showCASE
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Overview: In this week's showCASE, our experts take a close look at the Polish Law and Justice (PiS) government's policy stance, with particular focus on new retail tax laws. CASE also explores the United Kingdom's Supreme Court ruling for government to consult parliament before Brexit can proceed.

The fiscal cost of electoral debt

By: Paul Lirette

On November 3, Deputy Prime Minister Mateusz Morawiecki announced that the timeline for implementing a new retail tax proposal remains to be determined. The new tax formula, one that aims to fulfill Law and Justice's (*PiS*) promises to tax the foreign-dominated retail industry, is linear across all retailers at 1.2 per cent of business turnover, yielding an estimated 1.6 billion złoty (US$ 400 million) per year, and, unlike the previous version, is hoped to not meet objection from the European Commission (EC).

The government's first new retail tax law, introduced on September 1st, 2016, had two applicable rates: 0.8 per cent for retailers with revenues between 17 million Polish złoty (US$ 4.4 million) per month and 1.4 per cent for those exceeding 170 million Polish złoty (US$44 million) per month. Smaller retailers, those earning less than 17 million Polish złoty per month, would not be subject to the new retail tax.

Polish Ministry of Finance 2017 Draft Budget Forecast	
GDP Growth	3.6 %
CPI Inflation	1.3%
Fiscal Deficit (% of GDP)	2.9 %

However, on September 19, the EC launched an in-depth investigation on the new Polish retail tax over concerns that the progressive rate based on turnover would create an unfair advantage for smaller franchises, effectively breaching EU state aid rules. On September 20, the Commission issued an injunction, suspending the application of the tax law until investigations conclude. Wiesław Janczyk, a high official in the Ministry of Finance, plans to seek a dialogue with the EC to find out whether the new linear retail tax currently under discussion would be more acceptable. The goal is to put forward a new proposal to the Polish Parliament by the end of November 2016.

But this is not the first Law and Justice (PiS) Government policy to face heavy criticism and pushback, in some cases, by the party's own deputies. For instance, Deputy Prime Minister Mateusz Morawiecki criticized President Andrzej Duda's plan to convert Swiss franc loans into zloty, suggesting the law should only apply to less affluent citizens and that it would require further assessment before being enforced. The reduction of the retirement age and the "500+" program (paying citizens for giving birth) also faced criticism, this time from the former Polish Ministry of Finance Paweł Szałamacha, who suggested that the Ministry of Labour failed to provide an accurate assessment of possible financial consequences of the programme.

Overall, the PiS government seems to be increasingly finding itself wedged between a rock and a hard place. Whether or not PiS will be able to strike the right balance between delivering on inflated social spending promises made during their election campaign and not breaching the EU's 3% deficit cap, which is currently forecasted at 2.9% of GDP in 2017, remains to be seen. But for now, PiS faces harsh fiscal choices as it walks a thin line to deliver a new tax law that finds the Commission's approval, keeps Polish businesses happy, and does not anger foreign investors or crush the economy.

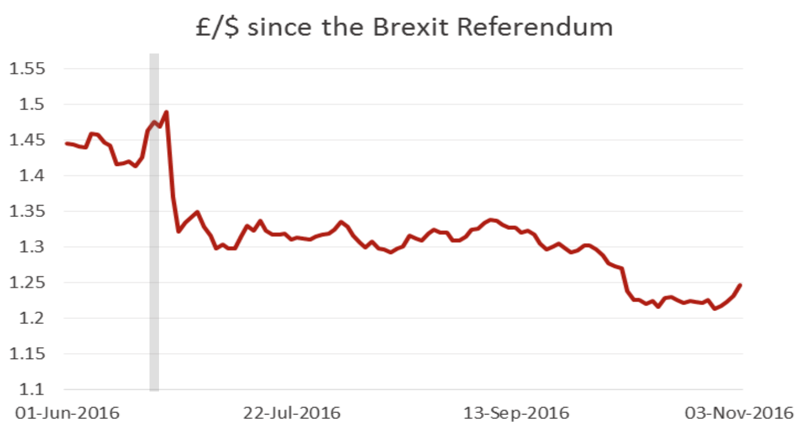
Brexit: delaying the inevitable?

