showCASE
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Overview: In this week's showCASE our experts dissect the possible implications a change to the rules governing tax-free allowance could have on the Polish economy, and how this relates to the current government's spending promises.

Coming to terms with reality

By: Grzegorz Poniatowski, Director of Fiscal Policy Studies, CASE

On November 29, after a frenetic two-day legislation process, Polish President Andrzej Duda signed a bill that amended the threshold and rules for granting tax-free allowance on personal income.

Starting in the next fiscal year, the new threshold for tax-free allowance will increase from 3,091 PLN to 6,600 PLN. However, this increase will only be applicable to lower-income taxpayers, as taxpayers who earn more than 11,558 PLN (which is less than the income of half-time employees earning minimum wage) and less than 85,000 PLN will continue to be given a tax-free allowance up to the current value of 3,091 PLN.

The cost of the tax-free allowance adjustment for low earners will mostly be borne by those who make more than 85,000 PLN (approximately US$20,000) yearly. Earning an income above this threshold will lead to a gradual phase-out of this allowance, eventually resulting in no allowance at all at the highest income levels.

Source: Wikimedia commons

By reshuffling the personal income tax structure, the government is attempting to convey the message that it is fulfilling promises from its successful electoral campaign. But in reality, it is not actually making good on these promises. As CASE alerted readers last October, the roster of promises made by the government during the campaign were extremely dangerous for the stability of public finances. Among the promises of the incoming government was an increase of the tax-free threshold up to 8,000 PLN. This increase was supposed to apply to all tax payers, a move that would decrease tax revenues by 17 billion PLN.

Confronted with tight budgetary constraints and a slowing pace of economic growth (in part due to other policies the government is promoting), this new move decreases the tax burden for less than three percent of taxpayers, shifting the burden of fiscal expansion to those who already give back the highest share of their income to the state, namely the middle class.

Deputy Prime Minister Morawiecki admitted that the government is facing real constraints in implementing its policies, as it "has already given 37 billion PLN to the (Polish) people this year." But the current profligate policies of the government endangers Poland's policy credibility, and has already resulted in a substantial downward revisions of GDP growth rates (as well as increased costs of government bonds). Economists known well that there is no such thing as a free lunch, but it is not proven if the government knows that yet.

Coming to terms with reality

By: Iakov Frizis, Economist, CASE

This past week, the Basel Committee failed to reach agreement on an update of the Basel III banking reform measures, as representatives from both sides of the Atlantic clashed on the issue of banks using internal models in the determination of the riskiness of their loans.

The updated framework under discussion aims to address concerns regarding gaming, errors, and monitoring difficulties. The new framework also hopes to restore market confidence in risk-based capital ratios (total risk based capital/risk weighted assets, or RWAs), an indicator of capital adequacy that has been estimated largely through the use of the internal rating based approach (IRB).

Unfortunately, the IRB approach has resulted in extensive variation in RWA calculations across banks; to address this issue, the Basel committee is considering constraining the use of IRBs through the introduction of output floors. This reform is to be based on a standardized approach for credit risk, which, contrary to IRB, prescribes external credit ratings for certain exposure. Notably, considerations have centered on two levels of exposure: setting an average risk weight by risk category or instead focusing on aggregate RWAs.

However, such a move has run into disagreement from players on both sides of the Atlantic. US quasi-governmental agencies such as Freddie Mac and Fannie Mae, when coupled with deeper financial markets and extensive securitisation, allows US banks to reduce their exposure to residential mortgages; this motivates lenders to keep high yielding, riskier commitments on their balance sheets. On the other hand, faced with more favourable weights for well-rated and well-secured credits, European banks choose instead to keep large amounts of mortgages on their balance sheets.

Switching systems, and in particular the adoption of output floors, is expected to have a significant asymmetric effect across the global banking sector, as it increases capital requirements for lower-risk weight portfolios, such as mortgage loans, which are widely held by European banks. Consequently, this would require substantial increases in capital requirements for European banks, exacerbating profitability issues and offering a competitive edge to banks in the US.

