

# Tug of War

## Poland: Economic Outlook

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# Executive Summary (macro)

Financial markets volatility has surged in recent weeks as a result of economic tug-of-war between risks of persistently high inflation calling for more aggressive monetary tightening, and worries of recession. The uncertainty about what the next few months will bring in terms of inflation, economic growth, macroeconomic and geopolitical stability or energy security is very high. And the multitude of disturbances affecting the global economy is so great that the economic cycle has accelerated tremendously – the trends are changing at such a pace that sometimes the direction of travel alters before we are able to see the previous stage in the data.

A while ago, signals of easing tensions in global supply chains, improvement in maritime freight and falling commodity prices were raising hopes that global inflationary pressures may be turning around. Yet recently, the growing risk of energy crunch in Europe suggests that another price jump later this year cannot be ruled out.

Polish economy sees growing evidence of major activity slowdown underway, which is likely to drag GDP growth down to around 1% y/y at the end of 2022 and slightly below zero in early 2023. Yet, we see chances for a gradual revival later next year, after/if the EU recovery money gets unlocked and situation in Ukraine stabilises. The magnitude and length of the recession may be bigger if energy problems in Europe prove more severe than we think.

In our view as long as most companies believe the economic downturn is likely to be short-lived, it should not trigger a major jump in unemployment, as firms will prefer to reduce working hours, trim bonuses or refuse wage hikes than to cut employment, to avoid problems with acquiring skilled workers back once demand starts reviving. Such 'unemployment-less recession' does imply, however, that the wage-price spiral should not unwind.

Inflation is close to its local peak, according to our baseline scenario, and after levelling off in the summer months, it may descend slightly later this year. Yet, energy and food prices still generate upside risk for this forecast as both may surprise and grow much further in the autumn. The underlying inflationary trend is still strong and will push core inflation above 10% y/y this year, but we argue that the price pressure should be fading over time, amid weakening demand and easing wage claims.

Before the pandemic there were arguments that monetary policy is ineffective in stimulating economy and reviving inflation from very low levels as it is like „pushing on a piece of string”. Meanwhile it should be very efficient in curbing inflation when it is already high - pulling strings is what central banks can do efficiently. Yet, when the post-pandemic inflation surge became a global problem many central banks were hesitating long before taking action. NBP has been pulling its string consistently for the last ten months, yet recently started signalling it may be willing to stop if inflation stabilises. We see the main reference rate halting near 7.0% after the summer holidays, as the looming demand destruction and easing labour market tension should help to tame inflationary pressure. Yet, uncertainty about inflation and currency outlook implies that the risk of more tightening cannot be ignored.

The very high nominal GDP growth boosts tax revenues, which clearly helps the public finances. We see growing chances that the state budget will end this year with deficit close to the planned level (-PLN30bn). Yet, it does not tell us much about the true fiscal situation as the large part of expenditures (also those triggered by war in Ukraine) was pushed outside the central budget and remains not transparent. We estimate that GG balance may be close to -3.5% of GDP in 2022. Next year is still a big unknown, yet it is hard to expect a major fiscal consolidation in the election year (our estimate: -4.0% of GDP). Disbursement of EU recovery funds remains a distant future, it seems, as the government makes little progress in fulfilling the required milestones.



# Executive Summary (markets)

## FX

From April to early June, the zloty strengthened against the euro. This was helped by improving global risk appetite and the country's ongoing cycle of rapid rate hikes. The situation reversed in early June, with the NBP's announcement of the policy of "ending rate hikes", which came even before there were convincing signs that inflationary pressures in Poland were dying down. As this coincided with the acceleration of the rate increase cycle by the Fed and other major central banks, the zloty came under pressure. Despite the marked weakening of the zloty, the MPC's July meeting also confirmed that the NBP is aiming to complete the cycle of hikes. We believe that the slowing of the global and domestic economies and the subsequent deterioration in the global sentiment, in combination with a growing current account deficit and falling expectations for interest rate increases at home, will continue to put pressure on the zloty. We expect high volatility in the EUR/PLN exchange rate in 3Q, but assume that the exchange rate will center around 4.80.

## FI

Steadily rising inflation and rapid rate hikes supported vigorous increases in the domestic yield curve. The situation reversed in mid-June, with the global rise in recessionary fears and the decline in energy commodity prices. Thanks to this, inflation expectations in the domestic market also began to fall gradually, affecting the strengthening of domestic debt. This, along with the NBP's policy of "ending rate hikes", translated into a reduction in market expectations for terminal level of interest rates in Poland and a further decline in the domestic curve. We expect a further fall of domestic yields in 3Q, basing on the continued impact of the same factors that led to the curve's decrease in June albeit on a smaller scale than that seen in the last few weeks.



# 2022 Forecasts – what has changed

Indicator	Our view in April 2022	Our view in July 2022
GDP	War in Ukraine generated a sudden stop shock for the economy, albeit of moderate magnitude - after very strong start of the year, the real activity may stall in the next two quarters. GDP growth may slow to c.3.5% in 2022, as all main demand components will suffer and supply disruptions will likely weigh on output.	Starting point in 2022 was even better than expected in April (8.5% y/y GDP growth in 1Q), which lifted average 2022 GDP growth forecast to 4.7%, but the story is unchanged: major slowdown is on its way in all demand components. We anticipate a technical recession in 2H22, and a gradual economic revival in 2H23.
GDP breakdown	Consumption still solid, but the shock to real disposable income will likely outweigh the boost in demand for basic goods due to refugee inflow. Investment rebound slowed by lower confidence, delay in recovery plan and rising rates. Current account gap widening amid terms of trade deterioration, but net export's contribution to GDP growth may actually improve amid domestic demand cooldown.	We see less reasons to be optimistic about consumer demand outlook, as wage growth started lagging behind inflation, while consumer confidence collapsed raising doubts about a possible drop in saving rate. Investment still expected to slow. Massive inventory build-up witnessed in recent quarters may reverse as recession worries grow. Net exports' contribution to GDP still expected to improve, despite widening current account gap in nominal prices.
Labour market	Inflow of refugees may ease labour market pressures in the long run, but the short-term effect neutral at best, the impact will differ across sectors.	Record low jobless rate, but wage pressure seems to be easing as firms worry about looming recession, plus Ukrainian women join labour force (mainly in services).
Inflation	Energy and food price shock will drive inflation higher – despite the likely extension of temporary tax cuts CPI may stay in double digits until late summer. Core inflation, after jumping above 7% in mid year, should start easing in 2H amid lower demand.	CPI may peak at almost 16% y/y in summer months but the risk still asymmetric to the upside – energy and food prices may trigger another inflation jump in the autumn. Core inflation likely to exceed 10% y/y in 2022; its deceleration possible next year if labour market tensions start easing.
Monetary policy	Interest rate peak will be higher due to inflation surprise, pressure on the currency and looming fiscal easing. We think the NBP will stop rate hikes at 6% in mid-year.	Baseline scenario assumes peak reference rate at 7.0%, but if inflation jumps again in the autumn and/or PLN sells off rapidly, MPC may have no choice but to do more.
Fiscal policy	Higher costs of anti-inflation measures, refugee inflow, new tax reductions, defence spending will boost fiscal deficit in 2022 to c.4.5% of GDP, at least. We still hope for unfreezing the EU funds, but the government does not seem to hurry, so the inflow of money before the year-end may be negligible.	Fiscal deficit in 2022 may be close to 3.5% of GDP, as higher than expected inflation is boosting revenues more than anticipated. Hard to expect major fiscal consolidation in 2023, as it is the election year. Disbursement of EU recovery funds still distant as the government makes little progress in fulfilling the milestones.
Fixed income market	We see positive circumstances for a return of foreign demand, but the expected increased supply could prevent a quick fall of bond yields even at the time when the war in Ukraine would be over. Yield curve compression should be seen until the middle of 2023, bullish steepening should follow as the MPC moves to rate cuts.	Falling inflation expectations and rising global recessionary fears should support the strengthening of domestic debt. A factor further supporting declines in domestic yields will be the NBP's policy of "ending the cycle of rate hikes" further lowering expectations of a terminal interest rate level in Poland.
FX market	The war in Ukraine redrew the FX landscape in the region, sending PLN to the weakest levels ever. Its recovery is already advanced but may face burdens in the form of weaker than usual relative economic performance of Poland.	The ongoing cycle of rapid rate hikes has been an important factor supporting the zloty's quotations. "The policy of ending the hike cycle" announced by the NBP on June 7, which coincided with the global rise in recessionary fears, clearly weakened the zloty. The same factors should exert pressure on PLN throughout 3Q.

# Economy

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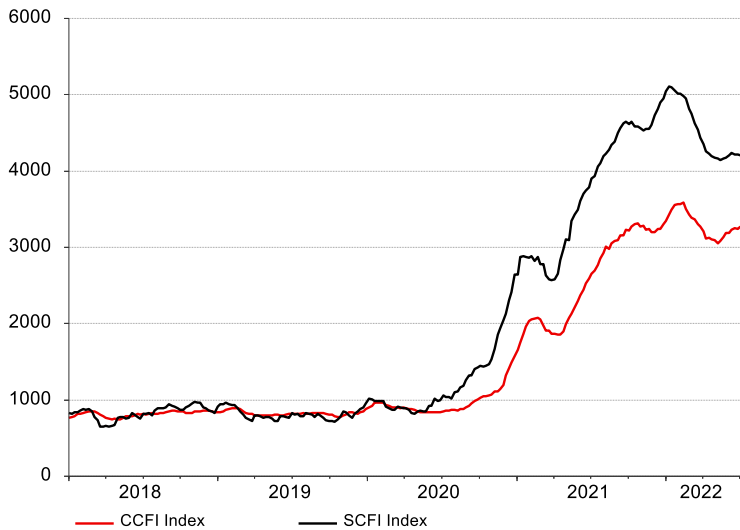


# Global supply chains: how persistent improvement?

The first half of 2022 saw growing evidence that the tensions in global supply chains started easing. There was a clear improvement of delivery times in maritime transport and reduction of international freight costs. The global PMI survey confirmed that supplier delivery times came off the peak, which correlated well with a turnaround in manufacturing input prices. All those factors combined were raising hopes that the worst in global supply chains is over and the situation may continue improving later this year.

Yet the last few days saw a resurgence of fears that another wave of lockdowns may hit China due to the arrival of the new BA.5 variant of coronavirus. As a result, cities across country started re-imposing restrictions and Shanghai fears a second lockdown, which may potentially paralyse the sea ports again.

### China Containerized Freight Composite Index (CCFI) & Shanghai Containerized Freight Composite Index (SCFI)



Source: Refinitiv Datastream, Santander



### Ocean Timeliness Indicator

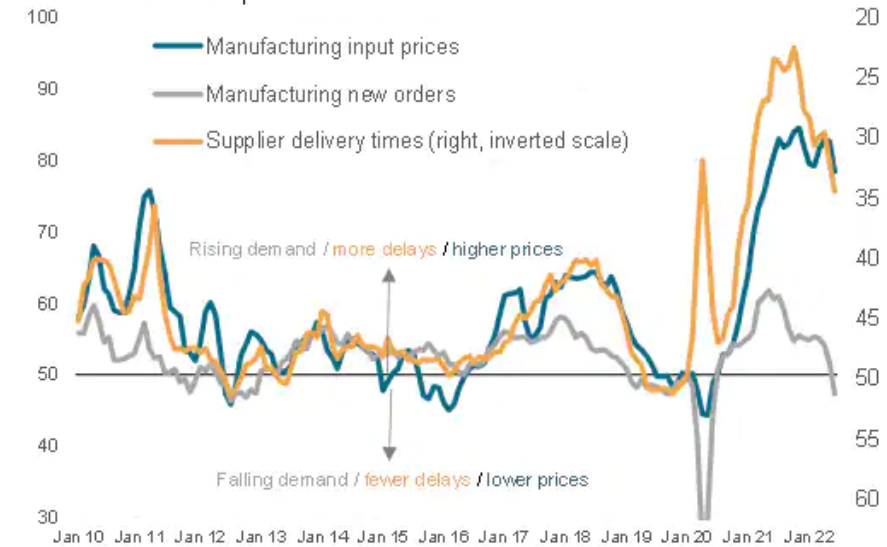
Cargo Ready Date to Destination Port Departure, to 7/3/22



Sources: Flexport Research

### Manufacturing demand, supply and prices

S&P Global G4 developed economies' PMI\*



\* GDP weighted average of the US, UK, Eurozone and Japan. Source: S&P Global



# Global economic slowdown on its way

One of the reasons why problems with global supply chains started easing and delivery times improved was the worsening of global demand and new orders. We see growing evidence that the world economy, and developed world in particular, is heading towards a major slowdown.

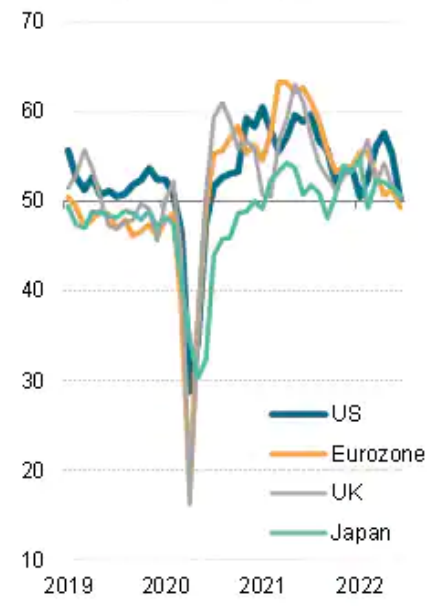
The growing risk of energy shortages in Europe (as gas supplies from Russia seem less and less secure) adds another layer of uncertainty and implies that the outlook for this region looks particularly grim.

## PMI indices for major developed economies

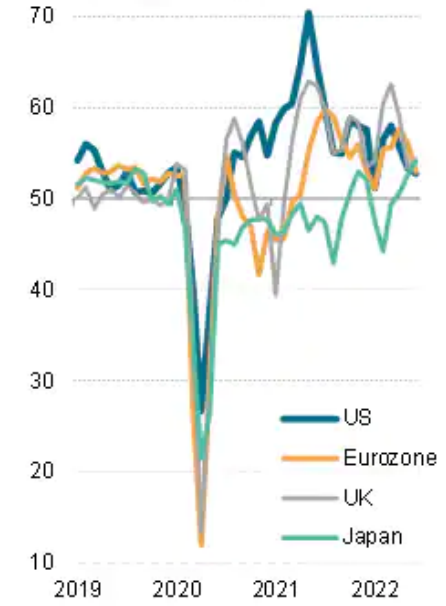
Flash Composite PMI of 'G4' developed economies



PMI Manufacturing Output Index



PMI Services Output Index







# Poland: financial markets anticipating recession

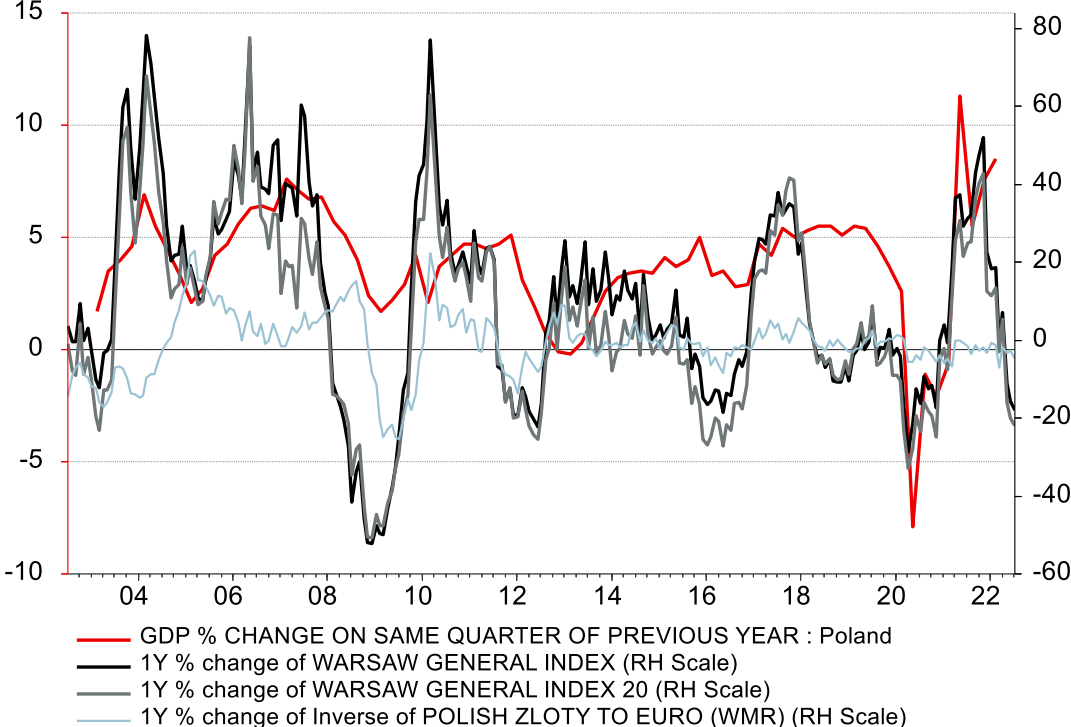
Macroeconomic data come with a delay. We have just started receiving evidence from the economy about a slowdown. The markets however tend to respond to the changing macroeconomic situation even before the confirmation in official data. In fact, the slowdown is being priced in for some time now. Negative slope of the yield curve is one of the usual signs that market participants are betting on lower GDP growth. The equity market is another place where such signals can be found. It should be remembered, however, that markets can be wrong and the history shows that such recessionary signals were not confirmed by the real activity data every single time.

