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Eco WEEK

ECONOMIC RESEARCH DEPARTMENT

## Summary

### Eurozone

**Fiscal tensions**

The European Commission has just published its autumn forecasts. Once again, Germany is likely to show a larger surplus than was forecast a year ago, and a debate is underway about the stance of fiscal policies in other main countries of Eurozone in 2016 (France, Spain and Italy).

► **Page 2**

### Poland

**Conservative right promises**

The general election of October 25 allowed the conservative Law and Justice Party to concentrate the political power in Poland. Promises of greater revenue redistribution (lower taxes for the poor, subsidies for families with children) and more active state involvement in stimulating growth and regional development were the key arguments that convinced voters

► **Page 4**

### Market overview

► **Page 7**

### Summary of forecasts

► **Page 8**

**Also in :**

Eco TV WEEK

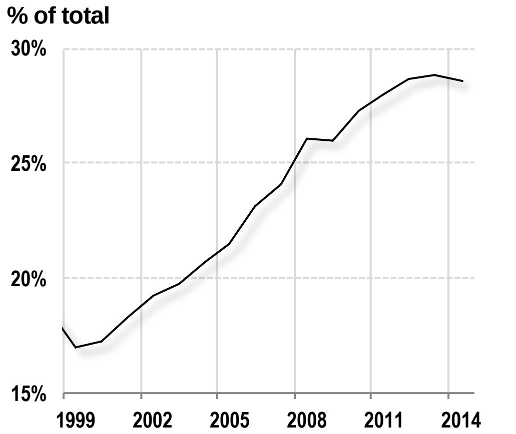
# France-Germany: is the gap narrowing?

- **Growth in French and German GDP is barely the same in 2015'Q3**
- **Germany is likely more affected by the downturn in world trade**

Judging by initial estimates of national accounts, France's economy grew slightly faster than Germany's in the third quarter of 2014, i.e. by 1.4% annualised versus 1.3%. Detailed German figures are not yet available, although indications are that activity was driven mainly by private and public sector consumption. Business investment fell in Germany whereas it continued to rise in France, and at a slightly faster pace than before.

According to economic surveys, the performance gap between France and Germany could continue to narrow between now and year-end. That should not come as a surprise. Germany's economy is very open, with almost 46% of GDP devoted to exports. Together with its exposure to emerging markets and specialisation in industrial capital goods, this makes Germany more sensitive than other countries to the slowdown in international trade, which is affecting the manufacturing sector above all. The French economy is more reliant on services – which account for 79% of business value added and a third of exports - and is naturally less cyclical. The French economy is often more resilient when global outlook becomes less positive.

**SHARE OF EMERGING MARKET ECONOMIES IN GERMAN EXPORTS**




Source: IMF

**THE WEEK ON THE MARKETS**

*Week 9-11 15 > 12-11-15*

| | | | | | |
|---|---|---|---|---|---|
| ↘ **CAC 40** | 4 984 | ► | **4 857** | **-2.6** | % |
| ↘ **S&P 500** | 2 099 | ► | **2 046** | **-2.5** | % |
| ↗ Volatility (VIX) | 14.3 | ► | 18.4 | +4.0 | % |
| ↘ **Euribor 3M** (%) | -0.07 | ► | **-0.08** | **-0.8** | bp |
| ↗ Libor $ 3M (%) | 0.34 | ► | 0.36 | +1.8 | bp |
| ↘ OAT 10y (%) | 1.02 | ► | 0.93 | -8.7 | bp |
| ↘ Bund 10y (%) | 0.70 | ► | 0.61 | -9.1 | bp |
| ↘ US Tr. 10y (%) | 2.33 | ► | 2.33 | -0.4 | bp |
| ↗ **Euro vs dollar** | 1.07 | ► | **1.08** | **+0.1** | % |
| ↘ Gold (ounce, $) | 1 088 | ► | 1 079 | -0.8 | % |
| ↘ **Oil (Brent, $)** | 47.0 | ► | **43.9** | **-6.5** | % |

Source: Thomson Datastream

# Eurozone

## Fiscal tensions

**■ The European Commission has published its autumn forecasts. As regards eurozone growth, it is a little more optimistic than us, expecting GDP to rise 1.8% in 2016 after 1.6% in 2015.**

**■ The Commission's public-finance forecasts will be compared with the 2016 draft budgets submitted by member-states. In late November, the Commission will release opinions on these drafts and whether they comply with European rules.**

**■ Once again, Germany is likely to show a larger surplus than was forecast a year ago, and a debate is underway about the stance of fiscal policies in other main countries of Eurozone in 2016 (France, Spain and Italy).**

In the middle of last week, the European Commission published its autumn economic forecasts. Brussels expects eurozone GDP to grow 1.6% in 2015 and 1.8% in 2016, representing a slight adjustment relative to its spring forecasts of 1.5% and 1.9% respectively. Like most other observers, the Commission's experts emphasised that although the slowdown in emerging-market countries would put a drag on growth, it would not threaten the eurozone recovery, which is still being supported by lower oil prices, the ECB's highly expansionary monetary policy and the weak euro.

As regards the public finances, the Commission expects the improvement underway for the last few years to continue. Two factors are now at play. Firstly, activity is recovering, which is causing a cyclical reduction in Eurozone fiscal deficit. Secondly, the ECB's highly expansionary monetary policy is holding down sovereign yields, reducing the amount of interest paid by member-states. The Commission estimates that in 2015, the first factor has reduced Eurozone deficit by 0.4 points of GDP, and the second by 0.3 points. In 2016, the effect of the cyclical upturn could remain at the same level (0.4 points), while interest charges are expected to fall only marginally, resulting in a positive 0.1-point impact. The Commission believes that these two factors are now the main forces driving the reduction in public-sector deficits, since fiscal policy[1] has been near-neutral in 2015 and is likely to remain so next year.

