

Warsaw, November 27, 2002

INFORMATION AFTER THE MEETING OF THE MONETARY POLICY COUNCIL

on November 26-27, 2002

The Monetary Policy Council held its meeting on November 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. The Council discussed the external conditions of the Polish economy and tendencies in the real sector of the economy, in the area of wages and social benefits, in public finance sector, in the area of money supply, lending and interest rates, and the formation of inflation expectations, prices and the inflation outlook.

Decision of the Monetary Policy Council

In October 2002, in the economy dominant were still the developments that supported the strengthening of a low level of inflation:

- all core inflation measures lowered,
- inflation expectations of both, individuals and bank analysts, have stabilized at the same low level as a month before,
- the annualized dynamics of total money supply lowered visibly, the dynamics of cash stabilized, and the annualized dynamics of lending remains at a low level,
- a moderate wage growth – in conditions of a high level of unemployment – does not threaten in a form of the increased inflation pressure,
- the growth forecasts of the world economy, including, in particular, the German economy, indicate that the economic boom can be expected only in the 2nd half of 2003, and it will be much slower than forecasted a month ago.

The factors that decide on the economic growth – and indirectly on inflation tendencies – in 2003 and 2004 rather confirm the earlier data on a gradual improvement of the economic activity.

- **In the 3rd quarter this year**
 - the added value in industry increased,
 - the drop of the volume of construction and assembling production decreased,
 - the data on the improvement of the financial situation of enterprises got confirmed,
 - a high sales dynamics in sections included into market services was maintained.A higher pace of the GDP growth in the 3rd quarter is a positive signal, especially at the background of the worsening economic situation in Germany.

- **In October:**
 - the sold industrial output was bigger than in the same month last year by 3.2%,
 - the retail sales dynamics increased, in nominal terms it was higher by 5.1% than in the same month last year.

However, there is still uncertainty about the permanence of the boom:

- The drop of construction output got bigger (from 6.1% to 8.8%).
- Latest results of the economic situation research made by GUS indicate worsening of the climate in processing industry, construction, and retail sales.
- Despite the improvement of the financial situation of enterprises, the investments expressed in fixed prices after three quarters were – like in the 1st six months this year – lower by 15.5% than in the same period of 2001 (this drop, however, was related to enterprises that hire more than 50 employees, so in this situation it does not decide on the scale of the investment drop taken into consideration in national accounts).
- The latest forecasts shift in time again the moment of the economic boom in Germany what results in shifting the period of the accelerated growth of Polish exports into the second half of 2003.

Summing up, it should be said that the growth pace of domestic demand within the quarters to come would gradually increase. The process of integration with the EU, especially in 2004 and in the following years, will contribute to the acceleration of the investment growth.

There are still factors that can make it difficult to stabilize inflation on a low level:

- Despite the fact that oil prices on world markets lowered in October, the uncertainty connected with the conflict concerning Iraq makes it necessary to expect their rise again.
- In October, the third month in a row already, the deposits of households placed at banks dropped, in part as a result of the lower interest rates and the introduction of the tax on interest income.
- Despite a very low dynamics of monetary aggregates, it is difficult to assess precisely what will be their delayed reaction to the already made decisions on the interest rate cuts that as related to 2001 are at a radically lower level.
- There is a threat of a bigger than planned in the draft act on the state budget for the year 2003 economic deficit of the public finance sector, mainly as a result of a bigger shortage of this sector units beyond the state budget.
- The rise of sale prices in industry in 2002 is the evidence of these prices high sensitivity to a change of the exchange rate of the zloty. Together with the improvement of the economic growth dynamics, there should be expected the increased current account deficit of the balance of payments what would depreciate the zloty. In this situation, it cannot be excluded that in the 2nd half of 2003 and in 2004 two factors that increase the inflation pressure will be cumulated: the increase of domestic demand and the drop of the exchange rate of the zloty.

That is why, although now there are no serious visible threats to the accomplishment of the inflation target in 2003, the increase of inflation pressure by the end of 2003 and in 2004 cannot be excluded.

