ECONOMIC COMMENT

6 June 2018

Can Polish companies afford wage hikes and no inflation?

In the last years, trends in wages and inflation in Poland were rather surprising – nominal wage growth did not accelerate in 2014-16 despite quick fall of unemployment, and when wage hikes finally arrived, they did not translate into higher inflation, which eased, instead of rising. We try to explain these phenomena by analysing results of Polish companies and we claim that changes in profitability were an important driving force. In 2013-2015, performance of Polish companies deteriorated, which is why they could not afford higher wages. However, in the following years, profits improved markedly, allowing strong wage growth acceleration. Low global inflation has kept growth of prices of tradable goods at bay. In non-tradable goods sector, the financial situation was so good that there was no need to hike prices. In our view, in the following quarters, the firms' profitability will be deteriorating due to strong wage pressure and rising non-wage costs. Under such circumstances, price pressure should be going up in a few quarters' time, but not earlier, as companies still have buffers thanks to positive results built in the last two years.

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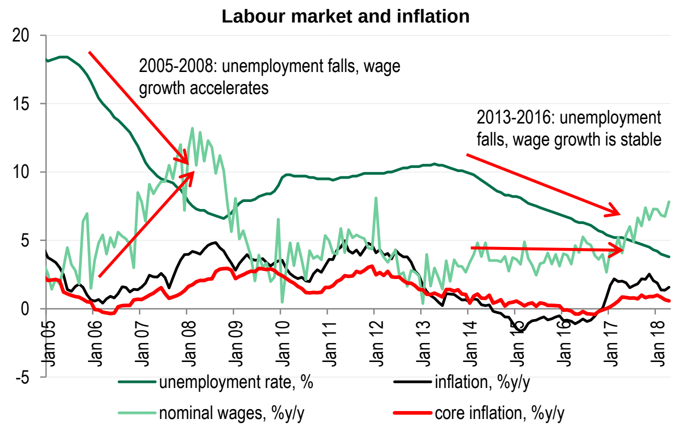
Since May 2013, unemployment in Poland has been continuously going down. At the start of 2016, the LFS unemployment rate reached the all-time low at 6.7% set in September 2008. In April 2018, the unemployment rate was at 3.8%. During this time, Polish companies were suffering from labour shortages and were looking for workers abroad, especially in Ukraine. At the end of 2016, wage growth started to accelerate after a long stabilisation at about 4% y/y and was rising by more than 7% y/y at the start of 2018, the fastest after the financial crisis of 2008. One could ask why the wage growth started to accelerate only after three years of falling unemployment and why the fast wage growth did not translate into higher inflation. During the previous period of falling unemployment, in 2005-2008, wage growth acceleration happened without delay and one year after wage growth had surpassed 7% y/y, inflation was above the upper border of tolerance band around target (3.5% y/y).



After deflation of 2014-2016, CPI moved into the positive territory again and temporarily even reached the NBP target of 2.5% in November 2017. However, soon inflation slipped again and looked modest not only against the macroeconomic background with GDP expanding by 5% y/y and output gap closed in 2H17, but escaped the trend visible in other CEE countries. Low headline and core inflation readings at the start of 2018 may be partially explained by strong falls in insurance and financial services prices, but these factors do not tell the whole story.

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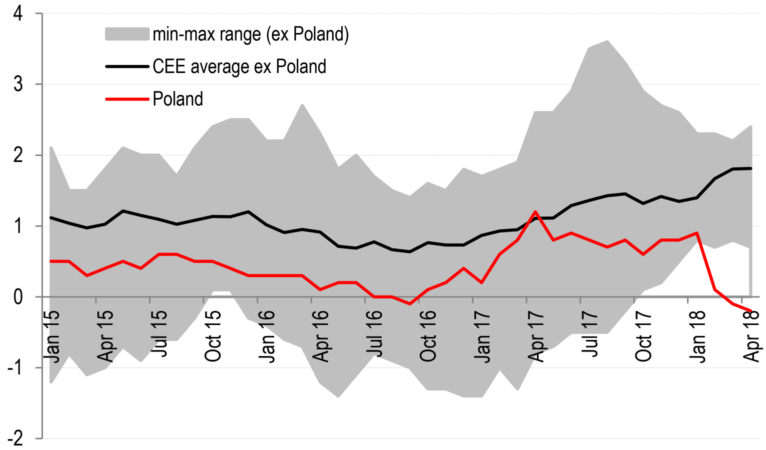
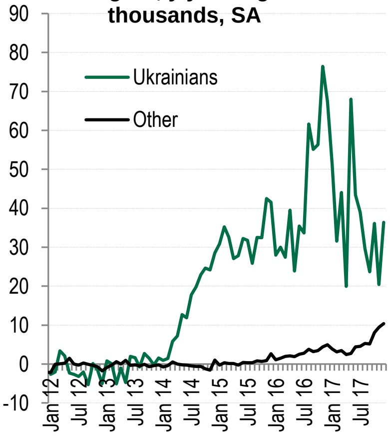
Core HICP inflation in Central and Eastern Europe, % y/y



