NBP

National Bank of Poland

Monetary Policy Council

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Opinion of the Monetary Policy Council on the *Draft Budget Act for the Year 2013*

The conduct of fiscal policy is of prime importance to the Monetary Policy Council in terms of ensuring appropriate coordination of monetary and fiscal policy (i.e. the so-called *policy mix*).

The *Draft Budget Act* and other documents which accompany parliamentary work on the Act[1] do not cover all the entities of the public sector. Therefore, the MPC assessment, whose aim is to gauge the consequences of adopting the fiscal measures described in the *Draft Act* for the entire economy, also relies on other official government documents, statements by members of the Cabinet as well as estimates and forecasts drawn up by the NBP.

I. Macroeconomic assumptions of the *Draft Budget Act*[2]

The *Draft 2013 Budget Act* rests on the assumption that the economic activity in the euro area, and consequently also in Poland, will remain subdued. In the light of current data, this assumption should be deemed realistic. At the same time, the *Draft Budget Act* envisages further public finance consolidation, which, while necessary to sustain long-term growth in Poland, may pose a downward risk to GDP growth in the short run.

According to the *Justification* to the *2013 Draft Budget Act*, economic growth will slow down to 2.2% in 2013, from the 2.5% expected in 2012. The National Bank of Poland is of the opinion that the deterioration of economic conditions may be more profound than assumed by the Ministry of Finance. In the NBP's assessment, growth will lose momentum faster than envisaged in the *Justification*. This is indicated by, among others, current GDP estimates posted by the Central Statistical Office(GUS), according to which GDP growth slowed from 3.6% y/y in the first quarter of 2012 to 2.3% in the second. The NBP believes that the observed adverse trends will continue into 2013. In particular, domestic demand will remain

[1] Among others: The Act on Amending Certain Other Acts Related to the Execution of the Budget Act and the Strategy for Public Sector Debt Management.

[2] The assessment of macroeconomic assumptions of the *Draft Budget Act* is based on the November projection of inflation and GDP derived from the NECMOD model.

sluggish as a result of slow private and public consumption growth combined with further weakening in gross capital formation.

Slower investment growth next year will result, to a significant degree, from lower public investment, related to a large share of EU funds designated for this purpose having already been absorbed, as well as the impact of local government fiscal rules. At the same time, given the bleak outlook for growth at home and abroad, corporate and household investment will continue to persist at low levels. The National Bank of Poland believes that private investment growth will decelerate more than anticipated by the Ministry of Finance. This is indicated by weak capital expenditure figures for the second and third quarters of 2012 and the shrinking number of newly launched investment projects. Corporate investment may also be dragged by the deteriorating financial performance of enterprises.

The *Justification* assumes a slight improvement in the position of the household sector, which may be driven by a halting downward trend in employment in the economy and a rise in real wages. At the same time, the unemployment rate is expected to stabilise, albeit at a heightened level. As a consequence, private consumption growth is set to pick up - if only by a relatively small margin. Rising consumption will be supported by higher income from paid employment amidst a simultaneous real decline in social transfers. In the assessment of the NBP, labour market conditions may improve at a somewhat slower pace than envisaged in the *Justification*. In particular, as the NBP expects labour demand to drop further, and labour supply to rise more sluggishly than assumed in the *Justification*, employment in the economy as a whole may continue to fall. In effect, amidst a marked drop in the saving rate observed in the recent years, private consumption growth may - in the opinion of the NBP - be slightly weaker. This seems to be consistent with the "Central Statistical Office Note on the Updated GDP Estimate for the Years 2008-2011 and 2012 Q1 and Q2", which has noticeably revised downward the estimate of private consumption in the first half of 2012.

The NBP shares the opinion expressed in the *Justification* that, given the weakness of demand seen in countries being Poland's main trading partners, combined with flagging demand at home, export and import growth will remain weak. At the same time, the contribution of net exports to GDP growth will remain positive. In the light of the above, the assumption of a narrower current account deficit in 2013 should be accepted as realistic.

