12 October 2023

Economic Comment

Disturbing planned increase in public debt

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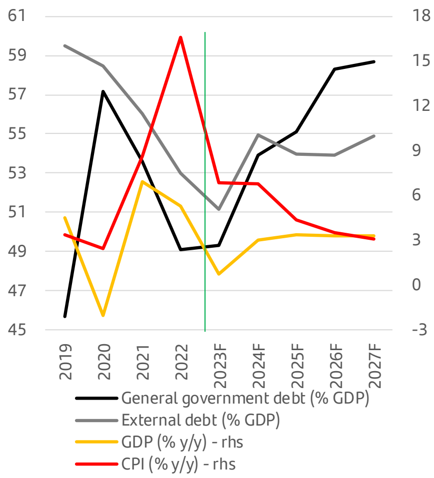
The Debt Management Strategy for 2024-2027 assumes a much faster increase in public debt than in the previous strategy last year (albeit from a lower level). The strategy assumes an increase in debt of almost 10 pp to 58.7% of GDP by 2027, a worryingly fast convergence towards the Maastricht criterion limit. The drive to minimise the risk of debt exceeding the national safety thresholds creates a temptation to further increase debt beyond the national public sector classification, but this does not seem consistent with the consolidation of public finances announced earlier this year by the Ministry of Finance or the BGK. In our view this creates negative risks for the rating along with expected increase in Poland's external debt, the slow decline in inflation, the gradual deterioration of institutional assessment indicators and the risk of losing EU funds, although our baseline scenario still foresees rating stabilisation. We see upside risks for the planned debt service costs and greater difficulties in extending durations in the face of potential debt demand problems. We assume that domestic banks will remain the main buyers of bonds with the support of local investment funds with a potential further outflow from foreign investors. We expect sizable gross bond issuance in 4Q, significantly higher on a net basis in 1Q24 and high asset swap spreads in subsequent quarters, particularly at the long end of the curve.

General government debt, Poland's external debt, inflation, GDP growth

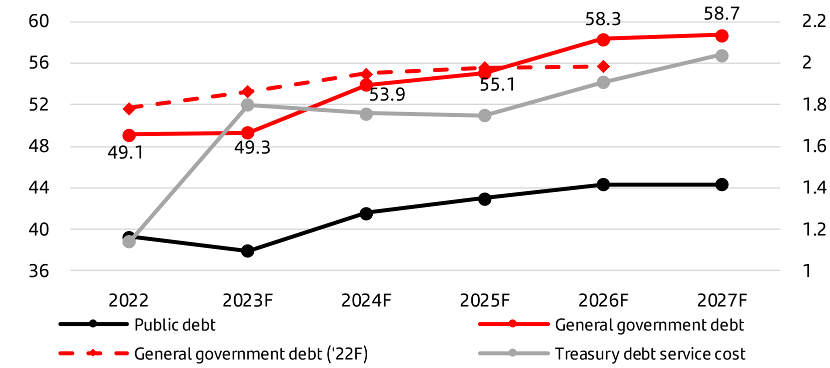


Source: Ministry of Finance, Santander
** Ministry of Finance forecast of the general government debt, other forecasts by Santander*

General Government debt projected to rise to almost 60% of GDP

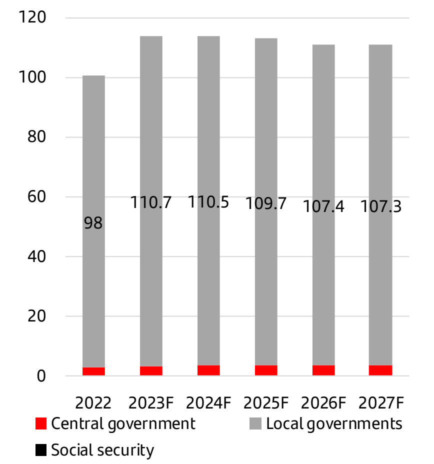
The Debt Management Strategy for 2024-2027 projects that general government debt will increase by almost 10 percentage points to 58.7% of GDP in 2027 from 49.1% of GDP in 2022, an alarmingly fast approach to the 60% limit defined in the Maastricht Treaty. Next year, debt is expected to rise to 53.9% of GDP from 49.3% in 2023, in line with the draft budget for 2024. Although GG debt will rise from a lower level than the one assumed in last year's strategy, the currently planned debt levels for the following years are higher compared to the previous strategy.