By: Iakov Frizis

On Thursday, the United Kingdom's Supreme Court surprised British Prime Minister Theresa May and the world by blocking the government's prerogative powers over Article 50. The ruling stipulated that the government needs to consult the parliament before starting procedures for the country's withdrawal from the EU.

Despite this setback, the British government appears to retain its strong pro-Brexit position. International Trade Secretary Liam Fox reiterated in the House of Commons the government's determination to respect the result of the referendum, underscoring the latter's disappointment in relation to the ruling, whilst Ms. May aims to appeal the court's judgment. Meanwhile, the EU maintained a non-interference position, as the spokesman of the EC's President, Jean Claude Junker, reaffirmed that the EU will not comment on internal legal issues in the UK.

The case against the government was brought to the highest court by a crowdfunded group calling itself the *People's Challenge to the Government*, a group launched following the Brexit referendum. To cover legal costs, the group gathered pledges from 4,918 people amounting to £170,550.



Source: IMF

The news of the results of this legal challenge appears immediately reverberated across markets, providing some relief for the beleaguered pound (which rose by 1.1% to US$1.2448). A subsequent surge came following the Bank of England's (BoE) decision to maintain benchmark interest rate at 0.25%, till end of year, pushing the currency to $1.2493 (or a 1.6% rise). Meanwhile, on Friday morning, the pound traded around $1.246, with expectations of appreciation over the coming weeks.

Despite recent economic growth, the BoE is facing a less positive outlook than in August, as uncertainty over Brexit is coupled with a sharp rise of prices. BoE's renewed forecast points to the biggest sustained overshoot of inflation since 1997, when BoE gained its policy independence, as inflation is expected to exceed the 2% target, reaching 2.7% over 2017 and remaining at that level throughout 2018.

The strengthening of the pound, coupled with BoE's more hawkish tone and increased uncertainty relating to Brexit plans, has contributed to a re-evaluation of positions by firms engaged in trade; the FTSE-100, a largely exporter-based index, saw a slight drop in the wake of the decision.

Looking forward, this decision introduces a number of possible courses of action for the British government, all of which appear to exacerbate the rift in society, as MPs are called to vote to accept or reject the result of a referendum. Shortly after the court's decision, prevailing opinion suggests that voting against the referendum is going to be a hard sell for MPs. This suggests that positive sentiment, linked to the court's ruling, is expected to have only a temporary effect over markets, as traders closely tune into signals coming out of Westminster.

At a glance

Declining construction, retail sales, and industrial production seem to signal that Q3 growth in the Polish economy will be slower than in the two preceding quarters (Q1: 3.1%, Q2: 3.0%). CASE experts believe that the end of the year growth will still be around 3.1 percent, which is 0.3 percentage point lower than already revised government expectations. CASE experts anticipate that next year the economy may slightly accelerate, reaching 3.4% growth (y/y) in 2017. Other issues also persist, such as high deficit levels, which are currently forecasted at 2.9% of GDP in 2017, just below the EU's 3% cap. Should actually GDP growth in 2017 be less than forecasted, this could create significant roadblocks for the new government's inflated social spending promises (see above).

Oct PMI drops to 50.2 from 52.2

Real GDP forecast (%)	2016	2017
CASE	3.1	3.4
IMF WEO	3.1	3.4
OECD	3.0	3.5

According to the Federal State Statistics Service, Russian GDP contracted by -0.6% (y/y) in Q2, the smallest contraction in six quarters, due in part to an increase in manufacturing production. After double digit inflation growth in 2015, the economy seems to be stabilizing with annual inflation slowing to 6.4% and consumer price growth going down from 6.4% to 6.2% in September. This seems to be a timid but positive sign for the country's economy after six quarters of contraction, caused in large part by economic sanctions and low oil prices. The economy ministry announced the plans to plug budget holes by raising up to 1 trillion roubles from selling state stakes in major companies during 2017-2019 as well as increasing borrowing.

Oct interest rate kept at 10.00% p.a.

