

MinFin may strengthen PLN before 29 December

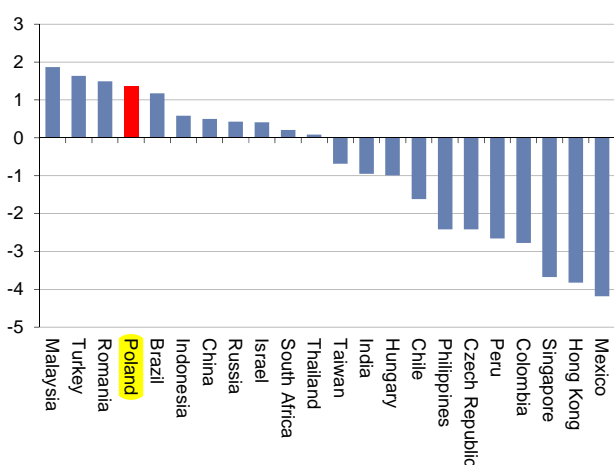
The coalition amended the rules for estimating PLN value of foreign debt for the debt ceiling purposes

In 2011, when the PLN was weak and debt close to the ceiling, the MinFin sold € and US\$ on the market to strengthen PLN

The lower chamber of the Polish Parliament passed the amendment of Public Finance Act, which changes the rules for estimating the PLN value of foreign debt for debt ceiling purposes. One of the fiscal rules which discipline Polish public finance refers to the debt and it sets three debt ceilings at 50%, 55% and 60% of GDP. Breaking 55% and 60% causes an automatic fiscal adjustment process, but more importantly, the MinFin tries to avoid piercing this level for credibility purposes (to show that the threshold is a real anchor).

Before the amendment, the last fixing of December was used to estimate PLN value of annual foreign debt. When the PLN was weak and debt close to the ceiling (most evident in 2011, the MinFin (and its agent BGK) sold EU funds and proceeds from foreign issuances on the market to strengthen PLN. In Dec-12 we recommended to play €/PLN outperformance vs €/US\$ and our position earned almost 3% within a few days.

Fig 1 Real interbank rate among highest in EM



Source: Reuters, EcoWin

Fig 2 PLN not overvalued even with 125bp cuts priced in



Source: Reuters, ING estimates

Now the statistical office may use the yearly average €/PLN, should debt approach the threshold, so there is less incentive for the MinFin to fight with the market

However, it can still try to strengthen PLN in order to show lower debt levels in statistics

PLN is not overvalued (fair value at 4.0800/€) even with the 125bp cuts priced in, PLN weakening can be postponed

The amended rule assumes that the end of the year €/PLN fixing will still be used to estimate the PLN value of foreign public debt by the statistical office, but the major difference is that should the debt break the threshold, the statistical office may use the yearly average €/PLN to determine whether it was broken. Also, the debt level can be net of pre-financing means for the next year (MinFin has a cushion of 3.6% of GDP).

As a result, there is less incentive for the MinFin to fight with the market and strengthen PLN before end of the year, as new rules make the piercing of the debt threshold less dependent on the end of the year fixing. However, the MinFin may still try to strengthen PLN in order to show lower debt levels in statistics. We expect that €/PLN fixing game should be less aggressive than last year, but still the MinFin may use its abundant FX liquidity to improve statistics. Last week €/PLN hovered in range of 4.0800-4.1000/€, and as long as it stays below 4.1100/€, the PLN appreciation trend remains intact. So, we expect a retest of 4.0800/€, and if broken it will open the way to 4.0500/€ before 29 December.

Separately, our model based on expected carry to risk in PLN vs EUR shows the PLN is not overvalued (fair value at 4.0800/€) even with the 125bp cuts priced in. Also the BoP shows a very rapid rebalancing of the economy and the external financing gap (12M C/A deficit adj. with capital acc. surplus), which decreased to 0.8% of GDP, down from 2.9% in Dec-2011. Consequently, we assume only gentle PLN weakening in a 3-6M horizon (to 4.25/€) together with the GDP slowdown (PLN is sensitive to cyclical weakness of domestic demand) and the peak in the easing expectations after which flows into bond market can slow. However, a new wave of global liquidity (counter reaction to Fed's QE 3.5) should sustain the flow into EM local bonds, especially those with a sound FX outlook, which can also postpone PLN weakening. **rafal.benecki@ingbank.pl**

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