

## **INFORMATION FROM A MEETING OF THE MONETARY POLICY COUNCIL, held on 28-29 January 2003**

On 28-29 January the Monetary Policy Council held a meeting. The Council read materials prepared by NBP Management Board and its Departments and also information and analyses furnished by the Ministry of Finance, banks and research institutes. The Council then discussed the external environment of the Polish economy as well as real trends, trends in payments and social welfare benefits, matters involving the public financial sector, the money supply, loans and interest rates and the structures of pricing and inflationary expectations, as well as the expected rate of inflation.

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

New economic data which emerged since the previous meeting of the Monetary Policy Council:

- a) Indicates strengthening signs of a continuing low growth rate in domestic demand:
  - a low salary growth rate in the industrial sector,
  - a further declining growth rate in construction industry proves the investment related demand to be very low,
  - the annual growth rate of monetary aggregates - M3 and loans - remains low, the cash growth rate has levelled off,
- b) Confirms that the German economy shows no signs of an upturn: optimism both by entrepreneurs and consumers' remained low for another month, economic growth forecasts have been downgraded.
- c) Shows that the current inflation and base inflation rate indicators have been reduced again.

Factors potentially stimulating inflationary pressure include:

- The level to date of interest rate cuts which, allowing for the customary time lag, will gradually stimulate growth in domestic demand in the second half of 2003 and in 2004,
- a probable overrun in the level of economic deficit in the public finance sector as envisaged in the draft 2003 Budget Act and uncertainty underlying fiscal policy for 2004,
- high oil prices fuelled by the impending military confrontation in Iraq.

**The Monetary Policy Council resolved:**

- to reduce the lombard rate from 8.75% to 8.50% p.a.,
- to reduce the re-discount rate from 7.50% to 7.25% p.a.,
- that the National Bank of Poland will conduct open market operations for 14-day maturities with a profitability rate of at least 6.50% p.a.,
- that the interest rate on term deposits taken by NBP from banks will be held at 4.50% p.a.,

**The Council confirms its neutral approach in respect of monetary policy.**

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In December 2002 inflation for the preceding twelve-month period stood at 0.8%, and fell below the short-term inflation target for 2002. This lower-than-expected inflation rate during the last several months of the year is primarily due to factors outside the domain of monetary policy. The major factors include:

- declining prices of foodstuffs and non-alcoholic drinks,
- a lower-than-expected rise in regulated prices, including a drop in alcohol and tobacco prices,
- a lower-than-expected global economic position.

2002 witnessed a continuing high supply in the foodstuffs and agricultural produce market stemming, amongst other causes, from good cereal, fruit and vegetable crops. These depressed the prices of foodstuffs and non-alcoholic drinks by 2.7%.

Relying on the available predictions for the 2002 national budget and pronouncements from bodies responsible for price regulation, a higher increase in excise duties and a curtailment of at least a portion of the lower VAT rates to date. This was attributable to a need to adjust indirect tax rates to those prevailing in the European Union. Consequently, an expectation of at least a 5% increase in regulated prices in 2002 would have been justified, whereas in reality it only reached 2.7%. This lower increase in prices in this group of goods and services was largely due to falling alcohol prices (3.1%) in the wake of the recently-reduced excise duty on spirits.

If it had been assumed that foodstuff, alcoholic and non-alcoholic drinks prices would grow at around the 2001 rate, the goods and services growth indicator in 2002 would have approached ca. 2.5%. In December 2002 the base inflation rate computed after exclusion of food and fuel prices was only 2%.

The considerable decline in the global economic situation contributed to the lessening of inflationary pressures via lower-than-expected growth in domestic demand and more favourable prices for numerous raw materials and imported goods.

**The next meeting of the Monetary Policy Council is scheduled for 25-26 February 2003.**

## I. Assessment of the economic situation

In November and December 2002 indicators anticipating the status of the US economy were markedly better than in the euro zone. American entrepreneurs' optimism was discernibly higher (the NAPM index rose in December to 54.7 in comparison with 49.2 in November); the orders portfolio in the processing industry expanded rapidly. In December American consumer-confidence weakened somewhat in comparison to November after information about employment figures was published. However, the high growth in US retail sales (4.6% compared to 2.7% in November) indicates that growth in individual consumption remains the chief growth factor in the American economy.

**Improved expectations in the USA**

By contrast, in the euro zone, the last two months of 2002 demonstrated a clear downturn, as shown by the majority of economic indicators. The industrial/economic activity index (PMI) dipped from 49.5 in November to 48.4 in December. German industry failed to report improvement; the IFO Institute indicator, best reflecting the mood of German companies rose only slightly - from 87.3 in December to 87.4 in January. Despite the Christmas shopping season, most West European economies (most notably those of Germany and Italy) suffered a sharp decline in consumer optimism (the index shows German consumer confidence declining from -11 in October to -17 in November and to -20 in December 2002). Evidence of the deteriorating confidence amongst German consumers is borne out by a fall in retail sales by almost 6% in November 2002, whereas in October the decline stood at a negligible 0.1%.

