MACROscope

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The rising wave

Poland: Economic Outlook

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Executive summary (macro)

After a very deep collapse of economic activity in April, May and June saw signals of rebound from the bottom, as the economic and social restriction were being lifted. High frequency data (mobility, card payments, energy consumption) suggest that the economy is gradually returning to life, although not everywhere at the same pace. Possibly, we are approaching the wave of upward forecasts revisions (especially those more pessimistic). However, we are not quite there yet, as reflected by the most recent IMF report, which showed more pessimistic economic outlook than in April. Good news is that Poland was one of very few countries, for which they did not cut their forecast. The main source of uncertainty is still the spread of pandemic. While most of developed countries were able to suppress the numbers of new infections effectively, in many emerging economies the wave is still rising. Worrying sign is the resurgence of infections in regions where restrictions were relaxed after they seemingly coped with pandemic. In Poland it is hard to talk about the second wave of coronavirus once the first wave (not too big, fortunately) has not started falling yet (see page 8).

We still believe the scenario of economic growth for Poland could be V-shaped: after GDP drop by almost 12% y/y in 2Q20, every next quarter should be better and as a result GDP could drop by c.4% this year and rebound by almost 6% in 2021. While it is not exactly true that Poland will be much less affected than other countries by the coronavirus this year (p.9), we have chance to rebound stronger than others in the following years. It will be supported by a couple of factors: relatively large rescue packages in Poland and in Germany (our biggest trading partner), tendency of shortening global supply chains, which we may benefit from, but also European Commission's large program supporting economic recovery with potentially large fund allocations for Poland (p.21-22).

According to the Monetary Policy Council the pace of economic recovery in Poland may be restrained by quite modest correction of the zloty exchange rate. We interpret such comment in the last MPC document as a signal of no tolerance from the central bank for stronger zloty. If such verbal interventions prove ineffective, other NBP actions cannot be ruled out: increasing QE, lowering its sterilisation, outright FX interventions or even introducing the currency floor (p.24). We think that further reduction of interest rates into the negative territory is the least likely option, possible only in situation when other central banks abroad start cutting rates as well in reaction to significant deterioration of economic outlook (which is not the baseline scenario, in our view).

Inflation in Poland is currently the highest in the EU (mainly due to services prices) and its decrease from the peak was mainly the result of cheaper fuel. But in our view the acceleration of disinflation is just a matter of time. We think that CPI and core inflation will drop this and next year clearly below the NBP target, mainly due to deeply negative output gap and decreasing cost pressure in companies, but also similar disinflationary global trends (p.19).

As regards the fiscal space, the picture has not changed much: the fiscal deficit is likely to breach 10% of GDP this year. Budget amendment planned for late July will not show the full picture as many pandemic-related expenditure has been pushed outside the central budget (p.20).

The first round of presidential election has not surprised and if the incumbent president Andrzej Duda wins in the second round, it should be market-neutral. The victory of Rafał Trzaskowski may potentially trigger major political changes, but its market implications are not clear for us (p.26).

We would like to turn your attention to the fact that this edition of MACROscope includes „Sectoral supplement: Export from Poland in selected sectors" prepared by Santander Bank Polska's Strategic Sectors Department.

Executive summary (markets)

FX

In the coming months zloty might be more susceptible to weakening than to strengthening due to a number of factors. Some of them are: the lowest interest rates in the CEE3 region, not very optimistic Covid-19 new infections data. On top of that, recent MPC statements suggest that the central bank would rather see a bigger role to play for the FX channel as far as supporting the economy is concerned. Looking at the global factors which potentially might contribute to a weaker zloty – it is the EURUSD which so far without success has tried several times to rise above 1.14, as well as increased risk aversion which might potentially result from bad news regarding the evolution of the pandemic or as a result of tense relations between USA, Europe and China (p.36).

FI

NBP will likely keep rates unchanged at the current level (0.1%) till the end of 2020 and maybe even till end of 2021. In the coming quarters as the economic growth slowly rebounds from the bottom, the inflation will keep declining.

At the front end of the curve, bond yields might remain low or might even slowly approach 0% as the liquidity in the banking sector remains abundant. The FRA and IRS might slowly increase, however, thank to slowly improving economy.

Long end of the curve will be under the influence of factors both local and global. As for the local ones, the July budget amendment should allow for more government bonds supply at the end of the Q3. The issuance should be easily absorbed by further NBP purchases. NBP after in May and June it mainly was buying the bonds of PFR and BGK, might focus more no the government bonds again going forward. As a result the increased bond supply should not negatively impact the yields. We estimate that the NBP will buy a total of PLN 200bn of bonds within its QE program. From the global factors, which might influence Polish rates only directly via core market yields, the important one is the launch and success of the European Commission EUR 750bn fund (potentially higher core yields) as well as the ECB's pandemic asset purchase program, currently at EUR 1350bn (which might help tighten the Periphery spreads).

In March we expected no cuts from the NBP and the 10Y Polish bond yields at 2%. In June, after unexpected NBP rate cut to 0.1%, we expect the NBP rates to stabilize while the 10Y bond yields to remain in check thanks to the declining inflation and NBP asset purchases (p.34).

2020 Forecasts Revisited

Indicator	Our view at the end of March	Our view at the end of June
GDP	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.	The dip in 2Q20 was lower than we thought three months ago, but the V-shaped trajectory still seems to be the baseline scenario (GDP -4% in 2020, +6% in 2021). It is supported by signals from recent data and record fiscal+monetary stimulus. The risk is lack of pandemic deceleration in Poland and new infections wave abroad .
GDP breakdown	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.	Forecasts still valid, more or less. Weakness of consumption and private investments will be partly offset by relative resilience of public spending and net exports improvement. Hope for decent export rebound in 2021 amid solid outlook for German economy (gigantic stimulus package), shortening of supply chains.
Labour market	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.	Many firms choosing reduction of worktime or/and salaries instead of job cuts. As we expected, the first wave of layoffs affected migrant workers, it seems. Overall, the households' income weakens significantly and the worst in the labour market is still ahead.
Inflation	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.	Lower CPI so far resulted mainly from cheaper fuel and some goods. Services prices have pushed core inflation higher so far, but we still believe that it is just a matter of time before inflation drops below the target.
Monetary policy	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.	After cutting rates to almost zero, the MPC seems worried about small PLN reaction, which could herald bigger activity in this field. We think negative interest rates in Poland are at the very end of list of possible NBP's options.
Fiscal policy	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.	We assume that government programmes will boost public spending by PLN115bn in total and we estimate GG deficit to exceed 10% of GDP this year.
Fixed income market	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.	Short end of the curve very low amid pressure of rising excess liquidity in the banking sector. Yields at the long end kept in check by the NBP purchases, despite rising POLGBs supply after the summer.
FX market	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.	Zloty more likely to weaken than to strengthen due to: very low interest rates, spread of pandemic, signals from the MPC that the central bank would like to see bigger importance of FX channel in supporting the economy. Still possible increase of global risk aversion.

Economy

1

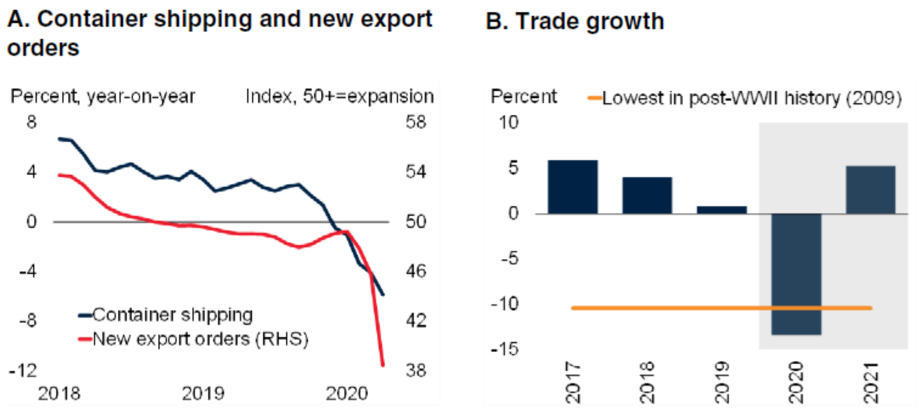
Global context: yo-yo effect?

Global victory over the coronavirus cannot be stated yet. Where the situation seemed more-or-less under control, restrictions were eased under pressure of economic damage and social expectations. Some countries are coping well with the new reality, but in some the infection curves have stopped falling, in some the uptrend has returned. (see next page). It has to be considered that every success on this battlefield will be prone to the yo-yo effect, albeit of a decreasing amplitude thanks to the growing awareness how to prevent the spread of the disease.

Getting out of lockdown looks like a ratchet mechanism – moving back to the stricter measures would require the politicians to admit to a mistake and would create meaningful costs. The announcement itself of the timeline of exit from lockdown and later the actual implementation gave financial markets a strong positive impulse. The removal of restrictions improved measures of activity, but the economic rebound was disproportionately smaller than the one on financial markets.

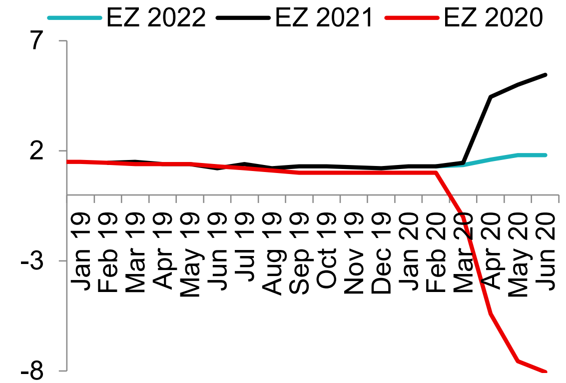
Apart from the unfreezing by removal of restrictions, there were also actions to heat up the business climate. The European Commission presented a huge support package called Recovery and Resilience Facility, Germany agreed a respectable fiscal package, rejecting its long-held balanced budget approach. Central banks also contributed with further stimulus measures. Despite all this, the market consensus on GDP growth and the estimates of supranational organisations still have not seen any upgrades.

Data and forecasts point to a massive decline of international trade turnover this year, with a rebound coming in 2021, but not covering in full the current loss.



Source: World Bank, Global Economic Prospects June 2020

Median GDP forecast for euro zone, for the indicated years, according to Bloomberg survey



Source: Bloomberg, Santander

Global manufacturing exports

Source: GUS, Bloomberg, Santander

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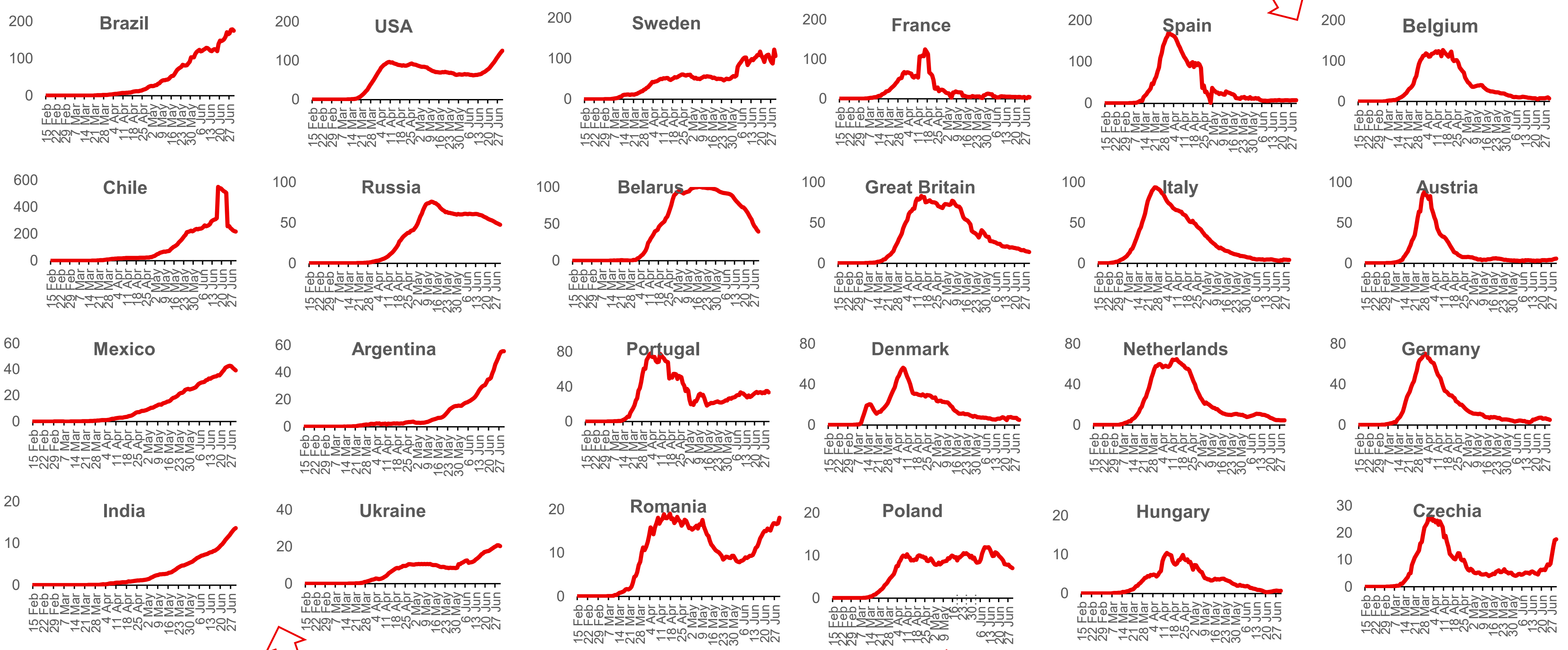
Global context: the spread of the pandemic

Fading away in most of developed countries

Daily number of Covid-19 infections per 1mn inhabitants, 7-day moving average:



Accelerating in many developing countries

Not great, not terrible

Source: Johns Hopkins University, Santander

Global context: GDP forecasts

Forecasts of supranational institutions differ somewhat, but in general point to a similar trajectory, which is also in line with the market consensus: deep recession in 2020 in almost all countries and a quite strong rebound in 2021 (but not strong enough to restore the pre-pandemic GDP level).

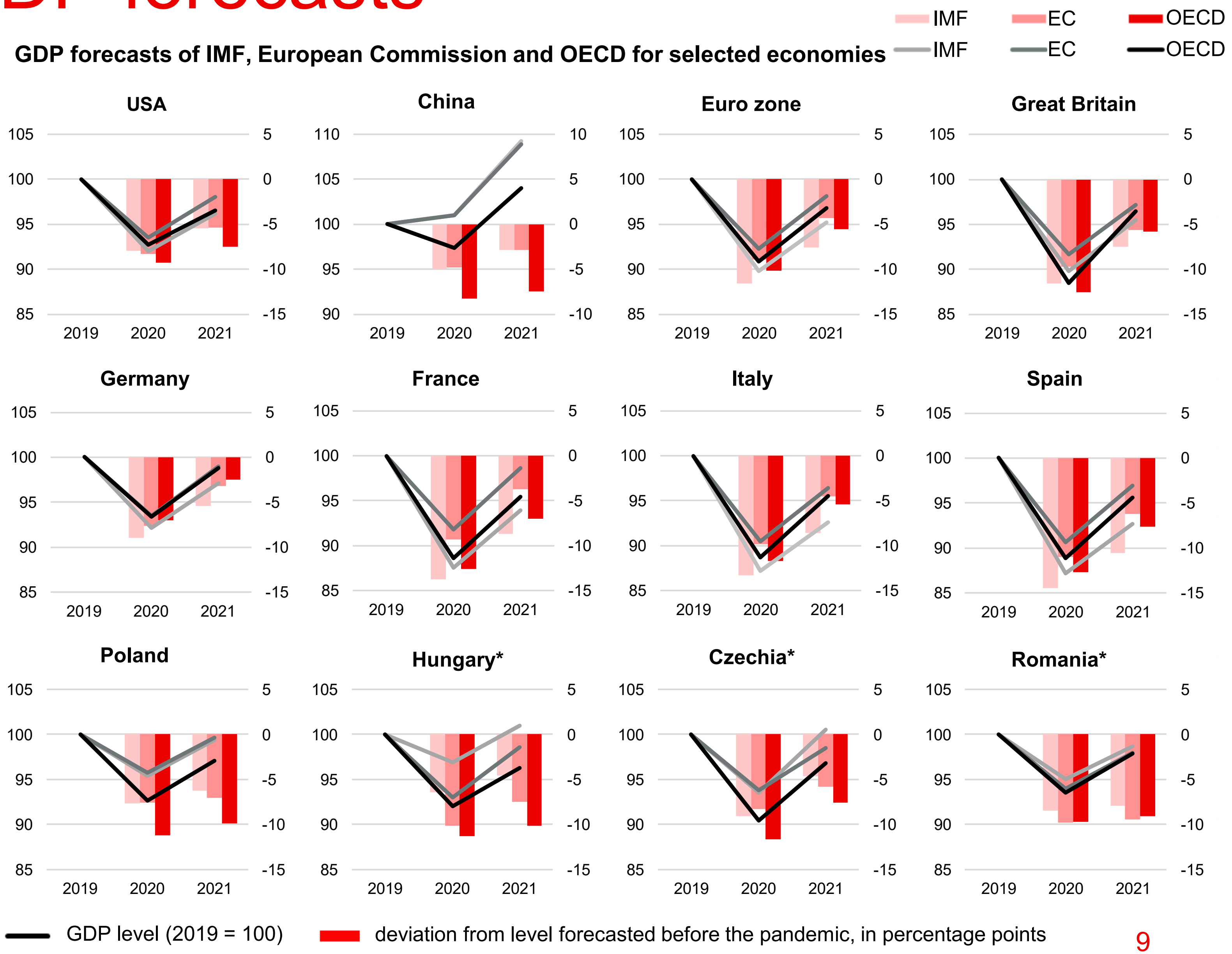
In most of developed economies the expected 2020 recession is to the tune of -5% to -10%.

The recession in Poland is likely to be a shallower one, which is not equal to stating that the pandemic is hurting Poland less than others.

A comparison of GDP paths in current forecasts and the ones from before the pandemic shows a loss of income in Poland (8-10%) similar to the average for other European countries.

We are slightly more optimistic than the Consensus about the strength of the 2021 rebound in Poland – it will be supported by relatively big size of support packages, strong links with the German economy, shortening of global supply chains and the EU recovery and resilience facility, of which Poland can be a large beneficiary.

GDP forecasts of IMF, European Commission and OECD for selected economies



Source: Santander, based on reports of IMF, EC, OECD

* IMF forecasts from April 2020, other countries: June 2020

Foreign trade: long way down in April

The drop in Poland's foreign trade turnover almost reached 30% y/y, a similar scale as during the global financial crisis. It is worth noting a relatively small decline of exports to Germany (compared to the rest of euro zone) and the fact that our most important trade partner is coping relatively well with the pandemic. While in 2H19 Germany weighed on Polish export's growth, now it can significantly support the export recovery from the trough.

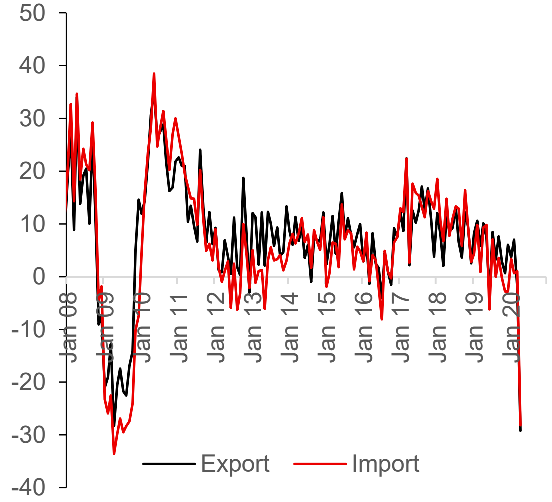
Trade relations with emerging economies are working well, albeit not great any more (in April just a tiny decline of exports in y/y terms, decline of imports smaller than with other main groups).

On the imports side, the much lower oil deliveries are blurring the picture. At the same time, in April Poland imported just a bit less of intermediate goods from emerging economies than a year ago (-5% from China, -2% from India, +54% from South Korea), which suggests that the supply chains have not been broken and that Polish companies see prospects for output recovery.

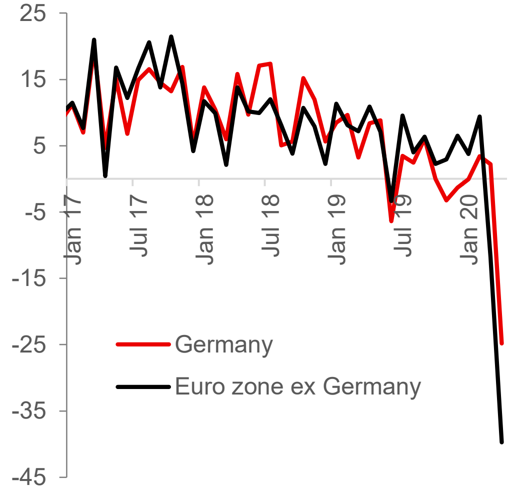
In May there was a sharp improvement in production of durable consumption goods in Poland, of which the country is an important supplier for Europe. Possibly, this crisis is no different from the normal low part of business cycles in the sense that Polish exporters also this time will manage with the help of a substitution effect to increase their share on European markets in early recovery phase (the market have shrunk significantly, though, and their growth forecasts keep sliding). Larger scale of PLN depreciation could be helpful here.

Considering that April was most likely the worst month in the cycle, it seems the scale of trade turnover in 2Q will be smaller than we estimated in late March (-50%). So far we see that our assumption of a big improvement in trade balance by €1-2bn has proved correct. This „premium" could wear off in the middle of the year as domestic demand gradually rises. Getting rid of negative y/y export and import growth may take time, however.

