MACROscope

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Coronavirus crisis: v-, V- or U-shaped GDP scenario?

Poland: Economic Outlook

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Executive summary (macro)

The global economy has entered the crisis we have never seen before. The shock not only affects both the supply and the demand sides but also virtually all economies in the world at once. The magnitude of the shock depends a lot on the persistence of the Covid-19 disease, which is very hard to predict. We have prepared different scenarios of economic growth in Poland. The one that we think is currently the baseline, assumes that economic activity in Poland is severely supressed until early June and then revives quite vigorously (V-shaped rebound). In this scenario, GDP contracts almost 1% in 2020, to rebound almost 5% in 2021. However, if for any reasons (problems with supply-chains, very slow recovery in demand) the re-opening of the economy is delayed, we may move to the alternative scenario, assuming more lengthy recovery (U-shaped), with -2.5% GDP drop in 2020, followed by 2.2% rise in 2021. Both variants should be approached with caution, as the uncertainty regarding the evolution of the disease and its consequences remains unprecedented. As a result, the magnitude and the length of the shocks could in fact prove even stronger.

Unemployment will soar, but at least in the short term its growth could be slowed by the fact that the wave of job cuts may affect migrant workers in the first place (we have already seen news about large numbers of Ukrainian citizens returning home). The government's 'Anti-crisis shield', once finally implemented, may also offer some help to companies, reducing slightly the collateral damage on the labour market. In the V-shaped scenario we expect the LFS unemployment rate to double from the current c.3% level. The U-scenario may see the number of unemployed rising by c.1 million, with jobless rate reaching 9% this year.

The global recession implies, in our view, strongly disinflationary environment. Even if the rapid changes in relative prices of some food products introduce some short-term CPI volatility, inflation should head downwards in the coming months at a quick pace. It will be supported by the collapse of fuel costs (despite weaker PLN) and a broad trend among companies to offer large online discounts, to defend against loss of sales in traditional channels. We see both CPI and core inflation descending towards 2% y/y by the end of this year.

Amid significant growth slowdown and inflation deceleration, the financial market will probably continue pricing-in further rate cuts from the Polish central bank. We think that in the baseline V-scenario the NBP will be reluctant to cut the reference rate further from the current 1.0%. However, the depth of the recession will be crucial for the bank's reaction and if it turns out that we are moving towards much worse GDP scenarios, another 50bp interest rate reduction could be on the cards.

The fiscal imbalance will grow sharply this year due to (a) cyclical drop of tax revenues, (b) shortfall in one-off revenues (likely delay of OFE reform, lower inflow from CO2 and 5G auctions), (c) new budget spending on the government's anti-crisis package. The total size of GG gap could surpass 6% of GDP, i.e. PLN145bn. However, in the world affected by Covid-19, the large-scale fiscal expansion to limit potential damage from virus-related disruptions is far from controversial. The Stabilising Expenditure Rule will need to be suspended temporarily to allow for more spending. The debt-to-GDP ratio will rise, but the distance from 44% at the end of 2019 to the constitutional limit 60% of GDP fortunately looks safe enough.

Executive summary (markets)

FX

The rise in risk aversion worldwide hit the zloty, with EUR/PLN soaring to over 4.60 from c4.25 in late January. When compared to its CEE peers, in YTD terms the zloty lost c7.3 vs euro, the koruna c7.5%, the forint c10%, the ruble c20%. We do not expect the zloty to follow the extreme 2008/2009 path. The unprecedented action taken by the central banks in response to the world financial crisis might have caused the subsequent waves of risk aversion (like during the euro zone debt crisis) being smaller than the one observed more than 10 years ago. Also, back in 2009 in Poland there has been a case of “FX options crisis” that additionally weighed on the zloty. There seems to be still strong faith that central banks and governments have enough ammunition to fight the impact of the coronavirus pandemic. Actions taken by them so far managed to stabilize or at least slow the down the trend in the equity market, but we think that after a pause we could see yet another leg down on share prices. This could push EUR/PLN further up in the short term, before the zloty starts to recover in 2H20E.

FI

Emerging market assets have been hit this year due to two main factors: 1) coronavirus-induced growth slowdown and 2) collapsing oil prices. Poland luckily does not belong to the group of commodity exporters hence its currency has not sold-off much (relatively) and long term yields have behaved well. In the Q1’20 Polish yields have declined (in a bull steepening fashion), asset swaps have widened considerably, but the spreads to the German yield curve narrowed. The quarterly yield range after two quiet quarters of 2H19 has risen back to levels last seen in 1H19.

In a V-shaped scenario we expect no more NBP rate cuts, front-end rates anchored while long-end rates capped by the NBP QE program which easily will absorb the increased POLGBs supply. According to our estimate the increased bond supply this year may amount to ~PLN100bn (central government deficit PLN130bn minus EU funds of around PLN33bn), which is in line with the recent Deputy Finance Minister Piotr Nowak’s comments.

In a U-shaped scenario we expect 50bp more rate cuts, front-end rates lower ~50bp and long-end yields also capped. Even larger bond supply – total likely to be above PLN 130bn - should also be absorbed by NBP but with a widening asset swap to above 100bp.

2020 Forecasts Revisited

Indicator	Our view in January	Our current view
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.	The Covid-19 disease is triggering a global recession. The magnitude of the shock depends on the length of the pandemic and the lockdowns. We still hope that the base case scenario is V-shaped, assuming a solid rebound since 2H20. In this scenario GDP contracts almost 1% in 2020, to rebound almost 5% in 2021.
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.	Consumption will stall, amid collapse of confidence, movement restrictions and households' income suffering a major blow, if not from unemployment rise then from likely cuts in wages. Private investments will drop sharply, to be offset only partly by higher public spending after the restrictions are gone. Net exports should move to even bigger surplus, as import will contract much faster than exports.
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.	In the V-shaped scenario we estimate potential unemployment rise at 500-600k, which would imply the jobless rate doubling from recent 3%. The unemployment jump will be reduced by migrant workers potentially suffering the first wave of layoffs.
Inflation	We expect CPI will peak in 1Q2020E, 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.	Temporary disruptions in food prices unlikely to outweigh strongly disinflationary environment, with many firms defending against lockdown by offering big discounts online. CPI likely to approach 2% y/y by year-end.
Monetary policy	Central bank will remain in the wait-and-see mode, looking through the (temporary) overshoot of inflation target, as economic growth weakens.	NBP rate will remain on hold at 1.0%, unless we move towards much more negative scenario. Markets will continue pricing-in more policy easing.
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 should 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.	Fiscal deficit likely to top PLN145bn, amid new spending (PLN30bn on the rescue package) and shortfall in revenues. Part of this amount (c.PLN33bn) could be financed by EU money.
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 should increase to around 2.40-2.50% due to higher core yields (which contribute +20bp) and normalizing curve shape (another +20-30bp).	In response to coronavirus NBP cut rates by 50bp to 1.0% and launched a QE program. In a baseline scenario we expect no more NBP rate cuts, front-end rates anchored while long-end rates capped by the NBP QE program which easily will absorb the increased POLGBs supply.
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.	Large scale global policy response stabilised the PLN after recent depreciation, but we think that after a pause we could see yet another leg down on share prices. This could push EUR/PLN further up in the short term, before the zloty starts to recover in 2H20E.

Starting point: the economy just before the pandemic

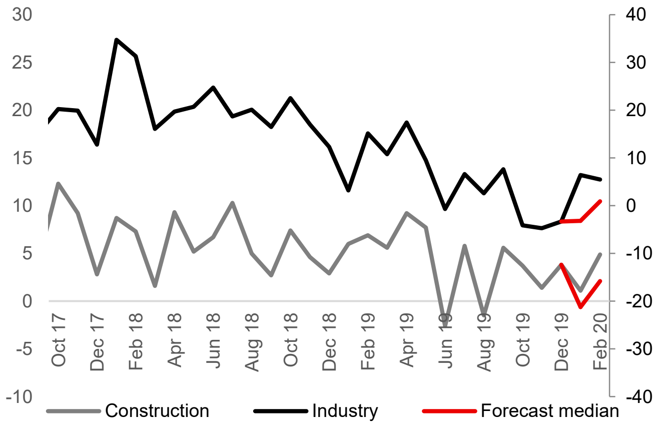
Output data in industry managed to surprise positively in both reported months of 2020, corresponding to a positive turn in European industrial PMIs, leaving an impression that some parts of the economy were about to re-accelerate after the 2H19 weakness.

The start of 2020 was no better for consumer spending than 4Q – with its surprisingly weak private consumption. In February retail sales did beat expectations, despite consumer confidence and retail trade sector sentiment trending down, but some early evidence of panic buying was seen in the details of the release.

The decline of the already record-low unemployment rate continued while wage growth returned above 7% y/y thanks to a large increase of the minimum wage.

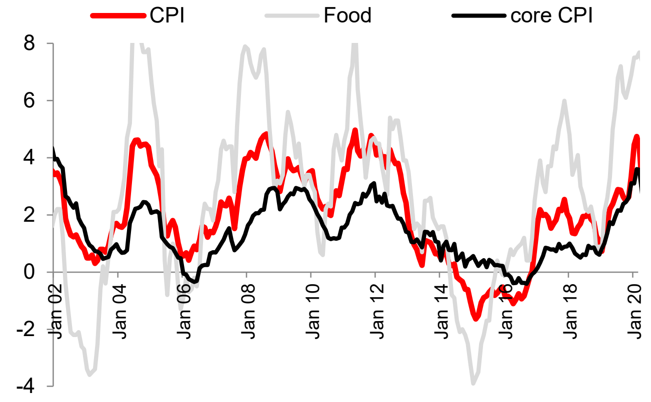
Inflation accelerated more rapidly than expected at the turn of the year and by February climbed to 4.7% y/y. Core inflation reached 3.6% y/y and services prices rose 6.4% y/y – both were the highest in c.18 years. Food inflation accelerated to 7.5% y/y (not seen since 2008) while an administrative hike sent electricity prices up 13.2% y/y.

