National Bank of Poland

Monetary Policy Council

Monetary Policy Guidelines for 2009

Warsaw, September 2008

Monetary Policy Guidelines for 2009 is a translation of the National Bank of Poland's *Założenia polityki pieniężnej na rok 2009* 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. The MPC pursues this strategy under a floating exchange rate regime. 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, in the central budget and in the statistics of the European Union. 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 also depends 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 to such a shock 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 – by pursuing an expansive monetary policy – the real effects of a supply shock resulting in a price increase and output decrease 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 durability of the shock's effects.

- 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. 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 path of inflation in the past since it has a bearing on the anchoring of inflation expectations at the level of the inflation target. In this context it is important to consider the length of the period in which inflation remained close to the target and the length of the period in which it deviated from the target.

If a binding decision is taken on the scheduled date of Poland joining the euro area and the related entry to ERM II, the Council will make all necessary adjustments of the monetary policy strategy and – in consultation with the Council of Ministers – of the exchange rate policy to conditions ensuing from the necessity of meeting the convergence criteria indispensable for the euro adoption. In the Council's opinion, the accession of Poland to the euro area should take place at the earliest possible date.

The Council expresses its view that in the coming years economic policy in Poland should be conducted in such a way as to – by implementing structural reforms – enable the sustainable fulfilment of the Maastricht criteria and, at the same time, the maximisation of benefits related to the euro area accession.

2. Monetary policy in 2009

The basic objective of the monetary policy conducted in 2009 will be – as in the previous years – to maintain inflation at the level of 2.5% in the medium term. At the same time, monetary policy will continue to be conducted in such a way as to support sustainable economic growth.

If a binding decision is taken on the scheduled date of Poland joining the euro area, the Council will adjust the monetary policy strategy to conditions ensuing from the necessity of meeting the convergence criteria indispensable for the adoption of the euro.

In the first half of 2008 the Polish economy was in the period of strong growth encompassing most of its sectors, although economic growth has been gradually slowing down for several quarters. The most important factor in GDP growth was still the rise in consumption and investment. Exports continued to rise, yet due to the persisting high growth in domestic demand and the strong increase in imports, which was supported by zloty exchange rate appreciation, the contribution of net exports to GDP growth continued to be negative. At the same time, the current account deficit was widening. Strong economic growth was accompanied by rapid employment growth and falling unemployment as well as high wage growth. The average wage in the economy was growing markedly faster than labour productivity, which led to a significant rise in unit labour costs. These developments were accompanied by a rise in core inflation.

In the first half of 2008 CPI inflation was above the NBP’s inflation target, which was, to a large extent, fuelled by strong growth in the prices of food and agricultural products and energy commodities in the global markets as well as significant increases in administered prices in Poland, i.e. factors that are beyond the direct impact of the domestic monetary policy. Rising prices of some services also contributed to the rise in CPI inflation. Factors decreasing the inflationary pressure were, on the other hand, the significant appreciation of zloty exchange rate and the increases of the NBP’s interest rates that started in 2007. Additionally, inflation was curbed by the continued decreases in the prices of manufactured goods imported from low cost countries. Despite price growth acceleration, in the first half of 2008 inflation in Poland was considerably lower than in most other Central and Eastern European countries.

In 2009, as in the previous years, both changes in the external factors affecting the Polish economy as well as domestic factors affecting the outlook for inflation and economic growth in Poland will be of considerable importance for the conduct of monetary policy.

Economic activity in the external environment of the Polish economy is largely affected by the turmoil in the global financial markets observed since the second half of 2007 as well as a considerable rise in oil prices. Those factors contributed to a slowdown in economic growth in many countries. In 2008 GDP growth will likely fall significantly below the level observed in 2007, among others, in the United States, the euro area and the United Kingdom. 2009 is expected to bring further decline in economic growth in major economies[1]. Low GDP growth in those economies, in particular in the euro area, which is Poland's main trading partner, through limiting Polish exports will be conducive to lowering economic growth in Poland.

In 2008 inflation increased to the highest level in several years in developed countries and in emerging economies. This rise in inflation was largely the result of a strong growth in the prices of food and energy commodities, including oil, in the global markets. The factor which might have contributed to the rise in inflation was the previously observed relatively low level of real interest rates in the international financial markets.

