2014 OUTLOOK: POLAND

MACRO, RATES AND FX

December 2013

ECONOMIC ANALYSIS DEPARTMENT
Bank Zachodni WBK S.A.

ekonomia@bzwbk.pl

+48 22 534 18 88

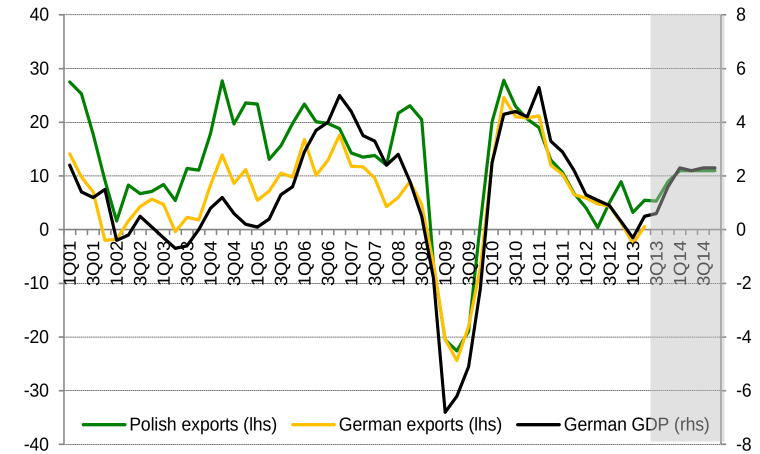
Overview

- Recent months have clearly shown that the Polish economy is on the path to economic recovery, in line with the scenario that we anticipated a year ago (each subsequent quarter of 2013 better than the previous one, with GDP growth topping 2% at the end of the year). The euro zone has left recession behind and, although the economy is still fragile, it should continue accelerating in the coming quarters. We expect 2014 to bring faster and more balanced economic growth in Poland. GDP could grow by slightly more than 3%, which is probably near or only slightly above the current potential growth rate for the economy. Net exports should remain an important driving force for recovery, albeit gradually diminishing in importance, while domestic demand should gain traction.
- As the Polish Monetary Policy Council stated that it would leave interest rates on hold until the end of 1H14, monetary policy will be quite uneventful in the next two quarters. However, we think it is quite likely that the process of monetary tightening will start much earlier in Poland than in the developed world. In our view, the first interest rate hike in Poland could materialise in autumn 2014, and may be followed by another in the last quarter. The normalisation of interest rates should be justified by strengthening domestic demand, improving labour market situation and inflation gradually trending upwards (although CPI growth may remain below the official target of 2.5% throughout 2014).
- An acceleration in economic growth, significant reduction in Poland's external imbalances and expected increase in interest rate disparity between Poland and the euro zone would, in our view, permit a moderate appreciation of the zloty in the coming quarters. Still, the scale of the move should be limited by the impact of QE3 tapering in the US, which may put negative pressure on emerging market currencies (even though the initial market reaction to the Fed's December decision has been limited). In the case of Poland, however, this pressure should largely be offset by a substantial improvement in the current account balance. We forecast EUR/PLN moving towards the 4.00 level (or slightly below) at the end of 2014. The onset of monetary tightening in Poland and QE3 tapering in the US should result in upward pressure on Polish bond yields. In the short run, such a move may temporarily be alleviated by the demand from the open pension funds (OFE), which may increase the share of bonds in their portfolios at the start of the year, before transferring them to the public sector (ZUS).

Export revival set to continue

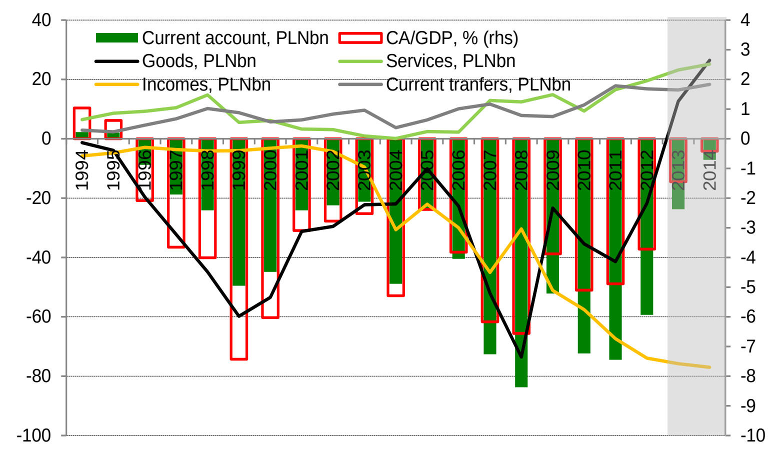
- Even though the recovery in the world economy is still fragile, we expect it to continue in 2014, supported by still ultra-loose monetary policies from the main central banks. The euro zone has left recession behind and should keep growing in the coming quarters; Santander's economists forecast 1.9% growth in 2014. Germany, Poland's most important trading partner, is expected to accelerate to 2.3% YoY.
- A solid recovery in Germany should further boost Polish exports, which have been performing decently, even during the period of economic slowdown abroad. This should allow exports to accelerate in the quarters ahead and maintain rapid growth (above 10% YoY, measured in euros) throughout 2014.
- The risk of a significant downturn in Ukraine (Poland's 8th biggest trading partner, with nearly a 3% share of exports) should be offset by expansion in other markets. Polish exports will continue to benefit from the recent geographical diversification: in the last couple of years exports to CEE countries, East Asia and the Middle East recorded very fast expansion (growing ca. five-, six-, and seven-fold, respectively in 2000-12). These markets, despite the slight deterioration in the economic outlook for emerging markets recently, should still outperform the developed world.
- Imports into Poland should continue to grow less than exports (given a moderate rebound in domestic demand), so we expect the trade balance to remain in surplus throughout 2014, while the current account deficit should shrink to ca. -0.5% of GDP (the lowest since the mid-1990s).

Polish exports vs. German GDP (% YoY)



Source: GUS, Eurostat, Santander, BZ WBK

Poland's balance of payments



Source: NBP, BZ WBK

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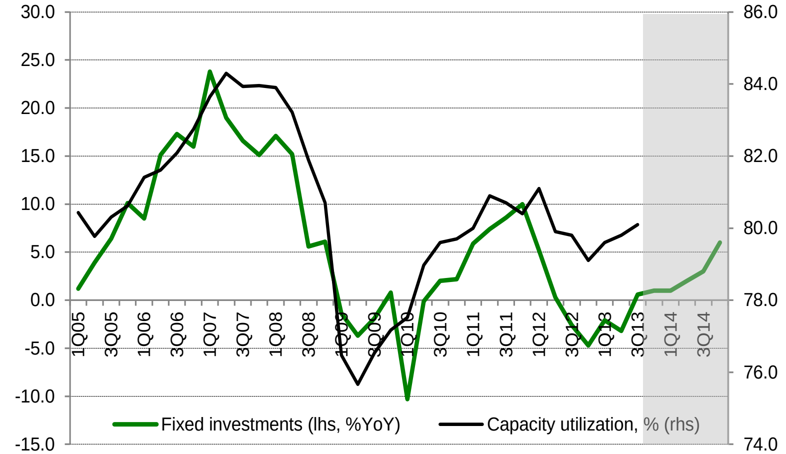
Investment growth picking up

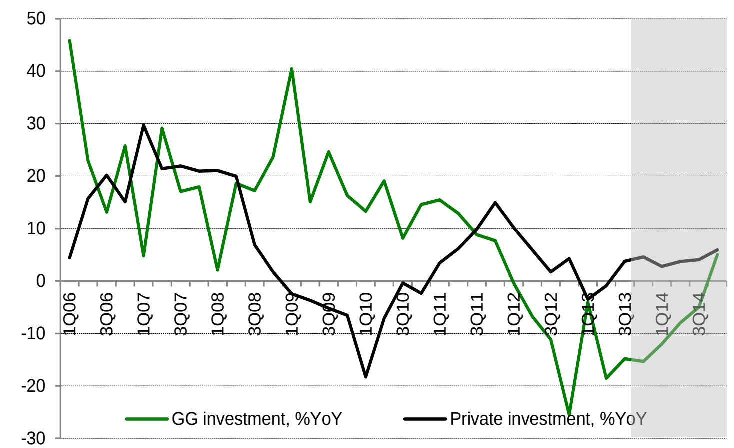
- Capacity utilisation, which dropped only slightly during the 2012 slowdown, has started to rebound in recent quarters, amid decent inflows of new orders (mainly to exporting sectors). The further increase expected should spur growth in fixed investments, as firms will have to expand to match growing demand from both external and domestic markets.
- In fact, the process of a recovery in investment has already started. In 3Q13 fixed investment growth turned positive (0.6% YoY) after four consecutive quarters of sizeable declines. It seems that the revival took place mainly in the private sector, while public investment outlays have fallen sharply since 2012 due to government fiscal constraints and the falling momentum of EU fund absorption at the end of the EU's 2007-2013 financial framework.
- We expect the positive trend in private investments to continue in 2014, spurred by the improving macroeconomic environment, growing business confidence and accommodative monetary policy. Meanwhile, in the last two years before the election, the government's focus on pro-growth economic policies and absorbing funds from the new EU financial framework should imply that the public sector will become much less of a drag as regards investment activity in the next two years.
- We expect the upward trend to continue, with total fixed investment growth accelerating to nearly 4% in 2014.

