6 November 2020

Opinion of the Monetary Policy Council on the *2021 Draft Budget Act*

At its meeting on 28 September 2020, the Council of Ministers adopted the *2021 Draft Budget Act*. The Act on Narodowy Bank Polski (Article 23, Journal of Laws 2019, item 1810, consolidated text as amended) obliges the Monetary Policy Council (MPC) to submit its opinion concerning the draft budget act.

The Opinion of the Council on the *2021 Draft Budget Act* contains an assessment of the envisaged shape of fiscal policy, which is of major significance due to the need to coordinate fiscal and monetary policy in a manner which will facilitate, to the extent possible, keeping the economy on a sustainable growth path and stabilising inflation around the NBP medium-term target. While drawing up the *Opinion*, the MPC pays particular attention to the macroeconomic assumptions of the *Draft Ac*t, the expected impact of fiscal policy on the economy, and the outlook for fiscal sustainability.

In the MPC's assessment, the *Draft Act* is based on realistic macroeconomic assumptions, although due to the pandemic, there persists elevated uncertainty about economic outlook in 2021. According to the *Draft Act* and current economic forecasts, after a substantial rise in 2020, the general government deficit may be expected to decrease in 2021. In 2021, economic policy should continue to prioritize supporting the return of the economy on the path of sustainable growth, while simultaneously preserving the sustainability of public finances.

I. Macroeconomic assumptions of the *Draft Budget Act*

In 2020, the Polish economy has been subject to major economic shocks due to the COVID-19 pandemic. In the first half of the year many countries, including Poland, experienced a strong decline in economic activity on the back of a rapid deterioration in the global economic climate, the imposed epidemic restrictions and a very substantial decline in sentiment. In 2020 Q3, following the easing of restrictions and implementation of anti-crisis measures, economic conditions rebounded. However, in 2020 Q4 the epidemiological situation deteriorated considerably, substantially increasing the risk of a new weakening in the economic climate.

The major swings in the economic situation observed throughout the year, along with the risks related to the future path of the pandemic, increased the uncertainty of forecasts of activity growth in the coming year. While evaluating the assumptions about the key macroeconomic variables contained in the *Draft Act*, it is necessary to take into consideration the persistent uncertainty about the scale of the expected recovery in 2021 and the permanence of the impact of the pandemic on the pace of economic growth, including growth of consumption and investment.

In the *Justification* to the *2021 Draft Budget Act* it was assumed that real GDP growth in 2021 will run at 4.0%, against a decline of 4.6% in 2020.

In line with the macroeconomic assumptions adopted in the *Draft Act*, private consumption will be the key driver of growth in 2021. The *Justification* states that the increase in this category, following the fall in 2020, will be supported by rising disposable income of households. This will be related to the assumed gradual improvement in labour market conditions, i.e. accelerated real wage growth and slower decline in average employment in the economy compared to 2020. Another factor driving domestic demand growth in 2020, outlined in the *Draft Act*, will be gross fixed capital formation. However, investment demand is not expected to fully recover, following a sharp decline in this category this year. The *Justification* assumes that investment growth in 2021 could be stimulated by the new financial instruments of the European Union developed in response to the COVID-19 pandemic. Moreover, the *Draft Act* states that the contribution of net exports to GDP growth will be close to zero in 2021. In the assessment of NBP, current data and forecasts show that the adopted scenario for the path of GDP growth and its structure may be considered realistic, despite the persistent high uncertainty about the scale of recovery in the coming year, including the development of investment. At the same time, it can be deemed that there exists a risk of GDP growth in 2021 proving slower than assumed in the *Draft.*

The *Draft Act* assumes the annual average inflation of consumer goods and services to decline in 2021 in relation to 2020 and stand at 1.8%. The November NBP projection also points to a lower inflation next year compared to 2020, although the scale of the decline in price growth may be somewhat smaller than assumed in the *Draft Act*. According to the

November NBP projection, inflation in 2021 will run close to the NBP inflation target. Factors with a downward effect on inflation will include the limited scale of the domestic demand recovery, slow price growth in Poland's external economic environment and the moderate growth of unit labour costs in the domestic economy. On the other hand, there may be an upward pressure on price growth stemming from regulatory factors, including the introduction of the energy capacity fee[1] and the sugar tax[2], as well as possible rises in waste disposal charges.

