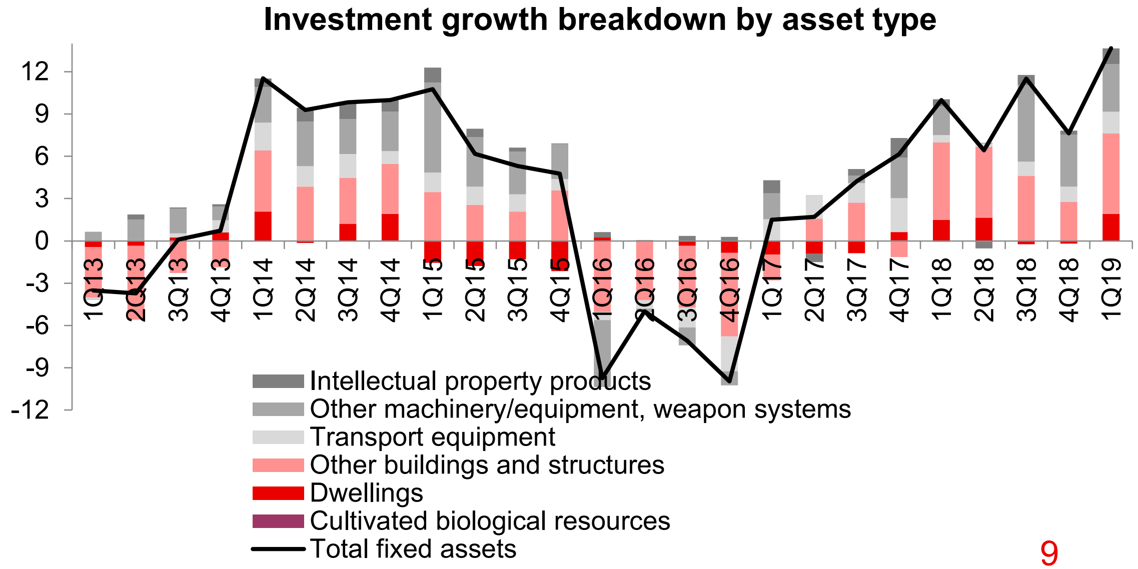
Investment surprised to the upside in 1Q19 expanding by 12.6% y/y. Investment in machinery and equipment rose by 12.7% y/y, indicating that the corporate sector remained active. A high reading in 1Q19 raised our expectations for the entire year, and we think that companies will be the main driver of investment this year. It seems they started many projects and extensively used the EU funds, which, as we stated before, will be peaking this year. Moreover, the labour market squeeze is a strong incentive for companies to invest in new machines replacing human labour and this will be supporting private investment this year.

Still, we maintain our view that the investment growth path will be decelerating and that assumption is based on the following:

- Reduction of local governments' investment plans versus 2019.
- Central government's plan to increase social spending resulting in need to cut on other expenditure
- Dampening of house sales after strong rise of real estate prices.
- Capacity constraints in the construction sector.
- Deteriorating global outlook, squeezed margins and tightening of banks' credit policy undermines the investment climate for the corporate sector and may discourage companies from starting new investments.



Source: GUS, Eurostat, Santander



Source: GUS, Eurostat, Santander

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Housing market: high price growth dampened sales

The housing market in Poland is still hot, as it is recording double-digit price growth, driven by the booming labour market, inflow of immigrants and rising costs of labour and materials.

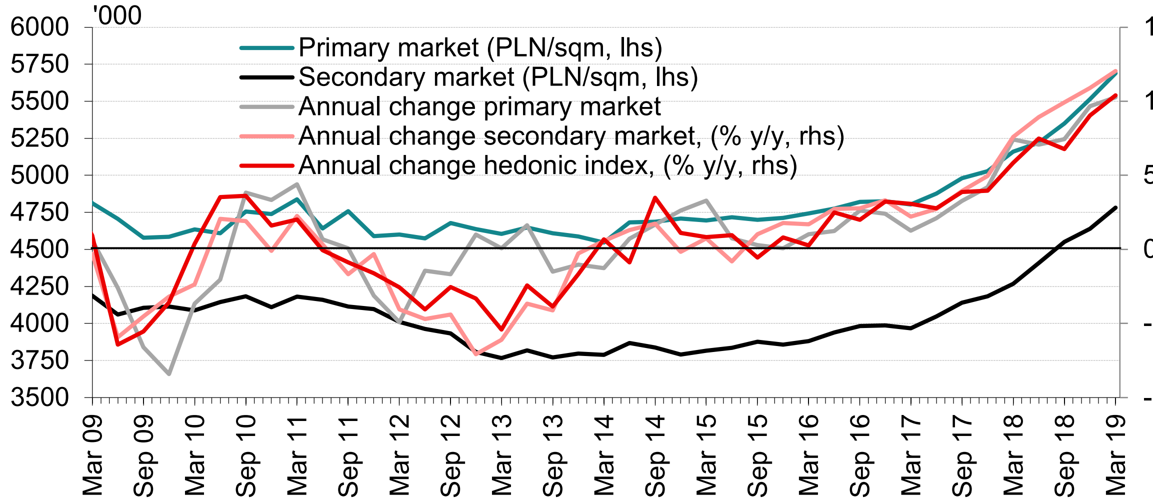
At the same time, primary market sales have fallen despite rising stock in the offer, at least in the six biggest cities, which account for about 1/3 of the whole housing market in Poland. In our view, this happened mostly due to the high price growth, which eroded the housing affordability.

Housing markets in the biggest Polish cities are dealing with supply constraints, i.e. lack of place for new investments. So far, this factor does not seem to limit the supply growth strongly, but the problem is recognised increasingly more. Hikes in prices were probably used as a tool to slow down the sales and prevent the available offer from being overly reduced.

We are expecting the demand to remain fairly strong amid favourable labour market situation and increased scale of social benefits, so supply constraints are just another factor supporting the high price growth, especially as the construction sector is also dealing with capacity constraints. On the other hand, high prices and large inflow of new flats imply decreasing yield on the investment, which gradually discourage buyers who treat housing as investment vehicle.

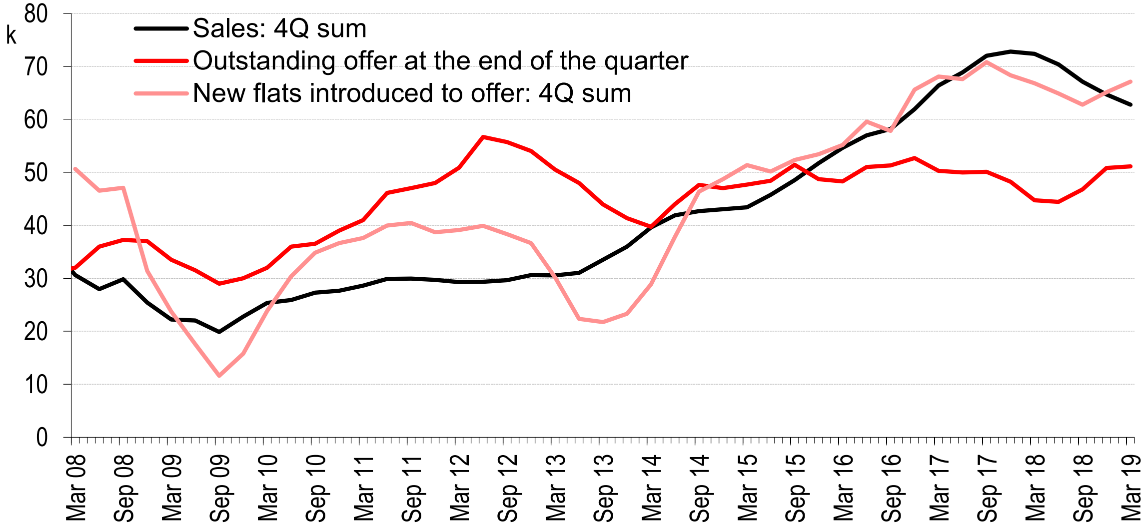
To sum up, as we expect the price growth to ease, following the weakening sales. Still, prices are likely to remain relatively high and the affordability will remain reduced. Additionally, developers can react with higher prices to any upward swings in the demand and this will weigh on investment in dwellings.

Transactional housing prices in 10 major cities



Source: NBP Santander

Primary market in the 6 biggest cities



Source: REAS, Santander

EU funds absorption peak in 2019 but impact lower than in 2018

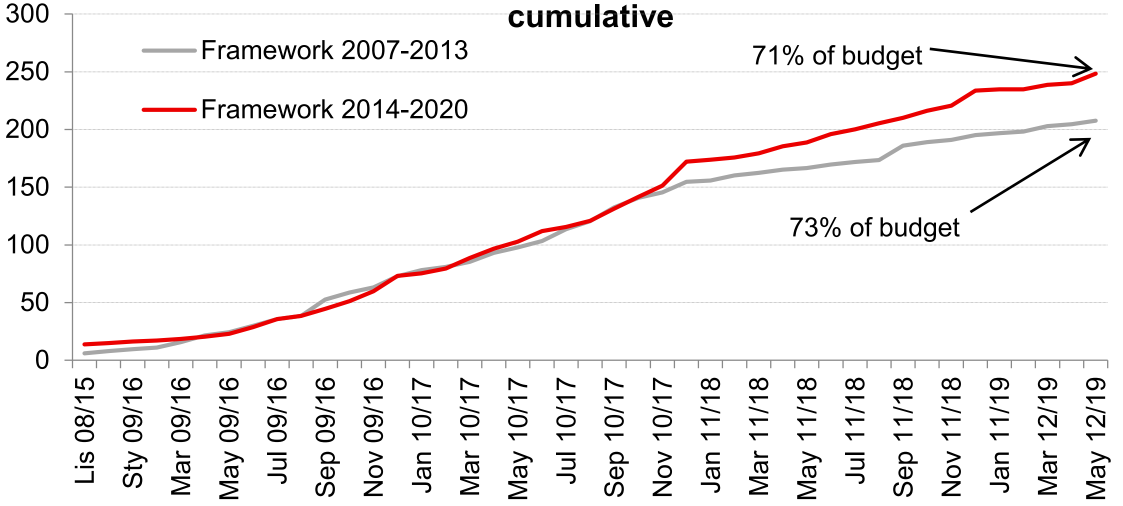
At the end of May 2019, 71% of the EU structural means from the 2014-2020 financing framework were contracted as compared to 73% in the corresponding period of 2007-2013 framework. 4Q18 has seen a major jump in total value of signed contracts, by PLN41.0bn (PLN23.5bn from the EU budget). This has raised our estimates for investment in 2020 and 2021.

The number of signed contracts is a starting points for estimation of investment. According to our model, contracts are transformed into actual investment gradually, with the highest intensity after six to eight quarters. For details refer to our 2017 Outlook Report.

As we have claimed earlier, in our view the nominal value of EU-financed investment will peak in 2019, most likely in the first half of the year, as the bulk of EU financing contracts were signed in 2017.