The Monetary Policy Council acknowledged that, from the point of view of future inflation, factors reducing the inflation pressure have got a bigger impact than factors threatening the inflation stabilization and decided to:

- **cut the lombard rate from 9.0% to 8.75% annualized;**
- **cut the rediscount rate from 7.75% to 7.50% annualized;**
- **cut the minimum yield on 28-day open market operations to the amount 6.75% annualized;**
- **cut the deposit rate (for term deposits placed by banks at the NBP) to the amount 4.75% annualized.**

The Council maintains its neutral position in monetary policy.

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The Monetary Policy Council has approved the financial plan of the NBP for the year 2003 and has continued its discussion on a medium-term strategy of monetary policy for the period 2004-2006. The Council has also accepted the *Report on Inflation in the 3rd Quarter 2002*.

The next meeting of the Monetary Policy Council will be held on December 17-18, 2002.

I. Evaluation of the economic situation

In the 3rd quarter this year, the added value in industry increased, the drop of the construction and assembling production volume decreased, and a high sales dynamics in sections included into market services was maintained.

The increase of domestic demand resulted from a further decrease of the accumulation drop and still high dynamics of individual consumption as compared to the increase of gross income at disposal of households. Despite a low dynamics of income growth, the dynamics of retail sales volume increased. At the same time, deposits dropped and lending to households grew faster. Both these phenomena at the same time are the evidence of a further drop of savings rate.

The data prepared by GUS on foreign trade turnover in the 2nd quarter 2002 show that the dynamics of exports accelerated considerably. The volume of Poland's exports in the 2nd quarter 2002 grew at the pace 7.4% despite a slow economic growth in Germany (0.1% of GDP in the 2nd quarter 2002) and in the euro zone (0.7% of GDP in the 2nd quarter 2002). On the basis of the information on payments for exports it is assessed that a big growth pace of exports volume has also been maintained in the 3rd quarter what indicates the increase of the demand driven elasticity of the Polish export. It can be assumed that the strengthening of the Polish export reaction to a growth of demand from abroad is of a permanent nature and is a result of the restructuring in exporting enterprises made within the period 2000-2001.

A clear strengthening of political risk worldwide in the 3rd quarter this year resulted in a considerable worsening of consumer confidence indices in major economies. The most visible it was in the USA where the Conference Board's index measuring confidence of American consumers dropped in October as compared to September this year by over 14 points, therefore at a similar scale as after the events of September 11, 2001 when this drop amounted to 17 points. The index of German consumers' confidence also declined from the level -5 in September this year to -11 in October. However, there were no big drops of indices reflecting

Improvement of economic situation in the 3rd quarter this year

Drop of savings rate

Good foreign trade results

Still poor consumer confidence, a little better confidence of entrepreneurs in the USA and the euro zone

confidence of entrepreneurs. It was, inter alia, affected by such factors as good results in the area of labor efficiency and growth in the U.S. economy in the 3rd quarter, and the stabilization of the situation at stock exchanges.

A positive signal for international financial markets was a bigger than expected interest rate cut by FED and the announcement of the President Bush administration about more fiscal steps in order to boost the American economy.

A favorable signal for the economic situation climate in the region of accession economies was also the official approval of the date of the European Union enlargement for the next 10 countries.

Still, a factor connected with a high level of uncertainty is the formation of oil prices on the world markets.

Until the half of October, oil prices have been maintained at a high level of about USD 28. Since the second half of October, however, the prices for that raw material dropped what resulted from the relaxation of a direct threat of the war in the Persian Gulf. Within the price of oil, the so-called war premium has been reduced. The average oil price in October this year amounted to USD 27.6 per barrel, so it was lower by USD 0.8 than in the previous month.

The price drop was also affected by the information on a further increase of oil production by OPEC member countries, despite the earlier decision on maintaining the existing limits at the unchanged level.

However, the oil prices drop did not last long, in November the price rose from the level of USD 22.8 per barrel on November 14 to USD 24.85 per barrel on November 25 this year.

Drop of oil prices in October, in November oil prices rose again

II. Situation in public finance sector

The accomplishment of the state budget after ten months this year means that there is no threat of exceeding the statutory level of budget deficit.

