

## In case you missed it: When trade, markets and the Fed collide

The Federal Reserve disappointed markets-and President Trump-this week by reining in overly dovish expectations for interest rate cuts. And Trump's subsequent decision to impose further tariffs on China has not helped sentiment, even though current US data remains strong

### In this bundle



#### The Fed's pre-emptive strike

The Federal Reserve has cut the fed funds target range by 25bp. We characterise this as an early pre-emptive move to help ensure the longest US economic...

By James Knightley

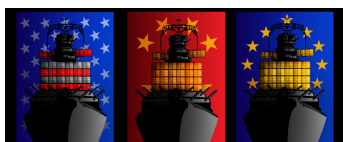


#### United States

#### Trade trumps positive payrolls

Another decent jobs' report, but with heightened trade tensions posing downside risks for growth, the Fed will remain in easing mode

By James Knightley



#### China

#### How will China retaliate against higher tariffs?

China is facing a new round of 10% tariffs on \$300 billion of goods exported to the US to be effective on 1st September. How China retaliates will...



#### United States...

#### Trump needs to take a step back to win his trade war

President Trump needs a trade deal with China in order to claim he is delivering on his promise to improve the terms of trade for the US. For a deal to be...



## Japan | South Korea

### Japanese-Korean trade tensions worsen

Japan has formally removed South Korea from a list of countries exempted from security export controls. This implies more restrictions and delays on...

By Robert Carnell

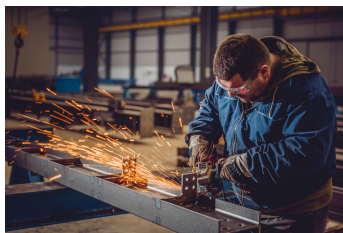


## United Kingdom

### Three takeaways from the Bank of England's August meeting

Despite an upgrade to growth and inflation forecasts, the Bank of England's latest announcement makes it fairly clear that rates are likely to remain...

By James Smith



## What a difference a day makes

Although the eurozone economy is rapidly losing momentum, growth in 2020 might be supported by a higher number of working days. While insufficient to...

By Peter Vanden Houde



## FX | Poland

### The Polish FX-mortgage saga is back with PLN and POLGBs at risk

The European Court of Justice is to give guidelines for Polish courts on FX mortgages, likely siding with debtors. Banks may face substantial losses,...

By Rafal Benecki and Piotr Poplawski

---

Article | 31 July 2019

# The Fed's pre-emptive strike

The Federal Reserve has cut the fed funds target range by 25bp. We characterise this as an early pre-emptive move to help ensure the longest US economic...

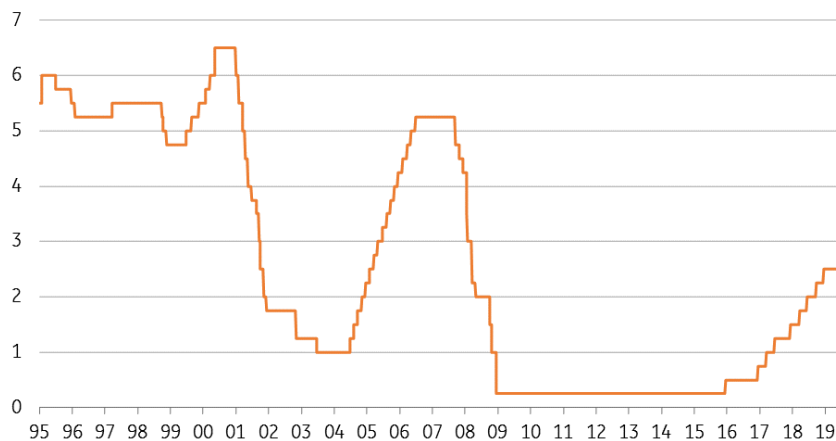


Source: Shutterstock

## A 25bp rate cut

As widely expected, the Federal Reserve has lowered the target range for the federal funds rate by 25bp to 2.00-2.25% and left the door open to more easing. It has also decided to conclude its balance sheet run down in August - two months earlier than previously announced. Today's decision to cut interest rates, for the first time since December 2008, was not unanimous though with Esther George and Eric Rosengren preferring to see policy left unchanged.

## Fed funds target rate (upper bound) 1995-2019



Source: Bloomberg, Federal Reserve, ING

### They never cut just once...

The Fed has been building up to this move over a number of weeks. Officials have frequently cited the weaker global backdrop and uncertainty over trade as factors that could act as a brake on US growth. Fed Chair Jerome Powell had already suggested they have contributed to business investment growth slowing “notably” and they were watching for signs of weakness elsewhere in the economy. Given the benign inflation backdrop, the Fed had room to loosen policy early and chose to take it.

