MACROscope

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Poland – the European champion?

Poland

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Executive Summary (macro)

No, Poland will not become the European champion in football, but in terms of GDP growth in the next two years it should be among the leaders. We certainly have a chance for the first place in 2025 when it comes to the lowest unemployment and the highest inflation. A high fiscal deficit will also place us close to the top of the EU.

Despite the exceptionally high volatility visible in high-frequency data (e.g. industrial production), in our opinion the Polish economy remains on the path of gradual economic recovery. Exactly a year ago, in a report entitled "It cannot get any worse", we put forward the hypothesis that the economy is at a turning point and GDP growth in the second half of 2023 should start to recover, accelerating to about 3% in 2024. In retrospect, we think that this was actually a good call and a scenario, assuming the leading role of consumption in this year's economic recovery, but also a break in the downward trend in industry, remains valid. For 2025, we expect a further slight acceleration in GDP to 3.5%, with upside asymmetric risks and a changing growth structure: consumption growth is likely to moderate due to slower real income growth, while investment, strongly supported by EU funds, should come to the fore. We also count on a gradual recovery of domestic exports, along with a mild economic recovery in Europe, resulting in an increase in demand for our goods.

The situation on the labour market is becoming an increasing challenge for the economy – there are reasons to believe that the slight decline in the number of employed in the first quarter of this year was not so much due to a decrease in demand for employees (economic activity began to grow, the number of vacancies increased), but to constraints on the labour supply side. We do not think that the shortage of workforce will rule out the prospects for faster economic growth in the coming quarters, but it may cause wage pressure to be a severe problem for companies, also making it difficult for the central bank to make further progress in the disinflation process. That said, we expect a moderate slowdown in wage growth in 2025, from the current level of 10%+ to about 7-8%, which will be supported by lower inflation than in previous years (a few percent rather than a dozen or so percent) and a smaller scale of the minimum wage increase (about 7.6% according to the latest government proposal). The increase in public sector wages in 2025 will also be much more modest than this year.

Inflation has started rebounding from the bottom, but so far quite sluggishly – the increase in CPI in May to 2.5% YoY was the sixth consecutive downward surprise compared to market forecasts, and the surprise concerned both the prices of goods and services. However, it seems to us that both the domestic macro environment (economic recovery driven mainly by consumption, high wage growth) and the external factors (reversal of downward trends in global commodity and food prices, weakening of the currency) are less and less conducive to rapid disinflation and, overlapping with the increase in energy prices from July, resulting from regulatory changes, will raise CPI inflation to around 5% by the end of this year, while core inflation will stabilize near 4%. Next year, CPI inflation should again be on a downward trajectory, although the pace of this decline will not be high in the situation of the progressive recovery of the economy and still quite fast (although not as fast as this year) increase in unit labour costs. In our view, core inflation will remain quite stable in these conditions, still close to 4%.

We are not changing monetary policy expectations: in our view, the Monetary Policy Council will lag behind most central banks around the world, keeping interest rates unchanged until at least mid-2025. Recent statements by the NBP Governor and MPC members clearly indicate that there is no reason to count on a reduction in interest rates this year, and the condition for starting a discussion on policy easing will be a sustained decline in inflation to the target – visible in the data and/or in the central bank's forecasts.

The implementation of this year's budget deficit is clearly worse than in previous years – after May, the rolling 12-month budget balance reached a record level of PLN -118 billion, compared to the full-year plan of PLN -184 billion. The risk to the fiscal deficit is, on the one hand, an ambitious plan of tax revenues, including in particular VAT, and on the other hand, the expenditure burden not provided for in the Budget Act. The European Commission has announced that it will propose to include Poland (along with six other countries) in the excessive deficit procedure (EDP), but the final decision of the EU Council on this matter may not be made until the autumn, perhaps after the government's draft budget for 2025 is prepared. In our opinion, the fiscal consolidation path suggested by the EC should not be too steep, taking into account Poland’s large spending on defence. We assume that the public finance deficit (GG) will amount to approx. 5.5% of GDP in 2024, and may be reduced by approx. 1 percentage point in the following year.

Executive Summary (markets)

FX market

Since the beginning of the year, the zloty has been in a slow appreciation trend. The EURPLN exchange rate rebounded twice from the level of around 4.25, with subsequent corrections reaching levels close to 4.38. The latest correction was related to the strengthening of the dollar on international markets and the political situation in France. We think this factor may negatively translate into risk appetite at least in the coming weeks, and the US elections may translate into increased volatility in the coming months. The Finance Ministry is likely to exchange most of the record foreign currency deposits with the NBP instead of the market, but one may not rule out that some will be exchanged directly in the market. At the same time, in the following months, the zloty will be positively affected by the growing interest rate disparity with the eurozone. We assume that the first rate cut by the MPC will take place in the middle of next year, and by then ECB rates may be reduced a few times. We assume that the zloty will remain strong in the coming quarters, but the path of the EURPLN rate in the coming months may be slightly higher than we have assumed so far. Still, the zloty could touch the 4.20 level over the next several months when the dollar begins to lose ground to the euro eventually next year and the economy accelerates.

Interest rate market

Since the start of the year and since the publication of the previous quarterly report, domestic market rates have remained in an upward trend. In mid-April, the 2-year swap rate returned to the level recorded before the unexpectedly large NBP rate cut last year. We assume that the local peak in yields is behind us. The upward trend in inflation and the maintenance of core inflation at elevated levels will make it difficult for rates to fall quickly. We assume a slow decline in yields as we approach the end of the year and the first rate cut. At that point, we also assume that the trend of curve steepening will begin to take hold. Asset swap credit spreads may stabilize in the face of political risks and a shortfall in VAT revenues on the one hand, and the chance of a smaller supply of fixed-coupon bonds in the face of more retail bond sales and a supply of new inflation-indexed bonds on the other hand.

2024: Forecasts and main risks

Indicator	Our view in December 2023	Our view in June 2024
GDP	Another year of weak economic conditions abroad. Despite the unfavourable international environment, we expect stable GDP growth of around 3% y/y, driven by domestic demand. Our forecast is still above consensus, which, however, started to move upwards after the parliamentary elections. We would also consider raising our forecast if it were not for the weakness of the German economy.	The scenario remains unchanged. The consensus has moved upwards, matching our forecasts.
GDP breakdown	Weakness in the euro area and the strong zloty will make for a difficult year for exporters. Balance of trade will worsen as imports rebound with domestic demand. Consumption will be the main driver of the recovery, and investments will remain in an upward trend, although advancing slower than recently. Reversal of the inventory cycle should support industry but hinder disinflation.	The scenario is without major directional changes, although the first quarter of 2024 brought a stronger than expected recovery in consumption and greater weakness in investments.
Labour market	The economic rebound suggests that demand for workers will not slow down. Unemployment will remain at the record low. Because of the increase of the minimum wage by another 20% and solid increases in the public sector average wage growth in the economy will remain in double digits.	The number of employed people decreased slightly in the first quarter, but we can see signals that this could have been due to supply-side constraints, not demand for labour. Such a situation at the outset of economic recovery is conducive to maintaining high wage growth.
Inflation	Disinflation will slow down, but CPI may still fall at the beginning of the year due to the extension of frozen electricity prices and zero VAT on food. In the second half of the year, we expect inflation to return to 6-7%. External environment is favourable for disinflation of commodity prices, but prices of services remain stubborn. Inflation's return to the target is not moving any closer.	Despite the recovery in consumption and high wage growth, inflation in the first months of the year surprised downwards. In the second half of the year, we still expect CPI to rebound, to around 5% y/y in December, which will be caused by the expiration of anti-inflation shields, with core inflation stabilizing.
Monetary policy	After the elections, the central bank became far more focused on inflation than on GDP growth and unemployment. Rates will remain unchanged until 4Q24, with two rate cuts, 25 bps each, possible at the end of the year.	A clear change in the central bank's reaction function indicates that the MPC will not be in a hurry to ease the policy. We assume that interest rates will remain unchanged until about mid-2025.
Fiscal policy	Negligible chance of accelerated fiscal consolidation after the change of the government, due to the electoral calendar and the previous government's additional spending, among other factors. Fiscal policy will support GDP recovery, but will not tame inflationary pressures.	The scenario remains unchanged.
Fixed income market	An upward adjustment in market rates, especially short-term swap rates and bonds, may take place at the beginning of the year, thanks to distant rate cuts and large issues. However, the size of adjustment may be reduced by low inflation. Later in the year, we expect a gradual decline in rates as the curve steepens.	The beginning of the year brought a significant upward movement in rates, which was not stopped by a temporary drop in inflation below target. The decline in market rates in the next months may be gradual, and the trend of steepening the swap curve may not begin permanently until the turn of the year, nearer the first rate cut.
FX market	In the coming year, we expect a strong and relatively stable zloty, which may be supported by late rate cuts, weaker dollar and higher inflows of EU funds. The threshold exchange rate for profitable exports will constraint the appreciation.	Essentially, our forecasts remain unchanged, although higher political risks in Europe and the US and a stronger dollar may limit the scale of the appreciation.

Economic growth

1

GDP growth: on the path to 3+

In recent months, we have been going through moments of doubt about the pace of recovery in the domestic economy, due to the disappointing monthly data from the first months of the year (especially March). From today's perspective, however, **it seems that the scenario of accelerating economic growth, based primarily on a recovery in consumption, is still valid.**

GDP growth accelerated in 1Q24 to 2.0% y/y, almost exactly in line with our forecast shown in the previous quarterly report (2.1%), and the contribution of private consumption turned out to be even greater than we had expected: its growth accelerated to 4.6% y/y, despite a somewhat disappointing retail sales performance, pointing to the strong role of services in consumer spending.

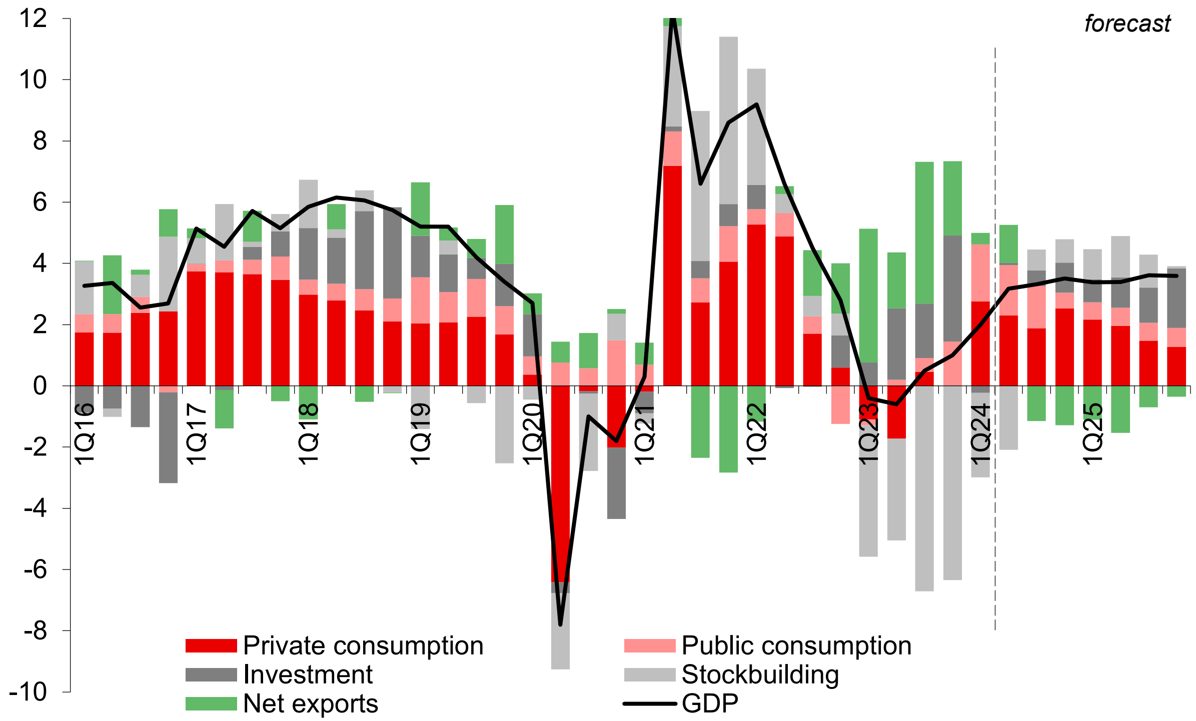
In the coming quarters, we assume a further acceleration of economic growth, to around 3% on average this year and around 3.5% in 2025.

Consumer spending will remain the main driver of growth in the coming quarters, supported by exceptionally high household income dynamics.

In 2025, however, the consumption momentum is likely to begin to lose steam (real wage and social benefits growth will be markedly lower than this year), while the role of the most important growth driver will, in our view, be taken over by investment, supported, among other things, by strong implementation of EU-funded projects.

The risks for next year seem to us to be slightly tilted upwards (mostly on the investment side), but we are still in no hurry to significantly revise our forecasts as long as there are no more convincing signals confirming an improvement in the global and especially European economy.

GDP growth in Poland and its breakdown, % y/y



Source: GUS, Santander

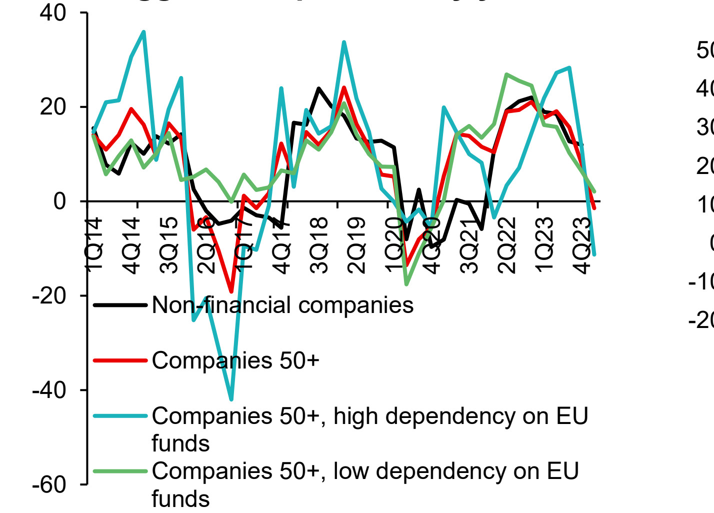
Investment: slowdown in 2024 and then recovery

We have proposed that 2024 would be slightly weaker in terms of investment growth than 2023 due to the end of the settlement period for EU funds from the 2024-2020 financial framework and the end of the election cycle. **The data for 1Q24 indicate that it may be even weaker than our expectations - investment showed a 1.8% y/y decline against a 15.8% y/y increase in 4Q23. We expect a gradual improvement in the following quarters**. We base this assumption primarily on the unblocking of EU funds, highlighted by an increasing number of EU financing contracts. The pace of contracting is similar to previous frameworks, so we do not see "catching up” effect.

The substantial deterioration in investment performance has, in our view, largely come from the corporate sector, as evidenced by the decline in outlays in companies employing 50 or more people in 1Q24. Firms are susceptible to the EU funding cycle and, in addition, have seen deteriorating financial performance in recent quarters, which has historically been a strong disincentive to invest. We assume a gradual improvement in companies' investment prospects, although growth in this area is likely to remain muted.

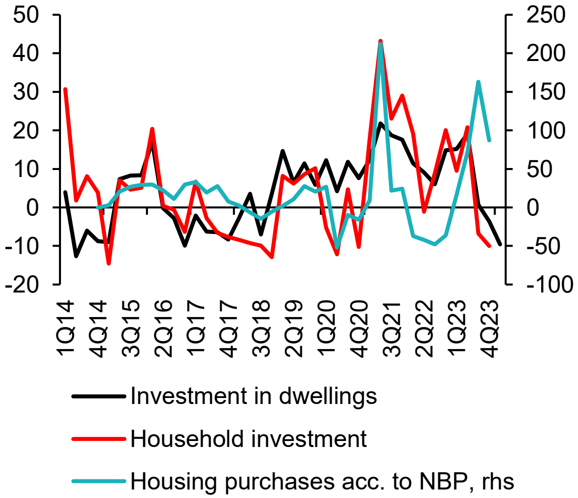
Household investment and related spending on housing look rather surprising. Despite a strong rebound in the housing market in 2H23, evident in credit demand and house prices, GUS data show a decline in investment in these sectors. We have mixed feelings about the reliability of these data, but nevertheless assume moderate growth this year.

Total investment in companies vs. investment in biggest companies, % y/y, nominal

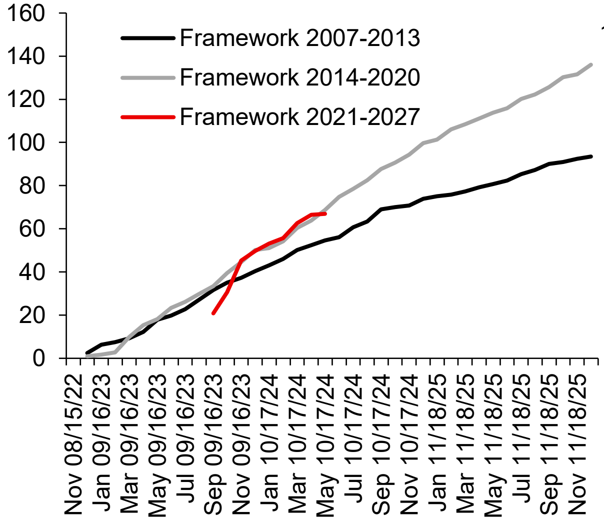


Sectors with high dependency on EU funds: construction, transport,energy, water – based on NBP research

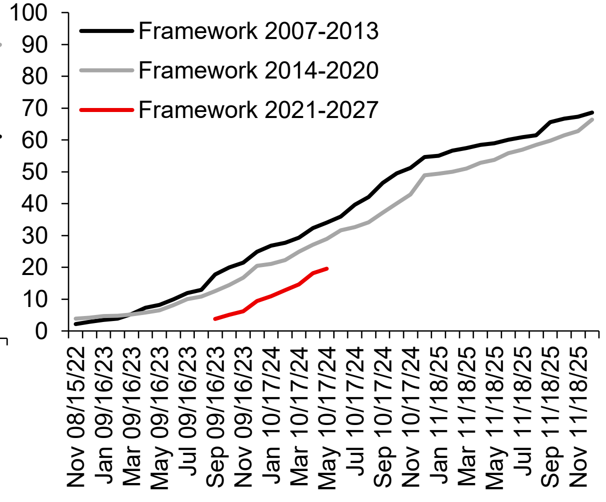
Household investment vs. investment in dwellings, % y/y



Total value of applications, PLNbn



Value of signed EU financing contracts as % of total budget



The time axis puts together corresponding periods of the three EU Multiannual Financial Frameworks, e.g. Feb 2024 in the current MFF with Feb 2017 in the 2014-2020 MFF and Feb 2010 in the 2007-2013 MFF.

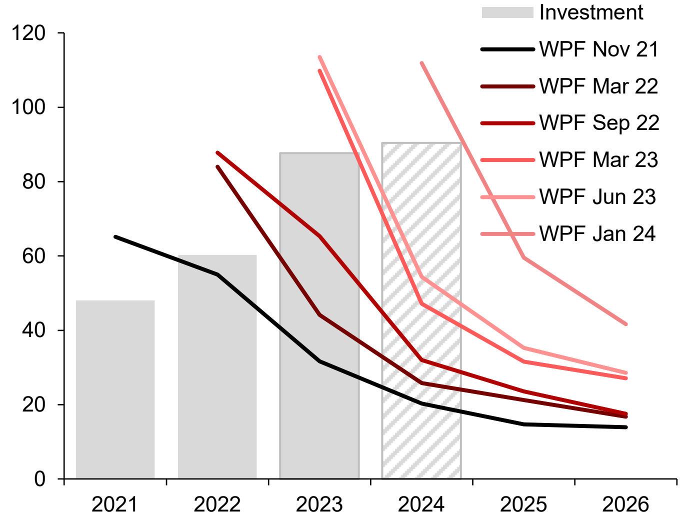
Source: Eurostat, GUS, Ministry of Funds and Regional Policy, Santander

Investment: public sector

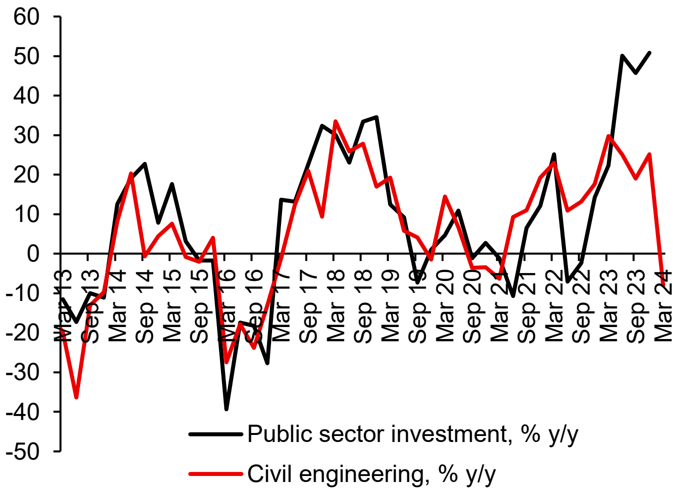
In our December 2023 MACROscope, we suggested that local government investment this year could be similar in nominal terms to 2023, translating into a zero or even negative contribution to total real investment growth. The recently published Multiannual Financial Plan (WPF) supports our expectations: local governments are forecast to spend PLN111.9bn on investments in 2024. Their plans for 2023 at the beginning of last year were at PLN109.8bn, suggesting a slight increase in nominal terms. Figures for 1Q24 showed a 7% y/y increase, which we believe is related to the completion of investments started earlier, and we expect this growth rate to decrease in subsequent periods.

However, we remain fairly optimistic about the outlook for central sector investment. While civil engineering production data suggests a slump in public sector investment in 1Q24, we assume that this data may paint a slightly overly pessimistic picture, especially in the face of the GDDKiA (national road agency) data showing that it increased its capital expenditure by 20% y/y in the first four months of the year. Also, military spending will be supporting the sector's outlays, although it is worth noting here that data on arms and ammunition imports suggest some slowdown in recent months. We also note that since mid-2022, around 40% of Polish arms and ammunition imports come from Bulgaria. As we did not find information on significant arms contracts with this country, and the Bulgarian defence minister said that most Bulgarian arms exports go to Ukraine, we assume Ukraine could be also the final destination of Polish imports from Bulgaria. This means that almost half of the country's arms imports are not part of the actual investment expenditure.

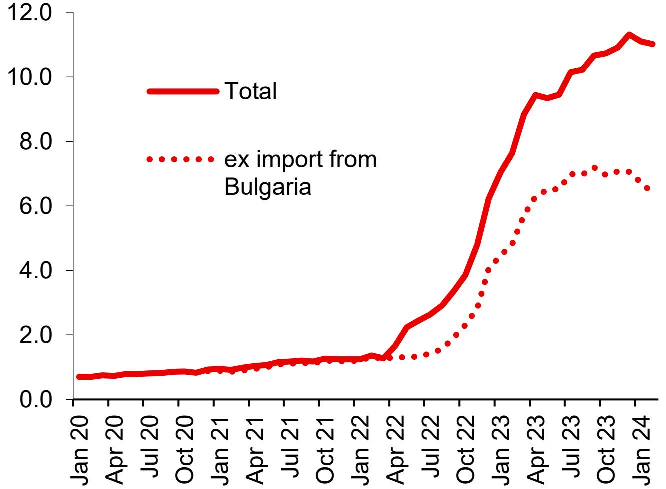
Local governments' investment – plans in WPF and realisations, PLNbn



Public sector investment vs civil engineering spending, % y/y



Imports of arms and ammunition, PLNbn, 12-month sum



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Source: Eurostat, GUS, Santander

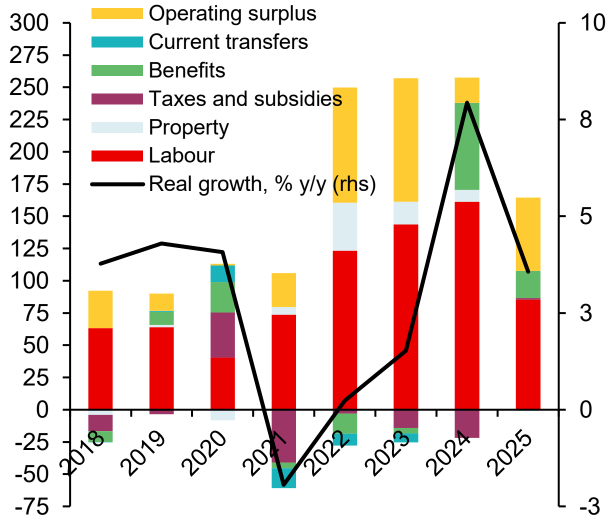
Consumption: upward surprise

We have been claiming for some time that this year will be a very good year for consumers. The strong private consumption print for 1Q24 (+4.6% y/y) supports this view. A marked improvement in consumer spending is also evident in card spending by Santander Bank Polska's (SBP) customers - the rebound has been evident since mid-2023, and services are an important component of the improvement - according to our data, real spending growth on services exceeds 20% y/y.

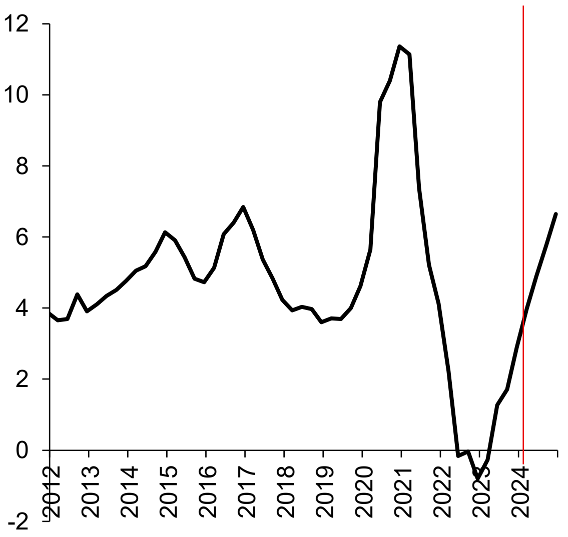
The fall in inflation, amid still strong wage growth and high indexation of social benefits (and the post-election introduction of new ones) will result in the highest gross disposable income growth in real terms in years. With our assumptions on consumption (**growth of around 4% in real terms**), households will still have plenty of room to increase their savings rate - from 3% at the end of 2023 to 7%, in our view, at the end of 2024.