Output and market expectations, %y/y



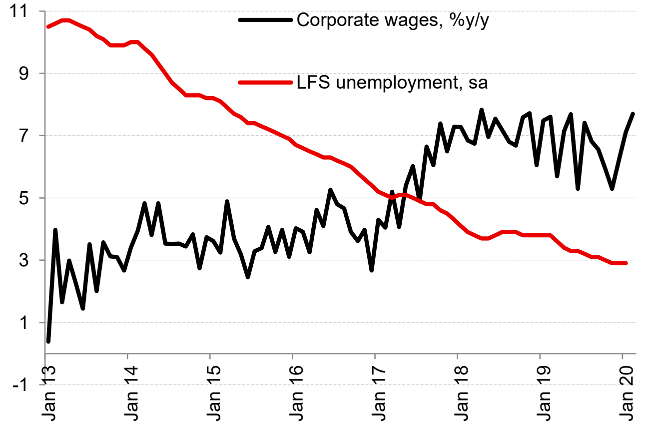
Source: GUS, Bloomberg, Santander

CPI inflation and selected components, %y/y



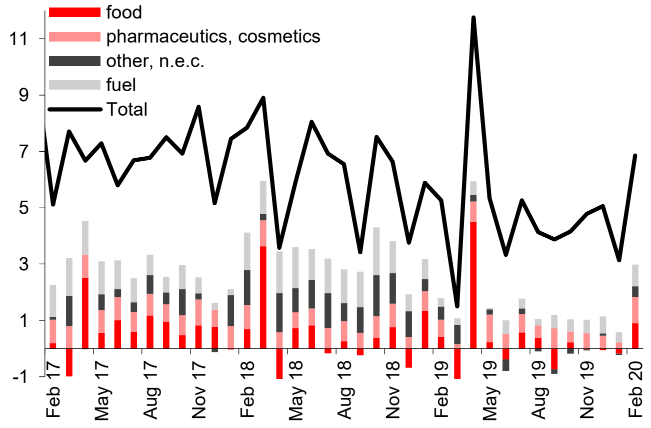
Source: GUS, NBP, Santander

Labour market data



Source: GUS, Eurostat, Santander

Retail sales and growth contributions of selected components, %y/y



Source: GUS, Santander

Covid-19 outbreak triggered a "sudden stop" shock

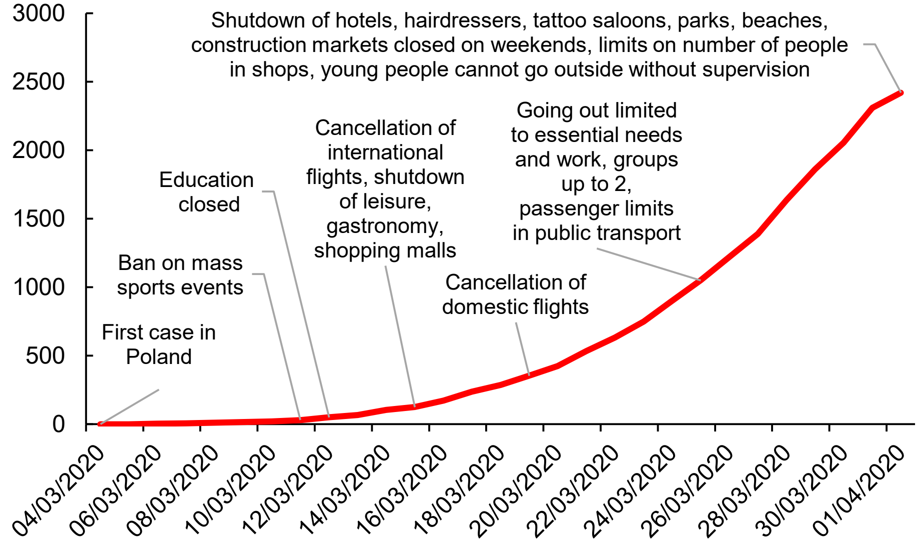
In March 2020 the Polish economy was hit by Coronavirus-related shock. The government responded by ordering to close restaurants, bars, recreation centres, most shops in malls, recommending people to stay home and banning international flights from 15 March on (education was closed on 12 March, mass sports events were banned on 11 March).

This shock is quite different from economic shocks we knew before due to its "sudden stop" nature and initial impact on consumer-related services. The shock is affecting both the demand and the supply side of the economy, as it is making consumers stay home and banning them from using some services or buying certain products. Firms, on the other hand, are faced with falling labour supply, as some parents need to stay home to take care of children or are sick / or in quarantine. Also, anecdotal evidence shows that many workers from Ukraine decided to return home before Ukraine shut its borders on 28 March. There is also a risk that a whole plant will be shut down if an employee contracts to Covid-19. Note that the same shock is affecting many Poland's trading partners, additionally strengthening the negative impact.

These two processes lead to breaks in supply chains and create additional effects, e.g. inability to deliver industrial supplies. Some sectors, e.g. automotive, consumer electronics already decided to suspend production amid lack of demand and shortage of supplies.

On the next slides we present our scenarios for economic developments in virus-affected Poland.

SARS-CoV-2 timeline in Poland, number of confirmed cases as of 01/04/2020 15:00 CET



Source: Ministry of Health, PM Office, Santander

How deep may be the value added disruption?

In the stress environment that we are currently facing, the modelling of behaviour of final demand components is extremely difficult in our view, and subject to high uncertainty. Thus, we decided to estimate the potential size of the GDP growth disruption by applying a set of time-limited shocks to the value added in specific sectors of the economy.

We have calibrated the shocks to different economic sectors (NACE Rev 2, two digit level), relying on the anecdotal evidence, media information, high-frequency bank data reflecting financial transactions, but also our subjective judgement.

We assumed that consumer services will be hit the most. Manufacturing will be hit a bit later and at a lower scale, yet consumer-related branches like car manufacturing or furniture manufacturing will suffer relatively more. There are also some branches that could potentially benefit from the current situation, e.g the e-commerce or post / delivery services.

We assume that in the next few weeks 95% of the economy will suffer a decline in value added in the lockdown period. In 60% of the economy this decline will be larger than 5%, in 40% larger than 10%, in 25% larger than 15% and in 5% larger than 50% (in some areas, however, the drop could be as bit as 90%).

List of the potentially most affected sectors of the economy:

Sector	Share in Value Added
Exposed to most severe value added contraction:	
Sale and repair services of motor vehicles and motorcycles	2.0%
Water and air transport services	0.2%
Accommodation services	0.5%
Food and beverage serving services	0.7%
Travel agency, tour operator and other reservation services	0.1%
Creative, arts and entertainment services	0.4%
Library, archive, museum services	0.1%
Gambling and betting services	0.1%
Sporting services and amusement and recreation services	0.2%
Other personal services	0.8%
Sub-total	**5.1%**
Exposed to severe value added contraction:	
Textiles	0.2%
Wearing apparel	0.4%
Leather and related products	0.1%
Computer, electronic and optical products	0.4%
Electrical equipment	1.0%
Machinery and equipment n.e.c.	1.1%
Motor vehicles	1.2%
Other transport equipment	0.5%
Furniture	0.9%
Constructions and construction works	8.4%
Services furnished by membership organisations	0.1%
Repair services of comput. and personal and household goods	0.6%
Private households with employed persons	0.1%
Advertising and market research services	1.3%
Land and pipeline transport services	3.9%
Sub-total	**20.3%**

Source: GUS, Santander

GDP growth scenarios: v, V, U ?

The Chinese authorities are planning to end the Wuhan shutdown on 8 April, i.e. about 80 days after surpassing 100 infections mark.

In our analysis, we assume two versions regarding the length of economic shutdown in Poland: (1) lockdown-related disruptions last for 55 days starting from 15 March (optimistic scenario) and (2) last for 85 days – until the early June (more realistic).

Then we assume two types of reactions: V-shaped recovery assuming that the economy will be able to resume quickly in 3Q20, and U-shaped, with more sluggish response, more bankruptcies and more layoffs.

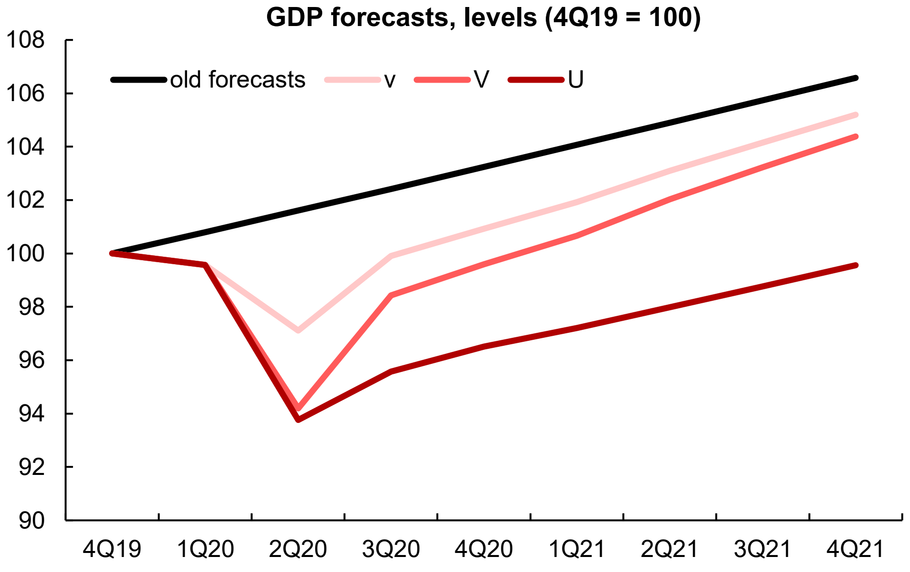
Overall, we present three GDP scenarios:

"v" – 55 day disruptions, quick rebound,

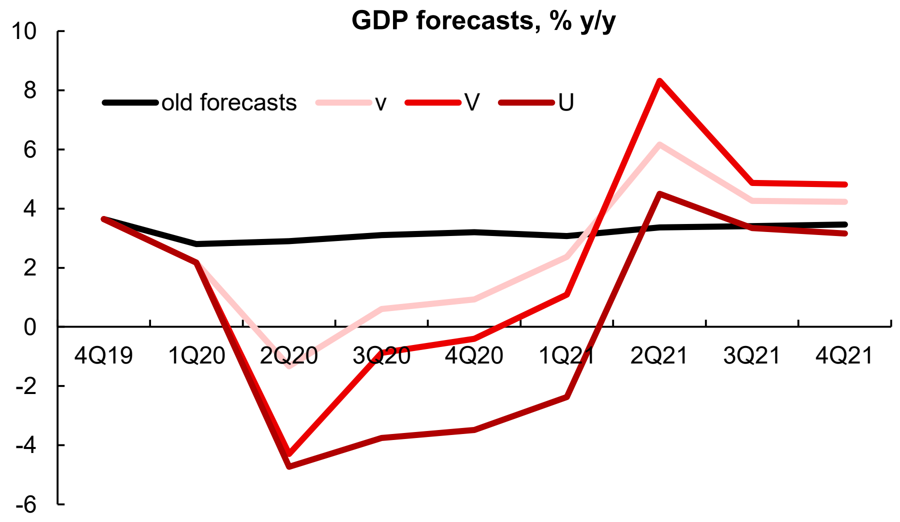
"V" – 85 day disruptions, quick rebound,

"U" – 85 day disruptions, sluggish rebound.

We think the second "V" scenario is currently the baseline. However, the uncertainty regarding these paths is huge and so far the probability has been moving steadily towards less optimistic outcomes. The scenarios may need to be revised as new data will be flowing in, as potentially both the magnitude and the length of shocks could in fact prove even stronger.