### An early, pre-emptive move

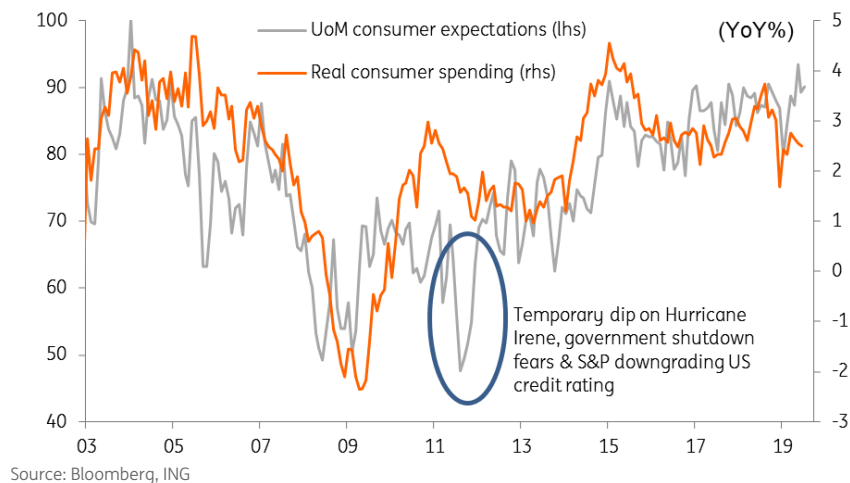
We characterise today's move as a precautionary, pre-emptive policy change to ensure that the US economic expansion – already the longest since the National Bureau of Economic Research's database began in 1854 – continues for a good while longer. However, the Fed never cuts rates just once and we doubt it will this cycle.

The language in the Fed statement is fairly vague and offers room for flexibility over coming months. It keeps in play what futures markets are pricing - at least another three rate cuts before the end of 2020. But, if anything, the statement (and vote outcome) offers more support to our more cautious outlook of only one further rate cut, most likely coming in September.

The labour market was still described as “strong” and activity is still expanding at a “moderate” rate. Moreover, the Fed's base case remains that “sustained” growth, a “strong” labour market and inflation “near” the 2% target “are the most likely outcomes”.

We see no reason for this situation to change in the near term. After all, domestic demand is strong, asset prices are high, the labour market is robust and even the manufacturing sector has shown renewed signs of life thanks to the US-China trade truce. Indeed, the strength of the consumer sector can certainly offset some of the headwinds from lingering global growth worries.

## Consumers have the confidence and the cashflow to spend



## Trade to determine the policy outlook

Nonetheless, the Fed continues to highlight the “uncertainties” and it is the trade story that remains critical to the outlook for policy. This is very firmly in President Trump’s hands. Should tensions escalate once again, tariffs are hiked, markets sell-off and economic weakness spreads then the Federal Reserve will respond with more stimulus given the benign inflation backdrop.

However, we remain open to the view that the fear of economic weakness for both sides will lead to China and the US finalising a deal later this year, even if it doesn’t necessarily achieve all of President Trump’s initial demands. President Trump wants to go into next year’s election with the economy in the best shape possible. A positive boost to sentiment from a trade deal would be a shot in the arm for the economy and help his re-election chances. It would also clearly reduce the need for additional Fed policy easing.

### Author

**James Knightley**

Chief International Economist

[james.knightley@ing.com](mailto:james.knightley@ing.com)

# Trade trumps positive payrolls

Another decent jobs' report, but with heightened trade tensions posing downside risks for growth, the Fed will remain in easing mode



A Donald Trump supporter at a presidential rally in Michigan

**164k** July increase in non-farm payrolls  
165k consensus

## Payrolls a victim of the economy's success

US non-farm payrolls rose 164,000 in July, almost identical to the 165,000 consensus forecast. There were 41,000 downward revisions to the past couple of months and we are running well below the 220,000 or so average seen through 2018. On balance, however, the report shows that US companies still have an appetite to hire. Indeed, we continue to argue that a slowdown in hiring should be expected. This is the longest US economic expansion since records began in 1854 with unemployment close to 50-year lows at 3.7% (same as in June) so it is unsurprising that companies complain that difficulty finding suitable workers is the biggest constraint on hiring.

**3.2%** Annual rate of wage increases YoY  
versus 3.1% consensus forecast

## Wages boosted by competition for staff

This competition for workers helped push wage growth higher in July. A second consecutive 0.3%MoM gain has lifted the annual rate of wage growth up to 3.2%. This is well ahead of the 1.6% consumer price inflation figure so real household disposable incomes are rising at a decent clip, which should underpin support for spending.

