Poland Economics View

Diverging monetary and fiscal policies

OUR TAKE

In this note, we are updating our forecasts in order to take into account the impact of announced fiscal easing, large refugee inflows, and stronger-than-previously-expected data for January and February. We also take a look at risks related to diverging monetary and fiscal policy paths.

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Growth upgrade instead of a downgrade — We expect economic activity to weaken significantly in 2Q and 3Q on the back of lower exports and investment. Despite this fact, we upgrade our full-year GDP forecast to 3.9% in 2022 from 3.6%, as the very strong beginning of the year provides a "statistical" boost to our forecast.

Lower taxes, higher spending — Since the beginning of the year, the government announced a number of fiscal measures that should boost consumption. These include additional personal income tax cuts, pension increases, and energy tax cuts. We estimate the total cost of measures announced over last 12 months at approximately 4.5-5% of GDP.

Policy mix in focus — The diverging paths of fiscal and monetary policies can be a source of risks. Fiscal easing could force the central bank to hike rates more than it would otherwise be required. The mismatch in timing of fiscal and monetary impulses creates also a risk of sharp downturn in 2023.

Upward pressure on yields — A combo of widening fiscal deficit and quick rate hikes is pushing bond yields higher. The rise in yields, if continued, would lead to significant increase in interest payments, limiting room for active fiscal policy in the future.

Diverging monetary and fiscal policies

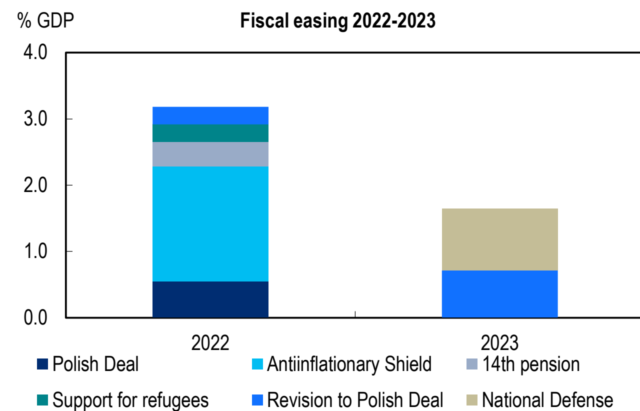
In February, in an initial reaction to the breakout of the Russia/Ukraine conflict, we cut Poland's 2022 GDP forecast. Now, after only a few weeks, we are adjusting the forecast higher, and although the revision is not large (up by 0.3 pp to 3.9%), its upward direction is meaningful. We see at least three factors justifying higher growth forecast.

Fiscal easing

In March, the government announced new cuts in personal income tax (PIT) and social security contributions. The changes are likely to cost the general government sector 0.2% of GDP in 2022 and approximately 0.8% of GDP in 2023. These numbers might seem modest, but they should be read in a wider context. In recent months, the government also announced other spending increases or tax cuts, the combined value of which approaches 5% of GDP (Figure 1).

Apart from significant reductions in personal income tax, the government increased pension indexation, decided to pay out the fourteenth pension, lowered VAT and excise on energy and food, and increased defence spending. All these measures, with exception of military equipment purchases, will have positive impact on consumption already this year. In light of the energy price shock, we think additional transfers or tax reductions will directly translate into higher spending, thus smoothing consumption.

Figure 1. Tax cuts and spending increases in 2022-2023 are likely to reach 4.5-5% of GDP



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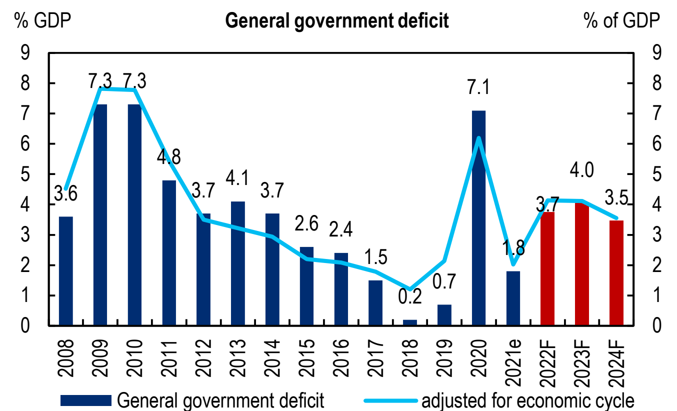
Source: Citi Research Estimates, Finance Ministry, PAP, KPRM

Figure 2. Fiscal deficit is set to widen and we see risks to our forecast skewed to the upside



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Source: Eurostat, Citi Research

