

Warsaw, 31 March 2004

**INFORMATION FROM A MEETING OF THE MONETARY POLICY COUNCIL**  
**Held on 30 - 31 March 2004**

On 30 - 31 March 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.

In February 2004 the annual indicator was 1.6%, as in January 2004.

The economic data for the period since the last Monetary Policy Council meeting of February 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 4.9% in February 2004 against 5.1% in January 2004,
- continued low growth rate in corporate loans; its annual rate of growth rate in February 2004 was at 2.3% against 2.4% in January 2004. The annual growth rate for households was at 14.1% and 13.8% respectively; its growth was influenced foremost by an increase in housing loans.
- accelerates growth of labour efficiency in the corporate sector; it increased in industry as a whole by 19.4% on an annual basis (15.3% in January of this year), while in the processing industry by 23.7% (in January of this year by 18.3%).

**II. Growth trends in the economy are clearly consolidating. The Polish economy is currently in a revival phase, stimulated by rapidly increasing export. 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. Growth in the long term basically depends on the implementation of specific structural reforms.**

- in February 2004, as compared to February 2003, industrial production was as a whole greater by 18.4% and with 23.3% for the processing industry. After seasonal trends, the growth in production as a whole was 17.0%, with 21.4% in the processing industry. The growth trend in production strengthened in the processing industry (with annual growth rate at 18.9%) as well as in industry as a whole (15.0%),
- continued high growth rate in exports; in accordance with payments statistics in January 2004, there was an 11.6% growth of exports denominated in euro and 32.8% growth of exports denominated in USD,
- results of March survey on the general condition of enterprises indicates continuing improvement in the general market trends of the processing industry,
- retail sales growth of 12.1% on an annual basis was reported in February 2004, in comparison with 7.6% for the previous month,
- according to GUS data, the corporate financial situation in 2003 was significantly more favorable than in 2002. There was an improvement in all of the efficiency

indicators and an increase in the share of companies showing a net profit. The results in operational activities of the corporate sector in 2003 increased in comparison with that of 2002 by 86%, while the gross financial results increased more than four times,

- GUS data indicate stagnation in construction-assembly production. However, there has been significant improvement in corporate financial results, investment increase in the processing industry and an observed significant increase in the sales of cement and other construction materials indicate the possibility of increasing expenditures on investments in the economy.

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

A high budget deficit, increasing governmental loan requirements, risk of not introducing the programme for the reduction of current expenditures and the rationalization of their structure 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. As of the last meeting of the Council, i.e. from 25 February to 26 March 2004 the zloty strengthened against the euro by 1.96% and weakened by 0.64% against the USD, which does not, however, change the fact that the zloty remains clearly weaker than in the corresponding period of the previous year.

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

Against these threats, the Council notes with disquiet increasing political instability that may hamper the passage of laws necessary for the recovery of public finances.

**IV. Other possible factors of inflationary pressure:**

- growth in inflationary expectations reported in the course of the past four months. Individual inflation rate expectations on a 12-month basis increase from 1.6% in December 2003 to 2.4% in March of this year. The inflation forecast of bank analysts on an 11-month basis increased from 2.5% to 2.8% respectively,
- increase in oil price forecast. Actual forecast of the average annual price of oil in 2004 was increased by 1.3 USD/b in comparison with that forecast in February 2004. From September 2003 to March 2004 the forecast of oil price increased 26.0 USD/b to 30.7 USD/b,
- growth in price of foodstuffs in 2004 may be greater than that indicated in actually available forecasts. This indicates, amongst others, increasing expectations of food sector businesses that there will be higher shop prices,
- growth in the PPI indicator that in February increased by 0.6% and was 4.1% on an annual basis, similarly as in January of this year,
- high rate of cash in circulation. In February 2004 the annual rate of growth of this aggregate was 16.1% (16.6% in January).
- growth in salaries; average annual growth rate of monthly gross salary in the corporate sector increased from 5.1% in December of last year and 3.5% in January of this year to 6.3% in February of this year. The salaries fund in the corporate sector grew in February by 4.8% on an annual basis, i.e. the highest increase since May 2001 (5.6%),

## Decision of the Monetary Policy Council

**The Council resolved: To leave the monetary parameters unchanged and maintain its neutral approach to monetary policy. The Council does not exclude the possibility of adopting a restrictive approach at the next meeting.**

The next meeting of the Council will take place 26 – 27 April 2004

### External factors

February and March 2004 saw a worsening of the economic climate in the main regions of global economy. This was reflected in the lowering of business confidence indicators (in the USA and in the euro area) and in consumer confidence (in the USA), which, however, on the whole remain at high levels. This situation is mainly the result of worse than expected USA employment market data, while in the euro area with a less optimistic prognosis for sales in the corporate sector which are under an ever greater influence of the common European currency appreciation. Analysts do not expect an improvement in confidence in the next few months also because of an increase in geopolitical risk after the Madrid attacks.

