Higher wages are slowly boosting inflation

This week

- **The most important event this week will be FOMC meeting scheduled for Wednesday.** We expect that after interest rate hike in December 2017, FED will maintain status quo in its monetary policy this week - the target range for the Federal Reserve funds rate equal to [1.25%; 1.50%]. Markets will focus on possible change in the tone of the statement concerning inflation outlook. However, in our view, the statement will not deliver any new information substantially altering our scenario of the US monetary policy, in which FED will hike interest rates by 25bp in March 2018. Simultaneously the FOMC meeting will be the last one chaired by J. Yellen. In February J. Powell will be sworn into office as Chairman of Federal Reserve. We believe that publication of the statement after the FED meeting this week will be neutral for the financial markets.
- **Important hard data from US will be also released this week.** The publication of data from the US labour market is scheduled for Friday. We expect non-farm payrolls to have increased by 180k in January vs. 148k in December 2017, with unemployment rate level remaining unchanged at 4.1%. Before the Friday's reading some additional information on the labour market will be provided by the ADP report on private sector employment (the market expects an increase by 183k in January vs. 250k in December). The results of business surveys will also be released this week. We forecast that ISM Manufacturing Index declined to 58.8 pts vs. 59.7 pts in December, which will be consistent with the results of regional business surveys. We expect that the Conference Board Consumer Confidence Index will signal a slight improvement in households' sentiment in January (124.5 pts vs. 122.1 pts in December). On the other hand, the final University of Michigan Index will most likely indicate its deterioration (95.0 pts in January vs. 95.9 pts in December). We believe that the aggregated impact of US readings on the financial markets will be limited.
- **Significant data from the Eurozone will be released this week.** We expect that GDP growth rate rose to 0.7% QoQ in Q4 2017 vs. 0.6% in Q3 2017. We believe that HICP inflation dropped to 1.2% YoY in January vs. 1.4% in December 2017. In our view, the Eurozone readings will not significantly impact the financial markets.
- **The January PMI indices for Chinese manufacturing (Caixin and CFLP) will be released this week.** We forecast that Caixin PMI rose to 52.0 pts vs. 51.5 pts in December while CFLP PMI decreased to 51.5 pts vs. 51.6 pts in December. We expect that business surveys results in China, which indicate stabilization of sentiment in manufacturing, will be neutral for the financial markets.
- **The estimate of Polish GDP in 2017 will be released on Tuesday.** We forecast that the GDP growth rate amounted to 4.5% YoY vs. 2.9% in 2016. The data on industrial production, assembly-construction production and retail sales, released in November-December period, signal a slight upside risk to our forecast. However, in our opinion, higher than expected annual GDP growth in 2017 will have no material impact on PLN and prices of Polish bonds.
- **The January data on business sentiment in Polish manufacturing will be released on Thursday.** We expect that PMI rose to 55.2 pts from 55.0 pts in December, which will be consistent with the results of business surveys conducted by GUS. The scale of improvement in sentiment in Polish manufacturing was limited by a deterioration of sentiment in German manufacturing (see below). Our forecast is in line with the market consensus and therefore its materialization will be neutral for PLN and prices of Polish bonds.

Last week

- **The ECB meeting was held last week and the unchanged parameters of the monetary policy were maintained.** According to the press release, the ECB expects that interest rates are likely to be left at the current level for a longer period of time, significantly exceeding the horizon of the asset purchase program (so-called forward guidance). The part saying that the ECB was ready to increase the scale or extend the horizon of the asset purchase program was left unchanged. At the press conference held after the meeting the ECB Governor M. Draghi, referring to the future prospects of extended asset purchase program, indicated that there were three possible scenarios: time horizon of the program would be extended, time horizon of the program would be extended and its volume limited or the program would end in September 2018. At the previous ECB meetings M. Draghi said that he did not anticipate sudden termination of quantitative easing program. Therefore, his statement was perceived by the market as hawkish and resulted in a rise in yields on German bonds. During the press conference M. Draghi made a reference to recent EUR strengthening. He said that recent increase in exchange rate volatility was a source of uncertainty which required monitoring. M. Draghi stated that despite exchange rate was significant for economic growth and price stability it was not an objective of the ECB policy. We expect that June ECB macroeconomic projection will indicate a drop in core inflation in 2019 and 2020. In our view, it will induce ECB to extend the asset purchase program while tapering its scale. As a consequence, we maintain our scenario that the ECB will in June extend the asset purchase program until December 2018 reducing its scale to EUR 15bn starting from September 2018. At the same time we expect that the first hike of the deposit rate will take place in September 2019 and the main interest rate will be hiked in December 2019.

