

NBP

Narodowy Bank Polski

Monetary Policy Council

Monetary Policy Guidelines for 2014



Warsaw, September 2013

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In setting the *Monetary Policy Guidelines for 2014* the Monetary Policy Council fulfills the requirements of Article 227 of the Constitution of the Republic of Poland which obligates it to present monetary policy guidelines to the Sejm annually, concurrently with the submission of the draft Budget by the Council of Ministers. Pursuant to Article 53 of the Act on the National Bank of Poland (Narodowy Bank Polski), *Monetary Policy Guidelines* are published in the Official Gazette of the Republic of Poland "Monitor Polski".

The *Guidelines* present the basic elements of the monetary policy strategy pursued by Narodowy Bank Polski and an outline of macroeconomic conditions that may have an impact on this policy in 2014. In addition, the *Guidelines* comprise a description of monetary policy instruments.

Monetary Policy Guidelines for 2014 take into account information available up to 30 August 2013.

Monetary Policy Guidelines for 2014 is a translation of the publication of Narodowy Bank Polski entitled *Założenia polityki pieniężnej na rok 2014*. In case of discrepancies, the original prevails.

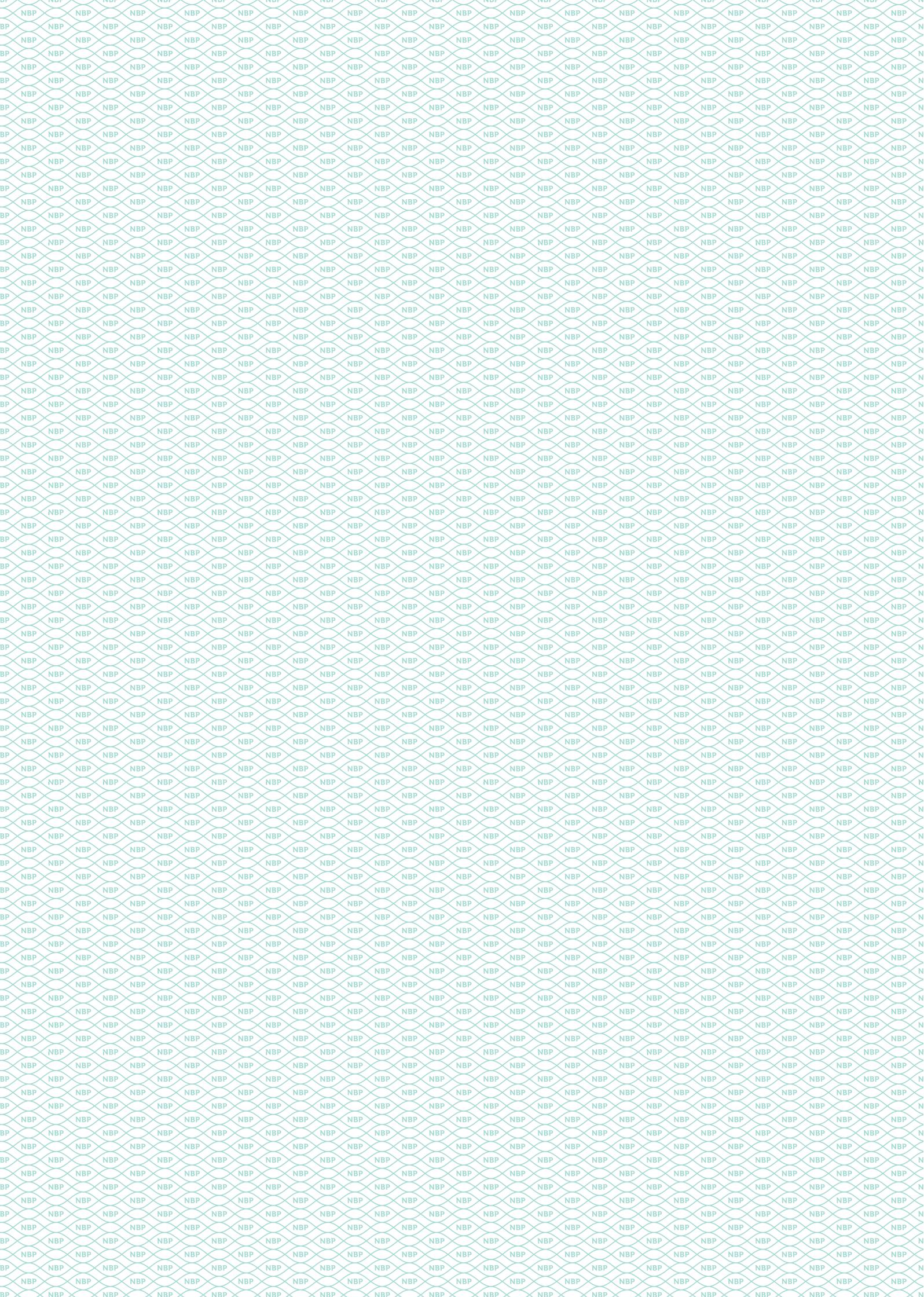
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Introduction



Introduction

The experience of the global financial crisis has somewhat modified views on the appropriate manner to conduct macroeconomic policy. In terms of central bank activity this means, in particular, a shift towards more flexible implementation of inflation targeting strategy and adding macroprudential policy to the central bank's stabilization policy instruments.

