Inflation Report

Third Quarter 2003

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SUMMARY

1. The twelve-month consumer price index (CPI) growth in subsequent months of the third quarter remained at 0.7–0.9%. In relation to the corresponding quarter of 2002, it was characterised by the relatively slow growth of food prices (showing a decline in the previous year) as well as slower growth of officially controlled prices and prices of other goods and services.

2. The twelve-month producer price index (PPI) in the third quarter was stable and settled slightly below 2%. During the period, a similar trend was followed by the manufacturing price index. Meanwhile, a substantial fall was recorded in prices in the ‘electricity, gas and water supply’ section (as a result of smaller electricity price increases than in 2002) and a significant price growth in ‘mining and quarrying’ (inter alia, due to copper and coal price increases in international markets).

3. Annual money supply growth, measured with M3 index, continued to be low. Its acceleration in September to 3.1%, up from 1.7% in August, was largely attributable to zloty depreciation. The change in the M3 index in the third quarter was determined by the strong growth of corporate deposits, further expansion of notes and coins in circulation (by 16% in September, annualised) and a decline in household deposits related, among other things, to the continuing appeal of forms of saving other than bank deposits (such as investment funds and treasury bonds).

Annual household credit growth ran at 8–10%, with housing loans being the main component. Annual growth of corporate credits in the period examined stayed below 2%. Their growth resulted from exchange rate movements. The volume of zloty-denominated credits declined, whereas currency-denominated credit growth, expressed in zloty, was attributable solely to foreign exchange movements.

4. The situation of the general government budget in the third quarter worsened compared to the corresponding period of 2002. Due to slow growth of tax receipts and high subsidies transferred to extra-budgetary funds, the budget deficit widened to 4.6% of GDP from 2.2% of GDP in 2002, based on preliminary estimates.

5. According to NBP estimates, GDP growth in the third quarter of 2003 was similar to that recorded in the previous quarter and amounted to 3.7%. However, its structure altered: consumption growth slowed down while gross capital formation accelerated. In the third quarter, consumption growth continued to exceed growth of registered disposable household incomes.

In the period examined, added value growth in industry settled at the same level as in the previous quarter, added value growth in market services slowed down, while the decline in added value in construction was partially halted.

6. Output growth in the third quarter, as in previous quarters, was the result of increasing labour efficiency. Falling employment was still recorded, although on a smaller scale than in 2002. Both the numbers of unemployed being registered and the unemployment rate continued to decrease. This does not signify, however, that unfavourable tendencies in the labour market had been reversed in the long term as many indices for that market deteriorated.

7. The current account deficit in the third quarter was 650m euro lower than in the corresponding period of 2002, falling to 2.4% in relation to GDP. The decisive effect on the improvement of the current account balance was exercised by further reduction in commodity trading deficit and the growing positive balance on unclassified transactions. In the period from July to September, commodity exports and imports climbed, respectively, by 7.1%, and 2.6% (in euro terms, on a cash basis) in relation to the corresponding period of the previous year.

* * *

In the third quarter of 2003, the Monetary Policy Council did not change basic NBP interest rates, leaving the lombard rate unchanged at 6.75%, the rediscount rate at 5.75%, the reference rate at 5.25% and the deposit rate at 3.75%.

At its September meeting, the Council resolved to reduce the banks' required reserve rate from 4.5% to 3.5%.

In the third quarter, annual CPI, core inflation and PPI indices remained stable at a low level. At the same time, low household inflation expectations were also reinforced.

In the context of further falls in employment, strong payroll discipline was maintained in enterprises throughout the third quarter. As a result, incomes from hired labour in this sector were nominally lower than a year before. In total, it is estimated, however, that gross registered disposable household incomes expanded in the third quarter compared to the corresponding quarter of 2002, and the rate of personal consumption growth continued to exceed that of gross registered disposable household income.

Household deposits in the third quarter continued to shrink, whereas the annual household credit growth remained moderate. Overall, it is estimated that household financial savings in the third quarter were negative. The annual growth of corporate credits returned to a very low level after major increases in the previous quarter. Concurrently, a significant increase was observed in corporate deposits.

High growth of sold industrial output was sustained, in particular in manufacturing, while the rate of decline in construction decreased. The volume of retail sales in the third quarter was higher than in 2002. Favourable trends in Polish exports observed in preceding months continued to intensify.

Monthly evaluations of the general economic climate carried out by the Main Statistical Office (GUS) in the third quarter, both in manufacturing and in construction, were definitely better than in the corresponding period of the two preceding years.

All in all, available information on the economic situation in the third quarter pointed to strengthening symptoms of a recovery, which may constitute a potential source of inflationary pressure in the future. Therefore, caution in the conduct of monetary policy was advised.

The biggest concerns of the Council continue to be raised by the condition of public finances. When giving its opinion on the draft *Budget Act for the year 2004*, the MPC voiced its fear that the assumed considerable general government budget deficit and the resulting growth of long-term interest rates would lead to the crowding-out of private sector investments by budget expenditure, thus hampering economic growth. This trend would be accompanied by growing uncertainty concerning foreign exchange rates. In general, the MPC found the 2004 draft budget contributes to undermining lasting and sustainable economic growth.

Factors representing potential sources of inflationary pressure in the third quarter also included persistently fast growth of notes and coins in circulation and high oil prices in international markets.

When taking decisions to keep interest rates unchanged in the third quarter, the MPC also considered the scale of the interest rate cuts made so far which would have a delayed bearing on the gradual growth in domestic demand in late 2003 and in 2004.

This year's inflation target (measured with the annual CPI as in December 2003) stands at 3% with a permissible band of deviations of +/-1%. The annual CPI, at 1.3% in October, is expected to grow slowly until the year-end and settle well below the lower bound of the inflation target in December.

* * *

The economy is in a stage of recovery. Growth trends are determined by improved investment growth. The scale of investment growth, however, will depend on the progress made in public finance reform. We estimate that only partial implementation of the public finance rehabilitation programme is likely before the end of 2005. This would reduce the risk of a public finance crisis. Still, the uncertainty as to the prospects facing that sector would remain, with the high borrowing needs of the state limiting availability of external financing to the private sector. Thus, the situation of public finances is contributing to slowing down economic growth.

In spite of this, we project accelerated GDP growth in 2004 higher than this year and anticipate its maintenance at a level close to that recorded in 2004 throughout 2005.

Nevertheless, faster economic growth will not result in a meaningful increase in employment as this would require a reduction in labour costs for operating businesses and the establishment of a more favourable environment for start-ups. The economy's production capabilities will rise steadily, though chiefly through capital formation.

If the above scenario of external and internal conditions for the years 2004–2005 is implemented, one should expect accelerated inflation rate which should remain within the range of the inflation target, namely, at the level of 2.5% +/- 1%, throughout the period.

Nevertheless, the emergence of inflationary elements cannot be ruled out. The primary uncertainty factor are the developments in public finances. Food and oil price deviations from the current trends should also be envisaged.

Basic macroeconomic indicators

	Q1	Q2	Q3	Q4	2001	Q1	Q2	Q3	Q4	2002	Q1	Q2	Q3
		2001					2002					2003	
						real growth							
GDP	2.2	0.9	0.8	0.2	**1.0**	0.5	0.9	1.8	2.2	**1.4**	2.2	3.8	3.7
Domestic demand	-1.0	-1.7	-1.5	-2.3	**-1.7**	-0.1	1.1	1.2	1.3	**0.9**	2.3	1.9	2.3
Total consumption	1.2	1.1	1.7	2.7	**1.7**	2.8	2.6	2.8	3.2	**2.8**	1.0	2.9	2.1
Personal consumption	1.5	1.5	2.1	3.2	**2.0**	3.5	2.9	3.1	3.5	**3.3**	1.4	3.9	2.8
Gross capital formation	-12.6	-12.2	-12.5	-13.0	**-12.6**	-17.9	-5.5	-5.6	-3.7	**-6.9**	12.7	-3.1	3.1
Gross fixed investment	2.1	-8.0	-11.7	-12.0	**-8.8**	-12.8	-7.9	-5.9	-3.6	**-6.8**	-3.6	-1.7	3.5
Household savings rate (%)[1]	9.4	10.9	10.6	11.6	**10.6**	5.0	8.5	6.5	8.4	**7.1**	4.3	7.6	
Household financial savings rate (%)[2]	5.3	3.9	4.0	4.8	**4.5**	2.0	3.2	-0.5	0.6	**1.3**	2.4	2.2	
Unemployment rate (%)	16.1	15.9	16.3	17.5	**17.5**	18.2	17.4	17.6	18.1	**18.1**	18.7	17.8	17.5
Disposable income (corresponding period previous year = 100)	101.8	101.2	102.6	100.1	**101.4**	98.7	100.1	98.6	99.8	**99.2**	100.4	101.8	
State Treasury indebtedness (PLN million, nominal)[3]	273,192.9	271,584.9	291,795.1	283,939.5	**283,939.5**	309,388.4	320,880.1	331,205.4	327,909.1	**327,909.1**	353,421.4	362,639.2	367,856.7
General government deficit (PLN million)	-14,992.5	-18,805.5	-21,865.0	-32,358.3	**-32,358.3**	-16,436.8	-24,922.5	-29,146.7	-39,112.5	**-39,112.5**	-15,495.5	-23,818.4	-33,081.5
External indebtedness (EUR million)	80,817	83,528	80,262	81,265	**81,265**	84,560	80,725	81,569	79,518	**79,518**	81,452	80,241	

[1] Household savings to gross disposable incomes. Savings represent that portion of gross disposable incomes not allocated to consumption.
[2] Household financial savings to gross disposable incomes. Financial savings represent the growth in household money stocks (the total of bank deposit growth, notes & coins and investments in securities, less household borrowing growth).
[3] Period end.
Source: GUS, Ministry of Finance and NBP figures, NBP estimates (GDP and domestic demand in the second quarter of 2003, gross savings rate, financial savings rate, disposable incomes).

Basic monetary indicators

	Q1	Q2	Q3	Q4	2001	Q1	Q2	Q3	Q4	2002	Q1	Q2	Q3
		2001					2002					2003	
Corresponding period previous year = 100													
CPI[1]	106.2	106.2	104.3	103.6	**103.6**	103.3	101.6	101.3	100.8	**100.8**	100.6	100.8	100.9
PPI[1]	103.8	100.9	100.7	99.6	**99.6**	100.3	101.2	101.1	102.2	**102.2**	103.6	102.0	101.9
Nominal growth rate of end-of-period figures (corresponding period previous year = 100)													
Money supply (M3)	114.7	107.8	112.6	109.2	**109.2**	103.2	102.5	98.5	98.0	**98.0**	100.5	101.3	103.1
Deposits and other liabilities	116.4	108.9	113.6	108.9	**108.9**	101.7	100.5	96.5	95.7	**95.7**	97.7	98.1	99.8
of which:													
Household deposits	119.9	115.9	117.0	106.7	**106.7**	103.3	100.1	95.2	96.1	**96.1**	94.2	93.2	93.8
Corporate deposits	105.4	99.8	105.3	116.4	**116.4**	104.9	113.7	110.8	101.4	**101.4**	111.2	116.0	121.1
Claims[2]	114.1	104.8	111.4	109.3	**109.3**	107.0	109.4	105.1	105.2	**105.2**	108.7	106.1	105.5
of which:													
Claims on households	121.1	102.2	119.9	114.7	**114.7**	117.7	115.6	108.4	108.6	**108.6**	107.2	108.5	110.3
Claims on corporates	111.2	106.8	106.0	103.7	**103.7**	98.2	102.1	101.2	101.4	**101.4**	108.3	103.3	101.6
Real growth rate[3] of end-of-period figures (corresponding period previous year = 100)													
Money supply (M3)	108.0	101.5	108.0	105.4	**105.4**	99.9	100.9	97.3	97.1	**97.1**	99.9	100.5	102.1
Deposits and other liabilities	109.6	102.5	108.9	105.1	**105.1**	98.5	98.9	95.3	95.0	**95.0**	97.1	97.4	98.9
of which:													
Household deposits	112.9	109.1	112.2	103.0	**103.0**	100.0	98.5	94.0	95.4	**95.4**	93.6	92.4	93.0
Corporate deposits	101.6	99.0	104.6	116.9	**116.9**	104.6	112.4	109.6	99.2	**99.2**	107.4	113.6	118.8
Claims	107.5	98.6	106.8	105.5	**105.5**	103.6	107.6	103.8	104.4	**104.4**	108.1	105.2	104.6
of which:													
Claims on households	114.0	96.2	114.9	110.7	**110.7**	114.0	113.7	107.0	107.7	**107.7**	106.6	107.7	109.3
Claims on corporates	107.2	105.9	105.3	104.1	**104.1**	97.9	100.9	100.1	99.2	**99.2**	104.6	101.2	99.7
Reference rate (%)[4]	17.00	15.50	14.50	11.50	**11.50**	10.00	8.50	7.50	6.75	**6.75**	6.00	5.25	5.25
Lombard rate (%)[4]	21.00	19.50	18.50	15.50	**15.50**	13.50	11.50	10.00	8.75	**8.75**	7.75	6.75	6.75

[1] In the last month of the quarter.
[2] Claims are made up of claims on: households, non-monetary financial institutions, corporations, non-commercial institutions operating for the benefit of households, local government institutions, social security funds. They encompass all categories of loans and advances, purchased debt, enforced guarantees and warranties, due and outstanding interest, receivables on repurchase agreement transactions, debt securities, equity securities and other claims.
[3] CPI deflated, PPI deflated corporate deposits and claims on corporations.
[4] Period end.
Source: GUS and NBP.

1
Domestic demand and supply

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1.1. Domestic demand[1]

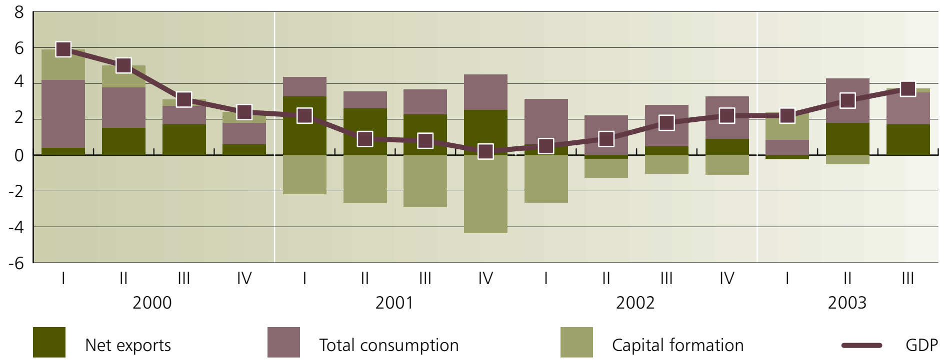
According to NBP estimates, in the third quarter of 2003 domestic demand growth exceeded that recorded in the second quarter. Its structure also evolved as consumption growth was smaller while gross capital formation accelerated, chiefly due to higher gross fixed investment.

Table 1
GDP and domestic demand growth, 2002–2003

		2002				2003		
	2002	Q1	Q2	Q3	Q4	Q1	Q2	Q3*
	Corresponding period previous year = 100							
GDP	101.4	100.5	100.9	101.8	102.2	102.2	103.8	103.7
Domestic demand	100.9	99.9	101.1	101.2	101.3	102.3	101.9	102.3
Consumption	102.8	102.8	102.6	102.8	103.2	101.0	102.9	102.1
Personal consumption	103.3	103.5	102.9	103.1	103.5	101.4	103.9	102.8
Capital formation	93.1	82.1	94.5	94.4	96.3	112.7	96.9	103.1
Gross fixed investment	93.2	87.2	92.1	94.1	96.4	96.4	98.3	103.5
Share of net exports in GDP growth (%)	0.5	0.6	-0.2	0.5	0.9	-0.2	1.9	1.4

* NBP estimates.
Source: GUS.

Figure 1
Contribution of final demand components to GDP growth (%)



Source: GUS.

[1] If not indicated otherwise, all growth figures in this chapter are quoted annually, in real terms.

Given the figures on rapid growth in investment good output and reduced fall in construction output, it is estimated that gross fixed investment was superior to its level of the third quarter 2002. Meanwhile, inventory growth ran at a similar level as a year before and, as a result, growth in gross capital formation in the third quarter was slightly lower than growth of gross fixed investment.

Personal consumption growth, very high in the second quarter, declined. Nevertheless, it continued to exceed growth of registered disposable household incomes.

GDP and domestic demand growth in the period from Q1 2002 to Q3 2003 is shown in Table 1, while the share of personal demand components in GDP growth is presented in Fig. 1.

In addition to domestic demand growth, improved performance of net exports contributed to annual GDP growth being sustained at the Q2 level.

1.1.1. Consumption

Nominal salary and social benefit growth figures indicate further accelerated growth of registered gross disposable household incomes in the third quarter.

Growth in average monthly gross salaries in the corporate sector was higher than in the second quarter in relation to the corresponding period of 2002 (by 2.4% nominally against 2.2% in the second quarter), whereas the decrease in average employment (by 3.5% against 4.1%) proved lower. Incomes from hired labour in the corporate sector were nominally 1.2% lower than a year before (by 2.3% in the first quarter and by 1.9% in the second quarter). Meanwhile, it is estimated that in central government institutions, similarly to the second quarter, employment increased and the growth of average salaries was higher than in the corporate sector. In total, in the third quarter total incomes from hired labour were 1.7% greater than a year before (by 1.1% in the second quarter).

Increased growth in social security benefits paid out in the third quarter was slightly slower than in the previous quarter (by 5.2% nominally against 5.4%). Disbursements of social security allowances, were also smaller than in 2002 with falling payouts of unemployment benefits, family and nursing allowances and other social security transfers, and with growing payouts of pre-retirement allowances and benefits.

It is estimated that in the third quarter both the nominal incomes of farmers and interest income continued to decline. At the same time, accelerated growth was observed in incomes from registered non-agricultural business activity conducted by individuals and in incomes derived from private ownership. Overall, it was found that in the quarter of 2003 the nominal growth of gross disposable incomes in relation to the third quarter of 2002 exceeded 3.0%. In the context of quarterly CPI growth to 0.8%, the purchasing power of registered gross disposable household incomes in the third quarter was superior to that recorded in the corresponding period of 2002, by roughly 2.3%.

The fall in net financial household savings in the third quarter amounted to 4.5bn zloty. Total deposits held at banks shrank by 1.3bn zloty, indebtedness resulting from credits, loans and other claims expanded by 4.5bn zloty, and the growth in notes and coins in circulation reached 1.3bn zloty. According to NBP estimates, the growth in the value of household financial assets outside the banking system (by 4.1bn zloty against 5.1bn zloty) placed primarily with investment funds (by 3.6bn zloty against 4.5bn zloty) was lower than in the second quarter. As a result, the value of household financial savings[2] in the third quarter was negative (-0.4bn zloty). On the basis of residential housing figures, it is estimated that both gross fixed investment and capital formation rose (household non-financial savings). Combined, gross household savings in the third quarter stood at approximately 11bn zloty and were approximately 2% less than a year before.

[2] Financial savings represent the net growth in household money stocks (the total of bank deposit growth, notes & coins and investments in securities, less household borrowing growth).

Personal consumption growth outpaced the growth in the purchasing power of gross disposable household incomes and, according to NBP estimates, settled at 2.8% in the third quarter (against 3.9% in the second quarter).

1.1.2. Capital formation

Based on the figures on investment expenditure by large and medium-sized enterprises and on construction and investment good output, it is assumed that in the third quarter gross fixed investment increased for the first time since the first quarter of 2001.

According to NBP estimates, the decline in construction output in the third quarter amounted to roughly 3.0%, and the sales of investment construction work remained at the 2002 level. Meanwhile, increased output of enterprises producing chiefly investment goods expanded from about 10% in the first half of the year to about 15% after three quarters of 2003.

Investment expenditure by large and medium-sized enterprises from January to September 2003 rose by 1.2%, in constant prices, compared with the corresponding period of 2002 (in the first half of the year, the figure was 2.2% lower), while gross fixed investment of these enterprises – increased by 1.0%. As it was, it may be estimated that in the third quarter the growth in corporate investment expenditure settled at 7.3%, in constant prices, and that of gross fixed investment at 6.6%. According to GUS figures, growth in investment in buildings and structures was exceptionally high, reaching 4.4% from January to September and 15.7% in the third quarter alone. Investment in the purchase of machines and equipment, and transport equipment was, respectively, 0.5% lower and 1.8% higher.

The high growth of investment in buildings and structures in the corporate sector against a background of continuously slow construction output growth indicates that in the remaining institutional sectors, in particular those of central and local government institutions as well as financial institutions, the increase in gross fixed investment was less pronounced than in the corporate sector. This provides a basis for estimating that there was a significant decrease in overhaul expenditure allocated to gross fixed investment, reflected in shifts in the structure of construction output.

It is very difficult to assess investment growth in the household sector. If the growth in the surface area of flats handed over in the third quarter were to serve as the direct basis for estimation, growth of over 250% in that sector would have to be reported. However, the dramatic growth in the number of completed flats was an artificial phenomenon triggered by amendments to the building law (long occupied buildings were registered although the investment had been made in earlier years), and not the result of ongoing investment processes. Household investment growth in the third quarter should, therefore, be significantly lower, while investment in most of the completed flats in that period should be allocated to gross fixed investment by households estimated during preceding years (inclusive of the black market).

Given slower investment growth everywhere, except in the corporate sector, and falling investment in repair work, it is estimated that gross fixed investment growth for the entire economy was less significant than that in the corporate sector. Compared to the third quarter of 2002, it grew by about 3.5%.

Inventory growth in the third quarter is estimated to be slightly faster than a year before, although gross capital formation growth lagged behind gross fixed investment growth.

1.1.3. Public finance situation

The situation of the state budget in the third quarter of 2003 deteriorated in relation to the corresponding period of the previous year. Following low growth in tax receipts and high subsidies transferred to extra-budgetary funds, preliminary estimates indicate that the general government budget deficit widened to 4.6% of GDP from 2.2% of GDP a year before.

1

The state budget receipts in the third quarter were almost 5% lower than in the corresponding period of 2002. This could be traced to falling non-tax receipts accompanied by very weak growth of tax receipts. Relatively slow growth of revenues from indirect taxation was the effect of low inflation and persistently low domestic demand. Despite a distinct output recovery fuelled by exchange rate favouring exporters, corporate income tax receipts declined. This was partially attributed to the changes in depreciation principles introduced in 2002[3] and to the lowering of the corporate income tax rate from 28% to 27%. As a result of low salary growth and continuously falling employment, the growth of personal income tax receipts was also slow.

General government budget expenditure expanded in the third quarter by 7.3% above the corresponding period of the previous year. The contributing factors included primarily a significant increase in subsidies transferred to the Social Security and Employment Funds, signalling financial difficulties experienced by these funds. Given full utilisation of the planned Employment Fund subsidies already in the third quarter and high subsidy expenditure by the Social Security Fund compared to the level planned, these funds will be forced to expand their indebtedness towards the banking sector during the fourth quarter.

The budget deficit financing structure in the third quarter was determined by the growing costs of securing funding from the sale of treasury securities in the domestic market. As a result, the deficit was financed chiefly from time deposits placed in general government budget accounts held at the NBP and the state budget had no more zloty-denominated time deposits in late September. At the end of July, their assets were worth 8.9bn zloty, whereas at the end of August their value declined to 5.2bn zloty. This trend may lead to the further growth of costs of securing funds by the state budget in the domestic finance market in the fourth quarter when borrowing needs of the public finance sector will expand significantly.

Table 2

Performance of central government budget after three quarters of 2003

	Q1–Q3 2003	Q3 2003	Q1–Q3 2003/ Q1–Q3 2002	Q3 2003/ Q3 2002	Performance plan after Q3 (%)
Receipts, of which:	**109,307.2**	**37,403.9**	**104.7**	**95.2**	**70.2**
– Taxation, of which:	95,100.5	34,475.5	102.7	103.5	68.6
– indirect taxation	68,931.0	23,891.8	103.9	105.3	71.2
– corporate income tax	8,881.8	3,615.3	87.8	93.0	61.7
– personal income tax	17,287.7	6,968.4	106.8	103.3	63.2
– Non-tax income	14,206.7	2,928.3	120.9	49.2	83.1
Expenditure, of which:	**142,388.7**	**46,681.1**	**106.6**	**107.3**	**73.2**
– debt servicing	16,974.2	4,675.4	100.8	106.1	62.5
– Employment Fund subsidy	3,944.0	914.0	139.4	130.6	100.0
– Social Security Fund subsidy	23,875.8	9,103.0	98.6	124.1	85.4
Deficit	**-33,081.5**	**- 9,263.6**	**113.5**	**222.3**	**85.4**

Source: Ministry of Finance data.

[3] These changes consisted in raising the depreciation rate for new fixed investment projects to the uniform rate of 30% in the first year following their entry into records. The possibility for appropriating a greater than to date portion of fixed asset investment to costs in the first year following the execution of the investment project meant a reduction of CIT taxable base and was aimed at encouraging enterprises to undertake investment activity.

Box 1. Fiscal developments in 2004

The government presented a draft budget act for the year 2004 which assumed budget receipts of 152.8bn zloty, a budget expenditure of 198.3bn zloty and a deficit of 45.5bn zloty. At the same time, a change was proposed in the methodology for calculating the budget deficit consisting in the exclusion from budget expenditure of subsidies to the Social Security Fund to cover open-ended pension fund (OPF) contributions. In 2004, the budget deficit calculated using the currently applicable methodology would amount to 56.9bn zloty, that is, would be higher than this year's by 1.8% of GDP. Significant deficit growth was due, on the one hand, to the reduction of the income tax rate for enterprises and individual entrepreneurs to 19%, and on the other, to the surging budget expenditure. This growth resulted primarily from the necessity to finance the new expense item, namely, the EU budget contribution, and to ensure co-financing of EU structural funding. Additionally, higher domestic expenditure was envisaged under the 2004 budget act.

The considerable widening of the state budget, and the resulting imbalance of the public finance sector, will have many negative consequences for the economy. The strong demand-side impulse triggered by it, further enhanced by the inflow of funds from the European Union, which will be spent outside the state budget, will contribute to growing inflationary pressure. Additionally, the increased borrowing needs of the public finance sector will lead to a reduction in corporate sector financing, and in particular will seriously hamper the achievement of gross fixed investment growth planned in the budget act. Higher issues of treasury securities will also result in higher uncertainty as to trends in foreign exchange rates.

Another very serious threat accompanying the scale of fiscal expansion proposed for the next year is the risk of public indebtedness overrunning the level of 55% of GDP, the second prudential threshold defined in the Act on Public Finances. Although the draft budget does provide for public indebtedness, plus projected disbursements under warranties and guarantees, to reach 54.8% of GDP by the end of 2004, this forecast is based on optimistic assumptions concerning exchange rates, privatisation receipts and extra-budgetary fund deficit. Given the above, it is highly probable that public indebtedness will exceed the 55% of GDP limit. This would necessitate a dramatic reduction in the public finance deficit in 2006 by over 5% of GDP. As a consequence, significant curbing of spending on basic state functions and tax increases would then become inevitable.