Public sector debt measures, % GDP (Ministry of Finance forecast)



Source: Ministry of Finance, Santander

Debt of other public sector units outside Treasury, PLNbn (Ministry of Finance forecast)



Source: Ministry of Finance, Santander

Such a significant increase in GG debt will stem from an increase in central government debt, by around 7pp to 45.6% of GDP in 2024 from the 38.5% planned for 2023, and the growing debt of special purpose funds serviced by BGK. What stands out is the increase in the debt of the Armed Forces Support Fund and in the debt of the Road Fund. The debt of the COVID-19 Fund is expected to grow until 2024 and then gradually decrease. According to the Strategy, the net debt of public enterprises is also expected to grow. The Ministry of Finance estimates that local government debt will gradually decrease both as a proportion of GDP and in nominal terms - in contrast to last year's assumptions.

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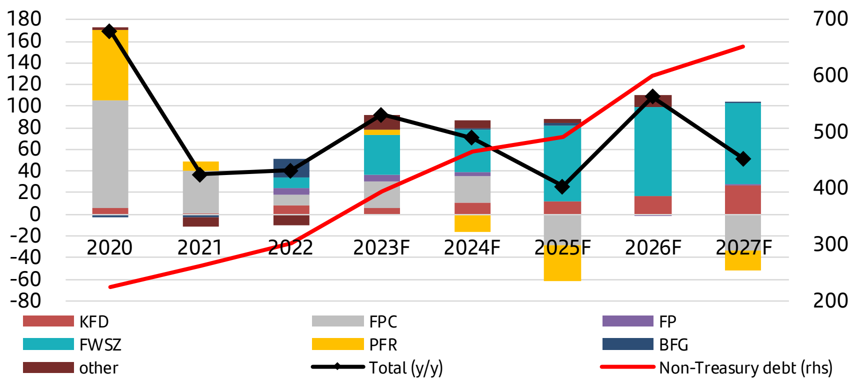
The strategy projects a significant increase in state guarantees in the coming years. In the forecast horizon, the increase is as much as PLN200bn higher than it was assumed in the previous plan and is largely a result of the indebtedness of extra-budgetary funds.

In our view, implementation of such a fiscal policy direction raises the risk of GG debt exceeding 60% of GDP in future years. Exceeding this threshold does not automatically make fiscal policy more restrictive, but it may lead the country to become a subject to the Excessive Deficit Procedure (EDP)[1]. There are also domestic public debt safety thresholds (55% and 60% of GDP), enforcing higher restrictiveness of fiscal policy (they use the domestic definition of debt). The desire to minimise the risk of such a scenario creates the temptation to continue pushing spending outside of the national classification of public debt to a greater extent also in the following years. We believe that due to the planned rapid growth of debt outside the central budget the process of consolidating public finances announced earlier this year by the Ministry of Finance and BGK seems not very likely or at least will proceed very slowly.

Non-Treasury general government debt (change and total level, PLN bn)



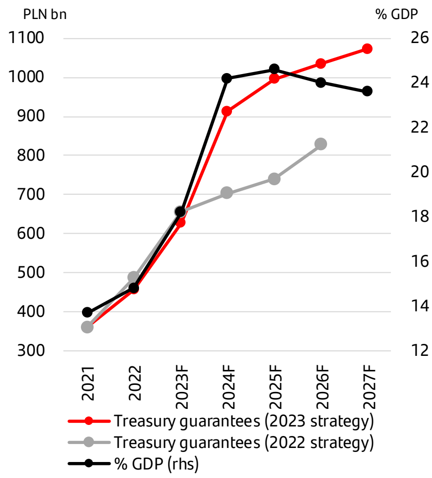
Non-Treasury general government debt (change and total level, PLN bn)

