NBP

National Bank of Poland

Monetary Policy Council

MINUTES OF THE MONETARY POLICY COUNCIL DECISION-MAKING MEETING HELD ON 29 AUGUST 2007

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

The main topics raised at the meeting were the turbulences in international financial markets and their impact on the outlook for economic growth, the labour market situation in Poland and the public finance situation. The Council discussed the influence of these factors on the future inflation in Poland.

Some Council members pointed out that both the current and forecast inflation were close to the inflation target, while core net inflation had remained for a longer period close to the lower limit for deviations from the inflation target. Such developments of core inflation warranted caution in monetary policy and abstaining from a decision to change the interest rates. Other members emphasised that the year-on-year drop in core inflation in July was connected with a significant increase in telecommunication services prices one year before. Apart from that, they argued that the rising growth of prices of services was an indication of an intensifying Balassa-Samuelson effect. They also pointed out that oil prices in the world markets remained above the levels assumed in the July projection.

The members of the Council discussed the turmoil in international financial market observed in August 2007 and its impact on the outlook for global and Polish economies. Some members pointed out that the turbulences in financial markets resulted in lowering forecasts of economic growth in the United States and Europe. Though, at the moment, it is difficult to assess the scale of impact those problems will have on the US economy, it can be expected that the forecasts of economic growth in the external environment of the Polish economy will be further decreased. It was argued that if economic growth in the United States and Europe fell short of previous expectations, then smaller exports of Poland should be expected, resulting in lower economic growth and lower inflationary pressure. In view of the above factors, it was recommended to remain cautious, abstain from the decision to change interest rates at the August meeting and adopt a "wait and see" approach, following the example of some other central banks. It was pointed out that delaying the decision to raise the interest rate would not have any significant impact on monetary policy effect on inflation.

On the other hand, other Council members emphasised that the financial disturbances have a strong influence on the global economy when they are accompanied by a significant and long-lasting decline of stock prices. Such a situation occurred in 2000, when stock exchange indices slumped, among others, due to decreased confidence in the reliability of companies' financial reporting. In the opinion of those members, the turbulences observed in August were similar to those which occurred back in 1998, when they were rooted in the financial markets themselves. Those upheavals had not had any significant impact on the situation of the enterprise sector nor had they dampened significantly economic growth in the United States. Moreover, the August turmoil in the global financial market did not affect the financial market in Poland. It was emphasised that some central banks decided to raise their interest rates in the face of financial market turmoil. In the opinion of these members, a halt in monetary policy tightening in Poland, due to disruptions in international financial markets, might suggest that the National Bank of Poland would in future ease monetary policy in the event of problems resulting from financial institutions incurring excessive risk, which could increase moral hazard. It was also argued that currently the economic growth in Poland is primarily driven by domestic demand and thus the impact of economic growth in the external environment of the Polish economy on GDP growth is currently lower than it used to be.

While addressing the developments in the labour market, some Council members pointed out that in 2007 Q2 the growth of unit labour costs in the economy was significantly higher than forecast in the July projection. Those members pointed also out that a rapid growth of wages in the enterprise sector had been sustained in 2007 July, which signalled that wage growth in the economy would remain high in 2007 Q3. Those members also argued that the acceleration in wage growth was spreading to a growing number of industries and sectors of the economy. It was emphasised that the higher than previously expected increase in the minimum wage which was announced by the government would be a factor conducive to higher wage growth. It was also pointed out that the high wage growth would be supported by the fast and higher than forecast drop in the unemployment rate, which fell – in the assessment of those members – below the NAWRU. Those members believed that the persistence of the excessively rapid wage growth in the economy would after a lag lead to higher inflation. As a result, this may diminish the competitiveness of Polish exports and, consequently, dampen economic growth in the longer period. This would also be conducive to rising imbalance in the balance of payments, which would raise the macroeconomic risk of Poland.

