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Economic Comment

2024 Budget: Big deficit and even bigger debt

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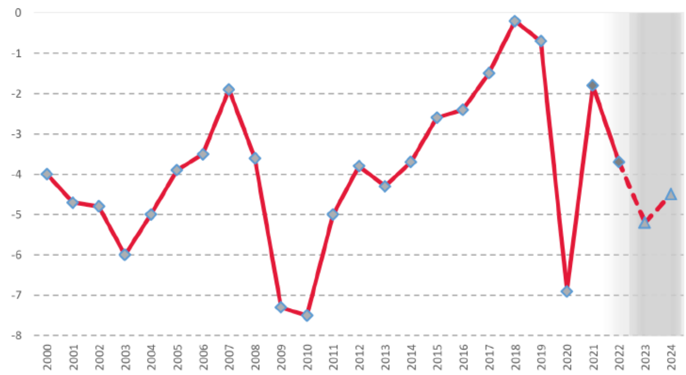
The government has approved 2024 draft budget with a state budget deficit at PLN164.8bn and a general government deficit at 4.5% of GDP (around PLN170bn). In 2023 the budget gap is expected at PLN92bn and the GG deficit at over 5% of GDP. The macroeconomic assumptions seem realistic, but not very cautious - in our view, they do not create a safety margin for revenues. Moreover, the plan for 2024 includes a novelty in a form of a downward revision of spending plans by 1.1% of GDP, which decreases the budget's safety margin also on the expenditure side. As a result, we see a greater risk than in previous years that the execution of the budget in 2024 may be worse than planned. Using the methodology comparable with the previous years (without a discretionary expenditure adjustment), the planned fiscal deficit for 2024 would be 5.6% of GDP.

Public debt is expected to rise to 54% of GDP in 2024, up by around 5 pp compared to 2023. The budget's borrowing needs will rise to record levels of PLN225.4bn net and PLN420.6bn gross in 2024, driven by the high deficit as well as rising debt maturities. In our view, the prospect of a strong increase in debt supply arising from the government's budget plans (we anticipate domestic bonds issuance at around PLN 9.5bn per auction on average) should be reflected in higher ASW spreads and higher government bond yields. Additional risks to the already ambitious plans include accounting for almost PLN30bn in loans from the National Recovery Plan (which may prove difficult to unlock, as was the case this year) and the possibility of further costly spending proposals emerging during the rest of the election campaign.

The government has adopted 2024 budget draft with a deficit of PLN164.8bn. The deficit of the entire public finance sector under the EU methodology (GG) for 2024 is planned at 4.5% of GDP (around PLN170.0bn).

According to the draft, the central budget deficit in 2023 will amount to PLN92bn and is expected to be in line with the amendment to the State Budget Act adopted in July, provided that savings on the expenditure side can be achieved by the end of this year, as revenue execution will be lower by almost PLN7bn than planned in the July amendment and by around PLN10bn compared to the original version of the budget. The balance of the entire GG sector is expected to equal around 5.2% of GDP this year (which is not explicitly stated in the text, but can be read from the chart - see below). The levels of the currently planned fiscal deficits in 2023 and 2024 are clearly above those projected in April's Convergence Programme Update (which predicted deficits at 4.7% of GDP in 2023 and 3.4% of GDP in 2024) and the European Commission's spring forecasts (5.0% and 3.7%, respectively).

General Government balance according to the 2024 budget draft (% of GDP)



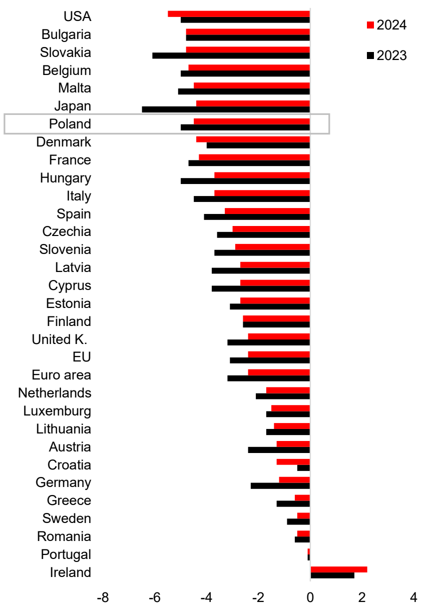
Source: 2024 Budget draft, explanatory memorandum

Macroeconomic forecasts for 2024

	Budget	Bloomberg	Santander
GDP level, PLN bn	3770.9	-	3748.9
GDP growth, %	3.0	2.6	3.2
Consumption, %	3.1	3.2	3.7
CPI inflation, %	6.6	6.0	6.9
Employment, %	1.2	-	0.6
Unemployment, %	5.2	5.2	5.4
Wages, %	9.8	-	10.0

Source: Finance Ministry, Bloomberg, Santander

GG balance in 2023-23: Poland according to the 2024 budget draft, other states according to the EC spring economic forecasts, % GDP



