MINUTES OF THE MONETARY POLICY COUNCIL DECISION-MAKING MEETING HELD ON 26 SEPTEMBER 2007

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 impact of the turmoil in the international financial markets on the outlook for economic growth, labour market situation in Poland, external imbalance and public finance situation. The Council discussed the influence of these factors on the future inflation in Poland.

The members of the Council devoted a lot of attention to the situation in international financial markets and discussed the impact of increased uncertainty on the outlook of economic growth in the global and Polish economies. Some discussants pointed out that the Polish financial sector is safe from turmoil similar to that which occurred in the United States and Western Europe in August and September 2007. They argued that in Poland, in contrast to the United States, mortgage loans are only granted by institutions remaining under the banking supervision and that the domestic market does not offer as complex financial instruments as those available in the markets which experienced the turbulences.

Other discussants pointed out that the turmoil in international financial markets did spread beyond the US subprime loan market, which can be evidenced by problems in the German and British financial markets. They also pointed out that if the problems in the US housing market exacerbate, this situation combined with the appreciation of the euro may dampen euro area growth. They also assessed that the heightened uncertainty may persist for the next few months, as the necessary adjustment in the structure of assets and liabilities of international financial institutions would proceed gradually. It was also emphasised that in the face of turmoil some central banks decided to ease or restrain further monetary policy tightening and adopt a wait-and-see strategy observing the developments in the financial markets and in the real economy.

While discussing the outlook for economic growth, it was underlined that due to the financial market turbulences the forecasts of economic growth were lowered for the United States, while in Europe there was a decline in business confidence indicators. It was argued that if the economic growth in the external environment of the Polish economy fell short of previous expectations, then lower growth of Polish exports should be expected and, consequently, also lower economic growth and lower inflationary pressure. It was also pointed out that GDP growth was approaching the growth of potential output, while the structure of economic growth was still very favourable from the point of view of the inflation outlook due to the increased investment of enterprises.

Other Council members pointed out that deceleration of economic activity in Europe would not have to translate into lowering of the Polish exports growth, since in the past, in a period of low economic growth, the Western European countries – especially Germany, which absorbed a major part of Polish exports – had increased demand for relatively cheap products from Poland. In the assessment of those members, the current data indicated that the Polish economy remained in the period of strong growth and that the output gap was positive, which was conducive to raising the inflationary pressure.

While discussing the stability of the financial sector, some discussants emphasised that the funding of the Polish economy was based to a larger extent on the banking market than on the capital market and that the property structure of banks was dominated by foreign capital. It was pointed out that it could not be ruled out that potential problems of international financial institutions with capital links to Polish banks might affect the condition of the Polish financial sector. In this context, the issue of separating the banking supervision from the central bank was raised, which in case of turmoil in the financial market may impede the coordination of the measures taken by the central bank and the banking supervision.

Moreover, some discussants pointed to a high growth in loans to households and to the increased share of consumption loans in total households' loans. In the assessment of those discussants, the rapid credit expansion combined with the liberalisation of loan granting criteria may be conducive to deterioration of the credit portfolio of banks, which may prove – along with risks originating in international financial markets – an additional threat to the stability of the Polish financial system. Furthermore, the high growth of loans indicated that the growth of domestic demand may be faster than the growth of potential GDP, which could increase the inflationary pressure. In the opinion of those discussants, the pursued monetary policy should counteract the excessive lending growth. Other members of the Council argued, however, that high growth of loans did not have to mean a deterioration of the quality of banks' credit portfolios, as it resulted from the improved creditworthiness of households related to their increased disposable income, higher employment and lower unemployment rate.

During the meeting it was pointed out that the year-on-year inflation in August clearly undershot the target. Some members emphasised that the inflation decrease in August was deeper than it had been forecasted. Other members pointed out the decrease in inflation was connected with the reduction of prices of internet services that month and that the effects of this reduction would fade out at the beginning of 2008. The rising growth of food prices was also emphasised. Another point under discussion was the possible impact of the annual adjustment of the CPI basket on inflation, which is scheduled for early 2008.

