

MINUTES OF THE MONETARY POLICY COUNCIL DECISION-MAKING MEETING HELD ON 29 OCTOBER 2008

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

The discussion at the meeting focused on: situation in the external environment of the Polish economy, outlook for economic growth in Poland, situation in the labour market and the prospects of Poland's entry to the euro area. The Council discussed the impact of those factors on future inflation developments in Poland in view of the October projection of inflation and GDP.

While discussing the situation in the external environment of the Polish economy, further considerable deterioration in the outlook for economic growth in the global economy was noted. It was emphasised that the crisis of the financial sector in the United States contributed to intensifying unfavourable developments in the real economy of that country. Attention was also paid to considerable deterioration of economic climate in Great Britain and strong slowdown in economic activity in the euro area as well as considerable lowering of growth forecasts for the euro area's economy. Moreover, it was emphasised that in the time to come the weakening of the economic activity would be experienced not only in the developed but also in developing economies, including Asian and Latin American countries. In the case of economies exporting commodities, an important factor conducive to lower economic growth would be the decline in the value of their exports caused by falling commodity prices, whereas the decline in economic activity in the emerging economies which import commodities might additionally contribute to the lowering of prices of those commodities. It was pointed out that the slowdown in global economic activity curbed inflationary pressure, prompting central banks of many countries to ease their monetary policy.

The Council paid a lot of attention to the impact of the weakened global economy and the turmoil in the global financial markets on the outlook for economic growth in Poland. It was pointed out that the recession in the euro area, which is Poland's main trading partner, would lead to the lowering of demand for Polish exports. It was emphasised that deteriorating growth outlook in the global economy and the increased uncertainty in the external environment might – despite still relatively good condition of the Polish economy – contribute to the worsening of households' expectations of the future economic situation in Poland and, as a result, to the weakening of consumption demand. It was also argued that the drop in the value of households' assets being the result of the downturn in the financial markets might additionally dampen the consumption growth. It was also pointed out that changes in the external environment of the Polish economy might adversely affect the investment activity of enterprises in Poland. Investment growth may slow down primarily due to worsening entrepreneurs' expectations concerning the future demand in the foreign and domestic markets. Moreover, it was emphasised that the rise in risk premium driven by the turmoil in the international financial markets had led to a rise in market interest rates in Poland, and, consequently, to an increase in the cost of credit, which would also contribute to the weakening of investment growth in the time to come. Difficulties in acquiring capital for new investment, related to falling share prices in the capital markets, may also have the same effect. Attention was also drawn to further tightening of loan granting criteria by banks. A possible decrease in the inflow of

foreign direct investment to Poland and deteriorating outlook for the financing of enterprises with foreign loans were also listed among adverse effects of the weakening world economy and the crisis in the global financial markets.

While assessing the outlook for economic growth in Poland, it was pointed out that in the coming quarters the above discussed factors would be conducive to lowering GDP growth. It was emphasised that the decline in economic growth was signalled, inter alia, by the deterioration in economic climate indices observed in the past few months. It was also emphasised that the growth of retail sales and industrial output in 2008 Q3 was markedly lower than in the first half of 2008. On the other hand, some members of the Council pointed out that the decline in the GDP growth in Poland would be curbed by the inflow of EU structural funds for financing investment projects, the expected relatively low level of prices of oil and other commodities as well as the zloty exchange rate depreciation observed between July and October 2008 which, if proved lasting, might mitigate the adverse impact of the weakening economic activity in the external environment of the Polish economy on the growth of Polish exports.

While addressing the situation in the labour market, it was assessed that in the near term wage pressure may be expected to continue despite the decline in economic growth. At the same time, however, it was pointed out that in the longer term the wage pressure would ease due to the falling labour demand signalled, inter alia, by further decline in the annual employment growth in the corporate sector in September 2008. It was also argued that due to the economic slowdown in Western Europe, one could expect increased returns of Poles from economic migration and, consequently, a rise in the number of the economically active persons, which would contribute to further easing of the wage pressure. Moreover, it was assessed that the strong rise in corporate investment observed in the past few quarters would result in labour productivity continuing at a relatively high level, contributing to the improving of the unfavourable relation between the wage and labour productivity growth in the time to come.

