

**National Bank of Poland**

**Monetary Policy Council**

**Monetary Policy Guidelines  
for the Year 2006**

**Warsaw, September 2005**

# 1. Strategy of direct inflation targeting

According to the Art. 277 para. 1 of the Constitution of the Republic of Poland “the National Bank of Poland shall be responsible for the value of Polish currency.” The Act on the National Bank of Poland of 29 August 1997 states in Art. 3 that “the basic objective of NBP activity shall be to maintain price stability, and it shall at the same time act in support of Government economic policies, insofar as this does not constrain pursuit of the basic objective of the NBP”.

Contemporary central banks understand price stability as an inflation low enough as not to exert negative influence on investment, saving and other important decisions taken by economic agents. Ensuring thus understood price stability is a fundamental way in which the central bank contributes, by means of its decisions, to high and sustainable economic growth. Central banks view price stability symmetrically, which means that they respond both to inflationary and deflationary threats.

The Monetary Policy Council (MPC) bases its monetary policy on the direct inflation targeting (DIT) strategy. International experience shows that this strategy is an effective method of ensuring price stability. Having brought down inflation to a low level, in 2004 the MPC adopted the permanent inflation target at 2.5% with a symmetrical tolerance range for deviations of +/- 1 percentage point. This arrangement may be in force until Poland joins the EMU II or the term of office of the present MPC expires. The MPC pursues the inflation target under a floating exchange rate regime which should be maintained until Poland's accession to the EMU II. Floating exchange rate regime does not rule out foreign exchange interventions, should it turn out necessary for the inflation target implementation.

The Council maintains the understanding of the inflation target and its implementation as set forth in the *Monetary Policy Guidelines for the year 2005*:

- First, the notion of *permanent* inflation target means that it refers to inflation measured as a year-on-year change in prices of consumer goods and services in each month compared to the corresponding period of the preceding year. For a better understanding of inflation processes it is also justified to use annual and quarterly inflation indices such as those used in the NBP's inflation projection and the central budget. Core inflation indices also play an important role in the assessment of inflationary pressure.

- Second, the adopted solution means that monetary policy is explicitly focused on keeping inflation as close to the 2.5% target as possible rather than only containing it within a deviation band without specifying its centre. The adopted solution provides anchoring for inflation expectations, thus facilitating the pursuit of monetary policy, which in case of shocks requires smaller and less frequent exchange rate changes.
- Third, shocks are inevitable in the economy. Depending on the strength of a shock and the degree of inertia of inflation expectations, the scale and the duration of inflation deviation from the adopted target may differ. The central bank usually does not respond to deviations from the inflation target which it deems temporary and which lie within the tolerance range around the target. In countries with a permanently low inflation, the central bank does not have to respond even when inflation leaves the tolerance band temporarily. In the case of shocks viewed as leading to permanent deviation from the inflation target, the central bank adjusts its monetary policy accordingly.
- Fourth, monetary policy reaction to shocks will also depend on their causes and nature. The reaction to demand shocks is a relatively minor issue, since in this case inflation and output move in the same direction. Under inertial inflation expectations, an increase in interest rates weakens the economic activity and, in a longer perspective, inflationary pressure.

Supply shocks are a much more difficult problem from the point of view of monetary policy, as in that case output and inflation move in opposite directions. Inappropriate monetary policy reaction may have far-reaching negative consequences for the economy. An attempt to fully neutralise the impact of a supply shock on inflation through monetary policy may lead to an unnecessary plunge in output, as the supply shock itself already has a negative effect on demand and investment. On the other hand, an attempt to fully accommodate a supply shock resulting in price increase and output decrease – by pursuing an overly loose monetary policy – usually leads to permanently higher inflation, which, in turn, requires a far more restrictive monetary policy in subsequent periods, bringing about a relatively strong deceleration in economic growth. Reaction of the central bank should depend on the assessment of the shock's durability.