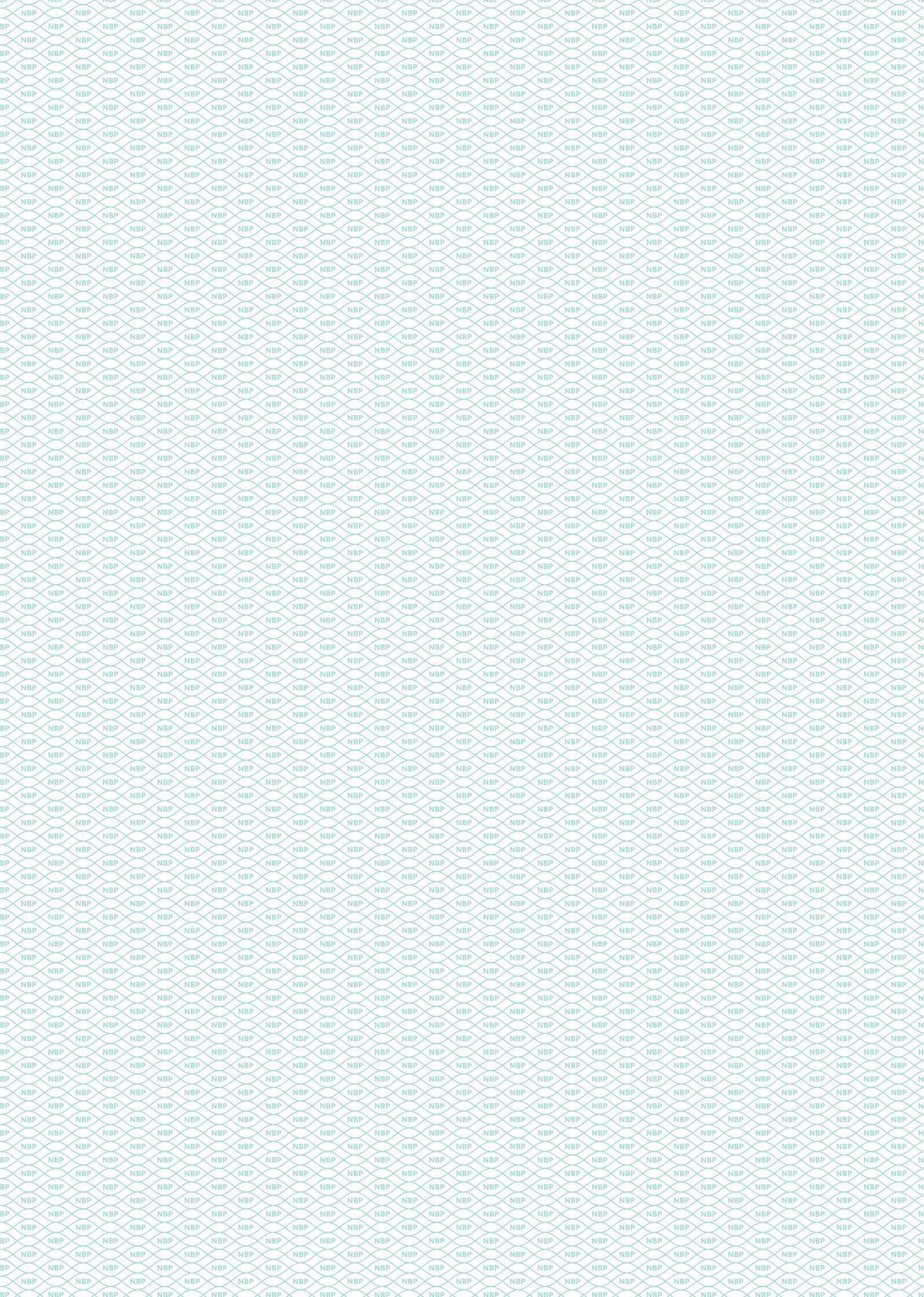
The inflation targeting strategy is an effective way to ensure price stability. At the same time, central banks have begun to use it more flexibly than in pre-crisis times, availing themselves of the possibilities offered by its medium-term nature. In the period preceding the global financial crisis, central banks exercised flexibility in inflation targeting to a small degree. This resulted from the conviction that keeping inflation low and stable was a sufficient contribution of monetary policy to maintaining balance in the economy. Yet, the experience of the global financial crisis and the prolonged recession in many countries has shown that stabilizing inflation is a very important, but hardly sufficient condition to maintain economic balance. Thus, central banks are now allowing longer periods of inflation deviating from the target, as long as this is conducive to macroeconomic stability.

