National Bank of Poland

Monetary Policy Council

Monetary Policy Guidelines for the Year 2007

Warsaw, September 2006

Monetary Policy Guidelines for the Year 2007 is a translation of the National Bank of Poland's *Założenia polityki pieniężnej na rok 2007* in Polish. In case of discrepancies, the original prevails.

1. Strategy of direct inflation targeting

According to the Article 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 Article 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. After having brought down inflation to a low level, starting from 2004 the MPC adopted a 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 EMR II. The MPC pursues this strategy under a floating exchange rate regime, which should be maintained until Poland’s accession to the EMR II. Floating exchange rate regime does not rule out foreign exchange interventions, should they turn out necessary for inflation target implementation.

The Council maintains its present understanding of the inflation target and the way of its implementation:

- 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 month 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 the monetary policy is unequivocally focused on maintaining inflation as close as possible to the target of 2.5% and not only within the tolerance range. The adopted solution provides anchoring for inflation expectations, thus facilitating the pursuit of monetary policy, which requires smaller and less frequent exchange rate changes to be effected in response to shocks.
- Third, the occurrence of shocks in the economy is inevitable. The scale and duration of an inflation deviation from the adopted target differs depending on the strength of the shock and the degree of inertia of inflation expectations. The central bank does not usually 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 actually leaves the tolerance band temporarily. In the case of shocks viewed as leading to a 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. An interest rate increase weakens economic activity and, consequently, 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 drop in output, as the supply shock itself already has a negative effect on consumption and investment. On the other hand, an attempt to fully accommodate a supply shock resulting in a price increase and output decrease – by pursuing an expansive monetary policy – usually leads to persistently higher inflation, which, in turn, requires a far more restrictive monetary policy in subsequent periods, bringing about a stronger deceleration in economic growth. Reaction of the central bank should depend on the assessment of the duration of the shock.
- 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, consequently, an increase in inflation level due to the emerging wage pressure. In such a situation, monetary policy has 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 distinguish, at least roughly, temporary effects from permanent changes in inflationary pressure.

- Sixth, because of the delayed reaction of output and inflation to the pursued monetary policy, its influence on current inflation is rather limited. Current decisions of the monetary authorities affect price developments in the future in a similar way that current inflation is influenced by interest rate changes made several quarters before. However, the length of these lags is not constant and, to a large extent, depends on structural and institutional changes ongoing in the economy. As a result of changes in the transmission mechanism of monetary impulses central banks can only approximately assess the time lag between a change in interest rate and its strongest observed impact on real variables (output, employment), and then on inflation.
- Seventh, monetary policy affects the economy not only by changing the interest rates but also by keeping them unchanged for a period of time. The decision to keep interest rates unchanged for several periods (months or quarters) also 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 central banks may start to less adequately describe 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 information, and not only the inflation projection; (b) it is not possible to make use of 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 uncertainty, rather than an exercise of strict control over economic processes.
- Ninth, in pursuance of monetary policy, while assessing the inflation outlook, especially when inflation is low, central banks allow for the prices of assets because of the need of

ensuring financial stability. In the conditions of liberalised financial markets and amid favourable developments on the supply side of the economy, which are supporting low inflation, it is becoming ever more essential for monetary authorities to allow for the financial stability in their decisions. If in response to low inflation central banks reduce interest rates too much, this may lead to a rapid asset price growth. This growth is accompanied with the risk of the so-called unstable boom, where higher inflation surfaces with a considerable lag. Such rapid growth in asset prices is also accompanied with the rising risk of their violent and considerable slump, which poses the threat to the stability of the financial system and the real economy. Financial system stability ensures effective operation of the transmission mechanism, which is crucial for appropriate monetary policy implementation. In assessing the risk of the emergence of disruptions in the asset market and the inflation outlook, it may be useful in the longer run to account for the paths of monetary aggregates.

- Tenth, in assessing monetary conditions, not only the level of real interest rates should be considered, but also the level of the real exchange rate. Thus understood restrictiveness of monetary policy impacts, along with the implemented fiscal policy, the total restrictiveness of macroeconomic policy. An overly expansive fiscal policy is the most common reason that necessitates keeping the interest rates at a higher level.
- Eleventh, an important input into monetary policy decision-making process is the balance of factors 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. When assessing the factors influencing future inflation, the duration of the period of low inflation should be taken into account.

The Council maintains its belief it would be most beneficial for Poland to pursue an economic strategy aimed at creating conditions for the introduction of the euro at the earliest possible date.

