MACROscope

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Gear down to three

Poland: 2020 Outlook

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Executive summary (macro)

Please find below the main economic themes for Poland in 2020:

- Poland is lagging the developed Europe in this economic cycle. The slowdown, which started quite late, may not end before the end of 2020. We see chances for a gradual improvement of business activity in Germany and the euro zone in the second half of the year, but we may have to wait until 2021 before we see a visible pickup in Polish GDP growth, due to domestic demand inertia (sluggish investments) and base effects (expiring boost for consumption from the pre-election fiscal package). According to our forecast, **GDP growth will slow to almost 3% in 2020, from around 4% in 2019 and 5% in 2018**.
- **After three years of solid investment expansion, 2020 may see a sudden stop**, mainly due to cuts in local governments' spending and falling activity in infrastructure development. Companies still have incentives to invest, switching to less labour intensive and less energy intensive technologies, but their spending on fixed assets will be constrained by the delayed effects of high uncertainty about economic outlook, and tighter banks' lending policies.
- Labour market tensions started easing, it seems, as demand for jobs is slowing. But **labour costs will not decelerate much in 2020, remaining among the top headaches for firms**. New regulations (15% minimum wage hike, PPK, potential introduction of social contributions for civil contracts) will contribute to increasing the burden. Since 2016 the domestic professionally active population is shrinking by 100-200 thousand people per year, due to ageing and institutional changes (500+, lower retirement age), so even keeping employment stable requires a constant inflow of migrants. So far, this inflow continues, but seems to be slowing. The risk of significant outflow of Ukrainian workers to Germany after the latter opens its borders for professionals in 2020 seems to be diminished by the strength of downturn in German manufacturing, plus the structural skills mismatch (small ratio of Ukrainians speaking German and having required qualifications) .
- Spike in electricity price, plus a jump in different types of living costs (waste and water management, transport, parking, kindergarten fees) and tax hikes will **push CPI strongly up in January, possibly even to 4% y/y**. However, in the environment of economic slowdown in Poland and abroad and weakening labour market tensions the inflationary impulse is unlikely to be sustained. Thus, **we expect inflation to retrace back towards the official target 2.5% in the second year-half**.
- Economic growth close to potential, inflation at the target (sooner or later), lack of external imbalance – in such environment the central bank can do hardly anything else but sit and wait. The MPC's increasing focus on economic growth outlook suggests, in our view, that the tolerance for inflation target's breach may be quite large as long as worries about economic slowdown persist. It is quite possible that **interest rates in Poland will remain on hold until the end of current MPC's term of office (2022)**, as suggested by NBP governor Adam Glapiński.
- **Fiscal deficit is unlikely to be zero in 2020, but should remain low by historical standards, near 1% of GDP**. Nominal GDP growth will not decelerate much due to higher inflation, which is supportive for tax revenues. The supply of bonds will be also relatively low and easily absorbed by the domestic investors, out of which commercial banks play key role. The government will use tricks to avoid breaching the stabilising spending rule (pushing out expenditure to a special fund), and the public debate about possible relaxation of this rule started, which may herald looser fiscal policy in the coming years.

Executive summary (markets)

FX

The passing year was full of important external and internal events that failed to push EUR/PLN persistently out of the range observed since mid-2018.

We expect a status quo for 2020 in terms of the zloty performance vs the euro but EUR/PLN could approach 4.25 in the first months of 2020 assuming that nothing will stop the United Kingdom from leaving the EU by the end of January and that US-China relationship would not deteriorate after the "phase one" deal is agreed.

However, we do not expect the zloty appreciation to continue below 4.25 per euro since the internal factors – FX mortgage loans, gradual economic growth deceleration amid stagnant investments, deeply negative real interest rates – could curb gains. Additionally, in 2H20 the market could focus on some global risks. There could be uncertainty ahead of the outcome of the US presidential elections and it would be important how the UK-EU negotiations on the final conditions for Brexit are advanced - the track record does not suggest any fast line in the issue.

FI

In 2019 EM fixed income rallied significantly after core yields were brought down by trade tension fears, EM central banks cut rates while Fed and ECB both cut rates and relaunched QE programs. In 2019 Polish bond yield curve moved lower, flattened and traded narrower versus the German curve.

In 2020 we expect the front end of the bond curve to remain anchored at around 1.50% as NBP will not change rates. Long end bond yields will increase to around 2.40-2.50% due to higher core yields (which contribute +20bp) and normalizing curve shape (another +20-30bp).

In 2020 net borrowing needs, albeit higher than in 2019, will be significantly lower than in previous years and will not pose financing risks as the demand from Polish banking sector remains strong while foreign investors hold a decreasing percentage of outstanding marketable Polish securities.

2019 Forecasts in rearview mirror

Indicator	Our view - 12 months ago	Outcome
GDP	The economic cycle has matured and the coming quarters will see GDP growth slowing moderately, yet still holding somewhat above potential.	Confirmed. The first half of the year was still relatively strong, despite deepening slowdown in Germany, but in mid-year the economy has clearly lost momentum; the view was right in general.
GDP breakdown	Consumption still contributing the most, although slowing gently amid deceleration of real disposable income. Moderate investment growth continues, fuelled largely by public spending on infrastructure. Net exports slightly negative again.	Consumption was weaker than we had thought, but remained the key driver of GDP growth. Investments were stronger in H1, fuelled mainly by firms while public spending stagnated; notable slowdown followed in next two quarters. Net exports was positive for GDP due to surprisingly weak 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.	Confirmed. Labour market remained tight although at the end of the year tensions started easing, it seems, as the economy slowed. The (slowing) inflow of migrant workers has continued, domestic labour force kept shrinking. Wage growth was still decent, although started weakening at the end of the year.
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.	The inflation's pickup has finally happened and was even stronger than we had anticipated due to weather anomalies affecting food prices. Core inflation almost exactly followed the upward path we predicted last year, driven by companies' efforts to defend/rebuild margins.
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.	Confirmed. The MPC voted on both rate hikes and rate cuts in 2H19 but with no success, as vast majority of Council members supported stable policy. Inflation's rise was perceived as temporary in the context of global economic slowdown.
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.	Confirmed. Despite surprisingly big fiscal package PiS implemented before elections, total spending and fiscal deficit remained under control. Central budget deficit will be lower than planned (again) but GG balance roughly in line with earlier expectations.
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.	Decline of bond yields was much deeper than expected due to situation in global markets – worries about world economic slowdown and sudden shift towards policy easing by main central banks abroad.
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.	Zloty traded in a narrow band vs euro, just at slightly stronger levels than we had predicted.

2020 Forecasts and main risks

Indicator	Our view (in a nutshell)	Main risks
GDP	Moderate economic slowdown (or, in fact, normalisation of growth), likely to continue, dragging GDP growth from c.5% y/y in 2018 and c.4% in 2019 to around 3% - near (or only slightly below) the potential growth rate. It should be a good starting point for slight recovery in 2021 if global economy starts bottoming out.	Our forecast is based on the assumption of no further deterioration of growth in the euro zone / Germany. Any material worsening of global growth outlook would imply a downward risk for our GDP forecast. Brexit and trade wars remain on top of the list of risk factors. Faster global growth rebound would imply upside risk for forecasts.
GDP breakdown	Private consumption remains the key growth engine, buoyed by rising households' income. Investment in stagnation, amid cuts in public spending and firms' outlays constrained by delayed effects of high uncertainty. Inventories shrinking, while net exports contributing positively to GDP amid export slowly gathering traction and import lagging behind due to slower domestic demand.	Export could weaken further if European economy keeps slowing and global trade tensions escalate. Consumption may not live up to expectations if precautionary savings rise amid uncertain environment. On the flip side, investment slowdown could be less severe if public administration accelerates tenders and spending on infrastructure (mainly railway, where lots of money is allocated).
Labour market	Labour market tensions easing as demand for jobs softens and output growth slows. Wage growth stable near 6% y/y with minimum wage hike adding c.1pp. Employment growth near zero, jobless rate stable at record low level.	Even deeper economic slowdown should not boost unemployment rate quickly, as firms are likely to avoid losing competent workers. The first wave of staff reduction would probably affect short-term migrants.
Inflation	We expect CPI will peak in 1Q2020, possibly even touching 4% y/y, amid hikes in energy tariffs and other administered prices. Later on, inflation should subside, stabilising near the official target.	Lack of energy tariffs hike would trim CPI path by 0.5pp. Inflation's retreat from the peak could be faster if economic slowdown proves deeper than expected.
Monetary policy	Central bank will remain in the wait-and-see mode, looking through the (temporary) overshoot of inflation target, as economic growth weakens.	The balance of risk for interest rates seems to be tilted downwards due to worries about bigger GDP slowdown. But if global economy bottoms out and CPI does not drop below the target, market could start pricing-in rate hikes again in H2.
Fiscal policy	Zero deficit in the central budget does not mean zero GG balance, but the gap will not be much greater than 1% of GDP, which means low bond supply and shold be positive news for investors. As always, much bigger challenge seems to be the next fiscal year, when one-off items financing the generous social transfers expire.	Budget plan for 2020 could be at risk if some of important one-off revenues (like OFE transformation) are not legislated in time and/or economic growth slowdown proves much more significant.
Fixed income market	In 2020 we expect the front end of the bond curve to remain anchored at around 1.50% as NBP will not change rates. Long end bond yields will increase to around 2.40-2.50% due to higher core yields (which contribute +20bp) and normalizing curve shape (another +20-30bp).	Risks to the downside of our yield forecast include escalating trade tensions, Hong Kong protests and/or Hard Brexit which would slow global growth and force central banks to ease further. Risks to the upside include better than expected US growth in 2020, significant fiscal spending in the eurozone or significantly incrased issuance.
FX market	Global moods improvement after external risks related to Brexit and trade wars diminish should strengthen the zloty at the start of the year, but later on the EURPLN should converge to 4.30, its average for the last few years.	Escalation of trade tensions, return of global recession fears or Hard Brexit are the main external risk factors for PLN. Domestic one includes return of worries about accelerated FX loans conversion.

Global backdrop and risks (1)

2020 will unfold against an interesting global backdrop. Here are some of the main points:

Main central banks have so far not communicated willingness to change rates over the course of 2020. Market does not expect the ECB to change rates either (top, right). It is only in the US that roughly 1x 25bp cut is being priced in (top, left). Fed will continue to rebuild its balance sheet to improve liquidity in the money markets.

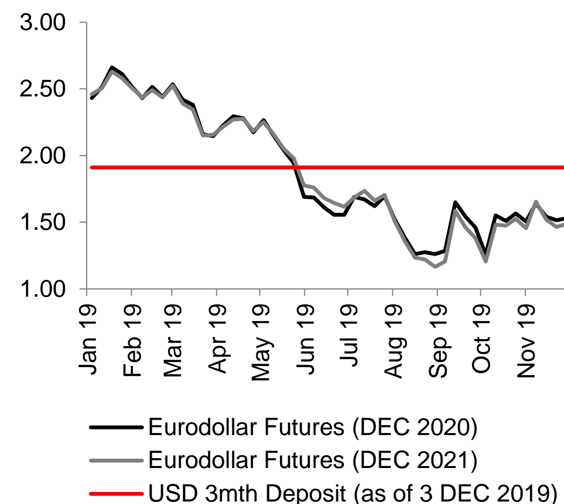
As the US keeps decoupling itself from the world, institutions such as WTO lose their power and deglobalisation progresses, global trade enters the 2020 with not-too-bright prospects. Evolution of 3 main DHL's early indicators for current state and future development of global trade is shown here (bottom, left).

59th US presidential elections are scheduled for 3rd Nov 2020. There is a lot of uncertainty regarding possible candidates on both sides: will president Trump become Republican candidate again or is he going become a victim of the impeachment process? Would another Republican candidate be less confrontational? On the Democratic side current polls show Biden, Sanders and Warren are top 3 contenders with the latter being regarded as market-unfriendly due to possible tax increases on the wealthy.

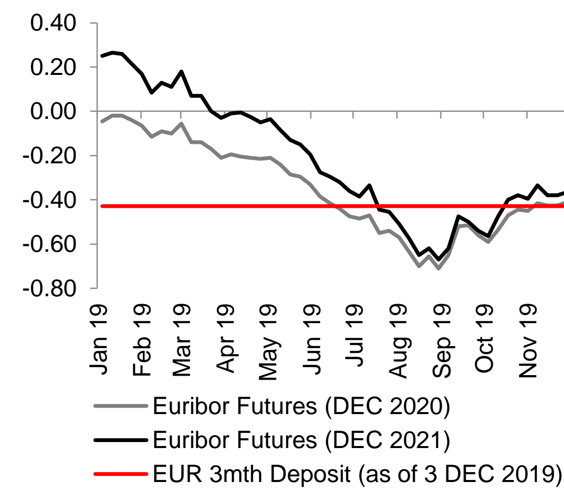
Food inflation in a few emerging market countries. Swiftly rising food prices in China (pork prices) and India (onion prices) might put additional pressure on consumers and contribute to even slower growth in the countries. The growth rates are expected to remain pretty low in 2020 to start with (bottom, right).

Eurozone growth has bottomed as the worst – in terms of the initial negative impact of tariffs on the global manufacturing growth – seems to be already behind us. Our bank's base case is for a slow recovery in 2020 led by a pick up in (German) investment.

Eurodollar and Euribor Futures vs Current Deposit Rates

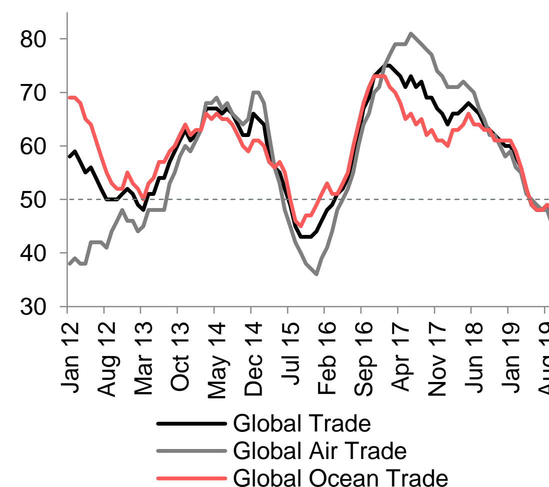


Source: Bloomberg, Santander



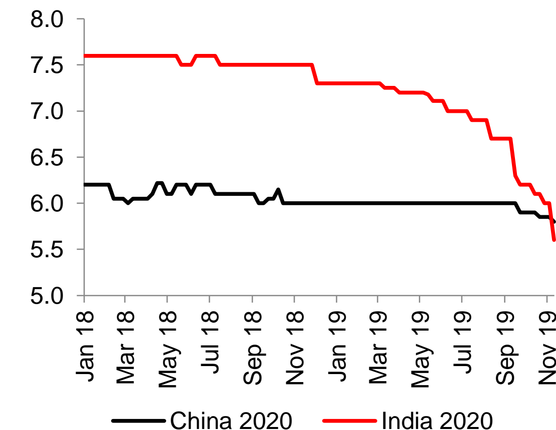
Source: Bloomberg, Santander

DHL Global Trade Barometers



Source: Bloomberg, Santander

2020 Growth Expectations in China and India are Slowing



Source: Bloomberg, Santander

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Global backdrop and risks (2)

We see the following risks to the global economy in 2020:

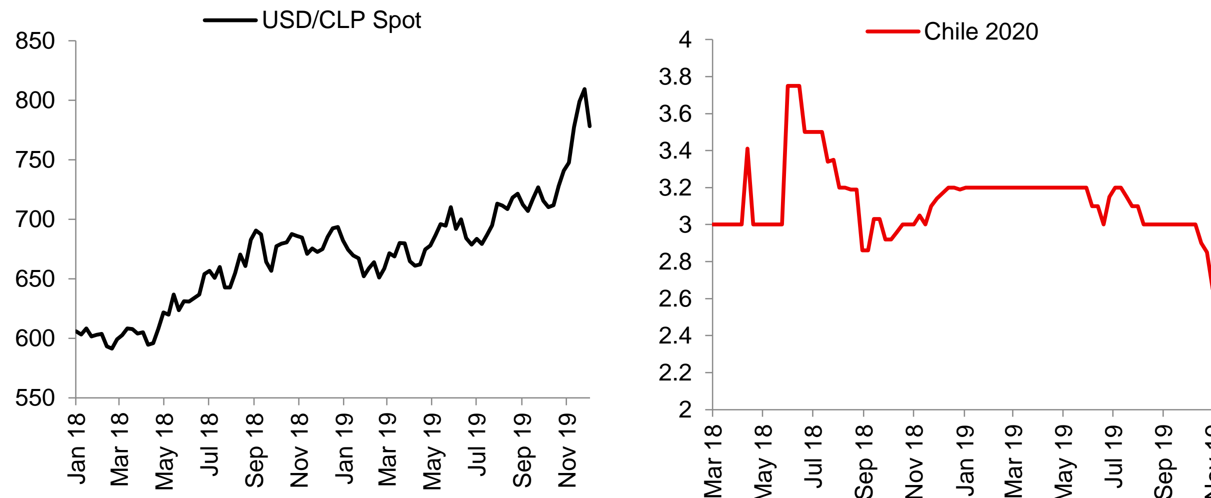
The lack of even a „Phase 1" US-China trade deal. While the deal itself would probably be too shallow and temporary to significantly impact the global economy, the sheer fact of an even small progress in talks would be positive for the markets. Lack of such a deal would push the markets into strong negative sentiment.

Protests and unrest have spread across LATAM countries and already have had significant impact on local currencies (forcing some central banks to intervene – top, left), yields and economic growth rates (top, right). If those unrests are not addressed properly there remains a risk of escalation in 2020 leading to further negative impact on financial assets and possibly on commodities as well if the supply chains would be disrupted (e.g. possible further strikes in the port of Antofagasta, Chile).

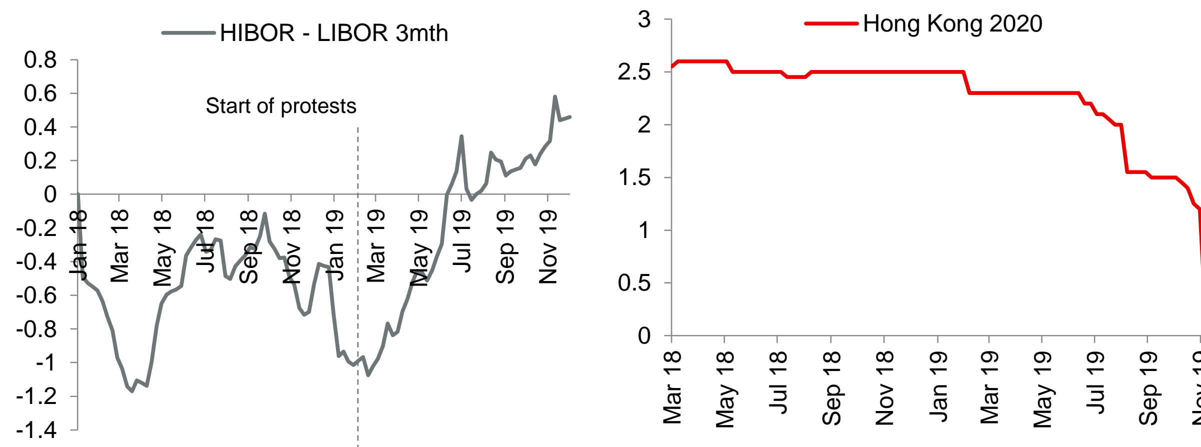
Duration of the protests in Hong Kong has left the scar on the expected growth rate for 2020 (bottom, right) but because of the HKD peg to the dollar the local currency cannot act as a buffer. If the protest continue into 2020, it is worth monitoring funding pressure as proxied by 3mth HIBOR – 3mth LIBOR spread (bottom, left) which has been on the rise since the early 2019.

As Europe grapples with slow growth, eurozone governments might consider increasing fiscal spending at some point in 2020. One of the top candidates for the role would be Germany, which unlike France, has not loosened fiscal policy so far, but also is the biggest European economy and the one with significant budget surplus.

In Chile protests are impacting currency (L) and 2020 expected growth (R)



The HIBOR – LIBOR 3mth spread is an indicator of funding pressure with HKD pegged to USD (L), protests are impacting expected 2020 growth (R)



Source: Bloomberg, Santander

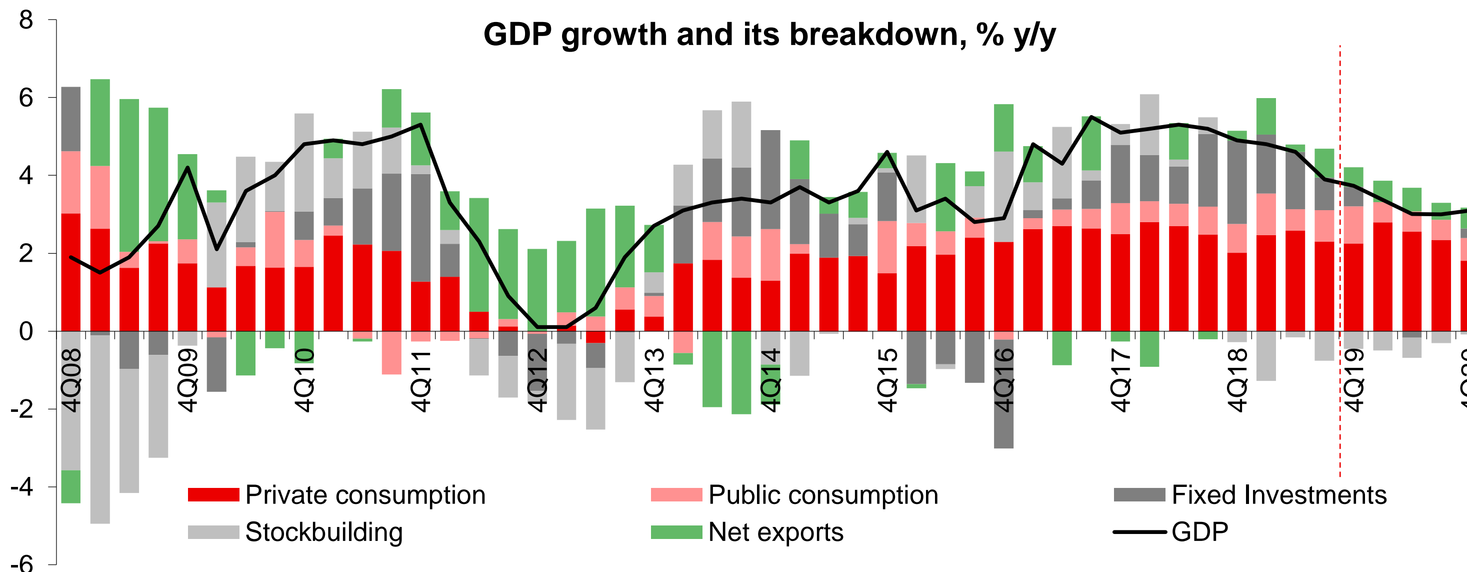
5, 4, 3,… Gradual slowdown in progress

As we expected last year, Polish economy started slowing in 2019. After better than expected 1H19, the third quarter showed a notable deceleration (from 4.8%-4.6% to 3.9% y/y), and yet it remained slightly better than we had predicted last year (3.7%), and probably still slightly above the potential growth level.