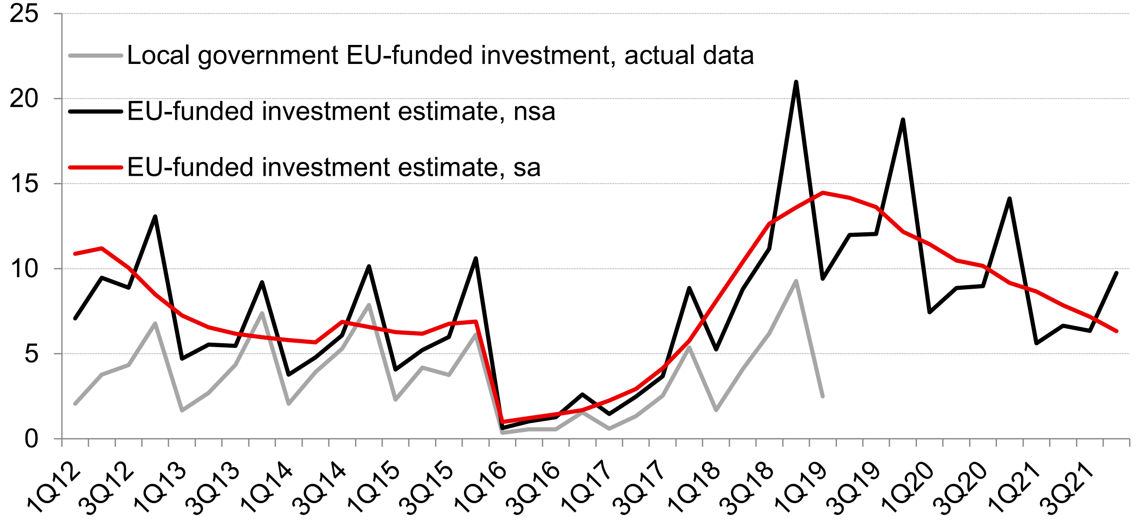
Contribution of EU means to total investment growth is unlikely to be higher than in 2018, so EU means will be the major contributor to total investment growth in 2019, yet not supporting its acceleration.

Utilisation of EU funds: 2008-12 vs 2015-19, PLNbn, signed contracts, cumulative



Source: Ministry of Development, Ministry of Finance, Santander

Estimate of EU-funded investment, PLNbn



Source: Ministry of Development, Ministry of Finance, Santander

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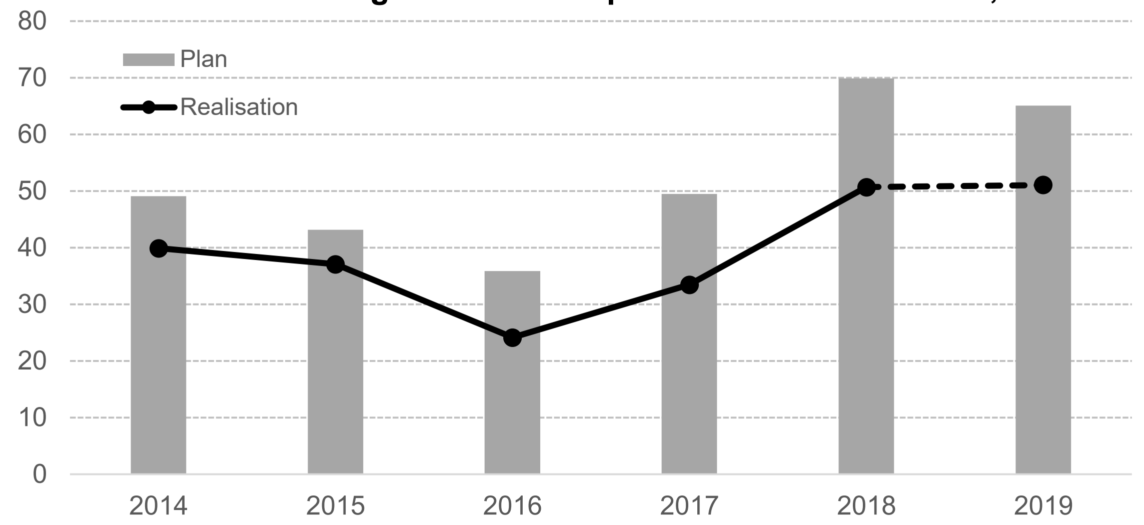
Public sector investment to go down

Local governments started 2019 on a high note, delivering 33.8% y/y rise in nominal terms in 1Q. However, total local government investment plans for 2019 are lower than for 2018. Historically, realisation is at 70-80% of the plan and typically lower plan in y/y terms yields a lower realisation in y/y terms. Thus, we think that the performance in this sector will be weakening over the year and the strong result in1Q19 was mostly an artefact of investment boost in 2018.

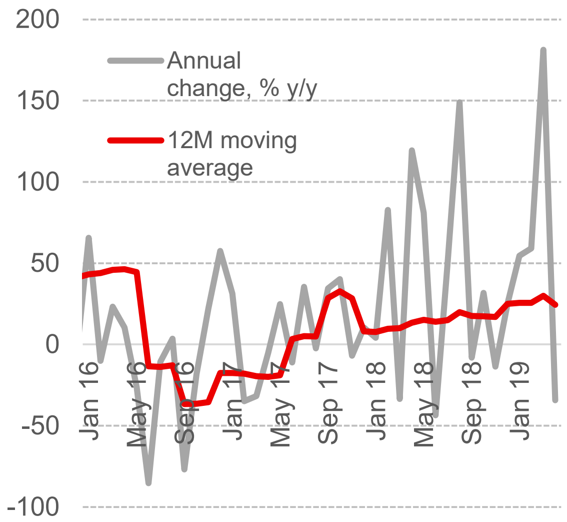
Central government investment also started the year with high growth rates, 98% y/y in nominal terms in 1Q19 (yet this data seem to be volatile and deliver very high or very low growth rates). In April the investment fell markedly in annual terms. One month is clearly not enough to say that the trend has reversed, even though we have rationale to expect that (need to cut on non-essential spending to finance the new social transfers programme).

However, other evidence is available. We have analysed tenders organised by GDDKiA, which is a government agency responsible for building roads. In April, May and June the value of finished tenders plunged by 85% per annum. A lot of tenders were cancelled as there were no bidders or simply the lowest bid was above the budget. This means that the new starts of road investments is going to deteriorate significantly in 2H19.

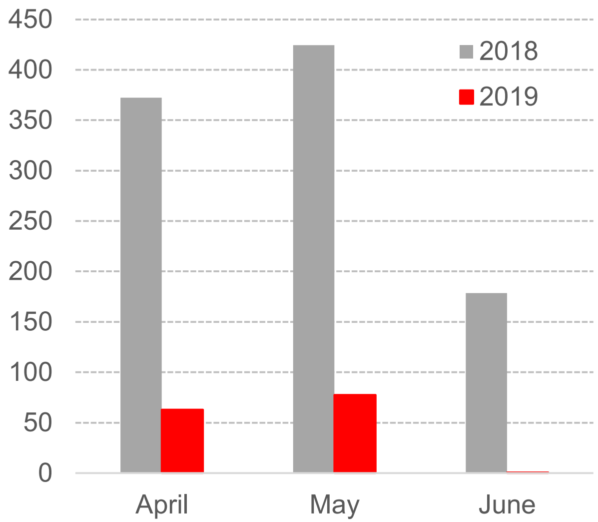
Investment in local governments – plans versus realisations, PLNbn



Central budget investment, % y/y



Successful GDDKiA tenders, PLNbn



Source: Ministry of Development, Ministry of Finance, Santander

Export: resilient but slowing

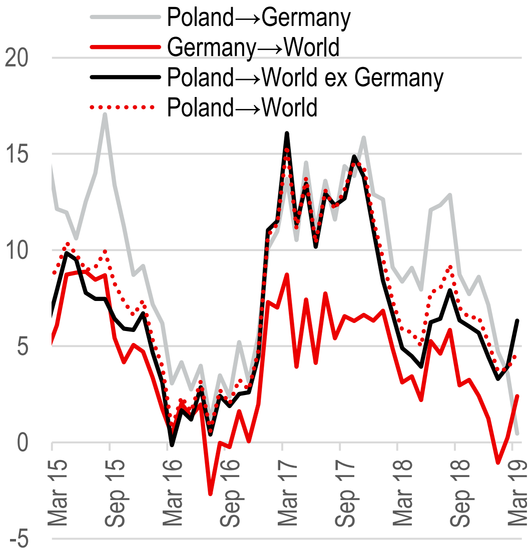
Domestic demand in core euro zone countries remains solid, deterioration of consumer sentiment is gentle in most cases. Still, the German imports of Polish consumer goods, which we considered a pillar of Polish outperformance, simply collapsed, from +10% y/y on average in 4Q18 to -9% in 1Q. However, at the same time Poland's export ex Germany has remained sound, thanks to a rebound in processed food, consumer non-durables, industrial vehicles and car parts. The gap caused by disappearing exports growth to Germany in 1Q was closed thanks to a larger contribution from countries such as the UK, France, Italy, China and Hungary. In the case of the UK this might have just been stock-piling ahead of (the initial) Brexit deadline – GUS data for April imply a 5 to 10% y/y decline. Trade with Africa started to yield a visible positive contribution to total exports growth, while Asia no longer weighs on the result.

The USA continues to be a particularly promising direction, not only for Poland, but also for the whole CEE region since mid-2018, with stable export growth. We believe this comes from a mix of factors: (still) relatively strong US growth, the need to find substitutes for Chinese goods after several rounds of US tariff charges, the efforts to set up a channel for exports of US energy commodities to Europe (with Poland having the right infrastructure). However, exports to the USA has not intensified enough to help close the German gap.

In May there was a noticeable acceleration of foreign new orders in Polish industry, from c10% y/y to 20.2% y/y. Since the turn of the year domestic orders have grown faster than foreign ones, the gap in their growth rates seems to be closing now. This suggests that the EU economy may be bottoming out, which could prevent further decline of Polish exports growth.

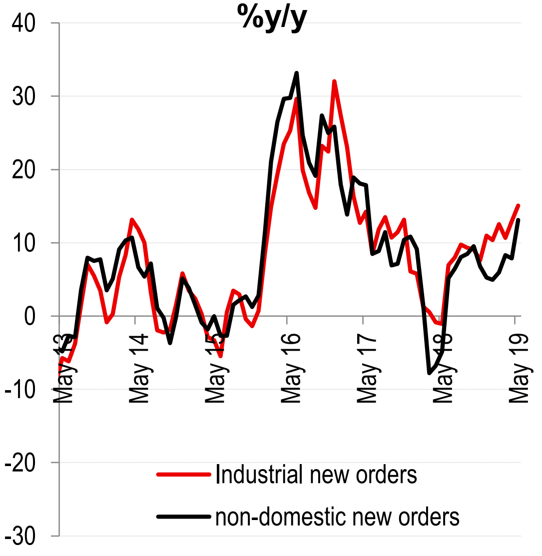
It seems the relative resilience of Polish exports will hold. On one hand the disappearing growth contribution from Germany is a big blow. On the other hand, trade ties with several other countries have improved, filling this gap. The outcome may only be a moderate deceleration in the nearest quarters and stabilisation once the euro zone gets some traction.

