

Warsaw, 30 June 2004

INFORMATION FROM A MEETING OF THE MONETARY POLICY COUNCIL

Held on 29-30 June 2004

On 29-30 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 in the area of payments and social welfare benefits, trends in the public finance sector, trends in the money supply, loans and interest rates, and in the formation of pricing and inflationary expectations as well as inflationary prospects.

The annual inflation rate rose from 2.2% in April 2004 to 3.4% in May 2004 – to a level significantly higher than expected, nearing the upper limit of the permissible deviation from the inflation target. There was a further significant increase in the PPI indicator – to a level of 9.6%. There were also strong increases in all measurements of the base inflation rate from a level of 1.2%-2.3% in April 2004 to 2.0%-3.7% in May 2004. Inflation forecasts by NBP experts signal the risk of a further increase in inflation.

Observed acceleration of inflation is to a large extent a result of the growth in the prices of fuels and food, an increase in indirect tax rates and other factors connected with Poland's EU accession. This type of price increases does not have to lead to a permanently increased inflation if it does not strengthen inflationary expectations and in effect does not lead to further increase in salaries and prices. With this as background it is significant that increased inflation expectations of households, took place even before the publication of the inflation data for May 2004. Since the beginning of 2003 there has also been a systematic growth in expectations of price increases in retail trade.

Risk of inflation growth, which is connected with increasing inflationary expectations, is increased by a significant growth in domestic demand. Conducted analyses indicate that the slowing down of the growth rate of the PPI and of retail sales, noted in May 2004, resulted chiefly from the compensatory acceleration effect during the period of March-April, connected with Poland's EU accession. This means maintenance of the strong growth trend of these measurements which has been observed for many months.

Endeavouring that the increased inflation has a transitory character and that, after the expiry of extraordinary factors, it returns to a level in line with the MPC's inflationary target (2.5%), the Council has resolved to raise the NBP rates by 0.5 point percentage to the level of:

- **reference rate 5.75% on an annual basis;**
- **lombard rate 7.25% on an annual basis;**
- **deposit rate 4.25% on an annual basis.**

The Council maintains its restrictive monetary policy stance. The resolutions of the MPC come into force as of 1 July 2004.

I. Factors favouring a low inflation rate:

- growth rate in corporate loans has decreased; its annual growth rate was at –2.3% in May 2004 against 0.7% in April 2004. Corporate demand for credit may be limited by the still high level of their own financial sources which remain at their disposal;
- continued high growth rate of labour efficiency; in May 2004 it increased in industry as a whole by 12.8% on an annual basis (by 22.4% in April 2004) while in the processing industry by 14% (by 25.1% in April 2004);
- continued high unemployment, which could to a certain degree limit pressure on salary increases. In May 2004 the average salary in the enterprises sector rose by 4.4% in comparison with May 2003 as compared with the increase by 4.6% in the period from April 2003 to April 2004.

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

- from the beginning of the year inflationary expectations of households are increasing. Inflation rate expectations of individuals within the next 12 months rose from 1.6% in December 2003 to 2.7% in June 2004. Inflation rate forecasts of bank analysts for the end of 2004 did not change (3.0%), however, the inflation forecasts for the next 11 months decreased insignificantly (2.7%) as well as the forecast of the average annual inflation in 2005 (2.8%). Both surveys were conducted at a time when the size of inflation for May 2004 was not known.
At the same time there was a further growth in price increase expectations in retail trade. Traders are signaling further price increases, mainly in foodstuffs. The general condition indicator informing of planned price increases for foodstuffs has been increasing systematically from the beginning of 2003;
- there are significant increases in the PPI indicator. In May 2004 they increased by 1.2% in comparison with April, while producer prices inflation on an annual basis accelerated from 7.5% in April to 9.6% in May 2004 - a level which was the highest since December 1997. NBP analyses indicate that the acceleration of producer prices inflation resulted foremost from producer prices increase in domestic sales which was amongst others 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. In Q1 of 2004 the GNP growth rate was 6.9% in comparison with 4.7% in Q4 of 2003. The main factor of the strong GNP growth was domestic demand which exceeded the level of a year ago by as much as 5.7% in comparison with 2.6% in Q4 in 2003. In Q1 of 2004 an increase in gross investment expenditures was also noted, which amounted to 3.5%, in comparison with 0.1% in Q4 of 2003. May 2004 was a further month in the growth rate of the sold production of industry. Industrial production as a whole was greater by 12.3%, with 14.3% on an annual basis

in the processing industry. After seasonal adjustments, the total production growth was 14.9% on an annual basis, with 17.1% in the processing industry. While the April growth of construction-assembly production was not maintained, however, in connection with the observed phenomena of issuing invoices for a portion of works in April, it is estimated that in the period of April – May construction-assembly production was higher than a year before by about 4.5%, which indicates a gradual revival of a growth trend in this industry branch.