This is a welcome development for the Eurozone as a whole. It reflects the general improvement in the European public finances and will support the upturn in activity after a number of years during which fiscal consolidation has been a major drag on growth. The Commission expects the public-sector deficit/GDP ratio in the eurozone to be around 2% this year, and to fall by another few tenths of a point in 2016. Similarly, the public debt/GDP ratio should finally start falling in 2015 to 94% of GDP, and fall further in 2016, for the first time since 2007.

[1] Affecting the budget balance via the change in the structural primary balance.

### Forecasts for the eurozone

| GDP growth | 2015 | 2016 | 2017 |
|---|---|---|---|
| % | October/November | | |
| European Commission | 1.6 | 1.8 | 1.9 |
| OECD | 1.5 | 1.8 | 1.9 |
| IMF | 1.5 | 1.6 | 1.7 |
| BNP Paribas | 1.5 | 1.5 | 1.9 |

**Table 1** Sources: EC, IMF, OECD, BNP Paribas

### Eurozone draft budgets (DBs)

| % of GDP | Budget balances 2015 | | Budget balances 2016 | | Structural improvement expected in 2016 | |
|---|---|---|---|---|---|---|
| | DB | EC | DB | EC | DB | EC |
| Belgium | -2.6 | -2.7 | -2.1 | -2.6 | 0.5 | 0.4 |
| Germany | 1 | 0.9 | 0 | 0.5 | -0.8 | -0.2 |
| Estonia | 0 | 0.2 | -0.1 | 0.2 | -0.4 | -0.1 |
| Spain | -4.2 | -4.7 | -2.8 | -3.6 | 0.2 | -0.1 |
| France | -3.8 | -3.8 | -3.3 | -3.4 | 0.5 | 0.3 |
| Italy | -2.6 | -2.6 | -2.2 | -2.3 | -0.4 | -0.5 |
| Luxembourg | 0.1 | 0 | 0.5 | 0.5 | -0.1 | 0.2 |
| Malta | -1.6 | -1.7 | -1.1 | -1.2 | 0.5 | 0.4 |
| Netherlands | -2.2 | -2.1 | -1.5 | -1.5 | -0.1 | -0.3 |
| Austria | -1.9 | -1.9 | -1.4 | -1.6 | 0.0 | -0.4 |
| Slovenia | -2.9 | -2.9 | -2.2 | -2.4 | 0.6 | 0.2 |
| Slovakia | -2.7 | -2.7 | -1.9 | -2.4 | 0.8 | 0.1 |
| Finland | -3.4 | -3.2 | -2.8 | -2.7 | 0.0 | 0.2 |
| Ireland | -2.1 | -2.2 | -1.2 | -1.5 | 0.7 | 0.9 |
| Portugal | n/a | -3 | n/a | -2.9 | n/a | -0.5 |
| Greece | n/a | -4.6 | n/a | -3.6 | n/a | 0.8 |
| Cyprus | n/a | -0.7 | n/a | 0.1 | n/a | -0.2 |
| **Eurozone** | | **-2.0** | | **-1.8** | | **-0.1** |

**Table 2** Sources: EC, Autum forecast 2015 and draft budget from national governments

### Draft budgets of member-states in the spotlight

The Commission's forecasts regarding the public finances of each member-state will provide a reference point for assessing the 2016 draft budgets that governments submitted to Brussels in mid-October[2]. In late November, the Commission will release its opinions on whether these draft budgets are feasible and compliant with European rules. We compare the draft budgets of member-states with the Commission's forecasts in table 2 above. Overall, the

[2] Greece and Cyprus have not had to provide such plans because they are under "budgetary surveillance" as part of their European adjustment and financing programmes. Portugal's recent parliamentary election and subsequent difficulty in forming a government means that it has not yet been able to submit its draft budget to the Commission. As a result, the Commission's forecasts for Portugal assume no change in policy in 2016.

Commission is pleased that the eurozone will only have three countries (France, Spain and Greece) with a general government deficit/GDP ratio of over 3% next year. At the other end of the spectrum, Luxembourg and Estonia will have a balanced budget and Germany will have a substantial surplus. As might be expected, these latest countries are planning to pursue a neutral or slightly expansionary fiscal policy next year[3]. As table 2 shows, however, they will not be the only ones: Italy and the Netherlands, and perhaps also Austria and Portugal according to Commission forecasts, may do the same in 2016.

### Weaker-than-expected fiscal efforts in France, neutral stance in Spain and expansionary policy in Italy

In France, the European Commission expects the structural balance to improve by 0.3 points of GDP in 2016, less than the 0.5-point reduction required for a country in its position and less than the 0.8-point reduction demanded by the European Commission in spring 2015 when the country updated its stability and growth programme. The government is banking on growth of 1.5% next year, which would allow it to meet its target in nominal terms. Meeting that commitment, even with very slow improvement in the structural balance, would satisfy the letter, if not the spirit, of the European rules. However, if French growth is weaker than expected[4] and if France misses the target, it will be unable to put forwards that it has met its "best endeavours" obligation through sufficient structural efforts[5].

Regarding Spain, the European Commission does not expect the country to meet its deficit-reduction targets in 2015 or 2016. There are many reasons for this: the Commission is using figures that were not available to the government when preparing its plans, growth forecasts are now less optimistic, there are concerns about overspending by Spain's regions, and there are differences of opinion regarding whether certain measures are structural or exceptional, particularly for 2015. Those factors have produced some wide divergences in 2015 and 2016 forecasts (see table). Since this year, activity in Spain accelerated sharply and the government is increasingly relying on that faster growth to reduce the public deficit, to the extent that it is planning near-neutral fiscal policy next year. This is not what could be expected from a country still subject to an excessive deficit procedure, but such a strategy may not be a bad one in a country where unemployment is still well above 20% of the labour force. In addition, we believe that the strength of the current recovery remains the best guarantee that the deficit could durably fall below 3% of GDP, no matter it does so in 2017, one year after the deadline set by Brussels.

