NBP

National Bank of Poland

Rada Polityki Pieniężnej

MINUTES OF THE MONETARY POLICY COUNCIL DECISION-MAKING MEETING HELD ON 28 NOVEMBER 2007

During the meeting, the Monetary Policy Council discussed the outlook for inflation developments 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, current inflation developments, the outlook for economic growth and the prospects of public finance in 2008 and in subsequent years. The Council discussed the influence of these factors on the future inflation in Poland.

While discussing the changes in the environment of the Polish economy, it was pointed out that there were downward revisions of the forecasts of economic growth in the United States and the European Union and that there was a risk of a deceleration in worldwide economic growth, which may slow the growth of Polish exports and the inflow of direct investments and, consequently, reduce the rate of economic growth in Poland. Nevertheless, it was argued that in the past, in the period of low economic growth, some Western European countries had reported increased demand for relatively cheap products from Poland, which complicated the assessment of the actual impact of the world economic slowdown on Poland's economic growth. Moreover, it was pointed out that the current GDP growth was primarily driven by rising domestic demand (i.e. consumption and investment).

Some Council members emphasised that, in the face of the deteriorating situation in international financial markets and the dampening prospect of economic growth, major central banks were expected to ease their monetary policy. Other Council members pointed out that those central banks which did not raise their interest rates or lowered them despite rising inflation are precisely the banks of the countries directly affected by the financial market turmoil.

In this context, it was pointed out that the low interest rates that had been observed until recently had led to the creation of excessive global liquidity, which was not reflected in the inflation of consumer prices, but caused a significant rise in asset prices instead. For two years now, the prices in the world markets of some assets have been falling, and so it is currently hard to assess the direction in which the liquidity surplus will be moving.

While discussing the economic growth in Poland in the years to come, some Council members emphasised that GDP growth should gradually decrease in the next years, which would be easing the demand pressure. Moreover, a fast growth in investments of enterprises, which is indicated by the data for the first three quarters of 2007, should be favouring the growth in potential output. Both these factors will be conducive to limiting the inflationary pressure. Other members of the Council pointed out that the October data on industrial production and retail sales did not signal a weakening of economic activity in Poland. It was emphasised that the high growth of domestic demand was supported by rapid increase of wages and very good financial results of enterprises. Moreover, those members also believed that even though the GDP growth would probably slow down in the coming years, it would remain at a relatively high level.

While addressing the situation in the labour market, it was pointed out that the high wage growth led to a considerable increase in unit labour costs in the economy. It was argued that the wage growth in the economy in 2007 Q3 was higher than expected in the October projection. The continuation of the high growth of wages is also suggested by record-high data on corporate wages in October and the continuously falling rate of unemployment. Some Council members pointed out that the wage differentials between the private and the public sector may be rising, which would lead to the outflow of skilled public sector workers to private companies and thus increase the wage pressure in the public sector. Some discussants indicated that, due to the high wage growth in 2007 Q3, the rise in remuneration costs outpaced the growth of enterprises' revenues for the first time in a long time, which may be an indication that the falling trend of the relation of labour costs to revenues had been reversed.

In the opinion of other Council members, however, the rise in unit labour costs had not so far translated into rising inflationary pressure due to high profits of enterprises. Moreover, the growth of unit labour costs may be expected to go down in the monetary policy transmission horizon due to the expected acceleration in labour productivity resulting from fast growth in investments. It was also emphasised that a potential deceleration in the global economy, including Western European economies, might lead to lower emigration of Polish workers, which would limit the wage pressure.

While addressing the current inflation, it was pointed out that following a long period of inflation running below the inflation target, in October the annual growth of consumer price exceeded the inflation target of 2.5%. Some Council Members emphasised that the rise in CPI inflation in October was to a large extent the result of a surge in food and fuel prices, while the core inflation net of those prices remained at a relatively low level. The same members pointed out that it was difficult to assess at the moment whether the factors responsible for inflation rise would prove permanent. Other Council members, however, pointed out that all measures of core inflation had risen since the previous month and the increase in core inflation net of food and fuel prices was significant as compared to the changes of this indicator over the past year. They believed this suggested that the inflationary pressure that had been building for some time was beginning to be reflected in the growth of prices.

