NATIONAL BANK OF POLAND

MONETARY POLICY COUNCIL

REPORT

ON MONETARY POLICY IMPLEMENTATION

IN 2003

WARSAW 2004

This report covers a period during which monetary policy was conducted by the Monetary Policy Council of the first term in office. Therefore the current MPC members have not introduced any significant changes to the contents of the report and have limited themselves to editing it.

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SUMMARY

1. Pursuant to Article 227, Paragraph 1, of the Constitution of the Republic of Poland "The central bank of the State shall be the National Bank of Poland. It shall have the exclusive right to issue money as well as to formulate and implement monetary policy. The National Bank of Poland shall be responsible for the value of Polish currency."

According to *Medium-Term Monetary Policy Strategy for the Years 1999–2003* adopted in 1998, the strategic monetary policy target of the Monetary Policy Council was reducing the inflation rate to below 4% by the end of 2003. The Monetary Policy Council decided that the monetary policy target in 2003 (announced in June 2002 and confirmed in *Monetary Policy Guidelines for the Year 2003* published in September 2002) would be an inflation rate at the level of 3% at the end of 2003, with a tolerance limit for deviations of +/– 1 percentage point.

2. In December 2003, the annual inflation rate amounted to 1.7% and thus was in line with the target adopted in *Medium-Term Monetary Policy Strategy for the Years 1999–2003* and slightly lower than the short-term inflation target set in *Monetary Policy Guidelines for the Year 2003*. An inflation rate 0.3 percentage point below the lower tolerance limit for deviations from the target was achieved with an acceleration in growth of food and non-alcoholic beverages prices that conformed to expectations, and a growth of regulated prices of goods and services that was much lower than expected.

3. In 2003, the Monetary Policy Council lowered NBP interest rates on six occasions. The reductions were introduced in the first half of the year. The reference rate was reduced from 6.75% to 5.25%, the rediscount rate from 7.50% to 5.75%, the lombard rate from 8.75% to 6.75%, and the deposit rate from 4.75% to 3.75%.

4. In 2003, a gradual recovery of the Polish economy was observed. The GDP growth rate rose from 2.3% in Q1 to 4.7% in Q4 and averaged 3.7% over the entire year.

A strong growth in industrial output was maintained — the increase in production was driven by manufacturing, growing due to rising exports and increased competitiveness in the domestic market. The increase in consumer demand was accompanied by signs of rising investment in manufacturing. The financial performance of enterprises also markedly improved in 2003.

Despite unfavourable external conditions, exports remained a factor supporting the economic growth. According to 2003 payment statistics, the increase in export revenues amounted to 8.7% in euro and 30.3% in US dollar terms, while in 2002 the growth rates were 2.7% and 8.8%, respectively. As a result of a reduction in trade deficit, current account deficit decreased in 2003 — for the fourth successive time — to the level of 1.9% of GDP.

5. The monetary policy in 2003 took into consideration the continuously high deficit of the public finances in 2003, as well as the prospects that this deficit may grow significantly in 2004.

The condition of the public finance sector remains the most important factor that could hamper efforts aimed at stabilising inflation at a low level. High budget deficit, increasing state borrowing needs and difficulties associated with the implementation of the public expenditure reduction programme may lead to financial market disturbances, resulting in increases in Treasury securities yields and the weakening of the zloty exchange rate.

In-depth, swift and effective reforms aimed at fiscal consolidation are necessary in order to avoid the accumulation of public debt and falling into the debt trap. If no fundamental changes focused on permanent improvement in the public finances situation are introduced in 2004, the debt will soon approach the constitutional limit, which will jeopardise sustainable economic growth and make the reduction of unemployment more difficult. In 2003, public debt (together with guarantees and endorsements) amounted to 51.6% of GDP, which means that the first prudential threshold has been exceeded.

INFLATION TARGET IN 2003

In *Monetary Policy Guidelines for the Year 2003* the Monetary Policy Council set the short-term inflation target (measured as the 12-month increase in the prices of consumer goods and services in December 2003) at 3% with a tolerance for deviations up to +/– 1 percentage point. This target was of an auxiliary character with regard to the medium-term target, set in *Medium-Term Monetary Policy Strategy for the Years 1999–2003*, which was adopted in 1998 — i.e. reducing the inflation rate to below 4% by the end of 2003.

In December 2003, the annual inflation rate amounted to 1.7% (Appendix No. 1) and thus was in line with the target adopted in *Medium-Term Monetary Policy Strategy for the Years 1999–2003* and slightly below the short-term inflation target set for 2003. An inflation rate 0.3 percentage point below the lower tolerance limit for deviations from the target was achieved with an acceleration in growth of food and non-alcoholic beverages prices (2.1%) that conformed to expectations, and a growth of regulateded prices of goods and services (2.3%) that was much lower than expected.

In mid-2002, when the monetary policy guidelines for 2003 were being developed, it was assumed that the rise in regulated prices would amount to 3.6% — 4.8%, in line with the assumptions underlying the 2003 Budget Act. In fact, the increases in excise duty rates proved to be lower than predicted. The growth in energy prices, including electricity and heat energy, was also smaller than expected. If the rise in regulated prices in 2003 had conformed to the forecasts of mid-2002, the annual inflation rate would have amounted to 2% — 2.3%.

The long-term process of curbing inflation in Poland has resulted in limiting the inflation rate to levels recorded in developed countries in recent years. The average annual (12-month moving average) HICP[1] inflation rate for Poland was falling systematically from 10.2% in October 2000 to 0.7% in December 2003. In the European Union, the average annual HICP inflation rate in December 2003 stood at 2.0% and in the euro zone the figure amounted to 2.1%. Since August 2002 Poland meets the inflation convergence criterion that is one of the conditions of joining the euro zone.

[1] Harmonised Index of Consumer Prices — a measure enabling comparisons of price changes in the EU member states and candidate countries.

From the point of view of the monetary policy conduct, two periods can be distinguished in 2003. In the first half of the year, the MPC lowered the reference rate on six occasions. In the second half, monetary policy parameters remained unchanged.

Arguments in favour of interest rate cuts in the first half of 2003 were the stabilisation of the inflation rate at a low level and the persistence of factors curbing the inflation growth in the future:

- annual CPI dynamics remained at a low and relatively stable level and most core inflation measures exhibited a slight downward trend. Inflation expectations of households remained at a low level. (Tables 1, 2 and 3);
- strong wage discipline was maintained by enterprises;
- investment outlays were falling;
- the rate of increase in loans to corporate sector was low.

The assessment of prospects of an increase in economic activity as a factor influencing future inflation rates also had a significant impact on the MPC decisions concerning interest rate reductions in the first half of 2003. Despite the persisting weak economic growth prospects in the euro zone (and above all in Germany), economic recovery symptoms became more pronounced in Poland:

- industrial output was growing gradually;
- exports were still growing rapidly;
- monthly Central Statistical Office's business tendency surveys indicated improvement in manufacturing and construction;
- enterprises' financial performance also improved.

In the opinion of the Council, however, the initial stage of economic recovery did not - despite the weakening zloty - lead to a rise in inflationary pressure that could jeopardise the achievement of the 2004 inflation target.

The MPC also took into account factors that could constitute a potential source of inflationary pressure — above all the uncertain public finance condition. The uncertainty concerned the scale of economic deficit of the public finance sector in 2003 as well as the extent to which the fiscal policy would further expand in 2004 and in the following years. The high and growing dynamics of currency in circulation as well as high prices of oil in the world markets, which might rise even further, were also factors that could spark inflationary pressure. These factors emerged during a period of economic recovery.

Table 1

Selected annual core inflation measures and CPI

	Exclusive of most volatile prices	Net of food and fuel prices	15% trimmed mean	CPI
Sep 02	1.3	2.8	1.5	1.3
Oct 02	0.9	2.3	1.3	1.1
Nov 02	0.8	2.1	1.3	0.9
Dec 02	0.7	2.0	1.2	0.8
Jan 03	0.5	1.6	1.0	0.5
Feb 03	0.5	1.5	0.8	0.5
Mar 03	0.5	1.4	0.8	0.6
Apr 03	0.0	1.2	0.6	0.3
May 03	-0.1	1.2	0.8	0.4
Jun 03	-0.1	1.1	0.9	0.8
Jul 03	0.0	0.8	1.0	0.8
Aug 03	0.1	0.8	1.0	0.7
Sep 03	0.3	0.9	1.2	0.9
Oct 03	0.7	1.2	1.2	1.3
Nov 03	1.0	1.3	1.4	1.6
Dec 03	1.1	1.4	1.5	1.7

Source: Central Statistical Office (CSO) data, NBP calculations.

Table 2

Inflation expectations of consumers (in 12 months)

Sep 02	Oct 02	Nov 02	Dec 02	Jan 03	Feb 03	Mar 03	Apr 03	May 03	Jun 03	Jul 03	Aug 03	Sep 03	Oct 03	Nov 03	Dec 03
1.0	0.9	0.9	0.8	0.7	0.6	0.4	0.4	0.5	0.3	0.4	0.8	0.7	0.7	0.9	1.6

Source: Ipsos opinion polls, NBP calculations.

Table 3

Inflation forecasts of bank analysts (in 11 months)

Sep 02	Oct 02	Nov 02	Dec 02	Jan 03	Feb 03	Mar 03	Apr 03	May 03	Jun 03	Jul 03	Aug 03	Sep 03	Oct 03	Nov 03	Dec 03
2.9	2.5	2.5	2.5	2.6	2.3	2.1	2.2	2.0	2.3	2.2	2.2	2.3	2.3	2.3	2.5

Source: Reuters.

In the opinion of the Monetary Policy Council, the changes that occurred in the economic situation and forecasts in the second half of 2003 called for increased caution with regard to monetary policy.

According to expectations, annual consumer price indices rose gradually; this was accompanied by rises in core inflation measures and producer price indices. The inflation expectations of consumers also increased, especially at the end of the year (Tables 1, 2 and 3).

Upward trends in the economy, largely caused by an upswing in exports, gradually strengthened despite unfavourable external conditions:

- GDP growth rate and the annual dynamics of industrial output were increasing (Appendix No. 2);
- export receipts were still growing rapidly (Appendix No. 3);
- enterprises' financial performance was still improving and Central Statistical Office research indicated a further increase in demand in manufacturing.

In the opinion of the Council, the related gradual increase in inflationary pressure did not in itself jeopardise the achievement of the 2004 inflation target. At the same time, however, factors that could render stabilisation of inflation at a low level more difficult - which had already been present in the first half of the year - were gaining importance. The most important such factor was uncertainty concerning the current and future situation of the public finance sector. Budget liquidity problems, the increasing public debt to GDP ratio, the rising probability of exceeding statutory prudential thresholds, as well as the uncertainty regarding the prospects of a rapid and efficient public finance reform caused a further depreciation of the zloty exchange rate against the euro in the second half of the year. The considerable strengthening of the euro against the US dollar in this period was an important factor contributing to the weakness of the Polish currency.

The Council's decision to keep interest rates unchanged was also based on the scale of the reductions introduced to date and their delayed effect on the gradual increase in domestic demand.

In the first half of 2003, the Monetary Policy Council lowered the NBP interest rates on six occasions. The reference rate was reduced from 6.75% to 5.25%, the rediscount rate from 7.5% to 5.75%, the lombard rate from 8.75% to 6.75%, and the deposit rate from 4.75% to 3.75%. As a result, the nominal interest rates reached their lowest level since the beginning of the transformation period. Real rates also declined — in the period from December 2002 to December 2003 the NBP reference rate CPI-deflated fell by 2.39 percentage points (from 5.90% to 3.51%), and its average level in 2003 dropped by 1.7 percentage points in relation to 2002. In December 2003, the reference rate (producer price index - deflated (PPI)) declined by 2.96 percentage points (from 4.45% to 1.49%) in comparison to December 2002; on average, it was 4.51 percentage points lower in 2003 than in 2002. The fall in interest rates was accompanied by a substantial depreciation of the zloty.