In our view, in 2025 the disposable income will slow down, but it will nevertheless continue to remain solid, enabling consumption to increase. However, its growth rate will not be as high as this year, in our opinion.

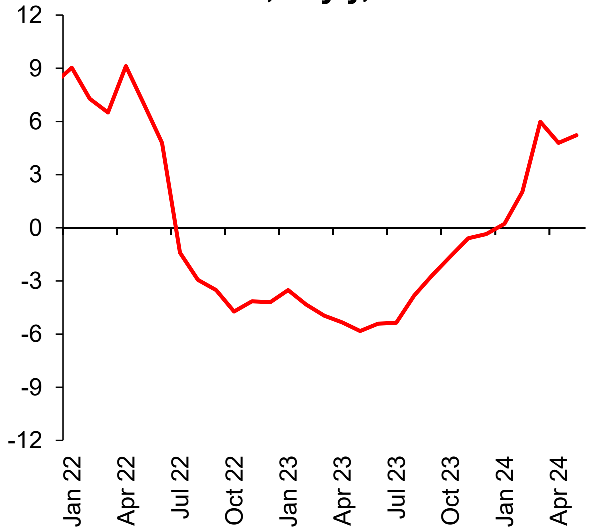
Household disposable income, % y/y



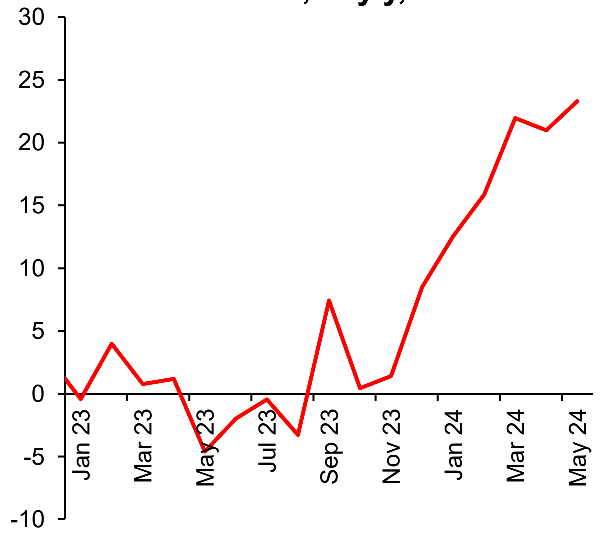
Saving rate, % (4QMA)



Average card payments of SBP clients, % y/y, CPI-deflated



Average services card payments of SBP clients, % y/y, CPI-deflated



Source: Eurostat, GUS, Santander

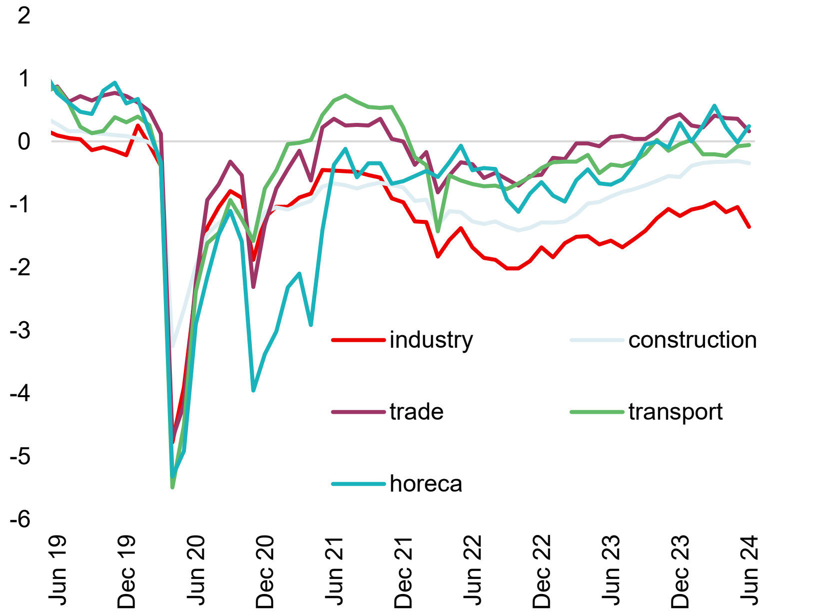
Industry: the weakest link or a compressed spring?

Industrial sentiment, despite a gradual improvement over the past six quarters, remains worse than in other sectors. The PMI has remained below the neutral 50-point level for two years and has fallen sharply in the last three months.

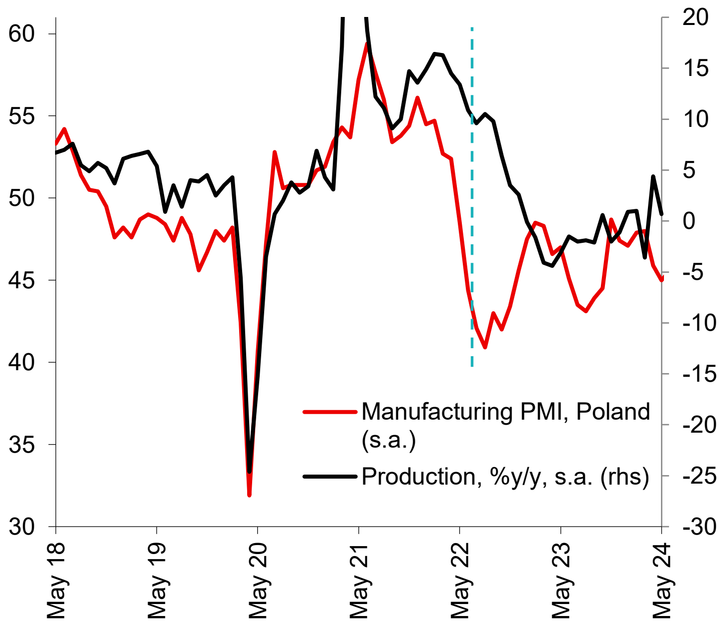
In our view, **the business surveys draw too negative a picture of the industry**. Actually, since mid-2022 the manufacturing PMI seems to be negatively correlated with industrial output. The powerful unwinding of the pandemic shock to Polish industry at the end of 2021 and in 1H22 made 2023 look like a year of stagnation. The prolonged wait for a rebound in Europe also left its mark. However, production levels returned to the pre-pandemic trend in the middle of last year and have been moving in line with it ever since, in line with our forecast made a year ago (although in recent months strong calendar effects prevent a clear conclusion if it is still following the trend).

Economic conditions in Europe have started to improve and domestic consumption growth has restarted. This should keep **domestic production around the pre-pandemic upward trend line in the second half of the year**, in our view.

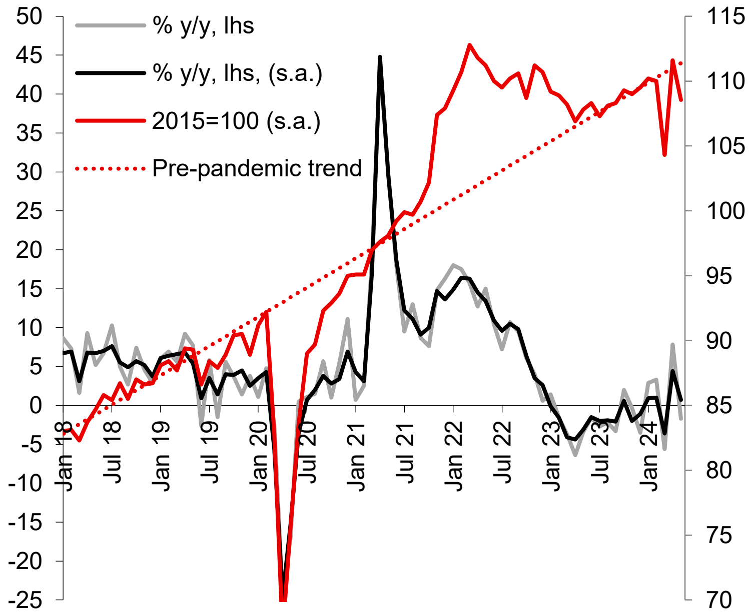
Sectoral business climate indicators, standardised



Industrial output in Poland vs. PMI



Industrial output in Poland



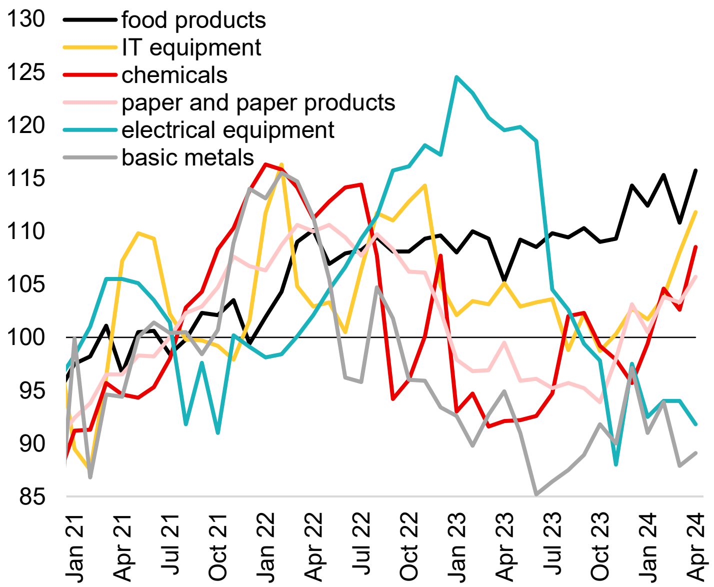
Source: Eurostat, GUS, Santander

Industry: the weakest link or a compressed spring?

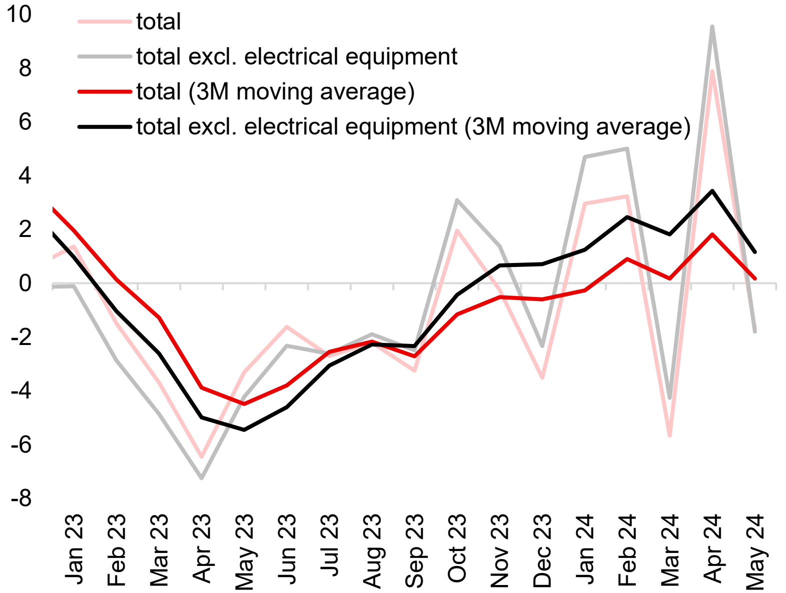
Many industries, especially those with stronger foreign exposure, have remained stagnant over the past quarters. Their production volumes were flat or even declining in 2023. For several months now, however, a positive change has been visible. **A number of industries are showing a breakthrough of the weakness and stagnation of 2023**, e.g. foodstuffs, the paper industry, chemicals and electronics.

On the other hand, there are few industrial sectors whose production remains at a reduced level - such is the case in the production of metals and electrical equipment. In the case of the latter category, it is a matter of a global weakening in demand for lithium-ion car batteries - a consequence of the decline in sales of electric cars in Western Europe after some governments withdrew subsidies. Poland has been heavily involved in car battery production over the past few years. We believe the demand should return as part of the green transition and consumers regaining a sense of real income growth after a period of high inflation (and the introduction of EU tariffs on EVs from China). **Had it not been for the performance of EV production, the path of the industrial rebound would have been steeper, allowing annual production growth (smoothed by the 3M average) to break above zero as early as November instead of February**. However, the May weakness in industrial output reminded us that in this business cycle it is safer to expect a gradual and shaky rebound rather than a decisive one.

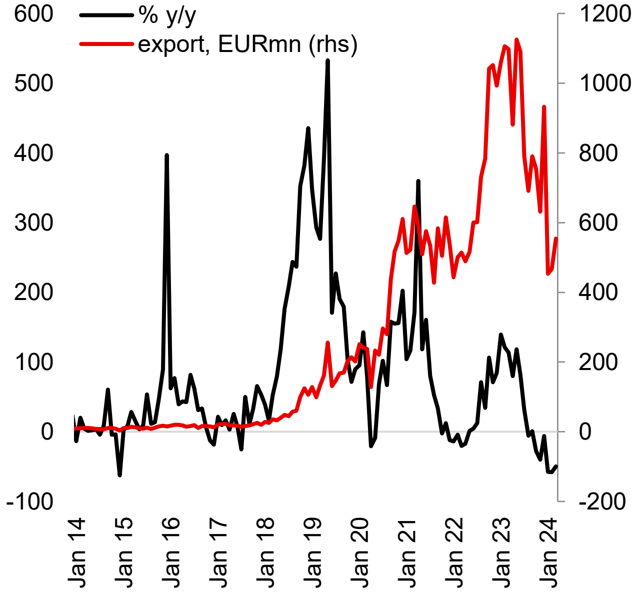
Volume of production – selected industries, s.a., 2021 average = 100



Industrial production, % y/y



Export of lithium-ion batteries



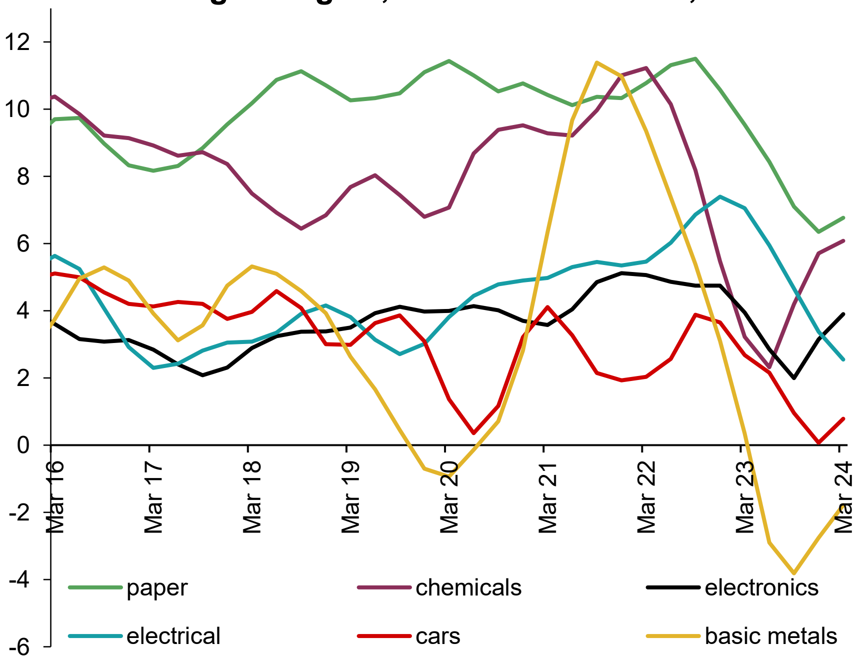
Source: Eurostat, GUS, Santander

Industry: margins up, leader of durable goods rebound

The assessment of the condition of the industrial sector in Poland can also be approached from the perspective of average margins. We assume that companies in industries facing weak demand are generally cutting margins, while those that can afford to raise them are apparently already operating in an improving market, in an environment marked with economic recovery. **Over the past few quarters, average margins have turned a corner in many areas of Polish industry, reinforcing our belief that the sector has moved into a rebound phase**. We obtained this result by smoothing the margins with a statistical filter extracting trend plus cyclical changes.

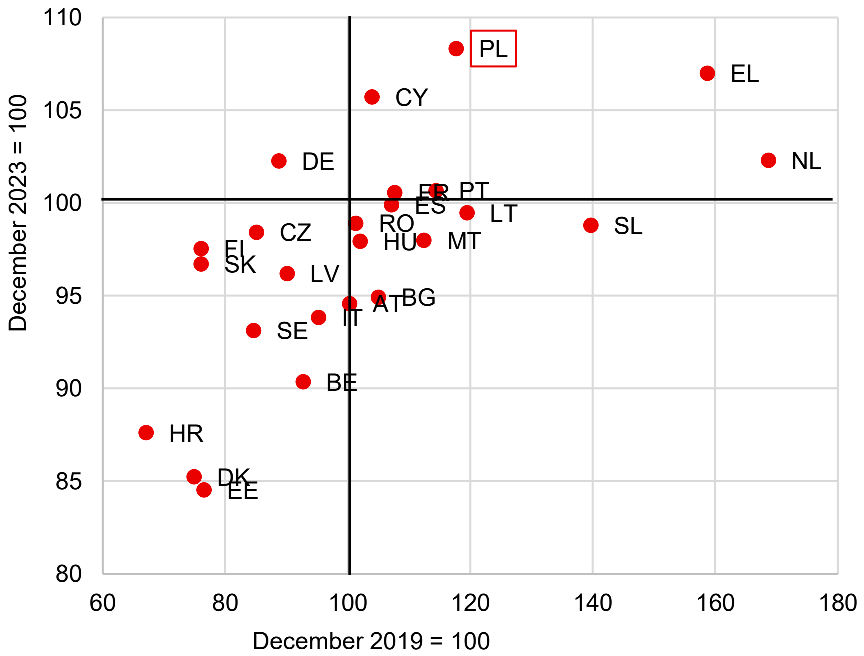
Poland remains at the forefront of EU countries in terms of the scale of the rebound in production relative to pre-pandemic levels, not only at the total production level, but also at the level of the main industrial groupings. Domestic industrial sector ranks, however, in the middle of the EU pack when it comes to the change in production levels this year. The exception is **consumer durables, in the production of which Poland has shown the strongest rebound this year of all EU countries**. This is an area of production where Poland is an important supplier to Europe.

Average margins, selected industries, %



Data smoothed with a statistical filter which extracts the trend and cyclical component

Production volume of consumer durables, s.a.



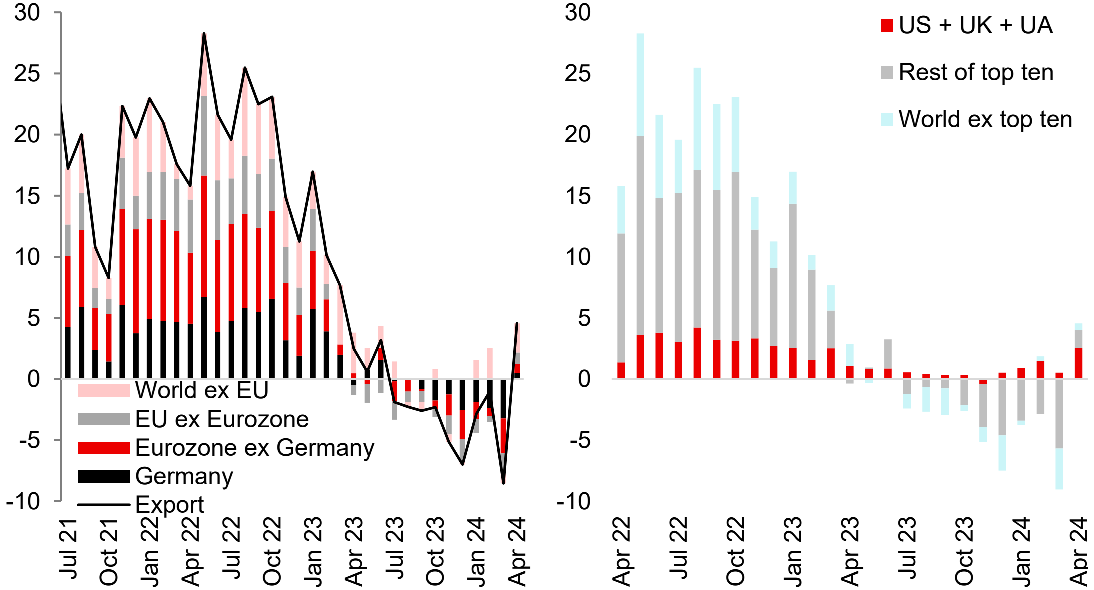
Source: Eurostat, GUS, Santander

Export: what budged, the vectors of rebound

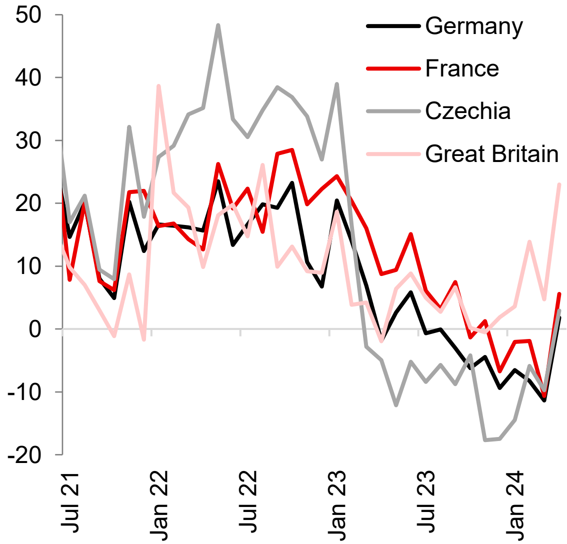
Since mid-2023 until March this year, the annual growth of merchandise exports, as shown by the stats office, remained negative. This consisted of negative contribution from both exports to Germany, the rest of the euro area, the EU countries outside the euro area and the non-EU countries taken as a whole. The latter category managed to contribute positively to the total export growth in some of the months, which shows that in the conditions of a weak economic situation in the EU, Polish exporters have been looking for other destinations. However, the result of this category is significantly influenced by shipments to Ukraine, where the high export growth may be related to the transit of international aid. In April, total exports have already started to grow y/y.

Due to the large share of the EU in Polish exports (75%) and in the light of the first signs of recovery in Europe, it is generally better to follow the growth prospects of the main export recipients rather than the possibility of developing new trade directions in order to assess the potential of Polish export to grow this year. However, it is worth noting that the top ten recipients include three non-EU countries (the UK, Ukraine, the USA), which receive a total of over 12% of Polish goods, the average export growth for the last three months for each of them exceeded 10% y/y and in April alone 20% y/y. **Market forecasts collected by Bloomberg for GDP growth in the top ten recipients of Polish exports have recently shown the first rebound in expectations for 2024 in a long time**. However, these growth assessments for both 2024 and 2025 are still significantly worse than a year ago, although at a similar level as at the turn of the year.

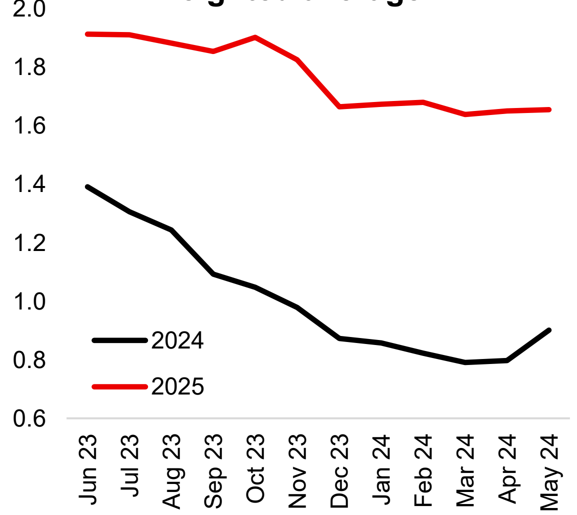
Export growth structure, in EUR, % y/y (different approaches)



Polish export growth to top partners, % y/y



Evolution of economic growth forecasts regarding 10 top receivers of Polish export, weighted average



Source: Eurostat, GUS, Bloomberg, Santander

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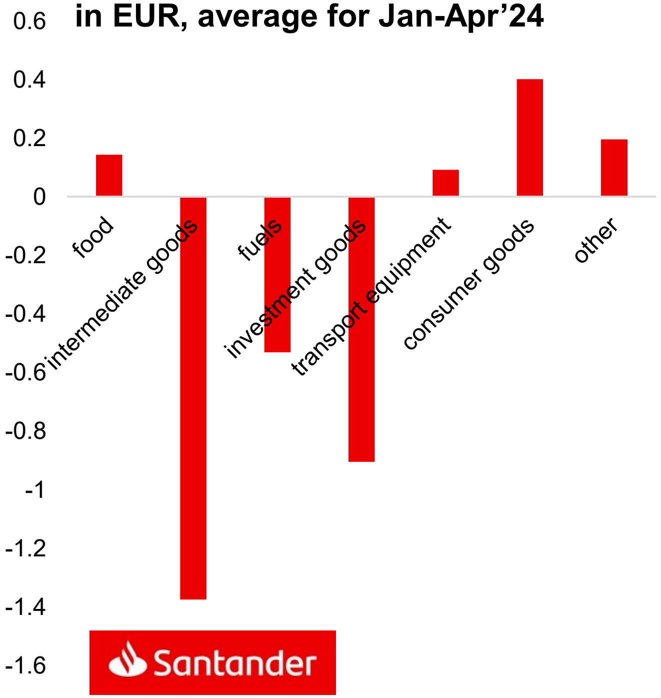
Export: what budged, the vectors of rebound

The categories of goods positively affecting Poland's annual export growth this year are consumer goods, foodstuffs and means of transport (vehicles and parts), as well as a residual category including military equipment.