## Trade remains key for markets and Fed

The latest escalation of trade tensions and the fear that it will hurt confidence, put up costs, damage supply chains and make business less inclined to invest and hire new workers will continue to drive market sentiment. Nonetheless, a strong domestic jobs market helps to mitigate the threat to activity in the near term. With unemployment at such low levels and the competition of staff remaining intense, workers have a sense of job security. With wages rising in a benign inflation environment, they have spending power too.

However, the “uncertainties” that the Federal Reserve worries about – trade and a weaker global growth story – are being ratcheted up and the Fed looks set to follow this week’s rate cut with another 25bp move in September. What happens thereafter depends largely on how trade talks progress.

A positive conclusion in the coming months coupled with the US’ strong domestic fundamental (our base case) should mean this concludes the “midcycle adjustment” Jerome Powell described on Wednesday. But if the situation deteriorates and economic weakness spreads then the Fed will respond with more stimulus given the benign inflation backdrop. As such monetary policy, much like trade policy, is firmly in President Trump’s hands.

### Author

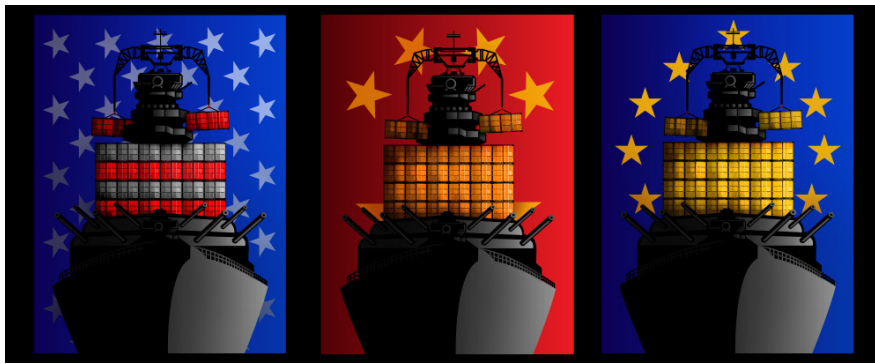
**James Knightley**

Chief International Economist

[james.knightley@ing.com](mailto:james.knightley@ing.com)

# How will China retaliate against higher tariffs?

China is facing a new round of 10% tariffs on \$300 billion of goods exported to the US to be effective on 1st September. How China retaliates will...



Source: Shutterstock

## US raises tariffs on China

The US is to levy a further 10% of tariffs on the remaining \$300 billion of goods it imports from China. The tariff will become effective on 1st September. This escalation of the trade war comes hot on the heels of trade talks that ended with no progress on 31st July after only half a day of discussions, but which were described as "constructive" by Director of the US National Trade Council, Peter Navarro.

## How will China retaliate and impacts on the trade war?

There are a few things that China can and probably will do in retaliation to the US' new round of tariffs:

1. **Announce China's unreliable entity list.** This could exclude some US companies from doing business with Chinese companies. The unreliable entity list is said to be announced soon. The market has been guessing which US companies will be the first to be included in the list, and thereby shut out from doing business with China.
2. **Prohibit exporting "rare-earth" materials to US** and related companies that use them in the production of US products (very important in a lot of hi-tech/electronic products). This could halt, or at least slow some US production.
3. **Increase tariffs on US goods.** Though China imports far less from the US than the US imports from China, China could still raise tariff rates further - conceivably beyond 25%. China already raised tariffs from 10% to 25% on \$60 billion of US goods on 1st June.

These possible sources of retaliation from China would, of course, escalate the trade war further.

## Impact of US tariffs and China retaliation on the Chinese economy

For the 10% tariffs on the rest of the \$300 billion goods imported from China, this involves electronic devices.

The 10% tariffs on \$300 billion goods will hurt some US tech product companies, which have so far been shielded from the tariffs. US companies could conceivably shift value chains away from China in an attempt to limit the blow of tariffs on their margins. Over the medium term, this is certainly possible, but in the short-run, this is unlikely to be practical given the highly specialized nature of some of these products.

Rare earth export embargoes will heap further pressure on US tech companies. Though they may have some inventories of rare earths, these probably won't last long. Alternative sources of rare earth materials are being developed to try to lessen dependence on China which is currently the source for 80% of global rare earth supply. But this will also take time. In the short run, the alternatives are either paying a much higher price to gain access to rare earth supplies or going without altogether.

## Impact of possible China tariffs

The impact on China of imposing higher tariffs on the US is similar to the impact on the US of raising tariffs on China. Both actions weigh on margins, turnover and the profitability of domestic industry. One way to alleviate the damage from tariffs would be to import more from other economies. Europe is a likely option (for both the US and China) but we expect that this will not work for all goods, and supply constraints may also limit the degree to which this will be possible.