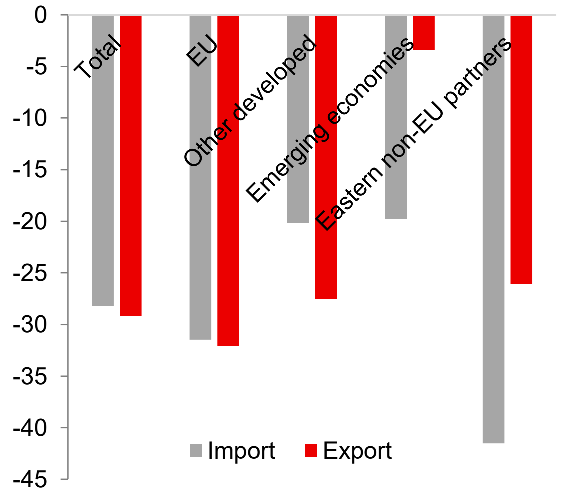
Foreign trade in goods, EUR, %y/y



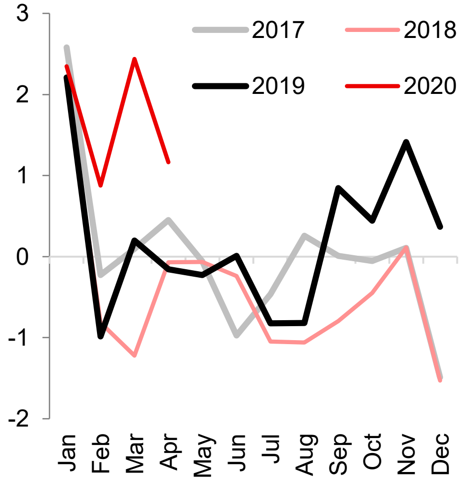
Foreign trade in goods, EUR, %y/y



Foreign trade by country groups, April, EUR, %y/y



Trade balance in goods, €bn



Source: GUS, NBP, Santander

To get more information about export by sectors, please see the Supplement prepared by Strategic Sectors Department.

Output and sales: rebound has started in May

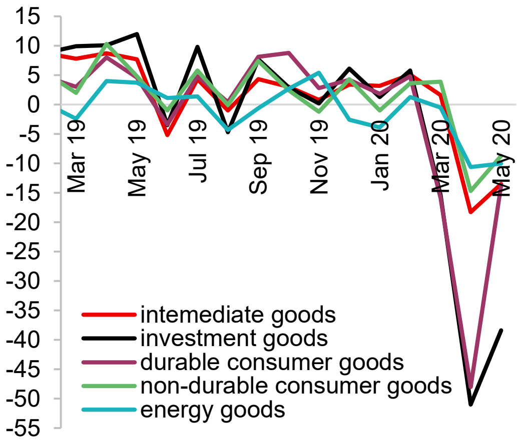
Industrial output and real retail sales both declined in April by more than 20% y/y. The parts of industry highly exposed to foreign demand (autos, furniture, electronics, other transport equipment) suffered more than the ones focused mostly on the domestic market. (food, pharmaceutics). The positive effect of Covid-19 on the latter needs to be seen as temporary, however, linked to stock building. A similar differentiation was seen in retail sales data: autos, furniture, consumer electronics and house appliances (so durable goods) registered a larger decline than other categories.

In May the scale of falls was already much smaller: output at -17% y/y, real retail sales at -7.7% y/y. That month there was no longer a clear relations between the scale of decline and the exports exposure among industries. Autos, machinery and equipment and furniture were still showing the largest drop, but production of electrical appliances actually rose 1.2% y/y and electronics saw a relatively small decline (-10.1% y/y). The rebound in retail sales was supported by all categories, in particular by clothing and shoes and by furniture, RTV, household appliances (realisation of deferred demand). Sudden weakness of household incomes is an obstacle to further improvement of retail sales.

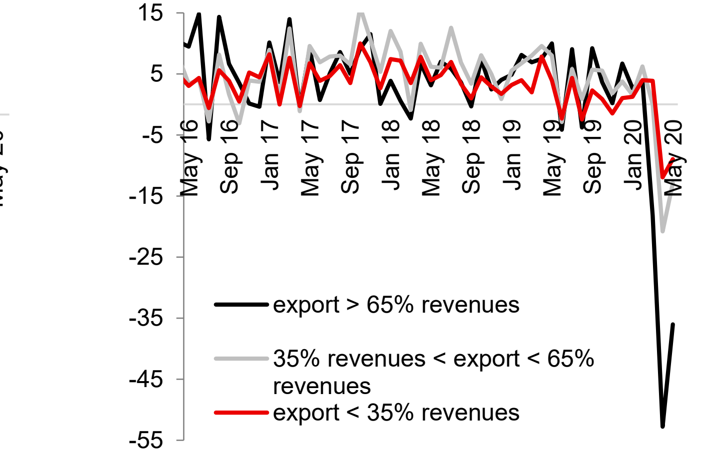
Construction output showed more inertia, falling by only 0.9% y/y in April and 5.1% in May. The Covid-19 effect is more visible in the number of building permits and house starts dropping more than 28% y/y.

Data for April and May that we already know and our forecasts for June confirm that 2Q20 will see a major drop in GDP, most likely exceeding 10% y/y.

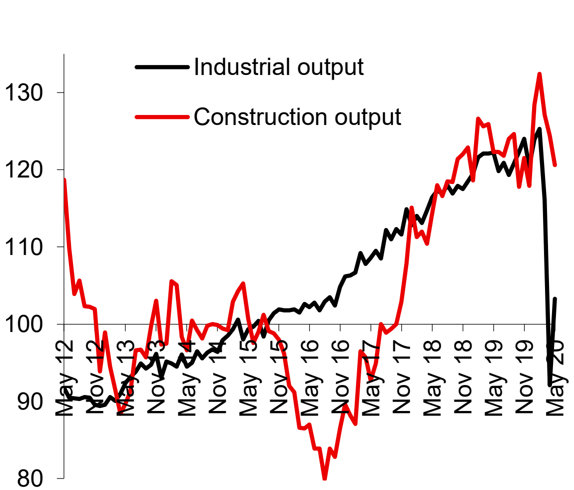
Production by main industrial groupings, %y/y



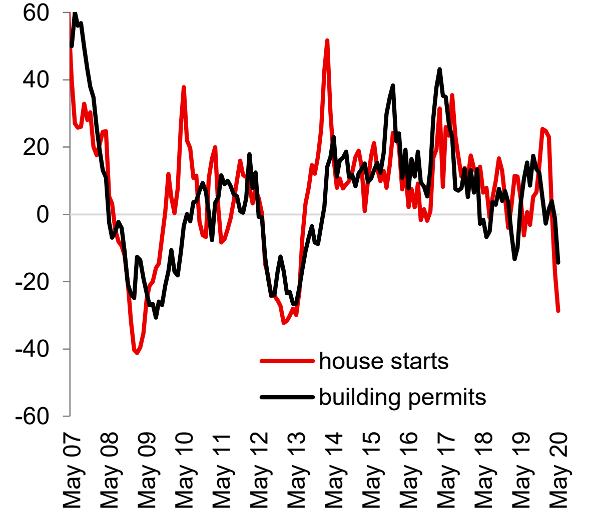
Manufacturing output, %y/y, industries grouped by exposure to foreign marekts



Industrial and construction output, SA (2015=100)



Housing statistics, %y/y



Source: GUS, Santander

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Sentiment indexes: rebound continued in June

The April collapse of sentiment indicators was unlike anything Poland has seen before. Faced with many unknowns and surprised by sudden decisions to stop operation, enterprises indicated in mass negative state and prospects of their activity. In May the first shock was gone – sectoral expectations components improved, but current situation components slipped lower. In June both sets went up.

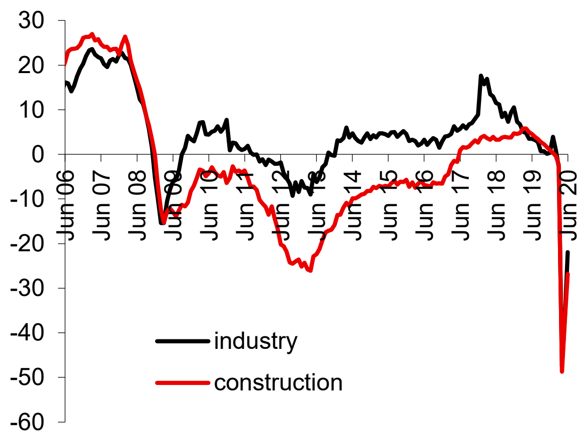
The shock was also seen in the attitude of consumers. Initially c.50% in April and 45% in May considered the pandemic as a serious threat to their health and finances. In June the shares were already more than by a half lower and below the share of indications that the pandemic is a small threat (vs 5:1 and 3:1 ratios of serious vs small threat in April).

In June main sub-indexes of consumer confidence returned above the 2009 and 2013 lows, the assessment of current and expected financial situation almost converged (vs the initial complete collapse of expectations). Soon after the all-time low was reached in April on major purchases index, the indicator sprang back, and real retail sales of furniture, consumer electronics and household appliances jumped from -16.9% y/y to +14.4% y/y.

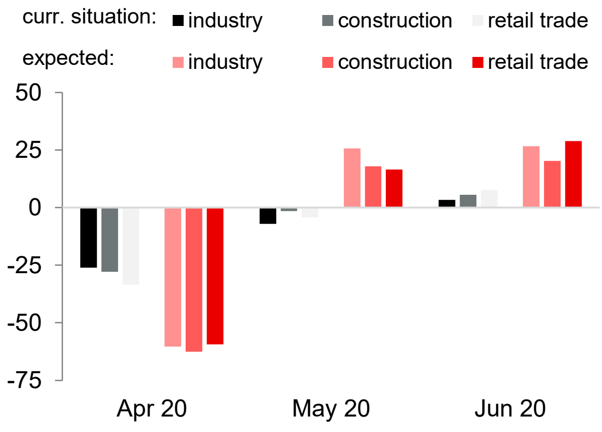
Real damage caused by the pandemic will not disappear soon. But it seems that corporations and consumers are already able to assess their situation with more calm and knowledge – and their economic activity will be affected not by the shock itself, but rather by its consequences for, e.g., the labour market.

The continued recovery of the economy is not only pictured in survey-based sentiment indicators, but also in a set of live trackers of various aspects of Economic and social activity, which we can check with high frequency (shown on the next page).

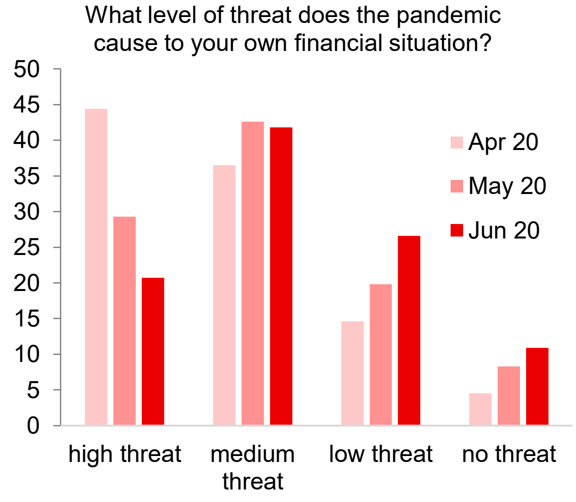
Business sentiment



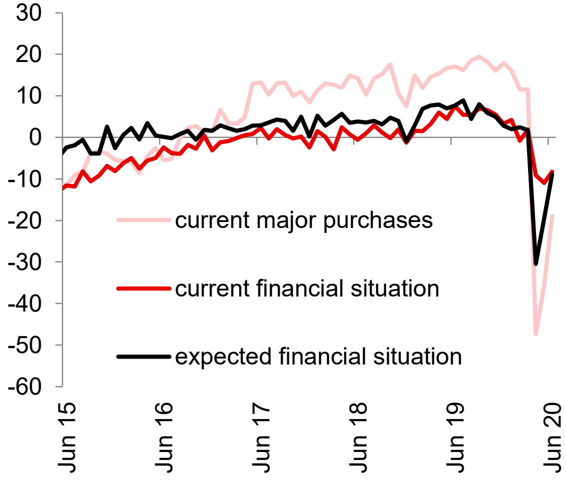
Business sentiment, m/m change



Consumers' attitude vs the pandemic



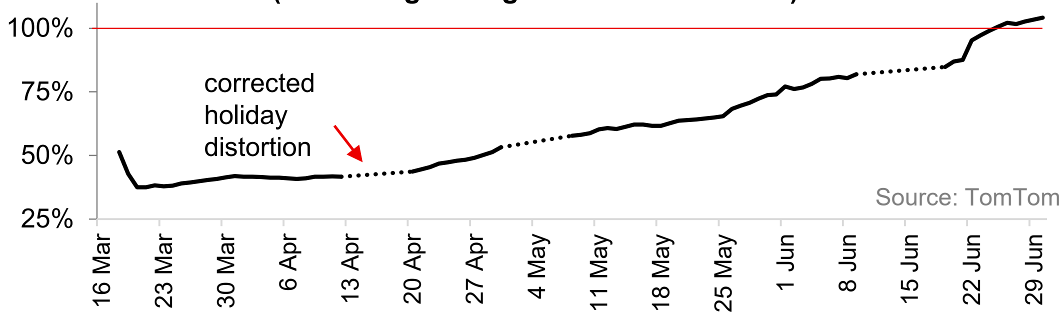
Consumer sentiment



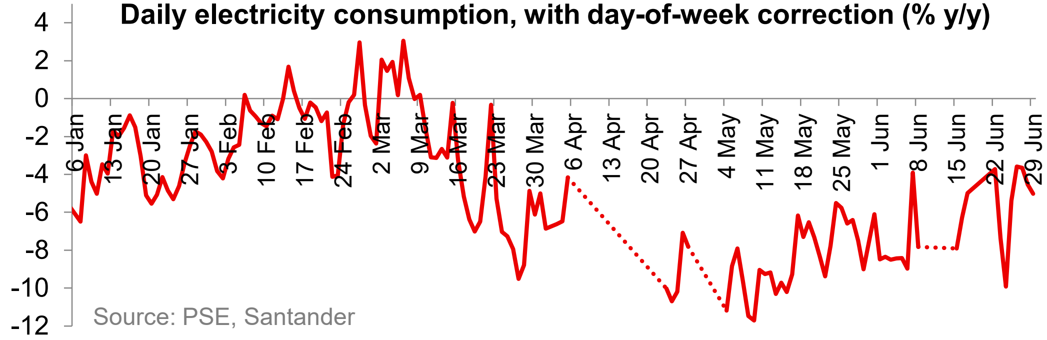
Source: GUS, Santander

Live economic trackers: slowly up

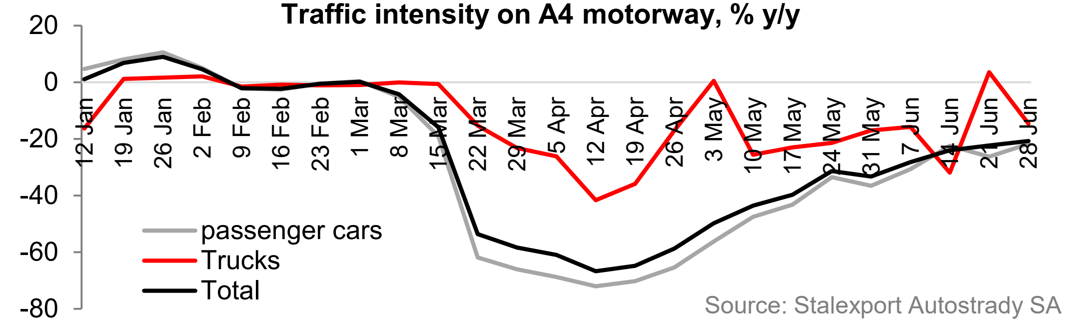
Tomtom road traffic index, Warsaw (7d moving average as % of 2019 value)



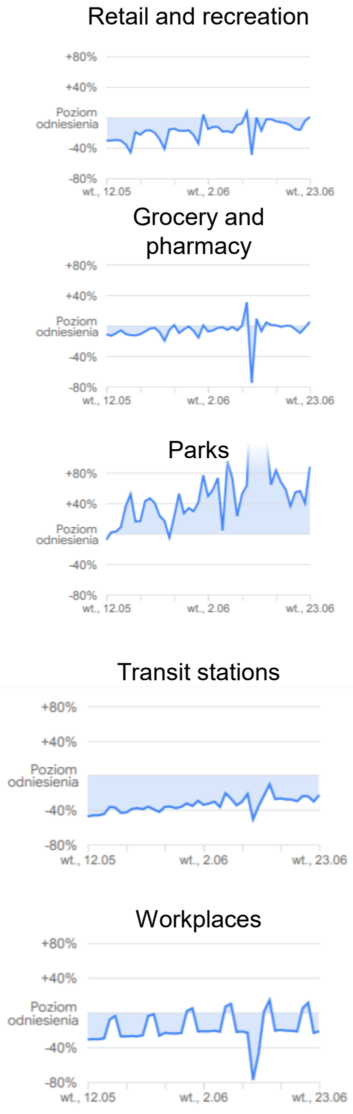
Daily electricity consumption, with day-of-week correction (% y/y)



Traffic intensity on A4 motorway, % y/y

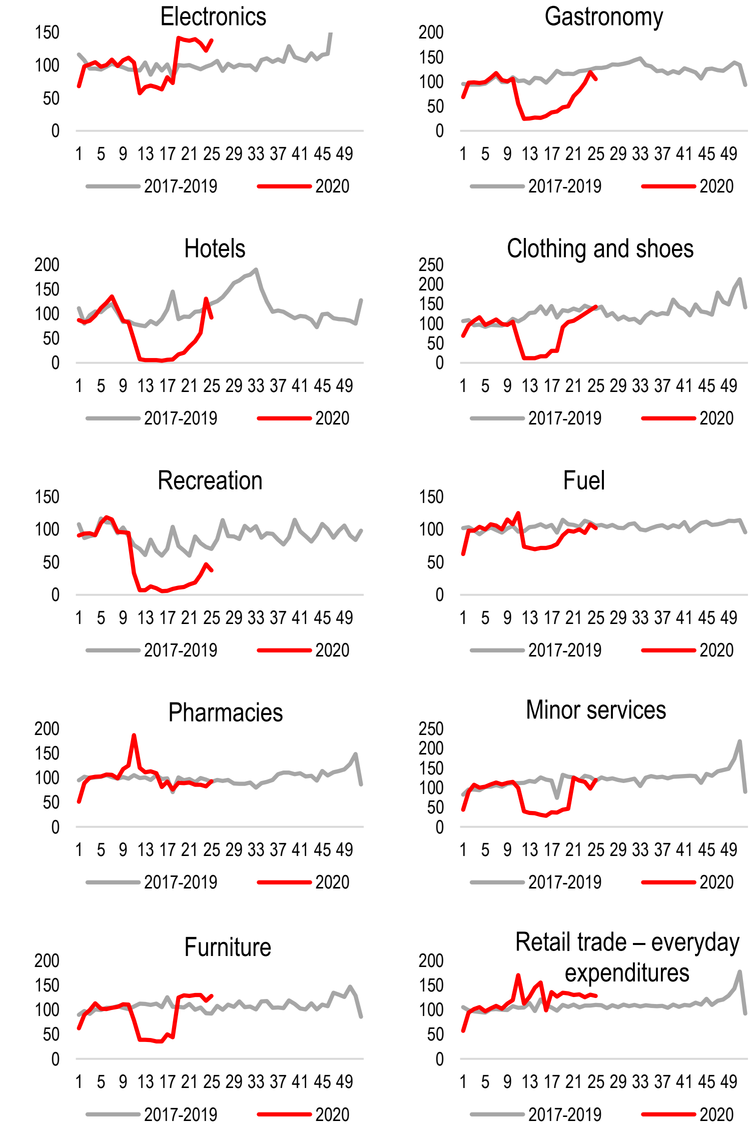


Google mobility report



Source: Google

Credit card payments in selected categories (first 10 weeks of the year = 100)



Source: Santander

Labour market: disappearing demand and workers

Data from the corporate sector show that the labour market reaction was quick and stronger than in the previous crises. One major difference versus previous events is the divergence in two metrics: employment and number of employees. In the previous crises there were no important differences between these two. Currently, employment is falling much faster.

Let us remind: number of employees is a simple sum of people working with job contracts (permanent and temporary). Employment is a sum of posts filled with workers with job contracts but calculated as full-time jobs. Thus, the latter is vulnerable to reductions in working time and to absences due to sick or childcare leaves.

Our interpretation is that the number of employees is showing actual layoffs (but also voluntary leaves and expiry of term contracts) and the difference between these two statistics is showing an epidemic-related reduction in working time, which we assume to be temporary. Let us remind, however, that this is a mere estimation, because we do not know the actual working time of laid off workers.

Thus, our estimate points that about 1/3 of reductions in employment are actual layoffs, and we are expecting this ratio to go up in the months to come, as entrepreneurs will be normalising their working time and at the same time making decisions on desirable staff levels.

Which sectors were reducing employment? Answer is by no means surprising: primarily these, which saw falling output: manufacturing of leather products, furniture, cars, mining. However, various sectors were responding differently as regards choice between layoffs and working time reductions. Manufacture of paper, real estate activities and administrative services were firing, while manufacture of electronics, metals, chemicals focusing on working time reductions.