Let's turn to Italy. When the Commission adopted measures to make fiscal rules more flexible in January, we highlighted at the time that

### Meanwhile in Germany...

Germany remains the odd one out. As has often been the case in recent years, Germany underestimated how strong its public finances would be in 2015, partly but not only because German GDP growth has been stronger than expected. A year ago, the German government expected the budget to be balanced in 2015, but in the end there could be a surplus of 1% of GDP. Next year, the Chancellery is still expecting a balanced budget, implying a loosening of fiscal policy equal to 0.75 points of GDP. Even factoring in the cost for Germany of allowing in large numbers of migrants – expected to be 0.25% of GDP in 2016 after 0.1% in 2015 – the European Commission is expecting Germany to adopt less fiscal stimulus and is forecasting a surplus equal to 0.5% of GDP next year. Germany's debt ratio will continue to fall very rapidly and will probably be back below 60% by the end of the decade. As regards macroeconomic imbalances, however, Germany is increasingly a rule-breaker, with a current-account surplus that is likely to remain above 8% of GDP for the forecast period. The 6% limit was broken in 2012, but the Commission, showing leniency to Germany, has still not addressed the problem.

Italy would be the main beneficiary[6]. This will indeed be the case. In spring 2015, when updating its stability and growth programme, the Italian government put forward the fiscal impact of a series of structural reforms to relax its target. This autumn, its wants to use the "investment clause" to shift its adjustment trajectory a little further, this time taking into account the cost of certain investments benefiting from European co-financing. Overall, Matteo Renzi is expecting Italy's structural public deficit to deteriorate by 0.4% of GDP next year, rather than improve by 0.5%, and is asking the Commission to approve that target.

The Commission is due to give its recommendations on the draft budgets of each member-state by 23 November, which is when its opinions will be discussed within the Eurogroup. It has already highlighted risks of non-compliance in the Spanish case and asked the Spanish government to review its plan. But we still don't know whether it could broadly approve the French and Italian draft budgets, even though showing that it will be monitoring the situation closely. As a result, we are starting to see some criticism of the fact that some of the largest countries in the Eurozone are reducing their efforts before they have complied with all European rules. Eurogroup president Jeroen Dijsselbloem also recently expressed concern that some could start thinking that the European Commission's opinions may be becoming politicised, whereas the European Council is the place where decision can be political. It is up to the Commission to prove that that is not the case and remind observers that, a year ago, all European leaders were calling loudly for the flexibility available under the Stability and Growth Pact to be used in full.

[3] The member-states that will adopt an expansionary fiscal policy are those where the structural improvement expected in 2016 is negative (in red).

[4] It should also be noted that as well as weak real growth, low inflation and therefore low nominal growth are limiting the effectiveness of France's public spending cuts, which are heavily reliant on measures to freeze or limit nominal spending.

[5] For more details about the 2016 French budget see "2016 budget proposal: austerity and stimulus", H. Baudchon, Ecoweek 23/10/15.

[6] See "Eurozone: Less austerity in exchange for more reforms and investment", Ecoweek, 16 January 2015.

# Poland

## Conservative right promises

**The general election of October 25 allowed the conservative Law and Justice Party to concentrate the political power in Poland. The party now controls the Seijm (the Lower House of Parliament), the Senate (the Upper House) and the Presidency and has nominated the new government without having to form a coalition. The planned rotation at the top of the Monetary Policy Committee (during 2016) will allow it to increase its influence over monetary policy decisions as well.**

**The promises of greater revenue redistribution (lower taxes for the poor, subsidies for families with children) and more active state involvement in stimulating growth and regional development were the key arguments that convinced voters. The challenge now will be to implement it while keeping deficits under control.**

**Despite its spectacular success, the Law and Justice Party fell short of a constitutional majority. The conversion of the loans in Swiss francs into zlotys, which may require amending the constitution, will be the first issue for which a consensual solution with the Civic Platform Party, now the opposition, will have to be found.**

### Seijm and Senate composition

| | Seijm | Senate |
|---|---|---|
| Law and Justice (PiS) | 235 | 61 |
| Civic Platform (PO) | 138 | 34 |
| Peasants party (PSL) | 16 | |
| Modern party | 28 | |
| Pawel Kukiz (K'15) | 42 | |
| Polish People | | 1 |
| Independents | | 4 |
| TOTAL | 460 | 100 |

*Source: Press reports*

### Conservatives to govern alone

The legislative election of October 25 changed the game in Polish politics. For the first time since the end of the communist rule, a single party will control all branches of power. The conservative Law and Justice Party (PiS) won an absolute majority (51%) in the Seijm and a majority of 61% in the Senate. This occurred five months after Andrzej Duda of the PiS won the presidential election. Thus, after eight years of being in the opposition, the PiS is back in power. The strong majority allows it to govern alone without forming a coalition to determine Polish political priorities and economic policy. Moreover, as the mandates of eight of the nine members of the National Bank of Poland's monetary policy council end in early 2016 and a new NBP governor will be appointed in the middle of the next year, the grip of the PiS on economic policy will be even tighter[1].

The Civil Platform Party (PO) will become the main opposition force with 138/460 seats. In the parliament, it will be able to count on its former junior coalition partner, the Peasants Party (16 seats), as it did in the past to form the government. On some issues, it may count on the new formation, the liberal Modern Party (28 seats). The positioning of the new Pawel Kukiz, the "anti- establishment" political formation that won 42 seats, is less clear: some of the ideas announced during the election campaign were closer to those of the PiS than of the PO. It is worth noting that even the eventual support from the Kukiz movement would not allow the PiS to gain a constitutional majority.

