NBP Narodowy Bank Polski

Monetary Policy Council

March 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 the National Bank of Poland. 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 21 February 2014.

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

Contents

Summary

In the second half of 2013, there was a slight revival in global economic activity. Acceleration in GDP growth was particularly marked in the United States, while in the euro area output growth remained only slightly above zero. In turn, in major emerging economies GDP growth in 2013 Q3 – and most likely in 2013 Q4 – stayed low, relative to their previous performance. Global business climate indicators published in recent months point to further gradual improvement in business conditions, notwithstanding some deterioration in sentiment in the United States and China.

Persistently weak demand pressure and slowing growth in the prices of many food products in the global markets supported low inflation in the world economy in 2013 Q4. In the United States, the rise in CPI inflation towards the end of 2013 and at the beginning of 2014, was related to a hike in growth of energy prices, with core inflation remaining stable. On the other hand, in the euro area HICP inflation declined, which was related to falling food prices growth combined with a further decrease in core inflation. At the same time, in emerging economies inflation was running below the long-term average. In some of these countries, however, depreciation of the exchange rate was conducive to increase in inflation.

The monetary policy of the major central banks has still been expansionary. Besides reducing the scale of asset purchases (by a total of USD 20 billion, down to USD 65 billion a month), the Fed declared that it would keep short-term interest rates at near-zero (0.00%-0.25%) well past the time that the unemployment rate declines below 6.5%. In November 2013, the ECB decreased its interest rates by 0.25%, including the interest rate on main refinancing operations to 0.25% and again declared its intention to keep interest rates at the present or lower level for an extended period of time. The ECB also confirmed it was ready to implement a programme of purchasing government bonds of the member states that were most affected by the sovereign debt crisis. The Bank of England continued strongly expansionary monetary policy as well, assessing that its interest rate should remain unchanged at 0.50%.

Fed's decisions to scale back quantitative easing were conducive to a deterioration in sentiment in some emerging markets. The decline in asset prices in these markets was amplified by the worsening economic outlook in some of these countries. In order to reduce the scale of capital outflows some central banks in emerging market economies intervened in the foreign exchange market in January 2014 or increased their interest rates. In turn, in developed economies financial asset prices rose.

In Poland, the annual growth in consumer goods and services prices in continued at a low level in 2013 Q4 (0.7% y/y in December) [1]. Low inflation was supported by lack of demand and weak cost pressures in the economy. At the same time, all core inflation measures declined. 12-month inflation expectations of financial sector analysts have remained slightly below the inflation target and stood at 2.3% y/y in February 2014. In turn, inflation expectations of enterprises and consumers have stayed below the tolerance band for inflation.

[1] In January 2014, according to the preliminary GUS (Central Statistical Office) data, inflation remained at 0.7% y/y. However, the data on inflation in January 2014 may be revised as a result of changes in the structure of the CPI basket introduced by GUS at the beginning of each year.

In the second half of 2013, economic activity in Poland continued to accelerate gradually. The annual GDP growth stood at 1.9% in Q3 and 2.7% in Q4 (as against 0.8% in 2013 Q2). Rising domestic demand has contributed – for the first time since 2012 Q1 – to the pickup in GDP growth in the second half of 2013. It was related to a slight recovery in consumer demand and a modest increase in investment. This was accompanied by a reduction in the negative contribution of inventories to GDP growth. Net exports continued to be the main driving force of economic growth, although their contribution was lower than in the previous quarters.

Gradual economic recovery led to a certain improvement in the labour market. This was indicated by a further increase in the number of working persons in the economy in 2013Q4 and a slight reduction in the unemployment rate. Annual wage growth in the economy somewhat decreased. Due to a simultaneous pickup in labour productivity, growth in unit labour costs in the economy also declined, and remained below the long-term average.

Since the previous *Report*, the Monetary Policy Council has not changed the NBP interest rates, leaving the reference rate at 2.50%. In March 2014, it assessed that interest rates should remain unchanged for a longer period of time, i.e. at least until the end of the third quarter of 2014.

In recent months, owing to a slip in the sentiment towards emerging markets, the prices of Polish shares and government bonds decreased. However, gradual improvement in economic conditions in Poland and narrowing external imbalances were containing the scale of a decline in Polish asset prices and were conducive to the appreciation of the zloty. In the housing market there were further signs of recovery.

At the same time, credit growth – despite some acceleration – has remained relatively slow. In 2013 Q4, corporate debt growth picked up marginally. This was driven by, besides some relaxation of lending conditions by banks (in particular, with respect to the SME sector), higher corporate demand for loans. Household debt growth continued to accelerate in 2013 Q4, mainly due to a further increase in the consumer loan segment. In 2013 Q4, broad money continued to expand relatively slowly, while M1 growth decelerated, which was mainly due to changes in the term structure of corporate deposits.

In 2013 H2, improvement in the current account balance continued, although it slightly lost momentum in annual terms as compared with 2013 H1. The slowdown reflected mostly the declining surplus in the trade balance amidst rebound in domestic demand. As a result of further - albeit slower - improvement in the current account balance in 2013 H2, some of Poland's external imbalance indicators improved. In particular, the current account deficit in relation to GDP declined further. The financial account balance continued to decrease in annual terms, which was mainly due to a reduction in non-residents' investments in Polish securities.

The *Inflation Report* is structured as follows: in Chapter 1 economic developments in the external environment of the Polish economy are presented in the context of their impact on inflationary developments in Poland. Those developments as well as domestic factors affecting them are discussed in Chapter 2. *Minutes of the Monetary Policy Council decision-making meetings* held in November 2013-February 2014, together with the *Information from the meeting of the Monetary Policy Council* in March 2014, are presented in Chapter 3. Minutes from the MPC meeting held in March will be published on 20 March 2014 and so will be included in the next *Report*. MPC voting records in the period October 2013-January

2014 can be found in Chapter 5. Moreover, Chapters 1 and 2 of this *Report* include four boxes: "Introduction of asymmetric exchange rate target by the Czech National Bank", "Changes in the monetary policy of the central banks in the emerging market economies after the global financial crisis", "The sequencing of fiscal consolidation – conclusions from the literature" and "External debt stability".

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 March projection based on data available up to 14 February 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 0.8-1.4% in 2014 (compared to 1.1-2.2% in the November projection) and 1.0-2.6% in 2015 (as against 1.1-2.6%) and 1.6-3.3% in 2016. In turn, with a 50-percent probability the March projection sees the annual GDP growth in the range of 2.9-4.2% in 2014 (compared to 2.0-3.9% in the November projection), 2.7-4.8% in 2015 (as against 2.1-4.5%) and 2.3-4.8% in 2016.

1 External environment of the Polish economy

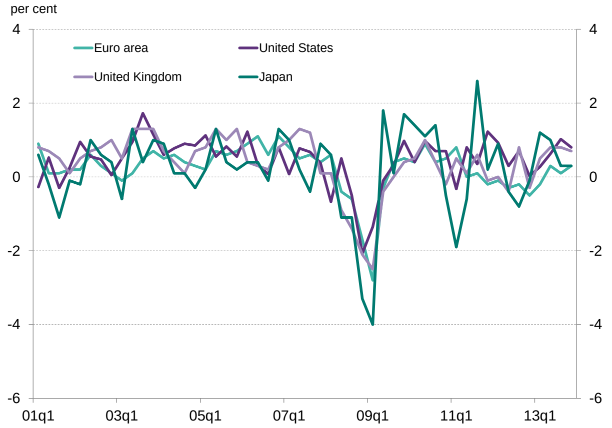
1.1 Global economic activity

In the second half of 2013, there was a slight revival in global economic activity. Acceleration in GDP growth was particularly marked in the United States, while in the euro area output growth remained only slightly above zero. In turn, in major emerging economies GDP growth in 2013 Q3 – and most likely in 2013 Q4 – stayed low, relative to their previous performance. Global business climate indicators published in recent months point to further gradual improvement in business conditions (Figure 1.2), notwithstanding some deterioration in sentiment in the United States and China.

In the United States, GDP growth accelerated in 2013 Q3 and Q4, to 1.0% q/q and 0.8% q/q, respectively (as compared with 0.6% q/q in 2013 Q2, Figure 1.1).[2] Output growth in 2013 Q4 was supported primarily by expanding consumption. Net exports also contributed extensively to output growth; this was the effect of a significant acceleration in exports, amidst weak imports. Investment contributed less to GDP growth than in the previous quarters, which can be attributed to a decline in housing investment. In turn, as the fiscal tightening continued, falling government spending had an adverse impact on GDP growth.

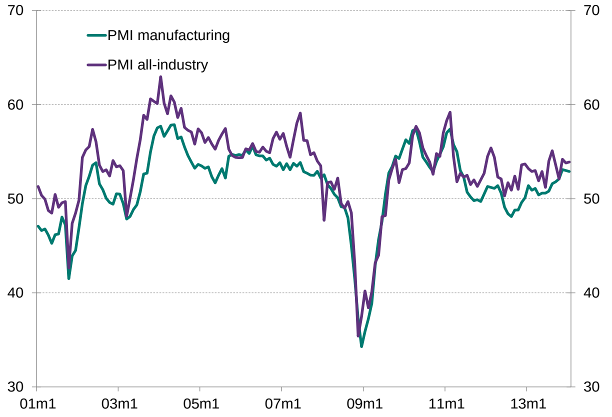
However, at the beginning of 2014, the recovery in the United States could somewhat weaken.[3] This was indicated by decrease in industrial output and retail sales in January 2014. Moreover, at the beginning of this year business climate deteriorated (a drop in ISM index in January). Improvement in real estate market also slowed down in the recent months. Although the prices of

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



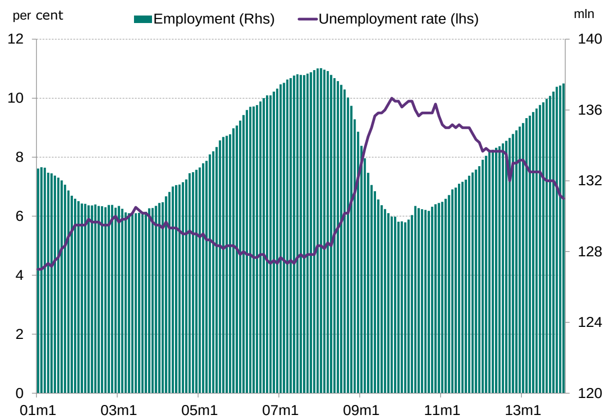
Source: Bloomberg data.

Figure 1.2 Global PMI index



Source: Bloomberg data.

Figure 1.3 The registered unemployment rate and employment levels in the United States



Source: BLS data.

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

[3] This weakening could be partially attributed to exceptionally unfavourable weather conditions.

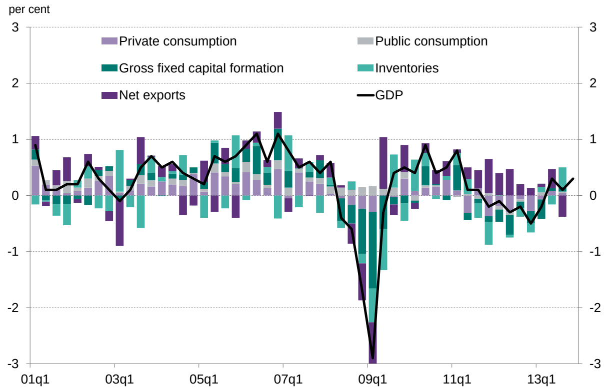
real estate were on a steady upward path, sales of homes contracted. Lower real estate demand can be attributed to increase in interest on mortgage loans, related to the tapering of asset purchases by the Fed (see Chapter 1.3 *Monetary policy abroad and international financial markets*). Further improvement in labour market conditions was, on the other hand, conducive to economic activity growth in the United States. In particular, unemployment rate decreased further (partly due to a lower labour participation rate; Figure 1.3).

In the euro area, GDP growth in 2013 Q3 and Q4 remained low (at 0.1% and 0.3 q/q, respectively, as against 0.3% q/q in 2013 Q2; Figure 1.4). Output growth was driven by a positive – for the first time in several quarters – growth in domestic demand. The main category to have added to domestic demand was the change in inventories. The contributions of investment and consumption to GDP growth were also positive, but much smaller than that of inventories. Net exports, on the other hand, had a dampening effect on GDP growth.

In the largest euro area economy – Germany – GDP growth in 2013 Q3 and Q4 amounted to 0.3% and 0.4% q/q, respectively (comparing to 0.7% q/q in 2013 Q2). The slowdown in GDP growth in the second half of 2013 was related to weaker consumption growth, which occurred despite a further increase in employment and a slight decline in the unemployment rate. A factor conducive to demand growth in Germany was rising investment, which was supported by lifting uncertainty about the prospects for demand, combined with favourable financing conditions. In turn, exports, after deceleration in 2013 Q3, revived in Q4 2013. As a result, towards the end of 2013, net exports contribution to GDP growth was positive.

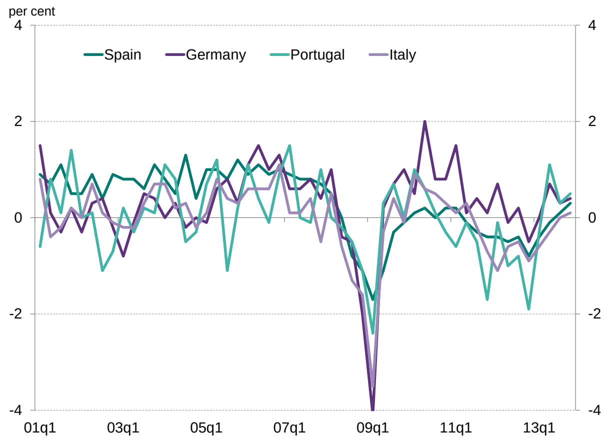
A positive sign observed in the euro area is the growth in output in some of the countries most severely affected by the debt crisis and previous

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



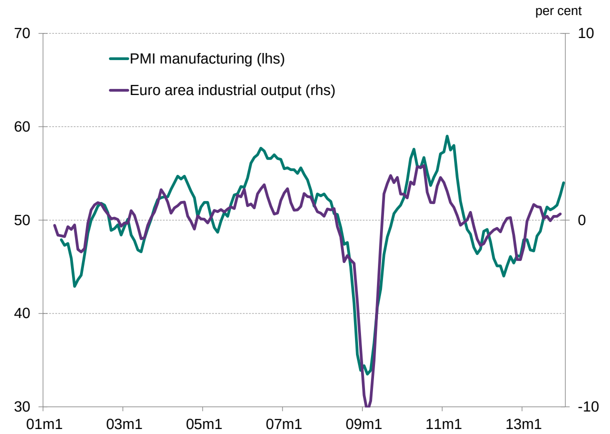
Source: Eurostat data.

Figure 1.5 GDP growth in selected euro area economies (q/q)



Source: Eurostat data.

Figure 1.6 Industrial output growth* and PMI index in manufacturing in the euro area



Source: Eurostat data, Markit.

* Change in the 3-month moving average of the industrial output as against the average of three months before.

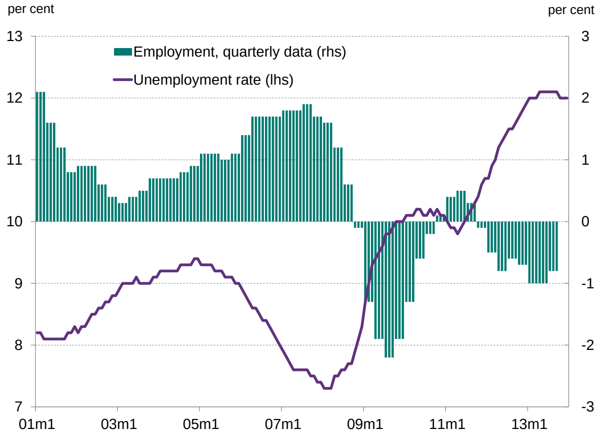
loss of competitiveness (Figure 1.5). In Spain, GDP growth in 2013 Q3 and Q4 was positive for the first time in nine quarters, which in Q3 – and most probably in Q4 – resulted from a rise in both consumption and investment.

The improvement in the euro area economic conditions is also signalled by rising business climate indicators at the beginning of 2014 (Figure 1.6). Yet, low industrial output growth, falling retail sales and persistently weak labour market conditions (Figure 1.7) point to a moderate outlook for GDP growth in this economy.

In the countries of Central and Eastern Europe, GDP growth continued to strengthen in 2013 Q3 and Q4 (Figure 1.8). According to available data, in 2013 Q3, the recovery in economic activity in these countries was driven by rising domestic demand. In some of them (Estonia, Latvia) investment growth gained substantially. Improving domestic demand is also evidenced by further growth in imports of most of these countries, which was accompanied by only marginally rising exports. Household consumption in the majority of the region's countries, supported by declining inflation, also increased. Yet the increase was merely moderate, which could have been related to the persistently heightened unemployment rate in many of these economies.

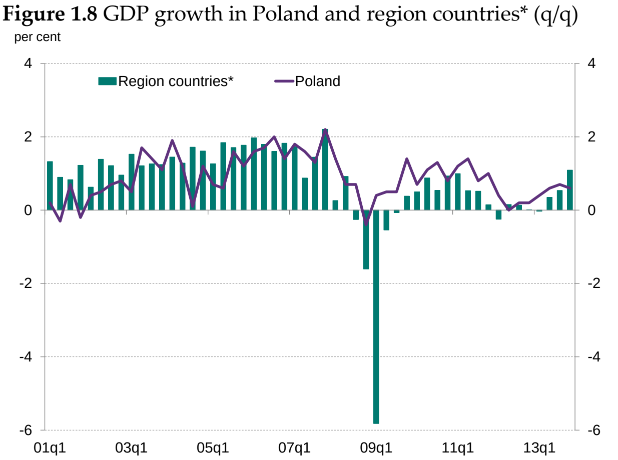
In the major emerging economies, GDP growth in 2013 Q3 – and, most likely, 2013 Q4 – stayed at a low level, relative to their previous performance (Figure 1.9). GDP growth in China in 2013 Q4 was dampened by slowing investment growth amidst rising market interest rates and weaker lending growth. On the other hand, GDP growth was supported by rising consumption and exports. At the beginning of 2014, the PMI index fell below 50 points, which suggests weaker economic conditions ahead.

Figure 1.7 Employment (y/y) and unemployment rate in the euro area



Source: Eurostat data.

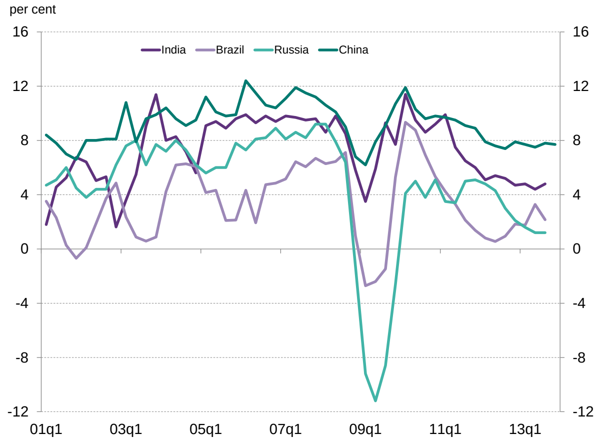
Figure 1.8 GDP growth in Poland and region countries* (q/q)



Source: Eurostat data.

* Region countries include: Czech Republic, Slovakia, Hungary, Lithuania, Romania, Latvia, Estonia, Bulgaria. Indicator was calculated as weighted average with weights based on each country share in Polish exports.

Figure 1.9 GDP growth in China, India, Brazil and Russia (y/y)



Source: Bloomberg data.

1.2 Inflation developments abroad

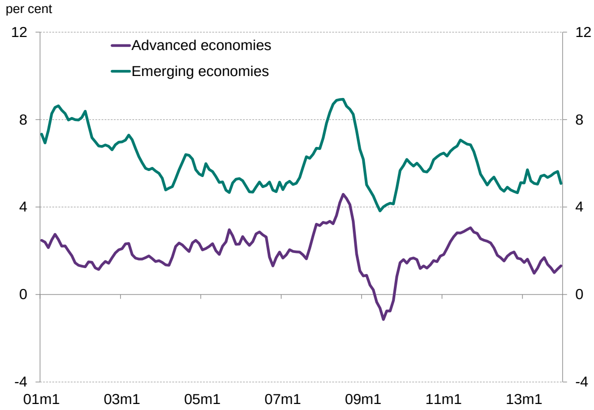
Persistently weak demand pressure and slowing growth in the prices of many food products in the global markets supported low inflation in the world economy in 2013 Q4 (Figure 1.10).

In developed countries, inflation was running below the long-term average, despite a slight rise in some of these countries in the recent months, driven by an increase in growth of energy prices. In the United States, core inflation remained stable, while the rise in CPI inflation towards the end of 2013 and at the beginning of 2014 was related to a hike in growth of energy prices (Figure 1.11). On the other hand, in the euro area, amidst weak demand pressure, HICP inflation dropped off. The decline in HICP inflation was related to falling food prices growth, combined with a further decrease in core inflation.

Also in emerging economies inflation was running below the long-term average. This was supported by relatively weak demand and slower growth in food prices. In some of these countries with floating exchange rates (among others in India, Brazil, Turkey, Indonesia) depreciation of exchange rate was, on the other hand, supporting increase in inflation.

In the countries of Central and Eastern Europe, inflation continued to decline and was running well below the long-term average towards the end of 2013 and at the beginning of 2014 (Figure 1.12). Core inflation in this group of countries remained low. At the same time – in similarity to other regions of the world – in most of these economies weakening growth in food prices was observed. In addition, many CEE countries saw further year-on-year decline in energy prices. In some of these economies, depreciation of exchange rates was contributing to higher inflation. Depreciation of the exchange rate was seen, among others, in the

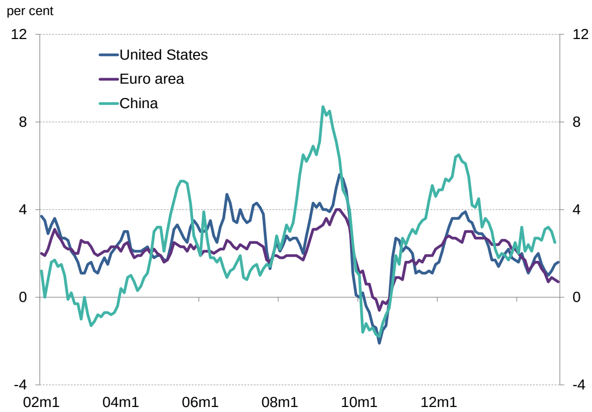
Figure 1.10 Inflation in major advanced and emerging* economies (y/y)



Source: Bloomberg data, NBP calculations.

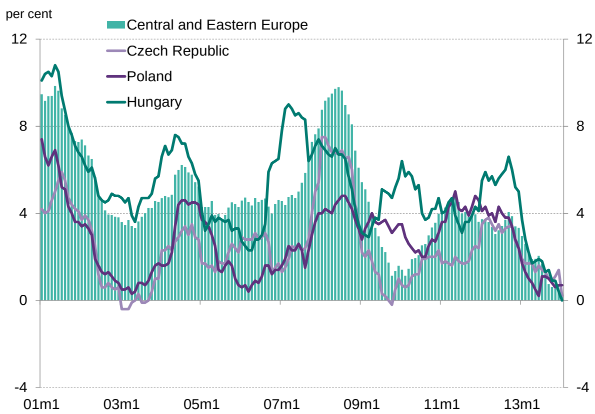
* Weighted average inflation in the developed and the largest emerging economies (accounting for 80% of the GDP in this group of countries in 2012). Country groups in accordance with the IMF division. Weights adopted for the respective countries are based on their GDPs.

Figure 1.11 CPI inflation in the United States and China and HICP inflation in the euro area (y/y)



Source: Bloomberg data.

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.

Czech Republic after the Czech National Bank adopted an asymmetric exchange rate target (see Box 1: *Introduction of asymmetric exchange rate target by the Czech National Bank*).

Box 1: Introduction of asymmetric exchange rate target by the Czech National Bank

The Czech National Bank (the CNB) was the first among the central banks of the transition countries to introduce inflation targeting strategy.[4] The strategy has been pursued since 1997, however, since its initial announcement, the inflation target has been lowered several times (CNB 2007; Figure B.1.1, Figure B.1.2).

Figure B.1.1 Inflation target, interest rate and inflation forecasts of the CNB

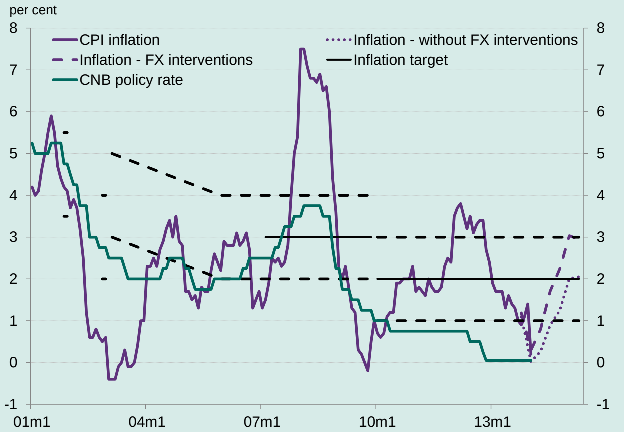
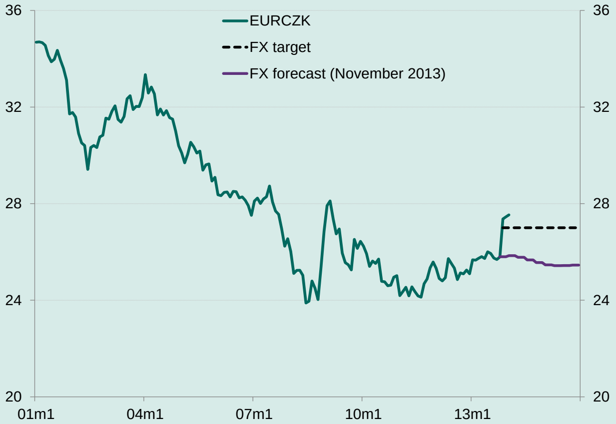


Figure B.1.2 The EUR/CZK exchange rate (increase denotes depreciation)



Source: Own compilation based on CNB data.

The most recent change of the inflation target took place in 2007, when the CNB declared that the target will stand at 2.0% +/- 1 p.p. as of 2010. In doing so, the CNB set its inflation target at the low level, selected by most developed economies. Lowering inflation target entailed the risk that – amidst recession and low inflation (or deflation) – the central bank's capacity to stimulate the economy through reducing the real interest rate will be constrained by the zero lower bound on the nominal interest rate. This risk materialised in the wake of the global financial crisis. The restrictive Czech fiscal policy and continuing recession prompted the Bank to cut the interest rates close to zero in 2012.

Since the end of 2012, the CNB has kept the base rate (interest on 2-week repo operations) at a level slightly above zero (0.05%). Despite the persistence of negative real interest rates, the GDP has been shrinking since the beginning of 2012 (in 2012, GDP growth stood at -1.0% y/y, and in the first three quarters of 2013, at an average of -1.7% y/y). At the same time, inflation has been running below the target since the beginning of 2013, and the CNB forecasts of late 2013 pointed to a 50% probability of deflation in the subsequent quarters and inflation returning to the target not sooner than at the beginning of 2015 (Figure B.1.1; CNB, 2013b).

Unable to cut nominal interest rates any further, in November 2013, the CNB announced the adoption of the exchange rate as an additional instrument of monetary easing. The Bank announced the launch of currency interventions[5] aimed at weakening the Czech koruna against the euro down to 27 EUR/CZK[6] (which meant a

[4] Following the currency crisis which hit the Czech Republic in May 1997, the CNB was forced to float the koruna and consider a different nominal anchor.

[5] Thus, the CNB implemented the IMF recommendations submitted during its Czech mission in the spring of 2012 and in 2013. Another institution to support the currency interventions was the OECD.

[6] „*The CNB will intervene on the foreign exchange market to weaken the koruna so that the exchange rate of the koruna against the euro is close to CZK 27*"(CNB, 2013a). Earlier (in September 2011) an asymmetric exchange rate target was adopted by the Swiss National Bank

depreciation of approx. 5 per cent). Furthermore, the CNB declared that the exchange rate target will be treated asymmetrically, i.e. a weakening of the Czech koruna above 27 EUR/CZK will be tolerated, whereas an appreciation below this level will trigger interventions.[7]

According to the CNB declarations, the asymmetric exchange rate is to stay until the risk of inflation persisting below the target has decreased substantially, which – according to the Bank – is not likely to happen before early 2015. At the same time, the weakening of the Czech koruna is expected to shift the inflation path up by 1 p. p. (CNB, 2013b). In effect – considering the swift transmission to inflation through the exchange rate channel – the depreciation of the koruna is expected to curb the risk of deflation already at the beginning of 2014. It is also to shorten the period of inflation return close to the target down to approx. one year.[8]

Although the effectiveness of the exchange rate targeting in preventing deflation may only be assessed *ex post*[9], at this stage the following results of the interventions have already been observed:

- a depreciation of the Czech koruna to a level compliant with the CNB intentions (i.e. the exchange rate is maintained above 27 EUR/CZK, Figure B.1.2). The effectiveness of the interventions is ensured by the fact, that the CNB has unrestricted funds to intervene in the market (the Bank sells the koruna while buying foreign currencies), which strengthens the credibility of this policy.
- a slight decline in the PRIBOR market interest rate (of approx. 0.05 p.p.; Figure B.1.4), which occurred despite no change in the CNB policy rate. The decrease in the PRIBOR rate resulted most probably from a decrease in the FX-swap implied interest rate. Due to the arbitrage between the markets for these instruments, the decline in the FX-swap implied rate also entailed a decline in the interest on domestic currency deposits.

According to the data presented by the CNB, the currency interventions carried out between 7 and 20 November 2013 amounted to CZK 200 billion (approx. 5% of GDP and 22% of the CNB assets). Although the CNB has not yet disclosed the amount of the interventions launched after 20 November, the balance sheet of the Bank reveals a significant reduction in the scale of the currency interventions. From the start of the interventions to 10 February 2014, the assets of the CNB increased by a total of approx. 28%.

