NARODOWY BANK POLSKI

Monetary Policy Council

Monetary Policy Guidelines for 2023

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Warsaw, 2022

In setting the *Monetary Policy Guidelines for 2023*, the Monetary Policy Council, hereinafter the "Council", fulfils the requirements of Article 227 Section 6 of the Constitution of the Republic of Poland, which obligates it to formulate monetary policy guidelines and present them to the Sejm on an annual basis.

In the *Monetary Policy Guidelines for 2023* the Council has maintained the monetary policy strategy pursued by Narodowy Bank Polski, hereinafter "NBP", so far. Price stability remains the main statutory objective of monetary policy. At the same time, monetary policy will be conducted in a way that helps maintain sustainable economic growth and financial stability.

NBP will continue to pursue the strategy of a medium-term inflation target at 2.5%, with a symmetric band for deviations of +/-1 percentage point. NBP's interest rates will remain the principal instrument of monetary policy. Monetary policy will continue to be implemented under the floating exchange rate regime. However, NBP does not rule out interventions in the foreign exchange market. The scope, manner and scale of using monetary policy instruments by NBP will take into account in a flexible way the determinants of monetary policy implementation, including in particular market conditions as well as economic consequences of the Covid-19 pandemic and Russia's military aggression against Ukraine.

The *Monetary Policy Guidelines for 2023* is a translation of the publication of Narodowy Bank Polski entitled *Założenia polityki pieniężnej na rok 2023*. In case of discrepancies, the original prevails.

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Chapter 1. Monetary policy strategy

According to Article 227 Section 1 of the Constitution of the Republic of Poland (Journal of Laws of 1997, item 483, as amended), "Narodowy Bank Polski shall be responsible for the value of Polish currency". The Act on Narodowy Bank Polski of 29 August 1997 (Journal of Laws of 2022, item 492 and 655) 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."

Fulfilling the main obligations of NBP laid down in the Constitution of the Republic of Poland and in the Act on Narodowy Bank Polski, the Council strives to maintain price stability. At the same time, monetary policy is conducted in a way that helps maintain sustainable economic growth and financial stability.

The Council has been pursuing the price stability objective by using inflation targeting strategy. Under this strategy, since 2004 the monetary policy objective has been to keep inflation – understood as the annual change in the consumer price index – at 2.5% with a symmetric band for deviations of +/-1 percentage point in the medium term. In countries pursuing inflation targeting strategy, inflation rate is lower than in other countries, on average. Since 2004, the average annual growth in CPI in Poland has been 2.7%, i.e. has been in line with the NBP's target.

The medium-term nature of inflation target means that due to macroeconomic and financial shocks, inflation may temporarily deviate from the target and even run outside the band for deviations from the target. The response of monetary policy to shocks is flexible and depends on their causes and the assessment of persistence of their consequences, including the impact on inflation developments. Each time inflation deviates from the target, the Council flexibly determines the desirable time necessary to bring it back to the target, as bringing inflation rapidly back to the target may entail significant costs to macroeconomic and financial stability. When deciding on the changes of monetary policy parameters, the Council takes into consideration price adjustments taking place in the economy, whose sources are beyond the impact of domestic monetary policy. In current conditions, these adjustments are mostly related to the shocks caused by Russia's military aggression against Ukraine and consequences of the COVID-19 pandemic as well as to the effects of the structural changes taking place in the economy, including the energy transition, and to the process of Poland's convergence to the more advanced economies.

The monetary policy strategy pursued by the Council assumes flexibility of the instruments applied. This means that the range of instruments used by NBP can be adapted to the nature of disturbances observed in the economy and market conditions. The flexible use of monetary policy instruments is conducive to effective functioning of the transmission mechanism as well as macroeconomic and financial stability.

While taking monetary policy decisions, the Council considers the time lags in the transmission mechanism of monetary policy. The time lag between a decision on monetary policy parameters and its peak impact on real variables (such as output or employment) and on inflation takes several quarters and may change over time. Moreover, monetary policy is conducted under uncertainty, in particular about future economic developments.

Stabilising inflation at a low level is an important, yet insufficient condition to maintain balance in the economy, which, in turn, supports price stability in the long term. Imbalances in the financial sector may pose a threat to long-term price stability. Those imbalances should be counteracted mainly by macroprudential policy aimed at reducing systemic risk and in that manner supporting long-term, sustainable economic growth. This is important especially amid the free movement of capital and highly integrated financial markets. Monetary policy conducted by the Council supports macroprudential policy and in particular is conducive to financial system stability and mitigates the risk of imbalances building up in the economy, by taking into account developments in asset prices (including real estate prices) and lending growth, insofar as this does not constrain the pursuit of the basic objective of NBP.

