

Warsaw, 26 May 2004

## INFORMATION FROM A MEETING OF THE MONETARY POLICY COUNCIL

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On 25-26 May 2004 the Monetary Policy Council held a meeting. The Council read materials prepared by the Management Board and the NBP Departments, as well as information and analytical materials prepared by the Ministry of Finance, banks and research institutes. The Council discussed the external environment of the Polish economy as well as real trends, trends in payments and social welfare benefits, trends in the public finance sector, trends in the money supply, loans and interest rates, and the formation of pricing and inflationary expectations as well as inflationary prospects.

**Increasing since the beginning of the year inflation expectations of households, stabilised in May at a higher level. Some measurements of inflation expectations once again increased in May while expectations of price increases in retail trade achieved the highest level since 1997. In April there was a significant growth in the PPI indicator while some producers are planning further significant price increases in the nearest months. There were increases, though in various degrees, of all measurements of the base inflation rate. These factors combined with a decisive increase in economic activity, whose scale surpasses expectations, indicate a high likelihood of further increase in inflation.**

However, prepared analyses indicate that some of the indicators influencing an increase in inflationary expectations may be connected with Poland's European Union accession and probably have a temporary character. It may be assumed that data soon to become available will allow to better assess the force of influence of the transitory effects.

**Taking this into account, the Council resolved: To leave the monetary parameters unchanged and maintain its restrictive approach to monetary policy.**

In April 2004, the annual CPI was 2.2%.

The base inflation indicator on an annual basis were from 1.2% to 2.3%.

## **I. Factors favoring a low inflation rate:**

- continued low growth rate in corporate loans; its annual growth rate was at 0.8% in April against -0.4% in March 2004. However, a significant increase in financial resources of the corporate sector may limit its demand for credit;
- continued high growth rate of labour efficiency; it increased in industry as a whole by 22.4% on an annual basis in April 2004 (by 24.5% in March 2004) while in the processing industry by 25.1% (by 28.0% in March 2004)
- continued high unemployment, which could, to a certain degree, limit pressure on salary increases.

## **II. Factors giving rise to the risk of inflation growth:**

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- growth in inflationary expectations observed from the beginning of the year stabilised in May 2004 on a higher level. The inflation rate expectations of individuals within the next 12 months, rose from 1.6% in December 2003 to 2.4% in May 2004. Inflation rate forecasts of Bank analysts in the perspective of the next 11 months did not change (2.9%), however, the forecasts for the end of 2004 rose (3.0% against 2.6% last month). At the same time there was a further very strong growth of price increases expectations in retail trade, which reached the highest level since December 1997;
- there was a significant growth in the PPI indicator in April. This increase amounted to 2% in comparison with March, while producer price inflation accelerated from 4.9% in March to 7.5% in April on an annual basis, a level which was the highest since October 2000. Prepared analyses indicate that with relative continuity of the effective nominal exchange rate the acceleration of producer price inflation resulted foremost from producer prices increase in domestic sales which was a consequence of changes of raw material prices on world markets;
- the Polish economy is in a strong revival phase, whose growth rate exceeds earlier expectations, based on rapidly increasing export. However, there are also ever stronger signs of a significant revival of domestic demand. In April 2004, as compared to April 2003, industrial production was as a whole greater by 21.9%, with an increase of 25.2% in the processing industry. After seasonal trends, the growth in production as a whole amounted to 21.5%, with 24.9% in the processing industry. There was consolidation of the production growth trend in both the processing industry (with annual growth rate at 22.6%) as well as in industry as a whole (19.1%);
- retail sales have had a significant growth rate for several months (in March their value in current prices increased by 20.7% on an annual basis, and by 30.6% in April 2004). Such high growth rate of retail sales resulted partly from expectations of price increases after EU accession. However, even the high growth rate of those product sales as to which there were

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no price increase expectations after EU accession, indicates that the growth trend in retail trade may have a permanent basis;