Figure B.1.3 Absorption of liquidity by the CNB (levels of repo operations and O/N deposits)

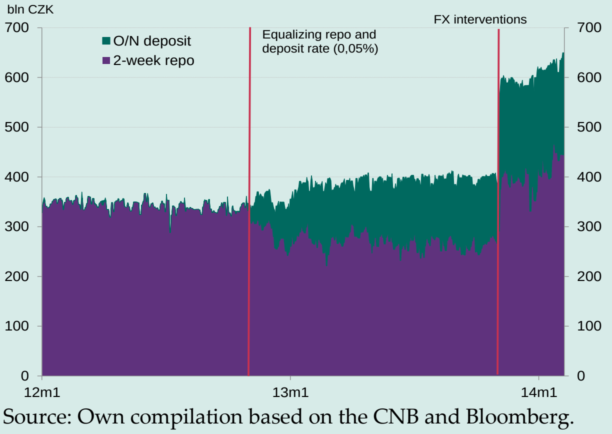
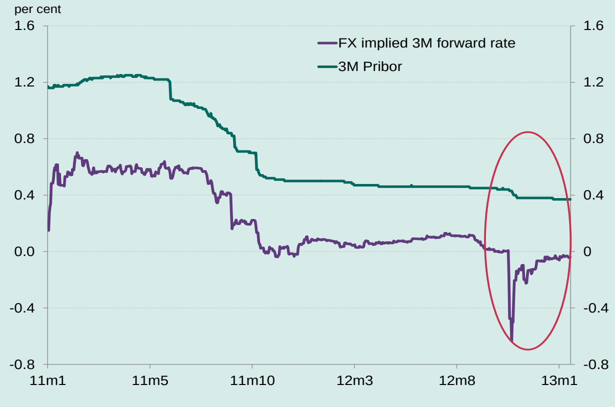


Figure B.1.4 Pribor 3M and FX-swap implied 3M rate



Source: Own compilation based on the CNB and Bloomberg.

(SNB 2011). However, there is a substantial difference between the CNB and the Swiss National Bank in applying the instrument. While prior to the interventions the Czech koruna exchange rate was close to the equilibrium rate (IMF 2013), the Swiss franc was considered by the Swiss National Bank as markedly overvalued (SNB 2011).

[7] *"The CNB regards the commitment as asymmetric* (…) *On the stronger side of the CZK 27/EUR level, the CNB is preventing the koruna from appreciating further* (…) *On the weaker side of the CZK 27/EUR level, the CNB is allowing the koruna exchange rate to float*." (CNB, 2013d).

[8] Estimations of the impact of the koruna depreciation on inflation are fraught with risk. On the one hand, the pass-through may be enhanced by sustained exchange rate weakening. On the other hand, the present phase of the business cycle (i.e. early recovery phase) – combined with adverse business conditions among main Czech trading partners – is restricting the pass-through.

[9] Although in November and December 2013 inflation rose, in January 2014 it declined again to 0.2% (Figure B.1.1).

The banking sector in the Czech Republic is characterised by excess liquidity. Hence, an additional increase in the sector's liquidity resulting from interventions is absorbed, either by open market operations (2-week repos) or by the O/N deposit at the central bank (Figure B.1.3). Since the interest rate on both is the same (0.05%), repo operations and the O/N central bank deposit are close substitutes for the commercial banks.

The launch of an asymmetric exchange rate target has caused a certain lack of cohesiveness to the CNB communications.[10] Since 2008, the CNB has been publishing forecasts of the koruna nominal exchange rate vis-a-vis the euro. According to the latest forecast, published in the November 2013 *Inflation Report* – i.e. after the announcement of the decision to intervene in order to weaken the exchange rate – the koruna exchange rate was to appreciate slightly.[11]

References:

CNB (2007), *The CNB's new inflation target and changes in monetary policy communication*, 8 March 2007.

CNB (2013a), *CNB keeps interest rates unchanged, decides on interventions*, CNB release of 7 November 2013.

CNB (2013b), *Inflation Report – IV 2013*.

CNB (2013c), *The CNB buys foreign exchange worth about CZK 200 billion*, CNB release of 25 November 2013.

CNB (2013d), *The exchange rate commitment: how the CNB keeps the exchange rate close to CZK 27 to the euro*, http://www.cnb.cz/en/faq/the_exchange_rate_commitment.html

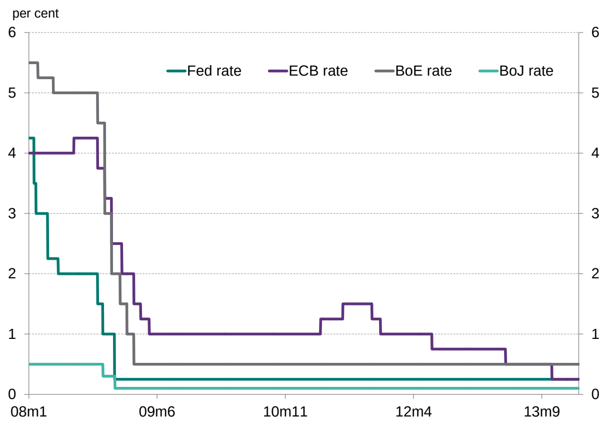
IMF (2013, *Czech Republic. 2013 Article IV Consultation*, August 2013.

SNB (2011), *Swiss National Bank sets minimum exchange rate at CHF 1.20 per euro*, SNB release of 6 September 2011.

1.3 Monetary policy abroad and international financial markets

Since the November *Inflation Report*, the monetary policy of the major central banks has still been expansionary (Figure 1.13; Figure 1.14). This notwithstanding, the Fed scaled back its quantitative easing in two steps, in December 2013 and January 2014. The Fed's decisions caused the sentiment in emerging markets to deteriorate. The decline in asset prices in these markets was amplified by the deteriorating economic outlook in some of these countries. In turn, asset prices in developed countries increased somewhat.

Figure 1.13 Interest rates of major central banks



Source: Bloomberg data.

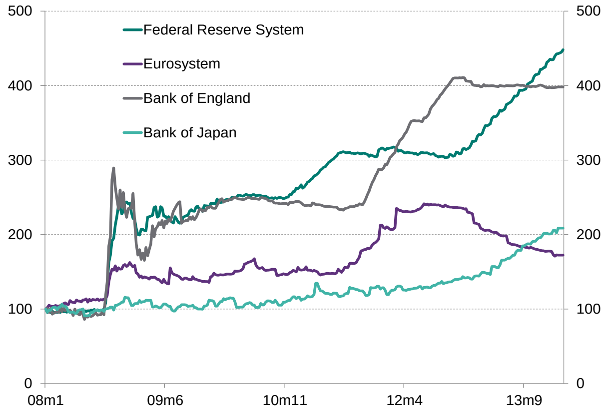
Besides reducing the scale of asset purchases (by a total of USD 20 billion, down to USD 65 billion a month), the Fed declared that it would keep short-term interest rates at near-zero (0.00%-0.25%) well

[10] In the recent years, the CNB has markedly expanded the range of the information released. In particular, since 2008 it has published interest rate forecasts and since 2009 – as the first central bank in the world – the forecast of the nominal bilateral rate (in the form of fan charts).

[11] The cut-off date for the November *Report* was 25 October 2013 i.e. prior to the announcement of the decision on the interventions. However, the *Report* – published a little later – contained a reference to the use of the exchange rate as a supplementary instrument to mitigate monetary conditions by the CNB. It also presented, beside the baseline scenario, the findings of a projection assuming a depreciation of the exchange rate down to 27 EUR/CZK (as an alternative scenario).

past the time that the unemployment rate declines below 6.5%, especially if the projected inflation in the next 1-2 years continues to run below 2.5%, and long-term inflation expectations remain well anchored. Hence, the Fed extended the time horizon of its declaration to keep US interest rates very low.

Figure 1.14 Balance sheets of major central banks, January 2008 = 100



Source: NBP calculations based on Bloomberg data.

In November 2013, the ECB decreased its interest rates by 0.25%, including the interest rate on main refinancing operations to 0.25%, while leaving the rate on deposit facility at 0.00%. Moreover, the ECB again declared its intention to keep interest rates at the present or lower level for a longer period. In January 2014, the declaration was strengthened and the ECB emphasised its determination to ensure highly accommodative monetary conditions. The ECB also confirmed it was ready to implement a programme of purchase government bonds of the member states that were most affected by the sovereign debt crisis, and that it could launch a new programme of liquidity provision to banks.

The Bank of England, in turn, assessed that its interest rate should remain unchanged at 0.50%, although the unemployment rate was approaching the threshold set in previous forward guidance. [12]The Bank of England also declared to remove incentives to expand household lending with its loan support programme (*Funding for Lending Scheme*).

Bank of Japan left the value of its asset purchase programme unchanged at JPY 60-70 trillion. However, in mid-February 2014 it doubled the scale of its loan-support programme (*Stimulating Bank Lending Facility*) and extended the application period of this facility by one year (till March 2015).

[12] Between August 2013 and February 2014 the Bank of England assessed that the interest rates should not be increased until the unemployment rate remained above 7%. The declaration is conditional on the Monetary Policy Committee forecast of the annual CPI inflation not exceeding 2.5% over the following 18-24 months and medium-term inflation expectations not rising significantly above the inflation target, with the stability of the financial system not being at risk. Such a form of forward guidance was abandoned by the Bank of England in February 2014.

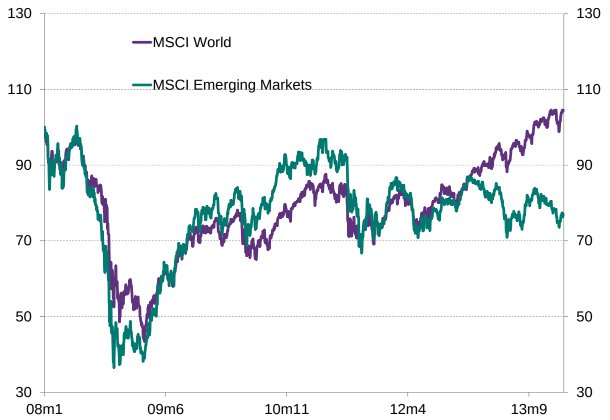
Following the previous *Report*, as a result of the Fed's decisions and deterioration in economic and political conditions some emerging markets experienced capital outflows, fall in asset prices and depreciation of their currencies. Deterioration in sentiment towards emerging markets escalated in January 2014, when the risk that Argentina would suspend the service of its liabilities rose, the political situation in Ukraine deteriorated and data were released pointing to slower than previously expected recovery in many emerging market economies, including in particular China.

The scale of capital outflows was determined mainly by domestic factors, in particular the size of external or fiscal imbalances and economic outlook. However, political factors (in case of Turkey or Ukraine), high share of non-residents in local asset markets (South Africa) and vulnerability of the economy to changes in crude oil prices (Russia) also played a rule.

Capital outflows led to an increase in government bond yields, decline in share prices and depreciation of many currencies (Figure 1.15; Figure 1.16; Figure 1.17). In order to contain depreciation of the exchange rate, some central banks intervened in the foreign exchange market in January 2014.

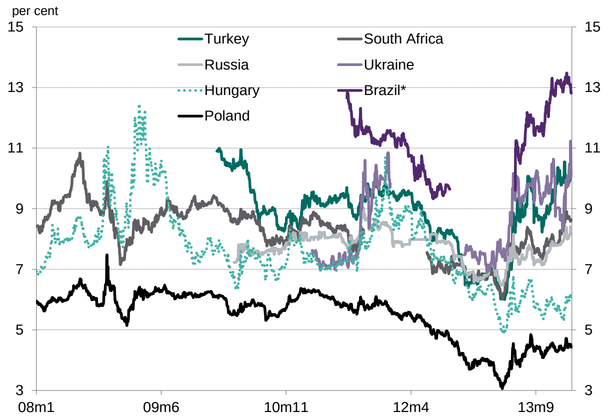
In order to reduce the scale of capital outflows some central banks (Brazil, South Africa and Turkey) increased their interest rates. The interest rate increase was particularly large in Turkey, whose currency had depreciated to a historical low against the US dollar in the second half of January (see Box 2: *Changes in the monetary policy of the central banks in the emerging market economies after the global financial crisis*). These actions could bring the decline in asset prices and the depreciation of the currencies of emerging markets to a halt in early February 2014. As an exception, the

Figure 1.15 Global stock indices, January 2008 = 100



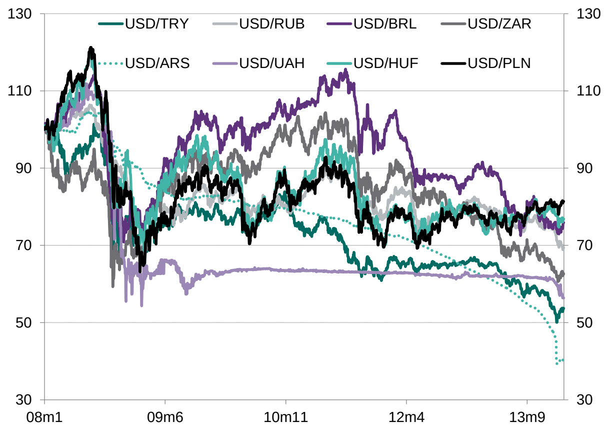
Source: NBP calculations based on Bloomberg data.

Figure 1.16 10-year emerging market bond yields



Source: Bloomberg data.
*9-year bond yields

Figure 1.17 The emerging market currencies exchange rates versus the dollar (January 2008 = 100; increase denotes an appreciation of the currency)



Source: Bloomberg data.

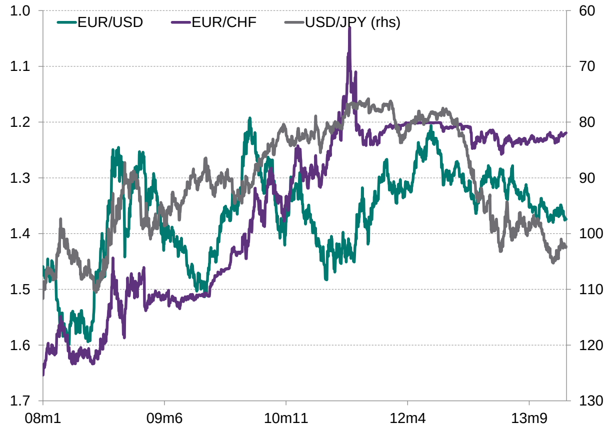
escalation of political crisis in Ukraine in mid-February caused the solvency outlook for this country to deteriorate, which triggered a marked increase in the country's government bond yields and further depreciation of the hryvnia.

Most central banks in emerging market economies kept their interest rates at a low level, while some of them continued to lower the rates. The Czech National Bank intervened to weaken its currency (see Box 1: *Czech National Bank introduces asymmetric exchange rate target*).

Since the previous *Report*, the United States government bond yields have increased, mainly as a result of reduction of asset purchases by the Fed, albeit to a lesser extent than in mid-2013 when the Fed first indicated it could be slowly closing its asset purchase programme. However, the releases of slightly weaker data on economic activity in United States, combined with a deterioration of the international market at the turn of 2014 caused a temporary decline in yields on US Treasury securities (Figure 1.19).

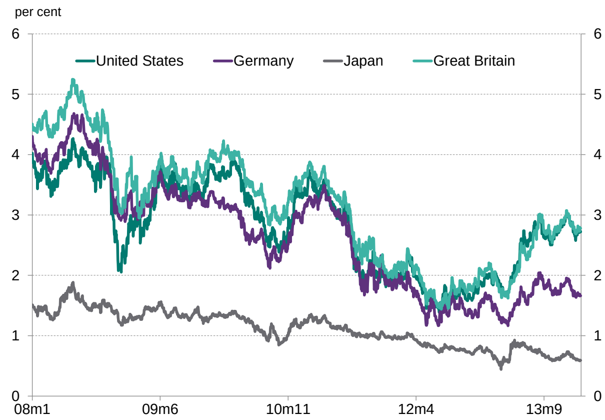
Similar trends could also be observed in other bond markets in developed countries (Figure 1.19). Government bond yields in euro area member states that were most affected by the sovereign debt crisis decreased (Figure 1.20). This was due to the ECB's declaration that it was willing to purchase these bonds, and to signs of economic recovery in the area. These signs also contributed to appreciation of the euro against the US dollar. However, in January 2014, the euro depreciated against the dollar, due to deteriorating global sentiment letting investors to choose safe haven currencies (Figure 1.18).

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)



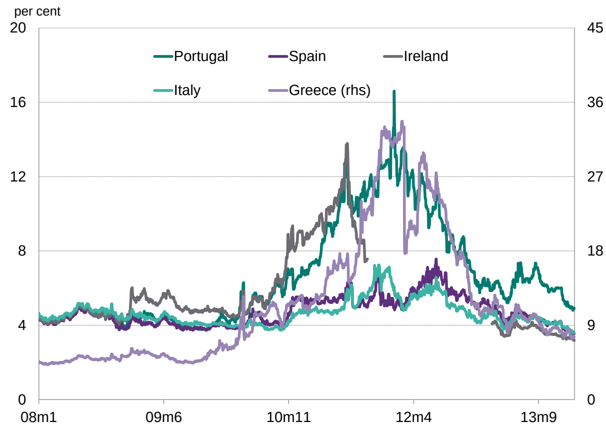
Source: Bloomberg data.

Figure 1.19 10-year bond yields of United States, Germany, Great Britain and Japan



Source: Bloomberg data.

Figure 1.20 10-year bond yields of Greece, Spain, Ireland, Portugal and Italy



Source: Bloomberg data.

Box 2: Changes in the monetary policy of the central banks in the emerging market economies after the global financial crisis[13]

In recent years, the central banks of emerging market economies (EMEs) have modified somewhat their monetary policy frameworks. These changes were triggered by the following factors. Firstly, the global financial crisis showed that low and stable inflation was insufficient for macroeconomic stability to be preserved. In particular, the stabilisation of inflation by the Fed and other central banks before the crisis did not prevent imbalances from building up in the US and the global economy. Secondly, following the financial crisis, portfolio capital inflows increased in many EMEs characterised by relatively rapid economic growth (Figure B.2.1). These flows were, in particular, encouraged by exceptionally accommodative policy of major central banks. Capital inflows had the following consequences for the EMEs:

- until mid-2011, currencies of many EMEs were under growing pressure to appreciate, which could have eroded the price competitiveness of enterprises in these countries, thus causing or adding to external imbalances;
- until mid-2013, interest rates in the EMEs were declining, leading to a rise in domestic asset prices; lending in EMEs also recorded an increase, which triggered a rise in real property prices (Figure B.2.2);

Figure B.2.1. Portfolio capital inflows to EMEs*

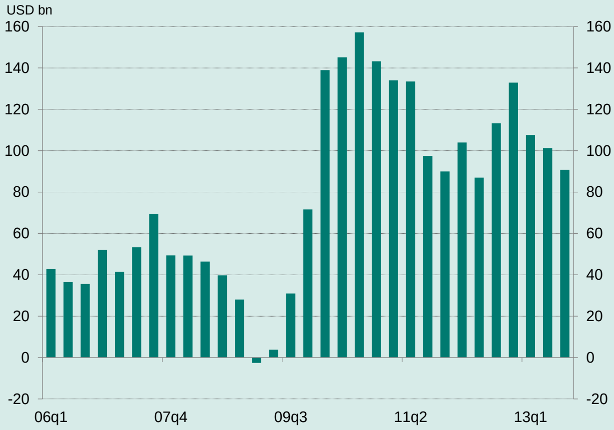
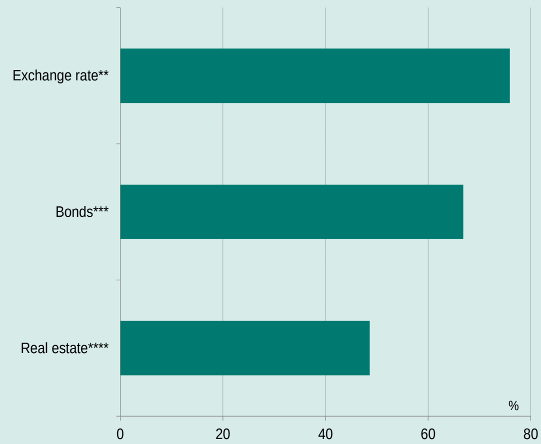


Figure B.2.2. Asset prices in EMEs (Q1 2009 = 100)



Source: NBP calculations based on central bank, Bloomberg and BIS data.

*The emerging economies in the left graph consist of the following: Brazil, Chile, Colombia, Croatia, the Czech Republic, Hungary, India, Indonesia, the Philippines, Poland, Romania, South Africa, South Korea, Thailand and Turkey.
**The JP Morgan Emerging Market Currency Index.
***The JP Morgan Emerging Market Bond Index.
****Arithmetic mean of real property prices (in USD) in Brazil, the Czech Republic, Hungary, Indonesia, Malaysia, Mexico, Peru, Poland, Romania, South Africa, Thailand and Turkey.

- external foreign-currency corporate debt has increased[14], which may, in the longer term, boost liquidity and exchange rate risk;
- EMEs face higher risk of sudden capital outflows due to a change in global risk perception – similar to that following Fed's QE taper talk in 2013 Q2 (see Box 1: *The impact of the Fed's QE tapering communication on the valuation of financial assets* in *Inflation Report – November 2013*).

Keeping interest rates well below their pre-crisis levels was to help contain capital inflows to EMEs (Figure B.2.3). Yet, the policy turned out to be insufficient to curb these inflows (Figure B.2.1), while possibly adding to growth in asset prices, including real property prices (Figure B.2.2).

[13] This box relates to monetary policy and macroprudential measures aimed at reducing the range of capital flow fluctuations. No fiscal or administrative policy measures have been taken into account.

[14] This refers mainly to heavier issuance of corporate debt instruments in international debt securities markets. In 2012 and 2013, these almost doubled in China, Brazil and countries of South-East Asia; they also rose by nearly 50% in Russia and India.

Figure B.2.3. Central bank interest rates in the emerging countries**

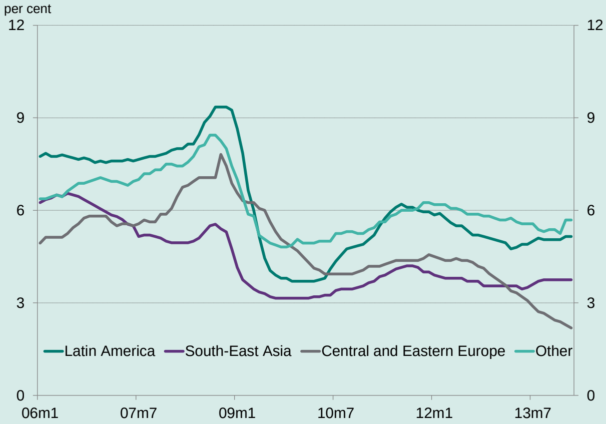
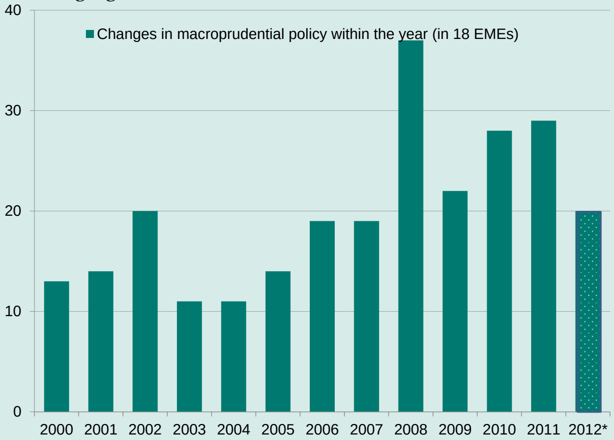


Figure B.2.4. Macroprudential measures taken by central banks of emerging countries***



Source: NBP calculations based on Bloomberg and BIS data

**Arithmetic mean. The emerging economies in the left graph consist of the following: for Latin America – Brazil, Chile, Colombia and Peru; for Central and East Europe – the Czech Republic, Hungary, Poland, and Romania; for East and Southeast Asia – Indonesia, Korea, Malaysia and Thailand; for other countries – Egypt, India, Israel, South Africa and Turkey (for the latter, the rate assumed as the base rate for the whole period under review was the rate on repo operations).

***The emerging economies in the right graph consist of the following: Brazil, Chile, Colombia, Croatia, the Czech Republic, Hungary, India, Indonesia, Malaysia, Mexico, Peru, Poland, the Philippines, Romania, South Africa, South Korea, Thailand and Turkey.

Therefore some of the EMEs supplemented their monetary policy strategies with new tools and additional objectives, which they believed would ensure macroeconomic and financial stability. The changes included:

- supporting financial stability by means of macroprudential policy tools (Figure B.2.4):
  - in 2010, the Central Bank of the Republic of Turkey augmented its monetary policy strategy with two indirect goals – to curb the increase in lending and to limit short-term capital inflows;
  - in 2011, the Bank of Korea supplemented its primary goal (price stability) with an additional one – financial stability;
  - also some other EMEs (Brazil, Malaysia and Thailand) introduced issues related with financial stability into their monetary policy strategy;
  - macroprudential measures are also adopted by central banks whose monetary policy goals do not officially include financial stability (Bank of the Philippines and Bank of Indonesia);
- more frequent foreign exchange interventions:
  - central banks attempted to reduce exchange rate volatility with foreign exchange interventions, either on regular (Turkey from June 2013, Brazil from July 2013) or occasional basis (e.g. Chile, Indonesia, India or South Africa);
  - in 2013, the Czech National Bank decided to introduce an asymmetric exchange rate target, as there was no more room for further interest rate cuts (see Box 1: *The Czech National Bank introduces asymmetric exchange rate target*); *Introduction of asymmetric exchange rate target by the Czech National Bank*
- modification of the interest rate policy:
  - the Central Bank of the Republic of Turkey changed, on several occasions, the width of the band for short-term interest rates in order to raise the cost of speculative transactions; the Bank also increased the reserve requirement ratio on short-term liabilities (also with respect to liabilities denominated in foreign currencies), which was to be conducive to extending the maturities of investors' liabilities and to mitigating liquidity risk in the banking sector;
  - also, some other central banks (People's Bank of China, Croatian National Bank, Reserve Bank of India, Bank Negara Malaysia) changed the required reserve ratio or the base for reserve calculation, in order to affect lending growth without changing the interest rate;
- modification of monetary policy communications:
  - the Central Bank of the Republic of Turkey has been taking advantage of controlled ambiguity in relation to interest rates and liquidity. The communication in these areas was also vague, probably

so as to increase the volatility of short-term interest rates and curb the scale of short-term capital inflows.

As the modifications listed above were introduced only recently, we cannot fully evaluate their effectiveness. In particular, notwithstanding the efforts made (e.g. Bianchi (2009), Benigno et al. (2010), Galati and Moessner (2011), Aiyar et al. (2012), Aikman (2012), Giese et al. (2013)), the macroprudential policy transmission mechanism has not been fully described. However, the experience of central banks, in particular those in East and Southeast Asia, which had launched macroprudential policy measures in the wake of the Asian crisis of 1997, shows that macroprudential policy could not fully prevent imbalances in some segments of the financial market from building up. Also foreign exchange interventions by EME central banks were not always sufficient to reverse strong trends – especially in the case of depreciation – in foreign exchange markets. This is suggested, in particular, by the experience of the Central Bank of the Republic of Turkey, whose foreign exchange interventions showed little success in slowing down the pace of depreciation of the Turkish lira. The scale of the lira depreciation may have been additionally exacerbated by frequent and hard-to-interpret changes in the parameters of monetary policy aimed at discouraging short-term capital inflows. For this reason, in January 2014 the Bank decided to significantly increase its interest rates and to restore the transparency of its monetary policy. Other EMEs (Brazil, South Africa) tried to prevent capital outflows with interest rate increases rather than additional modifications of monetary policy. The experience described above shows that the effectiveness of monetary policy instruments in reducing capital outflows depends on the credibility of the central bank and the quality of economic policy.

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Bianchi (2010), *Overborrowing and Systemic Externalities in the Business Cycle*, Federal Reserve Bank of Atlanta Working Paper No. 2009-24.

Galati i Moessner (2011), *Macroprudential Policy – a Literature Review*, February 2011.

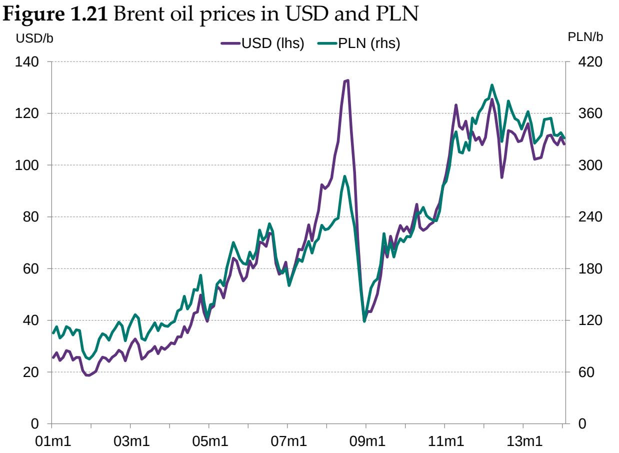
Giese J., Nelson B., Tanaka M., Tarashev N. (2013), *How Could Macroprudential Policy Affect Financial System Resilience and Credit? Lessons from Literature*, Financial Stability Paper no. 21, Bank of England, May 2013.

1.4 Global commodity markets

In 2013 Q4 and at the beginning of 2014, global prices of most commodities, including oil, did not change significantly. Situation in the world commodity markets was strongly shaped by supply factors, with only a minor impact of the Fed's QE tapering.

In 2013 Q4 and at the beginning of 2014 the average price of Brent oil remained high, at approx. USD 110/b (Figure 1.21). The still relatively high prices of this commodity at the end of 2013 resulted in large part from disruptions to its global production. Oil supply continues to be adversely affected by the

Figure 1.21 Brent oil prices in USD and PLN



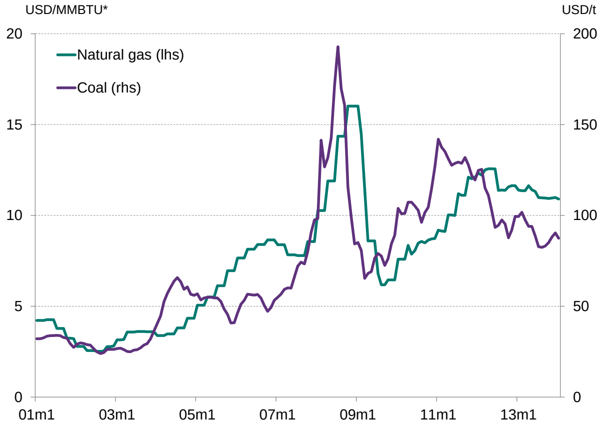
Source: US Energy Department data, NBP calculations.

situation in Libya, where extraction was heavily restricted at the end of 2013.[15] At the same time, continued fast growth in shale oil production in the United States, coupled with expectations of this trend being sustained in the coming years, added to the supply of oil. A relatively stable oil prices at the beginning of 2014 may reflect market belief that OPEC producers are ready to reduce oil production against the signs of weaker than expected recovery in global growth.

