POST-MPC COMMENT

3 September 2014

All is not lost that is delayed

The Monetary Policy Council kept interest rates unchanged, in line with our forecast, with market consensus and with recent comments of its members (cut in September was suggested by only a few of them). As we have already noted for a couple of times, shift of risk balance for the economic growth and for inflation, which was observed over the last weeks, justified an interest rate cut (even by 50bp) already today. But it seems that the Council wants to see more data. The most important sentence of the communiqué states that if upcoming data confirm tendencies observed recently, then the Council "will start an adjustment of economic policy". We maintain our view that NBP interest rates will be cut by 75bp in the upcoming months.

The Monetary Policy Council kept interest rates unchanged in September. This was in line with market consensus and our expectations, but there were some bids on the market that the cut may be implemented already today. Despite no rate cut, the interest rate market did not react negatively to the decision, as at the same time we saw a positive impact (also on the zloty) of events in Ukraine (chances for a cease-fire).

As we have already noted for a couple of times, shift of risk balance for the economic growth and for inflation, which was observed over the last weeks, justified an interest rate cut (even by 50bp) already today. It seems that such voices in the MPC are still in minority, and other members wanted to see more data from the economy, confirming that the economic scenario has changed.

This is reflected in the statement, as the most important sentence reads: "*if the incoming data confirm weakening of economic activity and an increase in risk of inflation remaining below the target in the medium term, the Council will start an adjustment of monetary policy*". The Council noted also a rather obvious observation: that recently the uncertainty has increased as regards economic growth in Poland, and thus prospect of inflation's return to target.

As regards inflation outlook, the MPC clearly pointed out that we are currently facing: 1. sub-zero inflation, i.e. much below target; 2. lack of demand-side pressure; 3. lack of cost pressure; 4. very low inflationary expectations of households and companies. Taking into account that at the same time the Council wrote that "incoming data point to a slowing momentum of economic growth", we have no doubts that monetary easing is about to start soon.

Answering to the question what would have to happen to prevent rate cuts, NBP governor said that, among other things, the Council had to see outstanding performance in manufacturing. Well, our forecast of industrial output for August assumes a negative year-on-year growth rate; but even a reading slightly above zero would surely not point to such scenario. Putting this straightforward, we think next macro data will allow the MPC to cut rates already in October. At the press conference, Marek Belka said that the Council does not have to wait for the November's projection. Additionally, the last sentence of the statement says that the Council will "start an adjustment" of monetary policy, rather than "will adjust". This means that the cycle of rate cuts may be initiated in October. Given the obvious MPC's lack of haste in taking actions – shown today – we see risk that the expected by us scale of rate reductions (75bps) will be spread across three months (three 25bp rate cuts each month in 4Q) rather than in October-November.

Why the MPC did not cut interest rates already today? It all suggests that the adequate motion was discussed, but did not gain majority (NBP President said the Council was not unanimous today). One of arguments was high uncertainty regarding situation in the East (the war in Ukraine). Secondly, during the conference Belka mentioned about the forward guidance, which the MPC has formally abandoned in July, but apparently it is still committed to it somehow and (at least some members) did not want to change interest rates before the end of third quarter.

To sum up, today the Monetary Policy Council opened the door to interest rate cuts. We can say that informal easing bias was introduced. We would have to see a significant positive surprise in economic data to prevent the Council from cutting rates, in our view. We still think that given recent change of macroeconomic scenario the Council will cut rates by 75bp in the upcoming months, probably in gradual steps by 25bp every month in Q4.

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Fragments of the MPC statement (indication of changes as compared to July statement)

Growth in global economic activity remains moderate, although the economic situation varies across countries. In the United States, following a contraction in GDP in early 2014, ~~indicators of economic activity have improved over recent months~~ **economic growth accelerated significantly in 2014 Q2. Moreover, economic indicators suggest that the recovery will continue in the coming quarters.** At the same time, **economic growth** in the euro area, ~~weak recovery continues~~ **came to a halt in quarterly terms, as GDP in Germany and Italy decreased and France remained in stagnation. Economic activity indicators for the euro area may be pointing to some improvement in economic activity in Q3, though a deterioration in industrial sentiment has been recorded of late. In the largest emerging market economies, economic activity growth remains weak relative to their previous performance.** ~~Moderate growth in global economic activity is conducive to maintaining low inflation in many economies, including the euro area and Central and Eastern European countries.~~ **Prices of many agricultural and energy commodities has decreased in recent months. Along with moderate global economic growth, this contributes to low inflation in many countries. In Poland's immediate environment – including in the euro area and the countries in Central and Eastern Europe – inflation remains close to zero.** Major central banks continue their expansionary monetary policy. ~~In June, the European Central Bank decreased interest rates and announced additional liquidity providing operations to banks in order to stimulate lending.~~ **While the Federal Reserve has been reducing the scale of quantitative easing, the European Central Bank intends to expand it. As a result, some central banks in the countries strongly linked with the euro area have recently reduced their interest rates.**

In Poland, ~~a gradual economic recovery continues~~ **incoming data point to a slowing momentum of economic growth. In 2014 Q2, economic growth was slightly lower than in previous quarter. A decline in GDP growth resulted from a decrease in contribution of net exports below zero and a decline in investment growth. At the same time, a slight acceleration in consumption growth and a significant increase in inventories were conducive to a higher GDP growth rate.** ~~Nonetheless, May data show that annual growth in industrial output, construction and assembly output as well as in retail sales was slower than in the preceding months.~~ **According to data for July, the annual growth in industrial production and retail sales remained low, while construction and assembly output growth plunged.** Also, some economic activity indicators have recently declined, which may point to a further slowdown in economic activity. ~~The economic recovery is accompanied by a moderate acceleration in lending growth, both to companies and households.~~

~~Labour market conditions are improving gradually. Corporate sector data for May indicate a stabilization of employment and a slight acceleration in wage growth. This was accompanied by a decline in unemployment rate, which however remains at an elevated level.~~
As economic growth decelerated in the second quarter, the number of the employed in the economy continued to rise. At the same time, wage growth eased. According to data for July, growth in employment continued in the enterprise sector, while the wage growth stabilized.

Expansion in lending to the corporate sector and households in recent months has stabilized at a moderate level.

In ~~May~~ **July**, the annual CPI inflation ~~was lower than expected and stood at 0.2%~~ **declined and was negative (-0.2%),** remaining well below the NBP inflation target of 2.5%. ~~At the same time, all core inflation measures remained very low. This was accompanied by a further fall in producer prices and a decline in inflation expectations of both companies and households.~~ **The decline in inflation was driven by decline of food prices and lower core inflation, which indicates a lack of demand pressure. Also, a decline in producer prices confirms no cost pressures. It is accompanied by very low inflation expectations of businesses and households.**

~~In the opinion of the Council, in the coming months inflation will remain very low and may temporarily fall below zero. In the following quarters, the ongoing economic recovery and improvement in the labour market should support a gradual increase in inflation and its approaching the target in the projection horizon. This assessment is supported by the July projection of inflation and GDP. Nonetheless, uncertainty persists over the scale of further acceleration of economic growth and the prospects of inflation returning to the target.~~ **In the opinion of the Council, uncertainty about the outlook for economic activity in Poland has recently increased, which translates into higher uncertainty about the prospects of inflation returning to the target.** The Council decided to keep NBP interest rates unchanged. ~~The Council decisions in the coming months will depend on the incoming information, which impacts the assessment of the outlook for economic growth and inflation in the medium term.~~ **If the incoming data confirm weakening of economic activity and an increase in risk of inflation remaining below the target in the medium term, the Council will start an adjustment of monetary policy.**