



Monetary Policy Strategy beyond 2003

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I Introduction

According to the *Medium-Term Strategy of Monetary Policy (1999-2003)* adopted by the Council in September 1998, the inflation rate was not supposed to be above 4% at the end of the period. *The Monetary Policy Guidelines for the Year 2003* set a more specific short-term inflation rate target of 3% with permitted fluctuations of ± 1 percentage point. In December 2002, the twelve-month inflation rate reached 0.8%, and the annual average inflation rate for 2002 was 1.9%. Thus, inflation in Poland fell to a level observed in developed countries in recent years. The vast majority of forecasts indicate that the inflation rate at the end of 2003 will be low enough to meet the mid-term monetary policy objectives.

The Monetary Policy Strategy beyond 2003 has been developed for a number of reasons.

Firstly, it is required that monetary policy based on a direct inflation target define the inflation target over a medium-term horizon. This leads to the enhancement of the flexibility of monetary policy in response to unexpected events and creates the most favourable economic conditions for the attainment of the key objective of the policy. Additionally, the medium-term perspective of relatively stable prices supports the preservation of low inflationary expectations, thus building up favourable foundations for high economic growth.

Secondly, due to delays in the monetary transmission mechanism, the effects of the decisions taken in 2003 will be fully seen as late as in 2004 to 2005 since, as proven by empirical research, the time lag for the maximum reaction of the inflation rate to a change in interest rates by the NBP takes about 18 months. Since the effects of decisions made in different periods tend to compound, monetary policy should be conducted with a time horizon of several years, to take into account the medium-term targets and the expected conditions in which they will be achieved. For the sake of clarity, the guidelines should be announced to the general public, which explains the reason underlying the mapping out and publishing of *The Monetary Policy Strategy beyond 2003* at this time.

Thirdly, a low inflation rate furnishes monetary policy with a new framework. After a long period of lowering the inflation rate, current monetary policy should be oriented towards its stabilisation at a low level.

Equally important, the Council believes that Poland's prospective membership in the European Union beginning in 2004 necessitates the stabilisation of inflation at a level consistent with an economic policy strategy that assumes Poland's joining the euro-zone at the earliest date possible. In

this process, the zloty will join the Exchange Rate Mechanism 2 (ERM2) and the Polish economy will seek to fulfil the nominal convergence criteria.

The Monetary Policy Council is convinced that Poland would profit the most from the adoption of an economic strategy that fosters optimum conditions for the introduction of the euro in 2007, which is the earliest date possible. The key advantages of euro-zone accession include:

- A substantial reduction of macroeconomic risk.
- Enhanced availability and reduced costs of capital,
- Intensified trade activities with the euro-zone arising from the elimination of foreign exchange rate risk,
- Elimination of some transaction costs,
- Increased comparability of prices and enhanced competitiveness.

With the above-listed factors in place, investment and increasing effectiveness will be stimulated, translating into an acceleration of economic growth. Taking into account the existing level of integration of the Polish economy with the EU economy, these advantages should be much greater than the costs associated with the absence of an independent monetary policy. Therefore, early membership in the euro-zone creates favourable conditions for the acceleration of the real convergence process. The completion of the disinflation process and moving towards the stabilisation of inflation at a low level will lead to the absence of any short-term contradictions between the process of real convergence and the need to fulfil the nominal criteria.

To become a member of the euro-zone, Poland is required to sustain low inflation and stable public finances. These economic features foster a durable acceleration of economic growth. In preparing for its membership in the euro-zone, Poland has also been involved in the process of laying a solid foundation for its economic growth. For this reason, the main task of the National Bank of Poland in the years to come will consist of maintaining low inflation and within its competencies, preparing Poland for the introduction of the single European currency.

This document is composed of eight parts. It focuses first on the performance of the *Medium-Term Strategy of Monetary Policy for the years 1999 to 2003* to define the starting point for the new Strategy. Next, the new strategy and the new monetary policy target follow, accompanied by the presentation of the rules for fulfilment of the convergence criteria and structural factors connected with the conduct of the Strategy. The last part of the document offers a description of the predicted evolution of the NBP's instruments.

II

Strategy for the Years 1999 to 2003 – Advancement of Performance

In September 1998, the Monetary Policy Council announced its *Medium-Term Strategy of Monetary Policy (1999-2003)*, which introduced the Direct Inflation Target (DIT) and determined the medium-term monetary policy target, i.e. a consumer price growth rate reduction to below 4% in 2003.

