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Poland Economics View

Will 5% be enough to make NBP act?

- ***Our take:*** *We raise our inflation forecast and update NBP rates outlook. CPI is likely to approach or even briefly exceed 5% in the coming months, before it falls next year. High inflation will probably make the NBP start the tightening cycle earlier than it intended, but this will be still later than the market is pricing in.*

- **Recovery started early** — New GDP data confirms the economy expanded in the first quarter by 0.9% QoQ, despite the third pandemic wave and restrictions that were in place. We expect the recovery to continue in the coming months and our economic growth forecast of 4%+ in 2021 and 5%+ in 2022 remains in place.

- **Inflation already above 4% and rising** — Headline inflation reached 4.3% YoY in April and although fuel and food prices were important drivers, the core inflation likely remained high at around 3.7%, even despite high base effect. We were surprised by the strength of durable goods inflation (furniture, cars).

- **New forecasts shows high inflation** — Our updated forecast shows the CPI could actually hit 5% in the coming months. Inflation will probably fall next year as transitory effects fade and base effects kick in. However it will remain relatively high and still above the target, due to a mix of very strong domestic demand and accommodative fiscal and monetary policy.

- **Monetary policy outlook** — The market is pricing in the first rate hike already in October 2021 but we find it unrealistic. The MPC will start a tightening cycle earlier than it intended, but not as fast as the market is pricing in. We discuss the most likely timeline in the note below.

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Will 5% be enough to make NBP act?

We revise our inflation forecast and expect CPI to run at a significantly higher level than previously assumed. According to the updated forecast (Figure 1) headline inflation is likely to rise towards 4.8% in May and can even slightly exceed 5% later during 2021. In our view there is a number of factors that make us expect faster price growth in Poland.

First, inflation surprised to the upside in recent months which almost automatically raised the starting point for the CPI path for next twelve months. More importantly, however, the economy appears in a much better shape than previously expected, which is likely to feed into demand side pressures. We had expected GDP to rebound sharply in 2Q after the end of the third pandemic wave but the most recent data shows that the recovery started already in 1Q, as the economy grew by 0.9% QoQ. High frequency indicators that we follow suggest the strong activity continued in April and May, even despite the third covid wave. This suggest the GDP growth will reach at least 4.2% in 2021, with risks skewed to the upside. Since investment fell in previous quarters, the surge in demand is likely to face capacity constraints and we expect the adjustment to happen through higher prices.

Figure 1. Poland - Monthly inflation forecasts

	Apr-21	May-21	Jun-21	Jul-21	Aug-21	Sep-21	Oct-21	Nov-21	Dec-21	Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22
CPI (%YoY)	4.3	4.8	4.6	4.7	4.7	4.7	5.0	5.1	5.2	5.1	4.8	4.1	3.6	3.5	3.3
CPI (%MoM)	0.8	0.3	0.4	0.0	-0.1	0.2	0.4	0.2	0.2	1.2	0.3	0.3	0.4	0.2	0.2
Core inflation (% YoY)	3.7	4.0	3.8	3.9	4.0	3.9	4.0	4.0	4.0	4.2	4.1	3.7	3.5	3.4	3.3

Source: Citi Handlowy Research, GUS, NBP

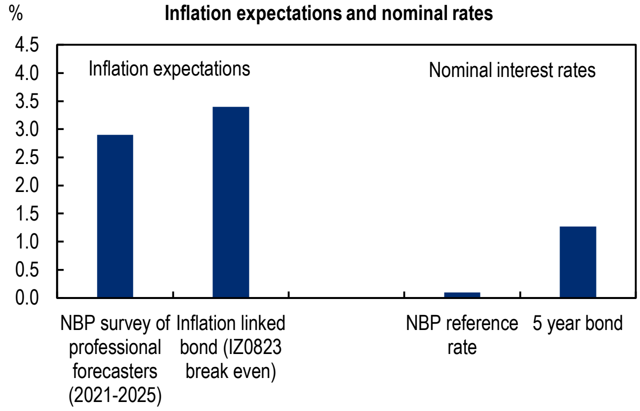
Tight labour market will add fuel to the fire. Wage growth has remained surprisingly resilient (8% YoY in March, well above forecasts), whereas unemployment rate hovered at all-time lows (~3%). Although there is some slack in certain sectors that were most affected by restrictions (hotels, restaurants), they account for only 1.6% of employed in Poland. Moreover, as the government decided to reopen restaurants by the end of May, we expect employment to rise sharply even in these sectors.

Finally, policy mix remains a pro-inflationary force as well. With inflation expectations running at around 3% (Figure 2) and the key policy rate at ZLB, the real rate in Poland is deep in negative territory. So far there has been no signal from the central bank that the majority of MPC members would be ready for quick and substantial rate hikes. This leaves Poland on a trajectory of high or even accelerating inflation, unless policy stance changes. The fact that only a few months ago the monetary authorities pushed PLN weaker through a series of large scale FX interventions is not helping either to contain inflation pressure. Looking at planned increase in public investment financed by EU recovery funds, the fiscal policy is likely to be another force boosting demand.

Is inflation transitory?