	2020	2021	2022	2023P	2024P	2025P	2026P	2027P
Total change (y/y) PLN bn	169.8	37.2	40.8	91.9	70.6	25.9	108.8	51.5
KFD	6.1	1.1	8.4	5.4	11.3	12.0	17.0	26.3
FPC	99.4	39.4	9.4	32.4(24.9)*	24.2	-28.7	0.0	-33.6
FP	0.0	0.0	6.1	6.1	3.8	0.0	-1.1	1.3
FWSZ	0.0	0.0	9.9	37.1	39.6	70.2	82.7	75.1
PFR	65.4	8.5	0.0	5.0	-16.3	-33.7	0.0	-18.6
BFG	-3.2	-3.2	17.1	0.0	0.5	2.5	0.0	1.0
inne*	2.1	-8.7	-10.1	13.4	7.5	3.6	10.2	0.0
Non-Treasury debt (PLNbn)	224.8	262	302.7	394.6	465.2	491.1	599.9	651.4

KFD = National Road Fund, FPC = COVID-19 Response Fund, FP = Aid Fund, FWSZ = Armed Forces Support Fund, PFR = Polish Development Fund, BFG = Bank Guarantee Fund.
* Debt Management Strategy for 2024-2027 assumed increase in 2023 by PLN24.9bn; FinMin revised estimate upwards after release of the Strategy to PLN32.4bn.
Source: Ministry of Finance, Santander

In our view, debt servicing costs could exceed 2% of GDP faster than the strategy assumes. We see risks on the side of higher servicing costs with looming large issuance and the assumption that interest rates will stay relatively higher for longer in the coming years. We think that domestic debt will roll over at a higher cost. In the case of foreign debt, on the other hand, the cost per issue does not need to increase significantly in the next 2 years, due to the fact that maturing bonds were issued several years ago with quite high coupons, which need not be significantly higher with new issues. On the other hand, net issuance is expected to be significantly higher next year and continuing this trend in the following years with a slow decline in yields on the underlying markets may increase costs to a greater extent. In addition, financing costs could increase if the EU Recovery Fund loan could not be raised.

Treasury guarantees, PLN bn (Ministry of Finance forecast)



Source: Ministry of Finance, Santander

[1] having violated the debt rule by having a government debt level above 60% of GDP, which is not diminishing at a satisfactory pace — this means that the gap between a country's debt level and the 60% reference needs to be reduced by one 20th annually (on average over 3 years) https://eur-lex.europa.eu/EN/legal-content/glossary/excessive-deficit-procedure-edp.html

Greater risk to the rating?

The rising debt trajectory is negative for the rating outlook. Although the significant debt build-up planned in the 2024 draft budget (to 53.9% of GDP) might have been concerning, it likely would not alarm rating agencies as long as the increase was deemed transitory. Yet, a multi-year upward trajectory could raise serious concerns about the future of the rating. The qualitative indicators used by rating agencies to assess the institutional environment, as published by the World Bank, have already clearly deteriorated in recent years.

For the risks to the rating to materially increase, we believe Poland's external debt-to-GDP ratio would have to also increase significantly and inflation should remain at elevated levels for much longer. In the case of external debt, we assume an increase over the next few years to around 55% of GDP from just above 50% currently, but given its significant decline in recent years, the size of the increase we expect is unlikely to be sufficient to impact the rating. Controlling inflation is important for Poland's rating as it is classified in the category of the country's institutional strength. The assessment of the central bank's independence from the government depends on the length and magnitude of the deviation of inflation from the target. We estimate that inflation will gradually return to the target, although more slowly than the market assumes, while too rapid (in our view) rate cuts from the MPC and the central bank's determination to maintain negative real rates in a situation of a below-neutral unemployment rate for the labour market raises the risk of inflation remaining above the target for longer. In our view, an attempt to lower relative debt ratios through high inflation would be negative from a rating perspective.