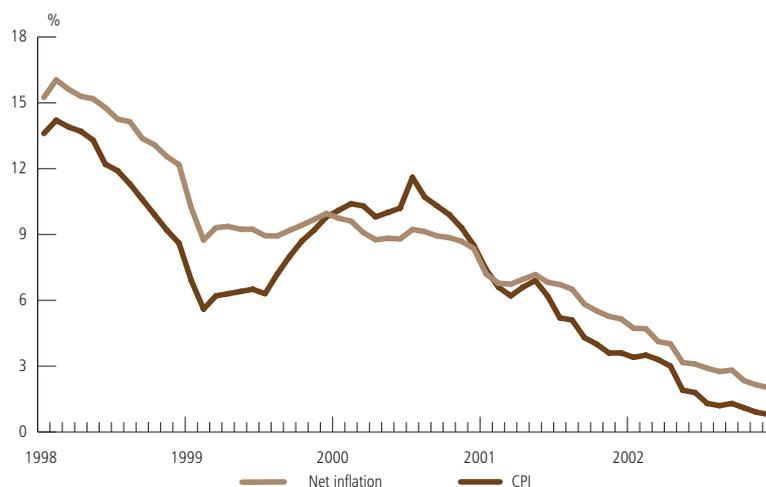
The Monetary Policy Council believes that the adoption of the DIT strategy was the most beneficial for monetary policy in a country such as Poland. This stemmed from the need for the completion of the inflation reduction process in light of increasing economic openness, the integration of financial markets, as well as the deep and deteriorating external disequilibrium. Other strategies did not guarantee a lasting reduction of the inflation rate (in the case of the monetary aggregates control) or exposed the economy to the risk of serious distortions on the financial market with all their adverse consequences for the real economic sector (with maintained exchange rate targeting). In the opinion of the Council, the experience gained by both Poland and other countries also showed that, in the end of the 90s, eclectic monetary policy oriented towards simultaneous control of interest rates or monetary aggregates and the exchange rate faced contradictions which could not be overcome.

For this reason, the DIT strategy was free from the weaknesses present in other monetary policy strategies, while its obvious advantages included:

- A clearly defined monetary policy objective comprehensible to the economic environment,
- Due to its openness, the system allows for public verification of the direction and effectiveness of the monetary policy, thus enhancing its credibility,
- With the appropriate credibility of the central bank, the strategy allows the suppression of inflationary expectations,
- Increased flexibility in the application of monetary policy instruments offers room for the central bank to select its reaction, depending on the type of events that might threaten the achievement of the inflation targets.

The evolution of the exchange rate policy towards a floating exchange rate regime and determination of the annual, short-term inflation targets were intended to support the introduction of the DIT system. The floating

Graph 1: Net inflation rate and CPI in the years 1998 to 2002 (% change against the same period of the previous year)



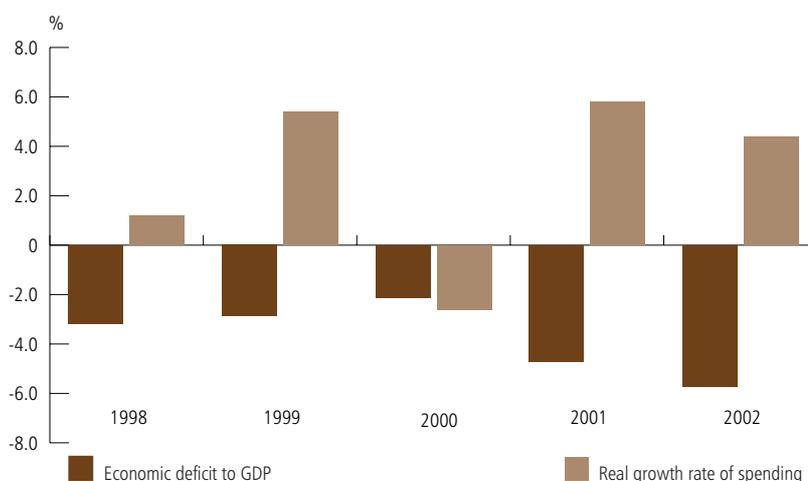
Source: The Central Statistical Office (GUS) and the NBP.

exchange rate system assured the necessary cohesion of the strategy and facilitated the elimination of the basic source of the excessive liquidity in the banking sector. Determination of the annual inflation targets oriented the system towards the inflation reduction planned at that time, while striving to attain the basic medium-term objective.

