

Warsaw, 30 September 2003

INFORMATION FROM THE MEETING OF THE MONETARY POLICY COUNCIL

held on 29-30 September 2003

A meeting of the Monetary Policy Council was held on 29-30 September 2003. The Council was provided with the materials prepared by the NBP as well as information and analyses furnished by the Ministry of Finance, banks and research institutes. The Council discussed recent developments in the external environment of the Polish economy and trends in economic performance with regard to payments and social welfare benefits, in the public finance sector, with regard to money supply, credits and interest rates, inflation expectations and price levels as well as inflation prospects.

Decision taken by the Monetary Policy Council

August 2003 saw a deterioration of the annual CPI from 0.8% to 0.7% reported in July and June 2003. Similarly, the base inflation rate indicators stabilised at a low level.

Other economic data, which emerged since the previous meeting of the Monetary Policy Council indicates:

I. Continuous presence of future inflation-limiting factors:

- A low growth rate in industrial production prices; at 1.9% both in July and August 2003,
- Continuing strict salary discipline. Between January and August 2003, the average monthly salary in the corporate sector grew by 2.1% in nominal terms comparing to 4.2% on a year-to-year basis. After eight months 2003, a real growth in salaries was equal to 1.6%.
- In addition, the annual growth rate of monetary aggregates M3 remains low (at 1.4% in August against 0.7% in July 2003 and 1.3% in June 2003),
- A continuous moderate annual growth rate of receivables from households (at 8.4% in August against 7.9% in July 2003 and 8.5% in June). The annual corporate credit growth remained low at 1.8% both in August and July 2003,
- The inflationary expectations of households and bank analysts have steadied at a low level.

II. Confirms strengthening signs of the economic revival::

- August 2003 witnessed a 5.8% growth in PPI on a year-to-year basis. The slow-down in the production growth rate was affected by working time in

August 2003 being shorter by one working day; net of seasonal factors, the PPI grew by 8.8% and the processing industry PPI grew by 10%,

- In August 2003, construction industry production fell by 3.0% on a year-to-year basis, falling by 2.2% net of seasonal factors in the production, i.e. by the same amount as reported for July 2002. A 50% growth in the production of finishing construction companies has been sustained,
- September opinions on the economic situation in the industrial processing sector improved against opinions reported for August 2002 and 2001.
- On a year-to-year basis, a growth in exports was reported; by 4.9% EUR-denominated exports and by 26.5% in USD-denominated exports, after eight months 2003 (in accordance with payment statistics),
- Retail sales have been growing steadily, with a growth rate of 5.5% in August 2003.

III. Other possible factors creating inflationary pressure include:

- Developments in the 2004 fiscal policy and unclear budget perspectives for the coming years increase uncertainty as to the future FX rate level, as indicated by current developments on the FX market. The preliminary budget for 2004 poses a threat to continuous and sustainable economic growth. The high crediting needs of the budget stimulate an increase in long-term market interest rates which, in turn, will result in “pushing out” funds for companies,
- A continuous high growth rate of cash in circulation. In August 2003, the annual growth rate of the aggregate reached 15.7% (13.9% in July 2003 and 14.9% in June 2003),
- High oil prices prevailing despite a drop in the average oil price to 27.0 USD/b in September 2003. In consequence of the OPEC decision on reducing the oil production quota, the prices may bounce back to a high level.

Furthermore, the Council took into consideration the scale of interest rate cuts performed so far, as they will affect a gradual increase in the national demand at the end of 2003 and in 2004.

After a discussion, the Monetary Policy Council resolved to leave the NBP interest rates unchanged.

At the same time, the Monetary Policy Council decided to reduce the required reserve rate for banks from 4.5% to 3.5%. The resolution on the reduction will become effective on 1 October 2003 and applies to the required reserves to be maintained starting from 31 October 2003.