The Council discussed the usefulness of the indicator of core inflation net of food and fuel prices as a measure for assessing inflationary pressure. Some Council members were of the opinion that in the light of empirical studies for the United States core inflation is a good gauge of the price level trend. Other Council members, however, pointed out that the net core inflation in the United States in the past ten year had been lower on average than CPI inflation and so it failed to fully reflect the movements of consumer prices. It was also emphasised that net core inflation accounted for the supply-side globalisation effects of disinflationary nature (decline in the prices of goods imported from low production costs countries), but only to a limited degree – for the demand-side globalisation effects of inflationary nature (growing prices of energy commodities and food).

While discussing future inflation, some members of the Council pointed out that the price growth in the coming quarters was already determined to some extent. Those members believed that inflation would be temporarily increased, which would primarily be the result – just like in many other countries – of increased food and fuels prices, i.e. factors beyond the control of monetary policy. Other Council members emphasised that the October inflation projection pointed to the continuation of high inflationary pressure throughout the projection horizon, among others due to the growth in domestic demand above GDP growth rate as well as wage growth outpacing the rise in labour productivity.

The discussants pointed out that an increase in inflation, particularly when it is triggered by a surge in food and fuel prices, which significantly affect the perception of inflation by consumers, may lead to increased inflation expectations and thus pump up the pressure for the growth of wages. The risk of second-round effects is higher than in 2004 due to the tight labour market, including a markedly lower unemployment. On the other hand, it was argued that the current risk of second-round effects was significantly lower than at the time of oil shocks in the 1970s.

At the meeting, the Council also discussed the growth of food prices in the world markets, which is currently stepping up inflation both in Poland and in the majority of other countries. Some discussants assessed that the increased growth of food prices may continue in the longer term. At the same time, it was argued that the food price increase would mean changing the relative prices and a rise in the food expenditures of households. As a result, there may be a lowered demand for other goods, which would limit the rise of the overall price level. Other Council members pointed out that the increase in food prices in international markets could be transitory and result from negative supply shocks. In the context of the food price developments, the question was raised of a possible increase of VAT rates on unprocessed food and catering services in 2008 and of its impact on inflation.

The Council devoted a lot of attention to the outlook for the public finance. It was emphasised that due to the low actual state budget deficit till the end of October 2007 and, at the same time, the restated announcement that this year's deficit would be implemented at the expected level, there was a risk of a considerable accumulation of public expenditure in the last two months of 2007, which would be conducive to raising inflationary pressure. Moreover, it was pointed out that, on the one hand, there appeared announcements of tax cuts and, on the other, the wage growth in the budget sector would be most probably higher than accounted for in the draft Budget Act for 2008. It was also emphasised that some acts passed by the previous Parliament before its dissolution could increase the public finance imbalance for many years to come.

While discussing the issues related to the exchange rate, it was pointed out that since September 2007 the zloty had significantly appreciated. On the one hand, appreciation of the zloty limits the impact of high oil prices on inflation in Poland, on the other, however, it dampens the competitiveness of the Polish economy, contributing to rising external imbalance. Still, it was emphasised that the export enterprises to a large extent use imported goods in their production, which limits the negative impact of the appreciation of the zloty on their financial situation. It was also argued that the zloty appreciation was decreasing the zloty-denominated value of EU subsidies to the Polish agriculture and the value of Polish emigrants' remittances, which is conducive to lower domestic demand. Similarly, it was indicated that at the moment it was difficult to assess the sustainability of the factors that had been conducive to the recent zloty appreciation.

In conclusion of the discussion it was agreed that the sustained fast growth of demand, the tight labour market, the significant increase in current inflation and the risk of the related second-round effects, as well as the expected considerable surge in demand of the public finance sector until the end of 2008, all warranted the assessment that the probability of inflation overshooting the inflation target over the monetary policy transmission horizon was significant and this necessitated an interest rate increase at the November meeting.

A motion to raise the key NBP interest rates by 25 basis points was put forward and passed. The Council raised the interest rates to the following levels: the reference rate at 5.00%, the lombard rate at 6.50%, the deposit rate at 3.50% and the rediscount rate at 5.25%.

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