GUS study published on 22 June 2004 of the general condition indicates a further improvement in the climate of the general condition in the processing industry. An assessment of the climate of the general condition, taking account of seasonal adjustments, was the highest for the entire period studied, i.e. since 1992. There was also improvement in the assessment of the climate of general condition in construction and trade than in the previous month.

- monetary policy is conducted with a lax fiscal policy and a lack of clear perspectives as to the scale of reforms, which could lead to the recovery of public finances;
- supply factors may lead to a further increase in inflationary pressure. Oil prices continue at a high level and the forecast prices of this raw material were very insignificantly decreased. The current forecast of the average annual price of oil in 2004 was decreased by 0.4 USD/b in comparison with the forecast in May 2004. From September 2003 to June 2004 the forecast prices increased from 26.0 USD/b to 34.3 USD/b.

The price of foodstuffs in May 2004 increased by 0.6%, while the foodstuffs inflation rate for May amounted to 5.2% on an annual basis. In the first half of June the price of foodstuffs rose in comparison with May 2004 by 2.4%.

The next meeting of the Council will take place 27-28 July 2004.

External factors

Significant increase in the price of oil in April and May 2004, accompanying other price increases in energy carriers negatively influenced the May survey results of consumer expectation in the US and in the euro area.

Weakening of price pressure on the oil market in June brought American consumers back to an optimistic mood. Evidence of a high growth rate of demand in US households found confirmation in accelerated retail sales as well as a clearly higher than expected increase in number of permits for the construction of houses in May 2004. In May and June there was also an improvement in the situation on the American labour market. There was a clear above market expectations increase in US industrial production, which influenced an increase to 77.8% in the industrial indicator for production power utilisation in industry – a level highest since May 2001.

There was an improvement in the general condition of enterprises in the euro area, particularly in Germany. The main factor galvanizing the general German industrial condition is – similarly as in Q1 of 2004 – foreign demand. A strong export growth rate in April 2004 was accompanied by a considerable acceleration in industrial production. A significant increase in the pace of export orders, covering to a great extent investment goods, may indicate a continuation of favourable trends in German industry for the Q2 2004.

**Improvement
in climate of
general
condition in
euro area**

The average price of Brent oil in May 2004 was 37.9 USD/b and was higher by 14% in comparison with April 2004 and by 47% in comparison with May 2003. This was the highest annual price increase since February 2003. The high level of oil prices was influenced foremost by the increased political risk in oil production countries (mainly Iraq and Saudi Arabia), continued low level of oil and benzene supplies and higher than expected increase of demand for oil.

At the beginning of June 2004 OPEC decided to raise oil production limits. The impact of this decision on a decrease in the price of oil turned out to be short lasting. Widening war activities in Iraq and increased sabotage attacks on the oil infrastructure of that country interrupted further price decreases. After the first 20 days in June 2004 the average price of oil amounted to 35.8 USD/b. After the OPEC decision to increase production limits the Department of State for Energy lowered somewhat in June 2004 the forecast for the price of oil for 2004 to 34.3 USD/b, thus by 0.4 USD in comparison with the May 2004 forecast.

**High oil
prices on
world
markets**

Economic situation in Poland

According to GUS published data, the rate of GNP growth in the Q1 of 2004 amounted to 6.9%, in comparison with 4.7% in Q4 of 2003. Domestic demand was decisive in the strong GNP growth rate which exceeded the level of the year before by as much as 5.7%, in comparison with 2.6% in Q4 in 2003. Increased domestic demand resulted from a very high growth rate of accumulation (21.8%, in comparison with 0.9% for Q4 in 2003), which occurred during a moderate revival in expenditures on fixed assets (3.5%) and a surprising strong increase in supplies.