Source: Finance Ministry, EC, Santander

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The macroeconomic assumptions, upon which the budget draft was based, seem realistic, but not cautious - in our view, they do not create a safety margin for revenues. Moreover, the projection for 2024 includes a novelty in the form of a 'historically determined' difference between planned expenditure and its execution, in the amount of 1.1% of GDP, which decreases the budget's safety margin also on the expenditure side. As a result, we see a greater risk than in previous years that the execution of the budget in 2024 may proceed worse than planned. **Under the methodology from the previous years (without the discretionary adjustment to expenditures by 1.1% of GDP), the planned fiscal deficit for 2024 would equal 5.6% of GDP.**

At first, we attributed the convergence of the state budget deficit (4.4% of GDP) and the GG deficit (4.5% of GDP) to the implementation of the public finance sector consolidation suggested some time ago by the government. However, it appears that our guess was premature – the consolidation was not formally implemented, as evidenced, for example, by the fact that the difference between the public debt in domestic methodology and the general government debt will grow next year to a new record high of PLN465bn (from PLN302bn at the end of 2022 and PLN393bn in 2023). However, the transfer of PLN12bn from the state budget to the Covid-19 Fund (which will reduce the Fund's need to issue its own bonds) can be seen as a step towards a consolidation.

The explanation of the declining gap between the budget deficit and the GG balance next year can be found in a methodological issue: in GG terms, expenditure is recognised on an accrual basis, which means that the general government balance will include only a part of the planned high expenditure on the purchase of military equipment (around PLN32bn out of a total of PLN81bn). To some extent, this also explains the significant difference between the planned GG deficit (around PLN170bn) and the planned increase in debt (PLN338bn), which is expected to rise to 54% of GDP in 2024, by around 5 percentage points compared with the current year.

From 2024 on, the EU's fiscal rules will be restored, after being suspended for several years due to the pandemic. These rules indicate that the fiscal deficit should not exceed 3% of GDP, while debt should remain below 60% of GDP. The European Commission allows the deficit to be higher in the starting point, but the reduction in the following years should equal at least 0.5% of GDP p.a. (in structural deficit terms). The government's plan theoretically meets this condition, although in a peculiar way: by raising the deficit forecast for 2023 (from 4.7% of GDP in April's Convergence Programme Update to around 5.2% today) and adding a discretionary adjustment on the expenditure side in 2024 (1.1% of GDP).

Main budget parameters

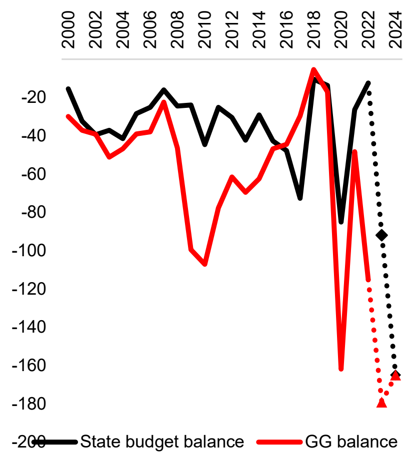
	2022 realisation	2023 expected realisation	2024 draft
Revenues (PLNmn)	504 821	594 577	683 572
Expenditure (PLNmn)	517 399	686 577	848 342
Balance (PLNmn)	**-12 578**	**-92 000**	**-164 770**
GG balance (% GDP)	**-3.7%**	**-5.2%***	**-4.5%**
GG debt (% GDP)	**49.1%**	**49.3%**	**54.0%**

*Source: Ministry of Finance, Santander, * estimate based on chart from the budget draft*

Macroeconomic assumptions without safety margin

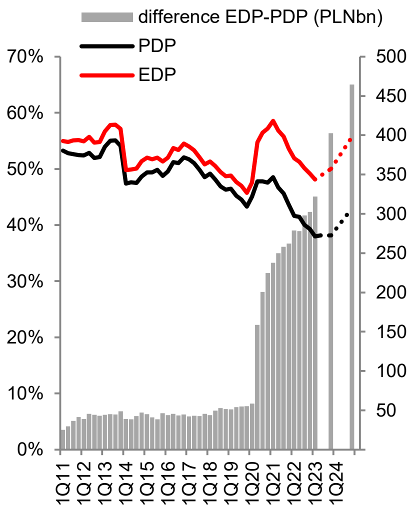
Macroeconomic assumptions are more or less in line with market consensus. However, recent weaker data from the economy (2Q23 GDP, July industrial production) suggest downside risks, making these forecasts not really conservative. The budget was created on the assumption that GDP will grow by 0.9% in 2023 and by 3.0% in 2024. We expect growth of 0.9% in 2023, 3.2% in 2024, while the Bloomberg consensus is at 0.9% and 2.6% respectively. The GDP recovery will come mainly from an improvement in private consumption, which will accelerate from -0.9% this year to 3.3% next year. We agree with this assumption. Investment is assumed at 3.8% this year and 4.4% next year. The factor behind the slight acceleration in investment growth is expected to be the realisation of Recovery Fund investments. However, in our view, there is a downside risk to investment forecasts in 2024 due to the exhaustion of funds from the previous EU financial framework.