Arguments in favour of a more flexible implementation of inflation targeting include also growing impact of supply shocks on the economy – a phenomenon observed already in the pre-crisis period – in particular shocks involving increased commodity price volatility in global markets. In the face of prolonged increase in commodity prices combined with inflation persistently remaining above the target, central banks usually tightened monetary policy only when faced with a risk that inflation expectations would be anchored above the inflation target. Equally, as commodity price growth subsequently flattened, and inflation fell below the target, the banks have exercised caution in relaxing their monetary policy. An excessive response from the central bank to shocks that remain beyond the direct influence of monetary policy, could trigger violent swings in inflation and output. Growing impact of international capital flows on domestic economic developments provides another ground for a more flexible inflation targeting strategy.

Moreover, the prolonged period of weak growth in the global economy, occurring amidst consistently low inflation and inflation expectations, has allowed monetary policy, to a greater extent, to be directed towards stimulating economic recovery and stabilising financial market sentiment. Such policy would be particularly appropriate in economies where fiscal tightening has an adverse effect on economic activity. In this environment, the central bank's communication plays an important role in stimulating economic activity by curbing the uncertainty about monetary policy parameters in longer term.

The experience of the past few years also speaks in favour of acknowledging macroprudential policy as another, besides monetary policy, instrument of the central bank's countercyclical policy. The application of this instrument rests on the conviction that besides the classical business cycles – usually addressed with monetary policy instruments – we see longer financial cycles occurring in the economy which should be tackled with macroprudential policy measures.

Growing number of countries are setting up institutions in charge of macroprudential policy conduct. In most cases, the central bank plays a major role in this area. Arguments in support of central banks' key role in macroprudential policy include their expertise in analysing economic developments from the macroeconomic point of view and independence allowing them to make decisions which, while potentially weighing down short-term economic activity, are necessary to maintain economic balance in longer term. This is why it is particularly important that the recommendations issued by the European Systemic Risk Board regarding setting up national institutions responsible for macroprudential policy are implemented, and that the central bank's leading role in pursuing this policy is ensured.



Chapter 1

Monetary policy strategy



Monetary policy strategy

The Monetary Policy Council, hereinafter „the Council”, has decided to maintain the key elements of NBP monetary policy strategy that were established in the Monetary Policy Guidelines for 2013. In 2014 the monetary policy strategy will be pursued according to the following rules.

According to Article 227 section 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 (Narodowy Bank Polski) of 29 August 1997 states in Article 3 section 1 that “the basic objective of the activity of the NBP shall be to maintain price stability, while supporting the economic policy of the Government, insofar as this does not constrain the pursuit of the basic objective of the NBP”.

Nowadays central banks understand price stability as inflation so low as not to negatively affect decisions taken by economic agents, including investment and savings decisions. Ensuring price stability is a fundamental way in which the central banks contribute to balanced economic growth. In pursuit of the task of maintaining price stability, central banks respond both to inflationary and deflationary threats.

Since 1998 the Council has based its monetary policy on inflation targeting (IT). Beginning 2004, the Council adopted a permanent inflation target of 2.5% with a symmetrical tolerance band for deviations of ± 1 percentage point. The Council pursues the strategy under a floating exchange rate regime. However, the floating exchange rate regime does not rule out foreign exchange interventions when they turn out necessary to ensure domestic macroeconomic and financial stability, which is conducive to meeting the inflation target in the medium term.

The experience of NBP and other central banks shows that the IT strategy – applied with appropriate flexibility – is an effective tool to ensure price stability in the medium term and, at the same time, is supportive of macroeconomic stability. The global financial crisis has shown that in order to ensure macroeconomic stability, monetary policy should be pursued in such a way as to – while striving to stabilise inflation at the target level – limit the risk of accumulating imbalances in the economy, especially those resulting from unsustainable credit booms. The possibility to flexibly set the parameters and adjust implementation of available monetary policy instruments according to the situation in the domestic financial system is a factor, which may mitigate this risk.

Besides monetary policy, fiscal and macroprudential policy play an important role in maintaining macroeconomic stability. In order to maintain price stability in the longer term, it is necessary to conduct fiscal policy ensuring the long-term stability of public finances and a macroprudential policy which mitigates the risk of imbalances building up in the economy.

Domestic monetary policy is also largely conditional upon monetary policy conducted by major central banks, whose decisions (especially those concerning interest rates and quantitative easing programmes) – through their influence on global financing conditions,

including risk premia embedded in individual assets prices – may fuel volatility of international capital flows, thus impacting domestic economic developments.

In 2014, NBP's monetary policy will remain focused on meeting the medium-term inflation target.

