NBP Narodowy Bank Polski

Monetary Policy Council

# Monetary Policy Guidelines for 2016

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Warsaw, 2015

In setting the *Monetary Policy Guidelines for 2016* the Monetary Policy Council fulfils the requirements of Article 227 of the Constitution of the Republic of Poland, which obligates it to present monetary policy guidelines to the Sejm on an annual basis, concurrently with the submission of the draft Budget Act by the Council of Ministers. Pursuant to Article 53 of the Act on the National Bank of Poland (Narodowy Bank Polski), the *Monetary Policy Guidelines* are published in the Official Gazette of the Republic of Poland, *Monitor Polski.*

The *Guidelines* present the key 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 2016. In addition, the *Guidelines* comprise a description of monetary policy instruments.

The *Monetary Policy Guidelines for 2016* take into account information available up to 7 September 2015.

The *Monetary Policy Guidelines for 2016* is a translation of the publication of Narodowy Bank Polski entitled *Założenia polityki pieniężnej na rok 2016*. In case of discrepancies, the original prevails.

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# Introduction

In the first half of 2015, global economic growth remained moderate, with economic performance continuing to vary significantly across countries. While in the United States and Great Britain economic conditions gained further strength, in the euro area activity growth continued at a moderate pace, notwithstanding a gradual recovery. At the same time, GDP growth in emerging economies – especially in China – slowed down, hampering the exports of developed countries and exerting a downward pressure on commodity prices. The different scale of economic recovery in developed economies translated into divergent monetary policies between the United States and the euro area, which are likely to continue into 2016.

Moderate economic growth worldwide is accompanied by a slow, and – in some countries – negative, price growth. The persistently low global inflation continues to be largely driven by developments in commodity prices, which, after a sharp decline in the past year, show no clear signs of rebounding. Although the risk of persistent deflation in the euro area has diminished, market measures of inflation expectations based on prices of financial instruments continue to point to a sizeable probability of a cumulative price decline in a two-year horizon. Threats related to deflation – especially the risk of rising real burden of public and private debt repayments, and the risk of de-anchoring of inflation expectations – were probably among the reasons for the ECB's introduction of the quantitative easing programme.

Against this background, the following external determinants of the NBP monetary policy in 2016 emerge. Firstly, moderate GDP growth and low inflation abroad, especially in the euro area, may weaken both the economic recovery and price growth in Poland. Secondly, the slowdown in emerging economies, particularly in China, may dampen the demand of these economies for goods manufactured in other countries and deteriorate general sentiment, which would have an adverse impact on economic conditions in Poland's external environment, especially in the euro area. Given China's considerable share in the global demand for commodities, a more marked slowdown in this economy would also dampen their prices, thus additionally reducing inflation across the world – including in Poland. Thirdly, the likely tightening of monetary policy by the Fed and its impact on international capital flows may trigger relative changes in the prices of individual assets including exchange rates; it may also boost their volatility. Heightened volatility in the financial markets may interfere with the conduct of monetary policy, especially in small open economies, in which capital flows constrain the effectiveness of this policy.

The NBP monetary policy in 2016 will depend on the cumulative impact of the above-listed external factors and internal conditions on the economic situation, including domestic price developments.

Although price growth in Poland was below the inflation target, or even below zero over the past year, a stable real GDP growth has been sustained for the last few quarters. Furthermore, amidst rising employment, nominal wage growth remains stable and enterprises' financial performance is sound. The absence of adverse effects of the negative price growth on the private sector is due to the relatively low indebtedness of this sector. Moreover, the sources of deflation are predominantly external and affect mostly the prices of food and energy, which for most economic agents in Poland is a factor positively influencing their economic situation.

Taking into account the external, and probably temporary nature of the shocks causing price growth to deviate from the target, while not intending to allow for a sustained decrease of long-term inflation expectations – as this might increase the risk of deflation persistence and, hence, its adverse macroeconomic effects – the Council has decided to maintain the key elements of NBP monetary policy framework, in particular, to keep the medium-term inflation target unchanged at 2.5% with a symmetrical band of deviations of ±1 percentage points.

When formulating the *Monetary Policy Guidelines for 2016*, the Council has taken into account the uncertainty related to the direction and nature of shocks which might occur in the economy. For this reason, the Council intends to continue to use the flexibility of the NBP monetary policy strategy, focusing on the medium-term character of the inflation target. This means that monetary policy will continue to take into account the impact of any potential supply shocks or global factors – given the lags in the transmission mechanisms – on price developments, causing periodic deviations of inflation from the target.