From 1999 to 2002, the DIT system served as the vehicle for monetary policy implementation. 1999 saw the follow-up to the process initiated in February 1998, of zloty devaluation in relation to the foreign currency basket and an increase in the bandwidth of permissible zloty fluctuations against the central parity. In April 2000, in response to a motion by the Monetary Policy Council, the Ministers' Council resolved to implement a free-floating exchange rate system. Low inflation achieved at the end of 2002 enables the presumption that the objective of the medium-term strategy for the years 1999 - 2003 will be attained. Monetary policy greatly contributed to overcoming an overtly swift growth in internal demand, a rapid growth of the internal disequilibrium and the risk of a currency crisis that occurred in conjunction with this growth. This resulted in the reduction of the current account deficit from over 8% of the GDP to 3.6% of the GDP.

It should be emphasised that the inflation rate strayed from the short-term inflation targets within this period, primarily as a consequence of the features and conditions of the DIT addressed by the Council in the document dated September 1998. By definition, determination of the inflation targets in the form of the Consumer Price Index assumes its increased volatility in comparison to core inflation indices. Discrepancies between these indices are of particular importance in the case of supply shocks. Over the discussed period, such shocks were causing considerable fluctuations in fuel and

Graph 2: Economic deficit¹ (as GDP %) and expenditures of the public finance sector (real growth rate) from 1998 to 2002



¹ The economic deficit – the General Government cash balance, net of transfers to the Funded Private pillar of the pension system and court-ordered compensation payments to pensioners and public sector employees for lack of indexation in the early 1990s.
Source: The Ministry of Finance.

foodstuffs prices. The net inflation rate, which eliminates that impact, remained stable and showed smaller discrepancies in relation to the adopted short-term inflation targets.

The Council also pointed to possible difficulties that could prevent the achievement of the annual inflation targets as a consequence of lags in the monetary policy transmission mechanism. At the same time, the Council decided against the relaxation of monetary policy to an extent aimed at full neutralisation of the favourable impact of supply shocks on the decreasing inflation rate. Along with the implementation of the Strategy, the indicative nature of the annual inflation targets was growing increasingly apparent.

On top of that, the period saw the emergence of unfavourable outcomes of mismatched fiscal and monetary policy. An expansive fiscal policy required a tight monetary policy, which led to a reduced inflation rate at the expense of the real economic sector, which was burdened with higher costs than it probably would have incurred with a more restrictive fiscal policy in place resulting in a more relaxed monetary policy. In addition, monetary policy was considerably hindered by the growing obscurity of public finance.

A significant improvement in monetary policy credibility has been achieved despite a failure to attain short-term inflation targets. The remarkable decline of inflation expectations of both private individuals and the financial sector support the foregoing view. Apart from the effective reduction of the inflation rate, the enhanced credibility of the central bank is also attributable to the adopted system of a floating exchange rate, which laid the basis for coherence of the adopted monetary policy strategy and facilitated its effective implementation despite international market disruptions. Regular inflation reports and other documents offered extensive explanations of the divergences in performance of the annual inflation targets.

To summarise, the monetary policy conducted between 1998 to 2002 brought about the principal effect of inflation reduction from 13.2% in December 1997 to 0.8% in December 2002. The annual average inflation rate came down from 11.8% in 1998 to 1.9% in 2002, reaching the level observed in developed economies. The experiences of these countries indicate that low inflation fosters durable economic growth. Furthermore, it is a factor determining the fulfilment of the inflation criterion, which is one of the conditions for euro-zone membership and, in turn, is favourable for attaining steady economic growth.

Despite a programme aimed at the limitation of operational liquidity implemented by the NBP, the sale of foreign currencies from privatisation proceeds directly through the NBP caused the failure of a directly planned switch to the operational liquidity shortage in the banking sector. Difficulties in reaching a durable shortage of liquidity and uneven distribution of liquidity in commercial banks prompted the National Bank of Poland to redeem bonds indexed to the inflation rate issued in 1999 in order to maintain slightly excessive liquidity in the banking sector, resulting in the enhanced competitiveness of the banking sector.

