**MINUTES OF THE MONETARY POLICY COUNCIL
DECISION-MAKING MEETING HELD ON 27 AUGUST 2008**

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

The discussion at the meeting focused on exchange rate developments and their impact on economic growth, external balance and inflation, the outlook for economic growth in Poland and abroad and the situation in the labour market. The Council discussed the influence of these factors on future inflation in Poland.

While analysing the impact of exchange rate developments on the outlook for inflation and economic growth in Poland, attention was paid to the depreciation of the exchange rate of the zloty and other currencies of the region, both against the US dollar and the euro, which was observed in August 2008. It was indicated that at present it was difficult to assess whether the observed zloty depreciation would be of permanent nature. Yet, some members of the Council pointed to the risk of zloty depreciation in the context of the anticipated economic slowdown in Poland. Moreover, they indicated that changes in the exchange rate of the euro against the US dollar might be important for future zloty exchange rate developments. Those members emphasised that in the case of further depreciation of the zloty, the exchange rate would cease to be the factor curbing inflation in Poland. At the same time it was pointed out that the slowdown in the global economy, including in the EU economies, might result in lower demand for Polish exports which would contribute to the depreciation of the equilibrium exchange rate. Other members of the Council also pointed out that despite the recently observed depreciation, the exchange rate of the zloty continued to be considerably stronger than in the previous quarters. They argued that although exchange rate appreciation constituted a factor curbing imported inflation, further interest rate hikes might lead to a renewed appreciation of the zloty exchange rate, which could negatively affect the competitiveness of Polish manufacturers and, as a result, economic activity in Poland.

While analysing the developments of the zloty exchange rate, the Council discussed the impact of the appreciation on the external balance of the Polish economy. It was pointed out that according to preliminary data in the first half of 2008 the foreign trade deficit had deepened. Attention was also paid to the fact that preliminary data suggested changes in the structure of financing of the current account deficit of the balance of payments, reflected in a decline of foreign direct investment and a growth in portfolio investment in 2008 Q2. Some members of the Council argued that the rise in the foreign trade deficit had probably been driven by a strong appreciation of the zloty exchange rate leading to deteriorating competitiveness of Polish producers both on the domestic market as well as on foreign markets. Other members of the Council pointed out, however, that import growth outstripping export growth could have been connected with high growth in domestic demand, hence, considering the expected economic slowdown in Poland, import growth should be expected to decline. Besides, those members reasoned that in the longer term wage growth outpacing labour productivity growth might be a more important factor leading to deteriorating competitiveness of Polish exports.

While addressing changes in the external environment of the Polish economy, attention was paid to the persisting, despite relatively high GDP growth in 2008 Q2, unfavourable outlook for economic growth in the United States, as well as deeper than expected deterioration in economic conditions in certain EU economies. Particular attention was paid to strong economic slowdown, deteriorating economic conditions indicators and further worsening of consumer sentiment in economies which constitute the main markets for Polish exports – Germany, France, Italy and Great Britain. The worsening outlook for exports in the euro area was also pointed to, particularly for German exports, which, due to the strong trade links between Polish and German exporters, might translate into a decline in Polish exports.

During the discussion, attention was paid to a considerable drop in fuel prices in the global market observed since early July 2008, noting, at the same time, that at present it was difficult to assess whether this phenomenon was of permanent nature. Some members of the Council argued that due to the anticipated further deterioration in business conditions in the developed countries, the risk of further strong growth of fuel prices in the global market had declined. Moreover, those members indicated that slower growth in global demand might also translate into curbing the rising prices of other commodities which would be conducive to reducing global inflation.

While discussing the outlook for economic growth in Poland, it was pointed to the signs of economic slowdown i.e. lower that expected growth in industrial output and further decline in manufacturing orders in July 2008, deteriorating financial results of enterprises and growing share of semi-finished goods and work-in-progress, goods and finished products in the structure of inventories in the first half of 2008 as well as a deterioration of the majority of economic conditions indicators. Some members of the Council pointed out that a further decline in GDP growth might by triggered by limited investment, which could be driven by deteriorating profit ratios of enterprises. Moreover, they argued that further weakening in business conditions in the EU might – through falling demand for Polish exports – lead to a deeper-than-currently-anticipated decline in economic growth in Poland. Other members of the Council pointed out, however, that GDP growth in 2008 Q2 had probably been higher than anticipated in the June projection, which suggested that the scale of subsequent decline in economic growth might be smaller that projected. They also indicated that drawing conclusions about changes in economic activity in Poland based on the monthly data on industrial output was subject to uncertainty, especially taking into account the growing share of services in the structure of the Polish economy.

