NBP

National Bank of Poland
Monetary Policy Council

# MINUTES OF THE MONETARY POLICY COUNCIL DECISION-MAKING MEETING HELD ON 26 NOVEMBER 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: situation in the external environment of the Polish economy, outlook for economic growth and inflation in Poland, credit market conditions, zloty exchange rate developments and prospects of the public finance sector.

While addressing the situation in the external environment of the Polish economy, a further deterioration in the outlook for global economic growth, and in particular, recession already observed in the United States, the euro area and Great Britain, was noted. It was also pointed out that global economic slowdown had been accompanied by a strong decline in the prices of oil and other commodities which was conducive to curbing global inflation. It was noted that those factors urged many central banks to further considerable interest rate cuts. In some countries fears of deflation have emerged. It was emphasised that due to strong links between the financial sector and the real economy it was difficult, at the moment, to assess how strongly the global financial crisis would affect the activity in the world economy; although, this impact might prove considerable.

While discussing the impact of the weakened global economy and the turmoil in the global financial markets on the outlook for economic growth in Poland, attention was paid to the downward revisions of forecasts of the domestic economic growth. It was argued that lower than expected data on industrial output and retail sales in October 2008 and weaker financial results of enterprises after the three quarters of 2008 as compared with 2007 as well as declining economic climate indices corroborated expectations of economic slowdown in Poland. Attention was also paid to the findings of enterprise surveys pointing to a decline in the expected demand and employment indices. It was emphasised that the anticipated deterioration of the situation in the labour market in Poland combined with the recession observed in Polish migration’s major destination countries might contribute to deteriorating households’ sentiment, and, as a result, to lowering consumption demand. In the opinion of some Council members, considerable deterioration in the external environment of the Polish economy and a risk of significant decline in investment and consumption demand due to deteriorating expectations about future economic situation in Poland suggested that in 2009 GDP growth in Poland might prove lower than anticipated in the NBP’s October projection.

In this context, it was also pointed out that an important factor conducive to the weakening of the domestic demand would be banks’ tightening of their lending policy. Some members of the Council argued that 2009 might see a stabilisation or even a decrease in corporate and household lending. A more difficult access to loans will result mainly from the currently introduced by banks tighter loan granting criteria and conditions (more rigorous assessment of creditworthiness, higher margins, increased required collateral, higher non-interest costs of credit etc.), while the increase in costs of loans may result, to some extent, from the increase in interest rates offered by banks on deposits. Market interest rates remaining at an elevated level and limited access of banks to external financing are also conducive to curbing lending. Yet, some Council members noted that the monetary data had not, thus far, suggested any considerable slowdown in lending.

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While addressing the situation in the labour market it was pointed out that – despite some deceleration – the growth of wages and unit labour costs had remained at a high level. In the opinion of some members of the Council, subsequent quarters might be expected to bring a decline in employment and a rise in unemployment which might be driven by probable increase in labour supply resulting from demographic factors and lower incentives for economic migration of Poles to other EU countries. The majority of the Council members assessed that the expected decline in economic growth and the related deterioration in the labour market situation would translate into lowering wage pressure which, given the falling current inflation considerably limits the risk of the second round effects.

While analyzing current inflation in Poland it was noted that for a year it had been remaining above the upper limit for deviations from the NBP inflation target. Some Council members pointed out that the currently heightened inflation resulted largely from high growth in administered prices (mainly prices of non-market services related to flat maintenance and energy prices) not directly influenced by monetary policy. At the same time it was noted that the rise in prices of some market services driven by demand pressure was also contributing to inflation remaining at an elevated level. Other members of the Council argued that the consumption growth had been continuously below the GDP growth which, in their opinion, meant that demand pressure in the Polish economy was limited. Those members pointed out that October 2008 saw a decline in four out of six core inflation indices, and core inflation net of food and energy prices remained at the level recorded in September 2008.

While discussing future inflation developments, some members of the Council pointed out that due to time lags in the monetary transmission mechanism, the outlook for inflation after 2009 was currently of key importance for monetary policy. Those Council members emphasised that the expected decline in inflation would be faster than anticipated in the October projection. In their opinion, the following arguments supported such an assessment: probably stronger than previously expected economic slowdown in Poland, considerable easing of the global inflationary pressure (including further decline in commodity prices), weaker – amidst declining demand – translation of the currently observed growth in unit labour costs into prices and faster lowering of wage growth than anticipated in the projection. Those members of the Council pointed out that the growth of both food and fuel prices in 2009 might prove lower than forecast. It was also emphasized that the rise in administered prices, including prices of energy, together with an increase of excise duty on tobacco products due to the required adjustment of tax rates to the EU regulations would be delaying the process of lowering inflation. It was pointed out that the uncertainty about administered prices developments was an important factor that hinders identifying the time of inflation returning to the inflation target.