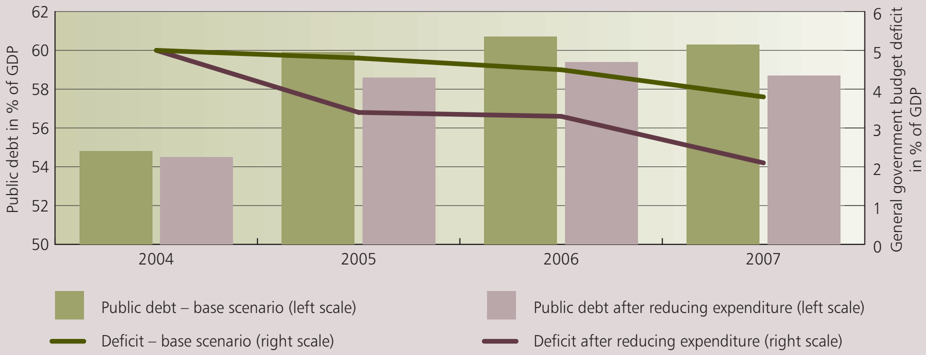
Box 2. Programme of streamlining and curbing public expenditure

Independently of the draft budget act for the year 2004, the government adopted the *Programme of streamlining and curbing public expenditure*. This agenda envisages a reform of many social expenditure categories, where public funds are spent ineffectively. These include disability pensions, the Agricultural Social Insurance Fund (KRUS), sickness and pre-retirement allowances and the system for promoting the employment of disabled persons. The Programme also envisages, for instance, a change of the mechanism for indexing old-age and disability pensions and the extension of the retirement age for women by 5 years (this change would take effect in the years 2010–2020). Overall, it is estimated that the savings on social expenditure generated as a result of the implementation of the above measures in the years 2004–2007 would exceed 30bn zloty.

The Programme provides for steps to be taken in the administrative and economic sphere to reduce expenditure by a total of about 20bn zloty in the years 2004–2007. These initiatives include curbing administrative expenses, cutting defence spending, expanding taxable income and raising budget receipts following the restructuring of the mining sector and the Polish State Railways (PKP).

Overall, most of the proposed savings would be generated in 2005 and in subsequent years. However, the adopted measures may prove insufficient to avoid the risk of public indebtedness overrunning the limit of 55% of GDP already in 2004. In this context, urgent implementation of the proposed initiatives in the sphere of social expenditure to curb the exceptionally high deficit of the public finance sector in 2004 should be given top priority.

Figure
State budget deficit and public debt after the implementation of the *Programme of streamlining and curbing public expenditure*



Source: *Programme of streamlining and curbing public expenditure.*

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1.2. Domestic demand

According to NBP estimates, GDP growth in the third quarter of 2003 was similar to that recorded in the previous quarter and amounted to 3.7%. Added value growth in industry was the same as in the second quarter, added value growth in market services slowed down, and the decline in added value in construction was less pronounced. Output growth in the third quarter, similarly to previous quarters, was achieved as a result of increased labour efficiency. Employment continued to fall although at a slower rate than in 2002. Both the number of the unemployed being registered and the unemployment rate declined.

Trends in GDP and added value growth in major sectors of the national economy are shown in Table 3.

Table 3
GDP and added value growth, 2001–2003

		2002				2003		
	2002	Q1	Q2	Q3	Q4	Q1	Q2	Q3*
	Corresponding period previous year = 100							
GDP	101.4	100.5	100.9	101.8	102.2	102.2	103.8	103.7
Total added value	101.4	100.5	100.9	101.9	102.1	102.0	103.6	103.5
Industry	101.0	98.0	99.0	102.7	104.0	104.1	108.3	108.3
Construction	92.5	86.7	89.1	96.8	94.2	80.5	92.6	97.7
Market services	103.4	103.7	103.5	103.3	103.0	103.3	105.0	104.2

* NBP estimates.
Source: GUS figures.

1.2.1. Output and GDP

According to NBP estimates, in the third quarter of 2003 total added value grew by 3.5% in relation to the corresponding period of 2002 (against 3.6% in the second quarter). Added value growth in industry was similar to that recorded in the previous quarter, and the decline in added value in construction was reduced. It is estimated that the growth of added value in market services was smaller than the surprisingly high level noted in the second quarter.

Third-quarter sold industrial output (of large and medium-sized enterprises) was 9.0% higher than in the corresponding period of 2002, including 10.5% in manufacturing. The high output growth was related to rising exports and the improved competitiveness of domestic output in the internal market. Symptoms of investment demand growth were becoming evident. During the three quarters of 2003, the highest output growth was recorded in enterprises manufacturing primarily investment goods (a 15% growth against the corresponding period of 2002). This could be partially attributable to growing exports of investment goods but could equally attest to rising investment purchases made by domestic enterprises. In the enterprises producing mainly distributive goods, the output was about 9% higher than in the first three quarters of 2002, and in those producing consumer goods it increased by roughly 7%.

Particularly high output growth was achieved in the section of the manufacturing industry characterised by large share of foreign capital, selling their goods primarily in export markets (furniture manufacturing, manufacture of motor vehicles, trailers and semi-trailers, manufacture of electrical machinery and apparatus, manufacture of rubber and plastic products, manufacture of machinery and equipment).

Higher industry output, similarly to previous quarters, was obtained in the context of falling employment and growing labour efficiency. In the third quarter, as in the preceding one, efficiency measured by the volume of sold output (in constant prices) per employee was greater than in the

Figure 2
Labour efficiency, real remuneration and payroll labour cost growth in industry (Corresponding quarter previous year =100)

Source: GUS figures and NBP calculations.

corresponding period of 2002 by over 12%. As of the third quarter of 2002, efficiency growth is accompanied by the decline in payroll-related labour costs. The spread between efficiency growth and payroll-related labour cost growth in the last two quarters stayed above 18%. (Fig. 2)

High industrial output growth in the last two quarters contributed to the increased utilisation of production capacity. Still, according to manufacturing enterprises[4], their output capacity is being utilised to less than 75%. In the third quarter, the share of enterprises assessing their production capacity as excessive in relation to the existing demand decreased. Meanwhile, however, the value of the index describing adjustment of output capacity to demand (weighted balance of reported cases of excessive or inadequate output capacity) exceeded 40%. Growth in the use of production capacity is likely to lead to increased investment in the future.

The fall in construction output was mitigated. In the third quarter, the construction output was estimated at about 1.5% less than a year before. Repair work growth was also considerably slower than in 2002, whereas growth in investment construction work remained at the level recorded in the corresponding quarter of the previous year. Meanwhile, very high, more than double, output growth was observed in enterprises involved in the preparation of building sites.

Figure 3
Use of production capacity and sold manufacturing output, 2000–2003

Source: Research into general economic situation. General economic situation in industry and construction, GUS, July–September 2003.

[4] Research into general economic situation. General economic situation in industry and construction, GUS, July–September 2003.

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According to NBP estimates, added value growth in market services declined in the third quarter from a surprisingly high level in the second quarter (from 5.0% down to 4.2%). Retail sales volume was higher than in the third quarter of 2002 by 6.4% (in the second quarter of 2003, its 9.8% growth was recorded). The volume of wholesale trade expanded. Compared to the same periods of 2002, in the first half of the year its growth was 3.4% lower, to slow down by 1.9% from January to September 2003. Service sales growth in transport and communication was similar to that recorded in the first half of 2003.

1.2.2. The labour market

In the third quarter of 2003, the improvement of some indices in the labour market was accompanied by the deterioration of others.

Positive symptoms recorded in that period include:

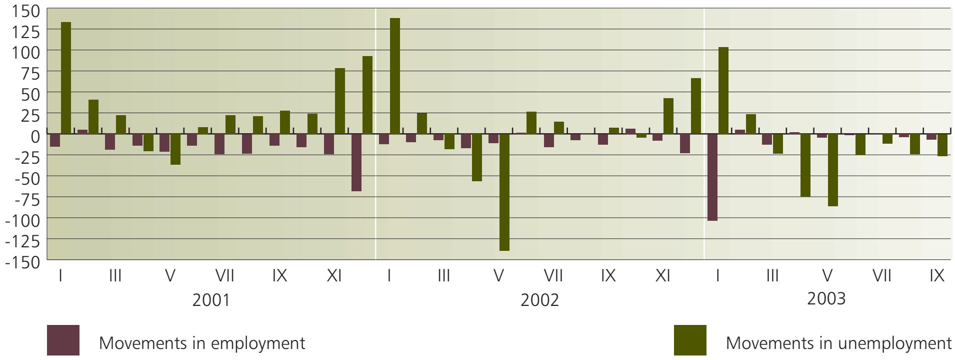
- weakening rate of employment decrease in the corporate sector observed from the beginning of the second quarter,
- stable unemployment figures in September following a period of seasonal decline in summer months (for the first time in five years),
- an increased number of job offers placed with employment offices compared to previous quarters (roughly by 50% in relation to the third quarter of 2002),

Table 4
Basic labour market indices, January–September 2002 and 2003

Item	2002	2003	Change
Professional activity ratio (%)			
Q1	55.5	54.4	*
Q2	55.6	54.7	*
Q3	55.6	b. d.	*
Employment ratio (%)			
Q1	44.2	43.3	*
Q2	44.6	44.1	*
Q3	44.6	b. d.	*
Average employment in corporate sector from January to September			
(in thousand persons)	4916	4724	-192
Number of registered unemployed at end of September			
(in thousand persons)	3,112.6	3,073.3	-39.3
Number of newly registered unemployed from January to September			
(in thousand persons)	1,857.4	1,889.6	42.2
Number of deregistered unemployed from January to September			
(in thousand persons)	1,859.9	2,043.3	183.4
of which: those who found employment	924.9	1,001.9	77.0
Number of reported job offers from January to September			
(in thousand persons)	423.3	585.8	162.5
Unfilled vacancies at the end of September (in thousand)	13.4	22.2	8.8
Registered unemployment rate at end September in %	17.6	17.5	

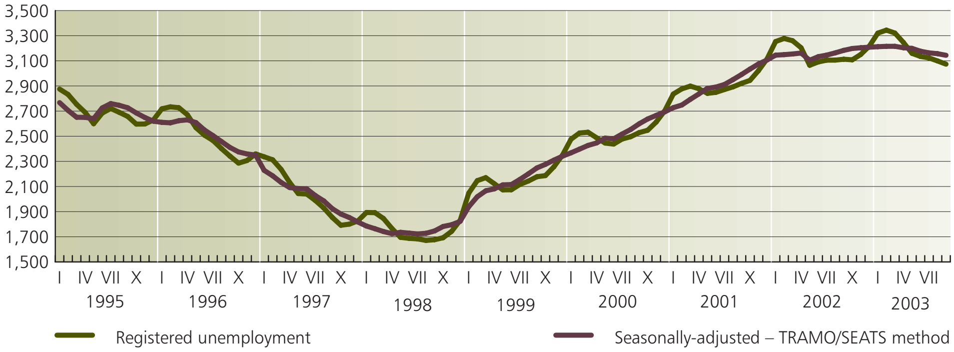
* Figures as of the first quarter of 2003 were generalised based on population balances developed using the findings of the 2002 National General Census; these data are incomparable with the findings of studies published for earlier periods.
Source: GUS figures and NBP calculations.

Figure 4
Movements in average employment and registered unemployment (previous month =100) (in thousand persons)



Source: GUS figures and NBP calculations.

Figure 5
Registered unemployment ratio, inclusive and net of seasonal effect (in thousand persons)



Source: GUS figures and NBP calculations.

- maintenance of the registered unemployment index (net of seasonal effect) at an almost unchanged level for the last few months (cf. Fig. 2),
- a growing number of persons without unemployment benefit entitlement; their records deleted at employment offices, and
- a decline in registered unemployment rate from 17.7% in June to 17.5% in September.

At the same time, however, the following negative phenomena were observed in the labour market in the third quarter:

- progressive employment reductions in subsequent months of the quarter in relation to the preceding months, more pronounced in August and September than in the previous three months (Fig. 4),
- an increased number of newly registered unemployed compared both to the corresponding quarter of 2002 and the preceding quarter (respectively, by 19,300 and 159,300 persons), and
- an increased number of unemployed graduates as of July 2003, similarly to 2002.

It should also be kept in mind that the changes recorded in the third quarter such as, for instance, growth in the number of deregistered unemployed or decline in the registered unemployment ratio, do not denote automatic transfer from unemployment to employment but, on the contrary, may reflect reduced professional activity (Box 3, Box 4). In over 50% of cases, deregistration of unemployed from the records kept at employment offices is due to other reasons than finding employment. These include, for example, entry to training courses, voluntary resignation from unemployed status or failure to confirm

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Box 3. Unemployment rates – various definitions

The most commonly quoted measure characterising the labour market is the unemployment rate. The following formula provides the basis for calculating the unemployment rate:

Unemployment rate = number of unemployed/ number of professionally active = number of unemployed / (number of employed + number of unemployed

Hence, the rate of unemployment is determined by both the numbers of unemployed and the employed which, combined, generate the number of those professionally active. Accordingly, the unemployment rate may decrease not only as a result of the unemployed finding employment but also of the unemployed giving up the search employment. Such situation is a permanent feature of the Polish labour market and this fact should be borne in mind when referring to falling unemployment in Poland.

Unemployment rates have different meanings depending on the input data used for their calculation and on the adopted definition of an unemployed person. The most commonly used unemployment rates include the registered unemployment rate and the BAEL unemployment rate (economic activity survey).

For the purpose of calculating the registered unemployment rate, the unemployed are considered to be persons registered with the employment office. Meanwhile, employment figures are estimated on the basis of GUS studies on employment in various sectors of the economy. The advantage of that measure is the frequency of its publication (every month). Its drawback, on the other hand, lies in the allocation of persons reporting to the employment office to category of the unemployed. In practice, not all the unemployed visit employment offices and not all persons reporting to employment offices fall within the unemployed category.

The BAEL unemployment rate is calculated on the basis of the definition of an unemployed person consistent with the International Labour Organisation (ILO) standards. The ILO defines an unemployed person as one who does not work, is seeking employment and is capable of working. The information required to calculate this unemployment rate is gathered from quarterly polls conducted on a representative sample of persons aged 15 and more. The undisputable advantage of thus calculated unemployment rate is the permanence and explicitness of the definition of an unemployed person and the reliance on representative studies. This unemployment rate is published on a quarterly basis.

Box 4. Movements in Labour Force Activity in Poland, 1993–2002

Since the onset of transformations, a falling trend in professional activity has been observed in the Polish labour market. This is clearly reflected in the BAEL figures and recently also in the comparison of the findings of the National General Censuses of 1988 and 2003. Significant shifts in the percentage of economically active persons do not apply to all age groups to the same extent (See Figs. 1 and 2). This phenomenon is most pronounced among persons aged 24 and less and those of the pre-retirement age, living in rural areas. The labour force participation of people aged 25 to 45 has not been subject to major changes, basically. On the other hand, the participation of women aged 25 to 29 in the labour market is growing.

The decline in the labour force participation of persons aged below 24 and resulted less from a dramatic increase in the educational activity of young persons in this age group, both at the secondary and university level. Furthermore, a high unemployment rate persisted in these age groups since the early 1990s, growing rapidly at a time of slower economic growth.

The enormous difference in the labour force participation of persons aged 55 and more residing in cities and rural areas is attributable to the absence of employment opportunities for rural area residents of that age. These persons remain unemployed due to their usually low professional and geographic mobility. Given existing opportunities for securing basic means of subsistence (assistance provided by other family members, social transfers, etc.) in the context of relatively low costs of living, such persons decide to withdraw voluntarily from the labour market altogether instead of retaining their unemployed status. A different situation is observed in cities where labour force activity fell only slightly in the course of the last 10 years, even climbing in some age groups, despite the falling (especially in recent years) number of vacancies.

Figure 6

Movements in percentage of professionally active persons by age and gender, 1993–2002 (%)

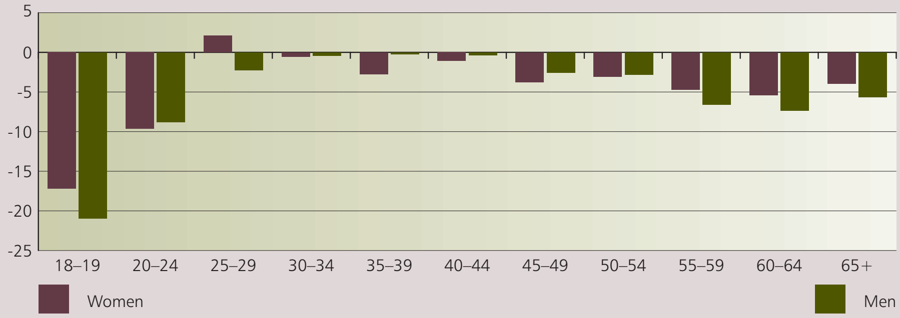


Figure 7
Movements in percentage of professionally active persons by age and city/rural area division, 1993–2002 (%)

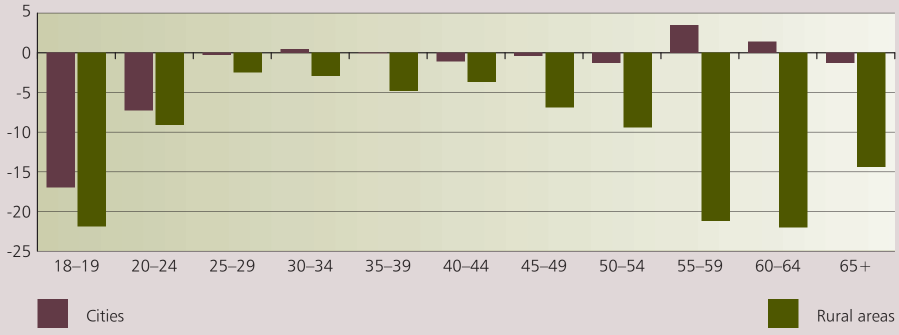
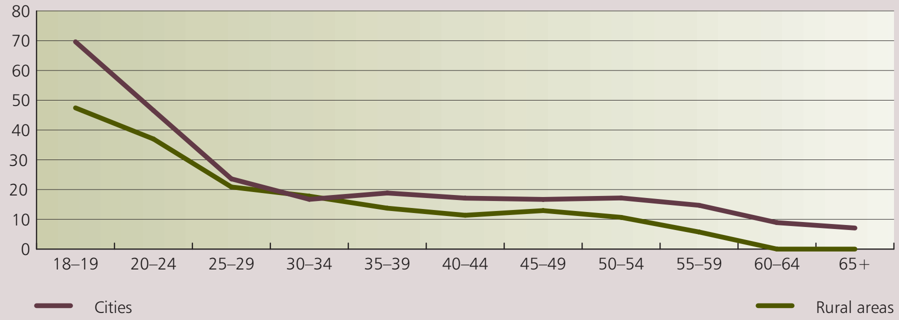


Figure 8
Unemployment rate by age and city/rural area division, Q4 2002



Movements in labour force activity largely affect the current unemployment rate. Low unemployment in rural areas is traced to over-employment among persons aged 50 and less (hidden unemployment) and a dramatic decline in the labour force participation of persons aged over 50. In cities, the fall in labour force activity was not as pronounced and hidden unemployment is not a widespread phenomenon. On the other hand, cities saw their number of jobs decrease steadily. As a result, the unemployment rate in cities is distinctly higher.

As explained above, the issue of declining labour force participation and unemployment growth varies significantly depending on age group, gender and place of residence. This finding should be reflected in the draft policy aimed at enhancing the professional activity of the Poles.

readiness to work, acquisition of old-age or disability pension, pre-retirement allowance or benefit entitlement. In the second and third quarter of 2003, persons whose records were struck off the register of unemployed as a result of their finding employment accounted for some 49.7% of deregistered unemployed, whereas in the same period of the previous year this group represented over 50%.

Overall, the analysis of labour market indices in the third quarter leads to the conclusion that despite certain positive changes observed in the period under scrutiny, no lasting reversal of unfavourable trends has yet taken place.

1.2.3. Privatisation processes

Privatisation receipts in the 2003 budget act have been projected at 7.4bn zloty. After the first three quarters of 2003, the general government budget received 1.435bn zloty, representing 19.4% of the planned amount. Inadequate performance of the plan and little progress made in the privatisation of large state-owned companies suggest that, similarly to the years 2001–2002, planned privatisation receipts have been overestimated and that a portion of the general government budget deficit will have to be financed from other sources.

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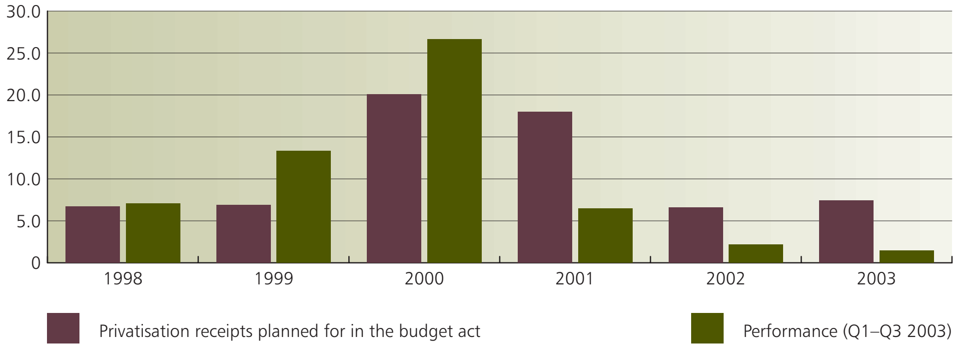
Figure 9
Plans and financial effect of privatisation, 1998–2003 (billion zloty)



Source: Ministry of Finance.

1.2.4. Producer prices in industry and construction (PPI)

In the third quarter of 2003, average quarterly *producer price indices* (PPI) settled at a level close to that recorded in the previous quarter: PPI calculated in relation to the corresponding quarter of 2002 grew by 1.9%, and in relation to the second quarter of 2003 – by 1.0%. The annualised quarterly PPI index fell in the third quarter in relation to the second-quarter figure in all sections of industry, except for mining and quarrying, and its level was affected the most, similarly to the previous two quarters, by price movements in manufacturing (cf. Table 5 and Fig. 10).

The twelve-month PPI indices remained stable at around 2% since May (cf. Fig. 11). A similar trend was followed by the price index in the manufacturing section, chiefly due to the stabilisation, after dynamic growth at the beginning of the year, of prices in the 'manufacture of coke, refined petroleum products and nuclear fuel' section (cf. Fig. 12). Meanwhile, significant price growth in this section in the third quarter in relation to the corresponding period of 2002 was recorded in the following subsections: manufacture of motor vehicles, trailers and semi-trailers (by 3.8%), manufacture of tobacco products (by 7.2%) and manufacture of base metals (by over 7.4%). Price growth in the 'manufacture of base metals' section was traced to price increases of most industrial metals traded on international commodity exchanges.

Table 5
Quarterly PPI in industry and construction, 2002–2003

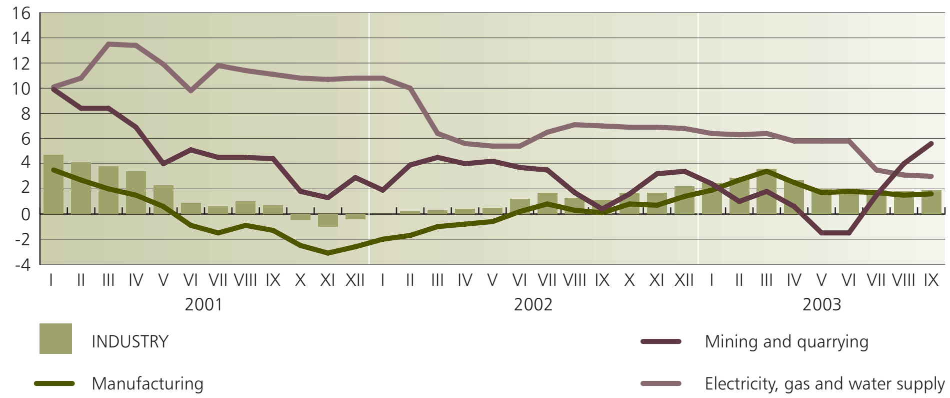
Item	2002					2003					
	Q1	Q2	Q3	Q4	Annual	Q1		Q2		Q3	
	Corresponding quarter previous year =100				average	*	**	*	**	*	**
INDUSTRY (PPI), of which:	100.2	100.7	101.4	101.9	101.0	103.0	101.0	102.2	99.9	101.9	101.0
– mining and quarrying	103.6	103.9	101.9	102.7	103.0	101.7	100.3	99.2	96.8	103.7	105
– manufacturing	98.4	99.6	100.4	101.0	99.9	102.7	101.2	102.0	100.0	101.6	100.6
– electricity, gas and water supply	109.0	105.5	106.9	106.9	107.0	106.4	100.3	105.8	100.5	103.2	101.9
CONSTRUCTION	102.0	101.4	101.0	100.6	101.2	99.4	99.3	99.0	99.8	98.8	99.9

* Corresponding quarter previous year = 100.
** Previous quarter =100.

Figure 10
Share of PPI price growth by industry section in PPI growth (corresponding quarter previous year = 100)

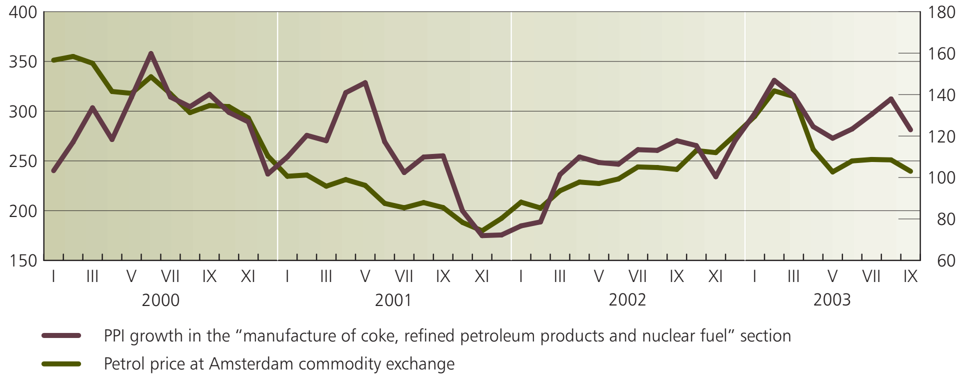
Source: GUS.

Figure 11
PPI in industry and its sections (corresponding month previous year =100)



Source: GUS.

Figure 12
PPI growth in the "manufacture of coke, refined petroleum products and nuclear fuel" section (corresponding month previous year =100) and fuel prices on the Amsterdam exchange (in US$ per tonne)



Source: GUS and Reuters.

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Figure 13
PPI growth in the "manufacture of base metals" section (corresponding month previous year =100) and copper prices in international markets (in US$ per tonne)

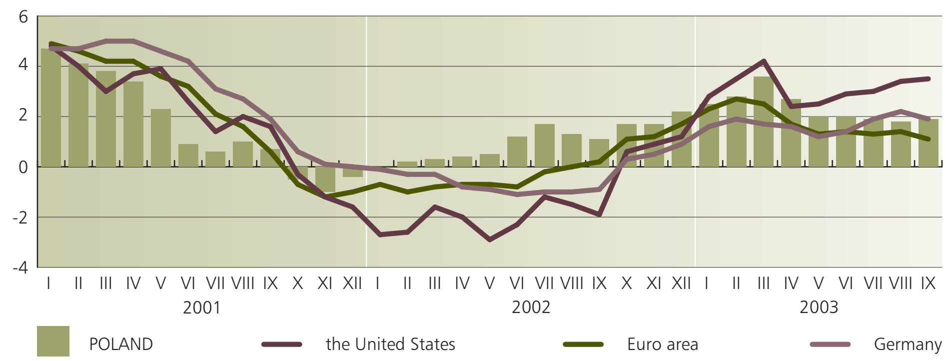
Source: GUS and Reuters.