II. Situation of public finances in 2020

The starting point for the assessment of fiscal policy outlined in the *Draft Budget Act* is the performance of public finances in 2020. As a result of the COVID-19 pandemic and the measures implemented by the government in order to contain it, fiscal policy has been loosened substantially. Firstly, a comprehensive fiscal anti-crisis package has been introduced, aiming, above all, at curbing the long-term adverse economic effects of activity decline, including halting a wave of bankruptcies and limiting the risk of a rise in long-term unemployment. The package encompasses, among others, subsidies to enterprises disbursed by the Polish Development Fund (PFR), wage subsidies, exemption from social security contributions, loans to the self-employed, work suspension benefits and solidarity allowances. Secondly, the pandemic-driven drop in economic activity led to a deterioration in the general government balance due to the operation of the so-called automatic stabilisers. In total, the deficit of the general government in ESA2010 terms amounted to 4.4% of the annual GDP[3] in the first half of 2020, with the cost of the anti-crisis measures implemented in that period accounting for approx. 3.2% of GDP, according to NBP estimates. It needs to be pointed out that the anti-crisis measures reduced the scale of the recession in 2020 and will contribute to faster growth in 2021.

In line with the government's forecast contained in the autumn fiscal notification,[4] the general government deficit for the entire year 2020 is to stand at 11.8% of GDP. With the

[1] Act of 8 December 2017 on the power market (Journal of Laws of 2020, item - consolidated text, item 247, as amended).
[2] The so-called sugar tax includes charges levied on the sale of: (i) beverages with added sugars or sweeteners, caffeine or taurine; (ii) alcoholic beverages with a nominal volume not exceeding 300 ml. See also Act of 14 February 2020 on the amendment of certain acts in connection with promotion of healthy consumer choices (Journal of Laws, item 1492).
[3] All figures related to GDP presented in this document have been estimated on the basis of the forecasts of nominal GDP in 2020 contained in the *Justification* to the *Draft Act*.
[4] See also. *EDP notification tables – October 2020*.

termination of most anti-crisis measures launched in response to the first wave of the pandemic, in particular the exhaustion of one-off support forms, and the economic activity pick-up in 2020 Q3, the situation of the public finance could have been expected to improve in the second half of 2020, and the whole-year headline deficit to be substantially lower than assumed by the government. However, the second wave of COVID-19 infections raised the uncertainty of macroeconomic and fiscal forecasts, and of the fiscal outcome for the entire year.

III. Fiscal policy in 2021

Based on the *Draft Budget Act*, and taking into account legislation currently in force, as well as current macroeconomic forecasts, the general government deficit may be expected to decline in 2021. This anticipated decline in the deficit is to result, above all, from the fading of one-off anti-crisis measures launched in 2020 (this effect will reduce the sector's deficit by more than 3 percentage points of GDP).[5] At the same time, it needs to be pointed out that although the bulk of the support has been provided in 2020, firms will continue to draw on it also in the subsequent years.

When analysing the levels of public expenditure not directly related to combatting the pandemic or anti-crisis measures provided for in the *Act*, the rate of spending growth may be expected to be slower than observed in recent years. This refers in particular to current government spending (on wages and purchases of goods and services), whose growth will slow down due to, among other things, the freeze on government sector wages. This is indicated by the amount of budgetary units' current expenditure planned in the *Draft Act*, which is 5.4% higher than that provided for in the amended *2020 Draft Budget Act,* while this expenditure category had been planned (in the *Budget Act* before its amendment) to increase by 7.7% y/y in 2020. In 2019, in turn, this expenditure was realized at a level 8.5% higher than the year before.