While addressing the exchange rate issues, some members of the Council emphasized that the current exchange rate of the zloty was weaker than anticipated in the October inflation projection which may contribute to price increases. Moreover, those Council members pointed out that zloty depreciation limited translation of lower commodity prices in the world markets into domestic prices. Other members of the Council assessed that the impact of the zloty depreciation observed in the past few months on inflation in Poland would be limited due to the lower pass through of exchange rate changes to consumer prices amidst the expected economic slowdown.

While discussing the exchange rate developments, it was pointed out that zloty depreciation in the past few months had largely been driven by the outflow of foreign capital from developing economies connected with the turmoil in the global financial markets. It was argued that the role of interest rate differential between Poland and the euro area and the United States had been temporarily limited, and the outlook for exchange rate developments depended to a major extent on the situation in the financial markets of the developed countries. Some members of the Council emphasized that exchange rate depreciation increases the volume and service cost of foreign corporate debt. Yet, it was also pointed out that weaker exchange rate of the zloty might mitigate the adverse effects of the economic slowdown in the euro area on the demand for Polish exports.

The Council paid a lot of attention to the prospects of fiscal policy in 2009 in the light of the announced amendments to the draft Budget Act. It was pointed out that keeping the budget deficit at the level adopted in the original draft Budget Act would mean – under the assumption of a lower economic growth – tightening of the fiscal policy. Some members of the Council noted, however, that the final shape of the Budget Act was not yet known and the planned lowering of the expenditure did not have to mean their actual reduction, among other things, due to the possibility of reallocating some of the funds not spent in 2008 to the subsequent year. The Council emphasized that maintaining fiscal discipline in the public finance sector may be conducive to easing monetary policy.

While addressing the issue of Poland's accession to the euro area, attention was paid to increased uncertainty about the implementation of the schedule of Poland's euro adoption, which was due to the lack of political consensus on this matter so far. At the same time it was pointed out that the monetary policy should take into account the risk of a strong economic slowdown in Poland making the compliance with the Maastricht fiscal criterion more difficult.

The Council also analyzed the liquidity conditions in the banking sector and their impact on the monetary policy transmission mechanism. In this context, the Council discussed the need for possible further adjustment of monetary policy instruments to liquidity conditions in the interbank market.

While discussing the decision on interest rates, some Council members assessed that further deterioration in the outlook for global economic growth, including the recession observed in Poland's major trading partners, the signs of considerable decline in economic activity in Poland in subsequent quarters and the resulting anticipated significant lowering of the inflationary pressure in the medium term justified easing the monetary policy at the Council's November meeting. The factor favouring the decision to ease the monetary policy was maintaining the public finance discipline amidst the expected economic slowdown declared by the government's representatives. Those members of the Council also argued that the lowering of the NBP interest rates would prevent banks from limiting lending. Other Council members, however, pointed at the difficulty to identify the horizon of inflation returning to the inflation target and the considerable volatility of the zloty exchange rate as factors speaking for keeping the interest rates unchanged. Those members assessed that changes in the monetary policy parameters, if any, should be implemented at a later date – i.e. after the Council has got acquainted with the Budget Act for 2009 and with the subsequently released data on inflation and economic growth in Poland.

The Council also discussed the scale of the NBP interest rate reduction at the current meeting. In the opinion of some Council members the considerable deterioration of the outlook for economic growth in Poland spoke for lowering interest rates by 50 basis points at the November meeting. The majority of the Council members, however, assessed that developments in the Polish economy justified a gradual easing of monetary policy. They pointed out that amidst persisting high risk aversion in the international financial markets a too strong interest rate reduction at the current meeting could lead to further exchange rate depreciation.

A motion to lower the NBP interest rates by 50 basis points was put forward. The motion did not pass. A motion to lower the NBP interest rates by 25 basis points was put forward and passed. The Council decided to lower the NBP interest rates to the level: the reference rate to 5.75%, the lombard rate to 7.25%, the deposit rate to 4.25% and the rediscount rate to 6.00%.

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