Fast wage growth will have a limited impact on inflation

This week

- **The most important event this week will be the meeting of the Monetary Policy Council scheduled for Wednesday.** We expect that the MPC will decide to leave interest rates at an unchanged level. The results of the latest NBP inflation projection will also be presented. We expect that the inflation profile will not change significantly compared to the March projection, as the impact of the forecast's lower starting point (Q2 2018) will be offset by higher expected dynamics of fuel prices. We believe that the expected GDP growth rate may be slightly raised in the short-term horizon but its downward trajectory in the coming quarters will be maintained. In our view, the NBP Governor, A. Glapiński, will repeat his view that interest rates will remain unchanged until the end of 2019. We believe that projection results, press release after the Council meeting, and NBP Governor's remarks during the conference will be neutral for PLN and the prices of the Polish debt.
- **Significant data from the US will be released this week**. We forecast that CPI inflation rose to 2.9% YoY in June vs. 2.8% in May, due to higher core inflation (2.3% YoY vs. 2.2% in May). The preliminary University of Michigan Index will be published on Friday. We forecast that its value rose to 98.4 pts in July vs. 98.2 pts in June. In our view, the aggregate impact of US readings will be neutral for PLN and the prices of the Polish debt.
- **ZEW index reflecting the sentiment among analysts and institutional investors regarding the economic situation in Germany will be released on Tuesday.** The market expects that its value dropped to -18.2 pts in July vs. -16.1 pts in June. In our view, conducive to the deterioration of sentiment was the sell-off observed in the emerging markets in recent weeks.
- **Data on the Chinese balance of trade will be released on Friday**. We expect that its balance rose to USD 31.7bn in June vs. USD 24.9bn in May. Conducive to the increase in export dynamics was the faster execution of orders before the planned date of the introduction of tariffs by the US. However, due to high base effects, we forecast that export dynamics recorded a decline in June down to 9.5% YoY vs. 12.6% in May. At the same time, we expect that import dynamics dropped to 19.3% from 26.0%. The publication of data from China will be neutral for the markets, we believe.
- **Final data on June inflation in Poland will be released on Friday.** We expect that inflation will not change compared to the flash estimate (1.9% YoY vs. 1.7% in May). The increase in inflation in June resulted from higher dynamics of fuel prices and core inflation (see below). The reading should not be market moving.

Last week

- **Non-farm payrolls in the US rose by 213k in June vs. a 244k increase in May (revised upwards from 223k), running above the market expectations (increase by 187k).** The highest increase in employment was recorded in education and health service (+54.0k), business services (+50.0k), and manufacturing (+36.0k). On the other hand, employment decreased in retail trade (-21.6k) and utilities (-0.3k). The unemployment rate increased to 4.0% in June from 3.8% in May, running significantly above the market expectations. In effect, directly after the publication of the data, USD weakened vs. EUR. The unemployment rate, despite its increase in June, continues to run clearly below the natural unemployment rate indicated by FOMC (4.5% - see MACROmap of 18/6/2018). In addition, the increase in the unemployment rate in June resulted from the activation of some so-far unemployed persons; hence, it does not signal deterioration in the US labour market. This view is supported by the decrease in the number of professionally inactive persons with a simultaneous similar increase in the number of the unemployed. Consequently, the participation rate rose to 62.9% in June vs. 62.7% in May. The annual dynamics of average hourly earnings has not changed in June compared to May and amounted to 2.7%. We expect that subsequent months will record further increase in wage growth, as the situation in the US labour market will improve. The results of business surveys were also released last week. The ISM index for manufacturing increased to 60.2 pts in June vs. 58.7 pts in May. The index increase resulted from higher contributions of three of its five sub-indices (for output, suppliers' delivery times, and inventories). Lower contributions of the sub-indices for employment and new orders had an opposite impact. Non-manufacturing ISM also recorded an increase and amounted to 59.1 pts in June vs. 58.6 pts in May. Conducive to the index increase were higher contributions of its sub-indices for business activity and new orders, while lower contributions of the sub-indices for employment and suppliers' delivery times had an opposite impact. The last week's data from the US economy support our scenario, in which the annualized US GDP growth rate will increase from 2.0% in Q1 to 3.7% in Q2.