**Sharp deterioration of consumer-confidence in the euro zone**

Global oil prices continue to be a big question mark. A general strike in Venezuela and the already commonly-shared perception of the inevitability of a war with Iraq once again sent oil prices up in December 2002. On 20 December the price of oil reached USD 30 a barrel and levelled off. Thus, the average price of oil, month on month, was the highest in December 2002. Compared to December 2001 it rose by nearly USD 10 a barrel i.e. by nearly 50%.

**Oil prices rise again**

Venezuela's continued general strike, which has paralysed the country since early December, has reduced the global oil supply by over 2 million barrels a day. This is compounded by the market's anguished concern about the likelihood of continued supply of oil from the Persian Gulf. A war with Iraq may cause global oil production to shrink by another 2.5m. barrels a day (the current Iraqi quota under the oil-for-food programme). Should these two crises coincide, oil prices are bound to increase.

The Polish economy is showing signs of slow and gradual economic revival. During the third quarter of 2002 it grew by 1.6% and gross added value rebounded to 1.8%. On the demand side, growth was mainly stimulated by individual consumption and exports.

**In third quarter 2002 GDP grew by 1.6%**

In December 2002, the annual industrial output rose by 5.1%. Seasonally adjusted industrial production grew by 4.1% year on year. Production growth in the most significant industrial category – the

**Industrial production growth – further fall in**

processing industry - reached 6.7% (seasonally adjusted growth – 5.3%). Construction and assembly production shrank in December by 10.4% (the decline in November being -8.6%).

**construction and assembly production**

The November figures for the balance-of-payments confirm that a positive trend in foreign trade has been maintained. Exports are growing ever faster. Exports in EUR terms rose for a third month in a row – in this case the rise amounted to 6.1% as compared with the preceding year. Since the beginning of the year receipts from exports has risen by 2%. After a decline in October, imports rose again (by 3.1% in comparison with November 2001). Nevertheless, imports for the year to date were below the figures for the previous year (a fall of 3.4%).

**Good November results for foreign trade**

Reliable statistical data also shows a higher level of exports. Between January and October 2002, exports computed in EUR rose by 5.3%. Similarly, imports were higher than in 2001, even if their value rose at a lower rate (+2.8%).

Increased exports between January and October 2002 were primarily attributable to higher sales to Russia, Norway and Sweden. In terms of the main country groups, the most significant growth in sales was reported in the group of countries belonging to the Commonwealth of Independent States - 12.1% (including a 22% increase in exports to Russia) and Central and Eastern European countries - 9.8%. Sales to European Union countries rose by 4.1%. The lower growth rate of sales to EU countries principally resulted from a fall in exports to Germany (by 0.7%). The poor results of exports to Poland's main trading partner were partly offset by a large increase in exports to France and Sweden.

**Changes in the geographic structure of Poland's export**

Analyses of economic performance by the Central Statistical Office in December 2002 indicated a break in the trend of improving respondents' optimism, a trend which emerged at the beginning of 2002. Seasonally adjusted data indicates that the assessment of the situation in the processing industry, in terms of both domestic and foreign demand, sold products, inventory levels and the potential for on-going settlement of financial liabilities in December 2002 was pessimistic and bleaker than in November (although better than in December 2001). This pessimism was supported in respect of employment forecasts and was additionally reported in respect of the financial situation and the overall economic conditions. In the construction industry increasing pessimism was noteworthy in respect of the assessment of demand, production and the economic situation of construction and assembly companies. Research into trade points to the continuation of very pessimistic perceptions of the current and future standing in this sector.

**Worsening economic situation in the processing and in the construction industries**

The most recent research into the economic situation (carried out in January) indicates that pessimism is strong amongst respondents. A slight improvement was noted in the assessment of the overall conditions of the processing industry, primarily due to better-than-expected forecasts relating to demand and production; however the assessment of the current situation by companies continues to be negative. On the other hand, the pessimistic

assessment of the current situation of construction and trade intensified (primarily in respect of product sales by the construction industry and trade sales figures, as well as the financial standing of companies). Forecasts for the nearest future are equally bleak.

## II. Situation of public sector finances

Government revenue in 2002 was lower than expected. Lower than planned receipts from indirect taxes and personal income tax were partly offset by high corporate tax receipts (CIT) and non-taxable receipts, chiefly stemming from higher NBP earnings and customs duties. Higher tax receipts, approx. +7.3%, indicate that the economic situation in 2002, especially the financial situation of Polish companies, was slightly improved.

Despite a shortfall on the revenue side (PLN 1.6Bn.), the budget deficit reached PLN 39.4 Bn. (0.5% below the statutory limit) due to a reduction in expenditure to PLN 182.9 Bn., and partly to lower-than-expected costs of public debt servicing.

The funding of the deficit in 2002 was different than forecast. Privatisation receipts reached PLN 2.3 Bn. instead of the planned PLN 6.6 Bn. The deficit was financed mainly by the issue of Treasury securities on the domestic market, and issues in foreign markets partly covered foreign debt repayment. Consequently, planned net sales of Treasury securities on the domestic market were exceeded in respect of both Treasury bills and bonds.