Investment growth and capacity utilisation



Source: GUS, NBP, BZ WBK

Investment growth in public and private sectors (nominal terms)

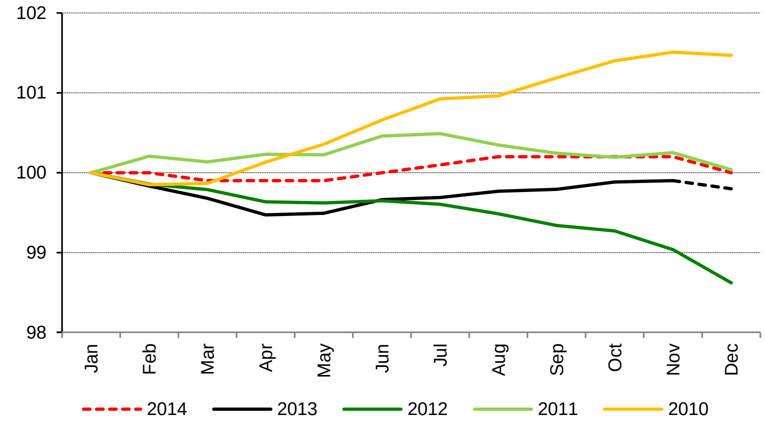


Source: Eurostat, BZ WBK

A gradual improvement in the labour market

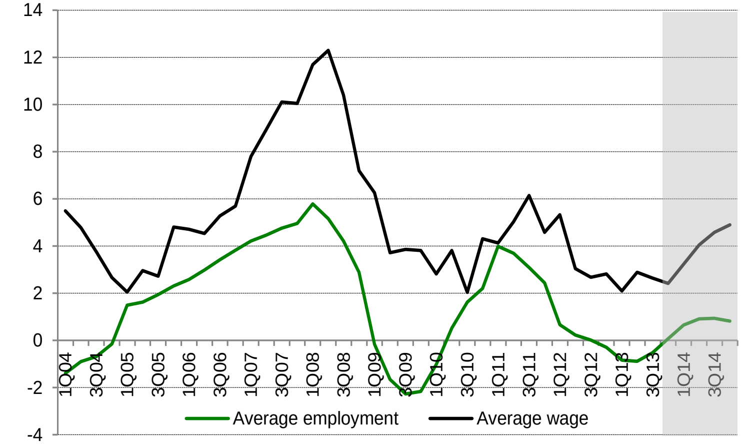
- Despite the long-held view that Poland needs at least 3% GDP growth to drive an improvement in the labour market, the first signs of positive tendencies in this area already emerged in 2Q13, when the economy was still expanding at a sluggish pace of below 1% YoY.
- We believe that continuing export expansion and a pick-up in investment activity will stimulate demand for labour in the following quarters. Still, the pace of employment growth will probably be moderately low (not exceeding 1%YoY) given that Polish companies did not scale back employment sharply in the slowdown cycle. Thus, the potential for short-term labour productivity gains is probably quite substantial.
- The unemployment rate already started decreasing in the first half of 2013 and we expect it to drop further, to ca. 12.7% at the end of next year. The decline in unemployment may be slowed down to some extent by the gradually increasing labour participation rate.
- Wage growth remains moderate and is not very likely to accelerate sharply. However, some improvement is possible here given the accelerating output, employment and companies' better financial results.
- The recovering labour market is driving a clear improvement in consumer confidence.

Employment in corporate sector (January=100)



Source: GUS, BZ WBK

Employment and wages in corporate sector (% YoY)

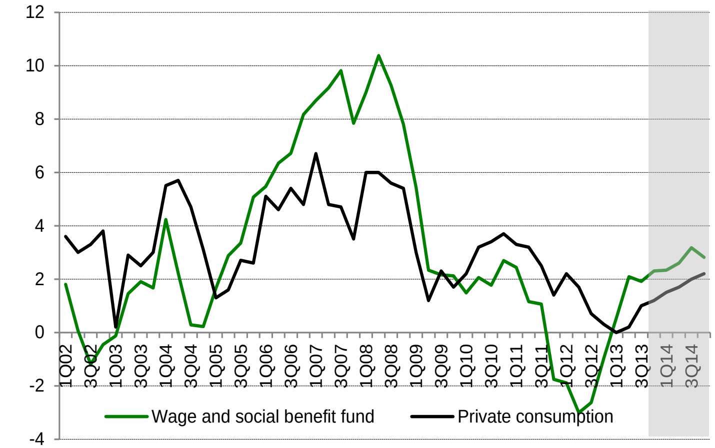


Source: GUS, BZ WBK

Consumption demand strengthening moderately

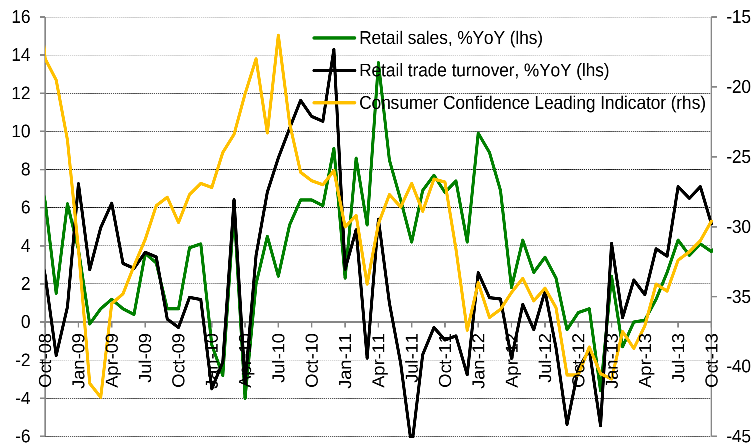
- Households' real disposable income has rebounded in 2013, with moderate nominal growth in wages and social benefits and a substantial decline in the inflation rate. We see households' income growth continuing to accelerate moderately, thanks to the further improvement in the labour market. Even though real growth in pensions and social benefits should be subdued (as opposed to the situation in 2013, indexation will be based on very low inflation and eroded by a gradually increasing CPI), it should be offset by a bigger increase in labour income.
- We assume that the household savings rate, which rebounded sharply (from close to zero) in the second half of 2012, depressing private consumption, should not increase much further in 2014. The improving macroeconomic outlook, along with higher income growth and consumer confidence in an environment of low interest rates, is likely to trigger a slightly higher propensity to spend among Polish consumers.
- As a result, acceleration in the private consumption growth, which already started in 2H13, is likely to continue. Having said that, one should be aware that a return to pre-crisis growth rates of consumer demand seems quite unlikely in the near future. We are forecasting a nearly 2% increase in private consumption in 2014, up from ca. 0.6% in 2013.

Private consumption vs. household income (% YoY)



Source: GUS, BZ WBK

Consumer confidence and retail sales (% YoY)

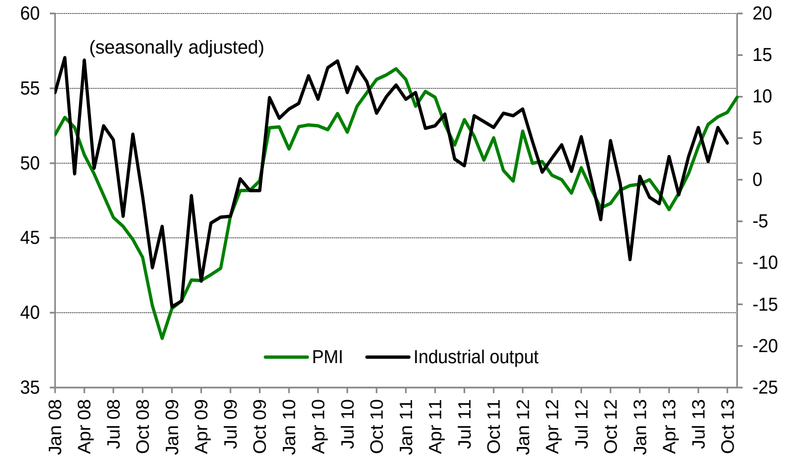


Source: GUS, BZ WBK

Industry expanding, construction recovering

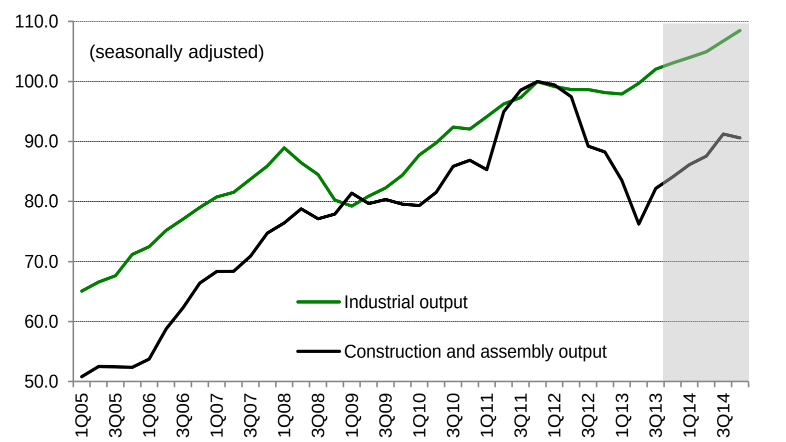
- The export-led recovery that started in 2013 resulted in a significant acceleration in industrial output growth, especially in those areas that are main drivers of Polish export growth (manufacturing of metals, electrical equipment, furniture, motor vehicles, food, etc.). We assume that accelerating economic growth abroad (especially in Germany) will permit the continuation of the industrial sector's rapid expansion, and we think industrial production should grow by nearly 6% YoY in 2014 (more than twice as fast as in 2013). The recent PMI survey signalled that, on top of quickly growing export orders, domestic orders also started picking up in 4Q13, and we think this trend will continue into 2014.
- After over a year-long downturn in the construction sector that started with the end of preparations for the Euro 2012 Football Championship, signs of recovery have already emerged. Construction and assembly output, after having fallen by ca. 30% from the peak, started recovering slowly, yet still remains well below the levels recorded in 2011. We estimate that this sector's output may grow by nearly 10% in 2014, supported by reviving investment activity in the private sector and the government re-focusing on spending EU funds (infrastructure investments), after it made some room for public spending via the pension system overhaul.

Industrial production vs. manufacturing PMI



Source: GUS, Markit, BZ WBK

Production in manufacturing and construction (4Q11=100)

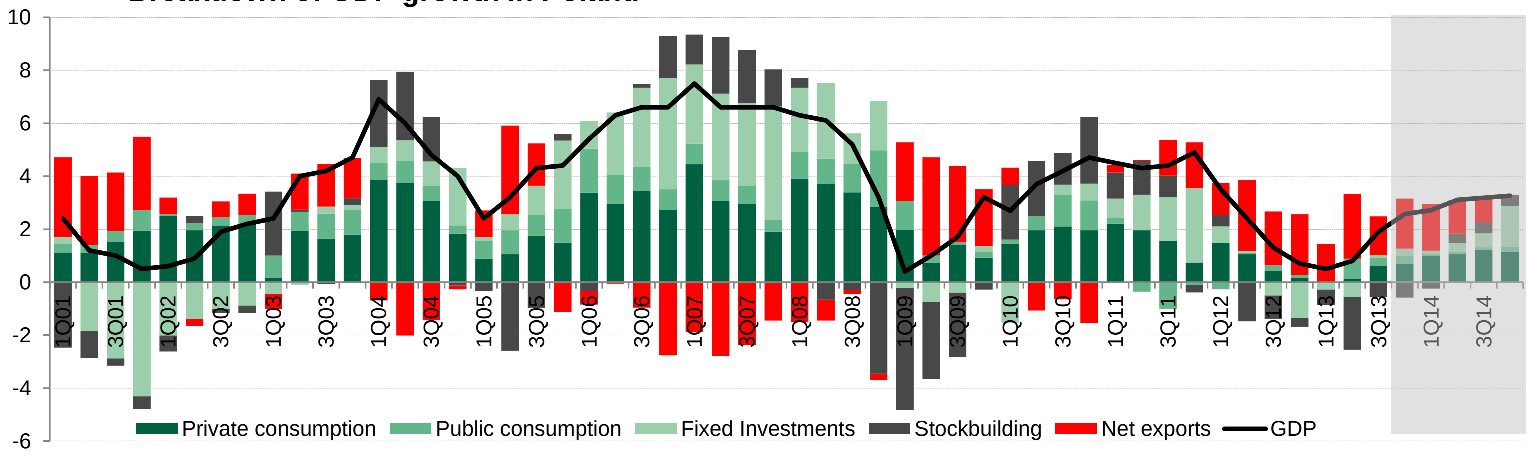


Source: GUS, BZ WBK

Faster and more balanced GDP growth

- The above-mentioned trends should drive faster and more balanced economic growth in Poland. We think net exports will remain an important driving force for recovery, albeit gradually diminishing in importance, while domestic demand should gain traction.
- Still, it has to be recognised that the pace of economic recovery is likely to be rather moderate when compared to the impressive growth rates recorded prior to the 2008 global economic crisis. Poland should grow at slightly above 3% in 2014, which is probably near, or only slightly above, the current potential growth rate for the economy.
- While the recovery is set to be less outstanding than in the past, it should be more benign from a macroeconomic stability viewpoint. Moderate growth in domestic demand is not likely to trigger any significant deterioration in the balance of payments position. Also, it should have only moderate inflationary consequences.

