Minutes from the Monetary Policy Council Decision-Making Meeting held on 3 September 2014

Members of the Monetary Policy Council discussed the current and future monetary policy decisions against the background of macroeconomic developments in Poland and abroad.

While discussing the economic conditions abroad, Council members emphasized that since the previous meeting the uncertainty in the environment of the Polish economy had increased significantly. The growth in uncertainty was driven by an escalation of the conflict in the East and signs of the euro area returning to stagnation. It was pointed out that growing uncertainty about unfolding military crisis in the East as well as economic sanctions would have an adverse impact on economic conditions in Poland and Europe. Attention was drawn to a deepening recession in Ukraine and an ongoing economic downturn in Russia, accompanied by a depreciation in currencies of both countries. These factors have a negative impact on Polish exports and – in consequence – on domestic economic activity.

Some Council members, on the other hand, expressed an opinion that economic sanctions, though severe for some industries, would probably have a limited impact on Poland's trade and domestic economy. Moreover, it was noted that – despite elevated uncertainty driven by growing geopolitical risk in the recent period – the zloty had been relatively stable. A few Council members, however, pointed to a slight depreciation in the zloty since the previous meeting. Furthermore, they were of the opinion that the likelihood of a sharp fall in financial asset prices in the event of a sudden increase in risk aversion had recently increased, especially amidst limited volatility and low turnover in the financial markets.

Council members emphasized that developments in the euro area were an important source of external risk for the economic growth in Poland. In 2014 Q2, the euro area returned to stagnation, which was mainly due to economic conditions in the largest economies of this region. In particular, GDP remained unchanged for the second quarter in a row in France and fell in Italy and Germany. Council members also pointed to a decline in industrial activity indicators in the euro area. At the same time, a few Council members were of the opinion that a rebound in economic activity in the United States since 2014 Q2 might translate into global economic recovery, including in the emerging market economies. As a result, this could have a positive impact on activity of the German economy, and consequently on activity of the Polish economy.

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It was pointed out at the meeting that inflation in the euro area had declined near zero. A few Council members expressed a view that low inflation would – through lower indexation of household incomes – affect demand growth and contribute to extending the period of stagnation in the euro area. Council members pointed out that since the Council's previous meeting, expectations of additional monetary easing by the European Central Bank had increased. Attention was also drawn to interest rate cuts in economies having strong links to the euro area, as well as rising interest rate differential between Poland and its immediate environment.

While discussing the economic conditions in Poland, it was emphasized that incoming data point to a decline in economic growth. Although the annual growth rate of GDP in 2014 Q2 decreased slightly, it was supported to a large extent by a built-up in inventories amidst a decline in net exports and growth in investment. According to some Council members, this may indicate a risk of adjustment in production in the coming quarters to a decrease in sales growth. Weakening economic activity is also confirmed by the data on industrial production and leading industrial indicators, which in the recent months were significantly lower than a few months ago. Moreover, it was stressed that consumer sentiment had declined in the recent period and construction and assembly output growth was came almost to a halt in July. Some Council members also indicated that the pace of recovery in the labour market slowed down as well, as shown by a decrease in employment growth, wage growth and unit labour costs in 2014 Q2.

A few Council members, however, expressed the opinion that elevated uncertainty associated with the escalation of the crisis in Ukraine could have been a major factor behind weakening investment growth in 2012 Q2 and deterioration in economic indicators in the recent period. Therefore, the persistence of the weakening in economic indicators and investment growth is hard to assess. Some Council members assessed that the economic growth could stay close to previous quarters. They indicated that a slight acceleration in private consumption growth in 2014 Q2 and a certain increase in retail sales in July pointed to a continued increase in consumer demand. The rise in consumer demand is supported by the ongoing recovery in the labour market and a steady increase in real wages amidst very low price growth. A few Council members also pointed to a certain growth in industrial production in July.

