

## Information on the meeting of the Monetary Policy Council on March 26-27, 2002

The Monetary Policy Council held its meeting on March 26-27, 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.

### I. External conditions.

1. Within the recent period there appeared data indicating that the boom in the world economy will come faster and it will be stronger than it was expected earlier. It is good information for the outlook of Polish exports and the development of the economy, but the anti-inflationary impact of the external economic situation may be weaker than it was expected earlier.
2. In the United States, the purchasing managers index (PMI) in industry rose in February this year to 54.7, the highest level since April 2000, and the index of new orders exceeded 60. Joined with the biggest since June 2000 rise of industrial production noted last month, the increased level of manufacturing capacity utilization in industry (to 74.8% from 74.5% in January and 74.4% in December) and the fact that capital goods flows in January this year were significantly bigger than on average in the 4th quarter last year - it increases the chances of bigger capital investments in the American economy. Due to these data, even though the consumer confidence index dropped, a high level of household indebtedness and the current account deficit maintained, in March this year the economic growth forecasts in the United States were increased to 1.3 - 2.6% GDP (from 1.3 - 1.9% a month before). According to the latest data, the consumer confidence index in the United States rose from 95 a month before to 110.2 in March this year. In 2003, the growth is expected to be at the level 3.5 - 4.4% GDP.
3. Despite still poor economic results, in the recent period there have been released the data indicating a future improvement of the economic situation in the euro zone. After a clear rise in February this year (to 88.5), the German business climate index (IFO) increased significantly again in March (to 91.8) and it reached the highest level since April 2001. In February this year, the improvement was also noted in case of the purchasing managers index for the euro zone (to 48.6 from 46.3 a month before and 42.9 in October 2001) and the European consumer confidence index. The current forecasts indicate that the growth pace in the European economy will increase during the year (from the level close to zero in the 1st quarter to approximately 2.5% in the 4th quarter this year). During the whole year, GDP in the euro zone will grow this year by 1.1% and in 2003 by 2.9%.
4. In connection with the improvement of the economic situation outlook, as compared to the previous month, the probability of interest rate raises in Poland's external conditions in the second half of the year increased. Due to the decreasing interest rates difference, the foreign investors' tendency to place their portfolio capital in Poland may be reduced what would contribute to the weakening of the exchange rate of the zloty or at least counteract its appreciation. The Swedish Riksbank, at its last meeting, was the first to make a decision to tighten monetary policy.
5. In March this year - as a result of the increase of forecasts of the demand for oil connected with better outlook of the economic growth worldwide, the increase of tension between the United States and Iraq and the OPEC decision to maintain the production on the actual level - oil prices on world markets rose to the level of USD 25 per barrel. This situation prompts to verify upward the actual forecasts of oil prices. The insofar forecasts indicating that the oil price in the first six months will amount to USD 18 per barrel (now, according to the market forecast average, it will be USD 21) appear to be not actual. This will probably mean the increase of fuel prices on the domestic market and the reverse of the observed so far halting impact of fuel prices on inflation.

### II. Production, economic growth.

1. In 2001, the economic growth pace amounted to 1.1%. The GDP dynamics decreased in subsequent quarters (from 2.3% in the 1st quarter to 0.3% in the 4th quarter). The domestic demand decreased by 2% and the demand drop increased in the subsequent quarters (from 1.3% in the 1st quarter to 2.9% in the 4th quarter). Individual consumption increased in the whole year 2001 by 2.1% and the dynamics of this category grew from quarter to quarter (from 1.5% in the 1st quarter to 3.2% in the 4th quarter). The main factor that halted the GDP growth was the drop of gross investments in fixed assets that amounted to 10.2% last year.
2. In February this year, the sold industrial output was bigger by 0.4% than a year before while its drop by approximately 0.8% was forecasted.
3. Better than expected data on the sold industrial output joined with:
  - The results of the research of the economic situation in March this year indicating the improvement of both current and expected in the nearest period demand and production and the sales of goods by trade enterprises (in March this year, the sales forecasts are not negative for the first time since June 2001);

- The data on retail sales (rise by 4.7% in January and by 7.7% in February this year as compared to the same months last year);
- Bigger than in February last year revenues from indirect taxes and income tax from legal entities that are the most sensitive to the economic situation;
- Better outlook of the economic situation worldwide;
- And the fact that full results of interest rates cuts have not been revealed yet can suggest that a gradual economic boom should take place. However, drawing firm conclusions is premature and one should wait for the confirmation of positive trends in subsequent months.

