6 September 2017

Poland

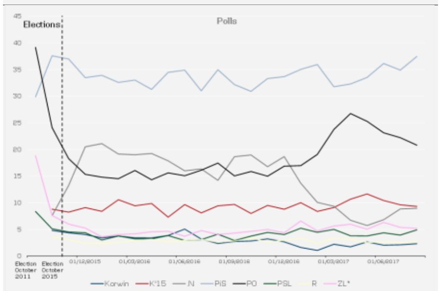
Polish economy powering ahead amid external tensions

Political situation: enemies abroad, support at home

This note summarises our impressions from our visit to Warsaw on 28 and 29 August, where we met with key policy institutions, local experts and private banks. On the political front, there is considerable concern that the Polish government is in the midst of isolating itself vis-à-vis its EU partners, as EU cases against Poland are piling up fast. In addition to the old and still open rule of law procedure, the EU launched an infringement procedure against Poland in late July over the changes to the legal system (different retirement age for female and male judges). In addition, the EU Commission is planning to bring Poland to the EU Court of Justice on three cases in Eastern Poland. The government's reluctance in taking in refugees under the EU allocation system has also upset the EU partners. Furthermore, relations with France are strained following the spat between French President Macron and Polish Prime Minister Beata Szydło over the French proposal to change the rules on posting workers within the EU. Finally, some members of the Polish government have called for German war repatriations, which has not helped Poland's standing with Germany.

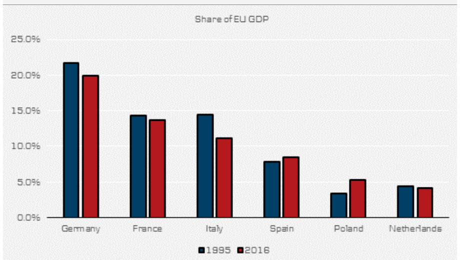
However, the EU may refrain from seeking the 'nuclear option' of suspending Poland's voting rights in relation to the infringement procedure. Firstly, such action would require unanimous support from all other EU countries, including Hungary that has stated its support for Poland. Secondly, despite the sour relations with France and Germany, both countries can probably not afford an open and potentially destabilising conflict with a key EU member country in the difficult upcoming Brexit negotiations. As can be seen in the chart, Poland is not a negligible economic player in the EU anymore. Instead, a more likely scenario is a continued dialogue without a clear solution or the EU seeking a compromise. The EU can also choose to bring some of the cases to the EU Court of Justice. In addition, the EU could try to put administrative blocks on the release of EU structural funds.

PIS party support has surged over the summer



Source: Various Polish media outlets

Poland not a negligible economic player in the EU anymore



Source: Macrobond Financial, Danske Bank

Key points

- During our visit to Warsaw on 28 and 29 August we met with key policy institutions, local experts and private banks.
- Political risk premium has flared up again following the latest spat between the Polish government and the EU.
- The Polish economy continues to power ahead driven by solid private consumer demand and a pick-up in EU funds' absorption.
- Fiscal performance is yet again outmatching expectations.
- Higher wage growth and inflation are set to prompt a more hawkish pricing of the National Bank of Poland—but too early after today's meeting.
- EUR/PLN is set to fall due to solid Polish economic growth, strong fiscal performance and the possible more aggressive pricing of NBP.

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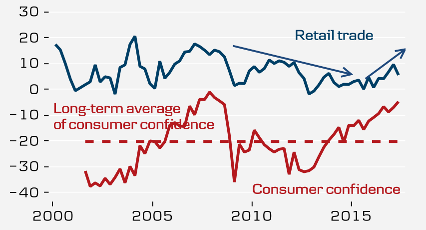
The government can claim that it has domestic legitimacy. Despite the tensions with the EU and protests in the biggest Polish cities over the summer, the support for the PIS party has increased considerably and is now higher than in the general election! Why is that? Many we met pointed to economic reasons for the support with a large (notably the poorer) part of the population gaining considerably from the new child benefit cheque, a key government initiative. The solid economic growth and falling unemployment rate are probably also lending support. Furthermore, the EU attacks on the government may actually have strengthened the population's support for the government, which is seen to stand up against the elite in Brussels. As the economy is expected to grow healthily until the until the next election in 2019 and the government has fiscal space to pursue popular spending initiatives and the opposition remains relatively weak, the government should be able to sustain the high levels of support.

