MACROscope

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Multidimensional puzzle

Poland: Economic Outlook

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Złoty Bank
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POLAND

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Executive summary (macro)

Uncertainty remains the key theme, both locally and externally. The global monetary easing cycle is in progress and the discussion about a coordinated fiscal stimulus broadens, and yet it remains uncertain how quickly it is going to heal the economic growth outlook. So far, the malaise in international trade and manufacturing continues, with an increasing risk of spillover to labour markets and services. As we have argued before, the more prolonged the stagnation in Europe, the greater potential threat for Polish economy, despite our relative resilience and the government's fiscal package serving as a cushion against external shocks. **The latest high-frequency data suggest that Polish GDP growth slowed to c.4% y/y in the third quarter, which still allows us to keep our GDP forecast at 4.3% for the entire 2019 and at 3.5% for 2020**. However, the risks are mounting.

External risks are one thing, but local factors are also getting increasingly challenging. The already elevated labour cost dynamics (the key obstacle for doing business, according to Polish firms) will be additionally boosted by the introduction of PPK and elimination of 30x social security contribution threshold. And now the ruling party added one extra hurdle: a nearly 16% surge in the minimum wage in 2020, a first step in a bolder move until 2024. Energy tariffs are likely to spike as well, after their freeze in 2019. We think that all those factors will have bigger impact on inflation than on economic activity, and thus **our CPI forecast at above 4% in January and 3.5% on average in 2020**.

However, opinions on that matter vary. The Monetary Policy Council, for example, remains unconvinced about significant threats to medium-term inflation outlook and instead seems to be increasingly worried about economic growth prospects. Yet, it looks like the views within the panel are getting more polarised, as in Q3 both rate hike and rate cut proposals were voted. It will be interesting to see the next NBP projections, to be released in November. However, we still think that neither of the extreme factions are likely to get majority in the coming quarters and so the **main interest rates will remain on hold at least until the end of 2020**. In late December 2019 Jerzy Osiatyński ends his term of office and will be replaced by the President's nominee, but at this stage it is too early to say if it will change the balance of votes significantly.

On the fiscal front the situation still looks secure enough, as this year's budget performance suggests that the deficit may be again lower than planned, despite payment of 13th pension, extension of 500+ subsidy and lowering PIT rates. For 2020 the government assumed zero deficit for the first time ever. Still, the rating agencies Fitch and Moody's see the structural fiscal gap rising substantially in 2020. In fact it is not completely clear, if the government really wants to achieve the balanced budget, as there were already signals (also from PiS senior officials) suggesting that budget will be amended after the elections. In any case, we think that unless the economy slows much more than we currently anticipate, the size of the deficit should stay low enough to keep investors sleep well at night.

On October 13th Poland will hold the general elections. **Taking into account recent opinion polls it seems very likely that the ruling Law and Justice will win enough votes to secure outright majority in the parliament** and continue governing the country for another four years. From the market point of view, this should be a fairly neutral outcome.

Executive summary (markets)

FX

We decided to pull up our year-end EUR/PLN forecast and flattened path for 2020 at 4.30 mainly accounting for the prolonging growth uncertainty, as well as unclear consequences of the upcoming verdict of the European Court of Justice. It is hard to know exactly what will be the market behaviour around the ECJ ruling but we think that assuming sharp and persistent zloty depreciation is not a good idea. While the PLN may still depreciate, the selloff should not be long-lived. The scale of upward EUR/PLN move will be limited by the demand from exporters (some have been waiting for higher levels for a while), possibility of government/BGK intervention and profit taking by investors.

FI

The global backdrop for fixed income markets remains favourable with the main central banks (PBoC, ECB, Fed) having delivered on easing in September. Global growth slowdown seems to be stronger and longer lasting than initially thought. Local Polish factors support fixed income as well with softer economic data, dovish MPC and decent budget performance. We expect global markets volatility to increase which, together with local events (especially ECJ ruling on October 3rd) should command a slightly higher risk premium for holding Polish assets – 10Y up to 2.15% by year-end, wider spread vs Bund. Whereas 2Y anchored at 1.50%

Markets have to a large extent digested the negative impact from the US-CN trade dispute hence core markets yields remain vulnerable (to a spike) to any positive news and might pose additional risk for Polish assets.

Global market volatility to increase as a function of geopolitics, macroeconomic divergence as new supply chains emerge and slightly less potent (on the margin) monetary policy versus diversified local factors.

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.	After better-than-expected start of the year, the recent data show increasing spillover from European slowdown to Polish industry. The government's fiscal package provides a cushion, but will not prevent economy from slowing further.
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 growth likely to get a new boost in 2H19-1H20 from the fiscal transfers. Investments will slow gradually, as a surge in private spending will not fully offset lower momentum in public investments. Net exports likely to deteriorate amid weakening exports and robust imports.
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 seemed to ease slightly, amid firms' restructuring and automation. Wage growth has stabilised, but remains elevated. Surge in minimum wage will add to the pressure, especially on micro and small companies, while bigger ones will suffer costs of PPK and elimination of 30x ZUS threshold.
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 exceeded expectations in 1H19 not only due to high food prices but also fuelled by long-awaited rebound in core inflation. The cost-driven inflation rise will continue, in our view, pushing CPI to c.3.5% by year-end and above 4% at the start of 2020.
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 and weakening growth outlook means that the Polish MPC will overlook increase of domestic inflation, even if it exceeds expectations. Rates likely to remain stable in 2019-2020, although both rate cuts and rate hikes will be under discussion at the forthcoming meetings.
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.	Despite generous boost of social transfers, total budget spending remains restrained. Government's plan to achieve zero budget deficit in 2020 may be too ambitious but markets have no reasons to worry about fiscal stability for now.
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.	Following the massive bond markets rally over the summer, we think yields may go up a bit, in reaction to higher sovereign risk premium (slowing, growth, ECJ ruling) and higher global volatility.
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.	EUR/PLN forecast higher due to prolonging growth uncertainty, uncertainty regarding ECJ verdict and continued dollar strengthening vs euro.

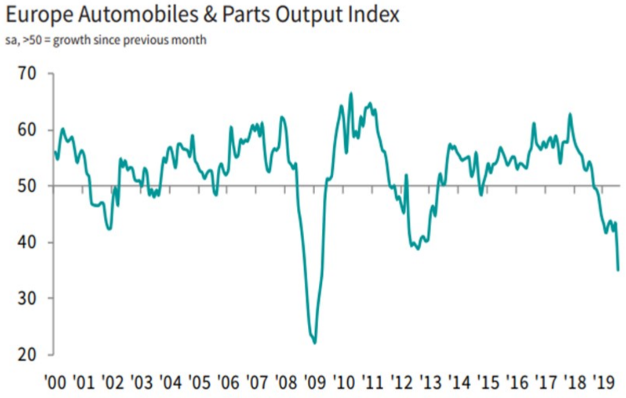
External environment: bad news keep coming

It looks like the market panic about the looming global recession has eased somehow after the summer holidays, following the main central banks' tilt towards more accommodative policies. However, the data coming from the world's major economies are still far from optimistic. Since the early months of this year we've been looking for a convincing evidence that the end of the global economic slowdown is round the corner but it seems that it is still hard to find one.

The news from the euro zone are particularly worrying, with slump in manufacturing still deepening (led by Germany and by the automotive sector). But the downturn in trade, manufacturing and investment is much more widespread, which is reflected by data from Asia, among others. What was keeping global economy afloat so far was the resilience of services. But the question is how long it may last, as even in this area negative signals emerged recently. Labour markets in Europe are also showing signs of cooling down, which may negatively affect consumers' spending pattern in the coming months.

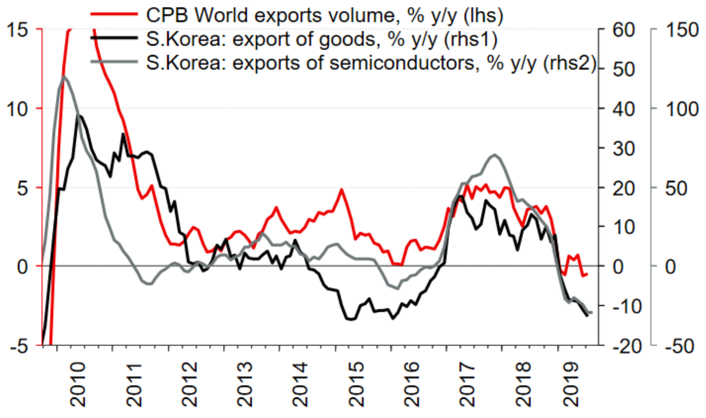
The key factor dimming the global growth outlook by constraining international trade and investment is still the high uncertainty, resulting from a number of economic and geopolitical risk factors. These include primarily the trade tensions (not only US-China row, but also potential US tariffs on European cars), the risk of conflict(s) in the Middle East, the looming Brexit, and the political instability in some areas (most recently, the launch of US President's impeachment procedure).

Slump in European automotive sector deepens



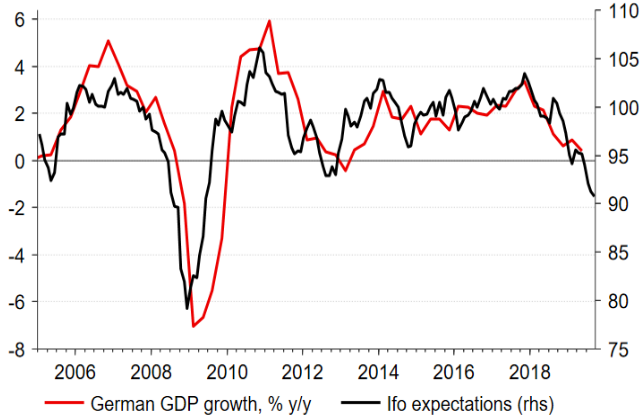
Source: IHS Markit

World trade in contraction



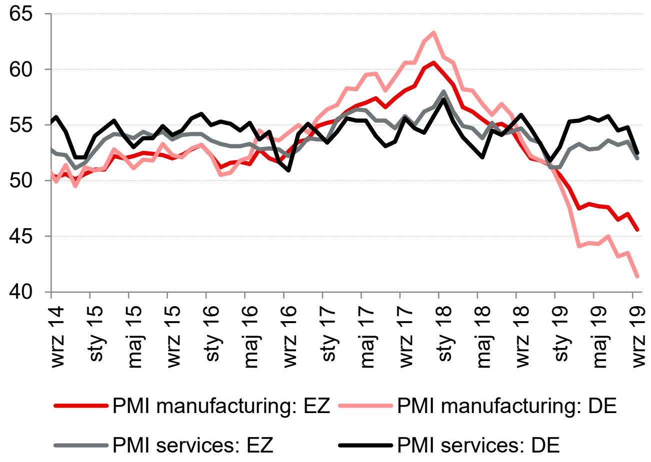
Source: Refinitiv Datastream, Santander

Germany heading towards recession?



Source: Refinitiv Datastream, Santander

European industrial slump affecting services?



Source: IHS Markit, Santander

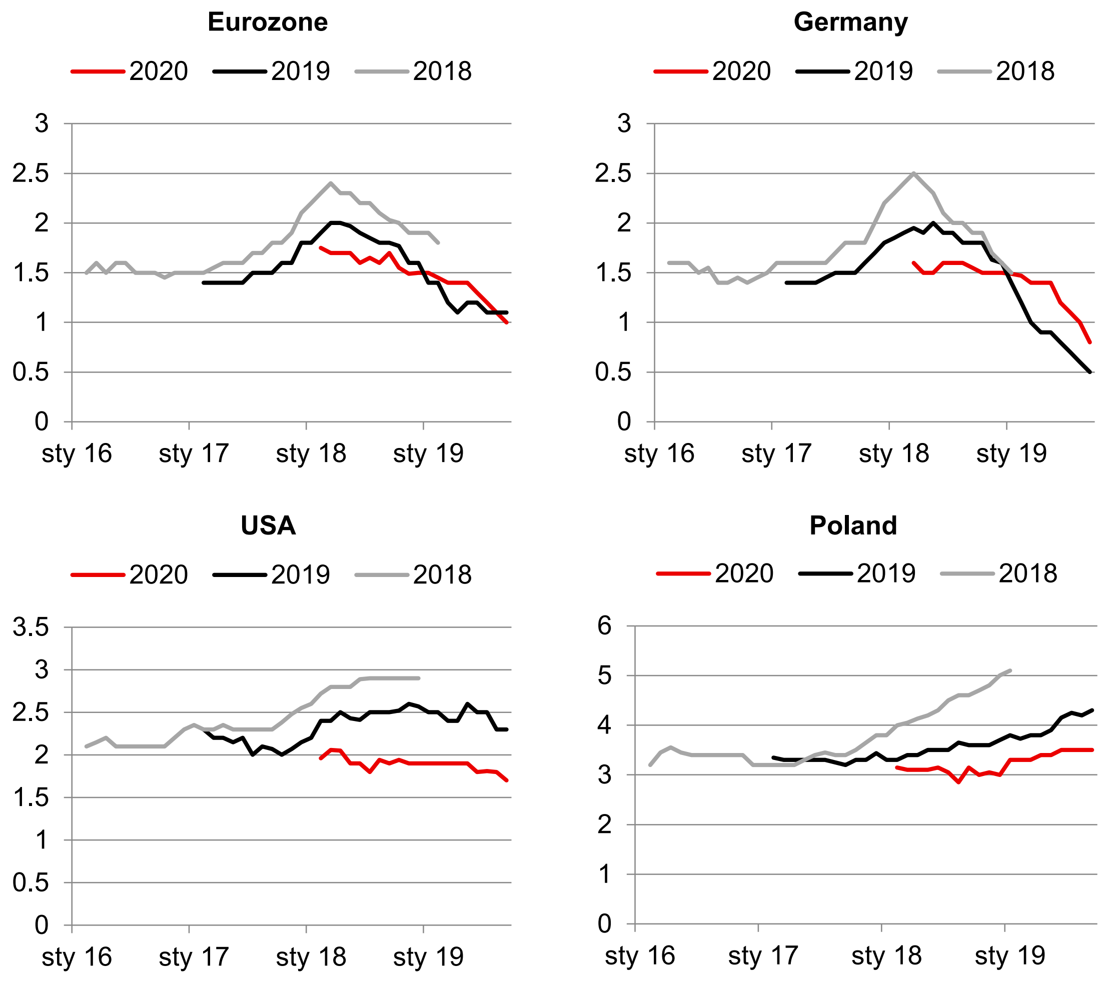
GDP forecasts falling… not yet in Poland

Recently the OECD and the ECB have trimmed their economic growth forecasts quite substantially and as a result they no longer expect that the next year will see a rebound of economic activity in the euro zone as compared to 2019. The IMF is likely to follow suit when it releases its economic forecasts update in October. The market consensus is moving gradually in the very same direction.