### III. Wages, social benefits.

1. The situation on labor market is getting worse constantly - in February this year the unemployment rate rose to 18.1%. In the economic situation survey, entrepreneurs announced further employment reductions within next months, however, clearly smaller than it resulted from assessments expressed in January this year. The Government's adoption of the project to make the labor law more flexible gives hope for a gradual improvement of the situation on labor market. It is a very important positive part of the Government's program.
2. Within the period January - February this year, average gross wages in the enterprise sector were higher by 5.7% than in the same period last year, and the growth in real terms amounted to 2.2%.
3. The employment in the enterprise sector lowered in February this year by 0.2% as compared to January. As compared to the period February - January 2001, the average employment was lower by 5% what in conditions of the increase of average real wages by 2.2% means the drop of purchasing power of total income generated from the work in enterprises.
4. The average pension and disability benefit in the period January - February this year was bigger by 14.6% than in the same period of 2001 and its purchasing power increased by 10.8%. The increase on a similar scale is also related to pensions and disability benefits in agriculture. However, joined with:
  - A drop of the number of pension and disability benefits recipients,
  - The fact that in the same period last year a single adjusting payment for too low valorization of benefits in 2000 was made,

in the 1st quarter this year a drop of total income generated from pensions and disability benefits is expected.

5. The above mentioned data suggest that in the 1st quarter this year real income at disposal can be decreased. In this situation, a probable relatively high increase of individual consumption will mean a drop of households' tendency to save. In the next quarters of 2002, a gradual acceleration of the growth pace of income at disposal is forecasted.

### IV. Situation in public finance sector.

1. In February this year, the revenue situation of the state budget improved - tax revenues were higher by 12.7% than a year before. Within the period January - February, the budget revenues were at the level close to the observed in the same period of 2001 and tax revenues were higher by 3.2%. The budget deficit accomplishment after February amounted to 34.3% of the limit planned in the enacted *Act on the State Budget for the Year 2002*.
2. However, according to present forecasts, the economic deficit in 2002 will be maintained at a very high level (5% of GDP) that is close to the level noted in 2001.
3. A big supply of Treasury securities that is necessary to finance lending needs of the budget - a result of a big deficit and small revenues from privatization:
  - Contributes to maintaining a high level of long-term market interest rates;
  - Reduces possibilities of financing the development of enterprises;
  - Results in the inflow of a foreign portfolio capital placed in Government bonds through which it contributes to the appreciation of the exchange rate of the zloty without the strengthening at the same time of the competitiveness of the economy - unlike direct foreign investments.

That is why it is necessary to take firm actions to lower the economic deficit of the public finance sector.

### V. Money supply, loans, interest rates.

1. The growth pace of total money supply (M2) on the twelve-month scale lowered to 11.4% from 12.3% in January this year. According to the analyses made at the NBP, the money supply dynamics exceeding 10% in countries where inflation is low was a very rare phenomenon.
2. Cash in circulation (except the banks cashiers desks) increased in February this year by PLN 1.2 billion (by 3.2%) as compared to the amount at the end of January. The annualized dynamics increased from 15% in

January this year to 16.7%. The reasons of this phenomenon and its possible impact on inflation require a further detailed recognition.

3. A further drop (from 9.6% in January this year to 7.9%) was noted in case of an annual growth pace of PLN-denominated deposits of individuals.

In January and February this year, a monthly growth pace of PLN-denominated bank deposits is decidedly smaller than in the same periods in previous years. The available information indicates that a lower dynamics of bank deposits this year is not connected with putting the funds into alternative forms of saving - the growth of investment funds assets and the volume of sold bonds returned to the level noted before November last year.

The dynamics of foreign currency deposits of households increased to 16.8% from 16.3% a month before. However, the growth of foreign currency deposits amount converted into PLN took place while there was noted a drop of these accounts balance as converted into USD and it resulted from the depreciation of the exchange rate of the zloty.

4. In February this year, the dynamics of lending to individuals increased from 14.4% in January this year to 14.7%. The growth pace of lending to businesses on the twelve-month scale lowered from 5.2% to 4.7% in February this year.
5. A big shortage of budget revenues with small revenues from privatization results in the increase of lending needs of the public sector. In February this year, the budget sector net debt in the banking system increased by 3.2% and the twelve-month dynamics amounted to 50%. February was the consecutive month of the increasing role of the budget sector in total money creation. The relationship of the net debt of the budget sector and M2 increased from 15.4% in February 2001 and 20.3% in January this year to 20.7%.
6. In February this year, as a reaction to the cut of basic interest rates of the NBP in January, banks made considerable adjustments of interest rates on deposits and loans. An average interest rate on PLN-denominated deposits of individuals was reduced from 7.7% in January this year to 6.6% (the smallest changes were made in case of the interest rate on savings and settlement accounts - ROR). The interest rates on consumer loans to individuals were considerably reduced - on average by 1.6 percentage point and it was the biggest cut since the beginning of 2001. The scale of reduction of an average interest rate on loans to businesses was close to the one noted in January this year and it amounted to approximately 0.5 percentage point. During recent year, the differentiation of interest rates on loans offered by commercial banks increased: in February 2001 the interest rate of a one-year loan to businesses was within a range 19.4 - 24.4%, while in February this year from 10.9 to 20.7%.
7. The recently observed tendencies in monetary aggregates:
  - Maintained high growth pace of money supply,
  - Drop of a deposit dynamics,
  - Growth of the dynamics of cash in circulation,

can make it difficult to stabilize and lower inflation further in future.