Besides monetary and macroprudential policy, fiscal policy plays an important role in maintaining macroeconomic stability. A fiscal policy which mitigates the impact of economic shocks, while ensuring long-term stability of public finance, is necessary to maintain macroeconomic stability.

The Council implements the inflation targeting strategy under the floating exchange rate regime. The floating exchange rate regime does not rule out interventions in the foreign exchange market whenever it is warranted by the market conditions or conducive to ensuring the country's macroeconomic or financial stability.

Monetary policy communication is an important element of the Council's inflation targeting strategy. Thus, the Council's decisions together with their determinants are presented in the press releases (*Information from the meeting of the Monetary Policy Council*), as well as in the *Minutes of the Monetary Policy Council decision-making meetings*, *Inflation Reports*, *Monetary Policy Guidelines* and the *Report on Monetary Policy*. Furthermore, the Council's decisions and their determinants may be explained by the Governor of NBP at the press conferences and in the individual statements by the Governor of NBP or the members of the Council.

In line with the adopted strategy, in 2023 monetary policy parameters, including NBP interest rates, will be adjusted to the economic situation so as to ensure long-term price stability and, at the same time, support sustainable economic growth and financial stability.

Chapter 2. Monetary policy instruments in 2023

Determinants of monetary policy instruments

In 2023 the scope, manner and scale of use of monetary policy instruments by NBP will take into account the factors associated with its conduct. As in previous years, monetary policy instruments may be used in a flexible manner to account for the changing macroeconomic and market conditions.

The persistence of liquidity surplus in the domestic banking sector, expected by the central bank, will have a significant impact on the manner and scope of use of monetary policy instruments by NBP in 2023. In this situation, on a net basis – as in previous years – NBP's monetary policy instruments will be of a liquidity-absorbing nature. Banking sector liquidity in 2023 will be boosted by the purchase of foreign currencies by NBP, mainly from the Ministry of Finance. The NBP sale of foreign currencies to the European Commission, related to the currency conversion of the EU membership fee, and a rise in currency in circulation, will have a curbing effect on the level of banking sector liquidity.

The operational target of NBP's monetary policy in 2023 will be to keep the POLONIA rate running close to the NBP reference rate. Depending on the market conditions, the POLONIA rate may deviate from the NBP reference rate within the corridor set by the NBP lombard rate and the NBP deposit rate.

Interest rates

The key instrument of monetary policy in 2023 will be the NBP interest rates.

The NBP reference rate will determine the yield obtainable on the main open market operations conducted by NBP, while at the same time affecting the level of short-term market interest rates.

The NBP lombard rate will determine the interest on the lombard credit offered by NBP, allowing to obtain funds from the central bank on an overnight basis.

The NBP deposit rate will determine the interest rate on deposits, allowing to deposit funds with NBP on an overnight basis.

The discount rate will determine the interest on the bill discount credit.

Open market operations

Main operations will be the key instrument by means of which NBP will strive to achieve the operational target of monetary policy. Through its main operations, NBP will shape liquidity conditions in the banking sector, and consequently – the level of the POLONIA rate. These operations will normally be carried out on a regular basis, typically with a 7-day maturity. During tenders for main operations, NBP will apply a fixed-rate tender procedure with the rate at the level of the NBP reference rate. Due to the expected further persistence of liquidity surplus in the

banking sector in 2023, these operations will be carried out in the form of NBP bills issuance. The manner in which main operations are conducted may be modified if justified by a change in market conditions or parameters of NBP's monetary policy.

Fine-tuning operations will be an instrument supplementing main operations with regard to the achievement of the operational target of monetary policy. Their use may be motivated by the need to provide liquidity or to absorb liquidity from the banking sector. As part of liquidity-providing operations, NBP may offer repo transactions and redeem NBP bills before maturity. In the case of liquidity-absorbing operations, the central bank may issue NBP bills or offer reverse repo transactions. The maturity and yield of these operations as well as the way in which they are carried out will be adapted to the purpose of their application.

Structural operations may be conducted in order to change the liquidity structure in the banking sector in the long term, as well as to ensure the liquidity of the secondary market for debt securities or to strengthen the monetary transmission mechanism. As part of structural operations, NBP may purchase or sell debt securities in the secondary market, as well as issue bonds.