Downward forecast revisions for 2020 started, although it is still barely visible in the Bloomberg consensus. But the room for further downgrades does not seem to be great, in our view, given already improving global growth prospects.

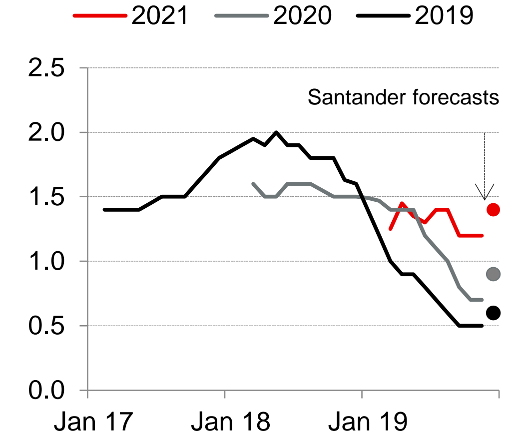
We are adjusting our 2020 forecast slightly lower, from 3.5% to 3.1%, mainly due to more pessimistic view on investments, where numerous signals of stagnation appeared, mainly in the public sector (see pages 14-16). Consumption and net exports should be limiting the pace of the slowdown, though.

Overall, we see GDP growth retracing from c.5% in 2018 to around 4% in 2019 and near 3% in 2020. It should be a good starting point for slight recovery in 2021 if global economy starts bottoming out.

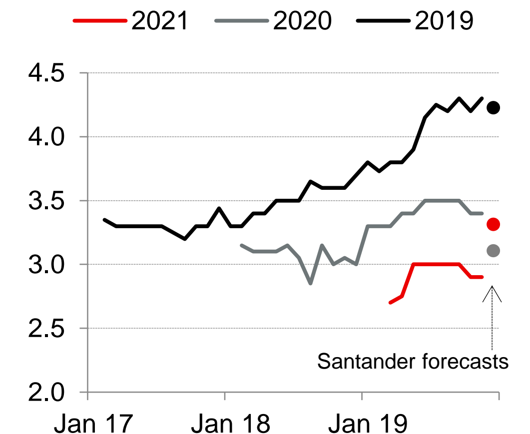


Source: GUS, Santander

Bloomberg consensus for GDP growth in:



Dots represent current Santander forecasts
Source: Bloomberg, Santander



Dots represent current Santander forecasts
Source: Bloomberg, Santander

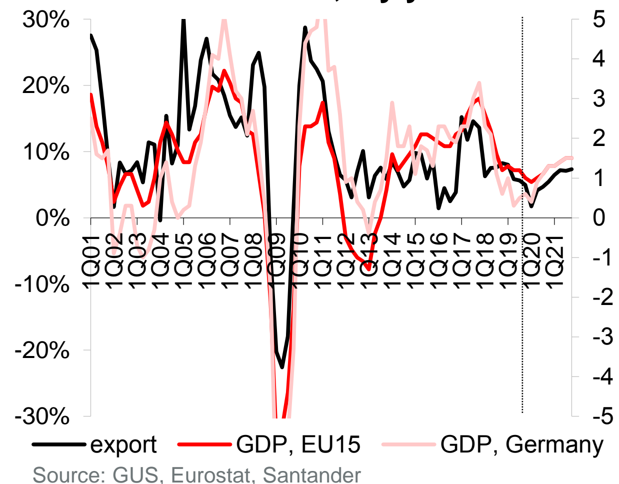
Foreign trade: fingers crossed for the European rebound

The deceleration of the European economies and the German one in particular left marks on Polish exports. Several mitigating factors appeared during 2019, but eventually seem to have failed to prevent a slowdown. These factors are UK restocking (ahead of the first Brexit date), more intensive ties with US and China, improved relations with non-EU neighbours, cyclical changes to Poland's foreign market shares (see top right and bottom right charts).

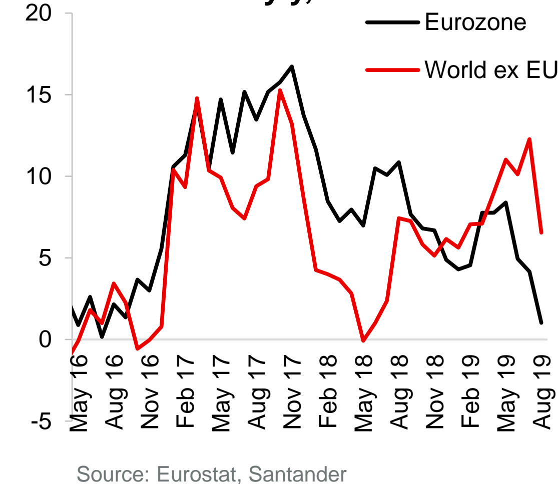
Smoothed export growth in € terms remained in 1H19 in the range observed in 2018 (4-10% y/y). Only the recent observations are indicating a more visible slowdown, especially that companies are pretty downbeat on business outlook. The slowdown in trade with the EU comes from the fact that many member countries are shrinking markets. Notice that Poland is still able to increase exports to most of them despite their total import is declining (bottom left).

Going forward, one thing to notice is that market consensus for economic growth in Germany (by far Poland's the most important trading partner) is higher for 2020 (0.7%) than for 2019 (0.5%). If we take weighted average of growth forecasts for the whole EU, Russia, the US, Ukraine and Belarus, receiving together c90% of Polish exports we get 1.2% for 2019 and 1.1% for 2020.

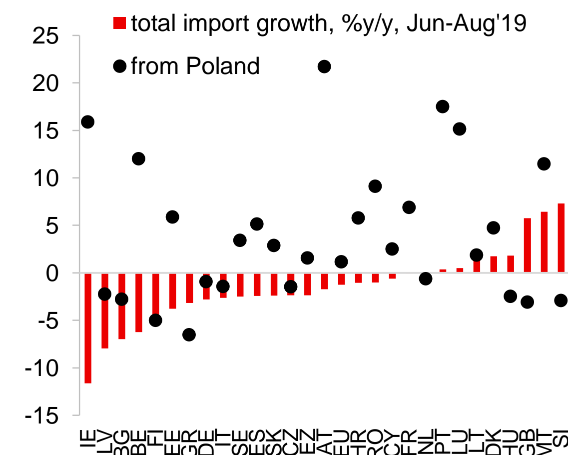
This suggests, in our view, that Polish exports growth in 2020 on average may be only slightly weaker than this year. On a quarterly basis we expect a V-shaped export growth profile: our GDP growth forecast for the euro zone (and Germany) includes a rebound in the coming quarters, which should also mean a change of direction to positive in Polish exports growth, judging by the historical data correlations (top left).



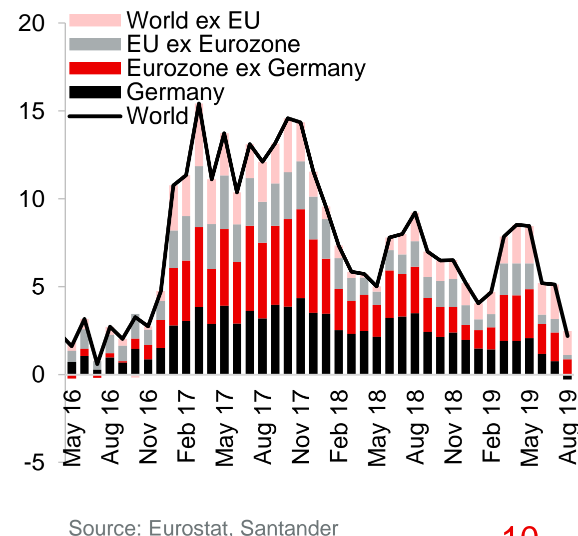
Source: GUS, Eurostat, Santander



Source: Eurostat, Santander



Source: Eurostat, Santander



Source: Eurostat, Santander

Export growth: diversification is not enough

We took a closer look at what happened to exports to the EU, Poland's core trading partner. All broad economic categories are now contributing no more than a year ago. The contribution of consumer goods to Polish export growth to the EU fell less within the last 12M than other broad categories (see top left chart).

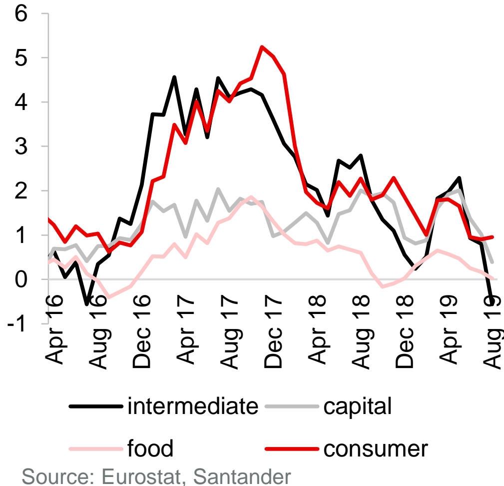
There is no sign yet of a positive turn in demand from EU businesses for Polish goods, in fact intermediate goods are now the worst performer among broad categories, weighing on overall exports growth. But the trade data are quite lagged, and some of the EU leading indicators seem to start bottoming out already (top right).

Polish exporters resorted to diversification of trade ties to make up for the shrinking EU demand and were quite successful in 2019. Only a few EU countries can still show a y/y rise in both the intra-EU trade and in trade with non-EU partners at the same time (bottom right).

The question is how long can Poland rely on the non-EU partners (with a c11% share in total exports) waiting for the EU to recover. What may be enough to prevent outright y/y declines in exports, may be too little to preserve the 2018 and 1H19 growth rates. 2019 was the first time in many years when export/GDP ratio did not grow (bottom left). This was mainly due to weak exports to EU.

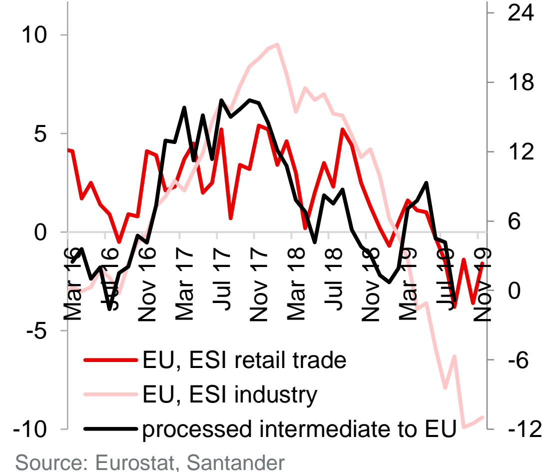
With tentative signs of a rebound in German exports and a chance for tariff cuts between US and China we think some improvement in Polish exports is not that far away. We believe the external environment will generate enough demand in 2020 to keep Polish exports growing, the longer we wait for a rebound in Europe the deeper the export slowdown could be.

Exports growth contributions type of goods, % y/y



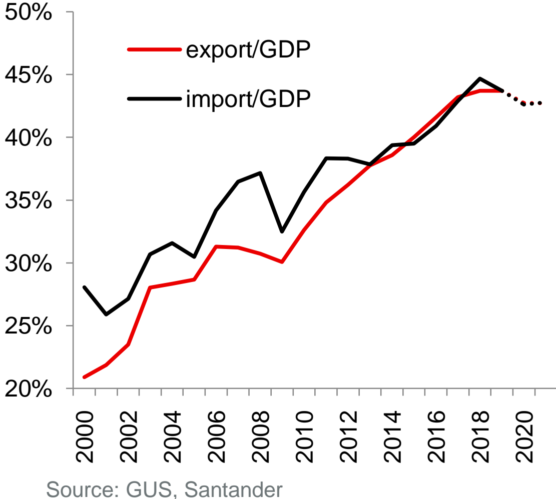
Source: Eurostat, Santander

Intermediate goods exports to EU vs business sentiment, %y/y



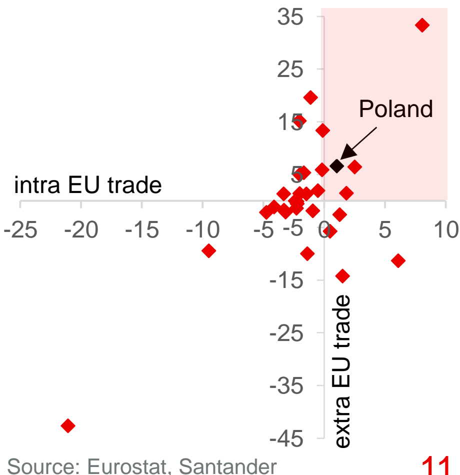
Source: Eurostat, Santander

Trade of goods relative to GDP



Source: GUS, Santander

Exports growth, EU countries, % y/y, Jun-Aug'19



Source: Eurostat, Santander

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Import weakness due to one-offs

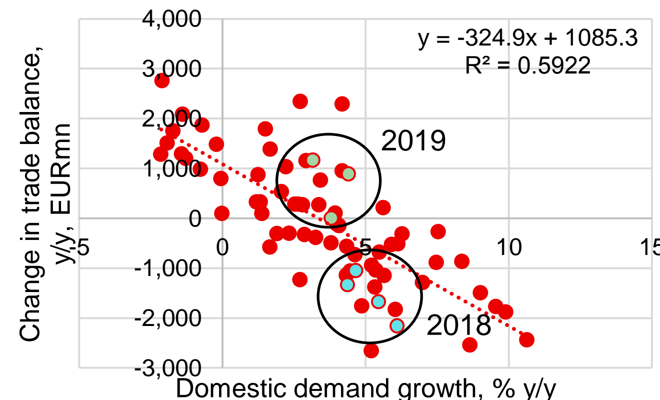
In 2019, we were quite surprised by behaviour of Poland's trade balance, which improved markedly versus 2018 despite the still strong domestic demand (top left chart). The question is: is this a one-off or a new pattern that is likely to hold? Our claim is that this development was mostly due to behaviour of imports, which decelerated from 10.5% y/y in 2018 to 4.0% in Jan-Sep 2019, while exports decelerated only marginally: from 7.4% y/y in 2018 to 6.5% in Jan-Sep 2019.

Analysis of BEC* import categories clearly reveals two culprits of the import weakness – industrial supplies and fuels/lubricants (top right chart).

As regards industrial supplies: imports of primary ones actually improved in 2019, so the processed are the main laggards. Imports of processed industrial supplies are highly correlated with Poland's exports in the very same category (bottom left chart). Weaker situation in global industry weighed on Poland's exports of processed industrial supplies and this translated into weaker imports. Thus, lower imports in this category are only partially responsible for improvement in the trade balance.

However, imports of fuels/lubricants tell a different story: in 2018 Polish companies imported an outstandingly high amount of these products – by over 30% more than in 2017 (bottom right chart). The high statistical base effect is currently yielding a negative growth rate in this category, but it seems that the 2019 import volume is only slightly lower than suggested by economic performance (by EUR0.3-1.2bn). Thus, in our view the trade goods balance improvement was a one-off mostly due to exceptionally high imports of fuels and lubricants in 2018. For 2020 we are expecting a normalisation. Growth rate of imports could go up by 0.1-0.5pp as oil imports return to the relations with GDP growth.

Trade balance surprisingly improved in 2019



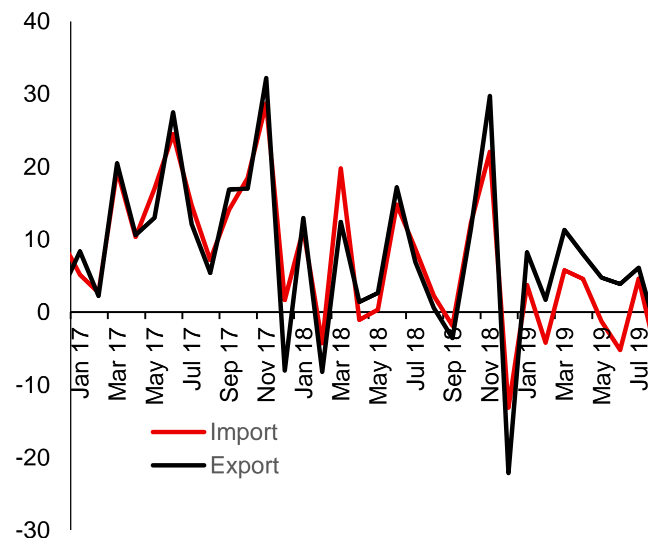
Source: NBP, GUS, Santander

Nominal change of imports by categories, y/y difference in EUR bn

	y/y change Jan-Aug 18	y/y change Jan-Aug 19	Difference
Consumer goods	2.2	2.4	0.2
Food for industry	-0.1	0.0	0.1
Industrial supplies	3.3	0.2	-3.2
Fuels, lubricants	2.9	-0.5	-3.4
Capital goods	2.3	1.6	-0.7
Transport equip.	2.5	1.9	-0.6
Total	**13.2**	**5.7**	**-7.5**

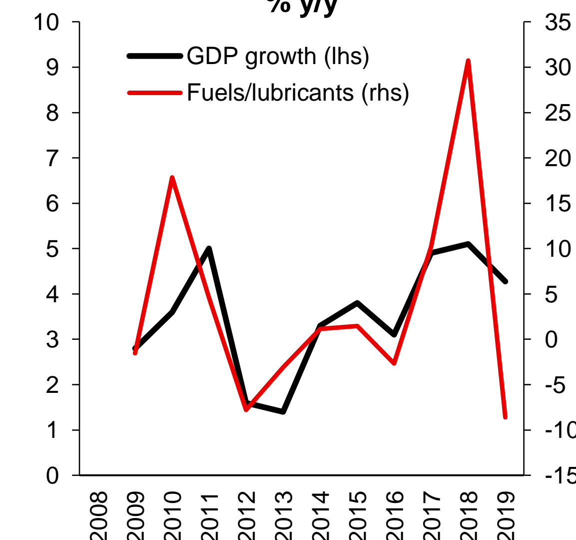
Source: Eurostat, Santander

Processed industrial supplies – export and import, % y/y



Source: Eurostat, Santander

Fuels/lubricants imports vs GDP growth, % y/y



Source: Eurostat, Santander

* BEC = Broad Economic Categories

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Current account to improve in 2020

Subdued economic activity abroad will negatively affect Polish exports in the nearest quarters, while slower growth of domestic demand will weigh on imports, so we expect both categories to be on average slightly lower than in 2019, but to be rebounding after reaching a trough in early 2020 (top left chart). Exports will be still outpacing imports, so we see some slight improvement in goods balance.

In our view, a similar trend will be witnessed in services, but the pace of improvement is likely to slow a bit as compared to previous years, partly due to worsening climate in transport sector, which not only feels the impact of intra-European trade slowdown, but also struggles with changes in regulations. The so-called EU Mobility Package could potentially limit the expansion of Polish road transport services (16.1% of total service export, top right chart) in the coming years and/or encourage Polish firms to relocate to other countries.

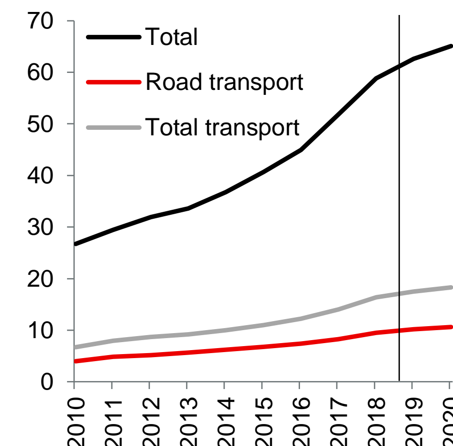
On the primary income balance, we expect a further strong (yet slower) growth of outflowing salaries, in line with developments on the domestic labour market (strong presence and wage hikes for foreign workers, tentative signs of Polish migrants returning from abroad). Weaker GDP growth will weigh on companies' results and this will limit the growth rate of outflowing dividends and reinvested earnings, while outflowing incomes on portfolio investment will continue to fall gradually. The inflowing revenues will grow slower than total outflows, given less dynamic growth of EU inflows, so we expect some slight widening of primary income deficit in 2020.

The secondary income balance should be generally governed by the same trends as primary balance (growing outflowing salaries, higher Poland's contribution to the EU with stabilising or even falling inflows from the EU), we expect its deficit to widen slightly.

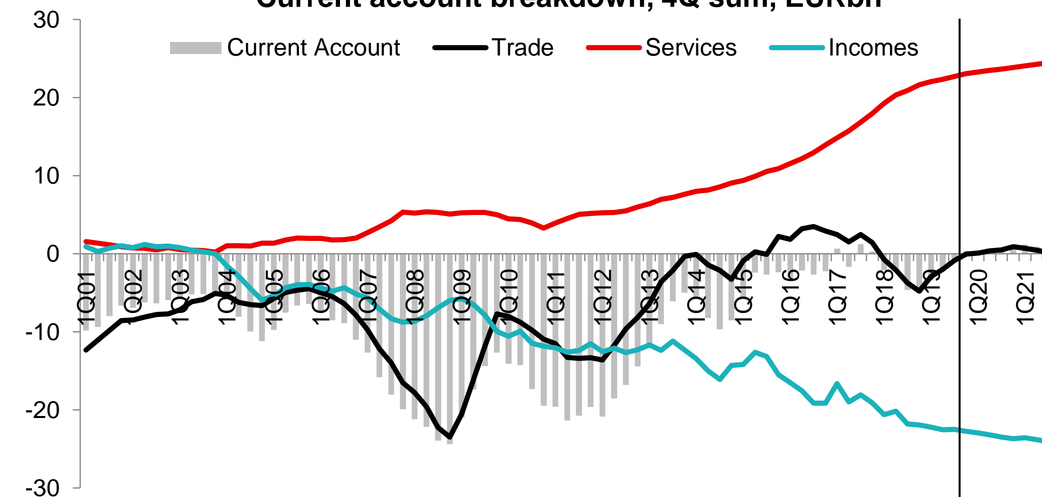
All in all, we expect some improvement in the current account surplus to 0.2% of GDP from +0.1% expected at the end of 2019 (bottom chart). We expect net exports to contribute 0.5pp to GDP growth in 2020 as compared to 0.6pp in 2019.

Source: NBP, Santander

Export of services, EURbn



Source: NBP, Santander



Source: NBP, Santander

Dark clouds over investment outlook

We expect investment growth to slow down from 5.8% in 2019 to a mere 0.2% in 2020. In our view, there are many signals showing that investment activity is decelerating at a fast pace in 4Q19:

1) Major deceleration of construction output (investment in construction makes up roughly 50% of total investment), see top left chart.

2) Declining capacity utilisation (yet from a very high level) see top right chart.

