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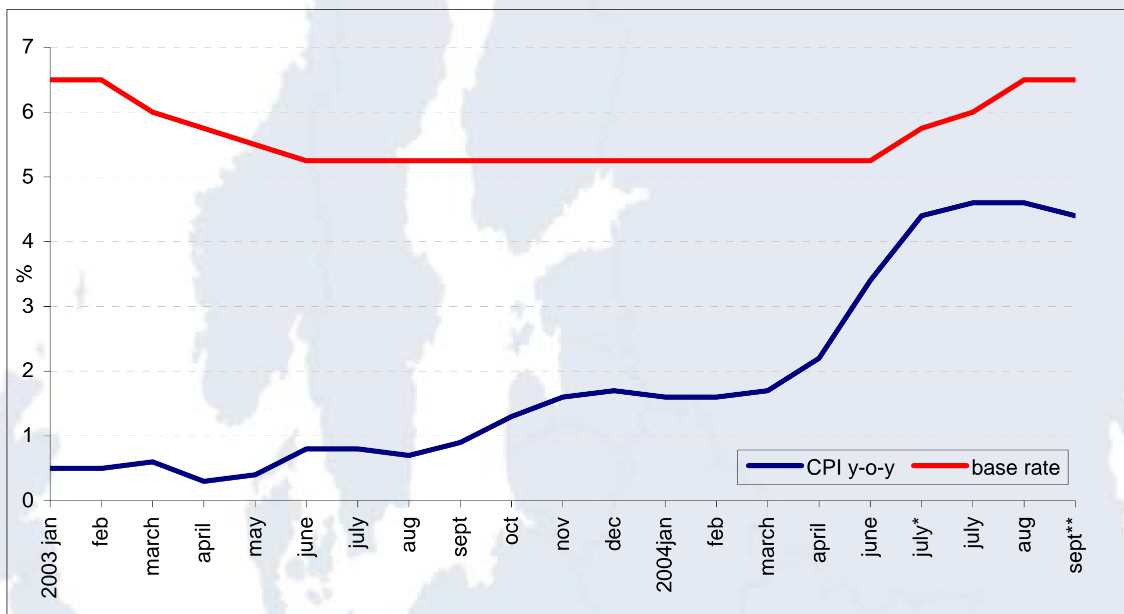
POLISH CENTRAL BANK SURPRISED THE MARKET AND KEPT BASE RATE ON HOLD

The Polish Central Bank surprised the market and kept the 6.50% base rate unchanged on its last meeting at the end of September. The National Bank of Poland (NBP) started its tightening course this summer, and has already raised the base rate by 125 bp so far.

NBP reacted quite aggressively to the surging inflation, and hiked the key rate surprisingly by 50 bp on its August meeting.



**June rate hike came into effect in July*
*** CPI forecast*

According to bank officials the goal was to show the bank's strong antiinflationary commitement. NBP published its Inflation Report late August, in which the inflation projection was published for the first time. In the Inflation Report NBP assumed the food prices to rise by roughly around 9% y-o-y till the Q1 2005. The inflation projection model showed the NBP put significant weight on the inflation expectations even on the short run. According to the analysts these assumptions were a bit exaggerated, and NBP's 6% y-o-y Q4 2004 inflation projection differed from the reality. (NBP forecasted CPI peaking at 6.2% y-o-y in Q1 2005 and remaining outside the target band through 2006.) The projections of the Inflation Report could not be taken too seriously because the report did not take in to account the impact of the latest two rate hikes. In spite of that the earlier aggressive moves of the NBP and the hawkish outlook in the Report triggered significant rate hike expectations. The FRA curve priced in a 75-100bp tightening over the next 3-4 months. The key rate was expected to rise to 7,25-7.5% by the first quarter of the next year.

Later on as the August macro figures came out in September, the rate hike expectations started to cool down. Despite the polish GDP increased by 6.1% y-o-y in Q2 (highest in the region), and topped the 6.0% forecast, the structure of the growth did not point to any inflation pressure and did not necessitate any significant rise of the base rate. Export remained the driving engine of the growth, while the domestic demand dropped from 5.7% of Q1 to 5.1% in Q2. The 3.3% rise of the investments proved to be disappointing.

