

Warsaw, 27 April 2004

## **INFORMATION FROM A MEETING OF THE MONETARY POLICY COUNCIL**

**Held on 26-27 April 2004**

On 26-27 April 2004 the Monetary Policy Council held a meeting. The Council read materials prepared by the Management Board and the NBP Departments, as well as information and analytical materials prepared by the Ministry of Finance, banks and research institutes. The Council discussed the external environment of the Polish economy as well as real trends, trends in payments and social welfare benefits, trends in the public finance sector, trends in the money supply, loans and interest rates, and the formation of pricing and inflationary expectations as well as inflationary prospects.

**An analysis of the economic situation indicates that in last period there was a significant increase in inflationary expectations. This is a result of supply shocks, increased demand pressure and changes to the price structure caused by Poland's EU entry. Although some of these factors have a transitory character, the observed economic revival, which in itself is an inflationary risk factor, gives rise to fears that these expectations may become persistent and as a result there may be a risk of exceeding the upper limit of the inflationary target.**

**Taking these factors under consideration the Council decided to change its monetary policy approach to restrictive and decided not to change the level of interest rates, maintaining the reference rate at 5.25%, the lombard rate at 6.75% and the NBP deposit rate at 3.75%.**

In March 2004 the annual CPI indicator was 1.7%, as in January 2004. The annual base inflation indicator was from 1.1% to 1.7%

#### **I. Factors favoring low inflation:**

- continued moderate money supply level; annual rate of growth of the M3 aggregate increased by 5.7% in March 2004 against 4.9% in February 2004,
- continued low growth rate in corporate loans; its annual growth rate in March 2004 was at -0.4% against 2.3% in February 2004. The annual loan growth rate for households was at 13% against 14.2% in February of this year
- accelerated growth of labour efficiency in the corporate sector; it increased in industry as a whole by 24.5% on an annual basis (19.4% in February of this year), while in the processing industry by 28.0% (in February of this year by 23.7%). At the same time, an analysis of employment on the basis of the Study on the Economic Activity of the Population may signal that the actual rate of growth of employment in the corporate sector is probably higher than its rate of growth calculated on the basis of data from corporate statistics. This may indicate that there is an actually lower increase in labour efficiency.

#### **II. Factors giving rise to an increase in inflation risk:**

- consecutive month of an observed growth in inflationary expectations. Individual inflation rate expectations on a 12-month basis increased from 1.6% in December 2003 to 2.5% in April of this year. The inflation forecast of bank analysts on an 11-month basis increased from 2.5% to 2.9% respectively. At the same time there was a strong increase in the general condition indicator, illustrating price expectations in retail trade, which had the highest value since November 1999.
- The Polish economy is currently in a revival phase, stimulated by rapidly increasing export. There are indications of renewed investment activity. The fastest since January 2001 increase in the salaries fund may be

larger than that of last year. NBP estimates that the GNP rate of increase in the first quarter will be 6.4% while the GNP for the entire 2004 should be above 5%, which indicates a faster than expected closing of the demand gap,

- according to an April GUS study, the general condition of the processing industry was the highest for the entire period studied, i.e. from 1992. There was a less pessimistic assessment of the condition in construction and trade than in the previous month,

- increase in construction-assembly production, significant improvement of corporate financial results, increase of investments in the processing industry and observed significant increase in the sale construction materials indicates the possibility of increasing investment expenditures in the economy. Furthermore, NBP studies regarding the general condition of enterprises indicates an increase in the percentage of enterprises declaring a start of new investments. This indicator had the highest value since 1999.

- amongst the supply shocks influencing an increase in inflation growth the price of foodstuffs in 2004 carries with it the greatest risk and it may be greater than that indicated in actually available forecasts. This indicates, amongst others, as signaled in the GUS study of the general condition, foodstuff price increases in April of this year and expectations of further, significant increase of those prices in the next few months, as formulated by food selling businesses. In the first half of April food prices increased by 2.3% in comparison with the first half of March of this year, i.e. significantly stronger than expected,

- growth in the PPI indicator which increased in March 2004 by 1.3% and was 4.6% on an annual basis, which is the highest growth rate since January 2001. The increase of this indicator was foremost a result of an increase in obtained export prices. Nevertheless, the NBP estimates indicate also a significant increase in prices obtained by producers on the domestic market,