Declarations of hiring a foreigner, y/y change in thousands, SA



Unit Labour Costs in industry, %y/y, 3M moving average

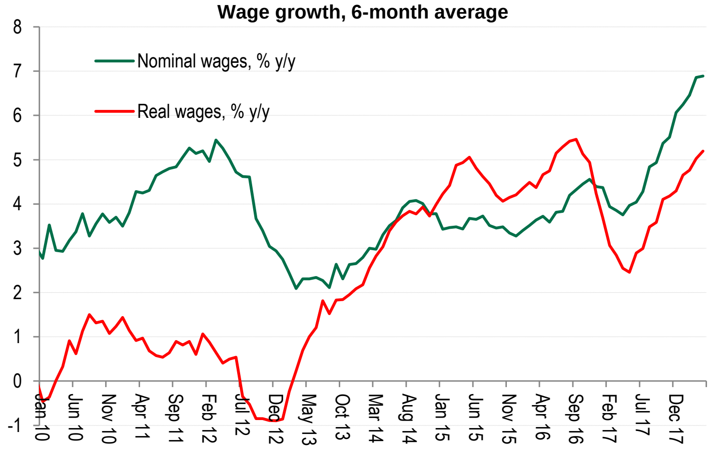
In an attempt to explain the surprising development of prices and wages, we looked into profit and loss accounts of Polish companies, released by the Statistics Poland in the [publication] “Financial results of economic entities I-XII 2017”. This document covers firms from the enterprise sector employing more than nine people. In total, this sector employs 1/3 of workers in Poland.

Why did not wages accelerate in 2013-2016?

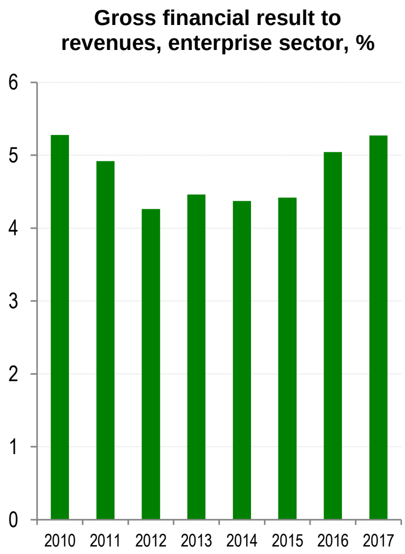
In 2013-2016, wages were rising at a stable pace of about 4% y/y and did not accelerate. Surely, at that time there were some buffers allowing for improvement of workers’ conditions without resorting to wage hikes, such as shorter working hours, change of civil or temporary contracts into fixed-job agreements. Maybe also the inflow of workers from Ukraine may serve as an explanation of lower wage pressure. However, in this case, it is difficult to explain why wages suddenly accelerated at the end of 2016, when inflow of Ukrainian workers was at its peak. Maybe their wage aspirations went up at that time?

Let us note that in that period inflation was going down and even turned negative, so wages were accelerating in real terms. Deflation may have curbed wage demands, as prices fell most considerably in first need products, which may have been easily acknowledged by households. Additionally, deflation affected the financial situation of companies. Apart from deflation, in 2013-2016 we saw rather moderate economic growth (2.9% y/y on average), but despite that wages increased, in some sectors (e.g. industry) even outpacing the labour productivity. In our view, even stabilisation of wage growth was a burden for companies in that period.

Wage growth, 6-month average



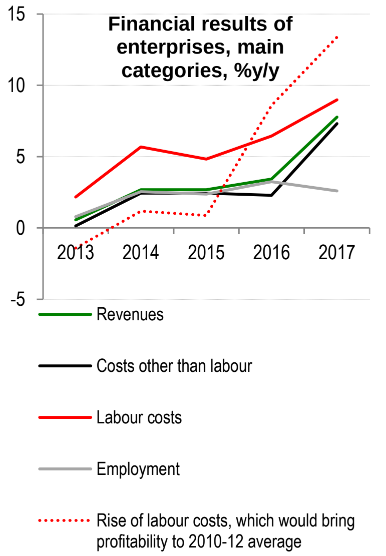
In our view, the financial situation of companies explains the development of unemployment-wages relation. In 2010-2012, the average profitability of Polish companies, calculated as gross financial results in relation to total revenues, was at 4.8%. In 2013-2015 this indicator was close to 4.4% and rebounded to 5.0% only in 2016. What was behind lower profits in 2013-2015? Revenues were advancing rather slowly, but a notch higher than non-wage costs. Wage costs rose markedly faster than revenues, partially due to employment growth, which was highly correlated with revenues. Thus, profitability was undermined by the very wage growth, which was simply too fast, given tendencies in productivity, demand and prices. If the companies had

