Monetary Policy Guidelines

for the Year 2005

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1
Strategy of direct inflation targeting

According to the Art. 227 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 the 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 economic policies of the Government, insofar as this does not constrain pursuit of the basic objective of the NBP".

In practice this broadly defined basic objective of the activity of monetary authorities calls for specification. First, contemporary central banks understand price stability as an inflation rate low enough 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 to achieving a high and sustainable economic growth. Second, irrespective of qualitative determining of the main objective, it is becoming a common practice among central banks to assign it a specific numerical value. This is because in recent years more and more central banks have been pursuing their monetary policy within the framework of the direct inflation targeting (DIT) strategy.

The Monetary Policy Council (MPC) based its monetary policy on DIT strategy in 1998. Since the strategy was implemented in a period of disinflation, the Council decided to accept subsequent annual targets for the mid-term perspective. After inflation had been brought down to a low level the Council decided that in the new environment the way of formulating the inflation target should be changed. That is why in the *Monetary Policy Strategy beyond 2003*, published in February 2003, the MPC adopted permanent inflation target set at 2.5% with a symmetrical tolerance range for deviations of +/- 1 percentage point. In February 2004 the present MPC confirmed the fundamental elements of the *Monetary Policy Strategy beyond 2003,* i.e. the level of the inflation target, the width of the tolerance range for deviations from the target, and maintaining the floating exchange rate regime until Poland's accession to ERM II. The Council also expressed a conviction that adopting an economic strategy aimed at paving the way for introduction of the euro at the nearest possible date would be the best strategy for Poland.

The incumbent MPC has prepared the *Monetary Policy Guidelines* for the first time. That is why the MPC decided to begin this important document with explaining how it understands the inflation target and the way of its implementation.

- First, the notion of *permanent* target means that it refers to year-on-year inflation measured each month in relation to the corresponding month of the preceding year. In contrast, in the period of 1999-2003 it was evaluated only once a year, in December (in relation to December of the previous year). The permanent target will be binding until Poland joins ERM II or till the end of term of the present MPC.
- Second, the Central Statistical Office (GUS) presents the data on inflation in the form of indicators calculated as the change in the prices of consumer goods and services (CPI) in a given month in relation to the corresponding month of the previous year. This measure is the main basis for interpreting the inflation target. However, for better understanding of inflation developments it is also useful to apply quarterly and average annual inflation indices, such as those used in NBP inflation projection or in the budget. The use of quarterly indicator is motivated by the fact that the inflation projection, which is a very important point of reference for MPC decisions, makes it possible to assess probable inflation deviations from the target on a quarterly basis. The reasons to use the average annual

indicator are as follows: a) it eliminates temporary deviations from the inflation target; b) some important variables are presented in this way in the inflation projection; and c) it is used in the budget forecast and other government documents and programmes.

- Third, the adopted solution means that the monetary policy is unequivocally focused on maintaining inflation as close as possible to 2.5% and not only within the tolerance range. This is a different approach than the ones pursued in a number of countries, where the inflation target is defined as a range without a central value. The adopted solution provides better anchoring for inflation expectations.

- Fourth, inflation fluctuations within the band should be treated as a natural consequence of minor shocks and business cycle factors. It can be assumed that these fluctuations are compensated in the longer term and so do not normally require any action on the part of monetary authorities. Nevertheless, in case of the occurrence of unexpected and strong shocks pushing inflation out of the tolerance range, a reaction of the central bank may be required.

- Fifth, monetary policy reaction to unexpected shocks will depend on their strength and character and also on the degree of inertia of inflation expectations. The reaction to demand shocks is a relatively minor problem because in this case inflation and output move in the same direction. An increase in interest rates, accompanied by inertial inflation expectations, weakens the economic activity and, in a longer perspective, inflationary pressure. Supply shocks are much more difficult to cope with. The main problem is that in the case of supply shocks output and inflation move in opposite directions, as it was the case with the oil shocks of the 70s. In their aftermath, there was a surge in inflation in many countries and a parallel decline in output resulting from increased costs and narrowed profit margins. Inappropriate monetary policy reaction may have far-reaching negative consequences for the economy. An attempt to fully neutralise the impact of a supply shock may lead to an excessive loss in output as the supply shock has itself a negative effect on demand and investment. On the other hand, an attempt to fully accommodate a supply shock by pursuing too expansionary monetary policy usually leads to acceleration in inflation, which in turn requires a far more restrictive monetary policy in the subsequent periods, leading to a relatively strong deceleration in economic growth.

