Economy and Financial Markets
25th August 2020 7 pages

Poland Economics Flash

Deficit and borrowing needs likely to undershoot forecasts

- The government's revision to 2020 Budget Act assumes a significant increase in this year's borrowing requirement.
- We think there is a lot of room for positive surprises as compared to the revised budget. According to our estimates, the actual central government's deficit may be by at least PLN 30bn (1.3% of GDP) lower than planned.
- Based on these calculations, we think 2020 borrowing requirement has been almost fully financed and the Finance Ministry can now focus on pre-financing of 2021.
- The exact size of gross borrowing needs appears less important to markets as long as the central bank continues its asset purchase program.
- If there is such a need, we think the central bank may carry on with bond purchases after 2020 and roll over its bond positions in the following years. This means the QE program will work as an important stabilizing force for the bond market, even despite accommodative fiscal policy.

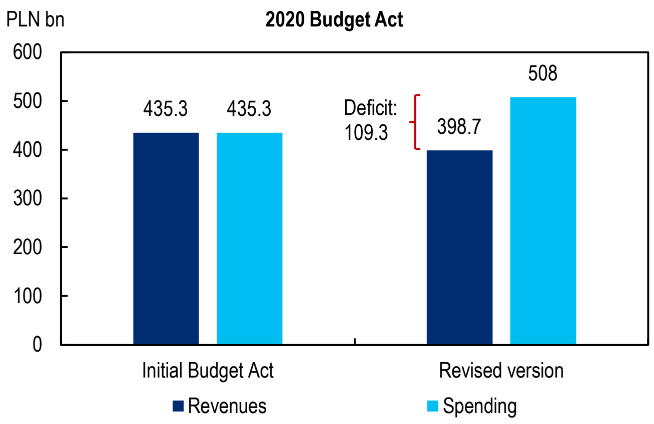
Piotr Kalisz, CFA
+48-22-692-9633
piotr.kalisz@citi.com

Cezary Chrapek
+48-22-692-9421
cezary.chrapek@citi.com

2020 GBR and bond issuance

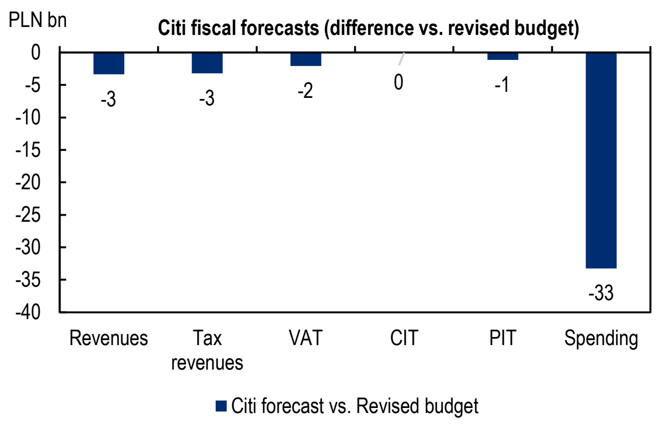
The newly revised budget shows the extent of the damage the pandemic has caused to the public finance. While the initial Budget Act approved early this year assumed that the spending limit would match revenues, the government is now planning the 2020 deficit to reach as much as PLN 109.3bn or 4.9% of GDP. The revised budget assumes a significant drop in tax revenues due to the pandemic shock leading to lower consumption and company profits. It also assumes a substantial rise in spending as a result of government's discretionary measures aiming to boost growth (Figure 1). The above numbers reflect only a portion of the overall public sector as they mainly include spending of central government entities and omit local governments, social security funds and spending of various funds that technically remain outside the central government but constitute a part of a broad general government sector. However, despite its incomplete nature, the central budget deficit is an important piece of news for market participants as it is a crucial input for borrowing needs and bond issuance forecasts. From this point of view, we think the revised budget leaves room for positive surprises.

