Inflation Report
October 2009

National Bank of Poland
Monetary Policy Council

Warsaw, October 2009

The *Inflation Report* presents the Monetary Policy Council's assessment of the current and future macroeconomic developments influencing inflation. The projection of inflation and GDP presented in Chapter 4 was prepared at the Economic Institute of the National Bank of Poland. The projection was prepared with the use of the NECMOD macroeconomic model. Content-related supervision over the works on the projection was entrusted to a member of the NBP's Management Board, Mr. Zbigniew Hockuba. The NBP Management Board approved the submission of the projection to the Monetary Policy Council. The inflation projection is one of the inputs to the Monetary Policy Council's decision-making process.

This Inflation Report is a translation of the National Bank of Poland's *Raport o inflacji* in Polish. In case of discrepancies, the original prevails.

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Summary

Following the decline in the two previous quarters, 2009 Q2 saw a rise in global economic activity, supported by anti-crisis measures implemented by many governments and central banks. Improvement in economic activity was recorded in both advanced and emerging economies, albeit in most of them this activity remains low. The recently released data point to further gradual improvement in global economic activity in 2009 Q3. In 2009 Q2 low activity in the global economy was accompanied by a decline in the general price level of consumer goods and services in developed economies and a further easing of inflation in developing economies. At the same time, core inflation indicators in major economies remain positive, although they have declined further in the past few months.

Recently the situation in international financial markets has stabilized to some extent and the global financial crisis has been halted. The main market measures of risk have returned to levels close to those observed before the collapse of Lehman Brothers. As a result of lower risk aversion the world's major stock exchange indices increased strongly, whereas government bond yields in developed countries remained stable. Major central banks continued to pursue an accommodative monetary policy, and the money market saw a significant drop in liquidity and credit risk.

Starting from March 2009, as risk aversion in international financial markets was gradually diminishing and first signs of a possible improvement in the outlook for growth in the world economy appeared, the price of oil has shown a rising tendency. In turn, the prices of agricultural commodities – following a strong increase observed between 2007 Q1 and 2008 Q3 and a plunge in 2008 Q4 – stabilised at a relatively low level in 2009 which was driven by weak demand related to the global recession and the favourable supply situation in 2009.

In June–August 2009 the annual growth of prices of consumer goods and services in Poland remained within the range of 3.5%–3.7%, i.e. slightly above the upper limit for deviations from the NBP's inflation target, and in September it slowed to 3.4% y/y. The heightened annual inflation was driven to a large extent by past increases in administered prices as well as by the rise in tobacco product prices and the fast growth of alcoholic beverage prices, both due to excise tax hikes. Another factor conducive to keeping inflation at an elevated level was the strong depreciation of the nominal exchange rate of the zloty in the second half of 2008 and at the beginning of 2009. On the other hand, inflation was curbed by a further decline in the prices of fuels and the reduction in the prices of natural gas for households in June 2009.

The majority of core inflation measures edged down in June–August 2009, while still remaining relatively high. This indicates that the weakening of demand so far has not fully

offset the increases in administered prices and excise tax rates as well as the effects of the earlier exchange rate depreciation.

In 2009 Q3 the growth of producer prices (PPI) slowed to 2.2% y/y, down from 4.2% y/y in 2009 Q2 which was mainly due to a negative annual price growth in *manufacturing*. In the two first months of 2009 Q3 producer prices in the domestic market grew slower than in the previous quarter. In contrast, the fast growth of producer prices of exported goods continued, which was related to the previously observed strong depreciation of the zloty.

In 2009 Q1 zloty-denominated import prices increased significantly due to an increase in commodity prices, including oil prices, and the strong depreciation of the zloty. In turn, in 2009 Q2 import prices declined slightly in connection with the appreciation of the zloty. In year-on-year terms import prices rose by 12.4% and 13.0% respectively in 2009 Q1 and Q2 as compared with 4.1% in 2008 Q4.

Since the publication of the previous *Report* bank analysts' forecasts of CPI inflation over an 11-month horizon have remained relatively stable at levels slightly lower or equal to the NBP's inflation target. On the other hand, the objectified measure of inflation expectations of individuals at a 12-month horizon, following an increase in May and June 2009 to 3.8%, fell back to 3.4% in September and October 2009.

In 2009 Q2 real GDP growth amounted to 1.1% y/y (compared to 0.8% y/y in 2009 Q1). Private consumption, despite a weaker growth than in the previous quarter, had a positive contribution to GDP growth. At the same time, low investment activity of enterprises and reduction of their inventories, related to the economic slowdown, resulted in negative contributions to GDP growth of both gross fixed capital formation and the change in inventories. As a result, domestic demand in 2009 Q2 declined and net exports became the main driver of GDP growth.

Weakening private consumption growth in 2009 Q2 was largely the effect of slower growth in household real income. This was due, on the one hand, to a slowdown in average nominal wage growth and a decrease in employment, and on the other hand, to inflation continuing at an elevated level. Weakening consumption demand was also driven by markedly slower than a year ago growth in consumption loans. The relatively strong growth in income from social benefits, in turn, had an opposite effect. However, household condition surveys in 2009 Q3 may signal a rebound in the unfavourable tendencies in consumer confidence.

In 2009 Q2 gross fixed capital formation fell by 3.0% y/y. The fall in investment was observed in the corporate sector and in housing construction. At the same time, the general government sector experienced a rise in investment expenditure which partly offset the decline in investment outlays in the private sector. Business condition surveys of the NBP indicate that in 2009 Q3 enterprises continued to show low interest – though slightly higher than in the previous quarters of 2009 – in starting new investment projects.

According to the Ministry of Finance's preliminary estimates, in the first nine months of 2009 the total central budget revenue increased by 5.2% y/y. This was driven by very high revenues from the European Union, whereas tax revenues were lower than in the corresponding period of 2008. In turn, central budget expenditure rose by 13.9% y/y. Consequently, in the period January–September 2009 the central budget recorded a deficit of PLN 21.5 billion, which constitutes 79.0% of the annual plan following the amendment of the *Budget Act for 2009*. Moreover, 2009 Q2 brought a marked deterioration in the financial situation of local government entities and special purpose funds. As a result of the growing deficit of the central budget and other government budget entities, 2009 will see a significant deterioration in the general government balance in terms of ESA'95 as compared with 2008, which will lead to public debt growth.

Amidst weak economic activity abroad and a slowdown in the Polish economy, 2009 Q2 saw a deepening of the significant decline in the volume of imports and – to a smaller extent – exports. Due to the earlier depreciation of the zloty and the structure of the Polish foreign trade, the decline in imports, was markedly deeper than the decline in exports, which translated into a significant positive contribution of net exports to GDP growth in 2009 Q2.

The growth of value added in 2009 Q2 resulted mainly from the growth in the service sector and – to a lesser extent – in the construction sector. A negative contribution to total value added was recorded in industry, which saw a considerable output decline in year-on-year terms.

Weak economic activity is reflected in the labour market situation, which is confirmed i.a. by an increase in unemployment rate, the fall in employment and easing wage growth. The slowdown in wage growth coupled with a productivity growth increase in 2009 Q2 translated into a drop in the growth of unit labour costs in the economy.

Following the 25-basis-point reference rate reduction to 3.50% in June 2009, the Monetary Policy Council kept interest rates unchanged in subsequent months. The June reference rate cut was followed by a decline of interbank market rates, while the liquidity premium, measured with the WIBOR-OIS spread, remained increased, although it is markedly lower than at the turn of 2008 and 2009. Yields on Polish treasury bonds decreased only slightly, share prices, on the other hand, rose considerably. In 2009 Q2 prices of flats – depending on the market segment – were either stable or showed a slight downward trend. Since the publication of the previous *Report* the nominal exchange rate of the zloty has appreciated significantly.

Due to the economic slowdown and unfavourable outlook for sales, as well as further tightening of banks' credit policies, loans to enterprises have exhibited a declining trend since April 2009. Credit has kept flowing to the household sector, though the scale of credit flow is significantly smaller than in the previous years, with the fall in the growth rate being more pronounced in housing loans than in consumer loans. In the opinion of banks, the most important reason for curbing the supply of loans is the uncertain outlook for economic conditions, which increases the risk related to extending new loans and to the quality of the already extended credit portfolio. The slowdown in credit growth has been reflected in the fall of the growth of the broad monetary aggregate M3.

In 2009 Q2 the current account balance saw further improvement – in terms of four quarters the current account deficit in relation to GDP decreased to 2.9% (against 4.0% after 2009 Q1). The improvement in the current account balance was driven mainly by a further reduction in the trade deficit, connected with a significantly deeper decline in imports than in exports.

Minutes of the Monetary Policy Council decision-making meetings held in June, July, August and September 2009 together with the *Information from the meeting of the Monetary Policy Council* in October 2009 are presented in the chapter "Monetary policy in

June–October 2009". *Minutes* from the MPC meeting held in October will be published on 19 November 2009 and so will be included in the next *Report*.

Chapter 4 of the *Report* presents the projection of inflation and GDP prepared by the NBP staff and based on the NECMOD model, which is one of the inputs into the Council's decision-making process on the NBP interest rates. Under constant interest rates, there is a 50-percent probability that projected inflation will lie within the range of 3.3–3.5% in 2009 (compared to 2.8–3.5% in the June projection), 0.8–2.2% in 2010 (compared to 1.1–3.2%) and 1.1–3.2% in 2011 (compared to 0.8–3.4%). According to the October projection, the annual GDP growth will remain, with a 50-percent probability, within the range of 1.1–1.5% in 2009 (compared to -0.4–1.1% in the June projection), 0.8–2.8% in 2010 (compared to 0.2–2.5%) and 2.2–4.2% in 2011 (compared to 2.4–4.5%).

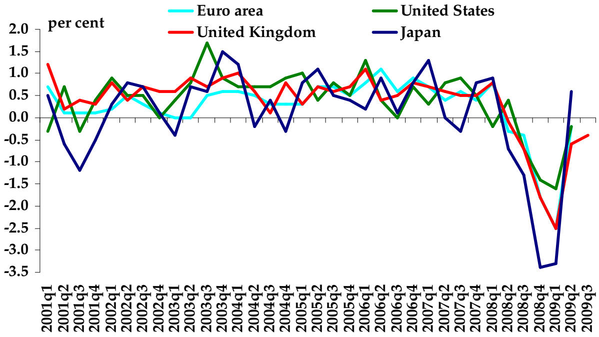
Chapter 1

External environment of the Polish economy

1.1 Global economic activity

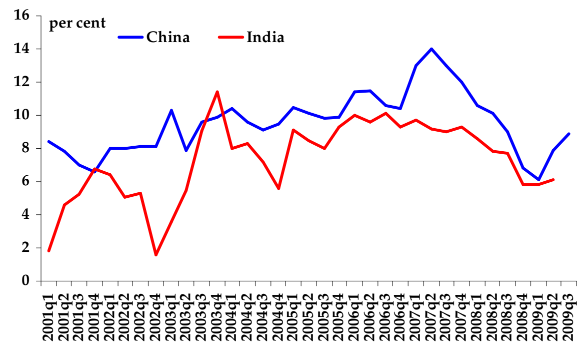
Following the decline in the two previous quarters, 2009 Q2 saw a rise in global economic activity, supported by anti-crisis measures implemented by many governments and central banks[1]. The recently released data, including the data on GDP in 2009 Q2, point to an improvement in economic activity in the United States, the euro area, and Japan, albeit this activity continues at a low level, and to an easing of recession in the United Kingdom (Figure 1.1). GDP growth accelerated further in China in 2009 Q3. Moreover, GDP growth increased slightly in India in 2009 Q2 (Figure 1.2), whereas in other Asian emerging economies GDP in quarterly terms grew considerably after the decline in the previous quarter. Following the slump in the two previous quarters, 2009 Q2 brought stabilisation in global trade. Moreover, business sentiment indicators point to a further improvement of the global economic situation in 2009 Q3[2]. The containment of recessionary tendencies in the global economy

Figure 1.1:
Economic growth in selected advanced economies (q/q).



Source: Eurostat and IMF data (seasonally adjusted).

Figure 1.2:
Economic growth in China and India (y/y).

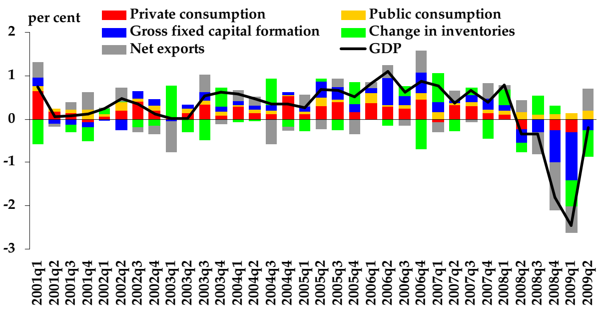


Source: Reuters data.

[1] According to the IMF estimates of October 2009, global GDP grew by o 3% q/q (in annual terms) in 2009 Q2 as compared to the 6.25% decline in 2009 Q1.

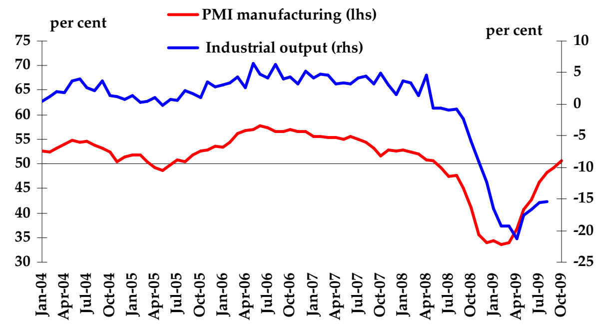
[2] After a rise in August 2009 to the highest level since December 2007, in September 2009 the JPMorgan Global All-Industry Output Index and Global All-Industry New Orders Index increased further, exceeding for a second month in a row the level of 50 points, which points to a recovery in the global industry.

Figure 1.3:
Euro area GDP growth (q/q).



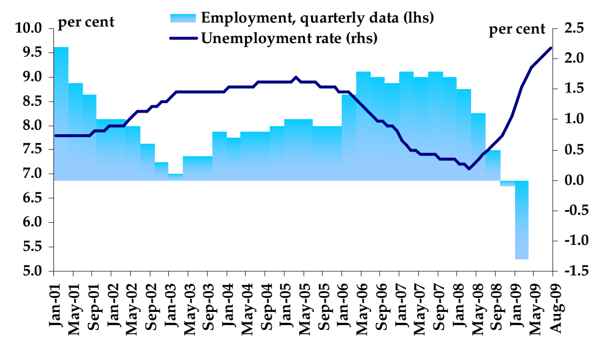
Source: Eurostat data (seasonally adjusted).

Figure 1.4:
Euro area industrial output (y/y) and PMI for manufacturing.



Source: Eurostat, Markit data.

Figure 1.5:
Euro area employment (y/y) and unemployment rate.



Source: Eurostat data.

in 2009 Q2 was accompanied by an upward revision of forecasts for the years 2009–2010[3].

In 2009 Q2 GDP in the United States decreased for the fourth consecutive quarter (by 0.2% q/q), yet the scale of the decline was considerably lower than in the two previous quarters (Figure 1.1). Moreover, macroeconomic data released in the past few months point to growing activity in the majority of sectors of the US economy in 2009 Q3.

Following the slump in the two previous quarters, 2009 Q2 brought only a minor decline in the euro area GDP (by 0.2% q/q as compared to 2.5% q/q in 2009 Q1, Figure 1.3), and in the two major economies of the region, Germany and France, which constitute the main markets for Polish exports, slight growth (by 0.3% q/q) was recorded[4].

Strong demand from Asian countries translated into a considerable easing of the decline in euro-area exports. In the analysed period, the import decline eased as well, albeit to a lesser extent. As a result, net export in 2009 Q2 had a positive contribution to the euro area GDP growth (as compared with the negative contribution in the previous quarter). 2009 Q2 saw further growth in public consumption, and a slight increase in household consumption. On the other hand, private investment continued to decrease, yet the scale of the decline was reduced. Similarly to the previous quarter, reduction in inventories had a considerable negative contribution to euro-area GDP growth.

In 2009 Q3 economic activity in the euro area remained low, which was reflected, among other things, by the continued decrease in retail sales. The situation in the euro area labour market continued to deteriorate in the recent period (Figure 1.5). The still tight credit conditions were also a factor behind weak economic activity in this region. On the other hand, growth in industrial output continued (in month-on-month, season-

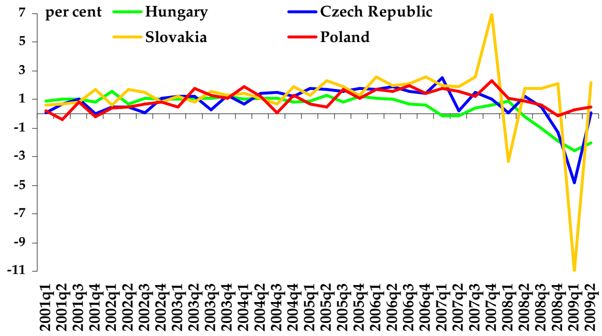
[3]According to IMF October 2009 forecasts global GDP may decline in 2009 by 1.1% y/y, and then increase by 3.1% y/y in 2010 as compared to the drop by 1.3% y/y and increase by 1.9% y/y forecast in April 2009.

[4]Yet, in annual terms, euro area GDP growth in 2009 Q2 continued to be very low (-4.8% y/y as compared to -4.9% in 2009 Q1).

ally adjusted terms) and business sentiment indicators in manufacturing improved further (Figure 1.4). Consumer sentiment improved as well.

Among Central and Eastern European countries the recessionary tendencies eased in 2009 Q2 in the Slovak Republic and in the Czech Republic, where GDP in quarterly terms increased by 2.2% and 0.1% respectively following a slump in the preceding quarter. In the other countries of the region except for Poland (i.e. in Hungary and in the Baltic States) 2009 Q2 brought a further GDP decline although in quarterly terms its scale was lower than in the preceding quarter (Figure 1.6). Higher external demand was conducive to increased activity in those countries, yet, domestic demand continued on a downward trend.

Figure 1.6:
Economic growth in selected Central and Eastern European countries (q/q).

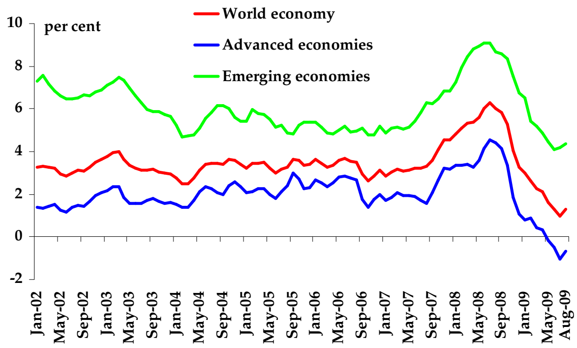


Source: Eurostat data (seasonally adjusted).

1.2 Inflationary processes abroad

In 2009 Q2 low activity in the global economy was accompanied by a decline in the general price level of consumer goods and services in developed economies and a further easing of inflation in developing economies. The inflation decline observed in the global economy was also driven by the negative base effect connected with a considerable rise in energy prices in the period until July 2008 (Figure 1.7). The gradual fading out of this effect, connected with the slump in commodity prices in the world markets in the second half of 2008 and their steady increase in 2009, translated, in turn, into a slight inflation rise in the global economy and slower price declines in developed economies in August 2009.

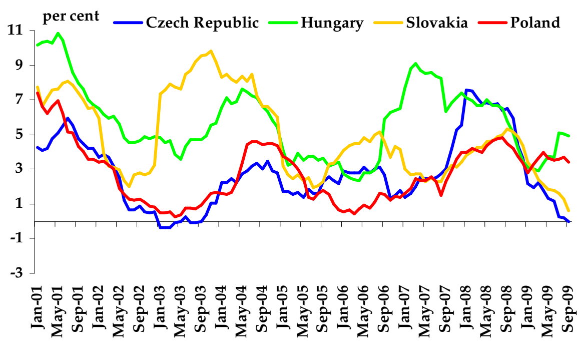
Figure 1.7:
CPI in the world economy (y/y).



Source: IMF data.

In the period June–September 2009 the general price level of consumer goods and services in the United States continued to fall. This period brought deflation also in the euro area. At the same time, core inflation indicators in those economies remain positive, although they have declined further in the past few months (to 1.5% y/y in the United States and to 1.2% y/y in the euro area in September 2009).

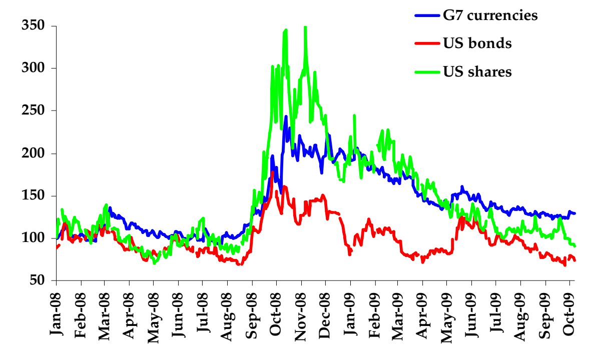
Figure 1.8:
CPI in selected Central and Eastern European Countries (y/y).



Source: National CSO's data.

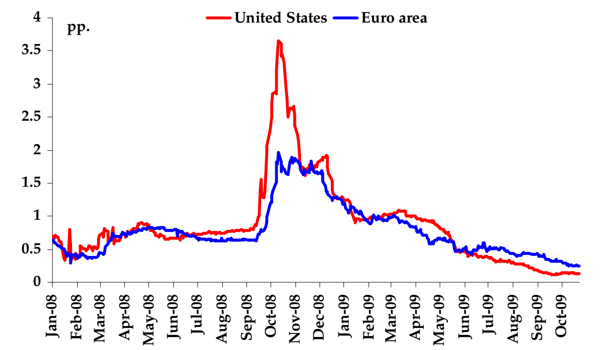
The considerable reduction of inflationary pressure connected with weak economic activity translated into a further significant fall in inflation also

Figure 1.9:
Level of risk in international financial markets (volatility in the US stock and bond markets and volatility of G7 economies' exchange rates; January 2008=100; an increase denotes an increase in volatility).



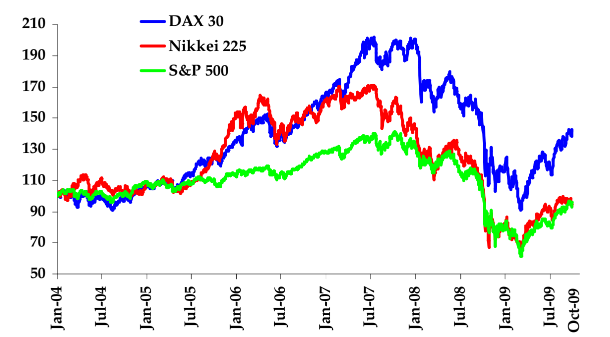
Source: Bloomberg data, NBP calculations.
Volatility in the US stock and bond markets is measured by the VIX and the MOVE index, respectively, and volatility of G7 economies' exchange rates by the JPMVXYG7 index.

Figure 1.10:
Liquidity and credit risk in the international money markets (spread between the 3-month LIBOR and the 3-month OIS rate in the US and the euro area).



Source: Reuters data, NBP calculations.

Figure 1.11:
Stockmarket indices in the United States (S&P 500), Germany (DAX 30) and Japan (Nikkei 225); January 2004=100.



Source: Reuters Ecowin data, NBP calculations.

in the majority of Central and Eastern European countries (Figure 1.8). In the past few months a considerable rise in inflation has been recorded only in Hungary, where it was driven by the VAT rate increase effective since July 2009.

1.3 International financial markets and monetary policy abroad

Recently the situation in international financial markets has stabilized to some extent and the global financial crisis has been halted. The main market measures of risk have returned to levels close to those observed before the collapse of Lehman Brothers (on 15 September 2008), whose bankruptcy sparked off a period of vehement disruptions in the financial markets (Figure 1.9). The money market saw a significant drop in liquidity and credit risk, reflected in a decline in the LIBOR-OIS spread[5] (Figure 1.10). In reaction to the release of positive economic data (among others, better-than-forecast results of US listed companies, better-than-forecast data on GDP in the United States and in the euro area, rise in leading economic indicators in the United States and in some European economies) risk aversion dropped which led to strong increases in the world's major stock exchange indices (Figure 1.11). Despite an increased risk propensity among investors, government bond yields in developed countries remained stable (Figure 1.12).