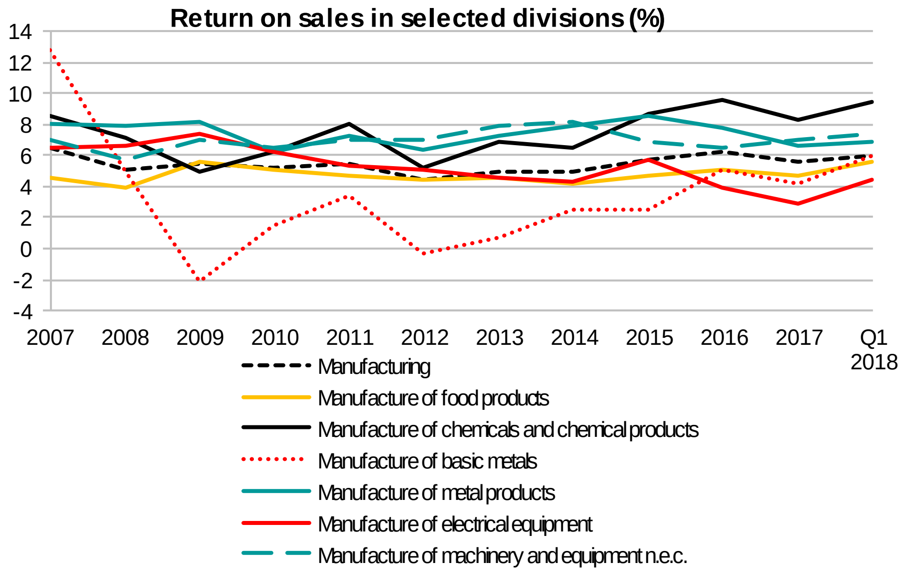
- **The Minutes of the June FED meeting were released last week**. As we expected, the document included FED members' views on short- and medium-term prospects for the economic situation in the US, mainly in the context of the effects of the protectionist actions of D. Trump's administration. Most FOMC members believe that the tariffs and restrictions in global trade may have a negative impact on business sentiment and investments in the US. Thus, they indicate that protectionist actions in global trade pose a downside risk to the FOMC members' economic projections presented at the June meeting. The Minutes do not alter our scenario, in which FED will hike rates two more times in 2018, each time by 25 bp (in September and December).
- **According to the flash estimate, CPI inflation in Poland rose to 1.9% YoY in June vs. 1.7% in May, running below the market consensus equal to our forecast (2.0%)**. GUS published partial data on inflation structure, including information about inflation rate in the categories "food and non-alcoholic beverages", "energy", and "fuels". Conducive to higher headline inflation were higher dynamics of fuel prices (15.2% YoY in June vs. 9.2% in May) and higher core inflation, which, according to our estimates, stood at 0.6-0.7% in June vs. 0.5% in May. On the other hand, lower dynamics of food prices (2.7% YoY in June vs. 3.0% in May) had an opposite impact. The June data do not alter our forecast of average yearly inflation in 2018 (1.6% vs. 2.0% in 2017).
- **The Polish manufacturing PMI rose to 54.2 pts in June vs. 53.3 pts in May.** As a result, it reached the highest level since January 2018. Conducive to the indicator increase were higher contributions of three of its five sub-indices (for new orders, employment, and output). Lower contributions of the sub-indices for suppliers' delivery times and stocks of goods purchased had an opposite impact. Especially noteworthy in the data structure is the difference between the growth rate of total new orders (sub-index value amounting to 54.6 pts) and new exports orders (51.4 pts). This shows that the situation in Polish manufacturing is currently positively impacted mainly by strong domestic demand, with the inflow of foreign orders being less significant. We believe that this tendency results from the recovery observed now in construction which has a positive impact on the manufacturing activity – mainly in branches connected with construction. It thus mitigates the negative impact of the slowdown in global trade on Polish manufacturing (see MACROmap of 2/7/2018). The average value of the Polish PMI in Q2 (53.8 pts) stood only slightly below its average value in Q1 (54.0 pts), which, combined with the data on industrial production and construction-assembly production for April-May, poses an upside risk to our forecast of GDP growth in Q2 (4.9% YoY vs. 5.2% in Q1).
- **Significant data from the German economy were released last week**. The monthly dynamics of industrial production rose to 2.6% in May vs. -1.3% in April, running clearly above the market expectations (0.4%). Its increase resulted from higher output dynamics in all its categories (manufacturing, energy, and construction). Orders in German manufacturing also recorded an increase, rising by 2.6% MoM in May vs. a 1.6% decrease in April, which was clearly below the market expectations (1.1%). It is also worth noting that it has been their first month-on-month increase since December 2017. Data on the German balance on trade have also been released