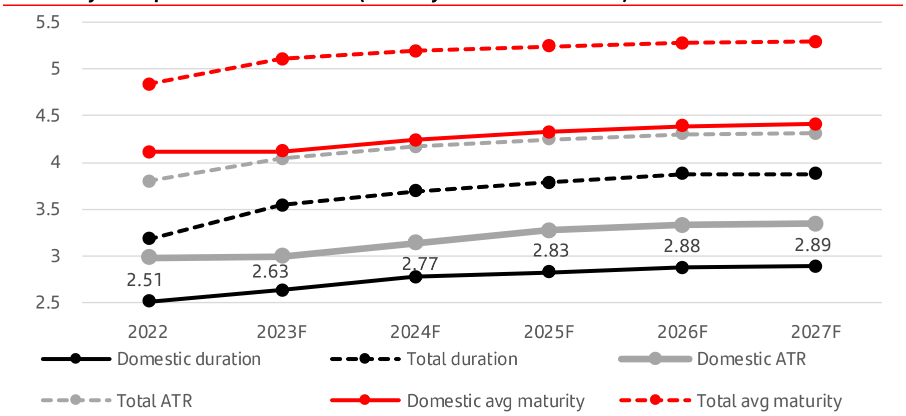
In the near term, two factors will be stabilising the rating: the relatively strong GDP growth rate and the still rising level of GDP per capita and. Failing to unlock EU funds would certainly have a negative effect, which would be particularly negative it would lead to higher fiscal deficits and a faster increase in public and external debt.

Although we do not expect a reaction from the rating agencies in the near term, changes in macroeconomic parameters in the following years may be negative for Poland's rating.

FinMin plans to increase duration and FX issuance

In our view, the planned increase in domestic debt durations may be difficult to achieve. Market conditions appear more difficult than last year, and yet the Ministry of Finance has planned a higher durations path for both domestic and foreign debt. The lengthening of the durations for foreign currency debt should come as no surprise given the significant increase in issuance, and these are typically with longer maturities than domestic ones. At the same time, the increase in durations for domestic debt seems to us to be somewhat more difficult to implement. Our doubts are related to the planned substantial issuance of treasury bills and our assumed generally greater difficulty in selling long-term bonds. In part, the effect of longer-term durations could be achieved by the high scale of planned issuances with only slightly higher durations of new debt compared to the current average.

Treasury Debt parameters in Poland (Ministry of Finance forecast)



ATR – average time to refixing in years. In contrast to duration it includes also CPI-linked bonds and it is not affected by interest rates levels

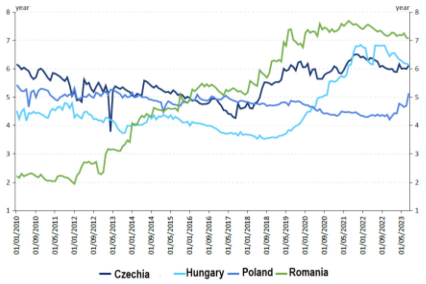
Source: Ministry of Finance, Santander

WGI indicators, Poland's positions as percentile

	2015	2021	2022
Voice and accountability	81.8	63.4	65.2
Political Stability and Absence of Violence/Terrorism	74.8	61.3	61.8
Government Effectiveness	74.3	61.4	61.8
Regulatory Quality	79.5	75.7	74.5
Rule of Law	76.2	64.3	64.2
Control of Coruption	74.8	68.1	68.4

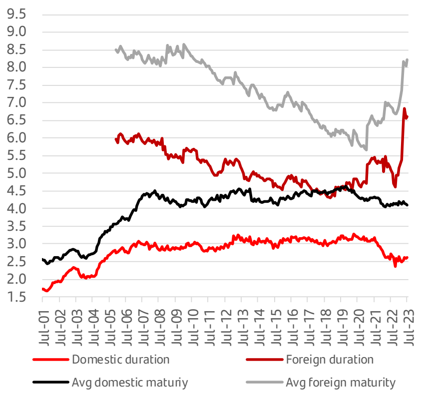
Source: World Bank, Santander

Average maturity of Treasury debt in CEE region, in years



Source: MNB

Treasury debt parameters in Poland



Source: Ministry of Finance, Santander

The share of foreign currency-denominated debt in Treasury debt is expected to remain in the 20-25% range which we consider safe for the sustainability of public finances. The path of the share of foreign currency debt in the latest strategy has been increased compared to the previous one by 1.3-2 percentage points, but it assumes the fulfilment of the main assumption, i.e. keeping it below 25%. The high FX issuance makes the Treasury FX debt stabilise near 21-22% of total debt with a slight increase assumed only for 2024. In our view, this is neutral from the point of view of the country's rating and the assessment of the sustainability of public finances. From a rating agency point of view, the optimal level would probably be much lower (closer to 10%), as long as we assume that plans to adopt the euro are rather distant. However, the current level is still close to historic lows and, after a significant drop from more than 30% in previous years, there is room for higher FX issuance in the face of increased borrowing needs with a desire to reduce pressure from the local market.