While pursuing monetary policy, the Council will be guided by the following principles:

- First, the notion of permanent inflation target means that it refers to inflation measured as a change in prices of consumer goods and services in each month compared to the corresponding period of the preceding year. While analysing inflation developments the use of quarterly and annual inflation indices is also justified, such as those applied in NBP's inflation projection, in the state budget and in the statistics of the European Union (hereinafter “the EU”), including the harmonized index of consumer prices – HICP. An important role in the assessment of inflationary pressure is also played by core inflation indices which make it easier to distinguish between temporary changes in the consumer price index from more sustained changes in inflation pressure.
- Second, monetary policy is unequivocally focused on maintaining inflation in the medium term as close as possible to the target of 2.5% and not just within the tolerance band. This is to facilitate the anchoring of inflation expectations and thus to allow the central bank to change monetary policy parameters less frequently in response to potential shocks affecting inflation. It may also lead to lower volatility of long-term interest rates.
- Third, the occurrence of shocks in the economy is inevitable. Depending on the strength and the direction of the shock as well as the inertia of inflation expectations, the scale and the duration of inflation deviation from the adopted target may differ. In countries with sustained low inflation, the central bank usually does not respond to deviations from the inflation target if it deems them temporary, even when inflation leaves the tolerance band. When assessing the need for a response, the Council takes into account the extent to which inflation expectations are anchored, which affects the scale and persistence of the impact of demand and supply shocks on inflation.
- Fourth, monetary policy response to shocks depends on their causes and nature. In the case of demand shocks inflation and output move in the same direction. An interest rate increase weakens economic activity in the short term and, subsequently, inflationary pressure.

In the case of supply shocks output and inflation move in opposite directions. The dilemmas of monetary policy in such a case are as follows:

- An attempt to neutralise the impact of a supply shock on inflation with a monetary tightening may lead to an even deeper plunge in output growth resulting from supply shock's negative impact on consumption and investment.
- An attempt to accommodate – by pursuing expansionary monetary policy – the real effects of a supply shock, resulting in a rise in inflation and a decline in output

growth, usually leads to persistently higher inflation. This, in turn, requires far more restrictive monetary policy in subsequent periods. This leads to a stronger deceleration in economic growth than the monetary policy tightening that prevents inflation from being sustained at a heightened level.

In the case of shocks resulting from changes in risk perception, it is of prime importance to determine whether changes reflect economic fundamentals, and to what extent they can be reversed with the central bank's standard instruments. Where changes in risk perceptions are transitory, a premature monetary policy response may lead to excessive interest rate volatility, and consequently to inflation and economic growth rate volatility. Therefore, in an environment marked by substantial and frequent changes in risk perception, it is crucial to adjust monetary policy parameters gradually.

The central bank's response to a shock depends also on the assessment of the persistence of its impact, including the assessment of the risk of the so-called second round effects. Therefore, when assessing the risk of inflation stabilizing at a heightened level the important factors to be considered include the degree to which inflation expectations have been anchored and the overall macroeconomic conditions, which might either support or mitigate wage pressures.

As far as response to shocks is concerned, it is of particular importance that the central bank may flexibly specify the time horizon of inflation returning to the target, i.e. conditional on the nature of the shock and its persistence.

- Fifth, monetary policy should take into account the need to maintain financial stability which is indispensable to ensure price stability in the longer term and which enables effective functioning of the monetary policy transmission mechanism. In this context, when assessing the balance of risks to future inflation and economic growth, asset price developments are of particular importance. Excessive interest rates cuts and the long-lasting maintaining lowered interest rates amidst low inflation and simultaneous fast economic growth may lead to a rapid asset price growth, thus increasing the risk of the so-called speculative bubbles. Rapid asset price growth is accompanied by the growing likelihood of asset price deviation from the levels justified by fundamentals, which increases the risk of an abrupt and significant decline in asset prices in the future. Rapid increase in asset prices, especially if it is accompanied by a fast rise in lending, poses a threat to the financial system stability, and consequently – in the longer term – to sustainable economic growth and price stability. Monetary policy supporting financial system stability is thus consistent, in the longer term, with the achievement of the basic objective of the central bank's activity i.e. ensuring price stability, although it may occasionally pose a risk of temporary deviation of inflation from the target. In order to maintain consistency between attempting to keep inflation at the target and supporting financial system stability, under certain conditions it may be necessary to lengthen the inflation target horizon.
- Sixth, the stability of the financial system, economic balance and long-term stability of inflation are closely dependent on developments in lending. If lending expands significantly faster than GDP over a longer period, imbalances in the economy may escalate, especially if credit growth and real property prices reinforce each other in

a feedback loop. Monetary policy, supported by macroprudential policy, should strive to prevent unsustainable booms in the mortgage markets, as their collapse can trigger a sharp and prolonged economic slowdown.

- Seventh, in order to preserve financial stability and curb the risk of imbalances building up in the economy, macroprudential policy is of particular importance, which, through selective impact on certain credit aggregates and asset prices may be a more adequate tool in limiting macroeconomic imbalances than monetary policy, as it involves less cost to the real economy.
- Eighth, in assessing the degree of monetary policy restrictiveness not only should the level of real interest rates (i.e. adjusted for expected inflation) be considered but also the level of the real exchange rate (i.e. adjusted for the price level at home and abroad). Thus understood restrictiveness of monetary policy impacts, along with the implemented fiscal and macroprudential policies, the total restrictiveness of macroeconomic policy. Ensuring price stability amidst an overly expansionary fiscal policy may require a tight monetary policy, including keeping interest rates at a heightened level. In turn, if fiscal policy is tightened, monetary policy can be looser, in particular if fiscal tightening weighs heavily on economic activity.
- Ninth, monetary policy is pursued under uncertainty, which means that economic processes cannot be precisely managed. This natural uncertainty means that while taking decisions related to monetary policy it is necessary to take into account all available information relevant for inflation developments, rather than the results of inflation projection only. Models used by central banks to forecast inflation may be imperfect in adequately reproducing behaviour of the economy if only because of its ongoing structural changes. In addition, it is not possible to adopt a simple policy rule which could be ex ante known to market participants.
- Tenth, an important input into the monetary policy decision-making process is the balance of factors affecting the probabilities of future inflation running above or below the target. This balance is based on the assessment of the economic developments, including the inflation projection. While assessing the factors affecting future inflation, the Council takes into consideration the past inflation developments since they have a bearing on the anchoring of inflation expectations at the inflation target. In particular, the Council takes into account the length of the period in which inflation remained close to the target and the length of the period in which it deviated from the target.