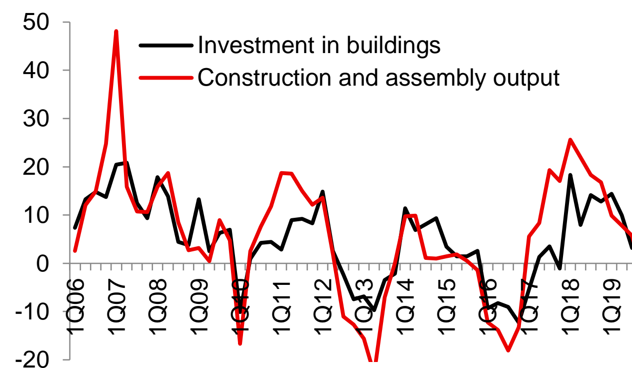
3) Declining demand for investment loans (according to NBP Senior Loan Officers' Survey), see bottom left chart

4) Declining leases, see slide 16.

5) Major decline of GDDKiA (public agency for road construction) tenders: total value to ytd tenders fell by over 80%, see bottom right chart.

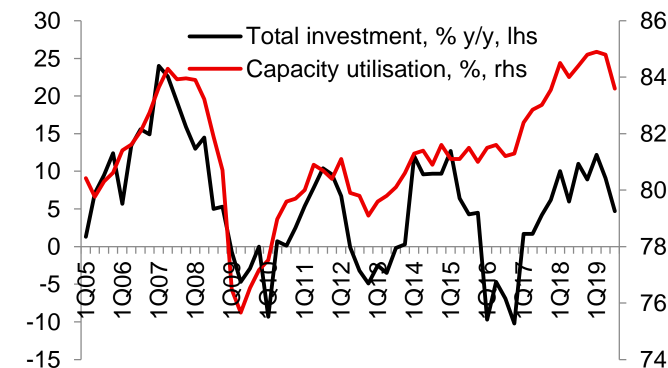
We see growing evidence that this weakness will hold in the quarters to come and we elaborate more on public and private investment on the following two slides.

Investment and construction, % y/y



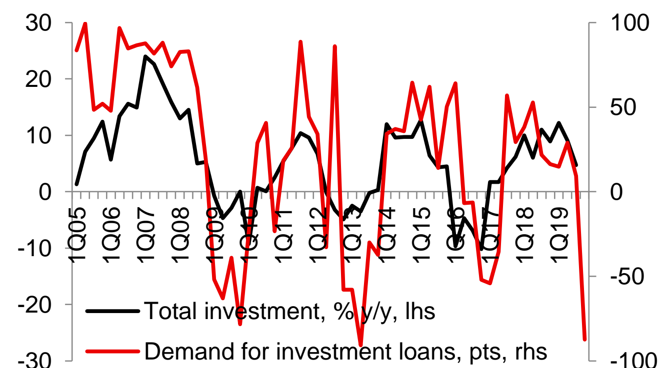
Source: GUS, Eurostat, Santander

Investment and capacity utilisation



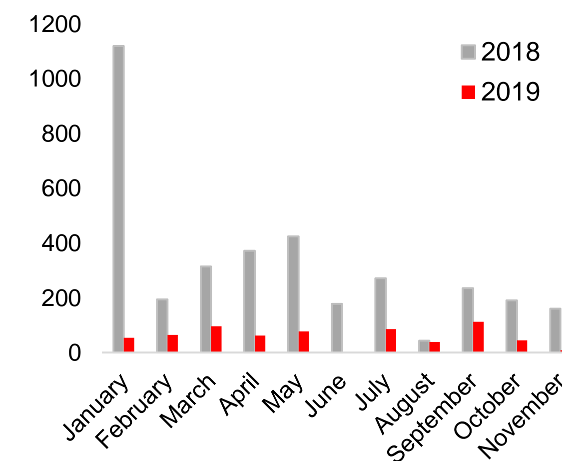
Source: GUS, NBP, Santander

Investment and demand for investment loans



Source: GUS, NBP SLO survey, Santander

Successful GDDKiA tenders, PLNmn



Source: GDDKiA, Santander

Santander

Public investment to remain weak

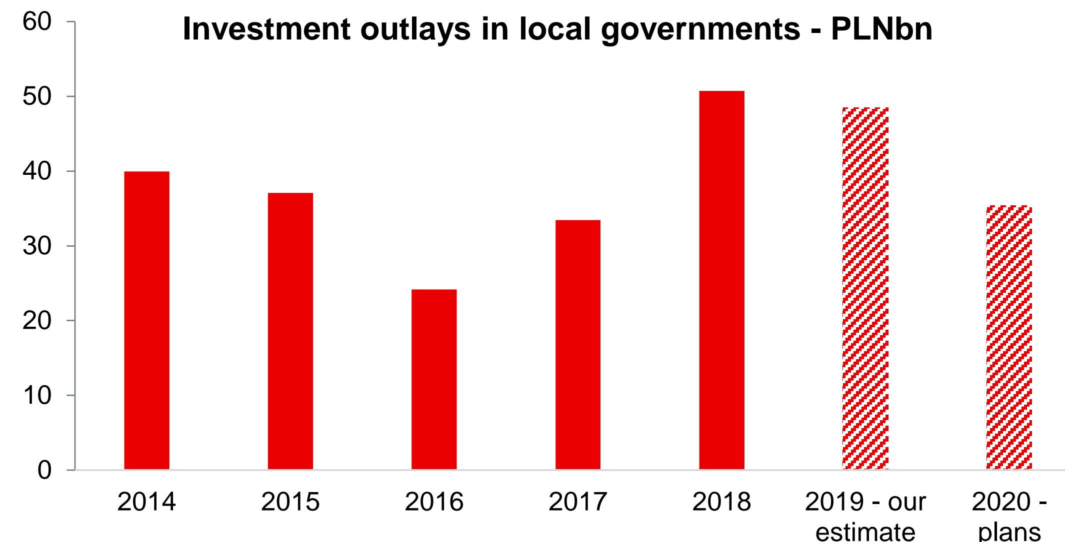
3Q19 showed a major slump in local government's investment: -8.9% y/y versus +9.6% y/y in 2Q19 and +33.8% y/y in 1Q19. In our view, local governments' weakness in investment outlays will be prolonged.

First, local governments are facing rising costs of public services and decreasing incomes, e.g. due to cuts in PIT rates, which make up 20% of their total revenues. This is encouraging local governments to cut spending in non-essential sectors as well as boosts their debt. Data show that a growing number of local government entities are expected to surpass the 60% debt-to-revenue threshold, see bottom left chart (note that this threshold used to be legally binding for local governments, but it is not anymore, so we are using it just as an indicator).

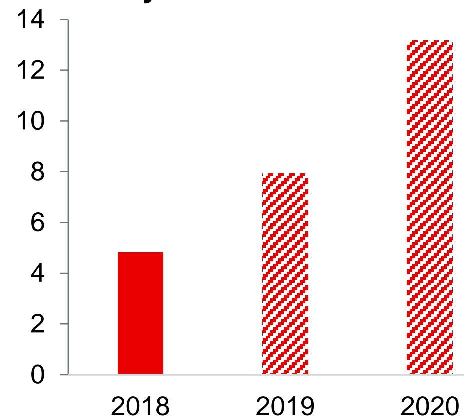
Second, as we have been claiming on numerous occasions, the EU funds utilisation has peaked at the turn of 2018 and 2019, so EU-funded investment will show a declining contribution to total investment growth in the upcoming years, see bottom right chart.

The two factors mentioned above have their reflection in local governments' investment plans for 2020 (see top chart): so far the plans assume a decline by over 25% as compared to the outcome we expect for 2019. Given that the actual realisation usually does not exceed 85% of the initial plan, we would not rule out a 30% decline in local government investment in 2020.

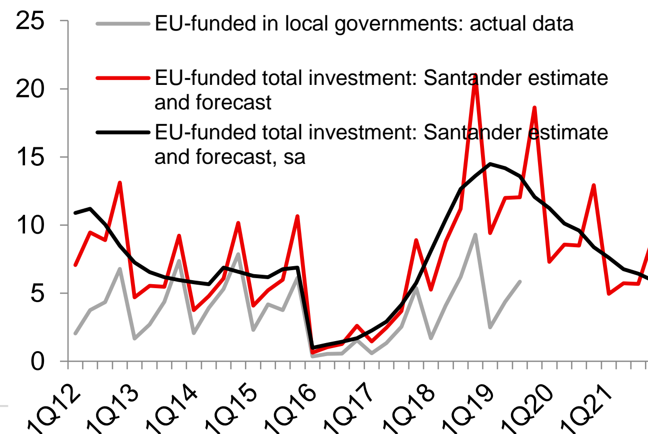
Investment of the central sector also decelerated markedly, showing -3.8% y/y in 1Q19 and about 4% y/y in 2Q19 versus +40.1% y/y in 4Q18. In our view, central investment will remain sluggish, given the government's focus on social benefits and low number of road building tenders, shown on the preceding slide.



Source: Finance Ministry, Santander



Source: Finance Ministry, Santander



Source: Ministry of Development, Santander

Santander

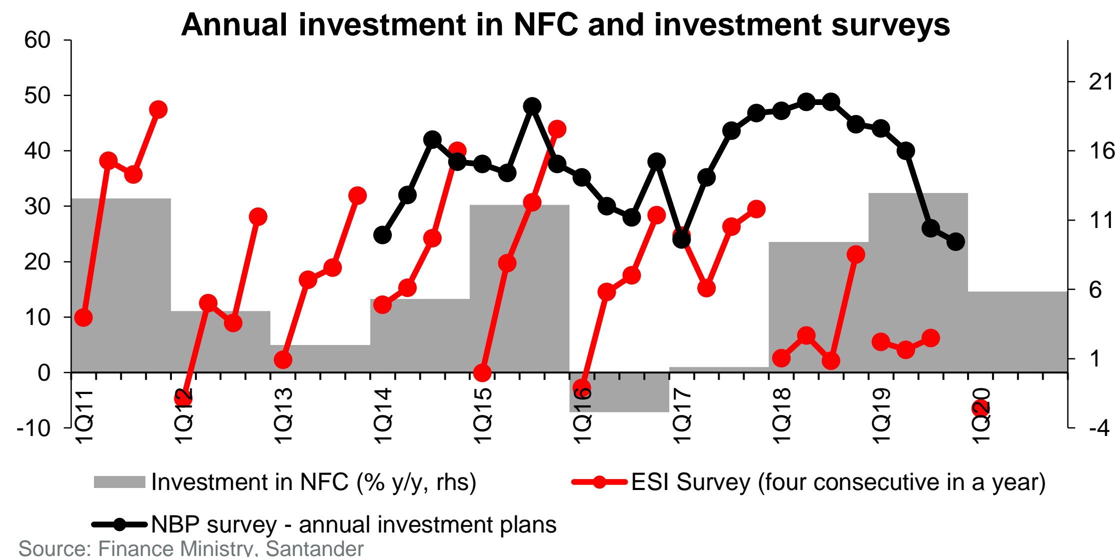
Private investment slowing down

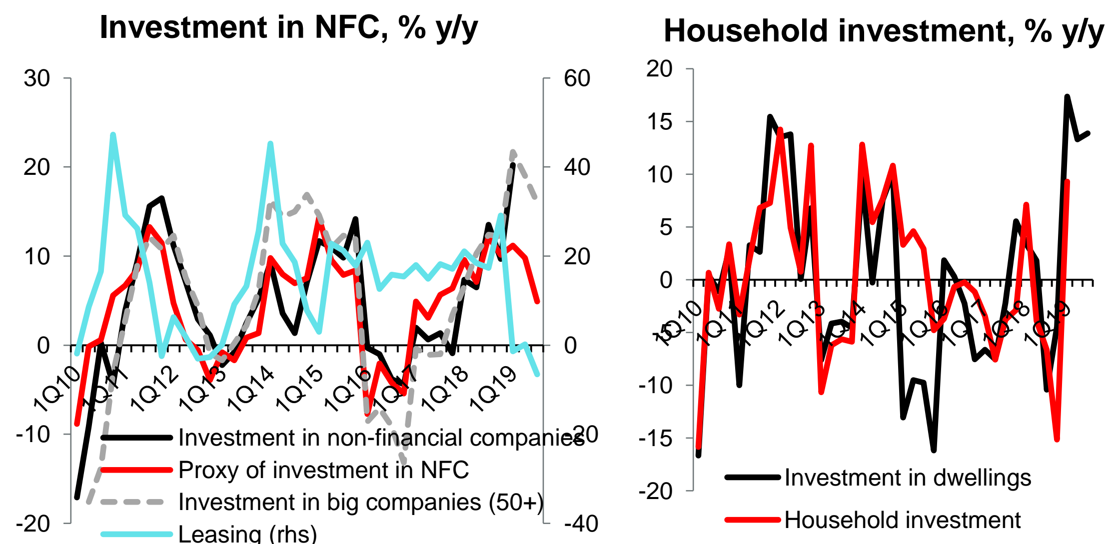
General outlook for private investment is not bright, as the economic climate is deteriorating quickly, and this is likely to affect investment decisions in non-financial companies (NFC). The worse investment climate seems to be reflected in sentiment surveys, as both ESI/GUS and NBP survey showed a major downward correction of investment plans: the most recent edition of both surveys showed the lowest level in years (see top chart). However, we still have neither seen data on total private investment in 3Q19, nor breakdown for household and NFC outlays in 2-3Q19, so have to speculate a bit on that.

In our view, NFC investment was slowing down in 3Q19. First, numbers on investment outlays in the biggest companies (50+) showed a deceleration to 11.3% y/y from 17.0% y/y in 2Q19. Second, investment in non-housing construction and machinery, which we use to proxy NFC investment, showed a major slowdown in 3Q19 to 1.2% from 10.2% in 2Q19 and to 5.6% from 11.6%, respectively (see bottom left chart). These numbers suggest actually that the size of the slowdown in 4Q19 could be significant – typically we would be expecting some inertia, due to continuing projects, but construction, where inertia is stronger, has already stagnated (autocorrelation coefficient: 0.7 for construction, 0.45 for machinery). Third, leases declined by 6.5% y/y 3Q19, recording the strongest decline since 2009.). The only positive signal on investment is a GUS number on estimated value of new investment in 3Q19, which showed some rebound, but only in transport, while other sectors recorded a further reduction.

Household investment is strongly connected to investment in dwellings and in our view the housing market boom is likely to hold for some time. Even if slowing labour market and deteriorating consumer optimism hit the demand for flats, developers have so many projects in the pipeline that they would be forced to reduce prices, supporting sales and mitigating the slowdown.

To sum up, we are expecting household investment to slow down to 5.0% y/y in 2020 from 7.0% y/y in 2019 and NFC investment to go down to 6.0% y/y from 14.0% y/y.





Source: Eurostat, Santander

Source: Ministry of Development, Santander

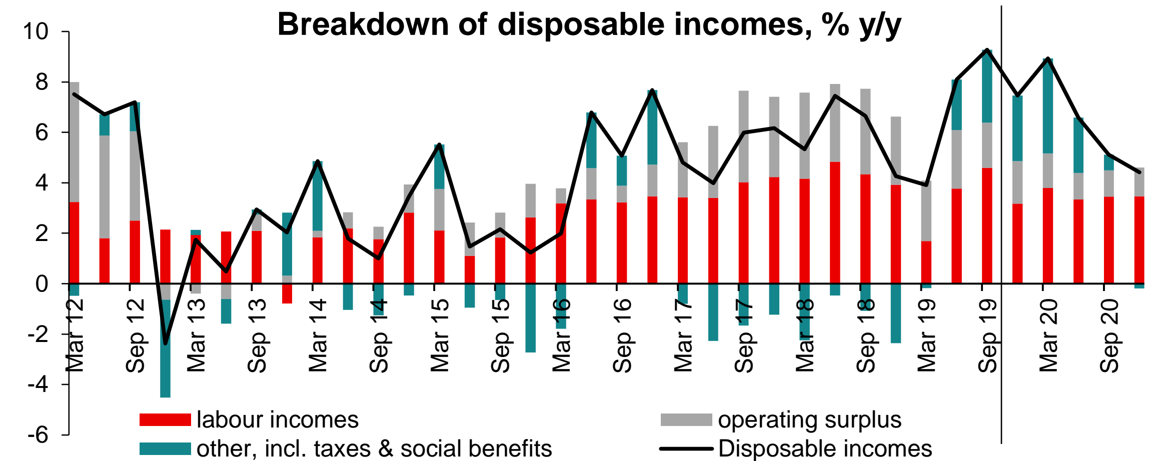
Santander

Consumption fuelled by incomes

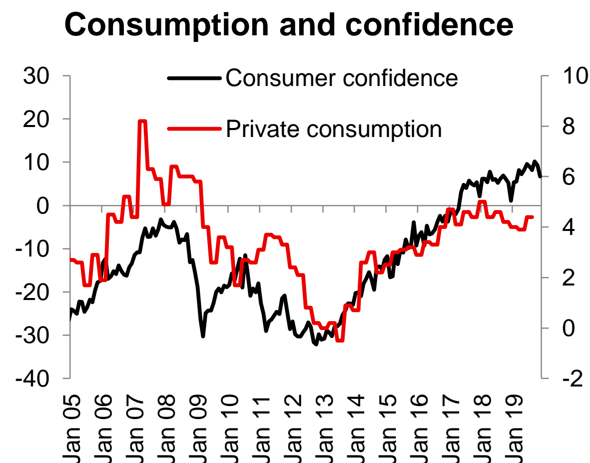
We expect the disposable incomes to be decelerating over the course of 2020, but from a very high level, close to highs seen last in 2008-2009.

In our view, labour incomes will remain quite robust given stabilising employment and still decent wage growth (see pages 18-20). Incomes from the operating surplus will be under negative pressure of slowing GDP growth. Meanwhile, the positive impact of changes in social benefits / taxes, generated by extension of 500+ child benefit programme, 13th pension (to be repeated in the coming years) and cuts in PIT rate, will wane over time (see top chart).

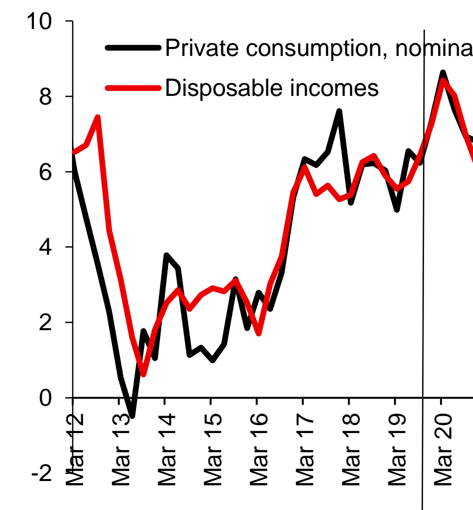
Slower growth of incomes and higher CPI inflation will bring the consumption growth down in H2 (bottom middle chart), but in our view this deceleration will not be major, as consumers will try to smooth their spending at the cost of savings, which we expect to have been building up throughout 2019. Consumer optimism moved back a bit, but remained generally strong and this should be supportive for consumption (see bottom left chart). We are forecasting private consumption to grow by 4.1% in 2020, as compared to 4.2% in 2019. No hike in energy prices would add 0.1-0.2pp to consumption.



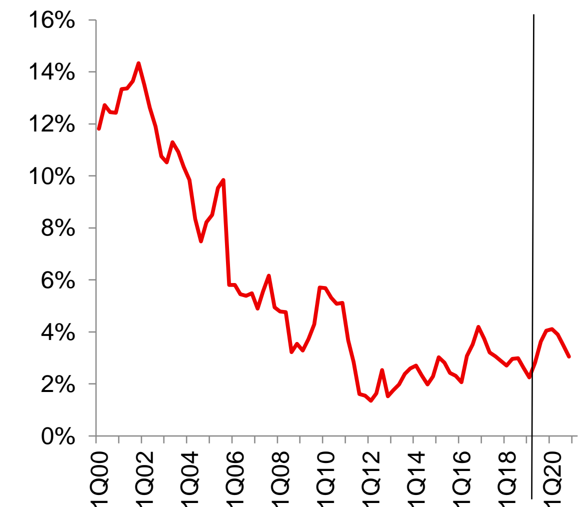
Source: Finance Ministry, Santander



Source: GUS, Santander



Source: NBP, Santander



Source: GUS, Santander

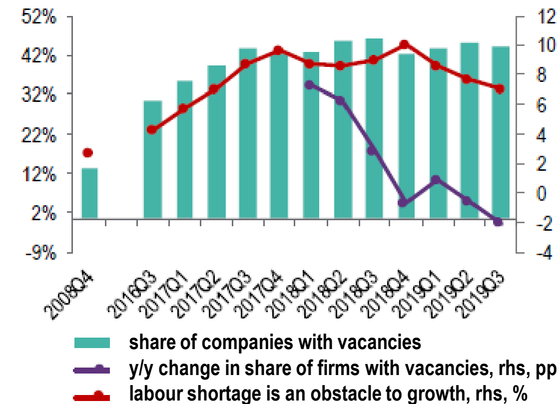
Labour demand cooling down

The labour market remained tight in 2019, judging by new record lows in the unemployment rate and by shares of companies reporting labour shortages (top left chart).

At the same time we saw symptoms of weakening labour demand: lower pace of job creation and a rise of job destruction (top middle), falling hiring plans reported in (most of) business surveys (top right, bottom right), drop in corporate employment in the last few months (bottom left).

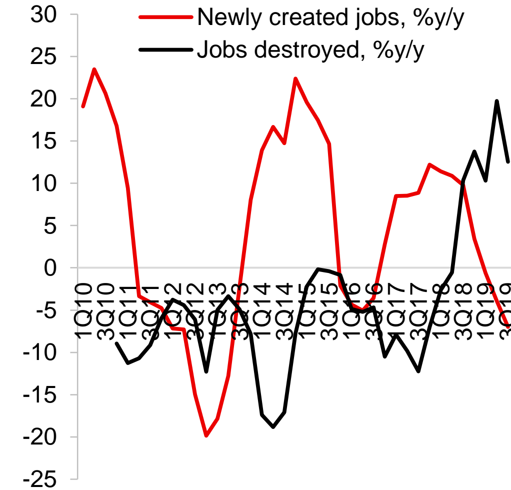
We expect employment to stagnate in 2020, as GDP growth around 3% p.a. does not really require more jobs to be created (bottom middle chart).

