NBP Narodowy Bank Polski

Monetary Policy Council

July 2014

Inflation Report

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 Narodowy Bank Polski. In terms of the contents, works on the projection were supervised by Andrzej Sławiński, General Director of the Economic Institute. The projection was prepared with the use of the NECMOD macroeconomic model. 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.

The time horizon of the analysis presented in the Report is conditioned by the availability of macroeconomic data. In turn, the periodisation of the analysis (breakdown into sub-periods) is conditioned by the development of particular variables. The cut-off date for the data in this Report was 20 June 2014.

This *Inflation Report* is a translation of Narodowy Bank Polski *Raport o inflacji* in Polish. In case of discrepancies, the original prevails.

Contents

Summary

In 2014 Q1, global economic activity growth remained moderate. In the United States, GDP contracted, which was probably a temporary development. At the same time, in the euro area, GDP growth was only marginally above zero. In the largest emerging market economies, output growth remained slow compared to their previous performance.

In the first months of 2014, inflation in the world economy continued at low levels. In advanced economies, inflation stayed close to or below the inflation targets in these countries (respectively in the United States and in the euro area), in spite of an uptick in inflation recorded in some. In the emerging market economies, inflation stabilised below the long-term average. In some countries, including in Central and Eastern Europe, inflation continued to decline.

With low inflation and moderate economic activity in advanced economies, monetary policy of major central banks has remained strongly expansionary. The Fed has kept its interest rates close to zero (0.00-0.25%), while reducing the scale of quantitative easing (to USD 35 billion a month). The Fed announced that it was ready to keep short-term interest rates close to zero even after the asset purchase programme ends. Also the Bank of England kept its interest rates close to zero. The ECB reduced its interest rates, including the rate on main refinancing operations (to 0.15%) and the deposit rate (below zero, to -0.10%). At the same time, the ECB announced that the interest rates would be kept unchanged for an extended period of time given the outlook for low inflation. Furthermore, the ECB announced an introduction of additional measures aimed at increasing lending in the euro area.

Amidst expansionary monetary policy and low inflationary pressure global financial asset prices have increased, while exchange rates in some emerging market economies have strengthened. These were driven by a decline in risk aversion in the global financial markets.

In Poland, the annual growth in consumer goods and services remained low in 2014 Q1 and Q2 (0.2% y/y in May). Low inflation was supported by declining food prices, still negative, though slowly accelerating, growth in energy prices and low demand pressure reflected in a decrease in most core inflation measures. Producer prices in industry continued to fall – yet, a bit slower than in the previous quarter – confirming lack of cost pressure in the economy. Low inflation was accompanied by a decline in all measures of inflation expectations.

In 2014 Q1, GDP growth in Poland picked up to 3.4% in annual terms. An acceleration in output growth was primarily associated with a further rise in domestic demand. In particular, investment growth accelerated substantially, as did – although on a smaller scale – consumption. The contribution of inventories to GDP growth was close to zero, while that of net exports decreased, yet stayed positive.

Economic recovery was accompanied by a gradual improvement in labour market conditions. In 2014 Q1, growth in the number of working persons in the economy accelerated, while unemployment rate decreased markedly. Alongside that, wage growth in the economy as well as in the corporate sector rose somewhat and labour productivity slowed down. As a result, growth in unit labour costs increased slightly, yet remained at a moderate level.

With no inflationary pressure and ongoing economic recovery at home, Monetary Policy Council has not changed NBP interest rates, leaving the reference rate at 2.50%. Gradual upswing in domestic economic activity, coupled with both narrowing external imbalances and improvement in country's creditworthiness, have contributed to rise in prices of Polish financial assets over recent months. The increase in asset prices was additionally driven by monetary policy easing by the ECB. Gradual improvement in economic conditions was also conducive to further signs of revival in the housing market.

At the same time, ongoing economic recovery brought a slight acceleration in lending in 2014 Q1. Growth in corporate lending was primarily recorded in the short-term loans segment and, to a lesser extent, investment loans. Household debt growth continued to gradually accelerate in 2014 Q1, mainly due to a further revival in consumer loans.

In 2014 Q1, the current account deficit continued to narrow. The reduction in the current account deficit resulted primarily from a further rise in the trade surplus. Lower current account deficit in 2014 Q1 helped improve some of Poland's external imbalance indicators. The financial account balance was negative in 2014 Q1 and significantly lower compared to 2013 Q4. This was largely due to an outflow of capital from the debt market, fall in other investment and an increase in the residents' external assets.

The *Inflation Report* is structured as follows: Chapter 1 presents economic developments in the external environment of the Polish economy in the context of their impact on inflationary developments in Poland. These developments as well as domestic factors affecting them are discussed in Chapter 2. *Minutes of the Monetary Policy Council decision-making meetings* held in March-June 2014, together with the *Information from the meeting of the Monetary Policy Council* in July 2014, are presented in Chapter 3. Minutes from the MPC meeting held in July will be published on 21 August 2014 and so will be included in the next *Report*. MPC voting records in the period January-May 2014 can be found in Chapter 5. Moreover, Chapters 1 and 2 of this *Report* include four boxes: "Monetary policy easing by the ECB", "Impact of tensions between Russia and Ukraine on Polish economy", "The role of market services in the development of the Polish economy" and "Monetary policy transmission mechanism in Poland in the light of recent studies".

Chapter 4 of the Report presents the projection of inflation and GDP based on the NECMOD model, which is one of the inputs into the Council's decision-making process on the NBP interest rates. In line with the July projection based on data available up to 13 June 2014 (cut-off date for the projection) – under the assumption of constant NBP interest rates – there is a 50-percent probability of inflation running in the range of -0.1-0.4% in 2014 (compared to 0.8-1.4% in the March projection), 0.5-2.1% in 2015 (as against 1.0-2.6%) and 1.3-3.1% in 2016 (as against 1.6-3.3%). In turn, with a 50-percent probability the July projection sees the annual GDP growth in the range of 3.2-4.1% in 2014 (compared to 2.9-4.2% in the March projection), 2.6-4.5% in 2015 (as against 2.7-4.8%) and 2.3-4.5% in 2016 (as against 2.3-4.8%).

1 External environment of the Polish economy

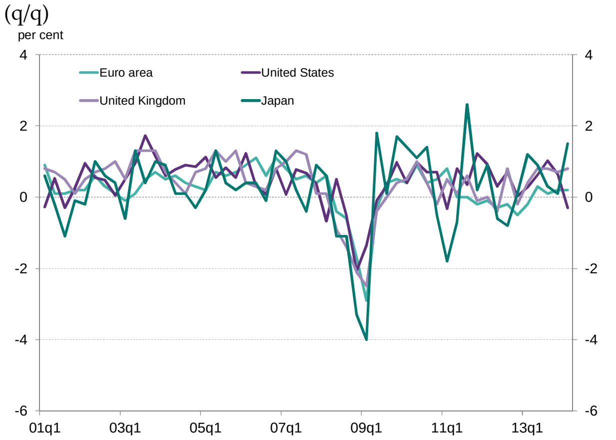
1.1 Global economic activity

In 2014 Q1, global economic activity growth remained moderate, although the situation varied across the countries (Figure 1.1). In the United States, GDP contracted in 2014 Q1, which was probably a temporary development. At the same time, in the euro area, GDP growth was only marginally above zero. In the largest emerging economies, 2014 Q1 output growth remained slow compared to their previous performance.

GDP in the United States declined by 0.3% q/q in 2014 Q1, following a rise of 0.7% q/q in the previous quarter (Figure 1.1). [1] Decrease in output was primarily attributable to unusually severe weather conditions, resulting in a smaller contribution of inventories to GDP growth and a decline in exports and investment, amidst sustained robust growth in household consumption.

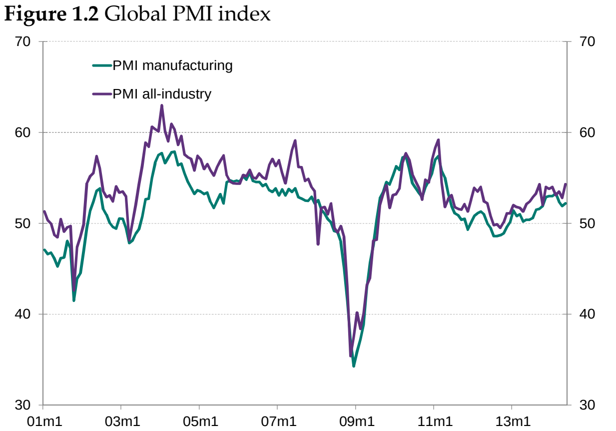
Recently released data point to a likely rebound in economic activity in the United States at the beginning of 2014 Q2. In April and May, corporate sentiment improved (the ISM-PMI index continued to rise), while indicators of consumer confidence remained relatively high. Also conditions in the US labour market continued to strengthen, although the decline in the unemployment rate was still driven by, besides higher employment, a decrease in the labour participation rate (Figure 1.3). At the same time, industrial output accelerated, while retail sales growth slowed down.[2] The upward trend in real property prices was sustained, yet the

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



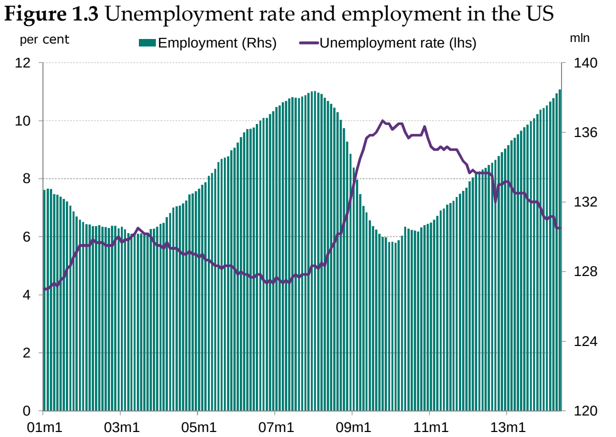
Source: Bloomberg data.

Figure 1.2 Global PMI index



Source: Bloomberg data.

Figure 1.3 Unemployment rate and employment in the US



Source: BLS data.

[1] The quarterly GDP growth figures presented in this chapter are seasonally adjusted.

[2] It has to be noted that the slowdown in the US retail trade could have been related to shift in demand due to severe winter.

market continued to stall.[3]

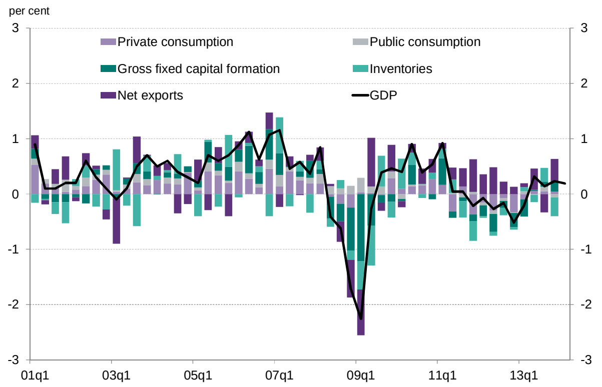
In the euro area, GDP growth slowed down to 0.2% q/q in 2014 Q1 (as against 0.3% q/q in 2013 Q4; Figure 1.4). This slowdown occurred on the back of weaker investment and export performance, amidst a slight rise in consumption.

Of all the larger euro area member states, only Germany and Spain saw an acceleration in quarterly growth. Economic activity in these countries was driven by accelerating domestic demand. In Germany in particular, consumption and investment spending was gathering pace, supported by the relatively upbeat corporate sentiment. In the remaining euro area countries, notably France, economic growth lost momentum (turning negative in Italy) with flagging exports and a further decline in both consumption and investment demand.

Ongoing economic recovery in the euro area, in particular with respect to consumer demand, is signalled by rising retail sales and strong consumer confidence at the beginning of 2014 Q2. Yet the pace of the recovery will probably remain slow due to the persistently unfavourable conditions in the labour market (Figure 1.6), further contraction in lending and sluggish industrial output trends accompanied by a slight weakening in business sentiment (Figure 1.5).

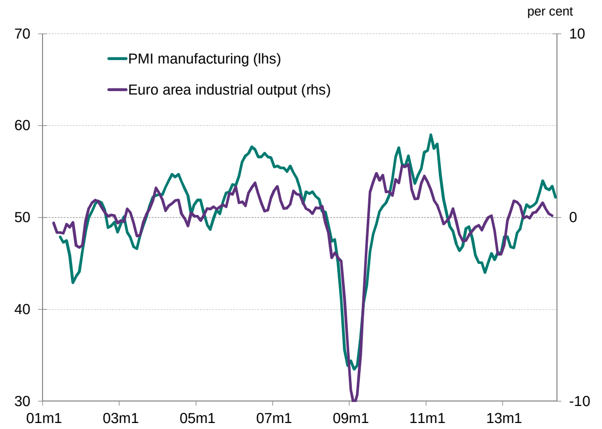
In the majority of economies of the Central and Eastern European economies, recovery continued in 2014 Q1 (Figure 1.7). In the Czech Republic, which is an important trading partner for Poland in the region, growth lost momentum; this, however, was caused by an one-off factor.[4] Business climate indicators, labour market data as well as retail sales and industrial production

Figure 1.4 GDP growth in the euro area (q/q)



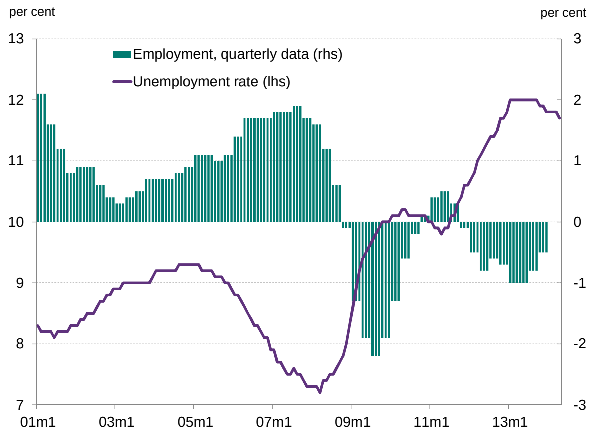
Source: Eurostat data.

Figure 1.5 Industrial output growth* and PMI index in manufacturing in the euro area



Source: Eurostat data, Markit.
* Change in the three-month moving average of the industrial output as against the average of three months before.

Figure 1.6 Employment (y/y) and unemployment rate in the euro area



Source: Eurostat data.

[3] The stagnation is reflected in a decline in the number of homes sold in annual terms, which resulted from higher cost of mortgage loan after the Fed embarked on the tapering of quantitative easing. At the same time, leading property market indicators did not suggest any improvement in the nearest future.

[4] At the beginning of 2014, excise tax was raised in the Czech Republic, which resulted in accelerated demand in 2013 Q4, and a slowdown in 2024 Q1.

growth – all point to further economic recovery in the region.

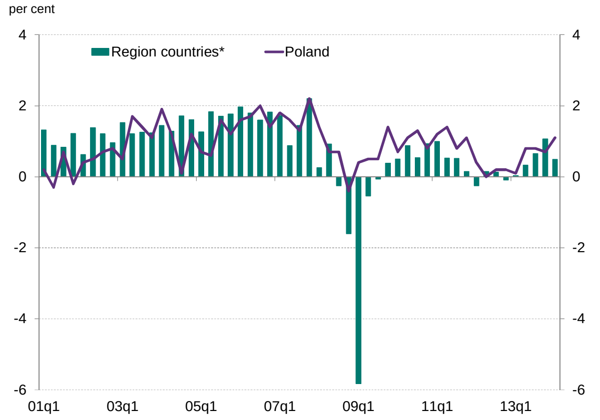
In the largest emerging market economies, GDP growth in 2014 Q1 remained slow compared to previous performance, with some of these countries facing a decline in output growth (Figure 1.8). In China, economic growth in 2014 Q1 was dragged down by weaker export and construction performance. Also in Russia growth lost momentum, weighed down by an increase in uncertainty related to political tensions between Russia and Ukraine. The Russian-Ukrainian crisis sparked considerable capital outflows from Russia, which forced the central bank to raise interest rates substantially (see Chapter 1.3 *Monetary policy abroad and international financial markets*).

1.2 Inflation developments abroad

In the first months of 2014, inflation in the world economy remained low (Figure 1.9). In some countries, including the euro area and Central and Eastern European economies, inflation continued to decline.

In spite of an uptick in inflation recorded in some advanced economies, inflation remained close to or below the inflation targets in these countries. In the United States, inflation reached 2.1% in May, compared to 1.4% average for the 2014 Q1. The rise in the CPI resulted from an acceleration in food price growth and a slight increase in core inflation, amid unfolding recovery. In the euro area, on the contrary, HICP inflation declined to 0.5% in May, which was related to a fall in core inflation and a slow growth in food and energy prices[5] (Figure 1.10).

Figure 1.7 GDP growth in Poland and region countries* (q/q)

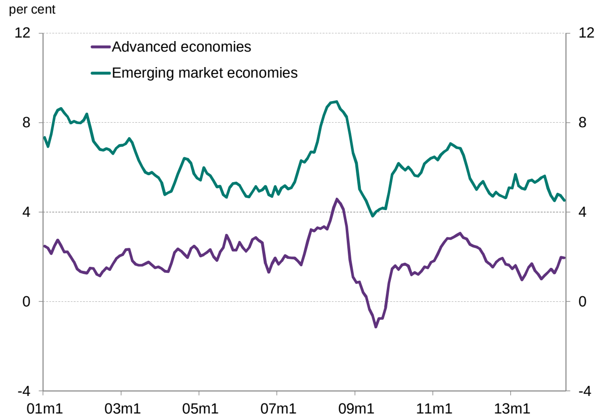


Source: Eurostat data.
* Polish exports-weighted average. Region countries include: Czech Republic, Slovakia, Hungary, Lithuania, Romania, Latvia, Estonia, Bulgaria.

Figure 1.8 GDP growth in China, India, Brazil and Russia (y/y)

Source: Bloomberg data.

Figure 1.9 Inflation in major advanced and emerging market economies* (y/y)



Source: Bloomberg data, NBP calculations.
* GDP-weighted average of advanced and emerging market economies (EMEs of 80% of EME GDP in 2012). Country groups in line with the IMF classification.

[5] A divergence in energy and food price growth between the United States and Europe can be explained with far more severe winter in the United States compared to Europe. This resulted in higher prices for food and heating fuels, in particular crude oil, in the United States. Moreover, a rise in coal consumption in some European countries has been translating into a higher contribution of this commodity to energy prices. Unlike prices for coal, prices for crude oil fell sharply in early 2014 (see: 2.5 *Global commodity markets*).

In emerging market economies, inflation stabilised below the long-term average, although its rates in individual economies were trending in different directions. In some major emerging market economies, inflation was still low due to subdued economic activity and the persistence of low food and energy price growth. In several economies with a flexible exchange rate regime (mainly Turkey, South Africa, Russia and Ukraine) currency depreciation led to a rise in inflation.

In Central and Eastern Europe, inflation dropped to zero (Figure 1.12), dragged down by weaker food price growth, a further decline in energy prices and a fall in core inflation in a majority of countries in this region. In the Czech Republic, a devaluation of the currency in November 2013 was conducive to higher inflation, including core inflation, and helped keep the inflation rate slightly above zero. Bulgaria – with a fixed exchange rate regime – has been experiencing deflation for more than six months, also in terms of the core inflation.

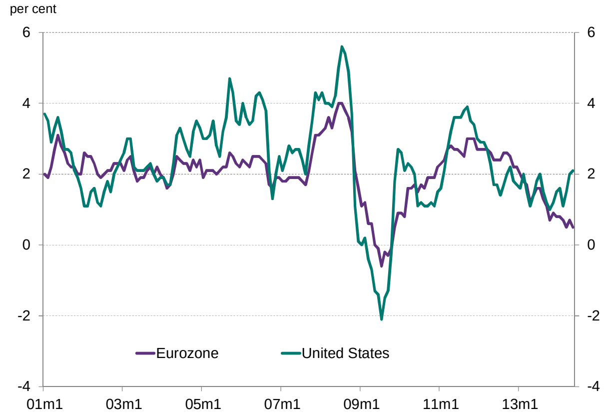
1.3 Monetary policy abroad and international financial markets

Since the publication of the previous *Inflation Report*, monetary policy of the major central banks has remained strongly expansionary (Figure 1.13, Figure 1.14).

The Fed has kept its interest rates close to zero (0.00-0.25%). At the same time, it has reduced the scale of quantitative easing to USD 35 billion a month. The Fed announced that it was ready to keep short-term interest rates close to zero even after the asset purchase programme ends, especially if the projected inflation does not exceed the Fed's long-term goal of 2%, while longer-term inflation expectations remain well anchored.

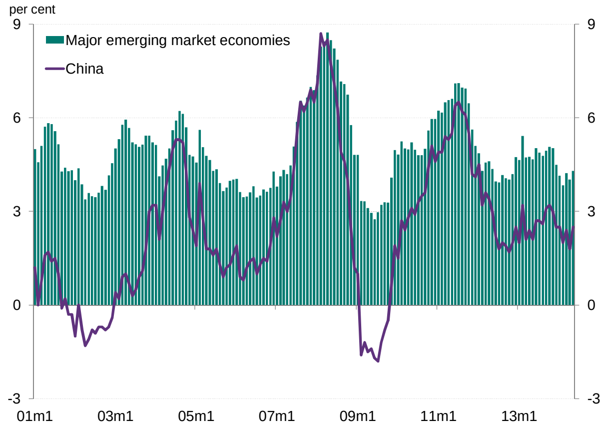
Also the Bank of England has kept its interest rates close to zero. The Bank of England justified its

Figure 1.10 CPI inflation in the United States and HICP inflation in the euro area (y/y)



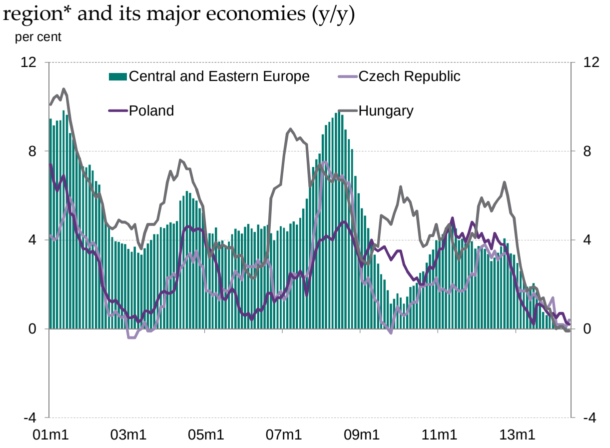
Source: Bloomberg data.

Figure 1.11 CPI inflation in the major emerging market economies* (y/y)



Source: Bloomberg data.
* GDP-weighted average in Brazil, China, India, Russia and South Africa.

Figure 1.12 CPI inflation in the Central and Eastern Europe region* and its major economies (y/y)



Source: Bloomberg data.
* The average of inflation indices in Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania and Slovakia.

decision to maintain interest rates at a low level with persistence of the capacity slack in the British economy, despite an acceleration in GDP growth.

The ECB reduced its interest rates, including the rate on main refinancing operations (to 0.15%) and the deposit rate (below zero, to -0.10%). At the same time, the ECB announced that the interest rates would be kept at this level for an extended period of time given the outlook for low inflation. The ECB also announced an introduction of additional measures aimed at increasing lending in the euro area. This includes in particular targeted longer-term refinancing operations (*targeted LTROs*) of up to EUR 400 billion in 2014. The ECB also pointed to a possibility of launching an asset purchase programme, including in particular, purchases of asset-backed securities (see *Box 1: Monetary policy easing by the ECB*).

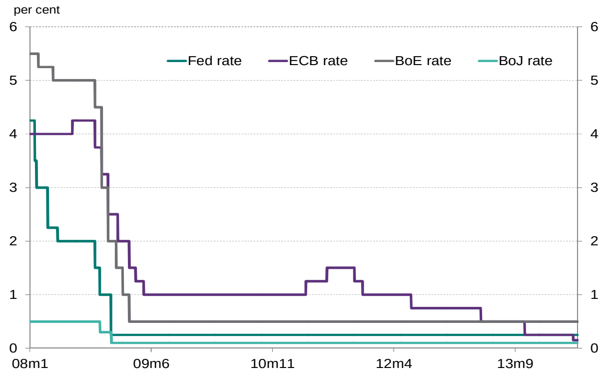
The Bank of Japan continued its programme of asset purchases of JPY 60-70 trillion a year and the loan support programme, while leaving interest rates close to zero.

Since the previous *Report*, financial asset prices have increased worldwide (Figure 1.15). The increase in prices was driven by a fall in risk aversion in the global financial markets, as monetary policy of the major central banks remained expansionary and inflation pressure stayed low.

In the advanced economies, government bond yields declined (Figure 1.16, Figure 1.17), owing to temporarily slower economic recovery in these countries in early 2014 and expansionary monetary policy of their central banks (see Chapter 1.1 *Global economic activity*). Due to monetary policy easing by the ECB, the steepest decline in bond yields was recorded in the euro area.

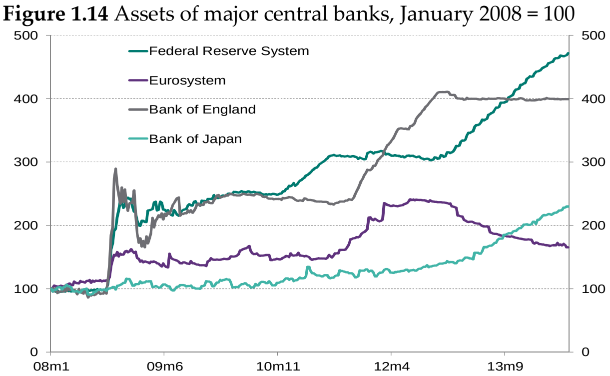
Due to a decline in risk aversion asset prices (stocks and bonds) rose and exchange rates appreciated also in some emerging market

Figure 1.13 Interest rates of major central banks



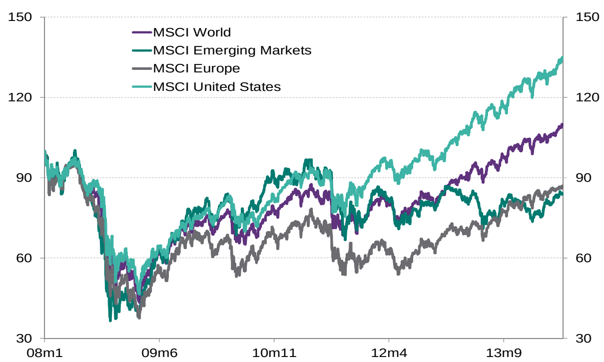
Source: Bloomberg data.

Figure 1.14 Assets of major central banks, January 2008 = 100



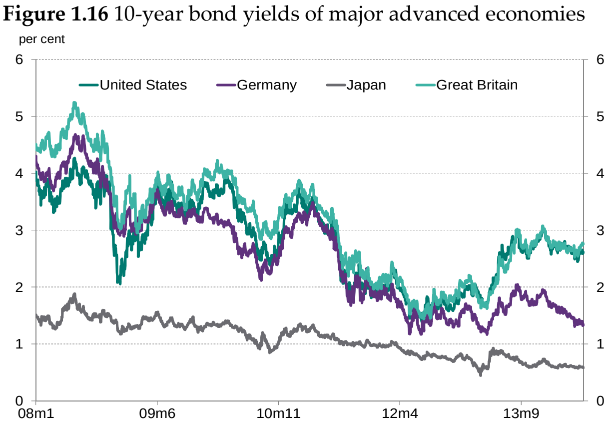
Source: NBP calculations based on Bloomberg data.

Figure 1.15 Global stock indices, January 2008 = 100



Source: NBP calculations based on Bloomberg data.

Figure 1.16 10-year bond yields of major advanced economies



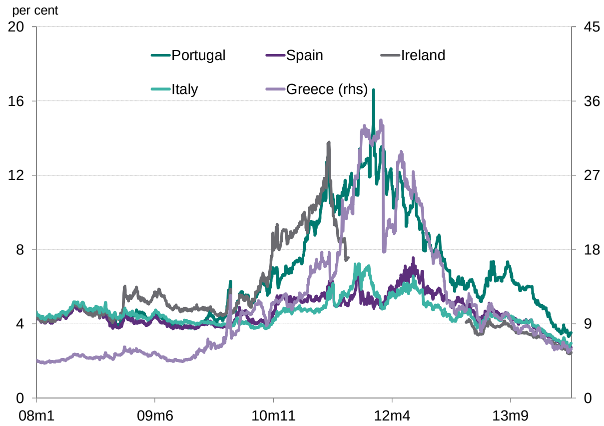
Source: Bloomberg data.

economies (Figure 1.15, Figure 1.19). The financial market developments, however, differed across countries. In some countries, signs of economic recovery translated into a rise in asset prices.

In China, Ukraine and Russia, slow economic growth as well as political tensions between Russia and Ukraine contributed to depreciation of their currencies. To counter these developments, the central banks of Russia and Ukraine increased their interest rates. Thanks to these measures and the approval of a stand-by arrangement for Ukraine by the IMF, depreciation of the currencies of those economies came to a halt.

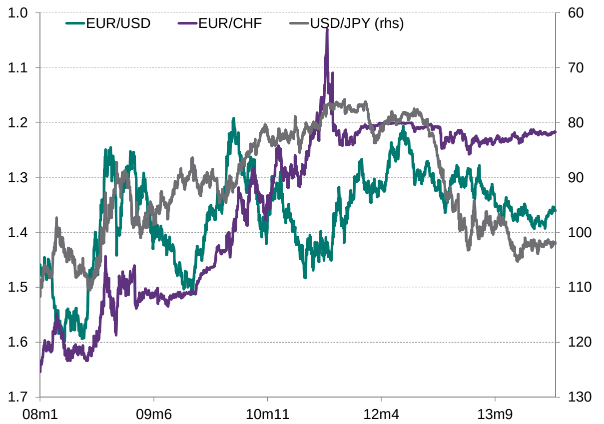
In Central and Eastern Europe, the National Bank of Hungary decreased its base rate to 2.3% and announced the intention to introduce measures aimed at reducing Hungary's foreign debt through increasing participation of domestic investors in the Hungarian government bond market. In turn, the Czech National Bank has kept interest rates close to zero and maintained its commitment to keep exchange rate of the Czech koruna against the euro at least at 27 EUR/CZK.