Other members of the Council pointed out that, despite the rapid growth of wages in enterprises, July brought a significant drop in the growth of unit labour costs in industry and so the deterioration in the relation between wages and productivity was not perpetuated in this sector. Moreover, the same members emphasised that over the past few years wage growth in industry had been lower than productivity growth. These tendencies had to be reversed at some point and thus at the moment wage growth outpaced productivity growth. It was argued that the wage growth outpacing productivity growth would be limited in time, as at some point it is bound to negatively affect the financial results of companies. It was emphasised that in the first half of 2007 enterprises reported record high financial results, with the contribution of wage costs in total costs remaining stable and low, which indicated that enterprises did not have to increase their prices in response to wage growth acceleration. The same members also emphasised that in 2006 and at the beginning of 2007 the growth of unit labour costs in the economy outpaced inflation, yet inflation increased only moderately. Additionally, those members pointed out that in comparison to the similarly developed neighbouring countries the accumulated wage increase in manufacturing since 2002 had been significantly lower in Poland and the corresponding productivity growth considerably higher than in those countries. It was argued that the productivity growth in Poland will be fuelled by the dynamically rising investment. It was also pointed out that, in line with the NBP's analyses, the growth of unit labour coast in the economy as calculated on the basis of LFS (BAEL) data may in fact be overestimated due to the problems with the BAEL accounting for the effects of increased foreign migration of Polish workers.

During the discussion on economic growth in Poland, some Council members pointed out that the GDP growth in Poland was slowing down, which was confirmed by macroeconomic data and business survey results. They also emphasised that the high growth in investments and restructuring taking place in enterprises were contributing to the growth of potential GDP, which would be easing inflationary pressure. They also argued that, in line with the July projection, at the beginning of 2009 the growth of potential GDP may outpace the growth of actual GDP, which would weaken the inflationary impact of strong economic growth.

Other members pointed out that domestic demand was growing faster than GDP leading to a widening current account deficit. They believed that this deficit remained moderate for the time being, but its increase will make it an important factor affecting the inflation outlook. It was argued that the statistical data for July 2007 indicated that the strong growth of domestic demand and growing current account deficit would most probably continue in Q3. In the assessment of those members, a factor supporting the continuation of a rapid growth in consumption demand was – apart from the dynamically rising aggregate wages – a rapid build-up in consumer credit, which kept on stepping up despite two interest rate increases.

The members of the Council also discussed the developments of food prices. It was pointed out that, despite good crop harvest in Poland, there was an increase in the prices of cereals, which have a considerable impact on the overall food prices. It was also stressed that there was an unexpected rise in the prices of other food products and a heightened risk of faster food price growth in the world markets.

The members of the Council also devoted a lot of attention to public finance situation. It was pointed out that the current standing of this sector was favourable. Still, it was underlined that the announced changes in the way of indexing old-age and disability pensions additionally linking the indexation to wage growth would result in increased public expenditure and higher consumption demand. It was also argued that the prolongation of old regulations on early retirement may be still conducive to deactivating some part of the labour force and, thus, negatively affect the potential output and step up the wage growth at the same time. Moreover, in the opinion of some Council members also the reduction in the disability pension contribution under no reduction of public spending would raise the aggregate demand. It was assessed that the announced changes in the public finance – if implemented – would be leading to a rise in the deficit of the public finance sector and an increase in domestic demand and inflation.

The members of the Council also discussed the exchange rate developments of the zloty. In this context, both the impact of fundamental factors was emphasised and also of the tendencies in international financial markets, including the current account balance, portfolio capital and direct investment flows, as well as increased uncertainty connected with probable parliamentary elections in Poland.

In the Council's assessment, in the conditions of increased uncertainty associated with the turmoil in international financial markets, the balance of risks for future inflation pointed to the necessity of a monetary policy tightening. This was supported by the assessment of inflation outlook carried out on the basis of macroeconomic data and the July inflation projection. Another important argument for raising the interest rates were the recent decisions leading to a decrease in revenues and an increase in expenditures of the public finance sector, which may lead to a deterioration of the public finance balance and create additional inflationary pressure in the medium term.

A motion to raise the key NBP interest rates by 25 percentage points was put forward at the meeting. The motion passed. The Council raised the interest rates to the following levels: the reference rate to 4.75%, the lombard rate to 6.25%, the deposit rate to 3.25% and the rediscount rate to 5.00%.