Poland inflation and central bank independence

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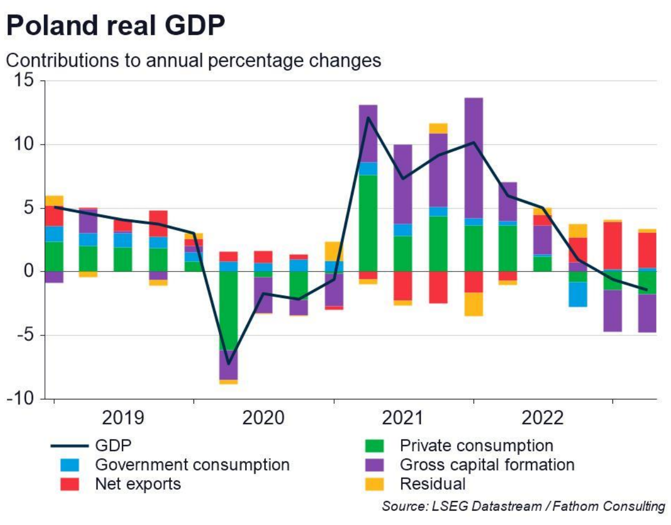
Poland has positioned itself as one of the key emerging countries in Europe, having enjoyed substantial economic growth over the past 20 years. The Polish economy managed to escape with one of the mildest contractions in GDP during the COVID-19 pandemic, and followed that with a strong recovery. However, over the past year the country's economic fortunes have been on a downward trend. Its trajectory was disrupted by the surge in global inflationary pressures, and this turbulence was severely aggravated by the start of the war in Ukraine, an event which affected Poland particularly. Recently, concerns have been voiced about the independence of its central bank, creating a reputational challenge which could dim the country's future outlook.

The massive influx of refugees from Ukraine competing for homes, food and services since early 2022 (there are currently roughly one million Ukrainians in Poland) helped to fuel the highly inflationary environment in Poland, which has eroded households' purchasing power. Meanwhile higher input costs severely constrained the industrial sector, one of the key engines of the Polish economy. As a consequence, private consumption and business investment fell sharply. Against this backdrop, exports have continued to shine against all odds, despite an unfavourable external environment — mainly due to the resilience of the automotive sector. But this has not been enough to avoid the economy contracting in the second quarter of this year.



Now, the strong disinflationary trends in global supply chains and the ongoing domestic weakness are weighing down on inflation, which has been falling steadily over the past few months. However, the disinflation process in Poland still pales in comparison to other countries in Central and Eastern Europe. Since its peak, core inflation has fallen by only 2.1 percentage points (pp) in Poland, in contrast with a fall of 4.1 pp in the Czech Republic, 7.0 pp in Slovakia and 10.5 pp in Hungary. This clearly indicates that domestic factors are causing inflation to become more entrenched in Poland relative to its neighbours, and hints that the country faces a more challenging road ahead to bring inflation back to target.

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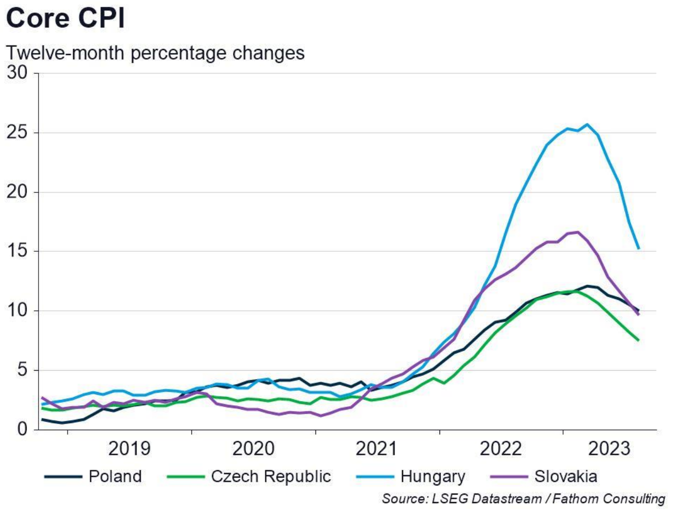
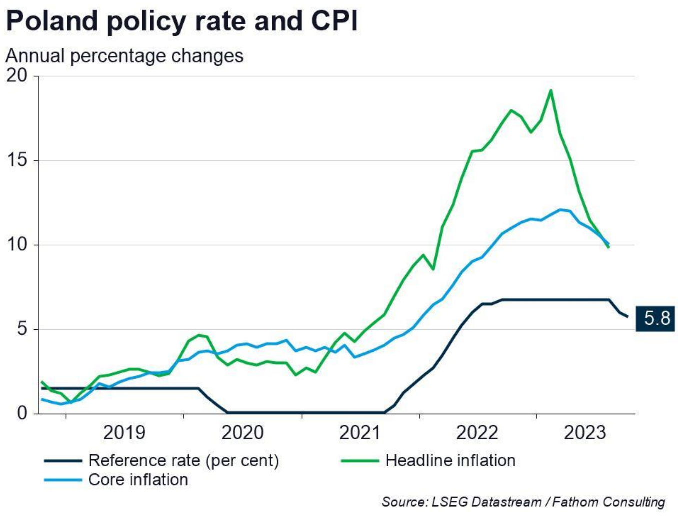