Polish economy steaming ahead

The Polish economic growth remains solid. Private consumption is boosted by the child benefit cheque and record low unemployment (which fell to an all-time low of 7.1% in June) and higher real wage growth. Consumer confidence is back at pre-crisis levels. As one of the local experts put it, the child benefit cheque has boosted the purchasing power of especially lower-income households. Industrial production is holding up despite moderation in the manufacturing PMIs. Furthermore, the absorption of EU funds is picking up, which will boost growth.

Consumer confidence close to all-time high



Source: Macrobond Financial, Danske Bank

In light of the strong economic momentum we raise our forecast for this year to 4.0% (from 3.7% previously) and slightly for next year to 3.5%. The expected slowdown next year is due to a mix of factors: base effects from 2017, waning effects of the 500+ programme and increasing labour shortages limiting employment growth. On the positive side, the absorption of EU funds is set to increase further, while higher gross wages are set to support private consumption.

Solid growth outlook

	2016	2017	2018	2019
GDP (% y/y)	2,7	4,0	3,5	3,3
GDP deflator (% y/y)	0,3	1,6	1,8	1,8
CPI (% y/y)	-0,7	1,9	2,5	2,5
Private consumption (% y/y)	3,7	4,8	3,8	3,5
Fixed investments (% y/y)	-7,9	1,3	3,2	3,5
Unemployment (%)	8,3	7,5	7,3	7,1
Current account (% of GDP)	0,1	-0,5	-0,9	-1,5

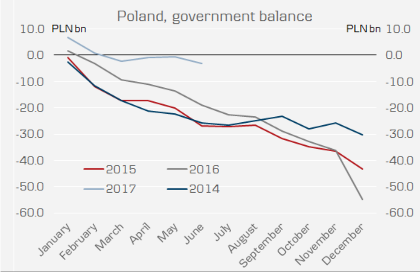
Source: Danske Bank

However, longer term the shortage of labour can become a constraint, especially in light of the lowering of the retirement age. Furthermore, many expressed concern about the unpredictability of the government, hurting the attractiveness of Poland as an investment destination for foreign companies. This was seen as hindering the technological transformation that is necessary to lift Poland beyond the middle-income trap, as seen in Hungary.

Fiscal policies: exceeding expectations

The fiscal performance continues to exceed expectations. Through June, the central government recorded a modest deficit of PLN3.1bn, significantly smaller than the PLN19bn deficit last year. The local governments are also doing well, recording a surplus of PLN13bn. The strong performance is a combination of solid economic growth, success in boosting tax compliance and expenditure under-execution. The tax compliance gains on VAT alone are estimated to be around PLN6bn so far this year, exceeding the MOF's assumption of PLN4-5bn for 2017. In addition, efforts to improve compliance among companies paying corporate income tax appear to work, as CIT is growing faster than the tax base.

Significantly stronger fiscal performance this year than in past years



Source: Macrobond Financial

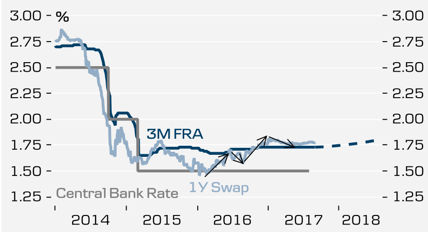
The government expects the deficit to be around 2.5% of GDP for 2017. The deficit outturn may even be lower, as the budget in the latter half of the year assumes record-large absorption of EU funds of PLN35bn, which is unlikely to materialise. Our guess is a deficit of around 2.2% of GDP, which would create significant upside for next year's budget.

