Economy and Financial Markets
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Poland Economics View

Waiting for the first rate hikes

Inflation is set to rise in the coming months, exceeding the central bank's 2.5% target by as much as four percentage points. We think some of this increase will be temporary but the underlying price pressures are strong enough to justify policy tightening. We expect the first rate hike in Poland in early 2022 and we see the terminal rate at around 2%.

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GDP to grow by more than 5% — Economic growth remains strong but the dispute with European Commission over rule of law issues means that inflow of EU funds will be delayed. Poland should still be able to grow by more than 5% in 2021-2022, yet risks are to the downside.

And prices by more than 6% — Inflation is expected to follow a hump shaped path. We expect CPI to reach almost 6.5% in early 2022 on the back of higher energy prices, but then to start falling. In the note we summarize key factors that will be driving inflation.

When will the MPC hike? — Prospect of falling inflation raises questions about an appropriate monetary policy response. In the note we provide a brief summary of arguments showing why we think the MPC should respond with rate hikes. Although the market is still implying a possibility of the first rate hike in 2021, we expect the MPC will wait until 1H22.

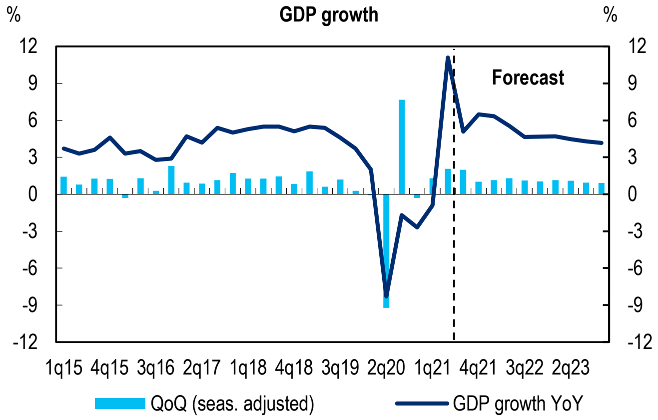
Waiting for the first rate hike

Recent data releases confirm the post-pandemic recovery continues at a fast pace. Based on monthly indicators published so far, we estimate 3Q GDP growth at around 2% QoQ, though with risks of somewhat weaker outcome. Momentum is likely to fade in the 4Q as the initial boost to demand resulting from reopening is set to moderate. The fourth pandemic wave could lead to increased social distancing again, but we think its overall impact on activity will be much weaker than in 2020. On this trajectory the economy should be able to grow by more than 5% in 2021.

A legal dispute between Poland and European Commission over judiciary reform remains a potential risk for growth outlook. The Commission is withholding the approval for the country's recovery plan, citing rule of law concerns. This implies that disbursement of the money from post pandemic Resilience and Recovery Facility (in total ~7% of GDP) will be delayed by several months, thus removing one of potential boosts to economic activity. RRF inflows in 2021-2022 were planned at 1.2% of GDP and were supposed to deliver approx.0.1 pp of additional growth in 2021 and around 0.4 pp in 2022. We think the government is likely to largely offset this impact by easing fiscal policy in line with already announced budget revision.

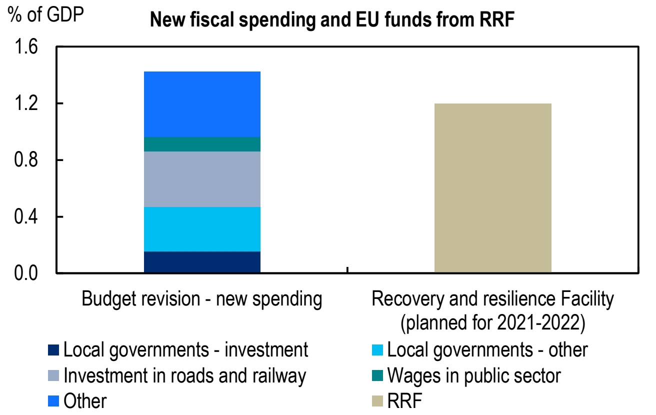
Having said that, we expect that after growing 5.2% in 2021 the economy will expand by another 5.3% in 2022, with private consumption being an important contributor. Dynamic pace of growth combined with already high capacity utilization, tight labour market and high commodity prices will be supportive for inflation.