- Fifth, most of supply shocks are transitory and limited in scale. Thus, they do not require an immediate reaction. However, in the case of strong shocks even temporary acceleration in price growth may bring about a relatively permanent rise in inflation expectations and, in turn, an increase in inflation due to wage pressure. In such a situation, the task of monetary policy is to prevent secondary effects of the supply shock (the so-called second round effects). The risk of such effects is substantial in countries with a short history of low inflation. Very useful in analysing supply shocks are core inflation indices, which help, at least roughly, to distinguish temporary effects from permanent changes in inflationary pressure.
- Sixth, because of delayed reaction of output and inflation to the monetary policy pursued, its influence on current inflation is limited. Current decisions of the monetary authorities affect price developments in the future just as current inflation is influenced by interest rate changes made several quarters ago. Unfortunately, these lags are not constant and depend, to a large extent, on structural and institutional changes in the economy. Changes in the transmission mechanism result in a situation in which central banks can only approximately assess the time lag between a change in interest rate and its strongest observed impact on the real variables (output, employment), and then on inflation.
- Seventh, monetary policy affects the economy not only through changing the interest rates but also through keeping them unchanged for a period of time. The decision to keep interest rates unchanged for several periods (months or quarters) has substantial consequences for the economy because it leads to a gradual widening or narrowing of the output gap.
- Eighth, monetary policy is pursued under uncertainty. Large uncertainty is due,, among others, to the fact that inflation projection models utilised by the central bank may start to less adequately describe the economic processes owing to the ongoing structural changes in the economy. This means that (a) while making decisions it is necessary to take into account all available data, and not only the inflation projection; (b) it is not possible to adopt a simple policy rule which could be known *ex ante* to market participants; and (c) forward-looking monetary policy has to be presented to the public as an attempt to achieve the inflation target under large uncertainty, rather than an exercise of strict control over economic processes.

- Ninth, in assessing monetary conditions, not only the level of real interest rates should be considered but also the level of the real exchange rate.
- Tenth, an important input into monetary policy decision-process is the balance of risks affecting the probabilities of future inflation running above or below target. This balance is based on the inflation projection, the assessment of the actual economic developments which may deviate from the scenario presented in the projection as well as the course of variables and information not accounted for directly in the projection. While assessing the factors influencing future inflation, the Monetary Policy Council will also take into account the duration of the period of low inflation.

The Council maintains its belief that the most favourable for Poland would be to adopt an economic strategy focused on creating conditions that would guarantee the introduction of the euro at the earliest possible date.

## **2. Conditions for monetary policy implementation**

In the period from June 2004 to February 2005, inflation in Poland was running above the upper limit of the tolerance range for deviations from the target. Increased inflation was mainly the result of the price increase connected with Poland's accession to the European Union (an increase in food prices and a higher direct tax rate) and also a surge in crude oil and other commodity prices in the world markets. The impact of those factors on the inflation is confirmed by the fact that starting from April 2004 the net inflation, which excludes food, non-alcoholic beverages and fuel prices, has been considerably lower than headline CPI inflation.

The months preceding Poland's accession to the European Union were marked by a growth in domestic demand. Output and sales reported a rapid growth, which was reflected in a 7% growth of GDP recorded in 2004 Q1.

Faced with strong price shocks and domestic demand growth, whose sustainability was rather difficult to assess at first, the MPC judged that despite persistently high unemployment there appeared a risk of second round effects, i.e. wage growth triggered by increased inflation expectations. Such risk is higher in countries with a short history of low inflation. In an attempt to prevent this threat, the central bank tightened its monetary policy increasing

interest rates by the total of 125 basis points. Interest rate increases occurred gradually, in three consecutive months (June-August 2004).

Since the second half of 2004, the price effects of the accession shock have been fading out rapidly, which was evidenced, among others, by a drop in current inflation and a shrinking gap between headline CPI and “net” inflation. Economic growth was decreasing faster than accounted for in the inflation projections prepared in 2004. The drop in inflation was also driven by the absence of second round effects, higher-than-expected appreciation of the exchange rate and exceptionally high cereal crops in 2004. In turn, inflation was driven upwards by rapidly growing oil prices. As a result of a one-off price increase connected with Poland’s entry to the European Union, the annual inflation rate stayed at a higher level until 2005 Q1 and dropped significantly only in 2005 Q2.