III

Monetary Policy Strategy

The framework for the *Monetary Policy Strategy beyond 2003* is based on experience connected with the implementation of the direct inflation targeting strategy, the completion of the disinflation process and the approaching membership in the European Union followed by membership in the euro-zone. While the previous Strategy was oriented towards the reduction of the inflation rate, this *Strategy* offers a redefinition of the core task of monetary policy. Presently, the task is to stabilise inflation at a low level. Given low inflationary expectations, low inflation will enable monetary policy to be less restrictive than the policy effective during the disinflation period. The change outlined above is of crucial importance for monetary policy conducted after year 2003 in light of the diminishing macroeconomic risks Poland faces as the EU accession date approaches. Implementation of the DIT strategy will be viable with a relatively lower disparity of short-term interest rates between Poland and the euro-zone.

The great effectiveness of the direct inflation targeting strategy that was pursued during the period of disinflation strongly justifies the need to apply this approach in conditions of stabilising inflation. As it is often emphasised, despite the possible occurrence of highly volatile exchange rates, the DIT strategy has proven to be the most advantageous for those countries which wish to maintain a low inflation rate. Typically, central banks operating in a low-inflation environment have already gained anti-inflation credibility. The risk of a significant deviation of the actual inflation from the inflation target is diminished, resulting in the increased flexibility of monetary policy to deal with unexpected shocks. For this reason, monetary policy conducted within the framework of the direct inflation targeting strategy should be still mapped out on the basis of a floating exchange rate. In light of its experience, the Council believes that such a strategy is the most effective inflation-controlling measure and reduces the risk of serious shocks on the foreign exchange market.

Pursuing the DIT strategy, on the basis of a comprehensive analysis of macroeconomic data, the central bank defines and announces the inflation target to the public. Next, it adjusts interest rates accordingly, in order to maximise the probability of achieving the target. Through such a monetary policy, low inflationary expectations can be effectively consolidated, and in turn facilitate the stabilisation of inflation.

The effectiveness of the DIT strategy is supported by the floating exchange rate system, since the policy of adjusting the exchange rate could force interest rate changes inconsistent with the adopted inflation target. Therefore, a floating exchange rate regime should be maintained until the moment of entering ERM2, while the adopted band of permissible fluctuations of the exchange rate within ERM2 should be of maximum width.

IV Monetary policy objective

New experience gained over the implementation of the DIT strategy as well as new challenges faced by monetary policy after year 2003 force certain modifications to the current monetary policy strategy. With inflation stabilised at a low level, annual inflation targets set out at the end of a given calendar year can be replaced by continuous targeting. Owing to such an extended time horizon, the time lags between decisions made by the central bank and their effects can be taken into account and add to the enhancement of the credibility and flexibility of the monetary policy. Furthermore, determination of the continuous inflation target is consistent with the open framework of the newly drawn-up *Strategy*. *The Strategy* sets out the core task of Poland's membership in the euro-zone. In the opinion of the Council, Poland should access the euro-zone at the nearest date possible, once all the nominal convergence criteria are met. The latter are only partially dependent on monetary policy.

In consideration of the above, the monetary policy is targeted to attain a stable inflation rate of 2.5% after year 2003 with a permissible volatility band of ± 1 percentage point either side of this target. In the opinion of the Monetary Policy Council, in Poland the above-defined continuous inflation target is consistent with strong economic growth. At the same time, the predefined inflation target comes close to the expected reference value for the inflation criterion. From 1998 to 2002, reference values remained between 1.8% and 3.4%, or 2.7% on average. Therefore, an inflation rate stabilised at the level of 2.5% does not guarantee that the inflation criterion is fulfilled. However, any subsequent attempts to adapt inflation to the requirement defined in the criterion will not require a substantial reduction in the price growth rate in Poland over a short period of time.

Although the adopted inflation target exceeds the rate of inflation at the end of 2002, it does not necessarily imply that an expansive monetary policy be conducted by the NBP, as the falling price growth rate in 2002 stemmed primarily from transient factors such as a good harvest and reduced excise taxes on alcohol.

The extent to which a continuous inflation target of 2.5% with a permissible volatility bandwidth of ± 1 percentage point is attained, will be assessed on the basis of the Consumer Price Index (CPI) on a year-over-year basis. Such an inflation measure has been generally applied in the Polish economy since the beginning of the transformation period and out of the various price indexes, it is the one best recognised by the general public. Should some unexpected shocks push inflation outside the permissible

volatility band, monetary policy will be aimed at reinstating it and bringing it closer to the target over a medium-term time horizon. In such a time horizon, efforts will be made to attain the monetary policy target in a manner assuring minimum production volatility.