Required reserve system

The main objective of the required reserve system will be to enhance the stability of short-term market interest rates. This is ensured by the averaged reserve requirement, which allows banks to determine the amount of funds held on the account with the central bank throughout the reserve maintenance period, provided that the average level of reserve holdings at NBP does not fall below the value of the required reserve. At the same time, the reserve requirement reduces the scale of NBP open market operations conducted to absorb liquidity surplus.

Changes in the required reserve ratios will depend on the conditions in which monetary policy will be pursued in 2023.

Standing facilities

Standing facilities offered by NBP are designed to limit the scale of overnight market rate fluctuations by stabilising liquidity conditions in the banking sector.

The lombard credit will enable banks to obtain overnight credit from the central bank on each trading day. This credit is collateralised with assets accepted by the central bank, including, among others, government securities, government-guaranteed debt securities, securities issued by NBP, municipal bonds, covered bonds and corporate bonds with a high credit rating. The interest rate on this credit determines the marginal cost of obtaining funds from the central bank, which will act as a ceiling for the overnight market rate.

The deposit facility will allow banks to deposit their liquidity surpluses with the central bank on an overnight basis on each trading day. The interest on the overnight deposit will fix the floor for the market rate determined for this term.

The width of the corridor between the NBP lombard rate and the NBP deposit rate will be shaped in a way conducive to the effective transmission of monetary policy, taking into account the smooth functioning of the interbank short-term deposit market.

Bill discount credit

NBP may offer the bill discount credit aimed at refinancing loans granted to entrepreneurs by banks.

Foreign exchange swaps

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

Foreign exchange interventions

NBP may intervene in the foreign exchange market.

Chapter 3. Monetary policy determinants in 2023

External conditions

In the first half of 2022, economic activity growth varied across economies, and in many countries it was gradually slowing down. Economic conditions were adversely affected by rising prices of energy and agricultural commodities and production components as well as persistent disruptions in global supply chains coupled with high international shipping costs. Russia's military aggression against Ukraine was a major external shock, which compounded the above shocks, and contributed to weaker sentiment and higher uncertainty in the global economy. The above factors contributed to a decline in real GDP in the United States in the first half of 2022. In turn, in the euro area, GDP growth was relatively strong, although the economic outlook had deteriorated markedly. At the same time, labour market conditions remained favourable in both the United States and the euro area, which, combined with sound financial situation of households supported private consumption growth, despite persistently elevated inflation levels. Some emerging economies recorded a considerable weakening in economic activity. In China, this was largely due to an increase in COVID-19 infections and the associated strict sanitary policies, and in Russia and Ukraine, to the economic slump following the war.

Global inflation rose markedly in the first half of 2022, reaching the highest levels in decades in many economies – both advanced and emerging market ones. The main source of the global increase in inflation was the sharp rise in energy and agricultural commodity prices as well as disruptions in global supply chains and international transport, resulting in higher prices of materials and production components. The above shocks were amplified by the effects of Russia's military aggression against Ukraine. At the same time, owing to previous increases in energy prices and recovery in global demand following the pandemic crisis, supported by accumulated household savings and a robust labour market conditions, core inflation increased substantially in many economies. In some economies, fiscal measures were introduced to mitigate the decline in households' purchasing power, which was attributable particularly to a sharp increase in energy and food prices.

Amid a significant increase in inflation across the world, in the first half of 2022 central banks tightened their monetary policy. Most central banks in advanced and emerging market economies raised interest rates and discontinued net asset purchases. Since March 2022, the Federal Reserve of the United States has raised interest rate (by a total of 2.25 percentage points, to 2.25-2.50% as of the end of August). In turn, the European Central Bank launched its first interest rate hike since 2011 in July 2022, and in particular it raised the deposit rate by 0.50 percentage points, to 0.00%. Central banks in Central and Eastern Europe and many non-European emerging market economies significantly tightened their monetary policy by raising interest rates visibly.

Available forecasts point to the risk of a deterioration of global economic conditions in the second half of 2022 and a potential marked slowdown in global GDP growth in 2023, which will put a downward pressure on commodity prices. As a result, it is now expected that following a surge in inflation in 2022, in 2023 – as the factors currently boosting price growth fade and economic activity weakens – inflation should decline, yet it will remain above the central banks' inflation targets in many economies.

Domestic determinants

At the beginning of 2022, the economic conditions in Poland were favourable. The robust economic activity was supported by rising consumption, underpinned by very good labour market conditions, including low unemployment and rising wages, as well as demand generated by the inflow of refugees from Ukraine. Strong domestic demand and the relatively high capacity utilisation were also conducive to higher investment, although this was hampered by rising costs and supply issues. A substantial contribution to GDP growth in 2022 Q1 was made by the increase in inventories. In contrast, the contribution of net exports to GDP growth was negative, due to weaker exports as a result of ongoing supply chain disruptions, amid the still relatively high import growth.

