

Poland Macro Flash

New budget suggests steeper yield curve

- **Government has approved a draft version of 2013 budget.** Although the full document is not available yet, details published by Reuters and local press (Rzeczpospolita, Gazeta Wyborcza, 4 September 2012) allow for a preliminary assessment. The Ministry now expects GDP growth to slow towards 2.2% YoY in 2013, well below 2.9% projected in June but in line with our forecasts. Inflation is forecast to reach 2.7% YoY in 2013, which is also consistent with our forecasts.
- **Gap in tax revenues worth PLN 7bn?** We believe spending limits are achievable but given projected economic performance, we see a risk of lower-than-expected tax revenues. Although planned revenues from the value-added tax (VAT) are in line with our forecast, we believe CIT and possibly PIT revenues could undershoot government targets. All the more so since a) CIT is usually highly cyclical, b) it reacts to changes in economic performance with some lag and c) most importantly, its reaction is usually non-linear. According to our estimates, this could imply a shortfall of around PLN 7bn (or 0.4% of GDP) in tax revenues, unless the government takes additional action to boost tax receipts (for more details, see page 2 of the document).
- **Is the central bank coming to the rescue again?** The non-tax revenues of PLN 30.6bn are also planned at a relatively high level, even despite low NBP profit (PLN 0.4bn). In our view, this might imply the Finance Ministry hopes for a bigger transfer from the central bank's profit but does not want to include it in the budget. We believe the NBP profit could be indeed bigger than PLN 0.4bn but we doubt it would reach a level comparable to the PLN 8bn recorded in 2012. This might be difficult to repeat unless the zloty weakens more vs. last year's already depreciated level of EUR/PLN 4.4.
- **Automatic stabilizers in action.** In line with our expectations, the budget draft suggests the Finance Ministry has decided to let automatic stabilizers work and is not trying to tighten policy to keep the overall deficit on track towards previously announced levels. We believe this is a correct strategy given on the one hand an unfavourable economic environment, and on the other hand elevated public debt. According to our estimates, the overall general government deficit is likely to remain below 3.5% of GDP in 2012 and probably close to 3% in 2013, which should allow the European Commission to remove the excessive deficit procedure.
- **Market implications.** The risk of budget revenue shortfall is likely to haunt investors in the coming months, possibly leading to a steepening of the bond yield curve — for more details, see page 2 of the document.

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Market Implications

So far, the Polish government has been skillfully managing investors' expectations and the economy's good performance has helped to attract foreign capital to the bond market. However, the new budget draft is one of the first signs of old challenges faced by Poland. In our view, like in 2009, the slowdown will likely lead to deterioration in fiscal accounts and possibly to more significant revenue shortfall, which could exceed PLN 10bn or 0.6% of GDP (including 6-7bn shortfall in tax revenues). We believe over time investors might become more worried about Poland's fiscal outlook and the risks of budget revision. Having said this we expect the government will eventually either: a) present additional measures aiming to improve the budget balance and calm markets or b) revise the budget during a year if such a shortfall cannot be filled with additional revenues.

What does it mean for the market? A deteriorating fiscal outlook increases the chances of a steepening of the yield curve. On the one hand, shorter-term bonds are likely to be supported by prospects of monetary policy easing by the Polish central bank. On the other hand, the longer-term bond yields might be kept at relatively higher levels by fears of budget revision and deterioration of the fiscal accounts. In a comparable period of 2H 2009 when the economy slowed, the budget deficit widened and interest rates dropped, while the spread between 10-year and 2-year government bonds in Poland fluctuated around 100-120bps, vs. around 80bps now.

Figure 1. Macroeconomic assumptions in the 2013 Budget

	Actual Previous budget draft (dated June 2012)			Budget draft (current version)		Citi forecasts	
	2011	2012	2013	2012	2013	2012	2013
GDP YoY	4.3	2.5	2.9	2.5	2.2	2.6	2.2
Private consumption YoY	3.6	1.9	2.7	-	-	2.0	2.2
CPI YoY	4.3	4.0	2.7	4.0	2.7	3.9	2.6
EUR/PLN (avg)	-	-	-	-	4.1	4.18	4.27
Unemployment rate	12.4	12.6	12.4	13.0	13.0	13.1	13.0

Source: Finance Ministry, Reuters, Rzeczpospolita, Gazeta Wyborcza, Citi Research

Figure 2. Key revenue and spending aggregates in the Budget Draft vs. our simulation based on Citi macroeconomic forecasts.

(PLN bn)	Actual	Budget draft (current version)		Citi simulation	
		2012	2013	2012	2013
Total revenues	278	292	299	291.2	289.1
VAT	121	122	126.4	122.1	126.0
Excise duties	58	62	64.5	61.0	64.0
CIT	25	27	29.6	27.9	27.9
PIT	38	40	42.9	38.8	39.6
Spending	303	327	335	319.6	334.5
Deficit	25	35	35.6	28.3	45.3*

Source: Finance Ministry, Reuters, Rzeczpospolita, Gazeta Wyborcza, Citi Research

*Note: According to Polish law the deficit cannot exceed the level set in the Budget Act. Our "simulation" suggests that in order to meet this requirement the government will need to adopt additional revenue measures or cut spending.

Appendix A-1

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