

Warsaw, 27 August 2003

INFORMATION FROM A MEETING OF THE MONETARY POLICY COUNCIL, held on 26-27 August 2003

On 26-27 August 2003 the Monetary Policy Council held a meeting. The Council read materials prepared by NBP and also information and analyses furnished by the Ministry of Finance, banks and research institutes. The Council then discussed the external environment of the Polish economy as well as real trends, trends in payments and social welfare benefits, matters involving the public financial sector, the money supply, loans and interest rates and the structures of pricing and inflationary expectations, as well as the expected rate of inflation.

Decision of the Monetary Policy Council

In July 2003 inflation remained low and the annual CPI was not different than in June 2003 reaching 0.8%. Similarly, the base inflation rate indicators stabilised at a low level.

Other economic data, which has emerged since the previous meeting of the Monetary Policy Council:

I. Indicates: continuous presence of future inflation-limiting factors:

- A low growth rate of industrial production prices; at 1.8% in July 2003 against 2.0% in June 2003,
- A continuous strict salary discipline. Between January and July 2003, the average monthly salary in the corporate sector grew by 2.1% in nominal terms comparing to 4.4% year on year. After seven months 2003, a real growth in salaries was equal to 1.6%.
- In addition, the annual growth rate of monetary aggregate M3 remains low (at 0.7% in July 2003 against 1.2% in June and 0.3% in May),
- A continuous moderate annual growth rate of dues from households (at 7.7 in July 2003 against 8.4% in June and 7.5% in May). Following a growth period (March to May), the annual corporate credit growth bounced back to a low level to reach 1.7% in July,
- The inflationary expectations of households and bank analysts have steadied at a low level,
- In the 2Q 2003, the GDP growth rate (year on year) in the euro zone fell to 0.4% against 0.9% and 1.2% in the 1Q 2003 and 4Q 2002, respectively. In Germany, the GDP in the 2Q 2003 was 0.2% lower than in the 2Q 2002.
- The August forecast of the annual average oil price in 2003 decreased from 29.4 USD/barrel to 27.6 USD/barrel.

II. Confirms: strengthening signs of the economic revival:

- In July 2003, the PPI grew by 10.3% year on year, including a 11.1% growth in the processing industry; the July results consolidated the upward trend in the production volume, which is particularly evident in the processing industry,
- For the first time in over three years July 2003 saw a positive annual growth in construction and assembly production at 1.6%; all groups of construction and assembly companies completed works above the level noted in July 2003. As in the preceding months, an over two-fold increase in the production of the companies responsible for preparing construction sites was reported as well as a 50% increase in the production of the construction and finishing companies,
- Some other signs of investment revival can be observed; following a decrease experienced since the first half of 2000, the first half of 2003 witnessed an increase in investment outlays in the industrial processing sector (by approx. 16% annually in current prices). At the same time, some improvements in the financial condition of companies could be seen. In the first half of 2003, net financial result amounted to PLN 8.8 bn (against PLN 1.5 bn year on year). Sales income on products, goods and materials grew faster than their inherent costs,
- The assessment of the market situation climate in the industrial processing and construction sectors prepared in July and August clearly offer a more positive picture when compared with the same period in the past two years,
- In the first half of 2003, a 26.9% growth of exports expressed in dollar terms and a 3.3% growth in exports expressed in euro terms (based on the customs statistics) and by 29.5% and 5.2% according to the payment statistics, respectively, year on year. It was reflected by positive financial results achieved by exporters in the first half of 2003. The share of export sales in the sales income on products, materials and goods grew from 14.9% in the first half of 2002 to reach 16.8% in the first half of this year,
- Retail sales have been growing steadily with a growth rate of 5.4% in July 2003.

III. Other possible factors creating inflationary pressure include:

- Considerable uncertainty as to the size of economic deficit in the public finance sector in 2003 coupled by even higher uncertainty underlying the fiscal policy profile in 2004 and subsequent years. The estimates prepared by the NBP signal that an increased deficit in public finance in 2004 combined with some additional transfers from the European Union may create a significant demand impulse,
- A continuous high growth rate of cash in circulation. In July 2003, the annual growth rate of the aggregate reached 13.9% (14.9% in June 2003 and 15.7% in May 2003),
- High oil prices. In July 2003, the average price of Brent oil amounted to 28.5 USD/b, translating into a growth of 0.9 USD against June 2003 price. At the same time, it was the third consecutive month of growing oil prices. Since the beginning of the month, oil prices have remained at approx. USD 30.00/barrel,
- Increasing food prices. Experts' estimates concerning the size of future agricultural production indicate that the coming months will see a weakening influence of supply factors that have been contributing to the decreasing prices of foodstuffs for over two years. Drought as well as crop yields below the past

years' average will cause shortages in the domestic grain supply from this year's crops. Due to poor crops throughout Europe, it will be difficult to import grain to cover the shortages, avoiding an increase in prices.