- GUS studies in May of the general condition indicate that the seasonally adjusted assessment of the general condition of the processing industry remained at a level that was near to the highest level for the entire period studied, i.e. since 1992. There was a less pessimistic assessment of the condition in construction and trade than in the previous month;
- there are indications of renewed investment activity. There has been a next month of construction-assembly production increase (by 6.2% in March, by 25.7% in April). Production in the largest division of construction concerned with the elevation of buildings, civil and marine engineering increased by 29.8%, in enterprises performing finishing construction work by 40.8%. There is continued high sales level in cement and other construction materials. The very high growth rate in construction-assembly production and in sales of construction materials is also a result of introducing a significant increase in the VAT tax rate as of May 2004 for materials and construction services. In the 1<sup>st</sup> quarter of 2004 a further improvement was noted in the financial results of enterprises, which together with growing and high utilisation of production capacity allows to expect a revival of investment;
- supply factors constitute an ever greater threat to further increase in inflationary pressure. There are continued high oil prices and for a consecutive time there has been a successive increase in the forecast prices of this raw material. The current forecast of the average increase in the annual price of oil in 2004 increased by 3.3 USD/b in comparison with that forecast in April 2004. From September 2003 to April 2004 the price forecast increased from 26.0 USD/b to 34.7 USD/b. Furthermore, the price of foodstuffs in April increased significantly by 2.1%. The foodstuffs inflation rate for April amounted to 4.6% on an annual basis;

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- lack of public finances reforms and political instability are the source of continued uncertainty on financial markets leading to an increase in the yield of treasury securities and the weakening of the zloty exchange rate. According to the NBP there is an increasing likelihood of exceeding the second prudential threshold, i.e. 55% of the GDP, already in 2004.

The next meeting of the Council will take place 29 – 30 June 2004.

## External factors

Economic activity indicators from April 2004 have not changed the general view of the international condition that has been in formation since the beginning of this year.

In the US economy there is high growth rate in investment demand which has been confirmed by data on economic growth in the 1<sup>st</sup> quarter of 2004 (investments increased by 9.2% in comparison with the 1<sup>st</sup> quarter of 2003, which were the most dynamic component of domestic demand). Continued high level of indicators in the condition of the corporate sector, increasing pace of orders in the processing industry, and the strong growth in industrial production in April 2004 allow to expect that the upturn in the American economy will continue in the 2<sup>nd</sup> quarter of 2004.

However, there is a continued lack of clear signs of a permanent improvement of the condition in the euro area. External demand was the source of accelerated growth in the 1st quarter of 2004 in most economies of that region. There are, however, no signs of improvement in domestic demand, including consumer demand. Data for the 1<sup>st</sup> quarter regarding the activeness of retail trade and household confidence in the main countries of the euro area confirm the weakness of consumer demand that has continued in this region for already two years.

The inflationary effects of the strong increase in oil prices became apparent in April 2004, which is confirmed in the clear acceleration of production costs in most economies. In light of increasing signs of economic upturn in the US economy there has been an increase in market expectation of a rates hike by the FED.

In April 2004 the average price of Brent oil was 33.4 USD/b. In that month there was a systematic price increase (by 4.2 USD, i.e. by 14%). This trend continued also in the first half of May 2004 when the price of oil reached a level of nearly 40 USD/b and hence the highest since 1990. Strong pressure on oil price increase was connected with increased tension in the Middle East. Expansion of military activities in Iraq and increased attacks on oil infrastructure constitutes a real threat to the continuity of oil supply.

Increased economic growth in many parts of the world led the International Energy Agency to once again raise its forecast of world oil demand. According to these forecasts, the demand for oil this year will increase by 2 mln b/d and thus a biggest increase since 1988. A decrease in benzene supplies at the beginning of May 2004 was an added reason for an increase in oil prices.

In May 2004 the Department of State for Energy increased the forecast of oil prices for 2004 to 34.7 USD/b and thus by as much as 3.3 USD in comparison with the forecast for April 2004. From the beginning of the year, the forecast of prices was increased by 6.4 USD by that institution.

**Improvement of confidence in the US economy, lack of improvement in the euro area**

**High oil prices on world markets**

## **Economic situation in Poland**

According to initial NBP estimates, the rate of GNP growth in the 1st quarter of 2004 was significantly higher than in the 4th quarter of 2003 and amounted to about 6.4%. A faster growth in consumption and export while at the same time a relatively low import were the deciding factors in the increased GNP rate of growth.

It is estimated that in the 1st quarter individual consumption was higher than last year by about 4.6%. An increase in purchasing power available to households was at a similar level, with the decisive factor being the highest since the beginning of 2002 rate of growth on earnings from wage labour and earnings from economic activity on own account in non-agricultural sections of the economy. It is estimated that in the 1<sup>st</sup> quarter 2004 export was higher by 18.8% than the year before, particularly on account of increased sales abroad of processing industry products and services

The financial situation of enterprises in the 1st quarter 2004 was decidedly more favorable than in the analogical period of the previous year. This is evidenced by a significant improvement of all the indicators of effectiveness and increase in the percentage of enterprises registering net profit (about 10 points percentage).