Considering that the NBP tasks include measures to support the stability of the domestic financial system, the Council judges macroprudential policy to be an indispensable instrument complementary to the flexible inflation targeting. Given the considerable freedom of capital flows and the integration of the financial markets, the effectiveness of monetary policy may be partially limited. Under such circumstances optimal economic policy requires using the tools which might directly affect sources of funding, the structure and risk of lending in the economy. For this reason, it is important to implement the recommendation of the European Board for Systemic Risk concerning the creation, at the national level, of institution responsible for macoprudential policy as well as to ensure the central bank's leading role in the conduct of this policy.

# Chapter 1. Monetary policy strategy

According to Article 227 Section 1 of the Constitution of the Republic of Poland, "Narodowy Bank Polski shall be responsible for the value of Polish currency". The Act on Narodowy Bank Polski of 29 August 1997 states in Article 3 section 1 that "the basic objective of the activity of 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 NBP".

Nowadays central banks define price stability as low, yet positive inflation, which does not adversely affect the decisions of economic agents, including investment and savings decisions. Price stability may be threatened not only by excessive inflation, but also by persistent deflation, especially if accompanied by slow economic growth or stagnation.

By ensuring price stability, NBP contributes to sustainable economic growth in Poland.

Since 1998, the Monetary Policy Council has been pursuing the price stability objective within the inflation targeting framework. The essence of this framework consists in acknowledging price stability as the primary objective of monetary policy and in a public announcement of a numerical target for inflation.

Following a period of disinflation in 1998-2003, during which inflation targets were set annually, in 2004 the Council adopted a continuous medium-term inflation target of 2.5%, with a band for deviations of +/-1 percentage points.

Over more than the past ten years, the monetary authorities have succeeded in ensuring price stability (average annual growth of CPI in Poland has been 2.4%, i.e. close to the target set by NBP), amidst relatively stable economic growth and the absence of major macroeconomic imbalances. This shows inflation targeting to be an effective strategy for maintaining price stability, and indirectly – for ensuring macroeconomic stability.

Yet, the analysis of the causes of the global economic crisis has led to a partial modification of the views on the appropriate way of implementing monetary policy. Nowadays, it is generally accepted that stabilising inflation at low levels is a very important, if insufficient condition to keep the economy in equilibrium. In order to ensure macroeconomic stability monetary policy has to be pursued in a manner which – while striving to keep inflation at the target in the medium term – would simultaneously curb the risk of imbalances mounting in the economy, especially in the financial system.

Taking this into consideration, NBP continues to conduct monetary policy within the inflation targeting framework. At the same time, NBP implements monetary policy in a flexible manner, putting strong emphasis on preserving long-term macroeconomic stability, even if at times this is accompanied by inflation running below or above the target.

Besides monetary policy, an important role in maintaining macroeconomic stability is played by fiscal policy. In order to maintain macroeconomic stability it is necessary to pursue a fiscal policy which prevents the general government sector from running up excessive debt and which creates a fiscal space which is necessary to stabilise economic conditions when negative shocks occur. Of prime significance to macroeconomic equilibrium, and to the stability of the financial system, is also appropriate macroprudential policy, which curbs the systemic risk in the financial sector. Fiscal and macroprudential policies adjusted to domestic conditions are particularly important under free capital flows, i.e. particularly within the European Union. This is because domestic monetary conditions are partially determined by policies of major central banks, which may not be fully suitable for macroeconomic conditions in Poland.

With regard to the above, the Council has decided to maintain the key elements of the current NBP monetary policy strategy. At the same time, the Council is taking into account the evolution of views on the role of monetary policy, triggered by the recent global financial crisis and the resulting recession as well as growing impact of external developments on the situation in the Polish economy. Hence, when implementing monetary policy the Monetary Policy Council places increased emphasis on flexibility of the inflation targeting strategy and the necessity to include macroprudential policy in the range of stabilisation instruments of the State.