It needs to be emphasised that due to the lags in the response of the economy to the monetary policy, the impact of current monetary policy on current inflation is limited. Current decisions of the monetary authorities affect price developments in the future, just as the current inflation is influenced by interest rate changes made several quarters before. However, the time lag between an interest rate decision and its strongest impact on real variables (output, employment) and then on inflation is not constant. It depends, to a large extent, on structural and institutional changes in the economy. Those changes mean that central banks can assess this time lag only approximately. Turmoil in the domestic and international financial system may constitute an additional factor disrupting the monetary transmission mechanism. In view of the above factors, central banks allow the possibility of

current inflation running temporarily outside the band for deviations from the target, while striving to maintain price stability in the medium term.

Since joining the EU, Poland has been obliged to strive for full participation in the third stage of the Economic and Monetary Union (EMU), which has to be preceded, in the first place, by joining the ERM II. If a decision is taken on Poland joining the ERM II, the Council will make all necessary adjustments to the monetary policy strategy and – in consultation with the Council of Ministers – to the exchange rate policy to conditions ensuing from the necessity of meeting the convergence criteria required for the euro adoption. In the opinion of the Council, Poland's participation in the ERM II and the euro area should be considered after the financial crisis in the euro area countries has been overcome and the final institutional framework of the euro area has been established, under the conditions that would allow for the maximization of benefits offered by currency integration and minimization of its costs.

Chapter 2

Monetary policy instruments



Monetary policy instruments

Interest rate

The principal instrument of monetary policy is the short-term interest rate – NBP's reference rate. Changes in this rate result from the direction of the implemented monetary policy.

NBP's reference rate determines the yield obtainable on the main open market operations while, at the same time, affecting the level of short-term market interest rates.

NBP's lombard rate determines the cost of obtaining liquidity at NBP. It sets the ceiling for the overnight market rate.

NBP's deposit rate determines the interest on deposits made with NBP. It provides the floor for fluctuations of the overnight market rate.

The levels of NBP's deposit and lombard rates set the corridor for overnight interest rate fluctuations in the interbank market.

Open market operations

Open market operations are used to influence banking sector liquidity conditions in a way which allows to keep short-term market interest rates at a level consistent with the binding inflation target as set by the Monetary Policy Council. In particular, the central bank conducts open market operations on such a scale as to enable the POLONIA rate to run close to NBP's reference rate.

Main operations are carried out on a regular weekly basis, typically with a 7-day maturity. A fixed rate at the level of NBP's reference rate is binding during tenders. Due to the expected persistence of liquidity surplus in the banking sector in 2014 these operations will be carried out in the form of NBP bills issue.

Fine-tuning operations may be conducted in order to limit the volatility of short-term market interest rates. They may involve liquidity-absorbing operations (issue of NBP bills, reverse repo transactions) or liquidity-providing operations (redemption of NBP bills before maturity, repo transactions). The maturity and yield of these operations as well as the exact manner in which they are carried out depend on the situation in the banking sector.

Structural operations may be conducted in order to influence long-term liquidity structure in the banking sector. If required, the central bank may carry out the following structural operations: bond issue, purchase or sale of securities in the secondary market.

Reserve requirement

The system of required reserves contributes to the stability of the shortest-term market interest rates in the reserve maintenance periods. The fact that banks hold balances on accounts with NBP means that during each business day they have funds readily available to facilitate mutual settlements. At the same time, the averaged reserve requirement system allows banks to determine the amount of funds held on the current account with the central bank throughout the maintenance period.

The reserve requirement also reduces the amount of surplus funds at banks' disposal. This means that the reserve requirement – amidst liquidity surplus in the banking sector – contributes to lower volume of the liquidity-absorbing open market operations.

Changes in the required reserve ratio depend on the liquidity level in the banking sector as well as the conditions prevailing in the interbank market.

Standing facilities

Standing facilities are aimed at limiting the scale of overnight market rate fluctuations. Banks participate in these facilities on their own initiative.

Standing deposit facility enables banks to deposit their liquidity surpluses with the central bank on an overnight basis. The interest on the facility constitutes the floor for the market rate quoted for this period.