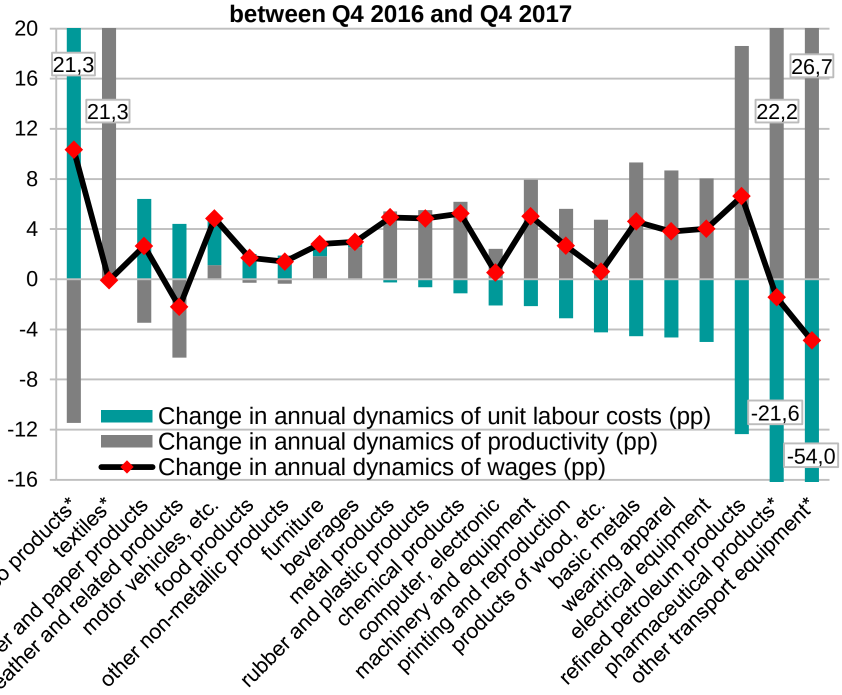
- **Numerous data from the US economy and business survey results were released last week.** According to the flash estimate, the annualized GDP growth rate decreased to 2.6% in Q4 vs. 3.2% in Q3, which was below market expectations (3.0%). Lower GDP dynamics resulted from lower contribution of net exports (-1.13 pp in Q4 vs. 0.36 pp in Q3) and inventories (-0.67 pp vs. 0.79 pp). Higher contributions of private consumption (2.58 pp vs. 1.49 pp), investments (1.27 pp vs. 0.40 pp) and government spending (0.50 pp vs. 0.12 pp) had an opposite impact. In 2017 GDP grew by 2.3% vs. a 1.5% increase in 2016. Thus, likewise in the whole 2017, private consumption remained the main source of the US GDP growth in Q4 2017. Preliminary data on durable goods orders were also released last week and increased by 2.9% MoM in December vs. a 1.7% increase in November. The main factor contributing towards increase in the monthly orders dynamics was higher growth rate of orders for means of transport (resulted from an increase of orders for military aircrafts and parts). Excluding means of transport, durable goods orders rose by 0.6% MoM in December vs. a 0.3% increase in November. Especially noteworthy in the data structure is the increase in orders for non-military capital goods, excluding aircrafts (8.4% YoY in November and in December), being a leading indicator for future investments. Data on new home sales (625k in December vs. 689k in November) and existing home sales (5.57M vs. 5.78M) were also released last week. They indicate minor drop in economic performance of US real estate market in December. We forecast that annualized GDP growth rate will decrease to 2.0% in Q1 2018.
- **Flash January business sentiment indicators (PMI) for major European economies were released last week.** Composite PMI for the Eurozone rose to 58.6 pts in January vs. 58.1 pts in December, which has been its highest level since June 2008. The index increased due to higher values of the indicator in France (59.7 pts in January vs. 59.6 in December) and its slight decrease in Germany (58.8 pts vs. 58.9 pts). Both in France as well as in Germany higher sub-indices for business activity in the services sector was recorded, while sub-indices concerning output in manufacturing declined. Other Eurozone countries covered by the survey recorded an improvement. Especially noteworthy in the data structure is the decrease of the German manufacturing PMI to 61.2 pts in January vs. 63.3 pts in December, when it reached a record high level. The decrease in the indicator resulted from lower contributions of its all five sub-indices (new orders, output, employment, and stocks of goods purchased and delivery times). In our view, the correction in German PMI is associated with record high level in December and is