Source: Santander



Source: Santander

Annual GDP forecasts, % y/y

	2020	2021
v	0.6	4.3
V	-0.9	4.8
U	-2.5	2.2

Source: Santander

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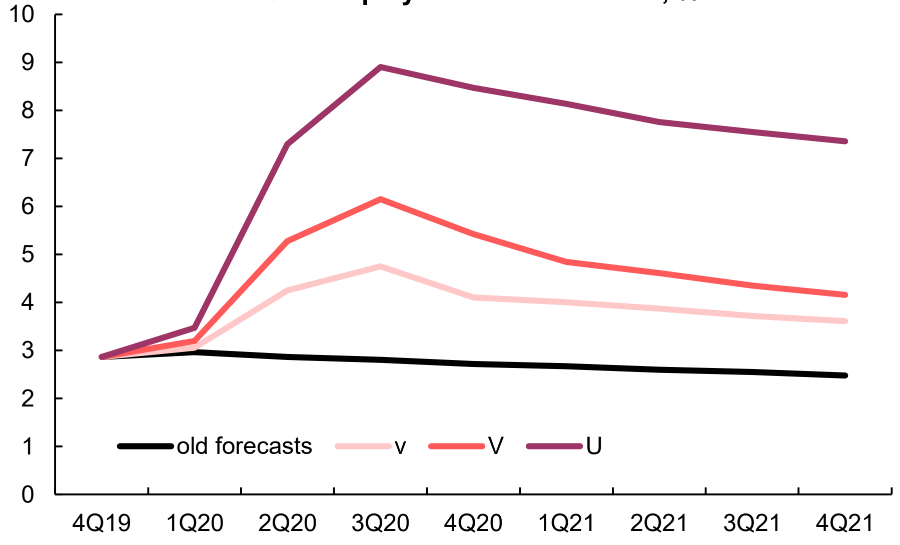
Labour market: unemployment up, wages down

After years of steady unemployment decline and rapid wage growth, we are likely to see a turnaround in the Polish labour market. The most recent surveys already signalled that between 1/3 and 2/3 of firms is mulling layoffs due to Covid-19 outbreak.

However, if the shock to GDP is relatively short-lived (V-shaped scenario), we see reasons to believe that the job losses could be relatively contained. First of all, we think that the wave of job cuts will affect migrant workers in the first place. Some of Ukrainians have already returned home before borders closure. Many of them were barely even visible in Polish statistics (less than cPLN500k were registered in Polish social security) and will not show up in unemployment numbers. Moreover, we think that – similarly to 2009 – at least some firms may be reluctant to shrink staff as long as they believe that disruption in business is temporary (labour hoarding). Simply, those employees will be needed badly once the lockdown is over, especially that migrants' return could be delayed. The effectiveness of the government's measures aimed at job retention is yet to be seen, but on margin they should offer some employment protection as well.

LFS unemployment rate forecasts, %



Source: Santander

LFS unemployment rate forecasts, % eop

	2020	2021
v	4.1	3.6
V	5.4	4.2
U	8.5	7.4

Source: Santander

Still, households are likely to suffer a major hit in labour income. According to our estimates, job reductions alone could lower this year's total wage bill by c.4% in V- and c.10% in U-shaped scenario. Additionally, wage cuts could be quite common (yet hopefully temporary) in the crisis-affected sectors. The government's anti-crisis measures in fact encourage firms to lower salaries by 20% during the disruption period. Also, Poland has relatively large share of working population in flexible forms of employment: either self-employed (1.3m ex farmers), working on civil contracts (1.7m, our of which 0.4m is retirees) or on temporary contracts (3.1m). For them, the risk of losing current revenue is particularly high. The likely drop in households' disposable income (plus potential collapse of consumer confidence) is likely to depress private consumption. On the other hand, in 2019 households have built a savings buffer as they did not spend the extra social transfers on consumption, which creates at least some buffer for difficult period ahead.

Number of people in groups potentially at biggest risk of losing job/income:

Civil contracts, ex retirees and pensioners:	1.3m
Civil contracts, retirees and pensioners:	400k
Paid employment, retirees and pensioners:	1m
Employed within last 3 months:	463k
Employed on temporary contracts:	3.1m
Employed in micro-firms:	4.2m
Self-employed, ex farmers:	1,3m
Helping family members:	360k

Source: GUS, Eurostat, Santander

Inflation: going downhill

The Coronavirus-related economic disruptions made us revise our CPI forecasts downwards. We are now expecting CPI in 2020 at 3.0% on average and 2.1% y/y in December versus our earlier forecast of 3.6% and 3.1% respectively, presented in the previous MACROscope. In U-shaped scenario, we would see inflation at 2.6% on average and 1.1% in December.

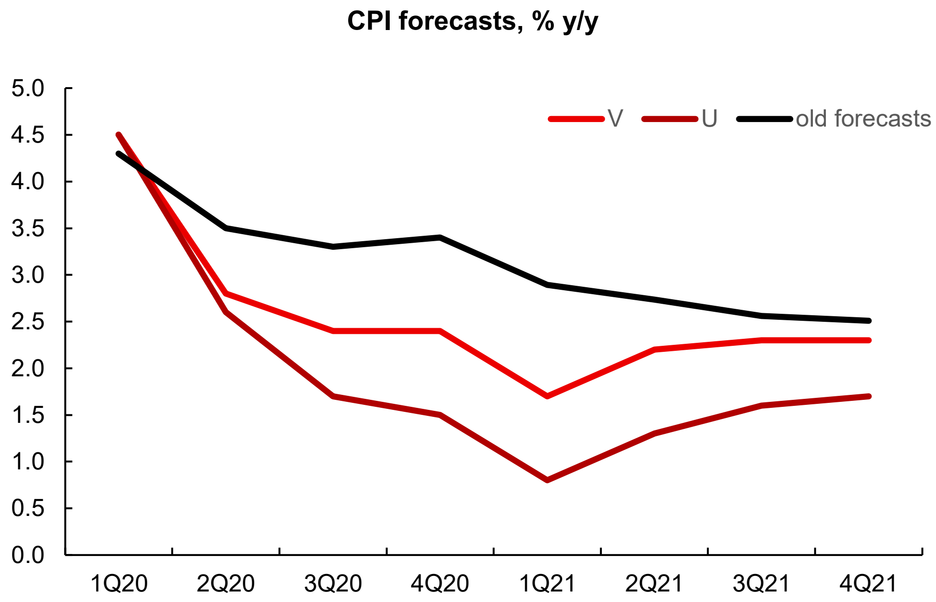
While Coronavirus is likely to increase prices in some categories, like food or hygienic products (at least in the short run), the fall in commodity and services prices, as well as generally lower demand pressure will push prices lower, in our view.

One of major sources of downward revision is crude oil, which we are expecting to average at $32.5/bbl (PLN130) in 2020 versus our earlier forecasts at $60 (PLN230). Such a reduction is deducting 0.5 pp from 2020 CPI.

We have revised our 2020 core inflation forecast to 2.6% from 3.1%, deducting 0.3 pp from headline CPI.

Our forecast of food prices stands at 6.4% y/y on average in 2020, up from 5.7% y/y, adding 0.2 to our CPI forecast.

Overall, we are convinced that the general direction for inflation will be downwards. Having this in mind, we cannot rule out a short-term volatility in CPI readings, not only due to rapid changes of relative prices, but also due to possible measurement errors – in the lockdown period GUS will have to rely solely on the online polling.



Source: Santander

Foreign trade: surplus about to rise

We simulated the impact of coronavirus on Polish trade ties at a disaggregated level. Based on anecdotal evidence and our own judgement we assumed a various depth of the shock to particular Broad Economic Categories. We also used different time profiles of post-epidemic recovery for groups of trade partners.

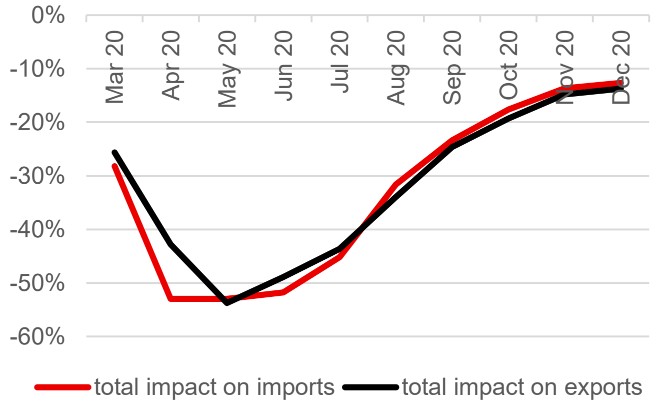
On the imports side we also made assumptions about the drop in demand for particular BEC categories and the time profile of demand recovery. The resulting path of imports is thus shaped by both supply and demand side restrictions.

The negative impact on foreign trade volumes is concentrated in the next three months and reaches a c.50% deviation of both exports and imports from the 2019 path.

We expect to see the improvement of the goods trade balance in the first months of the epidemic. The assumption that Asia recovers faster than Europe leads to a slight deterioration of the trade balance in later months of the simulation vs the benchmark.

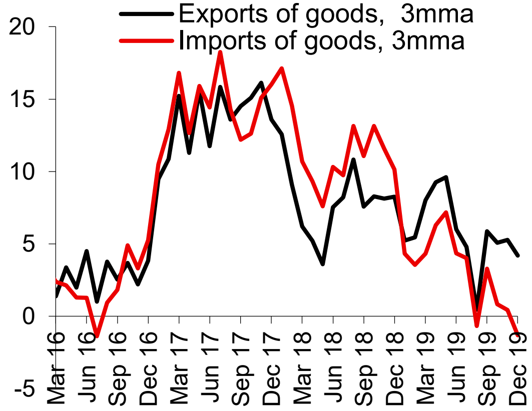
A limitation of the exercise is that we take trade partners' shares as fixed, whereas Polish producers showed in the previous years that they can adapt to demand conditions by geographical diversification. This was in our view one of the key reasons why Poland managed to systematically post stronger production and exports figures than Germany and peers in 2018-2019. As a result the model might overestimate the negative shock.

Estimated impact of Covid-19 on Poland's trade volumes



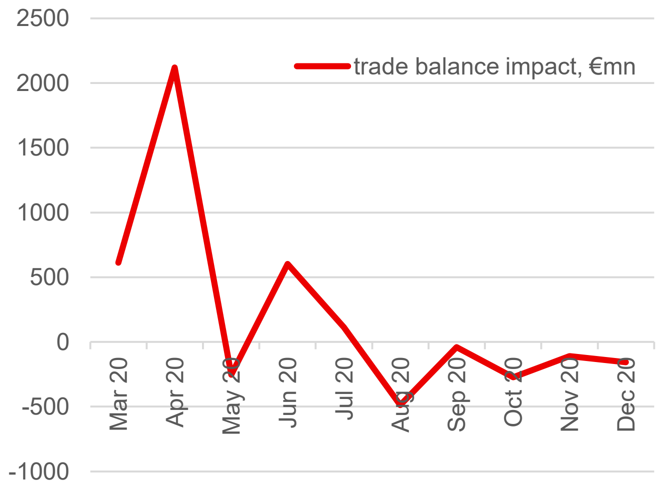
Source: Santander

Exports vs imports, % y/y



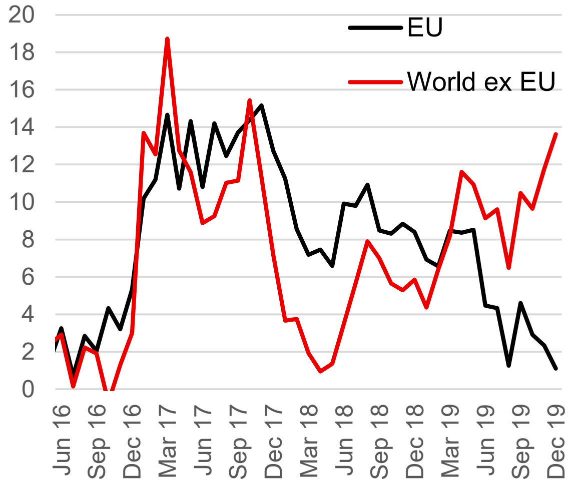
Source: NBP, Santander

Net effect of the shock on trade balance



Source: Santander

Polish exports growth, % y/y 3mma



Source: Eurostat, Santander

Fiscal policy: the deficit will soar

The Coronavirus crisis will cause a major deterioration of GG deficit and we estimate it at cPLN145bn (6.3% of GDP) as compared to PLN32.2bn (1.4% of GDP) assumed in the budget act. We are expecting the general government debt to hit 52% of GDP in 2020, up from 46.0% in 2019.