When analysing the monetary policy decisions taken in 2003, one should also bear in mind that due to delays in the monetary transmission mechanism, their impact on inflation will largely materialise in 2004 and 2005. Thus, the decisions of the Monetary Policy Council should be viewed in light of the inflation target beyond 2003, which is set at the level of 2.5%, with a tolerance for deviations up to +/– 1 percentage point.

FACTORS CONDITIONING MONETARY POLICY IMPLEMENTATION

External factors

In *Monetary Policy Guidelines for the Year 2003*, the Monetary Policy Council pointed out that any forecasts concerning external factors that influenced economic growth and inflation in 2003 were highly uncertain.

An expected global economic recovery started in 2003, which was most noticeable in the US and Asian economies (Table 4).

Table 4

External conditions affecting monetary policy, 2001-2002

	2002	2003				
	I-IV	I-IV	I	II	III	IV
United States – GDP growth (%)[1]	2.2	3.1	2.1	2.4	3.6	4.3
Japan – GDP growth (%)[1]	-0.3	2.7	2.7	2.4	2.0	3.8
Euro zone – GDP growth (%) of which Germany[1]	0.9 0.2	0.4 -0.1	0.7 0.1	0.1 -0.3	0.3 -0.3	0.6 0.0
Oil prices (Brent, USD/barrel)[2]	25.0	28.9	31.4	26.1	28.4	29.4
United States – CPI inflation (%)[3]	1.6	2.3	2.9	2.1	2.2	1.9
Euro zone – CPI inflation (%)[3]	2.2	2.1	2.3	1.9	2.1	2.1
United States – federal funds rate[4]	1.25	1.00	1.25	1.00	1.00	1.00
Euro zone – refinancing rate[4]	2.75	2.00	2.50	2.00	2.00	2.00

[1] In relation to the corresponding period of the previous year.
[2] Period average.
[3] Period average relative to the corresponding period of the previous year.
[4] Period end.
Source: Bloomberg, Eurostat, International Energy Agency.

Table 5

2003 GDP growth forecasts

	Spring 2002	Autumn 2002	Spring 2003	Autumn 2003	Performance
USA	3.1	2.3	2.4	2.8	3.1
Germany	2.7	1.4	0.4	0.0	-0.1
EU	2.9	2.0	1.3	0.8	0.7
Euro zone	2.9	1.8	1.0	0.4	0.4

Source: European Commission.

On the other hand, the growth in the EU, which is particularly important for Poland due to the scale of mutual economic relations, was much weaker than expected earlier (Table 5). The largest discrepancy between the expectations and the actual outcome was observed in Germany, where the GDP slightly declined in comparison to 2002. The slowdown in the activity in the

German economy did not, however, lead to a decrease in its import demand[2]. German imports from countries offering cheaper products, including Poland, increased[3, 4].

Apart from the increase in external demand for Polish goods, the reduction in the trade deficit in 2003 was also caused by the conditions of price and cost competition, which were still favourable for the Polish foreign trade (Table 6).

Table 6

Changes in competitiveness ratios*

(in % in relation to the corresponding period of the previous year)

	2002				2003			
	I	II	III	IV	I	II	III	IV
Export prices to industrial output prices	0.4	6.3	3.7	6.7	4.3	5.2	0.5	0.3
Export prices to unit labour costs	0.5	9.7	11.3	17.6	13.1	18.6	11.1	20.9

* The above ratios illustrate price and cost competitiveness of exports; their growth depicts improved competitiveness.

Source: CSO data, NBP calculations.

Just as in 2002, the contributing factors here were the significant depreciation of the zloty both in nominal and real terms (Table 7) and the fact that labour productivity growth in the domestic economy exceeded wage growth[5]. Average unit labour costs in manufacturing fell by around 9.0% in zloty terms in 2003 in relation to 2002. Along with the depreciation of the zloty against the euro in this period (by 14.1%), this translated to a decrease in unit labour costs in euro terms by around 20.2%.

Table 7

Annual movements in PLN exchange rate, 2001-2003

(% change in relation to the previous year)

PLN exchange rate	2001	2002	2003
Nominal effective	9.0	-4.0	-8.5
PPI deflated real effective	7.9	-3.8	-7.2
Real effective deflated with unit labour costs	7.7	-9.5	-17.4

"-" means the zloty depreciation.

Source: NBP and CSO data, NBP calculations.

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[2] German imports rose by 2.6% in 2003 (according to German estimates) against a fall of 1.6% in 2002.

[3] In 2003, Poland was already the fifth largest non-EU supplier on the German market, overtaking Japan with regard to the value of supplies.

[4] According to the Central Statistical Office data, in 2003 the value of Polish exports to Germany in euro terms rose by 9.1% in relation to 1.8% in 2002.

[5] In the period from December 2002 to December 2003 labour productivity in manufacturing grew by 21.2% while wages rose by 4.5% in real terms.

Table 8

Average deviation of the fixing rate from NBP central parity of 11.04.2000 (%)*

	Q1	**Q2**	**Q3**	**Q4**
2001	-8.8	-13.5	-7.7	-10.3
2002	-10.4	-10.0	-4.2	-6.8
2003	-5.3	-3.8	-1.9	0.2

*/ "–" means deviation from parity towards appreciation.
Source: NBP.

The following factors contributed to the depreciation of the zloty in 2003:

- a significant increase in risk premium caused by the growing uncertainty about future fiscal policies. The risk premium additionally rose due to unstable situation in the Hungarian foreign exchange market, which rendered the investors reluctant to pour their capital into Central European markets;
- the decrease (noticeable since 2001) in Polish and foreign real interest rates differential;
- the smaller flow of foreign direct investment into Poland;
- the increasing appreciation of the euro against the US dollar in the world market[6].

In 2003, the most important factors working towards the appreciation of the Polish currency were a further improvement in the current account balance as well as a substantial growth in productivity and the related decrease in unit labour costs.

With the US and Asian economies progressively recovering and the US dollar strongly depreciated, the rise in dollar prices in the world raw-material markets accelerated rapidly in 2003. The increase in the prices of non-energy materials[7] was almost twice as fast as in 2002 and Brent oil prices rose by 15.4% against a rise by 2.3% in 2002. This, along the depreciation of the zloty, increased the growth rate of the producer prices, especially in the second half of 2003.

[6] In 2003, the euro appreciated against the US dollar by around 20 %; the average annual depreciation of the nominal EUR/PLN exchange rate was 14.1% in 2003 (against a depreciation of 5.1% in 2002) and the zloty exchange rate against the US dollar rose by 4.7% (while in 2002 it remained at the 2001 level).

[7] Within this group, metal prices increased most rapidly, rising by 12.8% in 2003 against a 4% drop in 2002.

Food prices and regulated prices

In line with August 2002 expectations, food and non-alcoholic beverages prices rose by 2.1% in December 2003. The most significant rise occurred from September 2003 onwards, which was related to the situation in the agricultural market. The fact that crops were lower than in the previous year (especially with regard to grain) and the decreasing livestock production, coupled with a moderate increase in consumption, lead to rises in the prices of staple agricultural products and consequently to an increase in retail prices of food.

Increases in retail prices were recorded in all basic groups of food products, except for fish, sugar, honey and chocolate products. The rises were most significant with regard to bread and cereal products, milk, cheese, eggs, vegetable oil and fruit.

In December 2003, the twelve-month regulated prices growth rate amounted to 2.3%, while August 2002 forecasts had been in the range of 3.6% — 4.8%. The projected increases in energy prices, including electricity and heat, turned out to be lower than initially expected. Locally regulated prices of goods and services were also rising less significantly than had been assumed. Moreover, excise duty rate increases were lower than predicted. If August 2002 regulated prices growth forecasts had been accurate, the inflation rate in December 2003 would have amounted to around 2% — 2.3%, i.e. would have remained within the set inflation target band.

Systemic environment, relations between monetary and fiscal policies

Monetary Policy Guidelines for the Year 2003 stressed that in order to establish the foundations for a sustainable equilibrium of the public finance sector, employment growth and economic development it was necessary and urgent to implement certain structural and systemic reforms, including further liberalisation of the labour law, privatisation and the rationalisation of current budget expenditure. Delays in reforms or failures to implement them depress the long-term growth rate of the Polish economy. The persistent structural deficit of the public finance sector and the related borrowing needs of the budget limit the pool of funds that could be earmarked for corporate investment. The drain of domestic savings by the public sector is one of the factors that limits the room for monetary policy manoeuvre in terms of interest rate cuts. As a result, the unfavourable policy mix raises the real costs of achieving and maintaining internal and external equilibrium.

In 2003, obstacles hampering the creation of new jobs were still present in the labour market. At the beginning of the year changes (including amendments to the Labour Code), rendering employment conditions more flexible, were introduced. They made it slightly easier for the entrepreneurs to adjust employment to current needs and financial capabilities and at the same time reduced the redundancy. The Labour Code was, however, amended again at the end of the year for some of the formerly introduced amendments had not been in line with the European Union standards.

Nonwage labour costs are an important obstacle to the creation of new jobs. As yet no way of lowering compulsory contributions (to the Social Security Fund and Labour Fund) has been found that would not affect the insurance character of those contributions. At the same time, the relatively easy access to social benefits makes it possible for employees to start drawing their disability and pre-retirement pensions early. Moreover, research has indicated that the number of economically inactive people who returned to the labour market in 2003 was smaller than in previous years.

The considerable "tax wedge"[8] (which amounted to 43% in 2002) induces entrepreneurs to avoid payroll taxes by resorting to flexible forms of employment (which are less burdened by contributions) and employing people in the grey economy. The widespread scale of this phenomenon may be indicated by the widening gap between the number of employees registered in the BAEL database (a collection of data on the economic activity of the population) and the figures reported by companies. Moreover, according to the official Central Statistical Office estimates, around 900,000 people are currently employed in the grey economy, not paying taxes or social security contributions.

The unemployment benefit, which is relatively high in comparison to the minimum wage (in 2003 it was less than 15% lower than the net minimum wage) and, in addition, is not adjusted for regional differences in wages. Thus, it discouraged the least skilled unemployed from seeking employment, especially in less developed regions, where the purchasing power of benefits is relatively high compared to wages.

More jobs were created in 2003[9] but at the end of the year around 25% of job offered by employers were still vacant, which points to a persistent mismatch between supply and demand

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[8] Tax wedge is the difference between the costs of labour for the employer (gross wages + compulsory contributions paid by the employer) and the remuneration received by the employee (net wages) relative to total costs of labour.

[9] Over 30% more job offers were registered at employment offices in 2003 in comparison to the previous year.

for labour. Considerable differences between unemployed persons with respect to their opportunities to find jobs corresponding to their skills, along the limited professional and spatial mobility of the unemployed, may be the underlying reason for this phenomenon[10]. The persistence of long-term unemployment confirms this — in 2003 over 50% of the registered unemployed had been jobless for over a year.

In the light of the above, it appears that measures focusing directly on the labour market (amending labour laws, facilitating the employment of graduates, etc.) will not be sufficient to improve the situation. Changes are necessary, especially with regard to the social security and welfare systems, which would transform the labour cost structure in a way that would create more incentives for legal employment and at the same time would not drastically reduce the benefits for persons who really need them.

