MINUTES OF THE MONETARY POLICY COUNCIL DECISION-MAKING MEETING HELD ON 31 OCTOBER 2007

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: changes in the environment of the Polish economy, exchange rate and food prices developments and the outlook for economic growth. The Council discussed the influence of these factors on the future inflation in Poland in view of the October inflation projection.

While discussing the changes in the environment of the Polish economy, it was pointed out that considerable uncertainty persisted as to the assessment what effects the turmoil in international financial markets would have on the outlook for growth and inflation in the global and Polish economies. It was emphasised that there had been a downward revision of the forecast of economic growth in the United States and, to a lesser degree, in the euro area, and that the sentiment of euro-area consumers and producers was less optimistic. It was pointed out that in the past, in the period of low economic growth, Western European countries had reported increased demand for relatively cheap products from Poland. However, the recently observed appreciation of the zloty might result in a decrease of exports due to the deteriorated competitiveness of Polish products. As a consequence, economic slowdown of Poland's main trade partners would translate into a weakened economic activity in Poland. It was also pointed out that in the face of turmoil in international financial markets some central banks decided to ease or restrain further monetary policy tightening despite mounting inflationary pressure.

Some Council members argued that the impact of the disruptions in the US real estate market on economic growth may prove weaker than expected, due to the continuously stable net value of the assets held by US households. Moreover, the discussants pointed out that the situation in international financial markets had stabilised to some extent. It was emphasised that, despite persistent uncertainty as to the impact of turmoil on global economic growth, some central banks had raised interest rates over the recent period, which was related to rising inflationary pressure observed in those economies. It was also argued that one of the factors that contributed to the recently observed turmoil in international financial markets, was lax monetary policy previously pursued by major central banks.

The members of the Council devoted a lot of attention to the zloty exchange rate. In this context, the influence of fundamental factors as well as tendencies in the international financial markets were considered. Some Council members also pointed to the possible impact of the parliamentary election outcome in Poland on exchange rate developments. It was emphasised that the zloty had appreciated since the previous meeting of the Council. Some Council members argued that the zloty appreciation would limit price growth. Those members pointed out that in Poland, just like in other small open economies, foreign exchange movements are an important factor influencing economic situation and inflation. Other Council members, however, indicated that, at the moment, it was difficult to assess the sustainability of the factors that had been conducive to zloty appreciation.

While commenting on the current inflation, some Council members pointed out that the average 12-month HICP for Poland, which is considered in the assessment of the compliance with the inflation Maastricht criterion, had been steadily rising since the end of 2006. At the same time, it was argued that there was a considerable risk that in the next few quarters Poland might cease to comply with the Maastricht inflation criterion. Other members emphasised that net inflation continued at a low and stable level and that the rise in CPI inflation in September 2007 resulted primarily from a rise in food prices, which was independent from the monetary policy.

At the meeting, the Council also discussed food price developments. Growth of these prices may continue in the longer term as it stems, to a large extent, from structural factors connected with increased demand for food in developing countries. At the same time it was pointed out that in Poland food still accounted for a considerable part of the consumption basket of households. As a result, a significant price increase in this group of products may be conducive to increasing inflation expectations and, consequently, to further build-up of wage pressure. Some Council members, however, claimed that the risk of second-round effects connected with food price growth was not high, as further acceleration of wage growth was rather unlikely considering the appearing symptoms of weakening economic growth.

While discussing the influence of global factors on the inflation outlook, some Council members concluded that inflation was still being curbed by a decline in prices of goods imported from countries of low production costs. However, an ever increasing pressure on growth of prices should be expected due to rising demand of those countries, which is already visible in the food and commodity markets. This means that the impact of globalisation factors on inflation may be reverted. Other members pointed out that in the face of rising demand an increase in food output might occur, which would mitigate the pressure on price growth. The same members indicated that, at the moment, it was difficult to assess the joint effect of globalisation factors on future inflation.

