MINUTES OF THE MONETARY POLICY COUNCIL DECISION-MAKING MEETING HELD ON 29 JULY 2009

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 outlook for economic growth abroad and in Poland, medium-term inflation outlook, fiscal policy and credit market conditions.

The Council devoted a lot of attention to the outlook for global economic growth, while at the same time pointing out the considerable uncertainty surrounding the activity in the world economy both in the near future and in the longer term. It was emphasised that in the light of some data, including in particular those on the United States and China, recessionary tendencies in the world economy might have been halted in 2009 Q2, which is to a large extent connected with the fiscal and monetary stimulus programmes being implemented in many countries. Some Council members assessed that those programmes may be conducive to a recovery of global economic growth in 2010. They argued that accelerated economic growth in China may have an effect of reviving the activity in other Asian economies and – through increasing trade, which would also include raising those countries' demand for imported investment goods – lead to an economic recovery in the euro area and the United States. Other members of the Council, however, believed that the incoming information was rather ambiguous and that on the basis of data signalling a strong increase in savings accompanied with a drop in household consumption in the United States and also a further deterioration in the euro-area labour market in 2009 Q2, it was difficult to expect any marked rise in global economic activity in the near term. Moreover, they argued that with the end of the stimulus programmes implemented in the United States and many other countries the activity in these economies may slacken again, which may be connected with government expenditures being trimmed to curb budget deficits and limited spending of indebted households.

While addressing the long-term outlook for the world economic growth, some Council members argued that the global financial crisis may negatively affect the potential GDP growth in many countries. This may be driven by the steep decrease in world trade and international capital flows, in particular foreign direct investment, the breakdown of a part of the financial sector and the ensuing reduced access of economic agents to credit and also by the relatively persistent rise in unemployment. In the opinion of those Council members, the high level of uncertainty as to the impact of the financial crisis on economies in the longer term significantly hinders the assessment of the future economic growth and inflationary pressure in the world and in Poland, especially with the use of econometric models which are based on historical data.

While addressing the situation in the domestic economy, it was pointed out that some positive signals regarding the economic activity appeared recently. It was assessed that the deceleration of recessionary tendencies in Poland may be indicated by the slower decline of industrial output, an improvement in some business confidence indicators and the fact that part of the data for June proved better than expected. Some Council members assessed that the GDP growth in 2009 Q2 may have been positive and slightly higher than expected in the June projection, which raised the probability of above-zero GDP growth in the whole of 2009.

Other Council members, however, emphasised that in the light of the June NBP projection the GDP growth would be lower than the potential output growth in the monetary policy transmission horizon. Those members assessed that in the time to come recession abroad would continue to negatively affect the activity in the Polish economy, in particular through the low demand for Polish export products and a drop in foreign direct investment conducive to lowering labour productivity. They emphasised that the rise in unemployment, declining growth of real wages and the drop in the value of households' assets observed till 2009 Q1 would be contributing to further reduction in consumption demand in the coming quarters. They also argued that the prospects for investment growth in the enterprise sector remained negative, among others, due to the pessimistic – despite some improvement – sentiment of entrepreneurs, hindered access to credit and possible further tightening of banks' credit policies and also deteriorating corporate profits. In the assessment of some Council members, economic growth in Poland may run below the central path of the June projection of the NBP, among others, due to the possibly lower economic activity abroad than accounted for in the projection, weaker than projected investment growth connected with the negative business sentiment and a stronger increase in unemployment along with the ensuing drop in households' disposable income. Those members also argued that the recently observed appreciation of the zloty would be conducive to reducing net exports and, consequently, to lowering GDP growth.

At the meeting the Council also discussed the fiscal policy and its impact on the outlook for economic growth in Poland. It was pointed out that in the light of the draft amendment of the *Budget Act for the Year 2009* passed by the lower chamber of the Parliament the drop in tax revenue in 2009 would be significantly deeper than the scale of the assumed increase in the central budget deficit. In the opinion of some members of the Council, with a persisting structural deficit of the general government, part of lost tax revenue would be compensated by ad hoc measures aimed at increasing non-tax revenue or cutting or postponing budget expenditure. In the assessment of those Council members, such measures would be conducive to a one-off reduction of the central budget deficit in 2009, but at the same time to its increase in the following years. This creates the risk for the public debt to breach the so-called prudential thresholds provided for in the *Public Finance Act* and also the limit set forth in the Constitution, which would necessitate a strong fiscal tightening and would have a procyclical effect of undercutting domestic demand and slowing GDP growth. Moreover, in the assessment of those Council members, the shifting of some central budget expenditures to other general government units, which was assumed in the discussed bill, led to reducing the transparency of the public finance and increasing the uncertainty as to the actual scale of fiscal imbalance in Poland. In this context it was emphasised that there was a need of implementing structural reforms, including the public finance reform, in Poland in the longer run, which would favour a permanent increase in economic growth.