Breakdown of GDP growth in Poland

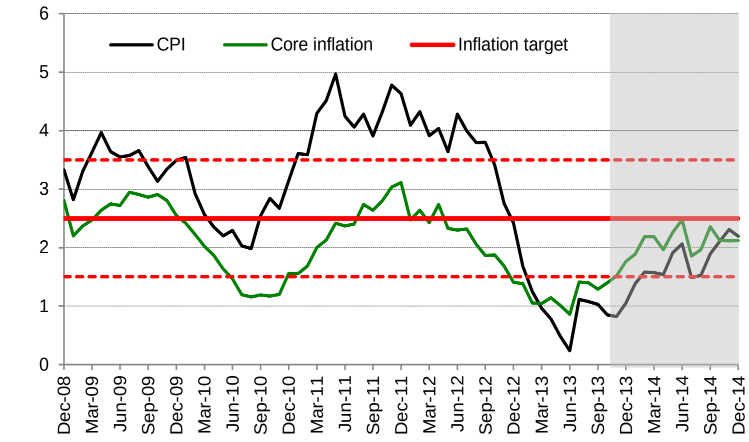


Source: GUS, BZ WBK

Inflation slowly returning towards target

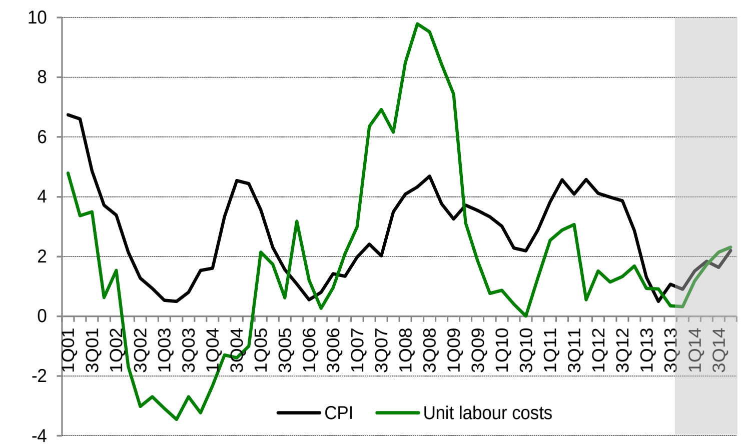
- The significant economic slowdown and global deflationary environment pushed inflation in Poland much lower in recent quarters, with CPI growth dipping temporarily to almost zero (in mid-2013) and rebounding to ca. 1% in 2H13 (still well below the 2.5% target), mainly due to administrative price hikes. Underlying price pressures are weak, however it is noteworthy that the scale of the drop in core inflation has been much less significant than the decline in the CPI.
- The expected acceleration in domestic demand growth and the recovery in the labour market should not be strong enough to generate a significant inflationary move in 2014. Still, in our view, these factors should drive some acceleration in consumer price growth next year. On our numbers, the growth in unit labour costs will start accelerating in 2014, creating at least some underlying pressure. On top of that, we will probably have a less favourable situation in the commodities and food markets. Thus, we see both CPI and core inflation gradually trending upwards in 2014. Certainly, deflation is not a threat for Poland at this stage, in our view.
- We forecast the inflation rate reaching 2% YoY in the middle of 2014 and probably fluctuating around this level in the second half of the year, with a good chance of topping the NBP's official target (2.5%) in 2015.

Inflation in Poland (%YoY)



Source: GUS, NBP, BZ WBK

Inflation vs. unit labour costs (% YoY)

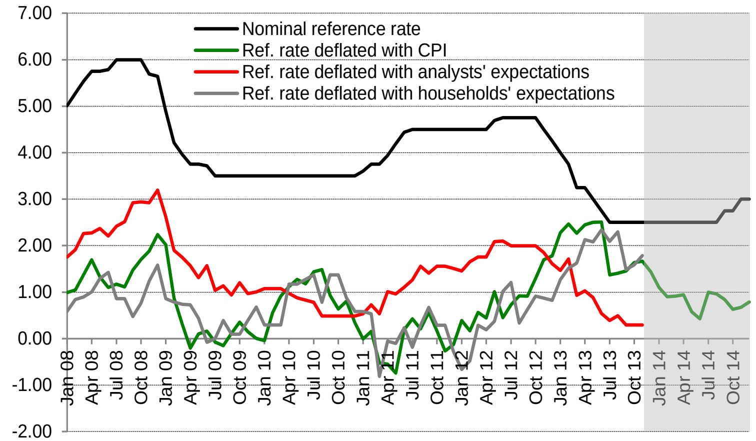


Source: GUS, BZ WBK

Interest rate hikes possible in 2H14

- The monetary policy of the main central banks abroad is likely to remain in expansionary mode for a prolonged period, as the pace of global economic recovery (especially in the euro zone) is rather slow and the inflation outlook still subdued.
- Poland's Monetary Policy Council recently extended its forward guidance, declaring stable interest rates until at least the end of the first half of 2014. It seems very likely it will stick to this pledge, so monetary policy should be quite uneventful over the next two quarters.
- However, we think it quite likely that the process of monetary tightening will start much earlier in Poland than in the developed world. Even though some MPC members have recently suggested that the period of stable rates could be extended into the second half of 2014, we think the first interest rate hike in Poland could materialise in autumn 2014, and may be followed by another in the last quarter.
- The start of monetary policy normalisation should be supported by a better economic scenario than the MPC is currently anticipating. We expect GDP growth to be slightly faster and better structured (stronger domestic demand) than forecast in the last NBP projection. Also, the labour market improvement will probably be faster and stronger (the NBP assumes that employment will not grow until mid-2015, with ULC rising more slowly than we expect), affecting the medium-term inflation prospects. Thus, we think that after GDP growth tops 3% and inflation 2%, the MPC will react to prevent real interest rates from dropping towards zero.

Interest rates in Poland (%)



Source: NBP, GUS, BZ WBK

NBP projections in its *Inflation reports* (central paths)

	GDP growth			
	Nov 12	Mar 13	Jul 13	Nov 13
2013	1.5	1.3	1.1	1.3
2014	2.3	2.6	2.4	2.9
2015	x	3.1	3.0	3.3
	CPI inflation			
	Nov 12	Mar 13	Jul 13	Nov 13
2013	2.5	1.6	0.8	1.0
2014	1.5	1.6	1.2	1.7
2015	x	1.5	1.5	1.9

Source: NBP

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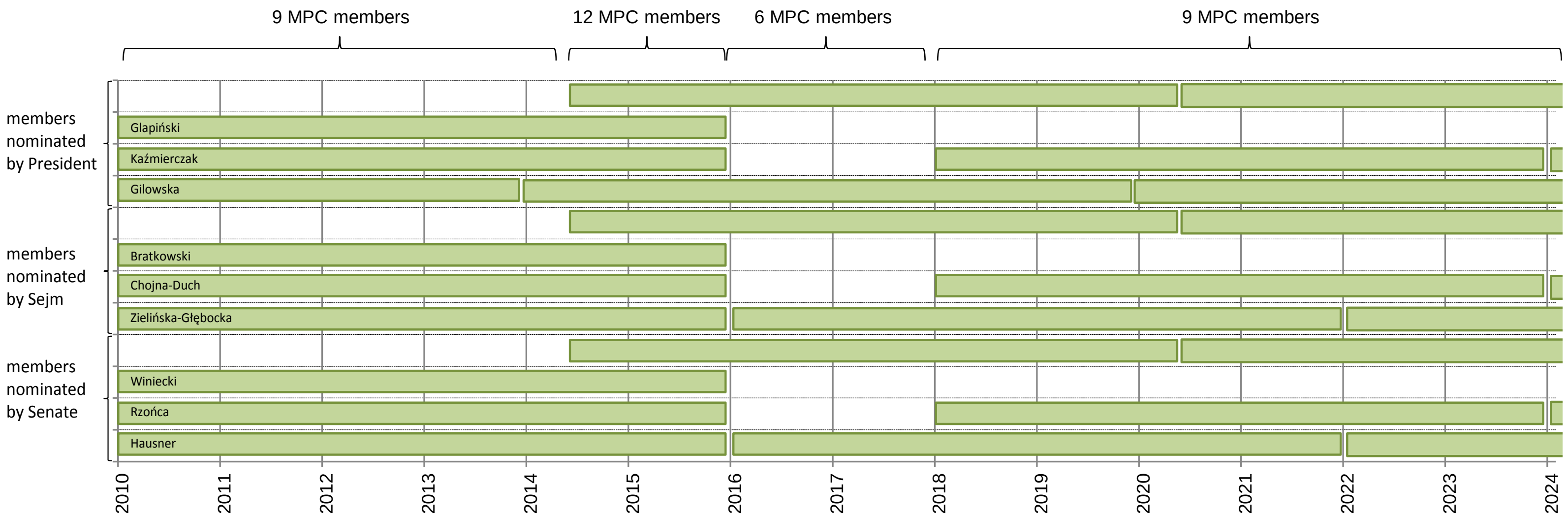
Interest rates scenario – risk factors

- There are several risk factors for our interest rate scenario, which may delay the start of monetary policy tightening in Poland.
- First of all, if global economic recovery proves to be slower than expected, it may imply a lower inflation path both abroad and in Poland (lower commodity prices, deflationary environment abroad), thus pushing central banks around the world into even longer periods of ultra-loose monetary policies.
- In December, the President will nominate a new MPC member (after Zyta Gilowska stepped down in October) and the new appointment is unlikely to be as hawkish as former member Gilowska (one of the most hawkish members).
- The Ministry of Finance has proposed an amendment to the NBP Act, assuming that the MPC may temporarily grow from nine to 12 members (+ NBP Governor), then decrease to six in 2016 and increase to nine again in 2018. If the law is approved quickly, it may already imply three new members in the Council in 2014. And this may tilt the balance of views in the MPC even more towards the dovish side.