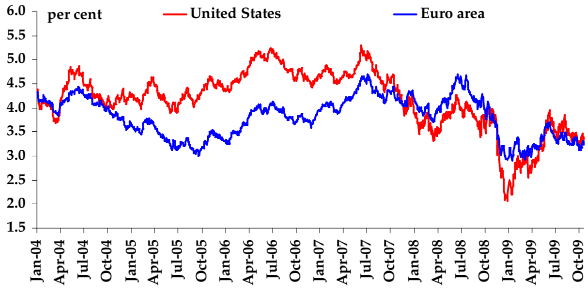
The improved sentiment in the global financial market over the past few months found a reflection in the prices of emerging countries' assets. The news about an increasing number of emerging economies gradually recovering from recession, upward adjustments of economic forecasts for 2009 and 2010 and global investors' increased propensity to riskier investment strategies led to strong share price increases, declines in bond yields and the appreciation of those countries' currencies.

[5]The LIBOR-OIS spread is considered to be a measure of banks' aversion to lend to each other. It is a difference between the LIBOR and the OIS rate.

Since the last *Report* major central banks have continued to pursue an accommodative monetary policy. The Fed has kept the Federal Fund Rate unchanged at 0.00–0.25%, and the European Central Bank (ECB) has kept its main interest rate at 1.00%. The Swiss National Bank (SNB) has not changed the 3-month LIBOR band which is currently 0.00–0.75%, indicating that it will still attempt to keep the rate in the lower end of this range, i.e. at a level close to 0.25%; Figure 1.13. According to the expectations of bank analysts (Bloomberg data) the Fed, SNB and ECB will not change their interest rates in the next six months. The expectations of analysts and the forward market suggest that the Fed will raise its interest rates at the end of 2010 Q2, while the first interest rate hikes by the ECB and SNB can be expected no sooner than in 2010 Q3.

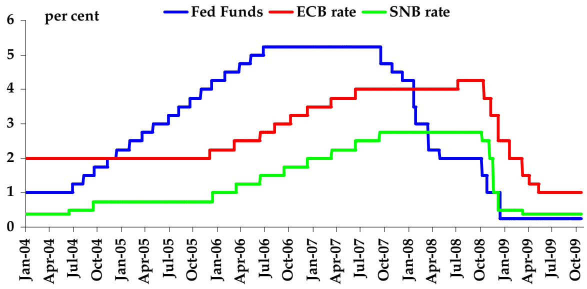
Apart from keeping interest rates unchanged, major central banks continued with unconventional monetary policy measures involving purchases of financial assets and aimed at supporting credit markets. The Fed announced that it would gradually slow the pace of these purchases and that it anticipated that they would be executed by the end of the first quarter of 2010. The ECB has also been employing unconventional measures, though it excluded the necessity of their extension. It is only the Bank of England that extended its asset purchase programme with additional GBP 50 billion to the total amount of GBP 175 billion.

Figure 1.12:
Yields of 10-year US and euro area bonds.



Source: Bloomberg data.

Figure 1.13:
Fed Funds rate, ECB refinancing rate, and SNB rate.

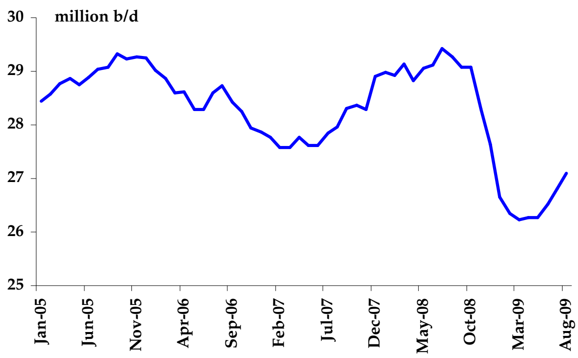


Source: Central banks' data.

1.4 Global commodity markets

Starting from March 2009, as risk aversion in international financial markets was gradually diminishing and first signs of a possible improvement in the outlook for growth in the world economy appeared, the price of oil had a tendency to rise. Oil prices grew despite a falling demand for this commodity. The factor limiting oil-price growth was increasing oil output in oil-producing countries (Figure 1.14). In 2009 Q3 the average Brent oil price was 69.1 USD/b and was 9.2 USD/b (i.e. 15.4%) higher than in 2009 Q2. In

Figure 1.14:
OPEC-11 (Iraq not included) oil production.



Source: The US Energy Department data.

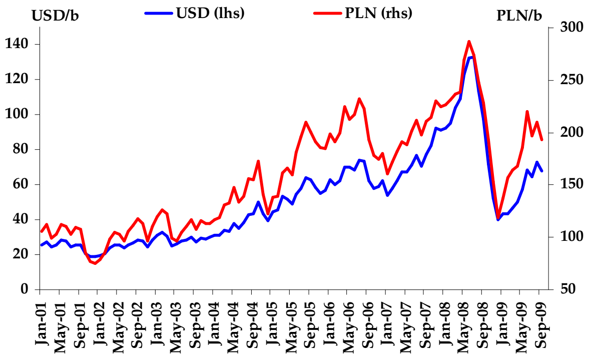
the recent months the rising tendency of crude oil prices has been halted (Figure 1.15).

Following a significant decline connected with the outflow of capital from the commodity market originated in July 2008, coal prices stabilised at approx. 60 USD/t. In turn, natural gas prices, the changes of which display a 6–9-month lag in relation to oil price shifts (which results from the character of futures contracts), having achieved a high in 2008 Q4, dropped by approx. 60% and currently stand at approx. 220 USD/1000 m^3 (Figure 1.15).

Following a strong increase observed between 2007 Q1 and 2008 Q3, the prices of agricultural commodities in 2008 Q4 plunged and then stabilised at a relatively low level (Figure 1.17).

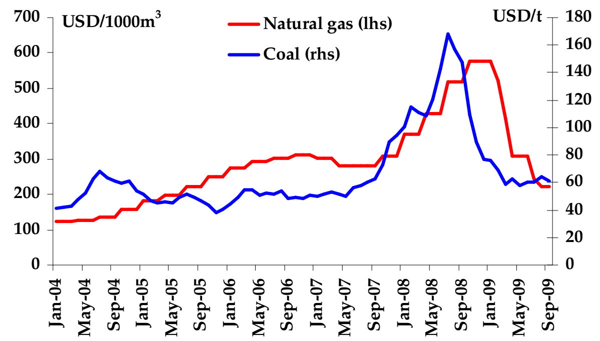
The decline in agricultural commodity prices was related to a weaker demand connected to the global recession. Another factor responsible for the reduction in agricultural commodity prices was an earlier decline in oil prices, which contributed to lowering the prices of transport and production costs (including fertiliser prices) and reducing the profitability of biofuel production, which resulted in a decreased demand for agricultural commodities used for this production. On the supply side, a factor conducive to lowering the prices of agricultural products was an exceptionally high crop of cereals, especially wheat, in the 2008/09 season, and higher forecasts of the world production of cereals in subsequent years released by international institutions.

Figure 1.15:
Brent crude oil prices in USD and PLN.



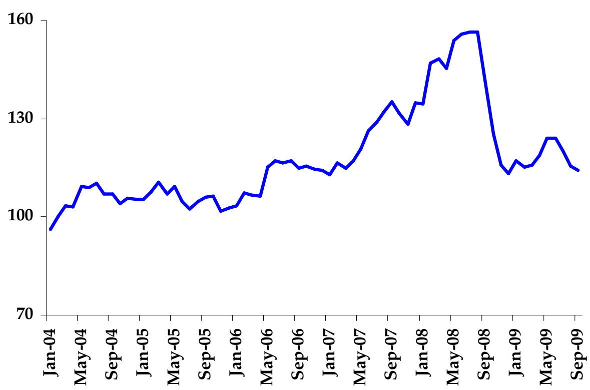
Source: The US Department of Energy data, NBP calculations.

Figure 1.16:
Coal and natural gas prices in the global markets.



Source: IMF data.

Figure 1.17:
Index of agricultural commodity prices in the global markets (2004 Q1=100).



Source: IMF data, NBP calculations.

Chapter 2

Domestic economy

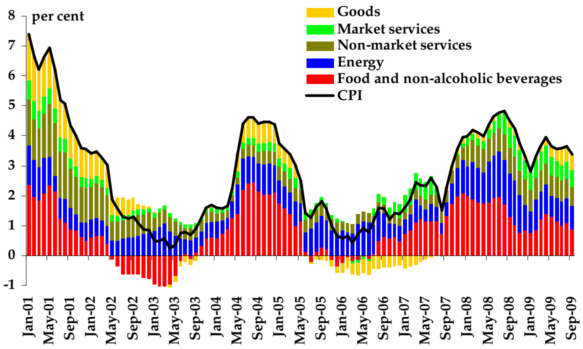
2.1 Inflationary processes

2.1.1 Consumer prices

In June–August 2009 the annual growth of prices of consumer goods and services in Poland remained within the range of 3.5%–3.7%, i.e. slightly above the upper limit for deviations from the NBP's inflation target, and in September it slowed to 3.4% y/y, i.e. somewhat below this limit (Figure 2.1).

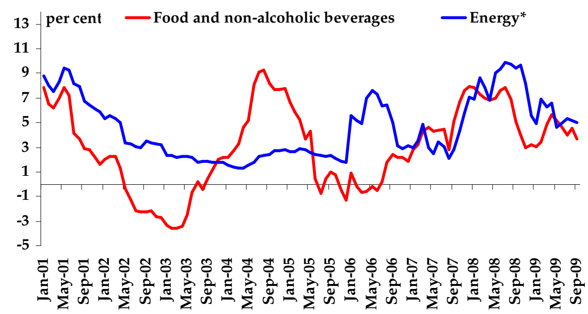
The heightened annual inflation was driven to a large extent by past increases in administered prices, including the prices of energy carriers (electricity and heating for households) and dwelling-maintenance services. Other factors that contributed to heightened inflation included the rise in tobacco product prices due to changes in the excise tax[6] and the fast growth of alcoholic beverage prices due to earlier excise tax hikes. Inflation remained at an elevated level also because of fast, although weakening, growth in food and non-alcoholic beverage prices and strong annual growth of heating fuel prices (especially coal prices).

Figure 2.1:
CPI and main categories of prices (y/y).



Source: GUS data, NBP calculations.

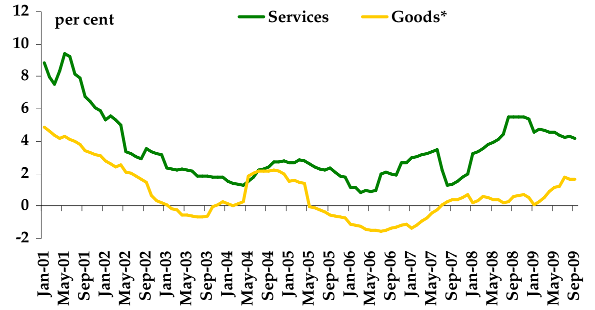
Figure 2.2:
Food and energy prices (y/y).



Source: GUS data, NBP calculations.
*The category of *energy* includes energy products (electricity, gas, heating, fuel) and engine fuels (for private means of transport).

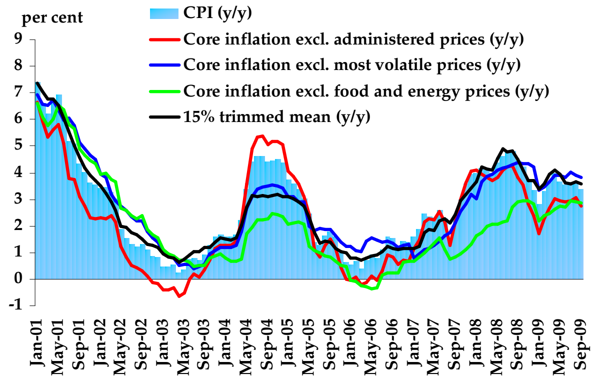
[6] In July 2009 new excise-tax regulations entered into force which provided for the withdrawal of tobacco products with 2008 excise marks. Since July 2009, legally traded tobacco products must be marked with this year's excise marks and, consequently, taxed according to this year's higher excise rate. The increases in the excise tax on tobacco products resulted from domestic regulations being adjusted to the minimum excise tax rate in force in the European Union.

□ **Figure 2.3:**
Services and goods prices (y/y).



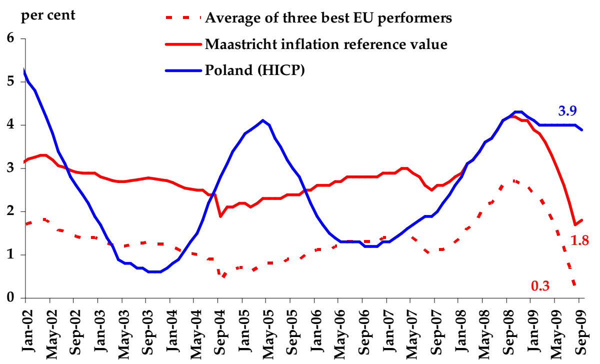
Source: GUS data, NBP calculations.
*The category of *goods* does not include food, non-alcoholic beverages or energy.

□ **Figure 2.4:**
CPI and core inflation measures.



Source: GUS data, NBP calculations.

□ **Figure 2.5:**
HICP inflation in Poland (12-month moving average) and the Maastricht criterion (y/y).



Source: Eurostat data, NBP calculations.

Other factors conducive to keeping inflation heightened included: the strong depreciation of the nominal exchange rate of the zloty in the second half of 2008 and at the beginning of 2009 and the still high growth of services prices driven by the persistent, though easing, demand pressure. On the other hand, in the analysed period inflation was curbed by a further decline in the prices of fuels and the reduction in the prices of natural gas for households in June 2009[7].

Core inflation

In June–August 2009 the majority of core inflation measures edged down. Only the index of core inflation net of food and energy prices increased from 2.7% in June to 2.9% in September 2009 (Figure 2.4). The rise in core inflation net of food and energy prices was primarily driven by increased excise tax rates on tobacco products (see footnote on the previous page). The fact that core inflation has remained relatively high indicates that the weakening of demand so far has not fully offset the increases in administered prices and excise tax rates as well as the effects of the earlier exchange rate depreciation.

The Maastricht inflation criterion

The 12–month moving average of HICP inflation in Poland, considered while assessing the compliance with the Maastricht inflation criterion, remained at 4.0% in June–August and decreased to 3.9% in September 2009. However, the reference value for the inflation criterion declined from 2.6% in June to 1.7% in August, i.e. to a historic low, and then edged up to 1.8% in September 2009. As a result, the gap between the 12-month moving average of HICP inflation in Poland and the reference value widened to 2.3 percentage points in June–August, and then

[7]In line with the new tariffs natural gas prices for households were reduced by 9.7% on average, with a concurrent average increase in gas distribution tariffs of 10.4%. As a result, according to GUS data households' natural gas bills decreased by an average of 1.2%.

narrowed to 2.1 percentage points in September 2009.

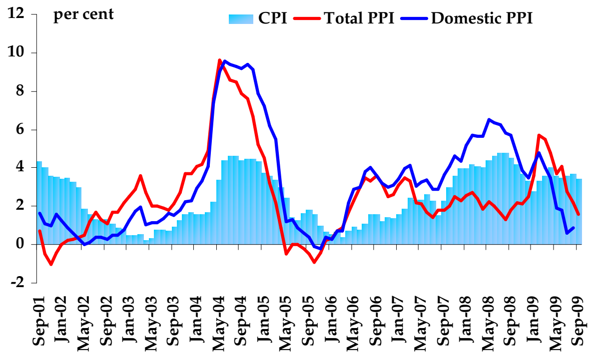
2.1.2 Producer prices[8]

In 2009 Q3 the growth of producer prices (PPI) slowed to 2.2% y/y, down from 4.2% y/y in 2009 Q2 (Figure 2.6). The notable drop in the growth of total producer prices was mainly due to a negative – for the first time since 2006 – annual price growth in *manufacturing*. The largest contribution to total producer price growth was made by *electricity, gas, steam, hot water and air conditioning supply*, although it was smaller than in the previous quarter (Figure 2.7). In the two first months of 2009 Q3 producer prices in the domestic market grew slower than in the previous quarter (0.6% y/y in July and 0.9% y/y in August, as compared with 2.4% y/y in 2009 Q2). In contrast, the fast growth of producer prices of exported goods continued, which was related to the previously observed strong depreciation of the zloty.

2.1.3 Import prices

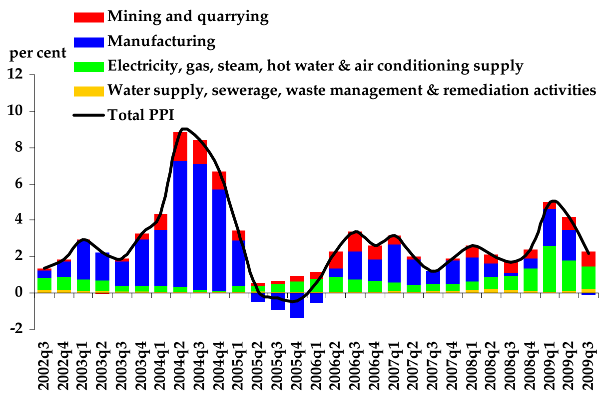
In 2009 Q1 zloty-denominated import prices increased significantly (by 10.5% q/q, against 4.8% q/q in 2008 Q4) due to the increase in commodity prices, including oil prices, and the strong depreciation of the zloty. In turn, in 2009 Q2 import prices declined by 0.3% q/q in connection with the appreciation of the zloty. In year-on-year terms import prices rose by 12.4% and 13.0% respectively in 2009 Q1 and Q2 as compared with 4.1% in 2008 Q4 (Figure 2.8).

Figure 2.6:
CPI and PPI changes (y/y).



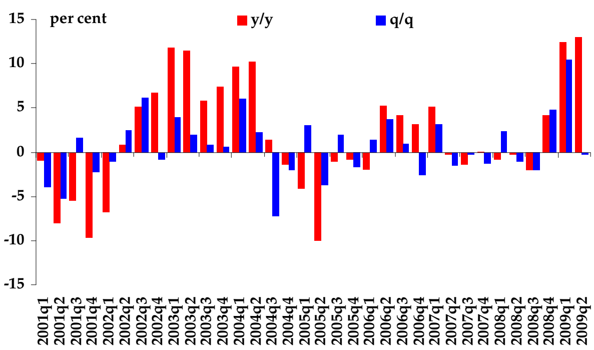
Source: GUS data.
Since January 2009 the Central Statistical Office (GUS) has published PPI data using PKD 2007 classification (instead of the previously used PKD 2004 classification).

Figure 2.7:
Composition of PPI total annual growth.



Source: GUS data.

Figure 2.8:
Changes in import prices expressed in PLN.



Source: GUS data.

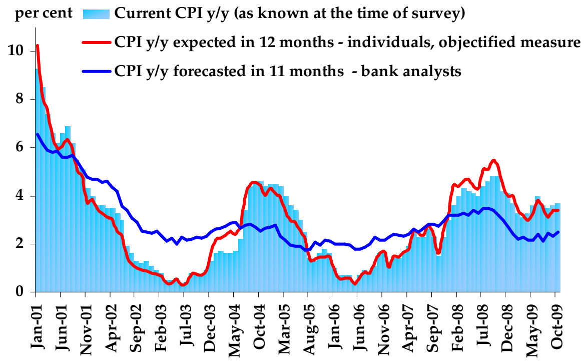
[8] Total producer prices in industry and in four main sections (i.e. *mining and quarrying*; *manufacturing*; *electricity, gas, steam, hot water and air conditioning supply*; *water supply, sewerage, waste management and remediation activities*) referring to a specific month are published in the next calendar month, while the prices in particular divisions of *manufacturing* and the producer prices in the domestic market are available with a longer lag (of about two months).

2.1.4 Inflation expectations

Since the publication of the previous *Report* bank analysts' forecasts of inflation over an 11-month horizon have remained relatively stable at levels slightly lower or equal to the NBP's inflation target (Figure 2.9). At the same time, there was an increase in bank analysts' forecasts for the end of 2009 (from 3.0% in June to 3.7% in October 2009) and in their forecasts of average annual inflation in 2009 (from 3.1% to 3.5%, respectively).

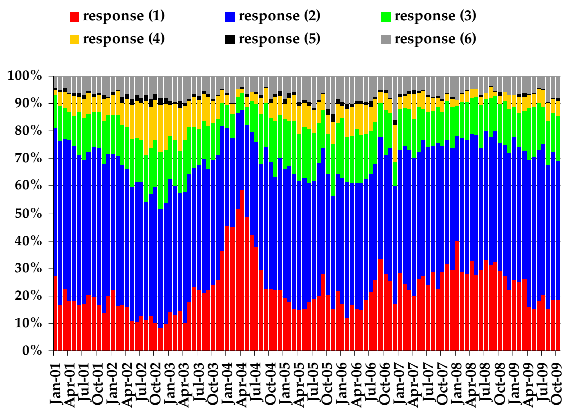
On the other hand, the objectified measure of inflation expectations of individuals, following an increase in May and June 2009 to 3.8%, fell back to 3.4% in September and October 2009. At the same time, there was no significant change in the structure of responses in the survey study of inflation expectations of individuals (Figure 2.10).

□ **Figure 2.9:**
Inflation expectations of individuals and inflation forecasts of bank analysts.



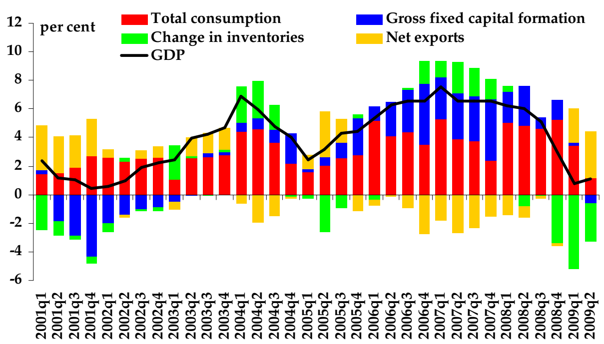
Source: Ipsos, Reuters, GUS, NBP calculations.

□ **Figure 2.10:**
Inflation expectations of individuals – responses to the question asked by Ipsos.



Source: Ipsos data.
Ipsos survey question: "Considering the present situation, do you think that prices during the next 12 months: (1) will grow faster than they do now; (2) will rise at the same rate; (3) will grow at a slower rate; (4) will stay the same; (5) will decrease; (6) it is hard to say?"

□ **Figure 2.11:**
Contribution of aggregate demand components to GDP growth.



Source: GUS data.

2.2 Demand and ouput

In 2009 Q2 real GDP growth amounted to 1.1% y/y (compared to 0.8% y/y in 2009 Q1) and was lower than that expected in the previous *Report* (Figure 2.11).

Private consumption growth slowed in comparison to the previous quarter, although its contribution to GDP growth remained positive. In contrast, investment growth remained negative. The process of enterprises adjusting to the currently low level of economic activity found reflection in a further reduction of inventories – the contribution of the change in inventories to GDP growth was negative, similarly as the contribution of gross fixed capital formation. In consequence, despite consumption growth domestic demand in 2009 Q2 declined by 2.1% y/y.

The economic slowdown in Poland and the recession abroad contributed to a further drop in the volume of imports and to the stabilisation of the volume of exports at a low level in 2009 Q2. Due to the earlier strong depreciation of the zloty and the change in the terms of trade, the plunge in imports was markedly deeper than the drop in exports, which resulted in net exports in 2009 Q2 becoming the main driver of GDP growth.

The growth of value added in 2009 Q2 resulted mainly from the growth in the service sector and – to a lesser extent – in the construction sector. A negative contribution to total value added was recorded in industry, which saw a considerable output decline in year-on-year terms.

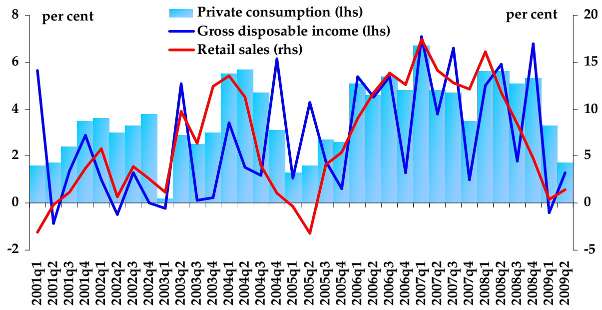
2.2.1 Consumption demand

In 2009 Q2 private consumption growth declined to 1.7% y/y (as compared with 3.3% y/y in 2009 Q1). Public consumption in 2009 Q2 increased by 0.9% y/y (as compared with 5.7% y/y in 2009 Q1).