Figure 1. Economic growth is expected to stay above 5% in 2021-2022 thanks to robust domestic demand, in particular private consumption



Source: Statistics Poland, Citi Handlowy Research

Figure 2. Delays in inflow of EU funds remains a risk for growth, but in the near term this should be offset by fiscal easing



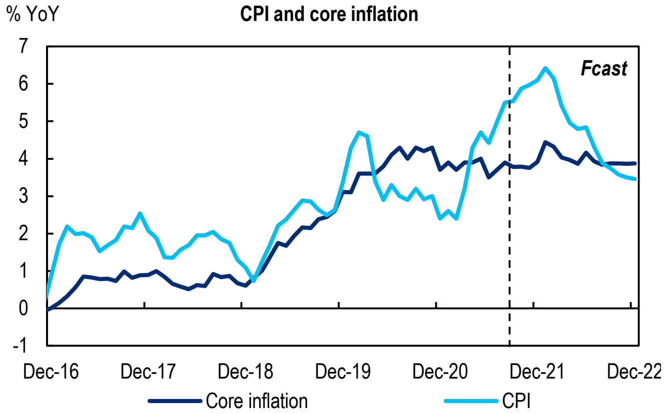
Source: Finance Ministry, European Commission, Citi Handlowy Research

Inflation outlook

Inflation has been a source of biggest surprises in recent months. In August CPI rose to 5.5%, the highest level in more than two decades. As compared to our forecasts prepared three months ago headline inflation was as much as 1 percentage point higher, while core inflation was 0.4 pp higher. As far as non-core factors are concerned, the rise in gas and fuels prices was a prominent contributor to the surprise.

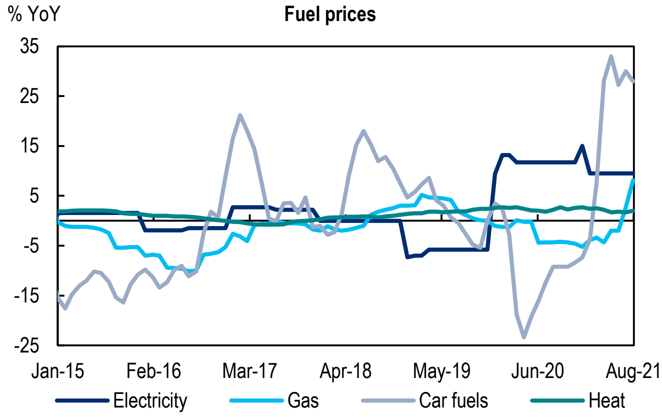
Looking ahead, according to our estimates CPI will rise even more in the coming months, peaking close to 6.5% in early 2022 and then falling back towards 3.5% by the end of 2022. This hump shaped inflation path is due to several factors (energy, fuels, base effects) and given their importance, in the following sections we provide more information on our thinking.

Figure 3. Headline inflation is expected to peak in 1Q22 and then fall, but core inflation is likely to be stubbornly high



Source: NBP, Statistics Poland, Citi Handlowy Research

Figure 4. This year fuel prices were an important driver of CPI but we expect electricity and gas prices to play a much more important role in the coming months



Source: Citi Handlowy Research, Statistics Poland

Energy prices

We expect energy prices to remain an important driver of inflation in late 2021 and 2022. In Poland gas and electricity prices for households are regulated and therefore the pace of their growth depends on administrative decisions. After two gas price increases (in May and August 2021), the Energy Regulator has already approved another 7.4% increase in gas prices starting from October. Overall gas bills, as recorded in CPI statistics, will rise by around 3% as bills also include some fixed components that will not change for now. According to our estimates, new gas prices will add 0.1pp to the headline CPI in October.

