

National Bank of Poland  
Monetary Policy Council



MONETARY POLICY GUIDELINES  
FOR THE YEAR 2001

Warsaw, September 2000

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In line with the *Medium-Term Monetary Policy Strategy for the Years 1999-2003*, as approved by the Monetary Policy Council, the objective of the monetary policy conducted by the central bank is to lower inflation, with the subsequent perspective of stabilising prices, which is essential to lay lasting foundations for long-term economic growth. The basic principle of monetary policy is the pursuit of a direct inflation target. The first years in which the National Bank of Poland (NBP) pursued a monetary policy derived from a strategy of direct inflation targetting have demonstrated that the problems encountered in achieving annual inflation targets were largely the result of the "supply shocks" which buffeted the Polish economy in recent years, and also increases in officially controlled prices. Despite the restrictive monetary stance adopted since autumn 1999 and the relatively favourable development recently of the long-term conditions impacting inflation (as regards monetary factors and domestic demand growth), the year 2000 has for the second time in succession brought a real danger of the annual inflation target being overshot.

The medium-term monetary policy target remains bringing down inflation to under 4% by the end of 2003.

## **1. TARGET**

The experience of recent years indicates that supply shocks, coupled with a Government response to them that has not always corresponded to the pursuit of monetary policy targets, constituted a major factor disrupting the process of disinflation. This contributed to inflation running higher in 2000 than had been projected by the Monetary Policy Council. There continues to be great uncertainty as to the situation in 2001 with respect to a series of factors that condition achievement of the inflation target, yet remain beyond the control of

monetary policy. The monetary policy target for the year 2001 should therefore be a credible one, while at the same time allowing performance of the medium-term monetary policy target. With these considerations in mind, the Monetary Policy Council has set an inflation target of 6%-8% year-on-year consumer price growth at year end 2001.

The inflation target for 2001 is higher than that adopted for the previous year, since the Council does not expect the supply factors which have been fuelling swifter inflation in Poland since mid-1999 to recede, particularly not in the first half of the year. The operation of these factors, which are independent of monetary policy, together with uncertainty concerning the scope and force of their impact on inflation, lie behind the setting of the inflation target within a broader bandwidth than previously. The target thus established does not contradict the medium-term monetary policy target, since it will be possible to accelerate the pace of disinflation once the influence of these supply shocks has waned. Should the impact of these supply factors in 2001 differ from that projected by the Monetary Policy Council, causing inflation to run below the lower boundary of the target range, the Council will adjust its monetary policy stance accordingly, with a view to performance of the medium-term target.

Achieving the inflation target for 2001, in the context of the medium-term policy target, may require a tightening of the monetary policy stance, particularly in the light of the fact that the *Draft Guidelines for the National Budget in 2001*, as published in July 2000, place the primary responsibility for lowering inflation on the shoulders of monetary policy.

In view of the projected external environment (with an increase in external demand, boosting Polish export growth), and also projections as to the development of the real economy, the National Bank of Poland believes that pursuit of the inflation target in 2001 will be undertaken in conditions where GDP growth comes to around 5% and the current account deficit amounts to some 7% of GDP. If the volatility of the demand for money remains at the level recently seen, then, given the inflation target established and the forecast growth in GDP, money supply growth in 2001 is projected to come to 40-46bn zloty.

## **2. INSTRUMENTS**

In 2001, monetary policy will be conducted in the framework of direct inflation targetting, with a floating exchange rate. The guiding principle of this strategy is to adjust interest rate policy to correspond to the projected level of inflation. This means that the central bank sets itself no target in terms of the exchange rate of the zloty against other currencies, nor does it make any formal commitment concerning intervention on the foreign exchange market. However, the NBP does reserve the right to undertake such intervention should it deem this essential for performance of the inflation target.

### **2.1. Interest rates**

The principal policy instrument employed by the National Bank of Poland are interest rates. The official rates of the central bank are the reference rate, the lombard rate and the rediscount rate.