Looking ahead, according to comments made by the chairman of the Basel Committee Stefan Ingves, the output floor is going to be part of upcoming reforms as a fait accompli, meaning any debate will occur on the actual specifications of the output floor that is to be introduced. Nevertheless, no update on the topic is expected from Basel before January, when European representatives will meet their newly-assigned counterparts in a Trump administration.

Time is of the essence when looking at the magnitude of the adverse effect that the US's proposal may have on European lending institutions. The introduction of an output floor would be another challenge in a year full of them for European banks, who continue to face the legacy of non-performing loans, capital restructuring and persistent challenges of low profitability. While an accounting change would not harm the real position of the sector, it is just another obstacle to overcome on the road back to health.

At a glance

Last week, the Central Statistical Office in Poland published quick estimates of GDP growth in Q3 of 2016. During the last quarter, GDP increased in real terms by 2.5% year over year, which comes in much lower than expectations. While private consumption has been increasing, due in large part to accelerating wages and higher welfare spending, investment activity remains subdued, weighing on growth expectations. CASE experts forecast 2016 growth at 2.8% and anticipate that the economy may accelerate slightly in 2017. However, high deficit levels caused by inflated social spending could likely lead to deficits exceeding 3 percent threshold, and together with increasing policy uncertainty, may hamper future GDP growth.

October unemployment down to 8.2% from 8.3%

GDP slows to 2.5% y/y

Real GDP forecast (%)	2016	2017
CASE	2.8	3.4
IMF WEO	3.1	3.4
OECD	3.0	3.5

According to the Federal State Statistics Service, Russian GDP growth in Q3 was -0.4% (y/y), a positive improvement compared to the previous rate of -0.6% (y/y) in Q2. October's projected inflation rate was even more optimistic, declining to 6.1% (y/y) - the lowest level in 3 years, surpassing market expectations and moving towards the Central Bank's target of 4.0% for 2017. On the other hand, the unemployment rate reached 5.4% in Q3 and is expected to continue growing, reaching 5.7% in Q4. Despite releasing a positive forecast for the Russian economy, the World Bank adds a note of caution that Western sanctions over Crimea and continued intervention in Ukraine and Syria could still be an obstacle for Russia's economic recovery.

Nov Manufacturing PMI up to 53.6 from 52.4

Real GDP forecast (%)	2016	2017
IMF WEO	-0.8	1.1
OECD	-1.7	0.5

Despite significant restructuring challenges faced by the banking sector, confidence in the German economy remains at a good level (according to the latest IFO Business Climate report). GDP q/q growth is down to 0.2% from 0.4% during Q2, as the German economy tapers off a cyclical upswing. The ECB's QE program is also introducing added pressure for the country's highly fragmented banking sector, while failing to boost investment in plants and equipment, two sectors which contracted by 0.6% in Q3. Further, according to the Federal statistics' office, a drop in net exports was offset by a rise in household spending, founded on record-high employment, rising purchasing power and persistence of low borrowing costs during Q3.

Nov HICP (Prelim) down to 0.1% m/m from 0.2%.

Nov CPI stable at 0.8% m/m.

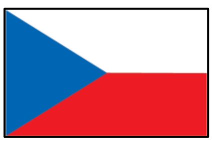
Real GDP forecast (%)	2016	2017
IMF WEO	1.7	1.4
OECD	1.6	1.7

At a glance

On November 30th, the National Bank of Ukraine announced that the current account deficit dropped to US$234 million in October. The reduction of the deficit was mainly due to the scheduled payments of interest on restructured Eurobonds that were made in September. The balance of payments showed a surplus of US$91 million in October. Earlier in November, the NBU released its updated macroeconomic forecasts, which left 2016 GDP growth forecasts unchanged at 1.1%. Growth for 2017 and 2018 were both revised down to 2.5% and 3.5%, respectively. The NBU kept headline inflation expectations unchanged at 12% for 2016, 8% for 2017, and 6% for 2018, further supporting the Central Bank's decision to cut key interest rates by 100 bps to 14% on October 27, which reflected decreased price stability risks. In October 2016, headline inflation stood at 2.8% month to month while accelerating to 12.4% in annual terms.