Figure 1. Expected changes in energy prices in Poland (% MoM)

	Expected energy price changes (% MoM)			x
	Gas bills	Electricity bills	Heating	Impact on CPI (contribution in pp)
Oct 21	3.1		1	0.09
Nov 21			1	0.02
Dec 21			1	0.02
Jan 22	5	15	1	0.80
Feb 22			1	0.02
Mar 22			1	0.02
Apr 22			1	0.02
Total (Oct'21-Apr'22)				**1.02**

Source: Citi Handlowy Research Forecasts

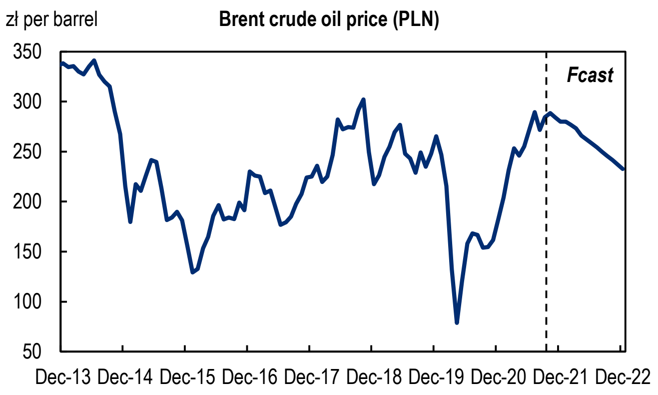
This is probably not the end of energy price increases. As Figure 5 shows, in our forecast we assume another 5% rise in gas bills (equivalent to approx. 12% increase in gas prices) starting from January 2022. Nevertheless, even more important will be an upward adjustment in electricity prices. Although the final decision has not been made yet, Polish media have informed that electricity companies are planning to ask the regulator for an approval of up to 40% rise in prices. Even assuming that the regulator agrees for only approx. 25% increase, this would lift overall electricity bills by around 15%, adding 0.6-0.7 pp to inflation in January 2022.

Apart from electricity and gas prices, we expect also heating bills to rise in the coming months. Our forecast assumes 7% increase spread over next seven months but - if anything - risks are to the upside.

Fuels

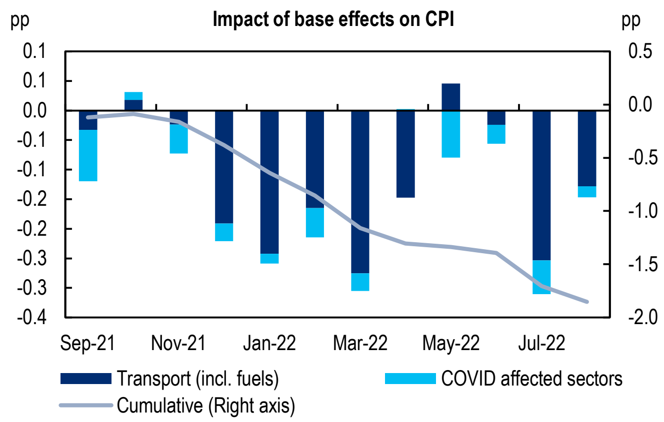
Prices of car fuels rose by 28% over last year, mostly due to higher oil prices. While fuel prices are likely to stay elevated in the coming months, we expect them to drop next year. This forecast reflects Citi house view on crude oil prices as well as the impact from possible PLN appreciation. Consequently, in our view fuels will be one of important factors lowering headline CPI in 2022 and offsetting the earlier energy price increases. If we are wrong and contrary to our expectations fuel prices stay unchanged in 2022, end-of-year inflation can be by 0.3-0.4 pp higher than our base case assumes.

Figure 6. Oil prices are expected to fall by approx. 14% by the end of 2022, deducting 0.3-0.4 pp



Source: Citi Handlowy Research, Bloomberg

Figure 7. Base effects related to transport and COVID-affected sectors (recreation, hotels, restaurants) will deduct close to 2pp from CPI over next 12 months



Source: Statistics Poland, Citi Handlowy Research Estimates

Base effects

While looking at year-on-year inflation path, one needs to take into account the importance of base effects. Due to reopening of the economy in 2Q21, prices of goods and services recorded unusual growth rates. Although some of those increases probably reflect tight labour market and reduced slack in the economy, a significant component of price increases was one off and will not be repeated in the future. This will almost automatically push the year-on-year inflation lower in the coming quarters.

Base effects related to transport prices and reopening of the economy are likely to be exceptionally powerful in 2022. According to our estimates they will deduct from the CPI as much as 2 pp over next year (Figure 7), with 0.5 pp attributable to recreation, hotels and restaurants.

Potential risks

The above arguments explain why we expect inflation first to rise significantly over next four months (energy prices), but then to fall again (base effects). However, risks to our forecast are asymmetric and are skewed to the upside.

