18 November 2014

# Opinion of the Monetary Policy Council on the 2015 *Draft Budget Act*

The assessment of the government's plans concerning fiscal policy is of paramount importance, as fiscal policy needs to be coordinated with monetary policy in a way which will help, to the extent possible, to keep the economy on a sustainable growth path and bring inflation back to the target.

In this Opinion, the MPC takes into account the consequences of adopting fiscal measures presented in the *Draft Budget Act* for the entire economy. Since, similarly to the previous years, the *Draft Act* does not cover all the units of the general government sector, this Opinion also takes into account other official government documents, statements by government officials, as well as estimates and forecasts developed by NBP.

## I. Macroeconomic assumptions of the *Draft Budget Act*[1]

In accordance with the *Justification to the 2015 Draft Budget Act*, economic growth will amount to 3.4% y/y in 2015, which will be driven by an acceleration in economic growth abroad as compared with 2014. Although the NBP's July inflation projection assumed a similar growth rate, in the light of the currently available data and forecasts, it has become more likely, that in 2015 economic growth across the world, and, consequently, in Poland, will be below the assumptions adopted in the *Justification*.

According to the *Justification*, domestic demand, in particular private consumption and gross fixed capital formation, will be the primary growth factor behind economic growth in 2015, while the contribution of net exports will be negative. The predominant role of domestic demand in GDP growth does not raise major objections of Narodowy Bank Polski and appears to be the most realistic scenario. However, taking into account considerable uncertainty in the global economy, notably in the euro area, as well as the worsening outlook for global demand, investment growth in the Polish economy may fall below the level assumed in the *Justification*.

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



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The forecast of growth in gross fixed capital formation presented in the *Justification* is mainly based on the assumption that private investment will increase. The acceleration in private investment growth in 2015 is justified by a relatively high cost competitiveness of Polish enterprises, lower cost of capital acquisition and a positive impact of government programmes. Indeed, these factors should support investment growth. However, in recent months, there have been some negative news from the Polish economy, pointing to a worsening in the economic climate in the industry and construction sectors. It should also be emphasized that the numerous signs of weakening economic growth in the euro area, including in Germany, are likely to have an adverse impact on the investment of Polish enterprises operating in the European system of technological production links. In the opinion of Narodowy Bank Polski, these data reduce the likelihood that investment growth will accelerate to 7.4% in 2015, as assumed by the Ministry of Finance.

According to the assumptions of the *2015 Budget Act*, in 2015 there will be a slight acceleration in private consumption growth (up to 3.0%), while public consumption growth will fall (to 2.2%). In the opinion of NBP these assumptions are realistic and generally consistent with the central bank's forecasts. Further growth in private consumption will be supported by rising real households' income from paid employment as well as employment and wage growth. Consumption will also be supported by the change in the pension indexation rate and in the child tax relief. On the other hand, a slightly lower public consumption growth results from the implementation of public finance consolidation plan.

According to the *Justification*, imports will accelerate in 2015, expected to be driven by rising domestic demand. At the same time, it has been assumed that exports growth will stabilize on the back of a moderate improvement in the external business climate, as a result of which the contribution of net exports to growth will remain negative in the coming year. While the forecast of contribution of net exports to growth does not raise objections, NBP is of the opinion that the volume of foreign trade may be lower next year. This may be driven, on the one hand, by slower investment growth, and, on the other, by weaker than assumed in the *Justification* economic climate abroad that will be curbing exports growth.

The *Justification* assumes a moderate improvement in the labour market in 2015, which will be driven by a positive, albeit weaker than in 2014, employment growth and gradually rising nominal wages in the corporate sector. The scale of the improvement will be limited by a wage bill freeze in the central government subsector. In the light of the current NBP forecasts and in line with the *Justification*, the improvement in the labour market will slow down and the growth of the wage bill in the economy in 2015 will be similar to that observed in 2014.