The next data, which cast doubts about the surging inflation, was the August CPI figure. Consumer inflation rose only by 4.6% y-o-y in august, and was at the same level as in the previous month. Food and non-alcoholic beverages increased by 9.3% y-o-y, and the 14.8% rise of the fuel prices also contributed significantly to the surge of inflation. CPI was expected to peak at this level, and supposed to fall in the coming months towards 4% by the end of the year. The 2.3% y-o-y net inflation figure was also favorable and underpinned the view, that the recently rising CPI was rather due to one off factors like the oil price shock. The latest statistics showed that food prices in the first half of September declined by 0.1% m-o-m, defying Central Bank's outlook about the surging food prices.

Industrial production and retail sales figures did not support the idea of growing inflation pressure either. The 5.1% wage growth in August should not be treated dangerous either, because it was justified by the current high productivity growth.

In the meantime the Polish government passed the 2005 budget draft, which reflected a bigger restriction than earlier expected. According to the draft the deficit should be cut back by 10 billion zlotys to 35 billion zloty in 2005. The smaller deficit next year also supports the disinflation process.

These developments concerning the inflation outlook had their impact on the inflation expectations as well. The latest survey of Ipsos Demoskop recorded a decline in September for the second consecutive month. It has to be noted that NBP is treating the results as the preliminary data to its own model of the inflation expectations.

The statements of the Central Bank officials also indicated that the bank's view might change. Jan Czekaj member of the NBP's Monetary Policy Council said that inflation had reached its peak in August and the threatening inflation pressure was over. Czekaj, who already voted against the 25 bp rate hike in July according to the latest government bulletin, said that CPI was likely to be around 4.4-4.6% y-o-y in September. He claimed that the effect of the oil price shock was going to fade away by mid-2005 just like the surge of food prices, which was due to the EU accession. Mr. Wojtyna and Mrs. Wasilewska-Trenker, who are also member of the Monetary Council also said dovish comments, however they still supported the 25 bp rate hike in July. Mrs. Wasilevska also mentioned that the inflation peaked in August and

likely to decline in the rest of the year. The statement by Wasilevska was significant because she is believed to be a median voter, so her vote could be decisive at the meetings. The economy minister, Jerzy Hausner also suggested that there was no reason for further rate hikes.

Despite the latest macro figures, which did not reflect any inflation pressure, and the changing view of some central bank officials, the decision of the Monetray Council was not obvious before the meeting. Leszek Balcerowicz the head of the NBP said, that the bank was not focusing on monthly figures but adjusting its policy to its long-term outlook. It is for these reasons a 25 bp rate hike would have been realistic because it would have indicated that the central bank was aware of the fading inflation pressure, but still would have showed that the bank was strongly committed to its 2.5% inflation target, which was likely to be endangered according to the former NBP's projections. Right before the voting, the latest Reuters poll showed that 18 out of 19 analysts expected a rate increase, but they remained divided on the size of the move. Some expected a 50 bp tightening.

The central bank's monetary council finally left the base rate unchanged at 6.50%. Leszek Balcerowicz Central Bank Governor said that the uncertainty and the unclear impact of the recent rate hikes made the decision makers to hold off another rate hike. He turned down comments on what uncertainty he was thinking of. The central bank also justified its decision with the significant appreciation of the zloty (zloty gained more than 8% versus the euro since the EU accession), favorable core inflation and easing food price pressure.

Regarding the future, central bank said, that the monetary policy would focus to bring down inflation to the 2.5% midpoint of the target range. The goal is to achieve the target without causing any excess volatility of the economy.

The statement makes monetary tightening on the coming board meetings quite likely. It seems that Poland has not reached the end of the tightening cycle yet. Not raising the base rate in September was just because the policy makers wanted a clearer picture. The decision was also highly dependent on the appreciation of the zloty, so any depreciation in the future could trigger a rate hike. Mr Balcerowicz was likely outvoted this time, but he might get the majority in the future.

FIRMING SKK, WAR BETWEEN THE MARKET AND THE CENTRAL BANK

The Slovak Koruna (SKK) has come under severe appreciation pressure recently. The National Bank of Slovakia (NBS) indicated several times that the rate of appreciation was considered to be too fast. The Central Bank has already cut the base rate by 150 bp this year in order to stave off the overwhelming firming of the Slovakian unit, but the attempts have proved to be ineffective so far. Following the latest 50 bp rate cut in June the base rate stood at 4.5%. The strengthening of the SKK could be attributed to the strong macro fundamentals, but the significant hot money inflow also contributed to the firming. The Slovak Koruna broke through the level of 40 EUR/SKK and hovered steadily below it. Further rate cuts and continued FX and repo intervention are likely this year.