### Poland: GDP growth vs yield curve slope



Source: Refinitiv Datastream, Santander Bank Polska

### Poland: GDP growth vs stock market indices



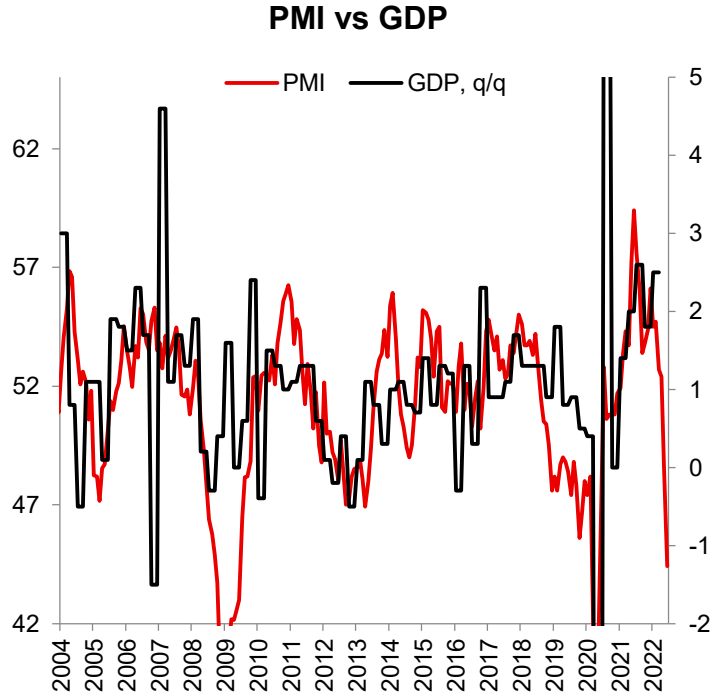
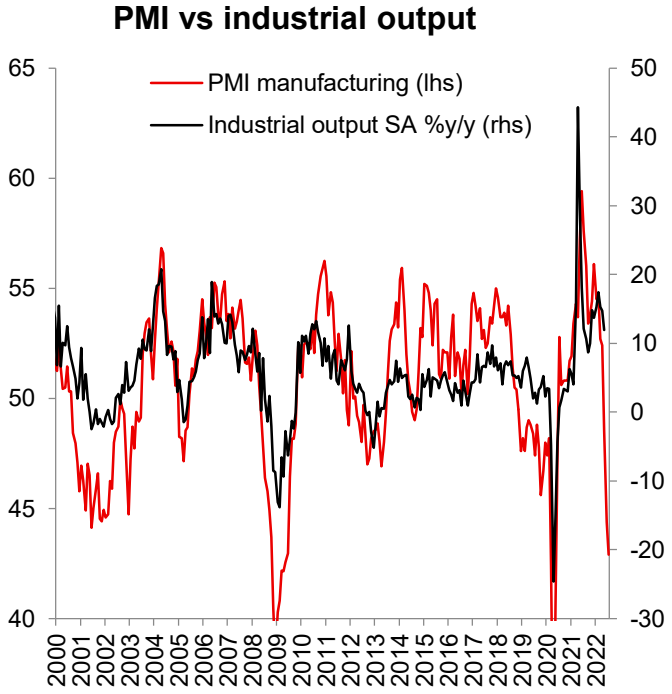
Source: Refinitiv Datastream, Santander



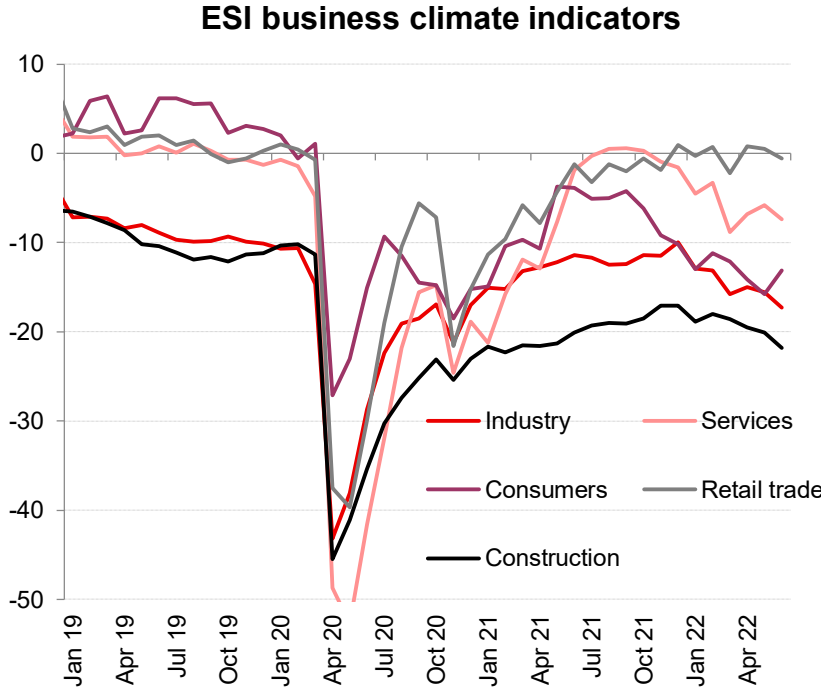
# Leading indicators spell trouble

Leading indicators have also started issuing warning signs. Manufacturing PMI has already registered two large 4pp declines in a row, quickly getting to the lowest level in two years and deep within the business contraction territory. New orders and output were the main culprits behind the decline, in June registering almost the largest drop in the survey's history, following only 2020 Covid-related declines. This PMI indicator is suggesting a very strong downturn in the economic activity and we are indeed expecting the economic growth to slow down substantially in 2H22 when it comes to the y/y growth (see page 11).

The negative sentiment is not limited to manufacturing. It is broad-based, judging by the ESI sectoral indicators. Retail trade seems to be the outlier here, but in our view in this case the indicator is boosted up by the uncomfortably low levels of merchandise stock (see page 16).



Source: S&P Global, GUS, Santander



Source: EC, Santander



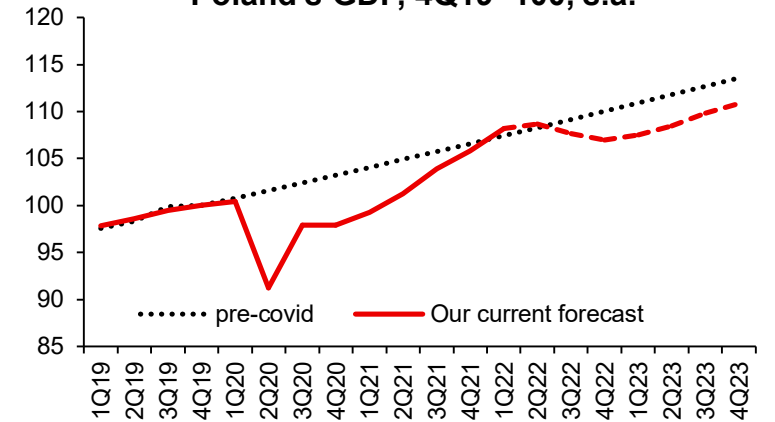
# Entering a technical recession

We keep our forecast of **4.7% GDP growth this year**. While the year started on a high note, bringing the GDP back to the pre-covid trend, the combined effect of war in Ukraine, higher prices and stronger rate hikes will undermine the economic growth, triggering a technical recession in 2H22. The following year is likely to see an economic rebound, but the base effect will keep the annual growth rate at a low level (**1.4%**). We are actually expecting the economic momentum in 2023 to be slightly stronger than in 2022.

Energy crisis, especially disruptions in natural gas supply, are the main risk factor, in our view.

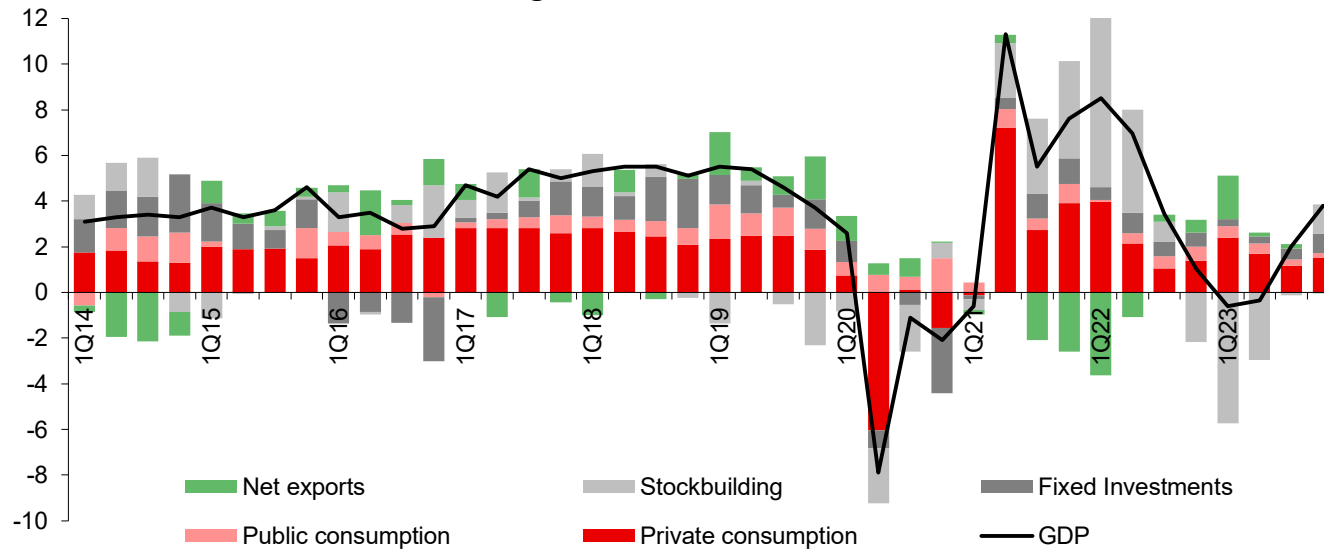
On the following pages we present main assumptions behind our forecast.

### Poland's GDP, 4Q19=100, s.a.



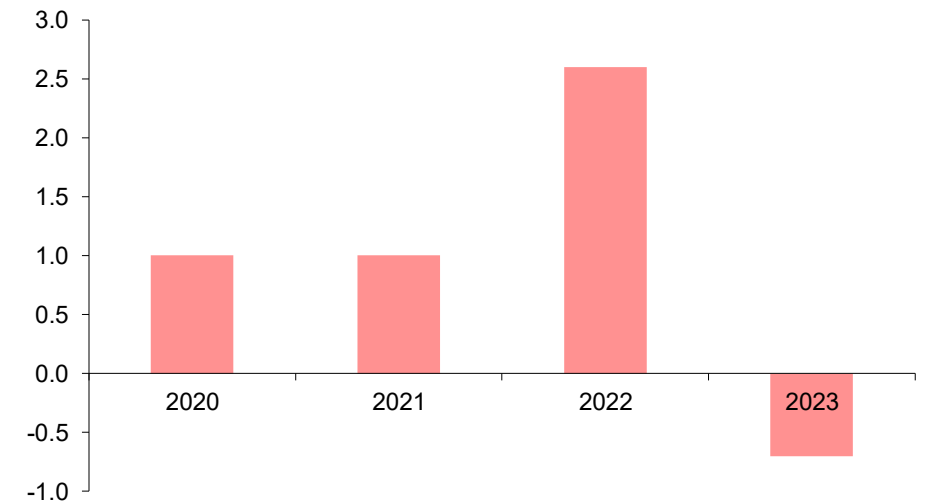
Source: GUS, Santander

### Poland's GDP growth and its breakdown, %



Source: GUS, Santander

### GDP carry-over effect: annual GDP growth rate if all quarters are set to 0% q/q



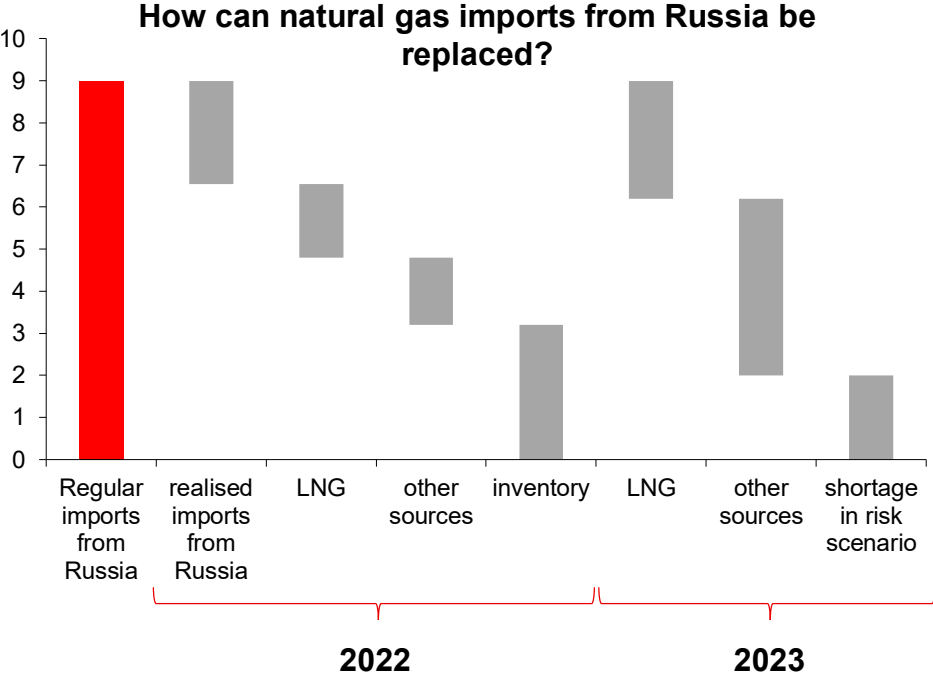
Source: Santander



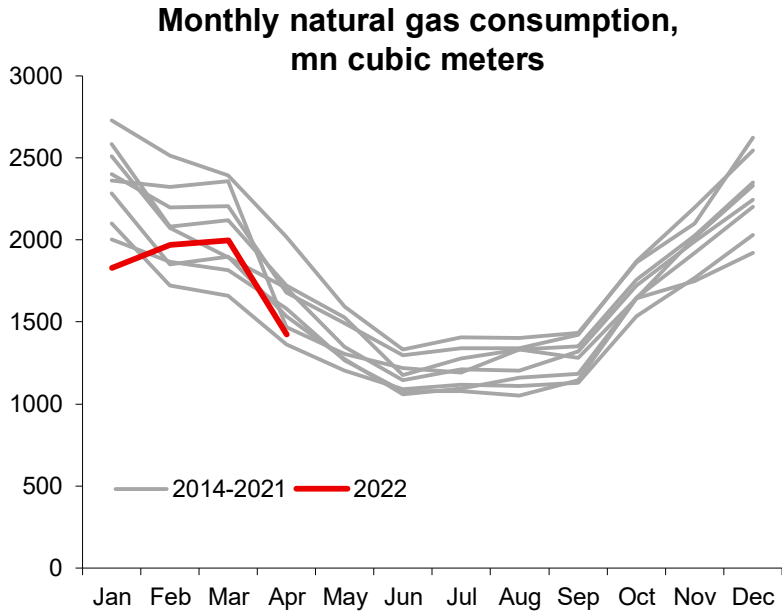
# Risk scenario: natural gas crisis

Total stop of flow of natural gas from Russia to Poland and limited flow from Russia to other European countries mean **higher risk of shortages**. While 2022 seems to be rather safe, mostly thanks to high storages, 2023 could prove challenging and we think that shortages are possible. While shortage could possibly reach as much as 4 bn cubic metres (above 20% of domestic demand), we assume 2 bn cubic metres shortage in our risk-case scenario (above 10%). Natural gas is a major energy source in Poland (about 16-17% of total energy consumption), so supply disruption may be detrimental to the economy. Such a major shortage would have to result in natural gas rationing, subject to political decisions.