2. Conditions for monetary policy implementation

Current forecasts indicate that inflation in 2007 will decrease as compared to 2006 in the United States and will edge down in the euro area (forecast inflation[1] in the United States will be at 2.6% in 2007, compared to 3.5% in 2006, while euro-area inflation will be 2.1% in 2007 versus 2.2% in 2006). In line with these forecasts, a slight deceleration in economic growth is expected in the euro area in 2007 in comparison to 2006 (forecast economic growth[1] in the euro area in 2007 will amount to 1.8% compared to 2.3% in 2006). A lower rate of economic growth in 2007 is also expected in the United States (forecast economic growth[1] will slide to 2.5% compared to 3.4% in 2006). However, there is a risk of an even greater global economic growth weakening in 2007 than that anticipated in the quoted forecasts. Such a scenario would play out if global imbalances reversed rapidly or if the expected drop in property prices in the United States turned out deeper than anticipated. Should this scenario materialise it would have negative impact on the Polish economy via changes in external demand, weakening of the rate of economic growth and shifts in the fiscal condition with all their consequences. The joint impact of these factors on monetary policy conditions would be difficult to define.

Globalisation processes that have been progressing intensively for more than a decade, increased the impact of global inflation determinants (including global output gap, global-scale price competition) in relation to their domestic counterparts (domestic output gap). Thus, the developments in the world economy should be watched very carefully. Moreover, available data indicate that future anti-inflationary effect of globalisation processes may prove weaker than it was the case in the past.

Since 2005 Q2 the high growth of global economy was accompanied by accelerated economic growth in Poland. In the first half of 2006 economic growth was ever more significantly encouraged by rising domestic demand. The acceleration in domestic demand was accompanied by sustained positive contribution of net exports to GDP growth. Such a structure of GDP growth is favourable from the point of view of its sustainability, as confirmed by economic forecasts for 2007. According to current forecasts the economic growth rate in 2007 will be

[1] Consistent with *The Economist consensus.*

approx. 5.0% with domestic demand growing faster than GDP growth rate, the rate of growth of consumer demand similar to GDP growth rate and a markedly higher rate of investment growth. After a period of inflation running significantly below the lower tolerance limit for deviations from the inflation target, in August inflation returned to the band of acceptable deviations. Also the measures of core inflation have risen since the beginning of 2006. A factor that may mitigate the impact of faster domestic demand growth on inflation is the possibility that the rising demand might be partly absorbed by increased imports. The force of this impact, however, will depend on the path of transaction import prices and the foreign exchange rate. With the presently low current account deficit, increased imports would not be conducive to generating excessive pressures in the 2007 balance of payments.

The stepped up economic growth contributes to the fast growth in the number of people working in the economy observed since the second half of 2005. The rapid growth in the demand for labour may result from low labour reserves in enterprises, from high production capacity utilisation and the fact that most new jobs are created in the more labour-intensive service sector. The fast growth in the demand for labour may also, to some extent, result from the inflow of foreign direct investment to Poland, which is accompanied by moving jobs to Poland from countries with relatively high costs of labour. At the same time, an increase in the supply of labour may be influenced by a rise in working-age population, though BAEL data point to a drop in the economically active figure. On the other hand, economic migrations of Polish workers to several EU countries contribute to lowering labour supply in Poland. A significant rise in the demand for labour paralleled with a concurrent lowering of the rate of growth of labour supply – considering the mismatch in the structure of labour supply and the demand for labour – may be conducive to increased wage pressure. The wage pressure may be mitigated by the still high, though falling, unemployment.

Very important for inflationary processes are changes in unit labour costs in the economy, which depend on the relation of wage to labour productivity growth. The rise in labour productivity in industry still outstrips the rate of wage increase, which has the effect of reducing unit labour costs in this sector. By contrast, unit labour costs in the economy as a whole have been growing since 2004 Q3.

It can be expected that labour productivity growth will still be supported by the rising investment in the economy. This will be additionally favoured by the continuing inflow of foreign direct investment accompanied by the influx of modern technologies and management methods. Sustainability of a high rate of investment will depend on the economic climate and structural and institutional factors, which determine the investment climate. The most crucial structural and institutional factors include: the volume of total fiscal burdens, prospects of reducing public finance imbalance, efficiency of property rights protection and contract enforcement, and the intensity of regulations restricting economic freedom.

Considering the dynamic growth in the demand for labour, the above-mentioned situation as regards labour supply and a lack of structural reforms that would lead to increased labour productivity, it may be expected that in 2007 the rate of growth of unit labour costs in the economy will rise in relation to 2006.

