MACROscope

Polish Economy and Financial Markets

June 2002 — Nº 35

Flaw in a diamond

- The CSO data for Q1 2002 indicate an increase in the financial results and a decrease in the businesses' stock levels. We would like to emphasise these data in particular as the growing profits and the decreasing stock levels should be the pre-market indexes of the forthcoming recovery in respect of the private investments. While the economy was supported by private consumption over the last three quarters, April saw a y/y decrease in the nominal salary pool and over a 5% real decrease, which clearly indicates that the economy recovery in H2 will be difficult unless it is supported by the growth in the investments.

- After a few months savouring the increasing optimism in respect of the projected economy's return to the growth path, April represented substantial disappointment, as the better part of the statistics published for this month did not disclose any increase in the business activity, suggesting that the stage of the economic slowdown may as well prove to be more long-term than expected. The substantial disappointment against the projections was evoked by the information on the labour market situation, industrial output growth and retail sales. The economy recovery was not supported by the data on monetary processes flow either (although the change in the calculation methodology made the data interpretation very difficult). The inflation prospects saw a substantial improvement.

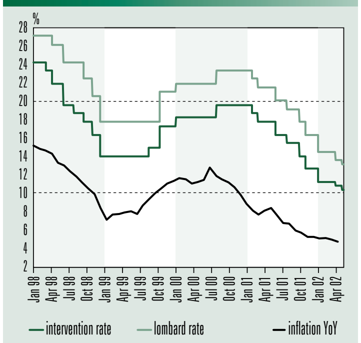
- On the other hand - especially at the end of the month - there was some positive information as well. The research on the economic situation of businesses and consumers' optimism indicated some improvement once more. There was a substantial increase in the budget tax income which seems to reflect the improvement in the businesses financial standing and the increased trade turnover. A clear cut improvement in the businesses' standing was recorded by the CSO as well which published the businesses' financial results for Q1 2002. Finally, the NBP data disclosed a substantial increase in foreign trade turnover, both in terms of exports and imports.

- In May, the Monetary Policy Council (MPC) cut interest rates by another 50 basis points, which over the last 14 months totals interest rate cuts at 1000bp. What is more, after publishing the information on a substantial decrease in food prices in May and adjusting down the inflation projections not only for May but for the remaining part of the year, it seems very likely that the MPC will cut rates by another 50bp as soon as in June, which would be the third cut in a sequence.

- There is a dispute over the strength of PLN. While the Government expects the MPC to undertake actions aimed at weakening PLN, the MPC believes the existing exchange rate policy is adequate. In our opinion, the Government supported by the President will aim at replacing the exchange rate regime with the managed float. Despite some pretences, we can see some headroom for compromise in this respect, in particular in the context of the EMU accession.

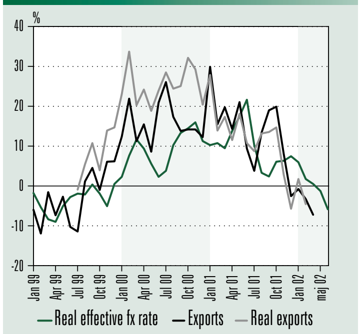
Financial market		**on 31 May 2002**			
NBP deposit rate	6.00	WIBOR 3M	9.60	PLN/USD	4.0311
NBP intervention rate	9.00	Yield on 52-week T-bills	9.00	PLN/EUR	3.7782
NBP lombard rate	12.00	Yield on 5-year T-bonds	8.55	EUR/USD	0.9334

NBP rates and inflation



Source: CSO, NBP

Exports and real effective zloty fx rate r/r



Source: CSO, BZ WBK

In this issue:

Piotr Bielski
Economist
Warsaw (+48 22) 653 47 33
piotr.bielski@bzwbk.pl

Aleksander Krzyżaniak
Warsaw (+48 22) 586 17 21

Sławomir Nosal
Poznan (+48 61) 856 55 67

www.bzwbk.pl

Investment cycle about to kick in

- Positive corporate financial results in 1Q2002
- Rising profits may be used to finance investments
- Finished products inventories decreased
- Inventory-investment cycle is coming
- There will be no „statistical inventory effect" in 1Q02 GDP growth data

Corporates return to black

Central Statistical Office has just released 1Q02 data on corporate profits and inventories. We pay close attention to these data because rising profits and falling inventories should be leading indicators of upcoming recovery of private investments. While in the last three quarters private consumption kept the economy going, in April wage bill declined YoY in nominal terms and fell more than 5% in real terms, which clearly indicates that without pick up in investments economy will have hard times recovering later this year.

Table 1 below shows that corporate sales fell 0.4%YoY in real terms, but at the same time costs fell some 1%. Notice that cost reduction in 1Q02 was achieved despite some pick up in corporate wages. Indeed, job destruction has accelerated from 4.5%YoY in 4Q01 to 4.8%YoY in 1Q02. Actually YoY fall in revenues and costs took place amid major drop in financial revenues (which fell 35%YoY or PLN2.5bn) and in financial costs (26%, PLN2.6bn). Revenues and costs net of financial component rose 1.1% and 0.6%YoY respectively.

Revenues, costs, profits of the corporate sector tab. 1

	Revenues % YoY	PPI % YoY	Revenues, real terms, % YoY	Costs % YoY	Wages % YoY	Gross financial result divided by revenues (net of coal mining)	Net financial result divided by revenues (net of coal mining)
1999 1Q	7,3	4,1	3,2	9,4	7,8	1,2	-0,2
1999 2Q	9,3	5,1	4,1	10,1	10,5	2,7	1,4
1999 3Q	9,2	5,9	3,3	10,9	11,6	1,3	0,0
1999 4Q	13,2	7,5	5,8	13,5	12,2	1,5	0,3
2000 1Q	17,1	7,9	9,2	15,8	16,9	2,1	0,8
2000 2Q	19,8	8,1	11,7	20,2	12,7	1,7	0,8
2000 3Q	16,7	8,6	8,2	14,9	11,2	2,5	1,3
2000 4Q	14,9	6,9	8,0	14,3	10,5	1,5	0,4
2001 1Q	7,1	4,2	2,9	8,1	9,4	1,2	0,1
2001 2Q	0,0	2,2	-2,2	0,3	7,3	1,4	0,5
2001 3Q	3,0	0,8	2,3	4,1	7,4	0,8	0,3
2001 4Q	-0,2	-0,6	0,4	1,3	4,9	-0,7	-1,1
2002 1Q	-0,2	0,2	-0,4	-1,0	5,3	2,0	0,7

Source: CSO, BZ WBK

Corporate sector net of black and brown coal returned into black reaching 2% gross and 0.7% net profits computed as ratio to sales. While it is too early to speak about a new trend, we certainly see a break of the previous one-year long deterioration of corporate financial results. Actually this better performance has already been indicated by strong CIT collections reported in February-April budget data.

Collapsing finished products Inventories, a light in the tunnel

In Poland retained profit is a key source to finance investments. According to preliminary M3 data corporate credit has been declining in nominal terms YoY in March and April, although we do not fully trust the quality of M3 data released by the central bank amid recent changes in methodology. But even if credit data are correct, higher profits will provide financial resources for future investments, not to mention lagged effect of falling interest rates on credit demand. Of course in order to invest corporates have to see signs of recovering demand.

Inventories and liabilities tab. 2

% YoY	Inventories				Dues and claims resulting from deliveries	Short-term debt	
	materials	production in progress	finished products	goods		bank credit	resulting from deliveries
2000 1Q	13,3	13,0	5,7	19,1	17,8	18,6	21,5
2000 2Q	14,0	22,5	8,0	25,5	22,6	20,7	21,2
2000 3Q	13,6	20,4	16,6	15,6	19,3	18,5	16,1
2000 4Q	7,7	22,0	12,0	8,1	15,5	21,5	11,0
2001 1Q	3,1	13,6	5,0	4,3	8,1	14,6	5,6
2001 2Q	-1,2	2,6	3,5	-2,8	1,8	11,1	2,6
2001 3Q	-4,4	2,4	0,3	-2,3	2,3	8,4	3,4
2001 4Q	-7,7	1,0	-0,7	-2,7	1,2	2,2	0,2
2002 1Q	-5,8	-11,8	-6,7	1,6	3,4	15,0	4,0

Source: CSO, BZ WBK

In 2001 as a whole revenues from sales rose 0.7% YoY, so 1Q02 1.1% rise is an improvement. Moreover table 2 provides a summary information about corporate inventories, which suggests a major decline in inventories across the board. Inventories of finished products fell 6.7% YoY and production in progress collapsed 11.8% YoY. This big drop requires further investigation.

The biggest share in finished products inventories (FPI thereafter) is held by production of foodstuffs and drinks, it was equal to 22% in 1Q02 and was only marginally bigger than in 1Q01. FPI in this sector fell 4% and similar trend was observed in almost all major sectors: wood (4% share, 8.8% drop in FPI), coke and oil refining (7%, -15.6% FPI), machinery manufacture (4.7%, -6.8% FPI), furniture (3.8%, -2.6% FPI), vehicles (3.1, -27.4% FPI). There are only three exceptions from this general trend. FPI in chemical sector (9.5% share in total FPI) and in manufacture of other goods (non-metal, non-rubber and non-plastic, 8.1% share) rose 6.8 and 5% respectively. Another exception was black coal sector (2.3% share) with FPI rising 8.6%YoY. Note that heavy chemistry and brown and black coal sector showed sharp profits recovery in 1Q02 (net profits to sales at 3.6% and 1.8% respectively), while manufacture of other goods was deeply in red showing 4.6% net loss.

Inventories of materials were still falling but the pace has slowed a bit, while inventories of goods for resale have broken w two-year nosedive and rose in 1Q02. This can be attributed almost entirely to wholesale and retail trade which account for 69.6% of all goods inventories. It appears that domestic trade sector has finally reacted to robust consumption demand, which accelerated from 1.5%YoY in early 2001 to above 3%YoY in the last two quarters. Of course one has to keep in mind the early Easter effect which has probably inflated somewhat inventories in retails sector.

Interestingly together with better profits corporates remain cash rich, showing 15%YoY rise, after 17.2%YoY rise in 4Q01. At the same time short bank credit has risen 15%YoY in 1Q02, comparing with only 2%YoY rise in 4Q01. Well, it is only short-term (i.e. less than one year) but certainly it does not fit well with recent corporate credit slowdown reported by the central bank. A 276%YoY rise was reported in mining sector (non-coal) 94.4%YoY in chemical sector, 113% in production of electrical equipment, 50% in production of vehicles. In wholesale trade (13.3% of all reported short-term bank credit) credit fell 9.5% while in retail trade it rose 107.8%YoY (probably partly as a result of earlier Easter). Last but not least we note that short-term debt resulting from unpaid services and deliveries rose 126.4%YoY in domestic ground and pipe transportation sector. We do not know which of the two state monopolies has a serious problem (PGNiG or PKP) but and unpaid bills rose from PLN1.8bn to PLN4.1bn in just one year.

What do we make of all these data?

Decline of finished products' inventories across the board suggests that classic inventory-investment cycle is around the corner. Therefore weakening consumption demand amid lower wage bill will be offset by inventory rebuilding and then by a pick up in investments. We also note that there will be hardly any „statistical inventory effect" on 1Q02 GDP data. We have seen deep inventory slump in 1Q01, but we have also witnessed similar in order decline from already depressed levels in 1Q02.

Economic update

- The April economy results below expectations
- However, the economic situation recovery signals are still there.
- Summer will melt down the inflation rate even to 2% y/y

The April economy results are poor - a flaw in a diamond?

After a few months savouring the increasing optimism in respect of the projected economy's return to the growth path, April represented substantial disappointment, as the better part of the statistics published for this month did not disclose any increase in the business activity, suggesting that the stage of the economic slow down may as well turn out to be more long-term than expected. The substantial disappointment against the projections was evoked by the information on the labour market situation, industrial output growth and retail sales. The economy recovery was not supported by the data on monetary processes flow either (although the change in the calculation methodology made the data interpretation very difficult). There was a substantial improvement in the inflation prospects.

On the other hand - especially at the end of the month - there was some positive information as well. The research on the economic situation of businesses and consumers' optimism indicated some improvement once more. There was a substantial increase in the budget tax income which seems to reflect the improvement on the businesses financial standing and the increased trade turnover. A clear cut improvement on the businesses' standing was recorded by the CSO as well which published the businesses' financial results for Q1 2002. Finally, the NBP data disclosed a substantial increase in foreign trade turnover, both in terms of exports and imports.

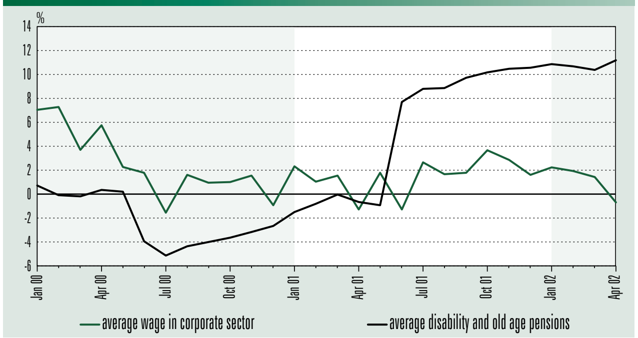
The general assessment of the economic situation changed only in respect of the adjusted inflation rate path for the rest of 2002, and the moment of recording the clear cut and strong signals of an upward trend in the data from the real economic sphere has been slightly deferred. This allowed for further loosening of the monetary policy by the central bank. One should still expect the full effects of loosened monetary policy and a gradual recovery of the global economy to materialise in H2. They will allow for an accelerated economy growth in Poland up to over 3% y/y in Q4 2002.

Below are the comments on the key April economic results.

Employment and salary fund are melting down...

