Warsaw, 25 February 2004

INFORMATION FROM A MEETING OF THE MONETARY POLICY COUNCIL

Held on 24-25 February 2004

On 24-25 February 2004 the Monetary Policy Council held a meeting. The Council read materials prepared by the Management Board and the NBP Departments, and 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 and prices expectations as well as inflationary prospects.

In January 2004 the annual CPI indictor was 1.7% as in December 2003.

The economic data for the period since the last Monetary Policy Council meeting of January 2004 indicate:

I. Continuing presence of some factors supporting the continuation of a low inflation level:

- continued moderate money supply level; annual rate of growth of the M3 aggregate increased by 5.1% in January 2004 against 5.6% in December 2003,
- continued low growth rate of loans in the economy. Annual rate of growth rate in corporate loans in January 2004 was at 2.6% against 2.1% in December of last year, with 13.8% and 13.6% for household loans respectively,
- after acceleration of salary growth trends in December, the January statistics do not confirm a weakening of corporate salaries discipline. The annual growth trend in the average monthly gross corporate salary in the corporate sector has decreased from 5.1% in December of last year to 3.5% in January of this year.

II. Growth trends in the economy are clearly consolidating. The Polish economy is currently in a revival phase. If the consumption trend is maintained at a level close to that of 2003, one can expect a continuance of growth trends in the economy for the next few years. This will gradually increase inflationary pressure.

- according GUS data the GDP rate of growth in the 4th quarter of 2003 was at 4.7%, while for the entire 2003 it was 3.7%,
- in January 2004, as compared to January 2003, industrial production was as a whole greater by 14.3%, with 17.9% for the processing industry. After seasonal trends, the growth in production as a whole was 16.6%, with 20.7% in the processing industry. The growth trend in production became stronger both in the processing industry (with the annual growth rate of the trend at 16.8%) and in industry as a whole (13.0%),
- growth trend of investment in the economy has not been reported, however, one observes a clear growth trend of investment in the processing industry; in the course of three quarterly periods in 2003, investment expenditures in the processing industry increased in current prices by 19.6%,
- results of February survey on the general condition of enterprises indicates continuing improvement in the general market trends of the processing industry,
- retail sales growth of 7.6% was reported in January 2004,
- growth of exports; in accordance with payments statistics in 2003, there was a 8.7% growth of exports denominated in euro and 30.3% growth of exports denominated in USD, while in 2002 this growth was respectively 2.7% and 8.8%,
- there are continuing signs of an economic revival in the USA and Japan that may contribute to a moderate revival in the euro area and at the same time influence a growth in external demand.

III. There has been no change to the importance of factors hampering the stabilisation of inflation at a low level. The Council re-emphasises that the most important of these is the condition of public finance.

A high budget deficit, rapid growth in public debt, increasing loan requirements and uncertainty as to the present situation and prospects for pubic finance are the cause of the weakening the exchange rate of the zloty and the increasing profitability of treasury securities. As of the last meeting of the Council on 21- 23 January of this year, the zloty weakened against the euro by 3.2% and 3.8% against the USD.

The Council re-emphasises, that fundamental, swift and effective reforms leading to recovery of public finance are indispensable for avoiding debt build-up that threatens exceeding prudential thresholds specified in the Public Finance Act and which would prevent rapid economic growth and unemployment reduction. According to current NBP estimates, there is likelihood of exceeding the second prudential threshold i.e. 55% of the GDP in 2004.

Against this background, the Council notes with disquiet those decisions of the Sejm that worsen the condition of the state budget for 2004 and in following years. It is also disquieting that there is a possibility of delays in privatisation that will cause an even faster growth in public debt.

IV. Other possible factors of inflationary pressure:

- High growth rate of cash in circulation. In January 2004 the annual rate of growth of this aggregate was 16.5% (17.1% in December of last year),
- Further growth in oil prices. Actual forecast of the average annual price of oil in 2004 has been increased by 1.1 USD/b in comparison with the January 2004 forecast,
- Systematic growth in the PPI indicator which in January reached a level of 4.2%,
- Growth in price of foodstuffs in 2004 which may be greater than is indicated in actually available forecasts,
- Growth in inflationary expectations reported in the course of the past three months and worsening of response structure to survey questions.