The left-wing parties (unified under the name of United Lefts) failed to cross the 8% threshold and did not get any seats in the new parliament.

The first session of the parliament was held on November 13: the deputies elected Marek Kuchcinski as new Sejm Speaker and Stanislaw Karczewski as Senate Speaker. President Duda officially accepted the resignation of the government headed by Eva Kopacz. The new government will be headed by the PiS Party deputy leader Beata Szydlo. Mateusz Morawiecki, today the CEO of Bank Zachodni WBK, will take the reins of a new Ministry of Development that will replace the existing Ministry of Economy and coordinate economic policy for Finance, Infrastructure, Energy and Treasury Ministries. The roles of Finance and Treasury Ministries will be reformed according to the first announcements of Mrs. Szydlo.

### Economic policy to turn left

After the announcement of the results, the PiS reiterated its intention to put in place several reforms that we may qualify as "leftist," boosting revenue redistribution and protecting workers while implementing pro-active industrial and regional policies.

The introduction of monthly benefits for low-income families with children seems to be on the top of the "social policy" agenda of the new majority. The genuinely demographic policy encouraging families to have more children has become more than necessary in Poland as the fertility rate has been declining since 2009 (after a period of low growth in 2004-2008) to reach a very low 1.3 births per woman in 2013. The PiS announced a subsidy of PLN 500 (€ 117) per child for poor families with two or more children. If implemented fully, this will represent a permanent cost for the budget of 1.1% of GDP per annum.

In another measure aiming to support the poorest, the PiS is planning to raise the threshold for income that is exempt from taxation to PLN 8000 from PLN 3091 (the current level does not reach even a half of the official poverty line). The measure may cost

[1] The Sejm, the Senate and the President each appoints three NPC members, while the NBP governor (who is the tenth MPC member) is nominated by the President.

local and regional governments about PLN 14 bn (which is equal to a loss of fiscal income of 0.7% of GDP).

The promise to lower the retirement age, which was raised to 67 years in 2011 under the previous government in reaction to the rapid ageing of the population (this level would have to be reached by 2020) may appear to be the most costly to put in place. Therefore, the reduction will probably concern only those who have worked during 40 full years. Yet it may cost the pension system at least PLN 10 bn per annum (0.5% of GDP). Given the ongoing increase in life expectancy (which was 77 years in 2013, up 1.15 years since 2009), the cost is expected to increase over time. The introduction of free medicine for seniors is also on the agenda of the new ruling party.

In the field of protecting workers, the new majority intends to ban the so called "trash labor contracts" (the highly flexible civil law contracts that allow employers to hire and fire workers freely without paying social contributions and, therefore, without offering them social protection). The measure will be costly for employers, who will have to comply with standard labor law procedures for hiring and firing and pay social contributions for the workers that were hired on "trash" contracts in the past. The costs may reach PLN 1.5 bn (about 0.1% of GDP). Moreover, the introduction of the minimum wage of PLN 12 per hour is planned. In order to compensate somewhat for the new costs weighing on enterprises, the PiS is planning to cut the corporate income tax for SMEs to 15% (from the standard rate of 19%).

## The fiscal slippage is not on the agenda but new taxes are

The new government's spending appetite may, however, be somewhat diminished by the strict constraints that weigh on the fiscal policy. Domestic fiscal rules are even tighter than the EU rules (which limit the deficit at 3% of GDP and the debt at 60% of GDP). The local fiscal rules limit the spending expansion[2] to 3% for 2016, the rate already envisaged by the previous government. Therefore, either all new spending will have to be funded by new fiscal revenues or the fiscal rules will have to be modified or suspended (which is not on the agenda at the moment).

To find ways to finance the new measures, the current coalition intends to improve tax collection. For tax collection, President Duda has already signed a measure imposing stricter controls on the transfer pricing that exceeds EUR10mn on cross-border transactions with affiliates.

However, in light with the strong spending appetite, the improvement of tax collection will not suffice. To bridge the fiscal gap, new sectorial taxes are to be introduced. The authorities intend to introduce a tax of 0.39% on banking assets that should provide about PLN 5-6 bn per annum (0.3% of GDP) in new revenues. The tax on turnover for retail hypermarkets (the stores with a surface of more than 250 sq meters) may reach 2%, thus providing an additional PLN 3.5 bn per annum (0.2% of GDP) in revenues. Some sectors will see their tax bill decrease. This will be the case for copper and silver extraction; the PiS has already submitted to parliament the tax bill aiming to suspend the copper and silver tax until 2026.

## Directed lending to escape fiscal rule constraints

The strong constraints that weigh on the fiscal spending in Poland do not allow the government to fund massively the sector or regional policies directly through the budget. To circumvent this constraint, the new majority intends to actively use directed lending. During the campaign, the PiS announced its intention to get up to PLN 350 bn over six years (about 3% of GDP per annum) in central bank funding. The final design of the program remains under consideration, but it may use the example of the Bank of England's Funding for Lending. The measure intends to provide support to deprived regions that lack investments for their reorientation (in particular Silesia) as well as to specific sectors, notably the ailing coal mining sector that needs state-backed restructuring[3]. The directed lending schemes will include funding by Bank Gospodarstwa Krajowego (BGK), Polskie Inwestycje Rozwojowe (PIR), Industrial Development Agency (ARP) and the National Bank of Poland and will be completed with the expected funding from the EU[4]. Put together, this funding may reach PLN 1.4 trln (74% of GDP2016e) and may be added to what the official budget is able to deliver.

