Weakening of PLN will not boost the economic growth

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 leave interest rates unchanged. We believe that the NBP Governor, A. Glapiński, will repeat his opinion that NBP rates will not change in 2019 and 2020. An interesting issue is whether the NBP Governor will maintain his view voiced the month before that NBP rates might remain stable until the end of the MPC term falling at the beginning of 2022. The matter of deeper-than-expected slowdown of investments and consumption growth in Q4 2018 is likely to be raised during the conference. We believe that the statement after the Council meeting and the remarks of the NBP Governor during the press conference will be neutral for PLN and yields on Polish bonds.
- **This week we will see important hard data from the US.** Data on orders in manufacturing will be released on Monday which, in our view, increased by 0.2% MoM in November vs. a 2.1% decrease in October, due to higher orders for aircrafts in the Boeing company. The manufacturing ISM will be released on Tuesday. We expect that it dropped to 52.7 pts in January vs. 58.0 pts in December, consistently with the results of regional business surveys for services. The delayed by the government shutdown hard data on the US economy may be released this week (see MACROmaps of 21 and 28/1/2019). US readings this week will be neutral for the financial markets, we believe.
- **Data from Germany will also be released this week.** The market expects that new industrial orders increased by 0.3% MoM vs. a 1.0% decrease in November. In accordance with the consensus, the monthly dynamics of industrial production rose to 0.7% in December from -1.9% in November. The improvement of both indicators will mainly result from the last month's low base effects. In addition, the market expects that the surplus in the balance on foreign trade will decrease to EUR 18.4bn in December from EUR 19.0bn in November, with a simultaneous acceleration in exports and imports growth.

Last week

- **The FOMC meeting was held last week.** As we expected, FED has left the target range for federal funds unchanged at [2.25%; 2.50%]. Contrary to expectations, FED has deleted from the statement the fragment about the intention of further gradual monetary tightening. FED now believes that, in the light of the current situation in the global economy and financial markets as well as limited inflationary pressure, the Federal Reserve can afford to be "patient" in taking decisions on interest rates and will make their level conditional on the aforementioned macroeconomic factors. The unexpected change in the tone of the statement to more dovish has resulted in USD weakening vs. EUR. The change in FED's rhetoric poses a downside risk to our forecast, in which the Federal Reserve will hike interest rates twice this year, each time by 25bp (in Q2 and Q4 2019). The market is currently pricing in a partial interest rate cut in 2019.
- **Non-farm payrolls in the US rose by 304k in January vs. a 222k increase in December (revised downwards from 312k), running clearly above the market expectations (a 165k increase).** The highest increase in employment was recorded in leisure and hospitality (+74.0k), education and health service (+55.0k), and construction (+52.0k). On the other hand, employment decreased in information activity (-4.0k) and utilities (-0.5k). Unemployment rate rose to 4.0% in January vs. 3.9% in December, though still staying clearly above the natural unemployment rate indicated by FOMC (4.4% - see MACROmap of 7/1/2019). It resulted from a decrease in the number of employees with a simultaneous increase in the number of unemployed due to the government shutdown. It should be noted here that unemployment rate in the US is estimated on the basis of another survey carried out among households instead of companies as for the estimates of non-farm payrolls. Due to the survey methodology, the effect of the government

shutdown is only visible in this other survey. Thus, the increase in unemployment rate is temporary, unless the federal government functioning is suspended again in February. The participation rate rose to 63.2% in January vs. 63.1% in December. The annual dynamics of average hourly earnings dropped to 3.2% in January vs. 3.3% in December. The solid data from the US economy resulted in a temporary appreciation of USD vs. EUR. The results of business surveys in the US were also released last week. The ISM index for manufacturing increased to 56.6 pts in January vs. 54.3 pts in December. The index increase resulted from higher contributions of three of its five sub-indices (for new orders, output, and inventories). The Conference Board Index was also released last week and dropped to 120.2 pts in January vs. 126.6 pts, mainly due to a sharp decrease in the expectations sub-index. The final University of Michigan Index also indicated deterioration of consumer sentiment, decreasing to 91.2 pts in January vs. 98.3 pts in December and 90.7 pts in the flash estimate. The index decline resulted from the decrease of its sub-index for both the assessment of the current situation and expectations. We expect that the annualized US GDP growth rate will decrease to 1.4% in Q1 2019 vs. 2.7% in 2018. Possible lack of agreement between D. Trump and the Congress on financing the wall along the US border with Mexico which may result in another government shutdown poses a downside risk to this scenario.