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The Council re-affirmed the basic conditions contained in the **Monetary Policy Strategy beyond 2003**:

- Monetary policy will be conducted within the framework of direct inflation targeting strategy (DIT). Floating exchange rate system should be maintained until the moment of entering ERM2,
- The Council re-affirms that the aim of monetary policy is targeted to attain a stable inflation rate of 2.5% with a permissible volatility band of +/-1 percentage point,
- The Monetary Policy Council is convinced that Poland would profit the most from the adoption of an economic strategy that fosters optimum conditions for the introduction of the euro at the earliest date possible.

Decision of the Monetary Policy Council:

- **The Council resolved: <u>to leave the monetary policy parameters unchanged and maintain its neutral approach to monetary policy, though it does not exclude adopting a restrictive approach at the next meeting.</u>**

The next meeting of the Council will take place 30 – 31 March 2004

External factors

Stronger revival signals in the global economy

In January 2004 there was a consolidation of revival signals in the global economy. There was a rapid increase in the USA of the so-called leading indicators. There has been an improvement in economic confidence amongst businesses and households which is confirmed by an increase of the rate of orders received by the processing industry and the high turnover in retail trade.

Indicators of current activity in the euro area continue to indicate a weakness in consumer demand, a lack of improvement in the main indexes of household confidence while in the German economy there is a deepening drop in retail sales. The euro area's revival has been accompanied by confidence of European business which was most clearly signalled by the indicators of investment climate in Germany, namely the indicators of the IFO institute.

January 2004 saw the deepening of the dollar's depreciation on global markets which has been observed for nearly two years and which has been most apparent against the euro (in January the average monthly exchange rate of the EUR/USD was at the level of 1.26 against 1.23 in December 2003).

High oil prices on global markets

In January 2004 the price of oil continued to rise on global markets. The average price of Brent oil was equal to 31.2 USD/b, i.e. 1.3 USD more than in December of last year. Reserves of oil in the USA, which were kept at a historical minimum, together with the clearly lower than normal registered temperatures in January of this year in South-Eastern USA, contributed to maintaining growth tendencies.

The price increases in January of this year led the Department of State for Energy to increase in February of this year its forecast of oil prices for 2004 to 29.4 USD/b (an increase of 1.1 USD/b in comparison with the forecast of January 2004).

Economic situation in Poland

Improvement of Current account balance in 2003

In December 2003 the current account deficit amounted to EUR 680 million, which was EUR 190 million higher than in December 2002. Deepening of the negative current account balance was on the one hand a result of an increase of the deficit for earnings and services items, while on the other hand significantly lower than the previous months improvement in the balance of commodity payments. The value of export receipts increased by 25.2% while the value of import debits increased by 18.4% (this was the highest increase in import debits since January 2001).

In the period January to December 2003 the negative balance of the current account decreased by EUR 3.5 billion (compared to EUR 7.2 billion in 2002). The improvement in the current account balance, as similarly in previous years, stemmed mainly from a decrease of EUR 2.4 billion in the commodity payments deficit and an increase in the excess of unclassified turnover by EUR 1.9 billion. The remaining items on the current account were influencing, however, in the direction of worsening the balance: the negative balance of earnings and services deepened and the positive balance of transfers was subject to a decrease.

GDP increase by 4.7% in 4th quarter of 2003; 3.7% for entire 2003

According to GUS data the growth trend of the GDP in the 4th quarter of 2003 amounted to approximately 4.7%. Such a significant acceleration was a result of a strong growth trend of added value in industry whose growth rate in the 4th quarter amounted to 9.7%. The divisional industrial structure indicates that the main factor for growth continued to be in production destined for export. During the entire 2003 the highest growth rate was for firms manufacturing investment goods in the amount of about 21% which were destined for foreign recipients to an even greater extent. The increasing level of economic activity gave rise also to an accelerated sale of supply goods (from 9% after three quarterly periods to 11% for the entire 2003). There was a relatively weaker growth of around 6% in consumer goods manufacturing.

