Economic outlook for 2020

Ernest Pytlarczyk
Marcin Mazurek
Piotr Bartkiewicz
Maciej Zdrolik

February 6th 2020
Global economy:

Stabilization of economic activity

Coronavirus - a temporary shock

Fed and ECB reaction functions skewed to low rates
No policy moves in 2020
Poland:

Externally balanced and on its way to internal re-balancing

Sorry, no stagflation here
Almost in external balance.

- It was for long expected that current account would be more and more in disequilibrium as income account and transfers accounts would go deeper in the red. Such a static view failed to account for the fact that past investment would finally become productive and overcome some of outflows.
- In 2013 the sum of merchandise trade and services accounts turned to the black and since then ongoing improvement has been the name of the game. However, it would be an oversimplification to state that only exports and issues of competitiveness are at play.
Exports and imports have various contributions to the structural improvement in goods and services balances.

Trade in goods: Exports trend intact, imports shifted. HP filtered.

Trade in services: exports grows faster than imports. HP filtered.

Source: own elaboration based on NBP data

- It is quite straightforward to show that the trend in goods exports has remained quite regular and has not changed. However, the trend in imports shifted lower. As we show later it is connected with changes in the structure in domestic demand, not the structure of exports.

- Services sector tells a different story. It is here, where competitiveness is a decisive factor with low wages and high labor productivity being in the center of attention.
Poland is able to achieve (external) balance easier at any consumption and investment rates.

Lesser deficit with any expansion in investment.

Taking account both services and goods, relation is materially different for consumption.

- 2013 marks a level shift (investment and goods balance, left-hand graph) or even a complete reversal (consumption and the sum goods & services balances, right-hand graph) in relations with the growth of domestic demand components and external balance.
- Any growth in investment implies higher goods balance than it used to before 2013. We took into account only goods assuming that investment growth is irrelevant for services balance.
- Due to the expansion in services exports, higher consumption growth may now be linked to even better balance and the relation with goods-only weakened a lot (higher consumption does not automatically entail a deficit on goods balance). Taking the correlation at face value we may infer that the negative external balance effects of fiscal transfer are not visible or there is a fundamental change in play that makes them irrelevant for external equilibrium.
- Economy may stay balanced with higher GDP growth than before. That’s new and fundamental.
How come has the whole economy become less import-dependent?

- **Import intensity of foreign-oriented manufacturing has not changed materially over the years.** It can be shown econometrically that change in imports is still a viable determinant of exports whereas consumption and investment have become statistically insignificant over time.

- **It seems that the structure of consumption changed.** It shifted towards services that are domestically provided; it leads, ceteris paribus, to a fall in imports. The best proof we have is a disconnection between the growth of retail sales and consumption. **Retail sales do not explain short-term changes in consumption any more.**

- It fits nicely with structural changes in consumption over time as it becomes more service-intense with higher GDP per capita levels. It also explains why advances in consumption are less correlated with higher imports.

- We do not have a sensible idea why investment growth has become less import-intense. Maybe it is just a statistical artifact or a composition effect.
Polish-German decoupling? A temporary thing.

Impressive drop in PL-GER correlations (average of 4,5,6 year rolling windows)

Raw GDP comparison for a change

Why?

- **Possibility #1**: As exports cycle is flatter, Polish domestic demand can take the driver’s seat.
- **Possibility #2**: Specifics of PL, EU-sponsored investment cycle. It may go counter the Eurozone cycle.
- **Possibility #3**: Additional boost for consumption demand in Poland due to fiscal transfers. Temporary factor.

- **All in all**: We should be readying for a return of correlation in 2020 but not in a fast and abrupt pace. EU-sponsored investment cycle shifts into the reverse gear in 2020 and consumption demand is cooling after the years of prosperity. Acceleration in Germany does not entail automatic acceleration in Poland in such circumstances.

Source: own elaboration based on Eurostat data

Source: Eurostat
Absent a meaningful change in euro area GDP, Polish GDP growth can be anywhere.

Assuming normal GDP growth in the euro area, Polish GDP growth can be anywhere.

The same applies to net exports.

- We think that sequential GDP growth in Eurozone will remain bottled in the 0.1-0.4% interval in 2020. It does not say anything on Polish GDP growth and its NX component. It is domestic demand that can tip the scale in normal times.

- When the change in economic activity abroad is huge, the impact on the whole economy reaches also the domestic cycle. When the change is relatively small, domestic components can still follow their respective cycles. Depending on the degree of synchronization of those with the cycle abroad, the growth and NX contribution can be anywhere in normal circumstances.

- Let’s make a tour of domestic demand components then.
Private consumption set to slow, following real income growth on its way down.