The prices of gas have been stable over the past few months. In turn, coal prices rose in 2013 Q4, possibly driven by the Chinese authorities' announcing the closure of small mines (Figure 1.22).[16]

The index of global food prices has not changed significantly in the past few months, although the prices of individual agricultural commodities have been trending in different directions (Figure 1.23). Some of them have been dragged by good weather and water conditions in most countries and the related increase in the supply of certain agricultural products.[17] Cheaper animal feeds, in turn, translated into lower cost of animal production and a significant fall in meat prices. Yet, simultaneously, concerns about the level of wheat harvest in Argentina and the Black Sea region, coupled with rising wheat imports to China, led to an increase in wheat prices.[18] Expanding Chinese demand has also fuelled milk price growth.[19]

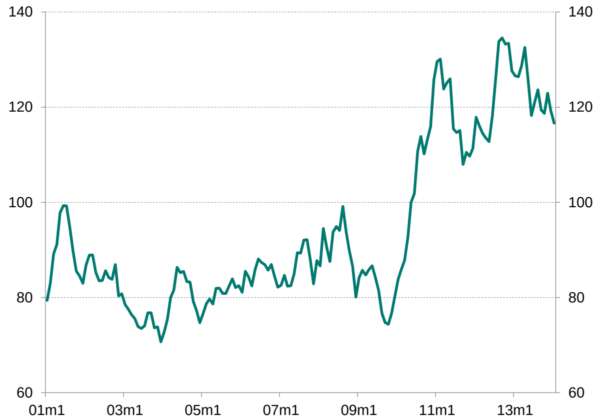
Figure 1.22 Gas and coal prices in the global markets



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 1.23 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.

[15] The problem with oil extraction in Libya had started as early as in June 2013. Yet, the situation deteriorated markedly in August, with November and December bringing the Libyan output down to near-zero levels.

[16] Due to lack of availability of data concerning wholesale gas prices in Poland, gas prices quoted in this chapter relate to prices of Russian gas in Germany.

[17] The commodities whose prices have declined include rape, sugar and coffee.

[18] Due to the droughts in West Africa, prices of cocoa have risen as well, although by much less than wheat prices.

[19] Prices of skimmed powder milk kept growing throughout November and December 2013, under the demand pressure from China.

2 Domestic economy

2.1 Inflation developments

2.1.1 Consumer prices

In 2013 Q4, the annual growth in consumer goods and services prices in Poland continued at a low level (0.7% y/y in December; Figure 2.1).[20]

Persistently negative growth in energy prices, being the result of the previously observed reductions in tariffs for natural gas and electricity and declining fuel prices, supported low inflation., Growth in commodity prices remained low as well due to lack of demand pressure. At the same time, growth in food prices weakened, which was mainly related to the favourable supply conditions in most agricultural commodity markets. A slight decline in inflation in late 2013 was also driven by slowing growth in the prices of services (see Chapter 2.1.2 *Core inflation*).

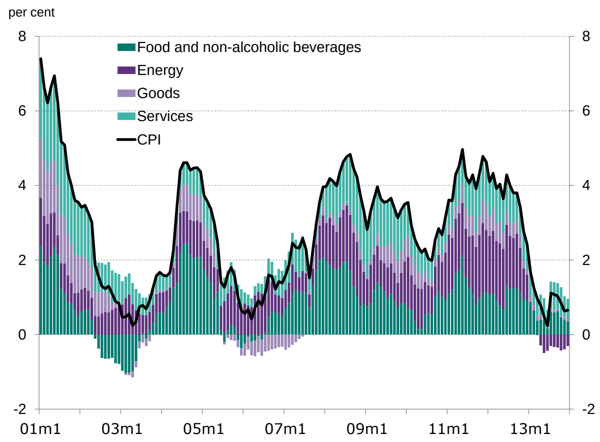
Low inflation was further supported by weak cost pressures in the economy. This is indicated by deepening decline in producer prices in industry (see Chapter 2.1.3 *Producer prices in industry*).

2.1.2 Core inflation

Since the November *Report*, all core inflation measures declined (Figure 2.2). Inflation excluding food and energy prices fell from 1.3% in September 2013 to 1.0% in December 2013.

The decline in core inflation in the analysed period resulted from weaker growth in the prices of services. This weakening was primarily due to a

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)

	2005	2006	2007	2008	2009	2010	2011	2012	2013
CPI (%)	**2.1**	**1.0**	**2.5**	**4.2**	**3.5**	**2.6**	**4.3**	**3.7**	**0.9**
Food and non-alcohol beverages (pp)	0.6	0.2	1.3	1.6	1.0	0.7	1.3	1.0	0.5
Energy (pp)	0.8	0.8	0.6	1.3	0.8	1.0	1.5	1.4	-0.3
Goods (pp)	0.1	-0.4	0.0	0.2	0.4	0.3	0.5	0.4	0.1
Services (pp)	0.6	0.4	0.7	1.2	1.2	0.6	1.0	0.9	0.6

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

[20] In January 2014, according to the preliminary GUS (Central Statistical Office) data, inflation remained at 0.7% y/y. However, the data on inflation in January 2014 may be revised as a result of changes in the structure of the CPI basket introduced by GUS at the beginning of each year. Due to the preliminary nature of the data, GUS did not publish information on changes in all components of the CPI basket. Therefore, a more in-depth analysis of the January price changes in particular groups will be presented in the subsequent Report.

decrease in charges for mobile phones and cable and digital TV (promotion launched by television operators; Figure 2.3).

2.1.3 Producer prices in industry

In 2013 Q4, producer prices in industry (PPI) continued to decline (posting growth of -1.3% y/y as against -1.1% y/y in the previous quarter), which indicates persistently weak cost pressures in the economy (Figure 2.4).[21] Decrease in PPI in 2013 Q4 was supported by a slight zloty appreciation in annual terms.

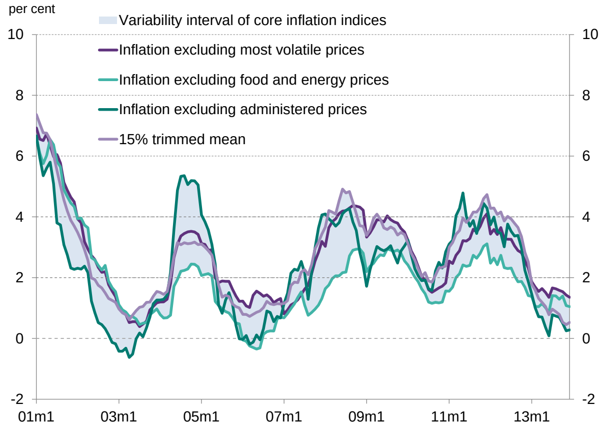
As a result of the zloty appreciation, the decline in producer prices in the exported goods market was stronger than that in the domestic market. This is due to the fact that import intensity of the export sector, including sensitivity of the sector's price to changes in the zloty exchange rate, is higher than in the sector producing for the domestic market. The producer price index for exports declined from -0.8% y/y in 2013 Q3 to -1.1% y/y in 2013 Q4, while domestic PPI stood in that period at -1.3% y/y and -1.5% y/y respectively.

2.1.4 Import prices

The decline in zloty denominated prices of imported goods – observed since 2012 Q4 – was halted in 2013 Q3 (Figure 2.5). Import prices declined in 2013 Q3 by a mere 0.1% y/y (as compared to a 1.5% y/y fall in the previous quarter).

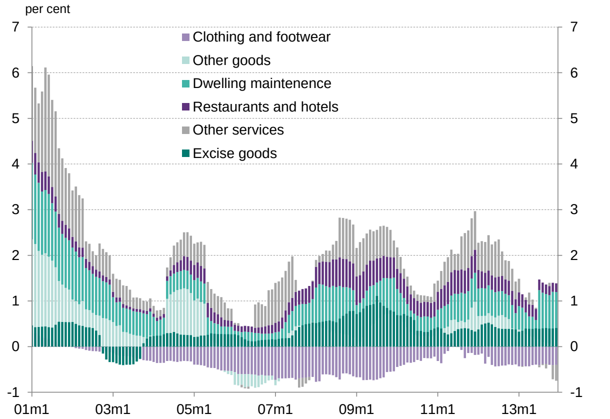
The halt in the decline of import prices was driven by an increase in the annual growth of dollar denominated prices of imported goods, mainly fuels. In turn, the zloty was stronger than a year ago, which helped to maintain negative growth in these prices.

Figure 2.2 Core inflation measures (y/y)



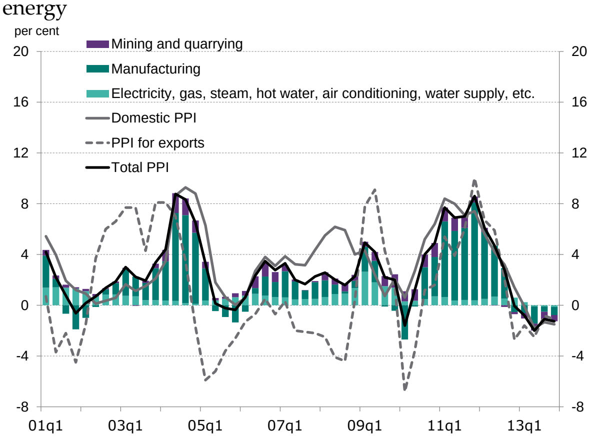
Source: GUS data, NBP calculations.

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.

[21] In January 2014, PPI rose to -0.9% y/y as compared to -1.0% y/y in the preceding month.

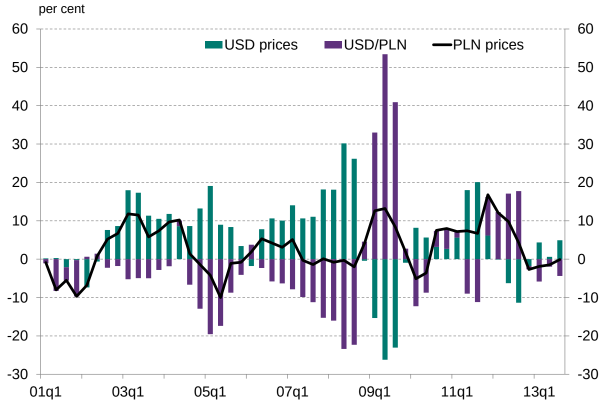
2.1.5 Inflation expectations

Following the previous *Report*, 12-month inflation expectations of financial sector analysts have remained slightly below the inflation target and stood at 2.3% y/y in February 2014 (Figure 2.6).[22] At the same time, their forecasts of the 2014 annual average inflation gradually declined – from 2.1% in October 2013 to 1.6% in February 2014. In turn, the 2015 average annual inflation forecasts persisted at 2.5% and the 2016 average amounted to 2.5% as well.

This is broadly in line with the expectations of average annual inflation in 2014 and 2015 as indicated by the findings of the *NBP Survey of Professional Forecasters* of December 2013.[23] The median of the 2014 aggregated probabilistic forecast amounts to 1.7%, while the median of the 2015 forecast stands at 2.5% (Table 2.2).[24]

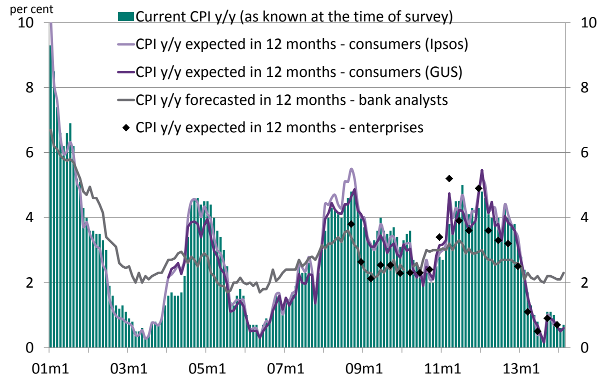
Inflation expectations of enterprises in 12 months' horizon continued at a low level. After growth in 2013 Q3 to 0.9%, in 2013 Q4 they decreased to 0.7%. The decline in inflation expectations of enterprises was mainly due to changes in current inflation known to them at the time of the survey.[25]

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



Source: GUS data, NBP calculations.

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.

[22] Starting from the current *Report*, the forecasts of financial sector analysts are measured with their median, which is less sensitive to changes in the number of people surveyed than the average of individual forecasts, which was used previously.

[23] The NBP Survey of Professional Forecasters is conducted on a quarterly basis. It comprises experts from financial institutions, research centres and employer and employee organisations. Their forecasts are formulated in probabilistic terms, which enables to take account of various economic development scenarios and assess the compatibility of forecasts. For a detailed description of the survey results, see http://amakro.nbp.pl

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

[25] The survey question addressed to enterprises refers to current inflation. In the latest survey it was as follows: "In October 2013 the CPI inflation index amounted to 0.8% in year-on-year terms. In the opinion of your enterprise, within the nearest 12 months prices will: (1) rise faster than hitherto; (2) rise at the same pace; (3) rise more slowly; (4) remain unchanged; (5) fall; (6) I don't know."

Inflation expectations of consumers also remained low. After a rise to 0.9% y/y in October 2013, in subsequent months – following a decline in current inflation – these expectations gradually weakened. In February 2014, expectations of consumers stood at 0.6% y/y.[26]

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	1.7	1.3 - 2.2	0.2 - 3.1	61%
2015	2.4	1.8 - 3.0	0.5 - 4.5	69%

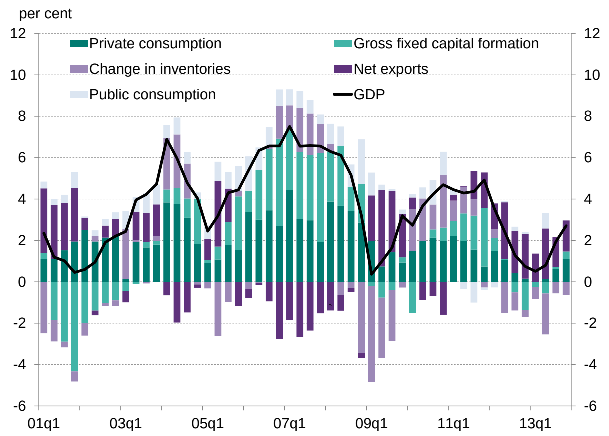
Source: NBP Survey of Professional Forecasters, December 2013.

2.2 Demand and output

In the second half of 2013, economic activity in Poland continued to accelerate gradually. The annual GDP growth stood at 1.9% in Q3 and 2.7% in Q4 (as against 0.8% in 2013 Q2; Figure 2.7; Table 2.3). GDP growth picked up also in quarter-on-quarter terms and reached 0.9% q/q in 2013 Q3 and 0.8% q/q in 2013 Q4 (as against 0.6% q/q in 2013 Q2; seasonally adjusted data, NBP estimates).

Rising domestic demand has contributed – for the first time since 2012 Q1 – to the pickup in GDP growth in the second half of 2013. It was related to a slight recovery in consumer demand and a modest increase in investment. This was accompanied by a reduction in the negative contribution of inventories. Net exports continued to be the main driving force of economic growth, although their contribution to GDP growth was lower than in the previous quarters.

Figure 2.7 GDP growth and its components



Source: GUS data.

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
GDP (%)	5.1	1.6	3.9	4.5	1.9	0.5	0.8	1.9	2.7
Private consumption (%)	5.7	2.1	3.2	2.6	1.2	0.0	0.2	1.0	2.1
Public consumption (%)	7.4	2.1	4.1	-1.7	0.2	-0.1	4.3	1.7	2.1
Gross fixed capital formation (%)	9.6	-1.2	-0.4	8.5	-1.7	-2.1	-3.2	0.6	1.3
Inventory increase (percentage points)	-1.1	-2.4	2.0	0.6	-0.6	-0.5	-2.0	-0.5	-0.7
Net exports (percentage) points)	-0.6	2.7	-0.7	0.9	2.0	1.3	2.5	1.4	1.5

Source: GUS data.

[26] Starting from the current *Inflation Report*, the measure of consumers' 12 months inflation expectations will be based on a relevant GUS survey. Until the end of 2013, NBP used corresponding survey data provided by the company Ipsos (formerly Ipsos-Demoskop, Demoskop), which had at its disposal the longest series of survey data on inflation expectations of Poland's consumers. However, at the beginning of 2014, Ipsos ceased to conduct consumer surveys from which these data were obtained. The change of the source of survey data does not affect the assessment of inflation expectations of consumers, as up to now both measures of expected inflation have been very similar (Figure 2.6; see http://www.nbp.pl/homen.aspx?f=/en/statystyka/expectations.html).

2.2.1 Consumption demand

Following a period of stagnation in the first half of 2013, consumer demand rebounded in the second half of the previous year. Private consumption growth amounted to 1.0% y/y in Q3 and 2.1% y/y in Q4 (as compared to 0.2% y/y in 2013 Q2; Figure 2.8), remaining below the long-term average. According to NBP estimates, private consumption in quarter-on-quarter terms, after posting a growth in 2013 Q3 (up to 0.5% q/q as against 0.2% q/q in the previous quarter; in seasonally adjusted terms) slowed down slightly in 2013 Q4 (to 0.2% q/q in 2013 Q4).

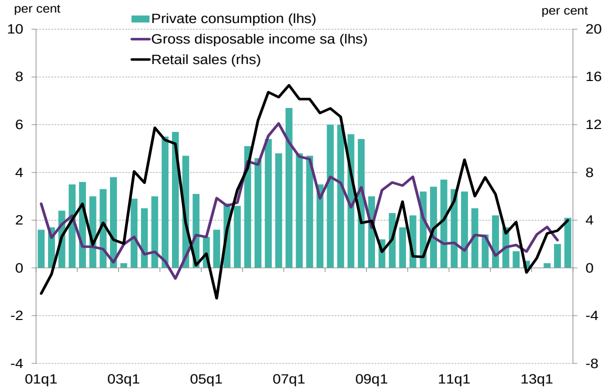
The recovery in consumption is also confirmed by a pickup in retail sales recorded in 2013 Q3 and Q4.[27]

Consumer demand in the second half of 2013 was supported by a slight acceleration in wage growth in the economy and a modest increase in employment (see Chapter 2.4 *The labour market*).[28] Recovery in consumption was also encouraged by an improvement in consumer sentiment (Figure 2.9) and further easing of consumer credit conditions. At the same time, persistently elevated unemployment was curbing growth in consumer demand.

2.2.2 Investment demand

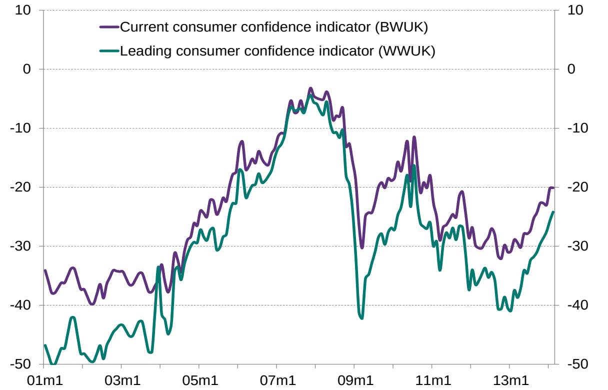
In the second half of 2013 – after a year of decline – investment in the economy rebounded slightly. The annual growth in gross fixed capital formation amounted to 0.6% in Q3 and 1.3% in Q4 (as compared to -3.2% y/y in 2013 Q2) According to NBP estimates, the quarter-on-quarter growth in

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



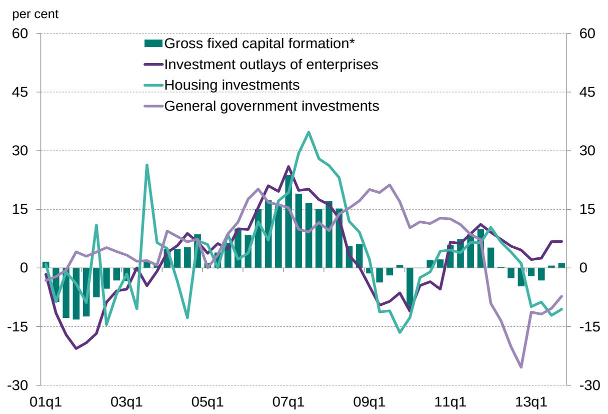
Source: GUS data, NBP calculations.

Figure 2.9 Consumer confidence indicators



Source: GUS data.

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



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

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

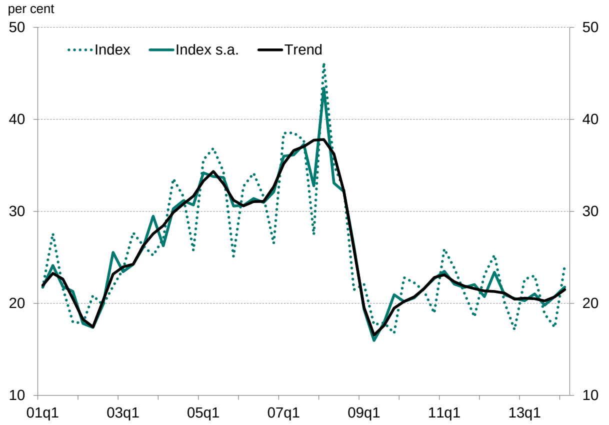
[28] The rise in real wages was supported by low inflation.

investment also picked up (investment growth in Q3 stood at 1.0% q/q and in Q4 0.2% q/q, as compared to -0.5% q/q in 2013 Q2; seasonally adjusted data).

According to NBP estimates, the upturn in investment in the economy in the second half of 2013 was the result of increased corporate investment (Figure 2.10).[29] This was probably fuelled by further gradual improvement in business conditions. At the same time, the declines in both public sector and housing investment were less pronounced than in previous quarters. Investment activity continues to be significantly weaker in the public sector, as compared with the corporate sector, due to sustained measures aimed at reducing fiscal imbalances. In turn, the absence of a significant recovery in household investment could be attributed to a sluggish improvement in the financial condition of households.

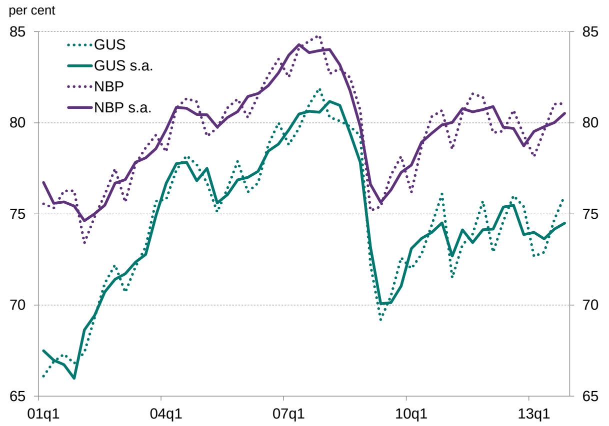
At the same time, the outlook for corporate investment activity in the coming quarters improved. Production capacity utilization continued to rise gradually (Figure 2.12). This was accompanied by an improvement of corporate expectations about future demand, orders and production, reflected in NBP's business climate surveys.[30] Enterprises currently anticipate a recovery in investment, which is mostly visible in their annual plans. These plans show both a rising share of investors embarking on new investment

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



Source: NBP economic climate survey.

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.

[29] The pickup in corporate investment is also confirmed by the results of GUS F-01/I-01 survey for 2013 Q3. According to GUS data, enterprises increased all categories of investment. The strongest rise was seen in corporate outlays on motor vehicles. A marked, albeit slower increase was recorded in the expenditures on buildings and constructions. A small, yet positive growth was also observed in the case of investment in machinery and equipment.

[30] *NBP Quick Monitoring. Economic climate in the enterprise sector in 2013 3Q and forecasts for 2014 Q1*, NBP

projects and a surge in the total annual expenditures. The index of new investment, i.e. the share of enterprises planning to start new investments within a quarter, also slightly increased (Figure 2.11).

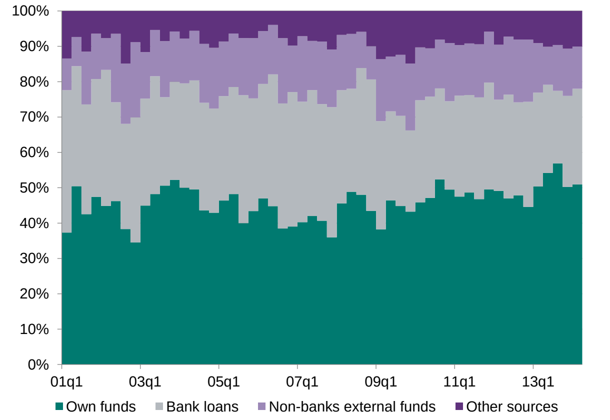
2.2.3 Government demand

The condition of public finance in 2013 was significantly affected by weak growth in domestic demand, which contributed to a reduction in tax revenues of the general government sector (Figure 2.14). At the same time, the fiscal tightening was continued limiting the growth in public spending. Yet, the scale of revenue decline was so significant that despite these measures, the deficit of the general government sector widened (to exceed 4% of GDP).

According to preliminary data, the 2013 state budget deficit amounted to PLN 42.5 billion and thus was higher than the one recorded in 2012 (PLN 30.4 billion). The deficit was also higher than the level envisaged in the 2013 *Budget Act* before the amendment (PLN 35.6 billion). The deterioration in the budget balance resulted from a 3.0% y/y decline in the total state budget revenue (the realization of income at the level envisaged in the *Budget Act* before the amendment was supposed to translate into a 4.1% y/y increase). At the same time, the increase in spending was low and amounted to merely 1.1 % y/y.[31]

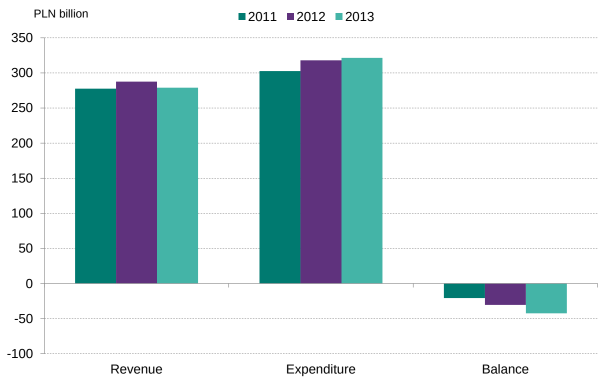
According to preliminary data, in 2013, local governments recorded a deficit of PLN 0.05 billion, i.e. PLN 2.99 billion lower than in 2012. The improvement was largely driven by a slowdown in local governments spending growth (to 1.8% y/y). According to NBP's monetary statistics, in 2013, local governments somewhat reduced their debt to

Figure 2.13 Main source of financing new investments (% of respondents declaring given source)



Source: NBP economic climate survey.

Figure 2.14 State budget performance in the period January-December



Source: Ministry of Finance.

[31] Considering the level of spending assumed in the 2013 *Budget Act* before the amendment, growth in spending was supposed to reach 5.3% y/y.

the banking sector (by almost PLN 0.1 billion), as compared with their debt increase of PLN 2.0 billion recorded in 2012.

In 2013, the deficit of the Social Insurance Fund increased markedly. The difference between revenues from contributions and expenditures for benefit payments was, to a greater extent than in the previous years, financed by a loan from the state budget, and to a lesser extent, by a budget subsidy. The Social Insurance Fund debt to the state budget increased in 2013 by PLN 12.0 billion as compared to a PLN 3.0 billion rise in 2012. Moreover, in 2013, the Social Insurance Fund's deficit was again financed by drawing on the Demographic Reserve Fund (PLN 2.5 billion). In 2013, the balance of the Labour Fund also deteriorated. In turn, the National Health Fund reported a slightly larger surplus than in 2012.

In 2014, the condition of public finance will be significantly influenced by the enacted changes in the functioning of the capital pension system. The transfer of government bonds from the portfolios of open pension funds (OFE) to the Social Insurance Institution (ZUS) and their subsequent redemption will contribute to the reduction of the public debt-to-GDP ratio by approx. 7.6 percentage points, while the general government debt-to-GDP ratio will fall by approx. 8.5 percentage points. As a result of the 2014 change in the methodology of the national accounts, this transaction will not , however, have any direct impact on the general government balance.[32] The general government balance will, instead, be affected by the sustained decline in debt service costs (by approx. 0.3 percentage points of GDP) and a possible exit of some of the insured persons from open pension

[32] In accordance with the ESA95 system of national accounts, currently applicable in the EU Member States, the said transfer of assets is recorded as general government revenue which would imply a one-off surplus of this sector of 4%-5% of GDP in 2014. However, from September 2014 a new system of national accounts - ESA 2010 – will be launched, according to which this one-off effect on the balance of general government sector does not take place.

funds.[33] The decline in the cost of public debt service and growth in income from contributions paid for people who will withdraw from open pension funds, along with the expected gradual economic recovery, will be the main source of the reduction in fiscal imbalance expected in 2014.

Box 3: The sequencing of fiscal consolidation – conclusions from the literature

The increase in public debt to historically high levels, observed in most developed countries during the global economic crisis and the ensuing increase in insolvency risk in some countries, called for exceptionally large-scale fiscal adjustments, which were aimed at limiting public debt and curbing its growth rate. However, these adjustments are implemented in an unfavorable macroeconomic environment. Deleveraging of the private sector, observed in many countries, and the simultaneous implementation of fiscal adjustment measures by the majority of key developed economies, limit the ability to compensate for the falling government demand with other components of domestic demand and net exports. Under these conditions, it is particularly important to appropriately distribute the fiscal adjustment process over time, on the one hand, in order to reduce the scale of its impact on economic growth in the short and medium term, and on the other hand, to ensure that fiscal policy is perceived by economic agents as credible and consistent with the government's solvency.

The main argument in favour of, at least partial, postponement of fiscal tightening in the current situation, is the fluctuation of the fiscal multiplier[34] over time and its higher level during the economic downturn[35]. As a result of high values of the fiscal multiplier fiscal tightening, by weakening GDP growth, may lead to an increase in public debt to GDP ratio rather than its decline in the short term. This means that the tightening brings the opposite effect than intended, resulting in so-called self-defeating austerity. Decision on the choice of the specific sequencing of fiscal consolidation should account for the fact that current factors responsible for the elevated multipliers are largely temporary in nature. The most important of these factors are the zero lower bound for interest rates and generally constrained effectiveness of monetary policy (Fisher 2011), disturbances in the functioning of the financial system (Corsetti et al. 2012a), spare capacity in the economy (Auerbach , Gorodnichenko 2012), or the simultaneous conduct of fiscal consolidation by many countries. Once these factors subside, the fiscal multiplier is likely to decrease, which means that consolidation measures will be carried out at lower cost in the form of a reduced GDP growth. However, when planning consolidation measures, it has to be borne in mind that it is difficult to predict when multipliers will decline. Batini et al. (2012) used fiscal multiplier estimates during the recession and expansion to simulate the effects of fiscal tightening in the United States, Japan and the euro area. The results show that consolidation, if spread over a longer period of time, achieves the same or greater reduction in the debt ratio, than if carried out it in the initial period, and in addition it involves lower economic costs. A comparison of gradual consolidation with the more front-loaded one shows that it is even more advantageous when the initial conditions are unfavorable (high levels of public debt and interest). The situation is opposite when the financial markets in their assessments of credit risk tend to rely more on the value of structural budget balance than the level of public debt.