Transformations in the ownership structure of the State Treasury property have not accelerated. Net privatisation receipts totalled PLN 2.96 billion in 2003 against PLN 7.4 billion provided for in the Budget Act (net privatisation receipts in 2002 amounted to PLN 2.18 billion). These revenues were achieved primarily through the sale of minority shares owned by the State Treasury (e.g. the sale of Polish Telecom shares brought in PLN 1.63 billion).

The flow of foreign capital into the Polish economy has stabilised at a relatively low level. Foreign direct investment amounted to PLN 16.4 billion in 2003 against PLN 16.8 billion in 2002 and PLN 23.3 billion in 2001 (data from the NBP balance of payments on a transactions basis).

Restrictions on competitive mechanisms, which are still present in certain sectors of the Polish economy (e.g. telecommunications, refineries), result in prices that are higher than in the conditions of perfect competition (producers who enjoy a monopolistic position in the market make extraordinary profits). The impact of imperfect competition in Poland has been estimated

[10] Central Statistical Office research (based on municipal records on residence addresses) shows that during the period from 1995 to 2002 the number of persons changing their addresses permanently or temporarily in subsequent years did not fluctuate significantly and ranged from 1,030,000 to 1,130,000. Among those persons, over a half moved because they were offered a more attractive job, but only one in ten moved because of the threat of unemployment.

to be around 0.2 — 0.3 percentage point of PPI inflation per year[11], which should be interpreted as a surplus in the PPI compared to a perfect competition situation.

The monetary policy in 2003 took into consideration the continuously high deficit of the public finances and the prospect that this deficit may grow significantly in 2004.

The deficit of the central budget in 2003 amounted to 4.5% of GDP (i.e. 0.5 percentage point less than in 2002) and was below the limit stipulated in the Budget Act. The reduction in the deficit was largely caused by the lower than expected budget expenditure. The cut in budget expenditure, which amounted to ca. PLN 5.3 billion (i.e. 2.7% less than planned), proved to be much larger than the short fall in budget revenue (PLN 3.6 billion, i.e. 2.3% of the planned amount). The smaller budget expenditure resulted primarily from the fact that the cost of servicing public debt[12] was lower than expected and certain conditional[13] as well as property (mainly investment) expenditure was not incurred. However, when compared to 2002, the expenditure of the central budget was higher by 3.4% last year (by 2.6% in real terms, CPI-deflated) and the rise in the expenditure of the entire sector amounted to 6.1% (5.2% in real terms) [14].

The imbalance of the public finance sector in 2003 was compounded by the loss recorded by other units of the sector. The nominal value of this deficit was comparable to the 2002 level (0.9% of GDP) and resulted on the one hand from an increase in the deficit recorded by the State's special purpose funds, particularly the Social Security Fund, and on the other hand from a decrease in the deficit of local governments.

As a consequence, the cash deficit of the public finance sector amounted to 5.4% of GDP and the economic deficit[15] to 4.6% of GDP. Thus, the levels of both indicators of fiscal situation

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[11] NOBE Independent Centre for Economic Studies, *Raport na temat wpływu regulacyjnych aspektów procesu integracji na poziom cen*, paper commissioned by the Ministry of Finance of the Republic of Poland, Warsaw, November 2003.

[12] This resulted from the fact that the actual level of domestic and international interest rates was lower than assumed in the 2003 budget.

[13] There were no grounds to make the conditional expenditure stipulated in the *2003 Budget Act* because the actual receipts from excise and customs duties at the end of Q3 of last year were lower than the amount that would allow conditional expenditure to be initiated.

[14] Taking into account the expenditure financed from non-refundable EU funds, the expenditure of the public finance sector grew by 6.5% and 5.7%, respectively.

[15] The economic deficit is the cash deficit of the public finances sector plus the disbursement of compensations for the failure to raise wages as well as retirement and disability pensions at the turn of 1992 and less the transfer of social insurance contributions from the Social Insurance Institution to open-ended pension funds (OFE); NBP calculations.

were lower than in 2002. However, taking into account the considerable acceleration in economic growth in 2003, this does not mean that the situation of the public finance sector improved — the structural cash deficit of the sector was comparable to the 2002 level.

Table 9

Measures of fiscal imbalance

	2002	2003	
	Performance	Budget Act	Performance
	PLN billion		
Central budget deficit	-39.4	-38.7	-37.0
Cash deficit of the public finance sector	-46.0	-48.3	-43.8
Economic deficit of the public finance sector	-39.3	-40.1	-37.1
	as percentage of GDP		
Central budget deficit	-5.0	-4.9	-4.5
Cash deficit of the public finance sector	-5.9	-6.1	-5.4
Economic deficit of the public finance sector	-5.0	-5.1	-4.6
Structural deficit of the public finance sector according to IMF methodology	-5.1	-	-5.0

Note: Due to a change in the methodology of nominal GDP calculation (in February 2004 the Central Statistical Office published adjusted national data for the years 1995-2003), deficit as a proportion of GDP in 2003 cannot be directly compared to the amounts forecasted in the *2003 Budget Act*.

The persistence of high public finance sector deficit caused the public debt to exceed the first prudential threshold stipulated in the Public Finance Act, i.e. 50% of GDP, in the last year. The public debt, augmented by the prospective payments due to guarantees and endorsements, amounted to 51.6% of GDP at the end of 2003.

Unfavourable prospects with regard to the condition of public finances in 2004 and in the following years were an important element that conditioned the stance and direction of monetary policy in 2003. The draft of the 2004 Budget Act developed in September 2003 assumed a further increase in the imbalance of the public finance sector. The State budget deficit assumed in this draft was increased to PLN 45.5 billion, i.e. 5.3% of GDP, and if it were calculated according to the methodology used in previous years (where the Social Security Fund reimbursement for transfers to compulsory funded pension pillar constituted budget expenditure), the State budget deficit in 2004 would amount to 6.6% of GDP. The considerable rise in deficit in 2004 is only partly due to the necessity of paying Poland's membership contribution to the EU budget, which will amount to around PLN 5.8 billion this year. Without this liability the State budget deficit would amount to around 5.9% of GDP. Together with the rise in the deficits of the other units of the public finance sector, the entire sector deficit is expected to reach around 8% of GDP, despite further acceleration in economic growth. The high level of the public finances deficit assumed for this year is also tantamount to a serious threat of the public debt exceeding the second prudential threshold (55% of GDP).

The uncertainty concerning fiscal situation in the next years was not alleviated by the draft *Public Expenditure Reform and Reduction Programme* prepared by the government in October 2003. The proposed solutions, aimed at increasing revenue and retrenching expenditure, assumed a financial effect of around PLN 50 billion over the years 2004–2007. The comprehensive implementation of this programme would reduce the public finances sector deficit by around 1.6% of GDP in 2007, which would not eliminate the risk of subsequent prudential thresholds being exceeded in the nearest future. The assumed increase in general government deficit in 2004, the fact that fundamental adjustment measures were only planned for 2005, and fears concerning the final shape of the *Public Expenditure Reform and Reduction Programme* were among the factors that contributed to maintaining NBP's interest rates unchanged in the second half of 2003.

MONETARY POLICY INSTRUMENTS

In order to set short-term interest rates in the appropriate way, the NBP used the following combination of instruments: open market operations, lending and deposit operations and reserve requirements.

The structural liquidity surplus of the banking sector persisted throughout 2003. The central bank continued its reduction, mainly by outright sales of Treasury bonds from the NBP's portfolio obtained in 1999 as a result of the conversion of non-tradeable liabilities of the State Treasury towards the central bank. The operating liquidity surplus was absorbed by means of the issuance of 14-day NBP money market bills.

Interest rates

The implementation of the monetary policy within the direct inflation targeting regime means that the NBP's official interest rates are maintained at the level consistent with the adopted target. Open market operations and lending and deposit operations with yields set by the Monetary Policy Council, influence the level of interbank market rates and indirectly influence deposit and lending rates offered by commercial banks. This in turn influences decisions of households related to savings and consumption, as well as the level of corporate investment.

The rates which defined the direction of the monetary policy pursued by NBP in 2003 were the reference rate, the lombard rate and the deposit rate.

The reference rate set the minimum yield obtainable on money market bills sold as part of open market operations. From January 1 2003 on, the maturity of the basic open market operations, i.e. the issue of the NBP bills, was reduced from 28 to 14 days. The minimum interest rate on the liquidity-absorbing short-term open market operations indicated the current direction of the monetary policy and influenced the interbank deposits rate with similar maturity.

The lombard rate determined the maximum cost incurred by the banks obtaining money from the central bank for one day. **The deposit rate** specified the price offered by the central bank to commercial banks for overnight deposits in the NBP.

The interest rates in the money market ranged in the vicinity of the reference rate, within the fluctuation band set by the lombard rate and the deposit rate.

The Monetary Policy Council reduced the minimum yield on the NBP bills in 2003 on six occasions. The yield was reduced by 1.5 percentage points from 6.75% at the end of 2002 to

5.25% at the end of 2003. The reduction in official interest rates was unequal and led to the narrowing of the symmetrical corridor of market interest rate fluctuations.

Table 10

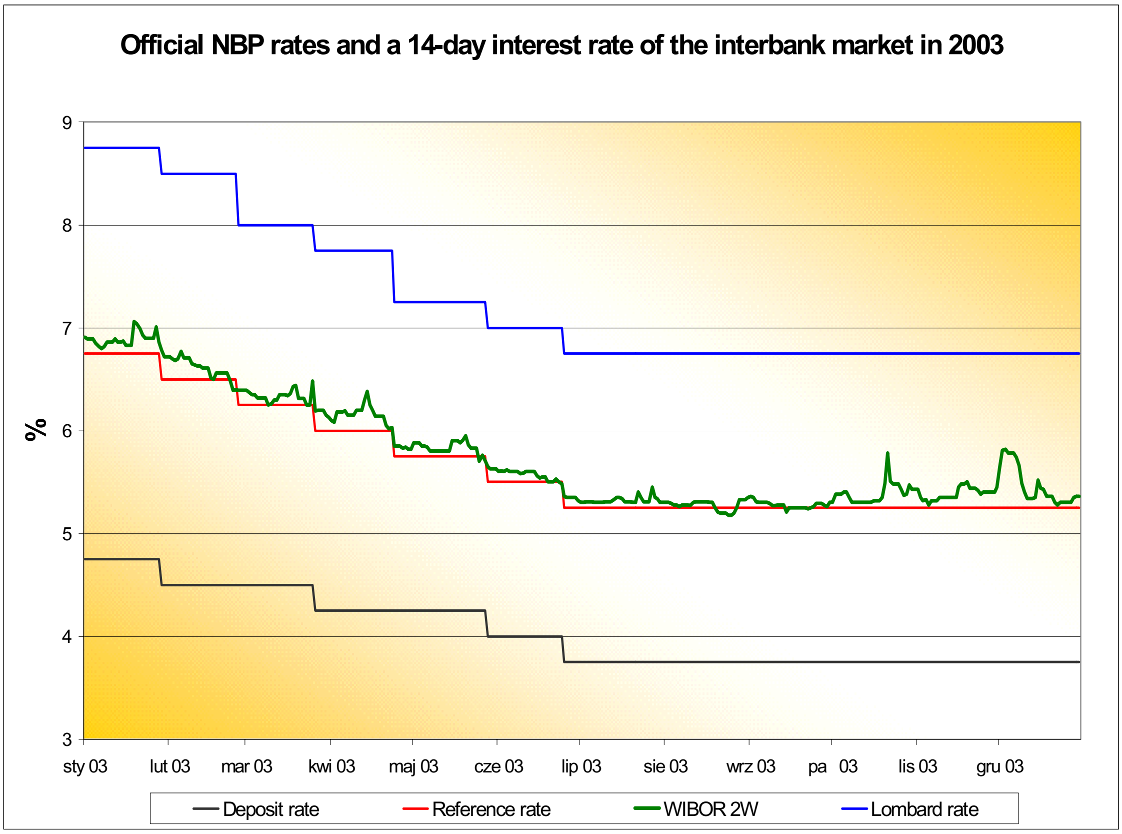
Rulings of the Monetary Policy Council regarding changes in the official interest rates in 2003

