EU money to Poland: a wake-up call for decision makers

Markets learnt about the rising risk of EU money being withheld from Poland last week. However, the market reaction was quite muted. While the Rule-of-Law standoff threatens new EU funding to Poland, this is in line with the baseline scenario

Financial market participants are already assuming virtually no new EU fund flows to Poland before the late 2023 general election as a base case. However, there is mounting concern about 2024 when the absorption from the current EU budget ends and inflows of new funds look set to be modest.

Context

Although the European Commission (EC) formally greenlighted Poland's National Recovery Plan (NRP) in June, funds from the EU's Recovery Fund have not been disbursed. This is because Poland did not fulfil so-called horizontal milestones, in particular rules governing the independence of judges. As such, the country cannot start to absorb the €24bn in grants or the €12bn in preferential loans under the NRP.

The latest media reports suggest there are risks surrounding the EU's structural and cohesion funds from the new 2021-27 multi-year budget. Poland's allocation of grant money from these funds is three times as high as the NRP grants (above €75bn), and the implementation of them was expected to reach full-speed beginning in 2024. Direct payments to farmers (around 20% of EU transfers to Poland) are not subject to potential delays, given that they are processed at the EU-wide level. Taken together, the potential withholding of new EU funds to Poland, amounts to some €100bn.

New and old EU money flows to Poland

The main concern right now relates to the 'new' EU money to Poland as inflows already underway from the EU are not seen as likely to be disrupted. Because of the so-called T+3 rule, funds from the 2014-20 multi-year budget can be disbursed through the end of 2023. According to our estimates, the amount of remaining funds is around €20bn and given that Poland has an effective track record, the country should be able to absorb all of it. As of September 2022, contracts with EU financing have covered almost 100% of the available budget envelope, while payments were advanced in less than 75% of cases (as you can see in the chart below).

Historically, overlapping two consecutive EU budgets has been far from perfect. Poland's experience is not impressive as shown by the sizeable drop in EU cohesion fund flows in 2016, to 1.6% of GDP compared to 2.2% of GDP in 2015, down from 3.3% of GDP on average in the previous three years. The previous EU budget expired in 2015, while investment projects from the new budget were not yet ready. The situation in late 2023 may be similar, and a sizeable gap in EU money flows may materialise in 2024.

Partnership Agreement in place but not activated due to Rule-of-Law issue

After the adoption of the Partnership Agreement in late June 2022, the EC made it very clear that the member states must fulfil so-called horizontal and thematic enabling conditions in the implementation of cohesion policy programmes. One of the enabling conditions requires compliance with the EU Charter of Fundamental Rights, which includes independence of the judiciary, during the whole programming period. If these conditions are not fulfilled, the EC cannot reimburse expenditures related to the parts of the programme concerned. The recent changes in the judiciary system introduced by the Polish authorities are not perceived as sufficient by officials in Brussels.

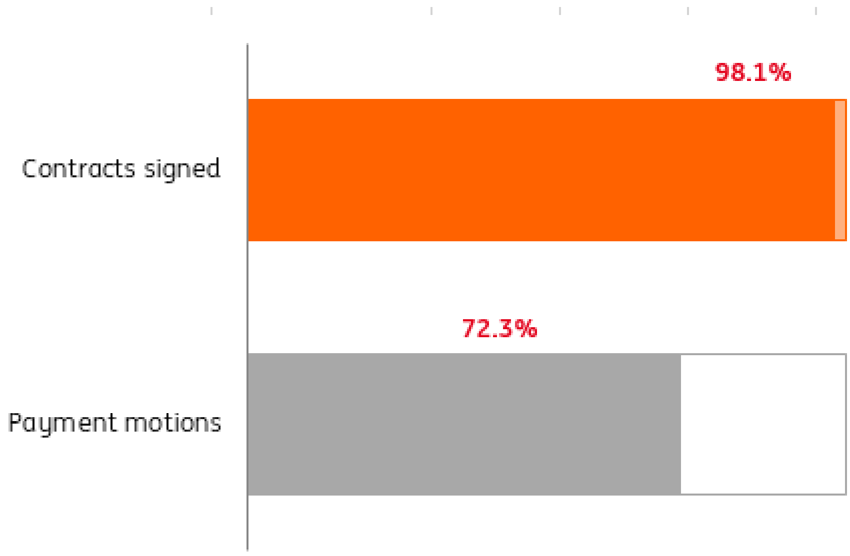
Little hope for compromise before the end of 2023

A solution to the political deadlock ahead of next year's general elections looks unlikely. This applies both to the new NRP (about 1% of GDP yearly from 2023 to 2026) and cohesion funds (above 2% of GDP yearly from 2024). The rhetoric of the current government has been centred on maintaining independence from EU bureaucrats in decision-making, so the scope for concessions in the run-up to next year's elections is narrow. However, because confidence in the EU is very high in opinion polls, the internally-divided government will not be looking for an open conflict with Brussels. The opposition has generally shown a readiness to solve clashes with the EU. The Rule-of-Law and independence of judges remain key topics in internal policy disputes.

Therefore, a scenario of no new EU money to Poland before the general election in late 2023 appears to be a baseline scenario for financial market participants. Flows of EU money will be delayed and this will hit Poland's economy in 2024. Provided that the new EU money is not activated, the overall net balance of EU transfers to Poland (EU transfers minus Poland's contribution to the EU) may appear close to balance (zero net flows) rather than a sizeable surplus (net balance of 2.1% of GDP yearly on average in 2017-21).

Absorption of 2014-20 EU cohesion funds for Poland

A percentage of total available funds



Source: ING estimates.

Statements from rating agencies

The potential withholding of the EU's large budget for Poland could have dire economic and market implications. According to Moody's, a further deterioration in the Rule-of-Law could negatively impact investing in Poland and further intensify the conflict between Warsaw and Brussels, which would be a credit negative. Withholding payments from the 2021-27 financial perspective would weigh on Poland's economic as well as fiscal strength – Moody's assessed.

A similar view was presented by Fitch. The agency pointed out that delays in the disbursement of structural funds could undermine investor confidence, negatively impact the Polish zloty and hence lead to a further increase in inflationary pressure. So long as the delay is not substantial, it would not markedly impact the current absorption or investment trends, but the main risk is the suspension of EU money inflows after 2023.

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