MINUTES OF THE MONETARY POLICY COUNCIL DECISION-MAKING MEETING HELD ON 19 JANUARY 2011

At the meeting, the Monetary Policy Council discussed issues related to the external environment of the Polish economy, including developments in commodity prices and the situation in the financial markets, as well as the outlook for economic growth and inflation in Poland.

While addressing the external developments it was pointed out that although many countries reported a considerable rise in CPI inflation, global economic growth was still accompanied by low core inflation. It was emphasized that despite the persisting risk of further turmoil in the global economy, the hitherto observed recovery in major developed economies – although not very strong – seems relatively sustainable. At the same time, in the opinion of some Council members previously formulated concerns about a considerable GDP slowdown in major emerging economies are diminishing.

While analysing the situation in the euro area, some members of the Council indicated that recovery in this economy was rather weak and proceeded amidst persistently high unemployment. According to those Council members, in the short term, the announced reduction of the fiscal imbalance may be conducive to lowering GDP growth in the euro area countries. Those Council members emphasized that strong dependence of the Polish economy on the economic developments in Germany might imply that an expected slight deceleration of GDP growth in Germany could be followed by a reduction of GDP growth in Poland. Other members of the Council argued that the economic developments in Great Britain, where significant fiscal tightening might be observed, confirm the limited scale of negative – in the short term – effects of fiscal consolidation on economic growth. Moreover, in the opinion of those Council members, favourable economic developments expected in Poland's major trading partners, including Germany, where GDP is supposed to run above its long-term average, and further economic recovery in the Central and Eastern European countries, will support the growth of Polish exports, and consequently, of GDP.

While discussing the outlook for inflation, attention was paid to the further rise in the prices of energy and agricultural commodities in the global markets. Members of the Council emphasized that this trend was driven, to a large extent, by long-term factors, i.e. growing demand, especially from emerging countries amidst limited supply growth over the next few years. Factors conducive to growing prices of certain commodities include also unfavourable weather conditions in some countries and growing production of biofuels. At the same time, some Council members argued that expansionary monetary policy of major central banks combined with improved sentiment in financial markets supported intensified speculation in the commodity markets. Some members of the Council pointed to the attempts undertaken by American supervisory institutions to limit the scale of this activity.

While discussing the issue of appropriate response of the monetary policy to price hikes in the global commodity markets, some members of the Council made reference to the experience of the 1970s oil crises. They emphasized that countries which at that time decided to conduct a relatively restrictive macroeconomic policy managed to keep inflation at a fairly low level. In the opinion of those Council members, although commodity shocks are external in nature, they should be taken into consideration when determining domestic monetary policy in order to prevent inflation from remaining at a heightened level. In this context, those Council members pointed out that currently the increase in global commodity prices translated into a rise in inflation in majority of countries.

Some Council members pointed to the unprecedented scale of fiscal expansion in major developed economies which, amidst a limited possibility of its reduction, would be another factor likely to boost inflation in the external environment of the Polish economy in the longer term.

While addressing the outlook for domestic economic growth, members of the Council pointed out that data on GDP in 2010 Q3, monthly data on economic activity in 2010 Q4 and indicators of economic conditions in January 2011 confirm that economic growth in Poland was continuing at a relatively high level. It was emphasized that in the subsequent quarters GDP growth might translate into gradual intensification of the domestic inflationary pressure, though GDP growth will probably not exceed its long-term average.

Some members of the Council pointed to a relatively fast growth in private consumption whose further rise might be supported by growing employment. In the opinion of those Council members, consumption growth might also be supported by fast growth in housing loans to households exceeding disposable income growth considered neutral with respect to the risk of rising inflation. Those Council members also pointed out that a relatively high and still growing production capacity utilization and very good financial results of companies, especially large ones using capital-intensive technologies, should contribute to a recovery in investment. Favourable outlook for demand of the private sector, combined with favourable economic developments abroad should – in the opinion of those Council members – support relatively fast GDP growth.

Other members of the Council emphasized that persistently high unemployment, which had been growing in the last months of 2010 and which is likely to limit the growth of individual consumption, constituted an uncertainty factor with respect to the scale of further recovery. According to those Council members, the absence of a revival in lending to the corporate sector and a possible tightening of banks' lending policies due to the deterioration of their loan portfolio might be conducive to the reduction of corporate investment, especially of small and medium-sized enterprises. Moreover, it was pointed out that the risk of a slowdown in domestic economic growth should be reckoned with in the case of strong turmoil connected particularly with the strong fiscal imbalance in certain euro area countries.

