NBP

National Bank of Poland

Monetary Policy Council

MINUTES OF THE MONETARY POLICY COUNCIL DECISION-MAKING MEETING HELD ON 26 MARCH 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 food prices and regulated prices, the outlook for economic growth, situation in the labour market and the level of interest rates in Poland and abroad.

While discussing current inflation developments, it was pointed out that as a result of the annual revision of the CPI basket, the inflation data for January had been significantly revised downwards (from 4.3% y/y to 4.0% y/y). It was also emphasised that in February inflation was significantly below expectations despite a rise up to 4.2% y/y. Lower than expected growth in prices in February was driven – apart from the revision of the CPI basket – by lower than expected growth in food and fuel prices. In the opinion of some Council members, a significant downward revision of the January inflation, together with markedly lower than expected inflation in February, allowed to assume that inflation might return within the limit for deviations from the NBP's inflation target sooner than accounted for in the February inflation projection.

When addressing the decline in the annual growth of food prices observed in February, some Council members pointed out that the decline had also been recorded in other countries of the region, which might suggest that the strong growth in food prices experienced since mid-2007 was beginning to slow down. A decline in the growth of food prices in the coming period is also suggested by prices of futures contracts in the world food markets, which reflect favourable forecasts of this year's crops. Other members of the Council pointed out that, due to the expectations that crops in 2008 would be higher than in 2007, prices of certain food products and agricultural commodities might even be expected to decline in 2008-2009.

It was pointed out that the rise in the annual inflation in February 2008 in relation to January 2008 was primarily driven by a strong growth in regulated prices. It was underlined that the CPI excluding regulated prices fell in February 2008 as compared to January 2008. Some members of the Monetary Policy Council indicated that regulated prices would be a major factor driving inflation in Poland both in 2008 and probably in the subsequent years. This is mainly related to the expected considerable rise in energy prices, which will result from the probable convergence of gas prices in Poland to those in other EU countries and from the need of the power generating sector to raise funds to finance the necessary investment (connected with a possible electricity shortage) and to cover the expenses incurred by the environmental protection regulations. Some Council members, however, pointed out that the ongoing liberalisation of the energy sector might curb the growth of energy prices.

While discussing the impact of tax policy on consumer price developments, some Council members pointed out that the adjustment of excise duty and VAT rates to the EU regulations, which is to take place after the expiration of the transition periods negotiated by Poland, might be an important factor driving inflation in Poland in the years to come. Nevertheless, it was emphasised that the

00-919 Warszawa, ulica Świętokrzyska 11/21, phone (+4822) 826 99 55, fax (+4822) 826 37 51,
telex 81 46 81 nbp.pl, www.nbp.pl

timing of changes in indirect taxes is uncertain. The Council also paid attention to the fact that changes in indirect taxes might be of importance for Poland as regards its compliance with the Maastricht price stability criterion. In this context the members of the Council pointed to the need to appropriately coordinate the fiscal and monetary policies in the period preceding Poland's accession to the euro area.

When discussing net core inflation, some members of the Council argued that its strong rise in February was primarily the result of a surge in administered prices. Therefore, at least for a certain period of time, this measure may reflect the inflationary pressure stemming from changes in domestic demand only to a limited extent. Other members pointed out that a rise in the demand pressure is most clearly visible in some parts of the services sector. It was also argued that the growth in prices of market services had already been following an upward trend for a longer period, and its one-off drop in mid-2007 resulted from the way in which price promotions were accounted for in the price index.

Some Council members emphasised that a significant rise in administered prices, combined with previously recorded strong increases in food and fuel prices, might translate into a rise in perceived inflation and thus boost inflationary expectations of households. In this context, they pointed out that the monetary policy should account for the related increased risk of second-round effects.