Figure 1.17 10-year bond yields of Greece, Spain, Ireland, Portugal and Italy



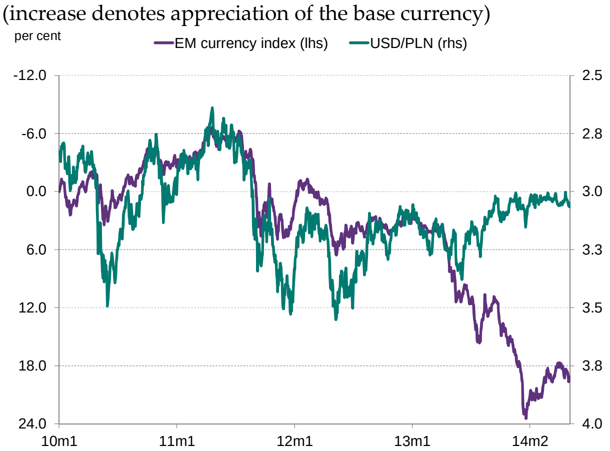
Source: Bloomberg data.

Figure 1.18 The euro and yen exchange rates versus the dollar and Swiss frank exchange rate versus the euro (increase denotes an appreciation of the currency).



Source: Bloomberg data.

Figure 1.19 Aggregated change in the emerging market economies exchange rate index vis-a-vis the USD/PLN rate (increase denotes appreciation of the base currency)



Source: Bloomberg data.

Box 1: Monetary policy easing by the ECB

The recovery in the euro area remains subdued (see *1.1 Global economic activity*), which – apart from weak food and energy price growth – is conducive to very low inflation (see *1.2 Inflation developments abroad*). In May, HICP inflation in the euro area was 0.5%, i.e. markedly below the ECB's definition of price stability (i.e. below, but close to 2%). Moreover, economic growth in the euro area is still facing headwinds, related in particular to the ongoing deleveraging, which impairs the effectiveness of the credit channel of the ECB monetary policy (see *Private non-financial sector deleveraging in advanced economies*, *Inflation Report – November 2012*).

In the light of these circumstances, the ECB eased monetary conditions at its June 2014 meeting. In particular, it reduced the main refinancing operations and the deposit rate by 0.10 percentage points, to 0.15% and -0.10% respectively, and the rate on the marginal lending facility, by 0.35 percentage points, to 0.40%. This made the ECB the first major central bank to introduce a negative deposit rate,[6] supported by a declaration that interest rates will be kept unchanged over a longer period.

Moreover, the ECB announced a range of measures aimed at improving the effectiveness of the monetary policy transmission mechanism, in particular of its the credit channel:

- in two following years, the ECB will conduct targeted long-term refinancing operations (TLTROs) with maturities of up to 4 years and a total amount of up to EUR 400 billion in 2014. Their design will be similar to the longer-term refinancing operations conducted in 2011 and 2012 (see *Quantitative easing of major central banks*, *Inflation Report - March 2012*). Yet, like in the case of loan-support programmes launched by the Bank of England, Bank of Japan and Bank of Hungary (see *Quantitative easing programmes of the major central banks*, *Inflation Report – November 2012*), the borrowing entitlement of a financial institution under TLTROs will depend on net lending extended by this institution, excluding loans to households for house purchase;[7]
- the ECB suspended absorption of liquidity which it had provided to commercial banks through bond purchases under the Securities Market Programme (see *Quantitative easing of major central banks*, *Inflation Report – March 2012*);
- the ECB extended the period during which it would conduct main refinancing operations at a fixed rate with full allotment, from July 2015 to the end of 2016.

The ECB also confirmed it was preparing for a possible introduction of a programme of outright purchases of asset-backed securities (ABS). The ECB holds that the purchases of these securities could support loan securitisation in the euro area, which would help ease bank lending terms. Moreover, the ECB did not exclude taking other unconventional measures, including a launch of government bond purchase programme, should inflation stay low for too prolonged period.

[6] Up to that point, only two central banks – the Bank of Sweden in 2009 and the Bank of Denmark in 2012 – had opted for a negative deposit rates. The experience of these central banks shows that reducing the deposit rate below zero did not produce a material decrease in the deposits placed with the central bank, or lower deposit rates at commercial banks. At the same time, the introduction of a negative deposit rate in Denmark contributed toa downward pressure on the Danish krone.

[7] Financial institutions will be able to borrow, under the first TLTRO operations in September and December 2014, an amount equal to 7% of the total loans extended by that institution, excluding loans to the public sector, outstanding on 30 April 2014. From 2015, the borrowing allowance under targeted LTROs will equal three times the value of net lending extended by that financial institution. Targeted LTROs will be carried out at the rate of the main refinancing operations plus 10 bps.

1.4 Global commodity markets

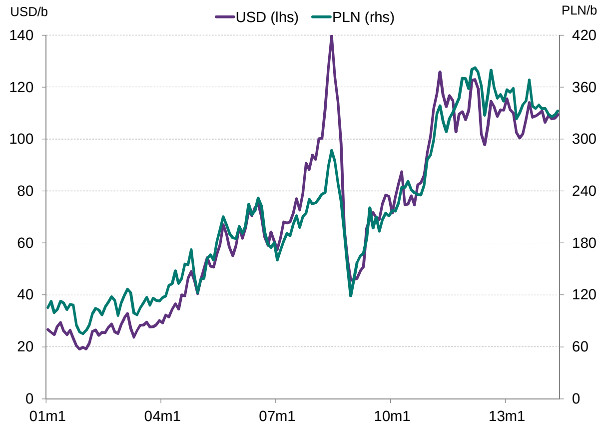
In the first half of 2014, most commodity prices in the global markets remained relatively stable and were mainly affected by supply factors.

The average Brent crude oil price in the first half of 2014 remained high (approx. 108 USD/b, Figure 1.20) due to changes in supply conditions, particularly due to military conflicts in Iraq and Libya and Iraq.[8] On the other hand, ongoing fast growth in US oil production from shale deposits and still weak global economic activity, especially in emerging market economies, were conducive to a fall in oil prices. So far, tensions between Russia and Ukraine have not had any material impact on oil prices.

In the first half of 2014, natural gas prices remained relatively stable and coal prices went down by 10% (Figure 1.21).[9] Against the background of stable natural gas prices, this apparent decline in coal prices was caused by the ongoing shift of US electricity production from coal to natural gas due to growing natural gas production from shale deposits. Decline in coal prices was additionally driven by weaker demand from emerging market economies, mainly from China, due to weak economic conditions.

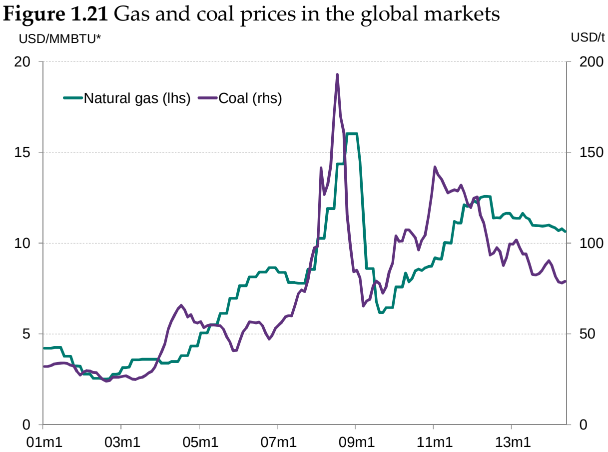
The food price index in the global markets was stable in the recent months (Figure 1.22), although prices of individual commodities were trending in different directions. Animal diseases in the United States and Europe and unfavorable weather conditions in Brazil and the United States contributed to rising prices of pork, coffee, sugar and frozen orange juice. Concerns that supply of wheat might fall due to tensions between Russia and Ukraine resulted in a temporary increase in

Figure 1.20 Brent oil prices in USD and PLN



Source: Bloomberg data.

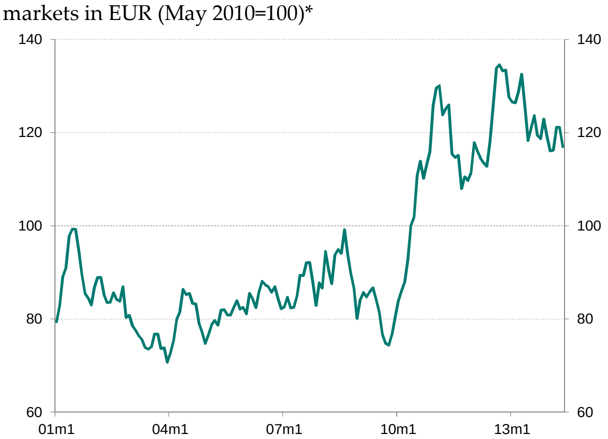
Figure 1.21 Gas and coal prices in the global markets



Source: IMF data.

* MMBTU - Million British Thermal Unit; 1 BTU is the amount of energy needed to raise the temperature of one pound of water by one degree Fahrenheit.

Figure 1.22 Index of agricultural commodity prices in the global markets in EUR (May 2010=100)*



Source: Bloomberg, Reuters data, NBP calculations.

* The index comprises prices of: wheat, rape, pork, potatoes, sugar, cocoa, coffee, skimmed milk powder, butter, frozen orange juice concentrate. The system of weights used in the IACP reflects the consumption structure of Polish households.

[8] This chapter bases on monthly data up to May 2014. Due to an escalation of conflict in Iraq, Brent crude oil prices started to rise afterwards, reaching 114.8 USD/b on 20 June 2014.

[9] Due to the lack of available data on wholesale gas prices in Poland, gas prices presented in this chapter refer to prices of Russian natural gas in Germany.

prices for this commodity. At the same time, prices for milk and dairy products went down, which was due to weaker demand from Russia and China.

2 Domestic economy

2.1 Inflation developments

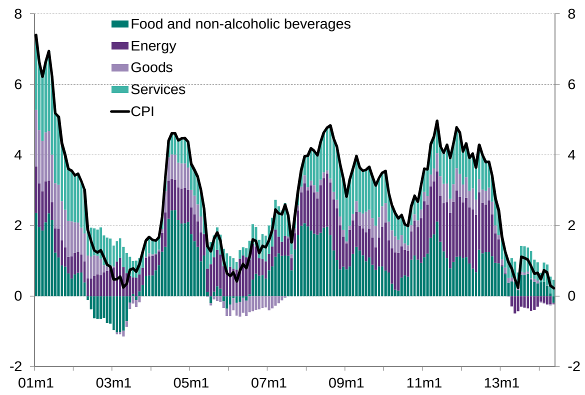
2.1.1 Consumer prices

The annual growth in consumer goods and services in Poland has remained low since the beginning of 2014, declining to 0.2% y/y in May (Figure 2.1).

Low inflation over that period was supported by declining food prices, mostly those of vegetables,[10] still negative, though slowly accelerating growth of energy prices, and low demand pressure, as indicated by a decline in non-food prices and a slower growth in the prices of services (see Chapter 2.1.2 *Core inflation*).[11]

Producer prices in industry continued to fall – yet, to a bit lesser degree than in the previous quarter. This confirms a lack of cost pressures in the economy (see Chapter 2.1.3 *Producer prices in industry).*

Figure 2.1 Changes in CPI and main price categories (y/y)



Source: GUS data, NBP calculations.

Table 2.1 Changes in CPI and main price categories (y/y)

	2010	2011	2012	2013	2014				
					Jan	Feb	Mar	Apr	May
CPI (%)	2.6	4.3	3.7	0.9	0.5	0.7	0.7	0.3	0.2
Food and non-alcohol beverages (pps)	0.7	1.3	1.0	0.5	0.4	0.4	0.3	0.1	-0.2
Energy (pps)	1.0	1.5	1.4	-0.3	-0.2	-0.2	-0.2	-0.2	0.0
Goods (pps)	0.3	0.5	0.4	0.1	0.0	0.0	0.0	0.0	0.0
Services (pps)	0.6	1.0	0.9	0.6	0.3	0.5	0.6	0.5	0.5

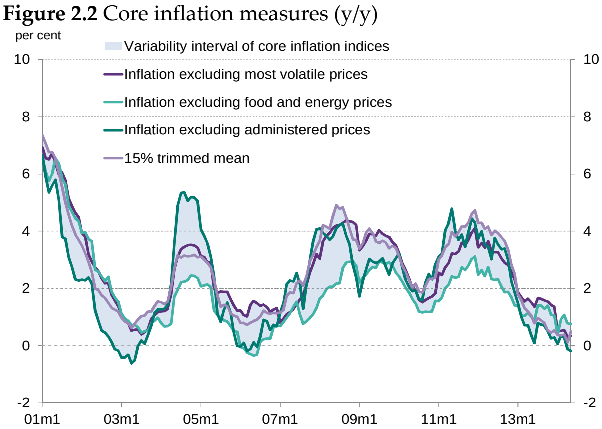
Source: GUS data, NBP calculations.
Due to rounding off, contribution of changes in prices of particular goods and services to the CPI may not sum up to the total consumer price growth.

2.1.2 Core inflation

Since the previous *Report*, most core inflation measures have decreased (Figure 2.2). The declining core inflation in the analysed period reflected lack of cost and weak demand pressures in the economy, coupled with moderate wage growth.

The inflation rate excluding food and energy prices declined from 1.0% y/y in December 2013 to 0.8%

Figure 2.2 Core inflation measures (y/y)



Source: GUS data, NBP calculations.

[10] The fall in vegetable prices stemmed from favorable weather conditions for agriculture in Poland and in Europe (a short and mild winter, earlier than in the previous year beginning of the growing season and, consequently, lower costs of greenhouse production of vegetables and lower prices of imported vegetables).

[11] Energy prices declined on account of a reduction in electricity tariffs for households in January 2014. The decline in energy prices was contained by an increase in natural gas tariffs for households in January 2014 and a rise in fuel prices in May 2014 due to the statistical base effect related to a fall in fuel prices seen in May 2013.

y/y in May 2014, mostly on account of lowering prices of goods in most trade groups.[12] Also growth in the prices of services marginally decelerated, which was due to a slowdown in nearly all groups, most specifically in cable and digital TV charges and in administered prices of services related to housing (Figure 2.3).[13]

2.1.3 Producer prices in industry

In 2014 Q1, the growth in producer prices in industry (PPI) remained negative and amounted to -1.2% y/y (as against -1.3% y/y in 2013 Q4 and -1.1% y/y in in 2013 Q3), which indicates a lack of cost pressures in the economy (Figure 2.4).[14]

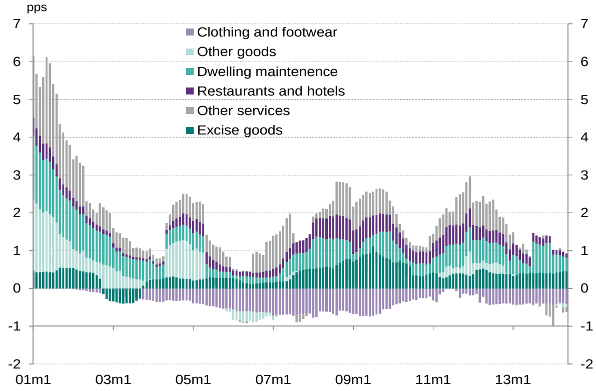
PPI continued at low levels due to a stabilization in industrial commodity prices and weak growth in unit labor costs in industry.

A slight appreciation of the nominal effective exchange rate in annual terms exacerbated the decline in producer prices of the exported goods, which deepened from -1.1% y/y in 2013 Q4 to -1.5% y/y 2014 Q1. The decrease in domestic PPI slowed down over that period, from -1.5% y/y to -1.2% y/y respectively.[15]

2.1.4 Import prices

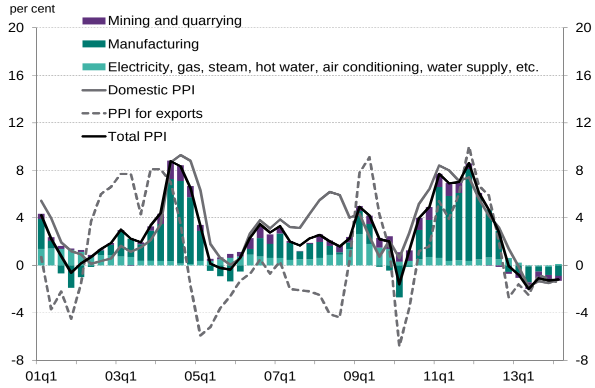
The decline in zloty denominated prices of imported goods – observed since 2012 Q4 – significantly deepened in 2013 Q4 (Figure 2.5). Import prices fell in 2013 Q4 by 2.8% y/y (as compared to a decrease by a mere 0.1% y/y in 2013 Q3), i.e. returned to a low growth rate of the previous year (-2.7% y/y).

Figure 2.3 Composition of core inflation (y/y)



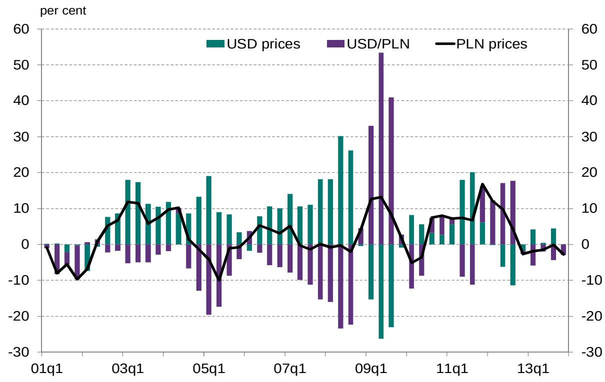
Source: GUS data, NBP calculations.

Figure 2.4 Composition of annual growth of total PPI by sections of industry, domestic PPI, PPI for exports and PPI excluding energy



Source: GUS data.

Figure 2.5 Composition of annual growth of import prices in PLN terms



Source: GUS data, NBP calculations.

[12] With the exception of a growth in the prices of alcoholic beverages due to a rise in the excise tax on spirits in early 2014.

[13] The decline in the annual growth of digital and cable TV charges was due to a statistical base effect attributable to the increase in those charges in March and April 2013. In contrast, the decline in the annual growth in administered prices of services related to housing resulted mainly from a decrease in waste disposal charges in January 2014.

[14] In April 2014, PPI growth stood at -0.7% y/y (as compared to -1.3% y/y in the previous month) and it fell to -1.0% in May 2014. In both months the PPI change was mainly driven by a change in price growth in manufacturing.

[15] According to Eurostat data.

Deepening decline in import prices was associated with a decrease in the annual growth of prices of imported goods denominated in dollars (mainly fuels), and stronger than a year earlier zloty exchange rate.

2.1.5 Inflation expectations

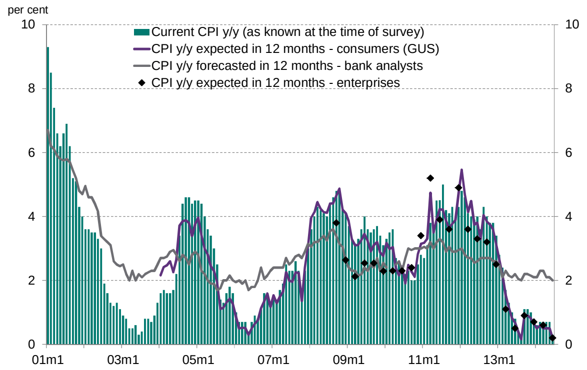
12-month inflation expectations of financial sector analysts have remained slightly below the inflation target for the past five quarters. Since the previous *Report*, these expectations have decreased from 2.3% to 2.0% in June 2014 (Figure 2.6). At the same time, analysts' forecasts for the 2014 and 2015 annual average inflation also declined – respectively from 1.6% to 0.6% and from 2.5% to 1.9%, while the 2016 average inflation forecast remained at 2.5%.

In turn, according to the *NBP Survey of Professional Forecasters* of March 2014,[16] the median of aggregated probabilistic inflation forecast for 2014 amounts to 1.2%, for 2015 stands at 2.3% and for 2016 is 2.5% (Table 2.2).[17]

Inflation expectations of enterprises over the 12 months' horizon fell from 0.6% in 2014 Q1 to 0.2% in 2014 Q2.

With a decrease in inflation, measures of inflation expectations of consumers also declined. Between December 2013 and May 2014, these expectations stood around 0.6-0.5% y/y, whereas in June 2014 they fell to 0.2% y/y.

Figure 2.6 Inflation expectations of consumers and enterprises and inflation forecasts of bank analysts



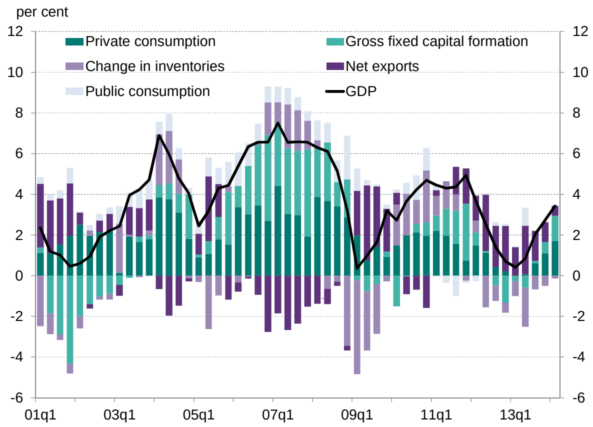
Source: Ipsos, GUS, Reuters and NBP data.
For consumers and enterprises – objectified measure.

Table 2.2 Forecasts of CPI inflation derived from individual interval forecasts (in %)

Horizon	Median	50% probability	90% probability	Probability of 1.5-3.5% range
2014	1.2	0.9 – 1.6	0.1 – 2.6	28%
2015	2.3	1.8 – 32.7	0.4 – 3.8	75%
2016	2.5	1.9 – 3.0	0.6 – 4.6	72%

Source: NBP Survey of Professional Forecasters, March 2014.

Figure 2.7 GDP growth and its components



Source: GUS data.

[16] The *NBP Survey of Professional Forecasters* is conducted on a quarterly basis, with a participation of experts from financial institutions, research centres and employer and employee organisations. Their forecasts are formulated in probabilistic terms, which allows taking account of various economic development scenarios and assessing the compatibility of forecasts. For a detailed description of the survey results, see: http://amakro.nbp.pl

[17] The median of aggregated probability forecast is derived from the aggregation of individual interval forecasts of the surveyed experts.

2.2 Demand and output

In 2014 Q1, GDP growth in Poland picked up to 3.4% in annual terms (Figure 2.7, Table 2.3), while in quarter-on-quarter terms it remained unchanged and amounted to 0.9% (seasonally adjusted data, NBP estimates).

The accelerated output growth in 2014 Q1 was primarily associated with a further rise in domestic demand. In particular, investment growth picked up substantially, as did – although on a smaller scale - consumption growth. The contribution of inventories to GDP growth was close to zero, while the contribution of net exports decreased, yet stayed positive.

2.2.1 Consumption demand

In 2014 Q1, consumption demand continued to strengthen. Private consumption growth amounted to 2.6% y/y, against 2.1% y/y in 2014 Q4 (Figure 2.8), thus remaining below its long-term average. Also in quarter-on-quarter terms, private consumption picked up in 2014 Q1 (to 1.2% q/q, compared with 0.6% q/q in the previous quarter; seasonally adjusted data, NBP estimates).

The gradual recovery in consumption in 2014 Q1 is also indicated by the increasingly stronger retail sales performance in most categories[18].

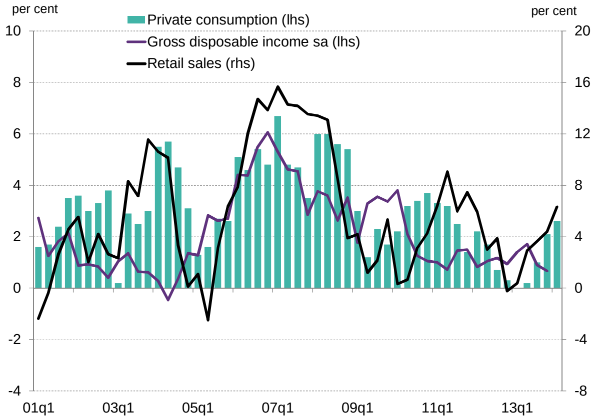
Consumption demand in 2014 Q1 was supported by accelerated wage growth and expanding employment in the economy (see Chapter 2.4 *Labour market*). The revival in consumption was also driven by further improvement in consumer confidence (Figure 2.9) and moderately easier

Table 2.3 Growth of GDP and its selected components (y/y) and contribution of inventories and net export to GDP

	2008	2009	2010	2011	2012	2013 q1	2013 q2	2013 q3	2013 q4	2014 q1
GDP (%)	5.1	1.6	3.9	4.5	1.9	0.5	0.8	1.9	2.7	3.4
Private cons. (%)	5.7	2.1	3.2	2.6	1.2	0.0	0.2	1.0	2.1	2.6
Public cons. (%)	7.4	2.1	4.1	-1.7	0.2	-0.1	4.3	1.7	2.1	0.7
Gross fixed capital formation (%)	9.6	-1.2	-0.4	8.5	-1.7	-2.1	-3.2	0.6	1.3	10.7
Inventory increase (pps)	-1.1	-2.4	2.0	0.6	-0.6	-0.5	-2.0	-0.5	-0.7	-0.1
Net exports (pps)	-0.6	2.7	-0.7	0.9	2.0	1.3	2.5	1.4	1.5	0.5

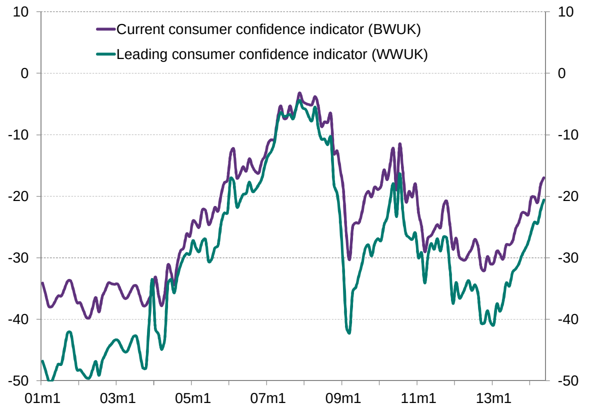
Source: GUS data.

Figure 2.8 Growth of private consumption, gross disposable income and retail sales (y/y, constant prices)



Source: GUS data, NBP calculations.

Figure 2.9 Consumer confidence indicators



Source: GUS data.

[18] In April, retail sales continued to accelerate, which was partially down to the statistical base effect related to the timing of the Easter – especially with respect to the *food, beverages and tobacco products* category.

The data on retail sales published on a monthly basis refer to sales by firms with a workforce of more than nine persons. Total retail sales data (which also include sales by firms employing 9 persons or less) are published on an annual basis only. Data available on a monthly basis also include turnover in retail trade, comprising all enterprises. Yet, these data are less correlated with consumption than retail sales. Hence, this Report refers to monthly retail sales data.

consumer credit conditions. At the same time, consumption growth was hampered by the sluggish decline in the unemployment rate.

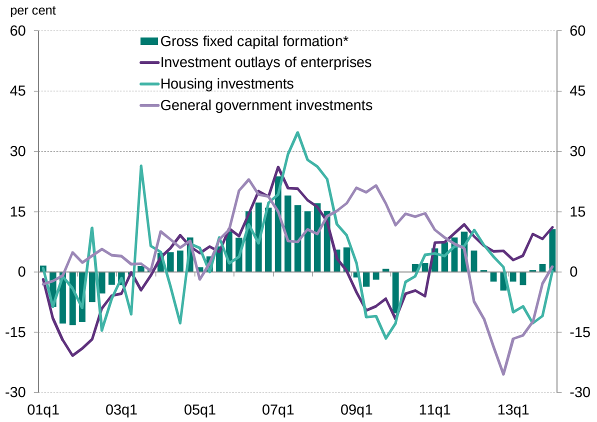
2.2.2 Investment demand

In 2014 Q1, investment growth in the economy accelerated. The annual growth in gross fixed capital formation reached 10.7% y/y as compared to 2.0% y/y in 2013 Q4. In quarter-on-quarter terms investment growth also gained momentum (up to 3.9% q/q versus 1.6% q/q in 2013 Q4; seasonally adjusted data, NBP estimates).

Stronger investment growth in the economy in 2014 Q1 was the combined effect of a halt in the decline in housing investment, steeper growth in corporate investment and a small increase – following two years of decline – in public sector investment (Figure 2.10).[19] Growth in housing investment was supported by an improvement in households' economic situation amidst interest rates remaining at historically low levels. Growing residential investment was also driven by the launch of the government housing scheme "Flat for the Young" as well as the signs of recovery in the housing market. Further gradual economic recovery also fuelled corporate investment.

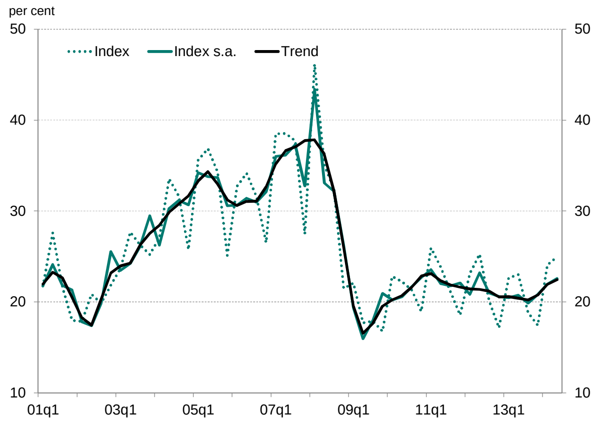
In 2014 Q2, according to the NBP business condition survey, enterprises envisage further acceleration in investment activity. This is indicated, in particular, by a rising percentage of enterprises planning to embark on new investment projects within a quarter; yet, their share still remains below the long-term average (Figure 2.11). Favourable investment outlook is also confirmed by a growing share of enterprises declaring an unfolding of the previously commenced

Figure 2.10 Investment in the economy (y/y, NBP estimates for the NECMOD model; data seasonally adjusted)



Source: NBP data.
*GUS data (seasonally adjusted).