During the period, in the mining and quarrying section there was significant price growth related primarily to price increases in coal mining. It was the consequence of the coal-price increase recorded in international markets since May. It could also be encouraged by intensifying consolidation processes in the Polish coal mining industry. These are confirmed by shifts in the Herfindal-Hirshmann coefficient which grew from about 800 points in the years 2000–2002 to over 1,700 in the first six months of the year. In March, the Coal Mining Holding Company was established with a 60% share in total coal output. The concentration of such a large portion of the market in the hands of one entity enables it to influence domestic coal price levels.

One of the factors contributing to price growth in the mining and quarrying section in the third quarter was the annual price growth in mining of metal ores of around 7%. It was attributable to copper price surges in international markets.

Meanwhile, prices declined in the electricity, gas and water supply section, which was due to the price growth of energy carriers being significantly slower than a year before (in July 2002, monthly price increases amounted to 4.3% and in July 2003 to approximately 1.8%[5]). Price growth in coal mining in the third quarter did not translate into energy price growth because of valid long-

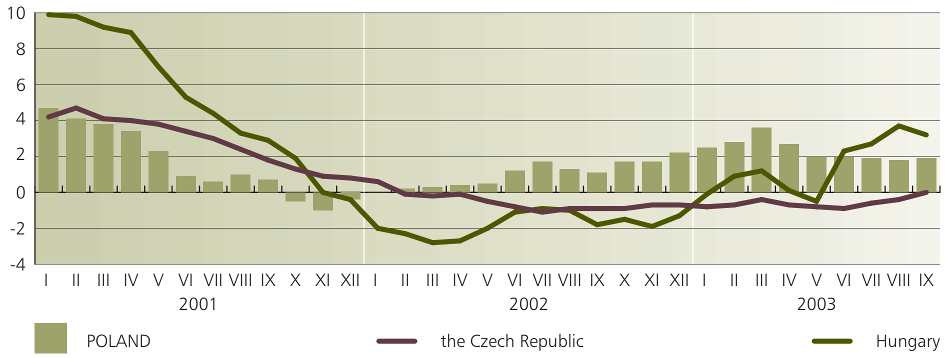
Figure 14
PPI in Germany, Euro area, the US and Poland (corresponding month previous year = 100)



Source: Bloomberg.

[5] Maximum price growth for individual energy distribution plants is determined administratively by the Energy Sector Regulatory Office (URE).

Figure 15
PPI in the Czech Republic, Poland and Hungary (corresponding month previous year = 100)



Source: Bloomberg.

term contracts for coal deliveries to large customers and the pricing procedure applied by the Energy Sector Regulatory Office (URE).

Construction output prices in the third quarter continued to show a slight deflationary trend observed since the beginning of the year (cf. Table 5).

PPI indices in the euro area countries, similarly to Poland, have displayed high stability during the last five months. In Germany, in subsequent months of the third quarter the PPI index settled at around 2% (cf. Fig. 14). Meanwhile, the PPI index in the US ran at a significantly higher level than European indices and expanded from 3% in July to 3.5% in September. This could be accounted for by the falling US dollar exchange rate against the euro, and raw material price increase in international markets, to which producer prices in the US respond very fast.

In the Czech Republic, the annual PPI index in September stood at 0%. This level was reached after 11 consecutive months of negative growth. Meanwhile, in Hungary dynamic PPI growth triggered by forint depreciation in the second quarter of 2003 was recorded in the third quarter (cf. Fig. 15).

2
External factors

2

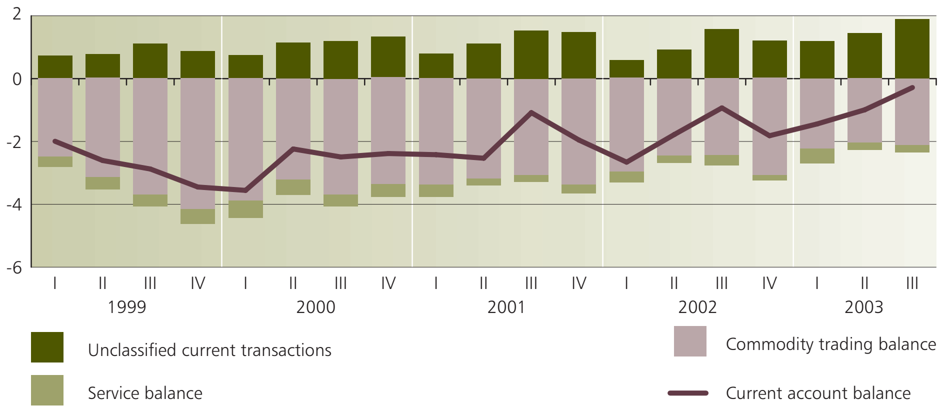
2.1. Foreign trade and the balance of payments

In the third quarter of 2003, the current account deficit continued to decline (Fig. 16). From July to September 2003, the negative current account balance amounted to 280m euro and was 650m euro lower on the corresponding period of the previous year[6]. Further reduction of commodity trading deficit and growing positive balance on unclassified transactions[7] had decisive effect on its improvement to the record level since 1997, i.e., since ECU/EUR-denominated data were published for the first time. Additionally, the negative balance on services and incomes was also lower than in the third quarter of 2002. The only item of the current account which contributed to exacerbating its negative balance were transfers (their surplus dropped by 150m euro).

Following these favourable changes, the relation of the current account deficit to GDP declined in the third quarter to 2.4% (down from 2.7% in the second quarter of 2003 and 3.6% in the third quarter of 2002).

Cash-basis statistics point to accelerated growth of euro-denominated trade in the third quarter compared to the first half of the year. From July to September 2003, the value of euro-denominated export receipts climbed by 7.1% on the corresponding period of the previous year, while in the first six months of 2003 it increased by 5.1%, respectively. Meanwhile, the value of import expenditure increased in these periods by 2.6% and 1.5%, respectively. In the context of export growth remaining higher that import growth (Fig. 17 and Fig. 18), the negative balance on commodity trading shrank in the third quarter to 2.1bn euro, i.e. by 330m euro compared to the corresponding quarter of 2002.

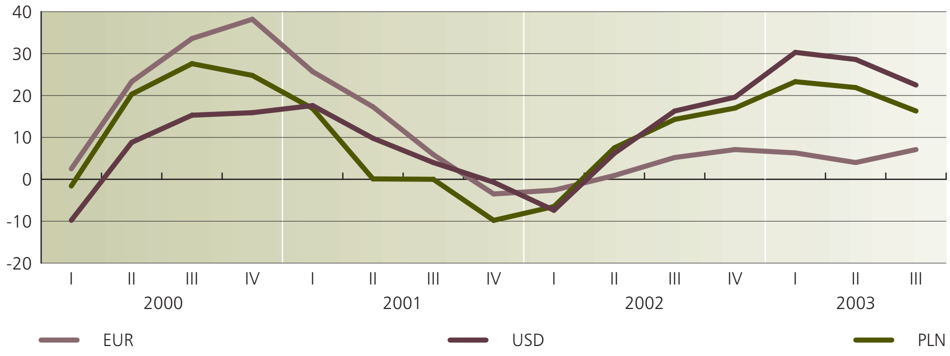
Figure 16
Current account balance, 1999–2003 (in euro billion, by quarter)



Source: NBP.

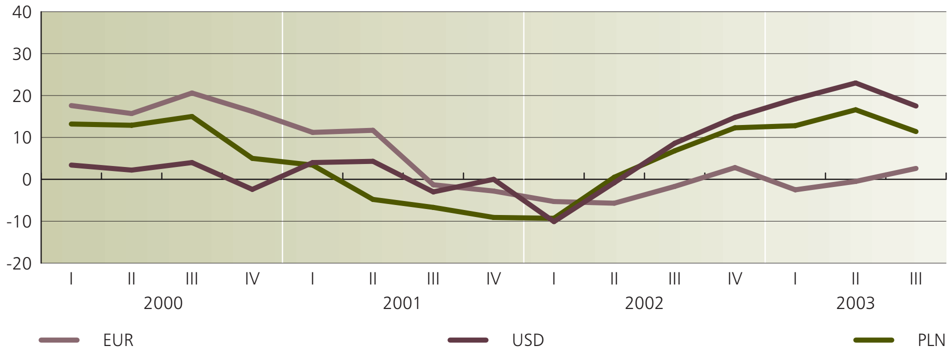
[6] The surplus in the current account in September 2003, recorded for the first time since August 1998, had a large share in this marked improvement.
[7] This balance usually rises in summer months. This year, its growth was further fuelled by zloty depreciation against the currencies of neighbouring countries and the announced introduction, as of October, of the visa regime for Ukrainian, Belorussian and Russian citizens.

Figure 17
Polish export growth, cash basis – 12-month progressing average (percentage change on corresponding period previous year)



Source: NBP.

Figure 18
Polish import growth, cash basis – 12-month progressing average (percentage change on corresponding period previous year)



Source: NBP.

Favourable trends in foreign trade are also reflected in item-based statistics. From January to September 2003, the negative trade balance shrank by 1.5bn euro on the corresponding period of the previous year. This tendency was accompanied by accelerated trade growth in the third quarter in relation to the first half of the year. According to preliminary data, in the first nine months of 2003 the value of euro-denominated exports rose by 6.0% on the corresponding period of the previous year, whereas from January to June 2003 it expanded by 3.3%, respectively. The value of imports after three quarters of 2003 increased by 1.0%, while in the first half of the year it had declined by 2%. If, however, we were to eliminate the effect of price movements, export growth would be significantly stronger than in 2002: in the first seven months of 2003, the export volume expanded by 14.6% against 5.7% in the corresponding period of 2002. The import volume also expanded (by 5.2%), though its growth was slower than a year before (7.2%).

The falling trade deficit was encouraged by progressive zloty depreciation against the euro and the improving effectiveness of Polish enterprises. Unit labour costs, expressed in zloty, in the corporate sector fell in the second quarter of 2003 by some 9.7 % in relation to the corresponding quarter of 2002. Combined with zloty depreciation against the euro (by over 17%), it signified a decline in unit labour costs expressed in euro by about 23%, in other words, a distinct improvement in the competitive position of Polish producers against their foreign counterparts (Cf. Table 6, Fig. 19 and Fig. 20).

2

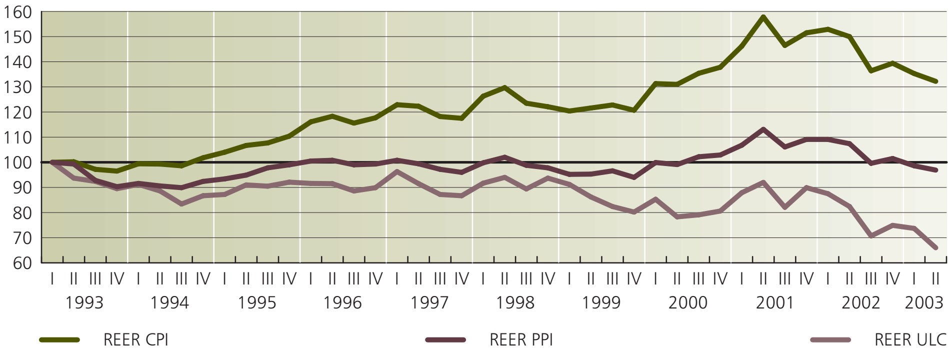
2

Table 6
Export yield indices (percentage change on corresponding period previous year)

	2002				2003	
	Q1	Q2	Q3	Q4	Q1	Q2
Export prices / Producer prices	0.4	6.3	3.7	6.7	4.6	5.7
Export prices / Unit labour costs	0.6	10.5	12.0	19.7	14.0	19.4

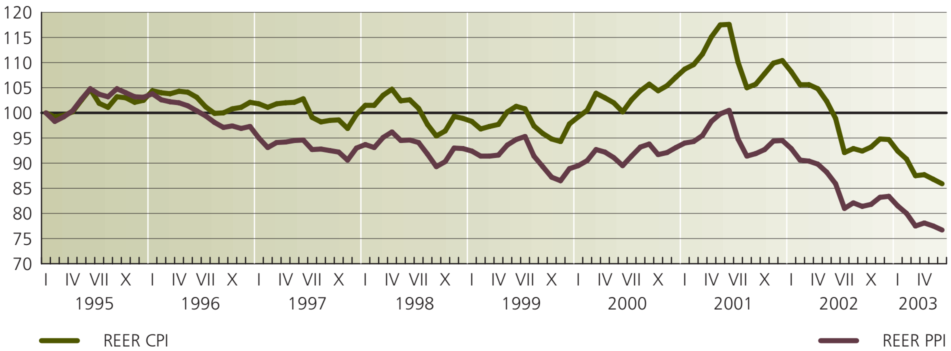
Source: Own calculations based on NBP and GUS figures.

Figure 19
Real effective zloty exchange rate against currencies of major trading partners, CPI, PPI and ULC-deflated (Q1 1993 = 100, decline denotes currency depreciation)



Source: Own calculations based on NBP figures.

Figure 20
Real effective zloty exchange rate against CEE currencies, CPI and PPI-deflated (January 1995 = 100, decline denotes currency depreciation)

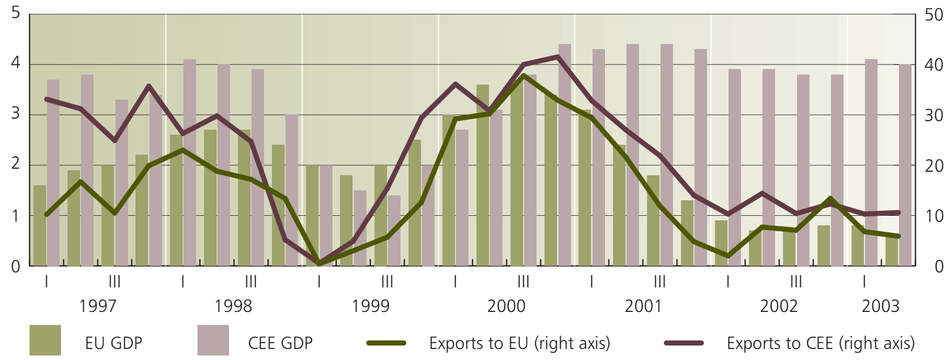


Source: Own calculations based on NBP figures.

Despite further weakening of import demand in Germany (the annualised value of German imports in the second quarter dropped by 0.2%, following a 7.5% growth in the first quarter), the growth of Polish exports to that country accelerated (Fig. 22). This was accounted for by a higher German demand for less costly goods originating, inter alia, from China and countries of Central and Eastern Europe.

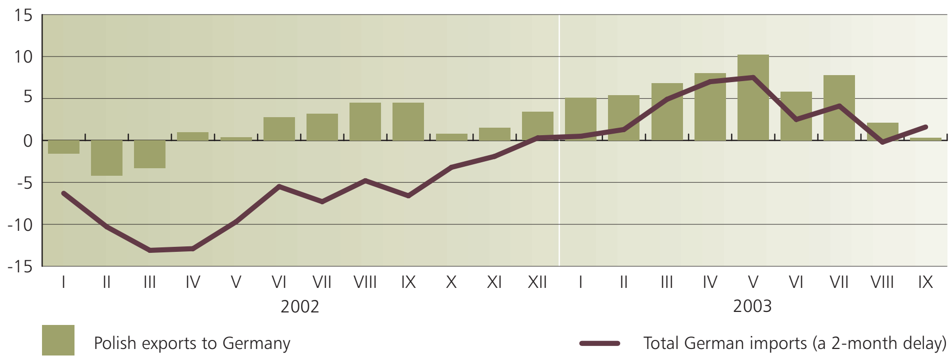
Polish exports to the remaining EU countries grew faster in the period (from 3.5% to 6.2%), which was primarily due to the distinct acceleration of growth of exports to Italy and halt in the fall of export sales to Great Britain. Also noteworthy was very high growth of exports to Sweden and Spain (by 18% and 16%, respectively), since the beginning of the year,. Nevertheless, the increase in the rate of sales to most EU countries was markedly lower in the period January–September 2003 than a year before (Table 7).

Figure 21
Movements in GDP in EU and CEE countries* (in constant prices, annual moving average) and movements in Polish exports to EU and CEE (in EUR current prices) (percentage change on corresponding period previous year)



* The Czech Republic, Estonia, Lithuania, Latvia, Slovakia, Slovenia and Hungary.
Source: NBP calculations based on GUS, Eurostat, OECD and Bloomberg figures.

Figure 22
Growth of Polish exports to Germany and German imports (3-month moving average, in EUR current prices) (percentage change on corresponding period previous year)



Source: FTIC and Statistiches Bundesamt.

Exports to Central and Eastern European (CEE) countries since the beginning of the year were characterised by the highest growth dynamics, which largely contributed to the accelerated growth of total Polish exports (Fig. 23). The share of CEE countries in Polish exports remained at its highest level since the disintegration of COMECON. The high growth of exports to that group of countries was attributable to their import demand growth being significantly higher than that of import demand of the European Union and to the changes taking place in the structure of those exports. Their share of parts and accessories for machinery and equipment expanded as a result of growing trade between subsidiaries of multinational corporations established in this region of Europe. The main factor affecting export growth to CEE countries in the period January–September 2003 were increased sales to Lithuania and Slovakia, i.e., to the countries with the highest GDP growth rates in the region.

Among positive tendencies observed in the third quarter in Polish exports, halt in the fall of sales to CIS countries should be mentioned. This was the result of both a reduction of export decline to Russia – the largest recipient of Polish goods in that group of countries – and significant sales growth (by 10% on the corresponding period of 2002) to the remaining CIS countries.

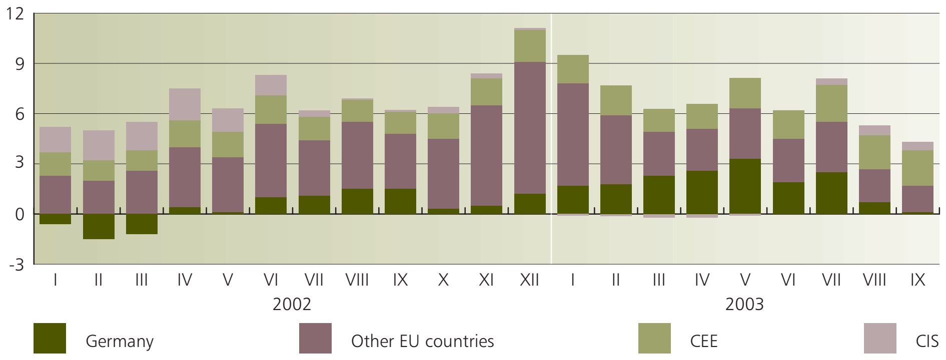
2

Table 7
Movements in exports by major groups of countries (EUR)

	Structure (%)			Growth (% change over previous year)			Growth effect (%)		
	2002 I–IX	2003 I–VI	2003 I–IX	2002 I–IX	2003 I–VI	2003 I–IX	2002 I–IX	2003 I–VI	2003 I–IX
Total	**100.0**	**100.0**	**100.0**	**6.7**	**3.3**	**6.0**			
Developed countries	**75.3**	**75.6**	**74.9**	**6.1**	**2.9**	**5.3**	**4.6**	**2.2**	**4.0**
EU	69.1	69.8	68.6	5.5	3.4	5.2	3.9	2.4	3.6
Germany	32.9	32.8	32.4	1.3	3.3	4.3	0.4	1.1	1.4
France	5.9	6.3	6.2	19.1	9.2	9.9	1.0	0.6	0.6
Great Britain	5.2	4.8	4.9	8.6	-7.1	0.5	0.4	-0.4	0.0
Italy	5.3	5.6	5.4	1.6	2.1	7.4	0.1	0.1	0.4
Central and Eastern Europe	**12.5**	**13.0**	**13.5**	**11.8**	**9.8**	**14.0**	**1.4**	**1.2**	**1.7**
CIS	**7.1**	**6.6**	**6.8**	**15.4**	**-3.4**	**1.6**	**1.0**	**-0.2**	**0.1**
Russia	3.3	2.9	2.8	25.6	-11.7	-8.4	0.7	-0.4	-0.3
Developing countries	**4.9**	**4.7**	**4.7**	**-6.0**	**2.8**	**1.3**	**-0.3**	**0.1**	**0.1**

Source: FTIC.

Figure 23
Share of major trading partners in Polish export growth*
(% change on corresponding period previous year)

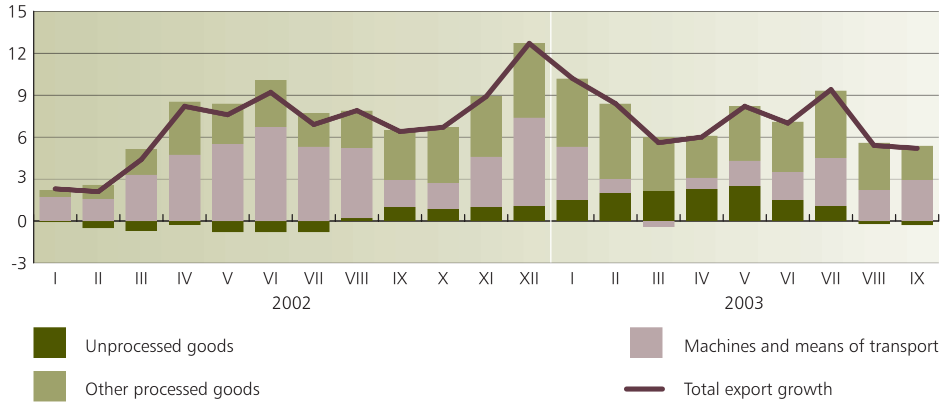


* 3-month moving average, in euro current prices
Source: FTIC.

As shown by the analysis of the commodity structure of Polish exports, their growth in the third quarter was primarily encouraged by increased sales of machinery and transport equipment. In particular, this was attributable to the rapid growth in personal car exports. After the first nine months of 2003, the value of these exports rose 10.1% in relation to the corresponding period of the previous year (after six months of 2003, the relevant figure showed a 8.5% decline). The good export performance of the automotive industry was attributed, on the one hand, to the recovery in the European car market, and on the other, to the launching of the production and exports of a new car model in Poland (Fiat Panda). At the same time, a high growth of car parts and accessory sales was sustained. From January to September 2003, the value of these exports surged by 27% on the corresponding period of 2002.

Relatively high growth of 12% was also displayed in the period by exports of subassemblies and components (exclusive of car parts). Meanwhile, sales of finished machinery and equipment

Figure 24
Shares of major commodity groups in Polish export growth*
(% change on corresponding period previous year)



* 3-month moving average, in euro current prices
Source: FTIC.

Table 8
Movements in exports by major SITC groups of goods (EUR)

	Structure (%)			Growth (% change over previous year)			Growth effect (%)		
	2002 I–IX	2003 I–VI	2003 I–IX	2002 I–IX	2003 I–VI	2003 I–IX	2002 I–IX	2003 I–VI	2003 I–IX
Total	**100.0**	**100.0**	**100.0**	**6.7**	**3.3**	**6.0**			
Non-processed products	**14.8**	**15.1**	**15.0**	**-1.2**	**10.7**	**7.5**	**-0.2**	**1.5**	**1.1**
Foodstuffs	7.2	7.5	7.8	1.5	15.2	14.5	0.1	1.0	1.0
Raw materials	2.5	2.8	2.7	2.1	19.6	13.0	0.1	0.5	0.3
Mineral fuels	5.1	4.8	4.6	-6.1	0.1	-5.1	-0.4	0.0	-0.3
Processed goods	**85.2**	**84.9**	**84.9**	**8.1**	**2.1**	**5.7**	**6.8**	**1.8**	**4.8**
Chemicals	6.2	6.5	6.5	4.9	10.9	9.5	0.3	0.7	0.6
Machinery and transport equipment	37.4	36.3	36.7	10.9	-1.9	4.1	3.9	-0.7	1.5
Other industrial goods	41.5	42.1	41.8	6.3	4.4	6.6	2.6	1.8	2.7

Source: FTIC.

expanded by 1.0% compared to the previous year, whereas those of durable consumer goods shrank by 4.3% (of which sales of the main item, television sets, fell by 22%).

In the remaining groups of processed goods, export growth after the first nine months of the year was faster compared to the first half of the year. Particularly high growth was recorded in sales of furniture, steel products (as a result of increased metal prices in international markets) and chemicals.

From January to September 2003, a 1% growth was also recorded in import value on the corresponding period of the previous year (Table 9). This trend was supported not only by increased imports of distributive goods (indirect consumption) (Fig. 10) utilised primarily for export production (Fig. 26) but also by the halted decline in imports of investment goods (due to higher imports of industrial transport equipment). In addition to low investment demand in the first six months of the year, the decrease in the value of investment good imports in the examined period

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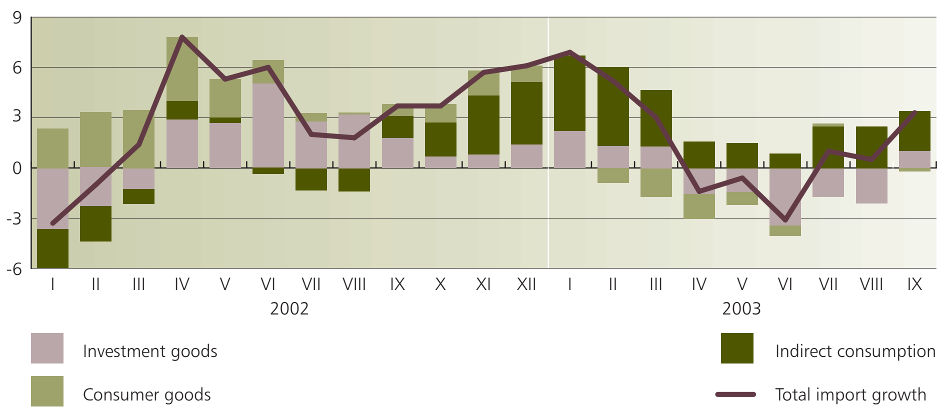
Table 9
Movements in import distribution structure according to purpose (EUR)

	Structure (%)			Growth (% change over previous year)			Growth effect (%)		
	2002 I–IX	2003 I–VI	2003 I–IX	2002 I–IX	2003 I–VI	2003 I–IX	2002 I–IX	2003 I–VI	2003 I–IX
Total	**100.0**	**100.0**	**100.0**	**3.7**	**-2.0**	**1.0**			
Investment goods	**19.2**	**18.0**	**18.6**	**10.6**	**-8.3**	**-2.3**	**1.9**	**-1.6**	**-0.4**
Investment goods, exclusive of transport equipment	14.0	13.2	13.3	-0.9	-8.0	-4.3	-0.1	-1.1	-0.6
Industrial transport equipment	5.2	4.7	5.3	60.6	-9.0	3.1	2.0	-0.5	0.2
Indirect consumption	**59.1**	**60.8**	**60.7**	**0.0**	**1.9**	**3.7**	**0.0**	**1.1**	**2.2**
Indirect consumption, exclusive of fuels	50.2	53.3	51.3	2.1	1.3	3.2	1.1	0.7	1.6
Fuels and lubricants	8.8	9.6	9.3	-10.5	7.3	6.6	-1.1	0.6	0.6
Consumer goods	**21.6**	**21.1**	**20.6**	**9.0**	**-7.0**	**-3.6**	**1.9**	**-1.6**	**-0.8**
Foodstuffs and beverages	3.6	3.4	3.2	1.4	-12.7	-8.7	0.1	-0.5	-0.3
Personal cars	4.7	5.2	5.0	17.1	3.6	7.2	0.7	0.2	0.3
Durable goods	2.6	2.3	2.3	3.6	-12.7	-11.8	0.1	-0.3	-0.3
Semi-durable goods	4.0	3.8	3.8	15.3	-8.7	-6.2	0.6	-0.4	-0.3
Non-durable goods	6.5	6.1	6.1	6.7	-9.2	-4.6	0.4	-0.6	-0.3

Source: FTIC.

