23 May 2017

PLN: Look before you leap

Georgette Boele
Senior FX strategist
Tel: +31 20 629 7789
georgette.boele@nl.abnamro.com

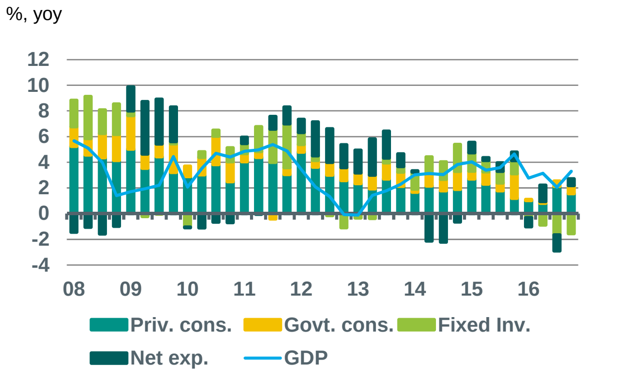
Nora Neuteboom
Economist Emerging Markets
Tel. +31 20 343 77 31
Nora.neuteboom@nl.abnamro.com

- **The zloty has rallied by around 5% this year versus the euro**
- **The Polish economy is strong…**
- **…but there are risks on the horizon**
- **The Polish central bank remains dovish**
- **We think that there is more upside in the zloty this year and next…**
- **… but we would only position on weakness**

Introduction

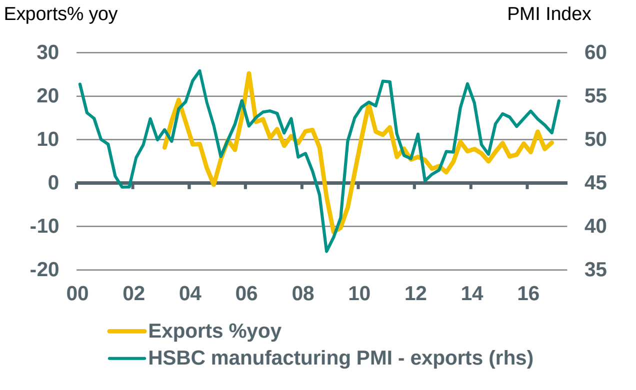
Since 5 December the Polish zloty has strengthened by around 5% versus the euro. Initially, the rally was driven by expectations that the central bank may increase official rates earlier than expected. Nevertheless, the indication given by the central bank that rates will remain stable going forward has resulted in an increase in demand for short-term Polish bonds to lock in the carry. Uncertainty surrounding the French Presidential election has caused some volatility, but as soon as it became apparent that the pro-Europe Emmanuel Macron would win the French presidential election, the zloty took off again. Since then EUR/PLN has dropped below 4.20 on several occasions. However, EUR/PLN has failed to move significantly below this level.