The series of the April disappointing statistics was started by the data on salary and employment. The average salary in the business sector recorded a nominal growth of only 2.3% y/y, while in March the growth rate was of 4.8% y/y. Real salaries went down by 0.7% y/y. At the same time, employment in the business sector decreased by 4.8% y/y and the redundancy pace was similar to the March figure. The nominal salary pool in the business sector after the March decrease of 0.2% y/y, in April it dived by 2.6% y/y. In real terms, the salary fund decreased by over 5% y/y. This raises an obvious question if the private consumption growth observed since the beginning of 2002 can be maintained. If the redundancy pace is maintained, and the sudden slow down in salaries turns out to be a long term phenomenon, the consumption demand may face hard budget limitation (although the interest rates have been decreasing, the consumers' penchant for raising loans may be limited in view of the unemployment threat).

Salaries and social benefits — a real growth



Source: CSO, BZ WBK

...however, not in the State owned companies and the budget zone.

It should be emphasised at this point that the aggregated data do not provide a complete picture of the differentiated situation on the labour market and income standing of households. For instance, according to the recently published the CSO's „Information on the social-economic standing of Poland in Q1 2002", the salary growth dynamics in the private sector over the first three months was 5.1% y/y, while in the case of the State owned entities it was as much as 17.5% y/y. What is more, in Q1 the salaries in the private sector were 16.8% lower than in the public sector. While the private sector witnesses a substantial growth in the output capacity and the decrease in single labour costs, which with some delay should stimulate investments, the State owned companies remain „resilient" to the changing economic environment and the economic situation conditions. In Q1, the budget zone saw a 6.7% growth in the salaries and a 14.4% growth in disability and old age pensions. Given the decrease in the inflation rate down to

3.4% at the same time, the growth in the purchasing power of social benefits and salaries in the public sector (representing almost a half of the employed total) was not the worst one... as for the slow down phase.

Stagnant industrial production

In March industrial production figures looked bad. In April they were bad indeed. CSO reported that the production declined 4.4% MoM and grew only 0.2% YoY in April. While this time around there was one working day more than in corresponding month of 2001, such low annual growth must imply that adjusted series were deep in red again. This is in contrast with March figures, where headline production rate reached -3.2% YoY, but after correction for the number of working days the adjusted index increased substantially. Production in manufacturing performed only marginally better, falling 3% MoM and increasing 0.7% YoY - in adjusted terms also below zero.

Released by the CSO seasonaly adjusted index of industrial production sold also confirmed weakness of the April data, decreasing by almost 2% in YoY terms.

One should not expect the May industrial output figure to be impressive once again - we project a decrease of ca. 3% y/y. This, similarly to March, will primarily be the result of the lower number of business days than a year ago. The low output growth dynamics will add to the list of the arguments the MPC will give as rationale for yet another interest rate cut in June (see page 9).

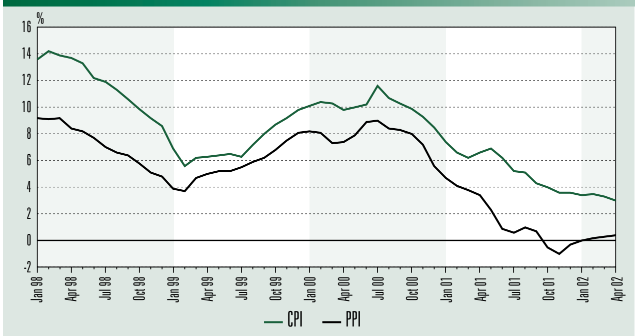
Real growth YoY

Source: CSO, BZ WBK

Inflation keeps falling

Inflation rate declined to 3.0% YoY in April from 3.3% in March, approaching another psychological barrier and beating up another record in Polish post-transition history of market economy. CPI increased 0.5% MoM, propelled mostly by price hikes in fuels (3.1% MoM), pharmaceuticals (2.6%), and energy (0.7%). Yes! The „Lapinski effect" worked out, though its strength was fairly moderate compared to previous healthcare fund calculations (that suggested ca. 8% price growth). Nevertheless the fact is that drug prices did not decline as promised by healthcare minister. The growth could have been even higher than 2.6% because, while the new list of subsidised drugs was introduces on 10th April, it is likely that CSO accounted for only 2/3 of whole price increase this month and the remaining 1/3 would be added to May figure. Gas price hike also proved to be slightly weaker than expected, reaching 0.7%. But again, CSO survey was probably unable to capture whole impulse because it could be prolonged in time, so the reminder could be visible in May inflation figure. The main disinflationary factor in April came from food market, where prices grew 0.5% MoM (ca. 0.2% lower than suggested by the preliminary data) i.e. three times slower than in corresponding period of 2001.

Inflation YoY



Source: CSO

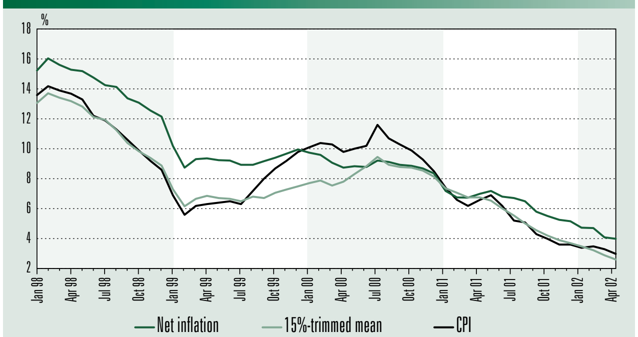
...and will be even lower

Food market supports disinflation in Poland for almost 24 months (with the temporary disturbance in 2Q01) - everyone knows that. But nobody has expected that this process would deepen so much in the middle of 2002. CSO reported that prices of food and non-alcoholic beverages collapsed 1.3% MoM in second half of May after 0.4% decline in first half of the month. This brings food prices down in May by 0.8% MoM on average, compared to previous estimates of ca. 0.2%. As food products have nearly 30% weight in the CPI basket, you might imagine that the impact on inflation rate is substantial. We forecast headline inflation rate in May at 2.0-2.1% YoY. But what is even more important than the May CPI figure is that such data might suggest completely different path of food prices for the rest of the summer this year. Because of massive excess supply on markets for almost all kinds of food products the deflation of food prices started earlier and will be deeper than usually. This suggests - contrary to what was assumed so far - that inflation might not pick-up since June, but may remain flat or even decline slightly (by 0.1pt) in two subsequent months. Of course in July and August other factors might enter, like market interventions or market protection, as it is likely that the government would try to stabilise the trend somehow. Nevertheless our present forecast leaves inflation rate very close to 2.0% YoY for May-July period. Three months of inflation around or even below Eurozone's level! This would be an important factor for monetary policymakers. Fourth quarter will bring about some price acceleration caused by administrative price hikes and we disagree with finance ministry forecast of inflation below 3% in December. Nevertheless it seems very likely that inflation will end this year slightly below the lower end of MPC's target.

Core inflation declines as well

NBP released core inflation measures for April. Annual growth rate declined for all five measures computed by the central bank. What's important is that the measure most closely watched by the MPC members i.e. 15%-trimmed mean went down by the same degree as headline inflation rate (30bps). In May when CPI inflation will reach its lowest point this year at ca. 2.2-2,3%, 15%-trimmed mean could be very close to 2%. Net inflation (i.e. excluding food and fuels) remains well above headline inflation rate, indicating that present disinflation is to large degree the result of extremely low growth of food and fuel prices. But even this measure reached 4% in April - the lower bound of MPC's inflation target for 2002. When the CPI trend reverses in 2H02, most of core indices would probably start growing as well, but meanwhile they constitute another argument advocating monetary easing.

Core inflation YoY

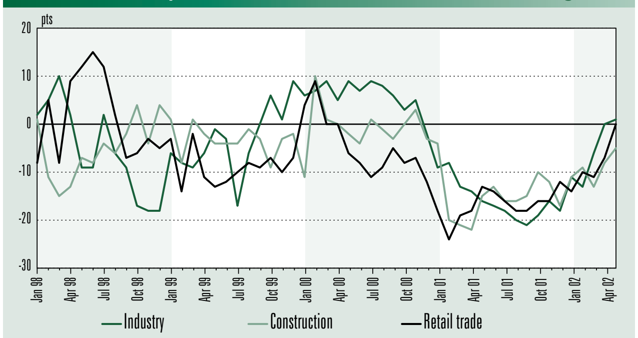


Source: CSO, NBP

Meanwhile, the economic situation has been improving...

Despite rather poor industrial output in April, the economic situation improved once again in May. What is important, once again the improvement was recorded by practically all research centres surveying the field. It should be emphasised that entrepreneurs have continued to report the increasingly accelerated process of placing new orders, in particular export orders, for the last couple of months. You may judge on your own how the above corresponds with the dramatic tone of the politicians' requests to weaken PLN substantially. What is more, the increasing number of businesses has been interested in investments. For instance, according to Pentor's research carried out based on the order placed by Puls Biznesu, investment climate improved by 12pts m/m in May and although the current rate remains negative, the expectations rate was 6pts against -6pts last month. Besides, the rate of Pentor and Puls Biznesu had been positive for the first time for 14 months, leaving the economic slow down phase. The other indexes remained negative although they kept on moving towards the positive values.

Business climate by CSO YoY growth



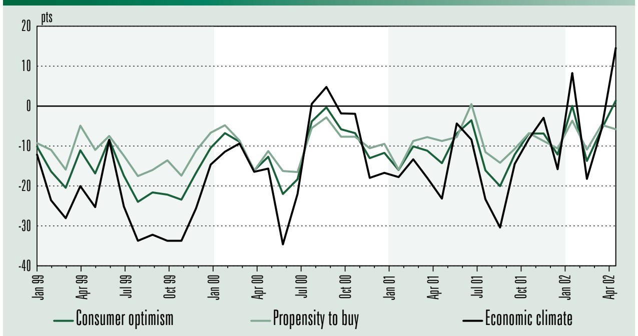
Source: GUS, BZ WBK

The most worrying feature of the survey is that in all sectors job destruction process is expected to continue at the unchanged pace, which is even somehow more depressing result than in previous months (when companies expected deceleration of labour shedding). This does not provide for any optimism regarding labour market situation, which in turn might endanger the continuation of domestic demand growth. Private consumption cannot be financed by savings de-stocking forever. And of course this must imply the sharp rebound of unemployment rate in second half of 2002, when 900,000 of graduates will enter labour market. This in turn suggests that ahead of local elections scheduled for autumn the government could be very desperate in his efforts to reach any visible signs of economic improvement. Would you guess what it means for monetary policy?

...together with consumer optimism

According to Demoskop consumer optimism rose in May three points to 78 pts. It resulted from better assessment of general economic situation (up eight points), while propensity to shop inched down. Inflation expectations continue to fall and even the fear related to high unemployment appears to vane and we are yet to see the impact of Szczecin shipyard nationalisation on job safety feel-good factor. According to Pentor farmers' sentiment deteriorated rapidly in May and fell 16 points. Institute concludes that farmers' protests period should be expected.

Consumer optimism YoY change

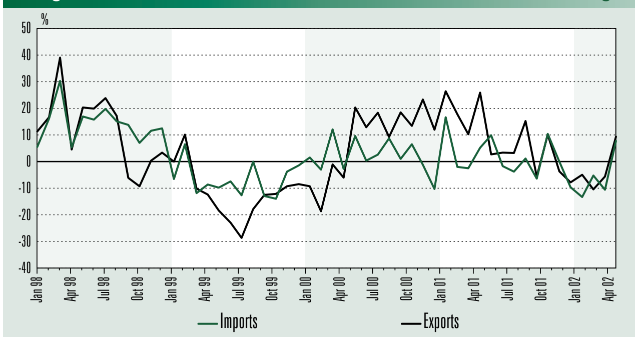


Source: Ipsos-Demoskop

Foreign trade volumes increase as well...

Current account deficit reached US$806m in April compared to US$612m in March and US$520m in April'01. The gap was higher than expected. Nevertheless the foreign trade volumes proved to be surprisingly strong. Export grew 13.5% MoM and import 12% MoM, both figures returned into black in YoY terms (9.4% and 7.8% YoY respectively) after five months period of deep annual decline. MPC put quite high attention to these data, suggesting that they reflect upcoming recovery in both external and internal demand. While such sharp increase in both import and export volumes after prolonged period of stagnation looks really suspicious and could reflect some one-time phenomenon, we recall that the signals of improving portfolio of new export orders has been reported by Polish companies for at least three-four months. And some signs of pick-up in export were already visible in March data when its growth was notably stronger than seasonal. We expect that trade volumes will keep improving in subsequent months, however import recovery should be faster leading to widening trade deficit. Current account will deteriorate as well, up to ca. 5% of GDP by the end of year. We were somewhat surprised with the weakness of unclassified flows balance reflecting the cross-border trade. The surplus increased to US$238m from US$139 in March, while we've expected at least US$400m.

Foreign trade volumes YoY change



Source: NBP

...and budget tax revenues

April data about budget execution broadly confirmed optimistic hints gave earlier by minister Marek Belka. Central budget deficit increased to 50% of annual plan from 41.1% last month. Revenues reached almost 30% of plan, growing 2.2% YoY (Jan-Apr) compared to 3.5% YoY planned for whole year. Expenditures (34.2% of plan) increased 4.1% YoY, slower than 7.1% YoY assumed in annual plan. Revenue figures confirm earlier signs of improvement in corporate sector. Indirect taxes accelerated to 9.7% YoY in Jan-Apr and 21.2% YoY in April. Although it is difficult to isolate the effect of economic recovery from the effect of newly introduced taxes (excise tax on electricity, higher VAT rates), this upturn probably reflects to some extent strong retail sales figures reported in March. CIT inflows remained strong, growing 14.1% YoY cumulatively (Jan-Apr) and 15.3% YoY only in April, well above 4.2% targeted for whole year. PIT revenues performed rather poorly, especially given that the full effect of interest income tax probably has revealed this month. Two factors could have contributed to this result: declining nominal wage bill and the fact that large number of people could have decided to exploit tax deductions for flat purchase just before they were completely removed since 2002. In general budget revenues apparently keep improving, delivering rather bright perspective of meeting this year budget plan. Expenditure side looks reasonable as well, while spending growth remains under control and still well below this year target level. The only unusual factor was very high domestic debt servicing costs growth (132.2% YoY in April), that probably resulted from delaying some payments from March (March figure was unexpectedly low, reaching -52% YoY).

