

POST-MPC COMMENT

2 July 2014

Neutral bias instead of forward guidance

The Monetary Policy Council kept interest rates unchanged in July and in line with our expectations dropped the forward guidance. However, contrary to what we expected, the market did not interpret this change as a signal of rising chances for interest rate cut after summer vacation, as the NBP president Marek Belka firmly stated that probability of cuts remains very low and suggested an introduction of a quasi-neutral bias. In our view, monetary policy easing could take place if next data on economic activity would be very weak (inflation below zero will be no surprise!). However, if coming data confirm a continuation of moderately fast growth (which is our baseline scenario), then rates will remain stable at current level.

The monetary Policy Council kept interest rates unchanged in July, with the reference rate still at 2.5%. Quite considerable changes were applied to the post-meeting statement, but this came as no surprise. The MPC has been suggesting for a while already that after seeing the new NBP projection in July it would be able to better assess the monetary policy outlook and modify its communication with the market. In particular, as we expected (and as was suggested by NBP president Marek Belka and a few other MPC members), the sentence declaring stable interest rates until end of 3Q14 (forward guidance) was removed. Instead, the MPC wrote that its decisions in the coming months will depend on the incoming information and its impact on economic growth and inflation outlook in the medium term. What is important, at the very beginning of the post-meeting press conference the NBP president Marek Belka stressed that change of the statement does not mean that interest rate cut should be expected in September and he reiterated that probability of such a move is very low in Council's opinion. He added also that the change in communication means that any move in monetary policy can be expected in the upcoming months and decision will depend on incoming information about the economic situation. Thus, one can say that the MPC returned to the neutral bias in the monetary policy.

The main conclusions from the NBP projections presented in the MPC's statement are indicating lower path of CPI inflation and slightly slower growth of GDP in comparison with March's predictions (see table below). According to the central bank, inflation rate can temporarily drop below zero (the NBP governor Marek Belka said during press conference that it can last a couple of months), but in the following months inflation should start gradually increase towards NBP's target of 2.5%. It should be emphasized that after receiving such forecasts, assuming stabilisation of economic growth rather than its significant acceleration and subdued pace of inflation pickup in the next two years, the MPC still thinks that the probability of further rate cuts is very low. It confirms our opinion that to make decision about further monetary easing the Council would need to see a significant deterioration of economic growth in the incoming data. Temporary drop of CPI below zero will not be argument for a rate hike, as such scenario is already anticipated by the MPC. The next decision-making meeting is scheduled for September and by then we will see many new information that would help to verify if we are heading towards economic slowdown or whether (as we expect) recent weaker-than-expected indicators were just transitory disturbances in trend and in next quarters economic activity will continue expanding at decent pace (first monthly indicators for 3Q14 will be probably even more important for the Council than 2Q14 GDP growth). In the latter scenario, which we still see as the baseline, rate cuts are still unlikely.

Inflation and GDP projections in the subsequent *Inflation reports*

	GDP growth				CPI inflation			
	Jul 13	Nov 13	Mar 14	Jul 14	Jul 13	Nov 13	Mar 14	Jul 14
2014	1.2-3.5	2.0-3.9	2.9-4.2	3.2-4.1	1.2-3.5	2.0-3.9	0.8-1.4	-0.1-0.4
2015	1.6-4.2	2.1-4.5	2.7-4.8	2.6-4.5	1.6-4.2	2.1-4.5	1.0-2.6	0.5-2.1
2016			2.3-4.8	2.3-4.5			1.6-3.3	1.3-3.1

According to the NBP projections, the GDP and CPI growth will fall in the ranges given above with probability of 50%.

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Fragments of the MPC statement (indication of changes as compared to June 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. In the euro area, weak recovery continues and GDP growth in 2014 Q1 was slower than expected. Activity growth remains slow relative to previous performance in the largest emerging market economies, including China and Russia, where it weakened in major emerging economies remains slow as for these countries. Moderate growth in global economic activity is conducive to maintaining low inflation in many countries, including the euro area and Central and Eastern European countries. In recent months, inflation fell to near zero in the Central and Eastern Europe. Monetary policy of the major central banks remains expansionary. **In June, the European Central Bank has indicated a possibility of further monetary policy easing in the near future decreased interest rates and announced additional liquidity providing operations to banks in order to stimulate lending.**

In Poland, GDP growth in 2014 Q1 accelerated to 3.4% y/y, close to the March projection a gradual economic recovery continues. An acceleration in economic growth was driven by faster investment growth and a slight acceleration in consumer demand. In April, **Nonetheless, May data show that annual growth in industrial output growth stabilised, while construction and assembly output decelerated. At the same time, as well as in retail sales growth picked up was slower than in the preceding months. At the same time, a recent decline in some business climate indices points to a possible slowdown in economic recovery. This was The economic recovery is** accompanied by a moderate acceleration in lending growth, both to companies and households.

The recovery has been translating into an improvement of labour market conditions are improving gradually. According to the Labour Force Survey, in 2014 Q1 **Corporate sector data for May indicate a stabilization of employment growth in the Polish economy accelerated and a slight acceleration in wage growth.** This was conducive to accompanied by a decline in unemployment rate, yet it remains which however remains at an elevated level. Heightened unemployment restricts wage pressure in the economy.

In April **May, CPI inflation fell substantially below the March projection, to 0.3%, i.e. was lower than expected and stood at 0.2%, remaining** markedly below the NBP inflation target of 2.5%. **At the same time, all core inflation measures also declined 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 Council got acquainted with the inflation and GDP projection prepared by the Economic Institute, which is one of the inputs to the Council's decisions on the NBP interest rates. In line with the July projection based on the NECMOD model – prepared under the assumption of unchanged NBP interest rates and taking into account data available until 13 June 2014 (projection cut-off date) – there is a 50-percent probability of inflation running in the range of -0.1-0.4% in 2014 (as compared to 0.8-1.4% in the March projection), 0.5-2.1% in 2015 (as against 1.0-2.6%) and 1.3-3.1% in 2016 (as against 1.6-3.3%). At the same time, the annual GDP growth – in line with the July projection – will be, with a 50-percent probability, in the range of 3.2-4.1% in 2014 (as compared to 2.9-4.2% in the March projection), 2.6-4.5% in 2015 (as against 2.7-4.8%) and 2.3-4.5% in 2016 (as against 2.3-4.8%).

In the opinion of the Council, gradual economic recovery is likely to continue in the coming quarters, while inflationary pressure will remain very low 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.** The Council decided to keep NBP interest rates unchanged. The Council maintains 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 its assessment that NBP interest rates should be kept unchanged until the end of the third quarter of 2014. More comprehensive assessment of monetary policy perspectives and potential adjustment of interest rates will be possible after the Council gets acquainted with incoming information, including the July NBP projection.