Furthermore, the Council took into consideration the size of interest rate cuts made to date, as they will effect a gradual increase in the national demand in the second half of 2003 and in 2004.

The Monetary Policy Council resolved:

To leave the monetary policy parameters unchanged and maintain its neutral approach towards monetary policy.

The Council approved "Report on Inflation in 2Q 2003"

The discussion will be continued at the next meeting of the Council, which is scheduled for 29-30 September 2003.

I. Assessment of the economic situation

July 2003 saw a continuous improvement in investors' optimism in the USA. The ISM ratio, which reflects a corporate demand, grew to 51.8 pt in July against 49.8 pt in June 2003.

The improvement in the entrepreneurial climate was not accompanied by any improvement in consumer optimism as the Conference Board ratio reflecting the USA consumer climate dropped from 83.5 pt in June 2003 to 76.6 pt in July, predominantly in consequence of the lack of any improvement observable on the labour market.

Ever stronger signs of the growing confidence of corporates, confirmed by some favourable economic results generated in the USA (a GDP growth of 2.3% on the annual basis in the 2Q 2003 and 1.7% growth in orders for the American industry compared to May 2003), were accompanied by such phenomena as the dollar gaining ground against the euro and the continued bull market on world exchanges.

Contrary to the USA economy, the euro zone corporates' more optimistic expectations (with the German IFO Institute indicator growing up to 90.8 pt in August 2003 from 89.3 pt in July and 88.8 pt in June and the PMI Index for the euro zone reaching 50.2 pt in July compared to 48.2 pt in June) were not reconfirmed by any improvement of the economic figures. In 2Q 2003, the GDP (annual) growth rate in this region decreased to 0.4% against 0.9% and 1.2% in the 1Q 2003 and 4Q 2002, respectively. In Germany, the GDP in 2Q 2003 remained lower than in 2Q 2002 by 0.2%. Furthermore, the 2Q 2003 saw a GDP drop in France, Italy and Holland. According to the European Commission, some signs of revival will be seen only in the last quarter of 2003, with economic growth in the euro zone in 2003 not exceeding 0.6%.

The average price of Brent oil was USD 28.5/barrel in July 2003, that is USD 0.9 above the June 2003 price. At the same time, it was the third consecutive month of increasing oil prices. Since the beginning of August, oil prices have remained at about USD 30.00 per barrel.

July saw a drop in OPEC production by 60,000 b/d when compared to June and amounted to 25.4 m b/d, i.e. nearly 0.2% above the oil production limits effective since 1 June 2003. At the same, prompted chiefly by favourable oil prices, the cartel held the official limits at their existing level. Since the beginning of August, the price of oil from the OPEC basket remains above the top target ceiling (28 USD/b).

The average oil price forecast in 2003 published by the State Department for Power was subject to a decrease from 29.4 USD/b to 27.6 USD/b in August 2003.

In June 2003, the current account deficit fell to EUR 83 m. i.e. to the lowest level seen since August 1998. Compared to June 2002, the negative current account balance decreased by EUR 368 m (and by over EUR 2 bn since the beginning of 2003). A substantial reduction in the deficit stemmed from both a decrease in the negative commodities balance of

Improvement in the investment climate in the USA

Slowdown in the economic growth rate in the euro zone countries

Continuing high prices on global oil markets

payments as well as by an increase in the surplus of non-classified payments.

The commodity payments deficit of EUR 487 m in June 2003 was the lowest since 1997 (the first publication of the monthly figures on the balance of current payments in ECU and EUR). Reduction in the negative balance is attributed to growing receipts from exports by 8.4% (the highest witnessed in 2003) and combines with payments for imports growing by 0.3% when compared to June 2002. Since 1 January 2003, exports have increased by 5.2% and imports declined by 1.5%.

In accordance to the data presented in the item-based statistics, the growth in the Polish exports in the first half of 2003 was predominantly affected by increasing sales to Germany. Within this period, the value of exports (expressed in EUR) grew by 3.3, year on year (compared to a 0.3% reduction in the first half of 2002). This distinctive change of trends in Polish exports to Germany stemmed mainly from some shifts in the import demand structure of the latter country towards an increasing share of less expensive products; in addition, imports of semi-finished products and raw goods developed faster when compared to imports of finished products. In view of the above, a rise in German imports from the CEE countries and China was observed.