In short, China's importers, producers and consumers of US imported goods will pay higher prices in the future unless alternatives are found.

## Using all the retaliation methods

We expect China to use all the retaliation methods described above, but not all at once. We believe China will deliver each retaliation methodically, and deliberately, one by one.

We believe China's strategy in this trade war escalation will be to slow down the pace of negotiation and tit-for-tat retaliation. This could lengthen the process of retaliation until the upcoming US Presidential Election. It won't have escaped the authorities in China's attention that a full-blown trade war is unlikely to help President Trump's chances in the election.

Is this election interference? Well as they say, all's fair in love and (trade) war.

# Trump needs to take a step back to win his trade war

President Trump needs a trade deal with China in order to claim he is delivering on his promise to improve the terms of trade for the US. For a deal to be...



President Donald Trump shakes hands with Chinese President Xi Jinping during a meeting on the sidelines of the G-20 summit in Osaka, Japan

## Another disappointment

Market optimism increased after Presidents Trump and Xi decided last month to resume negotiations. Since then, China's official news agency Xinhua has said some Chinese companies are seeking new purchases of US agricultural products. This is a step in the right direction, but not more than a very small step. Markets could be in for another disappointment because, as of yet, there are no other concrete signs that negotiators are getting closer to a deal. On the contrary, China has demanded that the US lift all tariff hikes before a deal can be cut, which doesn't align well with the American approach to keep the pressure on even after a deal, to enforce Chinese compliance. US weapons sales to Taiwan and the subsequent Chinese threat to put all American companies involved on a black list, have also not helped to create a positive negotiating climate.

Trump never misses a chance to say that China needs a deal much more than the US. And looking at trade alone, he's right. After all, American demand for Chinese products contributes more than four times as much to Chinese GDP than the contribution of Chinese demand to US GDP. This

explains why China was willing to make concessions during the first round of negotiations in the spring of 2018. In those talks, led by Treasury Secretary Steven Mnuchin, China offered to raise its imports of US products by \$70 billion, an increase of more than 50%. China also offered to open up its financial, automotive and energy markets.

Mnuchin thought he had put together a pretty good deal, but long term China hawks Robert Lighthizer and Peter Navarro dismissed it as insufficient and convinced the President to scrap it.

US trade representative Lighthizer and trade advisor Navarro are known for their decade-long fierce criticism of China's economic policy and they see Trump's presidency as a golden opportunity to address their issues. As a result of their influence, the US is demanding, not just lower Chinese import barriers to get the trade deficit down and fewer restrictions for foreigners to invest in China, but a much broader wish list, which includes China giving up its ambition to become a market leader in various high tech markets in 2025. For China, this is unacceptable interference with its right to determine its own economic policy.

## Overplaying his hand

By continually hiking tariffs on Chinese imports, Trump has been trying to push China into accepting these far reaching demands.

Aiming high and piling on the pressure has always been Trump's favourite strategy. But this time it could get him into trouble. He has had little success with this tactic for over a year now. In the final phase of the unsuccessful negotiations last spring, China took on a tougher stance and there are no signs yet that this has changed. Giving up sovereignty is simply not a price that China is prepared to pay for the sake of frictionless trade with the US.

To avoid overplaying his hand, Trump will have to scale down his demands. Free trade with the US is worth a lot to China, but demanding that China give up its ambition to conquer tech markets is pushing it too far. The US blacklisting of tech company Huawei has been seen by China as part of America's plan to stop the economic progress of Chinese tech companies.

A less confrontational approach by the President would help as well. Trump's communication style is not always perceived by the Chinese as respectful, which increases the domestic pressure on Chinese leaders to be tough as well.

Treating the Chinese as an equal partner creates a more positive negotiating climate in which other differences- for example regarding the enforcement mechanism of a trade deal- could be resolved more easily.

## Another round of tariffs

For now, there are no signs that the US administration is prepared to water down its demands and change its negotiation style. Given the much tougher public stance of the Chinese authorities, further concessions would be a face losing event for Chinese leaders which also makes it unlikely that a deal will be cut anytime soon.

As a result, the two sides seem to be too far apart and the negotiating climate has deteriorated too much for a deal to be struck anytime soon. This makes it likely that a new round of negotiations will be unsuccessful as well. Chances are that the President will then follow through on his threat to extend the tariff hike to all imported goods from China. In which case, China will retaliate.