- **In accordance with flash estimate, GDP in Poland rose by 5.1% in 2018 vs. 4.8% in 2017, running slightly above our forecast equal to the market expectations (5.0%).** Conducive to the increase in GDP dynamics were higher contributions of investments (1.3 pp vs. 0.1 pp) and public consumption (0.7 pp vs. 0.6 pp). Lower contributions of private consumption (2.6 pp vs. 2.9 pp) and net exports (0.0 pp vs. 0.1 pp) had an opposite impact. The contribution of inventories has not changed and amounted to 0.5 pp. Thus, the main source of GDP growth in 2018 was private consumption (see MACROpulse of 31/1/2019)). Based on GUS data, we have estimated that real GDP growth rate stood at 4.9% YoY in Q4 2018 vs. 5.1% in Q3. We estimate that conducive to lower GDP dynamics were lower contributions of inventories (-0.6 pp in Q4 vs. 1.0 pp in Q3) and private consumption (2.0 pp vs. 2.7 pp). Higher contributions of net exports (0.8 pp vs. -0.9 pp) had an opposite impact, while the contribution of investments has not changed and amounted to 1.7 pp. Thus, the main source of GDP growth in Q3 like in Q4 was private consumption. The marked slowdown in investments and consumption growth recorded in Q4 supports our forecast in which GDP dynamics in 2019 will decrease to 3.3% vs. 5.1% in 2018.
- **Polish manufacturing PMI rose to 48.2 pts in January vs. 47.6 pts December, running above the market consensus (47.8 pts) and our forecast (48.0 pts**). Thus, the index has now for three months in a row been running below the 50 pts threshold dividing expansion from contraction of activity. The index increase resulted from higher contributions of three of its five sub-indices (for new orders, employment, and inventories). Lower contributions of the sub-indices for output and suppliers' delivery times had an opposite impact. Especially noteworthy in the data structure is a sharp increase in the sub-index for stocks of finished goods which stood at the highest level since February 1999. This suggests that the scale of demand weakening has surprised manufacturers (see MACROpulse of 1/2/2019). The January data about business climate in Polish manufacturing and in Poland's major trading partners (see MACROpulse of 28/1/2019) point to a high likelihood of a deeper than we expected slowdown of economic growth in 2019. This poses a downside risk to our forecast of GDP growth in Q1 (3.7% YoY vs. 4.9% in Q4).
- **According to the flash estimate, the quarterly GDP dynamics in the Eurozone has not changed in Q4 compared to Q3 and amounted to 0.2% (1.2% YoY in Q4 vs. 1.6% in Q3), running in line with the market expectations and below our forecast (0.3%).** Last week we also saw flash GDP estimates for some Eurozone economies, i.a. France (0.3% QoQ in Q3 and Q4), Spain (0.7% in Q4 vs. 0.6% in Q3), and Italy (-0.2% in Q4 vs. -0.1% in Q3), which recorded a technical recession (GDP decrease for two consecutive quarters). The GDP data are a flash estimate and do not

include its structure. Subsequent GDP estimate for the Eurozone in Q4, reflecting the growth rate in all the countries of the single currency area, will be released on 14 February and data on GDP structure will be released on 7 March.