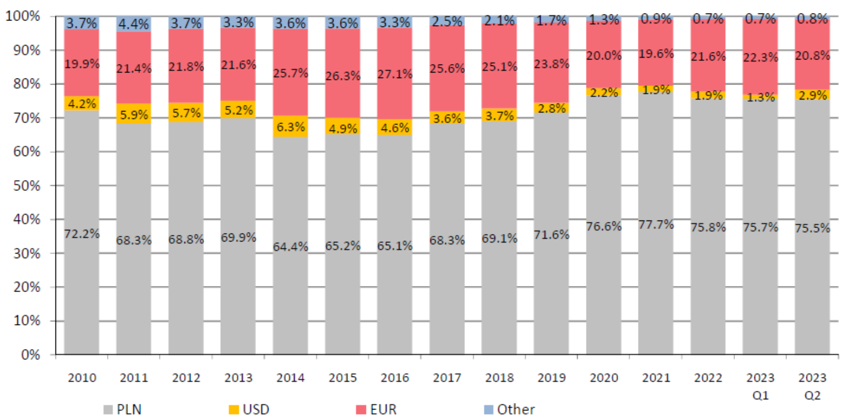
We also think that higher currency issuance is partly a response to foreign investor preferences and the market situation. The relatively high yields on Polish treasury bonds denominated in euro and dollar suggest little potential problems with their sale, which cannot be fully said about domestic bonds. We think that the current levels of yields on domestic local currency bonds do not necessarily compensate for foreign currency risk to foreign investors, and hedging a currency position is costly for them, especially taking into account high level of basis swaps.

Foreign currency debt will be influenced by loans from the EU's Recovery and Resilience Fund. The draft budget for next year envisages borrowing from the RRF programme for the National Reconstruction Programme (KPO) at PLN28 bn. The government has also requested that the total scale of loans from the Recovery Fund to be increased from €11.5 billion by additional €23 bn. Should the European Commission agree to this, the increase in foreign currency debt would be higher than the strategy assumes.

Foreign currency debt of the entire public sector (GG) will grow faster than that of the state treasury due to the financing of the Armed Forces Support Fund (FWSZ). The FWSZ Defence Fund will be responsible for the majority of debt growth outside the Treasury in future years. Although the budget of the FWSZ has been classified, we conclude from the information in the 2024 draft budget and press releases that the FWSZ's activities will likely be financed mainly by hard currency ($) loans from the US and Korea (on top of subsidies from the budget).

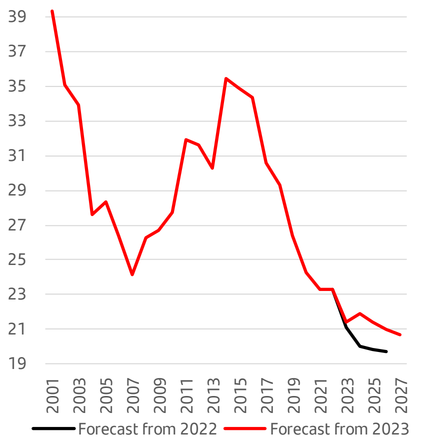
We think the increase in FWSZ debt could raise the share of government foreign currency debt to around 32% by 2027 from the current level of around 24.5%, and the additional loans from the Reconstruction Fund (€23 bn) requested by the government could raise this share to around 36%, close to historically high levels and above the local peak of 2016. In our view, from the point of view of sector stability, more foreign currency debt would be unfavourable.