While assessing the outlook for economic growth in Poland, it was pointed out that the growth of retail sales and industrial output in February were significantly higher then expected. In the opinion of some Council members, these data confirmed the continuation of strong activity in the Polish economy in 2008 Q1 suggesting, at the same time, that the global economic slowdown had thus far not deteriorated economic climate in Poland. Some members of the Council pointed out that GDP growth would remain at a relatively high level unless the negative impact of the slowdown in the world economy on the economic growth in Poland would rise. Certain members of the Council argued that in view of the estimates of potential GDP growth in Poland this meant that the output gap would remain positive in the coming period, which would, in turn, call for a further tightening of the monetary policy. It was also pointed out that despite previous interest rate increases high growth of credit aggregates continues, including growth of consumption loans granted to households.

Other members of the Council pointed out that the data on GDP in 2007 Q4 confirmed that, from the point of view of inflationary pressure, the structure of economic growth continued to be favourable and was better then expected (lower growth of domestic demand, including primarily lower growth of private consumption and lower negative contribution of net exports to GDP growth together with higher investment growth). They argued that if GDP growth in 2008 proved higher than assumed in the Budget Act, then the budget deficit, similarly to 2007, might be markedly lower than assumed, which would, in turn, curb inflationary pressure.

During the discussion it was pointed out that 2007 Q4 brought a decline in enterprises' profitability rate of gross turnover. Some Council members argued that this might result in enterprises assessing their financial condition less favourably, which amid growing production costs might urge them to increase prices of their products. Other members of the Council pointed out that deteriorating financial results of enterprises, combined with possible tightening of banks' lending policies, might result in lowering investment of enterprises and, in consequence, lead to a decline in GDP growth.

When analysing the situation in the labour market, it was pointed out that the data on wages in the enterprise sector in February were higher then expected, and the growth of employment remained at a high level. Some members of the Council indicated that the currently observed wage rise had been very high both in nominal and real terms as compared to that of the past few years, which confirmed persistently strong wage pressure in the economy. It was also emphasised that the dynamic growth in wages exceeded labour productivity growth, resulting in a further increase in unit labour costs.

While discussing external factors affecting the Polish economy, it was pointed out that uncertainty persisted as to the growth outlook for the global economy. Some members of the Council indicated that forecasts of the economic growth in the United States had recently been revised downwards despite a considerable easing in monetary and fiscal policies. The situation deteriorated also in the euro area, while in the opinion of some Council members, the pace of this process might indicate that economic slowdown in the euro area was not only driven by the recession in the United States but also by weak domestic demand in the euro area. Some members argued that a decline in the global economic growth, and particularly in the growth of Western European countries, might negatively affect the growth of Polish exports and, consequently, might lead to a decline in GDP growth in Poland. At the same time, faced with the uncertainty about the possibility of selling their products abroad, enterprises may limit their investment activity, which might also have a negative impact on GDP growth. Other members of the Council indicated that the negative impact of the slowdown in the world economy on the economic situation in Poland might be mitigated by the changing geographical structure of Polish foreign trade.

When discussing the monetary policy it was pointed out that too strong policy tightening, combined with interest rates cuts by the US Federal Reserve and the ECB interest rates kept unchanged, may be conducive to the inflow of speculative capital to Poland and to an excessive exchange rate appreciation. In turn, such an excessive strengthening of the zloty may lead to deteriorating the competitiveness of the Polish foreign trade, which amid a slowdown in the world economy may result in a decline in the growth of Polish exports and GDP. In this context, some Council members emphasised that possible consequences of a further increase in the interest rate disparity for the zloty exchange rate should be taken into consideration while taking decisions on interest rates.

While addressing the issue of the exchange rate, some Council members argued that despite the recently observed appreciation of the zloty, it should be treated neutrally in taking monetary policy decisions due to the possible considerable fluctuations of the exchange rate.

After discussion, it was assessed that primarily the following factors point to a significant probability of inflation remaining above the inflation target in the medium term: the continuation of the fast economic growth, probably exceeding the growth of potential GDP, significant surge in wages and employment and the risk of higher inflation expectations due to heightened current inflation and expected further growth in regulated prices. In the Council's assessment, these arguments justified monetary policy tightening at the current meeting. Members of the Council also discussed the scale and pace of the needed monetary policy tightening.

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 5.75%, the lombard rate to 7.25%, the deposit rate to 4.25% and the rediscount rate to 6.00%.

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