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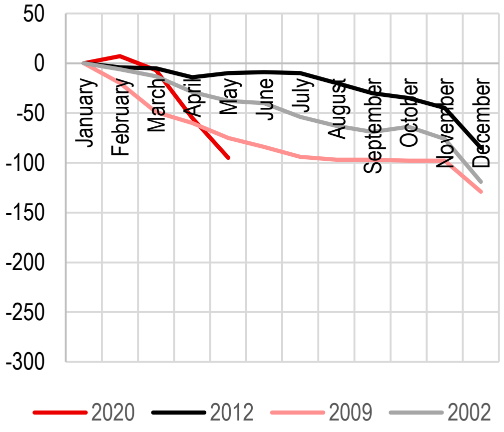
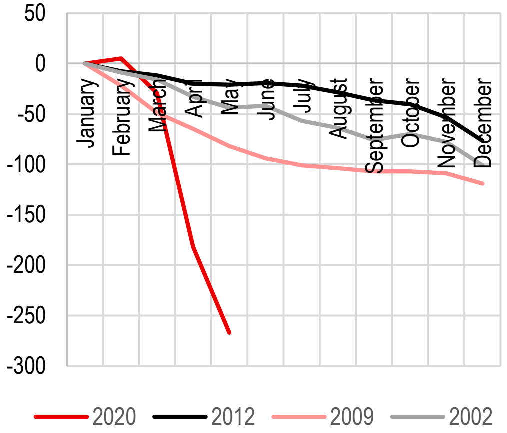
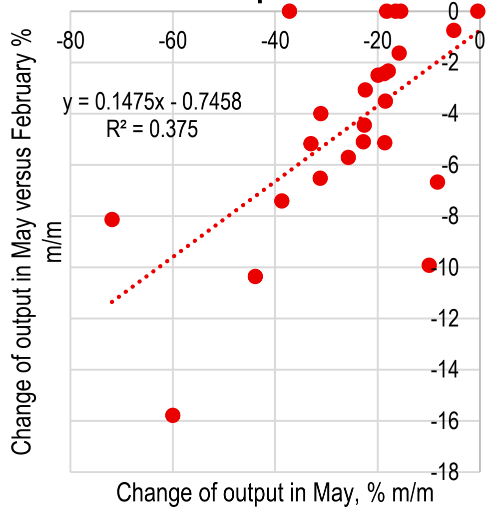
Number of employees in enterprise sector, difference versus January in thousands.



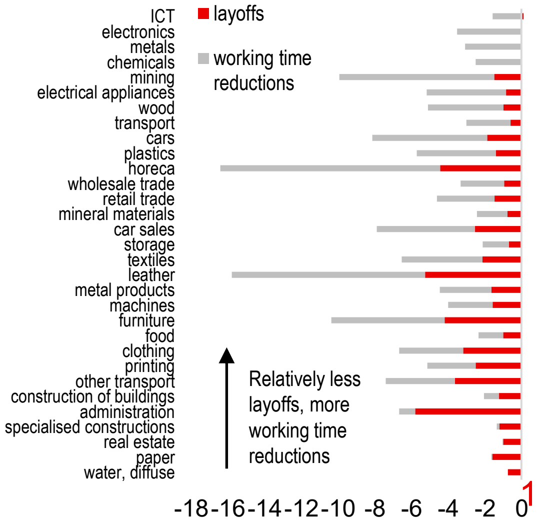
Employment in enterprise sector, difference versus January in thousands.



Decline in employment vs decline in output



Breakdown of employment reductions by sectors



Source: GUS, Santander

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Labour market: how many layoffs? (1)

Data from the corporate sector, cited at the previous page, is only a part of the economy, so we are trying to estimate the total number of workplaces that were shed during the crisis. In order to do that we have to look at other statistics.

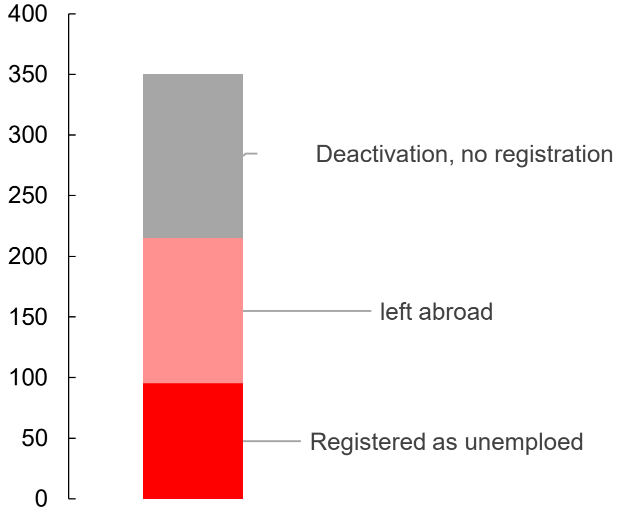
Data on registered unemployment suggest a rise of the number of jobseekers by 95k between May and February. However, in our view this indicator is only partially catching the effect of job shedding and we draw that conclusion based on data on massive departures of foreigners (-223k total in March and April, about 10% of total population) amid insignificant rise of foreigners registered as unemployed (+225 people in February-April).

The number of employees in the corporate sector (selected sectors, firms employing 10 and more people about 40% of all workers) suggest a decline by 100k in February-May. If we assume that small companies were firing at a similar scale (and this is probably too optimistic, as small companies are prevalent in service sector, which was hit the hardest), then we could extrapolate the number of layoffs to 250k. However, data on corporate sector does not take into account civil contract workers, which are the first in the row to be laid off, nor the self-employed, so we should treat this number as understated.

The ZUS data (social security institute) on number of people in pension security system showed a decline by 216k between February and May and in our view this is the statistic that may be treated as a starting point for further estimations, as it is covering the biggest portion of the working population. However, the unemployed are also subject to social security, at least as long as they are entitled to employment benefit (granted typically for a 180 day period, thus covering the whole epidemic period in Poland), so we should add them to our estimate (95k). Moreover, many foreigners are not registered in ZUS. For example, according to NBP estimates there were 800 thousand Ukrainians working in Poland, and only 60% of that number are registered in ZUS. As the number of foreigners registered in ZUS fell by 71k (10%), we estimate total layoffs of foreigners at 110-130k. In total, our estimate of layoffs until May sits at about 350-370k, i.e. about 2% of working population.

Our earlier forecast of total number of layoffs in 1H2020 was at 480k (and trough at 650k in 3Q20) and it seems that we may have been a bit too pessimistic. Data from June, when the restrictions were removed almost completely, will be key is assessing outlook for the upcoming months.

Breakdown of shed jobs: sum for March-May



The estimates shown above suggest that as much as 1/3 of people who lost their work did not register in the employment office. What are the possible explanations for that? We see four potential stories: 1) some people just chose to deactivate and exit the labour market, 2) about 40% people who lose jobs do not register as a rule (according to BARP Survey), 3) some people were unable to register in the first phases of the epidemic as employment offices were closed, 4) some jobseekers could have postponed their registration in order to get higher benefits (currently PLN881.30 for three months and PLN692 later on, since 1 September: PLN1200 and PLN942.30, respectively).

Source: Santander

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Labour market: how many layoffs? (2)

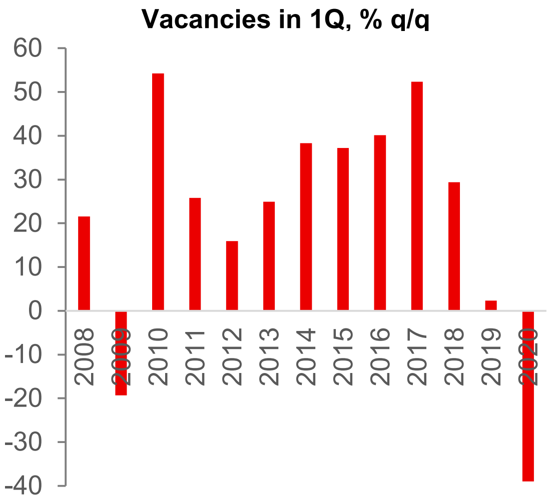
Bear it in mind that the estimate of layoffs is just one side of the coin. The other is the epidemic's impact on new job creation.

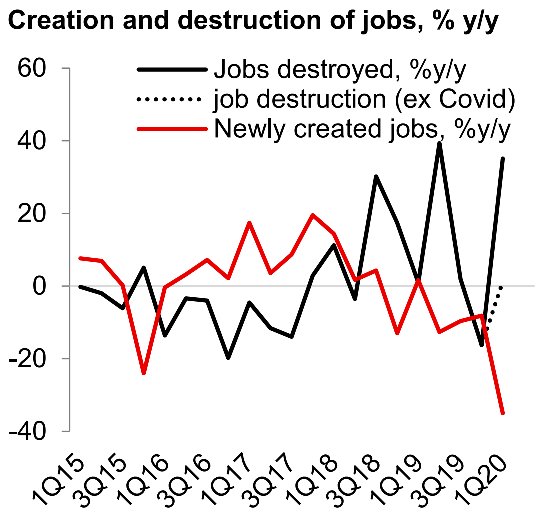
Demand for labour as measured by number of vacancies declined by 46.3% y/y in 1Q20. Falls were observed also in the previous quarters, but by 7% on average. The epidemic has visibly amplified this negative tendency. On a quarterly basis vacancies fell by 39%, while typically 1Q saw a rise (with an exemption in 2009).

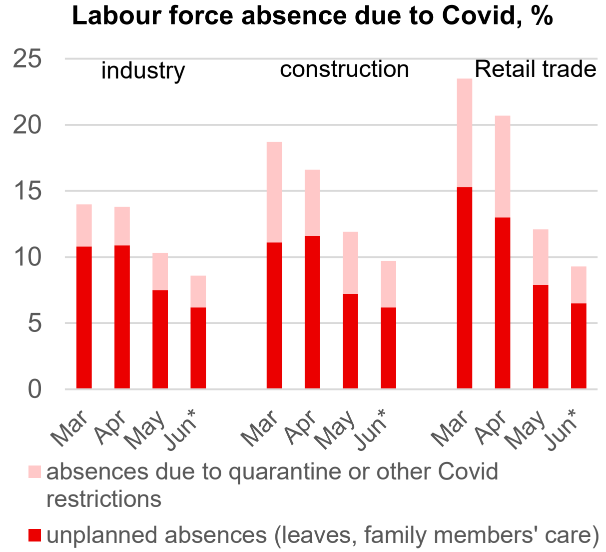
The number of freshly created workplaces was by 35% y/y lower (-8.1% y/y previously), while number of liquidated workplaces rose by 35.1% y/y to almost 120k and was the highest since 4Q2011 (surveyed companied admitted that they removed 30k jobs due to the epidemic).

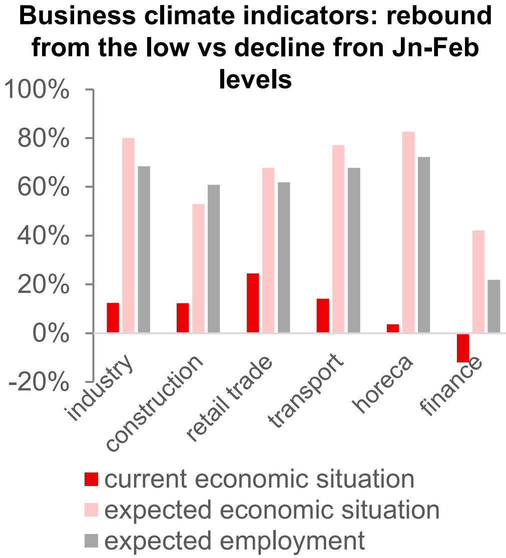
The labour supply was also limited in 1Q20 by childcare benefits for parents with children up to 8 years due to closure of schools and kindergartens. According to LFS Survey, 2.3% of working population took advantage of this instrument. Further 0.6% were not working due to quarantine. Business climate Survey showed these number remained relatively high in March and April and then declined.

Business climate indicators for future employment rebounded quite markedly and this is quite a positive signal.









Source: GUS, Santander

Labour market: what about incomes?

Estimate for number of lost workplaces is a starting point for estimates of disposable incomes and for their forecasts. As we already know, the GUS employment in the corporate sector fell three times stronger than the number of employees, as the latter statistic also accounts for lower working time due to sick or childcare leaves. We think that this pattern could be translated into the whole economy, with total reduction of working time in scale of 1 million full-time jobs (6%) until May. Note that we are not speaking here of hours worked but of paid employment.

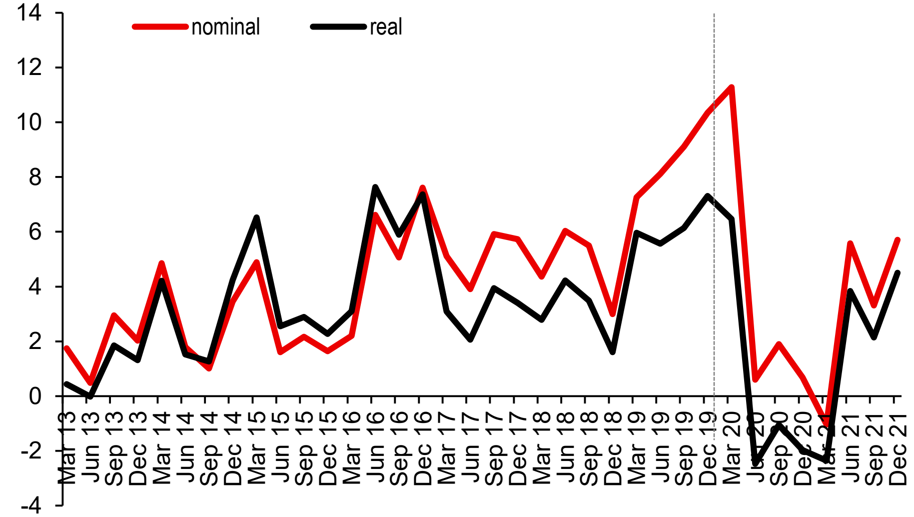
Wage growth declined to 1.2% in May from about 7.5% in January-February, i.e. by roughly 6 percentage points. These numbers come from the corporate sector, so bigger companies and job contracts, but given lack of other data we extrapolate these on the whole working population. If we marry these with the employment data, we get an estimate of labour income falling by 11% versus a counterfactual scenario with no epidemic.

We also make an assumption that incomes of the self-employed (without employees) will follow a historical relation with GDP, and we also correct them by anti-crisis instruments introduced by the government (social contribution waivers, loans, subsidies).

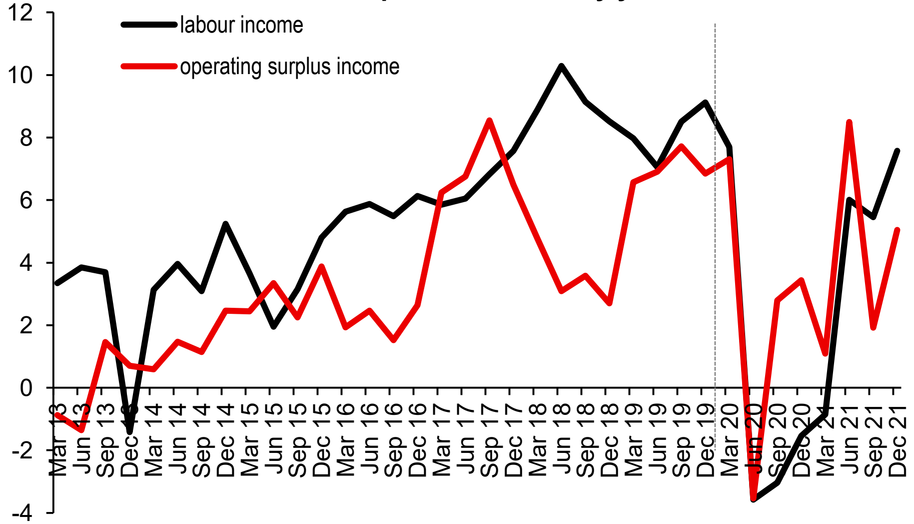
We also add childcare and sick benefits to incomes from social benefits as well as account for change in NBP rates. We estimate net effect of NBP rate cuts at +PLN1.0bn quarterly.

In total, we estimate 2020 disposable income to rise by 0.0% y/y in real terms and by 2.1% y/y in real terms in 2021.

Disposable incomes, % y/y



Nominal labour and operating surplus incomes, % y/y



Source: GUS, Santander

Santander

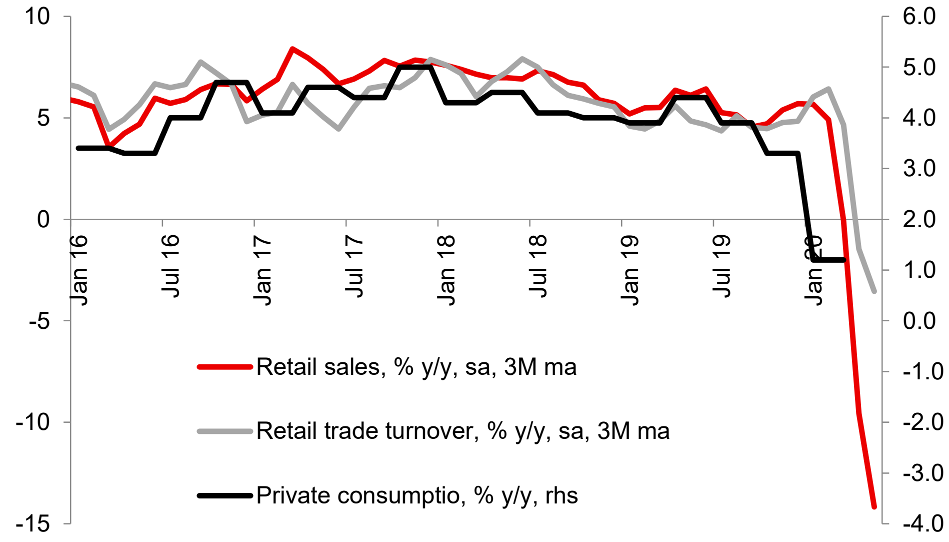
Consumption: below zero

The epidemic crisis and restrictions had a diverse impact on consumption patterns. There was a temporary rise of sales in some product categories, e.g. hygienic and food with longer usability dates, but in general we estimate that first need goods, especially food, did not suffer from the crisis. E-commerce was a major benefactor. Some goods and services, like household appliances, clothing, cosmetics and hairdressers recorded a major decline and than a fast rebound, partly due to postponed demand or thanks to a creation of new needs (remote communication, computers for students, new furniture). Some goods and consumer services, like recreation, restaurants or hotels are still rebounding and their sales are below pre-epidemic level.

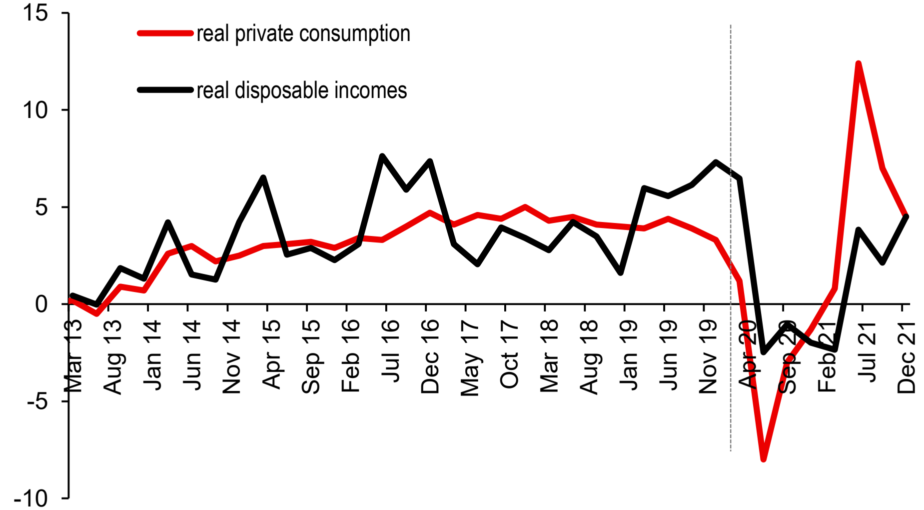
Two former of these categories are in our view more present in the retail trade turnover data than the latter one. That is why we are inclined to focus more on retail sales data (decline by 16.5% y/y on average in April and May) than on retail trade turnover (decline by 4% y/y in April and May). On the other hand, total private consumption is less volatile than retail trade turnover or retail sales, partially due to inclusion of services, which are not present in the two monthly statistics.

In 1Q20 the private consumption decelerated more than it was suggested by relations with retail sales or turnover (by more than 2 percentage points), so we think that in 2Q20 consumption could fall by even 8% y/y. Thus, consumption will fall more than incomes (-2.8% in 2020), so we see rising saving rate, which will allow for a stronger rebound of consumption in 2021 (+6.0% y/y).

Consumption, retail sales and retail trade turnover, % y/y



Consumption and incomes, % y/y



Source: GUS, Santander

Inflation: icarian flight

High altitude of services prices inflation in the recent months, and, as a consequence, of the whole core inflation leaves an impression that the pandemic is inflationary.

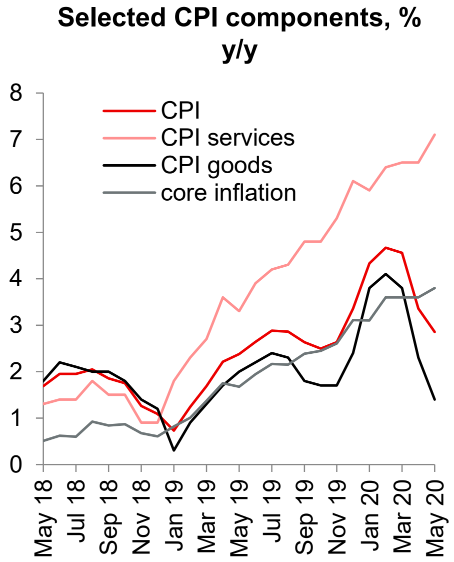
We do not agree with this and think that as more and more restrictions are lifted, the negative effect of the pandemic on CPI growth will be getting more visible. The reason for this is the steep deepening of the output gap. As a result, by the end of this year inflation will drop below 2.5% y/y, possibly even below 2%. In our view the trend will continue in 1H21, and readings around 1% y/y are possible in this period.

The factors acting this year as obstacles to the decline of inflation are temporary. This means that they will strengthen the negative base effect in 2021 CPI. This may be the case with, e.g. the passing of extra costs due to sanitary precautions on clients, the weather (Poland has already experienced this year a drought, tempests, hailstorms and flooding) or the wave of realisation of earlier demand, deferred by Covid-19 restrictions.