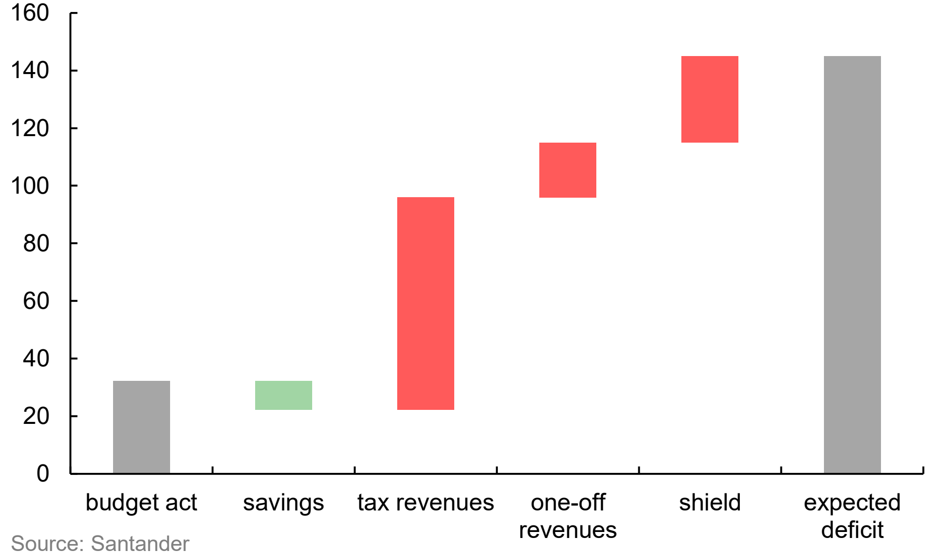
We base our estimates on our V macroeconomic scenario and assume that tax/contributions revenues will miss the target by PLN75bn, the government will resign from OFE transformation (PLN19bn) and will spend PLN30bn on the rescue package (in line with the government assessment of costs, shown in the bill). Additionally, the government will cut spending in non-essential sectors by PLN10bn. We assume that the government will not launch the investment part of its rescue programme already in 2020.

We are expecting the Stabilising Expenditure Rule to be suspended. In our view this will not be negative for Poland's credit rating, as long as the suspension is temporary.

The Public Finance Act assumes a cautionary threshold of 55% public debt-to-GDP ratio. Its break results in need to introduce a rescue programme and plan no deficit in the central budget and local governments for the next year. This law could however be changed easily.

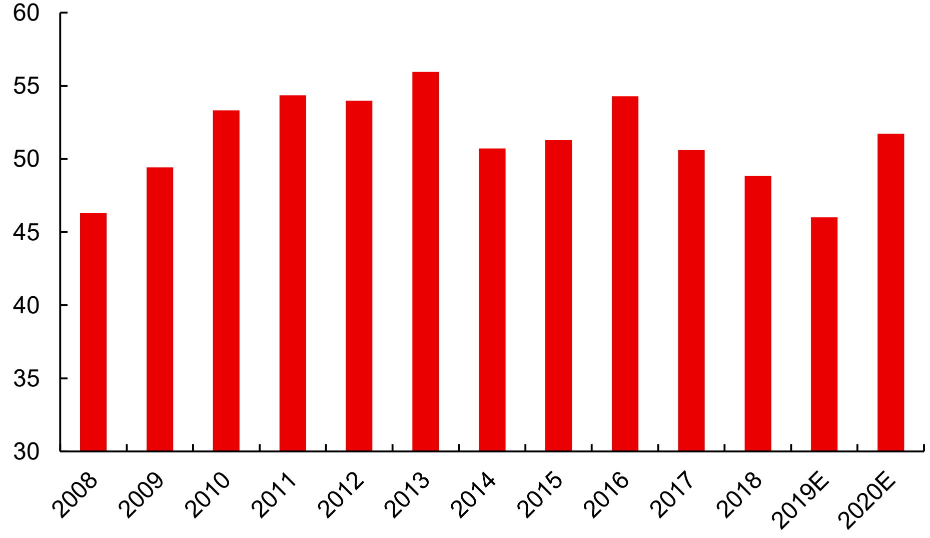
Another cautionary threshold is set at 60% and is enshrined in the Constitution, unlikely to be changed. This law actually stops any public borrowing after this limit is hit. Note however that Polish law debt limits are applied to domestic definition of public debt, which stood at 43.7% of GDP in 2019.

Forecasts of 2020 general government deficit, PLNbn



Source: Santander

General government debt – actual and our forecast, % of GDP



Source: Eurostat, Santander

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Government’s Anti-crisis Shield

The government prepared a rescue package estimated at PLN212bn (c.10% of GDP), out of which PLN67bn represents actual public spending (about 3% of GDP), PLN75bn in government’s liquidity support and PLN70bn in NBP liquidity support. We have described in more details the initial version of the package in our Economic Comment.

Key areas of support are:

- Jobs and income loss prevention (e.g. subsidised wages, reduced worktime, payments to the self-employed and people working on civil contracts, administration fees, taxes and social contributions postponed until June);
- Liquidity support for companies (e.g. extended guarantees, microloans, 3 months of social contributions of micro-firms and the self-employed covered by the state);
- Additional healthcare expenditures;
- Liquidity support for the financial sector (e.g. lower reserve requirement, repos, lower systemic risk capital buffer);
- Investment program (e.g. on infrastructure, schools and hospitals) to help revive economy once the lockdown is over;

Many social distancing restrictions have been imposed.

The short-term expenditure part of the package (labour market instruments and healthcare) relative to GDP is slightly higher than what countries like Italy, Spain, the UK and Canada have launched, comparable to the Czech package, and lower than the response of the USA, Germany, France, Austria, Sweden or Switzerland. However, Poland also added a longer-term investment program. The liquidity/guarantees part of the package (ex central bank tools) looks relatively small vs main EU countries. We stress here that comparison of sizes of the support packages may be imprecise due to their different composition.

The Shield has been designed for no more than three months of economic stall and is supposed to be enlarged if the crisis lengthens

Size of the package, by main pillars, PLNbn (given at the press conference announcing the package)

Jobs and income loss prevention	30
Liquidity support for companies	74
Liquidity support for the financial sector	70
Healthcare	7.5
Investment program	30
Total	**212**

Source: Government, Santander

Total impact on general government expenditures, PLNbn (according to the bill introducing the package)

	2020	**2021**	**2020-2030**
Central budget	10.2	3.3	28.1
Local governments	0.0	0.0	0.0
Social Security Fund	2.5	0.0	2.5
Fund for Guaranteed Employee Payments	2.7	0.0	2.7
Labour Fund	14.9	0.0	14.9
Disability Fund	0.2	0.4	4.1
Total	**30.5**	**3.6**	**52.3**

Source: Government, Santander

Monetary policy turned unorthodox

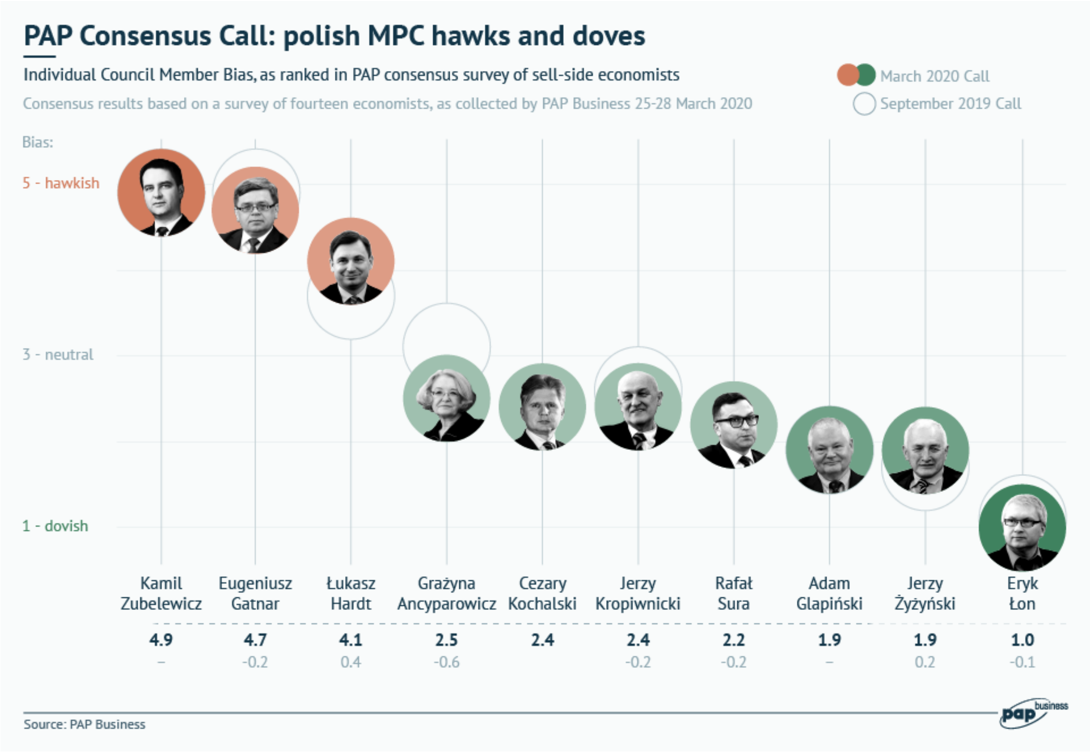
The abrupt change in economic environment triggered a rapid turn in monetary policy. In mid-March the MPC decided about emergency rate cut by 50bp, trimming the reference rate to 1.0%, plus applied a set of other measures:

- Cut of reserve requirement ratio from 3.5% to 0.5% and increase of interest paid on the required reserves from 0.5% to 1.0%,
- Start of repo operations, supplying banks with liquidity (potentially unlimited),
- Start of bond purchases from the secondary market (Polish QE),
- Introduction of a facility similar to the ECB's TLTRO enabling banks to refinance loans for corporations (details yet to be revealed).

Also, a set of regulatory measures have been announced by different authorities (KNF, BFG etc.), including a release of systemic risk buffer for banks, changes in rules of creating provisions, changes in approach to liquidity requirements, to facilitate banks financing the economy.

The monetary policy has turned unconventional, and we think that those 'non-standard' policy tools (which, by the way, are now commonly used globally, so probably we should no longer call them non-standard) will be now used in the first place to counter the economic consequences of pandemic.

Amid significant growth slowdown and inflation deceleration, the financial market will probably continue pricing-in further rate cuts from the Polish central bank. We think that in the baseline V-scenario the NBP will be reluctant to cut the reference rate further from the current 1.0%. However, the depth of the recession will be crucial for the bank's reaction and if it turns out that we are moving towards much worse GDP scenarios, another 50bp interest rate reduction could be on the cards.



Poland's strengths

Looking for bright spots in the current dire situation, we identified a list of factors, which may mitigate the shock for Poland and facilitate the recovery:

Diversification of trade ties outside Europe before the epidemic means that Poland is now better suited to benefit from revival of demand in economies that could recover sooner than Europe (Asia, Australia?).

