National Bank of Poland
Monetary Policy Council

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

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

The main topics discussed at the meeting were: labour market situation, the outlook for inflation outlined in the inflation projection and the zloty exchange rate developments.

Some Council members pointed out that 2007 Q2 brought acceleration in the pace of wage growth in enterprises, which remained higher than labour productivity growth leading to growth in unit labour costs in this sector. Those members also emphasised that the share of labour costs in the costs of enterprises had been falling for a few years and that now this tendency might have reversed. In their opinion, if the rise in unit labour costs is not accompanied by a rise in the prices of products manufactured by enterprises, their financial results will worsen, which would weaken their propensity to invest to a larger extent than it would be the case if the weakening was the result of increased cost of credit in connection to interest rate increases. If, on the other hand, the rise in labour costs is passed through to prices, this will lead to higher inflation. A high wage growth in enterprises can also lead to accelerated wage growth in the public sector, where only slight productivity growth was observed, which would be conducive to increased inflation.

Other Council members argued that it was not only the growth rate of unit labour costs that should be considered but also their level. In their opinion, the level of unit labour costs in Poland was currently relatively low, which resulted in very good financial results of enterprises allowing them to absorb growing labour costs without the need to raise their prices. Those members also pointed out that the findings of corporate survey did not reveal strong build-up in wage pressure in the nearest future and that, according to these survey, only a very small share of enterprises signalled a rise in the prices of their products in response to the growing wages. The same members also emphasised that the decisions taken by the Government increasing the accessibility to the Polish labour market for workers from countries to the east of Poland, together with the increased geographical mobility of Poles, should be conducive to curbing the wage pressure in the economy.

Some Council members indicated that the currently observed strongly growing demand in the product market, amid a limited growth in domestic supply, will lead to increased inflation. In the assessment of those members, a strong demand pressure was, among others, reflected in the continuously high growth of retail sales.

Other members, however, pointed out that the observed economic growth was currently slowing down, which should ease the demand pressure in the economy. Moreover, those members emphasised that a significant contribution to GDP growth was made by investments, which increased the capital stock and thus contributed to the rise in the potential output and labour productivity. The potential output was also positively affected by a considerable inflow of foreign direct investment. They pointed out too that the observed wage build-up and the reduction in the disability pension contribution may be conducive to an increased supply of labour. Overall, the rise in the capital stock and labour supply should, in the opinion of these members, increase the potential output and thus curb the inflationary pressure. They also argued that the rapid growth in domestic demand would be partially absorbed by growth in imports, which should contain the pressure for price growth. Moreover, the same members pointed out that a fast growth in retail sales mainly applies to durable goods treated as quasi-investments (cars, furniture, radio and television equipment and household appliances), the prices of which do not rise.

Another topic raised at the meeting was the outlook for inflation outlined in inflation projection based on the ECMOD model and the results of other forecasts conducted at the NBP. Some Council members emphasised that the inflation forecasts used at the NBP pointed to a higher inflation path than it had been forecasted a quarter before. According to the central projection based on the ECMOD model, in 2009 CPI inflation would approach the upper limit for deviations from the inflation target (3.5%), while core net inflation would actually reach this level. In the assessment of those members, should there additionally occur a negative shock in the food or fuel market, CPI inflation would rise in 2009 markedly above the upper limit for deviations from the inflation target. Moreover, the discussants pointed out that, in the projection horizon, the estimated probability of inflation breaching the upper limit for deviations from the inflation target was on the rise. At the same time, they believed that the anti-inflationary impact of the already implemented and scheduled reduction of the disability pension contribution would not be as large as accounted for in the projection.

Other members argued that, in line with the central projection based on the ECMOD model, inflation remained within the band for deviations from the inflation target throughout the projection horizon. They also pointed out that the results of other forecasts conducted at the NBP pointed to a lower inflation path than the ECMOD-based projection, while one of the forecasts actually pointed to inflation decline at the end of the forecast horizon.