The impact of fiscal tightening on the economy is also exerted by the hysteresis effect, i.e., a permanent reduction in production capacity of the economy as a result of transitory shocks (e.g. DeLong, Summers 2012). This phenomenon is associated, in particular, with sustained long-term unemployment. The possible presence of

[33] Contributions paid for persons who will withdraw from open pension funds will constitute revenue of the general government sector.

[34] The fiscal multiplier is the relation of a change in GDP to the scale of fiscal measures causing this change.

[35]. This issue was discussed in more detail in Box 2: *The impact of fiscal tightening on GDP growth under present conditions* in *Inflation Report – July 2013*.

hysteresis effects is an additional argument for spreading fiscal adjustment programme over a longer period of time. The study by Bagaria et al. (2012) for the United Kingdom indicates that under these conditions the negative effects of consolidation may persist 2-4 years longer than in the case of budgetary consolidation conducted in the period of stable economic situation.

Financial markets doubts about the fulfillment of the government's consolidation plans or even the country's solvency may constitute the main obstacle to spreading the fiscal adjustment programme gradually over time. In such conditions, a front-loaded adjustment can be more beneficial for the credibility of fiscal policy and through a decrease in interest payments, for the economy and public finances (Rawdanowicz 2012). Such timing of fiscal tightening is especially justified in a specific case when there are expectations of a prolonged period of constrained effectiveness of monetary policy and a strong effect of sovereign fiscal spillovers on private debt[36]. In the circumstances where financial market pressure is high, the benefits of lowering the interest rate on public debt, as a consequence of adjustment measures, may outweigh their negative impact on current demand (Corsetti et al. 2012b). When the debt to GDP ratio is high, fiscal consolidation may result in a positive wealth effect affecting the private sector (Perotti 1999). Consequently, the negative impact of the fiscal adjustment may be, at least partially, compensated with higher private demand resulting from an improvement in expectations. Some authors (e.g. Alesina and Ardagna 1998) also point out that a fast-paced fiscal adjustment, even of considerable magnitude, may be politically easier to accept compared to a gradual one. This is because the later type of consolidation may lead to what is known in the literature as reform fatigue.

Theoretical arguments presented above are supported by empirical literature on past fiscal adjustments. Barrios et al. (2010) analysed adjustments carried out in the years 1970-2008 among 35 developed countries. They found that gradual consolidation is more likely to be successful[37], and the front-loaded fiscal adjustment is particularly ineffective if undertaken in a period of recession or low economic growth. The authors also conclude that in the event of a financial crisis, consolidation should be carried out after the condition of the banking sector has improved (especially if more aggressive fiscal tightening is planned). However, the analysis results are different when public debt level is high and the interest rate noticeably exceeds the rate of potential growth, which implies the existence of the so called snowball effect[38]. In such circumstances it is more effective to implement most of the consolidation measures in the initial periods. Similar conclusions are presented in the Pennings, Perez Ruiz (2013) study, which also shows that spreading fiscal consolidation over time could limit its negative effect on economic growth. At the same time, the authors find that in the analysed sample a high level of public debt may have been one of the reasons for implementing front-loaded consolidations. In turn, Baldacci et al. (2013) study fiscal tightening episodes carried out in periods when lending to private sector is limited and acknowledge that in such conditions consolidations should be gradual because lower demand of the public sector cannot be offset by private sector demand.

Fiscal rules and fiscal institutions constitute a factor likely to increase the credibility of consolidation plans and medium-term objectives set by the government and, consequently, help to spread fiscal adjustment measures over time. The impact of fiscal rules on the assessment of insolvency risk by the financial markets has been confirmed in a study by Iara and Wolff (2010), which shows that the rules contribute to a reduction in bond yields, particularly during periods of increased risk aversion in the financial markets. In the past few years, a number of countries introduced new fiscal rules and fiscal institutions or strengthened the already existing ones.

[36] Higher yield on public debt may entail higher costs of debt for individuals, thus leading to a deterioration in business conditions. (i.a. Zoli 2013)

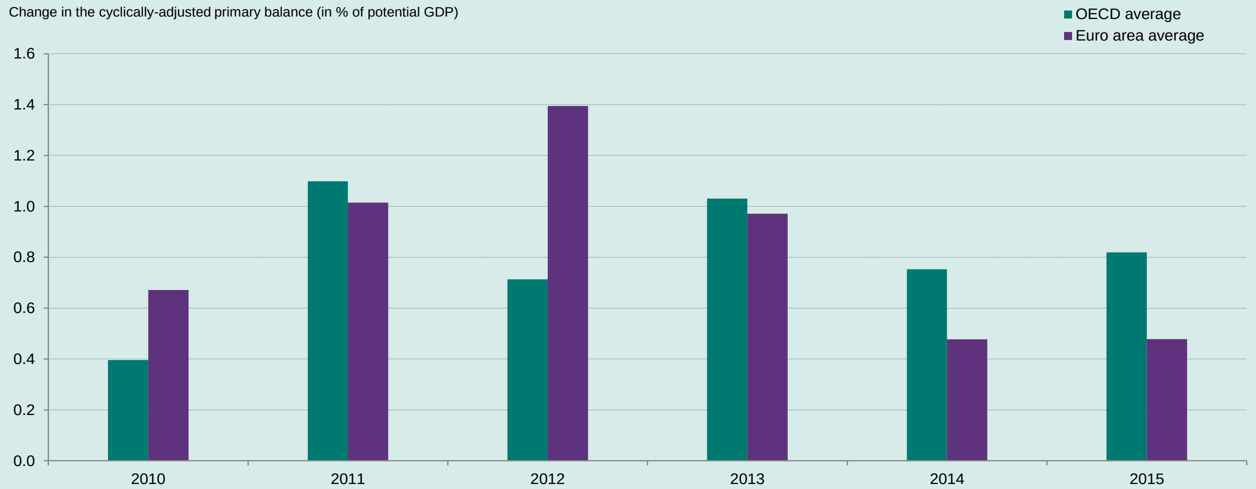
[37] Consolidation was considered successful, if three years after its launch, the public debt was lower by at least 5% of GDP than before.

[38] This is the effect of an automatic rise in the public debt-to-GDP ratio, connected with the difference between the interest rate on public debt and the rate of economic growth. The strength of this effect is directly proportional to the size of this difference and the initial debt-to-GDP ratio.

In the opinion of Schaechter et al. (2012), the main motivation behind these measures was to provide a credible medium-term anchor for fiscal policy.

Arguments raised in the literature indicate that in an environment of an economic slowdown and ongoing deleveraging of the private sector, fiscal adjustment should be spread over time. This would limit its negative impact on economic growth and consequently in some cases could help bring the public debt-to-GDP ratio on a downward trend faster. However, this strategy entails risks, especially if financial markets perceive the debt level to be high and if declarations concerning future fiscal adjustments are not considered to be credible. Under these circumstances, postponing of fiscal adjustment may lead to an increase in government bond yields and faster build-up of public debt. The planning of a gradual fiscal adjustment is currently made additionally difficult by the heightened uncertainty regarding growth prospects and the lowering of fiscal multipliers in the future. In these conditions, the fiscal adjustment path needs to be tailored to the specific situation of each country and the constraints they face. Therefore, as a result of market pressure faced by so-called peripheral euro area countries, in their case the fiscal adjustment was concentrated to a greater extent in the first years after the crisis, especially since their central banks (contrary to central banks of other countries) could not intervene on secondary bond markets. Meanwhile, other developed countries, in particular USA and Japan, enjoying the confidence of financial markets and having the option of intervening on bond markets, were able to spread the fiscal adjustment over time to a larger extent, as shown in Figure B.3.1.[39]

Figure B.3.1 Magnitude of fiscal adjustments in developed countries.



Source: OECD data.

References:

Alesina A., Ardagna S. (1998), *Tales of fiscal adjustment; Economic Policy*, CEPR & CES & MSH, vol. 13(27), October.

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Corsetti G., Kuester K., Meier A., Müller G.J. (2012b), *Sovereign Risk, Fiscal Policy, and Macroeconomic Stability*; IMF Working Paper

[39] Both in the euro area and in other advanced economies, despite fiscal adjustment efforts ongoing since 2010, the debt-to-GDP ratio is still rising. This is a consequence of the high initial level of fiscal deficits, as well as the persistently low growth rate, partly resulting from the aforementioned fiscal adjustments. Current forecasts indicate that a reversal of the rising trend of this ratio will take place no sooner than in 2015.

WP/12/33.
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2.2.4 Exports and imports

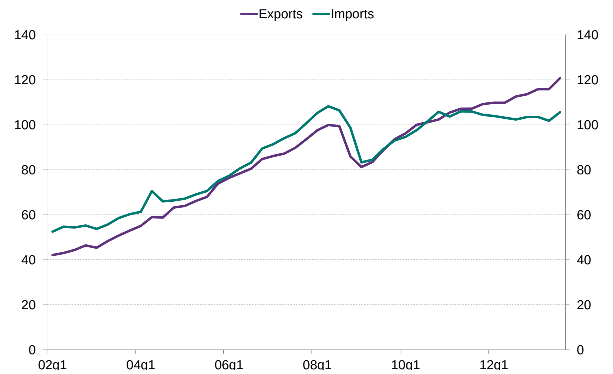
2013 Q3 brought a recovery in Poland's foreign trade driven by a gradual improvement in economic conditions abroad and growth in domestic economic activity (Figure 2.15). The pick-up in export growth (to 7.5% y/y from 5.7% y/y in 2013 Q2) was accompanied by rising imports (by 3.2% y/y compared to a 1.0% y/y decline in 2013 Q2).[40]

The growth in Poland's foreign sales was driven by a pickup in exports to the euro area (up to 4.7% y/y as compared with 1.7% y/y in 2013 Q2) and a significant rise in the growth rate of exports to EU countries outside the euro area (to 10.8% y/y from 6.2% y/y in 2013 Q2). Exports to non-EU countries rose slightly slower than in previous quarters, yet its growth rate remained high (10.4% y/y as compared to 14.5% y/y in 2013 Q2).

The higher growth in foreign sales to EU countries - both within the euro area and outside the euro area – resulted from growing exports of intermediate and consumer goods. The acceleration in exports to the EU countries was supported by a recovery in EU domestic demand and the associated increase in trade between EU countries.

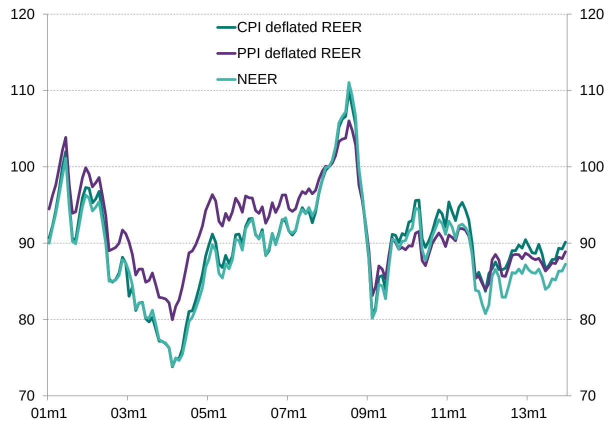
After more than a year of decline, Polish imports grew in 2013 Q3. The rise in imports was supported by growth in domestic demand (see. Chapter 2.2.

Figure 2.15 Polish real exports and imports of goods (2010=100).



Source: Eurostat data.

Figure 2.16 Zloty real and nominal effective exchange rate (increase denotes appreciation; January 2008=100)



Source: NBP and the European Commission data.

[40] The growth rates presented in this chapter refer to changes in the seasonally and working day adjusted volume of foreign trade published by Eurostat. In the period October – December 2013 export growth slowed down to 4.2% y/y. The decline in foreign sales growth was observed in all major groups of Polish trade partners. In turn, import growth remained unchanged compared to 2013 Q3

Demand and production) as well as an acceleration in export production, which is characterised by high import intensity.

In the second half of 2013 the nominal effective exchange rate of the zloty gradually appreciated (Figure 2.16). At the same time, in accordance with the NBP business climate survey, the market exchange rate of the zloty to euro remained weaker than the threshold exchange rate of export profitability declared by enterprises (Figure 2.17).[41] The persistently high profitability of exports is reflected in the low percentage of businesses indicating the exchange rate as a barrier to growth (this percentage remains at the lowest level since the research began).

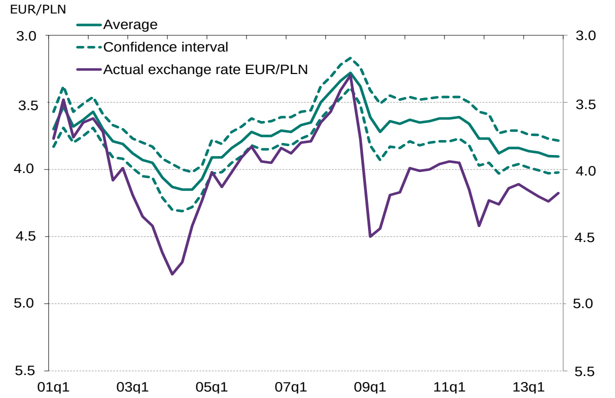
2.2.5 Output

In the second half of 2013, the annual growth in gross value added accelerated to 1.8% in Q3, and to 2.7% in Q4 (as against 0.8% in 2013 Q 2). This was largely associated with slower decline in gross value added in construction and a continued mild rise in industry. At the same time, value added growth in services remained moderate (Figure 2.18).[42]

Data on construction suggest that activity in the sector gradually improved further in the second half of 2013 and in January 2014. The decline in construction-assembly production became less pronounced, and the rate of growth in construction orders, while still negative, continued to increase (Figure 2.19).

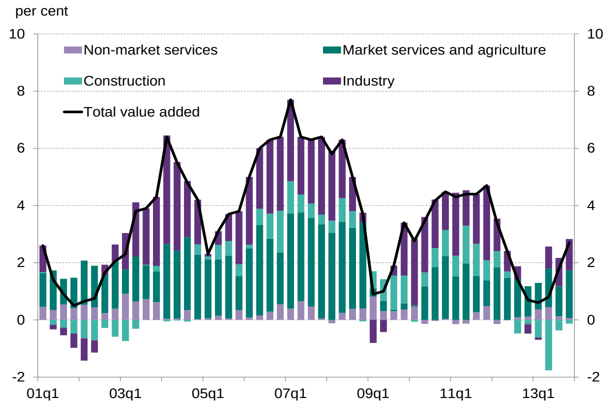
Also industrial output expanded faster in the second half of 2013 and in January 2014 than in the preceding quarter. Considering the current

Figure 2.17 Average threshold exchange rate (EUR/PLN) of exports profitability declared by enterprises



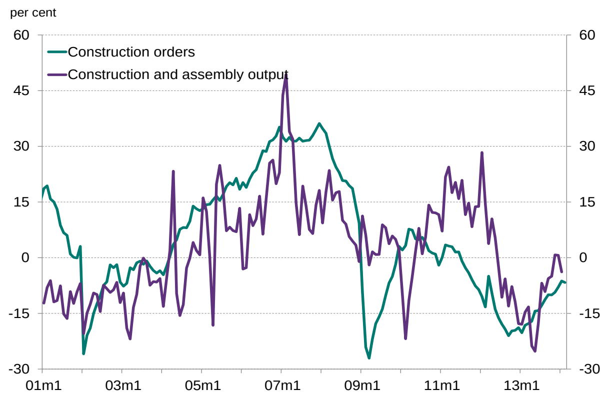
Source: NBP data and estimates.

Figure 2.18 Sector contribution to annual growth of gross value added



Source: GUS data, NBP calculations.

Figure 2.19 Annual growth of construction and assembly output and construction orders



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

[41] 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 (NBP Quick Monitoring). The survey question is as follows: "What is the threshold exchange rate, in terms of PLN, at which exports are (will be) unprofitable?" *NBP Quick Monitoring. Economic climate in the enterprise sector in 2013 Q4 and forecasts for 2014 Q1*, NBP.

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

relatively high levels of the PMI index and a rise in the index of new orders in industry, this points to continued recovery in this sector (Figure 2.20).

In turn, the service sector is sending ambiguous signals. On the one hand, wholesale sales growth weakened in 2013 Q4, to 4.4% y/y (against 5.3% y/y in 2013 Q3). On the other, retail sales by businesses employing more than 9 people as well as sales of services by transport entities strengthened markedly (see Chapter 2.2.2 *Consumption demand*).[43]

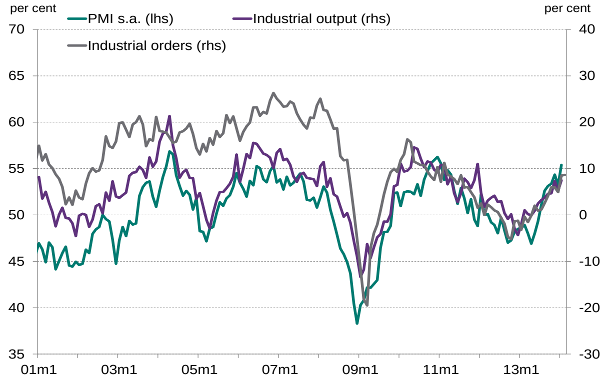
The levels of most leading GUS business climate indicators in 2013 Q4 and in the beginning of 2014 show a further improvement in the assessment of the economic outlook by businesses (Figure 2.21).

2.3 Financial situation in the enterprise sector

In 2013 Q3, the financial situation in the enterprise sector continued to improve. The financial results of enterprises in 2013 Q3 increased significantly as compared with the corresponding period of the previous year (Figure 2.22).[44] In particular, an improvement was observed in the result on sales and the percentage of profitable enterprises. The sector's liquidity position remained strong (Table 2.4).

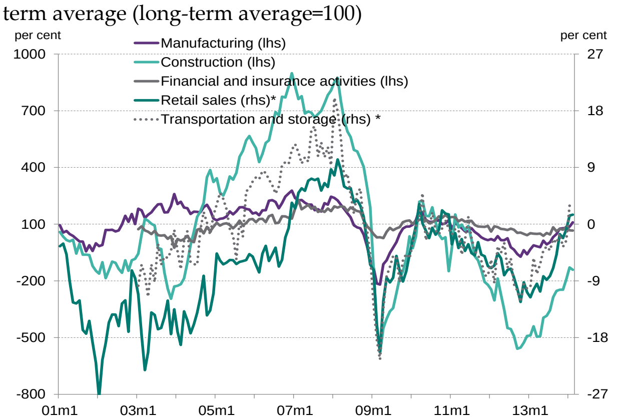
Better financial performance of companies in 2013 Q3 was driven by rising result on sales and – to a lesser extent – the result on other operating activity. Higher profit on sales was achieved by increasing revenue from sales – especially foreign ones – which was not accompanied by equally significant rise in costs. The increase in profit on other operating

Figure 2.20 PMI and annual growth of sold production of industry and of industrial orders



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

Figure 2.21 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.

Table 2.4. Selected financial efficiency ratios in the enterprise sector

per cent	2009	2010	2011	2012				2013		
				q1	q2	q3	q4	q1	q2	q3
Sales profitability ratio	5.0	5.2	5.3	4.4	4.3	4.3	4.2	4.3	4.5	4.6
Net turnover profitability ratio	4.1	4.4	4.5	4.1	3.9	3.5	2.4	3.2	4.7	4.1
Total debt ratio (s.a.)	46.9	47.1	48.9	48.5	48.6	48.6	48.3	48.4	48.5	48.3
Gross profit to interest ratio (s.a.)	7.1	7.8	7.5	6.8	5.9	5.7	5.6	5.5	5.6	5.9
	end of period data									
Liquidity ratio of the first degree	0.39	0.40	0.38	0.34	0.32	0.31	0.34	0.33	0.34	0.33

Source: GUS data.

[43] Monthly data on retail sales do not fully reflect total retail sales growth. See footnote 28.

In 2013 Q4, sales of services in transport entities rose by 8.1% y/y (at constant prices), compared with 3.7% y/y in the first three quarters of 2013. This constitutes a very substantial rise.

[44] Slight deterioration in the result as compared to 2013 Q2 was driven by seasonal decline in income on dividends and was not related to primary operating activity of companies.

activity was driven by favourable result on the sale of fixed assets.

The improvement in financial situation also translated into further growth in profitability ratios of corporates. Both sales and net turnover profitability ratios were higher in 2013 Q3 than a year before and remained at levels close to their long-term averages.

Also a liquidity ratio of the first degree increased in 2013 Q3 as compared to 2012 Q3. The strong liquidity position of companies is additionally confirmed by the NBP business climate survey pointing to a growing percentage of companies reporting no liquidity problems.[45] At the same time, NBP's survey indicates that in the second half of 2013, large enterprises still faced considerably fewer liquidity problems than smaller companies.[46]

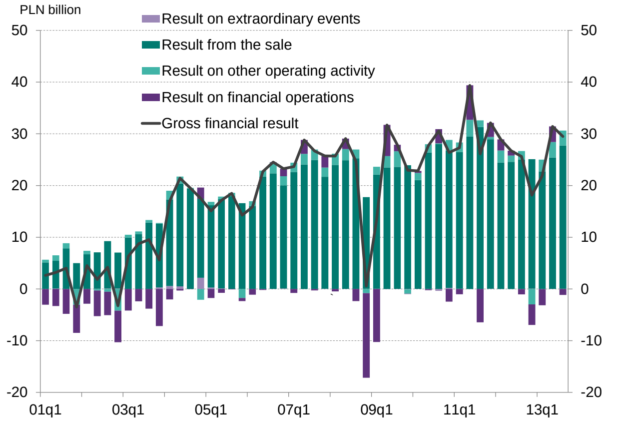
2.4 Labour market

2.4.1 Employment and unemployment

Gradual economic recovery contributed to a certain improvement in the labour market. This was indicated by a further increase in the number of working persons in the economy as well as a lower fall in the number of persons working in the enterprise sector in 2013 Q4 (in annual terms; Figure 2.23). Towards the end of 2013 and in the beginning of 2014, unemployment rate was slightly lower than a year before.

According to the Labour Force Survey data, in 2013 Q3 and Q4, the number of working persons increased by 0.1% and 0.5% y/y, respectively (as compared to a 0.5% y/y decline recorded in 2013 Q2). The rise in the number of persons working in

Figure 2.22 Gross financial result of enterprises and its components



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

Figure 2.23 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.

[45] *NBP Quick Monitoring. Information on the condition of the enterprise sector with a particular focus on business conditions in 2013 Q4 and the forecast of business conditions in 2014 Q1*. NBP.

[46] *NBP Quick Monitoring. Information on the condition of the enterprise sector with a particular focus on business conditions in 2013 Q4 and the forecast of business conditions in 2014 Q1*. NBP.

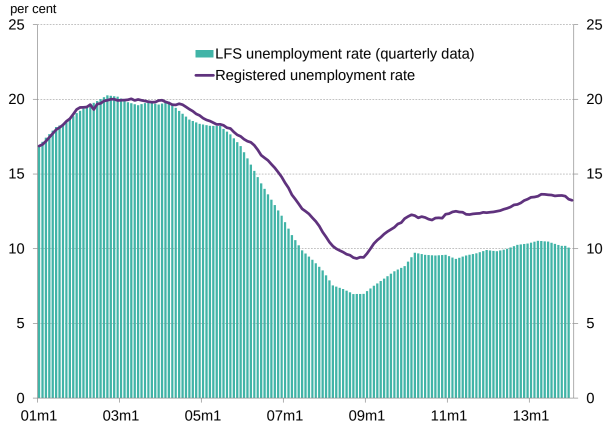
the economy in 2014 Q4 was primarily the result of growth in the number of persons employed in services (by 0.9% y/y versus 0.3% in 2013 Q3). The number of persons working in industry continued to increase – yet, to a lesser degree than in the previous quarter (by 1.1% y/y as compared to a 1.8% y/y growth in 2013 Q3). At the same time, the number of people working in agriculture continued to slump (a 3.0% decline against a 5.0% decline in 2013 Q3).

Data on the enterprise sector in 2013 Q4 point to a lower fall in the number of working persons (in Q4 it amounted to 0.8% y/y versus a fall of 1.2% y/y in Q3).[47]

Growth in employment forecasts indicator in NBP's business climate surveys (in seasonally adjusted terms) is also indicative of improvement of the labour market situation. According to this indicator, in 2014 Q1 more companies are planning to increase employment than cut it.[48]

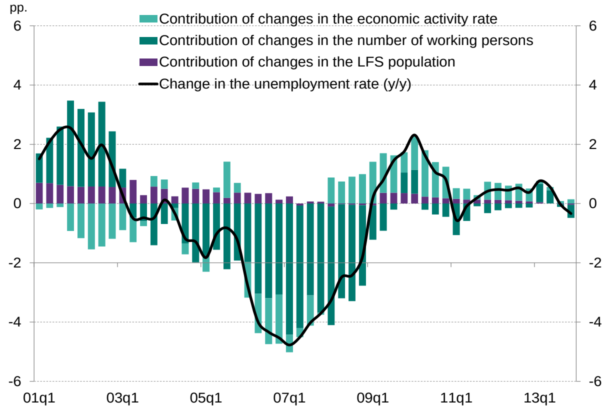
The LFS unemployment rate in 2013 Q4 slightly decreased and amounted to 10.1% (as against 10.2% in 2013 Q3, seasonally adjusted data; Figure 2.19).[49] Also, monthly data from labour offices indicated a gradual decrease in the unemployment rate (the registered unemployment rate, seasonally adjusted, decreased in January 2014 to 13.2% as compared with 13.6% in October 2013).[50]

Figure 2.24 Registered unemployment rate and unemployment rate according to the Labour Force Survey



Source: GUS data (seasonally adjusted).

Figure 2.25 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 into changes resulting from: 1) change in the size of working age population (in the graph, change in the population in LFS terms), 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.

[47] In January 2014, the number of working persons in the enterprise sector did not change in annual terms. January data are, however, to a large extent distorted due to a change in the sample of enterprises investigated by GUS at the beginning of each year.

[48] *NBP Quick Monitoring. Economic climate in the enterprise sector in 2013 4Q and forecasts for 2014 Q1*, NBP

[49] A fall in unemployment rate in annual terms was mostly due to the increase in the number of working persons in the economy, accompanied by a slight increase in the number of those economically active (Figure 2.25).

[50] There are two reasons for the differences between the unemployment rate according to the LFS and the registered unemployment rate: 1) different definition of an unemployed person, 2) different definition of the population to which the number of unemployed is referred.

2.4.2 Wages and labour productivity

In 2013 Q4, annual wage growth in the economy slightly decreased. Due to a simultaneous pickup in labour productivity, growth in unit labour costs in the economy also decreased and remained below the long-term average.

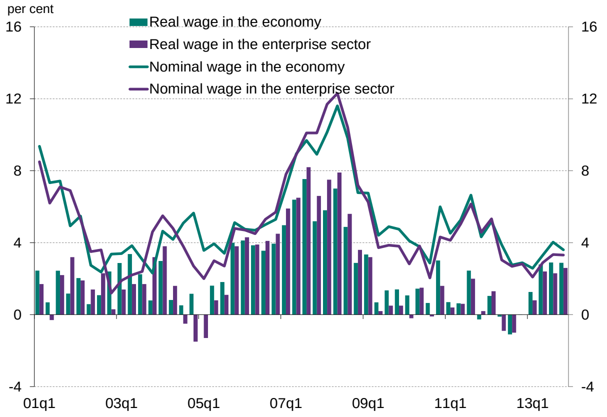
Wage growth in the economy in Q4 amounted to 3.6% y/y (as compared with 4.0% y/y in 2013 Q3; Figure 2.26). The monthly data from the corporate sector for 2013 Q4 and the beginning of 2014 point to a stabilization in wage growth at the level lower than long-term average.

In the recent period, the index of labour market tensions (calculated as the number of non-subsidized job offers per one unemployed; Figure 2.27) rose, suggesting some improvement in the bargaining position of employees as against employers. The possibility of further moderate wage growth is also indicated by NBP's business climate survey, as in 2014 Q1 the proportion of enterprises planning wage rises has increased. Yet, this percentage is still well below the long-term average and the average amount of planned pay rise has decreased.[51]

Along with an increase in GDP growth in 2013 Q4, labour productivity growth also improved. At the same time, wage growth slightly decelerated. As a result, unit labour costs growth decreased and remained below the long-term average (Figure 2.28).

Towards the end of 2013 Q4 and in the beginning of 2014, industrial enterprises continued to record a negative growth in unit labour costs. This was due to still higher growth in labour productivity than in wages (Figure 2.29).

Figure 2.26 Annual wage growth in the economy and in the enterprise sector (in nominal and real terms)

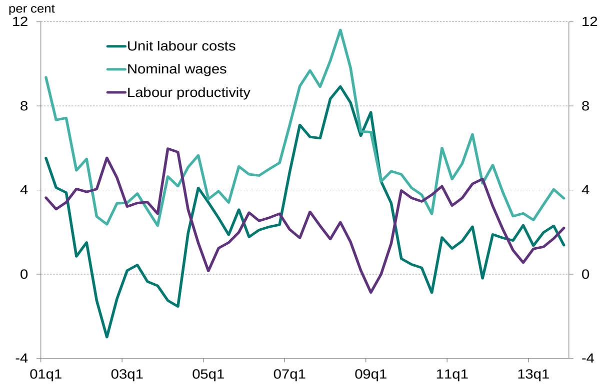


Source: GUS data.

Figure 2.27 Market tension index (number of vacancies per one unemployed)

Source: GUS data, NBP calculations.

Figure 2.28 Annual growth in labour productivity, wages and unit labour costs in the economy



Source: GUS data, NBP calculations

[51] *NBP Quick Monitoring. Economic climate in the enterprise sector in 2013 4Q and forecasts for 2014 Q1*, NBP

2.5 Financial markets and asset prices

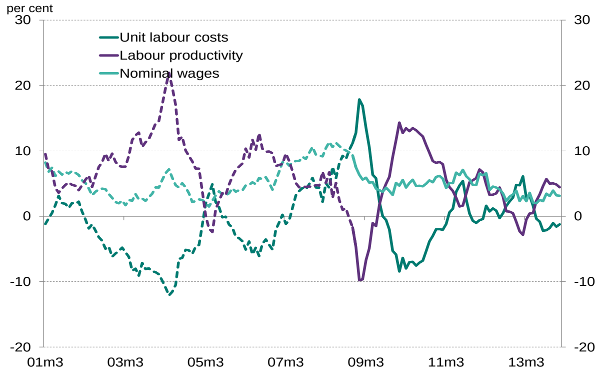
In recent months owing to a slip in the sentiment about emerging markets the prices of Polish shares and government bonds decreased. However, gradual improvement in the economic conditions in Poland and narrowing external imbalances were containing the scale of a decline in Polish asset prices and were conducive to the appreciation of the zloty. There were further signs of recovery in the housing market.

