Bank Zachodni WBK
Grupa Santander

ECONOMIC COMMENT

4 September 2018

Spending does not rip in pre-election budget

According to draft budget for 2019 approved by the government, the state budget deficit will reach PLN28.5bn, and the general government deficit is assumed at 1.8% of GDP. Despite 2019 being the election year, the planned spending growth is moderate, due to limit imposed by the stabilising expenditure rule. The budget revenue target seems within reach, despite ambitious assumptions regarding VAT collection. Net domestic borrowing needs will increase substantially in 2019 due to planned reduction of foreign financing. The main buyers of debt will be probably domestic commercial banks, again.

The fact that the fiscal deficit was planned for the election year at one of the lowest levels in history should be positively perceived by investors, decreasing worries about a potential turn towards excessive fiscal expansion ahead of elections. On the other hand, bear in mind that the good fiscal performance in recent years was largely a result of exceptionally positive economic environment, while the structural GG balance of Poland is still one of the worst in the EU, and will remain so in 2019.

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Main macroeconomic assumptions to 2019 budget draft

	2018 plan	2018 E	2019 plan
GDP in current prices (PLN bn)	2057.2	2104.6	2233.7
GDP growth (% y/y)	3.8	3.8	3.8
Private consumption	3.5	3.8	3.5
Fixed investments	7.6	9.1	8.4
Inflation, avg. (% y/y)	2.3	2.3	2.3
Wages, enterprise sector (% y/y)	5.3	6.2	6.1
Wages, national economy (% y/y)	4.7	5.7	5.6
Employment, national economy (% y/y)	0.8	1.7	0.5
EURPLN, average	4.25	4.15	4.15
NBP rate, average (%)	2.3	1.5	1.5
C/A balance (%GDP)	-1.0	-0.6	-1.0

Source: Ministry of Finance

"E" = expected outcome
"plan" = predicted in the budget draft/bill

The Polish government approved the preliminary budget draft for 2019. The document assumes budget deficit at PLN28.5bn, the lowest level in a decade, with revenues at PLN386.9bn and expenditures at PLN415.4bn. General government deficit is expected to reach 1.8% of GDP.

Macroeconomic assumptions do not raise major concerns

The macroeconomic assumptions, on which the budget draft is based, seem (similarly as a year ago) to be safe enough from the budget planning perspective. GDP growth expected next year is 3.8% (the same as a year ago) which is close to the market consensus and our forecast. The draft still assumes 3.8% economic growth in 2018, although in light of the available data it seems obvious it can easily be 1 pp higher. As regards GDP components, the forecast of next year's investments seems ambitious, while the forecast of private consumption seems too conservative. Wage growth can be significantly higher than assumed, in our view, due to growing labour shortage. Taken together, the macroeconomic assumptions imply a chance of higher tax base, creating a safety margin for planned budget revenues. Assumptions about next year interest rates and inflation are realistic and in line with market consensus (albeit the 2018 CPI is overestimated). The biggest risk for the assumed macroeconomic scenario is the possibility of economic slowdown abroad, stemming from, among others, geopolitical situation and changes in international trade relations.

Budget deficit (again) significantly below plan in 2018

2019 budget draft assumes that the budget deficit in 2018 will amount to PLN23.8bn, meaning that it will be again well below what was planned in the budget law (PLN41.5bn). This year, budget revenues should be PLN11.7bn higher than the initial government's plan, while expenditures should be PLN6bn less than planned.