Possible changes in MPC composition due to proposed amendment to the NBP Act



Source: BZ WBK

Source: BZ WBK

Budget deficit 2013 and 2014 below the plan

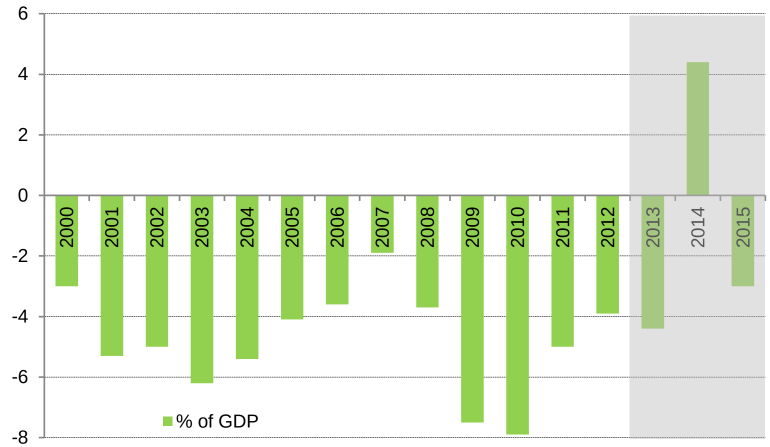
- As mentioned many times in the past, the 2013 budget deficit is likely to be ca. PLN8bn smaller than assumed in the Ministry of Finance amendment.
- The government's macroeconomic assumptions for 2014 seem quite conservative (GDP at 2.5%), so there is also a chance of lower deficit realisation.
- Still, keep in mind that the fiscal consolidation planned for 2014 will primarily be driven by the proposed changes in the pension system.
- We expect the general government deficit to decline from 4.4% of GDP in 2013 to some 3.6% in 2014 (formally, a surplus will be shown in ESA95 terms). Of this reduction, ca. 0.7pp. will be connected with OFE changes. These include: (1) lower public debt management costs; (2) lower subsidies to the Social Security fund FUS (depending on the number of people opting-in for OFE); (3) the assets of people who have less than ten years to retirement will gradually and proportionally be transferred to the public sector (the 2014 transfer will be bigger than in subsequent years as it will affect more people). See the following slides for more details on OFE changes and the possible market implications.
- Overall, the pace of fiscal consolidation in Poland should be slower than initially planned, but the European Commission already allowed for one more year of delay. Given the positive growth outlook for 2015 too, the GG deficit could decrease to around 3% of GDP, as required by the Commission. This would allow Poland to leave the Excessive Deficit Procedure.

Revenue, spending and balance of the budget 2013-2014

(PLN bn)	2013 amended (1)	2014 (2)	Change (2) / (1)
Revenue, including:	275.7	276.5	0.3%
Tax revenue	239.2	248.0	3.7%
- *VAT*	113.0	115.7	2.4%
- *CIT*	22.0	23.3	5.9%
- *PIT*	40.9	43.7	6.8%
Non-tax revenue	35.0	26.9	-23.1%
Spending	327.3	324.2	-0.9%
Spending (excl. OFE)	327.3	333.5	1.9%
Budget balance	-51.6	-47.7	-
Balance (excl. OFE)	-51.6	-57.0	-

Source: Ministry of Finance, BZ WBK

General government balance (% of GDP)

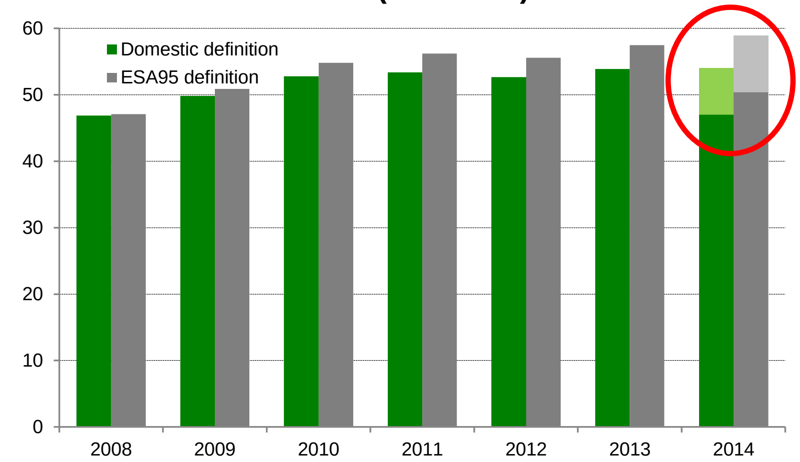


Source: Eurostat, BZ WBK

Lower public debt due to changes in OFE system

- Due to changes in the pension system, the public debt-to-GDP ratio will go down by ca. 8pp, as bonds will be transferred to the public sector. This will help move away from the (suspended) safety thresholds and from the constitutional limit of 60%.
- The government plans to lower safety thresholds (50% and 55%) only in the new spending rule, but to maintain the 55% in the Public Finance Act. Keep in mind that the road fund (KFD) is not included in the domestic definition of public debt, so there is quite a significant difference between the Polish and the ESA95 definitions of public debt.
- As regards the new ESA2010 rule, it is quite clear that it will not permit the government to show a fiscal surplus in 2014 (in any case, this would not matter, as it would be a one-off, disregarded by the markets). However, it looks like the public debt will be lower thanks to bonds transferred from OFE to the public sector, not only according to the Polish definition, but also under ESA2010. For example, in its new autumn forecasts, the European Commission lowered the public debt figures for Poland from 58.2% in 2013 to 51% in 2014 (and 52.5% in 2015).
- The most important challenge for the new finance minister and for the government is to make room for spending connected with the new EU perspective (above €80bn in 2014-20), while at the same time keeping fiscal consolidation on track.

Public debt and OFE effect (% of GDP)

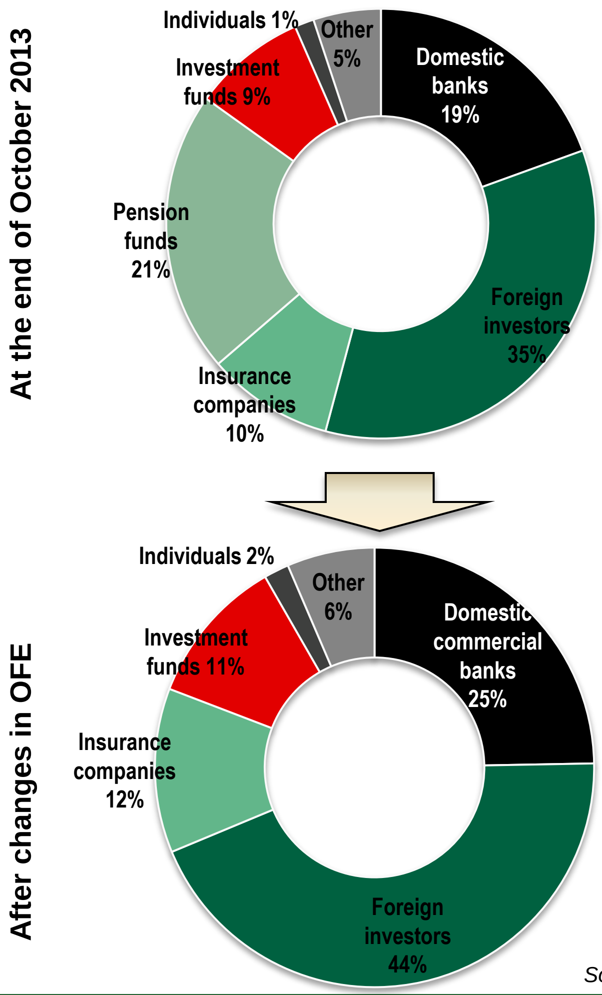


Source: Ministry of Finance, GUS, Eurostat, BZ WBK

OFE overhaul: Bond market more dependent on foreign investors

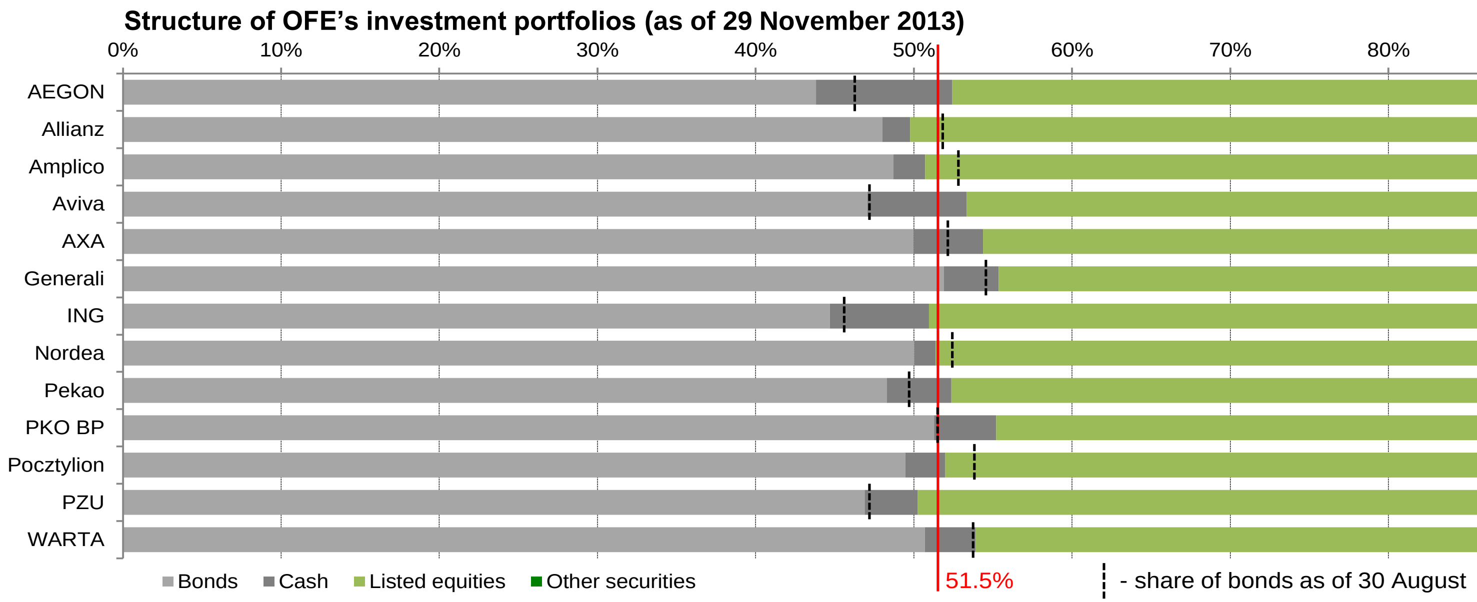
- The share of foreign investors in the local bond market should increase by some 10pp from 33.7% to ca. 43% after the OFE sector is eliminated (based on end-October data).
- For some of the bonds (DS series maturing in 2020, 2021, 2023), foreign investors' share will increase to ca. 60%, while, in some series (WZ maturing in 2017, 2021) ,the concentration of bonds in one (foreign) hand will be as high as 20%.
- The changes mean more dependence on foreign money flows, which implies higher volatility and a possible liquidity premium. This should be especially the case in the 3-5Y segment, where OFE mostly held bonds. As regards the series, OFE generally opted for fixed coupon bonds (PS, DS).
- An additional risk of some outflow by foreign investors next year might be connected with the possible downward adjustment of Poland's weight in global bond benchmarks. However, even assuming that most investors follow the benchmarks, this would represent no more than a few (2-3) $bn. This would not be much more significant than last October's outflow, which amounted to PLN7bn. The selling was concentrated at the short-end of the curve, but the impact on yields was limited. Of course, the outflow of foreign money was to some extent offset by OFE buying govies, a situation that will not be repeated in 2014.