Share of companies: with vacancies and declaring that labour shortage is an obstacle to growth



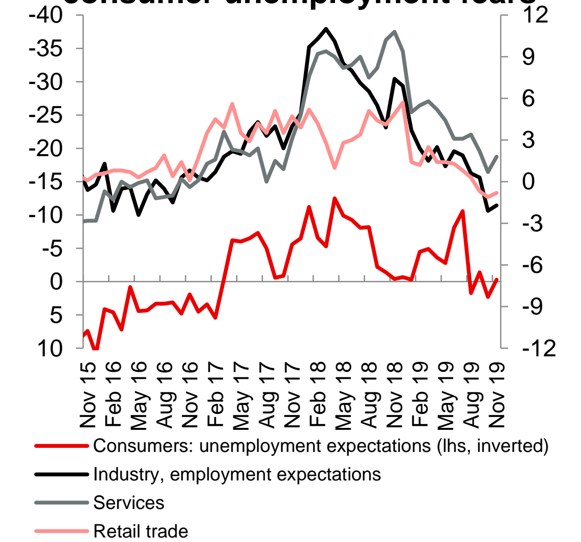
Source: NBP Quick Monitoring Survey

Labour demand and vacancies, 4QMA



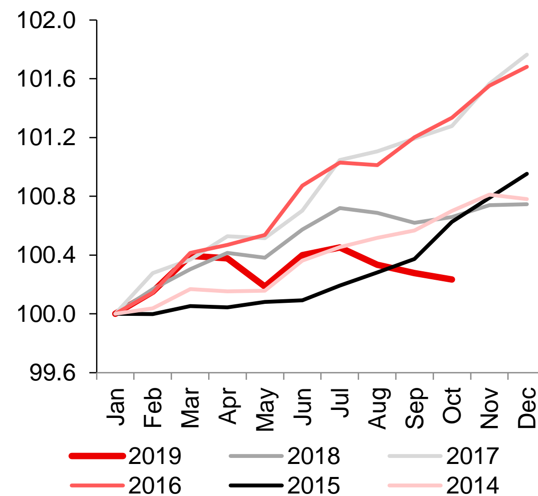
Source: GUS, Santander

ESI employment indices and consumer unemployment fears



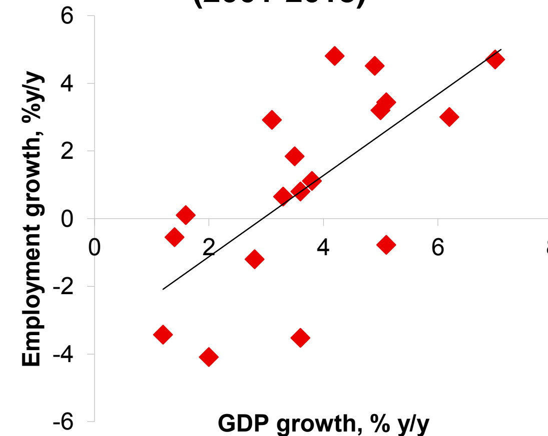
Source: European Commission, Santander

Employment in corporate sector (Jan=100)



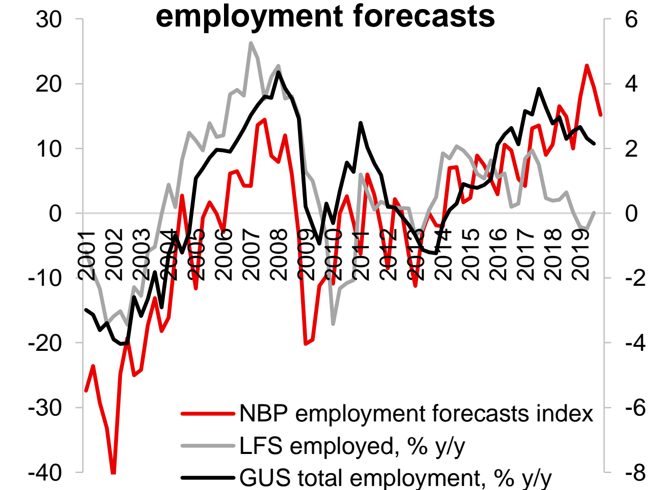
Source: GUS, Santander

Employment growth vs GDP growth (2001-2018)



Source: GUS, Santander

Employment growth and employment forecasts



Source: GUS, NBP, Santander

Santander

Labour supply depends on migrants

As we have argued many times in the past, the utilisation of the domestic labour resources is virtually full. The domestic working age population and the number of professionally active people have been in decline in recent years due to the rapid ageing, shrinking by 100-200k people per year since 2016. Even the steady increase of labour participation rates in most of age groups (bottom right chart) is not quick enough to reverse or even to stop this trend.

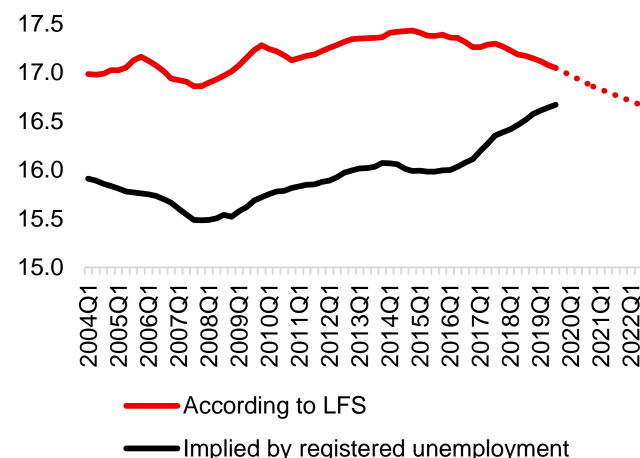
Poland still enjoys the inflow of migrant workers, mainly from Ukraine. We see evidence of this trend in social security registers (top right), data about border crossings, or even unemployment statistics (the latter do not show it explicitly, but the growing migrant population is reflected in quickly rising implied number of professionally active people, derived from the registered jobless rate; it contrasts with declining LFS numbers on active population, which exclude short-term migrants – top left).

In 2020 the migrants' inflow may slow, due to (a) further decline of relative attractiveness of Polish market to Ukrainians (measured by relative wage level, job security, FX rate) and (b) temptation to seek career opportunities in Germany after it opens borders for professionals (bottom left).

However, as the demand for jobs weakens, this is going to be less of a problem for firms. In fact, in case of deeper slowdown, short-term migrant workers are probably the first to suffer job cuts. Also, the downturn in German economy reduces the risk of significant outflow.

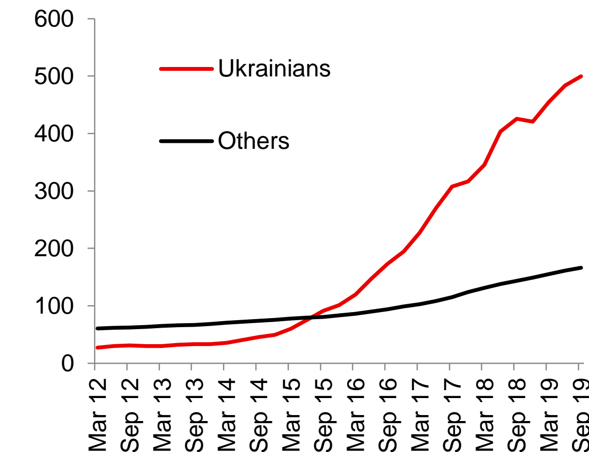
Poll by Personnel Service, recruitment company seeking Ukrainians for Polish companies, showed a gently declining interest in getting Ukrainian workers and a growing number of those telling they would not consider hiring a Ukrainian at all (78% of companies vs 74% a year ago).

Professionally active population (4qma, millions)



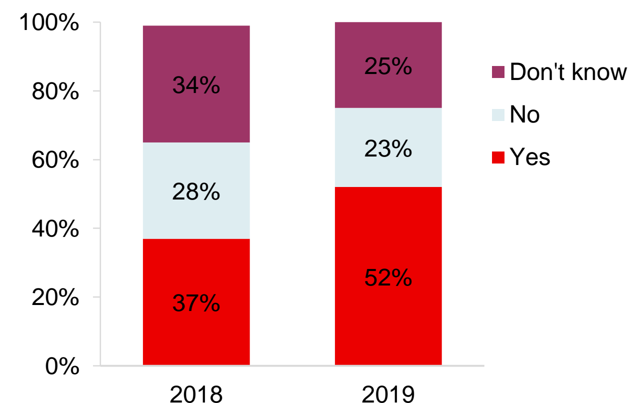
Source: GUS, Eurostat, Santander

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



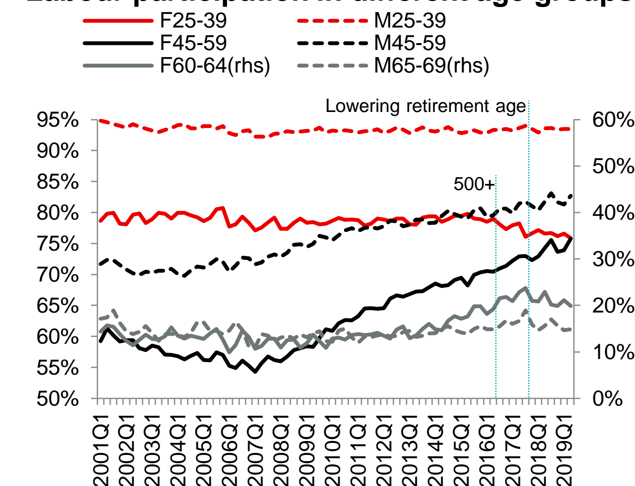
Source: ZUS, Santander

Survey among Ukrainians workers in Poland: Do you consider moving to work in another country?



Source: OTTO Workforce

Labour participation in different age groups



Source: Eurostat, Santander

Santander

Wage pressure to ease… slightly

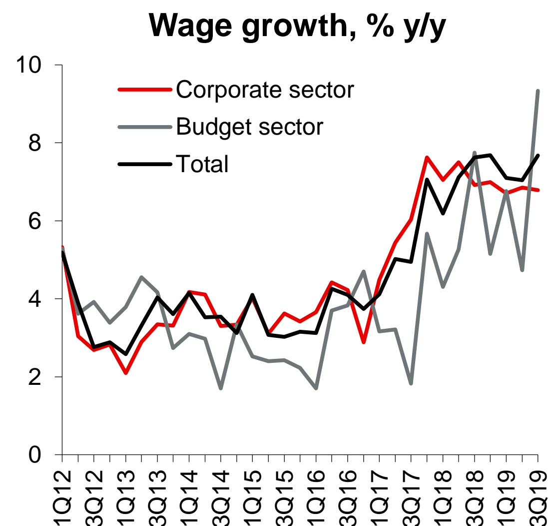
NBP in the last Quick Monitoring quarterly report signalled lower wage pressure felt by the surveyed enterprises (top right chart). This is consistent with declining momentum in corporate wage growth statistics (top left).

Surprisingly, the economy-wide wage growth deviated from corporate wage growth and accelerated to 7.7% y/y in 3Q19, but it was caused mainly by large-scale wage hikes in the budgetary sector (education). In general, it looks like the weakening labour demand will result in easing of the wage pressure in the coming quarters.

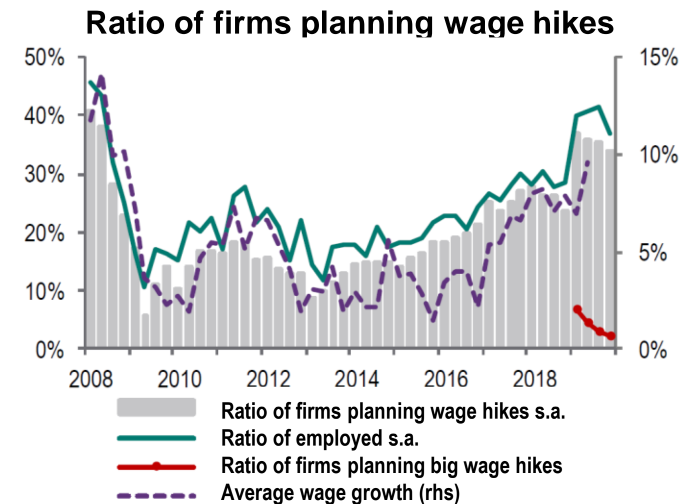
For the last couple of years the wage pressure in Poland has been dampened by the growing inflow of Ukrainians (bottom right). The inflow might decline next year, but together with job opportunities. Weaker labour demand may prove a stronger factor than the potential reduced inflow of foreign workforce.

The 15% minimum wage hike in 2020 will add c. 1pp to total wage growth in the economy, according to our estimate. But we believe that in case of better paid jobs a gentle slowdown may take place in response to the changing economic conditions. Note also that a rise of minimum wage does not necessarily mean a rise of labour income – in some cases it could only mean a different structure of the pay (higher basic wage, lower productivity-linked part).

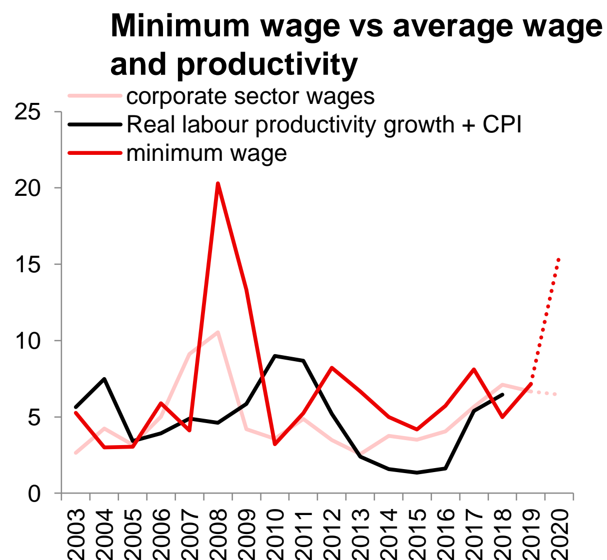
Overall, the labour market may see both a lower demand and lower supply next year, leading to a gradual deceleration in wages.



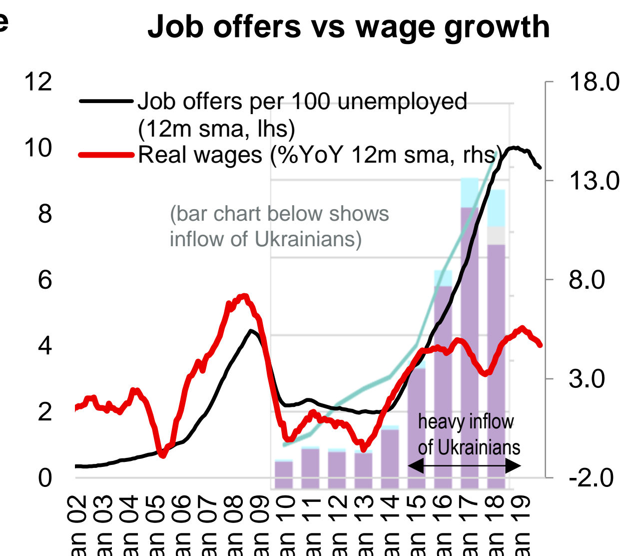
Source: GUS, Santander



Source: NBP Quick Monitoring Survey



Source: ZUS, Santander



Source: ZUS, GUS, Santander

Santander

Costs of labour increasingly painful

It looks like the shortage of workers recently became lesser constraint for Polish companies. But costs of labour remained the top challenge (see top left and bottom left charts).

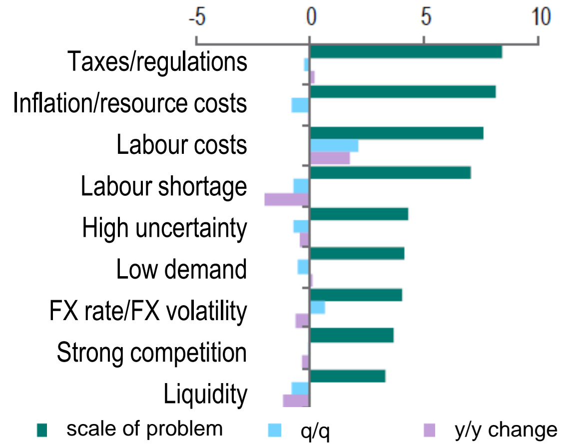
Labour costs were the fastest growing category of company costs in 2019 (bottom right). The economy is slowing down and yet labour costs are about to further rise significantly, partly due to administrative decisions like the introduction of PPK (employee capital plans) and the large rise of the minimum wage. Companies can respond in 2020 with lower recruitment and/or transmission of higher costs to own prices. As a result employment growth may slow down more while core CPI would be supported. The mitigating factors are signals of easing wage pressure (top right) and the behaviour of other company costs.

Other types of costs, apart from labour costs, seem less of a concern for companies. Producer Price index, which is a mix of natural resources, intermediate goods for business and prices of final industrial products, stopped growing y/y in October vs 2.5% y/y average growth in 1Q19. It will in our view show only marginal growth of c0.7% in 2020. This should improve companies' tolerance for further wage growth, without resignation from further recovery of margins.

If GDP growth drops more than we expect and trigger job shedding, then there are two issues to take under consideration: the presence of foreign labour force (easier to remove from payrolls when necessary) and the tighter tax compliance.

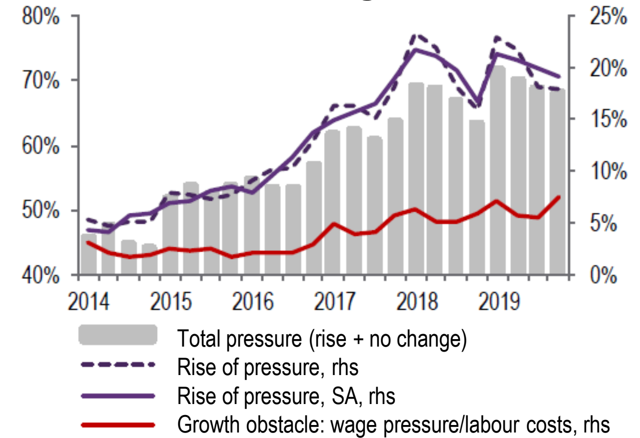
The government's drive to improve tax compliance through tighter tax and social security contributions system might have reduced manoeuvring space for companies faced with quick rise of labour costs, raising risk that at some point of the slowdown companies would need to respond with more layoffs. But, as we mentioned earlier, the first wave of job cuts is likely to affect migrant workers.

Barriers of growth (% of the surveyed companies), 3Q19



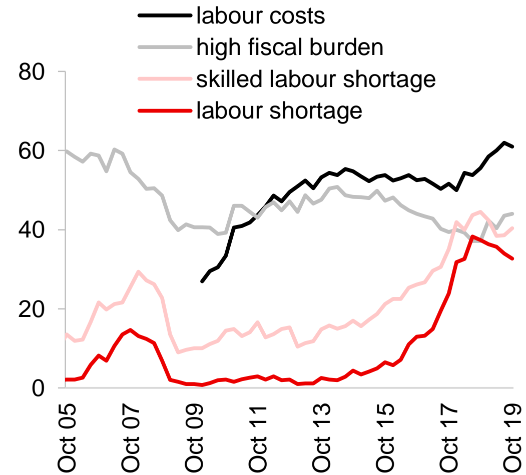
Source: NBP Quick Monitoring

Share of companies: feeling wage pressure; declaring wage pressure/high labour costs as an obstacle to growth



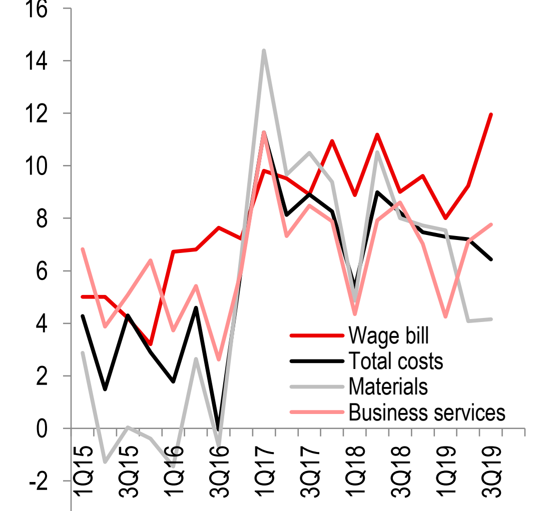
Source: NBP Quick Monitoring

Main obstacles to growth, industry, % of companies



Source: GUS, Santander

Enterprises employing 50+, costs, %y/y



Source: GUS, Santander

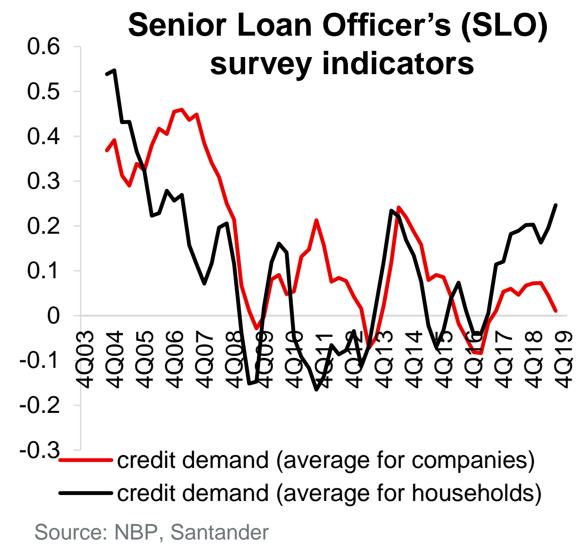
Santander

Credit crossroads

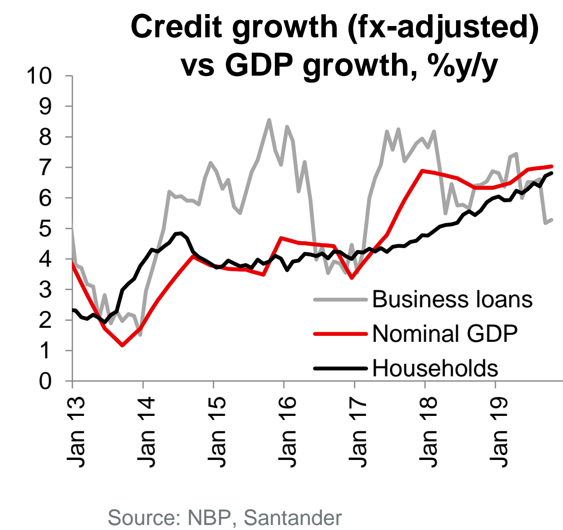
The main trends in monetary aggregates remained intact in 2019, letting M3 grow at 9%+ y/y: demand deposits accelerated further to c14.5% y/y, cash in circulation showed stable high growth above 11% y/y. Consumer loans maintained a c9% y/y growth rate while PLN mortgage loans reached 12% y/y. At the same time there was a deceleration in corporate loans, both PLN and fx-denominated. The portfolio of fx mortgage loans kept shrinking at c4% y/y as there was no relevant new sales in this category to offset repayments.

It seems there are two trends hidden beneath the apparently neutral/boring headline monetary data. Total credit grew at a similar rate to nominal GDP. However, certain divisions appeared at the sectoral level. The very low rates environment and still almost record high consumer optimism helped maintain quick rise of household credit. Banks show cautious stance vs this elevated household demand, by gradually tightening credit criteria (consumption did not slow down on this tightening in previous years because of fiscal stimulus). On the other hand the poor global growth outlook decreased corporate credit demand and banks seem reluctant to supply credit too this segment.