According to the *Justification*, a sharp fall in inflation in 2014 was largely caused by supply shocks in the food and energy markets, accompanied by low demand pressure, which is reflected in low core inflation. In 2015, as the expected economic rebound materialises and the supply shocks recede, CPI inflation will rise – while still running low. These assumptions are in line with NBP forecasts, according to which the persistence of the negative output gap will mean the absence of inflation pressure.

## II. Fiscal Policy in 2015

Since 2011, the developments in public finance have been determined by the process of fiscal consolidation, with the pace of deficit reduction gradually slowing down. In 2011-2012, far-reaching fiscal adjustments were carried out, which weakened economic growth, in particular as a result of cuts to public investment. A contractionary fiscal policy was continued, on a smaller scale, in 2013.

In 2014, the balance of the public finance sector will improve. According to the forecast of the Ministry of Finance published in the autumn fiscal notification, the deficit in ESA2010[2] terms will decline from 4.0% of GDP in 2013 to 3.3% of GDP in 2014. The improvement will, however, result largely from changes introduced to the Open Pension Funds (OFE) system. The revenues of the Social Insurance Fund (FUS) will increase as a result of 83% of OFE participants having opted out from continuing to transfer their social contributions to OFE. Meanwhile, the transfer of OFE assets to FUS carried out in February 2014 results in lower interest payments on public debt.

According to the NBP estimates, the part of fiscal policy which impacts aggregate demand in the economy (i.e. adjusted for the impact of changes in OFE), should have an almost neutral influence on the business cycle in 2014. Fiscal policy is therefore less

[2] The change of the national system of accounts from the ESA95 to the ESA2010 system, which entered into force in autumn 2014, slightly improved the picture of public finance. The average nominal deficit of the general government sector in 2010-2013 (in the October 2014 fiscal notification as compared with the April 2014 notification) was revised downward by PLN 1.8 billion (the revision for 2013 not only accounted for the effects of implementing the ESA2010 system, but was also due to updating of the source data), while the nominal GDP from 2010-2013 was revised upward by an average of 1.5%. As a consequence, the deficit to GDP ratio decreased by an average of approximately 0.2 percentage points and the public debt to GDP ratio - by 1.3 percentage points.



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contractionary, than estimated by the NBP in the autumn of 2013. This change is largely due to lower-than-assumed inflation. Lower inflation implies that a given level of nominal government expenditure assumed in the *2014 Budget Act*, translates into higher real expenditure, leading to a higher level of the general government deficit as well as the structural deficit. According to the NBP estimates, the difference between the previously forecasted and the currently expected rise in prices in 2014 leads to the reduction of the scale of fiscal tightening in 2014 by 0.3 percentage points of GDP.

The outlook for the fiscal policy stance in 2015, arising from the *draft Act*, is very close to that seen in 2014. The increase in cash deficit of the state budget as presented in the draft results mainly from one-off payment for F-16 aircraft and increase in the budget subsidy to FUS.

Neither of above mentioned factors, however, affects the level of the ESA2010 general government balance.[3] A gradual improvement of the latter balance may be expected next year. It will be driven once again by changes in the functioning of OFE, leading to a rise in FUS revenues from contributions and a decline in interest payments on public debt. As the changes became effective in the course of 2014, their full impact will be seen in 2015. According to the Ministry of Finance forecasts, the ESA2010 general government deficit, is expected to decline to 2.5% of GDP. In the opinion of NBP, the risk of materialization of a less favourable macroeconomic scenario may translate into a slightly higher deficit. However, its reduction in 2015 below 3% of GDP, in line with the EDP requirements, does not appear to be at risk.

