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Poland Macro View

PLN – And what after the rally?

- In this note we try to assess whether the recent zloty rally can be sustained in the coming months.
- **Subdued growth suggests FX weakness** – In previous years, periods of economic slowdown were accompanied by zloty depreciation. Given recent signs of domestic demand weakness we expect depreciation pressures to mount.
- **Policymakers want to avoid appreciation** – We believe Polish authorities would like to avoid further substantial currency appreciation and are likely to take actions if this is deemed necessary.
- **Finance Ministry** – The Ministry has already decided to limit the amount of EU fund inflows that are exchanged directly in the market. If there were further appreciation we would expect intensified verbal interventions.
- **Central bank** – Given the recent softening of MPC rhetoric we believe the central bank would also want to avoid PLN strengthening. Apart from verbal interventions the MPC could eventually accelerate any rate cut cycle.
- **Quasi interventions possible** – If the appreciation trend persists the central bank would have the option to begin a programme of FX purchases in order to build up international reserves, in line with IMF recommendations. However, in our view this would probably start only if appreciation was even greater, possibly below 3.9 EUR/PLN.
- **FX forecasts** – Given the unfavourable growth outlook and policymakers preference to avoid zloty strength we see the balance of risks skewed disproportionally towards PLN weakness over the next six months.

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With thanks to
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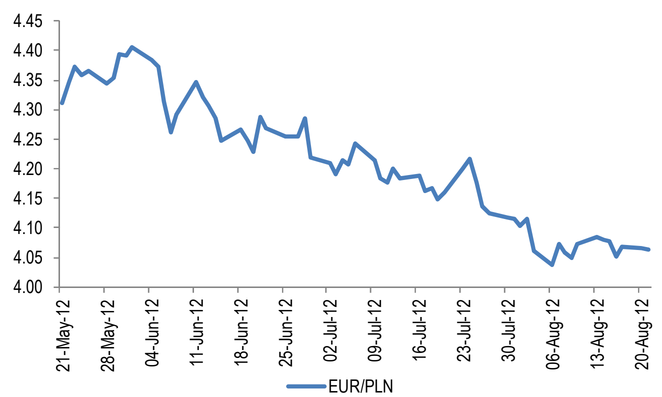
PLN – And what after the rally?

Since the beginning of June the zloty has rallied substantially with EUR/PLN not only returning below 4.10, but also briefly touching 4.03 (Figure 1). Initially the appreciation trend coincided with large inflows into the bond market. However, even a significant debt market correction that pushed long term yields up by 25bp had a relatively small impact on the PLN. This raises the question of whether the zloty can resume its upward trend. To be clear, in our view despite its appreciation the zloty is – at least from the longer term perspective - still relatively cheap or at least it is not expensive. Indeed, as argued earlier (*FX Survey – When Pain Brings Also Some Gain*) surveys conducted among exporters suggest the zloty is considerably weaker than the rate that would make exporters uncompetitive – a rough approximation of what could be "equilibrium" rate for PLN. The latest survey conducted by the Polish central bank is putting such a "breakeven" rate for 2Q 2012 at 3.88. Additionally, models used by the IMF suggest that real effective exchange rate in Poland is broadly consistent with fundamentals[1].

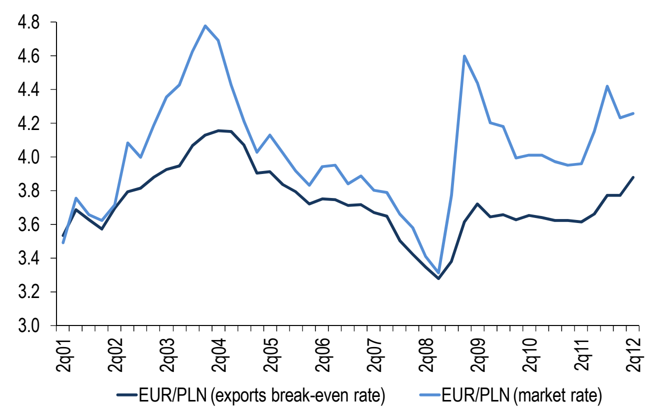
However, although we believe the zloty is probably fundamentally slightly undervalued, we think in the near term risks are skewed more towards depreciation rather than appreciation. This view is based on two arguments: 1) the outlook for a GDP slowdown makes further substantial appreciation unlikely; 2) policymakers would probably be unhappy with further appreciation and we believe they might eventually take action to stop it[2]. In the following sections we try to develop these arguments as they seem to be downplayed by market participants.