Consequently, in 2016, the monetary policy strategy will be pursued within the following framework:

- First, the Council pursues the medium-term inflation target of 2.5% with a symmetrical band of deviations of ± 1 percentage point. The medium-term orientation of the target means that although it refers to inflation as measured by the annual percentage change in the level of consumer prices in a given month in relation to the corresponding month of the previous year, shocks affecting the economy may cause inflation to temporarily deviate from the target. Striving to keep inflation as close as possible to the target each quarter would require frequent and considerable changes in the interest rates, which would generate significant costs for the real economy, and under certain circumstances could pose a threat to financial stability.
- Second, the monetary policy response to shocks and the resulting deviations of inflation from the target depend on the underlying cause and the character of these shocks and the assessment of the sustainability of their effects, including their impact on price developments and inflation expectations. The Council flexibly determines the time necessary for inflation to return the target, depending on the character of the shock, its persistence and the overall assessment of risks posed by the shock to both price stability and broadly understood macroeconomic stability in the medium term.
- Third, the Council implements inflation targeting under the floating exchange rate regime. The floating exchange rate regime does not rule out interventions in the foreign exchange market when they prove necessary to ensure macroeconomic and financial stability of the country, which is conducive to meeting the inflation target in the medium-term.

- Fourth, the Council conducts monetary policy in such a way so as to support the stability of the financial system, which is necessary to ensure price stability in the longer term and enable smooth functioning of the monetary policy transmission mechanism. Therefore, in its decisions the Council takes into account the prices of assets, especially the prices of real estate, and growth in lending. In order to support the stability of the financial system it may be necessary – under certain conditions – to lengthen the horizon of achieving the inflation target.
- Fifth, macroprudential policy is also of considerable significance for financial stability and mitigating the risk of economic imbalances. This policy is characterised by, among others, the capacity to selectively influence certain credit aggregates, above all, mortgage loans. For this reason, macroprudential policy can be a more effective tool in reducing macroeconomic imbalances than monetary policy.
- Sixth, flexibility of the monetary policy strategy pursued by the Council means that the NBP instruments and types of collaterals used will be adjusted to the character of disturbances that may occur in the financial markets. Flexibility of monetary policy instruments is conducive to the effective operation of the transmission mechanism and supports macroeconomic and financial stability, which are necessary for ensuring price stability in the longer term.
- Seventh, when assessing the degree of monetary policy restrictiveness not only the level of real (i.e. adjusted for inflation expectations) interest rates should be considered, but also the level of the real (i.e. adjusted for the price level at home and abroad) exchange rate. The restrictiveness of monetary policy is connected with the implemented fiscal and macroprudential policy; these in combination determine the degree of restrictiveness of macroeconomic policy.
- Eighth, due to lags in the transmission mechanism, the impact of the currently pursued monetary policy on current inflation is limited. Therefore, current decisions of the monetary authorities affect future price developments, while current inflation is influenced by interest rate decisions taken several quarters before. However, the time lag between an interest rate decision and its peak impact on real variables (output, employment) and then on inflation is not constant. Disturbances in the domestic and international financial system may constitute an additional factor disrupting the monetary transmission mechanism.
- Ninth, monetary policy is pursued under uncertainty, which excludes the possibility of a precise management of economic processes. For this reason, in taking monetary policy decisions it is necessary to consider the largest possible set of information relevant for inflation developments.

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 by participation the ERM II. If it is decided that Poland should join the ERM II, the Council will make all necessary adjustments in the monetary policy strategy and – in consultation with the Council of Ministers – in the exchange rate regime, in order to meet 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 in a situation that would allow for the maximization of benefits offered by currency integration and the minimization of its risks.

# Chapter 2. Banking sector liquidity and monetary policy instruments in 2016

**Banking sector liquidity in 2016**

It is expected that in 2016 monetary policy will be conducted in conditions of the banking sector liquidity surplus.

The level of the banking sector liquidity surplus will be primarily affected by the measures taken by the Ministry of Finance in relation to financing the borrowing needs of the state budget, foreign debt service and the use of EU funds. Any operations involving foreign currency transactions with NBP affect the level of the banking sector liquidity. If foreign currencies are purchased by the central bank, the banking sector liquidity surplus increases; the sale of foreign currencies causes the decrease of the banking liquidity level. The service of the foreign debt executed through the foreign currency account of the MF with NBP as well as an exchange of budgetary foreign currency funds in the interbank market are neutral in terms of banking sector liquidity.

It is expected that the reduction in the excess liquidity of the banking sector, a process observed since 2014, will continue in 2016, although it is possible to be on a smaller scale. A steady rise in currency in circulation and in deposits being a base for calculation of the required reserve level will gradually limit the amount of the banking sector excess liquidity. The net purchase of foreign currencies resulting from FX transactions will have the opposite effect, namely increasing the surplus liquidity.