It remains to be seen whether the global monetary easing cycle started recently will be enough to halt this trend. It seems the ECB clearly sees the limits of its own policies' effectiveness, and this is why Mario Draghi has called repeatedly for more accommodative and more supportive fiscal policies in Europe. Whether such fiscal stimulus really comes, in what size and when, still remains an open question.

GDP growth consensus forecasts for Poland were in the upward trend earlier this year but have stabilised recently, as the most recent data show growing evidence that negative external shocks started spilling over to Polish manufacturing and trade. The government's pre-election fiscal package will serve as a cushion against this backdrop, at least in the next few quarters. But if negative trends in Europe continue, the outlook for Poland will start deteriorating, no question about it. For now, we keep our GDP forecasts for 2019-2020 unchanged (at 4.3% and 3.5% respectively), as they are reasonably cautious, in our view. However, the risk for the next year is gradually mounting and developments in global economy should be monitored closely.

Evolution of GDP growth consensus forecasts according to Bloomberg



Source: Bloomberg, Santander

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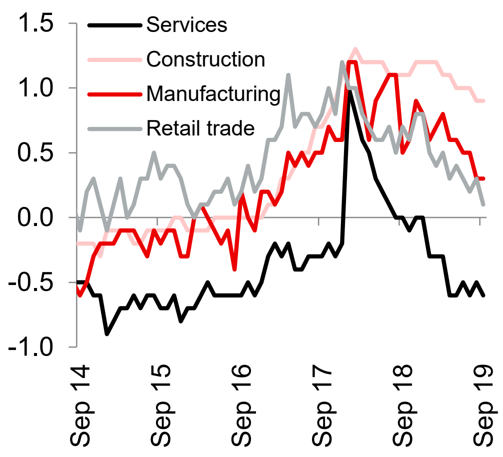
Polish soft indicators getting even softer

Indicators of business sentiment keep declining across all sectors. Businesses report weaker demand, expected activity, employment demand, more difficult financial situation.

We are particularly worried about signals from the transport sector, where business sentiment stabilised in 2Q only to collapse again in 3Q. This suggests further reduction of economic activity ahead.

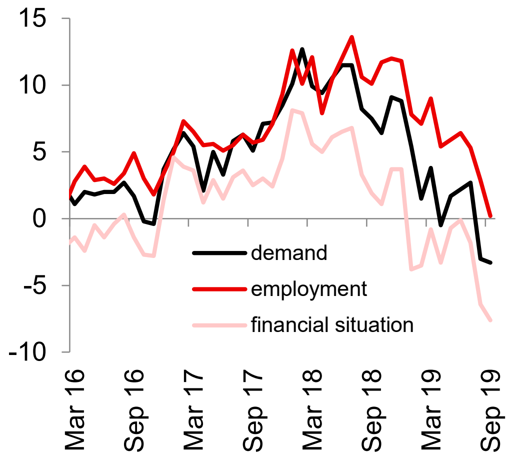
From a longer-term perspective, Polish business climate does not deviate much from the German one and copies its trend, at times with some delay. With Germany growing in pessimism, we do not think Polish manufacturing could escape a similar negative trend.

Sectoral confidence indicators



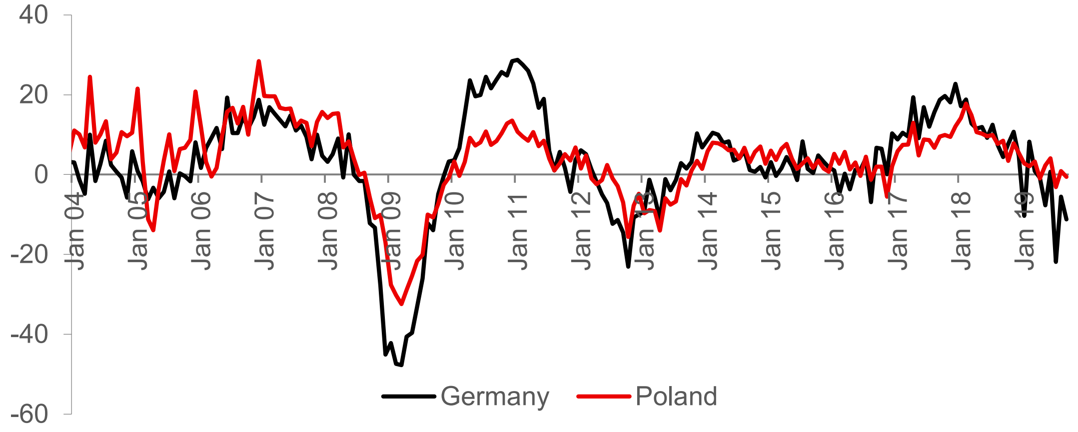
Source: GUS, Santander

Expectations of the transport sector



Source: GUS, Santander

ESI, industrial new orders indicators



Source: European Commission, Santander

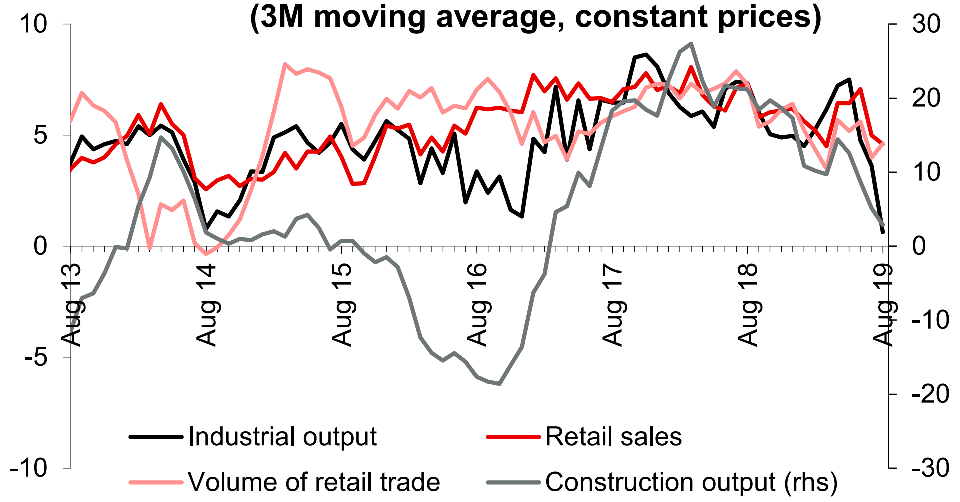
Growing signs of weakness

Growing pessimism corresponds to declining growth of real economic activity. Industrial output growth surprised positively in all months of 1Q, but in June and August it came well below expectations – to the tune of unexpectedly turning negative y/y. The August seasonally adjusted production growth was the weakest in three years.

Given the correlation with output, this leaves little hope that exports will remain resilient, even if July figure beat expectations. A simultaneous deceleration in new orders makes us feel that weak 3Q output growth is not about one-offs.

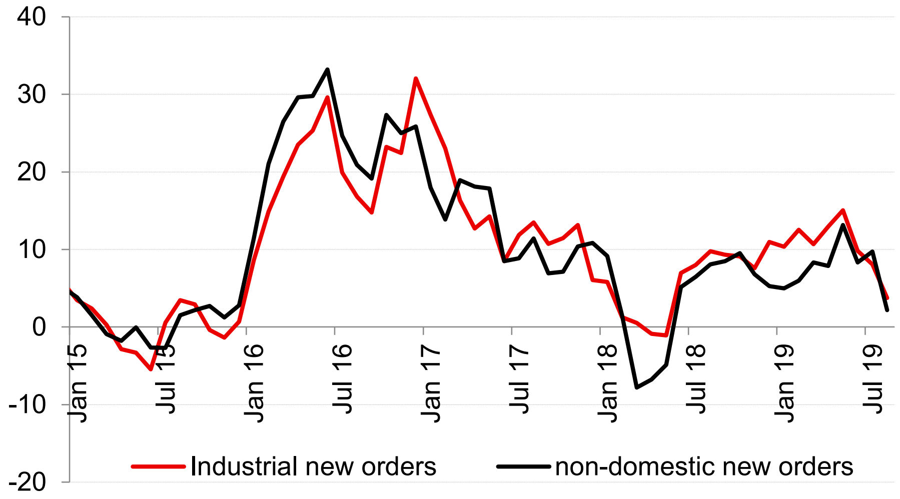
Construction output lost momentum as well due to EU funds cycle and declining new contracts. Retail sales are still growing, but less than in 2018.

Output and sales growth, %y/y (3M moving average, constant prices)



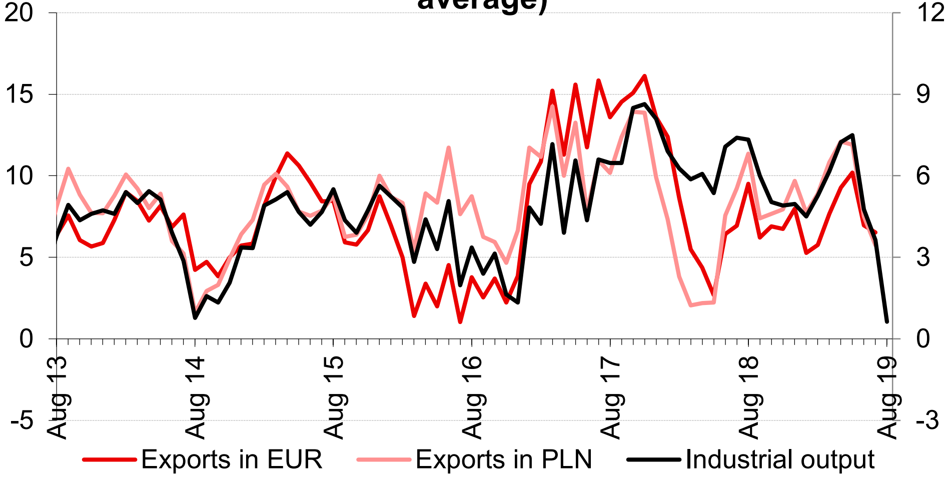
Source: GUS, Santander

Value of industrial new orders, %y/y (3M moving average)



Source: GUS, Santander

Industrial output vs. exports, %y/y (3M moving average)



Source: GUS, NBP, Santander

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Export growth: losing ground

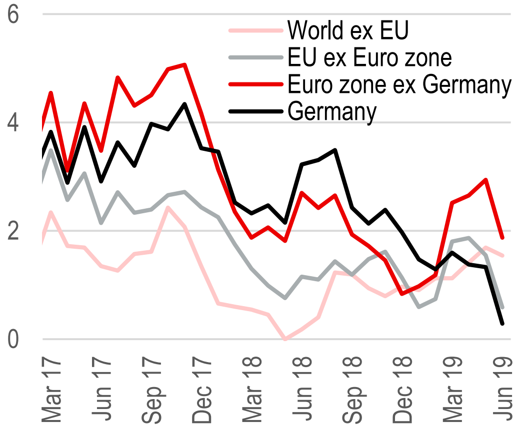
Polish export growth is still positive albeit losing momentum. With 80% of demand coming from the EU, and 28% from Germany in particular, it is next to impossible for Polish exporters to be immune European slowdown. A quarter ago we saw that the shrinking demand from Germany was offset by stronger trade with other European countries. Now, exports to Germany remains poor while the offsetting factor is fading as the European economy keeps slowing down. This points to further decline of Polish exports.

One of the partners contributing strongly to Polish export growth in 1Q was the UK. We argued in the previous quarterly report this could be temporary and related to stockpiling ahead of the initially scheduled Brexit date, and indeed in 2Q the UK received 4% y/y less Polish goods vs +13% in 1Q.

The part of exports that still looks solid is the contribution from non-EU countries like the USA, China or Belarus, which however have insufficient weight in Poland's structure of exports to protect Polish exporters from the consequences of weaker EU.

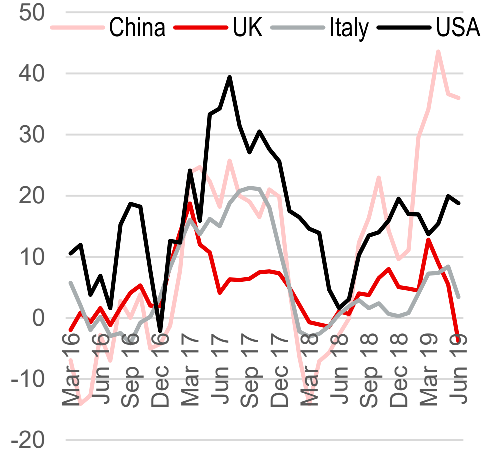
The substitution effect we mentioned in previous editions of MACROscope to explain the resilience of Polish exports is still working. It is still the case that Poland is able to grab a larger share of European consumer goods markets in an economic downturn, but, at the same time, as the EU's underperformance continues the Europeans are losing appetite for major purchases. Even if Polish intermediate goods are increasing their presence on European markets, the deterioration of global growth outlook is pushing EU businesses towards lower output, which translates to lower demand for input. This is why there is neither a collapse in Polish exports nor a total resilience to what happens in the EU economy.