Figure 1. Since early June the zloty strengthened by around 8% against euro



Source: Reuters, Citi Research

Figure 2. Exporters don't complain about zloty strength suggesting to us the zloty is probably still undervalued



Source: Citi Research, NBP. Note: "Break-even" rate is EUR/PLN rate at which exports become uncompetitive. Data based on central bank's poll conducted among entrepreneurs.

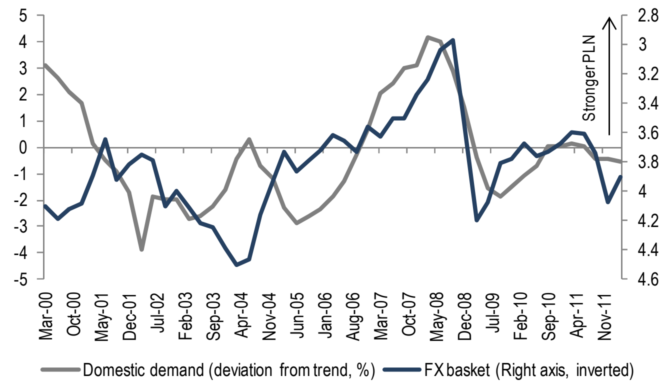
[1] IMF Country Report 12/162.

[2] Additionally, downward pressure on the zloty could be reinforced in the event of an intensification of the sovereign debt crisis and rising risk of Grexit in the following months. However, we leave this topic aside and focus more on country-specific factors that are likely to affect PLN.

Growth slowdown to weigh on zloty

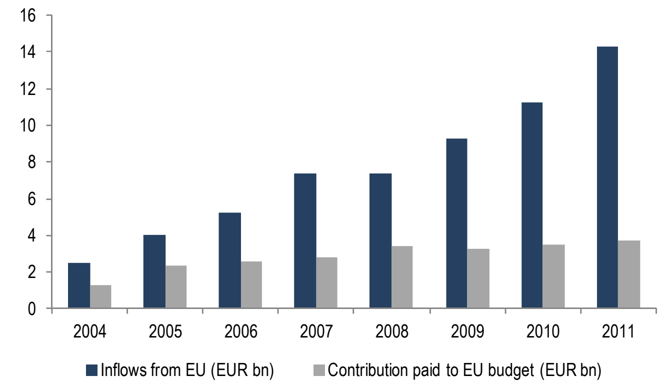
Recently periods of economic slowdown have been accompanied by currency depreciation. Indeed, the contemporaneous correlation between the cyclical components of GDP (measured as deviation of GDP or domestic demand from the trend) and the exchange rate exceeds -70% (see also Figure 3). It seems the zloty responds to signs of economic weakness and adjusts to offset the impact of negative shocks. In particular this was the case in late 2008 and early 2009 when domestic demand collapsed and EUR/PLN jumped, eventually helping Poland to avoid recession. The available hard data on industrial production, construction output, retail sales, employment and wages all point towards significant economic growth deceleration in 2Q and 3Q. If historical relationships between growth and FX rate can be relied on there are reasons to expect at least stabilization and possibly also a reversal of EUR/PLN trend in the coming months.

Figure 3. Recent periods of economic downturn led to currency depreciation



Source: Citi Research, GUS, Reuters. Note: FX basket consists of EUR/PLN (70%) and USD/PLN (30%)

Figure 4. Finance Ministry can channel around EUR14bn of EU cohesion and structural funds through the central bank



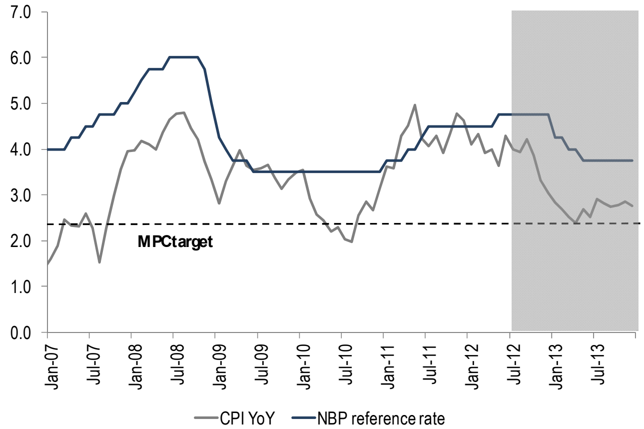
Source: Ministry of Finance, Citi Research.