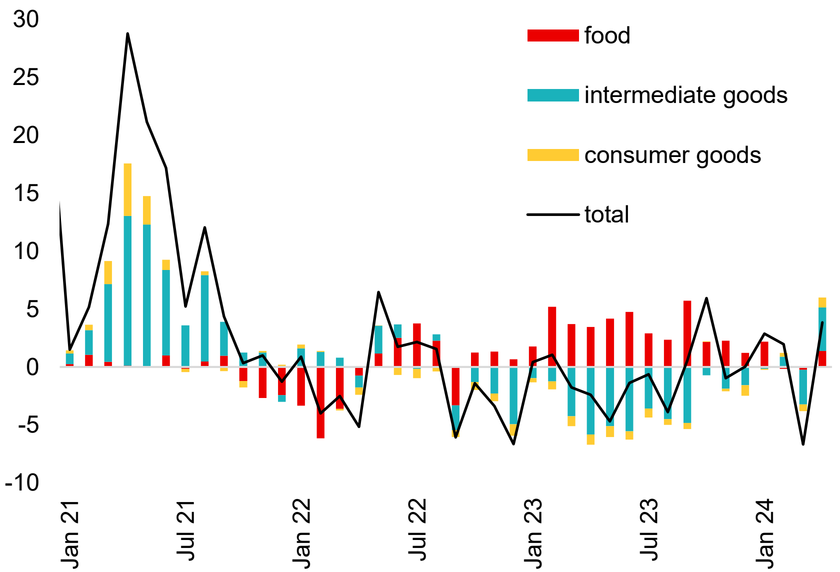
In contrast, intermediate goods, whose behaviour is linked to the European business cycle, were still the most negative contributor. **A rebound in the EU would take the brake off the growth rate of Polish exports**. This is a key category usually generating around 25% of export receipts and usually underpinning the total export growth. The data for April alone suggest that such a removal of the brake in intermediate goods is taking place right now. However, positive statistical effects were strongly at work in that month, so one should be cautious in drawing conclusions.

Despite the obstacles in the form of a strong zloty, rapidly rising labour costs and, before that, energy costs, **the share of imports from Poland has been increasing in the European market over the past year**, in line with a multi-year trend. In the case of durable goods, Poland's share was higher in 2021 than it is now, but this happened under exceptional circumstances (home retrofitting after the outbreak of the pandemic) - in general, based on the example of previous business cycles, it can be assumed that the recovery in Europe should be conducive to increasing Poland's share in this class of goods.

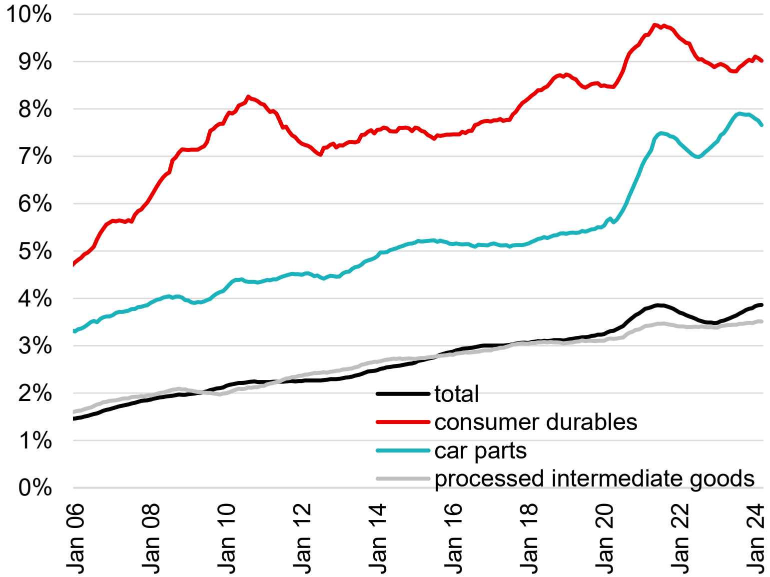
Contribution to export growth, y/y, in EUR, average for Jan-Apr'24



Contribution to export growth, y/y, selected categories of BEC classification, data on export weight



Share of import from Poland in total EU import



Santander

Source: Eurostat, GUS, Santander

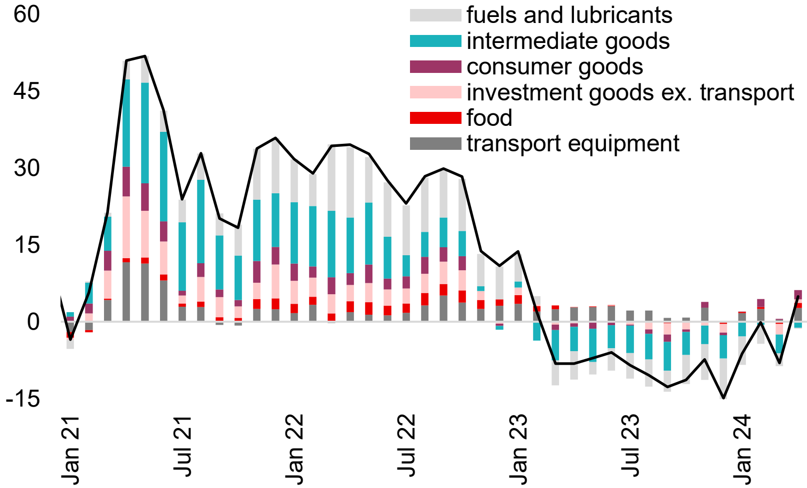
Import: energy commodities still have impact

According to the data on the value of goods shipped to Poland, last year's large declines in imports were primarily driven by lower deliveries of energy commodities and intermediate goods. 2023 was a year of negative base effect after an unusually strong increase in imports of energy commodities in 2022, which occurred due to both a radical increase in their prices and a several dozen per cent increase in the volume of supplies. The effect has faded and now energy commodity prices are relatively stable. It does not, however, mean that their imports will no longer have a large impact on Poland's total import growth. Poland currently imports these commodities to a large extent by sea, so every now and then a large surge in imports will occur with the arrival of a ship. The effect of the resignation from raw materials deliveries from Russia by pipeline will therefore be greater volatility in the import data. In April, for example, the country with the largest contribution to the rebound in total merchandise imports was Saudi Arabia. The monthly increase in the value of shipments from this country was 60% and the annual increase accelerated to 105% from -27%.

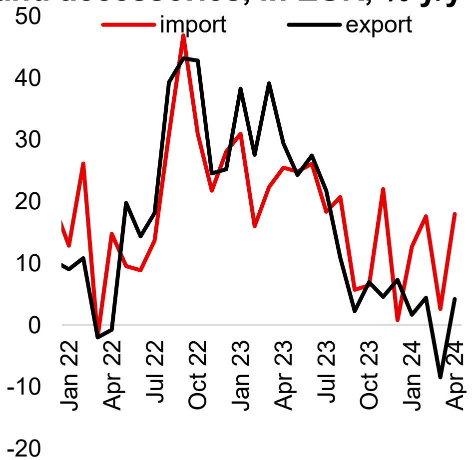
In contrast, the weak imports of intermediate goods last year were related to the underperformance of Polish industry. The high correlation with industrial production suggests that a significant demand for intermediate goods from abroad will come together with the improvement in industry that we expect.

The elements that have recently contributed significantly to the improvement in import flows are food, consumer goods and intermediate goods. In this respect, **the import data are consistent with our scenario of a recovery based on domestic demand**, particularly private consumption. A comparison of the behaviour of exports and imports of goods constituting large one-off household expenditures (cars, white goods, A/V and IT equipment), suggests that a positive change in consumer attitudes has occurred faster in Poland than in our EU trading partners.

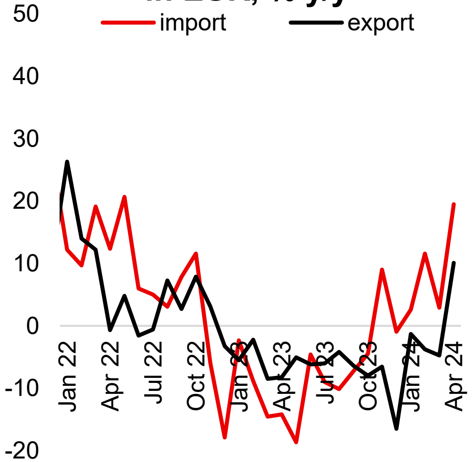
Contribution to import growth in EUR, % y/y



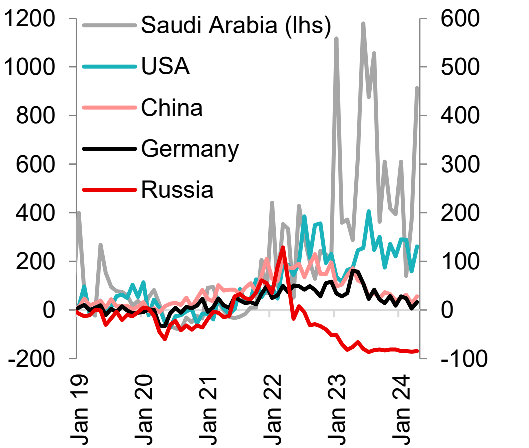
Transport equipment, parts and accessories, in EUR, % y/y



Consumer durables, in EUR, % y/y



Import value from selected countries, % change vs. 2019 average



Source: GUS, Santander

Labour market

2

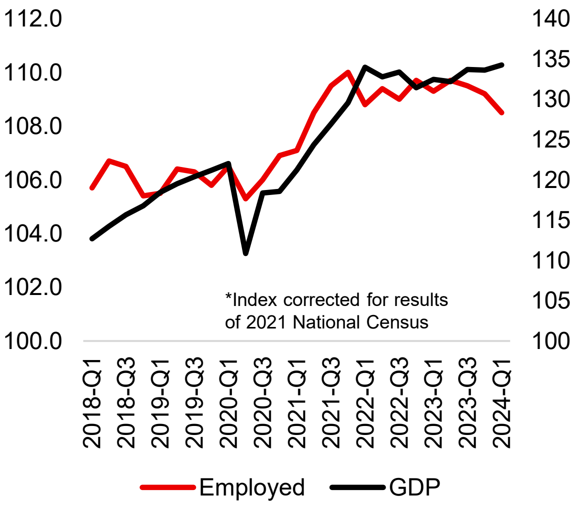
Lower employment: demand or supply effect?

The beginning of the year, despite the recovery in economic growth, brought a deterioration in employment statistics. The number of employed people in the first quarter fell by 170k y/y according to the National Accounts data and by almost 140k according to the LFS. At the same time, however, the GUS's labour demand survey revealed the first increase in the number of job vacancies in 1Q in two years (by 15.3% q/q), and the NBP's Quick Monitoring indicated a return of the percentage of companies with vacancies above the multi-year average.

Such seemingly inconsistent signals may indicate that the recorded **weakness in employment may be more the result of constraints on the labour supply side than a decline in labour demand**. Such a situation is certainly facilitated by the negative demographic trends we are currently observing (see page 19).

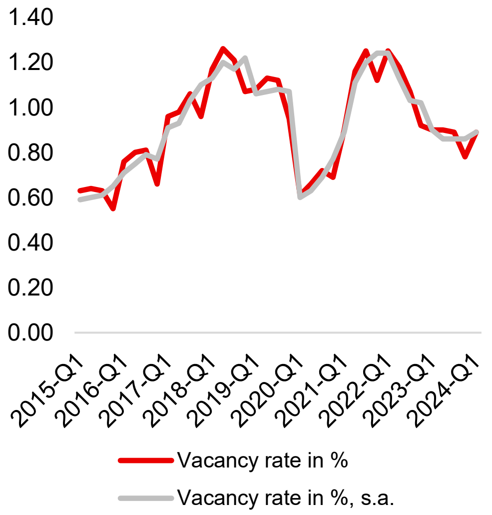
A signal that does not quite seem consistent with this diagnosis is the simultaneously rising (slowly but nevertheless) number of the unemployed people - according to LFS by +40k y/y in 1Q24. Nevertheless, the unemployment rate still remains very close to record lows.

Number of the employed* vs GDP, 2015=100, s.a.



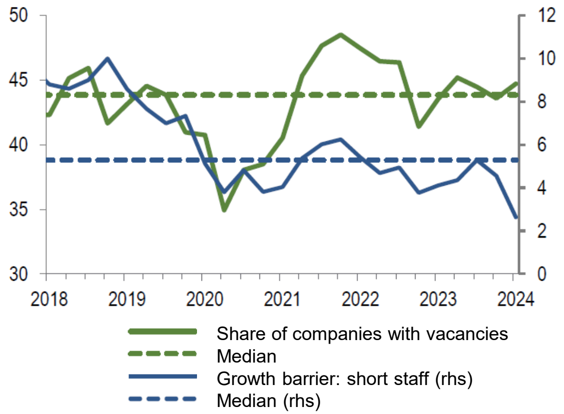
Source: Eurostat, Santander

Indicator of vacancies, %



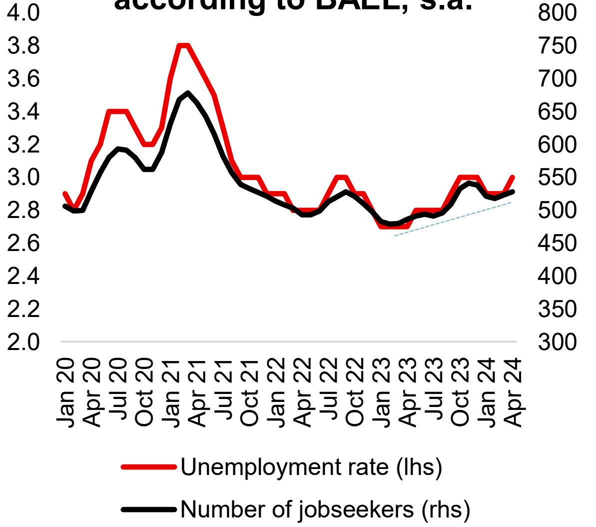
Source: GUS, Santander

Share of companies with vacanies and complaining that short staff is a growth barrier, %



Source: NBP Quick Monitoring

Unemployment rate and number of jobseekers according to BAEL, s.a.



Source: Eurostat, Santander

Santander

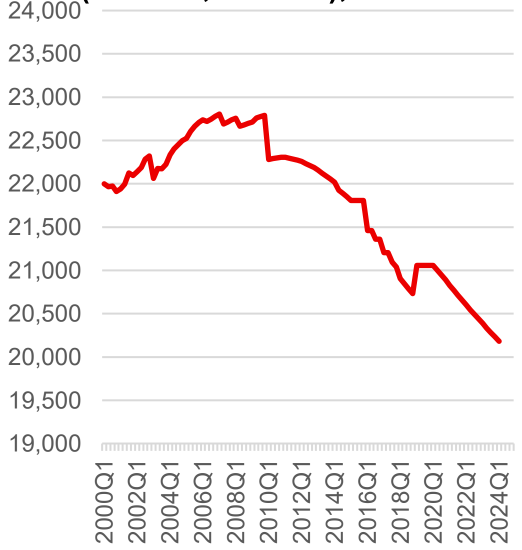
Deteriorating labour market demographics

The number of people in the professional prime age (between 20 and 60/65) has been in a strong downward trend for a long time (having decreased by over 200k per annum in the last few years) and this trend will continue in the coming years. The impact of this phenomenon on the domestic labour market has so far been successfully neutralised by an increase in professional activity and labour migration – as a result, despite the shrinking working-age population, the number of people working in the economy has stabilised in the last two or three years at a record high of over 17 million.

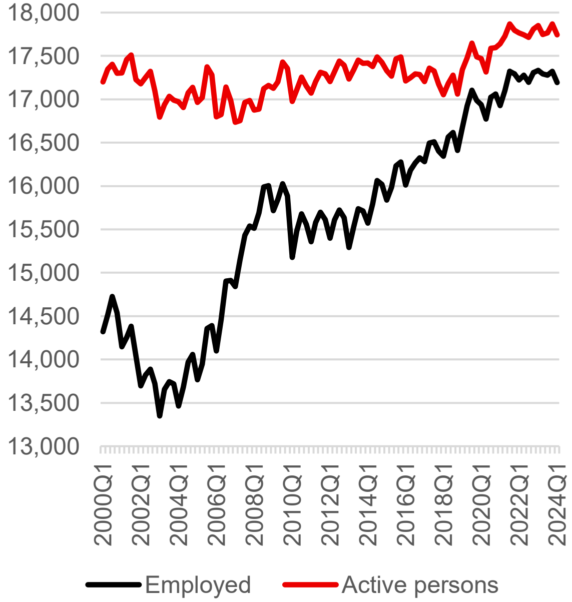
Have we already used up all the reserves of the labour market? Probably not, but it looks like the so-called low-hanging fruits have already been picked. The economic activity rate has increased strongly in the last few years and, as a result, Poland is now above the EU average, and the potential for further growth is becoming more and more modest. There are still groups in which economic activity deviates downwards from patterns in developed countries (in particular: young people under 20 and women aged 60+). However, a significant change in their behaviour may be difficult and require appropriate policies.

According to our estimates, in an extremely optimistic (although not very realistic) scenario, in which it is possible to raise economic activity to the EU maximum in each age group, theoretically as many as 4.8mn more people (!) could be activated on the Polish labour market. In a more realistic scenario, when it is possible to activate young and old people to the EU average, the **potential increase in the number of available workers is about 800 thousand**.

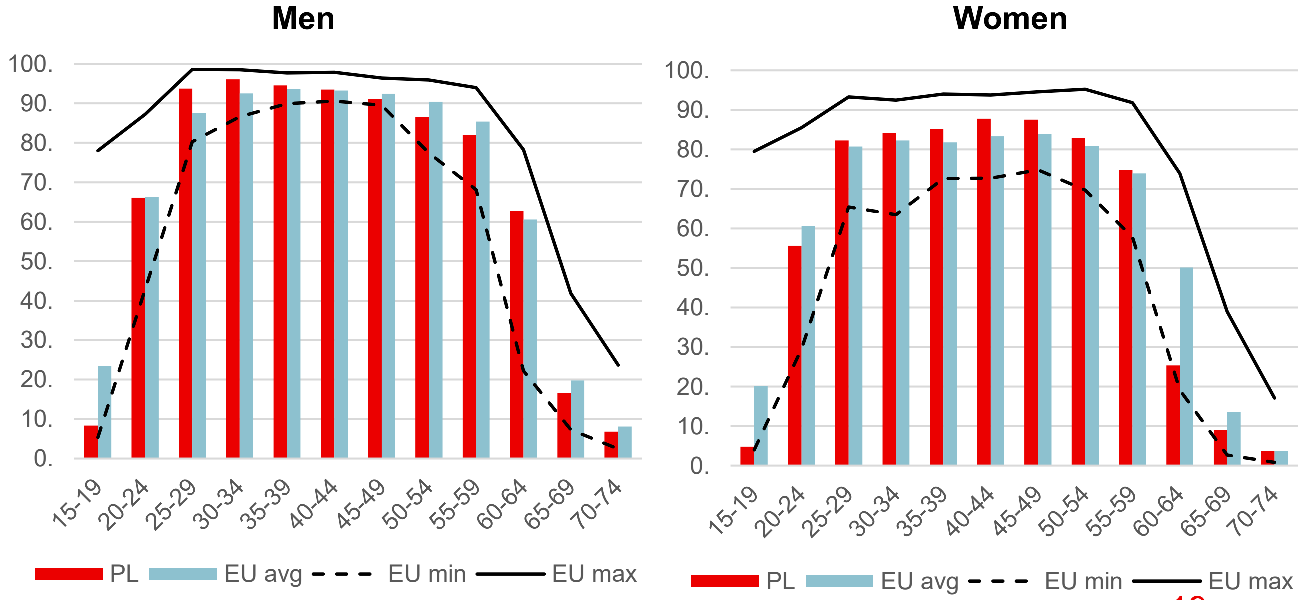
LFS prime age population (W20-59, M20-64), thousands



Number of workers and economically active, thousands



Labour participation rate by age cohorts (4Q23), %



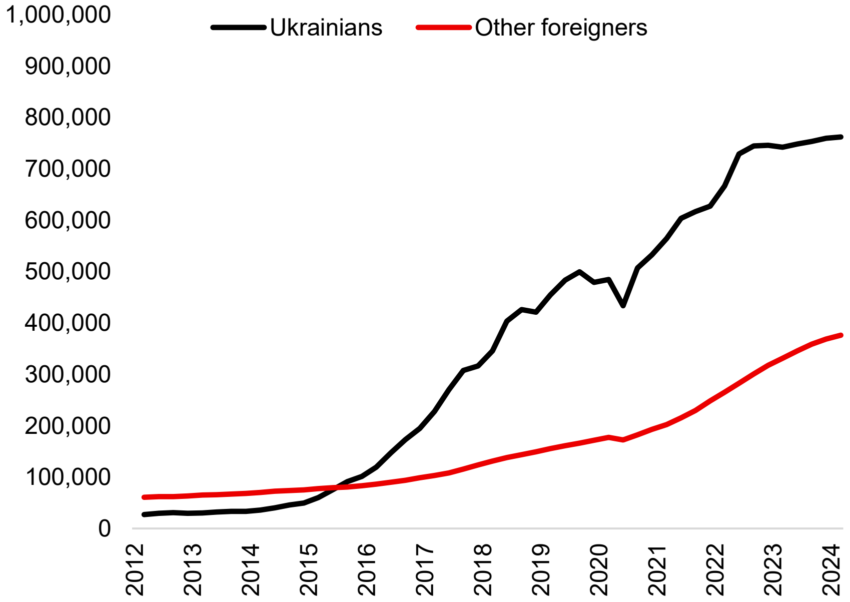
Source: Eurostat, Santander

Lifelines: migration and sectoral realocation

The influx of foreign workers continues to be a lifeline for the Polish labour market. While migration from Ukraine has basically exhausted its greatest potential (ZUS data still indicate a slight, but clearly fading increase in the number of registered Ukrainians; PESEL data suggest stabilisation for about six months at about 955 thousand), the upward trend in registered foreigners from other countries continues. However, the scale of the phenomenon is moderate: **the number of foreigners registered in Social Security (ZUS) is growing at a rate of 40-70 thousand per year, i.e. 3-4 times slower than the pace at which the domestic working-age population shrinks** (it should be remembered, however, that the ZUS statistic covers only people officially employed; the actual scale of the influx of migrants may be greater, some of them probably find work in the informal economy).

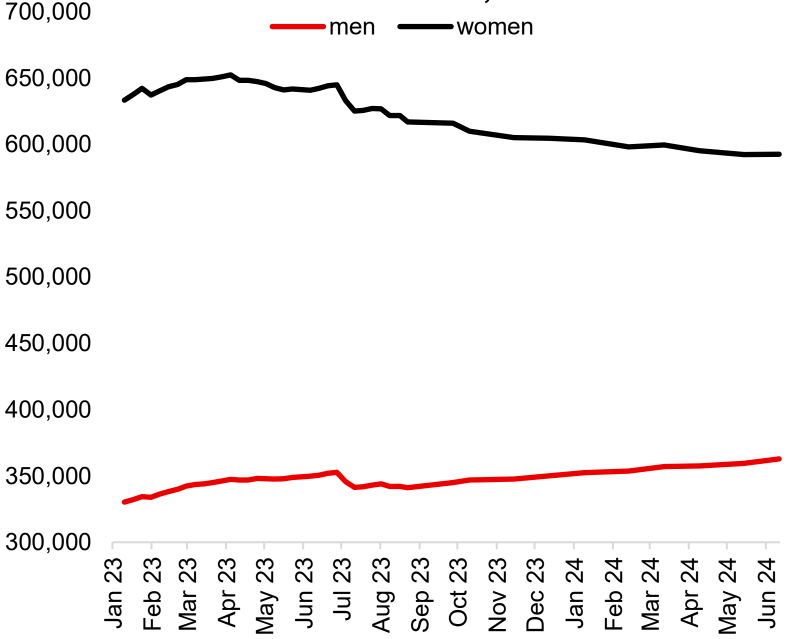
Another safety buffer for the Polish labour market is the potential for a more optimal allocation of employees between sectors. For example, 8% of working population is still in agriculture (almost 1.5mn) while in most developed countries the percentage of employees in this sector is 2-3 times lower. The reallocation of workers from less to more productive sectors is already underway and will probably continue before the shortage of workforce becomes a hard development constraint for domestic companies.