We assume that households, energy generation and food-related industries (agriculture, food production, production of fertilizers) would be exempt from any gas cuts. We also assume that households will be encouraged to cut their use of gas by about 5%. This means that other sectors would be forced to cut their use of natural gas by about 20%. This could be especially negative for industries using gas for securing high temperatures, like glass and metal plants. **We estimate impact on annual GDP growth at c1-2%. Dec-Feb period is the most vulnerable, as 1/3 of annual consumption takes place in these months.**



	Share in domestic demand
Energy generation	31.6%
Industry	35.8%
Chemicals	14.9%
Non-metallic mineral products	6.4%
Food, beverages, tobacco	5.0%
Manufacture of metals	4.0%
Commercial and public sectors	6.9%
Households	23.3%



Source: Eurostat, Santander



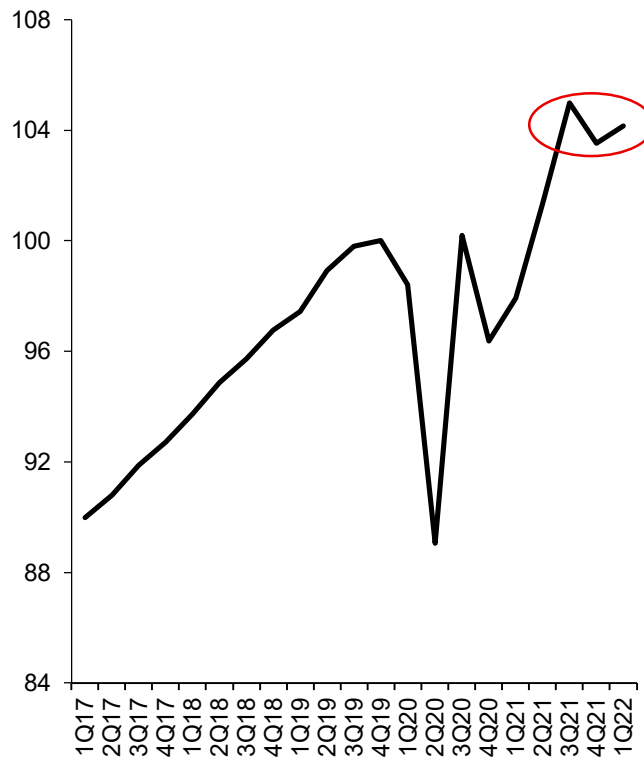
Source: Santander



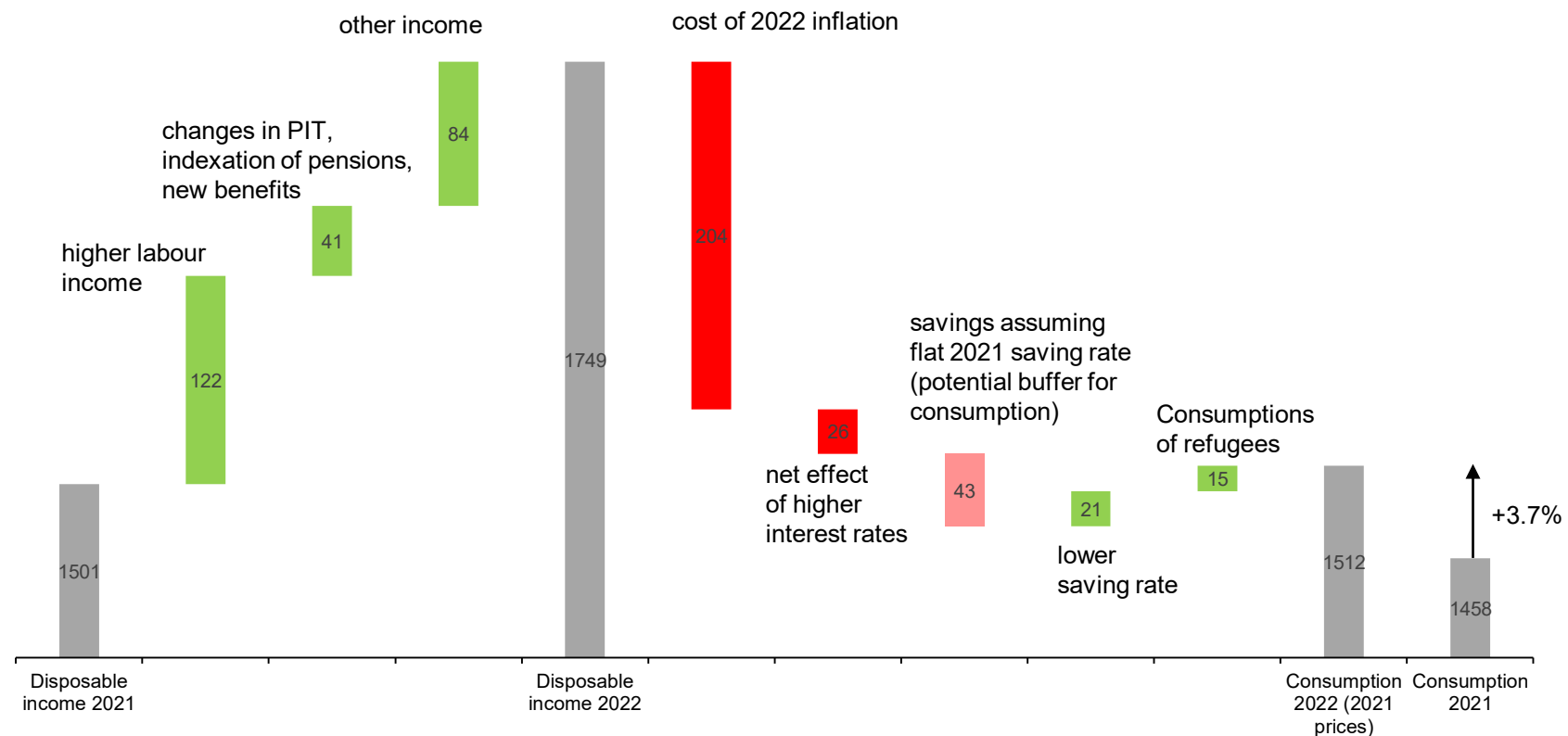
# Consumers under pressure

Despite solid GDP growth in 1Q22, private consumption growth was a disappointment for the second straight quarter, remaining still below the level seen in 3Q21 (seasonally adjusted). We still remain moderately positive about consumption outlook in 2022. Yet, we are expecting a major slowdown, to 3.7% from 6.1% in 2021, as inflation will consume a large part of disposable incomes. We think however that the strong rise in households' disposable incomes, additional consumption of refugees and reduction in saving rate (and/or loan vacations) will help secure a **positive growth rate of total consumption**. That having said, consumption patterns are likely to change, with durable goods and some non-essential spending likely to suffer more than other sectors (see next pages).

### Individual consumption, 4Q19=100, s.a.



### Changes in consumption and incomes, breakdown, PLNbn



Source: GUS, Santander

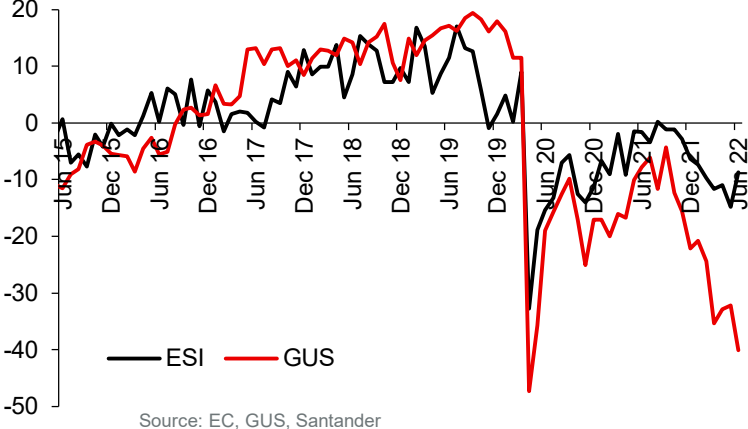


# Durable goods taking a hit

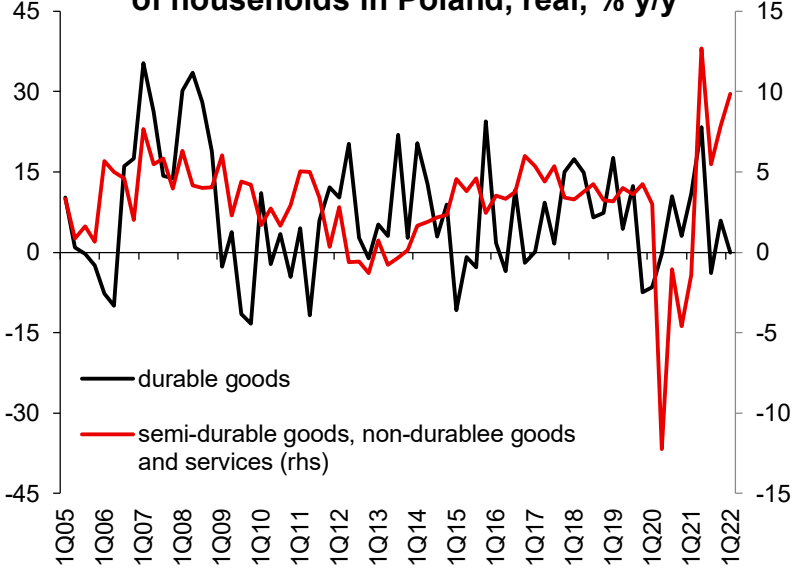
It looks like consumers are putting **larger expenditures on hold**. The two available survey-based measures that proxy appetite for major purchases have diverged recently, but both are historically low. In recent quarters the growth in durable goods consumption was quite low compared to the rest of private consumption (services and non-durables). Similar pattern was also seen in retail sales data.

Industrial companies from the consumer durables group are faced with deteriorating flow of new orders, confirming the reduced demand for these goods, which are usually the first purchases to be dropped when households feel less comfortable with their budgets.

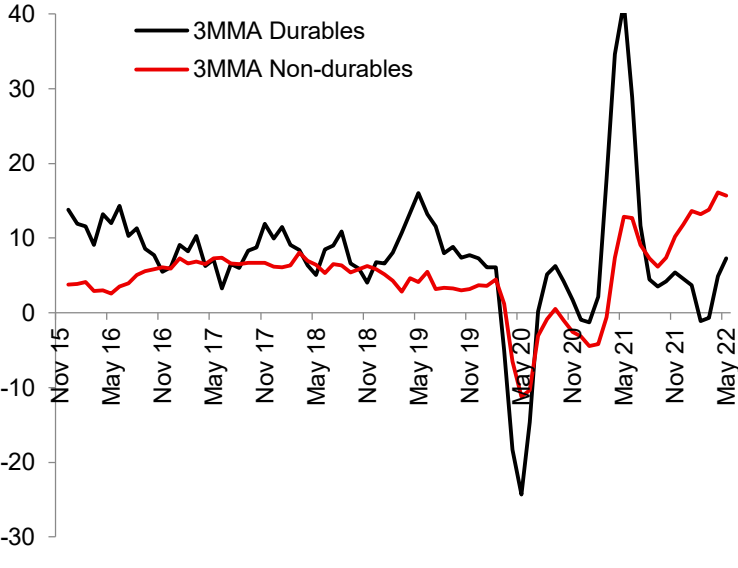
### Consumer sentiment, major purchases at present



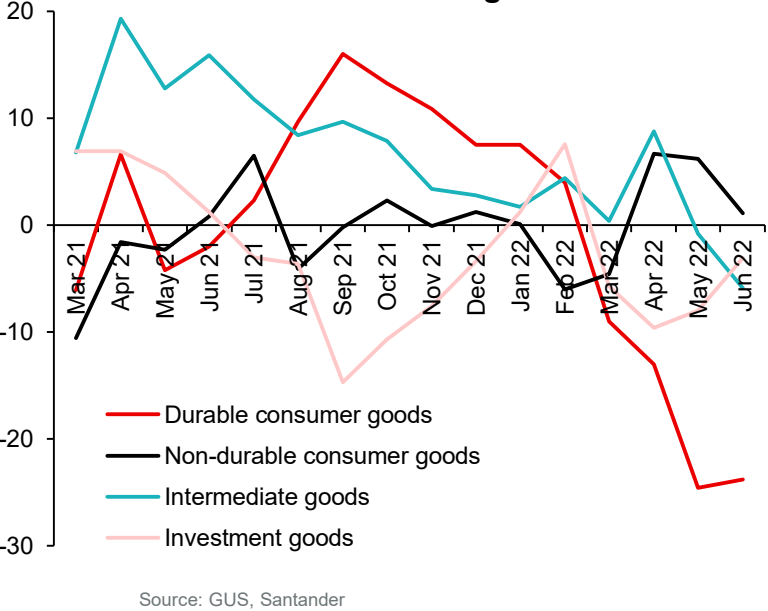
### Final consumption expenditure of households in Poland, real, % y/y



### Retail sales, real, % y/y



### Business sentiment indicators, Industry, current domestic and foreign order books



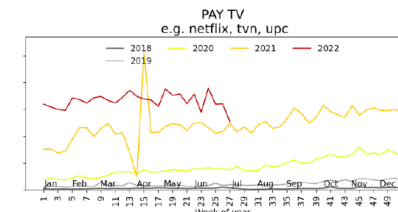
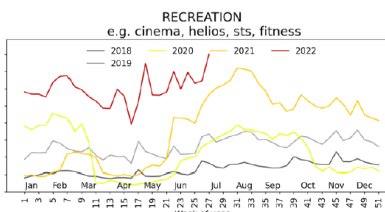
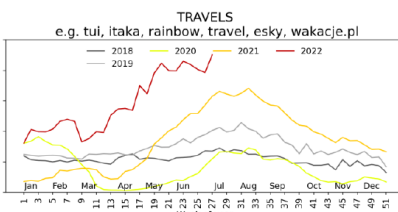
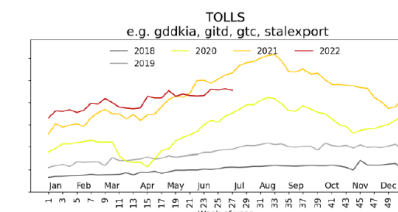
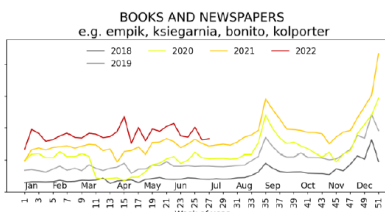
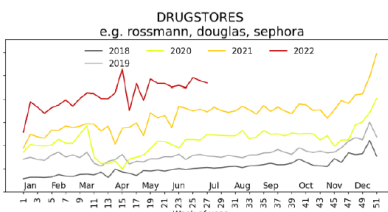
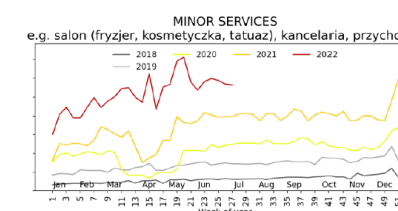
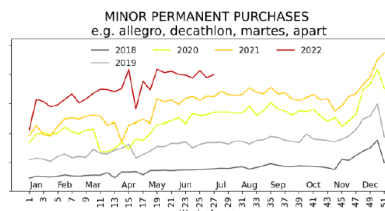
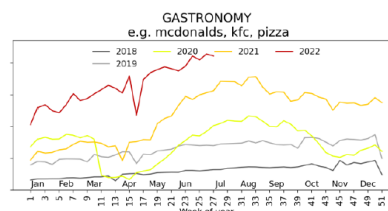
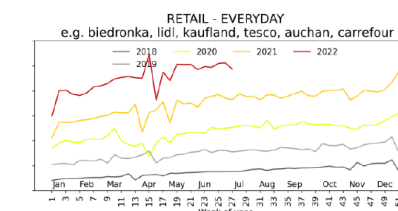
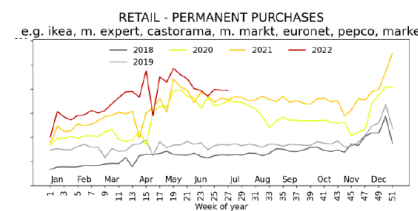
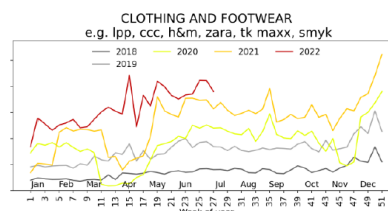
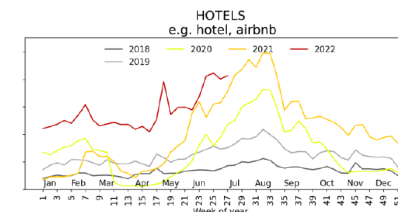
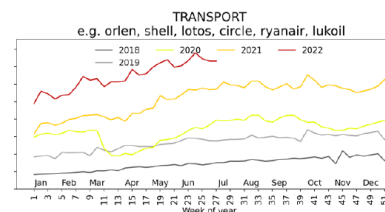
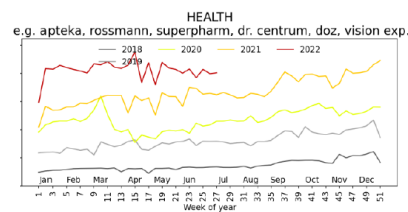


# Card payments show mixed evidence

Card payments of Santander Bank Polska customers: selected categories based on MMC, number of transactions

Santander's card data suggest that:

- The evidence is mixed. Some categories show signs of weakness, while others remain resilient
- Travel, transport, gastronomy, leisure still seem to be booming amid unfulfilled pent-up demand
- Road tolls clearly stagnating, showing that very expensive fuel is preventing summer surge in road transport
- Other non-essential spending seems to be gradually weakening



Source: Santander



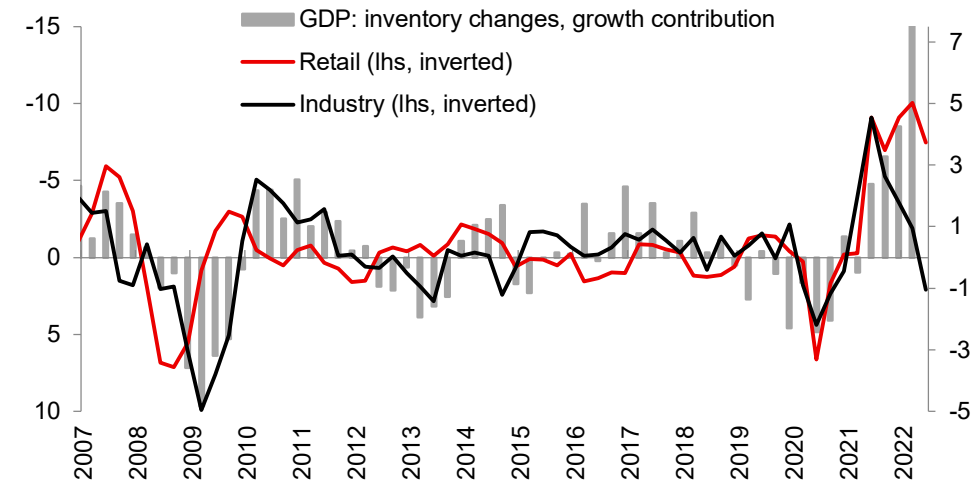
# Can rapid stockbuilding continue?