While discussing the situation in the labour market it was pointed out that the relation between the growth of wages and the growth of labour productivity was worsening. Some Council members pointed out that the rise in unit labour costs, and thus also in the costs of enterprises, might lead to worsening their profitability and a decline in the international competitiveness of the economy. Those members claimed that wage growth in Poland was very high in comparison to the majority of Central and Eastern European countries. In the opinion of those Council members, in the nearest future a deceleration of the wage growth should not be expected, as despite a relatively high unemployment rate in Poland, enterprises experienced increasing difficulties in finding new employees. Those members assessed that labour market data signalled building-up inflationary pressure in the Polish economy. They also argued that even in case of deceleration of the economic growth, the wage growth in Poland may remain at a high level contributing to the rise in inflation.

Other Council members were of the opinion that wage growth exceeding growth of labour productivity should not prove permanent, as at some point it is bound to negatively affect the financial results of companies. It was emphasised that the share of wage costs in total costs remained at a low and stable level, which meant that enterprises would not have to increase their prices in response to wage growth acceleration. It was pointed out that enterprises had been undergoing intensive restructuring over the past few years, which had contributed to the observed improvement in the financial results and financial liquidity of this sector. Moreover, it was also pointed out that the accumulated wage growth in Poland over the past few years was markedly lower compared to the neighbouring countries at a similar level of development. It was also emphasised that the fast growth in unit labour costs in the economy had not as yet led to a significant inflation increase. It was claimed that this situation resulted from good financial results of enterprises, which allowed them to absorb the rising wage costs, fierce price competition related to the globalisation and increased flexibility of supply stemming from lower costs of increasing production capacities. It was pointed out that the inflationary pressure was also curbed by increased domestic savings (as evidenced by the inflow of assets to investment funds), higher imports contributing to the rise of the current account deficit and zloty appreciation.

The members of the Council also discussed Poland’s balance of payments. It was emphasised that the *Forecast of the Balance of Payments of the Republic of Poland for the year 2008*, which was adopted during the meeting, pointed to a building-up of the external imbalance of Poland. It was highlighted that though a moderate current account deficit was typical of the economies in the period of real convergence, it was a cause for concern that the forecasted ratio of this deficit to GDP was rising fast. It was pointed out that if the relation between wage growth and productivity growth continued to deteriorate, the international competitiveness of the Polish economy would worsen, which would be conducive to raising the external imbalance. Other Council members assessed that in the nearest future a build-up in the current account deficit should not be significantly increasing the macroeconomic risk of the Polish economy, as in the globalised economy it was possible to finance larger current account deficits than in the past. Moreover, Poland’s membership in the European Union contributed to a significant reduction of the country’s macroeconomic risk.

The Council also discussed the situation of public finance. Some Council members pointed out that despite the early parliamentary elections and the ensuing increase in some of the state budget expenditures in 2008, the so-called budget anchor had been preserved. Other members, however, assessed that the spending of the public finance sector as a whole had increased significantly in 2007 and their structure had become more rigid. It was also argued that the recently introduced changes to the public finance would be deteriorating this sector’s situation not only in 2008 but primarily in the following years. Additionally, it was emphasised that the public finance situation could worsen significantly in the event of economic slowdown.

The members of the Council agreed that it was difficult at the moment to assess the duration of the increased uncertainty in the international financial markets or its impact on the global and, consequently, Polish real economy. They also concluded that the data to be published in the nearest future, both those concerning the domestic economy and those coming from the international markets should be very carefully analysed. In the Council’s assessment, in the medium term the probability of inflation running above the inflation target had decreased to a certain degree due to the previously implemented monetary policy tightening and thus it was not necessary to change the interest rates at that meeting.

The Council kept the interest rates unchanged: the reference rate at 4.75%, the lombard rate at 6.25%, the deposit rate at 3.25% and the rediscount rate at 5.00%.