- Sixth, supply shocks are usually 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 permanent rise in inflation expectations and, in turn, a further increase in inflation due to building wage pressure. In such a situation, monetary policy's task is to contain secondary effects of the supply shock *(second round effects)*. In countries with a short history of low inflation the risk of such effects is substantial. Very useful in analysing supply shocks are core inflation indices, which allow distinguishing, at least roughly, temporary changes in inflationary pressure from the permanent ones.

- Seventh, because of delayed reaction of output and inflation to monetary policy, its influence on the current inflation is small. Any current action of the central bank affects price developments in the future, just as the current inflation is influenced by interest rate changes made several quarters before. 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 make only an approximate assessment of the time lag between a change in interest rate and its strongest observed impact on real variables (output, employment) and then on inflation.

- Eighth, monetary policy affects the economy not only through changing interest rates but also by keeping them unchanged for a period of time. Lack of decision on interest rate level for several periods (months or quarters) is also a decision having substantial consequences for the economy, whenever it leads to a gradual widening or narrowing of the output gap.

- Ninth, monetary policy is conducted under high uncertainty, which means, among other things, that the model utilised by the central bank for projecting inflation may not reflect the consequences of structural changes ongoing 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) a forward-looking monetary policy has to be presented to the public as an attempt to balance risk factors associated with achieving the inflation target, rather than an attempt to control economic processes.
- Tenth, in assessing the stance of monetary policy not only the level of real interest rates should be considered but also the level of real exchange rate.

Despite the problems produced by supply shocks and the unavoidable uncertainty of forecasts, the MPC will strive to bring inflation back to the target as quickly as possible in order to create conditions conducive to long-term economic growth. The need to force inflation back to the target stems also from the necessity to fulfil the Maastricht criteria, which have to be met if Poland is to benefit from the opportunities offered by euro area membership.

2
Conditions for monetary policy implementation

In the second half of 2003 the Polish economy entered the initial stage of economic recovery. This brought about a gradual growth in demand and inflation. The main task of monetary policy was to adjust to the forecasted growth of inflationary pressure in the next phases of the business cycle.

In the spring of 2004 the Polish economy experienced strong price shocks in the form of food and crude oil price rises. The strength of these shocks was reflected by the large gap between the indices of the CPI and the net inflation, i.e. the index of core inflation which excludes the growth in food and crude oil prices.

Monetary authorities faced a difficult choice as to how they should react to the rise in inflation which did not result, in any significant way, from a growth in domestic demand. The central bank was not able to prevent the increase in inflation, which was a direct effect of the food and oil price rises. Still, the bank was obliged to prevent the second-round effects which might have resulted from increased inflation expectations.

That is why in 2004 the monetary policy not only had to respond to the forecasted growth in demand pressure but also had to contain inflation expectations, which might have produced wage demands and a rise in prices in contracts for future supplies.

Monetary policy also had to take into account the influence the supply shocks exert on the future inflation by affecting the economic activity and domestic demand.

The unexpectedly rapid rise in food prices in spring 2004 might have reduced the expenditure of households – through a decrease in their real income – on other goods and services. However, some signals allow an assumption that there was a shift from more expensive products to their cheaper substitutes.

The surge in crude oil prices up to their historical highs increased the production costs. This, however, did not have a significant effect on the current performance of enterprises, which registered record profits in the first half of 2004. Still, the persistence of high oil prices could harm the economic recovery also because this would lead to a greater transfer of the national income to oil-exporting countries.

The supply shocks which have affected the Polish economy increased the uncertainty in conducting the monetary policy. Additionally, economic theory does not provide precise guidelines as to how to optimise the central bank's reaction to supply shocks in order to minimise the costs of bringing inflation back to target.

Precise assessment of the time span necessary to reduce inflation to the target is further hindered by the uncertainty surrounding exchange rate forecasts and the uncertainty as to how the high unemployment rate would affect wage demands in the situation of large structural unemployment in Poland.

Past experience indicates that in Poland changes in the exchange rate have had a faster and, at the initial stage, also stronger influence on inflation than the changes in the interest rate. That is why a stronger than expected appreciation of the zloty may shorten the period of bringing inflation down to the target, while its potential depreciation may have the opposite effect.

A crucial factor affecting the conditions of monetary policy implementation is the fiscal policy of the government. In 2003 the ratio of public debt to GDP surpassed the 50%

level. In 2004, despite the favourable realisation of the budget, the ratio will be only slightly lower than 55%. This is a sign of deepening imbalance in the public finances, which requires a proper reaction aiming at a significant deceleration in public debt growth. The Government presented proposals of such action in the *Public Expenditure Rationalisation and Reduction Programme.* In 2005 a number of legal changes outlined in the *Programme* will be implemented, which will facilitate a reduction of the general government deficit, central budget included, in comparison to 2004. It will be a step in the right direction but will not be sufficient to halt the negative trend in public finance and to reverse the increasing ratio of public debt to GDP. In order to ensure that the ratio of the public debt to GDP stays well below 60% in the medium term, the reform of public finance has to be continued. If the dynamic economic growth and the new markets for Polish exports are to be maintained, the taxes and other fiscal burdens should not be raised. In such a situation, it is the rationalisation and reduction of public spending that is a crucial factor in restoring the balance of public finances.