The change in the primary structural balance of the public finance sector, adjusted for the impact of the changes in the pension system will again be close to zero. The following factors will work towards reducing the general government deficit: continued wage freeze in the government sector, phasing out domestic single area payments for farmers and introduction of minor changes aimed at improving tax compliance. However, the effects will be weakened by measures increasing the deficit: raising the pension indexation rate for most pensioners, modifications in the calculation of child relief for income tax purposes, and a slight rise in expenditure on co-financing of EU

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[3] The ESA system of national accounts is based on the principle of accrual accounting according to which the purchase of military equipment is recognized when the equipment is delivered and not when the payment is made. This means that the purchase of the F-16 aircraft increased the expenditure of general government in 2007-2009. The increase in subsidies to FUS in 2015 largely results from lower (by over PLN 7 billion) FUS revenues associated with the changes in the pension system (cash from interest and redemption of non-Treasury debt instruments transferred from OFE and the "security slider").



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projects related to the overlapping of funds utilization in 2015 under two EU financial frameworks.

## III. Assessment of macroeconomic impact of fiscal policy

Fiscal policy measures described in Part II will be broadly neutral to economic growth, CPI inflation and potential output in the years 2015-2016. These measures will cause only minor shifts in the structure of domestic demand. Simulations conducted by NBP[4] show that they will put an upward pressure on gross fixed capital formation while dampening public and private consumption.

Domestic demand growth will be hampered by maintaining of the wage freeze in the government sector in 2015. As well as directly curbing public consumption, it will also have an indirect adverse effect on private consumption – through a reduction in income from paid employment. In 2015, fiscal policy will be conducive to higher gross fixed capital formation. As the funds start to be used under the new 2014-2020 EU financial framework, there will be a slight rise in public investment co-financed with EU transfers. The bidirectional and small-scale impact of the above fiscal measures on domestic demand will be largely offsetting and thus will have no material impact on the future path of economic growth.

Since the fiscal measures announced in the *Draft Act* are almost neutral to domestic economic conditions – and hence to demand pressure in the economy – they have no significant impact on CPI inflation in the medium term.

NBP is of the opinion that the impact of fiscal measures on the production capacity of the Polish economy will be rather insignificant. On the one hand, increased public investment spending will have a lagged boosting effect on the capital stock in the economy. This positive influence will be offset by an adverse labour market impact of the so-called tax wedge resulting from the freezing of PIT thresholds (which may raise the equilibrium unemployment rate in the economy).

## IV Fiscal imbalance in 2015 and compliance with fiscal rules

The *Draft Act* is the first budget draft to have been prepared under the so-called stabilising expenditure rule (SER). The rule was designed in such a way as to operate

[4] Holding the assumption of no adjustment on the monetary policy side.



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counter-cyclically, helping to stabilise the general government deficit at 1% of GDP, and the public debt at 43% of GDP.

There are two disciplining modes of the rule. If the general government deficit exceeds 3% of GDP, or the public debt to GDP ratio exceeds 48%, a more restrictive version of the rule applies. In such a scenario, the acceptable real growth of public expenditure must be at least 2 percentage points below long-term average GDP growth, regardless of the current state of the economy. A milder version applies if the general government deficit is lower than 3% of GDP, and public debt exceeds 43% of GDP, but remains below 48% of GDP; or when the debt is lower than 43% of GDP but the balance of the so-called control account[5] is under -6% PKB. In such circumstances, the required adjustment in real expenditure growth as compared to the long-term average GDP growth is 1.5 percentage points, and the adjustment is suspended when the economy is in a marked slowdown (the forecast GDP growth is at least 2 percentage points below its long-term average).

Since the general government deficit exceeded 3% of GDP in 2013, the restrictive version of the rule applies to the 2015 budget. Thus, expenditure growth must be 2 percentage points lower than long-term average GDP growth. According to the *Justification to the Draft Act*, the level of expenditure adopted in the *Draft* meets this requirement[6].

The changes introduced to the pension system in 2014, resulting in higher revenue of the Social Insurance Fund, have significantly facilitated the fulfilment of the SER in 2015. As spending limits were being set under SER, this increase in revenue was treated as a discretionary change on the revenue side of the general government sector, raising the allowed level of expenditure.[7] Moreover, a one-off reduction in public debt related to the transfer of assets from Open Pension Funds (OFE) to the Social Insurance Institution (ZUS) reduced the expenditure on interest payments, thus enabling a relatively faster growth of all the other spending categories. Interest payments in 2014-2015 are in addition declining due to the fall in Treasury yields observed since 2012.