Figure 1. New budget revision assumes substantially lower tax revenues and a significant increase in budget spending



Source: Citi Research estimates, Finance Ministry data

Figure 2. While there is some room for negative revenue surprise, spending is likely to undershoot the plan



Source: Citi Research estimates based on Finance Ministry data

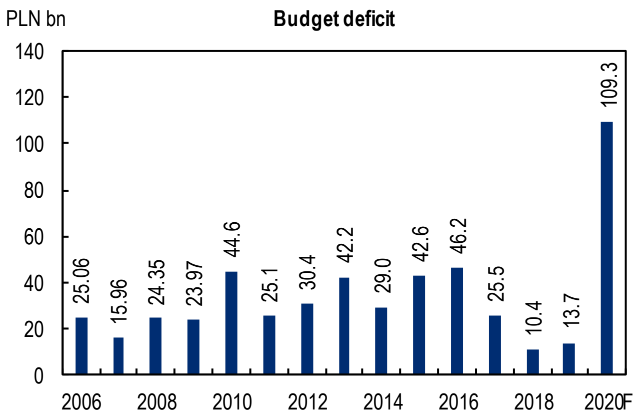
It seems likely the actual deficit will be substantially lower than the Finance Ministry is currently planning. The shortfall of PLN 109.3bn would be almost seven times higher than the cumulative deficit recorded in first seven months of the year. To reach that new deficit limit, the central government gap in each of the remaining five months of the year would need to be higher than the total year-to-date deficit. We find it implausible. Looking at the budget breakdown, the revenue estimates done by Finance Ministry are close to what we expect (Figure 2). Although the actual VAT or personal income tax receipts could be even lower than the government is planning, the difference between our estimates and the Finance Ministry's plan is relatively small, especially when compared to the overall size of the deficit. A more important source of potential budget surprises is on the expenditure side, where spending was planned at a level that may be difficult to deliver. In a typical year, spending undershoots the plan by around 3%, which reflects the usual difficulty with finalizing all spending projects on time. This year we think expenditures will undershoot the limit by a more significant margin. In particular, we expect public investment to be lower than planned, as the pandemic shock will negatively affect the pace at which infrastructure projects are realized or started. This view seems to be confirmed already by July construction output data that showed a surprisingly deep drop in infrastructure construction output. According to our estimates, the actual 2020 deficit will be lower than planned by around 30% and will not exceed PLN 80bn (vs. PLN 109.3bn planned).

The cautious budget planning appears justified in light of the pandemic shock. The Finance Ministry probably chose to increase the deficit limit by as much as possible in order to have sufficient fiscal space if the new COVID wave turns more serious than currently assumed. Thanks to this the government would be able to avoid another budget revision and could respond quickly to potential new growth shocks. Also, we think the Finance Ministry probably tries to bring forward some of the spending that normally would be planned for next year, for example by transferring money to the Solidarity Fund, the entity that will pay out additional pensions only in 2021. Shifts between 2021 and 2020 are due to the fact that this year the expenditure rule, which puts strict limits on spending growth, was temporarily suspended. The restriction will become binding again in 2021 and therefore the Finance Ministry may prefer to accelerate some spending to avoid consequences of the fiscal rule.

Issuances to be lower than planned

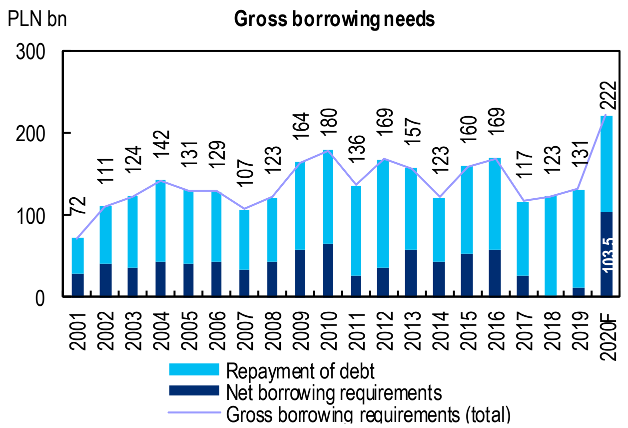
Borrowing needs are likely to undershoot the government's projections as well. Lower-than-planned deficit would imply that also gross borrowing requirement (GBR) can surprise positively. According to our estimates, this year's GBR can reach approximately PLN 190-200bn and although this would be a historically high level, the borrowing requirement would be below PLN 221.5bn assumed in the revised budget. Since a large portion of anti-recession measures was pushed out of the budget and is financed by special anti-COVID funds, the borrowing requirement can be substantially lower than feared at the beginning of the pandemic. This is also why despite historically strong correlation between the size of the general government deficit and GBR, this time the GBR rises much less than the overall fiscal gap (Figure 6).

