

Economics

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Poland Macro View

Don't Believe in Second-Round Effects

- Although some MPC members are concerned that high inflation could lead to second-round effects, we don't share this view.
- Recent economic data and forward looking indicators suggest the labour market has entered a period of slowdown. Taking into account the low number of new job offers and the fact that new jobs are being generated in the construction sector we believe the labour market situation is more likely to deteriorate than improve in the coming quarters.
- A weak labour market does not allow employees to push for substantial wage increases as employers' bargaining position is stronger. Indeed, only 9% of Polish firms see signs of rising wage pressures, while less than 7% of firms report that wages are growing faster than labour productivity.
- Taking this into account, we believe the risk of rate hikes in 1H 2012 is much smaller than some MPC members suggest. We expect that policymakers' rhetoric will soften in the coming months as the MPC will likely prefer a wait-and-see policy in order to better assess developments in the labour market and changes in inflation pressures.

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Don't believe in second-round effects

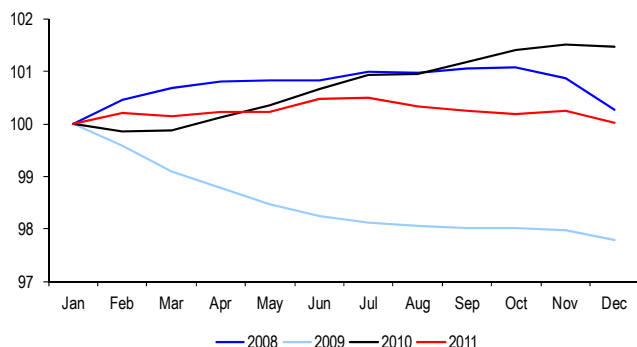
From their speeches, one of the main reasons why Polish central bankers have stuck so consistently to their hawkish rhetoric is the fear that above-target inflation will eventually lead to higher inflation expectations and result in second-round effects. However, this scenario would be possible only if the labour market was tight enough to allow for a sufficient rise in wages. In this note we take a look at various labour market indicators and try to assess the risks of second-round effects.

Definitely not a boom period for the labour market

In recent weeks several MPC members expressed concern that high current inflation could become a more permanent phenomenon¹. Indeed, if high CPI led to higher inflation expectations, this might result in stronger wage growth, higher labour costs and, eventually completing the cycle, into higher price growth. This scenario could materialise if the current or future labour market situation were good enough to give employees some bargaining power. However, looking at a variety of different indicators, it is hard for us to find any convincing signs of this labour market tightness.

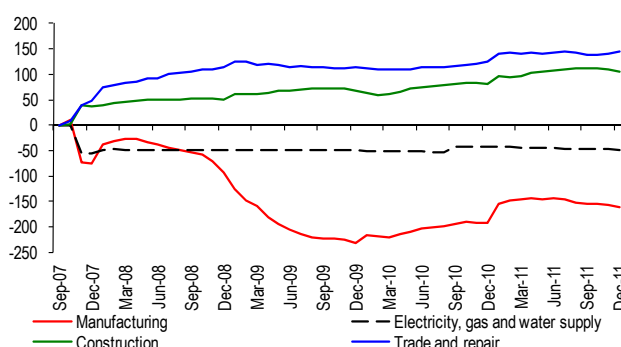
As Figure 1 shows, after a substantial downturn in 2009 (blue line) the labour market saw a recovery in 2010 (black line), only to slow again in 2011 (red). Despite dynamic economic growth, employment actually dropped in four out of six months in 2H 2011. This suggests the labour market has entered a phase of slowdown and given inertia in hiring and firing decisions, this period could last for at least a few quarters more. In other words, the present labour market advantages the buyer (employer) rather than the seller (employee) – a situation that is unlikely to change anytime soon. Indeed, taking a slightly longer perspective, since the beginning of the 2007 crisis a substantial drop in employment was recorded in manufacturing while new jobs were added in the construction sector as well as trade and repair (Figure 2). The former was most likely related to finalisation of infrastructure investment projects ahead of the Euro 2012 football championships as Poland struggled to upgrade infrastructure and build stadiums that will be used during the sport event. However, such an employment structure suggests the situation in the labour market is more likely to deteriorate than improve over the next year as investment projects finalise or will be realised at a slower pace than was the case in the run-up to Euro 2012. This means that not only now, but also in the foreseeable future employers will have a stronger position in the market than employees.

Figure 1. After a period of stabilisation employment in the corporate sector is heading lower



Source: GUS, Citi Investment Research and Analysis

Figure 2. The rise in employment in the construction sector may be reversed after finalisation of Euro 2012 investments



Source: GUS, Citi Investment Research and Analysis

¹ Such risks were highlighted for example in MPC minutes after 8th February meeting.

It appears that, for the time being, the labour market has reached a situation in which the number of people leaving unemployment is actually matched by inflows of newly unemployed. Indeed, in recent months the number of new unemployed persons picked up somewhat, but this was roughly in line with an improvement in the number of people leaving unemployment registers (Figure 3). However, those who are de-registered as unemployed often leave the labour market and simply stop looking for a job. Furthermore, a low number of job offers suggests the situation in the labour market is unlikely to improve anytime soon (Figure 4). This is also confirmed by forward looking indicators, as surveys conducted by the central bank suggest some deterioration in companies' employment plans.

