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Cover photo:

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Translated by:

“Sigillum”

Layout and print:

Printshop NBP

Published by:

National Bank of Poland

Department of Information and Public Relations

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I

Monetary policy in 2004

The implementation of the *Medium-Term Monetary Policy Strategy for the Years 1999-2003* will be completed in 2003. According to all forecasts available, the medium-term target of the monetary policy set by the Monetary Policy Council (MPC) in 1998 – a CPI inflation rate below 4% – will be achieved.

In February 2003, the Monetary Policy Council adopted the Monetary Policy Strategy beyond 2003. This document sets forth the principles for administering monetary policy in the coming years. It will continue to be based on direct inflation targeting. Under the adopted strategy, starting from January 2004 a continuous inflation target of 2.5% will be pursued on a year-to-year basis, with a permissible deviation band of ± 1 percentage point. This means that as of early 2004 the performance of the inflation target will not be verified in December, as has been the case so far, but in the course of 2004 and the subsequent years. Setting a continuous inflation target was possible owing to lower inflation and conducting a policy of stabilizing the inflation rate at a low level.

Until joining ERM II, the strategy of direct inflation targeting will take place in a floating exchange rate environment. The floating exchange rate system ensures flexible response to unexpected shocks affecting the economy. International experience shows that such exchange rate systems reduce the risk of a currency crisis. Notwithstanding the above, the MPC reserves the right, as in the previous years, to intervene on the currency market, should this prove necessary for the achievement of the inflation target. If the inflation rate goes beyond the permissible deviation band, monetary policy will be revised to ensure its restoration to the level consistent with the target set within a medium-term time horizon. This measure should help reduce variations in national productivity.

The monetary policy in 2004 will be pursued in a manner aiming to enable Poland's accession to the euro zone as soon as possible. In 2004, it is advisable for the Polish government and the NBP to initiate negotiations with the representatives of the European Commission and the European Central Bank regarding Poland's membership in ERM II. In the opinion of the MPC, the permissible corridor for fluctuations should remain as wide as possible ($\pm 15\%$) and be introduced for a period as short as possible, i.e. two years in the case of ERM II. As shown by the experience of many countries, the reduction of the foreign exchange fluctuation band frequently gives rise to speculative attacks and currency crises.

Therefore, the timing of ERM II accession should allow for the meeting of other convergence criteria, namely those involving inflation rates, long-term interest rates, central government deficit and public indebtedness, as early as in the second year of the membership. The meeting of the criterion concerning central government deficit requires comprehensive public finance reforms, which are also indispensable for the establishment of foundations for sustainable economic development. These reforms are also necessary for sustainable fulfilment of the public debt criterion.

It is in Poland's best interest to meet the convergence criteria as soon as possible as not only is it a condition the country's accession to the euro zone but is also consistent with high and stable economic growth. The euro zone membership will allow our country to enjoy substantial economic benefits resulting from reduced macro-economic risk, lower costs of securing external funding, higher volume of trade with the euro zone, elimination of some transactional costs, more extensive price comparability and enhanced competition.

II

Factors affecting the performance of the monetary policy target

Monetary policy is pursued in an environment which is also affected by factors beyond the control of the central bank.

External factors

External business activity may significantly affect inflation levels via a demand channel while the global situation may lead to movements in supply and pricing of inputs.

Global growth forecasts for the year 2004 point to a gradual recovery of external business activity. According to forecasts available in August 2003, economic growth in 2004 is expected to exceed this year's figure both in the euro zone, where GDP growth of about 2.0% is envisaged (against 0.8% forecast for the year 2003), and in the United States, where growth is to come to roughly 3.7% (against 2.5% in 2003). Recent years have shown, however, that forecasts of economic growth may be subject to a large margin of error and should therefore be approached with caution.

In 2004 the demand factors are unlikely to contribute to substantial price increases in the world raw-materials markets. Nevertheless, periodic supply movements attributable primarily to higher geopolitical risk cannot be ruled out, which, in consequence, may lead to wider price fluctuations on raw materials markets, including in particular oil prices.