State budget balance and general government balance, in PLNbn



Source: Finance Ministry, Santander

Public debt according to domestic methodology (PDP) and EU's general government (EDP), as % of GDP



Source: Finance Ministry, Santander

CPI inflation has been assumed at 12.0% this year and 6.6% next year. Our forecasts are similar (11.7% and 6.9%). It seems that the government assumed that electricity prices will be unfrozen and VAT cuts on food will be reversed (these changes add ca. 3 percentage points to average annual inflation in 2024). The draft budget does not mentions these, but we assume that the budget is based on the assumption that these measures will not be extended beyond 2023.

The government has assumed average wage growth in the national economy at 12.3% in 2023 and 9.8% in 2024. Employment is expected to grow by 0.3% this year and 1.3% next year. These expectations are similar to ours.

Budget revenues: quite optimistic

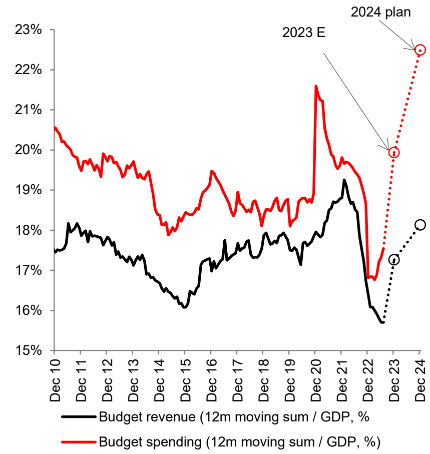
Budget revenue was assumed at PLN683.6bn, 20.4% higher than in 2023. In nominal terms, an increase of PLN89bn has been planned. The bulk of this increase comes from VAT and PIT taxes. At the same time, it is worth noting that the planned revenue in 2023 has once again been revised downwards: by c.PLN7bn against the July budget amendment and by around PLN10bn against the original budget act. **Even after this adjustment, the revenue plan for this year seems ambitious (the revenue-to-GDP ratio would have to jump sharply upwards in the final months of the year).**

Budget revenues (PLN mn)

	2022 realisation (1)	2023 expected realisation (2)	2024 draft (3)	2024 change (3) - (2)
Total revenues	**504 821**	**594 577**	**683 572**	***88 995***
1. Tax revenues	**465 456**	**525 415**	**607 791**	***82 376***
VAT	230 391	259 600	312 625	*53 025*
Excise	79 773	84 500	88 763	*4 263*
Gambling tax	3 886	4 400	4 700	*300*
CIT	70 137	73 000	78 283	*5 283*
PIT	68 107	89 635	108 839	*19 204*
Mining tax	3 787	4 400	3 700	*-700*
Bank tax	6 079	5 930	6 250	*320*
Retail sales tax	3 297	3 950	4 630	*680*
2. Non-tax revenues	**36 782**	**65 368**	**71 877**	***6 509***
Dividends	1 680	3 005	2 485	*-520*
Payment from NBP profit	844	0	6 000	*6000*
Custom duties	8 272	8 661	9 602	*941*
Budgetary units revenues and other non-tax revenues	22 536	50 021	48 801	*-1 220*
Payments of local governments	3 451	3 681	4 989	*1 308*
3. Non-refundable funds from the EU and from other sources	**2 582**	**3 793**	**3 904**	***111***

Source: Finance Ministry, Santander

Budget revenue and spending, 12M moving sum as % of GDP



Source: Finance Ministry, Santander

VAT revenues were assumed at PLN312.7bn, 20.4% higher than the expected level in 2023. If we adjust these assumptions for the effect of the VAT increase on food (the zero tax rate is in force until the end of this year), the increase will be around 15% (we estimate this effect at around PLN12bn). In our view, this is rather optimistic, but not unrealistic, assuming nominal GDP growth of around 10% and an economic recovery, which usually favours an increase in the effective tax rate. The government also assumes an improvement in tax collection after the implementation of mandatory e-invoicing; the actual effectiveness of this measure is difficult for us to assess.

PIT revenue is planned at PLN108.8bn against a planned realisation of PLN89.6bn in 2023. The nominal growth is therefore 21.4%, while after adjusting for higher returns related to the change in the tax scale in the middle of the year, it is around 9% (we estimate this effect at PLN10bn). Compared to the assumed 9.8% increase in wages in the national economy (and the wage bill by 11.1%), the indexation of pensions by 12.3% (and the pension fund by 14.0%) and the increase in teachers' salaries by 12.3%, this assumption seems rather conservative.

Inflows from other taxes are expected to increase by PLN10.2bn, consisting mainly of a PLN5.3bn (7.2%) increase in CIT and PLN4.3bn (5.1%, including PLN2.2bn as a result of rate indexation) in excise duties. These assumptions are, in our view, quite conservative.

Non-tax revenue is set to rise to PLN71.9bn, or 10%. Almost all of the increase is explained by the assumption of a PLN6bn inflow from the NBP profit. This is, in our view, a quite risky assumption - the high cost of open market operations, rising bond yields in the core markets and the strengthening of the zloty this year, especially against the dollar, in our view pose the risk of another negative NBP financial result.