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[5] The control account is a register of past deviations of the general government balance from the target of -1% of GDP.

[6] The Draft Act does not contain detailed information on the expenditure of all the entities covered by the rule, in particular, local government units, the National Health Fund and the National Road Fund or the remaining funds deposited with the BGK Bank.

[7] According to Art 112aa of the Act on Public Finance, the limit of expenditure under the SER is adjusted for the " total forecasted value of discretionary activities (...) relating to taxes and social insurance contributions".



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Apart from the changes to the pension system, there have been other discretionary measures taking effect in 2014-2015 which have affected the level of 2015 expenditure limits. The estimated aggregate size of their effect shown in the *Justification to the Draft* is higher than NBP estimates[8].

The above-mentioned factors facilitating the implementation of the SER's recommendations[9] lead to a situation where the rule is complied with in 2015 despite the absence of an actual fiscal tightening (see part III of the Opinion). However, as these factors are of a temporary character, the observance of SER will be more difficult in the future. With the level of government public debt standing at 46.5% of GDP[10], in order to bring the debt-to-GDP ratio down to 43% of GDP, it will be necessary to progressively tighten fiscal policy for the next four to five years. During this period, numerous new sources of upward pressure on public expenditure may arise, hindering the fulfilment of the rule.

As a result of the fiscal adjustment measures introduced by local governments, these units posted a budget balance close to zero in 2013, i.e. the best result since 2007. In the following years local government spending may be expected to rise, which will translate into a lower level of the so-called expenditure sub-limit established by the stabilising expenditure rule. This will pose an obstacle to drafting a budget compliant with the rule. The above mentioned increase in expenditure may result from, among others, financing of projects co-financed under the 2014-2020 EU financial framework. Taking into account the current status of preparations for the absorption of these funds, as well as the path of the 2007-2013 framework implementation, it may be expected that local government units will not start drawing on those funds on a large scale until 2016.

[8] The difference results partly from the fact that the *Justification* includes the effect of the amendments passed in April 2014 which limit the scope for VAT deductions on company cars and fuel, without accounting for the effect of the extension of the scope of such deductions at the beginning of 2014 related to the expiry, at the end of 2013, of the derogation concerning the use of limitations to VAT deductions in relation to cars purchased.

[9] The level of the 2015 expenditure is also affected by a one-off factor which complicates compliance with the SER rule, namely the payment of an instalment for the F-16 planes amounting to PLN 5.4bn. Nevertheless, the impact of this factor is smaller than that of the factors listed in the text which are conducive to observance of the SER rule.

[10] In accordance with *The Public Finance Sector Debt Management Strategy in the Years 2015-2018* , the ratio of government public debt to GDP is expected to stand at 47.7% at the end of 2014. However, in the context of the SER, the relevant public debt figure is one where the value of foreign-currency debt is calculated using average annual exchange rates and is additionally adjusted by deducting the amount of cash held by the government for the purpose of financing of the borrowing requirement of the state budget in the following year (see Art. 38 a(4) and Art 112aa(4) of the Act on Public Finance).



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A rise in spending related to co-financing of projects under the 2014-2020 EU framework may also be expected at the central government level, in particular as a result of implementation of investment projects scheduled under the National Road and Motorway Construction Programme. Other factors which might hinder the observance of SER include: wage pressure resulting from the freeze on government sector wages, which has been in place since 2011; the expiry in 2017 of the temporary increase in the VAT rate of 1 percentage point; and the rising share of people who have reached retirement age in the general population.

The changes in the functioning of the Open Pension Fund introduced in 2014 and a decline in interest payments on Poland's sovereign debt, largely driven by global factors, have provided some additional fiscal space. According to the NBP estimates presented in part III of the Opinion, this has been used to ensure that in the years 2014-2015 a moderate improvement of the budget balance is achieved without fiscal policy tightening. The adoption of such a strategy can be considered from two vantage points.