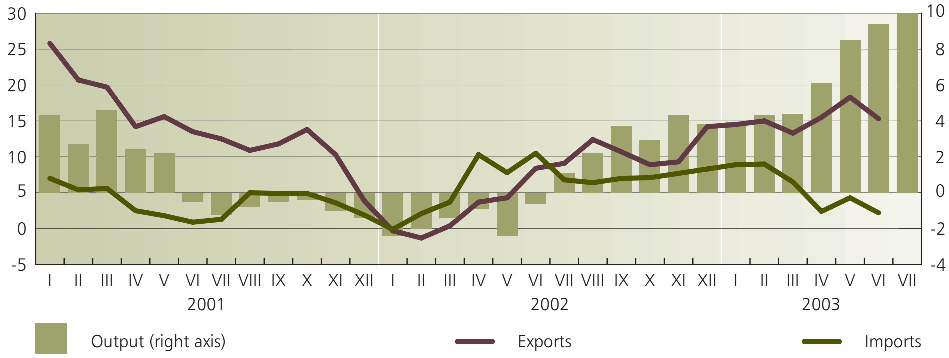
was also enhanced by the decline in their prices related chiefly to the substitution of imports originating from developed countries with less costly imports from developing countries (predominantly from China).· After the third quarter of 2003, Polish imports of Chinese investment goods rose by 25% on the corresponding period of the previous year.

Figure 25
Shares of major commodity groups in Polish import growth*
(% change on corresponding period previous year)



* 3-month moving average, in euro current prices
Source: FTIC.

Figure 26
Polish foreign trade growth vs. sold industrial output growth*
(% change on corresponding period previous year)



* 3-month moving average, in euro current prices
Source: FTIC.

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Table 10
Selected prudential ratios

Prudential ratio			2002			2003	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Current account balance to GDP (%)*	-4.0	-3.6	-3.6	-3.6	-3.1	-2.7	-2.4
Commodity trading balance to GDP (%)*	-6.1	-5.8	-5.5	-5.5	-5.2	-5.2	-5.0
Direct investment to current account balance (%)	42.9	51.7	69.2	71.5	57.4	55.9	213.0
(Current account deficit plus direct investment) to GDP (%)	-3.1	-1.7	-0.6	-1.0	-1.4	-1.0	0.7
Foreign debt service to export receipts (%)	37.5	37.7	36.2	56.0	45.6	54.5	-
Official reserve assets expressed in months of imports	7.6	6.9	7.1	6.2	7.2	6.8	6.5

*annualised
Source: NBP figures and estimates.

In the meantime, the value of consumer good imports, in the context of weak consumer demand and progressing zloty depreciation, remained below the 2002 levels. The only commodity group whose import value grew on the 2002 performance was motor vehicles. The most severe decline was observed in food imports (especially in processed foodstuffs) and durable goods.

In the third quarter of 2003, inward long-term foreign capital in the form of direct investment amounted to 0.6bn euro, exceeding more than twice the current account deficit. This signified a visible improvement in the deficit financing structure which, however, did not result from increased inward foreign capital but from reduced deficit.

During the quarter examined, over 1.2bn euro of capital portfolio investment, both foreign and local, was withdrawn from Poland.

The assessment of external imbalance in the third quarter was conducted on the basis of selected prudential indices (Table 10). All indices stayed at a safe level and most of them improved compared to the preceding quarter.

2

Box 5. Inward foreign investment and economic growth

In order to determine the relation between the share of investment in GDP and sustainable economic growth, Solow's growth (capital formation) model was used, refined with a GDP growth equation resulting from the neo-classical production function combined with technological progress, in the meaning adopted by Hicks. The resulting formula takes the following form:

$$s = \left(\frac{\gamma_Y - (1-\alpha)n - x}{\alpha} + \rho\right)\frac{K}{Y},$$

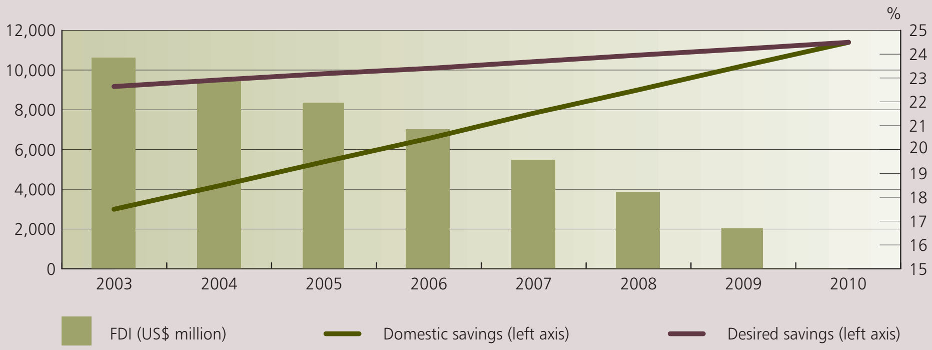
where s denotes the savings rate, γ_Y – GDP growth, α – product to capital flexibility, n n – working population growth, x – technological progress growth, ρ – capital depreciation rate, K – capital resource, and Y – GDP-measured product.

Based on the estimates [developed by Gradzewicz and Kolasa, 2003], capital to GDP ratio of 2.1 was adopted. Flexibility α = 0,34 was defined at a standard level assumed in growth calculation. Annual capital depreciation rate was projected at 4.5%, whereas that of technological progress growth at 2.4%. Average annual growth of working population was adopted at 0.76%, which would correspond to a 5% fall in BAEL unemployment rate by 2010 (assuming constant population of professionally active persons).

The adopted parameterisation indicates that the combined savings rate should stand at 22.4% for a 5% real GDP growth to be achieved in 2003. If we assume the domestic savings rate in the 2003 input year at 16.5% (at 17.3% in 2001 and lower in 2002) and PLN/EUR exchange rate prevailing in August 2003 (close to the equilibrium exchange rate estimated by [Rubaszek, 2003]), foreign savings in the form of direct investment (FDI) of 9.5bn euro would have to be attracted to reach the set target.

Maintaining 5% GDP growth in the following years would require a steady growth of combined savings rate to 24.5% in 2010. If we were to assume that by the end of the period the economy would become self-sufficient in financing the desired level of capital formation (the domestic savings rate would match the rate of investment in the economy) and that the real zloty to euro exchange rate would remain unchanged, the average desired inflow of foreign savings in the form of FDI in the years 2003–2010 would have to stand at 5.3bn euro annually.

Figure
Desired FDI and savings rates, 2003–2010



Source: Gradzewicz M., Kolasa M., 2003, *Szacowanie luki popytowej dla gospodarki polskiej przy wykorzystaniu metody VECM* [*Estimating Demand Gap for the Polish Economy using VECM Method*], "Bank i Kredyt" (edited) Rubaszek M., 2003, *The Optimal ERM2 Central Parity for the Polish Zloty*, Working Papers from ECB Research Meetings "Equilibrium Exchange Rate in Accession Countries: Macroeconomic and Methodological Issues", materials presented at ECB working meeting on September, 5.

2.2. External prices

In the third quarter of 2003, there was distinct growth of the US dollar prices of industrial raw materials (cf. Table 11). Metal price growth (annualised) reached its peak since the second half of 2000. This was primarily accounted for by growth of copper prices, with their monthly average on the London Metal Exchange exceeding US$1,800 per tonne in September against the 2002 average of US$1,580 per tonne. Previously, copper prices had only run at such high levels in December 2000. Their current growth is attributed to recovering investment demand in the world economy, chiefly in the United States and China.

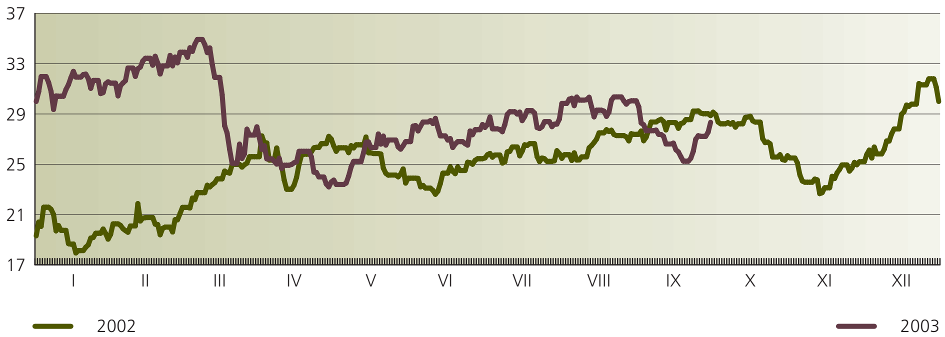
In the third quarter, oil prices also increased (Fig. 27). The average Brent oil price in that period stood at US$28.4 per barrel, i.e., was US$2.4 higher than in the second quarter of 2003.

Table 11
Movements in prices of basic raw materials (% change on previous year, in US dollar terms)

	In relation to corresponding quarter of previous year				In relation to previous quarter			
	2002	2003			2002	2003		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Non-energy raw materials,	17.4	13.4	10.2	6.8	2.7	2.4	-1.2	2.7
of which:								
Food	19.0	14.8	12.3	0.7	2.6	-0.3	-1.5	-0.1
Industrial raw materials,	15.0	11.3	7.3	16.0	2.8	6.6	-0.8	6.8
of which:								
Raw materials of agricultural origin	26.1	18.3	11.1	17.3	2.8	7.4	-0.6	6.9
Metals	6.6	5.7	3.9	14.9	3.0	5.8	-1.0	6.6
Oil (Brent)	38.7	48.5	4.0	5.4	-0.4	17.0	-17.0	8.7

Source: "The Economist" and Bloomberg.

Figure 27
Brent oil prices, 2002–2003 (daily figures in US$ per barrel)



Source: Bloomberg.

Oil price trends were effected mainly by supply-side factors. Oil production in OPEC countries (exclusive of Iraq) declined in the third quarter by over 500,000 barrels per day on the previous quarter. This was the consequence of an OPEC decision calling upon member states to reduce oil output to previously agreed limits (Fig. 28) in connection with the anticipated resumption of Iraqi oil supplies to international markets[8]. Another step bringing the oil supply in line with growing Iraqi exports was OPEC's September resolution to cut production quotas by 900,000 barrels a day. This came as a big surprise for the market both in the context of relatively high fuel prices prevailing at the time (running much above the base limit of the target price of US$22 per barrel declared by OPEC) and low level of oil reserves in developed countries[9]. It is worth mentioning at this point the high effectiveness of the cartel's pricing policy in recent years. As of January 2000, the average monthly price of the OPEC oil basket remained above the base limit of the OPEC target for 40 out of 45 months.

[8] Contrary to earlier expectations and declarations of new Iraqi government, until August oil production in that country did not exceed 1m barrels a day. The reason for the delay was unstable internal situation in Iraq, including cases of sabotage frequently targeting oil production infrastructure. Due to severe damage, the pipeline transporting oil from northern fields to the Turkish port of Ceyhan, the main Iraqi export terminal, was closed down in August.

[9] OPEC's decision was prompted by concerns that rapid increase in oil production in Iraq could contribute to the reoccurrence of the situation from 1998 when the UN allowed Iraq, under the "Oil for food" programme, to increase its production to 2.5m barrels a day. As a result, large surplus of supply over demand led to the lowering of average Brent oil price to US$12.7 per barrel.

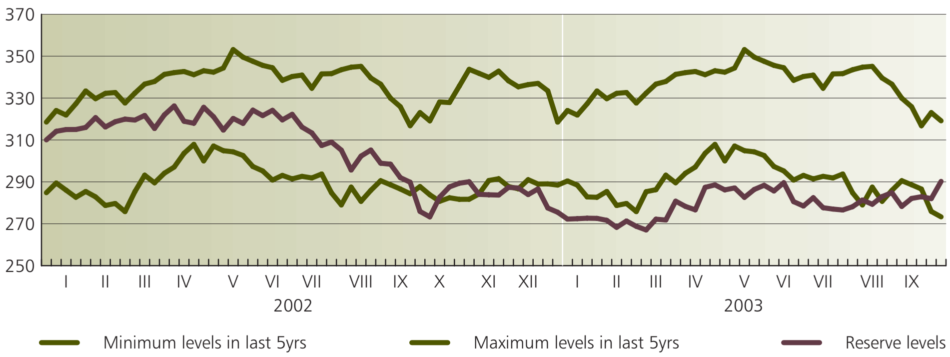
Figure 28
Oil production in OPEC-10 countries and official output limits, 2000–2003 (in million barrels per day)

Source: Energy Information Agency – US Department of Energy.

The slight growth in the demand for oil in the third quarter was only seasonal. In July and August, it could be traced to an increased demand for petrol, and in September to the beginning of the period of furnace oil reserve replenishment before the new heating season. According to the estimates of the International Energy Agency (IEA), this demand amounted to 700,000 barrels per day above the corresponding period of the previous year.

Nevertheless, the curbing of oil production by OPEC and delayed resumption of Iraqi exports hampered the rebuilding of oil reserves, contributing to its price growth[10]. According to the American Petroleum Institute, US oil reserves continued to stay below the five-year minimum volume (Fig. 29).

Figure 29
US oil reserves, 2002–2003 (end-of-week figures in millions of barrels)

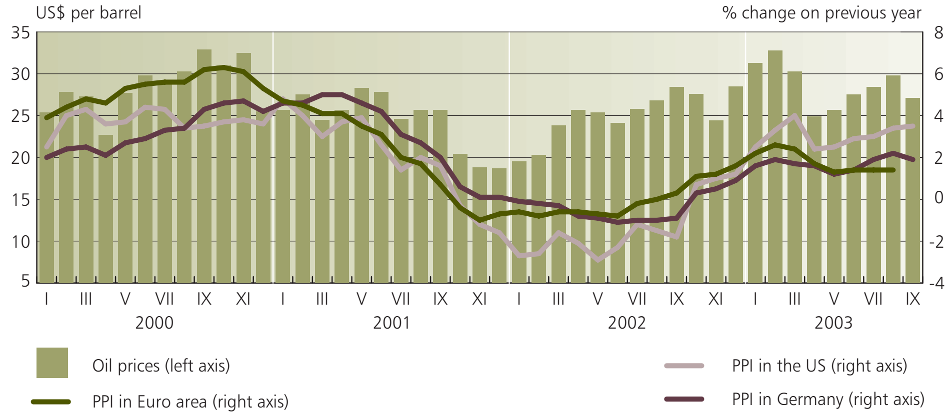


Source: American Petroleum Institute.

Price growth of oil and industrial raw materials in the third quarter fuelled price growth in the world's largest economies. In the United States, the annual PPI index grew from 2.9% in June to 3.5% in September (Fig. 30), while the CPI index increased from 2.1% to 2.3%, respectively. Meanwhile, in the euro area the annual PPI remained unchanged at 1.4% (Fig. 31), while CPI climbed from 1.9% in June to 2.1% in September.

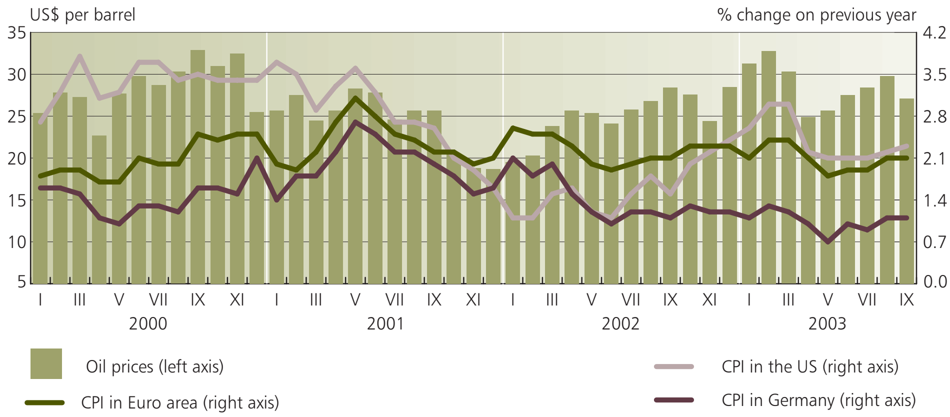
[10] According to IEA estimates, there was a slight increase in oil and petroleum product reserves in developed countries in the third quarter. In August, they represented 53 days of projected demand, i.e. 2 days more than in the second quarter.

Figure 30
Oil prices and PPI in the US, Euro area and Germany



Source: Bloomberg.

Figure 31
Oil prices and CPI in the US, Euro area and Germany



Source: Bloomberg.

Figure 32
Transactional price indices (PLN) in Polish foreign trade, 2001–2003

Source: GUS.

Alongside growth in oil prices, the pricing terms in Polish foreign trade deteriorated (Fig. 32). The *terms of trade* ratio in the period January–July 2003 amounted to 97.2 against 104.8 in the corresponding period of 2002. This was attributable to the growth of zloty-denominated transaction prices being higher in imports than in exports. In the course of the first seven months of 2003, unit import prices rose by 10.7% (against a 1.3% decline in the corresponding period of 2002), and export prices – by 7.6% (against a 3.4% growth in the corresponding period of 2002). The zloty depreciation, in progress throughout 2003, also contributed to accelerated growth of zloty prices in Polish foreign trade.

3
Inflationary processes

3

3.1. Consumer prices

In the third quarter of 2003, for the first time in two years, an acceleration of average annual CPI growth was recorded from 0.5% in the second quarter to 0.8% in the third. This acceleration was caused by the halting of the falling trend in food and non-alcoholic beverage prices observed for the previous five consecutive quarters. Growth in officially controlled prices in the third quarter was markedly slower than in the first two quarters of 2003, whereas growth in the prices of other goods and services turned out to be only slightly smaller than in the preceding quarter.

The twelve-month CPI growth in subsequent months of the third quarter 2003 was relatively stable. Compared to the corresponding quarter of 2002, it was characterised by:

- slow food price growth (a small seasonal fall in food prices was recorded only in August, while a year before it continued for all months of the quarter),
- half the 2002 growth of officially controlled prices which, nevertheless, continued to exceed the overall CPI growth,
- 250% weaker than in 2002 growth in prices of other goods and services.

Growth of food prices in the third quarter was determined by agro-meteorological conditions other than those prevailing in 2002. The production situation in agriculture was generally less favourable than a year before and in the first half of 2003. This year's crop and fruit harvests (collected in the spring and early summer periods) were lower than in 2002. The scale of livestock production was also gradually limited, including, primarily, pork meat. As a result, foodstuff supply surpluses were eroded. In this context, food price declines, typical for July and August, were weaker this year than in previous years and their growth in September stronger.

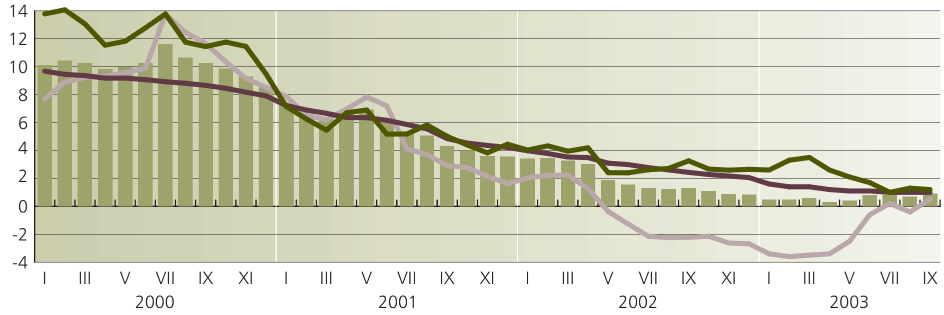
In the group of officially controlled prices, the basic factor stimulating growth in the third quarter were electricity price increases related to the newly launched charge rates. Domestic fuel

Table 12
Price growth in basic consumer good and service groups

	2002	2003		2002			2003	
	Weight structure		VII	VIII	IX	VII	VIII	IX
	%		Corresponding period previous year = 100					
Total	**100.0**	**100.0**	**101.3**	**101.2**	**101.3**	**100.8**	**100.7**	**100.9**
Food and non-alcoholic beverages	29.7	28.2	97.9	97.8	97.8	100.2	99.6	100.5
Officially controlled prices,	27.1	27.2	102.6	102.7	103.2	101.0	101.3	101.2
of which: fuel	3.7	3.7	99.3	100.7	101.4	105.2	106.5	105.1
Other goods and services,	43.2	44.6	102.8	102.6	102.4	101.0	101.0	101.0
of which: non-food goods	26.1	26.7	101.7	101.5	101.3	100.0	99.9	99.9
Services	17.1	17.9	104.4	104.3	104.1	102.6	102.7	102.6

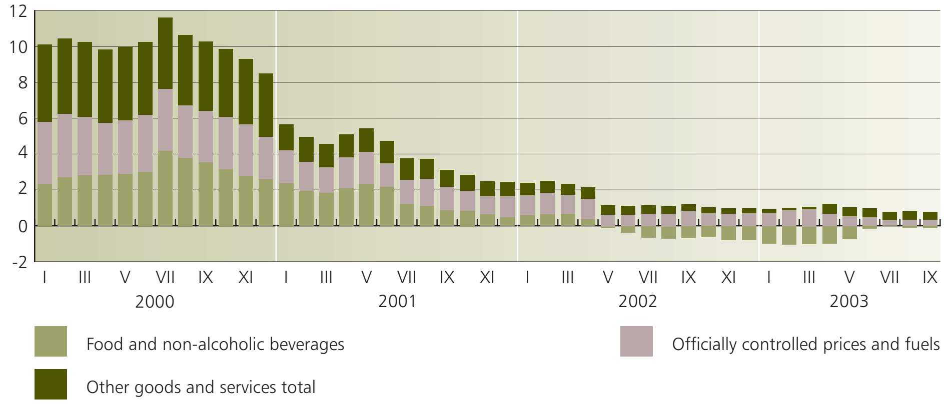
Source: GUS figures and NBP calculations.

Figure 33
Movements in CPI and major price categories, 2000–2003
(corresponding month previous year = 100)



Source: GUS figures and NBP calculations.

Figure 34
Share of individual price categories in CPI, 2000–2003
(corresponding month previous year = 100)



Source: GUS figures and NBP calculations.

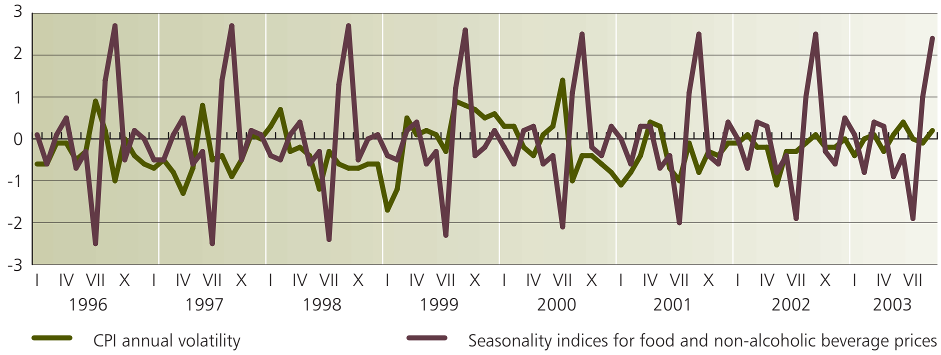
prices also grew following the decline in the zloty exchange rate and the rise of world prices. Furthermore, growth recorded in the third quarter in some subgroups of officially controlled prices derived from earlier price movements whose effect was spread over a longer time.

Prices of other consumer goods and services in the third quarter ran in accordance with the trends observed during the previous quarter. (Table 12, Fig. 33, and Fig. 34).

Prices of food and non-alcoholic beverages in the third quarter, on a twelve-month scale, were 0.1% higher than a year before (in the third quarter of 2002, they were over 2% lower). The highest growth was recorded in the prices of; fruit – by over 9%, vegetables – by 3.5%, and oils and other fats – by 2.2%.

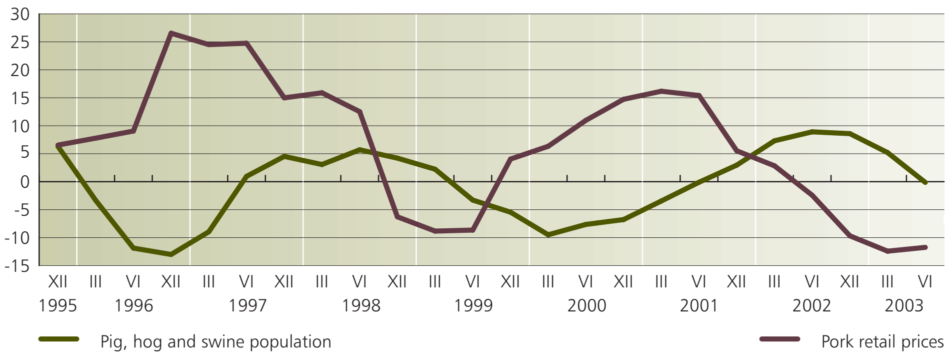
In the third quarter, the average prices of vegetal products were higher than in 2002. Meanwhile, the prices of farm animals (cattle, pigs, hogs and swine) were lower than last year, whereas poultry and milk collection prices were higher. The pricing situation in the foodstuff market was derived from supply movements in the produce market. Since mid-2002, high supply, primarily of crops, pigs, and poultry, persisted in the domestic food market. This could be traced to high 2002 crop harvests and the peak stage of pig farming. The situation began to change in mid-2003,

Figure 35
Annual CPI volatility and seasonal ratios for prices of food and non-alcoholic beverages



Source: GUS figures and NBP calculations.

Figure 36
Movements in retail pork prices and population of pigs, hogs and swine
(corresponding period previous year = 100)



Source: GUS figures and NBP calculations.

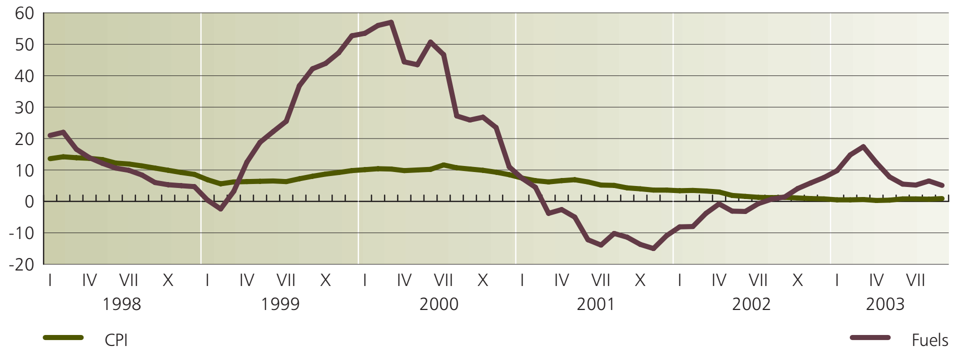
largely due to the anticipated lower harvests of crops and falling livestock production. This led to a gradual increase in price growth of basic produce and, consequently, in retail food prices.