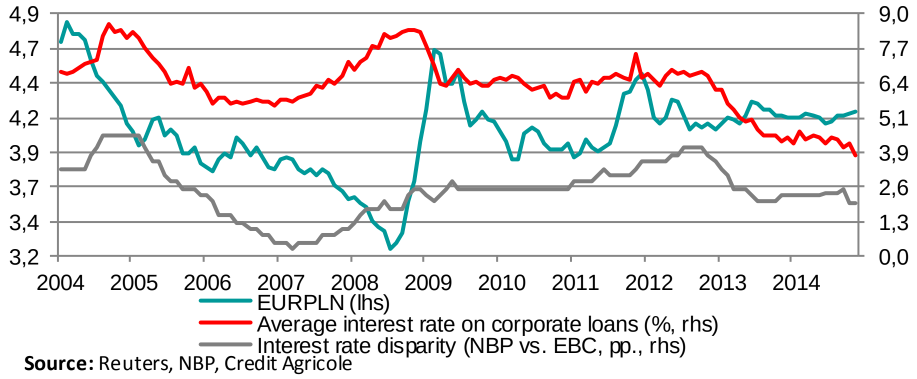
- **According to the flash estimate, inflation in the Eurozone dropped to 1.4% YoY in January vs. 1.6% in December, running in line with the market expectations and above our forecast.** The decrease in inflation resulted mainly from lower dynamics of energy prices, while higher growth rate of the prices of services had an opposite impact. We expect that in subsequent quarters the annual inflation rate within the single currency area will stay within a downward trend to reach 0.9% YoY in Q4 2019. In addition we forecast that that core inflation in the Eurozone will not exceed 1.4% in the horizon of the next two years. This poses a downside risk to our forecast, in which the first hike of ECB interest rates (deposit rate) will take place in September 2019 and the main interest rate will be hiked in December 2019. The market is now pricing in an interest rate hike in the Eurozone (by 10bp) n Q2 2019.
- **China Caixin manufacturing PMI dropped to 48.3 pts in January vs. 49.7 pts in December, running visibly below the market expectations (49.5 pts)**.It has thus hit the lowest level since February 2016 and for two months in a row has been staying below the 50 pts threshold dividing expansion from contraction of activity. The index decrease resulted from lower contributions of the sub-indices for new orders, output, and inventories. Higher contributions of the sub-indices for employment and suppliers' delivery times had an opposite impact. Like in the December data, especially noteworthy is the decrease in the sub-index concerning new orders with a simultaneous increase in the sub-index for new export orders (see MACROmap of 17/1/2019). This indicates that the main factor behind the decrease in the sub-index for total new orders was weaker domestic demand. On the other hand, the CFLP PMI recorded a slight increase and rose to 49.5 pts vs. 49.4 pts in December. The approaching end of the 90-day truce in the US-China trade war, which falls on 1 March, is an essential factor of uncertainty concerning the Chinese manufacturing outlook. The current negotiations between the US and China have so far failed to bring any significant progress which points to a high risk of further escalation of the trade war in subsequent months. We maintain our forecast, in which H1 2019 will see further slowdown of Chinese GDP growth, which in Q2 2019 will reach its local minimum amounting to 6.1% YoY. In H2 2019 we expect acceleration of economic growth and consequently in the whole 2019 the GDP dynamics in China will amount to 6.4% vs. 6.6% in 2018. However, we believe that subsequent stimulus tools will be launched in the coming quarters with a view to maintaining a gradual slowdown of the Chinese GDP. Consequently we expect that in Q2 and Q3 2019 the People's Bank of China will again decrease RRR by 100bp in total.

Weakening of PLN will not boost the economic growth

Last week we presented a report, in which we said that NBP would not have been able to stimulate economic growth in Poland exclusively with the use of low-interest loans scheme. This means that the central bank would have to opt for a simultaneous launch of other unconventional tools in the monetary policy. The need to use such tools is the bigger the weaker the influence on the economic activity of the monetary policy using traditional channels (foreign exchange rate and interest rate). Below we analyze the impact that the PLN depreciation generated by the NBP would have on the economic conditions in Poland.

A common view is that the slowdown of GDP in Poland during the first phase of the crisis (between 2008 and 2009) would have been significantly more pronounced if Poland had not had an independent interest rate policy and the system of floating foreign exchange rate as tools of limiting the impact of negative external shocks on the domestic economic activity. At the time the MPC significantly cut nominal interest rates, which was conducive to their decrease in real terms, lower cost of capital, higher domestic demand, and weaker PLN.