Weakening consumption demand was largely the effect of a slowdown in household income growth. According to GUS estimates, the growth of nominal gross disposable income of households decreased significantly (to 2.9% y/y and 5.0% y/y respectively in 2009 Q1 and Q2 as compared with 10.8% y/y in 2008 Q4). This was due, inter alia, to developments in the labour market driven by slowing economic growth (see Chapter 2.3 Labour market). Following an uninterrupted growth since 2005, average employment in the economy in 2009 Q1 and Q2 declined in quarterly terms. At the same time, there was a marked slowdown in average wage growth, including in the corporate sector where wage growth slowed from 6.8% y/y in 2009 Q1 to 4.4% y/y in 2009 Q2[9]. As a result, the growth of aggregate nominal wages in the economy slowed to 3.9% y/y in 2009 Q2 (as compared with 9.9% y/y in 2008 Q4 and 7.0% y/y in 2009 Q1).

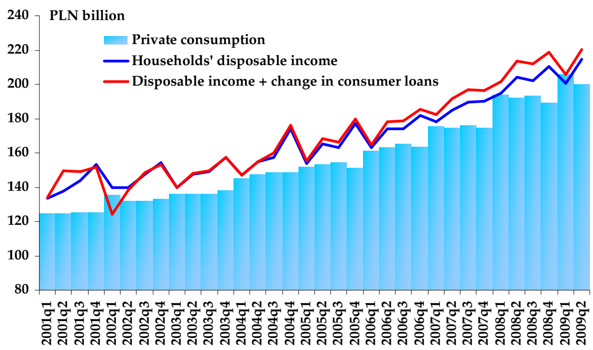
On the other hand, the growth of income from social benefits remained strong in 2009 H1[10], which was partly related to the old-age and disability pension indexation in March 2009. In 2009 Q2 average gross old-age and disability pension from the non-agricultural social-security system increased by 8.6% y/y in nominal terms (as compared with 10.4% y/y in 2009 Q1), whereas the average agricultural old-age pension grew by 6.1% y/y (as compared with 6.6% y/y in 2009 Q1).

Figure 2.12:
Growth of private consumption, gross disposable income and retail sales (y/y, constant prices).



Source: GUS data.

Figure 2.13:
Private consumption expenditure and disposable income of households including the change in consumption loans (current prices).



Source: GUS, NBP data.

[9] Income from paid employment accounts for slightly more than 50% of gross household disposable income, of which approx. a half accounts for income from paid employment in the corporate sector.

[10] Income from social benefits accounts for less than 25% of gross household disposable income.

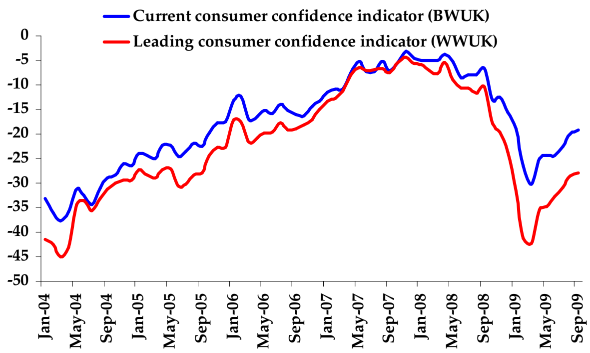
Amidst inflation continuing at an elevated level[11], declining growth of nominal household disposable income contributed to a strong reduction in income growth in real terms (especially in 2009 Q1 when real income declined by 0.2% y/y[12]; in turn, in 2009 Q2 it increased slightly – by 1.3% y/y), which is conducive to the weakening of consumption demand (Figure 2.12).

In 2009 Q1 and Q2, similarly to the previous period, consumption loans constituted an additional source of financing consumption demand; their value increased in those two quarters respectively by PLN 5.6 billion and PLN 5.7 billion (Figure 2.13). Yet, as compared with the previous year's situation, growth in this type of loans decreased in 2009 Q2 by 40%, i.e. by PLN 3.7 billion (see Chapter 2.5 Credit and money[13]).

Falling consumption demand was reflected in slowing growth of retail sales in real terms: in 2009 Q1 retail sales growth declined to 0.4% y/y (as compared with 4.8% y/y in 2008 Q4) and in 2009 Q2 it increased slightly, to 1.4% y/y (Figure2.12). A decline in sales growth was recorded mainly in the category of cars and fuels. In turn, in 2009 Q3 the growth of retail sales rebounded to 3.7% y/y in real terms, which may suggest a gradual recovery in consumption demand.

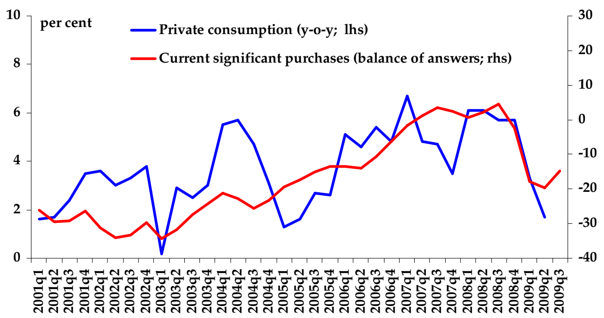
According to household condition surveys, consumer concerns about growing unemployment were further contained in 2009 Q3. There was also an improvement in the assessment of households' saving ability and intended major purchases in the coming year. At the same time, the expectations about future changes in the financial condition of households and changes in the general

Figure 2.14:
Consumer confidence indicators.



Source: GUS, NBP data.

Figure 2.15:
Private consumption expenditure and consumer sentiment (assessments of intended major purchases).



Source: GUS, NBP data.

[11] 3.3% y/y and 3.7% y/y in the two first quarters of 2009 respectively.

[12] It is worth noting that the decline in household disposable income was stronger than the decline in private consumption growth. As a result, gross household savings in 2009 Q1 were negative for the first time since 1995.

[13] The data discussed in Chapter 2.5 Credit and money concern changes in the volume of loans adjusted for the impact of the zloty exchange rate fluctuations against major currencies, while the data presented in this chapter refer to published monetary data (not adjusted for the impact of exchange rate fluctuations). In the case of consumption loans, exchange rate changes have only a limited impact on the development of household indebtedness because the share of foreign currency loans in this category is small.

economic situation of the country improved.

The results of these surveys may indicate a rebound in the previously observed unfavourable tendencies in consumer confidence and a gradual improvement in household sentiment, though it is difficult to assess whether this change will be lasting. Together with the increase in retail sales growth observed in 2009 Q2 and Q3, the results of the household surveys (including, among other things, the assessment of intended major purchases in the coming years – see Figure 2.15) might point to the possibility of a decline in consumption demand being contained in the time to come.

2.2.2 Investment demand

In 2009 Q2 gross fixed capital formation fell by 3.0% y/y (Figure 2.16), and the investment rate (the ratio of investment to GDP) declined to 21.5%[14] (Figure 2.17).

The fall in investment activity was observed in the corporate sector and in housing construction. At the same time, the general government sector experienced a rise in investment expenditure which partly offset the decline in investment outlays in the private sector.

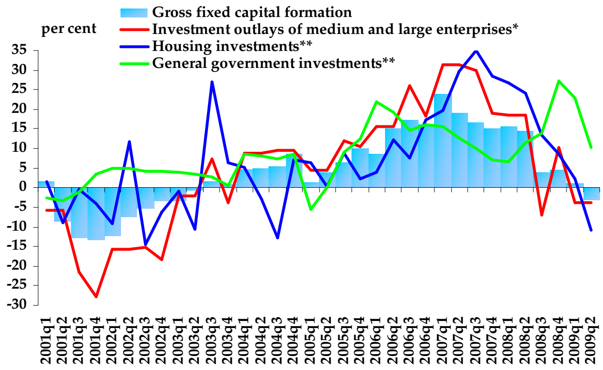
In nominal terms, investment growth in the non-financial corporate sector in 2008 Q2 remained at a very low, yet still positive level. Positive investment growth in nominal terms was largely the effect of the previously observed strong depreciation of the zloty. Enterprises continued to increase their expenditure on machinery and equipment (of which one third is imported, thus the nominal value of the corresponding expenditure largely depends on the exchange rate) and on real estate, while reducing their expenditure on motor vehicles.

According to business condition surveys of the NBP[15], in 2009 Q3 enterprises continued to show low interest – though slightly higher than in the

[14]The investment rate is calculated on the basis of data for the past four quarters.

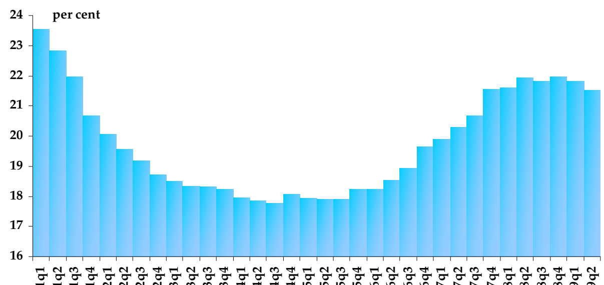
[15]See: *Information on the Condition of the Enterprise Sector, Including the Economic Climate in 2009 Q3 and Forecasts for 2009 Q4*, NBP.

Figure 2.16:
Investment in the economy (y/y).



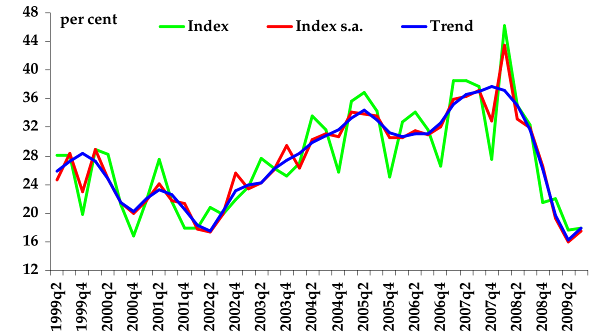
Source: GUS data, Ministry of Finance data, NBP calculations.
* Due to lack of data on investment outlays of enterprises in Q1 and Q2 of each year, the chart presents the growth for the first half of a year.
** NBP estimates for the NECMOD model; seasonally adjusted data.

Figure 2.17:
Investment to GDP ratio (gross fixed capital formation to GDP in nominal terms; quarterly data, cumulated over last 4 quarters.)



Source: GUS data, NBP calculations.

Figure 2.18:
Index of new investments (the percentage of enterprices planning to start new investments within the coming quarter).



Source: NBP business tendency survey.

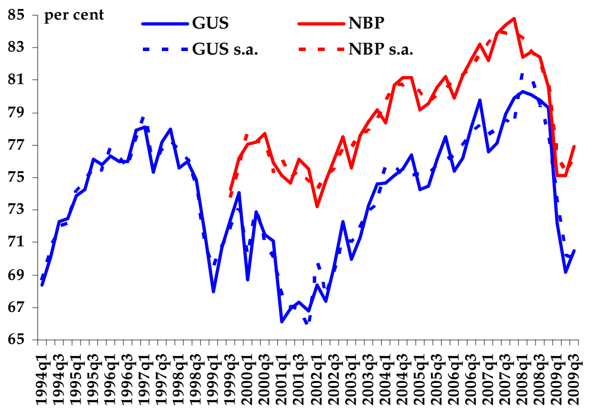
Table 2.1: Decomposition of gross fixed capital formation in the corporate sector (per cent).

	2007				2008				2009	
	q1	q2	q3	q4	q1	q2	q3	q4	q1	q2
Land	0.2	0.0	0.1	0.0	0.1	0.1	0.1	0.1	0.0	0.0
Buildings and premises	32.3	35.7	38.4	40.8	35.5	35.8	40.4	39.9	37.2	40.2
Machinery and equipment	47.4	44.2	43.8	42.6	44.2	44.3	42.5	43.2	45.1	47.2
Means of transport	13.1	13.7	11.3	11.0	13.4	13.3	10.7	9.0	9.1	7.0
Other fixed assets	6.1	5.7	6.0	5.3	5.8	5.6	5.3	5.9	6.0	4.7

Source: GUS data, NBP computations.

previous quarters of 2009 – in starting new investment projects[16] – the index of new investment, despite certain improvement, remains at a historically low level following the slump in 2008 (Figure 2.18). At the same time, in the light of those surveys 2009 Q3 brought a certain improvement in several business condition indicators and opinions formulated by entrepreneurs. Amidst uncertainty about the duration of the economic slowdown, restricted access to external sources of financing[17] and low production capacity utilisation (Figure 2.19), investment activity of enterprises may be expected to continue at a low level in 2009 Q4.

□ **Figure 2.19:**
Production capacity utilisation in industry (GUS) and in the corporate sector (NBP).



Source: GUS data, NBP business tendency survey.
The production capacity utilisation obtained from the GUS business survey is significantly lower from one obtained from the NBP business survey. However, the changes in this indicator are similar in both surveys. The difference is due to the fact that the two surveys are based on different enterprise samples. The NBP sample in September 2009 included 897 enterprises from the whole non-financial corporate sector. The GUS sample, in turn, includes approx. 3500 enterprises from section C according to PKD 2007 classification (manufacturing; data till 2001 refer to a GUS sample of approx. 3500 enterprises from section manufacturing excluding waste processing). The difference may also reflect the over-representation of big enterprises in the NBP sample, while the GUS sample is representative with respect to enterprise size.

2.2.3 General government demand

According to the Ministry of Finance's preliminary estimates, in the first nine months of 2009 the total central budget revenue increased by 5.2% y/y. It should be noted, though, that the total revenue in the analysed period was positively influenced by very high revenues from the European Union (which grew by 103.6% y/y; Figure 2.20). The rapid growth in this category, observed in particular from May to July 2009, was mainly the result of conversion of some funds received from the European Commission as an advance payment under structural funds and the

[16] The intention to start new investment is declared by 21.6% of respondents in 2009 Q4 as compared with 17.5% in 2009 Q3 (in seasonally adjusted terms).

[17] 2009 Q2 and Q3 brought further tightening of corporate lending conditions; see: *Senior Loan Officer Opinion Survey on Bank Lending Practices and Credit Conditions. 2009 Q3*, NBP. In the light of the business condition surveys of the NBP, obtaining a bank loan continues to be a major problem for a considerable part of investors.

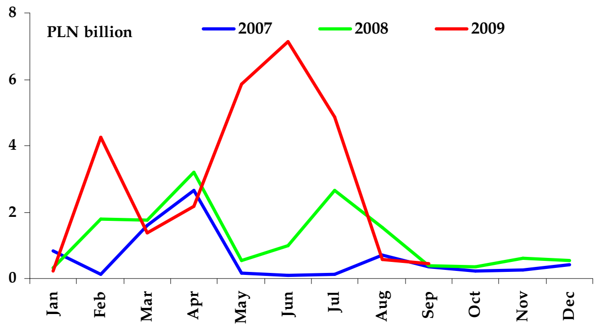
Cohesion Fund from the Financial Perspective for the years 2007–2013. Yet, the period January–September 2009 saw a decline in tax revenues (by 3.7% y/y)[18].

In turn, central budget expenditure rose in the period January–September 2009 by 13.9% y/y. The high growth of expenditure was driven by rising costs of foreign and domestic debt servicing, higher transfers to FUS (Social Security Fund) and the settlement of liabilities of the Ministry of National Defence incurred in 2008.

As a result, in the period January–September 2009 the central budget recorded a deficit of PLN 21.5 billion[19], which constitutes 79.0% of the annual plan following the amendment of the *Budget Act for 2009* (see Box below)[20].

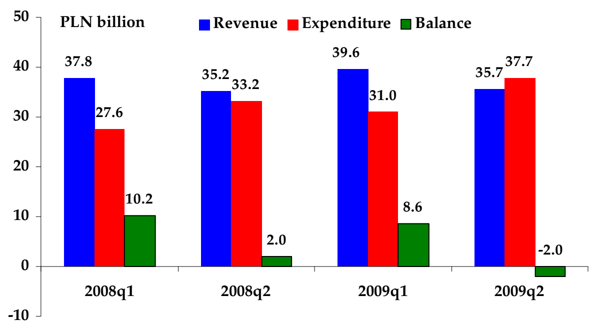
2009 Q2 brought a marked deterioration in the financial situation of local government entities, largely driven by a considerable slowdown in the growth of own revenues amidst the persistently high growth in expenditure. In 2009 Q2 local government entities recorded a deficit of approx. PLN 2.0 billion as compared with the surplus in the same amount recorded in the corresponding period of 2008[21] (Figure 2.21). The revenue situation of the special purpose funds also deteriorated, mainly as a result of more pronounced unfavourable trends in the labour market. Moreover, rising unemployment and systemic changes[22] translated into a considerable

Figure 2.20:
Central budget revenue from EU funds.



Source: Ministry of Finance data.

Figure 2.21:
Revenue and expenditure of local government entities.



Source: Ministry of Finance data.

[18] All categories of tax revenues except for the excise duty dropped over the period January–September 2009: VAT by 5.5% y/y, PIT by 6.7% y/y, and CIT by 14.3% y/y. This was primarily due to the deteriorating economic situation and the introduction of systemic changes (among other things, shortening of VAT return periods from 180 to 60 days and replacement of three PIT rates with two rates of 18% and 32%).

[19] In the corresponding period of 2008, the central budget deficit amounted to PLN 4.2 billion, i.e. 17.4% of the annual plan.

[20] The level of deficit planned in the amended *Budget Act for 2009* is PLN 27.2 billion.

[21] In the first half of 2009 local government units recorded a surplus of PLN 6.6 billion as compared with PLN 12.2 billion in the first half of 2008.

[22] Inter alia, payment of pre-retirement allowances and benefits, the reimbursement of costs of postgraduate internships and specialisation courses of medical doctors and nurses, as well as increased amount of allowance granted to the unemployed undertaking business activity, all financed

growth in the Labour Fund's expenditure.

As a result of the growing deficit of the central budget and other government budget entities, 2009 will see a marked deterioration in the general government balance in terms of ESA'95 as compared with 2008, which will lead to public debt growth.

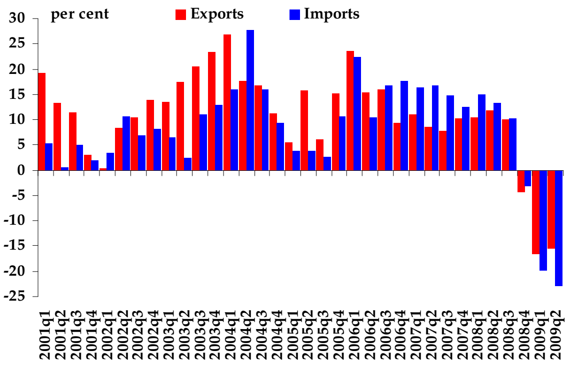
A detailed discussion of possible public finance sector developments in 2010 was presented in the Opinion of the Monetary Policy Council to the draft *Budget Act for 2010*.

Amendment of the *Budget Act for 2009*

In July 2009 the lower chamber of the Polish Parliament (Sejm) adopted the amended *Budget Act for 2009*. The amendments include increasing the central budget deficit in 2009 from PLN 18.2 billion to PLN 27.2 billion, with revenue expected to fall by approx. PLN 30.1 billion (including the decline in tax revenues by approx. PLN 45.1 billion) and an anticipated drop in expenditure by PLN 21.1 billion. It should be noted that the reduction in expenditure was partly the result of transferring approx. PLN 9.9 billion earmarked for the construction and modernisation of roads from the central budget to the National Road Fund which has been obliged to finance this expenditure.

As indicated in the amendments, part of the decline in tax revenues, which occurred in 2009, is to be compensated by increased income from the European Union and other non-returnable EU funds as well as by rising non-tax revenues. The inflow of EU funds is to exceed the amount indicated in the *Budget Act for 2009* by PLN 8.2 billion (i.e. by 24.4%), mainly due to crediting the income account of the central budget with a part of funds obtained from the European Commission in the form of advance payments towards future expenditure under the structural funds and the Cohesion Fund for the years 2007–2013. The utilisation of funds from advance payments to finance the central budget deficit in 2009 will have a dampening effect on the budgets of future years, where the expenditure linked to the EU funds will exceed the related income. The forecast of the central budget non-tax revenues was adjusted upwards (as compared to the act before the amendment) by PLN 7.3 billion, i.e. by 40.6%, which is mainly the result of increased revenues from dividends disbursed by companies with State Treasury participation and an increase in other non-tax revenues (inter alia, revenues from exchange rate gains linked to the processing of payments under the Common Agricultural Policy).

Figure 2.22:
Polish exports and imports (volumes, y/y).



Source: GUS data, NBP calculations.

2.2.4 Exports and imports

Amidst weak economic activity abroad and a slowdown in the Polish economy, 2009 Q2 saw a deepening of the significant decline in the volume of imports and – to a smaller extent – exports. Due to the earlier depreciation of the zloty and the structure of the Polish foreign trade, the decline in imports (by 19.9% y/y as compared with 17.2% y/y in 2009 Q1) was markedly deeper than

by the Labour Fund.

Table 2.2: Polish export and import competitiveness measures.

Change (per cent)	2006			2007				2008				2009
	q2	**q3**	**q4**	**q1**	**q2**	**q3**	**q4**	**q1**	**q2**	**q3**	**q4**	**q1**
Export prices / Unit labour costs*												
y/y	9.5	13.3	14.1	12.7	6.7	6.2	1.7	1.6	-0.5	-5.0	1.0	17.1
q/q	6.2	4.0	1.0	1.1	0.5	3.4	-3.3	1.0	-1.6	-1.3	2.9	17.1
Import prices / Domestic producer prices**												
y/y	3.4	0.9	0.3	1.8	-2.8	-3.7	-3.9	-5.9	-5.0	-5.9	4.1	14.8
q/q	0.9	-1.0	-1.6	3.7	-3.8	-1.9	-1.9	1.6	-2.8	-2.8	8.5	12.1
REER ULC***												
y/y	-1.0	-4.2	-2.3	-4.0	2.2	3.4	5.5	9.3	12.5	14.3	-7.0	-24.1
q/q	-3.8	-1.3	2.3	-1.2	2.4	-0.1	4.3	2.4	5.3	1.6	-15.1	-16.5

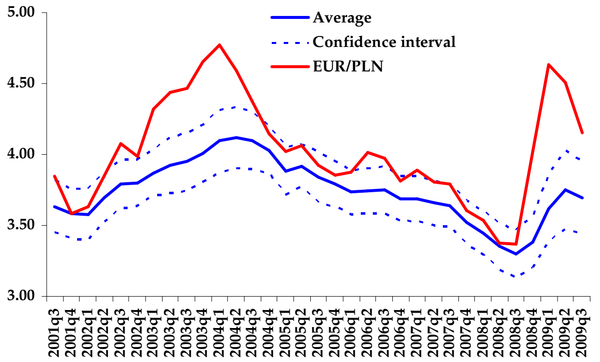
Source: NBP's calculations based on Eurostat, OECD and GUS data.
* Unit labour cost (ULC) index is calculated as the ratio of payroll growth to labour productivity growth, measured as output (volume) in manufacturing per person employed in this sector.
** Domestic PPI in manufacturing.
*** Estimates on the basis of monthly GUS data and ECB data. REER ULC – real effective exchange rate deflated with unit labour costs in manufacturing. Minus denotes depreciation.

the decline in exports (by 13.9% y/y in 2009 Q2 as compared with 13.3% y/y in 2009 Q1), which translated into a significant positive contribution of net exports to GDP growth in 2009 Q2[23] (Figure 2.22).

The decline in exports of means of transport moderated in comparison with 2009 Q1, particularly with respect to passenger cars and automobile parts, which was due to the growth in demand for small and relatively cheap cars (prevailing in automotive exports from Central Eastern Europe, including Poland) related to the introduction of bonuses for scrapping old vehicles in some Western European countries. In the context of continuing weak domestic demand in Poland's major export partners, the decline in exports of investment goods deepened, and – after a slight increase in 2009 Q1 – the exports of consumer goods decreased as well.