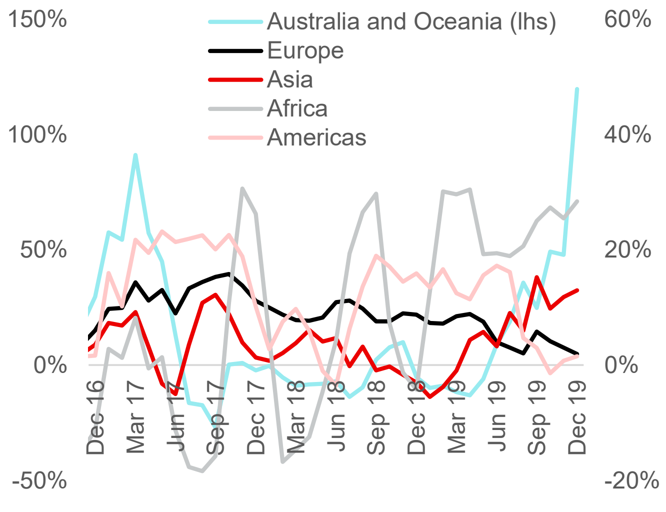
For five years Business Process Outsourcing and Shared Service Centres sector has been growing rapidly in Poland. This structural change means a significant contribution to Poland's C/A balance. This sector seems to be relatively resilient to the restrictions imposed due to the epidemic and suitable for teleworking.

Consumers may have been able to build up savings ahead of the epidemic: private consumption seemed weaker in 2H19 than the income side (incl. increased social transfers) suggested. This may now help smooth consumer spending.

Relatively low employment and value added generated by tourism. Poles often spent summer holidays abroad, but this time are likely to stay, possibly leading to more holiday expenditures in the country and less demand for foreign currencies due to travelling. According to HICP weights Poles spend 1.05% of incomes on package international holidays.

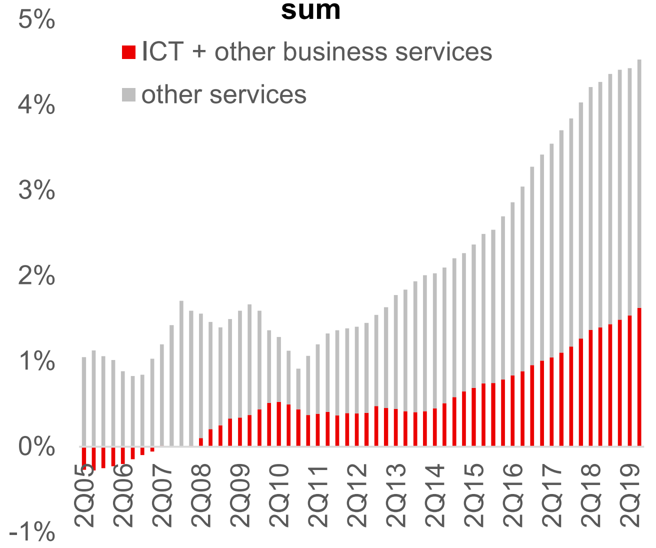
Poland is a large net importer of energy commodities which have seen their prices drop massively since the outbreak of the epidemic. This constitutes a positive supply shock for the Polish economy.

Exports by continent, % y/y, 3M mov. avg.



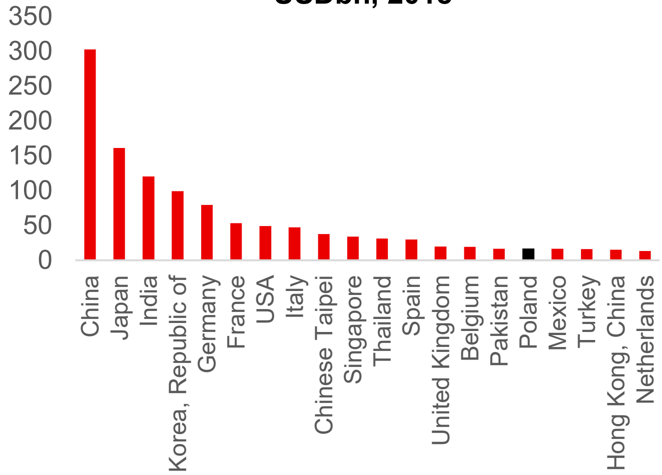
Source: GUS, Santander

C/A services balance, % GDP, 4Q mov. sum



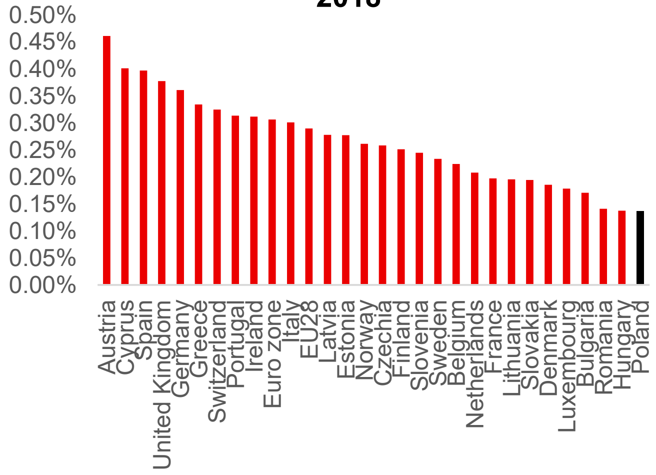
Source: NBP, Santander

World's top net importers of fuels, USDbn, 2018



Source: WTO, Santander

Share of employment in tourism sector, 2018



Source: Eurostat, Santander

Poland’s weak spots

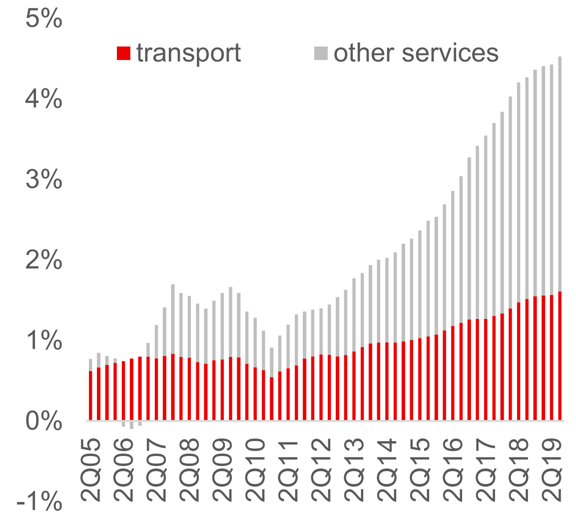
The following factors can make it more difficult for Poland to resist the current economic shock and to quickly move to a recovery:

International transport services expanded in recent years and are a relatively big chunk of value added and an important part of the overall C/A balance

Relatively high share of the self-employed in total employment, who are now at high risk of bankruptcy/liquidity issues/unemployment (although out of total 2.3m, 1m are farmers, potentially less exposed to current crisis).

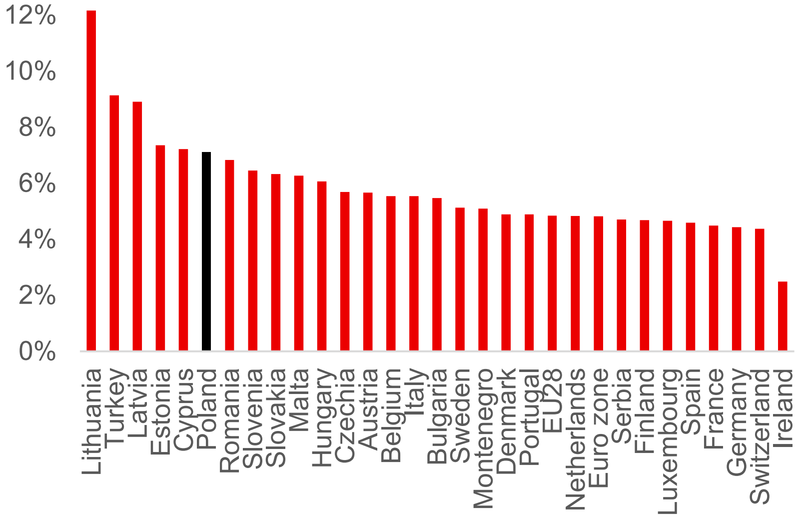
Ukrainian workers are a significant support of the economy. The lockdown and the economic shock may prevent them from returning to work in Poland for a prolonged period. Generally a drop in labour demand looks unavoidable, but in the short-term worse access to Ukrainian workers may mean disruptions in some sectors (agriculture, construction). In the long-term a weakened inflow of Ukrainians would mean a less vigorous rebound and lower potential growth. The epidemic in Ukraine is developing with a lag compared to Poland which may result in reluctance to open the border later on to prevent a secondary outbreak.

C/A services balance, % GDP, 4Q mov. sum



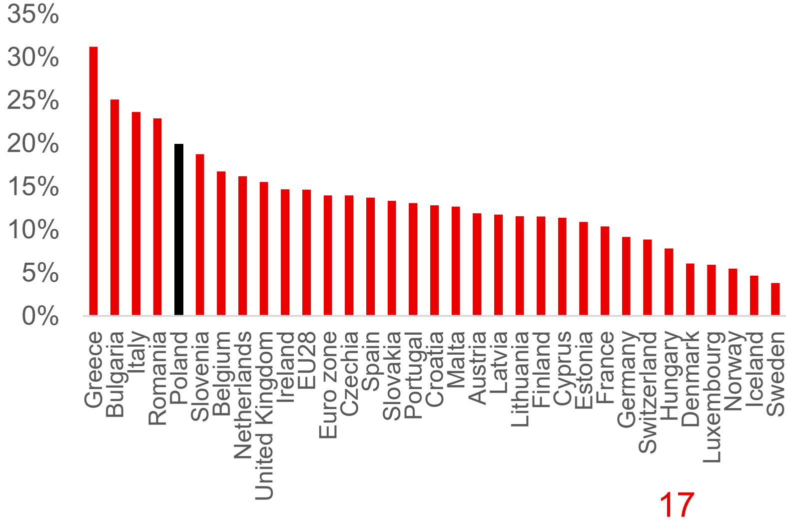
Source: NBP, Santander

Share of transport and storage in Value Added



Source: Eurostat, Santander

Share of the self-employed in total employment



Source: Eurostat, Santander

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FX – Zloty could weaken before getting stronger

The rise in risk aversion worldwide hit the zloty, with EUR/PLN skyrocketing to over 4.60 from c4.25 in late January (+c9%).