Figure 3. In our view Finance Ministry's central budget deficit assumption is rather conservative.



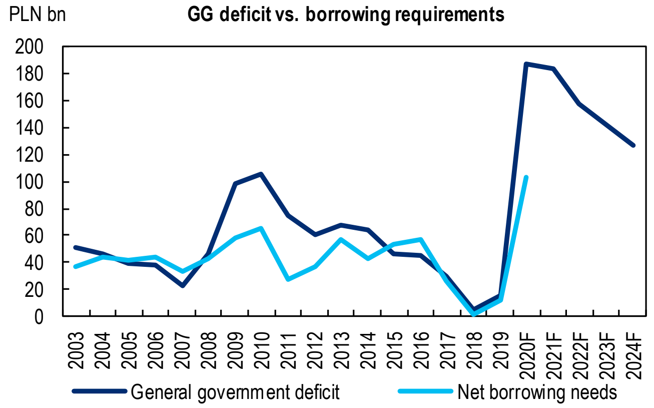
Source: Finance Ministry estimate, Citi Research

Figure 4. We expect net and gross borrowing needs could be lower than planned by the government by around PLN 20-30bn.



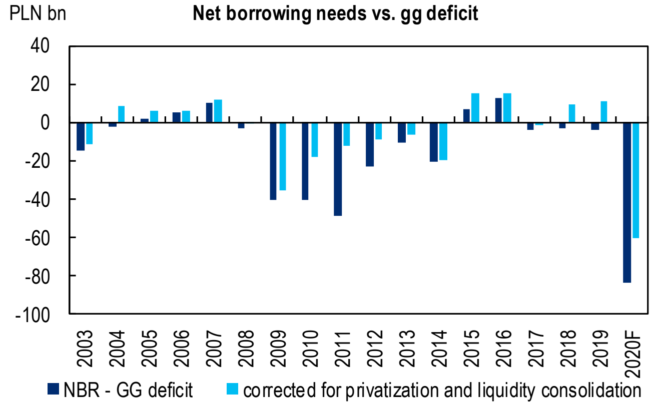
Source: Finance Ministry estimate, Citi Research

Figure 5. Historically net borrowing needs were well correlated with general government deficit



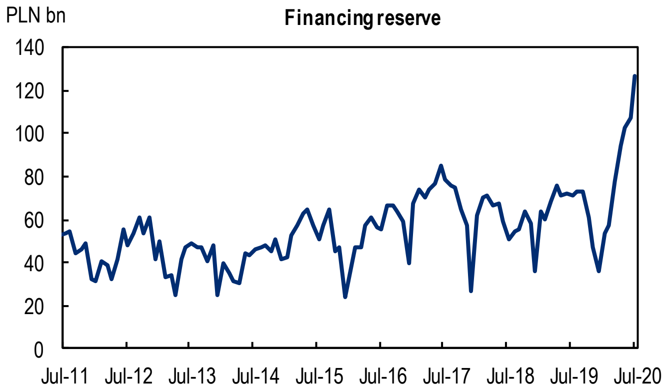
Source: Ministry of Finance, Citi Research; Finance Ministry estimate of net borrowing needs, Citi Research estimate of general government deficit

Figure 6. This year the difference results from pushing government anti-crisis spending outside the central budget. Possibly FinMin general government deficit estimate could be revised upwards



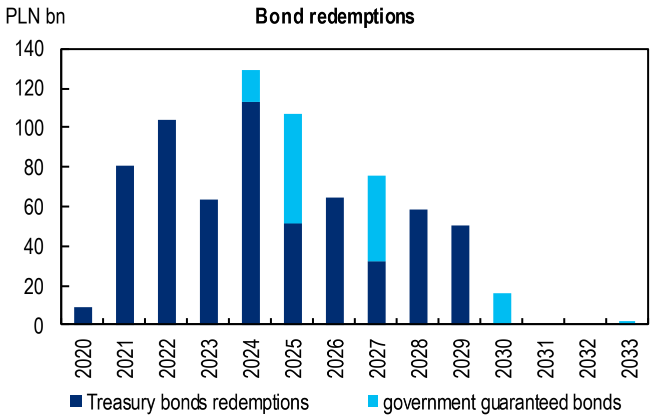
Source: Ministry of Finance, Citi Research, *NBR-GG deficit = net borrowing requirements – general government deficit. In 2009-2014; light blue bars show difference between NBR and GG deficit corrected for proceeds from privatization, which were relatively high in 2008-2013, and funds from public sector liquidity consolidation, which started to be utilized in order to lower the issuance in 2011

