

Information on the meeting of the Monetary Policy Council on June 25-26, 2002

The Monetary Policy Council held its meeting on June 25-26, 2002. The Council was submitted the materials prepared by the Management Board and departments of the NBP as well as information and analytical materials prepared by the Ministry of Finance, banks and research institutes. On this basis the Council discussed the external conditions of the Polish economy, the situation in the real sector of the economy and tendencies in the area of wages and social benefits, in public finance sector, money supply, lending and interest rates and the formation of prices and inflation expectations.

1. The Monetary Policy Council decided to set the inflation target for the year 2003 at the level 3% (with tolerance at +/- 1 percentage point). It is the specification of the medium-term monetary policy target set in September 1998: lowering inflation to the level below 4% in 2003. It is also the level that is coherent with the inflation index accepted by the Government in Guidelines of the state budget draft for the year 2003.
2. Moreover, the Monetary Policy Council informs that in the second half of this year the guidelines of the medium-term strategy of the monetary policy will be published within the framework of which the next medium-term inflation target will be defined. The Monetary Policy Council assumes that the basis for these guidelines will be the strategy of Poland's accession of the Economic and Monetary Union prepared in consultation with the Government.
3. The conditions for the accomplishment of the inflation target in 2002 appeared to be considerably more favorable for the inflation reduction than it was forecasted at the moment of its setting in August 2001. Unexpectedly positive were the supply-driven factors, especially in relation to foodstuff and fuel prices. Smaller than forecasted will be the growth of prices subject to administrative regulation. The domestic demand dynamics has been established at a lower level.
4. Due to the above mentioned, it is possible to expect that inflation - if there is no unexpected and unfavorable supply shocks in the second half of this year - will the most likely be clearly lower than 4% what constitutes the bottom limit of the range of the inflation target announced in August 2001. This will be the case despite the cutting of interest rates of the NBP since August 2001 to May this year by 6.5 percentage points in total.
5. Considering these circumstances and aiming at the primary target of the monetary policy that is the stabilization of inflation on a low level and also considering the need to preserve transparency about the priorities of the carried out monetary policy, the Monetary Policy Council decided to lower the level of the inflation target for the year 2002 to 3% with a permissible fluctuation range +/- 1 percentage point.

The Monetary Policy Council discussed and approved the Balance of payments of the Republic of Poland for the 1st quarter 2002 and Inflation Report in the 1st quarter 2002 and was submitted The Evaluation of the Economic Situation of Banks in 2001 and The Evaluation of the Impact of Monetary, Tax and Supervisory Policies on Banks Development in 2001 prepared by the Commission for Banking Supervision.

I. External conditions.

Since the last meeting of the Monetary Policy Council signals indicating that the external conditions should support a gradual economic boom in Poland have been maintained.

- The economic growth in the United States is still expected.
- Visible are the signs of the economic situation improvement in the euro zone economy where the economic growth at the moment is assessed at 1.3% (1.2% a month before). In Germany, similarly to the situation in May this year, this indicator is assessed at 0.9%.

II. Production, economic growth.

1. A general evaluation of the economic situation indicates that the growth pace of the economic activity will probably be a little slower than it was indicated by the earlier macroeconomic data. In the 1st quarter this year, Gross Domestic Product increased in real terms by 0.5% as compared to the same period last year and as compared to 0.2% in the 4th quarter 2001. The domestic demand was maintained at the level noted a year before while in the 4th quarter 2001 it dropped by 2.8%. Individual consumption increased by 3.5% as compared to the increase by 3.3% in the 4th quarter last year, and gross investments in fixed assets lowered by 13.3% as compared to the drop by 13.5% in the 4th quarter of the previous year.

2. The economic situation should begin to improve gradually in the 2nd half this year. It may be indicated - besides a favorable impact of external conditions - by:
 - An improvement of earnings of enterprises in the 1st quarter this year that is favorable for the increase of investment activity.
 - A higher than forecasted by the NBP increase of income from employment and income at disposal of households in the 1st quarter of this year. The NBP assessment of the nominal growth of income at disposal of households in 2002 has been increased from 3.3% to 4.3%.
 - In May this year, the economic situation indicator set by the Institute of Economic Development of SGH increased by 3 points. May was the fourth month in a row where the economic situation in processing industry improved. Enterprises expect a further improvement of the economic situation.
 - In May this year - for the first time since the beginning of the economic situation survey by the Gdansk Institute for Market Economics (January 2001) - the entrepreneurs positively evaluated the economic situation. The entrepreneurs expect a further improvement of economic situation.