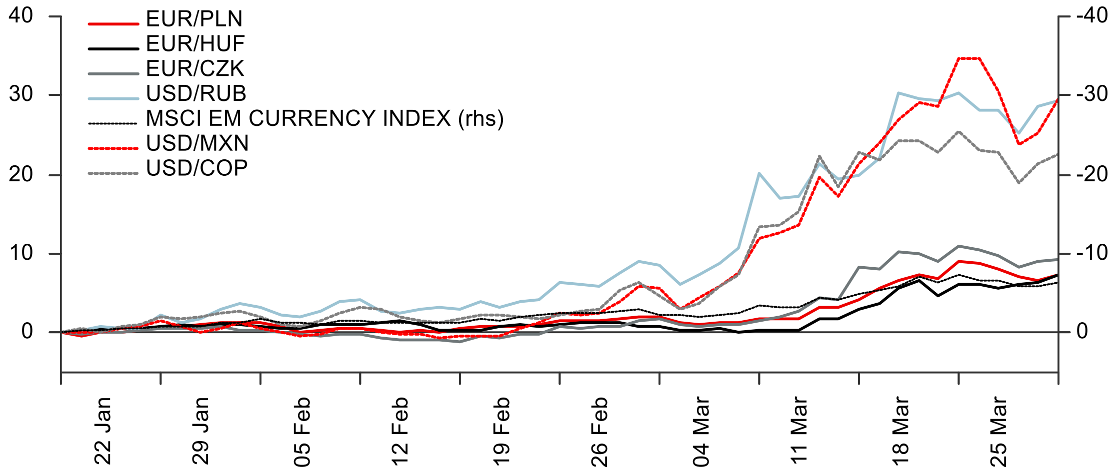
The scale of the zloty's depreciation may look substantial, but when we compare it to the EM universe, the EUR/PLN was around the middle of the pack. Some currencies lost much more, and it seems that being a commodity exporter might have generated additional negative pressure. At the same time, the number of COVID-19 cases and weight of tourism in the country's GDP do not seem to be vital factors explaining the scale of the currency's changes seen since late January.

As showed on the second chart, in the past EUR/PLN suffered substantial upside waves triggered mainly by the external factors. In 1Q20, the EUR/PLN YTD performance resembles 2012 the most (95% correlation). In such scenario, there would be no further zloty depreciation. However, the exchange rate path since January is also very similar to 2011/2012 (73%) or 2008/2009 (83%).

We do not expect the zloty to follow the extreme 2008/2009 path. Since the World Financial Crisis, the market paradigm seems to have changed meaningfully – whenever a risk factor emerged, investors would seek help from the central banks. That is why we do not think EUR/PLN could converge to the 2008/2009 path. If the zloty was to depreciate at the pace similar to 2011/2012, EUR/PLN might rise to nearly 5.0 in next two months. For now, this is not our base scenario.

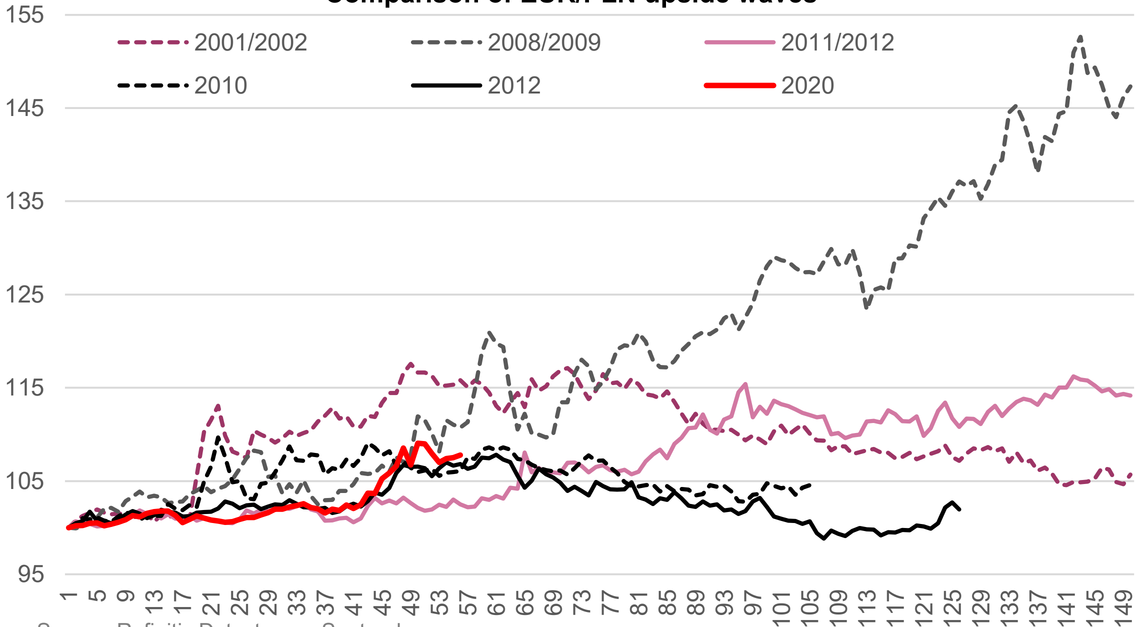
Central banks and governments have already taken steps to shield the economy from the severe measures introduced to fight the coronavirus pandemic. These actions have so far managed to stabilize or at least slow the down the trend in the equity market, but we think that after a pause we could see yet another leg down on share prices. This could push EUR/PLN further up in the short term, before the zloty starts to recover in 2H20E.

EM currencies (20 Jan 2020 = 100)



Source: Refinitiv Datastream, Santander

Comparison of EUR/PLN upside waves



Source: Refinitiv Datastream, Santander

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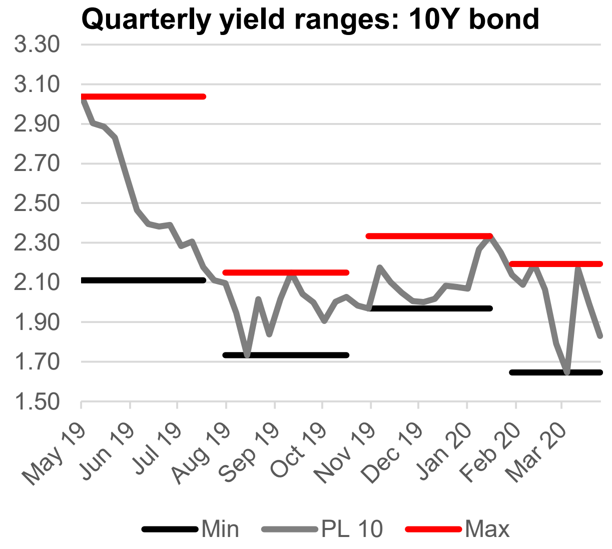
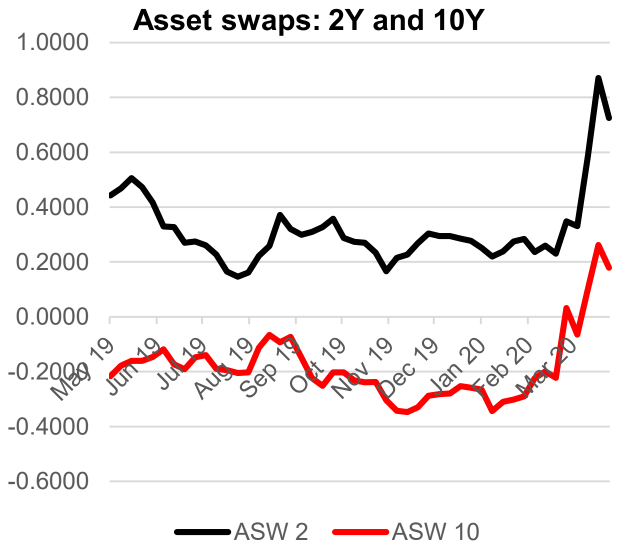
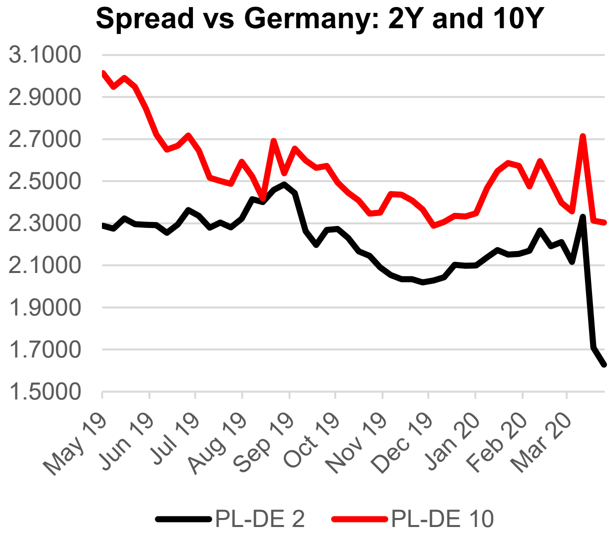
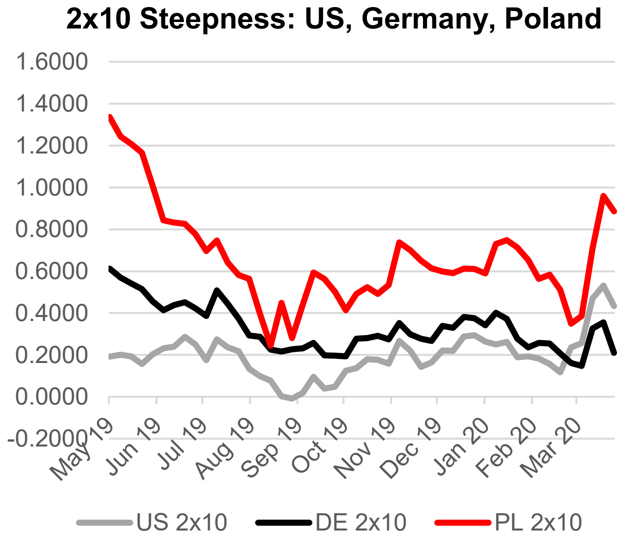
FI – Yields capped by QE

- Four plots on the right depict Polish yields behaviour in the Q1'20 in the context of the past 1 year. As can be seen: yield level has declined in general (#1) with asset swaps widening (#2) but spreads to Germany (#3) narrowing. The curve has bull steepened (#4) and the quarterly yield range at 55bp has increased to a level last seen in H1 2019 (#1) then at 93bp.
- In a **V-shaped scenario** (growth rebound in H2'20) we expect:
  - NBP to stay on hold at 100bp (no more cuts)
  - Front-end yields to remain anchored near main rate
  - Long-end yields to remain capped at current levels by the NBP QE programme. Our estimates suggest the increased bond supply this year at ~PLN100bn (central government deficit PLN130bn minus EU funds of around PLN33bn), which is in line with the recent Deputy Finance Minister Piotr Nowak's comments.
- In a **U-shaped scenario** (recession into H1'21) we expect:
  - NBP to cut rates by another 50bp
  - Front-end yields to decrease to the new main rate
  - Long-end yields to remain capped at current levels by NBP QE programme. Even the further increased bond supply – total likely above PLN130bn - would be bought by the NBP. In a strong recession scenario yields would probably decrease with swaps going much lower than POLGBs yields (ASW wider to levels above 100bp)









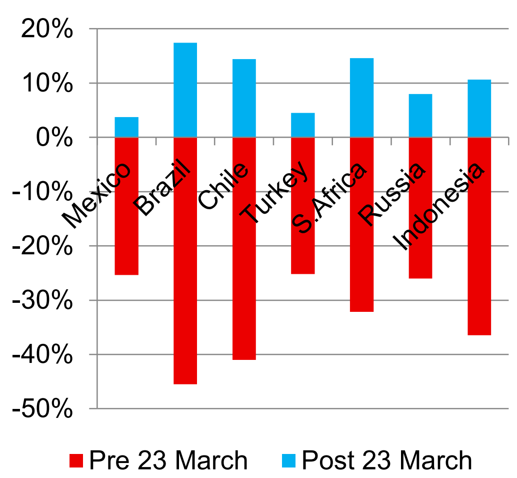
How the Emerging Markets sold off this year