The NBP will maintain interest rates at a level consistent with achievement of the inflation target adopted, acting to influence the level of nominal short-term money market rates. Money market rates impact lending and deposit rates at the commercial banks. In turn, commercial bank rates affect the savings, consumption and investment decisions taken by households and corporates.

In influencing short-term interest rates, the NBP utilises a variety of instruments, such as open market operations, reserve requirements, and lending and deposit taking.

### **2.2. Open market operations**

As a policy instrument, open market operations allow the central bank to maintain selected market interest rates at a level considered desirable in terms of the conduct of monetary policy. Open market operations permit a flexible response to movements in banking sector liquidity, adjusting the

balances held by banks on account at the central bank relative to demand in such a way as to attain the desired level of interest rates.

The types of open market operations conducted by the NBP will be determined by developments in the liquidity position of the banking system.

The impact of central bank interest rates will be reinforced in 2001 following the elimination of surplus operational liquidity within the banking sector. To this end, the NBP will continue its outright sales of Treasury bonds acquired from central government in 1999 under the conversion of government obligations to the central bank. Further, in seeking to move to a shortfall of operating liquidity within the banking sector, the Bank does not exclude the issue of its own securities.

The emergence of a shortfall of operating liquidity at the banks will necessitate modifications to the system of conducting open market operations. The reference rate, in determining the interest rate applicable to the primary category of short-term operations providing liquidity to the banking system, will retain its function as an instrument reflecting the current policy stance of the NBP. However, it will cease to determine the floor for interbank rates.

In carrying out operations to secure a shortfall of operating liquidity, the NBP will seek to attain this goal gradually. As a result, excess liquidity may still persist in 2001. In these circumstances, the central bank will conduct operations to siphon off liquidity, chiefly by utilising for this purpose issues of 28-day NBP money market bills and acting directly to influence one-month interbank rates. In this scenario, the Bank will also retain the present system of interest rates. The reference rate will continue to be the minimum rate for short-term open market operations absorbing liquidity. As in the year 2000, this rate will determine the floor for rates on interbank deposits with maturities comparable to those of NBP operations.

In the process of arriving at a shortfall of operating liquidity, the situation may arise where the NBP will be conducting both operations that supply liquidity

to the market and those that absorb it. The Bank will then adjust the instruments employed and scope of open market operations accordingly, to ensure that this situation lasts for the briefest period possible.

### **2.3. Reserve requirements**

The primary function of required reserves will continue to be to cushion the impact on interbank rates of ongoing movements in the liquidity of the banking system, thereby facilitating maintenance of the selected rate at the level desired by the Bank. However, following the lowering of reserve requirements in 1999, their role has diminished as an instrument for the lasting absorption of liquid funds from the banks. Further changes in reserve ratios will be contingent on developments conditioning the performance of monetary policy.

### **2.4. Lending and deposit taking**

The lombard rate will continue to serve as a maximum interest rate determining the marginal cost of funds on the interbank market, while at the same time indicative of the overall direction of adjustments to monetary policy. In order to facilitate liquidity management at the commercial banks and to stabilise the factors conditioning monetary policy, in 2001 the NBP will consider advancing loans for same-day repayment. These loans would be collateralised by Treasury securities.

A shortfall of operating liquidity may result in sharper fluctuations in short-term interest rates. The prime reason for this would be movements in public sector balances at the NBP (in the balances held by government institutions and central government special-purpose funds). To set a floor on interbank rate fluctuations for the shortest-dated deposits, the Bank would introduce a central bank deposit rate (the ceiling on such fluctuations would continue to be the lombard rate). The deposit rate would constitute the price at which the central bank would accept short-term deposits from the banks. The interest rate offered on these deposits would be below the NBP reference rate. The introduction of these instruments represents a further stage in



implementing the plan for adjusting the policy instruments applied by the NBP to correspond to those within the European System of Central Banks.

As in previous years, rediscount facilities will principally be utilised to provide seasonal refinance for purchases of agricultural produce and will not constitute a significant source of liquidity to the banking sector. The rediscount rate will be integrally linked to the level of the lombard rate.