Foreigners registered in ZUS



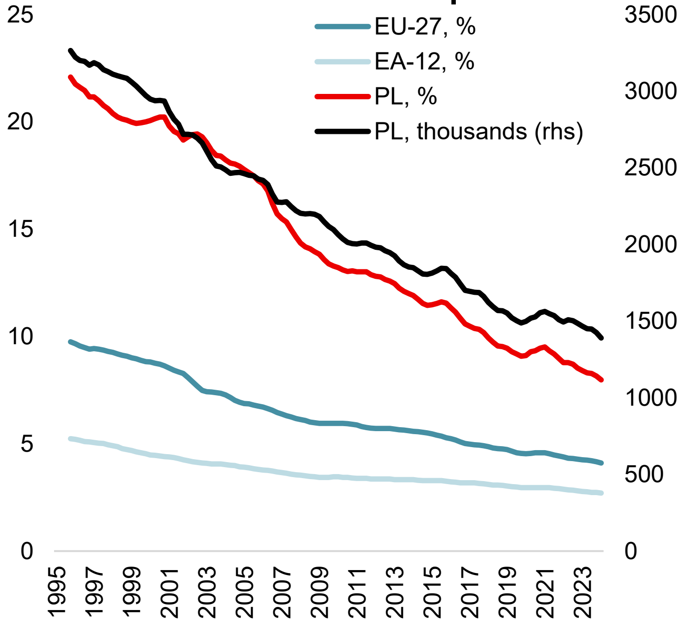
Source: ZUS, Santander

Number of people with registered PESEL UKR number, thousands



Source: dane.gov.pl, Santander

Employment in agriculture: Poland vs Europe



Source: Eurostat, Santander

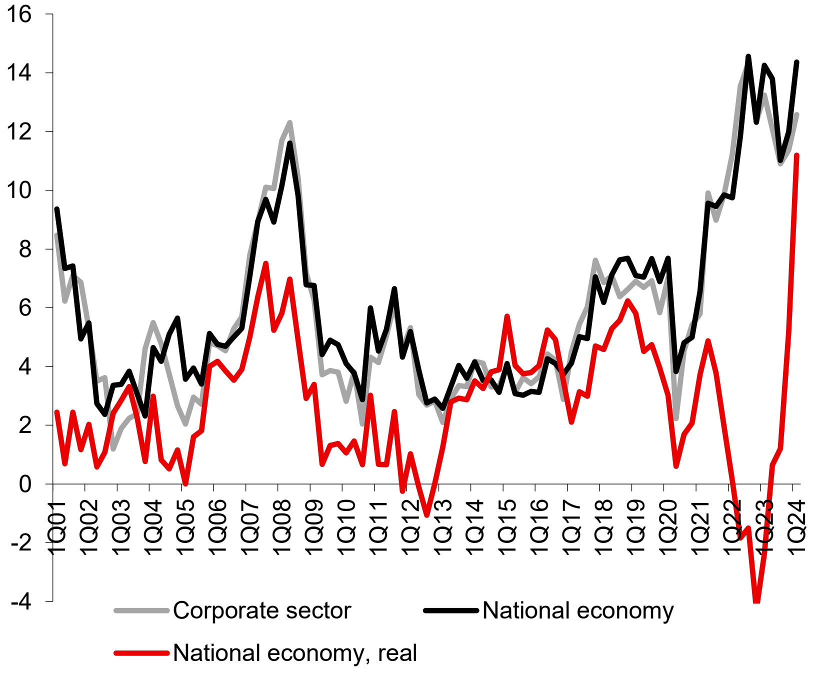
Santander

Wages grow at the fastest pace in 20 years

Despite a marked slowdown in inflation at the beginning of the year and a slight decline in employment, wage growth remains at an exceptionally high, double-digit level – the highest since the late 1990s. This can probably be attributed in part to regulatory issues: the minimum wage has risen sharply again this year. But at the same time, it also seems consistent with the growing importance of the supply side constraints, which is mentioned on the previous pages.

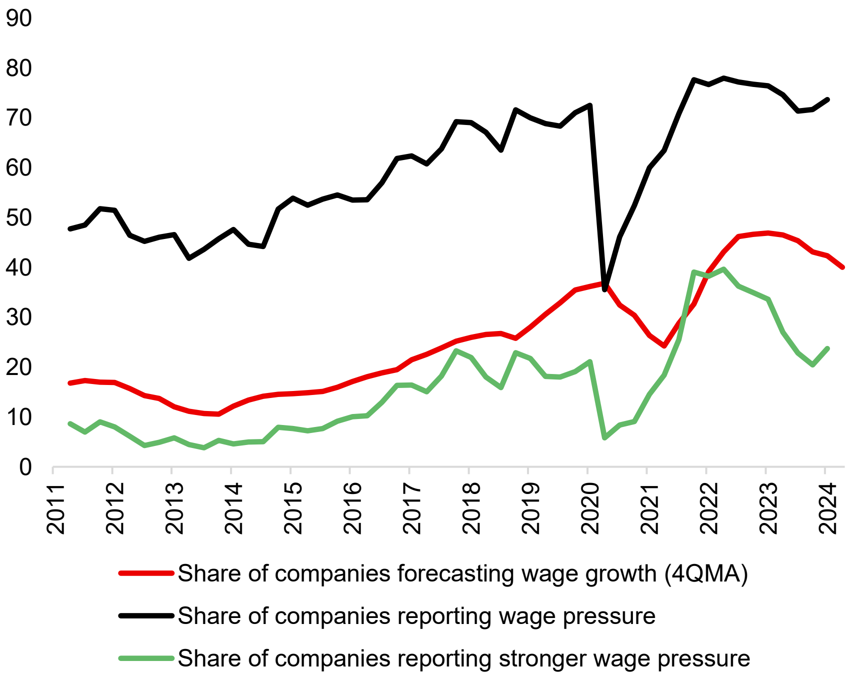
However, business surveys suggest that companies are gradually feeling less and less pressure to increase wages. In our view, **wage growth will remain at a double-digit level in the coming months, but in 2025 it should slow down to 7-8% y/y**, which will be supported on the one hand by the observed inflation, clearly lower than in 2022-2023, and on the other hand by a smaller scale of the minimum wage increase – approx. 7.6% y/y according to the latest government proposal. In 2025, salary increases in the public sector will also be much more modest than this year.

Wage growth, % y/y



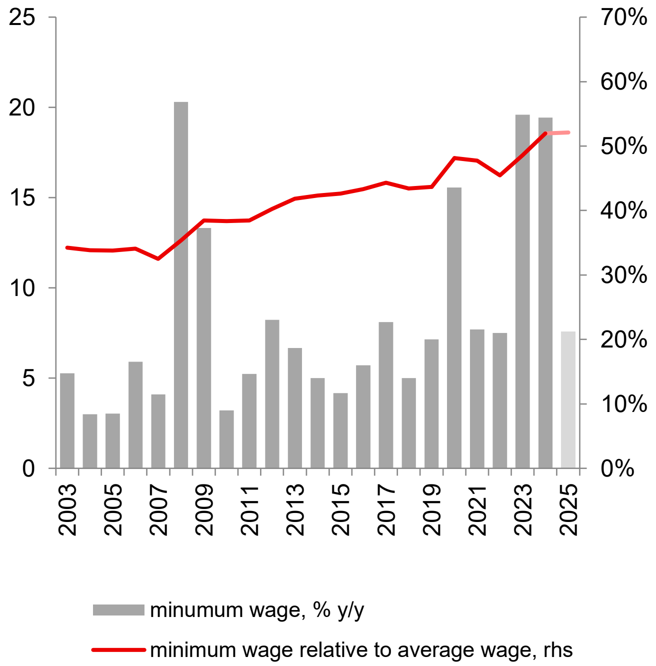
Source: GUS, Santander

Wage pressure according to NBP Quick Monitoring, %



Source: NBP Quick Monitoring

Minimum wage



Source: GUS, Santander

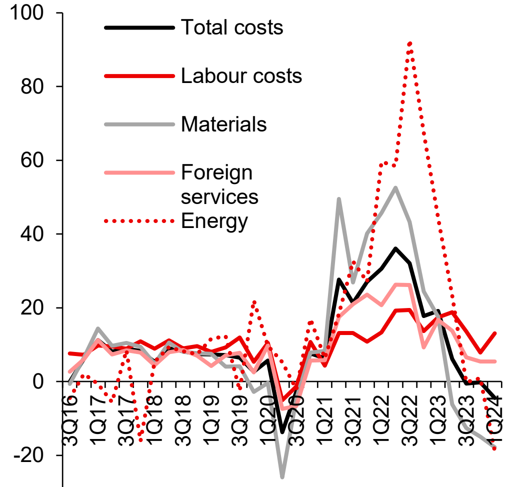
Santander

Wage growth will hinder the margin improvement

High wage growth will translate into rising labour costs on companies' balance sheets. Already in recent quarters, labour costs have become the fastest-growing component of companies' costs and, in our view, this will continue to be the case at least until the end of this year.

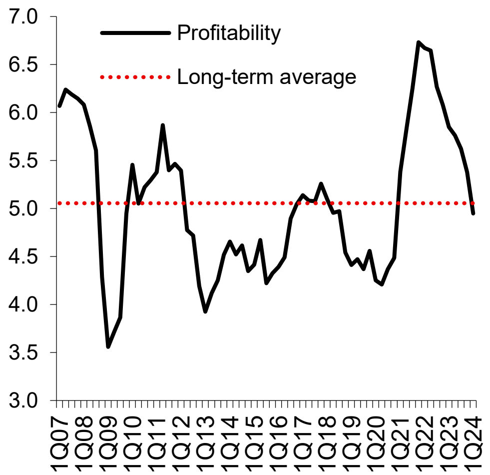
In 2023, companies faced a sharp decline in profitability, which in our view was primarily due to the weaker economy and occurred despite a decline in total costs. In 2024, **the economic recovery should help companies to rebuild lost profitability**. However, this will be more challenging in sectors where labour costs make up a bigger part of the balance sheet. In these sectors, we believe **there may be more pressure to improve margins through retail price increases**. Our analysis indicates that the ratio of labour costs to financial results is highest in services, in particular healthcare, administration and transport, professional, scientific and technical activities. Manufacturing, construction and energy are more resilient to wage increases, although there are also sectors within manufacturing that are more labour-dependent, such as clothing and furniture manufacturing.

Costs of companies employing 50+, % y/y



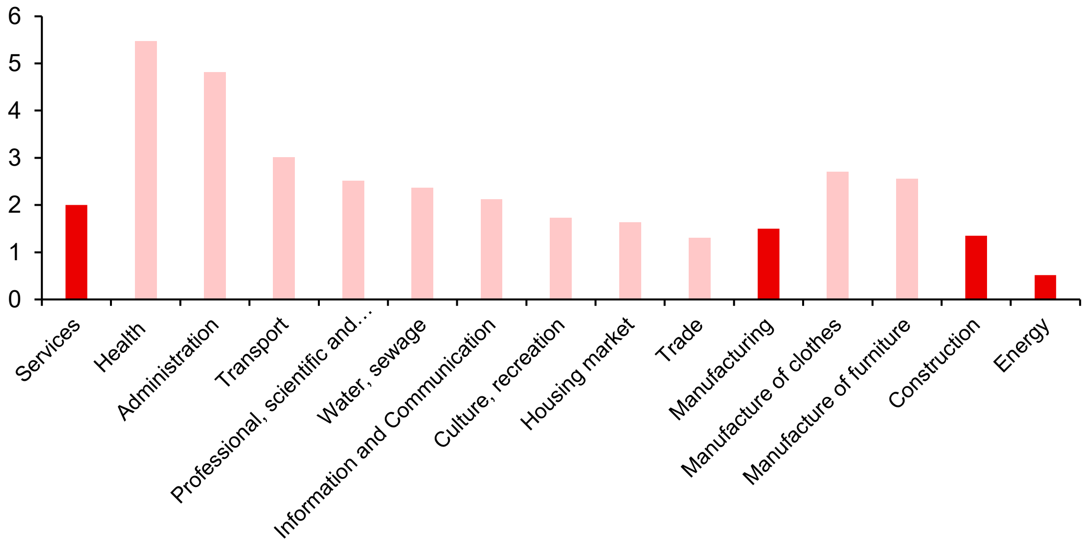
Source: GUS, Santander

Profitability of 50+ companies, %, 4-quarter moving average



Source: GUS, Santander

Labour costs as muplitple of net financial results in companies employing 10 and more people, 2018-2023 average



Source: GUS, Santander

Santander

Inflation

3

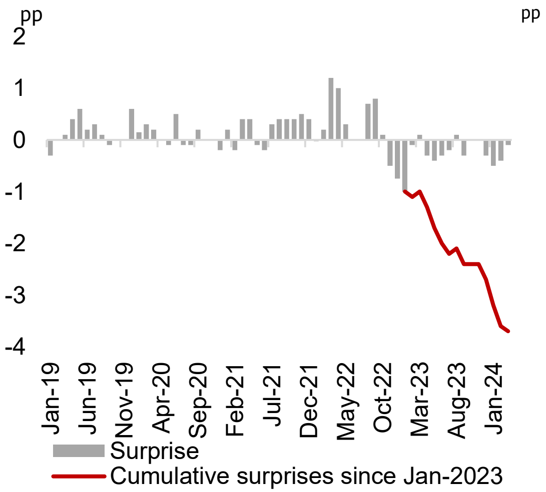
Inflation continues to surprise downwards

Inflation has started to rise, but so far quite sluggishly – in May it rose to 2.5% y/y and it was the sixth month in a row when the reading turned out to be lower than market forecasts, with the sum of surprises since the beginning of 2023 at -4.1 percentage points. Systematic errors in forecasts indicate that economists (including us) are still unable to satisfactorily explain price behaviour in a rapidly changing economy.

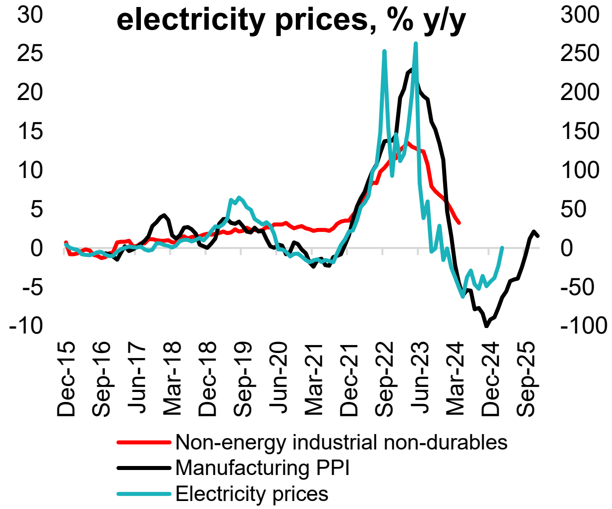
In retrospect, we believe that there were many sources of surprises: underestimating the impact of the decline in energy prices on prices of food and durable goods, but also transport services (cheaper aviation fuel, affecting flight prices), the impact of the zloty strengthening (durable goods, food, cars), the previous stagnation of demand, declines in the prices of other raw materials (the decline in steel prices translated into lower car prices, and wood prices affected the prices of furniture) and the policy of manufacturers deciding to reduce margins. The prices of selected goods and services probably increased excessively and in advance during the pandemic and after the start of the conflict between Russia and Ukraine in order to secure an appropriate level of margins or compensate for the temporary mismatch between demand and supply (domestic tourism). Perhaps at that time, companies that did not have such a need, but only followed the competition, also decided to raise prices. Since the fall in commodity prices, the process of normalization of margins has been underway, which could also have been underestimated by the market consensus, as well as the impact of the rapid reduction in industrial prices compared to Europe. To a large extent, the categories that had previously surprised upwards have been surprising downwards in recent quarters, which was reinforced by a change in the structure of consumer demand: the shift of the burden of spending back from goods to services.

It is worth noting that **at least some of the trends that have so far supported rapid disinflation have recently started to reverse.**

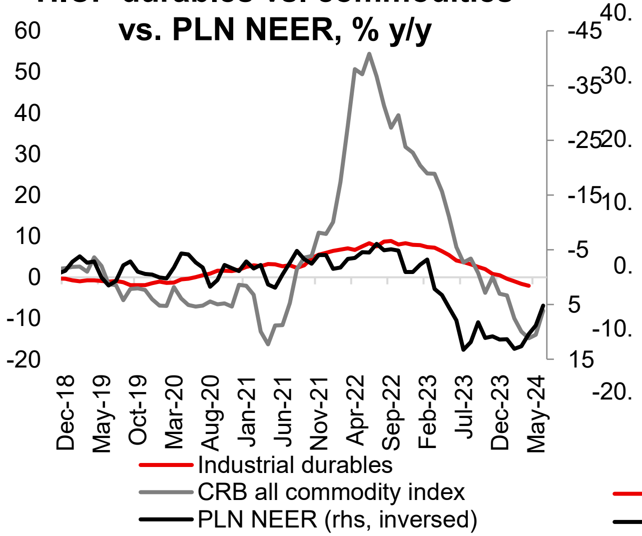
CPI surprises, pp



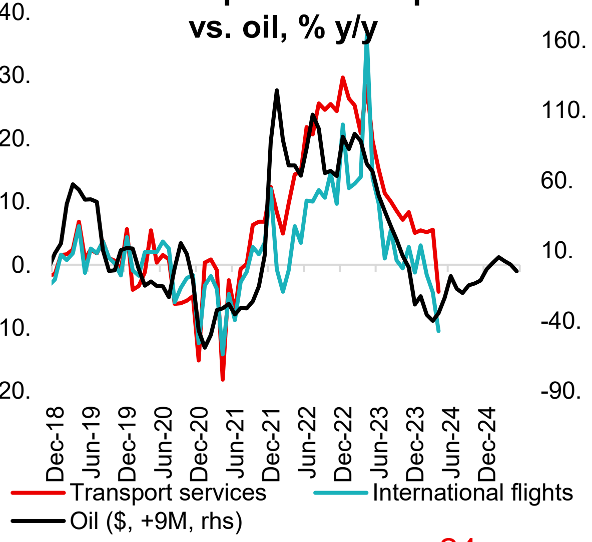
HICP non-durables vs. PPI vs. electricity prices, % y/y



HICP durables vs. commodities vs. PLN NEER, % y/y



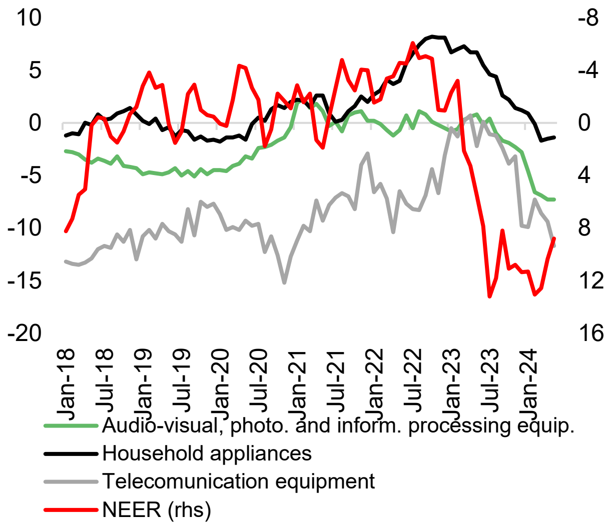
HICP transport service prices vs. oil, % y/y

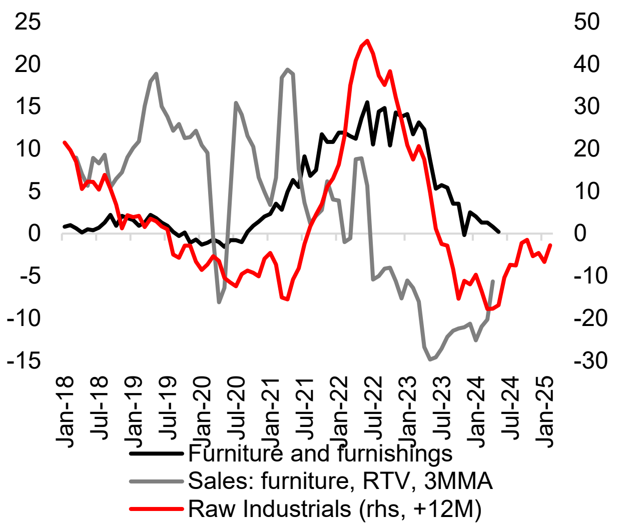


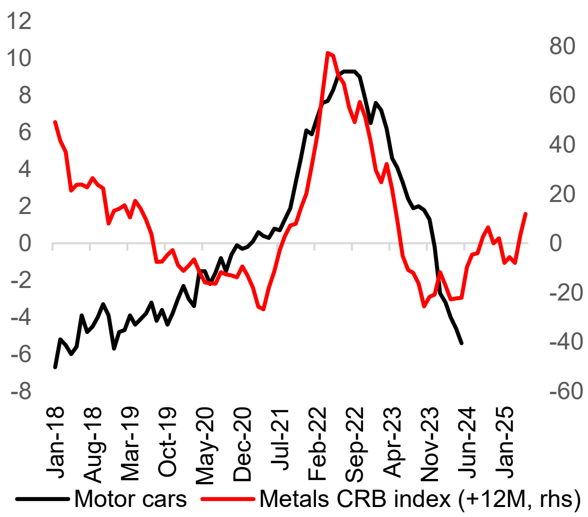
Santander

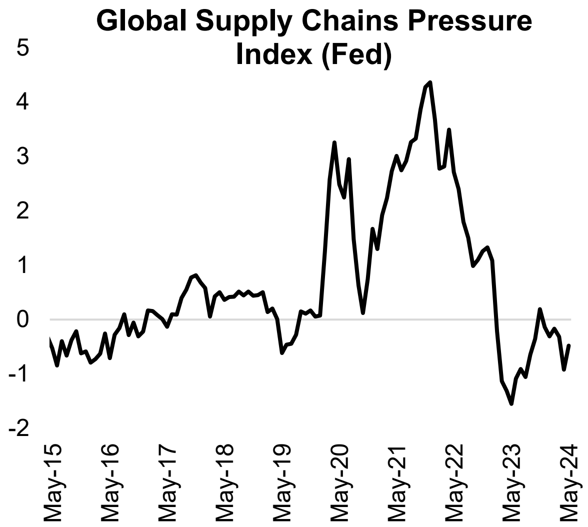
Source: Bloomberg, LSEG, JP Morgan, GUS, Eurostat, NBP, Santander

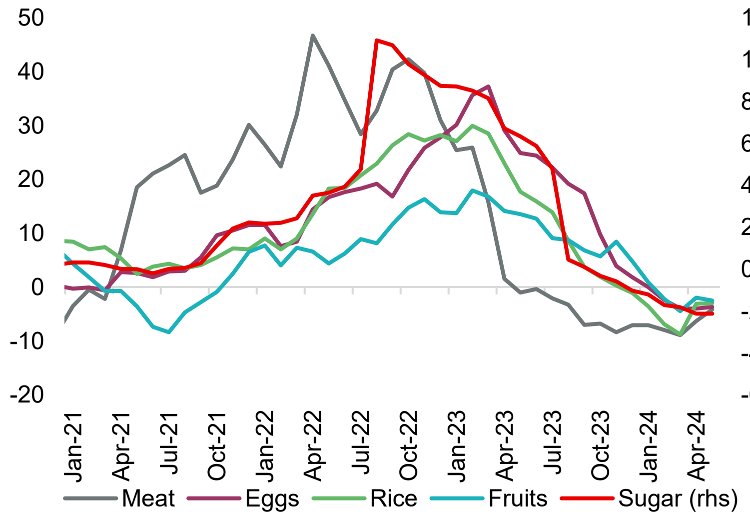
Selected components of CPI inflation (1/2)

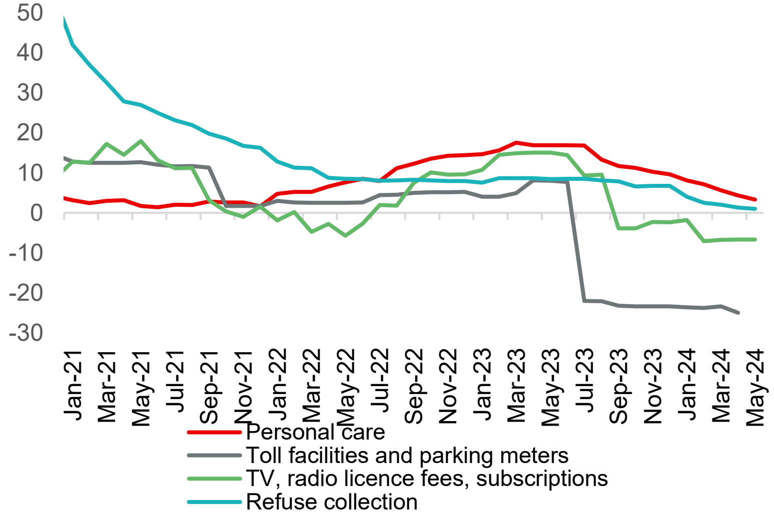


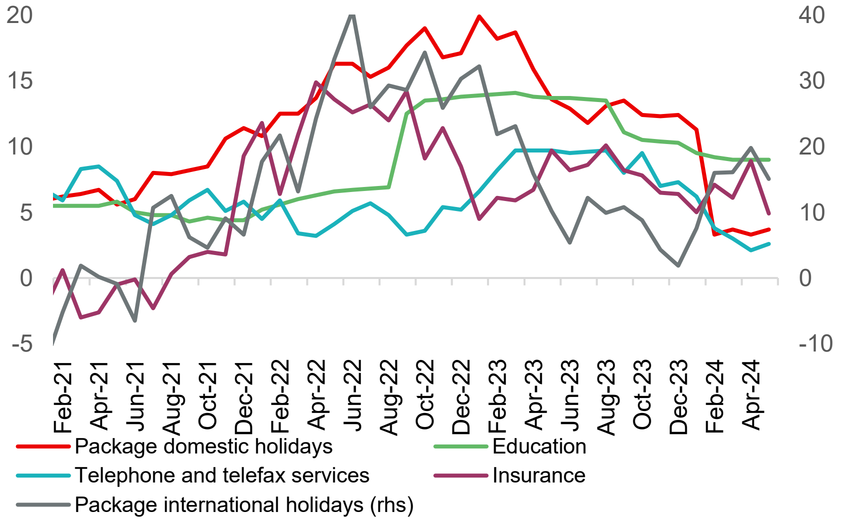












Source: GUS, Eurostat, Fed, Santander

Selected components of CPI inflation (2/2)