today. It rose to EUR 20.3bn in May vs. EUR 19.4bn in April, which was slightly above the market expectations (EUR 20.5bn). It increased given an increase in export dynamics (1.8% MoM in May vs.-0.3% MoM in April) and a decrease in import dynamics (0.7% in May vs. 2.2% in April). The better-than-expected data from the German economy signal that the earlier indicated by us downside risk to our forecast of the German GDP (0.6% QoQ in Q2 vs. 0.3% in Q1) has decreased.

- **Business survey results for Chinese manufacturing were released last week.** CFLP PMI dropped to 51.5 pts in June vs. 51.9 pts in May, while Caixin PMI dropped to 51.1 pts in June vs. 51.4 pts in May. Especially noteworthy in the structure of the two indices is the decrease in the sub-index for new export orders. In both cases it stood below the 50 pts threshold dividing expansion from contraction of activity. The decline in new export orders in Chinese manufacturing is related to higher import tariffs imposed by the US on Chinese goods worth USD 50bn (see MACROmap of 18/6/2018). In our view, the trade war in its current state will have a limited impact on the dynamics of the Chinese GDP – we estimate that its direct impact (excluding multiplier effects and the impact of deteriorated global sentiment on investments and imports) will not exceed 0.1 pp. Thus, we maintain our forecast, in which the Chinese GDP dynamics will decrease to 6.6% in 2018 vs. 6.9% in 2017. The main risk to our scenario is possible further escalation of the protectionist measures in global trade (see below) and its impact on the global sentiment.
- **Last week the US President D. Trump hardened his position concerning trade policy vis-à-vis China.** As the first stage, tariffs on products worth USD 14bn would be introduced (in addition to the current ones amounting to USD 36bn, in total USD 50bn). D. Trump warned that if China imposed retaliatory tariffs on US exports, the US would impose new tariffs on Chinese goods worth USD 200bn. At the same time, he said that if it also met with China's retaliation, the US would impose higher tariffs on subsequent goods from China worth USD 300bn. This would mean the imposition of increased tariffs on China's entire exports to the US. D. Trump's remarks point to a high likelihood of further escalation of protectionist measures in global trade and, consequently, are negative for global sentiment and PLN.