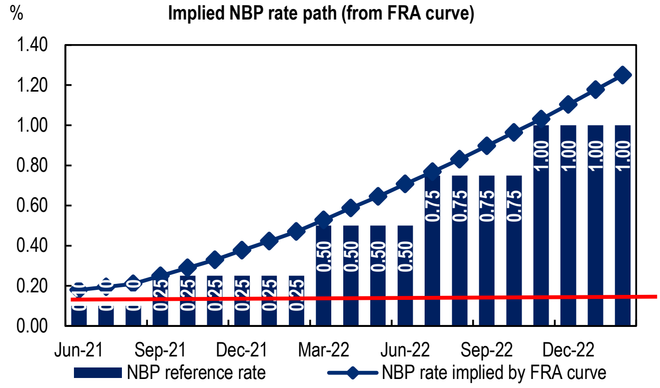
The consequence of all the above factors is a substantially higher CPI path. For sure, some of inflation that we are about to see in 2Q will be transitory and will be related to reopening of the economy. These will include changes in clothing prices, restaurants, packaged holidays or hotels. However, the boost to domestic demand appears more permanent and therefore our forecasts suggest that even when one-off factors fade and the impact of base effects starts to lower inflation in 2022, the CPI path will remain above the central bank's target. We expect also core inflation to stabilize at a high level, thus confirming that the inflation shock is more permanent and would require a monetary or fiscal policy response

Figure 2. High inflation expectations mean real rates in Poland are deeply negative



Source: Citi Handlowy Research, NBP, Thomson Reuters

Figure 3. FRA curve is pricing the first rate hike already in September-October 2021



Source: Citi Handlowy Research, Bloomberg

Monetary policy implications

A sharp rise in market rates in recent weeks shows investors are pricing a scenario of faster rate hikes in Poland. FRA curve is implying the first rate hike to 0.25% already around September/October 2021, followed by hikes in February, July and November 2022 (see Figure 3). The rise in market expectations was fueled by a mix of inflation surprises in the CEE region, as well as by comments of four (out of ten) MPC members who suggested readiness to hike rates. According to most hawkish policymakers a small hike might be a way to 'anchor inflation expectations' and show that the MPC is ready to act.

We are not convinced a rate hike of 15bps, as suggested by some of MPC members, would make any difference for the market. Inflation is already running significantly above the target and a small rate adjustment would do little to tame inflation expectations, change real rates or affect domestic demand. We note also that hawkish signals coming from four MPC members are not enough to tilt the balance of powers within the Council. Hawks would need to convince two more MPC members (or governor Glapiński, who has a casting vote) to win the majority, which we find unlikely to happen in the near term.

Our base case scenario is that the MPC will start by changing its rhetoric in the coming months but will try to wait with rate hikes as long as possible. The next inflation projection will be published in July and this will be the first opportunity for a change in the statement. In any case we think the MPC will still prefer to err on the side of being too dovish and therefore it may fall short of market's hopes for a substantially more hawkish message. After this change the MPC will probably shift to a wait-and-see mode, adjusting its rhetoric progressively depending on the incoming data. We expect the NBP would also gradually limit the size of its QE program (SOOR) as it was recently mentioned as a prerequisite for the beginning of the tightening cycle. A mix of somewhat more hawkish rhetoric and tapering would allow the NBP to buy some time before it starts rate hikes. Furthermore, if the central bank's macroeconomic projections show a downward inflation path after 2021, this should make it easier for the MPC to postpone rate hikes.

The above timeline means the NBP will likely begin the tightening cycle later than the market is currently pricing in, but also earlier than the central bank initially planned (i.e. earlier than mid-2022). Given the market pressure we are observing at the moment and the pace at which the NBP is likely to adjust its rhetoric/QE, we now think the first rate hike is possible around 2Q22. When the first step is made, the next rate hikes will follow at a faster pace as the MPC will likely try to catch up with high inflation and rising price expectations. This would mean that the base rate could reach 0.75-1% by the end of 2022 and we think the cycle could end at around 1.5-2% by mid-2023. The terminal rate at 2% appears low, but in light of expected relatively slow policy tightening by the ECB, this seems the most likely outcome at the moment.

Figure 4. Terms of MPC members

	Appointed by:	Date of appointment	Term started on:	Term to end on:	Index of relative dovishness (most dovish=1)
Eugeniusz Gatnar	Senate	13-Jan-16	13-Jan-16	12-Jan-22	4.5
Jerzy Kropiwnicki	Senate	13-Jan-16	13-Jan-16	12-Jan-22	3.2
Grażyna Ancyparowicz	Sejm	30-Jan-16	30-Jan-16	29-Jan-22	1.8
Eryk Łon	Sejm	30-Jan-16	30-Jan-16	29-Jan-22	1.1
Łukasz Hardt	President	17-Feb-16	17-Feb-16	16-Feb-22	4.2
Kamil Zubelewicz	President	17-Feb-16	17-Feb-16	16-Feb-22	4.8
Jerzy Żyżyński	Sejm	18-Mar-16	18-Mar-16	17-Mar-22	1.5
Adam Glapiński	Sejm	10-Jun-16	21-Jun-16	20-Jun-22	1.5
Rafał Sura	Senate	16-Nov-16	16-Nov-16	15-Nov-22	2.1
Cezary Kochalski	President	21-Dec-19	21-Dec-19	20-Dec-25	2.2

Source: Citi Handlowy Research, PAP, NBP

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