Exports, %y/y



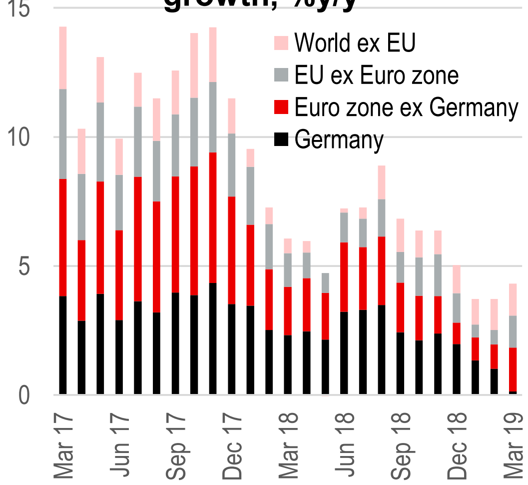
Source: Eurostat, Santander

Value of industrial new orders, %y/y



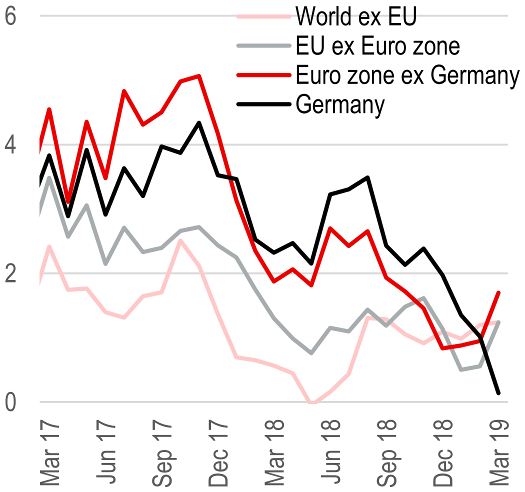
Source: GUS, Santander

Contributions to Polish exports growth, %y/y



Source: Eurostat, Santander

Polish exports, %y/y



Source: Eurostat, Santander

External balance: moderate deterioration ahead

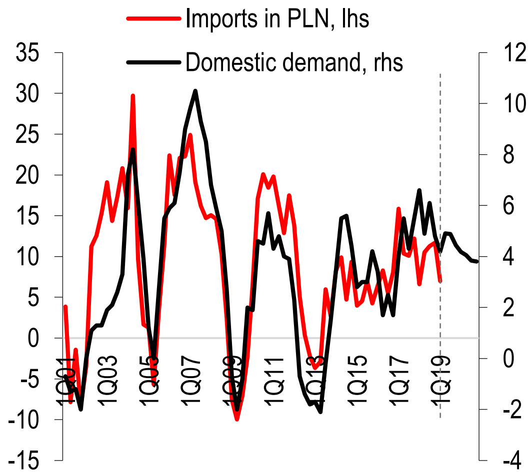
When it comes to imports, the first few months of 2019 have shown a surprising weakness (in 1Q19 import growth slowed to 4.6% y/y, its lowest since mid-2016), despite relatively healthy domestic demand. We think that re-acceleration of import growth in the coming quarters is very likely, given the expected rebound in consumption, rising companies' spending on fixed assets (read: imported machinery), and moderate zloty strengthening.

A factor that has (temporarily) slowed down import revival is the contamination of Russian oil flowing to Poland, which caused a temporary suspension of oil transit via the Drushba pipeline. Russian oil represents c.4% of Poland's total imports, and thus the disruption of oil supplies likely dampened import growth in 2Q19. However, the inventories will have to be replenished later on, so the impact will only be transitory.

Summing up: a gradual slowdown in exports and relative strength of imports should result in widening of trade deficit in the coming quarters.

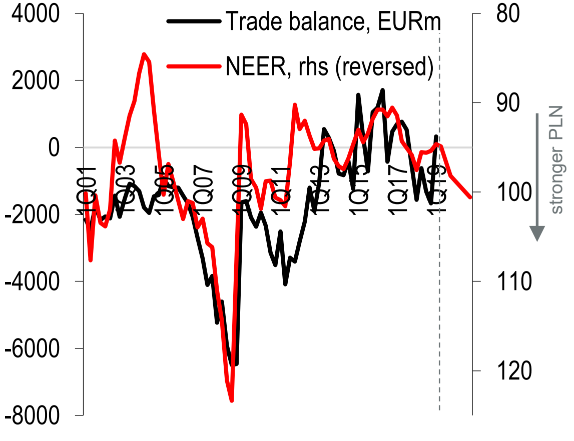
Looking from a different angle, we find arguments for looming deterioration of Poland's external balance also in the non-financial sectoral accounts. The moderate surplus in Poland's total net lending position in the recent quarters was possible to achieve mainly because the deterioration in non-financial companies' balance was largely offset by rapid improvement in general government balance. The latter is now going to reverse (as the fiscal deficit is about to reach -1.7% of GDP this year, vs. -0.4% in 2018), while the companies' surplus is likely to shrink further amid continuing private investment rise and margin squeeze. As a result, the total net lending position (which corresponds closely to the joint current account and capital account balance) may worsen visibly, moving from c.1.5% of GDP surplus at the start of the year to c.0.5% deficit by the year-end.

Import vs domestic demand, % y/y



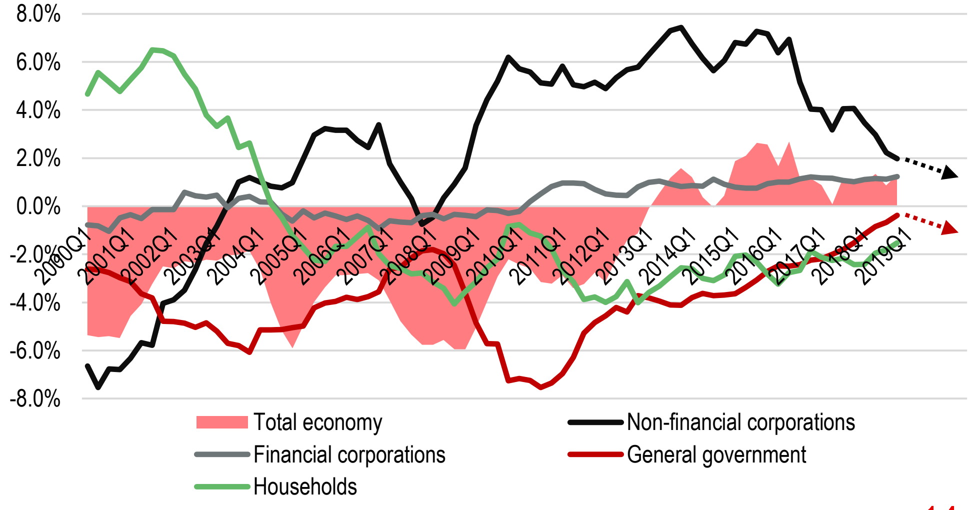
Source: NBP, GUS, Santander

Trade balance vs PLN nominal effective exchange rate



Source: NBP, BIS, Santander

Non financial account: net lending/borrowing by sector (% of GDP)



Source: Eurostat, Santander

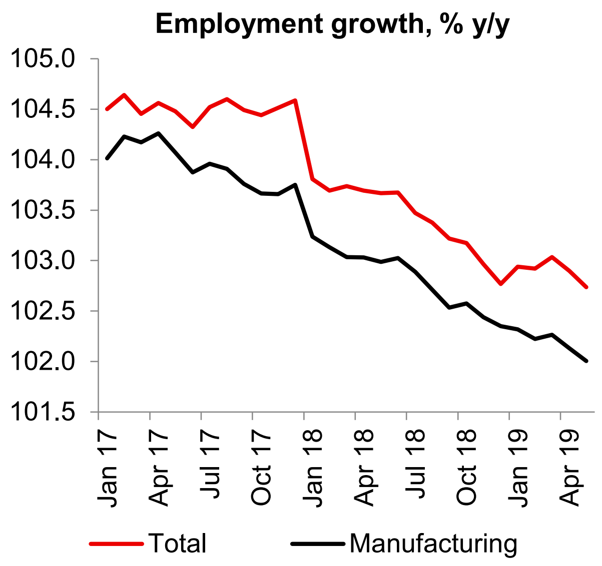
Labour market: employment growth slowing

Job creation has been slowing. Business sentiment surveys are also capturing reduction of employment components across the sectors. This could be a reflection of both worries about the global growth prospects and acknowledgment of the limitations of the tight labour market (which encourages a switch of companies to less labour-intensive technologies - we assume this is why investments rose so much in 1Q).

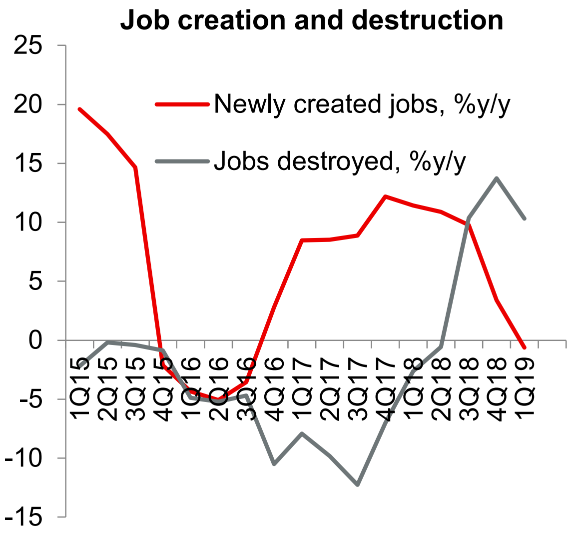
In 1Q19 in Poland the total number of vacancies was 6.5% lower y/y and the number of newly created vacancies (in the quarter) was down 17.3% y/y. In both categories it was the first y/y decline since 2013. The number of newly created jobs in 1Q was marginally higher than a year ago (+1.7% y/y, and with a correction for liquidated workplaces it was up 2.1% y/y). In the previous quarters we had historically high share of unfilled vacancies among newly created jobs (24% in 4Q18) – this time the share dropped to the lowest level in three years, 11.7%.

Looking at the market from a different angle: corporate sector employment is growing at a declining pace (3.4% on average in 2018, 3% in 1Q, 2.8% in April-May), while according to LFS it already started declining. In recent months the slowdown has become more evident: in April the m/m change of corporate employment was the weakest for this particular month in six years and in the case of May the result was the weakest in ten years.

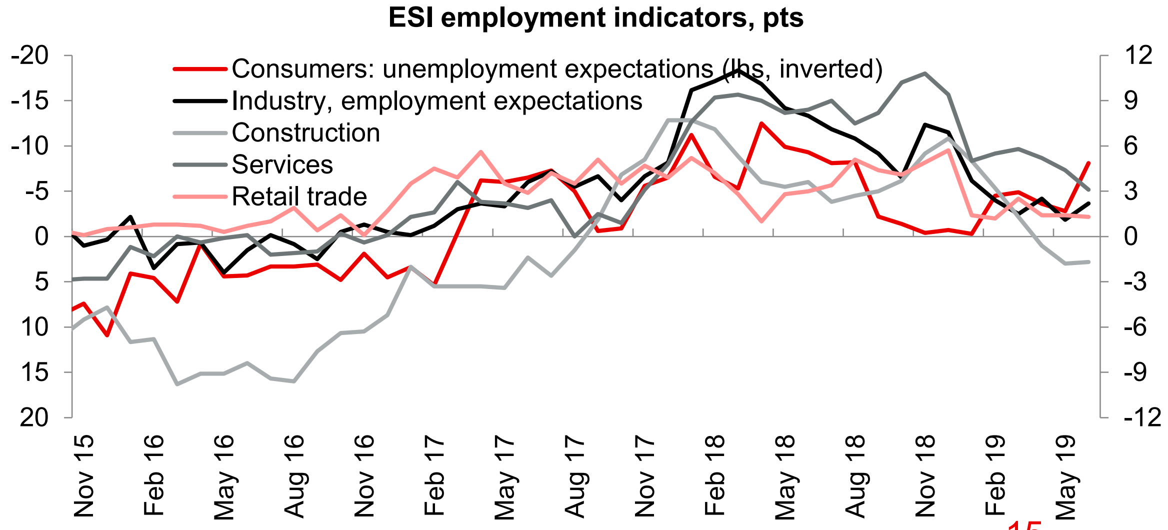
We assume that even if firms are already correcting labour demand for the expected slowdown (although usually the labour market is lagging behind the cycle), the labour market is so tight that we have to see some more wage acceleration. Wages ex mining (removed for being a volatile component) rose from 7.0% to 7.7% y/y in May, the highest level so far in this cycle (such pace was previously seen in 2009). Wage growth might be flirting with 8% in 2H19.



