MONETARY POLICY GUIDELINES
FOR THE YEAR 2002

Warsaw, September 2001

Pursuant to Article 227, para. 1, of the Constitution of the Polish Republic, the National Bank of Poland is responsible for the value of Poland's currency. The effect of inflation is to decrease the purchasing power of the zloty. Article 3 of the Act on the National Bank of Poland of August 29, 1997, states that "the basic objective of NBP activity shall be to maintain price stability, and it shall at the same time act in support of Government economic policies, insofar as this does not constrain pursuit of the basic objective of the NBP". The goal of NBP monetary policy is to achieve a lasting reduction in inflation that lays the basis for stable, long-term economic growth. Price stability also makes possible future membership in European Economic and Monetary Union.

I THE INFLATION TARGET FOR 2002

In September 1998, the Monetary Policy Council adopted a *Medium-Term Monetary Policy Strategy for the Years 1999-2003*. In this, it declared that the strategic monetary policy target was to bring down inflation, as measured by the Consumer Price Index, to below 4% by the end of 2003. The Council maintains its commitment to achieving this strategic target. The particular stages in doing so are represented by annual inflation targets, which up to now have been set as a percentage range. In pursuing its inflation targets, the central bank takes its decisions in consideration of any information that may have a material impact on price growth and utilises all available instruments.

In working towards its strategic monetary policy target, the Monetary Policy Council will be seeking to attain an inflation target of 5% year-on-year consumer price growth at the end of 2002. The Council has set a permissible bandwidth around this target of ±1 percentage point.

The change in the method of specifying the target range stems from a conviction that, as price growth diminishes, so it becomes increasingly important to indicate explicitly the level of inflation that the Council intends to achieve. The provision for a margin of tolerance around the percentage target, on the other hand, is attributable to the inevitable uncertainty that exists concerning those factors which condition performance of the inflation target yet are independent of monetary policy, including, in particular, the size of the public sector financial deficit, any possible movements in zloty exchange rates, or the appearance of supply shocks on the markets for foodstuffs and/or fuels. An increase in the public sector financial deficit, a significant weakening of the zloty, or a rise in food and/or fuel prices triggered by supply shocks could cause inflation to diverge on the upside of 5%, while movements in the opposite direction could take inflation to the downside of that target.

The experience gathered so far in implementing the *Medium-Term Strategy* indicates that inflation can be strongly influenced in the short term by temporary supply shocks. Yet adjustments to monetary policy parameters in response to unexpected inflationary impulses have a delayed impact on prices. For these reasons, the Monetary Policy Council emphasises that performance of the strategic monetary policy target takes precedence over achieving the target for 2002.

At the same time, the Council draws attention to the fact that attaining an inflation target of 5% will signify a relatively small reduction in price growth over the period to year end 2002. This period should see a steadying of inflation and a more durable adjustment of inflation expectations to the level of price growth being recorded. This will create favourable conditions for lowering inflation further and achieving the annual inflation target in 2003. However, a temporary increase in the annual rate of inflation in the course of 2002 cannot be excluded.

II FACTORS CONDITIONING PERFORMANCE OF THE MONETARY POLICY TARGET

External factors

Forecasts for the world economy in 2002 vary widely, ranging from a scenario of global recession to a return to the path of moderate growth. The terrorist attack on the USA and the possibility of a protracted campaign of retaliation have heightened uncertainty as to world economic growth rates and movements in world commodity prices, including oil prices.

The world economic environment will influence the development of the Polish economy and the conditions for the performance of the inflation target, with the factors involved including the growth rate of external demand, movements in prices for basic commodities and oil, the level of inflation in the countries that are Poland’s principal trading partners, and the exchange rate of the US dollar against the euro.

The external factors affecting performance of the inflation target in 2002 are generally little different from those considered most probable by the Monetary Policy Council when the inflation target for 2002 was announced. It should be noted, however, that were the global recession scenario to come to pass, while this would have similar effects in terms of inflationary pressure, it would constitute a serious threat to economic growth, and would also furnish even more powerful arguments for the institution of structural reforms to increase the competitiveness of the Polish economy.

Food prices & indirect taxes

The Council has assumed that positive trends will remain at work on the food market at least in the first half of 2002. Experts believe that the grain balance in this period will be in greater equilibrium than in the 2000-2001 season and that the tendencies on the market for meat will continue to lessen pressure for price growth, while this year's crop of fruit and vegetables should not push up these food prices, which are the most volatile of all. Nevertheless, one source of uncertainty as regards the future pace of food price growth remains next year's harvest and the situation on the food market in the latter half of 2002. Were the scenario of global recession to be fulfilled, food price growth would be curtailed by lower consumer demand.

In view of the difficult situation in public finances, an increase in rates of indirect taxation next year would appear rather likely, and this could accelerate consumer price growth. However, the scope and scale of this increase have not as yet been definitively established, which constitutes an additional source of uncertainty.