However, in the context of PLN weakening, more important from interest rate cuts was the then recorded strong increase in global risk aversion, reflected by rapid outflow of portfolio capital from emerging equity markets (including Poland). It contributed towards improving the price competitiveness of Polish exports, enabling to partly absorb the negative shock of lower foreign demand. In other words, at the initial phase of the crisis, PLN was weakening mainly because the investors were selling off risky assets and not because the MPC was cutting domestic interest rates.



Source: Reuters, NBP, Credit Agricole

During the second phase of the crisis, between 2012-2013, the structure of the monetary impulse (exchange rate channel vs. interest rate channel) differed from that observed between 2008 and 2009. This difference is well illustrated by the example of Poland, where interest rate disparity (difference between the level of interest rates in the Eurozone and Poland) decreased much more, mainly due to the impossibility of further interest rate cuts in the Eurozone, where they were close to zero. In turn, PLN depreciated less than in the first phase of the crisis, due to increased demand for risky assets in that period. The main source of this demand was the quantitative easing program carried out in the monetary policy by some central banks, by the US Federal Reserve, in particular, and consisting in assets purchase kept at a fixed monthly level. In addition, the Federal Reserve's announcement that it would keep the federal funds rate at a level close to zero "for an extended period of time" (so-called forward guidance) supported low yields on long-term bonds, thus increasing the demand for higher-interest debt of the emerging market countries. In effect, despite a sharp decrease in the NBP reference rate, PLN did not substantially depreciate.

We believe that in the event of the materialization of the scenario of strong and sustainable slowdown of economic growth in the world and in Poland (to ca. 2% YoY), PLN will behave like in the second phase of the crisis and the scale of its depreciation will be small even in the conditions of a significant decrease of interest rates by the MPC. In accordance with the NBP surveys, the significance of interest rates disparity in explaining the changes in foreign exchange rates in Poland is relatively small. More important for PLN are changes in risk aversion. In our view, the potential for PLN depreciation due to higher risk premium is also limited (compared to the scale of the depreciation observed between 2008 and 2009). Our view is supported by the evolution of the main macroeconomic indicators for Poland since the breakout of the financial crisis. The imbalances in the Polish economy have since significantly diminished – the deficit in the balance on foreign trade has been visibly reduced and the deficit of the public finance sector in relation to GDP is lower. We estimate that the public finance deficit decreased to ca. 1% of GDP in 2018 and thus was record low. In addition, Poland is being increasingly treated by investors as an advanced and not an emerging market. For example, Poland was so classified in September 2018 by FTSE Russell agency. The change in the way Polish assets are perceived by the investors means that increase in global risk aversion will be conducive to only a limited depreciation of PLN.

In addition, our baseline scenario assumes that the ECB will launch the Long-Term Refinancing Operations (LTRO) scheme in June 2019. The monetary easing by the ECB will be conducive to increased liquidity in the banking sector within the single currency area and higher demand for risky assets (including Polish bonds). Such conditions will limit PLN potential to depreciate amid slowdown of global economic growth.

Another argument supporting the expected by us limited scale of PLN depreciation is the concern about the stability of the financial system. A significant depreciation of PLN vs EUR and even stronger (due to higher risk aversion) depreciation of PLN vs CHF would be conducive to higher service costs of foreign exchange mortgage loans for households which could result in a higher percentage of non-performing loans.

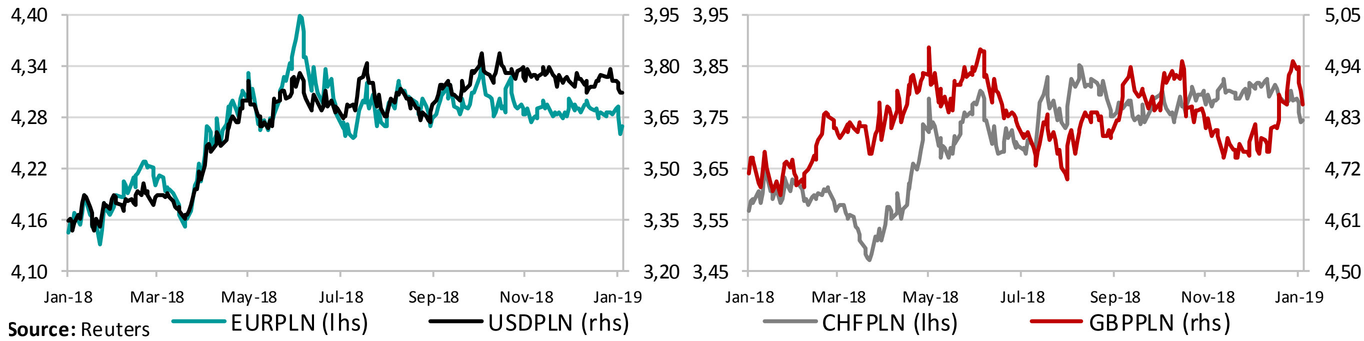
Considering the factors outlined above, we assume that amid significant and sustainable slowdown of economic growth, PLN will depreciate by maximum 5% due to the combined impact of interest rate cuts by the MPC and higher risk aversion.