Figure 2.11 Index of new investments (percentage of enterprises planning to start new investments within the coming quarter)



Source: NBP economic climate survey.

[19] Also the results of GUS F-01/I-01 survey point to stepping up corporate investment in 2014 Q1. Growth in corporate investment was due to strongly accelerating outlays on motor vehicles, which may have been partly driven by the temporarily resumed full deduction of VAT on the purchase of cars with LCV type certification. On the other hand, investment in buildings and constructions as well as machinery and equipment slowed down.

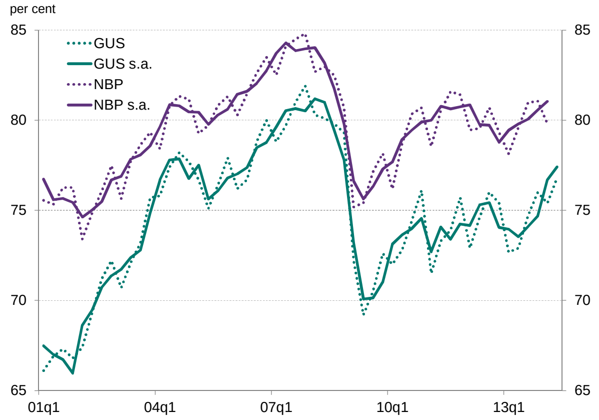
investment projects.[20] Rising propensity of businesses to invest could have been driven by increased capacity utilization amidst persistently strong financial condition in the enterprise sector (See Chapter 2.3 *Financial condition in the enterprise sector*; Figure 2.12).

2.2.3 Government demand

In January-May 2014, the central budget deficit totalled PLN 22.5 billion and was markedly lower than in the corresponding period of 2013 (PLN 31.0 billion; Figure 2.13). The deficit reached 47.3% of the amount envisaged for 2014, compared to 73.4% of the final outturn after May 2013. Overall central budget revenue in January-May 2014 was 6.8% higher than in the corresponding period of 2013, with tax receipts having risen by 9.9% y/y. A particularly sharp increase was recorded in VAT income (a rise of 18.0% y/y). Central budget expenditure, in turn, was lower than a year before (by 0.8%), which resulted, to a great extent, from lower debt service costs. Spending under this heading amounted to PLN 15.4 billion, compared with PLN 19.3 billion in the corresponding period of 2013. The decline was partially related to the transfer of Treasury bonds from Open Pension Funds (OFE) to the Social Insurance Institution (ZUS) and their subsequent write-off. The rest of the change was attributable to a different debt servicing schedule than in 2013.

In 2014 Q1, local government units registered a budget surplus of PLN 9.6 billion, i.e. PLN 1.7 billion higher than in 2013 Q1. The improvement was a result of robustly rising local government revenue from its share of income tax receipts and a subdued growth in current spending (2.4%), especially on wages. In contrast, there was a marked rise in capital expenditure – by 17.5%. The debt of local government units as of the end of

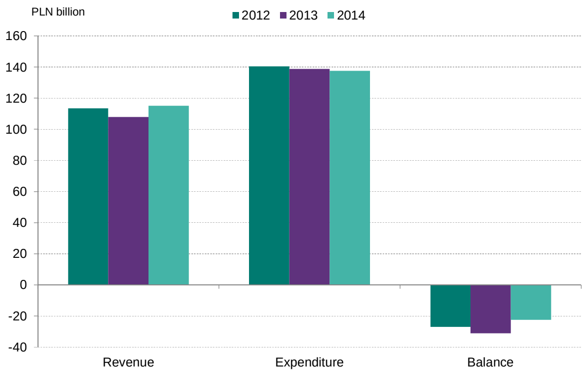
Figure 2.12 Production capacity utilisation in industry (GUS) and in the corporate sector (NBP)



Source: GUS data, NBP economic climate survey.

The degree of capacity utilisation based on GUS business tendency survey is significantly lower that quoted in NBP surveys. However, trends in both indicators are similar in both surveys. The difference in the data results from the difference in the enterprise sample on which surveys are based on. The difference may also stem from the fact that large enterprises are overrepresented in the NBP sample, while the GUS sample is representative in terms of the enterprise size.

Figure 2.13 State budget performance in January-May



Source: Ministry of Finance.

[20] The expected recovery in corporate investment is also reflected in further improvement in balance of planned changes in the total volume of quarterly expenditure and growing estimated value of newly launched investment .

2014 Q1 amounted to PLN 68.6 billion and was slightly higher than as of the end of 2013 (PLN 66.7 billion).

Also the balance of the Social Insurance Fund (FUS) improved. Unlike in the previous year, FUS did not increase its debt in the early months of 2014, having received more subsidy from the central budget and additional funds resulting from the transfer of OFE assets. The balance of the National Health Fund (NFZ) was comparable to last year's figure.

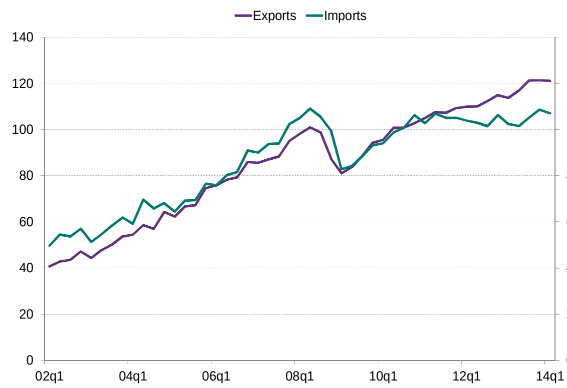
Convergence Programme. 2014 Update envisages that the general government sector will attain a one-off surplus of 5.8% of GDP in ESA 95 terms, related to the handover of assets from OFE to ZUS.[21] Besides this one-off effect, the changes in the pensions system will contribute to a lasting reduction in the general government sector deficit through lower debt service costs and higher revenue from pension contributions, as some of the insured will opt out of OFE membership. Combined with the planned maintenance of the government sector wage freeze until 2015, this should enable a reduction of the general government sector deficit to below 3% of GDP, in line with the requirements of the Excessive Deficit Procedure, which Poland is subject to.

2.2.4 Exports and imports

In 2014 Q1, a recovery in both export and import volume was gaining momentum. At the same time, the export volume rose by 6.4% y/y and import volume by 4.6% y/y (as compared with 5.6% y/y and 2.2% y/y respectively in 2013 Q4; Figure 2.14).[22]

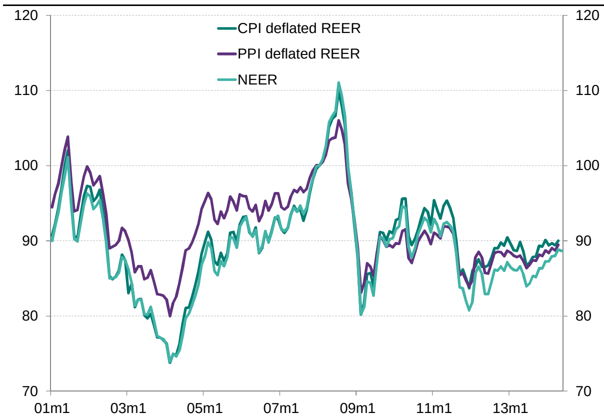
Stronger growth in overall exports in 2014 Q1, despite a sharp decline in sales to non-EU

Figure 2.14 Polish real exports and imports of goods (2010=100)



Source: Eurostat data.

Figure 2.15 Zloty real and nominal effective exchange rate (increase denotes appreciation; January 2008=100)



Source: NBP and the European Commission data.

[21] Starting from autumn 2014, a new national accounts system, ESA 2010, will be introduced, under which this operation will have no impact on the balance of the sector.

[22] The growth rates cited in the main text of this chapter relate to changes in foreign trade volumes as published by Eurostat.

countries (-3.4% y/y as compared with 7.6% y/y in 2013 Q4), was due to a significant rise in exports to the euro area (to 10.3% y/y from 4.9% y/y in 2013 Q4) and to the remaining EU countries (to 9.0% y/y from 5.6% y/y in 2013 Q4).

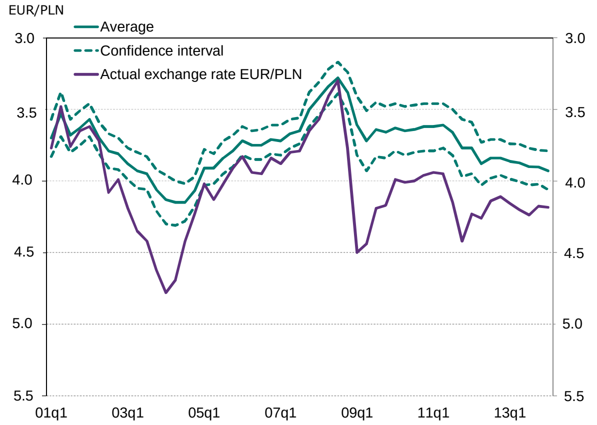
Faster growth in exports to the euro area resulted from across-the-board expansion in all goods categories, supported by ongoing recovery in euro area economic activity.

Exports to non-EU countries declined mainly due to lower sales of Polish goods to Russia and Ukraine.[23] The fall in exports to these countries was related to the mounting political tensions between them resulting in a slowdown in economic growth and currency depreciation observed in both countries (see Box 2. *Impact of tensions between Russia and Ukraine crisis on the Polish economy).*

In turn, the rise in imports in 2014 Q1 was driven by increasingly robust economic activity at home, reflected in a faster growth in imports of intermediate goods. At the same time, imports were fuelled by continued upturn in export production, which is highly import-intensive.

In 2014 Q1, the nominal effective exchange rate of the zloty appreciated (Figure 2.15). Despite the stronger zloty, NBP business climate surveys point to a still high price competitiveness of Polish exports.[24] The market zloty exchange rate against the euro remained weaker than the threshold exchange rate of export profitability as declared by enterprises (Figure 2.16).[25] High export profitability was also reflected in a small percentage of businesses quoting the exchange rate as a barrier to

Figure 2.16 Average threshold exchange rate (EUR/PLN) of exports profitability declared by enterprises



Source: NBP data and estimates.

[23] According to Eurostat data showing the nominal value of external trade (in EUR). Eurostat data on the volume of exports do not afford an analysis of the volume of trade with Poland's respective trade partners. According to data on nominal trade exchange, in 2014 Q1 Polish exports to Ukraine decreased by 20.4%, and to Russia – by 6.9% y/y.

[24] *NBP Quick Monitoring Survey. Economic climate in the enterprise sector in 2014 Q1 and forecasts for 2014 Q2*, NBP.

[25] The export profitability threshold exchange rate is determined as the average of values quoted in response to the relevant question of the NBP business climate survey (*Information on the condition of the enterprise sector with a particular focus on business conditions*). The survey question is as follows: "What is the threshold exchange level, in terms of PLN, at which exports are (will become) unprofitable? "*NBP Quick Monitoring Survey. Economic climate in the enterprise sector in 2014 Q1 and forecasts for 2014 Q2*, NBP

their growth, as well as close to the all-time low share of unprofitable exports in revenue from foreign sales.

Box 2: Impact of tensions between Russia and Ukraine on the Polish economy

Tensions between Russia and Ukraine weighted on capital inflows to these countries and contributed to a sharp depreciation of their currencies and a deterioration in their economic conditions. Between 2013 Q4 and 2014 Q1, GDP growth fell from 3.3% to -1.1% in Ukraine and from 2.0% to 0.9% in Russia. According to consensus forecasts, GDP in Russia is likely to grow by mere 0.7%, and fall by 4.1% in Ukraine.[26] Reform programme for Ukraine implemented with IMF's support,[27] aims to restore macroeconomic stability over longer run. Yet, measures taken under this facility might be temporarily adding to weaker economic growth in this country, particularly as a result of fiscal tightening and increases in gas tariffs. In Russia, the main headwinds to economic growth include lower private and public consumption, as oil prices have been stable over recent years, difficulties in meeting budget requirements and interest rate increases by the Bank of Russia in March and April 2014.

Deterioration in economic conditions in Ukraine and Russia, exacerbated by tensions between these countries, might influence economic activity in their trading partners, including Poland. The scope of this influence has been limited so far, and if further steps to ease conflict between Russia and Ukraine are taken, their impact on economic conditions in Poland is likely to remain contained.

Figure B.2.1 Share of Russia and Ukraine in exports of selected countries

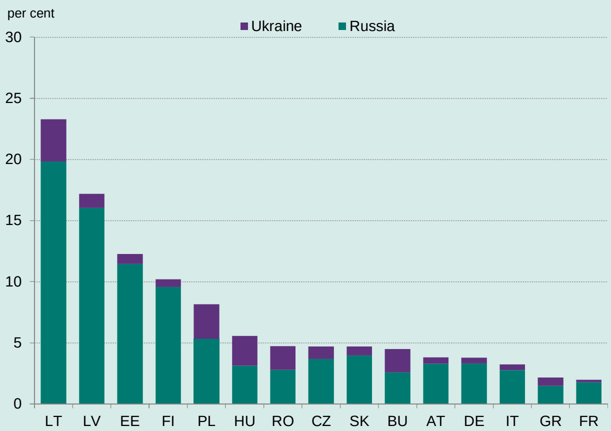
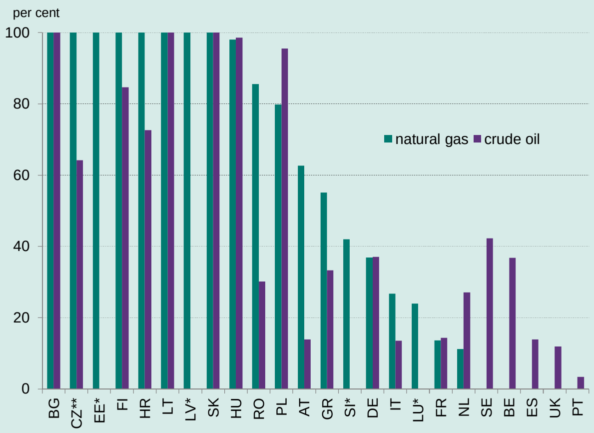


Figure B.2.2 Share of Russian natural gas and crude oil in imports of these commodities in selected European countries



Source: Eurostat, European Commission

*No or very limited capacity to refine crude oil.

**Estimate of Czech imports of Russian natural gas does not take into account the possibility of substituting approx. ¼ of natural gas imports from Russia with Norwegian natural gas, afforded by the connection to the German transfer infrastructure and the agreement signed in 1997 on natural gas delivery from Norway.

[26] Bloomberg June survey.

[27] On 30 April 2014, the IMF approved a stand-by arrangement of USD 17 billion for Ukraine. The first disbursement (USD 3.2 billion) was released immediately on the decision, whilst the following two will be subject to bi-monthly reviews and fulfilment of performance criteria required by the IMF. The programme of economic reforms for Ukraine includes: (i) maintaining flexible exchange rate of the hryvnia to restore competitiveness and adopting inflation targeting in 2015, (ii) stabilizing the financial system, (iii), gradually reducing the general government sector deficit (to approx. 3% of GDP in 2016, from the 5.2% of GDP as forecast for 2014), (iv) eliminating losses in the energy sector (among others, through raising energy prices charged to households) while enhancing safety nets protecting the poorest consumers and (v) improving transparency of administrative procedures and business climate.

Impact of tensions between Russia and Ukraine on foreign trade

Weaker economic conditions in Russia and Ukraine might result in lower export growth to these countries. As Poland is involved in global supply chains, the impact of economic slowdown in Russia on Polish exports might be also indirect. However, vulnerability of Polish exports to tensions between Russia and Ukraine ought to be assessed against the following factors.

Although Poland is one of the largest European exporters to Russia and Ukraine (Figure B.2.1), combined share of these partners in total exports from Poland is limited (in 2013, it was 5.3% and 2.8%, respectively).[28] As a result, although in the first four months of 2014, value of Polish exports to Russia and Ukraine declined by 8.2% and 26.3% y/y, respectively, the total impact on growth in exports was just 1.2 percentage points. It should be also noted that Polish exports to Russia and Ukraine started to abate already in mid-2013, long before the escalation of political crisis in Ukraine.

Over past few years, durable consumer goods have been constituting ever larger share of Polish exports to Eastern Europe.[29] Demand for these goods is more vulnerable to fluctuations in business cycle. In the first four months of 2014, exports of these goods from Poland to Russia and Ukraine fell by 16.2% y/y and 25.4% y/y, respectively. However, as Russia has so far never imposed sanctions on durable consumer goods, an increasing importance of these goods in Polish exports to Russia would cushion the impact of any administrative decisions taken by Russian authorities to reduce imports from Poland. However, food and agricultural products, which are particularly vulnerable to sanctions, still constitute 14% of Polish exports. At the same time, the embargo on Polish pork introduced by Ukraine in 2007 was lifted in June 2014, which should counterbalance the adverse impact of sanctions from Russia on this category of goods. A decline in Polish exports to Russia and Ukraine might be also limited due to participation of Polish firms in global supply chains, which makes it easier to redirect some exports to other markets.

Impact of tensions between Russia and Ukraine on inflation

With respect to inflation, tensions between Russia and Ukraine have so far been reflected in prices for pork. After Russia introduced embargo on Polish pork in mid-February 2014, Polish exports of pork to Russia plummeted by 70.4% y/y in the first four months of 2014. As a result, prices for pork declined by 3.2% m/m in March.[30] With respect to crude oil and natural gas, there has been no material increase in prices for these commodities due to tensions between Russia and Ukraine.[31] The impact on the zloty has also been limited.

At the same time, Poland is one of the countries, which are strongly dependent on Russian crude oil and natural gas (Figure B.2.2), and thus vulnerable to any supply disruptions. Suspension of natural gas supplies to Ukrainian recipients in June 2014 did not hamper gas supplies to Poland.[32] The impact of potential reduction in crude oil and natural gas supplies should be counterbalanced against high stocks of gas in Poland, and an

[28] Despite an increase in exports to Russia in recent years, the share of this country in Polish exports is significantly smaller than during the 1998 Russian crisis. Before 1998, Russia accounted for more than 8% of Polish exports. At that time, it was the second most significant export market after Germany; currently it is the fifth one.

[29] This change was related to international corporations relocating production to Poland with a view to exporting goods to CIS countries, mostly to Russia. This was of the greatest significance to companies specialising in production of durable consumer goods, including, above all, household equipment. The value of consumer goods exports to Russia expanded more than tenfold during the last ten years (2003-2013).

[30] In April and May, pork prices rose back, by 1.1% m/m and 0.9% m/m, respectively. Due to substitution effect, prices for other kinds of meat also decreased. Meat prices declined by 0.8% m/m in March, and by a further 0.2% m/m in April. However, in May they increased back by 0.3% m/m.

[31] Favourable supply conditions in the global natural gas market should put a downward pressure on natural gas prices during the renegotiation of the contract with Gazprom in November 2014.

[32] The supplies were suspended solely to Ukrainian recipients, while natural gas is still channeled to other recipients.

increase in capacity to compensate for any supply disruptions with other sources, from 2015 on.[33]

If tensions between Russia and Ukraine do not intensify unexpectedly, their impact on Polish economy will likely remain limited. According to NECMOD simulations, lower economic growth in Russia and Ukraine might translate into weakening in Polish economic growth by 0.2 percentage points in 2014-15. At the same time, the impact on inflation in Poland should be of around 0.2 percentage points in 2014, and of 0.1 percentage points in 2015. However, the ultimate impact of tensions between Russia and Ukraine will likely depend on further development of the conflict, and is therefore subject to uncertainty.

2.2.5 Output

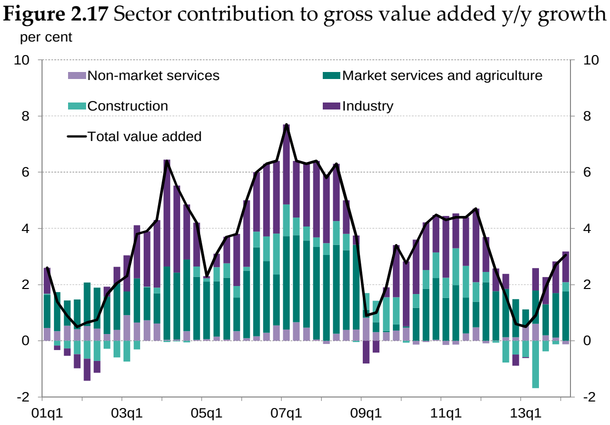
In 2014 Q1, the annual growth in gross value added accelerated to 3.0% (compared with 2.7% in 2013 Q4). This was primarily related to a rise - for the first time since 2012 Q1 - in value added in construction accompanied by further, if somewhat weaker than in the previous quarter, pick-up in value added growth in services and a moderate output growth in industry (Figure 2.17).[34]

The rise in gross value added in construction was reflected in a material pickup in the sector's output in 2014 Q1, which was facilitated by the fairly mild winter. Yet, a certain slowdown observed in construction output growth and orders in April and May implies a possible weakening in the upward trends in this sector (Figure 2.18).

Also industry data show recovery to have lost some pace in the first quarter as well as in April and May, following a period of stronger performance. Despite the above, industrial output growth and the PMI index have remained at the levels indicating a rise in economic activity in this sector (Figure 2.19).

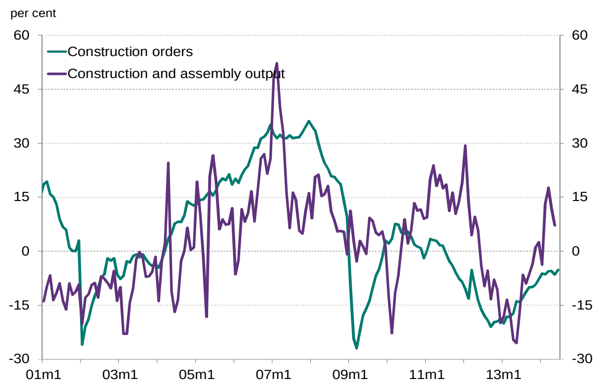
In the service sector, conditions have strengthened more firmly in 2014 Q1. Further acceleration in retail sales by businesses employing more than nine people (see Chapter 2.2.2 *Consumption demand*)[35] was

Figure 2.17 Sector contribution to gross value added y/y growth



Source: GUS data, NBP calculations.

Figure 2.18 Annual growth of construction and assembly output and construction orders



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

[33] There is a possibility of reverse gas supplies from the Czech Republic and Germany, as well as an increase in supplies through Belarus. In 2015, liquid natural gas terminal will be completed in Swinoujście, with up to 5 billion m^3 capacity (compared with 10 billion m^3 imported from Russia).

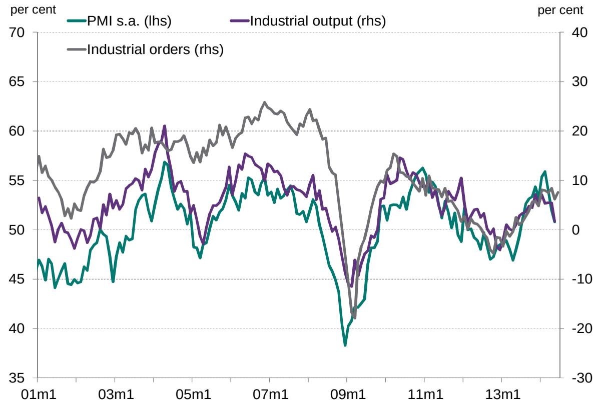
[34] Data on industrial output, orders, the PMI index, construction and assembly output and orders in construction are based on seasonally adjusted data (NBP calculations).

[35] Monthly data on retail sales do not fully reflect total retail sales growth. See footnote 18.

accompanied by rising nominal growth in the wholesale turnover, to 5.7% y/y in 2014 Q1 (compared with 4.4% y/y in 2013 Q4). At the same time, sale of services in transportation businesses slowed down slightly, to stand at 5.3% y/y in 2014 Q1 (compared with 8.1% in 2013 Q4).[36]

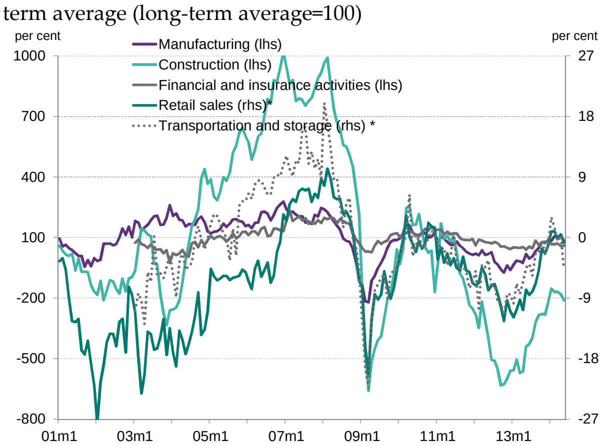
Following a period of growth, most GUS leading indicators of the business climate fell somewhat in 2014 H1, remaining close to their long-term averages, however (Figure 2.20). This shows that the improvement in enterprises' assessment of the economic outlook has been curbed.

Figure 2.19 PMI and annual growth of sold production of industry and of industrial orders



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

Figure 2.20 Forecast of economic situation in relation to the long-term average (long-term average=100)



Source: GUS business tendency survey, NBP calculations.
*As the value of the indicators of transportation and storage and retail sales are close to zero, the Figure presents their level instead of its changes against its long-term average.

Box 3: The role of market services in the development of the Polish economy

(Summary of analyses and conclusions based on the report of the NBP's Economic Institute "The role of market services in the development of the Polish economy")[37]

Over the past two decades, Polish economy has seen a gradual reallocation of labour from industry to the services sector. As a consequence, share of employment in services rose from 27.4% in 1995 to 37.1% in 2012 (Figure B.3.1). At the same time, the share of the services sector in the total value added grew only from 47.1% in 1995 to 48.9% in 2012 (Figure B.3.2). The rising importance of the services sector is a natural process in a catching-up economy and, in line with experience of many other countries, will bring in slower economic growth and less volatile business cycle in Poland.

[36] The increase in the sale of services in transportation businesses in 2014 Q1 was higher than in 2013 (3.0 % y/y) and in 2012 (4.3% y/y).

[37] The text bases on dataset from between 1995 and 2012. Construction, non-market services (public administration and national defense, education, health care and social welfare) and financial and insurance activities were excluded from analysis due to considerably greater cyclicality and unique character of long-term growth trends. More detailed results of the study can be found in the paper of the NBP's Economic Institute "*The role of market services in the development of the Polish economy*".

Figure B.3.1 Employment in Poland by sector

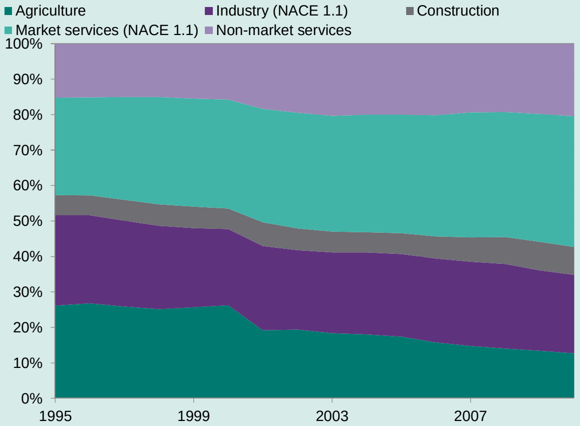
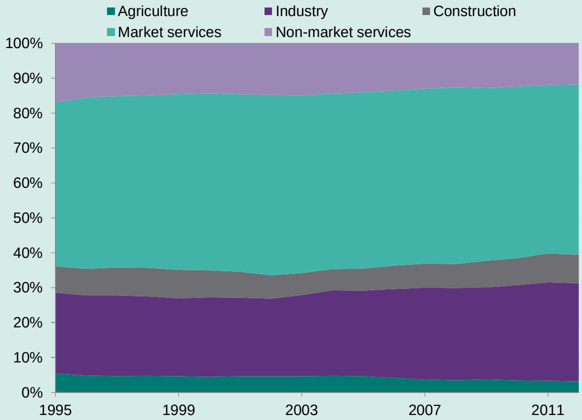


Figure B.3.2 Value added in Poland by sector

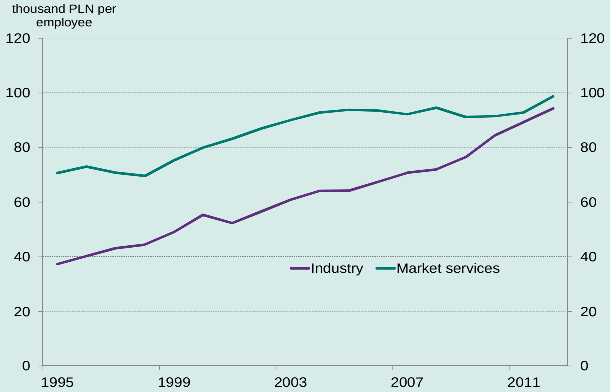


Source: Eurostat.

Impact of growing importance of the services sector on labour productivity in the Polish economy

Slow rise in the share of services in value added against a fast increase in employment results from much slower labour productivity growth in the services sector[38] (Figure B.3.3), similarly to developments worldwide. At the same time, unlike in advanced economies, the level of productivity has been higher in the services sector than in industry. This is a consequence of a higher initial level of capital intensity and total factor productivity (TFP).

Figure B.3.3 Labour productivity in industry and services



Source: NBP calculations based on Eurostat data.

However, Poland should be slowly following developed countries in this respect, as in the past two decades the growth rate of TFP and capital intensity in industry was considerably faster than in services.

Both relatively fast rise in the share of services in total employment and slow labour productivity growth in this sector are a natural consequence of catching-up process. Therefore like in other counties, they will translate into slower economic growth in Poland. However, growing share of innovative products in services in Poland – conducive to higher productivity growth in this sector – might be a factor slowing down this process.