## VI. Prices, inflation expectations.

1. The consumer price index on the twelve-month scale in February this year amounted to 3.5%, i.e. slightly above the amount noted last month (3.4%). The CPI growth was affected the most by the growth of prices connected with the apartment lease and energy carriers, and halting impact on inflation was made by prices for clothes and footwear and mainly dropping prices for fuels.
2. During next several months, a further drop of consumer price index is probable. The lowest level should be achieved in May this year what will result from the so-called base effect, i.e. an exceptionally big growth of prices in May 2001 that mainly resulted from the disturbances in the seasonal nature of fruit prices and a considerable increase of prices for medicines and phone subscription fees. The actual forecasts provide for a gradual growth of the consumer price index in the further part of the year.
3. In February 2002 - as compared to January - the majority of annualized core inflation measures lowered and the "net" inflation (excluding foodstuff and fuel prices) was maintained at the level observed a month before (4.7%):
  - 15%-cut average from 3.5% to 3.2%;
  - inflation excluding the controlled prices from 3.2% to 3.1%;
  - inflation excluding the most variable prices from 2.9% to 2.8%;
  - inflation excluding the most variable and fuel prices from 3.4% to 3.3%.

The formation of the "net" inflation measure over the CPI confirms the statement of a favorable impact on inflation of groups of goods that are excluded from this index, i.e. foodstuffs and fuels. A tendency to drop of the remaining core inflation measures indicates, however, that the observed drop of inflation is related to all major groups of consumer goods and services and it is not caused only by potentially temporary factors.

4. In February this year, the sold industrial output prices were higher by 0.1% than a year before. In the 4th quarter 2001, a decreasing tendency of the sold industrial output prices was maintained, but in January 2002, these prices remained at the same level as in January last year.
5. Changes that took place in the structure of answers to the questions of Demoskop survey in March this year indicate a further, although very slight, improvement of individuals expectations concerning the future inflation. On one hand, after a clear drop a month before, the percentage of individuals forecasting that the prices will grow faster than now slightly increased. On the other hand, a group of people expecting that in 12 months' time prices will be lower than now increased. It should be remembered, however, that the observed improvement and then stabilization of a favorable structure of inflation expectations took place in the situation of a gradual drop of inflation. There is a risk that if inflation impulses appear they can lead to a fast reversal of this favorable tendency for future inflation.

The inflation rate expected by bank analysts both in December this year and in the 11-month horizon was maintained at the level noted a month before (4.6%).

## **VII. Decision of the Monetary Policy Council.**

1. Within a recent period:
  - Inflation is maintained at a relatively low level;
  - Core inflation measures lowered further indicating that a lower inflation does not only result from a favorable formation of potentially temporary prices, however, indisputable is a positive impact of a smaller growth of foodstuff prices and a drop of fuel prices;
  - Favorable for future inflation is a stabilization of inflation expectations of both bank analysts and individuals; in case of the latter, it should be remembered that favorable changes in the structure of expectations took place in the situation of decreasing inflation and the reversal of this tendency is possible at the moment when inflation impulses appear.
  
2. In favor of prudence in monetary policy are the following:
  - The fact that full results of interest rates cuts by 9 percentage points in total made since February 2001 to January 2002 have not been revealed yet;
  - The formation of monetary aggregates, especially the drop of the dynamics of deposits, the increase of the dynamics of cash in circulation, maintained high pace of money supply growth what may make it difficult to stabilize and lower inflation further in future;
  - A risk of conducting of a too loose fiscal policy and an unfavorable impact of this situation on future economic processes, including inflation processes;
  - An improvement of the outlook of the economic situation worldwide, which, although favorable for Polish exporters and the economic growth, means a smaller than earlier forecasted anti-inflation impact;
  - Information that may suggest a gradual boom in the economy;
  - The observed in March this year increase of oil prices on the world markets and the improvement of forecasts for these prices formation what will probably lead to the increase of fuel prices on the domestic market.

**Considering these arguments, the Monetary Policy Council decided not to change interest rates of the NBP and to maintain its neutral position in monetary policy.**

## **IX.**

The next meeting of the Monetary Policy Council will be held on April 24-25, 2002.