Policymakers happy to see weaker or stable zloty

And what if this time the economic slowdown fails to translate directly into zloty weakness? We believe that in this case the push for a weaker currency would come from Polish policymakers – the Finance Ministry and possibly also the central bank. Indeed, we see reasons to believe that the authorities would feel uncomfortable with excessive zloty appreciation as this would increase a risk of further economic slowdown and resulting deterioration in fiscal accounts. The tone of comments from the Finance Ministry earlier this year suggests that although the government welcomes the zloty trading around 4.1-4.2 EUR/PLN it most likely wants to avoid further PLN strengthening. In order to avoid such a scenario the Ministry has already announced a partial return to its previous policy of exchanging inflows from the European Union in the central bank, instead of selling them directly to the market. If the appreciation trend continues the Finance Ministry would probably start selling all (and not just part of) EU funds to the central bank. Given that cohesion and structural funds transferred to Poland are worth annually around EUR 14bn (Figure 4), the change in the policy could potentially make a difference for the market. In addition, we would expect more vocal verbal interventions from various government representatives.

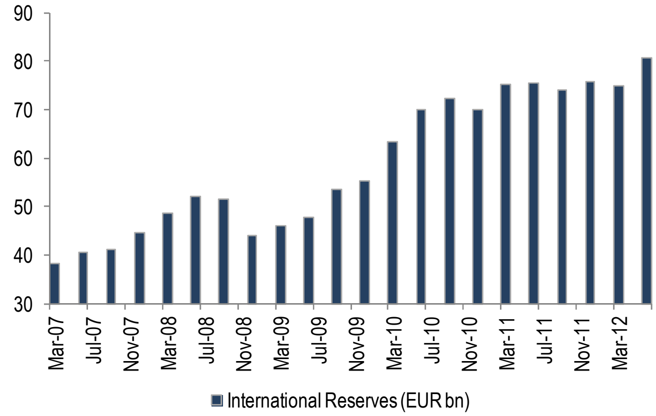
Outside the Finance Ministry, we believe that also central bankers are unlikely to welcome further zloty appreciation. The incumbent NBP management and MPC members have paid attention to FX moves and appeared willing to go for some form of market intervention if the zloty rate moved too quickly either towards appreciation or depreciation. When the zloty broke below 3.90 vs. euro in early 2010 some MPC members signaled a possibility of FX interventions and this was followed by central bank's purchases of foreign currencies in April 2010. In turn, when EUR/PLN weakened in September 2011 the central bank intervened by selling FX (see also FX Interventions – Either Big or None). Given that this time growth outlook appears even weaker and more uncertain than it was in 1Q 2010 we believe the MPC members may be even more willing to avoid appreciation.

Figure 5. We expect rates to be cut in 2012 but this could be accelerated if zloty continues to strengthen



Source: Citi Research, NBP, GUS.

Figure 6. International reserves have exceeded EUR 80bn but the central bank may want to increase it by additional EUR 15bn



Source: Citi Research, NBP.

Figure 7. The authorities in some EM countries are trying to stop currency appreciation but this is not a general tendency