Date	**Ruling:**
January 29	- Reduction of the minimum yield on the 14-day open market operations from 6.75% to 6.5% on a yearly basis - Reduction of the lombard rate from 8.75% to 8.5% - Reduction of the rediscount rate from 7.5% to 7.25% - Reduction of the deposit rate from 4.75% to 4.5%.
February 26	- Reduction of the minimum yield on the 14-day open market operations from 6.5% to 6.25% on a yearly basis - Reduction of the lombard rate from 8.5% to 8% - Reduction of the rediscount rate from 7.25% to 6.75%
March 26	- Reduction of the minimum yield on the 14-day open market operations from 6.25% to 6% on a yearly basis - Reduction of the lombard rate from 8% to 7.75% - Reduction of the rediscount rate from 6.75% to 6.5% - Reduction of the deposit rate from 4.5% to 4.25%.
April 24	- Reduction of the minimum yield on the 14-day open market operations from 6% to 5.75% on a yearly basis - Reduction of the lombard rate from 7.75% to 7.25% - Reduction of the rediscount rate from 6.5% to 6.25%
May 28	- Reduction of the minimum yield on the 14-day open market operations from 5.75% to 5.5% on a yearly basis - Reduction of the lombard rate from 7.25% to 7% - Reduction of the rediscount rate from 6.25% to 6% - Reduction of the deposit rate from 4.25% to 4%.
June 25	- Reduction of the minimum yield on the 14-day open market operations from 5.5% to 5.25% on a yearly basis - Reduction of the lombard rate from 7% to 6.75% - Reduction of the rediscount rate from 6% to 5.75% - Reduction of the deposit rate from 4% to 3.75%.

Source: NBP data.

Short-term interbank rates fell along with the reductions in the reference rate.

Figure 1



Source: NBP data

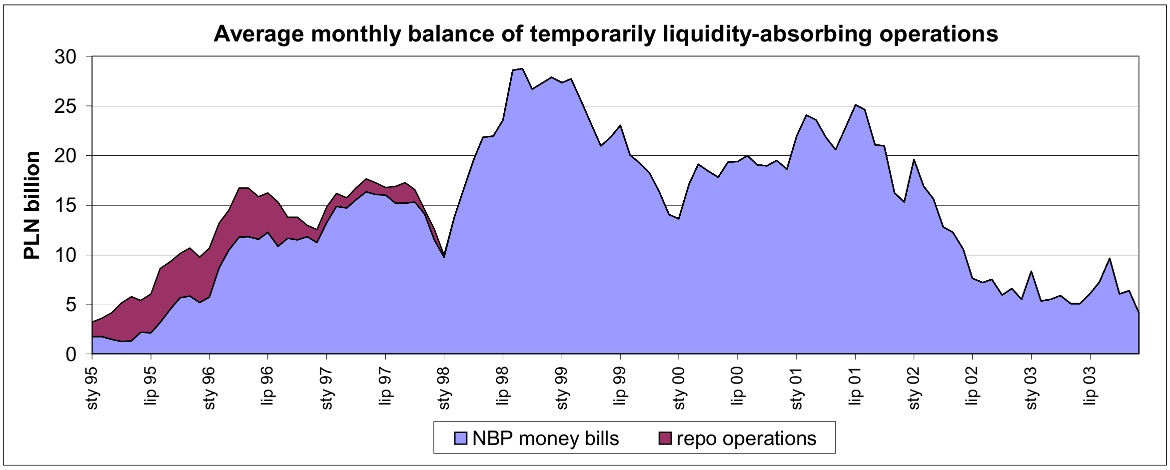
Open market operations

The principles of open market operations in 2003 were set in the resolution of the Monetary Policy Council of December 17, 2002. On its basis, the open market operations were divided into three major categories: basic, fine-tuning and structural.

The **basic** instrument used by the NBP in 2003 in order to limit the operating liquidity surplus in the banking system was the issue of the NBP bills. As compared with 2002, the maturity of the basic open market operations was reduced from 28 to 14 days. The change was aimed at facilitating the liquidity management by the central bank and commercial banks and to provide more stability in market rates. Moreover, it rendered the domestic system closer to the Eurosystem standards. The issue of 14-day NBP money market bills was performed weekly, on Fridays.

The scale of liquidity-absorbing operations, carried out in order to stabilize the market, is depicted in Figure 2.

Figure 2



Source: NBP data

The balance of open market operations decreased to PLN 6.0 billion at the end of 2003, i.e. by PLN 1.3 billion as compared with the level at the end of 2002. The drop resulted from the reduced operating liquidity surplus in the banking sector mainly due to the increase in notes and coins in circulation, increased volume of the zloty budget funds in the NBP, net sales of currencies by the NBP and sales of converted bonds from the NBP's portfolio.

In exceptional situations (e.g. in the case of significant disruptions in liquidity or in the case of a threat to the operations of the payment system), the NBP could use the following **fine-tuning operations**:

- issue of the NBP money market bills with maturity of 1 up to 7 days,

- purchase of Treasury securities from banks or buyout of the NBP money market bills prior to their maturity, if the need arises to increase the short-term liquidity of the banking sector.

Thus, fine-tuning operations could be both liquidity-providing and liquidity-absorbing. Their maturity was to depend on the duration of distortions. The instrument was not used in 2003.

In 2003, the sale of converted treasury bonds from the NBP's portfolio was completed[16]. Outright operation[17] was of **structural character** and permanently absorbed liquidity.

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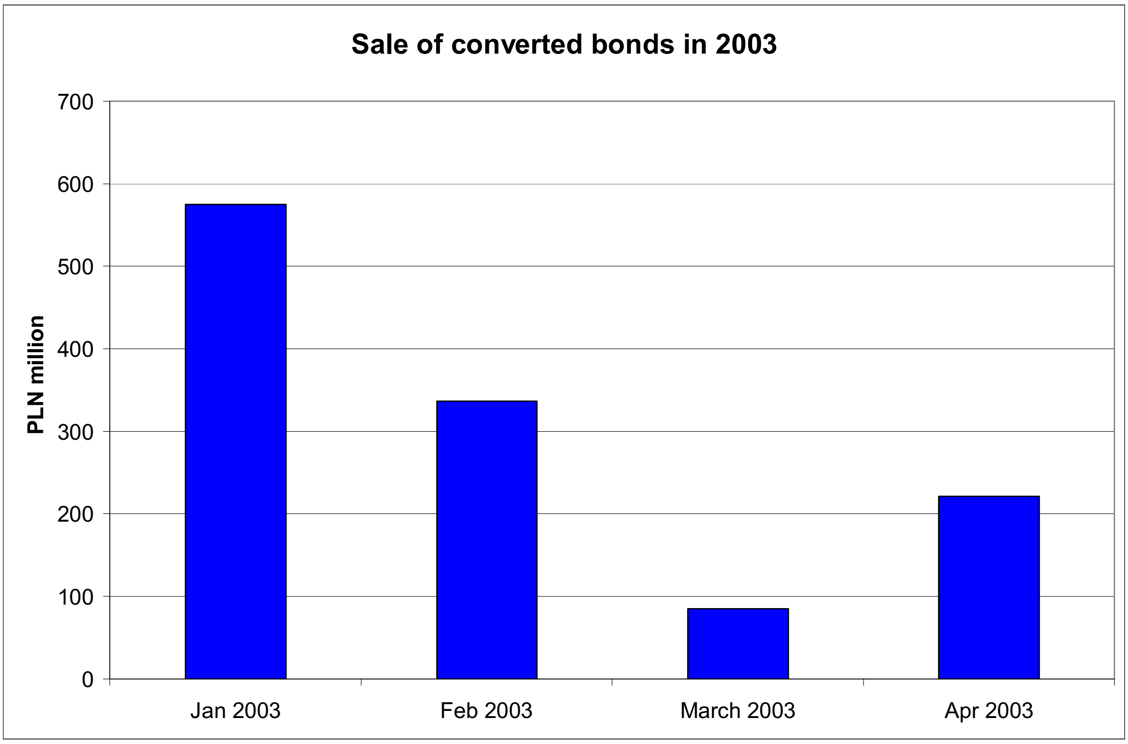
[16] Bonds issued by the State Treasury in 1999 to replace the debt towards the NBP with market securities.
[17] Unconditional sales of securities by the central bank to other banks.

Converted Treasury securities from the NBP's portfolio of the nominal value of PLN 1.24 billion were offered for sale in all tenders in 2003[18]. The standard amount of bonds offered for sale by means of a tender procedure was PLN 300 million. During the tender procedure, the NBP accepted the bond yield close to the market yield.

The scale of outright operations in 2003 (according to the nominal value of converted bonds sold in a month) is presented in Figure 3.

Figure 3



Source: NBP data

In 2003, open market operations were carried out with a group of 13 entities, i.e. 12 banks — money market dealers and the Bank Guarantee Fund. The banks–dealers were selected in accordance with the uniform qualification criteria of the Dealer Activity Index. The banks were very active in the FRA and IRS markets and had large shares in the markets of Treasury securities (bills and bonds), NBP bills, interbank deposits and FX swaps.

The NBP continued activities related to developing new procedures for the selection criteria for contractor banks in the open market operations system. In the future, the banks will be included in a list announced by the ECB and will participate in fine-tuning and structural

[18] The last operation of that type was carried out on April 17, 2003.

operations. The majority of requirements set by the ECB have already been implemented in the currently binding selection procedures.

Reserve requirement

The required reserves maintained by banks in the averaged system is one of the factors to smooth market interest rate fluctuations. The mandatory reserves are calculated on the basis of bank's collected deposits, funds obtained by selling securities and other repayable funds received by the bank. The funds accepted from other domestic banks, as well as funds from abroad accepted for at least two years are excluded from the basis for reserve calculation.

The principles for the calculation and maintenance of required reserves are set by Resolution 64/2001 of the NBP Management Board of December 21, 2001 as amended.

2003 brought the following changes in the principles for the calculation and maintenance of mandatory reserves:

- since September 30 — pursuant to Art. 39a of the NBP Act — the banks have reduced the amount of the calculated mandatory reserves by the equivalent of EUR 500 thousand, calculated according to the NBP average exchange rate as of the last day of the month that is the basis for the required reserves calculation,

- since October 31, 2003 — pursuant to Resolution 14/2003 of the Monetary Policy Council the required reserves rate has been reduced from 4.5 % to 3.5 %.

The mandatory reserves are calculated and held in zloty. The required reserve, held in the current account or in the mandatory reserves account may be used for daily financial settlements. There is no interest on the mandatory reserve funds.

The mandatory reserves are calculated and held by all banks except for banks which, pursuant to the rulings by the NBP Management Board adopted in 1994-2000, were exempt from the obligation to hold required reserves during the implementation of the repair programme. In 2003, three banks were exempt from the obligation pursuant to the rulings adopted in the previous years.

The exemption from the obligation to hold reserves expired during the year for two banks. The amount of the exempt reserves is PLN 422 million as of December 31, 2003.

