POST-MPC COMMENT

4 February 2015

Rate cut getting closer

The Monetary Policy Council kept interest rates unchanged (with reference rate still at 2%), but message of the statement and the conference clearly show high chances for a rate cut in March. The NBP governor did not rule out that scale of monetary policy adjustment can be higher than only 25bps and we also think that probability of such a scenario is increasing. We assume that the Council will cut rates by 50bps this year and can do it even in one move, should the financial market's situation stabilise, zloty continue to gain and activity data surprise to the downside.

The Monetary Policy Council again kept interest rates unchanged, so the reference rates has been running at 2.00% since October. The decision came as no surprise. Recent data from the Polish economy were quite positive (with solid growth of industrial output, recovery in the labour market, strong rise of January's PMI), so these MPC members, who were awaiting convincing signals of economic slowdown did not get any new arguments. Additionally, the financial market turmoil after the SNB decision and uncertainty about situation in Greece and in the Ukraine did not support a cut in February – the NBP president clearly suggested after the last meeting that periods of high FX volatility are not the best moment to adjust rates. This month's statement included this last argument as well – the MPC wrote that it kept interest rates unchanged "taking into account the recently heightened volatility in the financial markets".

NBP governor, Marek Belka, stressed quite clearly during the press conference that the odds for a rate cut increased and next month, should the situation not change significantly, there may be a majority for monetary policy easing. In the final paragraph of the statement the key sentence was changed. Currently, the MPC does not exclude adjustment in the monetary policy "should the expected period of deflation be extended, which would increase the risk of inflation remaining below the target in the medium term". The second condition required to cut rates – macro data confirming the economic slowdown – has been removed. In our view, this is also a clear signal that the moment for a rate cut got closer.

We still expect a rate cut in March. First, fresh data released before the meeting will show deepening of deflation, weak industrial output and weaker 4Q14 GDP growth. Second, new NBP projections are likely to confirm that deflation will last longer than expected earlier. Third, the zloty should gain further thanks to the QE program launched in the euro zone and this should also make the decision to cut rates easier.

What is important, Marek Belka said during the press conference that the scale of rate adjustment may be larger than 25bp. Thus, it seems likely to us that the MPC will cut rates by 50bp this year and this might happen even in a single step when situation in the financial market stabilises, zloty continues to appreciate and deflation and economic activity data surprise to the downside.

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

Global economic activity growth remains moderate, although the situation varies across countries. **In** the United States ~~observed continued recovery in 2014 Q4, and the data on GDP in 2014 Q3 have been revised upwards~~ **GDP growth in 2014 Q4 stayed relatively robust compared to most developed economies, and the economic outlook is still positive.** ~~In contrast, activity growth in the euro area has continued to be slow, and the 2015 growth forecasts have been revised downwards in the recent months.~~ **In turn, in the euro area, which is Poland's main trading partner, activity growth has continued to be weak and the incoming information signal a merely slow recovery in the subsequent quarters. Similarly,** in the largest emerging economies, **including China**, economic activity has also remained weak as for these countries, **with growth in Russia decreasing close to zero.** ~~Russia's output growth has probably decreased close to zero.~~ In the past month, oil prices ~~continued to decline sharply~~ **have fallen again, accompanied by a decline in the prices of some other commodities.** Along with moderate global economic growth, this has been pulling down inflation in many countries ~~and contributed to deflation occurring in the euro area~~. **In Poland's immediate environment - including the euro area and most of the Central and Eastern European countries - the annual price growth has declined below zero. The fall of commodity prices may support economic growth in countries which are net commodities' importers.**

Major central banks ~~continue their expansionary monetary policy and~~ are keeping their interest rates at historically low levels. ~~The ECB and the Bank of Japan are running asset purchase programmes. At the same time, expectations of a gradual interest rate increase in the United States have strengthened which have contributed to a depreciation of the emerging market currencies, including the zloty. Heightened risk aversion in the international financial markets persists.~~ **At the same time, the European Central Bank has expanded its asset purchase programme significantly, adding sovereign bonds to the range of instruments targeted. The Swiss National Bank, in turn, unexpectedly abolished the Swiss franc's asymmetric peg to the euro, which resulted in its sharp appreciation vis-a-vis other currencies, including the zloty. The SNB also decreased its policy interest rates.**

In Poland, ~~economic activity growth in 2014 Q4 may have slowed down slightly~~. **preliminary national accounts data for 2014 indicate that GDP growth decreased slightly in 2014 Q4, remaining above 3%. Stable growth in consumption was accompanied by some weakening in investment growth. At the same time, imports growth slowed down more than that of exports, thus reducing the negative contribution of net exports to GDP growth.** ~~In November, industrial output growth decreased to near-zero levels, while construction and assembly output continued to fall. At the same time, retail sales growth decreased.~~ **In December, growth in industrial output, construction and assembly output and retail sales picked up.** Bank lending both to households and enterprises continues to rise at a steady rate. **At the same time, the sharp appreciation of the Swiss franc has increased the indebtedness of households with liabilities in this currency, which may limit their consumption.**

Labour market data point to a further ~~rise in corporate employment, which supports the decline in seasonally-adjusted unemployment~~ **decline of unemployment (in seasonally adjusted terms) resulting to a large extent from rising corporate employment**. Yet, wage pressure in the corporate sector remains limited, as indicated by continued moderate wage growth.

In ~~November~~ **December**, CPI inflation ~~remained negative and was below expectations at -0.6% y/y~~ **fell to 1.0% y/y, lower than expected**. This was accompanied by a **further** decrease in most core inflation indices, which confirms the absence of demand pressure in the economy. At the same time, the decline in producer prices ~~has also continued~~ **deepened**, pointing in turn to the lack of cost pressure. Inflation expectations of enterprises and households remain very low.

Taking into account the recently heightened volatility in the financial markets, the Council decided to leave the NBP interest rates unchanged. ~~The Council highlights that uncertainty regarding economic conditions in the environment of the Polish economy persists. If the expected period of deflation extends, which would increase the risk of inflation remaining below the target in the medium term, and incoming data confirm a slowdown in economic activity as well as weak growth in the environment of the Polish economy persists, the Council does not rule out further adjustment of monetary policy.~~ **However, the Council does not rule out a monetary policy adjustment in the nearest future, should the expected period of deflation be extended, which would increase the risk of inflation remaining below the target in the medium term. A more comprehensive assessment of the outlook for inflation returning to the target will be possible after the Council gets acquainted with the incoming information, including the March NBP projection.**

This analysis is based on information available until 04.02.2015 has been prepared by:

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