Worsening of global economic confidence

March 2004 noted an increased demand for low risk assets on financial markets that was reflected in a greater drop in the profitability of treasury bonds and lower stock exchange indexes. There was a significant increase in the exchange rate fluctuations of the main global currencies.

In light of the above phenomena, there was a clear lowering of expectations for a rate increase in the USA and in the euro area.

In February 2004 the average price of Brent oil was 30.9 USD/b and was slightly lower in comparison with that of January 2004. However since the beginning of the second part of February there was clear rise in prices resulting from the OPEC announcement of production limitations. The first half of March 2004 the price of oil stabilized at a high level (about 34 USD/b). At the same time the Department of State for Energy increased in March of this year its forecast of oil prices for 2004 to 30.7 USD/b (an increase of 1.3 USD/b in comparison with the forecast for February 2004).

High oil prices on world markets

### Economic situation in Poland

The corporate financial situation in 2003 has been significantly more favorable than in 2002. This is demonstrated in the improvement of all efficiency indicators and an increased percentage of companies showing a net profit (more than 7 percentage points).

Very good corporate financial results in 2003

The corporate sector's operational activity results in 2003 increased by 86% in comparison with that of 2002, while the gross financial results more than four times. The net financial result in 2003 was at PLN 18 billion with PLN 2 billion in losses incurred by the corporate sector in 2002. In comparison with 2002, losses from financial activity decreased (by about 5%) while at the same time there was a profit increase on the sale of products, goods and materials (by 53%).

An improvement in the level of the costs indicators and the net and gross profitability turnover indicators were noted in all sections with the exception of health protection and social welfare. There was also an improvement in the economic-financial condition of exporters where the basic factors of effectiveness were in that group of enterprises more favorable than in enterprises as a whole (with the exception of liquidity indicators).

In January 2004 there was a decrease in the current account deficit. In comparison with January of the previous year it decreased by EUR 260 million and amounted to EUR 80 million. The decrease in the negative current account balance was mainly an influence of the deficit decrease in the turnover of goods and the appearance of a positive balance on the side of earnings that was connected with an increase in earnings from the central bank's reserve assets. Another favorable influence on the balance of earnings was the seasonal decrease in expenditures.

Improvement in current account balance

The negative balance in the turnover of goods decreased in January 2004 by EUR 130 million. This was a result of a continuation of a higher export growth rate (11.6% in comparison with January 2003) than for import (increase of 7.3%). The January 2003 growth trend in the turnover of goods (both in export and to a greater degree in import) was clearly greater in comparison with the average trend in 2003. A strong increase in the value of imports was responsible for the fact that the balance of the turnover in goods was in January 2004

weaker than the average in 2003.

Industrial production increased in February by 18.4%. Similarly, as in previous months, the high growth trend in industrial production stemmed from strong sales in the processing industry that was 23.3% above the level of last year. After eliminating the influence of seasonal factors the increase in production on the whole was 17.0% while in the processing industry 21.4%. Gradually one can observe changes to the divisional structure of growth in the processing industry. As previously, high growth rate was reported in export sales divisions with large foreign capital participation. There was record increase in sales in the motors industry, resulting partly from low automobile sales in February of last year (80%). Also, within the group of dynamically growing divisions prevail those with domestic capital (metals production and iron goods), taking advantage of increasing world prices and low exchange rate of the zloty. A nearly double increase in sales was noted in the stockyard industry. One can assess that an increase in this division increased the growth trend of the industry as a whole by about 1 point percentage.

Industrial production growth in February, higher than expected

Despite significantly better weather conditions in comparison with the previous year, construction-assembly production fell in February on an annual basis by 6.3% (as against a loss of 24.2% in February of last year). Moreover, the corrected data for January in accordance with the actual GUS estimates, in January of this year construction sales were lower than in the previous year by 16.8%.

The GUS study published on 19 March 2004 shows a further improvement of the general condition of the processing industry. The assessment of the condition in comparison with the analogical month of previous years achieved a record level and was one of the highest for the entire period studied. However in construction further deterioration was noted in the negative assessment of the condition both in respect to February of this year as well as in comparison with assessments formulated in March for the entire period studied. There was a continued negative assessment of the condition in retail trade but it was better than in the analogical period of the previous year.

Improvement in condition of processing industry

Industrial entrepreneurs (especially producers of supply goods) and traders (mainly in the furniture branch and food products) are expecting an increase in sale prices in the next three months, while in construction enterprises an opinion is maintained that such a possibility is lacking.