not a signal of lasting deterioration of outlook for demand for goods manufactured in Poland and used in the production of final products in Germany. Last week's results of business surveys in Eurozone are upward risk for our forecast that quarterly GDP growth rate in the Eurozone will decrease to 0.5% in Q1 vs. 0.7% in Q4.

- **ZEW index reflecting the sentiment among analysts and institutional investors regarding the economic situation in Germany rose to 20.4 pts in January vs. 17.4 pts in December.** According to the press release, conducive to improved sentiment was better assessment of economic situation in Europe and USA. Attention should be paid to the assessment of the current situation in Germany, which reached the highest level in the survey history, i.e. since December 1991. Additional information on the situation in German economy was also provided last week by the Ifo Index reflecting the sentiment among German managers representing the manufacturing, construction, wholesale and retail trade sectors. This index rose to 117.6 pts in January vs. 117.2 pts in December, which was the highest level since November (historical maximum). The index increase resulted from higher sub-index concerning expectations while lower sub-index concerning the assessment of the current situation had an opposite impact. Sector-wise, improved sentiment was recorded in two of the four sectors (wholesale trade and manufacturing), while the situation in retail trade and construction deteriorated. The data on Ifo and ZEW pose a slight upside risk to our forecast, in which the quarterly GDP growth rate in Germany will decrease to 0.5% in Q1 vs. 0.9% in Q4.

Higher wages are slowly boosting inflation

Breakdown of change in YoY dynamics of wages in manufacturing between Q4 2016 and Q4 2017



Source: GUS, Credit Agricole, *out of scale values were presented in boxes

While assessing the prospects of inflation in Poland, and important issue is the observed in recent months fast growth of nominal wages, which may be conducive to increased cost pressure. Assessment of the impact of higher wages on inflation cannot be limited only to the analysis of wage dynamics. To estimate the impact of wages on costs incurred by enterprises one need to also take into consideration the growth of productivity. Unit labour costs are a measure taking into account the changes in productivity. They are a ratio of labour costs connected with a single worker and his productivity. Therefore the increase od unit labour costs may be limited by the growth of productivity. Using aforementioned dependencies we can break the increase of wages into two parts: the portion connected with higher productivity, thus not generating wage pressure for the enterprises, and the part not linked to higher productivity (i.e. increase of unit labour costs). The second part is connected to stronger bargaining power while negotiating the wages. This factor is negative for the firms' financial result and generates pressure on higher prices of their products and inflation.

In Q4 2017, in 18 out of 22 analysed branches of the manufacturing the average YoY growth rate of nominal wages in manufacturing was higher than in the same period year before. The structure of the wage data signals therefore that the observed in recent quarters acceleration of wage growth was wide ranging. Although, only in case of 8 branches of manufacturing (representing 48.4% and 46.5% of the wage fund) responsible for acceleration of the wages were faster growth of unit labour costs. At the same time in 17 branches (representing 69.4% of sold production of manufacturing and 46.5% of the wage fund) conducive to higher wage dynamics was the acceleration of productivity growth. It means that in the major part of manufacturing the acceleration of nominal wages growth did not generate a pressure on higher prices of final products.

