

## **MINUTES OF THE MONETARY POLICY COUNCIL DECISION-MAKING MEETING HELD ON 30 JULY 2008**

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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 exchange rate developments and their impact on economic growth, external balance and inflation, the outlook for economic growth in Poland, the labour market situation and the assessment of the risk of second-round effects. The Council discussed the influence of these factors on future inflation in Poland.

The Council paid close attention to the fact that as a result of the strengthening of the zloty so far, the present level of the exchange rate considerably outstripped that accounted for in the June inflation projection, which is likely to bring inflation down in the future. At the same time, some members of the Council pointed out that the recently observed appreciation of the zloty might have outpaced the appreciation of the equilibrium exchange rate. Some members of the Council argued that apart from the continuing interest rates differential between Poland and the euro area and the United States, expectations of further interest rate hikes in Poland, stimulating the inflow of short-term capital, might also have contributed to zloty strengthening. Given a low risk premium and favourable fundamentals of the Polish economy, subsequent interest rate hikes may, in the opinion of those members of the Council, bring further strong appreciation of the zloty. Other members of the Council argued that the anticipated economic slowdown in Poland might contribute to zloty depreciation. They also reasoned that at present it is difficult to assess whether factors which had led to zloty appreciation were of permanent nature. Those members pointed out that exchange rate developments are, to a great extent, affected by non-fundamental and external factors whose impact on the exchange rate is hardly predicable. Therefore, in their opinion, a depreciation of the zloty exchange rate cannot be ruled out.

In the discussion about the consequences of zloty appreciation it was pointed out that it contributed to curbing inflation by decreasing imported inflation, including by easing the impact of oil price growth in the world markets on domestic prices. Some members of the Council pointed out that the appreciation of the zloty exchange rate surpassing the appreciation of the equilibrium exchange rate might, with a time lag, negatively affect economic activity in Poland by decreasing the competitiveness of Polish exports, which would be conducive to increasing the negative contribution of net exports to GDP growth and might curb corporate investment activity. In the opinion of those members of the Council, a worsening outlook for Polish exports is signalled by the findings of the NBP's economic condition survey indicating a marked drop in 2008 Q2 in margins of enterprises manufacturing export products, a fall in the number of export contracts and an appreciation of the actual exchange rate outstripping the appreciation of the average exchange rate ensuring exports profitability declared by enterprises. Attention was also paid to GUS data on foreign trade deficit in 2007 which after revision proved higher than previously estimated, which was mainly connected with stronger import growth. In the opinion of some members of the Council this means that zloty appreciation may have a stronger impact on Polish foreign trade than previously estimated. Those members pointed out that the zloty appreciation will in subsequent

quarters further deepen the foreign trade deficit which would also be influenced by the economic slowdown abroad.

On the other hand, it was pointed out that according to preliminary national accounts data for 2008 Q1 export growth was maintained at a level close to the import growth despite the appreciation of the zloty exchange rate. It was also indicated that import growth might be connected not only with exchange rate appreciation but also with a strong growth of domestic demand. It was argued that wage growth outpacing labour productivity growth was also conducive to deteriorating competitiveness of Polish manufacturers.

The Council paid considerable attention to the role of the exchange rate in the conduct of monetary policy. Some members of the Council argued that in a small open economy, such as the Polish economy, changes in the exchange rate, in particular in relation to the equilibrium exchange rate, contribute significantly to a tightening of monetary conditions and should be taken into account in the decisions about interest rates. They pointed out that although the exchange rate appreciation is an effective channel of curbing inflation, excessive currency strengthening poses a risk of too severe an economic slowdown and of a worsening external balance. Other members argued that the recent strong appreciation of the zloty exchange rate could be temporary and therefore changes in the exchange rate should be treated as a neutral factor while taking decisions on interest rate. Some members of the Council pointed out that due to the specific character of exchange rate markets, the exchange rate can persistently deviate from the equilibrium exchange rate.

While discussing the outlook for economic growth, some members of the Council indicated that June data on lower than expected growth in industrial output, falling growth in retail sales and deteriorating economic conditions indicators in June and July together with information on lower capacity utilization in 2008 Q3 pointed to a gradual slowdown of the economic growth in Poland. Those members pointed out that limited investment and consequently lower GDP growth might also result from the likely deterioration of profit ratios of enterprises. Moreover, in the judgment of those members of the Council the second half of 2008 might be expected to see GDP growth below potential output growth which should be conducive to lowering the inflationary pressure. Yet, other members of the Council pointed out that the scale of the anticipated slowdown was limited and might not be sufficient to bring inflation down to the target over the monetary policy horizon. Moreover, despite a certain decline, credit aggregates continued to display a high growth rate which, in the opinion of those members, supported the inflationary pressure.