Council members discussed the level of interest rates and the impact of monetary policy tightening on economic growth. Some Council members concluded that increasing the interest rates in Poland to the level markedly higher than euro area level was warranted by a higher level of the neutral interest rate in Poland than in the euro area, which was due to the difference in potential output growth. Those members also claimed that interest rate increase in Poland should not be limiting the investment growth, as currently investments depended more on the optimistic expectations of entrepreneurs on the sustaining of the strong economic growth than on the level of interest rates. They also argued that a high level of stock exchange indices in Poland reduced the cost of investment in relation to the market value of enterprises, which favoured enterprises' decisions to invest. According to those members, a slight increase in interest rate should not dampen economic growth. In their opinion, this view is confirmed, among others, by the fact that, despite a rise in the key NBP interest rates in April 2007, the growth of corporate credit continued to step up in June 2007.

The members of the Council paid a lot of attention to the zloty exchange rate. In this context, attention was drawn both to the impact of fundamental factors and developments in international financial markets, such as the interest rate disparity, developments of the current account balance, changes in net foreign assets of the banking sector, purchases of investment funds abroad, inflow of foreign direct investment, EU funds and transfers from Poles working abroad. Some Council members pointed out that raising NBP interest rates would lead to appreciation pressure. Other members, however, did not share this opinion. Council members could not agree as to the impact of the April and June interest rate increases on the exchange rate of the zloty.

The members of the Council also discussed the outlook for inflation in the context of developments of the real effective exchange rate of the zloty and its impact on the competitiveness of the Polish economy. Some members quoted the examples of some EU countries which experienced wage growths exceeding the growth of labour productivity amid a stable nominal exchange rate, which led to a strong appreciation of the real effective exchange rate of their currencies and the loss of competitiveness of these countries. In the opinion of those Council members, if wage growth was allowed to outpace the growth of productivity, the competitiveness of Polish economy might suffer as a result. In consequence, the rate of economic growth would fall, diminishing the investment attractiveness of the Polish economy and leading to a decrease in the inflow of foreign direct investment.

Council members emphasised the favourable performance of the central government budget in 2007 Q2. Some Council members also pointed out that the reduction in the disability pension contribution would mean transferring some funds from the public to the private sector, the latter having higher propensity to save than the former, which should be conducive to reducing demand and, consequently, to curbing the inflationary pressure. Council members also pointed out that inflation was still offset by the drop in the prices of goods from low costs countries. The Council also discussed the outlook for food and energy prices. Council members emphasised that the inflation expectations of households declined for another consecutive month.

Some members were convinced that both the outlook for inflation outlined in the inflation projection and the macroeconomic data indicated that the probability of inflation running above target was still significantly higher than the probability of its running below target, which – in their opinion – warranted the interest rate increase. Additionally, the same members suggested that it was probable that Poland would join the ERM II in 2010. If inflation overshot the inflation target at that point, this could hinder the stabilisation of the exchange rate within the ERM II.

The Council also discussed the right time for a possible further tightening of monetary policy. Some Council members were of the opinion that the decision to raise interest rate should be taken at the July meeting, as this would follow from the results of the inflation projection based on the ECMOD model published in July. It was also suggested that a better assessment of the risk of inflation overshooting the inflation target in the monetary policy transmission horizon would require macroeconomic data that were to be released before the next meeting. Thus, it was suggested to suspend the decision to raise the interest rates.

Considering the results of the other forecasts conducted at the NBP, which did not point to a risk of inflation overshooting the inflation target, other Council members came to the conclusion that there were no grounds for a further monetary policy tightening. They also pointed out that it was not yet clear when Poland would join the ERM II and so the considerations connected with ERM II membership should not be taken into account in current interest rate decisions. Additionally, they emphasised that a monetary policy tightening may lead to zloty appreciation, increase expectations for further interest rate increases and, consequently, dampen economic growth.

At the meeting a motion to raise the key NBP interest rates by 25 basis points was put forward. The motion did not pass. The Council kept the interest rates unchanged: the reference rate at 4.50%, the lombard rate at 6.00%, the deposit rate at 3.00% and the rediscount rate at 4.75%.