National Bank of Poland

Monetary Policy Council

Monetary Policy Guidelines for the Year 2008

Warsaw, September 2007

Monetary Policy Guidelines for the Year 2008 is a translation of the National Bank of Poland's *Założenia polityki pieniężnej na rok 2008* in Polish. In case of discrepancies, the original prevails.

1. Monetary policy strategy

According to the Article 227 para. 1 of the Constitution of the Republic of Poland “the National Bank of Poland shall be responsible for the value of Polish currency.” The Act on the National Bank of Poland of 29 August 1997 states in Art. 3 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”.

Contemporary central banks understand price stability as an inflation low enough as not to exert negative influence on investment, savings and other important decisions taken by economic agents. Ensuring thus understood price stability is a fundamental way in which the central bank contributes, by means of its decisions, to high and sustainable economic growth. Central banks view price stability symmetrically, which means that they respond both to inflationary and deflationary threats.

The Monetary Policy Council (MPC) bases its monetary policy on the direct inflation targeting (DIT) strategy. International experience shows that this strategy is an effective method of ensuring price stability. Having brought down inflation to a low level, in 2004 the MPC adopted a permanent inflation target of 2.5% with a symmetrical tolerance range for deviations of ± 1 percentage point. This arrangement may be in force until Poland joins the ERM II. The MPC pursues this strategy under a floating exchange rate regime, which should be maintained until Poland’s accession to the EMR II. Floating exchange rate regime does not rule out foreign exchange interventions should they turn out necessary for the inflation target implementation.

The Council maintains the following understanding of the inflation target and the way of its implementation:

- First, the notion of *permanent* inflation target means that it refers to inflation measured as a year-on-year change in prices of consumer goods and services in each month compared to the corresponding period of the preceding year. For a better understanding of inflation processes it is also justified to use quarterly and annual inflation indices such as those used in the NBP’s inflation projection and in the central budget. An important role in the assessment of inflationary pressure is also played by core inflation indices.

- Second, the adopted solution means that the monetary policy is unequivocally focused on maintaining inflation as close as possible to the target of 2.5% and not only within the tolerance range. The adopted solution provides anchoring for inflation expectations, thus facilitating the pursuit of monetary policy, which in case of shocks requires smaller and less frequent interest rate changes.
- Third, the occurrence of shocks in the economy is inevitable. It is the scale and the duration of inflation deviation from the adopted target that may differ depending on the strength of the shock and the degree of inertia of inflation expectations. The central bank normally does not respond to deviations from the inflation target which it deems temporary and which lie within the tolerance range around the target. In countries with a permanently low inflation, the central bank does not have to respond even when inflation leaves the tolerance band temporarily. In the case of shocks viewed as leading to a permanent deviation from the inflation target, the central bank adjusts its monetary policy accordingly.
- Fourth, monetary policy reaction to shocks will also depend on their causes and nature. The reaction to demand shocks is a relatively minor issue, since in this case inflation and output move in the same direction. An interest rate increase weakens economic activity and, consequently, inflationary pressure. Supply shocks are a more difficult problem from the point of view of monetary policy, as in this case output and inflation move in opposite directions. Inappropriate monetary policy reaction may have far-reaching negative consequences for the economy. An attempt to fully neutralise the impact of a supply shock on inflation through monetary policy may lead to an unnecessary plunge in output, as the supply shock itself already has a negative effect on consumption and investment. On the other hand, an attempt to fully accommodate a supply shock resulting in a price increase and output decrease – by pursuing an expansive monetary policy – usually leads to persistently higher inflation, which, in turn, requires a far more restrictive monetary policy in subsequent periods, bringing about a stronger deceleration in economic growth. Reaction of the central bank should depend on the assessment of the shock's durability.
- Fifth, most of supply shocks are transitory and limited in scale. Thus, they do not require an immediate reaction. However, in the case of strong shocks even temporary acceleration in

price growth may bring about a relatively permanent rise in inflation expectations and, in turn, an increase in inflation due to the emergence of wage demands. In such a situation, monetary policy has to prevent secondary effects of the supply shock (the so-called second-round effects). The risk of such effects is substantial in countries with a short history of low inflation. Very useful in analysing supply shocks are core inflation indices, which help to distinguish, at least roughly, temporary effects from permanent changes in inflationary pressure.