When analysing inflation developments in Poland, it was noted that core inflation net of food and energy prices had increased in September 2008. Some members of the Council pointed out that the rise in core inflation was one of the major factors driving the considerable increase in CPI inflation over the past year. They emphasised that the increase in the growth of the prices of services was an important factor contributing to the rise in both CPI and core inflation. They argued that high growth of those prices in the analysed period resulted, on the one hand, from growing demand pressure (which, in turn, in the opinion of those members of the Council, was the result of the high wage growth and fast credit growth observed in the past few quarters), and, on the other hand, from intensifying cost pressure driven by rising unit labour costs. Moreover, those members pointed at the signs of growing share of services in households' consumption expenditure which suggests that the impact of the prices of services on CPI would be increasing. In the opinion of those members, accounting for those tendencies in the GUS revised CPI basket next year, provided the current prices trends continue, could be conducive to increasing inflation in 2009. Other members of the Council indicated that faced with deteriorating outlook for economic growth, the household demand for services might weaken, thus easing the pressure on further rise of those prices. They also indicated that the rise in the prices of services might be connected with the increasing demand for services resulting from the adjustment of the consumption structure in Poland to the structure prevailing in wealthier EU countries. Those members also argued that high annual growth of prices of certain services (e.g. in the group of *restaurant and hotel services*) resulted, to some extent, from previous strong increases of food prices, whereas in the case of some other services the price increases were largely related to insufficient competition in the markets of those services.

Some members of the Council pointed out that the rise in CPI inflation in the past year was largely driven by a rise in administered prices dependent on the decisions of central and local government entities (in particular, prices of services related to flat maintenance and energy prices), at the same

time emphasising that further rise in those prices would be conducive to increasing inflation also in the future. Other members pointed out that due to the expected continued high contribution of growth in administered prices to CPI inflation, bringing CPI inflation down to the inflation target would require curbing the core inflation through considerable easing of demand pressure.

While discussing the outlook for inflation, some members of the Council emphasised that increased growth of consumer prices in the past months had been largely driven by the high annual growth of food and fuel prices, and that the expected decline in the growth of those prices in the coming months, driven by falling commodity prices in the world markets, would bring inflation down. Yet, it was emphasised that at present it was difficult to assess whether the currently low level of oil prices was a lasting phenomenon or not. Some members of the Council indicated that already in September 2008 CPI inflation had decreased as a result of a strong decline in the annual growth of food and fuel prices. They also stressed that GDP growth falling below the growth of potential output in the coming quarters would contribute to curbing the inflationary pressure. Some members also argued that the rise in administered prices and increasing households' loan service burden resulting from rising market interest rates would limit the volume of current consumption, thus contributing to lowering demand pressure and, consequently, inflationary pressure. Inflation should also be curbed by the expected easing of wage pressure and the continuing disinflationary impact of goods imported from low-cost countries. Moreover, those members assessed that due to the possible considerable weakening of economic activity in Poland, inflation in the coming quarters might be significantly lower than assumed in the October inflation projection based on the NECMOD model. In the opinion of those members of the Council, considering the current exceptionally high uncertainty about the growth outlook for the world economy, reflected in significant and frequent revisions of macroeconomic forecasts, the usefulness of forecasts based on econometric models is lower than usual. It was pointed out that due to considerable deterioration in the situation in the external environment of the Polish economy, the works on the October inflation projection based on the NECMOD model involved quantification of the related risks, in the light of which the forecast GDP growth and inflation in Poland would be lower than suggested by the data released until 26 September 2008. Some members of the Council also pointed at other inflation forecasts which had been recently revised downwards.