Spending: rising sharply

The spending limit set by the Stabilising Spending Rule (SRW) is PLN1695.2bn, up from PLN1316.4bn in 2023. In nominal terms, the increase in the spending limit is as high as 28.8%, and in relation to GDP it rises to 45.0% from 38.2% of GDP. This will be the highest limit relative to GDP since the beginning of the spending rule (first applied in the 2015 budget). The spending limit after exclusion of local governments, the National Health Fund and some other selected entities was set at PLN1311.5bn against PLN1003.5bn a year earlier.

Budget expenses are expected to increase to PLN848.3bn from PLN693.4bn expected in 2023 - an increase of around 22%. Relative to GDP, spending will increase to 22.5% from 20.1% in 2023. **The main factors behind this increase are: increased spending on grants and subsidies as well as on benefits to individuals.**

The amount planned to be spent on grants and subsidies increases to PLN356.5bn from PLN292.3bn (+PLN64.2bn), including: **on compulsory social insurance** to PLN111.2bn from PLN81.5bn (+PLN29.7bn), **miscellaneous settlements** to PLN145.1bn from PLN123.6bn (+PLN21.5bn) and on **health care** to PLN14.8bn from PLN5.4bn (+PLN9.4bn). The increase in expenditure on compulsory social insurance results from higher subsidies to ZUS, the Social Insurance Institution (PLN87bn vs. PLN61.6bn in 2023, +PLN25.4bn) and to KRUS, social security institution for farmers (PLN24.2bn vs. PLN19.9bn in 2023, +PLN4.3bn). Higher outlays in the miscellaneous settlements category result from an increase in reserves to PLN41.2bn from PLN23.8bn (+PLN17.4bn), including a subsidy for the COVID-19 Fund worth PLN12bn. So far, the Fund has been financed mainly by the issue of BGK and PFR bonds, but now it will receive funds from the budget (and additionally PLN3.2bn from the FWRC, the fund receiving windfall tax from utilities). Still, the COVID-19 Fund's financial plans are set outside the Budget Act. Expenditure on health care is growing mainly in the unspecific category of other activities - to PLN13.6bn from PLN4.3bn in 2023 (+PLN9.3bn).

The amount envisaged for benefits for individuals rises to PLN143.4bn from PLN81.6bn (+PLN61.8bn), the increase is mainly seen in the family and compulsory social benefits category. Expenditure in the family category rises to PLN68.4bn from PLN43.9bn (+PLN24.5bn), driven by an increase in child benefit to PLN800 from PLN500. Expenditure in the compulsory social benefits category goes up to PLN67.5bn from PLN30.9bn (+PLN36.4bn).The increase is visible mainly in the category of financial benefits from the state budget to be paid by ZUS and KRUS - to PLN33.5bn from PLN4.2bn in 2023 (+PLN29.3bn).This is, in our opinion, primarily related to enactment of the so-called 14th pension as a permanent benefit, which - unlike the so called 13th pension - is not financed from the Solidarity Fund.

Current expenditures of budget entities are set to go up to PLN154.0bn from PLN139.0bn (+PLN15.0bn), i.e. by around 10.8%, which we believe is mainly due to high inflation and wage growth. The largest increases in nominal terms are visible in national defence (PLN4.1bn), the judiciary (PLN3.0bn), health care (PLN2.9bn) and public security (PLN2.7bn).

Investment expenditure is planned to go up to PLN73.3bn from PLN67.4bn (+PLN6.0bn). This includes outlays on national defence going up to PLN48.6bn from PLN39.1bn (+PLN9.5bn), in miscellaneous settlements category they fall to PLN8.8bn from PLN13.1bn (-PLN4.3bn, these are mainly funds earmarked for reserves). Other investment outlays are to rise to PLN15.9bn from PLN15.2bn.

Budget expenditures in 2024 by sections (PLNmn)

	2023 (1)	2024 (2)	change (2) - (1)
Budget expenditures	693 378	848 342	*154 964*
Agriculture and hunting	8 673	10 099	*1 426*
Forestry	14	8	*-6*
Fisheries	195	112	*-83*
Mining	1 794	1 794	*0*
Manufacturing	1 337	1 974	*637*
Trade	1 004	1 452	*448*
Hotels/restaurants	34	45	*11*
Transport, Communication	16 555	15 960	*-595*
Tourism	105	106	*1*
Housing	1 656	2 527	*871*
Services	736	803	*67*
IT	132	137	*5*
Higher education	30 947	32 055	*1 108*
Public administration	21 012	24 124	*3 112*
Offices of supreme state authorities, control and protection of law and the judiciary	3 514	4 244	*320*
Defence	85 691	99 992	*14 301*
Social security	112 579	178 938	*66 359*
National security and fire protection	22 856	25 726	*2 870*
Justice	20 045	23 310	*3 265*
Debt servicing	62 000	68 500	*6 500*
Various expenditures	199 762	215 771	*16 009*
Education	3 054	3 286	*232*
Health	17 488	29 909	*2 421*
Social aid	4 561	4 525	*-36*
Other tasks of social policy	4 392	5 099	*707*
Educational care	232	233	*1*
Family	63 650	89 159	*25 509*
Communal services and environment protection	2 184	2 384	*200*
Culture and heritage protection	5 254	4 341	*-913*
Botanical and zoological gardens, areas and items of nature protection	161	176	*15*
Physical education	1 757	1 553	*-204*

