MONETARY POLICY GUIDELINES FOR YEAR 2000

According to the *Medium-Term Monetary Policy Strategy for Years 1999-2003* adopted by the Monetary Policy Council, the most important goal of the central bank monetary policy is to reduce the inflation rate, and, in the longer perspective, to attain price stability. This is required to provide strong foundations for long term economic growth. The principal rule of monetary policy is to use direct methods of achieving the inflationary target. The medium term inflationary target is to lower the inflation rate to a level below 4% by the year 2003.

1. Goals

The principal goal of year 2000 monetary policy, which constitutes the succeeding stage in the accomplishment of a medium-term target, is to reduce the price growth of consumer goods and services. The growth should be contained below the level of **5.4% - 6.8%** by the end of year 2000 compared with the end of 1999.

The analysis of conditions, which may influence the achievement of inflationary target and which remain outside of monetary policy control, indicates a significant increase of uncertainty regarding these conditions in year 2000. This has persuaded the National Bank of Poland to widen the band of inflation, which was set as the short-term monetary policy target.

Pursuit of the inflation target in year 2000 will take place in difficult macroeconomic conditions. The inconsistent and insufficiently disciplined implementation of public finance policy in 1999 prevented the reduction of monetary policy restrictiveness. The actual level of fiscal policy restrictiveness will also determine the monetary policy and the eventual level of inflation rate for the year 2000.

Considering the forecasted external conditions (the increase in external demand resulting in the increase of Polish exports) and the forecasts of processes in the real economy, the National Bank of Poland estimates that the pursuit of the year 2000 inflationary target will take place in an environment of approximately 5% GDP growth rate and the current account deficit of approximately 7% of the GDP.

Under these guidelines, the estimated increase in money supply, which is consistent with the assumed inflationary target for year 2000 will amount to Zloty 38.8 – 47.9 billion. The inflationary target, according to the guidelines of the *Strategy*, will be achieved using direct methods; therefore the above mentioned money supply growth rate is a forecast and does not constitute an intermediate monetary policy target.

2. Instruments

To attain the year 2000 inflationary target and consistent with the direct inflationary target strategy, the National Bank of Poland shall use, as required, the entire spectrum of monetary policy instruments at its disposal. Interest rate shall remain the main instrument of monetary policy. The mechanisms of utilizing the instrument will depend, to a large degree, on the commercial banks' sector liquidity level.

Structural liquidity excess is defined as a situation, in which the central bank is a permanent net borrower from commercial banks as a result of both short- and long-term operations. This phenomenon has been present in the Polish banking system since 1995. Its fundamental reason is the growth of central bank's gross official reserves. The scale of the growth was so significant, that the structural liquidity excess was accompanied by **operational liquidity excess**. The latter term is defined as a situation of structural liquidity excess, in which the central bank is a net borrower from commercial banks as a result of short-term. Among others, it has been reflected on the liability side of the central bank balance sheet in the position of "securities issued by the central bank" (NBP money market bills).

In 1999, the National Bank of Poland has undertaken actions to curb the main source of liquidity creation, the growth of gross official reserves. The NBP attained the target by widening the band of permissible fluctuations of Zloty exchange rates, liquidation of the existing *fixing* mechanism and refraining from direct interventions on the foreign exchange market. As a result of these measures, the NBP has attained significant changes in its balance sheet structure and lowered the levels of banks' structural and operational liquidity excess. The conversion of the non-marketable state treasury liabilities toward the NBP to marketable securities will additionally reduce liquidity. Such securities will be sold to the banking sector within the open market operations.

In year 2000, the NBP will continue its actions to further reduce excessive liquidity. This, in an environment of structural liquidity excess, may lead to a transition from operational liquidity excess to **operational liquidity deficit**, which is a situation where the NBP will assume the role of a net lender to the banking sector as a result of short term operations. This situation would be reflected in the NBP balance sheet by the presence of open market operations in the short-term assets and by the presence of funds on bank accounts and long term NBP securities on the liability side. In a longer term, the NBP will strive to establish a situation of **structural liquidity deficit**, that is a situation, where the central bank is a net lender to the commercial banks.

A transition to operational liquidity deficit would mark a qualitative change in the conditions of conducting monetary policy, even before the state of structural liquidity deficit is attained. The central bank shall continue to be a net borrower from the commercial banks as a result of a sizeable portfolio of long-term NBP bonds remaining in the commercial banks' portfolios. Such change would require a modification of particular monetary policy instruments, their inter-relations, and the methods in which they are used.

