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## Monetary Policy Guidelines for the Year 2003

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Pursuant to Article 227, para. 1, of the Constitution of the Republic of Poland, the National Bank of Poland is responsible for the value of Poland's currency. Article 3 of the Act on the National Bank of Poland of August 29, 1997, states that the basic objective of NBP activity is to maintain price stability, while at the same time acting in support of Government economic policies, insofar as this does not constrain pursuit of the basic objective of the NBP. The effect of inflation is to decrease the purchasing power of the zloty. The aim of NBP monetary policy is to achieve a lasting reduction in inflation. A stable and low level of inflation constitutes the foundation for sustained and balanced economic growth. Maintaining a low rate of inflation also makes possible future membership in European Economic and Monetary Union, creating favourable conditions for attaining rapid economic growth and narrowing the gap in development that separates Poland from the advanced countries.

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## I The inflation target for 2003

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In the *Medium-Term Monetary Policy Strategy for the Years 1999-2003*, adopted in 1998, the Monetary Policy Council took as its strategic monetary policy target the lowering of inflation to below 4% by the end of 2003. In accordance with that strategy, the Monetary Policy Council decided (and announced in June 2002) that the monetary policy target for 2003 would be to achieve year-end inflation of 3%, within a target range of  $\pm 1$  percentage point.

The setting of a permissible bandwidth around the percentage target stems from the impossibility of predicting precisely events that are independent of monetary policy, yet impact performance of the inflation target. In particular, these include unexpectedly large swings in fuel and food prices, and fluctuations in zloty exchange rates, which are difficult to anticipate with precision. Uncertainty also surrounds the size of the public sector financial deficit and of privatisation receipts, together with the extent of consolidations of state enterprises and the associated restriction of competition.

The basis for monetary policy is a strategy of direct inflation targetting, which is linked to a floating exchange rate regime. This strategy, in explicitly identifying the monetary policy target, ensures a highly transparent monetary policy that encourages the maintenance of inflation expectations at a low level. At the same time, it allows a flexible response to changes in the macroeconomic environment, i.e., to changes in the external environment and in the condition of public finances, and to supply and demand shocks. Thanks to this, it lessens the risk of the emergence of tensions that could lead to crisis phenomena. The MPC believes that a floating exchange rate regime is the most appropriate for Poland on its path to membership in Economic and Monetary Union. Notwithstanding this, the MPC reserves the right, as it has so far, to intervene on the currency market within the framework of that regime, should this be necessary for the performance of the inflation target.

Setting the target at a level of 3%, with a bandwidth of  $\pm 1$  percentage point, signifies moving from a phase of lowering inflation to one of stabilising inflation at a low level. Stabilising inflation at a low level consolidates low inflation expectations and permits a further gradual reduction of interest rates and the narrowing of the rate differential between Poland and the countries of Economic and Monetary Union. The pace at which interest rates are brought to converge will be contingent on factors outside the influence of monetary policy, primarily on the fiscal policy pursued in the years immediately ahead.

Sustainable low inflation is one of the economic conditions written into the Maastricht Treaty under the convergence criteria. Attaining low inflation also assists in fulfilling other convergence criteria – on long-term interest rates and exchange rate stability – and makes possible membership in Economic and Monetary Union. Meeting the Maastricht criteria would lay a sound basis for long-term, balanced economic growth. Joining the euro area will bring additional benefits to the economy, such as a reduction in the cost of capital, a partial elimination of transaction costs, an acceleration of bilateral trade through the removal of exchange rate risk, and an increase in price transparency. The MPC therefore considers that the macroeconomic policy target for the coming years should be to fulfil the convergence criteria within a time frame that allows the euro to be introduced in Poland as soon as possible.

## II

## Factors conditioning performance of the monetary policy target

### External factors

The available forecasts for the development of the world economy in 2003 indicate that the improvement in external business activity will be a slow one. Economic growth is estimated to come to 1.8%-2.4% in the euro area, and 2.5%-3.2% in the United States. Any possible military conflict with Iraq carries a risk of oil price increases, which would additionally weaken global growth, while at the same time stimulating inflation. The disclosure of accounting abuse at certain American corporations constitutes a source of uncertainty on financial markets. As a result, the forecasts for the development of the external factors impacting economic growth and inflation in 2003 may be subject to a large margin of error. The effects of the upturn will most probably not be felt by the Polish economy until the second half of 2003.

### Food prices & officially controlled prices\*

It is projected that food price growth will speed up slightly in 2003, to around 2%. Experts believe this will be driven by lower harvests of grain, fruit and vegetables than those recorded in 2002. A rise in meat prices is also forecast, caused by livestock production being scaled back due to a fall in profitability. However, the large uncertainty attached to food price forecasts demands that consideration is given to the possibility of substantially faster growth in these prices.

On the basis of the information available, the NBP is of the opinion that growth in officially controlled prices in 2003 should decline slightly compared to 2002, to stand within a range of 3.6%-4.8%.