In Q1 of 2004 an increase of 3.5% in gross investment expenditures on fixed assets was noted, in comparison with 0.1% for Q4 of 2003. Data from F-01 database indicate that an increase in expenditures in large enterprises was chiefly a result of increased purchases of means of transport, which was undoubtedly influenced by expectations of

tax changes as of 1 May 2004.

In Q1 of 2004 the growth rate for individual consumption reached a level near that noted in the previous quarter (rate of growth amounted to 4%, in comparison with 3.9% in Q4 of 2003). The possibility of a stronger acceleration in individual consumption suggested a higher turnover in retail trade, significant improvement in available household incomes and a low reference point for the previous year.

**Higher than
expected
GNP growth
in Q1 of 2004**

According to GUS data cumulative consumption increased in Q1 of 2004 by about 0.7%. As a result, the growth rate of consumption a whole amounted to 3.3%, hence as much as in Q4 of 2003.

There is as yet no data on export and import growth rate for Q1. One can estimate, however, that the net export input to GNP growth amounted to about 1 point percentage, in comparison with about 2 point percentage in Q4 of 2003. The growth rate in production branches orientated on foreign sales indicates a likely further acceleration in Q1 of export growth rate. One should expect that a decreased participation of net export in GNP growth was caused by a strong increase in import, which is indicated by initial data from the current account.

In April 2004 the current account deficit amounted to EUR 610 mln. For the first time in 2004 there was a deepening of the negative current account balance in comparison with the previous year (by EUR 260 mln). This was an influence of the worsening negative balance in the turnover of goods. In April 2004 the foreign trade deficit increased to EUR 1.1 bln (thus it was the highest since December 2000). In comparison with April 2003 the deficit in the turnover of goods deepened by EUR 660 mln. A strong increase in import significantly exceeding export growth contributed to this. The value of import in comparison with April 2003 increased by 36.3%, thus the most since March 1998. Also, an increase in the value of export (by 25%) was higher than the average in the period January – April 2004. However, remaining positions influenced in the direction of improving the current account balance. The increase in the the positive balance of services and transfers was accompanied by a decrease in the earnings deficit.

After four months of 2004 the current account deficit amounted to EUR 950 mln and was by 1 bln lower in comparison with the period January – April 2003. All the positions influenced in the direction of improving the current account balance. The strongest – increase in the positive balance of services (by EUR 650 mln) and decrease in earnings deficit (by EUR 270 mln). In the following months of 2004 there is, however, a decrease in the influence of the improvement in balance of goods on the decrease in the current account deficit. In comparison with the period January – April 2003 the negative balance of foreign trade decreased by barely EUR 10 mln (while in the period January – March 2004 by EUR 70 mln). This results from acceleration of import, whose growth rate after four months of 2004 neared that of the export growth rate. In the period January – April 2004 the value of export increased by 21.8%, while import by 19.4% in comparison with the same period in the previous year.

**Improvement
in current
account
balance**

According to initial GUS data the annual growth rate of PPI amounted to 12.3% in May 2004, in comparison with 21.8% in April. To a great extent the smaller number of working days had an influence on the decrease in the annual growth rate in industry. The duration of work in May 2004 was shorter by 1 day than a year ago. After seasonal adjustments industrial production increased by about 15%. Decrease in the growth rate of the processing industry (from 25% in April to 14.3 in May) is also connected with the effects observed in the pre-accession months. In conformity with expectations,

the strong growth in minerals production industry was not maintained. One can assess, that this decreased industrial production growth as a whole by more than 2 points percentage. There was continued strong growth in mechanical vehicles production. After stabilization of the level of radio and television sets production lasting nearly one year, for a second consecutive month a clear acceleration was noted in the growth rate of this section. However, there was a stronger than expected decrease in the growth production rate of other industries with a large participation in export sales.

The jump increase in construction-assembly noted in April was not maintained. Its level in May was lower than a year ago by 13.4%. This data confirms that the very strong increase in construction-assembly noted in April turned out to be to a large extent caused by expectations of an increase of VAT on construction materials from 1 May 2004. Most probably in connection with this, April saw the issuing of invoices for a part of the works performed in May, which undervalued the level of construction production in that year. One can assess that in the period April – May construction – assembly was higher than a year ago by about 4.5%, which indicates a gradual revival growth trend in that branch.

