MINUTES OF THE MONETARY POLICY COUNCIL DECISION-MAKING MEETING HELD ON 27 JUNE 2007

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

The main issue discussed at the meeting was the prospects of economic growth and their impact on inflation.

Some Council members pointed out that the rate of GDP growth in Poland still exceeds the growth rate of potential output, leading to a widening of the output gap and a build-up in inflationary pressure. They assessed that in the nearest future the high rate of domestic demand growth will be sustained. Strong growth in demand will be supported by a considerable rise in nominal wages and employment, the inflow of transfers of earnings by people working abroad, strong lending growth, including accelerating rise in consumer loans, and an increase in disposable income of households due to a cut in disability pension contributions. Those members assessed that in the conditions of the currently high production capacity utilisation, the dynamic growth of domestic demand creates a significant risk of inflation growing above the inflation target in the medium term.

Other Council members emphasised that the structure of the current economic growth is still advantageous, with a growing share of investment, including greenfield foreign direct investments, which raises the economy’s innovativeness. This should lead to an increase in labour productivity and production potential of the economy and therefore constrain the inflationary pressure related to swift economic growth. These members also pointed out that the growth in disposable income of households does not necessarily have to lead to consumption growth, if it will be accompanied by a rise in this sector’s savings. They also assessed that a part of domestic demand growth will be absorbed by growing imports, which should limit the pressure for price growth. Moreover, those members pointed out that a drop in industrial production, construction and assembly production and retail sales, which was recorded in May, is a sign of a lower GDP growth in 2007 Q2. Some members of the Council also assessed that in the case of the expected lower rate of economic growth and a strong surge in potential output, GDP growth should not outpace the growth of potential output in the nearest future.

During its meeting the Council also discussed the labour market situation.

Some Council members pointed to a continually high rate of wage growth and to a very fast drop in unemployment, facilitating a further strong rise in wages. They indicated that strong wage growth in enterprises is accompanied by increasing wage pressure in the public sector, which is reflected in industrial actions. Those members pointed out that, despite the uncertainty concerning the unit labour costs, all available estimates of these costs obtained with the use of various calculation methods, indicate a worsening relationship between wage and labour productivity growth, which could lead to inflation increase. Those members pointed out that acceleration in price growth should also be fuelled by the rise in households’ disposable income resulting from the increase in wages, which should support the growth of consumption demand. They argued that, in the coming period, the rise in households' income related to an increase in aggregate wages will be strengthened by the cut in disability pension contributions, which will additionally contribute to net wage growth, fostering a relatively higher growth in consumption.

In the course of the discussion, it was pointed out that, by leading to net wage growth, the reduction of disability pension contributions should limit the pressure for further gross wage and labour cost increases in the longer term. Some Council members pointed out that, despite a considerable decrease, the unemployment rate in Poland is still high, which should also contain wage growth. Moreover, they assessed that the growth in unit labour costs should be constrained by the continuation of high productivity growth related to increased investment outlays, enterprises' restructuring and improving quality of the labour force. According to those Council members, at the moment it is difficult to assess whether the May slowdown in labour productivity growth in industry will prove permanent. Moreover, those members emphasised that a rise in unit labour costs does not have to lead to inflation growth, as the increase in competition connected, among other things, with the globalisation processes reduces enterprises' pricing power and, thus, their ability to pass the rising costs onto customers. They also pointed out that the observed high wage growth creates incentives to work for inactive people, which may contribute to an increase in labour supply and potential output. Those members also indicated that growing labour costs, amid the persistently high demand, might encourage enterprises to undertake investments aimed at replacing labour-intensive technologies with capital-intensive ones. They assessed that owing to, among others, a very good financial situation, enterprises have a considerable ability to undertake this kind of restructuring measures.

The discussion also concerned the public finance situation.