3
Monetary policy objectives in 2005

1. **Main objective.** The primary objective is to bring inflation down as soon as possible, first to the tolerance range and then to the target of 2.5%. Return to the target should proceed in a way which would not involve excessive fluctuations of output, interest rates, and of the inflation itself, as this would reduce the effectiveness of monetary policy.

2. **Factors facilitating and inhibiting return to the target.** The process of bringing inflation back to the tolerance range, and then to the target itself, depends primarily on lags in the transmission mechanism of monetary impulses in Poland. International experience and empirical results of the research on the transmission mechanism in Poland indicate that inflationary effects of the majority of shocks can be neutralised in the horizon of 1-3 years since the change of interest rates without causing excessive output fluctuations. The Council will continue to act towards a relatively prompt reduction of inflation to the rate of 2.5% in the next 5-7 quarters. Still, it has to be emphasised that there is a number of factors which may accelerate or delay the achievement of this goal. A faster return to the target could be possible if: a) inertial impact of the EU accession shock turns out to be weaker than expected; b) unexpected favourable supply shocks occur in the next months (e.g. a significant fall in energy prices in the world markets); and c) due to recent structural and institutional changes the time lags in the transmission mechanism have been shortened. The process of bringing inflation back to the target should be facilitated by three favourable trends. The first one is the nature of the current economic recovery. The present situation is better than in 1995-1997, when a comparable GDP growth rate was accompanied by such unfavourable phenomena as the credit boom and the rapidly growing current account deficit. Today, the economic growth is much more sustainable, primarily due to the strong export performance. The second favourable trend is the improvement in labour productivity well exceeding the wage growth rate. Obviously, this positive situation may deteriorate as an escalation of wage demands is still possible. Nonetheless, in the first half of 2004, when the output growth rate was at its peak and the financial condition of enterprises saw substantial improvement, the wage growth rate remained moderate. A continuation of this trend would be beneficial as the financial resources accumulated in enterprises could be then utilised to strengthen their competitive position and increase their workforce. The third trend which may have a favourable effect on the inflation outlook stems from the fact that, according to studies conducted in other countries, the transition from an over-ten-year period of high inflation to the phase of low inflation weakens the ability of companies to transfer the increases in production costs to consumer prices (also through the exchange rate channel, e.g. in case of depreciation). If, however, some strong negative supply shocks affect the economy (e.g. further oil price hikes), the period of the return to the inflation target may be longer.

3. **Forward-looking monetary policy.** The publication of the inflation projection, starting from the August 2004 *Inflation Report*, means that the decisions of the Monetary Policy Council will be even more guided with the future rather than current inflation. As the supply shocks significantly increased the uncertainty of the inflation projections, in the initial period the Council will also devote much attention to forecasts based on different models used in the NBP and other institutions. As in the past, the Council will point to a probable direction of the future changes in interest rate levels by announcing a certain bias in monetary policy. A tightening bias means that an increase in NBP interest rates is more probable than a reduction. Easing bias signals higher probability of lowering interest rates than increasing them. Neutral bias implies roughly the same probabilities of raising and reducing interest rates.

4. Apart from periods when inflation projection will show increased uncertainty, e.g. due to strong supply shocks, the Council will adopt a tightening bias whenever the factors affecting monetary policy decisions, inflation projection included, suggest that the probability of inflation exceeding 2.5% is considerably higher than the probability of its falling below that level. The Council will adopt an easing bias whenever the probability of inflation falling below 2.5% is significantly higher than that of inflation moving above 2.5%. If both probabilities are roughly equal, the Council will adopt a neutral monetary policy bias. Therefore, it may happen that the Central Bank, in an attempt to prevent inflation from deviating from the target in the future, will change the level of interest rates even if the current inflation is close to the target. The forward-looking monetary policy will be accompanied by the Council's effort to improve communications with the public and to signal changes in monetary policy bias.

5. Use of core inflation indices in the analysis of inflationary processes. Due to the occurrence of supply shocks and their interactions with demand shocks, it is not easy to correctly assess their persistence and the impact on the economy. Consequently, it is not easy to arrive at the right decision and then to provide a persuasive explanation for it. For that reason the Council will more extensively use core inflation indicators in its analyses and explanations of the inflationary processes, which is consistent with the practice of many other central banks.