The last couple of quarters saw an unprecedented surge in inventories (in 1Q22 stockbuilding was responsible for 7.7pp out of 8.5% y/y GDP growth), which raises the question if such trend can be sustained, especially if the demand starts slowing. Our answer is: probably not, but the correction does not have to be abrupt.

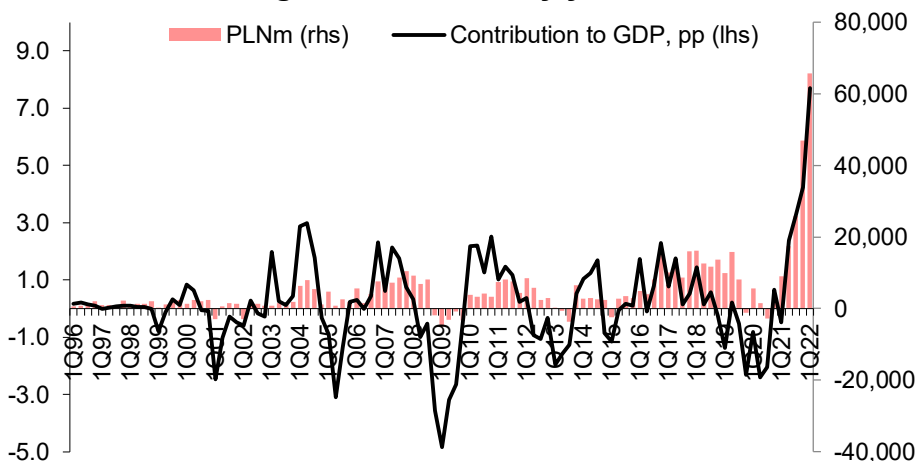
The data show that the main sector responsible for massive stockbuilding since 2020 was manufacturing, in a natural reaction to global supply chains disruptions. The inventory-to-sales ratio for this sector has already surged above the pre-covid trend, and according to business surveys firms in manufacturing no longer feel the pressure to restock and resupply. Even though the transition from just-in-time to just-in-case model may not have finished yet, industrial sector is likely to slow the inventory buildup given the quickly growing recession fears in Europe.

In contrast, inventories in retail trade, the second most important in terms of stockbuilding, have lagged behind the consumer demand in recent quarters and still may have some room to go (inventory-to-sales still way below pre-covid trend), as most companies in this sector still report insufficient stocks. Yet, worsening outlook for consumption should tame the pace of restocking.

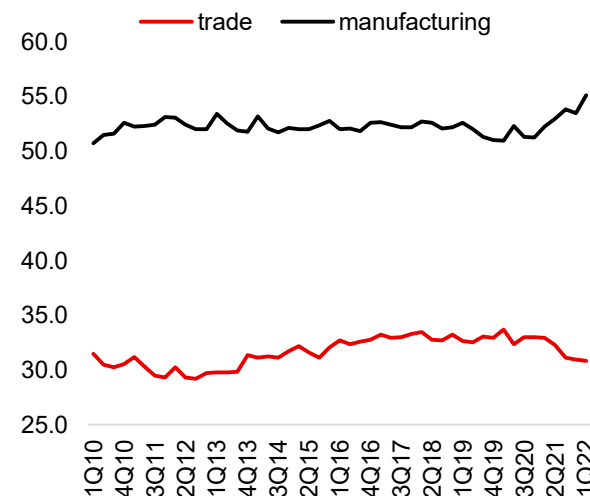
## Assessment of current stocks in industry and retail trade (ESI) vs inventories' contribution to GDP growth



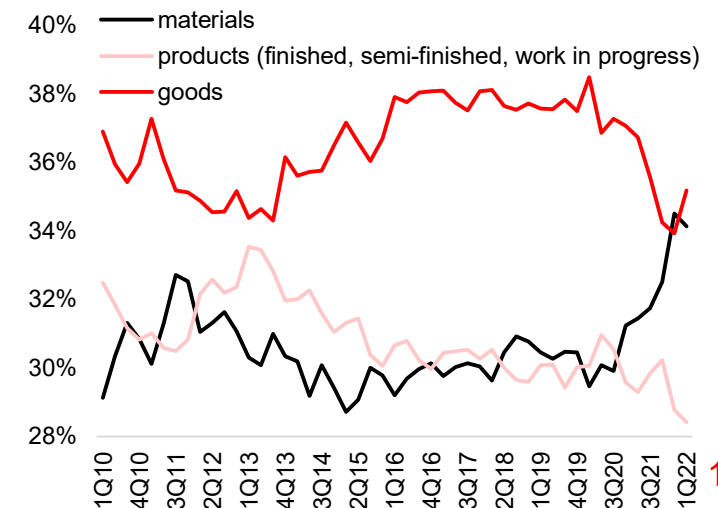
### Change of inventories y/y



### Share of two most important sectors in total inventories, %



### Structure of inventories





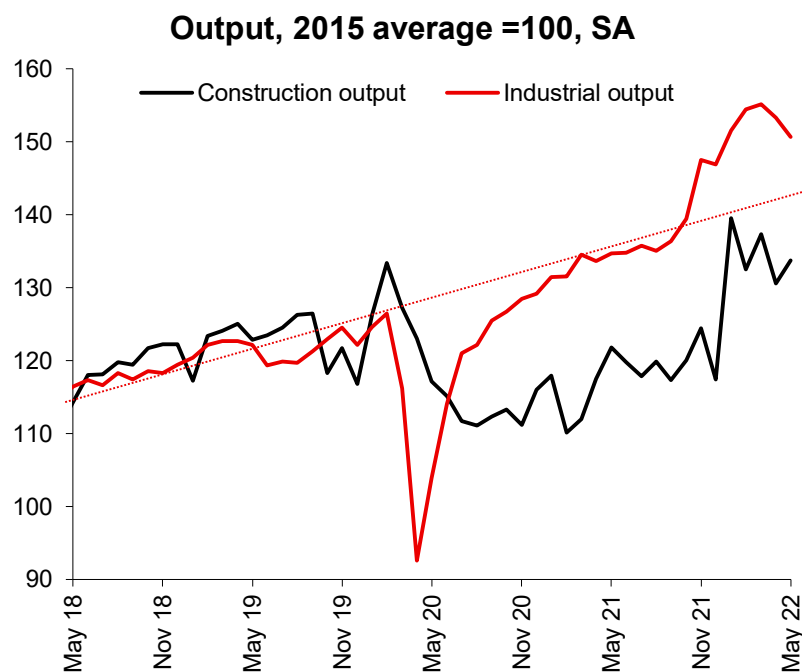


# Industry: end of post-pandemic rally

Polish industry has been one of the fastest recovering in the post-pandemic world, and the annual growth rates of output still look decent. However, the closer look at the sector shows that the trend is already turning around. It is clearly visible in the seasonally adjusted production levels in both manufacturing and construction, where the peak has been established at the start of 2022 and recent months saw a reversal. Two last prints of s.a. m/m industrial output growth showed declines exceeding 1%, with the May one being the weakest since the start of the pandemic.

New orders data deflated with PPI look as weak as the respective business climate indicators for the sector, heralding a major slowdown.

The seasonally adjusted output momentum is worsening most in commodity-based and chip-dependent industries plus consumer discretionary sector, while industries providing basic goods and services for households are relatively stronger, possibly due to the population boost after the inflow of Ukrainians.



Source: GUS, Santander



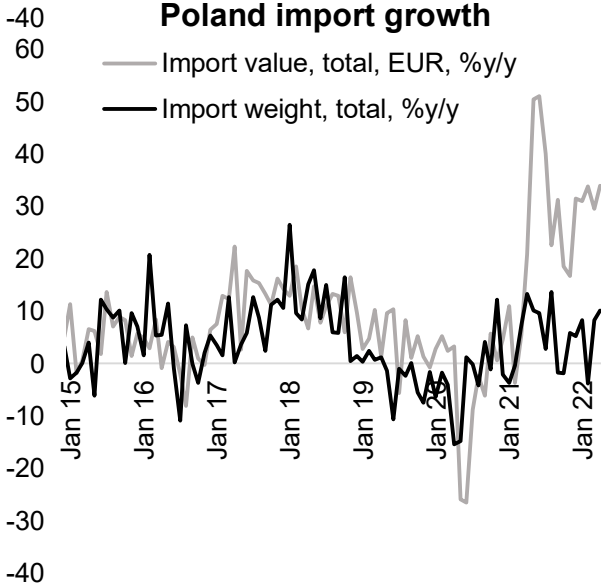
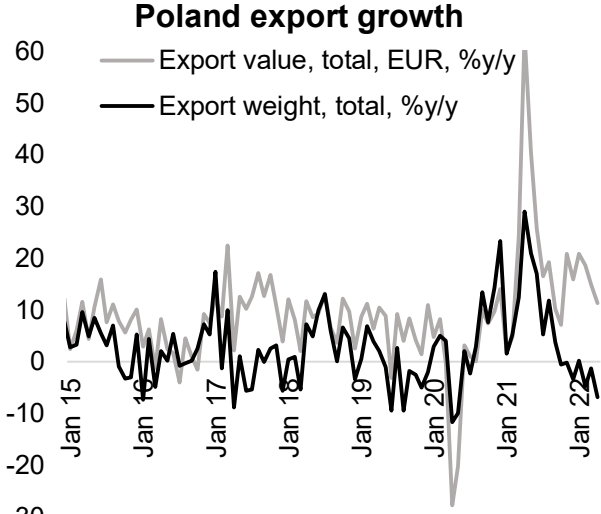
Source: GUS, Santander



# Foreign trade: double whammy

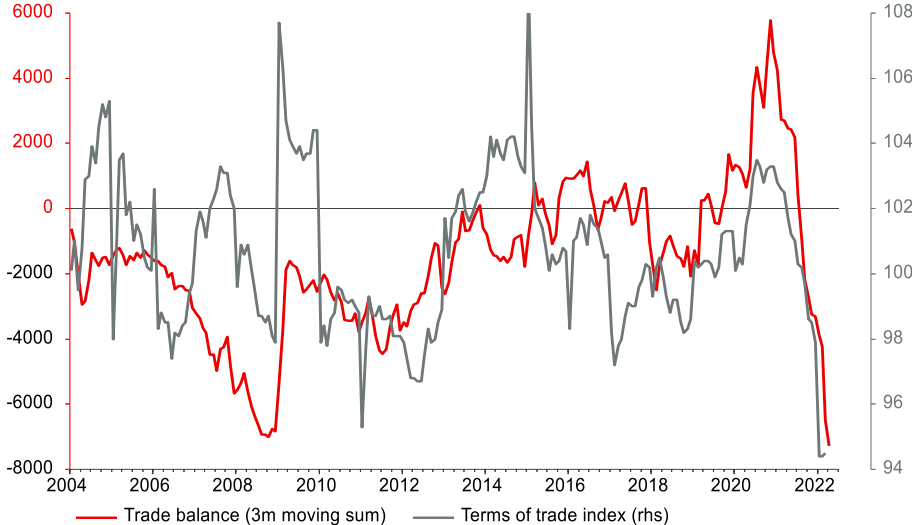
Poland's external balance keeps worsening, as two negative trends occur at the same time. On one hand, surge in energy commodity prices resulted in rapid terms of trade deterioration. At the same time, the slowdown in global manufacturing worsened Polish export's performance. While the scale of deceleration may be still hard to recognise in the nominal data, due to quickly accelerating prices, it can be proxied by the Eurostat numbers about the weight of transported cargos in foreign trade. The most recent PMI surveys signal further worsening of new export orders, which does not bode well for the exporting industries.

We expect current account deficit to keep widening, to around 5% of GDP at the end of this year, but the trend should start reversing in 2023, amid significant deceleration in domestic demand, a gradual decline of energy commodity prices and (hopefully) a rebound in global manufacturing activity, boosting demand for Polish products.



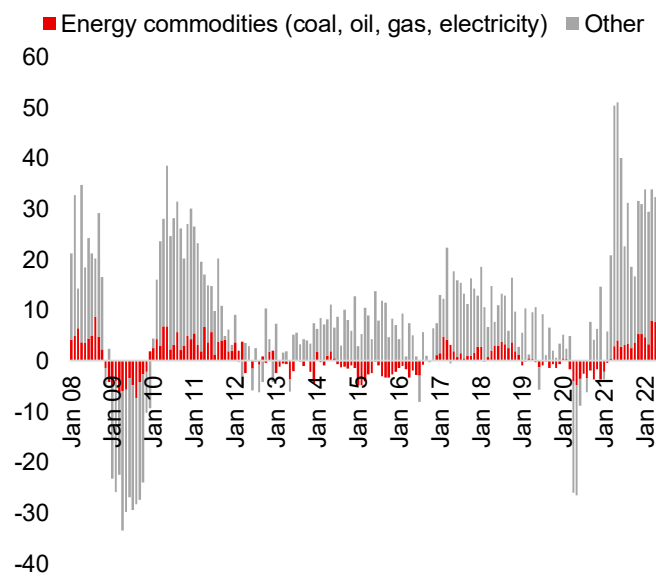
Source: Eurostat, Santander

### Terms of trade deterioration worsening trade balance



Source: Refinitiv Datastream, Santander

### Import growth contributions, %y/y



Source: Eurostat, Santander





# Labour market: wages unlikely to catch up with inflation

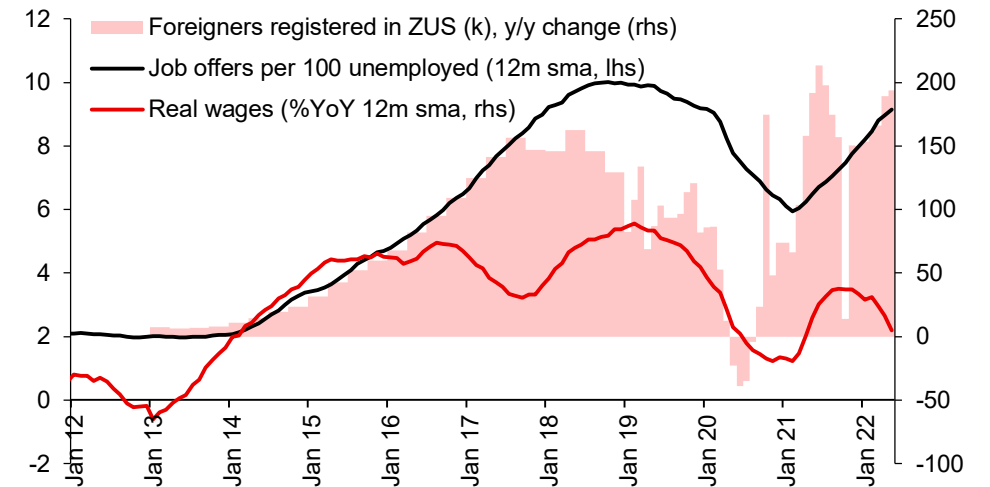
The labour market is really strong at the moment, with the unemployment rate at the record low and consumer surveys indicating no decline in perceived job security.

However, it seems employers see the situation differently – sectoral employment indexes are already moving down. PMI report for June saw a decline in the employment component. Given the upcoming economic slowdown, we are expecting **the labour demand to weaken as well. We are not expecting a major rise in layoffs, though.**

The decline in labour demand, in job offers and vacancies is likely to translate into slower wage growth. Corporate wages are already lagging behind inflation, and in the entire economy the growth is even smaller (due to the public sector). **The period of negative real wage growth is likely to hold for a few quarters.**

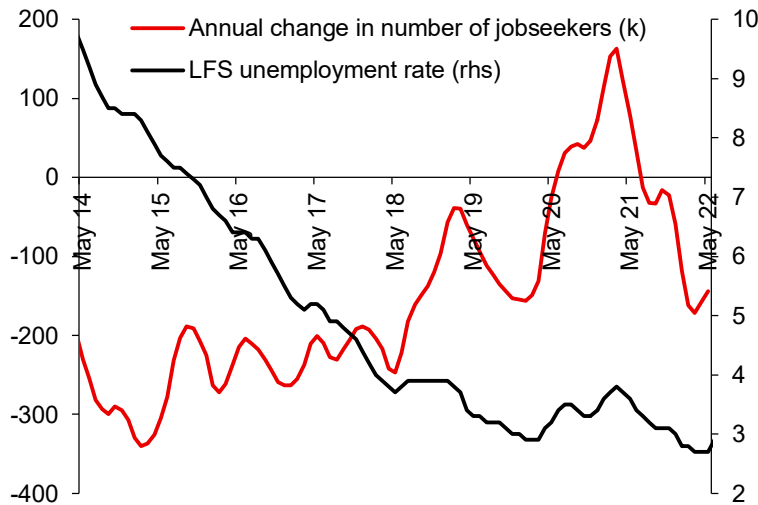
Entry of Ukrainian refugees to the labour market has already eased wage pressure in services – services saw the most considerable slowdown in wages in May, to 15.1% y/y from 16.7% y/y.