Change in structure of Polish bondholders due to OFE overhaul



Source: MoF, BZ WBK

OFE overhaul: Will OFE have to buy more bonds or sell equities?



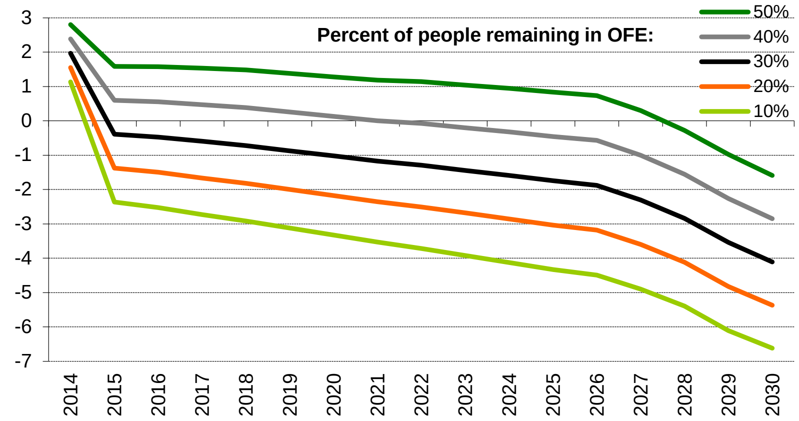
Source: KNF, BZ WBK

- At end-November, just one pension fund had above the 51.5% transfer threshold in State treasuries and State-guaranteed bonds. If this situation persists at the transfer date, bonds above that limit could be held to maturity or sold in the market, but no new investments would be allowed.
- Keep in mind that, within the 51.5% of total assets for each OFE, the value of treasury bonds and State-guaranteed bonds transferred by each OFE cannot be lower than that resulting from the share of treasuries and State-guaranteed bonds in each OFE's assets as at 3 September 2013 (the day preceding the announcement of the planned pension system overhaul). The chart above shows the share for the end of August as a proxy, reflecting that a few pension funds would have to buy bonds if their portfolio breakdown remains unchanged.
- As regards possible outflows from the Polish equity market, at end-November five pension funds (Allianz, Amplico, ING, Nordea and PZU) lacked the cash to cover the deficit between their T-debt holdings and the required 51.5% asset transfer ratio. The combined gap amounted to PLN 1.3bn and this implies, *ceteris paribus*, a potential equities sell-off in equity market until the end of January (the reference day for the asset transfer). However, under a scenario of a further rally in equities (not to mention additional equity purchases by pension funds) and/or falling bond prices, the share supply risk would heighten.

OFE overhaul: Will OFE remain a net receiver of funds?

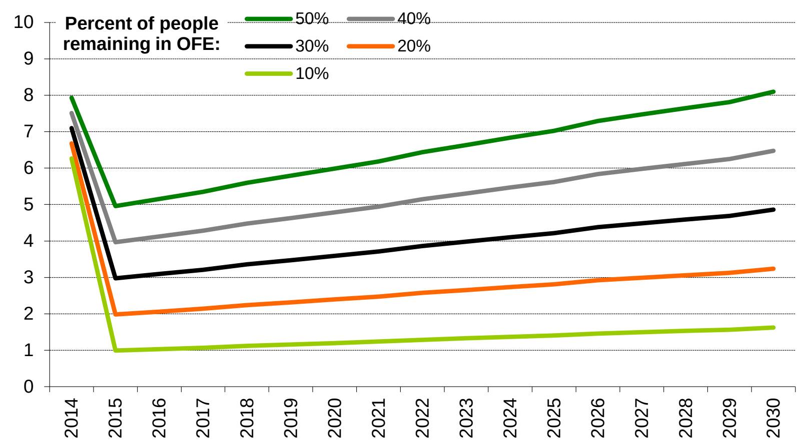
- One of the elements of the government's plan is that assets corresponding to people with less than ten years until retirement will gradually and proportionally be transferred to ZUS (2014 transfers will exceed those in subsequent years as more people will be affected).
- This will be a negative factor from the viewpoint of net flows to the pension funds, and the extent to which this is offset by the flow of contributions will depend on how many people decide to stay in OFE. The charts on the right present different scenarios, as calculated by BZWBK Brokerage analysts.
- In 2014, OFE will be still net receivers of funds, as all contributions will continue to be paid until people opt for either ZUS or OFE (i.e., mid-year). However, the net inflow of contributions in 2015 and subsequent years will depend on the ratio of those who opt-in (stay in OFE). Note that the charts show estimates excluding dividend effects. If this is taken into account, the below 30% of people opting-in for OFE would probably be enough to avoid net negative flows in the next few years.
- Also, it is worth remembering that, in the long run, OFE would become net sellers of assets anyway, even without the reform, as they would have to sell equities to pay pension benefits.

Estimated net inflow to OFE



Source: BZ WBK Brokerage

Estimated ZUS contribution to OFE



Source: BZ WBK Brokerage

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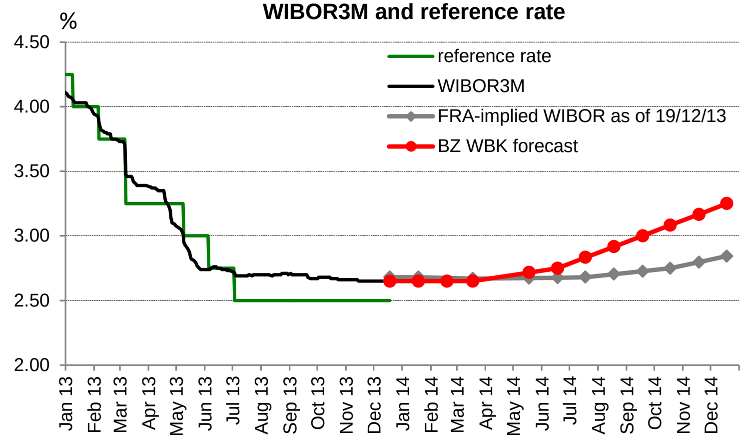
Will the market price in earlier hikes?

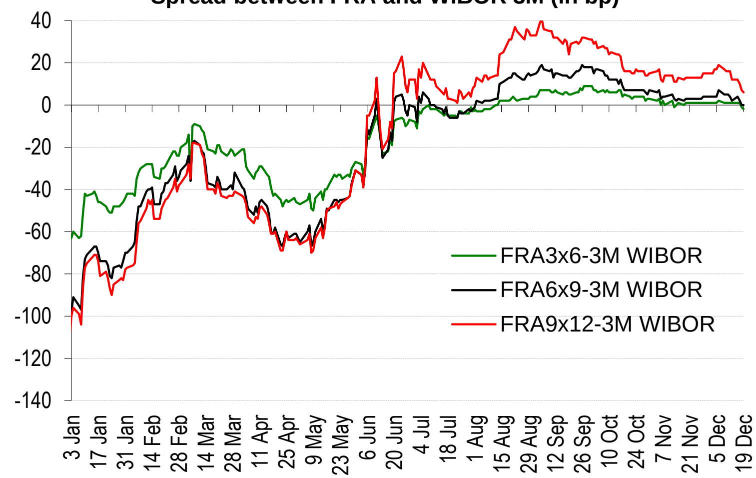
- A couple of factors have anchored money market rates at all-time lows. First, the MPC's forward guidance, assuming that official interest rates remain unchanged at least until the end of the first half of 2014. Second, some Council members have commented that rates might stay flat even longer. Lastly, the surprisingly low recent CPI readings lowered the inflation path for the next couple of quarters. FRA rates suggest that investors are still expecting the first hike in one year's time (FRA12x15 is oscillating near 3%).
- We expect the still subdued inflation path in 1Q14 and the MPC's relatively dovish rhetoric to keep WIBOR rates stable. A increasingly evident rebound in the Polish economy and gradually rising CPI inflation might cause the MPC to switch to a tightening bias for its monetary policy, and start hiking rates in the autumn. Our base-case scenario assumes two hikes in 2014 (50bps in total). Consequently, it should quickly translate into stronger WIBOR growth in 2H14, particularly after the first hike. FRA rates should be sensitive to macro changes and the curve of expected WIBOR rates (see chart) should be lifted when CPI and GDP increase during 2014.
- All in all, we expect WIBOR 3M to increase to 2.75% (on average) in June 2014 and to rise to 3.25% in December 2014, as the MPC starts its monetary policy tightening cycle. As mentioned in earlier slides on monetary policy, we see downside risks to this scenario.

