3 November 2021

Opinion of the Monetary Policy Council on the *2022 Draft Budget Act*

At its meeting on 28 September 2021, the Council of Ministers adopted the *2022 Draft Budget Act*. The Act on Narodowy Bank Polski (Art. 23, Journal of Laws 2020, item 2027, 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 *2022 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 at a level compatible with 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 conservative macroeconomic assumptions. Following a marked decline in the general government deficit in ESA terms in 2021, it may be expected to decline further in 2022. The reduction in the deficit will be primarily due to the expiry of the anti-crisis measures, supported by a favourable impact of economic activity on the situation of public finances. At the same time, fiscal policy in 2021 will contribute to higher consumer demand growth, especially through taxation changes under the "Polish Deal" programme.

I. Macroeconomic assumptions of the *Draft Budget Act*

In the *Justification* to the *2022 Draft Budget Act*, Poland's real GDP growth is assumed to decline to 4.6%, from 4.9% in 2021. According to the assumptions adopted in the *Draft Act*, economic growth in 2022 will primarily be driven by private consumption, supported by the rising real disposable income of households. The financial situation of households will benefit from the assumed improvement in the labour market and changes in taxation under the government's "Polish Deal" programme. In the opinion of NBP, the adopted assumptions concerning consumption growth may be considered realistic, although the growth of real disposable income will probably be hampered by the rise in the prices of fuels and energy carriers, which, given the relatively rigid demand for energy, will dampen households' real disposable income.

In line with the *Draft Act*, domestic demand growth is also to be supported by the continued recovery in investment demand, after its sharp decline in 2020. The *Justification* assumes investment growth in 2022 will be fuelled by the low cost of capital and government measures designed to support the economic recovery. According to the November NBP projection of inflation and GDP, the rate of investment growth in 2022 may be higher than assumed in the *Draft Act*; this difference results largely from the fact that the impact of the inflow of funds under the National Recovery Plan is unaccounted for in the Ministry of Finance forecast. At the same time, the *Draft Act* assumes that, like in 2021, GDP growth in 2022 will be hampered by the negative contribution of net exports, which is in line with the historically observed countercyclical behaviour of this category and with NBP expectations. In sum, in the assessment of NBP, current data and forecasts indicate that the adopted scenario for the pace and structure of economic growth in 2022 may be regarded as realistic.

In the *Draft Act* it was assumed that the average annual rate of consumer inflation will decline in 2022 compared to the 2021 level, running at 3.3%. The macroeconomic scenario presented in the *Justification* assumes that the impact of factors related to the COVID-19 pandemic on CPI inflation will fade, and there will be no more supply shocks which might affect the prices of food and energy commodities. On the other hand, the *Draft Act* indicates that the scale of the reduction in price growth in 2022 may be limited due to the further strengthening of GDP growth. NBP also expects that some of the factors currently boosting inflation will fade in 2022. However, the severe supply shocks observed this year, including very steep price rises in commodity markets, may shift consumer price growth substantially upwards also in 2022. In the November NBP projection of inflation and GDP it was assumed that the increase in the prices of CO_2 emission allowances, coupled with the lagged adjustment of global commodity prices to previous increases, will contribute to maintaining high growth in energy prices in 2022. Food price growth in 2022 may also remain elevated, due to the anticipated substantial rise in production costs, including those of animal feed, energy and artificial fertilisers. To sum up, in the opinion of NBP, due to the impact of the above factors of an exogenous character, it is highly likely that in 2022 CPI inflation will be substantially higher than assumed in the *Draft Act.*

II. Situation of public finances in 2021

The starting point for the assessment of the fiscal policy described in the *Draft Budget Act* is the situation of public finances in 2021. In the first half of 2021, the general government deficit in ESA2010 terms was a mere 0.2% of the full-year GDP forecast for 2021, which was one of the best results among the European Union countries – the average deficit in the EU countries in that period was 3.3% of GDP.

The situation of public finances in 2021 is therefore much better than in 2020, when the general government deficit amounted to 4.5% of GDP in the first half of the year and 7.1% of GDP in the whole year. This improvement stems in particular from two factors. The first one is related to the anti-crisis measures launched by the government in response to the COVID-19 pandemic. The magnitude of these measures in 2020 Q2 was exceptionally large, while in 2021, considering the smaller extent of administrative restrictions, it has been possible to reduce it significantly. According to NBP's estimates, the cost of the anti-crisis measures provided to households and firms in the first half of 2021 amounted to approx. 0.8% of GDP, whereas in the corresponding period of the previous year it reached 3.2%. Secondly, the improvement in the public finance situation is supported by the observed economic recovery, including robust growth in households' nominal consumption and sound labour market situation. This translates into rapid growth in revenue from taxes and social security contributions in ESA terms – in the first half of 2021 this revenue rose by 15.3% y/y. While the high annual growth in tax revenue resulted from the extraordinary dip in economic activity in 2020 Q2 due to the pandemic restrictions, the growth of tax and contribution revenue was also high in relation to the first half of 2019 (in these terms, the growth rate amounted to 14.6%).