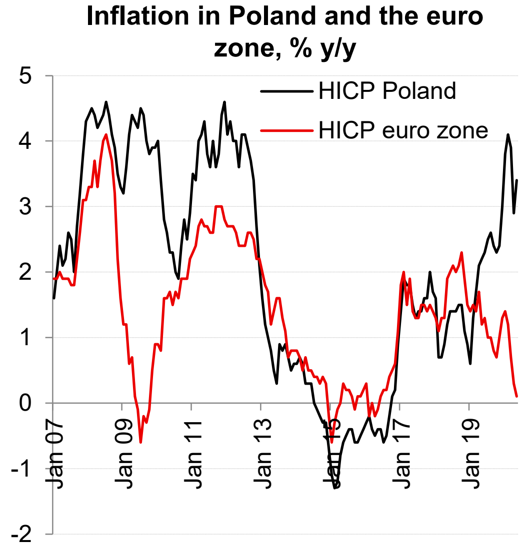
The pressure on lower CPI can also be seen in the gap with y/y PPI growth (negative since March).

Globally, the environment looks disinflationary and the euro zone is pretty close to entering a deflation.

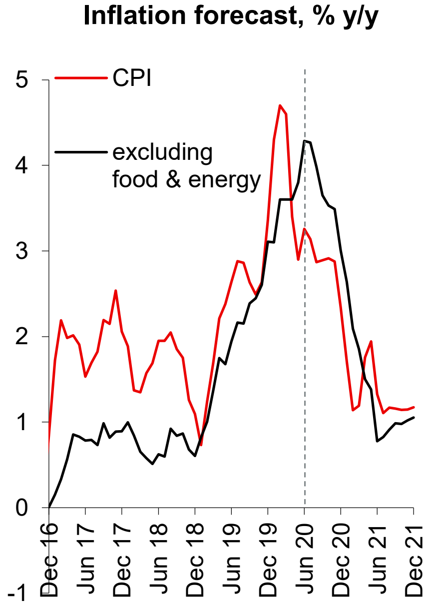
Inflation might be held near the target by the exchange rate, but so far the zloty has done little in this respect.



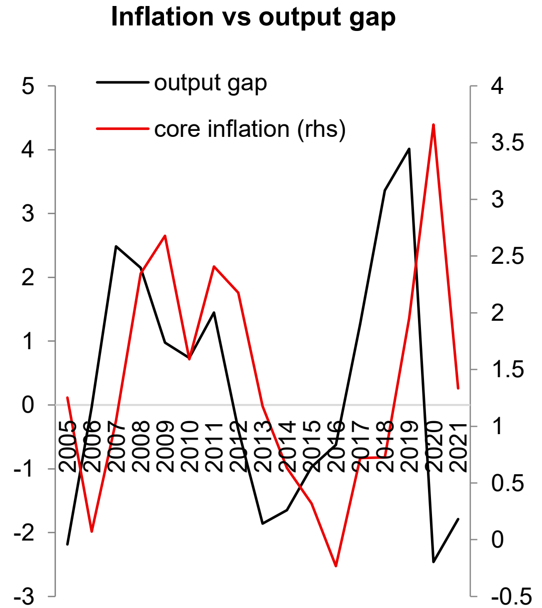
Source: GUS, NBP, Santander



Source: Eurostat, Santander



Source: GUS, NBP, Santander



Source: European Commission, GUS, Santander

Santander

Fiscal policy: facade budget

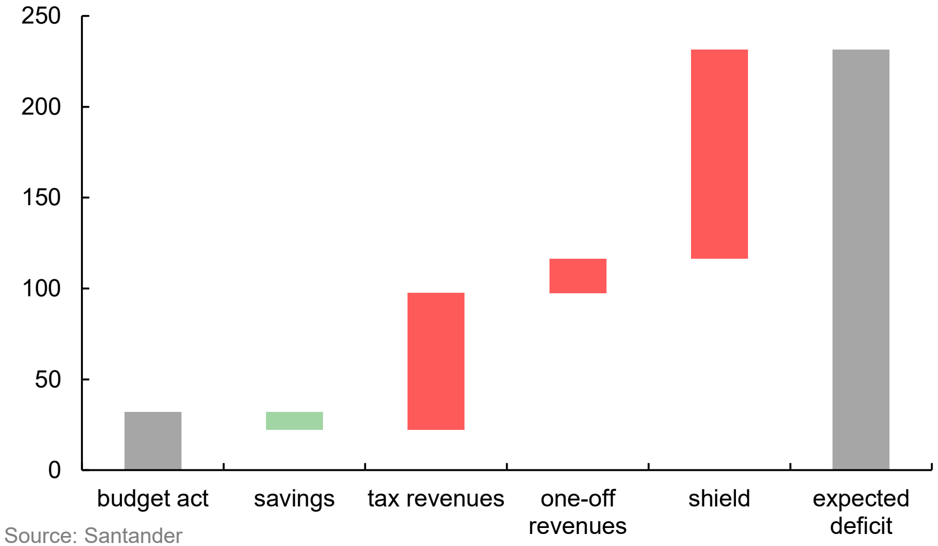
The central budget showed a deficit of PLN25.9bn after May. However, the informative message of this number is currently not very high, as the government has pushed its covid-related spending almost entirely outside of the budget. As of 22 June these spending totalled PLN100bn (including over PLN10bn of BGK guarantees). Moreover, the government is using covid-related funds to fill other funds, which are normally financed from the central budget. That is why the budget amendment, which is to be presented and agreed before the end of July, is a moderately important event, as the government can just put into this act whatever it wants and go on with creative accounting. The more relevant part of the amendment will be the one describing government bond supply plans.

What is more important: the current stabilising spending rule does not allow for such a rise in spending and the government will be forced to change it prior to amending the budget in order to avoid being held responsible before the Tribunal of State. The Finance Ministry proposal assumed a possibility to suspend the rule during an epidemic (under current law the rule can be suspended only during one of the extraordinary states defined in the constitution) and a mechanism of gradual return to the rule in 2-4 years from the trigger.

Data on tax incomes seems to be the only useful statistic in the central budget (yet PIT and CIT are distorted by extended payment deadlines, changing their seasonal pattern). These show a massive slowdown in April and May. We estimate that the gap in public incomes from PIT, CIT, VAT and excise duties in these two months totals PLN22bn versus the plan that we estimated based on government assumptions on annual growth rates). We are assuming some improvement in the months to come and think that total gap of all taxes and contributions in 2020 will reach PLN75bn.

We estimate that government support programmes will balloon the public finance spending by PLN115bn this year and stick to our estimate that the general government deficit will exceed 10% of GDP. Public finance debt will be close to 59% of GDP.

Our forecasts of public finance deficit in 2020, PLNbn



Source: Santander

Gap in central budget tax revenues in April and May as compared to plan, PLNbn

	Realisation	Plan	Difference
VAT	21.9	33.3	-11.4
PIT	9.8	12.0	-2.2
CIT	7.0	9.6	-2.6
Excise duties	9.8	12.9	-3.2
Sum	**48.5**	**67.9**	**-19.4**

Source: Ministry of Finance, Santander

EU recovery plan (1)

The European Commission presented assumption of „Next Generation EU" plan, which aims at supporting the European economy after the epidemic. Total value of the fund was envisaged at EUR750bn, broken down into EUR500bn of subsidies (including EUR66.8bn of guarantees) and EUR250bn of loans. Spending it to be focused on 2021-2024 period. These assumptions will be discussed and negotiated, so this is by no means the final shape of the proposal. We treat the presented numbers as a high estimate, which could be reduced under pressure of the „frugal four" (the Netherlands, Denmark, Sweden, Austria).

The Next Generation EU programme is a top-up of the 2021-2027 financial framework, but there is an important difference versus the previous EU budgets: it will be financed with issuance of EU bonds, and not – as earlier – with EU countries' contributions. The bonds will be issued by the European Commission with 3-30 years maturity and will be bought back in 2028-2058 with EU countries' financial contributions. That said, if bonds meet high demand (and we expect this to happen, as these papers will be treated as safe-haven assets), we would expect them to be rolled over. It this is the case, then the assumed spending per country has to be interpreted in gross terms, not in net terms (i.e. minus the contribution), as we do in case of other EU funding.

Tentative information and proposals suggest that Poland can get about EUR64bn, including EUR26.8bn in subsidies from Recovery and Resilience Facility, EUR6bn from Just Transformation Fund. Polish contribution was estimated at EUR28.5, but – as we noted above – we think these funds will be rolled over and the contribution will become a de facto budget guarantee.

Next Generation EU Programme

	Aim	Value
I pillar	**Support of EU countries' recovery**	**EUR655bn**
Recovery and Resilience Facility	For investment and reforms, including green and digital transformation	EUR310bn in subsidies, EUR250bn in loans
REACT-EU	Top-up for cohesion policy in 2020-22: subsidies for local governments, hospitals, companies – for employment, flexible work, liquidity for SME	EUR50bn
Support for green transformation	Just Transformation Fund	EUR30bn
	Rural Development Fund	EUR15bn
II pillar	**Starting the recovery and supporting private investment**	**EUR56.3bn**
Funds for InvestEU and Strategic Investment Facility	Guarantees for financing investment in digitalisation, infrastructure, R&D, under management of EBI and banks	EUR15.3bn +EUR15.0bn
Solvency Support Instrument	EU budget guarantees to EBI – capital support for companies with solvency problems, support for green and digital transformation	EUR26bn
III pillar	**Learning the lesson from the crisis**	**EUR38.7bn**
Health programme	Health security, quick reaction to the crisis, prevention of diseases, diagnostics and treatment	EUR7.7bn
rescEU	Subsidies and public offers governed by the EC: Quick response infrastructure, medicine, medical staff and patient transport systems	EUR2.0bn
Horizon Europe	Health and climate research, innovations	EUR13.5bn
Humanitarian Aid	Aid to endangered regions of the world	EUR5.0bn
NDICI	Aid to other countries, like Balkans and Africa	EUR10.5bn

Source: European Commission

EU recovery plan (2)

Lower EU funding for Poland in the 2021-2027 framework has been named as one of the risk factors for the Polish economy. The new programme reduces this risk, as the total sum of means for Poland is likely to be higher than in 2014-2020 framework.

We assume that the Next Generation EU programme will be shaped similarly as previous financial frameworks, i.e. potential beneficiaries will apply for financing, then will sign a contract (for about 60% of applications) and only then will be able to start spending the money.

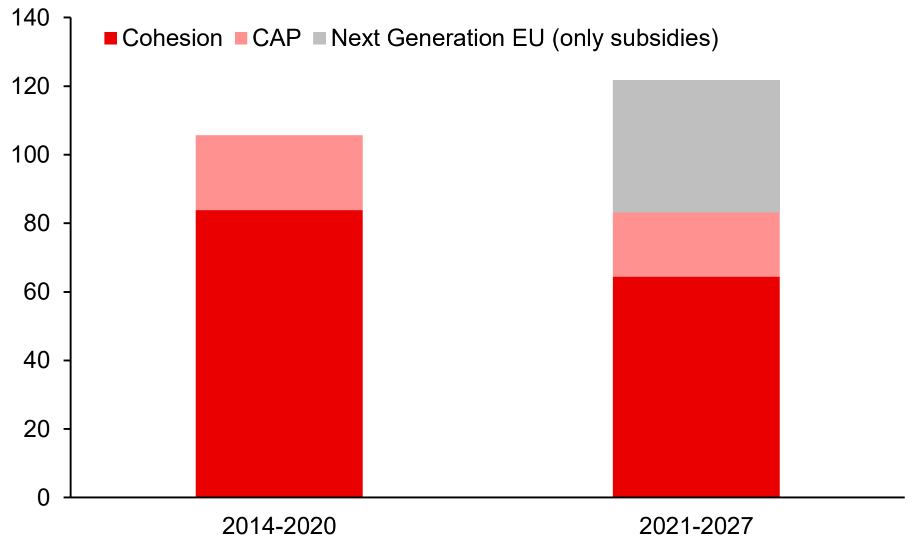
History shows that EU financial frameworks warm up slowly: in 2014-2020 the peak value of signed financing contracts was recorded in the fourth year of the framework and in the first 2 years only 5% of available means were contracted.

Then there is a long way from a financing contract to spending, at least when we think about big investments in infrastructure. Moreover, we expect that new means will crowd out some of public and private investment (e.g. comments of PM Morawiecki suggest that the anti-crisis investment package worth PLN30bn will be financed from EU means).

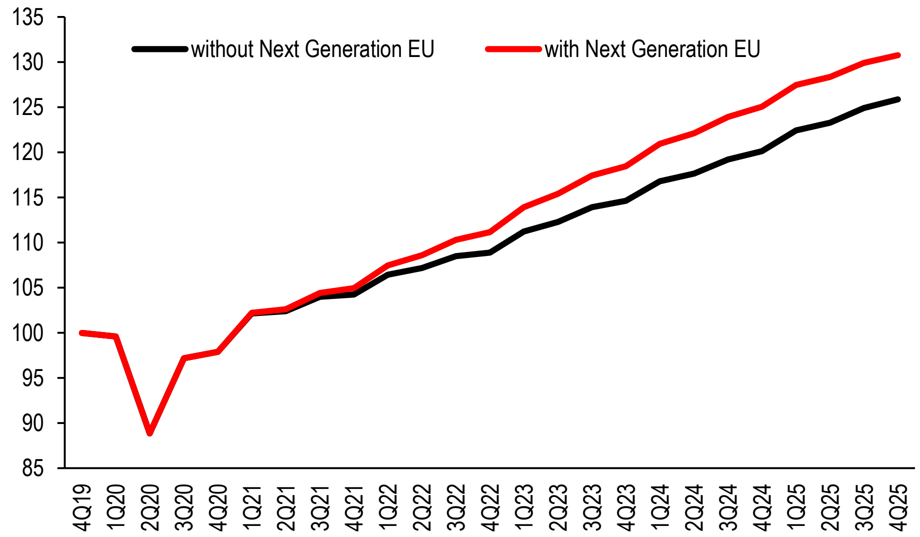
We are assuming that this time contracts will be signed faster due to a higher mobilisation due to the crisis and the shorter time horizon of available means.

Our estimates indicate that in 2025 the Polish GDP will be by 4% higher than in a scenario without the Next Generation EU programme. In 2021 the programme will add 0.3 pp to Poland's GDP growth, 1.2pp in 2022 and 1.4pp in 2023 (the peak of positive impact).

EU funding for Poland, EURbn



Our GDP forecasts, 4Q19 = 100



Source: European Commission, Santander

Santander

Monetary policy: negative rates are an extremity?

The Monetary Policy Council took us by surprise a few times over the last months. First, they cut interest rates almost to zero in May, and then they added to their June statement: ”the pace of the economic recovery could also be mitigated by the lack of visible zloty exchange rate adjustment to the global pandemic shock and to the monetary policy easing introduced by NBP”.

Remarks like these do not appear in the central banks' communication by chance. We read this statement as a verbal intervention and a suggestion of potentially higher NBP activity towards weaker PLN. The list of potential tools that central bankers can use is shown at the following page.

In our view, the Council has reached its limit as regards interest rate cuts and we view introduction of negative rates in Poland as very unlikely, possible only in a scenario of further interest rate cuts abroad, provided that global economic prospects deteriorate markedly (this is not our baseline scenario).

We have to admit that interpretation of Polish central bank's intentions is currently really difficult. Given that the MPC resigned from post-meeting press conferences, we can only base on official documents and media interviews. The latter seem to be unequivocal – 7 out of 10 MPC members spoke last months <u>against</u> (with various tiers of firmness) negative rates (see box on the right). We do not suspect two other members (Hardt and Zubelewicz) to support negative rates either. However, let us remind that prior to rate cut in May the comments of MPC members (including doves) also suggested no further easing. At the same time, we stories circulating among market players about an exceptionally dovish message from the teleconference between NBP and investors, where further reductions were not ruled out.

For sure, the communication is not the MPC's strongest skill, especially during the crisis. This could limit the effectiveness of these monetary policy tools that are based on credibility of central bank signals and on shaping expectations.

Jerzy Kropiwnicki (Bloomberg, 24/06): In [2021 r.] <u>we have to gradually, cautiously, gently return with interest rates to 2019 level</u>, as it was working well for the economy for years.

Eryk Łon (Radio Maryja, 23/06): In general I could say that the central bank has done a lot and the scale of cuts seems relevant to the scale of challenges faced by the Polish economy (…) Negative rates have both positive and negative effects. (Reuters, 4/06): <u>I see no arguments to cut rates further</u>. It seems that these will remain flat for a longer time, also in 2021.

Eugeniusz Gatnar (PAP, 9/06): As regards cuts already implemented by the MPC, I think it was too deep. A total cut by 50bp would do, primarily thanks to psychological factors (…) <u>[I am a strong opponent] of negative interest rates</u>. They could undermine the zloty's credibility, encourage deposit withdrawal and buy foreign currencies. They could also destabilise the banking sector.

Jerzy Żyżyński (PAP, 8,06): Rates have effectively reached the lower bound, there is no room for further cuts – a theoretical cut of reference rate to zero would yield no results. Let me note that real interest rates have been negative for some time already. <u>The Council did not discuss introducing negative nominal rates and I am personally against such decisions</u>. In my view, such a scenario is not probable.

Cezary Kochalski (PAP, 3/06): Currently interest rates are at a very low level and the central bank is using other non-standard tools. <u>I see no reasons to discuss negative interest rates</u>.

Rafał Sura (PAP, 2/06): As for the time being, the instruments used by the NBP are sufficient. Now we need to observe the reaction of the economy. As regards negative rates, I would not say no to any instrument, as currently <u>there is no need for a broader discussion of this issue, and obviously no need for such a solution</u>. (…) some PLN weakening would contribute to higher competitiveness of the Polish products, which is crucial for maintaining exporters' presence on foreign markets and for a quicker economic recovery after the pandemic. At the same it, out would limit the risk of inflation falling markedly below the NBP target in the medium term. However – despite major loosening of NBP monetary policy – the zloty exchange rate remained relatively stable. The NBP will analyse reasons for such a situation and it could affect its decisions and further actions.

Grażyna Ancyparowicz (PAP, 1/06): <u>I do not want to cut rates further</u>, but if it turns out that we have no other option, we could do it. Hypothetically, we could not rule out a very negative scenario, where cutting rates below zero is the only possibility. However, the probability of such a scenario is very low. Today I cannot say with 100% credibility that there will be no need to introduce negative rates. It is however worth noting that I was not discussing this issue with the Council.

Monetary policy: viable options for the MPC

The last change in the MPC statement suggests limited central bank tolerance for the zloty appreciation. What happens however if the domestic currency does not weaken?

On the right we are presenting the list of possible NBP action, sorter by our assessment of probability that particular tool will be used. We also pinpoint pros and cons of every option.

Verbal interventions	(+) No costs (−) Potentially low effectiveness if no actual action is likely / follows. Temporary (if any) impact on the currency, especially when the quality of central bank communication is low.
Forward guidance	(+) No costs, higher predictability of the monetary policy (−) Market is already pricing-in stable NBP rates until end of current MPC term (early 2022). Extending this horizon with forward guidance would not be credible. MPC could affect market expectations by not ruling out further cuts, but this would fuel questions about its actual readiness to introduce negative rates and to set precise conditions for that – not credible otherwise.
Increased scale of purchases	(+) Not controversial given current global conditions. At the same time, purchases could be sterilised at a lower scale (less NBP bills). Lower cost of debt servicing for the government. If the scale of QE abroad (e.g. ECB) is big enough, this could be key for the FX and necessary for exchange rate floor (see below). (−) Easy to start, not that easy to end. The bigger the scale, the more difficult to exit the policy without market distortions.
Outright FX interventions (selling PLN)	(+) Not announced, direct NBP interventions could lower investors' eagerness to push the zloty stronger. Ammunition is potentially unlimited. (−) Halting/reversing the strong trend could need a big scale of operations. NBP appearance on the market could make investors test the limits of the central bank.
Floor for EUR/PLN	(+) Alternative for negative rates used for some time by SNB and CNB. Potentially unlimited ammunition. (−) Necessary to follow the ECB scale of QE and results in accumulation of large FX reserves. Return to free floating FX regime could be difficult (risk of temporary market turbulence).
Negative interest rates	(+) Lower costs of recovery from the crisis for the government and for the NBP. (−) Risk for banking sector stability. Risk of speculative bubbles on the asset markets. Lower short-term rates do not have to be accompanied by lower rates on the longer end. Risk of lower loan accessibility, which could hinder the economic recovery. Difficult to explain to the society, not in line with the "success narrative" (Poland is doing way better than others).

Influx of new money

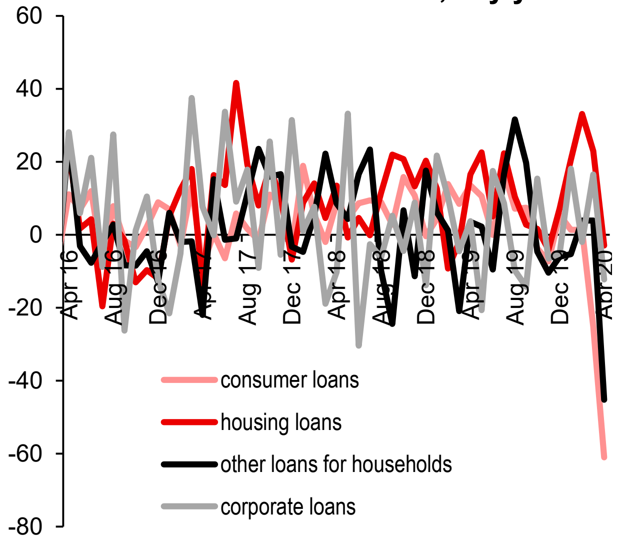
The coronavirus epidemic has hit the demand for loans and at the same time encouraged banks to tighten their lending criteria, leading to a decline in creation of new loans (left hand top chart).

On the other hand, the loan volume is supported by covid-related loan vacation. We estimate that about 10-15% of household loans and 20-25% of corporate loans could have been suspended, including over 30% of SME loans.

Creation of the new money through the credit channel was impaired, so the government and the NBP took over as credit creation stimulators. The government was loosened its fiscal policy and in order to finance this expansion is issuing vast amounts of bonds, mostly through PFR (Polish Development Fund) and BGK (state-owned bank). The new money is created when the banking sector buys this bonds (yet, to be precise: in case of T-bonds and BGK-bonds this happens when funds exit the government account and reach household or Corporate account). Then the NBP buys the said bonds from the banks, thus providing then with fresh liquid funds, which could be spent on further purchases of government bonds and further money creation.