The advanced accomplishment of the annual plan of the state budget revenues indicates that it is possible to reach the level of budget revenues that is close to the one planned in the act on the state budget for the year 2002. The financial effects of systemic changes that became effective in the 4th quarter this year, i.e. the

State budget deficit in 2002 at the statutory level

decrease by 30% of the excise tax on alcohol products and the quarterly settlements of VAT by small and medium-size enterprises do not result – according to the information from the Ministry of Finance – in an essential decrease of the state budget revenues. It is mainly the result of a very little interest of enterprises in the new system of settlements.

The dynamics of the state budget expenses in October this year was high what was, inter alia, related to high costs of the debt service, the increased subsidy for FUS, and transferring the funds for the teachers' salary rises (the accomplishment of the 3rd stage of the education reform). After ten months the state budget expenses were higher by 8.1% than in the same period last year, but the index reflecting their accomplishment as compared to the plan was not much different than the ones reached in the previous years. The outlook for achieving the planned amounts of revenues in 2002 will probably not make it necessary to reduce the budget expenses.

Within the recent months, the financial situation of FUS and FP was still unfavorable. These funds will note a big excess of expenses over the revenues that is financed by bank loans. Only the financial situation of the Agricultural Market Agency looks a bit more favorable than it resulted from the forecasted accomplishment inserted into the act on the state budget for the year 2003.

According to the NBP forecasts, the economic deficit of the whole public finance sector in 2002 will be at the level of about 5.8% of GDP, i.e. by 1 percentage point bigger than planned in the draft act on the state budget.

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

In October 2002, the M3 money supply increased by PLN 0.35 billion. This increase would have been bigger if there were not a strong appreciation of the zloty. After eliminating exchange rate differences, the growth of M3 would have amounted to PLN 1.7 billion. The annualized dynamics of money supply has been getting lower since May this year and it is the third month in a row when it is negative. In October it amounted to – 2.5%.

However, the annualized dynamics of cash in circulation

Economic deficit of public finance sector in 2002 bigger than planned

Low money supply, drop of deposits placed by households at banks, little interest in lending

stabilized: it amounted to 14.8% as compared to 14.6% in September and over 18% in previous months.

October 2002 was the third consecutive month when a material drop of deposits placed by households was noted – it amounted to over PLN 2 billion (after eliminating exchange rate differences, this drop would be lower by PLN 0.6 billion). The annualized dynamics of deposits of households is accompanied by a strong downward trend, in October it amounted to –5.6%.

In October, as compared to September this year, the drop of loans to both, businesses and households, was noted. Annualized dynamics of these categories in October this year amounted to 0.5% and 8.3%, respectively, while in September this year these amounts were 1.2% and 8.4%

As compared to September this year, in October – after a positive result of the referendum in Ireland – the zloty visibly appreciated against both the dollar by 0.7% and the euro by 0.3%. In November, the appreciation tendency of the zloty was stronger. Within the period November 1-25, the exchange rate of the zloty appreciated by 4.6% and 2.9%, respectively.

Appreciation of the exchange rate of the zloty

IV. Prices, inflation expectations

In October this year, the 12-month inflation lowered to the level 1.1% as compared to 1.3% in September this year. The lower annualized growth pace of prices in October this year results from the drop of prices for alcoholic beverages what was related to the decrease of the excise tax on alcohol products and a drop of prices for tobacco products as well. In October, the foodstuffs together with non-alcoholic beverages, alcohol and tobacco products got more expensive by 0.3%, while in September by 0.6% and by 0.6% a year ago. The prices for foodstuffs and condiments dropped within a year by 2%.

The annualized consumer price index at a record low level 1.1%

The annualized index of the sold industrial output prices in October amounted to 1.7%. It was affected by the price rise: in the section production and supply of electric energy, gas and water by 6.9%, in mining and quarrying by 1.0%, and in industrial processing by 0.8%. Therefore, there is still the phenomenon of the

biggest increases of output prices in sections with limited market mechanisms.

Inflation on a low level supports the enhancement of low inflation expectations. In November this year, inflation expectations of both, individuals and bank analysts, stabilized. The 12-month inflation rate expected by bank analysts at the end of this year amounted to 1.5% as a month before, but the expected annualized inflation rate (October 2003) amounted to 2.5%. The mid-year inflation rate forecasted for 2004 amounted to 2.7%. The inflation rate expected by individuals within the year to come amounted to 0.9%, as in October this year.

Low inflation expectations