Source: Finance Ministry, Santander

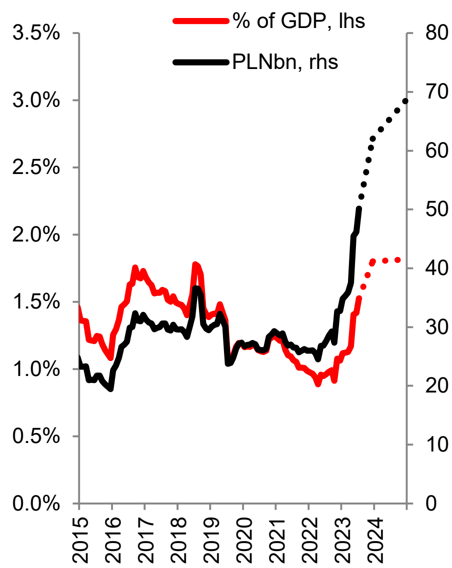
Debt servicing expenditure is set to rise to PLN68.5bn from PLN62.0bn this year (+6.5bn). In our view, the actual cost may be a bit higher, given that the largest scale of debt rollover at higher yields is yet to come.

National defence spending included in section 752 (strictly speaking: spending on the military) rises according to the draft budget to PLN100.0bn from PLN85.5bn in 2023, with the increase due to higher equipment purchases. Total budget expenditure in the national defence section is expected to be PLN113.3bn (i.e. including social security costs, pensions, etc.). On the other hand, according to the performance-based budget, expenditures on external security and border control increase to PLN98.4bn from PLN84.3bn (+ PLN14.1bn, figures for 2023 according to the original bill, before the amendment). Purchase of military equipment, excluded from the Stabilising Spending Rule by means of the new “defence clause”, financed by the budget and the FWSZ (Armed Forces Support Fund), will amount to PLN81.0bn, and the value of equipment deliveries planned for 2024 is at PLN31.9bn.

FUS (Social Security Fund) costs rise to PLN427.7bn from PLN354.6bn (+PLN73.2bn or +20.6%). Increase is expected mainly in expenditure on pensions: to PLN375.2bn from PLN310.1bn (+PLN65.1bn or +21.0%). **Expenditure of the FWRC** (Price Difference Payment Fund) was planned at PLN3.3bn.

A deficit of PLN32.5bn was planned in the European funds budget. One of the expenditure items is the implementation of projects under the **Recovery Fund** in the grant part worth PLN36.0bn, which is matched by revenues from the Fund in a similar amount.

Debt servicing costs, 12M moving sum



Source: Finance Ministry, Santander

Budget expenditures by economic groups (PLNmn)

	2022 realisation (1)	2023 amended budget (2)	2024 draft (3)	2024 change (3) - (2)
Budget expenditures	517 399	693 378	848 342	154 964
Grants and subsidies	256 143	292 350	356 503	*64 154*
Transfers to households	58 952	81 637	143 409	*61 773*
Current expenditure of budgetary units	100 296	139 006	154 034	*15 027*
Capital expenditure	25 238	67 376	73 346	*5 970*
Debt servicing	32 718	62 000	68 500	*6 500*
Contribution to the EU	34 294	34 883	37 180	*2 298*
Co-financing of EU funds-based projects	9 759	16 127	15 369	*-758*

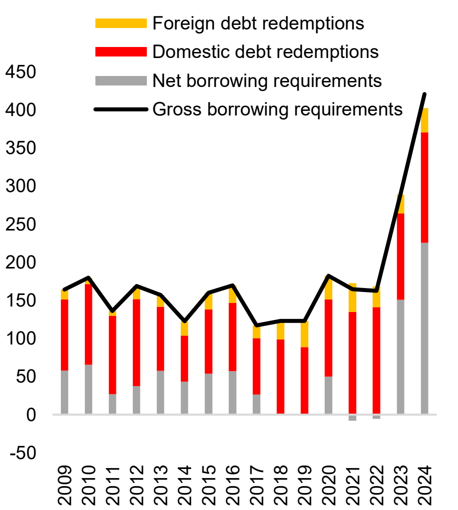
Source: Finance Ministry, Santander

Record high borrowing needs

The budget's gross borrowing needs are expected to rise to PLN420.6bn in 2024 from PLN288.8bn in the current year. In relation to GDP, the level of gross borrowing needs will rise to around 11.2%, the highest level since 2010. This is a result of both an increase in net borrowing needs to PLN225.4bn from PLN143bn (mainly due to the central budget deficit of PLN164.8bn and the European funds budget deficit at PLN32bn) and high debt maturities in 2024. Treasury securities redemptions in 2024 are expected to amount to around PLN145bn, including PLN83bn of domestic fixed coupon bonds, PLN31.2bn of domestic floating coupon bonds and PLN31.5bn of foreign currency-denominated bonds. In addition, approximately PLN24.9 billion of savings bonds will mature next year.

