10 June 2016 □ 6 pages

Poland Economics View

No, unemployment rate can't be negative

- Official forecasts and some market projections assume relatively optimistic growth in the short term followed by unrealistically strong growth in the following years.
- We look at recent cyclical trends and argue that a slowdown in Poland's GDP growth is long overdue. In 2016 and perhaps early 2017 we believe this could be avoided due to a child benefit program, but in the longer term, the challenges may be more difficult to overcome.
- In our view, the 3.5-4.0% medium term growth assumptions are at odds with the country's potential and demographic trends. Growth at this pace would imply a drop in the jobless rate to zero in 2018 (and yes, simulation for the following years would yield negative a unemployment rate).
- Having said this, we expect a mix of weaker GDP growth and significantly stronger wage pressures (in order to attract new workers to the labour force). Our forecast assumes also below-3% GDP growth after 2017.

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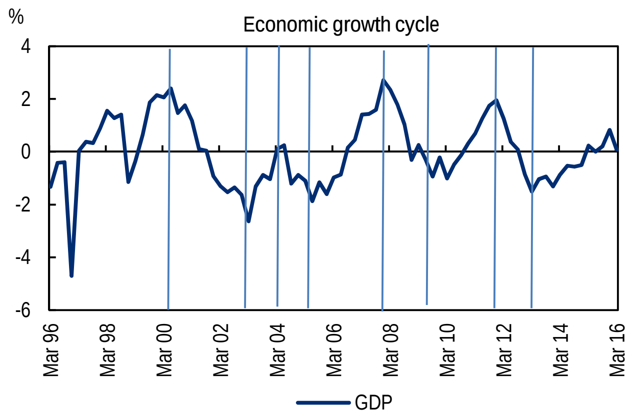
No, unemployment rate can't be negative

Official government projections point to almost 4% growth in Poland in 2016-2017 and some acceleration in the following years. Our forecast is only somewhat lower for 2016 (Citi forecast: 3.4%) but we feel increasingly anxious that achieving the government's targets may be more difficult than widely believed. There is a mix of cyclical as well as structural factors that explain why it may be risky to count on significantly higher growth in the near and medium term.

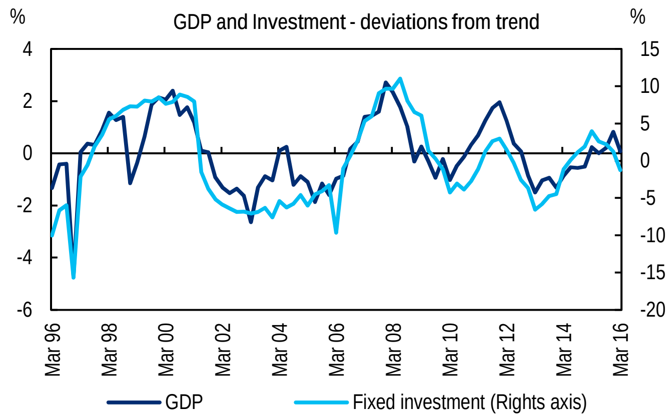
In cyclical terms, the current upswing in Poland is already longer than in previous similar periods after 2000. If we assume that weaker than expected growth in 1Q was only a one off, the period of above trend growth has already lasted three years. This is exceptional as the average length of the previous three consecutive upswings was two years. By this metric, it seems a slowdown in Poland is long overdue and therefore the weakness of 1Q data should not be easily dismissed.

Figure 1. Current economic upswing is significantly longer than previous cyclse



Source: Citi Research estimates based on Eurostat data

Figure 2. Historically, swings in investment were a good predictor for changes in business cycle and this is not good news for Poland

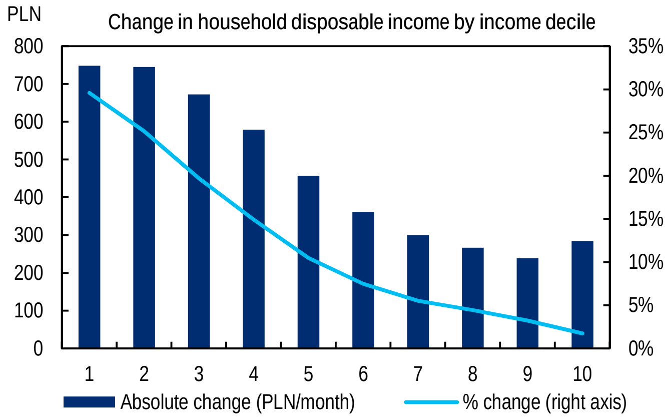


Source: Citi Research estimates based on Eurostat data

As a general rule the peaks and troughs of the economic growth cycle in Poland tend to be synchronized with swings in fixed investment. Unlike consumption, the changes in capex are a relatively good predictor of how the economic cycle is changing (Figure 2). If history is any guide, the fact that investment had started to lose momentum by 1Q 2015 might suggest that the recent slowdown in GDP could be a sign the cycle is indeed turning for the worse. The past periods of investment weakness usually lasted around two years which suggests a more significant recovery in gross fixed capital formation could still be a few quarters away. In other words we are not getting back towards 2014 or early 2015 investment growth rates anytime soon.