In the current deflationary environment, the use of such practices does not raise substantial overheating risks. However, it remains to be seen whether the new government will be able to taper the programs carefully in case of an acceleration of inflation. The particular difficulty will come from the fact that the projects the government intends to fund are long-term and of high social importance.

## CHF loan conversion: a compromise on how "sharing the burden" will be necessary

In many Central and Eastern European countries since the mid-2000s, the possibility to lend in foreign currencies allowed banks to develop the long-term mortgage market with low interest rates while attracting cheap funding from abroad. The currency risks related to these operations were hidden as during this period domestic currencies were appreciating and therefore not taken into account. In Poland by 2009 the housing loans in foreign currencies to households reached 12% of GDP. The depreciation of local currencies registered post-2009 raised credit risks in the banking sector, exacerbating troubles from the global financial crisis and the slump in domestic growth.

The regulators tried to curb FCU lending, but the "soft pressures" were barely successful in fully discouraging banks from lending in foreign currencies to households. By mid-2015 the housing lending in foreign currencies declined only slightly, reaching 10% of GDP and 10% of total banking assets in Poland. The bulk of the lending was done in Swiss francs (83% of the total, 8% of GDP).

[2] In general, the expenditures cannot rise more than the average real GDP growth rate of the past 8 years augmented by the rate of inflation expected in the budget law. And this pace will be reduced another 1.5pp given the already high level of state debt per GDP (50% of GDP).

[3] As a part of the restructuring process, the mines may also benefit from temporary tax or social security payment relief.

[4] Poland is and will remain the biggest net recipient of the EU funds (in nominal EUR terms) for the budget period of 2014-2020. Over the period of 2014-2020, the country will receive €105.8 bn (€29 bn for agriculture and €73 bn in cohesion funds). This equals ~3% of GDP per annum.

The specific attention Polish regulators paid to this problem[5] was, however, more successful than that of the regulators in neighboring Hungary as they managed to preserve the quality of the portfolio (see box below). In Poland by mid-2015 the NPL ratio on the housing loans in Swiss francs was only 4% (half of the economy's average).

> The situation in Hungary, with which the Polish case is frequently compared, was different as the measures of Hungarian authorities (taken starting in 2010) were less effective in limiting banks' exposure to the fx-linked credit risks of foreign currency mortgages. While the total exposure of banks to foreign currency mortgages was similar in both countries (12-14% of total assets on average in 2009-2013), the quality of the portfolios was different. In Hungary, the NPL ratio for this category of loans reached 24% mid-2014. This is 6x the level of Poland.
>
> In 2014 Hungarian authorities decided to take radical steps and obliged banks to convert all FCU mortgages into forints. The conversion was done at the market rates prevailing at the time the decision was made (in November 2014). The interest rates charged on new forint loans were tied to the local interbank rate, and the banks' spreads on new loans were capped. Thanks to this, the appreciation of the Swiss franc in January 2015 did not have an impact on household mortgage borrowers.
>
> The National Bank of Hungary helped banks to bear the losses that resulted from the conversion, notably by allocating EUR 9 bn from official fx reserves to allow banks to cover their open forex positions.

Despite the much lower importance of the problem of FCU mortgage lending in Poland for banks' stability (compared with neighboring Hungary), the issue resurfaced after the sharp appreciation of the Swiss Franc in early 2015. The electoral campaign exacerbated the debate and led to the adoption in early August 2015 of the law that imposes the mandatory conversion of the CHF mortgages into zlotys. The conversion was imposed at the historic exchange rate, generating costs for the banks[6]. Initially the project envisaged a 50/50 sharing of the costs between the banks and the borrowers, but the project was amended by the Seijm to be much more unfavorable for banks with a cost-sharing of 90/10. The original draft law estimated a cost to lenders of PLN 9.5 bn (0.5% of GDP): the cost increased to PLN 21 bn in the 90-10 split scenario. In this case, the cost (if frontloaded) would have exceeded the sector's aggregated annual earnings: over the first nine months of 2015, the net earnings of the banking system reached PLN 11.4 bn (0.64% of GDP). However, the Senate (governed by the PO majority at that time) rejected the 90/10 proposal, returning to the equal 50/50 cost-sharing approach.

Recently the banking regulator "entered the game" by raising capital requirements for several banks to above the regulatory minimum of 12% in proportion to their involvement in CHF loan financing (calling for an increase ranging between 4.39 pt and 0.71 pt to their capital). The decision may be interpreted as a "provisioning" for the potential costs of conversion (the additional capital requirements may be relaxed after the conversion is done, as the currency risk related to the CHF exposure will disappear). This may also be viewed as an element of bargaining against the conversion. Indeed as the additional capital cushion covers the risks of the banks that occur from the exposure to the CHF lending to unhedged borrowers, the conversion will become unnecessary from the point of view of the banking sector's stability.

The banking community announced that it envisages challenging the law on conversion in the Constitutional Court: the support to the CHF borrowers is considered unfair vis à vis the PLN borrowers that do not receive such support.

Therefore, the issue remains on the table, and we are just in the middle of the bargaining process. The question of cost-sharing is central. In order to realize the conversion in an orderly manner, the new government will have to find either a compromise with the banks on the way to share the costs without excessively damaging their revenues (or to compensate them). It may also try to find a compromise with the Civic Platform to amend the Constitution in order to counter banks' legal action. The alternative proposals (such as to create a special fund to help problem borrowers whatever the currency) may end up on the table as well.

[5] The Polish regulator KNF issued the "Recommendation S" in 2006 obliged banks informing customers over the related risks while creating additional depreciation buffers. In 2007, the risk weight for fx loans to households was increased and additional liquidity limits were introduced. The rules were tightened further since the depreciation risk materialized and the NPLs on the loans started increasing: the limits on debt to income ratios and new, higher risk weights were introduced.