Source: GUS, Santander



Source: GUS, Santander



Source: Eurostat, Santander

Migrant inflow continues, but is not enough

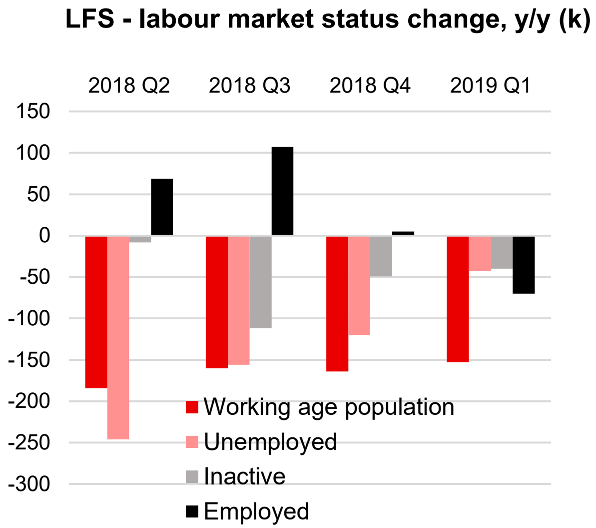
LFS data for 1Q showed that despite the booming economy the number of the employed decreased 0.4% y/y, for the first time in six years. All main categories of labour market status: working, unemployed, inactive, are now observing a decreasing headcount y/y. According to LFS, working age population has been shrinking for seven years already.

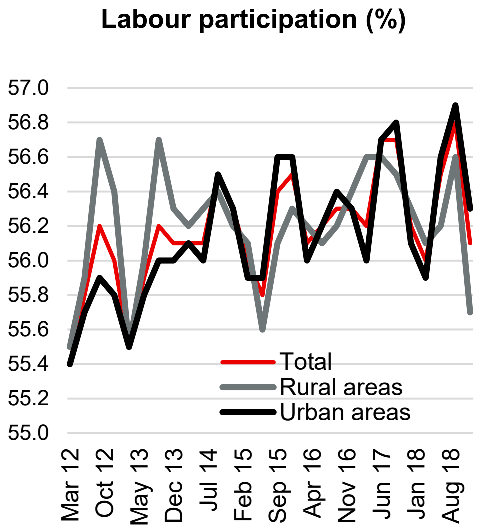
These data remind that the resilient economic growth of Poland would not be possible without the help of migrant labour force. LFS omits a great majority of Ukrainians and migrants of other nationalities working in Poland, because of the requirement to live in the sampled household for at least 12 months (while the migrants have to return to home countries to renew their work permits). The corporate sector data, in turn, capture those migrants that hold a regular contract, which means many are still left unaccounted for in these statistics. The data show positive employment growth (2.7% y/y in May).

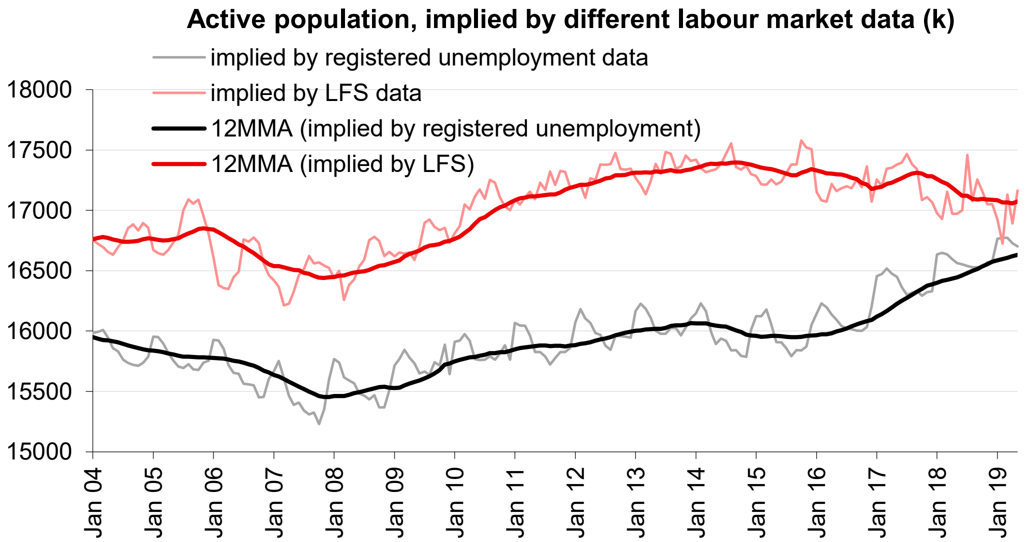
Another way of capturing the impact of migrants is to compare labour force numbers from LFS (which omit Ukrainians) and their implied values based on unemployment registers. In the former case a decrease is seen due to domestic demographics, while the latter source shows a strong rise, by c0.5mn since the start of 2017.

A draft of official migration policy being prepared by the government (to be revised every five years) signalled a diminishing migrant inflow. The policy is to focus on short-term coverage with migrant work of labour market shortages rather than on long-term hosting and integration of migrants. It also goes in the direction of bringing back Poles who left abroad in search of work and of pushing higher labour participation rates of certain social groups (women, aged 50+, long-time unemployed, inhabitants of rural areas).

As for the risk of losing the Ukrainian labour force to German market which opens in 2020, 300polityka web portal presented a survey among Ukrainians working in Poland showing that while one third considers moving to Germany, only c8-9% could communicate in German (which is one of the requirements).







Source: GUS, Eurostat, Santander

Inflation: target hit and the heat is still on

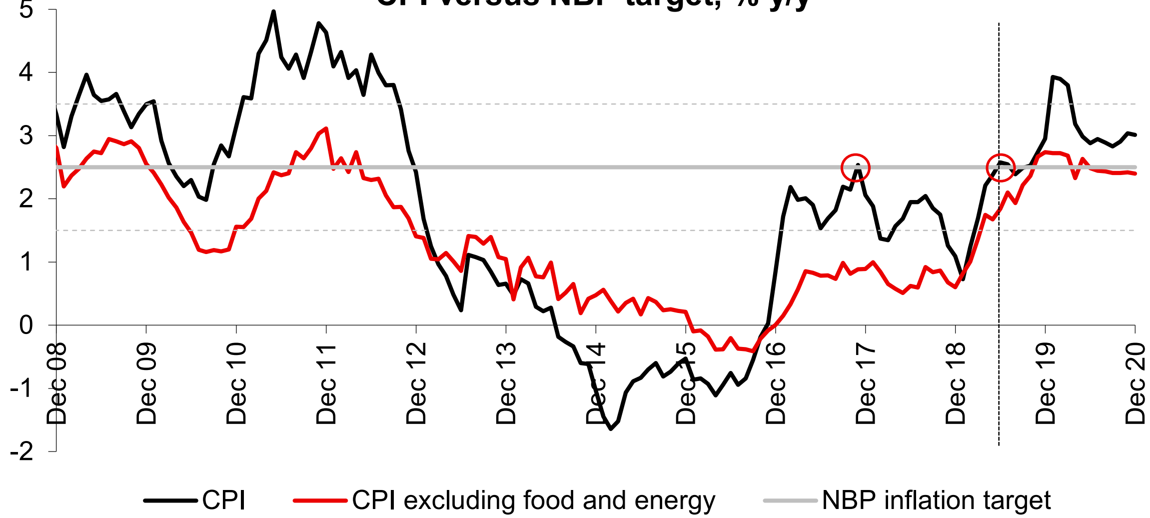
Flash reading for June showed CPI inflation rising to 2.6% y/y. The previous time it went up as far as the 2.5% target, in late 2017, it marked a local peak an soon after inflation slipped below the band of tolerance i.e. below 1.5%. This time is different. The CPI path might flatten from here through the summer months, but breaching 3% in early 2020 seems very likely to us – even in the benign case with electricity prices kept frozen for another year (which we think is unlikely).

In line with our previous expectations, the development of CPI this year is based on acceleration of services prices (forming the non-tradable part of core inflation). This in turn is a consequence of sound economic performance, higher labour and other costs – these are captured by unit labour costs measures which have been pointing to CPI acceleration for some time now.

Apart from that, several factors that stood behind the relatively low core inflation in 2018 should now be gone. We see the growing evidence of ending price wars in various sectors, including telecommunication, insurance, financial services and potentially also retail stores. The latter may be pushed towards further price increases if the government decides to impose the retail tax next year, seeking additional budget revenues.

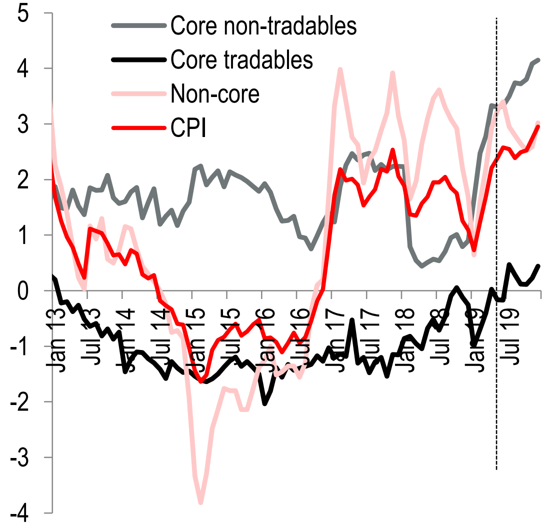
What is more, the non-core components, food in particular, maintained a relatively high pace instead of exhibiting a negative base effect already in 2019. Issues like the swine disease (ASF) and local weather are to blame and occurred irrespectively of the demand conditions in Poland (with the output gap wide open). This adds extra uncertainty to the steepness of the upward trend in our CPI forecast.

CPI versus NBP target, % y/y

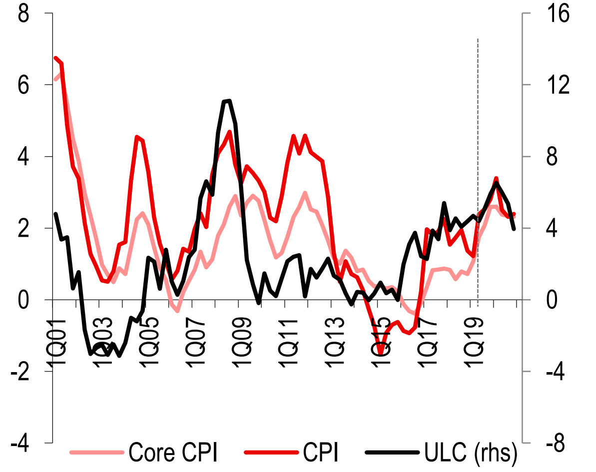


Source: GUS, NBP, Santander

Breakdown of inflation, % y/y



Inflation vs unit labour costs, % y/y



Source: GUS, Eurostat, Santander

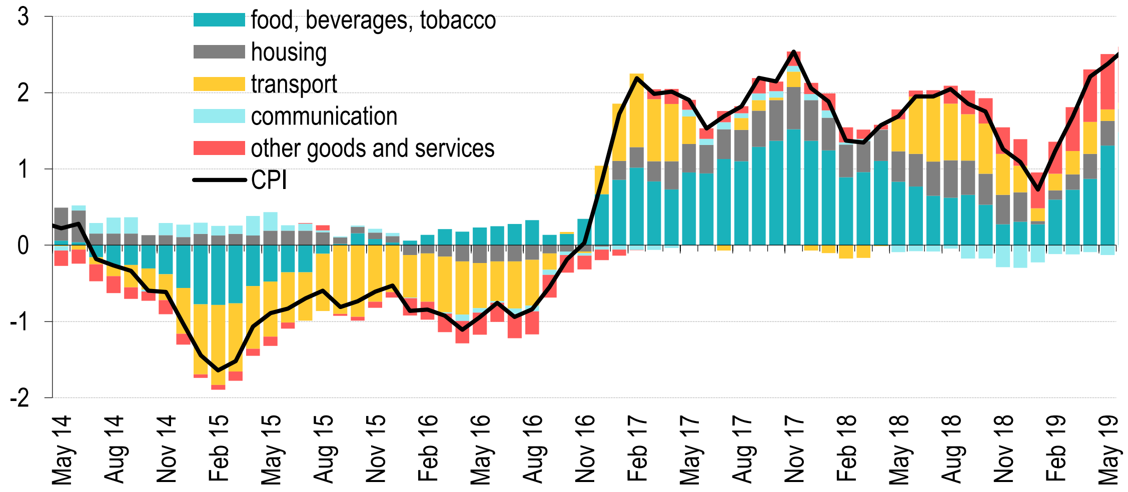
Inflation: agricultural and electric shocks to CPI

Food inflation have gone sharply up this year and weather conditions suggest its contribution to CPI will stay elevated. Part of the sharp rise in food prices is global (pork due to ASF), part is local: poor vegetable supply from 2018, delay in 2019 vegetable growth, another drought this year plus June heatwave mean no negative base effect in 2H19-1H20, superb fruit collection last year mean this time supply will be lower – and prices higher). The issue is the transmission of another year of expensive unprocessed food – we are already seeing a significant rise of consumer prices in hotels & restaurants category (4.1% y/y in May, up from 3.1% in Dec-18). Another consequence is a likely decline of CPI after 1Q20 assuming agricultural conditions are normal next year.