FX breakdown of general government debt



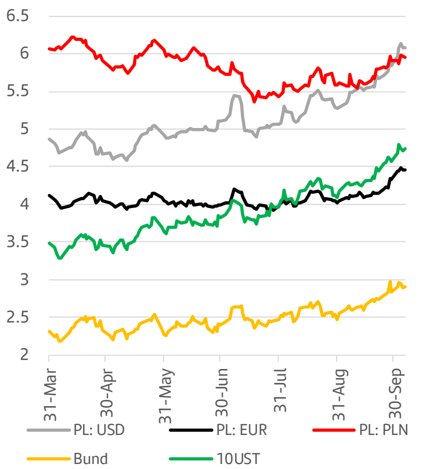
Source: Ministry of Finance, Santander

Share of FX debt in Treasury debt, PLN bn (FinMin forecast)



Source: Ministry of Finance, Santander

10Y yields of Poland's bond denominated in EUR, USD and PLN vs. German Bunds and 10Y US Treasuries, %



Source: Refinitiv, Santander

Sizeable bond supply in 4Q, but much larger in 1Q24.

The Ministry of Finance is planning sizable debt issuance in 4Q23. According to the supply plan, issuance at regular auctions is expected to amount to PLN 25-35bn at 3-4 tenders, with additional 1-2 swap auctions. In October, the ministry planned to sell PLN 9-20bn at two standard auctions, which coincides with the maturity of PLN 17.7bn of DS1023 bonds and additional interest payments of PLN 4.6bn.

The results of the first October auction were relatively good. The Debt Department sold around PLN9bn of bonds with demand exceeding PLN13bn. With a high sale of 5-year bonds, the bid-to-cover ratio was relatively low (around 1.28), but some investors may have been encouraged to buy by the downward yield movement in the core markets or by the slightly wider asset swap spread. The large amount of bids approved, as in the previous several auctions, is related to the looming high borrowing needs for the next year. We expect a large supply of treasury securities also at the next auction in October.

The Ministry of Finance reported that after the last bond auction the borrowing needs of the state budget in 2023 have been fully funded. Meanwhile, the pre-financing level of gross borrowing needs for 2024 is around 5%.

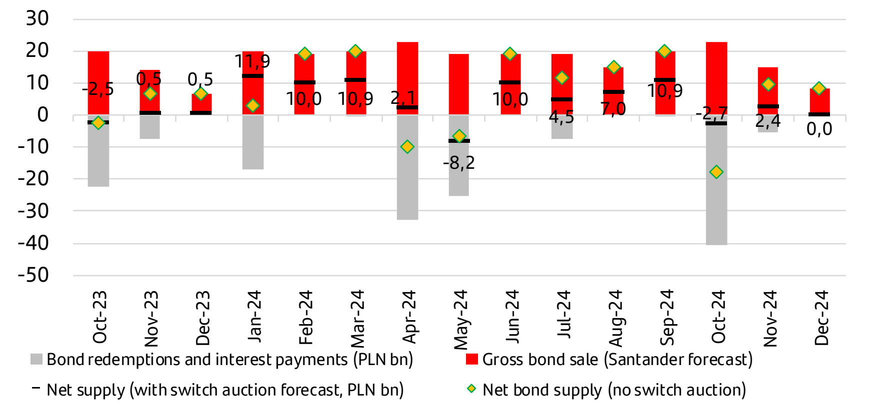
We presume that in view of the large borrowing needs, the Ministry of Finance may wish to maintain a high level of liquidity reserve. At the end of September, the buffer stood at around PLN133.7bn. Although it gives a lot of flexibility in debt management and subsequent issuances, we assume that the supply at auctions will remain relatively high in our view.

We expect low net issuance in November and December, but higher than in October. Amid lack of maturities and interest payments at c. PLN7.5bn and our assumed issuance of PLN20bn (with upside risk), including c. PLN6-12bn in swap auctions, there may be a slight upward pressure on yields from slightly higher issuance.

In 2024, we expect net issuance of marketable treasury securities of PLN154bn, in line with the Ministry of Finance's plans, including PLN100bn of treasury bonds and around PLN 54bn of treasury bills. As the Ministry of Finance has already adjusted the fiscal deficit down by 1.1% of GDP, number derived from a historical deviation between expenditure realisations and plans, we think that the room for positive surprises (i.e. lower issuance) may be limited. In 2024, gross bond issuance would amount to PLN 220bn, which translated to around PLN9.5bn per auction. Assuming that the Ministry can place an additional PLN20-30bn in the public finance sector units under the so-called assimilation, the effective average monthly gross supply of domestic government bonds (including swap auctions) would be around PLN20-21bn. Budget units financed with assimilation bonds are likely to sell them on the secondary market.