### Real wages vs job offers and foreign workers

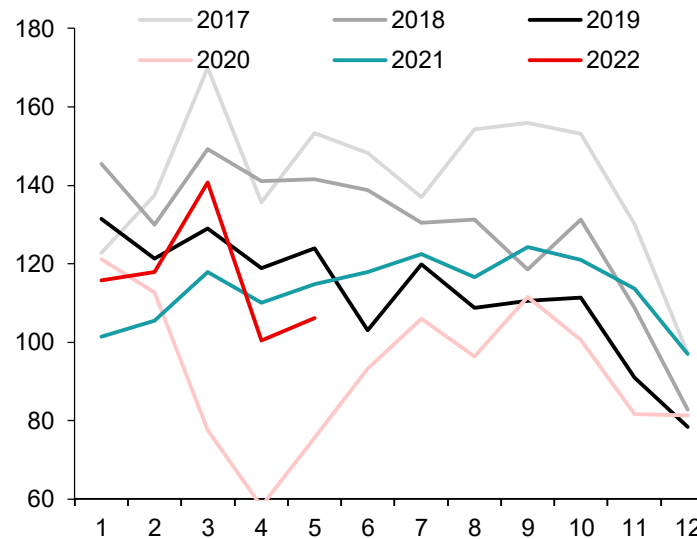


Source: GUS, Santander

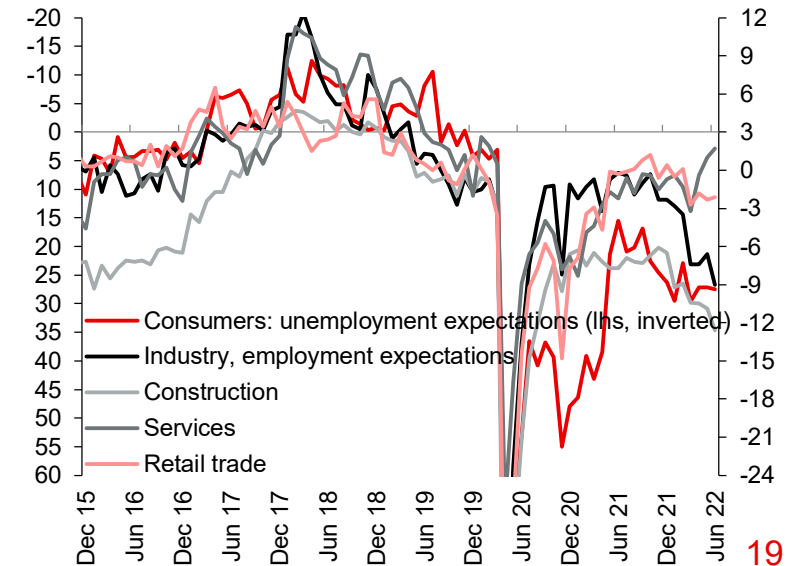
### LFS Unemployment



### Job offers by months, thousands



### Employment expectations surveys



Source: Eurostat, Santander

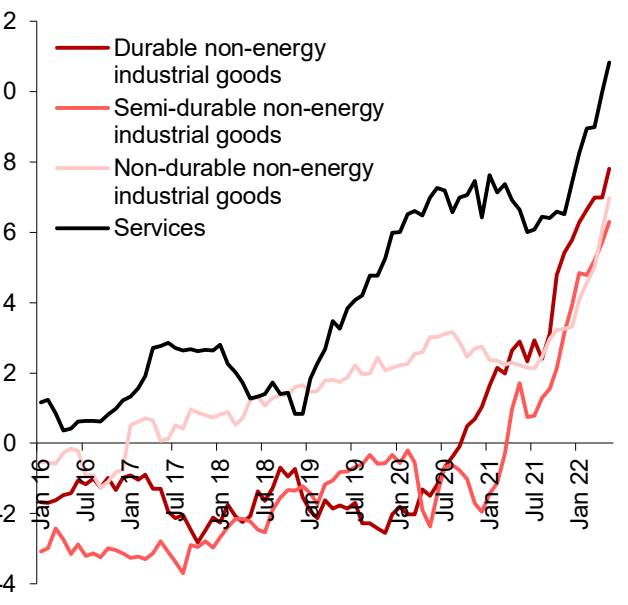


# Inflation still going higher...

Inflation has hit 15.6% y/y in June. So far, the **inflation data is not showing any slowdown**. Take any reasonable inflation breakdown you can think of and it will be going higher and higher. But stronger pressure is clearly visible even if you go down to single spending items. Higher price growth is affecting almost all categories, and the entire distribution of annual growth rates has shifted markedly over the last year: only about 2% of the CPI basket is not growing, compared to c20% in 2019-2021 period. 85% of categories are advancing by more than 5% as compared to 25% in 2019-2021.

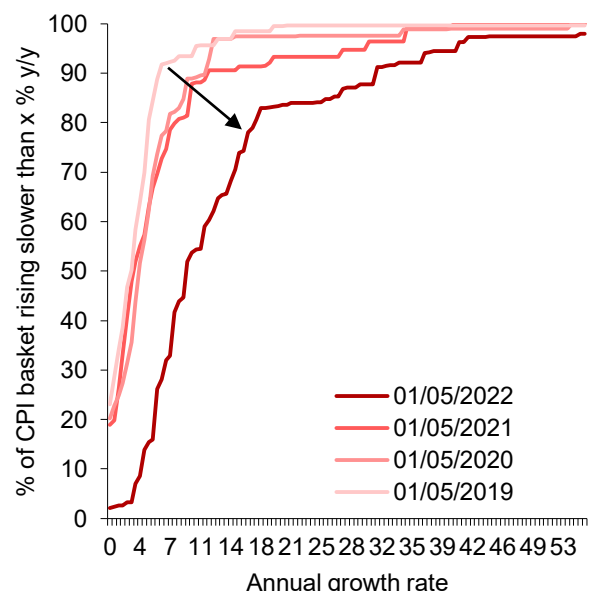
That having said, we are expecting a major deceleration in unit labour costs in 2023, and in our view this is going to draw core inflation lower. Decline in commodity prices, driven by recession fears, is also an argument behind **slower CPI momentum in 2023** (see next page). Main risks are: energy prices (possible disruptions in supply) and food prices (lower crops in Ukraine, drought in Poland).

CPI inflation in Poland, breakdowns, % y/y



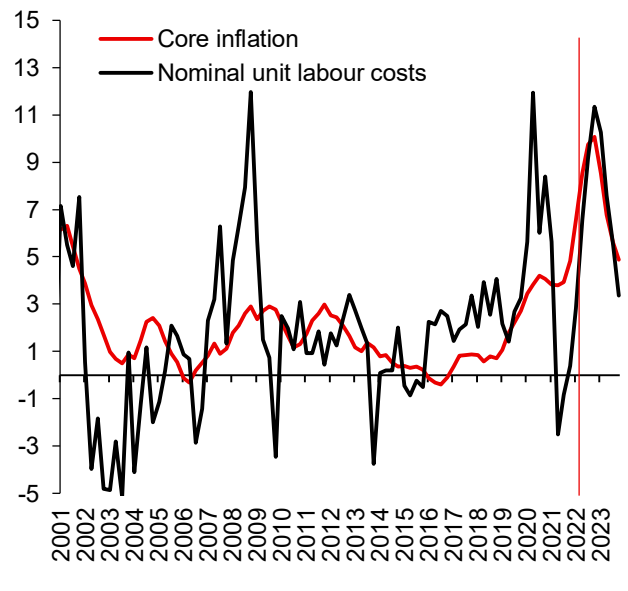
Source: GUS, Santander

CPI breakdown by categories – distribution functions



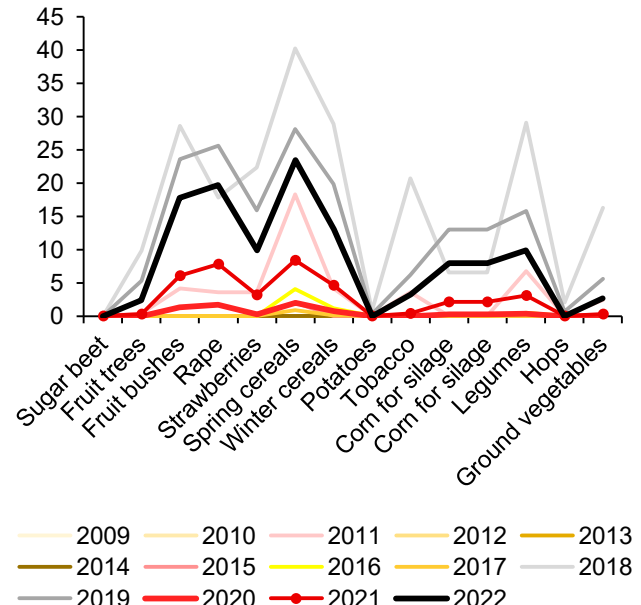
Source: GUS, Santander

Core inflation vs NULC, % y/y



Source: Eurostat, NBP, Santander

% of cultivated area under drought threat in the latest reporting period (1 May – 30 June)



Source: IUNG-PIB, Santander

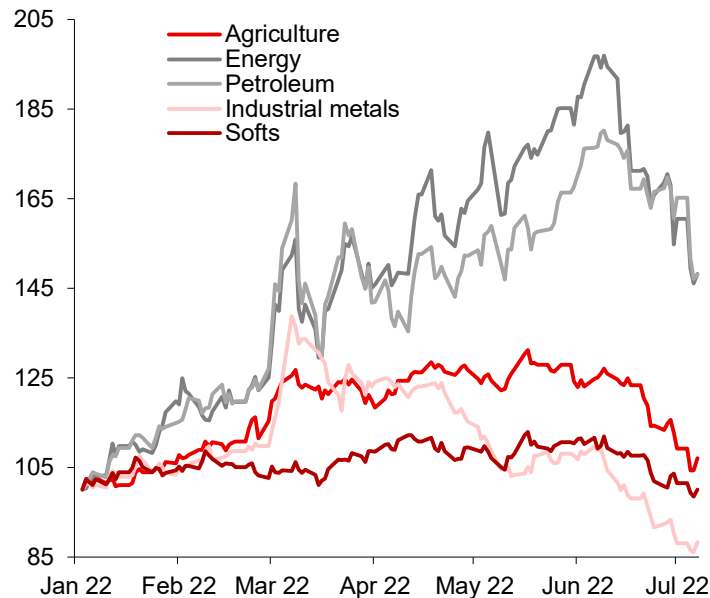




# ... but is the tipping point approaching?

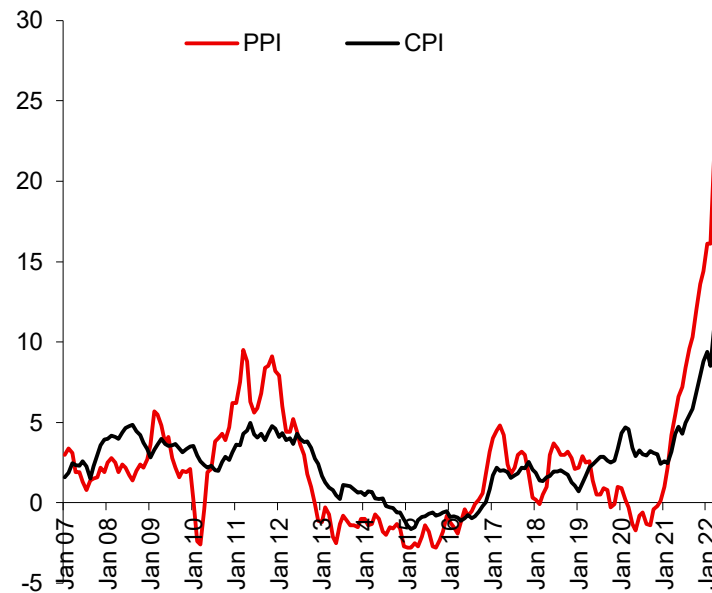
Historically, PPI has been a very good predictor of CPI, preceding major changes in CPI trends by a couple of months. Our models suggest that main drivers of PPI inflation are commodity prices and FX rates. Thus, **the recent broad decline in commodities based on recession fears is likely to drag PPI lower**, provided that this move is not offset by the weaker zloty. In March 2022 PPI was also pushed higher by a shock that was not captured by our models, but it seems that it was only a one-off phenomenon. Thus, we are expecting PPI inflation to go down soon, and CPI will follow suit, yet will remain elevated in the upcoming quarters.

### Bloomberg commodity indices, 03/01/2022 = 100



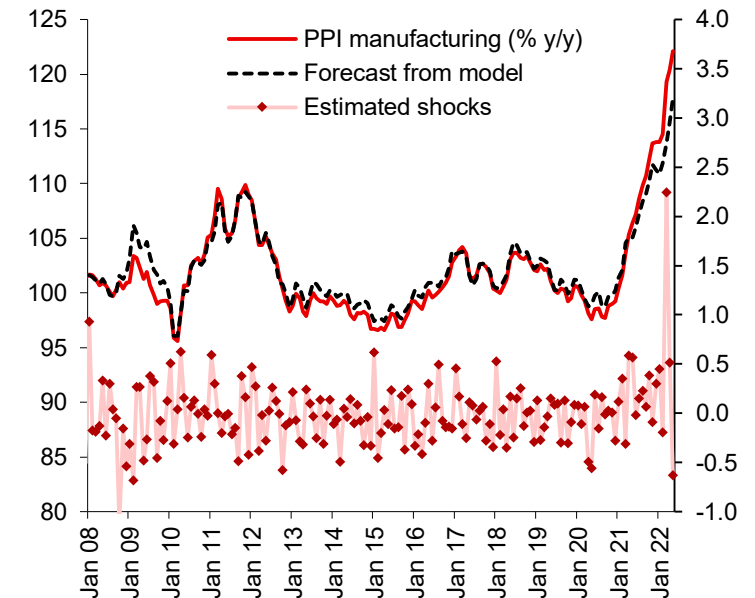
Source: Bloomberg, Santander

### CPI vs PPI, % y/y



Source: GUS, Santander

### PPI in manufacturing vs model\* and estimated shocks



Source: GUS, Santander

Note: Our model controls for seasonality, commodity prices, FX rates and autocorrelation terms



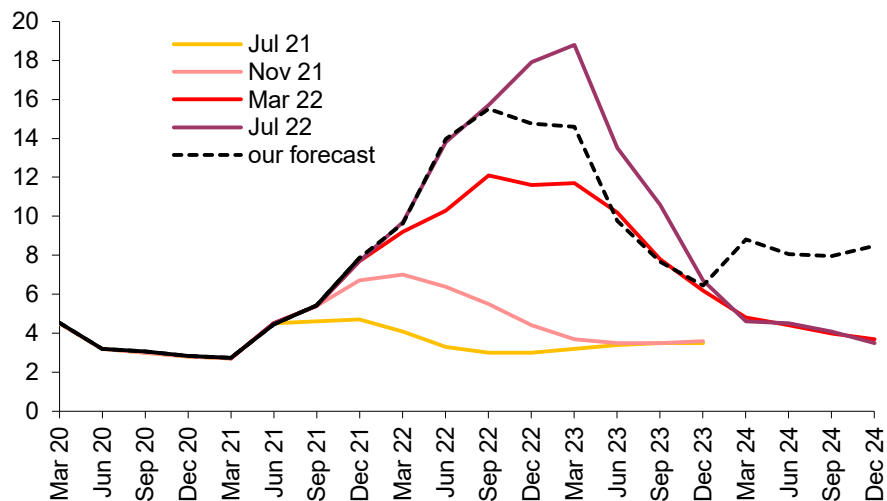
# Monetary policy: the end (of cycle) is nigh?

In July the MPC lifted the main reference by 50bp, to 6.5% - the level that we have described in April as theoretically consistent with bringing inflation back to the tolerance band around 2.5% target, based on the results of March inflation projection and the NBP's estimates of the monetary transmission.

The NBP governor declared in recent months that interest rate hikes will continue as long as CPI keeps rising, yet he also admitted that growing signs of looming recession are reducing the Council's appetite for tightening. Our current CPI forecast is almost identical with the NBP inflation projection (adjusting for the unrealistic NBP assumption that anti-inflation shield expires in October 2022) and implies that inflation rate should reach its local peak in the summer holidays, and another one (still below 16% y/y) in 1Q23. Our baseline scenario assumes that the MPC could end the tightening cycle with the reference rate at 7% in September.

What happens if CPI jumps again in 4Q22, after stabilising in the summer? Well, it depends on the situation. We think that Mr.Glapiński may not necessarily stick to his "autopilot" pledge (higher inflation = higher rates) if the CPI jump is triggered by energy price surge, while risk of recession will be growing. What makes things more complicated is the FX market behaviour, as in case of the persisting currency selloff the central bank may have little choice but to step up rate hikes, especially in the case of aggressive policy tightening of the main central banks abroad.

### CPI according to subsequent NBP inflation projections vs current Santander forecast, % y/y

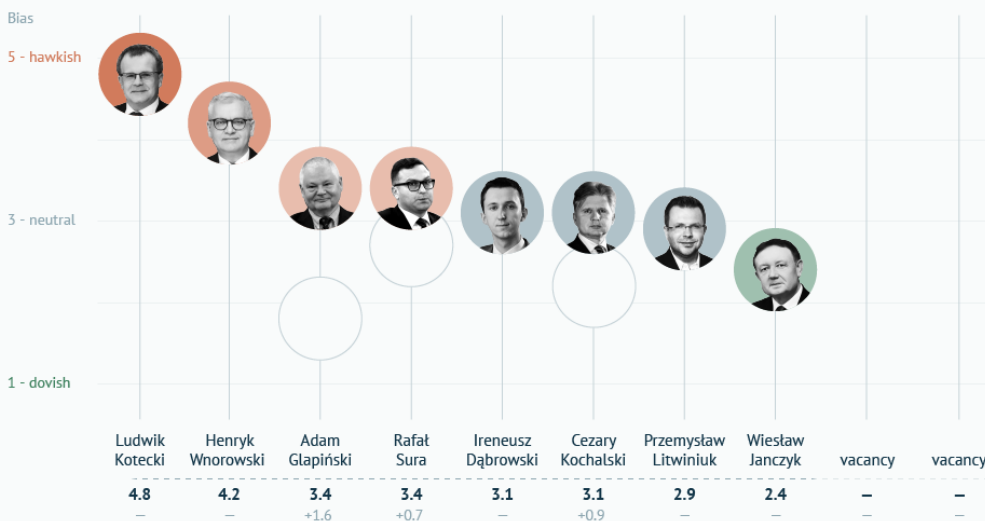


Note: NBP projection assumes that anti-inflation shield expires in Oct/22, our forecast assumes that it expires in Dec/23.  
Source: NBP, Santander

### PAP Consensus Call: polish MPC hawks and doves

Individual Council Member Bias, as ranked in PAP consensus survey of sell-side economists  
Consensus call based on a survey of 14 economists, as collected by PAP Business at 2-6th June 2022.