The annual growth trend of the average monthly gross salary in the enterprise sector, which increased from 5.1% in December of last year and from 3.5% in January of this year to 6.3% in February of this year, was amongst others a result of high payments in coal-mining and mining where as a result of the so-called 14 salaries the average salary increased nominally by 28%. The salaries fund in the enterprise sector has been increasing nominally for the past four months, while in real terms it has been increasing since January of this year. In February of this year in comparison with February 2003 it was higher by 4.8% in nominal terms and by 3.1% in real terms.

In February of this year an increase in labour efficiency was noted; in industry as a whole it increased by 19.4%, while in the processing industry by 23.7%.

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

The state budget revenue were higher by 3% compared to the analogical period last year which can be accepted as a good result in face of its forecast annual increase of 1.2%. The degree of annual revenue plan realization was also higher than last year's level (14.8%). The high increase in indirect taxes (7.1% year on year) had the greatest influence by far on the formation of the state budget revenue in the 1<sup>st</sup> and 2<sup>nd</sup> quarters of this year, with an especially strong influence in February (about 15% year on year). It probably resulted from the weakening of the zloty exchange rate as against the dollar and euro that causes increased inflow from taxes on imports and an increase of domestic demand, including demand for goods which will be subject to higher VAT rate as of May 1 of this year. Moreover, the size of indirect taxes was also influenced by higher inflow from the excise tax on the increased tax rates on engines fuel and tobacco products.

The budget expenditures in February of this year were nominally lower by 4.7% than the expenditures last year. This was connected with a lack of subvention for the FP (Labour Fund) from the beginning of this year and a limitation of subvention for FUS (Social Security Fund) in February of this year. Expenditures on servicing the public debt were lower (by 15.2%) than the level in the previous year mainly because of lower costs on the domestic debt (by 33.4%). As a result, the realization of the annual revenue plan of the budget expenditures

Low advance in expenditures and state budget deficit after two months of 2004

reached 16.2% which means significantly less than in the previous years.

The state budget deficit at the end of February was at the level of PLN 9.4 billion which means that 20.7% of the annual limit has been utilised, compared to 30% in the previous year.

Despite the good results of the state budget after February of this year, the state budget condition for the year 2004 will be determined only in the months after Poland's European Union accession and connected with this the introduction of new systemic solutions on the side of revenues (changes to tax provisions) as well as budgetary expenditures (membership fee to the EU budget). A change to time limits on the settlement of the VAT tax (import tax can even be settled with a two month delay) and the introduction of a system of excise depots, will cause a loss in revenues in May and June of this year. In part, the influence of these changes will be compensated from EU sources, the so-called budgetary compensation and transfers for adjusting the internal border, however, the compensation from this title (about PLN 0.3 billion) will not significantly lessen the budgetary liquidity problems. On the other hand, after May 1 of this year, the state budget will be required to transfer the member fee to the EU budget, which means an increase in the monthly expenditures by about PLN 0.7 billion.

At the same time, there exists the additional danger of not fulfilling the inflow from indirect taxation due to negative budgetary results from the parliamentary process on the law regulating the VAT rates (by about PLN 0.8 billion). Moreover, the valorization costs of pension and disability payments will be higher than planned (by about PLN 0.5 billion) as well as the EU membership fees in case there is a continuance of an unfavorable zloty exchange rate as against the euro. In light of the above factors, there decreases the likelihood of undertaking the announced steps that have as their goal decreasing the state budget in 2004 by about PLN 3 billion.

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

According to figures presented in forward information, in February of this year the M3 money supply increased by about PLN 3.1 billion (0.9%). It was observed this month that the significant weakening of the zloty had a great influence on the formation of the M3 aggregate. After eliminating the influence of fluctuating exchange rates the M3 increase in February amounted to about PLN 2.1 billion (0.6%). The annual growth rate of M3 aggregate amounted to 4.9% in February 2004 compared to 5.1% in January 2004.

The state of cash in circulation, after the January decrease of PLN 0.9 billion, increased by PLN 1.1 billion in February of this year (2.2%). The increase in the state of cash in circulation in February after the January decreases is a phenomena observed annually; the size of this year's increase was comparable to the average increase observed in previous years. The annual rate of growth of cash in circulation remained high and amounted to 16.1%.