While discussing current inflation it was pointed out that the CPI inflation in June declined to the upper limit for deviations from the inflation target of the NBP (i.e. to 3.5%), which was primarily the effect of a stronger than a year before seasonal drop in the food price growth and slower growth of prices of energy carriers resulting mostly from the base effect. Some members of the Council emphasised that June also saw a reduction in core inflation net of food and energy prices, which in 2009 Q2 as a whole proved slightly lower than forecast in the June inflation projection. Other Council members stressed that in the past few quarters core inflation remained at an elevated level and did not fall significantly despite a strong deceleration of economic growth, which pointed at the persistence of inflationary processes. In particular, the prices of some market services have been rising over the recent months, which in the opinion of those Council members might indicate a persisting demand pressure in some sectors of the economy. Moreover, those Council members pointed out that – despite a decline in June – the CPI inflation in the whole of 2009 Q2 proved markedly higher than in the June projection. In this context it was pointed out that the ex post real interest rates (deflated with current inflation) in Poland were close to zero.

While analysing the medium-term inflation outlook, some Council members assessed that – in line with the June projection – inflation in the monetary policy transmission horizon would fall below the inflation target, which would be driven with the negative output gap and easing wage pressure. At the same time, some Council members assessed that inflation in the medium term could be lower than envisaged by the central projection path due to lower growth of unit labour costs, which could result from a deeper drop in wage growth than that accounted for in the projection. Moreover, in the conditions of low demand the impact of ULC growth on inflation may be limited. Another factor mentioned as potentially conducive to lower inflation in the time to come was the significant appreciation of zloty exchange rate observed over the past few months.

Other Council members assessed that inflation in the coming quarters may be running above the central projection path, among others, due to the risk of higher commodity and food prices than in the projection and the continuing high demand for some services resulting from the structural changes ongoing in the Polish economy and increasing the prices of those services. Those members also pointed out that in line with the June projection, in 2010-2011 CPI inflation should be running below core inflation net of food and energy prices, which has not been observed since 2003. They also argued that, due to the difficult revenue situation of the general government sector, the coming period may bring further increases of administered prices, which would postpone the decline in inflation. On the other hand, however, they emphasised that an elevated inflation level in the time to come would mainly follow from the previously implemented and possible further increases of administered prices and only to a small extent from the continuing demand pressure.

The Council discussed the credit market situation and interest rate developments in Poland. It was pointed out that, despite the NBP interest rate cuts, in June 2009 the interest charged on some newly granted loans increased, which in combination with the concurrent decline in the interest paid on some new deposits pointed to increased interest margins of banks. In the opinion of some Council members, the imperfect pass-through of the reference rate to the interest rate charged on new loans was an argument against further cuts of NBP rates. Other Council members argued that the so far effected NBP interest rate cuts had, in the longer perspective, contributed to lowering the interest on loans and that the reduction in lending along with increased interest margins were related to the growing credit risk, particularly in the case of loans granted to corporates. The Council also analysed the impact of the NBP’s interest rates on long-term interest rates.

While considering the decision on interest rates, the Council assessed that the uncertainty about the outlook for inflation and economic growth in the world and in Poland justified keeping the rates unchanged at the current meeting. Some members of the Council believed that in view of the low level of real interest rates, the continuously elevated current inflation level and balanced – in their assessment – probabilities of inflation running above or below the inflation target in the medium term, the NBP interest rates should be kept unchanged also in the months to come. Other Council members assessed that inflation would drop below the NBP inflation target in the medium term, which combined with the risk of a stronger than expected decline in economic growth may justify the continuation of monetary policy easing in the future. The prevailing view at the meeting was that the probability of inflation running below the inflation target in the medium term was higher than the probability of inflation running above the target.

The Council kept the interest rates unchanged: the reference rate at 3.50%, the lombard rate at 5.00%, the deposit rate at 2.00% and the rediscount rate at 3.75%.

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