At the same time, the growth of exports to other EU states remained markedly below the 2002 level.

In July 2003, the PPI growth rate remained at a level exceeding its trend observed so far. Seen against July 2002, total production output grew by 10.3% compared to the expected growth of approx. 7%. In all sectors of industry, the production exceeded last year's levels: by 11.1% in the processing industry, by 6.9% in electric energy, gas and water production and distribution and by 2.1% in mining and quarrying.

It is indicated by the data published on the sectoral structure that the high growth in production observed in July comes as a consequence of increasing exports, although some considerable growth in sales observed in the machine and equipment industry and metal products industry (by 18.0% and 18.8%, respectively) indicate an increasing domestic investment demand. Compared to the same month in 2002, growth in production of mechanical vehicles, semi-trailers and trailers exceeded 40% and was attributed to the growth in sales of parts and semi-finished products for the motor industry and full production capacity reached by the Opel small engine capacity car, almost entirely designated for export. High growth in furniture production is maintained.

The results of July 2003 reinforced the growing trend in the production volume. It is particularly visible in the processing industry. The annual high and increasing growth of the trend have been maintained (growth from 7-8% after June to 8-9% in industry in general and from 8-9% to 10-11% in the processing industry).

In July 2003, after over three years of decline, production in the construction industry exceeded the level reported a year ago (by 1.6%). In all groups of enterprises, the level of works completed was higher in July 2003 than in July 2002. As in the preceding months, the production of the

Decrease in the current account deficit

Increasing exports to Germany

High growth of PPI

The highest growth in sectors producing for export

Growth in the construction industry production

companies responsible for preparing construction sites more than doubled and a 50% increase in the production of the construction and finishing companies was noted.

The first half of 2003 saw a markedly better picture of the financial condition of enterprises when compared to the condition last year and in 1Q 2003. The companies included in the research carried out by the Central Statistical Office, generated net financial result of PLN 8.8 bn (compared to PLN 1.5 bn in the first half 2002). The improvement is attributed to an increase in the sales of products, goods and materials. Exporters achieved more favourable results. In the first half of 2003, the share of export sales in sales income of products, materials and goods grew to 17% compared to 15% generated in during the first six months of 2002.

Research into the economic situation carried out in August 2002 indicates a continuous improvement in market conditions in the industrial processing sector, with better assessment of new orders and current production as well as the financial standing of enterprises. The general economic situation ratio in the construction industry remains positive and exceeds the equivalent ratios obtained in the same month in the past two years. Opinions about business conditions in the retail trade were slightly less pessimistic in July 2003 but worse than in August 2002. Although still negative, the opinions concerning current and future sales and current financial standing are considerably better.

Improvement in the financial conditions of enterprises

Positive opinions on economic situation in the processing and construction industry sectors

II. Situation of public sector finances

In July 2003, the state budget revenue remained below the level reported for the same period in 2002 (by 14.6%) in consequence of last July's transfer of the NBP dividend (adjusted by the NBP dividend, the state budget revenue in July 2003 exceeded the last year's revenue by 3.6%). State budget expenditures grew by 6.9% chiefly owing to increased subsidies to the Social Insurance Fund and the Labour Fund. It led to a high state budget deficit, significantly above the level of June 2003.

In July 2003, receipts from all taxes increased above last year's level, with receipts from corporate income tax increasing for the first time in the past few months (by 1.0%).

Within 7 months, the total state budget revenue grew by PLN 4.6 bn in nominal terms, year on year, i.e. by 5.8%. Receipts from personal income tax showed high growth (9.3%), while receipts from indirect taxes rose by 3.5%. However, performance of the indirect taxed annual plan remains poorer than expected (55.4% against 56.8% in 2002) in connection with higher than expected VAT returns resulting from high exports in the first months of 2003. Despite a growth in the CIT receipts witnessed in July, they remain quite low, as the state budget revenue received on this account within 7 months of 2003 was lower by 12.9% than the amount of revenue received in the same period of 2002.

After July 2003, state budget expenditure amounted to PLN 112.2, i.e. by 6.4% in nominal terms and by 5.6% in real terms above the year on

year figures, and reached 57.7% of the figure stipulated in the budget act.

As at the end of July, the state budget deficit reached approx. PLN 27.7 bn. It translates into a budget performance of 71.5% of the annual limit, i.e. above the level of previous years.