3. The information indicating the coming boom is accompanied, however, by the data indicating that its pace will be very moderate within the next couple of months:
 - The growth pace of retail sales lowered from 3.1% in April to 1.8% in May this year.
 - Results of the economic situation survey by GUS, in general proving the possibility of the economic situation improvement, indicate the worse than a month before evaluations of the current situation and less optimistic forecasts concerning future demand and production in industry. In construction, a general atmosphere of the economic situation is evaluated at the level close to the situation observed a month before and a year before. The evaluations of the atmosphere of the economic situation in retail sales maintained at the level noted in May this year and they are better than a year before, however, the forecasts for the next couple of months worsened.
 - Despite the decrease of final goods inventories in the 1st quarter this year, the entrepreneurs covered by the economic situation survey by GUS still assess that the level of inventories in industry is excessive and in retail sales - sufficient.
 - A recessive trend of industrial production has been maintained. In May this year, the industrial output was by 4.1% lower, and after eliminating seasonal factors (one business day less than in May 2001) by approximately 2% lower than a year before.
 - In May this year, the drop of construction output as compared to the same month of 2001 was bigger than in April (9.4% as compared to 6.2%), but the trend indicators confirm the observed a month before tendency to slow down the drop of construction and assembling production.

III. Wages, social benefits.

The latest data confirm a moderate although stable increase of income of households. As compared to the situation a month before, the assessment of a nominal growth of income at disposal of households in 2002 has been increased from 3.3% to 4.3%.

- A moderate level of nominal growth of average wages in enterprises has been maintained. Within the period January-May 2002, this growth in real terms amounted to 1.6% and was higher than a year before. A low level of economic activity does not enable forecasting of an essential acceleration of wage growth in the next couple of months.
- The drop pace of employment in enterprises insignificantly decreased. The average employment was lower by 0.2% as compared to April and by 4.6% than a year before. The unemployment rate dropped from 17.8% to 17.2%.
- In the 1st quarter this year, the drop of employment in the national economy was smaller than in the enterprise sector and a nominal growth of average wages was faster. Very high was also the growth of unemployment benefits and pre-retirement benefits.

IV. Situation in public finance sector.

1. The data on the state budget accomplishment indicate that there are no visible bigger threats to the accomplishment of the Act on the State Budget for the year 2002. However, there is a threat that the economic deficit will be higher due to the situation of earmarked funds: low revenues from social insurance contributions, delays in transferring due contributions to Open Pension Funds, growing expenses of the Labor Fund and a possibility to borrow by the Wage Guarantee Fund.
2. In the situation of a high economic deficit, especially dangerous is the decreasing transparency of public finance due to the increase of public expenses that, according to the currently applied by the Government principles of calculating revenues and expenses of the public sector, are not reflected in the earnings of this

sector. For example, the Agency for Agricultural Market that has already borrowed approximately PLN 1.5 billion intends to finance the additional intervention on the market using the resources coming from loans the repayment of which is guaranteed by the State Treasury. Such kind of debt increase should be treated as a form of increasing the deficit of the public finance sector.

3. The economic deficit of the public finance sector will be maintained in 2002 on a very high level (approximately 5% GDP), adversely affecting the economic growth perspectives. A big supply of treasury securities that is necessary to finance the borrowing needs of the budget, limits the possibilities to finance the development of enterprises and it may result in the appreciation of the exchange rate of the zloty without strengthening at the same time - as opposed to direct foreign investments - the competitiveness of the economy.
4. The Ministry of Finance presented Guidelines of the state budget draft for the year 2003 according to which the economic deficit of the public finance sector would amount to PLN 38.8 billion, i.e. 4.9% GDP, and the budget deficit is to remain at the high level of 2002. In the situation of a forecasted acceleration of the economic growth, it means a further loosening of fiscal policy. Therefore, there will be maintained the above mentioned negative impact of public finance on the economic development and, at the same time, the playing field of the monetary policy will be subject to a radical reduction.

V. Money supply, loans, interest rates.

As compared to the situation a month before, the evaluation of monetary situation was not subject to fundamental changes. The data still indicate that despite a low dynamics of monetary aggregates there are, in this area, some threats to future inflation:

- The annualized dynamics of money supply M3 is maintained at a low level, although as compared to April it increased insignificantly from 2.9% to 3.6%.
- The annualized dynamics of cash in circulation rose from 16.0% a month before to 17.9%. There is maintained uncertainty related to the reasons and possible inflation results of a high dynamics of cash in circulation.
- The deposits of households rose as compared to April by 0.6% but about 70% of this growth resulted from the depreciation of the exchange rate of the zloty. The annualized dynamics of deposits placed by households lowered from 1.9% to 1.6%. In May this year, for the first time an annualized drop of PLN denominated deposits was noted.
- The annualized dynamics of lending to households lowered from 16.5% a month before to 15.8%. Loans to businesses, after two months of the annualized drop (-1.8% and -1.9%, respectively), reached the level observed in May 2001. The annualized dynamics of net debt of Government institutions lowered from 14.5% a month before to 9.3%.
- The earlier cuts of the NBP interest rates have not been fully translated into changes of interest rates in commercial banks yet. In May this year, the average interest rates on loans and deposits at commercial banks dropped:
 - In case of term PLN-denominated deposits of households by 0.4 percentage point to 6.6%;
 - In case of PLN-denominated loans to businesses by 0.3 percentage point to 13.4%;
 - In case of PLN-denominated loans to individuals by 0.2 percentage point to 18.3%.