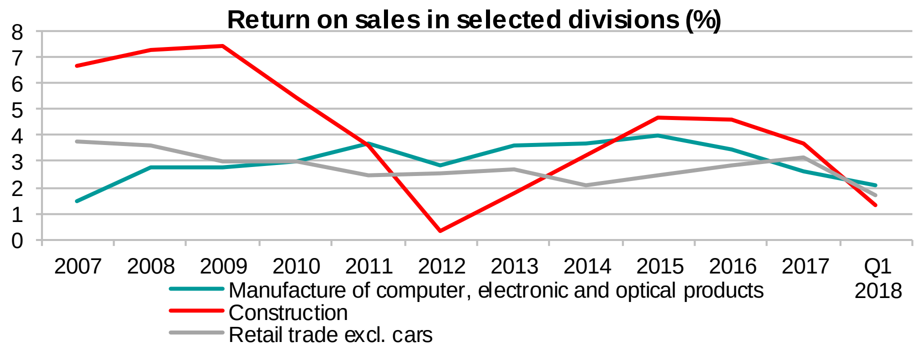
Fast wage growth will have a limited impact on inflation

The problem of the negative impact of the fast growth of nominal wages on the competitiveness of Polish enterprises has often been raised in the economic discourse in recent months. Below we present an analysis of this issue in the short- and medium-term perspective.



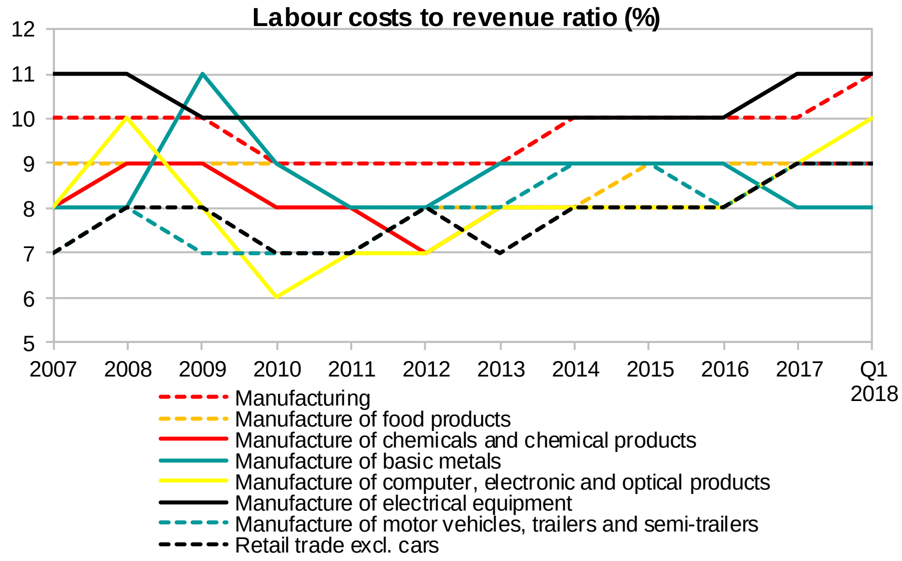
Source: PONT Info, Credit Agricole

To maintain the competitive advantage in the form of low production costs is especially important from the point of view of the export-oriented branches – segments of manufacturing where a significant portion of sales revenues comes from exports. We have analysed the return on sales (operating profit divided by net sales revenues) in these branches in recent years. This ratio can in simple terms be treated as the enterprise's margin. It can be observed that return on sales in export-oriented branches has increased in recent quarters. This means that the fast growth of nominal wages has not deteriorated the competitiveness of most export-oriented branches as the companies were compensating higher labour costs with higher productivity. It is also worth emphasizing that favourable tendencies in the return on sales in Q1 have been maintained despite the PLN strengthening recorded in that period.