Budget revenues and expenditures, %YoY, cumulative tab. 3

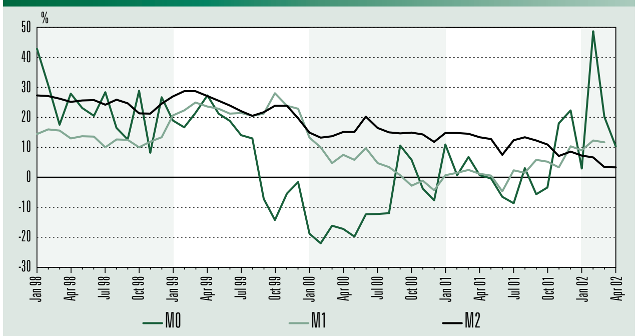
	Nov 01	Dec 01	Jan 02	Feb 02	Mar 02	Apr 02	PLAN 2002
Revenues	**3,9**	**3,4**	**-10,7**	**0,0**	**-1,0**	**2,2**	**3,4**
Indirect taxes	2,6	3,3	-3,2	3,9	6,0	9,7	10,9
CIT	-21,9	-20,9	-40,8	6,3	13,7	14,1	4,2
PIT	1,9	1,7	-5,0	-0,8	1,9	-0,5	13,5
Budget entities incomes	29,4	21,4	-47,3	-24,2	-43,4	-35,6	-31,4
Import tariffs	-19,9	-19,6	-14,0	-8,9	-8,8	-9,4	-14,9
Expenditures	**12,8**	**14,5**	**3,1**	**5,3**	**2,3**	**4,1**	**7,1**

Source: BZ WBK calculations

Monetary statistics distorted by the change in the methodology

Starting from March, after the central bank has changed the methodology of monetary statistics as well as the reporting standards of commercial banks, data on the money supply as well as its components are not too reliable (putting this very mildly). This was evidenced by the data published by the NBP in April - the figures presented differ completely from what we saw last month, and the differences in individual components (in comparison to the last month's results) amount to several (!) PLNbn. This probably results from two reasons: firstly, banks make serious errors in their reports developed in line with the new schemata, and this distorts results for the last months. Secondly, the series of historical data for the last 5 years published by the NBP are based on the estimates of the central bank and may not be free of errors. The data quality should be improving on a monthly basis. Nevertheless, we have decided we will not elaborate on these figures yet. The only thing worth mentioning at this point is the fact that the data indicate substantial growth in households' loans and drastic decrease in deposits. It is difficult to say though if the above represents the actual trends or errors in the NBP calculations. The regular upward trend in the narrow M1 aggregate raises concerns as well, because it usually preceded the inflation bounce in previous years.

Monetary measures **YoY change**



Source: NBP

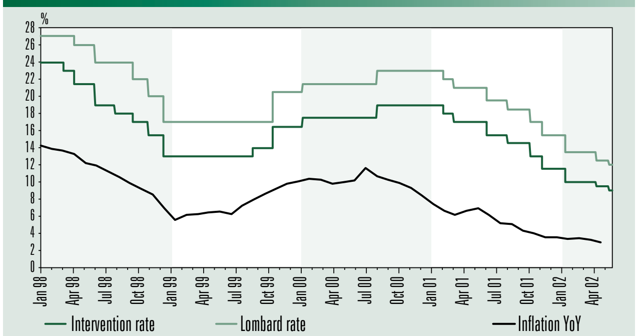
Central bank watch

- The MPC cut interest rates by 50 bps proving that economic arguments are more important than politics
- Next cut by further 50 bps possible in June
- Balcerowicz loves compromise – MPC voting results in 2001
- MPC unanimously rejects interventions
- Talks on strategy ahead of EMU entry started

MPC cuts rates again

On Wednesday 29 May the MPC cut all main interest rates by 50 bps and maintained neutral bias in monetary policy. Since 30 May main reference rate stands at 9%, lombard rate at 12% and deposit rate at 6%. Therefore the total interest rate reduction in last 14 months - since the beginning of easing cycle - reached 1000bps (in case of lombard rate even 1100bps). While we did not expect the decision to be taken this month, it has to be reiterated that this time it had very sound economic support from the data. And it has turned out that these arguments were much more important for MPC members that all the political considerations. Good, this is perhaps even more evident proof of their independence.

NBP interest rates and inflation



Source: NBP, CSO

The official MPC statement explaining the decision raises, as always, rather mixed emotions. On the one hand MPC noticed several factors strengthening positive low-inflation scenario, like: improvement of households' inflationary expectations, fall of core inflation measures, wage growth deceleration, improvement of food price growth. On the other hand the MPC's general economic outlook for the rest of the year hasn't changed, they even recognised several new factors confirming the upcoming recovery: strong improvement of companies' financial results in 1Q02, improvement in foreign trade volumes, growing budget tax revenues, improvement in construction sector. In general the statement does not provide much help in predicting the timing of the next possible interest rate movements. In fact virtually the same text could be used in June to explain cut as well as no-cut decision. What's important is that MPC said it anticipates continuing deep inflation decline in May, so theoretically if CPI falls to 2.0% YoY it should not be the factor triggering another rate cut. Nevertheless inflation decline in April was also said to be in line with MPC expectations, and at the same time listed between the arguments supporting the cut in May.

Further cuts will follow

After information about very strong decrease in food prices in May and revision down inflation forecasts not only for May but also for the rest of the year, one should consider revising interest rate scenario as well. Now it seems very likely that MPC will reduce the rates again by 50 bps already in June, delivering the third cut in a row. Several factors would support such decision. First of all, present CPI could touch another psychological threshold level (2%). Then, it will probably remain at this level (or slightly below) for next quarter. After such CPI plunge inflation expectations will surely collapse as well. Industrial production figure for May would look terrible (we forecast -3.1% YoY) because of lower number of working days. And finally the market pressure for the rate cut would be very intense. After all zloty remains reasonably strong and will remain strong even after such 50bps cut, contributing to slower price growth in subsequent months. Why not 100bps you might ask? It is possible, but not in one shot. MPC have clearly signalled two months ago that it moves to smaller steps now in order to reduce market expectations for further cuts, and it proved to be successful. So abandoning this commitment now would waste the advantage that is already earned. Next 50bps would be likely in August or September, especially that at this moment MPC would have the information whether the situation on food market is going to reverse due to state interventions and would know the preliminary budget assumptions for next year.

Balcerowicz loves compromise

NBP released its „Inflation report" for 2001. Among other interesting issues discussed in this volume, they've published the results of every voting over interest rates held in 2001. The breakdown is very useful as it gives some insight into MPC's decisive process last year. The results are presented in the table below. You can easily identify the „doves" and the „hawks" faction within MPC. Two MPC members are on the extreme positions: ultra-hawk Marek Dabrowski who never votes for the rate reduction and ultra-dove Janusz Krzyzewski who always opts for the cut. The voting pattern of NBP governor Leszek Balcerowicz suggests that he is the man of compromise - when doves demand deep easing and hawks are against, he supports the rate reduction but in a limited scale. His vote decided about the rate change three times (out of 7).

MPC voting results in 2001 **tab. 4**

	Feb 150	Feb 100	Mar 100	May 200	may 100	Jun 200	Jun 150	Aug 100	Oct 200	Oct 100	Oct 150	Nov 150
		yes	yes				yes	yes			yes	yes
Balcerowicz	-	+	+	-	-	-	+	+	-	-	+	+
Dąbrowski	-	-	-	-	-	-	-	-	-	-	-	-
Grabowski	-	+	-	-	-	-	+	+	-	+	-	-
Józefiak	-	+	-	-	-	-	+	+	-	+	-	-
Krzyżewski	+	+	+	+	+	+	+	+	+	-	+	+
Łączkowski	-	+	-	-	-	-	+	+	-	+	-	-
Pruski	-	+	-	-	-	-	+	+	-	+	-	-
Rosati	+	-	+	+	+	+	-	+	+	-	+	+
Wójtowicz	+	+	+	+	+	+	-	+	+	-	+	+
Ziółkowska	+	-	+	+	+	+	-	+	+	-	+	+

Source: „Inflation report 2001" after Reuters

NOTE: Numbers indicate proposed scope of a reduction in the main market rate with votes which resulted in a cut marked „yes". In some cases, several votes were held during a single meeting, but only one or none resulted in a rate change. A „+" mark denotes a vote in favour of a proposed cut and „-" a vote against it.

MPC unanimously rejects interventions

After making interest rate decision the MPC met Marek Belka to discuss government's proposal of FX policy changes. Finance minister came with an assistance of three other people - head of PM's Chancellery Marek Wagner, labour minister Jerzy Hausner and deputy finance minister Andrzej Raczko. The meeting was inconclusive, as was easy to predict. During MPC's press conference Leszek Balcerowicz underscored that the Council unanimously agreed that current free-float regime is beneficial for the economy and it should not be changed or modified. He also reiterated that whole campaign for zloty weakening boosted by the government is seriously misplaced, given the strong performance of Polish exports in April, given the significant improvement of Polish companies financial results in 1Q02, and given the fact that most of foreign trade is settled in euro which is actually appreciating against the zloty. Frankly speaking the most clear and straightforward message from the press conference was that the MPC likes the present FX regime as it is, it does not consider FX interventions to be efficient nor desirable, and that it would not pursue to 'artificially' weaken the zloty.

Talks on strategy ahead of EMU entry started

What was also important is that central bankers and Marek Belka started the debate over Poland's FX strategy ahead of ERM2 and EMU entry and they scheduled further working sessions to discuss this matter. If everything goes well, it's likely that they will be able to reach consensus on this issue this summer, perhaps in July or AuCSOt. MPC needs this consensus to set its next medium-term monetary policy strategy, and the government needs it to ensure smooth budget financing. Nevertheless in order to achieve a credible commitment for fast EMU entry Marek Belka should do something about his medium-term public finances strategy, and even earlier with the budget for 2003. Is this likely? We will see...

Comments of the MPC members

In May, the better part of the public statements made by the NBP representatives represented a response to the exchange rate campaign launched by the Government. Firstly, they refuted that the MPC's monetary policy represents the main reason for PLN appreciation. The MPC's members rather indicated the Government's policy, and, in particular, the record issue of securities this year, as the main driver for this adverse from the Government's point of view a phenomenon. Secondly, all representatives of the central bank rejected the concept of Marek Belka, MF, that indicated that the NBP should give up the policy of non-intervention on the FX market and should control PLN exchange rate by means of interventions. In their opinion, these operations would not be compliant with the direct inflation target agreed by the MPC as well as with the free capital flow system existing in Poland. In addition, the interventions would be expensive and predetermined to be a failure. Finally, they would pose a threat of FX market crisis in Poland.

WHO? WHERE? WHEN?	QUOTE
Dariusz Rosati, MPC member;	
PAP, 8 May	„We are still for market-driven foreign exchange. We consider that connecting direct inflation targeting with managed foreign exchange is inconsistent, costly and undesirable.”
	„Of course I am ready to discuss on how to lead to situation in which zloty exchange rate would reflect economic fundamentals, rather than speculative capital inflow into treasuries that Mr Belka keeps selling off.”
	„Zloty appreciation trend results from three reasons. First, we have Balassa-Samuelson effect i.e. faster growth of labour productivity, second we have capital inflow, and third we have high interest rates. These three factors would keep the zloty strong. It could negatively affect export sector.”
	„But the major force behind zloty appreciation are high budget financing needs. The inflow of foreign capital to Poland in last 3-4 months amounting to US$2bn is in 90% the inflow into treasuries that finance minister keeps selling to finance the budget. If we lowered rates by additional 5 bps, even theoretically, he would have to finance the budget anyway and sell the bonds with such prices and yields to attract foreign capital.”
	„All the countries that went through currency crisis had some kind of managed foreign exchange. Poland is the only country in the region which did not go through such crisis and I don't know the case of a crisis in a country with floating exchange rate.”
Radio ZET, 9 May	„If we look at foreign trade data, export and import, and at real foreign direct investment, not speculative (investment flows), then the zloty should probably be slightly weaker. But I don't want to say by how much because this it the matter that should be regulated on the market.”
Rzeczpospolita, 16 May	„We have experience that frequent interventions are ineffective and costly in situation when markets think that currency should be strong. And Poland is in such situation. [...] Permanent zloty weakening is impossible.”
	„Trading ranges are bad solutions. It invites speculation to test the boundaries.”
PAP, 16 May	„We are sceptical about the effectiveness of systematic interventions. Additionally, if they were to be sterilised, then they would be costly, and if they were to be non-sterilised, then with such scale of capital inflow we would have fast inflation growth and loss of control over money supply.”
	„This zloty appreciation recorded lately is about to end. The main cause [of zloty appreciation] is high supply of treasuries. And we expect that the supply will decrease in subsequent months.”
PAP, 29 May	„Signals from the food market show that in May inflation could fall below 2.5%. It is probably the end of declining inflation.”
	„In 2H02 the inflation would accelerate slightly. Last data suggest that at the end of year inflation would be below lower end of the target band.”
Andrzej Bratkowski, deputy NBP governor;	
PAP, 8 May	„In my opinion foreign exchange intervention would be ineffective in present situation, because it would hamper the efficiency of monetary policy and could lead to NBP and budget financial losses.”
	„Fears connected with zloty appreciation are exaggerated, because it almost entirely results from euro appreciation against dollar, which is favourable from Polish point of view. [...] We trade with Eurozone mostly and part of our import costs, relatively higher than in export, is related to US dollar. Therefore such exchange rate change is profitable. Developments in foreign exchange market experienced in recent weeks do not create any new threat.”
	„I'm sure finance ministry is aware that zloty is strong to large extent due to the need of financing budget deficit and high share of foreign investors in deficit financing.”
	„If one interpreted Belka's appeal as a call for changing foreign exchange mechanism, then NBP has no uniform stance yet on which mechanism would be the most beneficial for the future.”
	„But I think that bank would be rather willing to adopt one of the extreme measures, i.e. either leaving present system of free floating rate or adopting fixed rate, against which finance minister have already argued.”
	„Czech experience of foreign exchange interventions under low interest rates and strong appreciation pressure should be the warning for managed exchange rate regime enthusiasts. The only effect of those interventions was the move from central bank profits to losses. Such system is ineffective and I don't think MPC would decide to choose such exchange rate regime. We are talking here about the period since now until ERM2 entry.”
	„It is also unlikely that MPC would adopt any intermediate solution between free float and fixed exchange rate.”
	„In the extreme case fixed exchange rate could take shape of unilateral euroisation, though it is rather impossible considering EU stance. It might be also the currency board or any weaker form of currency board.”
Leszek Balcerowicz, NBP governor;	
PAP, 11 May	„Comparing zloty to forint and koruna we see the same tendencies, all currencies have strengthened amid expectations trhat after joining the EU these countries will become even more attractive. This is a certain side effect of expected success”.
Reuters, 16 May	„It (the currency) is a secondary problem in relation to reforms, to fundamental issues which will influence our speed of growth not just for one or two years but systematically for the years ahead.”
	„We are not facing an appreciation, we are facing an episode. ... The zloty is now weaker than on average in all of last year, or perhaps on the same level.”
Reuters, 21 May	„I would like to assure everyone, and calm some others, that the National Bank will continue to guard the stability of the currency”.
PAP, 23 May	„In all well developed economies central bank is independent to protect people against inflation. Stripping central bank of independence would smell pricey. And it would not promote the wealth creation.”
PAP, TVN, 29 May	„MPC presented the results of analysis regarding government's proposition and anonymously agreed that maintaining present exchange rate system is the solution beneficial for the country.”