- Fiscal package and strong labor market carried consumption to stable, above-normal growth that is unlikely to continue in 2020.
- Slower wage bill growth (despite elevated nominal wage increases) and lower indexation of pensions and rents imply slower growth of real incomes in 2020 (looks like a cliff but mind the consumption smoothing).
- The end of 2019 was marked by a strike of relatively big, negative price shock that is not going to fade in 2020. It is possible that consumers are going to pump up their precautionary savings in response.
- Consumption growth may be 3.5-4.0% at the start of 2020. Steady slide towards 3% (or less) is inevitable during the year, though.

![Real income slowing along with consumption](image)

![Hangovers in consumer confidence](image)
Private investment – foreign-owned companies to end their investment cycle in 2020, no breakthrough for local-owned corporates.

- Private investment was the dark horse of 2019 – foreign-owned private companies ramped up their activity, which allowed total corporate investment to experience double-digit growth. High FDI inflows in 2018 were likely the bellwether.
- Historically speaking, foreign-owned companies have been investing in small cycles, lasting 4-6 quarters, which would put significant downward pressure on total corporate investment in the first half of the year.
- We are agnostic regarding local companies’ investment (to believe it is to witness it). It is worth noting that overall business environment, due to sustained cost pressures, weaker demand prospects and persistent labor shortages, remains unfavorable for investment.
- Leading indicators of corporate investment (FDI inflows, newly started investment, capacity utilisation) point to lower corporate investment growth ahead.
Public investment in the middle of a cyclical downturn.

- Public investment slowed down considerably in 2019 – in the third quarter both local government and general government investment spending was already declining on an annual basis.
- If the previous investment cycle is an accurate guide, 2018 echoed 2011 (peak in spending growth), 2019 echoed 2012 (sharp slowdown) and 2020 should unfold similarly to 2013 (bottoming out). Second spending peak will occur in 2021-22, coinciding with local government elections (2022). EU funded contracts are signed rather slowly.
- In 2020 public investment is set to fall in y/y terms. The latest local government investment plans are less bleak than their earlier versions, but point to small (5-7% y/y) decline nevertheless, cumulating in the first half of the year.
GDP in 2020. We can’t call this a U-shaped recovery but H2 should be a bit better.

Economic outlook for 2020
Inflation. Food prices to decelerate, but still in the black y/y.

- Food prices may tip the scale whether CPI returns to target already in 2020. The chances for such scenario are very slim, though.
- We expect elevated food prices (still positive y/y growth). Current weather anomalies (high chances of warmest and driest winter on record in Poland) and the level of moisture in the ground suggests it would be hard to expect more benign food price profile even though 2019 was already close to record as far as seasonal growth of food prices is concerned.
- The behavior of seasonal food in May-September will be decisive. As you may see in the graphs, variating solely vegetables and fruits prices gives meaningfully different food inflation paths. It is a difference like between two sentences: „inflation easily returns to target in 2020“ and „2020 ends with 4% inflation“.

Source: own elaboration based on Ministry of Agriculture data

Source: own elaboration on Statistics Poland data
Core measures on the rise. Cyclical pressure seems at maximum right now.

We came up with cyclical inflation by regressing the 3-digit COICOP inflation categories on output gap (as measured by the method proposed by Hamilton*). The idea was to pin down those inflation categories that correlate best (with a lag) with output gap. We took into account the lags from 1 to 4 quarters.

The cyclical inflation fails to account for the heights of peaks and troughs in core inflation (and it should not be used to claim that X% of core inflation is cyclical) and it was not designed to do this. It captures the cyclicity of core inflation instead (see the graph); the heights and troughs are governed by exogenous price increases (and there are plenty of them right now).

* Hamilton J.D., 2018, „Why You Should Never Use the Hodrick-Prescott Filter“, RES 100(5), doi:10.1162/rest_a_00706
It is cyclicality that guarantees the return of inflation to target in 2020/2021. It will take time to confirm this trajectory, though.

- High inflation at the start of the year and gradual decline afterwards.
- Start of the year is going to be affected by exogenous price increases and tax changes: energy (electricity firmly up; gas modestly down; net-net up), higher excise tax on tobacco and alcohol, garbage collection (according to detailed data we analyzed, there is going to be a spike in January, although there are rumors on another round of increases). We forecast inflation to top at 4.3-4.4% in February/March (depends on fuel prices).
- Given the fact that we expect inflation pressure to be abating on cyclical grounds, it is fairly important to determine how far inflation will go in Q1. The higher the jump, the lower the inflation path will be in 2021. Base effects may make 2021 fairly easy for MPC and as such it may be a good argument in favor of keeping rates unchanged.

Source: own elaboration based on Eurostat data

Economic outlook for 2020
Rates will remain unchanged. MPC does not want to follow its predecessors.

- MPC has a strong preference to protect economic growth over reacting to temporary inflation spikes.
- The MPC’s reaction function may also be additionally based on the reactions of past MPCs. It seems 2012 and 2008 may serve as a good example of monetary policy mistakes - tightening was arguably not necessary. Of course the Council now has the benefit of hindsight while assessing those past moves. This benefit may be forged into cautiousness when witnessing a similar combination of weak external environment, temporary inflation spike and expected lower GDP growth.
A new era in public debt financing.

