

Polish legal veto positive for currency

The Polish zloty has risen after the country's president vetoed controversial legal proposals.



A clear positive for the zloty

The downside risk to the Polish zloty (PLN) has materially decreased after the country's president vetoed controversial proposals which gave the ruling party control over judicial appointments. The move, by President Andrzej Duda, was a surprise; he's blocked two out of three measures which would have given the Polish justice minister greater powers in choosing senior judges. The proposals had prompted street protests and fierce criticism from the European Commission.

The zloty may trade with a persistent degree of political uncertainty risk premium.

However, the move could lead to a constitutional showdown between the ruling party (the PiS) and the president. The PLN rallied this Monday but did not fully recover Friday's losses, which were driven by political uncertainty. Some degree of risk premium is still priced in.

Risks ahead

At this point, we estimate EUR/PLN is trading with around 0.5% risk premium and we expect this to remain for the time being. Should the PiS try to push for an imminent passage of a new bill, we expect the scope for PLN downside to be:

- More limited than would have been the case if the vetoed bill had been passed.
- Materially more limited than during political problems last seen in the first half of last year.

Back in early 2016, the political risk premium extremes in EUR/PLN were worth 2%-3.5%. This time around, we would expect, at most, a 2% political risk premium to be built in the currency as the situation is different, with a low probability of a credit rating downgrade and a better macro situation.

Polish government bonds

The decision is positive for Polish government bonds (POLGB), but given the relative resilience of the local bond market, the scope for a POLGB rally is more limited than for PLN spot, as seen in the price action after the President's news conference. Even if the situation deteriorates, on a relative basis, we expect a repeat of last week's price action where POLGBs were more resilient than FX. This POLGB resilience stems from the following factors:

- The bar for a credit rating downgrade is set very high following the rating agencies' action back in 2016, with the tricky politics already partly reflected in the current Polish sovereign rating.
- Unlike in 2016, the macro situation is more benign with a sharply improved fiscal dynamics (due to better tax collection).
- We see the global environment as supportive (ie, a dovish Draghi putting a lid on Bund yields) and providing a cushion to POLGBs for the time being.
- Valuation-wise, 10-y POLGBs were more stretched back in late 2015 (after the Polish Parliamentary elections) or early 2016 (when the credit downgrade occurred) than it is now.

All this suggests that POLGBs should be more resilient than the zloty, should negative headline news hit the market again. But it's clear that PLN prospects look better than before the veto earlier this Monday morning.

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