NBP

National Bank of Poland

Monetary Policy Council

MINUTES OF THE MONETARY POLICY COUNCIL DECISION-MAKING MEETING HELD ON 28 MAY 2008

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

The discussion at the meeting focused on: current inflation developments, assessment of the risk of second round effects, situation in the labour market, the outlook for economic growth in Poland and abroad and exchange rate developments. The Council discussed the influence of these factors on the future inflation in Poland.

While commenting on the current inflation, it was pointed out that in April CPI inflation had decelerated slightly (to 4.0% y/y), which had been driven by a decline in the annual growth of fuel and food prices. On the other hand, further acceleration in the growth of prices of certain services was a factor increasing inflation. It was emphasized that inflation remaining above the upper limit for deviations from the NBP's inflation target set at 3.5% was mainly the result of the previously observed rise in food prices and increases in administered prices. It was also indicated that increased inflation negatively affects financial condition of households, mainly those less affluent, in particular, when it is related to high growth in food prices. Yet, it was emphasised that due to favourable forecasts of harvest further decline in the growth of food prices may be expected.

Members of the Council paid a lot of attention to the reasons behind inflation remaining at the increased level. They argued that inflation developments in many countries, including Poland, were largely affected by increases in prices of food and oil in the global markets leading to changes in relative prices – i.e. factors beyond the impact of domestic monetary policy. It was pointed out that in comparison with other countries of the Central and Eastern Europe, Poland recorded the lowest CPI inflation and as regards HICP index only Slovakia had lower inflation than Poland. Some members of the Council stressed that additional factors, that are also largely beyond the impact of monetary policy, conducive to growth in prices in the new EU member states include: price and wage convergence and harmonisation of indirect taxes.

While discussing the outlook for inflation, some members of the Council pointed out that considering the recently observed rise in oil prices in the world markets and the results of the NBP's short-term forecasts, inflation in the quarters to come may be expected to remain above the upper limit for deviations from the target. In the medium term, higher inflation would be driven by high growth in wages and unit labour costs. At the same time, some members of the Council pointed out that further growth in gas and energy prices related to growing prices of energy resources and liberalisation of energy prices in Poland might be a factor driving inflation in 2009. In the longer term, weakening growth of energy prices should be driven by liberalisation of the energy market. On the other hand, inflation should be curbed by: lower GDP growth abroad, observed exchange rate appreciation and previous increases of interest rate.

Some members of the Council pointed out that a situation of inflation running markedly above the NBP's inflation target for a longer time increases the risk of second-round effects. This is so because increased inflation may lead to more permanent heightened inflation expectations, which is suggested by a large share of respondents in household surveys expecting inflation to remain at the present level.

Yet, other members of the Council pointed that inflation expectations of households observed in May had lowered. Moreover, some members of the Council assessed that the risk of second round effects is limited due to factors discouraging enterprises from further wage increases. In this context, members of the Council pointed at the expected slowdown in the economic growth reflected in a decline of business sentiment indicators in the corporate sector published in May, zloty appreciation and a deceleration in profit ratios of enterprises in 2008 Q1.

While addressing the situation in the labour market, some members of the Council pointed out that strong growth in wages continued to be the major risk factor for price stability. According to those members of the Council, the April data on wages and employment in the corporate sector and current estimates of unit labour costs in the economy for 2008 Q1 corroborated persistently high wage pressure. At the same time, some members of the Council pointed at a growing wage pressure in the public finance sector and related uncertainty about the 2009 budget. Attention was paid to the fact that increased inflation constituted one of the factors behind currently growing wage pressure in this sector.

While assessing the outlook for economic growth in Poland, some members of the Council pointed out that data concerning economic activity are currently characterized with large volatility related, *inter alia*, to a different calendar of holidays than in 2007 and restrictions imposed on retail trading on holidays. They argue that in such a situation more attention should be paid to business sentiment indicators which - although point at favourable economic situation - had declined in May. Those members also pointed out that in 2008 Q1 there was a decrease in the production capacity utilization. According to those members of the Council, economic growth in Poland in the quarters to come should decline to the level of potential growth. Other members of the Council emphasized that GDP growth in Poland continued to outpace the potential and signals of a slowdown are too weak to expect that inflation will return to the target without further adjustment of monetary policy.