GUS studies of the general condition published on 22 June 2004 indicates a further improvement in the general condition of industrial production. An assessment of the general condition climate, after seasonal adjustments, was the highest in the entire period studied, i.e. since 1992. There was also an improvement in the assessment of the general condition climate in construction and trade.

According to GUS data for May 2004, in comparison with April 2004 the average salaries in the enterprises sector decreased: nominally by 3.0%, by 4% in real terms. In comparison with May 2003 salaries rose nominally by 5.3% (by 3.1% in real terms), while in the analogous period of 2003 this increase was 1.8% (1.4%).

Increase in industrial and construction-assembly production

Condition of public finance sector

After five months of 2004 the combined state budget revenue was higher than in the analogical period last year by 9.1%, which is a very good result in face of the 1.2% annual increase set in the Budget Law.

The high increase in indirect taxes (13.4% year on year), both excise and VAT, had the greatest influence by far on the formation of the state budget revenue in the period of June – May 2004. Especially strong receipts from this title were connected with increased retail sales resulting from increasing domestic demand. Despite a lower tax rate on legal persons in 2004, the receipts from CIT after May 2004 are significantly higher than those of last year (14.8% year on year) and constitute as much as 60% of the annual plan. Such high receipts from CIT result from a favorable settlement of the annual CIT for 2003 and demonstrates an improvement in the corporate financial situation. Non-tax earnings (14.0%) were also significantly higher than in the previous year and were mainly from the title of higher earnings of state governmental units, lump sum EU payments to the state budget for the purpose of improving liquidity and *gmina* (communes) payments being the consequence of a change in the basis of financing self governing territorial units in 2004.

After five months of 2004 the state budget expenditures continued to be nominally lower than the expenditures last year (by 3.5% year on year) in comparison with their planned increase at the level of 5.6% for the entire year. Limitation of state budget expenditures was influenced by lower costs of servicing the domestic debt - by 17.3%, and subsidies for the FUS (Social Security Fund) (14.6%) and FP (Labour Fund) (84.3%). Higher than in the previous year, however, was the cost of servicing the foreign debt (24.6% year on year) and subsidies for FER (3.1%). As a result, the degree of performance of the annual revenue plan of budgetary expenditures, despite making in May 2004 a membership payment to the EU budget, amounted to 38.6% after five months of 2004, which is less than in the previous years.

As a result of a favourable earnings situation and low level of budgetary expenditures, the state budget registered at the end of May 2004 a deficit in the amount of PLN 15.3 bln (33.8% of the annual plan), hence, significantly lower than the amount last year (59.9% of that planned).

In June and July 2004 it can be expected that there will be a worsening of the state budget situation because of lower budget earnings caused by introduction from 1 May 2004 of indirect taxation in settlements.

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 planned financial situation for this group of public finance sector entities.

The NBP's assessment is that the cash deficit of the public finance sector will be formed in 2004 at the level of 6.5% of GNP and will be near the size planned by the Minister of Finance. The government accepted *Grounds for the Draft Budget Law for 2005* assume a reduction in the state deficit in 2005 to the level of PLN 38.8 bln, i.e. 4.1% of GNP from 5.3% of GNP planned for 2004. The level of the budget deficit set for the next year is based on the assumption of taking into account savings from the title of the not yet passed by Parliament laws contained in the *Programme for Rationalising and Limiting Public Expenditures*, i.e. changes to the valorisation principles of retirement-disability benefits and premium payments in the social security system. In face of a low progress made in advancing the *Programme* and the uncertain political situation, a risk is created of a higher than planned state budget deficit and in effect the deficit of the entire public finances sector. Moreover, there is a high probability that in 2004, the public debt will exceed the second prudential threshold (55% of GDP). This will mean that (without changing the debt definition) it will be necessary to drastically adjust fiscal policy in 2006. In light of this threat it is advisable to have a deeper reduction of the public deficit in 2005 than is indicated in the *Grounds*, through essential limitation of state budget expenditures that do not result in worsening the situation in the remaining segments of public finances.

**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.

**Low growth
rate for
corporate
loans**

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.

Drop in bond prices strongest for 2-year bonds

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.

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.

Significant growth in PPI indicator

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.

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.

NBP analysis shows 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).