	„Simultaneously we've agreed with government officials on further working meetings that should be a good habit. Subject of those meetings is supposed to be mainly FX strategy in a way towards Economic and Monetary Union."
	„I can see no ground for hypothesis that zloty is overvalued."
	„For Polish exports the zloty rate against euro is especially relevant, and it is weaker now than a year ago. The campaign to weaken the zloty is difficult to understand."
	„In my opinion one should consider how the export reacts. April figures show that export increased substantially. Import increased as well, which indicates that in Polish economy recovery is about to show up."
	„If there are very powerful forces pushing the zloty for the appreciation (and these are expectations for improved stability and investment profitability because of Poland's entry to EU, and also huge budget borrowing that encourages portfolio investments) then the interventions cannot neutralise it. It's the international experience."
	„The first of those forces we cannot neutralise, because we want to enter the EU and it would be beneficial. In the second case - the more budget borrows from the banks the less is left for companies, they cannot expand. MPC is unanimous in this case - if there are such powerful forces strengthening the zloty then no interventions can be effective."
Boguslaw Grabowski, MPC member;	
Reuters, 13 May	„At this point, intervention is not acceptable."
	„You do not stand in front of a charging train."
PR3, 14 May	„The main reason behind strong zloty is fiscal policy."
	„Prices of services are still much lower in Poland and in convergence process we would have adjustment of these prices to EU levels and appreciation of Polish currency. And it would follow for years. [...] Zloty would be stronger and stronger."
	„Changing the number of MPC headcount during the term in the office is nothing else than political assassination on central bank independence."
Rzeczpospolita, 20 May	„Investors are convinced that zloty will strengthen. In such situation interventions will not be successful.
	„It took us few months do decide on zloty floatation. Nobody should expect that we will return to trading band after half an hour discussion".
Wieslawa Ziolkowska, MPC member;	
PAP, 13 May	„I would prefer to reduce interest rates to stop expectations about future cuts. It would be the most effective activity, but I am not saying that it would be the only activity".
	„Even NBP governor does not know whether foreign exchange intervention would be effective. It is worth trying this method of influencing the exchange rate. Undoubtedly zloty is too strong and does not reflect Polish economic fundamentals".
	„I would prefer the market to determine the exchange rate, but if market appreciates the zloty because of interest rates maybe it is better to react with interest rates".
PAP, 28 May	„The inflation should be 2.5-2.7% The inflation in June should stay on the May level. June last year saw lower inflation the base is lower so we might see a slight rise of CPI."
	„None of the forecasts I know shows any risk of overshooting either the short-term or the middle-term inflation target, which is below 4% in 2003."
	„The signs of an economic revival in Poland have been very week so far, which makes this year's economic growth coming at 1%, in line with the government's expectations."
Grzegorz Wojtowicz, MPC member;	
Reuters, PAP, 14 May	„Experience has taught us that in a system of free capital flows we must have a floating exchange rate...So there is no question of manipulating the free-floating zloty. [...] The government's decision to launch talks should be viewed as policy co-ordination ahead of the country's expected entry in the euro-zone waiting room, the ERM-2 mechanism, after probable European Union accession in 2004. [...] It is difficult to talk about currency regime changes in public".
	„We need to talk seriously and see thing in long-term, strategic context".
Rzeczpospolita, 16 May	„We may decide to set a central parity against euro with a wide trading rage of +/-15%. But only in a situation when we are absolutely sure about soon membership in ERM2 and then we will replace zloty with euro".
Reuters, 16 May	„Buying foreign currency by the government on the market is less costly than NBP's interventions and it could be more effective."
Jerzy Pruski, MPC member;	
Radio ZET, 21 May	„Every economist knows that radical rate cut would weaken the zloty. It would be wrong to do at present situation".
	„Sometimes there are very specific situations when one can consider foreign exchange interventions. Such situation is not present in Poland".
	„NBP law amendment will be harmful for the economy".
	„Finance minister cares about short term, his target is to pursue policies that would lead to victory in next elections".
	„MPC is a convenient scapegoat".
Janusz Krzyzewski, MPC member;	
PAP, 22 May	„I would rather rule out rate cut, even a small one, on May MPC meeting".
	„In Polish situation interest rate policy should not be exclusively focused on current processes, such as decline of inflation to 3% in April, but also should anticipate these processes".
	„It should not be ruled out that interest rates may go up by the end of the year, but I do not believe in such scenario".

Information on the meeting of the Monetary Policy Council

On May 28-29, 2002

The Monetary Policy Council held its meeting on May 28-29, 2002. The Council was submitted the materials prepared by the Management Board and departments of the NBP as well as information and analytical materials prepared by the Ministry of Finance, banks and research institutes. On this basis the Council discussed the external conditions of the Polish economy, the situation in the real sector of the economy and tendencies in the area of wages and social benefits, in public finance sector, money supply, lending and interest rates and the formation of prices and inflation expectations.

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In reply to the Government proposals, the Monetary Policy Council discussed the principles of the exchange rate system performance in Poland. The Council declared itself for maintaining the exchange rate system without changes.

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I. External conditions.

Since the last meeting of the Monetary Policy Council the economic growth forecasts worldwide have not changed. External conditions should be favorable for the economic boom in Poland.

– The symptoms of a boom in the American economy are already visible. The probability of the sustained improvement of the economic situation is enhanced by the data on the increase of orders for durable goods and a better outlook for companies' earnings in April. As a month before, the economic growth in the United States is assessed at 2.2% in 2002 and 3.5% in 2003.
– A boom in the economy of the euro zone will be weaker and slower than in the United States. The economic growth in the euro zone is assessed at 1.2% this year and 2.9% in 2003, and in Germany 0.9% and 2.8%, respectively.

II. Production, economic growth.

A general evaluation of the outlook for the economic activity increase has not changed since the previous meeting of the Monetary Policy Council.

– A lot of information indicate a growing probability of the economic boom:
– A clear improvement has been noted in case of the earnings of enterprises. In the 1 st quarter this year, they generated net profit of PLN 1.7 billion as compared to PLN 15.8 million worth of net loss a year before. The earnings of enterprises can be used for investment financing.
– In the 1 st quarter this year, the inventories of final goods in enterprises decreased by 6.7% as compared to the same period last year.
– After a 5-month drop, the revenues from export in April this year were bigger by 9.4% than a year before what may confirm the opinions on a growing external demand expressed by entrepreneurs in the economic situation survey. The increase has also been noted in case of payments for import by 7.9% what, in turn, would signal the increase of domestic demand.
– The growth tendency in retail sales has been maintained. In April this year, retail sales were bigger by 3.1% than a year before and within the period January-April 2002, they were bigger by 5.2% than in the same period in 2001.
– Within the period January-April this year, tax revenues were higher by 8.3% than a year before. The indirect tax revenues increased by 9.7% (and in April by 21.2% - what, in part, resulted from the implemented systemic changes, especially excise on electric energy), and the income tax revenues from legal persons rose by 14.1%.
– In April this year, the drop scale of construction and assembling production clearly decreased. After removing seasonal factors, it was lower by 4.8% than a year before as compared to the drop by 13.8% in February and by 13.5% in March this year.
– In May this year, the results of the economic situation survey were subject to a further improvement. A general evaluation of the economic situation in industrial processing is close to the one expressed in April and better than a year before (although still negative). The assessments of the current production and forecasts for future demand and production are positive. The atmosphere of the economic situation in construction is evaluated positively, better than in April, and in retail sales less pessimistic than a month ago.
– At the same time, the data on the sold industrial output indicate that the economy in this sector has not turned to the boom phase yet. In April this year - when the work time was longer by one business day - the industrial production was higher by 0.2% than a year before. After eliminating seasonal factors, a drop of production by 0.9% has been noted. The stabilization of the sold industrial output trend that has been observed for 13 months is maintained. Moreover, a drop of wage dynamics - although favorable for future inflation - can contribute to the reduction of the growth pace of consumer demand.

III. Wages, social benefits.

1. As compared to the situation observed a month ago, the annualized growth pace of wages in enterprises decreased what may signal a drop of wage pressure in the economy.
   In April this year, average gross wages in the enterprise sector were higher by 2.3% than a year before and, in real terms, a drop of 0.6% was noted. Within the period January-April 2002, average wages in enterprises were higher by 4.5% than in the same period last year, and in real terms this increase amounted to 1.2%.
2. The average employment in the enterprise sector decreased in April by 0.3% as compared to March and it was lower by 4.8% than in April 2001. In April this year, a seasonal drop of the number of the registered unemployed was noted. The unemployment rate dropped from 18.1% to 17.8%.

IV. Situation in public finance sector.

Since the last meeting of the Monetary Policy Council, there was no information that would induce to the change of the evaluation of the public finance situation both this and next year.

– The data on the state budget accomplishment indicate that there are no visible bigger threats to the accomplishment of the Act on the State Budget for the year 2002.
  The economic deficit of the public finance sector in 2002, however, will be maintained at a very high level (approximately 5% GDP) what adversely affects the economy. A result of a big deficit and small revenues from privatization is a big supply of Treasury securities that is necessary for financing lending needs of the budget, which results in:
– a limitation of possibilities to finance the development of enterprises;
– an inflow of foreign portfolio capital that is invested in Government bonds by which it contributes to the appreciation of the exchange rate of the zloty without strengthening at the same time - as opposed to direct foreign investments - the competitiveness of the economy.
  Moreover, the delay in transferring the due contributions to Open Pension Funds by ZUS (within the period January-April this year, only 24.2% of the plan was accomplished, and ZUS announced additional delays in summer) and the situation of the Labor Fund can lead to the increase of the economic deficit this year.
– There is maintained uncertainty concerning the public finance, including especially the scale of the deficit in 2003. The basic task in the construction of the budget should be the reduction of expenses so it would be possible to decrease considerably the public finance deficit.

V. Money supply, loans, interest rates.

As compared to the situation a month before, the evaluation of monetary factors' impact on future inflation has not been subject to explicit changes.

– In April this year, a further drop of the annualized money supply dynamics was noted. The growth pace of money supply (aggregate M3) lowered from 3.5% in March to 3.4%. The dynamics of the aggregate M2 dropped from 8.4% to 7.8%.
– In April this year, the PLN-denominated deposits of households decreased by PLN 0.8 billion. The annualized dynamics of deposits placed by households dropped from 3.2% a month before to 2.2%. The reasons for this phenomenon are the decreasing growth pace of the people's income and a lowering profitability of placing funds in the banking system resulting from the reduction of the interest rates on deposits and the introduction of taxation of bank interest income.

- The amount of cash in circulation increased in April this year by PLN 1.2 billion as compared to March, and the annualized dynamics rose from 15.6% to 16%. There is maintained uncertainty concerning the inflation reasons and results of a high dynamics of cash.
- The annualized dynamics of lending to households, after a significant increase in March this year from 13.9% to 17.7% lowered in April to 15.5%. The growth pace of lending to businesses remains negative the second month in a row. In April this year, the drop on the 12-month scale amounted to 1.3%. The data on lending are probably distorted by banks' errors in loan classification connected with the introduced change of the methodology and they do not fully reflect the economic phenomena.

VI. Prices, inflation expectations.

1. A monthly increase of consumer goods and services prices in April this year was lower than a year before (0.5% as compared to 0.8% a year before). It mainly resulted from a three times lower growth pace of prices for foodstuffs and non-alcoholic beverages (0.5% as compared to 1.5% a year before). A big increase was noted in case of fuel prices (by 3.1% as compared to no changes a year before).
   An annualized consumer price index lowered in April this year from 3.3% to 3.0%. Its further, deep drop is forecasted to take place in May. It is possible to expect that in the further part of the year a gradual increase of inflation will take place to the level close to the lower limit of the range of the inflation target for 2002.
   The sold industrial output prices in April this year were higher by 0.4% than a year before.
2. All core inflation measures lowered:
   - 15%-cut average from 2.9% to 2.6%;
   - inflation excluding the most variable prices from 2.6% to 2.5%;
   - inflation excluding the most variable and fuel prices from 2.9% to 2.7%;
   - inflation excluding the controlled prices from 3.0% to 2.6%;
   - „net" inflation (excluding foodstuff and fuel prices) from 4.1% to 4.0%.
3. Since the previous meeting of the Council, the forecasts for oil prices have not changed. It is forecasted that in the 2 nd quarter this year an average oil price will amount to USD 25 per barrel, and during the whole year 2002 - USD 23. As compared to the situation a month before, a smaller increase of foodstuff prices is forecasted now.
4. Since the last meeting of the Council, the individuals' expectations about the future inflation improved considerably. A significant drop was noted in case of the percentage of the most pessimistic individuals who expect the price growth to be faster than at present. A group of individuals forecasting that the prices will grow at the same pace as so far has also decreased. The increase has been noted in case of the percentages of individuals who are the most optimistic expecting the following: a drop of the price growth pace, that the prices in a year's time will be the same as now and that the prices will be lower than at present.
   In May this year, the inflation rate expected by bank analysts lowered. The inflation expected by them at the end of December this year should be at the level 4.1% (drop by 0.3 percentage point as compared to April), and, in April 2003, they expect inflation at the level 4.2% (less by 0.2 percentage point than a month before).