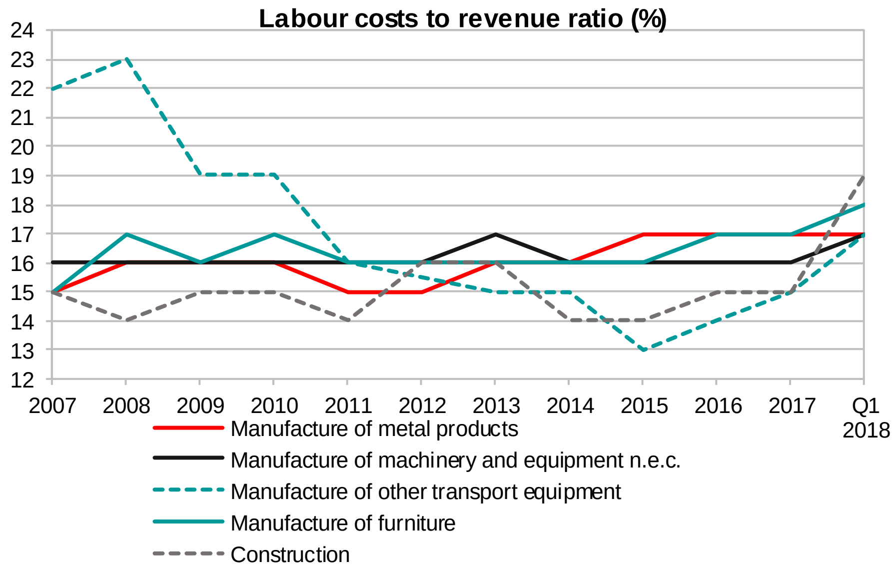
Source: PONT Info, Credit Agricole

We have identified three branches where return on sales decreased in the last years – manufacture of computer, electronic, and optical products, construction, and retail trade except of motor vehicles. In the case of construction, this tendency results from higher prices of raw materials. Similar situation occurred between 2010 and 2012 (the period of the construction boom related to EURO 2012). In turn, in the case of the manufacture of computer, electronic, and optical products, the decrease in margins could have been caused by the technological progress, contributing towards global decrease in prices of finished products in this category, namely also in revenues. In the case of retail trade, due to limited possibilities of increasing productivity fast, lower return on sales resulted mainly from higher cost of labour.



Source: PONT Info, Credit Agricole

The aforementioned conclusions about limited impact of higher wages on the competitiveness of enterprises are also confirmed by the analysis of the relation of labour costs and total revenue. Polish companies can be divided into branches where this ratio amounts to ca. 10% (i.a. manufacture of food, chemicals and chemical products, metals, motor vehicles, retail trade) and branches where it stands at ca. 15% (i.a. construction, manufacture of metals, manufacture of metal products). In the manufacturing, the percentage of labour costs in total revenues amounted to 11% in Q1 2018. It can be noted that, in some branches, wage growth was responsible for an increase in the labour costs to revenue ratio, but only to a limited extent. Against the historical backdrop, the percentage of labour costs in total revenues was stable in most branches.