- increase in the forecast oil prices. Current forecast of the average annual price of oil in 2004 was increased by 0.7 USD/b in comparison with that forecast in March 2004. From September 2003 to April 2004 the forecast oil prices increased from 26.0 USD/b to 31.4 USD/b,

- high budget deficit, increasing governmental loan requirements, and political instability are the source of continued uncertainty on financial markets leading to an increase in the yield of treasury securities and the weakening of the zloty exchange rate. In the last 12 months there has been a clear weakening of the zloty; it weakened against the euro by 11% and 3.5% against the USD that in conditions of a closing demand gap may lead to inflationary pressure,

- increasing political instability that may reduce the likelihood of passage of laws necessary for the recovery of public finances. According to current NBP estimates, it is very likely that the second prudential threshold, i.e. 55% of the GDP, will be exceeded already in 2004.

The next meeting of the Council will take place 18 May 2004.

## External factors

Data indicating a strong increase in new places of work in the US economy in March of this year had a positive effect on market climate. There was an improvement in the indicators reflecting both business confidence and American consumer confidence. March of this year also noted a significant increase in the rate of retail growth.

There was no improvement, however, in the main indicators of economic confidence in the euro area. Data regarding retail trade activity and household confidence confirm the continuance already for two years of a weak consumer demand in this region. There are especially unfavorable indicators of the current condition in Germany. March saw a worsening of expectations amongst German consumers, the IFO Institute indicator was lowered and there was a continued negative rate of growth in retail sales.

In light of increasing signs of economic upturn in the US economy there has been an increase in market expectation of a rates hike by the FRB – currently most analysts expect such a decision in the third quarter of this year.

In March 2004 the average price of Brent oil was 33.8 USD/b and was the highest since October 1990. Contrary market expectations and despite continuance of high oil prices, OPEC confirmed its decision to lower its extraction limits by 1 million barrels beginning from April of this year. At the same time, as a result of political risk the markets are fearful of continued supply of oil from Iraq. Also, information on a decrease in oil supplies in the US contributed to an increase in oil prices.

In April of this year the Department of State for Energy increased its forecast of oil prices for 2004 to 31.4 USD/b (an increase of 0.7 USD/b in comparison with the forecast for March 2004).

## Economic situation in Poland

In February 2004 there was a further decrease in the current account deficit. In comparison with February of last year it decreased by EUR 520 million and amounted to EUR 210 million. The decrease in the negative current account balance was foremost an influence of the positive balance of services (as a result of a high increase in their export which on the basis

**Improvement of confidence in the US economy, lack of improvement in the euro area**

**High oil prices on world markets**

**Improvement in current account**

of transactions was the highest balance noted) and a deficit decrease in the turnover of goods. Also, the positive transfer balance was higher than in comparison with the previous year. However, a deepening current account deficit was influenced by an increased earnings deficit.

**balance**

The negative balance in the turnover of goods decreased in February 2004 by EUR 230 million which was a result of a continuation of a higher export growth rate (13.4% in comparison with February 2003) than for import (increase of 6.5%). From the beginning of this year current account deficit has already decreased by EUR 1.1 billion. In the course of the first two months of this year all the positions positively influenced the improvement in current account balance with the strongest deficit decrease in the turnover of goods and a surplus increase in the exchange of services. In the period January – February 2004 the export value increased by 8.6%. Equally the rate of export growth as well as that of import was more than twice higher in comparison with the first two months of 2003 (then the export value increased by 7.2% and that of import by 3.3%).

Industrial production increased in March 2004 by 23.8% in comparison with March 2003. The high growth trend in industrial production on the whole continued to be a result of very strong sales in the processing industry whose volume exceeded the level of last year by 27.9%. A strong increase in the production growth rate resulted partly from differences in number of working days – March had 23 working days in comparison with 21 days in the previous month. After eliminating the influence of seasonal factors the increase in production on the whole was 18.3% while in the processing industry 21.6%. For the first time since June 2000 (with the exception of a single increase in July 2003) a production increase of 6.3% on an annual basis in construction-assembly was noted in March of this year. In the 1<sup>st</sup> quarter of 2004 construction-assembly production was lower by 4.3% than in the previous year.