First, it should be analysed to what extent the postponement of the fiscal adjustment is justified by the current economic situation at home and abroad. Weak growth prospects in the external environment of the Polish economy, contributing to the persistence of a negative output gap, constitute an argument against a more restrictive policy, as such a policy would be pro-cyclical. A similar situation is observed in most developed countries, many of which, as indicated by IMF forecasts, have opted for a counter-cyclical fiscal expansion in the years 2014-2015. On the other hand, the size of the imbalance in Poland's public finance remains relatively high. The 2015 structural deficit (approx. 2.5% of GDP) will still be too high to ensure the reduction of the public debt to GDP ratio. Furthermore, the timing of the global economy's return to a path of faster growth remains uncertain and may be further delayed. The strategy of postponing fiscal adjustments therefore entails a risk that it will be difficult to maintain the public debt to GDP ratio at a safe level in the future.

The second aspect of the assessment of the adopted strategy concerns the implications of the fact that the expenditure rule was adhered to with the help of favourable factors of a temporary nature. As indicated above, the stabilizing expenditure rule imposes a rather demanding blueprint for fiscal policy, which in the past has rarely been implemented in Poland. The credibility of the new expenditure rule will depend on its strict and transparent implementation in the future.



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## V. Public debt and financing of borrowing needs

The 2014 transfer of assets from the Open Pension Fund to the Social Insurance Fund (FUS) reduced the public debt according to the national methodology by approx. 7.7% of GDP, and the debt of the general government sector in ESA terms by 8.6% of GDP. At the same time, the share of debt denominated in foreign currencies increased, while the Public Finance Sector Debt Management Strategy in the Years 2015-2018 assumes it will be reduced again in the medium term to the level below 30%.

The *Draft Act* provides that in 2015 the net borrowing requirement of the Treasury will amount to PLN 54.0 billion (3.0% of GDP) and the gross borrowing requirement to PLN 154.8 billion (8.7% of GDP). Thus, the borrowing needs will be higher than their anticipated outturn in 2014 (PLN 47.4 billion and PLN 126.8 billion respectively), which is reduced by one-off effects related to changes in the pension system. The gross borrowing requirement will, however, be relatively low as compared to the previous years and other countries. According to the IMF, the sovereign gross borrowing requirements in Poland will amount in 2015 to 8.5% of GDP and will be lower than the EU average of 12.5% of GDP[11], slightly higher than in Slovakia (6.1% of GDP) and the Czech Republic (7.8% of GDP), and much lower than in Hungary (19.6% of GDP).

In the recent years, the conditions of financing the state budget borrowing requirements were significantly impacted by increased inflow of foreign investors to the domestic Treasury securities market. The above-mentioned asset transfers from the Open Pension Fund to the Social Insurance Fund (FUS) have increased the share of government bonds held by foreign investors. Economic research shows, that an increase in the share of foreign investors is associated with a decline in the average yield on Treasury securities, but at the same time it may lead to greater yield volatility[12]. Nevertheless, regardless of short-term fluctuations in market valuation of government securities, fundamental factors will be crucial for safe financing of the borrowing requirement. Poland belongs to the group of countries rated highly in this respect, due to the absence of significant imbalances in the economy, relatively high economic growth and low public debt as compared to other countries of the European Union. This is

[11] The arithmetic mean values for the 22 countries for which data are available (excluding the Baltic States, Luxembourg and the countries subject to international assistance programs - Greece and Cyprus).
[12] This effect was seen in Poland in mid-2013 when, as a result of concerns about the withdrawal of the Federal Reserve's quantitative easing program, emerging markets observed an outflow of capital.

confirmed by high and stable ratings of rating agencies. Since the outbreak of the global financial crisis, the Polish debt rating has seen a relative improvement as compared to the EU average.



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