In accordance with the government's forecast contained in the autumn fiscal notification, the general government deficit in ESA2010 terms is to stand at 5.3% of GDP in the whole 2021. Considering the very low deficit recorded in the first half of 2021, the persistently high growth in the tax revenue of the state budget in 2021 Q3 and the favourable macroeconomic conditions, it may be expected that the result for the entire year will be markedly better than the above-mentioned forecast.

III. Fiscal policy in 2022

Economic policy, including fiscal policy, continues to operate amid heightened uncertainty about the further course of the COVID-19 pandemic. In the *Justification* to the

Draft Act, as in the November NBP projection, it was assumed that the impact of potential successive waves of infections on economic activity will be far milder than was the case until mid-2021.

This means that in the scenario of macroeconomic and pandemic developments adopted in the *Draft Act*, extraordinary fiscal measures supporting economic agents faced with administrative restrictions, which mostly expired in the first half of 2021, will not be resumed in 2022. This will reduce considerably the level of general government expenditure and deficit. According to NBP estimates, the amount of the above assistance in 2020 was 4.1% of GDP, in 2021 it will reach around 1.0% of GDP and in 2022 it will be close to zero (comprising exclusively the cost of the tourist voucher).

As the anti-crisis measures expire, the most important change in fiscal policy in 2022 will be a significant modification of taxes on individuals' income resulting from income tax, as well as the health contribution, introduced as part of the "Polish Deal" programme. For most taxpayers, above all those in the lower tax brackets, these changes will mean an increase in disposable income, supporting consumer demand growth. Based on the information presented in the Regulatory Impact Assessment of the draft act introducing the changes, it can be estimated that the changes in the tax scales and principles for deducting the health contribution will result in a total loss of general government revenue amounting to 0.6% of GDP.

Current NBP forecasts show that public spending in relation to GDP will decline significantly in 2022, which will be mainly due to the above-mentioned termination of anti-crisis measures. Yet even when adjusted for these measures, public expenditure in 2022 will rise at a slower pace than nominal GDP. The slower growth in overall public expenditure will be above all due to the relatively slow growth in expenditure on social benefits in cash, which, according to NBP forecasts, will run at 4.8% in 2022. This will be driven by the expected decline in the number of beneficiaries of unemployment benefits and family allowances amid the economic recovery. Moreover, in the case of most social benefits, the indexation rate will be lower than the forecast nominal GDP growth. An additional factor reducing the pace of growth of benefit spending in 2022 will be the expiry of the so-called 14th pension, disbursed on a one-off basis in 2021. The decline in expenditure under this heading will be partially offset by the payment of a new benefit for families with children (the so-called Family Care Capital) and an increase in spending on energy allowances.

The aggregate growth of the remaining categories of public expenditure (adjusted for the effect of the expiry of anti-crisis support), including the components of public consumption and public investment, may run at a pace close to the forecast nominal GDP growth in 2022.

In accordance with the *Justification* to the Draft Act, the general government deficit in ESA2010 terms is to decline from 5.3% of GDP in 2021 to 2.9% of GDP in 2022. In light of the NBP forecasts, as stated above, the deficit of the sector in 2021 will probably be markedly lower than assumed in the *Draft Act*, and the scale of the improvement in this balance will be close to 1 percentage point of GDP.

According to NBP forecasts, the expiry of the anti-crisis support implemented in 2020 and 2021 to compensate economic agents for losses related to the pandemic restrictions, will result in an improvement of the general government balance by 0.8 percentage points of GDP. Considering the expected absence of such restrictions in 2022, the withdrawal of this assistance will not dampen economic activity. Secondly, the reduction of the general government deficit in 2022 will be supported by the favourable economic conditions, whose contribution NBP estimates at 0.5 percentage points of GDP.

IV. Fiscal policy imbalance in 2022

As mentioned above, following a steep increase in the fiscal imbalance in 2020, the situation of public finances may be expected to improve significantly in 2021-2022. Despite the implementation costs of the "Polish Deal" programme, current NBP forecasts indicate that in 2022 the general government deficit will be markedly lower than the EU benchmark of 3% of GDP. This concerns the general government deficit both in nominal, as well as in structural terms.