VII. Decision of the Monetary Policy Council.

1. As compared to the situation observed a month before, the following signals indicating the enhancement of factors that are favorable for low inflation appeared:
   - A clear improvement of inflation expectations of individuals took place and the inflation forecasted by bank analysts lowered;
   - According to the forecasts, the consumer price index lowered;
   - All core inflation measures decreased, and the annualized dynamics of the sold industrial output prices is maintained at a low level;
   - The dynamics of wages decreased what may signal a drop of wage pressure in the economy;
   - Forecasts of foodstuff prices growth lowered.
2. A general evaluation of the economic activity growth outlook has not changed since the last meeting of the Monetary Policy Council.
   A lot of information indicate a growing probability of the economic boom:
   - A clear improvement of earnings of enterprises;
   - A drop of inventories;
   - Maintaining of forecasts indicating that the external conditions should be favorable for the economic boom in Poland;
   - An improvement of the dynamics of export and import payments in April this year;
   - Maintaining of the growth tendency of retail sales;
   - Higher than a year before tax revenues of the budget, especially from indirect taxes and income taxes from legal persons;
   - A clear decrease of the drop scale in construction;
   - A further improvement of the results of the economic situation research.

   At the same time, the data on the sold industrial output indicate that the economy in this sector has not turned to the boom phase yet. Moreover, the drop of wage dynamics - although favorable for future inflation - can contribute to the reduction of the growth pace of consumer demand.
3. The prudence in monetary policy is prompted by:
   - Uncertainty concerning the scale of the economic deficit of public finance sector in 2002 and 2003;
   - Uncertainty concerning the oil prices;
   - A drop of the dynamics of deposits placed by households;
   - Maintaining of a high dynamics of cash and the monetary aggregate M1.

   It should be also remembered that full results of interest rate cuts by 9.5 percentage points in total made since February 2001 have not been revealed yet.
4. Considering these arguments, the Monetary Policy Council decided to:
   - Cut the minimum yield on 28-day open market operations from 9.5% to 9%;
   - Cut the rediscount rate from 11% to 10.5%;
   - Cut the lombard rate from 12.5% to 12%;
   - Cut the deposit rate from 6.5% to 6%;
   - Maintain its neutral position in monetary policy.

VIII.

The next meeting of the Monetary Policy Council will be held on June 25-26.

Government and politics watch

- Government wants to change the foreign exchange regime in Poland...
- ...and asks President Kwaśniewski for help
- Possible earlier adopting the managed float regime similar to ERM2
- Modified Belka rule „inflation plus 2% plus epsilon”
- Samoobrona grows to second big political force

Battle on the zloty - never ending story

Finance minister Belka met NBP governor Leszek Balcerowicz and presented him government proposal to change the exchange rate regime. Official government proposal is not known, but few alternatives emerge from finance ministry officials' comments: (1) interventions to prevent zloty trading stronger than certain level; (2) trading band which leaves little room for nominal appreciation a and lot of room for nominal depreciation, band could be official or secret. We think that second option is the most likely proposal. What will be the MPC reaction? In statement after extra meeting on 16 May the MPC said:

- best solution for Poland would be to join EMU asap
- which calls for reduction of fiscal deficit
- if government wants to weaken zloty, it should buy foreign exchange used to service external debt on the market not from the central bank
- balancing the budget would also support an elimination of the trend of excessive zloty appreciation

MPC is looks at government proposal from two angles: (1) what would be the proposal impact on inflation, especially in 2003, (2) how does this proposal fit into MPC preferred strategy to join EMU as early as possible. From this point of view government proposal that we think is most likely (i.e. asymmetric band) cannot be accepted, as it would generate inflationary impulse.

In such case government and central bank lawyers will come to the battlefield. Stanislaw Gomulka, finance minister advisor stated very clearly, that in government view MPC has a right to give opinion of government proposed exchange rate strategy, but has no right to veto it. Andrzej Jakubiak, head of NBP legal department said the opposite that all exchange rate policy changes have to be accepted by the both sides of Swietokrzyska Street. Gomulka added that in case there is a legal dispute parliament would have to amend the NBP law to be more specific, and such law would have to be signed by President.

As we know, the Monetary Policy Council in fact did not accept government's proposal to change the foreign exchange rate policy and weaken the zloty. Nevertheless, the cabinet probably will not give up in efforts to implement changes. But ministers cannot force the central bank to intervene (although they cancelled the NBP governor's bodyguards). So the Prime Minister Leszek Miller asked the President Kwasniewski to call the Cabinet Council meeting. It will take place on 12 June and Miller wants to complain about the difficulties the government faces due to inadequate monetary policy and overvalued domestic currency. While the President keeps repeating that he would guard the Constitution and he will not support any of measures conflicting constitutional order or European legislation, it's worth to notice that he also considers Polish zloty to be heavily overvalued and monetary policy to be excessively restrictive. Therefore - while it seems clear that he will not back the motion to increase the MPC's headcount or to add some additional goals for monetary policy - President might be supportive for the solutions aimed at changing the FX regime into some kind of managed float. But to change the regime they would have to either convince the MPC to agree or change the NBP charter making the government the only responsible for setting the principles of exchange rate setting. MPC members have questioned the latter solution saying that it's against the Constitution, and if they have solid legal opinion against it, it could be impossible to implement.

So the scenario is as follows. First minister Belka tries to obtain the MPC nod to new exchange rate strategy leading to weaker zloty. If MPC does not accept this strategy then government will go ahead with changes anyway. However, government cannot send troops to the central bank to force it to intervene. So in such case parliament will probably amend the NBP law to make it clear that MPC has no power to veto such changes. President Kwasniewski will sign such amendment, which then is challenged by the NBP before the Constitutional Tribunal, but until Tribunal rules, NBP will have to intervene to fulfil the government exchange rate strategy. Brace for a turbulent ride.

Nevertheless we think that ultimately the first option is more likely, although the MPC claims now that present FX regime is the best for Polish economy at present. It's worth noticing that both the central bank and the finance ministry agree that Poland should enter the EMU as soon as possible, and that the most difficult period on this road would be the two years that the country must spend in ERM2 system. Most likely they would prefer to shorten the period since EU accession to EMU entry as much as possible. But how to skip those two years in ERM2? We think that one of the options could be to adopt some ERM2-

mimicking FX regime ahead of EU accession and then to negotiate with EU to recognise this pre-EU period of managed float as complying the currency stability criteria set in Maastricht treaty. It remains to be seen whether this is likely, but we won't be surprised seeing the compromise on the strategy of EMU entry between both sides of Swietokrzyska this summer with one of the building block being the agreement on ERM2-type managed float system adoption since 2003.

Why is government making all that noise about the zloty?

It is worth understanding why government is making all that noise about strong zloty. After all it reduces the cost of servicing foreign debt and allows for deeper rate cuts than otherwise, which in turn reduces the cost of servicing domestic debt. We see three reasons. One is exemplified by last government decision to nationalise the Szczecin shipyard. It appears that many enterprises which are in state hands and are not able to restructure fast enough, so strong zloty leads to losses and layoffs. Therefore weaker zloty would give these firms a breather and prevent further labour shedding, outcome highly desirable by the government before elections. Secondly, the unpleasant budget arithmetic suggests that Belka rule „inflation +1" will be seriously jeopardised next year, and in order to prevent vast increase of fiscal deficit government will need 'inflation surprise'. Finally, sharp increase of Samoobrona popularity ahead of Fall local elections (see below) will make it more difficult for ministers Belka and Hausner to go ahead with unpopular social spending cuts. And without deep fiscal reforms government needs short term growth stimulus to do well in elections and to put 2003 budget together. The price would come in a form of higher inflation in 2003, but inflation ranks low in politicians' priority list.

Modified Belka rule „inflation plus 2% plus epsilon"

Finance minister Marek Belka said that budget spending should not exceed PLN195bn next year. Because next year inflation is planned at 3% and this year budget spending at PLN185.1bn, simple arithmetic implies budget expenditures that next year will rise 2.3% above planned inflation. While we understand that minister Belka statement was only indicative, it suggests that Belka rule „inflation plus 1%" will not guide budget spending next year. Surprised? Not really, this year budgets spending will also be above Belka rule, actually one should propose a modified Belka rule „inflation plus 2% plus epsilon", when epsilon is a rising function of Samoobrona popularity.

While finance ministry officials do not release a single piece of news about next year budget legislative changes do go ahead. Rzeczpospolita informed about planned changes in pension indexation scheme. Pensions would be indexed to last year inflation not to the planned inflation. Additionally pensions would rise above inflation at the rate 0.2 times the real wage growth. We recall that Jaroslaw Bauc, finance minister in lost his job partly because he proposed to freeze pensions, so markets should carefully watch the reaction of PM Miller, after all there are 7.5m pensioners' votes and local elections are coming. The formal proposal will be presented today by labour minister Hausner.

Rzeczpospolita brought news about planned changes in the budget spending. We wrote yesterday about plans not to include EU aid in the limit of public spending. But it appears that the plans go further, and also the matching funds provided by Polish entities will not be included in the public spending limit. So now we not only have a modified Belka rule, but also an unspecified public spending above such defined limit. Of course these are still plans, but we are more and more concerned that fiscal policy will become non-transparent and totally unpredictable. We do not have any deficit target, we do not know what rule guides the budget spending, and we can only keep guessing what public spending will not be limited by already very flexible unspecified rule.

Samoobrona grows to second big political force

Recall recent Pentor opinion poll that showed SLD-UP popularity falling to 33% and Samoobrona support rising to 18%. Last week another poll confirmed that it was not a statistical blip. According to PBS ie elections were held in May SLD-UP would enjoy 35% popularity (down from 43 in March and 39 in April), Samobrona would come second with 17% (11 and 13 respectively). PO will be third with 13% support, followed by PSL with 9%, LPR with 9% and PiS with 8%. And Somoobrona has only started its aggressive election campaign, so the trend could be in place for some time, making Samoobrona second big political power in Poland. It is clear now why SLD wants growth revival as soon as possible.

Comments of the government members and politicians

This may be a surprise for many that the comments made by politicians in May were not focused primarily on the necessity to cut interest rates by the MPC. This was because the Government and the governing coalition found a new life belt for the Polish economy - i.e. the PLN depreciation. Unfortunately, as is the case with the interest rates, the Government cannot make the decision on the exchange rate on its own. Therefore, similarly to previous months, politicians addressed their requests and threats to the Monetary Policy Council. Meanwhile, it should be noted that there was little information on the draft budget for the next year, although it was May every year that this issue was broadly discussed. Thus, it seems that the anonymous representative of the Ministry of Finance quoted by us was right talking about the difficulties with the limitation of the next year's deficit.