WIBOR3M and reference rate



Source: Reuters, BZ WBK

Spread between FRA and WIBOR 3M (in bp)

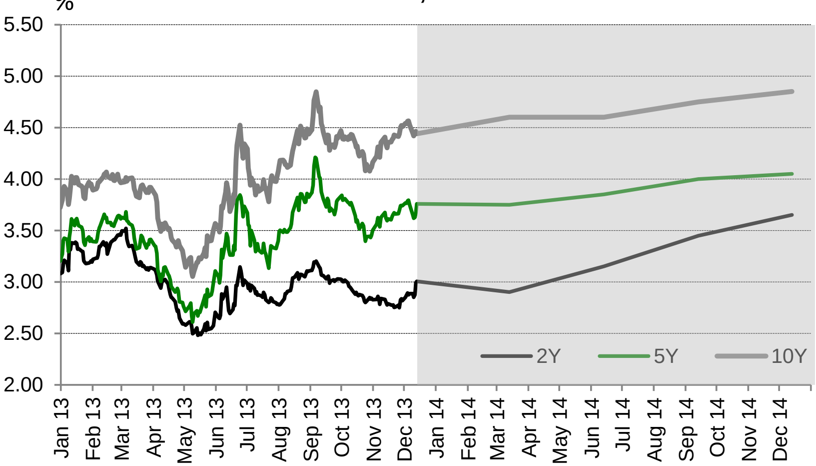


Source: Reuters, BZ WBK

Bonds and IRS under pressure from various factors

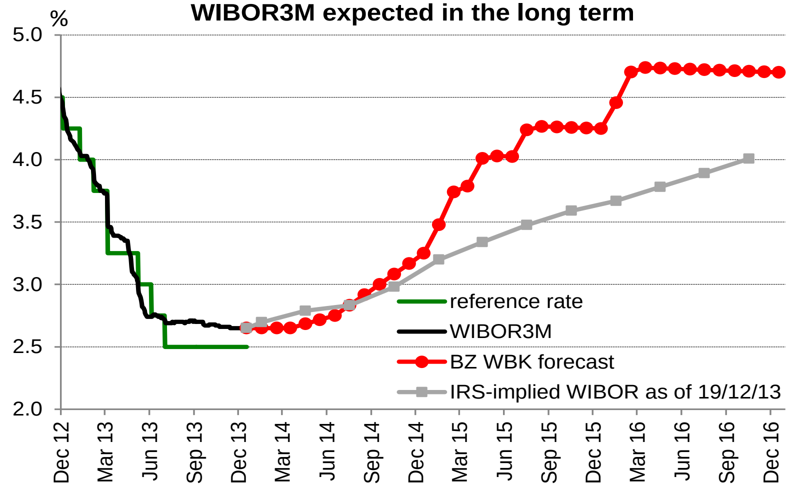
- In 2013, the Polish interest rate market saw a big change compared with 2012 due to (among others) the end of monetary easing by the MPC, renewed economic growth and expectations of QExit by the Fed in 2013. So, a bearish steepener developed as the belly and long end of curves shifted up, while the front end declined slightly.
- In 2014, we expect the domestic debt market to come under pressure from several factors. First, external factors, with the Fed's gradual QE3 tapering. Together with a better economic outlook, this should put some upward pressure on yields in core markets, especially in the belly and long ends. Our house view has 10Y German Bund yields rising towards 2.50% at end-2014.
- Second, following the OFE changes (see above), the debt market will be more sensitive to shifts in foreign investors' mood. At the same time, we may see some demand for government debt (probably at the front end of the curve) from pension funds at the start of the year to cover the required minimum.
- As regards local factors, the expected economic recovery, driven to a larger extent by domestic demand and a gradual increase in inflation, should contribute to higher yields.
- However, a stronger zloty (see following slides) and lower-than-assumed supply of Treasuries (on a possible positive surprise in budget revenues) should provide some support for domestic debt.
- Overall, we expect a continuation of the bearish steepener at the start of the year, with the front end relatively stable (still dovish MPC, low CPI, some OFE buying). Rising expectations of monetary tightening should drive a clear rise in the 2Y yield in 2H14. We forecast the 10Y yield increasing towards 4.90% over the course of 2014.

Yields of 2Y, 5Y and 10Y benchmarks



Source: Reuters, BZ WBK

WIBOR3M expected in the long term

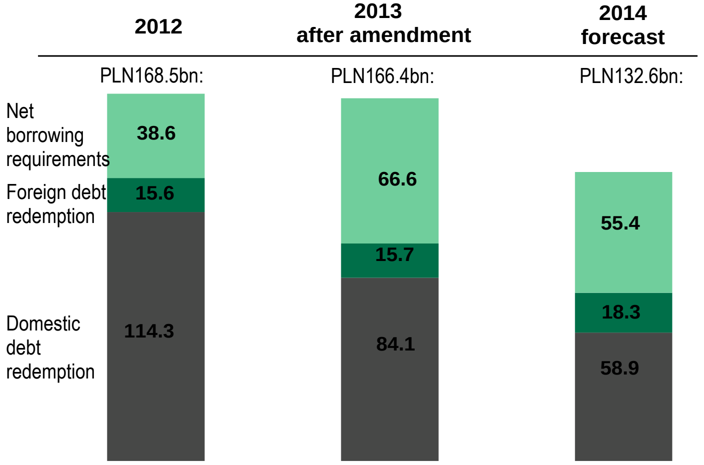


Source: Bloomberg, BZ WBK

Lower redemptions + OFE changes = lower supply

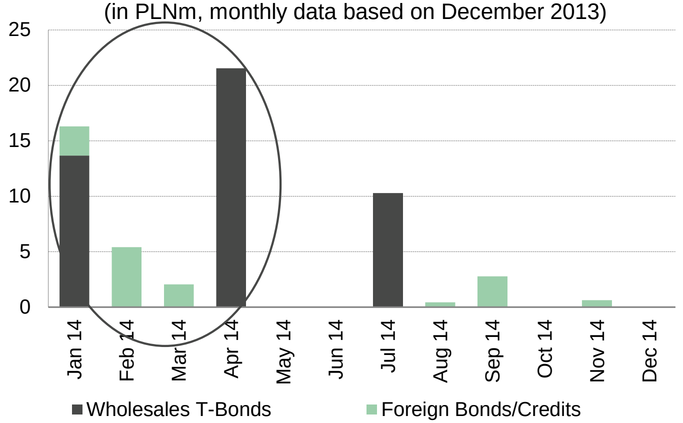
- The 2014 budget bill assumes a PLN47.7bn deficit (vs. PLN51.6bn expected for 2013). Next year's gross borrowing requirements amount to PLN132.6bn vs. PLN166.4bn in 2013. This comes not only from lower domestic redemptions (by PLN25bn), but also from lower net borrowing needs, mainly thanks to changes in the pension system. Of course, the OFE overhaul will change not only the supply, but also the demand side.
- Substantial 2014 debt redemptions will take place in January (domestic and USD bonds worth PLN16.3bn), February (FX bonds worth €1.3bn), April (domestic bonds worth nearly PLN22bn) and July (domestic bonds for PLN10bn).
- The funding structure of gross borrowing needs will be similar to in previous years. Issuance of PLN-denominated Treasury paper will still play the main role. As regards foreign funding, the Ministry plans to increase net issuance of FX-denominated bonds to nearly PLN14bn vs. only PLN3bn in 2013.
- The Ministry of Finance built up a safety liquidity cushion in 2013 that will cover a large part of the redemptions scheduled for 1Q14. This represents well above 20% of the total 2014 financing target. The Ministry aims to fully finance its 2014 target by the end of July 2014. This implies average monthly offerings of T-bonds for nearly PLN10bn in the January-July period, assuming that FX financing is fully covered.

Gross borrowing needs:



Source: Ministry of Finance, BZ WBK

Marketable Treasury Securities redemptions in 2014
(in PLNm, monthly data based on December 2013)

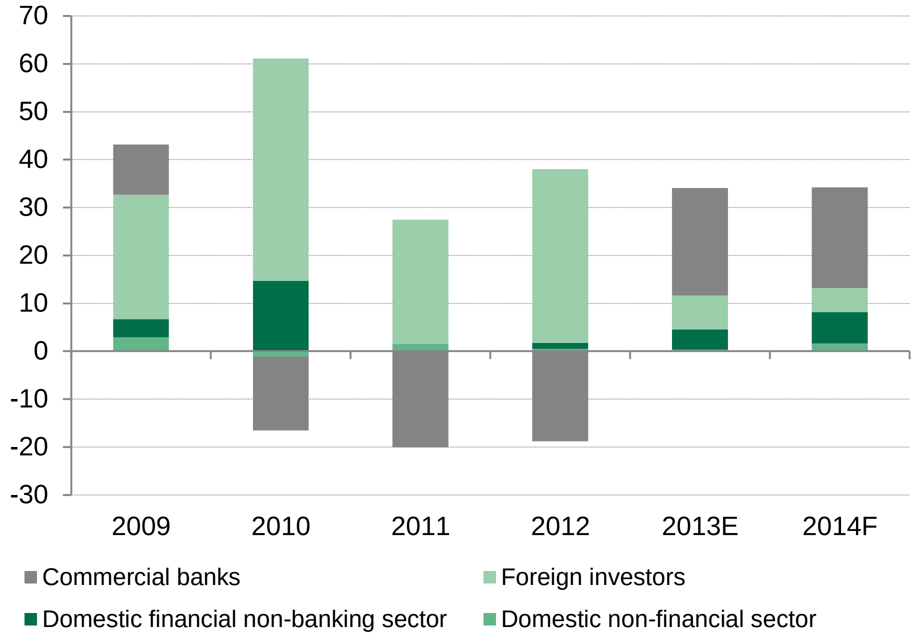


Source: Ministry of Finance, BZ WBK

Demand side of deficit financing the same as in 2014

- In 2013, contrary to 2010-2012, domestic commercial banks played the main role in financing the PLN-denominated borrowing requirements. At the same time, the share of foreign investors in domestic financing decreased significantly as compared to 2012.
- For 2014, we expect the structure of domestic financing to be similar to that in 2013, with domestic banks playing the key role. We believe the domestic financial non-banking sector's share will be roughly in line with this year, despite the disapearance of pension funds.
- As regards foreign investors, we see their share decreasing slightly (to PLN5bn net, down from the PLN7bn expected this year).
- In our view, the risk of a sharp outflow of foreign capital is rather limited. The breakdown of the foreign investor base seems to be relatively stable, as medium- and long-term investors remain the dominant force.
- To mitigate the risk of yields increasing due to possible outflows of foreign capital (benchmarking, liquidity issues after the OFE overhaul), we think it would be useful if the Ministry of Finance considered publishing a more detailed breakdown of non-resident holders of Polish PLN-denominated debt, as this would probably show a rising share of long-term investors (central banks and SWF).