Growth in public gross fixed capital formation may also be expected to be slower in 2021 than in 2020 (in the first half of 2020 the nominal growth of public investment was 13.2% y/y) – which will be related, among others, to a gradual exhaustion of EU funds under the 2014-2020 framework. On the other hand, investment growth may benefit from

[5] The cited estimates do not take into account the anti-crisis measures targeted at businesses and entrepreneurs announced by the Prime Minister on 4 November 2020. At least some of these measures will have an impact on the ESA-terms public finance performance also in 2021.

the use of European funds for post-pandemic economic recovery (in particular, the so-called Recovery and Resilience Facility), with the proviso that due to the ongoing negotiations in this area and the novel character of these funds, it will not be possible to forecast the amounts available until the National Recovery Programme has been presented.

On the other hand, total spending will be boosted by higher social benefits – after adjustment for one-off anti-crisis measures these will increase by 7.7% y/y according to NBP forecasts. This will be driven, among others, by the payment of the so-called 14th pension.[6]

The changes on the revenue side provided for in the *Draft Act* will contribute to a slight tightening of fiscal policy in 2021, with the basic tax rates being maintained at the current level. As of the beginning of 2021, the introduction of the so-called energy capacity fee charge and sugar tax is envisaged, as well the end of the suspension of the retail sales tax and the inclusion of limited partnership companies under the CIT scheme. In turn, the implementation of a new model of settlement of corporate income tax (the so-called Estonian CIT – a lump sum tax on corporate income) may translate into an expected temporary dip in the revenue of the state budget and local governments in the short term.[7]

IV. Fiscal imbalance in 2021

As indicated above, the significant rise in the public finance deficit observed in 2020, to an overwhelming degree results from the anti-crisis measures introduced by the government and the response of fiscal variables to the decline in economic activity. i.e. the operation of the so-called automatic stabilisers. Thereby, the increase in the fiscal imbalance resulting from these factors is not permanent, and the deficit of the sector will diminish once they have faded.

[6] See also the government's draft act on the subsequent additional cash benefit for pensioners in 2021 (Sejm print no. 280).

[7] In line with the estimates contained in the Regulatory Impact Assessment of the draft, its entry into force will translate into a revenue loss for the state budget and local government units of about PLN 6 billion per year in 2021 and 2022 and about PLN 3 billion in 2023. In 2024, the changes are to be neutral, and from 2025 onwards, an increase of approximately PLN 1 billion per year in the revenue of the public finance sector is expected.

Despite the expected decline in the general government deficit, the structural deficit may be expected to be higher in 2021 than in the years preceding the onset of the pandemic. However, under the present macroeconomic conditions – including the forecasted continuation of a negative output gap and higher unemployment than in previous years – an overly fast reduction in the public sector deficit might have an adverse effect on the pace of return of the economy to the sustainable growth path, thus making it more difficult to maintain sustainability of public finances in the medium term.

Economic policy in 2021 should continue to prioritise the return of the economy to the sustainable growth path, the protection of the productive capacity of the Polish economy and containment of negative economic impact of the pandemic on the economy, including on the labour market. Such a fiscal stance will be consistent with, among others, the decisions of the EU authorities to suspend the rules of the Stability and Growth Pact in 2020 and 2021.

In the following years, it will be warranted to undertake measures to further reduce the deficit of the public finance sector, including the structural deficit and take steps enabling the reduction of the public debt-to-GDP ratio, so as to create the space for employing fiscal policy to cushion the impact of negative macroeconomic shocks in the future.

V. Public debt and financing of the borrowing requirement

Due to the decline in economic activity and the launching of anti-crisis measures, the public debt-to-GDP ratio will rise substantially in 2020. *The Public Finance Sector Debt Management Strategy in the years 2021-2024* appended to the *Draft Act* envisages that in 2021 this ratio will increase further, albeit to a considerably lower degree than in the current year. In the subsequent years, the ratio of public debt-to-GDP is to gradually decline.