According to the draft budget, net borrowing needs in 2024 will be covered mainly by the issuance of government bonds**: in the domestic market, net supply is planned at PLN161bn compared to PLN63bn in 2023, of which net supply of marketable Treasury securities would increase to PLN153.7bn from the of PLN48bn expected realisation in 2023, while in foreign markets, net issuance is to increase to PLN65bn from PLN16bn this year**. Raising PLN28.6bn under the loan component of the National Recovery Plan is also an important part of the financing plan.

Gross borrowing requirements, PLN bn



Source: Finance Ministry, Santander

Borrowing needs and their financing (mln PLN)

	2023 budget act (1)	2023 expected realisation (2)	2024 draft (3)	2024 change (3) - (2)
State budget deficit	65 000	92 000	164 770	*72 770*
EU funds deficit	16 183	-3 406	32 509	*35 915*
Loans and advances granted	17 614	770	14 870	*14 100*
Pre-financing of tasks from the EU	319	319	0	*-319*
Payments related to shares in international institutions	1982	1 851	1 652	*-199*
Liquidity management	2 900	33 976	0	*-33 976*
European funds management	3 540	18 332	11 618	*-6 714*
Other	-21	-873	-24	*849*
Total (net borrowing needs)	**107 516**	**142 968**	**225 394**	***82 426***
Of which:				
1. Domestic financing	74 655	127 281	160 721	*33 440*
1.1 Treasury securities	74 655	62 944	160 721	*97 777*
1.2 Funds on budget accounts	0	64 337	0	*-64 337*
2. Foreign financing	32 861	15 687	64 673	*48 986*
2.1 Treasury bonds	-9 137	13 325	37 810	*24 485*
2.2 Loans received	-1 038	-863	-1 612	*-749*
2.3 Loans from SURE	13 471	0	28 642	*28 642*
2.3 Flows related to foreign currency accounts	29 566	3 225	-167	*-3 392*

Source: Finance Ministry, Santander

We expect the average issuance of domestic Treasury securities in 2024 to equal around PLN9.5bn per auction (with 2023 average at c.PLN6.6bn). This is a result of the planned record-high gross bond sales, including PLN155bn of fixed coupon bonds and PLN64bn of floating coupon bonds. In contrast to the current year, next year's issuance of fixed coupon bonds is expected to be significantly higher in relation to the issuance of floating coupon bonds, which may result from the assumption of higher demand for fixed coupon debt driven by the expected interest rate cuts. The ratio of fixed-to-floating coupon debt issuance would return near the historical level of around 70%.

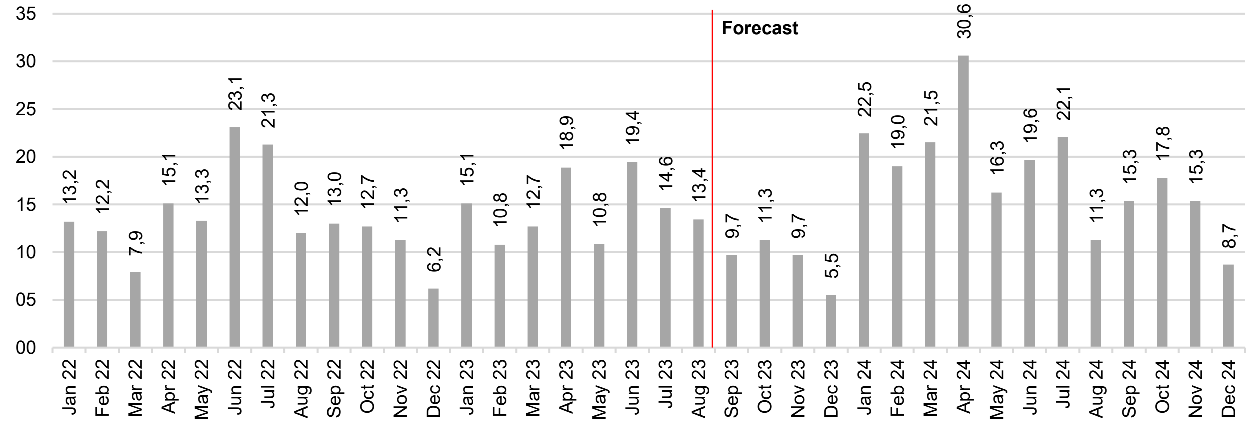
The government has also planned a gross sale of PLN69bn of foreign bonds. This implies a continuation of the issuance policy pursued since 2020, especially in 2022-2023, which, contrary to the previous few years, was characterised by an increase in nominal value of Poland's foreign currency debt. Due to the much larger scale of domestic bond issuance, this would not imply an increase in the share of foreign currency debt in total Treasury debt. Based on the figures from the budget, we expect the share of foreign currency debt to stabilise at around 22-23%, which is more or less close to the targets from the approved multi-annual Debt Management Strategy. The challenging financial situation may delay a further reduction in the foreign currency share by several years.