**Industrial  
production  
growth in  
March, higher  
than expected**

According to GUS data, the average salaries growth in the enterprise sector in March of this year in comparison with February of this year was nominally 2.1% (1.8% in real terms). In comparison with March 2003 this increase was nominally 7% (4.9% in real terms). On an increasing balance in the period January – March 2004 the average salary in the enterprise sector increased nominally by 5.5% (3.5% in real terms) while in the analogous period of 2003 this increase was 1.9% (1.4%) respectively.

At the same time there has been an accelerated increase in labour efficiency; increase of

24.5% (19.4% in February of this year) on an annual basis in industry as a whole, while in the processing industry by 28.0% (23.7% in February of this year).

According to GUS data from enterprise reporting the number of those employed in 2003 dropped by 2.7%. However, an analysis of the data from the Study on the Economic Activity of the Population indicates that the number of those employed in the economy (taking into account those enterprises employing from 1 to 9 workers) may have increased in 2003. An increase in employment may have concerned the more flexible forms of employment that are not reflected in data reported to GUS by enterprises. Also, estimates of the increase in labour efficiency on the basis of enterprise statistics may be higher than the actual increase in labour efficiency.

**Salaries  
growth in  
enterprise  
sector**

### **Condition of public finance sector**

In the 1<sup>st</sup> quarter of 2004 the combined state budget revenue was higher compared to the analogical period last year (7.8%) which is a good result in face of its forecast annual increase (1.2%). The degree of annual revenue plan realization was also higher than last year's level (23.3% as against 21.4% in the previous year).

The high increase in indirect taxes (9.5% year on year), especially VAT, had the greatest influence by far on the formation of the state budget revenue in the period from the 1<sup>st</sup> to 3<sup>rd</sup> quarters of this year. Especially strong influence from this title in February and March of this year demonstrate an increase in retail sales stemming probably from increasing domestic demand and an increase in imports in connection with tax changes from May 1 of this year. There were also higher inflows from the CIT tax (28.7% year on year) that is probably a result of the corporate financial situation.

The state budget expenditures after March of this year were nominally lower by 2.1% than the expenditures last year. This was connected with a lack of need of subsidy for the FP (Labour Fund) from the beginning of this year, lower costs for servicing the public debt and a slower realization of subvention for FUS (Social Security Fund) in February of this year. As a result, the degree of realization of the annual revenue plan of budgetary expenditures reached 23.9% which means significantly less than in the previous years.

**Lower than in  
2003 advance  
in  
expenditures  
and state**

As a result of a favorable earnings situation and limitation of budgetary expenditures, the

state budget deficit was after March of this year at a level of PLN 11.8 billion (26.1% of that and state planned), hence significantly lower than in the same period last year. (39.8%). budget deficit

Despite the good results of the state budget after March of this year, the key period for after three realizing the state financial plan will be the months of May to July of this year due to the months of expected loss of earnings and increase in expenditures connected with the introduction from 2004 May 1 of settlements with the EU budget.

### **Money supply, loans, interest rates, exchange rate**

According to figures presented in forward information, in March 2004 the M3 money supply increased by PLN 2.1 billion (0.6%) in comparison with February of this year. The significant weakening of the zloty had a great influence on the money supply in March of this year. After eliminating the influence of fluctuating exchange rates, the monthly growth rate of M3 aggregate amounted to PLN 2.9 billion (0.9%). The annual growth rate of the M3 aggregate was 5.7%

A change in the M3 supply stemmed to a great extent from an increase corporate deposits. In March 2004 they increased by PLN 3.3 billion (5.2%). There was foremost an increase in zloty deposit categories while there was an increase in solely means that were deposited on current accounts. The annual rate of growth in this category continues from September of last year at a level of above 20%, amounting in March of this year to 28.5%.

