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Poland Macro View

Rate curve already prices in a very optimistic scenario

- The market is pricing in three interest rate cuts over the next 18 months and appears to be ignoring the relatively hawkish rhetoric of MPC members. The FRA curve also implies around a 70% probability of a cut as early as December 2012.
- We believe current growth and CPI prospects suggest the need for lower rates, possibly already this year. However, we doubt the Polish MPC will be ready to make such a move.
- In this note we take a look at the “reaction function” of the Polish MPC and try to assess the chances of substantial policy easing in the near term. Our survey shows that most MPC members appear highly backward looking, focusing either on deviations of current inflation from the target or on the level of real interest rates (deflated with current inflation).
- Given our macroeconomic scenario, we expect that inflation will fall towards the target and real rates will rise substantially in 4Q’12 and 1Q’13. This should make backward-looking policymakers more willing to consider rate cuts sometime in early 2013. However, given that the FRA curve has already priced in a scenario of relatively quick rate cuts we believe there is little room for additional downward surprise in short-term rates.

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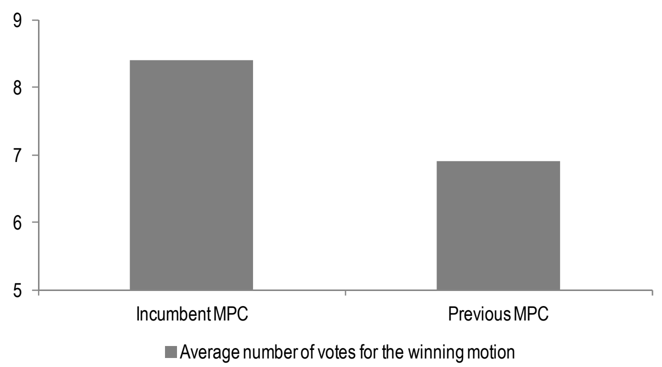
Little room for positive surprise from MPC

Only two months ago the Monetary Policy Council (MPC) in Poland raised policy rates by 25bps, thus being the only monetary authorities in the EU to tighten policy this year. Given that, at the beginning of the year, the market consensus (including us) was still expecting rate cuts the decision triggered some confusion among investors. It seems that in Poland – a country with relatively high economic growth, a stable financial system and improving fiscal outlook – monetary policy decisions are the primary source of surprises to market participants. Having said that, in this note we look at the way the MPC takes decisions and we try to assess future policy moves.

More homogenous, but less predictable voting

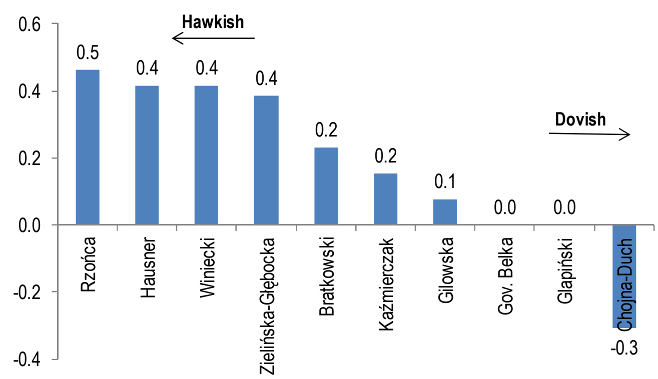
For investors closely watching actions of the Polish central bank one of the likely observations would be that the incumbent MPC has shown a remarkable preference for (close to) consensus decisions. Figure 1 shows, for example, that since January 2011, i.e. the beginning of the previous tightening cycle, decisions were on average taken with majority of 8.4 out of 10 votes, while the previous MPC had an average majority of 6.9 votes. Also the incumbent Council almost always votes on one motion per meeting, while the previous Council often voted on two or more interest rate motions. There are a few potential explanations for such behavior. Perhaps this time there are simply more “swing-voters” in the Council who tend to vote in a similar way. Or perhaps Governor Belka and some other Council members are keen to encourage more emphatic majority decisions to engender greater market confidence in its decisions. We lean towards the latter argument, especially as this explanation has also been highlighted by some Polish central bankers. Furthermore, it would seem to be consistent with somewhat surprising MPC decisions and comments by Governor Belka earlier this year[1].