First, our forecast assumes significant changes in gas/electricity/heating prices in 4Q21 and 1Q22, but beyond this date it is more difficult to have a clear view on regulator's decisions. In particular, the government may adopt measures trying to smooth energy price adjustment for households. Therefore, in our scenario we assume that after 1Q monthly growth in gas/electricity/heating prices will be in line with long term patterns. This is a very benign assumption and considering recent trends in the energy markets and taking into account usual lags in adjustment of retail energy prices, we think this assumption may understate actual inflation pressures. This leaves some room for upward inflation surprises, which would mean that the decline in CPI after 1Q22 would be slower than currently expected. As a rule of thumb, every 10% increase in electricity bills can add 0.4pp to inflation, while 10% increase in gas bills can add 0.2pp.

Second, our forecast does not assume significant second round effects. However, tight labour market, large size of inflationary shocks and the fact that inflation is running at the highest level in two decades suggest that such a risk should not be ignored. If a risk of second round effects was to materialize, actual medium term inflation path could be higher than currently assumed.

Figure 2. Monthly inflation forecasts

	Aug-21	Sep-21	Oct-21	Nov-21	Dec-21	Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22	Dec-22
CPI (%YoY)	5.5	5.5	5.9	6.0	6.1	6.4	6.2	5.4	5.0	4.8	4.8	4.3	3.9	3.7	3.6	3.5	3.5
CPI (%MoM)	0.3	0.4	0.5	0.2	0.2	1.6	0.2	0.3	0.3	0.2	0.1	-0.1	-0.1	0.2	0.3	0.1	0.2
Core inflation (%YoY)	3.9	3.8	3.8	3.8	3.9	4.4	4.3	4.0	4.0	3.9	4.2	3.9	3.8	3.9	3.9	3.9	3.9

Source: Citi Handlowy Research Forecasts, Statistics Poland, NBP

Monetary policy outlook

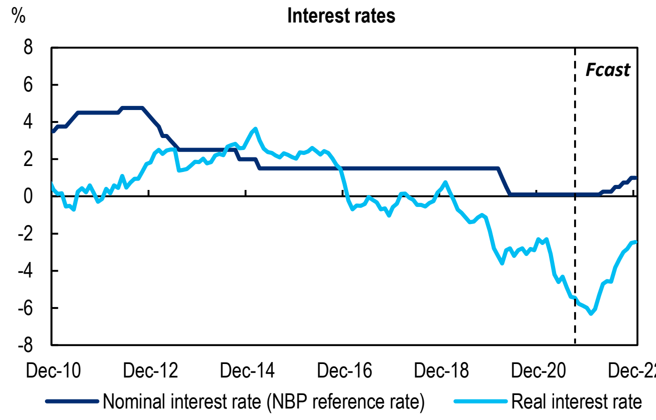
For months FRA/swap markets have been pricing in a possibility of an interest rate hike already in 2021, while the central bank downplayed such expectations. Considering a hump shaped path of inflation forecasts, the MPC insisted that inflation shock was only transitory and therefore rate hikes would be a mistake.

Our base case is that the central bank will start a rate hike cycle in early 2022 (March or April) and will lift the base rate to 1% by the end of 2022. We also see terminal rate of 2% to be reached in 2023.

Below we try to justify our view by answering some of key questions that we frequently hear from clients.

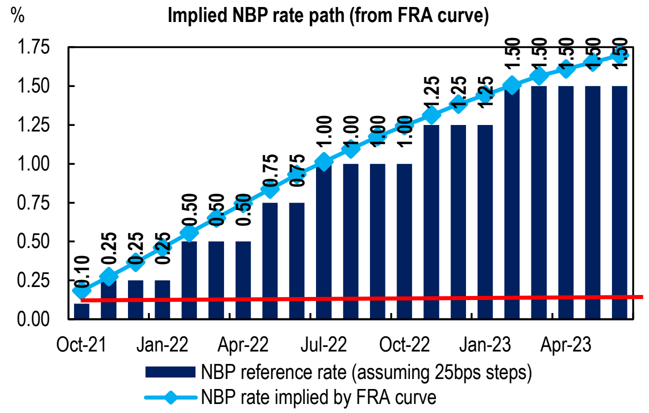
- **Is current inflation temporary or more long lasting?** Both. As our forecasts show, some of inflation increase will likely turn out only temporary. Base effects related to post-pandemic reopening of the economy will fade and supply chains disruptions will disappear over time. However, there is also a more lasting component in the CPI. The labour market and price pressures were already strong before the pandemic started and it seems that after a brief recession in 2020 the economy quickly returned to that state. Furthermore, our core inflation forecasts are showing little variability over next year or so as underlying inflation is estimated to stay close to 4%. Even headline inflation, which is expected to decline during 2022, will likely remain well above the NBP inflation target, thus suggesting that a considerable component in CPI is of a lasting nature.