**Monetary policy instruments in 2016**

**Interest rate**

The principal instrument of monetary policy is the short-term interest rate – NBP's reference rate. Changes in its level 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 fluctuations in 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 the NBP 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 liquidity conditions in the banking sector in a way which allows to keep short-term market interest rates at a level consistent with the inflation target set by the Monetary Policy Council. In particular, the central bank conducts open market operations on such a scale so 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 continued liquidity surplus in the banking sector in 2016, these operations will be carried out in the form of issue of NBP bills.

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 the yield of these operations as well as the exact manner in which they are carried out depends 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: issuance of bonds, and 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 account 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 level of liquidity in the banking sector as well as the conditions prevailing in the interbank market.

**Standing facilities**

Standing facilities are designed to limit the scale of overnight market rate fluctuations. Banks use standing facilities at 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 overnight deposit 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 (including Treasury securities, securities issued by NBP, municipal bonds, covered bonds and corporate bonds with a high credit rating). The interest on this credit determines the marginal cost of obtaining funds from the central bank, which constitutes the ceiling for the overnight market rate.

**Foreign exchange swaps**

NBP may carry out foreign exchange swaps. This is a transaction in which NBP purchases (or sells) Polish zloty against 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 2016 and its determinants

Stabilisation of inflation at 2.5% ± 1 percentage points in the medium term, which fosters sustainable economic growth, will remain the primary objective of the NBP monetary policy in 2016. Monetary policy parameters, including the level of the NBP interest rates will be flexibly adjusted to the changing conditions in the economy, so as to ensure price stability in the medium term, in line with the guidelines on monetary policy strategy presented in Chapter 1. In 2016, as in the previous years, the Council's decisions on monetary policy and assessment of the current state of the economy and future economic developments will be presented in the *Information from the meetings of the Monetary Policy Council* and at press conferences after meetings of the Council, as well as in the *Minutes from the Monetary Policy Council decision-making meetings, Inflation Reports, Monetary Policy Guidelines* and *Report on monetary policy implementation.*

**External determinants of monetary policy in 2016**

In the recent quarters, a moderate recovery in the global economy continued, with growth rates varying across the major economies. Whereas in developed economies GDP growth picked up gradually – with growth differential between the United States and the euro area – it slowed down in China, Russia and Brazil. In 2016, only a slight acceleration of global growth can be expected.

The moderate increase in global economic activity in the recent quarters has been a factor behind persistently low inflation in many countries. Price growth was further reduced by a sharp decline in commodity prices, especially oil, which largely resulted from an increase in its global supply. At the same time, oil price growth was curbed by the weakening growth in demand for this commodity from the emerging countries accompanied by weak demand from the developed countries. It is expected that along with the recovery in global economic activity and the fading impact of the previously observed declines in the prices of energy commodities on price growth, inflation in 2016 will increase slightly.

In the euro area the economic conditions are gradually improving, although economic growth remains moderate. GDP growth in the euro area is still dragged down by high debt levels of the private and public sector, as well as the relatively low competitiveness of some economies in the euro area. Despite the adverse impact of these factors on economic growth in the euro area, it is expected to continue to pick up in 2016. The upturn will be supported by the strongly expansionary monetary policy of the ECB, which has contributed to lower long-term interest rates and the depreciation of the euro against major currencies, and supports the recovery in lending. Further easing of fiscal policy restrictiveness in some economies of the euro area may also support demand in the region. As a result, consumption – amid the expected further improvement in the labour market and probably sustained low inflation – should continue to increase. At the same time, it is expected that the significant weakening of the euro will boost exports and corporate investment. Along with stronger economic growth in the euro area in 2016, inflation is expected to gradually increase, yet it will most likely remain below the level consistent with the ECB's definition of price stability.

Potential disturbances related to the implementation of the agreements concluded between Greece and its main creditors remain an important source of risk for further recovery in the euro area. However, it may be expected that the impact of a potential escalation of the Greek crisis on the euro area economy, and consequently on the Polish economy, should be smaller than in 2010-2012.

Another important risk factor is the possibility of a sharper economic downturn in emerging economies, especially in China, which could dampen euro area exports. The uncertainty associated with the Russian-Ukrainian conflict continues to be an additional source of risks for economic growth in the euro area.