## A deal after all

In the end, however, both sides have a strong incentive to strike a deal. Hoping for a more pro free trade democratic US president in 2021, China could, as President Trump suggested last week, decide to wait until after the US elections before it is willing to compromise. But a further deterioration in the tit-for-tat trade war will lead to significant economic damage for China because of its dependency on US demand.

Yet Trump also needs a deal. China is responsible for half of the overall American deficit in traded goods and Trump has vowed to take action. If he fails to get a result, he will only be able to point to the renewal of the Nafta trade agreement and a few smaller deals with countries on their exports of steel and aluminium to the US. That won't be enough for the president to claim he has successfully reduced the trade deficit.

As such, the US administration has a strong incentive to drop some of its most far reaching demands, which in turn would allow China to make concessions of its own. If an agreement is to be reached in the near future, Trump will need to back down.

## Japanese-Korean trade tensions worsen

Japan has formally removed South Korea from a list of countries exempted from security export controls. This implies more restrictions and delays on...



Japan today (Friday) formally removed South Korea from its whitelist for security export controls. There had already recently been some controls imposed on three chemicals vital for etching semiconductors requiring a case by case approval. This has now been expanded and the measures approved by Japan's cabinet.

The new export controls require exporters to apply for a permit to export goods that could be utilised for military use by sanctioned countries or for banned weaponry. Japan has (excluding South Korea) exempted 26 countries that have similarly tight or stricter export security controls.

Japan claims it's made the move because some shipments of chemicals have been ending up in North Korea. But most observers put the dispute down to a long-running spat about historical issues relating to Japan's wartime occupation of Korea.

The Korean government says it will announce details of its plan to remove Japan from its own "White List" early next week, though there are hopes that some resolution might be found in three-way talks between the two Asian nations brokered by the US in the sidelines of an ASEAN meeting taking place in Bangkok today.

---

*This trade dispute is a highly unwelcome addition*

---

While the economies of both Japan and Korea are currently weak, this is hardly going to help as some argue the measures are motivated by domestic political pressures, rather than any firm convictions about security concerns. Indeed, with the Bank of Korea recently dropping its hawkish tone and easing policy rates 25bp, such developments only increase the chances that they will have to act again, and perhaps sooner than markets were expecting. The Bank of Japan has, of course, virtually no room for further offsetting policy measures in the event of further weakness. And with a consumption tax hike for Japan looming in October, this trade dispute is a highly unwelcome addition to what is likely to be a very difficult time for the economy.

It is perhaps fortunate that the semiconductor industry is currently not facing particularly strong demand in the face of a global slump in mobile handset sales and their components, so the impact on production could certainly have been worse. Moreover, alternative suppliers, especially for Sodium Fluoride and the other chemicals for which Japan has been the main supplier, are likely to be forthcoming, though the switchover will obviously result in delays and further damage to Korea's struggling economy.

**Author****Robert Carnell**

Regional Head of Research, Asia-Pacific

[robert.carnell@asia.ing.com](mailto:robert.carnell@asia.ing.com)

## Three takeaways from the Bank of England's August meeting

Despite an upgrade to growth and inflation forecasts, the Bank of England's latest announcement makes it fairly clear that rates are likely to remain...



The Bank of England's Mark Carney

There's little doubt the August meeting was an awkward one for Bank of England policymakers. The sharp fall in market rate expectations has translated into higher growth and inflation forecasts in 2-3 years time. In normal times, this might be interpreted as a hawkish signal to markets - an overheating economy theoretically needs a greater degree of tightening.

But as the Bank is at pains to point out, policymakers are assuming a smooth Brexit path - whereas markets (and their expectations for interest rates) increasingly are not. With Brexit uncertainty set to intensify, we think it is very unlikely the Bank will embark on the tightening that it is still loosely signalling in its statement. Equally though, we think it's too early to be pencilling in rate cuts, given the likelihood that wage growth will continue to perform solidly over coming months.

## 1 A flatter yield curve boosts growth and inflation

The significant flattening in the UK interest rate swaps curve – a gauge of market expectations for future interest rates – since May has given both Bank's growth and inflation a modest boost in 2021/22. That's helped along by the fact that wage growth is expected to strengthen further from here. Skill shortages in the jobs market have already seen wage pressures build, and the BoE expects total pay to increase at a rate of 4% year-on-year by 2021.

## 2 Inconsistent Brexit assumptions mean the forecasts aren't as hawkish as they sound

In times gone by, that might have seen policymakers vocally push back against current market pricing, and warn that markets are too relaxed about the possibility of tightening. Unsurprisingly though, the Bank has opted against sending such a signal this time.

The BoE's forecasts are premised on Brexit going smoothly – something that looks [increasingly questionable](#). Policymakers have devoted an entire paragraph to explain the “inconsistency” that exists within their forecasts, which essentially boils down to: our models assume that Brexit will go smoothly, whereas the market's expectations for the future path of interest rates do not.