Food prices & officially controlled prices¹

Movements in food and non-alcoholic beverage prices have major impacts on the inflation rate as these products hold a large share in the basket of consumer goods and services (currently 28.2%).

It is forecast that in 2004 the average annual price growth of food and non-alcoholic beverages will stand at around 2%. Based on preliminary estimates, this year's harvests of grain, fruit and vegetables are expected to be lower than the average figure for the last two years. Yet, it is assumed that the 2004 harvests will be the average of previous years. As far as prices of foodstuffs of animal origin are concerned, the falling trend is expected to slow in 2003 and to be reversed in 2004.

Shifts in officially controlled prices, currently holding a combined share of 27.2% in the basket of consumer goods and services, are likely to have major influence on price growth.

The August 2003 outlooks for the world fuel market envisage a slow decline in oil prices. In 2004, external factors are likely to encourage price decreases in Poland. However, a slight acceleration in the growth of domestic fuel prices may occur due to the impact of internal factors, i.e., a possible increase in the excise duty rate, the launch of a fuel charge, and the policy pursued by domestic fuel producers and distributors. Domestic fuel prices will also be affected by movements in the zloty to the US dollar exchange rate.

At present, the National Bank of Poland estimates that in 2004 the average annual growth in officially controlled prices will be approximately 2%.

¹ Officially controlled prices include: 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.

Economic development and systemic factors

Following the economic slowdown in the years 2001-2002, external business activity gathered speed in 2003, primarily as a result of rapid growth in exports and a gradual improvement in investment. The decline in the inflation rate to the level recorded in developed countries and a significant reduction of the current account deficit of the balance of payments permitted a gradual decline in the control of monetary policy. In consequence, in the period from March 2001, when the series of cuts was initiated, to June 2003, the NBP interest rate was brought down 13.75 points, from 19% to 5.25%. The CPI-deflated real reference rate dropped over 7 points during that period.

The National Bank of Poland estimates that real GDP growth in 2003 will be 3-3.5%. As a result of further improvement in global economic outlooks, related among other things, to the effects of interest rate cuts made so far, the 2004 monetary policy will probably be pursued in the context of a 4-5% GDP growth. Economic recovery will be further encouraged by gradual improvement in the economic situation of Poland's major trading partners. Economic acceleration will be accompanied by a more rapid closure of the demand gap.

In the long term, monetary policy contributes to the acceleration of economic growth by stabilising inflation at a low level. Sustainable accelerated growth, however, also requires the implementation of specific structural reforms to eliminate numerous weaknesses of the Polish economy, including, but not limited to:

- Statutorily determined high social expenditures that destabilises the central government budget,
- Labour market distortions (such as high net salary burdens and lack of territorial differentiation of minimum pay),
- Excessive market regulation in some areas (energy sector and services related to flat usage) which blocks flexible supply adjustment,
- The persistently high share of state ownership in many key sectors of the economy (e.g., mining, fuel, and rail transport),
- The low efficiency of government administration (e.g., a high degree of arbitrariness in decision-making due to the poor quality of the regulatory framework, lengthy proceedings in commercial courts).

Leveraging of the growth opportunity associated with Poland's membership reform of public finances will in the European Union is contingent, among other things, on adequate utilisation of EU funds so that their highest proportion is allotted towards investments that promote growth. Once the above condition is fulfilled and the listed barriers to growth are removed, not only may the development gap be closed at a faster rate but the unemployment level will decline on a permanent basis and the reform of public finances will thereby be facilitated. The restructuring of the supply side will contribute to the stabilisation of inflation at a low level in the context of accelerated sustainable economic growth.

Fiscal policy

On the basis of the information available, it can be assumed that in 2004 the public finance disequilibrium will show further a downward trend. In relation to 2003, the central government deficit will increase by ca. 2% of GDP. All this will take place at the time of accelerated economic growth. Thus, the structural deficit – by definition – net of the impact of cyclical factors, will accelerate.