The fiscal deficit is expected to come in around 2.7% of GDP next year. The budget assumes tax compliance gains of 10bn, which would mean the government achieved its target of PLN18bn over two instead of three years. Furthermore, the government is switching to a more cautious budget planning assuming the maximum use of spending limit in its budget, although spending typically falls short of spending targets, given rather strict public procurement laws. Defence spending will remain at 2% of GDP in line with NATO requirements. While the lowering of the retirement age would increase spending by PLN10bn next year (in addition to the PLN2bn in Q4 this year when the new pension system is launched), the government's budget rule is likely to require savings elsewhere to meet the requirement of only 5% in total expenditure growth. Furthermore, the estimated cost of the lower retirement age assumes 100% of possible pensioners going into retirement, which may not be the case given the significant growth in wages and demand for labour in the economy.

Central bank policies: a dovish MPC remains on hold

Most of the local experts we met considered the National Bank of Poland's (NBP) monetary policy committee as quite dovish. Hence, they thought the MPC would first consider raising rates once inflation reached the central bank's inflation target of 2.5%. Most expect inflation to continue to be at modest levels and hence only factored in a rate hike in late 2018, a little bit more aggressive than the current market pricing, which sees a 30% chance of a rate hike over the next year.

Markets are pricing in an only about 30% chance of a rate hike over the next year

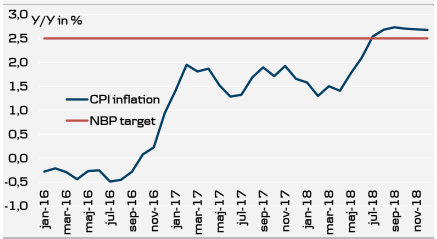


Source: Macrobond Financial, Danske Bank

The muted inflation developments in view of the tightening labour market and rising wage pressures remain a key puzzle. Many expected wage growth to pick up early next year from the current 5.5%. However, a key counterargument is the possible influx of Ukrainian workers, which has so far kept a lid on wage growth. However, Ukrainian workers may be less forthcoming given the recent tightening of working permit rules. Furthermore, the EU has opened up for three-month tourist visas, which may lead Ukrainians to seek employment in the informal sector in other EU countries.

The Polish central bank thought that the relatively short period of three-month tourist visas would constrain such an effect. Furthermore, the central bank expected other factors to boost the supply of labour, such as a structural flow of labour from the agricultural sector in demise to the rest of the economy and increasing labour market participation rates. This rate has increased from 56.2% last year to an expected 56.7% this year and could go to the German level of 70% in the long term. The NBP admitted that the pension reform would work in the opposite direction (as 300,000 might retire out of a labour force of 16.5m). The actual number of retirees under the new scheme was expected to be lower (maybe only half) and it would mainly be people with low skills.

The central bank inflation target will be reached in mid-2018

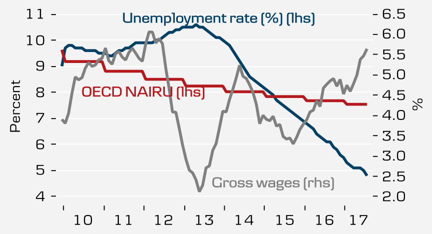


Source: Eurostat, Danske Bank

Our view is that the significant tightening of the labour market will add to wage growth and core inflation. We think that wage growth will rise to almost double-digit figures early next year. Given that the translation from a surge in wage growth to core inflation is about two months, we expect underlying inflation pressures to pick up significantly. Inflation will in our view reach the central bank's target by mid-2018. As a result we think the first hike could come concurrently, which is a bit ahead of market pricing.

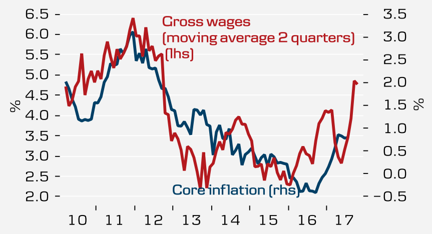
The central bank meeting today is likely to continue to convey the relatively dovish message with some hawkish members voicing concern about the impact of negative real rates on the savings in the economy. The governor will most likely point to no need for rate increases this and next year.

Increasingly tight labour market fuelling wage rises...