Standing credit facility (Lombard credit) enables banks to obtain overnight credit. The Lombard credit is collateralised with assets accepted by the central bank. The interest on this credit expresses the marginal cost of obtaining funds from the central bank, which constitutes the ceiling for the overnight rate.

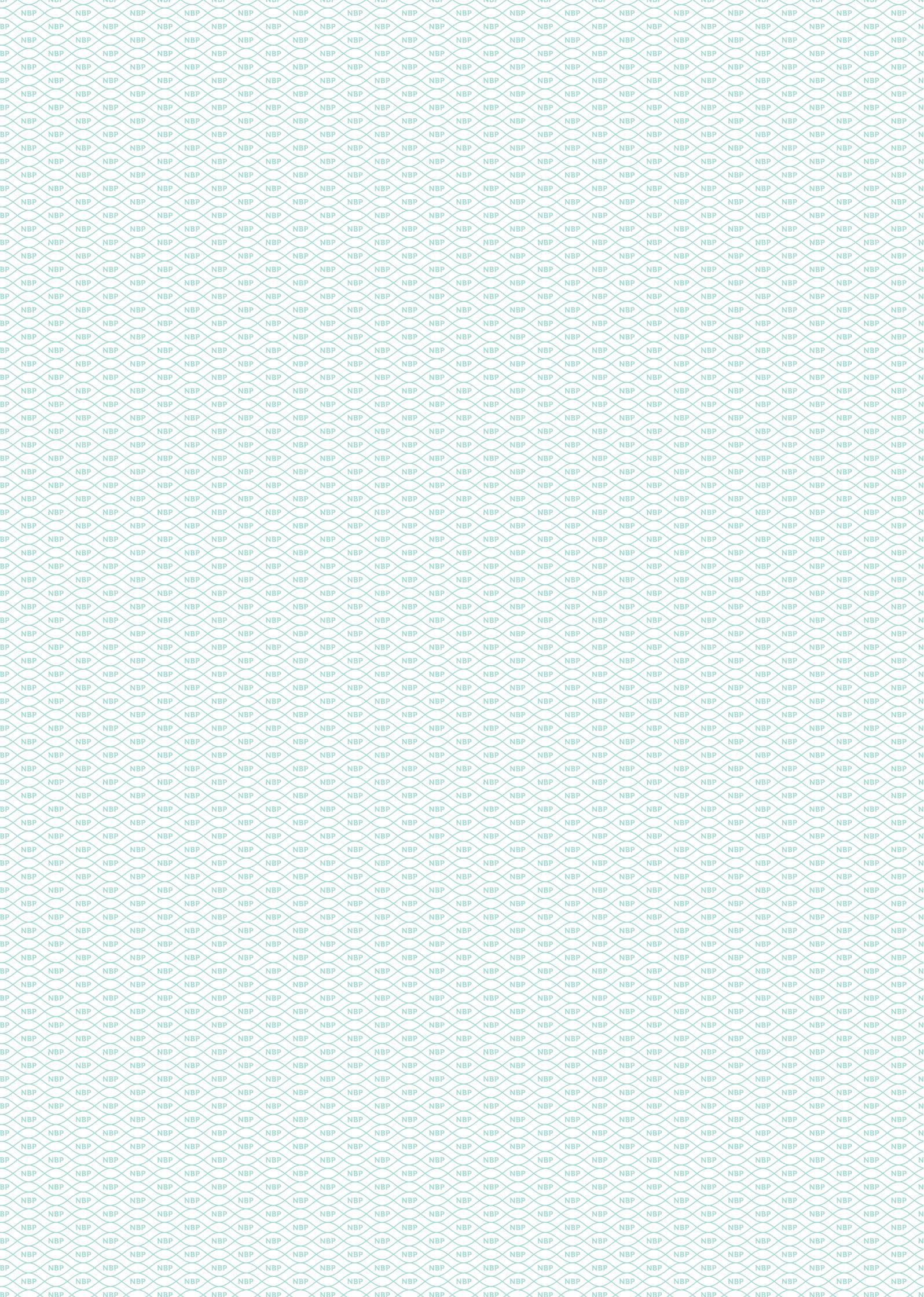
Intraday credit facility involving both zloty- and euro-denominated non-interest bearing loans offered by NBP is an important element of NBP settlement system, as the source of funds to be obtained during the business day. These loans are collateralised with assets accepted by the central bank.

Foreign exchange swaps

NBP may carry out foreign exchange swaps. This is a transaction in which NBP purchases (or sells) Polish zloty for foreign currency in the spot market and, at the same time, resells it (or repurchases) under a forward contract at a specified date.

Foreign exchange interventions

Foreign exchange interventions are another monetary policy instrument which may be used by NBP.



Chapter 3

Monetary policy in 2014 and its determinants



Monetary policy in 2014 and its determinants

Macroeconomic developments in the first half of 2013

In the first half of 2013, global economic activity remained low, yet diversified across economies. In the United States, despite a substantial fiscal tightening, the economic climate remained relatively favourable, supported by strongly expansionary monetary policy as well as improving labour and real estate market conditions. In the euro area, recession continued in 2013 Q1, however a slight recovery was observed in 2013 Q2. Positive GDP growth was recorded in 2013 Q2 in most euro area economies, including Germany. On the other hand, in economies affected by the debt and competitiveness crisis (i.e. Italy and Spain) GDP continued to shrink, albeit at a slower pace than before. At the same time, in the first half of 2013 GDP growth in the largest emerging economies was running low relative to their historical performance.