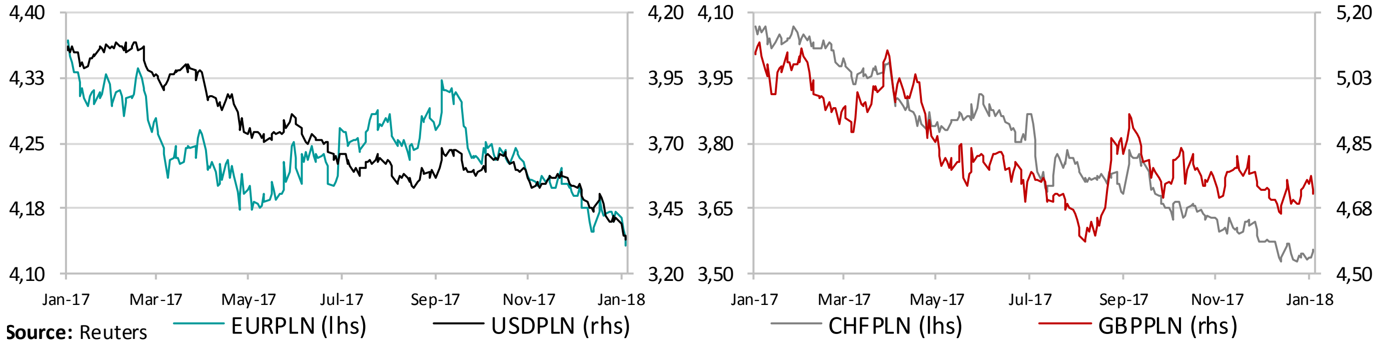
In order to estimate the impact of unit labour costs changes on the prices of sold production of manufacturing we used an econometric model. For each of the 22 branches of manufacturing we constructed a separate model, in which the YoY dynamics of prices of sold production (i.e. PPI inflation) is explained by the changes the nominal growth rate of unit labour costs, dynamics of fuel prices and the moving average processes. The dependencies in the model occur with a few months' time lag. In case of 13 branches, the impact of higher growth rate of unit labour costs on dynamics of prices of sold production is positive and statistically significant. These branches represent 66.7% of manufacturing production and 64.9% of the wage fund. We constructed also a similar model for the whole manufacturing. According to it, the increase of YoY dynamics of nominal unit labour costs by 1 pp is conducive, with a 2-month lag, to an increase of PPI inflation in manufacturing by 0.1 pp. It means that PPI inflation in manufacturing increased in 2017 by 0.7 pp, only due to higher unit labour costs.

Considering the assessment of monetary policy prospects in Poland, more important is the impact of higher unit labour costs on CPI inflation, than on PPI inflation. Therefore, we also constructed an econometric model, in which core inflation is explained) the dynamics of fuel prices and import prices lagged by 1 quarter and growth rate of nominal unit labour costs in Polish economy excluding agriculture lagged by 2 quarters. Based on this model we estimate that the increase of YoY dynamics of unit labour costs in Polish economy excluding agriculture had a limited impact on the increase of core inflation in 2017 r. (below 0,1 pp). In 2018 we expect acceleration of nominal growth of wages, with a simultaneous slowdown of GDP growth and lower dynamics of employment (see quarterly table). The result of this tendencies will be slightly higher dynamics of unit labour costs. However it will contribute to only a moderate increase of core inflation.

In our analysis we take into consideration only the impact of increasing wages on growing cost of enterprises. However, we omit the impact of higher demand pressure. Considering both factors, we believe that core inflation will increase to 2.0% YoY in Q4 2018. At the same time the CPI inflation will be hampered by forecasted by us further drop of food prices dynamics and dynamics of fuel prices, which will be lower in Q4 2018 than in Q4 2017, we believe. Aforementioned factors support our monetary policy scenario, in which, given a moderate wage pressure and the expected in the coming quarters gradual decrease in inflation to a level significantly below the inflation target, the MPC will leave interest rates unchanged until the middle of 2019. The main risk to our inflation scenario and – indirectly – to the forecast of NBP interest rates is the significant increase in oil prices that was recorded in recent weeks, signalling higher probability of secondary inflationary impulses related to increase in energy prices.

