

Warsaw, 25 June 2003

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

**held on 24-25 June 2003**

A meeting of the Monetary Policy Council was held on 24-25 June 2003. The Council was provided with the materials prepared by the NBP as well as information and analytical materials developed by the Ministry of Finance, banks and research institutes. The Council discussed recent developments in the external environment of the Polish economy and trends in economic performance with regard to payroll and social benefits, in the public finance sector, with regard to money supply, credits and interest rates, and inflation expectations and price levels as well as inflation prospects.

### **Decision taken by the Monetary Policy Council**

New economic data that have become available since the last meeting of the Monetary Policy Council show that:

**I.** In May, the low inflation trend hardened. The year-on-year CPI amounted to 0.4%. Factors that limit inflation growth in the future persist:

- PPI growth in May decreased to 2.1% from 2.7% in April and 3.6% in March,
- All core inflation ratios remain low, and the most reliable year-on-year net inflation ratio did not change in May in relation to April and amounted to 1.2%,
- Payroll discipline in the enterprise sector has been strengthened. In the period from January to May 2003, nominal growth of average salaries in the enterprise sector was markedly weaker than in 2002 and reached 1.8% against 4.6% in 2002. In May, average salaries remained at the previous year's levels and dropped by 2.9% compared to April 2003,
- Low annual growth of money supply expressed in the M3 aggregate persists (0.2% in May against 0.8% in April and 0.5% in March),
- Low inflation expectations on the part of households have strengthened, and their expected CPI growth in the course of this year declined in June to 0.3%, down from 0.4% in April and 0.5% in May,

- Moderate annual growth continues in claims on households (at 7.4% in May against 6.8% in April and 7.2% in March) and enterprises (at 6.3% in May against 7.2% in April and 8.3% in March).

**II.** Despite bleak outlooks for economic growth in the euro area and a downturn in the German economy, symptoms of gradual economic recovery have strengthened:

- In May 2003, sold industrial output grew by 11.7% year-on-year, including an increase in the processing industry's output by 13.8%. After the elimination of seasonal factors, total industrial output growth amounted to 8.8%, whereas that of the processing industry reached 10.6%. The May figures strengthened the distinctly developing trend in output volume established after April, especially in the processing industry. Indicators of the output volume trend (measured by average monthly value of 1995 output figure in constant prices) show increasingly higher growth (amounting to 6.9% for total industry in May year-on-year, and to 8.5% for the processing industry). Industrial output growth in May was attributable to a high growth of exports. The prospects for further growth in the processing industry have also improved;
- In May, there was a distinct decline in construction output recorded in the first months of 2003. Compared to May 2002, the construction and assembly output was 6.9% lower (in April and March by 13.6% and 25.3%, respectively). Growth indicators on the construction sector point to a slow improvement;
- Changes in the sectoral structure of construction output observed in April were confirmed, which may signify an improvement in investment demand in the coming months of the year. For the second month in row, output generated by enterprises involved in site preparation more than doubled, whereas that of enterprises carrying out building completion work grew by approx. 40%;
- High annual growth of retail sales persists, reaching 9.7% in May.

**III.** Factors constituting a potential source of inflationary pressure include:

- Persistent high uncertainty as to the directions of fiscal policy in 2004 and the ensuing years;
- Persistent high growth of notes and coins in circulation. In May, the annual growth rate of that aggregate exceeded 15%, whereas in March and April it amounted to 13.8% and 14.9%, respectively;
- Possible increases in world oil prices. In June, oil prices exceeded U\$28 per barrel, a record level since the beginning of the war in Iraq, while the forecasted average annual oil price in 2003 climbed from U\$26.8 per barrel in May to U\$27.9 per barrel in June.

**IV.** In its analysis of the factors affecting the future inflation rate, the Council also incorporated events that may have an impact on the PLN exchange rate over a medium term:

- The June referendum, wherein the Poles decided on Poland's accession to the European Union, should contribute to increased credibility and stability of the Polish economy;
- A reduction of Poland's future creditworthiness rating by Standard & Poor's from stable to negative due to the deterioration in medium-term fiscal prospects;
- Instability in the Hungarian foreign currency market and devaluation of the forint. Dramatic changes in the exchange rates of accessing countries' currencies may cause tensions in currency markets of other countries within this group, including Poland;
- Interest rate cuts by the European Central Bank by 0.5 percentage point, which contributed to the growing disparity of interest rates between Poland and the euro area and increased pressure towards zloty appreciation. The effect of that decision on the PLN exchange rate was offset, to some extent, by the two factors mentioned above.

The Council also took account of the scale of the interest cuts made so far which would contribute, with a time lag, to a gradual growth in domestic demand in the second half of 2003 and in 2004.

