NBP

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Monetary Policy Council

MINUTES OF THE MONETARY POLICY COUNCIL DECISION-MAKING MEETING HELD ON 25 JUNE 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: labour market situation, the outlook for economic growth and the exchange rate developments. The Council discussed the influence of these factors on the future inflation in Poland in view of the June inflation projection.

The Council paid a lot of attention to the outlook for CPI inflation in Poland in the coming quarters. Some members of the Council pointed out that according to the June inflation projection based on the NECMOD model, the forecast inflation would be gradually decreasing starting from 2009 Q1 and, in line with the central projection path, it would be approaching the inflation target faster than expected in the February projection. Those members emphasised that the increased inflation resulting from food and fuel price growth in the world markets is observed in many other countries, including the euro area. They assessed that – similarly to many other countries – the period of heightened inflation may prove longer than expected so far. At the same time, they pointed out that in May, despite a rise in regulated prices, inflation in Poland was still at the lowest level among the Central and Eastern European countries, which was, among others, due to the monetary policy conducted in Poland in the earlier period.

The Council members indicated that CPI inflation in May rose to 4.4% and that in the months to come it may be even higher, among others, due to the statistical base effect. They emphasised that at the beginning of 2009 a further increase in electricity prices triggered by their deregulation may be conducive to a rise in CPI inflation. Some Council members indicated that, in line with the June projection, core inflation net of food and energy prices would be gradually growing and in 2009-2010 it would run above 2.5%, which – in the opinion of those members – signals the build-up of demand pressure in the economy.

While discussing the outlook for economic growth in Poland, it was pointed out that in May the growth of industrial output was markedly lower than expected, which had been previously signalled by business sentiment indicators. In the opinion of some Council members, this may indicate a slowdown in the Polish economy in the nearest future. Those members argued that lower activity in the world economy, particularly in the euro area, together with the recently observed appreciation of zloty exchange rate would both contribute to the slowdown of the economic growth in Poland. They emphasised that in view of the June projection based on the NECMOD model, the forecast GDP growth in the second half of 2008 would be lower than the growth of potential GDP, which would be conducive to easing the inflationary pressure. Moreover, they argued that the composition of GDP in 2008 Q1 was favourable in terms of inflation outlook, as private consumption growth was lower and investment growth higher than GDP growth. Other members of the Council, in turn, pointed out that GDP growth in 2008 Q1 was higher than expected and most probably higher than potential GDP growth. While assessing the outlook for economic growth, those members highlighted that the data on industrial output in May were difficult to interpret due to the different calendar of public holidays than in 2007 and that the retail sales growth in May was relatively high.

Those members believed that the slowdown in economic activity in Poland would probably not be significant. They argued that in the time to come the consumption growth would not mark a significant decrease, among others, due to the continuously high growth of wages and loans to households and the rising share of consumer loans in total loans granted to households.

While addressing labour market developments, the continuation of a strong wage growth and unfavourable relation between wage and labour productivity growth were pointed out. It was emphasised that in May unit labour costs in industry increased significantly due to the drop in the industrial output growth and a high wage growth. It was underlined that in line with June projection based on the NECMOD model, the forecast wage growth in the economy throughout the projection horizon would be faster than labour productivity growth and thus unit labour costs would continue to rise. Some Council members pointed out that 2008 Q1 brought an increase in the share of wage costs in total costs of enterprises, which was conducive to raising the inflationary pressure. Those members assessed that the heightened pressure on wage growth in some public sector enterprises may be leading to wage increases in the coming period and, consequently, also to rising prices of products manufactured by those enterprises. They also argued that the heightened current inflation was one of the factors contributing to increasing the wage pressure in the public finance sector. In the opinion of some Council members, this raised the risk of second-round effects in the time to come.

Moreover, some Council members argued that high wage growth and the increased CPI inflation, due to the mechanism of old-age and disability pension indexation, would increase the expenditure of the state budget in 2009 and in subsequent years, which would be conducive to deepening the deficit of the public finance sector. In this context it was pointed out that the expected slowdown of economic growth and the ensuing decline in the growth of the central budget tax revenue would also be contributing to increasing the budget deficit.

Other Council members, however, assessed that the high growth of wages was to a large extent connected with the ongoing convergence of the Polish economy with richer EU member states. They pointed out that wage costs still made a relatively low contribution to the total costs of enterprises, and emphasised that in view of business tendency surveys the percentage of enterprises which reported rising costs of wages as an important factor behind the rising prices of their products remained low. In the assessment of those Council members, the risk of second-round effects was currently far lower than in the 1970s. They also argued that increasing employment under tight labour market conditions, at least in the short term, results in lowering the average labour productivity due to: declining capital-to-labour ratio, employing people whose qualifications are lower than those of the already employed and a high share of the services sector (where productivity growth is relatively low) in the employment growth, all of which had a joint effect of raising unit labour costs. They assessed that the expected activity slowdown in the Polish economy should, with some time lag, lead to curbing the wage growth. Moreover, some Council members believed that the demands of substantial pay rises in the public finance sector would not be satisfied in the nearest future.