There is also a risk that money from the Recovery and Resilience Fund may remain frozen next year, which may force an increase in the issuance of marketable government debt in zloty and/or foreign currencies.

Gross and net bond supply forecast, PLN bn (no assimilation bonds included)



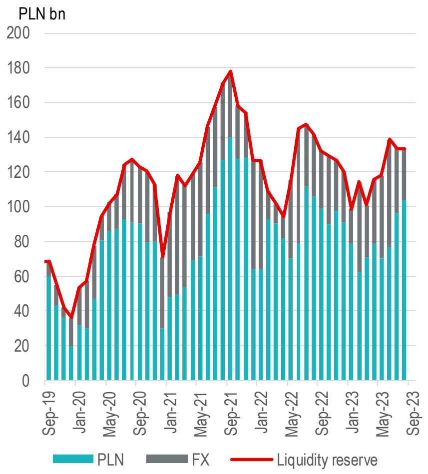
Source: Ministry of Finance, Santander, assimilation bonds may be sold in the market in any moment by public sector units, which receive them from the Ministry of Finance*

Demand may be more problematic than before?

The latest data on domestic bond portfolios for August showed a continuation of the previous trends, an increase in the domestic banking sector's domestic government bond holdings by PLN2.5bn (PLN40bn year-to-date) against a reduction in exposure from most other sectors, including both foreign investors and domestic investment funds.

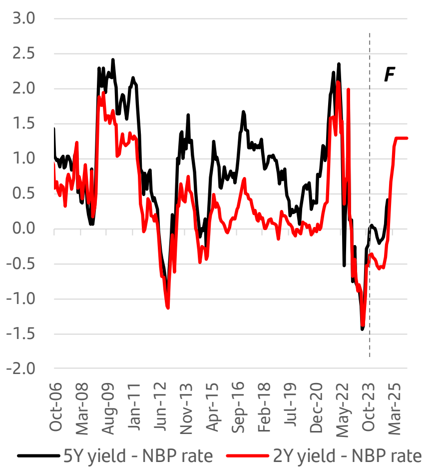
We expect domestic banks to remain the main buyers of domestic government debt in the coming quarters. We reiterate our estimate of potential net demand from the banking sector at PLN70bn, consistent with our expected increase in the deposit base and assuming that the share of government bonds in banks' balance sheets remains unchanged. Should the yield curve be sufficiently steep, we believe that banks could buy even more bonds.

Ministry of Finance liquidity reserve, PLN bn



Source: Ministry of Finance, Santander

Steepness of the bond yield curve, 2Y and 5Y bond yields vs. NBP rate, pct points



Source: Refinitiv, Santander, 2Y bond for 25 set at average level expected for 2024

Domestic investment funds may increase their purchases of government debt next year as new money flows in. We assume net inflows into investment funds next year of around PLN 20-25bn, most of which will come into debt funds. What may limit funds' demand are the basis swap levels, which encourage the purchase of foreign treasury bills using a currency swap and thus acquiring an additional premium. As long as basis swaps are strongly positive, they will encourage this type of arbitrage, provided that the scale of purchases is within the mandates and limits of individual funds.

Lower demand from abroad is quite likely. We believe that government bond yields in core markets are high enough to dampen the demand for Polish local currency debt. Such a scenario is particularly likely in the case of US investors, for whom the main incentive to buy PLN-denominated bonds would be the prospect of the dollar weakening against the zloty in subsequent quarters, as the yield spread has substantially diminished. For investors looking to hedge some of the exchange rate risk, the attractiveness of domestic debt is negatively impacted by the positive basis swap that used to favour foreign demand in 2008-14. Also, the addition of India to the major global bond indices may negatively impact the foreign demand. Assuming that benchmark investors are not currently materially underweight on Poland relative to the indices, we assume a possible outflow of at least PLN7-10bn by foreign investors from the domestic debt market.