- On the next slide we look at the YTD price behaviour in the EM universe of different asset classes. We split it into:
  - (31 Dec 2019 – 23 March 2020) in order to visualize the extent of the **initial sell-off** (red bars)
  - (23 March 2020 – onwards) in order to visualize the extent of the **subsequent risk rebound** (blue bars)
- The cut-off date is 23 March 2020 – on that day risk aversion peaked this year (S&P500 at 2200)
- 8 plots total are split by asset class (column-wise: Equity, FI, FX) and whether the country is an important commodity exporter (top – yes, bottom – no) and hence would be hit with lower prices of commodities, like oil this year
- As far as **Equities (1st column from left)** and **Front-end rates (2nd column)** are concerned – there is **hardly any difference** between high and low beta countries:
  - Most of the EM equities indices strongly sold-off . Then rebounded but only marginally.
  - Most front-end rates (with few exceptions) decreased as markets started to price in central bank cuts.
- As far as **Long-end rates (3rd column)** and **FX (4th column)** are concerned – there is **clearly a difference** between high and low beta countries:
  - USD/xxx currency pairs increased much more (25-30%) in commodity exporers vs (5-10%) in the rest of EM
  - Long-end rates increased in most commodity exporters as the increased sovereign risk (fiscal revenue shortages) was being priced in. Whereas rest of EM followed core yields lower

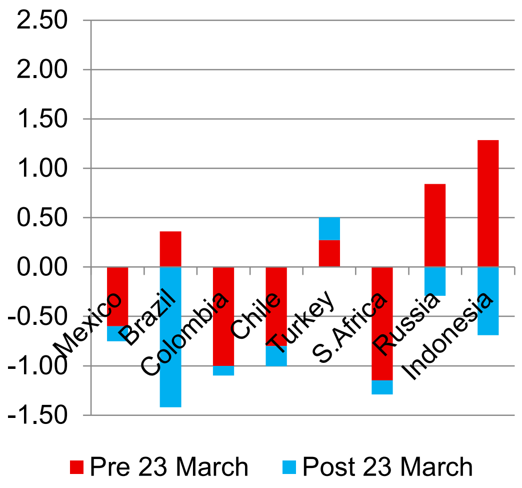
Poland being a low beta country has seen its currency sold off only 8% and rates lower along the curve (supported by the launch NBP QE programme). If the global-risk aversion persists or intensifies however we see an increased risk of low beta countries' FX, including PLN, performance worsening from here.

How the Emerging Markets sold off this year

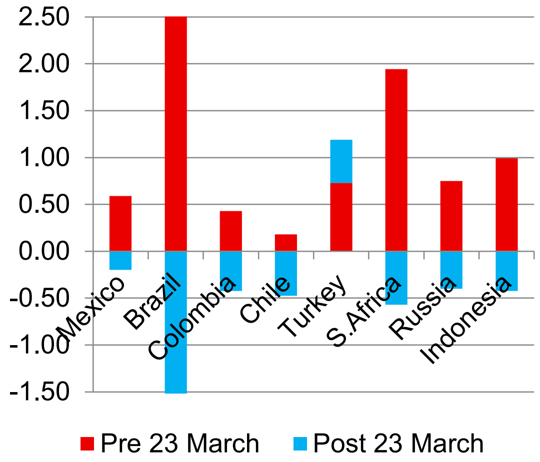
Equity indices



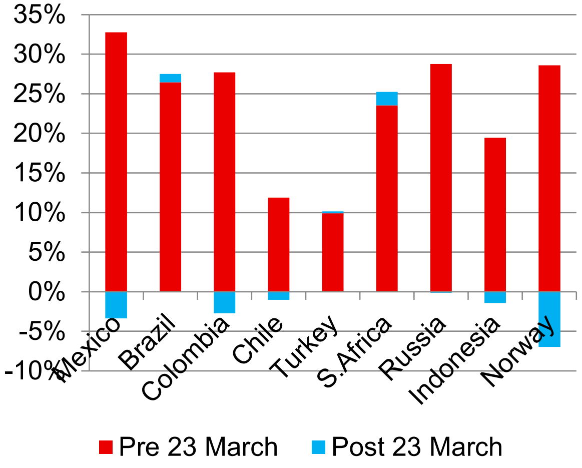
FI: 2Y rates



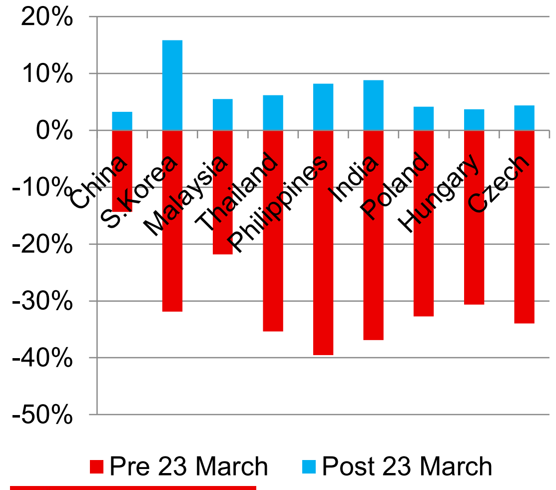
FI: 10Y rates



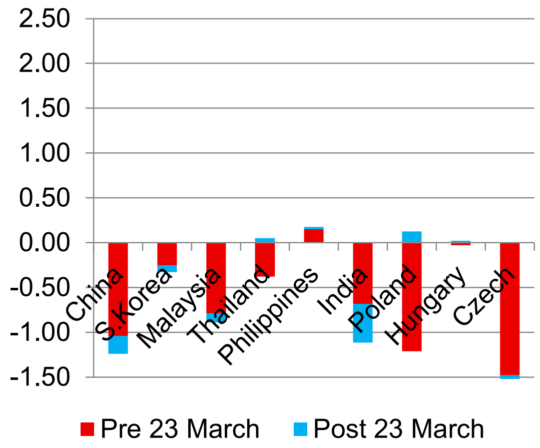
FX: USD/xxx



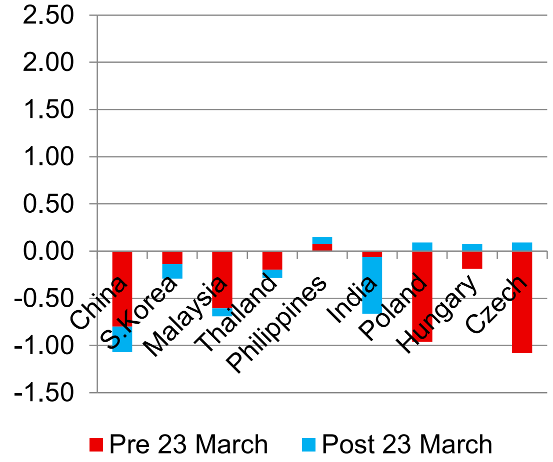
Equity indices



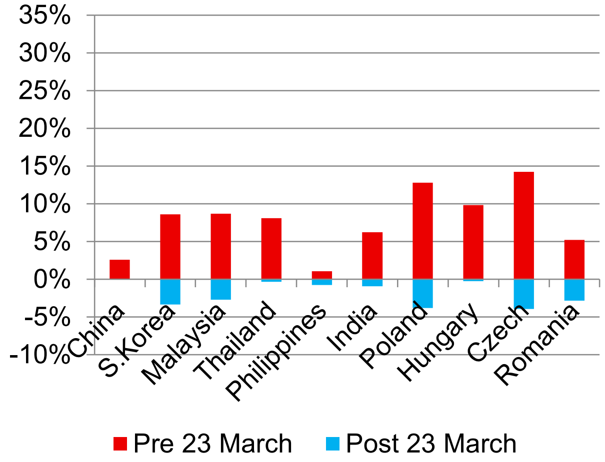
FI: 2Y rates



FI: 10Y rates

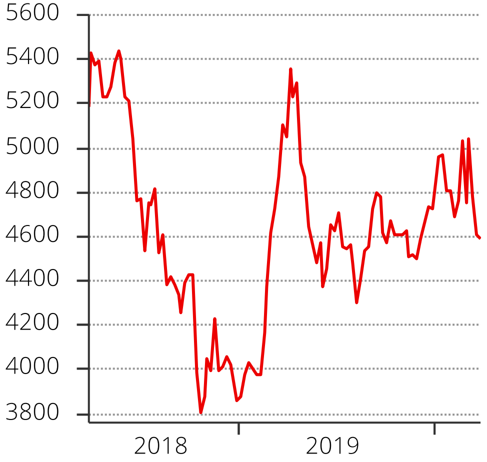


FX: USD/xxx



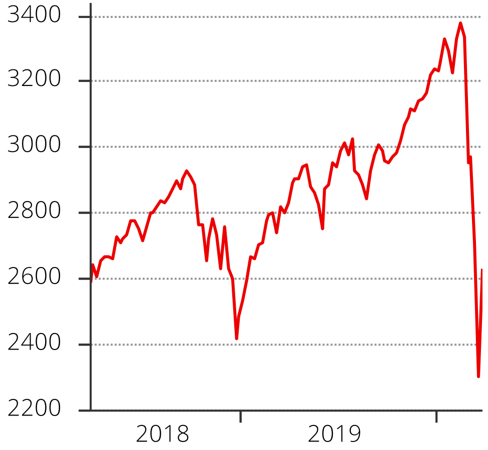
Global financial markets review

Shanghai stock index



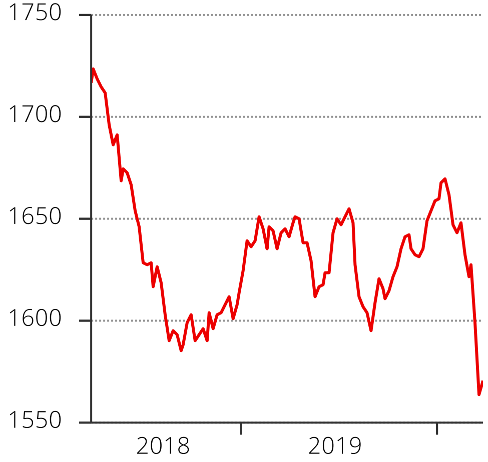
Source: Refinitiv Datastream, Santander Bank Polska

S&P500 index



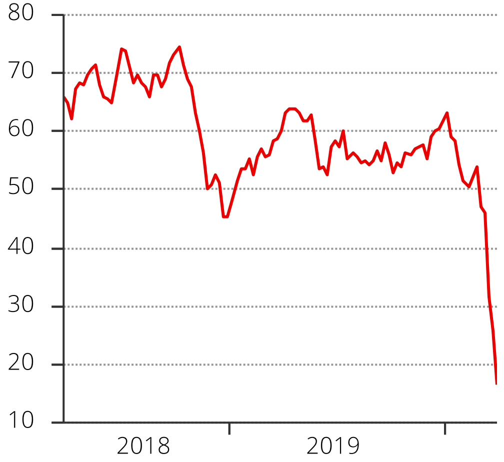
Source: Refinitiv Datastream, Santander Bank Polska