The process of attaining operational liquidity deficit may require that the NBP use at the same time the operations to provide liquidity and to absorb it. To avoid a reduction in the transparency of monetary policy, the NBP will perform an appropriate adjustment of the open market operations instruments and scope. This would enable the NBP to limit the period to a minimum, while maintaining the stability of fundamental market parameters.

2.1. Interest rates

In the situation of continued excess liquidity in the banks, the NBP will preserve the current interest rates system. The lombard rate will continue to serve as a ceiling defining the marginal cost of money on the inter-bank market and also as an indicator of the general direction of monetary policy changes. The interest rate on liquidity-absorbing short-term open market operations will continue to serve as a reference rate, providing information on the current direction of monetary policy. It will provide the floor for the rates on inter-bank deposits with maturities comparable to those of the NBP operations. The discount credit rate will be closely related to the lombard credit rate.

When the operational liquidity deficit in the banking system is attained, the interest rate system will be subject to certain changes. The reference rate will no longer serve as the floor for deposit market rates, but it will continue to provide information on the direction of current NBP policy. The rate will set the interest rate level for the open market operations, which will be used to provide banks with liquidity. To set the floor for inter-bank market interest rate fluctuations, which are characteristic for the shortest maturity deposits, the NBP may introduce a central bank deposit rate. The role of the lombard rate will not change.

2.2. Open market operations

Open market operations are the primary instrument providing the central bank with flexibility in reaction to changes in the banking system liquidity and market fluctuations of interest rates. They provide flexibility both in terms of the size of the reaction, the selection of the appropriate time to use the instrument and the duration of its use. Maintaining the desirable level of inter-bank market interest rates shall require an appropriate level of liquidity in the banking system. If the situation of liquidity excess persists in the year 2000, the NBP will conduct solely the liquidity absorbing operations, issuing for this purpose 28-day money market bills and directly influencing one-month inter-bank market interest rates. To attain operational liquidity deficit, the NBP will conduct the operation of unconditional sale of treasury bonds obtained in 1999 in connection with the conversion of the State Treasury liabilities towards the NBP. The NBP does not exclude a possibility of issuing bonds.

In case of operational liquidity deficit, the NBP will use the operation of conditional purchase of treasury bills as the active instrument of provision of liquidity to the commercial banking sector, which would stabilize the demand for reserve money.

2.3. Required reserves

A gradual reduction of liquidity excess in the banking system and the conversion of the non-marketable liabilities of the State Treasury into the marketable securities have enabled the NBP to lower the 1999 required reserve rate. The rate was lowered to the level of 5% for all types of liabilities, for which it is made. To prevent an undesirable liquidity growth in the commercial banking sector, the NBP has issued long term bonds, which were subsequently purchased by the banks with the funds released as a result of lowering the reserve requirement.

Further changes of required reserve rates depend on the conditions of monetary policy implementation and the competitiveness of the Polish banking system. Under favorable conditions the NBP may undertake subsequent measures. However, as a first step, it may pre-pay its bonds instead of lowering required reserve rates. A possible decision on these issues may be accompanied by the abolishment of the possibility to maintain part of the required reserve as cash in the banks' vaults.

2.4. Refinancing commercial banks

A possible change of the liquidity situation in the banking sector may require significant modifications of the system of refinancing commercial banks by the NBP.

Maintaining the current system in a situation of liquidity equilibrium or liquidity deficit may limit the effectiveness of monetary policy. To control the levels of lombard credit utilization according to the needs of the current monetary policy, the NBP may consider changing the procedures of extending, using and repayment of such credit.

2.5. Exchange rate

Implementing the guidelines of the *Medium-term monetary policy strategy*, the NBP will work to implement free floating exchange rate system, according to the proposal presented to the Council of Ministers.

Maintaining and strengthening the current role of the foreign exchange market in setting the level of exchange rates and the formal introduction of free floating exchange rate, will help to improve the effectiveness of the monetary policy in terms of influencing the interest rates and aggregate money. Thus it will aid the pursuit of the direct inflationary target.

Flexible exchange rate will help eliminate pressures in the current account and to promote adequate evaluations of foreign exchange risk among the market participants.

Due to the low level of the foreign exchange market development, the central bank does not exclude the possibility of intervention on the market.