The current estimated market supply of this year's crop harvests and the projected decline phase in pork production point towards a possible slow growth in produce prices at the turn of 2003 and 2004 and in 2004.

In the third quarter, there was a further slowdown in annual growth of ***officially controlled prices***[11]. However, on a quarter-to-quarter basis, this growth accelerated and amounted to 1.1%. Growth of officially controlled prices in the third quarter was derived chiefly from increased electricity prices (in connection with the newly launched charge rates applicable as of July 1, 2003),

[11] Officially controlled prices include prices of goods and services which are under limited influence of market mechanisms due to various types of administrative interference into their pricing process. The category of officially controlled prices, isolated for analytic purposes, includes prices:
– indirectly regulated by excise duty rates; this applies to those groups of goods and services in which excise duty share in the retail price structure is meaningful (for instance, alcoholic beverages, tobacco goods, fuels, and electricity),
– subject to control and approval of competent government agencies, primarily the Energy Sector Regulatory Office (electricity, gas, district heating, and hot water),
– with unified levels across the country (postal services, rail transport, TV and radio subscription),
– controlled by local authorities (municipal public transport), and
– set by the central government (court and public administration service fees).

Figure 37
CPI and fuel price index (corresponding month previous year = 100)



Source: GUS.

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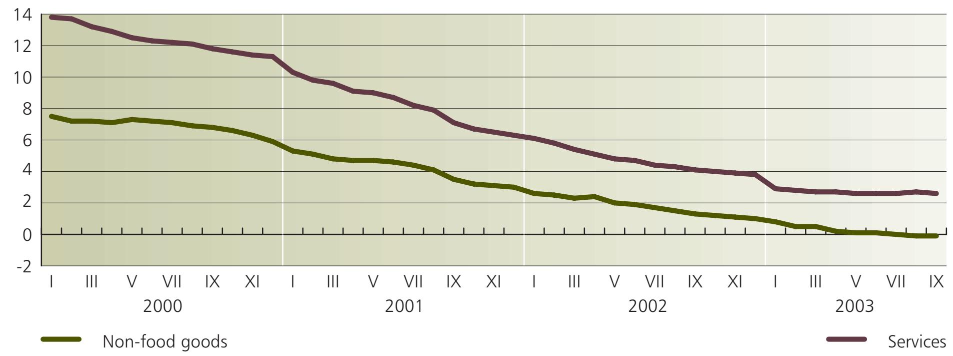
persistently high district heating charges, appreciating fuel and tobacco product prices (the delayed effect of the January excise duty rise).

Allocated to the group of officially controlled prices, ***fuel prices*** grew in all months of the third quarter 2003, and their growth was most pronounced in August (by 2.0% monthly). As shown by the Nafta Polska data on the structure of fuel prices based on the example of EU 95 fuel, the main cause of the fuel price increase was a 6.2% growth in prices of imported petrol (on an accrual basis, from June to September 2003) resulting from the weakening of the zloty to US dollar exchange rate in that period by 5.6% and growth in world prices of petrol by 0.5% as well as a 4.9% increase in producer and distributor mark-ups (computed as the difference between retail and sale prices).

In the price group of ***other goods and services***, annualised price growth in the third quarter was similar to that recorded in the previous quarter. Prices of non-food products, making up this group, showed a slightly falling trend, while service price growth remained stable and high (Fig. 38).

Very low price growth in the *non-food goods* sector in the third quarter was attributed to the persistent absence of demand pressure. Internal proportions of price growth in the subgroups making up non-food goods were not subject to major changes during the period. Slightly more marked than in the second quarter was the annualised decline in clothing and footwear prices. In the meantime, the highest annual price growth in the group was displayed by furniture and household articles and charges related to the use of flats or houses.

Figure 38
Price movements of other consumer goods and services
(corresponding month previous year = 100)



Source: GUS figures and NBP calculations.

The annual growth of *service prices* (allocated to other good and service price group), although almost half that of the year before, in the third quarter was high compared to the overall inflation ratio. Since the beginning of the year, it has remained stable.

The highest steady annualised growth in the analysed group since the beginning of the year was showed by charges related to the use of flats or houses (over 3%).

3.2. Core inflation

In the third quarter of 2003, both CPI indices and most measures of core inflation remained relatively stable (Fig. 41). In the period, two core inflation measures of those calculated by the NBP (exclusive of most volatile prices) were significantly lower than others which (combined with the CPI index) ran at 0.5 to 1.2% annually (Fig. 40).

The twelve-month index of ***core inflation excluding officially controlled prices*** (Fig. 42) in the third quarter was slightly below the CPI index. This could be traced to the relatively weak inflationary pressure from consumer prices subject to administrative control. Among excluded groups, the highest growth was recorded by electricity and district heating charges, and the prices of fuels and tobacco goods.

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Table 13
CPI and core inflation indices (change over corresponding month previous year)

	2002											
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
CPI	**3.4**	**3.5**	**3.3**	**3.0**	**1.9**	**1.6**	**1.3**	**1.2**	**1.3**	**1.1**	**0.9**	**0.8**
	Core inflation excluding:											
Officially controlled prices	3.2	3.1	3.0	2.6	1.7	1.3	0.8	0.7	0.6	0.5	0.2	0.2
Most volatile prices	2.9	2.8	2.6	2.5	2.1	1.9	1.6	1.5	1.3	0.9	0.8	0.7
Most volatile and fuel prices	3.4	3.3	2.9	2.7	2.4	2.1	1.7	1.6	1.3	0.8	0.6	0.4
Food and fuel prices (“net” inflation)	4.7	4.7	4.1	4.0	3.2	3.1	2.9	2.8	2.8	2.3	2.1	2.0
15% trimmed mean	3.5	3.2	2.9	2.6	2.0	1.9	1.7	1.7	1.5	1.3	1.3	1.2

Source: GUS figures and NBP calculations.

Table 14
CPI and core inflation indices (change over corresponding month previous year)

	2003								
	I	II	III	IV	V	VI	VII	VIII	IX
CPI	**0,5**	**0,5**	**0,6**	**0,3**	**0,4**	**0,8**	**0,8**	**0,7**	**0,9**
	Core inflation excluding:								
Officially controlled prices	-0.3	-0.5	-0.6	-0.6	-0.3	0.4	0.7	0.5	0.8
Most volatile prices	0.5	0.5	0.5	0.0	-0.1	-0.1	0.0	0.1	0.3
Most volatile and fuel prices	0.1	-0.1	-0.2	-0.5	-0.5	-0.3	-0.3	-0.2	0.0
Food and fuel prices (“net” inflation)	1.6	1.5	1.4	1.2	1.2	1.1	0.8	0.8	0.9
15% trimmed mean	1.0	0.8	0.8	0.6	0.8	0.9	1.0	1.0	1.2

Source: GUS figures and NBP calculations.

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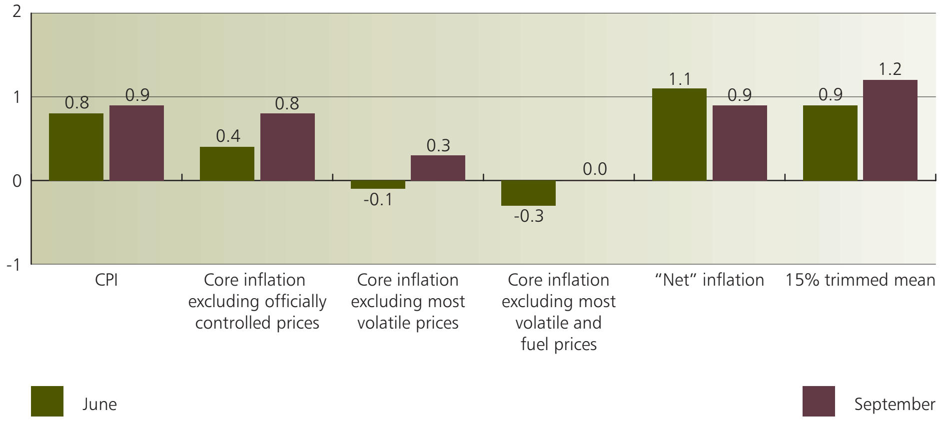
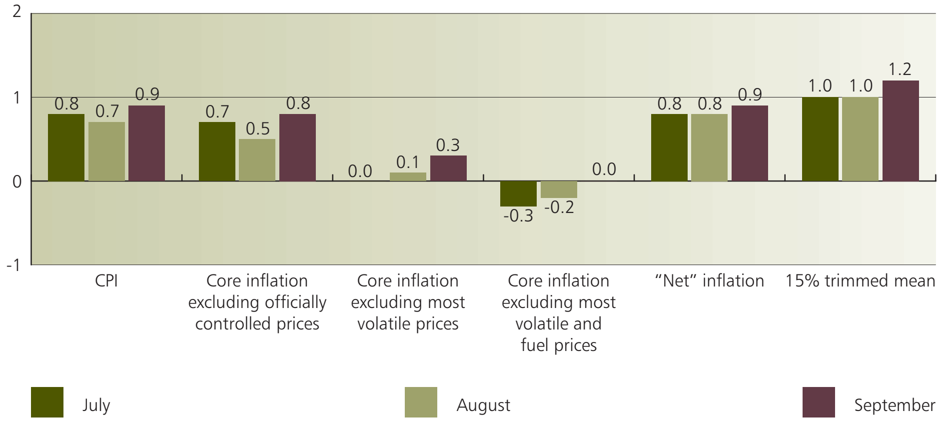
Figure 39
CPI and core inflation, June 2003 and September 2003
(change on corresponding month previous year)



Source: GUS figures and NBP calculations.

Figure 40
CPI and core inflation, Q3 2003
(change on corresponding month previous year)

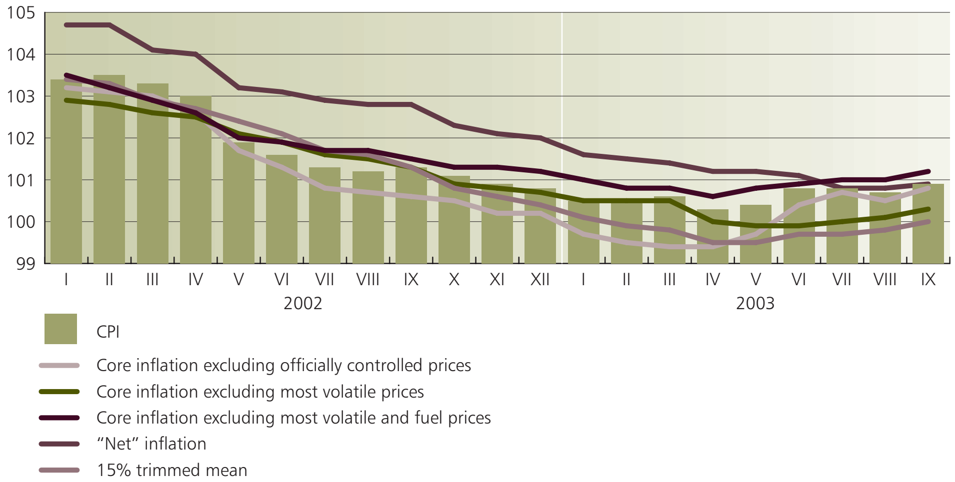


Source: GUS figures and NBP calculations.

Core inflation excluding the most volatile CPI prices (Fig. 43) as well as *core inflation excluding the most volatile and fuel prices* (Fig. 44) in the third quarter were considerably lower both in relation to the CPI index and other measures of core inflation. Among the most volatile prices, the highest number of pro-inflationary price groups was observed. These included poultry, eggs, fruit, potatoes, electricity and charges related to the use of flats or houses. In the meantime, as a result of the exclusion of the most volatile and fuel prices from the core inflation measure and the continuous fuel price growth throughout the quarter (a 5.6% increase on the corresponding quarter of the previous year) the core inflation measure plummeted, assuming negative values.

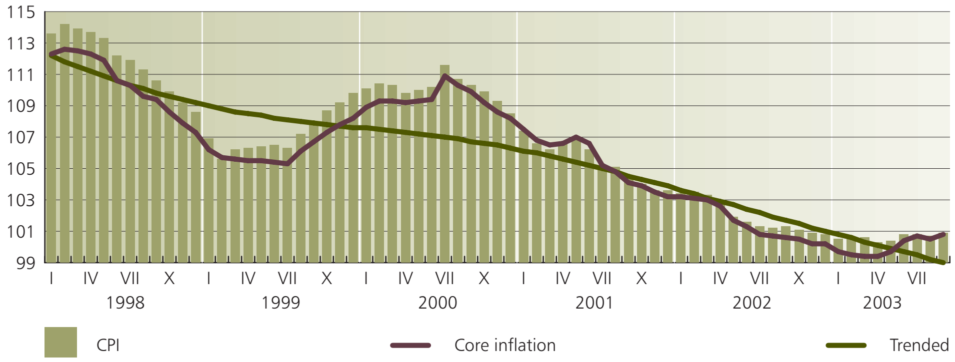
The '*Net' inflation* (Fig. 45) index, obtained through the exclusion of food and fuel prices from CPI, declined to 0.9% in the third quarter. As of August 2001, this measure ran at an average of 1.3 percentage point above the overall inflation rate, pointing to the strong anti-inflationary nature of excluded price groups (especially food prices). It was not until June 2003 that the inflation rate fell to the CPI level, exceeding it by a mere 0.3%. Meanwhile, in the third quarter 'net' inflation rate matched the CPI index.

Figure 41
CPI, core inflation and trended core inflation indices (corresponding month previous year = 100)



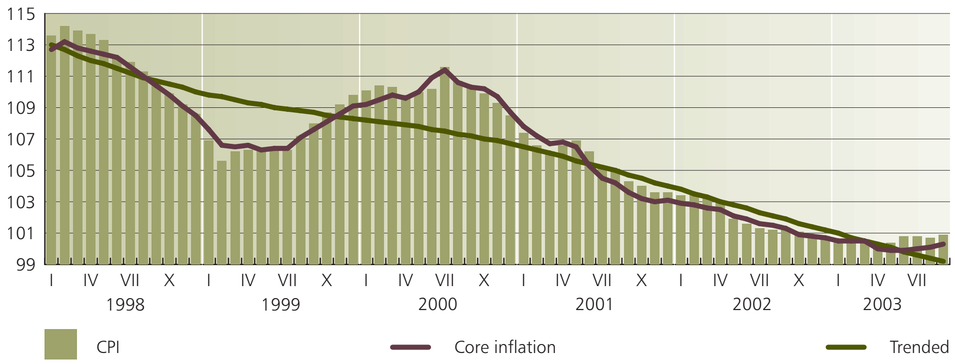
Source: GUS figures and NBP calculations.

Figure 42
CPI and core inflation indices excluding officialy controlled prices (corresponding month previous year = 100)



Source: GUS figures and NBP calculations.

Figure 43
CPI and core inflation indices excluding most volatile prices (corresponding month previous year = 100)



Source: GUS figures and NBP calculations.

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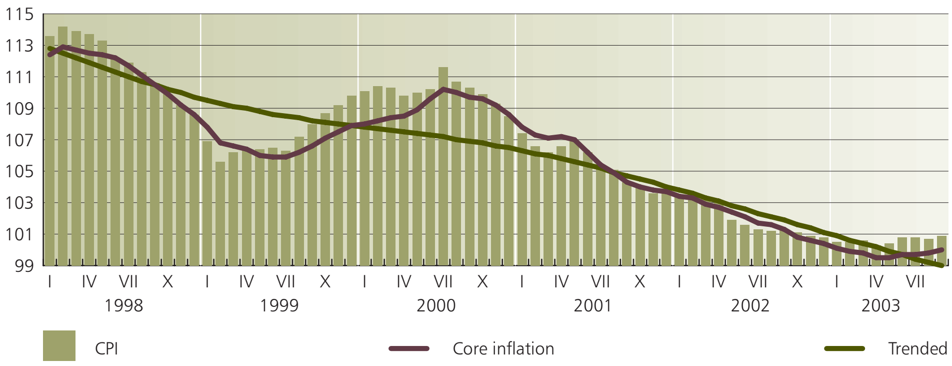
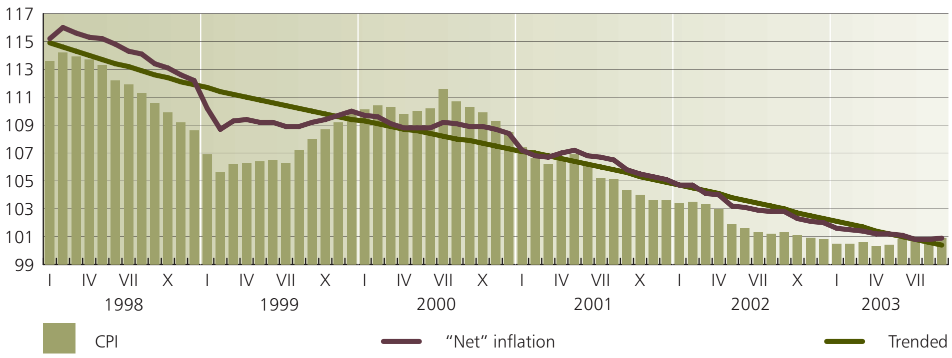
Figure 44
CPI and core inflation indices excluding most volatile and fuel prices (corresponding month previous year = 100)



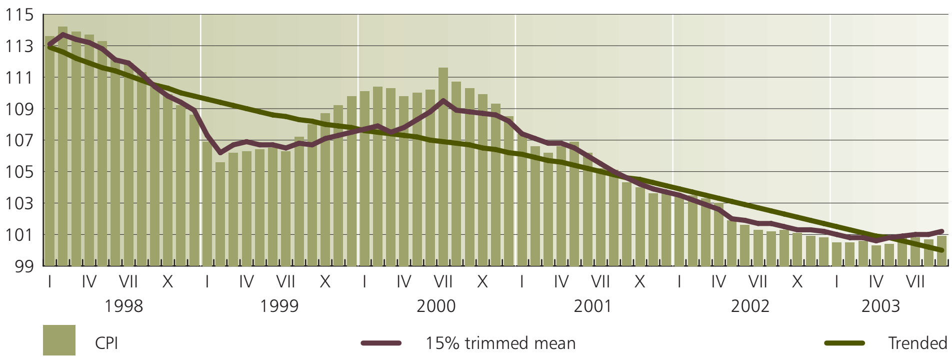
Source: GUS figures and NBP calculations.

Figure 45
CPI and "net" inflation indices excluding food and fuel prices (corresponding month previous year = 100)



Source: GUS figures and NBP calculations.

Figure 46
CPI and core inflation indices (15% trimmed mean) (corresponding month previous year = 100)



Source: GUS figures and NBP calculations.

Another core inflation measure, so-called ***15% trimmed mean*** (Fig. 46), was the only one in the third quarter to stay above the CPI index, hitting a record high in September. The groups marked by the lowest price growth included foodstuffs (meat, cured meat and vegetables) spirits, clothing, telecommunications, photo and audio-visual equipment, computer equipment and household appliances. The groups showing the biggest price growth comprised the following goods and services: fruit, potatoes, eggs, charges related to the use of flats (sewage and water supply), hot water, radio and television subscription, transport services (rail and sea transport), fuels, as well as newspapers and magazines.

4
Monetary policy and performance of the inflation target

4.1. Monetary policy in the third quarter of 2003

In the third quarter of 2003, the Monetary Policy Council (MPC) did not change the NBP basic rates, leaving the lombard rate unchanged at 6.75%, the rediscount rate at 5.75%, the reference rate at 5.25% and the deposit rate at 3.75%.

At its September meeting, the Council resolved to lower the banks' required reserve rate from 4.5% to 3.5%. The relevant resolution took effect on October 1, 2003 and applied to the level of required reserves to be maintained as of October 31, 2003.

The reduction of required reserves was consistent with the agreements regarding continued efforts to prepare the NBP operating system for participation in the Eurosystem, adopted under the Monetary Policy Guidelines for the year 2003. The key tasks in this area involved, inter alia, gradual harmonisation of the required reserve system with the Eurosystem. The current liquidity level of the banking sector determines the timing of required reserve rate cuts.

Detailed information on changes in the Polish required reserve system in the third quarter is presented in Box 6.

Box 6. Changes in the required reserve system in the third quarter of 2003

In the third quarter, the following changes in the operation of the required reserves were observed:

- Following the amendment to the Act on the National Bank of Poland, whereby each bank was allowed, under Article 39a, to reduce the computed required reserve by the equivalent of 500,000 euro (Official Journal No. 137 of August 6, 2003), as of September 30, 2003 – pursuant to Resolution 24/2003 of the NBP Management Board of August 21, 2003 – all banks brought down their computed required reserves, to be maintained as of September 30, 2003, by a total of roughly 0.8bn zloty.
- The Monetary Policy Council, taking account of the decline in the banks' operational liquidity projected for the fourth quarter, considered it necessary – in consistency with the Monetary Policy Guidelines for the year 2003 – to take steps aimed at maintaining liquidity at a level enabling the execution of one-way operations and lowered, on September 30, 2003, the required reserve rate by 1 percentage point, setting it at 3.5% (Resolution 14/2003 of the MPC, NBP Official Journal no. 17 of October 1, 2003). The resolution applies to the required reserves to be maintained as of October 31, 2003. The reduction of required reserves will result in a roughly 2.9bn zloty increase in the banking sector's liquidity in the fourth quarter of the year.

In the third quarter, annual CPI, core inflation and PPI indices remained low and stable. Low inflation expectations by households were also confirmed.

At the same time, in the context of further decline in employment in the third quarter stringent payroll discipline was sustained in enterprises. The annual nominal growth of average monthly gross salaries in the corporate sector at that time stood at 2.4% against 3.6% in the third quarter of 2002 (a 1.7% growth against 2.3%, in real terms). As a result, incomes from hired labour in the sector were nominally 1.2% lower than a year before. Meanwhile, incomes from hired labour in central government institutions as well as incomes from social security benefits increased. It is estimated that in the third quarter the combined registered gross disposable household income grew by over 3.0% nominally, or 2.3% in real terms on the corresponding quarter of the previous year.

Personal consumption growth in the third quarter continued to outpace the purchasing power growth of registered gross disposable household income and (according to NBP estimates) amounted to 2.8%, against 3.9% in the previous quarter.

Household deposits in the third quarter kept on shrinking. Alongside persistently slow growth of registered disposable income, this was due to the falling appeal of bank deposits compared to alternative forms of saving (investment funds and bonds). The annual growth of household credits remained moderate in the third quarter (at about 8%), and its increase to 10.2% in September was partially accounted for by zloty depreciation observed in the period. In total, it is estimated that the value of household financial savings in the third quarter was negative.

Following an acceleration in the period between March and June 2003, annual corporate credit growth returned in the third quarter to its very low level, below 2%. In the meantime, however, there was a substantial rise in corporate deposits and their annual growth climbed from 16.6% in June to 21% in September.

From April, high growth in sold industrial output, especially in the manufacturing industry, was sustained. In September, industrial output was 11.1% higher than a year before, while manufacturing output increased by 12.6% (and when seasonally adjusted, by 8.3% and 9.6%, respectively). Highest sales growth was recorded in industries with a substantial and growing share of exports, including in particular the automotive sector.

In the third quarter, the favourable trends in Polish exports observed in previous months were reinforced. According to the cash-basis statistics, in August, growth in the value of exports, expressed in euro, (by 5.4% compared to August 2002) was more pronounced than the average noted since the beginning of the year (4.9%).

Total construction output in the third quarter continued to fall. However, the annualised rate of its decline (seasonally adjusted) slowed down markedly as of June and remained at 2–3%. This trend was accompanied by high growth of output reported by enterprises involved in the preparation of building sites and those carrying out finishing construction work.

The results of the monthly assessments of the general economic climate by GUS in the third quarter, both for manufacturing and construction, were definitely better than in the corresponding period of the last two years.

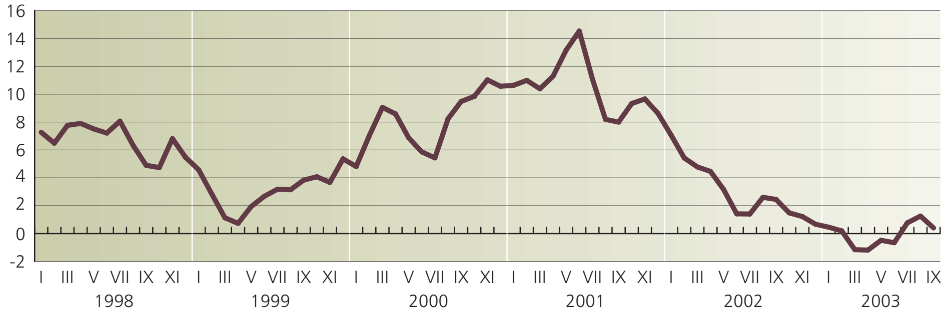
The volume of retail sales in the third quarter was 6.4% higher than a year before although it was partially due to organisational changes implemented by trading enterprises.

Overall, the available information on the economic situation in the third quarter pointed to the reinforcement of the symptoms of economic recovery, which could constitute a potential source of inflationary pressure in the future. Hence, caution in the conduct of monetary policy was advised.

The biggest concerns of the Council continued to be raised by the condition of public finances. When giving its opinion on the draft *Budget Act for the year 2004*, the MPC stressed that it assumed (in comparative terms) the widening of the general government budget deficit from 4.8% of GDP in 2003 to 6.6% of GDP in 2004. This signified substantial fiscal expansion, higher than that resulting from the need to finance budget expenditure relative to Poland's membership in the European Union and, as a consequence, posed a serious risk of public indebtedness running over the second prudential threshold of 55% of GDP. The draft, however, does not provide for any systemic solutions mitigating growth of expenditure, the overwhelming majority of which is fixed by nature. Because of that, the Council expressed its fear that substantial growth of the budget deficit and the resulting increase in long-term interest rates would lead to private investment being crowded out by general government spending, thus hampering economic growth. This trend will be accompanied by growing uncertainty concerning foreign exchange rates. Overall, according to the MPC the 2004 draft budget contributes to undermining lasting and sustainable economic growth.