The budget performance expected this year is more or less in line with our estimates. In our opinion, the favourable macroeconomic situation will be supportive for budget revenues, sending them to a level close to (or even a bit higher) than assumed by the government (July's drop in indirect taxes growth was, in our view, a temporary disturbance, possibly related to introduction of split payment mechanism). It will be probably the level of spending at the end of the year that would determine the actual full-year deficit level. Budget spending growth was quite slow in 1H18 (after June the expenditures were PLN9bn below the MinFin schedule). In July expenditures jumped, but mainly because of surge in debt servicing costs, which could be a result of one-off accounting operations (i.e. swap transactions) and it is unlikely to repeat in the

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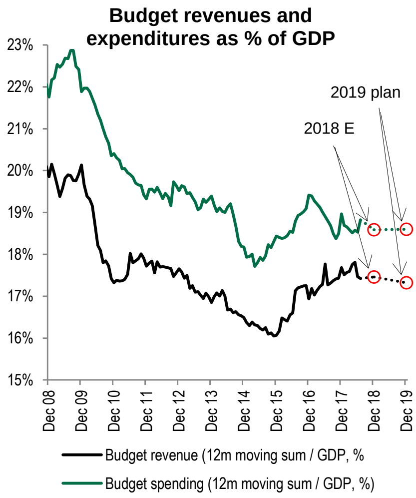
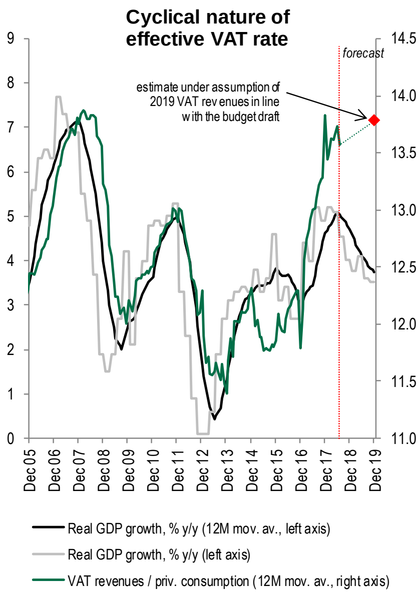




coming months (on the contrary, this cost item should decrease significantly). However, the MinFin officials suggested that in 2H18 the spending growth should accelerate due to “unlocking” of big investment projects. Moreover, the ministry can take steps at the end of the year to ‘smooth’ the path of deficit, shifting some of next year’s burden (by means of acceleration of some spending and/or front-loading of VAT returns, that would normally come in 2019). As a result, deficit close to PLN24bn seems realistic to us. The risk for this estimate is skewed to the downside, in our view (if the signalled unlocking of big expenditures proves in fact not so big).

It is worth to remember that the actual 2017 budget deficit was almost PLN7.5bn lower from what the government showed as the expected outcome when publishing the 2018 budget draft.

Planned revenues – realistic or excessive?

Budget revenues in 2019 are to grow by PLN19.5bn, or by 5.3% vs. the expected outcome for this year. A significant part of this growth comes from tax income (higher by PLN19.1bn, i.e. 5.6%). When compared to nominal GDP growth (slightly above 6% this year and in 2019), it does not seem to be a controversial assumption. However, when we look closer at the structure of revenues, plans of increasing inflows from VAT (by PLN12.3bn, or 7.3%) and PIT (PLN4bn, 6.6%) seem to be quite ambitious. On the other hand, assumed growth rates of other revenue categories are rather cautious.

What caught our attention is the assumed revenues from the value-added tax, which are to grow next year faster than this year even though GDP and consumption growth will probably be lower. Historical data point to strongly cyclical behaviour of effective VAT rate. According to our estimates, at the end of 1H18 it increased to the highest level in a decade (see the margin chart). Now, the peak of economic cycle is most likely behind us, which raises worries of declining effective VAT rate, following the expected GDP slowdown. That said, getting as high VAT revenues as the government had assumed for 2019 would require maintaining the effective tax rate at a level close to the local maximum from the mid-2018.