Slovakian basic rate

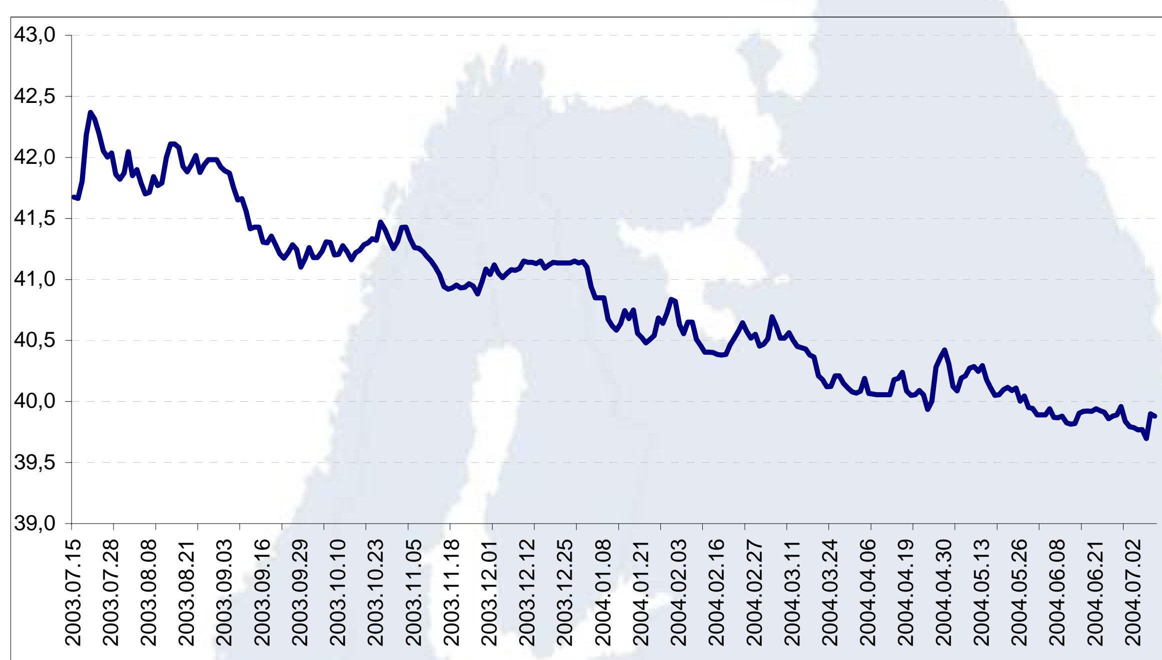
The Slovakian currency started to appreciate after the elections in 2002. However it has to be mentioned, that much of the real appreciation of the SKK was due to the administered price hikes and tax effects, without these the real appreciation was probably less than in the Czech Republic or in Hungary. The steady firming of the currency must have reflected the solid macroeconomic fundamentals. SKK has been supported by the buoyant growth, the growth rate of the Slovak economy in Q1 2004 outpaced the Czech and Hungarian performance. This year it is projected to be around 4%, the Central bank has just revised its projection upward to 3.8-4.4%. The net export proved to be the driving engine of the growth, current account deficit, that showed a 9% shortfall not long ago, dropped to –0.2% at the present. In March and April the current account both posted a surplus, that is unprecedented in the Central European Region. Regarding the export, the former investments in the automative industry have started to have their impact by now. The inflation outlook is also promising. Though the CPI climbed back to 8.3% y-o-y in May, after it had

temporarily dropped to 8.0% in April, NBS revised its end 2004 CPI target to 5.5-7.0% from the previous 5.7-7.3%. Inflation should drop significantly from August onwards, because last year's administered price hikes will leave the base by that time. The core inflation rate was already at a considerable low 2.8% level in May. From January 2005 CPI is expected to fall below 4%. The budget developments are not worrisome either, the prudent fiscal policy has contributed to the outstanding current account figures. At the middle of the year the aggregate budget deficit has amounted to only 15% of the annual target, and it might result in an undershooting of the 4% deficit plan.