2.5.1 Interest rates and financial asset prices

Since the previous *Report*, the Monetary Policy Council has not changed the NBP interest rates, leaving the reference rate at 2.50%. In November 2013 it suggested a longer period of keeping interest rates unchanged. The Council assessed that interest rates should remain unchanged until at least until the end of the first half of 2014.[52] Consequently, most analysts and market participants currently do not expect a new NBP interest rate rise before 2014 Q4. (Figure 2.30).

In recent months, Polish government bond yields increased, albeit to a lesser extent than in many other emerging markets. Disruptions in emerging markets in late January 2014 contributed to some increase in the yields. However, the cost of insurance of Polish debt (approximated by CDS rates) stayed low compared to other emerging market economies, which stabilised the yields on Polish government bonds (Figure 2.31). At the same time, in spite of Fed's decision to scale back quantitative easing, the share of non-residents in Polish government bond market ticked up in December 2013 (Figure 2.32).

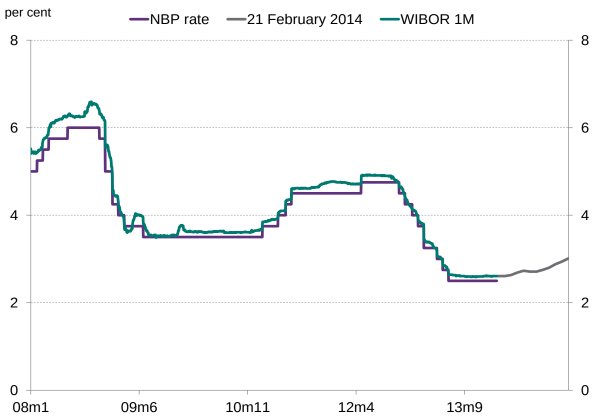
Figure 2.29 Annual growth in labour productivity, wages and unit labour costs in industry (moving 3M averages)



Source: GUS data, NBP calculations.

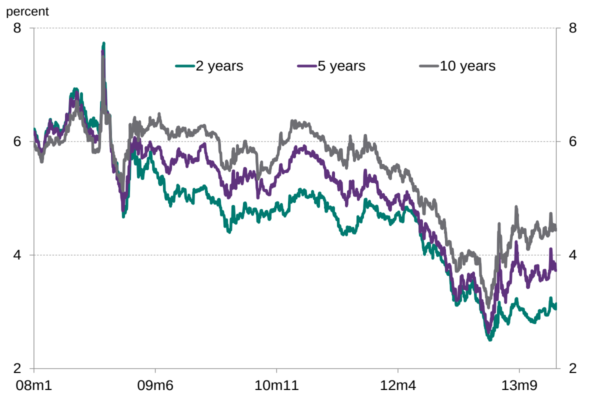
Since January 2009, new PKD classification (PKD 2007) has been used, due to which the growth rates of wages and employment in industry from December 2008 (dashed line in the graph) are not fully comparable with the subsequently recorded rates.

Figure 2.30 NBP reference rate, WIBOR 1M (till February 2014) and 1M interest rate implied by FRAs (since February 2014)



Source: Based on Bloomberg data.

Figure 2.31 Yields on Polish sovereign bonds



Source: Bloomberg data

[52] In March 2014 (i.e. after the cut-off date for this *Report*) the Council assessed that 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.

Between July and October 2013, the Monetary Policy Council assessed that the NBP interest rates should be kept unchanged at least until the end of 2013.

Following the previous *Report*, asset prices at the Warsaw Stock Exchange have been trending downwards (Figure 2.33). Yet the WIG index decreased by less than the MSCI Emerging Markets index. In contrast to other emerging markets, the decline in the prices of Polish shares was contained by the publication of better-than-expected macroeconomic data.

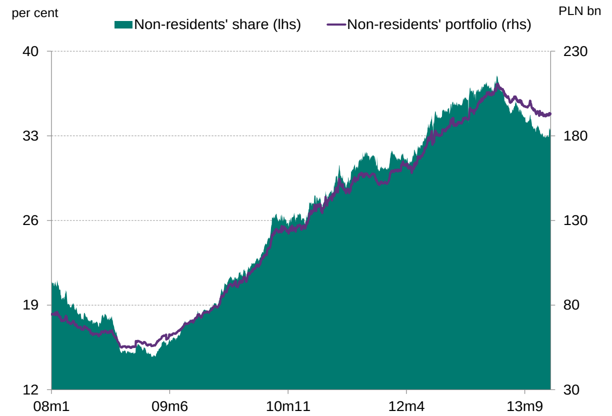
2.5.2 Exchange rate

In recent months, the zloty appreciated slightly. The appreciation of the zloty was supported by ongoing economic recovery (see Chapter 2.2 *Demand and output*) and the narrowing external imbalances observed in recent quarters (see Chapter 2.7 *Balance of payments*). Similarly to Polish government bonds, the zloty market was not entirely resilient to disturbances in other emerging markets. The zloty depreciated temporarily in late January 2014, along with a rise in the risk that Argentina would suspend the service of its liabilities, outlook for the Chinese economy weakened and prospects of financing Turkey's and South Africa's external imbalances deteriorated (Figure 2.34). However, the zloty depreciated to a lesser extent than many other emerging market currencies.

2.5.3 Home prices[53]

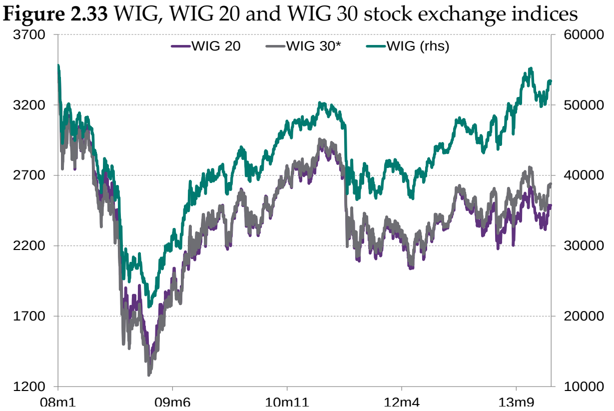
In 2013 H2, signs of recovery were observed in the housing market. The number of transactions concluded in the primary market continued to rise.

Figure 2.32 Non-resident exposure in the Polish sovereign bond market



Source: National Depository for Securities (KDPW) data.

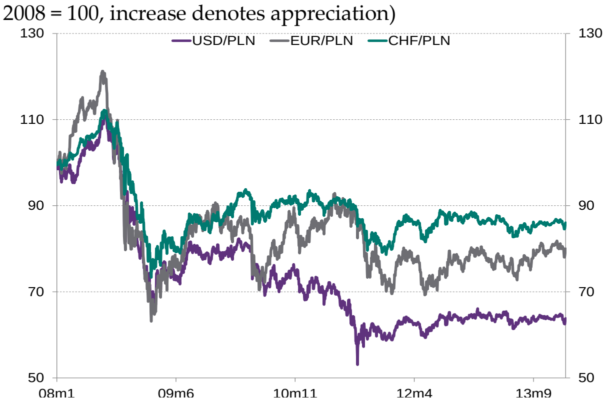
Figure 2.33 WIG, WIG 20 and WIG 30 stock exchange indices



Source: Bloomberg data.

*Introduced on September 23, 2013, WIG30 compounds shares of 30 largest and most liquid companies in the main market on the Warsaw Stock Exchange. Till the end of 2015, when WIG30 is to replace WIG20, both indices will be released parallelly.

Figure 2.34 Nominal exchange rate of the Polish zloty (January 2008 = 100, increase denotes appreciation)



Source: Bloomberg data.

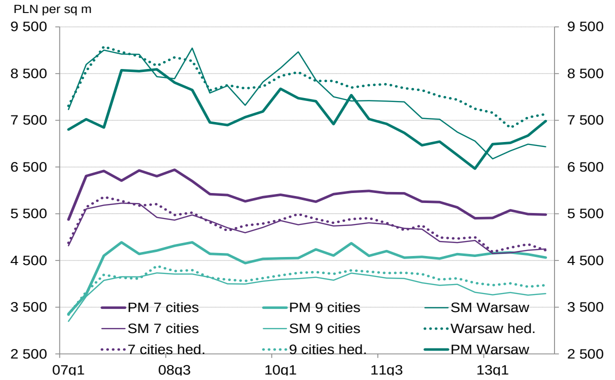
[53] More information on the Polish housing market can be found in the NBP publications *Report on home prices and the situation of the residential and commercial real estate market in Poland in 2013 Q3*, *Report on home prices and the situation of the residential and commercial real estate market in Poland in 2013 Q4* and *Report on the situation in the Polish residential and commercial real estate market in 2012*, available at the NBP website www.nbp.pl (only in Polish).

This allowed prices to stabilise or even rise, albeit slightly. In particular, some increase in prices was noted in big cities, most notably Warsaw (Figure 2.35).

The main driver of higher demand for apartments in 2013 H2 was improving economic outlook. Demand for apartments was additionally boosted by low interest rates on mortgage loans. However, a substantial part of the transactions were settled in cash. The shift in demand for housing due to a tightening in lending criteria announced for January 2014 also contributed to an increase in transactions. At the same time, the perspective of launching a new government scheme supporting the sale of apartments in the primary market ("Flat for the Young") in 2014, could contain the number of transactions in 2013 Q4, particularly for cheaper primary-market homes (see Chapter 2.6.2 *Loans to households*).

The rise in the number of transactions was accompanied by a further decline in the number of unsold apartments which, however, remains relatively high (Figure 2.36) This might be stabilizing prices, which allows for satisfactory return on investment, as the cost of dwelling construction remains low (see Chapter 2.1.3 *Producer prices in industry* and Chapter 2.6.2 *Loans to households)*.

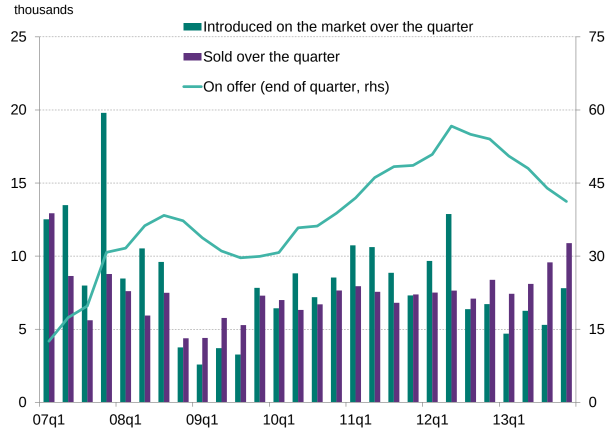
Figure 2.35 Average* prices of flats in Poland's 7 and 9 big cities



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

* Asking prices – average weighted by the number of offers; sale prices in the primary market – average weighted 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 – average adjusted for differences in the qualities of flats. PM – primary market, SM – secondary market, hed. – hedonic price index. The aggregate of seven cities encompasses: Gdańsk, Gdynia, Kraków, Łódź, Poznań, Szczecin and Wrocław, while the aggregate of nine cities involves: Białystok, Bydgoszcz, Katowice, Kielce, Lublin, Olsztyn, Opole, Rzeszów and Zielona Góra.

Figure 2.36 Apartments introduced in the market and sold over the quarter; apartments on offer at the end of the quarter



Source: GUS data, NBP calculations

* Data for Gdańsk, Gdynia, Kraków, Łódź, Poznań, Warszawa and Wrocław

2.6 Credit and money

Since the November *Report* credit growth – despite an acceleration – has remained relatively slow (Figure 2.37).[54] In 2013 Q4, the total debt of the non-financial sector, non-monetary financial institutions, local governments and social insurance funds increased by an average of PLN 0.8 billion per month, while in the corresponding period of 2012 the indebtedness was slightly decreasing (by an average of PLN 0.1 billion a month).[55]

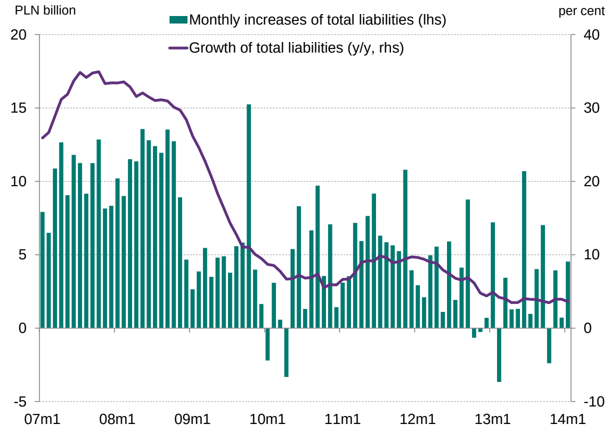
In 2013 Q4, corporate debt growth picked up marginally. This was driven by, besides some relaxation of lending conditions by banks (in particular, with respect to the SME sector), higher corporate demand for loans (Figure 2.39). At the same time, household debt growth continued to accelerate in 2013 Q4, mainly due to a further pickup in the consumer loan segment (Figure 2.42).

Amidst the persistently relatively slow growth in total credit, expansion in monetary aggregates in 2013 Q4 remained moderate.

2.6.1 Corporate lending

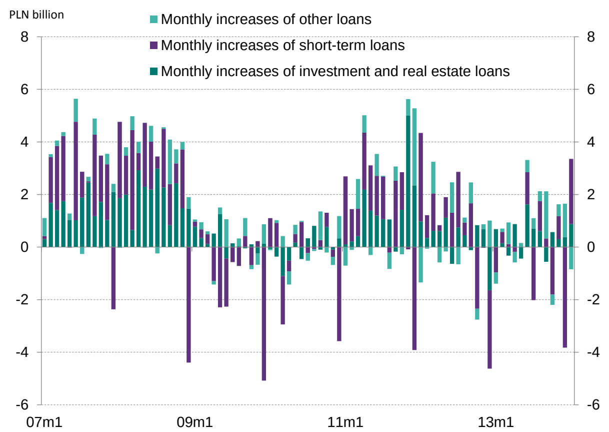
In 2013 Q4, typically for the end of a year, corporate debt decreased albeit to a lesser extent than in the corresponding period of the previous year (the average monthly decline amounted to PLN 0.7 billion against an average of PLN 1.6 billion in 2012 Q4).[56] The decrease in corporate debt was curbed by a slight increase in investment and real estate loans (against the background of their decrease in 2012

Figure 2.37 Total liabilities of non-financial sector, non-monetary financial institutions, local government units and social insurance funds



Source: NBP data.

Figure 2.38 Break-down of increases in loans to corporations



Source: NBP data.

[54] Data concerning 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, in December 2013 and January 2014), therefore average monthly increases in corporate loans and deposits are compared against corresponding periods of subsequent years.

[55] In January 2014, the total corporate debt increased by PLN 4.5 billion as compared to PLN 7.2 billion increase in the corresponding period of 2013.

[56] Corporate debt amounted to PLN 259.1 billion in December 2013.

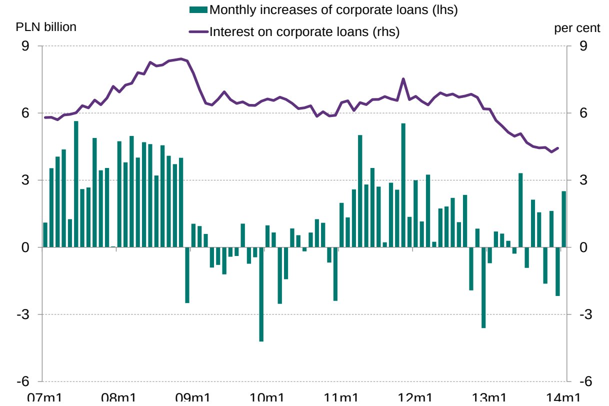
Q4) and a somewhat slower pace of decline in short-term loans (Figure 2.38).[57]

The scale of the decline in corporate sector debt in 2013 Q4 was limited by the sinking cost of credit, which – amidst unchanged NBP interest rates – indicated that spreads had slightly narrowed (in 2013 Q4, the interest rate on corporate loans was on average 0.2 percentage points lower than in 2013 Q3; Figure 2.39). The decline in lending was also mitigated by easing of lending standards to the SME sector as declared by banks.[58] Additionally, a corporate loan demand increased on the back of a gradual rise in economic activity. As reported by banks, the heightened corporate demand for loans resulted from increased financing needs for fixed investments and working capital.[59]

Rising loan demand in 2013 Q4 was observed primarily amongst large enterprises. As a result, despite the easing of lending standards to SMEs, growth in total credit to this sector remained significantly weaker than to the large enterprises (Figure 2.40).

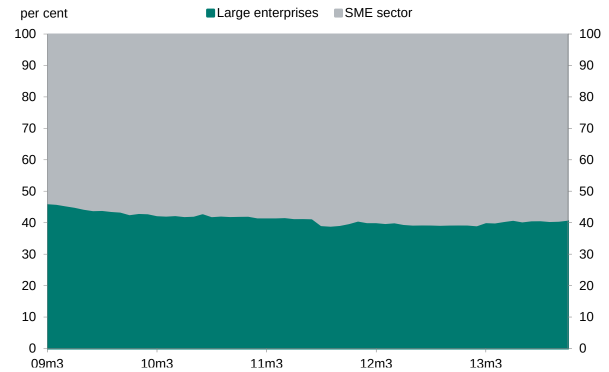
Corporates' foreign debt increased by EUR 2.0 billion, to EUR 112.3 billion in 2013 Q3 (Figure 2.41). The increase in foreign debt was driven almost entirely by growth in lending by foreign direct investors, amidst only a slight rise in portfolio investors' exposure to corporate debt instruments.

Figure 2.39 Monthly increases and average interest on new zloty denominated loans to corporations



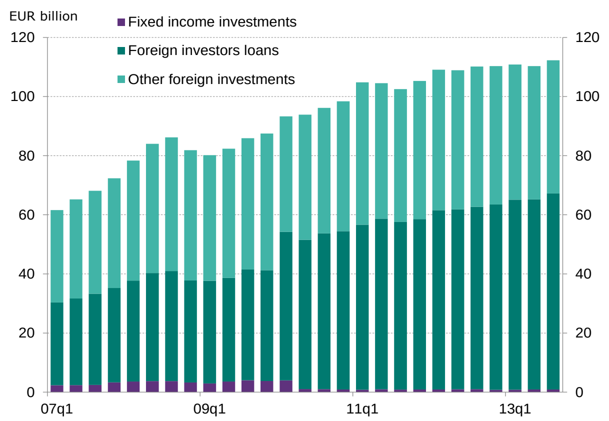
Source: NBP data.

Figure 2.40 Breakdown of corporate debt.



Source: NBP data

Figure 2.41 Foreign debt of enterprises



Source: NBP data.

[57] In January 2014, corporate lending increased by PLN 2.5 billion as against a decrease of PLN 0.7 billion in the corresponding period of 2013. The growth in corporate debt was driven mainly by an increase in short-term debt (by PLN 2.5 billion as against a drop of PLN 1.0 billion in January 2013), amidst further growth in investment and real estate credit (increase by PLN 0.9 billion compared to PLN 0.7 billion in January 2013).

[58] *Senior loan officer opinion survey on bank lending practices and credit conditions*, 2014 1Q, NBP.

[59] *Senior loan officer opinion survey on bank lending practices and credit conditions*, 2014 1Q, NBP.

2.6.2 Loans to households

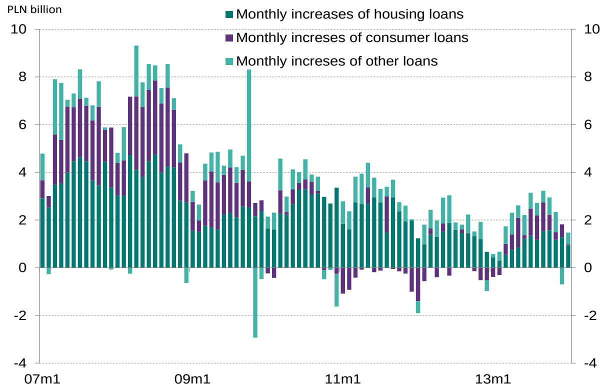
In 2013 Q4, following a sharp rise in 2013 Q3, monthly increases in housing loans stabilised at PLN 1.3 billion, thus being slightly higher than in the corresponding period of 2012 (when they averaged PLN 1.1 billion; Figure 2.43).[60]

Lending growth in the home loan segment was supported by rising household demand. The rise was related to the announced tightening of lending terms in early 2014, following the coming into effect of the amended Recommendation S.[61] The pickup in the housing loans was also fuelled by a certain improvement in households' economic standing at the end of 2013 (see also Chapter 2.4 *Labour market*).

Last year's rising loan demand may in turn have been constrained by postponement of home purchases in expectation of the January 2014 launch of the government-subsidised "Flat for the Young" housing scheme. Lending growth may have also been hampered by a tightening of lending policy by some banks with respect to housing loans, without any significant change in the spreads and interest rates on those loans (Figure 2.43; see also Chapter 2.5 *Asset markets).*

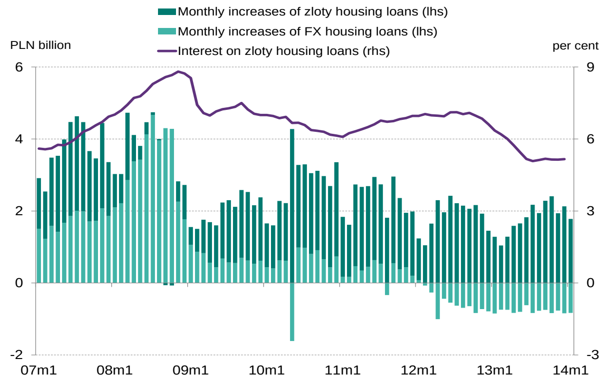
In 2013 Q4, lending in the sector of consumer loans continued to grow. Household debt arising from these loans increased in 2013 Q4 by an average of PLN 0.5 billion a month, while in 2012 Q4 it decreased by an average of PLN 0.4 billion a month (Figure 2.44).[62]

Figure 2.42 Break-down of increases in loans to households



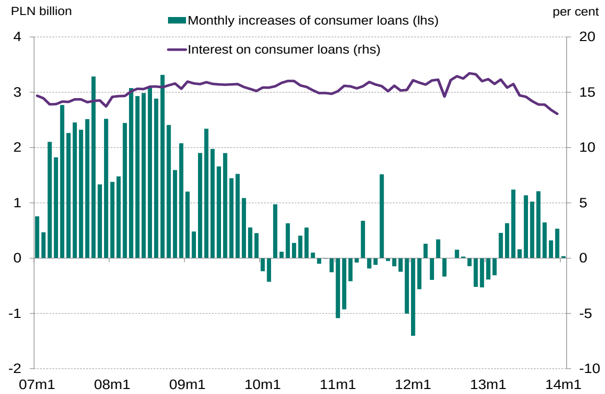
Source: NBP data.

Figure 2.43 Monthly increases and average interest on new housing loans to households



Source: NBP data.

Figure 2.44 Monthly increases and average interest on new consumer loans to households



Source: NBP data.

[60] In January 2014, housing loans increased by PLN 0.9 billion compared to PLN 0.4 billion in January 2013.

[61] *Senior loan officer opinion survey on lending practices and credit conditions,* 2014 1Q, NBP. The amended Recommendation S introduces, among others, a binding ceiling on the maximum LtV (*Loan-to-Value*) for mortgage loans. According to the recommendation, starting from January 2014, the amount of down payment when purchasing real estate should equal at least 5% of the property's value (this figure will be gradually raised to reach 20% in 2017).

[62] In January 2014, household debt arising from consumer loans remained at similar level as in December 2013, whereas in January 2013 this debt decreased by PLN 0.4 billion.

The further pickup in lending in the consumer credit segment was driven by a continued easing of banks' lending policies.[63] In particular, banks decreased their credit spreads, which translated into lower interest on consumer loans (in 2013 Q4, the interest was on average 0.8 percentage points lower than in 2013 Q3; Figure 2.44). The decline in the cost of credit, coupled with an improvement in households' economic situation, was conducive to further growth in demand for this funding source.

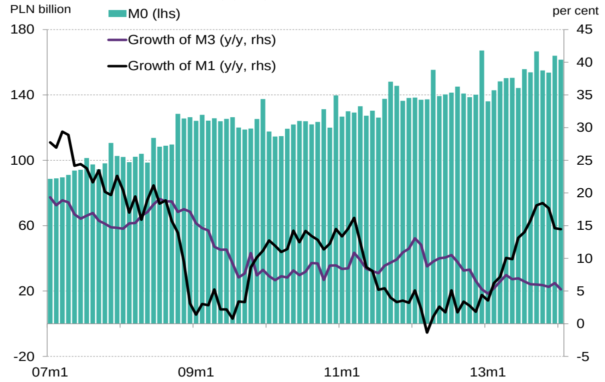
2.6.3 Deposits and monetary aggregates

In 2013 Q4, broad money continued to expand relatively slowly (Figure 2.45). At the same time, M1 growth slowed down, which resulted mainly from changes in the term structure of corporate deposits (slower growth in funds placed in current accounts, amidst a stronger growth in corporate term deposits).[64]

In 2013 Q4, the average monthly increases in total corporate deposits were significantly higher than in 2012 Q4 (PLN 6.1 billion compared with PLN 4.1 billion; Figure 2.46), which was probably supported by a sound liquidity position of enterprises.[65]

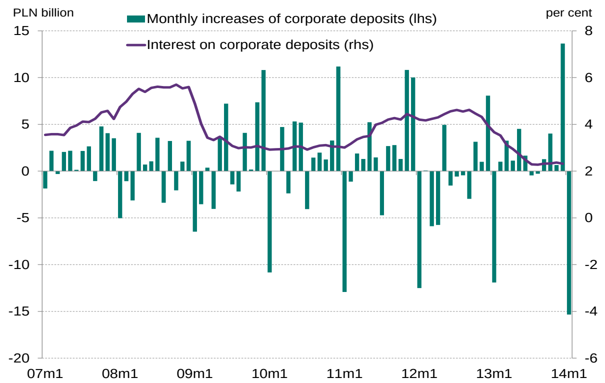
In 2013 Q4, household deposits continued to slow down in an environment of interest rates on deposits remaining at relatively low levels. Monthly increases in these deposits totalled PLN 4.6 billion and were lower than in the corresponding period of 2012 (when they amounted to PLN 5.4 billion; Figure 2.47).[66] At the same time, the inflow of household assets to investment funds increased (average monthly balance of flows to investment

Figure 2.45 Monetary aggregates



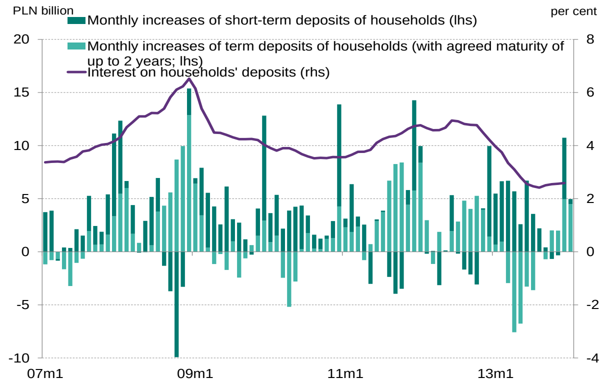
Source: NBP data.

Figure 2.46 Monthly increases and average interest on deposits of corporations



Source: NBP data.

Figure 2.47 Monthly increases and average interest on deposits of households



Source: NBP data.

[63] *Senior loan officer opinion survey on bank lending practices and credit conditions*, 2014 Q1, NBP.

[64] Term deposits are defined as ones with maturities of up to 2 years, and deposits redeemable at up to three months' notice. In January 2014, broad money growth slowed down (to 5.4% y/y) and M1 growth rate remained similar as in December 2013.

[65] *NBP Quick Monitoring. Economic climate in the enterprise sector in 2013 Q4 and forecasts for 2014 Q1*, NBP. In January 2014, a decline in corporate deposits – typical for the beginning of the year – was bigger than in the corresponding period of 2013 (it amounted to PLN 15.3 billion as against PLN 11.9 billion).

[66] In January 2014, growth in household deposits declined further and their increase was lower than in corresponding period of 2013 (PLN 5.0 billion as against PLN 5.5 billion).

funds in 2013 Q4 stood at PLN 1.1 billion compared with PLN 0.7 billion in the corresponding period of 2012).[67]

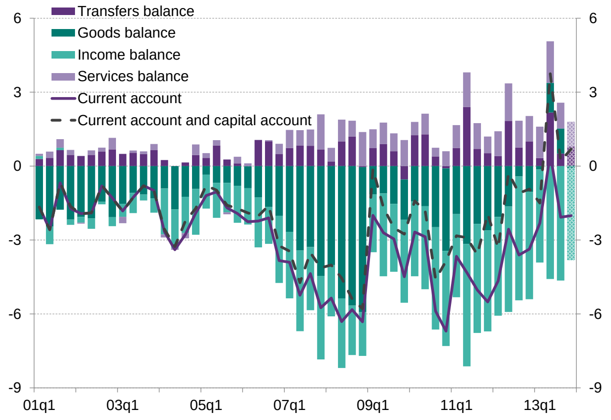
2.7 Balance of payments

In 2013 H2, improvement in the current account balance continued, although it slightly lost momentum in annual terms as compared with 2013 H1.[68] A slowdown in this improvement mostly reflected the declining surplus in the trade balance amidst rebound in domestic demand. The smaller surplus in the trade balance, together with a substantially negative balance in the income account, translated into a current account deficit of EUR 2.1 billion in 2013 Q3, and of EUR 2.0 billion in 2013 Q4 (as against deficits of EUR 3.6 billion in 2012 Q3 and EUR 3.4 billion in 2012 Q4; Figure 2.48).[69]

The capital account balance remained positive in 2013 H2, which was associated with further capital transfers from the European Union to Poland.