Exports growth contributions by regions, % y/y



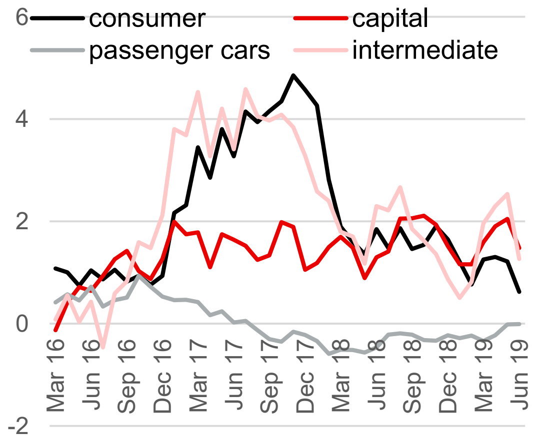
Source: Eurostat, Santander

Exports growth, selected countries, % y/y



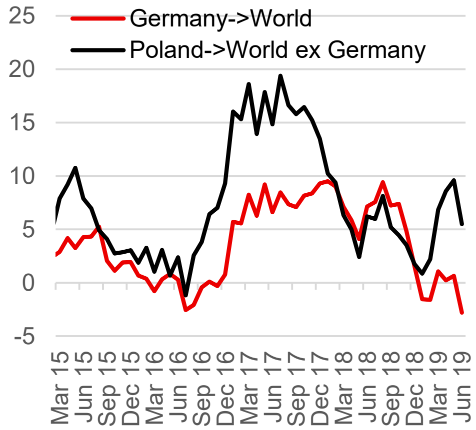
Source: GUS, Santander

Exports growth contributions by type of goods, %y/y



Source: Eurostat, Santander

Export of intermediate goods, Poland vs Germany, %y/y



Source: Eurostat, Santander

Investments still strong, but slowing

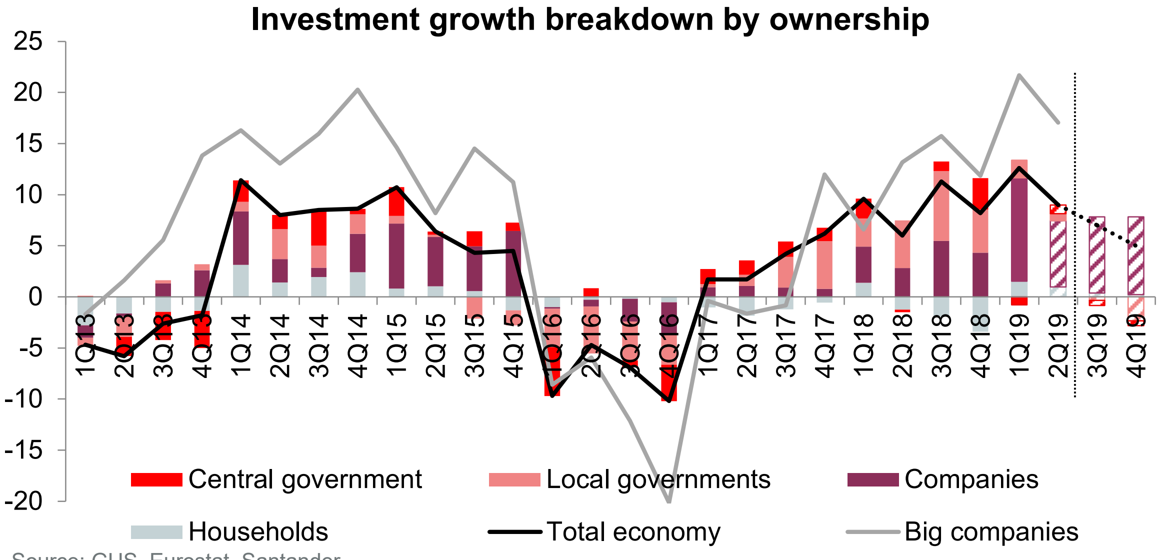
In 1Q19 investment accelerated to 12.6% y/y and grew at the fastest pace since 1Q15. 2Q19 still saw a strong performance, yet a bit slower: 9.0% y/y. In our view the investment growth will be slowing down in the quarters to come, to 5% y/y in 4Q19.

In the first half of 2019 the public investment has virtually stopped, both in local governments and the central sector. In our view this was a result of three factors: 1) negative statistical base effects after reaching the peak in EU funds utilisation, 2) local governments election in late 2018, also creating high base and encouraging to accelerate some projects 3) government's focus on lavish social spending. We are expecting these tendencies to stay in place.

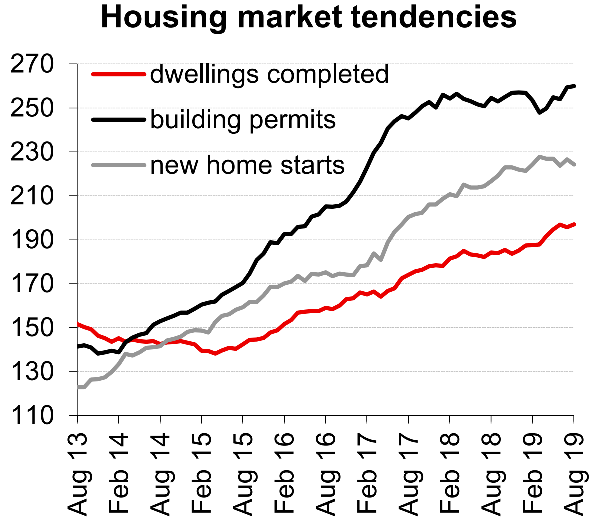
Private investment on the other hand, revived markedly at the start of 2019. However, the recovery was not broad-based: in companies employing 50+ only 9 out of 22 main manufacturing subsectors recorded an acceleration. The acceleration of total investment outlays was actually fuelled only by a few economic sectors: utilities, electrical appliances, administrative activities, land transport, manufacturing of cars and coke. This concentration raises doubts about the persistence of this rebound. In our view, 2H19 will continue to be strong as there are ongoing investment projects, but later the effects of negative global sentiments could undermine investment plans in companies.

Strong hike of minimum wage is in our view likely to encourage some companies to mull more automation investment in 2020.

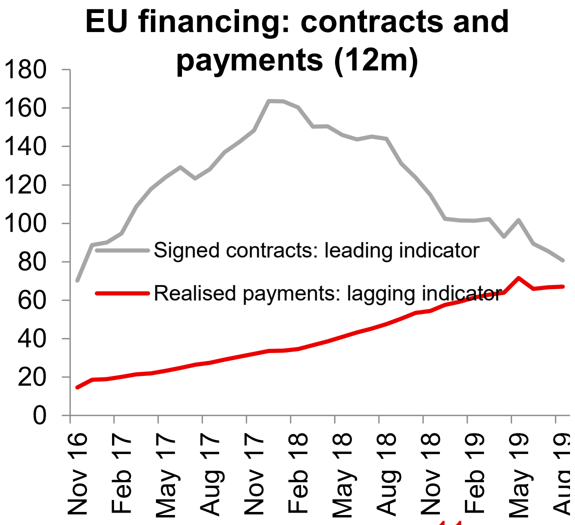
Investments of households (mostly dwellings) are likely to continue to grow, given that tendencies of the housing market are still strong, with building permits and new home starts near all-time peaks.



Source: GUS, Eurostat, Santander



Source: GUS, Eurostat, Santander



Source: Ministry of Development, Santander

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Consumption poised to remain strong

Despite deterioration in business climate indicators, the consumer confidence still runs close to all-time highs. And this seems to be justified by wages rising by about 7% y/y, unemployment at all-time low and the government launching new social transfers, boosting disposable incomes by PLN22bn in 2019 (i.e. by 1.7%) and by further PLN20bn in 2020 (by further 1.6%), provided that the 13. pension is to be paid again, as this was pledged by both the ruling party and the biggest opposition party, so seems quite sure. On top of that, the minimum wage was set to rise by over 15% y/y.

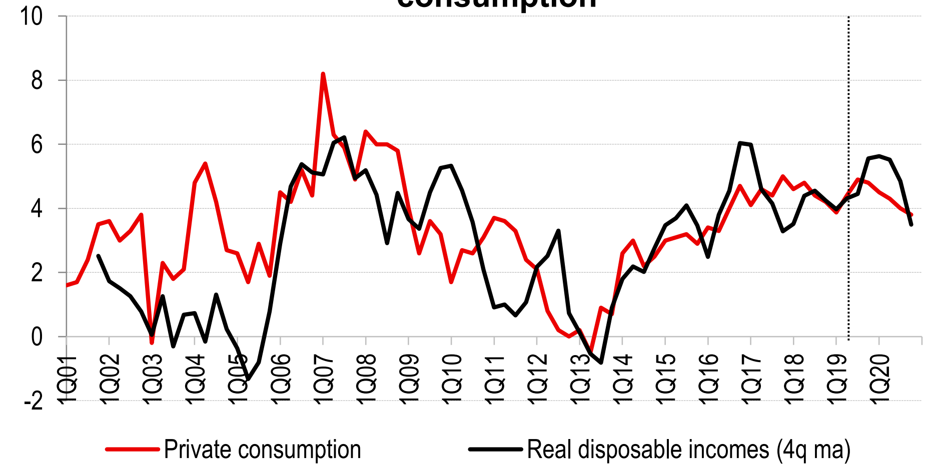
Given such circumstances, the private consumption is poised to remain strong or even accelerate at the turn of 2019/20. The downward risks for consumption seem limited at the moment. The major one is rising inflation, undermining households' purchasing power. But even taking into account our above-consensus CPI forecast (3.5% on average in 2020), our estimates point to an acceleration of real disposable incomes next year.

New social benefits boosting disposable incomes

	2019	2020
500+ child benefits extension	9,600	20,000
13. pension, net	8,600	9,400*
Lower PIT for the young	1,000	2,500
Lower PIT	2,500	9,500
Total	**21,100**	**41,400**

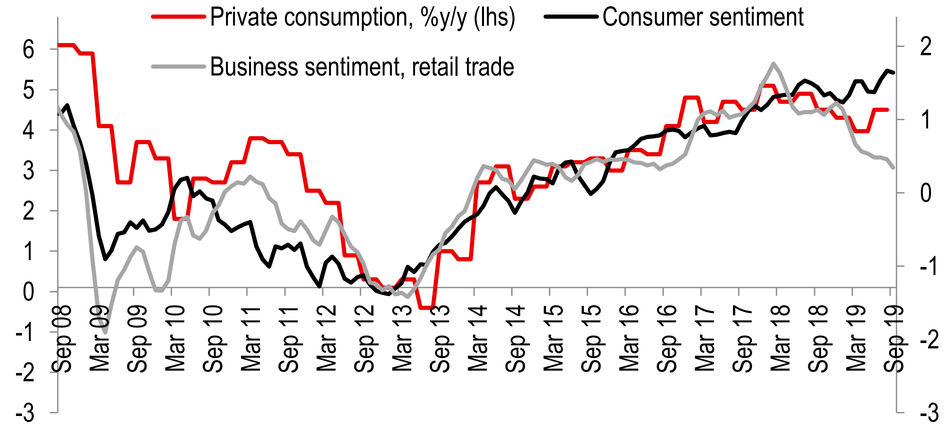
Source: Government, Santander * Not yet enacted

Growth of households' real disposable incomes private consumption



Source: GUS, Santander

Consumer confidence, business sentiment in retail, private consumption



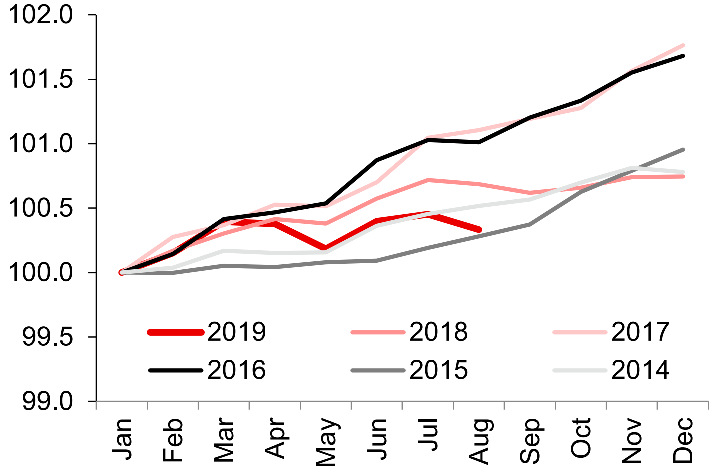
Source: GUS, European Commission, Santander

Labour market: cost awareness

Employment growth keeps slowing gradually. For some time we attributed this mainly to supply issues (labour shortage). Right now it seems the demand is declining too. GUS survey where businesses indicate main obstacles to expansion shows a shift of focus from complaints about lack of staff to labour costs. And labour costs will grow more next year not so much due to further tightening of labour market conditions, but for administrative reasons (PPK, social contribution limit, generous minimum wage hike).

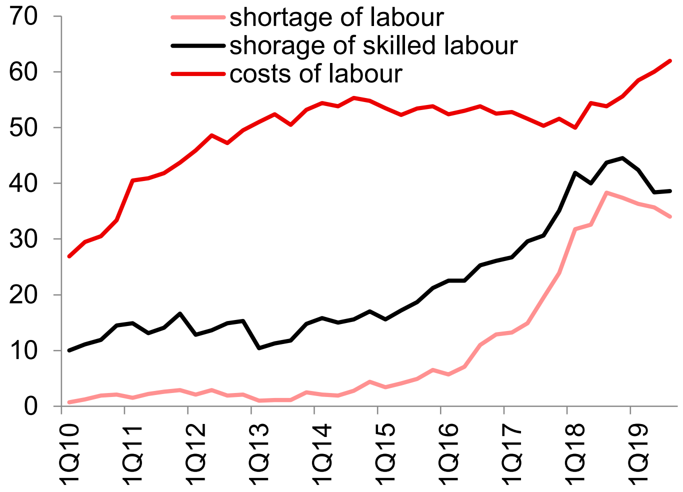
This may explain the turn in GUS statistics on new vacancies and job shedding – businesses are more cautious about hiring new employees and seeking ways to reduce labour intensity and restructuring may also speed up (labour force moving from less to more effective companies as the former collapse under the labour cost burden). Such situation should lead to stronger growth of wages, especially with the rise of CPI that reduces their real value while the labour market remains tight and for arithmetical reasons - with the large minimum wage hike coming.