Despite a temporary decline in GDP in the early months of 2015, economic conditions have remained good in the United States in the recent quarters. The outlook for the United States also remains favourable. Amidst improvement in the labour market and expansion in lending, further acceleration of consumer demand is expected. Increased productivity and a relatively sound financial condition of firms which significantly reduced the level of debt after the recent financial crisis should also boost economic activity in the United States. On the other hand, the possible consequences of the Fed's expected tightening of monetary policy, possible further strong appreciation of the US dollar and the slowdown in emerging economies are the source of risks for further economic recovery in the United States. Along with the expected acceleration in economic growth in the United States, inflation – after its decline in the first half of 2015, largely driven by the decline in energy prices – should rise again in the coming quarters.

Due to different economic situation in the euro area and the United States, there are also differences between monetary policy pursued by the ECB and the Fed. As expected by the FOMC first interest rate hikes in the United States may occur as early as 2015. In contrast, the ECB eased its monetary policy at the beginning of 2015 by significantly expanding the asset purchase programme. Under this programme, Eurosystem will purchase in the secondary market securities issued by the public and private sector – in the amount of EUR 60 billion per month until the end of September 2016, and in any case until a sustained adjustment in the path of inflation that is consistent with ECB's definition of price stability. An important factor of uncertainty is the impact of the divergent monetary policies pursued in the United States and the euro area on the situation in the world financial markets, including asset prices and exchange rates of currencies in emerging economies.

**Domestic determinants of monetary policy in 2016**

In the first half of 2015 GDP growth in Poland continued at a level similar to that seen in 2014. The growth of domestic demand, including of consumption and investment, observed amidst improving labour market conditions, good financial situation of businesses and growth in lending continued to be the main factor behind economic growth. The recovery was also supported by increased exports, fuelled by improving economic conditions in the euro area.

Available forecasts suggest that in 2016 GDP should continue to grow at a rate close to that seen in the first half of 2015, with domestic demand continuing to be the main driver of GDP growth. In particular, it is expected that the steadily growing consumer demand, observed in the last quarters, will continue in 2016, which will be driven by improving labour market situation and further rise in wages. Improving financial situation of households, along with lower credit cost than in previous years may boost housing investment. The increase should not, however, lead to a build-up of imbalances in this sector due to the further tightening of macro-prudential policy through lowering of the maximum LtV for mortgages. Growth in corporate investment in turn, despite the expected slowdown, should remain robust. Corporate investment will be fuelled by strong financial performance of businesses, high capacity utilization, the expected increase in domestic and foreign demand and lower than in previous years interest rates. Yet, there is a likelihood that public investment will temporarily lose momentum in 2016 as the absorption of EU funds under the 2007-2013 financial perspective come to an end and the new financial perspective funds start only gradually. At the same time, however – according to the current forecasts – public consumption growth will remain at the same level as in 2015. As a result, the net effect of fiscal policy on domestic macroeconomic conditions in 2016 should be close to neutral.

Despite the ongoing economic recovery in the first half of 2015, the annual growth in prices of consumer goods and services remained negative, although since March 2015 the scale of deflation has gradually diminished. Sharp declines in commodity prices are the main factor behind negative price growth. At the same time, the absence of inflationary pressure in the economy is associated with the persistently negative output gap and very low inflation worldwide. Moreover, despite relatively favourable conditions in the labour market, the economy continues to see low wage pressure. Consumer price growth is also curbed by the previously observed decline in food prices, brought about by favourable weather conditions in Poland and the Russian embargo on imports of food products from the European Union.

Available forecasts indicate that along with the fading impact of past declines in oil and food prices, price growth will gradually rise in the coming quarters and in 2016 will be higher than in 2015. Price growth will also be boosted by the expected closing of the output gap amidst economic recovery in the euro area and good situation in the domestic labour market.

In Poland, most macroeconomic indicators confirm lack of macroeconomic imbalances. Taking into account available forecasts, 2016 should also see no significant imbalances in 2016 – neither of external nor internal nature.

Yet, there remains considerable uncertainty around the above macroeconomic scenario associated with the expected economic conditions in Poland and its environment – especially in the euro area – and the situation in the financial markets. Better than expected performance of the domestic labour market and faster recovery in the euro area might boost GDP growth in Poland. On the other hand, economic growth and pick-up in price growth might be threatened by an economic weakening in the environment of the Polish economy driven by a stronger economic decline in China or a possible escalation of geopolitical tensions. These risk factors, if materialized, can lead to increased volatility in asset prices, including exchange rate. At the same time, possibility of limited transmission of good labour market situation on nominal wage growth, as well as developments in commodity prices, continue to be risk factors for price growth.

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