WHO? WHERE? WHEN?	QUOTE
Andrzej Raczko, deputy finance minister;	
Puls Biznesu, 6 May	„The faster the better rule still holds [regarding Poland's EMU entry]. There is no difference in this regard between NBP and finance ministry.... Both sides agree that if we join Eurozone fast it would be profitable for both sides."
	„Inflation criterion and public debt criterion seem to be within reach, but the question of long-term interest rates and budget deficit remains."
	„Foreign exchange [ahead of EMU entry] has to be set at the level that would enable stable economic development. We know that from long-term perspective, considering present current account deficit, zloty is overvalued at the moment. [...] Poland should devalue zloty ahead of ERM2 entry. [...] But the scale of devaluation should be considered thoroughly."
	„If we make it in time, Polish Yankee bonds issue could take place at the end of 1H02. [...] More or less the amount offered would be close to the amount mentioned in 2002 budget bill. It is US$800m."
	„I would not rule out the Japanese bond issue definitely. [...] Obviously the long-term goal is also to be present on Japanese market."
	„We don't rule out that in case of favourable conditions the next 20-year bonds issue would take place earlier than in autumn. [...] We want it to be the benchmark bond. [...] If market accepts the product, then we should keep selling it."
Marek Belka, deputy PM, finance minister;	
PAP, Reuters, 8 May	„The strong zloty is a 'curse' on the national economy."
	„The government should be prepared to take the initiative on foreign exchange policy...I am in favour of opening discussion with the central bank on possible alternatives."
	„I have already once hinted at possible devaluation. So far, there was no regular discussion on this with the Monetary Policy Council (MPC). We should put more emphasis on foreign exchange targeting."
	„The free float is the best protection against currency crisis but it also produces an environment in which excessive appreciation is possible. However I am against a fixed exchange rate regime."
	„I am deeply critical of the the wrong, misdirected policies of the national bank. The central bank hampered Poland's drive to catch up with the richer EU by aggressively targeting only one area of economic convergence, namely inflation."
Gazeta Wyborcza, 9 May	„Both NBP and MPC know that between hard peg and free float there are intermediate solutions that function in many countries. Many national banks resort to different types of market interventions. In Poland it is said that such intervention would be too costly now, but the overly strong zloty is even more costly. Governor Balcerowicz and my MPC colleagues think that zloty is too strong, but at the same time say that nothing can be done. So I am asking them: have you tried? We do not know if intervention is ineffective unless you try. I started the discussion on this topic because initiative on exchange rate policy is on government side. At the same time exchange rate policy requires joint action of the government and the central bank as required by Polish law".
PAP, Reuters, 10 May	„The decline in the zloty to roughly to 4.25 to the dollar would be safe and would aid exporters."
	„Monetary policy is a very strong factor, which impacts the zloty, because it determines short-term cash flows."
	„If on this issue (interest rates), the MPC does not see any room for manoeuvre, there exists a possibility of a return to the broader question of currency regimes, or (conducting) exchange rate policy within the framework of the current regime."
	„Without such talks with the central bank, this is not a possibility."
PAP, Reuters, 14 May	„The government asked finance ministry to propose changes to the rules of setting foreign exchange rate and to submit those changes to MPC. The proposals would be aimed at giving up the non-intervention rule and adopting the strategy of managing exchange rate to prevent excessive appreciation."
	„Under Polish law changes in foreign exchange policy would require the approval of the central bank. [...] There are a lot of options, and that will be the topic of our talks with the central bank."
	„Exchange rate policy does not have to be publicly announced, to keep the (financial) market guessing. [...] It could be for example secret band, if market would have to guess, the foreign exchange risk would increse."
	„I think that returning to crawling peg system would be inappropriate."
Reuters, 15 May	„The fact is that the public credibility of the Monetary Policy Council is now non-existent -- I share this view. I don't think you are credible if you simply stick to an over-restrictive monetary policy".
	„We cannot ignore the fact that the economy faces deep problems. Poland is on a steep disinflationary path. So I appeal to the MPC to redefine their strategy".
	„It has been premature to switch to direct inflation targeting as the sole pillar of monetary policy".
	„Devaluation is not an issue for the short-term, even though it is a viable option by the time Poland enters ERM-2 mechanism".
	„One (issue) is the short term...The other is what should be our strategy to the EU and Monetary Union and here the issues are different though not totally isolated. I think we can think of a system now that could bring us closer to the ERM-2."
	„All other things being equal, it is in the interest of Poland to enter ERM-2 and then the euro with a low zloty exchange rate...I could even imagine that our EU partners might advise an up-front devaluation".
	„I keep fingers crossed for a strengthening of the euro and I will be comfortable with a zloty worth four to the euro assuming the euro regained parity with the dollar".
Gazeta Wyborcza, 20 May	Q: „Can you reveal something about next year budget?"
	A: „Not yet. I can only say that we are still few billion above the assumed spending limit. But the situation is much better that in the Fall last year. I do not share the opinion of those who say that this year there will be dramatic difficulties, which so far have been hidden".
Radio Zet, 23 May	„Zloty depreciation by 15% would be too much. It would be dangerous both from inflationary point of view and from the perspective of those companies and households that have dollar and euro denominated debt."
	„Government has not made a proposal to the central bank to fix the exchange rate. We made a different proposal because fixing would be too dangerous".
PAP, 27 May	„[Budget] expenditures [in 2003] will be lower [than PLN195bn]; it depends on the inflation and on how 2002 expenditures will be executed."
	„Stripping MPC out of their competence is against the Constitution."
	„Latest comments from Leszek Balcerowicz suggests that they might to change the inflation target. I will have to ask him about it."
Radio Zet, 29 May	„It was good meeting, based on merits. Nevertheless it has not produced any spectacular results in a sense that MPC remains at the position that present FX policy system should be maintained."
	„On the other hand the government did not support MPC's proposition regarding finance minister's intervention on the FX market."
	„We've decided to meet regularly."
	„We've started the discussion on the exchange rate policy in a context of European integration."

Leszek Miller, prime minister,	
PAP, Reuters, 8 May	„Although we will experience the improvement of situation in our wallets mostly next year, already today we can look into the future with greater optimism.” „We entered the path of public finance balancing and recovering it from the depression.” „The conditions arise for wage de-freezing in public sector and for indexation of pensions that would grow only slightly this year.” „The government expects more decisive easing of interest rates and bringing the zloty to a more realistic level, and a more active central bank role.” „The overvalued zloty hurts Polish exporters. There should be close cooperation between the central bank and the government on this issue.”
Reuters, 13 May	„I agree with Finance Minister Marek Belka that the zloty should be at 4.25-4.30. The zloty is too strong and monetary policy is not good for the economy.”
Radio Zet, Reuters, 19 May	„If our last attempt (to make the central bank weaken the zloty) does not meet with a positive reaction and the MPC remains deaf to entrepreneurs' calls, then there will be no other solution but to increase the number of MPC members”. „A change to the central bank's charter is certain. I think that the parliamentary committee will try to prepare one project out of all proposals”.
Jacek Piechota, economy minister;	
PAP, 5 May	„According to various estimates it is said that today zloty is overvalued by some 20%. Ministry alerts the MPC and NBP that zloty overvaluation threatens profitability of Polish exports. Policy undertaken by the MPC encourages financial investors to place their money in Poland, which leads to zloty appreciation, killing our exports.”
Aleksander Kwasniewski, president;	
PAP, 8 May	„NBP should act to weaken the zloty that is too strong, harming exporters.” „I will talk to Leszek Balcerowicz about zloty exchange rate. I am for using economic, not political instruments in that matter.” „Polish exporters are at the margin of profitability at the moment. Strong zloty could be the most difficult obstacle for them.” „MPC conducts its policy in such a way that some indicators are welcome with pleasure, like for example inflation, but overvalued zloty remains a serious concern.” „MPC lowers the rates but not very deeply. Nevertheless the progress is in the right direction. Although latest reductions are considerable, there is still the field for manoeuvre. I believe that MPC would undertake correct actions after appropriate analysis. Though they should be more pronounced and more supportive for Polish exports.”
Anonymous finance ministry official;	
PAP, 9 May	„It will be difficult to reduce nominal budget deficit next year. Lowering the deficit would require lowering the debt. It's hard to count on early foreign debt repayment this year, as it was the case with Brazilian debt. Lowering the debt could only be made by its rolling.”
Witold Orlowski, President's advisor;	
PAP, Radio ZET, 13 May	„I think that government should work out it stance on what should be done with the exchange rate and inform the MPC. According to regulations government can and should come up with such initiative and should react depending on the MPC response”. „Central bank thinks that it is the only institution which has a right to decide about the exchange rate regime. This against the law and has nothing to do with the central bank independence. This is about the interpretation of the law, and such interpretations takes away from the government evident right to decide on the exchange rate strategy”. „Our situation would be better if zloty traded at 4.30 not 4.0 against the dollar”.
TVN, 23 May	„I don't know what the President would do. I will advise him to ask Constitutional Court for the consistency [of NBP charter amendment] with the Constitution.”
Reuters, 24 May	„All proposals should be considered. Whether it is only the government or the central bank that decides foreign exchange policy is a matter of argument. [...] In various countries we have various solutions on this matter.” „But it is absolutely obvious we cannot have a situation in which forex policy belongs to no one.”
Stanislaw Gomulka, finance minister's advisor;	
Gazeta Wyborcza, 17 May	„Government's competence is setting exchange rate policy. The proposals are submitted to MPC for consultation. MPC makes some remarks, and the government can consider it. But it decides on exchange rate policy on its own.” „[Government] is determined to implement its proposals. If MPC interprets this fragment of NBP charter differently, then we will have legal conflict. The government and the parliament would have to consider this. Perhaps the parliament would have to make this part of the NBP charter more precise.” „If NBP limited the scale of open market operations, then inflation target would be met and zloty would be weaker.” „Obviously [it could lead to inflation growth], but MPC has inflationary reserve, because it undershoot its target.”
Jarosław Kalinowski deputy PM, agriculture minister;	
PR3, 23 May	„I support even deeper changes. [...] Government should have a legal mandate to more offensively influence the exchange rate. Now the law says that government does it in co-operation with MPC. It would be good if we managed to change it in the Parliament into - MPC has a right to give opinion on”. „It cannot be that a group of few people, locked in the ivory tower, pretends they do not see what is happening in the economy”.
Marek Borowski, Sejm Speaker;	
PR1, 24 May	„Of course the relationship between NBP and the government could be specified differently, for example exchange rate policy could be specified differently, also target could be specified somewhat differently, or means through which NBP supports government policy. There are some possibilities”. „NBP law is not written on stone tablets, which cannot be touched, but one has to move with a great caution, no question about it.”
Marek Pol, deputy PM;	
PiG, 27 May	„We think that MPC is rather monotonous in their economic views. I think that larger group of people, and so the wider spectrum of economic concepts would enrich the MPC.”
Dariusz Szymczycha, advisor to president;	
PAP, Reuters, 29 May	„President will defend NBP's independence.” „President can veto NBP charter amendment or send it to Constitutional Court.” „President's veto could e unnecessary because he has probably managed to convince PM Miller not to support deputies' motion.”
Marek Wagner, head of PM's office;	
Gazeta Wyborcza, 3 Jun	„This is the end of the wage freezing in budget sphere. There must be a wage indexation, we don't say it must be already in March, but it will take place. There will be money for pensioners as well, because their benefits increased very little this year. This is why we want to carry over the pensions indexation in March and to take into account not only inflation but also wage growth.”

Market monitor

- PLN impacted by the dispute on the exchange rate regime
- Yield curve has dived substantially
- Market already responds to subsequent interest rate cuts
- Substantial interest in the bonds auction

Deviation of the zloty from the parity

Source: BZ WBK

PLN impacted by the dispute on the exchange rate regime

Last month PLN exchange rate was impacted by the dispute between the Government and the central bank related to the exchange rate regime in Poland. As at the end of April EURO/PLN rate was less than 3.60, and on 7 May USD/ PLN rate was only 3.95. Later on, however, the effects of the politicians' pressure on PLN depreciation started to bring effects. This was related to the growing market uncertainty in respect of the potential Government's actions which was going to change the policy of exchange rate from free float to managed float. As a result, PLN weakened substantially and on 17 May USD/PLN rate was 4.13 and EURO/PLN was 3.78. Then, PLN was the weakest against the FX parity - the departure was 8.6% at the stronger end against 12.3% as at the end of April. After the April significantly poor industrial output data published by the CSO on 20 May, investors believed in the subsequent interest rate cut to be effected soon by the MPC, which resulted in purchasing securities and PLN appreciation. There again appeared the PLN appreciation tendency. At the beginning of June the departure from the parity was 9.5% and stabilised at this level. EURO strengthened against USD on the global markets exceeding the level of 94 cents in the first week of June. As a result, PLN being stable against EURO (ca. EUR/PLN 3.75-3.80) strengthened gradually against USD and on 6 June the rate was 4.01.

Zloty fx rate

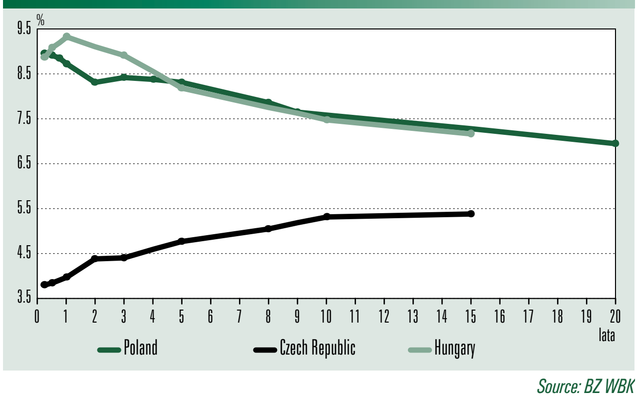
Source: BZ WBK

Yield curve has dived substantially

Already after the publishing the industrial output data there was a substantial decrease in the securities yield along the entire curve (i.e. by several base points). Another dive of 20-30bp resulted from the interest rate cut by the MPC. This, however, was not the end for it as the market almost immediately started to leverage subsequent cuts in the near future. A particularly strong impulse turned out to be a substantial decrease in food prices in May. It resulted in the yield dive from several to 20bp over one afternoon. Moreover, some impact was put by the unsatisfied demand after the bonds auction. Over the last month the yield dived on average by 60-70bp along the entire curve. The most substantial decrease was recorded by 2 year bonds - down by 80bp, while at the long end the decreases were milder: DS1110 securities yield decreased by 45bp, and 20 year bonds went down by 20bp.

In Poland and Hungary the main interest rate has been recently set at the same level of 9%. As the graph shows, in the shorter terms the Polish yield curve currently is substantially lower than the Hungarian one: in the 1 year sector the difference is 60bp and in the 3 year sector it is 50bp. In the longer terms the yield curves are similar. Both in Poland and in Hungary the yield curves disclose a negative bend, which represents the investors' expectations in respect of the further interest rate cuts. In the Czech Republic the curve is normal (i.e. growing) and

Yield curve



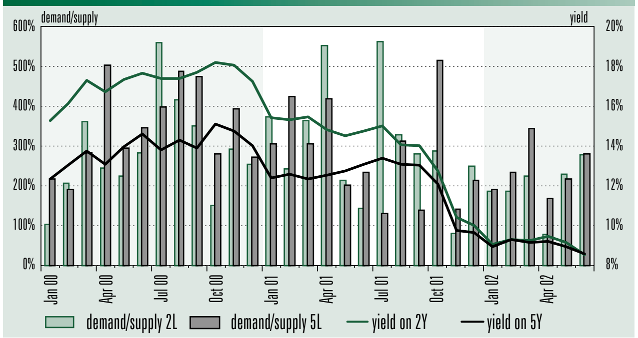
Source: BZ WBK

the entire curve goes above the level of 3.75% appointed by the main interest rate .