USDPLN at the lowest level since 2014

FX rates



Source: Reuters

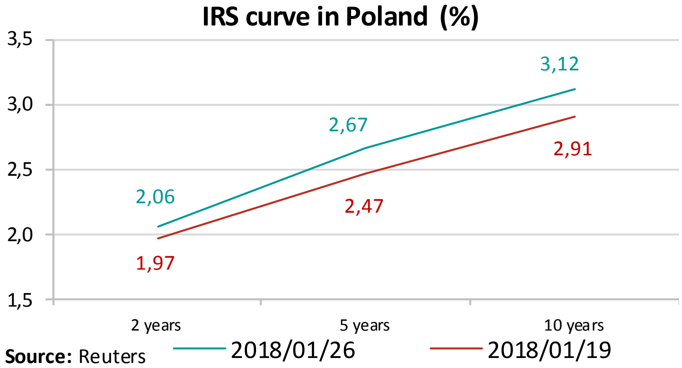
Last week EURPLN rate dropped to 4.1329 (PLN weakening by 0.9%). Due to scarce macroeconomic calendar, Monday and Tuesday saw stabilization of PLN. On Wednesday, PLN strengthened due to higher demand by foreign investors preparing for Friday's Polish debt auction. On Thursday PLN continued to appreciate despite hawkish tone of the conference after the ECB meeting. On Friday there was a correction, nevertheless PLN returned to the level slightly above 4.13.

Last week saw a further depreciation of USD against EUR supported by the Wednesday's statement by United States Secretary of the Treasury S. Mnuchin, who at the economic forum in Davos expressed an opinion that he was satisfied with the recent weakening of USD. As a result, last week USDPLN dropped to the lowest level since October 2014.

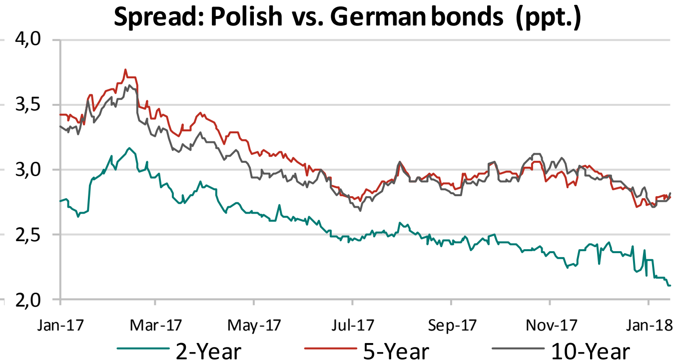
This week the most important event will be FOMC meeting. Nevertheless, we expect that its impact on PLN would be limited. Market focus will be also on data from the US labour market. Our forecasts are similar to the market consensus, therefore they will not be significant for PLN. Neutral for PLN will be also remaining US data (Conference Board Index, Manufacturing ISM Index, final University of Michigan Index). We consider that data from the Eurozone (flash estimate of GDP in Q4, flash HICP inflation), China (PMI indices for manufacturing) and Poland (GDP in 2017, Manufacturing PMI) will not be market moving.

Hawkish Draghi boosted IRS rates

IRS curve in Poland (%)



Spread: Polish vs. German bonds (ppt.)



Source: Reuters

Last week the 2-year IRS rates rose to a level of 2.06 (up by 9 bp), of 5-year rates to a level of 2.67 (up by 20 bp), and of 10-year rates to a level of 3.115 (up by 21 bp). In the first part of week there was a stabilization of IRS rates. On Thursday during the press conference after the ECB meeting a marked increase of IRS rates all along the curve was recorded. It resulted from the ECB president M. Draghi's statement on the future of quantitative easing in the Eurozone which was perceived by the market participants as hawkish. On Friday the IRS rates continued to grow. On Friday a debt auction took place at which Ministry of Finance sold PLN 7.0bn of 2-,4-,5- and 10-year bonds with demand amounting to PLN 10.4bn. The auction had limited impact on the curve.

This week the market focus will be on FOMC meeting scheduled for Wednesday. Nevertheless, in our opinion it will have no significant impact on the IRS rates. Neutral for the curve will be also Friday’s data from the US labour market, as well as remaining US data (Conference Board Index, Manufacturing ISM Index, final University of Michigan Index). Limited impact on the IRS rate will have also data from the Eurozone (flash estimate of GDP in Q4, flash HICP inflation), China (PMI indices for manufacturing) and Poland (GDP in 2017, Manufacturing PMI).