The stable macroeconomic environment and the promising outlooks made Slovakia highly attractive to the foreign investors. The demand for Slovak assets, like securities and direct investment shot up, and it obviously had its impact on the foreign exchange market. It has to be taken into account that according to a projection of the NBS in May, hot money worth of roughly 80 bln SKK was in Slovakia at that time as well. 17bln SKK worth of short term speculative capital has flowed in since the beginning of the year 2004.

As a result of the heavy capital inflows SKK firmed substantially since January 2004, the Slovakian unit firmed by 3.5-4% since the beginning of the new year. SKK eased temporarily in February, but gained significant strength during March. The two 50 bp rate cuts in late March and late April made SKK to ease a bit, but in May the koruna recovered from the depreciation. Central Bank Governor Mr. Jusko stated that the exchange rate developed favorable following the two rate cuts, the statement triggered a wave of buying the SKK, and the Slovakian unit was pushed below the level of 40 EUR/SKK. The warning statements by the NBS, which said that the bank was ready to intervene in order to outweigh the ungrounded appreciation was ignored by the market. EUR/SKK kept on firming, that finally made the Central Bank to slash the base rate by another 50 bp on July 1. Koruna eased again for a short while following the rate cut, but the market seemed to shrug off the measure, because SKK hit a new historic high again at 39.66/EUR. NBS intervened directly on the FX market to ease the koruna, and maintained, that it would use all instruments at its disposal to fend off the "unjustified" appreciation of the SKK. However the sterilized intervention might have significant costs because the increased foreign exchange reserves cause exchange rate losses in case of further strengthening of the koruna. Further rate cuts would benefit the Central Bank the costs of sterilizing the excess liquidity would be reduced.

EUR/SKK



The costs of the intervention indicate that the current opposition of the NBS to the firming SKK might diminish later on. NBS is aware of the fact that the strengthening of the local currency is unavoidable, statements by the Central Bank reveal, that NBS expects the koruna to appreciate by 1.5% annually during the next five years. However this pace might prove to be too slow. The pressure on the Slovakian currency is expected to prevail as a result of the strong capital inflow. The sound macroeconomic environment, the current account surplus, and the low wage costs make Slovakia extremely competitive in the region. It seems that the Slovakian enterprises could cope with the firming SKK. The strong export performance (export accelerated by 30% in April) and the current account surplus indicates, that the strong SKK is not a real trouble at the moment. Export is going to gain further impetus in the following years at the two giant car maker, the PSA Peugeot Citroen and Hundai/Kia will start to produce 300.000 vehicles a year from 2006.

The current appreciation of the koruna and the aggressive rate cuts resemble the Hungarian revaluation pressure in early 2003, and show that a managed float system can be exposed to the capital flows as well. The significant difference is that the NBS has only a soft target due to its managed float system, while in case of Hungary the fluctuation band substantially reduced the flexibility of the Hungarian National Bank. Regarding the interest rate path, the benign macroeconomic outlook, the muted inflation pressure and the better than expected fiscal outcome support the case for lower interest rate. However the tightening global interest rate cycle and the regional developments might decrease the pressure on the NBS.

AGREEMENT ON THE CONSTITUTIONAL TREATY

June 2004, the Intergovernmental Conference gave its final agreement on the constitution of the European Union. The constitution, prepared by the Convention and presented in its details almost exactly a year ago, has not been changed significantly since. It deals with the objectives, values, institutions and competences of the European Union, incorporates a charter of fundamental rights, assembles and amends EU and EC treaties. What remains to be done after the June Summit is to explain the constitution to the public in order to ratify it in every Member State.

The creation of the constitution is associated with several goals, and the outcome of the convention process can therefore be judged from various aspects. The constitution should provide EU citizens with a new identity, should promote political leadership, increase the institutional ability to act at the EU level, and has to divide policy competences between national states and the EU. As the basic future framework creating the environment of the evolution of the EU economy, all aspects of the constitution have an economic relevance. However, in this short exposition, two aspects merit increased attention: the division of competences between EU and the member states, and the reform of decision making procedures of the EU institutions.