The *Justification* assumes that due to the economic slow-down and low wage pressure, CPI inflation will drop to 2.7% next year, i.e. a level slightly above the inflation target. This is in line with NBP forecasts, with the caveat that, in similarity to the previous years, growth in energy and agricultural commodity prices in the global markets poses a potential risk to this scenario.

II. Fiscal Policy in 2013

A comprehensive evaluation of fiscal policy and its impact upon the economy requires an appropriate set of information on the finances of entities generating government demand. It is difficult to produce such an assessment on the basis of the submitted *Draft Act* alone, as it does not contain, among others, financial plans for major general government units, such as the National Health Fund (NFZ), the Demographic Reserve Fund (FRD) and the National Road Fund (KFD)[3]. Moreover, the *Draft Act* does not contain data on aggregate revenue, expenditure and deficit of the general government sector, despite these data being published annually by the government in the Convergence Programme Update.

Following a marked rise in the deficit of the general government sector in 2009-2010 - to 7.8% of GDP in 2010 - the process of its reduction started in 2011. In 2011, it was reduced by 2.8 percentage points of GDP and in 2012 it may decline by a further 1.5 percentage points of GDP. This may provide grounds for the EU Council to close the Excessive Deficit Procedure, which was launched against Poland in 2009. The *Convergence Programme. 2013 Update* envisaged further deficit cuts in the subsequent years, down to 1% of the GDP in 2015. However, in view of the weakening of tax revenues in 2012 and the deterioration of the outlook for growth, deficit reduction along the path envisaged in the Programme looks somewhat unrealistic unless additional adjustment measures are implemented.

The improvement in public finances observed in 2011-2012 is a structural one. NBP estimates show no significant improvement in the cyclical component of the budget balance; thus, the structural tightening of fiscal policy in 2011-2012, adjusted for the shifting of pension contributions from Open Pension Funds (OFE) to the state Social Insurance Fund (FUS) [4], amounted to over 3 percentage points of GDP.

In 2013 the government plans to continue the structural fiscal tightening, applied to both the revenue and expenditure side of public finances. The most important development boosting government revenue will be the launch of the third stage of the European Emissions Trading System (ETS), expected to bring home additional revenue of PLN 2.85 billion. Moreover, the effective personal income tax rate will rise slightly due to the freezing of tax thresholds. At the same time, the *Draft Act* is underpinned by optimistic assumptions regarding tax revenue.[5] Failure to obtain the forecast amount of government revenue from taxes may entail a need to additionally curb spending. Lower-than-assumed PIT and CIT receipts would also have an adverse impact on local government units.

Limiting of public spending will be supported by the impact of the temporary expenditure rule[6] and the freeze on government sector wages, as well as the existing local government fiscal rules, which may help further reduce the deficit of the local government sub-sector.

[3] Thus, it would seem that the Draft does not satisfy the provisions on the transparency of public finances laid down in the Directive on requirements for budgetary frameworks of the Member States (Council Directive 2011/85/EU) comprising a part of the so-called "Six-pack". Poland should transpose the provisions of this Directive to the national law by the end of 2013. The directive stipulates that within the framework of the annual budgetary processes, Member States shall identify and present all general government bodies and funds which do not form part of the regular budgets.

[4] The change, while strengthening the structural balance of public finances, does not constitute fiscal policy tightening in terms of the impact on aggregate demand.

[5] Factors of risk to the tax income forecast envisaged in the *Draft Act* involve both the assumption of a relatively high tax receipts outturn in 2012, as well as assumptions concerning the development of key macroeconomic indicators in 2013.

[6] In addition, the Draft Act does not appear to include the legislative changes announced by the Prime Minister on 12 October 2012 and adopted by the Government as draft acts on 8 November 2012, some of which will generate higher budget spending in 2013.

The year 2013 will also mark the beginning of the period during which the retirement age for both men and women will be gradually raised. The process will be conducive to slower social expenditure growth in the subsequent years. According to statements made by government representatives[7], the expenditure of the National Road Fund will also decline[8].