Information gathered on funds and agencies confirms that their standing did not improve significantly compared to preceding months. A rise of debt in the banking system by, amongst others, the Labour Fund, the Social Security Fund and the Agricultural Market Agency, as well as on the part of local authorities, shows that the remaining public finances sector created, in 2002, a larger deficit than in the previous year. This was larger even than the one declared at the beginning of the year. It is estimated that the economic deficit of the entire public finances sector for 2002 may reach approx. 5.5 – 5.7% of GDP.

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

In December 2002, the M3 money supply rose by PLN2.6 Bn. (0.8%) above that of November 2002. Interest rate differences (appreciation of the zloty against the dollar and weakening against the euro) had a material impact on the aggregate M3 volume. After elimination of interest rate differences, monthly rise in M3 would have amounted to approx. PLN3.8 bn. (1.2%). At the same time, approx. PLN 0.6 bn. of the rise in monthly M3 is attributable to accounting practises: in December banks booked receipts from the issue of bank bonds as other M3 components.

The M3 increase in December 2002 stemmed primarily from PLN 4.4 Bn. (8.6%) higher corporate deposits, a typical phenomenon prior to the

**Budget deficit in 2002 below statutory levels**

**Economic deficit of the public finances sector in 2002 accounted for 5.5 - 5.7% of GDP**

**Money supply increase in December results from typical year-end rise in corporate deposits**

**Decline in household deposits**

end-of –year period. Household deposits (private individuals) shrank by PLN 1.8 Bn. (0.9%), of which approx. PLN 0.8 Bn. was attributable to exchange-rate differences. The shrinking household deposit base manifest since the beginning of last year was accompanied by dynamic growth in the volumes ploughed into alternative forms of savings. Estimated flow of household funds to investment funds reached PLN 2 Bn. in December.

On the money-creation side, the year-end saw another typical December phenomenon, i.e. a drop in total amounts due by PLN 1.8 Bn. (-0.7%), caused primarily by a fall in amounts due from corporations (by PLN 3 Bn., i.e. 2.3%). Amounts due from households rose by PLN 0.3 Bn. (0.3%). The annual rate of growth in amounts due from households rose slightly in December 2002 to 8.5%, and the annual rate of growth of corporate loans reached 1.6 %.

**Low growth rate of loans**

In December 2002 the zloty continued to gain ground against the US dollar (0.9%), but depreciated 0.8% against the euro. The euro continued gaining against the dollar and rose by 1.9% during the month.

**Zloty stronger against the USD, weaker against the euro**

#### **IV. Prices, inflationary expectations**

In December 2002, the twelve-month inflation rate fell again to 0.8%. The trend was helped by the lower prices of food and non-alcoholic drinks, alcohol and tobacco, clothing and footwear. The growth rate of prices relating to domestic consumption and furnishing was also lower than in the previous year. On the other hand, transport costs rose slightly as a result of higher fuel prices. The latter had dropped during the preceding year.

**Annual indicator of commodities and consumer services reached 0.8%; average annual inflation rate at 1.9%**

At the end of 2002 the annual inflation indicator “net” (i.e. excluding food, non-alcoholic drinks and fuel prices from the CPI) totalled 2.0%. Other base inflation indicators at the end of 2002 fitted into a bandwidth of 0.16% (base inflation rate after the exclusion of regulated prices) to 1.2% (15% end-adjusted mean).

The average annual price increase in commodities and services totalled 1.9% in 2002.

The sold-products prices in December 2002 rose by 0.1% above those in the previous month. Sales value of industrial products over a twelve-month period rose by 2.2%, pushed up by rising prices in all sectors of industry. Prices rose most steeply on the part of producers in those sectors where market-force rules have not yet taken effect. Electricity, gas and water supply-sector production prices rose 6.8% (as compared to 10.8% during the previous year), and in mining and quarrying the same rose 3.4% (as compared to 2.9% during the previous year). In industrial processing, prices rose by 1.4% (as compared to a 2.6% drop during the previous year). The most significant price rises over the twelve-month period as reported in the manufacture of coke and refined petroleum products, were 20.6% higher than during the previous year (when they dropped by 19.7%).

Low inflation strengthens low inflationary expectations.

In January 2003 the structure of replies to questions from an Ipsos-Demoskop survey, based on which the analysis is conducted of individuals' inflationary expectations, deteriorated markedly in terms of impact on the quantification of the expected inflation rate. At the same time, January witnessed a further decline in the rate of current inflation, which neutralised the result of undesirable changes in the structure of replies to the questions of the survey. The quantification procedure of inflationary expectations justifies the conclusion that in January 2003 individuals expect a 0.7% rate of price rises this year, which implies that the same declined by 0.1 of a percentage point in comparison with the results of a survey conducted in December last year.

Meanwhile, banking analysts expect the inflation rate in the month preceding the same month of next year (i.e. December 2003) to rise by 0.1 percentage point to reach 2.6%, whilst the average annual inflation rate for 2004 is estimated to be 2.7%, or 0.1 percentage point above December's forecast.

**Low inflationary expectations**