Persistently weak economic activity in the first half of 2013 supported the decline in inflation in the developed economies. A slowdown in growth of food and energy prices enhanced this trend. In the emerging economies inflation remained moderate.

In the analysed period, major central banks continued strongly expansionary monetary policy. The European Central Bank decreased the interest rate on the main refinancing operations by 0.25 percentage point (to 0.5%), hinting at keeping interest rates low for an extended period of time. At the same time, the ECB maintained its preparedness to launch the programme of purchasing sovereign bonds of countries most severely hit by the debt crisis. In turn, the Federal Reserve kept the short-term policy rate at a near-zero level (0.00-0.25%) while leaving the quantity of asset purchases unchanged at USD 85 billion a month. However, since May the Fed has indicated the possibility of the quantitative easing programmes being tapered in 2013. Also the Bank of Japan kept its interest rates unchanged (at 0.0-0.1%). At the same time, a new asset purchase programme was announced, in which the Bank of Japan obliged to double the monetary base within two years while simultaneously increasing the inflation target.

The expansionary policy of major central banks boosted confidence in the financial markets in the first months of 2013, in particular, in the developed economies. In the emerging economies, confidence improvement was halted by the publication of weaker than expected macroeconomic data. In May and June, as the Federal Reserve indicated the possibility of earlier than expected tapering of the quantitative easing programme, sentiment in the financial markets deteriorated. This spurred an outflow of capital from emerging markets, leading to a depreciation of their currencies and a rise in yields on bonds, after their previous significant decrease.

In Poland, economic growth in the first half of 2013 was weaker than in 2012, despite its certain rebound in Q2. The slowdown was attributable to decrease in domestic demand. In the first half of 2013 investment was falling and growth in consumption decelerated to

a near-zero level. The main category contributing to economic growth was net exports, which resulted from accelerating exports and further fall in imports.

Slow GDP growth in the first half of 2013 resulted largely from further measures to curb the general government sector deficit. In 2012, the deficit of the general government sector was reduced to 3.9% of GDP (from 5.0% of GDP in 2011). In 2013 structural fiscal tightening has continued, largely as a result of a decline in public investment spending as compared to the previous years. The decline in public investment was related to completion of infrastructural projects launched in the run-up to Euro 2012 and adjustments arising from the application of the local government fiscal rules. Despite the ongoing fiscal tightening, the deficit of the general government sector may rise in 2013 owing to the economic slowdown and the operation of the so-called automatic stabilisers¹.

Slow economic growth persisting into the first half of 2013 led to a decrease in the number of working persons in the economy and a rise in the unemployment rate. At the same time, weak demand for labour caused wage growth to decrease compared to its 2012 level.

In the first half of 2013, bank lending – both to corporations and households – was constrained. In the case of households, credit growth was dragged down by weak demand, resulting specifically from households' worsening economic condition and the winding up of the *Family on Its Own* programme. However, in 2013 Q2 signs of a possible rebound in household lending were observed, particularly in the consumer credit segment. As regards corporate lending, slowdown observed in the first half of 2013 stemmed from both weak demand and tighter lending conditions set by banks. On the other hand, lending in the economy was supported by NBP interest rate cuts, translating into lower interest charged on corporate credit, mortgage loans to households and – to a smaller extent – on consumer loans.

In the period under review, CPI inflation decreased considerably, running at levels well below the NBP inflation target. The decline in inflation was primarily caused by weaker growth of energy prices, which was related to both the decline in administered prices of natural gas and lower than the year before prices of energy commodities in the global markets. Also growth of food prices lost momentum, in particular as regards processed food. This resulted from weaker demand, favourable supply conditions and declining energy prices, which dragged down production costs. Slower CPI growth additionally stemmed from weak demand growth in the economy, as evidenced by low levels of core inflation.

In the first half of 2013, the Council continued the cycle of monetary policy easing commenced in November 2012. Over the entire cycle, the Council decreased NBP interest rates by 2.25 percentage points, in particular reducing the reference rate to the level of 2.5% in July 2013, thus keeping this rate positive in real terms. Interest rate cuts were determined by the fact that the economic slowdown had proved more severe than expected, causing the inflationary pressure in the economy to ease considerably. In the assessment of the Council, the significant reduction of NBP interest rates, implemented until July 2013, supports economic recovery and limits the risk of inflation running below the inflation target in the medium term.

¹ The economic slowdown brought about a drop in the tax revenue of the state budget in the first half of 2013, forcing the government to submit a draft amendment to the 2013 Budget Act.

Monetary Policy in 2014

Stabilising inflation at $2.5\% \pm 1$ percentage point in the medium term will remain the main objective of monetary policy in 2014, which will support balanced economic growth.

