# MINUTES OF THE MONETARY POLICY COUNCIL DECISION-MAKING MEETING HELD ON 27 FEBRUARY 2008

During the meeting the Monetary Policy Council discussed the outlook for inflation developments in the context of the past, current and, primarily, anticipated economic situation.

The discussion at the meeting focused on: current inflation developments, including changes in regulated prices and food prices, situation in the labour market, the outlook for economic growth and the level of interest rates in Poland and abroad. The Council discussed the influence of these factors on the future inflation in Poland in view of the February inflation projection.

While commenting on the current inflation, the Council analysed the reasons for annual consumer price growth accelerating – as indicated by preliminary information released by GUS (the Polish CSO) – and remaining above the NBP's inflation target of 2.5% and also above the upper limit for deviations from the target, which is set at 3.5%. It was pointed out that the high level of CPI inflation in January was, to a large extent, the result of increased growth of regulated prices, including prices of services connected with flat or house maintenance and energy. Inflation growth was also driven by accelerating prices of other services as well as a further increase in food and fuel prices related to global factors, which are also responsible for the heightened level of inflation observed in many other countries. It was emphasised that inflation growth resulting from increased growth of regulated prices and rising food and fuel prices was in a large part beyond the control of domestic monetary policy. At the same time, it was underlined that the increase in net core inflation in January was probably larger than that of CPI inflation, which was the result of a rise in regulated prices and prices of services.

The Council paid a lot of attention to the outlook for inflation over the monetary policy transmission horizon. It was pointed out that in the months to come a further acceleration in net core inflation should be expected, among other things, due to the rise in regulated prices, particularly prices of energy and natural gas. It was emphasised that a one-off increase of those prices would be pushing up the annual CPI level for the next twelve months. It was emphasised that in view of the February inflation projection based on the ECMOD model, the forecast consumer price growth would remain close to or above the upper limit for deviations from the NBP's inflation target throughout the projection horizon, i.e. till 2010. At the same time, it was underlined that the expected continuation of CPI inflation above the inflation target in the time to come would largely result from factors that are independent from monetary policy, namely an increase in regulated prices and high growth of food prices. It was also pointed out that high inflation would probably continue in other economies of the region and also in the euro area and the United States. In this context, the Council discussed the optimal monetary policy in a situation when the external conditions are conducive to heightened inflation.

While discussing the probable path of food prices in 2008-2009, some Council members assessed that it was difficult to rapidly increase the global supply of food, and so the food price growth in 2008 and, consequently, CPI inflation might prove higher than accounted for in the February inflation projection. Other members of the Council believed that the food price growth should decelerate in the time to come, which was supported by futures quotations in food markets. They argued that the rise in food prices in 2007 had resulted not only from changes in the geographical structure of global demand but also from considerable supply shocks in global markets, and so the supply of food in 2008 may be significantly higher than in 2007.

Some Council members indicated that, despite a rise in CPI inflation in February, the percentage of respondents expecting faster price growth declined in the surveys of households' inflation expectations. In the opinion of those members, this may decrease the probability of the so-called second-round effects. Those members pointed out that the current structure of inflation expectations was more favourable than in the period of inflation growth in 2004. Other members of the Council, though, emphasised that the above mentioned data pointed to a persistently high percentage of respondents who expected CPI inflation to stabilise at its current, high level.

It was pointed out that even though Poland was still compliant with the Maastricht inflation criterion, there was risk that it might cease fulfilling the criterion in the coming period. At the same time, it was emphasised that except for Poland and Slovakia all the new member states of the European Union which remained outside the euro area failed to comply with this criterion. Attention was driven to the fact that Poland's possible incompliance with the inflation criterion in the time to come would, in part, follow from the expected growth in regulated prices, which remained beyond the control of monetary policy. In this context, some Council members pointed to the need to appropriately coordinate the fiscal and monetary policies in the period preceding Poland's accession to the euro area.

While addressing the labour market situation, it was pointed out that the growth of employment and wages in the enterprise sector in January was higher than expected. It was argued that in line with the central path of the February projection of inflation and GDP based on the ECMOD model, the forecast wage growth would outpace labour productivity growth throughout the projection horizon. It was emphasised that the so-far observed and expected increase in unit labour cost was conducive to increased inflationary pressure. Some Council members emphasised that rising unit labour costs may reduce the competitiveness of the Polish economy and bring about further deepening of external imbalance. Moreover, they pointed out that the recently observed wage demands in the public finance sector may be conducive to wage demands in the private sector of the economy.

Other members of the Council believed that the January data on wages and employment in the enterprise sector were difficult to interpret due to the change in the statistical sample of enterprises at the beginning of the year. Those members argued that due to the good financial standing of enterprises the high wage growth did not have to fuel inflationary pressure. Moreover, they pointed out that significant wage increases in the public finance sector in 2008 were rather unlikely, as they would require the budget deficit to be larger than the value assumed in the 2008 Budget Act.