One gets closer to solving this riddle when spotting in the budget draft the assumptions about further reduction of the tax gap. According to the government, this will generate around PLN7.5bn of additional revenues in 2019 – more than a half of total planned increase of VAT inflows. If the assumption is met in full, it could really offset the ‘natural’ decline of effective VAT rate, resulting from its cyclical character. The government has already made big progress in closing the VAT loopholes. MinFin estimates that in 2017, PLN10.8bn were obtained from sealing the tax system – more or less the amount assumed in the budget draft for that year. In 2018, another PLN10.6bn were expected to be raised from further increase of tax compliance. It is still difficult to assess the final fiscal effect, but it is likely to be a smaller amount, in our view, taking into account that the total growth of VAT revenue this year may be a bit above PLN10bn (with the economy at the peak of economic cycle). The assumption that efforts to curb tax gap will bring next year around another PLN7.5bn seems to be quite ambitious but on the other hand it cannot be excluded completely as new measures are being introduced: split payment, development of standard audit tax file (JPK), online data collection system for cash registers. Also, even if effects of increased tax compliance will be smaller than assumed, then in our view there is a safety margin for VAT incomes created by conservative assumptions regarding consumption growth. This means that the tax base can actually be higher than assumed.

Similar situation regards PIT revenues – the realisation of the assumed tax growth (6.6%) will be supported by the fact that the actual wage growth will be higher than assumed by the government, in our view.

According to budget draft, discretional activities will bring PLN12.3bn additional revenues in 2019 (or at least such amount was assumed for calculating the spending limit according to stabilising expenditure rule). The most significant position among these activities will be further elimination of tax gap, mentioned above. Another important element is the new fuel charge, which is supposed to bring PLN1.7bn to the budget.

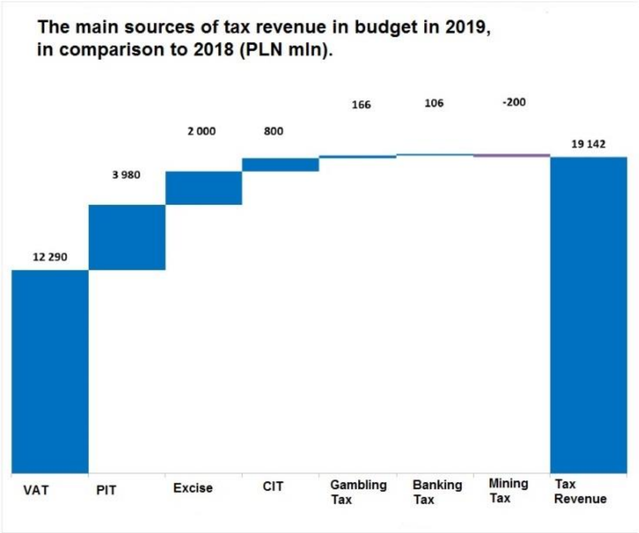
Budget (rightly) assumed lack of payment from the NBP’s 2018 profit, however a positive surprise from this side cannot be ruled out next year – we foresee that EURPLN and USDPLN will end this year above levels from end-2017, which would mean that NBP can profit from exchange rate differentials on FX reserves management.

In sum, budget revenues planned for 2019 in the draft seem to be achievable and don’t raise serious worries about their overestimation.

Main parameters of 2019 budget (PLN bn)

	2018 plan (1)	2018 EO (2)	2019 plan (3)	change (3) / (2)
Total revenues	**355.717**	**367.436**	**386.915**	***5.3%***
Tax revenues	331.673	340.589	359.731	*5.6%*
VAT	166.000	167.310	179.600	*7.3%*
CIT	32.400	34.000	34.800	*2.4%*
PIT	55.500	60.320	64.300	*6.6%*
Excise	70.000	71.000	73.000	*2.8%*
Bank tax	4.569	4.445	4.551	*2.4%*
Non-tax revenues	21.923	24.739	24.987	*1.0%*
Total expenditures	**397.209**	**391.197**	**415.415**	***6.2%***
Balance	**-41.492**	**-23.761**	**-28.500**	***19.9%***

Source: Ministry of Finance, BZ WBK



Source: Ministry of Finance

Rise of expenditures kept in check by the fiscal rule

Impact of selected cost items on overall budget spending in 2019 (PLN bn)