Corporate sector employment, Jan=100



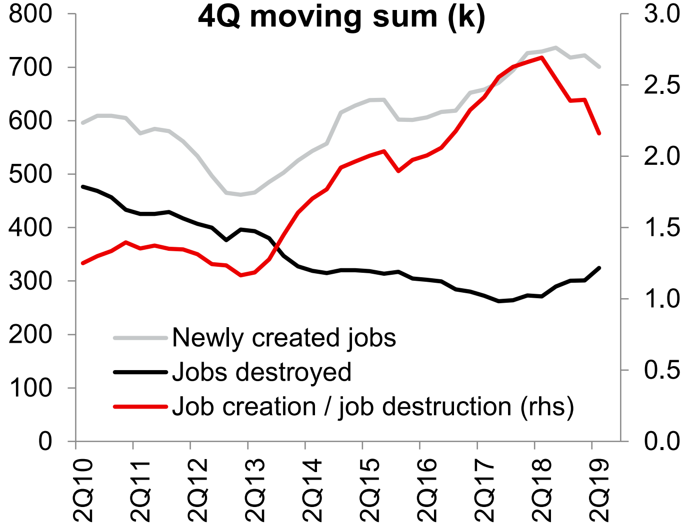
Source: GUS, Santander

ESI, industry, factors limiting production, % of companies indicating the factor



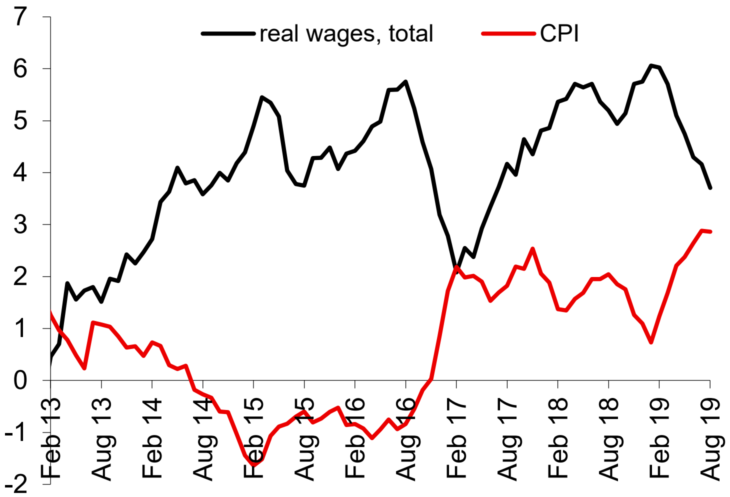
Source: GUS, Santander

Job creation and destruction, 4Q moving sum (k)



Source: GUS, Santander

Real wage growth in the enterprise sector, % y/y, 3M moving average



Source: GUS, Santander

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Minimum wage hike to be reflected in prices

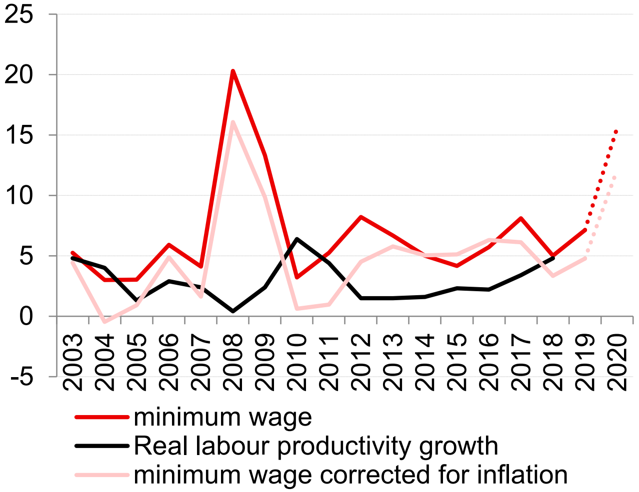
Ahead of October elections the ruling PiS party promised a series of substantial minimum wage hikes, starting with +15.6% in 2020 and by 78% in total by 2024. Academic research does not give a clear answer on net effect on the economy of minimum wage hikes. There is more consensus about risks arising when minimum wage goes above 50% of the average wage (which would happen in 2021 if the proposed hikes are delivered). A rise of minimum wage affects c15% of the employed and with such a strong pace of hikes this share would only grow – replacing in more and more cases the market mechanism of wage formation with an administrative one.

The additional labour cost pressure may be removed: by shifting to clients (inflation), reduction of employment, expansion of grey economy, fall of margins. We believe the adjustment will mostly come via CPI, but the effect will be limited (0.2pp in 2021) – minimum wage is most often used in sectors that are already passing higher costs to clients (services are currently driving inflation higher); the economy is still too strong to allow total employment cuts, but the restructuring process may occur faster due to minimum wage hikes; the government's focus on tax compliance may prevent expansion of the grey economy; we think that companies are unlikely to let their profit margins drop as the worse global outlook leaves little hope that the growing turnover will make up for it.

Risks to Poland's ability to attract FDI also need to be taken into account.

Note that 98% of minimum wage earners are in the private sector and the hike is generally positive for the general government finances (the 2021 hike is to yield a net amount of PLN1.06bn)

Minimum wage vs productivity



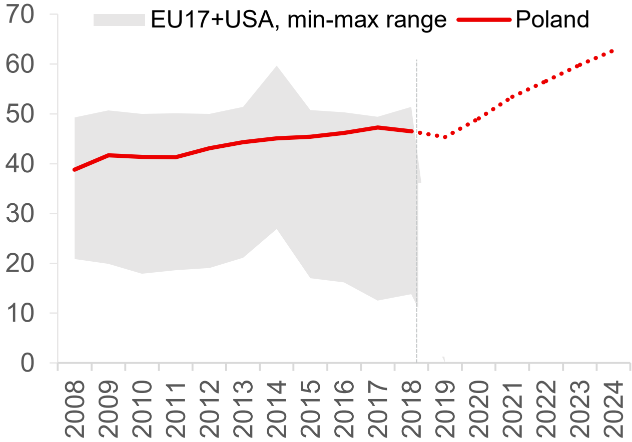
Source: GUS, Santander

PiS proposal of minimum wage hikes

year	Minimum wage, PLN	% rise
2019	2250*	7.1
2020	2600*	15.6
2021	3000	15.4
2022	3333**	11.1
2023	3667**	10.0
2024	4000	9.1

* Already approved; ** Interpolated values
Source: GUS, Santander

Minimum wage as % of average wage



EU17: BG, CZ, DE, EE, IE, ES, FR, HR, LV, LT, LU, HU, MT, NL, PL, PT, RO, SL, SK, UK
Source: Eurostat, Santander

Inflation: further up

In line with our expectations, CPI was climbing and hit 2.9% y/y in July and August. Core inflation excluding food and energy prices rose to 2.2% y/y in these two months. Strong upward momentum was also generated by food prices, especially in meat (due to ASF), fruit and vegetables (draught).

In September CPI growth eased a bit to 2.6% y/y amid lower food and fuel prices (core inflation actually grew despite the decline of headline CPI). But before year-end we expect inflation to climb further, with CPI peak at 4.5% y/y in 1Q20 and core inflation at 3% y/y in 4Q19 or 1Q20. We are expecting average CPI in 2020 at 3.6%.

Upward momentum in CPI will be fuelled by:

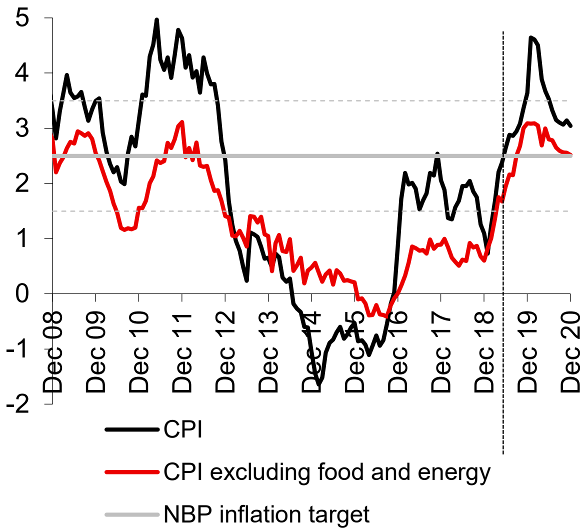
1) Upward tendencies in costs of business: rising labour and social security costs (PPK, abolition of limit on social security contributions),

2) Strong domestic demand, fuelled by social spending: lowering of PIT rates in October 2019, extension of 500+ child benefit in July 2019, bonus pension in May 2019 (and possibly also in 2020, though it was not put in the 2020 budget draft)

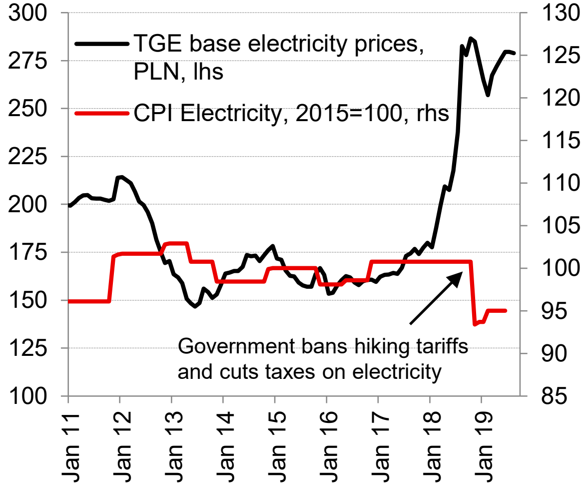
3) Strong hike of minimum wage (we expect it to add 0.2pp to CPI in 2020 on average)

4) Release of energy prices in January 2020 (so far, the government did not assume a further freeze for households). We assumed a rise in energy prices for households by 10%, adding 0.4pp to CPI in 2020 on average.

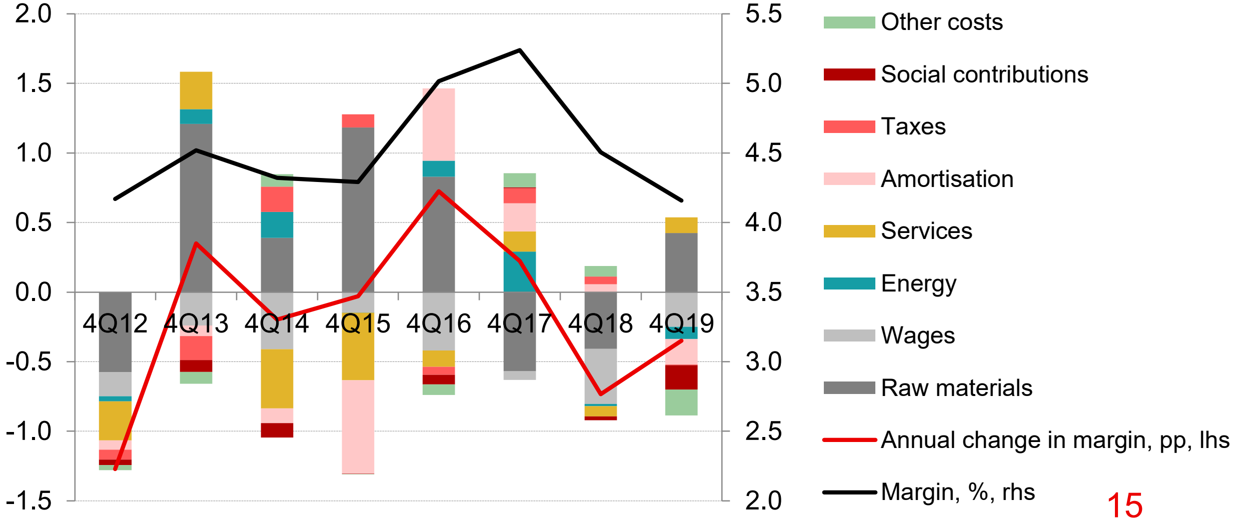
In 2H2020, development of food prices will depend on weather conditions. In case of no anomalies, the high base effect will kick in. But the ongoing climate change suggests, in our view, that the risk for food prices is skewed upwards.



Source: GUS, NBP, Santander



Source: TGE, GUS, Santander



Source: GUS, Eurostat, Santander

Santander

Monetary policy: mulling different options

Monetary policy in Poland became a bit more interesting, as at the two consecutive meetings two opposing motions were voted: interest rate hike in July and rate cut in September. The former was backed by only two members (Gatnar and Zubelewicz) and we think the support for the latter was not greater than that (Łon and possibly Żyżyński). The majority centred around NBP governor Glapiński still supports stable policy, but it seems that the discussions will get more intense in the coming months, as the MPC will have to weigh two worrying tendencies: inflation clearly exceeding the official target (the question is: for how long) and economy showing falling resilience to external economic shocks.

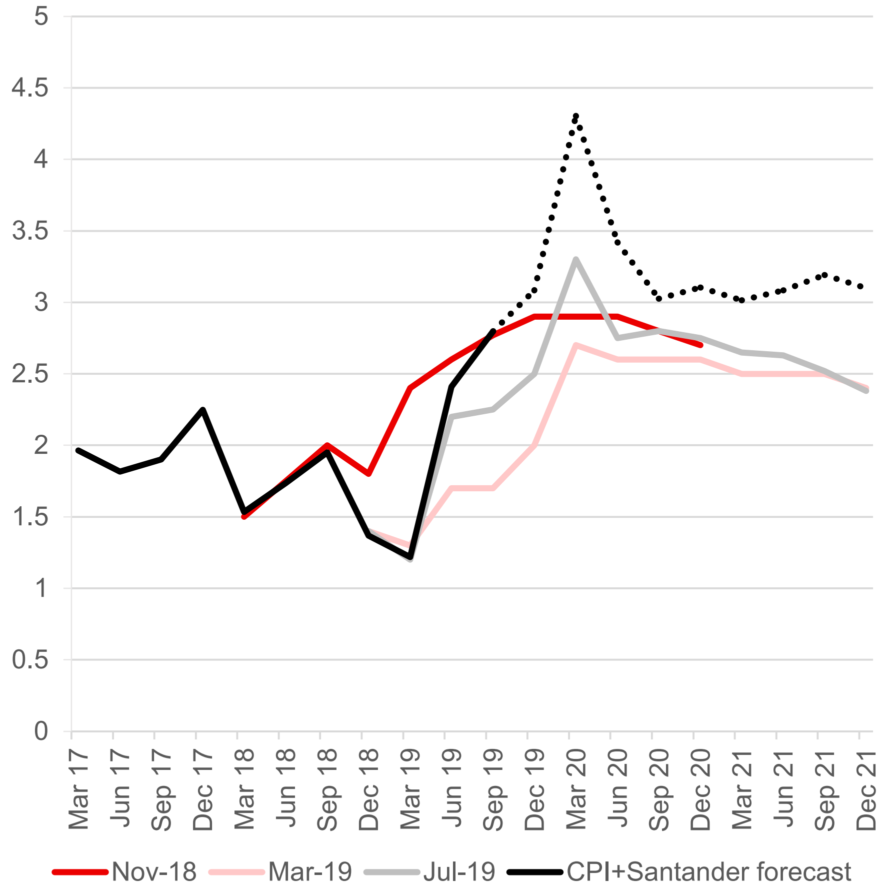
Some MPC members who were against policy tightening in the summer (Hardt, Osiatyński) suggested that they could support rate hikes by the year-end if inflation surge continues. But some others are increasingly worried about worsening growth outlook. As a result, the battle of the opposing factions will continue. Mr Glapiński clearly leans more towards the latter group, as he hinted recently that „the weather is not good for hawks" and stressed that Poland still has the room for rate cuts in case of surprisingly strong economic downturn.