Table 11

Changes in the volume of mandatory reserves in 2003
(in PLN million)

Type	As of December 31, 2002	Changes in quarters				As of December 31, 2003
		I	II	III	IV	
Mandatory reserves on the NBP account	13,039	35	123	- 714	- 2,263	10,220

Source: NBP calculations.

The following factors significantly influenced the change in the volume of mandatory reserves as of December 31, 2003 as compared to the volume as of December 31, 2002:

- reduction (since September 30, 2003) in the volume of the calculated mandatory reserves by the equivalent of EUR 500 thousand,

- reduction (since October 31, 2003) in the required reserves rate by 1 percentage point,

- expiration of mandatory reserves exemptions — on June 30 and December 31, 2003,

- growth in deposits that are the basis for the calculation of the mandatory reserve by 3.9 % on a yearly basis.

A surplus of the average volume of mandatory reserves in current accounts over the required volume of reserves occurred in all reserve periods in 2003, except for December when the deviation in the sector was negative and amounted to PLN 1.5 million. The surplus decreased, as compared with 2002, by PLN 13 million on average and averaged at PLN 30 million throughout 2003.

Since December 2001, the NBP has published daily information on the volume of mandatory reserves and the banks' balance in the NBP's current accounts and required reserve accounts on the previous day (NBPM page at Reuters Website).

Lending and deposit operations and banks refinancing

Lending and deposit operations performed with the central bank aimed at short-term supplement of the system's liquidity or at overnight deposits of the banks' surplus of free funds at the NBP. These operations are initiated by commercial banks and are to prevent excessive fluctuations of the interbank interest rates.

Lending and deposit operations include lombard facilities and overnight deposits. The lombard facility used by banks supplemented their current liquidity. The lombard facility interest rate specified the maximum cost of securing funds at the NBP, by setting a ceiling on fluctuations of the interbank rates. In 2003 the banks collateralised the lombard credit with Treasury securities. However, debt due to such facilities occurred neither at the end of 2003, nor at the end of the preceding year. The banks incurred debts within the dates that ended the mandatory reserves maintenance period in the current accounts at the NBP. The total amount of the lombard facility used throughout 2003 was PLN 11.6 billion (the average daily debt — PLN 34.2 million).

In the previous year, the banks deposited the surplus of their current funds at the NBP time deposit accounts as overnight deposits returnable on the following working day. The deposit rate constituted the lower limit for movements in short-term market rates. In 2003, the total amount of time deposits placed by the banks with the NBP equaled PLN 39.8 billion (the average daily deposit amount was PLN 157.2 million). The deposits increased by 35.8 % as compared with 2002. The value of a single deposit ranged between PLN 25 thousand and PLN 1.5 billion. The highest monthly sum of the banks' deposited funds amounted to PLN 10.1 billion (in February 2003).

In 2003, banks refinancing in the form of a rediscount and a refinancing facility for central investments did not change and did not play any active role in the monetary policy conduct.

The banks' debt at the NBP due to refinancing facilities and other claims on domestic banks[19] amounted to PLN 4.64 billion at the end of December 2003 (including the refinancing facility for central investments — PLN 3.29 billion) and decreased by 8.9 % as compared with 2002. The debt decrease resulted from repayments of the refinancing facility for central investments amounting to PLN 454.6 million, which was in accordance with the contractual repayment deadlines.

In 2003 the banks did not use the rediscount in the NBP.

On the other hand, similarly to the previous year, banks used the intraday credit facility every day. The credit facility was repaid during the same working day. As of December 31, 2003, 42 banks concluded contracts with the NBP. The banks' daily debt ranged from PLN 3.4

[19] Claims on domestic banks include the debt amount (PLN 1.28 billion) at the NBP current account that changed its accounting classification in 2003 and the debt amount (PLN 67.5 million) due to the refinancing facility for central investments and due to a loan for the central investment loan interest compounding.

billion to PLN 8.6 billion. Such a credit facility served to facilitate clearing and liquidity management in the banking system throughout a single working day.

Appendix 1. CPI

In 2003 a reversal of the downward trend in the annual CPI growth, initiated in August 2002 occured. Two sub-periods can be distinguished in terms of the inflationary processes development in 2003. In the first four months, the annual CPI was decreasing steadily from 0.8% in December 2002 to the historical lowest level of 0.3% in April 2003. In subsequent months of 2003, the inflation rate started to increase and amounted to 1.7% in December 2003.

The CPI growth of 1.7% at the end of 2003 resulted from:

- 2.1% growth in the prices of food and non-alcoholic beverages, adding to the CPI growth 0.6 percentage points,
- 2.3% growth in regulated prices increasing the CPI by 0.6 percentage points,
- 1.0% growth of prices of other consumer goods and services, contributing o.5 percentage points to an overall price increase.

In 2003, the highest CPI growth occurred in Q4, accompanied by the accelerated growth in the prices of food and regulated prices (Table 12, Figure 4).

Table 12

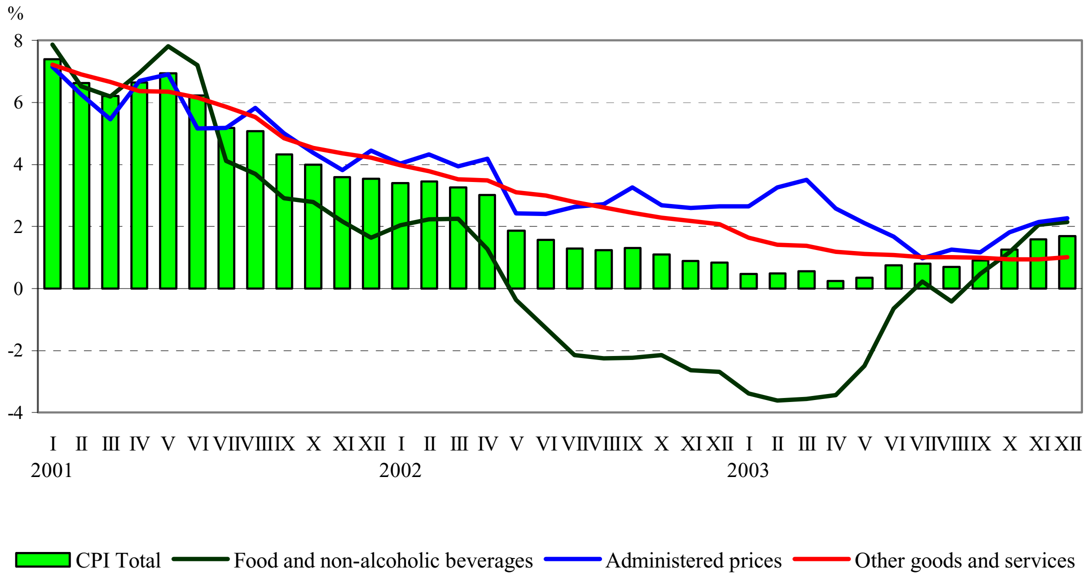
Growth in the base group of the CPI

Specification	2001	2002	2003	2001	2002	2003				
	Weight structure			XII	XII	III	VI	IX	XII	Annual averge
	%			Corresponding period in the previous year = 100						
Total	**100.0**	**100.0**	**100.0**	**103.6**	**100.8**	**100.6**	**100.8**	**100.9**	**101.7**	**100.8**
Food and non-alcoholic beverages	**30.1**	**29.7**	**28.2**	**101.6**	**97.3**	**96.5**	**99.4**	**100,5**	**102.1**	**99.0**
Regulated prices	**25.7**	**27.1**	**27.2**	**104.5**	**102.7**	**103.5**	**101.7**	**101.2**	**102.3**	**102.1**
Fuel	*3.5*	*3.,7*	*3.7*	*89.1*	*107.6*	*117.4*	*105.5*	*105.1*	*104.4*	107.9
Other consumer goods and services	**44.2**	**43.2**	**44.6**	**104.2**	**102.1**	**101.4**	**101.1**	**101.0**	**101.0**	**101.1**
Non-food products	*27.1*	*26.1*	*26.7*	*103.0*	*101.0*	*100.5*	*100.1*	99.9	99.9	*100.1*
Services	*17.1*	*17.1*	*17.9*	*106.3*	*103.8*	*102.7*	*102.6*	102.6	102.6	*102.7*

Source: CSO data, NBP calculations

Figure 4

Annual inflation and annual growth rates in the main price categories 2001 – 2003



Source: CSO data, NBP calculations

In 2003, the strongest growth tendencies were displayed in the group of ***food and non-alcoholic beverages***. In December 2003, on a twelve-month basis, they grew by 2.1% in comparison with the last year. The highest growth in food prices was observed starting from September 2003. This was a result of the situation in the agricultural sector. Lower crops when compared to 2002 (primarily grain crops) as well as decreasing livestock production combined with moderate consumption growth, contributed to a growth in the staple agricultural products' prices, and – as a consequence - an increase in the retail prices of food products.

Between January and December 2003, accelerated growth of retail prices was reported in all four base groups of food products, except for fish, sugar, honey and chocolate products. The highest growth was recorded in the prices of eggs (35.2%), fruit (11.5%), oil (7.3%), vegetables (3.8%), cheese (3.4%), bread and bakery (2.2%).

In December 2003, the twelve-month growth rate of ***regulated prices***[20] reached 2.3%.

[20] Regulated prices include prices of consumer goods and services, which are only to a limited extent affected by the market mechanisms due to a variety of administrative interference in the process of price formation. For analytical purposes, the regulated prices category includes prices:

- indirectly regulated by the excise tax rates; it applies to group of goods and services with a significant share of the excise tax in their retail price structure (alcoholic beverages, tobacco products, fuel, electricity), In the so-called basic price groups, with a dominant share in the regulated prices (including prices of power carriers as well as prices of consumer products subject to the excise tax), a growth rate in prices of the following products exceeded the average growth rate recorded for the group and remained markedly above the overall inflation rate: tobacco products (5.2%), gas (4.2%), electricity (3.9%) and hot water (3.8%). Prices of alcohol beverages remained at the 2002 level, as did the prices of telecommunication services and public administration services (from the so-called other groups of regulated prices).

Fuel prices, included in the regulated prices group, increased by 4.4% in 2003.

In 2003, ***prices of other consumer goods and services*** rose by 1.0% in 2003 (compared to 2.1% in 2002). A slowdown in the growth rate reported for this group of prices was primarily affected by the non-food products prices with their growth going down from 0.8% in January 2003 to 0.1% in December 2003 as a consequence of low demand. The most significant weakening of growth was recorded in the prices of household appliances, clothing and shoes, of which most remained at or below its 2002 level.

In 2003, in the basic groups of consumer goods and services the highest growth in prices was recorded in services (2.6%), of which prices related to housing services rose the most.

- subject to supervision and approval by authorized offices, primarily by the Energy Regulatory Authority of Poland (electricity, natural gas, central heating, hot water),
- uniform at the national level (mail services, railway transport, TV and radio subscription),
- controlled by local authorities (public transport) and defined by the government (court services, public administration services).

Appendix 2. GDP and domestic demand

In 2003, a 2.4% growth of domestic demand was recorde against 0.8% in 2002. The accelerated growth of the domestic demand stemmed from the reversal of the declining trend in the gross capital formation, accompanied by a slightly lower level of total consumption dynamics. For the fourth successive year an improvement in net exports was recorded, while the pace of the reduction in its deficit was greater than in 2002.

The GDP and domestic demand growth rates, and their relationship in the years 1996-2003 are shown in Table 13. The share of the domestic demand components in the GDP growth are shown in Figure 5; GDP and domestic demand dynamics by quarters are presented in Table 14.