Indexation of pensions and disability benefits	+6.9
Wage hikes in public sector	+2.4
Wage hikes for teachers	+1.8
Rise of defense spending	+3.5
Reduced social security contributions	+0.5
Lower retirement age	+3.0
State pensions for women w/4+ kids	+0.8
Total	**+18.8**

Source: Ministry of Finance, BZ WBK

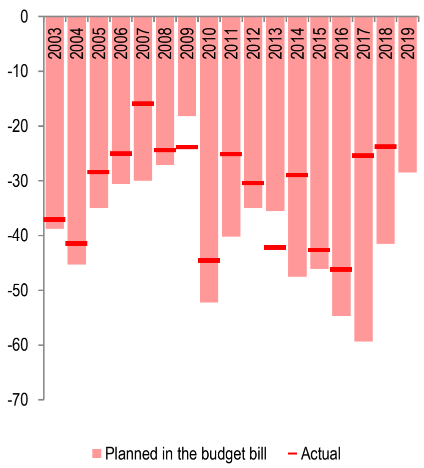
Budget spending was planned at PLN415.4bn, PLN24.2bn (or 6.2%) above the realisation of spending currently expected for this year and PLN18.2bn (4.6%) above the initial 2018 budget plan. Given the election calendar and the need to finance additional cost items, resulting from the existing legislation and government policies (details in the table on the left), the assumed rise of expenditures does not look to be elevated. By the way, not all of the key government projects generate further pressure on higher spending – take "500+" child benefit program as an example, the costs of which are to decrease next year by cPLN3bn due to, among others, higher wages (less persons eligible for benefit for the first child) and tighter control of beneficiaries.

As a result, budget expenditures are to grow less than the economy for the third year running, meaning that their share in GDP should decrease (to 18.6%, the lowest since 2015).

But, to be honest, it is hard to expect a different scenario as long as the government obeys the stabilising fiscal rule, which imposes limit on the growth of expenditures of the public sector, in line with average pace of economic growth and a negative adjustment due to public debt in excess of 43% of GDP. The "unbreakable spending limit" for institutions of the public sector, resulting from the rule is PLN621.2bn in 2019 and grows by PLN24.2bn vs the amount presented in the 2018 budget bill. The rise of expenditures due to "inelastic items" and those pre-set by other regulations consumes a big enough part of the quota that comes from the spending rule, that there is very little room for pre-election gifts to be placed in the central budget.

Deficit close to record lows

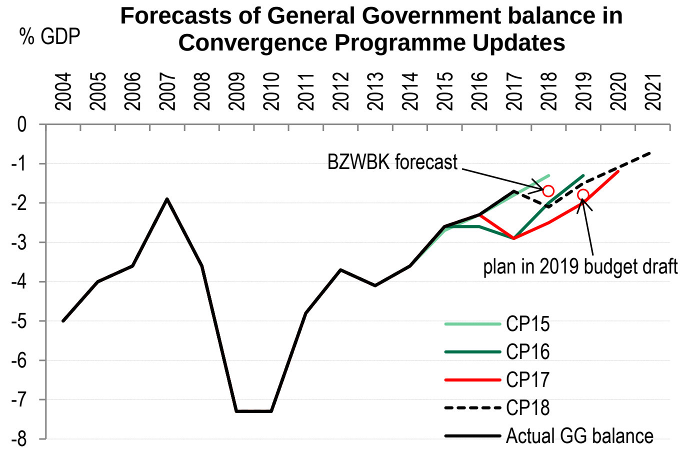
Central budget balance (PLN bn)