	Levels and changes in CPI: CPI % y/y May	Change in CPI % y/y rate 1M	Change in CPI % y/y rate YTD	Change in CPI % y/y rate y/y	Avg CPI % y/y 12M	Avg CPI % y/y YTD	Cum. m/m change YTD	diff. in m/m vs. median in 2018-2023 May	diff. in m/m vs. median in 2018-2023 YtD avg	avg since 2023	Weight (%)	Contribution to CPI: CPI % y/y May	Change in CPI % y/y rate 1M	Change in CPI % y/y rate YTD	Change in CPI % y/y rate y/y	Avg CPI % y/y 12M	Avg CPI % y/y YTD	Cum. m/m change YTD
Żywność																		
Sugar	-21.3	0.0	-11.0	-84.7	9.5	-18.0	-12.7	-1.3	-3.2	-1.8	0.23	-0.05	0.00	-0.03	-0.19	0.02	-0.04	-0.03
Vegetable fats	-10.9	0.1	2.6	-26.6	-4.6	-12.8	0.5	-1.1	-0.4	-1.1	0.2	-0.02	0.00	0.01	-0.05	-0.01	-0.03	0.00
Flour	-4.7	0.2	-0.5	-18.0	0.5	-5.6	0.4	-0.7	-0.9	-0.9	0.17	-0.01	0.00	0.00	-0.03	0.00	-0.01	0.00
Poultry	-4.2	2.1	2.9	-3.2	-4.9	-6.9	6.5	1.9	0.1	-0.6	1.21	-0.05	0.03	0.04	-0.04	-0.06	-0.08	0.08
Eggs	-3.7	0.3	-5.5	-28.6	9.9	-2.8	0.1	-1.0	-0.2	0.0	0.55	-0.02	0.00	-0.03	-0.16	0.05	-0.02	0.00
Rice	-3.0	0.1	-1.9	-20.7	4.2	-5.1	0.3	-1.1	-0.5	-0.5	0.09	0.00	0.00	0.00	-0.02	0.00	0.00	0.00
Pork	-2.7	-2.7	-9.5	-22.1	9.6	1.6	0.3	0.0	-0.7	0.0	1.31	-0.04	-0.04	-0.12	-0.29	0.13	0.02	0.00
Fruit	-2.5	-0.5	-7.3	-16.0	5.3	-2.1	1.3	-1.8	-2.2	-0.7	1.85	-0.05	-0.01	-0.14	-0.30	0.10	-0.04	0.02
Vegetables	0.1	0.9	-11.8	-24.6	12.3	1.7	5.0	1.2	-0.7	0.1	1.8	0.00	0.02	-0.21	-0.44	0.22	0.03	0.09
Butter	2.9	1.0	15.7	4.8	-6.5	-2.7	3.3	-1.7	1.0	-0.6	0.52	0.02	0.01	0.08	0.02	-0.03	-0.01	0.02
Cocoa and powdered chocolate	3.8	-1.3	-8.9	-17.4	13.8	7.3	2.0	-1.5	-0.6	0.1	0.02	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Mineral or spring waters	3.9	-1.5	-4.4	-12.2	9.9	5.8	1.4	-0.8	-0.3	0.1	1.59	0.06	-0.02	-0.07	-0.19	0.16	0.09	0.02
Energia																		
Liquid and solid fuels	-13.9	1.3	5.8	-18.7	-13.1	-16.7	-8.4	-1.1	-1.6	-1.8	2.17	-0.30	0.03	0.13	-0.41	-0.29	-0.36	-0.18
Towary bazowe																		
Telephone and telefax equipment	-11.7	-2.3	-1.9	-9.5	-5.0	-9.4	-5.6	-2.8	-0.4	-0.1	0.14	-0.02	0.00	0.00	-0.01	-0.01	-0.01	-0.01
Audio-visual, photographic and informa	-7.3	0.0	-4.5	-8.1	-2.9	-6.5	-3.8	0.2	-0.5	-0.2	0.39	-0.03	0.00	-0.02	-0.03	-0.01	-0.03	-0.01
Cars	-5.4	-0.8	-5.2	-9.5	0.1	-4.0	-2.6	-0.7	-0.9	-0.3	1.09	-0.06	-0.01	-0.06	-0.10	0.00	-0.04	-0.03
Household appliances	-1.4	0.1	-2.6	-8.1	2.3	-0.8	-0.9	0.2	-0.3	-0.1	0.8	-0.01	0.00	-0.02	-0.06	0.02	-0.01	-0.01
Garments	-0.7	-0.2	-3.7	-8.2	4.0	0.4	-0.5	-0.1	-0.2	0.1	2.91	-0.02	-0.01	-0.11	-0.24	0.12	0.01	-0.01
Furniture and furnishings	0.2	-0.6	-2.3	-8.5	3.7	1.1	-0.2	-1.1	-0.4	-0.2	1.06	0.00	-0.01	-0.02	-0.09	0.04	0.01	0.00
Footwear	0.9	-1.7	-2.9	-5.6	4.9	4.1	2.5	-1.2	-0.1	0.1	0.85	0.01	-0.01	-0.02	-0.05	0.04	0.04	0.02
Articles for personal hygiene and welln	2.1	-1.2	-8.0	-16.6	11.4	5.1	2.2	-0.6	0.0	0.4	2.61	0.05	-0.03	-0.21	-0.43	0.30	0.13	0.06
Personal care	3.3	-1.0	-6.3	-13.6	10.9	5.7	2.6	-0.5	0.0	0.4	3.51	0.12	-0.04	-0.22	-0.48	0.38	0.20	0.09
Cleaning and maintenance products	3.7	-2.0	-9.2	-15.8	13.5	7.4	0.7	-1.4	-0.4	0.4	1.06	0.04	-0.02	-0.10	-0.17	0.14	0.08	0.01
Books	8.2	3.7	0.9	3.7	5.5	3.3	-2.8	1.7	-0.3	0.1	0.18	0.01	0.01	0.00	0.01	0.01	0.01	-0.01
Usługi																		
of which television and radio licence fe	-6.7	0.0	-4.3	-21.7	1.5	-5.8	2.1	-0.1	0.0	-0.2	0.6	-0.04	0.00	-0.03	-0.13	0.01	-0.03	0.01
Transport services	-0.8	10.8	-2.9	-19.9	7.2	-1.8	-12.6	8.8	-1.6	-0.2	0.6	0.00	0.06	-0.02	-0.12	0.04	-0.01	-0.08
Refuse collection	1.0	-0.3	-5.7	-7.4	5.8	2.2	0.7	-0.6	-1.5	-0.7	1.71	0.02	-0.01	-0.10	-0.13	0.10	0.04	0.01
Package domestic holidays	3.7	0.4	-8.7	-9.9	10.2	5.1	0.5	-0.1	-1.3	-0.1	0.53	0.02	0.00	-0.05	-0.05	0.05	0.03	0.00
Insurance	4.9	-4.0	-1.5	-4.8	7.4	6.4	1.9	-0.5	0.9	0.5	1.07	0.05	-0.04	-0.02	-0.05	0.08	0.07	0.02
Package international holidays	15.1	-4.7	13.2	4.9	11.0	14.9	12.5	-3.3	3.3	0.9	1.01	0.15	-0.05	0.13	0.05	0.11	0.15	0.13

Santander

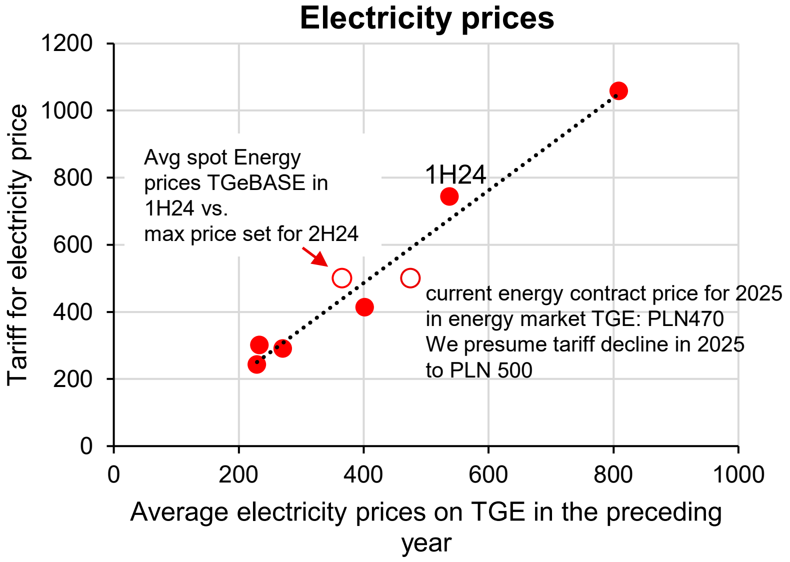
Source: GUS, Santander

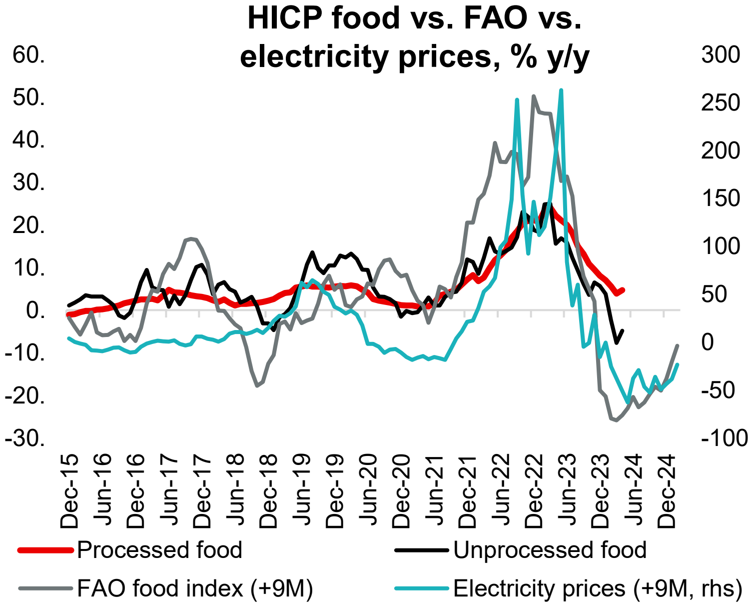
Higher energy and food inflation ahead

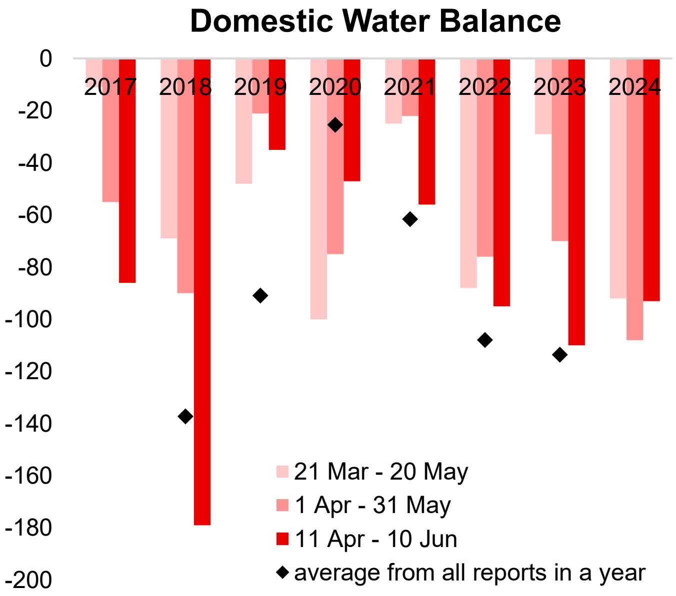
The President signed the Act on the Energy Voucher regulating energy prices in the second half of 2024 and on its basis we assume that energy prices will increase by slightly more than 20% in July, and gas prices by about 10%. We assumed increase in heating prices by 4%, but this will be a gradual process. The act assumes, among others a reduction in energy tariffs, which are to be approved by the Energy Regulatory Office by the end of June. Based on the electricity and gas contracts from TGE for 2025, we estimate that next year the chance of reducing gas prices is small, and in the case of electricity only a slight downward adjustment would be possible, but after the restoration of the higher power fee, we actually assume an increase in bills by about 5%. In the run-up to the presidential election, we believe the potential for larger increases in energy bills is limited. At the same time, however, the space for reducing bills also seems small.

In the case of crude oil, we assume that prices will stabilize this year and will rise slightly next year to just over USD 90 per barrel, approx. USD 10 above the Bloomberg consensus and the market valuation of futures rates, which increases the CPI path by approx. 0.1-0.2 percentage points.

The latest report on the state of drought threat for April-June indicates an improvement in the water balance compared to May, but with the exception of last year, it still indicates the highest share of the area at risk of drought for cereals and fruit since 2018. The FAO and CRB food indices point to a reversal of the downward trend in prices in Q1. And that is why we assume a higher average monthly dynamics of food prices later in the year than last year.







Source: TGE, FAO, GUS, Eurostat, NBP, Santander

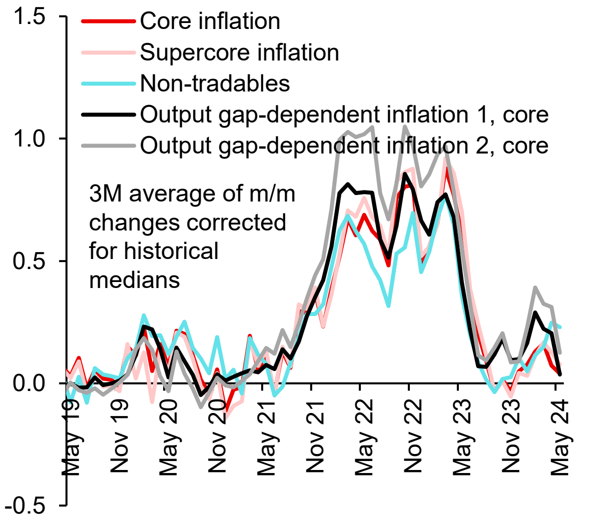
Core inflation still too high

The average monthly change in CPI prices excluding food and energy from the last 12 months was 0.32% m/m, which means a return to the average level from 2020, but it is still clearly above the 0.2% ensuring the achievement of the inflation target. The still larger share of the CPI basket than before the pandemic is recording inflation well above the target (for example >5% y/y). Similarly, a higher percentage of core categories record monthly price changes exceeding the multi-year median.

As the trend of appreciation of the zloty has stopped, consumption has begun to accelerate, and raw material markets have seen increases for some time, the room for further decline in producer prices seems limited to us. At the same time, the dynamics of unit labor costs is still high. In view of this, we assume that pressure on core prices may continue. So far, the relative lack of significant deterioration in margins in sectors with less exposure to exports has been evident. Indirect pressure on retailers' margins and prices may be caused by a slight unwinding of margins among exporters.

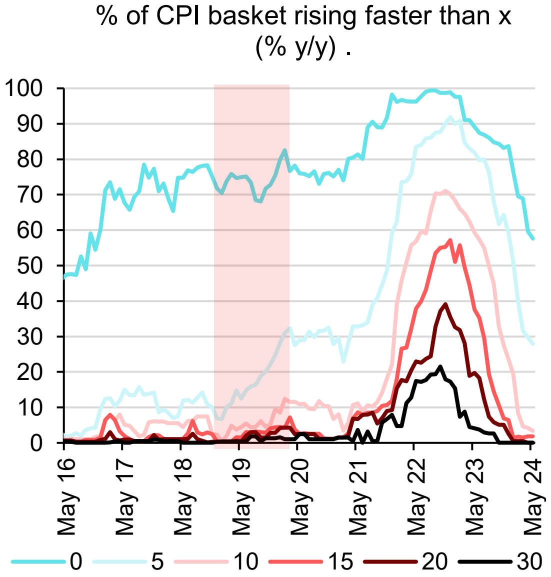
We assume that the average monthly increase in core inflation will remain at 0.3% until the end of next year, which will translate into an annual growth rate of about 4% on average. Our baseline forecast also points to core inflation near 4% by the end of next year.

Still elevated domestic non-tradables

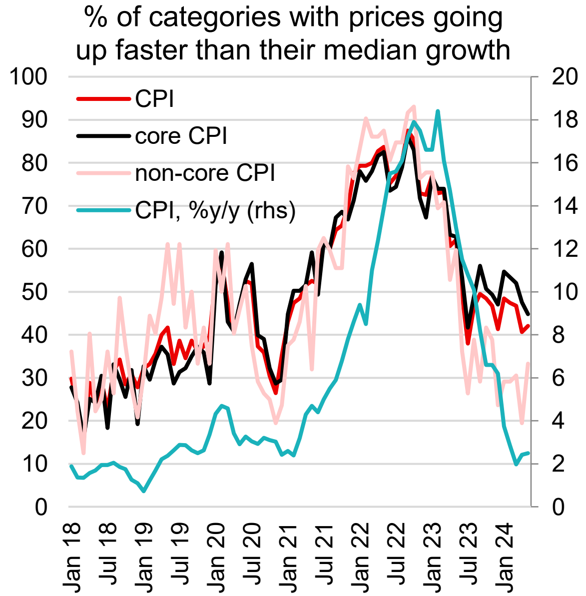


Core inflation depending on the domestic economic situation calculated as a set of elements of the inflation basket most correlated with the output gap, calculated in two variants

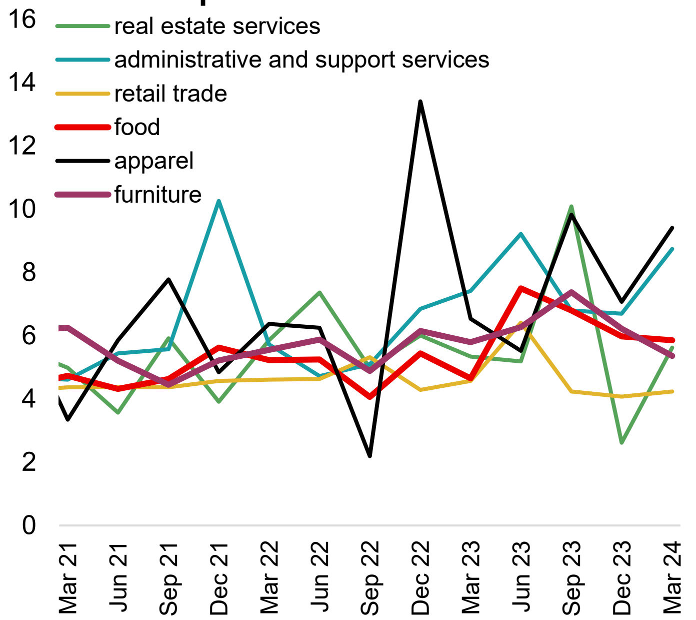
Share of CPI basket with >5% growth remains high



Share of core HICP categories rising above multiyear median still high



Stable margins in output with domestic exposure and retail trade



Santander

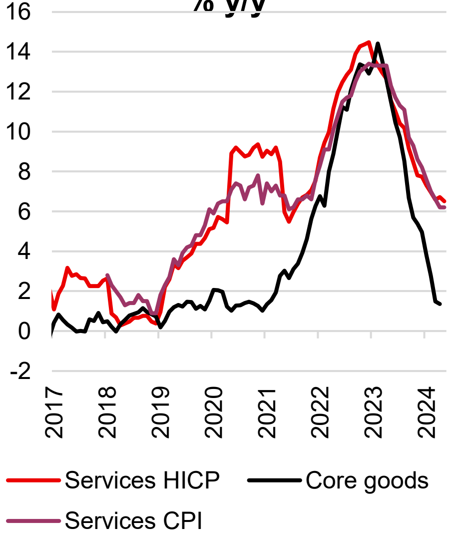
Source: Eurostat, GUS, Santander

Services inflation stubborn, yet fading

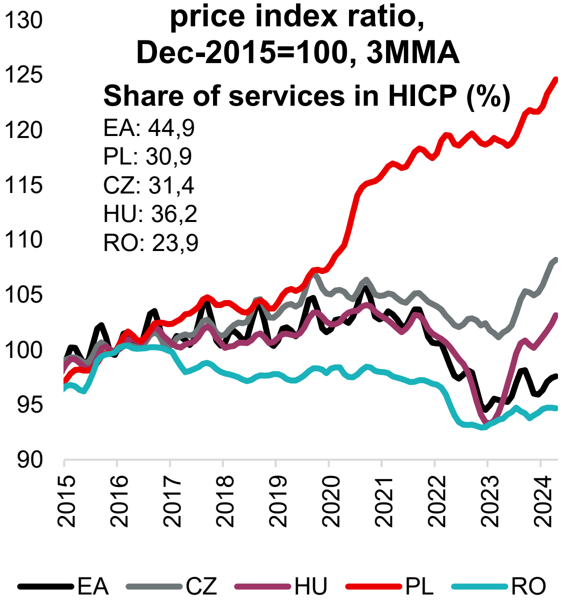
In recent months, in Poland, as in other countries, disinflation has been much faster in the prices of goods than services. What distinguishes Poland from other countries is the fact that in Poland services inflation clearly accelerated already before the pandemic and even at the peak of the inflationary momentum (turn 2022/23) it was not outpaced by the dynamics of core goods prices. As a result, while in many countries one of the arguments for greater persistence of services inflation may be the return of the disrupted relationship between prices of services and core goods to a pre-pandemic long-term trend*, in Poland this is rather the argument in the opposite direction: the index of relative prices (the relation of services prices level to core goods prices, i.e. excluding food and energy) not only did not fall below the pre-pandemic trend, but it broke out much above.

The prices of services are more susceptible to wage costs than the prices of goods, and these are growing exceptionally fast – real wages in Poland (unlike in some countries) have already managed to make up for the losses caused by increased inflation. Nevertheless, IMF research** indicates that the propensity to pass on wage increases to prices may be significantly lower in companies with solid financial results, and those in the services sector remain relatively high, above pre-pandemic levels. Overall, **we expect that the increase in CPI inflation in the coming months will be mainly a consequence of a rebound in goods prices, while the dynamics of services prices may continue to fade gradually** amid a recovery in consumption.

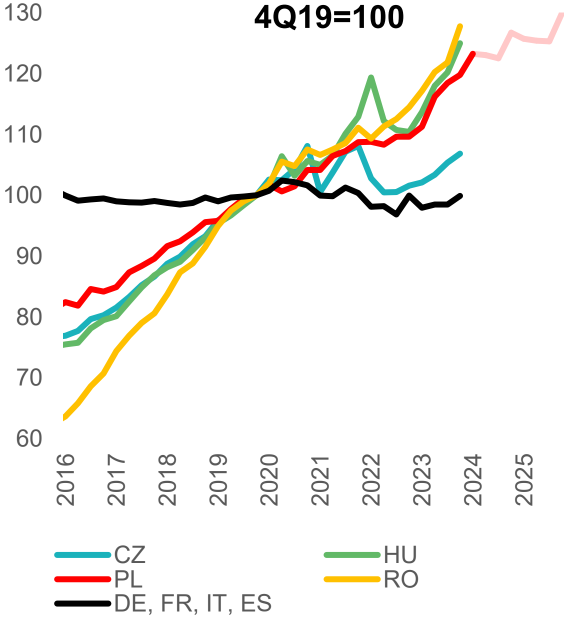
Services and core goods prices (ex food&energy), % y/y



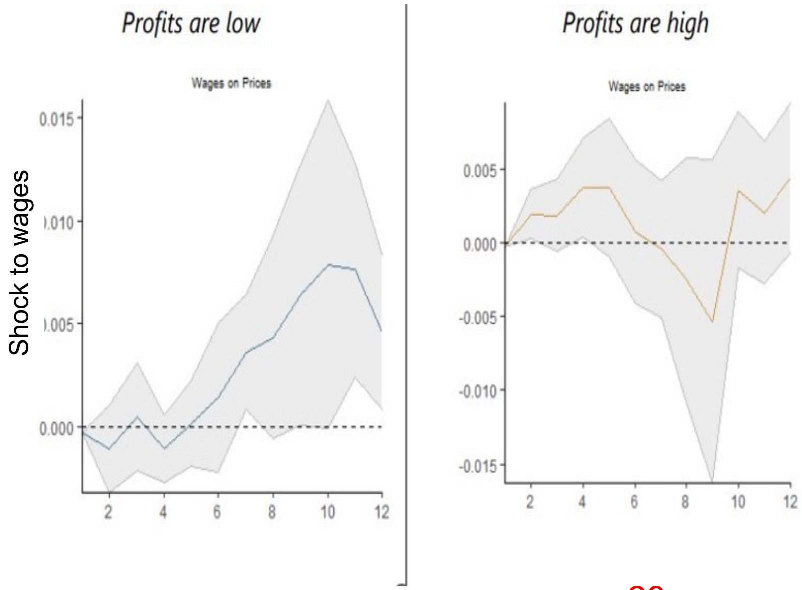
Services to core goods price index ratio, Dec-2015=100, 3MMA



Real LCI labour cost index, 4Q19=100



Reaction of inflation to wage impulse depending on the firms profit in the euro area **



Source: BIS, IMF, Eurostat, GUS, NBP, Santander

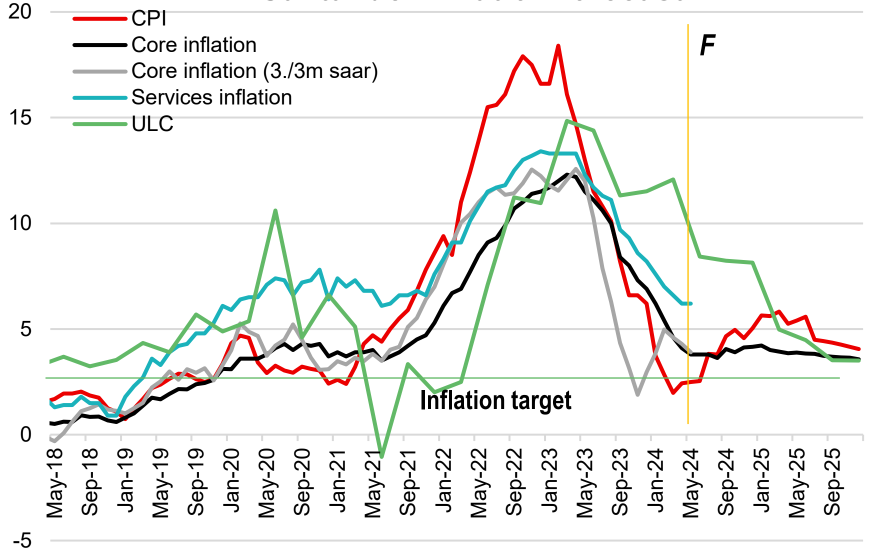
* Sectoral price dynamics in the last mile of post-Covid-19 disinflation, BIS Quarterly Review, March 2024 (link)
** Monetary Policy with Uncertain Inflation Persistence, IMF Working Paper, March 2024 (link)

CPI far from target

Our baseline scenario assumes an increase in the headline inflation index to almost 4% y/y in July and around 5% at the end of the year, while the local peak (slightly below 6%) should be at the end of 1Q25. In subsequent months we anticipate decline of CPI to around 4% at the end of 2025.