Lower current and forecast inflation persuaded the MPC to ease monetary policy in the first half of 2005. In March and April 2005, the MPC cut the interest rates by the total of 100 basis points and those cuts had been preceded by a change in the monetary policy bias. Macroeconomic data for 2005 Q1 pointing to decreased inflationary pressure in the economy compelled the MPC to further cut interest rates in the summer months of 2005 by the total of 100 basis points.

Currently, Polish economy has entered the stage of gradual recovery, but its scale and sustainability remain uncertain. According to the latest forecasts, GDP growth in 2006 will accelerate to 4-5% and will not be accompanied by significant increase in inflationary pressure. The results of NBP inflation projection published in August 2005 and prepared under the assumption of constant NBP interest rates over the projection horizon at the level of 4.75% indicate that inflation should be brought back close to the target in the middle of 2007.

Factors that may be responsible for future inflation deviating from the inflation projection include changes in crude oil prices, exchange rate and food prices. Oil prices, exchange rate and food prices are variables whose forecasts are always highly uncertain. Additionally, in the case of oil prices there is an uncertainty on the degree to which their increase will contribute to the dampening of economic growth. It should be noted that according to the current forecasts oil prices may, in the medium term, grow or stay at a higher level. The economy would also be negatively affected by a strong zloty appreciation if the appreciation was larger than the labour productivity growth. At the same time, structural changes taking place in Polish economy raise uncertainty on the degree of adequacy of econometric models to the actual state of the economy. In particular, factors such as the increased flexibility of the labour

market, restructuring of enterprises and international competition may all be reducing inflationary pressure.

The conditions of monetary policy implementation are also influenced by fiscal policy, which affects the level of prices through changes in direct taxes. The persistence of this effect on inflation is conditional, among others, on the degree of inertia of inflationary expectations. The stance of fiscal policy (in particular, the size of the general government deficit) also affects aggregate demand. Besides, the situation of public finance may also affect the volatility of financial asset prices, including the exchange rate.

Over the past few years, the general government deficit have stayed at a high level, which, combined with the fact that proceeds from privatisation were lower than in the previous years, was conducive to rapid public debt accretion. Having surpassed the 50% level in 2003, the growing public debt to GDP ratio was halted in 2004. In 2005, the Polish Parliament passed only some of the bills proposed under the *Public Expenditure Reform and Reduction Programme*. In contrast, the bills increasing public expenditure were passed, which undermined the outlook for public finance consolidation. In order to minimise the risk of exceeding statutory thresholds to public debt to GDP ratio it is required to reduce the budget spending. The consolidation of public finances is also necessary for the reduction of the fiscal burdens on domestic enterprises, which would help improve their competitiveness in the international market.

Institutional conditions of the economy are another key factor affecting the way monetary policy is pursued. Despite the reforms implemented over the past 15 years, Polish economy still faces institutional weaknesses which limit the level of employment and reduce the effectiveness of the utilisation of production factors. Thus, the reforms limiting the institutional weaknesses would allow the economy to increase its potential and follow a higher, non-inflationary path of growth. Besides, by increasing market flexibility, such reforms would be conducive to limiting real GDP fluctuations around potential output.

### **3. Monetary policy objectives in 2006**

In line with the strategy of direct inflation targeting pursued by the National Bank of Poland, the main objective of the MPC's monetary policy is to stabilise inflation at the level of 2.5% in the medium term. The Council will strive to contain inflation expectations at a low level.