The household deposits increased in February of this year by PLN 1.6 billion (0.8%) and after removing the influence of exchange rate fluctuations by about PLN 0.8 billion (0.4%). The annual rate of growth of this category amounted to - 1.3%. An increase in household financial assets, which are an alternative to bank deposits (assets of investment funds, deposits in Skok, bonds and treasury bonds), remained moderate in February of this year. According to actual data the balance of payments and redemption of investment fund units amounted to about PLN 0.3 billion in February of this year. The significant January decrease in bank deposits did not reflected in an assets growth of investment funds, which amounted to only about PLN 0.3 billion.

Each year February is characterized by a decrease in corporate deposits. In the current year their state decreased by PLN 0.6 billion (1%) and after eliminating the influence of exchange rate fluctuations by about PLN 0.9 billion. The annual rate of growth in this category continues for six months at a level of above 20%, amounting in February of this year to 22%.

Also in February there was an increase of PLN 1.2 billion (11.6%) in the deposits of self-government institutions, which is typical for this month and results from the schedule for transferring subventions from governmental institutions of the central government.

The indebtedness of the banking sector to non-banking entities increased in February of this year by PLN 1.8 billion (0.7%), however, this increase was in its entirety a result of the weakening of the zloty. After eliminating exchange rate fluctuations the state of indebtedness did not change in comparison with January. Household loans increased in February by PLN 0.6 billion (0.6%), after clearing it of the influence of exchange rate fluctuations its state decreased by PLN 0.1 billion. This decrease in comparable conditions was identical to that of

Low growth rate for corporate loans; moderate for households

last year. The annual indebtedness growth rate for households amounted in February to 14.1%, although this increase, similarly as in the previous month, was due mainly to an increase in housing credits.

The nominal increase in corporate indebtedness amounted in February of this year to PLN 0.8 billion (0.6%) and after eliminating exchange rate fluctuations this category decreased by PLN 0.2 billion. The annual rate of growth for corporate loans continues at a low level; in February of this year it amounted to 2.3%.

In the period of 25 February to 26 March 2004 the zloty strengthened against the euro by 1.96% and weakened against the dollar by 0.64% (from the beginning of the year the EUR/PLN and USD/PLN exchange rates rose by 0.55% and 4.21% respectively). As a result, the zloty exchange rate expressed in categories of the currency basket strengthened from the level of 3.3% to 2.4%.

Positive macroeconomic data (especially the current account balance being below market expectations) and the acceptance by the Sejm on first reading of laws connected with the programme for the reform and limitation of public expenditures contributed to the reversal of the downward trend of the zloty exchange rate which was observed in February.

Fluctuation in benchmark bond prices decreased from the last meeting of the MPC. The yield on 2-year, 5-year and 10-year bonds decreased in this period by 4, 11 and 14 b.p. respectively (from the beginning of the year this change was 15, - 1 and 14 b.p. respectively).

The stabilisation of 2-year bond yields resulted from continued expectation of NBP rate increase after the MPC announced the possibility of adopting a restrictive approach to monetary policy. The far end of the yield curve was positively influenced by the decline in the yield of government bonds on global markets and information indicating that the programme for the reform and limitation of public expenditures may gain political support in Parliament.

For the first time since October 2003, March saw a tender for 10-year bonds. Despite a minor advantage of buyers the tender price of the bonds did not depart from market prices, and the tender had a stabilising influence on the secondary market.

Market  
stabilization of  
Treasury bonds

### **Prices, inflationary expectations**

In February 2004 the annual CPI was 1.6%, as in January of this year. In comparison with February 2003, the highest increase in prices was in foodstuffs and non-alcoholic beverages (2.7%), prices in transport (2.4%), prices for apartment usage (2.8%), which resulted foremost from the price increase of power carriers (3.1%). Prices of clothing and footwear, however, were lower than in February 2003

The net inflation in February 2004 on an annual basis amounted to 1.1%, while in January this indicator amounted to 1.2%. Amongst five measurements of base inflation indicators on an annual basis increased, one decreased and one remained without change.

After an increase of 0.6% in the PPI in comparison with January of this year, the annual growth rate of the PPI continued at an unchanged level and amounted in February of this year to 4.1%. This indicator has remained at the highest level since January 2001. The greatest influence on the indicator of prices of industrial production sold in February 2004 has been the increase in industrial raw materials (industrial metals, oil, coal) on global markets and the growth in export prices that is connected with the weakening of the zloty against the euro and the currency basket.

There has been an increase in the inflation expectations of individuals and bank analysts. The inflation rate expectations of individuals in March of this year, within the next 12 months, amounts to 2.4% (by 0.2 point percentage more than in the previous month). Bank analysts forecast that in December 2004 the inflation rate will be 2.7% (with no changes), in February 2005 at 2.8% (increase of 0.2 point percentage), while the average annual rate of inflation in 2005 at 2.8% (increase of 0.2 point percentage).

Increase in  
inflation  
expectations