NBP

National Bank of Poland

Monetary Policy Council

MINUTES OF THE MONETARY POLICY COUNCIL DECISION-MAKING MEETING HELD ON 25 FEBRUARY 2009

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

The discussion at the meeting focused on the zloty exchange rate developments, the outlook for economic growth in Poland and abroad and credit market conditions. The Council discussed the influence of those factors on the future inflation developments in Poland in view of the February projection of inflation and GDP.

The Council paid a lot of attention to exchange rate developments. It was pointed out that the currencies of Central and Eastern Europe, including the zloty, had weakened significantly since the previous meeting of the Council. It was emphasized that the depreciation of those currencies was triggered, inter alia, by the deteriorating economic outlook for the countries of the region, including concerns over macroeconomic stability of some of those countries. An increase in the global aversion to risk, resulting in capital outflow from the emerging markets, fears of financing large trade deficits in some countries, and foreign exchange transactions by short-term investors were also considered as factors conducive to the depreciation of the currencies of the region, including the zloty. It was pointed out that the scale of zloty depreciation resulting from a relatively larger liquidity of the Polish foreign exchange market did not reflect the comparatively favourable condition and outlook for economic growth in Poland. Some Council members pointed out that the zloty depreciation might have been additionally strengthened by demand for foreign currency of Polish enterprises engaged in option contracts.

The Council also discussed the impact of changes in the NBP interest rates on the zloty exchange rate developments. Some members of the Council argued that in a period of high exchange rate volatility a considerable interest rates reduction may increase the risk of further depreciation of the exchange rate. Other Council members emphasized that the impact of the interest rate disparity on the zloty exchange rate had recently been limited. They pointed out that the economic outlook for Poland constitutes the factor influencing the zloty exchange rate developments. According to those members of the Council, easing the monetary policy will counter the excessive deterioration of economic growth and, therefore, it may be a factor conducive to strengthening of the zloty exchange rate in the medium term.

While analyzing the impact of the zloty depreciation on the economy, it was pointed out that the weakening of the exchange rate contributes to reducing the domestic demand by increasing households' and enterprises' expenditure on servicing financial obligations denominated in foreign currencies. On the other hand, it was pointed out that the zloty depreciation improves the competitiveness of Polish exports, and, contributing to the rise in prices of imported goods, is conducive to the increase in competitiveness of Polish producers in the domestic market. It was also indicated that the zloty exchange rate depreciation leads to a rise in the zloty value of EU funds.

While discussing the impact of the zloty depreciation on the credit market situation, some Council members indicated that as a result of the weakening of the Polish currency the zloty value of bank assets denominated in foreign currencies increases. Without raising the capital it may lead to a decrease in banks' capital adequacy ratios and, in consequence, may be conducive to further reduction of lending.

While analyzing the impact of the zloty depreciation on the budget deficit and public debt, the Council members indicated that the exchange rate depreciation increases public spending on contributions to the European Union budget and on servicing the foreign debt. Some members of the Council assessed that a significant zloty depreciation may limit the foreign investors willingness to finance the borrowing needs of the state budget. Additionally, some Council members pointed out that further depreciation of the exchange rate may cause long-term investors, holding debt instruments issued by the Polish government, to hedge against the foreign exchange risk by making transactions in the forward market, which may strengthen the zloty depreciation as a result of arbitrage between the spot and the forward market. Other Council members, however, pointed to a relatively small share of foreign debt in the total debt of the general government sector and the dominant share of domestic investors in financing the borrowing requirements of the state. According to those Council members an increase in the borrowing needs of the governments of the developed countries resulting from undertaken counter-crisis measures is a more important factor than the zloty depreciation in limiting the possibility of external financing of the budget deficit and public debt in Poland, as well as in other developing countries.

While addressing the situation in the external environment of the Polish economy, the deepening recession in developed economies (the United States, the euro zone, Japan) and the increasing slowdown in economic growth in developing countries was noted. It was argued that the worsening outlook for economic growth in China may put the expected improvement in global economic performance at risk. It was also indicated that some of the central banks had continued to ease their monetary policy in the recent period. Some members of the Council pointed out, however, to a change in monetary policy stance of the central banks of Central and Eastern Europe, which was due to the recent depreciation of their currencies.

While discussing the outlook for domestic economic growth, it was pointed out that the decrease in industrial output and orders in January 2009, as well as worsening indicators of economic climate confirm that the activity in the Polish economy is deteriorating further. Moreover, it was noted that reduced lending by banks, increase in the burden for economic agents due to the previously incurred foreign-currency-denominated liabilities as well as increases in administered prices limiting the purchasing power of households will be conducive to decreasing domestic demand. The negative influence of a significant deterioration of economic outlook on corporate investment was also noted. It was indicated that further decrease in demand for Polish exports, which is connected with the deepening recession experienced by Poland's major trade partners, will contribute to a further deterioration of economic growth in Poland. The impact of the decrease in foreign demand for Polish exports may be cushioned by the depreciation of the zloty exchange rate. Some Council members assessed that the scale of the economic slowdown in Poland may be larger than forecasted in the February NECMOD projection.