Forecasts of the monthly macroeconomic indicators

Main monthly macroeconomic indicators in Poland

Indicator	Dec-16	Jan-17	Feb-17	Mar-17	Apr-17	May-17	Jun-17	Jul-17	Aug-17	Sep-17	Oct-17	Nov-17	Dec-17	Jan-18
NBP reference rate (%)	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50
EURPLN*	4,40	4,32	4,31	4,23	4,23	4,18	4,23	4,25	4,25	4,31	4,24	4,20	4,18	4,15
USDPLN*	4,18	4,00	4,07	3,97	3,88	3,72	3,70	3,59	3,57	3,65	3,64	3,53	3,48	3,35
CHFPLN*	4,11	4,04	4,05	3,96	3,90	3,84	3,86	3,72	3,72	3,77	3,65	3,59	3,57	3,56
CPI inflation (% YoY)	0,8	1,7	2,2	2,0	2,0	1,9	1,5	1,7	1,8	2,2	2,1	2,5	2,0	
Core inflation (% YoY)	0,0	0,2	0,3	0,6	0,9	0,8	0,8	0,8	0,7	1,0	0,8	0,9	0,9	
Industrial production (% YoY)	2,2	9,1	1,1	11,0	-0,6	9,1	4,5	6,2	8,7	4,3	12,3	9,0	2,7	
PPI inflation (% YoY)	3,2	4,0	4,5	4,8	4,2	2,4	1,8	2,2	3,0	3,2	3,0	1,8	1,4	
Retail sales (% YoY)	6,4	11,4	7,3	9,7	8,1	8,4	6,0	7,1	7,6	8,6	8,0	10,2	6,0	
Corporate sector wages (% YoY)	2,7	4,3	4,0	5,2	4,1	5,4	6,0	4,9	6,6	6,0	7,4	6,5	7,3	
Employment (% YoY)	3,1	4,5	4,6	4,5	4,6	4,5	4,3	4,5	4,6	4,5	4,4	4,5	4,6	
Unemployment rate* (%)	8,2	8,5	8,4	8,0	7,6	7,3	7,0	7,0	7,0	6,8	6,6	6,5	6,6	
Current account (M EUR)	-106	2548	-514	-405	350	-264	-892	-203	189	120	297	233		
Exports (% YoY EUR)	9,0	15,1	6,4	19,7	3,2	19,2	7,2	13,3	11,5	10,0	15,5	14,8		
Imports (% YoY EUR)	9,8	16,0	10,5	19,8	4,6	21,7	14,5	13,2	7,8	7,5	14,8	15,9		