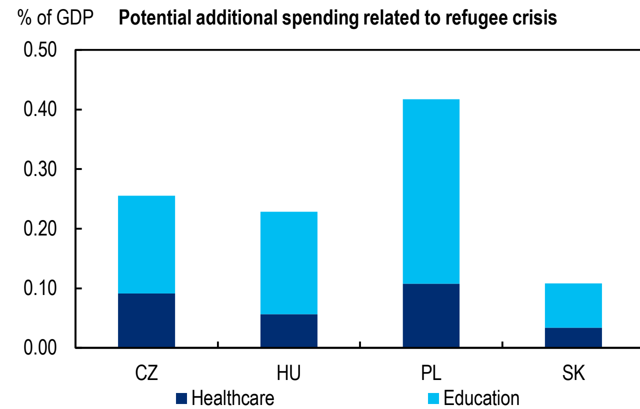
Refugee inflow

The number of refugees from Ukraine that have entered Poland has already exceeded 2.3mn. There is no detailed data on how many of those fleeing the conflict have already moved further west to Germany or other EU states. However, the most recent data show that in less than two weeks, half a million Ukrainian citizens applied for identification numbers (PESEL) that would allow them to use public services in Poland. Given that obtaining PESEL in current circumstances requires hours of waiting in lines, it is likely that a vast majority of refugees planning to stay in Poland have not had a chance to apply for it.

UNHCR projected in February that approximately 1.5 million refugees could stay in Poland (two-thirds of all who arrived so far). This would imply an

approximately 4% increase in Poland's population in 1-2 months, with all the potential consequences for the economy. According to our back-of-the-envelope estimates, spending on food and basic items by refugees (or financing of this spending by the government, households, or NGOs) could easily add 1-1.5 percentage points to consumption growth. This, along with fiscal easing, could exacerbate price pressures in 2Q22.

Figure 3. Refugee wave is likely to lead to higher public spending



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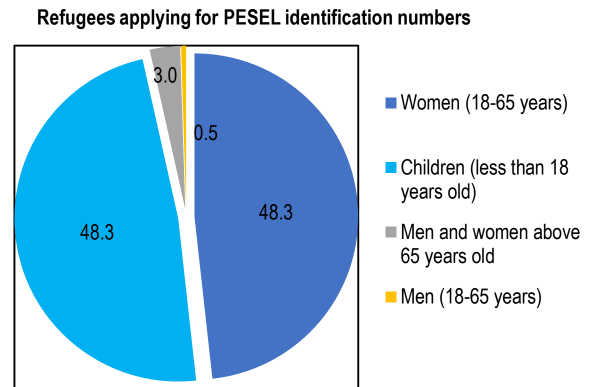
Source: Citi Research Estimates

Figure 4. Approximately half of Ukrainian refugees who applied for PESEL ID number are women in working age



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Source: KPRM, Citi Research Estimates

High starting point

A very important – even if unexciting – factor contributing to growth in 2022 is related to the strong beginning of the year. Monthly data for January and February, the period preceding the breakout of the Russia/Ukraine conflict, were surprisingly robust. Even if March surprises to the downside, the first two months should be sufficient to ensure 1.5-2% QoQ GDP growth in the 1Q22.

Assuming significant weakening of activity mid this year (average quarter-on-quarter GDP change at -0.6% in 2Q and 3Q), the economy can expand by approximately 4% in 2022. This is not to say that weaker readings are impossible. Admittedly, geopolitical events mean that a wide range of outcomes is possible, but our point is that data and information available so far allows for somewhat more optimism than we thought a few weeks ago. For 2022 growth to be significantly lower than 4%, the economic activity would need to suffer significantly more than it seems likely at the moment.

Updated forecasts

We believe the best description of the current situation is: the slowdown is real, but it is not visible in 2022 average data. For example, our new base case assumes 3.9% GDP growth in 2022 (+0.3 pp vs. previous forecast), followed by 2.7% in 2023. In the near term, private consumption is likely to hold well, thanks to refugee spending, but the prospect of high energy bills and shrinking saving buffers will eventually weigh on 2023 consumption.

We expect inflation to run on average above 10% in 2022, and close to this level in 2023. Our inflation forecast assumes possible decline in oil prices later this year, but if this does not materialize, CPI could be higher.

Economic activity and inflation can be affected by changes in geopolitical situation, which seem largely unpredictable at the moment.

One potential risk which needs to be taken into account is the possibility of a ban on energy imports from Russia. So far, Poland has announced its own plans to wean itself from Russian gas, oil and coal by the end of 2022. By that time, Poland is likely to have access to the Baltic Pipe, a pipeline that will make the country independent from Russian gas supplies.

However, if the EU decided to pursue an immediate ban on energy imports (not our base case), this could have a more significant, though transitory, impact on activity. To our best knowledge, there are no model estimates of the costs of such an energy import ban for Poland. However, a widely quoted and commented study for the German market (see here) suggests that the cost for the German economy would be between a few tenths to 3% of GDP. Since Poland is relatively less dependent on Russian gas, and the Baltic Pipe is expected to be fully operational in 4Q22 anyway, we treat these estimates as an upper limit for potential costs.