2.6. Other actions

In the situation of operational deficit of liquidity, the band of short-term interest rates fluctuations may widen. The main reason of the widening will be the fluctuations in the NBP account balances of the public sector (accounts of the government agencies and the government targeted funds). The lombard rate will continue to act as the ceiling for the fluctuations. Since the process of issuing money market bills will not be continued, there will be a need to introduce a new instrument to set the floor for interest rates fluctuations. Therefore the NBP will consider the possibility of accepting commercial bank short-term deposits on terms specified by the central bank. The interest on this instrument will remain below the NBP reference rate.

3. Conditions

The following are the most important conditions of implementing the monetary policy for year 2000: the size of the current account deficit and the public sector budget deficit. The level of uncertainty in the pursuit of the inflationary target may also be increased by the increase of raw materials and food prices on the world and domestic markets. The level of increases in indirect tax rates, which was unknown at the time of development of the *Guidelines,* may also increase the uncertainty.

The current account deficit will depend to a large degree on external demand factors. The growth of the markets, which are most important to Polish exports, will exert a decisive influence on the ability to maintain the current account deficit on a safe level, which would not pose a threat to the stability of the Polish financial markets.

A substantial growth of Polish exports, possible in the conditions of projected improvement in the economic situations in the foreign markets is feasible most of all if there is an improvement of competitiveness of Polish products. Given the uncertainty of the growth of exports, the control of the internal demand growth becomes the first priority. Since the growth of consumer and investment demand is still relatively high, the increase of restrictiveness of fiscal policy should become the main factor in limiting the growth of internal demand. Attempts to limit internal demand growth by further increasing the restrictiveness of monetary policy would be less effective, and would further aggravate the unfavorable combination of fiscal and monetary policy.

Based on the information regarding the processes in the public finance sector available on the day of adoption of the *Guidelines*, the NBP notices a threat of relaxation of fiscal policy in the year 2000. The high level of central government deficit, increased imbalance of the budgets of municipalities and target funds, especially the Social Insurance Fund, are the indications of such a possibility. Moreover the growth of liabilities of public sector entities, and the obligations already assumed by the state for the nearest years (among others full implementation of pension reform, payment of compensation to the employees of the public sector and retirees and restructuring expenditures) are additional testimony to the threat. Fiscal policy, which makes no progress in reducing the public sector deficit and at the same time increases the level of indirect taxes, would not be consistent with the implemented monetary policy. Funding the state budget deficit from foreign sources would pose an additional threat. Such methods of funding state budget deficit would cause the increase of external imbalance not only by increasing the internal demand but also by appreciation of the zloty exchange rates.

The National Bank of Poland expresses its conviction, that the final drafts of the budgetary law and the budget plans of public sector entities adopted for the year 2000 and their subsequent implementation would lead to an increase rather than the decrease of the fiscal policy restrictiveness. A significant improvement in the transparency of the fiscal policy would also aid its credibility.

The NBP forecasts that the favorable funding structure of the current account deficit with dominant share of direct investments will be maintained in year 2000. The inflow of direct investments will be a result of the implementation of the privatization processes in the economy, the position of Poland among the so called emerging economies, and the approach of the moment of the Polish economy integration with the European Union structures. The planned free floating of the zloty exchange rate should also aid stability of the Polish financial market. The system of free floating exchange rate introduces a self-regulation mechanism into the economy, which significantly reduces the probability of amassing pressures resulting from the growth of current account deficit. Free floating the exchange rate and further reduction of foreign exchange limitations may, however, may increase the fluctuations of the zloty exchange rate, and thus render the achievement of the short-term inflationary target more difficult.

The achievement of the inflationary target in year 2000 will depend on further developments on the world raw materials markets. The projected improvement in the global economy may result in growth of prices of food and raw materials. Also the domestic market may witness price growth stronger than hitherto, additionally accelerated by growing pressure of the producers to use solutions, which would improve the profitability of agricultural production. Considering that the direct target of the monetary policy was set as a growth rate of consumer goods and services prices, the level of changes in indirect taxes will be an important element of uncertainty in the accomplishment of the short-term inflationary target.

The analysis of conditions for the implementation of the year 2000 monetary policy points to a growth of uncertainty regarding their levels in the coming year. The growing external inequilibrium, growing public sector deficit and high level of uncertainty regarding other above-mentioned factors may render the attainment of the inflationary target more difficult than in 1999.