The NBP estimates the scale of fiscal tightening to reach approx. 0.6 percentage points of GDP in 2013, i.e. significantly less than in 2011-2012. The fiscal tightening envisaged for 2013 is relatively modest, considering the high level, at which the structural deficit will remain; however, amidst the adverse macroeconomic conditions in the external environment of the Polish economy, it is difficult to determine the optimum pace of consolidation. On the one hand, excessive fiscal tightening could lead to an even deeper economic slow-down, possibly at a detriment to foreign investors' perceptions of Poland. On the other hand, as the so-called automatic stabilisers are triggered, an excessive rise in the deficit may also have an adverse effect on the perceptions of Poland's financial stability and on economic growth.

III. Assessment of macroeconomic impact of fiscal policy

In striving to achieve the most effective combination of monetary and fiscal policy (the so-called *policy mix*), the assessment of the medium-term impact of fiscal consolidation on GDP and inflation may be of prime significance.

The medium-term impact of the measures described above (which reduce the deficit of the general government sector) on the domestic economy will be determined by their impact on demand. Simulations run by the NBP indicate that the fiscal adjustments described by the *Draft*, which reduce the expenditure and increase the revenue of the general government sector, will weaken growth in all the categories of aggregate demand in 2012-2013: private and public consumption, gross capital formation and inventories. As a result, GDP growth will be lower by an average of 0.3 percentage points.[9] Bearing in mind large differences in the estimates of fiscal multipliers presented in the literature[10], these findings should be treated with caution.

The NBP believes gross capital formation to be the category most affected by the measures aimed at reducing general government sector expenditure. This will primarily stem from the planned cuts to public investment, which, as suggested by the aforementioned research findings, has a relatively strong bearing on GDP growth. The measures aimed at reducing the fiscal imbalance will also indirectly influence corporate and residential investment, the impact being primarily mediated through its adverse effect on aggregate demand and households' disposable income. The adverse impact of fiscal consolidation on the size of

[7] According to the statement made by the Minister of Finance on 5 September 2012, National Road Fund spending will drop from approx. PLN 18 billion in 2012 to PLN 15 billion in 2013.
[8] The *Draft Act* does not provide any information on that issue.
[9] Assuming no adjustments on the monetary policy side.
[10] See e.g.: Ramey, V.A. (2011). Can Government Purchases Stimulate the Economy? Journal of Economic Literature 49 (3), pp. 673-85; Gechert S., H. Will (2012). Fiscal Multipliers: A Meta-Analysis of the Literature. IMK Working Paper No. 97; Boussard, J., F. de Castro, M. Salto (2012). Fiscal Multipliers and Public Debt Dynamics in Consolidations. Economic Papers 460, European Commission.

investment may be partially offset by the programme, announced by the Prime Minister[11], providing for investment financing by state-owned enterprises and Bank Gospodarstwa Krajowego. As the details of these plans are not known yet, it is impossible to assess their economic impact.

The freeze on government sector wages announced in the *Draft* and the application of the temporary expenditure rule will translate directly into the size of public consumption. Declining income from paid employment will also have a secondary effect on private consumption. Income will be additionally stemmed by the rise in the effective PIT rate as tax thresholds will remain frozen as well as changes in taxation of authors.

The extent to which fiscal tightening impacts on economic growth will be mitigated by slower import growth resulting from weaker domestic demand, which is typical of an open economy. However, given low import intensity of the categories remaining under the strongest influence of fiscal policy adjustments, i.e. public investment and public consumption, the ensuing decline in imports will be relatively small.

In the NBP's assessment, the impact of fiscal policy adjustments on the productive capacity of the Polish economy will be determined, on the one hand, by lower investment outlays, translating - with a lag - into a smaller stock of capital and a possible rise in the equilibrium unemployment rate (NAWRU) driven by an increase in the so-called tax wedge, and on the other hand, by the labour participation rate growing with the raising of the retirement age. Moreover, potential GDP growth is also determined by macroeconomic stability, which may be supported by a credible and disciplined fiscal policy. The fiscal adjustments recently implemented in Poland bring the country closer to attaining this goal.