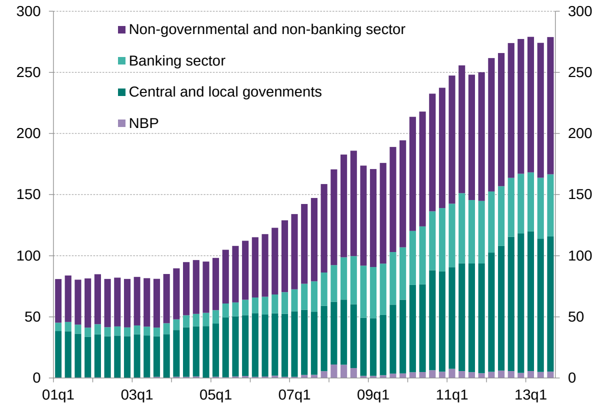
The financial account balance continued to decrease in annual terms and reached EUR 0.4 billion in 2013 Q3 and EUR -0.5 billion in 2013 Q4 (as against EUR 4.6 billion in 2012 Q3 and EUR 3.7 billion in 2012 Q4). That decline was mainly due to a reduction in non-residents' investment in Polish securities. Moreover, 2013 Q4 saw one-off transactions involving investors' withdrawal from a Special Purpose Entity that added to decline in the balance in the financial account (these transactions caused a decrease in both foreign direct investment to Poland and investment of Polish entities abroad).

Figure 2.48 Current account balance (EUR billion)



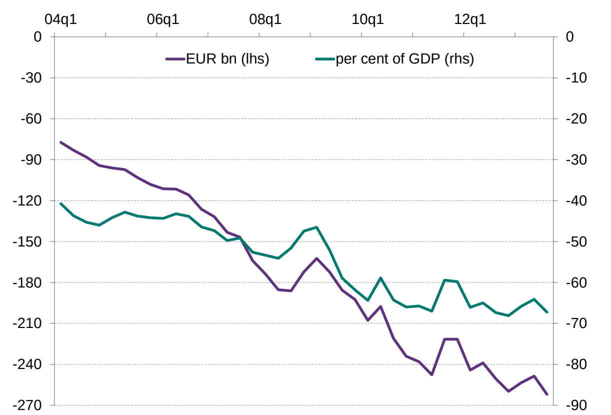
Source: NBP data and estimates.

Figure 2.49 Poland's external debt (EUR billion)



Source: NBP data.

Figure 2.50 Poland's net international investment position



Source: NBP data.

[67] The total value of household assets amounted to PLN 888.7 in December 2013.

[68] Data on the current, capital and financial accounts are based on quarterly data up to 2013 Q3 and monthly data for October-December 2013.

[69] The deficit on the income account is related to good financial performance of Polish enterprises (see Chapter 2.3 Financial situation in the enterprise sector). The remaining balances on the current account did not change substantially in 2013 H2 as compared with 2012 H2. Both the services and the current transfer balances remained positive.

As a result of further – albeit slower – improvement in the current account balance in 2013 H2, some of Poland's external imbalance indicators improved. In particular, the current account deficit in relation to GDP (in terms of a 4-quarter moving average) declined further and the surplus in the combined current and capital accounts in relation to GDP increased (Table 2.5**Table 2.**). At the same time, Poland's external debt to GDP ratio slightly rose, while Poland's international investment position to GDP ratio decreased.

Table 2.5. Selected external stability indicators (4-quarter moving average)

	2008	2009	2010	2011	2012	2013			
						q1	q2	q3	q4
Current account balance/GDP(%)	-6.6	-3.9	-5.1	-5.0	-3.7	-3.1	-2.3	-1.9	-1.6
Current and capital account balance/GDP (%).	-5.4	-2.3	-3.3	-3.0	-1.5	-1.0	0.1	0.4	0.8
Trade balance/GDP(%)	-5.8	-1.7	-2.5	-2.7	-1.4	-0.8	-0.1	0.3	0.5
Official reserve assets expressed in terms of monthly imports of goods and services	3.3	5.3	5.4	5.2	5.6	5.7	5.6	5.3	5.2
Foreign debt/GDP (%)	48	62	67	67	73	73	71	72	-
Average maturity of government debt	5.3	5.3	5.4	5.3	5.4	5.5	5.5	5.4	
Net international investment position/GDP (%)	-48	-62	-66	-59	-68	-66	-64	-67	-
Foreign debt maturing in up to 1 year plus the current account balance/official reserve assets (%)*	174	153	129	126	100	104	112	122	-
Foreign debt maturing in up to 1 year/official reserve assets (%)*	147	120	102	107	93	100	104	112	-

Source: NBP data.

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

Box 4: External debt stability

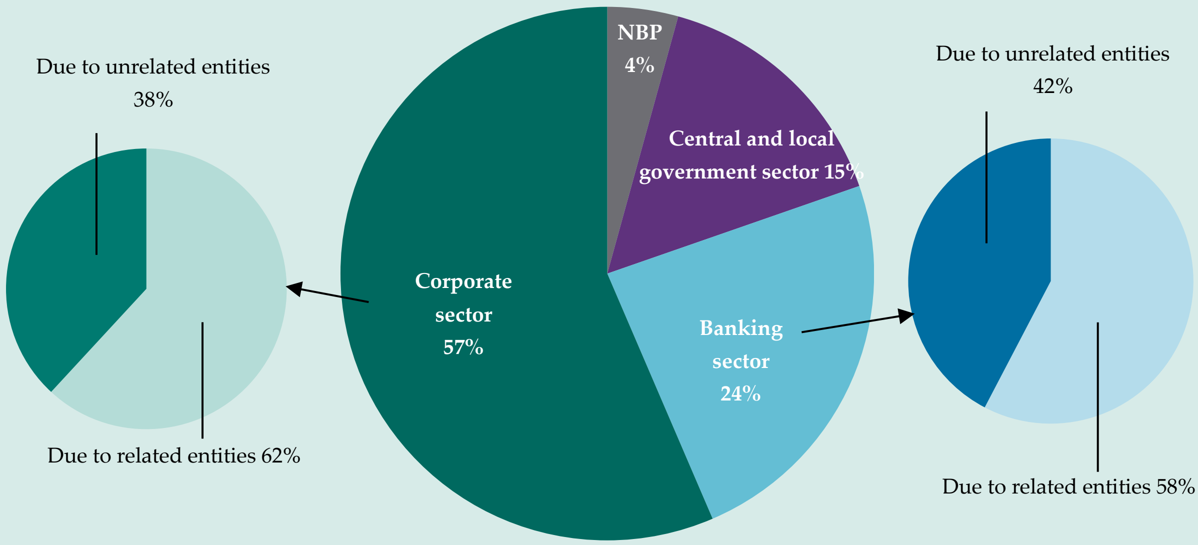
One of the many indicators used to asses the degree of a country's external imbalance is the ratio of short-term debt – adjusted by both the current account deficit forecast for the year and the share of long-term debt maturing within the year – to the stock of foreign exchange reserves. In this approach, the amount of foreign exchange reserves is compared with foreign investors' borrowing requirements. When the ratio equals 1, the country is able to repay the foreign debt maturing within the year in full – as well as finance the current account deficit directly from the sale of foreign exchange.

The above rule should not be applied mechanically, since it is also essential to know the rollover probability of maturing debt. For example, virtually all of the short-term intra-company loans extended within multinational corporations are rolled over, being part of the group's long-term financial plan. In this case, extension of financing does not depend on the economy's balance of payments, but on the international corporation's ability to obtain funds.

In 2013 Q3, Poland's short-term debt amounted to EUR 88.4 billion (of which EUR 60.0 billion was debt with original maturity of one year or less); long-term debt maturing within one year amounted to EUR 28.4 billion, while the forecast deficit of the current account reached EUR 7.9 billion. These amounts stood at 23%, 7% and 2% of GDP, respectively.

In the sectors most heavily indebted abroad, i.e. corporates and banks, most of the debt is extended within capital groups. (Figure B.4.1). Altogether, the stock of debt owed to related entities amounted to EUR 43.0 billion in 2013 Q3, which accounts for 49% of Poland's total short-term external debt in this period (of this, EUR 31 billion can be traced to corporates and EUR 12 billion, to banks). Given the high profitability of Polish banks and enterprises, and sound fundamentals of the Polish economy, there is no reason why these liabilities should not be rolled over in full. The low likelihood that parent companies will withdraw financing is also indirectly confirmed by the experience of late 2008 and early 2009, when, after the collapse of Lehman Brothers, not only was foreign financing of Polish banks not recalled, but it was even expanded.

Figure B.4.1 Poland's external debt structure



Source: NBP data.

Short-term debt owed to unrelated entities amounted to EUR 43.4 billion in 2013 Q3. An important part of this debt is trade credit extended by unrelated foreign companies (which amounted to EUR 12.3 billion in 2013 Q3). However, these liabilities are largely offset by Polish exporters' claims on foreign companies. At the same time, as indicated by NBP surveys of the economic climate, a large share of both the claims of Polish businesses on foreign clients and their liabilities to foreign suppliers are settled on time, which is additionally conducive to these liabilities being refinanced.[70] Considering the above factors, it is to be expected that – with the current levels of external trade – also trade credits will be rolled over.

The remaining short-term external debt comprises central and local government debt (EUR 13.6 billion), other short-term liabilities of corporates and banks (EUR 6.7 billion and EUR 8.9 billion respectively), as well as non-residents' current accounts and deposits at NBP (EUR 3.8 billion).[71] Considering the coverage of the government's borrowing needs in 2014 and the stock of corporates' and banks' deposits abroad (EUR 1.8 billion and EUR 6.8 billion, respectively), it can be assumed that also a substantial part of the above liabilities is characterised by low rollover risk[72].

It is quite widely believed that the risk of capital outflows is associated with the fact that a significant portion of Polish Treasury bonds is held by foreign investors. This risk is real and could temporarily materialize in periods of severe turmoil in global financial markets, when capital flows out of emerging markets. Therefore capital

[70] *NBP Quick Monitoring. Economic climate in the enterprise sector in 2013 3Q and forecasts for 2014 Q1*, NBP

[71] In 2013 Q4, total stock of the general government debt instruments amounted to EUR 92.9 billion.

[72] According to a statement made by Piotr Marczak, Director of the Public Debt Department at the Ministry of Finance, the prefinancing of the 2014 borrowing requirement stood at 53% as of 4 February 2014.

inflows to the Treasury bond market are often treated as functionally similar to short-term capital inflows, although these are long-term securities.

This approach is justified in the case of approximately 20% of Polish Treasury bonds which are found in banks' trading portfolios, and thus are actually used for performing short-term transactions. However, one must also take into account that, with the exception of periods of turmoil in the financial markets, the vast majority of these are arbitrage transactions, which are in effect speculation of a stabilizing character (relative value trades), are aimed at restoring the equilibrium of prices and price relationships. In the longer term, this increases the liquidity of the market for Treasury bonds and reduces the sensitivity of their prices to capital outflows.

According the Ministry of Finance data, approximately 80% of Polish Treasury bonds that remain in the possession of foreign investors are found in the portfolios of long-term investors: pension funds, insurance companies and investment funds. These institutions purchase Polish Treasury bonds mainly due to their high credit quality, the favourable domestic macroeconomic conditions, and above all, the liquidity of the domestic Treasury bond market as well as the inclusion of Polish Treasury bonds in global bond indexes, which constitute a point of reference for fund managers.

In addition, in the case of some foreign investors, the so-called index tracker funds, whose strategy consists in replication of returns generated by the index and of its risk profile, the main cause of demand for Polish Treasury bonds is not the interest rates differential (*carry trade*), but the fact that asset managers in indexed funds adapt the structure of investment portfolios to the structure of a selected benchmark global bond index. The portfolio manager can at times keep slightly more or fewer bonds of a given country in relation to the benchmark portfolio – if he performs arbitrage transactions with the aim of taking advantage of price anomalies arising on the market – but in the long term the share of bonds of a given country tends to reflect the country's share in the benchmark index accepted by the given institution.

In such a situation, the influence of long-term foreign investors holding Polish Treasury bonds on the zloty exchange rate only to a relatively small extent results from capital flows. It is mainly revealed indirectly, in periods of significant weakening of the zloty exchange rate as a result of an increase in risk aversion on the global financial market, when long-term investors hedge against the effects of a weakening zloty exchange rate.

NBP estimates indicate that long-term investors generally do not hedge their zloty exposures because they are not willing to give away the higher yields on the Polish bonds in a forward rate. However, in periods of significant weakening of the zloty, investors may hedge against further depreciation by selling the Polish currency forward. This triggers a fall in the forward zloty exchange rate, exacerbating – by the covered interest rate parity – the fall in the spot zloty exchange rate. Yet, this does not result from an actual outflow of capital, but from the hedging demand of long-term investors.

3 Monetary policy in November 2013 – March 2014

At the meetings in November and December 2013 as well as in January, February and March 2014 the Monetary Policy Council decided to keep the 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. At the same time the MPC was extending the declared period of keeping NBP interest rate unchanged. In March 2014 the Council assessed that 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.

What follows in the next part of the chapter are the previously published *Minutes of the Monetary Policy Council decision-making meetings* held between November 2013 and February 2014 as well as the *Information from the meeting of the Monetary Policy Council* in March 2014. *Minutes of the Monetary Policy Council decision-making meeting in* March 2014 will be published on 20 March, and thus included in the next *Report*.

Minutes of the Monetary Policy Council decision-making meeting held on 6 November 2013

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

While referring to economic activity abroad, it was indicated that in 2013 Q3 global economic conditions had improved somewhat. It was also pointed out that economic developments were diversified globally. In the emerging markets, economic growth has stayed low as for these economies. At the same time, growth is gradually accelerating in some developed countries, although downside risks to economic activity in the coming quarters persist.

While discussing developments in the United States, it was highlighted that the recovery was building up there, most notably in the manufacturing industry and in the labour market. At the same time, it was noted that economic data for September 2013 had been slightly weaker than expected. At the same time, risk of weakening economic activity prevailed due to uncertainty about future fiscal policy in the country and the temporary suspension of the activities of the federal government in October.

While discussing the economic developments in the euro area, it was pointed out that quarterly GDP growth in 2013 Q3 had probably remained positive. However, a few Council members noted that the economic recovery might not be sustainable in some euro area countries due to the persistence of risks in the banking sector in these countries. During the discussion the opinion was also expressed that – amid declining inflation in the euro area – the likelihood of further monetary policy easing by the European Central Bank had risen.

It was also noted that GDP growth in China had accelerated slightly in 2013 Q3. At the same time, it was highlighted that GDP growth had remained relatively low as for this country. A few Council members indicated that the persistently weak activity in major emerging market economies was due to both relatively weak economic growth in developed countries as well as relatively low domestic demand growth in emerging market economies.

While analysing developments in financial markets, some Council members indicated that the increase in risk aversion in 2013 Q2 and Q3 contributed – as in the case of other emerging economies – to a decline in non-resident holdings of Polish sovereign bonds and a depreciation of the zloty. It was pointed out, however, that the Polish currency had depreciated less than many emerging market currencies. Furthermore, it was emphasized that since August the zloty had appreciated. It was observed that relative stability of the zloty might have been, in particular, due to a reduction in Poland's external imbalance in recent quarters. At the same time, the gradual decline in the non-resident holdings of Polish sovereign bonds has been reducing the risks associated with debt financing by foreign capital.

While discussing the current economic developments in Poland, Council members pointed out that the data on domestic economic activity released since the previous meeting had shown further recovery, particularly in the industrial sector. It was however highlighted that some of the data had turned out to be weaker than anticipated, and the acceleration in output growth had so far lagged behind the rise in leading indicators. It was also pointed out that the main factor behind increase in activity had been external demand growth, while domestic demand growth had stayed limited.

Some Council members pointed to the ongoing stagnation in the labour market, including the persistently elevated unemployment. This has not, so far, been mitigated by the slight increase in employment observed in the corporate sector in recent months. Stagnation in the labour market leads to weak growth in wages, which reduces the cost and demand pressures in the economy.

Referring to the economic outlook, Council members pointed out that – in the light of the November projection – GDP growth was likely to continue to accelerate. Nonetheless, economic recovery will be still moderate, and thus the output gap will stay negative in the entire projection horizon. Some Council members pointed out that acceleration in GDP growth in the coming quarters should be driven by a recovery in domestic demand, especially investment, which would be supported by the inflow of EU funds under the new budget perspective. A few Council members pointed out, however, that slow growth in corporate lending might curb private sector investment growth.

Referring to the inflation projection, Council members emphasized that the projected inflation returned to the band for deviations from the inflation target in the projection horizon, but posed no threat to meeting inflation target in the medium term. Apart from weak demand pressure, low inflation – in light of the projection – should also be supported by weak pressure on global commodity prices. A few Council members pointed out that since the zloty might appreciate amid improvement in the domestic economic conditions, substitution of domestic goods with imported ones might prove to be another factor conducive to lower inflation.

According to a few Council members, inflation may rise above the projection, should demand pressure prove stronger than assumed in the projection, or should negative shocks occur in the commodity markets. Moreover, according to these members, the temporary inflation increase anticipated in the projection in 2014 Q2 could – if translated into higher inflation expectations – result in some reduction in the real interest rate. It was also noted that an upside risk to global inflation continued to be posed by highly expansionary monetary policy of the major central banks.

Council members agreed that interest rates should remain unchanged at the current meeting. It was pointed out that the reduction in interest rates in the first half of 2013 and their stabilization in the second half of the year supported the recovery of the domestic economy, return of inflation to the target and stabilisation in the financial markets.

The Council assessed that in spite of the expected acceleration of economic growth, GDP growth in the coming years (i.e. in the projection horizon) would remain moderate, and the risk of a substantial increase in domestic inflationary pressure, which would pose a threat to meeting the inflation target in the medium term, was limited. This assessment was also supported by the November projection of inflation and GDP. Therefore, the Council decided that it would be justified to maintain interest rates at current levels at least until the end of the first half of 2014.

The Council kept the NBP's interest rates unchanged: the reference rate at 2.50%, the lombard rate at 4.00%, the deposit rate at 1.00% and the rediscount rate to 2.75%.

Minutes of the Monetary Policy Council decision-making meeting held on 4 December 2013

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 referring to economic activity abroad, the members of the Council pointed to global economic growth remaining moderate (due to persistently modest recovery in developed economies and historically low rates of GDP growth in emerging countries).

In particular, it was pointed out that economic conditions in the United States had improved, which was, however, partly driven by still highly expansionary monetary policy in that country. Some Council members emphasized that given the likelihood of the Federal Reserve starting QE tapering, the sustainability of recovery in the US economy was not certain. At the same time, these Council members were of the opinion that QE tapering might be accompanied by an easing of other parameters of the Fed's monetary policy, including changes to parameters of forward guidance. A few Council members pointed to the fact that QE policy had changed financial markets' response to macroeconomic data, and its withdrawal could trigger additional volatility in the financial markets.

While referring to the euro area, it was emphasised that due to the persistently high unemployment, the ongoing deleveraging process and uncertainty over the outlook for the euro area economy, GDP growth in 2013 Q3 was only slightly above zero. In the opinion of the Council, one could hardly expect its tangible acceleration in subsequent quarters. Some Council members indicated, however, that fiscal tightening had been scaled back in many euro area countries, which should have a positive impact on their economic growth in the short run. It was also pointed out that the November ECB decision to lower the main interest rate and the possibility of further easing of monetary policy in the euro area may support demand growth in that economy.

While analysing situation in the developing countries, some Council members indicated that growth outlook for major emerging economies had recently been revised downwards. In this context, a few Council members emphasised that the weakening GDP growth in those countries could be a long-lasting phenomenon, related the so called middle-income trap. Moreover, in the opinion of those Council members, cyclical factors (i.e. moderate scale of recovery in developed countries) also dimmed the prospects of a marked GDP acceleration in emerging economies (in particular in those that are commodity exporters).

While discussing inflationary processes, it was indicated that global inflation remained low, which was supported by moderate economic activity and a fall in commodity prices. Some Council members pointed to the recently rising risk of deflation in some countries. In particular, it was probably the risk of inflation falling below zero that had made the ECB lower its main interest rate, and led the Czech National Bank to introduce an asymmetric exchange rate target.

At the same time, a few Council members assessed that the unprecedented scale of quantitative easing carried out by major central banks might, in the long run, fuel concerns about a substantial rise in inflation across the world. Other Council members indicated that the additional liquidity provided to the financial system by major central banks had not, as yet, translated into increased money supply. Therefore, no inflationary pressures were observed in the consumer goods market. In turn, a marked increase in asset prices amidst persisting moderate global economic growth proves, in the opinion of these Council members, that additional liquidity had been used to invest in financial assets.

While referring to domestic economic activity, Council members noted that GDP data had confirmed the continuation of a gradual recovery in 2013 Q3. At the same time, however, some Council members emphasized that although domestic demand had picked up – after a few quarters of a decline – its rise was small and net exports continued to be the main driver of growth. In this context, a few Council members pointed out that given the low growth in the external environment of the Polish economy and the persisting risk of deterioration in economic conditions abroad, the strength of further economic recovery in Poland was uncertain. At the same time, it was noted that there was some slowdown in industrial output and retail sales growth in October, which was however accompanied by further improvement in economic climate indicators (including PMI in manufacturing) and a smaller decline in construction and assembly output.

Referring to the situation in the labour market, it was pointed out that wage growth had accelerated slightly, which could support further rebound in consumption. At the same time, the still elevated unemployment rate showed that no loosening of wage discipline should be expected. In this context, it was emphasized that the growth of unit labour cost in the economy had remained low for the last few years.

While assessing the situation in the credit market, some Council members emphasized that easing of consumer loan policy of financial institutions, accompanied by an improvement in consumer sentiment, had contributed to a marked rise in these loans over the recent months (which supported recovery in consumer demand). The rise in consumer loans combined with a stable increase in mortgage loans, translated into gradual acceleration of lending to households. In turn, lending growth to enterprises remained low, in particular in the segment of investment loans. This may point to further sluggish growth in investment demand of corporations, above all under capacity underutilization in the economy. While discussing the developments in the banking sector, it was indicated that the growth in household deposits continued to weaken.

Referring to inflation, Council members pointed out that in October 2013 CPI had decreased and inflation had remained markedly below the target. In addition, it was indicated that core inflation remained low, producer prices continued to decline, and inflation forecasts of financial sector analysts decreased. Some Council members emphasized that available forecasts pointed to a low risk of inflation exceeding the target in 2014. However, a few Council members noted the fact that core inflation ran at a level that in the past did not guarantee CPI inflation remaining within the tolerance band of deviations from the target.

In the opinion of the Council, NBP interest rates should remain unchanged at the current meeting. It was emphasized that the reduction in interest rates in the first half of 2013 and their stabilisation in subsequent quarters supported the recovery of the domestic economy, a return of inflation to the target and stabilisation in the financial markets.

The Council maintains its assessment that gradual economic recovery is likely to continue in the coming quarters, however, inflationary pressures will remain subdued. Therefore, the Council confirmed that it would be justified to maintain interest rates at current levels at least until the end of the first half of 2014.

The Council kept NBP's interest rates unchanged: 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 of the Monetary Policy Council decision-making meeting held on 8 January 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 the economic activity abroad, it was pointed out that the global economic conditions were gradually improving. Council members emphasized that the scale of this improvement remained diversified, but the magnitude of this diversification was different than in previous years. There have been signs that economy is recovering in developed countries. Meanwhile, economic growth in emerging market economies is low as for these countries.

In the United States, a marked acceleration in economic growth and declining unemployment rate (partly due to a decrease in the number of economically active persons) have prompted the Federal Reserve to start reducing the scale of quantitative easing. At the same time, the Federal Reserve extended the suggested horizon for keeping interest rates near zero. In the euro area, in turn, the sentiment of economic agents has improved. This improvement has so far not been coupled with a marked acceleration in economic growth. As no demand pressure is expected in the euro area, the European Central Bank has maintained its commitment to keep the interest rates at present or lower level. In this context, some Council members highlighted that the European banking sector was still in a difficult position. They indicated that by dampening lending growth in the euro area it contained GDP growth in the region. However, it was emphasized that economic conditions in Germany - Poland's main trading partner - remained sound compared to the rest of the euro area. At this point, it was highlighted that economic conditions in other countries of Central and Eastern Europe, which also have close links with the German economy, continued to improve. Nevertheless, it was noted that forecasts for Germany did not explicitly indicate that economic growth was recovering at a significant pace.

While discussing the situation in the environment of the Polish economy, it was also noted that global inflation was low. Low inflation is supported by moderate global economic activity and stabilisation of global commodity prices, especially for energy, underpinned by structural changes in the oil and natural gas markets. A few Council members assessed that in the coming years commodity prices could stabilize or fall.

When discussing developments in the financial markets, some Council members pointed out that the Federal Reserve's decision to reduce the scale of quantitative easing in the United States contributed to a slight increase in the volatility of asset prices in a number of emerging market economies. These members also pointed out that the prices of Polish assets had remained stable, which might indicate that fundamentals of the Polish economy are perceived positively by the markets.

Referring to domestic economic activity, a few Council members assessed that the recovery in the following quarters would be substantial and might close the output gap relatively fast. Some Council members indicated that retail sales and industrial output growth (adjusted for seasonal and calendar factors) had accelerated, while the decline in construction and assembly output had narrowed. Council members also pointed out that fiscal policy would be an important factor influencing the pace of GDP growth in 2014 and the subsequent years. A few Council members were of the opinion that there was a risk of some relaxation in the public sector wage discipline in the coming years. Other Council members argued that an acceleration in growth of government expenditure was rather unlikely in the following years due to ongoing Excessive Deficit Procedure for Poland. It was in particular highlighted that there was a risk of a decrease in EU fund inflows should measures to reduce the public sector imbalance came to a halt.

While discussing the likely structure of GDP growth in Poland in the following quarters, a few Council members emphasised that while Polish exports were supported by the high price competitiveness of Polish businesses to a great extent, the contribution of net exports to GDP growth might be expected to decrease due to an acceleration in consumer demand growth and an increase in gross fixed capital formation.

In particular, some Council members pointed out that the NBP surveys indicated an improvement in forecasts of corporate performance, including higher propensity to invest of businesses, which may be a sign of revival in domestic demand. Yet, other Council members indicated that growth in investment lending was still slow.

While assessing credit market conditions, Council members noted that the corporate lending was still low. This, however, is accompanied by accelerating consumer lending growth and a sustained increase in mortgage lending for households. In their discussion on the banking sector conditions, a few Council members indicated that the pace of household deposit growth continued to decelerate.

While discussing economic growth, Council members were also referring to long-term challenges relating to structural and regional policy and to the competitiveness of Polish enterprises. In this context, a few Council members highlighted that an increase in the EU funds share in co-financing research and development projects might be favourable for the Polish economy.

When discussing current labour market conditions, Council members pointed out that the unemployment rate was still elevated, which hampered wage growth and decreased the chance of a significant recovery in consumption. According to a few Council members, the economic recovery was still not robust enough to bring about a significant employment growth. However, a few Council members assessed that – as business climate continued to improve – demand for labour was likely to grow at a stronger pace, which was also reflected in NBP surveys. However, these surveys do not indicate a risk of a marked acceleration in corporate wage growth. A few Council members also noted that an increase in minimum wage at the beginning of this year, and the related increase in some social benefits indexed to minimum wage, might be conducive to an increase in consumer demand. It was, however, argued that the rise in productivity, which is typical of this stage of recovery, mitigated the risk of excessive cost pressures in the labour market in the coming quarters.

With reference to price developments, Council members indicated that in November the CPI index decreased and that inflation was still markedly below the target. Other signs of weak demand and cost pressure include low core inflation and declining producer prices in industry. Council members also pointed to continuously low inflation expectations of household and corporate sectors and the inflation forecasts of financial sector analysts.

Council members emphasised that in light of available forecasts the 2014 inflation would stay below the November projection. Nonetheless, in the first two quarters of 2014 the CPI index may increase moderately due to base effects. In the opinion of some Council members, inflation would stay below the target not only because of low demand pressure, but also due to stabilisation in energy prices. Yet, other Council members pointed to the factors which, in their opinion, could be conducive to higher inflation in the near future. These involve growing demand pressure and a raise in local taxes, as well as higher prices of gas and some services related to the general government sector.

The Council decided that the NBP interest rates should remain unchanged at the current meeting. Furthermore, the Council maintained its assessment that the gradual improvement in economic conditions was likely to continue over the coming quarters, while inflation pressure would remain limited. In this context, the Council confirmed that it would be justified to maintain the interest rates at the current level at least until the end of the first half of 2014. At the same time, Council members recognized that the findings of the March NBP projection would enable a more comprehensive assessment on the horizon of keeping the interest rates at the current level.

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 of the Monetary Policy Council decision-making meeting held on 5 February 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 economic activity abroad, it was indicated that the global recovery is still moderate. Data on euro area point to a slowly improving economic conditions. In turn, activity growth in the United States – which is visibly stronger than in the euro area – recorded signs of weakening in comparison to previous expectations. At the same time, in China and in other emerging economies, where growth has slowed down to a low level (considering their past performance), there is persisting uncertainty about future developments in GDP. A few members of the Council also highlighted that, taking into consideration the significant scale and limited effectiveness of the stimulus provided so far to the emerging economies, there is little scope for revival of economic activity through additional actions of these countries' authorities.

While analysing the external environment of the Polish economy, the Council also discussed reaction of the financial markets to the QE tapering of the Federal Reserve and to the increased risk of Argentina suspending its debt servicing. These events have had a negative effect on the sentiment of market participants. The deterioration in investor sentiment, in particular in relation to certain emerging economies, resulted in an outflow of capital from some of these countries and a weakening of their currencies. In order to limit the scale of the depreciation, some of the central banks intervened on the currency market or raised their interest rates. Some of the Council members pointed to the fact that monetary policy tightening was conducted in economies characterised by heightened inflation and substantial external imbalances. Therefore, the increase in interest rates in these countries was supporting the restoring of their macroeconomic equilibrium – both internal and external.

In Poland the exchange rate of the zloty – i.e. the currency of a country usually included in the group of emerging markets – has weakened relatively slightly. According to the Council members, the resilience of the zloty to changes in the sentiment of the financial markets is supported by the relatively favourable economic situation in Poland, including the lack of any significant imbalances.

Referring to domestic economic growth, it was stressed that preliminary GDP data for 2013, as well as monthly data on economic activity and indicators of economic conditions point to a continued gradual recovery of growth. The Council members drew attention to the fact that the implied GDP data for 2013 Q4 confirm that net exports are still contributing substantially to GDP growth, while domestic demand remained weak (this relates in particular to investment demand). Some of the Council members argued that the current structure of GDP growth – based to a large degree on exports, with only a gradual recovery of domestic demand – supports the maintenance of low inflationary pressure and, at the same time, contributes to the Polish economy remaining balanced.