While analysing the situation in the labour market it was pointed to persistently high growth in wages and unit labour costs running well above the level anticipated in the June projection. Some members of the Council argued that the relation between wage growth and labour productivity growth might deteriorate in the near future due to the expected economic slowdown and the resulting decline in labour productivity growth. On the other hand, other members of the Council reasoned that the economic slowdown would contribute to lower labour demand, and consequently, with a certain time lag, would curb wage pressure, whereas the persistently relatively high investment growth would be conducive to growth in labour productivity. They also paid attention to the diminishing importance of wage pressure as a growth barrier indicated by enterprises in the NBP’s business condition surveys and gradually declining employment growth amidst continued growth in economic activity. Moreover, those members argued that tensions in the labour market would be eased as a result of declining migration outflows, due to, among other things, weakening in business conditions in Great Britain and other EU countries. It was also pointed out that high wage growth was partly related to the process of convergence of the Polish economy with richer countries of the EU.

When assessing the impact of the persistently high wage growth on inflationary processes, some members of the Council argued that amidst continuing fast growth in demand, entrepreneurs might tend to pass on the increase in labour costs to prices. Moreover, attention was paid to the fact that growing consumer demand driven by rising income of households was conducive to growing inflationary pressure as indicated by the rise in core inflation, including growth in the prices of services, which had been observed for several quarters. Those members also pointed out that the anticipated rise in CPI in August 2008 created a risk of a rise in inflation expectations. On the other hand, some members of the Council indicated that the previous month saw inflationary expectations stabilising and that an economic slowdown in Poland would limit the risk of second-round effects. They also pointed out that the impact of a rapid wage growth on inflation might be mitigated by the decline in the share of labour costs in the total costs of enterprises, observed in the previous years.

Some members of the Council pointed out that factors contributing to persisting demand pressure might include, apart from rapid wage growth, still high although declining credit growth, including high growth in consumer loans. Other members of the Council argued, however, that as a result of the declining value of financial assets of households and the growth in new loans, asset encumbrance had been growing which should limit households' future borrowing capacity. They also emphasised that an economic slowdown might have the same effect. At the same time it was pointed out that the possible growth in interest-rate differentials might have a limited impact on the growth in credit aggregates due to the possibility of zloty-denominated loans being substituted by foreign-currency-denominated loans. On the other hand, it was argued that an interest rate rise should be conducive to a decline in credit growth, among other things, through influencing the expectations of future income of households.

The meeting also addressed current inflation developments. It was pointed out that in July core inflation net of food and energy prices continued to run at the level recorded in June 2008, and the acceleration of CPI inflation as compared with the previous month had been driven by the increasing growth of food, energy and fuel prices. The attention was also paid to the fact that inflation in Poland, similarly as in Slovakia, continued to be the lowest in the region. It was also emphasised that the 12-month moving average HICP inflation taken into account while assessing the compliance with the Maastricht price stability criterion, despite its increase, still had not exceeded the reference value.

While discussing the decision on interest rates, some members of the Council pointed out that the scale of economic slowdown might not be sufficient to bring inflation down to the target over the monetary policy horizon. Moreover, curbed appreciation of the zloty coupled with the risk of exchange rate depreciation connected with the expected slowdown in the Polish economy, falling real interest rates – despite the already implemented interest rate increases – and the risk of inflation expectations continuing at a heightened level justified, in their opinion, raising interest rates at the present meeting. In the judgement of those members, delaying subsequent interest rate increases might boost the costs of bringing inflation down to the target. In the opinion of other members of the Council, considerable economic slowdown abroad, signs of economic slowdown in Poland, the already implemented interest rate increases and the expected decline in wage pressure would constitute factors bringing inflation down to the target in the medium term. Those members also pointed out that interest rate rise could be conducive to the appreciation of the zloty exchange rate which would pose a risk of a deeper economic slowdown in Poland and further rising of external imbalance. Moreover, they argued that a more comprehensive assessment of the risk of inflation continuing at a heightened level in the medium term would be possible after analysing the data to be released in the coming months.

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 6.00%, the lombard rate at 7.50%, the deposit rate at 4.50% and the rediscount rate at 6.25%.

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