MINUTES OF THE MONETARY POLICY COUNCIL DECISION-MAKING MEETING HELD ON 25 APRIL 2007

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

The Council paid considerable attention to the prospects of economic growth. Council members pointed out that the Polish economy is in the stage of strong economic growth and that the high GDP growth may be expected to be sustained in the medium term, at least. The factors supporting robust economic growth should be the inflow of foreign direct investment and EU funds, as well as optimistic expectations of enterprises regarding future economic situation, additionally boosted by the prospect of Poland hosting the European Football Championships in 2012. In the opinion of some Council members, high economic growth in the coming years will be favoured by strong economic growth in EU countries.

Most Council members considered the current GDP growth to be higher than the potential output growth. However, the Council members differed in their assessment of the magnitude of the impact this factor may have on inflationary pressure.

Some members of the Council believed that there is a significant risk that a demand growth exceeding the growth of potential GDP would lead to a rise in costs and, consequently, to higher inflation and widening external imbalance. They pointed out that, in the medium term, inflation running above the inflation target would result in Polish economy gradually losing its price competitiveness.

Other members of the Council emphasised that the structure of the current economic growth is favourable for low inflation, as over the past several quarters the contribution of investment to GDP growth has been rising, which should be conducive to increasing the potential output and limiting inflationary pressure. Moreover, they assessed that the high GDP growth in 2007 Q1 was to some extent the result of favourable weather conditions, which most strongly affected the construction output. The disappearance of these one-off factors in the next quarters, they argued, may reduce the risk of inflation increase.

Another issue discussed at the meeting was the impact of the European Football Championships, which is to be co-hosted by Poland in 2012, on the outlook for economic growth and inflation. Council members assessed that the organisation of the championships should help sustain the high rate of economic growth in the years to come. Some discussants pointed out that the rise in potential output related to hosting the event will be lower than demand growth and also that it will be delayed in time, which should lead to inflation increase. Furthermore, the discussants argued that the investment connected with the championships will be to a large extent financed with public funds, thus creating the risk of a further deepening of the public finance imbalance.

The Council paid significant attention to the situation in the labour market and its impact on inflation outlook. In the opinion of the majority of Council members, a significant risk factor of inflation growth is the currently observed acceleration in wage growth in the corporate sector. They emphasised that the following factors will contribute to wage growth acceleration: significant decline in unemployment, structural mismatch in the labour market and the emigration of Polish workers to other EU countries, as well as wage convergence between Poland and EU countries. They also argued that the currently observed fast economic growth is strengthening employees' expectations for wage growth acceleration.

Some Council members pointed out that it remained uncertain to what extent the recently observed wage growth acceleration in enterprises was the result of permanent tendencies and to what extent it was fuelled by one-off factors and, therefore, should be seen as a temporary development. Thus, they were convinced that a more comprehensive assessment of the scale of wage pressure strengthening will only be possible after more labour market data are released. These Council members assessed that the rise of unit labour costs will still be constrained by a dynamic increase in investment outlays in the enterprise sector, which should be conducive to sustaining high growth of productivity in this sector. It should also be supported by the structure of employment changing towards a greater share of young workers with relatively higher productivity, yet also higher wage expectations, in relation to the persons who retire. Some discussants pointed out that the wage growth will still be curbed by globalisation processes and the ensuing increase in international competition. They argued that the wage growth acceleration does not necessarily have to lead to inflation growth due to the very good financial standing of enterprises which makes it possible for them to partially absorb wage increases without the need to raise their prices. Moreover, some Council members emphasised that the rising growth of wages may be partially related to acceleration in the process of Polish wages converging to those in other EU countries, which should be taken into account in monetary policy.

The members of the Council also discussed the impact of the zloty exchange rate on inflation. In this context, some Council members tended to pay more attention to fundamental factors, including the inflow of foreign direct investments and EU funds, while others put greater emphasis on developments in the international financial markets.

During the meeting, the Council also addressed the April projection of inflation and GDP presented by NBP analysts and based on the ECMOD model. The projection is one of the inputs to the decision-making process on NBP interest rates. The April projection indicates that, assuming constant interest rates, there will be a gradual inflation increase in the monetary policy transmission horizon. According to the central projection path, inflation, after a temporary fall in 2007 Q3, will gradually rise and, in the second half of 2009, it will approach the upper limit for deviations from the inflation target.

The discussion revealed three different assessments of the April projection. Some Council members accepted the inflation outlook outlined in the April projection as probable. Other discussants, however, assessed that inflation may prove higher than that indicated by the projection, due to the projection's possible underestimation of wage and GDP growth. Finally, other members of the Council pointed out that, in line with the April projection based on the ECMOD model and other forecasts prepared at the NBP, in the short term inflation will be running clearly below the inflation target, while in the longer term it will be lower than it is outlined in the projection.

Most Council members were of the opinion that it is necessary to tighten monetary policy, yet there were different views on the right timing of the interest rates increase.

In the opinion of some Council members, the assessment of the balance of risks for future inflation did not provide clear grounds for tightening the monetary policy at the present meeting. They pointed to the uncertainty as to the duration and scale of wage growth acceleration. They also underlined that inflation expectations have remained low, not creating risk for inflation growth. They also indicated that the recently observed acceleration in CPI inflation was primarily the result of supply-side and statistical factors. At the same time, they argued, core inflation has remained low. Additionally, they highlighted that, according to the majority of forecasts, in the short term inflation will be most probably running below the inflation target. Raising the interest rates, they maintained, may boost expectations of their further increases. Moreover, a monetary policy tightening may, in their opinion, lead to lowering economic growth and, thus, the decision to raise the interest rates should only be taken when more evident risks to achieving the inflation target arise.

The majority of Council members assessed that in order to keep inflation close to the target in the medium term, it is necessary to tighten the monetary policy at the present meeting. These members believed that increasing the interest rates would send a signal that monetary authorities are committed to achieve the inflation target, which would strengthen the credibility of the pursued monetary policy, lead to the stabilisation of inflation expectations and ease the pressure on wage growth. These members also assessed that a slight monetary policy tightening should have only slight, if any, impact on economic growth. They pointed out that postponing the decision to raise the interest rates may contribute to rising macroeconomic imbalances and inflation. In such a situation, the cost of a monetary policy tightening aimed at bringing inflation back to the target would be significantly higher than the cost of preventing inflation growth by a pre-emptive adjustment of monetary policy parameters, especially amid the globalisation-related weakening of a short-term link between output gap and inflation.

At the meeting, 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 4.25%, the lombard rate 5.75%, the deposit rate 2.75%, the rediscount rate 4.50%.

The Council discussed the appropriate way in which this decision should be communicated to the public.