Monetary policy parameters, including the level of NBP interest rates, will be flexibly adjusted to the changing economic situation and the ensuing assessment of the likelihood of inflation running in the medium term at a level consistent with the inflation target.

In its decisions, the Council will also take into consideration the condition of the financial sector, whose stability is the precondition for price stability in the longer term. In determining the degree of restrictiveness of monetary policy, the Council will also continue to consider the shape of fiscal policy. Another factor of significance for monetary policy conduct will be macroprudential policy which, together with monetary and fiscal policy, determines the overall restrictiveness of economic policy.

In the case of fierce escalation of the crisis in Poland's external environment and serious turmoil in the domestic financial market, the Council allows for the possibility to flexibly adjust the monetary policy instruments, in particular, to use open market operations with various maturities as well as to adjust the type of collateral in open market operations to the situation in financial markets.

In 2014, monetary policy will probably continue to be conducted under uncertainty, changing sentiments and volatile risk aversion in the global economy. The outlook for global economic growth will continue to be a source of uncertainty, which may be related to weak, despite somewhat improved, economic conditions in the euro area. Strongly expansionary monetary policy of major central banks, resulting in heightened asset price volatility, will provide another source of uncertainty. The process of quantitative easing tapering by these banks may trigger sudden shifts in risk assessment in the global financial markets, increasing, at the same time, the volatility of exchange rates and bond yields, thus affecting the domestic economic processes, including inflation developments.

Macroeconomic determinants of monetary policy in 2014

In 2014, the Polish economy will continue to be significantly affected by the conditions in the global economy. Current forecasts expect 2014 GDP growth in the United States to exceed 2013 figure and approximate the long-term average. In the euro area, the gradual economic recovery is expected to continue, supported by stronger GDP growth in Germany, Poland's main trading partner. Amidst weak demand pressure in the global economy and the absence of major shocks in the commodity markets, global inflation should remain moderate.

In parallel with somewhat faster global GDP growth, a gradual rebound in economic activity is also anticipated in Poland. The gradual acceleration of GDP growth in Poland will also be supported by a marked easing of monetary policy implemented in 2012 and 2013, contributing to higher domestic demand. Yet, in 2014 GDP growth in Poland will probably remain below its potential, which will help to keep inflation low. Expected recovery in GDP growth in Poland, could gradually translate into a improvement in labour market conditions.

Demand in the Polish economy is likely to be still hampered by further fiscal policy tightening, which, however, is indispensable to maintain public finance stability in the longer run and meet the obligations resulting from the EU Stability and Growth Pact. The government's *Guidelines for the 2014 Draft Budget* foresee an extension of the wage freeze in most units of the central government and social insurance subsectors. Moreover, the *Convergence Programme, 2013 Update* provides for a further reduction in public investment due to reduced absorption of EU structural funds.

Bank lending can be expected to remain subdued in 2014, which will be related to the moderate GDP growth. Lending in the economy may be supported by the government's programme of credit guarantees for small and medium enterprises and the relaxation of supervisory regulations relating to consumer loans. Moreover, banks' credit policy will be affected by the amendment to Recommendation S – regarding housing loans – which will take effect in 2014.

Liquidity in the banking sector in 2014

It is expected that in 2014, as in the previous years, monetary policy will be conducted under the conditions of excess liquidity in the banking sector. The amount of this surplus, which has been stable since the beginning of 2013, may rise slightly in 2014.

The level of the liquidity surplus will be strongly affected by the decisions of the Ministry of Finance, including the decisions on financing the borrowing needs of the State budget, servicing foreign debt of the Treasury and the use of EU funds. These decisions are related to the consolidation of the state budget accounts process.

The funds obtained from the EU that are to be used in the domestic currency need to be exchanged. The way those funds are exchanged has crucial importance for the level of banking sector liquidity. If the central bank purchases the inflowing foreign currency, the liquidity surplus in the banking sector will increase. On the contrary, exchanging EU funds directly in the interbank market has no impact on the level of the liquidity surplus.

Servicing Poland's external debt through the use of funds kept on the Ministry of Finance foreign currency account with NBP, credited mainly with proceeds from the issue of bonds in foreign markets, is neutral in terms of excess liquidity. If, on the other hand, the Ministry of Finance obtains foreign currency needed to service the debt through the purchase of foreign currency at NBP, the liquidity surplus in the banking sector will decline.

A gradual expansion in currency in circulation as well as deposits, which constitute the base for calculating required reserve, will curb surplus liquidity in the banking sector.

Monetary policy communication in 2014

Communication of the central bank with the public is an important element in monetary policy implementation. As part of its communication policy, the Council presents its assessment of the current and future economic developments. As in the previous years,

publication of the *Monetary Policy Council Press Releases* and press conferences held after the MPC meetings, as well as *Minutes of the Monetary Policy Council Decision-Making Meetings* and voting of the Council members, *Inflation Reports*, *Monetary Policy Guidelines* and the *Report on Monetary Policy Implementation* will remain the most important communication tools in 2014.

Narodowy Bank Polski