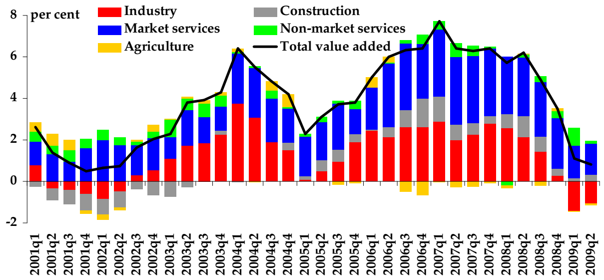
[23]National accounts data on exports and imports. According to GUS foreign trade statistics, exports in constant prices dropped in 2009 Q2 by 16.0% as compared to 17.0% in 2009 Q1, while imports in constant prices dropped by 23.6% as compared to 20.1% in 2009 Q1.

Figure 2.23:
Average threshold exchange rate of exports profitability (EUR/PLN) declared by enterprises.



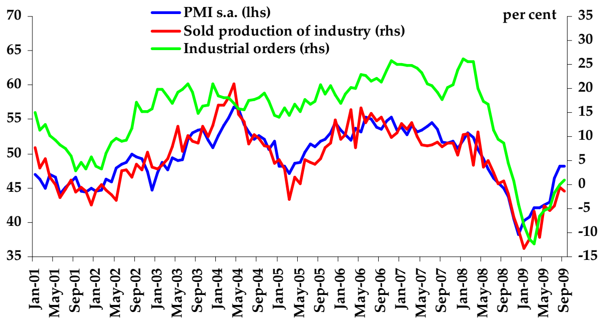
Source: NBP data and estimates.
The threshold exchange rate - at which exports become unprofitable, is determined as the average of responses to a question (see below) included in the survey of NBP quick monitoring addressed at enterprises *Information on the Condition of the Enterprise Sector, Including the Economic Climate.* The survey covers non-financial enterprises representing all NACE (PKD) sections (except for Agriculture, Forestry and Fisheries) of both public and non-public sector, including small and medium-sized enterprises and large entities.
Survey question: "What is the threshold level of the foreign exchange rate at which exports will become (is) unprofitable (in zloty)?"

□ **Figure 2.24:**
Sector contribution to annual gross value added growth.



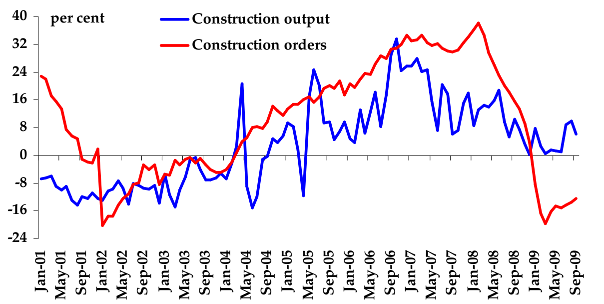
Source: NBP calculations on the basis of GUS data.

□ **Figure 2.25:**
PMI and annual growth of sold production of industry and of industrial orders.



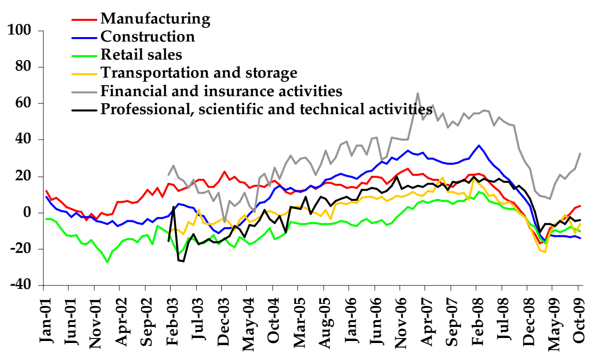
Source: GUS data (seasonally adjusted), NBP calculations.

□ **Figure 2.26:**
Annual growth of construction output and construction orders.



Source: GUS data (seasonally adjusted), NBP calculations.

□ **Figure 2.27:**
Indicators of future economic activity in selected sections.



Source: GUS business tendency survey.

On the other hand, the fall in exports of intermediate goods was reduced, probably due to a certain recovery in the exports sector of some euro area economies (see chapter 1.1 The global economic activity), particularly the German economy.

In the face of high import intensity of the Polish exports and further weakening of the investment activity of enterprises, a strong decline in the imports of intermediate and investment goods continued in 2009 Q2. Whereas the drop in imports of food and consumer goods deepened due to the further weakening of consumer demand as well as the earlier strong depreciation of the zloty conducive to an increase in demand for domestic goods at the expense of imported goods. The stronger decline in consumer goods imports could have also been driven by the reduction of stocks by enterprises.

2009 Q1 brought further significant improvement to the competitive position of enterprises producing for the domestic market and of Polish exporters, which was connected with a significant depreciation of the zloty exchange rate (Table 2.2). The appreciation of the zloty in 2009 Q2 and Q3 was conducive to the deterioration in the price competitiveness of Polish producers, although the NBP business conditions survey indicates that it still remains at a high level (Figure 2.23).

2.2.5 Output

In 2009 Q2 the growth of gross value added slowed in relation to 2009 Q1 and amounted to 0.8% y/y (Figure 2.24). The slowdown in value-added growth in 2009 Q2 was driven by a decline in value added in industry while the positive contributions of construction and market services stabilized. Market services remained the main growth component of gross value added.

Monthly data on industry, especially the gradually slowing decline (in annual terms) in industrial output and industrial orders as well as the September rise in industrial orders (Figure 2.25), all signal a gradual improvement in this sector. A certain output growth in the time to come is also possible in the construction sector, which may be indicated by decelerating negative growth of construction orders observed in the past few months and by positive year-on-year growth of construction and assembly output (Figure 2.26). It is worth noting that the rise in construction and assembly output is strongly supported by dynamic production growth in civil engineering, which may be connected with an increased level of public spending on infrastructural projects.

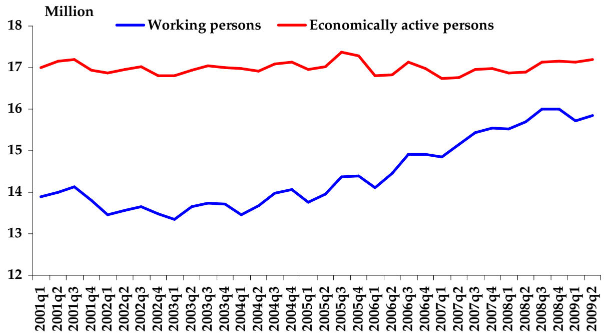
The tendencies signalled by the monthly data on industry and construction are, to a large extent, confirmed by GUS business tendency surveys which point to a general improvement of enterprise sentiment in 2009 Q3 relative to the previous quarter. In most sectors of the economy indicators of forecast economic situation reached their lowest values in February or March 2009 (Figure 2.27). Since then a steady improvement in the manufacturing indicator has been observed, whereas the construction and retail trade indicators, after a small improvement, have stabilised at a low level.

2.3 Labour market

The economic slowdown has been impacting the labour market more and more markedly. BAEL (LFS) data point to a stabilisation (in quarterly terms) of the number of working persons in 2009 Q1 and Q2 (Table 2.3, Figure 2.28). After a slight growth in the previous quarter, 2009 Q2 saw a decline in average employment in the national economy (by 0.5% y/y). Moreover, data on employment in the enterprise sector in 2009 Q3 indicate that the decline is deepening (to 1.8% y/y as compared to a decline of 1.0% y/y in the previous quarter; Figure 2.30).

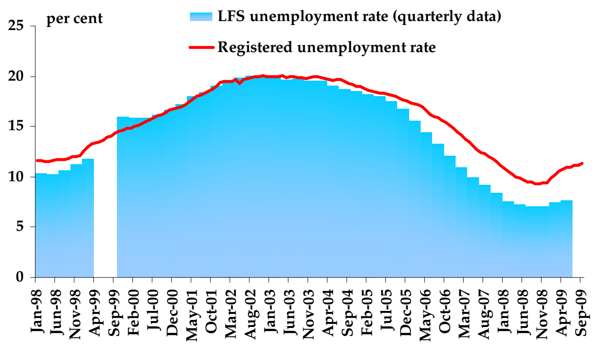
2009 Q2 brought a decrease in fixed-term-contract employment reductions which had so far constituted an element of employers' adjustment to the economic slowdown. In the two preceding quarters this process contributed significantly to slower growth in the number of working persons (Table 2.3). On the other hand, the scale of

Figure 2.28:
Working persons and the economically active in the economy (according to BAEL).



Source: GUS data.

Figure 2.29:
Unemployment rate registered by labour offices and unemployment rate according to LFS.



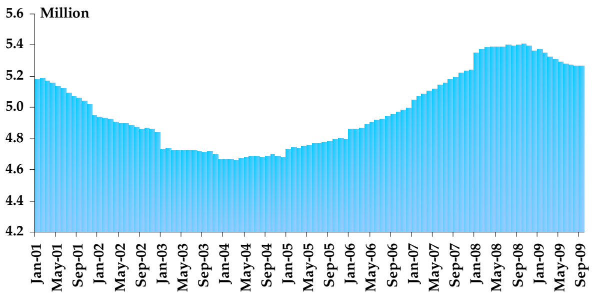
Source: GUS data (seasonally adjusted).
Data till 2002 are adjusted for the results of the 2002 National Census.
The LFS survey was not conducted in 1999 Q2 nor in Q3.
There are two reasons for the differences between the unemployment rate according to BAEL and the registered unemployment rate: (1) Different definition of unemployed person. (2) Different definition of population to which the number of the unemployed is referred.

Table 2.3: Working population according to BAEL in selected sections.

	Working persons in 2009q2		Growth in 2009q1		Growth in 2009q2		Growth in 2009q1	Growth in 2009q2
	thousands	structure per cent	y/y thousands	y/y per cent	y/y thousands	y/y per cent	q/q seasonally adjusted per cent	q/q seasonally adjusted per cent
Total	15,847	100	199	1.3	158	1.0	0.0	0.1
Total excluding private agriculture	13,866	87.5	231	1.7	280	2.1	-0.2	0.4
Place of residence								
urban areas	9,805	61.9	74	0.8	49	0.5	-0.6	0.3
rural areas	6,042	38.1	125	2.1	109	1.8	0.5	0.2
Economic sector								
agriculture	2,120	13.4	-57	-2.7	-149	-6.6	-0.8	-1.7
industry	4,910	31.0	-21	-0.4	-45	-0.9	-1.5	-0.1
services	8,806	55.6	277	3.3	352	4.2	0.8	1.0
Ownership sector								
public	4,298	27.1	29	0.7	53	1.2	0.5	0.3
private	11,548	72.9	171	1.5	104	0.9	-0.2	-0.1
Employment status								
hired employees	12,197	77.0	177	1.5	189	1.6	-0.2	0.5
employers and self-employed	3,035	19.2	24	0.8	3	0.1	0.2	-0.1
contributing family workers	615	3.9	-3	-0.5	-35	-5.4	-1.0	-1.6
Type of job contract								
fixed-term contract	3,232	26.5	-49	-1.6	-5	-0.2	-0.3	0.4
permanent contract	8,965	73.5	226	2.6	194	2.2	-0.7	0.2

Seasonally adjusted growth was computed based on data seasonally adjusted with TRAMO/SEATS on a sample beginning in 1995 Q1. Data on working persons in the public sector were seasonally adjusted on a sample beginning in 2002 Q1.
Source: GUS data, NBP calculations.

□ **Figure 2.30:**
Employment in the enterprise sector.



Source: GUS data.

working hours adjustment increased[24].

In addition, the diminishing demand for labour finds reflection in data on the number of vacancies reported by employers to labour offices[25] as well as in the rapid increase of unemployment among young people.

Despite unfavourable developments in the labour market, labour supply growth was maintained in 2009 Q2. This increase was primarily fuelled by the continuous growth of the population's propen-

[24] In seasonally adjusted terms the average number of working hours per week on the main job dropped in 2009 Q2 by 0.5% q/q as compared to a decline of 0.1% q/q in 2009 Q1.

[25] In June–September 2009 the number of vacancies reported by employers to labour offices fell by 22.4% y/y (compared to a drop of 24% y/y in previous four months).

sity to be economically active which began in 2008 Q1 and, to a lesser extent, by demographic developments (Figure 2.28). The economic activity ratio in 2009 Q2 rose in relation to the corresponding period of the previous year in all age groups.

Amid the continuing growth in labour supply, the weakening of the demand for labour translated into further – though slower than in the previous quarter – unemployment rate growth. The seasonally adjusted LFS unemployment rate in 2009 Q2 rose to 7.6% (from 7.5% in the previous quarter), while the seasonally adjusted rate of registered unemployment increased to 11.3% in September 2009 (from 10.8% in May 2009). Slower unemployment growth – accompanied by a stabilisation of the fall in the number of vacancies – translated into the levelling-off of the labour market tensions index (Figure 2.34).

The results of NBP business tendency surveys[26] indicate that in the nearest future some weakening of the so far unfavourable labour market tendencies can be expected. In 2009 Q3 the forecasts of employment in the enterprise sector improved for the second consecutive quarter. The forecasts of employment in 2009 Q4 improved in manufacturing, construction and trade. Nevertheless, the forecasts of an employment decrease still prevail in all sectors over the forecasts of an increase.

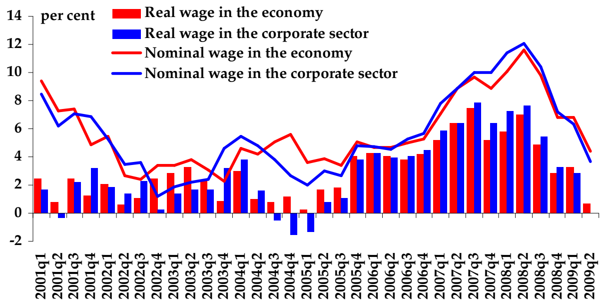
Declining demand for labour also fed through into weaker wage growth. In 2009 Q2 nominal wage growth in the economy slowed significantly, which was primarily the result of their slower growth in the enterprise sector (Figure 2.31). In 2009 Q3 the growth of nominal wages in the enterprise sector increased slightly (to 3.9% y/y from 3.7% y/y in 2009 Q2).

After falling in two preceding quarters, labour productivity edged up in 2009 Q2 (by 0.1% y/y)[27], which amidst a weaker growth of wages translated into a drop in the growth of unit labour

[26] See: *Information on the Condition of the Enterprise Sector, Including the Economic Climate in 2009 Q3 and Forecasts for 2009 Q4*, NBP.

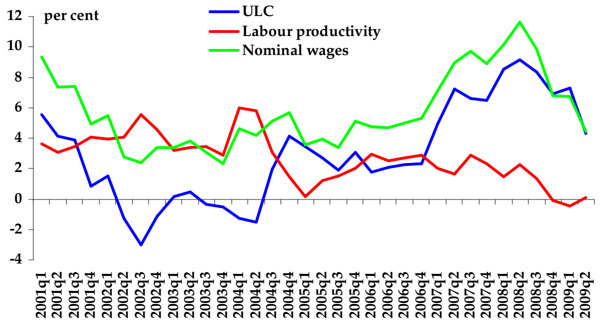
[27] Labour productivity in the economy: GDP in constant average annual prices from the previous year per one person working in the economy according to the BAEL.

Figure 2.31:
Annual growth of wages in the economy and in the corporate sector (nominal and real).



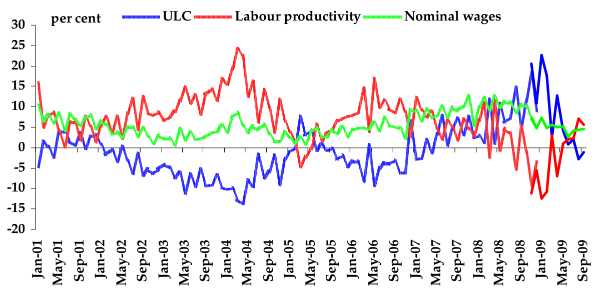
Source: GUS data, NBP calculations.

Figure 2.32:
Annual growth of labour productivity, wages and unit labour costs (ULC) in the economy.



Source: GUS data, NBP calculations.

Figure 2.33:
Annual growth of labour productivity, wages and unit labour costs (ULC) in industry.



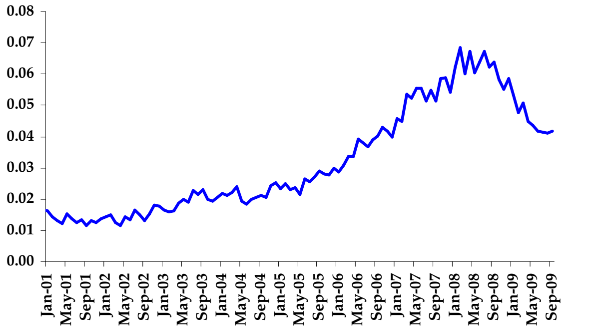
Source: GUS data, NBP calculations.
Since January, 1 2009 new classification of activities has been employed in statistics (PKD 2007), which results in growth of wages and employment in industry in the period starting in November 2008 being not fully comparable with the data from preceeding periods.

costs in the economy[28], though it remained relatively high (in 2009 Q2 it stood at 4.3% y/y compared to 7.3% y/y in the previous quarter; Figure 2.32).

The growth of unit labour costs in industry has significantly decelerated over the past few months and in August–September 2009 unit labour costs fell in year-on-year terms (Figure 2.33).

The NBP business tendency survey[29] indicated that the slowdown of wage growth in the enterprise sector may be restrained in the coming months. In 2009 Q3 the percentage of companies intending to raise their wages remained unchanged and for the second consecutive quarter proved higher than the percentage of enterprises planning to recourse to wage cuts[30]. In the GUS consumer tendency survey the percentage of people who are afraid of becoming unemployed – despite still being high – has significantly dropped in relation to the previous quarter.

Figure 2.34:
Labour Market Tightness Index (the number of vacancies per unemployed person).



Source: GUS data (seasonally adjusted), NBP calculations.
The Vacancy-Unemployment Ratio is directly proportional to the probability of an unemployed person finding a job (the more vacancies per unemployed the more likely he/she is to find a job) and inversly proportional to the probability of filling a vacant post by an employer (the more job offers in relation to unemployed persons the less likely it is to fill in the vacancy). The index reflects the relative power of employees and employers in wage negotiations.

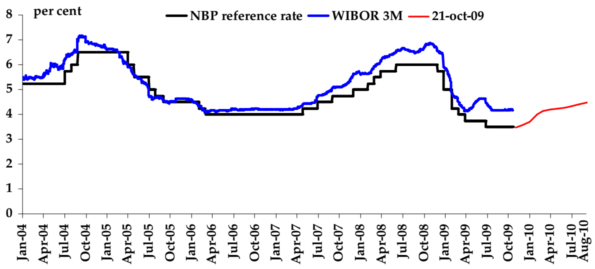
2.4 Financial markets[31]

2.4.1 Asset prices and interest rates

Short-term interest rates

Following the 25-basis-point reference rate reduction to 3.50% in June 2009, the Monetary Policy Council kept interest rates unchanged in subsequent months. The June reference rate cut was followed by a decline of interbank market rates. WIBOR 3M declined from the average level of

Figure 2.35:
NBP reference rate, 3-month WIBOR and 1-month interest rate implied by FRAs.



Source: Reuters data, NBP calculations.

Figure 2.36:
Yields of the Polish benchmark bonds (y/y).

Source: Reuters data.

[28] Unit labour costs in the economy: nominal aggregate wages in the economy (average nominal wage in the economy multiplied by the number of people working in the economy according to the LFS) to GDP (in constant average annual prices from the previous year).

[29] See: *Information on the Condition of the Enterprise Sector, Including the Economic Climate in 2009 Q3 and Forecasts for 2009 Q4*, NBP.

[30] Pay increases in 2009 Q3 and Q4 were anticipated by 7.3% of enterprises. At the same time, 4.2% of the surveyed enterprises declared wage reductions in 2009 Q4 (compared to 5.6% declared in the previous quarter).

[31] The cut-off date for the data presented in this section is 21 October 2009.

4.60% in June 2009 to 4.19% on average in the period 1–21 October 2009.

According to the results of the Reuters survey of 9 October 2009) analysts expect the reference rate to remain at 3.50% in 2009 Q4. They differ, however, in their expectations about the reference rate level over a one year horizon: about two thirds of analysts expect the reference rate to increase (by 25 or 50 basis points) over a one year horizon, and about one third of them expect the reference rate to be kept unchanged[32].

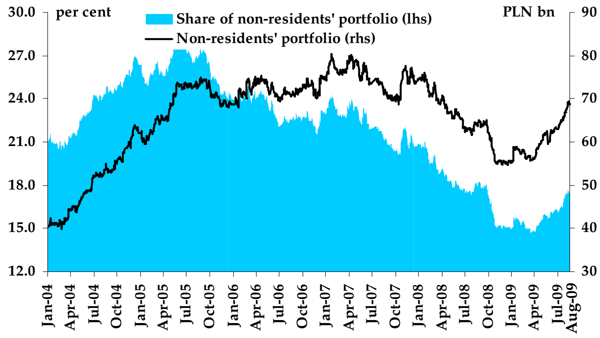
One-month WIBOR FRA rates (including the risk premium; Figure 2.35) could point to expectations of the NBP rates at 3.50–3.75% over the next three months and at 4.50–4.75% over a one year horizon. It should be emphasized, however, that the quotations of these contracts may still be distorted by a heightened liquidity and credit risk premium included in the WIBOR rate. The liquidity premium, measured with the WIBOR-OIS spread, remains increased, although it is markedly lower than at the turn of 2008 and 2009. Thus despite a certain improvement of the situation in the interbank market, banks remain reluctant to lend to each other.

Yields on Polish treasury bonds decreased only slightly as compared with the previous *Report*, yet tend to show significant volatility (Figure 2.36). Among the external factors acting towards a decline in yields the key role was played by an improved sentiment of financial market participants towards emerging economies and the associated inflow of foreign portfolio investment to those countries. On the other hand, the gradual rise in market expectations about the future interest rate level in Poland was a factor conducive to yield increases. Another such factor were probably the concerns about the deteriorating situation of the public finance sector.

As a result of a more stable situation in the financial markets and of improved investor sentiment towards emerging countries, 2009 Q3 brought a further increase in non-residents' involvement in the debt market in Poland (Figure 2.37).

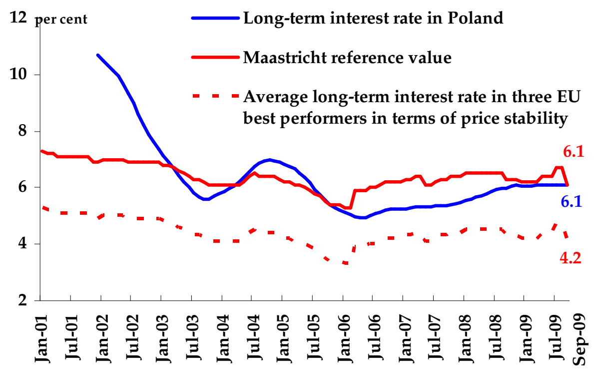
[32] 35% of analysts expect the reference rate to remain at 3.50%, 31% expect the reference rate to be increased to 3.75%, and another 31% – to the level of 4.00%. The remaining analysts expect the reference rate to reach 4.50%.

Figure 2.37:
Non-residents' participation in the Polish Treasury bond market.



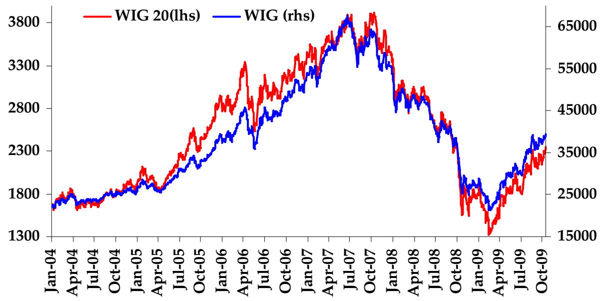
Source: National Depository for Securities (KDPW) data.

Figure 2.38:
Average annual yield (12-month moving average) for long-term Treasury bonds in Poland versus the reference value for the Maastricht criterion.



Source: NBP estimates based on Eurostat data.

Figure 2.39:
WIG and WIG 20 stock exchange indices.