As it was reminded in Point 1 of the present *Guidelines*, the pursuit of monetary policy is hindered by the emergence of negative supply shocks, i.e. price increases which do not result from changes in the domestic demand. This type of shock, which will be making the NBP’s monetary policy implementation difficult in 2007, was caused by unexpectedly adverse weather conditions in agriculture, which had the effect of significantly lower than expected harvest.

Favourable for the Polish economy is its growing integration with the EU economy, which is contributing to the rising share of the euro in domestic foreign exchange transactions and, consequently, leads to the gradual reduction of zloty exchange rate volatility in relation to the common European currency observed since 2005. This volatility was also diminished by the continually low inflation in Poland. A factor that could once again increase the volatility of zloty exchange rate against the euro would be the worsening of the public finance condition.

Fiscal policy in 2007 will be an important determinant of monetary policy. The key element of the proposed budget draft is the assumed high growth rate of the central budget’s expenditure exceeding the forecast GDP growth rate. This shape of fiscal policy means that the structural deficit of the public finance and credit needs of the state will be kept at overly high levels. Additionally, another threat results from the increased liabilities of the Treasury due to the passing of defective legal acts. In consequence, the public debt will continue to build up and its relation to GDP will be gradually heading towards the constitutional limit. The situation when the proportion of debt approaches this limit may eventually necessitate a big correction in the pursued fiscal policy. The currently observed high rate of economic growth should be used to introduce reforms which would permanently contain the public finance structural deficit, which is necessary if the rate of growth of public debt is to be reduced. Diminishing the structural deficit of the public finance is also a necessary condition for Poland’s entry to the euro area and for its taking full advantage offered by this accession. Sound public finance and inflation continuing at the target level increases the chances of raising investment in the economy, which in turn would help accelerate the process of real convergence. This would also lead to a permanent improvement of Poland’s competitive position.

Despite the reforms implemented since the beginning of the transition period, the Polish economy still faces numerous structural and institutional weaknesses which limit the possibilities of taking full advantage of the potential of Polish economy, negatively affecting the level of employment and the effectiveness of production factor utilisation. Halting the privatisation process may have negative impact on the quality of corporate governance and on the efficiency of enterprises. Too small scale of deregulation processes, particularly in the so-called network industries (power production and supply, telecommunications), which would encourage increased price competition in many goods and services markets. Extending the prospect of euro-area membership may become a factor negatively affecting the inflow of direct investment, which foster efficiency growth and, consequently, support economic growth and low inflation. Postponing the prospect of Poland’s entry to the euro area may cause a relative rise in the level of long-term interest rates (as a result of an increase in the inherent risk premia), which would have a negative impact on the budget. Other countries’ experience shows that the implementation of efficiency-increasing structural and institutional reforms enables the achievement of the inflation target with a higher rate of economic growth.

The proposed legislative bills which could limit the independence of the central bank may hamper the pursuit of monetary policy. The institutional changes being introduced in the supervision over the financial sector may pose risk to the simultaneous maintenance of financial system stability and price stability. In 2007, and particularly in its first months, some impact on the pursuit of monetary policy may be exerted by the change of the NBP’s President.

3. Monetary policy objectives in 2007

The Council will strive to ensure that the return of inflation to the target level of 2.5%, which is forecast for the beginning of 2007, proves permanent. However, similarly to the previous years, in case strong and unexpected shocks should arise the monetary policy will be pursued in a way ensuring the implementation of the target in the mid-term horizon. This is due to the lags in the monetary policy transmission mechanism. This way of monetary policy implementation helps to curb the fluctuations of output.

If the expected continuation of a high rate of economic growth is accompanied by building inflationary pressure, it may be necessary to adjust the pursued monetary policy accordingly. Adjusting monetary policy to the changing economic conditions is a common way in which central banks stabilise inflation at the inflation target in the medium term.

As it is currently estimated, in Poland the monetary policy instruments of the central bank exert the strongest impact on inflation in the horizon of 5-7 quarters. At the same time, it should be pointed out that there is a considerable uncertainty surrounding the strength and lag of the monetary policy transmission mechanism, which may change due to structural changes ongoing in the economy.

Lags between the change of interest rates effected by the central bank and its impact on economic and inflationary processes make inflation projection an important input to monetary policy of central banks. Therefore, in pursuing its monetary policy, the MPC will continue to take into account the results of subsequent inflation projections prepared by the NBP's economists and also the results of inflation projections prepared by other research centres. 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 its forecast course, as such deviations may point to a change in future economic developments as compared to the previous projections.