Furthermore, the Monetary Policy Council:

- Adopted a resolution on approving „Monetary Policy Guidelines for 2004”
- Approved “The Balance of Payments of Poland Forecast for 2004”
- Approved “The Balance of Payments based on Transactions and Balance of Foreign Assets and Liabilities of the Republic of Poland for 2002”.
- Approved “The Balance of Payments of the Republic of Poland for the first six months 2003”.

The next meeting of the Council is scheduled for 28-29 October 2003.

I. Overview of the economic situation

In August 2003 positive signals of the approaching economic revival in the international economic situation continued. This was confirmed by growing prices on international stock markets and improving corporate confidence indexes. In the USA, the ISM has been rising on four consecutive occasions up to 54.7 in August against 45.4 in April 2003; in the euro zone, the PMI reached 49.1 in August against 46.6 in June 2003. Increased optimism of the business circles was noticeable in all large economies of the euro zone: in France, Germany and Great Britain. The improving investment climate in Germany is reflected by the Ifo index, reaching 91.9 in September 2003 against 90.8 in August 2003.

August and September 2003 witnessed a decrease in market expectations of interest rate reductions both in the USA and the euro zone.

In August 2003, the average price of Brent oil/barrel equaled USD 29.8 and was higher by almost 1.5 USD than the price reported in July and by almost USD 5.00 than in April 2003. In the first and third decade of August 2003, oil prices remained above USD 30.00/barrel and reached the highest level quoted since the beginning of war in Iraq. The rising oil prices stem from political situation in Iraq and from persisting low oil stock level in the developed countries.

The first half of September 2003 witnessed a marked drop in oil prices following decreasing demand for petrol and reconstruction of distilled fuel stock, including fuel oil. Over the period, the average oil price remained at USD 27.5/barrel. Moreover, news from Iraq contributed to the decrease in oil prices. It is estimated that in the first half of September 2003, oil production in Iraq increased to 1.5 m.b./d, i.e. it is realistic to anticipate a bounce of the oil production to the pre-war level from the beginning of 2004.

According to GUS estimates the GDP growth rate in the second quarter 2003 reached 3.8%, i.e. it exceeded the expected level.

Total PPI grew by 5.8% in August 2003 viewed on a year-to-year basis. Compared to last year, production growth was observed in the processing industry (by 7.1%) and in electricity, gas and water production and supply (by 1.6%), while there was a fall in mining and quarrying (by 8.4%).

A slower PPI growth rate compared to the PPI growth rate reported in the two preceding months was affected by working time in August being shorter by one working day (after seasonal factors, the total PPI growth rate reached 8.8% and the processing industry PPI reached 10.0%). Another factor that has begun to affect deterioration in the production growth is so-called statistical base effect (in subsequent months growth rates will be computed in relation to the growing level of production in 2003).

As in the preceding months, the PPI growth reported in August is chiefly attributed to the favourable developments in sectors of high and

Improvement in the investment climate in the USA and the euro zone

High oil prices on global markets in August – drop in oil prices in the first half of September

PPI growth of 5.8%

increasing share of exports, including motor vehicles, trailers and semi-trailers sector, furniture sector, rubber and plastic articles sector and metal articles sector.

Since March 2003, a production growth in the motor vehicle sector exceeds 21% on a year-to-year basis, to reach 44.1% and 42.7% in May and July 2003, respectively. The growth comes as a consequence of a high, approx. 50% growth in the exports of car parts and accessories and continuously increasing growth in the exports of passenger cars. The value of passenger car exports lower by 20% in January and February 2003 than the value reported for the same months of 2002, exceeded the level reported for March 2002 by 35.1% and almost doubled in May 2003 when compared on a year-to-year basis.

High growth in export production and sales in the motor industry

After a growth reported in July 2003 (by 1.7% on a year-to-year basis), construction industry production fell again below the level reported in August 2002 (by 3.0%). There is little doubt that the fall was affected by a shorter working time when compared to August 2002 (a decline of 2.2% similar to the decline observed in July 2003 after seasonal effect elimination) but, primarily, it reflects a continuously low growth in the investment demand. An over two-fold growth in the production of the companies responsible for preparing construction sites observed in the previous months dropped to 67%, while over 50% growth in the production of finishing construction companies was maintained.