Treasury securities issuance assumed in 2023 budget plan (mln PLN)

	2024 draft			2023 expected realisation	Net change (2024 – 2023E)
	Net	Redemptions	Gross	Net	Gross
Treasury bills	54,478	0	79,051	0	*54,478*
Marketable bonds – fixed coupon	72,087	83,064	155,151	20,687	*51,400*
Marketable bonds – floating coupon	27,153	37,190	64,343	33,842	*-6,689*
Marketable bonds – index-linked	0	0	0	-6,518	*6,518*
Saving bonds	7,004	24,868	31,871	14,931	*-7,927*
TOTAL	**160,721**	**145,122**	**305,843**	**62,944**	***97,777***

Source: Finance Ministry, Santander

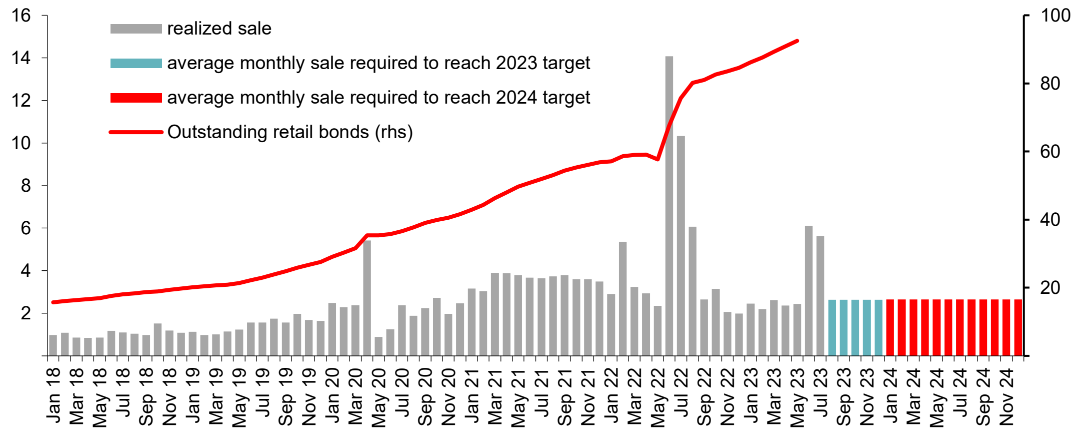
Gross government bond issuance (excl. T-Bills) – historical data and Santander forecast, PLN bn



Source: Finance Ministry, Santander

The budget assumes (realistically, in our view) a moderate size of savings bonds issuance. The plan for next year is to reduce gross retail bond sales to PLN31.9bn from the PLN37bn planned for this year, and on a net basis to PLN7bn from PLN14.9bn. This is a fairly conservative assumption given the relatively high level of interest rates. However, the conservative approach may be a result of the significant overestimation of the plans for the current year in the original version of the 2023 Budget Act, and of their subsequent gradual downward revisions.

Saving bonds sales (PLN bn)



Source: Finance Ministry, Santander

The delay in the agreement with the European Union on the rule of law issue raises concerns about the acquisition of the loan part of the RRF funds assigned to Poland. The government has planned a PLN28.6bn loan from the EU's Recovery and Resilience Facility in next year's budget. It is difficult at the moment to predict when/whether the internal dispute the Constitutional Court that prevents its operation will end. The Court is to decide on the constitutionality of the amendments to the Supreme Court Act. At the same time, there is great uncertainty on how long the process of new government formation after the October elections will last and, as a result, when any other legislative changes that will bring Poland closer to an agreement with the EC on the unblocking of RRF funds for KPO (national recovery plan) will be possible. Such a situation raises upside risks for the issuance size of Treasury securities next year.

The Treasury's borrowing needs will be at a record high, but on the other hand, debt issuance by BGK (state-owned bank) and PFR (Polish Development Fund) may be significantly lower than in previous years, thanks, among other things, to the fact that the Covid-19 Fund run by BGK will see a cash injection of PLN12bn from the state budget. The draft budget also assumes no increase in foreign loans (in fact it mentions a slight reduction in both 2023 and 2024). According to earlier media reports, significant payments resulting from arms purchases (according to the draft, a total of more than PLN80bn next year) are most likely to be financed with trade credits: the media reported, among other things, a plan for a credit line provided by South Korea. However, the financial plan of the FWSZ (Armed Forces Support Fund) are not disclosed in the draft budget, although they ultimately affect the value of the planned public debt, which is expected to rise to 54% of GDP in 2024. The fact that substantial payments are planned for next year, while the value of the military equipment expected to be delivered next year will be significantly lower explains in part the difference between the increase in GG debt and deficit (the latter is calculated on an accrual basis). What it also means is that in the following years armament spending may have a greater impact on the deficit and a smaller impact on the debt.

Where to find the demand to cover the record issuance?