High demand on T-bond auction

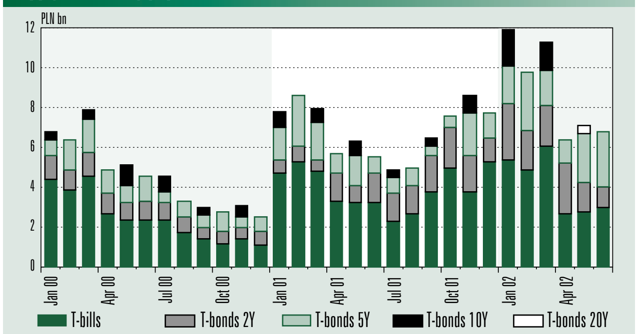
During the auction held on 5 June the finance ministry sold all offered bonds: PLN1.0bn of 2-year (OK0404) and PLN2.8bn of 5-year papers (PS0507). Investors' demand was high - it exceeded PLN 10.5bn like in February and March this year, reaching PLN10.623bn. Despite the offer was quite different in both cases, demand on 2- and 5-year T-bonds was 2.8 times bigger than the supply for both kind of papers. It was obvious that after interest rate cut made by the MPC in May, the yields will be lower than previous month. It happened, but much lower supply of 2-year papers caused that its yields fell more (by 60 bps) than yields on 5-year bonds (by 36 bps). As a result, average yield on 2-year bonds was 5 bps lower than on 5-year papers.

Demand/supply ratio and yields on 2Y and 5Y T-bonds



Source: BZ WBK

Supply of treasury papers



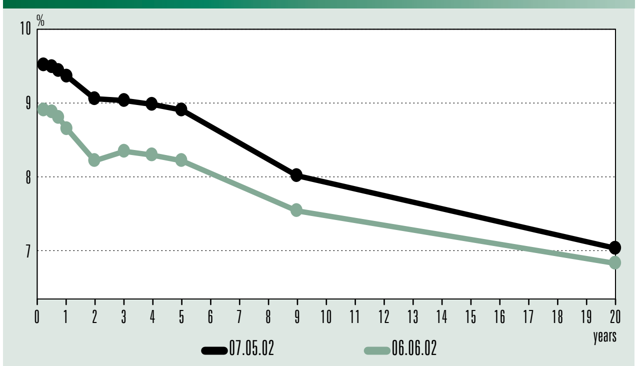
Source: Finance Ministry

T-bill auctions in April and May 2002 (PLN m)

Date of auction	OFFER (SALE)			
	13-week	26-week	52-week	sume
06.05.2002	100 (100)	–	600 (599,86)	700 (699,86)
13.05.2002	–	–	600 (600)	600 (600)
20.05.2002	–	–	700 (700)	700 (700)
27.05.2002	–	–	800 (800)	800 (700)
Total	**100 (100)**	**–**	**2700 (2699,86)**	**2800 (2799,86)**
03.06.2002	–	–	600 (600)	600 (600)
10.06.2002	–	–	500 (500)	500 (500)
17.06.2002	–	–	900	900
24.06.2002	100	–	900	1000
Total	**100 (100)**	**–**	**2900**	**3000**

Source: Finance Ministry

Yield curve



Source: BZ WBK

T-bond auctions in 2002

month	1st auction							2nd auction			
	date	T-bonds	offer (PLN m)	sale (PLN m)	T-bonds	offer (PLN m)	sale (PLN m)	date	T-bonds	offer (PLN m)	sale (PLN m)
January	09.01	OK1203	2 800	2 800	PS1106	1 900	1 900	16.01	DS1110	1 800	1 800
February	06.02	OK1203	2 000	2 000	PS1106	2 900	2 900	13.02	DZ0811	500	495,5
March	06.03	OK1203	2 000	2 000	PS1106	1 800	1 800	20.03	DS1110	1 400	1 400
April	03.04	OK0404	2 500	1756,5	PS1106	1 200	1 200	10.04	WS0922	400	400
May	08.05	OK0404	1 500	1 500	PS0507	2 400	2 400	–	–	–	–
June	05.06	OK0404	1 000	1 000	PS0507	2 800	2 800	–		–	–
July	03.07	OK0404	–	–		–	–	17.07	DS1110	–	–
August	07.08	OK0804	–	–	PS0507	–	–	–	–	–	–
September	04.09	OK0804	–	–	PS0507	–	–	18.09	DS1110	–	–
October	02.10	OK0804	–	–	PS0507	–	–	–	–	–	–
November	06.11	OK0804	–	–	PS1107	–	–	20.11	DS1112	–	–
December	04.12	OK1204	–	–				–	–	–	–

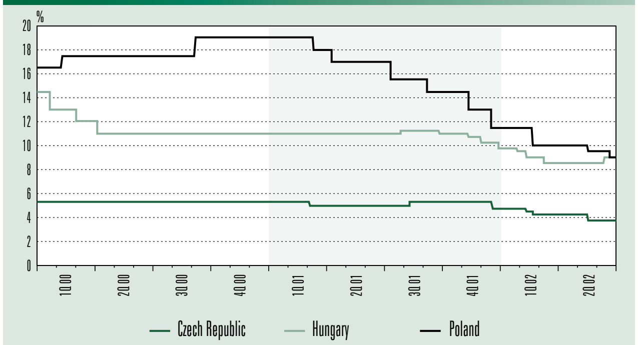
Source: Finance Ministry

International review

- Interest rates in Hungary at the same level like in Poland
- Inflation in the Eurozone reached 2% - the ECB target's ceiling
- Activity indicators rose in both US and Eurozone

In May the central bank of Hungary raised its main interest rate by 50 bps to 9.0%. The increase came as a result of growing risk of inflation surge after wage growth acceleration, fuel price hikes and loose fiscal policy. The decision surprised the market that expected central bank to wait for more transparent inflationary outlook. This way interest rates in Hungary are at the same level like in Poland. The main interest rate in Czech Republic is much lower amounting to 3.75%.

Central European interest rates



Source: Reuters

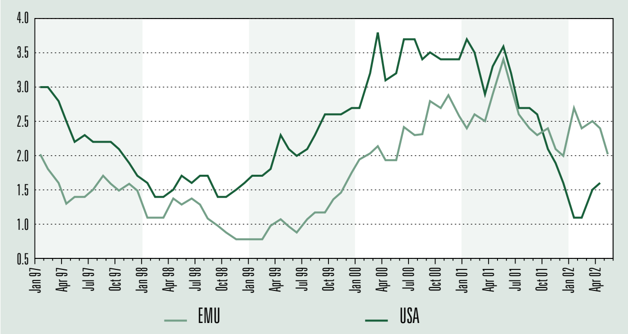
In April Eurozone inflation declined to 2.4% YoY from 2.5% recorded in March. The figure was much worse than suggested by preliminary estimates (2.2%). On a monthly basis price index increased 0.5% while early estimates pointed to 0.3% MoM. The highest inflation among EU-15 countries recorded in Ireland (5.0% YoY) and the lowest was in Germany and Austria (1.6%). Additionally Eurostat released its estimate of euro launch on price growth in Eurozone, suggesting that in 1Q02 the operation added up 0.16 percentage point to headline inflation rate.

Inflation in the eurozone decreased to 2.0% in May from 2.4% in April. The fall was deeper than expected - market consensus pointed to 2.1%. CPI indicator reached ceiling of the European Central Bank's inflation target.

In Germany estimates of May inflation rate have been released, showing 0.1% MoM and 1.2% YoY growth. It would mean quite substantial decline from 1.6% YoY recorded in April, while market expected 1.4% YoY. Germany has still the lowest inflation rate in whole Eurozone.

In April US inflation reached 0.5%MoM, slightly above market consensus, after 0.3% in March. Inflation indicator calculated in YoY terms increased to 1.6% from 1.5% in March. Core inflation (excluding energy and food) amounted to 0.3%MoM.

Inflation YoY



Source: Reuters

Preliminary figures for US GDP growth in 1Q02 proved to be the highest for last two years, though somehow weaker than earlier estimates and market expectations. GDP increased 5.6% QoQ, while earlier preliminary estimate pointed to 5.8% and analysts expected 6%. Downward revision was caused by lower growth of consumption expenditures and deeper decline of investments.

GDP growth in the euro zone amounted to 0.2% QoQ and 0.1% YoY in 1Q2002.

French GDP increased 0.4% QoQ in 1Q02. The figures for 4Q01 have been revised down from -0.3% QoQ to -0.4%. The results for the first quarter suggest that French economy expanded faster than other two major EU-15 economies, i.e. Germany and Italy.

GDP growth in Germany reached 0.2% QoQ and -1.2% YoY in 1Q02. Growth on a quarterly basis, after two consecutive quarters of decline, was driven mainly by strong export performance (1.9% QoQ compared to -1.1% recorded in previous quarter), so the recovery resulted from stronger foreign demand.

Eurozone industrial production increased 0.5% MoM, faster than market expected (0.1%). On annual basis 2.9% decline was recorded, in line with consensus forecasts.

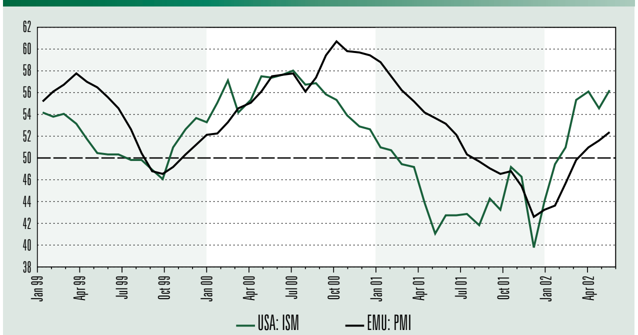
Industrial output in US rose 0.4%MoM and was equal to consensus. Capacity utilisation increased to 75.5% in comparison with 75.3% in previous month.

US retail sales increased 1.2% MoM. It was the highest growth since October 2001, much stronger than 0.7% expected by the market. Data release was followed by temporary US dollar appreciation against euro. Dollar was depreciating in recent weeks amid concerns over the sustainability of US economic recovery. These figures might signal that such concerns were unfounded, and that the probability of Fed's interest rate hike in the near term increases.

German IFO rose in May to 91.5 points from 90.5 in April, and was well above 90.6 points expected by the markets. May data confirmed that recovery was coming and that April slippage was probably a short-term departure from the trend.

PMI index reflecting business activity in Eurozone manufacturing sector increased to 51.5 in May from 50.7 in April, in line with market expectations. The index firmed above the level of 50 that constitutes the frontier between economic development and recession. PMI index for Germany - the Eurozone's biggest economy - increased to 49.8 from 49.1 last month, also in line with expectations. Apparently German industry still only approaches the breakpoint level. Analogous index for US economy called ISM surged in May to 55.7 from 53.9 last month, much stronger than expected 54.1.

Activity indicators



Source: Reuters

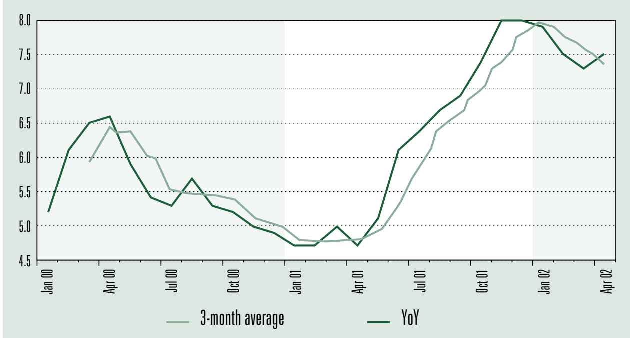
Governors of 10 biggest world central banks that participate in a meeting in Basel issued a special statement that said that both US and EU must have already passed the bottom of economic cycle and the signals of recovery are clear. In central bankers' view inflation remains under control in two biggest world economies.

US consumer sentiment index calculated by the University of Michigan rose to 96.9 points in May from 96 in April.

ECB President Wim Duisenberg said in his testimony before Economic and Monetary Affairs Committee that ECB is convinced that Eurozone has already entered the recovery phase. However it's still too early to assess how strong the trend is, which introduces additional uncertainty into bank's inflation forecasts. Duisenberg stressed that inflation exceeds ECB expectations, remaining above 2% target level for 23 months. He also suggested that the bank might hike interest rates pretty soon.

Broad money supply growth in the eurozone accelerated unexpectedly to 7.5% in April from 7.3% in March, while another decline to 7.1% was forecasted. 3-month average level went down from 7.6% to 7.4%, but it is still much higher than set by the ECB reference level of 4.5% (such growth of money supply does not lead to rise in inflationary pressure). ECB stated that April money supply growth resulted from uncertain economic situation world-wide. These data give an argument for restrictive monetary policy. However, they should not significantly influence the ECB's decision on interest rates yet and most probably the rates will remain unchanged in the near time.

M3 money supply



Source: Reuters

In April US consumers' spending grew 0.5% MoM and their income increased by 0.3% MoM, while markets expected 0.7% and 0.3% respectively. Consumers' confidence index reached 109.8 in May, growing quite strong from 108.5 in April (market expected 109).