In pursuit of membership of the euro-zone in the nearest possible future, it is necessary to publish and follow the additional price index that verifies the fulfilment of the inflation convergence criterion defined in the Maastricht Treaty. It is represented by the Harmonised Index of Consumer Prices (the HICP) based on a twelve-month moving average. The HICP is still based on a basket of consumer goods and services that offer the best reflection of changes in purchasing power associated with the disposable income of the average Polish household. While differences between the domestic CPI and the HICP ratios are not significant, for internal analyses the Council will also use the core inflation measures calculated and published by the NBP since the above-described ratios have the disadvantage of being susceptible to shocks that are beyond the capacity of monetary policy measures, such as changes in food supplies or fuel prices.

Continued support for monetary policy by vigorous publicity is vital to reduce uncertainty and develop an understanding of the decisions made by the central bank among market participants. It also enhances the transparency and credibility of monetary policy. Owing to the open attitude displayed by the central bank, market participants have relatively little difficulty in assessing its decisions in terms of the achievement of the monetary objectives set by the bank. Furthermore, an active public relations policy contributes to increased responsibility and accountability of the central bank to market players for the monetary policy it conducts. Key instruments employed in public communication include quarterly inflation reports published by the bank, information from the Council's meetings, other materials published on the NBP web site, press conferences, public speeches as well as participation in seminars and scientific conferences.

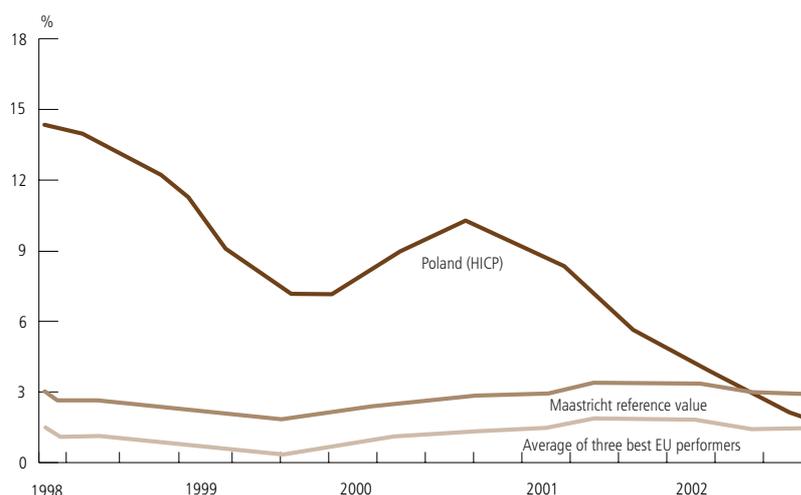
V Convergence Criteria

The second key task to be faced by the National Bank of Poland in the coming years is to lead Poland to join the euro-zone in the nearest possible future. The Maastricht Treaty specifies the convergence criteria for euro-zone candidates with respect to the inflation rate, long-term interest rate, stability of the foreign exchange rate, general government deficit and public debt. Fulfilment of the first three criteria will be directly affected by monetary policy.

The inflation criterion is fulfilled when the annual average inflation rate, as measured by the Harmonised Index of Consumer Prices, as used in the European Union, upon verification does not exceed the average inflation of the three EU states with the lowest price growth ratio by more than 1.5 percentage points. The average reference value in the period from 1998 to 2002 was equal to 2.7%. In the absence of strong disruptions driving the inflation rate in the euro-zone, the admissible inflation rate may be lower than the average reference value upon verification of the criterion for Poland. Poland has met the inflation criterion for several months now.

