

Warsaw, 25 August 2004

INFORMATION FROM THE MEETING OF THE MONETARY POLICY COUNCIL

Held on 24-25 August 2004

The Council decided to raise the NBP interest rates by 0.5 percentage point to the level of:

- reference rate 6.5% on an annual basis;
- lombard rate 8.0% on an annual basis;
- deposit rate 5.0% on an annual basis;
- rediscount rate 7.0% on an annual basis.

The Council maintains its restrictive monetary policy stance. The resolutions of the MPC come into force as of 26 August 2004.

Factors decisive as to the scale of the increase resulted from the August inflation projection and the risk of appearance of wage pressure stemming from inflation expectations.

The Council acknowledged this decision as indispensable despite the fact that some of the factors, which in the last few months contributed to an increase in inflation, in particular the price effects of Poland's European Union entry, are slowly abating.

Endeavouring that the increased inflation has a transitory effect, the Council does not change its position that the tightening of monetary policy should take place gradually.

There has been a continued revival in the world economy. In the United States investment expenditures, which have been growing for the fifth consecutive quarter, were the main factor in pushing up an increase in the GDP; while in Germany, the largest economy in the euro area, the main source of the GDP increase in the first half of 2004 were strong exports.

Positive signals and economic data for the euro area indicate an economic rebound (including a stronger increase in consumption in many countries of the euro area in Q1 of 2004 than in the previous year, as well as increased investments). The economic revival in countries being Poland's most important trading partners should – *ceteris paribus* -contribute to an increase in demand for Polish exports.

The increase in the price of oil in world markets, which took place to date, contributed to the acceleration of inflation in most of the world economies. This was reflected in the worsening of consumer confidence in the US and in the euro area.

The present increase in the price of oil should not significantly decrease the growth dynamics of the world economy. This results foremost from the fact that the current level of real oil prices as well as their growth rate are significantly lower than the ones registered during oil crises. However, one cannot exclude the negative influence of continued high oil prices on the economic growth of Poland's main trading partners.

The Polish economy is in a strong growth phase. According to the NBP estimates the annual growth rate of the GDP in Q2 of 2004 was around 6% (in comparison with 6.9% in Q1 of 2004). The economic growth results to a large degree from a dynamic exports growth. There are more signals of an increase in investment expenditures and according to the GUS (Central Statistical Office) data investment in enterprises in Q1 of 2004 was higher by 8.7% than in the corresponding period of 2003. A high increase in the level of expenditures manufacturing was registered (by 21.9%) and in the servicing of real estate and firms (by 16%). After a three-year drop investments in trade increased by 7.7%. Published data confirm continued positive assessment on the part of enterprises of the future economic situation and the possibility of marketing production from new investments.

An increase in the utilisation of the production capacity, which was observed for several quarters (it reached a level of 80.7% at the end of Q2 of 2004), favours the appearance of inflationary pressure; in longer perspective it should be softened through supply effects of the currently increasing investments. Added to this are the effects of high oil prices and of other raw materials, the effects of low grain crops in 2003 and the price effects resulting from Poland's EU entry, and in particular an increase in the price of Polish food products and a VAT increase on construction materials. The annual inflation rate rose in July 2004 to 4.6%, remaining above the MPC's upper tolerance limit for deviations from the inflation target. A high PPI growth was maintained (8.6%). There was also an increase in the majority of the core inflation measures from a level of 2.3%-4.5% in June 2004 to 2.3%-5.1% in July 2004.

In line with the assessment that will be presented in the August *Inflation Report*, to be published on 31 August 2004, it is expected that within the next two years the GDP growth rate will amount to 4.5%-5.5%. Starting in 2005, the role of net exports in economic growth will drop – amongst other as a result of expected real appreciation of the zloty – and investments should become the decisive factor in growth. The high growth of investment outlays in 2005-2006 will be a consequence of both a low base of the index, high level of production capacity utilisation, as well as a result of the influence of investments independent of the business cycle (including those financed from EU funds) with an accompanying multiplier effect.

The sustainability of the economic revival shall be conditioned on the performance of public finances reforms. Lack of necessary reforms may lead to exceeding the next prudential thresholds of the public debt to the GDP ratio and producing the significant effect of raising the risk premium in Poland, which through the zloty depreciation may become a source of additional inflationary pressure.

In line with the inflation projection which will be presented in the August *Inflation Report*, assuming there is no change in the interest rates, the probability of inflation remaining above the inflation target of 2.5% in 2005 and 2006 is higher than the likelihood that inflation rate will remain below the target. With a likelihood of 50%, inflation rate will remain within a range of 2.8%-5.5% in Q4 of 2005 and 1.6%-5.1% in Q4 in 2006.

In 2005 – in line with experts' assessments – supply shocks will gradually abate, there will be a particularly strong drop in the food prices growth rate. These factors will result in lower inflation. However, a decrease in inflation will depend on the development of inflation expectations and their influence on wages and prices.

NBP

The risk related to inflation growth are foremost the growing household inflation expectations, which rose in August 2004 to 4.5%, as against 4.0% in July 2004 and 0.8% in August 2003. One should note, however, that in the last month the growth in inflation expectations was lower than the increase in current inflation. According to the Council, the development of expectations in the future will to a large extent depend on the conduct of monetary policy.

The Council considers that some of the factors which in the last months contributed to an increase in inflation are gradually abating, especially some of the price effects stemming from Poland's entry into the EU. Moreover, the increase in wages remains moderate, while the annual growth of labour productivity in industry continues to exceed the wage growth. As a result the annual growth of unit labour costs remains negative. An increase in employment shown in the *Labour Force Survey* is not confirmed by data from the enterprises sector.

The Council will meet on 9 September 2004 when it will discuss the *Monetary Policy Guidelines for the Year 2005*.

The next meeting of the Council at which the parameters of monetary policy will be discussed will take place on 28 - 29 September.