The return of inflation close to the target creates favourable conditions for ensuring that inflation expectations will remain at a low level. Stronger anchoring of inflation expectations would facilitate the pursuit of the inflation target in the future, amid lower interest rate volatility and output fluctuations. However, the sustainability of low inflation expectations in the months to come and in the next year will depend on the path of food prices, regulated prices and the prices of fuels. In 2007 the Council will thoroughly analyse the changes in these prices against the risk of the emergence of secondary inflationary effects. Should the likelihood of such effects arising be high, the Council will undertake the necessary measures to counteract an increase in inflation expectations. The Council will pursue its monetary policy in a way that would ensure sustaining inflation close to the inflation target.

An important element of inflation targeting is the communication with the general public. The Council presents its assessments of the current economic situation and future economic developments. The major communication instruments include *Inflation Reports*, MPC press releases and press conferences following meetings of the Council. The Council will use its best efforts to ensure transparency of the monetary policy. In *Inflation Reports*, the Council will strive to cover in greater detail the arguments raised in discussions during its meetings.

The stabilisation of inflation at the target level will facilitate the future fulfilment of the Maastricht price stability criterion, which is one of the conditions for Poland's membership in the euro area. Moreover, inflation running at a level consistent with the inflation target will be conducive to reducing the inflation risk premium inherent in long-term interest rates and thus to their lowering. This should facilitate the compliance with the long-term interest rate criterion. Therefore, the achievement of the inflation target will also aid the fulfilment of the Maastricht criteria, which would allow Poland to take full advantage of opportunities offered by the membership in the euro area. The Monetary Policy Council will support the National Bank of Poland’s activities aimed at the implementation of the scenario of Poland’s accession to the euro area at the earliest possible date and will cooperate with the Government to achieve this objective. Setting the date of Poland’s accession to the euro area, supported by a reliable programme of reforms, would undoubtedly help increase the effectiveness of these actions. The Council is convinced that it is advisable for the GUS (Polish Central Statistical Office) to start publishing a harmonised index of consumer prices (HICP), which is used to assess the convergence in terms of the Maastricht price stability criterion.

4. Monetary policy instruments

Banking sector liquidity

The year 2006 saw increased liquidity surplus in the banking sector in average annual terms. Since Poland's accession to the European Union in 2004, the main source of liquidity surplus growth has been the inflow of EU funds and the associated purchase of foreign currencies by the NBP. 2006 brought a stepping-up in the rate of growth of currency in circulation, which contained the increase in liquidity surplus.

In 2007, the scale of the liquidity surplus growth will still mostly depend on the scale of foreign exchange transactions of the central bank, changes in the volume of currency in circulation and the volume fluctuations of the deposits of the Ministry of Finance at the NBP. In 2007, the limit of these deposits agreed with the Ministry of Finance will amount to an annual average of PLN 4.9 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. Open market operations include:

Main operations in the form of issues of 7-day NBP bills. Tenders for the bills are conducted on a regular weekly basis, with their minimum yields set according to the NBP reference rate. The central bank executes the main operations on a scale that allows the market WIBOR SW rate, which corresponds to main operations' maturity, to settle around the NBP's reference rate.

Fine-tuning operations may be performed in order to mitigate the impact of unexpected short-term movements in the liquidity of the banking sector on the level of short-term interest rates. These operations may be both liquidity-absorbing and liquidity-providing and include: issuing NBP bills, repo and reverse repo transactions and redemption of NBP bills before maturity.

Structural operations can be performed in order to change 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 the reserve requirement is to cushion the impact of movements in the banking sector on interest rates fluctuations. Any possible changes in the reserve ratio or introduction of other solutions aimed at bringing the required reserve system closer to Eurosystem requirements will depend on the liquidity conditions in the interbank market.

Standing facilities

Standing facilities are meant to limit the scale of fluctuations of the overnight interest rate of the interbank market. Banks participate in these operations on their own initiative.

Deposit facility enables banks to deposit their liquidity surplus on an overnight basis at the central bank, and the interest on this facility constitutes the lower limit for the market rate quoted for this period.

Lombard facility enables banks to obtain credit from the central bank on an overnight basis. The interest on this facility determines the maximum cost of obtaining money from the central bank and constitutes the upper limit for the overnight market rate. Lombard facility is collateralised with securities accepted by the central bank.

Intraday credit facility, i.e. both zloty and euro loans offered by the NBP, will remain an important element of the clearing system, as the source of finance obtained during the operating day . These are non-interest bearing loans. Similarly as in the case of the lombard facility, they are collateralised with securities accepted by the central bank.

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. Thus, there may be circumstances under which the NBP will decide that it is necessary to intervene in the currency market in order to stabilise inflation.