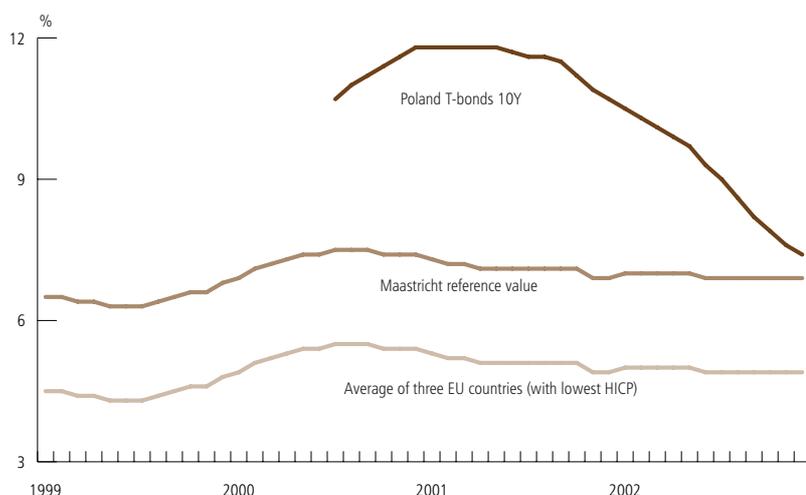
The long-term interest rate criterion is fulfilled when the average annual nominal interest rate on long-term (typically 10-year) treasury bonds does not exceed the average calculated for the three EU states with the lowest

Graph 3: The degree to which Poland has met the convergence criterion of the inflation rate



Sources: Eurostat, NBP.

Graph 4: The degree to which Poland has met the convergence criterion of the interest rate



Sources: Eurostat, NBP.

inflation rate by more than 2 percentage points. Owing to the assessment of convergence with regard to the interest rate criterion, the reliability of a permanent decrease in the inflation rate can be verified with an impartial arbiter i.e. the financial market acting as the assessor. Once market participants are assured of the durability of the deflation process, long-term inflationary expectations and the yield on long-term treasury papers will be diminished, leading to the fulfilment of the interest rate criterion. Recently, the current yield on ten-year treasury bonds has already fallen below the reference value. On this basis, we can presume that the annual average yield will decrease sufficiently enough to meet the interest rate criterion.

To meet the exchange rate criterion, the foreign exchange rate in the ERM2 has to be maintained for at least two years without “excessive tensions” on the foreign exchange market. Although the system permits currency fluctuations within a band of $\pm 15\%$ around the central parity, other factors such as the absence of significant tensions on the foreign exchange market might also be taken into account when assessing the stability of the exchange rate. Devaluation of the central parity would not be in accordance with the criterion.

Fiscal criteria are met if the general government deficit and the relation of public debt to GDP (calculated in accordance with the ESA 95 methodology) do not exceed 3% and 60% respectively in the accession country. Only specific circumstances permit the above-given ceilings to be exceeded. Presently, Poland meets the public debt criterion while still exceeding the criterion with regard to the general government deficit.

Fulfilment of all the criteria is subject to verification in the form of the Convergence Reports prepared by the European Commission and the European Central Bank.

VI Structural Constraints of the Monetary Strategy

In many aspects, the current structure of the Polish economy seems more favourable to monetary policy than it was upon the introduction of the DIT strategy back in 1998. At present, almost 75% of the GDP is produced by the private sector. The privatisation process of many industries is highly advanced or completed. Other positive factors include the amendments to the Labour Code introduced in 2002. However, the Monetary Policy Council recognises the persistence of considerable structural weaknesses, which impede economic growth and the consolidation of public finances, while increasing the cost of stabilising inflation at a low rate. These comprise:

- High mandatory social expenditures, which destabilise the state budget,
- Distortions of the labour market, only partially alleviated by the amendments to the Labour Code of 2002,
- The restricted operation of market mechanisms with respect to certain industries (electricity production and supply, housing) hindering flexible supply-side adjustments,
- The major extent of state ownership in many important sectors of the economy,
- Large scale bureaucracy in the economy and the low effectiveness of government administration.

Structural features of the economy have a major impact on the size of the general government deficit and on the productivity growth rate, thus affecting possible reconciliation between quick economic growth and low inflation. Their improvement, by introducing structural reforms, comes as one of the preconditions to be met to restore the health of public finances. In turn, economic development would draw multiple benefits from the curtailing of the general government deficit. Firstly, the excessive growth of public debt which hinders entrepreneurs' access to credit and threatens them with a debt trap, would be prevented. At the same time, by attracting foreign portfolio capital, the deficit contributes to the appreciation of the zloty which is not compensated by productivity growth. Secondly, a precondition for Poland accessing the euro-zone is to curb the deficit which, in addition, will strengthen the economic growth of the country.