Figure 3. Real rates in Poland are deeply negative, despite very robust GDP growth



Source: Citi Handlowy Research, NBP, Statistics Poland

Figure 4. FRA market is pricing in the first rate hike already in November 2021



Source: Citi Handlowy Research estimates based on Bloomberg data

- **If inflation is driven by energy prices, does it make sense to respond with rate hikes?** For obvious reasons MPC decisions will not change global energy prices or CO2 emission allowances. However, there are underlying inflation pressures completely independent from gas or electricity prices and they may require an adequate response. Furthermore, the need for the MPC to look through energy shocks is symmetric. On one hand the monetary policy should not automatically respond to higher electricity or gas prices. On the other, the existence of energy shock should not absolve the MPC from responding to underlying inflation pressures.

- **Inflation forecasts are showing CPI returning to the upper limit of the target so why would the MPC need to hike rates?** Our base case forecast indeed assumes the CPI will return towards 3.5% in 2022, but this is conditional on zloty appreciation towards EUR/PLN 4.4. Without appreciation the CPI would be by around 0.4 pp higher. If the MPC were to keep rates on hold and look through current inflation, the zloty probably would continue to depreciate and therefore the inflation would stay outside the target band.

- More importantly, the key reason why we think rate hikes will be hard to avoid is that the current level of interest rates is simply too low not only for the world with 5.5% inflation, but even for a world with inflation at the target. With nominal short-term interest rates at 0.1%, the real rate is deeply negative. Estimates of neutral real rates (NRI) are highly uncertain but most estimates for Poland that we are aware of oscillated before the pandemic around (positive) 1-3%. COVID might have changed NRI but it is hard for us to imagine conditions in which the Polish economy growing at approx. 5% would require negative 5.5% real rates. To put it in another way, even if the MPC does not feel urged to try to lower inflation, policy tightening seems justified on grounds of policy normalization.

- **If rate hikes are needed, why not hiking in 2021?** In our view rate hikes already this year would be easy to justify in light of significant inflationary shock. The only reason why our base case assumes the first rate hike only in early 2022 is simply due to the fact that over recent month MPC members openly and repeatedly suggested their preference for rate hikes in 2022.

Based on comments from NBP officials we think policymakers would like to avoid currency appreciation before the year end. Postponing hikes until next year seems to be a way that allows the central bank to keep zloty weak without large interventions.

We expect the NBP's November macroeconomic projection to show a higher inflation path over next two years than in the previous forecasting round in July. However, CPI outlook for 2022 will probably be still lower than in our forecast as the NBP will not include electricity price hikes (they will likely be approved only in December). Therefore we think November meeting will be an opportunity for the Council to shift rhetoric towards somewhat more hawkish. However, rate hikes will be delivered a few months later, in early 2022. The exact timing of the first rate hike is complicated by the fact that terms of most MPC members expire in 1H22 and therefore it is unclear to what extent policymakers will be willing to take important decisions in final months of their term. We expect the rate hiking cycle to begin in March or April, after big changes in the lineup of the MPC but we do not rule out a possibility of an earlier move (January or February).