The results of operational activity in the enterprise sector for the 1<sup>st</sup> quarter increased in comparison with the 1<sup>st</sup> quarter 2003 by 75.6%, while the net financial results more than four times, reaching the level of PLN 13.4 billion. In comparison with the 1<sup>st</sup> quarter 2003 losses from financial activity decreased by more than 50% , together increase in profits from the sale of products, goods and materials (by about 70%).

Indicators showing the effectiveness of the enterprises sector improved in comparison with the 1st quarter of the previous year. Indicators of the level of costs from activity as a whole decreased by 3.1 points percentage thanks to a faster growth of earnings from economic activity as a whole (increase of 19.6%) than costs from that activity (increase of 15.8%). Liquidity indicator of 1st degree increased by 6 points percentage, exceeding the 20% level recognised as safe from the point of view of cash liquidity. 35.7% of enterprises obtained a liquidity of above 20%.

Improvement in the indicators of cost levels and profitability of gross and net turnover was noted in all sections. There was also an improvement in the economic-financial situation of exporters in comparison with those observed last year, with the basic relations of effectiveness in that group of enterprises being more favorable than those of enterprises as a whole (with the exception of the liquidity of 1<sup>st</sup> degree indicator) .

In March 2004 there was again a decrease in the current account deficit. However, its decrease was clearly weaker than in the two previous months of 2004. In comparison with March 2003 the current account deficit decreased by EUR 50 mln and amounted to EUR 520 mln. The decrease in the negative current account balance was an influence of the positive balance of services (caused similarly as in the previous month by a high increase in export – on the basis of transactions was the highest balance noted and at the same time a decrease in export) and a decrease of the negative balance of earnings. A deficit increase in the turnover of goods had a negative influence on the change to the current account balance. The deepening negative balance in the turnover of goods in March 2004 (by EUR 200 mln) was the largest in the course of the last two years. This was a result of a higher rate of import growth (11.7% in comparison with March 2003) than for export (increase of 8.5%). The decrease of the positive transfer balance influenced the direction of the deepening current account balance.

**Higher than expected GNP growth in 1st quarter 2004**

**Financial improvement of enterprises**

**Improvement in current account balance**

From the beginning of 2004 the current account deficit decreased by EUR 1,2 billion. In the first three months of 2004 the improvement in the current account balance was influenced foremost by a surplus excess in the exchange of services as well as a deficit decrease in the turnover of goods and earnings. However, the excess in current transfers was lower than in the 1<sup>st</sup> quarter of last year. In the period January – March 2004 the value of export increased by 12,8%, while the value of import increased by 8,5%. In as far as there was a decrease in the growth rate of export in comparison with previous months, in case of import an accelerated growth rate was observed. In comparison with the period January – March 2003 the growth rate in 2004 was nearly three times higher (with the value of import increasing by 3.3%). Export also showed itself to have a higher increase than in the previous year (in the period of the first months of last year it increased by 8.3%).

GUS published initial data on industrial production growth was for a consecutive time higher than market expectations. In April the PPI indicator exceeded the 2003 level by 21.9%. There was continued very high increase in processing industry production whose volume exceeded the 2003 level by 25.2%. Construction-assembly production, after the first in four years significant increase noted in March (by 6.2% after correction), in April 2004 exceeded the 2003 level by as much as 25.8%. Such a high increase is in our assessment partly a result of compensating for high losses from January and February, nevertheless the scale of the increase is surprising and demonstrates an actual revival of this branch.

**Increase in industrial and construction-assembly production**

May GUS studies of the general condition indicate that the seasonally adjusted state of condition for the processing industry continued at a level near that of the highest one in the entire studied period, i.e. since 1992. The state of condition in construction and trade was assessed less pessimistically than in the previous month.

According to April GUS data in comparison with March 2004 the average salary did not increase nominally and in real terms decreased by 0.8%. In comparison with April 2003 this increase amounted to nominally 4.6% (2.3% in real terms). On an increasing balance January – April 2004 the average salary in the enterprise sector increased nominally by 5.4% (by 3.5% in real terms), while in the analogous period of 2003 this increase was 2.4% (1.9%).

There is continued increase in labour efficiency; in industry as a whole it increased in April 2004 by 22.4% on an annual basis (24.5% in March 2004) while in processing industry by 25.1% (by 28.0% in March 2004).

There has been for several months an increased growth rate in retail sales (in March their value in current prices increased by 20.7% on an annual basis, by 30.6% in April). The very strong acceleration in the retail sales growth rate in March and April 2004 – according to NBP estimates – was the main consequence of intensified purchases of goods prior to Poland's European Union accession. It is estimated that the acceleration in the retail sales rate to the extent of about 70% was caused by fears of price increases of goods after EU accession. Estimates show that this had the greatest effect on the automobile sector.