[6] The total cost is calculated as the difference between the value of the debt now, and the amount the borrower would have had to pay if the loan were taken out in PLN.

# Markets overview

## The essentials

*Week 9-11 15 > 12-11-15*

| | | | | | | |
|---|---|---|---|---|---|---|
| ↘ | **CAC 40** | 4 984 | ▶ | **4 857** | **-2.6** | % |
| ↘ | **S&P 500** | 2 099 | ▶ | **2 046** | **-2.5** | % |
| ↗ | Volatility (VIX) | 14.3 | ▶ | 18.4 | +4.0 | % |
| ↘ | **Euribor 3M** (%) | -0.07 | ▶ | **-0.08** | **-0.8** | bp |
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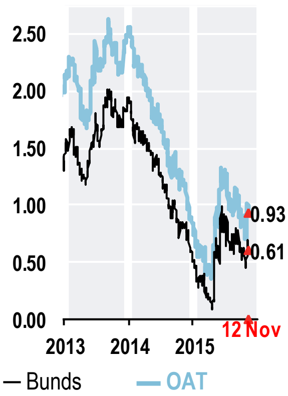
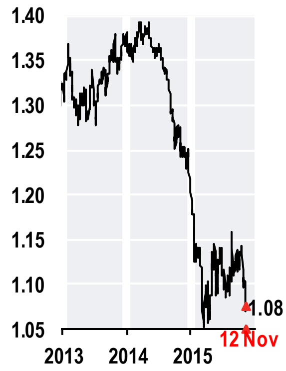
| ↘ | US Tr. 10y (%) | 2.33 | ▶ | 2.33 | -0.4 | bp |
| ↗ | **Euro vs dollar** | 1.07 | ▶ | **1.08** | **+0.1** | % |
| ↘ | Gold (ounce, $) | 1 088 | ▶ | 1 079 | -0.8 | % |
| ↘ | **Oil (Brent, $)** | 47.0 | ▶ | **43.9** | **-6.5** | % |

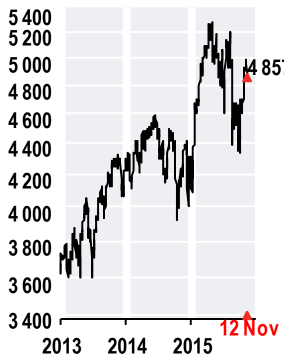
*10 y* **bond yield, OAT vs Bund**




**Euro-dollar**




**CAC 40**




## Money & Bond Markets

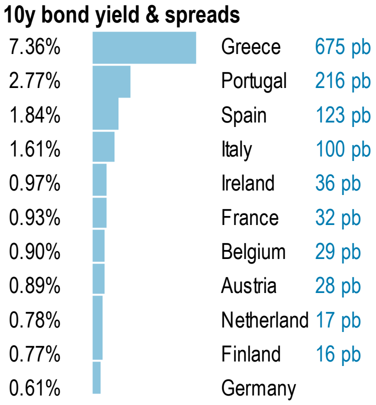
| Interest Rates | | highest' 15 | | lowest' 15 | |
|---|---|---|---|---|---|
| **€ ECB** | **0.05** | 0.05 | at 01/01 | 0.05 | at 01/01 |
| Eonia | **-0.14** | 0.14 | at 01/01 | -0.15 | at 28/09 |
| Euribor 3M | **-0.08** | 0.08 | at 01/01 | -0.08 | at 12/11 |
| Euribor 12M | **0.08** | 0.33 | at 01/01 | 0.08 | at 12/11 |
| **$ FED** | **0.25** | 0.25 | at 01/01 | 0.25 | at 01/01 |
| Libor 3M | **0.36** | 0.36 | at 11/11 | 0.25 | at 06/01 |
| Libor 12M | **0.93** | 0.93 | at 09/11 | 0.61 | at 16/01 |
| **£ BoE** | **0.50** | 0.50 | at 01/01 | 0.50 | at 01/01 |
| Libor 3M | **0.58** | 0.59 | at 12/08 | 0.56 | at 11/03 |
| Libor 12M | **1.04** | 1.08 | at 05/08 | 0.95 | at 16/01 |

*At 12-11-15*

| Yield (%) | | | highest' 15 | | lowest' 15 | |
|---|---|---|---|---|---|---|
| € | AVG 5-7y | **0.61** | 0.91 | at 16/06 | 0.24 | at 12/03 |
| | Bund 2y | **-0.24** | -0.08 | at 01/01 | -0.29 | at 07/07 |
| | Bund 10y | **0.59** | 0.99 | at 10/06 | 0.08 | at 20/04 |
| | OAT 10y | **0.90** | 1.33 | at 10/06 | 0.36 | at 15/04 |
| | Corp. BBB | **2.28** | 2.28 | at 24/09 | 1.29 | at 10/03 |
| $ | Treas. 2y | **0.62** | 0.78 | at 16/09 | 0.44 | at 15/01 |
| | Treas. 10y | **2.12** | 2.48 | at 10/06 | 1.67 | at 02/02 |
| | Corp. BBB | **4.09** | 4.21 | at 02/09 | 3.41 | at 30/01 |
| £ | Treas. 2y | **0.55** | 0.82 | at 05/08 | 0.39 | at 23/03 |
| | Treas. 10y | **1.74** | 2.19 | at 26/06 | 1.36 | at 30/01 |