The main factor in accelerating rate of growth of the GDP in the 4th quarter of 2003 was the distribution of consumption and the positive input of net exports. The growth trend in individual consumption increased to 3.9%. One can assume that this was a result of an increase in disposable income.

Contrary to expectations, there was no acceleration of investment demand in the 4th quarter. The gross expenditures on fixed assets were higher than the year before by barely 0.1%. However, in the processing industry, in the course of three quarterly periods of 2003, investment expenditures rose in current prices by 19.6%.

There has been continued very high export growth due chiefly to growing foreign sales of processing industry products. In face of a lack of a definite revival in investment demand, there was a weaker growth in imports. As a result, the net export input to the GDP growth in the 4th quarter was at a level close to that reported in the second quarter (approximately 1.9%).

Increase in industrial production higher than expected in January this year

The increase in industrial production in January 2004 was higher than market expectations. Despite a shorter work period by one working day in comparison with January of last year, industrial production rose on the whole by about 14.3%. The second month reported a very high growth trend in the processing industry where the sales volume increased by 17.9% (in December by 18.7%). After eliminating the influence of seasonal factors the increase in production on the whole was 16.6% while in the processing industry 20.7%. As previously, the highest growth rate was reported in divisions with large and growing export sales.

After moderately good results in December of last year, which was as result, amongst others, of favourable weather conditions, January saw a return to a downward trend in construction. In comparison with January of last year construction-assembly production was lower by 9.5%. The decline was reported in all construction divisions.

Positive assessment of the condition of the processing industry

The February GUS study indicates the maintenance of a positive assessment of the general condition of the processing industry. On the whole an improvement in demand in this section resulted chiefly from a positive assessment of foreign demand. Industrial entrepreneurs forecast that in the course of immediate months the favourable condition will be maintained as far as export possibilities as well as in an increase of domestic demand and in sold production. Investment goods producers gave the best assessment regarding demand as a whole, which together with their signalling a lack of a ready supply of products, seems to indicate the possibility of investment revival of the economy.

Condition of public finance sector

In January the state budget revenue were nominally higher than those in the same period last year (an increase of 2.9%), as a result of higher by 37.7% non-tax receipts chiefly from revenues of state budget units. Tax revenues showed an increase of only 0.4% which was a consequence of the obligatory higher participation of territorial self-governing units in personal and corporate taxation, which is obligatory as of 1 January 2004. The level of realisation as a whole for the revenue plan was 7.8% in January of this year and was higher than that reported in January 2003.

The budget expenditures realised in January were higher by 3.3% than in the analogous month of last year. The moderate expenditures growth was a result, amongst others, of a low level of the cost of servicing the public debt and not transferring the subvention to the Labour Fund. On the other hand, the state budget transferred to FUS and FER more means than during the same period last year. The state budget expenditures after January of this year reached 8.1% of the size set forth in the Budget Act, which is the same as that in the analogous period of 2003.

The budget deficit was approximately PLN 4.2 billion which means that about 9.3% annual limit had been utilised, compared to 10.4% last year.

In January of this year, the chief source of financing loan requirements of the state budget was from means amassed at the end of 2003 and from input of eurobond issues.

Money supply, loans, interest rates, exchange rate

According to figures presented in forward information, in January 2004 the M3 money supply decreased by PLN 6.2 billion (-1.8%) in comparison with December 2003, reaching at the end of the month a level of PLN 333.9 billion. Changes in the money supply were materially affected by the weakening of the zloty exchange. After removal of the influence of exchange rates the M3 decrease amounted to about PLN 7.2 billion (-2.1%). The annual growth rate of M3 aggregate amounted to 5.1%.

The state of cash in circulation decreased by PLN 0.9 billion (-1.8%), reaching at the end of January 2004 a level of PLN 48.5 billion. The annual rate of growth of cash in circulation decreased from 17.1% in December 2003 to 16.5% in January 2004 and its value should still be recognised as high.