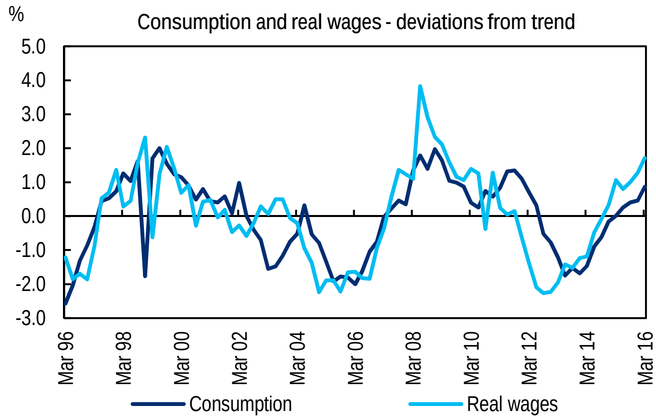
Nevertheless, we expect the Polish economy should avoid a major slowdown, mostly because a large fiscal easing program which may help to offset some of the drag from weaker investment. The fiscal easing is in the form of increased transfers to families with children. Its total cost is estimated this year at PLN 17bn (~0.9% of GDP) out of which 2.2bn has already been paid out in May. Transfers will be disproportionally directed towards low income households, for whom the disposable income will rise by 20-30% (Figure 3). Such a boost in consumers' incomes with a high propensity to spend, is in our view a harbinger of a sharp acceleration in consumption, most likely towards 5% YoY in 2H 2016. Assuming a likely increase in imports due to higher consumption, the 500+ child benefit program could add around 0.3-0.4% percentage points to economic growth in 2016, largely offsetting weakness in fixed investment.

Figure 3. Child benefit program should significantly boost disposable incomes



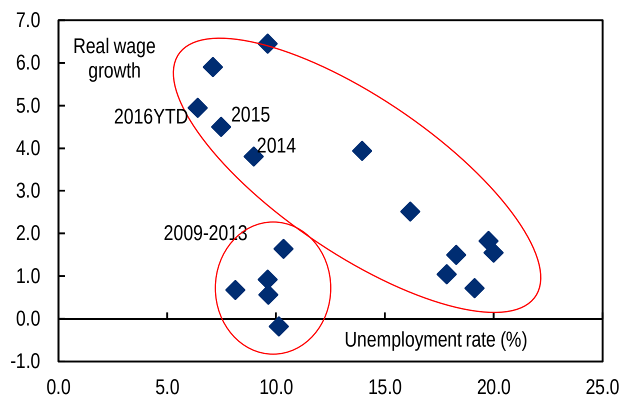
Source: Cenea estimates, Citi Research

Figure 4. Strong wage growth momentum supports private consumption



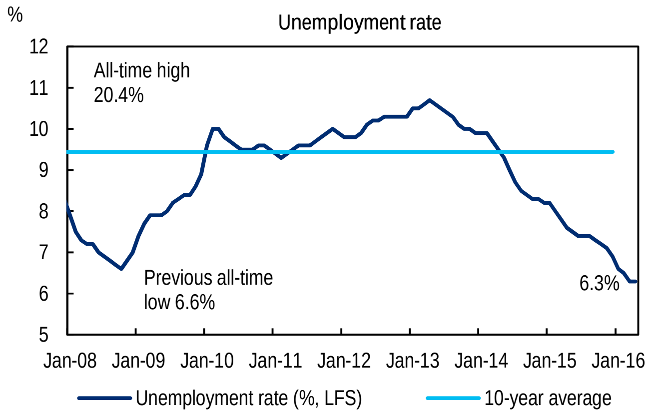
Source: Citi Research estimates, Eurostat and GUS data

Figure 5. After a break in the post-GFC period (2009-2013) the link between unemployment and real wage growth is back again