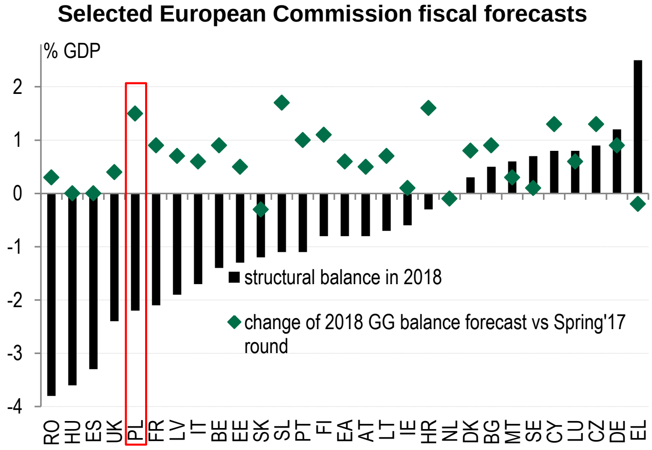
The central budget deficit is to amount to PLN28.5bn – slightly above the actual reading for 2017 and the expected outcome for the current year. At the same time, it would be one of the smallest deficits planned in a budget draft since 2009. The deficit of the whole general government sector consistent with ESA2010 methodology is to reach 1.8% GDP (vs 1.7% in 2017 and a similar level that we expect to see this year).

The fiscal deficit planned for the election year at one of the lowest levels in history should be received positively by investors, decreasing fears that the policy could turn towards excessive fiscal expansion ahead of the general elections. On the other hand, bear in mind that the strong budget performance in recent years is to a large extent a result of exceptionally supportive economic environment, while the structural general government balance of Poland is still one of the worst in the EU - and will likely remain so in 2019.

What is more, it is important to remember that the analysed document is just a draft version of the budget. The government can still introduce some changes to it before the end of September, and then the document will be discussed in the parliament. It is quite likely that during the parliamentary work on the budget there will be strong pressure to increase spending (e.g. by more generous wage hikes in the public sector). The parliament cannot increase the deficit above the limit set by the government, so any proposals to boost spending must be accompanied by indication of the source of extra revenues. The spending limit determined by the fiscal rule is the additional safety measure, and the fiscal space it provides for 2019 is already exhausted. However, if the political will to increase expenditures proves strong enough, one could imagine a sudden rise in optimism regarding the assumed effects of further tax gap reduction in 2019.



Source: Ministry of Finance, BZ WBK



Source: European Commission, BZ WBK

Coverage of borrowing needs

The draft budget for 2019 envisages net borrowing needs of PLN45.99bn, compared with the expected 2018 value of PLN39.7bn (vs PLN 63.3bn planned initially). Gross borrowing needs are planned at PLN163.71bn, compared with the expected outcome of PLN159.48bn this year (vs PLN181.7bn planned). The total 2019 borrowing needs will be only slightly higher than the expected outcome for 2018. However, owing to the planned reduction in external funding, the net issuance of bonds on the domestic market in 2019 will rise significantly more, to PLN57.05bn, from PLN35.27bn in 2018. Out of this amount, the net supply of PLN-denominated wholesale bonds will be PLN53.2bn, and the increase in debt related to savings bonds –PLN4bn.

We believe that in 2019, just like this year, the Ministry of Finance will not be issuing T-bills (although the debt service costs include, as usual, a certain amount related to the discount on T-bills issued during the year). In our opinion, this is a contingency instrument, but – similarly to the previous years – the Ministry will be trying to maintain debt maturity at approximately 5 years, which should provide an effective disincentive to issuing short-term papers. Additionally, the low 2Y/10Y spread (which we predict to remain below 160 bp) should contribute to extending the maturity of the Polish T-bonds.

Who will be buying the Polish debt next year? We predict that – similarly to this year – the domestic banking sector will remain the key recipient of the MinFin supply. Over recent months, Polish banks have significantly increased their exposure to T-bonds: between January and June, their portfolios of domestic debt securities increased by PLN19.5bn, while the total increase in debt related to PLN-denominated market T-bonds slightly exceeded PLN13bn. We would like to recall that at the beginning of the year, we estimated the potential demand for T-bonds among Polish banks at approximately PLN35bn, and it seems this scenario is likely to be fulfilled. We are expecting a similar trend in 2019. The supporting factors include the regulatory requirement for banks to maintain liquid asset to cover on-demand and short-term deposits (to keep the LCR ratio at an appropriate level), as well as low interest rates making bank products with longer maturities less attractive to clients.