Impact of growing importance of the services sector on the business cycle

A positive consequence of an increasing role of market services is the stabilizing effect this process exerts on the business cycle of the economy as a whole. This is because the amplitude and frequency of business cycle fluctuations of both value added and employment are lower for market services than for industry. This means that the business cycle in case of services is relatively longer and milder than for industry (Figure B.3.4, Figure B.3.5).

The reason for the lower amplitude in business cycle fluctuations for market services compared to industry is more diversified structure of demand for services and relatively smaller sensitivity to business cycle fluctuations of the economy as a whole.

In turn, greater sensitivity of industry to economic fluctuations is due to changes in demand for production and

[38] Labour productivity – value added per one employee.

supply goods over the business cycle of the economy as a whole. This holds also for consumer durables, whose purchase can be delayed as economic conditions deteriorate.

Figure B.3.4 Business cycle components in GDP * and in value added in services and industry

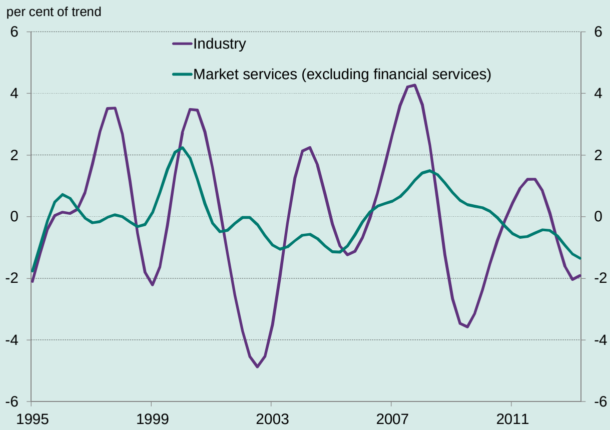
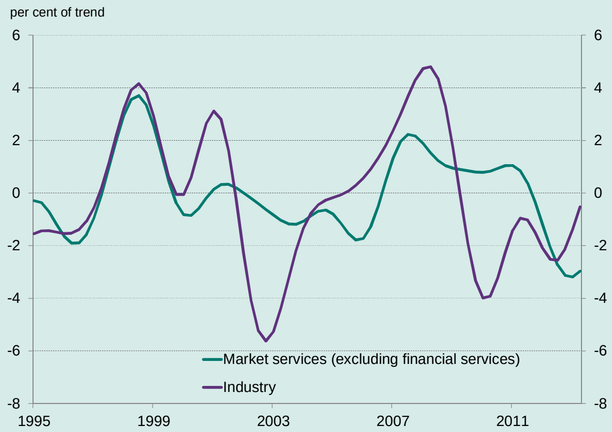


Figure B.3.5 Business cycle components in GDP* and size of employment in services and industry



Source: NBP calculations based on GUS data.

*The cyclical component to trend ratio determined with the use of the Christiano–Fitzgerald band-pass filter.

The greater cyclicality of industrial production compared to services is also partly due to a larger share of exports in industry.[39] The fact that services are less sensitive to business cycle fluctuations probably results also from households striving to smoothen consumption and relatively stable demand for ancillary services,[40] which are considered as fixed costs from the enterprise's perspective. over the business cycle.

Steadily growing share of services in employment and value added in Poland should therefore lead to slower economic growth in the long run and lower business cycle volatility.

2.3 Financial situation in the enterprise sector

In 2013 Q4 and 2014 Q1, the financial situation in the enterprise sector remained sound.

The financial results of enterprises in 2013 Q4 increased compared with the corresponding period of the previous year, driven by an improvement in results unrelated to core business operations of companies, including smaller losses on the sale and revaluation of fixed assets and investments (Figure 2.21).[41] In turn, profit on sales decreased. Lower result on sales was recorded primarily in the energy

Table 2.4 Selected financial efficiency ratios in the enterprise sector

per cent	2009	2010	2011	2012	2013 q1	2013 q2	2013 q3	2013 q4	2014 q1
Sales profitability ratio	5.0	5.2	5.3	4.3	4.3	4.5	4.6	3.8	4.5
Net turnover profitability ratio	4.1	4.4	4.5	3.4	3.2	4.7	4.1	3.4	3.8
Percentage of profitable enterprises	77.3	78.4	78.0	76.8	61.6	68.8	73.4	79.6	67.6
	end of period data								
Liquidity ratio of the first degree	0.39	0.40	0.38	0.34	0.33	0.33	0.33	0.35	0.34

Source: GUS data.

[39] Demand shocks originating, among others from eg. the euro area, influence the Polish business cycle to a great extent. The synchronization is particularly strong for a 3-year cycle, which is characteristic for the industrial sector.

[40] For example, the cost of office space maintenance, security, etc.

[41] At the same time, the financial performance of companies in 2013 Q4 deteriorated as compared to 2013 Q3, mainly due to a decline in the result on sales.

sector, where it was driven by reduced demand for energy due to the relatively mild winter. At the same time, in some sectors – in particular manufacturing and trade – result on sales rose.

The improvement in financial results was accompanied by a marked increase in net turnover profitability ratio, compared with the corresponding period of the previous year, and a rise in the percentage of profitable enterprises (Table 2.4). At the same time, sales profitability ratio decreased – along with a decline in the result in sales – and stood below the long-term average.

Data for 2014 Q1 indicate a further improvement in the financial situation of enterprises. The gross financial result of enterprises rose, compared with the previous year, supported by more favourable results in all areas of enterprises' activities.[42] The biggest contribution to the improvement in gross financial result was from increased result on sales, amidst growing domestic sales and exports.[43] The improvement in the financial results of enterprises was also supported by lower currency losses and was accompanied by rise in sales profitability and net turnover as against 2013 Q1.

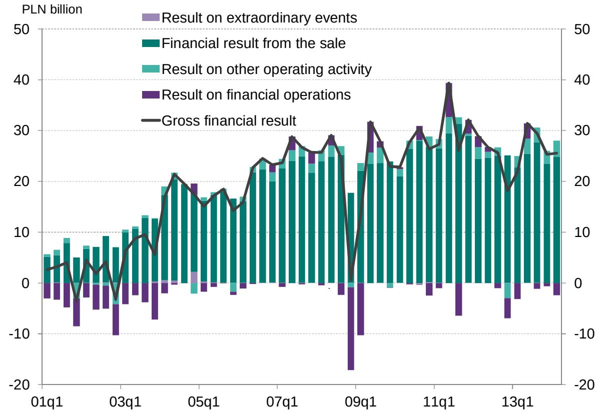
The liquidity position of companies in 2013 Q4 and 2014 Q1 remained sound as indicated by a slight rise in the liquidity ratio of the first degree in annual terms and a reduction in the percentage of enterprises reporting liquidity problems or payment delays as a barriers to development.[44]

2.4 Labour market

2.4.1 Employment and unemployment

In 2014 Q1, economic recovery was accompanied by

Figure 2.21 Gross financial result of enterprises and its components



Source: GUS data based on F-01/I-01 forms. NBP calculations.

Figure 2.22 Change (y/y) in the number of persons working in the economy according to the LFS data and reports of entities with a workforce of over 9 employees (GN); change in the number of persons employed in the enterprise sector

Source: GUS data, NBP calculations.

*LFS data adjustment for the findings of the 2011 National Census in GUS publications refers to the period starting in 2010 Q1. In order to preserve data comparability, earlier data in the graphs presented in this chapter have been corrected by the NBP.

[42] Gross financial result in 2014 Q1 was similar to that recorded in 2013 Q4.

[43] Growth in domestic sales accelerated as compared to 2013 Q4 (to 3.1% y/y against 1.6% y/y), while that of exports slightly decelerated (to 3.6% y/y from 4.6% y/y).

[44] *NBP Quick Monitoring Survey. Economic climate in the enterprise sector in 2014 Q1 and forecasts for 2014 Q2*, NBP.

a gradual improvement in labour market conditions.

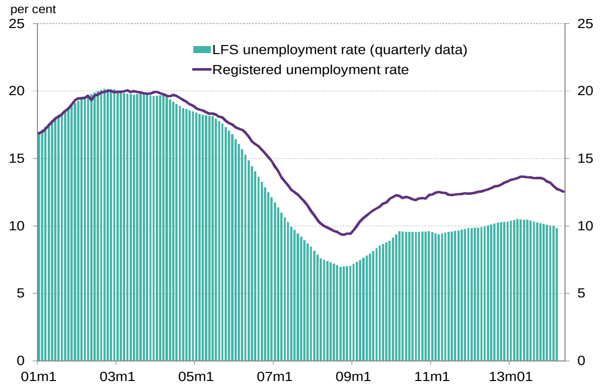
According to Labour Force Survey data, in 2014 Q1 growth in the number of working persons in the economy accelerated to 1.8% y/y (as compared to 0.5% y/y in 2013 Q4). This was primarily the result of the growth in the number of persons employed in services, which gained momentum amidst the recovery in this sector (up to 2.1% y/y from 0.9% y/y in 2013 Q4). The number of persons employed in industry also grew faster than in the previous quarter (by 2.5% y/y as compared to 1.1% y/y in 2013 Q4). At the same time, a fall in the number of those employed in agriculture decelerated (to -1.0% y/y against -3.0% y/y in 2013 Q4).

In 2014 Q1, for the first time in over a year employment in the enterprise sector also slightly increased (by 0.1% y/y against a fall of 0.8% y/y in 2013 Q4).[45] NBP business climate surveys indicate that this growth may be sustained in 2014 Q2. In particular, the employment forecast indicator remained positive, indicating that enterprises planning to increase employment still outnumber these anticipating to reduce it.[46] Improvement of this indicator – significant in 2014 Q1 – slowed down in 2014 Q2, however.

In 2014 Q1, the seasonally adjusted LFS unemployment rate amounted to 9.8% being markedly lower than in the previous quarter (10.1%; Figure 2.23). Also the annualised LFS unemployment rate declined, despite a significant increase in labour supply (Figure 2.24). The growth in labour supply was driven by rising economic activity rate among women aged 15-34 and persons approaching retirement age (45-59/64).

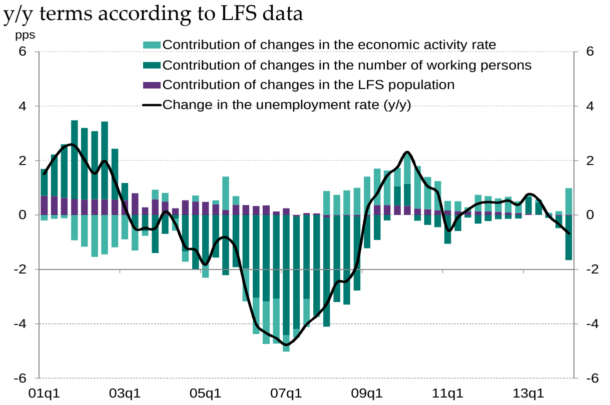
Data from labour offices also indicate a further gradual decline in unemployment in the recent months. In April 2014, the seasonally adjusted

Figure 2.23 Registered unemployment rate and unemployment rate according to the Labour Force Survey



Source: GUS data (seasonally adjusted).

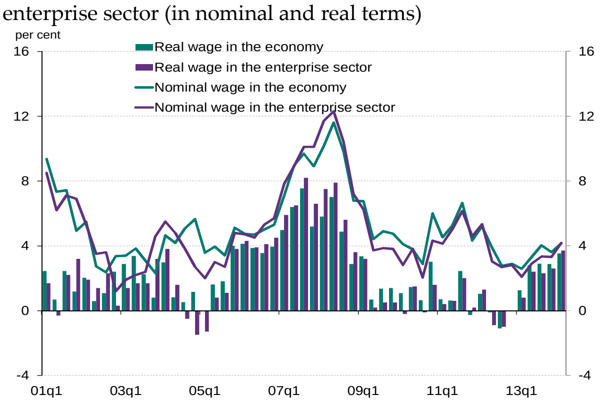
Figure 2.24 Breakdown of change in the unemployment rate in y/y terms according to LFS data



Source: GUS data, NBP calculations.

Change in the unemployment rate can be further broken down in: 1) change in the size of working age population (in LFS terms, as in the graph), 2) change in economic activity of productive-age persons (change in the economic activity rate), 3) change in labour demand in LFS terms. Change in the population in LFS terms may depend on demographic trends or migration.

Figure 2.25 Annual wage growth in the economy and in the enterprise sector (in nominal and real terms)



Source: GUS data.

[45] Both in April and May 2014 employment growth in the corporate sector amounted to 0.7% y/y.

[46] This refers to seasonally adjusted indicator. *NBP Quick Monitoring. Economic climate in the enterprise sector in 2014 Q1 and forecasts for 2014 Q2*, NBP.

registered unemployment rate stood at 12.7% (as compared to 13.2% in January 2014).[47] At the same time, according to NBP estimates, in 2014 Q1 the likelihood of job loss declined substantially, while the likelihood of finding work grew slowly.

2.4.2 Wages and labour productivity

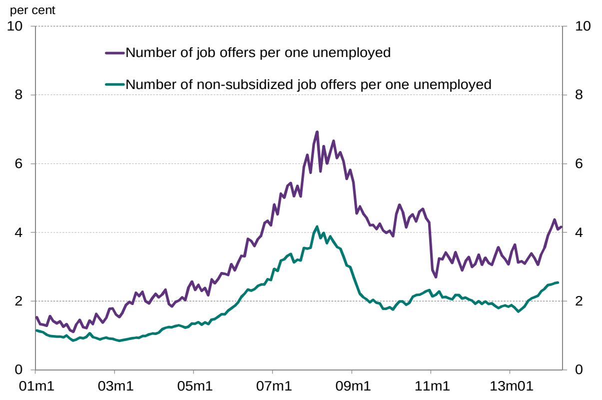
In 2014 Q1, wage growth in the economy and the corporate sector picked up somewhat. At the same time, labour productivity slowed down. As a result, growth in unit labour costs increased slightly, yet, remained at a moderate level.

The increase in demand for labour associated with the recovery in domestic activity boosted pay growth in the economy, including in the corporate sector in 2014 Q1. Wage growth both in the economy and the corporate sector stood at 4.2% y/y (as against 3.6% y/y and 3.3% y/y respectively in 2013 Q4; Figure 2.25).[48]

In 2014 Q1, the faster pay rise was accompanied by an increase in the index of labour market tensions (Figure 2.26).[49] The year-long growth of this index suggests a gradual erosion of the advantage of the employers in wage negotiations with employees. However– as indicated by NBP's business climate surveys – this has not had a significant impact on the plans of enterprises regarding wage rises. The proportion of enterprises planning wage rises in 2014 Q2 – although higher than a year ago – fell slightly on a quarterly basis. At the same time, the size of the planned rise in wages remains small.[50]

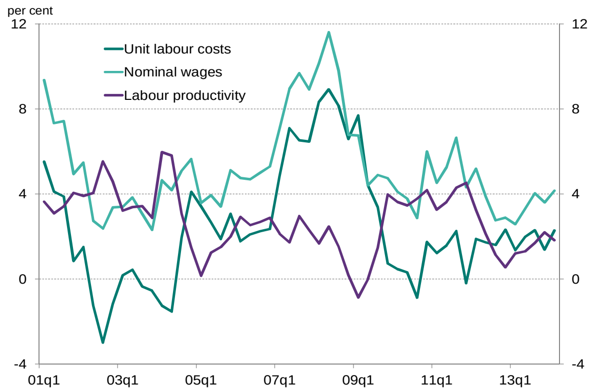
In 2014 Q1, the growth in the number of working persons in the economy exceeded that of GDP, resulting in a slower rise in labour productivity.

Figure 2.26 Market tension index (vacancies per unemployed)



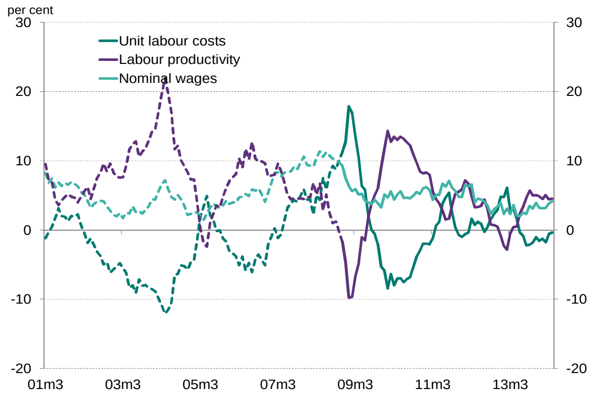
Source: GUS data, NBP calculations.

Figure 2.27 Annual growth in labour productivity, wages and unit labour costs in the economy



Source: GUS data, NBP calculations.

Figure 2.28 Annual growth in labour productivity, wages and unit labour costs in industry (moving three-month averages)



Source: GUS data, NBP calculations.

Since January 2009, new PKD classification (PKD 2007) has been used, due to which the growth rates of wages and employment in industry from December 2008 (dashed line in the graph) are not fully comparable with the subsequently recorded rates.

[47] According to Ministry of Labour and Social Policy estimates the seasonally adjusted registered unemployment rate declined to 12.6% in May 2014. There are two reasons for the difference between the LFS unemployment rate and the registered unemployment rate: (1) the definition of an unemployed person is different, (2) the definition of population to which the number of unemployed persons is referred is different.

[48] In April and May 2014, wage growth in the corporate sector amounted to 3.8% y/y and 4.8% y/y respectively.

[49] The index of labour market tensions is calculated as the number of nonsubsidised job offers per one unemployed.

[50] *NBP Quick Monitoring. Economic climate in the enterprise sector in 2014 Q1 and forecasts for 2014 Q2*, NBP

This, coupled with accelerating wage growth, translated into higher unit labour costs growth (Figure 2.27).

In turn, monthly data on industrial enterprises indicate a continued decline in unit labour costs in this sector in 2014 Q1, amidst labour productivity still growing faster than wages (Figure 2.28).

2.5 Financial markets and asset prices

Over recent months, prices of Polish financial assets have risen on the back of the gradual domestic economic recovery, coupled with both narrowing external imbalances and improvement in the country's creditworthiness. The rise in asset prices was additionally driven by monetary policy easing by the ECB. Gradual improvement in economic conditions was also reflected in further signs of revival in the housing market.

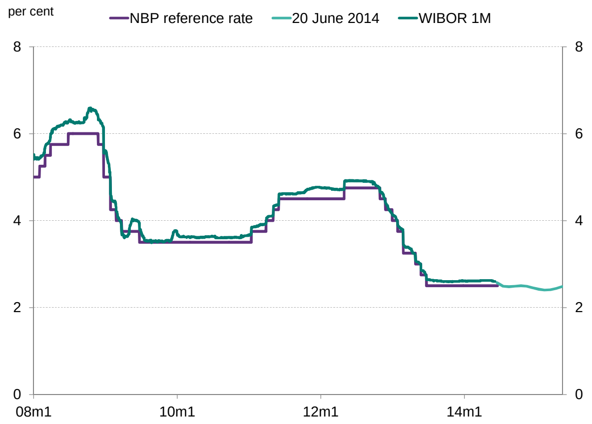
2.5.1 Interest rates and financial asset prices

Since the publication of the previous *Report*, the Monetary Policy Council has not changed NBP interest rates, leaving the reference rate at 2.50%. The majority of market participants currently expect that NBP interest rates will be stable in the coming quarters, although some also point to a possibility of a reduction in interest rates (Figure 2.29).

Similarly to other emerging market economies, Polish government bond yields fell in recent months (Figure 2.30) (see Chapter 1.3 *Monetary policy abroad and international financial markets*) supported by expected monetary easing by the ECB and abatement of risk aversion in the international financial markets.

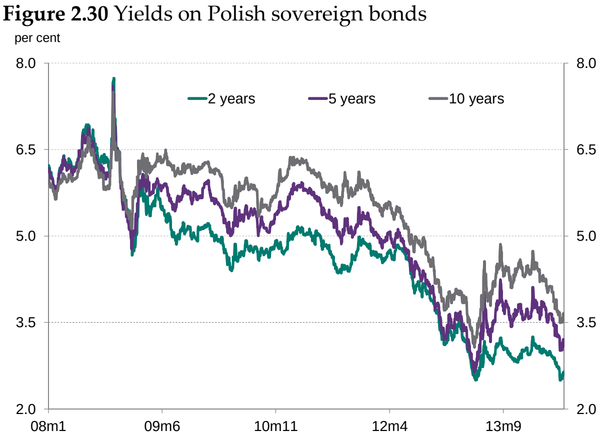
The fall in Polish government bond yields was also driven by an improvement in country's credit risk assessment, reflected in narrowing CDS spreads. Following a period of decline since May 2013, the share of non-residents in the Polish bond market has

Figure 2.29 NBP reference rate, WIBOR 1M (till June 2014) and 1M interest rate implied by FRAs (since June 2014)



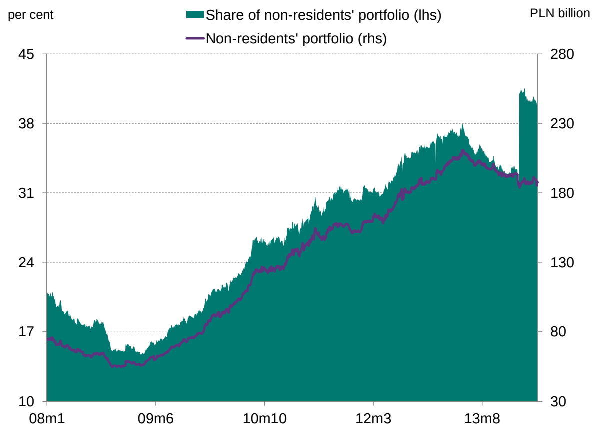
Source: Bloomberg data, NBP calculations.

Figure 2.30 Yields on Polish sovereign bonds



Source: Bloomberg data.

Figure 2.31 Non-resident exposure in the Polish sovereign bond market



Source: National Depository for Securities (KDPW) data.

stabilized,[51] despite a continued reduction in the scale of Fed's quantitative easing and the political crisis in Ukraine (Figure 2.31).

Since the previous *Report*, major stock indices in Poland have risen (Figure 2.32) on the back of good financial performance of Polish enterprises and a gradual economic recovery at home.

2.5.2 Exchange rate

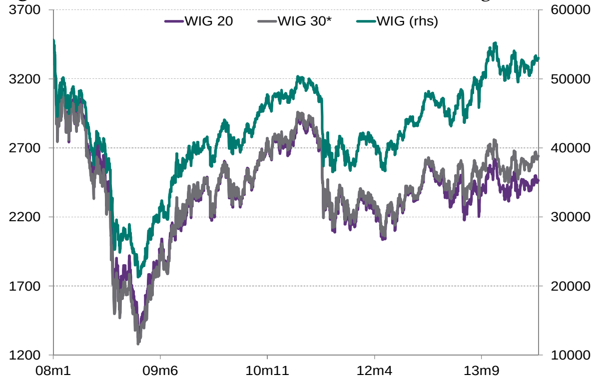
In recent months, the zloty has appreciated against the euro (Figure 2.33), which was due to further gradual improvement in economic conditions (see Chapter 2.2 *Demand and output*) and narrowing external imbalances over recent quarters (see Chapter 2.7 *Balance of payments*), as well as monetary policy easing by the ECB (see Chapter 1.3 *Monetary policy abroad and international financial markets*).

2.5.3 Home prices[52]

In 2014 Q1, the housing market showed further signs of revival. The number of transactions concluded in the primary market continued to rise. This was driven by growing demand for housing, which was supported by gradual economic recovery, low interest rates on zloty denominated mortgage loans, as well as the launch of a new government scheme supporting home sales in the primary market ("Flat for the Young"). Due to low price limits this scheme contributed to a stabilization or even a slight decline in home prices in Poland's major cities (Figure 2.34).

At the same time, tightening of mortgage lending criteria in early 2014 was conducive to lower demand for housing and lower home prices, both in

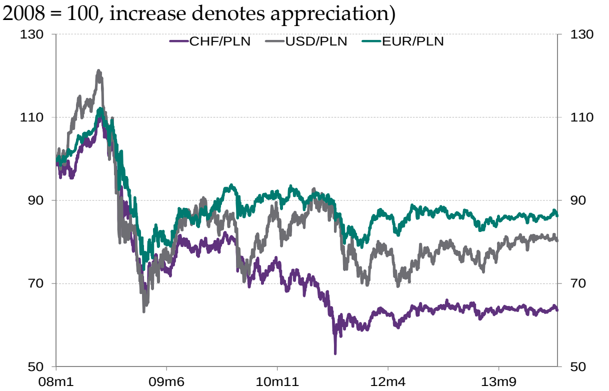
Figure 2.32 WIG, WIG 20 and WIG 30 stock exchange indices



Source: Bloomberg data.

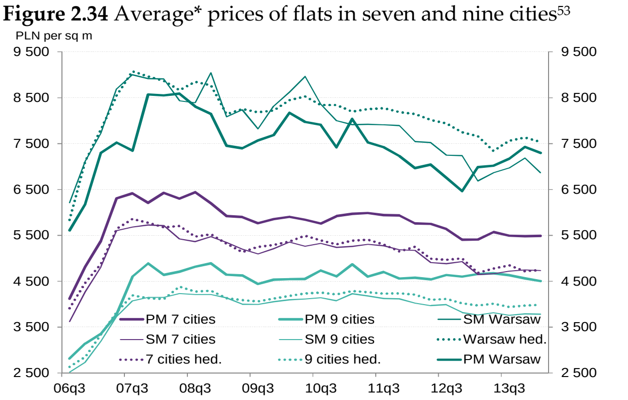
*WIG30 compounds shares of 30 largest and most liquid companies in the Warsaw Stock Exchange. WIG30 is to replace WIG20. Until the end of 2015, both indices will be released.

Figure 2.33 Nominal exchange rate of the Polish zloty (January 2008 = 100, increase denotes appreciation)



Source: Bloomberg data.

Figure 2.34 Average* prices of flats in seven and nine cities[53]



Source: NBP calculations on the basis of sale price data from the NBP survey and PONT Info Nieruchomości asking price data.

* Asking prices are weighted by the number of offers; sale prices in the primary market –by the share of the housing stock in a given city in the total housing stock of all cities; sale prices in the secondary market were adjusted for differences in the qualities of flats. PM – primary market, SM – secondary market, hed. – hedonic price index.

[51] The surge in the share of non-residents in the Polish government bond market was associated with the transfer of part of the government bonds from open pension funds to the Social Security Institution (ZUS), which resulted in lower share of domestic investors in the Polish government bond market.

[52] More information on the Polish housing market can be found in the NBP publications *Information on home prices and the situation in the residential and commercial real estate market in Poland in 2014 Q1*, available at the NBP website www.nbp.pl.

[53] The index for seven cities includes: Gdańsk, Gdynia, Kraków, Łódź, Poznań, Szczecin and Wrocław, and the index for nine cities – Białystok, Bydgoszcz, Katowice, Kielce, Lublin, Olsztyn, Opole, Rzeszów and Zielona Góra.

the primary and secondary markets (see Chapter 2.6 *Credit and money*).

Growing number of transactions was accompanied by a further decline in the number of unsold housing units (Figure 2.35). Alongside that, the number of building permits issued in 2014 Q1 exceeded that recorded in the corresponding period last year. This was most probably because of an increase in profitability of real estate development in previous quarters. The number of new housing investments rose in 2014 Q1, in part probably due to winter season being less severe than a year before.

Figure 2.35 Housing construction in Poland in first quarters

Source: GUS data, NBP calculations.

* Production index measures housing construction sector conditions (flats started less completed introduced to the market, 12-month moving value of work in progress). An increase in the index may indicate that investors might be unable to meet commitments on completed facilities, which can lead to investment freeze and irregular payments.

Box 4: Monetary policy transmission mechanism in Poland in the light of recent studies.[54]

Structural features relevant for the monetary policy transmission mechanism and model-derived results

Structural features of the Polish economy allow for the operation of all traditional channels of monetary policy transmission mechanism. Yet, since NBP adopted inflation targeting strategy, the relative importance of particular channels has changed (Table B.4.1). The most considerable change observed over recent years was a weakening impact of the exchange rate on inflation and economic growth.

Simulations performed on a small structural MMT 2.0 model of transmission mechanism show that following a 1 percentage point rise in the short-term interest rate for four quarters inflation falls by approx. 0.7 percentage points in the sixth quarter after the impulse. The decline in inflation can be predominately attributed to the interest rate channel. The remaining change can be explained with the exchange rate channel and the credit channel (Figure B.4.1).

Table B.4.1 Structural features of the Polish economy relevant for the monetary policy transmission mechanism

Main structural factors strengthening the channel, 1998-2013	Main structural factors weakening the channel, 1998-2013
Interest rate channel	
▪ development of the financial system; ▪ important role of bank credit among external sources of business finance; ▪ growing competition in the banking sector.	▪ dominant role of internal sources of business finance; ▪ foreign currency loans.
Credit channel	
▪ dominant role of banks in the financial system; ▪ important role of bank credit among external sources of business finance.	▪ liquidity surplus in the commercial banking sector; ▪ dominant role of internal sources of business finance.
Exchange rate channel	
▪ openness of the economy, growing number of commercial and financial relations with abroad.	▪ trade within global supply chains; ▪ decline in inflation and its volatility.

Source: NBP study based on Kapuściński *et al.* (2014).

Has the response of inflation to changes in short-term interest rates become stronger?

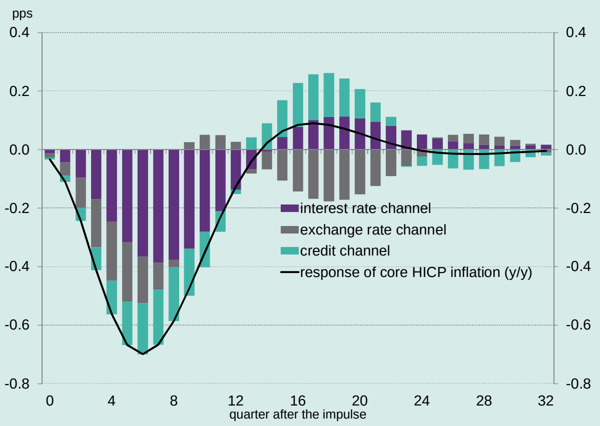
The response of inflation to the monetary policy impulse, estimated by means of the MMT 2.0 model, is greater than suggested by the previous studies (Demchuk et al., 2012). This seems somewhat surprising,

[54] The box bases on a study of NBP's Economic Institute: Kapuściński *et al.* (2014).

especially when considering that model-based simulations show no significant change in the response of economic activity to the interest rate impulse and a weakening of the exchange rate channel (both appreciation effects of monetary policy tightening and the exchange rate pass-through).