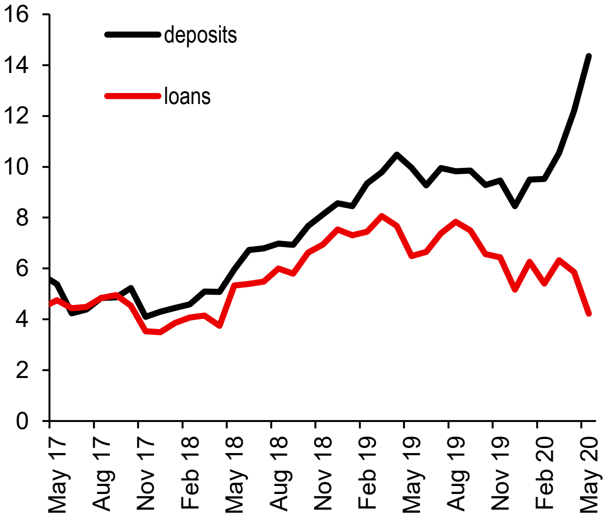
Given the scale of the government programme the money supply started to accelerate despite rather weak loan growth (see bottom chart) and we can observe a major divergence between growth rates of deposits and loans (top right hand chart).

New loan creation, % y/y



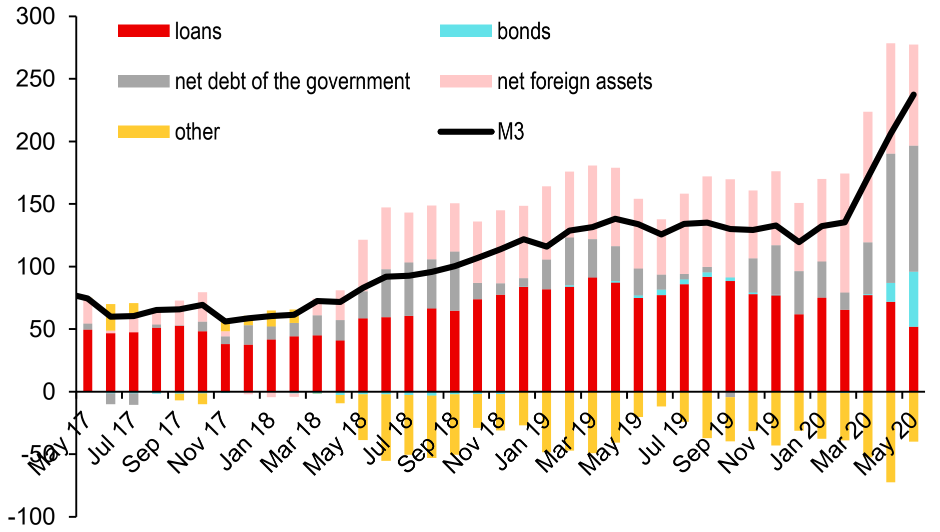
Source: NBP, Santander

Loans and deposits, % y/y



Source: NBP, Santander

M3 money supply and its creation factors, y/y change in PLNbn



Source: NBP, Santander

Politics: the final stretch of presidential election

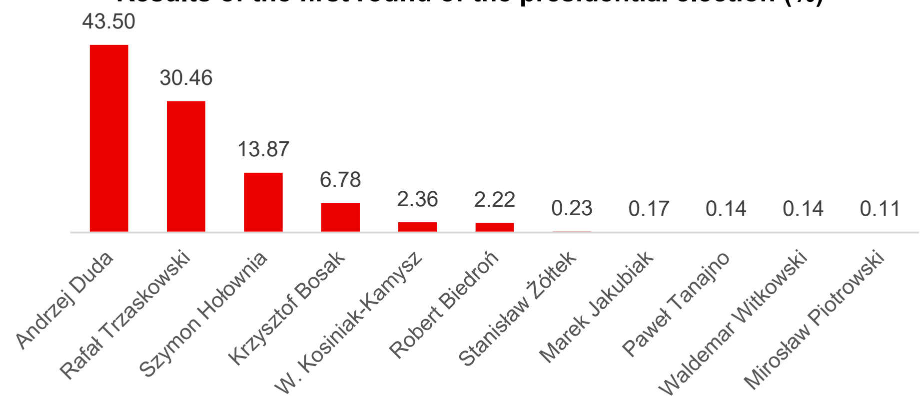
In the first round of presidential election, the incumbent Andrzej Duda got 43.5% votes, Rafał Trzaskowski came the second with 30.5% votes (turnout rate was high, 64.5%) and they will meet again in the second round on 12 July.

The large advantage of Duda vs Trzaskowski (13pp) seems to secure a high chance for him to beat the rival. On the other hand, polls (see details in the table) suggest chances are close to equal. The final outcome is far from certain in our view and the fight for votes will continue until the very last moment. It is hard to tell now if the final two-week stretch of the election campaign brings a significant twist, like more promises with high fiscal impact. Observation from recent weeks is that the ruling party is aware of the growing limitations to further rise of spending.

Re-election of Andrzej Duda would be a confirmation of the status quo and in our view should be neutral for financial markets.

What would a victory of Rafał Trzaskowski change? Polish president's prerogatives are not big, the key ones – from the market perspective – are limited to staffing some high posts and the ability to veto bills (details on the next page). On the one hand, investors may see positively the lower risk of further controversial changes in the legal system or in the fiscal expansion, as these could be vetoed by the president. On the other hand such a change of political configuration would cause a lower political predictability in the short term (reduced governing ability of the current ruling party in face of veto threat, possibly risk of snap elections with another populist campaign), which could decrease foreign investors' appetite for Polish assets for the time being.

Results of the first round of the presidential election (%)



Source: National Electoral Commission (PKW)

Polls regarding the second round of the presidential election (%)

	PUBL.	RAFAŁ TRZASKOWSKI	ANDRZEJ DUDA	undecided	will not vote
Kantar/CATI+CAWI	28.06	44.7	45.4	9.9	-
Indicator	26.06	49.1	50.9	-	-
Estymator	26.06	49.4	50.6	-	-
Pollster	25.06	46.48	44.83	8.69	-
Kantar/CATI	25.06	45	47	8	-
IBRiS	26.06	47.5	48.7	3.8	-
IPSOS	24.06	47	43	9	
Social Changes	24.06	44	46	6	4
Pollster	22.06	49	51	-	-
IBRiS	21.06	45.5	45.6	5.4	3.5
IBRiS	23.06	46.0	45.2	8.8	-
United Survey	22.06	46.9	45.8	4.4	3.0

Source: ewybory.eu

Politics: what can the Polish president do?

Key prerogatives of the Polish president (nominations, designations):

- Designates and appoints the Prime Minister under the ordinary procedure of government establishment,
- Accepts the resignation of the government tasks it with further functioning until a new cabinet is set: acceptance is: obligatory - if the government got a no-confidence vote or is not granted a confidence vote; optional: if the sole reason for handing the resignation by the PM to the President is the PM's own initiative,
- Upon request of the PM, under martial law appoints and dismisses the commander-in-chief of the armed forces,
- Upon request of the Minister of National Defence appoints and dismisses Chief of the Polish General Staff,
- Upon request of the Minister of National Defence appoints and dismisses chiefs of military branches,
- Appoints and dismisses members of the National Security Council,
- Designates and dismisses Polish ambassadors in other countries (requires countersigning)
- Receives letters of credentials and letters revoking accredited representatives of other countries,
- **Files a motion to the Sejm to appoint the president of the National Bank of Poland,**
- **Appoints 3 members of the Monetary Policy Council,**
- Appoints 2 members of the National Broadcasting Council,
- Appoints 2 members of National Media Council, out of candidates of parliamentary clubs and deputies' clubs, which have no representation in the government (requires countersigning)
- appoints and dismisses members of Social Dialog Council
- Upon request of the National Council of the Judiciary appoints judges
- Designates 1 member of the National Council of the Judiciary (requires countersigning)
- **Appoints the First President of the Supreme Court** out of candidates of the General Assembly of the Supreme Court Judges.
- Appoints presidents of the Supreme Court,
- Appoints the President of the Supreme Administrative Court out of candidates of the General Assembly of the Supreme Administrative Court Judges,
- Appoints vice-presidents of the Supreme Administrative Court,
- **Appoints the President and the Vice-President of the Constitutional Court** out of candidates of the General Assembly of the Constitutional Court Judges,
- Awards professor's degree to science and arts workers and academic teachers,

Key prerogatives of the Polish president (other):

- **Can veto bills** – sending back the bill to the Sejm for further consideration. The Sejm can reject the veto by a qualified majority of 3/5 of votes with more than a half of the statutory number of deputies present.
- Before signing a bill, can resort to the Constitutional Court to check compliance with the constitution of the bill.
- May shorten the term of office of the Parliament if it does not pass the budget bill to the president for signature in 4 months since receiving the draft from the government.
- Shortens the term of office of the Parliament if the general procedure and the two stand-by procedures fail to establish a government.
- Is the Head of the armed forces – in peace time exercises supreme command over the armed forces via the Minister of National Defence,
- Ratifies and terminates international agreements (requires countersigning); some international agreements may be ratified or terminated by the president only after a parliamentary approval is expressed in a bill.
- Has the right to order an inspection by the Supreme Audit Office,
- May file a motion to the Constitutional Court to check: compliance with the constitution of a normative act, a settlement of a dispute regarding competence,
- Has the right to file a draft motion to make a member of the cabinet take constitutional responsibility.
- Has the right to file a draft motion to make the following officials take constitutional responsibility (requires countersigning): the President of the Supreme Audit Office, the President of the National Bank of Poland, the Commander-in-Chief of the armed forces, a departmental minister, a member of the National Broadcasting Council,
- Awards orders and medals,
- Can exercise law of grace,
- Attributes Polish citizenship at his own discretion.

Source: Santander, based on legal documents

Financial markets

2

Due to pandemic rates have been cut to zero…

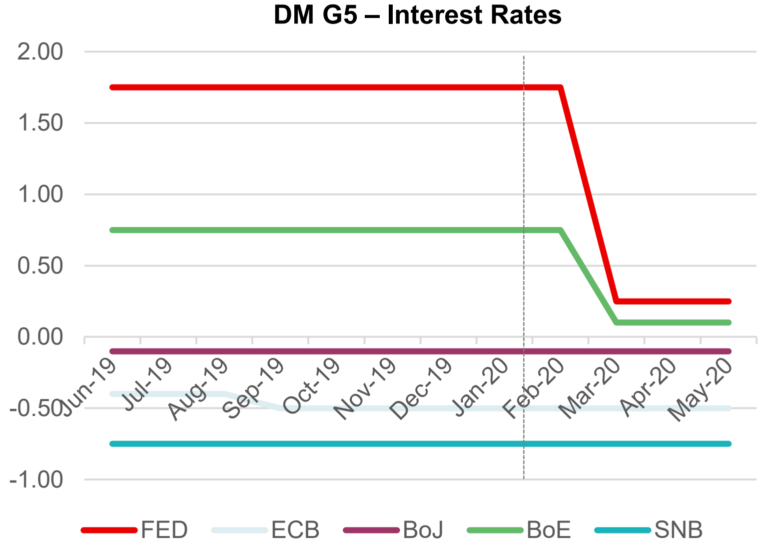
In light of the Covid-19 pandemic the central banks globally started to aggressively cut rates.

In the DM world, rates have been cut everywhere except for the ones where the rates have already been below zero (SNB, ECB) or the ones which raised rates to zero not long ago (Riksbank).

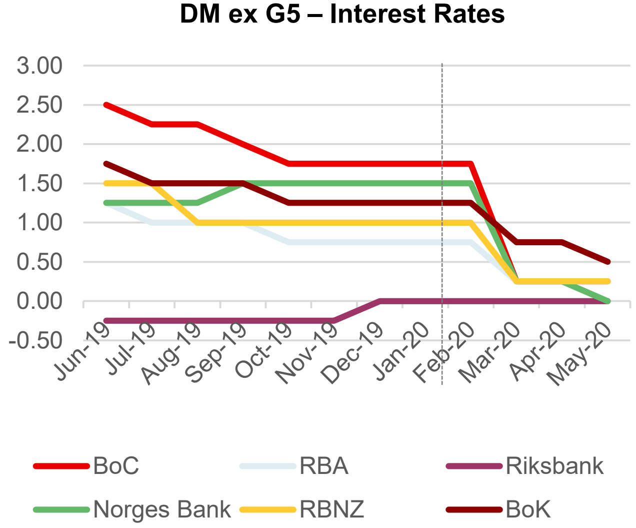
With rates near zero the central banks are focusing on the non-standard measures.

In the EM high yielders the disinflation process had progressed for some time anyway before Covid-19 and central banks remained in the cutting cycles. The pandemic has accelerated these moves. The cuts do progress despite significant weakness of local currencies, often up to 20%.

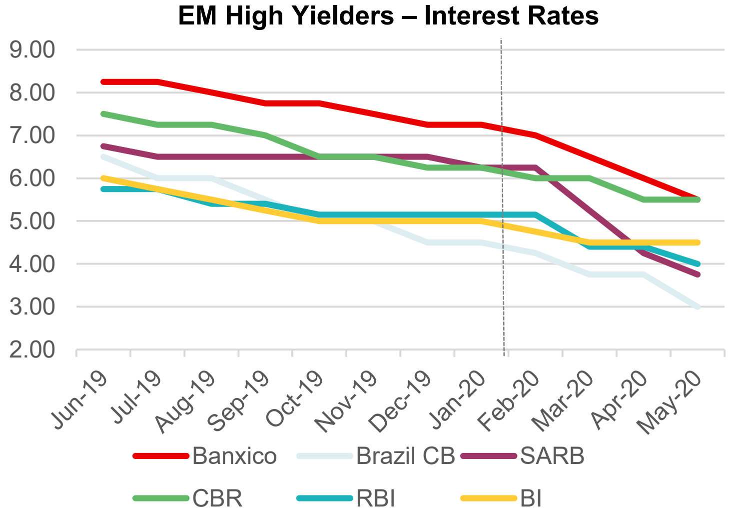
In the EM low yielders the pandemic has initiated the cutting cycle and in one case (Czechia) have turned the cycle around. As a result in some of the EM countries (like in the CEE region) the interest rates also approached zero and – similarly to the DM world – imply that in order to further stimulate the economies the central banks need to use non-standard policy measures.



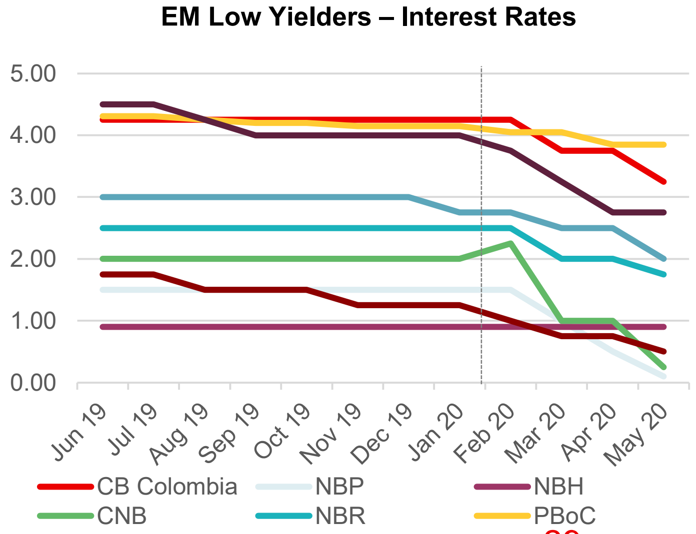
Source: Bloomberg, Santander



Source: Bloomberg, Santander



Source: Bloomberg, Santander



Source: Bloomberg, Santander

Santander

…which forced an increase or a launch of QE…

With interest rates near zero the central banks launched or accelerated asset purchase programmes.

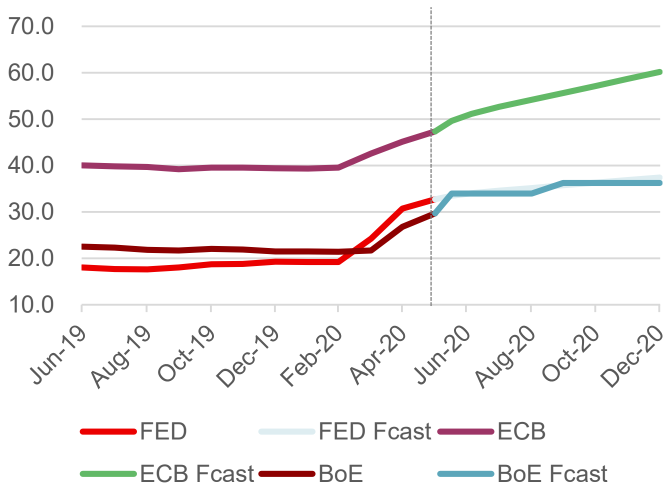
Assuming that the declared asset purchases till end of the year will be realised, the balance sheets will reach 40% of GDP for the US and UK and 60% for the ECB (top, left).

In the DM world it is the US which increased their balance sheet the most year to date – by 14pp of GDP. Not far behind is Japan, where BoJ accumulated assets at a large scale despite the elevated starting level. Both the UK and ECB have beefed up their balance sheets by around 7pp year to date (top, right).

In Poland, the NBP bought (as of 17 June) PLN95bn bonds which constitutes 4.3% of GDP. Because asset purchases as a tool are new to the central bank, the year to date increase in assets in pp also equals 4.3pp (bottom, left).

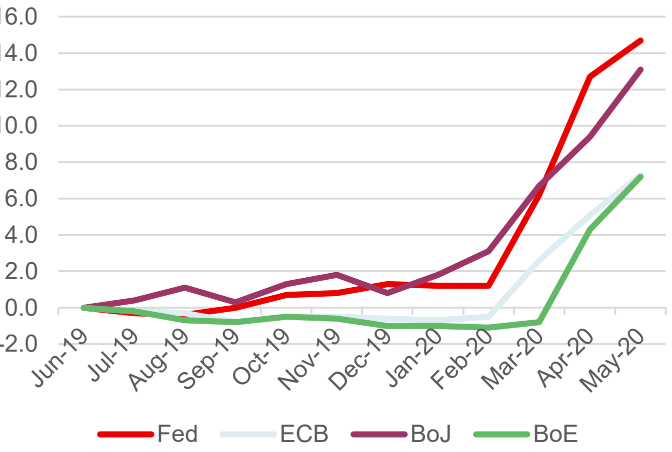
In a situation where the interest rates have gotten in the vicinity of zero and the differences between them will likely become more stable it is plausible that the relative size of the central bank balance sheets (as % GDP) will become a leading factor in the relative performance of asset price changes (bonds, FX). By this measure Polish central bank lags ECB's balance sheet by around 3.5pp (bottom, right).

CenBank b.s. as % GDP. History and forecast



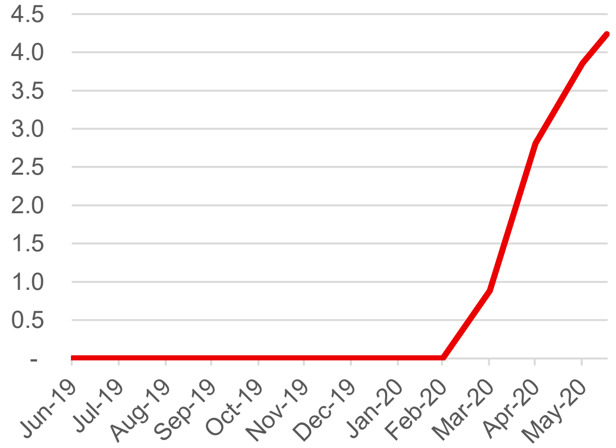
Source: Bloomberg, Santander

Increase in CenBank b.s in p.p.



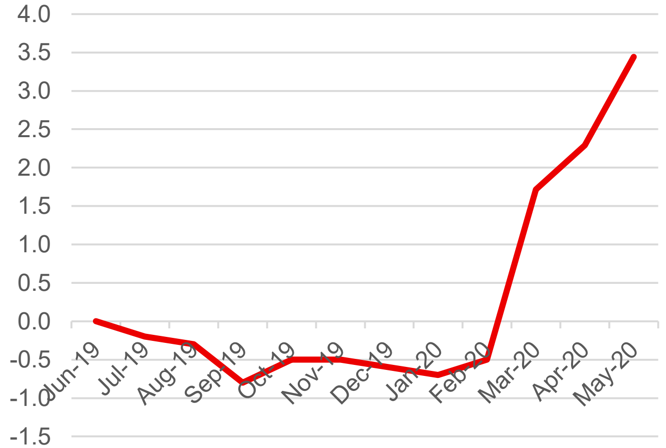
Source: Bloomberg, Santander

Increase in NBP b.s. in p.p.



Source: Bloomberg, Santander

ECB b.s. (% GDP) – NBP b.s. (% GDP) in p.p.



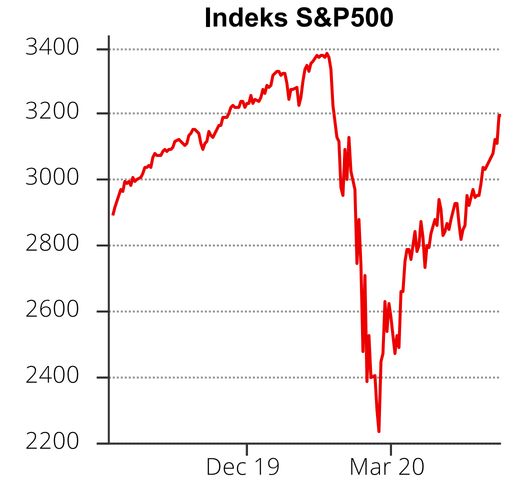
Source: Eurostat, Santander

Santander

…which helped assets make a „V”-turn

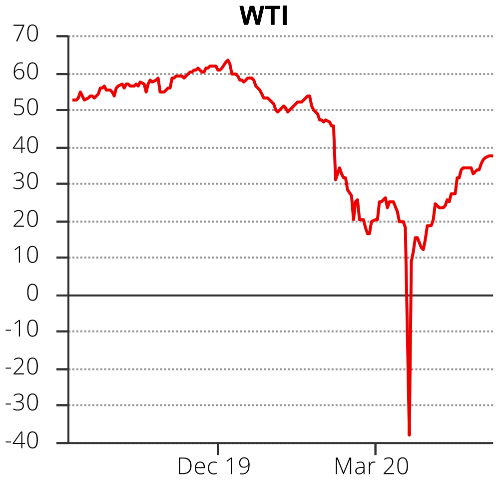
Briefly after the significant decline markets have calmed down and started to price a V-shaped economic recovery.