*At 24-9-15*

**10y bond yield & spreads**

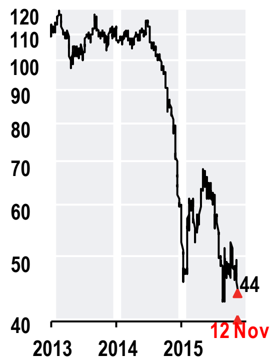



## Commodities

| Spot price in dollars | | lowest' 15 | | | 2015(€) |
|---|---|---|---|---|---|
| Oil, Brent | **44** | 43 | at | 24/08 | **-11.5%** |
| Gold (ounce) | **1 079** | 1 079 | at | 12/11 | **+2.4%** |
| Metals, LMEX | **2 225** | 2 225 | at | 12/11 | **-14.1%** |
| Copper (ton) | **4 836** | 4 836 | at | 12/11 | **-14.6%** |
| CRB Foods | **359** | 344 | at | 17/03 | **+9.3%** |
| w heat (ton) | **162** | 147 | at | 17/09 | **-16.6%** |
| Corn (ton) | **141** | 132 | at | 15/06 | **+8.3%** |

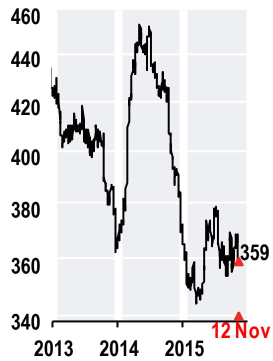
*At 12-11-15* *Variations*

**Oil** (Brent, $)




**Gold** (Ounce, $)


**CRB Foods**




## Exchange Rates

| 1€ = | | highest' 15 | | | lowest' 15 | | | 2015 |
|---|---|---|---|---|---|---|---|---|
| **USD** | **1.08** | 1.21 | at | 01/01 | 1.05 | at | 13/03 | **-11.1%** |
| GBP | **0.71** | 0.79 | at | 06/01 | 0.69 | at | 17/07 | -8.8% |
| CHF | **1.08** | 1.20 | at | 01/01 | 0.98 | at | 16/01 | -10.2% |
| JPY | **132.21** | 145.08 | at | 01/01 | 126.57 | at | 15/04 | -8.9% |
| AUD | **1.51** | 1.61 | at | 24/09 | 1.37 | at | 28/04 | +2.3% |
| CNY | **6.85** | 7.51 | at | 01/01 | 6.57 | at | 13/04 | -8.8% |
| BRL | **4.08** | 4.75 | at | 24/09 | 2.91 | at | 23/01 | +26.7% |
| RUB | **70.93** | 81.80 | at | 24/08 | 53.47 | at | 16/04 | -2.3% |
| INR | **71.44** | 77.19 | at | 24/08 | 66.07 | at | 13/04 | -6.5% |

*At 12-11-15* *Variations*

## Equity indices

| | Index | highest' 15 | | | lowest' 15 | | | 2015 | 2015(€) |
|---|---|---|---|---|---|---|---|---|---|
| **CAC 40** | **4 857** | 5 269 | at | 27/04 | 4 084 | at | 06/01 | +13.7% | **+13.7%** |
| **S&P500** | **2 046** | 2 131 | at | 21/05 | 1 868 | at | 25/08 | -0.6% | **+11.8%** |
| DAX | **10 783** | 12 375 | at | 10/04 | 9 428 | at | 24/09 | +10.0% | **+10.0%** |
| **Nikkei** | **19 698** | 20 868 | at | 24/06 | 16 796 | at | 14/01 | +12.9% | **+23.9%** |
| China* | **63** | 85 | at | 27/04 | 55 | at | 07/09 | -4.8% | **+7.2%** |
| India* | **448** | 553 | at | 03/03 | 438 | at | 07/09 | -5.0% | **+1.5%** |
| Brazil* | **1 176** | 1 886 | at | 22/01 | 1 030 | at | 29/09 | -8.5% | **-27.8%** |
| Russia* | **445** | 587 | at | 18/05 | 396 | at | 24/08 | +18.6% | **+23.7%** |

*At 12-11-15* *Variations*

* Indices MSCI

# Economic forecasts

| En % | GDP Growth 2014 | GDP Growth 2015 e | GDP Growth 2016 e | Inflation 2014 | Inflation 2015 e | Inflation 2016 e | Curr. account / GDP 2014 | Curr. account / GDP 2015 e | Curr. account / GDP 2016 e | Fiscal balances / GDP 2014 | Fiscal balances / GDP 2015 e | Fiscal balances / GDP 2016 e |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Advanced** | **1.8** | **1.9** | **1.8** | **1.4** | **0.3** | **1.4** | | | | | | |
| **United States** | **2.4** | **2.6** | **2.3** | **1.6** | **0.1** | **2.0** | **-2.2** | **-2.5** | **-2.9** | **-2.8** | **-2.4** | **-2.4** |
| Japan | -0.1 | 0.4 | 0.6 | 2.7 | 0.7 | 0.7 | 0.5 | 3.5 | 3.6 | -5.3 | -4.4 | -3.9 |
| United Kingdom | 2.9 | 2.3 | 1.6 | 1.5 | 0.1 | 1.5 | -5.1 | -4.7 | -4.3 | -4.9 | -3.8 | -2.8 |
| **Euro Area** | **0.9** | **1.6** | **1.5** | **0.4** | **0.1** | **1.0** | **2.1** | **3.0** | **2.8** | **-2.4** | **-2.1** | **-1.8** |
| Germany | 1.6 | 1.6 | 1.6 | 0.8 | 0.2 | 1.2 | 7.6 | 8.4 | 8.3 | 0.7 | 0.7 | 0.5 |
| France | 0.2 | 1.1 | 1.4 | 0.6 | 0.1 | 0.9 | -0.9 | 0.1 | -0.1 | -4.0 | -3.8 | -3.4 |
| Italy | -0.4 | 0.8 | 1.0 | 0.2 | 0.2 | 0.9 | 1.9 | 2.1 | 2.1 | -3.0 | -2.6 | -2.3 |
| Spain | 1.4 | 3.2 | 2.5 | -0.2 | -0.5 | 0.8 | 0.8 | 0.5 | 0.4 | -5.8 | -4.2 | -2.9 |
| Netherlands | 1.0 | 2.0 | 2.2 | 0.3 | 0.3 | 1.0 | 10.8 | 9.9 | 9.2 | -2.8 | -2.1 | -1.8 |
| Belgium | 1.1 | 1.3 | 1.4 | 0.5 | 0.2 | 1.2 | 1.4 | -0.4 | -0.4 | -3.2 | -3.0 | -2.7 |
| Portugal | 0.9 | 1.6 | 1.5 | -0.2 | 0.5 | 0.8 | 0.6 | 1.3 | 1.5 | -4.6 | -2.9 | -2.3 |
| **Emerging** | **4.5** | **3.7** | **4.2** | **5.6** | **6.7** | **7.0** | | | | | | |
| China | 7.3 | 6.8 | 6.5 | 2.0 | 1.7 | 2.0 | 2.1 | 3.7 | 3.1 | -2.1 | -2.4 | -2.9 |
| India | 7.1 | 7.1 | 7.5 | 6.6 | 4.8 | 6.3 | -1.7 | -1.3 | -0.7 | -4.4 | -4.1 | -3.9 |
| Brazil | 0.1 | -3.0 | -2.0 | 6.3 | 8.8 | 7.0 | -4.5 | -3.9 | -2.5 | -6.2 | -8.4 | -8.1 |
| Russia | 0.6 | -4.1 | -1.2 | 7.8 | 15.8 | 7.2 | 3.2 | 6.5 | 6.4 | -1.2 | -5.0 | -4.5 |
| **World** | **3.3** | **2.9** | **3.1** | **3.7** | **3.8** | **4.5** | | | | | | |