According to some members of the Council, in successive quarters – together with further improvement in growth prospects – investment activity should increase significantly. Some of the Council members argued that taking into account good financial situation of companies and low credit costs, relatively high capacity utilization should be a factor encouraging firms to invest. These Council members emphasised that favourable prospects for corporate investment growth are indicated by the NBP business tendency surveys, which show an increase in investment outlays planned for 2014, as well as an increase in the percentage of companies intending to begin new projects. A few of the Council members pointed out that the revival of outlays on fixed assets should also be supported by a rebound of investments related to further inflow of EU funds, in particular to the local government sector.

While analysing the prospects for further recovery in consumption, the Council members indicated that growth of disposable income is still low, limiting the increase in household expenditure. At the same time, a few Council members assessed that low inflation and a gradual improvement in the situation on the labour market will be conducive to the revival in individual consumption in the coming quarters.

While discussing the outlook for external trade, some members of the Council pointed out that low labour costs in Poland continue to support high price competitiveness of Polish goods abroad, and hence – exports growth. The favourable outlook for exports performance is also related to the anticipated acceleration of growth in Poland's main trading partner countries, as signalled by the upward revisions of their GDP growth forecasts. At the same time, a few Council members assessed that stronger import growth resulting from the expected investment revival will dampen the contribution of net exports to GDP growth.

While analysing trends in lending, some of the Council members pointed to the still weak credit growth. In particular, corporate lending for financing investment continues to rise only slowly, which – in the opinion of those Council members – indicates persistently high risk aversion on the part of both banks and enterprises. Yet, a few Council members stressed that growth in credit to the private sector has accelerated. They highlighted, in particular, the increasing availability of corporate credit, evidenced by the rising percentage of loan applications being approved. With corporate investment expected to accelerate in the subsequent quarters, this will facilitate a revival in lending to that sector, especially amidst banks' declarations of looser lending criteria for some types of loans.

Addressing labour market conditions, some members of the Council pointed out that so far they have been improving very slowly. In particular, employment growth is insufficient to bring down the unemployment rate. In effect, as at the end of 2013, the unemployment rate was still relatively high. A few Council members were of the opinion that since the probability of finding a job has risen – as has the ratio of non-subsidised vacancies to the number of the jobless – the outlook for labour market developments is favourable. In the opinion of those Council members, positive signs in this respect include also some improvement in willingness of increasing employment declared by enterprises and a decline in fears of losing a job reported by private individuals.

In the context of labour market impact on inflation, some of the Council members observed that the persistently high unemployment rate has a mitigating effect on both cost and demand pressures (on the former, by restricting wage pressure, on the latter, by reducing disposable income). Those Council members noted that in the past few years wage and unit labour cost (ULC) growth has been slow. A few Council members assessed that, also over the next few quarters, ULC growth should remain slow. Yet other members of the Council argued that in response to the improving economic conditions, wage pressure may materialise fairly promptly, hence the pace of ULC growth may pick up substantially within a short span of time.

While analysing inflation developments, the Council members highlighted that inflation – including core inflation – continued to be very low, and the available forecasts point to it likely remaining low also in the subsequent quarters. Low core inflation is supported by a further decline in producer prices and sustained low inflation in Poland's main trading partners. In turn, the risk of substantial rise in energy or food prices is constrained by the conditions in international commodity markets, where the moderate scale of global economic recovery is conducive to price stabilisation. Therefore there is no significant risk of inflationary pressure rising markedly in Poland in the nearest future. At the same time, a few Council members argued that in its monetary policy decisions the central bank should take into account the fact that the current low inflation is partly related to temporary factors remaining beyond the influence of domestic monetary policy.

The Council decided that the NBP interest rates should remain unchanged at the current meeting. Furthermore, the Council maintained its assessment that the gradual improvement in economic conditions was likely to continue over the coming quarters, while inflation pressure would remain limited. In this context, the Council confirmed that it would be justified to maintain the interest rates at the current level at least until the end of the first half of 2014. At the same time, Council members recognized that the findings of the March NBP projection would enable a more comprehensive assessment of medium-term outlook for inflation and economic growth.

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%.

Information from the meeting of the Monetary Policy Council held on 4-5 March 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, economic conditions remain favourable despite signs of some weakening observed in the recent period. At the same time, the euro area has been experiencing a slow, yet somewhat limited recovery. Activity growth in the largest emerging economies continues to be weak as compared with their previous performance. Some of these economies have seen deterioration in business indicators in the recent period. Moderate growth in global economic activity is conducive to maintaining low inflation in many countries.

Data on domestic economic activity confirm a continuation of the gradual recovery in Poland. In 2013 Q4 economic growth was higher than in 2013 Q3. GDP growth was supported primarily by net exports. At the same time, domestic demand contribution to GDP growth increased. This was related to accelerating consumption and investment growth.

The gradual recovery at the beginning of 2014 is indicated by a further growth in industrial output and retail sales in January 2014. At the same time, growth in construction output was negative. Yet, business climate indicators suggest that recovery will continue in the coming quarters.

The gradual economic recovery is contributing to an improvement in labour market conditions. According to the LFS, in 2014 Q4 the number of persons working in the economy was higher than a year before. This helped to reduce somewhat the unemployment rate, which however remained elevated. Unemployment persisting at heightened levels is hampering wage pressure in the economy.

According to preliminary data, CPI inflation stood at 0.7% in January 2014, thus remaining markedly below the NBP inflation target of 2.5%. This was accompanied by a decline in core inflation measures, which confirms that demand pressure continues to be weak. In turn, weak cost pressure in the economy is manifested by a further drop in producer prices. This is accompanied by low inflation expectations.

Lending to the private sector – while accelerating slightly – remains limited. In particular, since mid-2013 there has been a gradual acceleration in consumer loans. The past few months have seen a slight growth in housing and corporate loans from a low level.

The Council got acquainted with the projection of inflation and GDP prepared by the Economic Institute, being one of the inputs to the Council's decisions on NBP interest rates. In line with the March projection based on the NECMOD model – prepared under the assumption of unchanged NBP interest rates and taking into account data available until 14 February 2014 (projection cut-off date) – there is a 50-percent probability of inflation running in the range of 0.8-1.4% in 2014 (as compared to 1.1-2.2% in the November 2013 projection), 1.0-2.6% in 2015 (as against 1.1-2.6%) and 1.6-3.3% in 2016. At the same time, the annual GDP growth – in line with the March projection – will be, with a 50-percent probability in the range of 2.9-4.2% in 2014 (as compared to 2.0-3.9% in the November 2013 projection), 2.7-4.8% in 2015 (as against 2.1-4.5%) and 2.3-4.8% in 2016.

In the opinion of the Council, gradual economic recovery is likely to continue in the coming quarters, however, inflationary pressures will remain subdued. Such assessment is confirmed by the March projection of inflation and GDP. Therefore, the Council decided to keep NBP interest rates unchanged. In the Council's assessment 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.

In the opinion of the Council, lowering interest rates in the first half of 2013 and keeping them unchanged in subsequent quarters, supports recovery of the domestic economy, gradual return of inflation to the target and stabilisation in the financial markets.

4 Projection of inflation and GDP

This inflation and GDP projection was prepared by the Economic Institute of the National Bank of Poland 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[73], 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 March projection based on the NECMOD model covers the period from 2014 Q1 to 2016 Q4. The starting point for the projection is 2013 Q4.

The cut-off date for the projection was 14 February 2014.

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

4.1 Summary

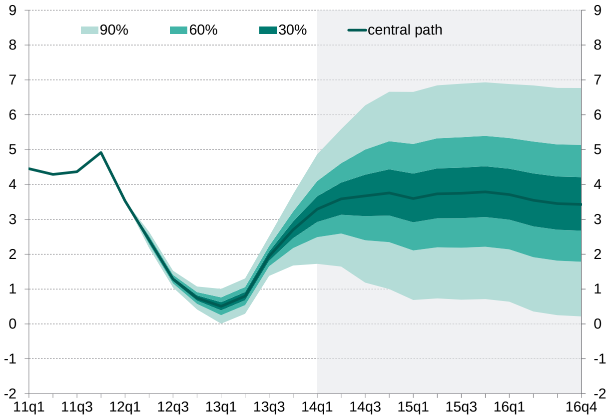
The Polish economy is in a recovery phase of the business cycle, which means that the scenario outlined in the previous *Projection of inflation and GDP* is materialising (Figure 4.1). Improving conditions abroad are conducive to the revival at home. In 2013 Q4, the euro area saw positive year-on-year GDP growth for the first time since 2011. Quarterly Central Statistical Office (GUS) estimates reveal a sound structure of domestic growth. The 2.7% y/y expansion in 2013 Q4 was the combined effect of positive contributions from private and public consumption, investment and net exports.

In the years 2014-2015, as external conditions improve and the EU funds under the newly agreed 2014-2020 financial framework start flowing in, output growth will pick up. Yet, considering the merely modest improvement in the euro area business conditions, it will remain below the long-term average of the period preceding the financial crisis. Recovery will also be supported by the historically low NBP interest rates, which - according to the assumption adopted in each forecasting round - remain unchanged throughout the entire projection horizon.

In 2016, as the settlement of the EU 2007-2013 financial framework is completed, the inflow of EU funds will ebb, dragging down domestic demand. The GDP growth will also be adversely affected, if to a lesser extent, by the countercyclical behaviour of net exports and the continuation of relatively good business conditions abroad.

As the Polish economy continues on the recovery track, GDP will rise faster than 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

Figure 4.1 GDP (y/y, %)



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

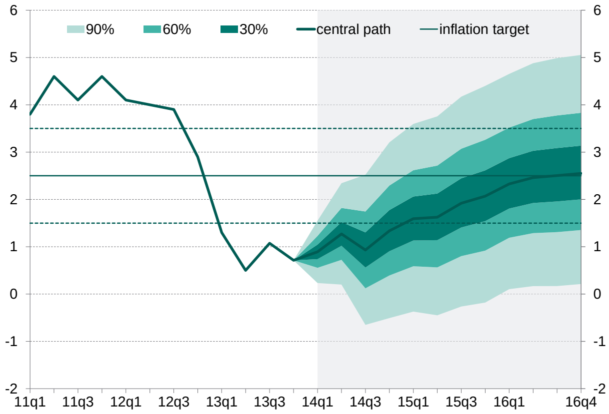
2012 Q2, will gradually start closing, and converging to approximately zero in the years 2015-2016.

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 period are the effect of the slowdown in domestic economic growth in 2013, which had a particular impact on core inflation (Figure 4.2). In addition, low inflation levels continuing into 2014 will be supported by the decisions of the Energy Regulatory Office (URE), resulting in reduced electric energy prices and only a slight rise in natural gas prices in January 2014.

In the years 2015-2016, the recovery in the Polish economy will put an upward pressure on prices of the main components of the consumer goods and services basket (core inflation, food prices, energy prices). Yet, owing to the modest scale of the recovery, CPI inflation will remain relatively low, staying, until 2016 Q1, below the NBP inflation target. Factors conducive to 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.

The main source of uncertainty surrounding this inflation and GDP projection are the possible developments in the euro area and the related trends in the zloty exchange rate. Both the probability of further economic downturn in the euro area and that of growth accelerating above the level assumed in the central projection scenario are deemed to be equal. As a result, for both GDP and inflation, the risk of those variables running above or below the central path is similar, which is reflected in the fan-charts for both of those variables (Figure 4.1, Figure 4.2).

Figure 4.2 CPI inflation (y/y, %).



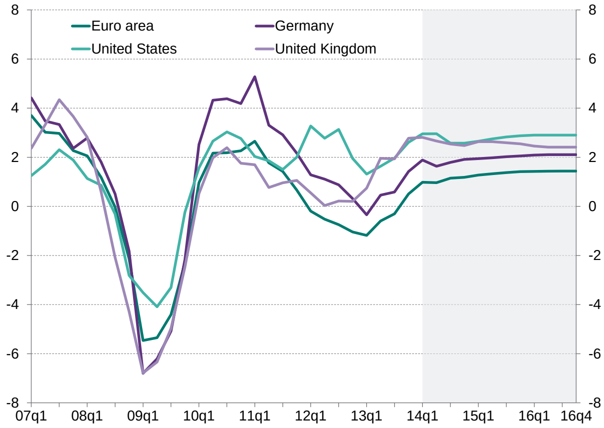
4.2 External environment

In 2013, GDP growth in advanced economies, in particular the United States and Great Britain, was running higher than assumed in the November projection. As a result, in the current forecasting round, expectations as to the future economic growth abroad have been revised upwards, while still running below the long-term average of the pre-crisis period.[74]

Amongst Poland's main trading partners, the United States enjoy the best outlook for growth over the projection period. The output growth forecast for the United States rises to an average of 2.8% y/y in the years 2014-2016 (Figure 4.3). Such a scenario is indicated by the declining unemployment rate, sustained industrial output growth and a rise in business sentiment (see Chapter 1.1 *Global economic activity*).

In the euro area, growth is expected to average 1.3% y/y in the years 2014-2016. The forecast of modest growth in the region is supported by good prospects for euro area exports related to stronger demand growth in the United States and Great Britain as well as the ongoing restructuring of the export sector in the region's periphery area. Also, there are expectations of internal demand in the euro area being restored, which is indicated by the positive readings of consumers' and producers' sentiment indices (in particular, in Germany, Italy and Spain). In addition, as the pace of fiscal consolidation in the euro area slows down, its adverse impact on GDP growth will diminish. Internal demand growth in the euro area will be dragged by the ongoing process of private sector

Figure 4.3 GDP abroad (y/y %).



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

deleveraging and businesses' problems with availability of bank credit in some countries of the region.

The index of energy commodity prices is running slightly below the expectations of the previous projection, which is the effect of downward revisions of forecasts of natural gas and coal prices early in the projection horizon (Figure 4.4).[75] These price adjustments were driven by weaker demand, a result of the relatively mild winter in Europe. Towards the end of the projection horizon, the index of energy commodity prices will remain stable, amidst the moderate pace of economic growth and favourable supply conditions. It is expected that oil supply will increase on the back of rising shale oil extraction in the United States as well as, in the longer term, the stabilisation in the situation in Libya (see Chapter 2.5 *Asset markets).* The nearest future is also expected to see rising supply of natural gas extracted from shale. Contracts in the futures market point to a likely rise in the prices of coal which can be triggered by the anticipated increase in imports of this commodity to China, amidst cutbacks to coal mining in this country.

In 2013 Q4, the index of agricultural commodity prices was running above the levels assumed in the November projection, mainly due to a rise in the prices of wheat and milk, largely driven by heightened demand from China (Figure 4.4). Over the projection horizon, the index will decline to stabilise below the path envisaged in the previous forecasting round. Early in the projection horizon, agricultural commodity prices will be dampened by lower than expected, in the November projection, prices of meat, which results from a decrease in prices of animal feed.

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

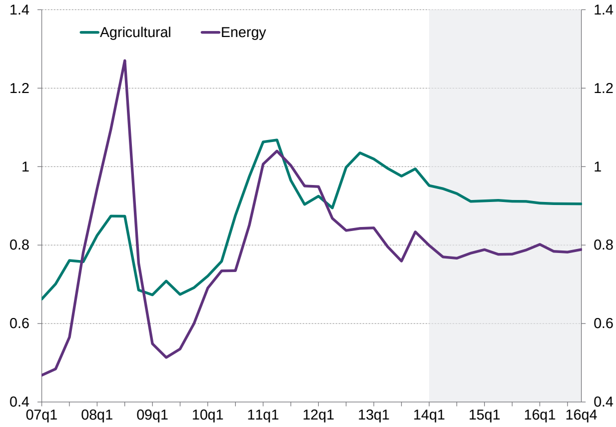
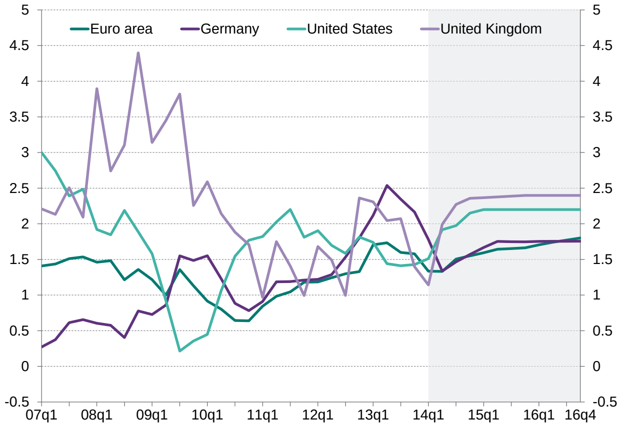


Figure 4.5 Inflation abroad (y/y, %).



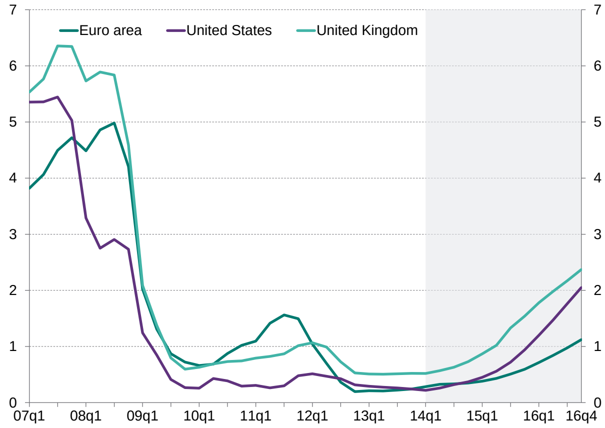
[75] The global index of energy commodities comprises the prices of: coal, oil, and natural gas.

Against the background assumed in the projection, i.e. a moderate scale of recovery abroad, the persistently high unemployment rate and relatively stable commodity prices, inflation in the euro area and the United States will continue to be 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. In particular, the projection assumes that in the nearest quarters, both the ECB and the Fed will keep their interest rates at the present level, with a possible rise only in the second half of 2015 (Figure 4.6, see Chapter 1.3 *Monetary policy abroad and international financial markets*).

The prospect of economic growth being lower in the euro area than in the United States suggests that the euro may weaken against the US dollar – down to 1.28 in the middle of and later on in the projection horizon.

Figure 4.6 Interest rate abroad (%).

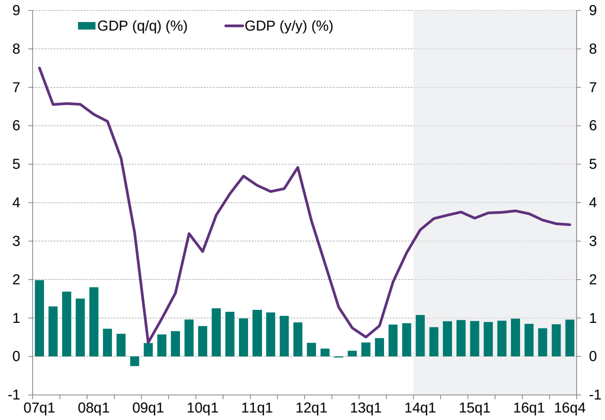


4.3 Polish economy in the years 2014-2016

Aggregate demand

In the years 2014-2015, business conditions in Poland are expected to improve, with GDP increasing on average by 3.6% y/y. Higher economic growth will be driven by accelerated expansion in domestic demand, amidst a negative contribution of net exports (Figure 4.8). Rising domestic demand growth, amidst modest improvement abroad, will be driven by an increase in private consumption, corporate investment and a rebuild of inventories. An additional stimulus for output growth will be provided by the inflow of EU funds, especially those earmarked for investment. In 2016, as the settlement of the EU 2007-2013 financial framework is completed, the

Figure 4.7 Economic growth.



inflow of EU funds will ebb, dragging domestic demand growth (Figure 4.11). Yet the extent of the GDP slowdown will be smaller, owing to the countercyclical behaviour of net exports and to continuation of relatively good business conditions abroad.

Private consumption growth will rise early in the projection horizon, and subsequently stabilise - starting from the 2014 Q3 - at level close to 3.0% y/y (Figure 4.9). Consumption will benefit from the improvement in the labour market, which will translate into rising employment and wages. As a result, growth of the wage bill as deflated with consumer prices will run at close to 4.0% y/y over the projection horizon, i.e. the highest rate since the beginning of the financial crisis. Faster growth of income from self-employment will also be conducive to a revival in consumer demand. The increase in disposable income will be dragged by low income from bank deposits and bonds, although the impact of this effect will be relatively weak. Income from this source is adversely affected by the historically low levels of the NBP interest rates, which - according to the assumption adopted in each forecasting round - will remain unchanged. Rising private consumption, amidst low savings rate, will be supported by the expanding stock of consumer loans. The rise in the loan volume will be driven by households' improving financial condition along with the relaxation of lending standards following the amendments made to Recommendation T.

In 2014, public consumption growth will remain rather slow, due to the consolidation measures in the public finance sector, including a freeze on government sector wages. Yet, consumption growth will accelerate in 2015-2016, assuming only those fiscal policy changes that result from the parliamentary acts already passed, or comprised in the Draft Budget Act adopted by the government.

The path of gross capital formation in the

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

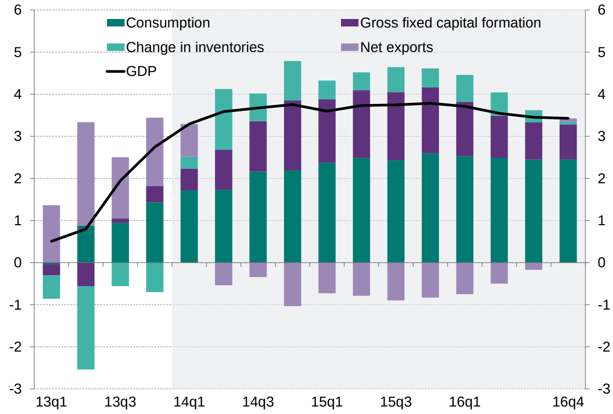
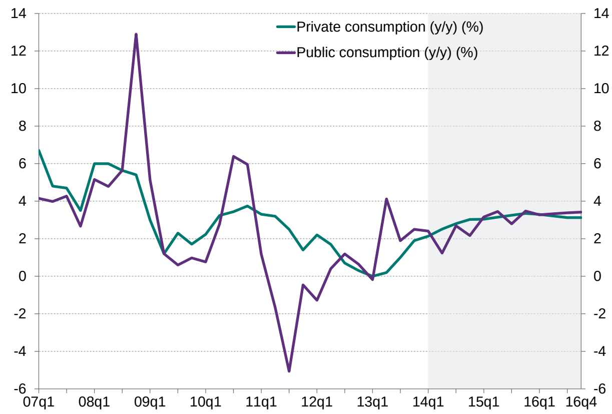


Figure 4.9 Private and public consumption.



projection horizon will, in turn, be determined by the level of EU capital transfers (Figure 4.10, Figure 4.11, Figure 4.12). Until 2015, both private and public investment co-financed with EU funds will continue to rise. In the last year of the projection horizon, as the settlement of the EU 2007-2013 financial framework is completed, the amount of this investment will decrease. Improved economic conditions early and in the middle of the projection horizon will, on the other hand, favour a rebound in private investment (i.e. corporate and housing), which results from a heavily pro-cyclical nature of this category.

Growth of gross fixed capital formation of enterprises will be relatively strong in the period 2014-2015, averaging 9.5% y/y.[76] The revival in corporate investment will be supported by economic recovery at home and abroad, and a higher take-up of EU transfers earmarked for private sector's capital expenditure (Figure 4.11). This scenario is indicated by the increase, in 2013 Q3, in estimated value of newly started corporate investment projects despite the still fairly weak GDP growth rate (1.9% y/y).[77] The projected growth in corporate investment will be supported by rising replacement investment. As a result of fall in corporate investment in the wake of the financial crisis, the current pace of fixed asset replacement, measured by the ratio of investment to fixed assets, is at its slowest since 2004.[78] The present level of capacity utilisation, which exceeds its long-term average, will constitute an important driver of investment growth.[79]

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

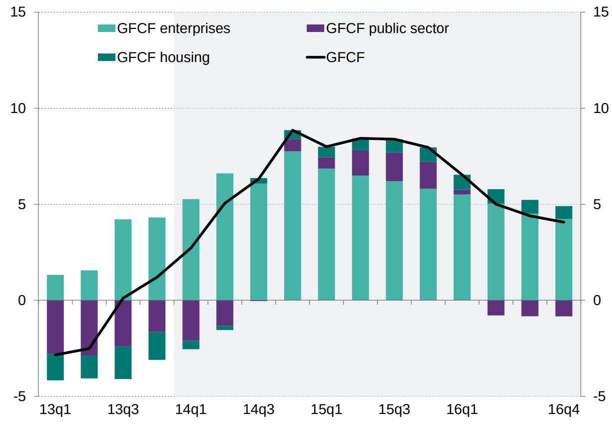
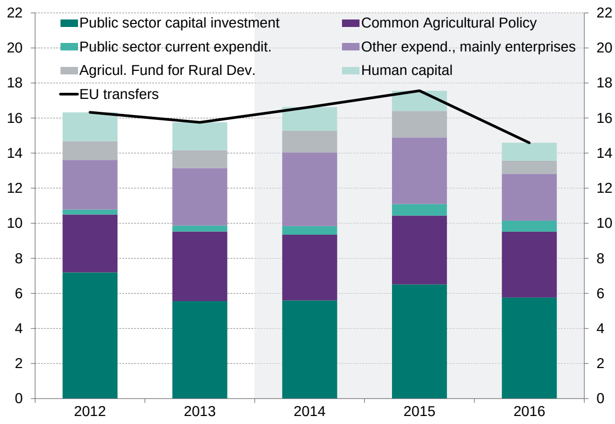


Figure 4.11 EU transfers (in bn. EUR) – breakdown.



[76] 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 corporate sector investment (in accordance with the national accounts methodology) and some of the household sector investment (investment of micro-enterprises, investment of private farms)

[77] *Financial situation in the enterprise sector in 2013 Q3*, NBP.

[78] *Financial situation in the enterprise sector in 2013 Q3*, NBP.

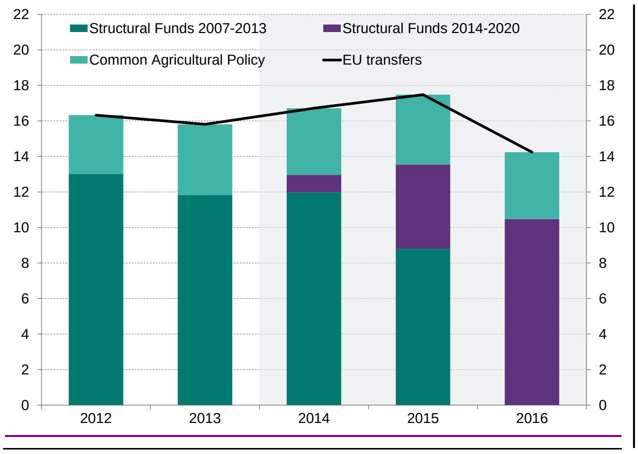
[79] *NBP Quick Monitoring. Economic climate in the enterprise sector in 2013 3Q and forecasts for 2014 Q1*, NBP.

Enterprises' sound financial standing enables them to self-finance investment.[80] On the other hand, the persistence of interest rates at the current, relatively low level (which results from the assumption of a constant NBP reference rate adopted in the projection) would have a stimulating effect on demand for investment credit. Another factor adding to credit demand will be the *Portfolio Guarantee Line De Minimis.* The guarantees granted under this programme will increase credit availability for micro-, small and medium-sized enterprises which do not have enough assets to collateralise an investment loan. Thus, terms of lending to these businesses have been relaxed markedly.[81] In 2013 Q4, the above factors caused - for the first time in a year and a half - a rise in demand for credit intended to finance capital expenditure.[82]

In the last year of the projection horizon, as the use of funds from the EU 2007-2013 financial framework has ceased, there will be a decline in EU capital transfers designated for both enterprises and, through the *Rural Area Development Programme*, for farmers. Along with weakening in domestic demand, this will dampen investment of those groups.

In 2013, public investment declined due to a decrease in funds for the implementation of road projects under the *2011-2015 National Road Construction Programme* and cutbacks in local governments' capital expenditure resulting from the application of the local government fiscal rules. The downward trend is expected to level off at the beginning of 2014, and subsequently reverse. The negative impact of the fiscal rules on local government investment growth will gradually wane, which will be supported by an increase in their income due to an improvement in the

Figure 4.12 EU transfers (in bn. EUR) – breakdown.



[80] *Financial situation in the enterprise sector in 2013 Q3*, NBP.

[81] *Senior loan officer opinion survey on bank lending practices and credit conditions*, 2014 Q1, NBP.

[82] *Senior loan officer opinion survey on bank lending practices and credit conditions*, 2014 Q1, NBP.

country's economic situation. Besides, in 2014 funds from the 2014-2020 EU financial framework will be available to use (Figure 4.12). This is indicated by the government's decisions of June and October 2013 to include in the *2011-2015 National Road Construction Programme* new road investment projects which assume the use of structural funds under the new EU 2014-2020 financial framework. According to the provisions of the *Programme*, outlays dedicated to this purpose will amount to PLN 3.8 billion in 2014 and to PLN 13.5 billion in 2015. Thus, in the years 2014-2015, especially in 2015, there will be an overlap in the utilisation of funds from two EU financial frameworks: the current (2007-2013) and the new one (2014-2020). In 2016, the use of funds provided under the 2007-2013 EU financial framework will cease, causing a new drop in the inflow of EU funds intended for co-financing general government sector investment. As a consequence, total public investment will decrease.

Over the projection horizon, as the situation of households improves, there will be a lagged revival in housing investment. Housing outlays, while still decreasing, will do so at a gradually slower rate, to bottom out at the beginning of 2014 and stabilise at 5.9% y/y in 2015-2016. Factors adding to growth in demand for homes will include the government programme *Home for the Young*, launched in 2014, and the stability of interest rates at a historically low level, assumed in the projection. The sum of these factors will outweigh the impact of the amendment to Recommendation S, introduced at the beginning of the year, that tightens the criteria for housing loan extension. The scenario of recovery in the residential development market is supported by the gradual increase in value of new housing loan agreements observed since the second half of 2013 and the rising number of home construction starts in this period.[83]

In tandem with strengthening 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 the middle of the projection horizon will remain negative. Towards the end of the projection horizon, responding to decreasing domestic demand growth, 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.

Macroeconomic equilibrium

In the wake of the global financial crisis, potential output growth slowed down markedly. In the projection horizon, potential GDP growth is expected to gradually pick up, while remaining below its long-term average. At the same time, as the Polish economy continues on the recovery path, GDP will rise faster than potential output. As a consequence, the output gap, which has been negative since 2012 Q2, will gradually close and will remain at a near- zero level from 2015 (Figure 4.14).

In the projection horizon, three factors will have a positive effect on potential output growth (Figure 4.15). Firstly, the currently weak growth in total factor productivity will gradually return to the level observed before the global financial crisis. Secondly, corporate investment growth will translate into higher growth of productive capital.