## 3 Business investment forecast slashed

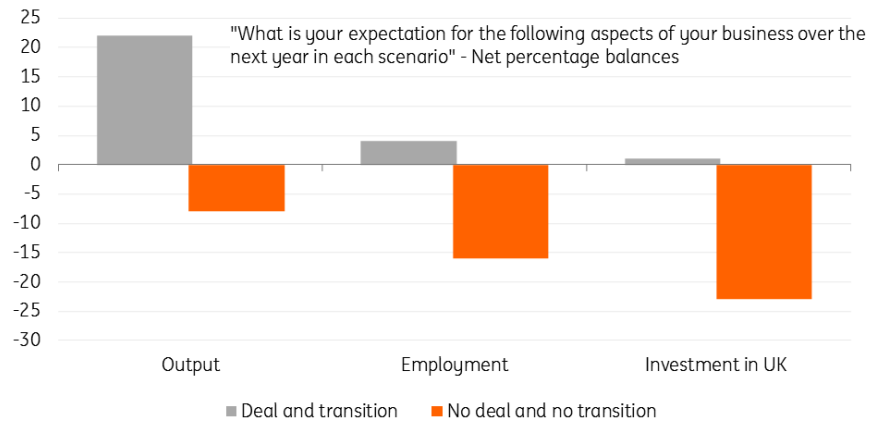
All of the above shouldn't come as too much of a surprise to markets – the challenge for the Bank today was always going to be marrying together the more hawkish forecasts, and the more cautious short-term outlook, without stepping into the political arena.

What is a little more surprising is the extent to which the Bank has cut back its business investment forecast for 2020. Having previously expected capital spending to grow by 3% next year, it now expects it to fall by 1.5% – a pretty substantial change. This follows a new survey of businesses by Bank Agents, which found that even in the case of a deal being struck, on balance firms did not expect to increase investment.

To us, this suggests that interest rates are likely to remain on hold for the foreseeable future. While the Bank's forward guidance notionally points to further tightening, we think the mounting uncertainty related to Brexit – even in the case Article 50 is extended further, or where a deal is agreed – means this is unlikely to materialise.

## Business don't expect investment to increase, even if there's a deal

Net balances of firms



### Author

**James Smith**

Developed Markets Economist

[james.smith@ing.com](mailto:james.smith@ing.com)

Article | 29 July 2019

## What a difference a day makes

Although the eurozone economy is rapidly losing momentum, growth in 2020 might be supported by a higher number of working days. While insufficient to...



Quarterly growth rates are typically adjusted for seasonal variations and the number of working days. Without this modification, growth would show a very sawtooth pattern, as some quarters have more working days and some economic activities are typically weaker in a particular season (think of construction during the winter). However, for the yearly growth figures, such adjustments are not usually made, even though the number of working days can differ from one year to the next.

### Leap year

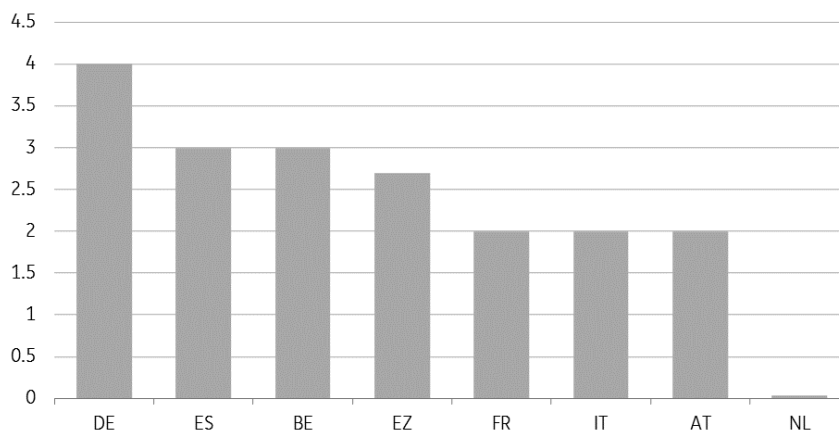
2020 is a leap year and on top of that, public holidays in a number of countries fall on a Sunday, which actually increases the number of working days. For Germany, this amounts to four more working days in 2020 while for most of the other bigger member states, there are two to three additional 'days of toil'. A weighted average of the seven biggest member states yields 2.7 extra working days next year for the eurozone as a whole. A back of the envelope calculation would state that with about 250 working days, one additional day is equivalent to 0.4 percentage point of additional growth.