Source: Macrobond Financial, Danske Bank

which should push core inflation up over the next year



Source: Macrobond Financial, Danske Bank

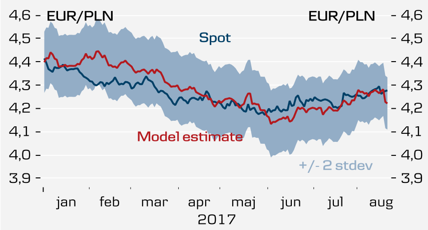
The outlook for the PLN: economic strength trumps political uncertainty

After a strong run this year, the PLN weakened almost 2% over the summer following the new strains in Poland's relations with the EU following the government's plans to change the retirement rules for judges. In addition, the weakness was exacerbated by a deterioration in global risk sentiment and the still-benign Polish inflation developments, which reduced the market pricing of the central banks. There was a perception that the PLN is undervalued and that a fair value for EUR/PLN was around the 4.00-4.10 level. The current account remains close to balance, after strengthening over the past years.

The big question was how the dispute with the EU would affect the PLN. One line of argument (and one we quite favour) was that as long as the economy stays strong and is under control fiscally, the dispute with the EU will not be a decisive factor for the currency. Furthermore, Hungary is still expected to stand by Poland, if the EU were to try and push for the nuclear option of suspending Poland's EU voting rights. However, some were less certain that Hungarian president Viktor Orbán, who is seen as a pragmatist, would maintain his pro-Poland stance, in view of a possible generous EU offer. Furthermore, renewed tensions between Poland and its EU counterparts may come into play after the German elections, as France and Germany may team up against Poland.

We think that the general strong growth in the economy, strong fiscal performance and the possible more aggressive pricing of NBP will support the PLN. Political risk premiums may support EUR/PLN in case of new tensions between Poland and the EU (such as after the German election), but we view that as selling opportunity for the cross. Hence we maintain our forecasts for EUR/PLN at 4.22 in 3M (rolling down from 4.24 in our August FX forecast), falling to 4.18 in 6M and 4.16 in 12M.

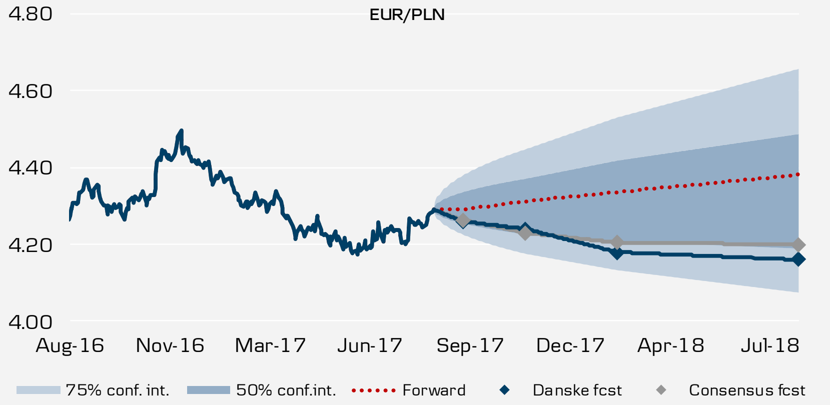
The current EUR/PLN is higher than our short-term model predicts



Source: Danske Bank

Source: Macrobond Financial, Danske Bank

We target EUR/PLN at 4.24 in 3M, 4.18 in 6M and 4.16 in 12M



EUR/PLN	1M	3M	6M	12M
Forecast (pct'ile)	4.26 (35%)	4.24 (29%)	4.18 (18%)	4.16 (20%)
Fwd. / Consensus	4.29 / 4.26	4.31 / 4.23	4.34 / 4.20	4.38 / 4.20
50% confidence int.	4.24 / 4.33	4.23 / 4.37	4.21 / 4.42	4.19 / 4.49
75% confidence int.	4.21 / 4.37	4.18 / 4.45	4.13 / 4.53	4.07 / 4.66

Source: Danske Bank

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Expected updates

None.

Date of first publication

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