## **Condition of public finance sector**

After four months of 2004 the combined state budget revenue was higher compared to the analogical period last year (9.4%) which is a good result in face of its forecast annual increase (1.2%). The degree of annual revenue plan realization was also higher than last year's level (32.9% as against 29.8% in the previous year).

The high increase in indirect taxes (13.2% year on year), especially VAT, had the greatest influence by far on the formation of the state budget revenue in the period from the 1<sup>st</sup> to 4<sup>th</sup> quarters of this year. Especially strong influence from this title demonstrate an increase in retail sales stemming probably from increasing domestic demand and an increase in imports. There were also higher inflows from the CIT tax (6.2% year on year) that is probably a result of the improvement in the corporate financial situation. Significantly higher than in the previous year were also non-tax earnings (34.5%) mainly from the title of high customs duties inflow and earnings of state governmental units.

The state budget expenditures after April of this year, similarly as in the previous month, were nominally lower than the expenditures last year (by 4% year on year) in comparison with their planned level of 5.6% for the entire year. Limitation of state budget expenditures was influenced by significantly lower costs of servicing the public debt (by 13.3%), including domestic debt (by 25.7%) and subsidy for the FUS (Social Security Fund) (12%) and FP (Labour Fund), which for the first time was funded from the state budget in March 2004. Furthermore, general subsidy expenditures were characterised by a lower growth rate as well as subsidies for FER. As a result, the degree of realization of the annual revenue plan of budgetary expenditures reached 30.9% after four months of 2004 which means less than in the previous years.

As a result of a favourable earnings situation and low level of budgetary expenditure, the state budget registered at the end of April 2004 a surplus (PLN 0.8). At the end of April 2004 the level of the budget deficit amounted to PLN 10.99 bln (24.3% of that planned), hence, significantly lower than the amount last year (46.4.% of that planned).

The results after four months decrease the threat of a lower than planned budgetary earnings in 2004. However, the key period for realizing the state financial plan will be the months of May – July 2004 due to the expected loss of earnings and increase in expenditures connected with the introduction from May 1 of settlements with the EU budget.

There is continued good earnings condition of the FUS, FP, NFZ. Funds. This is to a great extent an effect of the growth in salaries and consequently high growth rate of premium payments. A continuation of this trend may contribute to a better than expected planned on this level financial situation of the above group of public sector entities.

**Lower than  
in 2003  
advance in  
expenditures  
and state  
budget deficit  
after four  
months of  
2004**

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

In April 2004, compared with March 2004, money supply increased significantly. The M3 aggregate increased in April by PLN 8.2 bln (2.4 %). The exchange rate differences had major impact on it. After eliminating their influence the M3 increased by PLN 0.7 bln (2.1) which still constitute one of the highest monthly growth for the last two years. The annual nominal growth rate of the M3 aggregate was 8.4 % and it achieved the highest value since December 2001. The observed growth of the M3 aggregate resulted mainly from important increase in deposits and corporate loans as well as commitments to the sector of other non-monetary financial institutions. The deposits and other commitments towards enterprises were still showing an increasing trend which has been observed since the end of the last year. Compared with March 2004 they increased by PLN 6.1 bln (9.3 %). After eliminating the influence of fluctuating exchange rates the increase amounted to PLN 5.9 bln. The annual growth rate of corporate deposits in April was equal 20.9 % - the most since July 2000. Such a significant increase in corporate deposits in April should be connected with an increase in the economic growth rate and also with a quickly increasing value of sales which stemmed from fear of an expected price increase after Poland's EU accession.

In April of this year household deposits at banks decreased by PLN 1.4 bln (0.7 %). After removing the influence of exchange rate fluctuations their decrease was even more significant and amounted to PLN 2.4 bln (1.2 %). Negative growth rate of the household deposits slightly increased to -1.6 %. It was not, however, the only result of the exchange rate fluctuations (strong appreciation of gold a year ago in conjunction with major depreciation in April of this year). The level of household savings as an alternative to bank deposits did not significantly change in comparison with March.

The state of cash in circulation outside bank tills increased in April 2004 by PLN 1.6 bln (3.1 %). The major growth rate of cash in circulation, at the end of April, just before the long weekend, is a typical phenomenon. The annual growth rate of cash in circulation dropped down to 12 % which is the lowest value since December 2002.

Among factors of money supply creation debtors increased nominally by PLN 5.9 bln (2.2 %). After eliminating the influence of fluctuating exchange rates this growth amounted to PLN 4.5 bln (1.7%). Changes in the state of debtors among other things resulted from the significant increase in households indebtedness.