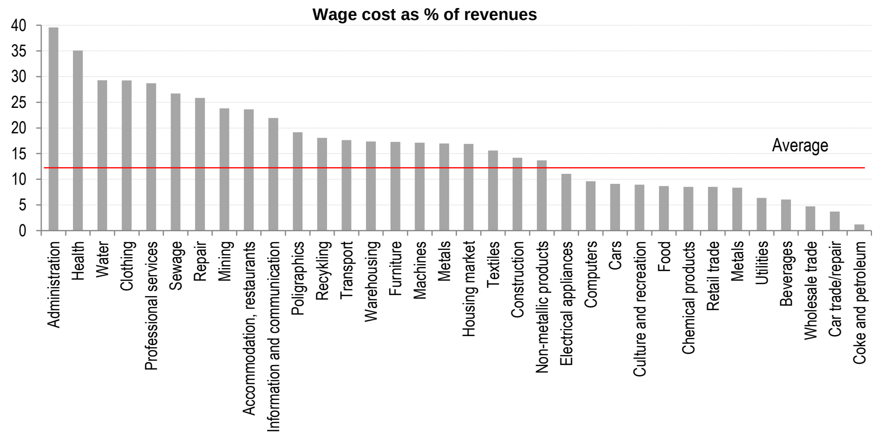


wanted to keep profitability at 2010-2012 average, the wage growth in 2013-2015 should have been by 4 percentage points lower than observed. Mind that the average profitability in enterprise sector was dragged lower by negative results of mining, utilities and coke/petroleum manufacturing, given low global coal prices. If we account for this sectors, wage growth could be called "adequate", given financial situation of Polish companies.

In 2016, profitability improved markedly, mostly due to lower rise in non-wage costs, so companies were able to envisage higher wage budget for the next year and address the rising labour shortage and escalating wage pressure. Interestingly, in 2017 the corporate profitability improved even further, mainly thanks to a quick expansion of revenues. This means that wage budget for 2018 could have been planned lavishly.

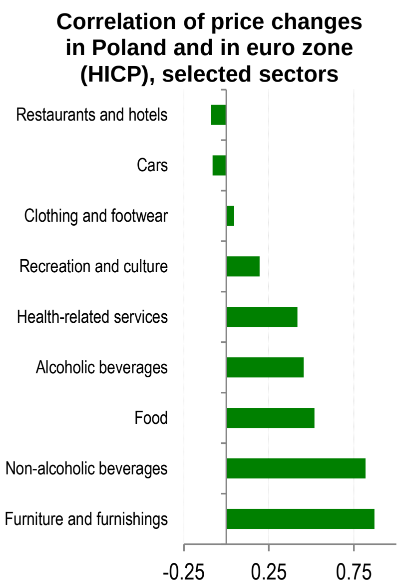
In 2017, thanks to a strong domestic and foreign demand, Polish companies recorded a major rise in revenues, by 7.8% y/y on average. Non-wage costs also went up, but a bit slower, by 7.3% y/y. Based on these figures, we calculated how much rise in wage costs companies could have endured without suffering loss of profitability versus benchmark of 2016. The answer is 11.2% y/y, more than the actual growth of wage costs (9.0% y/y). If we take average profitability in 2013-16 as a benchmark, wage costs could have risen by as much as 15.8% y/y. With average in 2010-12 as benchmark, this would be 13.4% y/y. To sum up, in 2017 Polish companies could have afforded strong wage hikes with no risk of a major drop in profitability.



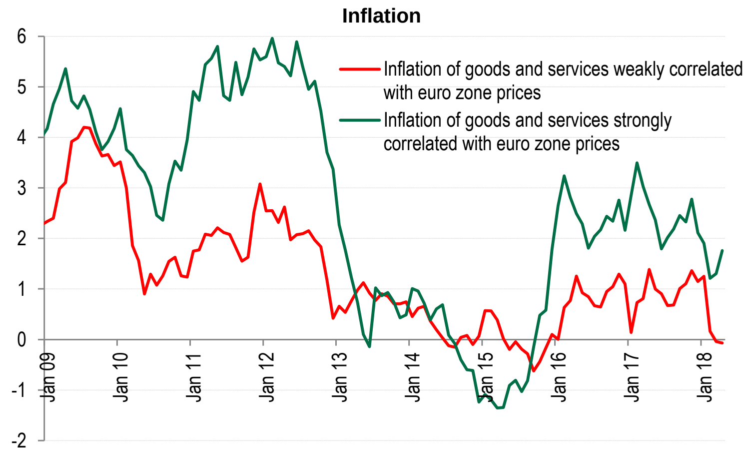


Why have prices risen weakly since 2013?