Figure 1. Incumbent MPC tends to take decisions with relatively large majority



Note: Estimates based on last six quarters of MPC votes. In case of the previous MPC estimates were carried out on a sample of 6 quarters up to 2Q 2009. Source: Citi Research, estimates based on data from NBP Inflation Reports.

Figure 2. Traditional classification of Polish MPC members between hawks and doves doesn’t seem to make much sense anymore



Note: Higher values show that a respective MPC member voted on average in a more hawkish way than the consensus. Source: Citi Research, estimates based on data from NBP Inflation Reports

In our view, any hopes that decisions made by a strong majority could increase the central bank’s credibility are not justified, as this appears to be shaped by different factors. Moreover, we do not see anything detrimental in a situation where interest rate decisions are taken by a slim majority, even if a central bank governor remains

[1] For example on 27th March Governor Belka said in a Bloomberg interview that a mistake of being a little too slow with rate hikes is less severe than a mistake of going forward with rate hikes and then being forced to reverse them. However, a week later, after the MPC meeting, Governor Belka became much more hawkish without a noticeable reason and in early May he joined a majority voting for a rate hike. In our view, a possible explanation of such a change in views is that the governor did not want to be outvoted by “hawks”.

in the minority. On the contrary, a strategy chosen by coalition-seeking and dissent-avoiding policymakers could complicate communication with markets if it were to lead to delayed decisions, unconvincing communiqués or inconsistencies between comments of individual MPC members and their final votes. Furthermore, it could also mean that traditional ways of differentiating between MPC hawks and doves based on past voting records could be highly misleading as votes seem to be clustered around final outcomes, based on our findings.

Figure 2 shows a classification of MPC members based on whether a particular policymaker voted in a more hawkish or more dovish way than the consensus. For example, this would place Andrzej Kaźmierczak in a group of moderate members even though he proved to be one of most vocal hawks in recent months, voting for a hike as early as April. All in all, we think the apparent dissent-avoiding and consensus-seeking behavior of most MPC members explains why the Polish central bank's decisions have been more difficult to predict of late than in the past. That is because we think the timing of rate hike or cut decisions is now, to a relatively bigger extent, based on internal dynamics of discussions within the MPC and is less dependent on CPI and growth forecasts.

Watch out for real rates and current inflation

Since a simple distinction between hawks and doves does not work well, we believe the best way to predict future MPC decisions is by looking at key factors that particular policymakers focus on. Figure 3 does that by summarizing the key arguments mentioned by each MPC member, either during press interviews or meetings with investors and analysts. A few things are clear[2]:

First, there is a relatively big group of policymakers that tend to focus on the level of real interest rates and they believe the real rate should not fall below zero. These MPC members give different reasons to justify their view, including some controversial arguments that higher real rates would boost the deposit base and thus would allow faster lending growth. Whatever the exact reasons, this group of at least three MPC members seems unwilling to accept a drop in the real reference rate below 0% and this unwillingness is likely to be an important factor when decisions on rates are taken. In our view, this group includes A. Kaźmierczak, J. Hausner and J. Winiecki.

Second, there seems to be a group of three MPC members who like to emphasize that stubbornly high inflation, fluctuating above the central bank's target of 2.5%, calls for policy action (A. Glapiński, Z. Gilowska and A. Zielińska-Głębocka). Their focus on meeting the target is, however, based on past rather than future or predicted inflation performance.

Third, there is also a group within the MPC that seems more willing to accept temporarily higher inflation in order to avoid excessive economic slowdown. These members (Governor Belka, A. Bratkowski, E. Chojna-Duch) appear more forward looking and more concerned about consequences of excessive economic slowdown that could materialize should the euro zone recession deepen.

[2] The idea of grouping MPC members along these lines was suggested by Andrzej Raczko, member of NBP management board, who emphasized various factors affecting MPC decisions. However, the description of particular groups and in particular the decision who belongs to what group comes from us.