In accordance with research in the literature, the role of foreign exchange rate in shaping the volumes of exports and imports and the GDP is small against the backdrop of their other determinants. More significant for exports and imports profiles are: the scale of monopolistic competition, wide array of export products, product quality, productivity of companies, or degree of production fragmentation within the global chains of value added. According to NBP estimates (consistent with IMF surveys results), the maximum increase in annual GDP dynamics resulting from PLN depreciation by 1% does not exceed 0.1 percentage point. The impact of foreign exchange rate on consumer prices was diminishing in recent years, due to changes in the production process resulting from the internationalization of production. The NBP estimates that PLN depreciation by 1% will result in CPI inflation increase by 0.07 percentage point.

In the light of the above studies, the assumed by us PLN depreciation (by 5%) would contribute to a moderate extent towards the recovery of economic growth (by ca. 0.4pp) and inflation (by 0.35pp). Consequently, we expect that, wishing to stimulate economic growth and inflation, the NBP will have to use additional unconventional tools in the monetary policy at a bigger scale. In the next MACROmap we will present an analysis of the use of subsequent tools from the NBP toolbox.

US data neutral for PLN

FX rates



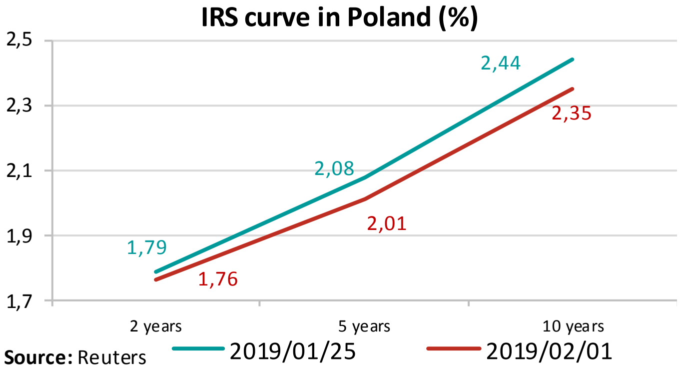
Source: Reuters

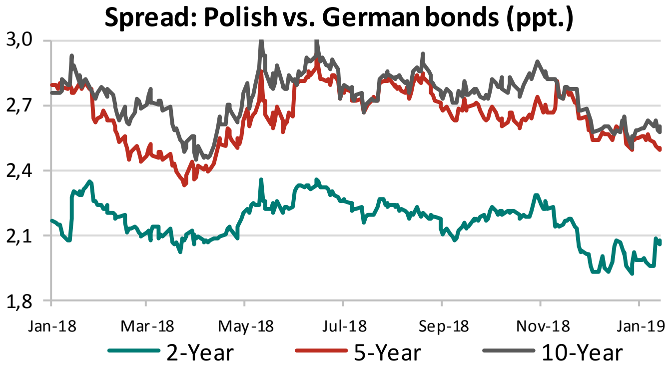
Last week, the EURPLN exchange rate dropped to 4.2712 (appreciation of PLN by 0.3%). Monday through Wednesday, EURPLN was stable, ranging from 4.28 to 4.30. Thursday saw PLN appreciation in reaction to the change in FED bias to more dovish (see above). On Friday there was a correction supported i.a. by the publication of better-than-expected data from the US labour market.