- Sixth, because the reaction of output and inflation to the pursued monetary policy is delayed, its influence on the level of current inflation is limited. Current decisions of the monetary authorities affect price developments in the future just as current inflation is influenced by interest rate changes made several quarters ago. However, the length of these lags is not constant and, to a large extent, depends on structural and institutional changes ongoing in the economy. Changes in the transmission mechanism of monetary impulses result in a situation in which central banks can only approximately determine the time lag between an interest rate decision and its strongest observed impact on real variables (output, employment) and then on inflation.
- Seventh, monetary policy affects the economy not only by changing interest rates but also by keeping them unchanged for a period of time. The decision to keep interest rates unchanged for several periods (months or quarters) has substantial consequences for the economy as well, because it leads to a gradual widening or narrowing of the output gap.
- Eighth, monetary policy is pursued under uncertainty. Large uncertainty is due, among others, to the fact that inflation projection models utilised by central banks may start to less adequately describe economic processes owing to the ongoing structural changes in the economy. This means that (a) while making decisions it is necessary to take into account all available information, rather than just the inflation projection; (b) it is not possible to adopt a simple policy rule which could be known *ex ante* to market participants; and (c) forward-looking monetary policy has to be presented to the public as an attempt to achieve the inflation target under uncertainty, rather than an exercise of strict control over economic processes.
- Ninth, in pursuance of monetary policy, while assessing the inflation outlook, especially when inflation is low, central bankers account for the prices of assets because of the need to

ensure financial stability. In the conditions of liberalised financial markets and amid favourable developments on the supply side of the economy supporting low inflation, it is becoming ever more essential for monetary authorities to allow for the financial stability in their decisions. If in response to low inflation central banks reduce interest rates too much, this may lead to rapid asset price growth. This growth is accompanied with the risk of the so-called unstable boom, where higher inflation surfaces with a considerable lag. Such rapid growth in asset prices is also accompanied with the rising risk of their violent and considerable slump, which poses the threat to the stability of the financial system and the real economy. Financial system stability ensures effective operation of the transmission mechanism, which is crucial for appropriate monetary policy implementation. In assessing the risk of turmoil in the asset market and the inflation outlook, it may be useful in the longer run to account for the paths of monetary aggregates.

- Tenth, in assessing monetary conditions, not only the level of real interest rates should be considered but also the level of the real exchange rate. Thus understood restrictiveness of monetary policy impacts, along with the implemented fiscal policy, the total restrictiveness of macroeconomic policy. An overly expansive fiscal policy is the most common reason that necessitates keeping the interest rates at a higher level.
- Eleventh, an important input into monetary policy decision-making process is the balance of factors affecting the probabilities of future inflation running above or below target. This balance is based on the inflation projection, the assessment of the actual economic developments, which may deviate from the scenario presented in the projection, as well as the course of variables and information not accounted for directly in the projection. While assessing the factors affecting future inflation, central banks take into consideration the length of the period in which inflation remained close to the target, because such course of inflation favours the anchoring of inflation expectations.

The Council maintains its belief that that it would be most beneficial for Poland to pursue an economic strategy aimed at creating conditions for introduction of the euro at the earliest possible date, with proper consideration of the balance of costs and benefits connected to the euro adoption.

2. Monetary policy in 2008

The Polish economy is currently in the period of strong growth encompassing all its sectors. The dominant contribution to GDP growth comes from the fast growing domestic demand. Exports rise significantly, yet due to the recovery in domestic demand and concurrent imports acceleration, the contribution of net exports to GDP growth will be negative in 2007. Strong economic growth is accompanied with fast growth in employment and falling unemployment. Average wage in the economy is growing faster than labour productivity, which leads to a rise in unit labour costs.

In 2008 a slight slowdown in relation to 2007 in the economic activity is expected in the euro area, while in the United States the economic growth is to step up[1]. In the United States, however, the risk persists of significantly lower economic activity connected to the possibility of a deeper than expected fall in real estate prices in the US market and of high volatility in global financial markets being continued in the longer period. Under such a scenario, general economic conditions in the world economy would worsen. This, in turn, through limiting the external demand, would be conducive to weakening the rate of economic growth in Poland.

An important element of external conditions are crude oil prices, which according to the current forecasts should remain high in the years to come[2]. In view of the favourable forecasts of global economic growth a relatively large increase in the world demand for oil is expected both in the second half of 2007 and in 2008, which may be conducive to a further drop in oil inventories. Moreover, maintaining oil output by OPEC countries[3] at an unchanged level and a high political risk in oil producing regions may lead to a further rise in price pressure of this commodity.