As a result many of the equity indices moved back higher and currently are close to where they were just before the pandemic outbreak.



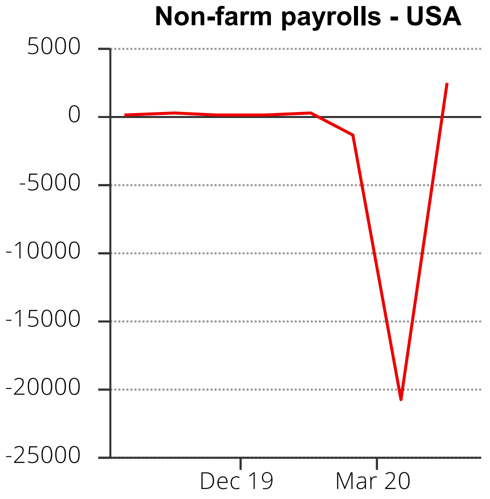
Source: Refinitiv Datastream, Santander Bank Polska

Source: Refinitiv Datastream, Santander Bank Polska

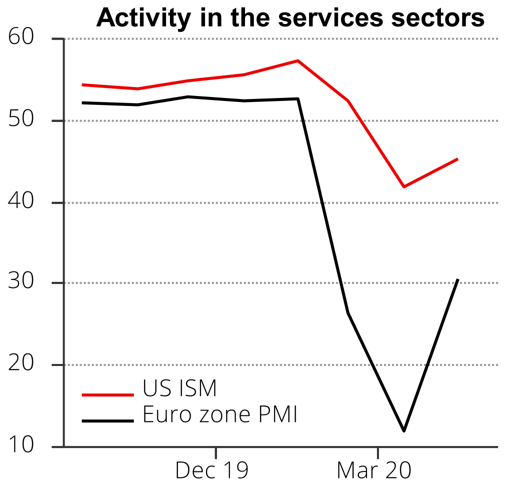


Source: Refinitiv Datastream, Santander Bank Polska

For many market participants such a quick and significant rebound of risky assets was unfounded. The surprise might have been smaller if one took into account the enormous monetary policy loosening that happened and V-shaped recovery in some soft indicators.



Source: Refinitiv Datastream, Santander Bank Polska



Source: Refinitiv Datastream, Santander Bank Polska

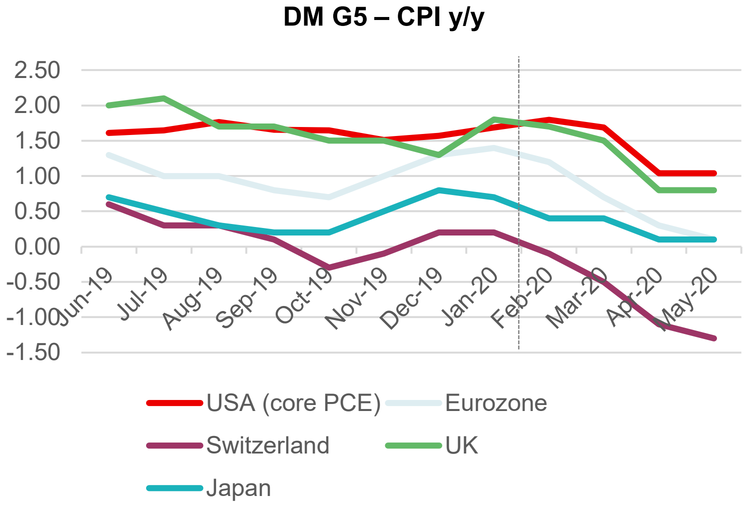
Santander

The pandemic is strongly disinflationary globally…

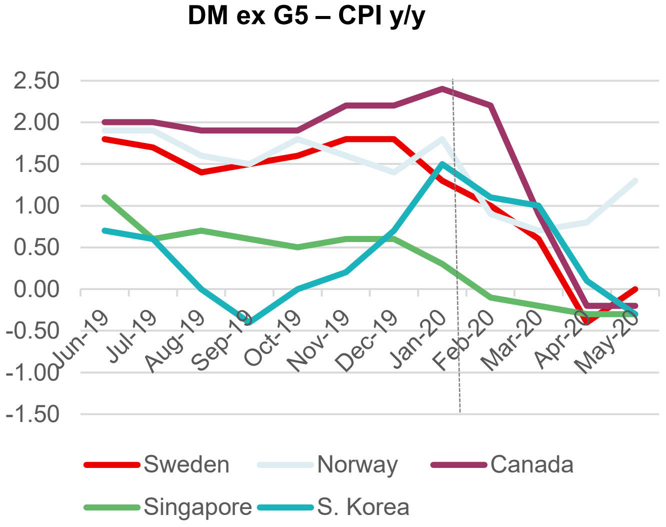
For the DM world the pandemic turned out to be strongly disinflationary (plots at the top)

Declining CPI, abrupt rate cuts, new QE programmes all constituted a good environment for the fixed income assets. Not surprisingly yields have declined (plots at the bottom).

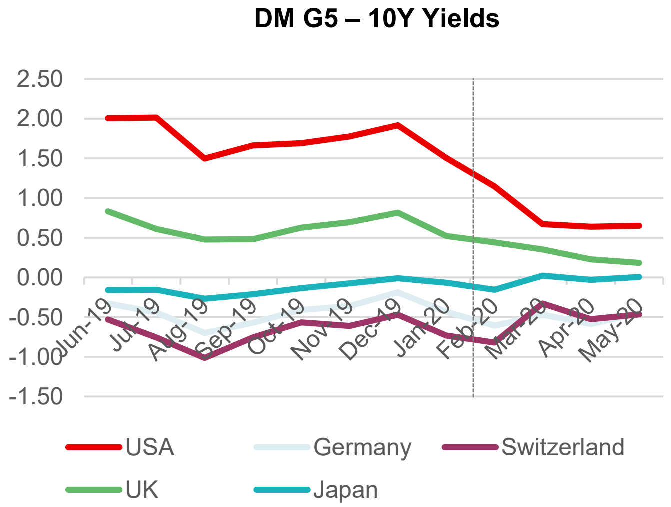
We are expecting the end of 2020 bond yields at 1.0% (vs current 0.7%) while those of German Bund at -0.25% (vs current -0.45%)



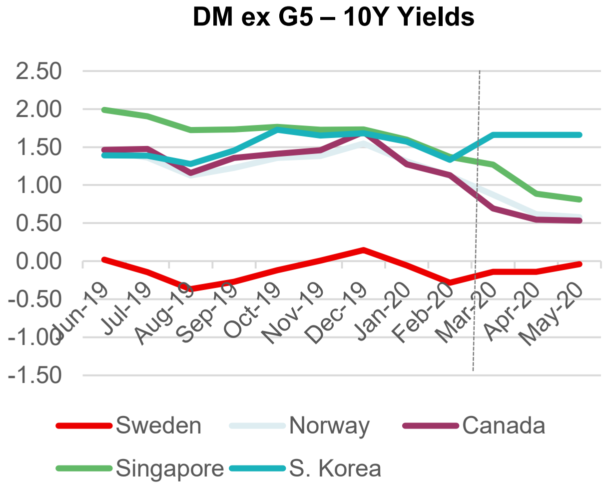
Source: Bloomberg, Santander



Source: Bloomberg, Santander



Source: Bloomberg, Santander



Source: Bloomberg, Santander

… EM yields declined significantly…

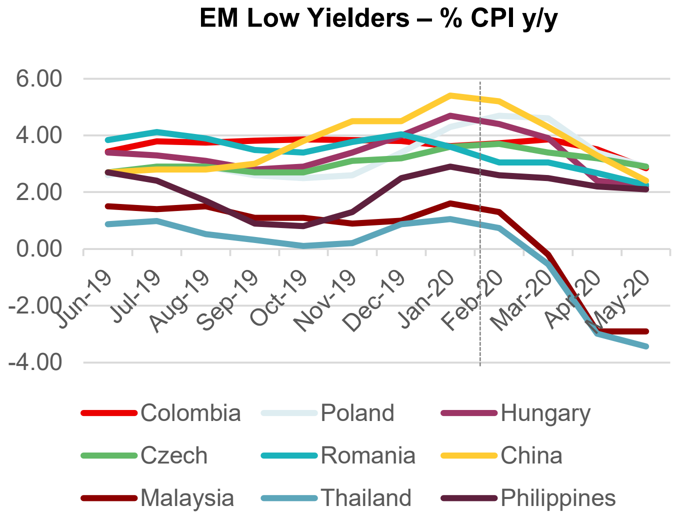
Similarly to the DM world, the pandemic turned out strongly disinflationary for the EM world. The effect is especially noticeable in the EM low yields (top, left).

On top of that, some of the EM countries like Poland, Hungary, Romania, Croatia, Colombia and Brasil launched, relaunched or are thinking about launching the QE programmes.

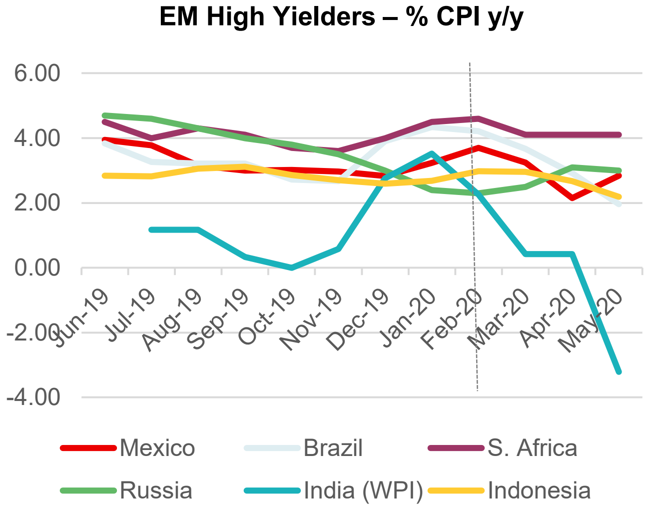
It is worth having a closer look at the EM yields during the crisis:

- In the first phase of typical nature the 10Y yields dynamically increased as investors liquidated their positions. This phase was accompanied by significant weakening in EM currencies – often up to 30%.
- In the second phase the 10Y yields declined again. What is remarkable here is that they declined *below* the pre-pandemic levels. And all this happening with EM currencies still weaker than before the pandemic.

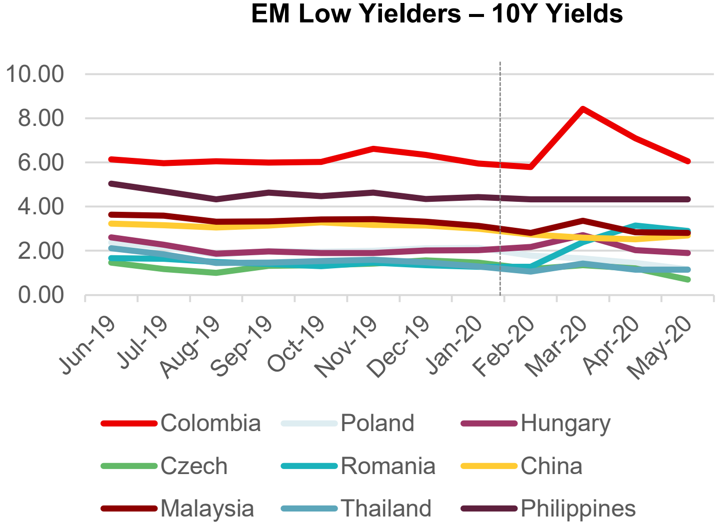
All this points to unmatched strong disinflationary feature of the pandemic crisis and suggests that low rates and non-standard monetary policy instruments and low yields are likely to remain with us for longer.



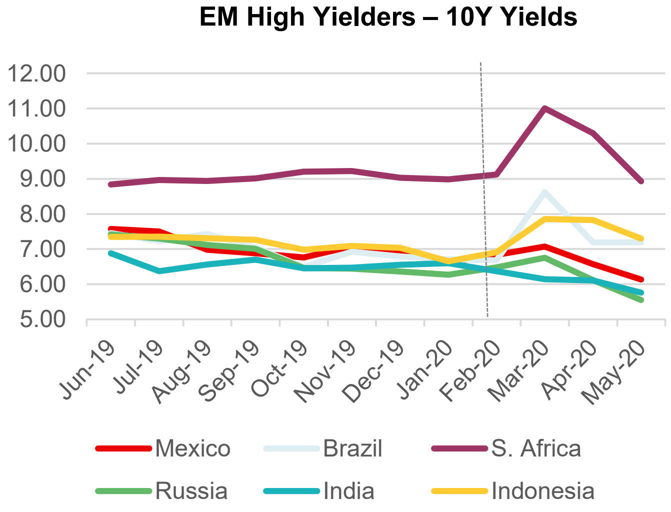
Source: Bloomberg, Santander



Source: Bloomberg, Santander



Source: Bloomberg, Santander



Source: Eurostat, Santander

Santander

…including in Poland, while the curve steepened

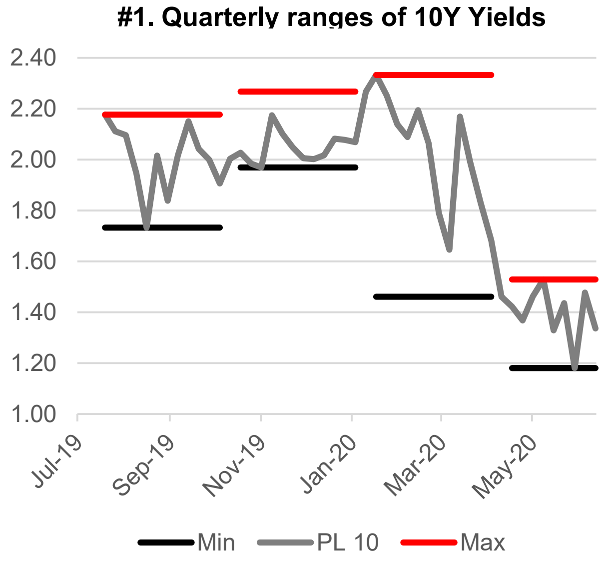
The four plots on the right describe the behaviour of Polish yields in 2Q2020 in the context of the whole past year.

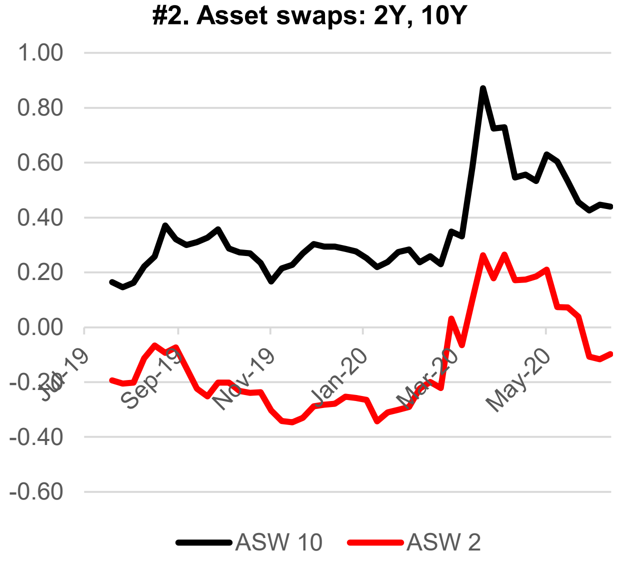
The level of yields declined significantly (#1) also thanks to the NBP rates cuts. Worth noting that NBP cut rates from 1.50% to 0.10% (by 140pb) while the 10Y declined only from 2.0% to 1.40%, less than proportional vs rate cuts.

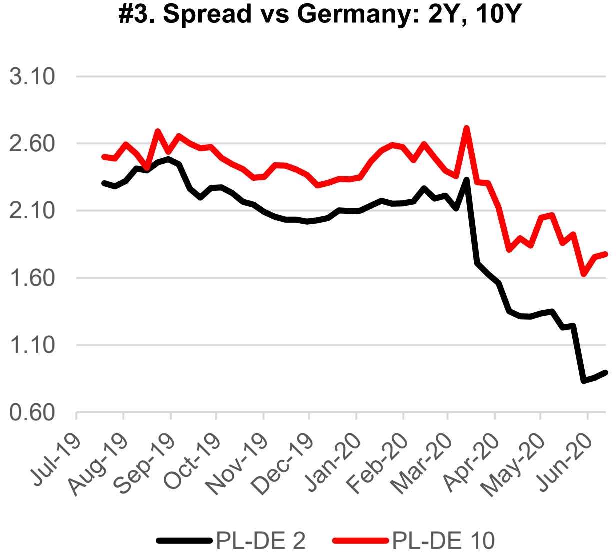
Asset swaps (#2) in their classic response initially widened after which in Q2 2020 started to narrow again. They have not returned to the pre-Covid-19 levels yet though.

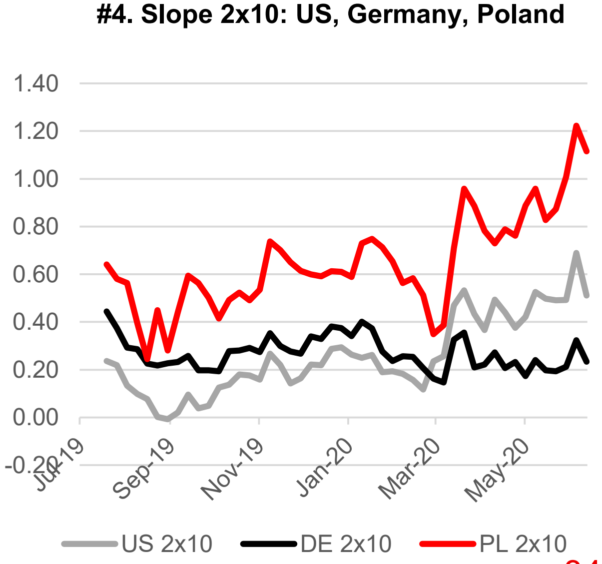
The spreads of Polish bonds over the German ones (#3) have narrowed (NBP cut rates while the ECB has not). The spreads in the 10Y tenors less so. The narrowing was supported by news about European Commission new EUR750bn fund, the increase in the EBC's pandemic asset purchase programme to EUR1350bn (temporarily lower risk of higher European Periphery yields).

As a result of quick rates cuts, the yield curves have steepened (#4) as in the US or Poland. In Germany the slope of the curve remained roughly unchanged.







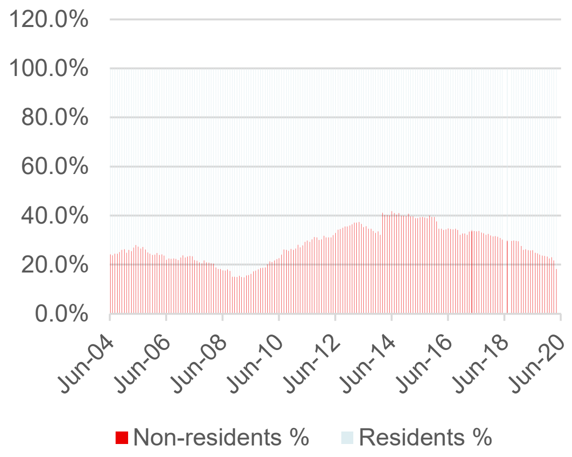


% share of foreign investors in POLGBs declines

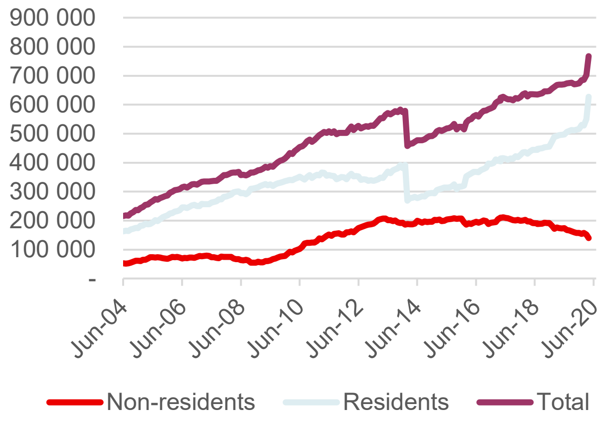
As far as Q2 2020 is concerned we only have data till the end of April. According to Ministry of Finance:

- The share of foreign investors in POLGBs declined to 18.2% - the lowest level since September of 2009 (top, left).
- The increase in the total bonds took place because of the increases in the domestic purchases (top, right).
- Breakdown by ownership / investor types (bottom plot) shows that it is commercial banks that are responsible for a majority of the increase. In particular neither mutual funds nor insurance (which are holding PLN 51.3bn and 64.4bn respectively). The amount of POLGBs that banks hold increased to PLN 420.8bn.