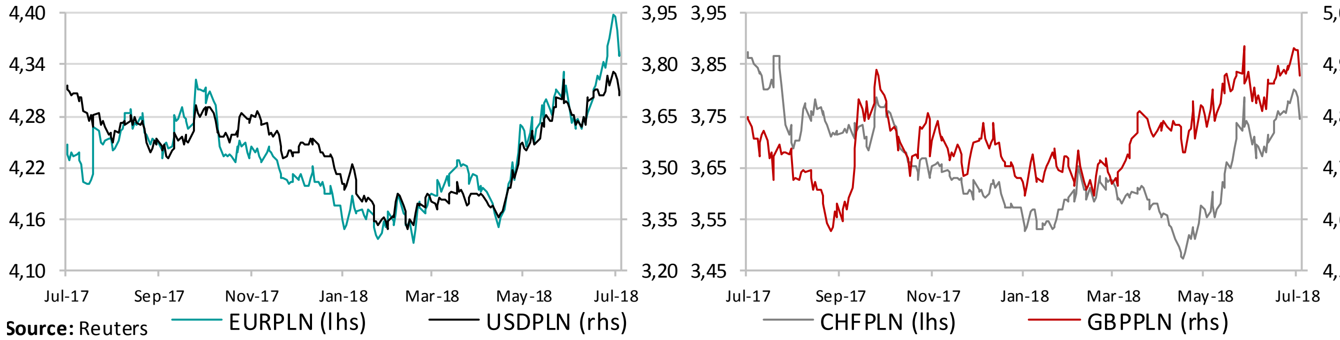


Source: PONT Info, Credit Agricole

The above relationships are important from the point of view of the inflation scenario in Poland. In the case of export-oriented branches, strong foreign competition will limit the possibility of raising the prices of final products. Such scenario will be materializing due to small percentage of labour costs in total revenues – even in the event of a sustained fast increase in nominal wages, their impact on enterprises' margins will be limited. For instance, assuming that the percentage of labour costs in total revenues amounts to 10% and wages increase by 10%, with other conditions unchanged, the enterprise's margin would decrease by only 1 percentage point. This situation, combined with the expected by us relatively low inflation in the Eurozone and the anticipated moderate appreciation of PLN, will not force a fast increase in prices of final products by Polish export-oriented companies, which will limit the increase in inflation in Poland in subsequent quarters. In turn, in the non-tradable goods sector (e.g. retail trade and other services or segments of manufacturing open to foreign competition to a small extent) higher labour costs will have more significance in the process of shaping prices, as these can easily be transferred to consumers. Pay rises for employees will be conducive to an increase in the prices of goods offered by these branches with a view to maintaining the enterprises' margin unchanged, which, in our view, will be reflected by a gradual increase in core inflation. The factors outlined above support our forecast of inflation (1.6% in 2018 and 1.3% in 2019).

PLN has partly made up for the losses from two weeks ago

FX rates



Source: Reuters

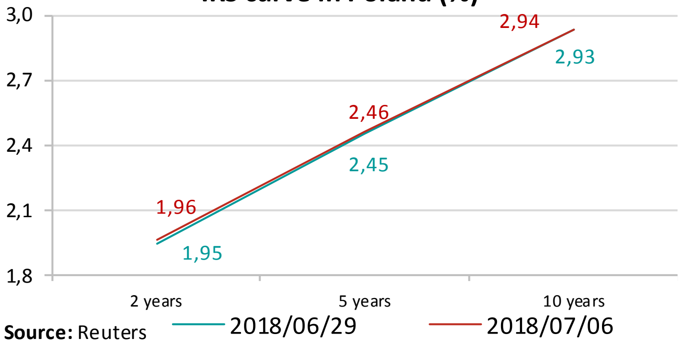
Last week, the EURPLN exchange rate dropped to 4.3549 (PLN strengthening by 0.4%). On Monday, PLN continued its depreciation vs. EUR due to increase in global risk aversion. Consequently, EURPLN rose above 4.41, hitting the highest level since the beginning of January 2017. High EURPLN rate, with a simultaneous increase in risk appetite, boosted foreign demand for PLN. In effect, from Tuesday we observed a correction and gradual PLN strengthening. On Friday morning, PLN was slightly depreciating but data from the US labour market released in the afternoon, which contrary to expectations indicated increase in unemployment rate, resulted in its strengthening.

Due to PLN strengthening vs EUR, PLN was also appreciating vs. other major currencies. Consequently, last week, PLN appreciated vs. USD (by 0.9%), CHF (by 0.8%), and GBP (by 0.5%).

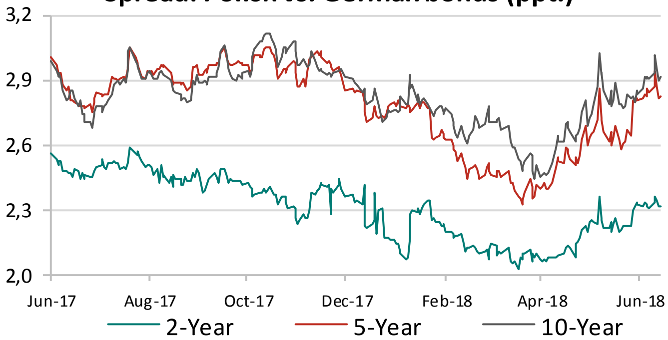
We believe that this week PLN will remain under the influence of global sentiment, determined by protectionist measures in global trade. The last week's remarks of D. Trump (see above) indicate high probability of their escalation, which would be negative for PLN. The MPC meeting scheduled for Wednesday will not have a significant impact on PLN, we believe. Neutral for PLN will also be data from the US (CPI inflation and preliminary University of Michigan index) as well as data on the balance on trade in China.