Another issue is what happens next with electricity tariffs. Under current legislation, an energy boost to household prices is coming next year. The freeze of electricity prices in 2019 has been crucial for keeping inflation expectations well anchored, judging by the episode with miscommunication about the freeze at the turn of the year (a temporary spike in consumer inflation expectations). We believe that letting electricity prices adjust to market conditions would cause more than a temporary rise of CPI growth (as NBP governor Adam Glapiński wants to see it) because of second round effects (as enterprises might counter the further margin squeeze by lifting own prices) and the likely surge of inflation expectations. 2H19 will already be a test period – as larger companies will no longer be covered by the price freeze (consumers will still be protected from the higher costs).

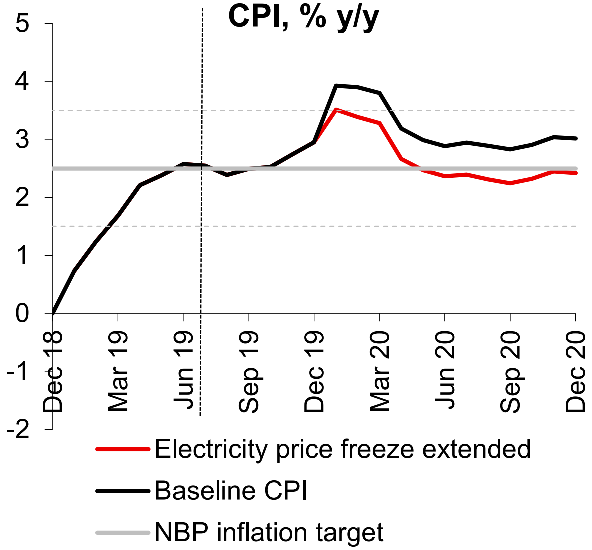
The removal of the freeze sends our CPI path to almost 4.0% in January 2020, before settling around 3%. In this scenario we assume that the electricity excise and transfer charge which were lowered in 2019 in order to shield households from higher energy bills (and effecively caused electricity bills to fall y/y) will not be restored to 2018 values – so only the price of electricity will be adjusted.

CPI growth breakdown, % y/y



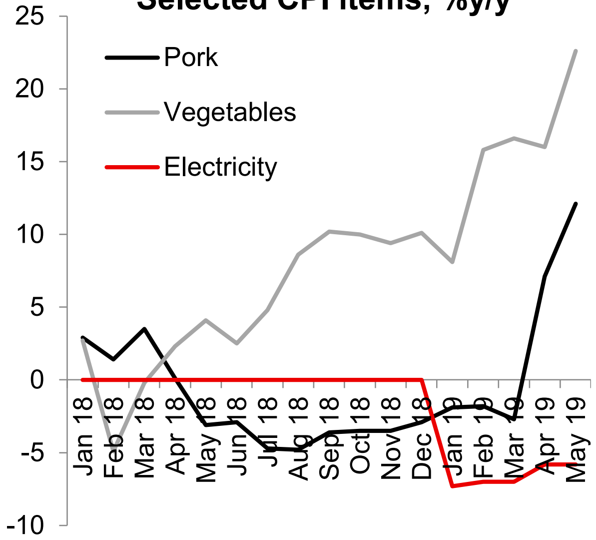
Source: GUS, Santander

Effect of electricity price un-freeze on CPI, % y/y



Source: GUS, Eurostat, Santander

Selected CPI items, %y/y



Source: GUS, Santander

Santander

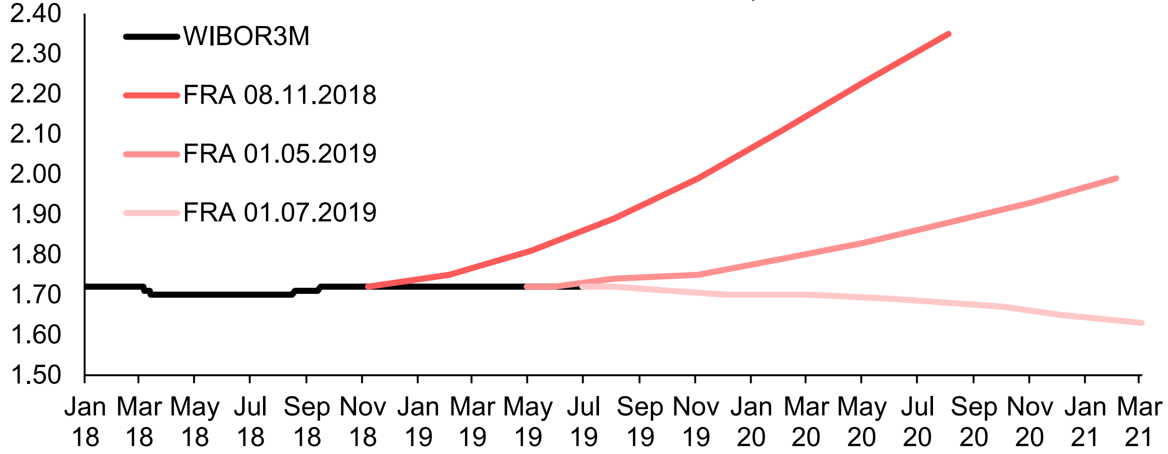
Monetary policy: global wind of change

A significant dovish shift in global central bank's policy bias will not leave the Polish central bank unaffected, in our view. Even before we argued that the Monetary Policy Council will be very patient and will have large tolerance for inflation's deviation from the target. But now it seems even more likely that the Monetary Policy Council will look through an increase of domestic inflation, even if it exceeds expectations. As a result, it seems that interest rate hikes are off the table for now, at least until the global environment improves visibly.

At the same time, we still think there will be no reason to talk about monetary easing in Poland in the foreseeable future, as economic growth remains solid (despite slowing gently) and inflationary pressure is building. Even if the zloty appreciates, it still has relatively large room to go until it can be seen as significantly overvalued. Another argument against rate cuts is the situation of domestic banking sector, which is already facing a challenging environment, excessive tax and regulatory burden, and struggling to reach satisfactory level of profitability.

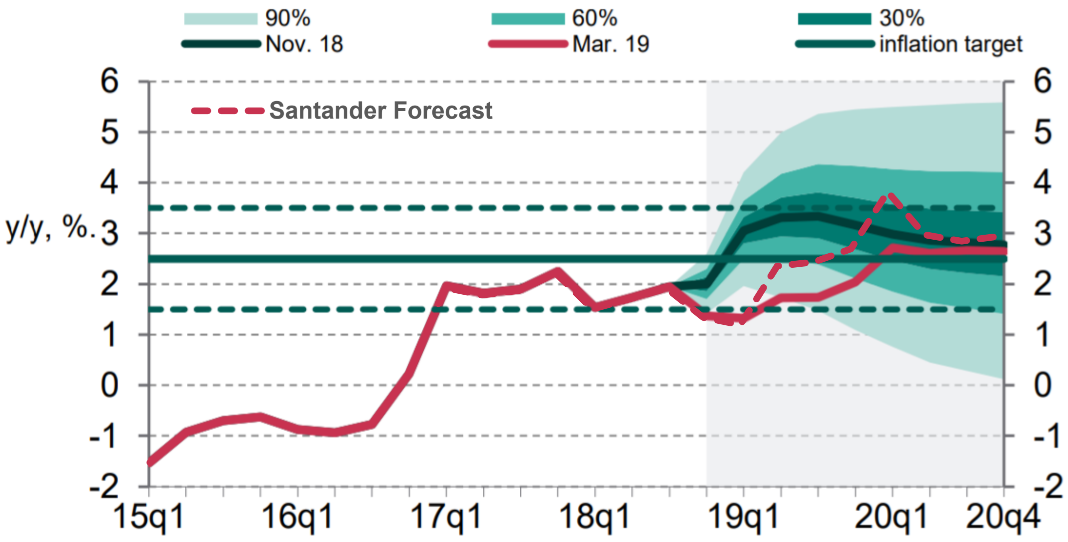
In July the central bank will show its new economic projections. The last version released in March showed higher GDP growth and lower inflation than its previous edition. This time, we think inflation path will probably go up again, as most likely the NBP will pencil in a spike in energy tariffs since the beginning of 2020. Thus, the new inflation profile in the NBP forecast may look similar as it did back in November 2018 – CPI rising substantially in the short run (to 3.5% or even slightly above), but then retracing back to the inflation target in the medium run. The central bank was arguing in the previous report that one of key factors keeping inflation in check was faster potential output growth, and we think such rationale will repeat also this time.

WIBOR and FRA rates, %



Source: Reuters, Santander Bank Polska

Inflation projection and Santander forecast



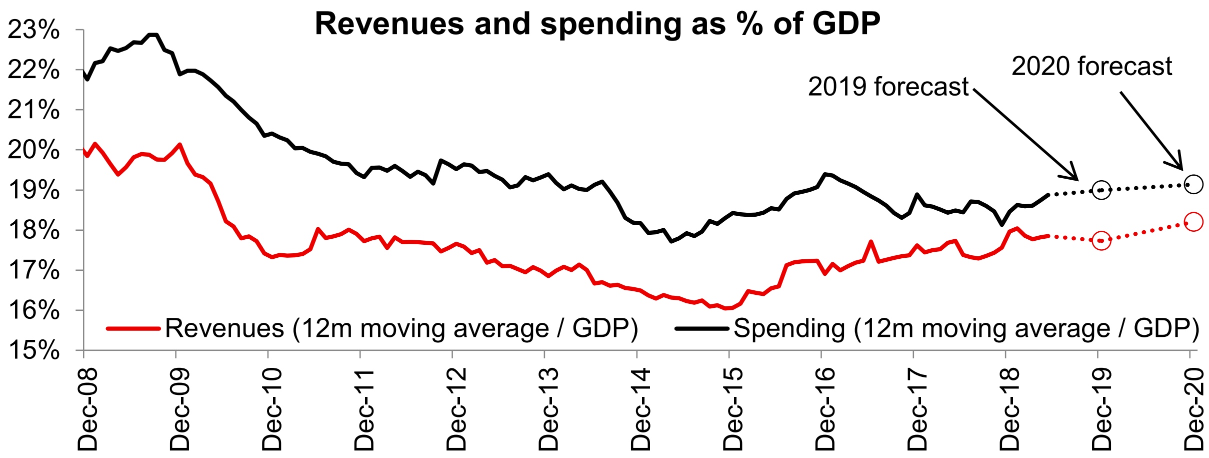
Source: NBP, GUS, Santander Bank Polska

Fiscal outlook: deficit to widen but remain contained

Data on the central budget realisation for May suggest that the year is likely to end close to the assumed deficit limit (PLN28.5bn). On one hand, the GDP growth is currently expected to be faster than assumed earlier, which is positive for the balance, but on the other the government is launching a big ticket social spending programme. In our view, the government will do all it can to deliver the announced package without exceeding the deficit limit this year, as changing it could be seen as a bad PR move in the election year. This may effectively mean cuts in other spending categories.