### **3. CONDITIONING FACTORS**

The inflation target for 2001 will be pursued in an environment where economic growth will continue to pick up compared to 1999, while the current account deficit will continue to run high. The maintenance of a large current deficit heightens the risk of instability on the foreign exchange market, which could also jeopardise performance of the inflation target. The continuation of rapid domestic demand growth in the countries of the European Union can be expected to stimulate Polish export growth. At the same time, any expansion of domestic demand in Poland, particularly consumer demand, strongly accelerates import growth, as evidenced by the experience of recent years. Thus, a very important macroeconomic policy objective, as in the previous year, should be controlling the pace of domestic demand growth.

A significant factor determining the effectiveness of monetary policy in 2001 and in subsequent years will be the state of public sector finances. The maintenance of macroeconomic stability in Poland requires a radical reduction in the imbalance of government finances and the swiftest possible attainment of a surplus, while continuing the process of structural and institutional reform. However, this challenge poses numerous fiscal policy problems.

The *Draft Guidelines for the National Budget in 2001* (as published in July 2000) targets a decline in the public sector financial deficit, in economic terms, from the 2% of GDP forecast for 2000 to 1.6% of GDP in 2001. It is projected that this advance in tightening fiscal policy, burdened as it is by the growth of

"fixed expenditures" as a result of macroeconomic developments in 2000 taking a different course than forecast, is to be accomplished through sharp cuts in other areas of central government expenditure, including spending on development objectives. However, the scale of the decrease in the economic deficit thus to be achieved (0.4% of GDP) does not constitute a decisive step towards a major and lasting reduction in the current account deficit, nor towards supporting the process of disinflation. In addition, the pattern of financing for the public sector deficit, with a large contribution being made by foreign capital, unsettles the operation of the automatic mechanism for the gradual restoration of external equilibrium via exchange rate adjustments. Given the decline in privatisation receipts and greater weight of foreign debt service in the years to come, the reduction in the deficit that has been targetted does not ease the threat of macroeconomic destabilisation in the medium term. Moreover, the risk that fiscal policy implementation in 2001 and 2002 might prove less restrictive than declared could be exacerbated by any disparity in the assumed rates of economic growth in 2001 and inflation in 2000, which would impact the estimated levels of government receipts and expenditures.

Thus, the planned reduction of the economic deficit does not give grounds for relaxing monetary policy. The lack of a decisive tightening of fiscal policy in 2001, with an ensuing stabilisation of the current account deficit at a level similar to that recorded in 2000, does not eliminate the risk of periodic disruption on the foreign exchange market, with the consequences that this entails for inflation. The insufficient fiscal policy support to monetary policy will thereby sustain a relationship between these two policy areas that is far from optimal. Stepping up the restrictive nature of monetary policy as a substitute for tighter fiscal policy does not encourage a consolidation of Poland's economic stability, diminishes the effectiveness of anti-inflation measures and weakens economic growth.

In the year 2001, a major impact on price growth will continue to be exerted by non-monetary factors. The alterations to the system of indirect taxation planned for 2001, with an increase in VAT and excise duty to bring these into line with European Union requirements, could result in steeper consumer

price growth, although this will not reflect the ineffectiveness of monetary policy. Supply dislocations on the market for foodstuffs will continue to have an important influence on the level of consumer prices, with the extent of this influence dependent on official intervention on that market.

The maintenance of high oil and industrial commodity prices in 2001 due to the upturn in the world economy, allied with the projected low growth of prices for industrial goods and foodstuffs, could lead to a deterioration in Poland's terms of trade, thereby serving to aggravate external disequilibrium.

The Monetary Policy Council emphasises that the most effective manner of lowering the cost of disinflation is a marked acceleration of structural economic change. This should involve speeding up the process of privatisation, dismantling protectionist barriers, demonopolisation, and the development of competitive markets in such areas of the economy as agriculture, the production and distribution of liquid fuels, electricity and district heating, telecommunications and municipal services.

The year 2001 may bring the full deregulation of exchange controls, originally planned for 2000. However, the move to a fully floating exchange rate in April 2000 largely neutralises the potential adverse repercussions of this on monetary policy and any increased threat of disruption on the foreign exchange market.