The ongoing, meaningful change in the structure of public debt financing marks another, interesting aspect of external rebalancing of the Polish economy.

First, local holders public debt have been "crowding out" foreign investors. The share of the latter does not exceed 25% now. It is not that foreigners dump Polish debt in flocks. Nor that they do not have any influence over the yield (price) anymore. Local holders, mostly banks are almost price-insensitive (buy only) because government papers are treated as a vehicle to match their assets and liabilities. Foreign holders seem to be marginal buyers and their attitude influences market pricing both ways.

Secondly, the Ministry of Finance is selling more and more bonds to households (see the left hand side graph). It seems we are not even close to the limit here. Treating the scale in which households participate in debt financing in Hungary as a benchmark (~20%), Poland (~2%) is miles away. What is more, the perception of low deposit rates in Poland propels demand for other forms of saving (and retail bonds are hardly different from deposits as they are not marked-to-market by households).
Is stagflation a real risk in Poland?

The combination of higher inflation and lower growth raised some odd comments that stagflation was coming to Poland. It is not.

- Firstly, the expected combination of growth and inflation in 2020 is not unusual at all.
- Secondly, stagflation in developed countries in the 70s was not about a one year of high inflation and low growth. It was years of inflation that reinforced itself regardless of growth. Mechanisms allowing such feedback loops are absent now. Consider:
  - (1) Indexation mechanisms allowing price-wage spiral to form are not present.
  - (2) There is no rise of unemployment now.
  - (3) Nominal variables did not break out of long-term trends.
  - (4) Core and non-core elements of inflation are weakly correlated, there certainly is not tight relationship there.

* - arrows indicate the scope of „typical“ forecasts for 2020 around median analysts’ expectation; taken from recent NBP macroeconomic survey.
Yet another year with political risks present in the background.

- Presidential elections are held in May (the exact date is 10.05). Polls suggest re-election. However, it is a close call and should be treated with caution. No-change scenario implies a continuation of Law and Justice policy, possibly with more leeway in fiscal matters. A change, however, would have several consequences.

- First of all, it would be hard for the president and the parliament to work together. We would call it „hard cohabitaion”. The president can block almost any bill since vet-proof majority would have to be build across party lines. This way the fiscal policy would be strictly following the expenditure rule. It would mean, on balance, tighter fiscal policy over the cycle.

- Given the fact that the Senate is now under the control of opposition, it implies a possible, major change in the composition of MPC in the next term (starting mostly in 2022). Opposition has a well-established history of channeling more hawkish candidates to MPC. It is a scenario for 2022, though.

* - the difference between strong supporters and strong adversaries of the president in the first poll in the year when elections are held.
EURPLN. Consequences of external balance.

More balance -> less volatility*

![Graph showing monthly standard deviation of EURPLN and USDPLN](chart)

Source: own elaboration on NBP data

- Coronavirus turned everything in the markets upside down.
- Only 2 weeks ago (in Polish version of the report) we bet on the possibility of stronger zloty on the back of global upswing and higher inflation. Now, there is only one leg: inflation. Therefore, EURPLN may take a different course in the short term. It seems that higher inflation matters only for real rates and MPC is not going to do anything with that (this thinking did not change, but now even the markets may be less interested in the inflation story as it does not entail even a possibility of higher nominal rates).
- In the medium term we see weaker zloty. The breakeven rate for exporters is on the rise. Moreover, it seems it would be hard to achieve such high GDP growth rates in the future and labor market is set to remain tight (and nominal wages running quite fast). All in all not very conducting environment for the currency. However, as Poland became externally balance, hopes for sharp depreciation are ill-suited and overall FX volatility should be lower.

* The sample omits 2009 for a good reason: when the world seems to be coming down, nothing can shelter currency from panic.

** The break-even level is the exchange rate which zeroes exporters’ profit (this level is surveyed by the NBP and presented as average from sample).
mBank’s forecasts

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Domestic demand</td>
<td>%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment</td>
<td>%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Private consumption</td>
<td>%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CPI (average)</td>
<td>%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CPI (year end)</td>
<td>%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>USD/PLN (year end)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>USD/PLN (average)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EUR/PLN (year end)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EUR/PLN (average)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CHF/PLN (year end)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CHF/PLN (average)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CHF LIBOR 3M (average)</td>
<td>%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CHF LIBOR 6M (average)</td>
<td>%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WIBOR 3M (average)</td>
<td>%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WIBOR 6M (average)</td>
<td>%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EURIBOR 3M (average)</td>
<td>%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EURIBOR 6M (average)</td>
<td>%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>USD LIBOR 3M (average)</td>
<td>%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>USD LIBOR 6M (average)</td>
<td>%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Repo rate (year end)</td>
<td>%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unemployment rate (year end)</td>
<td>%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Economic outlook for 2020