*end of period

Forecasts of the quarterly macroeconomic indicators

Main macroeconomic indicators in Poland

Indicator		2017				2018				2017	2018	2019
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
Gross Domestic Product (% YoY)		4,1	4,0	4,9	4,8	4,2	3,9	3,6	3,6	4,5	3,8	3,3
Private consumption (% YoY)		4,7	4,9	4,8	4,3	4,2	3,9	3,5	3,8	4,7	3,9	3,0
Gross fixed capital formation (% YoY)		-0,5	0,9	3,3	6,9	8,6	7,2	7,2	6,6	3,6	7,2	5,0
Export - constant prices (% YoY)		9,6	3,1	7,6	7,5	5,6	6,5	6,6	6,2	7,0	6,2	5,0
Import - constant prices (% YoY)		9,7	6,0	5,7	6,9	6,4	7,1	7,2	8,2	7,1	7,2	6,0
GDP growth contributions	Private consumption (pp)	2,9	2,9	2,9	2,1	2,7	2,3	2,1	1,9	2,7	2,3	1,8
	Investments (pp)	0,0	0,1	0,6	1,7	1,0	1,2	1,2	1,6	0,6	1,4	0,9
	Net exports (pp)	0,4	-1,3	1,1	0,6	-0,2	0,0	0,0	-0,7	0,2	-0,2	-0,3
Current account***		0,1	-0,4	0,0	-0,5	-0,8	-0,4	-0,1	-0,5	-0,5	-0,5	-0,7
Unemployment rate (%)**		8,0	7,0	6,8	6,6	6,7	6,1	6,2	6,5	6,6	6,5	6,5
Non-agricultural employment (% YoY)		2,1	2,4	1,8	1,6	1,2	0,7	0,4	0,3	2,0	0,6	0,0
Wages in national economy (% YoY)		4,1	5,0	4,9	5,9	6,8	5,8	6,1	6,8	5,0	6,4	6,5
CPI Inflation (% YoY)*		2,0	1,8	1,9	2,3	1,8	1,9	2,0	1,2	2,0	1,7	2,0
Wibor 3M (%)**		1,73	1,73	1,73	1,72	1,72	1,72	1,72	1,72	1,72	1,72	1,97
NBP reference rate (%)**		1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,75
EURPLN**		4,23	4,23	4,31	4,18	4,17	4,14	4,12	4,10	4,18	4,10	4,15
USDPLN**		3,97	3,70	3,65	3,48	3,53	3,45	3,38	3,33	3,48	3,33	3,27

* quarterly average
** end of period
***cumulative for the last 4 quarters

Calendar

TIME	COUNTRY	INDICATOR	PERIOD	PREV. VALUE	FORECAST*	
					CA	CONSENSUS**
		Monday 01/29/2018				
14:30	USA	Real private consumption (% MoM)	Dec	0,4		
		Tuesday 01/30/2018				
10:00	**Poland**	**Annual GDP (% YoY)**	**2017**	**2,9**	**4,5**	**4,5**
11:00	Eurozone	Preliminary GDP (% QoQ)	Q4	0,6	0,7	0,6
11:00	Eurozone	Business Climate Indicator (pts)	Jan	1,66		1,70
14:00	Germany	Preliminary HICP (% YoY)	Jan	1,6	1,60	1,60
15:00	USA	Case-Shiller Index (% MoM)	Nov	0,7		0,7
16:00	USA	Consumer Confidence Index	Jan	122,1	124,5	123,0
		Wednesday 01/31/2018				
2:00	China	Caixin Manufacturing PMI (pts)	Jan	51,6	51,5	51,5
11:00	Eurozone	Preliminary HICP (% YoY)	Jan	1,4	1,2	1,3
11:00	Eurozone	Unemployment rate (%)	Dec	8,7		8,7
14:15	USA	ADP employment report (k)	Jan	250		183
15:45	USA	Chicago PMI (pts)	Jan	67,6		64,2
20:00	USA	FOMC meeting (%)	Jan	1,50	1,50	1,50
		Thursday 02/01/2018				
2:45	China	Caixin Manufacturing PMI (pts)	Jan	50,2	52,0	51,3
9:00	**Poland**	**Manufacturing PMI (pts)**	**Jan**	**55,0**	**55,2**	**55,2**
9:55	Germany	Final Manufacturing PMI (pts)	Jan	61,2	61,2	61,2
10:00	Eurozone	Final Manufacturing PMI (pts)	Jan	59,6	59,6	59,6
14:30	USA	Initial jobless claims (k)	w/e	233		235
15:45	USA	Flash Manufacturing PMI (pts)	Jan	55,5	55,5	
16:00	USA	ISM Manufacturing PMI (pts)	Jan	59,7	58,8	59,0
		Friday 02/02/2018				
11:00	Eurozone	PPI (% YoY)	Dec	2,8		2,3
14:30	USA	Unemployment rate (%)	Jan	4,1	4,1	4,1
14:30	USA	Non-farm payrolls (k MoM)	Jan	148	180	178
16:00	USA	Final U. of Michigan Sentiment Index (pts)	Jan	94,4	95,0	95,0
16:00	USA	Factory orders (% MoM)	Dec	1,3		0,8

*The forecasts of macroeconomic indicators for Poland were prepared by Credit Agricole Bank Polska S.A. The forecasts of foreign indicators were prepared by Crédit Agricole Corporate and Investment Bank

** Reuters

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