

INFORMATION FOLLOWING THE MEETING OF THE MONETARY POLICY COUNCIL

held on 27-28 May 2003

The Monetary Policy Council held a meeting on 27-28 May 2003,. The Council reviewed documents drawn up by the NBP as well as information and analytical documents from the Ministry of Finance, banks and research institutes. The Council discussed the current situation in the external environment of the Polish economy and trends in real values, wages and social benefits, public finance, money supply, loans and interest rates as well as the evolving scenario of inflation, price changes and inflationary perspectives.

Decision of the Monetary Policy Council

New economic information that has appeared since the previous meeting of the Monetary Policy Council indicates that:

I. In April 2003, the low inflation level continues. The following factors limiting the future growth of inflation strengthened:

- the industrial output price index declined,
- indices of core inflation continued to shrink, the most reliable index – net annual inflation – reached 1.2% in April, 0.2 of a point down on March;
- the inflationary expectations of natural persons and bank analysts stabilised at a low level;
- moderate wage growth was maintained. The faster growth in April mainly stemmed from the low baseline. This April, the average wage increased sharply (including wages in the following sectors: production and supply of electricity, natural gas and water and in postal and telecom services) while in 2002 this peak had been observed one month earlier.

II. Symptoms of a gradual economic recovery became stronger:

- Industrial output grew by 8.3% year on year this April. After an adjustment for seasonal effects, the total industrial output growth amounted to 5.6%, and that of the processing industry to 6.6%;
- Retail sales increased by 11% year on year this April, having fallen by 1.7% this March, and in this March and April, the growth was 4.0% as compared to the corresponding period a year ago;

- The financial results of enterprises showed a clear improvement in Q1;
- In Q1 of this year, exports grew by 30.6% in USD terms and by 6.6% in euro terms compared to the first quarter of last year;
- The assessment of the future condition of the construction and processing industries improved;
- Construction output continued to fall, but the monthly rate of this fall had clearly slowed; in addition, contractors for construction finishing jobs reported business almost 40% higher this April than a year ago, while the output of companies preparing land for development almost doubled.

III. The potential sources of long-term inflationary pressures comprise:

- The probability of exceeding the economic deficit of the public finance sector as projected in the draft 2003 budget act and uncertainty as to fiscal policy in 2004;
- Cash in circulation continued to rise quickly. The annual growth rate of this aggregate has been fluctuating around the level of 15% since the middle of last year;
- World petroleum prices may increase. In May, the forecast of the 2003 annual average price of this raw material was increased.

The Council also took account of the scale of interest rates cuts made so far, the delayed impact of which will cause domestic demand to gradually increase in the second half of 2003 and in 2004.

The Monetary Policy Council has decided as follows:

- **The National Bank of Poland shall enter into 14-day open market transactions at a rate of return no lower than 5.50% per annum;**
- **The lombard loan interest rate shall be cut from 7.25% to 7.00% per annum;**
- **The interest rate on time placements accepted by NBP from banks shall amount to 4.00% per annum;**
- **The bill-of-exchange rediscounting rate shall be cut from 6.25% to 6.00% per annum.**

The Council maintains a neutral approach to monetary policy.

The Council has also taken the following resolutions:

- **to accept the “Report on the fulfilment of monetary policy guidelines in 2002”;**
- **to approve the “Report on the activities of the National Bank of Poland in 2002”.**

The Council accepted the "2002 inflation report”.

The next meeting of the Monetary Policy Council is scheduled for 24-25 June 2003.

I. Economic situation assessment

This April, optimism among Euro-zone companies continued to deteriorate; indices reflecting the condition of industry and the investment demand in this sector fell (Reuter's PMI fell to 47.8 pts in April from 48.4 pts in March, IFO dropped to 86.6 pts from 88.1 pts). In May, IFO grew slightly to 87.6 pts.

A lack of optimism among Euro-zone companies

German GDP figures for Q1 point to stagnation; market analysts and main research institutes project that this trend will be maintained until the end of this year. This is confirmed by the negative data on current economic activity in Germany (in March, industrial production fell, as did industrial purchasing and retail sales, while the number of unemployed increased).

Weak economic activity in Germany

In the USA, consumer sentiment clearly improved this April (the Michigan university index rose to 86 points from 77.6 at the end of March), but this has yet to be reflected in business climate (the ISM confidence index slid to 45.4 pts in April from 46.2 in March).

After a sharp drop in March, petroleum prices stabilised in April. The average price was USD 24.9 per barrel, USD 5.4 down on March 2003 and USD 0.7 lower than in April 2002.

Oil prices stabilise in April

The lower price level was mainly caused by the end of the military action in Iraq and the relatively light damage to the oil infrastructure of that country.

In May petroleum prices grow again

In May, oil prices remained at around USD 26 per barrel. The average price was USD 0.7 up on April. May forecasts indicate that in 2003, the annual average price of petroleum will be USD 26.8 per barrel. The May price growth probably means that the forecast of annual average oil prices will be raised in June.