The meeting also addressed the influence of the NBP interest rates reductions on domestic demand and on the situation in the banking sector as well as in the credit market. It was indicated that interest rate cuts ease the burden of servicing zloty-denominated loans of economic agents, which limits the risk of debts being unsettled by these agents, and, in consequence, acts towards increasing the stability of the financial system. It was also emphasized that lowering the interest rates leads to an increase in purchasing power of the these agents, which may contribute to an increase in domestic demand. Some Council members pointed, however, to the uncertainty surrounding the impact of lower interest rates on the domestic demand in the context of the credit market distortions. They indicated that the NBP interest rate cuts made in November and December 2008 – despite a significant drop in the 3M WIBOR rate – were accompanied by a smaller decrease in interest on corporate loans, only a slight decrease in interest on housing loans and a small increase in interest on consumer loans. Those Council member argued that the reductions of the NBP interest rates decrease the banks' incomes from servicing the previously granted loans, which – coupled with a relatively high interest rate on deposits – may induce banks to increase margins on newly granted loans. According to some Council members, too low competition in the Polish banking sector may be a factor limiting the influence of the reductions of the NBP interest rates on the interest on loans.

Some members of the Council indicated that limited demand for loans from economic agents related to negative outlook for economic growth may constitute a barrier to the credit growth. They emphasized that the decrease in creditworthiness of economic agents related to the drop in value of their assets and the increase in the burden due to the incurred foreign-currency-denominated loans may also be a factor limiting the credit growth.

The Council discussed the possibility of modifying the employed monetary policy instruments in order to improve the liquidity situation in the banking sector and prevent extensive reduction of banks' lending, including the potential extension of maturity of repo transactions, lowering the reserve requirement rate and reducing the deposit rate to a greater extent than other NBP interest rates. The Council also debated on the issues connected with employing the instruments directly influencing the zloty exchange rate in the context of developments in the foreign exchange market.

While addressing the outlook for inflation, some Council members estimated that in the nearest future CPI and core inflation will remain at elevated levels, which also is indicated by the February NECMOD inflation projection. Those members argued that substantial rise in administered price and current strong depreciation of the zloty exchange rate will be conducive to increasing inflation. Other members pointed out that the February NECMOD inflation projection points to an increase of the negative output gap leading to a considerable drop in the inflationary pressure in the monetary policy transmission horizon. Those members also pointed to a decreasing wage pressure in the Polish economy. According to those Council members, the risk of permanent overshooting the inflation target due to the zloty depreciation is small in the conditions of significantly weakening demand. Those members assessed that – despite a strong depreciation of the zloty exchange rate – the core inflation in 2009 Q1 may be lower than forecasted in the February inflation and GDP projection. Moreover, they pointed out that in February 2009 the inflation expectations of households and bank analysts declined. At the meeting, the uncertainty related to inflation developments in the nearest period resulting from accounting for the changes in the consumption basket of households by GUS was also brought up.

The Council also discussed the prospects of fulfilling the Maastricht price stability criterion by Poland. Some Council members indicated that due to a more rapid drop in current headline inflation in most European Union countries than in the Polish economy, in the nearest future the 12-month moving average HICP inflation in Poland, taken into account when assessing the compliance with the price stability criterion, may still exceed the reference value. Other Council member pointed out, however, that according to the February inflation and GDP projection in the NECMOD model it may be expected that the CPI inflation will decrease to a low level over the monetary policy transmission horizon, and, thus, Poland will be complying with the price stability criterion in the medium term.

While analyzing the influence of fiscal policy on the economy, some Council members pointed out that the scale of reductions of public spending in 2009 announced by the government is larger than assumed in the February inflation and GDP projection. Those members indicated that the change in the way of financing some infrastructural expenditure, which shifts the expenses incurred for this purpose by the central budget to other units of the general government sector, may – should difficulties with acquiring sufficient funds on the market arise – lead to the refrainment from a part of these expenditures. They also emphasized that a more severe economic slowdown than the one currently expected by the government, and consequently lower-than-expected budget revenues, may lead to further curbing of budget expenditures. Those Council members argued that a restrictive fiscal policy supports further monetary policy easing. Other Council members, however, pointed to the actions announced by the government aimed at alleviating the effects of the crisis, including, inter alia, mortgage-loan-repayment aid for the unemployed, which will limit the restrictiveness of the fiscal policy.

While considering the decision on interest rates, some Council members argued that the quickly deteriorating economic situation in the world and in Poland, the drop in inflation below the target over the projection horizon expected in the February inflation and GDP projection, and the relatively high restrictiveness of fiscal policy are factors supporting additional considerable NBP interest-rate cuts. Those members assessed that in the current conditions the influence of the interest rate disparity on the zloty exchange rate, and, by the same token, the risk of further depreciation of the zloty exchange rate, is limited. Other Council members argued that the risk of further significant depreciation of the zloty exchange rate that may lead to a considerable deterioration of economic activity in Poland, and the uncertainty about the magnitude of the impact of interest-rate cuts on domestic demand justified the decision of keeping interest rates unchanged at the current meeting. According to the majority of the Council members, given the considerable depreciation of the zloty the scale of the reduction of the NBP interest rates at the February Council meeting should be moderate.

Motions to lower the NBP interest rates by 25 and 50 basis points were put forward. A motion to lower the NBP interest rates by 50 basis points did not pass. A motion to lower the interest rates by 25 basis points was passed. The Council decided to lower the NBP interest rates to the level: the reference rate to 4.00%, the lombard rate to 5.50%, the deposit rate to 2.50% and the rediscount rate to 4.25%.

The Monetary Policy Council judged also that the situation on the foreign exchange market may justify employing the instruments directly affecting the zloty exchange rate.

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