While analysing the exchange rate developments and their impact on the economy, a significant appreciation of the zloty in the recent period was underlined. It was emphasised that the exchange rate appreciation tightened Poland’s monetary conditions and was conducive to easing the inflationary pressure, as the prices of imported goods denominated in zloty were falling. In this context it was pointed out that the current zloty exchange rate was stronger than in the June projection based on the NECMOD model and thus future inflation might prove lower than it followed from the projection. It was argued at the same time that the currently observed zloty exchange rate appreciation would result, with some time lag, in a growing current account deficit. Some Council members believed that the rising deficit should be curbing inflationary pressure by stepping up the growth of the demand for imported goods at the expense of the demand for domestic goods. On the other hand, some Council members assessed that the expected slowdown in economic growth in Poland should be conducive to a reduction of the current account deficit.

Some Council members pointed out that the zloty exchange rate appreciation and rising unit labour costs were conducive to worsening financial results of exporters. They argued that this may lead to a decrease in the scale of investments undertaken by exporting enterprises and, consequently, a decrease in potential GDP growth. In the opinion of those members, in view of weakening activity in the economies of Poland's most important trade partners and the ensuing decline in the foreign demand for Polish products, enterprises will react to the worsening of their financial results by raising the prices of products destined for the domestic market, which in turn will be adding to the domestic inflationary pressure.

While addressing the developments in the environment of the Polish economy, the uncertainty concerning the economic situation in the United States, the euro area and the United Kingdom was pointed out. It was stressed that the decrease in indicators of economic climate in Germany was signalling a deteriorating situation in this economy. It was assessed that the slowdown of euro-area economic growth may be delayed in time but would certainly come. It was argued that the cycle of monetary policy easing in the United States most probably came to an end, while in the euro area signals emerged of a monetary policy tightening in the near future. It was emphasised that in case monetary policy was tightened in the euro area or the United States, an increase of the NBP interest rates would not result in a further widening of the interest rate differential between Poland and those economies. Some Council members assessed that the global level of interest rates was currently too low, which meant that in order to bring inflation down it was necessary to tighten monetary policy both in the developed and developing economies. In this context attention was drawn to the dilemmas of central banks facing the risk of stagflation, i.e. a situation when a decline in economic activity is accompanied by heightened inflation. The appropriate monetary policy response to a rise in inflation caused by factors independent of the domestic monetary policy was also discussed.

The members of the Council emphasised the lack of structural reforms, including the public finance reform, which are of great importance for shaping the long-term outlook for economic growth and inflation. In the opinion of the Council members, abandoning the public finance reform may lead to a non-optimal policy mix. It was also emphasised that without a clearly defined path of harmonising the rates of indirect taxes with the EU requirements and without a detailed liberalisation programme of the energy market, the assessment of future price growth path, particularly as regards administered prices, is problematic.

The Council also discussed an optimal communication policy of the central bank's decision-making body with the environment with a view to influencing the financial markets expectations as to the future monetary policy. On this occasion the great importance of the central bank's communication was stressed for the formation of inflation expectations in the situation when, due to strong and persistent price shocks in the commodity markets, inflation may remain at a heightened level for a longer period. In this context the Council emphasised that the lack of any precise declaration on the part of the government about the planned date of Poland's accession to the euro area may in the current situation become a factor impeding the pursuit of the optimal monetary policy.

While considering the interest rate decision, the Council assessed that the probability of inflation remaining above the inflation target in the monetary policy transmission horizon is higher than the probability of inflation running below the target. This assessment was supported by the inflation outlook presented in the June projection and also by the latest data on inflation and high wage growth outpacing the labour productivity growth. Such an assessment justified raising interest rates at the current meeting. The Council also discussed the future path of NBP interest rates. In the opinion of some Council members bringing inflation down to the target in the medium term may require a further monetary policy tightening in the coming months. Other Council members, however, argued that a further monetary policy tightening might result in an excessive appreciation of zloty exchange rate. They pointed out that the increased current inflation was to a large extent the effect of factors beyond the influence of the domestic monetary policy and argued that the expected lowering of the economic growth should be conducive to easing the inflationary pressure.

A motion to raise the key NBP interest rates by 25 basis points was put forward at the meeting and passed. The Council raised the interest rates to the following levels: the reference rate to 6.00%, the lombard rate to 7.50%, the deposit rate to 4.50% and the rediscount rate to 6.25%.

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