The increase in the central government deficit can be traced to a high dynamic of public spending and liabilities of the central and local government, only partially attributable to Poland's

accession to the European Union. The high level of other expenditures is the consequence of the government's failure to carry out structural reforms.

The fiscal policy envisaged for the year 2004 will contribute to higher public indebtedness which is likely to exceed 55% of GDP, i.e., the second threshold as defined in the Act on public finance. This should be treated as an important sign of a public finance crisis. Pursuant to the Act on public finances, in the following year the government is obliged to submit a draft budget providing for a decline in the ratio of State Treasury indebtedness to GDP by the end of the budget year.

The high and growing central government deficit in the years 2001-2004 and the resulting rapidly expanding public debt threaten economic development. A more relaxed fiscal policy reduces enterprises' chances of obtaining debt financing. Banks prefer to place their funds in low-risk government bonds instead of funding high-risk investment projects. Expanding public indebtedness also contributes to growing uncertainty which, in turn, discourages investment. Thus, the condition of public finance gradually stunt growth in the development potential of the economy and defers the fulfilment of fiscal convergence criteria.



III

Monetary policy instruments

In May 2004, on Poland joining the European Union, the National Bank of Poland will become a member of the European System of Central Banks. Nevertheless, the principles of Poland's monetary policy will continue to be autonomously defined by the MPC.

Interest rates

Interest rates represent the principal instrument employed by the Monetary Policy Council to achieve the adopted inflation target. The rates which define the direction of the monetary policy being pursued are **the reference rate, the lombard rate and the deposit rate**. The NBP will make sure the level of interest rates is consistent with the adopted inflation target, by directly influencing money market rates.

The reference rate sets the minimum yield obtainable on basic open market operations, while at the same time influencing deposit rates in the interbank market for comparable maturities.

The lombard rate determines the maximum cost of securing funds from the central bank, by setting a ceiling on fluctuations in overnight market rates.

The deposit rate constitutes the lower limit on movements in market rates. It allows banks to place O/N deposits at the central bank once they have funds available.

The deposit and lombard rates set the permissible fluctuation band for overnight rates in the interbank market. The corridor thus established will run symmetrically to the reference rate.

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 **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 **operating liquidity surplus**.

There are many factors affecting banking sector operating liquidity whose levels in 2004 cannot be accurately projected. These include, first of all, notes and coin in circulation, volume of central government deposits at the NBP, purchase of foreign currencies by the NBP under transfers from the European Union and sale of foreign currencies by the NBP for the purpose of servicing foreign debt. It is highly probable that operating liquidity surplus will persist in the banking sector throughout 2004. If however, the banking sector temporarily loses operating liquidity, the NBP will adjust monetary policy instruments accordingly.

In 2004, efforts will be continued aimed at limiting structural liquidity surplus. This objective will be achieved gradually, subject to the conditions prevalent in the money market.

Open market operations

Open market operations will be the primary instrument to allow interbank market rates to be kept at a level to achieve the projected inflation target.

The NBP will make use of the following set of instruments under open market operations:

Basic operations in the form of issuing 14-day NBP money market bills.

Tenders for the bills will be conducted on a regular weekly basis, with their yields corresponding to the reference rate established by the MPC.

Fine-tuning operations will be applicable in the event of unexpected movements in the banking sector's liquidity or in the case of distortions leading to shifts in interbank market rates undesirable from the point of view of the monetary policy being pursued.

These would include both liquidity-absorbing and liquidity-providing operations such as issues of NBP money market bills, repurchase operations and buyout of the NBP money market bills prior to their maturity.

Structural operations will aim to alter the level of banking sector liquidity in the long term.

In 2004, the central bank could, if necessary, buy out its own bonds held in the portfolios of the commercial banks or issue long-term securities.

Reserve requirements

One of the primary functions of mandatory reserves will be 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 stabilising market rates at the desired level.

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

Lending and deposit operations

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

Lombard facilities represent a source of short-term, overnight liquidity. They allow the banks to contract 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.

Other operations

An important element of the clearing system are intraday credit facilities which constitute a form of central bank loan for repayment during the same working day. They are interest-free and are collateralised by treasury securities.