Surveys of the statistical office among companies continue to indicate declines in price, both in retail trade and services. The behaviour of the latter had some anticipatory properties when the inflation trend changed at the turn of 2022/23. The fact that they are still falling suggests that one may still need to wait for the upside inflation surprises.

Santander inflation forecast



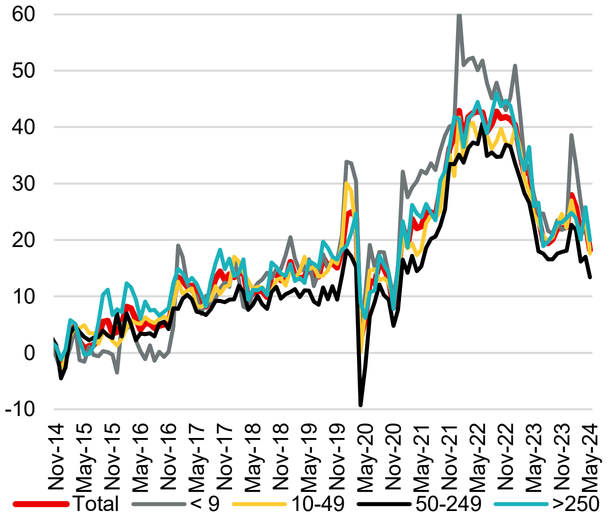
Inflation forecasts

CPI	2024	2025	2026
Santander	3.6	4.9	3.4
Bloomberg	4.0	4.0	3.0
NBP macroeconomic survey	4.3	4.1	3.4
NBP projection without shields	5.7	3.5	2.7
NBP projection with shields	3.0	3.4	2.9

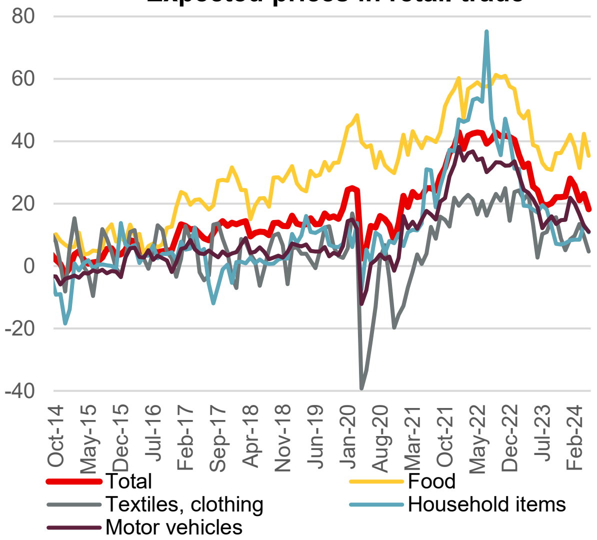
Core inflation	2024	2025	2026
Santander	4.3	3.8	2.6
NBP projection without shields	4.7	4.5	3.8
NBP projection with shields	4.7	4.5	4.1

Expected price tendencies in retail trade and services (statistical office)

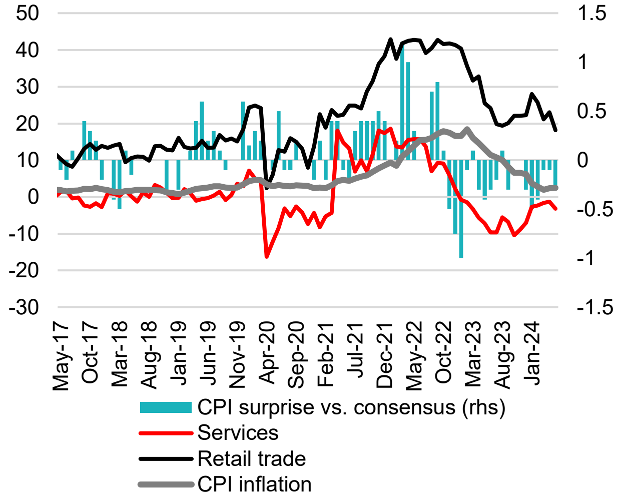
Expected prices by employment size



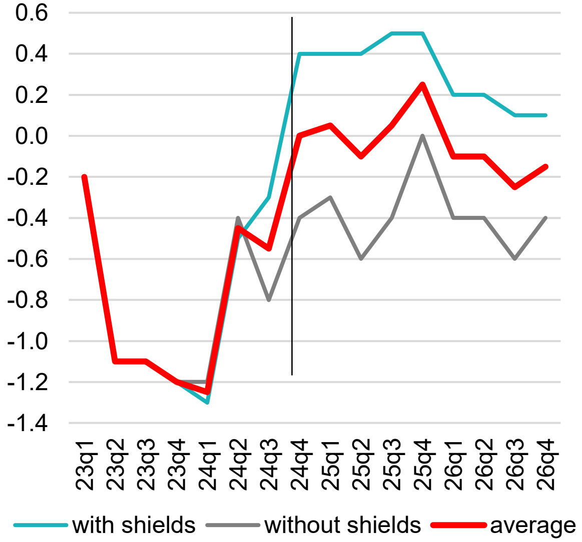
Expected prices in retail trade



Expected price in trade and services (Statistical office, pts) vs. CPI % y/y



Output gap according to NBP March projection



Source: GUS, Bloomberg Eurostat, NBP, Santander

Economic Policy

4

Monetary policy: hardened hawkishness

Over the past two months, there has been a clear hawkish turn in the statements of NBP President Adam Glapiński. The NBP president explicitly stated at the press conference in June that there is no room for discussion of rate cuts in the current environment, and there has been no dovish sentiment at MPC meetings recently.

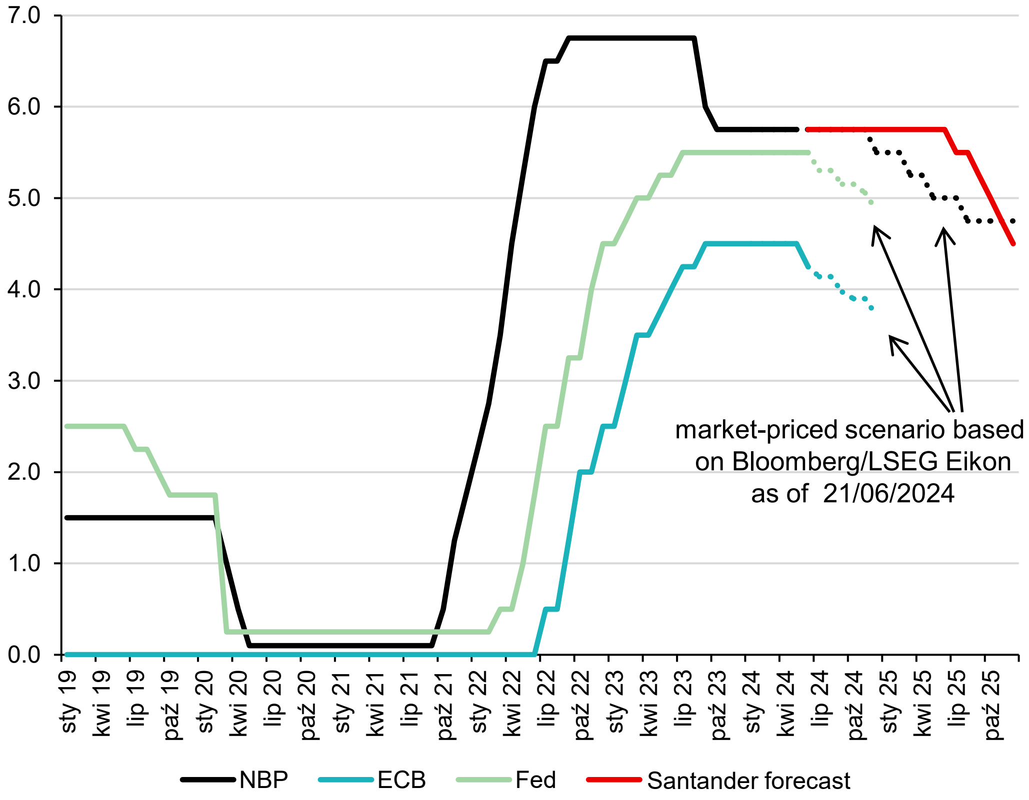
Glapiński has firmly declared that interest rates will not go down if inflation is rising. This means that **the chances of cuts this year are almost zero** if the widely expected scenario of a gradual rise in CPI in 2H24 comes true (according to NBP forecasts, inflation will rise from the current 2.5% to just above 5% y/y in December, which is consistent with our scenario). He also pointed to a rather loose fiscal policy and rapid wage growth, which, according to him, is currently the biggest cause for concern.

The start of a cycle of rate cuts by the ECB "will not have a significant impact" on NBP policy according to Glapiński.

The NBP president even suggested **the risk of an interest rate hike** - should CPI inflation continue to rise or not decline next year. Glapiński also indicated a **condition for rate cuts - a sustained decline in inflation to the target** - visible in the data or in forecasts for the coming period. In our view, this condition will not be met until the middle of next year.

Ultimately, the NBP President keeps the door open to all scenarios. In our view, the stabilisation of interest rates at least until mid-2025 and then gradual reductions as the inflation rate falls remains the baseline scenario.

Main interest rates of central banks, %



Source: Bloomberg, LSEG Eikon, Santander

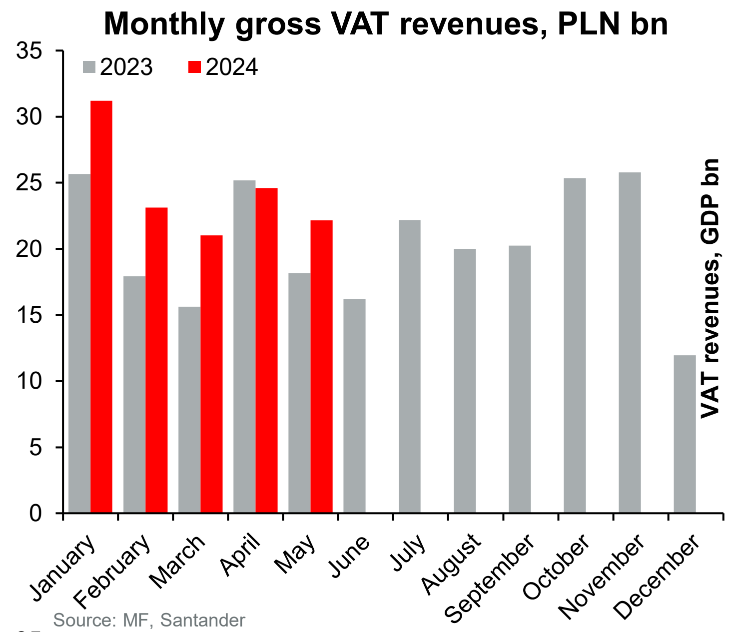
Fiscal policy: lower revenues

Since the release of the last Macroscope, **VAT revenues have remained the main risk to finishing the year with the GG deficit at 5.1% of GDP**, as assumed in the Budget Act.

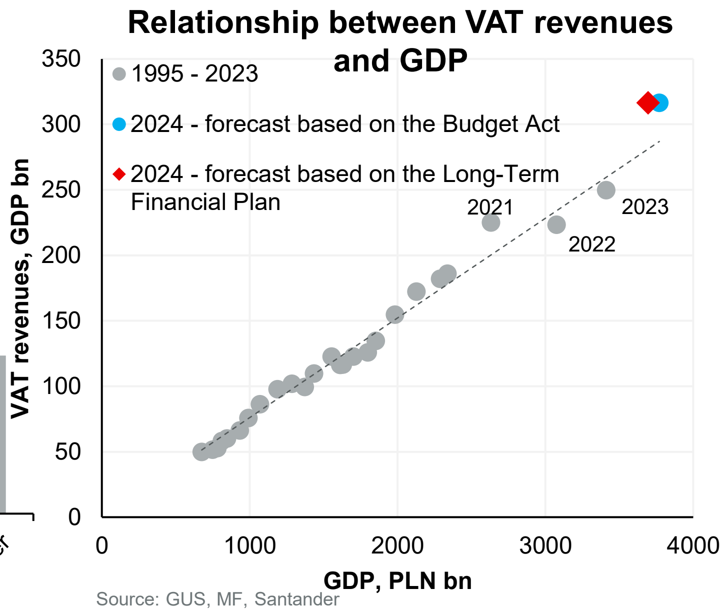
According to the plan presented in the Act, VAT revenues should increase by about 30% y/y. Although in 1Q24 their net inflow was about 27% higher than in 1Q23, other fiscal data suggest that this might have been caused by significant VAT refunds in December last year. VAT revenues in gross terms (after adding the amount of refunds) increased at the end of 1Q24 only by about 3% y/y.

Concerns about the actual size of VAT revenues may also be raised by the fact that, at least in the last twenty years, the scale of their growth has not neared the level currently expected by the government. Moreover, the structural relationship between VAT revenues and the size of their tax base also does not suggest that this year could be the first in which such an increase occurs. For VAT revenues to increase by about 30%, given the level of economic activity assumed in the Budget Act or the Long-Term Financial Plan of the State, there would have to be a significant deviation from the relationship observed so far. Finally, it is worth noting that the increase in the VAT revenues will not be supported by the VAT gap, which, according to the Ministry of Finance's estimates, increased from 7.3% in 2022 to 15.8% in 2023.

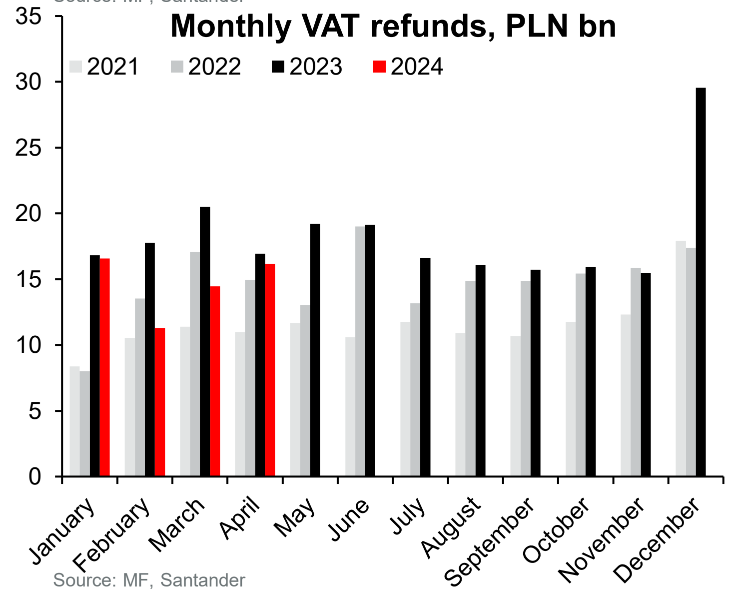
As a result, **we still believe that the level of VAT revenues in 2024 may be lower by c. PLN25-30bn than projected in the Budget Act**.



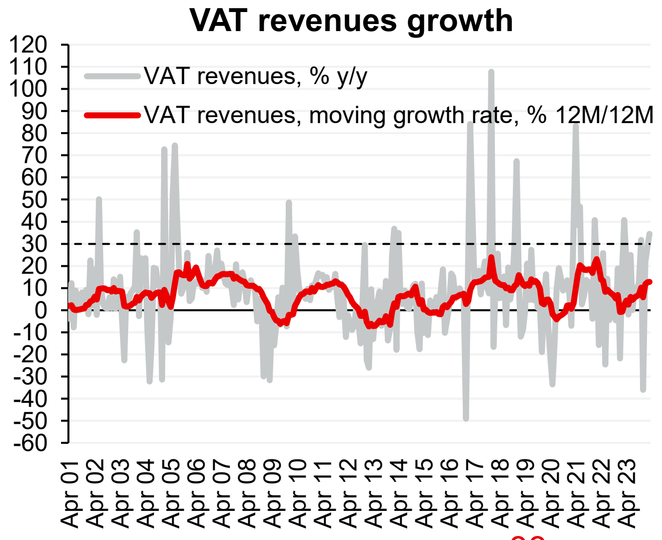
Source: MF, Santander



Source: GUS, MF, Santander



Source: MF, Santander



Source: MF, Santander

Fiscal policy: higher expenditures

Public finances will be additionally challenged by the recently passed, new fiscal policies, especially the ones limiting the increase of energy prices.

According to the impact assessment, the overall effect of the measures related to energy prices on the general government sector will exceed PLN6bn, of which over PLN5bn (approx. 0.14% of GDP) will be covered by increasing the maximum expenditure limit of the COVID-19 Prevention Fund for 2024, which is another source of risk for keeping the GG deficit in line with the government's plans.

It is worth noting that the increase in the Fund's expenditure was most likely not included in the Long-Term Financial Plan of the State for 2024-2027 published on 30 April. The document only indicates that the forecast presented in it takes into account the impact of extending the protective measures until the end of June.

According to the projections presented in the Long-Term Financial Plan, the GG deficit should amount to 5.1% of GDP in 2024, and then it should be reduced by an average of 0.5 percentage points of GDP per year. Despite this, the forecast indicates that general government debt will exceed 60% of GDP in 2026, mainly due to defence expenditures.

This is a difference from the Debt Management Strategy published six months earlier, which did not forecast an increase in the GG debt to over 60% of GDP, despite the fact that it assumed a sharp increase in the debt of the Armed Forces Support Fund (from PLN9.9bn in 2022 to PLN314.6bn in 2027).

Nevertheless, the scale of the increase in the debt level expected by the government is likely to change. The Long-Term Plan does not take into account the reference trajectories of GG expenditures, which are likely to be handed over to Poland by the European Commission in a few weeks, or additional consolidation measures to be announced by the government in autumn in connection with the need to present a new medium-term fiscal structural plan to the EC.

Currently, our forecasts indicate that the general government deficit may amount to 5.5% of GDP in 2024. However, we do not expect the general government debt to exceed 60% of GDP in the coming years.

Estimated costs of new fiscal policies, PLN bn

Policy	in 2024	in 2025
Measures limiting the increase of energy prices		
- higher expenditures from the Covid Fund	5,2	1,4
- higher expenditures from the state budget	1,3	0,3
Social-security contributions moratorium		
- higher expenditures from the state budget	1,5	1,6
- lower revenues of GG funds	0,1	0,1
Higher funeral subsidy		
- higher expenditures from GG funds	0,8	1,9
- higher expenditures from the state budget	0,1	0,2
Mortgage loan moratorium		
- lower CIT revenues	0,6	-
Mortgage loan subsidies		
- higher expenditures from the state budget	0,4	1,7
Overall	**10,0**	**7,2**

Source: Santander's summary based on impact assessments

GG debt projections, % GDP

GG debt according to	2024	2025	2026	2027
Debt Management Strategy 2024-2027	53,9	55,1	58,3	58,7
Long-Term Financial Plan 2024-2027	53,4	57,3	60,5	61,3

Source: MF, Santander

Poland at risk of EDP

The European Comission intends to open excessive deficit procedures (EDP) for Poland, Belgium, France, Italy, Hungary, Malta and Slovakia. The decision comes as no surprise, as Poland's fiscal deficit is well above the reference level of 3% of GDP: the EC predicts that the GG deficit will equal 5.4% of GDP in 2024 and 4.6% in 2025, slightly above the government's recent forecasts of 5.1% and 4.4% respectively (and close to our estimates).

Poland is among the 5 countries for which "relevant factors" can be taken into account in the next steps towards the procedure. These Poland-specific factors include: a large increase in national defence spending (up to 4.1% of GDP in 2028), spending on strengthening the EU's external border (0.3% of GDP), emergency support to farmers (0.4% of GDP), strengthening the national fiscal framework, and the planned establishment of an independent Fiscal Council.

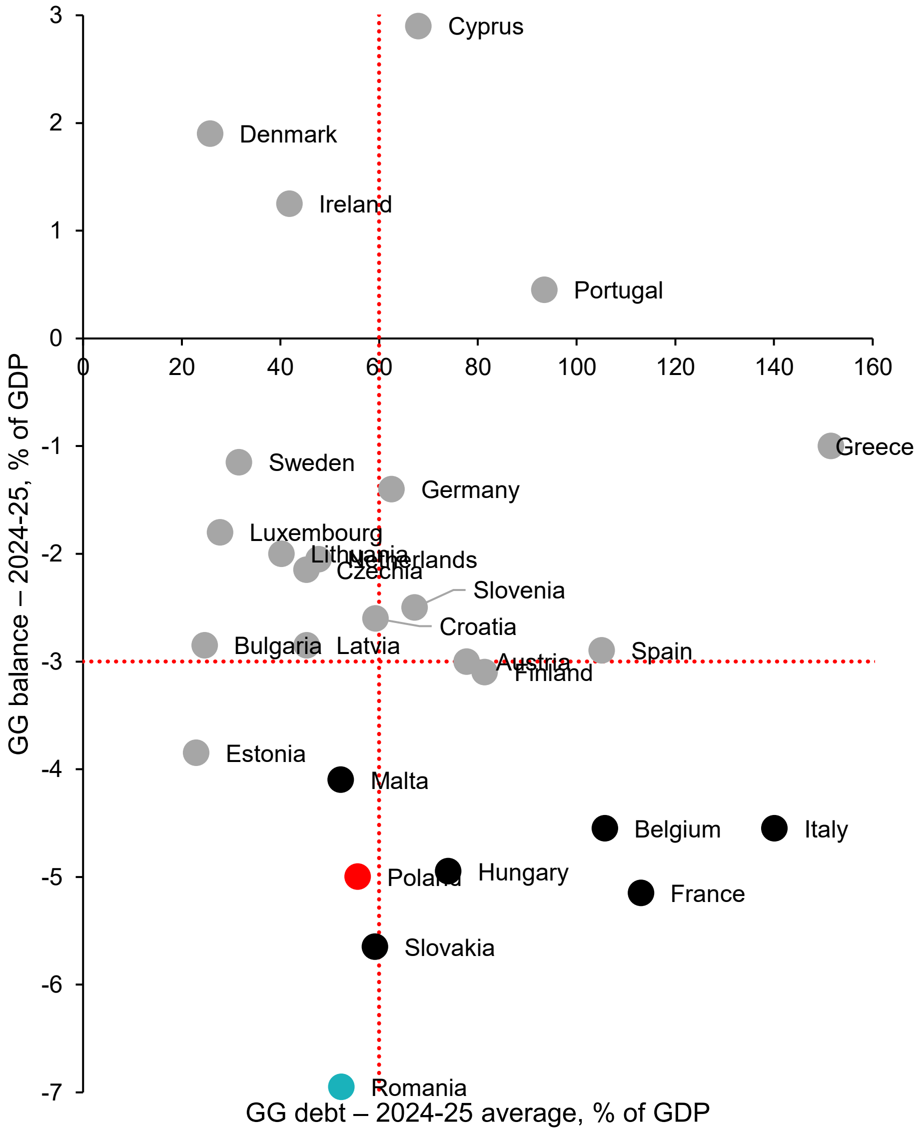
On the other hand, the EC's assessment of the Polish's current fiscal policy and its medium-term debt sustainability is quite harsh: the report indicates that fiscal policy in 2024 is likely to be more expansionary, despite the Commission's previous recommendations (due to the extension of the energy price measures, among other factors), and 10-year projections suggest that the debt ratio will steadily increase to around 85% of GDP in 2035.

The EC's recommendation was widely expected and does not constitute a breakthrough for the market. We still do not know the EC's recommendations on fiscal adjustment in Poland. In our view, the suggested pace of adjustment should not be too abrupt (rather below 1% of GDP per year), as it is likely to take into account country-specific factors (e.g., high defense spending). The final decisions on this issue may not be made until late autumn.

GG balance forecasts	2024	2025	2026	2027
The European Commission	-5,4	-4,6	-	-
Long-Term Financial Plan 2024-2027	-5,1	-4,4	-3,8	-3,3

Source: MF, European Commission, Santander

GG debt and balance according to EC forecasts



In grey – countries not under the EDP risk
In black – countries under the EDP risk
In red – Poland (under the EDP risk)
In blue – Romania, under the EDP since 2020

Santander

Financial markets

5

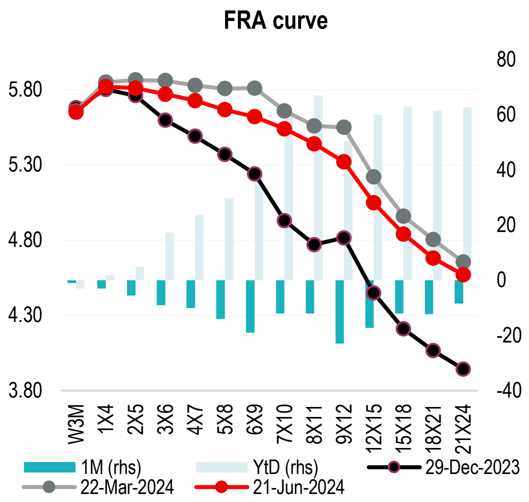
Stable situation in the swap market

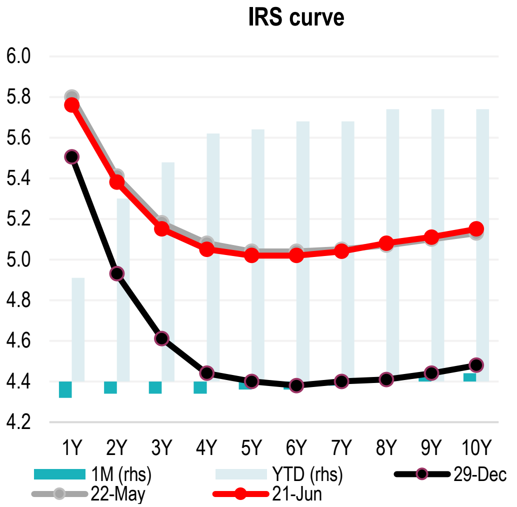
In the last quarter, the market continued to reduce the scale of expected NBP rate cuts, similarly to the core markets (max. 2 cuts priced in for the ECB and the Fed compared to approx. 4 in March). Last month, the IRS curve remained relatively stable with a slight decrease in rates on the core markets.