Finally, one member, A. Rzońca, seems to be driven by somewhat different factors than other policymakers. Indeed, his previous comments suggest he pays some attention to the level of the natural interest rate (in his view at 4.75-5.50%). He also believes the central bank should respond to unfavorable external shocks contributing to higher inflation but should not cut rates in response to favorable shocks (as the latter is unlikely to lead to “negative second round effects”).

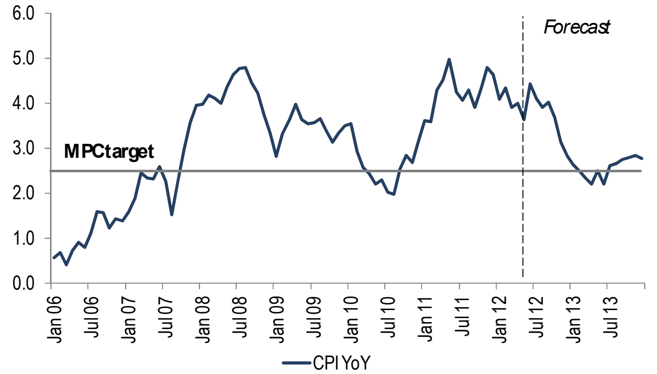
Figure 3. What do MPC members look at?

MPC member	Support for a rate hike?		What arguments do they focus on?
	Apr-12	May-12	
A. Kaźmierczak	Y	Y	Focused on the level of real rates; real rates should be positive to boost growth in bank deposits to ensure banks will have sufficient resources to fund lending growth even in case of deleveraging by foreign parent banks
J. Winiecki	N	Y	Wants to keep the real interest rate above 0%
J. Hausner	N	Y	Wants to keep positive real interest rates in order to make Polish companies to become "more efficient and to create structural competitiveness" (April 30, "*Rzeczpospolita*"); Mr. Hausner emphasizes also inflationary impact of the FX
A. Glapiński	Y	Y	Backward looking approach; he seems disturbed by the fact the CPI has remained above the target for extended period, concentrates on current CPI
Z. Gilowska	Y	Y	Focuses on keeping inflation close to the target and emphasizes low level of real rates (very little comments available)
A. Zielinska-Głębocka	N	Y	Emphasizes various factors but appears to focus on whether current CPI is above the target or not
M. Belka	N	Y	Forward looking approach, ready to accept temporarily higher inflation to avoid deeper slowdown, seeking consensus
A. Bratkowski	N	N	Forward looking approach, ready to accept temporarily higher inflation to avoid deeper slowdown
E. Chojna-Duch	N	N	Forward looking approach, ready to accept temporarily higher inflation to avoid deeper slowdown
A. Rzońca	N	Y	Believes the monetary policy response should be asymmetric – responding to unfavorable external shocks that contribute to higher CPI but not reacting to favorable shocks; Mr. Rzońca is also focused on keeping rates close to the natural rate (4.75%-5.50% in nominal terms)

Source: Reuters, Bloomberg, PAP, Citi Research

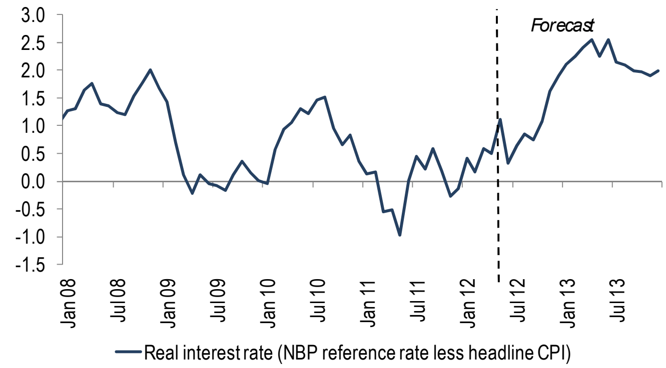
Although the above classification of MPC members is highly simplistic and doubtless overlooks many important factors affecting central bankers’ decisions, we believe it gives some indication regarding a likely direction of policy moves. As highlighted in Figure 3 at least six out of 10 MPC members are highly backward looking either because they focus on current inflation’s deviation from the target or because they try to keep real interest rate (again, deflated with current inflation) at a relatively high level. This simply means that as long as current inflation remains high, chances of interest rate cuts are low. We expect that in the coming months consumer price inflation will remain elevated but will return to the 2.5% target early next year (Figure 4). A similar inflation path was presented by NBP staff in their regular projection in early July. In our view, such a scenario would probably make at least three members soften their rhetoric by the end of 2012 or in early 2013. The fall of CPI would also imply a substantial rise in real rates by 1-2% points (Figure 5), opening doors for more dovish rhetoric from another three members.