Table 13

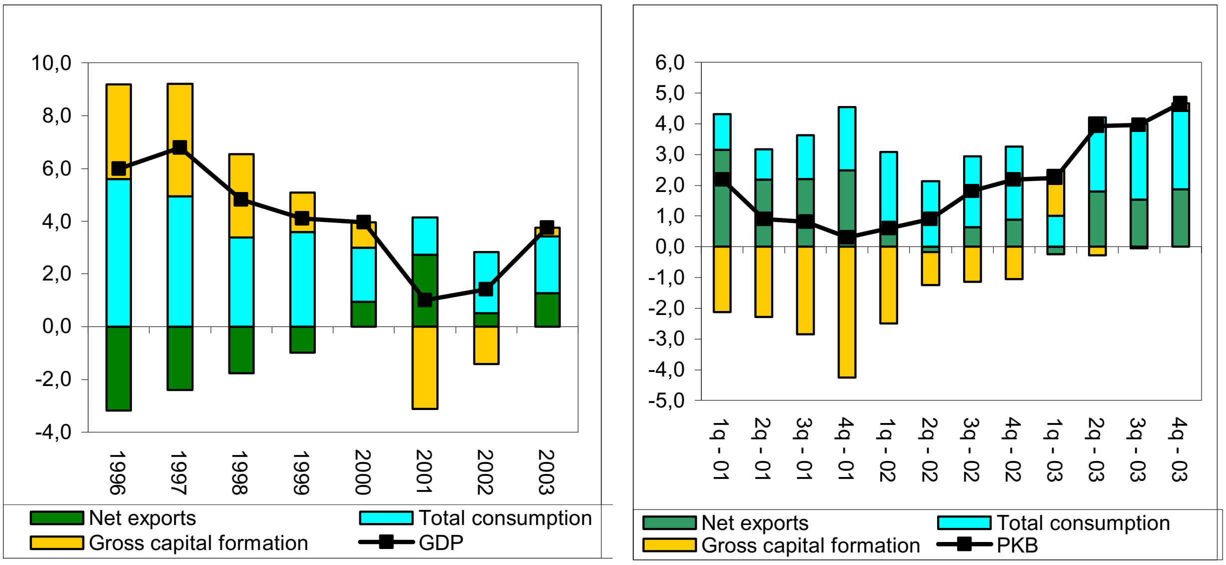
GDP and domestic demand 1996 — 2003

	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
	Previous year = 100, fixed prices							
GDP	106.0	106.8	104.8	104.1	104.0	101.0	101.4	103.7
Domestic demand	109.7	109.2	106.4	104.8	102.8	98.3	100.8	102.4
Consumption	107.2	106.1	104.2	104.4	102.5	101.7	102.8	102.5
Individual consumption	108.7	106.9	104.8	105.2	102.7	102.0	103.3	103.1
Gross capital formation	119.5	120.8	113.8	106.1	103.9	87.4	93.2	101.8
Gross fixed capital formation	119.7	121.7	114.2	106.8	102.7	91.2	94.2	99.1
Exports	112.0	112.2	114.3	97.4	123.2	103.1	104.8	113.0
Imports	128.0	121.4	118.5	101.0	115.6	94.7	102.6	107.9
Contribution of net exports to GDP growth (percentage points) .	-3.2	-2.4	-1.8	-1.0	1.0	2.7	0.5	1.3
	GDP % current prices							
Domestic demand	101.5	104.0	104.9	106.0	106.5	103.7	103.3	102.5
Consumption	81.0	81.0	80.3	81.1	81.9	82.9	84.5	83.7
Capital formation	20.5	23.0	24.6	24.9	24.7	20.7	18.9	18.8
Net exports	-1.5	-4.0	-4.9	-6.0	-6.5	-3.7	-3.3	-2.5

Source: CSO data.

Figure 5

Share of final demand components in the GDP growth



Source: the NBP calculations based on CSO data.

Table 14

GDP and domestic demand dynamics by quarters

	Year	Q1	Q2	Q3	Q4	Q1-4
	Corresponding period of the previous year = 100					
Total value added	2002	100.5	100.8	101.8	101.9	101.3
	2003	102.0	103.8	103.9	104.3	103.5
Industry	2002	96.7	97.9	101.7	102.8	99.8
	2003	104.1	108.1	108.0	109.7	107.6
Construction	2002	85.6	87.9	95.5	93.0	91.4
	2003	80.4	92.6	98.0	99.9	94.9
Market services	2002	104.5	103.9	103.9	103.6	104.0
	2003	103.4	104.6	104.2	104.2	104.1
GDP	2002	100.6	100.9	101.8	102.2	101.4
	2003	102.3	103.9	104.0	104.7	103.7
Domestic demand	2002	99.9	101.0	101.1	101.2	100.9
	2003	102.4	102.1	102.4	102.7	102.4
Total consumption	2002	102.7	102.5	102.8	103.1	102.8
	2003	101.1	102.8	102.9	103.3	102.5
Individual consumption	2002	103.6	103.0	103.2	103.6	103.3
	2003	101.4	103.8	103.5	103.9	103.1

Gross capital formation	2002	82.5	94.5	94.3	96.3	93.2
	2003	112.7	98.4	99.7	100.9	101.8
Gross fixed capital formation	2002	88.1	93.0	95.0	97.3	94.2
	2003	96.4	98.3	100.4	100.1	99.1

Source: CSO data.

The growth in gross capital formation in 2003 resulted from the rebuilding of the levels of tangible current assets after their steep decline in 2002. Meanwhile gross fixed capital formation fell for the third consecutive year. However, the extent of the decline was smaller than a year ago, and in Q3 a slight growth in outlays was noted for the first time in nine quarters. A clear rebound in investment demand was recorded in the corporate sector, particularly in manufacturing.

The individual consumption growth rate in 2003 was slightly lower than year ago and continued to be higher than the growth rate in the purchasing power of household gross disposable income. Despite further deterioration in the situation in the labour market, real incomes from paid employment incomes were higher than a year ago. Social benefits also increased. Apart from higher disposable income, the basic sources of financing the consumption growth in 2003 were the growth in unregistered incomes and the continuing, although weaker than in 2002, decline in household savings. The growth in collective consumption was slower than a year ago.

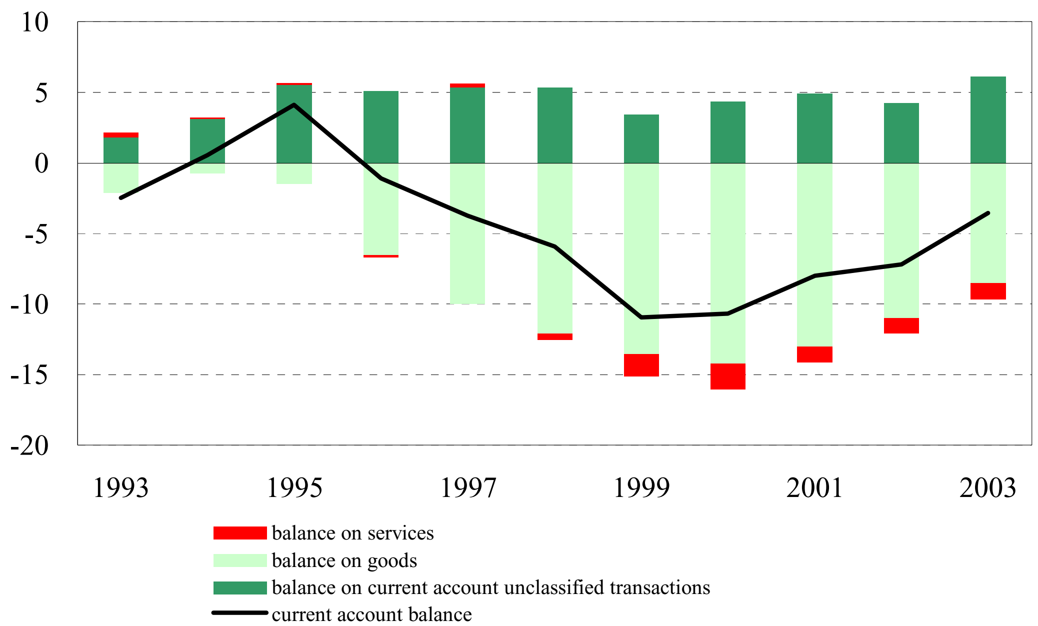
In 2003 the growth rate in exports was high, despite continuing weak external demand. The acceleration in exports and the slowdown in the fall in investment were accompanied by a growth in imports. However, it was slower than the growth in exports and, as a result, the net exports increased, although it remained negative. A further improvement in the external imbalance took place. Foreign savings in relation to GDP fell to 2.1%, from 2.6% in 2002. The decline in the need for foreign savings stemmed from an increase in the gross savings rate in the domestic economy as a result of increased savings in the corporate sector, against a slight decline in capital formation rate.

Appendix 3. External imbalance

In 2003 the current account deficit decreased for the fourth successive year. In 2003 that deficit amounted to EUR 3.5 billion — i.e. it was about EUR 3.7 billion lower than in 2002 and EUR 7.4 billion lower than in 1999. As a result, the current account deficit — as a percentage of GDP — fell during the last four years from 7.5% to 1.9%. The improvement in the current account deficit in 2003 resulted mainly from the reduction in the trade deficit in goods and a growth of surplus in unclassified transactions (Figure 6). On the other hand, the other items of the current account deteriorated its balance — the negative balance in incomes and services went down further and the positive balance on transfers decreased.

Figure 6

Current account balance (on a payment basis) 1993-2003
(billion ECU/EUR)



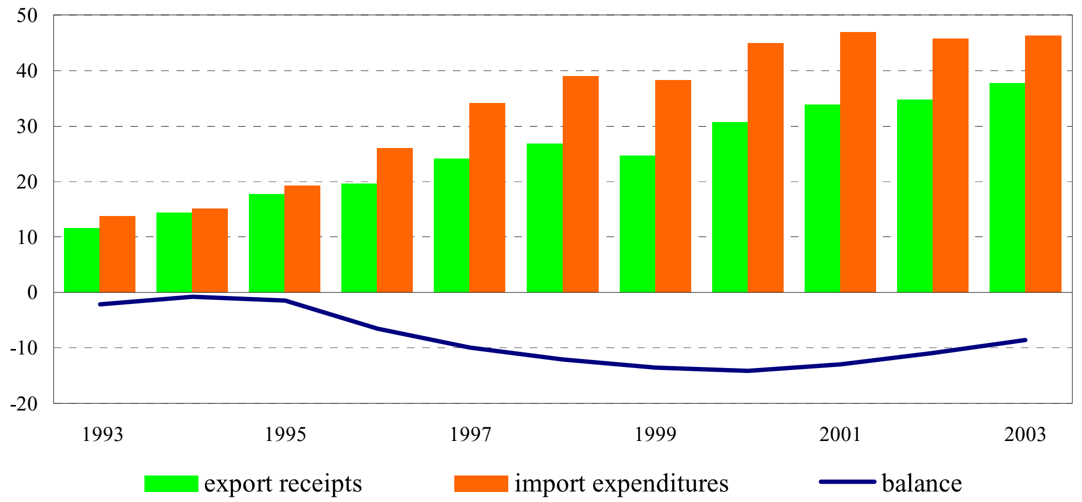
Source: NBP data.

Last year's improvement in the payment balance on goods (by EUR 2.4 billion) as compared to 2002 resulted from a higher growth rate in export receipts than in import expenditures (Figure 7). This stemmed from a strong appreciation of the euro against the US dollar, which lowered the dynamics of turnover expressed in euro against the dynamics in USD and PLN[21].