Real GDP forecast (%)	2016	2017
IMF WEO	-0.8	1.1
OECD	-1.7	0.5

In October, Germany remained an anchor of economic stability for the Eurozone. The rebound in economic activity follows a temporary Q3's slowdown, attributed to Brexit-related uncertainty and weakening global demand. The economy is on track for more robust growth over the next months, presenting a 2-year high inflation rate (0.8%) and accelerated economic activity, as reported by IHS Markit's Purchasing Managers' Index. This points to the continuation of the August's surge in manufacturing, prompted by stronger demand from U.S. and Asia; an upward trend also evident in unemployment indices, down to 6% in October – a record low exceeding previous forecasts. Meanwhile, following the general Eurozone trend of falling bond prices, yields of the German 10-year bund rose by 0.012 p.p. from this summer's low of near -0.2%.

Sept CPI (prelim) index rose to 0.2 from 0.1

Sept IFO Expectations index rose to 106.1 from 104.5

Real GDP forecast (%)	2016	2017
IMF WEO	1.7	1.4
OECD	1.6	1.7

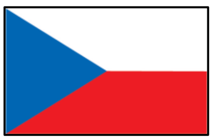
At a glance

Ukraine's economy grew by 1.4% (y/y) in Q2. This positive development builds on Q1 growth of 0.1% (y/y), the first quarter of growth in two years. Investment is a significant driver of growth as the risk of a full-scale military conflict with Russia seems distant at present. In line with expectations, Ukraine's Central Bank (UCB) announced a cut in the key interest rate by 100 bps to 14% on October 27th, which reflects decreased price stability risks. In late October, UCB also announced that the country's balance of payments was USD 474m in September, with the current account at USD 875m in negative and the financial account at USD 1.3bn in positive, with the latter driven mainly by public sector borrowing (US-backed Eurobonds).

Balance of payments at USD 474m in positive in September

NBU base policy rate reduced to 14%

Real GDP forecast (%)	2016	2017
IMF WEO	1.5	2.5
OECD	-	-



The Czech Republic entered November without any major changes to its economic life. Czech National Bank's (CNB) projections of annual price inflation remain unchanged for Q3 and Q4 2017 and stand at 2.2% and 2.4% respectively. Its economic outlook for the rest of the year is consistently moderately optimistic, with expectations of rebound up to 3.0% y/y GDP growth in 2017 and 2018 from 2.6% in Q2 2016 and expected 2.4% in Q4 2016. Along similar lines, the overall economic confidence in the country has slightly increased as well, with consumer confidence indicator rising by 2.5 points to 109.9 m-o-m and economic sentiment indicator increasing by 0.4 points to 97.5 m-o-m, as was announced last week by the Czech Statistical Office.

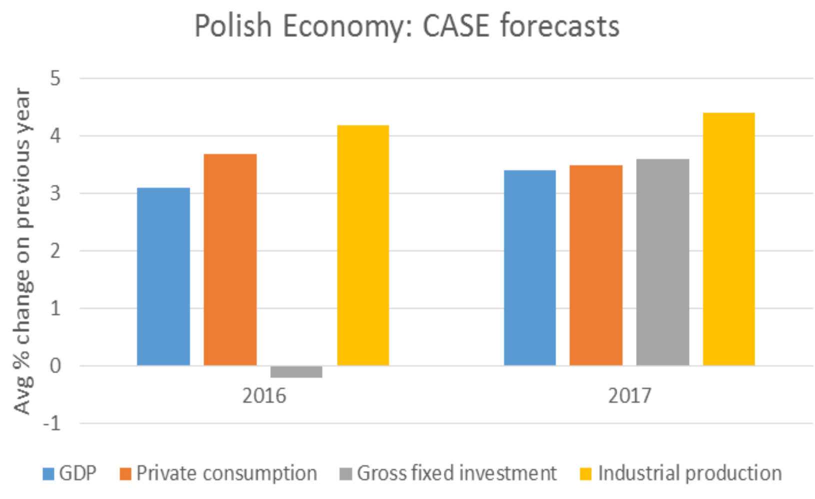
Oct Manufacturing PMI up to 53.3 from 52