Figure 4. After a temporary rise the inflation is likely to fall substantially in 4Q 2012 and in 2013 …



Source: Polish Central Statistical Office, Citi Research

Figure 5. … and this means that if MPC keeps nominal rates on hold this will push real rates much higher over next 12 months



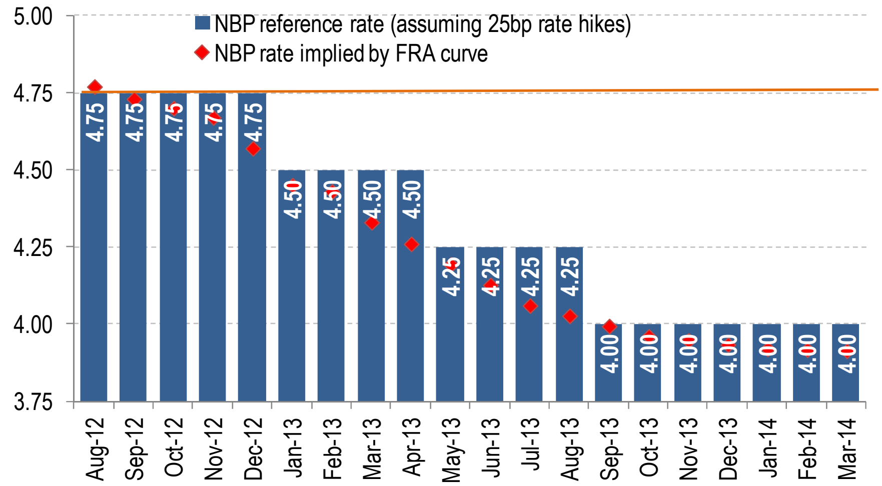
Source: NBP, Polish Central Statistical Office, Citi Research

Interest rate implications

So when could interest rates fall? We expect 50-75bps of rate cuts over the next 18 months with first reduction possible early next year. We believe economic growth prospects and the inflation outlook are already sufficient to justify cuts this year, but we doubt the Polish central bank would be willing to take such a step. Indeed, only two months ago the MPC voted 8-2 for a rate hike by 25bps and made every effort to convince the public the tightening move was justified and necessary. Taking into account recent MPC comments, and in particular the fact the MPC maintained an informal "tightening bias" at the July meeting, it may be very difficult for MPC members to seemingly change their views so quickly. All the more so, given the MPC tends to seek wider majority for its decisions and therefore any change in official stance could be gradual. In our view any incoming information about an economic slowdown or disinflation in Poland would first need to make the Council change the bias from "tightening" to "neutral" and only then the Council could move towards "easing". As the next policy meeting is scheduled for early September, this move towards "easing bias" would probably be slow and take several months. Having said that, in our base case scenario we expect the rate cycle to begin in early 2013 and we expect the base rate to fall towards 4.00-4.25% next year vs. 4.75% currently.

After the recent downward move last month the FRA curve is already pricing in three cuts starting from January 2013 (and with around 70% probability the first move would happen as soon as in December). This means the market is on the optimistic side of a range of possible rate cut scenarios. Having said this, we believe there is not much room for a positive surprise and we believe a further significant fall in the Polish swap curve in the near term is unlikely. Furthermore, given the prospect of some temporary inflation rebound during the summer months we see a risk of some upward move in the front end of the Polish curve.

Figure 6. FRA market is already expecting a lot of policy easing and in the short term room for further downward move is limited, in our view



Source: Reuters, Citi Research

Appendix A-1

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