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[1] The assessment by the Macroeconomic and Structural Analyses Department of the NBP, which accounts for the forecasts of external institutions (ECB, OECD, European Commission, commercial banks) of August and September 2007, indicates that the GDP growth rate in the euro area will decline in 2008 to 2.2% as compared to 2.5% in 2007, while in the USA in 2008 it will amount to 2.6% compared to the expected 1.9% in 2007.

[2] The forecast of the US Department of Entergy of 11 September 2007, adjusted for the difference between the prices of Brent and WTI oil following from futures market quotations, indicates that the average WTI oil price in 2007 will be 67.9 USD/b and in 2008 - 71.3 USD/b.

[3] Taking into consideration that the growth of oil output in non-OPEC countries is considerably slower than that of the global demand for oil,, the output of OPEC countries, which currently have relatively large reserves of production capacities, will be of crucial importance for fuel market equilibrium.

Over the past few years a steady increase in food prices has been observed in the global markets. The relatively long-lasting upward trend in food prices may indicate that it stems from structural changes rather than short-term adjustments. The increasingly tight connections between the domestic agro-food sector and the global food market may result in rising trend of the world food prices becoming a risk factor for inflation growth in Poland.

The perspectives of the continuation of the high oil prices and food price growth may be conducive to inflation rise in Poland in 2008. However, the monetary policy pursued by major central banks indicates their intension to ensure price stability in the medium term, which, considering the growing importance of trade connections among countries and incomplete pass-through of inflation to foreign exchange rates, should favour the curbing of inflation growth in Poland. In the euro area and the United States, in 2007 inflation will fall in relation to 2006, while the current forecasts for 2008 point to the stabilisation of the price growth in the euro area at the level close to definition of price stability by the European Central Bank and a further slight lowering of the inflation in the United States[4].

The outlook for economic growth in Poland in 2008 remains favourable. The GDP growth will probably fall slightly in relation to 2007. The structure of growth will most probably remain basically unchanged, with the primary role of domestic demand growth (investment and consumption) and still negative contribution of net exports to GDP growth. It can be assessed that investment growth will range at a high, double-digit level, which should be supported by, among others, the favourable demand outlook (both in Poland and abroad), high capacity utilisation and the inflow of foreign direct investment and funds from the EU. Consumption growth will probably result from fast growing disposable income of households, including in particular the growing aggregate wages (rise in the number of employed persons and pay rises additionally increased by the reduction of the disability pension contribution in 2007 and 2008[5]), increased

[4] The assessment by the Macroeconomic and Structural Analyses Department of the NBP, which accounts for the forecasts of external institutions (ECB, OECD, European Commission, commercial banks) of August and September 2007, indicates that inflation in the euro area will continue at 2.0% both in 2008 and 2007, while in the United States it will be 2.3% in 2008 compared to 2.7% in 2007.

[5] Act of 15 June 2007 amending the Act on the Social Security System and some other acts, among others, provides for the lowering of disability pension contributions to be introduced on 1 July 2007 by 3 percentage points on the employee's side and a further reduction on 1 January 2008 by 2 percentage points on the employee's side and 2 percentage points on the employer's side. Eventually, as a result of these changes, the disability pension will be reduced from 13% to 6% of the contribution assessment basis.

households' income from private business activity and the scheduled indexation of the old-age and disability pensions[6].

The fast economic growth and labour market recovery is accompanied by a gradually rising inflation. After a period when the annual CPI had remained below the lower limit of the tolerance band for deviations from the NBP's inflation target, at the beginning of 2007 the annual rate of inflation moved back into the tolerance band and in March returned to the target (of 2.5%). In the subsequent months inflation stayed close to the target. Nevertheless, having assessed that in the medium term the probability of inflation overshooting the target was larger than the probability of its running below the target, at its meetings in April, June and August 2007 the Council decided to raise the NBP's interest rates (by 25 basis points on each occasion).

Adjusting monetary policy to the changing economic conditions is a common way in which central banks stabilise inflation at the inflation target in the medium term. If expected high economic growth in Poland is accompanied by growing inflationary pressure, it will be necessary to further tighten the monetary policy. In the case of strong shocks, the monetary policy will be focused on target implementation in the medium term. The Council will aim at ensuring that bringing back inflation close to the target (2.5%) in the first half of 2007 is sustainable. Maintaining the inflation close to the target creates favourable conditions to anchor inflation expectations at the target level which should, in the future, enable the implementation of the inflation target with lower fluctuations of interest rates and GDP.

