NBP

National Bank of Poland
Monetary Policy Council

MINUTES OF THE MONETARY POLICY COUNCIL DECISION-MAKING MEETING HELD ON 27 OCTOBER 2010

At the meeting the Monetary Policy Council discussed the outlook for economic growth and inflation, situation in the public finance sector and in the labour market, monetary and credit aggregates and the exchange rate of the zloty.

While analysing the current situation in the real economy and the outlook for economic growth in Poland, fast growth in industrial output, retail sales and exports was pointed out. Some Council members argued that the data on the consumption of households in 2010 Q2 and retail sales indicated that the economic growth, which had so far been mainly reinforced by growing external demand, was increasingly supported by domestic factors. In their opinion the current consumption growth cannot be fully attributed to one-off factors such as rebuilding of assets in the areas affected by floods and transferring some purchases from 2011 in view of the expected change of VAT rates and changes in the regulations on VAT deduction on car purchases. In the opinion of those Council members, the improving labour market situation, including the relatively fast employment growth in the enterprise sector, would act towards further consumption growth. In turn, the strengthening private consumption amid further high export growth could translate into investment recovery in enterprises, even though due to the uncertainty surrounding the future economic situation, including the situation in the public finance sector, corporate investment growth in the quarters to come could remain low. Those members emphasised that the possibility of investment revival is suggested by an increase in production capacity utilisation above the long-run average and favourable financial and liquidity situation of enterprises, allowing them to self-finance investment. Moreover, in the opinion of those Council members, investment growth in the economy in the coming quarters – apart from the quickly growing public investment – might be also supported by housing market recovery, the symptoms of which appeared in 2010 Q3.

Other Council members argued, however, that the incoming data did not unequivocally confirm that the recovery in economic activity was sustainable. They pointed out that some forecasts indicated the possibility of economic growth weakening in 2011 or stabilising at a relatively low level in the next two years. They also emphasised that retail sales growth was most likely being raised by the rapid increase in the sale of automobiles and durable goods, which was driven by one-off factors. After the expiry of the impact of these factors – in the opinion of those Council members – the growth of household consumption may slacken, which is confirmed by the low growth of real wages. Those members also pointed out that investment growth was still very low, and in the recent period the sentiment of enterprises had worsened, including their expectations on output, demand and employment.

While discussing the outlook for inflation in Poland, the Council addressed the results of the inflation projection based on the NECMOD model and other forecasts. It was pointed out that, in line with the October projection, in its entire horizon the probability of inflation running above the NBP inflation target of 2.5% is higher than the probability of inflation running below this target. Other internal NBP forecasts also point to such distribution of those probabilities.

The members of the Council pointed out that in the short term inflation would be driven by rising food prices, caused by supply-side shocks in the country and abroad, changes in indirect tax rates and the rise in administered prices, primarily energy prices. Some Council members assessed that inflation would also be raised by delayed effects of the strong depreciation of the zloty during the economic crisis, which could not yet fully translate into consumer prices in Poland. In the opinion of other Council members, inflation would be limited by factors such as zloty exchange rate appreciation observed in recent months, low inflation in the external environment of the Polish economy and still weak demand and wage pressure, including the positive development of the relationship between the growth of labour productivity and aggregate wages. Some Council members assessed, however, that taking into account a possible decline in the potential growth of the Polish economy as a result of the financial crisis and other factors, the current rate of economic growth was already relatively high and would not be a factor limiting the inflation rise in Poland.

In the opinion of some Council members, after the expiry of factors temporarily raising inflation, in the absence of monetary policy tightening, inflation was likely to remain at an elevated level due to the expected increase in domestic wage and demand pressures, including a likely acceleration in unit labour cost growth and the inflation rise abroad. This is indicated by the forecast steady growth of core inflation net of food and energy prices in the projection based on the NECMOD model. Other Council members, however, assessed that inflationary pressures may be eased by an appreciation of the zloty and fiscal policy tightening in 2012 announced by the government. They also pointed out that inflation would decrease after the supply-side inflationary factors expire.