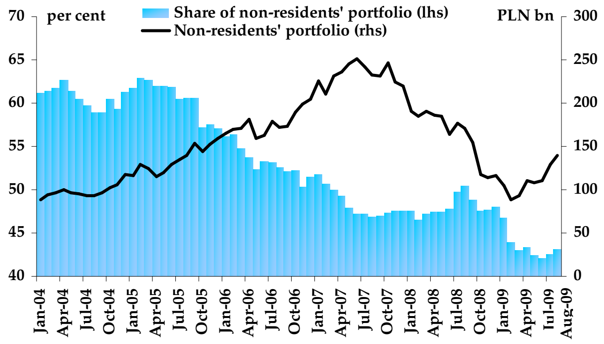
Source: Reuters data.

Since the publication of the last *Report* the spread between Polish 10-year Treasury bonds and German government bonds with similar maturities decreased to 284 basis points from the level of 293 basis points[33].

In the analysed period Poland continued to comply with the long-term interest rate criterion. In September 2009 the yield on Polish long-term bonds in average annual terms, used to assess the compliance with the Maastricht interest-rate criterion, amounted to 6.1%, while the reference value was 6.1% (Figure 2.38).

Since the previous *Report*, share prices have risen considerably. (Figure 2.39). Share-price growth was accompanied by a marked increase in foreign investors' involvement in the Polish market (Figure 2.40).

Figure 2.40:
Non-residents' participation in the Polish equity market (on the basis of market value of stocks).

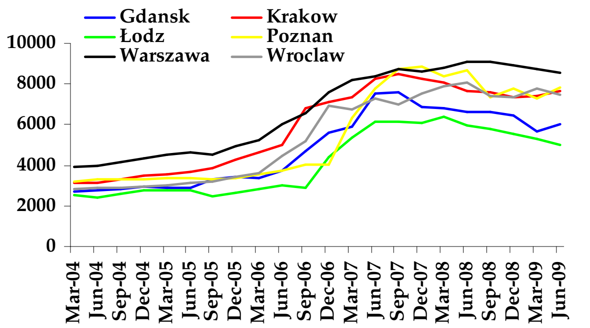


Source: NBP data.

Home prices

In 2009 Q2 prices of flats – depending on the market segment – were either stable or showed a slight downward trend. In the secondary markets of major cities sale prices continued to fall, while asking prices in the majority of cities increased slightly as compared with 2009 Q1. Yet, the slight increase in asking prices of flats in the secondary market might have been connected with the growing number of higher-standard flats offered. In the primary market asking-price growth oscillated around zero both in large cities and in small and medium-sized towns.

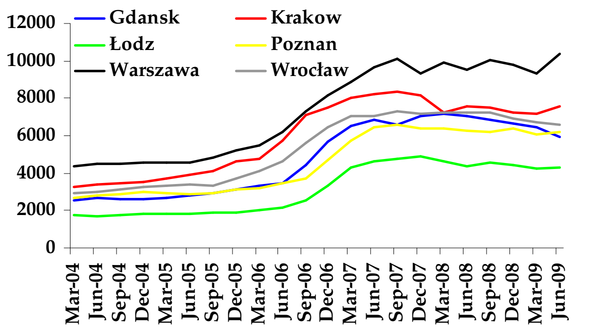
Figure 2.41:
Average asking prices (PLN/m^2) of flats in the primary market in Poland's six biggest cities.



Source: Data from the PONT Info Nieruchomosci asking prices database.

According to market information, sales of flats in 2009 were considerably lower than last year's sales, which, combined with their growing supply, resulted in a growing number of unsold flats. This was a result of persistently high prices which have undergone only a moderate decline since the end of 2007 (Figure 2.41, 2.42), banks' tighter housing loan terms and households' refraining from house purchasing in anticipation of further decline in housing prices.

Figure 2.42:
Average asking prices (PLN/m^2) of flats in the secondary market in Poland's six biggest cities.



Source: Data from the PONT Info Nieruchomosci asking prices database.

Considering the currently observed excess supply of flats, still high prices and the limited availability of housing loans, the coming months are

[33] In the case of Czech and Hungarian bonds, this spread was 98 and 388 basis points respectively.

likely to bring further downward pressure on flat prices. Therefore, there is a likelihood of further flat-price declines, a shift of non-completed housing construction to subsequent years and a decline in the number of newly started housing projects (which is reflected in the falling number of building permits issued; Figure 2.43).

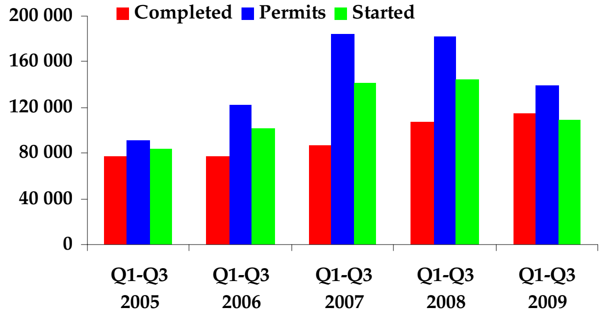
2.4.2 Exchange rate

Since the publication of the previous *Report* the nominal exchange rate of the zloty has appreciated significantly against the euro, the US dollar and the Swiss franc. Between 18 June and 21 October 2009 the zloty appreciated 15% to the US dollar and approx. 9% against the euro and the Swiss franc. In the period analysed one could also observe a marked appreciation of the other currencies of the region, i.e. the Hungarian forint and the Czech koruna (Figure 2.44).

The zloty appreciated between the end of June and the beginning of August 2009 and then, gradually, started to stabilise, while fluctuating within a reltively wide band. The main factors behind the appreciation of the Polish currency were of global nature, including a further decline in risk aversion in international financial markets which led to improved sentiment towards emerging-market currencies. The zloty appreciation was also supported by positive domestic macroeconomic data. Zloty appreciation coming to a halt in August 2009 could be the effect of both external (among others negative data on the region's economies, particularly lower Standard&Poor's ratings of Latvia and Estonia) and domestic factors. Among the latter an important role was probably played by an anticipated deterioration of Poland's fiscal situation in 2010.

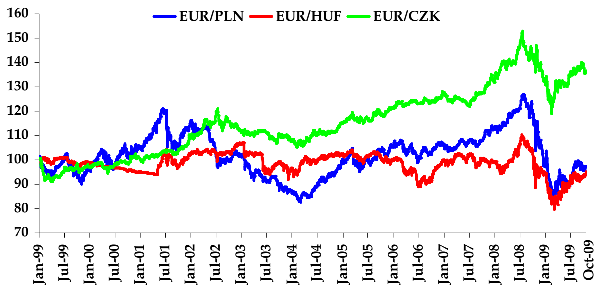
From March to August 2009 the appreciation of the nominal effective exchange rate of the zloty was accompanied by a corresponding appreciation of the real exchange rate of similar scale (Figure 2.45).

Figure 2.43:
The number of completed flats, construction permits issued and construction projects started.



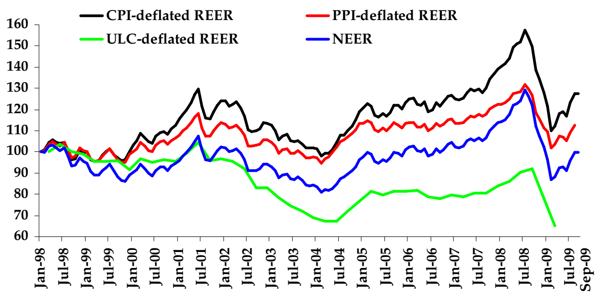
Source: GUS data.

Figure 2.44:
Nominal exchange rates of the Polish zloty, the Czech koruna and the Hungarian forint against the euro (increase denotes appreciation).



Source: EcoWin data.

Figure 2.45:
Zloty real and nominal effective exchange rate (increase denotes appreciation).



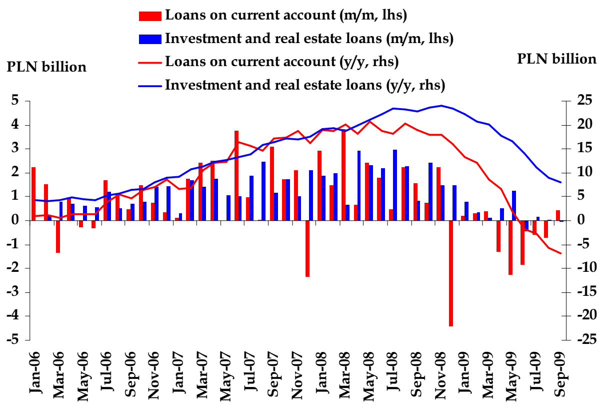
Source: NBP, European Commission, and EcoWin data.
For ULC (unit labour costs in manufacturing): quarterly data, NBP estimates based on GUS, ECB, and European Commission data.

2.5 Credit and money[34]

Credit

Since April 2009 loans to enterprises exhibited a declining tendency, with their value decreasing in April–September 2009 by a total of PLN 3.5 billion, i.e. by 1.6% (as compared to an increase of PLN 19.6 billion, i.e. 10.7% in the corresponding period of 2008). The decline in loans was mainly driven by loans on current account, but the slowdown extended also to long-term loans (Figure 2.46). As a result, annual changes in investment loans and loans for the purchase of real estate have been visibly shrinking, and in the case of loans on current account they have been negative since June 2009 (Figure 2.46).

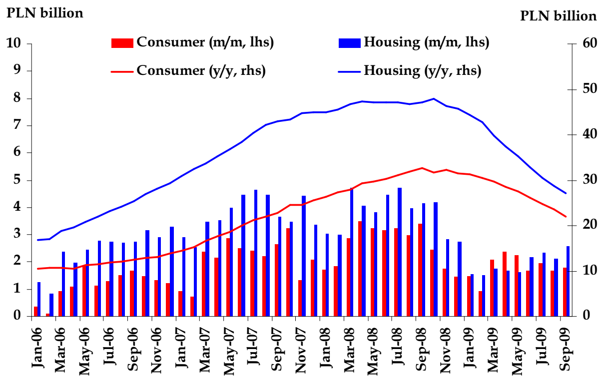
Figure 2.46:
Loans to enterprises (m/m and y/y).



Source: NBP data.

According to NBP survey studies[35] in 2009 Q2 banks recorded an increased demand for short-term credit, which was primarily related to an increased need for the financing of debt restructuring[36]. Due to the economic slowdown and unfavourable perspectives for sales, enterprises cut back their investment expenditure (see Section 2.2.2 Investment demand), which was reflected in a weakening demand for investment loans and loans for the purchase of real estate.

Figure 2.47:
Loans to households (m/m and y/y).



Source: NBP data.

Similarly as in the two previous quarters, in 2009 Q2 banks tightened the criteria for granting loans to enterprises[37], though the share of banks tightening their credit policies for large enterprises has been falling continually since 2008 Q4, which

[34] It should be emphasised that the monetary data released by the NBP over the past few quarters, most specifically those about the changes in the volume of housing loans to households and loans to enterprises, continued to be strongly affected by exchange rate shifts. Therefore, the monetary data presented in this charter refer to variables adjusted for the impact of fluctuations in the zloty exchange rate against main foreign currencies.

[35] See: *Senior Loan Officer Opinion Survey on Bank Lending Practices and Credit Conditions. 2009 Q3*, NBP.

[36] Growing demand for short-term loans may be connected with a deteriorating financial condition of enterprises and, to a lesser extent, with exchanging liabilities due to foreign currency derivative instruments for loans.

[37] The tightening of credit policies primarily consisted in increasing collateral requirements (which was indicated by over 80% of banks) and raising loan margins, in particular on higher-risk loans.

Table 2.4: Foreign loans of Polish enterprises in EUR (y/y in per cent).

	2007				2008				2009	
	q1	**q2**	**q3**	**q4**	**q1**	**q2**	**q3**	**q4**	**q1**	**q2**
Non-trade credit	31.6	35.3	29.5	23.1	27.0	30.3	27.9	17.6	8.2	2.1
Trade credit	24.4	23.6	26.2	24.2	23.7	20.9	16.2	-2.3	-15.8	-18.3

Source: NBP data.

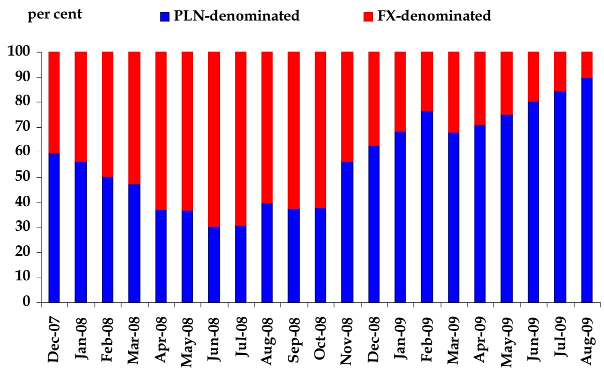
may reflect a gradual decrease in the scale of credit policy tightening.

According to NBP data, in 2009 Q2 the level of enterprises' foreign debt rose by EUR 1.9 billion (to EUR 80.5 billion) in relation to the end of the previous quarter, though its growth decreased from 0.3% y/y to -3.9% y/y (Table 2.4). Enterprises primarily made use of non-trade credit, which rose by 2.1% r/r (compared to 8.2% y/y at the end of 2009 Q1). In 2009 Q2 the value of trade credit decreased by 18.3%, which was related to a strong decline in imports. In this period there was also a fall (by 2.9%) in the value of indebtedness of enterprises due to debt securities held by foreign portfolio investors.

Credit to the household sector has kept growing, though the scale of this growth has been significantly smaller than in the previous years (Figure 2.47). In April–September 2009 the value of loans granted to this sector increased by PLN 21.7 billion, i.e. by 5.6%, while in the corresponding period of 2008 indebtedness had risen by PLN 38.8 billion, i.e. 14.0% (Figure 2.47). The decrease in the growth was more pronounced in housing loans than in consumer loans[38]. This more significant drop in the growth of housing loans was related, i.a., to the fact that the vast majority of banks stopped offering loans denominated in foreign currencies, which resulted in a significant reduction of the share of foreign currency loans in newly granted housing loans

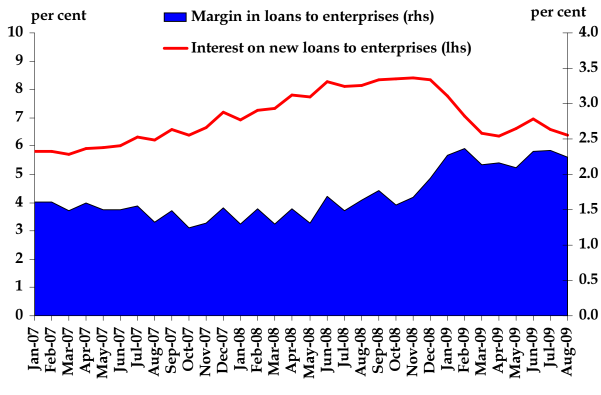
[38]In the analysed period the value of housing loans increased by PLN 10.9 billion, i.e. by 5.3% (compared to a rise of 16.2% in the corresponding period of 2008), while the value of consumer loans increased by PLN 9.3 billion, i.e. 6.5% (compared to 14.2% in the corresponding period of 2008).

Figure 2.48:
Currency structure of newly granted housing loans to households.



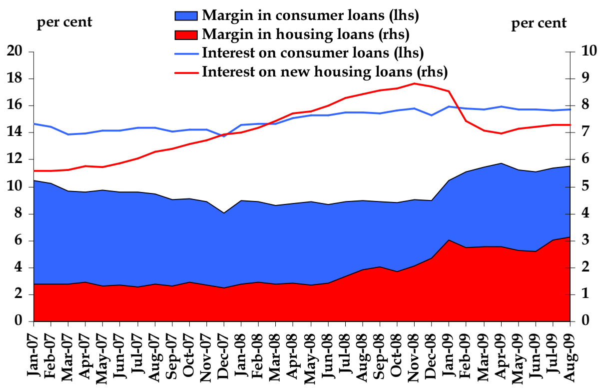
Source: NBP data.
Structure based on information from interest rates reporting of 20 banks whose market share in credits to non-financial sector amounts to approx. 75%.

Figure 2.49:
Average interest and margins in new loans to enterprises.



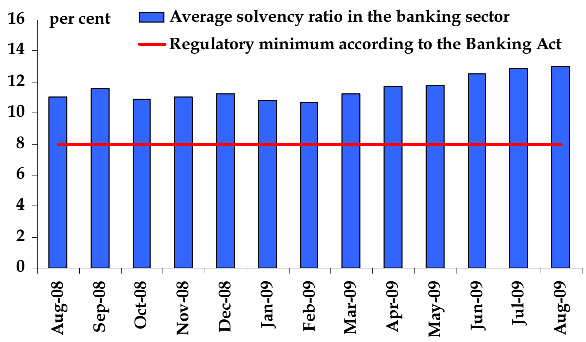
Source: NBP data.
Margin understood as the spread between the interest on loans and WIBOR 3M.

Figure 2.50:
Average interest and margins in new loans to households.



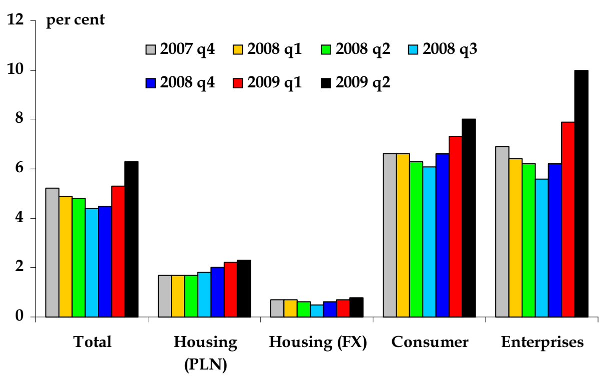
Source: NBP data.
Margin understood as the spread between the interest on loans and WIBOR 3M.

Figure 2.51:
Average solvency ratio in the banking sector.



Source: NBP data.

Figure 2.52:
Share of irregular loans in selected categories of loans.



Source: NBP data.

(Figure 2.48).

The slowdown in loans to households was to a larger extent driven by supply-side factors. Despite the deterioration in labour market situation, which negatively affected the income of households, in 2009 Q2 banks reported a slight pick-up in the demand for both housing and consumer loans. At the same time, banks tightened their credit policy in both segments of the market, though the scale of tightening was larger in the case of consumer loans, which was related to the fact that the share of irregular loans in total consumer loans has been rising and reached 8.0% in June 2009, compared to just 1.2% in the case of housing loans (Figure 2.52).

The average interest rate charged on new loans to enterprises was rising between April and June 2009 along with the interbank interest rates. In July 2009 the 3-month WIBOR declined following the NBP interest rate cut in June, which translated into a reduction of interest charged on new loans to 6.4%, i.e. the level close to that recorded in April 2009 (Figure 2.49). Despite the drop in the 3-month WIBOR, the interest on new zloty-denominated housing loans rose from 7.0% to 7.3% in April–August 2009, reflecting increases in margins declared by some banks. In turn, the average interest charged on new consumer loans declined from 15.9% in April to 15.7% in August 2009, in line with declarations of banks which tightened primarily their standards and non-price terms and conditions for granting consumer loans (Figure 2.50).

Financing and capital situation of banks

The growth of loans depends in part on banks' capital position and their ability to refinance credit expansion. Banks entered the period of strong economic slowdown with relatively low capital buffers, which was one of important reasons behind reduced credit supply in 2008 Q4 and 2009 Q1[39]. Over the recent months, the significance of this factor has been steadily diminishing, which was related to a rise in capital of most banks due

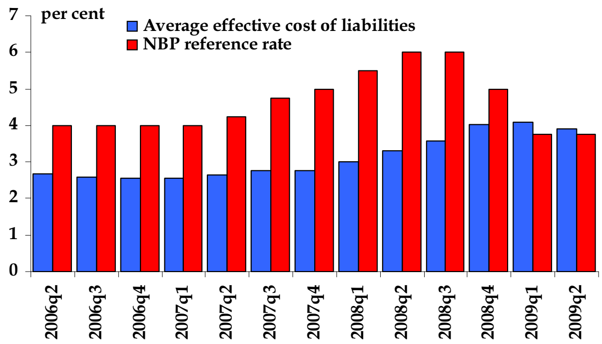
[39] See: *Senior Loan Officer Opinion Survey on Bank Lending Practices and Credit Conditions. 2009 Q3* (and previous quarters), NBP

to the retention of high profits gained in 2008[40]. The retention of bank profits raised the average solvency ratio of the banking sector to 13.0% at the end of August 2009, compared to 11.2% at the end of 2008 (Figure 2.51).

In the opinion of banks, the most important reason for curbing the supply of loans is the uncertainty about the outlook for future economic conditions. Banks have to take into account not only a higher credit risk associated with granting new loans but also a possible deterioration in the portfolio of the loans already granted (Figure 2.52). The deteriorating quality of loans extended to the non-financial sector has been visible since 2008 Q4, with the largest increase in irregular loans recorded in the case of loans to enterprises. The deteriorating quality of loans negatively affects the financial results of banks and hence also their capital adequacy and, consequently, their ability to grant new loans.

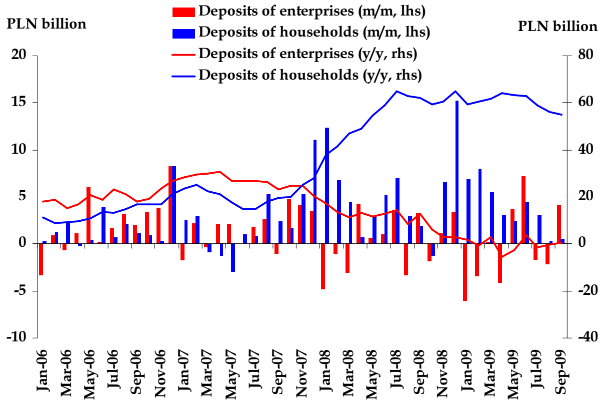
Among the reasons for reducing the supply of credit, banks also quoted financing constraints, primarily the persistently low liquidity and heightened premium for risk in the domestic market for longer-term unsecured interbank deposits, and an increased cost of foreign financing obtained from parent companies (among others due to a higher cost of financing of parent banks themselves), which provided incentives for banks to intensify their competition for retail deposits. As a result, the average effective cost of liabilities increased significantly and in the first half of 2009 exceeded the level of the NBP's reference rate (Figure 2.53).

Figure 2.53:
Average effective cost of liabilities (annualised).



Source: NBP data.
Effective cost of liabilities understood as the ratio of interest costs to liabilities towards the financial and non-financial sectors, as well as the central and local government sectors.

Figure 2.54:
Deposits of households and enterprises (m/m and y/y).



Source: NBP data.

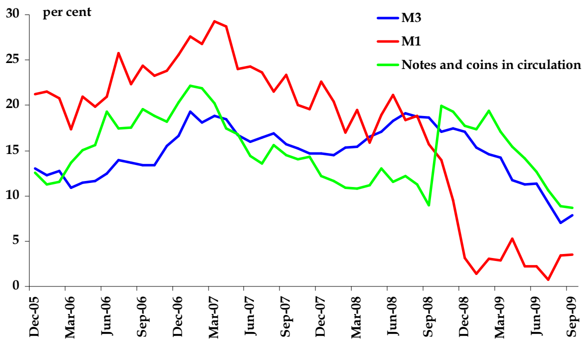
Deposits and monetary aggregates

Due to the increased level of corporate deposits in May, June and September 2009, the value of this aggregate in April–September increased by PLN 11.2 billion, i.e. by 8.1%. At the same time, the annual increases in corporate deposits have been declining and since February 2009 have hovered around zero (Figure 2.54).

[40] An additional factor contributing to the growth in the banking sector's solvency ratio was the government's recapitalisation of Bank Gospodarstwa Krajowego.

Deposits of households rose in April–September 2009 by PLN 10.7 billion, i.e. 3.0% (compared to PLN 19.8 billion, i.e. 6.8% in the corresponding period of 2008) and their annual growth declined by 4.4 percentage points to 17.3%. This was probably related to the slowdown in the growth of wages and disposable income and also to households' increased involvement in non-bank forms of saving (Figure 2.54). The 25.7-billion-zloty increase in financial assets in this period was primarily driven by the rise in the value of shares ammounting to PLN 11.6 billion (36.0%) and investment fund units of PLN 10.3 billion (16.7%).

Figure 2.55:
M3, M1 and notes and coins in circulation (y/y).