Forecasts for annualised average oil prices on world markets indicate that a steadying of fuel prices can be expected in 2003, although there is a risk of a considerable increase in the event of any military conflict with Iraq.

### Economic development, the policy mix & systemic factors

A slowdown of the economy has been observable in Poland since 2001. The roots of the adverse trends involved are attributable to the excessive rise in demand relative to economic potential in the latter half of the 1990s. This produced mounting disequilibrium within the economy (in terms of inflation and the current account deficit of the balance of payments), which necessitated counter-measures. In 1998, the Russian crisis resulted in a deepening of external disequilibrium (with the current account deficit rising to over 8% of GDP in the first quarter of 2000).

\* Officially controlled prices comprise those for: alcoholic beverages, tobacco products, fuels, electricity, gas, hot water, district heating, public rail transport, municipal public transport, postal services, telecommunications services, TV and radio licence fees, services of government administration, and court and lawyers' services.

The tightening of monetary policy begun in the second half of 1999, dictated by the need to bring down inflation and contain external disequilibrium, coincided with a general slackening of the economy, causing economic growth in Poland to slow at a rate similar to the slowdown in the euro area. Although the reduction in the pace of economic growth was similar to that in the euro area, Poland experienced a more profound decline in employment. The reasons for this should be sought in the utilisation of competitive reserves existing within the economy, and also in the rigid labour market. A large part of the decline in employment was also traceable to the restructuring of sectors of the economy where surplus employment persisted (mining, metallurgy, rail transport).

In spite of the unfavourable conditions, the process of restoring external equilibrium and lowering inflation was pursued consistently, which allowed a gradual easing of monetary policy to be commenced. From the beginning of 2001 to August 2002, the NBP interest rate of greatest importance to the money market was cut eleven points, from 19% to 8%. Core inflation dropped from double figures in 2000 to a level allowing it to be stabilised within the range of the medium-term inflation target adopted by the MPC in 1998. The current account deficit has decreased from the very dangerous level of over 8% of GDP in 2000 to less than 4% of GDP today. Since mid-2002, signs of a gradual economic upturn have become visible.

The MPC believes that the weaker economic recovery than expected among Poland's principal trading partners, in conjunction with the current outlook for domestic demand, supports a forecast of Polish GDP growth in 2003 within the range of 2%-3%. The MPC wishes to emphasise that a lasting regeneration of rapid economic growth can occur solely in the context of sustained macroeconomic equilibrium. This is possible where sufficient growth is cultivated in the domestic savings that fund investment. Failing this, the economy will be threatened either with a return of external disequilibrium, or with an increase in inflation. These developments, incompatible with rapid long-term economic growth, could thwart Poland's chances of swiftly achieving membership in Economic and Monetary Union. The MPC should like to note that a significant mobilisation of domestic savings will not take place without a rise in government sector savings, i.e., without a marked reduction in the government deficit.

The MPC considers that an obstacle to the tightening of fiscal policy, one that is also the prime barrier to a lasting acceleration of economic growth, is the persistence of structural weaknesses within the Polish economy, as previously mentioned in the *Monetary Policy Guidelines for 2002*, namely: distortions of the labour market that hinder the hiring of staff, lack of progress in dismantling monopolies within important sectors of the economy, the protection of unprofitable state enterprises at taxpayer expense, rather than their privatisation, the maintenance of a high proportion of social spending within government expenditure, which prevents the lowering of taxes, and the underdevelopment of infrastructure. These weaknesses cannot be overcome without embarking, in determined fashion, on such structural reforms as the further liberalisation of employment law, an improvement in the corporate legal environment, the streamlining of government current expenditure, and privatisation. These reforms will yield results in the shape of higher employment, enhanced efficiency and a lower government deficit. Reducing the government deficit would in turn allow an easing of monetary policy, which would additionally strengthen economic growth. In consequence, the economy could achieve a higher level of long-term economic growth and a lower level of unemployment at a lower rate of inflation.

The Monetary Policy Council forms its view of the relative tightness of fiscal policy by reference to the size of the adjusted public sector financial deficit. Taking account of cyclical factors, the information available at the time the present *Guidelines* are being adopted indicates that a further loosening of fiscal policy is set to take place in 2003. The danger is also posed of part of central government expenditure being shifted to the remaining components of the general government sector, i.e., to local government and to government special-purpose funds and agencies. This would lead to a further increase in the adjusted public sector financial deficit. The maintenance of a high deficit, coupled with low privatisation receipts, will mean the issue of a large volume of Treasury securities is needed to finance government borrowing requirements, which will



curtail the possibility of financing business development and will create an environment conducive to the firming of zloty exchange rates, without any parallel strengthening of corporate competitiveness.

A relaxation of fiscal policy in the context of the anticipated improvement in the state of the economy is one that gives cause for concern. The performance of reforms that permit the government deficit to be reduced would broaden the room for manoeuvre available to monetary policy. This would allow an improvement in the policy mix and in the prospects for economic growth in the long term.