6. Cooperation with the Government on accession to the euro area. Such cooperation becomes particularly important in view of Poland's prospective membership in the ERM II. Poland's participation in ERM II will impose a requirement to stabilise the exchange rate. Under the high mobility of international capital flows, the necessity to stabilise the exchange rate involves a potential threat that, in adverse conditions, severe tensions in the forex market may occur. The risk of such tensions will be the smaller, the sooner the situation in public finance improves, which would eliminate investors' worries about the level of public debt.

4
Monetary policy instruments

With Poland's entry to the European Union in May 2004 the National Bank of Poland became a member of the European System of Central Banks. Until the accession to the euro area, Polish monetary policy principles will be defined autonomously by the Monetary Policy Council. At the same time, the activities aimed at preparing the NBP's operational framework for membership in the Eurosystem will be continued.

Interest rates

The principal way of pursuing the inflation target is by determining the level of short-term interest rates. The NBP's reference rate defines the direction of the pursued monetary policy. The deposit and lombard rates set the fluctuation band for overnight interest rates in the interbank market. The band remains symmetrical in relation to the reference rate.

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

The **lombard rate** determines the maximum cost of securing funds from the NBP. Thus, it determines the ceiling for overnight market rates.

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

Banking sector liquidity

The banking sector liquidity performance is a resultant of many different factors. Among other things, it depends on foreign exchange transactions of the central bank and the changing level of funds deposited at the NBP by the Ministry of Finance.

In 2004 the main factor affecting the liquidity level in the interbank market has been the volatility of term deposits placed by the Ministry of Finance in the NBP, which contributed to a relatively high volatility of market interest rates. As a result of decisions taken in order to counteract this situation, the Ministry of Finance started to place some of its liquidity surplus in the banking sector, which will ensure a greater stability of market interest rates.

Another factor which will have a major impact on banking sector liquidity in 2005 is the expected rise in the volume of foreign exchange operations concluded between Polish and EU institutions. These will be bilateral transactions connected, *inter alia*, with transfers from the European Union and the payment of membership contribution. Their volume, time of payment, and the way of currency conversion may have an effect on banking sector liquidity in 2005.

Other factors to affect the liquidity level in the banking sector will be the sales of foreign currencies by the NBP for the purpose of servicing foreign debt, as well as changes in the volume of notes and coins in circulation.

In all likelihood, operating liquidity surplus will persist also in 2005. Should operating liquidity shortage occur temporarily in the banking sector, the NBP will adjust monetary policy instruments accordingly.

Open market operations

Open market operations are the principal instrument for maintaining short-term interest rates at a level consistent with the MPC established inflation target being implemented.

The NBP will make use of the following set of instruments under open market operations:

1. **Main operations** in the form of issuing 7-day NBP money bills.

Tenders for the bills will be conducted on a regular weekly basis, with their yields set according to the reference rate established by the MPC. Shortening their maturity from 14 to 7 days should result in the increased flexibility of this instrument's use by the central bank and will also facilitate the liquidity management of commercial banks. This should also limit the volatility of short-term rates in the interbank market.

2. **Fine-tuning operations** may be applicable in the event of unexpected short-term movements in the liquidity of the banking sector which might lead to undesirable, from the monetary policy perspective, fluctuations in short-term interest rates. These operations would be both liquidity-absorbing and liquidity-providing (issuing NBP money bills, repo operations, and buying out NBP money bills before their maturity).

3. **Structural operations** are aimed at altering the level of banking sector liquidity in the long term. Should the need arise, the central bank can conduct structural operations by buying back its own bonds (present in the portfolios of commercial banks), by purchasing securities in the market, or by issuing its own long-term securities.

Reserve requirements

One of the basic functions of mandatory reserves is to cushion the impact of movements in banking sector liquidity and thus to limit the volatility of interest rates. Possible further reductions in the reserve requirement ratio are conditional on the banking sector liquidity level.

Standing facilities

These facilities serve to stabilise the liquidity in the interbank market as well as to limit the fluctuations of overnight interest rates. In contrast to open market operations, commercial banks use standing facilities at their own initiative.

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

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

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

In 2005 the **POLONIA** (Polish Overnight Index Average) reference rate will be introduced. POLONIA will be the average overnight rate weighed with the interbank deposit market transaction volume. The aim of this rate is to reflect actual interest rates on short-term interbank deposits. Its calculation procedure will be similar to that already used within the Eurosystem in relation to EONIA rate (Euro Overnight Index Average).