What's hot this month

Monday	*Tuesday*	*Wednesday*	*Thursday*	*Friday*
3 June POL: T-bill auction (PLN 600m) *EMU: Producer prices (Apr)* *EMU: PMI (May)* *USA: ISM (May)*	**4** *EMU: Unemployment (Apr)* *EMU: Business climate (May)* *EMU: Economic sentiment (May)*	**5** POL: T-bond auction OK0404 & PS 0507 (PLN 1.0 and 2.8bn)	**6** POL: Food prices (2H May) *GER: Industrial orders (Apr)* *EMU: ECB meeting*	**7** *GER: Unemployment (May)* *USA: Unemployment (May)*
10 POL: T-bill auction (PLN 500m) *ITA: GDP (1Q)*	**11** *GER: Industrial output (Apr)*	**12** *FRA: Inflation preliminary (May)*	**13** *FRA: Industrial output (Apr)* *USA: Producer prices (May)*	**14** POL: Money supply (May) *ITA: Industrial output (Apr)*
17 POL: T-bill auction (PLN 900m) POL: Inflation (May) POL: Budget deficit (May) *ITA: Inflation final (May)*	**18** POL: Wages & employment (May) *EMU: Inflation final (May)* *USA: Inflation (May)*	**19** POL: Industrial output (May) POL: Producer prices (May) POL: Business climate (Jun) *EMU: Industrial output (Apr)*	**20** *EMU: Foreign trade (Apr)* *USA: Foreign trade (Apr)*	**21** POL: GDP (1Q) POL: Unemployment (Apr)
24 POL: T-bill auction (PLN 1bn)	**25** POL: MPC meeting *FRA: Inflation final (May)* *USA: Fed meeting*	**26** POL: MPC meeting (decision) *USA: Fed meeting (decision)*	**27** POL: Food prices (1H Jun) *EMU: Money supply (May)* *USA: GDP (1Q)*	**28** POL: Balance of payment (May) ITA: Inflation preliminary (Jun)
1 July POL: T-bill auction *EMU: Retail sales (Apr)* *EMU: PMI (Jun)* *USA: ISM (Jun)*	**2** *EMU: Unemployment (May)* *EMU: Business climate (Jun)* *EMU: Economic sentiment (Jun)*	**3** *EMU: Producer prices (May)*	**4** *GER: Industrial orders (May)*	**5** *FRA: GDP (1Q)* *USA: Unemployment (Jun)*

Source: CSO, NBP, Finance Ministry, Reuters

Data release calendar

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
MPC meeting	29-30	26-27	26-27	24-25	28-29	25-26	30-31[a]	27-28[a]	24-25[a]	29-30[a]	26-27[a]	17-18[a]
CPI	15	15[b]	15[c]	15	15	17	15	16 lub 19	16	15	15	16
PPI	18	19	18	18	20	19	17	20	18	17	20	18
Industrial output	18	19	18	18	20	19	17	20	18	17	20	18
Gross wages, employment	15	14	14	15	17	18	12	14	13	14	18	13
Trade	About 50 working days after reported period											
Balance of payments	31	28	28	30	29	28	31	30	30	-	-	-
Money supply	14	14	14	12	14	14	12	14	13	-	-	-
NBP balance sheet	7	7	7	5	7	7	5	7	6	-	-	-
Business climate indices	7[d] & 22[e]	20	20	18	21	19	18	22	19	18	21	19
Food prices, 1-15	-	8[e] & 27[f]	27	26	27	27	26	27	27	25	27	30
Food prices, 16-30	3	8	8	5	7	6	5	6	6	7	6	6

a) according to the preliminary schedule, b) preliminary data, c) final data (January, February), d) December 01, e) January 02, f) February 02

Source: CSO, NBP

Monthly indicators

		Apr 01	May 01	Jun 01	Jul 01	Aug 01	Sep 01	Oct 01	Nov 01	Dec 01	Jan 02	Feb 02	Mar 02	Apr 02	May 02 forecast	Jun 02 forecast
GDP	% YoY	x	x	0,9	x	x	0,8	x	x	0,2	x	x	1,5	x	x	1,0
Industrial output	% YoY	3,8	-0,4	-4,7	1,5	0,9	-3,7	1,8	-1,0	-4,8	-1,4	0,2	-3,1	0.2	-3,1	1,0
Retail sales***	% YoY	1,9	4,3	0,2	1,5	3,0	1,3	5,8	2,4	2,4	4,7	6,7	9,9	3,1	x	x
Unemployment rate	%	16,0	15,9	15,9	16,0	16,2	16,3	16,4	16,8	17,4	18,0	18,1	18,1	17,8	17,5	17,5
Gross wages**	% YoY	5,2	8,8	4,9	8,0	6,9	6,2	7,8	6,6	5,3	5,7	5,5	4,8	2,3	2,4	4,1
Exports (acc. to NBP)	USDm	2 559	2 472	2 477	2 556	2 616	2 287	2 778	2 555	2 540	2 308	2141	2 467	2 800	2 660	2 740
Imports (acc. to NBP)	USDm	3 269	3 638	3 379	3 382	3 635	3 176	3 953	3 509	3 430	3 418	2 952	3 148	3 525	3 490	3 594
Trade balance (acc. to NBP)	USDm	-710	-1 166	-902	-826	-1 019	-889	-1 175	-954	-890	-1 110	-811	-681	-725	-830	-855
Current account	USDm	-520	-737	-948	-287	-354	-304	-838	-417	-500	-847	-820	-612	-806	-420	-725
Budget deficit	PLN bn	-18,4	-20,4	-18,7	-19,4	-21,0	-21,8	-24,6	-27,7	-32,6	-6,9	-13,7	-16,4	-20,0	-24,0	-26,0
Inflation (CPI)	% YoY	6,6	6,9	6,2	5,2	5,1	4,3	4,0	3,6	3,6	3,4	3,5	3,3	3,0	2,0	2,0
Producer prices (PPI)	% YoY	3,4	2,3	0,9	0,6	1,0	0,7	-0,5	-1,0	-0,3	0,0	0,2	0,3	0,4	0,4	0,1
Money supply	% YoY	13,4	12,8	7,5	12,4	13,4	12,3	11,0	7,2	8,7	7,3	6,7	3,5	3,4	–	–
Deposits	% YoY	15,4	14,6	8,6	14,0	14,9	13,3	11,5	7,0	8,3	6,4	5,5	2,0	1,7	–	–
Credits	% YoY	12,2	10,9	4,8	11,5	11,8	11,5	9,7	8,9	9,3	9,0	8,8	7,1	6,4	–	–
USD/PLN	PLN	4,02	3,98	3,97	4,19	4,25	4,22	4,13	4,09	4,01	4,06	4,19	4,14	4,06	4,05	4,03
EUR/PLN	PLN	3,59	3,49	3,39	3,60	3,82	3,85	3,74	3,64	3,58	3,59	3,64	3,63	3,59	3,71	3,79
Intervention rate*	%	17,00	17,00	15,50	15,50	14,50	14,50	13,00	11,50	11,50	10,00	10,00	10,00	9,50	9,00	8,50
WIBOR 3M	%	17,17	17,22	16,88	16,01	15,35	14,73	14,01	13,91	12,29	11,04	10,60	10,32	10,20	9,88	9,30
Lombard rate*	%	21,00	21,00	19,50	19,50	18,50	18,50	17,00	15,50	15,50	13,50	13,50	13,50	12,50	12,00	11,50
Yield on 52-week T-bills	%	15,80	15,67	15,61	15,38	14,61	14,01	12,64	11,80	10,66	9,62	9,68	9,62	9,56	9,29	8,60
Yield on 2-year T-bonds	%	14,59	14,92	15,22	15,13	14,40	13,57	11,36	11,00	10,70	9,11	9,37	9,32	9,22	8,95	8,40
Yield on 5-year T-bonds	%	13,47	13,38	13,29	13,85	13,50	12,92	11,32	10,13	9,91	8,91	9,26	9,11	9,02	8,78	8,35
Yield on 10-year T-bonds	%	10,61	11,30	11,74	11,87	11,97	11,57	10,31	9,19	8,92	8,25	8,34	8,25	8,19	8,02	7,70

** at the end of period ** in corporate sector *** nominal*

Source: CSO, NBP, BZ WBK

Quarterly and yearly

		1998	1999	2000	2001	2002 forecast	2003 forecast	1 kw. 01	2 kw. 01	3 kw. 01	4 kw. 01	1 kw. 02	2 kw. 02 forecast	3 kw. 02 forecast
GDP	PLN bn	553.6	615.1	685.0	721.6	770.0	830.0	165.4	176.5	179.6	200.0	170.0	184.3	194.1
GDP	% YoY	4.8	4.1	4.0	1.0	1.9	3.5	2.3	0.9	0.8	0.2	1.5	1.0	1.5
Industrial output	% YoY	3.5	3.6	6.8	-0.2	2.5	3.4	4.5	-0.7	-0.8	-2.6	-1.6	-0.6	4.8
Real retail sales	% YoY	2.6	4.0	1.0	0.4	x	x	-3.1	-0.2	1.2	3.7	5.8	x	x
Unemployment rate*	%	10.4	13.1	15.1	17.4	19.0	19.0	16.1	15.9	16.3	17.4	18.1	17.5	18.2
Real gross wage	% YoY	3.3	4.7	1.0	3.3	0.7	1.5	2.5	.0.8	2.5	1.3	2.1	1.0	-0.5
Exports (acc. to NBP)	USDm	30 122	26 347	28 256	30 276	32 542	34 000	7 436	7 508	7 459	7 873	6 916	8 200	7 999
Imports (acc. to NBP)	USDm	43 842	40 727	41 424	41 955	44 104	47 000	10 584	10 286	10 193	10 892	9 518	10 609	11 369
Trade balance (acc. to NBP)	USDm	-13 720	-14 380	-13 168	-11 679	-11 562	-13 000	-3 148	-2 778	-2 734	-3 019	-2 602	-2 409	-3 370
Current account	USD	-6 862	-11 558	-9 946	-7 075	-9 159	-9 150	-2 170	-2 205	-945	-1 755	-2 279	-1 950	-2 529
Current account	% PKB	-4.3	-7.4	-6.3	-4.0	-4.9	-4.4	-4.9	-5.2	-4.2	-4.0	-4.1	-3.9	-4.6
Budget deficit*	PLN bn	-13.2	-12.5	-15.4	-32.6	-40.0	-42.0	-15.0	-18.8	-21.9	-32.6	-16.4	-26.0	x
Budget deficit*	% PKB	-2.4	-2.0	-2.2	-4.5	-5.2	-5.1	-9.1	-2.2	-1.7	-5.3	-9.7	-5.2	x
Inflation	% YoY	11.8	7.3	10.1	5.5	2.9	4.0	6.7	6.6	4.9	3.8	3.4	2.3	2.5
Inflation*	% YoY	8.6	9.8	8.5	3.6	3.9	4.0	6.2	6.2	4.3	3.7	3.3	2.0	3.0
Producer prices	% YoY	7.3	5.7	7.8	1.6	0.9	2.5	4.2	2.2	0.8	-0.6	0.2	0.6	0.8
Money supply	% YoY	25.3	24.6	15.2	11.9	–	–	14.7	11.8	14.1	12.9	5.8	–	–
Deposits	% YoY	28.4	26.4	17.2	13.2	–	–	17.1	13.6	15.7	13.3	4.6	–	–
Credits	% YoY	30.0	28.6	24.7	11.3	–	–	15.4	9.7	11.3	8.1	8.3	–	–
USD/PLN	PLN	3.4937	3.9675	4.3465	4.0939	4.09	4.02	4.0876	3.9895	4.2168	4.0805	4.1303	4.05	4.04
EUR/PLN	PLN	3.9231	4.2270	4.0110	3.6685	3.76	3.96	3.7765	3.4884	3.7551	3.6549	3.6199	3.70	3.81
Intervention rate*	%	15.50	16.50	19.00	11.50	8.00	8.00	18.00	15.50	14.50	11.50	10.00	8.50	8.00
WIBOR 3M	%	21.34	14.73	18.78	16.08	9.40	8.40	18.53	17.09	15.37	13.45	10.65	9.79	8.67
Lombard rate*	%	20.00	20.50	23.00	15.50	11.00	11.00	22.00	19.50	18.50	15.50	13.50	11.50	11.00
Yield on 52-week T-bills	%	18.59	12.95	17.77	14.77	8.81	8.20	17.02	15.70	14.67	11.72	9.64	9.10	8.30
Yield on 2-year T-bonds	%	18.08	12.41	17.37	13.91	8.53	7.80	15.59	14.91	14.37	10.83	9.27	8.860	8.20
Yield on 5-year T-bonds	%	15.83	10.87	14.00	12.59	8.43	7.80	13.12	13.38	13.43	10.45	9.09	8.72	8.10
Yield on 10-year T-bonds	%	x	9.60	11.79	10.74	7.76	7.30	10.46	11.22	11.81	9.48	8.28	7.97	7.50

** at the end of period*

Source: CSO. NBP. BZ WBK

Bank Zachodni WBK S.A.

TRESURY AND INTERNATIONAL DIVISION

plac Gen. Władysława Andersa 5, 61-894 Poznań
tel. 0 61 856 58 35 secretary, fax 0 61 856 55 65

This analysis based on information until 11.06.2002 has been prepared by::

ECONOMIC ANALYSIS UNIT

Piotr Bielski – Economist
tel. 0 22 653 46 63
e-mail: piotr.bielski@bzwbk.pl

Aleksander Krzyżaniak – tel. 0 22 586 17 21
Sławomir Nosal – tel. 0 61 856 55 67
fax: 0 61 856 55 65
e-mail: ekonomia@bzwbk.pl

Web site (including Economic Service web page): http://www.bzwbk.pl

TRESURY SERVICES DEPARTMENT

Paul Polaczek – tel. 0 61 856 55 73

Poznań

pl. Gen. W. Andersa 5, 61-894 Poznań
fax 0 61 856 55 65

Piotr Kinastowski
tel. 0 61 856 58 22, fax 0 61 856 55 65

Juliusz Szymański	0 61 856 58 25
Grzegorz Głowacki	0 61 856 58 25
Katarzyna Kamińska	0 61 856 58 25
Marzenna Urbańska	0 61 856 58 25
Waldemar Polowczyk	0 61 856 58 14
Robert Król	0 61 856 58 14
Zbigniew Mańke	0 61 856 58 14
Hanna Nowak	0 61 856 58 14
Adam Wandzilak	0 61 856 58 14
Żaneta Czerniak	0 61 856 58 14

Warszawa

Al. Jana Pawa II 25, Atrium Tower, 00-854 Warszawa
fax 0 22 653 46 79

Maciej Jędrzejak	0 22 653 46 70
Tomasz Dziedzic	0 22 653 46 67
Piotr Żagań	0 22 653 46 66

Wrocław

ul. Ofiar Oświęcimskich 38/40, 50-950 Wrocaw
fax 0 71 370 26 22

Krzysztof Pietrkiewicz
tel. 0 71 370 25 87, fax 0 71 370 26 22

Maciej Błęcki	0 71 370 26 63
Jerzy Rybczak	0 71 370 24 26
Aleksandra Skiba	0 71 370 24 86
Anna Tarnacka	0 71 370 26 24

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