High industrial output growth in April

In April, industrial output rose at a rate last seen in Q3 2000. Even though there was one working day less this April than a year ago, the total industrial output was higher by 8.3%, with output of the processing industry up by 10.2%. This strong acceleration, in comparison to the 5.5% growth reported in March, was almost entirely attributable to a very high increase in the sales of food products and beverages – up 15.1%. This was an effect of the late Easter, which changed the dates when retailers purchase foodstuffs and beverages from the food industry. This sector accounts for 20% of the total industrial output and 25% of the processing industry output. Had the food industry production grown at the same rate in April as in previous months, sold industrial output would have risen by 5.8% year-on-year in that month.

The April figures had a significant impact on the trends of industrial production volume and processing industry production volume reported after March. Following a period of moderate growth in the entire industry and of stabilisation in processing, a clear rising trend of production volume developed after April.

Growth highest in sectors producing for export

Apart from the exceptionally high increase in the food industry, trends in specific industrial sectors have not changed significantly. The

greatest rises were seen in sectors which have a high and growing proportion of export sales (office automation and computer manufacturing, furniture and other production, production of electric machines and instruments, chemicals).

Sub-zero temperatures at the beginning of April contributed to the continued drastic fall in construction output, but this fall was lower than in March (13.5% against 25.3%). The internal structure of the construction industry may, however, indicate a certain change in its situation. Compared to the corresponding period last year, this April finishing job contractors reported a 39.7% increase in sales, while the output of companies preparing land for development jumped almost twofold.

These production trends were reflected in the financial results of companies. According to preliminary data, the enterprises analysed by the Central Office of Statistics (GUS) achieved after tax earnings of about PLN 3.1bn in Q1 (against PLN 1.7bn last year). The higher earnings were a result of the sales of products, goods and materials growing faster than costs. In the cost structure, the proportion of gross wages, social insurance contributions and other benefits fell.

Better financial results and profitability ratios were recorded in industrial processing, the power industry and the rest of the service sector, while mining, construction and distribution reported worsening figures.

The number of companies reporting export sales increased to almost 40% of the total (against 37% a year ago). In 20% of these enterprises, export sales accounted for more than 75% of total sales. The economic situation of exporters improved compared to a year ago, and their basic productivity ratios were better than in the overall analysed population of companies. April production figures indicate that this trend could be maintained in the next quarter, thus boosting the recovery in investments.

The results of the research on the economic trends conducted by the Central Office of Statistics at the end of April 2003, using a sample of around 6 thousand enterprises, show that business climate improved significantly compared to March in the construction sector, while it remained unchanged in industrial processing. For these two sectors, it also shows a significant improvement on April last year and two years ago (particularly for processing). The standing of processing companies strengthened, though some detailed indices still remained negative. In comparison to assessments expressed in previous years in April, opinions on demand (including foreign demand), sold output and the ability to pay financial liabilities on time were better this April than in the entire period from 1998 to 2002. Industrial processing representatives continued to be very hopeful about the near future. Their assessments were better this April than in April last year and two years ago, though the majority of positive forecasts was smaller than in March. Respondents continue to link growing production and the future improvement of their standing with positive forecasts for domestic demand.

Unlike in the processing industry and construction, the business climate in distribution was not only assessed negatively (even though the

markets

Better company earnings figures in Q1 2003

Better business climate assessments in construction and processing industry

Worse business climate assessments in distribution

majority of negative assessments was slightly smaller than in March) but actually this assessment was the worst ever recorded in April of any year covered by this research.

II. Situation of the public finance sector

This April, the financial situation of the State budget was better than in the respective period last year. Tax revenues growing by 6.9% and spending increasing only slightly - by 0.3% - meant that the proportion of the actual budget deficit to that planned in the budget act was lower than last April.

High growth was observed both in indirect tax revenues (109.3%) and in personal taxes (116.7%). The high indirect tax receipts were partially a result of the new system of quarterly VAT settlement by small and medium enterprises, which shifts VAT receipts to the first month of every quarter. Greater personal income tax receipts are attributable to the additional revenue created by salary raises in the public sector and the indexing of old-age and disability pensions as of March, as well as to higher receipts from the tax on selected capital gains.

In contrast, the revenues from corporate income tax are low. This April, the State budget received approximately 18.1% less revenue on this account than in the respective period last year. Factors bringing down the volume of CIT included the 1% cut in the rate of this tax at the beginning of this year (down to 72%) and the introduction of a preferential depreciation rate for new fixed assets.

After four months of 2003, the revenues of the State budget were 7.0% higher in nominal terms than in the respective period of 2002, while the actual execution of the annual plan reached almost 30%, as in last year.

Public spending stood at PLN 64.4bn after four months of 2003 and was up only 1.8% on the expenditure in the respective period of last year, while the proportion occupied by planning implementation was much lower than in previous years.

All of this brought the budget deficit to some PLN 18.0bn, which means that approximately 46.6% of the annual limit was used. This is less than in previous years.