At the same time, the general government balance forecast for 2022 will be affected by temporary factors, which will fade in the subsequent years. The first of them is related to energy transformation. The overwhelming part of the income from the sale of CO_2 emission allowances, which will probably exceed PLN 20 billion in 2021, is currently credited to the state budget, thus improving the general government balance. The government's plans to redirect 40% of these funds to energy transformation, financed via

Energy Transformation Fund, will worsen the balance relative to the current situation, in particular after 2023.[1]

Another factor relevant to the outlook for the general government deficit in the medium term is the path of inflation in the subsequent years. In the short term, higher inflation translates into higher tax revenue, improving the current general government balance. However, elevated inflation translates with a lag into higher expenditure, due to indexation rules and higher costs of provision of public services. In 2023, with the expected marked decline in inflation, there may be an inverse effect to that observed today, i.e. a negative impact of the diminishing inflation on the general government balance.

V. Public debt and financing of the borrowing requirement

Despite the very low general government deficit in the first half of 2021, the increase in the sector's debt proved to be significantly higher – in the analysed period, the deficit in ESA2010 terms amounted to PLN 5.7 billion, while ESA2010 public debt rose by PLN 65.5 billion. Thus, the observed increase in debt was much higher than in the corresponding periods in pre-crisis years 2017-2019 (PLN 17.8 billion on average). The difference between the size of the deficit and the increase in debt is mainly accounted for by the increase in balances on accounts of government units. In particular, according to data from NBP financial accounts (ESA2010), there was a significant increase in the deposits of the units of the central subsector – from PLN 116.6 billion at the end of 2020 to PLN 186.7 billion at the end of the first half of 2021. At the end of 2019 this figure was PLN 65.2 billion.

Similarly to 2020, the increase in debt to a large extent concerned units of the sector other than the state budget – during the first half of 2021, State Treasury debt (after consolidation) rose by PLN 42.5 billion, while the debt of the COVID-19 Counteracting Fund and of the Polish Development Fund resulting from the issue of bonds due to the implementation of the so-called Anti-Crisis Shield increased by a total of PLN 31.4 billion.

Despite the above-mentioned rise in general government debt in the first half of 2021, the high growth of nominal GDP will cause the debt-to-GDP ratio to diminish in the current year. In line with the *Public Finance Sector Debt Management Strategy in the years 2022-2025* appended to the *Draft Act*, the public debt (as defined in the Public Finance Act) will

[1] In line with the government's draft act amending the Act on the Greenhouse Gas Emission Trading Scheme and the Environment Protection, establishing the Energy Transformation Fund.

decline from 47.8% of GDP at the end of 2020 to 45.4% of GDP at the end of 2021, while the ratio of general government debt (in ESA2010 terms) to GDP will decrease from 57.5% at the end of 2020 to 57.0% in 2021. In 2022, these ratios are expected to fall further – public debt to 43.8%[2] and debt in ESA2010 terms to 56.6%. In the opinion of NBP, these forecasts are prudent, in parallel to the forecast of the general government deficit in 2022.

In NBP's assessment, in the medium term the general government debt-to-GDP ratio can be expected to fall further. This will be further supported by the significantly favourable interest-growth differential. The average interest on debt in ESA terms decreased from 3.0% in 2019 to 2.4% in 2020 and 2.0% in 2021 (according to current NBP estimates). As a result of the rise in yields on Treasury securities observed since the beginning of this year, a trend which, in line with the expectations of the financial markets, will continue into 2022, an increase in the average interest on public debt may be expected in the coming years. However, due to the relatively long maturity of the debt – at the end of August 2021 the average maturity of the State Treasury debt was 4.86 years – this process will unfold gradually. Consequently, it may be expected that in the NBP projection horizon, i.e. until 2023, the average interest rate on public debt will persist below the level observed before the COVID-19 pandemic.

[2] The decline of 1.6 percentage points of GDP in the public debt at the end of 2022 compared to 2021, assumed in the *Strategy*, will in part be the effect of extending the scope of the public sector to include the Bank Guarantee Fund (BGF is already a unit of the sector in ESA2010 terms) pursuant to the Act of 11 August 2021 Amending the Public Finance Act and certain other acts (Journal of Laws item, 1535). As a result of the consolidation of Treasury securities held by the BGF, the public debt in relation to GDP will decrease in 2022 on a scale that can be estimated at 0.7 percentage points.