In the opinion of other members of the Council, even considerable slowdown of GDP growth would not contribute to a rapid decline in inflation, which was reflected in the NBP's October projection. Those members pointed at the results of other forecasts conducted at the NBP according to which the forecast inflation, despite downward revision, would be running at an increased level in the coming quarters. They also emphasised that in line with the central projection path, the forecast CPI inflation in 2009 would be running at a level above the upper limit of deviations from the NBP's inflation target even after accounting for the quantification of risks resulting from deteriorating outlook for the global economic growth. Those members emphasised that in the light of the October projection, core inflation would remain at an elevated level in the coming quarters. It was also underlined that some measures of inflation expectations of individuals increased in September. Some members of the Council pointed out that expectations of future inflation might increase as a result of the turmoil in the financial markets and the related zloty exchange rate depreciation observed in October. At the same time it was pointed out that in September inflation expectations of bank analysts and some measures of inflation expectations of individuals decreased; in the opinion of some members of the Council, the decline in the economic activity in Poland, as anticipated by households, might contribute to the lowering of households' expectations of future inflation.

The discussion at the meeting also focused on the prospects of Poland's accession to the euro area in the context of the calendar of preparation for the euro adoption presented in October by the Council of Ministers. It was pointed out that the likelihood of implementing this calendar was dependent upon the required majority in the Parliament supporting the amendments in the Constitution of the Republic of Poland and other legal acts necessary for euro adoption. At the same

time, it was pointed out that developments in the financial markets would be an important factor that may affect the prospects of Poland's adoption of the euro. While addressing the prospects of Poland's complying with the Maastricht inflation criterion, some members of the Council argued that the decline in the economic activity in many EU countries would be considerably stronger than in Poland, causing the reference value for this criterion to decrease stronger than inflation in Poland. In the opinion of those members of the Council, this means that that complying with the Maastricht inflation criterion in 2011 may require a more restrictive monetary policy than in a situation when Poland were to meet the convergence criteria at a later date.

The Council emphasised that the implementation of structural reforms, including the increasing of competition in certain sectors of the economy, would support the sustainable compliance with the convergence criteria.

While discussing the exchange rate developments, attention was paid to the strong weakening of the zloty exchange rate against the US dollar and the euro observed in October. It was pointed out that the exchange rate depreciation in October was driven by the turmoil in the global financial markets and the outflow of foreign capital and that it was present in all countries of the region pursuing a floating exchange rate regime as well as many other countries. In this context, a lot of attention was paid to the current macroeconomic situation and monetary policy in some small open economies. While discussing the exchange rates, it was pointed out that amidst increased uncertainty, exchange rate developments in small open economies are subject to stronger than usual fluctuations. Some members of the Council argued that credible prospects of Poland's accession to the euro area might limit the fluctuations of the Polish zloty against the euro, at the same time emphasising that delays in this process may lead to the depreciation of the exchange rate. The Council also discussed the impact of interest rate differential between Poland and the euro area and the United States on the zloty exchange rate developments.

While discussing the decision on interest rates, the Council assessed that the considerable deterioration of the outlook for global economic growth, as well as the increased uncertainty as to the future economic activity in Poland coupled with elevated current and expected inflation, justified keeping the NBP's interest rates unchanged at the current meeting.

The Council also discussed the level of the NBP's interest rates in the near term. Some members of the Council pointed out that in the coming quarters inflation should be expected to continue above the inflation target despite the decline in economic growth. They stressed that this, coupled with stronger weakening of the economic activity and, consequently, of the inflationary pressure in many EU countries, was likely to make it difficult for Poland to comply with the Maastricht inflation criterion. In the opinion of those members, those arguments spoke for keeping the interest rates unchanged in the coming months. Other members argued that the decline of GDP growth in the coming quarters below the potential output growth would bring inflation down to the target in the medium term, while pointing out that the weakening of the economic activity in Poland might prove stronger than currently assessed which, coupled with the limited credit availability and market interest rates remaining at an increased level due to the turmoil in the international financial markets, might contribute to bringing down inflation below the target. In the opinion of those members of the Council, those arguments might justify the need to lower the NBP's interest rates in the coming months.

The members of the Council emphasised that the assessment of the NBP's interest rates level consistent with ensuring price stability in the medium term would depend on the data to be released in the coming months.

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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