Higher sales of retail bond seem possible

We think that the retail bond sales plan for 2024 of cPLN7bn in net terms is realistic with a chance for a positive surprise. The Finance Ministry's plan calls for gross sales of around PLN2.5bn per month. The scale of retail bond sales could be even higher if, as in October, the Finance Ministry decided to maintain the attractive high fixed interest rate on savings bonds for a longer time, despite the fall in NBP rates. Currently, retail bonds account for around 7.2% of total Treasury debt compared to around 19-20% in Hungary, which shows room for further growth in funding from this source. Bear in mind, however, that a larger inflow of private funds into savings bonds would come at the expense of bank deposits and/or money kept in investment funds, which would limit the potential of these two sectors to buy bonds on the wholesale market.

BGK issuance higher than last year

The Ministry of Finance forecasts bond issuance for the COVID-19 Fund at cPLN32.4bn for 2023 and PLN24.2bn for 2024 as compared to cPLN9bn in 2022. The issuance volume for the current year has already been revalued upwards by around PLN7bn at BGK's latest auction, following the publication of the latest Debt Management Strategy,. BGK has also announced a total of five auctions in 4Q23. This, as well as the lack of a significant reduction in government bond issuance this year, is indicative of a tight outlook for funding. It is difficult to say whether the larger issuance for the COVID Fund this year means a reduction in issuance planned for the next year.

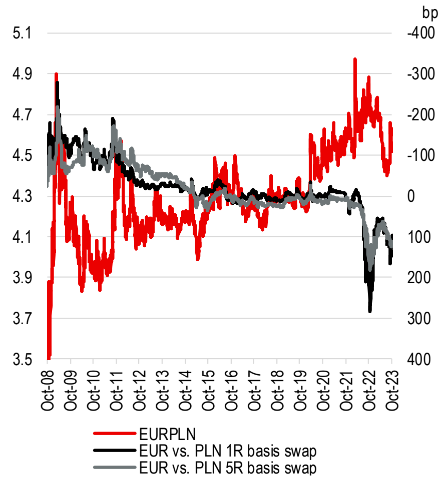
At the first auction in October, BGK sold bonds for ca. PLN1.3bn against a sizable demand of around PLN2bn. Yields on FPC bonds remain around 7-50bp above the benchmark government bond curve and may be an attractive alternative to treasuries despite the low liquidity. Larger BGK issuance also means a reduction in potential demand for treasuries.

The first major maturities of FPC bonds are not due until 2025. In contrast, the PFR bond matures around PLN16bn as early as March 2024, which will mean increased funding needs for the PFR in servicing the redemption of these bonds. According to the Debt Management Strategy, PFR does not plan to issue bonds in the following years. In the possible absence of funds from the EU's Recovery and Resilience Facility, the possibilities of pre-financing projects under the KPO (Polish National Recovery Plan) with PFR funds therefore seem limited, given the need to redeem the maturing debt.

NBP unlikely to help

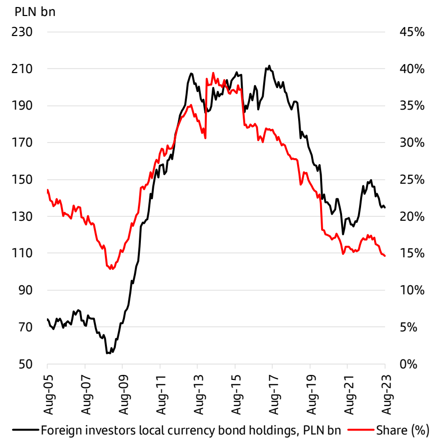
We assume that, in line with the NBP president's statements, the central bank will not be present in the debt market and will not buy bonds, despite the significant increase in borrowing needs and debt in the following years. With PLN4.5bn worth of PFR bonds in the NBP's portfolio maturing next March, we expect only a slight reduction in banking sector excess liquidity as these papers are redeemed.

EURPLN vs. basis swaps PLN vs. EUR



Source: Refinitiv, Santander

Foreign investors in the domestic bond market, PLN bn, %



Source: Ministry of Finance, Santander

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