## Not every working day means extra work

But not so fast. Additional working days don't necessarily mean that the total number of days worked will be higher. In fact, some countries grant additional days of leave when public holidays fall on weekends. In an analysis on the impact of the number of working days, the European Central Bank also noted that in industries with continuous production, there is hardly any effect (though a leap year still implies one additional day of production), while retail trade is often higher during the weekends and therefore doesn't benefit much when there are more working days during the week.

For construction activity, it depends on whether the extra days fall during the warm season or in winter. After all, an extra working day doesn't add much to building activity when it snows or freezes. Moreover, sectors like tourism and catering might even experience a negative effect in years with a higher number of working days (for those who cannot get enough of these calendar effects, the [Bundesbank](#) computed working elasticity for different sectors).

## Number of extra working days in 2020



Source: [www.arbeitsstage.de](http://www.arbeitsstage.de), ING

At the end of the day, the overall effect is not so easy to compute and might differ from country to country. The available estimates suggest that each extra working day in the eurozone increases annual GDP by 0.05 to 0.1%. Taking this into account, we forecast a positive growth effect of 0.2 percentage points for 2020.

## Author

### Peter Vanden Houte

Chief Economist, Belgium, Luxembourg, Eurozone

[peter.vandenhoute@ing.com](mailto:peter.vandenhoute@ing.com)

# The Polish FX-mortgage saga is back with PLN and POLGBs at risk

The European Court of Justice is to give guidelines for Polish courts on FX mortgages, likely siding with debtors. Banks may face substantial losses,...



A luxury apartment block in Warsaw

## The trouble with FX-mortgages: a quick recap.

Polish banks ceased to offer FX-denominated mortgages in 2012. However, outstanding credits, currently around PLN130bn (EUR30bn), still pose a significant risk to the Polish banking sector. Costs resulting from the rise in CHF/PLN were paid by creditors, but capital, regulatory and reputational costs of having such loans in the banking books grew as well.

President Duda pledged to convert those mortgages to PLN at original FX-rates. Eventually, in July 2019 parliament decided not to enforce that solution, rather putting the focus back on debtors in poor financial situations (with very low cost for banks).

60-80bn

Potential losses for the Polish  
banking sector

in PLN

## European Court of Justice to side with FX-debtors

Given the meagre support from the government, people with FX-mortgages decided to sue banks for damages in court. They usually argued that various parts of the mortgage agreements (i.e. the formula for calculating interest or low down-payment insurance, FX spreads or even the FX-denomination mechanism itself) were abusive and should be changed or removed. Most of those trials are still ongoing.

---

### *People with FX-mortgages decided to sue banks for damages*

---

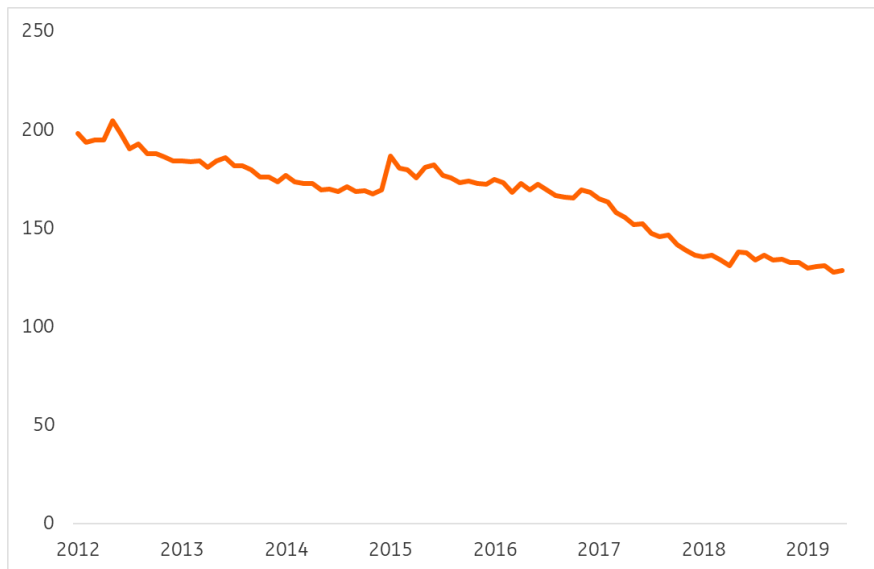
In the handful that are over, court judgements have been very inconsistent. Around half supported the plaintiffs and the other half sided with the banks. In some rulings, courts demanded the conversion of loans to PLN (at the original rate) but changed the base interest rate from LIBOR to WIBOR. In other rulings, courts cancelled whole mortgage agreements. Due to this discrepancy in verdicts, the Court of Warsaw asked the European Court of Justice for guidelines on what it should do when it recognises a particular clause in a loan-contract as abusive.