Figure 7

Export receipts and import expenditures 1993-2003

(annual figures, based on the payment statistics, billion EUR)



Source: NBP data

2003 saw a continuation of the upward trend, started in the second half of 2002, in the export receipts in euro terms. In the second half of 2003, and in Q4 of 2003 in particular, the growth of the export receipts accelerated clearly, while the value of import expenditures displayed a falling tendency during most of 2003, following its temporary growth in the Q4 of 2002. It was only a high growth of imports in December 2003 that contributed to its 2003 value exceeding that reported in 2002.

The acceleration in the exports growth rate stemmed mainly from the increase in sales to Germany, which occurred despite deterioration in the real GDP of that country. It was possible owing to the shift in the German demand towards suppliers offering lower prices, including Poland. Similarly, a growth in sales to the CEE countries was reported in 2003 at 17.1% against 12.5% in 2002.[22] The economic slowdown in the European Union was reflected in a weaker

[21] In 2003, export receipts denominated in EUR increased by 8.7% against 2002 (a 2.7% growth in 2002, and import expenditures grew by 1.3% (a 2.4% fall in 2002). In 2003, the export receipts expressed in USD grew by 30.3% (by 8.8% in 2002) and the value of import expenditures grew by 21.4% (against 3.2% in 2002). The PLN-expressed value of the export receipts in 2003 grew by 24.3% (by 8.2% in 2002) and the value of the import expenditures grew by 15.8% (2.7% in 2002).

[22] In addition, the share of the CEE countries in the Polish exports grew from 12.8% in 2002 to 13.75% in 2003.

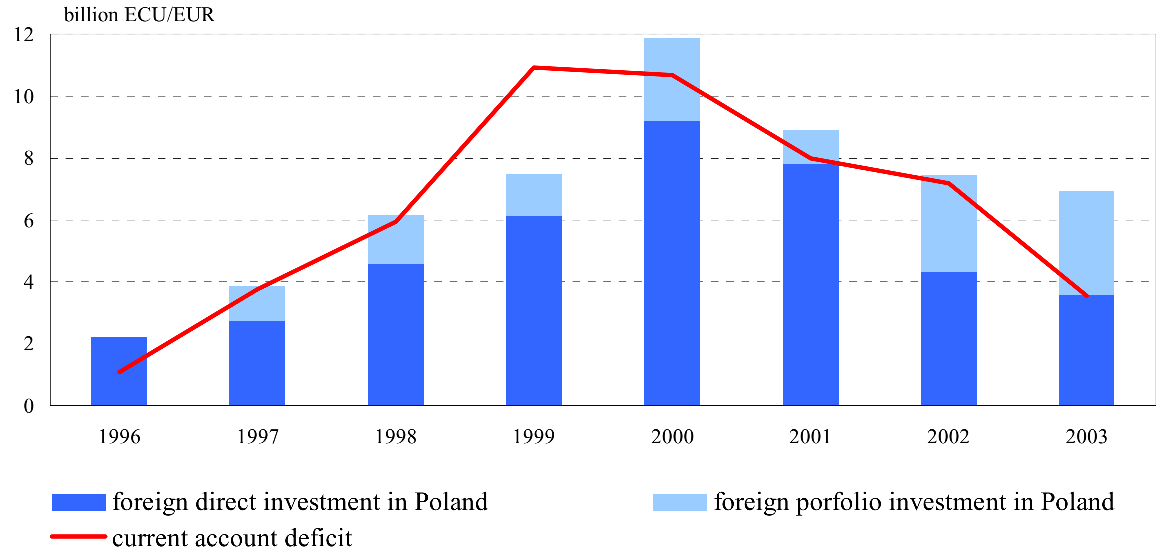
growth (reaching a two-fold decrease against 2002) of the Polish exports to the remaining EU countries (excluding Germany).

In the first six months of 2003, the growth of the Polish exports was determined primarily by the low processed goods (raw materials, in particular); whereas another upturn in the sale of machinery and transport equipment occurred in the second half of 2003.

Good export results recorded in 2003 are a result of the significant improvement in the competitiveness of Polish producers against their foreign partners. This resulted from the restructuring processes which had taken place in companies over recent years, together with the sharp depreciation of the zloty against the euro. The unit labour costs in the corporate sector, in zloty terms, fell by ca. 9% in 2003, as compared to 2002. When combined with the weakening of the zloty against the euro during that period (by 14.1%, respectively), it resulted in the fall in the unit labour costs, as in euro terms, by about 20.2%.

Figure 8

Current account deficit versus foreign investment inflow 1996-2003 – on a cash basis



Source: NBP figures

2003 witnessed an improvement in the financing structure of the current account deficit (Figure 8). In about 92% it was financed by the inflow of the long-term foreign capital in the form of direct investment (against nearly 55% in 2002). The improvement resulted from a marked reduction in the current account deficit. The above-mentioned inflow was concurrent to the inflow of net portfolio investment of EUR 2.2 billion in 2003 against EUR 1.9 billion in 2002.

The majority of selected warning indicators reflecting the risk of turbulences in the financial market resulting from external turbulence and the methods of its financing, improved substantially in 2003. The ratios related to current transactions i.e. the current account balance to the GDP ratio and trade balance to the GDP ratio improved when compared to the figures of the preceding years. An improvement in the ratio determining the extent to which the current account deficit is financed by the inflow of foreign direct investment was also observed, as well as in the ratio between the share of the current account deficit not covered by direct investment and GDP. The indicator of foreign reserves expressed in terms of monthly imports of goods and services remained at a safe level; nevertheless, its deterioration could be observed (Table 15).

Table 15

Selected warning indicators

Warning indicator	**2001**	**2002**	**2003**
Current account balance/GDP	-3,9%	-3,6%	-1,9%
Trade balance/GDP	-6,4%	-5,5%	-4,6%
Direct investment/current account balance	96,9%	55,7%	92,1%
(Current account balance –direct investment)/GDP	-0,1%	-1,6%	-0,2%
Foreign debt servicing/Exports of goods and services	47,3%	43,3%	46,3%
Foreign reserves expressed in terms of monthly imports of goods and services	6,9	6,7	6,3

Source: NBP calculations based on the balance of payment on a cash basis.

Appendix 4. The money supply

M3 money supply grew during 2003 by PLN 18.1 billion, i.e. by 5.6 % in nominal terms and by 3.9 % in real terms . The main reasons for the change in M3 during 2003 were the significant growth of notes and coins in circulation and the strong growth in corporate deposits. The growth of M3 was limited by a decline in household deposits (Table 16).

Table 16

Money supply in 2002 - 2003

Specification	As at Dec 31, 2002	As at Dec 31, 2003	Growth	Annual nominal growth rate	Annual real growth rate [1]
	PLN billion			%	
I. M1 money supply	136.6	158.1	21.5	15.7	13.8
II.M3 money supply	322.0	340.1	18.1	5.6	3.9
1. Notes and coins in circulation (excl. vault cash)	42.2	49.4	7.2	17.1	15.2
2. Deposits and other liabilities	278.0	288.4	10.4	3.7	2.0
2.1. Households	196.3	192.4	-3.9	-2.0	-3.6
2.2. Non-monetary financial institutions	7.3	8.9	1.7	23.3	21.3
2.3. Non-financial corporations	55.0	68.3	13.3	24.1	19.7[2]
2.4. Non-profit institutions serving households	8.3	8.6	0.3	3.7	2.0
2.5. Local governments	8.4	8.8	0.4	4.6	2.8
2.6. Social security funds	2.7	1.4	-1.4	-50.0	-50.8
3. Other M3 components	1.8	2.3	0.5	29.2	27.0

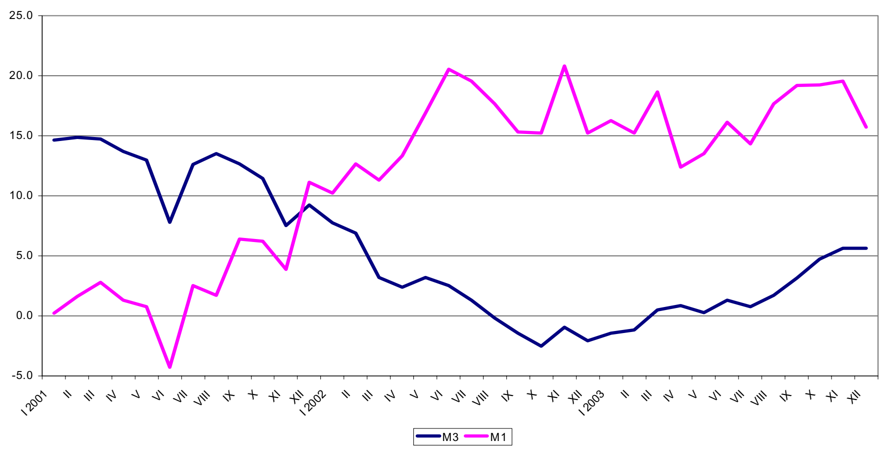
[1] Deflator - CPI
[2] Deflator - PPI

Source: NBP data.

The modest growth in the broad M3 aggregate was accompanied in 2003 by a steep rise in the M1 aggregate, including notes and coins in circulation and demand deposits in the banking sector (Figure 9). The significant growth of this aggregate in 2003 reflected a tendency, observable for the past two years, of increasing the share of higher liquidity components in the term structure of money supply. However, to a large extent, the growth of the M1 aggregate stemmed from a change in the methodology of its calculation, namely through the inclusion of tomnext and spotnext deposits in current deposits[23]. The share of M1 in the M3 aggregate increased from 42.4% in December 2002 to 46.5% in December 2003.

Figure 9

Annual nominal growth of M1 and M3



Source: NBP data

The growth in the notes and coins in circulation in 2003 amounted to PLN 7.2 billion (17.1%) and was much higher than in previous years. The annual growth rate of this category remained high throughout 2003. The fundamental factor which influenced the high rise in currency in circulation and in M1 aggregate was a lower alternative cost of high-liquidity financial assets maintenance, as a result of a decrease in interest rate on bank deposits. In addition, one of the factors generating a rise in notes and coins in circulation in 2003 was the net purchase of foreign currency by banks from exchange offices and individuals, amounting to USD 7.4 billion (against USD 4.6 billion in 2002).

Corporate deposits, which constitute another component of the M3 aggregate, grew by PLN 13.3 billion in 2003, with the annual growth rate of this category at 24.1%, i.e. very high when compared to the growth rate of preceding years. Household deposits included in the M3

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[23] Overnight deposits made on the working day following the transaction date ("tomnext") or on the second working day following the transaction date ("spotnext").

aggregate fell by PLN 3.9 billion in 2003, with their annual growth rate remaining negative since July 2002 to reach -2.0% at the end of 2003.

Q4 saw a reversal of the increasing trend of the financial assets held by households as an alternative to bank deposits. In the last quarter of 2003, these savings, including investment fund units, government bonds, Treasury bills and Credit Unions deposits, fell. It was accompanied by a simultaneous increase in household deposits. The broad M3 aggregate increased by the above-outlined alternative savings, grew by 6.7% in 2003.

Furthermore, changes in deposits in 2003 were influenced by the zloty exchange rate fluctuations, leading to approximately PLN 0.8 billion overestimation of the corporate deposits growth and approximately PLN 1.3 billion underestimation of household deposits fall.

In 2003, total growth in claims of the banking system on non-banking entities amounted to PLN 19.7 billion, i.e. by 8.1% in nominal terms and by 6.3% in real terms (Table 17).