In the discussion about the labour market situation, it was reasoned that high wage growth and growing unit labour costs continued to be major risk factors to inflation in the medium term. It was indicated that the economic slowdown had not curbed wage pressures yet. Some members of the Council pointed out that, as suggested by the findings of the NBP's business tendency survey, the outlook for employment and wage growth deteriorated in 2008 Q3 for the second consecutive time, and employment growth in enterprises was on a downward path. In the opinion of those members, 2008 H2 might see a gradual softening of the labour market which would be driven by the expected growth in economic activity and a lower scale of Poles' economic migration abroad. Some members of the Council also pointed out that an economic slowdown and related decreasing labour demand as well as worsening financial condition of enterprises should contribute to lowering the wage growth.

It was argued during the discussion that heightened current inflation together with adaptive inflation expectations posed a risk of inflation remaining at a relatively high level. It was also emphasized that the recent heated public debate about the price growth contributed to boosting inflation expectations. Yet, in the opinion of some members of the Council the impact of inflation expectations on wage growth should decrease together with weakening economic conditions. In the opinion of those members the recently observed strong appreciation of the zloty exchange rate

bringing down inflation expectations constitutes an additional factor reducing the risk of second-round effects.

At the meeting the current inflation developments were also discussed. It was pointed out that despite the increase in the consumer price index recorded in June (being primarily the result of a higher growth in the prices of food, fuels and certain services), inflation in Poland, similarly as in Slovakia, was the lowest in the region. It was also emphasized that the 12-month moving average HICP inflation taken into account while assessing the compliance with the Maastricht price stability criterion, despite its increase, still had not exceeded the reference value, which was due to fact that the currently observed rise in inflation is global in character.

At the same time, it was pointed out that June had seen an increase in all core inflation measures which, in the opinion of some Council members, corroborated growing inflationary pressure. While analyzing core inflation measures net of food and energy prices, it was emphasized that since mid-2006 this indicator had been on a steady rising path, and the June inflation projection pointed to its further growth and persistently high level in 2009. It was also noted that the past few years had seen core inflation net of food and energy prices running considerably below CPI inflation which, in case this relation continued, might mean the CPI inflation will remain above the inflation target also in 2009 or even beyond. On the other hand, some members of the Council pointed out that the expected decline in economic growth, the recent strengthening of the exchange rate and the previous interest rate hikes could bring inflation down close to the inflation target in the monetary policy horizon, albeit the expected rise in administered prices would be a factor supporting increased inflation.

While discussing the changes in the external environment of the Polish economy, some members of the Council emphasized persisting uncertainty about the duration of the slowdown in the world economy and its impact on economic growth in Poland. The data on the United States suggest, in the judgment of those members, that the fiscal impulse implemented in the United States has been largely offset by rising fuel prices and will drive only a short-lived acceleration of economic growth. According to the latest forecasts, the second half of 2008 should bring further slowdown in the US economy which might continue also in 2009. Moreover, those members pointed to a deteriorating growth outlook in the European economy, particularly in Germany which so far had reported relatively high economic growth.

Some members of the Council pointed out that considering the sources of the currently elevated inflation, central banks pursuing inflation targeting strategy did not aim at bringing inflation down to the target fast as this might result in an excessive decline in economic growth. In this context, it was pointed out that in Poland the measures which could lower the inflationary pressure and consequently reduce the costs of bringing inflation down to the target were structural reforms, including the reform of public finances. The reform of public finances should limit the pro-cyclicality of fiscal policy.

Potential further increases in interest rates were discussed at the meeting. Some members of the Council emphasized that the risk of inflation expectations being maintained at a heightened level and a strong rise in wages and unit labour costs combined with the anticipated only slight slowdown in economic activity weighted in favour of increasing interest rates at the July meeting. It was argued that the outlook for inflationary processes was largely affected by the developments in real interest rates which, despite the previous interest rate increases, continued to fall. Yet, the majority of the Council members judged that the strong appreciation of the zloty exchange rate, the expected softening of the labour market and the anticipated slowdown in economic growth coupled with the already implemented interest rate hikes would constitute factors bringing inflation down to the target in the medium term, yet, a more comprehensive assessment of the risk of inflation continuing at a heightened level would be possible after analysing the data to be released in the coming months. Moreover, those members indicated that too large a scale of interest rate hikes might favour

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excessive appreciation which, coupled with a deteriorating outlook for economic growth abroad would constitute a risk of a significant weakening of exports and pose a risk of a considerable economic slowdown in Poland and further rising of external imbalance. These arguments, in the opinion of the majority of the Council members, justified keeping interest rates unchanged at the present meeting.

A motion to raise the key NBP interest rates by 25 basis points was put forward at the meeting. The motion did not pass. The Council kept the interest rates unchanged: the reference rate at 6.00%, the lombard rate at 7.50%, the deposit rate at 4.50% and the rediscount rate at 6.25%.

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