DIVISION OF COMPETENCES

Investigating the history of the EU prior to the constitution, the evolution of common policies and the cooperation of national and EU level policy making has been driven by pragmatic decisions based on implicit economic arguments constrained by political and bureaucratic factors. Due to the bottom-up design of the European Union, it is not just the extent of externalities that dictates the choice of policies to be dealt with at the EU level: the scope of divergence of national interests also plays an important role (Alesina – Angeloni – Schuknecht [2003]).

Those were the first policies carried to the EU level, that fostered the creation of a single market without any types of barriers, and that encouraged competition. By now, those functions and areas of state responsibility belong to EU competences, that would otherwise carry the largest externalities, and that do not imply serious divergence of national interests.

The constitution-making process provided a unique opportunity to revise the previous process of competence alignment, to deal with the debated questions of harmonisation of fiscal policy, taxation, welfare programs. However, it was demanded as well, that the division of competences pictured flexibility as well, in order to serve as a lasting solution in case of economic changes.

At the end of the process, the final constitution does align policy competences, but the alignment is mainly based on the previous practice, and does not contain any innovative, forward-looking element. A new element is that energy policy appears for the first time among the policies belonging to the competence of the EU. In those areas that are characterised by national interest divergence – in taxation, and partly in social policy, and common foreign and security policy - unanimity in decision making prevails. This may be the result of divergent national interests and the need to create a constitution that can be agreed to by all member states.

The constitution in based on the notion of national states, and their relationship to the EU through the principle of subsidiarity. However, the constitutional design would have been more flexible if it provided for the collaboration of several nations inside the union, or between parts of a single nation, reflecting on the fact that economic problems in a common market do not follow historical national boundaries.

On the other hand, the constitution recognizes EU regions, but since they mostly lack the power to tax, they are in fact not independent of the national state or of the EU. Regions are the beneficiaries of EU policies, national states are paying the taxes. This existing mismatch of tax payers and beneficiaries has been incorporated into the constitution, instead of creating the possibility of solving the problem by a more flexible definition of territorial units (Frey [2003]).

INCREASED ABILITY TO ACT

If the Constitutional Treaty gets ratified, its provisions relating to the decision making mechanisms of the EU will enter into force by November 2009. The Nice Treaty will regulate decision making from November 2004 until then. It means that at least in the short term, the Constitutitonal Treaty has little influence on the functioning of the EU. Meanwhile, the five years between 2004 and 2009 will be characterized by the first problems posed by enlargement, that would need to be solved in a way that would convince EU-citizens in old and new member states of the merits of ten new states joining the EU.

The constitution introduces the process of double majority voting in Council decisions. This means, that a double majority of people and Member States (55% of the Member States representing 65% of the population) is needed to ensure the legitimacy of decisions. A blocking coalition must contain at least four member states. Compared to it, the Nice Treaty rules use the basic qualified majority framework, with 72,2% of the votes needed in the Council representing 62% of the EU population for a decision. There is also a redistribution of votes that strongly favours large countries – the so called Aznar bonus.

Until 2009, reaching a qualified majority decision in the Council will be twice as hard as was in the EU-15. However, after 2009 reaching a double majority decision will be even easier than it was in the EU-12.

According to Baldwin and Widgren [2004], both the Nice Treaty and the Constitutional Treaty rules favour the largest member states (D, UK, F, I) in the decision-making. The 2004 increase in their voting power comes at the expense of small and medium-sized members, the 2009 jump comes at the expense of Spain and Poland. However, in switching from the Nice Treaty rules to the Constitutional Treaty rules, the biggest losers are the medium size countries with approximately ten million inhabitants.

The Constitutional Treaty extends the scope of double majority decision, and generalises the co-decision procedure. Both these changes facilitate the decision-making capacity of the EU after 2009, and diminish the scope for logrolling. Meanwhile, even after 2009, there will be a large scope for countries to use veto-votes.

This is the first treaty to incorporate a special procedure for countries wanting to recede from the EU. While the above changes to decision making mechanisms relate to the “voice” of participants in the union, the provision for countries to leave the EU strengthens the possibility to use the “exit” way of expressing opinion.

While it may be claimed from several viewpoints, that the Constitutional Treaty falls short of potentials, it has to be recognized that even this June agreement is a real achievement in the light of existing divergences of national interests, that will provide a solid basis for future development of the European integration.