Contributions to GDP growth



Source: Thomson Reuters Datastream

Exports and manufacturing PMI are both improving

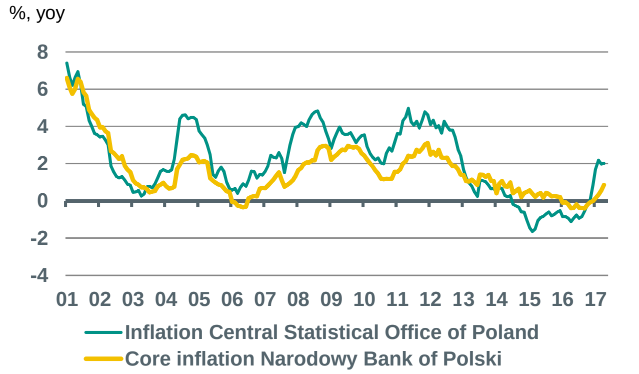


Source: Thomson Reuters Datastream

Strong Polish economy…

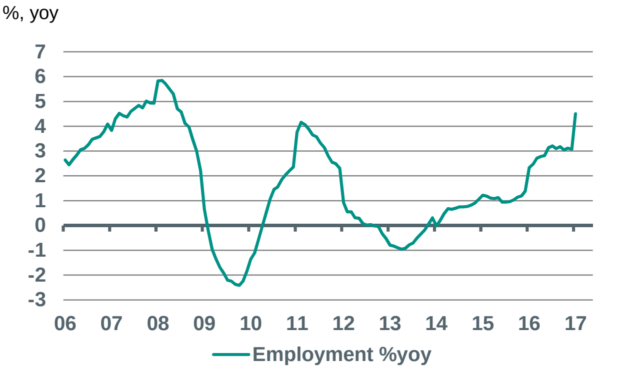
The macro-economic fundamentals of Poland have improved considerably. In Q4 2016 the Polish economy grew by 3.3% yoy, which is a strong improvement from the 2.0% yoy in the third quarter of 2016 (see graphs above). Private and government consumption has remained strong and net exports have contributed to growth again. The eurozone is an important market for Polish exports. Therefore, as long as growth in the eurozone remains strong, the Polish economy will profit via higher exports. Private consumption is expected to increase further in 2017 (by 2.5% yoy) mainly because of a rise in real wages. A sharp drop in public investment last year, on the back of lower EU funds, led to a fall in gross fixed investment of 5.2%, which dragged down overall economic growth. However, in 2017 the cycle of EU-funds will increase again stimulating fixed investment. Our base case is above-trend growth of 3% in Poland in the coming two years.

Inflationary pressures are increasing…



Source: Thomson Reuters Datastream

…and the labour market is tightening



Source: Thomson Reuters Datastream

…but there are risks on the horizon

There are two major risks that could seriously weigh on investor sentiment towards Poland and the zloty. First of all on the fiscal side. The 2017 budget bill plans for a rise in spending on defence and infrastructure, while reducing the retirement age. This, in combination with the suspension in September of the government's new tax plan, will put the budget deficit under renewed pressure. We expect the general government budget deficit to be around 3% in 2017, but disappointing government revenues could increase the budget above the 3% rule of the Stability and Growth (SGP) pact, which may initiate the Excessive Debt Procedure. Poland is consciously testing the limits of the SGP and the willingness to comply with the fiscal rules has deteriorated under the national conservative Law and Justice (PiS) party. The debt-to-GDP ratio is expected to rise slightly from 52% in 2016 to 53% in 2017-18. A move over 55% would trigger the public debt brake including measures such as salary freezes, and limits on pension increases. To cut a long story short: we think that there are some risks on the budget side and this may cap government investment in the future. This is a risk to economic growth.

Moreover, politics remains a clear risk. Poland's growth spurt of recent years has been partly based on its economic resilience and business-friendly policies. However, since the PiS party won the parliamentary election in 2015 with a majority, concerns about institutional independence and prudent macro-policies have risen. Protesters took to the streets in December last year to oppose controversial laws. The opposition blocked the podium in the lower house (Sejm) in protest against proposals to further restrict media freedom. Political uncertainty could from time to time lead to considerable weakness in the zloty.

Polish central bank remains dovish…

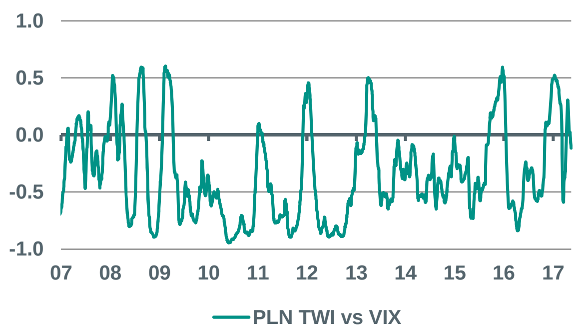
On 17 May, the Polish central bank left monetary policy unchanged. It said that "in the following quarters inflation will remain moderate with only a moderate rise in domestic inflationary pressure stemming from improving domestic economic conditions." Inflation sharply increased at the end of 2016 and now stands at 2%, which is close to the 2.5% target. Core inflation has edged up in recent months, from a percentage of 0% in December last year to 0.9% in April 2017. The increase in inflation is mainly due to the tightening labour market and pick up in wages. This will likely continue in 2017 due to the outflow of Ukrainian workers as the EU has lifted visa requirements, the lowering of the retirement age and the anti-migrant policy. With higher energy prices, a closing output gap and fiscal and monetary stimuli, we think that inflation may shoot above target in the second half of 2017. However, the central bank sees a limited risk of inflation running persistently above target in the medium term and we expect the central bank to remain dovish at least until 2018. The central bank has a 2.5% headline inflation target with a fluctuation band +/- **1**% point around this target.