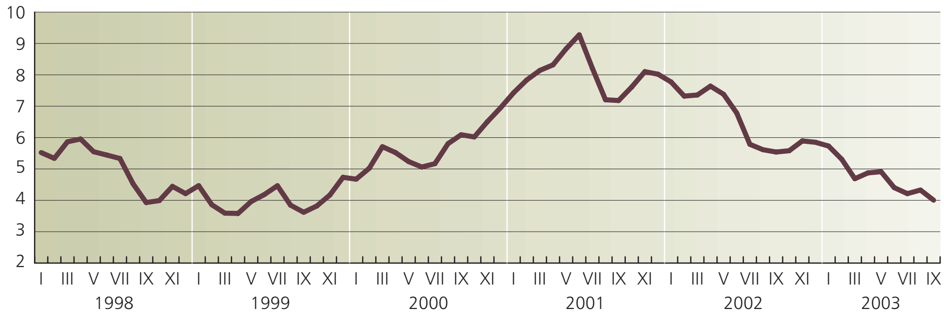
The factors representing potential sources of inflationary pressure in the third quarter also included a persistently high growth of notes and coins in circulation (reaching 16% in September, when annualised) and high oil prices in international markets (the forecast annualised price of this raw material in 2004 was raised from US$26.0 per barrel to US$26.6 per barrel).

Figure 47
Monetary Conditions Index (MCI) (Base period: December 1994)



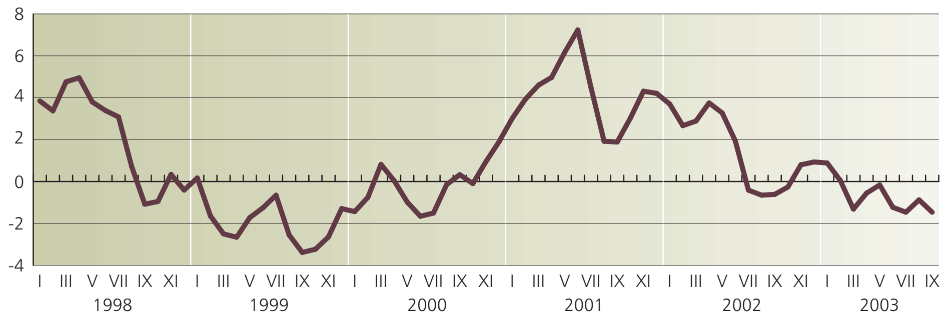
Source: NBP.

Figure 48
Monetary Conditions Index (MCI) based on deviations from REER and interest rates (Base period: December 1994)



Source: NBP.

Figure 49
Monetary Conditions Index (MCI) based on deviations from trended REER and interest rates (Base period: December 1994)



Source: NBP.

When taking decisions to keep interest rates unchanged in the third quarter, the MPC also considered the scale of the interest rate cuts made so far which would have a delayed bearing on the gradual growth in domestic demand in late 2003 and in 2004.

The scale of the restrictive nature of the monetary policy is illustrated by indices calculated by the NBP which tend to factor in movements in short-term real interest rate and real effective zloty exchange rate (Fig. 47, Fig. 48, Fig. 49, Box 7). These figures are indicative of a significant decrease in the restrictive features of the monetary policy since the beginning of 2001.

Box 7. Modified MCI indices

Starting with this edition of the Inflation Report, two modified Monetary Conditions Indices (MCI) will be additionally presented.

The first one is set as the weighted average of deviations in real effective exchange rate and real interest rate from their base-period levels. It is calculated using the following formula:

$$MCI = \alpha_1(r_t - r_0) + \alpha_2(q_t - q_0)$$

where r denotes real interest rate and q real effective exchange rate (REER). The strong growth trend of that index observed in the years 1997–2001 resulted from REER appreciation.

The second version of the MCI index is the index determined on the basis of deviations in corresponding values from the trend. It eliminates the effect of the growing trend in REER and the falling trend in real interest rates. This MCI index based on deviations from the trend is determined in accordance with the following equation:

$$MCI = \alpha_1((r_t - \overline{r_t}) - (r_0 - \overline{r_0})) + \alpha_2((q_t - \overline{q_t}) - (q_0 - \overline{q_0}))$$

where $\overline{r}$ denotes trended real interest rates and $\overline{q}$ trended REER, , with the remaining markings left unchanged.

In both cases the α_1 and α_2 _2 weightings were determined by means of an IS curve and Philips curve models, and amounted, respectively, to 0.66 and 0.33 for the level-based MCI, and to 0.58 and 0.42 for the deviation-based MCI. REER and interest rate trends were identified using the Hodrick-Prescott (HP) method. The three-month WIBOR rate deflated with the current CPI index was adopted as the real interest rate.

Presenting MCI indices in Inflation Reports is aimed at illustrating movements in monetary policy conditions. When interpreting the values adopted by these indices, the fact should be kept in mind that MCIs do not allow for differentiating the nature of foreign exchange shocks. Furthermore, the method consisting in the removal of the trend identified using the HP method results in movements in the past MCI values at the time of extending the data series to include the newly acquired information. These movements, however, are negligible and the method itself is convenient from the technical point of view.

4.2. The money supply

Movements in money supply in the third quarter of 2003 were characterised by:

- annual growth of M3 money supply stabilised at a low level,
- sustained high annual growth of notes and coins in circulation, excluding banks' vault cash, and
- the significant effect of foreign exchange movements[12] on deposit and credit levels.

M3 money supply grew in the third quarter of 2003 by 4.3bn zloty, or (1,3%). From January to September 2003, M3 monetary aggregate expanded by 8.9bn zloty, whereas in the corresponding period of 2002 it declined 7.6bn zloty. Since March, the annual M3 growth had reached a positive, though low, level, which in September stood at 3.1%.

The following factors primarily contributed to M3 movements in the third quarter: higher level of notes and coins in circulation, strong growth of corporate deposits and falling household deposits.

Notes and coins in circulation (except for bank vault cash) rose by 1.3bn zloty. Although their growth was significantly slower than in the previous quarter (2.7% against 7.3% in the second quarter), the annual cash increase amounted to 16.0% in September, reaching its record high since August 2002.

Growth of corporate deposits amounted to 4.1bn zloty. In particular, zloty-denominated deposits of that sector expanded (by 3.8bn zloty, or 8.0%). The increase in the zloty value of foreign currency liabilities was attributed exclusively to foreign exchange movements.

Household deposits continued to fall, both zloty-denominated (by 1.2bn zloty, or 0.8%) and those expressed in foreign currencies (by 0.1bn zloty, or 0.2%). The decline in the zloty value of currency--denominated deposits was substantially limited by foreign exchange movements. Discounting the effect

[12] Basic assumptions for calculating foreign exchange differences include: a two-currency basket: US dollar + euro; exchange rate: the rate prevailing on the last day of each month; currency weight: share of the operation denominated in a given currency in total currency operations.

Table 15
Money supply in Q3 2003

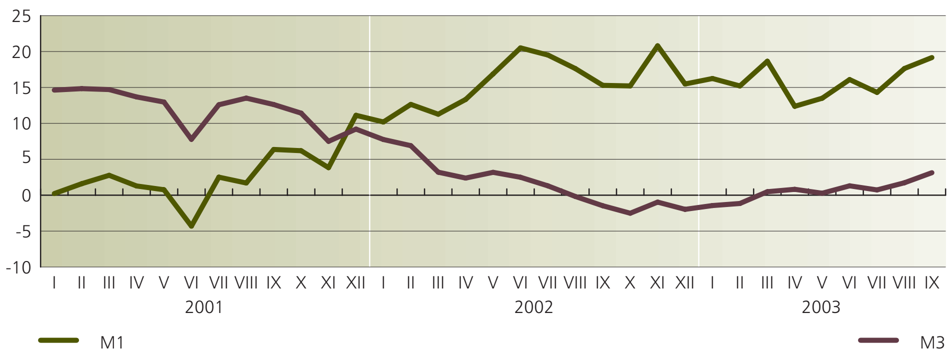
Item	Balance at September 30, 2003	Change IX 2003/VI 2003		Change IX 2003/IX 2002	
	billion zloty		%	billion zloty	%
I. M1 money supply	151.8	5.4	3.7	24.4	19.2
II. M3 money supply	330.9	4.3	1.3	10.0	3.1
1. Notes and coins in circulation (except for bank vault cash)	48.6	1.3	2.7	6.7	16.0
2. Deposits and others liabilities	278.3	2.8	1.0	-0.5	-0.2
2.1. Households	190.3	-1.3	-0.7	-12.6	-6.2
2.2. Non-monetary financial institutions	7.6	0.4	5.5	1.9	34.0
2.3. Corporates	60.8	4.1	7.2	10.6	21.1
2.4. Non-commercial institutions operating for the benefit of the households	8.5	0.1	1.7	0.2	2.8
2.5. Local government institutions	9.7	-0.3	-2.9	-0.1	-1.4
2.6. Social security funds	1.4	-0.2	-13.5	-0.5	-26.0
3. Other M3 components	4.0	0.2	5.4	3.8	2,389.8

Source: NBP.

of foreign exchange movements, the fall in currency-denominated deposits would stand at approximately 1.0bn zloty. The outflow of funds from households' bank accounts was partially linked to the continuing popularity of alternative forms of saving, including placements in investment funds (their assets expanded in the third quarter by 3.6bn zloty, and since the beginning of the year – by 11.9bn zloty[13]). The annual growth of household deposits kept falling till the year-end 2001 and was negative since July 2002. In September 2003, the annual decline of the category amounted to 6.2%.

M1 money supply (notes and coins in circulation and current deposits held in the banking system[14]) in the third quarter was attributable both to increased levels of notes and coins and of

Figure 50
M3 and M1 nominal annual growth (corresponding month previous year = 100)



Source: NBP.

[13] Investment fund assets, net of assets targeting exclusively legal persons.
[14] According to the methodology applicable as of March 2002, the concept of the "banking system" has been replaced with a broader notion of "monetary financial institutions" covering the central bank and other monetary financial institutions (formerly referred to as "commercial banks"). For greater clarity and transparency, the previously applicable terminology is used here.

current deposits. The value of current deposits rose in the discussed period by 4.1bn zloty (or 4.2%), and that of notes and coins in circulation – by 1.3bn zloty (or 2.7%). The share of current deposits and notes and coins in the M1 remained unchanged. Current deposits represented 68% of the M1 monetary aggregate, and notes and coins in circulation – 32%. The contribution of M1 aggregate to M3 increased slightly and stood at 45.8% (against 44.8% at the end of June) at the end of September 2003.

In the third quarter, total deposits expanded by 1.0%. The differentiation persists among the directions of movements in current and time deposits: the annual growth of current deposits reached 20.7% in September, whereas the annual growth of time deposits amounted to – 9.4%.

Money supply factors

Money supply factors in the third quarter of 2003 are presented in the table below.

In the period, the primary sources of money supply included, similarly to the second quarter, increased net indebtedness of central government institutions and higher claims. Meanwhile, money absorption was caused by the decline in net foreign assets.

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Table 16
Money supply factors in Q3 2003*

Wyszczególnienie	Change over Q2 2003		Change over Q3 2003	
	billion zloty	%	billion zloty	%
M3 MONEY SUPPLY (1 + 2 + 3 – 4 + 5 – 6)	**4.3**	**1.3**	**10.0**	**3.1**
Money supply factors:				
1. Net foreign assets	-4.9	-3.5	-7.0	-5.0
2. Claims	5.9	2.3	13.1	5.2
3. Net indebtedness of central government institutions	9.6	14.9	14.4	24.0
4. Long-term financial liabilities	1.2	1.2	8.0	8.2
5. Fixed assets (exclusive of financial assets)	0.5	1.9	1.7	6.1
6. Other net item balance	5.7	9.3	4.2	6.7

* Following methodological changes implemented in March 2002, money supply factors encompass long-term financial liabilities of the banking system (negative value) and banks' fixed assets (exclusive of financial assets).
Source: NBP.

Net indebtedness of central government institutions

In the third quarter, similarly to the previous period, the net indebtedness of central government institutions constituted the primary factor of money supply. By the end of September, its value reached 74.5bn zloty, growing in the examined period by 9.6bn zloty (by 14.9% nominally and by 15.6% in real terms). The reasons for this increase included:

- a 2.2bn zloty (or 2.5%) growth in banking sector claims on central government institutions under credits and debt securities, and
- a 7.4bn zloty (or 29.3%) decline in the banking sector's liabilities towards central government institutions.

The reduction of the assets deposited by the Ministry of Finance at the NBP was of key importance. It was related, inter alia, to the August redemption of two-year bonds worth 5.7bn zloty. Overall in the period, deposits of central government institutions in the NBP accounts declined by 7.8bn zloty (or 51.1%).

The increased indebtedness of central government institutions at commercial banks was derived chiefly from a 3.5bn zloty, or 4.1%, expansion of the portfolio of government debt securities in banks' assets, of which the volume of bonds rose by 4.9bn zloty and that of treasury bills fell by 1.4bn zloty. At the end of September 2003, the value of debt securities issued by central government institutions in the banking system amounted to 90.4bn zloty, including 88.5bn zloty in the portfolio held by commercial banks.

Claims

Total claims of the banking system grew in the third quarter of 2003 by 5.9bn zloty (or 2.3%) and constituted one of the major money supply factors. Claim growth was attributable to increased levels of credits, loans and other claims[15] on other domestic sectors[16] higher by 6.5bn zloty (or 2.6%), including zloty-denominated credits higher by 3.9bn zloty (or 2.3%) and currency-denominated ones expanded by 2.6bn zloty (or 3.4%). The rise in the zloty value of currency-denominated credits was caused, in full, by foreign exchange movements.

Annual claim growth kept slowing down as of March 2003 and stabilised in the third quarter, reaching 5.2% in September. At the end of September, the share of claims in the M3 broad monetary aggregate stood at 80.5% against 78.9% recorded a year before.

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The highest claim growth in the third quarter was recorded in the **household sector**. Since the beginning of the year, the share of claims on households as part of total claims expanded steadily and in September reached 37.1%. In the third quarter, zloty-denominated claims grew by 3.1bn zloty (or 4.7%), while currency claims rose by 1.4bn zloty (or 5.1%), largely due to foreign exchange movements. If they are disregarded, growth in this category would amount to 0.3bn zloty. Similarly to previous periods, household credits were primarily allocated to housing purposes (28.4% in September 2003). Housing loans also represented the largest item in the structure of total credits granted to individual consumers (38.8%). Individual entrepreneurs, included in the household category, incurred mostly investment credits (35.7%).

Since August 2002, annual growth of claims on households stabilised, fluctuating around 8%, and climbed to 10.2% in September 2003.

Table 17
Structure of claims in Q3 2003

Item	Balance at September 30, 2003	IX 2003/VI 2003 change		IX 2003/IX 2002 change	
		billion zloty	%	billion zloty	%
Total claims on	266.2	5.9	2.3	13.1	5.2
1. Households	98.7	4.5	4.8	9.2	10.3
2. Non-monetary financial institutions	15.1	0.3	2.2	-0.4	-2.4
3. Corporates	136.4	0.4	0.3	1.6	1.2
4. Non-commercial institutions operating for the benefit of households	1.0	0.0	1.3	0.2	21.5
5. Local government institutions	12.0	0.7	5.9	2.1	20.7
6. Social security funds	3.0	0.0	0.1	0.4	16.4

Source: NBP.

[15] The "other claims" category covers primarily collected claims, realised guarantees and endorsements, conditional operations and interest in arrears.
[16] Other domestic sectors include non-monetary financial institutions, entities of non-finance sector, local government institutions and social security funds.

As of March, the share of claims on corporates in total claims declined slowly and amounted to 51.2% at end September. The exposure of this sector to the banking system under credits, loans and other claims expanded in the third quarter by 1.2bn zloty (or 0.9%) due to exchange rate movements. Zloty-denominated credits shrank by 0.2bn zloty (or 0.3%), and the 1.4bn zloty (or 3.4%) increase in currency credits was fully attributable to the effect of foreign exchange movements. Annual growth of corporate credits was sustained in the subsequent months of the third quarter at a stable level of 1.7%.

In September, the indebtedness of enterprises, partnerships and co-operatives in the banking system grew in relation to June by 1.9bn zloty (or 1.7%) but, net of the effect of foreign exchange movements, that growth stood at a mere 0.6bn zloty. Meanwhile, the decline in the indebtedness of enterprises and state partnerships resulting from credit exposure, observed since the beginning of the year, was sustained. This category shrank in the third quarter by 0.7bn zloty (or 3.0%) following the decline in zloty-denominated credits. The balance on currency credits did not change under the effect of foreign exchange movements. Corporate credits were allocated in 33.7% to financing operating activity and in 32.9% to investment.

Net foreign assets

The net foreign assets of the banking system were worth 133.4bn zloty at the end of September and declined in relation to June by 4.9bn zloty, or 3.5%. This decline was attributable, on the one hand, to the reduction in foreign assets by 1.9bn zloty (or 1.0%), and on the other, to 3.0bn zloty (or 6.4%) growth of foreign liabilities. The fall in the balance of net foreign assets denominated in zloty was substantially mitigated by foreign exchange movements. In US dollar terms, net foreign assets were worth US$33.5bn at the end of the third quarter and fell US$2.0bn (or 5.5%) in relation to the end of June.

The change in the balance of foreign assets resulted from the shrinking of this category at commercial banks by 16.6%, with its concurrent 2.2% growth at the NBP. In the meantime, foreign liabilities of the banking system expanded in the third quarter as a result of 25.2% growth in NBP foreign liabilities.

Other items (net) balance

In the third quarter of 2003, the negative (net) balance on other items expanded by 5.7bn zloty, or 9.3 %, and amounted to –67.2bn zloty at the end of September. This trend was primarily attributable to the effect of movements in “foreign exchange” accounts.

The scale and direction of changes within this category were determined by other net assets at NBP. During the third quarter of the year, the negative balance of other net assets at NBP increased by 4.9bn zloty, or 14.6%, and reached –38.4bn zloty at the end of June. This growth was caused chiefly by the pricing of currency assets and liabilities translated into zloty. The changes resulting from technical book entries had no direct bearing on the M3 money supply.

Meanwhile, other elements contributing to the reduction of the negative other items (net) balance in the third quarter of 2003 included interbank and interbranch settlements of other financial institutions which shrank by 1.3bn zloty, or 29.6 %, while the value of their negative balance at end September amounted to –3.1bn zloty. The amounts reclassified from the accounts of interbank and interbranch settlements of other financial institutions, credited to deposit accounts of various entities, contributed to the expansion of the M3 money supply.

Banks’ fixed assets

The value of banks’ fixed assets (exclusive of financial assets) at the end of the third quarter stood at 29.9bn zloty and grew by 0.5bn zloty (or 1.9%) in relation to the end of the second quarter.

Long-term financial liabilities

The long-term financial liabilities of the banking system expanded in the third quarter by 1.2bn zloty, or 1.2%, reaching 105.9bn zloty at the end of September. Growth of this category was determined by a 1.3bn zloty (or 1.6%) higher balance of capitals and reserves. In relation to the previous period, the balance on deposits with maturities beyond two years declined by 0.1bn zloty (or 0.3%) and amounted to 21.8bn zloty at the end of September.

4.3. Monetary policy transmission mechanisms

4.3.1. Interest rates

4.3.1.1. Monetary policy and interbank rates

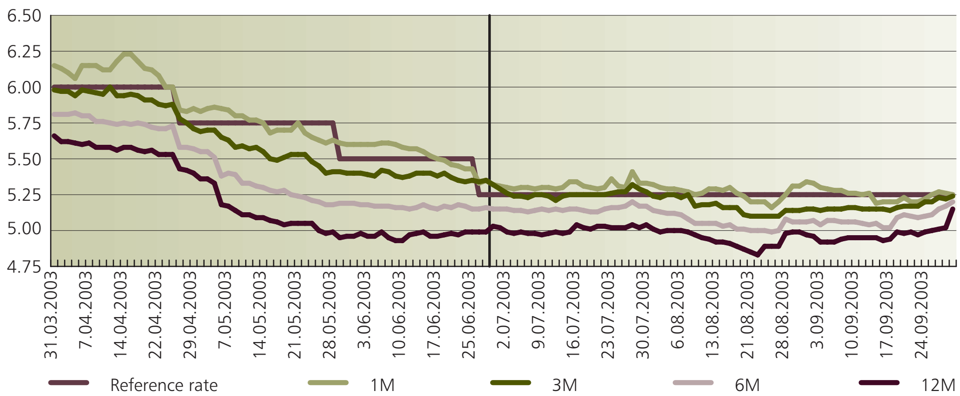
In the third quarter of 2003, the falling trend in money market rates[17] observed in the first half of the year was arrested. The direct cause of the shift in the trend was the revision of expectations by the participants of the financial market regarding the scale of interest rate cuts in the following months. The maintenance by the central bank of basic interest rates at an unchanged level constituted a clear signal that liberalisation of the monetary policy, pursued since 2001, was coming to an end.

Short-term liquidity problems resulting in movements of O/N deposit rates were experienced in the third quarter mainly on the days preceding the settlement of required reserves and were primarily attributable to inadequate evaluation by the banks of their own liquidity position. The strongest O/N rate growth was recorded in July when it temporarily exceeded the lombard rate. Lack of liquidity in the interbank market forced the banks to reach for lombard credit on July 29–30.

A new factor which started to affect expectations concerning the level of interest rates in the examined quarter were the concerns regarding the size of the 2004 budget deficit planned by the government and the possibility of excessive increases in public indebtedness.

In September, market participants assumed that the central bank would probably wait with interest rate cuts until detailed information on the Medium-Term Public Finance Strategy for the Years 2004–2007 was available. This is reflected in the decreasing volatility of interbank deposit rates, especially for 3M deposits, recorded at that time.

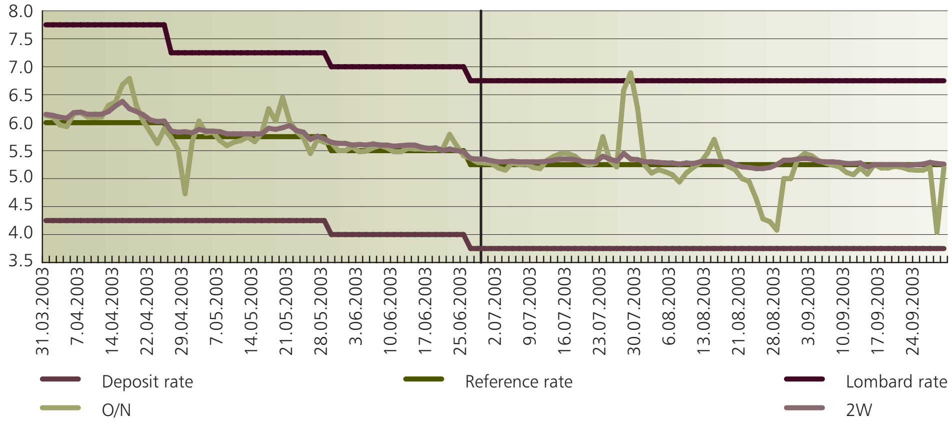
Figure 51
Intervention rate and 1M, 3M, 6M, 12M interbank deposit rates



Source: Reuters and NBP.

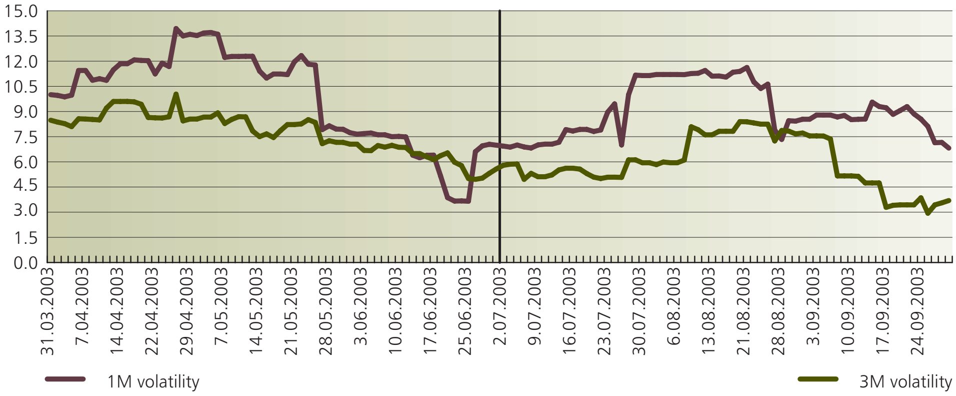
[17] Money market rates include interest on debt instruments (interbank placements, treasury bills, currency swaps) with maturity of up to 1 year.

Figure 52
NBP rates and O/N and 1M interbank deposit rates



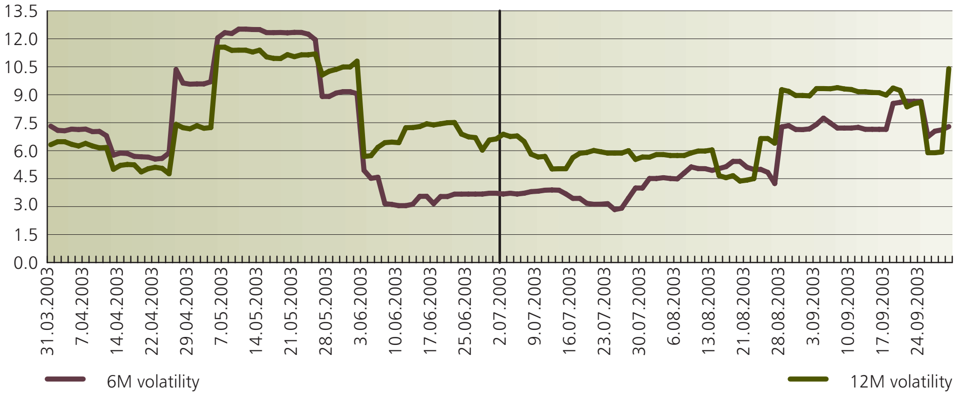
Source: Reuters and NBP.

Figure 53
21-day volatility of 3M and 1M WIBOR rates



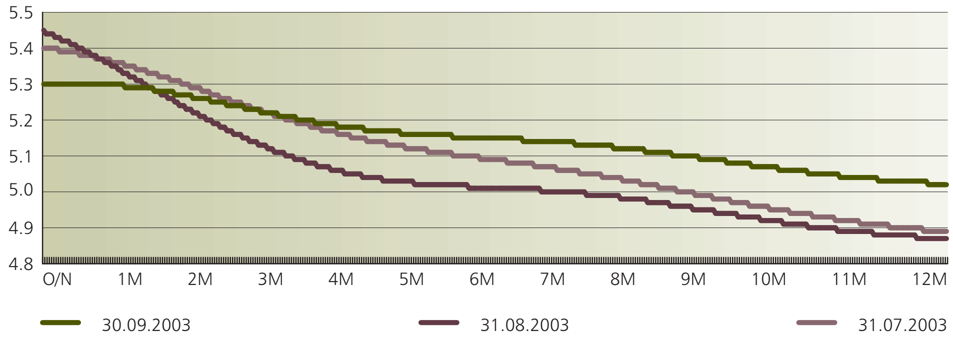
Source: Reuters and NBP.

Figure 54
21-day volatility of 6M and 12M WIBOR rates



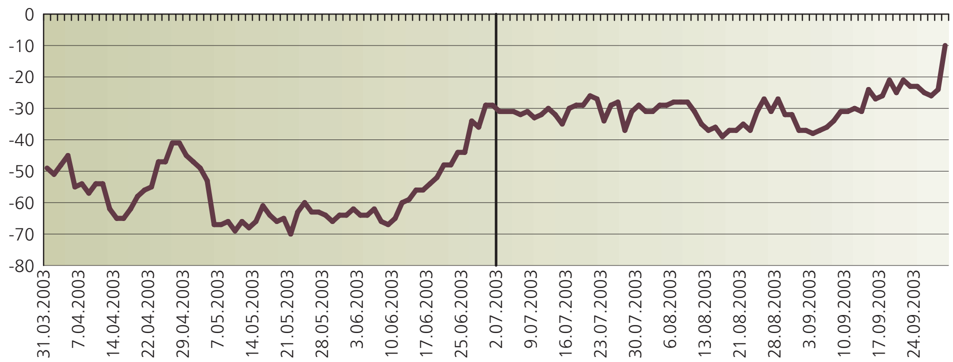
Source: Reuters and NBP.