Despite the continuation of favourable economic conditions, Russia's ongoing military aggression against Ukraine since late February 2022, along with the accompanying rise in inflation, resulted in a drop in consumer sentiment and entrepreneurs' assessments of the economic situation. The weakening in economic indicators was largely related to further rise in the prices of commodities and raw materials and problems with their availability, as well as increased uncertainty about future demand. As a consequence, in 2022 Q2 GDP growth declined compared to 2022 Q1.

In the first half of 2022, consumer price growth in Poland – as in many other economies – continued to rise. Inflation grew primarily on the back of the rapidly rising energy commodity prices in global markets, which had picked up significantly after the onset of the Russian military aggression against Ukraine. Since the beginning of 2022, inflation has also been boosted by higher electricity, natural gas and heat energy tariffs driven by the 2021 increases in the prices of energy commodities and carbon emission allowances. Due to higher energy and fertiliser prices and the outbreak of the Russian military aggression against Ukraine, agricultural commodity prices also reached very high levels, which was reflected in a steeper food price growth. Towards higher inflation acted also the ongoing global supply chain disruptions and high prices of international transport. These factors contributed to an increase in firms' operating costs. At the same time, the favourable economic conditions at the beginning of 2022 allowed companies to pass higher costs on to the consumer prices. As a result, core inflation increased further. Consumer price growth was tempered by the Anti-inflationary Shield, which comprised, among others, the abolition of excise tax on electricity for households and a reduction in excise tax on engine fuels, as well as a temporary reduction in VAT rates on selected goods, such as natural gas, electricity, heat energy, fuels for private means of transport and staple food products.

Against this backdrop, the Council continued interest rate increases initiated in 2021. From January to July 2022 the Council raised the NBP reference rate by a total of 4.75 percentage points, i.e. to 6.50%. In February, a decision was also taken to raise the basic required reserve ratio to its pre-pandemic levels, i.e. to 3.50%.

Current forecasts indicate that in the second half of 2022 and in 2023, following a period of a robust economic recovery in the previous quarters, GDP growth will weaken significantly. Domestic economic conditions will be framed by the negative supply shock related to the rise in global prices of energy and agricultural commodities and the persistent global supply chain disruptions. The forecast weakening of economic activity in the euro area and in other major economies will also have a negative impact on economic growth in Poland. In turn, the scale of domestic GDP growth slowdown will be mitigated by adjustments in fiscal policy. At the same time, GDP growth can be expected to pick up somewhat in the second half of 2023, which will be underpinned by public investment and improving economic conditions abroad, although GDP growth will remain moderate.

Current forecasts indicate that, owing to the persistent impact of factors boosting price growth so far, inflation will remain high in the second half of 2022. In contrast, in 2023 – as their impact on price growth diminishes amid slower domestic demand growth and the expected weakening of cost pressures in the labour market, as well as due to the effect of the NBP interest rate rises – inflation is anticipated to decline. At the same time, owing to the scale and persistence of previous macroeconomic shocks, including, in particular, commodity shocks, which were exacerbated by the war in Ukraine, the expected decline in inflation will take place gradually.

Uncertainty factors

The macroeconomic scenario outlined above is subject to high uncertainty. The main factor of uncertainty relating to economic conditions and price developments worldwide, including in Poland, in 2023, is the future geopolitical situation as well as the extent and persistence of disruptions to the functioning of the global and European economy caused by Russia's military aggression against Ukraine. In this context, the situation in the European energy market is particularly crucial. Owing to the hitherto significant share of Russia in European imports of energy commodities, changes in the volume of these imports as well as the possibility to substitute them, may have a major impact on future levels of these commodities prices.

There is also uncertainty about the scale and persistence of the expected deterioration in global activity and the subsequent pace of improvement in macroeconomic conditions. High uncertainty also surrounds the scale of production and possibility to export agricultural commodities from Ukraine , as well as other factors, including agrometeorological ones, which may affect food prices in international markets and in Poland.

Furthermore, the persistence of global supply chain disruptions is another risk factor, which can be driven – apart from the war in Ukraine – by developments in the COVID-19 epidemic in China

and the epidemic policy pursued by Chinese authorities. The future path of the pandemic continues to be a source of risk also in other countries.

Finally, uncertainty about domestic economic conditions, and, above all, about inflation developments in 2023, relates to fiscal policy response to macroeconomic shocks, including how long the Anti-inflationary Shield arrangements will remain in place.

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