For 2020, we are expecting budget expenditures to rise by about 6% y/y. We assume that the thirteenth pension will not be repeated. We estimate budget revenues to rise by 9%. Growth rate of tax revenues is likely to decelerate given the cuts in PIT taxation and diminishing potential gains from improved tax collection. Still, the revenue side will be supported by one-off inflows like the OFE transformation tax, or sales of 5G frequencies. This will yield an budget deficit very similar to the one planned for 2019 (below PLN30bn).

In our view the general government deficit will rise from 0.4% of GDP in 2018 to 1.7% of GDP in 2019 and 1.0% in 2020, so we are a bit less optimistic that the government that showed 1.7% deficit for 2019 and 0.2% surplus for 2020 in its Convergence Programme. We wrote more on the Convergence Programme in our Economic Comment.

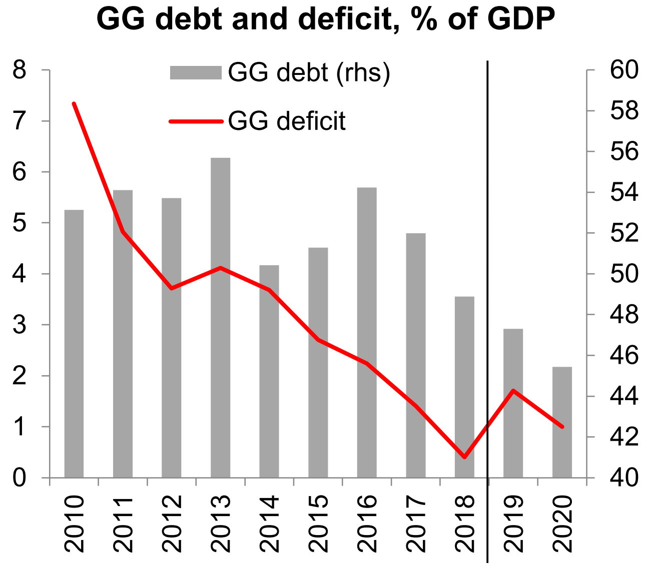


Source: Finance Ministry, GUS, Santander Bank Polska

Government macro forecasts for 2020 budget

Indicator	2019	2020
GDP	4.0	3.7
Consumption	4.0	3.8
Export	5.3	4.8
Import	6.0	5.1
CPI	1.8	2.5
C/A	-1.2	-1.4
Employment	2.2	0.5
Unemployment	5.5	5.1
Wages	7.6	6.0

Source: Finance Ministry, Santander Bank Polska



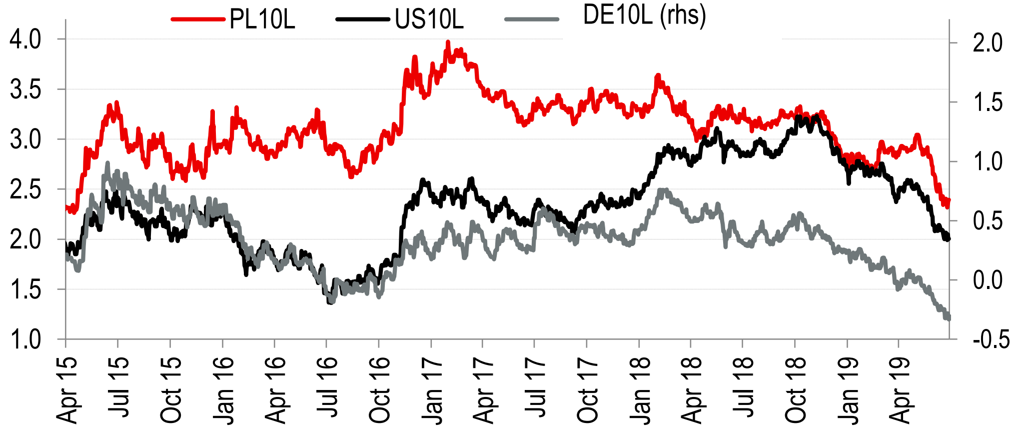
Source: Eurostat, Santander Bank Polska

Debt market: yields lower and lower

Concerns about global economic growth, continuing trade wars and resulting change of rhetoric of main central banks towards a much more dovish one support significant decline of yields. As regards local factors, the market will get the additional support from very low net debt supply in Q3 (bond redemption in July worth PLN13.1bn in principal and PLN4.5bn in interest), and most likely dovish tone of the MPC – the central bank will probably strengthen emphasis on the global economic slowdown. Information about high budget liquidity and its solid performance should also be supportive.

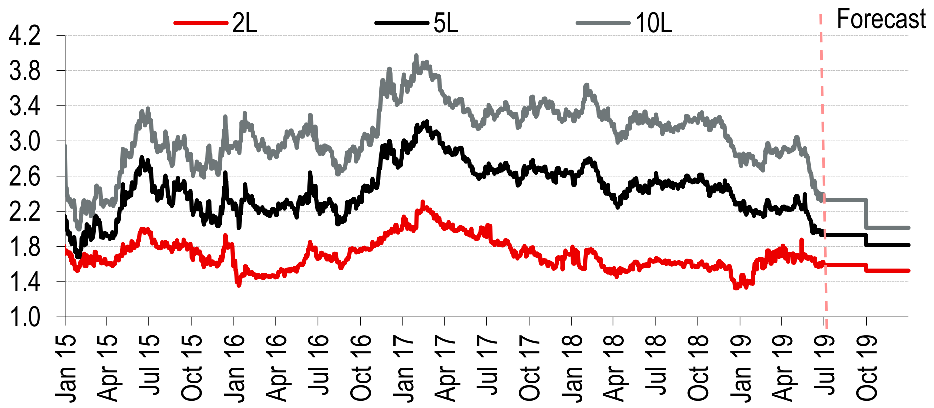
Temporary profit taking on the debt market is possible in the middle of summer holidays, if the FOMC fails to deliver interest rate cut at the July meeting. However, in the following few months horizon yields may decline even further. The economic data to be released in 3Q will cover the period when the effects of tariffs imposed by Donald Trump on China would resurface in full, which should fuel worries about global growth outlook. Moreover, a re-escalation of tension in trade relations USA-China and USA-Europe is quite likely. The verbal conflict of USA with Iran may also persist. Finally, bonds will be supported by the ECB policy outlook, as the bank – facing limited room for cutting rates further – suggested launching another round of QE programme.

Polish, German and US 10Y bond yields



Source: Thomson Reuters, Santander

Bond yield forecasts (EOP)



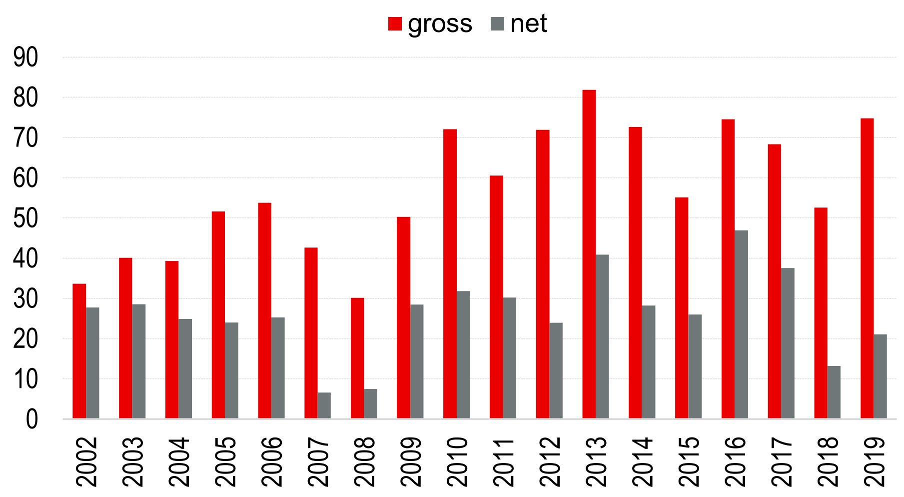
Source: Thomson Reuters, Santander

Debt market: supply still very low

Since the start of the year the increase of outstanding PLN-denominated debt has reached PLN21.1bn. There were no new issues of foreign currency debt (only FX debt worth PLN12bn was redeemed) and the exposure in FX loans remained unchanged. At the switching auctions the Ministry of Finance issued PLN59bn.

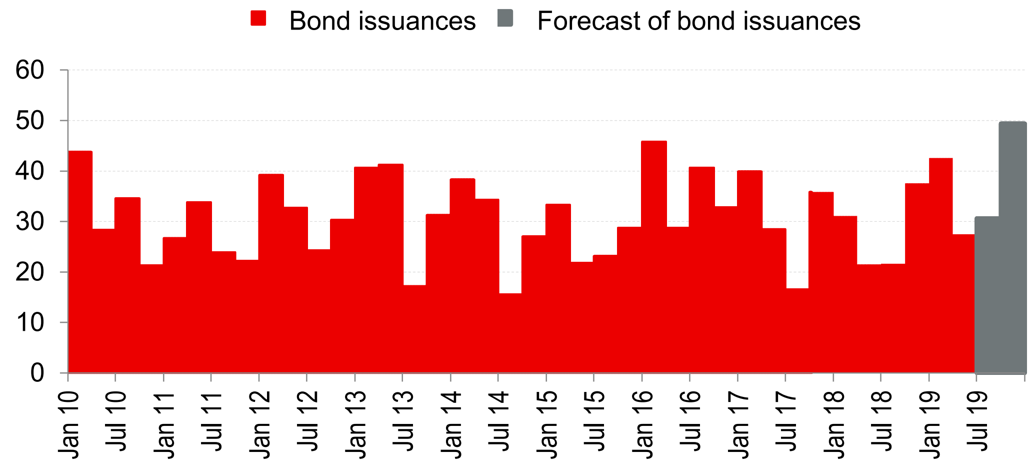
We estimate that by the year-end the Ministry will issue debt worth PLN80bn. The new issuances of bonds will reach c.PLN23bn. Switching auctions of debt maturing in 2019 – PLN21bn. Pre-financing of 2020 borrowing needs (planned to reach 30%) should be c.PLN30bn. Refinancing of maturing foreign currency debt switched into PLN should reach c.PLN6bn (under assumption of new debt issue worth USD2bn heralded by the FinMin).