Last week also saw the depreciation of GBP vs. EUR. That is because the UK wishes to renegotiate the Brexit agreement, while the EU is ruling out further talks on the issue, which increases the likelihood of Britain's uncontrolled exit from the EU (so-called hard Brexit). Noteworthy is also the last week's USD depreciation vs. EUR, in reaction to the dovish tone of the statement after the Wednesday's FED meeting. In effect, PLN appreciated vs USD last week by 0.9% and vs. GBP by 1.9%.

Crucial for PLN this week will be US data (new orders in manufacturing and non-manufacturing ISM), including possible publication of data that were not released when scheduled due to the government shutdown. However, we believe that they will have a limited impact on PLN. The MPC meeting scheduled for Wednesday will also be neutral for PLN.

Market focuses on MPC meeting





Source: Reuters

Last week, 2-year IRS rates decreased to 1.76 (down by 3bp), 5-year rates to 2.01 (down by 7bps), and 10-year rates to 2.35 (down by 9bps). Monday through Thursday, IRS rates were decreasing across the curve following the German market. The decrease in yields on German bonds was supported by investors' concerns about the global economic outlook and the change in FED's rhetoric to more dovish. Friday saw a partial correction due to the publication of better-than-expected business survey results for Polish manufacturing and data on non-farm payrolls in the US.

This week the market will focus on the MPC meeting scheduled for Wednesday. However, we believe that it will not have any significant impact on the curve. The publication of US data scheduled for this week (new orders in manufacturing and non-manufacturing ISM), including possible publication of data that were not released when scheduled due to the government shutdown, will also be neutral for IRS rates.

Forecasts of the monthly macroeconomic indicators

Main monthly macroeconomic indicators in Poland														
Indicator	Jan-18	Feb-18	Mar-18	Apr-18	May-18	Jun-18	Jul-18	Aug-18	Sep-18	Oct-18	Nov-18	Dec-18	Jan-19	Feb-19
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*	4,15	4,17	4,21	4,24	4,31	4,37	4,27	4,30	4,28	4,34	4,29	4,29	4,26	**4,28**
USDPLN*	3,34	3,42	3,42	3,51	3,69	3,74	3,66	3,71	3,69	3,84	3,79	3,74	3,72	**3,73**
CHFPLN*	3,59	3,62	3,58	3,54	3,74	3,78	3,69	3,83	3,75	3,80	3,79	3,81	3,74	**3,71**
CPI inflation (% YoY)	1,9	1,4	1,3	1,6	1,7	2,0	2,0	2,0	1,9	1,8	1,3	1,1	**1,2**	
Core inflation (% YoY)	1,0	0,8	0,7	0,6	0,5	0,6	0,6	0,9	0,8	0,9	0,7	0,6	**0,6**	
Industrial production (% YoY)	8,6	7,3	1,7	9,3	5,2	6,7	10,3	5,0	2,7	7,4	4,6	2,7	**3,7**	
PPI inflation (% YoY)	0,2	-0,1	0,5	1,0	3,0	3,7	3,4	3,0	3,0	3,2	2,8	2,2	**2,7**	
Retail sales (% YoY)	8,2	7,9	9,2	4,6	7,6	10,3	9,3	9,0	5,6	9,7	8,2	4,7	**5,3**	
Corporate sector wages (% YoY)	7,3	6,8	6,7	7,8	7,0	7,5	7,2	6,8	6,7	7,6	7,7	6,1	**6,5**	
Employment (% YoY)	3,8	3,7	3,7	3,7	3,7	3,7	3,5	3,4	3,2	3,2	3,0	2,8	**1,8**	
Unemployment rate* (%)	6,8	6,8	6,6	6,3	6,1	5,8	5,8	5,8	5,7	5,7	5,7	5,8	**6,1**	
Current account (M EUR)	2289	-792	-914	263	297	112	-994	-681	-858	-471	-221	**-929**		
Exports (% YoY EUR)	15,5	6,6	-4,4	9,9	1,4	7,0	8,4	7,3	0,0	12,1	7,1	**4,2**		
Imports (% YoY EUR)	19,0	9,5	0,3	13,6	2,9	8,7	10,0	11,2	5,4	17,5	9,9	**3,4**		