Referring to the current price developments, it was pointed out that annual inflation had fallen below zero in July, which had been in line with the July projection, although clearly below the expectations formed several quarters earlier. It was emphasized that the decline in inflation below zero was due to a negative growth of food prices amidst stagnant energy prices. At the same time, attention was drawn to the lack of demand pressure confirmed by historically low values of all core inflation measures and the persistence of negative growth of retail sales deflator. It was also indicated that despite recovery in the labour market, there was no wage pressure in the economy. Neither were there any cost pressures, as confirmed by a two-year decline in producer prices. It was pointed out that a

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significant decline in inflation and inflation expectations was conducive to rising real interest rates, despite a stabilization of nominal interest rates.

With regard to the economic growth outlook, Council members assessed that, similarly to 2014 Q2, economic growth in the coming quarters is likely to be lower than expected in the July projection, although – as pointed by a few Council members – will remain close to early 2014. Lower GDP growth than in the July projection is indicated mainly by weaker economic conditions in the environment of the Polish economy. Council members also emphasized that declining sentiment of domestic economic agents driven by growing uncertainty about developments in Ukraine might limit domestic activity.

While analyzing the outlook for inflation in the coming months, it was pointed out that in the following months it would probably be slightly lower than in the July projection. Lower inflation than expected in July will most likely be driven by a stronger decline in food prices (due to embargo imposed on Polish fruit and vegetables and reduced food commodity prices in the international markets), as well as weaker demand pressure associated with slower economic growth than expected in July. Some Council members also indicated that the expected persistence of very low inflation in the euro area would – through strong trade ties with the euro area – add to a reduction in price pressure in Poland. At the same time it was pointed out that – in line with available forecasts – inflation would rise above zero already in 2014, probably on the back of a higher growth rate of energy prices and food price growth rate turning positive.

While discussing decision on interest rates, the majority of Council members assessed that in the near future it would probably be justified to adjust the level of NBP interest rates. In their opinion, signs of economic slowdown in Poland and abroad, an absence of price pressure and increased risk of inflation remaining below the target in the medium term, as well as monetary policy easing in the euro area, are factors in favour of lowering interest rates. These members also assessed that, given moderate economic growth and persisting uncertainty, a risk of macroeconomic imbalances build-up following a probable decrease in interest rates was small. Some Council members considered that NBP interest rates should be reduced already at the current meeting. They argued that – considering a rise in risk of economic slowdown and inflation remaining well below the target in Poland in the coming quarters – it was justified to lower interest rates as soon as possible. Other Council members pointed to uncertainty about the persistence of economic slowdown and developments in the East, which justified – in their opinion – keeping interest rates unchanged at the current meeting. They also noted that in previous meetings the Council had signalled a stabilization of the interest rates till the end of 2014 Q3. At the same time, they emphasized that if the incoming data failed to alter significantly the assessment of economic conditions and inflation developments, it would be justified to begin monetary policy adjustment at the following meeting.

Yet, some Council members assessed that the adjustment of monetary policy in Poland was not currently justified. In their opinion, despite signs of economic slowdown, it is possible that the economic growth will remain stable in the coming quarters. They pointed

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out that given high uncertainty, the impact of interest rate changes on decision-taking by economic agents was limited. In their view, given limited demand for corporate loans, additional monetary stimulus would have little impact on corporate lending. In addition, they argued that any exchange rate depreciation – accompanying interest rate cuts – would affect purchasing power of households with liabilities denominated in foreign currencies. They also pointed out that should the uncertainty diminish, a reduction in interest rates might be conducive to emergence of macroeconomic imbalances.

At the meeting a motion was submitted to lower NBP interest rates by 0.50 percentage points. The motion did not pass. A motion was also submitted to lower NBP interest rates by 0.25 percentage points. The motion did not pass. The Council decided to keep NBP interest rates at the following levels: the reference rate at 2.50%, the lombard rate at 4.00%, the deposit rate at 1.00%, the rediscount rate at 2.75%.

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