Jerzy Osiatyński's term of office expires on 20 December 2019. His successor will be picked by the President Duda, who earlier appointed Mr. Hardt and Mr. Zubelewicz – two hawkish members of the current MPC. Who will be the successor of Mr. Osiatyński and what it brings to MPC's balance of votes remains an unknown at this stage.

We think the voting on both rate hikes and rate cuts is likely to repeat in the coming months, but the baseline scenario for Poland is still stable interest rates at least until the end of 2020.

The next interesting moment will be November, when the new inflation projection will be released. It is very likely it will show CPI path well above the previous one, at least in the short run. But in the long run projection will probably still converge below 2.5% target. Besides, please be reminded that the MPC has the tendency of downplaying the projection whenever it does not suit its narrative.

NBP inflation projections vs actual CPI & current Santander forecast (% y/y)



Source: NBP, GUS, Santander

Santander

Monetary policy: ornithology revised

Rate hike motions will likely appear in the last months of this year, if prices keep rising in line with the NBP projection. (18/07, PAP)

I think we may reach 3.5% inflation, soon, in Nov-Dec. We will enter next year with inflation above this band. Therefore my motion to hike rates. Obviously **I will not repeat such motions every month**, I would like to wait for other members' support. It may happen in November, with the new NBP projection. (17/09, Reuters)

If there is slowdown in the euro zone, there is no room for rate cuts currently, as it would threaten banking sector stability (23/08, PAP)

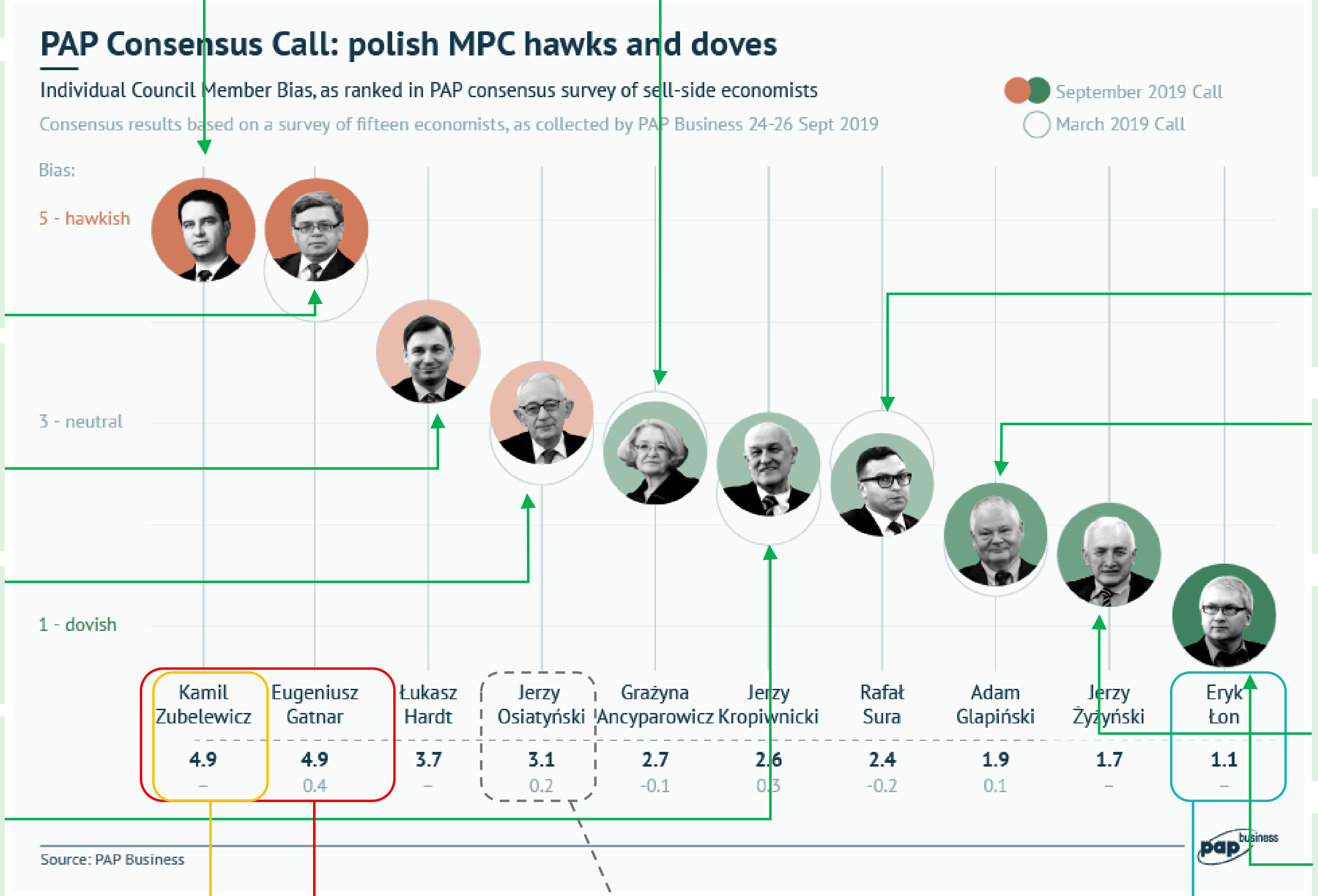
Inflation expectations are key. If they rise, it would be strong argument for hikes. High inflation cannot be ignored and if it goes to 3.5% persistently, **a rate hike should be considered. Even a small hike (15bp) would strengthen central bank credibility**. (19/09, DGP)

I stick to my earlier view that **at the end of this year there may be need to hike rates**. (31/07, PAP)

I do not share calmness of some MPC members. **We have to take into account that inflation will be higher** than in the NBP projection. I have repeated many times that the period of very stable monetary policy may be coming to its end (31/07, PAP)

There are estimates that minimum wage hike will not boost inflation too much. **Global slowdown is not a good time for monetary tightening**. (16/09, Bloomberg)

I currently use wait-and-see approach. But the **balance of risks for interest rates is tilted more towards hikes than cuts**, in my view. I was not present at July's meeting, but I neither saw a need to hike rates then, nor in the nearest future. (4/09, PAP)



Voted for rate hike in July 2019

Voted for rate hike in November 2018

Ends his term of office in December 2019

<u>Probably</u> voted for rate cut in September 2019

Minimum wage hike will not push inflation above 3.5% in 2020. There are no risks for interest rate stabilisation right now. (16/09, Bloomberg)

There is no reason for monetary easing. I think interest rate level is optimal. **I am against monetary tightening**, as many Poles have enormous loans. (21/08, Parkiet TV)

Today there are no reasons to change rates, interest rate stabilisation is the most optimal scenario. Inflation is slightly higher than assumed in NBP projection. But it is not a persistent growth, it is supply-driven. (11/09, MPC conference)

The impact (of minimum wage hike) on inflation will be minimal, c.0.1pp. Situation in Polish economy is ideal. There are no imbalances. **We have the room (for rate cuts) if needed...** If business climate deteriorates sharply, we can lower rates. (11/09, MPC conference)

From what I heard the minimum wage hike will not cause price acceleration. (23/09, Fronda)

Stabilisation of credit conditions. i.e. interest rates is very good for Polish economy. MPC policy should support loan growth so **maybe it is even worth considering rate cuts amid global economic slowdown** (8/08, PAP)

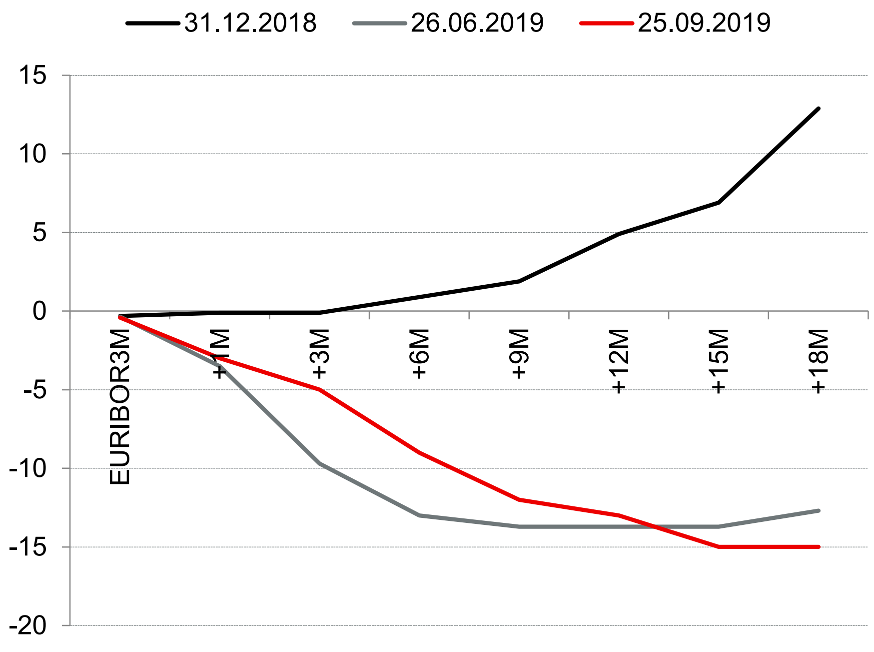
We should consider rate cuts, which is needed when we have symptoms of economic slowdown. (…) We need pre-emptive action. (23/09, Radio Maryja)

Polish economy needs low interest rates. (…) **Rate cut should be considered**. (16/09, Radio Maryja)

Money markets pricing

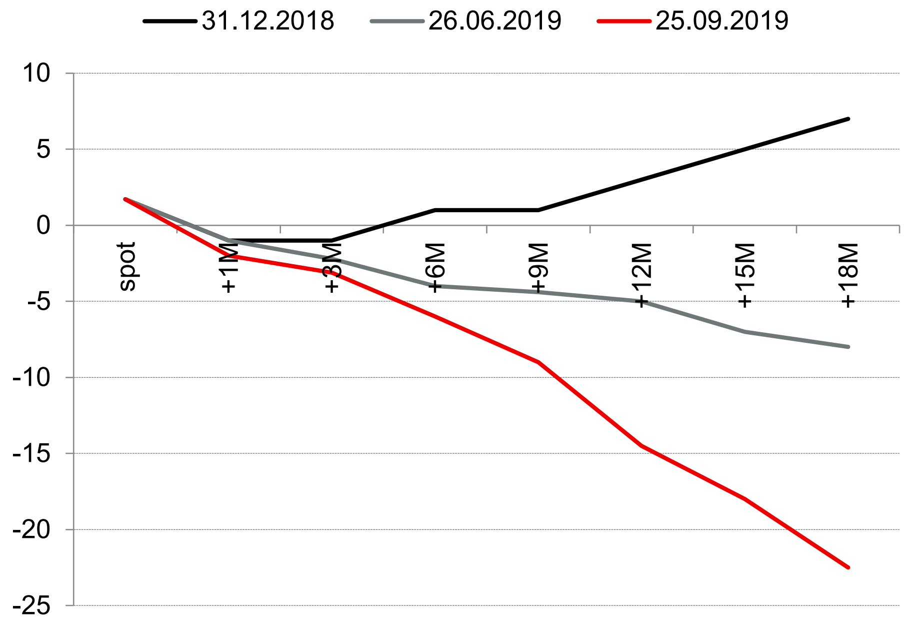
Polish money market is still pricing-in high probability of interest rate reduction, which we think is unlikely scenario.

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



Source: Refinitiv, Santander

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



Source: Refinitiv, Santander

2020 Budget: zero gap for the first time?

The government's budget draft for 2020 assumes zero deficit of the state budget, which was achieved thanks to some increase of taxation, large one-off revenues, but also due to restricted spending.

The macroeconomic assumptions for the budget do not raise major concerns, in our view. The revenue plan is ambitious but achievable, even though some assumptions (e.g. further rise in VAT collection) seem overly optimistic. The spending growth is very modest, partly due to assumed big cut in subsidy to Social Security Fund (FUS). Also, the draft does not secure funding for the already promised payment of the 13th pension, which implies that some part of the deficit may be phased out from the central budget to other public finance units.

For more detailed analysis of 2020 budget draft – please see our Economic Comment.