**The Monetary Policy Council resolved that:**

- **the National Bank of Poland will conduct 14-day open market operations with a minimum rate of return of 5.25% p.a.;**
- **the lombard credit rate will be lowered from 7.00% to 6.75% p.a.;**
- **Interest on term deposits accepted by the NBP from commercial banks shall be 3.75% p.a.;**
- **the rediscount rate will be lowered from 6.00% to 5.75% p.a..**

**The Council maintains its neutral attitude in monetary policy.**

The next meeting of the Monetary Policy Council is scheduled for 17-18 July 2003.

## I. Overview of economic situation

The data on the euro area's GDP published in early June in Q1 2003 point to a slowdown in all major economies in that region. In Q1 2003, the euro area's GDP grew by 0.8% compared to Q1 2002.

The levels of current economic activity indicators in April and May 2003 show that stagnation is likely to prevail in the euro area until the end of 2003.

Meanwhile, positive signals were recorded in the US economy. US consumer confidence, growing since April and encouraging conditions of monetary and fiscal policy as well as weakening political tensions in the world, resulted in a marked improvement of the investment climate in the US. The ISM index climbed from 45.4 percentage points in April to 49.4 percentage points in May 2003.

The improved investment climate in the US and interest rate cuts effected by the ECB stimulated a recovery in global equity markets. However, they did not bring about the strengthening of the US dollar against the euro.

May 2003 saw another increase in oil prices in world markets. The average Brent price amounted in May to U\$25.8, being by U\$0.9 higher than in April 2003. Price growth continued throughout the first half of June 2003. As a result, prices exceeded U\$28 per barrel – a record level since the outbreak of the war in Iraq. Key factors which recently affected price growth included persistently low oil reserves in developed countries and uncertainty regarding the resumption of oil exports by Iraq.

The rate of sold industrial output growth in May 2003 markedly exceeded anticipated levels. Compared to May 2002, total industrial output was higher by 11.7%, including that of the processing industry up by 13.8%. Accelerated growth in May was also attributable to 2003 working time, being augmented by an extra working day. Nevertheless, growth rate, taking account of seasonal factors was also high (according to the methodology applied by GUS, total industrial output growth net of seasonal factors stood at 8.8%).

Based on the published data on the sectoral structure, such high output growth in May may be attributed entirely to exports. In manufacture of motor vehicles, trailers and semi-trailers, sales, at constant prices, were 44.7% higher than the year before, whereas in manufacture of furniture by 36.7%, and in manufacture of electrical machinery and apparatus - by 35.0%. Growth in manufacture of chemicals and chemical products as well as in manufacture of rubber and plastic products exceeded 20%. The value of sales generated in these five sections, with the highest output growth and concurrently high export growth represents 25% of the value of sales generated by total industry.

The May figures strengthened the clearly-growing trend in output volume, present since April, especially in the processing industry. Indicators describing the output volume trend (measured by the average monthly value of 1995 output figures at a constant prices) show increasingly higher growth (amounting to 6.9% for total industry in May

Poor economic activity in the euro area

Improved investment climate in the US

High oil prices in global markets

High industrial output growth in May

Highest growth in industry sections with export sales

Smaller fall in construction and

year-on-year, and to 8.5% for the processing industry).

As expected, the dramatic fall in construction output observed in the first months of the year was slowed down in May. In relation to May 2002, construction and assembly output was by 6.9% lower (in April 2003 against the corresponding month of the previous year by 13.6% lower, whereas in March 2003 by 25.3%). Changes in the sectoral structure of construction output observed in April were confirmed, signalling improved investment demand. For the second consecutive month, output generated by enterprises involved in site preparation more than doubled, whereas that of enterprises carrying out building completion work grew by approx. 40%. The decline in the output of enterprises involved in general construction of buildings, civil and water engineering was reduced from 15.4% as recorded in April to 8.3%, whereas that of enterprises involved in building installation from 9.0% to 4.7%.

In the period from January to May 2003, nominal growth of average salaries in the enterprise sector was markedly weaker than in 2002 and reached 1.8% against 4.6% in 2002. In May, average salaries remained at the previous year's levels and dropped by 2.9% compared to April 2003. The above drop was the effect of a dramatically heightened increase in one-off payouts in April. It supported the hypothesis that, unlike in 2002, average salary levels in March, April and May 2003 resulted from transfers of payouts between months.