Appendix

Figure 5. Poland - Selected macroeconomic forecasts

Base case	**2q21**	**3q21**	**4q21**	**1q22**	**2q22**	**3q22**	**4q22**	**1q23**	**2q23**	**3q23**	**4q23**	**1q24**	**2q24**	**3q24**
GDP growth YoY	11.1	5.1	6.5	6.3	5.6	4.7	4.7	4.7	4.5	4.3	4.2	4.1	3.8	3.6
Inflation YoY (average)	4.5	5.3	6.0	6.0	4.9	4.0	3.5	2.6	2.7	2.8	2.9	2.7	2.6	2.6
Average wage YoY (national economy)	9.6	8.2	7.7	8.5	8.3	7.8	7.6	7.4	7.1	6.8	6.2	6.0	5.7	5.5
Registered unemployment rate	5.9	5.8	5.7	5.8	5.3	5.2	5.2	5.3	4.8	4.9	4.9	4.9	4.7	4.7
Unemployment rate LFS	3.5	3.4	3.0	3.3	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
NBP reference rate (eop)	0.10	0.10	0.10	0.10	0.25	0.75	1.00	1.50	1.50	1.75	2.00	2.00	2.00	2.00
WIBOR 3M (eop)	0.21	0.21	0.26	0.45	0.82	1.24	1.60	1.77	1.94	2.15	2.23	2.23	2.23	2.23
WIG (eop)	66067	70205	66695	68028	70069	72171	72893	73622	75095	77347	78121	78902	80480	82090
WIG20 (eop)	2218	2302	2187	2231	2298	2367	2391	2415	2463	2537	2562	2588	2639	2692

Negative scenario	**2q21**	**3q21**	**4q21**	**1q22**	**2q22**	**3q22**	**4q22**	**1q23**	**2q23**	**3q23**	**4q23**	**1q24**	**2q24**	**3q24**
GDP growth YoY	11.1	4.5	5.3	4.4	3.1	2.5	2.8	3.2	3.3	3.4	3.6	3.8	3.7	3.5
Inflation YoY (average)	4.5	5.2	5.6	5.4	4.0	3.1	2.7	1.9	2.2	2.4	2.6	2.6	2.5	2.5
Average wage YoY (national economy)	9.6	7.8	6.9	7.3	6.6	6.3	6.3	6.3	6.3	6.2	5.8	5.8	5.6	5.5
Registered unemployment rate	5.9	5.8	5.9	6.0	5.7	5.7	5.7	5.9	5.4	5.5	5.5	5.3	5.1	5.1
Unemployment rate LFS	3.5	3.4	3.2	3.5	3.1	3.2	3.2	3.3	3.3	3.3	3.3	3.1	3.1	3.1
NBP reference rate (eop)	0.10	0.10	0.10	0.10	0.10	0.10	0.25	0.25	0.50	0.50	0.75	0.75	0.75	0.75
WIBOR 3M (eop)	0.21	0.21	0.21	0.21	0.21	0.30	0.43	0.55	0.68	0.80	0.95	0.95	0.95	0.95
WIG (eop)	66067	68801	62572	61288	60642	62462	63086	63717	64991	66941	67611	68287	69652	71045
WIG20 (eop)	2218	2256	2051	2007	1984	2044	2064	2085	2127	2191	2212	2235	2279	2325

Positive scenario	**2q21**	**3q21**	**4q21**	**1q22**	**2q22**	**3q22**	**4q22**	**1q23**	**2q23**	**3q23**	**4q23**	**1q24**	**2q24**	**3q24**
GDP growth YoY	11.1	5.7	7.7	8.2	8.1	6.9	6.6	6.3	5.7	5.2	4.8	4.4	3.9	3.7
Inflation YoY (average)	4.5	5.4	6.4	6.6	5.8	4.9	4.3	3.3	3.2	3.2	3.2	2.8	2.7	2.7
Average wage YoY (national economy)	9.6	8.6	8.5	9.7	10.0	9.3	8.9	8.5	7.9	7.4	6.6	6.2	5.8	5.5
Registered unemployment rate	5.9	5.7	5.5	5.4	4.9	4.7	4.6	4.6	4.2	4.2	4.3	4.3	4.3	4.3
Unemployment rate LFS	3.5	3.3	2.8	2.9	2.5	2.4	2.4	2.4	2.3	2.3	2.3	2.3	2.3	2.3
NBP reference rate (eop)	0.10	0.25	0.50	0.75	1.00	1.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.50
WIBOR 3M (eop)	0.21	0.45	0.85	1.10	1.65	2.00	2.70	2.75	2.75	2.75	2.75	2.75	2.75	2.75
WIG (eop)	66067	71609	70931	75224	80530	82946	83775	84613	86305	88894	89783	90681	92495	94344
WIG20 (eop)	2218	2348	2328	2471	2647	2726	2753	2781	2836	2921	2951	2980	3040	3101

Source: Citi Handlowy Research Forecasts, Statistics Poland, NBP, Bloomberg

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