The conclusion that inflation responds stronger to interest rate changes may, to some extent, result from the model itself, as the model used currently accounts more for some elements of the transmission mechanism (e.g. the importance of expectations and of the credit channel). However, there is also a set of economic factors explaining this effect. Firstly, it is currently observed that the impact of changes in real economy on the price level in Poland is faster and somewhat stronger than in the past.[55] Secondly, expectations as a factor shaping both current economic activity and the price level have grown in importance. As a result of these circumstances, the impact of the interest rate channel is quicker and its effects overlap more with the direct impact of exchange rate fluctuations on import prices. Therefore, the response of inflation has become stronger as compared to the previous estimates. Yet, it should be noted that this effect may, to some extent, be temporary and due to the fact that the analysis covers an extraordinary period of disturbances related with the global financial crisis, during which agents adjusted faster to changes in economic conditions and the role of expectations increased.

Figure B.4.1 Breakdown of responses to the interest rate impulse



Source: Kapuściński et al. (2014).

Changes in the functioning of the main channels of the transmission mechanism

The latest analysis leads to two main conclusions regarding the functioning of the most important channels of monetary policy transmission mechanism in Poland. First, they suggest that crisis-related interest rate channel disturbances are gradually abating. Second, the results of the model-based simulations also indicate a weakening of the exchange rate channel of the transmission mechanism, especially with respect to the impact of the exchange rate on consumer prices.

Gradual disappearance of interest rate channel disturbances related to the global financial crisis

Disturbances in the interest rate channel caused by the financial crisis are slowly disappearing (Łyziak et al., 2011, Demchuk et al., 2012). Although the volume of trade in the money market continues to be lower than before the global financial crisis, money market rates adjust relatively quickly to monetary policy decisions, and spreads between money market rates and NBP reference rate have fallen to near zero (Figure B.4.2). Due to the lagged effects of the previously observed market turmoil the money market rates continue to impact the rates on loans and deposits. However, this impact is significantly less pronounced than in the initial stage of the crisis. In particular, one cannot reject the hypothesis that in the longer term the average interest rates on deposits and loans will fully adjust to changes in market interest rates.

The spreads between bank deposit and loan interest rates and money market rates remain, in many cases, at

[55] This is confirmed by the results of the estimation of the New Keynesian Phillips curve and NBP's labour market surveys, showing that over recent years the impact of demand variables, mainly of cyclical nature, on wage setting in the enterprise sector has increased (NBP, 2013). On the other hand, NBP's surveys of enterprises show that the frequency of price changes by enterprises has increased somewhat in the recent years, with variable mark-ups used somewhat more often than constant mark-ups (NBP, 2013b).

elevated levels as compared to the pre- crisis period. Comparing changes in the strength of retail rate adjustability in both periods, it seems that interest rates on deposits (especially with maturities ranging from 1 month to 3 months, i.e. those which banks sought the most in the recent years) are more responsive to changes in market interest rates than interest rates on loans. Weaker pass-through effect of changes in market rates on interest rates on loans may be associated with asymmetric adjustments in the periods of ups and downs in market rates (Sznajderska, 2013).

An increase in domestic interest rates leads to a decrease in loans denominated in the zloty. Growth in loans to households, including small family enterprises, falls faster and stronger compared to corporate loans.

Weakening of the exchange rate channel of the transmission mechanism

The impact of exchange rate changes on consumer prices (CPI) has declined in the past three years (Figure B.4.3). This phenomenon is a typical manifestation of the country's growing economic stability and rising credibility of its monetary policy, which was observed on a similar scale in industrialized countries in the late 1980s and early 1990s[56].

The decline in the pass-through of exchange rate changes into producer prices in industry (PPI) and accelerating response of those prices to exchange rate movements point to significant changes in the production process and may be indicative of a steady slowdown in the pass-through effect on consumer prices. Given that the pass-through effect for transaction prices of imports, including consumer goods, remains relatively high, it may be presumed that the decline in the sensitivity of consumer price to exchange rate changes is, to some extent, cyclical. Moreover, reduced volatility of the zloty observed in the recent period may – in line with the experiences of many developing countries (Correa, Minella (2006), Mihaljek, Klau (2007), Przystupa, Wróbel (2011)) – strengthen the pass-through effect. Consequently, the pass-through effect could be expected to increase in the future, to reach a level of slightly above 0.1.

Figure B.4.2 Spreads between money market rates and NBP reference rate

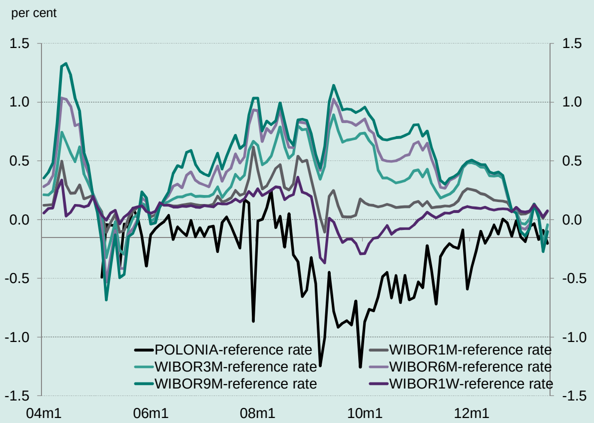
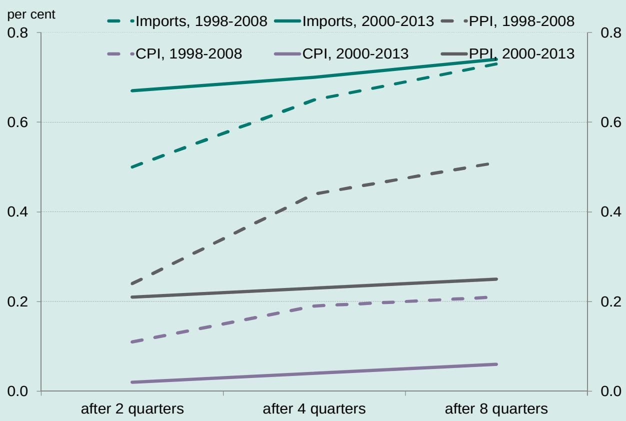


Figure B.4.3 The exchange rate pass-through effect according to the price index



Source: Kapuściński *et al.* (2014).

As indicated by NBP's recent studies, the impact of the exchange rate on the real economy has also decreased. The analysis of determinants of the Polish exports shows that while in 1998 the exchange rate explained almost 40% growth in exports, in 2013 it accounted for a mere 23% export growth. This is

[56] The estimates could have also been affected by a 2-year shift in the starting point of the analysis (from 1998 to 2000) and extension of the analysis to include the period between 2011 and 2013.

probably due to the rising importance of multinationals making settlements within their capital group. The analysis of the factors affecting the volume of imports suggests, in turn, that the importance of the exchange rate has remained relatively stable (approx. 20%). According to the latest estimates, 10% depreciation of the real effective exchange rate results, with a one-quarter delay, in an increase in the annual GDP growth in real terms of approx. 0.3 percentage points.

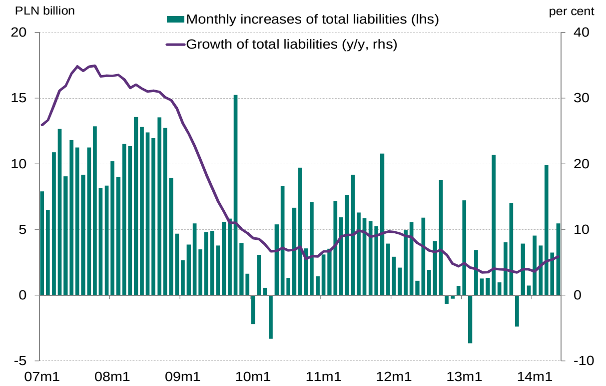
References:

Correa A. S., Minella A. (2006), *Nonlinear Mechanisms of the Exchange Rate Pass-Through: A Phillips curve model with threshold for Brazil*, Working Paper Series No. 122, Banco Central do Brasil.
Demchuk O., Łyziak T., Przystupa J., Sznajderska A., Wróbel E. (2012), *Monetary policy transmission mechanism in Poland. What do we know about it in 2011?*, NBP Working Paper no. 116, Narodowy Bank Polski.
Kapuściński M., Łyziak T., Przystupa J., Stanisławska E., Sznajderska A., Wróbel E. (2014), *Monetary policy transmission mechanism in Poland. What do we know about it in 2013?*, NBP Working Paper no. 180, Narodowy Bank Polski.
Łyziak T., Przystupa J., Stanisławska E., Wróbel E. (2011), *Monetary policy transmission disturbances during the financial crisis: a case of an emerging market economy*, Eastern European Economics, 49(5), 75-96.
Mihaljek D., Klau M. (2007), *Exchange rate pass-through in emerging market economies: what changed and why?*, BIS Paper no. 35.
NBP (2013a), *Badanie Ankietowe Rynku Pracy. Raport 2013*, Economic Institute, Narodowy Bank Polski.
NBP (2013b), *NBP Quick Monitoring Survey. Economic climate in the enterprise sector in 2013 Q2 and forecasts for 2013 Q3*, Economic Institute, Narodowy Bank Polski.
Przystupa J., Wróbel E. (2011), *Asymmetry of the exchange rate pass-through: an exercise on the Polish data*, Eastern European Economics, 49(1), 30-51.
Sznajderska A. (2013), *On the empirical evidence of asymmetry effects in the Polish interest rate pass-through*, The Journal of Economic Asymmetries, 10(2), 78-93.

2.6 Credit and money

Ongoing economic recovery brought a slight acceleration in lending in 2014 Q1 (Figure 2.36).[57] The rise in lending referred to all its main categories, with total debt of the non-financial sector, non-monetary financial institutions, local governments and social insurance funds increasing by an average of PLN 6.0 billion per month, as compared to PLN 2.3 billion recorded in the corresponding period of 2013. In 2014 Q1, this debt rose by 4.4%.[58]

Figure 2.36 Total liabilities of non-financial sector, non-monetary financial institutions, local government units and social insurance funds



Source: NBP data.

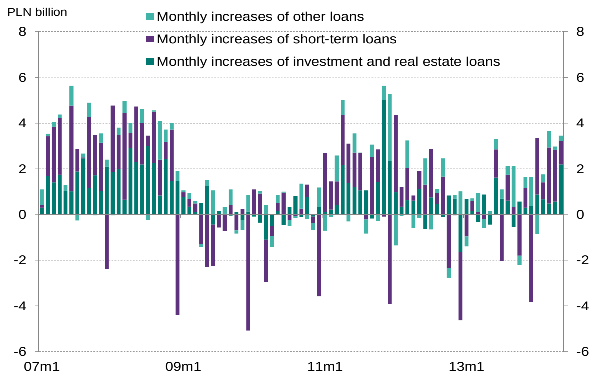
In 2014 Q1, corporate debt growth picked up. (Figure 2.37). Growth in corporate lending was

[57] Data on increases in assets and liabilities presented in this chapter refer to transactional changes. In the case of corporates, the size of both lending and deposits are subject to heavy seasonal variations (seen, in particular, at the beginning of the year), therefore average monthly increases in corporate loans and deposits are compared against corresponding periods of subsequent years.
[58] This debt increased by PLN 3.2 bn in April and PLN 5.4 bn in May (against PLN 1.2 bn and PLN 1.3 bn in the corresponding months of 2013). The growth rate of corporate debt stood at 5.9% y/y in May.

primarily recorded in the short-term loans segment and, to a lesser extent, investment loans. Household debt growth continued to gradually accelerate in 2014 Q1, mainly due to a further revival in consumer loans (Figure 2.42).

Amidst the further relatively slow growth in total credit, expansion in monetary aggregates remained moderate in 2014 Q1.

Figure 2.37 Breakdown of increases in loans to corporations



Source: NBP data.

2.6.1 Corporate lending

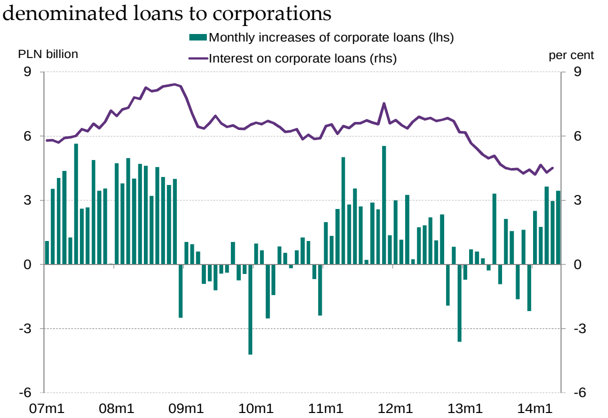
In 2014 Q1, corporate debt increased by an average of PLN 2.6 billion per month,[59] significantly faster than in the corresponding quarter of 2013 (with an average increase of PLN 0.2 billion). The rebound in lending in the corporate sector was primarily driven by high growth in short-term loans associated with the payment of premiums and annual bonuses (short-term loans increased by PLN 5.7 billion versus a PLN 0.4 billion decline recorded in 2013 Q1; Figure 2.37).

At the same time growth in investment loans increased slightly, which was driven by rising investment demand (see Chapter 2.2.2 *Investment demand*).

The recovery in lending to the corporate sector was supported by interest rates on loans remaining stable since July 2013, which – given unchanged NBP interest rates during this period – pointed to the stabilization of loan margins (Figure 2.38). The acceleration in lending was also driven by the increasing availability of bank credit and growing credit demand.[60]

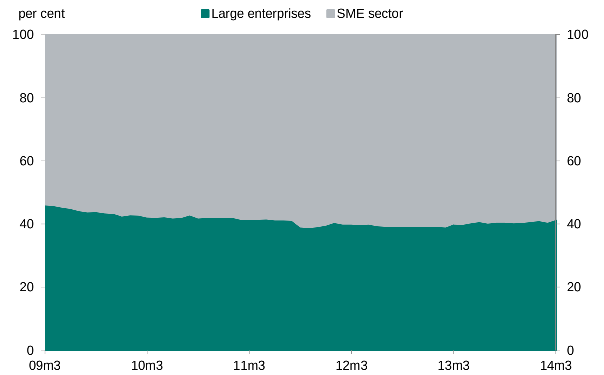
Growing demand for loans in 2014 Q1 was observed both among large enterprises and – to a lesser extent

Figure 2.38 Monthly increases and average interest on new zloty denominated loans to corporations



Source: NBP data.

Figure 2.39 Breakdown of corporate debt



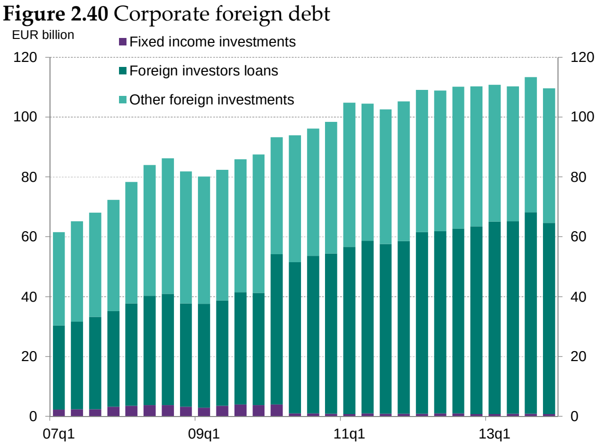
Source: NBP data

[59] In March 2014, corporate debt amounted to PLN 267.6 bn. In April and May 2014, corporate debt picked up by PLN 3.0 bn and PLN 3.4 bn correspondingly (versus a decline by PLN 0.3 bn in both April and May 2013).
[60] According to banks, easing in corporate lending policy was supported by a more favourable assessment of loan portfolios and increased competitive pressure on the part of other banks see: *Senior loan officer opinion surveys on bank lending practices and credit conditions*, 2014 Q2, NBP and *NBP Quick Monitoring. Economic climate in the enterprise sector in 2014 Q1 and forecasts for 2014 Q2*, NBP.

– small and medium-sized enterprises. Yet, the debt structure of the enterprise sector by company size did not change significantly as compared to the corresponding period of the previous year (Figure 2.39).

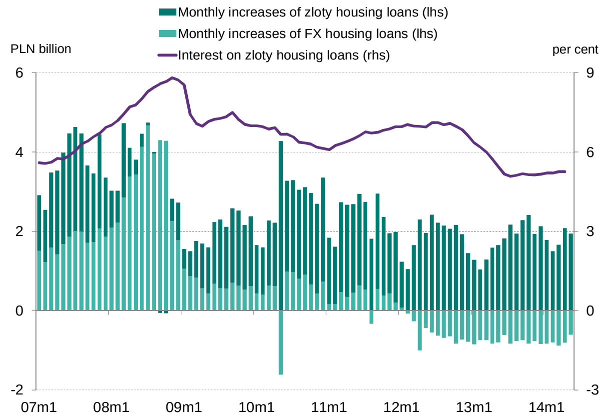
Corporate foreign debt in 2013 Q4 declined by EUR 3.7 billion, to the level of EUR 109.6 billion (Figure 2.40). This decline was almost entirely driven by the reduced scale of lending to businesses by foreign direct investors.

Figure 2.40 Corporate foreign debt



Source: NBP data.

Figure 2.41 Monthly increases and average interest on new housing loans to households



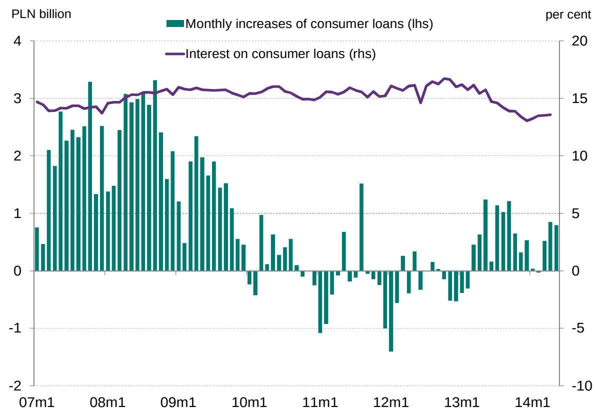
Source: NBP data.

2.6.2 Loans to households

In 2014 Q1, the average monthly increases in housing loans grew to PLN 0.8 billion as compared to PLN 0.4 billion in 2013 Q1 (Figure 2.41).[61]

The increase in lending in the home loan segment was primarily due to the signs of recovery in the residential market, the launch of the government-subsidized "Flat for the Young" housing scheme and persistently low interest rates on loans. At the same time, lending in this segment was curbed as banks declared their intention to tighten lending criteria imposed by the implementation of the amended S Recommendation (Figure 2.41).

Figure 2.42 Interest on new consumer loans to households



Source: NBP data.

In 2014 Q1, lending in the consumer loan segment edged up slightly (by an average of PLN 0.2 billion per month, as compared to an average monthly decline of PLN 0.1 billion in the corresponding quarter of 2013; Figure 2.42).[62]

A minor recovery in consumer loans was driven by a further gradual easing of banks' lending policies associated with the improved quality of loan portfolios reported by banks.[63]

[61] Both in April and May 2014, housing loans increased by PLN 1.3 bn (against 0.8 and 0.9 PLN bn a year before, respectively)
[62] In April and May 2014, consumer debt volume rose by 0.9 and 0.8 bn PLN (against 0.6 and 1.2 bn PLN a year ago).
[63] *Senior loan officer opinion surveys on bank lending practices and credit conditions*, 2014 Q2, NBP.

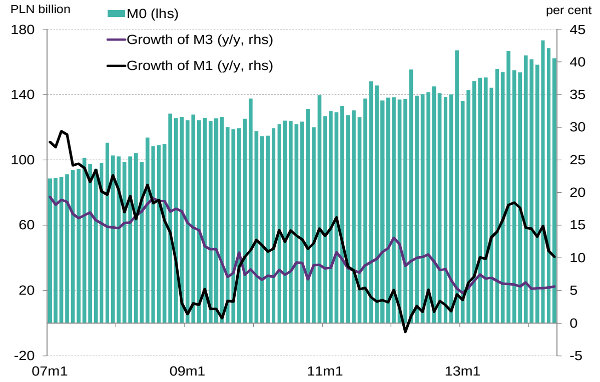
2.6.3 Deposits and monetary aggregates

In 2014 Q1 a relatively low growth rate of broad money continued (Figure 2.43). At the same time, growth in M1 aggregate decreased as compared to 2013 Q4,[64] mainly on the account of changes in the term structure of the deposits of enterprises and households (slower growth in funds placed in current accounts and stronger rise in term deposits).[65]

In 2014 Q1, corporate deposits decreased on average by PLN 4.1 billion a month as compared to their average decline of PLN 2.5 billion in the corresponding period of 2013 (Figure 2.44).[66] At the same time, amidst further relatively low interest rates, growth in household deposits continued to slow down. Monthly increases in deposits amounted to PLN 4.6 billion and were lower than in the corresponding period of 2013 (when they totalled PLN 5.3 billion; Figure 2.45).[67]

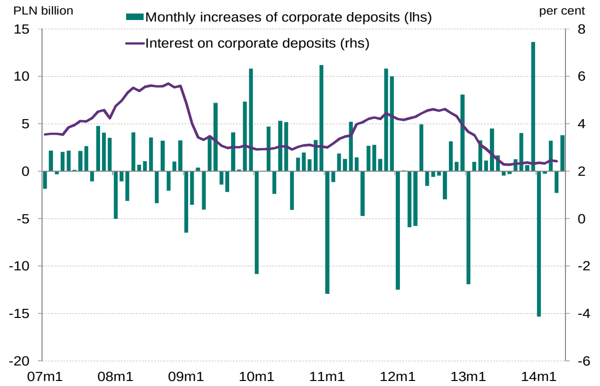
Alongside that, the volume of funds held by households in investment funds declined, which was related to the temporary drop in share prices on the Warsaw Stock Exchange (the average monthly net inflow of capital to investment funds in 2014 Q1 amounted to PLN 0.4 billion as against PLN 1.0 billion in the corresponding period of 2013). At the same time, the value of government bonds and life insurance policies held by households increased. The total value of households' financial assets increased to PLN 908.0 billion as compared to PLN 838.2 billion in the corresponding period of the

Figure 2.43 Monetary aggregates



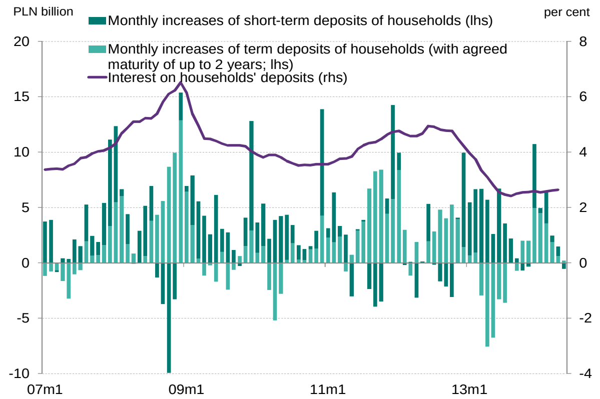
Source: NBP data.

Figure 2.44 Interest on deposits of corporations



Source: NBP data.

Figure 2.45 Monthly increases and average interest on deposits of households



Source: NBP data.

[64] In 2014 Q1, the growth rate of broad money remained at a level similar to that in 2013 Q4 (to 5.4% y/y). At the same time, the growth rate of M1 aggregate continued below the level recorded in 2013 Q4 (to 14.9% y/y).
[65] Term deposits – up to two-year deposits and deposits redeemable in up to three months. In April and May 2014, the growth rate of broad money (5.6% y/y and 5.4% y/y correspondingly) remained at the March 2014 level (5.4% y/y). At the same time, the rate of growth of M1 aggregate decreased to 10.2% y/y in May 2014 (versus 11.1% y/y in April and 14.9% y/y in March 2014).
[66] In April 2014, corporate deposits fell by PLN 2.3 bn as compared to their rise of PLN 1.1 bn registered in the corresponding quarter of the previous year. In May 2014, corporate deposits rose by PLN 3.8 bn (compared to an increase of PLN 4.5 in May 2013).
[67] In April 2014, household deposits increased by PLN 1.5 bn as against a decline of PLN 1.9 bn in the corresponding period of 2013. In May 2014, household deposits decreased by PLN 0.4 bn as compared to their fall of PLN 4.1 bn in May 2013.

previous year (Figure 2.46).[68]

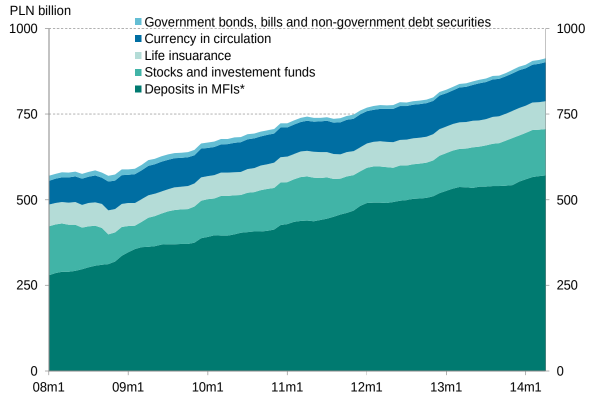
2.7 Balance of payments

In 2014 Q1, the current account deficit continued to narrow and amounted to EUR 0.8 billion (as against EUR 2.3 billion in 2013 Q1).[69] The reduction in the current account deficit resulted primarily from a further rise in the trade surplus, driven by a revival in external demand. The balances on the service and current transfer accounts were also positive. On the other hand, the income account balance remained negative, due to high returns of foreign direct investors in Poland on the capital employed in the country. This, in turn, was supported by the sound performance of Polish businesses (Figure 2.47).

At the same time, the capital account balance increased in 2014 Q1 (amounting to EUR 1.4 billion as compared with EUR 0.8 billion in 2013 Q1). This was primarily driven by an increase in EU capital inflows.

The financial account balance was negative in 2014 Q1, having fallen sharply compared to 2013 Q4. This was largely due to an outflow of capital from the debt market, fall in other investment and an increase in the residents' external assets. The increase in the financial account deficit was on the other hand restricted by the renewed inflows of direct investment to Poland, mainly through reinvested earnings.

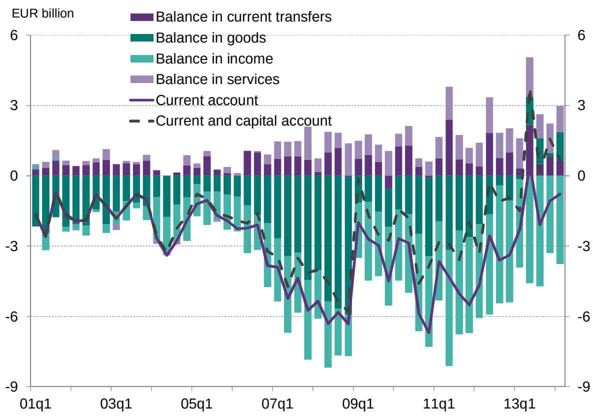
Figure 2.46 Households' financial assets



Source: NBP data.

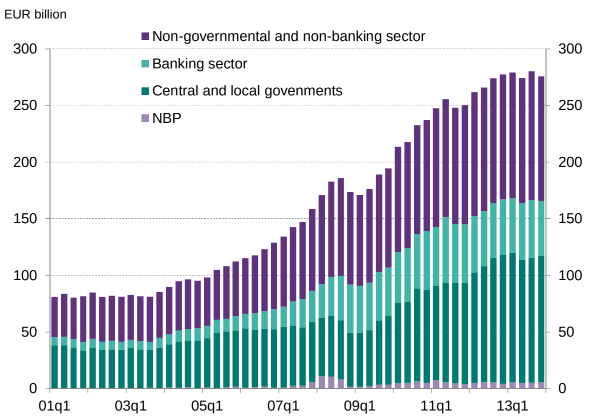
*MFIs (Monetary Financial Institutions) consist of banks, credit unions and money market mutual funds.

Figure 2.47 Current account balance



Source: NBP data and estimates.

Figure 2.48 Poland's external debt



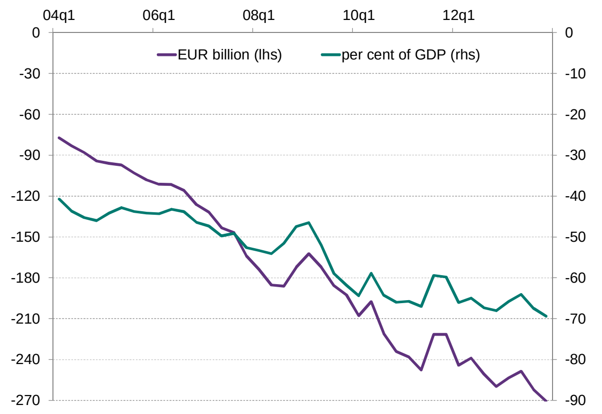
Source: NBP data.

[68] In April 2014, households' financial assets increased by PLN 5.0 bn as compared to PLN 2.0 bn in April 2013.

[69] Data on the current, capital and financial accounts are based on quarterly data up to 2013 Q4 and monthly data for January-March 2014.

Lower current account deficit in 2014 Q1 helped improve some of Poland's external imbalance indicators. In particular, current account deficit in relation to GDP decreased further (in terms of four-quarter moving average; Table 2.5).

Figure 2.49 Poland's net international investment position



Source: NBP data.