One of the key reasons for the large increases in Poland's inflation rate has been the systematic policy mistakes by the National Bank of Poland (NBP). In 2020 Q1, at the beginning of the pandemic, core inflation was already running significantly above the central bank's target of 2.5%, an overshoot which continued for almost a year. Not only did the NBP downplay the importance of this, but it opted to cut the policy rate three times, leaving it at historical lows of 0.1%, while conducting expansive open-market operations. It was only in October 2021, with inflation already running at 7%, that the NBP changed its rhetoric and started raising rates, but at a slower pace than was required given the severity of the inflationary problem. Further, in September 2022 the NBP decided to pause its rate-hiking cycle, despite inflation not showing any signs of abatement. Indeed, inflation continued to skyrocket to reach a peak of 19% in February this year, almost eight times the central bank target.

Orthodox monetary policy typically argues that the policy rate should be set according to the outlook for two variables — the output gap and inflation. Adam Glapiński, the president of the NBP, appears to place greater weight on the former. Indeed, he has a known aversion to positive real rates which he has described as "killing" for the economy. This may help to explain why the NBP has already started cutting rates. It did so last month by 75 basis points in a surprise to market expectations, and this week by a further 25 basis points. Poland has thus become the first central bank in Europe to cut rates, despite having one of the highest inflation rates on the continent, at near 10%.



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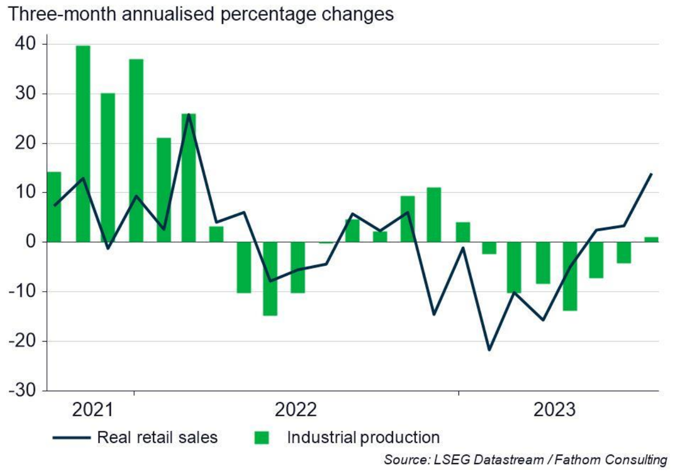
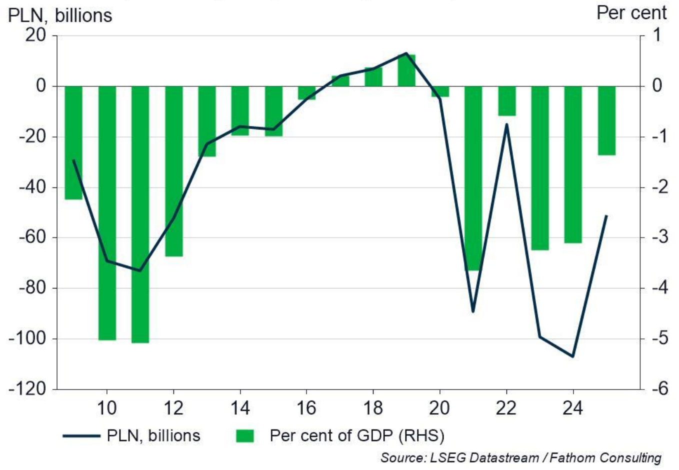
The NBP's decision to cut rates appears even less justified when we consider that the economy, although contracting now, is giving strong signs of a turnaround. Industrial production has managed to return to positive territory after seven months of decline, while the services sector is also recovering — retail sales are gaining momentum and real wages are growing strongly, paving the way for an improvement in household disposable income and therefore in private consumption down the line. Despite the current weakness of economic activity, the labour market has remained quite resilient, with the unemployment rate currently standing at historic lows of 5%. This mainly reflects companies' hesitancy to lay people off given the scarcity of talent in some sectors, an occurrence commonly described as 'labour hoarding'. Perhaps not surprisingly, the NBP has recently downplayed these pro-inflationary developments, potentially setting the scene for a new policy mistake.