Domestic financing – demand side (in PLN bn)

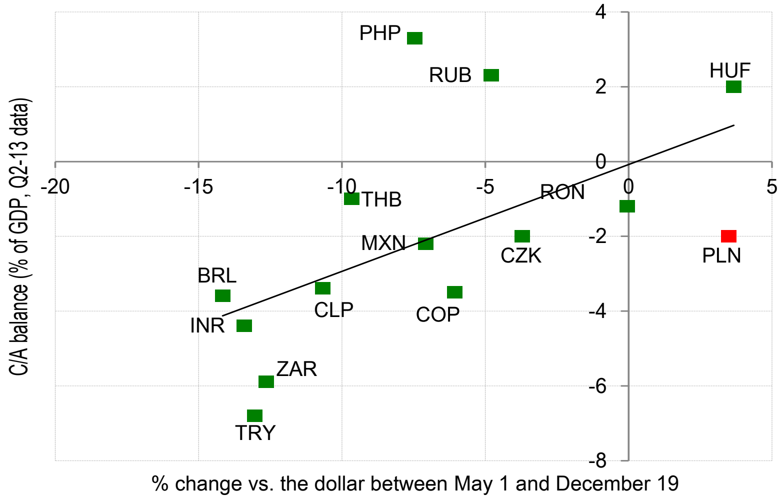


Source: Ministry of Finance, BZ WBK

Zloty impacted by both domestic and global factors

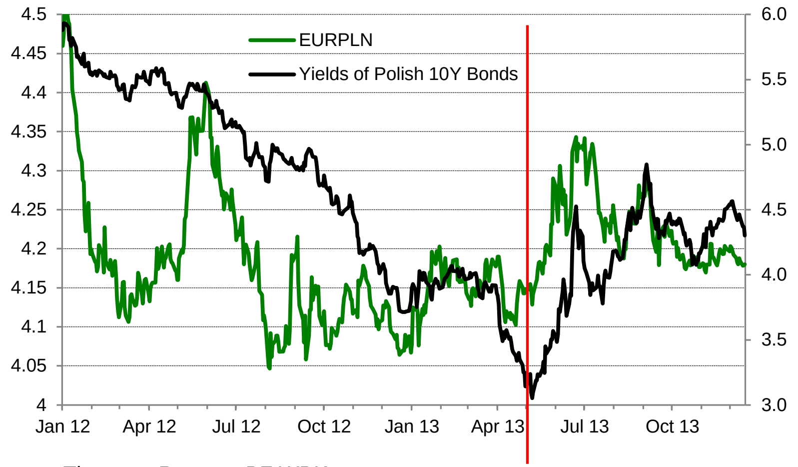
- The zloty is a cyclical currency, so in the medium and long term its behaviour is correlated with the economic cycle. However, the local market drivers have recently been overshadowed by global factors, with the performance of the zloty (and Polish bonds) being closely linked to changes in investors' expectations for the Fed's monetary policy.
- In December, the US Fed decided to start scaling back its quantitative easing as of January 2014. Ongoing gradual QE3 tapering implies negative pressure for emerging market currencies. However, the impact on the zloty should be limited, thanks to the sharp improvement in the C/A balance recently.

FX rate changes vs. C/A balance in emerging markets since Fed announced possible QE3 tapering



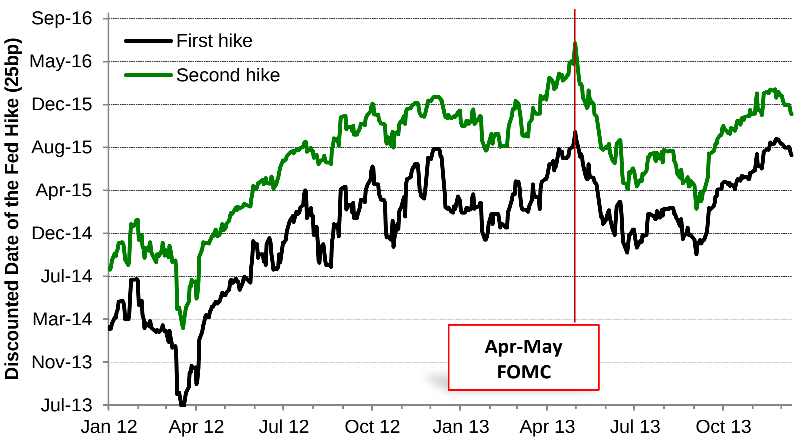
Source: Bloomberg, BZ WBK

EURPLN and yields on Polish bonds



Source: Thomson Reuters, BZ WBK

Expected timing of Fed rate hikes

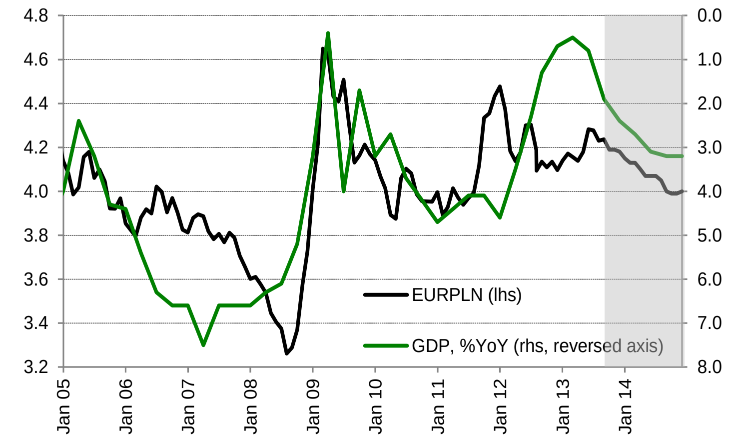


Source: Bloomberg, BZ WBK

Moderate zloty appreciation expected in 2014

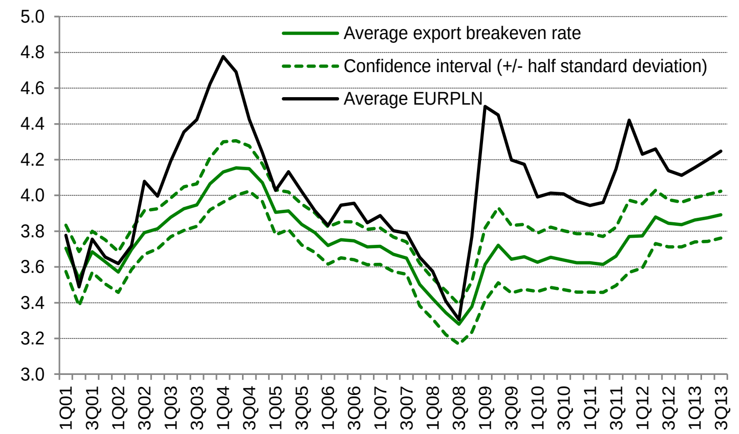
- An acceleration in economic growth, significant reduction in Poland's external imbalances and expected increase in interest rate disparity between Poland and the euro zone would, in our view, permit a moderate appreciation of the zloty in the coming quarters. Still, the scale of the move should be limited by the impact of QE3 tapering in the US, as mentioned earlier.
- We forecast EUR/PLN moving towards 4.00 (or slightly below) at the end of 2014. The zloty's appreciation against the dollar may be even stronger, given that we expect EUR/USD to approach 1.40 (see next slide).
- Importantly, the scale of currency strengthening should not be such that it curbs the competitiveness of Polish exports. According to a recent NBP survey, the average EUR/PLN breakeven point that allows Polish exporters to remain profitable stood at ca. 3.90 in 3Q13.
- The expected trends in the FX market should also have a limited impact on inflation. Firstly, the scale of the currency appreciation should not be that big. Secondly, recent NBP research shows that the pass-through effect from the exchange rate to inflation has decreased quite substantially of late.

EURPLN vs. Polish GDP



Source: GUS, Reuters, BZ WBK

Exchange rate at which exports becomes unprofitable



Source: NBP

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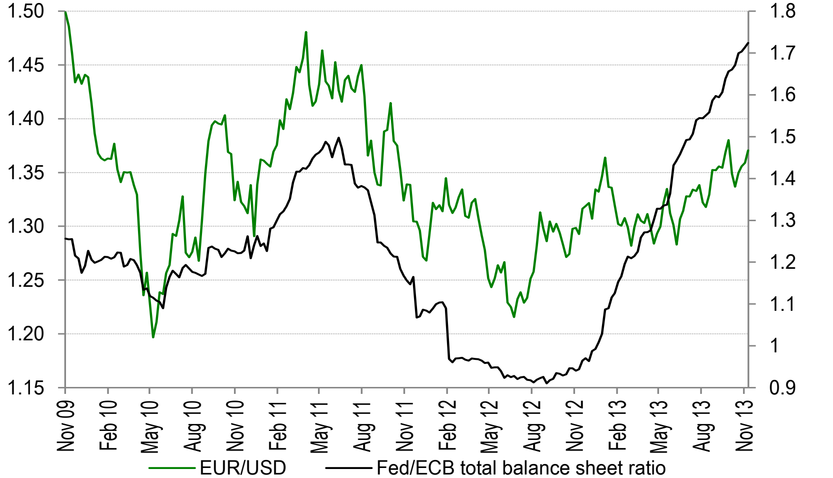
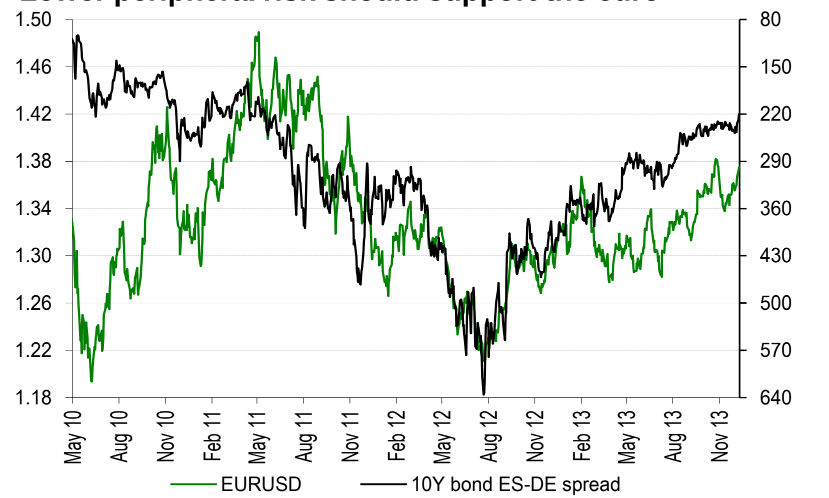
Economic rebound to push EUR/USD higher *

- We expect EUR/USD to move higher over 2014. We think that scaling back QE3 is not necessarily USD supportive. First, the market was basically ready for tapering to begin, and it seems the speed and conditionality of tapering are even more important for investors than the actual date of the announcement. Investors may focus on the fact that this is not tightening, simply that monetary conditions are now less expansive. Indeed, the Fed's balance sheet will keep growing and this makes room for a stronger euro.
- Additionally, euro zone peripheral risk has obviously declined over the last few months. The spread tightening vs. Bunds, accompanied by upgrades of credit ratings or outlooks –and a further improvement on the fiscal front amid an economic rebound– should also support the single currency.
- In the final months of 2013, the single currency was temporarily under pressure from heightened expectations of more easing from the ECB. However, Mario Draghi and other central bank officials tamed those expectations and hinted that the ECB is under no pressure to take additional measures soon. On the other hand, the potential for a more visible EUR/USD rebound may be limited as the ECB still sees the exchange rate as key for inflation and low HICP is now a concern for the Bank.
- Santander expects EUR/USD to be close to 1.40 at the end of 2014. A gradual increase in this exchange rate should support the zloty vs. the dollar. We forecast USD/PLN below 2.90 at end-2014.