Table 2.5 Selected external stability indicators (four-quarter moving average, in % unless stated otherwise)

	2009	2010	2011	2012	2013 q1	2013 q2	2013 q3	2013 q4	2014 q1
Current account balance(CAB)/GDP	-3.9	-5.1	-5.0	-3.7	-3.1	-2.3	-1.9	-1.3	-0.9
Current and capital account balance/GDP	-2.3	-3.3	-3.0	-1.5	-1.0	0.1	0.4	1.0	1.6
Trade balance/GDP	-1.7	-2.5	-2.7	-1.4	-0.8	-0.1	0.3	0.6	0.9
Official reserve assets (in monthly imports of goods and services)	5.3	5.4	5.2	5.6	5.7	5.6	5.3	5.2	5.0
Foreign debt/GDP (%)	62	67	67	73	73	71	72	71	-
Average maturity of government debt	5.3	5.4	5.3	5.4	5.5	5.5	5.4	-	-
Net international investment position/GDP	-62	-66	-59	-68	-66	-64	-68	-69	-
Official reserve assets / foreign debt (up to 1Y) plus CAB*	65	78	80	101	97	90	84	87	-
Official reserve assets/ foreign debt (up to 1Y)*	83	98	94	107	100	96	90	95	-

Source: NBP data.

*Indicators include foreign debt and level of official reserves at the end of the period.

3 Monetary policy in March – July 2014

At the meetings in March, April, May, June and July 2014 the Monetary Policy Council decided to keep NBP interest rates unchanged: reference rate at 2.50% on an annual basis, lombard rate at 4.00% on an annual basis, deposit rate at 1.00% on an annual basis, rediscount rate at 2.75% 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 between March and June 2014 as well as the *Information from the meeting of the Monetary Policy Council* in July 2014. *Minutes of the Monetary Policy Council decision-making meeting in* July 2014 will be published on 21 August, and thus included in the next *Report*.

Minutes from the Monetary Policy Council Decision Making Meeting held on 5 March 2014

At its meeting, members of the Monetary Policy Council discussed the current and future monetary policy decisions against the background of global and domestic macroeconomic developments and the March projection of inflation and GDP.

Referring to the situation abroad, the Council pointed out that the recovery in the global economy is still moderate. It was emphasised that activity growth in the United States may recently have lost some momentum, and GDP growth in 2013 Q4 has been revised downward. At the same time, it was assessed that a certain deterioration in the US data may be partly due to unfavourable weather conditions. Council members highlighted further improvement in the business climate in the euro area, where economic growth is nevertheless unstable and much weaker than that in the United States. It was also observed that inflation in the euro area has remained low.

Referring to the situation in the emerging economies, some Council members observed that business climate indicators for China, the largest emerging economy, point to a slowdown in activity growth at the beginning of 2014. Yet, a few Council members argued that activity growth in many Central and Eastern European countries has been accelerating. Council member expressed the opinion that heightened uncertainty related to future developments in Ukraine poses a risk to the economic situation in Poland's external environment. It was indicated that possible escalation of the conflict between Ukraine and Russia may undermine Poland's trade with the Eastern markets and dampen business sentiment and firms' propensity to invest. At the same time, it was judged that the potential weakening in Poland's exports to the Eastern markets, particularly food exports, could curb price growth in the domestic market. Yet, a few Council members argued that the risk related to future developments in the East may support the recently observed slight increase in global commodity prices and deterioration of the sentiment in the financial markets. In this context, other Council members observed that the recent hike in commodity prices may have been a temporary phenomenon, while the slowing demand in China could contribute to lower commodity prices in the longer term.

Addressing economic conditions in Poland, Council members underlined accelerating GDP growth in 2013 Q4. As expected, output growth was supported by higher domestic demand growth, primarily in terms of consumption, and – to a very small extent – investment. Yet, it was net exports that continued to be the main driver of GDP growth. Council members emphasised that monthly data from the beginning of the year point to a continued gradual recovery in the economy. In particular, retail sales and industrial production continued to rise, however a fall in construction and assembly output was also mentioned. Council members assessed that economic recovery is not accompanied by accumulation of any significant macroeconomic imbalances; the current account balance is improving. A few Council members also highlighted that the economic rebound has been accompanied by a stable growth in lending to the private sector.

While analysing the situation in the labour market, the signs of improvement, albeit a sluggish one, were observed. It was mentioned, that according to LFS, the number of working persons rose slightly in 2013 Q4, which contributed to a certain decline in the unemployment rate (in annual terms). It was, however, pointed out that in January employment growth in the corporate sector was halted. A few Council members, on the other hand, pointed to a rising number of job offers and falling likelihood of losing a job, which suggests continued improvement in the situation in this market in the following quarters. However, it was emphasised that the unemployment rate has persisted at elevated levels, thus hampering wage pressure in the economy. The absence of wage pressure is confirmed by a slowdown in both wage and unit labour cost growth in 2013 Q4.

Council members emphasised that the observed gradual recovery is not translating into higher inflationary pressure in the economy. It was observed that in January inflation remained stable and well below the target, while core inflation decreased. The absence of inflationary pressure is also signalled by negative growth of producer prices, amidst low inflation expectations of economic agents. A few Council members pointed out at this point that the annual consumer price growth is boosted, at the beginning of the year, by the statistical base effects.

While analysing the outlook for economic growth, Council members assessed that in the next few quarters economic recovery will probably continue at the pace envisaged in the March projection. It was emphasised that GDP growth will be supported by the revival in consumer demand. It was pointed out that in line with the projection, investment may be expected to pick up, especially in terms of corporate investment. Yet, a few Council members argued that corporate business activity may be weakened by the growing tax burden imposed on businesses by local government units.

Council members expressed the opinion that despite stronger economic growth, inflation – in light of the March projection – will return to the target only gradually, and will remain below the target at least throughout this year. Some Council members also invoked external forecasts pointing to the same scenario. In this context, those members highlighted the fact that – according to the projection – the expected gradual return of inflation to the target will be related to the narrowing of the output gap and its subsequent stabilisation at a positive, yet close to zero level. Council members observed that in line with the projection, wage and unit labour costs will accelerate, yet their growth will not be strong enough to jeopardise the inflation target in the medium term.

A few Council members also observed that the March projection – in comparison with the November one – expects lower inflation this year, coupled with higher forecasts of GDP growth. They argued that the persistence of inflation below the target during this year will result, to a large extent, from the impact of factors beyond the direct influence of the domestic monetary policy, including slow energy price growth. As a result, in the case of higher than assumed in the current projection energy price growth in subsequent quarters, inflation may return to the target faster than anticipated in the projection. Those members also highlighted that resulting from the projection increase in ratio of labour costs to corporate revenues may contribute to lower price competitiveness of Polish enterprises in the international markets. In this context, they pointed out that the recovery may be conducive to the inflow of capital and appreciation of the exchange rate, which would further limit price competitiveness of Polish enterprises. As a result, factors of production might be shifted towards the non-tradable sector – including residential construction – posing, amidst low interest rates, a risk of imbalances arising in this sector. Therefore, a few Council members were of the opinion that an interest rate increase may be justified, even if inflation remains below the target.

Yet, other Council members held the view that a significant interest rate rise aimed at curbing the risk of imbalances in the real estate market may come at a higher cost to the economy as a whole than the application of macroprudential instruments. They also underlined that the gradual decrease of the LtV ratio in mortgage loans this year and in the following years applied by the Financial Supervision Authority should limit the risk of accumulation of significant imbalances in the real estate market.

The Council decided that the NBP interest rates should remain unchanged at the current meeting. The Council discussed the indicated period of the probable maintenance of the NBP interest rates at an unchanged level. Some Council members were of the opinion that, given the March projection, which pointed to a very gradual return of inflation to the target, it may be justified to keep the interest rates unchanged until the end of 2014. One of the factors justifying the extended period of interest rate stabilisation was – in the opinion of some Council members – the need to limit economic uncertainty under mounting international risk related to the tensions emerging in the East.

Some Council members emphasised that owing to the uncertainty about future macroeconomic developments abroad, including in Ukraine, the indicated period of the probable maintenance of NBP interest rate should not be longer than before. A few of these Council members also believed that a shorter indicated period of no interest rate change may also be justified by the ongoing economic recovery and the risk of an earlier than projected return of inflation to the target.

As a result of the discussion, the Council assessed that the current and expected economic situation, including the results of the March projection of inflation and GDP justify maintenance of the NBP interest rates at an unchanged level over a longer period of time, i.e. at least until the end of the third quarter of 2014.

The Council left the basic interest rates unchanged at the following levels: reference rate at 2.50%, lombard rate at 4.00%, deposit rate at 1.00%, rediscount rate at 2.75%.

Minutes from the Monetary Policy Council Decision Making Meeting held on 9 April 2014

At its meeting, members of the Monetary Policy Council discussed the current and future monetary policy decisions in the context of macroeconomic developments in Poland and abroad.

While discussing external developments, it was pointed out that activity growth in the global economy is still moderate. The Council members noted that – after a temporary slowdown – the latest data point to improved economic conditions in the United States, while recovery in the euro area continues to be slow. At the same time, the Chinese economy is most likely slowing down further.

The Council members emphasised that inflation is low in many countries, which – if continues – may impede the deleveraging process in the largest economies. A few Council members referred to the factors which in their opinion may translate into a permanent decrease of global inflation. These factors include: a slower economic growth of the world economy and a downturn in the long-term commodity price cycle. Some of the Council members argued that for the next few years economic growth in the largest emerging economies will have a positive impact on the growth of global economic activity, which should be conducive to higher inflation around the world.

While analysing the external environment, it was pointed out that inflation in the euro area decreased to a very low level, which convinced the ECB to signal a possibility of further monetary policy easing. At the same time, however, a few members of the Council pointed out that low inflation in the euro area is mainly the result of strongly negative growth in energy prices – a favourable supply shock, which supports revival of the demand in this economy. Falling unit labour costs in member states most severely affected by the debt crisis is also a factor lowering inflation in the euro area. Decreasing unit labour costs help those countries overcome the recession, while preserving the competitiveness of German exports against countries outside the euro area. Those Council members also argued that a possible deflation in the euro area would not be significant enough to discourage agents from purchases, so the risk of second-round effects of price decreases is not significant. At the same time, in the opinion of those members of the Council, the continuation of highly expansionary monetary policy by the ECB – by increasing the risk of bubbles arising in the asset market – may even contribute to decreasing inflation. Other Council members assessed that possible emergence of expectations on falling prices may strengthen deflation tendencies in the euro area, and therefore the ECB will probably attempt to counteract this situation.

While analysing the outlook for economic conditions, it was pointed out that increasing importance of domestic demand in economic growth in Germany is a positive development. At the same time, some Council members stressed that the slowdown in economic growth in China may be a factor of risk for the improvement of economic conditions in Germany, and thus also in Poland. A few Council members assessed that due to a sharp rise in Chinese internal debt after the global financial crisis, currently it is difficult to expect a stimulus to the Chinese economy.

The Council members pointed out another source of uncertainty surrounding the outlook for economic growth in Poland is the situation in Ukraine – including the scale of the expected recession in the Ukrainian economy and the risk related to disturbances in economic relations between Ukraine and Russia. It was indicated that possible escalation of the conflict between Ukraine and Russia may undermine Poland's trade with the Eastern markets. In the view of currently available information, it was judged that although the potential weakening in Poland's exports to the Eastern markets may negatively affect some companies, it will not be a factor significantly reducing economic activity growth in the whole economy.

While discussing the financial markets' response to the conflict between Russia and Ukraine, it was emphasised that the zloty exchange rate has remained relatively stable, the yields on Polish sovereign bonds have not changed significantly and the impact on stock valuations was temporary. In the opinion of some Council members, favourable foreign investor sentiment towards the Polish economy is supported by its strong fundamentals and the lack of macroeconomic imbalances.

While analysing current data, it was highlighted that the accelerating growth of industrial output and retail sales together with the rebound in construction activity confirm a continued gradual economic recovery. At the same time, strong readings of most business climate indicators suggest probable activity growth continuing also in the subsequent quarters. Some of the Council members assessed that the rise in GDP growth may be quite substantial due to the possible acceleration in corporate investment spending in the nearest future. However, at the same time, some Council members pointed to the weakening of firms' expectations regarding their export orders, which may signal slower external demand, stemming firms' propensity to invest. Furthermore, a few Council members argued that, as slower economic growth abroad is probably a more durable phenomenon, GDP growth in Poland may remain moderate. In their opinion, a factor which may hamper consumer demand growth is substantial long-term indebtedness of some households.

Council members emphasised that the recovery of the Polish economy is starting to translate into labour market conditions. Employment in the corporate sector is gradually rising, with a concurrent decline in unemployment. Yet it was stressed that the unemployment rate persists at an elevated level, which constrains wage pressure. At the same time, a few Council members argued that while wage growth continued to be moderate, yet – considering low inflation – households' real disposable income growth is rising, which supports higher consumption growth.

Some Council members emphasised that lending growth, while somewhat stronger, remains slow. It was observed that firms' higher propensity to invest – observed against the background of low interest rates and improving business climate – is accompanied by higher corporate credit growth. At the same time, a few Council members observed that low interest rates on deposits continue to limit the incentives to save in the banking system.

While discussing inflationary processes, Council members pointed to inflation remaining markedly below the NBP inflation target, core inflation continuing at low levels, further decline in producer prices and low inflation expectations. Some Council members emphasised that the available forecasts pointed to a very slow increase in inflation and the absence of risks to price stability in the medium term.

The Council decided that the NBP interest rates should remain unchanged at the current meeting. Furthermore, the Council maintained its assessment that the NBP interest rates should be kept unchanged for a longer period of time, i.e. at least until the end of the third quarter of 2014. The Council members observed that a more comprehensive assessment of a need to change the horizon of keeping the interest rates at the current level will probably be possible during the July meeting of the Council, when a new NBP projection is to be presented.

The Council left the NBP interest rates unchanged at the following levels: the reference rate at 2.50%, the lombard rate at 4.00%, the deposit rate at 1.00% and the rediscount rate at 2.75%.

Minutes from the Monetary Policy Council Decision Making Meeting held on 7 May 2014

At its meeting, members of the Monetary Policy Council discussed the current and future monetary policy decisions in the context of macroeconomic developments in Poland and abroad.

While discussing external developments, Council members pointed to a gradual improvement in business conditions. It was noted that after growth in the United States had come to a halt in early 2014, the latest data pointed to a rebound of economic activity. In addition, it was highlighted that – although the Federal Reserve was gradually reducing the scale of its asset purchases – monetary policy in the United States continued to be very accommodative.

Council members also pointed out that a gradual recovery continued in the euro area. It was emphasised that recovery in Germany – Poland's main trading partner – was somewhat stronger than in other euro area member states. However, weaker March industrial orders and business sentiment in Germany were brought to attention. It was also noted that sentiment in the financial markets of the euro area countries most severely affected by the debt crisis had improved, which should translate into easier access to credit, and further into a gradual improvement in economic conditions in some of these countries.

Council members emphasised that inflation in many countries, including in particular in the euro area, remained low despite the ongoing economic recovery. This may convince major central banks, including the ECB, to continue their accommodative monetary policies. A few Council members expressed the opinion that deflation in the euro area was increasingly less likely, as indicated by the upward revisions of some inflation forecasts for the euro area. These members also highlighted the risks to longer-term growth sustainability associated with further monetary policy easing by the ECB.

In their discussion on developments in the external environment of the Polish economy, a few Council members cited factors which could potentially be conducive to lower growth in developed countries in the coming years, particularly in the euro area. These factors included possible further fiscal consolidation, ageing population and a decline in investment outlays, including for R&D, in developed countries following the global financial crisis. Furthermore, a few Council members indicated that attempts by Chinese authorities to rebalance economic growth in China away from investments might weaken demand for Chinese imports of investment goods from developed countries, particularly from Germany.

Referring to economic conditions in emerging market economies, it was noted that Chinese growth had weakened in 2014 Q1. Attention was also drawn to a deterioration in economic outlook for Ukraine and Russia, which was related to the Ukrainian crisis. While discussing the impact of the Ukrainian crisis on the Polish economy, the majority of the Council members judged that the mounting turmoil in Ukraine continued to pose a source of uncertainty for Polish economic growth outlook. They pointed out that a weaker economic growth outlook in Russia and Ukraine and a depreciation of their currencies might undermine Poland's trade with the Eastern markets. However, a few Council members were of the opinion that – given that Poland's trade with these markets was limited, and some of these exports could be redirected to other markets – the Ukrainian crisis would have a limited impact on Polish foreign trade, and in consequence, on economic growth in Poland. Council members also highlighted that the impact of the Ukrainian crisis on the sentiment in the international financial markets and the zloty exchange rate had been limited so far.

While discussing recent data releases in Poland, Council members pointed to ongoing growth in industrial output and retail sales as well as improved construction sector performance, all of which confirms continued recovery in domestic demand. It was indicated that, in contrast to earlier estimates, domestic demand had been the main driver of growth already in 2014 Q4, which had been – among others – due to much faster than expected rebound of investment spending. Yet, it was also emphasized that recent data on economic activity had been lower than expected and in some cases, including retail sales growth, export orders and leading indicators of business sentiment, had weakened. In the opinion of some Council members, the deterioration in sentiment could have been related with higher uncertainty due to an escalation of the conflict in Ukraine and weaker economic growth outlook in the trading partners in the East.

Council members noted that the rebound of economic activity was translating into improvement in labour market conditions. Employment in the corporate sector is gradually expanding, with a concurrent decline in unemployment. Yet it was emphasised that the unemployment rate persisted at an elevated level, which constrained wage pressure, as confirmed by slow unit labour cost growth. However, a few Council members expressed the opinion that – like in the previous recoveries – unit labour cost might be expected to pick up in the coming quarters, citing an acceleration in wage growth in recent months. On the other hand, some Council members argued that business conditions surveys did not point to an acceleration of wage growth in the near future.

Some Council members pointed to a slight improvement in lending growth, supported by low loan costs. At the same time, a few Council members drew attention to a low share of investment loans in financing of investment projects by small and medium-sized enterprises. Other Council members assessed that low interest on deposits continues to undermine the incentives to save in the banking system, which was reflected in increasingly weaker growth in corporate deposits.

In their discussion on inflation developments, Council members pointed to inflation remaining markedly below the NBP inflation target and still low core inflation, despite a rise in one of its measures. It was also emphasised that producer prices continued to decrease, and that inflation expectations remained low. Some Council members noted that the available forecasts pointed to a slightly slower rise in inflation in the coming months than envisaged in the March projection. Taking this into account, a few Council members expressed the opinion that inflation might return to the target later than forecasted in the March projection. Some Council members presented the view that accelerated economic growth might translate into a rise in inflation to a greater extent than currently forecasted. Moreover, a few Council members noted that the situation in Ukraine and the adverse weather conditions in many major food commodity exporters resulted in a considerable rise in their prices in the global markets. This is conducive to faster food price growth, whose deceleration – along with slow energy price growth – was previously one of the key factors keeping inflation down.

The Council decided that the NBP interest rates should remain unchanged at the current meeting. Furthermore, the Council maintained its assessment that the NBP interest rates should be kept unchanged for a longer period of time, i.e. at least until the end of the third quarter of 2014. The Council members observed that a more comprehensive assessment of macroeconomic outlook needed to change the horizon of keeping the interest rates at the current level will probably be possible during the July meeting of the Council, when a new NBP projection is to be presented.

The Council left the key NBP interest rates unchanged at the following levels: reference rate at 2.50%, lombard rate at 4.00%, deposit rate at 1.00%, rediscount rate at 2.75%.

Minutes from the Monetary Policy Council Decision Making Meeting held on 3 June 2014

At its meeting, members of the Monetary Policy Council discussed the current and future monetary policy decisions in the context of macroeconomic developments in Poland and abroad.

While discussing external developments, Council members indicated that growth in global activity remained moderate, but economic conditions varied across countries. Some Council members emphasized that recent data on activity in the major economies had been weaker than expected. In particular, in the United States GDP unexpectedly fell in the first quarter, albeit probably only temporarily. In the euro area, GDP growth was low, and some economic indicators pointed to a slowdown in recovery in the manufacturing sector in May 2014.

During discussion of the euro area, some Council members pointed to a dispersion in economic growth rates within the region. In Italy GDP declined in 2014 Q1, and in France output did not change. At the same time, in Germany – Poland's main trading partner – economic growth accelerated. A few Council members cited downside risks for German exports: still relatively low economic growth in China and economic slowdown in Russia. Some Council members also emphasized that the weakening of the Polish trade with Russia and Ukraine, recorded already in 2013, had intensified in the first months of 2014.

While discussing monetary policy abroad, Council members pointed out that the ECB had hinted it might ease its monetary policy at the June meeting. Some Council members emphasized that although the Federal Reserve was slowly reducing the scale of quantitative easing, monetary policy was still highly expansionary also in the United States. They also indicated that monetary policy in Central and Eastern Europe remained accommodative, and the National Bank of Hungary (MNB) had recently decreased its base rate to 2.4%. A few Council members emphasized that even though monetary policy of many central banks had been expansionary in recent years, inflation remained low worldwide.

When discussing inflation developments abroad, Council members pointed out that inflation in the euro area was still low, not only owing to a fall in food and energy price index, but also due to low core inflation. It was noted that inflation in the euro area remained well below the ECB's definition of price stability. In this context, the opinion was expressed that persistence of low inflation impeded deleveraging in the euro area member states most severely affected by the debt crisis. It was also highlighted that inflation in Central and Eastern Europe had also declined in recent months to only slightly above zero, or even reaching negative levels. It was pointed out that a decline in CPI inflation in Central and Eastern Europe over recent months was – like in the euro area – accompanied by a fall in core inflation.

Referring to the economic conditions in Poland, Council members indicated that GDP growth in 2014 Q1 had been close to the March projection and confirmed a gradual recovery of the Polish economy. Attention was paid to the favourable composition of GDP growth. In particular, there was an acceleration in domestic demand, especially investment demand, while foreign trade continued to record a surplus. However, some Council members pointed out that some indicators of activity in manufacturing sector had levelled off due to weakening in orders, employment and output sub-indices. In the opinion of these Council members, a decline in some economic indicators may reflect risks to further recovery of the Polish economy.

A few Council members noted that investment in Poland remained weak in relation to GDP compared to other countries in Central and Eastern Europe. They also indicated that the share of private investment was low compared to other EU member states. In this context, it was noted that corporate lending, including for investments, had rebounded.

Council members highlighted that the recovery in economic activity was translating into an improvement in the labour market conditions. Employment in the Polish economy is slowly rising, and unemployment is falling. It was emphasized that – in spite of a gradual recovery in the labour market – wage pressure remained limited, owing to a concurrent rise in labour force participation.

While discussing inflation developments, Council members pointed out that inflation had decreased in April, remaining markedly below the inflation target and considerably below the March projection. A fall in inflation in April was due to a decline in core inflation and falling food price growth. Some Council members indicated that a decline in inflation in recent months was driven by a fall in prices of an increasing number of goods. A few Council members also drew attention to continued fall in producer prices, decline in retail sales prices and further decrease in import prices.

With regard to expected inflation developments in months ahead, Council members pointed out that according to several short-term forecasts, inflation was likely to remain below the March projection. Some Council members also emphasized that – according to available forecasts – the probability of a temporary fall in inflation below zero in summer had risen. It was also noted that long-term breakeven inflation expectations had fallen. A few Council members, however, were of the opinion that – if the current pace of economic growth continued – a revival in demand pressure would be conducive to higher inflation. They also argued that due to reduced oil production in some countries, oil prices could rise in the coming period.

The Council decided that the NBP interest rates should remain unchanged at the current meeting. The Council maintained its assessment that the NBP interest rates should be kept unchanged until the end of 2014 Q3. While discussing future decisions, the majority of Council members pointed out that the expected inflation was lower than in the March projection, while uncertainty had risen, particularly with respect to the pace of economic recovery in the coming quarters and the outlook for monetary policy abroad. Given this, Council members observed that a more comprehensive assessment of the monetary policy perspectives and potential adjustment of interest rates would be possible after the Council got acquainted with incoming information, including the July NBP projection.

The Council left the key NBP interest rates unchanged at the following levels: reference rate at 2.50%, lombard rate at 4.00%, deposit rate at 1.00%, rediscount rate at 2.75%.

Information from the meeting of the Monetary Policy Council held on 1-2 July 2014

The Council decided to keep NBP interest rates unchanged: reference rate at 2.50% on an annual basis; lombard rate at 4.00% on an annual basis; deposit rate at 1.00% on an annual basis; bill rediscount rate at 2.75% on an annual basis.

Growth in global economic activity remains moderate, although the economic situation varies across countries. In the United States, following a contraction in GDP in early 2014, indicators of economic activity have improved over recent months. In the euro area, weak recovery continues. Activity growth in major emerging economies remains slow as for these countries. Moderate growth in global economic activity is conducive to maintaining low inflation in many economies, including the euro area and Central and Eastern European countries.

Monetary policy of the major central banks remains expansionary. In June, the European Central Bank decreased interest rates and announced additional liquidity providing operations to banks in order to stimulate lending.

In Poland, a gradual economic recovery continues. Nonetheless, May data show that annual growth in industrial output, construction and assembly output as well as in retail sales was slower than in the preceding months. At the same time, a recent decline in some business climate indices points to a possible slowdown in economic recovery.

The economic recovery is accompanied by a moderate acceleration in lending growth, both to companies and households.

Labour market conditions are improving gradually. Corporate sector data for May indicate a stabilization of employment and a slight acceleration in wage growth. This was accompanied by a decline in unemployment rate, which however remains at an elevated level.

In May, CPI inflation was lower than expected and stood at 0.2%, remaining markedly below the NBP inflation target of 2.5%. At the same time, all core inflation measures remained very low. This was accompanied by a further fall in producer prices and a decline in inflation expectations of both companies and households.

The Council got acquainted with the inflation and GDP projection prepared by the Economic Institute, which is one of the inputs to the Council's decisions on the NBP interest rates. In line with the July projection based on the NECMOD model – prepared under the assumption of unchanged NBP interest rates and taking into account data available until 13 June 2014 (projection cut-off date) – there is a 50-percent probability of inflation running in the range of -0.1-0.4% in 2014 (as compared to 0.8-1.4% in the March projection), 0.5-2.1% in 2015 (as against 1.0-2.6%) and 1.3-3.1% in 2016 (as against 1.6-3.3%). At the same time, the annual GDP growth – in line with the July projection – will be, with a 50-percent probability, in the range of 3.2-4.1% in 2014 (as compared to 2.9-4.2% in the March projection), 2.6-4.5% in 2015 (as against 2.7-4.8%) and 2.3-4.5% in 2016 (as against 2.3-4.8%).

In the opinion of the Council, in the coming months inflation will remain very low and may temporarily fall below zero. In the following quarters, the ongoing economic recovery and improvement in the labour market should support a gradual increase in inflation and its approaching the target in the projection horizon. This assessment is supported by the July projection of inflation and GDP. Nonetheless, uncertainty persists over the scale of further acceleration of economic growth and the prospects of inflation returning to the target.

The Council decided to keep NBP interest rates unchanged. The Council decisions in the coming months will depend on the incoming information, which impacts the assessment of the outlook for economic growth and inflation in the medium term.

4 Projection of inflation and GDP

This inflation and GDP projection was prepared by the Economic Institute of Narodowy Bank Polski and presents a forecast of economic developments under the assumption of constant NBP interest rates. In terms of the contents, work involved in the creation of this projection was supervised by Andrzej Sławiński, Director of the Economic Institute. The process was coordinated by the Bureau of Macroeconomic Forecasts of the Economic Institute. Using the macroeconomic model NECMOD[70], the projection was prepared as the outcome of an iterative process, in the course of which the paths of some variables were adjusted if they diverged from NBP experts' economic intuition based on their knowledge of economic processes. The Management Board of the NBP approved the projection to be submitted to the Monetary Policy Council. The projection constitutes one of the inputs to the Monetary Policy Council's decision making process concerning NBP interest rates.

The July projection based on the NECMOD model covers the period from 2014 Q2 to 2016 Q4. The starting point for the projection is 2014 Q1.

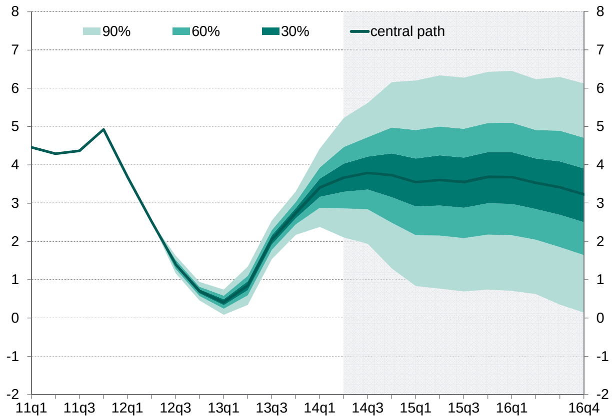
The cut-off date for the projection was 13 June 2014.

[70] Current version of the documentation of the model is available at the NBP website.

4.1 Summary

According to the Central Statistical Office (GUS) estimates for 2014 Q1, the Polish economy is experiencing a recovery phase of the business cycle (Figure 4.1), to an extent broadly envisaged in the previous, March *Projection of inflation and GDP*. National accounts data also point to a favorable structure of the national growth. The 3.4% y/y expansion in 2014 Q1 stemmed from an improvement in consumer (private and public) and investment demand with further positive contribution of net exports.

Figure 4.1 GDP (y/y, %)



Source: NBP (if not otherwise stated, this concerns all the figures and tables in this chapter).

Over the projection horizon, GDP growth will stabilize at an average of 3.6% y/y, i.e. slightly below the long-term pre-crisis average. The improvement in the domestic economic climate is curbed by only a moderate recovery predicted in the euro zone.

According to the current projection, a balanced composition of growth is to be sustained in the coming years. Private consumption, investment and public consumption will maintain their positive contribution to growth. The trade balance improvement, observed since 2011, will come to an end, while economic growth in 2014-2016 will coincide with inventory rebuilding.

The stable growth of private consumption over the projection horizon will be supported by a further improvement in the labour market, reflected in a steady increase in employment and wages. The positive impact on consumption will come also, especially over the short term, from low inflation, stimulating the growth of disposable income of households in real terms.