	Did authorities introduce any measures to stop currency from appreciation?
Brazil	Selic rate has been declining since August-11
Chile	No such measures
China	Expectation on CNY shifted since late 2011, and there has been no appreciation pressure (relative to the USD) since the beginning of the year. Compared with the same period last year, PBOC net purchase of FX was significantly lower in the past 6 months, and at times had to sell FX to meet the demand for FX.
Czech	No such measures
Hungary	No such measures
India	No such measures as the authorities are trying various ways to keep the currency from depreciating
Mexico	The FX Commission has stuck to its commitment to the free-float. It has two mechanisms aimed not at influencing the level of the FX but to mitigate its volatility during periods of appreciation/depreciation. The one that is currently active is a daily auction of a fixed amount of USD if the peso depreciates more than 2%, so this is the mechanism applied to reduce volatility during peso depreciation (rather than appreciation).
Peru	Purchased close to 9bn in reserves since the start of the year. In addition, the CB raised reserve requirements on certain types of foreign borrowing, to discourage capital inflows.
Philippines	* Cut overnight policy rates by 25bp to a new low of 3.75% in the July MB meeting that implied less positive carry for the peso
	* Tightened regulations on money being invested in SDA (special depo accounts) and strictly made it clear that only residents are allowed to invest in SDA. Directly meant to curb 'arb opportunities' (onshore rate vs offshore yields) onshore that 'hot money' may try to exploit and thus close 'loophole' that may sustain peso appreciation
	* Tightened banks' capability to accommodate NDF and thus ease trading that also exploits any 'arb opportunity' onshore and thus help ease peso appreciation
	* Treasury's funding via the long end of the curve while 'retiring' a large chunk of maturing t-bills to limit t-bill supply, lower short-term rates and limit portfolio money parking in short-term government debt instruments that can support peso appreciation
	* Gradually cut down size of BSP's forward book (unwind swap contracts) and extend duration of remaining contracts to 1) reduce frequency of BSP swap transactions (roll over maturing contracts) in the onshore swap market that can lower swap rates and support weaker spot exchange rate; and 2) improve capacity of BSP to sterilize 'hot money' in a QE3 environment and prevent future rapid peso appreciation
Poland	Government limited amount of EU funds exchanged directly in the market
Taiwan	CBC has been trying to keep TWD from weakening
Thailand	Gradually reduce its forward book in anticipation of the need to sterilize upcoming portfolio flows and deter future rapid Baht appreciation; As swap contracts are unwound, BoT implicitly injects Baht liquidity into the system (return Baht liquidity of the local banks) to lower interest rate pressure

Source: Citi Research

Having said this, for the time being it seems unlikely the central bank would get involved into open interventions by selling the zloty to the market and defending any particular FX level. We see several other solutions the NBP could try to use to weaken the PLN. *First*, we think it is likely the NBP could talk more openly about excessive FX moves, hoping that such verbal intervention could slow or even stop the appreciation trend. *Second*, zloty strengthening could lead to faster interest rate reductions, thus limiting inflows to Poland's government bond market. And *finally*, in case of further substantial zloty appreciation the central bank might think about interventions in a more disguised form by starting a programme of gradual purchases of foreign exchange in order to build an FX reserve cushion. Such a solution has been suggested by the IMF in recent years as a measure to bring official reserves to "adequate" levels[3].

To us, the effects of such a programme would be indistinguishable from those of 'ordinary' interventions (stronger PLN, higher FX reserves) but we believe this solution might be more acceptable for policymakers, especially given still relatively low level of international reserves. Also we believe the overall 'policy climate' in Poland or more globally makes central bank's interventions more acceptable, though admittedly some EM central banks still try to prevent currency depreciation (Figure 7). As far as Poland's official reserves are concerned they reached EUR 83.4bn in July and although this appears adequate according to various metrics it is still below current account gap and the level of external debt maturing within next 12 months. Arguably, given that the zloty is a free floating currency the central bank could afford maintaining FX reserves at a somewhat lower level. However, in the past low reserves were highlighted by private sector economists and investors as a source of vulnerability and we believe the central bank would like to change it and thus move the country from a "risky" to relatively "safer" basket. Having said this, building FX reserves for precautionary reasons appears to be a possible solution. According to our estimates, in order to build a sufficient precautionary cushion (and 100% coverage of gross external financing requirement) the FX reserves would need to rise by around EUR 10-15bn. This could be achieved by a mix of FX purchases either on the market or directly from the Finance Ministry. However, we believe such a FX purchase programme would be probably activated only if the zloty strengthened substantially, possibly moving towards or below 3.9 EUR/PLN.

To be clear, we don't think such quasi interventions are imminent. However our point is that Polish policymakers will be willing to avoid excessive appreciation and will use several tools to achieve this goal. Initially the authorities are likely to use verbal interventions but if the appreciation persists it could use more decisive measures. From the market's point of view it means that although capital inflows have helped keep the zloty at relatively strong levels and some further short term appreciation cannot be ruled out, we believe the PLN faces a disproportional risk of getting weaker over next six months. Furthermore, the stronger the zloty gets, the more likely the authorities will act to reverse the trend. Having said this, over next three months we expect the EUR/PLN to fluctuate between 4.0-4.1 level but we forecast the zloty to weaken towards 4.3-4.4 over a six month horizon.

[3] IMF Country Report 10/119, May 2010

Appendix A-1

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