The most striking, and usually understated, phenomenon is the fact the unemployment rate did not fall over last year even despite 4.3% economic growth in 2011. This suggests the economy is unable to generate a sufficient number of jobs even when growing at a quick pace. This observation is consistent with econometric estimates, as our regression model suggests that Poland needs to grow on average by around 0.9%QoQ GDP to keep stable employment. In other words, employment growth can be recorded when the economy is expanding by more than 3.7% (in annualised terms). This is an important observation given that even optimistic forecasts of the central bank assume a slowdown towards 3%YoY this year, and the market consensus is even lower.

Figure 3. Newly unemployed persons and people de-registered from labour offices (in thousands)



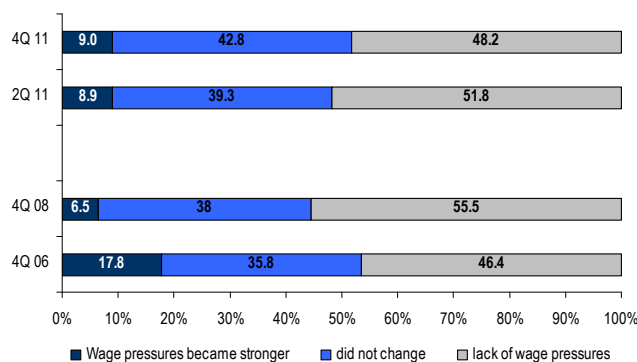
Source: GUS, Citi Investment Research and Analysis

Figure 4. Number of new job offers stabilised at a low level



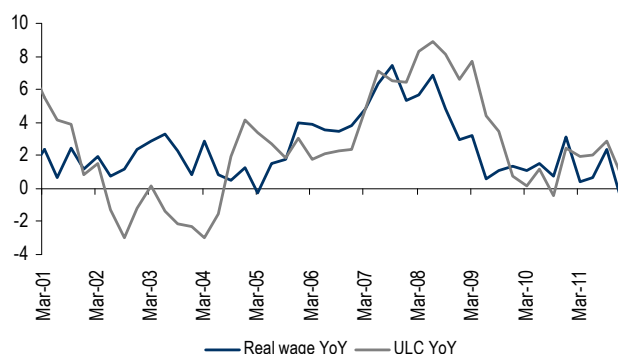
Source: GUS, Citi Investment Research and Analysis

Figure 5. Only 9% of firms can see rising wage demands



Source: NBP, Citi Investment Research and Analysis

Figure 6. Unit labour costs in the economy are rising at a slow pace



Source: GUS, CIRA estimates

Fears of second-round effects seem overdone

Given prospects for a further deterioration in the labour market it is difficult to imagine wage demands rising to a point that would create a risk to price stability. Actually it is quite difficult to see any signs of rising wage pressures. A good example is a recent central bank survey conducted among Polish firms which showed that only 9% of surveyed firms see signs of rising wage pressure, a number that has practically not changed over the previous six months. Also looking at recent wage trends it seems wage growth is harmless from an inflation point of view. Real wage growth in the whole economy has fluctuated around zero while unit labour costs in 4Q rose by around 1%YoY and this was lower than in previous quarters (Figure 6). The central bank's survey conducted in 4Q 2011 also shows that in only 6.8% of firms did wages grow faster than productivity.

We recognise a risk that the current oil price surge could in the future lead to higher wage demands but we believe it is more of a hypothetical than actual threat. Last year saw substantial food price shock and a significant increase in energy prices but this failed to generate substantial wage demands. And this was despite strong profits recorded by the Polish corporate sector that allowed firms to accommodate any potential wage demands. Given that now uncertainty regarding future growth and future corporate profits is much higher we doubt households would be successful in winning any substantial wage increases. All the more so given that – as argued above – the condition of the labour market does not allow employees a strong position in the bargaining process. Besides, we believe the current oil price “shock” is less acute for households than last year's food price shock, as Polish consumers spend five times more on food than fuels. Since second-round effects didn't materialise last year, this makes them even less likely in 2012, in our view.

Monetary policy implications

The weakness of the labour market suggests the room for a substantial rise in wage demands is very limited. This also means that although inflation is running above the target it will probably not translate into second-round effects. Therefore we don't share the concerns expressed by Polish central bankers and we don't think the above-target CPI should be treated as an argument for policy tightening. We believe the situation in the labour market will deteriorate further in the coming quarters and any hurried rate hikes might need to be reversed at a later stage. In such an environment we believe the best strategy for policymakers is to stick to a wait-and-see policy in the coming months and reassess the adequacy of the level of interest rates at a later stage when more information on the labour market becomes available.

We also expect that the central bank's rhetoric will gradually evolve towards more dovish tones and we expect the voices of most hawkish members to become much weaker. This might be partly reflected in the statement after the 7th March MPC meeting when the Council will see an updated version of the new inflation projection. In our view, the change in rhetoric might also revive market hopes for interest rate cuts by the end of 2012 and early 2013.

Appendix A-1

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