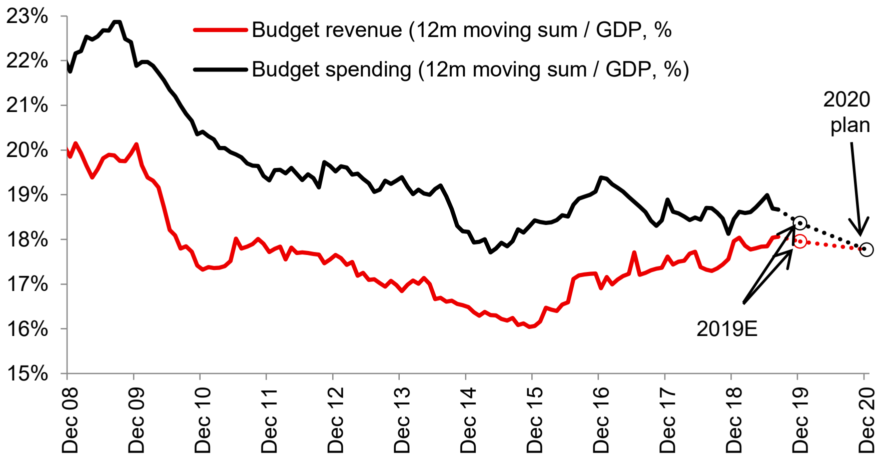
Overall, the government's fiscal plans were quite well received by investors, but not equally warmly by rating agencies. Both Fitch and Moody's signalled recently that they see budget assumptions as overly optimistic and expect fiscal deficit to be higher than planned by the government, especially in structural terms. The limited trust in government's „zero deficit" declaration also seems to be justified by comments of PiS senior officials', who mentioned that budget wil be probably amended after the elections. In any case, we think that unless economy slows much more than we currently expect, the size of the deficit should stay low enough to keep investors sleep well at night in the coming quarters.

2020 Budget Draft: main parameters (PLNm)

	2019 plan (1)	2019 fcast (2)	2020 plan (3)	change (3) / (2)
Total revenues	387,735	404,248	429,480	6.2%
Tax revenues	359,731	371,393	392,507	5.7%
VAT	179,600	185,400	200,150	8.0%
CIT	34,800	40,280	41,800	3.8%
PIT	64,300	65,815	66,515	1.1%
Excise duties	73,000	71,493	74,905	4.8%
Bank tax	4,551	4,689	4,878	4.0%
Non-tax revenues	25,806	30,768	34,631	12.6%
Total expenditure	416,235	416,235	429,480	3.2%
Budget balance	-28,500	-11,987	0	
GG balance(% GDP)	-1.8%	-1.0%*	-0.3%	

Source: Ministry of Finance, Santander; * Santander estimate

Budget revenues and expenditures as % of GDP



Source: Ministry of Finance, Santander

Santander

PiS on course for re-election

General elections are scheduled for 13 October. Taking into account the available opinion polls, it seems very likely that the ruling party (PiS) is going to win the elections with an outright majority.

We have drawn such a conclusion based on our stochastic simulation of distribution of mandates. We assumed that voting results are normally distributed random variables with mean equal to average from 5 most recent opinion polls and variances-covariances calculated based on last 40 opinion polls. We translate results into voting precincts, taking into account differences in voter preferences derived from results of last elections to the parliament, local governments and the European Parliament.

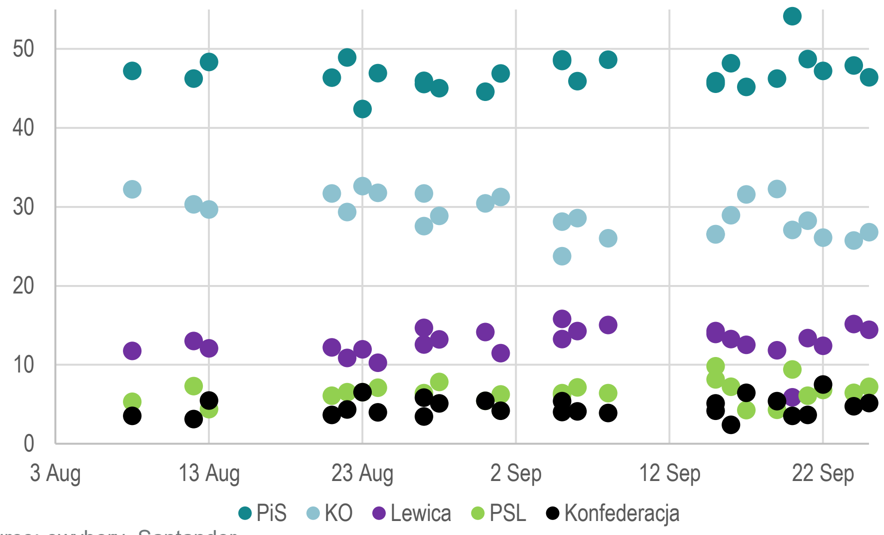
Our simulation suggests that PiS has an overwhelming chance to win an outright majority – about 90%. We are not expecting PiS to win qualified majority of 3/5 (to override presidential veto) or 2/3 (to change the constitution). We estimate the chance that the three opposition parties (KO, Lewica and PSL) win enough votes to form a government at 5%.

80% confidence interval for expected mandate distribution

Party	Expected mandates	Current mandates
PiS	231-262	240
KO	120-151	155
Lewica	42-67	0
PSL-Kukiz	0-26	38
Konfederacja	0-16	5
Others	1	22

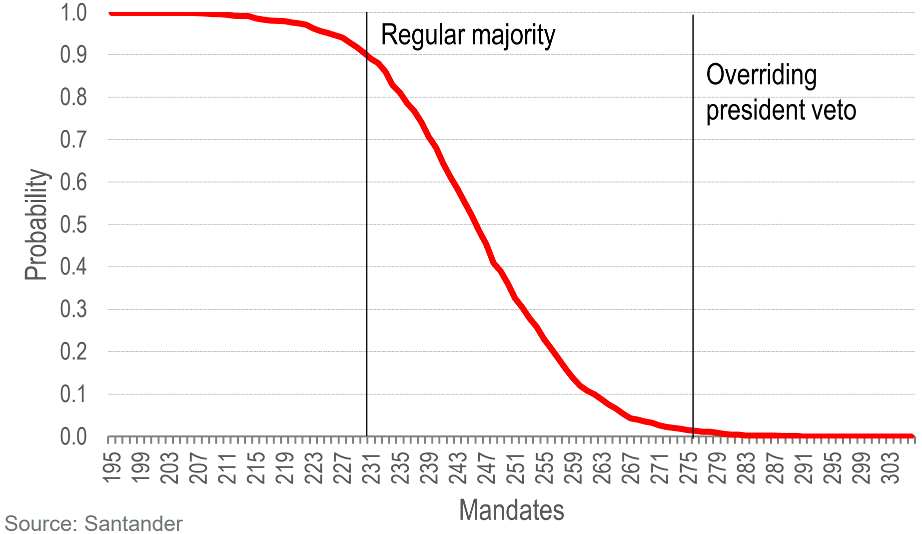
Source: Santander

Results of opinion polls



Source: ewybory, Santander

Probability that PiS will win not less than … mandates (assuming voting results in line with polls)



Source: Santander

Santander

Debt market: spreads wider, yields tad higher

In general the global backdrop for fixed income markets remains favourable with the main central banks (PBoC, ECB, Fed) having delivered on easing in September. Global growth slowdown - the fallout from the US-China trade dispute – seems to be stronger and longer lasting than initially thought hence is likely to fundamentally support core fixed income markets for some more time.

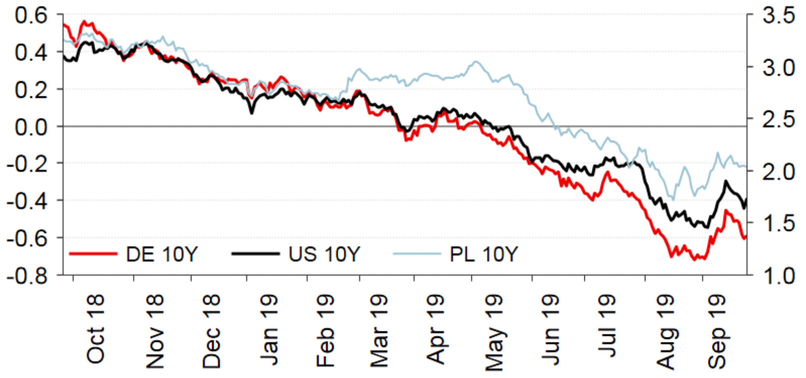
Local Polish factors like softer economic data, dovish MPC (with a motion for a cut on the September meeting), decent budget performance also seem to support local fixed income markets. On top of that in October there is PLN 9.8bn of principal redemption and PLN 4.1bn of interest rates payments.

That said, increasing global markets volatility (see next slide) which we expect in the coming quarters together with local events (especially ECJ ruling on October 3rd) should command a slightly higher yield premium on Polish assets in the months to come.

The initial impact of the US-China trade dispute on the global trade and manufacturing sectors seems to have been largely digested by markets by now. Hence the vulnerability of the core markets to any positive news (like for example a small deal between the nations or an uptick in the core inflation in the US) is relatively high, in our opinion.

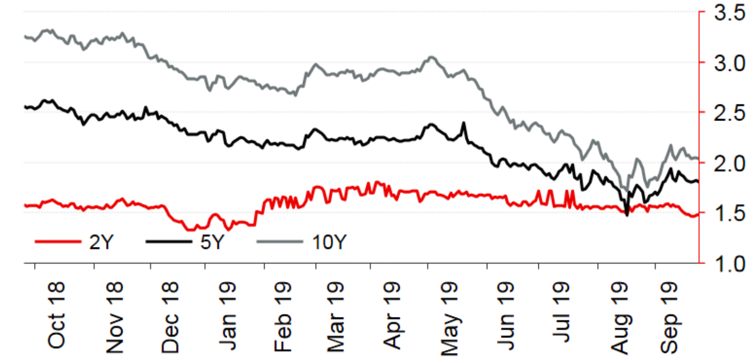
That is why we expect Polish 10Y bond yields to trade wider vs the presumably stable Bund to 275bp from the current 258bp and expect the 10Y bond yield to reach 2.15% at the end of Q4. In the meantime the short end (2Y) might be anchored by temporarily lower CPI (2.6% in September) and dovish MPC stance.

Polish, German and US 10Y bond yields



Source: Refinitiv Datastream, Santander Bank Polska

Polish 2Y, 5Y, 10Y bond yields



Source: Refinitiv Datastream, Santander Bank Polska

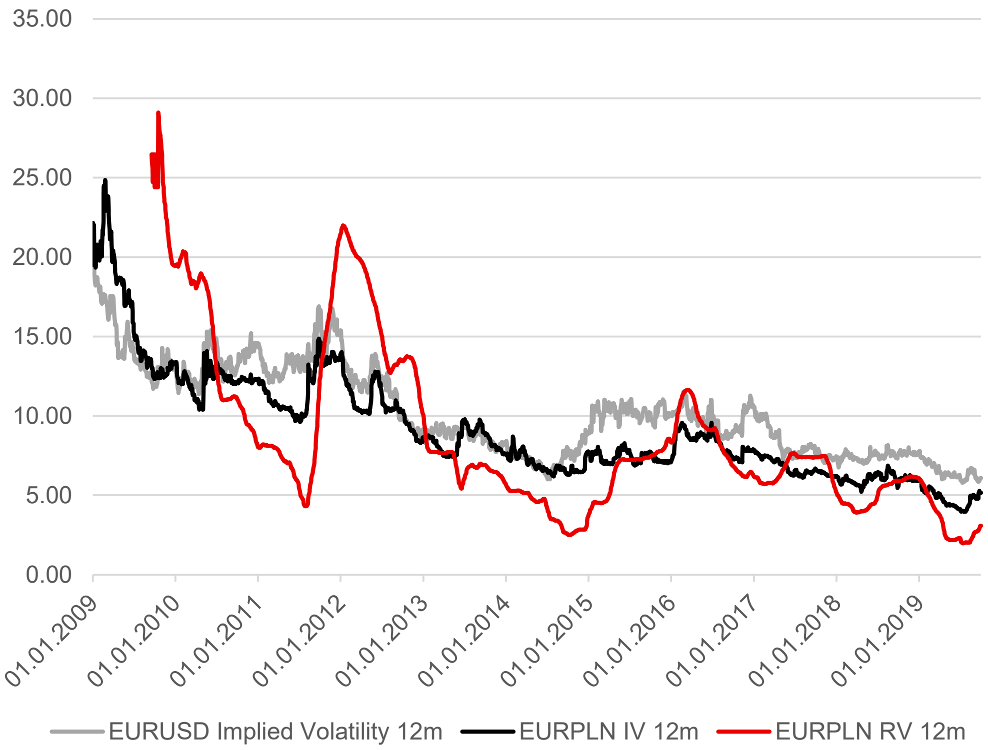
Santander

Markets: more volatility to come

After the volatility blow-up during the Lehman crisis markets entered a more than decade long period of decreasing volatility (chart on the right). The low volatility trend strongly supported by ECB's Mario Draghi's famous 2012 „Whatever it takes" moment and disrupted only a bit by August 2015 China 3% yuan devaluation **might be coming to an end now.** The following arguments might contribute with variable strength.

1. **Monetary policy**. With interest rates of main central banks having hit already zero lower bound and in some cases even lower it becomes more and more plausible that monetary policy has hit its first limits of how it is able to spur economic activity. It is safe to assume that this initially potent volatility killer has, on the margin, lost at least part of its potential.
2. **Geopolitical**. The US-China trade dispute is probably an emanation of a much deeper and fundamental issue between the two nations. The competitive situation will result in, at the very least, the US side less willing to intervene globally to sustain a global order as it increasingly focuses on the Pacific. The medium-term consequences of the situation is that the uncorrelated **volatility increasing situations** (example of which is the recent drone attack on Saudi Arabia oil facility) might become much more common and lead to increased financial markets volatility.
3. **Macroeconomic divergence**. As the structure of the global supply chains change, some nations with poor demographics (rapid aging) and the structure of their growth depending predominantly on exports (like Germany, Japan) become more vulnerable and are likely to suffer prolonged slowdown while other nations with healthy demographics and innovative economy (like US) might be doing just fine. Divergent macroeconomic conditions in the worlds main economies might translate to higher financial markets volatility and more opportunities for **relative value trades**
4. **Local factors**. As the dominant theme in the financial markets (main central banks loosening monetary conditions) becomes less influential on the margin, local factors will play an increasingly important role. Again contributing to overall volatility.