VI. Prices, inflation expectations.

Unexpectedly big price drop in May was mainly caused by factors of temporary nature. Inflation at a low level, however, is favorable for the strengthening of low inflation expectations. Therefore, the results obtained in May confirm the earlier assessments indicating a sustained nature of disinflation process that gives a chance to stabilize inflation at a low level:

- In May this year - according to expectations connected with a non-typical big price growth in May 2001 - the annualized consumer price index lowered. May this year, however, also appeared to be non-typical. Prices for vegetables, instead of a typical for this period increase, lowered considerably. Due to this, inflation dropped by about 0.5 percentage point more than forecasted to the level of 1.9%.
- All core inflation measures lowered:
 - 15%-cut average from 2.6% to 2.0%;
 - inflation excluding the most variable prices from 2.5% to 2.1%;
 - inflation excluding the most variable and fuel prices from 2.7% to 2.4%;
 - inflation excluding the controlled prices from 2.6% to 1.7%;
 - "net" inflation (excluding foodstuff and fuel prices) from 4.0% to 3.2%.

The drop pace of core inflation measures was slower than the drop pace of consumer price index. In May this year, the majority of core inflation measures (with the exception of inflation excluding the controlled prices) were formed above the consumer price index. The net inflation measure that is at the highest level (by 1.3

percentage point above the consumer price index) illustrates the particularly strong impact of fuels and foodstuffs on the reduction of inflation. The maintained for several months drop of all core inflation measures indicates that the reduction of inflation is not a temporary phenomenon.

- After a significant improvement a month before, the structure of answers to the questions of a survey of inflation expectations of individuals did not change essentially.
- In June, the inflation expectations of bank analysts lowered significantly. Now, they forecast that inflation in December this year will amount to 3.3% as compared to 4.1% a month before, and in the 11-month period - 3.6% as compared to 4.2% a month before.
- The sold industrial output prices were in April this year higher by 0.5% than a year before.
- Since the last meeting of the Council, the forecasts concerning oil prices have not changed. It is forecasted that in 2002 an average oil price will amount to USD 23. As compared to the situation within previous months, a risk of oil price rise decreased. In conditions of demand stabilization at a low level, the oil supply increased.

VII. Decision of the Monetary Policy Council.

1. As compared to the situation observed a month before, the following signals indicating the enhancement of factors that are favorable for low inflation appeared:
 - After a clear improvement a month before, a favorable for future inflation structure of inflation expectations of individuals was maintained and inflation forecasted by bank analysts lowered; inflation at a low level promotes the enhancement of low inflation expectations;
 - All core inflation measures dropped and the annualized dynamics of the sold industrial output prices is maintained at a low level;
 - A risk of oil price growth decreased.
2. The evaluations of the economic activity growth outlook indicate a smaller than a month before probability of a fast growth of domestic demand. It is still assessed that the improvement should begin in the second half this year, however, it will be more perceptible only in the 4th quarter.
3. The reduction of scale of interest rates cut is prompted by:
 - the outlook of a further loosening of fiscal policy in 2003 what constitutes a fundamental reduction of the playing field of monetary policy;
 - the drop of the annualized dynamics of deposits of households, and especially the drop of PLN-denominated deposits;
 - a high and growing dynamics of cash in circulation.

It should be also remembered that full results of interest rate cuts by 10 percentage points in total made since February 2001 have not been revealed yet and their forecasts are connected with considerable uncertainty. Moreover, in conditions of lower interest rates their smaller implicit changes mean a similar respective change.

4. **Considering these arguments, the Monetary Policy Council decided to:**
 - **cut the minimum yield on 28-day open market operations from 9.0% to 8.5%;**
 - **cut the rediscount rate from 10.5% to 10.0%;**
 - **cut the lombard rate from 12.0% to 11.5%;**
 - **cut the deposit rate from 6.0% to 5.5%;**
 - **maintain its neutral position in monetary policy.**

VIII.

The next meeting of the Monetary Policy Council will be held on July 18-19, 2002.