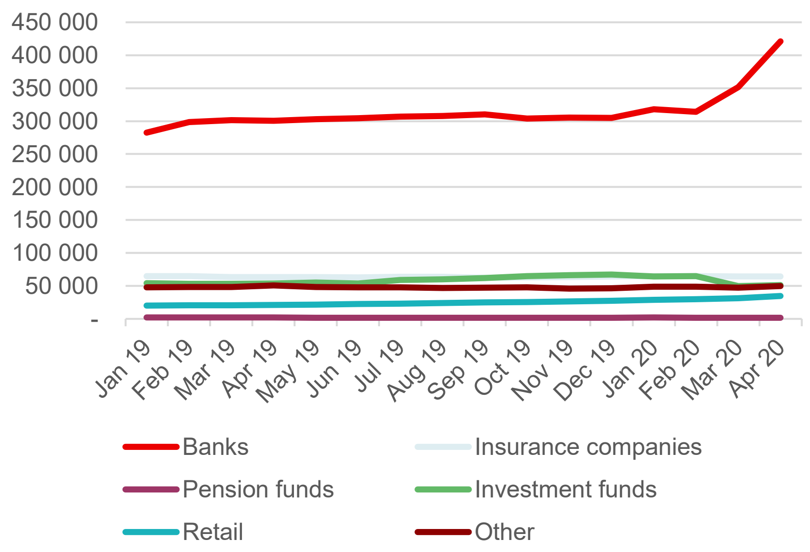
Ownership structure POLGBs, mld zł



Ownership breakdown POLGBs, % total



Ownership breakdown of POLGBs - Residents by type, PLN bn



Forecasts of interest rates and yields

We expect the NBP to keep rates unchanged at current 0.1% till the end of 2020 and maybe even till the end of 2021. Our expectations are consistent with current (mid-June) FRA markets values. By the end of the year we expect a gradual improvement in the economy with further disinflation (core CPI at 2% by year end).

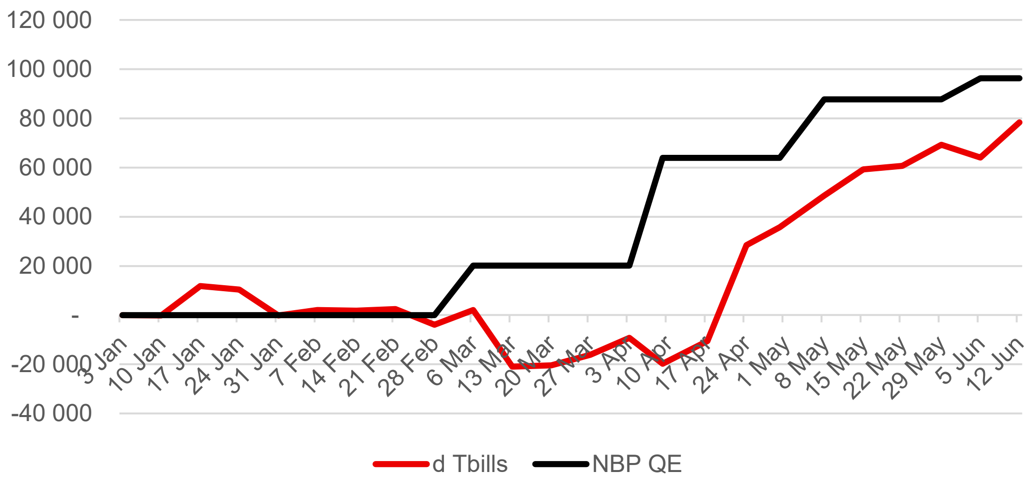
Short end of the curve will likely remain near the current levels. The short term IRS might slowly increase (from the current 2Y at 0.30%) as the economic situation normalises. In the meantime the bond yields (1Y at 0.05%, 2Y at 0.15%) will remain low or even are likely to decline further to 0.0% due to the overliquid banking sector. Most of the year to date NBP purchases landed in the banking system. From there the money has been allocated to the NBP bills, whose within-month level has increased year-to date by around PLN 80bn. As a result most of the QE purchases have been sterilized (top plot).

Long end of the curve will depend both on the global and local factors. We expect it at 1.20% by year end.

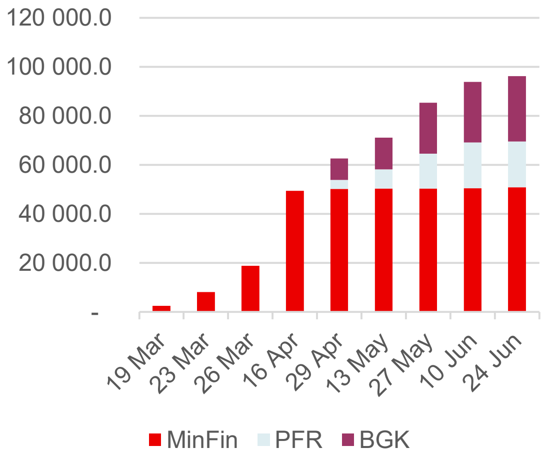
From the local factors, the pace at which the QE will continue will be one of the most important ones. The breakdown of the NBP purchases to date (bottom plots) suggests that since May 2020 NBP mainly bought bonds issued by PFR and BGK. In July the budget amendment will take place and might mean more bonds supplied at Ministry of Finance auction at the end of third quarter. At the same time the QE might again turn its focus more into the government bonds. As a result the bigger supply of bonds should not increase yields by much. We estimate that NBP might buy up to PLN 200bn of bonds in total.

From the global factors, two important ones are the launch of the European Commission's EUR750bn fund (potentially higher yields in the Eurozone) as well as the ECB's pandemic asset purchase programme (potentially narrower spreads) worth EUR1350bn.

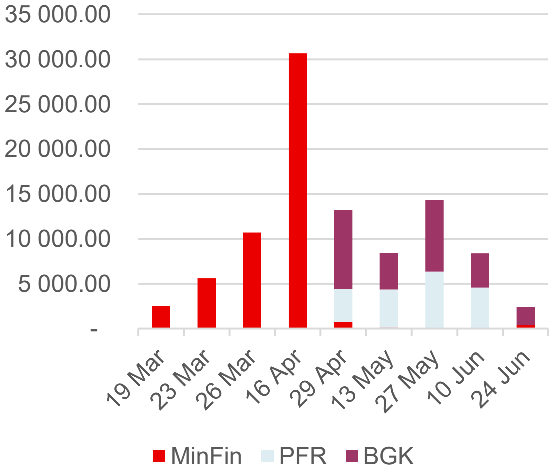
NBP QE purchases vs increase of the average NBP Bills auctions, PLNmn



Cumulative NBP QE purchases by bond type, PLNmn



NBP QE purchases by bond type, PLNmn



FX market – Lagging the rebound

The demand for the risky assets recovered but the EM currencies managed only to recover less than half of the losses suffered during the March high risk aversion.

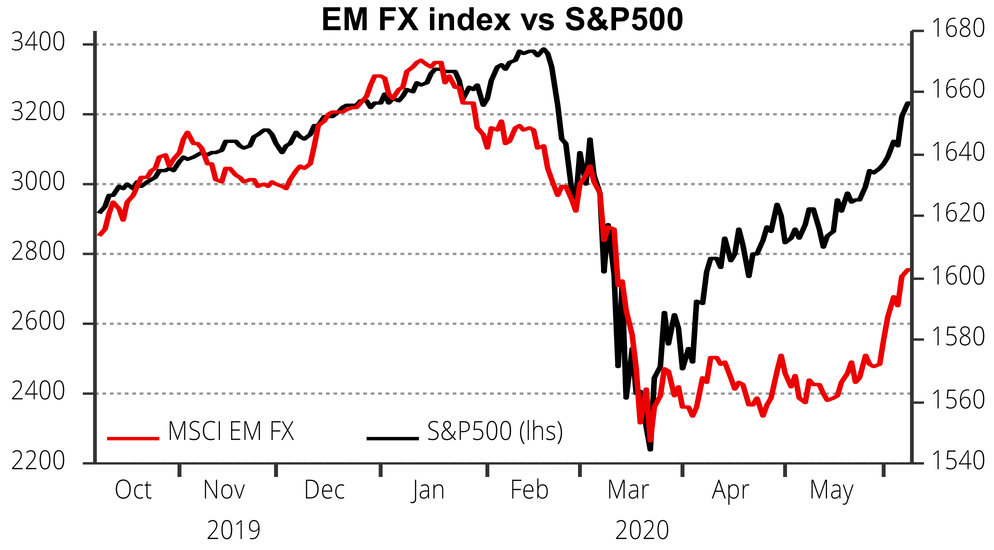
One of the factors behind this might have been the fact that the EM countries still have not contained the first wave of coronavirus. While the developed countries seem to have the situation under control, in the EM countries the total number of cases is still rising at an exponential rate.

In late June, 19 countries with at least 100k of the total COVID-19 cases made up more than 80% of the total world 9.4mn positive test results. Among them, 12 were EM countries.

During the March wave of risk aversion, the biggest losses were recorded for the EM currencies of commodity exporting countries. After they underperformed in 1Q20, they appeared a leaders of a subsequent recovery.

The CEE currencies (that depreciated close to average for the whole EM group in March) also recorded a decent gains after a period of a stabilization.

The zloty performance did not deviate much from its CEE peers despite the lowest interest rates in the region and Poland being clearly unable to stifle the COVID-19 pandemic.



Source: Refinitiv Datastream, Santander Bank Polska

Source: Bloomberg

FX market – Zloty sentenced to weakening?

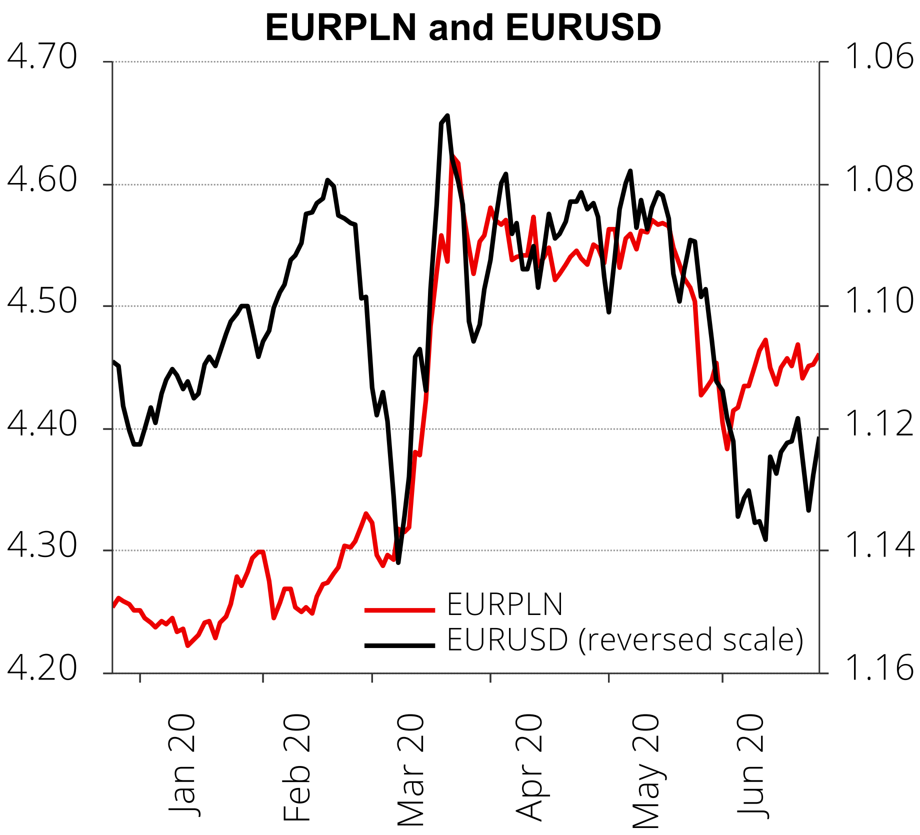
Poland has the lowest interest rates in the CEE region and the total number of the COVID-19 cases is still rising at a stable linear pace whereas Hungary and Czechia seem to have passed the peak of the new cases. Thus, the zloty could be particularly prone to depreciation should the market attention shift to the higher risk of a second wave of coronavirus cases.

Pace of the rally on the equity market slowed since the last FOMC meeting after which the US central bankers again expressed their skepticism regarding materialization of the V-shape recovery priced in by the market. Although these are events of a smaller potential impact than the coronavirus, the lack of progress in UK-EU talks and higher tensions in foreign trade relations between the US and Europe/China may make it more difficult for investors to ignore these returning risk factors.

EURUSD remains at an elevated level after the May/June strong rise. It tried to break 1.14 resistance several times but without success and there is higher risk for stronger dollar in the short term which could weigh on the zloty.

Additionally, the recent signals from the MPC suggest that its members, after having cut rates to nearly 0%, may use the FX channel as a next tool to support the economy.

At the next slide we show potential options the MPC could use to push the zloty towards weaker level if the deterioration of the global mood does not work first. In our view, if the MPC decides to take some action, it will not pause before it reaches its goal. We think this could be EURPLN at least at 4.60 for longer.



Source: Refinitiv Datastream, Santander Bank Polska

Forecasts

3

Economic Forecasts

		2018	2019	2020	2021	1Q20	2Q20	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21
GDP	PLNbn	2 120.5	2 273.6	2,266.7	2,425.9	552.2	509.1	560.5	644.8	562.3	581.2	600.8	681.6
GDP	% y/y	5.3	4.1	-3.8	5.8	2.0	-11.4	-4.1	-1.8	0.4	14.8	5.5	3.5
Domestic demand	% y/y	5.6	3.0	-3.7	5.0	1.7	-10.1	-4.2	-2.2	-1.0	11.7	5.5	4.2
Private consumption	% y/y	4.2	3.9	-2.8	6.0	1.2	-8.0	-3.0	-1.3	0.8	12.4	7.0	4.5
Investment	% y/y	9.4	7.2	-6.9	6.6	0.9	-12.0	-9.0	-6.0	-6.0	13.0	10.0	7.0
Industrial output	% y/y	5.9	4.2	-6.1	5.9	1.1	-17.8	-5.2	-2.5	-4.1	21.3	5.3	3.8
Construction output	% y/y	19.7	3.6	-0.6	5.1	5.0	-2.6	-3.8	0.9	-2.4	4.8	5.6	9.2
Retail sales (fixed prices)	% y/y	6.5	5.1	-1.5	3.5	0.2	-11.7	3.5	1.8	2.0	8.0	2.0	2.0
Gross wages in national economy	% y/y	7.2	7.2	3.5	4.8	7.7	1.2	2.6	2.7	2.2	6.7	5.1	5.1
Employment in national economy	% y/y	2.6	2.2	-2.2	-1.1	0.5	-2.4	-3.3	-3.6	-4.7	-0.9	0.5	0.7
Unemployment rate*	%	5.8	5.2	8.1	8.4	5.4	6.2	7.1	8.1	8.5	7.9	8.1	8.4
Current account	EURmn	-5 046	2 179	5,793	3,860	4,488	3,092	-2,208	421	2,865	-782	-474	2,251
Current account	% GDP	-1.0	0.4	1.1	0.7	1.0	1.7	1.4	1.1	0.8	0.1	0.4	0.7
General government balance (ESA 2010)	% GDP	-0.2	-0.7	-10.2	-2.6	-	-	-	-	-	-	-	-
CPI	% y/y	1.6	2.3	3.3	1.3	4.5	3.2	3.0	2.7	1.3	1.7	1.1	1.2
CPI *	% y/y	1.1	3.4	2.3	1.2	4.6	3.3	2.9	2.3	1.3	1.7	1.1	1.2
Core inflation	% y/y	0.7	2.0	3.7	1.3	3.4	3.9	4.0	3.3	2.2	1.2	0.9	1.0

* End of period; other variables – average in period

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Market Forecasts

		2018	2019E	2020E	2021E	1Q20	2Q20	3Q20E	4Q20E	1Q21E	2Q21E	3Q21E	4Q21E
Reference rate *	%	1.50	1.50	0.10	0.10	1.00	0.10	0.10	0.10	0.10	0.10	0.10	0.10
WIBOR 3M	%	1.71	1.72	0.69	0.28	1.62	0.59	0.28	0.28	0.28	0.28	0.28	0.28
Yield on 2-year T-bonds	%	1.59	1.57	0.68	0.15	1.39	0.48	0.44	0.43	0.08	0.12	0.20	0.20
Yield on 5-year T-bonds	%	2.51	1.97	0.86	0.65	1.55	0.79	0.55	0.55	0.65	0.65	0.65	0.65
Yield on 10-year T-bonds	%	3.21	2.38	1.40	1.30	1.87	1.34	1.20	1.20	1.30	1.30	1.30	1.30
2-year IRS	%	1.92	1.75	0.65	0.39	1.53	0.43	0.30	0.34	0.35	0.39	0.40	0.40
5-year IRS	%	2.43	1.84	0.86	0.94	1.58	0.62	0.58	0.68	0.78	0.87	0.99	1.13
10-year IRS	%	2.89	2.03	1.07	1.20	1.67	0.89	0.83	0.90	1.08	1.19	1.21	1.33
EUR/PLN	PLN	4.26	4.30	4.47	4.49	4.32	4.51	4.52	4.55	4.53	4.53	4.48	4.43
USD/PLN	PLN	3.61	3.84	4.02	3.90	3.92	4.09	4.03	4.03	3.97	3.95	3.87	3.80
CHF/PLN	PLN	3.69	3.86	4.13	3.93	4.05	4.24	4.16	4.08	4.02	3.97	3.89	3.83
GBP/PLN	PLN	4.81	4.90	5.05	5.21	5.02	5.08	5.00	5.11	5.20	5.29	5.23	5.12

* End of period; other variables – average in period
All shaded areas represent Santander's estimates

Source: NBP, Bloomberg, Santander

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MAKROskop

Warsaw, 30 June 2020

Sectoral supplement

Export from Poland in selected sectors

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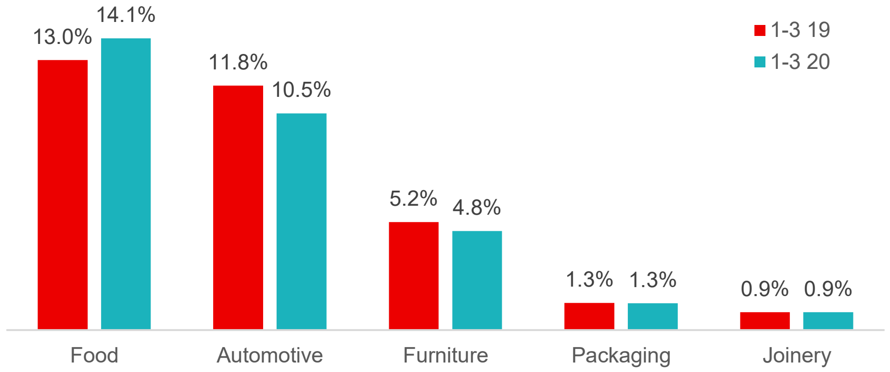
Executive summary

Historically, sectors presented below were the fuel of Polish exports' rapid growth. Cross-border sales of these products was growing faster than total export sales, which translated into high growth rates of Polish companies. It is clear that COVID-19 has changed the landscape of export sales – we can see declining sales not only in pro-cyclical sectors, like automotive or furniture, but also sectors that used to resist previous downturns, such as packaging or food products.

In the case of agri-food industry, a significant change on the demand side was the administrative limitation in the functioning of HoReCa sector, which is an important indirect recipient of products from Poland. Preliminary data show significant declines in export volumes in April, inter alia in the case of pig meat, poultry, beef and dairy products. On the other hand, the high level of retail sales of food on the EU market should support recovery of foreign sales.

Share of selected sectors in Polish exports



Source: Eurostat

As a result of the pandemic, demand for new cars in Europe has fallen sharply and car factories have ceased production. As a result, exports of the Polish automotive sector collapsed, following the situation on the European market. Data for May show that the scale of declines is decreasing, although it is still large. The sector is expected to return to its pre-crisis state relatively slowly.

Furniture manufacturers were hit hard by demand freeze in the EU. Polish furniture industry relies heavily on German furniture chains, sharp sales declines in April portray the scale of challenges, that Polish companies had to face when new orders stopped, and German warehouses were full of stock with their sales plummeting.

In case of builders joinery producers COVID-19 has stopped their bold expansion on the EU markets. Both commercial and residential construction sites were put to hold on some markets (mainly France, Italy, Spain) due to pandemic, dealing a blow to Polish exporters revenues. On the other hand, mass switch to home office did not spark a renovation impulse on the western EU markets, whereas in Poland and some CEE markets we saw a clear increase in the number of consumers interested in improving living conditions in their homes.

Packaging industry has confirmed its position as an industry relatively less affected by crises, yet even in this case April brought about decline in sales, mainly caused by lacking demand on EU markets. As consumers stayed at home, convenience trend (frequent, fast, convenient shopping), which until now remained a significant growth driver, has been nearly put to stop. In some segments of the packaging industry, mainly in hygiene and disinfectant packaging, demand in the EU was tremendous, and export sales data show singular peaks in sales to markets where dynamic increase in confirmed COVID-19 cases was observed.