1yr Implied Volatilities for EURUSD and EURPLN and 1yr Realized Volatility EURPLN (%)



IV = implied volatility, RV = realized volatility

Source: Bloomberg, Santander

Santander

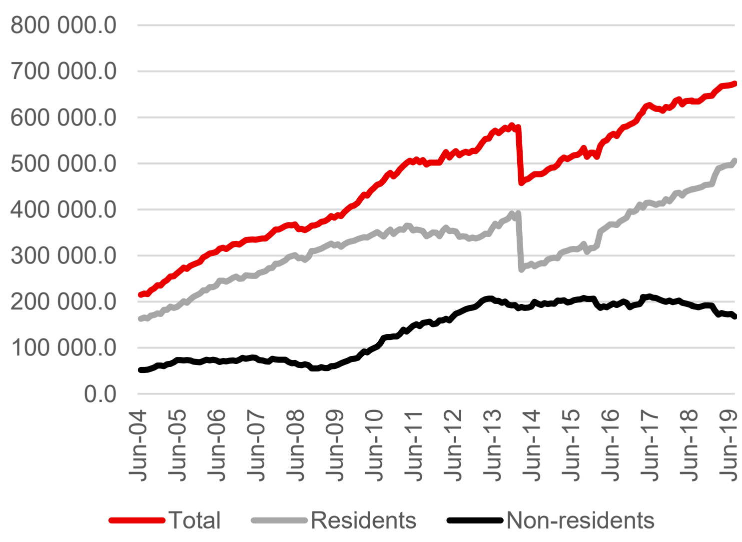
Debt market: Foreigners retreat, local banks step in

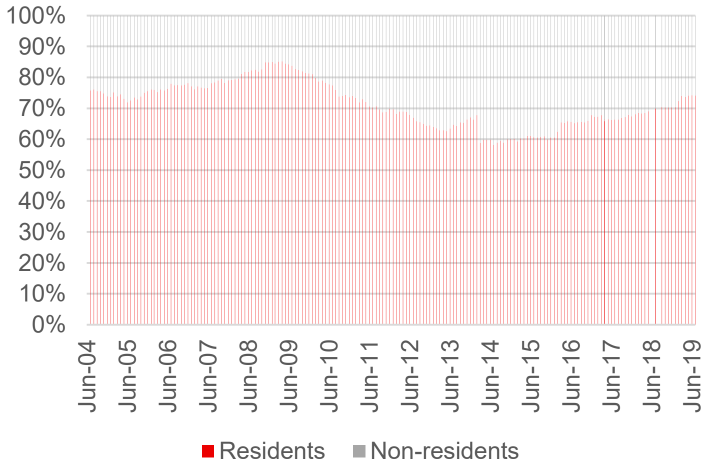
Polish Ministry of Finance latest data (31 August 2019) on PLN-denominated bonds ownership shows continuation of trends:

- **Total** ownership increased to PLN 675bn (+28bn YTD, +1.2bn m/m)
- **Residents** ownership grew to PLN 509bn (+53bn YTD, +3bn m/m) which now constitutes 75.4% of total. **Residents** ownership is dominated by Banks (PLN 308bn), Insurance (PLN 64 bn) and Mutual Funds (PLN 60bn), all of which kept on accumulating m/m by: +1.3bn, +0.1bn and +1.4bn
- **Non-residents** ownership decreased again to PLN 166bn (or -25.4bn YTD, -1.8bn m/m) which now constitutes 24.6% of total. **Non-residents** ownership decreased due to foreign central banks (-0.4bn) and mutual funds (-0.7bn) and „other" (-2.8n) while foreign banks accumulated (+2bn). Biggest sellers came from Asia (-2bn) and non-EZ European countries (-1bn) while EZ European countries accumulated (+2.6bn)

The data about debt financing by different classes of investors still supports the medium-term trend of increasing importance of local commercial banks in financing debt issuance. The final quarter of the year should be neutral regarding foreign investors' holdings of POLGBs as uncertainty regarding October parliamentary elections and ECJ ruling increases the odds of investors' neutral stance

Holders of Polish, PLN marketable bonds: Upper (PLN m) / Lower (% Total)

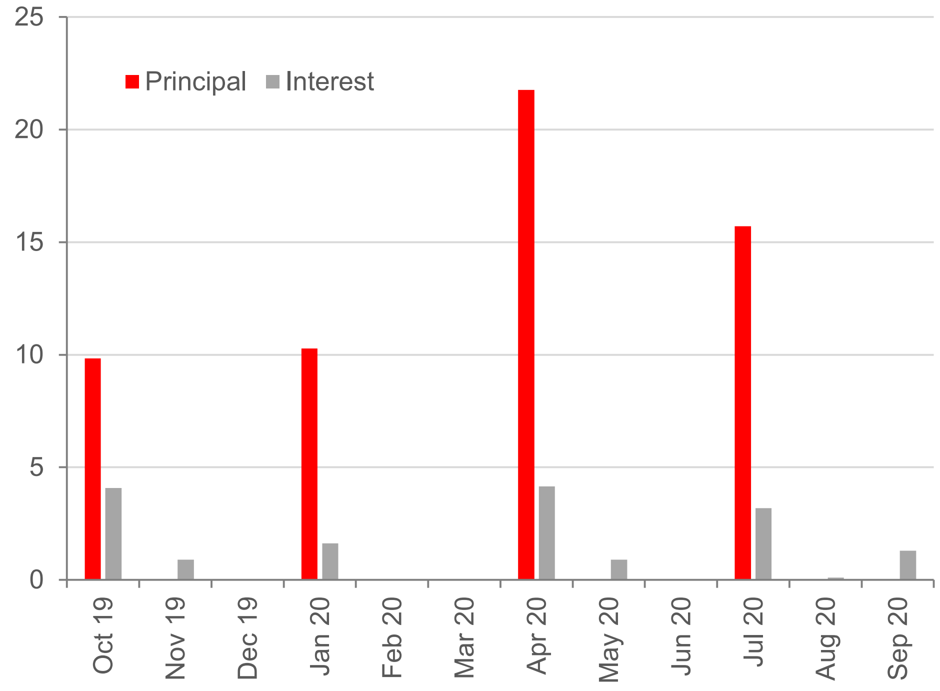




Source: Ministry of Finance, Santander

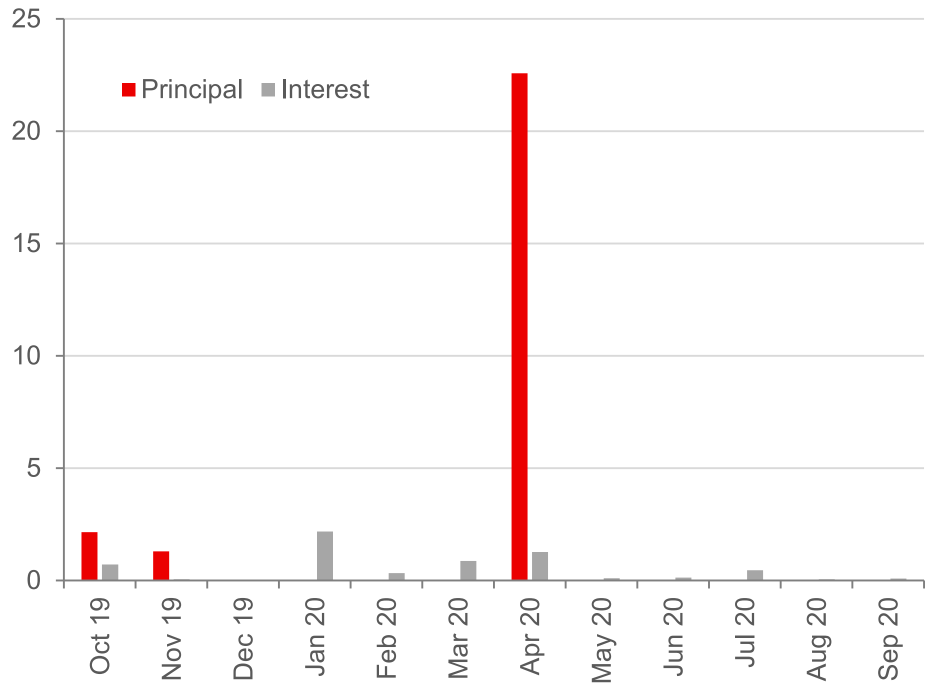
Debt redemptions

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

FX Market: Risks cumulate in 4Q19

We decided to pull up our year-end EUR/PLN forecast and flattened path for 2020 at 4.30 mainly accounting for the prolonging growth uncertainty, as well as unclear consequences of the upcoming verdict of the European Court of Justice. We think EUR/PLN may stay around 4.40 awaiting the ECJ ruling and that the FX mortgages factor could curb zloty gains in the remainder of the year.

The zloty has been quite volatile in the recent weeks as it first recovered roughly half of losses suffered in mid-July/late-August period but soon returned to c4.40 per euro.

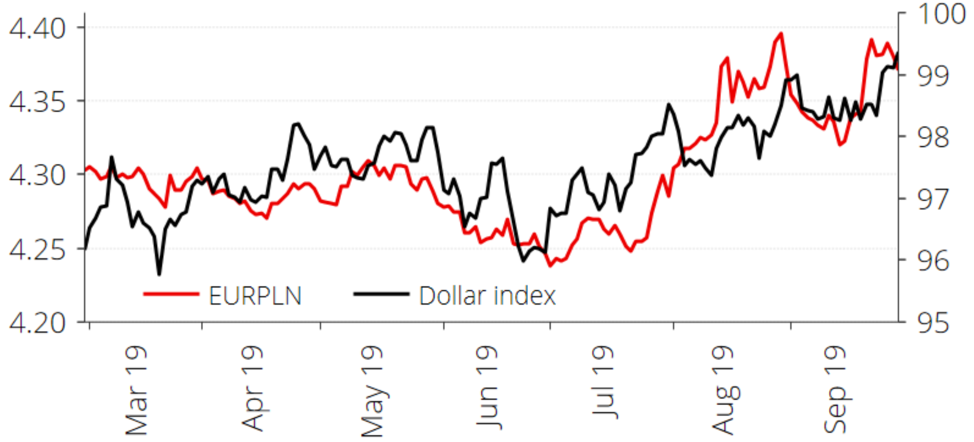
Year-to-date, ten of the main EM currencies lost vs the euro, out of which five were from the CEE region – the lira, forint, zloty, leu and koruna. At the same time, the euro depreciated vs six currencies from the G10 basket.

Nearly all EM currencies lost vs the dollar but the CEE underperformance suggests there could have been an additional, Europe-related risk factor. In our view, the issue could be the prolonging Brexit issue and the CEE economies' vulnerability to German economic malaise.

We also still have a Poland-specific risk factor on the table, namely the European Court of Justice verdict regarding Polish FX mortgages and more evidence of the economic slowdown in Germany spillover to Poland. The ECJ ruling is expected to be announced on October 3rd and we have already seen a significant zloty depreciation after the date of verdict emerged.

It is hard to know exactly what will be the market behaviour around the ECJ ruling but we think that assuming sharp and persistent zloty depreciation is not a good idea. While the zloty may still depreciate, the selloff should not be long-lived. The scale of upward EUR/PLN move will be limited by the demand from exporters (some have been waiting for higher levels for a while), possibility of government/BGK intervention and profit taking by investors.

EUR/PLN and dollar index



Source: Refinitiv Datastream, Santander Bank Polska

FX forecasts

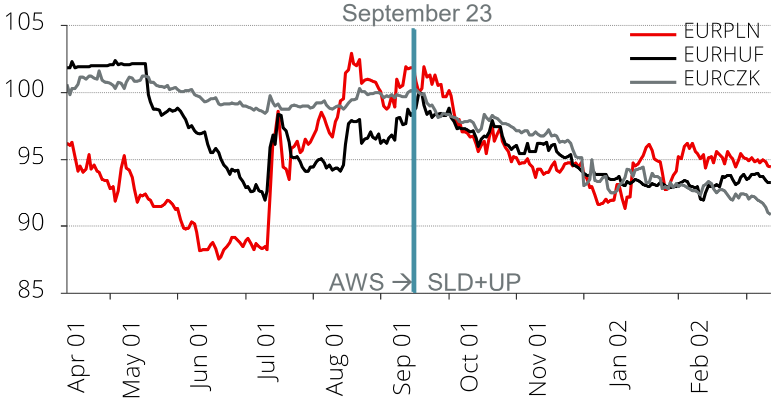
	4Q19	1Q20	2Q20	3Q20	4Q20
EUR/PLN	4.38	4.32	4.30	4.30	4.30
USD/PLN	3.90	3.79	3.76	3.72	3.68
EUR/USD	1.12	1.14	1.15	1.16	1.17

Source: Santander

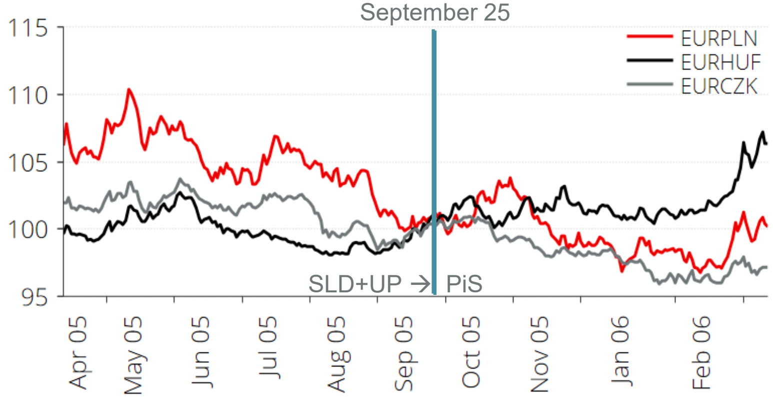
Santander

FX Market: General elections' impact not always the same

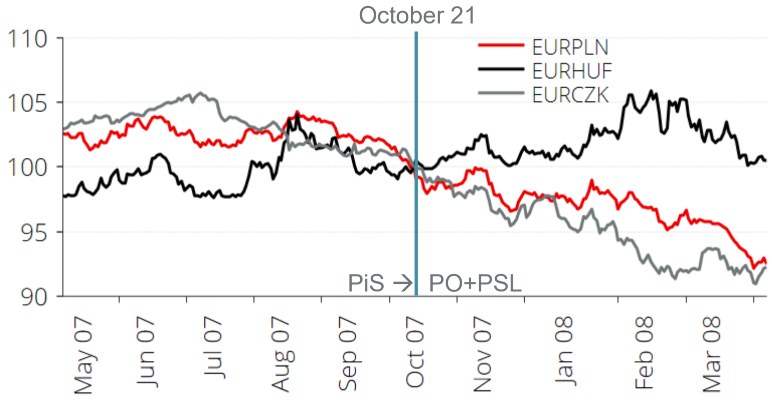
If PiS wins the majority in the parliament again, it should not affect Polish currency meaningfully, in our view. Back in 2015 the zloty did react to the elections as the market became concerned about fiscal implications of PiS pre-election promises, about potentially more dovish new MPC and about forced FX loan conversion promised in the presidential campaign. But, as shown on the charts below, the impact of elections on FX market was not always similar. This time, we think the election factor will not be material, as investors have already got used to the current government and PiS victory seems to be broadly anticipated.