Markets will focus on the MPC meeting

IRS curve in Poland (%)



Spread: Polish vs. German bonds (ppt.)



Source: Reuters

Last week, 2-year IRS rates increased to 1.96 (up by 1bp), 5-year to 2.46 (up by 1bps), and 10-year to 2.94 (down by 1bps). Last week IRS rates stabilized across the curve due to low activity of investors resulting from holiday period and the Independence Day in the US.

This week the market will focus on the MPC meeting. Currently the market is pricing in the first hike of interest rates in Poland at the turn of Q3 and Q4 2019. We believe that the conference after the MPC meeting will not bring any new information important for the monetary policy outlook in Poland and thus will not change the market expectations as to the start date of its tightening. Consequently it is likely to be neutral for IRS rates. Data from the US (CPI inflation and preliminary University of Michigan index) will also have a limited impact on the market, we believe.

Forecasts of the monthly macroeconomic indicators

Main monthly macroeconomic indicators in Poland

Indicator	Jun-17	Jul-17	Aug-17	Sep-17	Oct-17	Nov-17	Dec-17	Jan-18	Feb-18	Mar-18	Apr-18	May-18	Jun-18	Jul-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*	4,23	4,25	4,25	4,31	4,24	4,20	4,18	4,15	4,17	4,21	4,24	4,31	4,37	**4,38**
USDPLN*	3,70	3,59	3,57	3,65	3,64	3,53	3,48	3,34	3,42	3,42	3,51	3,69	3,74	**3,79**
CHFPLN*	3,86	3,72	3,72	3,77	3,65	3,59	3,57	3,59	3,62	3,58	3,54	3,74	3,78	**3,81**
CPI inflation (% YoY)	1,5	1,7	1,8	2,2	2,1	2,5	2,1	1,9	1,4	1,3	1,6	1,7	**2,0**	
Core inflation (% YoY)	0,8	0,8	0,7	1,0	0,8	0,9	0,9	1,0	0,8	0,7	0,6	0,5	**0,6**	
Industrial production (% YoY)	4,4	6,3	8,9	4,3	12,4	9,2	2,8	8,6	7,3	1,7	9,3	5,3	**7,0**	
PPI inflation (% YoY)	1,8	2,2	3,0	3,2	3,0	1,8	0,3	0,2	-0,1	0,5	1,0	2,8	**4,2**	
Retail sales (% YoY)	6,0	7,1	7,6	8,6	8,0	10,2	6,0	8,2	7,9	9,2	4,6	7,6	**8,2**	
Corporate sector wages (% YoY)	6,0	4,9	6,6	6,0	7,4	6,5	7,3	7,3	6,8	6,7	7,8	7,0	**7,0**	
Employment (% YoY)	4,3	4,5	4,6	4,5	4,4	4,5	4,6	3,8	3,7	3,7	3,7	3,7	**3,6**	
Unemployment rate* (%)	7,0	7,0	7,0	6,8	6,6	6,5	6,6	6,9	6,8	6,6	6,3	6,1	**5,9**	
Current account (M EUR)	-902	-296	311	218	436	278	-699	2072	-972	-982	-21	**-185**		
Exports (% YoY EUR)	7,2	15,0	13,4	11,5	15,8	15,5	2,6	11,7	5,5	-2,0	8,6	**2,4**		
Imports (% YoY EUR)	14,3	14,6	8,7	8,9	15,4	15,9	10,9	16,3	8,3	1,6	9,9	**0,9**		