In April of this year a significant increase in household bank loans was observed. The household debt increased by PLN 4.3 bln (4.1 %). After removing the influence of exchange rate fluctuations the real change in the debt amounted to PLN 3.7 bln (3.6 %). The annual nominal growth rate of household loans increased from 13.1 % in March to 18.2 % in April of this year. High growth rate of household debt in the Fall of 2003 almost completely stemmed from the increase in housing credits. April data received from banks show also an increase in volume of car loans, furniture purchase and household and RTV equipment. The debt increase to achieve the above mentioned objectives probably stemmed from a fear of price increase after Poland's EU accession. This may be a reason for its isolated character.

The April data show continued stagnation in corporate indebtedness in the banking sector. In April bank corporate indebtedness increased nominally from PLN 0.3 bln (0.2 %) which stemmed entirely from the zloty depreciation. After eliminating the influence of exchange rate fluctuations the enterprise indebtedness in the banking sector decreased by PLN 0.4 bln (0.3%). The annual growth rate of corporate indebtedness increased nominally from - 0.5 % in March to 0.8 % in April 2004. Such an increase resulted entirely from the exchange rate differences. The loan demand of enterprises may be limited by a significant increase in the availability of their own resources.

**Low growth rate for corporate loans**

In the period of 22 April to 21 May 2004 the zloty strengthened against the euro by 2% and 3.9% against the dollar (from the beginning of the year the EUR/PLN exchange rate has strengthened somewhat while USD/PLN rose by 4.2%). In the last twelve months the zloty weakened against the euro by 7.5% and 5.9% against the dollar.

**Drop in bond prices strongest for 2-year bonds**

Uncertainties resulting from political risk and existing dangers for the continuation of indispensable public finances reforms is the cause of the continuation of a long-term depreciation trend for the zloty. In May, fluctuations of the zloty resulted from a changing market assessment as to the chances of calling a government of Premier Belka and the publication of macroeconomic data for April.

A downward trend continued on treasury bonds market. From the last meeting of the MPC benchmark bond prices decreased. As a result the yield on 2-year, 5-year and 10-year bonds increased in this period by 53, 26 and 28 b.p. respectively (from the beginning of the year this change was 128, 107 and 86 b.p. respectively).

This trend was influenced to a greatest extent by factors of a domestic character, which is demonstrated by an increase in yield variability of 2-, 5-, and 10-year bonds in respect of an analogical eurobond area. Confirmation of a continued high investment risk is the lowering of Poland's long-term rating in domestic currency by Fitch Ratings.

Similarly, as in April, the high growth rate of industrial production strengthened expectations of a rates hike. Because of this, 2-year bonds, which are most sensitive to rates changes by the central bank, lost the most on their value.

## **Prices, inflationary expectations**

In April 2004 the annual CPI was 2.2% (1.7% in March). In comparison with April 2003, the highest increases in prices were in foodstuffs and non-alcoholic beverages (4.6%), prices for apartment usage and power carriers (3.0%) prices in transport (3.5%), including cost of fuels (4.7%). Lower than in April 2003 were prices of clothing and footwear.

**Significant growth in PPI indicator**

In April 2004 there was an increase in the base inflation indicators from 1.2% (net inflation) on an annual basis to 2.3% (base inflation indicator after excluding controlled prices).

The PPI increased in April 2004 significantly above market expectations and amounted to 7.5% on an annual basis, and at the same time was set at the highest level since October 2000.

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NBP analysis show that up to February 2004 the price producer price increases were a result chiefly of prices obtained in export. The index of domestic prices remained stable and amounted to about 2% on an annual basis. In March and April 2004 there was a change and the producer prices in the processing industry section were stimulated by domestic prices. This is chiefly connected with price increases in the following divisions: production of coke and oil refinery - where in that division the earnings from export sales amounted in 2003 to 6.3% - and metals production. After excluding these two divisions from the processing industry section the April prices would have increased by about 0.6% in comparison with March, hence, on the level of January and February. An increase in the PPI in the section of processing industry have to a great extent a supply character resulting from the increase in oil and metals prices on world markets. In divisions less dependent on raw material significantly smaller price increase are noted.

The inflation rate expectations of individuals in May 2004 , within the next 12 months, amounts to 2.4% (by 0.1 point percentage more than in the previous month). Bank analysts forecast that in December 2004 the inflation rate will be 3.0% (an increase of 0.4 point percentage), in April 2005 at 2.9% (no change), while the average annual rate of inflation in 2005 at 2.9% (increase of 0.1 point percentage).