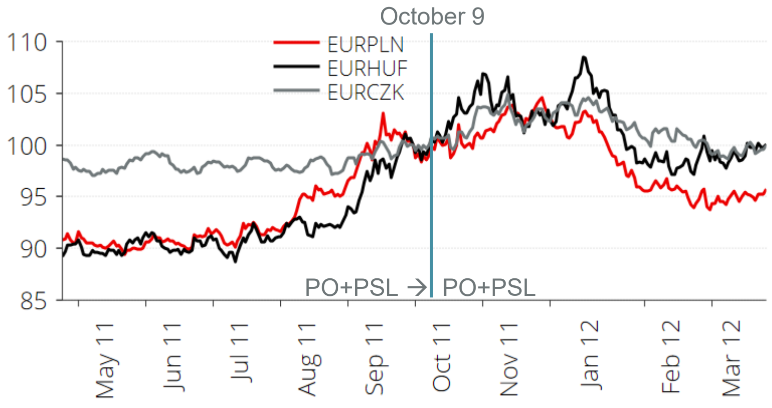
Source: Refinitiv Datastream, Santander Bank Polska



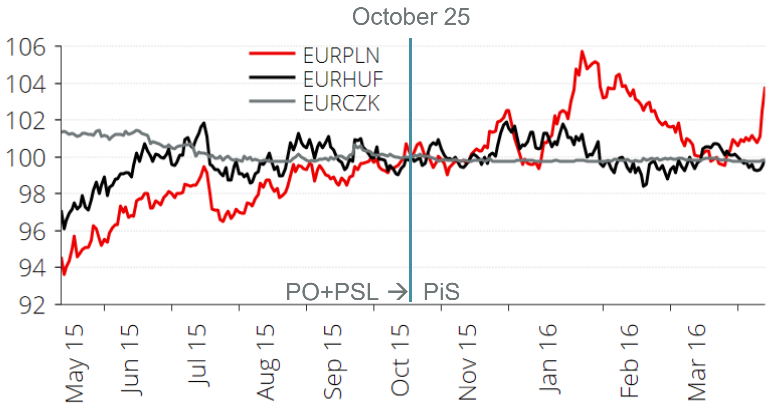
Source: Refinitiv Datastream, Santander Bank Polska



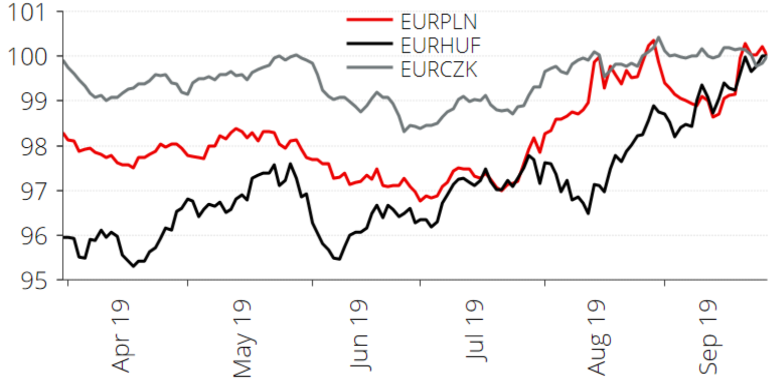
Source: Refinitiv Datastream, Santander Bank Polska



Source: Refinitiv Datastream, Santander Bank Polska



Source: Refinitiv Datastream, Santander Bank Polska



Source: Refinitiv Datastream, Santander Bank Polska

BIS Triennial Central Bank Survey 2019 - Global

Every 3 year the Bank of International Settlements takes a survey of around 1300 FX trading desks. The latest survey took place in in April 2019 and its results were published in September 2019. Main points:

1. **Daily average FX turnover** significantly increased to USD 6.6 tn in 2019 from USD 5.1 tn in 2016.
2. The share of **FX swap transactions** currently constitutes almost **half** of all FX transactions (Table 1)
3. The **US dollar remained the world's most dominant currency (Table 2)** and traded on the side of 88,3% of all transactions. Euro increased its share to 32.3%, while **Japanese yen significantly lost market share** -4.8pp to 16.8%
4. **The concentration of turnover (Table 3)** in the main financial centers increased to 79%. **London remained the dominant financial center** for FX trading and this despite the Brexit related headwinds. The share of 3 Asian financial centers (Tokyo, Hong Kong, Singapore) remained stable at around 20%. **The share of New York fell** by 3pp to 17% from 20%
5. Despite still being relatively low at 8th place, **onshore China market share** increased by a significant 90% increase over 3 years

Table 1. Percentage of average daily turnover, by insturment type

Instrument	2016	2019
FX swap	47%	49%
FX spot	33%	30%
Outright Forwards	14%	15%
Options	5%	4%
Currency swaps	2%	2%

Table 2. Percentage of average daily turnover, as a transaction side

Currency	2016	2019
USD	87,6%	88,3%
EUR	31,4%	32,3%
JPY	21,6%	16,8%
GBP	12,8%	12,8%
AUD	6,9%	6,8%

Table 3. Percentage of average daily turnover, by financial center

Center	2016	2019
Londyn	37%	43%
Tokyo + HK + Singapore	21%	20%
New York	20%	17%
Top 5 centers combined	77%	79%

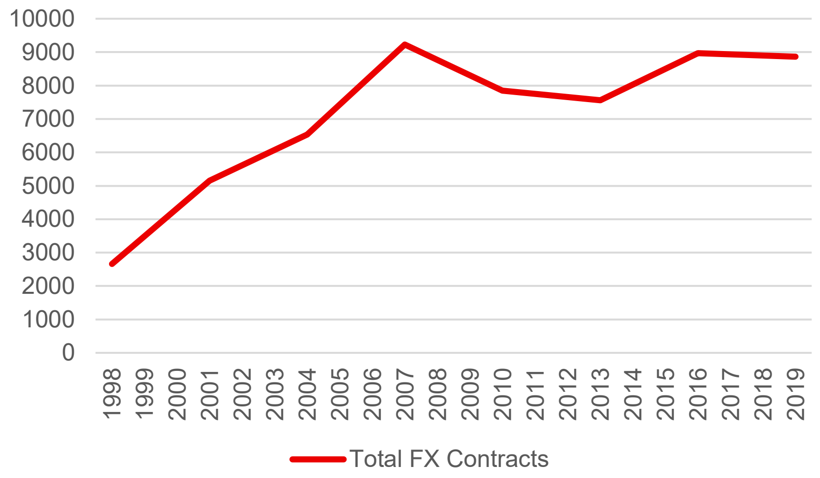
Source: BIS, Santander

BIS Triennial Central Bank Survey 2019 - Poland

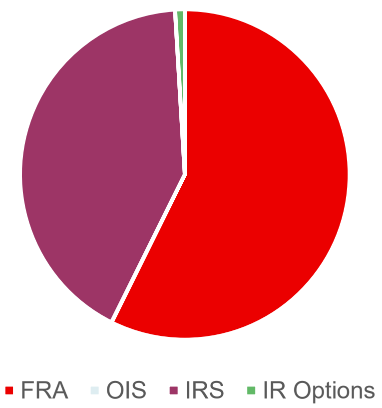
In Poland 13 financial institutions (domestic banks and branches of credit institutions) comprising 95-98% of the market took part in the survey. Double reporting eliminated. Main points:

1. Data for the Polish market is split into (1) **FX market** (FX spot, outrights, swaps, CIRS and FXO) and (2) **OTC IR market** (FRA, OIS, IRS).
2. In April 2019 **daily average net FX turnover (all currencies)** stood at USD 8.86 bn a decrease of 1pp versus the 2016 survey (see plot right)
3. As in the global case, it was the **FX swap transactions** that were most actively traded in Poland. The average daily turnover of USD 5.20bn constitutes **59%** of all FX transactions. The second most widely traded instrument was FX spot with USD 2.56bn or **29%** share.
4. Average daily turnover in **domestic OTC interest rate derivatives market** increased to USD 2.11 bn from 1.49 in 2016, a 40% increase with FRA and IRS having **99%** market share

Poland - Total OTC FX Daily Turnover [USD mln]

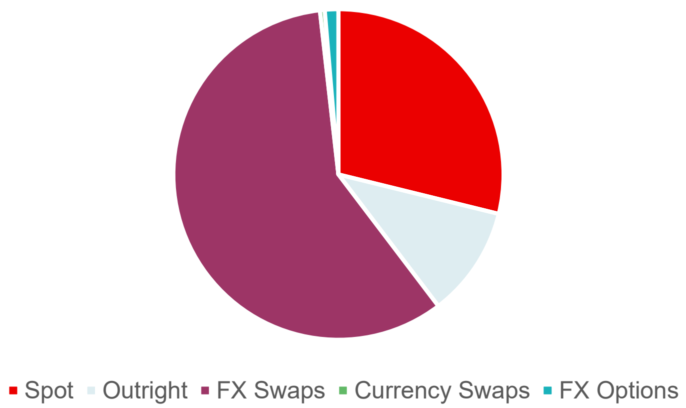


Poland - Total 2019 OTC Fixed Income Daily Turnover by Instrument



Source: BIS, NBP, Santander

Poland - Total 2019 OTC FX Daily Turnover by Instrument



Source: BIS, NBP, Santander

Economic Forecasts

		2017	2018	2019E	2020E	1Q19	2Q19E	3Q19E	4Q19E	1Q20E	2Q20E	3Q20E	4Q20E
GDP	PLNbn	1,989.3	2,115.7	2,262.6	2,416.3	520.2	545.6	562.6	634.2	562.7	583.5	597.0	673.1
GDP	% y/y	4.8	5.1	4.3	3.5	4.7	4.5	4.1	3.9	4.1	3.5	3.3	3.2
Domestic demand	% y/y	4.9	5.5	4.6	3.9	4.2	4.8	4.9	4.4	4.2	4.0	3.7	3.6
Private consumption	% y/y	4.5	4.5	4.5	4.1	3.9	4.4	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	4.1	3.9	6.1	4.2	3.2	2.5	1.1	3.4	5.8	5.3
Construction output	% y/y	13.7	19.7	6.8	3.0	9.9	7.8	5.2	6.0	2.1	4.4	3.8	1.9
Retail sales (real terms)	% y/y	7.1	6.5	3.8	2.5	4.1	8.1	5.5	2.1	0.8	0.7	3.4	5.5
Gross wages in national economy	% y/y	5.3	7.2	6.9	7.0	7.1	7.0	6.6	6.7	7.6	6.9	7.0	6.2
Employment in national economy	% y/y	3.3	2.6	2.2	-0.2	2.7	2.5	1.9	1.8	0.7	0.4	0.2	0.1
Unemployment rate *	%	6.6	5.8	5.3	5.1	5.9	5.3	5.1	5.3	5.4	4.9	4.9	5.1
Current account balance	EURmn	290	-5,046	-3,441	-6,204	2,110	430	-3,098	-2,883	1,455	257	-4,019	-3,897
Current account balance	% GDP	0.1	-1.0	-0.7	-1.1	-0.6	-0.4	-0.5	-0.7	-0.8	-0.8	-0.9	-1.1
General government balance (ESA 2010)	% GDP	-1.4	-0.4	-1.0	-0.4	-	-	-	-	-	-	-	-
CPI	% y/y	2.0	1.6	2.4	3.4	1.2	2.4	2.8	3.1	4.3	3.4	3.0	3.1
CPI *	% y/y	2.1	1.1	3.4	3.0	1.7	2.6	2.6	3.4	4.2	3.2	3.1	3.0
CPI excluding food and energy prices	% y/y	0.7	0.7	2.0	2.7	1.1	1.8	2.2	2.9	3.0	2.7	2.6	2.5

* End of period; other variables – average in period

Source: GUS, NBP, Santander

Market Forecasts

		2017	2018	2019E	2020E	1Q19	2Q19	3Q19	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	1.59	1.60	1.64	1.65	1.52	1.53	1.55	1.55	1.59	1.73
Yield on 5-year T-bonds	%	2.78	2.51	1.99	1.90	2.23	2.14	1.75	1.85	1.85	1.85	1.90	2.00
Yield on 10-year T-bonds	%	3.44	3.21	2.41	2.24	2.84	2.68	1.97	2.15	2.20	2.20	2.23	2.33
2-year IRS	%	1.94	1.92	1.76	1.82	1.78	1.81	1.70	1.75	1.76	1.79	1.83	1.90
5-year IRS	%	2.40	2.43	1.86	1.86	2.00	1.99	1.66	1.81	1.82	1.84	1.87	1.90
10-year IRS	%	2.86	2.89	2.09	1.93	2.34	2.29	1.75	1.97	1.90	1.90	1.92	2.02
EUR/PLN	PLN	4.26	4.26	4.32	4.31	4.30	4.28	4.32	4.38	4.32	4.30	4.30	4.30
USD/PLN	PLN	3.78	3.61	3.86	3.74	3.79	3.81	3.89	3.94	3.79	3.76	3.72	3.68
CHF/PLN	PLN	3.84	3.69	3.88	3.82	3.80	3.80	3.94	3.99	3.87	3.82	3.81	3.77
GBP/PLN	PLN	4.86	4.81	4.87	4.75	4.93	4.90	4.77	4.89	4.83	4.75	4.73	4.70

* End of period; other variables – average in period

Source: NBP, Bloomberg, Santander

This analysis is based on information available until **1.10.2019** has been prepared by:

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2. PROGNOZY MAKROEKONOMICZNE

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