APPROVAL OF THE CONVERGENCE PROGRAMS OF THE NEW MEMBER STATES

In early July 2004, the Ecofin approved the convergence programs of the new member states, and initiated the excessive budget procedure against those countries that did override the budget deficit limit of 3% for 2003 – against Cyprus, the Czech Republic, Hungary, Malta, Poland and Slovakia. However, the new member states do not face any sanctions, and the European Commission has supported the acceptance of their convergence programs as well, allowing them to set the pace of adjustment for themselves. This also means that they receive a transition period for the correction of their budgetary problems: the burdens put on the state budgets by the accession are acknowledged. However, in the medium term, all these countries will have to maintain a balanced budget or even a surplus.

The only country to record a budget surplus in 2003 was Estonia, and it plans to keep a balanced budget without a surplus from 2006 on. Latvia, Lithuania and Slovenia had a deficit not reaching the 3% ceiling in 2003, and they all plan to maintain a low level of deficit at 1-2% of the GDP until 2007. All these four countries carry low debt burdens. In Estonia, debt was below 6% of the GDP in 2003, and is projected to decrease to 3% by 2008. Latvia, Lithuania and Slovenia had debts of 15,3%, 21,5%, 28,6% in 2003, respectively. Latvia and Lithuania have projected the fastest growth rates in their convergence plans, around a yearly 6%.

Before the Ecofin approval, the European Commission evaluated all the convergence plans submitted by the new member states. The plans of the six countries with excessive deficits are of particular interest here. It is common, that these countries plan only a modest yearly reduction in their deficits. This is the politically most viable way, since in many of the six countries elections will soon follow up. Also, these countries fear the possible demand-decline caused by a too quick deficit reduction that would slow down economic growth.

According to the Commission, almost all six countries make plausible macroeconomic projections in their forecasts. The Czech growth forecast is quite cautious, while the medium-term Hungarian forecast is too optimistic. The Polish convergence plan contains overly optimistic assumptions on investment and private consumption. All six countries aim to gradually reduce their deficits, with Cyprus fulfilling the 3% limit by 2005, Malta in 2006, Poland in 2007 and Hungary in 2008.

Real GDP (% change)							
		2003	**2004**	**2005**	**2006**	**2007**	**2008**
CZ	CP	2,9	2,8	3,1	3,3	3,5	
	COM	2,9	2,9	3,4	-	-	
CY	CP	2	3,5	4,3	4,4	4,5	
	COM	2	3,4	4,1	-	-	
EE	CP	4,7	5,3	5,8	5,6	5,9	5,8
	COM	4,8	5,4	5,9	-	-	-
LV	CP	7,5	6,7	6,7	6,5	6,5	
	COM	7,5	6,2	6,2	-	-	
LT	CP	9	7	7,3	6,6	6,3	
	COM	8,9	6,9	6,6	-	-	
HU	CP	2,9	3,3 - 3,5	3,5 - 4	cca. 4	4 - 4,5	4,5 - 5
	COM	2,9	3,2	3,4	-	-	-
MT	CP	-1,7	1,1	1,7	2,1	2,1	
	COM	0,4	1,4	2	-	-	
PL	CP	3,7	5	5	5,7	5,7	
	COM	3,7	4,6	4,8	-	-	
SI	CP	2,3	3,6	3,7	3,8	3,9	
	COM	2,3	3,2	3,6	-	-	
SK	CP	4,2	4,1	4,3	5	4,7	
	COM	4,2	4	4,1	-	-	

CP: convergence program of the country
COM: Commission forecast

Hungary does not explain in detail the measures to be implemented to reduce the deficit, and the Ministry of Finance argues this is due to the particular way of planning the Hungarian budget. First the total amounts are planned, decided by the Parliament, and this is followed by the planning of more detailed measures. However, Cyprus, Slovakia and Poland have included a list of instruments used in deficit-reduction. Poland created the Hausner-plan, and is warned by the Commission to implement a pension reform as soon as possible. Hungary has already implemented the pension reform, that pictures itself in increasing the deficit. The Commission doubts whether the various measures taken up by Cyprus can be properly forecasted to have the intended effects. Slovakia, in spite of the "far-reaching and impressive public finance reforms" (Commission statement) created a not too ambitious and back-loaded deficit reduction plan. In the case of Hungary, the plan is front-loaded, too dependent on the efforts reached in the first periods. After 2008, the deficit is planned to be only slightly below 3%, that means the plan contains several risks.