Some members of the Council argued that the decline in profit ratios of enterprises might have a negative impact on investment growth. According to those members of the Council, also lower demand for Polish exports would be a factor curbing economic growth. Lower external demand related to economic slowdown abroad is corroborated by the results of the economic condition surveys for 2008 Q1 where indicator of export forecast declined again.

The meeting also focused on changes in the external conditions of the Polish economy. Some members of the Council pointed out that the data on GDP growth in 2008 Q1 for the United States and the euro area had proved better that expected. Other members of the Council argued that majority of economic indicators point at a serious slowdown in the American economy. Whereas referring to the situation in the euro area some members of the Council indicated considerable differences in economic growth between particular countries. They also emphasized that weak domestic demand together with a risk of a decline in external demand connected both with appreciation of the euro against the American dollar and the British pound and with the slowdown in the American and British economies, continued to be risk factors for economic growth in the euro area. Those members argued that concerns related to economic slowdown were translated into higher risk premia included in interest rates on corporate loans offered by banks in the euro area. It was also pointed out that Poland is among the EU countries whose business cycles are most closely correlated with the business cycle in the euro area which means that the slowdown in the euro area would probably have a negative impact on economic growth in Poland. Moreover, some members of the Council pointed out that uncertainty persisting in the world economy might result in lower inflow of direct investment to Poland which would also bring a decline in economic growth.

While addressing the dilemmas faced by central banks, some members of the Council pointed at a risk of stagflation, i.e. a situation where weakening economic growth would be accompanied by high inflation. In this context, the Council discussed appropriate response of monetary authorities to inflation remaining at an increased level, in particular, when it results, to a great extent, from factors beyond the impact of a domestic monetary policy.

While discussing exchange rate developments some members of the Council pointed out that zloty strengthening was an important factor tightening monetary conditions in the recent period. At the same time, it was pointed out that further rise in interest rate differential might result in increased inflow of short-term capital to Poland, driving further appreciation of the zloty and deterioration of financial results of enterprises which would have a negative impact on investment activity and economic growth. Other members of the Council argued that expectations concerning Fed and ECB interest rates had been changed, which is of significant importance for the outlook of interest rate differential in the period to come. With regard to the United States, interest rates are expected to be raised at the end of the year, whereas with regard to the euro area it had become common to expect interest rates to be kept at the current level. Moreover, these members of the Council pointed out that it was difficult at that time to assess the sustainability of the factors which had recently contributed to zloty appreciation.

While analysing the impact of exchange rate fluctuations on the economy, some members of the Council pointed at a risk of growing external imbalance in case of excessive zloty appreciation. Yet, other members of the Council argued that it was difficult to assess to what extent widened current account deficit was connected with exchange rate appreciation and to what extent it might result from economic growth exceeding the potential GDP growth.

At the meeting, members of the Council discussed the usefulness of the so-called Taylor rule in monetary policy. According to some members of the Council this rule should be used in conducting monetary policy. However, other members of the Council indicated that this rule should rather be used in *ex post* assessments. In this context they pointed at problems of correct specification of this rule and the uncertainty of the estimates of natural interest rate and potential output growth for Poland.

While referring to the interest rate decision, potential further tightening of monetary policy was discussed. In the opinion of some members of the Council, the risk of permanently heightened inflation expectations, high growth in wages and employment and GDP growth remaining above the potential output as well as the absence of clear signs of economic slowdown pointed at the risk of inflation remaining above the inflation target in the medium term. According to those members of the Council, those factors justified an interest rate increase at the May meeting. Moreover, those members pointed out that withholding the decision to raise interest rates increased the risk of inflation remaining above the inflation target for a longer period which would subsequently require more pronounced curbing of economic growth necessary to bring inflation down to the target. Yet, some members of the Council judged that the previous interest rate increases along with considerable appreciation of the zloty exchange rate and expected economic slowdown might prove sufficient to bring inflation down to the target in the medium term. The majority of the Council members argued, that a more comprehensive assessment of the risk of inflation remaining at an increased level will be possible after getting acquainted with the June inflation projection of the NBP. In their opinion, these arguments justified no interest rate change at the present meeting of the Council.

A motion to raise the key NBP interest rates by 25 basis points was put forward at the meeting. The motion did not pass. The Council kept the interest rates unchanged: the reference rate at 5.75%, the lombard rate at 7.25%, the deposit rate at 4.25%, at the rediscount rate at 6.00%.

Publication date: 19 June 2008