*end of period

Forecasts of the quarterly macroeconomic indicators

Main macroeconomic indicators in Poland												
Indicator	2018				2019				2018	2019	2020
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4			
Gross Domestic Product (% YoY)	5,3	5,1	5,1	4,9	3,7	3,6	3,2	2,9	5,1	3,3	3,2
Private consumption (% YoY)	4,7	4,9	4,5	3,9	4,2	3,5	3,4	3,3	4,5	3,6	3,0
Gross fixed capital formation (% YoY)	8,2	4,7	9,9	6,8	8,1	6,7	4,4	3,6	7,3	5,2	4,2
Export - constant prices (% YoY)	3,4	7,6	4,9	4,4	4,7	4,7	4,9	5,4	5,0	4,9	4,5
Import - constant prices (% YoY)	5,5	6,5	6,9	3,0	5,7	5,6	6,3	5,8	5,4	5,9	6,0
GDP growth contributions: Private consumption (pp)	3,0	2,8	2,7	2,0	2,7	2,0	2,0	1,6	2,6	2,1	1,7
GDP growth contributions: Investments (pp)	1,0	0,8	1,7	1,7	1,0	1,1	0,8	0,9	1,3	1,0	0,8
GDP growth contributions: Net exports (pp)	-1,0	0,9	-0,9	0,8	-0,4	-0,3	-0,6	-0,1	0,0	-0,3	-0,6
Current account (% of GDP)***	-0,2	0,0	-0,5	-0,7	-1,0	-1,0	-1,0	-0,9	-0,7	-0,9	-0,8
Unemployment rate (%)**	6,6	5,8	5,7	5,8	6,1	5,6	5,7	5,8	5,8	5,8	5,8
Non-agricultural employment (% YoY)	1,4	1,0	1,1	0,8	0,4	0,4	0,4	0,4	1,1	0,4	0,1
Wages in national economy (% YoY)	6,2	7,1	7,6	7,3	7,5	7,2	6,9	6,2	7,1	7,0	5,5
CPI Inflation (% YoY)*	1,5	1,7	2,0	1,4	1,6	1,6	1,2	1,4	1,6	1,5	2,0
Wibor 3M (%)**	1,70	1,70	1,72	1,72	1,72	1,72	1,72	1,80	1,72	1,80	2,30
NBP reference rate (%)**	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50	1,50	2,00
EURPLN**	4,21	4,37	4,28	4,29	4,30	4,33	4,29	4,25	4,29	4,25	4,15
USDPLN**	3,42	3,74	3,69	3,74	3,74	3,64	3,52	3,43	3,74	3,43	3,22

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

Calendar

TIME	COUNTRY	INDICATOR	PERIOD	PREV. VALUE	FORECAST*	
					CA	CONSENSUS**
		Monday 02/04/2019				
10:30	Eurozone	Sentix Index (pts)	Feb	-1,5		-0,6
11:00	Eurozone	PPI (% YoY)	Dec	4,0		3,2
16:00	USA	Factory orders (% MoM)	Nov	-2,1	0,2	0,2
		Tuesday 02/05/2019				
10:00	Eurozone	Services PMI (pts)	Jan	50,8	50,8	50,8
10:00	Eurozone	Final Composite PMI (pts)	Jan	50,7	50,7	50,7
11:00	Eurozone	Retail sales (% MoM)	Dec	0,6		-1,6
16:00	USA	ISM Non-Manufacturing Index (pts)	Jan	57,6	57,2	57,0
		Wednesday 02/06/2019				
8:00	Germany	New industrial orders (% MoM)	Dec	-1,0		0,3
	Poland	**NBP rate decision (%)**	**Feb**	**1,50**	**1,50**	**1,50**
		Thursday 02/07/2019				
8:00	Germany	Industrial production (% MoM)	Dec	-1,9		0,7
13:00	UK	BOE rate decision (%)	Feb	0,75	0,75	0,75
		Friday 02/08/2019				
8:00	Germany	Trade balance (bn EUR)	Dec	19,0		18,4

*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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