Some members of the Council pointed out that the possible crowding out by household lending of other types of bank activity, including the financing of corporate investment, and the relatively weak exchange rate of the zloty, which, among other things, boosts the costs of imports of capital goods, might be conducive to the reduction of the potential output growth of the Polish economy. Those Council members argued that the reduction of the capital part of the pension system might also have a negative impact on potential output growth. Other members of the Council assessed that changes in the allocation of contributions to the pension system would not adversely affect either GDP growth or potential output growth.

While addressing inflation it was pointed out that – in line with expectations – CPI inflation in December 2010 had risen to 3.1%, remaining above the NBP's inflation target of 2.5%. Some members of the Council emphasized that although the coming months were likely to bring a further rise in CPI inflation due to factors independent of domestic monetary policy such as increases in most VAT rates, inflation might be expected to fall in the second half of 2011. Other members of the Council pointed out that a rise in inflation in December 2010 was partly connected with a rise in core inflation and that available forecasts suggested that over the horizon of monetary policy's strongest transmission CPI inflation would remain above the inflation target. Those Council members emphasized that the rise in global commodity prices was a risk to price stability. This rise translates into increasing costs of production, which manifests itself in fast PPI growth. Continued economic recovery in Poland, combined with rising inflation abroad will, in the opinion of those members of the Council, make it easier for enterprises to shift growing costs onto consumers. Members of the Council agreed that the risk of inflation consolidating at a heightened level was enhanced by a considerable rise of inflation expectations of individuals and enterprises at the end of 2010, accompanied with upward revisions of inflation forecasts by financial sector analysts.

While analyzing the impact of increases in VAT rates on inflation developments, some members of the Council assessed that it would be insignificant and temporary since in the case of certain goods increases in VAT rates would be offset by reduced markups. Other members of the Council indicated that if, in line with preliminary estimates, the increase in VAT rates had the strongest impact on the costs of road transport, its secondary inflation effect might prove stronger than earlier assessed. Some members of the Council also argued that a stronger translation of the increase in VAT rates into inflation might also be due to a psychological effect resulting in a rise in inflation expectations.

While discussing the situation in the labour market, some members of the Council pointed to the persistent relatively high unemployment rate and a fall in unit labour costs in 2010 Q3 which limit the rise in wage pressure. However, other Council members argued that further recovery in the economy would boost wage demands of employees and reduce enterprises' ability to resist to those demands. The scale of wage demands may be additionally enhanced by persistently heightened inflation. On the other hand, in addition to increased staff turnover, enterprises' resistance to wage demands may be diminished by very good financial results of companies, especially commodity companies with relatively powerful trade unions.

While discussing the level of interest rates in the Polish economy, members of the Council assessed that the consolidation of the economic recovery abroad and the acceleration of economic growth in Poland, combined with further strong increases in global commodity prices and heightened inflation expectations, increased the risk of inflation running above the NBP's inflation target in the medium term. In the Council opinion this warranted a tightening of the monetary policy which, considering a certain improvement in the financial markets' sentiment, should take place at the current meeting. At the same time some members of the Council emphasized that the lower than in the past zloty exchange rate sensitivity to the interest rate differential raises the costs of a possible too late a reaction of the central bank to the inflationary pressure.

The majority of the Council members acknowledged that the raising of interest rates at the January meeting was the beginning of a gradual tightening of the monetary policy, the scale and pace of which would depend on incoming macroeconomic data. Yet, certain members of the Council assessed that at that moment it was difficult to decide whether a further tightening of the monetary policy would be necessary. According to those Council members, in its decisions the Council should take into account, among other things, the monetary policy of the European Central Bank which might start increasing interest rates only in the second half of 2011.

A motion to raise the NBP interest rates by 25 basis points was put forward at the meeting. The motion was passed. The Council decided to raise the interest rates to the following levels: the reference rate to 3.75%, the lombard rate to 5.25%, the deposit rate to 2.25% and the rediscount rate to 4.00%.

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