MSCI EM FX index



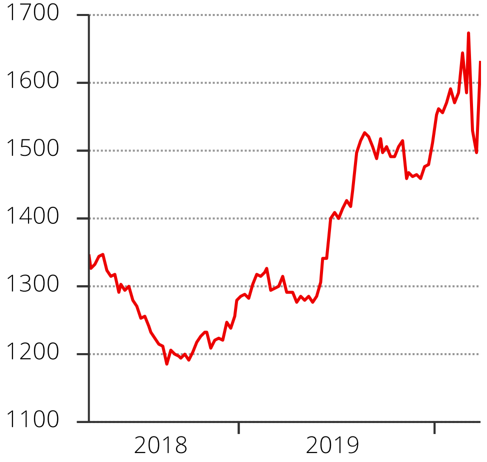
Source: Refinitiv Datastream, Santander Bank Polska

WTI



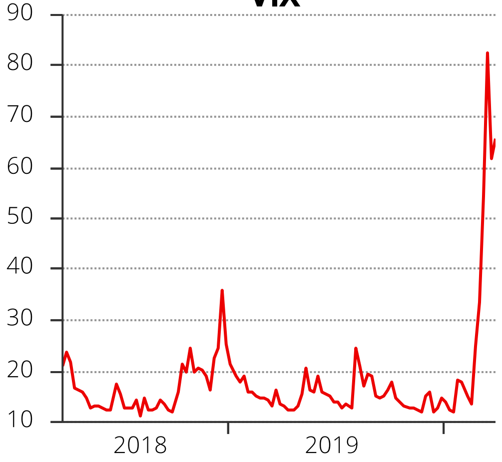
Source: Refinitiv Datastream, Santander Bank Polska

Gold



Source: Refinitiv Datastream, Santander Bank Polska

VIX

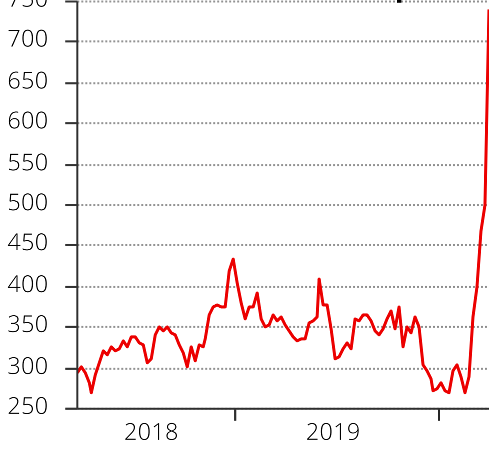


Source: Refinitiv Datastream, Santander Bank Polska

10Y UST yield

Source: Refinitiv Datastream, Santander Bank Polska

10Y BB bond – UST spread



Source: Refinitiv Datastream, Santander Bank Polska

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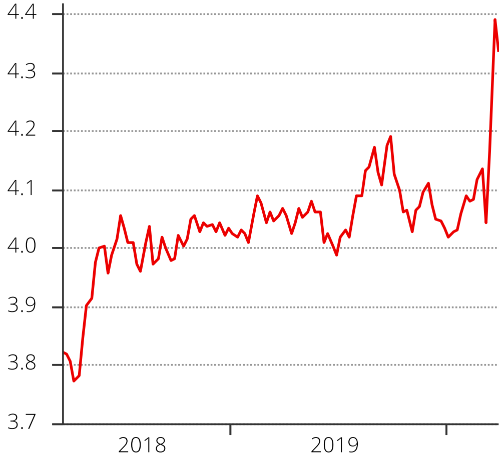
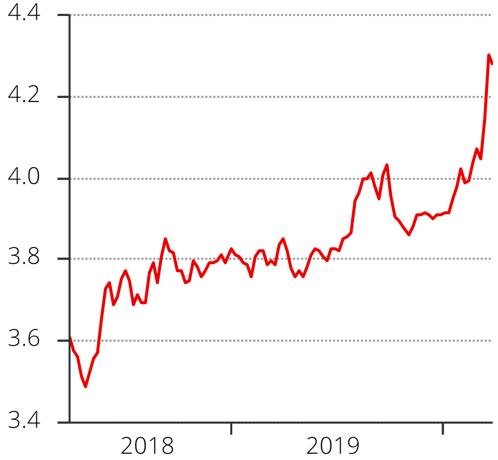
Polish financial market review

(1/2) EURPLN + (1/2) USDPLN



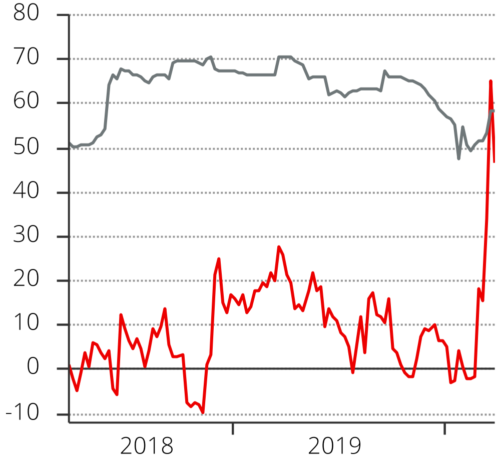
Source: Refinitiv Datastream, Santander Bank Polska

CHFPLN



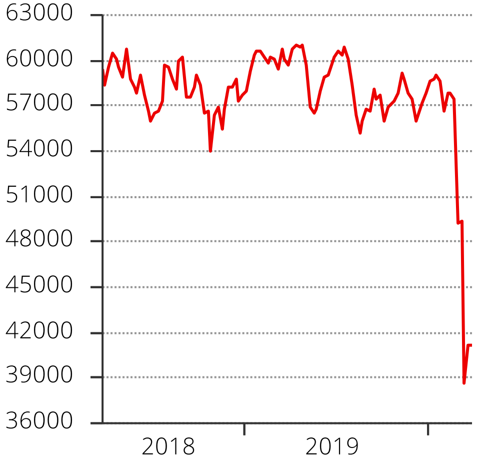
Source: Refinitiv Datastream, Santander Bank Polska

PLN 5Y ASW and USD CDS



Source: Refinitiv Datastream, Santander Bank Polska

WIG equity index

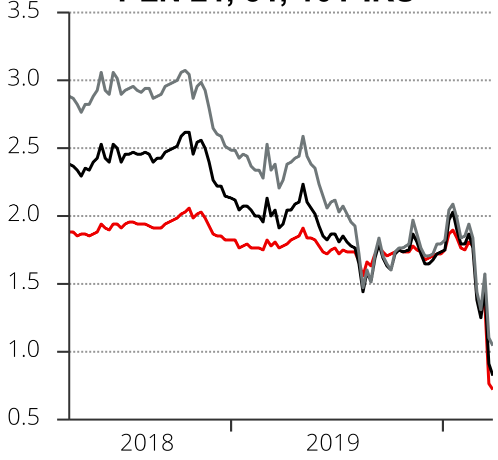


Source: Refinitiv Datastream, Santander Bank Polska

USDPLN 1M IMPL VOL

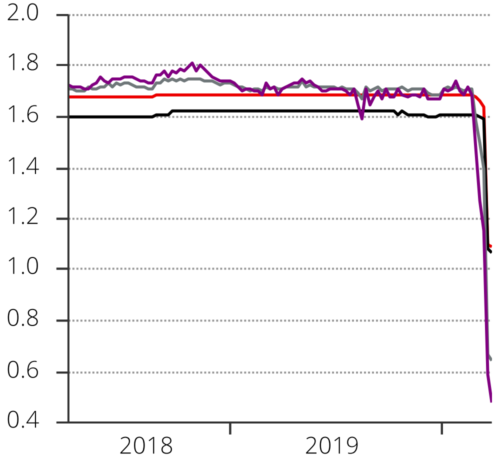
Source: Refinitiv Datastream, Santander Bank Polska

PLN 2Y, 5Y, 10Y IRS



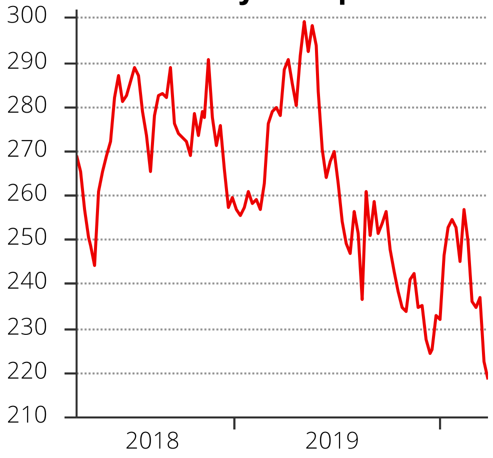
Source: Refinitiv Datastream, Santander Bank Polska

PLN WIBOR and FRA



Source: Refinitiv Datastream, Santander Bank Polska

PL-DE yield spread



Source: Refinitiv Datastream, Santander Bank Polska

Economic Forecasts

		2018	2019	2020E	2021E	1Q19	2Q19	3Q19	4Q19	1Q20E	2Q20E	3Q20E	4Q20E
GDP	PLNbn	2,115.2	2,265.0	2,316.3	2,473.5	520.0	545.7	561.0	638.3	558.8	536.3	568.6	652.5
GDP	% y/y	5.1	4.1	-0.9	4.8	4.8	4.6	3.9	3.2	2.2	-4.3	-0.9	-0.4
Unemployment rate (LFS)*	%	3.8	2.9	5.4	4.2	3.6	3.3	3.1	2.9	3.2	5.3	6.1	5.4
General government balance (ESA 2010)	% GDP	-0.2	-0.7	-6.3	-2.6	-	-	-	-	-	-	-	-
CPI	% y/y	1.6	2.3	3.0	2.2	1.2	2.4	2.8	2.8	4.5	2.7	2.3	2.4
CPI *	% y/y	1.1	3.4	2.1	2.4	1.7	2.6	2.6	3.4	4.4	2.6	2.3	2.1
CPI excluding food and energy prices	% y/y	0.7	2.0	2.6	1.6	1.1	1.8	2.2	2.7	3.4	2.6	2.3	2.1
Reference rate *	%	1.50	1.50	1.00	1.00	1.50	1.50	1.50	1.50	1.00	1.00	1.00	1.00
WIBOR 3M	%	1.71	1.72	1.29	1.18	1.72	1.72	1.72	1.71	1.62	1.25	1.15	1.15
Yield on 2-year T-bonds	%	1.59	1.57	1.24	1.18	1.64	1.65	1.53	1.45	1.39	1.15	1.20	1.20
Yield on 5-year T-bonds	%	2.51	1.97	1.62	1.64	2.23	2.14	1.76	1.76	1.55	1.63	1.65	1.65
Yield on 10-year T-bonds	%	3.21	2.38	1.97	2.00	2.84	2.68	1.99	2.03	1.87	2.00	2.00	2.00
EUR/PLN	PLN	4.26	4.30	4.47	4.51	4.30	4.28	4.32	4.29	4.33	4.59	4.55	4.40
USD/PLN	PLN	3.61	3.84	4.04	4.08	3.79	3.81	3.89	3.87	3.93	4.22	4.12	3.89
CHF/PLN	PLN	3.69	3.86	4.14	4.17	3.80	3.80	3.94	3.91	4.05	4.35	4.21	3.95
GBP/PLN	PLN	4.81	4.90	4.97	4.96	4.93	4.90	4.79	4.99	5.02	4.96	4.97	4.94

* End of period; other variables – average in period

Source: GUS, NBP, Santander

Santander

This analysis is based on information available until **31.03.2020** has been prepared by:

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