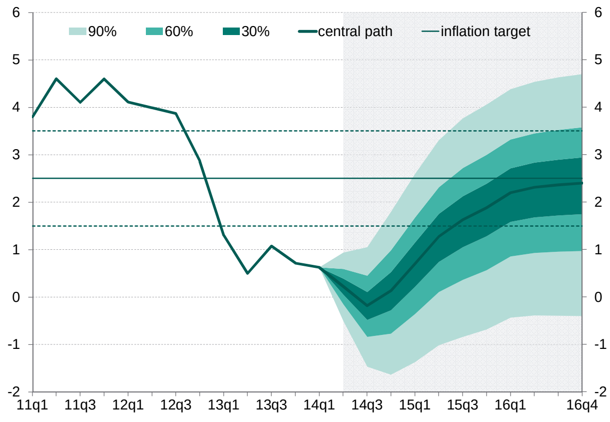
The gradual restoration of investment demand will be supported by a recovery in economic climate over the projection horizon both in Poland and in the external environment of the Polish economy. In 2014-2015 the growth rate of investment will gain additional momentum from increasing inflow of capital transfers from the EU. In 2016, as the settlement of funds under the EU 2007-2013 financial framework has been already completed, the growth rate in gross fixed capital formation will slow down.

As the Polish economy continues on the recovery track, GDP will rise faster than the potential output. As a consequence, the output gap, which is a comprehensive measure of inflationary pressure in the economy and which has been negative since mid-2012, will gradually start closing, and converging to approximately zero in 2015-2016.

Due to the mechanics of price adjustments in the economy, the response of CPI inflation to the size of the output gap is lagged. Low inflation levels early in the projection horizon are the effect of the slowdown in domestic economic growth in 2013, which had a particular impact on core inflation (Figure 4.2). The decline in CPI inflation in 2014 will also be due to a reduction in food price inflation, which could be tracked down both to favourable weather conditions, positively affecting the harvest of fruits and vegetables, and the Russian embargo on the imports of Polish pork. In addition, the decline in inflation levels in 2014 will be supported by the tariff policy applied by the Energy Regulatory Office (URE), resulting in reduced electric energy prices and only a slight increase in natural gas prices in January 2014.

In 2015-2016, the recovery in the Polish economy will put an upward pressure on prices of all the main components of the consumer goods and services basket (core inflation, food prices, energy prices). Yet, owing to a modest scale of the recovery, CPI inflation will remain relatively low, running below the NBP inflation target till the end of the projection horizon. Factors conducive to

Figure 4.2 CPI inflation (y/y, %)



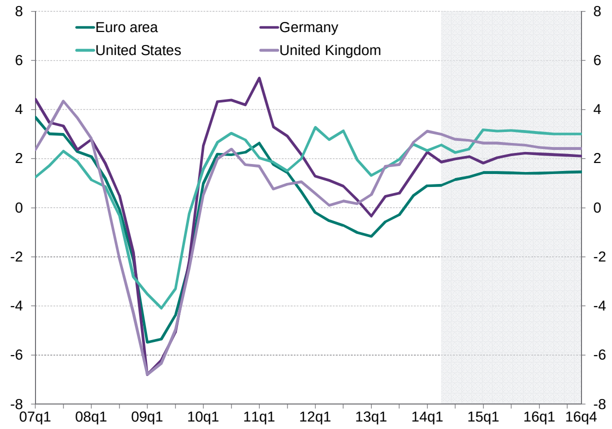
restricted inflationary pressure will also include stable commodity prices in international markets, dragged by slowly expanding global demand and rising supply of oil and shale gas.

Developments in the euro area are the main source of uncertainty to the outlook for inflation and GDP growth. As estimated, due to a sluggish recovery of the euro area coupled with a very low inflation pressure, inflation is more likely to persist - both at home and abroad - below the path assumed in the central projection scenario. This is reflected in the downward asymmetry in the fan-chart for this variable, while the risk to GDP is assessed to be symmetrical (Figure 4.1, Figure 4.2).

4.2 External environment

Current forecasts indicate a gradual upturn in the external economic environment of the Polish economy,[71] to a degree similar to the expectations of the March projection. Economic growth abroad gradually gathers speed over the projection horizon, while still running below the long-term average of the pre-crisis period (Figure 4.3).

Figure 4.3 GDP abroad (y/y, %)



Among Poland's main trading partners which are included directly in the projection, the United States enjoy the best outlook for growth over the projection horizon. GDP growth in the US economy is projected to accelerate, to an average level of 2.8% y/y in 2014-2016. Such a scenario is supported by, among others, decreasing unemployment and improving business and consumer sentiment (see Chapter 1.1 *Global economic activity*).

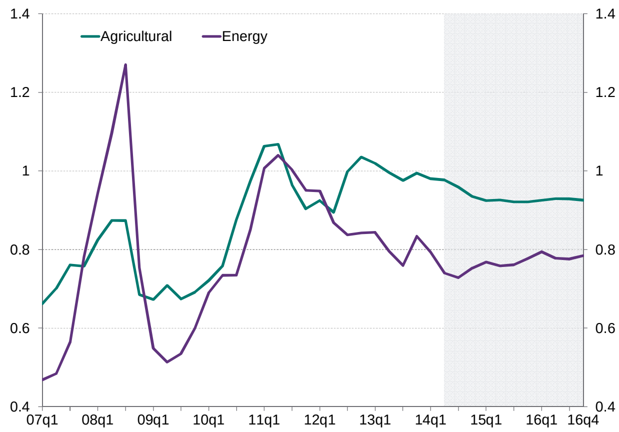
In the euro area, only a moderate recovery may be expected in 2014-2016, with an average GDP growth of 1.3% y/y. The forecast of modest growth

[71] In the NECMOD model, the external environment is represented by the euro area, the United Kingdom and the United States.

in the region is supported by good prospects for euro area exports related to stronger demand growth in the United States and the United Kingdom as well as the ongoing restructuring of the export sector in the euro area member states most severely affected by the debt crisis. Also, domestic demand in the euro area is expected to be gradually restored, which is indicated by positive readings of consumer sentiment indices (in particular, in Germany, Italy and Spain) and by an increase in retail sales. On the other hand, domestic demand growth in the euro area will be dragged by an ongoing process of private sector deleveraging and constrained access to corporate credit in some countries of the region.

The index of energy commodity prices in the global markets[72] is running slightly below the expectations of the previous projection in the short term due to downward revisions of forecasts of natural gas prices and, to a lesser extent, coal (Figure 4.4). These price adjustments were driven by weaker demand – a result of the relatively mild winter in Europe. This effect will fade off gradually over the projection horizon, supporting the return of the energy commodities prices included in the index to the March projection levels. In 2015-2016 the index will continue to growth very slowly due to only moderate global economic growth and favourable supply-side conditions. It is expected that oil supply will increase on the back of rising shale oil extraction in the United States, and, in the longer term, a stabilisation in oil producing countries affected by military conflicts (see Chapter 1.4 *Global commodity markets).* The nearest future is also expected to see rising supply of shale gas.

Figure 4.4 Index of commodity prices in the global markets (USD, 2011=1)



The index of agricultural commodity prices did not change significantly relative to the expectations of the March projection. An increase in prices of sugar, coffee and frozen concentrated orange juice,

[72] The global index of energy commodities comprises the prices of: coal, oil, and natural gas.

especially in the short term, which to a large extent stemmed from adverse weather conditions in the United States and Brazil, will be offset by lower-than-expected prices of milk and dairy products due to weaker demand from Russia and China (Figure 4.4). The index will stabilise in the medium and long term as a result of an only moderate increase in demand of emerging markets.

A moderate recovery abroad assumed in the projection, accompanied by persistently high unemployment rate and relatively stable commodity prices, results in inflation in the euro area and the United States being subdued until the end of 2016 (Figure 4.5).

In the light of the above, the projection scenario assumes a continuation of an accommodative monetary policy by the main central banks (Figure 4.6, see Chapter 1.3 *Monetary policy abroad and international financial markets*). In particular, the projection assumes that in the coming quarters, both the Bank of England and the Fed will keep their interest rates at the present level, with a possible increase no sooner than 2015 Q1. In turn, the ECB will start a cycle of monetary policy tightening not earlier than in late 2016.

The lower economic growth outlook in the euro area than in the United States and the later tightening of monetary policy by the ECB suggest that the euro may weaken against the US dollar – down to 1.29 in the medium and long term.

Figure 4.5 Inflation abroad (y/y, %)

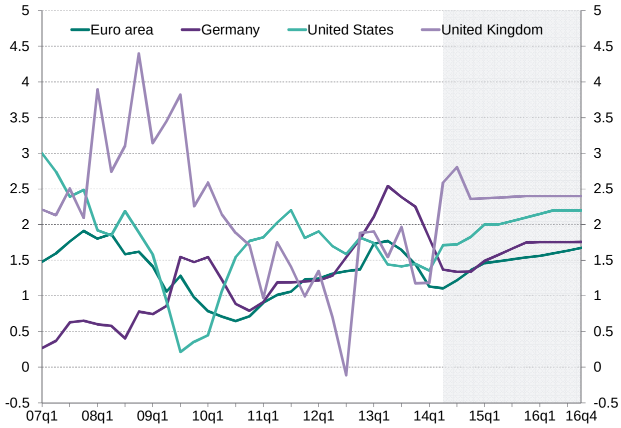
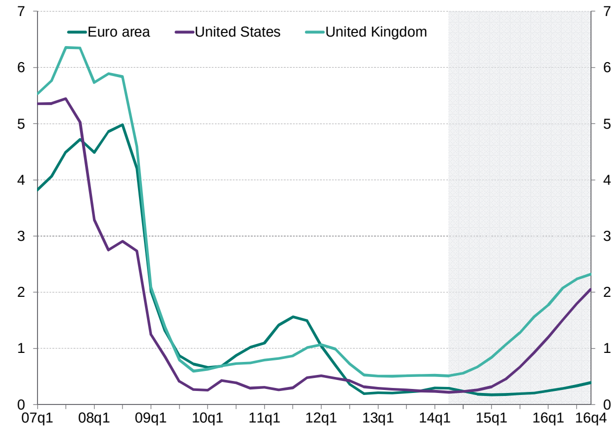


Figure 4.6 Interest rate abroad (%)



4.3 Polish economy in the years 2014-2016

Aggregate demand

The GDP reading in 2014 Q1 (3.4% y/y) confirmed the continuing upward trend in domestic demand observed over the last year, with a decreasing, yet still positive, contribution of net exports. Over the projection horizon, domestic demand will continue to grow and in the medium and long term it will slow down due to, among others, the expected decline in capital transfers driven by the completion of the settlement of the EU 2007-2013 financial framework (Figure 4.11). On account of a considerable rebound in domestic demand, amid a merely slight increase in foreign demand, contribution of net exports will be negative (Figure 4.8). As the effect of net exports being replaced with a rebound in domestic demand, the 2014-2016 GDP growth will remain stable (Figure 4.7).

In short-term, private consumption growth, as in 2013, will continue to accelerate (Figure 4.9), to stabilize in 2015-2016 at 3.3% y/y. Consumption will be positively affected by the improvement in the labour market, which is reflected in growing employment and increasing wage growth. As a result, over the projection horizon, dynamics of wage bill, as deflated by consumer prices, will stand at an average of 4.6% y/y, the highest level since the outbreak of the global financial crisis. The increasing growth rate of income from self-employment will be another factor behind the recovery in private consumption. This category will also be boosted by the expanding stock of consumer loans amid persistently low savings rate. The increase in the volume of credit will be driven by improving financial condition of households and easing in lending criteria after the amendment of Recommendation T. On the other hand, the increase in disposable income will be curbed by a relatively slow growth in spending on pensions resulting from the restriction of privileges entitling to early retirement, the raising of retirement age and low indexation of pension benefits. Low income on bank deposits and bonds will a have similar, yet weaker effect. The historically low level of NBP interest rates will have a negative impact on return on deposit and bond holdings (interests

Figure 4.7 Economic growth

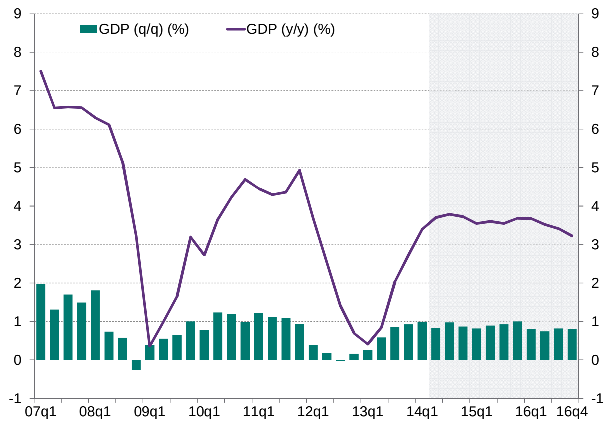
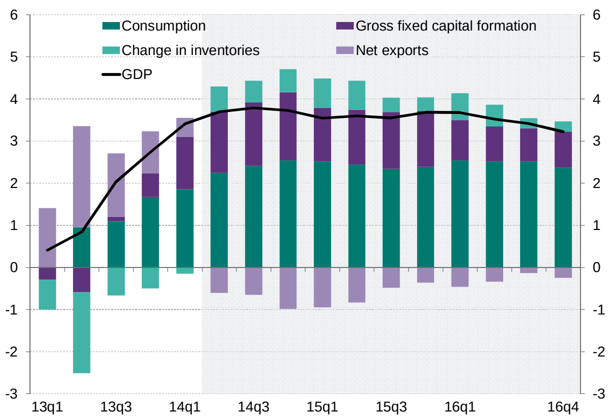


Figure 4.8 GDP growth (y/y, %) – breakdown



rates are – as in every projection round – assumed to remain unchanged over projection horizon).

By the end of 2015, the growth rate of public consumption will remain at a moderate level (similar to that recorded in 2013), which will be the result of continued freeze on government sector wages. In 2016, with renewed possibility of wage increase in the public sector, the growth rate of public consumption will accelerate, though it will remain below that of GDP.

In 2014-2016, the growth in gross fixed capital formation will be driven by economic recovery abroad, and relatively low (and declining over the projection horizon) real interest rates. Investment recovery in the coming years will be largely affected by EU capital transfers utilization (Figure 4.10, Figure 4.11, Figure 4.12).

In 2014 Q1, growth in gross fixed capital formation in the enterprise sector[73] (11.1% y/y according to NBP estimates) was supported by one-off factors, including favorable weather conditions and high expenditures of enterprises on the purchase of transport vehicles. These expenditures were related to favorable regulations allowing for a full deduction of VAT on the purchase of cars with LCV type approval.

In the short-term projection horizon, corporate investment will continue to grow at a heightened pace, due to economic recovery at home and abroad, and historically high utilization of EU funds allocated to capital expenditure of the private sector (Figure 4.11).

In the medium- and long-term projection horizon, the growth rate of fixed capital formation in the enterprise sector will decline to an average of 5.8%

Figure 4.9 Private and public consumption

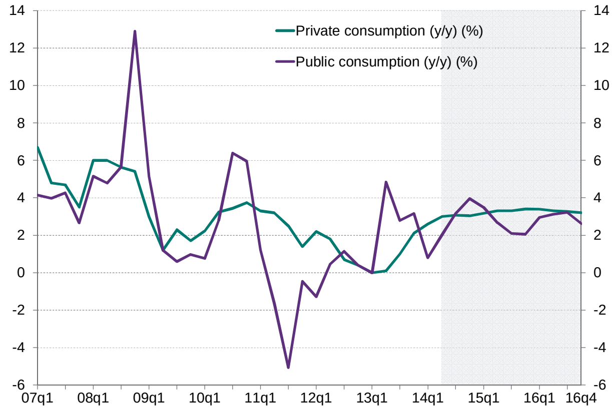
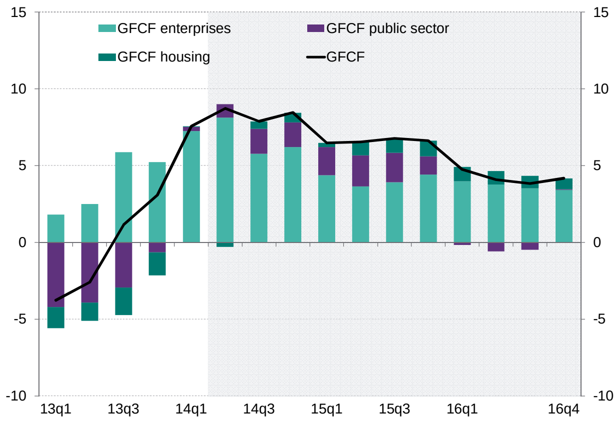


Figure 4.10 Gross fixed capital formation (y/y, %) – breakdown

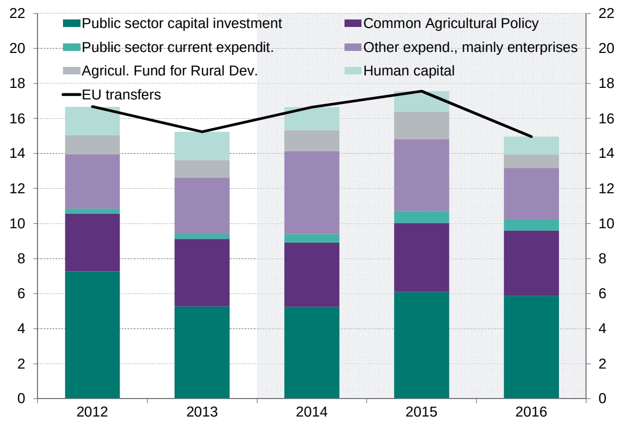


[73] In the NECMOD model, gross fixed capital formation is divided into three categories: corporate, public and housing investment. Thus, in the model the corporate investment category comprises of corporate sector investment (in accordance with the national accounts methodology) and a part of the household sector investment (investment of micro-enterprises, investment of private farms).

y/y. The weakening recovery in investment in 2015-2016 will be driven by a lower, as compared to 2014, growth in domestic demand and a merely moderate acceleration of GDP growth abroad. Over this period, corporate investment will also be dragged down by the end of funding opportunities under the 2007-2013 EU financial framework resulting in a reduction of capital transfers from the EU funds earmarked for corporates. The slackening investment in the medium- and long-term projection horizon is indicated by the gradual disappearance in 2014 Q1 of some positive trends observed in the recent quarters, including a fall in the estimated value of newly started corporate investment.[74] The NBP business survey also points to a downward adjustment of optimism among businesses observed in 2014 Q2 in such areas as expected demand, orders, exports, and overall assessment of the current situation.[75]

On the other hand, increase in corporate investment will be supported by a relatively good financial performance of the enterprise sector, allowing businesses to finance investment with their own funds.[76] In addition, interest rates remaining at their current historically low level (which results from the assumptions of a constant NBP reference rate adopted in the projection), would boost demand for investment credit. Another factor adding to the credit demand will be the *Portfolio Guarantee Line De Minimis.* The guarantee granted under this programme will increase credit availability for micro-, small and medium-sized enterprises, which do not have sufficient assets to collateralize an investment loan. The increase in corporate investment will also be driven by growing replacement investment, as indicated, among others, by higher than the long-

Figure 4.11 EU transfers (in EUR billion) – breakdown



[74] *Financial situation in the enterprise sector in 2014 Q1*, NBP.

[75] *NBP Quick Monitoring. Economic climate in the enterprise sector in 2014 Q1 and forecasts for 2014 Q2*, NBP.

[76] *Financial situation in the enterprise sector in 2014 Q1, NBP.*

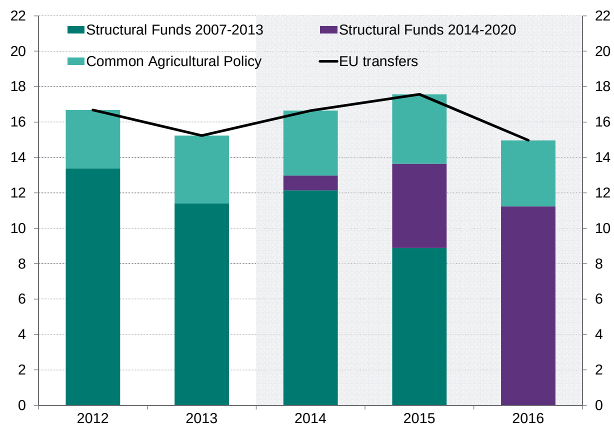
term average level of capacity utilization.[77]

In 2013, public investment declined as a result of reduced expenditure on road projects and limited capital expenditures of local government units, which is an effect of the fiscal rules imposed on local government investment. In short- and medium-term, this downward trend is expected to rebound. The recent years have brought a considerable improvement in the financial condition of local government units (and a narrowing in their deficit from approx. PLN 15 billion in 2010 to PLN 0.4 billion in 2013), which will ease the pressure on cutting back their spending. The expected improvement in the economic conditions in Poland, resulting in an increase in tax revenue, will have similar effect. Moreover, in 2014, the central government authorities, and in 2015 also the municipal authorities, will start using EU funds under the 2014-2020 financial framework (Figure 4.12). The government's decision to include new road projects using structural funds under the EU financial perspective 2014-2020 in the *National Road Construction Programme for 2011-2015* is in line with this scenario. Under the current provisions of the *Programme*, expenditures for this purpose are supposed to amount to PLN 2.9 billion in 2014 and to PLN 11.0 billion in 2015. Thus, in 2014 and especially in 2015, the funds provided under both the current (2007-2013) and the new EU financial framework (2014-2020) will overlap.

In 2016, the possibility of using funds provided under the 2007-2013 EU financial framework will come to an end and the usage of EU structural funds assigned for co-financing general government investment will drop. As a consequence, total public investment will decline.

Over the projection horizon, as the situation of

Figure 4.12 EU transfers (in EUR billion) – breakdown

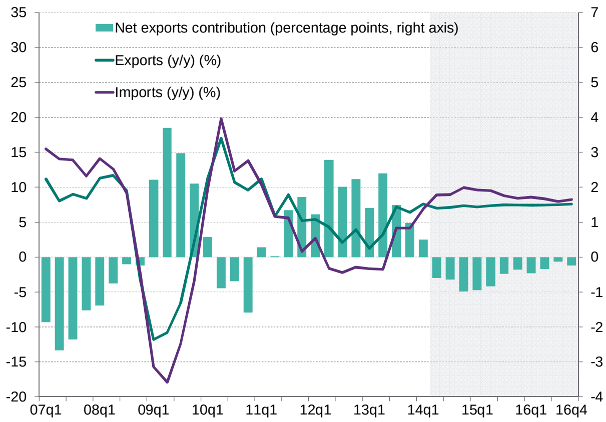


[77] *NBP Quick Monitoring. Economic climate in the enterprise sector in 2014 Q1 and forecasts for 2014 Q2*, NBP.

households improves, there will be a lagged rebound in residential investment. After the 2013 decline, growth rate of housing investment in 2014 will again be positive, reaching in 2015-2016 an average of 6.9% y/y. Factors adding to the growth in housing demand will include the government programme "Flat for the Young", launched in 2014, and the stability of interest rates at a historically low level, assumed in the projection. Both these factors will outweigh the impact of the amendment to Recommendation S, introduced in early 2014, that tightens mortgage loan granting criteria. The scenario of the recovery in the residential development market is supported by the gradual increase in the value of new housing loan agreements[78] observed since 2013 Q3, and the rising number of home construction starts[79] as well as the year-on-year growth in the number of issued building permits, recorded in 2014 Q1 for the first time in the past two years.

Along with improving conditions abroad and a rise in domestic demand, the years 2014-2015 will see the volume of external trade expanding, with a simultaneous decline in the contribution of net exports to growth (Figure 4.13). This results from the fact that the sensitivity of Polish imports to changes in business conditions at home and abroad is higher than that of exports. Thus, the contribution of net exports to growth in short- and medium-term projection horizon will remain negative. Towards the end of the projection horizon, in response to slowing increase in domestic demand, import growth will gradually flatten. In consequence, the contribution of net exports to growth will start rising, to reach a level close to zero at the end of the projection horizon.

Figure 4.13 Foreign trade



Macroeconomic equilibrium

[78] *Information on home prices and situation in the residential and commercial real estate market in Poland in 2013 Q4.*

[79] *Information on home prices and situation in the residential and commercial real estate market in Poland in 2013 Q4.*

After the global financial crisis, potential output growth in Poland slowed down markedly. However, over the projection horizon, potential GDP growth is expected to gradually pick up, while remaining below its long-term average. Since the beginning of 2014, the Polish economy embarks on a recovery path, and the real GDP has been rising faster than the potential output. As a consequence, the output gap, which has been negative since 2012 Q2, will gradually close reaching 0.1% of potential GDP in 2016 (Figure 4.14).

In the projection horizon, potential output growth will be negatively affected by falling population numbers driven by a negative balance of migration, mostly to the EU countries (Figure 4.15). Yet, three factors having a positive effect on potential output growth will be of much greater importance.

Firstly, currently weak growth in total factor productivity (TFP) will gradually return to the level observed before the global financial crisis.

Secondly, corporate investment growth will translate into faster accumulation of capital. At the same time, public capital growth, following a decline – driven by a significant decrease in public sector investment in 2012 and 2013 – will remain stable over the projection horizon, and hence neutral for potential GDP growth (see Figure 4.15).

Thirdly, positive developments in the labour market, reflected in decreasing unemployment equilibrium rate will positively affect potential output growth (NAWRU, Figure 4.17). The decline in the equilibrium unemployment rate will be supported by the flexibility of the domestic labour market, benefiting from a high share of flexible forms of employment, such as fixed-term labour contracts and civil law contracts as well as low

Figure 4.14 Output gap

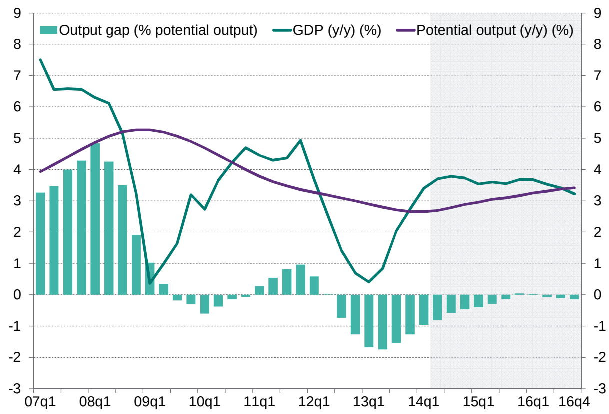
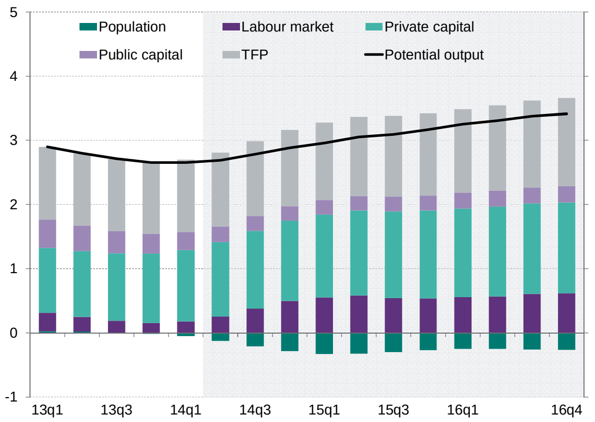


Figure 4.15 Potential output (y/y, %) – breakdown



trade union participation rate.[80] Moreover, wage indexation is far less frequent in Poland than in most European Union countries, which facilitates wage adjustment to market conditions.[81] Finally, following the decreasing current unemployment rate, the adverse phenomenon of hysteresis (which has created an upward pressure on the equilibrium unemployment rate) will gradually wane.

The observed increase in the demand for labour in the 2013 Q3 occurred in an earlier phase of the business cycle than previously. These changes may be associated with a lower cost of staff turnover due to growing share of fixed-term labour contracts and civil law contracts. Despite the fact that this reduces the stability of employment and weakens employees' bargaining position, it has a positive effect on the labour market as it allows firms to increase employment at an earlier phase of economic recovery as compared with the past. Also, in the recent years, the Polish economy has seen a rising share of services in the creation of new jobs, and the services sector itself is relatively less susceptible to business cycle fluctuations.

Over the projection horizon, amidst the closing output gap, employment is expected to rise further (Figure 4.16). The growth in the number of the employed in 2014 may additionally be driven by the statistical effect caused by the extension of maternity leave from 6 to 12 months for parents whose children were born since 1 January 2013.[82]

The statistical effect caused by the extension of maternity leave also resulted in a higher employment rate observed in 2014 Q1. In the coming quarters, labour participation rate will be stable due to balancing of institutional and

Figure 4.16 Employment and activity in the labour market

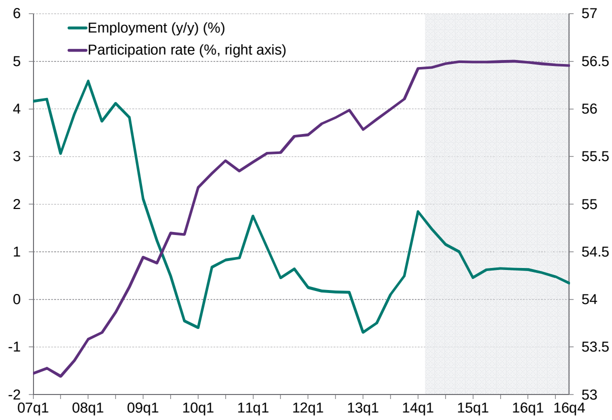
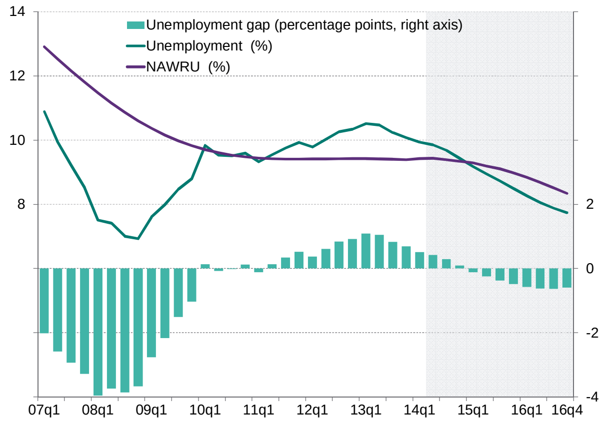


Figure 4.17 Unemployment



[80] *Labour market survey. Report 2013*, NBP.