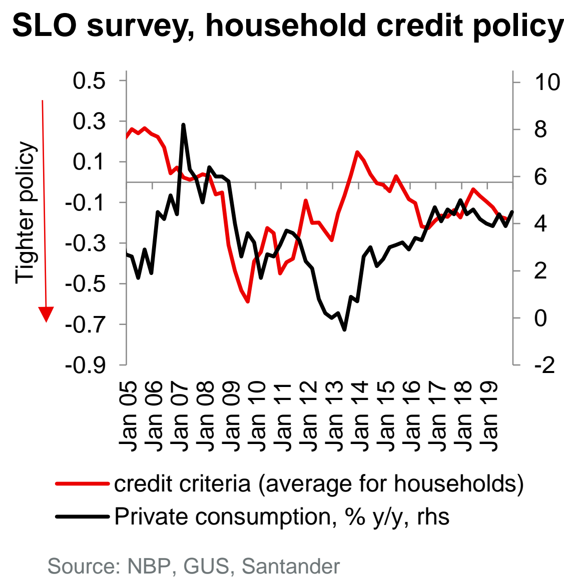
The NBP's Senior Loan Officers' survey (SLO) showed that in 2019 banks started to tighten credit policies. The report also signalled an abrupt decline of investment-linked and working capital credit demand from enterprises. The household sector wants to increase indebtedness, but banks are trying to cool down this segment with stricter criteria. Households may be trying to extend the period of strong consumption growth when wage bill is losing pace and social transfers may stop boosting incomes in a couple of quarters. The credit demand may also be stimulated by the quickly growing housing prices. There was even an acceleration of credit card activity in 2019 after several idle years.



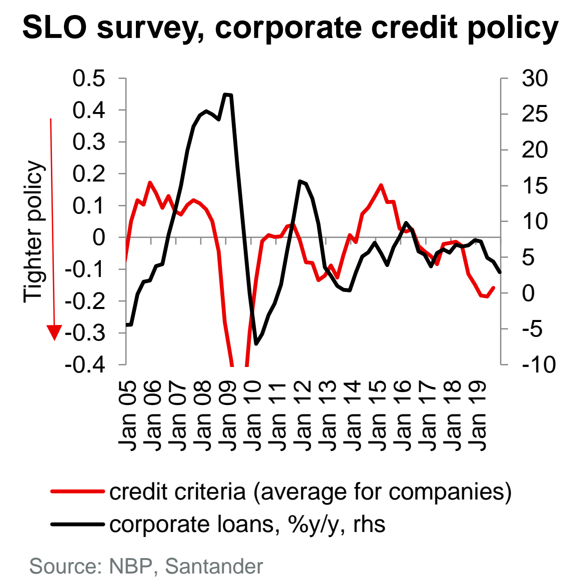
Source: NBP, Santander



Source: NBP, Santander



Source: NBP, GUS, Santander



Source: NBP, Santander

Santander

Corporate credit: slowing or not?

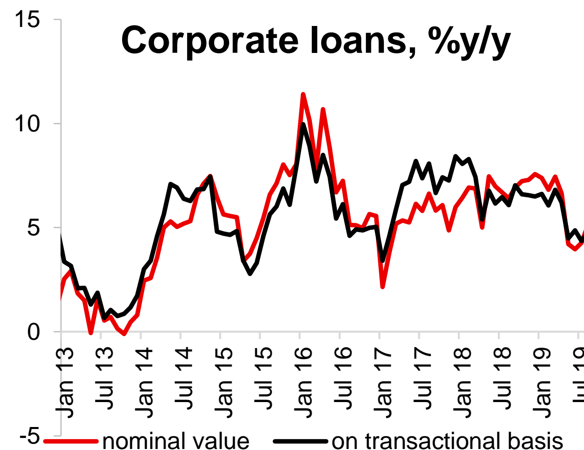
We assume that the slowdown in corporate credit comes from weaker economic outlook and stricter credit policies of banks, counterweighing the financing demand linked to the necessity to buy less labour-intensive technologies, to cope with the growing labour costs.

Long term credit of large enterprises moved between -3% y/y and +1% this year, while short-term loans in this sector have seen a mild slowdown so far and are still growing at c5% y/y. SMEs loan growth decreased from 15-20% at the start of the year to less than 10%.

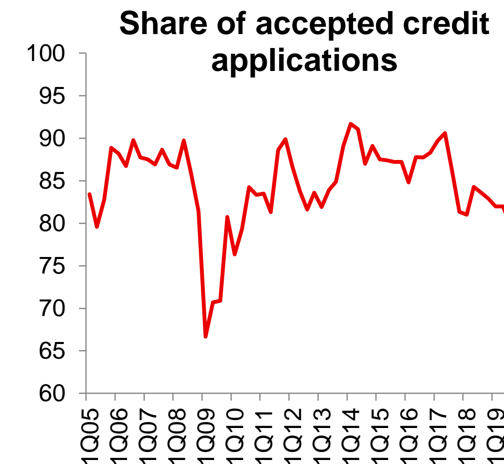
Surveys show that the share of companies that apply for credit is more or less constant in recent years. At the same time, the share of accepted credit applications is heading lower recently.

Another thing that drives corporate credit volumes lower is the growing pace of credit repayments, while origination is flat/declining. This could be a sign that companies are doing what is possible to cut down costs of current activity – including financing costs, (possibly using low interest-paying deposits). This might also reflect the lower need for working capital due to declining activity.

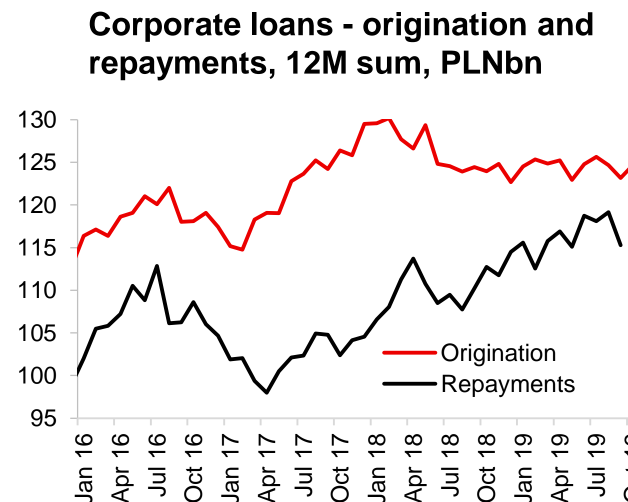
In recent years there was an increased interest of companies in leasing of transport and building equipment and other machinery. However also in this area there are reports of a slowdown.



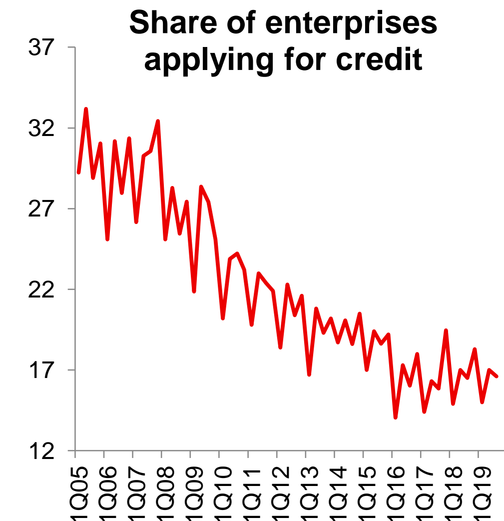
Source: NBP, Santander



Source: NBP Quick Monitoring



Source: NBP , Santander



Source: NBP Quick Monitoring

Inflation: hit 4% and run

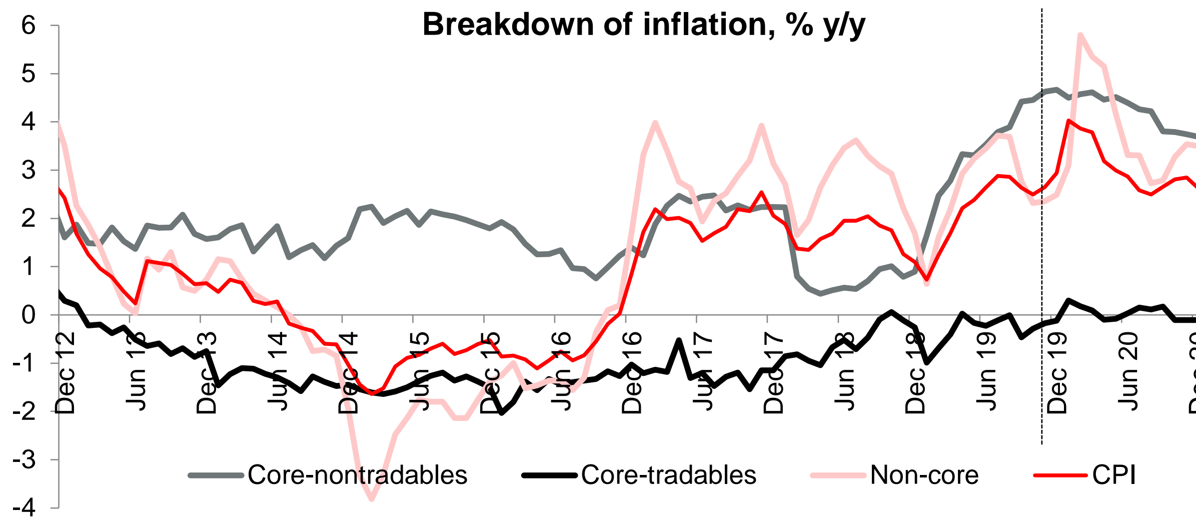
We expect CPI inflation to get near 4% y/y in January 2020 and then to gradually decline towards the 2.5% target at the year-end, with average annual price growth at 3.0% versus 2.3% in 2019. Our forecasts suggest core inflation excluding food and energy prices will peak at about 2.8% y/y in 1Q20 and then slide towards 2.3-2.4% y/y.

Recovery of margins was one of the factors behind the upward march of inflation witnessed in 2019 (see bottom right chart). In our view this process has not finished, which is why inflation's drop after 1Q20 will not be very quick, but moderate. Labours costs will continue to be putting a pressure on companies, with hike in minimum wage adding about 0.1-0.2pp to inflation.

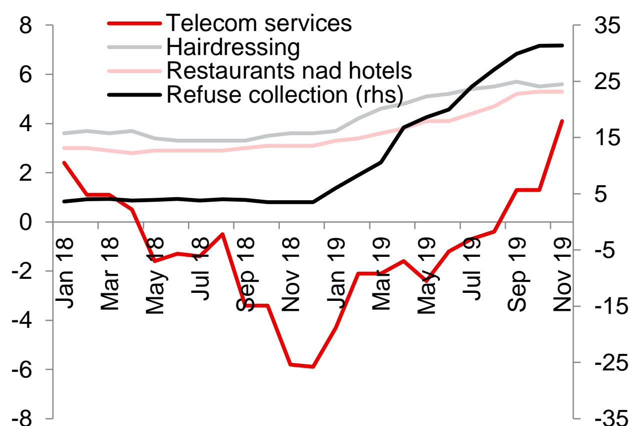
In our view, growth of food prices will remain relatively high, yet generally decelerating, while energy prices will jump markedly at the start of 2020, so non-core categories will be a major driver of CPI in 2020 (see next slide for details).

Prices of core non-tradables (mostly services) were the main driver of CPI in 2019 (bottom left chart). We are expecting its contribution to be declining in the course of 2020, given weaker economic growth. However, some administered categories (like waste collection) still have the potential to record very high growth rates, so we are not expecting a sudden deceleration, especially as private consumption will remain rather robust, in our view.

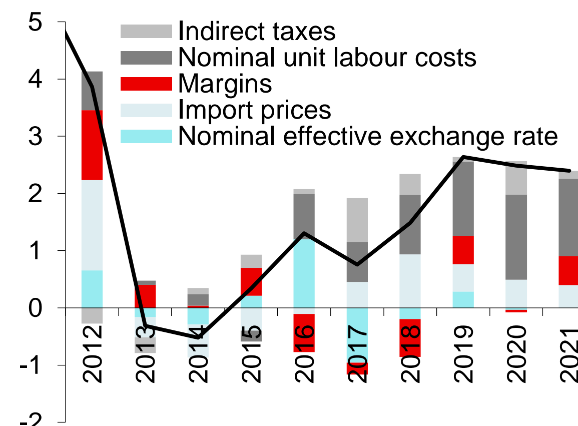
We gather that core tradables' prices will be stabilising in 2020 (which is historically a quite high result), given forecasts of accelerating core inflation in all major euro zone countries.



Source: Eurostat, GUS, Santander



Source: GUS, Santander



Source: AMECO, Santander

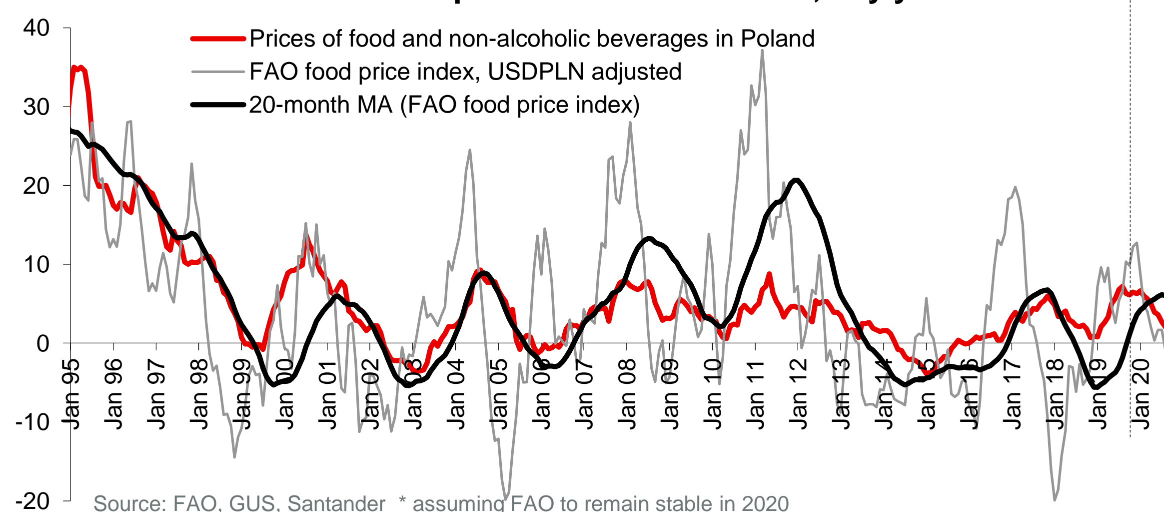
Santander

Inflation: will food price inflation ease?

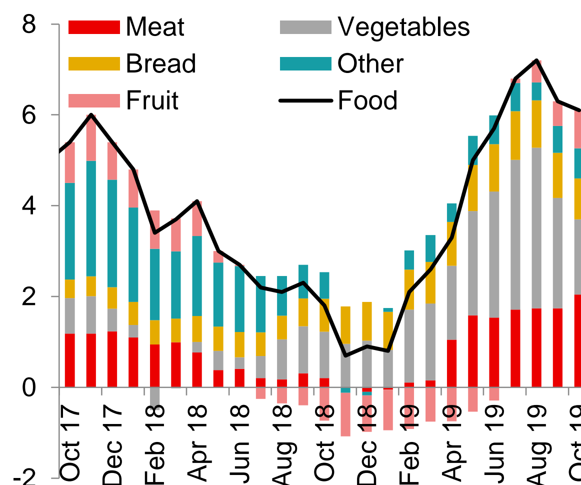
In 2019 food was a major contributor to CPI growth, as it rose by about 5% y/y on average (with peak at 7.2% y/y in August), driven by effects of drought and ASF on vegetables, fruit and meat supply. Typically it would be reasonable to assume a normalisation in 2020 and hence a low growth driven by high base effect. The FAO index of world food prices has been on the rise in recent months, but if we assume its stabilisation in the upcoming quarters, it should translate into stabilisation or even decline of domestic food prices in the second half of 2020.

However, the ASF disease in China is still spreading and the US Department of Agriculture is expecting Chinese pork output to be falling further in 2020 (40% lower than in 2018), so meat prices should remain at an elevated level globally. There is a growing risk of global sugar shortages, due to declining forecasts of output in India and Thailand (world's biggest producers), so prices of sugar are likely to accelerate markedly. Wheat prices also recently went strongly up due to disappointing information on output in the USA and Argentina. Finally, we could not rule out weather anomalies in 2020, as the effects of global warming become more and more evident. To sum up, risks for food prices seem to be skewed upwards, so we are expecting only a slight deceleration to 3.8% y/y on average in 2020.

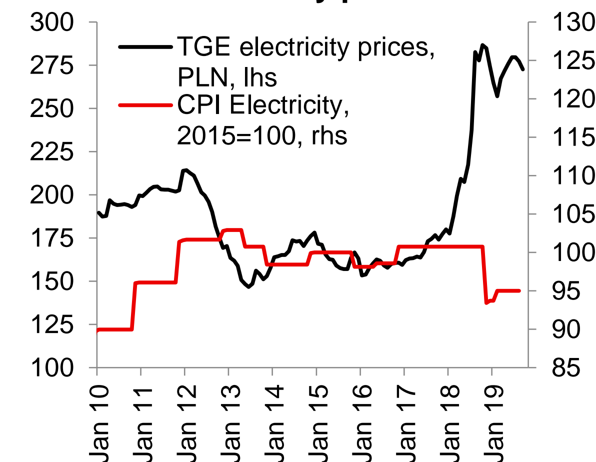
In 2019, the government decided to freeze the electricity tariffs, to take the burden off households. It remains unclear what steps will be taken in 2020. We cannot rule out that (part of) the burden will fall on energy companies this time. The regulator will release its decision on tariffs on 17 December. So far we expect costs in this category to go up by 10% in January, adding 0.5pp to CPI.



Source: FAO, GUS, Santander * assuming FAO to remain stable in 2020



Source: GUS, Santander



Source: GUS, TGE, Santander

Monetary policy: inflation is not an issue?

2019 was the fifth year in a row ending with the NBP reference rate at the all-time low 1.5%. In 2H19, motions both to hike and to cut interest rates were submitted but attracted very limited support. The vast majority of MPC members clearly preferred to stay put, keeping monetary policy unchanged, preferably for long, even though core inflation climbed to the point which in the past used to trigger a concern, if not a policy action.

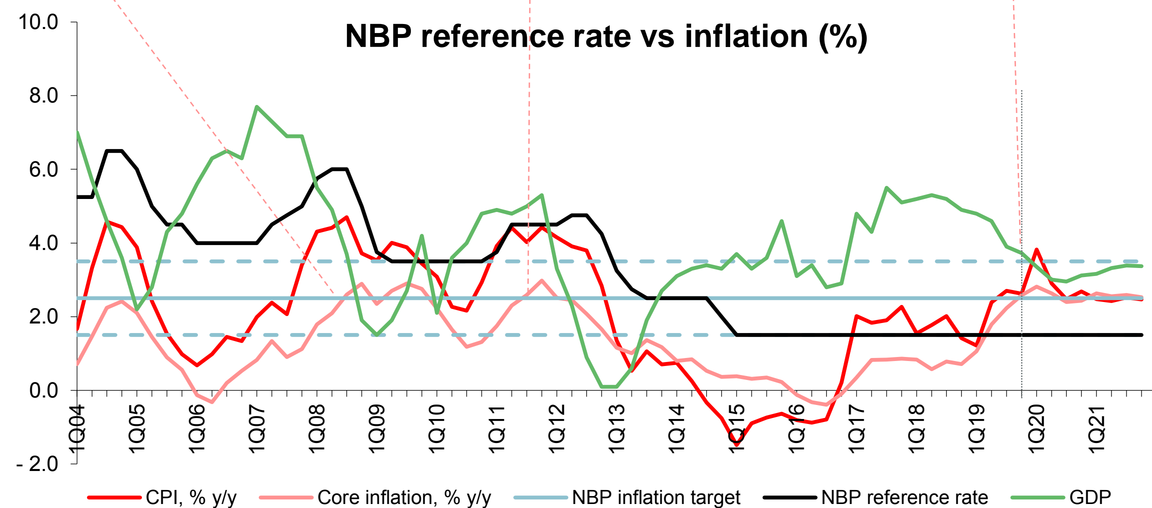
The Polish central bank runs the same direct inflation targeting strategy for years. But the emphasis in its communication has clearly evolved over time – if we compare press releases from different years which ended with core inflation reaching (or topping) 2.5%, there is a clear change in focus from inflation to economic growth (see charts).

Still, it would be an oversimplification to view the current MPC as simply more dovish than the previous ones. Please recall that they refused to relax monetary policy in 2016 despite slowing economic growth and prolonging deflation. Even recently, we saw evidence of quickly changing rhetoric of the NBP president Adam Glapiński, apparently aimed at active management of market expectations. Earlier this year, to tame rate hike expectations, he was emphasising building risks for GDP growth. In December, he strongly rebuffed market bets for rate cuts, underscoring Poland's economic growth resilience.

Apparently, interest rate stabilisation for as long as possible is of great value to the current policymakers.

Word clouds of MPC press releases when core inflation was reaching the 2.5% target:

December 2008 | **December 2011** | **December 2019**



Source: GUS, NBP, Santander

Monetary policy: keep calm and wait-and-see

Interestingly, despite seemingly growing concerns about the global economic slowdown and its impact on domestic outlook, the Polish central bank ends 2019 with its GDP growth projections for the next two years exactly at the same level as they were one year ago (despite lower starting point), and inflation forecasts substantially lower (despite higher starting point).

NBP forecasts from November 2018 turned out to have overestimated inflation but underestimated the GDP growth. Now, it looks the story is going to be opposite: we see economy slowing a bit more and CPI rising higher (at least at the start of the year) than the central bank anticipates.

Will it be enough to trigger any change in monetary policy bias? Very unlikely. As long as the economic growth outlook remains subdued and uncertain, the MPC will have high tolerance for inflation breaching the official target, hoping (perhaps correctly) that the price acceleration would not be persistent.

The financial market was pricing-in scenarios of both interest rate cuts and rate hikes few times since the start of the current MPC term, none of which proved correct. Recently the speculation for easing has renewed and may even strengthen if new data confirm that slowdown continues. However, we think that the NBP will keep its policy stable in wait-and-see mode.

If economy slows much more than we anticipate, some policy easing cannot be ruled out. We still think the MPC may use the conventional tool (i.e. rate cut) in the first place, as there is still room to do it. It could be accompanied with changes in macroprudential measures, e.g. LTV/DTI parameters for mortgages to avoid building bubbles in the credit and/or housing markets. However, concerns about banking sector stability will cause that the trigger for such action in terms of GDP growth would be probably quite low. Note that in 2016 growth slightly below 3% was not enough to trigger policy action.