Board members also discussed the situation of the public finance sector. Some members pointed out that the scale of the planned fiscal tightening in 2011 was not sufficient for curbing the public debt accumulation. Some Council members also indicated that due to the risk of lower than projected revenues from the VAT and lower income from privatisation in 2011, the scale of fiscal tightening and also the reduction of the borrowing needs of the central budget may prove smaller than assumed. Those members also pointed out that the revenues which would be reducing the borrowing needs of the central budget in 2011 were of one-off nature and would not curb the growth of public debt in the following years. Therefore, in order to halt the rapid public debt accumulation it would be necessary to increase the scale of fiscal tightening in the years to come. These members also emphasised that the likely lack of consent to deduct the cost of pension reform from the general government deficit would necessitate a strong fiscal tightening in the coming years in order to meet the requirements of the Stability and Growth Pact. According to those members, the strong fiscal tightening would be a factor curbing economic growth and inflationary pressure in Poland. Some Council members, however, pointed to the uncertainty concerning the fiscal policy after 2011. Moreover, some Council members pointed out that, because of the possibility of the so-called non-Keynesian effects of fiscal tightening, such tightening does not have to significantly reduce the short-term economic growth if it is mainly based on the reduction of general government expenditure. If, however, it was based on indirect tax increases, then it would act towards a short-term increase in inflation in Poland, rising the risk of inflation becoming entrenched at a heightened level.

While discussing the situation in the external environment, the continued recovery of moderate growth in the global economy was emphasised, including the persistence of low GDP growth in major developed economies and a gradual decline in the growth of the Chinese economy as a result of macroeconomic policy tightening in this country. The effects of high fiscal imbalance and its planned reduction, as well as the effects of monetary expansion, including non-standard measures undertaken and envisaged by major central banks continue to be an important uncertainty factor for the global economic growth. Some Council members assessed that the decline in China's economic growth could translate – through its adverse impact on the outlook for German exports – into a slowdown in the Polish exports. However, other Council members, assuming that the competitive exchange rate devaluations would not intensify and no collapse in the world trade should be anticipated, believed that the rapid growth in major emerging economies could be expected, which would support the relatively high demand for German and, indirectly, also for Polish exports.

Some Council members pointed out that GDP growth rate in the euro area was now close to the growth rate of the economies of the United States and the United Kingdom, which had historically grown faster than the euro area. Those members argued that this may be associated with different economic policy responses to the financial crisis in those economies. In particular, they pointed out that the relatively rapid improvement of business sentiment in Germany during the recovery from the recession might have been supported by the fact that fiscal deficit had not been allowed to rise to a high level in Germany, which limited the risk of increased future tax burden in this country.

Some Council members pointed out that – in view of the probably extended period of low interest rates being maintained by major central banks and the reintroduction of quantitative easing in the United States – a possible rise in interest rates of the NBP could increase the risk of rapid capital inflows and excessive appreciation of the zloty.

In turn, other Council members believed that the potential rise in interest rate disparity could only have a limited impact on the zloty exchange rate path. They pointed out that the exchange rate of the zloty, similarly to the currencies of other emerging economies, was significantly affected by changes in risk perception by investors in global financial markets. Therefore, any appreciation of the zloty would most probably be accompanied by the appreciation of the currencies of other emerging economies, i.e. Poland's competitors in international markets. Moreover, some Council members pointed out that the reintroduction of quantitative easing in the United States could also foster the appreciation of the euro against the dollar, which would have a beneficial influence on the relationship between the prices of Polish exports and imports.

Some Council members also assessed that stabilisation of the share of non-residents' investment in the domestic treasury bill markets in October 2010 might be a sign of certain curbing of the inflow of capital to this market, which reduced the probability of strong appreciation of the zloty exchange rate. Those members also emphasised that this share was currently at a relatively high level which might increase vulnerability of the zloty exchange rate to changes in the risk perception in the global markets.

Some members of the Council also addressed changes in the external environment of the Polish economy driven by the financial crisis, which were likely to impact the developments of the equilibrium interest rate in Poland. They assessed that the possible decline in the potential growth of the Polish economy might not have been accompanied by a similar fall in the equilibrium interest rate in Poland due to the likely increase in the investment risk premium in the emerging economies (a decline in the current account deficit regarded as sustainable by investors).

While analysing the situation in the labour market, it was pointed out that the rise in employment in the corporate sector accompanied by the simultaneous increase in the unemployment rate in September 2010 (in seasonally adjusted terms) continued, which might be driven by the persisting growth in the number of economically active persons, contributing to curbing the wage pressure. Some members of the Council also indicated that upon recovery from the current economic slowdown, employment started to rise amidst markedly lower GDP growth than in the past, which, coupled with growing number of economically active persons, might point at favourable structural changes in the Polish labour market in the past few years. It was also pointed at the stabilisation of the ratio of new job offers to the number of unemployed. At the same time, other Council members pointed at the uncertainty about the impact of the abolition of restrictions on Polish citizens accessing the labour market in Germany and Austria starting from May 2011 on the supply of labour in Poland, in particular, the number of highly qualified workers. Some members of the Council emphasised that amidst high percentage of enterprises where output had recently been increasing considerably faster than employment, the corporate sector might be expected to see further employment growth. Moreover they assessed that high wage restraint in the enterprises in the period of economic slowdown was rather a disturbance than a structural change that should fade off together with improvement in the economic situation. As a result, over the monetary policy transmission horizon, wage pressure in the economy may be expected to intensify.