From this point of view, the year 2006 will be of great importance. Stronger anchoring of the inflation expectations would facilitate the pursuit of the inflation target in the future with lower interest rate volatility and output fluctuations. However, it may prove difficult to sustain low inflation expectations in the months to come and in the next year. The main factor hindering the process of stabilizing inflation around the target may be further considerable oil price increases. It is very difficult to assess the impact of potential oil price increases on the next year's inflation mainly due to uncertainty as to their scale and persistence. The impact may involve both first and second-round effects. First-round effects include both direct impact of oil price increases on consumer goods prices and also indirect impact exerted through cost increases and producer price increases in subsequent stages of production. The strength of indirect effects depends on enterprises' possibility to pass higher costs to customers which, in turn, is largely determined by their competitive position and the stage of the business cycle. Permanent oil price increases raise permanently consumer price level, but their impact on inflation may be only temporary. However, the situation may be more complicated if the risk of second-round effects arises, with wage negotiations taking into account compensations for unfavourable impact of oil prices on real income. Wage increases may boost inflation expectations, which in turn may persuade enterprises to increase prices. In such situation, the oil shock not only results in a permanent increase in price level but also brings about more lasting inflationary effects.

As it was the case during the EU-accession shock in 2004, also in 2006 the Council will thoroughly analyse the situation from the point of view of second-round effects' risk from the recent and potential further oil price hikes. Should the likelihood of such effects be high, the Council will undertake the necessary actions aimed at counteracting the increase in inflation expectations. It should be noted that the risk of second-round effects may be contained through a persistently high level of unemployment and a slow pace of its reduction.

The probability of inflation running at the target level as a result of the pursued monetary policy is determined by lags in the transmission mechanisms of monetary impulses. It is currently estimated that in Poland monetary policy instruments of the central bank exert the strongest impact on inflation in the horizon of 5-7 quarters. Monetary policy will be conducted in such a manner as to achieve the target in this time horizon. This period may be longer or shorter depending on the type and strength of shocks affecting Polish economy.

The lags between the change in interest rates by the central bank and its impact on the economy and inflation make inflation projection an important input to monetary policy of

central banks. Therefore, in pursuing its monetary policy, the MPC will continue to take account of the results of subsequent inflation projections prepared by the NBP's economists and also the results of inflation projections prepared by other research institutions. Since econometric models are a simplified description of the economy, the MPC will also take into account the balance of risks affecting the probability of future inflation running above or below target. The Council will also take into consideration the deviations of the actual inflation path from the projected one as such deviations may point to a change in future economic developments as compared with the previously projected.

Communication with the general public is an important element of inflation targeting. The Council presents its assessments of the current economic situation and future economic developments. The major communications instruments include *Inflation Reports*, MPC press releases and press conferences following the MPC meetings. The Council will use its best efforts to ensure transparency and unambiguity of these instruments.

The stabilisation of inflation at the target also favours the fulfilment of the Maastricht criteria, which would allow Poland to take full advantage of opportunities offered by membership in the euro area. The National Bank of Poland will continue to act towards the implementation of the scenario of Poland's accession to the euro area at the earliest possible date, and will be cooperating with the Government to this end. Adoption of the common currency must be preceded with a compulsory two-year membership in the ERM II. While being a member of this system, Poland will have to stabilize the exchange rate. The exchange rate stabilisation will be the easier, the better is the situation of the public finance. The Monetary Policy Council maintains its view that Poland's membership in the ERM II mechanism should be as short as possible. Thus, Poland should join this exchange rate mechanism when it will be able to meet the remaining convergence criteria in its second year of membership. Moreover, the decision to join the ERM II should take account of the necessity and possibility of introducing amendments to the Constitution of the Republic of Poland and other legislative changes that would enable the Polish zloty to be replaced by the euro. The position taken in this regard by the government coalition which will be formed after the Parliamentary election will be of crucial importance here.

The MPC believes that a sustainable consolidation of public finance is important not only as the necessary condition for Poland to take full advantage of the opportunities provided by its membership in the euro area. Such consolidation would also result in a permanent improvement of Poland's competitive position. A country that can prove its capacity to

manage its public finance effectively and can permanently contain inflation at the target level has the chance to increase investment in the economy and thus accelerate the real convergence process.