IV. Fiscal imbalance in 2013 and compliance with fiscal rules

Appropriate fiscal rules and procedures may constitute a tool to limit the public finance imbalance and, subsequently, ensure sustainable fiscal discipline. Poland’s public finances are subject to a number of fiscal rules laid down in the national and European legislation. At this point, it should be emphasized that domestic rules apply to public finance statistics data consistent with the national legal standards, whereas European rules apply to ESA95 data.

The most important national fiscal rule is the public debt limit laid down in the Constitution of the Republic of Poland amounting to 60% of GDP and accompanying provisions of the Public Finance Act providing for adjustment measures, should the public debt limit exceed 50% of GDP and 55% of GDP[12].

Since 2011, the public debt according to the domestic methodology has remained above 50% of GDP. Therefore, the Draft Budget Acts for the years 2012 and 2013 have had to be prepared in a manner ensuring the preservation of the state budget deficit to state budget revenues ratio at a level no higher than in the previous year. The 2013 Draft Budget Act

[11] At the session of the Parliament held on 12 October 2012.

[12] Adjustment measures appropriate in such cases must also be undertaken by local government units which additionally have to comply with their own rules. The most important one is the debt to revenue ratio limit set at 60%.

meets this condition, largely owing to the adopted level of subsidies payable to the Social Insurance Fund. This level is too low to finance the gap between the Social Insurance Fund's contribution revenues and the Fund's expenditure, even taking into account the planned use of funds of the Demographic Reserve Fund[13]. The remainder of the gap is to be financed with a state budget loan[14], recorded as a financing transaction not increasing the state budget deficit.

The temporary fiscal rule defined in the Public Finance Act is a tool aimed at curbing the flexible expenditure of the state budget; however, savings resulting from the application of this tool are relatively small due to a large share of fixed expenditure in the total of expenditure[15].

Since 2008, the deficit of the general government sector in Poland has exceeded 3% of GBP. Therefore, the Council of the European Union decided to put Poland under the Excessive Deficit Procedure (EDP) setting the date for its correction for 2012. According to the fiscal notification published in October 2012, the Ministry of Finance expects the general government deficit to reach 3.4% of GDP in 2012.[16]

In line with the requirements of the EU's Stability and Growth Pact, Poland has adopted a medium-term budgetary objective (MTO), pursuant to which the structural balance of public finances should be -1% of GDP. This objective, if achieved, would ensure long-term fiscal sustainability and an appropriate safety margin, providing room for the operation of the so-called automatic stabilizers in the economy without breaching the fiscal rules laid down in the Lisbon Treaty and the Constitution of the Republic of Poland. According to the NBP's estimates, the 2013 structural public finance deficit will be close to 3% of GDP. Consequently, in order to reach the medium-term objective it is necessary to continue consolidation measures in the subsequent years. In the *Public Finance Sector Debt Management Strategy* attached with the Draft Act, the government reiterates its declaration to introduce to the national legislation the so-called permanent expenditure rule aimed to stabilize, in the medium period, the nominal balance of the general government in relation to GDP at a level corresponding to the medium-term budget objective.

[13] The Draft Act provides for supplying the Social Insurance Fund with funds from the Demographic Reserve Fund, although such funds were originally planned to be used to mitigate fiscal consequences of the society aging process in the coming decades. The depletion of these funds at present is not beneficial to long-term fiscal sustainability.

[14] According to the Social Insurance Fund's financial plan appended with the Draft Act, in 2013 the Fund's obligations resulting from state budget loans are supposed to go up by PLN 4.8 billion.

[15] The Draft Act does not provide any information on the volume of legally determined and flexible expenditure of the state budget. According to the NBP's estimates, flexible expenditure is to reach approx. PLN 99 billion in 2013, or less than 30% of the total expenditure.

[16] Taking into account the deficit adjustment for the costs of the pension reform, provided for under the Stability and Growth Pact, this would allow meeting the requirements of the Excessive Deficit Procedure if the deficit reduction is sustainable.