Table 17

Claims of the banking system 2002-2003

Specification	**As at Dec 31, 2002**	**As at Dec 31, 2003**	**Growth**	**Annual nominal growth rate**	**Annual real growth rate [1]**
	PLN billion			%	
Total claims:	244.4	264.1	19.7	8.1	6.3
1. Households	89.8	102.0	12.2	13.6	11.7
2. Non-monetary financial institutions	10.3	11.3	1.0	9.2	7.4
3. Non-financial corporations	129.5	132.2	2.7	2.1	-1.5[3]
4. Non-profit institutions serving households	1.0	0.8	-0.2	-17.6	-19.0
5. Local governments	11.3	12.9	1.6	14.0	12.1
6. Social security funds	2.4	4.8	2.4	99.8	96.5

[1]Credits and loans, collected debt, realised guarantees and endorsements, matured interest – outstanding, claims from repo transactions, debt securities, and other claims, excluding securities with equity rights, and shares.
[2] Deflator - CPI
[3] Deflator - PPI

Source: NBP data.

In 2003, the main source of growth in total claims was the growth in claims on households of PLN 12.2 billion (13.6%), almost entirely triggered by a rapid growth in the housing loans volume. The value of housing loans to households increased in the period between December 2002 and December 2003 by PLN 9.5 billion (47.5%) owing to the interest rate reduction on these loans, a prospective growth of fiscal burden in the housing and construction market transactions in 2004, and demographic factors. The share of housing loans in overall loans rose from 23.2% in December 2002 to 30.1% in December 2003.

The growth in the claims on enterprises in 2003 ranked among the lowest reported in the recent years, with its annual growth rate of 2.1% in December 2003. The NBP's business tendency survey points to low demand for products and services, delays in payment, exchange rate fluctuations and unstable fiscal regulations as the largest barriers preventing increase in the corporate lending activity. Interest rates level, on the other hand, does not constitute a considerable obstacle to access to loans for the enterprises.

As far as other categories of claims are concerned, 2003 witnessed a marked growth in claims on the social security funds (by PLN 2.4 billion, i.e. 99.8%) and on local governments and non-monetary financial institutions of PLN 1.6 billion (14%) and PLN 1.0 billion (9.2%), respectively. The growth was concurrent to a fall in the claims on non-profit institutions serving households (of PLN 0.2 billion, i.e. by 17.6%).

The change in the claims in 2003 was highly affected by the zloty depreciation. The nominal increase in the claims on the corporate sector stemmed entirely from exchange rate fluctuations. Adjusted for exchange rate fluctuations, the claims on the corporate sector would fall by approximately PLN 0.5 billion. In the household sector, exchange rate shifts overestimated the growth of claims by approximately PLN 3.5 billion.

Appendix 5. The voting of the MPC members on motions and resolutions adopted in 2003. [24]

Date of resolution	Subject	The MPC decision	Results of the MPC Members' votes
Jan 29, 2003.	Motion to reduce all interest rates by 0.5 percentage point	The motion failed to obtain a majority	**In favour:** J.Krzy ewski D.Rosati G.Wójtowicz W.Ziółkowska **Against:** L.Balcerowicz M.D browski B.Grabowski CA.Józefiak W.Ł czkowski J.Pruski
Jan 29, 2003.	Resolution on the rediscount rate, the reference rate, interest on refinancing loans and interest on term deposits at NBP	All interest rates were reduced by 0.25 percentage point	**In favour:** L.Balcerowicz B.Grabowski CA.Józefiak J.Krzy ewski W.Ł czkowski D.Rosati G.Wójtowicz W.Ziółkowska **Against:** M.D browski J.Pruski
Feb25, 2003.	Resolution on "Monetary Policy Strategy beyond 2003"		**In favour:** L.Balcerowicz B.Grabowski CA.Józefiak J.Krzy ewski W.Ł czkowski J.Pruski D.Rosati G.Wójtowicz **Against:** M.D browski W.Ziółkowska was not present at the meeting

[24] With the exception of the resolution of Sep 30, 2003 on defining the upper limit for liabilities resulting from the loans taken out by NBP in foreign banking and financial institutions.

Feb 26, 2003.	Motion to reduce the reference rate by 0.5 percentage point, interest on refinancing loans by 1 percentage point and to leave the interest on terms deposits at the NBP unchanged	The motion failed to obtain a majority	**In favour:** D.Rosati G.Wójtowicz **Against:** L.Balcerowicz M.D browski B.Grabowski CA.Józefiak J.Krzy ewski W.Ł czkowski J.Pruski W.Ziółkowska was not present at the meeting
Feb 26, 2003.	A resolution on the rediscount rate, the reference rate, interest on refinancing loans and interest on term deposits at NBP	A reduction in the reference rate by 0.25 percentage point, the rediscount rate and the interest on refinancing loans by 0.5 percentage point and to leave the interest on term deposits at NBP unchanged	**In favour:** L.Balcerowicz B.Grabowski J.Krzy ewski J.Pruski D.Rosati G.Wójtowicz **Against:** M.D browski CA.Józefiak W.Ł czkowski W.Ziółkowska was not present at the meeting
March 26, 2003.	A resolution on the rediscount rate, the reference rate, interest on refinancing loans and interest on term deposits at NBP	All interest rates were reduced by 0.25 percentage point	**In favour:** L.Balcerowicz B.Grabowski J.Krzy ewski W.Ł czkowski D.Rosati G.Wójtowicz W.Ziółkowska **Against:** M.D browski CA.Józefiak J.Pruski
Apr 23, 2003.	Resolution on approving the NBP financial statement as at 31 December 2002		**In favour:** L.Balcerowicz M.D browski CA.Józefiak J.Krzy ewski W.Ł czkowski J.Pruski D.Rosati G.Wójtowicz W.Ziółkowska B.Grabowski was not present at the meeting

Apr 24, 2003.	Motion to reduce the reference rate by 0.5 percentage point	The motion failed to obtain a majority	**In favour:** D.Rosati G.Wójtowicz W.Ziółkowska **Against:** L.Balcerowicz M.D browski CA.Józefiak J.Krzy ewski W.Ł czkowski J.Pruski B.Grabowski was not present at the meeting
Apr 24, 2003.	Motion to reduce the reference rate by 0.25 percentage point	The motion failed to obtain a majority	**In favour:** L.Balcerowicz J.Krzy ewski G.Wójtowicz **Against:** M.D browski CA.Józefiak W.Ł czkowski J.Pruski D.Rosati W.Ziółkowska B.Grabowski was not present at the meeting
Apr 24, 2003.	Motion to reduce the reference rate by 0.25 percentage point, the interest on refinancing loans by 0.5 percentage point and to leave the interest on term deposits with NBP unchanged	The motion succeeded to obtain a majority	**In favour:** L.Balcerowicz J.Krzy ewski D.Rosati G.Wójtowicz W.Ziółkowska **Against:** M.D browski CA.Józefiak W.Ł czkowski J.Pruski B.Grabowski was not present at the meeting
Apr 24, 2003.	A resolution on the rediscount rate, the reference rate, interest on refinancing loans and interest on term deposits at NBP	A reduction in the reference rate by 0.25 percentage point, the interest on refinancing loans by 0.5 percentage point, the rediscount rate by 0.25 and to leave the interest on term deposits at NBP unchanged	**In favour:** L.Balcerowicz J.Krzy ewski D.Rosati G.Wójtowicz W.Ziółkowska **Against:** M.D browski CA.Józefiak W.Ł czkowski J.Pruski B.Grabowski was not present at the meeting
May 27, 2003.	Resolution on approving the report on the monetary policy implementation in 2002		**In favour:** L.Balcerowicz M.D browski B.Grabowski

			CA.Józefiak J.Krzy ewski W.Ł czkowski J.Pruski G.Wójtowicz **Against:** D.Rosati W.Ziółkowska
May 27, 2003.	Resolution on assessing the activities of the NBP Management Board as regards the monetary policy implementation in 2002		**In favour:** L.Balcerowicz M.D browski B.Grabowski CA.Józefiak J.Krzy ewski W.Ł czkowski J.Pruski D.Rosati G.Wójtowicz W.Ziółkowska
May 27, 2003.	Resolution on approving the report on NBP operations in 2002		**In favour:** L.Balcerowicz M.D browski B.Grabowski CA.Józefiak J.Krzy ewski W.Ł czkowski J.Pruski D.Rosati G.Wójtowicz W.Ziółkowska
May 28, 2003.	A resolution on the reference rate, rediscount rate, interest on refinancing loans and interest on term deposits at NBP	All interest rates were reduced by 0.25 percentage point	**In favour:** L.Balcerowicz J.Krzy ewski D.Rosati G.Wójtowicz W.Ziółkowska **Against:** M.D browski B.Grabowski CA.Józefiak W.Ł czkowski J.Pruski
June 25, 2003.	Resolution on the reference rate, interest on refinancing loans, interest on term deposits, and the rediscount rate at the NBP	All interest rates were reduced by 0.25 percentage point	**In favour:** L.Balcerowicz J.Krzy ewski D.Rosati G.Wójtowicz W.Ziółkowska **Against:** M.D browski B.Grabowski CA.Józefiak W.Ł czkowski J.Pruski
Aug 27, 2003.	Motion to reduce all interest rates by 0.25 percentage point	The motion failed to obtain a majority	**In favour:** J.Czekaj D.Rosati G.Wójtowicz W.Ziółkowska

			Against: L.Balcerowicz B.Grabowski CA.Józefiak W.Ł czkowski J.Pruski M.D browski was not present at the meeting
Sep 30, 2003.	Resolution on establishing the monetary policy guidelines for 2004		**In favour:** L.Balcerowicz J.Czekaj B.Grabowski CA.Józefiak W.Ł czkowski J.Pruski G.Wójtowicz W.Ziółkowska **Against:** M.D browski D.Rosati was not present at the meeting
Sep 30, 2003.	Resolution on the mandatory reserves rate		**In favour:** L.Balcerowicz J.Czekaj M.D browski CA.Józefiak W.Ł czkowski G.Wójtowicz W.Ziółkowska **Against:** B.Grabowski J.Pruski ***D.Rosati was not present at the meeting***
Nov 26, 2003.	Motion to change the monetary policy bias from neutral to restrictive	The motion failed to obtain a majority	**In favour:** M.D browski B.Grabowski J.Pruski **Against:** L.Balcerowicz J.Czekaj CA.Józefiak W.Ł czkowski D.Rosati G.Wójtowicz W.Ziółkowska
Dec 16, 2003.	Resolution on approving the NBP financial plan for 2004		**In favour:** L.Balcerowicz J.Czekaj M.D browski B.Grabowski CA.Józefiak W.Ł czkowski J.Pruski D.Rosati G.Wójtowicz W.Ziółkowska
Dec 16, 2003.	Resolution on accounting policies, the structure of the assets and liabilities in the balance sheet and the profit and loss account of NBP		**In favour:** L.Balcerowicz J.Czekaj B.Grabowski CA.Józefiak W.Ł czkowski J.Pruski D.Rosati G.Wójtowicz

			W.Ziółkowska **Against:** M.D browski
Dec 16, 2003.	Resolution on creating and unwinding provisions against the FX risk of the zloty against foreign currencies at NBP		**In favour:** L.Balcerowicz J.Czekaj M.D browski B.Grabowski CA.Józefiak W.Ł czkowski J.Pruski D.Rosati G.Wójtowicz W.Ziółkowska
Dec 17, 2003.	Motion to change the monetary policy bias from neutral to restrictive	The MPC Chairman's vote decided that the motion would not be voted upon	**In favour:** M.D browski B.Grabowski CA.Józefiak W.Ł czkowski J.Pruski **Against:** L.Balcerowicz J.Czekaj D.Rosati G.Wójtowicz W.Ziółkowska