Figure 5. Poland - Key macroeconomic forecasts

	2021	2022	2023	2024
GDP growth (YoY)	5.7	3.9	2.7	3.6
Private consumption (YoY)	6.2	4.0	1.9	3.1
CPI (YoY, average)	5.1	10.2	9.1	4.0
CPI (YoY, eop)	8.8	7.5	7.5	4.0
NBP reference rate (%, eop)	1.75	5.50	3.50	2.5
Fiscal deficit (% of GDP)	1.8	3.7	4.0	3.5

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Source: Citi Research, Statistics Poland, NBP, Eurostat

Risk of suboptimal policy mix

Diverging directions of monetary and fiscal policies can have far-reaching consequences. Inflation seems to be currently one of the most important economic and political challenges in Poland. The central bank has turned significantly more hawkish, declaring readiness to bring inflation back to the target, even at the cost of additional significant rate hikes. Yet, fiscal policy is putting much more emphasis on boosting activity, which could eventually make the central bank's efforts more difficult. Lack of synchronization of the policy mix can have a number of consequences.

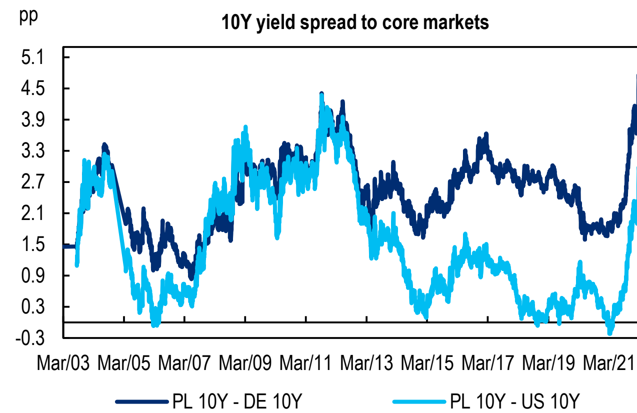
- **Mismatch of time horizons.** Tax cuts and spending increases will have impact on the economy practically immediately after the measures are implemented. By contrast, the near-term impact of monetary tightening on growth and inflation is limited and becomes more visible only after 4-8 quarters. In the present context, this means that effects of recently announced fiscal measures will likely be felt already in 2Q-4Q22, keeping (core) inflation high. Rate hikes by the MPC will not be able to change much in this dynamics, as their impact will be felt either by the end of 2022 or in 2023. If the MPC wanted to offset the impact of fiscal stimulus and cut inflation faster, it would need to hike rates significantly more than our current forecast assumes (5.5% in 3Q22). This in turn would increase chances of a boom-bust growth pattern, with very sharp deceleration in 2023.

- **Redistribution effects.** Those who benefit from fiscal policy measures are not necessarily those who are negatively affected by fiscal tightening. Personal income tax cuts as well as reduction in VAT on food will benefit

lower-income households, who tend to have higher propensity to spend. In turn, interest rate hikes will mostly affect indebted households, which tend to have higher-than-average incomes and lower propensity to consume. This is just another argument showing that a fight with inflation in a period of fiscal easing might push the central bank towards excessive interest rate increases. It also means that the fight with inflation will be less efficient than it could otherwise be, putting significant pressure on indebted households.

- **Rising borrowing costs.** Our forecasts suggest that fiscal deficit is likely to widen in 2022 by approximately 1.5-2% of GDP. Given geopolitical challenges and approaching elections, we think risks are skewed towards even more fiscal easing. The combined effect of looser fiscal and tighter monetary policy creates conditions for further rise in bond yields. Polish bond yields already increased significantly in recent months, and their spread to UST or bunds widened (Figure 6). Geopolitical risk premium can be only one of the reasons – a less favorable policy mix is most likely another one.

Figure 6. Polish bond yields rose as compared to UST and bunds



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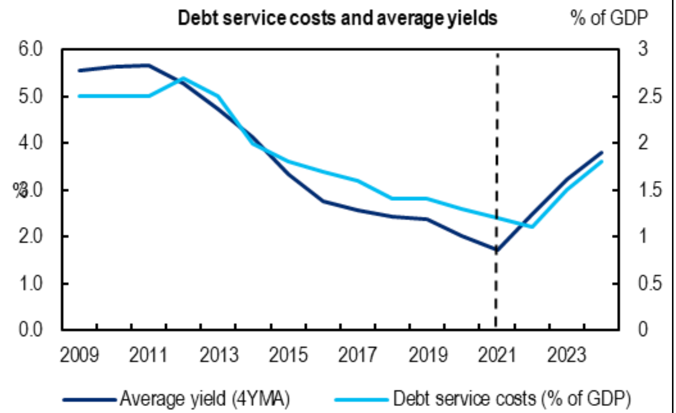
Source: Citi Research, Thomson Reuters

Figure 7. Rising bond yields are likely to increase debt service costs



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Source: Eurostat, Bloomberg, Citi Research Estimates

The consequence of this trend will be further pressure on debt service costs. While last year, interest payments on general government debt barely exceeded 1% of GDP, we think they can rise over next 2-3 years towards 2% of GDP (Figure 7). This would imply that any attempt to bring the fiscal deficit below 3% would require respectively larger adjustment in primary balance. Also, less fiscal space would limit the room for active fiscal policy in the future, constraining the ability to respond to shocks.

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