		General government deficit (% of GDP)					
		2003	2004	2005	2006	2007	2008
CZ	CP	-12,9	-5,3	-4,7	-3,8	-3,3	
	COM	-12,9	-5,9	-5,1	-	-	
CY	CP	-6,3	-5,2	-2,9	-2,2	-1,6	
	COM	-6,3	-4,6	-4,1	-	-	
EE	CP	2,6	0,7	0	0	0	0
	COM	2,6	0,7	0	-	-	-
LV	CP	-1,8	-2,1	-2,2	-2	-2	
	COM	-1,8	-2,2	-2,1	-	-	
LT	CP	-1,7	-2,7	-2,5	-1,8	-1,5	
	COM	-1,7	-2,8	-2,6	-	-	
HU	CP	-5,9	-4,6	-4,1	-3,6	-3,1	-2,7
	COM	-5,9	-4,9	-4,3	-	-	-
MT	CP	-9,7	-5,2	-3,7	-2,3	-1,4	
	COM	-9,7	-5,9	-4,5	-	-	
PL	CP	-4,1	-5,7	-4,2	-3,3	-1,5	
	COM	-4,1	-6	-4,5	-	-	
SI	CP	-1,8	-1,9	-1,8	-1,5	-0,9	
	COM	-1,8	-1,7	-1,8	-	-	
SK	CP	-3,6	-4	-3,9	-3,9	-3,9	
	COM	-3,6	-4,1	-3,9	-	-	

These six countries all have higher debt levels, than the four countries not reaching the deficit ceiling. Malta is the second most indebted country with 72% debt level in 2003. Cyprus carries the largest debt burden of 72,6% in 2003. Hungary has a debt level just below 60%, and plans to bring it down to 53,7% by 2008. Polnad, on the contrary, will even increase its debt, along with the plans of Slovakia, Latvia, Lithuania and the Czech Republic.

		General government deficit (% of GDP)					
		2003	2004	2005	2006	2007	2008
CZ	CP	37,6	38,4	39,7	41	41,7	
	COM	37,6	40,6	42,4	-	-	
CY	CP	72,6	75,2	74,8	71,5	68,4	
	COM	72,2	74,6	76,9	-	-	
EE	CP	5,8	5,4	5,1	4,7	3,4	3,2
	COM	5,8	5,4	5,3	-	-	-
LV	CP	15,3	16,2	16,8	17,3	17,7	
	COM	15,6	16,1	16,3	-	-	
LT	CP	21,5	22,4	22,2	21,4	21	
	COM	21,9	22,8	23,2	-	-	
HU	CP	59,1	59,4	57,9	56,8	55,6	53,7
	COM	59	58,7	58	-	-	-
MT	CP	72	72,1	72,4	70,5	70,4	
	COM	72	73,9	75,9	-	-	

General government deficit (% of GDP)							
		2003	**2004**	**2005**	**2006**	**2007**	**2008**
PL	CP	45,3	49	51,9	52,7	52,3	
	COM	45,4	49,1	50,3	-	-	
SI	CP	28,6	29,1	29,5	29,4	28,4	
	COM	27,1	28,3	28,2	-	-	
SK	CP	42,8	45,1	46,4	46,1	45,5	
	COM	42,8	45,1	46,1	-	-	

Slow budget consolidation leads to postponing the fulfillment of the Maastricht criteria, and later accession to the euro-zone for the affected countries. Slovenia, Estonia, Lithuania and Cyprus plan to enter the ERM2 in 2004 (for joining the ERM2, they do not have to fulfill the 3% criteria), and adopt the euro at the end of 2006. Latvia, Malta and Slovakia would enter the ERM2 in 2005 with adopting the euro at the beginning of 2008. Poland aims at a 2006 – 2009 combination, while the Czech Republic and Hungary are postponing the most their accession to the euro-zone with ERM2 in the beginning of 2007 and euro in 2009. The countries postponing accession to the euro-zone consider too fast accession would carry a far too large growth sacrifice, and estimate the value of infrastructure investments made to be higher than the gains of promptly joining to the euro-zone.

For the six countries having excessive deficits, if the convergence plans are not adhered to, the Commission will create new convergence programs that enable the countries to reach their deficit reduction targets.