Figure 55
Money market yield curves



Source: Reuters and NBP.

Figure 56
Spread between 1M and 12M interbank deposit rates



Source: Reuters and NBP.

In the case of the rates on deposits with maturities longer than 6 months, growing concerns related to the 2004 fiscal policy led to a dramatic reversal of their trend from a falling one into a rising one. A sudden increase in the volatility of the 12-month rate was observed before and after the MPC meeting held on August 25–29. Another significant growth of the volatility of deposit rates longer than 6 months was recorded on September 30 in response to extensive depreciation of the zloty exchange rate.

Following significant growth in 12-month deposit rates in the third quarter, the money market yield curve was flattened (Fig. 55). This fact reflected the increasingly remote prospects of subsequent NBP interest rate cuts. From July to September, the spread between 12M and 1M interbank deposit rates narrowed by some 20 basis points (bps) to minus 10bps (Fig. 56). Despite these changes, the maintenance of the negative slope of the money market yield curve shows that in the third quarter the market still expected further NBP interest rate cuts within one year.

4.3.1.2. Commercial bank reactions to central bank policies

In the third quarter of 2003, the Monetary Policy Council did not change basic NBP interest rates. However, in July and August commercial banks adjusted the interest rates on credits and deposits in response to the MPC's earlier decision. Most changes were introduced in July. In August, the banks made only small corrections bringing their borrowing and lending rates in line with those offered by competitors.

Table 18
Levels and movements of average* nominal deposit and credit rates until September 2003 (in percentage points)

	Rates as at December 2002	Rates as at June 2003	Rates as at September 2003	Change over December 2002	Change over June 2003
3M consumer zloty-denominated deposit rate	3.9	2.8	2.6	-1.30	-0.26
6M consumer zloty-denominated deposit rate	4.1	3.1	2.7	-1.33	-0.39
12M consumer zloty-denominated deposit rate	4.6	3.5	3.3	-1.21	-0.18
Total consumer time deposit rate	4.2	3.2	2.9	-1.32	-0.26
1-year zloty-denominated corporate credit rate	9.9	8.4	8.2	-1.75	-0.26
3-year zloty-denominated corporate credit rate	11.7	10.3	9.8	-1.93	-0.54
5-year zloty-denominated corporate credit rate	10.9	9.5	9.0	-1.88	-0.47
Consumer credit rate	17.5	15.9	15.6	-1.87	-0.35
Total consumer and corporate credit rate	12.8	11.2	10.8	-1.95	-0.41
1M WIBOR	7.06	5.51	5.25	-1.81	-0.26
NBP reference rate	6.75	5.25	5.25	-1.50	0.0

* Average weighted deposit and credit rates are computed on the basis of the data sent to the NBP by 11 largest commercial banks. The weights are represented by the banks' shares in the deposit or credit market.
Source: NBP.

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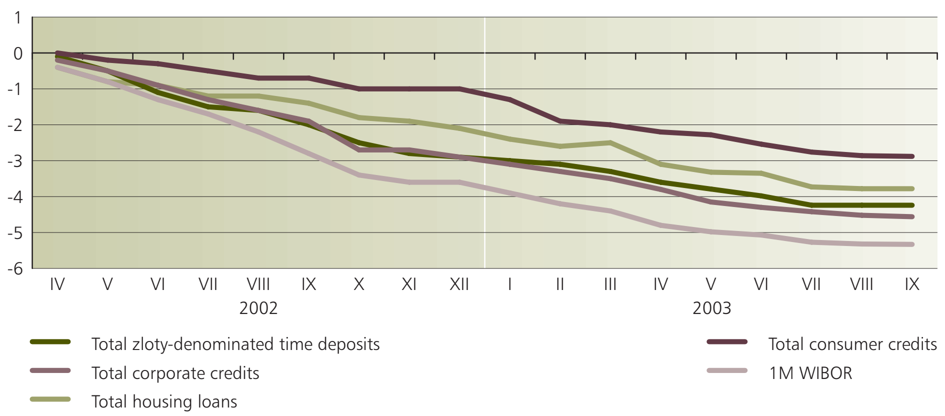
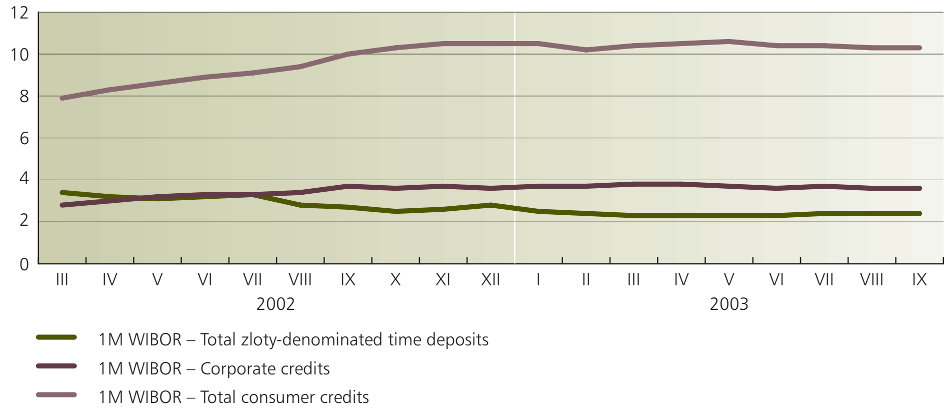
Already in July, the banks had cut interest on deposits, zloty-denominated credits granted in the current account, consumer credits and housing loans. Meanwhile, interest on corporate credits and other household credits was adjusted both in July and August. In September, the average weighted interest on basic categories of deposits and credits for households and corporates remained basically unchanged. A minimum cut in average weighted interest rate (by 0.1%) was recorded only with respect to credits offered to individual entrepreneurs.

Figure 57
Aggregate movements in selected interest rates since March 2002



Source: NBP.

Figure 58
Spread between borrowing, lending and WIBOR rates



Source: NBP.

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A more extensive analysis of changes in interest rates on credits and deposits offered to customers by banks (cf. Fig. 57) shows that as of March 2002 these rates declined at a slower rate than interbank rates. Aggregate movements in time deposit and corporate credit rates were similar. On the other hand, consumer credit rates were falling at a significantly slower rate, which reflected the persistent variation in the way individual customer groups were treated by the banks and their perception of associated risk levels.

As a result of the above movements in interest rates, consumer credit rates exceeded interbank rates way more than the corporate credit rates did.

Despite the fact that in the third quarter commercial banks were slashing their household credit rates more deeply than the rates on corporate credits, a significant disproportion between the two persisted. In September, consumer credit rates were higher than corporate credit rates by 672bps, while in September 2002 the gap amounted to 629bps. The primary causes of this continuing disproportion include lower, compared to corporates, households' sensitivity to the terms of credits offered.

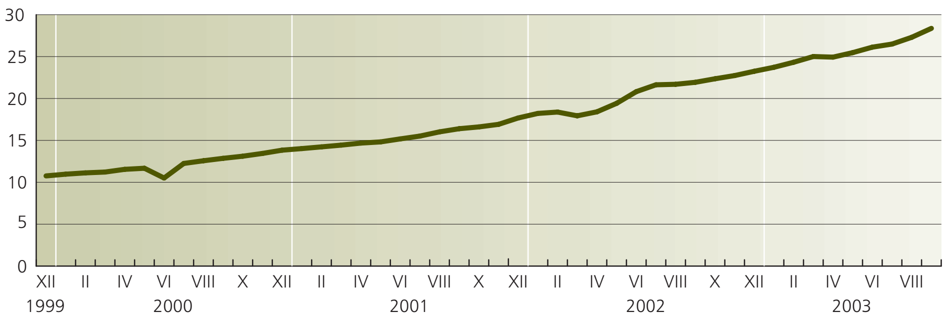
4.3.1.3. Interest rates and credit demand

In the third quarter of 2003, the commercial banks reduced interest rates on credits even though the NBP interest rates remained unchanged. Despite this, the rate of the decline in interest rates on corporate credits was slower than in previous quarters. In September, average consumer household credit rates decreased to 15.6% down from 15.9% in June, and average corporate credit rates declined to 8.9% down from 9.1% in June. Average housing credit rates settled at the lowest level, running at 6.9% in September. The low level of housing credit rates was accounted for by strong competition in that market and improved collateralisation.

From June to September 2003, falling interest rates were accompanied by annual household credit growth accelerating from 8.5% to 10.3%. This growth continued to gather speed even after being adjusted for the effect of foreign exchange movements[18]. Nominal growth of household credits in the third quarter stood at 4.4bn zloty, and net of foreign exchange movements – at about 3.4bn zloty. This trend was primarily attributable to housing loan expansion of 3.3bn zloty. The closing gaps in zloty- and currency-denominated housing credit rates and significant foreign exchange fluctuations contributed to a slower growth in currency-denominated housing credits. In the third quarter, the increase in currency-denominated housing household credits amounted to 1.7bn zloty (or approximately 1.1bn zloty when adjusted for foreign exchange movements), and that in zloty-denominated credits – to 1.6bn zloty. A

[18] The adjustment for the effect of foreign exchange movements consisted in converting the value of currency-denominated credits into Polish zloty, at the exchange rate prevailing at the end of June 2003.

Figure 59
Share of housing loans in total household credits (%)



Source: NBP.

new factor stimulating housing credit growth in the examined period was the announcement of the expansion, as of 2004, of fiscal burdens related to the conclusion of transactions in the housing market. In this context, households which had originally contemplated purchasing or building a flat in the future, decided to acquire flats or embark on construction work in 2003. At the end of the third quarter, the share of housing credits in total household credits expanded to 28.4% (Fig. 59).

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The third quarter brought also a slight increase in other household credits, including consumer credits. Their annual growth as of June 2003 remained positive and reached 0.5% in September, which could be related to economic recovery. In this context, high consumer credit rates seem less of a barrier to a more extensive credit campaign.

Corporate credit growth in the third quarter of 2003, despite relatively low lending rates, remained weak. By the end of September, annual corporate credit growth amounted to 1.7% (–0.35% net of the effect of foreign exchange fluctuations). A survey into general economic climate in the corporate sector conducted at the NBP[19] confirms that the level of interest rates in the third quarter did not restrict the availability of corporate credits. The percentage of enterprises pointing to interest rate levels as an obstacle to their development amounted to a mere 4.9%, in the period. Meanwhile, for a significantly higher number of respondent enterprises such barriers included demand, payment bottlenecks, foreign exchange movements, as well as unstable and defective tax regulations. The respondent enterprises looked forward to a stabilisation of credit rates. Given the lack of expectations regarding further reductions in costs of financing, and in the context of the improved liquidity situation, enterprises did not intend to contribute to credit growth in the nearest future. The poll's findings pointed to a slowdown in credit campaigns more pronounced than usual in the last quarter of the year.

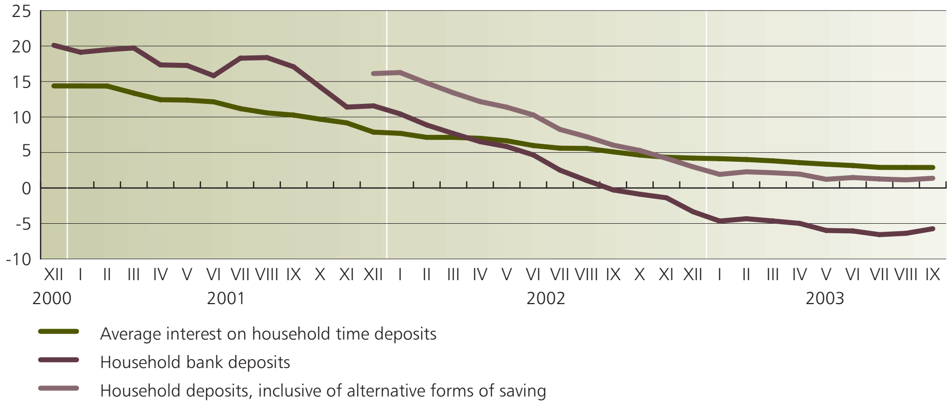
4.3.1.4. Interest rates and deposit levels

Deposit rates at commercial banks in the third quarter of 2003 were reduced despite the NBP leaving its basic interest rates unchanged. Average interest rates on household time deposits fell from 3.2% in June to 2.9% in September, while average corporate time deposit rates declined over the same period from 3.1% to 2.8%. Movements in deposit rates were accompanied by movements in deposit volume and structure.

Household bank deposits shrank in the third quarter by 1.4bn zloty, or 0.7% nominally, and net of the effect of foreign exchange movements, by 2.4bn zloty, or 1.1% . Annual bank deposit growth was low and stood at –5.7% nominally at the end of September. In the third quarter, similarly to the preceding eighteen months, households continued intensively to replace bank deposits with alternative forms of saving, including, in particular, investment fund units or treasury bonds. In July and August, as a result

[19] Business confidence survey conducted by the NBP is a questionnaire-based survey on a sample of 400 enterprises. A comprehensive analysis of research findings can be found on the internet at www.nbp.pl/publikacje.

Figure 60
Annual growth of household deposits (two perspectives) and average household time deposit rates



Note 1: Comparability of household deposit rates prior to and after March 2002 is limited due to changes in the methodology of interest rates statistics.
Note 2: Forms of household savings alternative to bank deposits, making up M3 aggregate include investment fund units, treasury securities and deposits held at SKOK savings fund.
Source: NBP.

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of a strong surge in share indices at the Warsaw Stock Exchange, yield rates generated by the funds investing in the equity market proved significantly superior to bank deposit rates. Despite the September revision of stock exchange quotations, in the third quarter, investment funds achieved yield rates significantly more attractive than the returns on bank placements. Entrusting money for management in investment funds frequently meant avoiding taxation of income from interest. This possibility constituted the primary incentive for households to purchase bank bonds. Their volume grew between June and September 2003 by 0.2bn zloty, to 4.0bn zloty. Combined value of deposits at SKOK savings funds, investment fund units, treasury bonds and bills held by households rose in the third quarter by 2.9bn zloty, totalling 52.9bn zloty at end September. This level corresponded to 25.1% of household bank deposits in that period. Annual household savings growth, inclusive of assets alternative to bank deposits, remained as of April within the 1–2% bracket and reached 1,37% in September (Fig. 60).

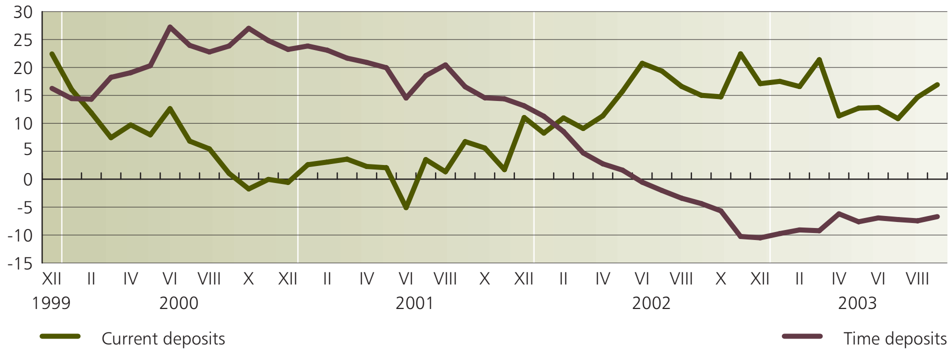
Corporate deposit growth in the third quarter stood at 4.1bn zloty (or 3.7bn net of the effect of foreign exchange movements), and it increased nominally from 16.6% in June to 21% in September. Although movements in corporate deposit growth rate in previous years were considerable, its acceleration in the third quarter was exceptionally high. For the time being, it is difficult to explicitly identify the sources of this.

Falling deposit rates contributed to a reduction in alternative costs of maintaining notes and coins in circulation and current deposits, which in many banks were at zero interest rate. This process was reflected by the shift in the structure of bank deposits observed in the third quarter and consisting in current deposit growth and decline in time deposits. In September, annual growth of current deposits stood at 16.9%, and that of time deposits at –6.7%.

Movements in the volume and structure of deposits in the third quarter constituted the extension of processes initiated in late 2001. Falling deposit rates, superior yields on forms of saving other than bank deposits and the opportunity to avoid taxation of interest income contributed to the reallocation of financial assets, enhancing their liquidity and maximising potential yield rates. Share value increases in the equity market in July and August offered an additional option for achieving attractive returns on household savings, which may contribute to the decreasing appeal of the debt securities market and the banking system in the future.

[20] The adjustment for the effect of foreign exchange movements consisted in converting the value of currency-denominated deposits into Polish zloty, at the exchange rate prevailing at the end of June 2003.

Figure 61
Annual growth of current and time deposits



Source: NBP.

4.3.1.5. Expected interest rates

Short-term expectations

At the end of the second quarter of 2003, the 4.99% interest charged on forward rate agreements (FRA 3x6) signalled that investors expected NBP rates to go down by 25bps in the third quarter. In July and August, this trend weakened slightly and in September the market ceased to expect further reductions of interest rates (cf. Fig. 62).

The sustainability of the expectations regarding NBP interest rate cuts through most of the third quarter of 2003 was related primarily to the fact that annual CPI indices settled below the lower boundary of the inflation target in that period. A lasting revision of short-term expectations (reflected in the interest charged on FRA contracts) did not take place until mid-September, following the announcement by the government of the assumptions for the Medium-Term Public Finance Strategy for the Years 2004–2007.

A particularly strong revision of expectations concerned movements in interest rates in a 6 and 9-month time horizon. A significant event which led to an increase in interest charged on FRA contracts was the assessment of the economic situation contained in the press release from the August meeting of the Monetary Policy Council. It clearly identified the threats accompanying the pursued fiscal policy and the observed economic recovery as the factors discouraging further NBP interest rate cuts.

The growth trend in interest rates applied also to FRA contracts with 12M maturities (Fig. 63, Fig. 64).

Figure 62
3M forward rate on the basis of FRA contracts with maturities falling on end September 2003

Source: Reuters and NBP.

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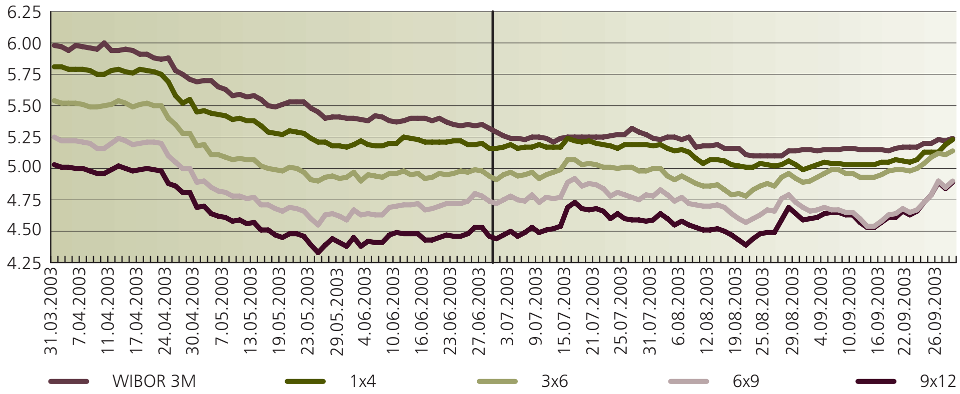
Figure 63
FRA contract rates for 3M WIBOR



Source: Reuters and NBP.

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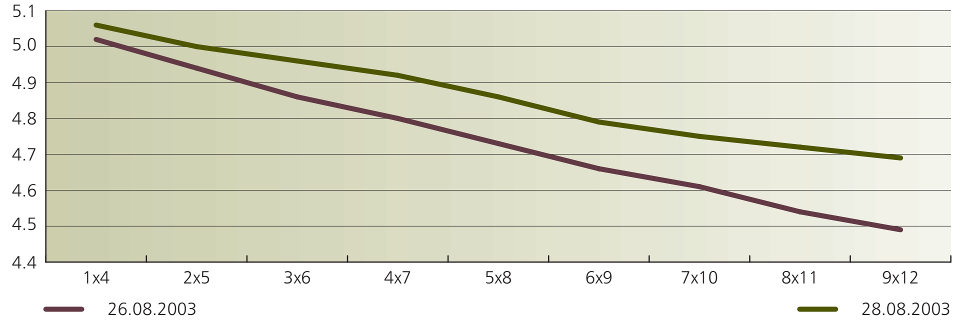
Figure 64
Change in position of 3-month forward interest rates, following MPC meeting in August 2003



Source: Reuters and NBP.

Long-term expectations

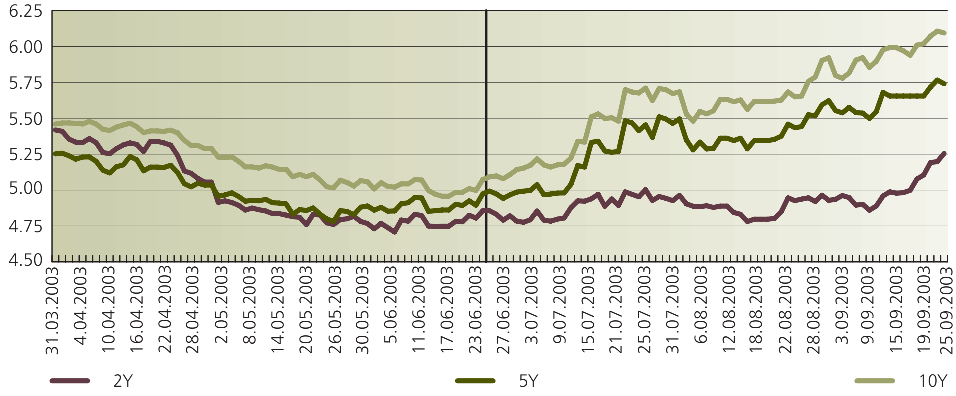
The growth trend in treasury bond yields, observed since the end of the second quarter of 2003, was sustained in the third quarter (Fig. 65).

Factors contributing to higher yields on (lower prices of) treasury bonds in that period included:

- investors' concerns regarding possible developments in the area of fiscal policy and public debt (size of the general government budget deficit in 2004 and the related volume of supply of treasury securities, expansion of public indebtedness, the risk of upsetting the balance between public indebtedness and GDP in the following years by over-running the limit set in the Polish constitutional Act), and
- bond price falls in the world market.

Investors' concerns regarding the situation in domestic public finances became evident as early as in the second quarter of the year. However, a distinct decline in treasury bond prices was not observed until July 2003 and then it was related to the adoption of the 2004 budget assumptions by the government. Following temporary appeasement of market moods in August associated with halt in the reduction in foreign investors' exposure in the Polish treasury securities market, observed as of the end of May, in September bond prices resumed their falling trend. This was due to the absence of reliable information on the assumptions behind the Medium-Term Public Finance Strategy. The trend

Figure 65
Treasury bond yield rates



Source: Reuters and NBP.

was further reinforced by the comments made by the representatives of Standard & Poor's and Fitch rating agencies pointing to a possible reduction of the long-term rating for zloty-denominated bonds issued by the Polish government.

In addition to domestic factors, the decline in the prices of treasury bonds in the third quarter was also linked to bond price falls in the world market. These falls were caused primarily by dispelled fears of deflation in the US economy in the face of increasingly distinct symptoms of economic recovery in that country. In this context, share indices rose at international stock exchanges and bond prices declined. As a consequence, bond yield rates in the euro area climbed systematically from early June to early September. So did the yield rates on Polish bonds. In September, under the effect of the above domestic factors returns on Polish bonds rose at a faster rate than those of Euro-area bonds. This significantly contributed to widening the gap between the two financial instruments (from an average of 130bps in the second quarter to 151bps in the third quarter in the case of bonds with 10-year maturities).

Following the price falls of Polish bonds and the weakening of the zloty exchange rate, despite concerns regarding the budget situation, in September foreign investors started to expand their portfolios of Polish treasury bonds again and, by the end of the month, the balances recorded at the beginning of the third quarter had been restored.

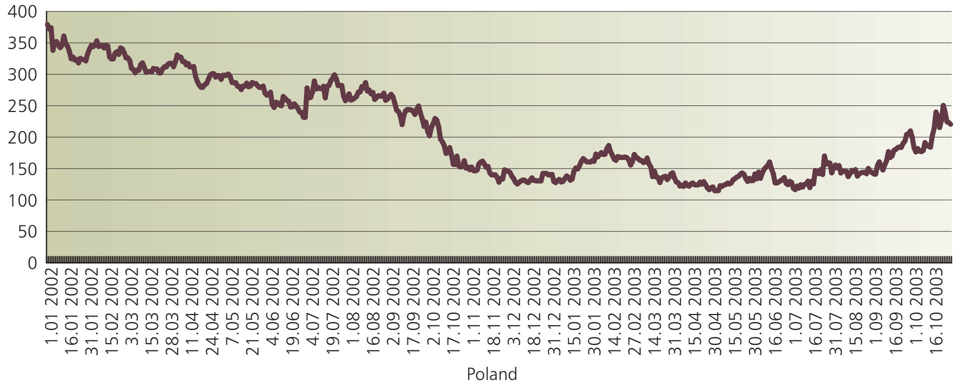
In September, growth of Polish bond yields was accelerated by the absence of market expectations for interest rate cuts by the central bank. Not anticipating further interest rate cuts, investors were selling mostly 2-year bonds earlier purchased for speculative purposes, counting on subsequent growth in their prices.

Because of movements in bond prices, in the third quarter the yield curve for all maturities moved substantially upward (Fig. 64).

The longer end of the curve moved the most, which reflected investors' concerns regarding the possible decline in the rating of Polish treasury securities and a delay in Poland's accession to the Economic and Monetary Union (EMU) due to a failure to meet the criterion of budget deficit volume. Meanwhile, yield rates of shortest maturities (up to 1 year) changed relatively little given persisting investors' expectations as to further NBP rate cuts.

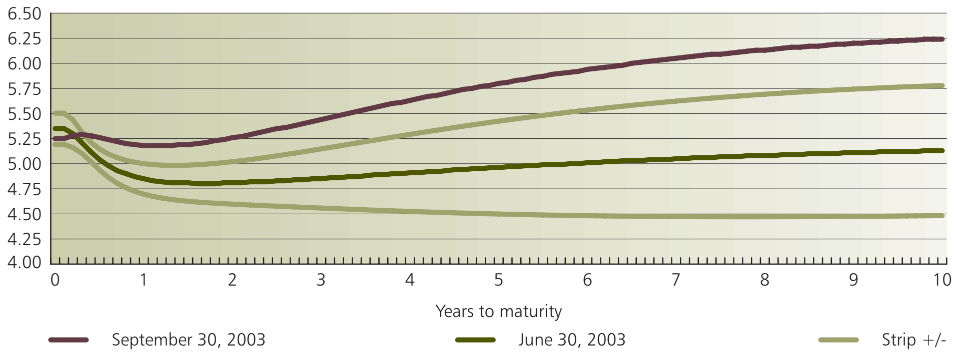
The analysis of the curve of annual forward rates in the third quarter points to a distinct revision of expectations regarding NBP monetary policy. At the end of June, investors expected that the minimum level of annual interest (amounting to 4.64% at the peak of the yield curve) would be achieved within about 8 months. At the end of September, this level rose to 5.09% and its achievement was expected within almost 9 months. For 5-year rates, within 5 years steady growth was observed from 5.28% at the beginning of the period to 6.31% at the end of September along with the increasing slope of the yield curve (faster decline in bond prices with long maturities).