● June 2022 Call  
○ November 2021 Call



Source: PAP Business





# Fiscal policy: state budget doing fine

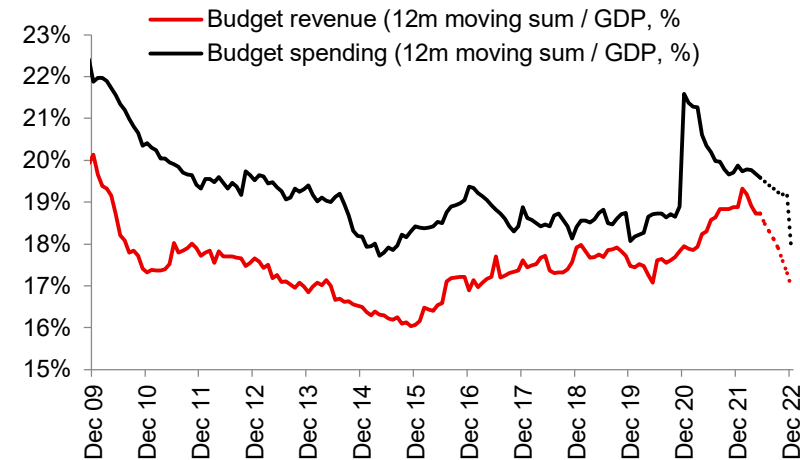
The situation of the state budget seems to be pretty good so far, as the very high nominal GDP growth strongly supports tax revenues, despite the implemented tax reductions (temporary cuts of indirect taxes called the 'anti-inflation shield', plus personal income tax changes). Tax inflows will likely slow in H2, yet we estimate that budget revenues may be c.PLN30bn higher than planned this year. Spending is also running ahead of the schedule, so we think that **2022 may end with the state budget gap close to the initial plan, i.e. ca PLN30bn**, unless the ministry decides to offload 2023 budget by front-loading massively the future expenditure – just like it did in two previous years (when budget spending in December alone surged by over PLN100bn).

The Finance Ministry has been signalling since April that 2022 budget bill will need to be revamped due to the new spending induced by war in Ukraine, and the work on the amendment will start in July. Yet recently the Ministry's chief economist suggested the amendment may not be necessary, which seems to confirm our view that it is possible to keep the deficit within the target limit. We think the amendment may be needed anyway due to the higher-than-planned spending. Plus, we see no reason why the ministry would completely abandon the strategy of front-loading expenditure, given that 2023 may be more challenging in terms of economic environment.

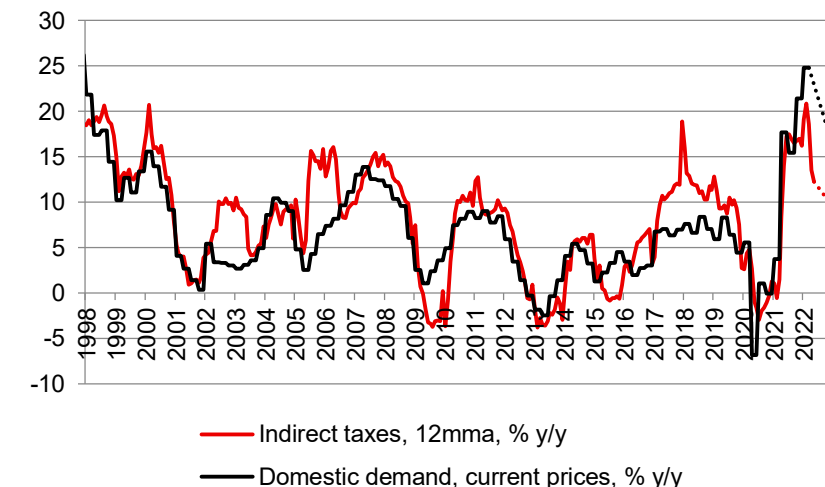
Yet, the situation of the state budget does not tell us much about the condition of the entire public sector, as the government has been phasing out the increasing part of the public spending to special purpose funds, which are out of the budget reporting scope. It applies also to the new spending that has appeared in recent months (support for Ukrainians, defence, coal subsidies) – according to our estimates at least PLN50bn in total. Thus, the assessment of the general fiscal outlook is quite difficult (see the next page).

The reason why the state budget balance may be important is that it determines to large extent the supply of government bonds in the remainder of the year. If the budget gap is close to the originally planned level, then the **Finance Ministry's borrowing plans would not have to differ much from what was initially drafted for 2022**. It implies that the Finance Ministry's liquidity situation may be more comfortable than we had imagined one quarter ago, even though other state agencies may be struggling to issue more debt amid growing spending burden outside the central budget.

### State budget revenue and spending as % of GDP



### Tax revenues supported by high nominal GDP growth



Source: MoF, GUS, Santander



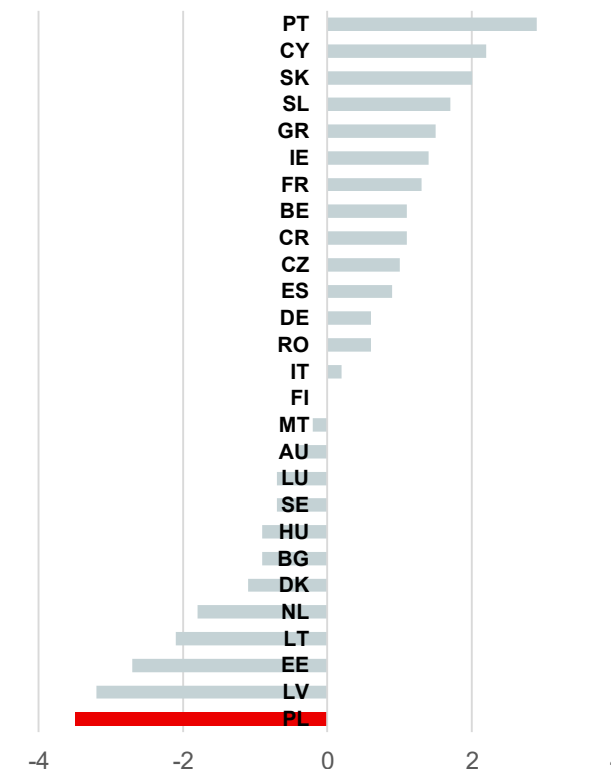
# Fiscal policy: moderately expansionary

We are trimming our expectations for **2022 general government deficit to 3.6% of GDP** from 4.7% of GDP in the previous quarter. The change is mostly due to higher expected revenues of the public sector, as our forecasts of nominal GDP growth went up significantly since April (by 5.5pp) Public spending forecast went up to much lesser extent, mainly due to higher expected costs of debt servicing.

Fiscal deficit in 2023 is a big unknown until the government presents more guidance. The recent update of Poland's convergence program released in April assumed balance -3.7% of GDP, while European Commission's forecast is -4.4%. We are somewhere in between with the estimate of **GG balance at -4% of GDP in 2023**.

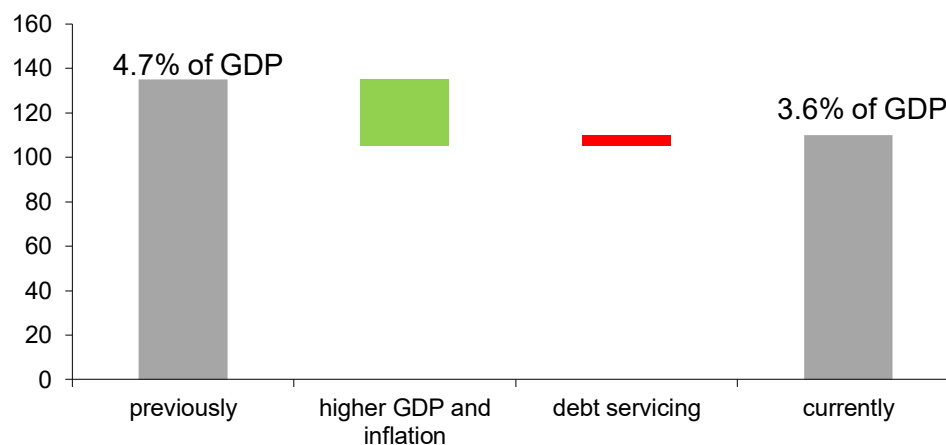
The macroeconomic environment is likely to be less supportive than in 2022, but still not that bad for revenue generation (possible technical recession at the turn of the year, but nominal GDP in 2023 still in double digits). The election cycle suggests that fiscal consolidation is not very likely. The government will be probably eager to introduce some new sweeteners for voters, but no plans were revealed yet. Still, the room for spending spree will be constrained by the stabilising expenditure rule (SRW). The government has recently tweaked the rule, which lifts the spending limit by c.5% of GDP (see next page) but it seems that the April's convergence program update has already silently assumed such a change, predicting fairly stable spending-to-GDP ratio, near 44% of GDP in 2023, while without the SRW amendment the ratio would have to go down significantly.

**Structural GG balance in 2022-23:  
change in EC Spring 2022  
vs Autumn 2021 forecasts**



Source: European Commission, Santander

**Change in our 2022 GG deficit forecast, PLNbn**



Source: Santander





# Spending rule: a fig leaf

The government has pushed a **change in the stabilising spending rule** (SRW). The main alteration is to be applied to the formula used to set limit for the general government sector spending. Currently, spending limit is indexed with NBP target (2.5%) and in the new version it will be indexed with expected inflation, and with additional correction for mistakes in previous CPI forecasts. Thus, the government is actually returning to an older version of the formula (used before 2015), which now will allow for higher spending, as inflation is markedly above the CPI target. Not surprisingly, CPI forecasts were replaced with NBP target in 2015, when inflation was low or even negative, so that the government could have spent more. Clearly the spending rule is acting as a fig leaf for the government's fiscal plans and is changed when it is convenient. This time the government also added a paragraph stating that in case of deflation the indexation is set to zero.

According to our estimates, the existing rule would allow for spending to rise to cPLN1120bn in 2023, while the alteration will allow to step it up to cPLN1230bn, **or by about 3.2% of GDP**. However, if the government updates its macroeconomic assumptions for 2023 budget (such a correction was suggested in the spending rule bill), the limit is likely to reach PLN1300bn (up by more than 5% of GDP).

## Old formula

$$WYD_n = WYD_{n-1} \cdot E_{n-1}(CCPI) \cdot [WPKB_n + K_n] + E_n(\Delta DD_n)$$

Indexed by inflation target (2.5%)

## New formula

$$WYD_n = WYD_{n-1}^* \cdot E_n(CPI_n) \cdot [WPKB_n + K_n] + E_n(\Delta DD_n)$$

Indexed by expected inflation (government assumption: 7.8%)

$$WYD_{n-1}^* = WYD_{n-1} \cdot \frac{CPI_{n-2}}{E_{n-1}(CPI_{n-2})} \cdot \frac{E_n(CPI_{n-1})}{E_{n-1}(CPI_{n-1})}$$

And corrected by mistakes in earlier CPI forecasts, but for 2023 another temporary formula will be used

# Financial markets

A close-up photograph of a desk with financial documents. A silver pen lies diagonally across the papers. The documents feature various charts, including a line graph with a blue line and a bar chart with multi-colored bars. The background is blurred, showing more papers and a computer monitor.

2

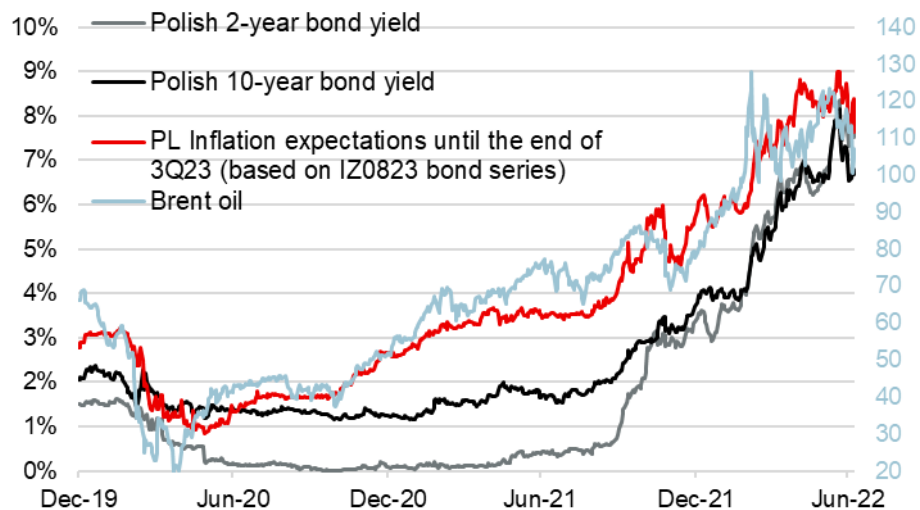


# FI outlook: falling inflation expectations should push Polish yield curve further down

We expect further declines in yields in domestic and core markets. This should be supported by declining inflation expectations fueled by recessionary fears, which were significantly reinforced as major central banks accelerated the pace of rate hikes. They also resulted in a decline in global energy commodity prices, which, along with some signs of a slowing economy at home, began to translate into a decline in inflation expectations in the Polish debt market. In the case of Polish yields, the NBP's communication signalling approaching end of the tightening cycle also played an important role. We expect that global trends and the gradual economic slowdown at home will also support further declines in Polish bond yields in Q3, albeit on a significantly lower scale than in Q2.

A risk factor here, potentially working in the opposite direction, is a possible increase in energy commodity prices in the fall as a result of a possible natural gas shortage in Europe. Concerns about such a scenario are already partially discounted by the 1-year inflation swap for the eurozone, which, so far, is moving in a different trend than the longer-term swaps for this economic area. Should the gas supply shock scenario materialise, we expect it to have the strongest impact on the upward trend of the shorter end of the domestic curve; at the longer end, the impact should be severely limited, due to its anticipated negative impact on the subsequent course of the economic cycle.

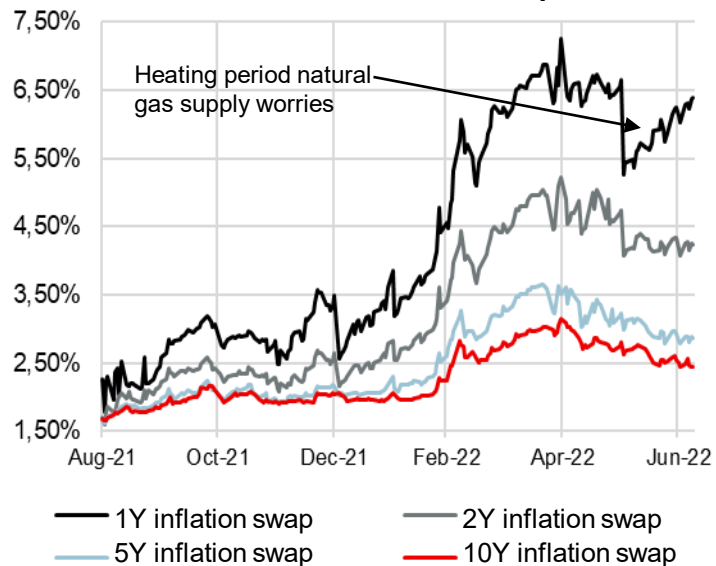
### Yields, bond market inflation expectations & Brent oil prices