After four months of this year, an unfavourable situation was reported by the Social Insurance Fund (FUS) and the National Health Fund (NFZ). Because of low receipts, FUS increased its liabilities to the banking system (by some PLN 0.8 on December of last year). The receipts of health contributions are also lower than planned, which means that there may be a shortage of funds available to the National Health Fund for financing the requirements of health service institutions. If expenditures are not reduced, this may lead to a further increase in the long-term liabilities of the health service.

In summary, it can be said that the results of the State budget after April 2003 do not indicate any danger of exceeding the statutory deficit limit set for 2003. However, the difficult situation of the Social Insurance Board and the National Health Fund may increase the economic deficit of

46.6% of the planned State budget deficit after April 2003

The economic deficit of the public finance sector may be higher than planned in 2003

the public finance sector.

III. Money supply, loans, interest and exchange rates

According to preliminary data, the M3 money supply decreased in April 2003 by PLN 0.4bn compared to the end of March (-0.1%). Changes in the M3 aggregate were significantly affected by exchange rate volatility – if this effect were removed, M3 would increase by PLN 1.6bn in April (0.5%). The annual M3 growth has been accelerating slightly for four months – it amounted to 0.8% at the end of April 2003.

Lower money supply in April

The monthly increase of cash in circulation, usually observed in April, was very high this year and amounted to PLN 1.8bn (4%), which is the highest monthly growth of this measure since December 2001. At the same time, the M1 aggregate declined by PLN 5.8bn (-4.3%), which was a result of some current deposits being moved to higher interest time deposits because of the long May weekend. In subsequent months, they can be expected to return to current accounts incorporated in M1.

In April, household deposits fell by PLN 2.5bn (-1.3%), but if the effect of exchange rate differences is excluded, this fall was only PLN 0.9bn (-0.4%). These figures show the continuing tendency of households to reduce the assets they keep in the banking system.

Household deposits continue to shrink

Corporate deposits went up by PLN 0.5bn (1%) in April, and if the effect of exchange rate differences were excluded, this growth would amount to PLN 0.9bn (1.8%). The annual growth rate of corporate deposits remained at 11.5%, a value similar as in March.

The total claims of the banking system, comprising mainly loans, decreased by PLN 1.3bn between the end of March and April 2003 (-0.5%), but this drop was a result of exchange rate movements. If their effect were excluded, the total claims would rise by PLN 1.4bn (0.5%) in April. The annual rate of growth of claims on corporations and households did not change significantly, as both measures were rising at some 7% in nominal terms. A substantial increase (PLN 0.8bn, 24.7%) was observed in the claims on social insurance funds as a result of the indebtedness of the Social Insurance Board.

Zloty strengthens in April but depreciates again in relation to the euro in May

In April 2003, the zloty gradually appreciated against both the euro and the American dollar (the average monthly zloty to euro exchange rate was 4.30 against 4.32 in March, PLN/USD 3.96 compared to 4.00 in March). In the first half of May 2003, movements of the euro/American dollar exchange rate had a strong influence on the exchange rate of the zloty. As euro appreciation speeded up on the global market, the zloty weakened in relation to the common currency.

IV. Prices, inflation expectations

In April 2003, 12-month inflation dropped to 0.3% against 0.6% in March 2003, mainly as a result of fuel prices, domestic running expenses and energy prices growing more slowly than a month ago. CPI continued to be brought down by the prices of food products and non-alcoholic

Annual CPI at 0.3%

beverages, liquors, tobacco, clothing and footwear. The scale of these groups' impact on the CPI had been steady since the beginning of the year.

Net annual inflation was 1.2% in April 2003, 0.2% down on the previous month. The monthly "net" inflation rate was the same a month ago: 0.1%.

In April 2003, the annual growth rate of the PPI amounted to 2.9% against 3.6% in March. In comparison to the previous month, the prices of industrial output fell by 0.4%, while they rose by 0.9% in March.

Production price growth lower than a month earlier

The slower PPI growth stemmed from the falling prices in industrial processing (mainly in coking and petroleum refining, where prices fell by 11%). This decline was mainly a result of lower oil prices on the world market. Had oil prices not gone down and the zloty not weakened, annual PPI growth in April 2003 would have been 3.1%-3.2%.

Slight increase in private individuals' inflationary expectations

In May, the distribution of responses to the Ipsos-Demoskop questionnaire used to analyse the inflation expectations of private individuals deteriorated in terms of its impact on quantifying the expected inflation rate. Combined with the increasing current inflation rate, this led to a slight increase in the quantified measure of inflation expectations, which went up to 0.5% (i.e. up 0.1% compared to April figures).

In May, only a very small number of banks participated in the Reuter's questionnaire, which limits the comparability of results. In May 2003, bank analysts projected that the rate of inflation in April 2004 would be 2.0%, 0.2 point lower than their views of a month earlier. The average annual inflation rate for 2004 was estimated at 2.4%, 0.3 points higher than in April. On the contrary, the projected inflation rate for the end of 2003 was 1.7%, i.e. 0.3% less than in April.

Low inflation expectations of bank analysts