In March of this year household deposits, after one month's period of increase in the previous month, decreased by PLN 2.1 billion (1.1%). After removing the influence of exchange rate fluctuations their decrease amounted to PLN 1.5 billion (0.8%). In March 2004 there was a collapse in the increasing annual growth trend of household deposits which decreased from 1.3% in February of this year to - 2.1% in March of this year. One of the main factors influencing an outflow in household deposits was a renewed interest in investment fund deposits. A positive balance in payments, unit redemptions and investment certificates amounted to about PLN 0.5 billion and was the highest since August 2003.

The state of cash in circulation outside of bank tills increased in March of this year by PLN 0.3 billion (0.6%). The annual rate of growth of cash in circulation amounted to 13% (16.0% in February of this year).

Household loans increased nominally by PLN 0.8 billion (0.7%). After taking account of the influence of exchange rate fluctuations this increase amounted to PLN 1.5 billion (1.4%). The annual growth rate amounted to 13.0% (14.2% in February) that is connected with a strong zloty depreciation in the previous year. A decrease in corporate loans in March of this year by PLN 0.9 billion (0.7%) stemmed entirely from the zloty appreciation. After eliminating the influence of exchange rate fluctuations, the level of corporate indebtedness in the banking sector did not register a change. For the first time since May 2002 the annual growth rate in corporate indebtedness reached a negative value which was – 0.4% which as in the case of household deposits was connected with the significant zloty depreciation last year

**Low growth  
rate for  
corporate  
loans**

In the period of 18 March to 22 April 2004 the zloty weakened against the euro by 0.6% and 3.5% against the dollar (from the beginning of the year the EUR/PLN and USD/PLN exchange rates rose by 1.1% and 7% respectively). In the last twelve months the zloty weakened against the euro by 11% and 3.5% against the dollar.

**Zloty  
depreciation  
in April**

Uncertainties resulting from political risk and existing threat to the continuation of indispensable public finances reforms had a strong effect on the money market situation which contributed to a depreciation trend for the zloty in April of this year, despite an improvement in the external equilibrium (deficit on the current account) and inflow of portfolio capital on the bonds and shares markets.

Fluctuation in benchmark bond prices increased from the last meeting of the MPC. The yield on 2-year, 5-year and 10-year bonds increased in this period by 51, 52 and 44 b.p. respectively (from the beginning of the year this change was 80, 52 and 54 b.p. respectively).

In addition to the exchange rate, factors that decisively influence this tendency were both of a global and domestic character. In the 1<sup>st</sup> quarter of April the yield on Polish bonds followed bond yields on international markets. In the second half of the month the drop in bond prices was a result of the publication of better than expected industrial production data. This increased expectations of a rates hike. The continuance of a difference in the yield of 5 and 10-year bonds at a high level in respect to an analogical euro bond area demonstrates that investment on the Polish market is considered to be very risky.

## **Prices, inflationary expectations**

In March 2004 the annual CPI was 1.7% (1.6% in February). In comparison with March 2003, the highest increase in prices was in foodstuffs and non-alcoholic beverages (3.3%), prices for apartment usage and power carriers (2.9%) prices in alcohol and tobacco products (2.3%). Prices of clothing and footwear, however, were lower than in March 2003

After a higher than expected increase in the price of foodstuffs in the first half of April one can forecast that the inflation will increase in April of this year to a level of 2,2% on an annual basis.

The net inflation in March 2004 on an annual basis amounted to 1.1%, as in February of this year.

There was an increase of 4.6% in the PPI in March of this year in comparison with the analogical period in 2003 (4.2% in February). The annual growth rate of the PPI continued at its highest level since January. The indicator of prices of industrial production sold in March of this year is a result of the continuation of a growth trend in the mining and excavation sector, especially in iron ore excavation which is connected with price increases of copper on world markets. The average price of a ton of copper on the London exchange in March of this year was once again the highest since November 1995 – USD 3009/t (an increase of 10% in one month and above 81% in comparison with March 2003).

There has been an increase in the inflation expectations of individuals. The inflation rate expectations of individuals in April of this year, within the next 12 months, amounts to 2.5% (by 0.1 point percentage more than in the previous month). Bank analysts forecast that in December 2004 the inflation rate will be 2.6% (a drop of 0.1 point percentage), in March 2005 at 2.9% (increase of 0.1 point percentage), while the average annual rate of inflation in 2005 at 2.8% (no change).

**Increase in  
inflation  
expectations**