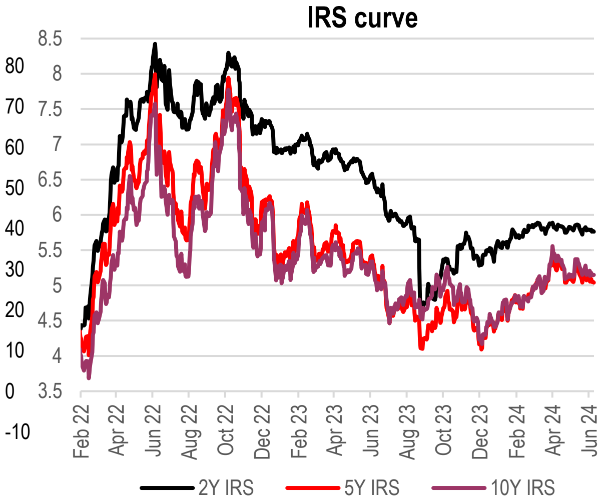
The domestic IRS curve remained inverted, but the slope increased marginally, mainly due to the increase in long-term rates, increasing the scale of the movement from the beginning of the year to about 20 bps, more than for the EUR, USD and regional curves.

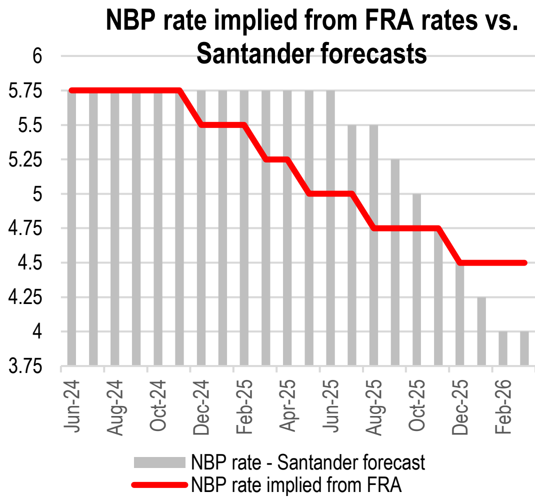
FRA rates no longer price in changes in interest rates this year, but discount reduction of 1 pp next year, at a faster pace than our assumptions (first move in mid-25 at the earliest). In our view although there is not much room for an upward movement of swap rates, at the same time their decline may be delayed due to the relatively distant moment of the start of the rate cutting cycle.

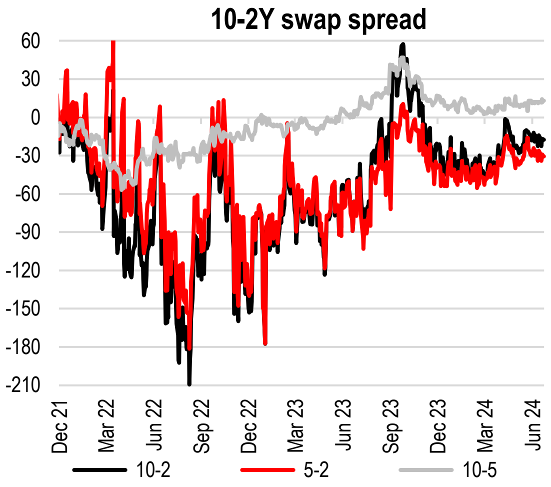
We may have to wait for upward inflation surprises, but the headline inflation will gradually climb up, and consumption has already shown its claw. Therefore, we maintain the assumptions that there will be no significant change in the slope of the swap curve until around the end of the year, when the moment of the first rate cut will be getting closer.

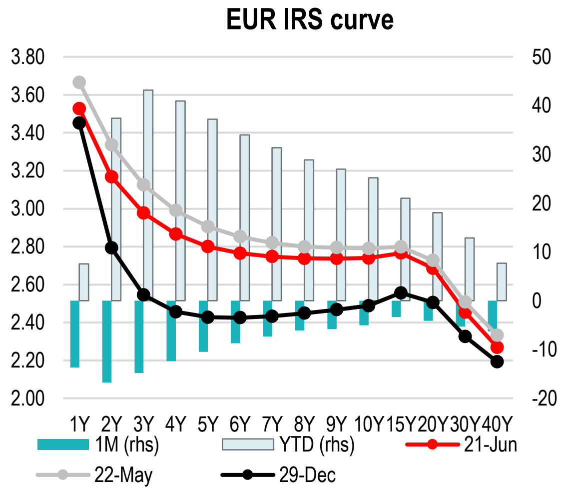












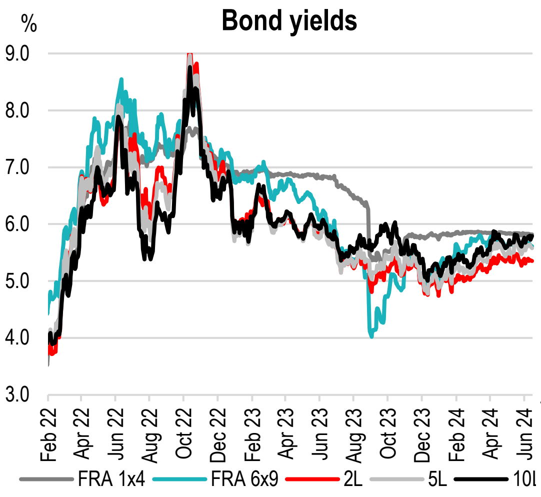
Source: LSEG, Santander

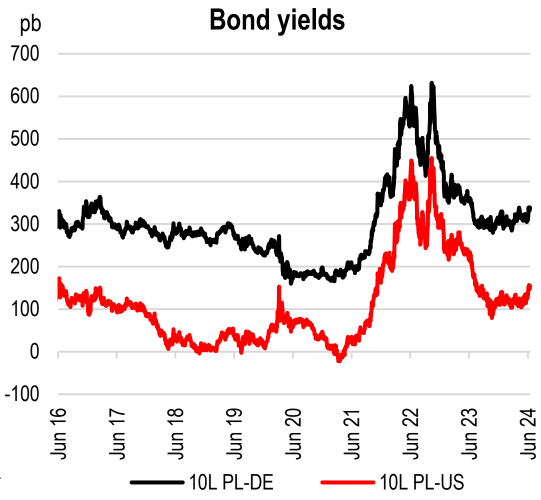
Spreads to Bunds are increasing slightly

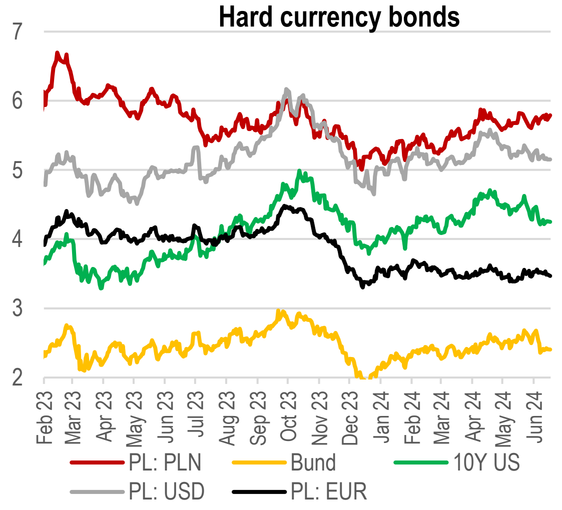
The bond curve steepened more than the swap by approx. 22bps over the 2-5Y section. The slope is positive, in the case of 2-10Y at 53 bps due to asset swap levels. Asset swap credit spreads increased in the last month and quarter by approx. 5-10 bps on 5-10Y tenors. On the other hand, at the short end, the decline occurred mainly in the last month by about 10bps due to a decrease in 2Y yields, which may indicate a recovery in demand from banks in May (perhaps they invested funds from maturing WZ0524 in fixed-coupon securities).

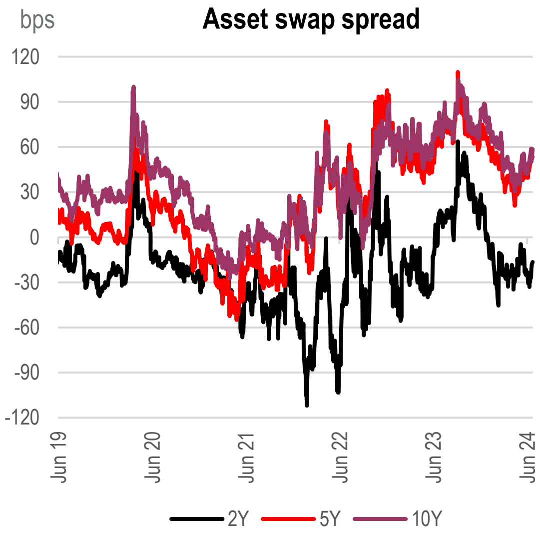
Since we do not expect any significant changes in swap rates in the near future, we assume that it is mainly the movement on bonds that will affect the level of credit spreads. In view of the high maturities and interest payments in July, a negative net issuance is possible (with fairly solid budget execution) and a narrowing of spreads. However, before this happens, we have parliamentary elections in France on the way, which may temporarily maintain a lower appetite for risk.

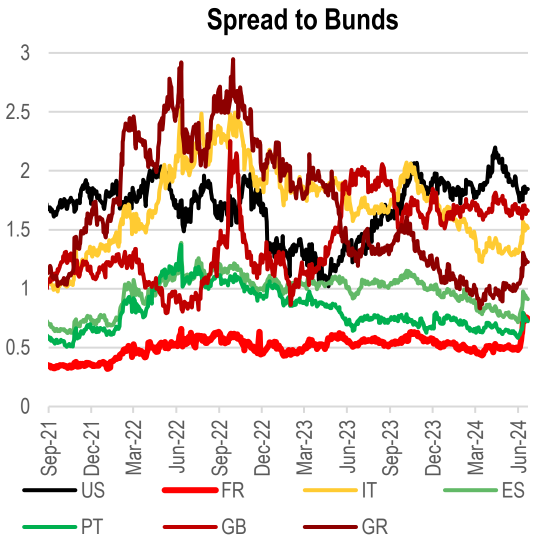
In our view, the political risk premium from France and the US could weigh on investor sentiment and could support credit spreads at relatively higher levels. On the other hand, there is also a chance for lower fixed-coupon bond issuance in the face of higher sales of retail bonds and the planned supply of CPI-linked bonds.

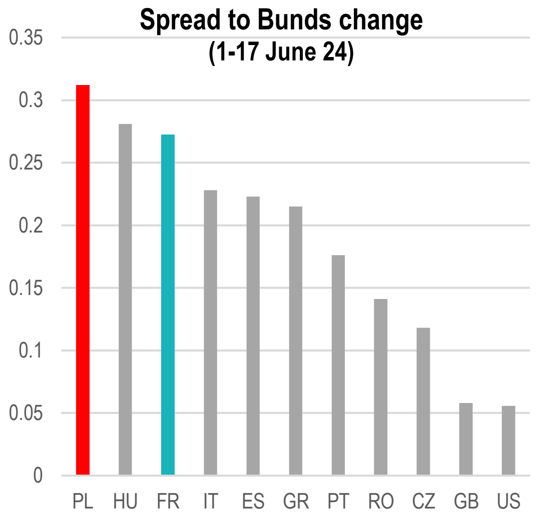






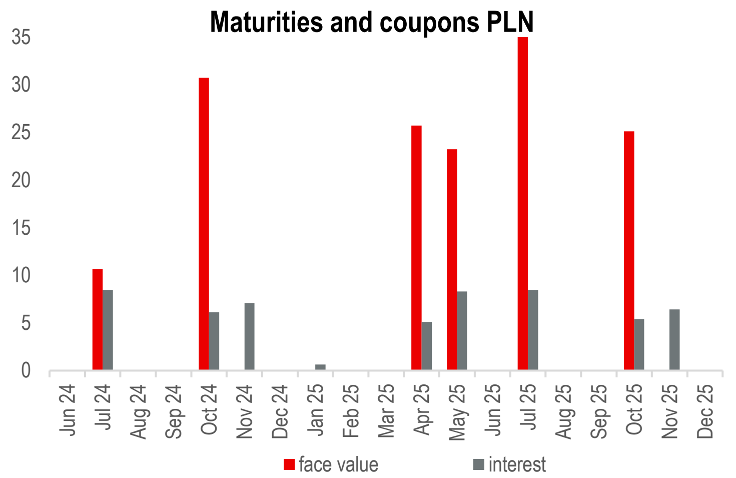


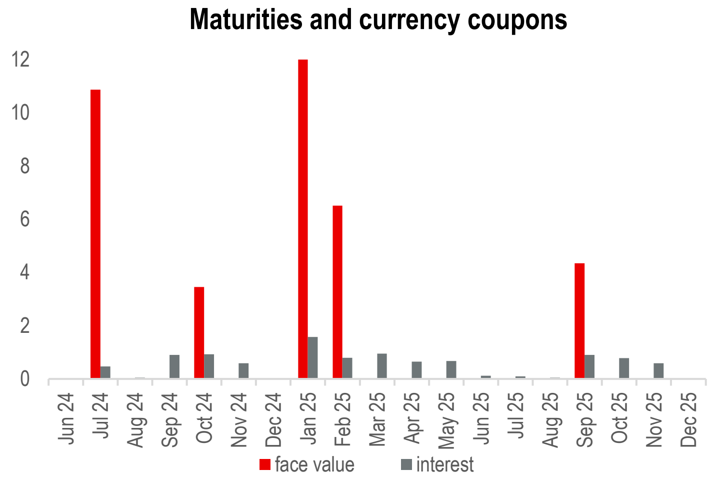


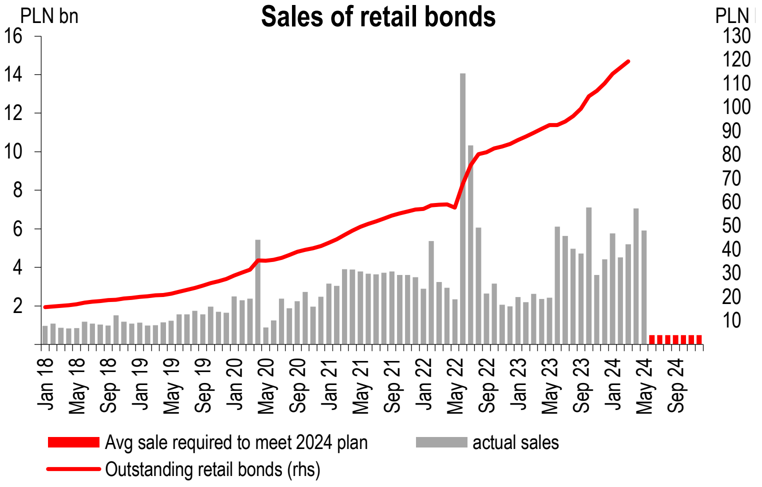


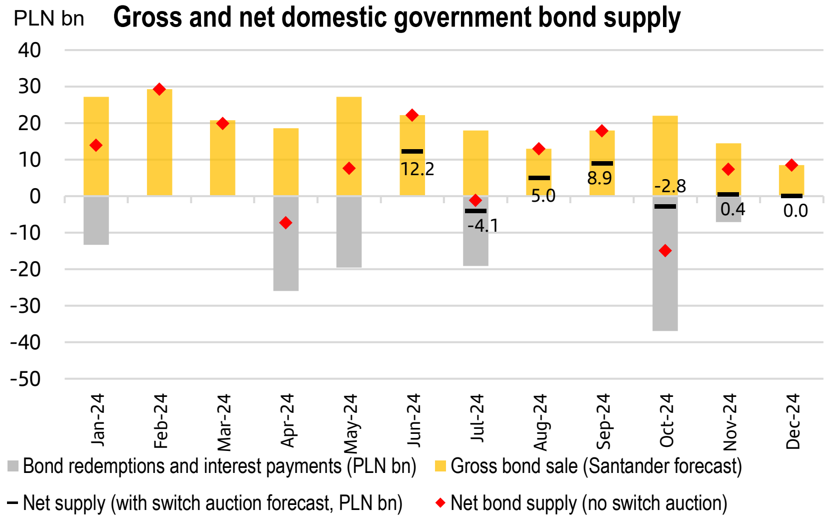
Source: LSEG, Santander

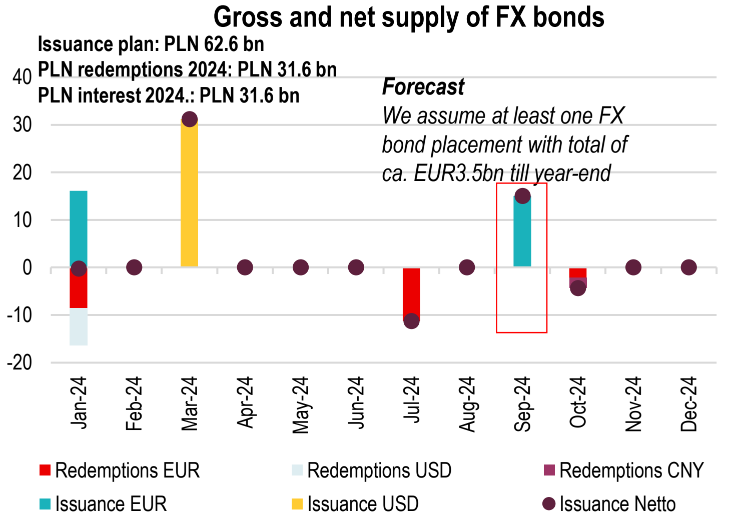
High retail bond sale, lower marketable bond issuance?

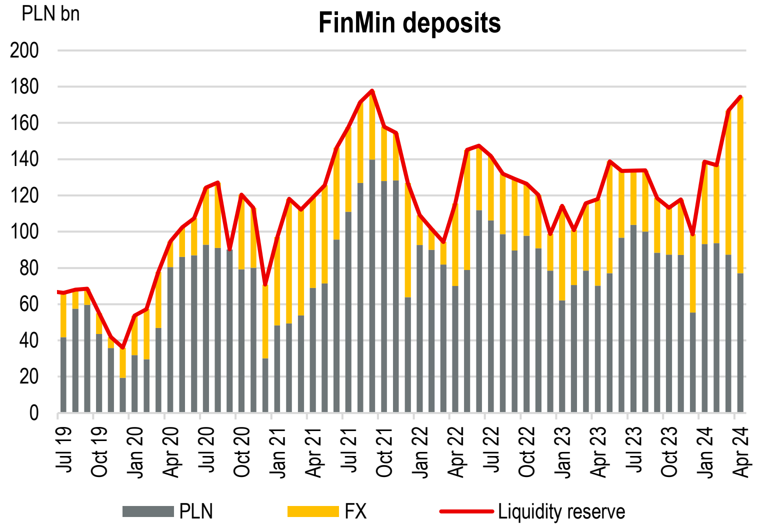












Santander

Source: LSEG, Ministry of Finance, Bloomberg, Santander

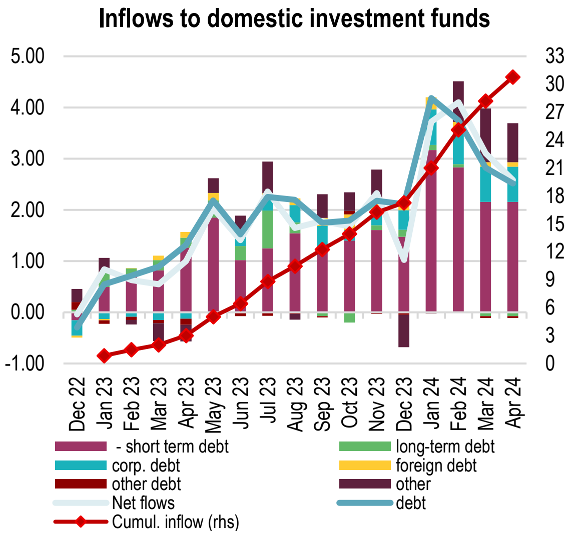
No demand from local and foreign funds for PLN bonds

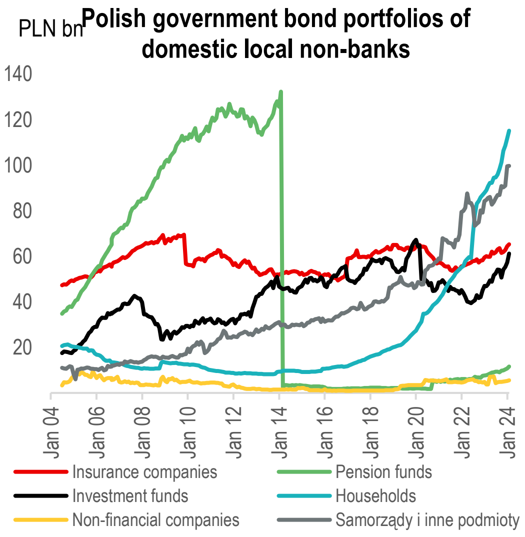
In April, the treasury debt decreased in the face of significant maturities and slightly lower issuances, with a decrease in the involvement of banks and investment funds and a further increase in purchases from households. In May, the issue of treasury debt was already positive.

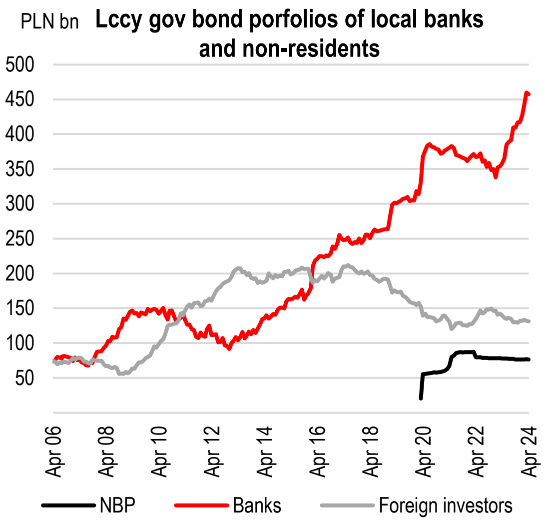
We assume that domestic banks will remain the main buyer of domestic bonds. In view of the continuing exceptionally high inflows to domestic investment funds, the decline in their net portfolios since the beginning of the year is surprising. Perhaps domestic funds are investing more in corporate bonds and foreign currency debt. The scale of inflows is so large, approx. PLN 16.4 billion since the beginning of the year, that we assume that when the moment of the first rate cut approaches, domestic funds will start to increase their exposure to domestic debt.

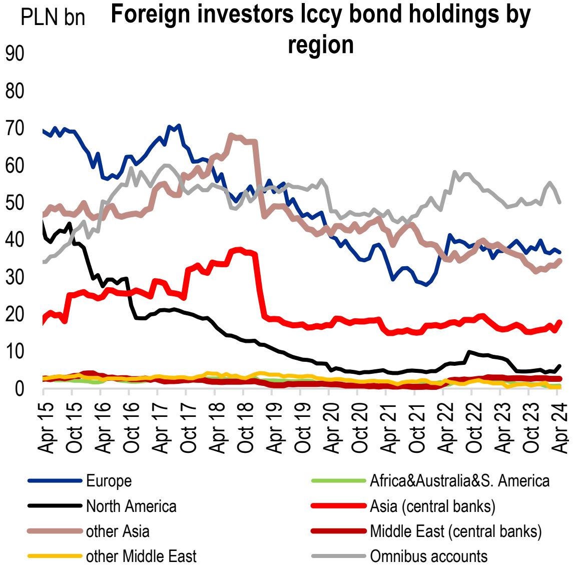
The Ministry of Finance reduced the interest rate on 3-year retail bonds, but only by 0.2 percentage points to 6.4%, which should keep demand at an elevated level. We believe that retail debt issues may be as much as PLN 30 billion higher than planned, which may reduce domestic or currency emissions.

There is still no clear increase in involvement among foreign investors. This may change at the end of the year, when the perspective of rate cuts approaches, the spread basis swap narrows even more and the perspective of a weakening dollar is more visible. On the other hand, it is worth remembering that in many countries both nominal and real rates remain higher, and the cycle of rate cuts will be faster.