[81] *Labour market survey. Report 2012*, NBP.

[82] According to the LFS methodology, persons on maternity leave are considered to be economically active and working. On the other hand, persons on child-care leave exceeding three months - and their number has decreased as a result of the extension of maternity leave - are among the economically inactive.

demographic factors. On the one hand, the labour participation rate will be boosted by the retirement age being raised since the beginning of 2013. On the other hand, the labour participation rate will be dragged down by the change in the age structure of the population, as a result of the growing number of persons of post-productive age and emigration observed predominantly among the economically active population.

The upward trend in the number of the employed, amidst stable labour force participation rate, will bring the LFS unemployment rate down to 8.0% in 2016 (Figure 4.17). Consequently, the gap between the current and the equilibrium unemployment rate will decline over the projection horizon, yet will not exceed the level of -0.6 percentage points (Figure 4.17). The negative unemployment gap will translate into a gradual increase in wage pressure (Figure 4.18) – real wage growth in 2014-2016 will slightly exceed labour productivity growth. Hence, the growth in unit labor costs will gradually accelerate (from 2.0% in 2015 to 2.8% in 2016), nonetheless cost pressures from the labour market will remain moderate.

The positive contribution of net exports to GDP growth in 2011-2013 translated into improvement in the current and capital account balance. As a result, in 2013 the surplus in this account amounted to 1.0% of GDP, which is record high since the mid-1990s when comparable statistics on the balance of payments started to be released (Table 4.3). Over the projection horizon, the positive current and capital account balance will gradually decrease, still remaining positive in 2014. The decline in the balance over the projection horizon will primarily result from the diminishing trade surplus (the effect of the negative contribution of net exports to growth observed since 2014 Q2). 2016 will bring a significant decline in the inflow of EU funds, which will be associated with the settlement of the 2007-2013 EU financial

Figure 4.18 Unit labour costs

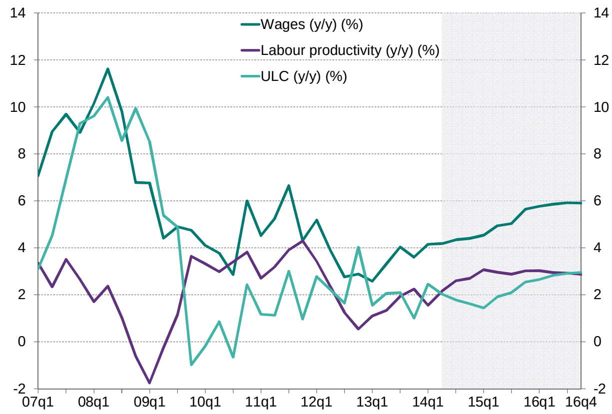
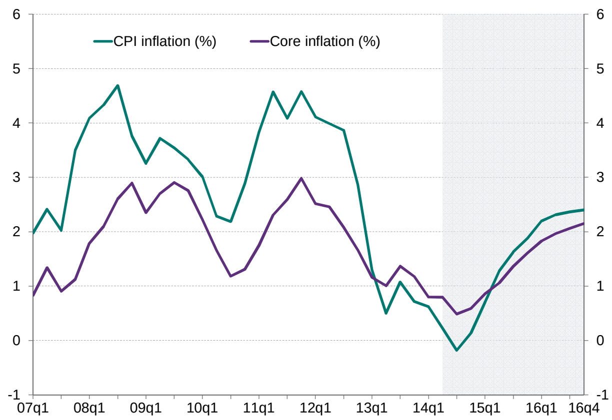


Figure 4.19 CPI and core inflation (y/y, %)



framework coming to an end in 2015 (Figure 4.12). Other components of the current and capital account – strongly negative balance of income only slightly offset with the positive balance of wages and remittances from abroad – will remain relatively stable in the projection horizon.

Exchange rate and inflation

Until the end of 2015, factors working towards a stronger zloty will narrowly prevail over opposite influences. The exchange rate of the Polish currency is running below the levels determined by the fundamental factors, which will support a gradual appreciation of the zloty over the projection horizon, bringing it closer to the equilibrium level. Another factor conducive to zloty appreciation, working through the expectations channel, is the recovery expected both in the domestic economy (reflected in a gradual closure of the output gap over the projection horizon) and abroad, coupled with the improving position of the public finance. The impact of the factors listed above will be partially mitigated by the weakening balance of the current and capital accounts. Moreover, over longer projection horizon the exchange rate will be exposed to downward pressure from the narrowing interest rate differential, which results from the projection's assumption of constant NBP reference rate amidst rising interest rates abroad. In effect, by 2016 the exchange rate will have stabilised and will play no part in the growth of consumer goods and services prices.

Over the projection horizon, core inflation will gradually rise, driven by both domestic and external factors (Figure 4.19). The steady improvement in domestic business conditions, reflected in the narrowing output gap, will step up demand pressure in the economy. It will be

Figure 4.20 Terms-of-trade

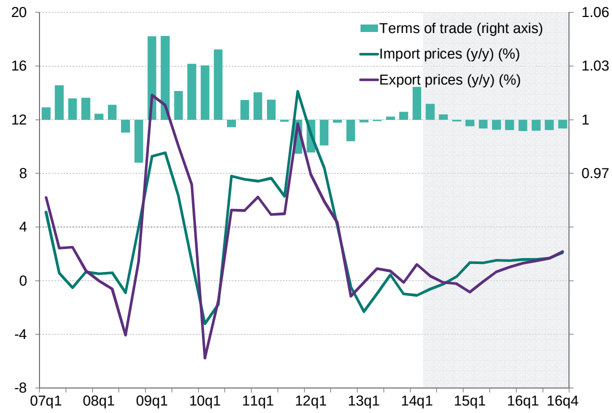


Figure 4.21 Inflation of food and energy prices (y/y, %)

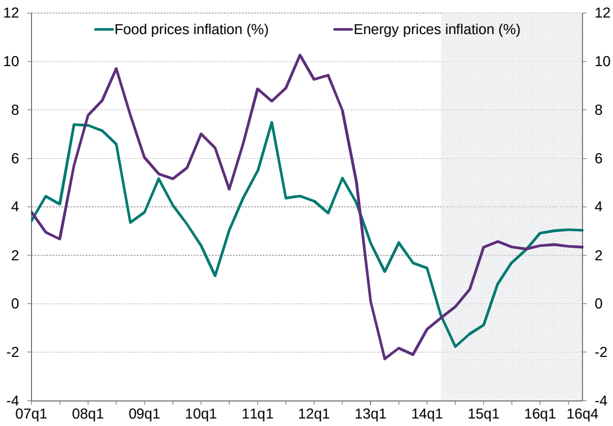
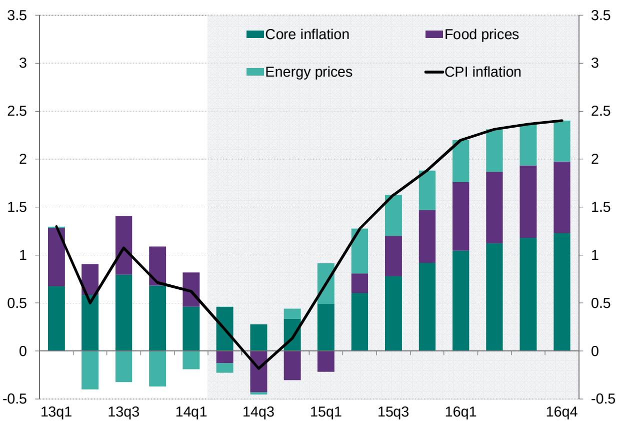


Figure 4.22 CPI inflation (y/y, %) – breakdown



accompanied by strengthening labour market conditions, rendering higher unit labour costs for entrepreneurs. The gradually rising inflation abroad, along with a slight appreciation of the zloty and its subsequent stabilisation, will cause import prices to rise only slightly (Figure 4.20). The above factors will produce a lagged effect of a higher price growth – core inflation will rise from 0.5% in 2014 Q3 to 1.2% in 2015 and to 2.0% in 2016.

In short term, projection horizon food prices will be the component with the strongest dampening impact on consumer price growth (Figure 4.22), which will be on a downward trend until 2015 (Figure 4.21). The decline in food prices results from the positive effect of the exceptionally short and mild winter on fruit and vegetable crops in Poland (and in Southern Europe). Since April 2014, when Russia imposed an embargo on pork imports in connection with the discovery of the ASF disease in Poland, there has also been increased supply of meat. In the longer projection horizon, a gradual rise in demand pressure in the domestic market will be constrained by developments in the global prices of agricultural commodities, which will remain stable throughout the projection horizon (Figure 4.4). As a result, food price inflation will pick up to 3.0% in 2016, remaining however below its long-term average.

Weak inflationary pressure in the short run is also supported by a decline in energy prices. Domestic energy prices fell by 1.5% in 2013, the lowest growth rate in this category since comparable data were first available, i.e. the 1990s. In 2014, average energy price growth will remain negative at -0.4%. This is driven by the reduction in electricity and natural gas rates charged to household[83], combined with declining global oil prices. Energy price

[83] The changes in the energy rates in 2014 include: a decrease in the prices of electricity in July 2013 and January 2014, a slight increase in natural gas prices as of 1 January 2014 and the expected absence of rises of energy carrier prices until the end of 2014.

growth will also be stemmed by currently very low prices of CO2 emission allowances, which are adding only moderately to the costs of the energy sector. Energy price inflation will rise in 2015 Q1, following changes in the electricity and natural gas rates for households. The 2015 hike in electric energy prices will result from the probable increase in tariffs, in order to take into account the costs related to the purchase of yellow and red certificates. The electric energy sellers have been re-obliged to buy these certificates, which are designed to fund the cogeneration process (i.e. the process of simultaneous electricity and heat generation). Despite this, energy price inflation will remain below its long-term average in the projection horizon. This is due to a mitigating influence of a sluggish growth in energy commodity prices in the global markets.

In sum, in the short-term projection horizon, the prices of the consumer goods and services will change only slowly, supported by declining food and energy prices (Figure 4.22). In the longer projection horizon, CPI inflation will embark on an upward trend, while remaining moderate at a level which will be below the NBP inflation target throughout the projection horizon. This derives from the fact that despite the recovery, the output gap, which is a comprehensive measure of inflationary pressure in the economy, remains negative throughout the projection horizon (-0.7% in 2014; -0.2% in 2015 and -0.1% of the potential output in 2016). Factors conducive to the weakness of inflationary pressure will also include stable commodity prices in the global markets, amidst slowly expanding global demand.

Assuming an unchanged NBP reference rate, the probability of annual inflation running between 1.5% and 3.5% is currently close to 0, rises in the short-term projection horizon, and to stabilise from the second half of 2015 at close to 50% (Table 4.2).

4.4 Current versus previous projection

In the current projection round, the expected GDP growth for the whole horizon is close to the March forecast, whereas changes in the CPI inflation path are more significant (Table 4.1).

In 2014, the forecasted CPI inflation y/y is 0.9 percentage points lower than the March projection, however in subsequent years the difference will gradually narrow – to 0.1 percentage points in the last quarter of the forecast. The downward shift in inflation in the projection horizon was driven by lower food prices and – to a lesser extent – a decline in core inflation. In 2015, the negative impact of these categories will be partially offset by faster-than-expected rise in energy prices.

Table 4.1 July projection versus March projection

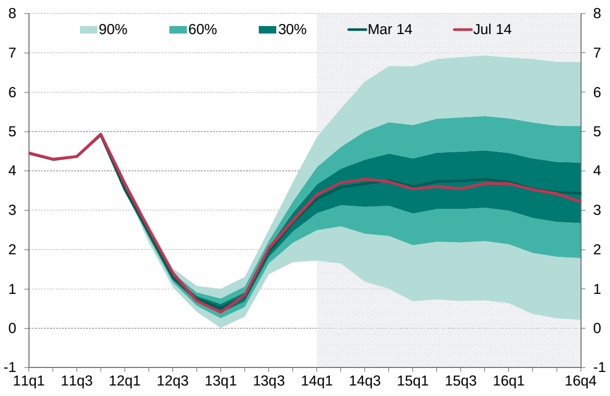
	2014	2015	2016
GDP (y/y, %)			
VII 2014	3.6	3.6	3.5
III 2014	3.6	3.7	3.5
CPI inflation (y/y, %)			
VII 2014	0.2	1.4	2.3
III 2014	1.1	1.8	2.5

GDP

In the projection horizon, GDP dynamics is close to that expected in the previous forecasting round and, except for 2014, there have been no major changes to the decomposition of economic growth (Figure 4.24). The most important factor for this revision is the inclusion of the preliminary 2014 Q1 estimate published by GUS, which shifted upwards the path of consumption and investment in 2014, while bringing down net exports and changes in inventories.

GUS estimates for 2014 Q1 point to a high, double-digit increase in gross fixed capital formation. The boost in investment activity was supported by favourable weather conditions and an increase in corporate expenditure on means of transport, owing to tax reasons. Both factors were of one-off nature, therefore they will strengthen the investment growth only in the short run, to weaken it in 2015-2016, when investment outlays fall back to level expected in the March projection.

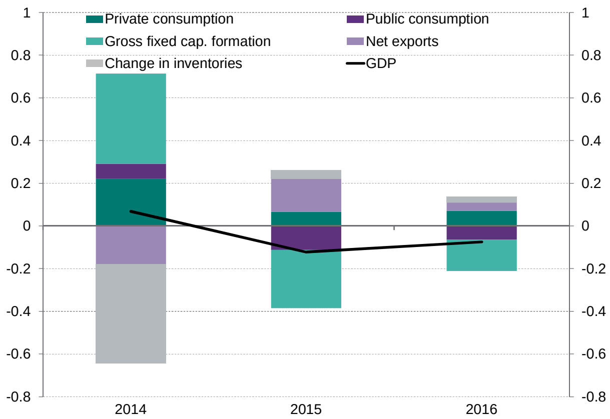
Figure 4.23 July projection versus March projection: GDP growth (y/y, %)



The 2014 Q1 GUS estimate of consumption growth, alike that for investment, was higher than forecasted in the March projection round. Taking into account the GUS estimate, as well as the lower inflation, which boosts real disposable income of households, the path of consumption was shifted upwards in the entire projection horizon.

As compared to the March projection, the forecasted public consumption growth was also corrected. In 2014, the upward revision in this category results from higher-than-assumed data on the actual spending of the public finance sector in 2013. The expected increase in 2014 dynamics of this category is also related to the improvement in the local government units' financial situation and the prospect of higher tax receipts of the whole general government sector. In April 2014, government decided to extend the period of wage freeze in the central government subsector for the year 2015, in line with the *Convergence Programme. 2014 Update*. This decision, adopted in the July projection resulted in lower public consumption growth forecasted for the following year.

Figure 4.24 Decomposition of deviations between July and March projection: GDP growth (percentage points)[84]



The positive impact of consumption and investment on GDP growth in 2014 is counterbalanced by the downward revision of the contribution of net exports and changes in inventories to growth after the release of lower-than-expected figures for these categories in 2014 Q1. In 2015, as a result of lower than forecasted in March domestic demand, amidst similar exchange rate and external growth, the contribution of net exports to the change in economic growth will be positive.

Inflation

Lower CPI inflation in the short- and medium-term projection horizon was driven mainly by a downward revision in food price forecasts. In the

[84] The data presented in the chart may vary slightly from Table 4.2, due to rounding of numbers to one decimal place.

short term, it is an effect of lower than expected prices of vegetables and fruits resulting from favorable weather conditions and lower meat prices after the introduction of the Russian embargo on Polish pork. In the longer projection horizon food price inflation will return to a level close to the expectations of the previous forecasting round, which will be supported by similar path of agricultural commodity prices in the global markets as compared to the March projection.

Throughout the projection horizon, CPI inflation will also be dragged down by a decline in core inflation, although to a lesser extent than the change in food prices. In the short-term, core inflation forecasts are reduced after the release of data for April and May 2014, which indicate a steeper than expected fall in the prices of some services. According to the draft Budget Law for 2015, in 2015, for the first time over the past 10 years, there will be no increase in excise duties on tobacco products. Such a change, as compared to the March projection, will further lower core inflation in the medium-term projection horizon. Another factor conducive to lower inflation, especially in the longer projection horizon, is slower growth in import prices, which will be driven by a downward revision of forecasted inflation abroad and a stronger zloty exchange rate. The appreciation of the exchange rate as compared to the March projection, is due to the increase in interest rates disparity, which took place after the expected interest rate hikes in the euro area had been postponed.

The negative impact of food prices and core inflation on CPI inflation in 2015 will be partially offset by energy price growth, being higher-than-expected in the March inflation projection. This increase is due to the obligatory purchase of

Figure 4.25 July projection versus March projection: CPI inflation (y/y, %)

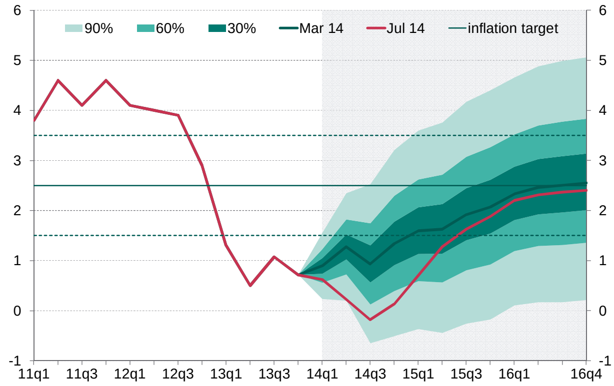
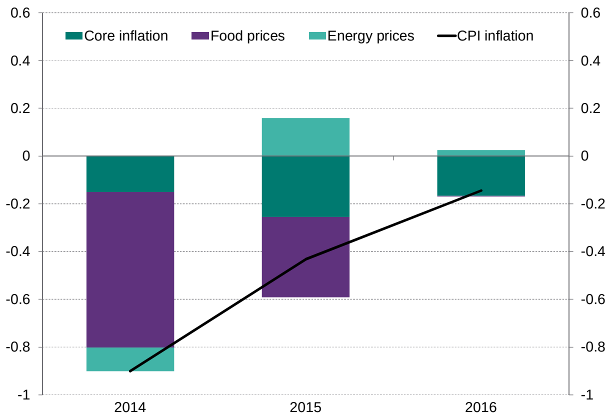


Figure 4.26 Decomposition of deviations between July and March projection: CPI inflation (percentage points)[85]



[85] The data presented in the chart may vary slightly from Table 4.2, due to rounding of numbers to one decimal place.

certificates, associated with production of electricity in cogeneration, by electricity suppliers.

4.5 Forecast uncertainty sources

The balance of risks indicates that within the projection horizon, inflation might be lower than suggested by the central projection path (Table 4.2). The balance of risks for the projection of GDP growth, however, is distributed symmetrically. The key sources of projection uncertainty are presented below.

Scale and sustainability of recovery in the euro area

The external environment, in particular the scale and sustainability of the recovery in the euro area, is the most important source of uncertainty for the inflation and GDP projection.

On the one hand, deeper than expected slowdown in economic growth in China and other emerging economies might pose a risk for the return of European economies on a stable recovery path. A significant and sustained appreciation of the euro, likely to be driven by a large current account surplus of the euro area, may also weaken economic activity and lower inflation rate in the euro area. A possible exacerbation of the debt crisis in some euro area countries, should the results of stress tests of the banking sector and the Asset Quality Review (AQR), scheduled for 2014, turn out to be negative, is another risk factor. The possibility of lower growth in the euro area is also indicated by deterioration in business sentiment in industry observed in recent months.

On the other hand, faster-than-expected growth in demand from emerging market economies could bring a stronger recovery in export-oriented

Table 4.2 Probability of inflation running:

	below 1.5%	below 2.50%	below 3.50%	below the central projection	Between1.5% and 3.5%
14q2	1.00	1.00	1.00	0.51	0.00
14q3	0.99	1.00	1.00	0.51	0.01
14q4	0.92	0.99	1.00	0.52	0.08
15q1	0.77	0.94	0.99	0.52	0.22
15q2	0.60	0.85	0.97	0.53	0.37
15q3	0.50	0.77	0.93	0.54	0.43
15q4	0.44	0.71	0.90	0.54	0.46
16q1	0.36	0.63	0.85	0.55	0.49
16q2	0.34	0.60	0.83	0.55	0.49
16q3	0.33	0.58	0.82	0.55	0.48
16q4	0.33	0.57	0.81	0.55	0.48

economies of the euro area, including Germany. The growth in euro area exports may also be driven by the planned introduction of reforms aimed at improving competitiveness of French and Italian economies and a deeper weakening of the euro as a result of the Fed's withdrawal from its QE programme. Domestic demand in the euro area may be enhanced by better than expected results of the AQR and stress tests in the banking sector translating into increased lending by European banks.

Escalation of the Ukrainian-Russian crisis

Possible escalation of tensions between Russia and Ukraine, resulting in a weakening of Polish foreign trade with these countries (*see Box 2: Impact of tensions between Russia and Ukraine on the Polish economy*) is another risk factor for the economic development scenario. The extension of economic sanctions imposed on Russia could also be an important factor, although such a scenario seems unlikely. Apart from negative consequences for economic growth in Poland and its main trading partners, this would translate into higher prices of crude oil and natural gas in the global markets. Also the position of food exporters to the Eastern markets, closely linked to the Ukrainian crisis, is fraught with uncertainty (including the possible introduction of the Russian embargo on Polish fruits and vegetables).

Wage pressure in domestic economy

The risks to the projection are also linked to developments in the domestic labour market. Firstly, while the last decade saw a significant increase in labour market flexibility, reflected in the decline in the equilibrium unemployment rate in this period, the direction of structural changes that determine labour market flexibility in the future is uncertain. Secondly, it is difficult to estimate changes in the labour participation rate over the projection horizon, in particular, due to demographic changes in the coming years and the uncertainty regarding the scale of migration. Considering the above risks, the extent to which the decline in the unemployment rate in the central projection scenario will translate to wage pressure in the economy is fraught with considerable uncertainty.

Food and energy prices in Poland

Other sources of uncertainty for the projection result from factors significantly affecting food and energy prices. The most important include the tariff policy of the Energy Regulatory Office, the weather conditions and developments in the global commodity markets.

Domestic energy prices will be largely affected by the future energy tariffs policy of the Energy Regulatory Office, including the possible liberalization of the gas and electricity market. There is also uncertainty about the impact on prices of a possible renegotiation of the agreement between PGNiG (Polish Oil and Gas Company) and Gazprom, and Climate and Energy Package aimed at reducing CO2 emissions. Currently, prices of CO2 emission allowances are very low and do not cause cost pressures, yet their possible rise continues to pose a risk for energy prices in Poland. Agrometeorological conditions are, in turn, the greatest risk not only for domestic food prices, but also prices abroad, feeding through to agricultural commodity prices in the global markets.

Developments in the global commodity markets will also be seriously affected by demand from the emerging economies, which – considering a relatively stable consumption in the developed economies – determines, to a large extent, changes in the global demand.

Moreover, a risk factor for future energy commodity prices is the scale of US production and exports of shale gas and oil, as well as supply disruptions caused by political instability in several oil producing countries.

Stabilizing expenditure rule

Another risk factor for the projection is the effect of the stabilizing expenditure rule adopted in the government's assumptions to the draft law amending the Law on Public Finance. Compliance with the expenditure rule in 2016 would require fiscal policy tightening as compared to the central scenario of the projection. However, due to the absence of detailed information on the nature of fiscal adjustment arising from the adoption of the rule, its potential effects are not accounted for in the July projection.

Table 4.3 Central path of inflation and GDP projection

	2012	2013	2014	2015	2016
Consumer Price Index CPI (% y/y)	3.7	0.9	0.2	1.4	2.3
Food prices (% y/y)	4.3	2.0	-0.5	1.0	3.0
Energy prices (% y/y)	7.9	-1.5	-0.4	2.4	2.4
Core inflation net of food and energy prices (% y/y)	2.2	1.2	0.7	1.2	2.0
GDP (% y/y)	2.0	1.6	3.6	3.6	3.5
Domestic demand (% y/y)	-0.1	0.0	4.2	4.3	3.8
Individual consumption (% y/y)	1.3	0.8	2.9	3.3	3.3
Public consumption (% y/y)	0.2	2.7	2.8	2.6	3.0
Gross fixed capital formation (% y/y)	-1.6	-0.2	8.1	6.6	4.2
Contribution of net exports (percentage point y/y)	2.1	1.5	-0.5	-0.7	-0.3
Exports(% y/y)	3.9	4.6	7.3	7.4	7.5
Imports (% y/y)	-0.7	1.3	8.8	9.1	8.3
Gross wages (% y/y)	3.7	3.4	4.3	5.0	5.9
Total employment (% y/y)	0.2	-0.2	1.3	0.6	0.5
Unemployment rate (%)	10.1	10.3	9.7	8.8	8.0
NAWRU (%)	9.4	9.4	9.4	9.1	8.6
Labour force participation rate (%)	55.9	55.9	56.5	56.5	56.5
Labour productivity (% y/y)	1.9	1.7	2.3	3.0	2.9
Unit labour costs (% y/y)	2.7	1.7	2.0	2.0	2.8
Potential output (% y/y)	3.1	2.8	2.8	3.1	3.3
Output gap (% of potential GDP)	-0.4	-1.6	-0.7	-0.2	-0.1
Index of agricultural commodity prices (USD; 2011=1.00)	0.96	1.00	0.96	0.92	0.93
Index of energy commodity prices (USD; 2011=1.00)	0.87	0.81	0.75	0.77	0.78
Price level abroad (% y/y)	1.3	1.6	1.3	1.6	1.7
GDP abroad (% y/y)	0.0	0.1	1.5	1.8	1.8
Current and capital account balance (% GDP)	-1.5	1.0	0.8	-0.4	-1.8
WIBOR 3M (%)	4.91	3.03	2.71	2.71	2.71

Source: LFS data is the data source for total employment labour force, participation rate and unemployment rate. Index of agricultural commodity prices is based on futures quoted mainly on European stock exchanges. Index includes prices of wheat, oilseed, pork, potatoes, sugar, cocoa, coffee, skimmed milk powder, butter and frozen concentrated orange juice allowing for weights reflecting the consumption structure of Polish households. The index of the prices of energy commodities includes the prices of crude oil, coal and natural gas allowing for the consumption structure of these commodities in Poland.

5 The voting of the Monetary Policy Council members in January – May 2014

■ Date: 8 January 2014

Subject matter of motion or resolution:
Resolution No. 1/GP/2014 on granting consent to the member of the Monetary Policy Council Jerzy Osiatyński to participate in activities of international organisations.

Voting of the MPC members:

For:		Against:
	M. Belka	
	A. Bratkowski	
	E. Chojna-Duch	
	A. Glapiński	
	J. Hausner	
	A. Kaźmierczak	
	A. Rzońca	
	J. Winiecki	
	A. Zielińska-Głębocka	

■ Date: 21 January 2014

Subject matter of motion or resolution:
Resolution No 2/GP/2014 on granting consent to the member of the Monetary Policy Council Adam Glapiński to participate in activities of international organisations.

Voting of the MPC members:

For:		Against:
	M. Belka	
	E. Chojna-Duch	
	J. Hausner	
	A. Kaźmierczak	
	E.J. Osiatyński	
	A. Rzońca	
	J. Winiecki	
	A. Zielińska-Głębocka	

A. Bratkowski was absent.

■ Date: 18 February 2014

Subject matter of motion or resolution:

Resolution No. 3/GP/2014 on granting consent to the member of the Monetary Policy Council Jerzy Hausner to participate in activities of international organisations.

Voting of the MPC members:

For:	M. Belka A. Bratkowski E. Chojna-Duch A. Glapiński A. Kaźmierczak E.J. Osiatyński A. Rzońca J. Winiecki A. Zielińska-Głębocka	**Against:**

■ Date: 8 April 2014 r.

Subject matter of motion or resolution:

Resolution No. 1/2014 on approving the Annual Financial Report of the National Bank of Poland prepared as of 31 December 2013.

Voting of the MPC members:

For:	M. Belka A. Bratkowski E. Chojna-Duch A. Glapiński J. Hausner A. Kaźmierczak E.J. Osiatyński A. Rzońca J. Winiecki A. Zielińska-Głębocka	**Against:**

Date: 6 May 2014

Subject matter of motion or resolution:

Resolution No. 2/2014 on approving the report on monetary policy implementation in 2013.

Voting of the MPC members:

For:		Against:
	M. Belka	
	A. Bratkowski	
	E. Chojna-Duch	
	A. Glapiński	
	J. Hausner	
	A. Kaźmierczak	
	E.J. Osiatyński	
	A. Rzońca	
	J. Winiecki	
	A. Zielińska-Głębocka	

Date: 6 May 2014

Subject matter of motion or resolution:

Resolution No. 3/2014 on the evaluation of the activities of the NBP Management Board as regards the implementation of the monetary policy guidelines for the year 2013.

Voting of the MPC members:

For:		Against:
	M. Belka	
	A. Bratkowski	
	E. Chojna-Duch	
	A. Glapiński	
	J. Hausner	
	A. Kaźmierczak	
	E.J. Osiatyński	
	A. Rzońca	
	J. Winiecki	
	A. Zielińska-Głębocka	

Date: 20 May 2014

Subject matter of motion or resolution:

Resolution No. 4/2014 on approving the report on the operations of the National Bank of Poland in 2013.

Voting of the MPC members:

For:	M. Belka A. Bratkowski E. Chojna-Duch A. Glapiński J. Hausner A. Kaźmierczak E.J. Osiatyński A. Rzońca J. Winiecki A. Zielińska-Głębocka	**Against:**

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