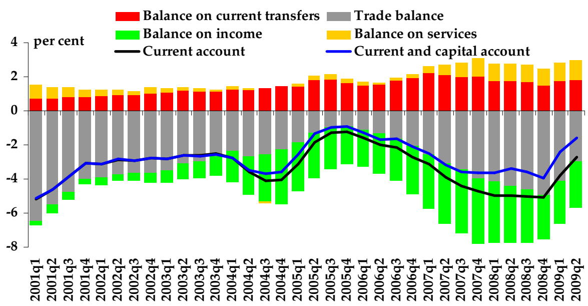


Source: NBP data.

The slowdown in monetary expansion observed since the second half of 2008 was reflected in a decrease of the annual growth rate of broad money M3, which fell in April–September 2009 by further 3.9 percentage points to 7.8% (Figure 2.55). In the recent period the slowdown has also affected the most liquid money components included in the M1 monetary aggregate, whose annual growth rate declined between the end of April and the end of September 2009 by 1.8 percentage points to 3.5%.

2.6 Current account and capital account of the balance of payments

Figure 2.56:
Current account relative to GDP (4-quarter rolling window).



Source: NBP data.

In 2009 Q2 the current account deficit amounted to EUR 845 million and was significantly lower than in the corresponding period of 2008 (EUR 5.1 billion). The improvement in the current account balance was driven by a reduction in the trade deficit, connected with a significantly deeper decline in imports than in exports – to a lesser degree – an increased surplus in the trade in services. The falling current account deficit was accompanied by a lower inflow of net capital related to loans and commercial loans obtained by Polish entities, as well as to foreign direct investment. On the other hand, there was a rise in the inflow of portfolio investment in debt securities as compared with the corresponding period of 2008.

The current account deficit (in terms of four quarters) in relation to GDP decreased to 2.9% (as compared with 4.0% after 2009 Q1 and 5.1% in 2008). The current and capital account deficit in relation to GDP decreased to 1.9% after 2009 Q2 (as compared with 2.7% after 2009 Q1 and 4.0% in 2008). The current account deficit was financed with the inflow of capital in the form of direct investment in 58.5%, and the current and capital account deficit in 90.5% (Figure 2.56).

Chapter 3

Monetary policy in June–October 2009

During the decision-making meeting in June 2009 the Monetary Policy Council lowered the interest rates by 0.25 percentage points. At the meetings in July, August, September and October 2009 the Council decided to keep the NBP interest rates unchanged: the reference rate at 3.50% on an annual basis; the lombard rate at 5.00% on an annual basis; the deposit rate at 2.00% on an annual basis; the rediscount rate at 3.75% on an annual basis.

What follows in the next part of the chapter are the previously published *Minutes of the Monetary Policy Council decision-making meetings* held in June, July, August and September 2009 as well as the *Information from the meeting of the Monetary Policy Council* in October 2009.

Minutes of the Monetary Policy Council decision-making meeting held on 24 June 2009

During the meeting the Monetary Policy Council discussed the outlook for inflation in the context of the past, current and, primarily, anticipated economic situation.

The discussion at the meeting focused on the outlook for economic growth abroad and in Poland, fiscal policy, zloty exchange rate developments and the situation in the credit market and the banking sector. The Council discussed the impact of those factors on future inflation in Poland against the background of the June projection of inflation and GDP.

While discussing the domestic economic growth, it was pointed out that decline in industrial output and very low growth of construction and assembly production in May 2009 confirmed the subdued economic activity in Poland. Some members of the Council pointed out that many macroeconomic indicators released recently, including the output data, were better than expected and some economic activity indicators pointed currently at a possible improvement in the outlook for growth in Poland. Other members of the Council argued, however, that worsening economic indicators in retail trade might signal further shrinking of consumption demand, which is driven i.a. by the decline in real aggregate wage in the enterprise sector. Those members also pointed out that according to the NBP preliminary assessments investment in the Polish economy might have strongly declined in 2009 Q2. Those members also emphasized that the June projection of the NBP pointed at further considerable decline in GDP growth in the coming quarters. Moreover, some members of the Council emphasized that the decline in economic activity in Poland might be stronger than indicated by the projection.

While discussing the external environment of the Polish economy, the successive signs of improvement in the outlook for world economic growth and stabilization of the situation in the global financial markets were pointed at. Yet, some members of the Council assessed that recession in the global economy might last longer that currently expected, and improvement of the situation in the financial markets might only be temporary. Those members emphasized that macroeconomic data did not univocally suggest that the downward trend in economic growth in the United States had been reversed. In the opinion of those members, recovery of the American economy would proceed gradually, which might delay the recovery of the euro zone and other developed economies. Those members indicated that 2009 was expected to bring a further strong decline in economic activity in the euro area and some forecasts pointed to the risk of GDP fall in this region also in 2010.

While analyzing the situation in the public finance sector, it was pointed out that a low growth rate of budget income in the first five months of 2009, including a considerable decline in tax revenues, which, given the persistently high expenditure growth, had led to a rapid increase in budget deficit. Some members of the Council pointed out that in order to limit the decline in tax revenues in 2009, the government would strive to increase non-tax revenues, including dividends from companies with State Treasury participation, which, given the restricted access to loans, might be conducive to additional cuts in investment expenditure by those enterprises. At the same time, those members assessed that – despite possible increase in the proceeds from dividends – the decline in budget income in 2009 would probably exceed the government announced growth in the planned deficit, which would suggest the need of cuts in some expenditure areas. Those members emphasized that the cuts in budget expenditure already announced by the government as well as possible further cuts would be conducive to a fall in domestic demand. The possible rise in taxes in 2010 might also lead to curbing domestic demand. It was also pointed out that the uncertainty about the scale of the actual expenditure cuts and the areas likely to be affected by these cuts, including the uncertainty resulting from some expenses being shifted from the central government budget to other units of the general government sector, makes it difficult to assess the impact of the changes in fiscal policy on the outlook for domestic economic growth.

While assessing the impact on inflation of changes in the situation of the general government sector and in the fiscal policy, the risk of a rise in inflation resulting from possible increases of regulated prices and indirect taxes in 2010 was indicated. Some members of the Council assessed that the rise in excise and VAT rates might be conducive to the CPI remaining at an increased level in 2010. Other members of the Council pointed out, however, that the possible tax increases and the government announced cuts in budget expenditure would be conducive to curbing domestic demand and, as a result, inflationary pressure. Those members also indicated that the rise in the budget deficit results mainly from the deteriorating economic conditions rather than from fiscal policy easing.

While analyzing the changes in current inflation it was pointed out that CPI inflation had fallen to 3.6% in May 2009, remaining, however, above the upper limit for deviations from the inflation target, set at 3.5%. It was emphasized that the inflation decline in May

2009 had mainly been driven by the negative base effect related to a strong rise in gas and energy prices in the corresponding period of the previous year. Some members of the Council indicated that the growth rate of consumer prices in the first few months of 2009 exceeded the average from the last eight years, which, by means of a base effect, might be conducive to a decline in the year-on-year inflation rate at the beginning of 2010. Those members also pointed out that in 2009 inflation was likely to remain at an increased level which would be driven i.a. by the positive base effect connected with a sharp fall in fuel prices in the second half of 2008.

While discussing the current inflation, some members of the Council also pointed out that inflation remaining above the upper limit for deviations from the inflation target was mainly connected with the previously effected increases in regulated prices and rising unprocessed food prices. Other members of the Council indicated that inflation was also driven – and would probably continue to be driven – by the persistence of inflationary processes. Moreover, they assessed that despite declining inflationary pressure some sectors of the economy continued to observe demand pressure as suggested i.a. by rising prices of market services.

The meeting also focused on HICP inflation developments in Poland. Some members of the Council pointed out that the difference between the 12-month moving average HICP inflation in Poland and the reference value for the price stability criterion increased in May 2009 to 1.0 percentage points. Yet, other members of the Council emphasized that inflation in Poland was higher than in Western European countries mainly due to considerable rises in regulated prices, which were beyond the direct impact of monetary policy. The difference in inflation levels might also be driven by the previously observed depreciation of the zloty exchange rate and a smaller scale of economic slowdown in Poland.

While discussing the outlook for inflation in Poland, attention was paid to the forecasted considerable decline in inflation in the projection horizon. Yet, some members of the Council pointed out that the situation in commodity and food futures markets pointed at the risk of a continuing upward trend in commodity and food prices, which might be conducive to rising inflation in Poland. Moreover, the decline in inflation might be curbed in the longer term by structural changes in the Polish economy boosting demand for market services. Those members also pointed out that in line with the projection in the years 2010-2011 CPI inflation should run below inflation net of food and energy prices which had not been observed since 2003.

Other members of the Council emphasized, however, that the June projection of the NBP pointed at the considerable widening of the negative output gap leading to a strong decline in inflationary pressure over the monetary policy transmission horizon. Moreover, some members of the Council assessed that in the medium term inflation might run below the central path of the projection due to the risk of economic growth abroad being lower than assumed in the projection. They also pointed out that due to the relatively slow adjustment of employment in the first stage of the economic slowdown, employment growth, and consequently also the growth of unit labour costs, might in the longer term be lower than accounted for in the projection. Those members also assessed that amidst low demand the impact of rising unit labour costs on inflation might be relatively weak. Moreover, in the opinion of those members of the Council, the zloty exchange rate is currently significantly weaker than the medium-term equilibrium rate which suggests that it might be stronger than accounted for in the projection.

While analyzing the developments in the exchange rate of the zloty, its relative stabilisation in the past few months was emphasized. On the other hand, it was pointed out that in May and June 2009 the zloty exchange rate had depreciated. It was stressed that at present zloty exchange rate fluctuations were impacted mainly by regional factors, in particular the unfavourable macroeconomic situation in some countries of Central and Eastern Europe. At the same time, attention was paid to the uncertainty about the impact on the zloty exchange rate of the worsening fiscal situation and the changing outlook for economic growth in Poland. On the other hand, some members of the Council assessed that the risk of zloty depreciation had considerably decreased as a result of improved sentiment in the global financial markets and was further mitigated by the relatively strong fundamentals of the Polish economy.

While discussing the impact of zloty exchange rate fluctuations on the economy, it was pointed out that the previously observed zloty exchange rate depreciation contributed to inflation persisting at an increased level. Some members of the Council assessed, however, that amidst low demand the impact of zloty depreciation on inflation would gradually decline. Those members emphasized that the current level of the zloty exchange rate increased the competitiveness of Polish products in foreign markets and in the domestic market, which is reflected in the improved current account balance and curbs the decline in domestic production.

While discussing the level of interest rates in Poland and abroad, it was pointed out that in the current situation the interest rate disparity between Poland and the euro area had a limited impact on zloty exchange rate developments. Yet, some members of the Council indicated that in the case of further decline in risk aversion in the international financial markets the currently observed disparity might boost the inflow of short-term capital to Poland. Other members of the Council pointed out, however, that this risk was mitigated by a still high level of risk premium prevalent in emerging economies. In the opinion of those members of the Council, the currently observed disparity was consistent with the higher natural interest rate and more favourable economic situation in Poland than in the euro area. Moreover, those members of the Council pointed out that ex post real interest rates (deflated with current headline inflation) in Poland were lower than in the euro area.

While analyzing the situation in the credit market, further strong decline in the growth of lending to the private sector was indicated. Some members of the Council pointed at the growing credit risk both with regard to corporate loans and household loans. Those members indicated that a considerable increase in lending might take place only after banks' concerns about the quality of their credit portfolios have abated. Moreover, they pointed out that limited lending was also driven by banks' high liquidity preference connected with their focusing on the improvement of their balance sheet structure through increasing the share of liquid assets. Other members of the Council emphasized that the strengthening of banks' capital base might support the increase in lending activity. In this context they assessed that the possible dividend payment by PKO BP would likely lead to a reduction in the supply of loans by this bank. Moreover, those members pointed out that if other banks also decided to pay out dividends, the financial stability risk might increase.

While considering the decision on interest rates, some members of the Council argued that the considerable decline in inflation over the monetary policy transmission horizon anticipated in the June projection, further economic slowdown in Poland, the risk of long-lasting low economic activity abroad and the relatively tight fiscal policy stance, justified lowering the NBP interest rates at the current meeting. Other Council members argued, however, that the low level of real interest rates, current inflation remaining at a heightened level and the uncertainty about the outlook for inflation in Poland amidst growing commodity prices in the world markets and the still high volatility of the zloty exchange rate as well as risks connected with the future fiscal policy justified keeping the interest rates unchanged at the current meeting.

A motion to lower the NBP interest rates by 25 basis points was put forward and passed. The Council decided to lower the NBP interest rates to the level: the reference rate to 3.50%, the lombard rate to 5.00%, the deposit rate to 2.00% and the rediscount rate to 3.75%.

Minutes of the Monetary Policy Council decision-making meeting held on 29 July 2009

During the meeting the Monetary Policy Council discussed the outlook for inflation in the context of the past, current and, primarily, anticipated economic situation.

The discussion at the meeting focused on the outlook for economic growth abroad and in Poland, medium-term inflation outlook, fiscal policy and credit market conditions.

The Council devoted a lot of attention to the outlook for global economic growth, while at the same time pointing out the considerable uncertainty surrounding the activity in the world economy both in the near future and in the longer term. It was emphasised that in the light of some data, including in particular those on the United States and China, recessionary tendencies in the world economy might have been halted in 2009 Q2, which is to a large extent connected with the fiscal and monetary stimulus programmes being implemented in many countries. Some Council members assessed that those programmes may be conducive to a recovery of global economic growth in 2010. They argued that accelerated economic growth in China may have an effect of reviving the activity in other Asian economies and – through increasing trade, which would also include raising those countries' demand for imported investment goods – lead to an economic recovery in the euro area and the United States. Other members of the Council, however, believed that the incoming information was rather ambiguous and that on the basis of data signalling a strong increase in savings accompanied with a drop in household consumption in the United States and also a further deterioration in the euro-area labour market in 2009 Q2, it was difficult to expect any marked rise in global economic activity in the near term. Moreover, they argued that with the end of the stimulus programmes implemented in the United States and many other countries the activity in these economies may slacken again, which may be connected with government expenditures being trimmed to curb budget deficits and limited spending of indebted households.

While addressing the long-term outlook for the world economic growth, some Council members argued that the global financial crisis may negatively affect the potential GDP growth in many countries. This may be driven by the steep decrease in world trade and international capital flows, in particular foreign direct investment, the breakdown of a part of the financial sector and the ensuing reduced access of economic agents to credit and also by the relatively persistent rise in unemployment. In the opinion of those Council members, the high level of uncertainty as to the impact of the financial crisis on economies in the longer term significantly hinders the assessment of the future economic growth and inflationary pressure in the world and in Poland, especially with the use of econometric models which are based on historical data.

While addressing the situation in the domestic economy, it was pointed out that some positive signals regarding the economic activity appeared recently. It was assessed that the deceleration of recessionary tendencies in Poland may be indicated by the slower decline of industrial output, an improvement in some business confidence indicators and the fact that part of the data for June proved better than expected. Some Council members assessed that the GDP growth in 2009 Q2 may have been positive and slightly higher than expected in the June projection, which raised the probability of above-zero GDP growth in the whole of 2009.

Other Council members, however, emphasised that in the light of the June NBP projection the GDP growth would be lower than the potential output growth in the monetary policy transmission horizon. Those members assessed that in the time to come recession abroad would continue to negatively affect the activity in the Polish economy, in particular through the low demand for Polish export products and a drop in foreign direct investment conducive to lowering labour productivity. They emphasised that the rise in unemployment, declining growth of real wages and the drop in the value of households' assets observed till 2009 Q1 would be contributing to further reduction in consumption demand in the coming quarters. They also argued that the prospects for investment growth in the enterprise sector remained negative, among others, due to the pessimistic – despite some improvement – sentiment of entrepreneurs, hindered access to credit and possible further tightening of banks' credit policies and also deteriorating corporate profits. In the assessment of some Council members, economic growth in Poland may run below the central path of the June projection of the NBP, among others, due to the possibly lower economic activity abroad than accounted for in the projection, weaker than projected investment growth connected with the negative business sentiment and a stronger increase in unemployment along with the ensuing drop in households' disposable income. Those members also argued that the recently observed appreciation of the zloty would be conducive to reducing net exports and, consequently, to lowering GDP growth.

At the meeting the Council also discussed the fiscal policy and its impact on the outlook for economic growth in Poland. It was pointed out that in the light of the draft amendment of the Budget Act for the Year 2009 passed by the lower chamber of the Parliament the drop in tax revenue in 2009 would be significantly deeper than the scale of the assumed increase in the central budget deficit. In the opinion of some members of the Council, with a persisting structural deficit of the general government, part of lost tax revenue would be compensated by ad hoc measures aimed at increasing non-tax revenue or cutting or postponing budget expenditure. In the assessment of those Council members, such measures would be conducive to a one-off reduction of the central budget deficit in 2009, but at the same time to its increase in the following years. This creates the risk for the public debt to breach the so-called prudential thresholds provided for in the Public Finance Act and also the limit set forth in the Constitution, which would necessitate a strong fiscal tightening and would have a procyclical effect of undercutting domestic demand and slowing GDP growth. Moreover, in the assessment of those Council members, the shifting of some central budget expenditures to other general government units, which was assumed in the discussed bill, led to reducing the transparency of the public finance and increasing the uncertainty as to the actual scale of fiscal imbalance in Poland. In this context it was emphasised that there was a need of implementing structural reforms, including the public finance reform, in Poland in the longer run, which would favour a permanent increase in economic growth.

While discussing current inflation it was pointed out that the CPI inflation in June declined to the upper limit for deviations from the inflation target of the NBP (i.e. to 3.5%), which was primarily the effect of a stronger than a year before seasonal drop in the food price growth and slower growth of prices of energy carriers resulting mostly from the base effect. Some members of the Council emphasised that June also saw a reduction in core inflation net of food and energy prices, which in 2009 Q2 as a whole proved slightly lower than forecast in the June inflation projection. Other Council members stressed that in the past few quarters core inflation remained at an elevated level and did not fall significantly despite a strong deceleration of economic growth, which pointed at the persistence of inflationary processes. In particular, the prices of some market services have been rising over the recent months, which in the opinion of those Council members might indicate a persisting demand pressure in some sectors of the economy. Moreover, those Council members pointed out that – despite a decline in June – the CPI inflation in the whole of 2009 Q2 proved markedly higher than in the June projection. In this context it was pointed out that the ex post real interest rates (deflated with current inflation) in Poland were close to zero.

While analysing the medium-term inflation outlook, some Council members assessed that – in line with the June projection – inflation in the monetary policy transmission horizon would fall below the inflation target, which would be driven with the negative output gap and easing wage pressure. At the same time, some Council members assessed that inflation in the medium term could be lower than envisaged by the central projection path due to lower growth of unit labour costs, which could result from a deeper drop in wage growth than that accounted for in the projection. Moreover, in the conditions of low demand the impact of ULC growth on inflation may be limited. Another factor mentioned as potentially conducive to lower inflation in the time to come was the significant appreciation of zloty exchange rate observed over the past few months.

Other Council members assessed that inflation in the coming quarters may be running above the central projection path, among others, due to the risk of higher commodity and food prices than in the projection and the continuing high demand for some services resulting from the structural changes ongoing in the Polish economy and increasing the prices of those services. Those members also pointed out that in line with the June projection, in 2010-2011 CPI inflation should be running below core inflation net of food and energy prices, which has not been observed since 2003. They also argued that, due to the difficult revenue situation of the general government sector, the coming period may bring further increases of administered prices, which would postpone the decline in inflation. On the other hand, however, they emphasised that an elevated inflation level in the time to come would mainly follow from the previously implemented and possible further increases of administered prices and only to a small extent from the continuing demand pressure.

The Council discussed the credit market situation and interest rate developments in Poland. It was pointed out that, despite the NBP interest rate cuts, in June 2009 the interest charged on some newly granted loans increased, which in combination with the concurrent decline in the interest paid on some new deposits pointed to increased interest margins of banks. In the opinion of some Council members, the imperfect pass-through of the reference rate to the interest rate charged on new loans was an argument against further cuts of NBP rates. Other Council members argued that the so far effected NBP interest rate cuts had, in the longer perspective, contributed to lowering the interest on loans and that the reduction in lending along with increased interest margins were related to the growing credit risk, particularly in the case of loans granted to corporates. The Council also analysed the impact of the NBP's interest rates on long-term interest rates.

While considering the decision on interest rates, the Council assessed that the uncertainty about the outlook for inflation and economic growth in the world and in Poland justified keeping the rates unchanged at the current meeting. Some members of the Council believed that in view of the low level of real interest rates, the continuously elevated current inflation level and balanced – in their assessment – probabilities of inflation running above or below the inflation target in the medium term, the NBP interest rates should be kept unchanged also in the months to come. Other Council members assessed that inflation would drop below the NBP inflation target in the medium term, which combined with the risk of a stronger than expected decline in economic growth may justify the continuation of monetary policy easing in the future. The prevailing view at the meeting was that the probability of inflation running below the inflation target in the medium term was higher than the probability of inflation running above the target.

The Council kept the interest rates unchanged: the reference rate at 3.50%, the lombard rate at 5.00%, the deposit rate at 2.00% and the rediscount rate at 3.75%.

Minutes of the Monetary Policy Council decision-making meeting held on 26 August 2009

During the meeting the Monetary Policy Council discussed the outlook for inflation in the context of the past, current and, primarily, anticipated economic situation.

The discussion at the meeting focused on the outlook for economic growth abroad and in Poland, medium-term inflation outlook, zloty exchange rate developments and credit market conditions.

While discussing the external environment of the Polish economy it was pointed out that the data on the United States and the euro area, including the GDP data for 2009 Q2, indicate easing of recessionary tendencies in those economies. In particular, it was emphasised that GDP in quarterly terms grew in Germany and France, i.e. in countries being the most important markets for Polish exports. It was pointed out that GDP growth might have been driven by growing demand for exports of those countries reported by the Chinese economy, which was connected with the fiscal stimulus programme supporting public sector investment in China. It was indicated that since the July meeting of the Council, the majority of economic sentiment indicators had further improved and GDP growth forecasts for 2010 in the United States and in the euro area had been slightly revised upwards.

At the same time, it was emphasised that the global economic activity had continued at a low level and at present it was difficult to assess whether the easing of recessionary tendencies would prove permanent and what would be the scale of a possible recovery. Considerable uncertainty about the outlook for the global economy is primarily connected with the next year's finalising of stimulus programmes which are now significantly contributing to mitigating recessions in major economies. The unfavourable situation in the labour market, strong rise in savings and decline in consumption in the United States together with further deterioration in euro-area labour market all indicate that the stimulus programmes may have only a limited bearing on reviving private demand. Another important factor affecting global economic growth will be GDP growth in China. The assessment of the growth outlook is additionally hindered by persisting problems in the banking sector.

Some members of the Council argued that the above mentioned factors, after a temporary recovery driven by direct effect of stimulus programmes, might bring about another decline in the global economic growth. In particular, those members argued that the expected recovery in the euro area might not prove long-lived. In this context, they pointed out that despite certain improvement in the financial markets conditions the majority of commercial banks operating in the euro area continued to tighten their lending policies. Other Council members assessed that despite considerable uncertainty persisting, the incoming information indicated an improvement in the outlook for the global economic growth, which might suggest that the global recession would be less severe than anticipated. Those members also pointed out that the growing role of Asian countries in the global economy might contribute to the recovery in the euro area despite weak domestic demand in this economy.

While analysing the inflationary processes abroad, it was pointed out that despite growing commodity prices the decline in overall price level in the United States and in the euro area had further deepened, amidst further decrease in positive core inflation indicators. Some members of the Council argued that these trends indicated that possible global inflationary threats would be probably of a longer-term nature and in the coming quarters major central banks should not be expected to start tightening their monetary policy. In the opinion of those Council members, the persisting pressure on price decline in the global economy would be, through import prices, curbing inflation in Poland. Other members of the Council pointed out that due to an unprecedented scale of stimulation measures introduced in the largest economies, the credibility of the so-called exit strategy from the expansionary macroeconomic policy would be of key importance for permanent anchoring of inflationary expectations and, as a result, for stabilising inflation at a low level.

