Minutes from the Monetary Policy Council Decision-Making Meeting Held on 8 October 2014

Members of the Monetary Policy Council discussed the current and future monetary policy decisions against the background of macroeconomic developments at home and abroad.

While discussing business conditions in Poland's external environment, Council members pointed out that global activity growth remained moderate and varied considerably across the regions. They emphasised that recovery continued in the United States, although its pace remained slower than in the previous business cycles. Council members observed that GDP growth in the euro area had been weak and that business climate indicators had deteriorated recently. Some Council members also drew attention to the downward revisions of growth forecasts for the euro area by international institutions. Council members also pointed to deteriorating business conditions in Germany, Poland's main trading partner, reflected in the declining levels of the PMI and IFO indices in the past few months, and in the sharp fall in industrial output and new orders in August. Council members indicated that in other large euro area economies, including Italy and France, economic activity growth remained slow and hampered by structural problems of these countries.

While discussing economic situation in the largest emerging economies, it was observed that the Russian economy might be in recession in 2014 Q3, while growth in China had probably slowed down. It was argued that the deteriorating economic situation of these countries would adversely impact Germany's exports, which in turn might subsequently weigh on the growth of Polish exports.

Council members highlighted a significant decline in the prices of commodities over the recent months, which supported a decrease in inflation in Poland and in its environment, including the euro area. It was observed that the euro area inflation had been gradually trending down towards zero.

While discussing monetary policy abroad, Council members underlined that the tapering of quantitative easing by the Federal Reserve was occurring against the background of the ECB stepping up its monetary expansion. It was pointed out that due to the divergence between monetary policy of the Federal Reserve and the ECB, the euro has recently weakened against the dollar, which would boost the euro area's price competitiveness vis-a-vis the US economy. The euro weakening was also accompanied by the złoty depreciation against the dollar.

It was indicated that the ECB launched the first conditional liquidity provision operations to banks in September and announced the start of asset purchases in 2014 Q4. Some Council members assessed that the ECB's strongly expansionary monetary policy – given the structural nature of weak economic growth and sluggish demand for credit – would prove ineffective in boosting economic growth in the euro area. Other Council members highlighted that although the scale of further quantitative easing by the ECB was unknown, it would last – according to the announcements of the ECB – for at least 2 years. Thus – they argued – the monetary policy in Poland's environment would remain highly expansionary for an extended period, which, assuming unchanged NBP interest rates, might be conducive to the inflow of short-term capital to Poland. However, a few Council members judged that the anticipated monetary policy tightening by the Federal Reserve could have more significant impact on financial markets – including the prices of Polish assets – than the monetary policy loosening by the ECB. Those members also underscored that in some emerging economies and developed economies which had been only slightly affected by the financial crisis, interest rates remained higher than in Poland.

While discussing economic situation in Poland, Council members pointed out that economic growth had slowed down in recent months. Some Council members emphasised that economic activity had proved weaker than forecasted in the July projection of NPB. At the same time, those members pointed to the flagging industrial output growth, stagnant construction and assembly output as well as the PMI index running below 50 points. They also observed that economic activity growth in Poland had been dragged down by a strong fall in exports to the former Soviet Union countries and a marked weakening in exports growth to the euro area. They argued that while retail sales continued to rise, the pace of this growth was below that observed in the first half of 2014. They also expressed the opinion that the weakening of GDP growth might not be temporary, and a few of them believed that there was a risk of further decrease in GDP growth in subsequent quarters.

In contrast, some Council members argued that economic growth had decelerated only slightly and its pace was currently close to potential output growth. They pointed to the gradually improving situation in the labour market, including a decline in the unemployment rate and further steady wage growth, which supported retail sales growth. They also argued that relatively robust economic activity was accompanied with sound financial situation of enterprises. A few of those Council members observed that both economic growth and domestic demand growth in Poland remained higher than forecasted a few quarters ago, when the Council had decided about the last interest rates cut. They also underlined that – according to the forecasts – GDP growth next year might be higher than this year.

Some members of the Council pointed out that GDP growth in the coming year would be affected by fiscal policy. A few members of the Council were of the opinion that the increase in social spending announced by the government suggested that the coming year might bring greater than previously planned rise in public expenditures. A few Council members pointed also to a possible increase in expenditures co-financed with the European Union funds. Some Council members believed, however, that the government-announced increase in social spending would be small (about 0.2% of GDP), and the deficit in 2015 would remain close to its 2014 level. Moreover, part of the public expenditures would be related to a repayment of liabilities incurred a few years ago. They also argued that the possibility of fiscal policy easing was limited due to the excessive deficit procedure being in

Narodowy Bank Polski ul. Świętokrzyska 11/21 00-919 Warszawa tel. +48 22 185 28 88 sekretariat.rpp@nbp.pl

force. A few Council members assessed, however, that budget deficit in 2014 will be probably markedly lower than it was planned in the budget act, which will mean easing of fiscal policy in the next year.