A deep decrease in deposits in the banking system was reported in January 2003 that stemmed to a large extent from a decrease in corporate deposits. On the whole deposits forming part of the M3 decreased by PLN 5.4 billion (-1.9%) and after eliminating the influence of exchange rate fluctuations this decrease amounted to approximately PLN 6.4 billion (-2.2%). The state of corporate deposits decreased by PLN 4.8 billion (-7.0%), with a decrease of PLN 5.0 billion (-7.3%) after clearing it of exchange rate influence. The annual rate of growth in corporate deposits continues to be at a relatively high level. The household deposits decreased in January by PLN 0.8 billion (-0.4%); after removing the influence of exchange rate fluctuations this drop was deeper at approximately PLN 1.5 billion (-0.8%). The continuous negative annual rate of growth of household deposits was subject to an increase in January to –1.7%. The significant January decrease in bank deposits was not reflected in an assets growth of investment funds, which amounted to only about PLN 0.3 billion.

Low corporate loan growth; moderate for households

Loans on the whole increased in January 2004 by about PLN 1.6 billion (0.6%) but their nominal growth was significantly overstated owing to exchange rate changes. After their elimination, the January growth amounted to about PLN 0.6 billion (0.2%). The growth in loans on the whole was foremost a result of an growth in the value of corporate loans, which increased by PLN 2.6 billion (1.9%); this increase, after eliminating the influence of exchange rates, was about PLN 2.0 billion (1.5%). The annual rate of growth for corporate loans increased from 2.1% in December of last year to 2.6% in January 2004. The value of household loans increased in January 2004 by PLN 0.5 billion (0.5%), while it was lower and was about PLN 0.2 billion (0.2%) after clearing it of the influence of exchange rate fluctuations. In the two previous years, in comparable conditions, there was a small drop in January of household indebtedness. The annual loan growth rate for households decreased insignificantly from 14% in December of last year to 13.8% in January 2004.

Zloty depreciation and high treasury bond price fluctuation

In the period of 21 January to 23 February 2004 there was further, systematic zloty depreciation. The zloty weakened both against the euro and against the dollar by 3.2% and 3.8% respectively. From the beginning of the year the exchange rate of EUR/PLN and USD/PLN increased by 4.0% and 4.2% respectively. An increase in fiscal risk (possibility of not receiving Sejm acceptance for the government's programme for creating a clear structure of public expenditures and their reduction) and an increase of political risk (possibility of government resigning and necessity for early elections) were factors that caused the depreciation. Existing zloty depreciation still cannot be attributed to macro-economic factors.

During the analogous period there was a high fluctuation in bond prices. The yield on 2-year, 5-year and 10-year bonds increased by 14, 7 and 3 b.p. respectively (from the beginning of the year this change was –4, 5 and 27 b.p. respectively). This is still at a level lower than that reported in November 2003. The fundamental factor influencing bond price fluctuation, similarly as in the case of the exchange rate, is an increase in fiscal and political risk. This led to the sale of bonds on the entire length of the yield curve from 13 January to 16 February. The nervous reaction of investors on the bond market was also increased by the weakened zloty in respect of the currency basket. As of 16 February, publication of the inflation indicator for January of this year (staking on a cut in rates) and renewed confidence in treasury bonds on global markets, was the factor that influenced the formation of a short-term downward yield trend. Despite high price fluctuation of treasury bonds and a further decline in the zloty's exchange and after the January sale, foreign investors in February re-built their treasury bonds portfolio, chiefly in the period from 16 – 23 February.

Prices, inflationary expectations

In January 2004 the annual CPI was 1.7%, as in December of 2003. In comparison with January 2003, the highest increase in prices was in transport (3.6%), apartment rents (2.6%), which resulted foremost from the prices of power carriers (3.0%), and price of foodstuffs and non-alcoholic beverages (2.2%). Prices of clothing and footwear, however, were lower than in January 2003

In January 2004 the annual PPI amounted to 4.2% (3.7% in December 2003), which means that it achieved the highest level since January 2001. This is a result of the growth in the prices of industrial raw materials (industrial metals, oil, coal) on global markets in the course of last year and in January of this year and also because of the growth in export prices that is connected with the weakening of the zloty against the euro.

The inflation rate expected within the next 12 months by individuals is 2.2% (in January of this year it was 2.1%), while bank analysts forecast that in December 2004 the inflation rate will be 2.7% (in January of this year 2.6% was expected), while 2.6% in January 2005 (with no changes).