Members of the Council also discussed the developments of inflation expectations. It was argued that following a rise observed in August 2010, the subsequent months recorded a drop in the majority of measures of household inflation expectations which were currently at the level close to the NBP's inflation target. Council members pointed at a decline in the number of enterprises which, in the business condition surveys, declared increases of their own prices, despite the expected rise in the commodity prices. Yet, according to some Council members, basing on the historical data, the resulting decline in markups may be expected to have minor and quickly fading off impact on inflation. At the same time, Council members pointed at an increase of inflation expectations of enterprises and financial sector analysts concerning growth in prices in the whole economy. It was emphasised that the anticipated rise in VAT and excise tax did not result in any considerable increase in inflation expectations. Yet, some members of the Council pointed at a risk of a rise in inflation expectations at the beginning of 2011, following the implementation of the announced changes in the indirect taxes rates.

The meeting also discussed the developments of monetary aggregates. Council members pointed at the continuation of a relatively stable M3 supply growth, declining annual growth in household lending and persistently negative, albeit gradually rising annual growth in corporate lending[1]. It was emphasised that corporate demand for credit remained weak, and debt increase in the banking sector concerned mainly large enterprises; on the other hand, no clear revival in lending to the sector of small and medium-sized enterprises could be seen. In the opinion of some members of the Council, the currently observed moderate growth in monetary aggregates did not point at a risk of growing inflationary pressure. Other members of the Council emphasised, however, that M3 growth was not low when compared to the growth of nominal GDP. Those members paid particular attention to the developments in housing loans, which increase more substantially than other categories of loans to households and enterprises. Those members pointed out that given the decline in the interest on mortgage loans as a result of reduction of bank markups and banks' expectations of rising demand for those loans, a further acceleration might be expected in the growth of housing loans which already exceeded the achievable growth of disposable income.

While considering the decision on interest rates, some members of the Council argued that the expected acceleration of economic growth supporting the improvement in labour market situation may – in the absence of monetary policy tightening – lead to a gradual rise in wage and inflationary pressure in the medium term. Those members of the Council claimed that the NBP interest rate increase would be justified in order to reduce the risk of the emergence of such pressure. Such an increase would constitute an adjustment of monetary policy parameters to the current assessment of economic situation following the period of a strong decline in economic activity caused by the global financial crisis. It would be also conducive to anchoring the inflation expectations at the level of the NBP’s inflation target.

In the opinion of other members of the Council, the persistently moderate economic growth in Poland, currently low wage and demand pressure (confirmed by core inflation running at a low level) and the possibility of increasing inflow of capital to emerging economies, including Poland, amidst the extended period of expansionary monetary policy pursued by major central banks, combined with the risk of further slowdown of the global economic growth, justified keeping the NBP interest rates unchanged at the present meeting of the Council. Those members also

[1] Adjusted for exchange rate changes.

emphasised that growing interest rate disparity combined with the appreciation of the exchange rate could support the increase in foreign currency lending.

The meeting also discussed a rise in the required reserve rate by 50 basis points. Some members of the Council pointed out that the required reserve rate was reduced as part of the anti-crisis measures undertaken in the period of strong liquidity disturbances in the financial markets. As this period ended, it was justified to increase this rate to the level maintained before the financial crisis. Such a decision would also constitute a signal of MPC's readiness to react to increasing inflationary pressure. Other members of the Council emphasised, however, that a rise in the required reserve rate would have a limited impact on the liquidity in the domestic money market and would not be a factor likely to translate into limiting the inflationary pressure in the economy. At the same time, they pointed out that a rise in reserve rate is not the best signal of MPC's readiness to react to growing inflationary pressure.

A motion to raise the required reserve rate by 50 basis points from 3.0% to 3.5% was put forward at the meeting. The motion passed. The decision applies to reserve requirement to be held from 31 December 2010. Also a motion to raise the NBP interest rates by 50 basis points was put forward at the meeting. The motion did not pass. 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%, the rediscount rate at 3.75% and the discount rate at 4.00%.

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