Current account deficit reduced to USD 234 million

Real GDP forecast (%)	2016	2017
IMF WEO	1.5	2.5
OECD	-	-



The Czech economy is suffering from an increasing outflow of funds from foreign-owned companies, who, according to the latest report prepared by the Czech Government, own a significant share of businesses in some of the most profitable sectors of the economy. At the same time, the economic sentiment indicator was reported to have increased again this month, from 97.5 in October to 99.3 in November. This has mostly been driven by a 2.3 p.p. increase in the confidence of entrepreneurs, while the consumer confidence decreased slightly by 1 p.p. The expectations for GDP growth also remain optimistic, and were recently revised up from 2.2% to 2.4% for 2016 and from 2.4% to 2.5% for 2017. Meanwhile, the unemployment rate is expected to be 1 p.p. lower both in 2016 and in 2017, and settle at 4.0% and 3.9% respectively (down from 4.1% and 4.0%).

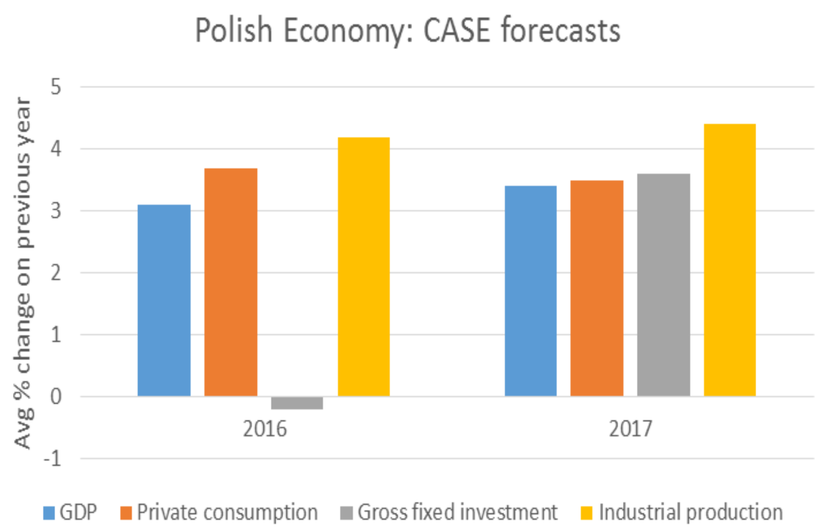
Economic sentiment indicator increasing by 1.8 pp

Real GDP forecast (%)	2016	2017
IMF WEO	2.5	2.7
OECD	2.4	2.5

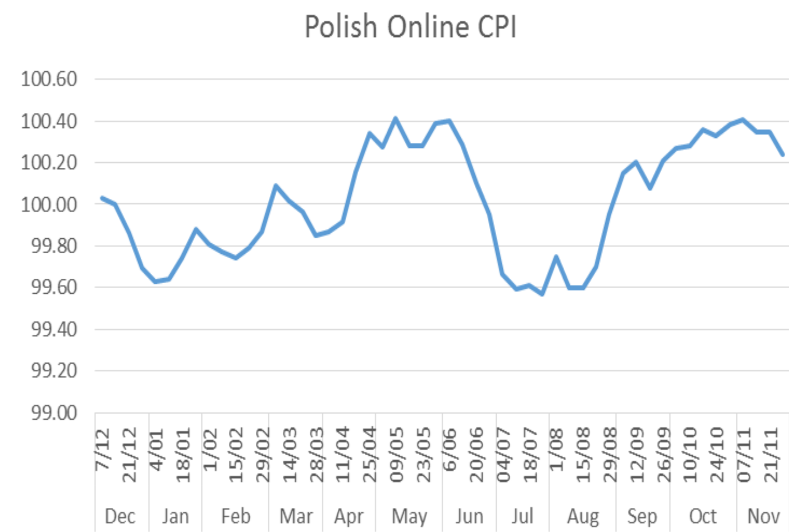
While Hungarian GDP is only expected to reach 2% in 2016, the usage of EU funds and ongoing stable household consumption should deliver growth in 2017 as high as 3%, projects Hungary's Ministry of Economy. Growth in 2017 will also benefit from increased bond ratings, from Ba1 to Baa3, and declining government debt burdens coupled with significant overall reductions in external vulnerabilities. Meanwhile, inflation continues to remain below the 3% Central Bank target with little signs that it will increase above target levels in 2017, a reality which could incite further rate cuts in the near future (although none are currently planned). Moving forward, the economy should benefit from growing business capital accumulation, inward FDI and increasing demand.