The research into the economic situation carried out by the Main Statistical Office indicate that September is yet another month of maintained favourable trends in industrial processing and still favourable, but in the respondents' opinion, worse market conditions in the construction industry. The respondents' negative assessment of the general business climate in retail trade is continued, with no noticeable signs of improvement.

Positive assessment of market trends in the processing and construction industry

Despite a slight deterioration of the respondents' optimism, the general business climate ratio in the processing industry is one of the highest reported in September since the beginning of research conducted by the Main Statistical Office.

II. Situation of public sector finance

After 8 months 2003, the state budget revenue was higher by 4.7% in nominal terms when measured on a year-to-year basis. After August 2003, only 61.8% of the plan specified in the budget act was executed, i.e. below the level reported for the past years. It indicates that the state budget revenue in 2003 will be below the volume planned in the act. In consequence of low receipts from CIT and non-tax revenue, the revenue generated in August remained 3% below the revenue of August 2002. A slight growth in indirect taxes and receipts from PIT was reported. Subsequently, despite expenditures remaining below the last year's level, a 15% growth in the budget deficit was reported when measured on a year-to-year basis.

After 8 months of 2003, budget expenditures amounted to PLN

126.1 bn. i.e. grew by 5.6% when compared to the budget expenditures for the same period of 2002. Execution of the expenditure plan after August 2003 is comparable to the level reported in the preceding years and equal to 64.7%.

After August 2003, the budget deficit reached approx. PLN 29.61 bn, translating into utilisation of approx. 76.4% of the annual limit, i.e. above the level reported in preceding years.

No observable improvement in the financial condition of the National Social Insurance Fund (FUS) was reported. Financial difficulties of the entity are indicated by receipts from insurance premiums below the planned level, a debt level close to the acceptable limit and the fact that only a part of funds due is transferred to the Open Pension Funds. The financial condition of the National Health Fund is also difficult in connection with lower than expected receipts from health insurance premiums. In addition, the NHF is struggling with due and payable dues of the patients' fund and possible compensation to hospitals arising from the provisions of the "203 Act".

Summarising, it can be anticipated that failure to execute the state budget revenue plan will result in adjustment of expenditures to a level ensuring realisation of the deficit defined in the Budget Act as well as in the increasing deficit of remaining units in the sector.

In the opinion of the NBP, economic deficit of the public finance sector in Poland in 2003 will remain at 5.4% GDP.

The draft *Budget for 2004 Act* predicts very high growth in the budget deficit from 4.8% of GDP in 2003 to 6.6% of GDP in 2004, including a subsidy to FUS to cover for the shortage of the premiums transferred to the Open Pension Funds. Despite continuation of the economic upward trend and return to the GDP rapid growth path anticipated in the governmental draft of the plan, it translates into a large-scale fiscal expansion. The scale of the expansion is larger than it would be required in order to finance budget expenditures connected with the membership of Poland in the European Union. The draft plan does not offer any system solutions to restrict growth in expenditures and most expenditures remain rigid. In consequence of a rapid growth in the state budget deficit and its credit needs in 2004, there is a serious threat that the public debt will exceed the second prudential threshold of 55% of GDP.

The draft budget for 2004 increases the threat to continuous and sustainable economic growth. Increasing economic risk will translate into a growth in the long-term interest rates and increased uncertainty as to the FX rate level.

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

Figures presented in the accelerated information indicate PLN 0.7 bn (0.2%) growth in nominal terms in the M3 money supply in August 2003. After the FX differences, the annual M3 growth rate in August remained unchanged, while the annual M3 growth rate reached 1.4%.