Research on market conditions, conducted by GUS at the end of May 2003 on a sample of some 6,000 enterprises, show improvement in general economic climate. Compared to April 2003, there was clear improvement in the economic climate in construction and a slight improvement in the processing industry. In the case of these two sections, and especially the latter one, that signified a considerable improvement over May 2002 and 2001. The figures, net of seasonal effects however, point to slighter improvement in the economic climate than the figures incorporating the seasonal effect would seem to indicate.

A marked improvement in assessments and prospects was recorded in the construction sector in relation to April, especially in terms of the expected portfolio of orders for construction and assembly work and output growth. In May, enterprises assessed their current and future construction and assembly activities more positively than in May 2002 and 2001.

As far as the processing industry is concerned, there may be a prospect of further improvement in the standing of enterprises, even though some detailed indicators assumed negative values. Assessments and prospects formulated in May 2003 were definitely better than in May 2002 and 2001, although in some cases they proved worse than in April 2003 (in particular with regard to current and future foreign demand and output volume).

The situation in trade was different than that observed in the processing and construction sectors. There, the economic climate in May was not only assessed as negative but its assessment was also the worst

**assembly output**

**Slowdown in salary growth**

**Improved economic prospects in construction and processing industry;**

**Continuing poor assessments for trade growth**

among those recorded to date in May across all years covered by research. It should be pointed out, however, that compared to April 2003 there was some improvement in the perception of those involved in trading activities, expressed in the reduced advantage of negative assessments of the entity's economic standing over the positive ones.

Research on economic conditions conducted in June confirmed improved climate in processing industry and construction. Assessments of the general economic climate in the retail trade remain poor.

## II. Overview of public finance

Despite lower taxation receipts after five months of the year in May 2003, the combined revenues of the state budget were higher, in nominal terms, by approx. PLN 2.4 bn, or 5.9%, than in the corresponding period of the previous year. Indirect taxation (up by 6.9%) had the most positive impact on the yield of all revenues. Relatively high growth was also displayed by receipts from personal income tax (8.7%). Meanwhile, receipts generated from corporate income tax remained low. In the course of five months of 2003, the state budget recorded a decline of approx. 11.7% in those receipts compared to the corresponding period of 2002.

The annual plan of budget receipts was performed to 36.4% after five months of 2003, signifying a deterioration over previous years. Current forecasts of budget receipts point to a possible non-performance of the volume planned in the budget act.

Budget expenditure after five months of 2003 stood at some PLN 80.0 bn, or 4.4% higher than the year before. It represents 41.1% of the planned figure envisaged in the budget act, and less than in previous years.

As a result, budget deficit amounted to ca. PLN 23.2 bn, resulting in 60.0% of the annual limit being used, a level comparable to the deficit recorded in previous years.

An unfavourable financial situation persists in some other entities of the public finance sector. Despite growth in receipts from security premiums since May 2003, the Social Security Fund (SSF) may generate lower than planned annual revenues. One of the symptoms of poor financial standing of the SSF is also its high indebtedness to the banking system (PLN 2.8 bn) and the still lower than planned proportion of security premiums being transferred to open-ended pension funds. Due to lower than planned receipts from health security premiums, the situation of the National Health Fund is also difficult. This will probably signify a further build-up of payable and owed claims in the healthcare sector. The Agricultural Market Agency was forced to resort to a bank credit facility, given a dramatic increase in expenditure in the first months of 2003.

Summing up, it may be said that the performance of the state budget after May 2003 does not indicate a risk of exceeding the statutory deficit limit assumed for 2003. The deficit of the remaining entities of the public finance sector will increase, however, the economic deficit rising to an estimated 5.2% of GDP.

In the light of the *Assumptions for the 2004 draft budget* adopted by the government, there is a risk of a growing imbalance of public finance

**60% of planned budget deficit after May 2003**

**Economic deficit of public finance sector in 2003 higher than assumed**

next year. Changes made to budget revenues (inclusion, against the NBP's recommendation, of the revaluation reserve of PLN 9 bn) and expenditure (exclusion of the subsidy for premiums transferred to open-ended pension funds of PLN 11.9 bn) ostensibly reduce the budget deficit in 2004 from approx. PLN 54 bn (6.3% of GDP) to PLN 33.1 bn (3.9% of GDP). The consequence of a high budget deficit in 2004 and 2005 will be dangerous growth in public debt and violation of the second prudential threshold (55% of GDP) provided for in the Act on Public Finance. This signifies a major accumulation of problems for public finances after 2005, with its negative impact for the economy.

### **III. Money supply, credits, interest rates, exchange rate**

In May 2003, M3 nominal money supply, according to the figures of preliminary, ad hoc information, grew by PLN 3.0 bn (0.9%) in relation to April. M3 annual growth follows a weak upward trend and stood at 0.2% at month end. The FX impact on M3 fluctuations in May 2003 was negligible.

