MINUTES OF THE MONETARY POLICY COUNCIL DECISION-MAKING MEETING HELD ON 25 MARCH 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 short-term interest rate developments in the context of conducted open market operations, zloty exchange rate changes, outlook for inflation and economic growth in Poland and situation in the banking sector.

The Council paid a lot of attention to the consequences of change introduced to conducting open market operations by limiting the supply of NBP bills. This change resulted in higher liquidity remaining in the banking sector and related reduction in short-term interest rates in the interbank market significantly below the NBP reference rate. It was argued that limiting the supply of NBP bills as compared to the demand is aimed at fostering activity of commercial banks in the interbank market. In the opinion of some discussants, lack of possibility of investing all the banks' liquid assets in money bills should further result in this liquidity being used to increase lending. At the same time, it was pointed out that limited supply of NBP bills translated into banks' increased interest in investing in Treasury bills.

Some members of the Council argued that changes introduced to conducting open market operations, translating into short-term interest rates in the interbank market lowering below the NBP reference rate should be taken into account in the Council's decisions concerning both the level of the NBP interest rates and the possible further changes in the monetary policy instruments used. At the same time, they pointed out that increased liquidity in the interbank market might impede exchange rate stabilization. Moreover, the Council decided that reduction of reserve requirement rate and decrease of the deposit rate by more that other NBP interest rates were not justified at the moment.

The Council also discussed the possible change in interest rates on FX swaps used by the NBP and extension of their maturity.

While addressing the exchange rate issues, it was pointed out that since the February meeting of the Council, the previously observed depreciation of the zloty had been halted. Some members of the Council emphasized that the role of interest rate disparity was temporarily limited, and exchange rate developments continued to be largely affected by other, mainly global and regional factors, which was indicated by similar changes in exchange rates of the currencies of Central and Eastern Europe. Other members of the Council argued that foreign exchange market is still marked by high volatility and that the Council should continue to take into account the risk of further depreciation of the zloty. In this context the importance of macroeconomic situation in other economies of the region and the impact of any negative developments in those countries on the zloty exchange rate were emphasized. In the opinion of those Council members, a major factor behind uncertainty concerning zloty exchange rate developments was prospects of Poland's accession to the euro area.

While discussing the exchange rate, it was stressed that the previously observed considerable zloty depreciation was the main risk factor for price stability in the coming months. It was pointed out that the weakening of the zloty, through a strong increase in fuel prices, contributed largely to a rise in inflation in February as compared to January 2009. Yet, at the same time, some Council members stressed that the impact of exchange rate fluctuations on inflation would probably be short-lived, and translation of the depreciation into domestic prices might be limited amidst economic slowdown. Other members of the Council argued that a rise in producer prices in February which proved considerably higher than expected, might be largely connected with the previously observed weakening of the zloty exchange rate. In the opinion of those Council members, although rising producer prices did not automatically translate into consumer prices, in the situation of weakening external demand, rising production costs might be compensated for by price increases in the domestic market, thus contributing to higher inflation. Those members also pointed out that any further weakening of the zloty might lead to the fading of the anti-inflationary effect connected with lower imported inflation.

It was emphasized that, apart from the previously observed considerable depreciation of the zloty exchange rate, higher inflation was driven mainly by rising administered prices, including, in particular, flat maintenance and energy prices. Some Council members argued that the coming months might be expected to see those prices continue to growth at an increased rate which would reduce a fall in inflation. It was also pointed out that food price developments resulting from unfavourable occurrences in the regions being important suppliers of main agricultural products, were a risk factor for inflation.

While addressing other factors affecting the outlook for inflation, some members of the Council pointed out that deepening recession in the global economy putting a downward pressure on inflation abroad and a relatively low level of prices of raw materials – below the level accounted for in the NBP February projection – would curb inflation in Poland. They also argued that amidst weakening external and domestic demand, falling demand for labour would cause faster that accounted for in the February inflation projection decline in wage growth which would be conducive to a reduction of growth in unit labour costs. Those Council members assessed that the above mentioned factors connected with strong decline in the demand pressure in the economy indicated faster decrease in inflation than accounted for in the projection, which is also suggested by the results of short-term forecasts prepared by the NBP.

While assessing the outlook for economic growth abroad, attention was paid to deepening recession in the United States and in the euro area as well as to further lowering of forecasts for those economies and the related risk of global recession lasting longer than accounted for in the February projection. It was emphasized that in response to the strong decline in economic activity and risks to stability of the financial sector, major central banks lowered their interest rates to very low levels and undertook actions aimed directly at increasing the supply of reserve money which were intended to intensify lending and decrease long-term interest rates. Attention was also paid to the fact that no further interest rate cuts were implemented by central banks of Central and Eastern Europe.

While discussing the domestic economic growth, it was pointed out that recession in Poland’s main trading partners translated into decreasing exports and industrial output which was corroborated by the data for the first months of 2009. It was argued that weakening demand in the economy was leading to falling employment in the corporate sector, rising unemployment and declining wage growth. At the same time it was emphasized that deteriorating situation in the labour market was curbing consumer demand which was reflected by retail sales data. It was also indicated that deteriorating financial situation of enterprises was hindering their investment activity. According to some members of the Council, the above mentioned factors, namely reduced external and domestic demand (both consumer and investment demand) would result in GDP growth being considerably lower than accounted for in the February projection. Other Council members emphasized that the risk of further zloty depreciation was also of considerable importance for the outlook of economic growth, since through increase in the value of obligations denominated in foreign currencies and the related rise in debt service costs it might also lead to further deterioration in financial situation of households and enterprises leading to lower GDP.

While analyzing the situation in the banking sector, attention was paid to high liquidity preference of banks and their striving to attract deposits of non-financial sector by offering still high interest rates. It was pointed out that high costs of financing bank activity resulting from the above were reflected in increased margins on newly granted credits. At the same time, however, it was emphasized that in the first few months of 2009 reduction in interests rates on deposits and loans, following a considerable lowering of the NBP interest rates, was observed. Some discussants argued that NBP interest rate cuts should lead to further fall in interest rates on deposits thus reducing the costs of banks' financing and contributing to a reduction in interest rates on loans. Yet, it was pointed out that considerable increase in banks' margins was largely due to higher credit risk and, consequently, no considerable reduction in margins should be expected.

Some members of the Council emphasized that even if NBP interest rates reductions were not fully reflected in interest rates on newly granted loans in commercial banks, lower interest rates decreased the costs of servicing already taken loans which was of considerable importance for the financial condition of some households and enterprises. Other Council members pointed out that the impact of further interest rate cuts on the development of bank lending was currently limited since the volume of loans depended, to a major extent, on factors not directly linked to the NBP interest rates (such as high liquidity preference and high credit risk assessment).

The Council discussed the prospects of Poland's accession to the euro area and related requirement to fulfill the convergence criteria, including, in particular, price stability criterion.

While considering the decision on interest rates, some members of the Council argued that considerable decline in economic activity leading to significant reduction in demand, combined with lower wage pressure, and consequently also inflationary pressure, justified further lowering of the interest rates. The reduction of the NBP interest rates should – in their opinion – translate into lower interest rates on deposits and loans in commercial banks contributing to intensified lending and preventing excessive decline in economic activity. Other Council members argued, however, that the decision on interest rates should take into account the lowering of the short-term interest rates in the interbank market significantly below the NBP reference rate driven by changes introduced to the conducting of open market operations. They also pointed at the risk of further zloty depreciation and at a decline of real interest rate.

A motion to lower the NBP interest rates by 25 basis points was put forward and passed. The Council decided to lower the NBP interest rates to the level: 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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