We could ask why Polish companies did not increase prices and inflation in Poland was low or even negative, if they had been undermined by lower profitability for a few years in a row? Firstly, the translation of cost pressure onto prices could have been distorted by rising effectiveness: automation, optimisation of output and supply chain. Secondly, some price-setting processes in Polish economy are driven by exogenous factors, such as prices on the global market. This could be applied mostly to tradable goods. In the discussed period, inflation was globally low, so prices in these sectors were not going up fast or they were even falling. Only recently we saw some rebound, mostly thanks to higher global commodity prices.

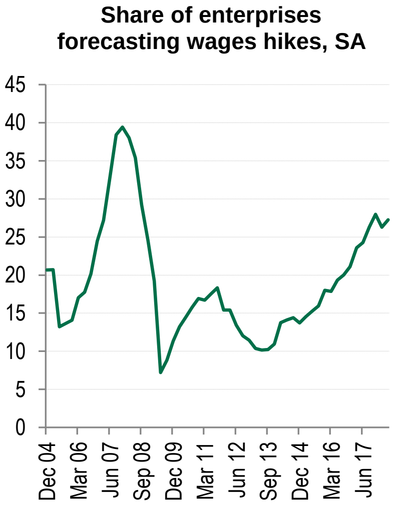


Thus, price-setting process in domestic-driven sectors may be a bit more interesting. In order to identify these sectors, we calculated the correlation coefficients between various HICP product groups in Poland and in the euro zone. If correlation in a specific sector is lower than 0.40, we categorise it as "domestic-driven". These include mostly services (recreation and culture, health, restaurants and hotels), but also some goods: alcohols, clothing and cars. In general, these make up 45% of the CPI basket. Such a sub-basket also has not shown major upward tendencies in prices over the last few years.



In domestic-driven sectors, average profitability improved slightly in 2013-2016 versus 2010-2012. That being said, domestic-driven companies did not see their financial results deteriorate, so they did not have the incentive to raise prices.

At the end of 2016, core inflation increased to about 1.0% y/y and was widely expected to go further up, given strong historical relation between wages and inflation in non-tradables. Usually, wage growth was supporting price growth in these sectors after two or three quarters. At the turn of 2017 and 2018, it seemed almost a done deal. Meanwhile, at the start of 2018, both headline and core CPI slid. In our view, this again may be explained by results of companies : in 2017 profitability was peaking in many sectors. Even though wage costs were rising fast, companies were able to easily internalise that, given rising revenues. Improving financial results stood for no need to feed the rising wage pressure into prices.



Pressure rising, but no "ketchup effect"

We already know 1Q18 results of companies employing 50 and more people, accounting for about 85% of the whole enterprise sector (nine and more people), both in terms of total employment and total revenues. In 1Q18, results of the biggest Polish companies deteriorated: revenue growth slowed down and was weaker than cost growth. Profitability fell to 4.8% from 5.4% in 1Q17 and 5.1% in 1Q16. Is such a correction in profits sufficient to adjust pricing or wage policy? In our view not, as profitability is still higher than 4.0-4.3% recorded in the first quarters of 2010-2013. What about profits in the remainder of the year? If we assume that revenues and non-wage costs will rise at the same pace as in 1Q18 (4.6% y/y and 4.4% y/y, respectively), then corporate profitability will be at 2017 level if labour costs rise by 6.1% y/y, at 2013-2016 average if labour costs rise by 12.6% y/y and at 2010-2012 average if labour costs rise by 10.3% y/y. In 1Q18, the actual labour costs rose by 8.8% y/y, so profitability will remain relatively high if 1Q18 trends hold during the year.

However, we cannot rule out that in the upcoming quarters the corporate profitability will go down further. Energy and commodity prices go up, and so do wages, undermining the companies' results. In our view, stabilisation of inflow of Ukrainian workers and rising labour shortages will boost the wage pressure, driving wage growth close to 10% y/y.

In such a situation, price pressure will go up, as increasing costs will not be accommodated by rising revenues. Still, this is unlikely to happen in 2018, as positive results from the previous years have built a nice buffer. Moreover, we are expecting no "ketchup effect," i.e. a rapid acceleration in inflation after years of weak price growth (similarly to shaking the ketchup bottle: first, without effects, and then ketchup goes out suddenly). "Ketchup effect" would be possible if Polish companies were postponing price hikes and then back-loading rapidly. This is not the case, as financial results show that price hikes were not necessary in the previous years, given improving profitability.

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