The ECJ's judgement is expected soon (between September and November). However, the Court's spokesperson has already announced what it most probably could look like. The ECJ is expected to say that when a Polish court finds an abusive clause in a loan-contract, it should either (1) remove the clause and change nothing else, or (2) judge the contract was non-existent (especially if that judgment is beneficial for the customer). In the first case, if the remaining agreement is still workable it should remain binding, especially when it is favourable to the customer.

What does it mean in practice? Consider what would happen if a court were to find an FX-denomination clause in a mortgage agreement abusive. If it removes it from the contract, the mortgage will be converted to PLN with the FX-rate prevailing at the date of loan origination. However, the interest will still track LIBOR, not the price of PLN (WIBOR). This isn't just a theoretical scenario as a couple of such verdicts have already appeared in courts.

In the second case, when an FX mortgage contract will be deemed as non-existent, the bank should also close its FX exposure in order to unwind funding in CHF and reconcile with clients. In both cases, the FX mortgage is converted to PLN.

## The value of FX-mortgages in the Polish banking sector, PLNbn



Source: Banking Association Survey

### Dire consequences for the Polish banking sector

If such rulings become widespread, encouraged by the ECJ guidelines, they might cause significant losses to Polish banks. In an extreme case, if all of the existing FX-mortgages were to be converted to PLN at the original rate and interest remained LIBOR-based, the cost for the banking system in Poland might reach PLN60-80bn.

These losses won't happen overnight and their full scale is highly uncertain as the ECJ guidelines aren't a substitute to the rulings of individual Polish courts. It will be still up to them to decide case by case, which will take years. The likelihood of verdicts which are unfavourable for banks will probably increase, but it is difficult to say by how much exactly. So far, around 10-thousand people out of 500-thousand FX-debtors went to trial. However, their number should grow rapidly when the probability of favourable rulings for clients rises as a result of the ECJ guidance.

---

*Banks could be forced to reduce credit supply dramatically in order to improve their capital positions*

---

That is why the ECJ ruling might hit Polish banks much faster if they are forced to build reserves for litigation losses. Auditors might explicitly ask for such reserves, especially if the number of lawsuits related to FX-mortgages starts to snowball and the likelihood of banks losing them exceeds 50%. In such a case, most of the banks in Poland would require recapitalisation because the size of required reserves would likely exceed (several times) their annual profits.

The Polish Financial Authority might provide some assistance to the banking sector by lowering the capital requirements (some of the buffers were created for the sake of CHF-risk). However, in our opinion, the amount of capital released this way will not be sufficient. So banks could be forced to reduce credit supply dramatically in order to improve their capital positions. In short, should the

ECJ guidance be unfavourable, banks could start freezing credit lines for several quarters, which could lead to a painful GDP slowdown.

## What does it mean for financial markets?

The costs of litigation in question are dependent on the CHF/PLN exchange rate (the higher it is, the higher the losses of the banks). This poses a significant risk for banks because there is a high chance that CHF/PLN will grow over time, especially when Polish courts start to issue actual verdicts aligned with the ECJ guidelines. Some banks might want to hedge this cost by buying CHF upfront. Therefore, we could see significant PLN depreciation in the coming quarters.

The ECJ ruling is also rather negative for POLGBs, but the impact is less clear cut. On the one hand, banks' growing reserves will create demand for Polish debt (you need to hold your reserves in something). On the other, a sharp rise of reserves should force banks to freeze the credit supply to the economy for a few quarters, which should depress GDP growth and pose the risk of a higher general government deficit and additional borrowing needs. All should increase the credit risk premium embedded in the POLGBs and subsequently raise yields.

## How can this can be mitigated?

The previous FX mortgage story from 2016 was equally risky for the banking sector and caused a major weakening in PLN and POLGBs. But at the end of the day, policymakers (Financial Stability Committee with new NBP governor Adam Glapinski) persuaded politicians to withdraw from the project as the potential hit to the banking sector, economy, fiscal side, PLN and POLGBs was very high. We don't know whether the same rational approach will be applied this time around. The longer the ECJ debates on the final guidance (e.g. in order to encompass FX loans cases in other member states), the more likely the 'hot' election period in Poland will pass and politicians will decide to find a kind of middle-ground solution for CHF-mortgages.

## Authors

### Rafal Benecki

Chief Economist, Poland

[rafal.benecki@ing.pl](mailto:rafal.benecki@ing.pl)

### Piotr Poplawski

Senior Economist, Poland

[piotr.poplawski@ing.pl](mailto:piotr.poplawski@ing.pl)

## Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.