In 2020, the financing of the government's anti-crisis measures and the shortfall in tax income, driven by the decline in economic activity, called for a substantial increase in the borrowing requirement by general government units. The debt aimed to finance these needs was incurred primarily by the State Treasury, the PFR and the COVID-19 Counteracting Fund (FPC[8]). Notably, the PFR and the FPC are not part of the public finance sector within the meaning of the Act on Public Finance. Thus, the securities issued by those entities or on their behalf, despite being covered by State Treasury guarantees,

[8] Bond issues were conducted by Bank Gospodarstwa Krajowego on behalf of FPC.

are not included in public debt according to this Act. However, the debt of these entities – issued in order to finance the government's anti-crisis measures – is considered as general government debt in ESA2010 terms.

Bond issuance to finance anti-crisis measures occurred mainly in 2020 Q2, which translated into a material increase in public debt. In the first half of 2020, public debt (as defined in the Public Finance Act) increased from PLN 990.9bn (43.3% of GDP) at the end of 2019 to PLN 1097.3bn (49.1% of GDP forecast by the government for 2020). The general government debt, in turn, rose from PLN 1045.4bn (45.7% of GDP) to PLN 1256.0bn (56.2% of GDP) in the same period.

The scale of the increase in public debt may be expected to be substantially smaller in the second half of 2020 than in the first half of the year. This is indicated by a marked reduction in the bond issues by the State Treasury, BGK and the PFR in the domestic market – in 2020 Q3 these totalled PLN 51.0bn, against PLN 184.3bn in Q2. Moreover, in 2020 Q3, these entities held free funds to draw on when needed in the subsequent months – this in particular refers to the State Treasury, which, by end-September 2020 had accumulated PLN 122.8bn on the budget accounts. With these circumstances in mind, the forecasts of the public debt-to-GDP ratio as at the end of 2020 contained in *The Public Finance Sector Debt Management Strategy in the years 2021-2024* (public debt at 50.4% of GDP and the general government debt at 61.9% of GDP) may be deemed conservative.

As the borrowing needs of public sector units and those implementing government programmes increased, the conditions for their financing also changed, to a great extent in connection with anti-crisis measures implemented by Narodowy Bank Polski, including interest rate cuts and the purchase of Treasury bonds and bonds guaranteed by the State Treasury. They contributed to securing the liquidity of the secondary market for these instruments, and to a decline in bond yields , which – in the case of yields on 5-year Treasury bonds, i.e. ones whose maturity is close to the average maturity of State Treasury debt – at the beginning of the year exceeded 2%, while currently they are hovering below 0.5%. Lower yields translated, in turn, into lower average cost of public debt service. Although this process occurs with a lag, the decline in yields in 2020 was significant and it can be estimated to cause a reduction in the average rate of interest on public debt from 3.0% in 2019 to 2.5% in 2020. This, in turn, means that despite the rise in public debt referred to above, interest payments will decline in 2020. In 2019 the above-mentioned payments amounted to PLN 31.4bn in ESA2010 terms, whereas in 2020 – in accordance with the forecast of the Ministry of Finance contained in the autumn fiscal notification – they will reach PLN 30.2bn.

In *the Public Finance Sector Debt Management Strategy in the years 2021-2024* it is foreseen that the public debt-to-GDP ratio will rise further in 2021 and gradually decline in the subsequent years. In the opinion of NBP, the conservative forecast of this ratio is well justified under present circumstances. At the same time, the levels of public debt-to-GDP ratio in 2021 and beyond are fraught with uncertainty. This stems mainly from uncertainty concerning the effects of pandemic on the pace of GDP growth and the size of the sector's deficit in the subsequent years. Taking into account the expected low level of interest rates in Poland and abroad, the average interest rate on public debt will probably continue to have a downward impact on public debt growth. However, it is advisable to take measures which – after the shock of the pandemic and the resulting increase in public debt – will enable a gradual reduction of the public debt-to-GDP ratio in the medium term.