V. Public debt and financing of borrowing needs

During the global economic crisis, the public debt to GDP ratio rose in Poland; however, the scale of the increase was markedly lower than in most EU member states and other developed countries. At the end of 2011, public debt as defined in the Public Finance Act reached 53.6% of GDP (and 56.4% of GDP in ESA95 terms). In 2012 those values are expected to go down on the back of a reduction in the primary public finance deficit, a favourable ratio of average interest on public debt to nominal GDP growth and an appreciation of the zloty exchange rate from a relatively weak level recorded at the end of 2011. In line with the *Public Finance Sector Debt Management Strategy in the years 2013-2015,* at the end of 2012 the state public debt is supposed to reach 52.4% of GDP (public debt in ESA95 terms – 55.5% of GDP).

According to the *Strategy*, the year 2013 is expected to bring further reduction in the state public debt to GDP ratio, down to the 51.4% of GDP. Thus, the debt ratio would move away from the second prudential threshold laid down in the Public Finance Act. In the opinion of the Monetary Policy Council, this scenario is subject to a certain risk, mainly related to the situation in the external environment of the Polish economy.

The growing public finance imbalance driven by the economic downturn boosted the Treasury borrowing requirements. However, the scale of the increase was limited, as some of the increase in the deficit in the years 2009-2010 was recorded by entities other than the state budget. In 2011, the borrowing needs fell sharply, partly on the back of a one-off factor in the form of introduction of centralised liquidity management. Since in 2012 this measure will have no material impact on the reduction of the Treasury borrowing needs, these needs may be expected to rise. Their net amount will be PLN 37.9 billion, whereas gross amount will reach PLN 168.5 billion. The year 2013 is expected to see a rise in net borrowing needs up to PLN 45.7 billion and a drop in gross borrowing needs[17] – down to PLN 145.0 billion.

The conditions for financing Treasury borrowing needs which prevailed in 2012 may be assessed as favourable. This is corroborated by the yield on 10-years Treasury bonds falling below 4.5%, a record high presence of foreign investors in the domestic Treasury securities market and the extension of average maturity of Treasury securities to 4.4 years. These phenomena may be attributed to investors shifting to the emerging markets in search of higher rates of return as the bonds issued by the euro area peripheral countries are deemed too risky, and the yield on bonds in markets traditionally deemed as “safe havens” fall to very low if not negative levels. Moreover, a change can be observed in the perception of emerging countries by financial markets, as these economies have proved to be more resilient to crisis than advanced ones. In the case of Poland, an additional factor on the one hand attesting to sound foundations of the economy, and, on the other hand, providing protection in the case of financial market turmoil is the so-called Flexible Credit Line (FCL) granted by the International Monetary Fund.

[17] Net borrowing needs is the amount of funds necessary to be obtained from the financial market in order to finance the state budget deficit and other items (inter alia, European funds balance, income from privatization balance) with the exclusion of debt refinancing. Gross borrowing needs additionally include the previous years’ debt falling due and payable in a particular year, for the repayment of which new debt has to be issued.

The above mentioned changes may be, to some extent, a long-lived phenomenon and persist also in 2013. At the same time, due to strong economic links with the euro area, the Polish financial market is sensitive to the risk of possible further turmoil in the eurozone. This constitutes an uncertainty factor for borrowing needs financing in 2013. Safe financing of the state budget will be supported by the reduction of gross borrowing needs to just 8.6% of GDP, the lowest level recorded in many years[18]. The targeted borrowing needs level is lower than in most of EU member states. According to IMF data[19], borrowing needs of the entire public finance sector in 2013 will reach 11.5% of GDP as compared to 12.3% recorded in the Czech Republic, 12.9% in Slovakia, 18.9% in Hungary and the EU average of 13.0% of GDP[20].

[18] In the years 2006-2012, the average level of gross borrowing needs was 11.4% of GDP.
[19] IMF Fiscal Monitor, October 2012.
[20] The average for 23 EU member states for which such data are presented by the IMF (with exclusion of Estonia, Luxembourg, Cyprus and Malta).