While addressing the situation in Poland, the members of the Council pointed out that the data on the domestic economic climate were ambiguous. On the one hand, further decline in Polish exports and persisting negative annual growth in industrial output (including the output of intermediate and investment goods), deepening fall in employment in the corporate sector, growing unemployment rate and further decline in bank lending all pointed to the continuation of low activity in the Polish economy. On the other hand, the majority of economic sentiment indicators rose, which may indicate an improvement in the economic situation in the months to come.

While discussing the outlook for economic growth, it was stressed that it largely depended on economic situation abroad and the related external demand for Polish products. It was pointed out that factors supporting economic growth in Poland included the continuing, albeit lower than in the previous quarters, consumption growth and a positive contribution of net exports, connected with both the improvement in the price competitiveness of the Polish products in relation to imports driven by the depreciation of the zloty in the second half of 2008 and at the beginning of 2009, and also by the effect of stimulus packages introduced in the major world economies. In this context it was argued that uncertainty related to GDP growth in Poland included how permanent would be the easing of recessionary tendencies in Poland's main trading partners and exchange rate developments. Some Council members pointed out that the zloty appreciation observed over the recent months, through lowering the price competitiveness of Polish products, may be conducive to reducing the contribution of net exports to GDP growth and to extending the slowdown in the Polish economy. Those Council members argued that the same effect may be brought by the deterioration of labour market situation, including the lowering of the real aggregate wages, which may translate into curbing consumer demand. It was pointed out that another factor that had a negative impact on GDP growth was the reduction in the supply of bank loans.

At the meeting, the Council also discussed current and expected inflation developments. It was indicated that the inflation rise in July 2009 to 3.6%, i.e. above the NBP's inflation target of 2.5% and slightly above the upper limit for deviations from the target set at 3.5%, was primarily driven by a strong surge in prices of tobacco resulting from changes in the excise tax and by a further increase in fuel prices. Some Council members argued that despite the fact that inflation could remain at a heightened level in the coming period – mainly due to the relatively high annual growth of food and regulated prices – the available forecasts point to its decline in the second half of 2010, which should be supported by the negative output gap connected with the still weak external and domestic demand, continuing low wage pressure and the previous appreciation of the zloty.

Other Council members emphasised that CPI inflation in Poland is characterised by a relatively high persistence and subsequent projections were extending the horizon of inflation returning to the target, which does not support the anchoring of inflation expectations. Those members also pointed out that in line with the June projection, in 2010-2011 CPI inflation should be running below core inflation net of food and energy prices, which has not been observed since 2003. Moreover, some members of the Council argued that the slowing potential output growth combined with the improving outlook for economic growth may cause the negative output gap to close earlier than anticipated. It was also emphasised that currently both inflation and GDP growth in Poland were significantly higher than in most countries of the European Union.

The Council paid a lot of attention to the exchange rate developments, emphasising the zloty appreciation in the recent period. Some Council members indicated that the improved sentiment in the world financial markets, relatively favourable economic situation in Poland as compared to other EU countries and the access to a flexible credit line of the International Monetary Fund lowered the risk of strong zloty depreciation. At the same time, the persistently heightened volatility of the zloty exchange rate was emphasised.

Some members of the Council indicated that one factor affecting the zloty exchange rate could be the disparity of nominal interest rates between Poland and the euro area and the United States favouring – especially amidst stabilising financial market situation – the inflow of capital, which was reflected in the growing share of foreign investors in the market of Polish Treasury securities. Other Council members, however, assessed that the perspectives of capital inflow to the Central and Eastern European countries were to a greater extent influenced by the sentiment of foreign investors towards the region and by the disparity in real terms, which was significantly lower than that calculated in nominal terms.

While addressing the situation in the banking sector, on the one hand – the further reduction of lending to the corporate sector was emphasised, and on the other – the still stable increases in consumer loans to households. In this context, some Council members pointed out that banks were increasing their profit margins, which meant that lowering of the costs of newly granted loans was smaller than the scale of the implemented cuts in the NBP interest rates. In the opinion of those Council members, the monetary policy should account for shifts in profit margins resulting from the business cycle. Other members of the Council argued that in the current situation the effectiveness of the credit channel was limited, which meant that possible further interest rate cuts would have only minor effect for the supply of credit.

While analysing the situation in the banking sector, the Council also discussed the situation of cooperative banks. It was emphasised that those banks have a large local significance, among others, due to the preferential loans they offer for investments and development projects in agriculture as well as their contribution to financing local governments. It was pointed out that cooperative banks were characterised with a surplus of deposits over extended loans and a lower share of irregular loans in their credit portfolios than commercial banks, which gave cooperative banks considerable potential for lending expansion. However, in the opinion of some Council members, an increase in lending by cooperative banks called for the adoption of measures aimed at raising regulatory capital of this sector.

While discussing interest rates, some members of the Council pointed out that the real ex ante rates, i.e. rates deflated with expected inflation, remained positive, which combined with the output gap remaining negative, could justify further NBP rate cuts. Other members of the Council, however, argued that amidst large uncertainty accompanying inflation forecasts and, at the same time, its high persistence, economic agents in their decision making would to a larger extent consider the real ex post interest rates, i.e. rates deflated with current inflation, which were currently close to zero and could be expected to run at a very low level also in the months to come.

While considering the decision on interest rates, the Council assessed that the uncertainty about the outlook for inflation and economic growth in the world and in Poland justified keeping the rates unchanged at the current meeting. Some Council members believed that the risk of economic growth continuing at a low level in the longer run combined with the forecasted significant inflation decline in 2010 might justify further easing of the monetary policy in the future. Moreover, it was argued that the anticipated increase in the deficit of the public finance sector would be primarily the effect of automatic stabilisers rather than anticyclical measures introduced in the fiscal policy, which – in the opinion of those Council members – did not restrict the possibility of further monetary policy easing. Other members of the Council pointed out that the incoming data suggested that the recession in the world economy and the slowdown of growth in Poland might prove milder than previously expected. Those members argued that signs of economic recovery justified the assessment that the probabilities of inflation running above or below the inflation target in the medium term were roughly equal, while the NBP's interest rates should be kept unchanged also in the coming months.

At the meeting, the prevailing view was that the probability of inflation running below the inflation target in the medium term was higher than the probability of inflation running above the target.

The Council kept the interest rates unchanged: the reference rate at 3.50%, the lombard rate at 5.00%, the deposit rate at 2.00% and the rediscount rate at 3.75%.

Minutes of the Monetary Policy Council decision-making meeting held on 30 September 2009

During the meeting the Monetary Policy Council discussed the outlook for inflation in the context of the past, current and, primarily, anticipated economic situation.

The discussion at the meeting focused on the outlook for economic growth abroad and in Poland, the medium-term inflation outlook, fiscal policy and the situation in the banking sector.

The Council paid considerable attention to the external conditions affecting the Polish economy. It was emphasised that the data on the United States, including the growth in industrial output and retail sales, improved situation in the real estate market and a further rise in economic sentiment indicators signal recovery in the US economy. While addressing the situation in the euro area, it was pointed out that despite some improvement in economic sentiment indicators, data on the real economy indicated that recovery in the euro area would likely materialise with a certain time lag with respect to the US economy.

Some members of the Council argued that rising unemployment in the United States and in the euro area remained a risk factor to the sustainability of the recovery in the world economy. In this context, attention was drawn to the unfavourable outlook for recovery in private consumption amid deteriorating situation in the labour market in those economies and the expected fading out of fiscal stimulus packages at the end of 2010 as well as the possibility of central banks moving to the so-called exit strategy from expansionary monetary policy. Other members of the Council pointed out that additional factors having a negative bearing on the outlook for consumption in the United States included rising household savings and the private sector's limited access to mortgage loans due to the considerable decline in real estate prices in the US that triggered the crisis in the banking sector. In turn, while discussing the situation in the euro area, those members emphasised that rising imports of investment goods to China might have largely contributed to the easing of recessionary tendencies in the euro area in 2009 Q2. In the opinion of those Council members, a possible weakening of external demand following the fading out of the stimulus package in the Chinese economy was a source of risk to the sustainability of the recovery in the euro area.

While addressing the outlook for global economic growth, some members of the Council pointed out that although private consumption in the United States and in the euro area might prove weak, the rise in demand in major emerging economies, undergoing the process of real convergence and recording significantly higher GDP growth than developed countries, would translate into a sustainable recovery in the external environment of the Polish economy. Those Council members also argued that the recovery in economic activity both in the United States and the euro area would be accompanied by a gradual rise in labour productivity which might be expected in view of the fact that the crisis affecting both economies had stemmed from problems in the financial sector rather than from real economy developments. In the opinion of those Council members, GDP growth of the major economies was likely to return to their potential growth level relatively fast.

While discussing the outlook for inflation in the world economy, some members of the Council emphasised that the difficult situation in the labour market affecting major developed economies and a relatively low demand pressure, combined with the weakening of the upward trend in oil prices in August 2009, would be curbing inflation in the coming quarters.

While discussing the situation in the Polish economy, it was pointed out that data on GDP in 2009 Q2 proved slightly better than expected. At the same time it was emphasised that GDP growth mainly resulted from the positive contribution of net exports due to a smaller decline of exports than imports, amid a fall in domestic demand following from further consumption deceleration and lower investment and inventories. While addressing the data for August 2009, it was stressed, on the one hand, that the growth of industrial output and retail sales had fallen short of expectations and, on the other hand, that economic sentiment indicators had further improved.

Some Council members pointed out that the growth of exports was still negative, while the expected slight recovery in euro-area activity would probably fail to immediately translate into a significant rise in the external demand for Polish products. It was argued that a possible further appreciation of zloty exchange rate, through worsening the price competitiveness of domestic goods, might be conducive to weakening the positive contribution of net exports to GDP growth in the coming quarters. Those Council members also pointed to the persistent unfavourable situation in the labour market as a factor contributing to lower consumption and, consequently, weaker economic activity. In the opinion of those members, considering the still unfavourable outlook for private investment growth and the risk of public investment cuts in the face of public finance sector deterioration, there persisted considerable uncertainty as to the perspectives of economic growth in the Polish economy.

Other Council members, however, argued that the expected recovery in the world economy would be a factor supporting domestic GDP growth. Moreover, in the opinion of those members, the scale of labour market deterioration would not be as strong as previously anticipated, in particular due to the fact that the employment decline should be curbed by lower real wages. They assessed – as a result – that the impact of the unfavourable labour market situation on consumption would be rather limited.

While analysing inflation developments, it was pointed out that the slight inflation increase in August 2009 was primarily due to a weaker seasonal drop in food prices amid an unchanged level of core inflation net of food and energy prices. Some Council members argued that in line with the majority of available forecasts, in the next few months inflation may temporarily remain at a heightened level, yet in 2010 inflation could be expected to fall even below the inflation target. A significant drop in inflation in 2010 would be driven – in the opinion of those members – by the delayed effects of labour market deterioration resulting both in reduced consumption demand of households and slower growth of costs in enterprises. The same Council members indicated that the inflation decrease would also be supported by the recent exchange rate appreciation and the stabilisation of commodity prices in the world markets.

Other Council members emphasised that a gradual recovery of economic growth should translate into higher demand, while the negative output gap might close up earlier than anticipated. Moreover, the heightened level of inflation, including the continuing growth in the prices of services, did not confirm – in the opinion of those Council members – a significant easing of demand pressure, which could be expected considering the strong weakening of GDP growth. While addressing forecasts, those members argued that inflation in 2009 Q2 and Q3 proved markedly higher than expected in the June projection. In the opinion of those members of the Council it could also be expected that the forecast inflation decrease below the target in 2010 may prove short-lived. Those members argued that in line with the current short-term forecasts the expected inflation decrease in 2010 to a large extent was to result from a strong deceleration of food price growth, which is rather unlikely considering the average price growth in this group of goods over the past few years. Moreover, while discussing the outlook for inflation, the Council pointed to the risk of an increase of regulated prices and indirect taxes in 2010 which, on the one hand, directly translate into a rise of the general price level and, on the other hand, bring about a reduction in the purchasing power of households and an easing of the demand pressure curbing inflation.

During the discussion on the public finance sector, some Council members pointed out that the rise of the deficit and public debt in relation to GDP resulted, to a large extent, from a strong slowdown in economic growth. It was argued that other EU countries also experienced a significant increase in public finance imbalances whose scale was even greater than in Poland. Other Council members, however, emphasised that of importance to foreign investors would be the comparison of the ratios of the deficit and public debt to GDP in countries of Central and Eastern Europe, including Poland, to the respective ratios in emerging countries characterised by lower fiscal imbalances. In this context it was argued that the deteriorating fiscal stance could be contributing to a weakening of the zloty exchange rate.

While addressing the planned increase of the public finance imbalance in 2010, some discussants pointed out that a strong rise in the deficit of the public finance sector could justify monetary policy tightening. At the same time, those members pointed out that even though a rise in public spending amid low economic activity supports GDP growth, the dominant effect triggered by a recovery could be the so-called crowding out effect where private sector demand is crowded out by public expenditure. Other Council members argued that the anticipated increase in the deficit of the public finance sector would primarily be the effect of automatic stabilisers rather than anticyclical measures introduced in the fiscal policy, which did not restrict the possibility of maintaining an accommodative monetary policy.

At the meeting, the Council also discussed issues related to the banking sector. Some Council members argued that the tightening of banks' credit policy towards the corporate sector was very strong, which could lead to a considerable reduction of economic growth. In this context the Council had a discussion on improving the access to bank loans for the corporate sector by introducing new monetary policy instruments by the central bank, similarly as it is done by the world's major central banks. In the opinion of some Council members, introducing new instruments, i.e. bill discount credit and the central bank's purchase of bonds issued by commercial banks, would allow banks to increase their lending. Those members argued that the launching of new instruments could make it easier for enterprises to obtain both short-term loans, which would limit the risk of enterprises experiencing liquidity shortage, and long-term loans, which would limit the scale of investment reductions. In the opinion of those Council members, the way of implementation and the character of new instruments reduced the risk of excessive interference of the central bank in banks' credit risk management system.

Other members of the Council, however, emphasised that the reduction in bank lending was a typical phenomenon accompanying economic slowdown and resulted not only from the rationing of credit supply and the increased cost of credit but also from diminished demand for credit on the part of enterprises. During the discussion it was also pointed out that the scale of lending reduction in Poland was smaller than in other countries of Central and Eastern Europe. While addressing the measures implemented by other central banks, those Council members argued that Poland was in a better economic situation as compared to countries, which were introducing unconventional monetary policy measures. At the same time, those members emphasised that introducing the proposed instruments could in fact contribute to widening the financing gap of banks (i.e. the difference between the collected deposits and granted loans). Those members also argued that easier access to central bank funds might demotivate banks to properly assess their credit risk. Moreover, in the opinion of those Council members, the central bank should not increase the capital base of banks by issuing money, and investments in the economy should be financed primarily from savings. In the opinion of those Council members, introducing new instruments would pose the risk of excessive money creation in the economy.

While considering the decision on the interest rates, the Council assessed that the information on economic developments released since the last MPC meeting justified keeping the rates unchanged at the current meeting. Some members of the Council believed that available data – including higher than expected GDP growth in 2009 Q2 and inflation remaining above the target and above the June projection – as well as further improvement in the outlook for economic activity justified the assessment that the probabilities of inflation running above and below the inflation target in the medium term were roughly equal. Other Council members argued, however, that the uncertainty about the scale and durability of economic recovery abroad and in Poland was still high and a more comprehensive assessment of the macroeconomic situation would be possible once the Council got acquainted with the October projection of inflation and GDP. At the meeting, the prevailing view was that the probability of inflation running below the inflation target in the medium term was higher than the probability of inflation running above the target. At the same time, the majority of the Council members assessed that the probability of inflation running below the inflation target in the medium term had decreased in recent months.

The Council kept the interest rates unchanged: the reference rate at 3.50%, the lombard rate at 5.00%, the deposit rate at 2.00% and the rediscount rate at 3.75%.

Information from the meeting of the MPC held on 27-28 October 2009

The latest data point to a further economic activity improvement in the United States and the euro area, even though activity remains subdued. Once again, GDP growth forecasts for 2010 have been slightly revised upwards in both economies. It is still difficult to assess the scale and sustainability of the expected recovery, especially given the persistent problems in the financial sector and the prospect of gradual restraint of stimulus packages.

In major economies the decline in the general price level continued driven by the global economic slowdown and an earlier drop in food and other commodity prices. In turn, crude oil prices in the world markets picked up again.

Data for 2009 Q3 on the Polish economy, including the data on industrial output, construction and assembly production and retail sales, as well as the majority of economic climate indicators signal further improvement in economic activity in that quarter. Unfavourable situation is continuing in the labour market: employment in the enterprise sector is falling, while the unemployment rate is rising. However, this was accompanied by a slightly higher than expected wage growth in enterprises. An adverse effect on economic growth is exerted by the tightening of banks' lending standards, in particular in relation to the enterprise sector.

In September 2009 the annual CPI inflation decreased to 3.4%, i.e. slightly below the upper limit for deviations from the target set at the level of 3.5%, though it remained above the NBP's inflation target of 2.5%. The decline in inflation was mainly driven by a drop in the annual growth of food prices. The annual inflation rate remaining at an elevated level results, to a large extent, from the earlier administered price increases and the depreciation of zloty exchange rate. Persistently high core inflation means that the demand weakening so far has not fully offset the increase of administered prices and the earlier exchange rate depreciation.

The Council got acquainted with the projection of inflation and GDP prepared by the Economic Institute of the NBP. The projection is one of the inputs into the Council's decision-making on the NBP interest rates. In line with the October projection – under assumption of constant interest rates – there is a 50-percent probability that inflation will remain within the range of 3.3–3.5% in 2009 (against 2.8–3.5% in the June projection), 0.8–2.2% in 2010 (against 1.1–3.2%) and 1.1–3.2% in 2011 (against 0.8–3.4%). According to the October projection, there is a 50% probability that the annual GDP growth will be within the range of 1.1–1.5% in 2009 (against -0.4–1.1% in the June projection), 0.8–2.8% in 2010 (against 0.2–2.5%) and 2.2–4.2% in 2011 (against 2.4–4.5%).

In the Council's assessment, inflation is likely to remain at an elevated level in the coming months, mainly due to the relatively high annual growth rate of administered prices, including especially energy prices, and food prices. Heightened inflation may also be supported by increase in oil prices, partially neutralised by hitherto zloty appreciation, and possible further growth of administered prices. However, in the medium term low demand pressure and slower growth of labour costs, amid persistent uncertainty regarding the growth outlook, should be leading to inflation decrease.

Having taken the above into account, the Council assesses the probabilities of inflation in the medium term running below or above the inflation target to be balanced. In the Council's view, the expected improvement in the global economic activity and the implemented cuts in the NBP interest rates together with the lowering of the required reserve rate will support the return of the economy to the potential growth path. The Council's decisions in the coming months will take account of the incoming information on the outlook for economic growth and inflation, the situation in the financial markets in Poland and abroad, information on the public finance sector and zloty exchange rate developments.

The Council will continue to analyse the impact of developments in the domestic interbank market on the monetary policy transmission mechanism in Poland.

The Council maintains its view that Poland should join the Exchange Rate Mechanism II and the euro area at the earliest possible date, after achieving the necessary political support for amendments to the Constitution of the Republic of Poland and other legal acts required for euro adoption in Poland.

The Council adopted the *Inflation Report – October 2009, Balance of Payments of the Republic of Poland for 2009 Q2* and *Opinion of the Monetary Policy Council on the Draft Budget Act for 2010.*

Chapter 4

Projection of inflation and GDP

The inflation and GDP projection has been prepared at the Economic Institute of the National Bank of Poland. Mr. Zbigniew Hockuba, a member of the NBP's Management Board, was responsible for content-related supervision and The Bureau of Macroeconomic Forecasts of the Economic Institute coordinated works on projection. The projection was prepared based on the NECMOD macroeconomic model[42]. In the course of the iterative process of projection, paths of variables which contradicted NBP experts' intuition were adjusted according to the experts' knowledge of economic processes. The Management Board of the NBP approved the projection to be submitted to the Monetary Policy Council. The projection was prepared under the assumption of constant NBP interest rates and serves as one of the inputs to the Monetary Policy Council's decision-making process.

International environment

The macroeconomic scenario presented in the projections assumes that the middle of 2009 marked a turning point in the contractionary tendencies in the world economy. The economic situation of Poland's trade partners will be steadily improving in the years to come. The global economy is supported in the process of recovery from the crisis by expansive fiscal and monetary policies in the United States and in European economies. The uncertainty about the durability and scale of the recovery in the real economy, combined with the lack of clear inflationary pressure in the short and medium term, will delay the cycle of interest rate increase in the euro area, the United Kingdom and the United States. The central banks of those economies will not give up their easy monetary policy until the beginning of 2010.

After the appreciation trend of the euro against the dollar revived in the first half of 2009, in the nearest quarters some weakening of these tendencies is expected alongside a relative stabilisation of EUR/USD exchange rate. In comparison to the situation observed over the past few years, there will also be a considerable reduction in the volatility of commodity prices. Despite recovering demand, the price fluctuations of agricultural goods will be insignificant until 2011, which in the medium-term horizon of the projection will be supported, among others, by this year's favourable cereal crops

[42] Current version of the model's documentation is available at the NBP web site.

(as compared to previous years' average). In turn, the prices of energy products will be gradually growing due to the resurge in global demand.

Aggregate demand

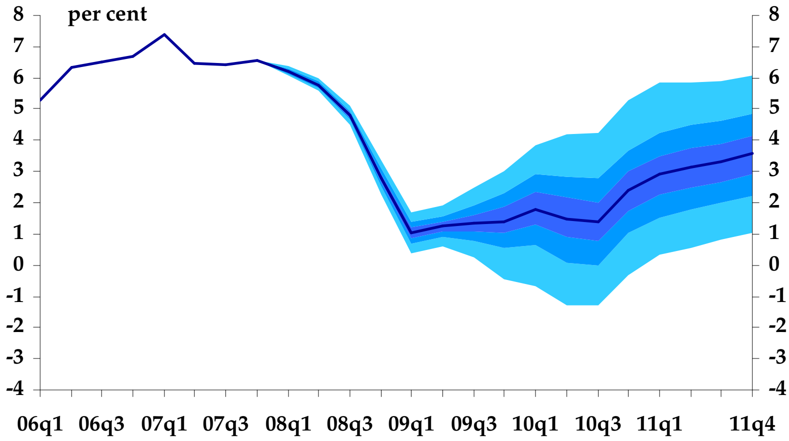
Following a significant decline in 2009, domestic demand will be steadily rebuilt over the coming years. In 2010 a significant contribution to the acceleration of domestic demand growth will be made by an increase of inventories, the level of which was strongly reduced by enterprises at the end of 2008 and in the first half of 2009. Domestic demand will also be stimulated by the financial inflow from EU structural funds and the resulting high growth of public investment. In 2011 the growth of domestic demand will be increasingly connected with improving consumer demand and growing investment activity of the private sector.

In the coming quarters, due to the still unfavourable market outlook and a limited availability of loans resulting from banks' restrictive credit granting policies, the investment demand of private enterprises will remain low. In the short-term projection horizon the credit risk increase caused by deteriorated economic situation will be a limiting force to the positive impact which the low reference rate of the central bank will exert on the cost of credit, and consequently, on stimulating investment activity. By contrast, in the longer-term projection horizon, resurge in the growth of gross fixed capital formation in enterprises will be supported by a gradual recovery of domestic demand and a climb (following a strong decline at the beginning of 2009) of trade volume to levels observed before the crisis, heightened confidence of foreign investors to the region as reflected in increased flow of direct investment as well as a high level of infrastructural investments which will be improving the conditions for enterprise operations in 2010. The gradual rebuilding of confidence in the interbank market plus declining credit risk are expected to act in the same direction. On the other hand, the growth in the prices of supplies, mainly from imports, will be a factor restraining investment demand.

In view of a deteriorating labour market situation – with some time lag in relation to the weakening aggregate demand growth – and a slowdown in the growth of disposable income, households will still be restraining consumer and investment demand. During the upcoming quarters, the negative impact of labour market deceleration on household spending will be reinforced by a cautious credit policy of banks. The considerable volatility of the exchange rate observed in the recent period, a significant uncertainty as to the future exchange rate path and the rise in profit margins on foreign currency loans will be diminishing the appeal of mortgage loans denominated in foreign currencies, which through their relatively low interest contributed to fuelling the housing boom over the recent years. Lower demand for housing combined with households' limited possibilities of financing investments, amid significant downward rigidity of flat prices, will mainly find reflection in a strong reduction of new housing investments after the completion of recently commenced investment projects.