Annual net debt issuances (after 2Q19)



Soruce: Ministry of Finance, Santander

Debt issuances and forecast of thereof (PLN bn)



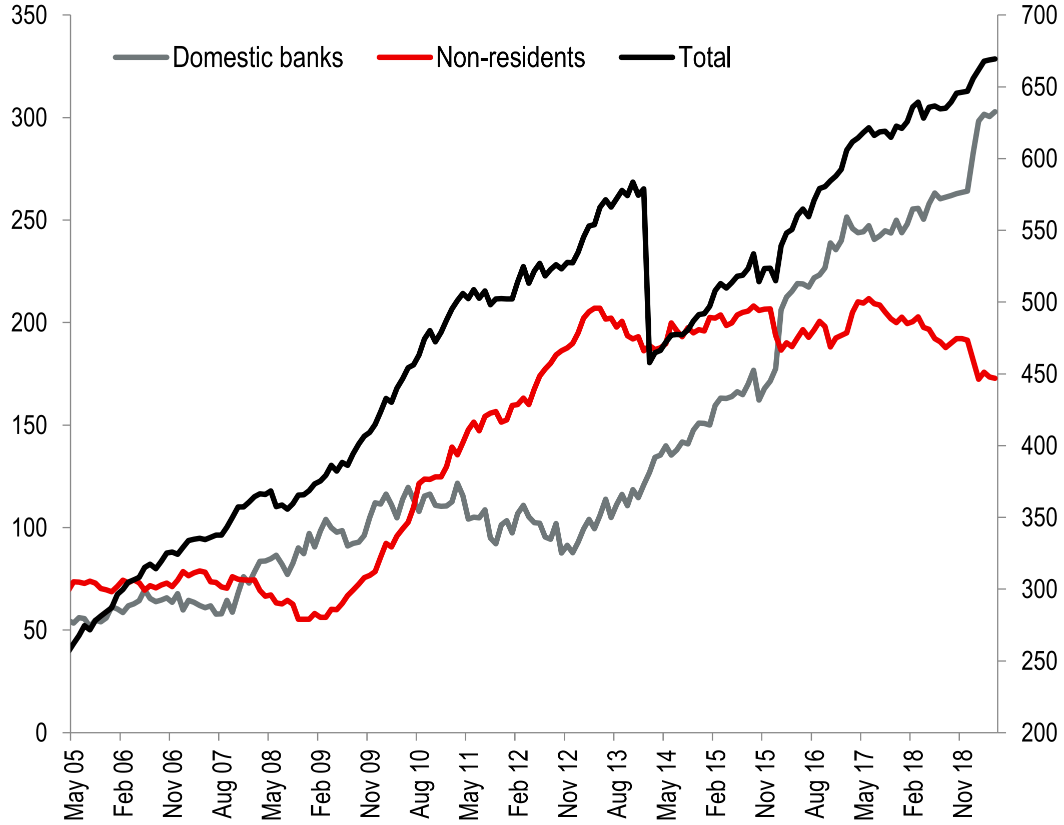
Source: Ministry of Finance. Santander

Debt martket: decreasing foreign exposure

This year's data about debt financing by different classes of investors confirm our scenario of rising importance of local commercial banks in financing debt issuance. We think that further increase of bank's balance sheets, spurred by rising short-term and on-demand deposits, will translate (just like in the previous months) into growing POLGBs purchases. We estimate that the Polish banking sector could increase its bond exposure by additional PLN1015bn until the end of 3Q19. We think that the persistence of tensions in international trade relations and the potential for launching another round of ECB's QE should translate into higher interest of domestic banks in fixed-coupon bonds with longer maturities (in contrast to what was the case in the previous year).

The final quarter of the year should be supportive for some rebuilding of foreign investors' holdings of POLGBs, amid deepening hunt for yields and competition among European financial institutions.

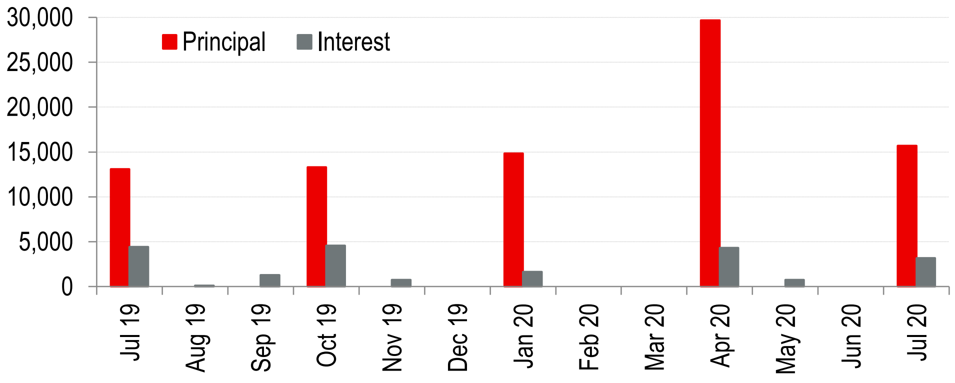
Holders of Polish, PLN marketable bonds (PLNbn)



Source: Ministry of Finance, Santander

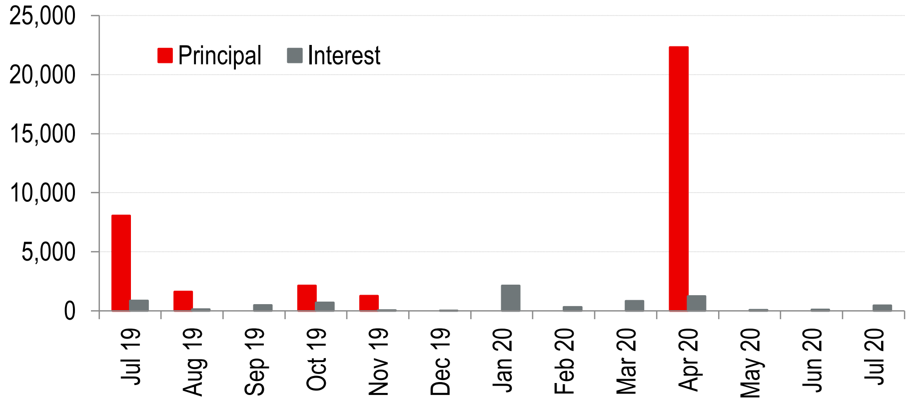
Debt redemptions, money market pricing

PLN-denominated bond redemptions and interest payments, PLN bn



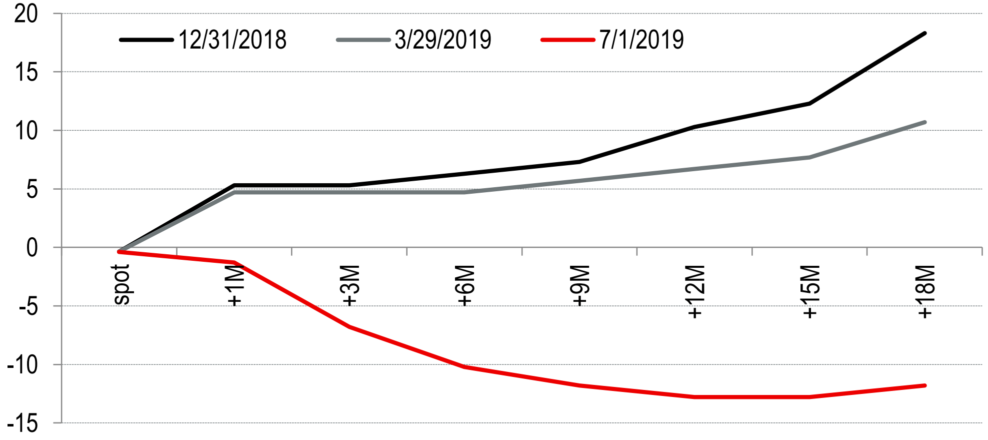
Source: Ministry of Finance, Santander

Foreign currency denominated bond redemptions and interest payments, PLN bn



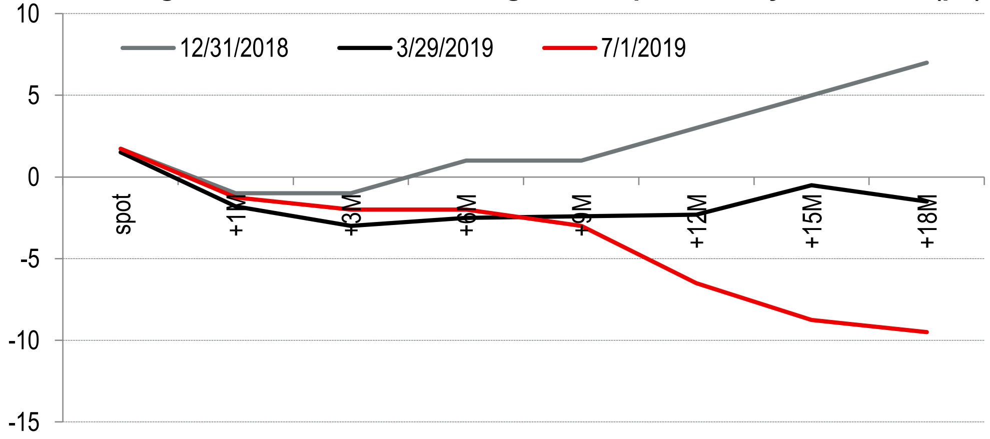
Source: Ministry of Finance, Santander

Change in Euribor3M in the coming months priced-in by the market (pb)



Source: Thomson Reuters, Santander

Change in Wibor3M in the coming months priced-in by the market (pb)



Source: Thomson Reuters, Santander

FX Market: Stronger starting point for 2H

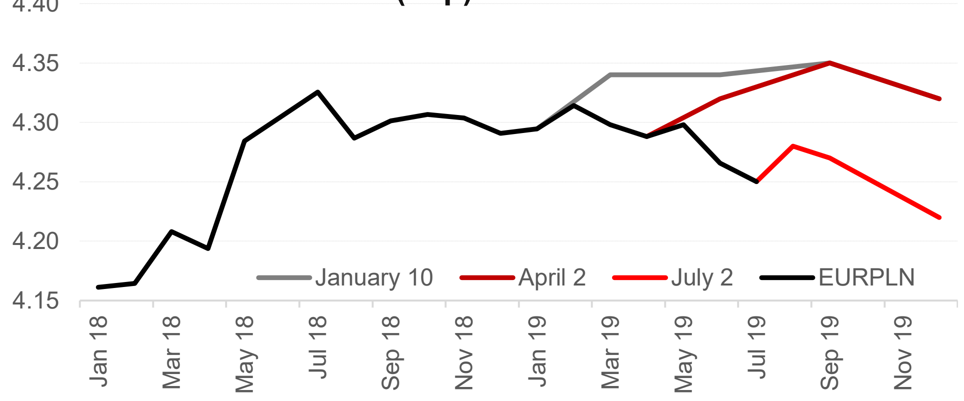
In 1H19, the zloty performed better than we had expected with EUR/PLN trading mostly in the lower half of the 4.26-4.34 range. In our 2019 Outlook released in early January, we said the Polish currency could be under pressure in 1H19 and then it may start to recover later in the year.

The factors we had outlined that were supposed to weigh on the zloty in 1H have actually not done their job. The economic slowdown in Poland is hardly visible, in early January the Fed withdrew from 2019 rate hikes and the Brexit can has been kicked down the road. Thus, EUR/PLN starting point for 2H19 is lower than we assumed at the beginning of the year and so we decided to cut our EUR/PLN forecasts for 2H19.

The zloty followed the global equity trends and EUR/USD performance. Global macro data and worries about the economic growth outlook encouraged the main central banks to soften their tone. The market has started to price in the Fed rate cuts which boosted the zloty. The combination of supportive internal/external factors pushed EUR/PLN below 4.25, its lowest since May 2018.

In 1Q19, the zloty was underperforming its EM peers and the rally observed since late May helped to improve its position only slightly vs the other EM currencies.