Source: Eurostat and GUS data, Citi Research

Figure 6. Unemployment rate is already at its all-time low



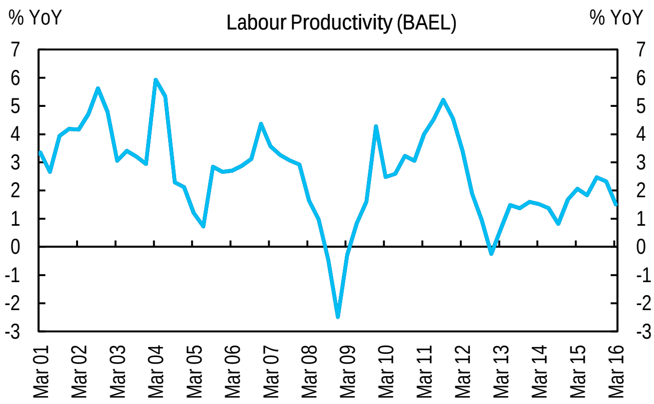
Source: Eurostat, Citi Research

The fiscal stimulus is being delivered while the labour market is already very tight and real wages have strong momentum (Figure 4). During the post-2008 slowdown, the link between low unemployment and real wages practically disappeared. However, as Figure 5 shows, we are again in a world where the low jobless rate is accompanied by high real wages and if anything, we see more room for the unemployment rate to fall. Also, the central bank's survey among firms shows that wage demands are gradually rising. Two large supermarket chains in Poland increase wages by almost 10% in March/April this year and publicized new wage levels in the media in order to attract new workers. While at least one more large hypermarket chain announced another 7% increase staring from July - a sign of rising wage pressure in labour intensive sectors The combination of sharply falling unemployment, rising real wages and higher social transfers seems a perfect mixture to fuel strong gains in private consumption in the coming quarters.

Looking beyond 2016, we doubt Poland could grow by c.4% in the medium term on a sustainable basis. According to our estimates the current growth trend is around 0.67% QoQ which brings us to annualized growth of around 2.7%. This may be treated as first order approximation of Poland's potential growth at which the economy can expand on a sustainable basis without putting upward pressure on inflation. Even if we assume the above estimate may be overly conservative it is unlikely the difference could be big enough to justify a growth rate permanently above 3.5% in Poland over the medium term. The government may hope to push the country's potential growth higher but this is easier said than done. Indeed, with weak investment activity, there is little sign capital can grow fast enough to change the picture. Also, the population ageing and plans to lower the retirement age suggest changes in labour force are unlikely to help much and most likely could push the potential growth rate even lower over the medium term. This means that in coming years, growth potential is likely to be on a downward trend and should fall significantly below 3% YoY (if it is not already there).

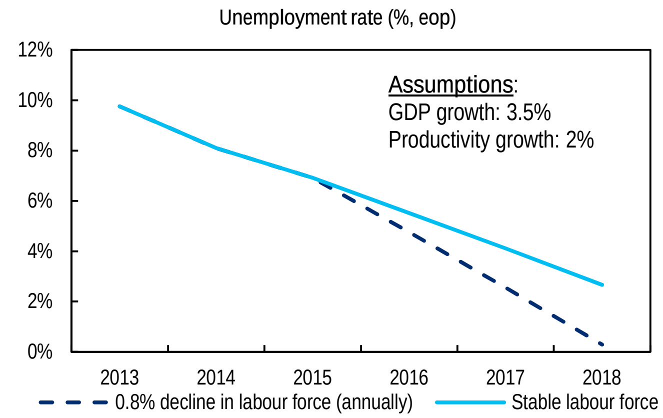
To put things in a perspective, it helps to analyze what 3.5% growth could mean for the labour market. Labour productivity growth over last fifteen years averaged 2.6% but it slowed in the post-GFC (global financial crisis) period and amounted to 2% over last five years (Figure 7). With widely assumed 3.5% GDP growth this would imply on average an increase in the number of the employed people by 1.5% or 240 thousand annually. In turn, the labour force is expected to shrink in the coming years by around 0.8% annually, which would imply that around 140 thousand people would 'vanish' from the labour market each year.

Figure 7. In recent years, labour productivity fluctuated c. 2% or less



Source: GUS and Eurostat data, Citi Research

Figure 8. Popular assumptions of 3.5% GDP growth in Poland would imply an unlikely sharp drop in the unemployment rate



Source: Citi Research estimates

The figure 8 shows our (admittedly simplistic) simulation of what could happen to the unemployment rate in a scenario consistent with 3.5% GDP growth and a 1.5% increase in employment. Assuming a decline in the labour force as currently predicted, the jobless rate would essentially drop to zero in 2018 (and yes, simulation for the following years would yield a negative unemployment rate). Even in a scenario of a stable labour force - for example as a result of increased labour force participation or immigration - the jobless rate would reach 2.7% by 2018. The above simulations show, that some of the usually accepted assumptions may be unlikely to materialize as they would imply a completely unrealistic labour market scenarios. Either GDP growth cannot stay at 3.5% or the labour supply needs to rise, possibly as a result of higher wages or much more immigration. We think the adjustment will happen both ways and therefore we expect growth to be slower, wage demands to be stronger and immigration to rise. Although we expect growth at 3.4% this year and possibly a similar level in 2017, our path now assumes only 2.9% growth thereafter. From investors' point of view, the above scenario also implies higher wage demands and gradually rising core inflation. At this stage, with CPI declining in year-on-year terms, an uptick in inflation would hardly be a reason to worry and we think the monetary authorities would be happy to see it materializing. However over time, the MPC would need to consider how to respond to the changing labour market situation. If nothing changes in labour market policies (low participation rate, plans to lower retirement age, lukewarm attitude to immigration) the rate hikes in 2H 2017 seem a likely scenario, in our view.

Economics Research

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