Treasury securities net sale (Santander forecast for 2024)

	Banks	NBP	Foreign investors	Mutual funds	Insurers	Households	Geberal government	Others	Total
2016	64.0	0.0	-14.2	3.1	6.9	1.1	4.4	3.3	68.7
2017	8.4	0.0	10.2	6.9	0.8	4.2	2.4	2.8	35.6
2018	20.2	0.0	-11.3	-1.7	5.3	4.1	9.2	9.2	34.9
2019	40.9	0.0	-34.1	12.0	-0.8	7.4	-0.7	-45.3	-20.6
2020	66.9	58.5	-23.6	-18.8	-7.0	13.4	12.6	5.2	107.3
2021	-10.4	28.4	-9.2	-3.3	-1.6	14.4	20.3	-0.1	38.6
2022	-11.7	-8.7	21.6	1.8	3.9	32.8	4.7	2.0	46.5
2023	60.6	-0.7	-17.0	8.0	3.0	13.0	-14.0	10.0	62.9
I 2024	9.5	0.1	0.0	4.0	0.8	3.4	0.1	1.1	19.1
II 2024	14.6	0.1	1.3	-0.6	-0.4	2.8	0.7	3.2	21.6
III 2024	18.2	0.1	-1.3	-1.0	-0.3	2.7	0.3	0.3	19.1
IV 2024	-2.4	-0.4	-1.1	-1.6	-0.4	1.6	0.3	0.5	-3.3
YTD 2024	40.0	-0.1	-1.1	0.8	-0.3	10.6	1.4	5.1	56.4
2024F	105.0	-4.5	10.0	10.8	5.0	14.5	5.0	3.0	148.8

Santander

Source: LSEG, Ministry of Finance, analizy.pl, Santander

Higher volatility weakens the zloty

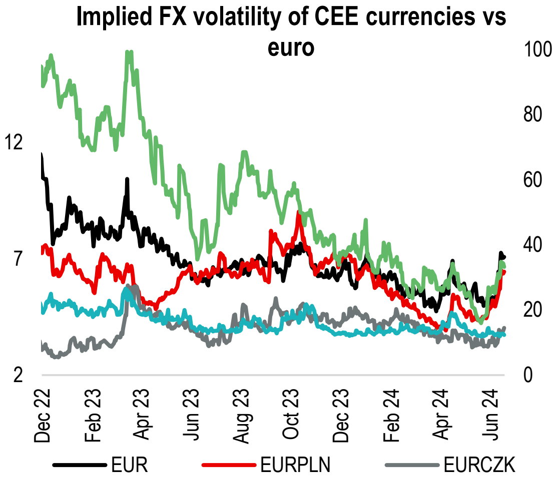
The zloty clearly weakened against the main currencies last month and was CEE underperformer. This could be due to the high positioning and lack of a marginal buyer. In such a situation, any reason would be enough to make a correction. The zloty's weakening is, among others, the aftermath of the dollar's strengthening on international markets and, indirectly, risk aversion in the face of the uncertain political situation in France or the secondary effects of elections in other emerging countries. The EURPLN correlation with the dollar increased to the highest level since the beginning of the year.

Since the start of 2024, the zloty exchange rate has hardly changed against the main currencies.

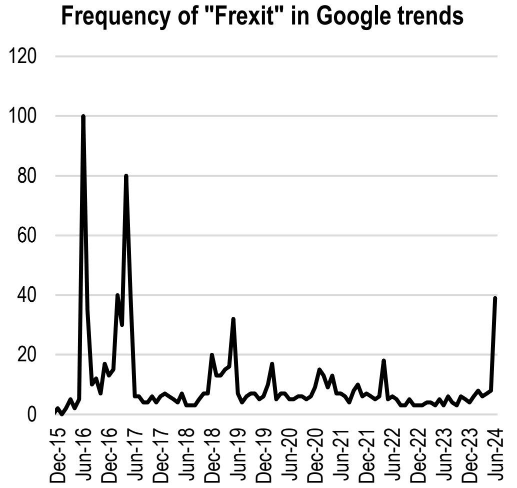
In the short term, the zloty may remain at weaker levels under the influence of volatility. This may remain at an elevated level in the face of political uncertainty in Europe related to the upcoming elections in France (30.06 and 7.07). In August, the market may already focus on the US elections, which may provide just as much volatility for the markets.

We assume that in view of the still poor export results, the Ministry of Finance will not decide to exchange the record foreign currency deposits (over EUR 20 bn on the Ministry of Finance's accounts after May) in the market.

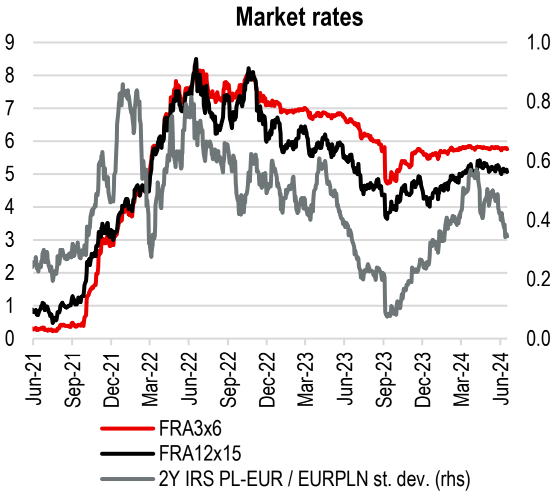
Increase in volatility unfavorable for the zloty



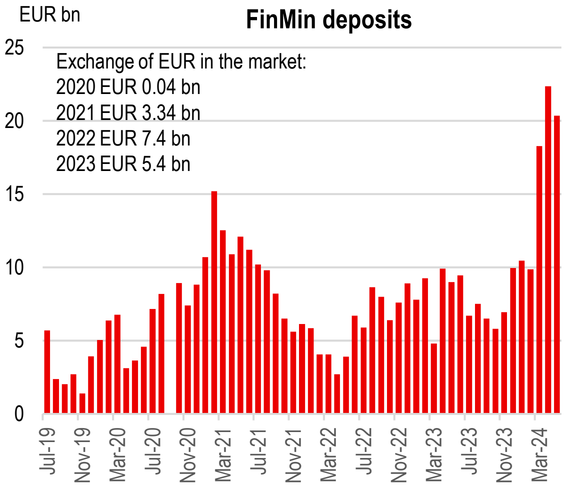
The zloty's sensitivity to political risk may remain elevated



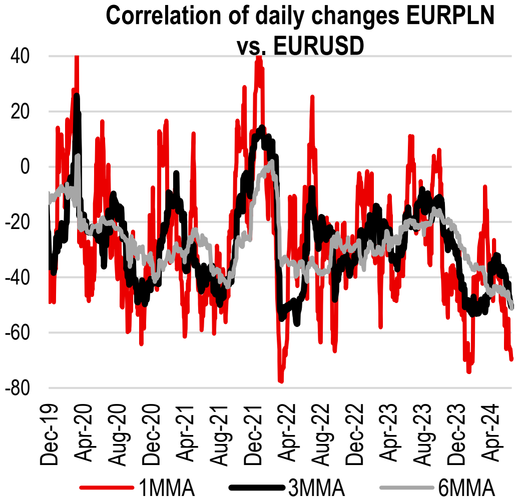
Rate disparity vs. euro remained flat near 220 bp



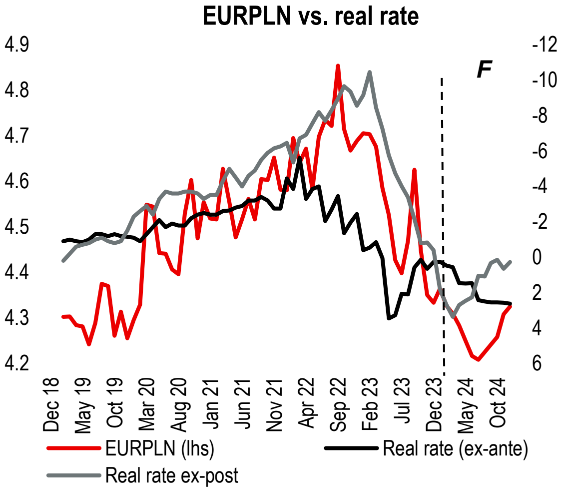
The inflow of foreign currency funds to FinMin accounts record high



Sensitivity of the PLN&HUF to $ has increased markedly



Ex-post and ex-ante real rates give mixed signals



Santander

Source: LSEG, NBP, Ministry of Finance, Santander

Smaller chances for stronger appreciation?

A gradual deterioration in the trade balance and current account is also likely to deteriorate later in the year.

The Marshal of the Sejm referred a preliminary motion for a State Tribunal for the President of NBP to the Constitutional Accountability Committee. The case will most likely be dealt with behind closed doors for 6-12 months. We maintain the assumption that in the long term, institutional quality indicators in Poland will improve, which will be beneficial for domestic assets.

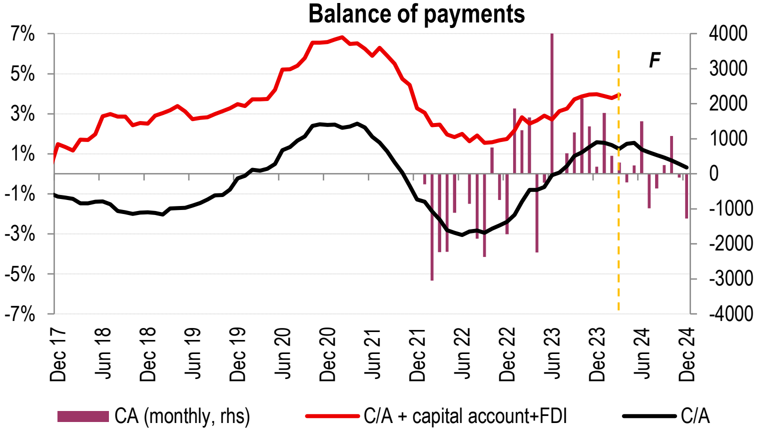
We expect that basis swap rates will remain relatively low, especially at the short end, which will allow for cheaper short-term borrowing and selling of the zloty in periods of higher volatility, but also make it easier for foreign investors to enter the domestic bond market.

In the long term, the zloty will be supported by a weaker dollar and potentially higher purchases of PLN bonds by foreign investors.

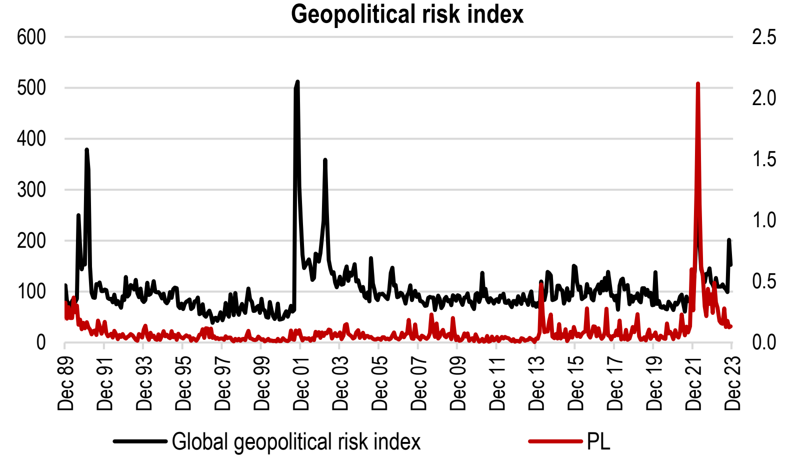
Faster easing by the ECB than by the NBP (we assume the first cut in mid-2025 due to the reduction of ECB rates by then even to 150bps) should be positive for the zloty.

A much stronger zloty could lead to a faster start of the rate cut cycle, but now the probability of such a scenario seems lower than not long ago.

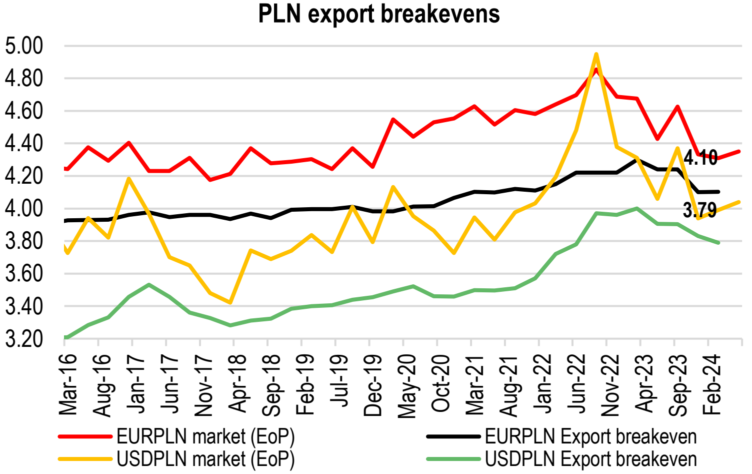
We expect a slightly weaker current account balance



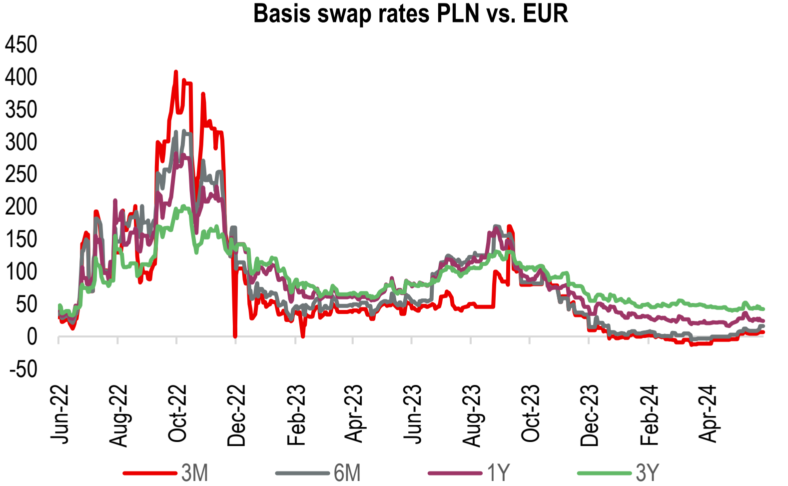
Geopolitical risks may increase towards the end of the year



The falling export profitability rate gives room for the zloty to appreciate

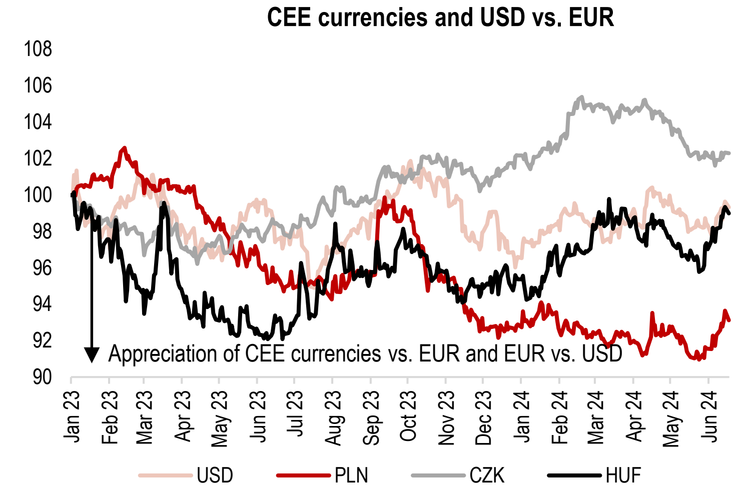


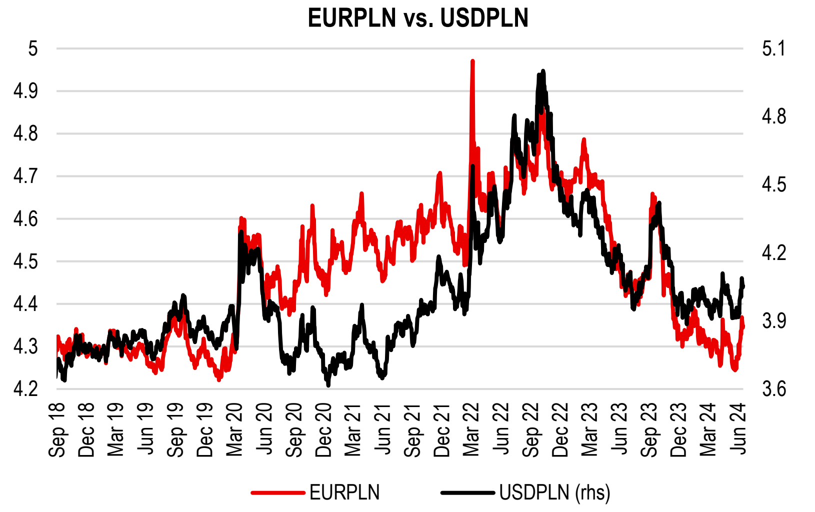
Low basis swaps (1-6M) will facilitate the sale of the zloty with an increase in volatility

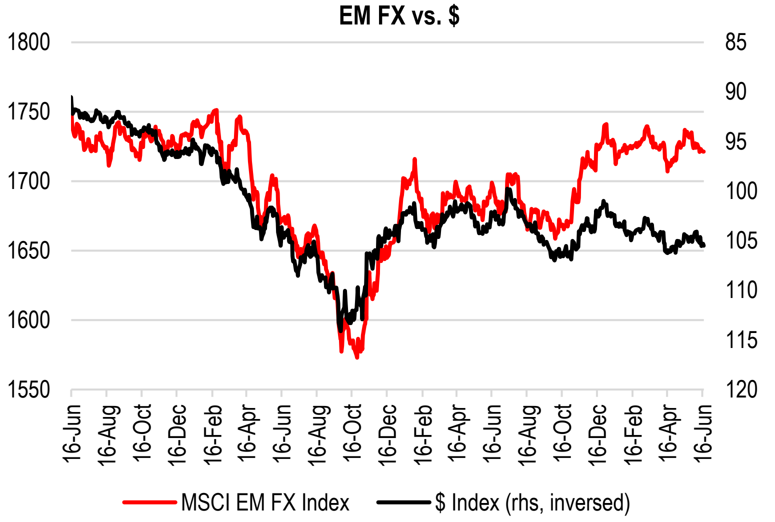


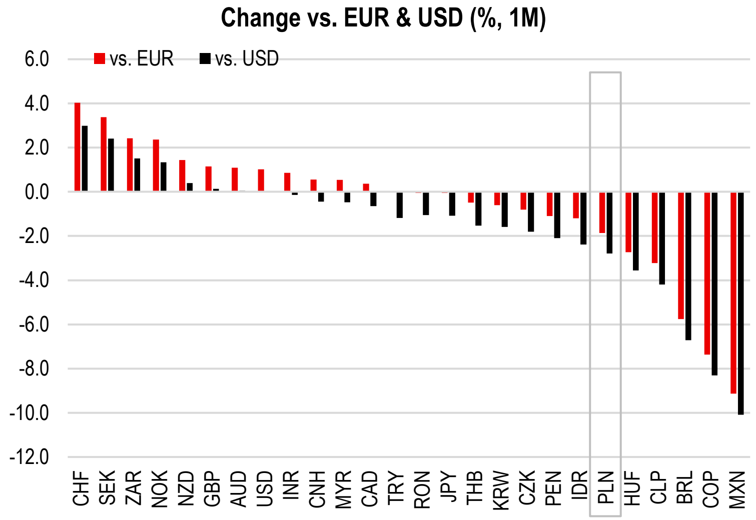
Source: LSEG, NBP, World Bank, Santander

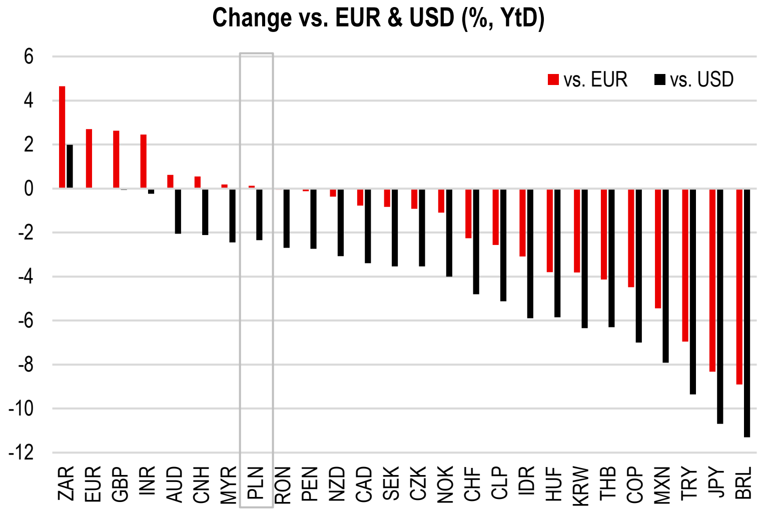
FX market overview

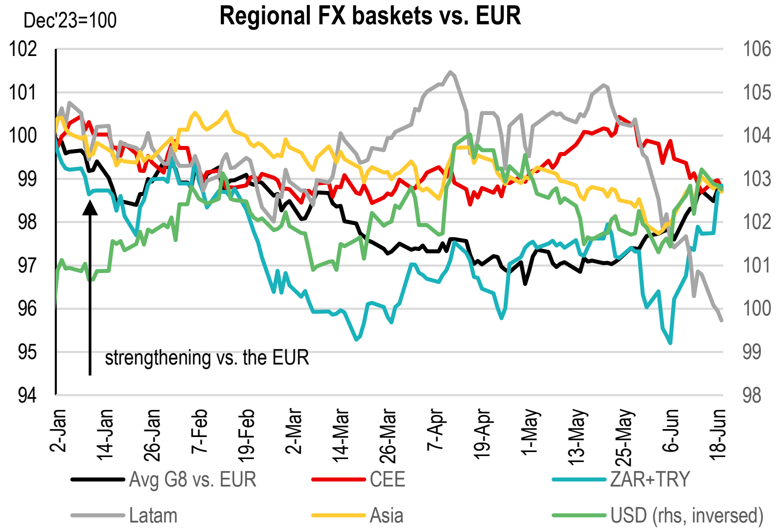












Santander

Source: Bloomberg, LSEG, Santander

Forecasts

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Economic Forecasts

		2022	2023	2024	2025	1Q24	2Q24	3Q24	4Q24	1Q25	2Q25	3Q25	4Q25
GDP	PLNbn	3,074.8	3,410.1	3,602.4	3,912.0	833.1	844.6	910.1	1,014.5	906.4	922.3	980.1	1,089.1
GDP	% y/y	5.3	0.2	3.0	3.5	2.0	3.2	3.3	3.5	3.4	3.4	3.6	3.6
Domestic demand	% y/y	5.2	-3.2	3.5	4.6	1.7	2.1	4.7	5.0	4.8	5.2	4.5	4.1
Private consumption	% y/y	5.2	-0.9	4.2	2.9	4.6	4.0	3.2	5.1	3.5	3.3	2.5	2.5
Fixed investment	% y/y	4.9	13.1	2.0	7.1	-1.8	0.5	3.0	4.0	6.0	6.5	7.0	8.0
Industrial output	% y/y	10.4	-2.1	1.1	5.7	-0.1	1.5	1.8	1.1	2.8	5.7	6.6	7.5
Construction output	% y/y	7.7	4.8	0.6	9.4	-8.7	-3.1	3.3	6.1	15.5	14.0	9.9	3.1
Retail sales (real terms)	% y/y	5.5	-3.6	4.8	5.1	5.0	5.1	4.0	5.0	4.2	3.1	4.6	8.0
Gross wages in national economy	% y/y	12.1	12.8	12.2	7.8	14.4	11.7	11.4	11.5	8.6	8.0	7.3	7.2
Employment in national economy	% y/y	2.0	0.6	-0.1	0.5	-0.2	-0.4	-0.1	0.0	0.5	0.5	0.4	0.4
Unemployment rate *	%	5.2	5.1	4.8	4.7	5.3	4.9	4.8	4.8	5.1	4.7	4.6	4.7
Current account balance	EURmn	-15,716	11,771	2,619	-3,409	2,578	1,493	-1,154	-297	217	-512	-2,455	-659
Current account balance	% GDP	-2.4	1.6	0.3	-0.4	1.2	1.2	0.8	0.3	0.0	-0.2	-0.3	-0.4
General government balance (ESA 2010)	% GDP	-3.4	-5.1	-5.5	-4.5	-	-	-	-	-	-	-	-
CPI	% y/y	14.3	11.6	3.6	4.9	2.9	2.5	4.1	4.9	5.7	5.4	4.4	4.2
CPI *	% y/y	16.6	6.2	5.0	4.1	2.0	2.5	4.7	5.0	5.8	5.6	4.4	4.1
CPI excluding food and energy prices	% y/y	9.1	10.2	4.3	3.8	5.4	3.9	3.8	4.1	3.9	3.8	3.7	3.6

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

Source: GUS, NBP, Santander

Market Forecasts

		2022	2023	2024	2025	1Q24	2Q24	3Q24	4Q24	1Q25	2Q25	3Q25	4Q25
Reference rate *	%	6.75	5.75	5.75	4.50	5.75	5.75	5.75	5.75	5.75	5.75	5.25	4.50
WIBOR 3M	%	6.02	6.52	5.86	5.50	5.86	5.86	5.85	5.85	5.85	5.77	5.48	4.89
Yield on 2-year T-bonds	%	6.35	5.67	5.08	4.06	5.05	5.28	5.11	4.89	4.49	4.11	3.91	3.74
Yield on 5-year T-bonds	%	6.36	5.66	5.40	4.54	5.19	5.55	5.57	5.30	4.95	4.60	4.35	4.25
Yield on 10-year T-bonds	%	6.10	5.83	5.60	4.76	5.36	5.69	5.74	5.60	5.25	4.90	4.55	4.33
2-year IRS	%	1.19	6.62	5.63	5.28	6.39	6.18	5.05	4.90	5.22	5.49	5.34	5.05
5-year IRS	%	1.69	5.92	5.01	4.94	5.53	5.37	4.59	4.57	4.70	5.14	5.08	4.85
10-year IRS	%	2.01	5.68	5.10	5.07	5.47	5.34	4.80	4.78	4.77	5.24	5.23	5.04
EUR/PLN	PLN	4.69	4.54	4.30	4.26	4.33	4.30	4.26	4.30	4.25	4.23	4.28	4.30
USD/PLN	PLN	4.46	4.20	3.95	3.69	3.99	4.00	3.92	3.87	3.76	3.67	3.67	3.66
CHF/PLN	PLN	4.67	4.68	4.37	4.02	4.57	4.42	4.31	4.17	4.07	4.00	4.01	4.00
GBP/PLN	PLN	5.31	5.50	5.22	4.97	5.06	5.02	4.90	4.91	4.83	4.77	4.81	4.84

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

Source: NBP, Bloomberg, Santander

This analysis is based on information available until **21.06.2024** has been prepared by:

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