Poland: CPI above 10% in March, policy mix seems unable to tame second-round effects

Headline inflation grew to 10.9% year-on-year on the back of a surge in gasoline and food prices due to the war in Ukraine. The Polish economy is absorbing new shocks and inflation will continue running at a double-digit pace in the coming quarters

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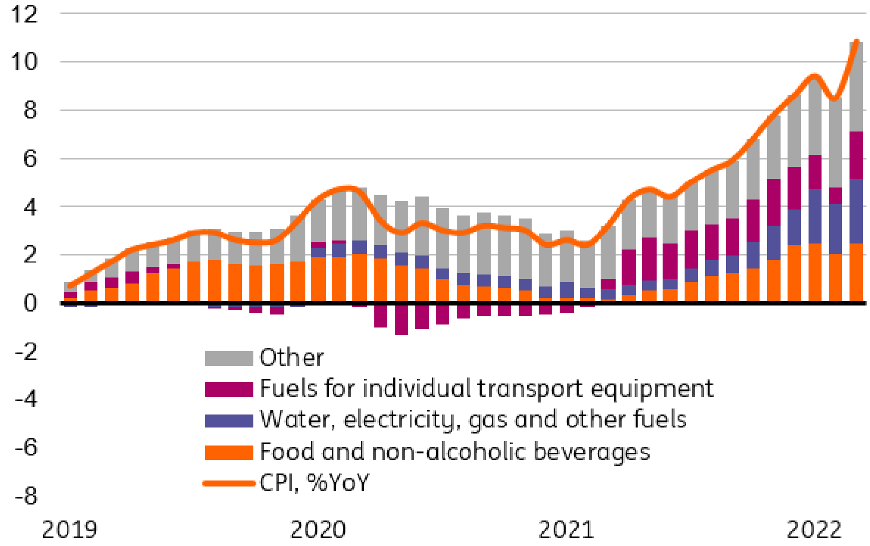
In March, CPI inflation rose to 10.9% year-on-year, from 8.5% year-on-year in February, reaching double-digit levels for the first time since the late 2000s. An increase in annual inflation by 2.4 percentage points vs. the previous month stemmed mainly from the sharp growth of gasoline prices (up 33.5% year-on-year, compared to 11.1% year-on-year in February). The annual growth of food and non-alcoholic beverages prices also gained momentum, contributing another 0.4 percentage points. The remainder could be attributed to higher core inflation that went up 7% year-on-year.

We expect continued price pressure in services (hotels, restaurants, recreation and culture). While on the one hand this reflects the post-pandemic recovery of demand, on the other it is linked to the mounting costs of energy and labour (signs of a price-wage spiral). We estimate that core inflation excluding food and energy prices approached 7% year-on-year in March.

Consumer inflation at double-digit levels



The Polish economy is absorbing new shocks and inflation will continue running at a double-digit pace in the coming quarters for several reasons. First, geopolitical tensions will keep gasoline prices elevated despite a high reference base from 2021 and a VAT cut. Second, already high upward price pressure on energy commodities has intensified as Russia is an important supplier of many of them. It will generate higher costs for transport and various sectors of manufacturing. Third, we project further increases in food prices amid lower harvests in the region of the conflict, as well as more expensive gasoline and energy, and fertilisers. Four, fiscal expansion is ahead. Anti-inflation shield measures should be rather selective in nature, whereas in practice they are broad-based. After cuts in indirect taxes (VAT, excise duty), authorities are planning a further reduction in direct taxes (the personal income tax rate is to be slashed to 12% from the current 17%). It will be accompanied by higher fiscal spending on defence and refugees (education, healthcare, social protection). The government has also declared aid for farmers suffering from higher prices of fertilisers, and domestic businesses are suffering from an embargo on Russian coal. We worry that the external supply shock is meeting strong domestic demand and the fiscal side should make consumption quite resilient despite the inflation surprise.

What does this mean for interest rates? There will be a limited demand barrier for high prices which facilitates second-round effects, i.e passing higher costs onto retail prices. That would make combating inflation a serious challenge. The current policy mix may prove ineffective in curbing inflation and it is likely to become persistent. Monetary tightening will be accompanied by pro-inflationary fiscal policy. A sizable portion of the current surge in commodity and wholesale prices will feed into consumer prices in the coming months and quarters.

In such an environment further monetary tightening will be required and we expect the main policy rate to go up to about 6.5% this year, and the terminal rate to 7.5%.

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