Figure 7. Finance Ministry will use some of its reserves for financing of gross borrowing needs in both 2020 and 2021



Source: Ministry of Finance, Citi Research

Figure 8. Government guaranteed bonds will mature in 2024 or later, potentially increasing the future borrowing needs of the budget



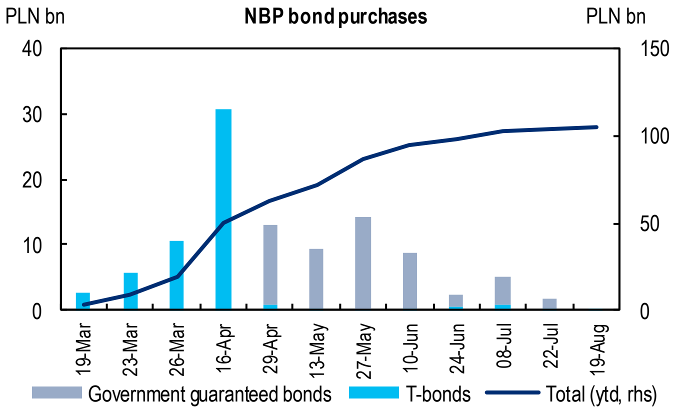
Source: Ministry of Finance, PAP, Citi Research

Although the central government's balance is likely to be lower than the revised budget is assuming, the overall fiscal stance is set to remain loose. The actual fiscal situation is well summarized by the general government balance, which apart from the central government also includes local governments, social security funds and various off-budget funds that are instrumental in providing the fiscal boost to the economy. Those funds can finance spending worth up to 8.8% of GDP, though it is uncertain at this stage whether the Eurostat will add the entire amount to the general government deficit in 2020 or whether this amount is spread over 2020 and 2021. Recent comments from Finance ministry officials suggest they see a risk that Eurostat could require that all the spending is included in this year's general government balance.

Central bank as a stabilizing force

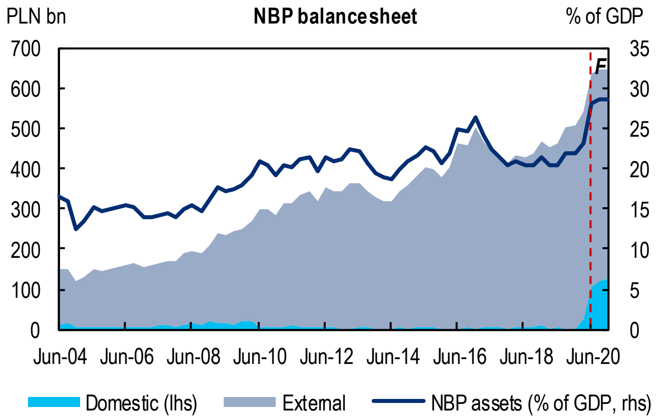
The exact size of gross borrowing needs appears less important to markets, at least as long as the central bank continues its asset purchase program. So far, as a part of its Structural Open Market Operations (SOMO), the central bank bought around PLN 105bn of bonds, i.e. equivalent of 4.6% of GDP, including PLN 52.6bn of government bonds (69% of new issuance since mid-March) and 52.2bn of government guaranteed bonds (40% of total issuance since March). With record high financing reserve, fewer issuances as well as high demand for bonds from other market participants, the central bank will likely buy fewer bonds than we previously expected. Most likely the purchases under the SOMO program will reach 5-6% of GDP in 2020, which would be lower than around 7.5% of GDP that we expected in April. We think the central bank may roll over its bond positions in the coming years and it may also continue bond purchases after 2020, if there is such a need. The key element of the central bank's asset purchase program is its flexibility as the NBP does not pre-commit to any particular asset purchase targets and can adjust its activity on each auction, depending on market conditions. Therefore it is possible the size of Polish QE program could be increased beyond our current estimates if the materialization of an adverse economic scenario justified such a response. All in all, we think the SOMO program will act as a stabilizing force, smoothing the yield path and minimizing the scale of bond market volatility. Having said this, we think as long as the NBP is ready to purchase bonds, the size of planned issuances will have limited impact on the market.