Systemic factors, the policy mix, economic development & external disequilibrium

A stable currency is one of the foundations of lasting economic development. Development of this sort also requires a stable and balanced system of public finances and a structurally competitive economy, something that in large measure determines the state of central government finances. Poland has seen the emergence of a non-optimal mix of monetary and fiscal policy (a tight monetary policy in reaction to an overly lax fiscal policy), which results in an increase – independent of monetary policy – in the cost of reducing inflation, in the form of slower GDP growth than would be possible with an optimum policy mix. The possibility of the world economy moving into a recessionary phase means that Poland's future economic growth will be even more heavily contingent than in previous years on macroeconomic stabilisation and an improvement in competitiveness.

In mapping out these monetary policy guidelines for 2002, the Monetary Policy Council wishes to call attention to the fact that this inappropriate policy mix is rooted in the failure to implement particular systemic changes, as evidenced primarily by:

1. Distortions of the labour market (including excessive payroll taxes, the ineffective operation of the social insurance system, a high and regionally undifferentiated minimum wage that inhibits employment of youth and less qualified staff, and the heavy cost of severance pay), which generate smaller employment and greater unemployment than would be the case with a flexible labour market. Poland's inflexible labour market has highly negative consequences for the economy. The fact that one in five members of the labour force remains out of work is enormously harmful in social terms and fuels the swelling government deficit. On the one hand, this stems from the growing government expenditure associated with unemployment, which prevents taxes from being lowered, while on the other it reflects the government revenues lost due to lower employment and the underutilisation of the country's productive capacity. Carrying out a reform of the labour market that removes the obstacles to employment growth represents a basic step towards the repair of public finances.

2. The restricted operation of market mechanisms with respect to certain products, particularly foodstuffs, hinders flexible supply-side adjustments (higher imports in the event of a poor harvest) and touches

off price shocks that fan inflation. In the context of the monetary tightening essential to curb inflation, this leads to a slackening of economic growth.

3. The maintenance of monopolies in many important branches of the economy, such as rail transport, the power industry, gas extraction and distribution, communications and municipal services, results in low productivity gains in these industries and constitutes a source of constant inflationary pressure. Lower productivity growth also restrains GDP growth.

4. The major extent of state ownership, which is principally dominant in those areas where monopolies also persist, is another factor behind slow productivity growth. Government subsidies to unprofitable production are a drain on the taxpayer and hinder the achievement of fiscal equilibrium.

5. High current expenditure, particularly social spending, which substantially exceeds the capacity to fund that expenditure from tax receipts, is yet another factor that destabilises government finances. This expenditure, for the most part index-linked, rises independently of the rate of economic growth, although the latter determines the level of tax receipts.

All of the structural weaknesses of the economy outlined above engender specific costs to the government, direct or indirect, and result in a deepening of the public sector financial deficit. This in turn soaks up private savings and widens the current account deficit. Rising expenditure necessitates an increase in the burden of taxation, inducing some businesses to scale down their operations, thus extending unemployment, or to move into the "grey economy", thereby cutting tax receipts. The growing public sector financial deficit represents a permanent source of disequilibrium within the economy, producing inflationary pressure and high interest rates. Financing the deficit by issuing more debt aggravates this disequilibrium, since the mounting expense of debt service increases the government deficit.

The Monetary Policy Council has analysed the longer-term impact of the proposals concerning the Budget for 2002, in terms of the effectiveness of these in bringing public finances into equilibrium. A precondition for the lasting success of any measures to rationalise public finances is that these proceed from appropriate structural and systemic reforms. However, the relevant decisions in this area were unknown prior to the formation of the new Government. As a result, in drawing up these monetary policy guidelines, the Council examined the consequences of both the introduction and the non-introduction of reforms to redress the structural weaknesses mentioned above.

The implementation of the reform scenario would mean the Government taking on the task of eliminating the structural weaknesses of the economy and public finances, and thereby laying the foundations for sustained equilibrium in public finances, an expansion of employment, economic development and a reduction in the cost of lowering inflation. This would at the same time lead to a more competitive economy, a factor of particular importance in the light of the danger posed by the scenario of global recession.

The further that future economic policy were to stray from this reform scenario, the greater would be the threat presented by an increase in the government deficit, and also – in conjunction with any world recession – by recessionary developments within the economy gaining momentum and unemployment rising in years to come.

The extent to which the reform scenario is realised will determine the room for manoeuvre in monetary policy, and also – which is partly related – the opportunity for long-term economic growth and the level of employment and unemployment.

The Monetary Policy Council gauges the strictness of fiscal policy primarily by the size of the adjusted public sector financial deficit. The Council believes this deficit should be significantly decreased in 2002 as a proportion of GDP. A swift reduction in public sector demand would allow an increase in private sector capital expenditure, thereby also enabling an acceleration of economic growth. The Council considers that the public sector financial deficit should chiefly be cut by trimming expenditure rather than by putting up taxes.