## III Monetary policy instruments

### Interest rates

Interest rates represent the principal instrument employed by the Monetary Policy Council to achieve the inflation target. In conducting open market operations, the central bank influences the level of interbank interest rates. Meanwhile, the lending and deposit rates offered by the commercial banks impact consumption and investment decisions, and thereby also the real economy and inflation.

The rates which define the direction of the monetary policy being pursued are the reference rate, the lombard rate and the deposit rate.

The **reference rate** sets the minimum yield obtainable on basic open market operations, while at the same time influencing market rates for comparable maturities. In 2003, the NBP will be shortening the maturity of its basic open market operations to 14 days. The reference rate will thus impact two-week money market rates. The shortening of operations to 14 days should enhance the effectiveness of the monetary policy transmission mechanism, will ensure that the central bank exerts a more precise impact on banking sector liquidity, and will represent an adjustment measure in conformity with the standards of the European Central Bank.

The **lombard rate** determines the maximum cost of funds at the central bank.

The **deposit rate** constitutes a floor on fluctuations in overnight rates.

### Banking sector liquidity

The situation in which the central bank is the constant net debtor of the commercial banks under short- and long-term operations, taken together, is referred to as a **structural liquidity surplus**. Where, in circumstances of surplus structural liquidity, the central bank is the net debtor of the commercial banks under short-term operations, this is referred to as an **operating liquidity surplus**.

In 2003, the NBP will be conducting its monetary policy in conditions of both a structural and an operating liquidity surplus. The transition to an operating liquidity shortage would involve the necessity of a large issue of NBP bonds. Given the high public sector financial deficit and relatively low privatisation receipts, a large issue of NBP bonds would constitute competition for Treasury securities and lead to an undesirable rise in their yields. For this reason, in conditions of an operating liquidity surplus, measures will be continued with a view to reducing the structural liquidity surplus. This objective will be pursued gradually, in line with prevailing money market conditions.

To avoid volatilities in the operating liquidity of the banking sector, the measures taken by the central bank will impart a uniform, liquidity-absorbing character to the overall direction of open market operations. To this end, the redemption is projected of the bonds indexed to inflation issued by the NBP in 1999. This will allow the maintenance of a modest operating liquidity surplus within the banking sector and will at the same time improve the competitive position of the banks. This operation would remove one of the factors acting to maintain excessive spreads between lending and deposit rates.

## Open market operations

Open market operations will be the primary instrument allowing money market rates to be held at the level desired in terms of achieving the adopted inflation target.

**Basic operations** will set the direction of the monetary policy being pursued. This role will be performed by the regular weekly issue of 14-day NBP money market bills. The yields on these operations will be determined by the reference rate established by the MPC.

**Fine-tuning operations** will be applicable in the event of unexpected movements in liquidity generating shifts in market interest rates that are undesirable in terms of the monetary policy being pursued. These may either be liquidity-providing or liquidity-absorbing operations.

**Structural operations** will serve to alter the level of banking sector liquidity in the long term. The NBP will continue to conduct outright sales of Treasury conversion bonds. It is also projected that the redemption will be carried out of the bonds indexed to inflation issued by the NBP in 1999.

## Reserve requirements

The primary function of required reserves is to constrain the impact of movements in banking sector liquidity in stimulating interest rate fluctuations. This stems from the requirement that the commercial banks hold the requisite balances on their current accounts during reserve maintenance periods and facilitates the task of the central bank in maintaining market rates at the desired level.

Reductions in the reserve ratio will be contingent on the level of surplus liquidity within the banking sector.

## Lending and deposit taking

These operations serve to cushion the impact of movements in banking sector liquidity by establishing a corridor for fluctuations in overnight rates. In contrast to open market operations, lending and deposit operations are carried out at the initiative of the banks themselves.

**Lombard facilities** represent a source of short-term, overnight liquidity. They permit the banks to draw down overnight loans at the central bank at the end of the day. Lombard loans are collateralised by securities, and the rate payable on them defines the marginal cost of interbank funds.

**Overnight deposits** allow the commercial banks to place one-day deposits at the central bank. The deposit rate acts as a floor on fluctuations in short-term interbank rates

## Other operations

**Intraday credit facilities** constitute a collateralised form of central bank loan for repayment during the same working day. While these are not considered a monetary policy instrument, they represent an important element in the settlement system. They serve to improve the efficiency of interbank clearings. In 2003, the NBP will extend the eligible collateral for intraday credit to include Treasury bonds.

\* \* \*

Work will be continued in 2003 to prepare the operating system of the NBP for participation in the Eurosystem. Key tasks in this regard will include the establishment of the technical support facilities for the conduct of open market operations and lending and deposit operations in compliance with the principles in force within the Eurosystem, and also the full harmonisation of the system of reserve requirements. These adjustments will be carried out gradually. They are designed to improve the efficiency of financial markets, which should strengthen the effectiveness of monetary policy transmission.