While discussing the changes in external factors affecting the Polish economy, the discussants pointed out that uncertainty persisted as to the growth outlook of the global economy, particularly of the United States and the euro area. Some Council members assessed that the slowdown in the economic growth in the United States may prove rather deep and persistent, among other things, due to problems with access to corporate credit. Those members emphasised that the slowing economic growth in the United States could be conducive to a slowdown in the world economy, including the euro area and emerging economies. Moreover, they pointed out that irrespective from the growth outlook of the US economy, some Western European countries witnessed factors which could lead to slowing economic growth in those countries in the time to come. Other members of the Council, however, argued that the lower activity in the United States could be a short-lived and small-scale phenomenon, among other things, due to the weakening of dollar exchange rate amidst rising openness of the US economy, still relatively high profitability of enterprises in this country and the considerable contribution of the service sector in GDP.

While discussing the outlook for economic growth in Poland, it was pointed out that the January data on retail sales and industrial output were significantly higher than expected. Some Council members believed that this could be an indication of strong activity of the Polish economy being sustained in 2008 Q1. Those members assessed that GDP growth in emerging economies, including the Polish economy, may remain at a high level in the time to come despite the slowdown observed in developed economies. They emphasised that, in line with the central path of the February projection based on the ECMOD model, throughout the projection horizon domestic demand would be growing faster than GDP, and GDP would remain above its potential level, which should be conducive to increased inflationary pressure. They also pointed out that the rise in the domestic demand was additionally being fuelled by high growth of loans, particularly consumer loans, which had not decreased in any significant way despite NBP interest rate increases. Some Council members also pointed out that the recently observed fast growth in banking sector deposits might potentially result in increased credit growth.

Other members, however, believed that at the moment it was hard to assess whether the January data indeed indicated the continuation of strong economic growth in Poland in the near future and they argued that a more comprehensive assessment of the prospects for GDP growth would only be possible based on data for subsequent months. Moreover, those members pointed out that the likely slowdown in the world economy might contribute to a slowdown in economic growth in Poland.

When discussing exchange rate developments, the discussants indicated that, despite the persisting turmoil in international financial markets, zloty exchange rate was stable, and that the final days of February brought its considerable appreciation. Some Council members believed that it was currently difficult to assess the sustainability of factors which had led to this recent zloty appreciation.

While discussing monetary policy, it was pointed out that further interest rate lowering was expected in the United States and the United Kingdom and that, as anticipated by financial markets, interest rates in the euro area would most probably also be reduced in 2008. Some Council members emphasised that several central banks eased monetary policy despite high inflation being observed in those countries. They also pointed out that the real interest rate in Poland was relatively high as compared to other countries of the region and that, due to the appreciation of the real zloty exchange rate, monetary conditions in Poland remained relatively tight. They argued that monetary policy tightening in Poland would increase interest rate disparity between Poland and the United States and the euro area, which might encourage the inflow of short-term capital to Poland and be conducive to zloty exchange rate appreciation. In the opinion of those members, this would weaken the competitiveness of the Polish economy and lead to further increase of external imbalance. They pointed out that in 2006-2007 in Poland – in contrast to some other countries of the region – the unfavourable trade balance was deepening with exports rising more slowly than imports. Moreover, some Council members assessed that rising interest rate disparity would be increasing the share of loans denominated in foreign currencies in total loans, which might weaken the impact of domestic monetary policy on domestic demand.

Other members of the Council pointed out that the reason for monetary policy easing by certain central banks was the expected economic slowdown and financial market turmoil. Those members emphasised that in Poland, similarly as in many other countries of the region, the level of nominal interest rates necessary to keep inflation at the target level was higher than in the euro area, among other things, due to the higher economic growth, resulting from higher labour productivity growth. They pointed out that in 2007 and at the beginning of 2008 CPI inflation in Poland increased more strongly than nominal interest rates and so the real interest rate had decreased. They also argued that a considerable proportion of foreign currency denominated loans to enterprises was concentrated in a relatively small number of large enterprises and thus changes in domestic interest rates should have noticeable impact on growth in loans granted to other enterprises and on domestic demand. Moreover, they pointed out that monetary policy was being tightened in some countries.

While discussing the interest rates decision, the majority of the Council members believed that it was necessary to contain the risk of sustained increased CPI inflation and curb the expected growth in net core inflation and a possible boost in inflation expectations. In the opinion of some Council members, the outlook for inflation outlined in the February projection justified a significant interest rate increase at the current meeting. In the assessment of the majority of the Council, monetary policy tightening should be measured and proceed gradually due to, among other things, the uncertainty about the potential impact of interest rate increases on zloty exchange rate and about the outlook for global economic growth. In this context, the future path of interest rates in Poland was also discussed.

A motion to raise the key NBP interest rates by 50 basis points was put forward. The motion did not pass. A motion to raise the key NBP interest rates by 25 basis points was put forward and passed. The Council raised the interest rates to the following levels: the reference rate to 5.50%, the lombard rate to 7.00%, the deposit rate to 4.00% and the rediscount rate to 5.75%.

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