The institution of reforms is essential to preserve macroeconomic stability in 2002 and subsequent years. In addition, this will lay the basis for a major expansion of economic activity in the years ahead. In 2002, on the other hand, GDP growth and the level of economic equilibrium will principally be affected by the external environment.

The Council estimates that, given the scenario of a slow upturn in the world economy and a stabilisation of oil prices, Poland’s GDP growth in 2002 could come to some 2.5%, with the current account deficit standing at around 4.5% of GDP. The global recession scenario, however, could result in lower GDP growth. These estimates are founded on the assumption that the necessary measures are taken to restore the health of public finances. Were the global recession scenario to be compounded by a lack of reforms, this could yield a further slowdown in GDP growth and an increase in the current deficit.

III MONETARY POLICY INSTRUMENTS

Monetary policy in 2002 will be conducted within the framework of a strategy of direct inflation targetting, with a floating exchange rate regime. This means that the central bank does not seek to achieve any specific exchange rate for the zloty against other currencies, nor does it make any formal commitment concerning intervention on the foreign exchange market. However, the NBP does reserve the right to undertake such intervention should it deem this essential for performance of the inflation target.

Interest rates

The principal instrument employed by the Monetary Policy Council in pursuit of its inflation target are interest rates. The rates which define the direction of monetary policy are the reference rate and the lombard rate. These influence the level of money market rates, which are of decisive importance for the lending and deposit rates available to both persons and corporates.

Open market operations

Open market operations are the primary instrument that allows the central bank to maintain money market rates at the level desired in terms of achieving the monetary policy target adopted. There are three categories of open market operation: basic operations, fine-tuning operations and structural operations.

Basic open market operations set the direction of the monetary policy being pursued. This role will be performed by the issue of NBP money market bills for 28-day maturities. The reference rate, which indicates the current direction of monetary policy, will continue to be represented by the minimum rate on basic open market operations. This will determine the rate offered on interbank deposits for a specified maturity.

Fine-tuning operations, for shorter maturities than those underlying basic operations, may be conducted in situations of short-lived disruptions to liquidity. The rates on these operations will take into account the level of the reference rate.

As part of the structural operations being carried out, the NBP may conduct outright sales of Treasury bonds. The intention of the Monetary Policy Council is for long-term interest rates to be set by the market. As a result, these sales will be staggered out over time, to limit to the minimum the impact they exert on the yield curve. In the event of a significant additional generation of surplus liquidity, the NBP does not exclude the issue of its own long-term securities as well.

The direction of the open market operations being conducted by the NBP will be predicated on the liquidity position within the banking sector. Should a shortfall in operating liquidity arise, the NBP will adjust its system of open market operations accordingly. The rates on basic liquidity-providing operations will be determined by the reference rate, which will continue to indicate the current direction of monetary policy. The direction taken by structural operations will depend on movements in the liquidity position of the commercial banking sector in the longer time frame. The rates on these operations will be set at tender.

Reserve requirements

The primary function of required reserves is to cushion the impact on interbank rates of ongoing movements in banking sector liquidity and to stimulate the demand for reserve money. This makes it easier for the central bank to maintain a selected market rate at the level desired. Any alteration to the reserve ratio will be contingent on developments conditioning the performance of monetary policy. The NBP does not rule out withdrawing the provision that declared vault cash is eligible for inclusion in required reserves. In that event, the NBP would lower the reserve requirement correspondingly. Such a change would be neutral in its effect on banking sector liquidity and on the earnings of the NBP. At the same time, however, it would represent a further step towards bringing reserve requirements into line with the standards of the European Central Bank.

Lending and deposit taking

In the context of the National Bank’s conduct of basic open market operations for 28-day maturities, substantial volatility is possible in shorter interbank rates, especially for one-day money. Smoothing out this volatility is to be the objective of lending and deposit-taking operations carried out with the commercial banks, at their initiative, which will involve lombard loans and overnight deposits. The rates applied to lending and deposit-taking operations will be determined by the range of fluctuations in one-day money market rates.

The lombard rate will as a rule continue to serve as a maximum interest rate determining the marginal cost of interbank funds for the shortest maturities.

The deposit rate will represent a floor on fluctuations in short-term interbank rates. This rate will constitute the price at which the central bank is willing to accept overnight deposits from the banks.

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The NBP will be seeking to modify its monetary policy instruments, adjusting them to correspond to the system of such instruments in operation at the ECB. These modifications will also be designed to enhance the efficiency of financial markets, which should strengthen the effectiveness of monetary policy transmission mechanisms. The pace of these adjustments will be contingent on changes in the legal environment and the situation on the markets. The National Bank will attempt to restrict the possibility of additional excess liquidity being created within the commercial banking sector.