Source: Refinitiv Datastream,

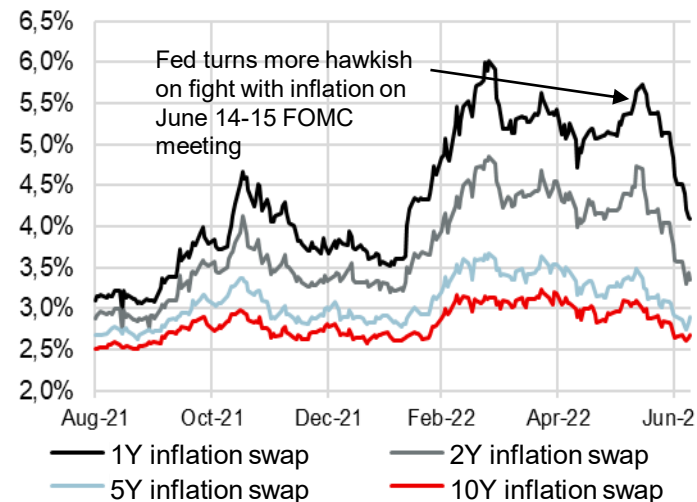


### Eurozone financial market inflation expectations



Source: Refinitiv Datastream, Santander

### US financial market inflation expectations



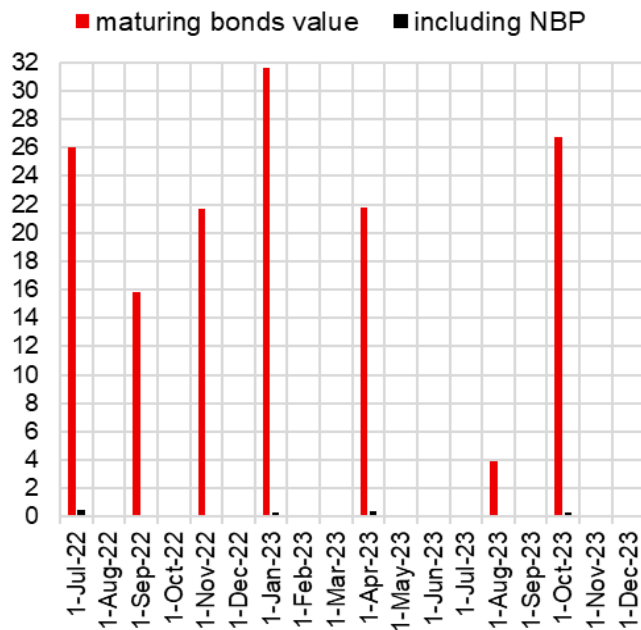
Source: Refinitiv Datastream, Santander



# FI outlook: treasury bond supply this year should not be a factor supporting yield increases

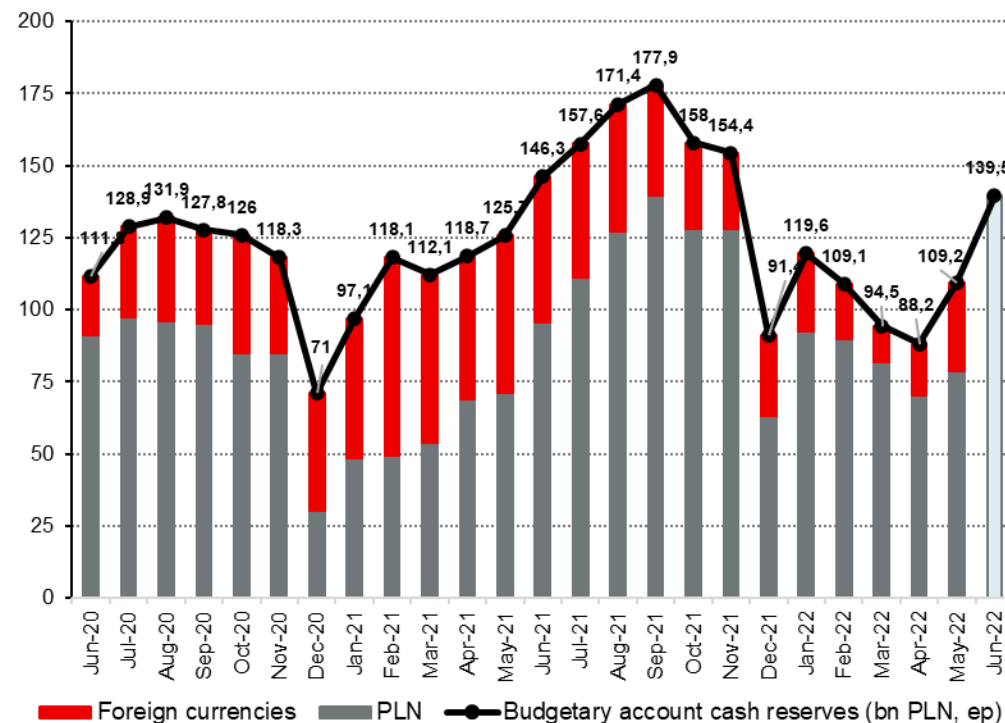
The financing of this year's budget's borrowing needs (PLN222bn) after June was around 84%. The high level of the budget's "liquidity cushion" (ca. PLN138bn) guarantees that, even after taking into account the necessity to redeem bonds maturing by the end of this year, there should be no problem with financing this year's budget needs, and, as in previous years, with partial pre-financing of next year's budget financing needs. Especially that, according to our recent estimates, the state budget deficit this year should be close to the planned level (PLN30bn). The strong increase in sales of retail savings bonds since June will also help. Taking all this into account, we believe that an increase in the government bonds supply this year should not be a risk factor significantly affecting yields of domestic debt.

### Bond maturity monthly scheme (bn PLN)



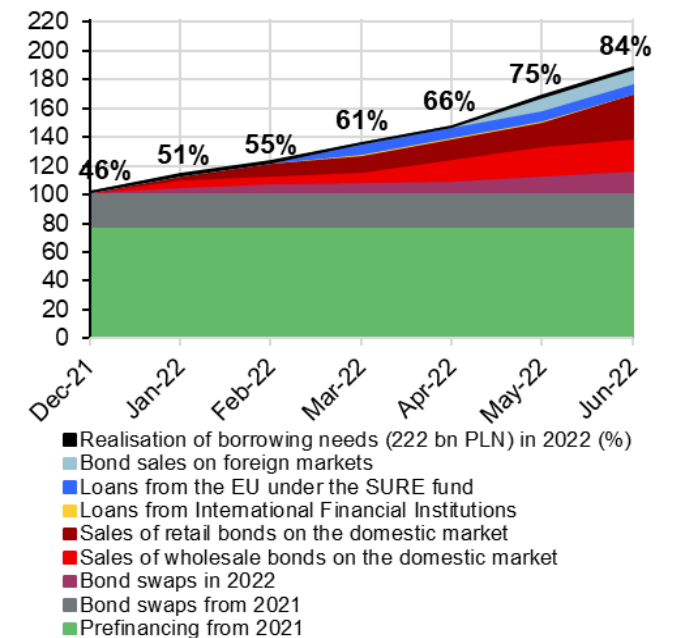
Source: MoF, NBP, Santander

### Budgetary accounts cash reserves (bn PLN, ep)



Source: MoF, Santander

### Structure of financing of borrowing needs of the budget (bn PLN)



Source: MoF, Santander



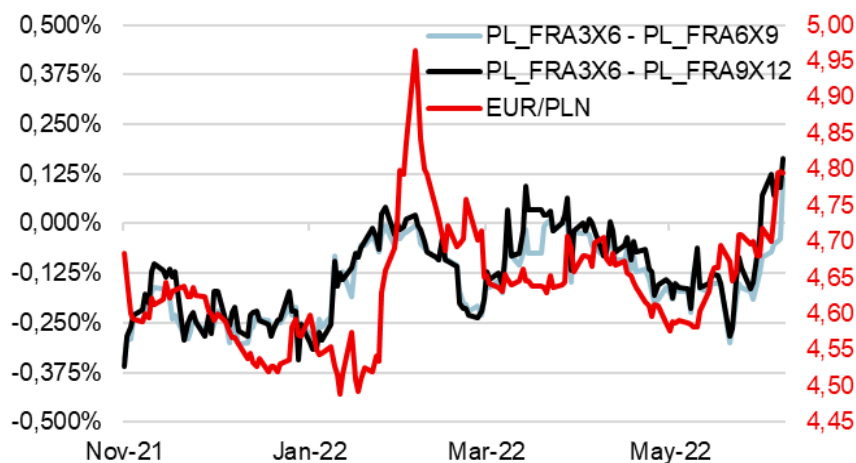


# FX Outlook: PLN under pressure from global slowdown and imminent end of a rate hike cycle

The start in October 2021 of a cycle of rapid rate hikes by the National Bank of Poland in response to rising inflation was a factor strongly affecting the zloty against the euro. The expectations channel was particularly important here. Anticipated further increases in domestic interest rates, among other things, allowed the zloty to quickly stabilise both at the outbreak of the war in Ukraine (February 24) and in recent months. As a result, by the end of May this year, the EUR/PLN exchange rate had returned to pre-war levels. However, the situation began to change from the moment the NBP signaled on June 7 that the cycle of increases was beginning to come to an end. As a result, the EUR/PLN exchange rate rebounded markedly. In addition, it was also helped by the global increase in risk aversion resulting from the Fed's announcement of an acceleration in the pace of rate hikes in the US, global recessionary concerns and the fragmentation of the eurozone debt market. Nevertheless, against the backdrop of the CE3 region's currencies, since then, there is a clear "breakaway" of the EUR/PLN quotation from the relatively stable EUR/CZK rate and an increase "towards" the forint, which is strongly weakening against the euro. In the conditions of a growing Polish current account deficit and the global appreciation of the dollar, the NBP's policy of "ending rate hikes" increases the risk of a significant weakening of the zloty. In such conditions, the possibility of wider use of currency interventions, signaled by the NBP, may have a limited impact on market behavior.

Looking ahead to Q3, we expect high volatility in the EUR/PLN rate, although we assume that the exchange rate's "center of gravity" will be around the 4.80 level.

### EUR/PLN vs. FRA market interest rate expectations spread



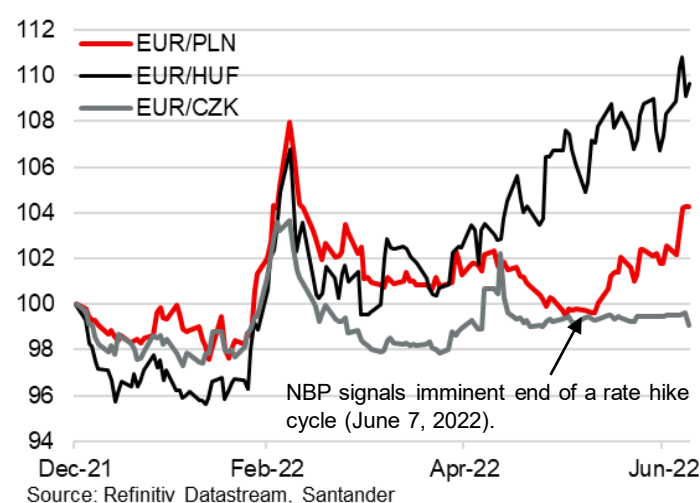
Source: Refinitiv Datastream, Santander

### EUR/PLN vs. Polish 2Y Asset Swap



Source: Refinitiv Datastream,

### EUR/PLN vs. EUR/HUF & EUR/CZK



Source: Refinitiv Datastream, Santander

# Forecasts



3



# Economic Forecasts

		2020	2021	2022E	2023E	1Q22	2Q22E	3Q22E	4Q22E	1Q23E	2Q23E	3Q23E	4Q23E
GDP	PLNbn	2,339.0	2,622.2	3,060.0	3,442.8	687.0	733.3	768.2	871.5	783.2	827.3	859.6	972.7
GDP	% y/y	-2.2	5.9	4.7	1.4	8.5	7.0	3.4	1.0	-0.6	-0.4	2.0	3.8
Domestic demand	% y/y	-2.9	7.6	5.8	0.9	13.2	8.6	3.2	0.5	-2.5	-0.5	1.8	3.9
Private consumption	% y/y	-3.0	6.1	3.7	3.0	6.6	3.8	1.8	2.8	4.0	3.0	2.0	3.0
Fixed investment	% y/y	-4.9	3.8	4.1	3.1	4.3	6.0	4.0	3.0	2.5	2.0	3.0	4.0
Industrial output	% y/y	-1.1	14.5	9.0	-1.1	16.8	13.2	8.5	-1.4	-4.5	-5.0	-1.6	7.0
Construction output	% y/y	-3.5	1.6	8.3	1.1	23.7	10.2	6.4	1.1	-4.8	-1.4	2.9	5.1
Retail sales (real terms)	% y/y	-3.0	7.4	5.2	1.3	9.7	10.7	3.4	-1.6	-3.8	-0.7	2.3	7.1
Gross wages in national economy	% y/y	5.3	8.9	11.6	7.8	9.7	13.1	12.2	11.6	9.5	7.5	7.4	6.9
Employment in national economy	% y/y	-1.0	0.4	1.8	1.1	1.9	1.8	1.6	1.8	1.2	0.9	1.2	1.3
Unemployment rate *	%	6.2	5.4	5.1	5.4	5.4	4.9	4.9	5.1	4.9	4.8	5.4	5.4
Current account balance	EURmn	15,287	-4,128	-33,282	-26,925	-8,883	-10,124	-8,098	-6,177	-7,373	-5,884	-6,797	-6,871
Current account balance	% GDP	2.9	-0.7	-5.1	-3.7	-2.7	-4.5	-5.1	-5.1	-4.8	-4.0	-3.7	-3.7
General government balance (ESA 2010)	% GDP	-6.9	-1.9	-3.6	-4.0	-	-	-	-	-	-	-	-
CPI	% y/y	3.4	5.1	13.5	9.6	9.6	14.0	15.5	14.7	14.6	9.8	7.7	6.5
CPI *	% y/y	2.4	8.8	14.4	6.5	11.0	15.6	15.5	14.4	12.7	8.4	7.3	6.1
CPI excluding food and energy prices	% y/y	3.9	4.1	8.7	9.6	6.6	8.5	9.7	10.1	8.5	6.8	5.6	4.9

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

Source: GUS, NBP, Santander



# Market Forecasts

		2020	2021	2022E	2023E	1Q22	2Q22	3Q22E	4Q22E	1Q23E	2Q23E	3Q23E	4Q23E
Reference rate *	%	0.10	1.75	7.00	6.50	3.50	6.00	7.00	7.00	7.00	7.00	6.75	6.50
WIBOR 3M	%	0.67	0.54	6.06	7.05	3.46	6.25	7.11	7.43	7.27	7.20	7.05	6.68
Yield on 2-year T-bonds	%	0.50	0.79	6.50	6.88	4.07	6.78	7.78	7.35	7.15	7.05	6.83	6.48
Yield on 5-year T-bonds	%	0.96	1.39	6.37	6.50	4.41	7.01	7.10	6.95	6.80	6.60	6.40	6.20
Yield on 10-year T-bonds	%	1.52	1.97	6.05	6.21	4.29	6.63	6.74	6.55	6.40	6.25	6.15	6.05
2-year IRS	%	0.62	1.19	6.62	6.71	4.68	7.21	7.42	7.16	6.96	6.87	6.66	6.33
5-year IRS	%	0.80	1.69	5.95	6.06	4.31	6.53	6.51	6.44	6.32	6.15	5.98	5.81
10-year IRS	%	1.15	2.01	5.62	5.86	4.10	6.16	6.12	6.10	6.00	5.88	5.81	5.74
EUR/PLN	PLN	4.44	4.57	4.71	4.69	4.62	4.65	4.79	4.78	4.74	4.71	4.68	4.63
USD/PLN	PLN	3.89	3.86	4.42	4.04	4.11	4.36	4.73	4.46	4.21	4.04	3.98	3.92
CHF/PLN	PLN	4.15	4.22	4.60	4.30	4.46	4.52	4.81	4.59	4.45	4.34	4.27	4.17
GBP/PLN	PLN	5.00	5.31	5.40	4.79	5.52	5.48	5.47	5.13	4.88	4.76	4.75	4.77

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

Source: NBP, Bloomberg, Santander



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#3 BEST OVERALL FORECASTER - POLAND



#2 BEST OVERALL FORECASTER - POLAND



#1 BEST OVERALL FORECASTER - POLAND



# Sectoral supplement

Strategic Sectors

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# Softer demand for plastics, solid for paper

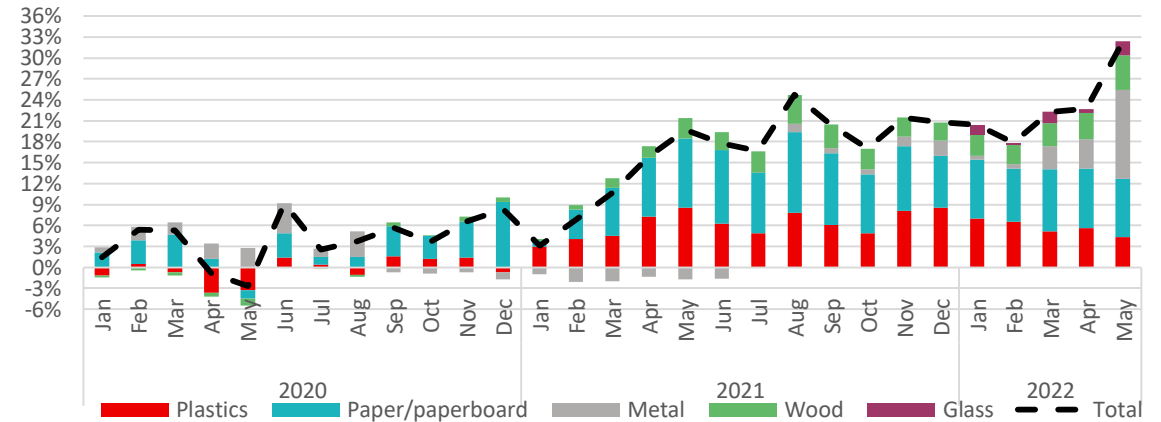
We estimate that sold production of packaging manufacturers grew in the first 5 months of 2022 by over 20% in YoY terms, fuelled mainly by metal packaging (partially due to low last year base effect) and wooden packaging, where in both cases we see growth at close to 50% YoY in value terms. In volume terms, we estimate that packaging industry grew by ca. 2% YoY, which translates into about 90% share of price increases in driving companies' revenues growth.

In case of plastic packaging we can see that in June average weighted price of plastics has returned to pre-invasion levels but signals of softening demand could indicate that downward trend would continue. Oil price is also declining since the first decade of June in USD terms but in PLN it still reaches new heights, which could reduce any space to further decline of plastics prices, at least those produced domestically (PE, PP). As a result, at the end of June plastics used in the packaging industry were the cheapest relative to Brent oil since the start of pandemic. Considering decreasing sold production growth of plastic packaging, this may confirm that demand is getting softer in this segment of the packaging industry.