Slight money supply growth in May

The key factor determining the money supply growth in May 2003 was the increase in corporate deposits, characteristic for that month and amounting to PLN 2.7 bn (5.3%). Also typical for the month of May was the considerable growth in deposits placed by local government bodies, totalling PLN 0.8 bn (8.3%). A relatively high increase was recorded in the volume of banks' indebtedness to non-monetary financial institutions, climbing since April by PLN 0.7 bn (9.6%). At the same time, however, household deposits in May 2003 dropped by PLN 1.5 bn (-0.8%). The negative annual growth of that category, persistent since July 2002, was further aggravated, to reach -6.5% in May 2003. The decline in household deposits is constantly affected by the persistently high attractiveness of alternative forms of saving such as, for example, the increased value of combined net assets of all investment funds in May 2003 totalling PLN 1.9 bn.

Further decline in household deposits at banks

Annual nominal growth of banknotes and coinage in circulation reached 15.6%, which represents its highest value since August 2002.

On the side of factors contributing to money creation, total receivables of the banking system went up in May by PLN 1.2 bn (0.5%), which was primarily due to an increase in receivables due from households (by PLN 1.3 bn, or 1.4%). After taking out the F/X impact, growth in household receivables amounted to PLN 0.9 bn (1.0%), hitting a record low compared to the corresponding periods of the years 1997-2002. Claims on corporates increased slightly by PLN 0.3 bn (0.2%), whereas claims on social security funds shrank by PLN 0.4 bn (-13.2%).

In May 2003, the PLN exchange rate was substantially influenced by fluctuations in the euro/US dollar exchange rate. As a result of a distinctly accelerated appreciation of the euro in the world market (an increase by 6.5% of the euro to US dollar exchange rate), the Polish zloty depreciated against the euro by 0.6%, while strengthening by 5.4% against the US dollar.

In June 2003, the PLN exchange rate was affected primarily by domestic political factors and developments in the Hungarian market. Because of these, the strengthening of the Polish currency after the successful outcome of the referendum on Poland's accession to the EU expected by market analysts did not take place.

**Zloty exchange rate fluctuations**

#### **IV. Prices, inflation expectations**

In May 2003, twelve-month inflation rate amounted to 0.4% against 0.3% in April, due to transport price growth, and in particular that of fuel prices and growing costs of housing maintenance and energy carriers. CPI was still lowered by prices of food and non-alcoholic beverages, alcoholic beverages, clothing and footwear.

**Annual CPI at 0.4%**

Net inflation in May 2003 p.a. amounted, similarly to April, to 1.2%. Monthly net inflation rate stood at 0.1%, i.e. was the same as in the previous three months of 2003.

Similarly to April, May saw a slowdown in PPI growth. Compared to the corresponding month of 2002, manufacturers' prices in industry were higher by 2.1% (by 2.7% in April). In relation to the previous month, prices of sold industrial output declined by 0.5% (by 0.6% in April).

**PPI growth slower than in the previous month**

Slower PPI growth was primarily attributable to a decrease in the prices in industrial processing as well as mining and quarrying, and in particular in manufacture of coke and refined petroleum products – by 8.5%. Price decline was due, to a large extent, to falling petrol prices (despite a slight increase in BRENT unrefined oil prices, petrol prices fell on the Amsterdam commodity exchange by over 6% in May, and petrol prices in Poland display a close correlation with the prices recorded on that exchange).

**Decline in consumer inflation expectations; deteriorating confidence of respondents**

Changes in the pattern of replies to the question of the Ipsos-Demoskop opinion poll, on the basis of which consumer inflation expectations are examined, point to deterioration in the respondents' confidence. In June, the percentage of highly pessimist respondents claiming that prices will grow faster than to date, increased the most. Public opinion researchers suggest that the deterioration in the manner of formulating inflation expectations by consumers may be linked to the concerns, fairly frequently voiced in public debates, that Poland's accession to the European Union will result in a growth of prices in the domestic market. Falling current inflation rates have led, however, to a decline in the measure of inflation expectations by consumers. Price growth expected by consumers in the course of the coming year amounted to 0.3%, i.e. was by 0.2 percentage point lower than in May 2003.

**Increased inflation expectations of bank analysts**

The inflation rate forecast by bank analysts for May 2004 stood at 2.3%, that is was by 0.3 percentage point higher than last month. Since February, these forecasts stabilise in the 2.0%-2.3% bracket. The inflation rate forecast for the year ending 2003 and the average annual price growth projected for 2004 remained at the level recorded in May 2003 and amounted to 1.7% and 2.4%, respectively.