While analyzing the inflationary developments, members of the Council highlighted the fact that CPI inflation continued to run below zero. The majority of the Council members emphasized that no cost pressure had been seen in the economy, as evidenced by the negative growth in producer prices and persistently low wage growth. They also argued that there were no signs of demand pressure, as indicated by the negative retail sales deflator and core inflation persisting close to zero. They also pointed to continuing decline in inflation expectations. They drew attention to increase in risk of longer than previously expected period of inflation remaining below the target, as suggested by the revisions of inflation forecasts.

According to some members of the Council, such a sharp decline in CPI inflation is largely supply driven, as evidenced by the deepening decline in food prices. They argued that the observed positive supply shocks improved the financial situation of enterprises and enhanced debt service capacity of economic agents. A few of them also pointed out that August brought a slight increase in one of the core inflation measures.

While discussing NBP interest rates level, the majority of Council members believed that due to the sluggish economic activity, the risk of further weakening of economic growth, the deepening of the negative output gap and, consequently, higher risk of inflation remaining below target in the medium term, it was justified to cut interest rates significantly. They pointed to the signs of economic slowdown in Poland and its environment, further decline in prices and inflation expectations and the absence of wage pressure. At the same time, they emphasized that interest rate adjustment was necessary due to the increase in real interest rates resulting from the decline in inflation and inflation expectations observed in the past few quarters. In this context, they stressed that the current real interest rates had become relatively high as compared with those in the recent years. They also pointed out the lack of inflationary risks in the Poland's environment and the growing scale of monetary expansion in the euro area, leading to an increase in the disparity of interest rates in Poland as compared with its environment. Those members also emphasized that a moderate level of credit growth in the economy and the absence of signs of imbalance in the housing market limited risks to financial stability. These members also believed that due to lags in the transmission mechanism of monetary policy, the adjustment of NBP interest rates should be rather quick and significant. In this context, a few Council members assessed, that a significant interest rates cut would be justified if it was accompanied with the statement, that this decision denoted the one-off adjustment in the interest rates to the current economic forecasts.

Some Council members believed, however, that NBP interest rates should remain unchanged. They pointed out that the slowdown in economic activity in the recent period was driven by factors beyond the impact of domestic monetary policy, namely external shocks and persistent uncertainty. Accordingly, in the current situation, monetary policy

Narodowy Bank Polski ul. Świętokrzyska 11/21 00-919 Warszawa tel. +48 22 185 28 88 sekretariat.rpp@nbp.pl

instruments might prove ineffective in stimulating economic activity. They argued that low inflation resulted mainly from supply shocks, which boosted real incomes of households and enterprises, and thus should not be offset by monetary policy. A few of those Council members also believed that lower interest rates were likely to slow down the process of corporate restructuring. Other Council members assessed, that interest rates cut would be justified only in the case of a considerable slowdown in economic growth.

A few members of the Council additionally argued that interest rates cuts, through stimulating domestic demand, amidst weak demand abroad, could bring deterioration of the current account balance. Other members of the Council pointed out, however, that in the recent quarters Poland had experienced a trade surplus, and the current account deficit had been so far financed by foreign direct investment and the inflow of EU funds.

A few Council members also underlined that interest rate cuts may contribute to the fall in deposits in the banking sector. Other Council members pointed out, however, that the sharp decline in deposits, and consequently, an increase in currency in circulation, would be a rather unlikely development in response to NBP interest rates cuts. They also emphasized that the possible conversion of deposits into cash by economic agents would not negatively affect the stability of the banking sector considering the persistently high liquidity surplus in the Polish banking sector. They underlined that deposits withdrawn from the banking sector could be spent on consumption and investments.

The Council also discussed the width of the interest rate corridor of standing facilities. It was pointed out that should the reference rate be lowered, the current width of the corridor would be very large in relation to the basic interest rate level. It was also emphasized that the resulting reduction in the lombard rate would have an impact on the ceiling for the so-called maximum interest. The Council members also noted that should the reference rate and the rediscount rate be lowered, the interest on the required reserve – assuming it was computed using the current method – would be higher than the interest rate of basic open market operations.

At the meeting a motion was submitted to lower NBP reference rate and NBP rediscount rate by 0.5 percentage points as well as a motion to lower NBP lombard rate by 1.0 percentage point. The motions passed. The motion was also submitted to change the remuneration on the required reserve funds to 0.9 of the reference rate. The motion passed.

The Council set the NBP interest rates at the following levels: the reference rate at 2.00%, the lombard rate at 3.00%, the deposit rate at 1.00%, the rediscount rate at 2.25%.

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Narodowy Bank Polski ul. Świętokrzyska 11/21 00-919 Warszawa tel. +48 22 185 28 88 sekretariat.rpp@nbp.pl