…while investor sentiment is positive for the zloty…

The zloty is at its highest level since September 2015 and the upward momentum is strong. The zloty is a currency that thrives in an environment of positive investor sentiment (low levels in risk indicators such as the VIX, and smaller CDS spreads on eurozone countries) when investors are searching for a European yield pick-up. Moreover, it thrives when global trade is improving and when the domestic economy is doing well (reflected by higher domestic equity prices). In terms of valuation, the zloty is substantially undervalued according to Purchasing Power Parity as calculated by the OECD. Furthermore, the technical picture is clearly in favour of the zloty, since EUR/PLN is currently below its 200-day moving average, which comes in at 4.32. This means that the long-term technical outlook for the zloty versus the euro is positive.

Zloty performs well in positive investor sentiment…

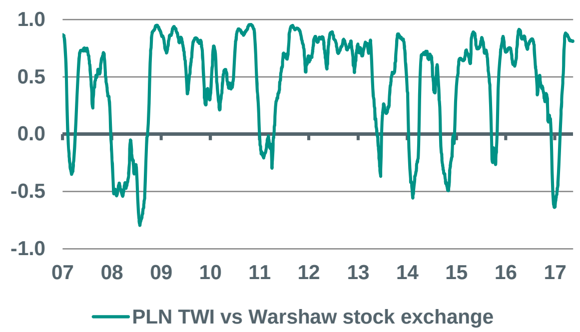
90-day rolling correlation



Source: Bloomberg, ABN AMRO Group Economics

…and positive domestic sentiment

90-day rolling correlation



Source: Bloomberg, ABN AMRO Group Economics

Does this mean that the zloty will go up in one straight line? We don't think so. First, EUR/PLN seems to have difficulty staying below 4.19 which could be a signal that the speculative investors are already positioned for strength. Second, the zloty has rallied on the back of Macron's election victory but Macron has also criticised the politics in Poland. As soon as the euphoria calms down and the focus moves again towards the political tensions between Poland and the eurozone, the zloty could come under pressure. In Poland, changes to the constitutional tribunal provoked the European Commission to start a 'rule-of-law' procedure. If Poland does not implement the Commission's recommendations, the procedure could end up stripping Poland of its voting rights in the EU Council. So far no real action has been taken by the EU, and we don't think that is likely at this point due to reluctance from the EU to initiate a further split between member states. Still, a further deterioration in relation between the EU and the PiS does pose a substantial risk.

Finally, up to now the central bank has remained very dovish, signalling its desire to keep rates on hold this year and next year. This should not spoil the carry party for the simple reason that Polish official rates are positive and substantially above rates elsewhere in Europe. There lies the difference with, for example, the Riksbank (Sweden). As the Riksbank has negative rates, a dovish stance will have a major impact on the krona. In the case of Poland a dovish stance by the central bank with relatively high official rates is not going to stop the rally in the zloty. It will only moderate it. If the Polish central bank were to signal tighter monetary policy ahead, the rate of the strengthening of the zloty would increase in the current environment. The central banks realises this and therefore it seems likely that the dovish stance will continue for the time being. This factor will only become a negative for the zloty once other European central banks bring official rates above zero again. However, we are still far away from this.

New forecasts

Taking all the above into account we think that the Polish central bank will err on the dovish side and is unlikely to hike interest rates before the ECB, despite the strong economy and higher inflation pressures. The stronger zloty is already a reflection of these dynamics. Even if investor sentiment were to deteriorate because of an increase in political uncertainty (elections in Austria, Germany and Italy or higher tensions between the eurozone and Poland), this is likely to be an opportunity to position for strength further down the road. We prefer to position in the zloty on weakness. To reflect this we have adjusted our forecasts for EUR/PLN to reflect a stronger zloty.

Our FX forecasts

New forecasts

	16-May	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018
EUR/PLN (new)	4.2016	4.25	4.25	4.20	4.15	4.10	4.05	4.00
EUR/PLN (old)	4.2016	4.35	4.25	4.20	4.20	4.20	4.20	4.20

Source: ABN AMRO Group Economics

Find out more about Group Economics at: **https://insights.abnamro.nl/en/**