Following up on the trend observed in the preceding months, August

Deficit of the public finance sector in 2003 at 5.4% GDP

Increasing fiscal expansion in 2004

A slight growth in money supply in August

2003 witnessed a PLN 1.1 bn. growth in cash in circulation, resulting in an annual cash growth rate of 15.7%.

Total deposits – the M3 component – deteriorated by PLN 0.4 bn. (-0.2%) in September 2003, i.e. by PLN 1.2 bn when adjusted by FX rate fluctuation. Corporate deposits were subject to a slight drop by PLN 0.8 bn. i.e. -1.4% since they were only slightly affected by the FX rates, while a drop in the household deposits by PLN 0.1 bn. (-0.1%) in nominal terms increased considerably when adjusted by FX rate fluctuations to reach PLN 0.7 bn. August 2003 saw the annual household deposit growth rate at -6.9%, with a slowdown in this category's growth rate observable since March 2002. The trend is parallel to continued development in other forms of savings alternative to bank deposits. July 2003 witnessed a PLN 1.9 bn. growth in the value of net assets of investment funds followed by an approx. PLN 1.7 bn. growth of same in August 2003.

In August 2003, total dues increased by PLN 1.4 bn. (0.6%), i.e. PLN 1.2 bn. after the elimination of FX differences. The highest share in the growth is attributed to the growth in household loans at PLN 1 bn. The annual growth rate of household loans in August 2003 amounted to 8.4%. Housing loans have constituted nearly 90% of the growth in private loans reported for the period of the past 12 months. A slow growth in corporate loans was reported with its annual growth rate in August at 1.8%.

In August 2003, the exchange rate of the zloty in nominal terms gained ground against the euro and depreciated towards the dollar. It stemmed from a change in the USD/EUR cross exchange rates; the average monthly value of the euro against the dollar deteriorated to 1.12, reaching the lowest level in the past four months.

September 2003 saw increasing fluctuation in the zloty exchange rate. Zloty was losing ground and the trend grew stronger in the second half of the month. Polish currency displayed stronger depreciation against the euro; EUR/PLN exchange rate went up to approx. 4.41 in the first half of September to reach 4.52 in the second half. On average, the zloty weakened against the euro by 2.3%. The weakening came as a result of uncertainty with respect to the public finance perspectives; moreover, the effect of the euro gaining ground again against the dollar on the global markets (the EUR/USD exchange rate improved from 1.08 at the beginning of September to 1.14 in the last week of September).

Iv. Prices, inflationary expectations

In August 2003 the twelve-month inflation rate reached 0.7% against 0.8% in July 2003. The insignificant CPI growth was affected by reductions in the prices of foodstuffs and non-alcoholic beverages (by 0.4%), prices of clothes and footwear (by 2.7%) and prices of alcohol and tobacco (by 3.0%). At the same time, an increase in transport prices (by 3.8%) was reported caused by fuel prices rising (by 2.0%) in consequence of high oil prices on international markets.

In August 2003, the "net" annual inflation rate totaled 0.8%, while the monthly "net" inflation indicator reached 0.1%.

The level of the annual PPI remained unchanged in August 2003,

Moderate growth in household loans; low growth in corporate loans

Weaker zloty in September

The annual CPI at 0.7%

The annual PPI at 1.9%

while producer prices grew by 1.9% on a year-to-year basis, and production sold price index grew by 0.4% (against 0.7% in July 2003).

September 2003 saw a decline in the inflation rate expected within the coming year by private individuals to 0.7% i.e. by 0.1 perc. point against the level reported in August 2003.

In September 2003, the inflation rate forecast by banking analysts for August 2003 reached 2.3% i.e. by 0.1 perc. point above the level reported for August 2003. There was a 0.2 perc. point drop in the inflation rate expected at the end of 2003 to 1.4%, while the annual average price growth forecast for the end of 2004 remained at its August 2003 level of 2.2%.

**Steadying low
inflationary
expectations**