Major factors which will affect the monetary policy in 2008 include the situation in the labour market and the situation in the public finance sector.

It is expected that the continuing high economic growth will further boost the demand for labour and the growth of the employed in the economy will remain positive, albeit lower as compared to 2007. Employment growth will be mainly the result of the enterprises running out of the possibilities to further increase production without employment increase and the result of new jobs being created in labour-intensive sectors, i.e. services and construction. Since 2006 the growth in demand for labour has been accompanied with a decline in the number of the economically active which is connected, among other things, with economic migrations of Poles

[6] At the end of May 2007 the government approved a draft that provided for the indexation of old-age and disability pensions to be conducted each year starting from 2008.

to some EU member states. It may be expected that this phenomenon unfavourable from the point of view of the economic potential will be curbed and that 2008 will see a gradual increase in labour supply. However, lack of complete and reliable data on the number of Poles working abroad significantly hinders the quantitative assessment of the impact of this phenomenon on inflation processes, and, as a result, increases the uncertainty in the conduct of monetary policy. In turn, the extension of period for taking early retirement and a considerable increase of minimum wage will have a negative impact on the number of the economically active. The extension of period for taking early retirement leads to deactivation of employees at pre-retirement age. The increase of minimum wage eliminates from the labour market part of the lowest qualified persons or shifts their employment to the grey economy.

Continuation of strong growth in the number of working persons and a relatively slow growth in the number of the economically active combined with labour supply and labour demand misalignment may aggravate problems faced by enterprises looking for appropriately qualified employees and contribute to maintaining high wage growth. As a result, despite favourable outlook for economic growth and growing labour productivity, the year 2008 is expected to see further increase in unit labour costs, and, in consequence, growing inflationary pressure.

Fiscal policy developments in the years 2008-2009 will be another important factor for the monetary policy. The importance of fiscal policy outlook in the years to come results from the fact that entities tend to take into account in their current decisions also the expected changes in the fiscal burden. The reduction of disability pension contribution, extension of pro-family tax reliefs in personal income tax and change of the tax scale including the reduction of the highest tax rate by 2009 will contribute to a significant reduction of general government revenues. These are the solutions which support the sustainable high economic growth in the long run provided they are accompanied with appropriate reduction in general government expenditure. At present, however, there are no specific proposals aimed to compensate for the reduction of general government revenues through the reduction of public spending, and the proposals which are put forward instead of easing taxes imply tax increase. Such solutions could weaken the favourable impact of the reduced tax wedge on the potential of the Polish economy. A risk factor for the growth outlook might be the fact that the declared tax reductions will be introduced amidst the expected continuation of fast economic growth, which may boost the public finance deficit, especially when the economic growth slows down. It is feared that this might increase inflationary pressure and worsen the policy mix.

While discussing the monetary policy issues, the Council takes into account the results of research and analyses carried out at the NBP. In 2008 the research will include also works on the costs and benefits of Poland's joining the euro area.

An important element of inflation targeting is the communication with the general public. For this reason, the Council presents its assessments of the current and future economic developments. An important element of communication are the *Minutes of the Monetary Policy Council decision-making meeting* published monthly since April 2007, which present major issues discussed at the Council's meetings and arguments put forward by the participants. *Inflation Reports,* press releases and conferences following MPC meetings will continue to be among major communication instruments in 2008. The Council will use its best efforts to ensure transparency of the monetary policy.

In line with the practices pursued by the growing number of central banks, in its attempt to provide a more insightful analysis of economic developments, the Council decided to limit the frequency of publications of the *Inflation Report* and inflation projection from four to three times a year. Such frequency of projection publication will be sufficient from the point of view of the medium-term character of interdependence between the monetary policy and economic processes. In turn, the time gained between preparations of subsequent *Reports* will be used to deepen the NBP research and to further develop analytical tools necessary for the efficient conduct of the monetary policy. Moreover, monthly publication of *the Minutes of the Monetary Policy Council decision-making meeting* started in 2007 will make it possible to present the opinions of MPC members on inflationary processes with considerably shorter lag and in a more detailed way. Thanks to this, the reduced number of *Reports* will not have any negative impact on the transparency of the monetary policy. Reports will be published in February, June and October.

