MINUTES OF THE MONETARY POLICY DECISION MAKING MEETING HELD ON 5 JUNE 2013

At its meeting, members of the Monetary Policy Council discussed the current and future monetary policy decisions in the context of macroeconomic developments in Poland and abroad.

While assessing the conditions in the external environment of the Polish economy it was noted that data on the euro area GDP in 2013 Q1 had proven to be weaker than expected and confirmed continuing recession in the euro area. Some members of the Council pointed to the fact that although business condition indicators for the euro area had improved somewhat, as observed in the recent period, they continued to suggest persisting recessionary trends in that economy, further delaying the prospects for economic recovery. Factor having an adverse effect on economic activity in the euro area – according to those members of the Council – was the on-going process of deleveraging in the private sector and tightening of the fiscal policy. This translated, in particular, into further deterioration of the labour market situation in many countries, which, combined with unresolved capital shortfall of some euro area banks, hampered growth of the euro area economy.

At the same time, it was pointed out that GDP growth in the United States accelerated in 2013 Q1. An important factor supporting activity in the U.S. economy was revival of consumption, observed amidst gradually declining unemployment. Some members of the Council pointed out that, in the opinion of market participants, improving situation in the labour market and continued economic recovery might urge the Federal Reserve to limit the scale of asset purchases over the next few quarters. The signs of a possible reduction of monetary policy expansiveness by the Fed had strongly effected the sentiment in the global financial markets. Consequently, the emerging markets, including Poland, saw some outflow of its portfolio capital, which was reflected in the weakening of the zloty exchange rate and rising yields on Polish bonds.

While addressing domestic economic activity in early 2013, it was indicated that GDP growth in the first quarter was significantly weaker than expected. It was also stressed that although investment decline had slowed down somewhat, domestic demand continued to decline amidst stagnation in consumption. Moreover, lower contribution of net exports to GDP growth confirmed that low activity abroad, in particular, the recession in the euro area, was adversely affecting the Polish economy. It was also emphasized that the monthly macroeconomic data (stagnation of industrial output and retail sales and further decline in construction output in April) signalled continued weak economic activity at the beginning of 2013 Q2.

Some members of the Council assessed that also the coming quarters might be expected to see persistently low economic activity in Poland, and that recovery might start later than previously assumed. In their opinion, economic activity would continue to be negatively affected by deteriorating situation in the labour market, low credit growth and on-going fiscal tightening (including the decline in public investment). Economic growth would further be curbed – in the opinion of those Council members – by the lack of a significant recovery in the euro area.

Other members of the Council assessed, however, that subsequent quarters might be expected to bring gradual recovery in economic growth. In this context, they pointed to positive signals from the national accounts data, i.e. a less steep investment decline in 2013 Q1 and acceleration in GDP growth, added value and exports in quarter-on-quarter seasonally adjusted terms. Moreover, in their opinion, the approaching economic recovery might be suggested by the improvement in some business condition indicators, halting the decline in the number of new orders in industry and accelerating growth in monetary aggregates observed at the beginning of Q2.

While analysing inflation developments it was pointed out that April 2013 saw another decline in inflation (to 0.8%), which remained markedly below the NBP inflation target. Some members of the Council emphasized that the fall in inflation in the past few months has been stronger than expected in the March projection, and that some of the latest short-term forecasts indicated possible further decline in inflation in subsequent months and its remaining below the lower limit for deviations from the NBP target over the coming year. When discussing inflationary processes, the steepening fall in producer prices (PPI) and continued lack of wage pressure were also noted. According to the majority of the Council members, when taking into account the lack of cost and wage pressures and weak growth prospects, the risk of inflation running below target in the medium term was still greater than the risk of inflation exceeding the target, despite the monetary policy easing implemented so far and some depreciation of zloty exchange rate observed recently. A few members of the Council emphasized, however, that inflation could return to the NBP target within a few quarters, as suggested by forecasts of financial analysts and *Assumptions for 2014 budget law* adopted by the Ministry of Finance.

While addressing the situation in the labour market, a few members of the Council pointed out that although wage growth remained slow, the lowest wages were rising faster than the average ones, which was due to the currently implemented and planned increases of the minimum wage. This contributed to rising unemployment among the young and the low-skilled workers. A few members of the Council argued, however, that an excessively low minimum wage would discourage labour participation, and the current ratio of minimum wage to average wage did not seem high.