Starting from the end of 2010 the easing of the wage growth deceleration and the containment of the unemployment rate growth, higher households' property income and steadily improving credit conditions, amid the central bank's favourable interest rate policy, will contribute to acceleration of private consumption and, in the longer perspective, also housing investment growth.

□ **Figure 4.1:** Central Projection and GDP growth fan chart.



Source: NBP.

The recovery of domestic demand growth and appreciation of zloty exchange rate in 2009 will contribute to a deteriorating trade balance in 2010 and 2011. The recovery in import demand in the European and US economies will have an opposite effect on the trade balance. As a consequence, starting from the beginning of 2010, net exports will no longer be a factor supporting the GDP growth as it was the case in 2009.

Macroeconomic equilibrium

The economic growth will remain below 2% y/y until 2010 Q3. In subsequent quarters GDP growth will rise slowly to reach the level of 3.6% y/y in the long-term projection horizon, which will be close to the growth of potential output (Figure 4.1). Until 2011 real GDP growth will be lower than potential output growth. As a result, the negative output gap will widen, pointing to a weakening of demand pressure in the economy.

A rapid increase in production capital connected with intensified infrastructural investment will constitute a factor supporting potential output growth, after the weakening of the effect of factors temporarily accelerating its growth in 2009 and previous years (such as tax reforms and effects of EU accession). On the other hand, growth will be negatively affected by a rise in the NAWRU rate and a restraint in the investment activity of private enterprises in 2009–2010.

The economic slowdown will bring about a reduction in the demand for labour. The drop in the number of employed will be limited due to deeper adjustments of real wages, taking into consideration the scale of the slowdown.

More flexible – in relation to the previous periods of growth deceleration in Poland – adjustments in the labour market and measures taken by the government to protect jobs (among others the implementation of a temporary production stoppages programme and further labour market liberalisation) will facilitate the absorption of increased labour supply connected with favourable developments in the demographic structure of the population (growing share of persons aged 25–44 characterised with a high economic activity ratio) and lowered migration net flows. In 2011, due to a recovery in the demand for labour, the scale of decline in the number of working persons will decrease, while the wage growth will accelerate. However, the growth of real wages will remain below labour productivity growth throughout the projection horizon, which will be conducive to closing the positive gap between wages and productivity.

Till the end of 2010 the actual unemployment rate growth will be faster than the rise of NAWRU, which may lead to closing the unemployment gap. In 2011, as a result of improved economic situation, the unemployment rate growth will be lowered and should not exceed the level of 12%. In turn, the rise of production costs, among others, connected with increase in imported intermediate goods, will translate into further moderate growth of NAWRU.

Since 2009 Q2, the real effective exchange rate of the zloty has been appreciating. These tendencies have been supported by gradual normalisation of the situation in the international financial markets, fast improvement in the current and capital account balance, including the balance on trade, and the disparity of real interest rates which was favourable for zloty appreciation. In the projection horizon, a steady appreciation of the equilibrium exchange rate will take place, despite some recovery in domestic demand which will contribute to raising the surplus of imports over exports. Among others this will result from a positive balance of transfers connected with EU fund inflow and a relatively high level of potential output in Poland.

The improvement of terms of trade in 2009, which is happening despite appreciation of the zloty exchange rate and amid favourable decreases of energy commodity prices in the world markets, will ease and subsequently be gradually reversed during the projection horizon. Foreign trade prices will increasingly translate into reduction in the ratio of the current and capital account balance to GDP. This ratio in 2010 will continue at negative levels and at the end of 2011 it will reach the value of approx. -2.5% of GDP.

Deteriorated current and capital account balance and the increased fiscal risk resulting from persistently high budget deficit and fast public debt growth will translate into a depreciation of the nominal exchange rate of the zloty starting from the beginning of 2010.

Cost pressure

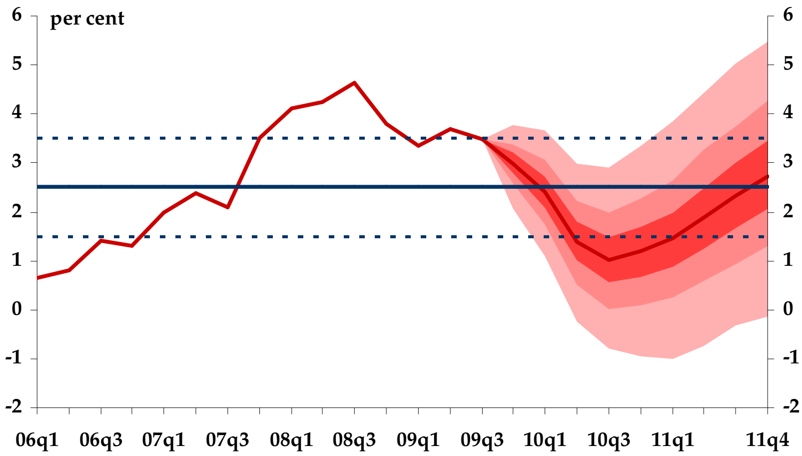
The decreasing wage growth and the reduction in the number of working persons happening in reaction to deteriorated economic situation, will make it easier for enterprises to cut their unit labour costs. Negative growth of the unit labour costs outside agriculture will persist from the beginning of 2010 up to 2011 Q2, when they will start to grow slowly following a recovery in domestic and external demand.

Amid the expected stabilisation in the growth of commodity prices and the exchange rate of US dollar against the euro in the projection horizon, the main factor affecting import prices will be the fluctuation of the zloty against the euro. The appreciation of the zloty in the short-term horizon of the projection and its reversal in 2010 will translate with some delay into the reduction and subsequent rise of import prices.

Inflation

The CPI inflation will be steadily decreasing till 2010 Q3, reaching the inflation target at the beginning of next year and then, after a period of running below the target, it will come back to the level of 2.5% in the middle of 2011. (Figure 4.2). The probability of inflation running below the inflation target of 2.5% will be steadily increasing to approx. 0.9 in the middle of the projection horizon and then it will decrease to approx. 0.5 in the last quarters of 2011. On the other hand, the probability of inflation remaining in the tolerance range for deviations from the target between the end of 2009 and 2011 will fall almost twofold before 2010 Q2 when it will stabilise around 0.4.

⊡ **Figure 4.2:** Central projection, inflation fan chart and NBP inflation target.



Source: NBP.

Table 4.1: Probability of forecasted inflation

	Probability of inflation				
	below 1.5%	below 2.5%	below 3.5%	below central projection	within (1.5%; 3.5%)
2009q4	0.00	0.16	0.85	0.48	0.84
2010q1	0.13	0.53	0.92	0.48	0.79
2010q2	0.54	0.87	0.98	0.49	0.45
2010q3	0.66	0.90	0.99	0.51	0.33
2010q4	0.59	0.85	0.96	0.49	0.37
2011q1	0.51	0.77	0.92	0.50	0.41
2011q2	0.41	0.66	0.84	0.51	0.43
2011q3	0.31	0.55	0.75	0.51	0.44
2011q4	0.24	0.45	0.66	0.51	0.42

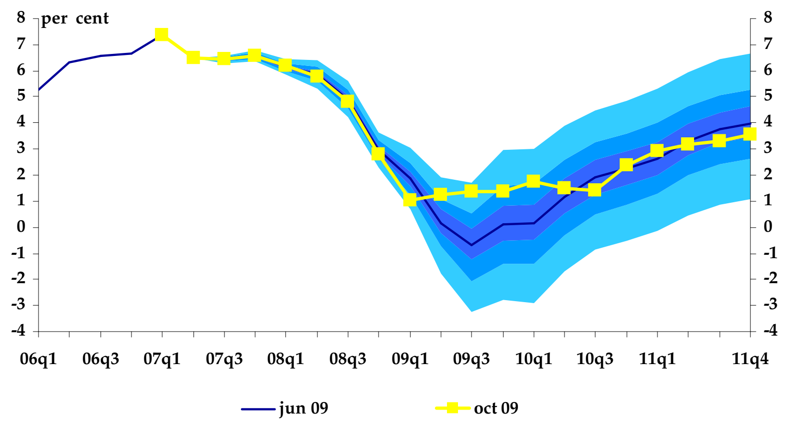
Source: NBP.

The growth of consumer prices in the coming year will be significantly affected by the lowering growth of food and energy prices, which will be fuelled by zloty exchange rate appreciation and a lack of clear rising trend in energy and agricultural commodity prices in the world markets. Core inflation will also be falling gradually along with easing of the cost pressure on the part of the labour market and amid persistently low growth of import prices. Exchange rate depreciation and higher growth of import prices in 2010, amid the limited possibilities of further labour cost reduction by enterprises coupled with first clear signals of labour market recovery will halt further decline in all inflation components of consumer prices in 2011.

October projection compared to June projection

In the October projection it was assumed that recession in the developed economies may be slightly shallower than expected in June. At the same time, current data on economic activity in 2009 Q2 and Q3 led to a significant upwards revision of the forecasts of GDP growth in Poland in 2009. However, the growth structure of GDP, including a high contribution of net exports amid stronger declines in trade than those accounted for in June, suggests, similarly as in the June projection, only a slow restoration of domestic demand in the further projection horizon.

⊡ **Figure 4.3:** October projection against June projection: GDP growth.

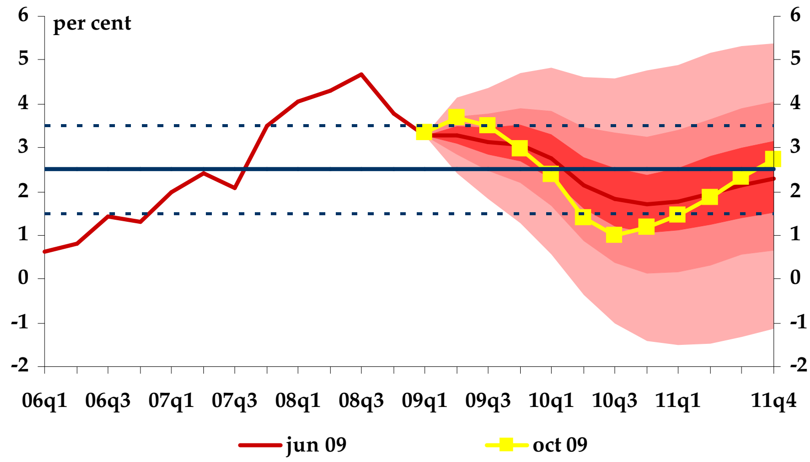


Source: NBP.

A significant improvement in the terms of trade in relation to the June projection, partially connected, among others, with a stronger depreciation of the US dollar against the euro exchange rate in the current year than accounted for in June, coupled with the high contribution of net exports to growth, resulted in a strong improvement in the current and capital account balance in 2009 and at the beginning of 2010. Despite a gradual reversal of the favourable ratio of export to import prices and a domestic demand recovery in the projection horizon, the lower current and capital account deficit will contribute to a stronger appreciation of zloty in 2009 and 2010 than it was expected in June.

The shifts in the assessments of cost pressure between the June and October projections are primarily connected with different paths of the zloty and dollar against the euro. The October projection points to a lower inflation in 2010 than expected in June, particularly in those inflation components which are characterised by a high commodity contribution (prices of food and energy carriers). To a lesser extent, changes applied to expectations on core inflation, which was being pulled in opposite directions by slight shifts in the forecasts of cost pressure caused by labour market and import price developments. It is only towards the end of the projection horizon that a stronger depreciation of zloty exchange rate will raise the path of core inflation above June projection levels.

□ **Figure 4.4:** October projection against June projection: CPI inflation.



Source: NBP.

Main areas of uncertainty

Global economic climate and its transmission to the state of Polish economy

The possibility of the world economic recession being extended in time, especially in the European countries, is an important risk factor for the current projection. The uncertainty connected with the continuation of the recovery in Poland's main trade partners is related, among others, to the reaction of developed countries' economies to governments and central banks withdrawing strong fiscal and monetary stimuli, the rate of import demand recovery in developing countries and a possibly delayed recovery in labour markets. The durability of the currently observed recovery signals in the world economy will translate into the speed at which Polish producers will rebuild their exports.

Difficulty in assessing future inflationary pressure, primarily in the US economy is an additional source of uncertainty. The changed perception of inflationary threats in the economy of the United States may be feeding through into strong fluctuations of the US dollar exchange rate. In consequence, this uncertainty may be increasing speculative pressure in commodity markets and affect the development of price processes in Poland.

Exchange rate developments and competitiveness of Polish economy

The risk signalled in previous forecasting periods connected with zloty exchange rate path remains. The risk of zloty exchange rate actually proving different than it was accounted for in the projection is bidirectional. The uncertainty of a weaker zloty exchange rate path is reinforced by risks connected with public finance sector developments, including the reaction of the foreign exchange markets to the possibility of public debt exceeding subsequent prudential thresholds. On the other hand, the relatively high economic growth in Poland, against the backdrop of other countries of the region and other EU member states, and liquidity surplus in the global financial markets may strengthen the inflow of foreign investment and contribute to zloty exchange rate appreciation. Neither does the October projection account for the potential effects connected with the possibility of the zloty being introduced to the ERM II in the coming years.

Both the instability of the zloty exchange rate and possibly lower than expected resilience of the structures of Polish economy to the unfolding economic slowdown may threaten the process of reversing the consequences of the economic crisis and contribute to dampening the outlook for rebuilding domestic demand in the projection horizon. In turn, possible deviations of the zloty's exchange rate may favour the current growth to be maintained or further reduced by affecting net exports.

Situation in public finance sector and fiscal policy

In comparison to the June projection, due to the adoption by the Council of Ministers of the draft *Budget Act for 2010*, there has been a reduction in the uncertainty connected with the shape of the government's income and expenditure policy in the coming quarters. However, there persists a high risk related to financing the deficit of the public finance sector. This risk is increased by the possibility of actual privatisation revenues proving lower than accounted for in the draft *Budget Act* and higher costs of financing the deficit due to a significant rise in the risk premium as public debt accumulates. In particular, the risk premium may increase as a result of financial markets' reaction to the breach of the prudential thresholds set out in the Public Finance Act and the Constitution of the Republic of Poland.

The perspective of exceeding those prudential thresholds and, consequently, of launching the statutory sanation procedures leads to the growth of risk related to fiscal policy adjustments in the longer projection horizon in comparison to previous forecasting periods. It seems possible that current expenditure of the public finance sector and also investment spending will be cut (including that financed by local government units). It cannot be ruled out, either, that taxes or social security contributions will be increased. At the same time, the risks connected with financing the sector's deficit persist.

The possibility of the government launching a savings plan starting from 2011 may affect both the demand side (reduction in internal demand) and the supply side (deceleration in capital formation or effective labour supply) of the economy, leading to restraining the economic growth rate in the longer projection horizon. In turn, the risks connected with public finance situation may translate into a stronger zloty exchange rate depreciation throughout the projection horizon and, indirectly, into higher growth in inflationary pressure than it is accounted for in the current projection.

Integration and institutional processes

The expected deterioration of the situation in the public finance sector with a concurrent tightening of banks' credit granting criteria over the past year translate into the uncertainty as to the scale of EU fund utilisation both by the public and the private sector. An important risk factor is the question whether the procedures connected with granting and using these funds by the administration will be effectively streamlined or not.

Another risk factor for the current projection is the implementation of EU standards on carbon dioxide emissions and the possible expiry of the period of lowered VAT rates on selected goods and services. No less significant is the uncertainty connected with future policies of the European Union in terms of trade exchange with other countries, agricultural policy or possible tightening of environmental requirements amid deteriorating situation in the EU internal labour market and a possible improvement in the sentiment towards protectionist policies.

It is assessed that the outcome of those risks is a higher probability of a weaker medium-term outlook for growth and higher inflationary pressure in relation to the scenario presented in the projection.

Labour market developments

In the situation of an increased supply of labour connected with demographic factors and intensification of return migration, labour market elasticity and the related possibility of absorbing additional labour supply are particularly significant for the growth of the Polish economy. Insufficient effectiveness of labour market institutions, including a lack of expected pro-employment effects of the introduced amendments to the labour law, coupled with potential effects of future tax and structural policies of the government may result in a slower economic growth and higher inflation in the years to come as compared to the current forecasts.

Discussion of data released after 21 September 2009

At the turn of September and October a significant increase was observed in both the current and expected coal prices in the world markets. The continuation of these tendencies and their transmission into domestic wholesale prices of coal may result in increasing the risk of higher inflation path than that indicated in the projection.

Summary of risks for inflation and GDP projections

It is assessed that in the medium-term projection horizon, due to factors not fully accounted for in the current forecasting period, there prevails the risk of inflation actually proving higher than indicated in the October projection. The positive direction of risk is mainly supported by the possibility of lower than expected labour market elasticity and the exchange rate risk connected, among others, with the situation in the public finance sector. The risks connected with the path of economic growth presented in the October projection are assessed as balanced. The balance of factors connected with the situation in the world economy and the effectiveness of the Polish economy's structures in adjusting to the economic downturn is negative, however in the horizon till the end of 2011 it may be compensated with the effects of stronger zloty exchange rate depreciation.

Table 4.2: The central path of the GDP and inflation projection.

	2008	2009	2010	2011
CPI (per cent y/y)	4.2	3.4	1.5	2.1
Food prices (per cent y/y)	6.1	3.8	-1.7	1.8
Energy prices (per cent y/y)	8.4	5.5	1.9	0.6
Core inflation excl. food and energy prices (per cent y/y)	2.3	2.8	2.7	2.6
GDP (per cent y/y)	4.9	1.3	1.8	3.2
Domestic demand (per cent y/y)	5.4	-0.9	2.2	3.2
Private consumption (per cent y/y)	5.4	2.1	2.1	2.5
Public consumption (per cent y/y)	7.3	1.7	0.4	1.5
Gross fixed capital formation (per cent y/y)	8.2	-1.3	2.2	3.5
Contribution of net exports (pp. y/y)	-0.7	2.1	-0.4	0.0
Exports (per cent y/y)	7.2	-11.6	3.5	11.7
Imports (per cent y/y)	8.2	-15.5	4.5	11.3
Average nominal gross wages(per cent y/y)	9.4	4.7	1.6	3.4
Number of employed (per cent y/y)	1.2	-1.4	-1.6	-0.4
Unemployment rate (per cent)	7.3	7.8	10.2	11.3
NAWRU (per cent)	11.0	11.1	12.0	13.0
Participation rate (per cent)	54.3	54.7	54.9	55.1
Labour productivity (per cent y/y)	3.7	2.6	3.4	3.7
Unit labour cost (per cent y/y)	5.3	1.8	-2.0	-0.3
Potential output (per cent y/y)	5.8	4.3	3.4	3.4
Output gap (percentage of potential output)	2.4	0.0	-2.1	-2.8
Index of agricultural commodity prices (USD; 2006=1.00)	1.13	0.95	0.99	0.99
Index of energy commodity prices (USD; 2006=1.00)	1.69	0.90	1.06	1.22
Foreign price level (per cent y/y)	2.5	1.3	1.1	2.0
Foreign GDP (per cent y/y)	0.6	-4.0	0.7	1.8
Current account and capital account balance (percentage of GDP)	-4.3	0.5	-1.8	-2.5
WIBOR 3M (per cent)	6.25	4.37	3.95	3.70

Source: NBP.
Notes: Data on the number of working persons, labour productivity and unit labour costs are own estimates of the Economic Institute of the NBP based on BAEL data. The index of agricultural commodity prices is constructed on the basis of the IMF's forecasts of the prices of wheat, pork, beef, poultry, fish, sugar, olive oil, oranges and bananas with weights reflecting the consumption structure of Polish households. The index of energy commodity prices includes the prices of crude oil, coal and natural gas taking into account the consumption structure of these commodities in Poland.

Annex

The voting of the Monetary Policy Council members on motions and resolutions adopted in May–August 2009

- **Date:** 13 May 2009

  Subject matter of motion or resolution:
  Resolution on the evaluation of the activities of the NBP Management Board as regards the implementation of the *Monetary Policy Guidelines for the Year 2008.*

  Voting of the MPC members:

For:		**Against:**
	S. Skrzypek	
	J. Czekaj	
	D. Filar	
	S. Nieckarz	
	M. Noga	
	S. Owsiak	
	M. Pietrewicz	
	A. Sławiński	
	H. Wasilewska-Trenkner	
	A. Wojtyna	

- **Date:** 13 May 2009

  Subject matter of motion or resolution:
  Resolution on approving the *Report on Monetary Policy Implementation in 2008.*

  Voting of the MPC members:

For:		**Against:**
	S. Skrzypek	
	J. Czekaj	
	D. Filar	
	S. Nieckarz	
	M. Noga	
	S. Owsiak	
	M. Pietrewicz	
	A. Sławiński	
	H. Wasilewska-Trenkner	
	A. Wojtyna	

- **Date:** 26 May 2009

  Subject matter of motion or resolution:
  Resolution on approving the *Report on the Operations of the National Bank of Poland in 2008*.

  Voting of the MPC members:

For:	S. Skrzypek	**Against:**	
	D. Filar		
	S. Nieckarz		
	M. Noga		
	S. Owsiak		
	M. Pietrewicz		
	A. Sławiński		
	H. Wasilewska-Trenkner		
	A. Wojtyna		

  Jan Czekaj was absent.

- **Date:** 27 May 2009

  Subject matter of motion or resolution:
  Resolution changing the resolution on the rate of reserve requirement of banks and the interest rate on the reserve requirement.

  Voting of the MPC members:

For:	S. Skrzypek	**Against:**	
	J. Czekaj		
	D. Filar		
	S. Nieckarz		
	M. Noga		
	S. Owsiak		
	M. Pietrewicz		
	A. Sławiński		
	H. Wasilewska-Trenkner		
	A. Wojtyna		

- **Date:** 24 June 2009

  Subject matter of motion or resolution:
  Resolution on the level of the reference rate, lombard rate, deposit rate and rediscount rate of the National Bank of Poland.

  MPC decision:
  The MPC lowered the interest rates by 0.25 percentage points (due to tie vote, the Chairman's casting vote was decisive).

  Voting of the MPC members:

For:	S. Skrzypek	**Against:**	D. Filar
	J. Czekaj		M. Noga
	S. Nieckarz		A. Sławiński
	S. Owsiak		H. Wasilewska-Trenkner
	M. Pietrewicz		A. Wojtyna

- **Date:** 29 July 2009

  Subject matter of motion or resolution:
  Motion to change the assessment of the probability of achieving the inflation target in the *Information from the meeting of the Monetary Policy Council held on 28–29 July 2009.*

  MPC decision:
  The motion was not passed (due to tie vote, the Chairman's casting vote was decisive).

  Voting of the MPC members:

For:		**Against:**	
	D. Filar		S. Skrzypek
	M. Noga		J. Czekaj
	A. Sławiński		S. Nieckarz
	H. Wasilewska-Trenkner		S. Owsiak
	A. Wojtyna		M. Pietrewicz

- **Date:** 25 August 2009

  Subject matter of motion or resolution:
  Resolution on the Monetary Policy Council's position (concerning the *Draft Ordinance of the Council of Ministers on establishing the National Coordination Committee for the Euro, the Coordination Council and Interinstitutional Working Groups for Preparing Euro Adoption by the Republic of Poland*).

  Voting of the MPC members:

For:		**Against:**	
	S. Skrzypek		
	J. Czekaj		
	D. Filar		
	S. Nieckarz		
	M. Noga		
	S. Owsiak		
	M. Pietrewicz		
	A. Sławiński		
	H. Wasilewska-Trenkner		
	A. Wojtyna		

- **Date:** 26 August 2009

  Subject matter of motion or resolution:
  Motion to change the assessment of the probability of achieving the inflation target in the *Information from the meeting of the Monetary Policy Council held on 25–26 August 2009.*

  MPC decision:
  The motion was not passed (due to tie vote, the Chairman's casting vote was decisive).

Voting of the MPC members::

For:	D. Filar	**Against:**	S. Skrzypek
	M. Noga		J. Czekaj
	A. Sławiński		S. Nieckarz
	H. Wasilewska-Trenkner		S. Owsiak
	A. Wojtyna		M. Pietrewicz