Poland retail sales and industrial production



Finally, the fiscal outlook also seems at variance with the NBP's latest projections of a sharp drop in inflation back to target. The primary government deficit, adjusted for the state of the business cycle, is expected to be 3.0% of potential GDP this year; and while it is projected to fall to 1.4% in 2024, according to OECD estimates, this is unlikely to be realised — at least, if the spending proposals tabled by the main political parties in campaigning for parliamentary elections on 15 October are put into practice. Further fiscal expansion is proposed by politicians across the political spectrum, including various social transfers such as increases in monthly child benefits, investment in public infrastructure and public-sector wage increases, as well as various forms of tax cuts.

Poland cyclically-adjusted primary balance



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The controversial monetary policy decisions taken by the NBP, particularly the most recent rate cuts just ahead of the upcoming elections, have put the independence of the central bank in the spotlight. The central bank president is a long-time associate of the head of Poland's ruling Law and Justice party, and the monetary policy council is deeply divided along party political lines, with numerous, heated allegations flying to and fro.

Such reports and allegations do not help to clear up the doubts about the independence of the NBP. Indeed, they tend to do further damage to the central bank's credibility at a time when such credibility is more important than ever, given the rise in global inflation and increasing economic uncertainty as the world moves away from the COVID-19 shock. An independent central bank is crucial for anchoring inflation expectations and for delivering lower and more stable inflation outcomes; the more a central bank's credibility comes into question, the more action it will need to take to achieve its inflation objective. All told, and despite the favorable short-term dynamics which should continue bringing down inflation, the improving macro outlook combined with dove-ish monetary policy and an expansionary fiscal policy stance provide the ideal breeding ground for a resurgence in inflationary pressures in Poland over the medium term.

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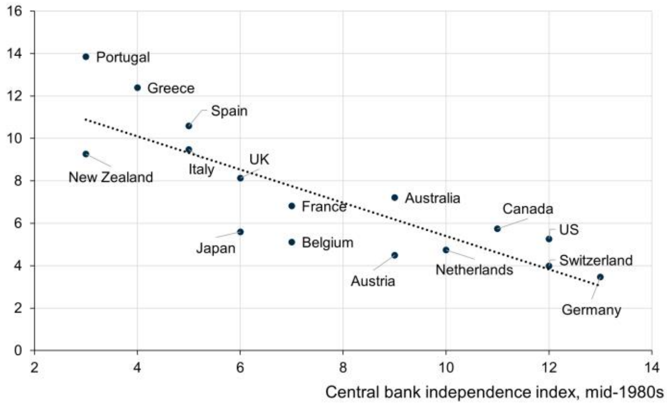
Average inflation rate, 1962-1990, per cent



Source: OECD / Grilli et al. / OWID / Fathom Consulting

Further reading

[Energy crisis fuels EU sovereign risks]

[EA inflation expectations on the rise]

[Global Outlook, Autumn 2023: fortunes diverging]

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