While analysing the situation in the banking sector, a few members of the Council pointed out that the recently implemented monetary policy easing had so far not contributed to a revival in lending, which – in their opinion – showed that further interest rate cuts offered only limited potential to boost economic activity. At the same time, those Council members pointed out that falling interest on term deposits, driven by NBP interest rate cuts, discouraged households from this form of saving; whereas term deposits are a relatively stable source of bank financing. Yet, other members of the Council emphasized, that the NBP interest rate cuts had been vastly passed through into interest rates on bank loans and deposits. They also stressed that as monetary policy transmission mechanism was characterised by considerable time lags, interest rate cuts should not be expected to translate immediately into lending and economic growth. In turn, as regards reduced volume of term deposits, those Council members indicated that withdrawn funds were transferred to current and savings accounts, and therefore only maturity structure of banks' liabilities changes.

In assessing the current interest rate level, some members of the Council emphasized that the scale of the monetary policy easing implemented so far was significant, and the NBP interest rates were currently low. According to a few Council members, excessively low interest rates might bring negative effects, namely: undermine the incentives for corporate restructuring, change the structure of bank lending (increase role of mortgage loans, while limiting lending to corporates), spur unprofitable in the long-term investment projects, and lead to asset price bubbles. Those members of the Council also pointed out that some of those factors might translate into lower potential growth. Other members of the Council argued that corporate restructuring was hampered to a much larger extent by institutional and legal factors, and given banks' current attitude to lending, the risk of financing unprofitable investment was not high enough to justify keeping interest rates at – what they assessed to be – an excessively high level. Moreover, in the opinion of those Council members, declining current and forecasted inflation was increasing real interest rates above the level adequate to the current macroeconomic conditions. At the same time, as regards the risk of decreasing potential output growth, a few Council members pointed out that it might also be driven by a prolonged economic downturn, which, causing heightened unemployment might have a lasting negative impact on human capital and increase the level of equilibrium unemployment.

While discussing the level of the NBP interest rates, the majority of Council members assessed that they should be lowered at the current meeting. However, their opinions differed as to the scale of the decrease. In turn, other Council members were of the opinion that the interest rates should be kept unchanged.

When discussing the NBP interest rate decision, the majority of the Council members pointed out that the incoming data confirmed stronger – than expected in March – economic slowdown in Poland and abroad, and a deeper than anticipated decline in inflation. Given the above and considering the uncertainty about the scale and timing of economic recovery in the euro area and the risk of prolonged period of weak economic activity in Poland, the scale of monetary policy easing should be expanded. Further interest rate cuts would support recovery in the Polish economy, and thus the return of inflation to the NBP target in the medium term. At the same time, some of those Council members assessed that the scale of interest rate cuts at the June meeting should be moderate in order to reduce their negative impact on households' propensity to save in the banking sector. In the context of the decision about the scale of interest rate cuts, those Council members also pointed to the issue of interest rate differential between Poland and major developed economies, which may be important for portfolio capital flows. Some Council members argued, however, that due to time lags in the monetary transmission mechanism, the monetary policy easing should be more decisive and the scale of interest rate cuts in June larger.

Other members of the Council assessed that the coming quarters should be expected to bring a gradual recovery in economic activity and a rise in inflation over the coming year (partly due to statistical base effect), which justified keeping the NBP interest rates unchanged. At the same time, expectations that the Federal Reserve would reduce the scale of quantitative easing could translate into the risk of increased capital outflows from the emerging markets, which – in the opinion of those Council members – also spoke in favour of keeping the NBP interest rates unchanged.

At the same time, in the opinion of the majority of the Council members, given the significant scale of the already implemented cuts in the NBP interest rates, the current cycle of monetary easing was coming closer to an end. The Council members pointed out that a more comprehensive assessment of the medium-term outlook for economic growth and inflation – allowing the discussion on the monetary policy stance in the coming months – would be possible in July, after the Council had got acquainted with the new NBP projection and information about a possible amendment to the budget law.

At the meeting, a motion was submitted to lower the NBP basic interest rates by 0.50 percentage points. The motion did not pass. A motion was also submitted to lower the NBP basic interest rates by 0.25 percentage points. The motion passed. The Council decided to lower the NBP basic interest rates by 0.25 percentage points to the following levels: reference rate to 2.75%, lombard rate to 4.25%, deposit rate to 1.25%, rediscount rate to 3.00%.

Publication date: 20 June 2013