Figure 9. The pace of NBP bond purchases slowed in the last few weeks



Source: PAP, CSO, Citi Research

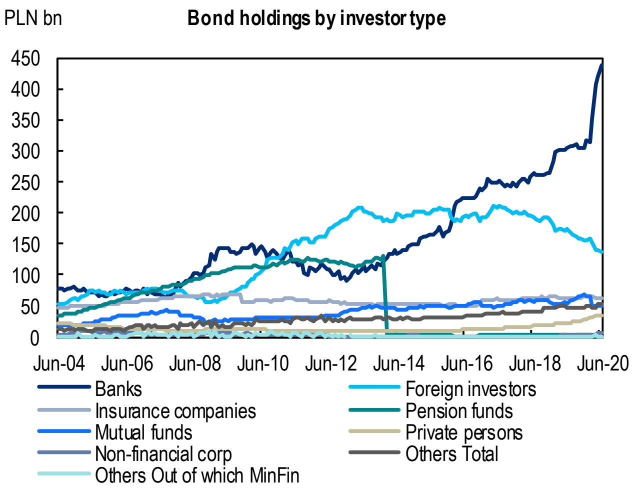
Figure 10. We expect total central bank's bond purchases could reach this year PLN 125bn, i.e. 5.5% of GDP.



Source: NBP, Haver, CSO, Citi Research

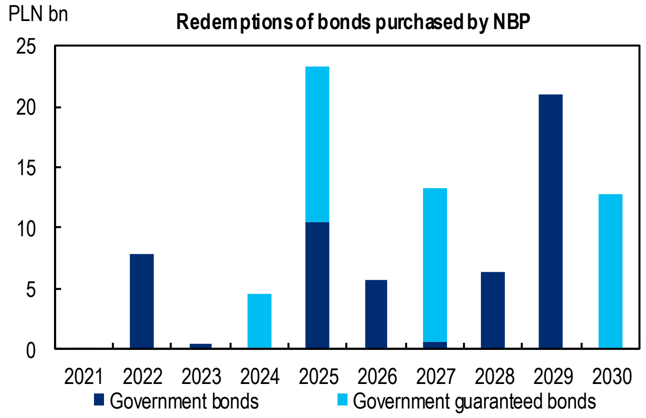
Apart from NBP, domestic banks also show strong demand for government bonds. Since February 2020 the domestic banking sector, excluding the NBP, increased POLGB holdings by around PLN 73bn. This happened amid a reduction of bond holdings by foreign investors (by ~PLN20bn) and domestic mutual funds (by PLN15bn). As government bonds are tax-exempt and central bank operations increase banking sector's excess liquidity we expect banks' demand for bonds to remain high also in the coming months. Small amounts of bonds repurchased by Finance Ministry at switch auctions and by NBP at its structural open market operations seem to confirm that local banks are unwilling to reduce POLGB holdings. The demand from local investors has helped to offset the negative impact of falling demand from offshore investors. Outflows from foreign investors came mainly from the US investment funds, which have been gradually exiting the Polish market since 2014 by not rolling over their debt positions. However, taking into account already small nominal exposure of US investors and the weakness of the dollar the room for further outflows of US investors appears smaller now.

Figure 11. Domestic banking sector was a key buyer of bonds this year



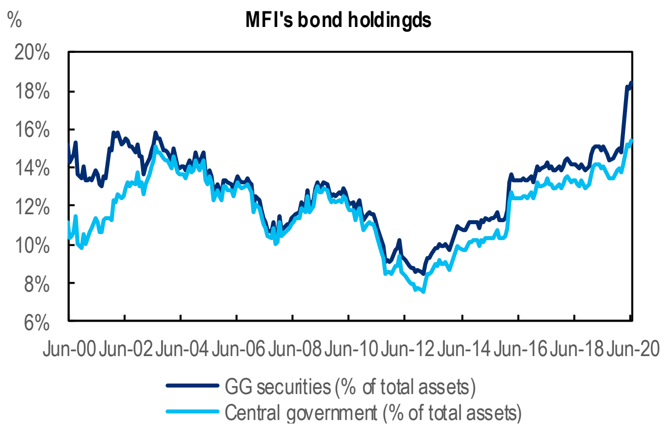
Source: Ministry of Finance, Citi Research