3. Monetary policy instruments

Banking sector liquidity

The year 2007 saw stabilisation of the level of liquidity surplus of the banking sector as measured with the scale of the issuance of NBP bills. It is estimated that the average value of the NBP bills issued this year will amount to approx. PLN 20 billion.

It is anticipated that after the rise in 2005-2006 the liquidity surplus in 2008 will be limited. Similarly to the previous years, the main factor conducive to raising the level of the surplus liquidity of the banking sector will be the inflow of EU funds to Poland and the currency conversion of those funds at the NBP. In turn, the factor responsible for lowering the surplus liquidity level will be the increase in notes and coin in circulation. The value of term deposits of the Ministry of Finance held with the NBP will average at the level consistent with that recorded in 2007.

Interest rates

The principal instrument of monetary policy are short-term interest rates. Changes in the NBP's reference rate define the direction of the pursued monetary policy. The NBP's deposit and lombard rates set the fluctuation band for overnight interest rates in the interbank market.

The NBP's reference rate determines the minimum yield obtainable on the basic open market operations, influencing, at the same time, the level of the short-term deposit rates in the market of unsecured interbank deposits.

The NBP's lombard rate determines the maximum cost of securing funds from the NBP. It sets the ceiling for the growth of the overnight market rates.

The NBP's deposit rate determines the interest on the deposits made with the NBP. It determines the lower limit for the fall of the overnight market rates.

Open market operations

Open market operations are the principal instrument for maintaining the short-term interest rates at a level consistent with the pursuit of the MPC-established inflation target.

Basic open market operations in the form of the issuance of 7-day NBP bills are conducted on a regular weekly basis. These operations are used by the central bank to manage the current liquidity level of the banking sector. Starting from 2008 a fixed rate at the level of the NBP’s reference rate will be binding during tenders for NBP bills.

The central bank will conduct basic operations on the scale that will enable the level of the POLONIA rate to settle around the NBP's reference rate. The transition from influencing the level of the WIBOR SW rate to the POLONIA rate results from the tendencies taking place in the term structure of the money market. Over the recent years there has been a rise, among others, in the share of overnight deposits in the total turnover of the market of unsecured interbank deposits. They currently account for the major part of all transactions. Thanks to the transition to the overnight rate, the NBP will be able to more effectively affect the economy through the monetary policy transmission mechanism. In turn, stabilising the overnight rate around the NBP reference rate will help banks to manage their own liquidity position more effectively.

Fine-tuning operations may be conducted in order to limit the impact of unexpected short-term movements in the liquidity of the banking sector on the level of the short-term interest rates, including the POLONIA rate in particular. These operations may be both liquidity-absorbing and liquidity-providing and may include: issuing the NBP bills, repo and reverse repo transactions and the redemption of NBP bills before their maturity.

Structural operations can be conducted in order to change the level of banking sector liquidity in the long term. Should the need arise, the central bank may execute the structural operations by issuing bonds, buying back its own bonds before their maturity, purchasing and selling securities on the secondary market.

Reserve requirement

The basic function of the reserve requirement is to mitigate the impact of movements in the banking sector on short-term interest rate fluctuations. Any possible changes in the reserve ratio will depend on the liquidity conditions in the interbank market.

Standing facilities

Standing facilities are meant to limit the scale of fluctuations of the overnight interest rate of the interbank market. Banks participate in these operations on their own initiative.

Deposit facility enables banks to deposit their liquidity surplus on an overnight basis with the central bank, and the interest on this facility constitutes the lower limit for the market rate quoted for this particular period.

Lombard facility enables banks to obtain credit from the central bank on an overnight basis. The interest on this facility determines the maximum cost of obtaining funds from the central bank and constitutes the upper limit for the overnight market rate. Lombard facility is collateralised with securities accepted by the central bank.

Intraday credit facility, i.e. both zloty and euro loans offered by the NBP, will remain an important element of the clearing system, as the source of funds obtained during the operating day. These are non-interest bearing loans. Similarly, as in the case of the lombard facility, they are collateralised with securities accepted by the central bank.

Foreign exchange interventions

Foreign exchange interventions are another monetary policy instrument which may be used by the NBP. In the Polish economy, exchange rate fluctuations exert a considerable impact on inflation. Thus, there may arise circumstances in which the NBP will decide whether it is necessary to intervene in the currency market in order to stabilise inflation.