COVID19 has uncovered our reliance on EU market

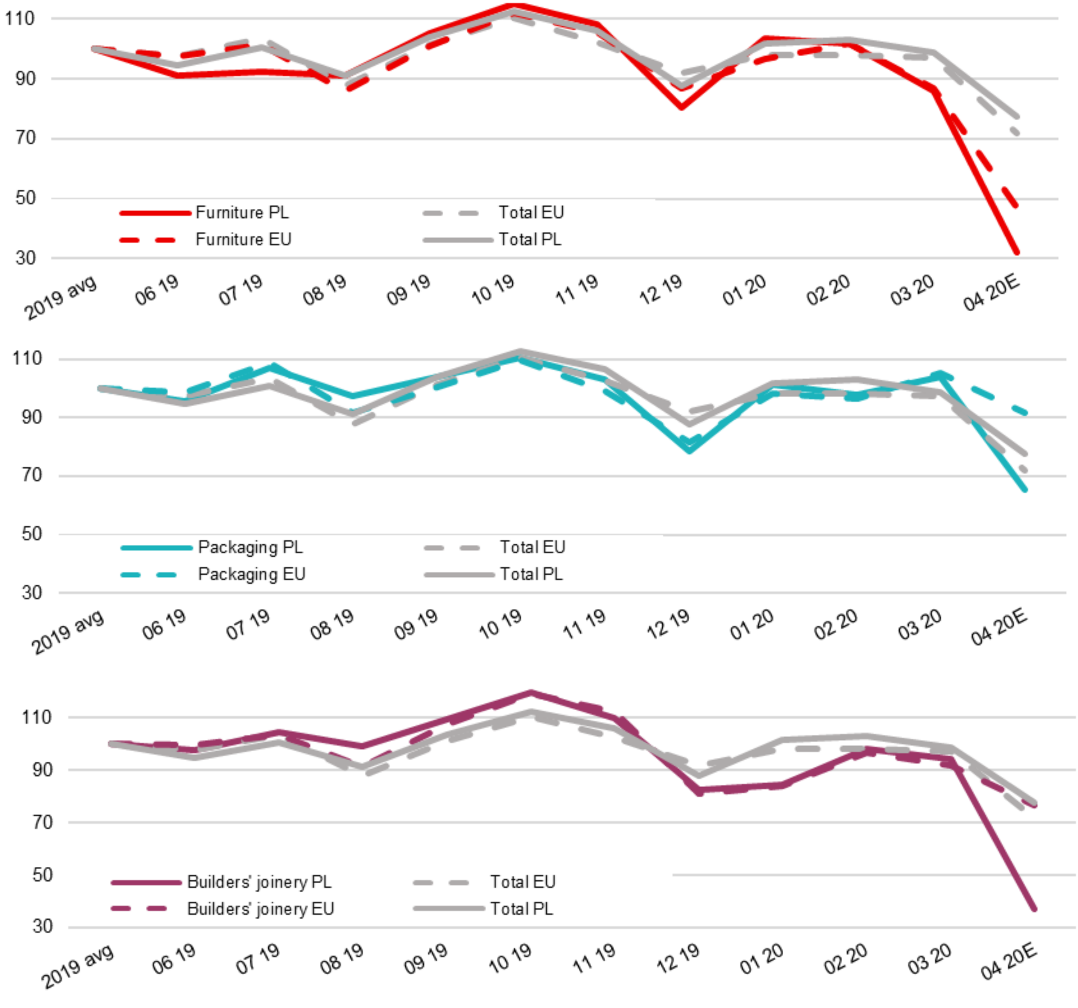
Furniture and Builders' Joinery industries noted deep declines of export value typical for pro-cyclical sectors. Interestingly, in both of these cases declines were deeper than EU average for each sector. Since these industries clearly showcase specialisation of the Polish economy relative to Europe and rest of the world (on the basis of Poland's rank in export value in these industries), hence it seems counterintuitive. As export data for April is available only for extra-EU markets we assumed that deliveries on the intra-EU market followed the same dynamics. Polish exporters rely heavily on the intra-EU market and, predominantly, only lately have begun to strengthen their footprint on the extra-EU markets. For companies from the „old" EU its a whole different story, as they had enough time to expand and consolidate their brands outside the EU, which turned out to be their strategic advantage during the pandemic and freeze in the EU consumption.

In case of furniture manufacturing, among export destinations that cushioned the decline in export value in March the most were Senegal, Egypt, Qatar, and Ivory Coast. At the same time, Polish furniture companies increased their shipments to Russia, Estonia, and lastly Egypt (which accounted for 39% of increase in exports from all of the EU to this destination), which turned out surprisingly immune to declines in April as well.

Among EU builders' joinery manufacturers, increased demand from Asia, mainly China, Singapore, Taiwan & Middle East – Saudi Arabia, saved their sales from plummeting. Meanwhile, Polish companies from this sector increased their presence on markets such as Canada or Australia. In April, China was the third largest destination of Polish builders' joinery by YoY value growth, yet it was the only Asian market on which Polish companies were present. No windows or doors were also shipped to Middle East, which is an investment-intensive region from the perspective of builders' joinery companies.

Packaging producers confirmed their resilience in the times of crisis, as on average, exports of packaging in the EU declined less than total exports, with significant flows to markets where number of COVID confirmed cases were increasing rapidly.

Index of Polish and EU export sales in selected sectors (2019 average = 100)



Source: Eurostat, Santander

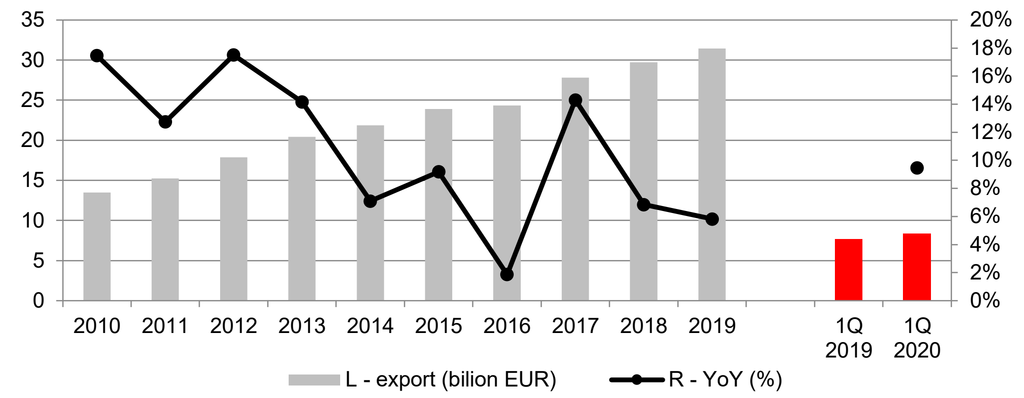
The fight against pandemic has affected food trade

Food exports is quite resistant to cyclical fluctuations in the economy, as the historical figures show. Since Poland's accession to the EU, the value of Polish foreign sales of food products has decreased only once, in 2009, during the financial crisis. That decrease was small and amounted to 2% YoY. Another record was reached in 2019 and the value of exports amounted to EUR 31.4 billion.

The beginning of 2020 was also promising for the Polish agri-food industry. In the first quarter, the value of exports was 9.5% higher on an annual basis. In February and March, in terms of value, the YoY increase amounted to 11-12%. In 1Q the highest positive dynamics was recorded in cereals (+166% YoY), sales of which were supported by high demand on the world market and an increase in transaction prices. Of other main product groups, slight one-percent increases were recorded for meat and dairy products, mainly due to sales in January and February. In the entire first quarter, tobacco exports increased strongly, by 20% YoY. It’s worth noting that in the indicated period, foreign sales of highly processed products accelerated. In March, export dynamics in this group reached 13% and their share in total value of exports was 52%.

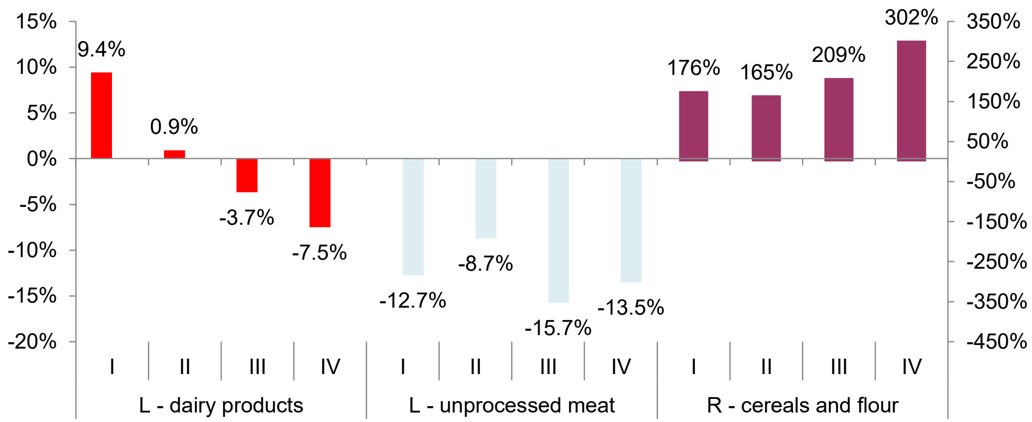
April was the first month in which the societies of EU countries remained in social isolation and in addition in most countries restrictions in the functioning of HoReCa sector were imposed. The HoReCa sector is an important recipient for some sectors of the Polish food industry, among others meat and dairy. As a result, export performance of these products deteriorated. However, assessment of total foreign sales in April will be available only after the publication of full export data.

Value of food export from Poland



Source: Eurostat, Santander calculations

Changes in export volumes in 2020, by main product groups (YoY)



Source: MinRol, MinFin, Santander calculations

Will retail sales of food support export sales?

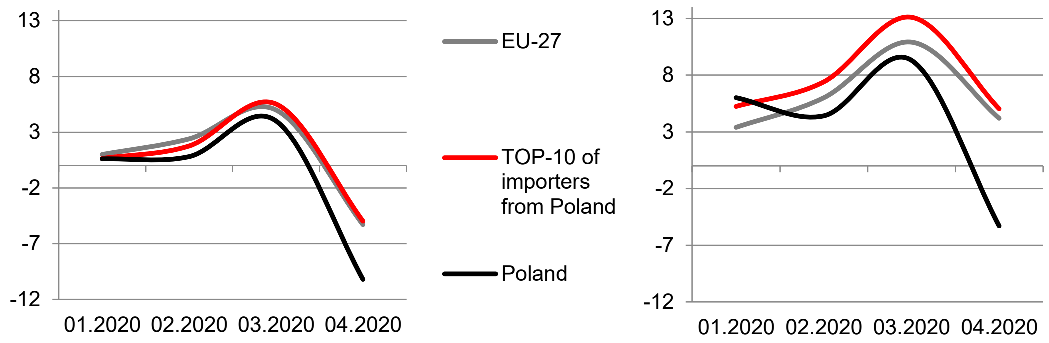
Consumer demand in Europe is still high and this is a positive signal in the context of food exports. Although retail sales of food fluctuated significantly on the turn of the first and second quarter, it remained quite pandemic resilient. The dynamics of retail food sales in March (according to Eurostat methodology) increased in the EU, due to the accumulation of stocks by consumers. It was caused by uncertainty related to the worsening of the epidemic situation. In turn, in April, demand weakened along with calming moods. It was also the month in which residents of the European Union were in social isolation. Importantly, despite the decrease, value of food retail sales in April in the group of EU-27 countries was 4.2% higher (in current prices) than in the corresponding month of 2019. Positive annual dynamics was also recorded in the group of 10 largest recipients of food products from Poland (+ 5%).

If this trend continues in the following months, strong demand for food on our export markets may be an important factor supporting Polish exports. Preliminary data from the British market indicate that this direction was maintained in May (+7.1% YoY).

Since packaged food accounts for over 60% of demand for packaging, significant declines in April had their impact on the packaging market in total. On average, Polish packaging companies balance their sales almost evenly between domestic market and exports, mainly to other EU markets. Declines seen in April took place in Poland as well and were only partially counterbalanced by increased demand for cleaning agents and disinfectants packaging. We estimate that sold production growth of Polish packaging companies was still positive in the first four months of 2020 but declines in April dragged growth rate even below 3% YoY. In March especially, demand for plastic packaging was booming in select categories, but nonetheless April was still difficult for the whole packaging sector, paper and paperboard packaging included, in spite of explosion in e-commerce trade.

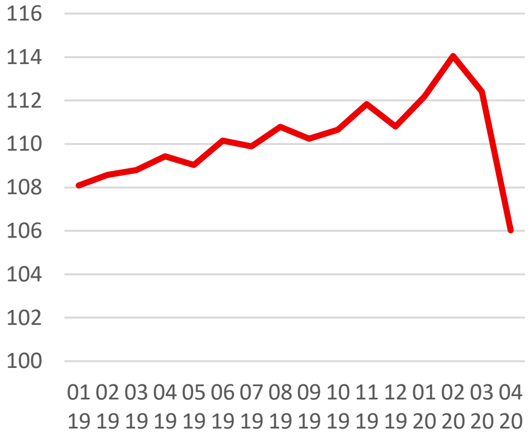
The dynamics of food retail in Europe (current prices)

MoM **YoY**

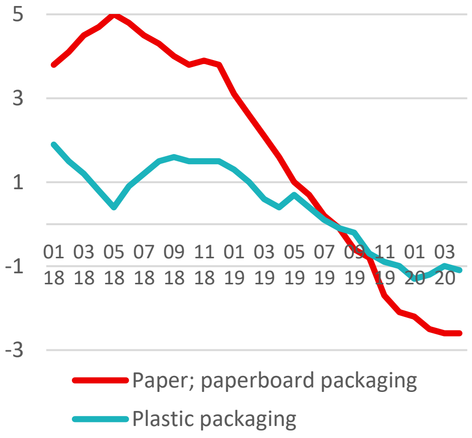


Source: Eurostat, Santander calculations

European retail sales of packaging index (2015 = 100)



YoY change in packaging producers' prices, EU average



Source: Eurostat, Santander

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Fall in demand for cars. Possible Chinese scenario?

Demand for cars in Europe has fallen sharply, and this is the most important factor driving Polish automotive exports. The number of registrations of new passenger cars at the peak of the lockdown in April dropped by 78% y/y. May brought further declines, although less sharp, by 57% y/y. However, situation varies between countries. In Germany, France and Italy decline was around 50% y/y in May, but the UK was still stagnating at -89% y/y.

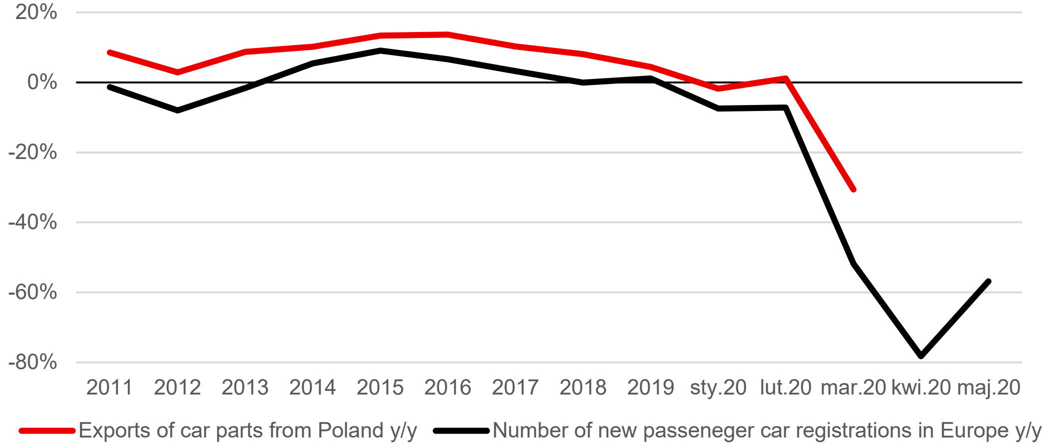
Exports of Polish automotive production may rebound from the bottom at different rates depending on the demand in particular segments. The passenger car factories located in Poland were one of the longest shut down in Europe, and after the restart they work on limited capacity. This was due to the low demand for the models produced there, mainly the ageing Opel Astra and Fiat 500. In turn, the situation of parts manufacturers depends on the rate of restarting production in European car factories, also resulting from the demand for models produced there.

Governments including Germany and France have announced large-scale aid packages for the automotive industry, including subsidies for the purchase of new cars, mainly electric and hybrid. Despite this, forecasts assume a 20-26% decline in the number of passenger car registrations in Europe throughout 2020*.

Demand in Europe's two most important export markets, the US and China, has also collapsed. However, available data on car sales in China shows return of that market to pre-crisis levels. Despite this, Chinese imports from Europe fell sharply in April. Weaker falls from the beginning of the crisis may have been due, among other things, to earlier orders and the recovery is being met by stocks and domestic production. However, willingness of Chinese consumers to quickly recover demand may be a good forecast for the sector globally, including car sales in Europe.

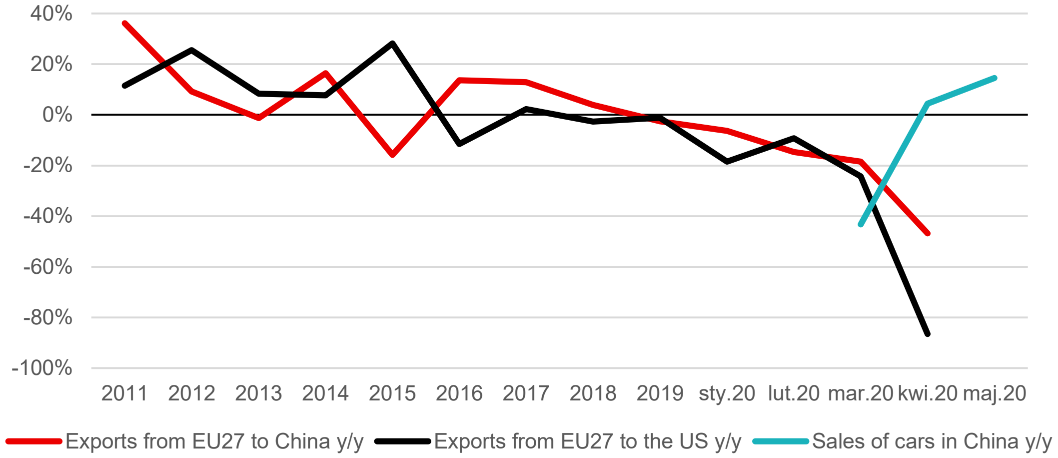
* ACEA, Bloomberg, LMC Automotive

Exports of car parts from Poland and car registrations in Europe



Source: Eurostat, ACEA

Value of exports of the automotive sector from EU27 to the US and China, and sales volumes in China



Source: Eurostat, CAAM

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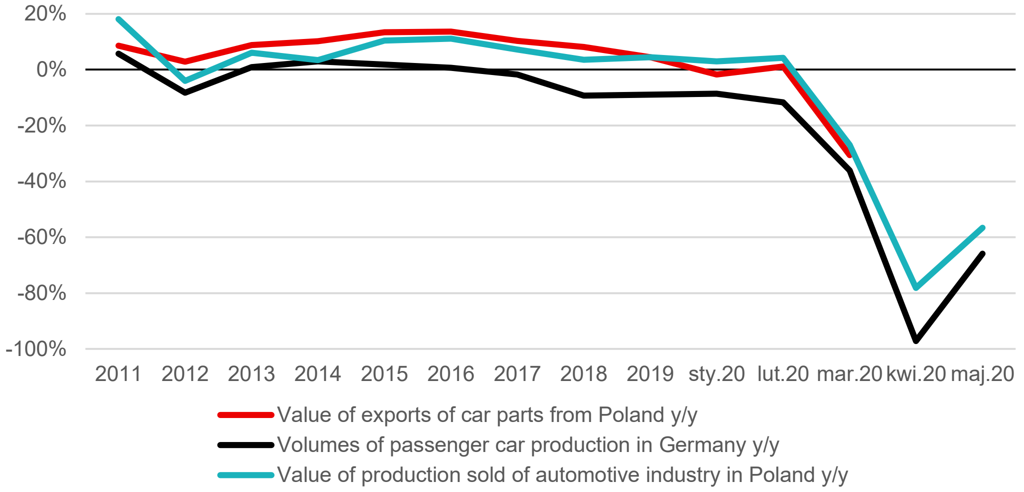
Slow resumption of car production

Poland is a large exporter of car parts, whose direct customers are mainly car factories in Europe. Production of cars in European plants was stopped in March. Restart took place from the end of April to June, often with delays, in most cases with gradual activation of production capacity. The average downtime was 30 working days, with the highest rates in Italy (41 days) and the UK (40 days). Production lost during this time was estimated at 2.4 million cars (with production of 15.8 million in 2019).

The largest importer of Polish components is Germany, where the production of passenger cars almost stopped in April. In May most of the German factories were already working, but most of them were underutilised, so production was still 66% lower y/y. Among the largest importers of Polish components, plants in the Czech Republic were also resuming work (" only" a 52.9% y/y drop in volume in May compared to -90% y/y in April), but production in the UK was still at a very low level (in April -99.7%, in May -95.4% y/y). May's volumes of German passenger car production and sold production of the Polish automotive sector, of which around 4/5 is directed abroad, indicate that the situation of Polish exports has improved, although decreases are still large.

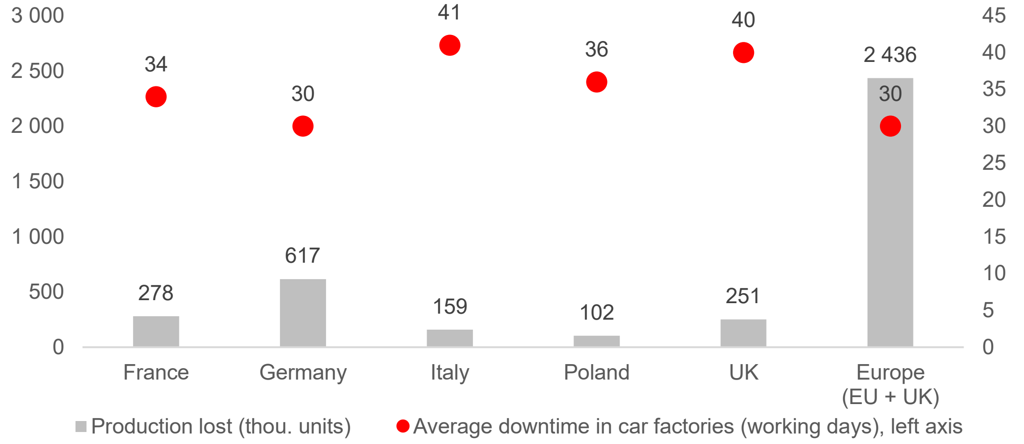
Ifo Institute forecasts that the German automotive sector will recover the longest of all sectors. The most likely term is 12 months. However, it is difficult to predict whether the sector's production will return to pre-crisis levels in this time horizon. Some global companies, fearing long-term effects of the crisis, are launching restructuring programmes. In the case of German manufacturers, these mainly include employment reduction (e.g. BMW, Volkswagen), in others - a broader spectrum of optimisation and repair measures (Nissan, Renault). Exports of batteries to electric cars, of which Poland is a large producer, may benefit from the crisis. Sales of electric cars in Europe are growing dynamically (+101% y/y in Q1 2020), supported by government subsidies.

Exports from Poland and production in Germany and Poland



Source: Eurostat, GUS, VDA

Production lost and downtime of car factories in Europe



Source: ACEA

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