Some Council members indicated that one of important risk factors for inflation growth is a pro-cyclical fiscal policy, which is reflected, among others, in the reduction in the disability pension contribution. They assessed that the rise of wage pressure in the public sector poses risk to sustaining the budget anchor. Those members emphasised that an overly expansive fiscal policy in the conditions of increasing inflationary pressure could lead to a policy-mix which is unfavourable from the point of view of long-term economic growth. Other Council members pointed out that the situation of the state budge is very favourable at the moment and that future fiscal policy is subject to considerable uncertainty related, among others, to the Government's response to increased wage pressure in the public sector. They pointed out that, despite a significant risk of a fiscal policy loosening, at present it is difficult to assess the impact of this policy on inflation in the medium term.

Referring to current inflation indicators, some Council members indicated that, despite the rapid economic growth, core inflation has remained low for a long time, which might be an indication of a low inflationary pressure. It was also pointed out that in the next few months inflation will most probably decrease. Other Council members, however, emphasised that there is a lag between a rise in economic activity and inflation growth. Furthermore, they pointed out that keeping CPI inflation at the inflation target might require core inflation to run at a lower level.

Another issue discussed at the meeting were monetary developments. Some Council members pointed out that a very fast credit growth may contribute to further growth in domestic demand and accumulation of inflationary pressure, among others, in the asset market. Other members of the Council assessed that the relation of credit to GDP is still low in Poland and that the observed rapid growth in lending is to a large extent the result of the process of Poland's catching up with countries at a higher level of development.

One of the topics addressed at the meeting was the impact of zloty exchange rate on inflation. In this context, the influence of fundamental factors as well as trends in the international financial markets was considered, including, among others, interest rate disparity, current account balance, outlook for economic growth, inflow of foreign direct investment, EU funds and transfers of earnings made by economic migrants as well as global liquidity and investment strategies of world financial market participants. In this context, some Council members indicated that raising NBP interest rates could give rise to appreciation pressure, which, in turn, might contribute to weakening exports and deepening the foreign trade deficit. Other members disagreed with this opinion and pointed to a low interest rates disparity in relation to the ECB rate. To substantiate this claim, they indicated that the April hike did not bring about appreciation pressure.

Some discussants pointed out that one of the factors that should favour inflation stabilisation in Poland is a bright outlook for global inflation resulting from a credible monetary policy pursued by the largest central banks. At the same time, they quoted the rise of commodity and food prices in the world markets, related to the impact of structural factors, as a risk factor for the growth of global inflation.

In the assessment of some Council members, the current interest rate of the NBP has probably been below the natural rate and thus it has not prevented the build-up of inflationary pressure. They pointed out that many central banks are raising their interest rates at the moment. Other members of the Council, however, argued that the estimates of the natural interest rates are subject to a considerable uncertainty.

Among Council members the opinion prevailed that, due to the accumulation of factors leading to inflationary pressure building up in the economy, sustaining inflation at a level consistent with the target in the medium term requires a monetary policy tightening in the nearest future. The members of the Council, however, differed in their views concerning the optimal moment for the interest rate rise. In the opinion of some Council members, the assessment of the balance of risks for future inflation did not provide clear grounds for tightening the monetary policy at the current meeting. They argued that the NBP inflation projection to be published in July 2007 could be a useful tool in assessing the inflation outlook in the monetary policy transmission horizon. It was also pointed out that an NBP interest rate hike that would come earlier than expected by the market could give rise to expectations for faster and higher interest rate rises, which could result in a stronger decrease in the rate of economic growth than necessary for stabilising inflation at the target level in the medium term. Other Council members, however, assessed that the potential costs of delaying the interest rate rise outweighed possible benefits related to postponing the decision to change monetary policy parameters. In particular, it was emphasised that in the conditions of a globalisation-related weakening of the short-term relation between domestic economic activity and domestic inflation and amid the adaptive nature of inflation expectations in Poland, the cost of a monetary policy tightening which would ensure the return of inflation to the target would be considerably higher than the cost of preventing inflation growth. Moreover, some Council members assessed that a monetary policy tightening in the face of alarming signals from the public finance sector would strengthen the credibility of the pursued monetary policy.

During the 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 to 4.50%, the lombard rate to 6.00%, the deposit rate to 3.00% and the rediscount rate to 4.75%.