The process of covering the financing needs may be much more difficult than in previous years. Given the large inflow of money to investment funds this year (their purchases of domestic Treasury bonds year-to-date are c.PLN5.5bn), we assume for next year an inflow of about PLN22bn. We think that at least half of these funds will go to debt funds. We assume that net purchases of retail bonds by households could amount to around PLN7bn, which would mean a realisation of the Finance Ministry's plan. After many years of falling exposure to the domestic debt market by foreign investors (with the exception of 2022), it is difficult to be optimistic about non-resident demand for POLGBs next year. Bond yields in core markets are relatively high, and while NBP interest rate cuts may encourage foreign investors to buy, a tougher fiscal situation may discourage them.

Domestic banks are likely to remain the main buyers of domestic debt. If we assume a stable share of government debt in banks' assets and a PLN150bn increase in banking sector deposits next year, banks will buy the net amount of bonds of c.PLN70bn. Deposit data and bond purchases in the first half of the year for PLN35bn are consistent with this pattern. If we assume a PLN170bn increase in deposits in the whole 2023, there should be net bond purchases for c.PLN86bn. This year's net purchases of government debt by domestic banks could be a record and next year's purchases could be only slightly lower.

Such a sales structure would mean that there would still be a shortfall in demand for debt worth around PLN60bn vs. the plan. We believe that the increased supply of Treasury bills could eventually create extra demand from domestic banks or funds, thanks to suitable liquidity, lower market risk or tax reasons.

Change in domestic government bond portfolios, PLN bn

	Banks	NBP	Foreign investors	Investment funds	Insurers	Households	General gov.	Other	Total
2005	-6.0	0.0	6.6	10.5	4.2	-3.5	2.2	17.0	31.1
2006	7.4	0.0	5.4	7.6	5.1	-4.0	1.8	17.2	40.4
2007	8.9	0.0	0.1	3.2	6.2	-2.2	1.4	13.4	31.1
2008	47.8	0.0	-18.6	-13.7	1.1	2.8	1.9	19.9	41.2
2009	10.5	0.0	25.9	3.3	-9.4	-0.9	3.9	13.8	47.1
2010	-15.4	0.0	46.4	3.2	4.3	-2.5	1.8	8.5	46.4
2011	-20.1	0.0	26.0	-0.1	-4.4	-1.3	3.7	7.3	11.1
2012	-18.8	0.0	36.3	9.7	-3.0	-0.3	2.9	-4.7	22.1
2013	23.2	0.0	2.7	4.5	-1.3	0.9	3.2	11.0	44.1
2014	36.1	0.0	2.8	0.1	0.9	-0.1	-0.6	-122.4	-83.1
2015	20.7	0.0	10.8	0.2	-0.7	1.4	0.8	-0.5	32.7
2016	64.0	0.0	-14.2	3.1	6.9	1.1	4.4	3.3	68.7
2017	8.4	0.0	10.2	6.9	0.8	4.2	2.4	2.8	35.6
2018	20.2	0.0	-11.3	-1.7	5.3	4.1	9.2	9.2	34.9
2019	40.9	0.0	-34.1	12.0	-0.8	7.4	-0.7	-45.3	-20.6
2020	71.9	53.6	-23.6	-18.8	-7.0	13.4	12.6	5.2	107.3
2021	-10.5	28.5	-9.2	-3.3	-1.6	14.4	20.3	-0.1	38.6
2022	-12.6	-7.8	21.6	1.8	3.9	32.8	4.7	2.0	46.5
1H23	35.9	-0.7	-11.3	5.5	2.2	6.7	-7.1	9.6	40.7
2023E	60.6	-0.7	-17.0	8	3	13	-14	10	62.9
2024F	105.0	-4.5	17.2	15.0	5.0	7.0	10.0	6.0	160.7

Source: Finance Ministry, Santander forecast

Nevertheless, high issuance this year and next year supports our view that asset swap spreads may remain elevated for the next few quarters. This is all the more so as large debt maturities also fall in 2025 and beyond. As a result, the important role short-term Treasury bills will play in financing 2024 will also mean growing challenges with financing the following years.

The liquidity cushion still allows for flexible planning and implementation of issuance. At the end of July, the Ministry of Finance's liquidity cushion stood at PLN133.3 billion, including PLN103.8bn of PLN deposits. Although July's amendment to this year's budget assumed a reduction in issuance and smaller liquidity cushion at the end of the year, we believe that the tight issuance schedule in the following quarters will mean that the cushion can remain at a relatively high level, and even if it falls in the final months of the year, the Ministry of Finance will want to rebuild it early next year.

Borrowing needs for 2023 have so far been financed at 94%, which has to do with the increase in the planned budget deficit and the higher estimate of borrowing needs for this year in the budget amendment (raised to PLN288.8bn). The increase in this year's deficit and the record financing needs next year mean that there is little room to reduce issuance later this year. As a result, bond sales at primary and swap auctions are likely to remain high. A large government bond issue would be in line with our earlier assumptions - based on this year's weak budget revenue performance - that the Ministry of Finance would not necessarily reduce bond issuance for the remainder of this year, against what was indicated in the budget amendment.

Additional information is available on request. Please contact Santander Bank Polska S.A. Financial Management Division. Economic Analysis Department. al. Jana Pawła II 17. 00-854 Warsaw. Poland. phone +48 22 534 18 87. email ekonomia@santander.pl. http://www.santander.pl.