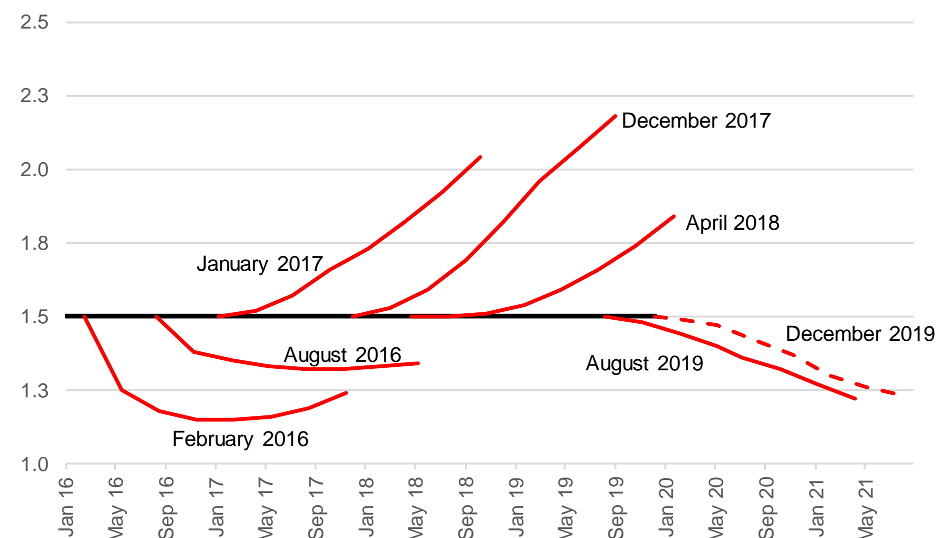
Inflation and GDP projections in subsequent Inflation reports

	GDP growth			
	Nov 18	Mar 19	Jul 19	Nov 19
2018	4.8 (±0.4)	-	-	-
2019	3.55 (±0.85)	4.0 (±0.7)	4.5 (±0.6)	4.3 (±0.4)
2020	3.25 (±0.95)	3.65 (±0.95)	3.9 (±0.9)	(3.55±0.85)
2021	-	3.35 (±0.95)	3.35 (±0.95)	(3.25±0.95)
	CPI inflation			
2018	1.8 (±0.1)	-	-	-
2019	3.25 (±0.65)	1.7 (±0.5)	2.0 (±0.3)	2.3 (±0.1)
2020	2.9 (±1.0)	2.65 (±0.95)	2.8 (±0.9)	2.85 (±0.75)
2021	-	2.4 (±1.1)	2.4 (±1.1)	2.6 (±1.0)

Middle points of GDP and CPI growth paths and width of 50-percent probability ranges.

Source: NBP, Santander

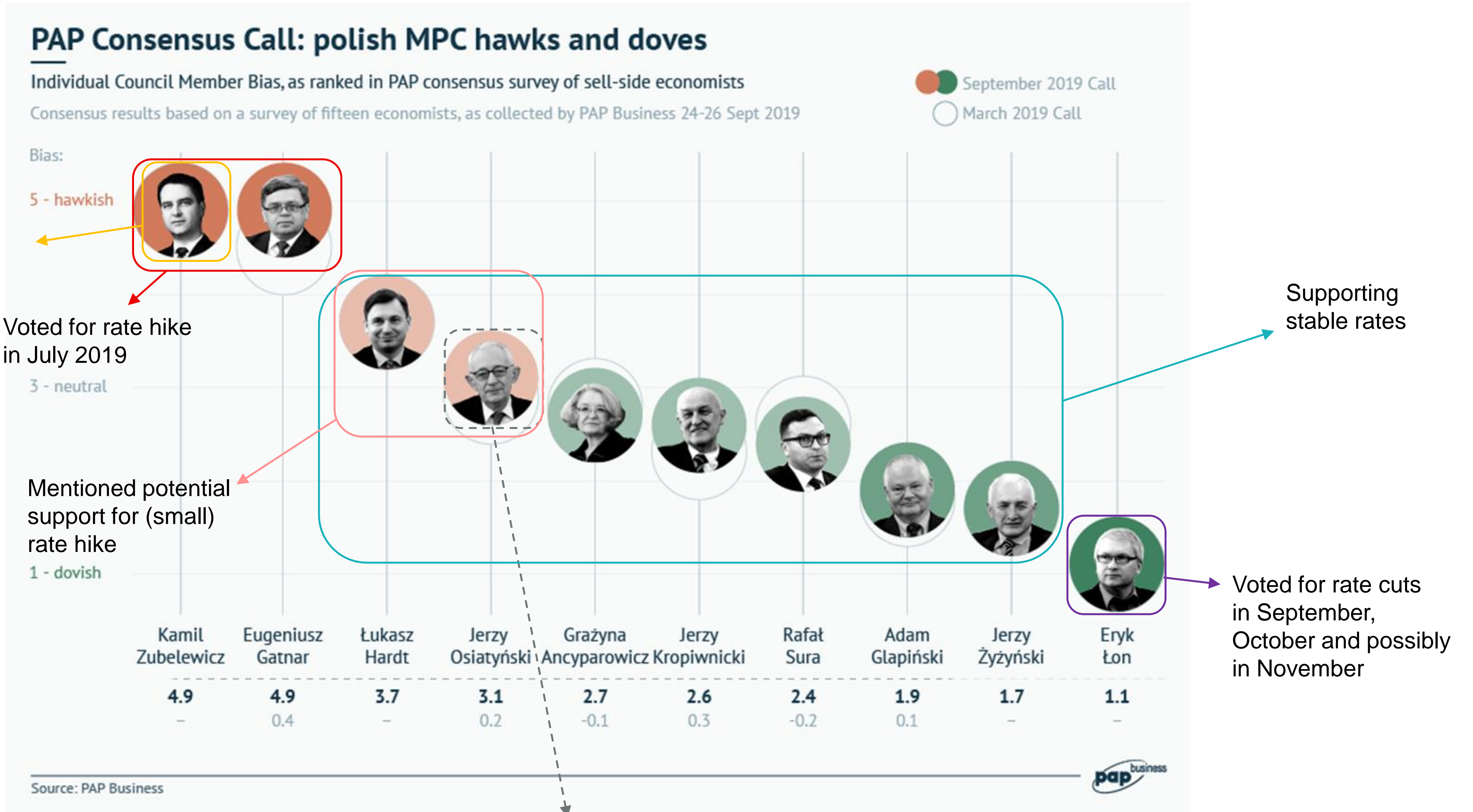
How the FRA market was pricing interest rate changes (%)



Source: Refinitiv, Santander

Santander

Monetary policy: minor support for changes



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Zero gap in the central budget?

2019 central budget deficit is likely to be much below the planned level, again. We estimate that tax revenues will be c.15bn higher than planned, while spending should be on target. As a result, budget gap in December 2019 may be around PLN14bn (half of the plan).

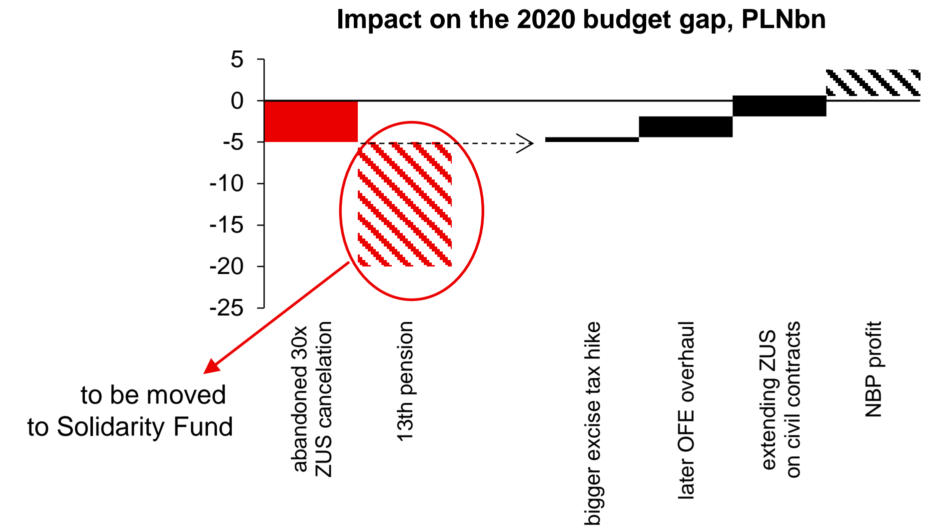
In 2020 the revenues outperformance is less likely to be repeated, as the plan is already quite ambitious given slowing economy, cyclical nature of tax collection and diminishing room for further improvement in tax compliance.

2020 budget gap was planned at zero before the elections (see our comment for details). Now the government is working on the revision of the bill, but it seems its general shape will remain broadly unchanged. Even if it ends up with deficit slightly below zero, the difference will be insignificant, in our view.

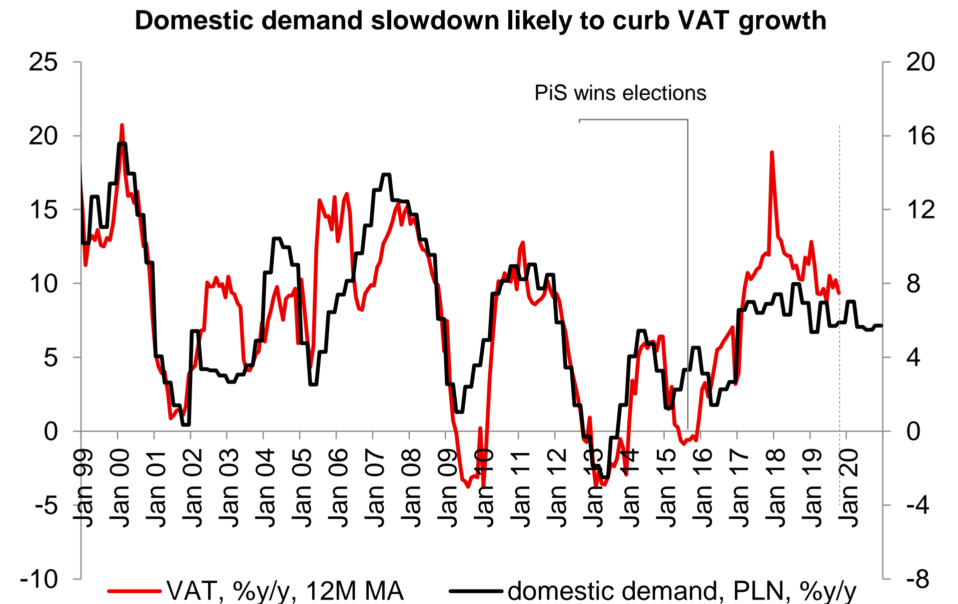
The biggest new element in 2020, not included in the initial budget draft, is the payment of 13th pension (annual cost c.PLN10bn), to be repeated every year. The government's trick is to stream this expenditure to "Solidarity Fund", which is outside the central budget and is not constrained by the limits of the stabilising spending rule. Still, it will increase the gap of the entire public sector and (possibly) next year's borrowing needs.

Another gap to fill is c.PLN5.5bn caused by abandoning the plan to cancel 30x social security threshold (30 times the average wage) – affecting the central budget via subsidy to FUS (Social Security Fund). It is likely to be offset by the following: bigger excise tax hike on alcohol/tobacco (+0.6bn), later implementation of OFE overhaul (+2.5bn), introduction of social contributions on civil contracts (+2-3bn). Together, it should be enough to end up with deficit close to zero.

On top of that, the budget in 2020 may benefit from the NBP profit, especially after recent change in central bank's rules of FX reserves creation. But the amount of the inflow from this source is hard to guess at the moment and probably will not be included in the bill (in 2018 the whole NBP profit of PLN3.9bn was used to resupply reserves; under new rules, PLN2.2bn would go to the central budget).



Source: Santander



Source: Ministry of Finance, Santander

Santander

… but no longer in the entire public sector

Last three years the government was successful in eliminating tax loopholes and raising tax collection, while budget benefited also from very good economic cycle. Thus, fiscal revenue-to-GDP ratio rose sharply since 2016. At the same time, spending-to-GDP was quite restrained despite populist government's agenda, which was enforced by the stabilising spending rule.

As a result, Poland achieved virtually zero fiscal deficit (according to ESA2010 standards) already in 2018, long before it was planned by the government.

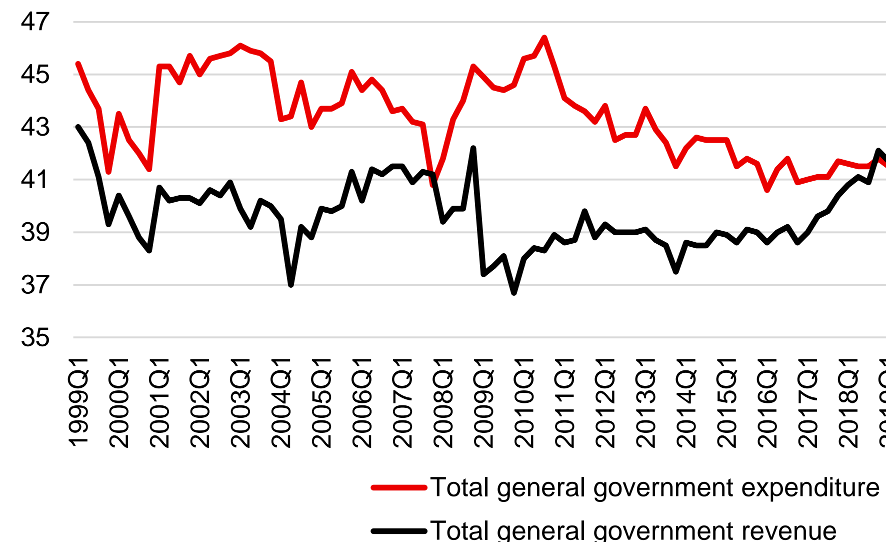
This positive trend is unlikely to continue, however, and the balance of the entire public sector is about to worsen in 2019/2020, mainly due to implementation of the costly election promises (large scale redistribution) and progressing economic slowdown, which will outweigh the diminishing progress in further tax compliance improvement.

The government uses tricks and creative accounting to keep the central budget deficit at (or close to) zero in 2020, but the costs will be passed to other sectors: local governments and social security.

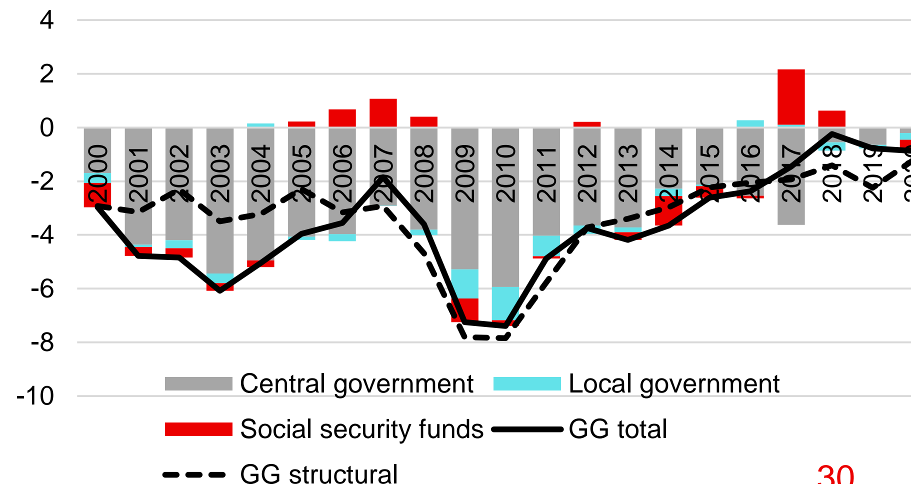
The good news is that the increase in general government (GG) deficit will be moderate, i.e. it is likely to stay far below the EU 3% threshold. According to our estimates it could go to c. 1% of GDP in 2019-2020.

The not-so-good news is that the structural (cyclically adjusted) balance looks worse, as according to the European Commission it will move from -1.4% to -2.2% of GDP in 2019, 6th biggest in EU. And this estimate does not include 13th pension.

The spending rule is a binding constraint, although the government already makes attempts to circumvent it (pushing expenditure to Solidarity Fund). But at least they do not dare to remove the rule from the law.



Source: Eurostat, Santander



Source: Eurostat, European Commission, Santander

Santander

Battle for the next EU budget begins

The European Commission's draft proposal of the 2021-2027 multiannual financial framework (MFF), shown in May 2018, assumed the EU budget at 1.11% of gross national income of the EU, which implied money allocations for Poland lower by c.20% as compared to 2014-2020 (see chart).

Now, the debate about the EU's next seven year budget is entering its crucial stage. For Poland, the biggest net beneficiary of the EU funds there are three main risks:

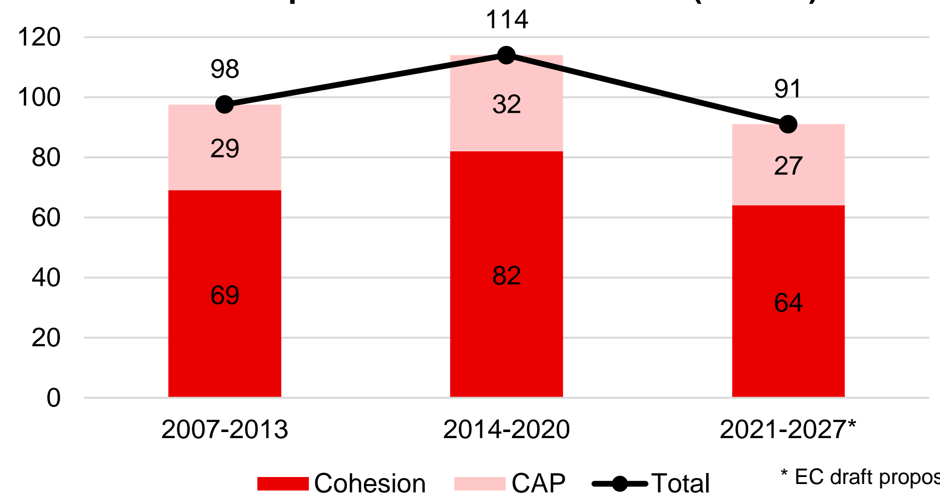
First, that the size of the budget may be trimmed further. The Finnish presidency proposed recently 1.07% of GNI, while Germany and other net contributors opt even for 1%. The good news is that the reduction of the EU budget is opposed by the new EC president Ursula Von Der Leyen and by the European Parliament (which suggests raising the budget to 1.3% of GNI).

Second, that there may be change in spending priorities (towards environment, research, migration) implying further cuts in funds for cohesion and agriculture, which are key for Poland.

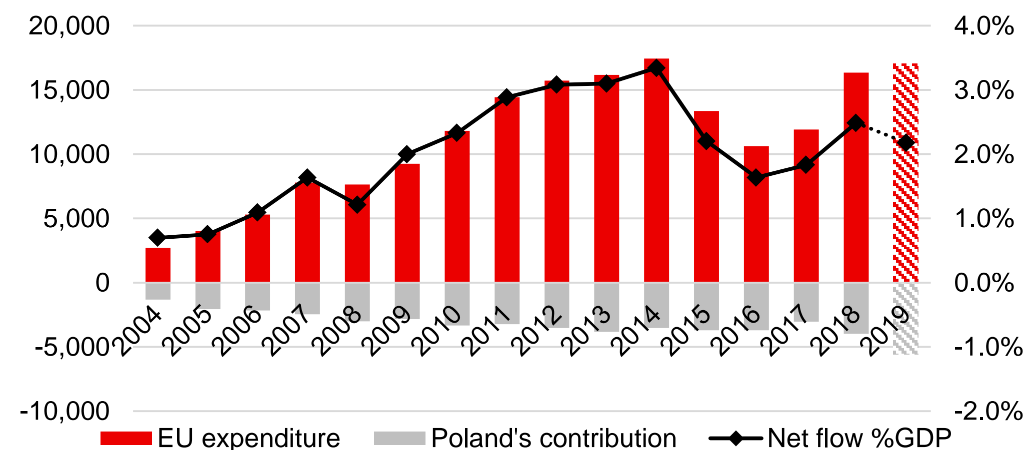
Third, that it seems the European Commission's new head is serious about tying the EU funding to the rule of law adherence. According to the draft EC proposal, the Commission would monitor the rule of law in all member states annually and the negative assessment may result in suspension or reduction of payments.

The negotiations on the new seven-year EU budget may last even until late 2020.

It should be remembered, though, that the economic impact of the negotiated numbers will be felt probably not earlier than in 2024, as the money from the current MFF will be spent according to t+3 rule, until 2023.



Source: European Commission



Source: European Commission, Finance Ministry, Santander

Borrowing needs still relatively small

2020 net borrowing needs, in line with 2020 budget assumptions, will amount to PLN19.4bn. We assume that additional PLN10.0bn will be needed to finance 13th pension, unless it will be borrowed again from the Demographic Reserve Fund (like in 2019). Hence, we estimate that the total net borrowing needs could amount to **PLN29.4bn**.

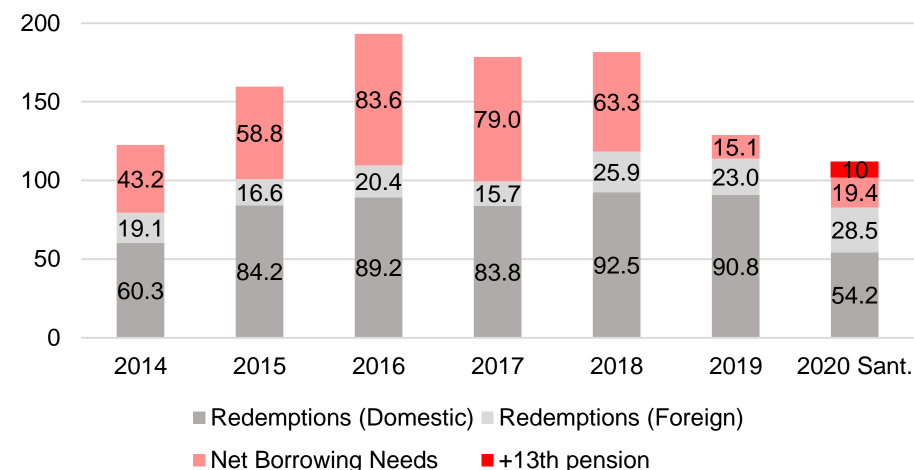
Even if we are correct and the net borrowing needs will be larger than initially planned, the absolute level is still small comparing to the previous years (e.g. year 2018 and before) and should not pose significant financing risks.

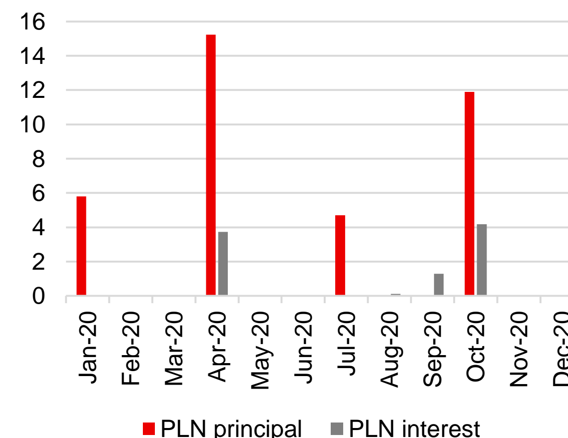
After adjusting the planned gross issuance of PLN 137.4bn for switches (rolling part of the debt from 2020 further into the future) which happened so far (PLN15.9bn), we estimate the gross borrowing needs will amount to PLN121.5bn before the inclusion of the cPLN10.0bn one-off, and PLN131.5bn after it.