In the opinion of the Council, removal of the above-outlined structural barriers including completion of the privatisation process, suppression of monopolies and in-depth reform of the Labour Code and budget

expenditures will not only facilitate more effective monetary policy but will also enable faster growth of potential production in the Polish economy, followed by a quicker and more sustainable development, and a discernible drop in the unemployment rate.

The Monetary Policy Council estimates that the economic deficit in year 2002 exceeded 5% of GDP. The deficit is excessive both in terms of the expected proceeds from privatisation and with a view to turning the Polish economy towards high-rate growth. It results in growing public debt in relation to GDP. Other disturbing factors include the mounting fiscal burden and uncontrolled increase in the debt of extra-budgetary units. The state budget will be drained by additional expenditures necessitated by the EU accession process. In light of the above, in-depth reforms of public finances and the co-related structural reforms are pre-conditional to achieving a sustainable acceleration of economic growth.

Changes in the NBP interest rates and the cost of maintaining low inflation will become more contingent upon the fiscal policy and structural reforms in the years to come. The date of accession to the euro-zone and the appropriate adjustments of monetary policy are dependent upon the fulfilment of the fiscal criteria of nominal convergence. It should be emphasised that a more rigid exchange rate system requires a more disciplined fiscal policy. The introduction of exchange rate fluctuation bands combined with a fairly non-restrictive fiscal policy adds substantially to the risk of a currency crisis. At the time of our participation in ERM2, the danger for such a scenario developing is greater the less disciplined and predictable fiscal policy is conducted.

VII

Monetary Policy and the Accession to the Euro-Zone

Accession to the euro-zone will be a multi-stage process. In stage one, the government of the Republic of Poland and the National Bank of Poland will negotiate the method of pegging the zloty to the euro upon joining the ERM2 system (selection of the central parity and permitted fluctuations band) with the representatives of the European Commission and the European Central Bank.

Not later than two years after accessing ERM2, Poland will be assessed in the Convergence Reports prepared by the European Commission and the European Central Bank. These reports will present an analysis of the exchange rate, inflation rate and long-term interest rate over the reference periods and the size of the general government deficit and public debt in the year prior to the year of verification.

In the estimation of the Council, owing to the continuous inflation target, a relatively quick reduction of inflation is achievable if it becomes necessary to meet the inflation criterion, regardless of any developments in the public finance sector. Once a final decision with respect to the euro-zone accession date is made, an additional short-term inflation target will be set to meet the inflation criterion, if the reference value were to be less than 2.5%.

VIII Monetary Policy Instruments

Within the framework of the adopted Strategy, the central bank will apply a suitable mix of monetary policy instruments to reach the pre-determined inflation target. The NBP will pursue the objective of introducing instruments uniform to those applied in the Eurosystem in open market operations; however, their selection and the speed of their adjustment process will be contingent on the prevailing market conditions and, in particular, on the liquidity of the banking sector.

Interest rates will be a key instrument necessary to attain the inflation target, while the reference rate, the lombard rate and the deposit rate will determine the general direction of monetary policy.

The reference rate will determine the profitability of basic NBP operations, which are a part of open market operations. This rate will directly affect the interest rate for inter-bank deposits with similar maturities.

The lombard rate will define the maximum cost of funds from the central bank, thus determining the ceiling (the upper limit) for market fluctuations of the O/N rates.

The deposit rate will represent the floor (the lowest permitted rate) for fluctuations in short-term interbank rates.

At present, the required reserve ratio in Poland exceeds the rate effective in the Eurosystem, as the NBP seeks to limit the scale of excess liquidity in the domestic money market. In the coming years, the most important changes to be introduced to the minimum reserve system include the reduction of the required reserve ratio to the level effective in the Eurosystem and introducing the remuneration on the required reserve funds, the latter only after the establishment of an appropriate legal basis. These changes are of particular importance as they not only bring the system closer to the arrangements adopted by the European Central Bank but they also enhance the competitiveness of the Polish banking system.

Credit and deposit operations will serve to alleviate the impact of short-term liquidity fluctuations in the banking sector on the market rates. With the lombard loans, banks will be capable of O/N borrowing and with the deposit facility, making O/N deposits.

In presenting *The Monetary Policy Strategy beyond 2003*, the Monetary Policy Council believes that this strategy will be consistent with the economic policy to be pursued after Poland joins the European Union in 2004 and in view of the quick accession to the euro-zone.