Relative Fed/EBC balance sheet favours higher EUR/USD



Lower peripheral risk should support the euro



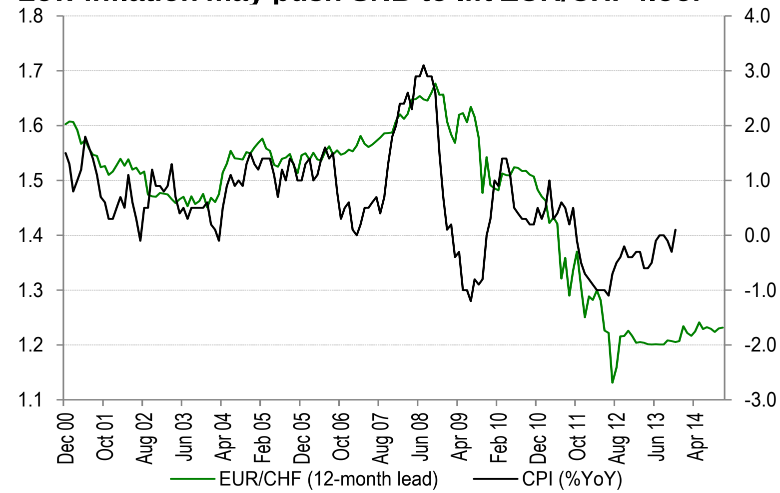
Source: Reuters, Bloomberg, BZ WBK

(*) Based on the Santander Global FX Strategy publication FX Compass, published on 12 December 2013

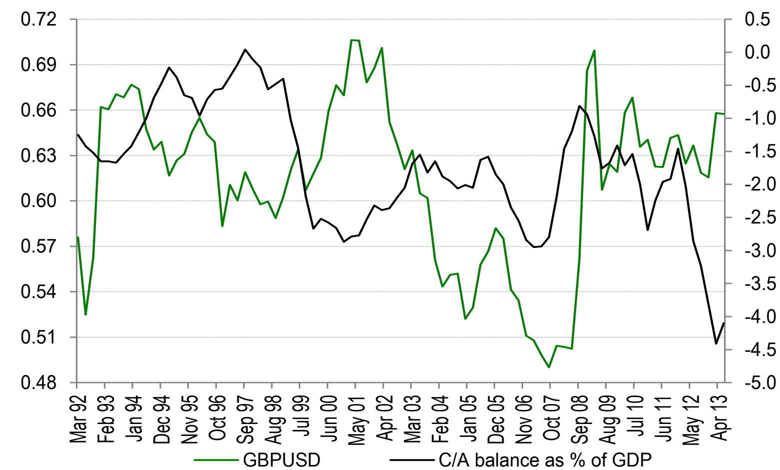
GBP stronger, CHF weaker in 2014? *

- The euro should appreciate versus the Swiss franc in 2014. If the global economic rebound proceeds in line with Santander expectations, the demand for safe-haven assets could decline and weigh on the franc.
- Also, the SNB still sees the franc as overvalued. SNB forecasts show that 12M CPI should stay below its ‘below 2%’ target in the medium term. The EUR/CHF floor is expected to stay at least at the current 1.20 level throughout 2014. But persistently low inflation may encourage the SNB to lift this floor, and Santander sees EUR/CHF at close to 1.30 at end-2014.
- Higher EUR/CHF should push the zloty stronger vs. the franc. We expect CHF/PLN to reach close to 3.10 at the end of 2014.
- Sterling gained quite significantly in 2H13 vs. both the dollar and the euro. This move was partly driven by surprisingly strong UK macro data that supported expectations that the BoE may start hiking rates already in late 2015.
- However, the unemployment rate remains above 7% and C/A as a % of GDP is clearly less than impressive (see chart), at only -2% for the US and +2% for the euro zone. This makes us think that the GBP has to give up some gains first, before it continues to appreciate during 2014.
- We expect GBP/PLN to decline to 4.81 in 3Q14 and then to rebound to ca. 4.88 at the end of 2014 as the pound is expected to regain strength versus the euro and the dollar.

Low inflation may push SNB to lift EUR/CHF floor



C/A deficit may constrain further GBP gains in the short term



Source: Bloomberg, BZ WBK

(*) Based on the Santander Global FX Strategy publication FX Compass, published on 12 December 2013

Macroeconomic Forecasts

Poland		2011	2012	2013	2014	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14
GDP	PLNbn	1,523.2	1,595.2	1,632.7	1,703.4	377.9	395.7	404.3	454.8	392.1	413.0	421.9	476.5
GDP	%YoY	4.5	1.9	1.5	3.1	0.5	0.8	1.9	2.6	2.7	3.1	3.2	3.3
Domestic demand	%YoY	3.6	-0.2	-0.3	2.2	-0.9	-1.7	0.5	0.7	1.0	1.9	2.3	3.4
Private consumption	%YoY	2.6	0.8	0.6	1.8	0.0	0.2	1.0	1.3	1.5	1.7	2.0	2.2
Fixed investments	%YoY	8.5	-0.8	-0.5	3.7	-2.1	-3.2	0.6	1.0	1.0	2.0	3.0	6.0
Unemployment rate [a]	%	12.5	13.4	13.5	12.7	14.3	13.2	13.0	13.5	13.8	13.0	12.5	12.7
Current account balance	EURmn	-18,519	-14,191	-5,270	-1,382	-2,313	362	-2,306	-1,013	-203	956	-1,116	-1,019
Current account balance	% GDP	-5.0	-3.7	-1.4	-0.3	-3.1	-2.3	-2.0	-1.4	-0.8	-0.6	-0.3	-0.3
General government balance	% GDP	-5.0	-3.9	-4.4	4.4*	-	-	-	-	-	-	-	-
CPI	%YoY	4.3	3.7	0.9	1.5	1.3	0.5	1.1	0.8	1.1	1.5	1.3	2.0
CPI [a]	%YoY	4.6	2.4	0.8	2.1	1.0	0.2	1.0	0.8	1.2	1.7	1.5	2.1
CPI excluding food and energy prices	%YoY	2.4	2.2	1.2	1.8	1.2	1.0	1.4	1.3	1.7	1.8	1.6	2.0

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

[a] at the end of the period

* surplus due to one-off changes in the pension system

Rates and FX Forecasts

Poland		2011	2012	2013	2014	1Q13	2Q13	3Q13	4Q13	1Q14	2Q14	3Q14	4Q14
Reference rate [a]	%	4.50	4.25	2.50	3.00	3.25	2.75	2.50	2.50	2.50	2.50	2.75	3.00
WIBOR 3M	%	4.54	4.91	3.02	2.86	3.77	2.96	2.70	2.66	2.65	2.72	2.92	3.17
Yield on 2-year T-bonds	%	4.81	4.30	2.97	3.22	3.29	2.77	2.98	2.85	2.88	3.07	3.35	3.58
Yield on 5-year T-bonds	%	5.44	4.53	3.47	3.88	3.49	3.09	3.63	3.65	3.73	3.82	3.95	4.03
Yield on 10-year T-bonds	%	5.98	5.02	4.04	4.67	3.95	3.58	4.26	4.39	4.57	4.60	4.70	4.82
2-year IRS	%	4.98	4.52	3.11	3.42	3.43	2.81	3.14	3.05	3.05	3.25	3.58	3.80
5-year IRS	%	5.24	4.47	3.51	4.00	3.52	3.08	3.76	3.69	3.78	3.90	4.08	4.22
10-year IRS	%	5.33	4.56	3.86	4.48	3.76	3.41	4.13	4.15	4.32	4.38	4.53	4.70
EUR/PLN	PLN	4.12	4.19	4.20	4.06	4.16	4.20	4.25	4.19	4.14	4.08	4.04	3.99
USD/PLN	PLN	2.96	3.26	3.16	2.96	3.15	3.22	3.21	3.08	3.04	3.00	2.95	2.87
CHF/PLN	PLN	3.34	3.47	3.41	3.23	3.38	3.41	3.44	3.40	3.32	3.26	3.21	3.11
GBP/PLN	PLN	4.75	5.16	4.94	4.85	4.88	4.94	4.97	4.98	4.90	4.83	4.84	4.84

Source: CSO, NBP, Finance Ministry, BZ WBK own estimates   [a] at the end of the period

This analysis is based on information available at 19 December 2013 and has been prepared by:

ECONOMIC ANALYSIS DEPARTMENT
ul. Marszalkowska 142, 00-061 Warszawa, Polska
Email: ekonomia@bzwbk.pl Economic Service Web site: http://skarb.bzwbk.pl/

Maciej Reluga* – Chief Economist
tel. +48 22 534 18 88. Email: maciej.reluga@bzwbk.pl

Piotr Bielski*	+48 22 534 18 87
Agnieszka Decewicz*	+48 22 534 18 86
Marcin Luziński*	+48 22 534 18 85
Marcin Sulewski*	+48 22 534 18 84

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DIRECTIONAL RECOMMENDATIONS IN BONDS		DIRECTIONAL RECOMMENDATIONS IN SWAPS	
	Definition		**Definition**
Long / Buy	Buy the bond for an expected average return of at least 10bp in 3 months (decline in the yield rate), assuming a directional risk.	**Long / Receive fixed rate**	Enter a swap receiving the fixed rate for an expected average return of at least 10bp in 3 months (decline in the swap rate), assuming a directional risk.
Short / Sell	Sell the bond for an expected average return of at least 10bp in 3 months (increase in the yield rate), assuming a directional risk.	**Short / Pay fixed rate**	Enter a swap paying the fixed rate for an expected average return of at least 10bp in 3 months (increase in the swap rate), assuming a directional risk.

RELATIVE VALUE RECOMMENDATIONS	
	Definition
Long a spread / Play steepeners	Enter a long position in a given instrument vs a short position in another instrument (with a longer maturity for steepeners) for an expected average return of at least 5bp in 3 months (increase in the spread between both rates).
Short a spread / Play flatteners	Enter a long position in given an instrument vs a short position in other instrument (with a shorter maturity for flatteners) for an expected average return of at least 5bp in 3 months (decline in the spread between both rates).

FX RECOMMENDATIONS	
	Definition
Long / Buy	Appreciation of a given currency with an expected return of at least 5% in 3 months.
Short / Sell	Depreciation of a given currency with an expected return of at least 5% in 3 months.

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