Figure 4.13 Foreign trade.

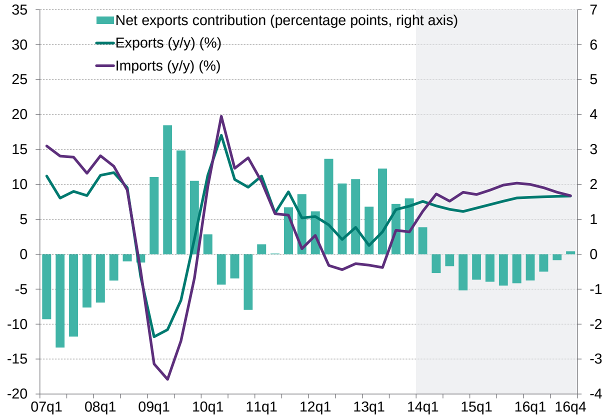
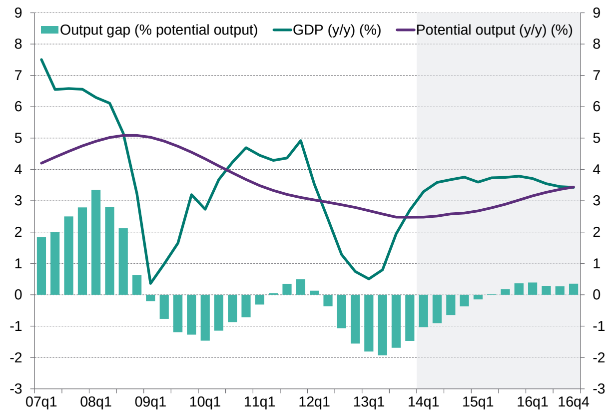


Figure 4.14 Output gap.



[83] *Information on Dwelling Prices and the Situation in the Market for Residential and Commercial Property in Poland in 2013 Q4*, NBP.

Thirdly, the equilibrium unemployment rate (NAWRU) will gradually drop; the increase in this rate has had hitherto an adverse effect on potential GDP growth (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 trade union participation rate.[84] Moreover, wage indexation is far less frequent in Poland than in most European Union countries, which facilitates wage adjustment to market conditions.[85] 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.

Over the projection horizon, the positive impact of the above factors will be partially offset by a decline in public capital growth, resulting from a substantial reduction in investment expenditure of the general government sector in 2012-2013. Potential GDP growth will be further dragged down by the anticipated decline in the population, caused by the persistently negative balance of migrations. As a result, although potential output growth will rise over the projection horizon, it will not exceed 3.5% y/y.

The labour participation rate will remain stable throughout the projection horizon, thus being neutral to potential output (Figure 4.16). On the one hand, the labour participation rate will be boosted by the retirement age being raised as of the beginning of 2013.[86] On the other hand, the labour participation rate will be dragged down by the change in the age structure of the population,

Figure 4.15 Potential output (y/y, %) - breakdown.

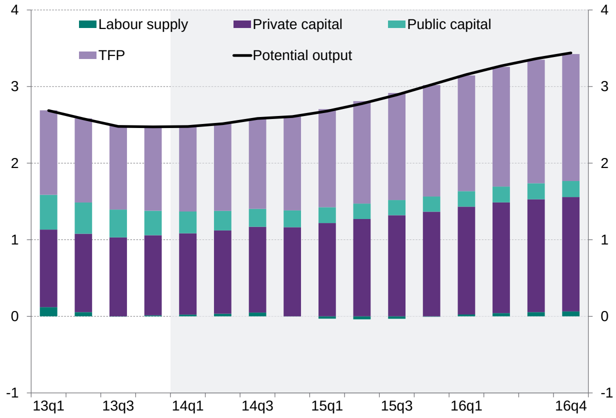
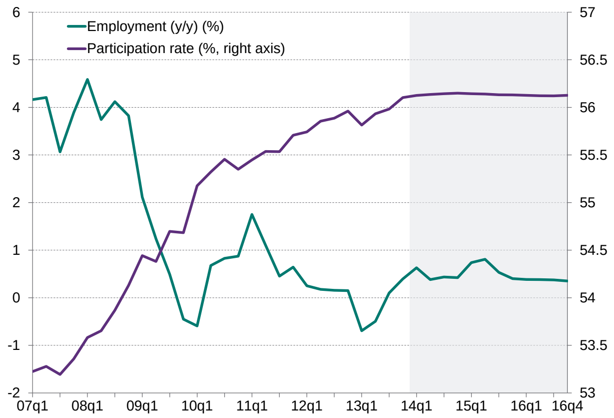


Figure 4.16 Employment and activity in the labour market.



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

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

[86] Estimated impact of this change is the rise in the labour force participation by approx. 300 thousand persons over the projection horizon.

as a result of the rising number of persons of post-productive age, and emigration, which is predominantly observed among the economically active population.

The increase in the demand for labour in 2013 Q3 occurred at an earlier phase of the business cycle than previously observed. These changes may be associated with a lower cost of staff turnover due to rising percentage of fixed-term labour and civil law contracts. Although this reduces the stability of employment and weakens the bargaining position of employees, it has a positive effect on the labour market as it allows companies to increase employment in the earlier phase of the economic recovery as compared to the past.

Moreover, in the recent years the Polish economy has seen rising share of services in the creation of new jobs, and the service sector itself has been relatively less susceptible to cyclical fluctuations. The years 2014-2016 are expected to see continued upward trend in the number of the employed, started in 2013 Q3, which will reduce the LFS unemployment rate to 8.4% in 2016 (Figure 4.16, 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 -0.5 percentage point (Figure 4.17). Wage pressure in the economy will therefore increase gradually, however, remaining at a moderate level due to a relatively small unemployment gap (Figure 4.18). As a result, real wage growth until the end of 2016 will stand at the level close to or slightly exceeding labour productivity growth. Growth in unit labour costs will gradually increase, from 1.1% in 2014 to 2.7% in 2016, although cost pressure 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. As a result, in 2013 the surplus in this account amounted to 1.1 %

Figure 4.17 Unemployment.

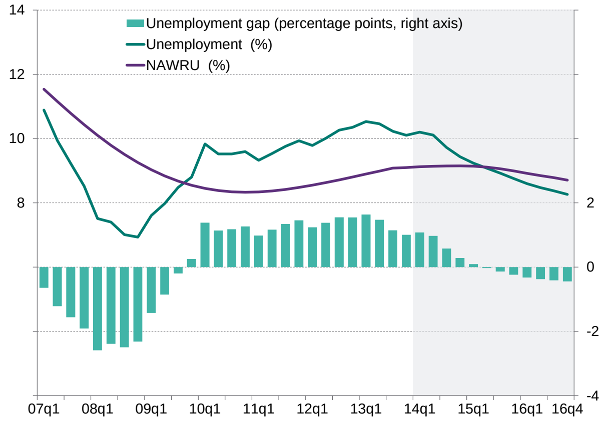
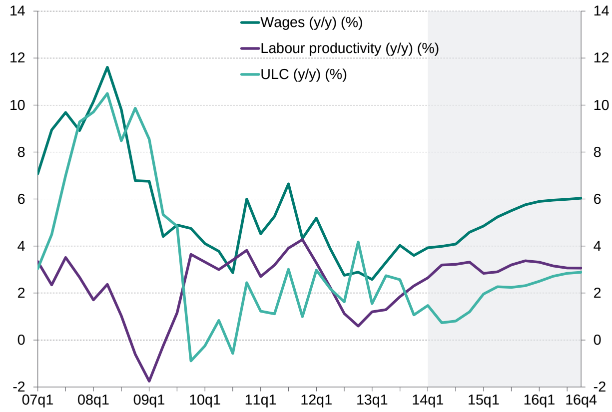


Figure 4.18 Unit labour costs.



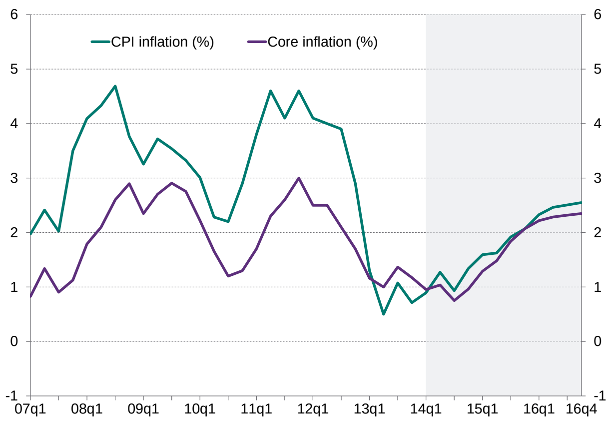
of GDP, which is the record high since the mid-1990s when comparable statistics on the balance of payments started to be released. Over the projection horizon, the positive current and capital account balance will gradually decrease, yet will still remain positive in 2014. The decline in the balance in 2014-2015 will primarily result from the narrowing trade surplus (the effect of the negative contribution of net exports to growth from 2014 Q2). Further reduction in the balance in 2016 results from decreasing inflow of EU funds, which is associated with the settlement of the 2007-2013 EU financial 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 remittances from abroad – will remain relatively stable in the projection period.

Foreign exchange rate and inflation

Factors supporting the strengthening and the weakening of the zloty in the projection will be largely balanced. On the one hand, the zloty exchange rate remains below the level determined by the fundamental factors, which supports gradual appreciation of the currency towards the equilibrium level in the projection horizon.

Factors contributing to the appreciation of the domestic currency through the expectations channel should also include recovery of the domestic economy (reflected in the output gap closing over the projection horizon) and rebound of the economy abroad, as well as improvement in the condition of the public finance. On the other hand, the weakening of the exchange rate will be driven by decreasing current and capital account balance and diminishing interest rate disparity (resulting from the assumption of a constant NBP reference rate adopted in the projection). As a result of the balancing of the above factors, the exchange rate will remain relatively stable and

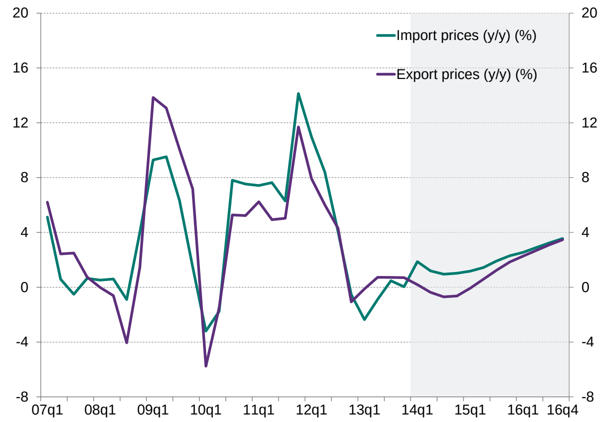
Figure 4.19 CPI and core inflation (y/y, %).



neutral for the increase in prices of goods and services in the projection period.

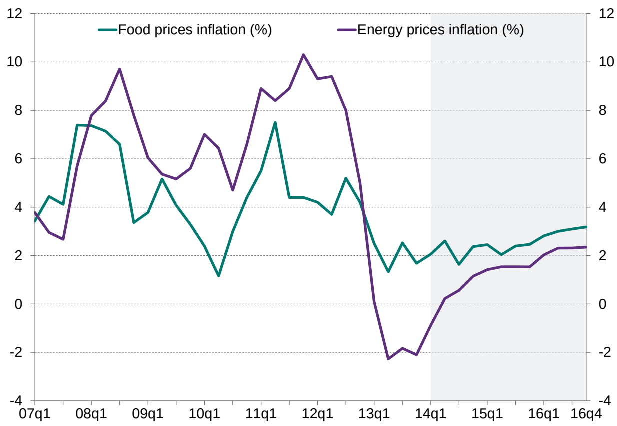
Core inflation will increase over the projection horizon, being affected both by its domestic and foreign determinants (Figure 4.19). Steady improvement of the domestic economic conditions, reflected in the closing output gap, will increase demand pressure in the economy. At the same time, the labour market will see a gradual improvement, which will be accompanied by growing unit labour costs. Stable exchange rate and slowly rising inflation abroad will translate into higher growth of import prices, although the scale of the growth will be moderate (Figure 4.20). The above factors will, with a certain delay, translate into price growth. As a result, core inflation will gradually rise from 0.8% in 2014 Q3, up to 2.3% at the end of 2016.

Figure 4.20 Terms-of-trade.



In the case of food prices, increasing demand pressure in the domestic market will be mitigated by agricultural commodity prices in the world market remaining stable throughout the projection horizon (Figure 4.4). As a result, food price inflation will rise from 2.2% in 2014 to 3.0% in 2016, yet will remain below its long-term average. In the short term food price inflation will be also influenced by the seasonal fall in the prices of unprocessed food (mainly vegetables) in 2014 Q3. This is due to the worse-than-average weather conditions in agriculture observed during the last season, pushing up prices of unprocessed food in 2013 Q3.

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

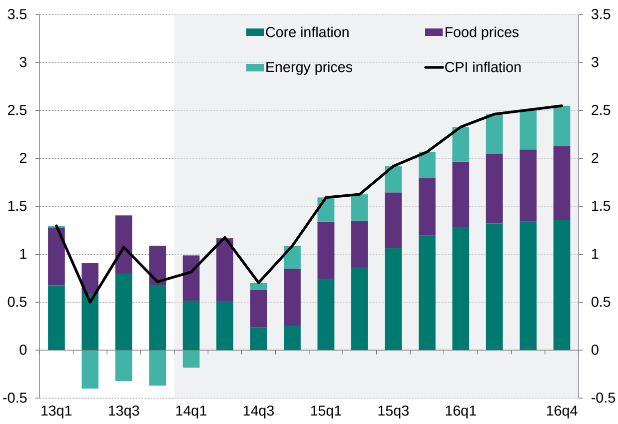


Domestic energy prices fell by 1.5% in 2013, which is the lowest price growth in this category since the time comparable data were first available, that is since the 1990s. The decline in energy prices in 2013 was driven by lower oil prices in the world market and reduced tariffs for households approved by the Energy Regulatory Office (including cuts in natural gas prices in January 2013 and electricity prices in July 2013). Growth in energy prices in 2014 will remain at a low, close to zero, level. This will be driven by the last year's change in electricity tariffs, a cut in electricity prices and a slight increase in natural gas prices, both of 1 January 2014. Growth in energy prices will be also limited by the persistently very low level of prices of CO2 emission allowances, which only moderately increase the costs of the energy sector. In the long-term, along with the economic recovery, energy price inflation will rise, yet, similarly to food price inflation, will remain significantly below the long-term average (2.2% in 2016). Growth in energy prices in the medium- and long-term will be curbed by declining oil prices in the world market and relatively stable prices of other energy commodities (natural gas and coal).

To sum up, in 2014-2016 growth in prices of all major components of the basket of consumer goods and services will gradually increase (Figure 4.22). As a result, CPI inflation will rise, still remaining at relatively low level (until 2016 Q1 below the inflation target). This is due to the fact that despite economic recovery, the output gap, which is a synthetic measure of inflationary pressure in the economy, will remain negative until 2015 Q1 and then will continue to run close to zero (0.1% in 2015 and 0.3% of potential output in 2016). Inflationary pressure will also be eased by stable prices of commodities in the global market amidst slowly growing global demand.

Under the assumption of a constant NBP reference rate, the probability of the average annual inflation ranging from 1.5%-3.5% significantly increases in the short-term and remains at a stable 50% level as of 2015 (Table 4.2).

Figure 4.22 CPI inflation (y/y- %) - breakdown.



4.4 Current versus previous projection

In the current projection round, GDP growth forecasted for the years 2014-2015 is higher by 0.5 percentage point on average as compared to the November projection (Table 4.1). The factors that contributed to the improved economic growth forecast, include, in particular, better than expected GDP growth in the second half of 2013, and more optimistic forecasts of economic conditions abroad.

As a result of the improved outlook for domestic economic situation the negative output gap is closing faster than expected in the November projection. Wage growth thus accelerates, which translates, with delay, into higher inflationary pressure.

Yet, in the short-term, the impact of regulatory changes leading to cuts in electricity prices for households and lower than expected core inflation in January 2014 will prevail. Slower price growth will also be supported by lower than forecasted prices of energy and agricultural commodities in the world markets. As a result, CPI inflation in year-on-year terms in 2014-2015 will not exceed the level forecasted in the previous projection round.

Table 4.1. March projection versus November projection.

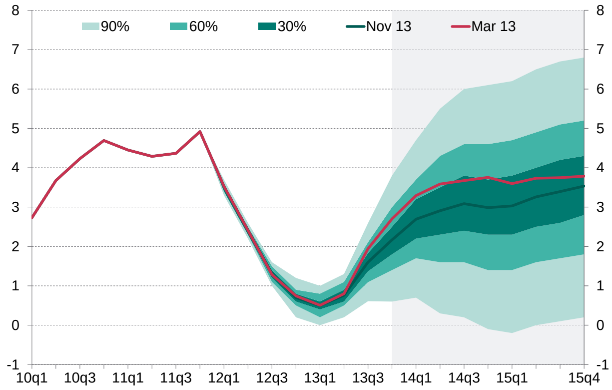
	2013	2014	2015
GDP (y/y, %)			
III 2014	1.6	3.6	3.7
XI 2013	1.3	2.9	3.3
CPI inflation (y/y, %)			
XI 2013	0.9	1.1	1.8
VII 2013	1.0	1.7	1.9

GDP

Upward revision of GDP growth forecast for 2014-2015, as compared with the November projection, was driven by all of major categories of domestic demand (private and public consumption, gross fixed capital formation, inventories).

Revision of the forecast of private and public consumption as well as investment in 2014, and, to a lesser extent, in 2015, was driven by better than anticipated data for these categories for the second half of 2013. In the long-term, higher private consumption growth is also supported by better financial condition of households. The data

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



released after the publication of the November projection indicate a stronger than expected (and faster than previously observed) response of the labour market to the economic recovery. In the current projection, wages and employment grow faster, which translates into higher income of employees.

Stronger growth of private investment is also supported by data from NBP Quick Monitoring indicating significant improvement in businesses' assessment of the future path of demand and new orders.[87] At the same time, data on investment plans of corporations indicate both an increase in the share of businesses embarking on new investment projects and their higher unit value as well as revival of their interest in bank loans.

Upward revision of the contribution of inventories to economic growth in 2014-2015, despite worse than expected data in the second half of 2013, results from adjustment of corporates to higher level of production. Faster than expected rebound of domestic demand in 2014-2015, as compared with in the November projection, is accompanied by higher imports. The contribution of net exports to growth is thus reduced, despite the improved outlook for economic growth abroad.

Inflation

Lower CPI inflation throughout the projection horizon was mainly due to the downward revision of the forecasts of energy prices. Lower path of this variable in the short term is explained by accounting for new tariffs for the distribution and sale of electricity to households as approved by the Energy Regulatory Office in December 2013. In the long-term, the reduction in energy price inflation was driven by the downward revision of the forecast of the energy commodity prices index in the global markets.

Figure 4.24 Decomposition of deviations between march and November projection: GDP growth (percentage points).

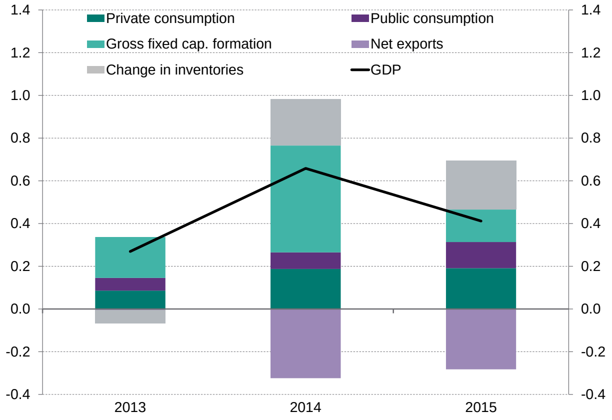
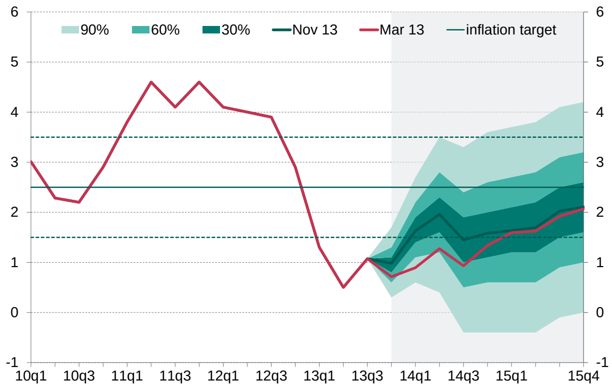


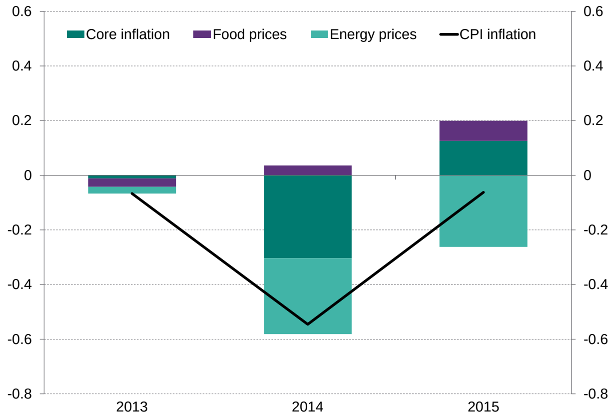
Figure 4.25 March projection versus November projection: CPI inflation (y/y, %).



[87] *NBP Quick Monitoring. Economic climate in the enterprise sector in 2013 Q4 and forecasts for 2014 Q1*, NBP.

The scale of the revision of inflation forecast in 2014, as compared to the November projection, was also affected by a decline in core inflation. Its reduction was the result of the accounting for lower than expected data for January 2014, which was driven by slower growth in the prices of excise goods, housing services and medicinal and pharmaceutical products. As the forecast horizon expands, the impact of changes in the assumptions about the scale of economic recovery increases. Growing demand pressure, reflected in the output gap closing in the second half of 2015, as against to its strongly negative levels assumed in the previous forecasting round, will increase core inflation and food price inflation in 2015. The rise in core and food price inflation will also be fuelled by faster improvement in the labour market, as compared with the November projection, boosting growth in unit labour costs.

Figure 4.26 Decomposition of deviations between March and November projection: CPI inflation (percentage points).



The impact of the above factors will be partly offset by lower import prices over the projection horizon. It was driven by a downward revision of the forecasted level of prices abroad and slightly stronger exchange rate of the zloty (the effect of zloty appreciation in 2014 Q1 as compared to the assumptions in the previous forecasting round). The scale of food price growth will be also limited by the downward revision of the forecasts of prices of agricultural commodities in the global markets.

4.5 Forecast uncertainty sources

It is assessed that within the projection horizon the balance of risk factors is distributed symmetrically around the central paths for both inflation and economic growth projection (Table 4.2). The key sources of projection uncertainty are presented below.

External environment and exchange rate

The external environment, in particular, the scale and sustainability of the prospective recovery in the euro area, continues to pose the most important source of uncertainty for the inflation and GDP projection. On the one hand, faster than expected growth in demand from the emerging markets could support stronger recovery in export-oriented euro area economies, including Germany. The upturn in the German economy may also be supported by increasing household consumption financed with wage growth, amidst persistently low interest rates. Should the reforms aimed to improve the competitiveness of the French economy be introduced, a growth in French exports may be a factor supporting the recovery in the euro area. The possible reduction of the scale of the appreciation of the euro, resulting from the Fed's withdrawal from the QE programme, may also boost exports of the euro area. Moreover, in 2014 the peripheral countries of the euro area are expected to see a decelerating decline in employment, which, combined with the planned reduction of the scale of fiscal consolidation, should support revival of domestic demand. On the other hand, a stronger than expected slowdown in economic growth in China and other emerging economies may pose a threat to European economies' re-embarking on a stable growth path. The weakening of economic activity in the euro area may also be driven by a significant and sustained appreciation of the euro, as a result of a significant surplus in the euro area's balance of trade. Another risk factor is a possible exacerbation of the debt crisis in some euro area countries, should the results of the stress test of the banking sector, scheduled for 2014, prove unfavorable. The related increase in the yields on these countries' bonds would raise the cost of their debt service and, indirectly, the costs of corporate financing.

Table 4.2. Probability of inflation running:

	below 1.5%	below 2.50%	below 3.50%	below the central projection	In the range (1.5-3.5%)
14q1	0.94	1.00	1.00	0.50	0.06
14q2	0.64	0.97	1.00	0.50	0.36
14q3	0.72	0.95	1.00	0.50	0.27
14q4	0.55	0.85	0.97	0.50	0.42
15q1	0.46	0.77	0.94	0.49	0.48
15q2	0.45	0.75	0.93	0.49	0.47
15q3	0.37	0.66	0.87	0.49	0.50
15q4	0.33	0.61	0.84	0.49	0.51
16q1	0.26	0.54	0.79	0.49	0.53
16q2	0.24	0.50	0.75	0.49	0.51
16q3	0.23	0.48	0.74	0.48	0.51
16q4	0.22	0.47	0.72	0.48	0.50

Domestic demand and the competitiveness of the Polish economy

A major source of uncertainty for the projection is the pace of recovery of Poland's labour market. Faster-than-expected increase in employment in the second half of 2013 – if this trend continues – will support individual consumption growth (by increasing the disposable income of the population). The scale and sustainability of the observed recovery in the credit market is another risk factor for the stability of the projection. A significant increase in the volume of loans would boost private consumption growth, as well as corporate and housing investment, thus contributing to a quicker improvement in domestic demand.

On the other hand, the protracted slowdown in the euro area along with the prevailing low savings rate may hamper growth in domestic consumption and investment. A major source of uncertainty for the projection is the response of exports and imports to the anticipated expansion in domestic and foreign demand. At present, Poland's trade account balance is at historically high levels due to the countercyclical nature of the contribution of net exports to domestic economic growth. It is expected that recovery will result in lower net exports, yet uncertainty about the scale and the pace of net export decline is an important source of risk for GDP path in the projection horizon.

Food and energy prices in Poland

One source of uncertainty for the projection is the hard-to-predict impact of regulatory policies and the situation in the global commodity market, on the level of domestic energy and food prices.

In this respect, considerable uncertainty relates to the impact of future EU environmental policies, which is difficult to estimate. This concerns, in particular, the recently implemented Climate and

Energy Package, whose aim is to reduce CO2 emissions. Future prices of CO2 allowances are difficult to predict. These will depend on both the ceiling to be imposed on those entitlements and the demand for these allowances – and hence on the economic activity in the EU countries. Uncertainty is further boosted by the absence of precise provisions concerning the allocation of proceeds from the sale of those entitlements and the size of investment in low-emission technologies and renewable sources of energy. Substantial uncertainty relates to regulatory activities in the food and energy markets as well as future tariff policy of the Energy Regulatory Office.

An important factor affecting the path of domestic energy and food prices are future prices of energy and food commodities in the global markets, determined by the relationship of supply and demand and thus subject to considerable uncertainty. Hence, on the one hand, uncertainty about commodity prices is related to growth prospects in the world's major economies, including the emerging economies. On the other hand, a risk factor for growth in commodity prices may be disruptions in commodities' supply. In the case of agricultural commodity prices, they may be primarily attributable to unfavorable weather conditions in agriculture in the coming years. In turn, the supply of energy commodities, in particular oil supply may be affected by the unstable political situation in oil producing countries. The response of the countries associated under the OPEC, including Saudi Arabia, to the possible disruptions will determine the scale of possible oil price increases. Another factor affecting energy commodity prices is the rising extraction of shale oil and gas in the United States, which systematically reduces US imports of energy carriers. The uncertainty about the scale of the extraction increase, as well as the legal conditions associated with the possibility of oil and gas exports by the United States are likely to affect energy commodities prices throughout the projection horizon.

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	1.1	1.8	2.5
Food prices (% y/y)	4.3	2.0	2.2	2.3	3.0
Energy prices (% y/y)	7.9	-1.5	0.3	1.5	2.2
Core inflation net of food and energy prices (% y/y)	2.2	1.2	0.9	1.7	2.3
GDP (% y/y)	1.9	1.6	3.6	3.7	3.5
Domestic demand (% y/y)	-0.1	-0.2	4.0	4.6	3.9
Individual consumption (% y/y)	1.2	0.8	2.6	3.2	3.2
Public consumption (% y/y)	0.3	2.1	2.1	3.2	3.4
Gross fixed capital formation (% y/y)	-1.7	-0.4	5.7	8.2	5.0
Contribution of net exports (percentage point y/y)	2.0	1.7	-0.3	-0.8	-0.3
Exports(% y/y)	3.9	4.5	6.8	7.4	8.3
Imports (% y/y)	-0.7	0.8	7.8	9.5	9.2
Gross wages (% y/y)	3.7	3.4	4.1	5.3	6.0
Total employment (% y/y)	0.2	-0.2	0.5	0.6	0.4
Unemployment rate (%)	10.1	10.3	9.9	9.0	8.4
NAWRU (%)	8.7	9.0	9.1	9.1	8.8
Labour force participation rate (%)	55.9	56.0	56.1	56.1	56.1
Labour productivity (% y/y)	1.8	1.6	3.1	3.1	3.1
Unit labour costs (% y/y)	2.7	2.0	1.1	2.2	2.7
Potential output (% y/y)	2.9	2.6	2.5	2.8	3.3
Output gap (% of potential GDP)	-0.7	-1.7	-0.7	0.1	0.3
Index of agricultural commodity prices (USD; 2011=1.00)	0.96	1.00	0.93	0.91	0.91
Index of energy commodity prices (USD; 2010=1.00)	0.87	0.81	0.78	0.78	0.79
Price level abroad (% y/y)	1.3	1.7	1.5	1.7	1.8
GDP abroad (% y/y)	0.0	0.1	1.5	1.7	1.8
Current and capita account balance (% GDP)	-2.2	1.1	0.5	-0.9	-2.3
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 October 2013 – January 2014

■ Date: 2 October 2013

Subject matter of motion or resolution:

Resolution No. 14/2013 amending the resolution on the regulations governing the Monetary Policy Council.

Voting of the MPC members:

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

Z. Gilowska was absent.

■ Date: 5 November 2013

Subject matter of motion or resolution:

Resolution No. 15/2013 on the required reserve ratios for banks, cooperative savings and credit unions and the National Association of Cooperative Savings and Credit Unions and the remuneration of required reserves.

Voting of the MPC members:

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

A. Glapiński was absent.

■ Date: 3 December 2013

Subject matter of motion or resolution:
Resolution No. 16/2013 on approving the Financial Plan of the National Bank of Poland for 2014.

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	

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