Real GDP forecast (%)	2016	2017
IMF WEO	2.5	2.7
OECD	2.4	2.6

The Hungarian economy regained traction in Q2, supported by buoyant private consumption and an improved external sector. Economic due diligence in the field of debt financing has also helped improve Hungary's overall financial situation. In August, exports grew at their fastest rate in over a year and industrial production grew after two months of contraction. Overall, the economies main drivers of growth include business capital accumulation, supported by inward FDI and, increasing household income, lower unemployment, deleveraging and low interest rates, which have contributed to an increase in overall demand for the economy. EU structural funds have also played a role in mitigating weak domestic investment caused by barriers to entry for SMEs and ever-changing regulations.

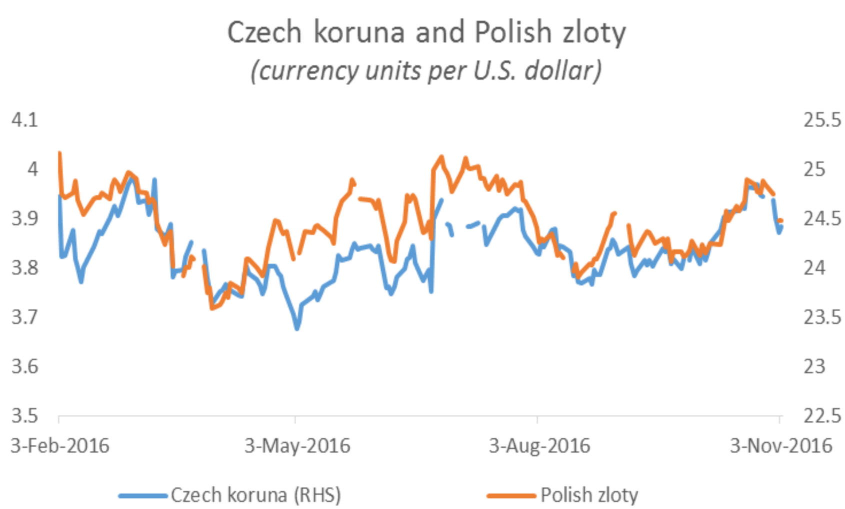
Oct PMI down to 57 from 57.2

Real GDP forecast (%)	2016	2017
IMF WEO	2.0	2.5
OECD	1.6	3.1

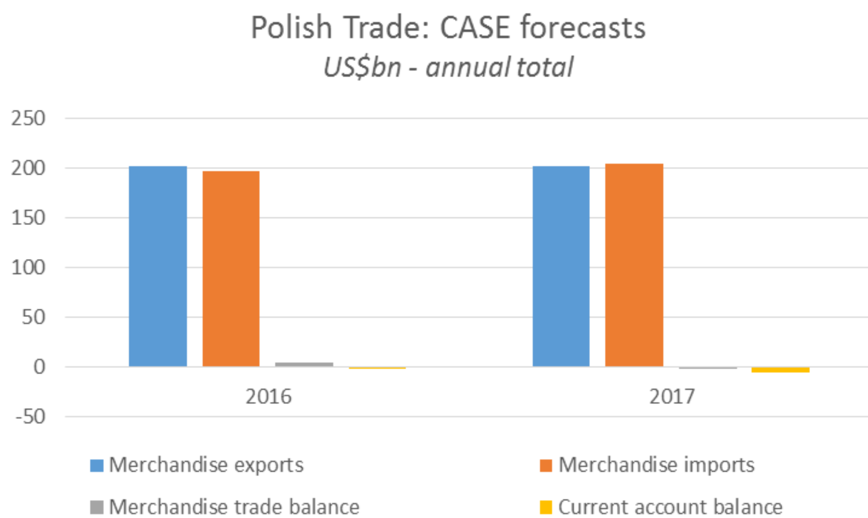


Source: CASE forecasts, updated October 17, 2016

Source: CASE. Most recent observation Oct 24, 2016



Source: IMF



Source: CASE forecasts, updated October 17, 2016

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