There should also be continued demand for government bonds from non-bank financial institutions (investment funds, insurance companies). In 1H18, their portfolio of domestic market bonds increased by PLN4.6bn. Individual clients' demand for investment funds' products may be temporarily weakened by recent events such as GetBack problems and the sell-off in Turkey. However, we assume that debt and money market funds' assets will continue to grow gradually in the coming quarters. A potential decline in client interest in the units of investment fund companies would probably mean a faster increase in bank deposits, and thus even greater demand for T-bonds among local banks.

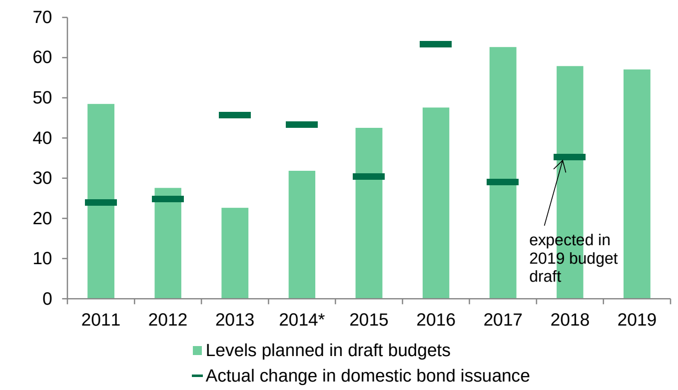
Given the continued tightening of US monetary policy and increased volatility in emerging markets, foreign investors may continue to reduce their exposure to Polish debt. Between January and June 2018, their portfolios of T-bonds shrank by approximately PLN10.5bn (and by about twice more in the last 12 months).

Coverage of financing needs (PLN bn)

	2018 plan (1)	2018 E (2)	2019 plan (3)	change PLN bn (3) - (2)	change % (3) / (2)
Net borrowing needs	**63.32**	**39.71**	**45.99**	***6.28***	***15.8%***
Financing of borrowing needs:					
Domestic, including	57.92	37.58	57.05	*19.47*	*51.81%*
- T-bonds	57.92	35.27	57.05	*21.78*	*61.81%*
- T-bills	-	-	-	-	-
- other	0.0	2.310	0.0	*-2.31*	*-100.0%*
Foreign financing	5.41	2.14	-11.06	*-13.20*	-642.1%
- T-bonds	-1.79	-3.28	-5.57	*-2.29*	-

Source: Ministry of Finance

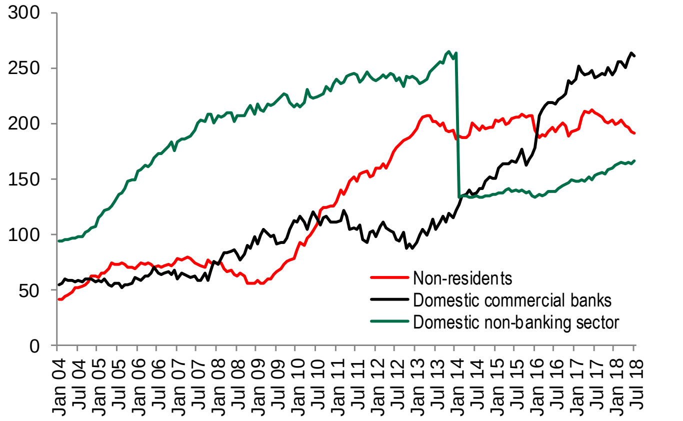
Net borrowing needs, domestic financing – draft budgets and outcomes, PLN bn



* data corrected for the termination of T-bond portfolios of open pension funds (OFE)

Source: Ministry of Finance, BZ WBK

Domestic T-bonds by type of bond holders in PLN bn



Source: Ministry of Finance, BZ WBK

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