Figure 12. NBP bought over PLN 50bn of government and over PLN 50bn of government guaranteed bonds



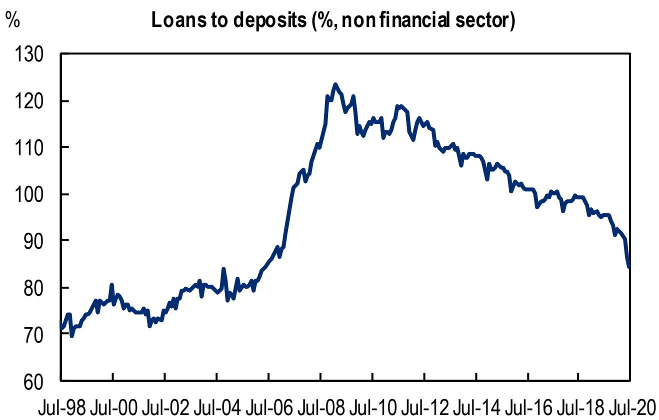
Source: Ministry of Finance, Citi Research

Figure 13. Share of both central and general government bonds in the domestic MFI's assets increased again in 2020…



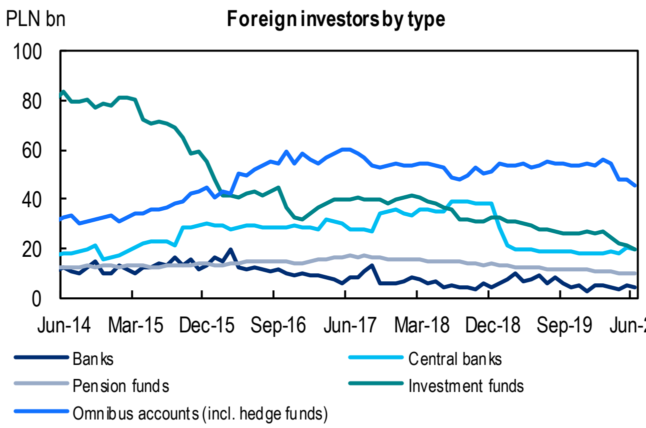
Source: NBP, Haver, Citi Research

Figure 14. …as banks prefer to hold funds in tax exempt bonds rather than extend new loans



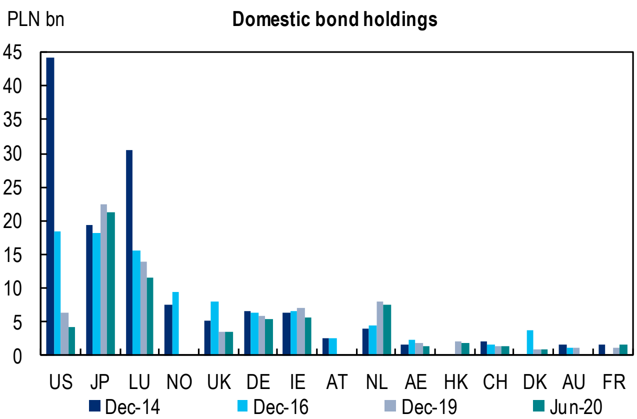
Source: NBP, Haver, Citi Research

Figure 15. Reduction in foreign investors bond holdings came mainly from investments funds in the last few years



Source: Ministry of Finance, Citi Research

Figure 16. This was mainly due to no rollover of debt by US funds



Source: Ministry of Finance, Citi Research

Economics Research

Piotr Kalisz, CFA

Chief Economist

+48 (22) 692-9633

piotr.kalisz@citi.com

Cezary Chrapek, CFA

Economist

+48 (22) 692-9421

cezary.chrapek@citi.com

Citi Handlowy

Senatorska 16

00-923 Warszawa

Polska

Fax: +48 22-657-76-80