The members of the Council also discussed labour market developments. Some Council members pointed out that the currently observed fast wage growth was connected with permanent factors such as the shortage of qualified workers and the ongoing process of Polish wages converging to the level of more developed EU countries. It was emphasised that the wage pressure may be additionally increased by possible second-round effects connected with the rising food prices. Discussants underlined that wage growth was still being fuelled by increased emigration of Polish workforce to EU countries. In turn, some Council members assessed that, most likely, the main emigration wave had already passed and that enterprises were beginning to adjust to labour market developments. The same members argued that the results of survey studies of enterprises indicated that a relatively small group of enterprises intended to raise wages, while in September 2007 the wage growth in the enterprise sector had recorded some deceleration. It was also emphasised that wage growth exceeding the rise in labour productivity would be limited in time, as the decelerating growth of the output and sales of enterprises would limit the possibility of pay rises. Additionally, it was argued that the growth of unit labour costs in the economy calculated on the basis of BAEL (LFS) data may be overestimated.

While discussing the issue of economic growth in Poland, it was noticed that in October 2007 GUS data on GDP growth in the first half of 2007 had been revised downwards. Moreover, it was emphasised that the macroeconomic data for September 2007 suggested a slowdown in economic growth (there was a decline in the growth of industrial production, retail sales and wages in the enterprise sector and also in money supply and loans to households). Nevertheless, some Council members argued that the latest data did not indicate the substantial economic slowdown which would reduce inflationary pressure, as there had not been any significant change of trends of those macroeconomic variables. Moreover, it was noticed that the lowering of economic growth had been anticipated and was accounted for in the October inflation projection.

The Council also discussed the outlook for inflation as outlined in the inflation projection based on the ECMOD model. Some members of the Council pointed out that, in line with the central projection, in 2009, CPI inflation and core net inflation will breach the upper limit for deviations from the inflation target. They also emphasised that the projection did not fully cover the risk of inflation overshooting the target. It was argued that the forecasted lowering of wage growth was rather unlikely amid continuing surge in demand and decreasing rate of unemployment, which, in their assessments, was running below the NAWRU. At the same time, those members pointed out that, due to the procyclicality of labour productivity, it was hard to expect it to accelerate amid the forecasted lowering of GDP growth. In consequence, they argued, the growth of unit labour costs may prove higher than forecast in the projection. It was also pointed out that the projection forecast a considerable acceleration of potential GDP growth, which was faster than suggested by experiences of other countries. Moreover, it was emphasised that the projection did not fully account for the risk of a permanent rise of food price dynamics and the risk of second-round effects. Other Council members, on the other hand, pointed out that the level of the zloty exchange rate accounted for at the starting point of the projection was weaker than that observed; at the same time a nominal exchange rate depreciation was forecasted in the projection horizon. It was argued that if the exchange rate of the zloty sustained at an unchanged level, inflation might be significantly lower than in the projection.

While addressing the situation of the public finance, some Council members emphasised the fact that the state budget deficit in 2007 should be considerably lower than envisaged and at the same time, its ratio to GDP would decreased in relation to the previous year. It was pointed out that in 2008 the ratio of the deficit to GDP should not increase and might even decrease. Some discussants, however, claimed that 2008 would bring a rise in the structural deficit of the public finance sector, which meant that the fiscal policy would have a procyclical impact on the economy.

As a result of the discussion some members concluded that the assessment of the inflation outlook based of the ECMOD-based October inflation projection and considering factors not accounted for in the projection indicated that the probability of inflation overshooting the target in the projection horizon was significant and warrant raising interest rates at the October meeting. Other Council members, however, were convinced that the recently observed appreciation of the zloty exchange rate limited the rise of inflation and that the inflation outlook would be affected by future developments in the foreign exchange market. They also pointed to the symptoms of an economic weakening.

A motion to raise the key NBP interest rates by 25 percentage points was put forward at the meeting. The motion did not pass. The Council kept the interest rates unchanged: the reference rate at 4.75%, the lombard rate at 6.25%, the deposit rate at 3.25% and the rediscount rate at 5.00%.