Domestic redemptions (principal and coupons) of marketable domestic bonds will amount to PLN61.5bn, while those of FX denominated bonds (principal and coupons) to PLN28.5bn. Domestic redemptions of retail savings bonds will amount to PLN7.3bn.

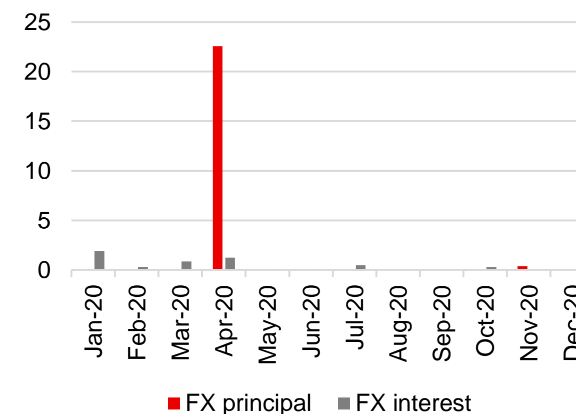
Ministry of Finance said as of 29 November 2019 it has pre-financed 33% of the 2020 gross borrowing needs (PLN44bn, we estimate) giving it a pretty decent buffer.

We estimate that the domestic commercial banks will have the capacity to increase their POLGBs holdings in 2020 by at least PLN15-17bn (due to need to preserve liquidity ratios amid rising deposit base), while retail bonds investors may add up to PLN10bn net as the instrument becomes more popular.





Source: Bloomberg, Santander



Source: Bloomberg, Santander

Financing of net borrowing needs

According to 2020 budget assumptions, **net borrowing needs in 2019 will amount to PLN 15.1bn** (vs 46.0bn initially assumed) and will be financed by:

FX bonds financing of minus PLN 16.4bn (redemptions)

Domestic financing of PLN 31.5bn, split into:

Sale of wholesale bonds with floating coupon: PLN 18.7bn

Sale of wholesale bonds with fixed coupon: PLN 2.9bn

Sale of retail bonds: PLN 4.8bn

Account held with Ministry of Finance: PLN 5.0bn

According to 2020 budget assumptions, **net borrowing needs in 2020 will amount to PLN 19.4bn**, 4.1bn more vs year before, financed by:

FX bonds financing of minus PLN 16.2bn (redemptions)

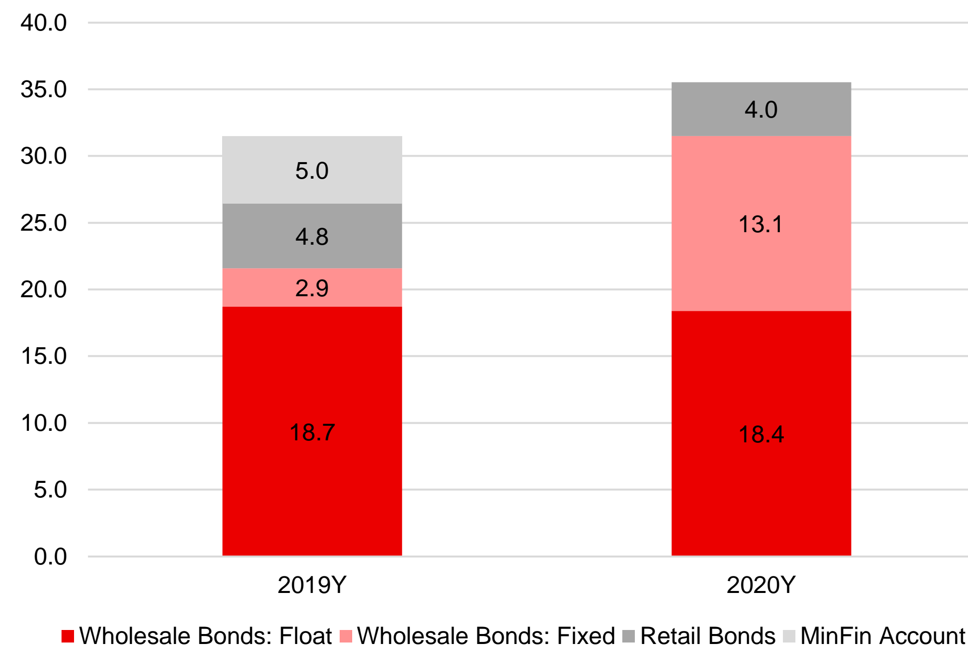
Domestic financing of PLN 35.5bn, split into:

Sale of wholesale bonds with floating coupon: PLN 18.4bn (-0.3bn y/y)

Sale of wholesale bonds with fixed coupon: PLN 13.1bn (+10.2bn y/y)

Sale of retail bonds: PLN 4.0bn (-0.8bn y/y)

Account held with Ministry of Finance: PLN 0.0bn (-5.0bn y/y)



Source: Ministry of Finance, Santander

2020 Financing: foreign investors less important

Data for October 2019 show that the share of non-residents in financing the treasury securities has been on the decline for the second year in a row down PLN32.3bn to PLN 159.2bn (a share of 23.7%).

By foreign holders **type**, the biggest sellers of POLGBs YTD were the central banks (sold PLN19.5bn), then mutual funds (PLN 6.6bn), then „Other" (PLN 6.5bn), pension funds were also net sellers (PLN1.9bn).

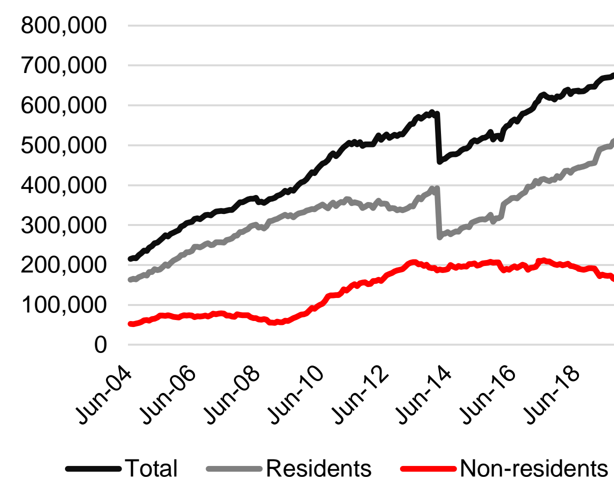
By foreign holders in **geographical breakdown**, the biggest sellers where in Asia (PLN22.0bn), then North America (PLN 5.1bn), then European countries outside Eurozone (PLN 2.5 bn).

We anticipate a continuation of the negative trend of foreign investors' engagement in POLGBs, mainly owing to the expected rise in core markets yields, which given the Polish negative (and declining because of rising inflation) real yields, slowing growth and flat yield curve, means investors may struggle to find convincing reasons for holding POLGBs.

It is worth to noting that in 2019 the notional of non-resident's portfolios has been consistently decreasing in every single quarter, by PLN15.6bn, PLN2.1bn, PLN10.5bn in Q1, Q2 and Q3 respectively. And another PLN4bn in October alone.

Despite the falling notional, the DV01 of non-residents' portfolio actually increased by around PLN1.1m during the 2019. This happened despite the fact that some of their bonds matured (PLN0.95m DV01): foreign investors net sold DS0725, DS0726, DS0727, old benchmarks, but bought the new one DS1029.

POLGBs holders by residence, PLNm

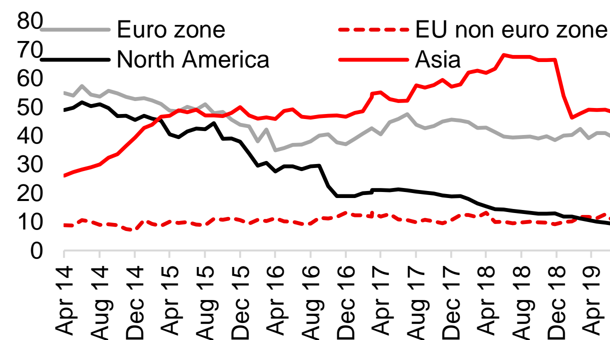


Source: Ministry of Finance, Santander

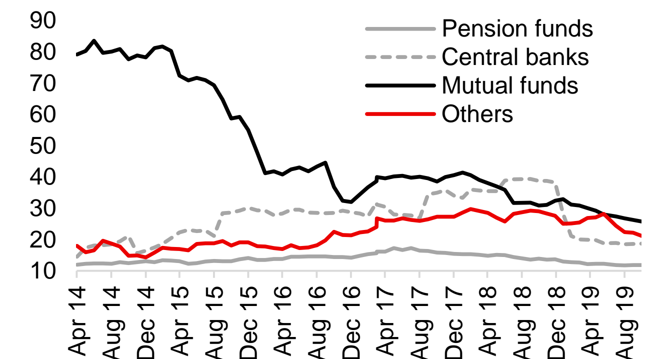
Foreign holders DV01 change by tenor, quarter

Tenors	Q1'19	Q2'19	Q3'19	OCT'19	YTD DV01 change
< 2Y	-0,58	-0,36	-0,11	0,10	**-0,95**
2-5Y	-0,61	0,85	-0,32	-0,13	**-0,21**
5-10Y	1,02	3,18	-0,92	-0,86	**2,42**
>10Y	-0,39	0,01	0,11	0,11	**-0,16**
Total	**-0,57**	**3,69**	**-1,24**	**-0,78**	**1,10**

Foreign holders – by geography, PLN bn



Foreign holders by type, PLN bn



Source: Ministry of Finance, Santander

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Low rollover risk – holders of maturing bonds

Rollover risk of POLGBs maturing in 2020 is relatively low (we estimate it at around PLN10.5bn). And even if all (or most of) foreign investors do not decide to reinvest the proceeds into POLGBs, Polish financial sector should be able to accommodate. The diversified non-resident structure diminishes the chances of such a scenario.

In October the outstanding Treasury Securities stood at PLN670.3bn (including retail bonds).

MinFin data for October (see table) show that PLN44.9bn of POLGBs are going to mature in 2020. Since October, two switch auctions (PLN2.7bn and PLN 4.2bn) decreased this amount to **PLN 38.1bn**

Assuming that 27.6% share of foreign investors did not change, it implies that **PLN10.5bn** is being currently held by foreign investors. Please note, however, the percentage held varies by each bond (see table on the right for details).

By investor type, its mutual funds (on average 24.6%), insurance (20.6%) and pension funds (9.6%) who keep the most of the foreign held bonds going to mature in 2020.

At least some of the estimated PLN10.5bn might be invested back into POLGBs contributing to a fresh demand. If the breakdown of the bonds was to remain unchanged this would imply close to zero demand for floaters (WZ) however cPLN1.0bn for OK series (2Y zero-coupon), PLN 4.5bn for PS series (5Y coupon) and PLN 5.1bn for DS series (10Y coupon).

On top of that, foreign bonds are going to mature in 2020 as well, main ones: EUR 5.25bn at 15 APR 2020 and JPY 10.00bn at 13 NOV 2020

Holders of Polish wholesale marketable PLN-denominated bonds maturing in 2020 (as of end October 2019)

Bond	Maturity date	Amount outstanding (PLNmn)	Total foreign investors (%)	Polish banks (%)	Polish insurance companies (%)
WZ0120	25 JAN 2020	6 698	0.6	72.3	15.8
OK0720	25 JUL 2020	7 646	13.9	49.1	3.5
PS0420	25 APR 2020	17 091	31.2	53.1	7.9
DS1020	25 OCT 2020	13 453	44.4	35.3	12.8
Total		**44 888**	**27.6**	**49.9**	**10.2**

Source: Ministry of Finance, Santander

Non-residents holdings of Polish wholesale marketable PLN-denominated bonds maturing in 2020 (as of end October 2019)

Type of holder	% of total maturing bonds held
Commercial bank	0.2
Central bank	1.7
Public institution	0.1
Insurance company	5.5
Pension Fund	3.0
Mutual fund	6.2
Hedge fund	0.5
Individual	0.0
Non-financial sector	0.8
Others	4.7
Omnibus account	4.9

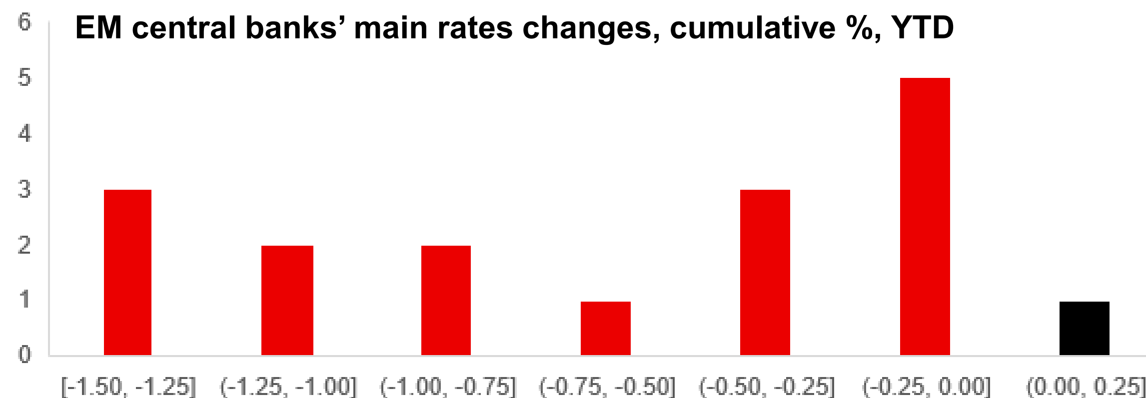
Source: Ministry of Finance, Santander

Emerging markets in the rearview mirror

Emerging markets fixed income has had a decent 2019 year. Majority of EM countries saw their yield curve levels lower. The exception was the front end of the Czech yield curve where rates increased as CNB was hiking to slow down inflation. The global move in yields lower was the result of escalating trade war tensions and resulting global manufacturing slowdown which finally led Fed to cut interest thrice (in 25bp steps) to 1.50-1.75%. Reintroduction of bond purchases by both the Fed and the ECB also helped.

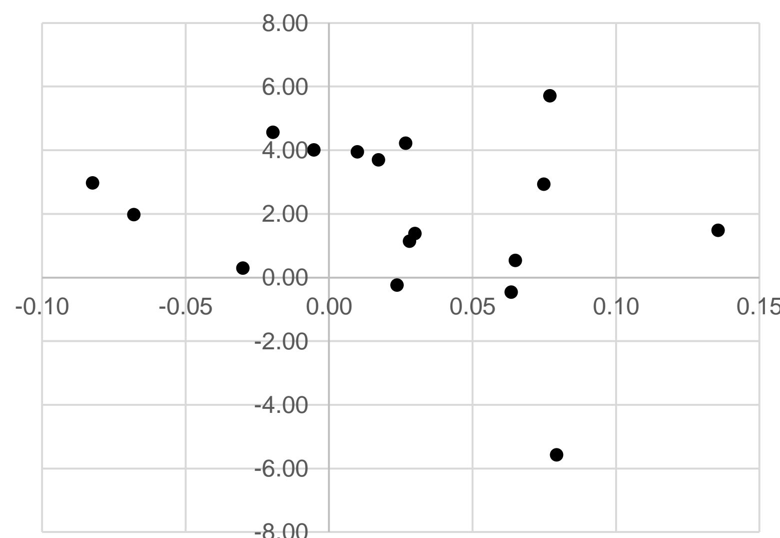
Most EM central banks cut interest rates in 2019. With majority of the moves being small 25bp or 50bp adjustments. Again, except for CNB (Czech) which was hiking. NBP (Poland), MNB (Hungary) and CBC (Colombia) remained on hold throughout the year despite rising inflation rates. Note, the chart on the right does not include Turkey (outlier: cut of 12pp).

In 2019 most EM currencies lost versus USD. The few exceptions being currencies of countries where 10Y real rates where relatively high (Mexico 4.80%, Russia 4.30%, Indonesia 3.10%) or rapidly rising (Philippines from -0.30% to 3.20% on rapid disinflation). Thailand was an outlier: accidentally profiting from Asian supply chain disruptions. None of the currencies with positive real rates lost in 2019 (see plot).



Source: Bloomberg, Santander

10Y real-rate (V) vs USD/EM performance (H)



Source: Bloomberg, Santander

EM FX vs USD change %, YTD

Currency pair	YTD change
USD/BRL	7.7%
USD/MXN	-0.5%
USD/CLP	13.6%
USD/COP	7.5%
USD/TRY	7.9%
USD/RUB	-8.2%
USD/ZAR	1.7%
UDS/PLN	3.0%
USD/HUF	6.3%
USD/CZK	2.4%
USD/CNH	2.8%
USD/INR	2.7%
USD/IDR	-1.9%
USD/MYR	1.0%
USD/THB	-6.8%
USD/PHP	-3.0%
USD/KRW	6.5%

Polish and core yields in 2019

Polish bond yields fell as those of most other EMs.

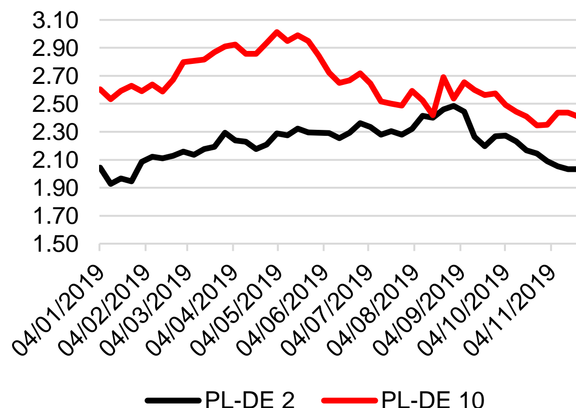
Polish bond yields, as usual, followed closely Bund yields. The 2Y spread oscillated around 200bp with an amplitude of 55bp, while the 10Y spread narrowed during the year by 35bp to 235bp from 260bp, with only slightly higher amplitude of 66bp.

Polish asset swaps in 2Y traded horizontally, while those at 10Y slightly narrowed over the 2019 year by 8bp to 29bp from 37bp. The yearly range of 2Y ASW was larger than that of 10Y ones.

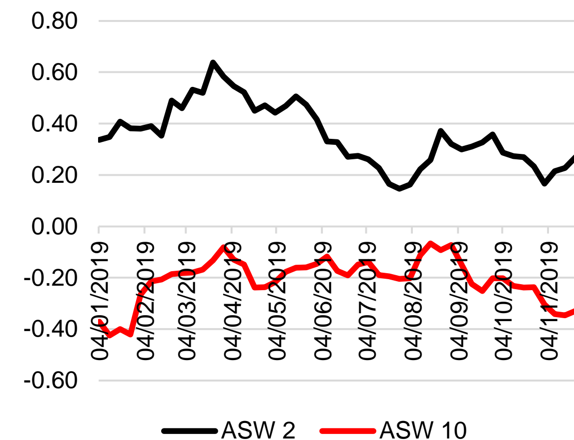
Polish bond 2x10 curve flattened by 75bp to 60bp following the flattening of the German bond curve by 55bp to 25bp, while the shape of the US bond curve remained unchanged at around 20bp in a spread (despite moving in parallell lower over the course of the year).

Polish yield volatility as proxied by quarterly 10Y bond yield ranges shows that the majority of the volatility happened in Q2 and Q3 (with quarterly ranges of 65bp and 57bp respectively) while the Q1 and Q4 where more calm (with quarterly ranges of 29bp and 27bp).

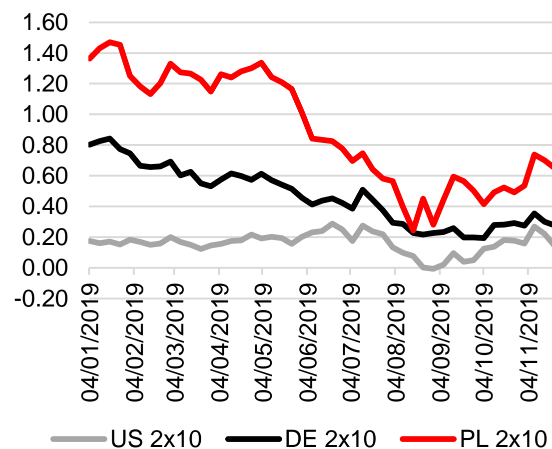
PL-DE bond spreads (2Y ,10Y)



PL asset swaps (2Y, 10Y)

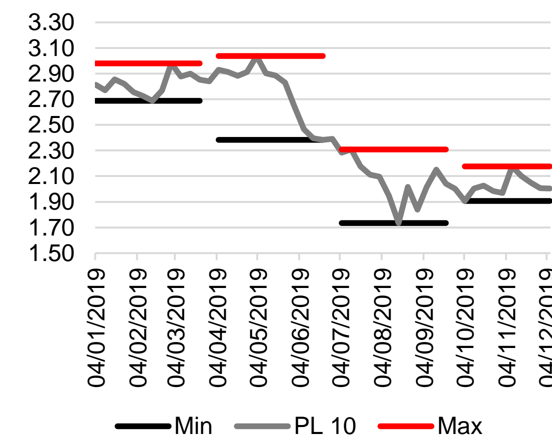


Bond curve steepness (US, DE, PL)



Source: Bloomberg, Santander

2019 PL bond yied ranges, by quarter



Source: Bloomberg, Santander

Yields to go up in 2020

Our base case of improving European fundamentals implies higher core rates in 2020 with the benchmark German 10Y Bund yield rising to -0.15% by the end of 2020, from the current -0.31%.

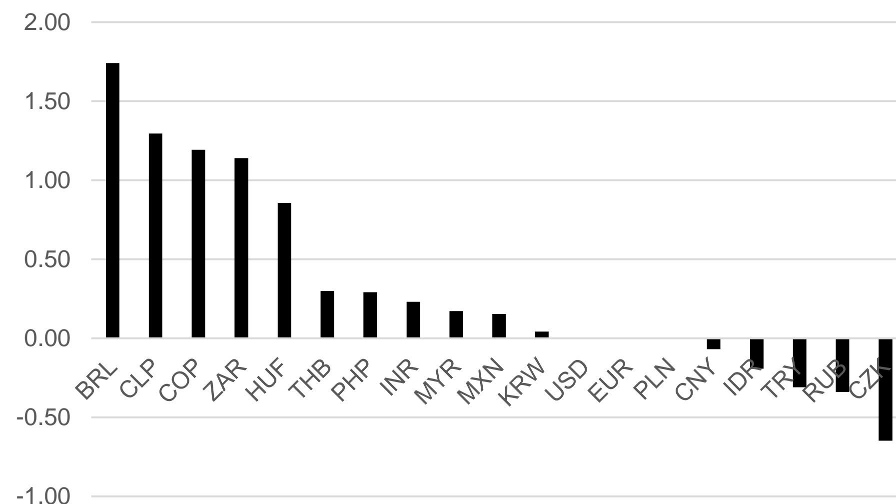
Polish GDP growth might be lagging European one by a couple or more quarters and as a result one would rationally expect a rebound in H2 2020 after Europe picks up in early 2020. However, as we write, the expectations are for slightly slower growth in Poland in 2020 – of around 3% (from around 4% in 2019).

Our base case is for NBP to hold rates in 2020 (despite the FRA market pricing in cuts already). As a result, the front end of the curve should remain well anchored.