Source : BNP Paribas Group Economic Research / GlobalMarkets (e: Estimates & forecasts)

# Financial forecasts

| **Interest rates** | | 2015 | | | | 2016 | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| End period | | Q1 | Q2 | Q3 | Q4e | Q1e | Q2e | Q3e | Q4e | **2014** | **2015e** | **2016e** |
| **US** | Fed Funds | 0.25 | 0.25 | 0.25 | 0.25-0.50 | 0.50-0.75 | 0.75-1.00 | 1.00-1.25 | 1.50-1.75 | 0.25 | 0.25-0.50 | 1.50-1.75 |
| | 3-month Libor $ | 0.27 | 0.28 | 0.33 | 0.63 | 0.88 | 1.13 | 1.50 | 2.00 | 0.26 | 0.63 | 2.00 |
| | 10-year T-notes | 1.93 | 2.33 | 2.06 | 2.35 | 2.45 | 2.55 | 2.60 | 2.65 | 2.18 | 2.35 | 2.65 |
| **EMU** | Refinancing rate | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 | 0.05 |
| | 3-month Euribor | 0.02 | -0.01 | -0.04 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.08 | 0.00 | 0.00 |
| | 10-year Bund | 0.18 | 0.77 | 0.59 | 0.40 | 0.40 | 0.45 | 0.50 | 0.70 | 0.54 | 0.40 | 0.70 |
| | 10-year OAT | 0.42 | 1.20 | 0.90 | 0.65 | 0.65 | 0.70 | 0.75 | 1.00 | 0.84 | 0.65 | 1.00 |
| | 10-year BTP | 1.29 | 2.31 | 1.73 | 1.30 | 1.20 | 1.25 | 1.35 | 1.60 | 1.88 | 1.30 | 1.60 |
| **UK** | Base rate | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.75 | 1.00 | 1.25 | 0.50 | 0.50 | 1.25 |
| | 3-month Libor £ | 0.57 | 0.58 | 0.58 | 0.75 | 0.75 | 1.00 | 1.25 | 1.50 | 0.56 | 0.75 | 1.50 |
| | 10-year Gilt | 1.58 | 2.03 | 1.77 | 1.95 | 2.05 | 2.15 | 2.20 | 2.30 | 1.76 | 1.95 | 2.30 |
| **Japan** | Overnight call rate | 0.02 | 0.01 | 0.01 | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 | 0.07 | 0.10 | 0.10 |
| | 3-month JPY Libor | 0.17 | 0.17 | 0.17 | 0.17 | 0.17 | 0.17 | 0.18 | 0.18 | 0.18 | 0.17 | 0.18 |
| | 10-year JGB | 0.40 | 0.44 | 0.35 | 0.45 | 0.50 | 0.55 | 0.70 | 0.80 | 0.33 | 0.45 | 0.80 |

| **Exchange rates** | | 2015 | | | | 2016 | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| End period | | Q1 | Q2 | Q3 | Q4e | Q1e | Q2e | Q3e | Q4e | **2014** | **2015e** | **2016e** |
| USD | EUR / USD | 1.07 | 1.11 | 1.12 | 1.09 | 1.05 | 1.04 | 1.03 | 1.02 | 1.21 | 1.09 | 1.02 |
| | USD / JPY | 120 | 122 | 120 | 124 | 128 | 130 | 132 | 134 | 120 | 124 | 134 |
| EUR | EUR / GBP | 0.72 | 0.71 | 0.74 | 0.70 | 0.69 | 0.69 | 0.68 | 0.68 | 0.78 | 0.70 | 0.68 |
| | EUR / CHF | 1.04 | 1.04 | 1.09 | 1.12 | 1.12 | 1.14 | 1.14 | 1.16 | 1.20 | 1.12 | 1.16 |
| | EUR/JPY | 129 | 136 | 134 | 135 | 134 | 135 | 136 | 137 | 145 | 135 | 137 |

Source : BNP Paribas Group Economic Research / GlobalMarkets (e: Estimates & forecasts)

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