POST-MPC COMMENT

8 October 2014

First cut is the deepest

The Monetary Policy Council cut the lombard rate by 100bp (to 3.0%), the reference rate by 50bp (to 2.0%) and kept the deposit rate unchanged (at 1.0%). Narrowing of corridor between the deposit and the lombard rate was aimed at adjusting it proportionally to lower level of rates. The door to further adjustment was left open and in our view a further correction in November is likely, but should not exceed 25bp. We stick to our forecast that reference rate will reach 1.75% at the year-end.

Poland's Monetary Policy Council decided to trim official interest rates. The reference rate was cut by 50bps to 2.00%, the lombard rate by 100bps to 3.00%, while the deposit rate remained unchanged at 1.00%. Consequently, the width of the symmetrical corridor around the reference rate between the deposit and the lombard rates narrowed from 1.5pp to 1.0pp. It is the first such decision in more than a decade. However, please note that when the width of the corridor was set on 1.5pp (April 2003), interest rates were at much higher level than currently (the reference rate was at 6.25%), so today's decision to narrow the corridor could be interpreted as the simple adjustment to the new environment (proportional to significantly lower official interest rates). Such interpretation was confirmed by the NBP's governor Marek Belka during the press conference.

Based on earlier behaviour of the MPC (no cut in September) and recent comments of its members, we were expecting a cautious pace of rate reductions (three cuts by 25bps each in October-December period), but in our view the decision to cut rates stronger was justified, taking into account the information, which appeared recently (weakening of economic activity in Poland and in the euro zone, lowering of the inflation path). In fact, we think that the decision to cut rates by 50bp should have been made already in September.

The Monetary Policy Council suggested in the statement that monetary policy easing is a response to deterioration of economic growth outlook and change in inflation prospects (lack of demand and cost pressure on prices, low inflation expectations). In the key sentence the MPC noted it "does not rule out further adjustment of monetary policy, should the incoming data, including the November NBP projection, confirm a considerable risk of inflation remaining below the target in the medium term". Marek Belka stressed during the press conference that the decision was not unanimous, but these MPC members, who voted in favour of a 50bp cut, supported the idea that rate adjustment should be concentrated in time and (possible) easing cycle should be ended quickly in order to limit the pressure on bond market. Belka's further comments suggested that he is also supporting such an opinion. Suggestions of further cuts were conditional. The NBP president said that the Council does not rule out further moves, but MPC's Kaźmierczak added quickly that it does not promise them either.

In our opinion, it is likely that the monetary Policy Council will cut official interest rates again in November, but the scale of reduction should not exceed 25bps. The new NBP's projections should confirm that the pace of inflation return to the target will be slower, than previously expected. On the other hand worsening economic outlook should not be deep enough to justify to more decisive move in official rates. Apart from that, Belka said on press conference that deposit rate at 0.50% will mean approaching unconventional monetary policy. We think that the MPC may leave the doors open for further monetary policy adjustment, in case the next macro data strongly disappoint, but in our opinion it will not have to use this option. Consequently, we stick to our forecast of total scale of rate cuts this year – the reference rate will reach 1.75% at the end of this year and will remain at this level until the end of 2015. This scale of rate cuts is practically priced-in by the financial market.

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

Growth in global economic activity remains moderate, although the economic situation varies across countries. ~~Following a contraction in GDP in early 2014,~~ economic ~~growth~~ **recovery** in the United States ~~accelerated significantly in 2014 Q2~~ **continues and economic outlook remains positive**. ~~Moreover, economic indicators suggest that the recovery will continue in the coming quarters.~~ At the same time, economic ~~growth~~ **activity** in the euro area ~~came to a halt in quarterly terms, as GDP in Germany and Italy decreased and France remained in stagnation~~ **is still subdued and the business climate indicators have recently deteriorated**. ~~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~~ **GDP** growth ~~remains weak relative to their previous performance~~ **is also relatively low and in some of them, including Russia, has been decelerating.** Prices of many agricultural and energy commodities have decreased in recent months. Along with moderate global economic growth, this contributes to low inflation in many countries. In Poland's immediate environment – including the euro area and the Central and Eastern Europe – inflation remains close to zero. Major central banks continue their expansionary monetary policy. **At the same time, as economic situation varies across major economies, monetary policies in these economies are diverging.** While the Federal Reserve has been tapering its asset purchase program, the European Central Bank has increased monetary expansion. ~~As a result, some central banks in the countries strongly linked with the euro area have recently reduced their interest rates.~~
~~In Poland, 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. 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.~~ **In Poland, data on economic activity in 2014 Q3 point to a further deceleration in economic growth. This is indicated by a slowing growth in industrial production, construction and assembly as well as retail sales in recent months. Lower economic activity growth is also indicated by a decrease in business climate indices.**
~~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.~~ **Despite lower economic activity growth, employment in the corporate sector continues to rise. Growing employment contributes to a decline in unemployment. Yet, the unemployment rate remains elevated, which continues to contain wage pressure. As a result, wage growth in the enterprise sector remains moderate. At the same time, expansion in lending to the corporate sector and households has stabilized.**
~~Expansion in lending to the corporate sector and households in recent months has stabilized at a moderate level.~~
In ~~July~~ **August**, the CPI inflation declined **again** and ~~was~~ **remained** negative (**-0.3%** y/y), ~~remaining well below the NBP inflation target (2.5%)~~. The decline in prices was driven by falling food prices **against high supply of agricultural products, lower prices of commodities in the global markets and the Russian embargo on food imports. At the same time** core inflation remained **very** low, which confirms the absence of demand pressure in the economy. The continued decline in producer prices points, in turn, to the absence of cost pressure. This is accompanied by very low inflation expectations of enterprises and households.
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 incoming data point to a deceleration in economic growth and an increased risk of inflation running below the target in the medium term.** Therefore, the Council decided to ~~keep~~ **lower** NBP interest rates ~~unchanged~~, except for the deposit rate, which remained unchanged, narrowing the spread between lombard and deposit rate. ~~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 does not rule out further adjustment of monetary policy, should the incoming data, including the November NBP projection, confirm a considerable risk of inflation remaining below the target in the medium term.**

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