FX forecasts (aop) and date of the forecast



Source: Santander

EM currencies performance

	12/31/18 - 03/29//19 (%)	
	vs EUR	vs USD
RUB	8.44	6.22
THB	4.68	2.55
CNY	4.62	2.48
CLP	4.17	2.05
COP	4.13	2.00
UAH	3.64	1.52
PEN	3.62	1.51
MYR	3.37	1.26
MXN	3.34	1.23
IDR	3.15	1.05
INR	3.00	0.90
SGD	2.64	0.54
HKD	1.85	-0.23
ZAR	1.24	-0.83
BRL	0.89	-1.17
HUF	-0.08	-2.12
CZK	-0.34	-2.37
PLN	-0.35	-2.38
RON	-2.41	-4.41
TRY	-3.03	-5.02
ARS	-11.23	-13.05

	03/29/19 - 06/28/19 (%)	
	vs EUR	vs USD
UAH	2.97	4.39
RUB	2.41	3.83
THB	2.08	3.49
CZK	1.54	2.94
ZAR	1.54	2.94
PLN	1.41	2.81
RON	0.81	2.20
ARS	0.59	1.98
BRL	0.45	1.83
MXN	-0.31	1.07
IDR	-0.57	0.80
HUF	-0.61	0.76
PEN	-0.63	0.74
HKD	-0.87	0.50
SGD	-1.17	0.20
INR	-1.19	0.18
CLP	-1.22	0.14
COP	-2.15	-0.80
MYR	-2.56	-1.21
CNY	-3.59	-2.25
TRY	-5.16	-3.85

Source: Bloomberg

FX Market: Further zloty appreciation possible

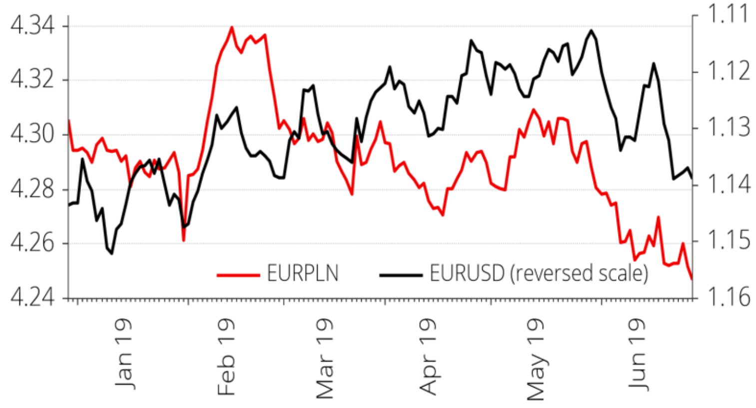
Technical analysis suggests that in the short term the zloty could give up part of its recent gains but in our view the 2H19 in general should be positive for the Polish currency. The key assumption underlying this scenario is a continuation of dovish tilt in monetary policies of main central banks and only mild deceleration of economic growth in Poland.

Since the global macro data still do not seem to give hope that the economic growth has reached the bottom, the zloty benefited from the market pricing more accommodative monetary policy by the global central banks. The US interest rate market is pricing a Fed rate cuts to be delivered in July.

Equities have already started to recover after the May sell-off amid higher chances for the US-China trade truce after the G20 summit and more monetary policy easing worldwide. Rising stock indexes – proxy of a robust demand for the risky assets – should support demand for the zloty.

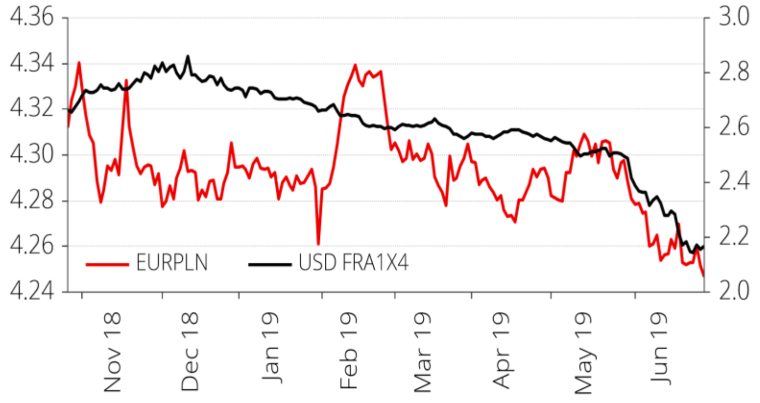
Furthermore, we think that in the coming months/quarters we may see more negative surprises in terms of macro data releases from the US rather than from the European economy. As a result, EUR/USD may rise and the weaker dollar would be positive for the EM currencies, including the zloty, particularly when the FOMC delivers rate cuts in 3Q19.

EUR/PLN and EUR/USD



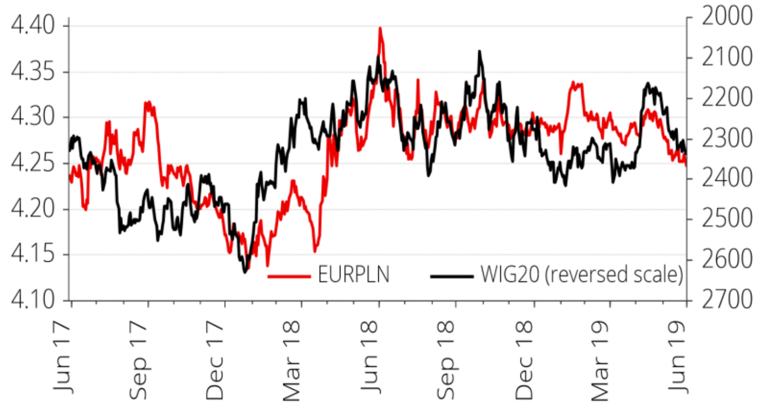
Source: Thomson Reuters Datastream, Santander Bank Polska

EUR/PLN and USD FRA 1x4



Source: Thomson Reuters Datastream, Santander Bank Polska

EUR/PLN and WIG20



Source: Thomson Reuters Datastream, Santander Bank Polska

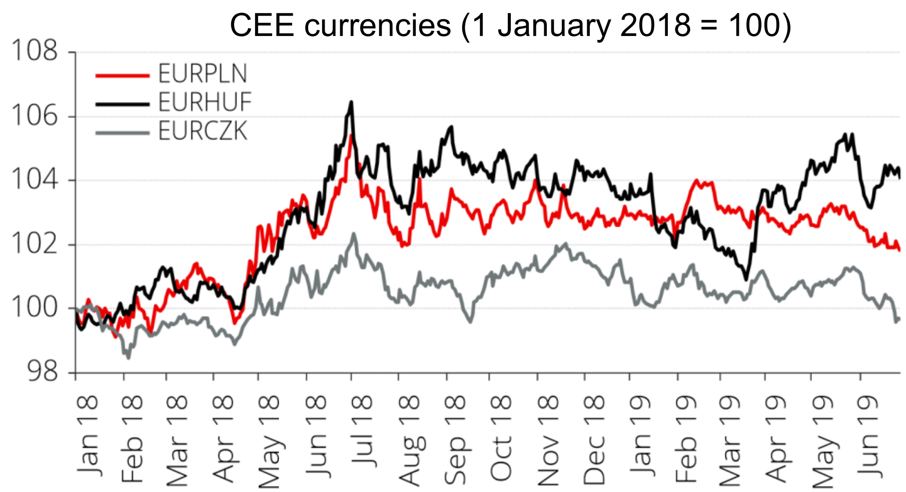
FX Market: Unsupportive factors – GDP and FOMC

We see two factors that could slow zloty gains – gradual deceleration of the Polish GDP growth and (potentially) delayed rate cuts in the US.

Since we uphold our view that the Polish economy will continue slowing gently after an exceptionally strong performance in 2018, the domestic economic trends should be no more than neutral for the zloty.

We also think that the market pricing of the Fed rate cuts has become too aggressive. We think the FOMC will leave monetary policy parameters unchanged in July and some easing could take place after the summer. Such decision could disappoint the market and trigger some short-term dollar appreciation which in turn could be negative for the zloty and its EM peers.

After the European Parliament elections were won clearly by the ruling PiS party and their chances for re-election in the general elections in the autumn seem to be growing, we no longer assume that the local political uncertainty ahead of elections could have a meaningful and persistent impact on the zloty.



Source: Thomson Reuters Datastream, Santander Bank Polska

Economic Forecasts

		2017	2018	2019E	2020E	1Q19	2Q19E	3Q19E	4Q19E	1Q20E	2Q20E	3Q20E	4Q20E
GDP	PLNbn	1,989.3	2,115.7	2,254.9	2,389.7	520.2	541.8	559.9	633.1	557.5	573.1	590.6	668.5
GDP	% y/y	4.8	5.1	4.3	3.5	4.7	4.5	4.2	4.0	4.0	3.5	3.4	3.3
Domestic demand	% y/y	4.9	5.5	4.6	4.0	4.2	4.9	4.9	4.4	4.2	4.0	3.8	3.8
Private consumption	% y/y	4.5	4.5	4.5	4.1	3.9	4.3	4.9	4.8	4.5	4.3	4.0	3.8
Fixed investment	% y/y	4.0	8.7	7.5	4.2	12.6	9.0	7.0	5.0	4.5	4.3	4.1	4.0
Industrial output	% y/y	6.5	5.9	5.5	5.3	6.1	5.6	5.8	4.5	3.8	5.2	6.0	6.0
Construction output	% y/y	13.7	19.7	6.2	2.7	9.9	8.1	3.9	5.1	1.2	3.2	4.2	1.9
Retail sales (real terms)	% y/y	7.1	6.5	4.9	3.3	4.1	6.8	6.8	4.7	3.4	3.4	4.9	5.6
Gross wages in national economy	% y/y	5.3	7.2	7.3	8.4	7.1	6.8	7.3	8.1	9.8	9.1	8.5	7.1
Employment in national economy	% y/y	3.3	2.6	2.0	-0.2	2.6	2.0	1.8	1.7	0.7	0.4	0.2	0.1
Unemployment rate *	%	6.6	5.8	5.4	5.1	5.9	5.3	5.2	5.4	5.5	5.0	5.0	5.1
Current account balance	EURmn	715	-2,882	-4,391	-9,155	1,832	277	-3,456	-3,044	581	-425	-4,604	-4,708
Current account balance	% GDP	0.2	-0.6	-0.8	-1.6	-0.3	-0.3	-0.5	-0.8	-1.0	-1.2	-1.3	-1.6
General government balance (ESA 2010)	% GDP	-1.4	-0.4	-1.7	-1.0	-	-	-	-	-	-	-	-
CPI	% y/y	2.0	1.6	2.2	3.2	1.2	2.4	2.5	2.7	3.9	3.0	2.9	3.0
CPI *	% y/y	2.1	1.1	3.0	3.0	1.7	2.6	2.5	3.0	3.8	2.9	2.8	3.0
CPI excluding food and energy prices	% y/y	0.7	0.7	1.9	2.5	1.1	1.8	2.1	2.6	2.7	2.5	2.4	2.4

* End of period; other variables – average in period

Source: GUS, NBP, Santander

Market Forecasts

		2017	2018	2019E	2020E	1Q19	2Q19	3Q19E	4Q19E	1Q20E	2Q20E	3Q20E	4Q20E
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	%	1.73	1.71	1.72	1.71	1.72	1.72	1.72	1.71	1.71	1.71	1.71	1.71
Yield on 2-year T-bonds	%	1.89	1.59	1.61	1.55	1.64	1.66	1.63	1.53	1.49	1.52	1.56	1.63
Yield on 5-year T-bonds	%	2.78	2.51	2.03	1.96	2.23	2.14	1.95	1.81	1.80	1.84	2.01	2.20
Yield on 10-year T-bonds	%	3.44	3.21	2.50	2.35	2.84	2.69	2.35	2.14	2.07	2.22	2.50	2.61
2-year IRS	%	1.94	1.92	1.78	1.83	1.78	1.81	1.77	1.76	1.76	1.80	1.84	1.92
5-year IRS	%	2.40	2.43	1.91	1.94	2.00	1.99	1.85	1.81	1.85	1.86	1.93	2.10
10-year IRS	%	2.86	2.89	2.19	2.10	2.34	2.29	2.11	2.01	1.88	1.99	2.15	2.36
EUR/PLN	PLN	4.26	4.26	4.27	4.20	4.30	4.28	4.27	4.22	4.21	4.21	4.20	4.17
USD/PLN	PLN	3.78	3.61	3.75	3.51	3.79	3.81	3.74	3.66	3.59	3.54	3.49	3.43
CHF/PLN	PLN	3.84	3.69	3.75	3.46	3.80	3.80	3.78	3.63	3.54	3.49	3.44	3.37
GBP/PLN	PLN	4.86	4.81	4.85	4.74	4.93	4.90	4.80	4.77	4.73	4.73	4.75	4.73

* End of period; other variables – average in period

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Source: NBP, Bloomberg, Santander

This analysis is based on information available until 02.07.2019 has been prepared by:

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