October unemployment down to 4.7% from 4.9%

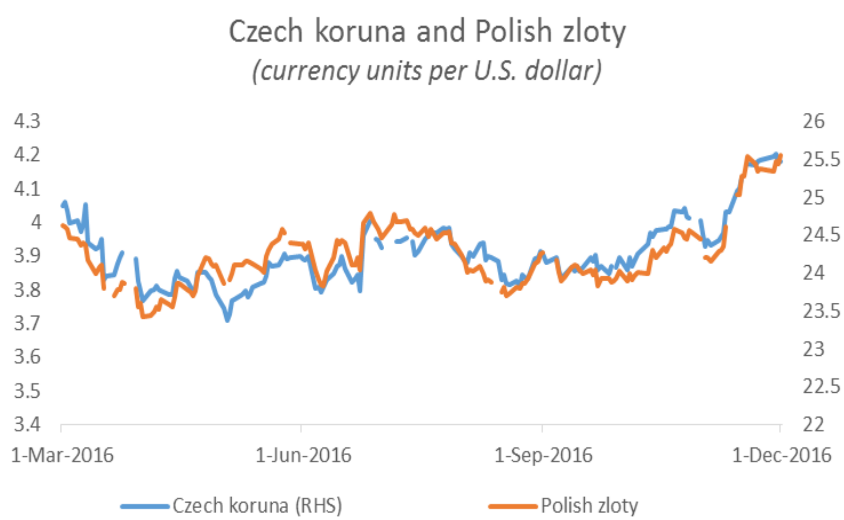
Real GDP forecast (%)	2016	2017
IMF WEO	2.0	2.5
OECD	1.6	3.1



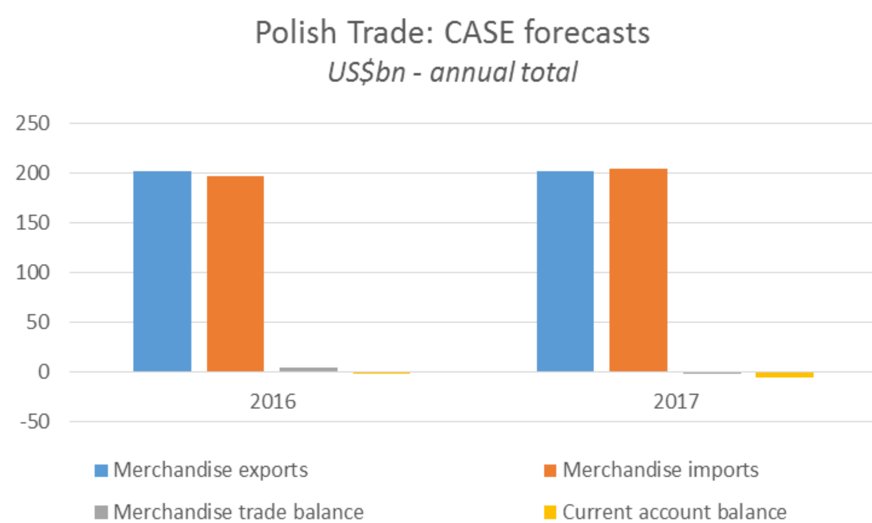
Source: CASE forecasts, updated November 14, 2016



Source: CASE, most recent observation Nov 28, 2016



Source: IMF, most recent observation December 1, 2016



Source: CASE forecasts, updated November 14, 2016

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