There has been no observable improvement in the condition of the Social Insurance Fund (FUS) after 7 months of 2003 despite the receipts from insurance premiums growing since March 2003. The amounts due from FUS to the banking system have almost reached their permissible limit and were equal to PLN 3.5 bn. Moreover, the planned volume of premiums transferred to the Open Pension Funds remains below its performance expectations (52.4%), indicating a current threat of transferring a smaller amount of the funds. The condition of the National Health Fund is also difficult and it is caused by lower than planned receipts from health insurance premiums. In all probability, it will translate to a growing volume of due and payable amounts from the health service.

Current information on the financial standing of other public sector finances units indicate that an increase in the economic deficit of the public finance sector in 2003 will reach an estimated 5.4% of the GDP, translating into a 0.3 percentage point growth in the deficit year on year.

The threat of an increasing lack of balance in the public finance sector in 2004 is approaching. The government assumes an increase in the state budget deficit of 6.7% GDP from 4.8% GDP in 2003 (and 5.3% and 3.6%, respectively, when not taking into account subsidies to the FUS to finance the shortage of insurance premiums to the Open Pension Funds). It means a large-scale fiscal expansion in spite of the expected continuation of the economic revival and return to the GDP fast growth. In part, the expansion is caused by the increasing expenditures connected with the EU accession; however, primarily it stems from the failure to reform the budget expenditures. The high state budget deficit in 2004 will result in a threatening growth in the public debt, the level thereof approaching the second prudential threshold (55% of the GDP), stipulated in the public finance act.

71.5% of the planned state budget deficit after July 2003

Deficit of the public sector finances in 2003 at 5.4% of GDP

III. Money supply, loans, interest rates, exchange rate

Preliminary data indicate that the M3 money supply grew slightly in July 2003 (by PLN 0.1 bn) to reach PLN 0.5 bn after the FX differences. The annual M3 growth rate was equal to 0.7%.

Compared to June 2003, the volume of cash in circulation outside banks' vaults increased by 0.4%. The annual cash growth rate reached 13.9%.

Household deposits growth has been declining for 12 months to reach an annual growth rate of 7.2% in July 2003. At the same time, there was a PLN 1.9 bn increase in the value of the net assets of total investment funds, which indicates the popularity enjoyed by this form of investment, offering an alternative to bank term-deposits. The annual growth rate of corporate deposits at 12.2% has maintained its level of the past four months.

A slight growth in money supply in July

On the money-creation side, the monthly increase in the total amounts

due was equal to PLN 0.5 bn (0.2%), to reach PLN 1.5 bn (0.6%) after elimination of FX differences. It was caused primarily by an increase in the debt of social insurance funds. The annual growth rate of amounts due from households remained at 7.7%. Following an increase (between March and May), the annual rate of growth in amounts due from corporations returned to a low level to reach 1.7% in July.

In August, the exchange rate of the zloty was predominantly affected by changes in the EUR/USD relationship on the global market. Over this period, the trend towards depreciation of the euro consolidated – the EUR/USD exchange rate depreciated by approx. 4.4% within 24 days of August. It consequence, the zloty weakened against the American dollar by 4.7% while gaining ground against the euro slightly by 0.5%.

**Weaker zloty
against the dollar**

IV. Prices, inflationary expectations

In July 2003, as in the preceding month, the twelve-month inflation rate reached 0.8%; its level remaining unchanged since June 2003. For the first time since May 2002, July 2003 saw an annual growth in the prices of foodstuffs and non-alcoholic beverages indicating a falling impact of this group of prices on a reduction in the overall CPI level.

**The annual CPI at
0.8%**

In July 2003, the “net” annual inflation totalled 0.8% (by 0.3 percentage point below the inflation in June 2003), while the monthly “net” inflation rate reached 0.2%.

**Drop in the PPI
annual growth
rate**

July 2003 saw a slight drop in the annual PPI growth rate. The industrial producer prices were higher by 1.8% year on year (by 2.0% in June and by 2.0% in May).

In August 2003, the structure of responses to the question in the questionnaire, which underlies the analysis of the inflationary expectations of private individuals, remained neutral in terms of its impact on the quantification result of the expected inflation rate. Due to a strong increase in current inflation, the quantified measure of the inflationary expectations rose to 0.8% (i.e. by 0.4% against the July figures).

**Steadying low
inflationary
expectations**

In August 2003, the inflation rate forecast by banking analysts for the month preceding the analogous month of the subsequent year (i.e. July 2004) amounted to 2.2%, i.e. was identical to the inflation rate noted in July 2003. Similarly, the inflation rate forecast as at the end of 2003 remained at the previous month’s level of 1.6%. In turn, the annual average price growth forecast for 2004 decreased by 0.1% percentage point when compared to July 2003 to reach 2.3%.