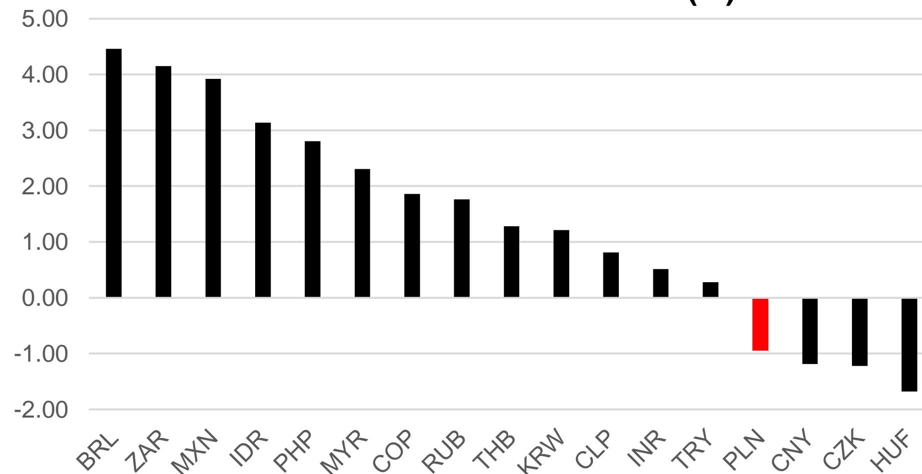
Within the whole EM world, Polish 10Y real rates are one of the lowest globally, comparable only to other CEE3 countries (possible Eurozone-related factor) and China. As a result investors looking for high real rates (e.g. „behind the curve" local central banks in the cutting cycle with plenty of scope for rally in the local bonds) might not invest in Poland, limiting inflows.

Similarly, investors looking for curve roll-down opportunities in the EM world might not look at Poland favourably – Polish swap 2x10 spread is one of the flattest – remaining in the vicinity of zero.

All in all, we think 10Y bond yields will increase in 2020, partly following core yields (20bp) and partly because larger supply and Eurozone growth pick up will allow for more curve normalization (steepness up by another 20-30bp back to 90bp). Hence, by the end of 2020 Polish 10Y yields might reach 2.40-2.50% from current 2.00%, with 2Y well supported around 1.50%.



Source: Bloomberg, Santander



Source: Bloomberg, Santander

FX Market: 2019 was still quiet

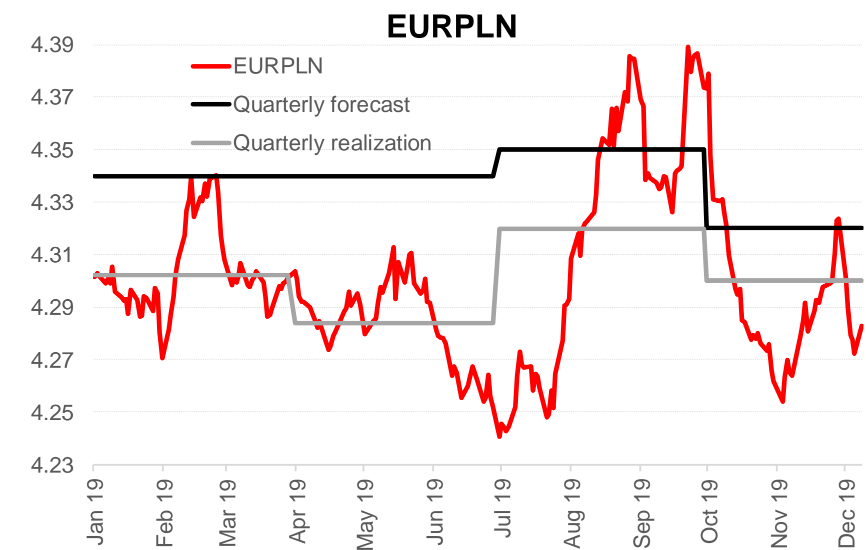
Prolonging Brexit, dovish shift of the central banks, trade wars, hopes for an economic recovery, major stock indexes at their fresh all-time-highs, sharp weakening of some LatAm currencies, social unrest in Hong Kong, parliamentary elections in Poland, ECJ opinion about CHF loans – all these events that evolved in 2019 failed to trigger any persistent directional trend on the Polish FX market.

At the time of writing, **annual EUR/PLN spot high-low spread is below PLN0.20 and is the lowest ever**.

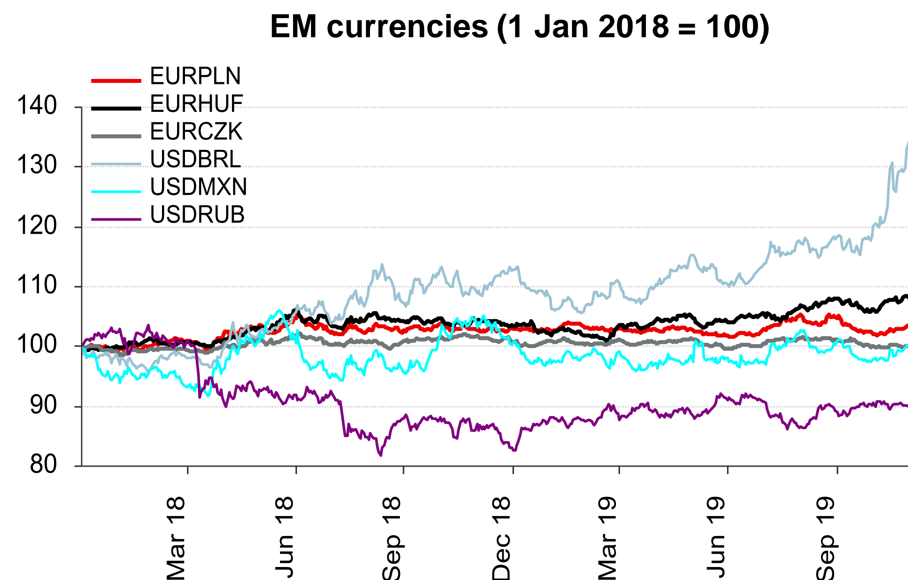
Low volatility could have been observed also in the case of some G10 crosses – EUR/USD annual high-low spread is now the lowest since the euro introduction, EUR/CHF the lowest since 2016, GBP/USD the lowest since 2015, USD/JPY the lowest since data is available (1971). As far as G10 currencies are considered, only for EUR/GBP and EUR/NOK, the annual high-low spread is now higher than in 2018.

According to Bloomberg, year-to-date the **majority of the EM currencies lost vs the dollar and gained vs the euro**. Generally the **trading range has been narrower than in 2018**. For the 20 major EM currencies we monitor, only for the Chilean Peso and Argentine Peso the trading range vs both EUR and USD was wider than last year. In the CEE region, EUR/RON and EUR/HUF recorded higher swings.

In our 2019 Outlook released in January 2019, we assumed EUR/PLN could be stable around 4.33 while the YTD average is at c4.30. For USD/PLN, we expected a drop to 3.50 in late 2019 but our assumption of higher EUR/USD did not materialize and the USD/PLN YTD average is now at c 3.84 vs forecasted 3.58.



Source: Reuters, Santander



Source: Refinitiv Datastream, Santander Bank Polska

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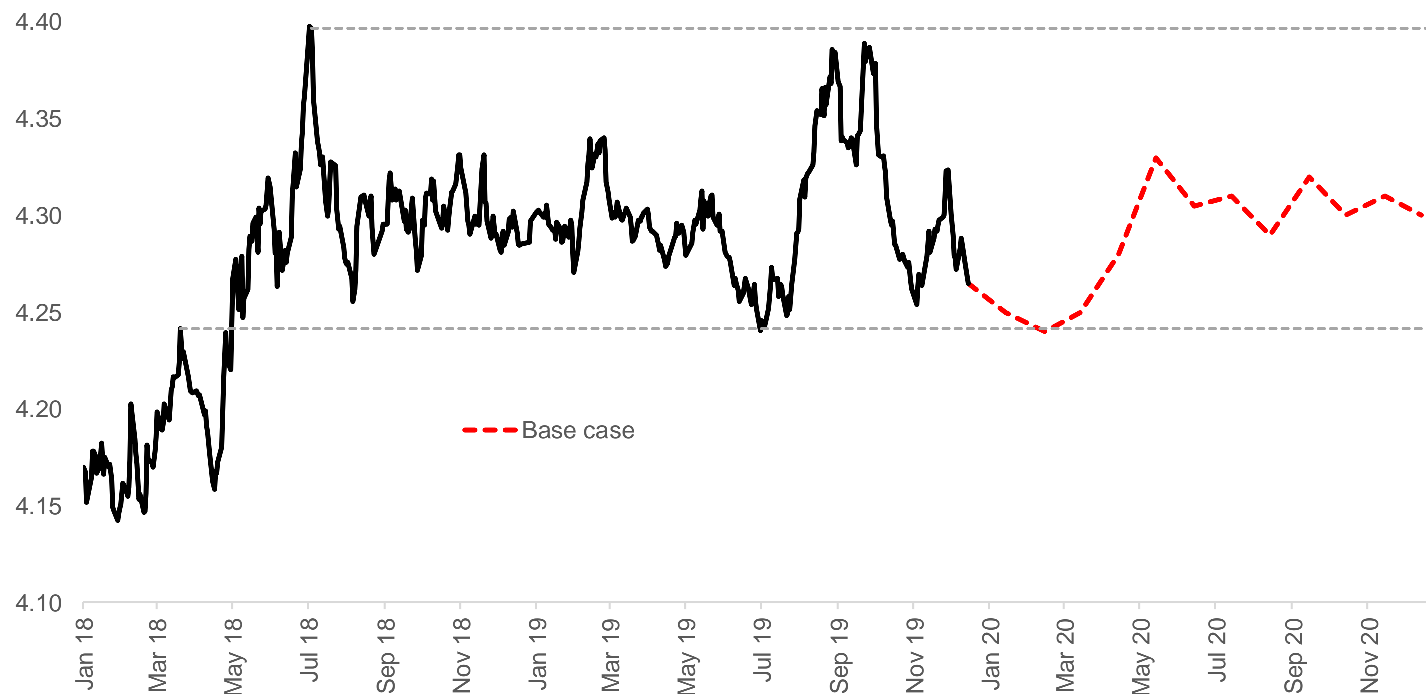
FX Market: EUR/PLN – Our scenario for 2020

Base case assumptions:

- **Soft Brexit** – UK leaves the EU orderly by the end of January; it does not mean however that all Brexit-related uncertainty is off the table, as UK will have less than a year to negotiate the divorce conditions
- **No new tariffs** – gradual but tough negotiations with China, situation at least does not get worse, politicians show willingness to reach an agreement
- **Gradual revival of euro zone economic activity** – pace of GDP growth bottoms out, PMIs rise thanks to Soft Brexit, among others
- **Higher EUR/USD** – weaker dollar should work in favour of the zloty as an emerging currency, this pattern worked well in the past
- **Uncertainty ahead of the US presidential elections in 2H20** – question mark how/if the geopolitical situation could change
- **Poland FX-mortgages story in the background** – no direct negative impact but limiting the scope for the zloty appreciation
- **No change of interest rates** in Poland, euro zone and US in 2020

Overall, since we do not expect global tensions to intensify, volatility should stay relatively low and **EUR/PLN shall hold within the range** observed since mid-2018. The global market mood should generally be in positive but the presence of the risk factors (the trade war, CHF loans) could prevent EUR/PLN from breaking the lower end of the range. Thus, the exchange rate could converge to 4.30 around which it has been moving for some time already.



Source: Reuters, Santander

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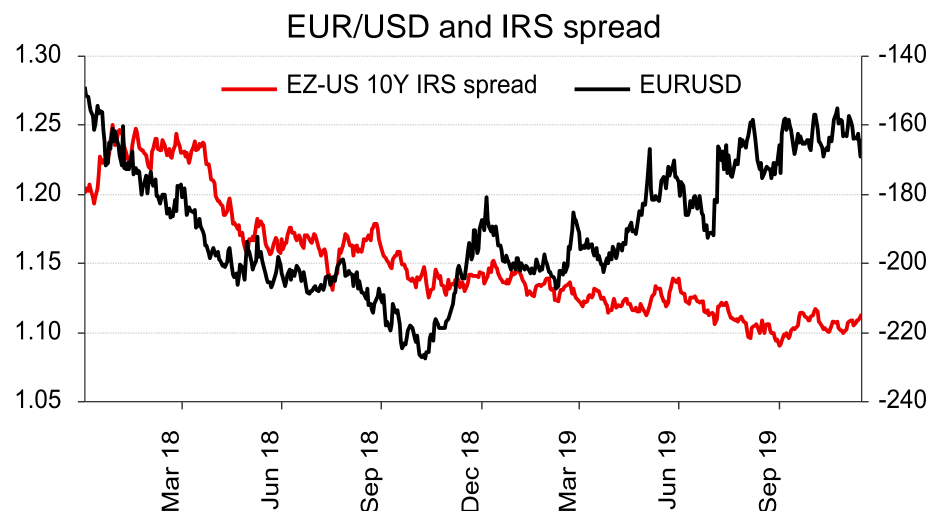
FX Market: EUR vs USD and CHF

EUR/USD → 1.18 at the end of 2020E

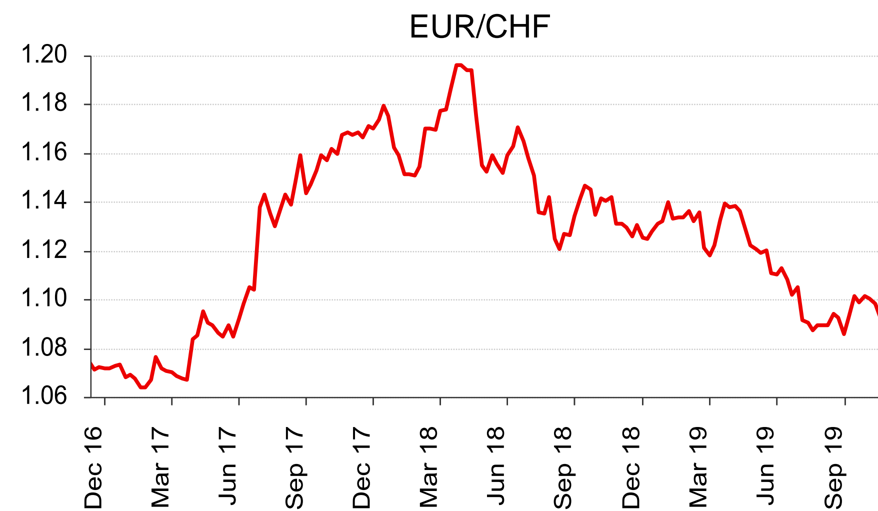
- Growth deceleration in the US and acceleration in the euro zone
- No rate hikes in the US – this supported the dollar in the previous quarters
- No more monetary policy easing in the euro zone
- Improvement of the global market mood – no hard Brexit and continuation of the trade talks

EUR/CHF → 1.15 at the end of 2020E

- Improvement of the global market mood – no hard Brexit and continuation of the trade talks implying lower demand for the safe assets
- SNB maintaining its dovish bias and reminding that the franc is „highly valued"



Source: Refinitiv Datastream, Santander Bank Polska



Source: Refinitiv Datastream, Santander Bank Polska

Political outlook: final lap in the election cycle

In 2020 the final part of the three-year election marathon in Poland will end, with presidential elections due in late April or early May (the date is not yet determined). The serving president Andrzej Duda is the frontrunner, enjoying high and stable approval rates. However, it may be too early to bet strongly on his re-election, as most of the opposition parties have not announced their candidates for the presidential run yet, and the campaign has not started. Also, Duda's odds may be negatively affected by the new wave of controversies regarding the judiciary system independence, or the scandal around the recently appointed head of the Supreme Audit Office (NIK) who was accused of fraud.

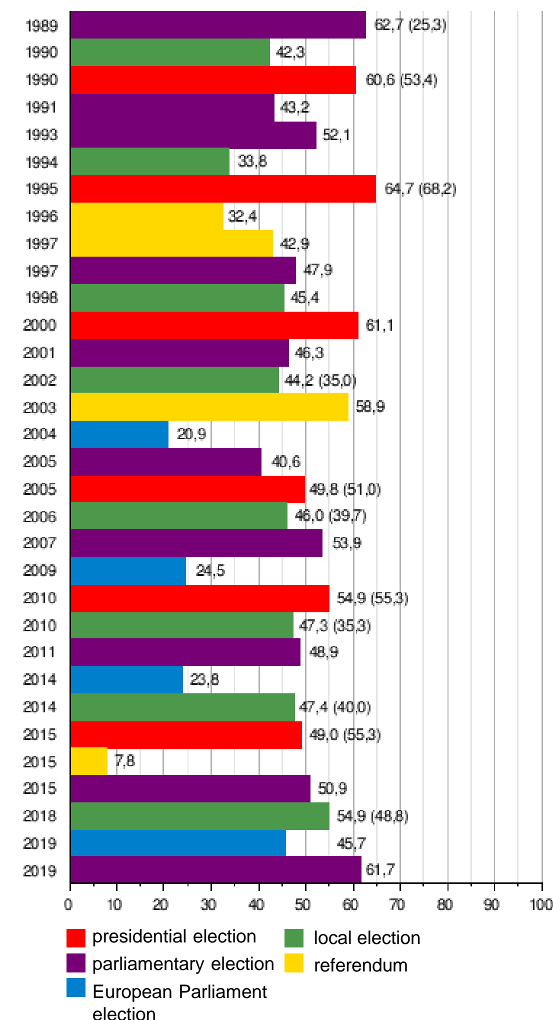
The presidential elections in Poland usually enjoy the highest turnout amongst all and the bar was already set very high in the parliamentary elections in October (62%). This makes the result even harder to predict.

The fact that the ruling Law and Justice has just lost the majority in the Senate (getting 48/100 seats) in October's parliamentary elections can be regarded as the orange light for Duda's chances. This is the first time in Poland's modern history when the opposition controls the upper chamber of the parliament. While the consequences for the government are not dire – the Sejm can overturn the Senate's veto with an absolute majority – it makes the law-making process longer.

The latter is not necessarily bad for the quality of enacted laws. But in practical terms, it may mean problems with meeting crucial deadlines. For example: according to the Polish law the budget bill should be approved by the parliament and sent to the President for signature by the end of January. If it does not happen, the President has the right to shorten parliament's term of office. However, even if it may be difficult to meet this deadline with 2020 budget, we think that there will be absolutely no reason for President Duda to use his powers and trigger snap elections.

It seems that the PiS government's policy should be calm and uncontroversial in the run-up to the presidential elections, to boost Andrzej Duda's re-election chances. We do not expect any more fiscal easing, as long as the room is constrained by the spending rule.

Voter turnout in Poland (%)



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Economic Forecasts

		2017	2018	2019E	2020E	1Q19	2Q19	3Q19E	4Q19E	1Q20E	2Q20E	3Q20E	4Q20E
GDP	PLNbn	1,989.4	2,115.2	2,264.6	2,403.1	520.0	545.7	561.0	637.9	559.4	577.8	590.7	675.3
GDP	% y/y	4.9	5.1	4.2	3.1	4.8	4.6	3.9	3.7	3.4	3.0	3.0	3.1
Domestic demand	% y/y	4.9	5.3	3.8	2.7	3.9	4.6	3.3	3.3	3.0	2.5	2.7	2.7
Private consumption	% y/y	4.5	4.3	4.2	4.1	3.9	4.4	3.9	4.5	4.5	4.4	4.0	3.6
Fixed investment	% y/y	4.0	8.9	5.8	0.2	12.2	9.1	4.7	2.0	0.0	-1.0	0.0	1.0
Industrial output	% y/y	6.5	5.9	4.4	3.5	6.1	4.2	3.3	3.5	2.0	3.6	3.7	4.5
Construction output	% y/y	13.7	19.7	4.2	-1.2	9.9	7.8	5.7	-2.3	-4.5	-2.4	-3.4	3.4
Retail sales (real terms)	% y/y	7.1	6.5	5.4	5.0	4.1	8.1	5.2	5.9	5.4	5.2	6.9	2.9
Gross wages in national economy	% y/y	5.3	7.2	6.9	6.2	7.1	7.0	7.7	5.8	6.6	5.9	6.0	6.2
Employment in national economy	% y/y	3.3	2.6	2.2	0.3	2.7	2.3	2.1	1.7	0.6	0.3	0.1	0.1
Unemployment rate *	%	6.6	5.8	5.2	5.0	5.9	5.3	5.1	5.2	5.4	4.8	4.8	5.0
Current account balance	EURmn	290	-5,046	261	1,646	2,110	430	-1,284	-995	2,342	822	-1,104	-414
Current account balance	% GDP	0.1	-1.0	0.0	0.3	-0.6	-0.4	-0.1	0.0	0.1	0.2	0.2	0.3
General government balance (ESA 2010)	% GDP	-1.5	-0.2	-0.8	-0.9	-	-	-	-	-	-	-	-
CPI	% y/y	2.0	1.6	2.3	3.0	1.2	2.4	2.8	2.7	3.8	2.9	2.5	2.7
CPI *	% y/y	2.1	1.1	2.9	2.6	1.7	2.6	2.6	2.9	3.7	2.7	2.5	2.6
CPI excluding food and energy prices	% y/y	0.7	0.7	1.9	2.6	1.1	1.8	2.2	2.6	2.8	2.6	2.4	2.4

* 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	1.57	1.49	1.64	1.65	1.53	1.44	1.45	1.49	1.50	1.51
Yield on 5-year T-bonds	%	2.78	2.51	1.99	2.09	2.23	2.14	1.76	1.83	2.00	2.10	2.10	2.15
Yield on 10-year T-bonds	%	3.44	3.21	2.37	2.25	2.84	2.68	1.99	2.00	2.14	2.20	2.25	2.40
2-year IRS	%	1.94	1.92	1.75	1.84	1.78	1.81	1.70	1.72	1.79	1.84	1.85	1.86
5-year IRS	%	2.40	2.43	1.83	1.97	2.00	1.99	1.66	1.69	1.85	2.00	2.00	2.03
10-year IRS	%	2.86	2.89	2.02	1.94	2.34	2.29	1.73	1.74	1.82	1.91	1.94	2.09
EUR/PLN	PLN	4.26	4.26	4.30	4.29	4.30	4.28	4.32	4.30	4.25	4.31	4.31	4.30
USD/PLN	PLN	3.78	3.61	3.84	3.73	3.79	3.81	3.89	3.88	3.76	3.76	3.73	3.68
CHF/PLN	PLN	3.84	3.69	3.86	3.81	3.80	3.80	3.94	3.91	3.81	3.83	3.81	3.77
GBP/PLN	PLN	4.86	4.81	4.89	4.73	4.93	4.90	4.79	4.95	4.74	4.76	4.73	4.70

* End of period; other variables – average in period

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Source: NBP, Bloomberg, Santander

This analysis is based on information available until **12.12.2019** has been prepared by:

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