*end of period

Forecasts of the quarterly macroeconomic indicators

Main macroeconomic indicators in Poland

Indicator		2018				2019				2017	2018	2019
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
Gross Domestic Product (% YoY)		5,2	4,9	4,2	3,8	3,2	3,5	3,2	3,0	4,6	4,5	3,2
Private consumption (% YoY)		4,8	4,5	3,9	4,3	4,3	3,5	3,6	3,4	4,8	4,4	3,7
Gross fixed capital formation (% YoY)		8,1	8,9	8,7	6,7	5,7	4,7	3,6	3,2	3,4	7,9	4,0
Export - constant prices (% YoY)		1,1	4,5	4,3	4,7	6,0	5,5	5,3	4,9	8,2	3,7	5,4
Import - constant prices (% YoY)		3,5	6,1	4,2	5,3	6,2	5,8	5,4	5,1	8,7	4,8	5,6
GDP growth contributions	Private consumption (pp)	3,0	2,7	2,3	2,2	2,7	2,1	2,1	1,7	2,7	2,5	2,1
	Investments (pp)	0,9	1,4	1,5	1,6	0,7	0,8	0,6	0,8	0,6	1,4	0,7
	Net exports (pp)	-1,2	-0,6	0,3	-0,1	0,1	0,1	0,2	0,0	0,1	-0,5	0,1
Current account (% of GDP)***		-0,2	0,1	-0,1	-0,6	-0,9	-0,9	-0,8	-0,9	0,2	-0,6	-0,9
Unemployment rate (%)**		6,6	5,8	5,9	6,0	6,4	5,8	5,9	6,0	6,6	6,0	6,0
Non-agricultural employment (% YoY)		1,4	1,2	0,6	0,3	0,3	0,3	0,3	0,1	1,9	0,9	0,3
Wages in national economy (% YoY)		6,2	7,4	7,0	7,1	7,6	7,0	6,7	6,6	5,3	6,9	7,0
CPI Inflation (% YoY)*		1,5	1,8	1,9	1,1	1,3	1,3	1,2	1,5	2,0	1,6	1,3
Wibor 3M (%)**		1,70	1,70	1,70	1,70	1,70	1,70	1,70	1,78	1,72	1,70	1,78
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
EURPLN**		4,21	4,37	4,27	4,24	4,23	4,20	4,18	4,15	4,18	4,24	4,15
USDPLN**		3,42	3,74	3,62	3,50	3,44	3,36	3,27	3,19	3,48	3,50	3,19

* quarterly average

** end of period

***cumulative for the last 4 quarters

Calendar

TIME	COUNTRY	INDICATOR	PERIOD	PREV. VALUE	FORECAST*	
					CA	CONSENSUS**
		Monday 07/09/2018				
8:00	Germany	Trade balance (bn EUR)	May	19,4		20,0
10:30	Eurozone	Sentix Index (pts)	Jul	9,3		8,2
		Tuesday 07/10/2018				
3:30	China	PPI (% YoY)	Jun	4,1	4,6	4,5
3:30	China	CPI (% YoY)	Jun	1,8	2,0	1,9
11:00	Germany	ZEW Economic Sentiment (pts)	Jul	-16,1		-18,2
		Wednesday 07/11/2018				
16:00	USA	Wholesale inventories (% MoM)	May	0,5		0,5
16:00	USA	Wholesale sales (% MoM)	May	0,8		0,6
	Poland	**NBP rate decision (%)**	**Jul**	**1,50**	**1,50**	**1,50**
		Thursday 07/12/2018				
11:00	Eurozone	Industrial production (% MoM)	May	-0,9		1,1
14:30	USA	CPI (% MoM)	Jun	0,2	0,2	0,2
14:30	USA	Core CPI (% MoM)	Jun	0,2	0,2	0,2
		Friday 07/13/2018				
	China	Trade balance (bn USD)	Jun	24,9	31,7	27,5
16:00	USA	Initial U. of Michigan Sentiment Index (pts)	Jul	98,2	98,4	98,3

*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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