Figure 66
Spread in yields on 10-year German and Polish bonds (in base points)



Source: Reuters and Bloomberg.

Figure 67
Zero-coupon yield curve in Q3 2003



Source: Reuters and NBP.

4.3.2. Exchange rates

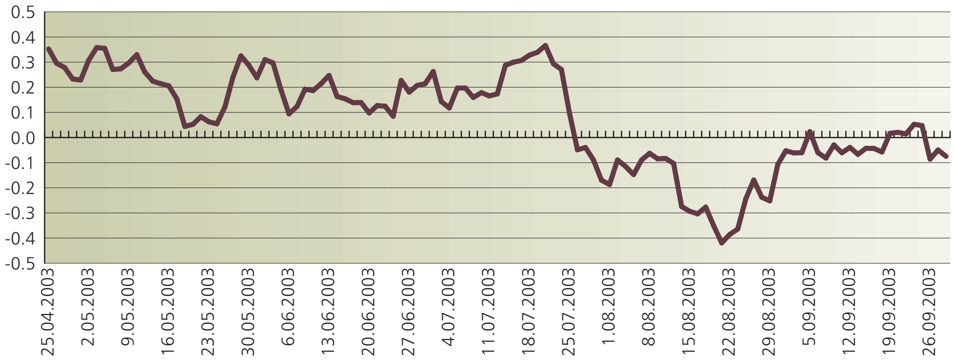
In the third quarter of 2003, the zloty depreciation trend, dating back to early 2002, was sustained. The average quarterly nominal effective zloty rate against a basket of the currencies most important to the Polish economy dropped in relation to the previous quarter by 1.7%, and in relation to the third quarter of 2002 – by 4.3% (Fig. 70). At the end of September, the nominal

Table 19
Movements in bond yield rates in the second half of 2002 and in three quarters of 2003*
(quarter-end figures as against preceding quarter-end figures)

	Maturity		
	2 years	5 years	10 years
Q3 2002	-109	-108	-81
Q4 2002	-105	-130	-90
Q1 2003	-51	-32	-28
Q2 2003	-59	-28	-30
Q3 2003	42	68	100

* The table lists absolute changes (in bps) in yields on tradable bonds with maturities close to 2, 5 and 10 years.

Figure 68
Correlations between yields on 10-year German and Polish bonds



Note: Correlation coefficients are calculated for daily absolute movements in yield rates (21 observations). Horizontal lines denote critical levels above which correlation coefficients assume non-zero values on a given level of relevance.
Source: Reuters and Bloomberg.

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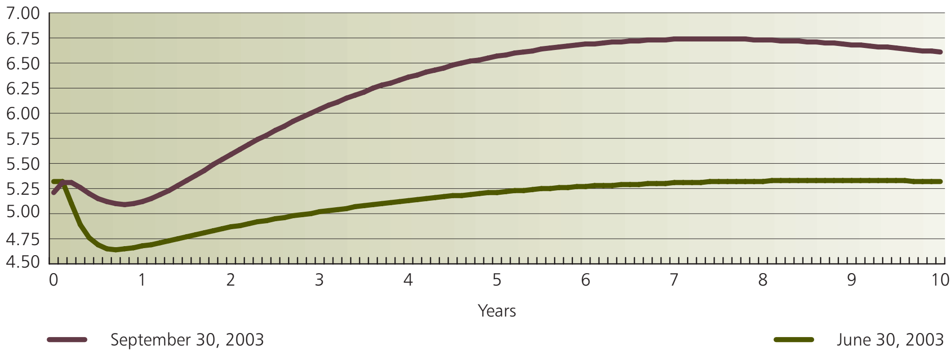
Figure 69
Annual output forward rate curve in Q2 2003



Source: Reuters and NBP.

effective zloty rate was 3.7% lower than at the end of June and 22.4% lower than its record high in the years 1998–2003 (recorded on June 13, 2001).

The primary zloty depreciating factor in the third quarter was growing uncertainty as to the shape of fiscal policy in 2004 and beyond. It contributed to an increase in risk premiums on investment involving Polish securities. Trends in the zloty exchange rate in that period were also strongly affected by movements in the EUR/US$ rate. High dependence on the EUR/PLN rate on the EUR/US$ rate is confirmed by the value of the correlation coefficient at 96.1% for monthly figures from the period January 2001 to June 2003 (Fig. 71). Furthermore, zloty depreciation could also be exacerbated by unfavourable information regarding the prospects for reducing future transfers from the European Union. The above factors led in the third quarter to growth in volatility of the zloty exchange rate – distinct against the US dollar (Fig. 72) and slight against the euro (Fig. 73).

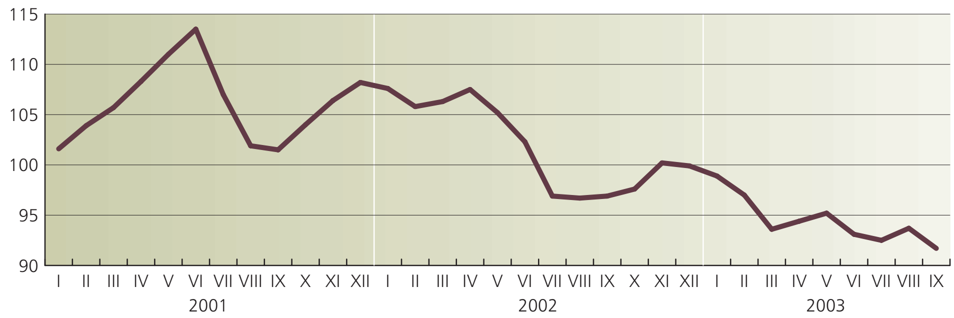
Zloty depreciation in the third quarter took place despite the presence of such fundamental factors encouraging the strengthening of the domestic currency as:

- Improved current account balance;
- Poland's inflation rate being lower than that of its major trading partners;
- High industrial output growth;
- Higher productivity and lower unit labour costs.

* * *

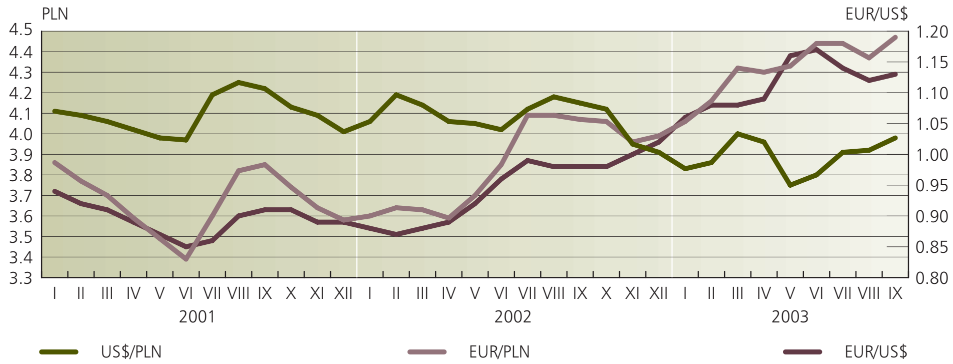
The long-term **pass-through coefficient** determining the effect of movements in the nominal effective zloty rate on the price growth of consumer goods and services, adjusted for the shift in inflation expectations and cyclical fluctuations in general economic conditions[21], dropped from 0.19 in the second quarter to 0.15 in the third quarter, with 54% of the pass-through effect cumulated in the first two quarters and 89% in the first year.

Figure 70
Nominal effective zloty rate, 2001–2003 (monthly figures, December 2000 = 100)



Source: NBP.

Figure 71
Zloty rate against USD and EUR and EUR/USD relation, 2001–2003

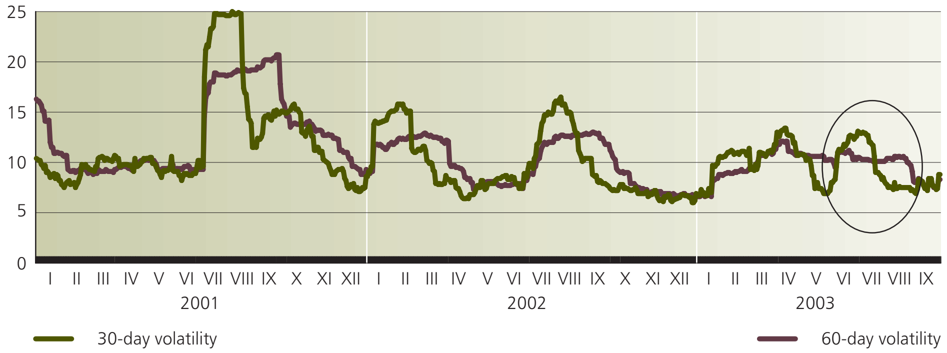


Source: NBP.

Figure 72
Volatility of US$/PLN rate, 2001–2003 (annualised) (%)

Source: NBP.

Figure 73
Volatility of EUR/PLN rate, 2001–2003 (annualised)



Source: NBP.

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Given the value of the pass-through coefficient and the time structure of the responses of internal prices to movements in the exchange rate, it may be estimated that in the third quarter the prices of consumer goods and services (calculated in relation to the corresponding period of the previous year) grew as a result of foreign exchange movements by 0.17 percentage point. This means that 22% of CPI growth in that period could be attributed to foreign exchange movements. The pass-through effect of movements in external prices (represented by Brent oil prices) had marginal effect on CPI in the third quarter.

In the first three quarters of 2003, foreign exchange movements accounted for 23% of CPI movements, and those of external prices – for 14%.

4.3.3. Inflation expectations

In the third quarter of 2003, consumer inflation expectations rose. Meanwhile, inflation forecasts of bank analysts formulated for the month preceding the corresponding month of the following year stabilised, while those developed for December 2003 declined (Fig. 74). It should be pointed out that the projections made by both respondent groups are not fully comparable. This is due – apart from the difference in time horizons adopted – also to the fact that consumer inflation expectations are objectified, i.e., quantified on the assumption that respondents perceive the course of price processes through the prism of official inflation statistics[22].

Consumer inflation expectations

In the third quarter, objectified measure of consumer inflation expectations[23], being a function of the pattern of replies to the question of the Ipsos poll (formerly Ipsos-Demoskop)[24] and the current inflation rate, grew by 0.4% in relation to the June figures and stood at 0.7%

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[21] In the conditions of low demand growth and stable inflation expectations, the pricing ability of enterprises falls causing a decline of the pass-through coefficient.

[22] More relevant information can be found, for instance, in the 2001 *Inflation Report*.

[23] In order to calculate quantitative indices of consumer inflation expectations, the probabilistic method is applied (a detailed method profile has been presented in: T. Łyziak (2000), *Badanie oczekiwa inflacyjnych podmiotów indywidualnych na podstawie ankiet jako_ciowych* [*Studying consumer inflation expectations on the basis of qualitative polls*], „Bank i Kredyt", nr 6, NBP). The quantified results constitute an objectified measure of the price growth expected by consumers in the twelve months ahead in the sense that the official measure of inflation quoted by GUS and known at the time of the poll is adopted under the calculation procedure as the current inflation rate perceived by respondents. As the Ipsos poll is conducted in the first half of the month, i.e., before the announcement by GUS of the inflation indices for the previous month, the year-on-year inflation rate going two months back is adopted as the current inflation rate.
Updated information on consumer inflation expectations can be found on the NBP website at www.nbp.pl, in the *Statystyka/Szeregi czasowe* section.

[24] Ipsos poll question regarding inflation expectations is formulated in the following manner: *Given what is currently happening, do you believe that over the next 12 months prices will: (1) rise faster than at present, (2) rise at the same rate, (3) rise more slowly,(4) stay at their present level, (5) go down, (6) it is difficult to say*.

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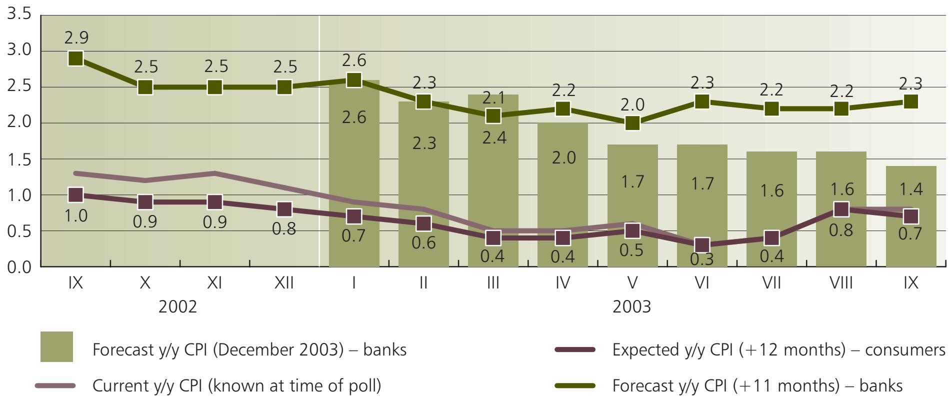
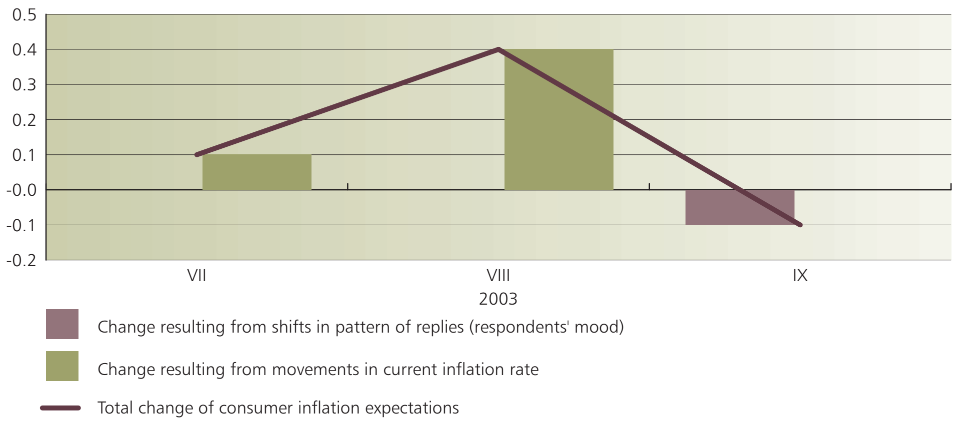
Figure 74
Consumer inflation expectations and bank analysts' inflation forecasts, September 2002 – September 2003



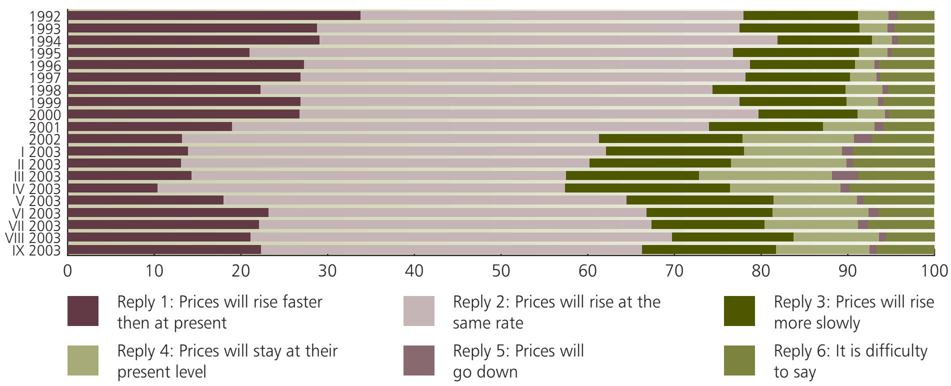
Source: Reuters, GUS, and own calculations on the basis of Ipsos (formerly Ipsos-Demoskop) figures.

Figure 75
Decomposition of movements in consumer inflation expectations in Q3 2003



Source: own calculations based on GUS and Ipsos figures.

Figure 76
Struktura odpowiedzi na pytanie ankiety firmy Ipsos w latach 1992–2001 (średnie roczne) oraz w 2002 r. i w I–III kwartale 2003 r.



Ipsos poll question: 'Given what is currently happening, do you believe that over the next 12 months prices will: *(1) rise faster than at present, (2) rise at the same rate, (3) rise more slowly,(4) stay at their present level, (5) go down, (6) it is difficult to say*.
Source: Ipsos and own calculations.

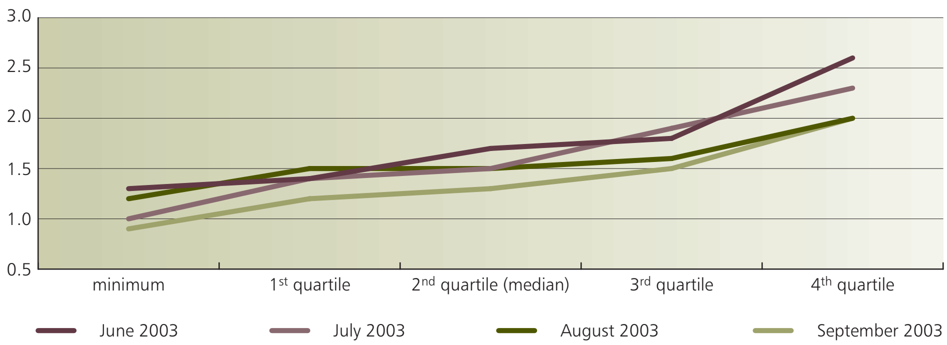
in September 2003. This growth may be attributed in full to accelerated price growth. In July and August, the pattern of replies to the poll question was neutral in terms of the effect on the quantification outcome, and in September it even contributed to reducing the objectified measure of expectations (Fig. 75).

The second factor affecting the outcome of quantification, namely, the change in the manner of formulating inflation expectations, expressed in the shifts in the pattern of replies to the poll question, following a period of gradual deterioration in the first half of 2003, in the third quarter was relatively stable, even improving slightly in September (Fig. 76). Although at that time the fraction of more pessimistic respondents foreseeing that in the course of the following twelve months prices would rise at the same or faster rate than at present expanded. At the same time, the percentage of respondents believing that prices would rise at a slower rate or stay at their present level increased. Meanwhile, the fraction of consumers declaring that in the course of the following 12 months prices would grow at the same rate as at present also shrank distinctly.

Inflation forecasts of bank analysts

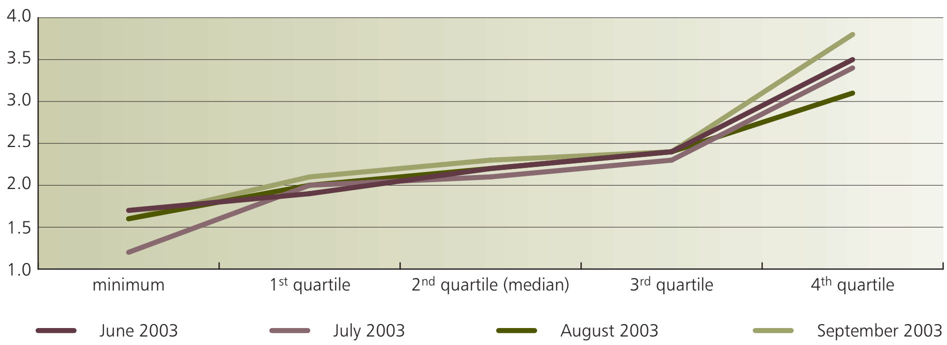
Inflation forecasts of bank analysts are obtained from quantitative polls developed by Reuters. In the third quarter, the distribution of projections regarding annual price growth in December 2003 shifted towards lower values (cf. Fig. 77). Whereas at the end of the second

Figure 77
Distribution of bank analysts' inflation expectations formulated with regard to annual inflation rate at year-end 2003, in June 2003 and by month of Q3 2003



Source: Reuters figures and NBP calculations.

Figure 78
Distribution of bank analysts' inflation expectations formulated with regard to annual inflation rate in the month preceding the corresponding month of the following year in June 2003 and by month of Q3 2003



Source: Reuters figures and NBP calculations.

quarter average forecasts stood at 1.7%, in the last month of the third quarter they settled at 1.4%. What did stabilise, on the other hand, in the context of relatively strong fluctuations of minimum and maximum declarations, was the distribution of inflation forecasts by bank analysts for the month preceding the corresponding month of the following year (Fig. 78). In the third quarter, average projections formulated in that time horizon were contained within the bracket of 2.2% (July and August) and 2.3% (September).

4.3.4. The wealth effect

In the course of the first two quarters of 2003, strong growth was recorded in household savings placed in investment fund units and other forms of indirect portfolio investment. Meanwhile, the value of direct household portfolio investment stayed at an almost unchanged level (Table 20).

Due to rapid growth of the value of household (direct and indirect) placements in securities, their relation to the value of deposits held in the banking sector grew at the end of the second quarter of 2003 to over 46%.

Economic recovery in the third quarter had a positive effect on the financial performance of business entities. This was reflected in dynamic growth of share indices of the companies listed at the Warsaw Stock Exchange in July and August 2003. Given relatively low interest rates on bank deposits, the observed trend encouraged shifts in investment preferences of many households.

The most extensive changes in the third quarter related to the value of the assets held by investment funds. The attractiveness of these institutions, offering higher returns compared to alternative forms of investment and the opportunity of avoiding tax burdens, contributed to the expansion of assets managed by funds targeting individual investors. In the third quarter, the value of such assets held by households rose by 12%, and in the course of three quarters of 2003 – by roughly 60%.

Table 20
Direct and indirect forms of household investment in the equity market (end-of-month balances, in PLN billion)

Type of involvement in equity investment	December 2002	March 2003	June 2003
1. Direct portfolio investment – securities (combined)*	**24.3**	**24.4**	**25.2**
Shares	8.1	7.3	8.3
Treasury securities (combined)	16.2	17.1	16.4
a) tradable bonds	5.9	7.0	7.2
b) savings bonds	7.7	7.5	7.2
c) treasury bills	2.6	2.6	2.5
2. Indirect portfolio investment (combined)	**55.9**	**62.1**	**71.3**
Open-ended investment funds (household investment assets)**	20.1	24.1	28.6
Open-ended pension funds (net assets)	31.6	33.6	37.8
Life assurance (life assurance placements, whereby placement risk is borne by the insuring party)	4.2	4.4	4.9
Total (1+2)	**80.2**	**86.5**	**96.5**
Above investment forms (combined) to deposits and other liabilities towards households in the banking system (%)	*37.7*	*40.5*	*46.1*

* securities in clients' investment accounts held in brokerage houses and offices
** NBP estimates; data on funds known to address their offer exclusively to legal persons were not incorporated.
Source: materials of Ministry of Finance, NBP, GUS, and open-ended pension funds.

Observed changes allow for formulating the following forecasts regarding future allocation of household financial resources:

- a further decline in the appeal of bank deposits to households should be expected,
- the attractiveness of collective investment forms (various kinds of investment funds) will grow at the expense of individual investment, similarly to developed countries with mature capital markets,
- pension funds will constitute the primary market sector where household savings will be ultimately placed; this investment trend may be encouraged by the introduction of relevant tax incentives.

5
Prospects for inflation

5

This year's inflation target (measured by annual CPI growth in December 2003) has been set at 3% with a permissible band of deviations of +/- 1%. It is expected that the annual **CPI index**, which stood at 1.3% in October, will rise slowly till the year-end to **settle right below the lower bound of the inflation target in December**.

Gradual recovery is observed in the world economy. We expect that it will continue throughout 2004 and 2005. In particular, we anticipate further acceleration of economic growth in the United States and, as a consequence, a moderate increase in economic activity in the euro area.

The Polish economy is currently at the initial stage of recovery, stimulated by dynamically growing exports. As long as consumption growth is sustained at a level close to that observed in 2002, we forecast the halt in decline in investment expenditure, which, in turn, will lead to accelerated economic growth in 2003. In the following years, continuation of growth trends should be expected in the economy, related to sustained high competitiveness of foreign trade and to further expected acceleration of investment growth.

The scale of investment growth will depend, however, on the progress of the public finance reform. We believe that until the end of 2005 only partial execution of the public finance rehabilitation programme seems most likely. This would reduce the risk of a public finance crisis. Nevertheless, uncertainty as to the prospects facing that sector remains and high borrowing needs of the state will limit availability of financing to the private sector. Thus, the condition of public finances will continue to slow down economic growth.

Despite this limitation, we anticipate accelerated GDP growth in 2004 higher than this year's, to be maintained throughout 2005 at a level close to that recorded in 2004.

Faster economic growth will not, however, bring about a significant surge in employment as this would require the lowering of labour costs borne by entrepreneurs and the establishment of a more favourable environment for start-ups. The economy's production capacity will be steadily expanded though largely as a result of capital formation.

If the above scenario of external and internal conditions for the years 2004-2005 is implemented, the inflation rate is likely to accelerate and throughout the period it should stay within the range of the inflation target, that is, 2.5% +/- 1%.

The emergence of inflationary factors cannot be ruled out. The condition of public finances will be the primary element of uncertainty. The fiscal impulse resulting from the increased deficit in that sector in 2004 may contribute to consumption and inflationary pressure growth. A failure to carry out fiscal reforms or a significant delay in their implementation may both lead to capital outflow, further zloty depreciation and the resulting inflation growth in 2004 and 2005. Uncertainty is also associated with the possibility of higher than assumed effect of economic recovery on employment growth, especially in 2005.

Additional uncertainty accompanies possible deviations of food and oil prices from the trends pursued so far. It may not be ruled out that unfavourable agro-meteorological conditions will result in a temporary acceleration of food price growth, which would equally affect inflation growth. The analysis of current tendencies also points to the risk of oil price increases in international markets.

Annex A
The voting of the Monetary Policy Council members on motions and resolutions adopted in the third quarter of 2003*

Date of resolution	Subject	Decision taken by MPC	Voting of Council members	
27.08.2003.	Lowering all interest rates by 0.25 percentage point	Motion failed to receive a majority of votes	**For:**	J. Czekaj
				D. Rosati
				G. Wójtowicz
				W. Ziółkowska
			Against:	L. Balcerowicz
				B. Grabowski
				C. Józefiak
				W. Łączkowski
				J. Pruski
			Absent:	M. Dąbrowski
30.09.2003.	The resolution to adopt monetary policy guidelines for the year 2004		**For:**	L. Balcerowicz
				J. Czekaj
				B. Grabowski
				C. Józefiak
				W. Łączkowski
				J. Pruski
				G. Wójtowicz
				W. Ziółkowska
			Against:	M. Dąbrowski
			Absent:	D. Rosati
30.09.2003.	The resolution to lower the banks' required reserve rate		**For:**	L. Balcerowicz
				J. Czekaj
				M. Dąbrowski
				C. Józefiak
				W. Łączkowski
				G. Wójtowicz
				W. Ziółkowska
			Against:	B. Grabowski
				J. Pruski
			Absent:	D. Rosati

* Except for the Resolution of September 30, 2003, setting the ceiling on liabilities resulting from the NBP taking out loans and credits in foreign banking and financial institutions.

A