## 4. Monetary policy instruments

The year 2005 saw increased liquidity surplus in the banking sector. This resulted mainly from the NBP's purchase of foreign currencies and lower level of term deposits placed in the central bank by the Ministry of Finance.

In 2006, liquidity surplus of the banking sector should remain at the level comparable to that recorded in 2005. The main factors affecting the liquidity level will include foreign exchange transactions of the central bank, the volume and changing level of funds deposited by the Ministry of Finance at the NBP and also changes in the volume of currency in circulation.

In 2006, the level of fixed-term deposits of the Ministry of Finance at the NBP, agreed with the Ministry of Finance, will amount to an annual average of PLN 5.6 billion.

### Interest rates

Short-term interest rates are the principal instrument of monetary policy. Changes in the NBP's reference rate define the direction of the pursued monetary policy. The NBP's deposit and lombard rates set the fluctuation band for overnight interest rates in the interbank market.

**The NBP's reference rate** determines the minimum yield obtainable on main open market operations, influencing, at the same time, the level of interbank deposit rates for comparable maturities.

**The NBP's lombard rate** determines the maximum cost of securing funds from the NBP. Thus, it determines the ceiling on fluctuations in overnight market rates.

**The NBP's deposit rate** determines the lower limit on movements in overnight market rates.

### Open market operations

Open market operations are the principal instrument for maintaining short-term interest rates at a level consistent with the pursuit of the MPC established inflation target. The NBP may use the following set of instruments in open market operations:

1. **Main operations** in the form of issues of 7-day NBP money bills. Tenders for the bills will be conducted on a regular weekly basis, with their minimum yields set according to the reference rate. The central bank will execute main operations on a scale allowing it to achieve liquidity balance on the market, and thus to establish 1-week WIBOR rate close to the NBP's reference rate.
2. **Fine-tuning operations** may be applicable in the event of unexpected short-term movements in the liquidity of the banking sector which may lead to undesirable, from the point of view of monetary policy, fluctuations in short-term interest rates. These operations would be both liquidity-absorbing and liquidity-providing (issuing NBP money bills, repo and reverse repo transactions and buying out NBP money bills before maturity).
3. **Structural operations** are aimed to alter the level of banking sector liquidity in the long term. Should the need arise, the central bank may execute the structural operations by issuing bonds, buying back its own bonds before maturity, purchasing and selling securities on the secondary market.

### **Reserve requirement**

The basic function of mandatory reserve is to limit volatility of interest rates by cushioning the impact of movements in the banking sector. Reductions of the reserve requirement and introduction of further changes in the mandatory reserve system will be conditional on the liquidity level in the interbank sector. Possible changes in the mandatory reserve system will be aimed at a gradual convergence of this instrument to the Eurosystem requirements.

### **Standing facilities**

These facilities serve to stabilise the liquidity level in the interbank market as well as to limit the fluctuations of overnight interest rates. Standing facilities are used at the initiative of commercial banks.

**Deposit facility** enables commercial banks to place their liquidity surplus on a deposit account at the central bank.

**Lombard facility** enables banks to take credit on an overnight basis. It is collateralised by securities and the interest rate payable on it defines the marginal cost of securing funds from the central bank.

**Intraday credit facility** will remain an important element of the clearing system. It is a form of loan from the central bank repayable on the same working day and it is collateralised with treasury securities.

### **Foreign exchange interventions**

Foreign exchange interventions are another monetary policy instrument which may be used by the NBP. In the Polish economy, exchange rate fluctuations exert a considerable impact on inflation. Therefore, strong exchange rate fluctuations may hinder stabilisation of inflation. Thus, there may be circumstances under which the NBP will decide whether it is necessary to intervene in the currency market in order to stabilise inflation.

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The National Bank of Poland will continue its efforts aimed at preparing the national operating system of the monetary policy for the membership of the Eurosystem. The year 2006 will see extended access to basic open market operations and widened scope of data published on liquidity conditions in the banking sector.