We do not see such tendency in case of papers, producer prices indices from German market show stable increases relative to pre-pandemic levels. Cellulose prices also noted another hike in June. High price of natural gas coupled with uncertain supply to European market do not bode well for any cellulose price decreases. From domestic perspective, we see no signs of decreasing dynamic of sold production in GUS data on paper and paperboard, which would indicate that demand remains stable.

In coming months we expect sold production dynamic to lower gradually due to increasing base from last year and decreasing momentum in retail sales in Poland and EU. We expect 12-16% growth of the packaging industry in 2022.

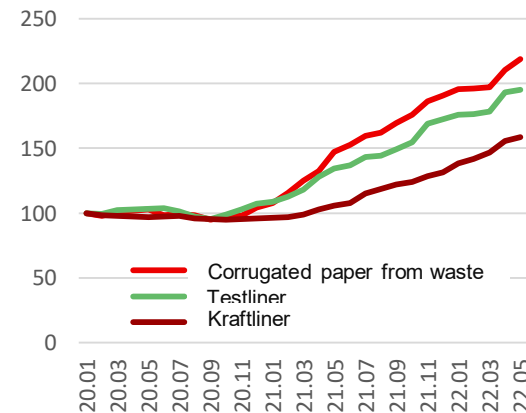
**Sold production\* of packaging by material type (YoY change)**



Source: GUS, Eurostat, Santander \*Manufactured production up to 2021, since 2022 sold production change

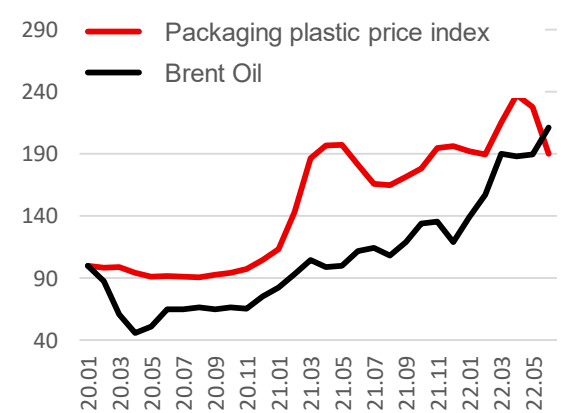
**Packaging materials price change (01.2020 = 100)**

**Papers prices in Germany**



Source: Destatis, Santander

**Plastics prices in Poland**



Source: Reporter Chemiczny, Plastech, Plastics Europe, Investing.com, Santander

# FX supports furniture industry but demand concerns rise

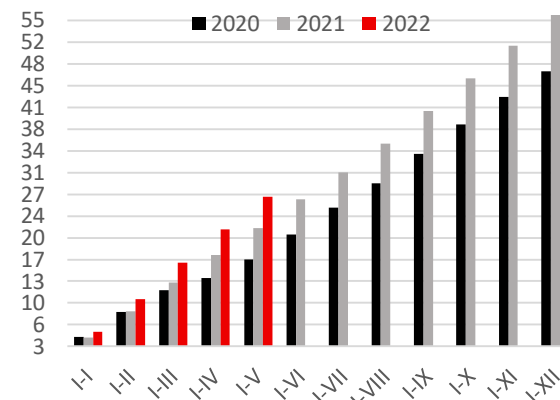
Furniture industry sold production grew by ca. 23% YoY in the first 5 months of 2022. There is relatively little impact of war in Ukraine apart from higher growth rate in March (27% YoY), possibly related to accommodating refugees. On the other hand, according to industry news companies have difficulties with increasing imports of cheap furniture from Russia and Belarus, which were not covered by sanctions in contrast to wood and wood products.

From cost perspective we see sustained growth trend of producer prices of wood based panels, which at the end of May crossed 30% YoY growth at EU level, at the same time price growth on German market was over 50% YoY since the start of 3Q 2021, reaching 72% in May. Selling price expectations of wood processing industry shows some hope for price decline. At both domestic and EU level, in June we saw increasingly clear signs of decreases, which should translate into softening of price inflation of materials used in furniture production. On the other hand, above mentioned decreases could be related to increasing concerns over economic growth in near future and resulting weaker demand.

Major consumer purchases (furniture included) indicator returned to pre-invasion levels after initial decline induced by war. We see this as evidence of strong wages growth, which starts to show signs of deceleration. There are also reports of weakening consumer demand. At EU level consumer confidence is clearly fading since 3Q 2021, which may indicate lower demand. This is confirmed by export dynamics, which decreased to 10,8% YoY down from 13,1% back in 1Q 2022.

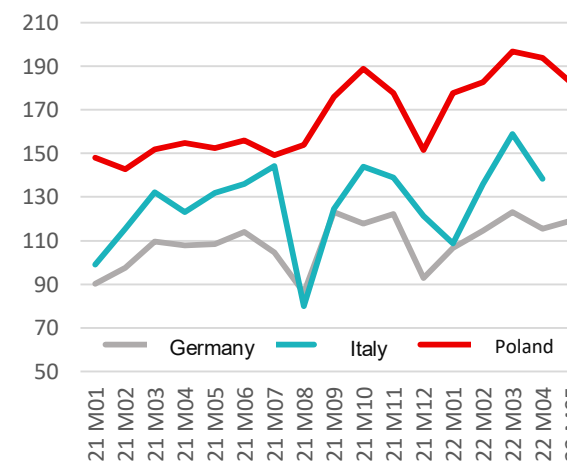
Nevertheless, domestic furniture producers are still supported by increasing EUR/PLN exchange rate, which allows them to remain cost competitive relative to their peers from eurozone, which may have supported sales margin improvement in 1Q 2022 to 6,3%. At year end we expect sold production to grow by 10-14%, mainly due to high growth rate in 1H 2022.

**Sold production of furniture industry (PLN bln)**



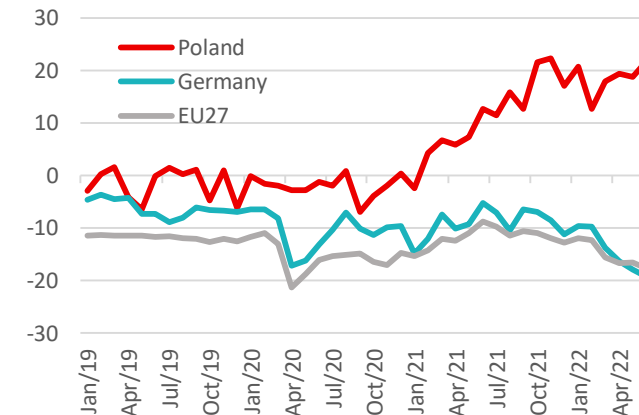
Source: GUS, Santander

**Furniture production revenue index (average 2015 = 100)**



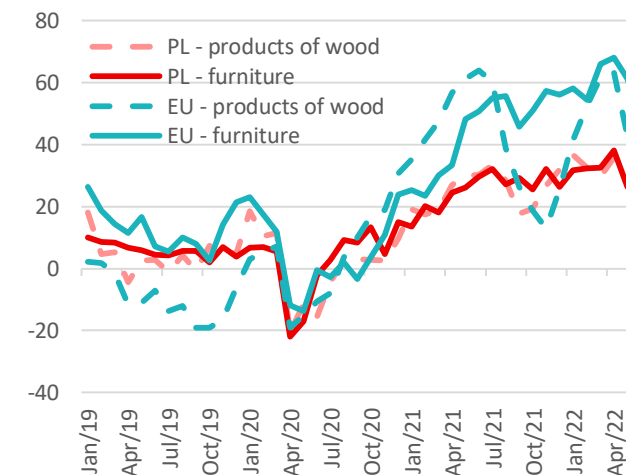
Source: Eurostat

**Major purchases intention over the next 12 months**



Source: Eurostat

**Selling price expectations PKD16; PKD31**



Source: Eurostat

# Slight improvement in car production

The start of the summer brought a slight recovery in passenger car production in Europe. In Germany, volumes rose by 18% MoM in May and by a further 0,5% in June, giving increases of 22% and 19% YoY respectively. In the Czech Republic, production in May was the highest this year (+30% MoM, +13% YoY), and the same was true in Spain (+13% MoM, +1% YoY), with the UK still at low levels. Although in these four countries together May was the best month of the year, the cumulative volume was 11% lower YoY (-32% against the Jan-May 2019 period).

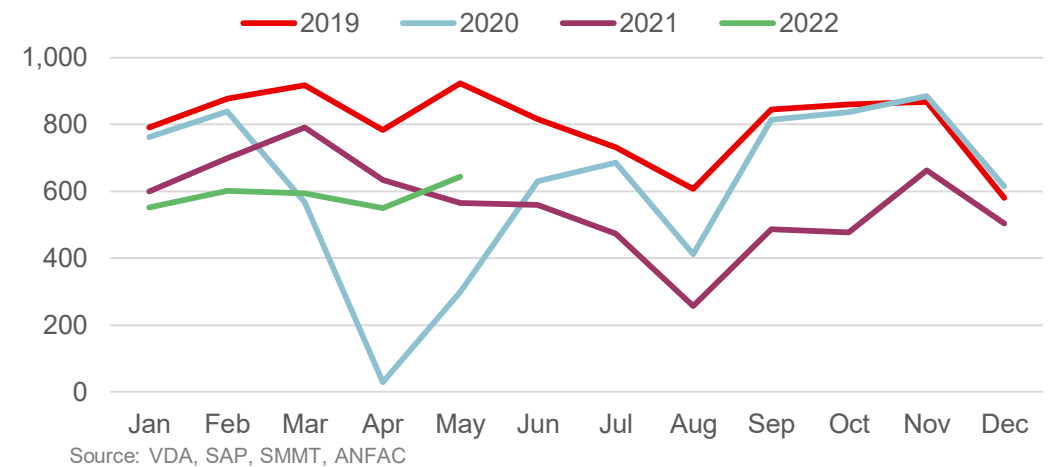
Ifo Institute research shows that the order backlog in the automotive industry in Germany remains at a high level, the highest of all manufacturing industries in the country. In April, this level ensured that production would be sold for a further 7,4 months, which is slightly less than in January (8 months).

The biggest constraint on production continues to be shortages of basic raw materials and components. According to the Ifo, in June, 89,8% of representatives of the automotive industry in Germany indicated problems in supply of materials. This level has persisted since the beginning of the year, having been higher in September (96,6%) and December (92,9%) of last year. German manufacturers expect the situation to continue for the next 11,5 months.

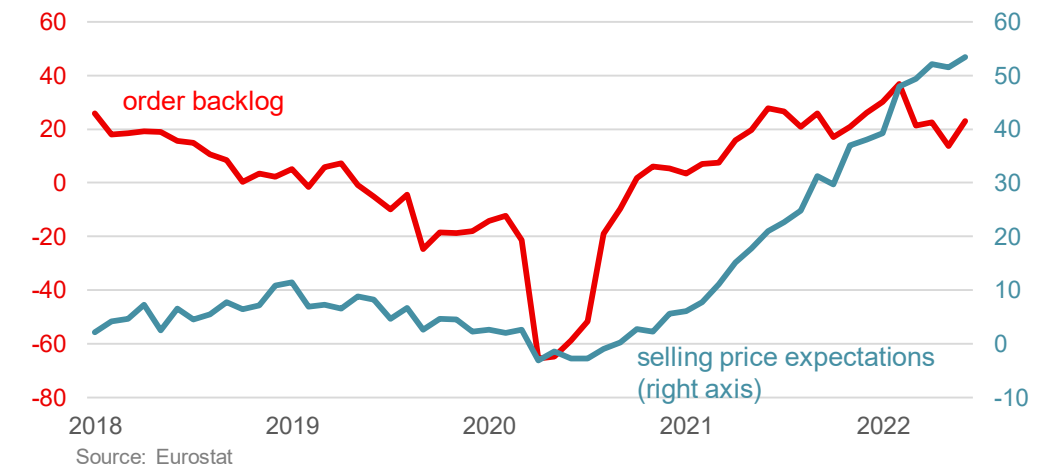
In a situation of high uncertainty and low volumes, carmakers have so far performed better than suppliers of parts and components, as evidenced by good financial results and results of the economic survey. Ifo data shows that, as of mid-2021, the index for the assessment of the current situation of car manufacturers in Germany outperformed that of suppliers. The same was true for expectations, which suppliers are assessing increasingly negatively. Car manufacturers, with high demand and orders, expect prices to rise, but they are also successfully pursuing a high price strategy, betting on models with high margins. Although suppliers' price expectations are also high, their ability to raise prices is clearly less.

It is unlikely that the summer slight recovery will herald a sustained and significant improvement. IHS Markit forecasts light vehicle production in Europe to increase by 4% in 2022 and by 11% in 2023. VDA, in turn, has lowered its 2022 sales forecast for Europe from +3% to 0% and for Germany from +5% to +3%.

**Production volumes of passenger cars in Germany, the Czech Republic, Spain and the UK (combined) in thousands of units**



**Orders and expected prices in the automotive industry in the EU (economic survey, balance of indications up/down)**

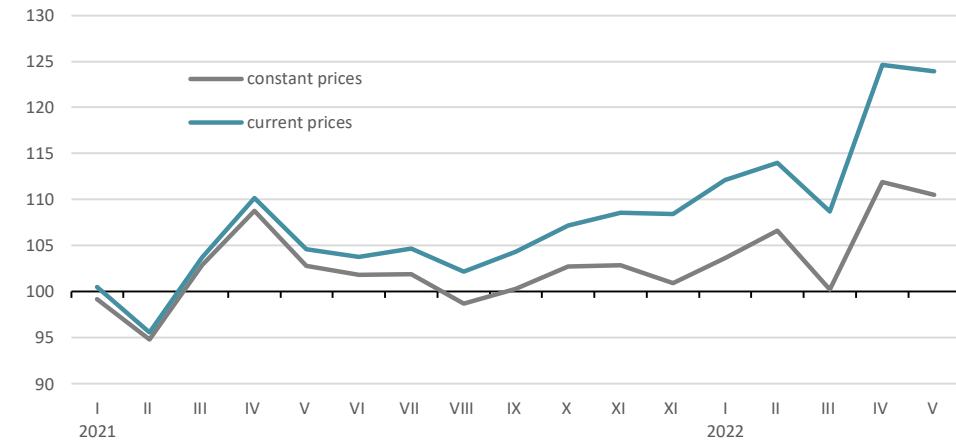


# Internal demand support turnover in food industry

The influence of the war in Ukraine is still visible in agri-food sector. Prices of agricultural raw materials, means of production for agriculture, energy, metals and building materials remain very high. But effect of the war is also the appearance of millions of refugees in Poland, which means a significant increase in number of consumers in the country. We estimate that approximately net 1,5 million refugees from Ukraine came to Poland. Increase in domestic demand is visible in retail food sales. According to GUS data, in May value of sales of food, beverages and tobacco products, expressed in constant prices, was higher by 10,5% than in the same month in previous year. In April, the dynamics was at a similar level. At the same time, there was a strong increase in food prices. As a result, retail sales in April and May, expressed in current prices, were higher by 24-25% YoY.

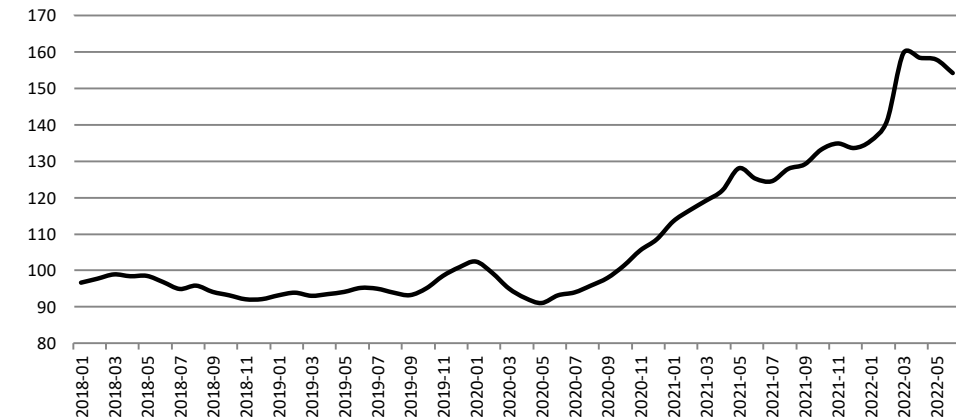
One of the most painful effect of Russian aggression against Ukraine is the increase in food prices. After the beginning of the war, the FAO world food price index reached 159,7 points in March, what means the increase of 59,7% compared to the 2014-16 average. Value of index in this month was higher by almost 19 points (or 13%) compared to the record level from February. After this jump, world prices of agricultural commodities stabilized. Slight declines were recorded in April and May. The downward trend continued in June, when the index fell to 154,2 points, i.e. 2,3% compared to May. However, food prices remained high. Importantly, the decline in the index was influenced, among others, by slightly lower MoM cereal prices. But it was a result of influence of seasonal factors and positive assessments of harvest in Northern Hemisphere this year. Therefore, these are not factors that may indicate a permanent change of the trend. Such conclusions must still be waited for the moment when information on two important issues becomes available. The first is actual supply of cereals from this year's Northern Hemisphere harvest. The second concerns foreign trade flows. Efficient export of grain from Ukraine is a critical area at present (during the war). In addition, export policy of Russia, which is the world's largest exporter of wheat, can be very volatile over the coming season.

Dynamics of food retail in Poland, YoY (%)



Source: GUS

FAO food price index (average 2014-16 = 100)



Source: FAO

This analysis is based on information available as of **8.07.2022** and has been prepared by:

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Sectoral approach resources: [www.santander.pl/korporacje/rozwiazania-sektorowe](http://www.santander.pl/korporacje/rozwiazania-sektorowe)

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