Current forward market quotations suggest that oil prices might remain at a relatively high level in 2009[2]. Despite decreasing forecasts of oil demand in developed countries, high growth in oil demand in developing countries and the concurrent slow rise in oil supply continue to be important factors affecting the prices of this commodity.

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[1] The assessment of the Economic Institute of the NBP, which accounts for the forecasts of external institutions (IMF, OECD, European Commission, commercial banks) available until September 2008 indicates that the GDP growth in the euro area will decline in 2009 to 1.0% as compared to 1.3% expected in 2008 while in the United States it will amount to 1.5% in 2009 as compared to 1.7% expected in 2008.

[2] Forward market quotations of September 2008 suggest that the average Brent oil price in 2008 will amount to 109.6 USD/barrel and in 2009 to 106.4 USD/barrel.

The strong growth in the prices of food and agricultural products in the global markets started in the autumn 2007 and persisting in 2008 was driven by both short-lived supply disturbances (drought in some countries) and by structural changes (increased food demand in emerging economies and the development of the biofuel market). In 2009, despite a marked decline in economic growth in the world economy, food prices, similarly to oil prices, are most likely to remain at a relatively high level, though their growth should slow down.

The global inflationary pressure that was driven by rising prices of energy commodities and food is expected to ease in 2009, which will be conducive to lower inflation both in developed economies – including the United States and the euro area[3] – and in emerging economies. Economic slowdown in countries that are Poland's main trading partners will also be conducive to curbing inflation in those countries. On the other hand, increased inflation expectations and the ensuing risk of second-round effects and inflation continuing at a heightened level are likely to have the opposite effect. The monetary policy conducted by major central banks will also be of importance in this respect.

The shocks observed in the global economy since the second half of 2007 are a challenge for the monetary policy of many central banks. On the one hand, central banks have to take into account a significant rise in current inflation and the risk of its persistence despite the fact that the increase in inflation is largely – in particular in small open economies – the result of external factors beyond the direct impact of their monetary policy. On the other hand, inflationary price shocks in energy commodity markets adversely affect economic growth. Therefore, in their decisions central banks have to take into consideration the risk of excessive slowdown in economic growth connected with the monetary policy tightening that would be necessary to bring inflation down to a low level in a short time. In countries where the rise in commodity prices has not been cushioned by exchange rate changes, banks also have to account for the higher

[3] The assessment of the Economic Institute of the NBP, which accounts for the forecasts of external institutions (IMF, European Commission, commercial banks) available until September 2008 indicates that consumer price inflation in the euro area will decrease in 2009 to 2.4% as compared to 3.5% expected in 2008 while in the United States in 2009 it will amount to 2.9% as compared to 4.5% expected in 2008.

risk of inflation remaining at a high level despite the slowdown in economic growth. In countries that have been directly affected by the financial market crisis, in turn, financial system stability is yet another issue taken into account in monetary policy decisions.

In Poland 2009 is expected to bring a decline in economic growth. The structure of GDP growth is unlikely to change significantly, with rising domestic demand continuing to play the key role (although, as compared with 2008 it will be to a larger extent related to consumption growth, and to a lesser extent to investment growth) and the contribution of net exports to GDP growth remaining negative. Slowdown in economic growth should ease the inflationary pressure and be conducive to stabilizing the current account deficit.

Labour market developments will be an important factor affecting inflation processes in Poland in 2009. The first half of 2008 saw persistently high demand for labour which coupled with limited labour supply led to the acceleration in wage growth to the level well above labour productivity growth. Slowdown in economic growth is expected to lower the demand for labour and ease wage pressure. At the same time, the upward trend in the number of the economically active observed since 2008 Q1 is likely to continue also in 2009. Diminishing scale of economic migration likely to be driven by a marked economic slowdown in the United Kingdom as well as Ireland and other euro area countries, will probably be a factor mitigating the tensions in the labour market.

These trends will contribute to easing wage pressure. The situation in the labour market in 2009, and, consequently, the wage growth will be also affected by the final shape of regulations on bridging pensions and the amount of minimum wage. Reduction in the number of professions eligible for early retirement would boost economic activity of the elderly and, as a result, would increase labour supply and ease wage pressure. Further considerable rise in the minimum wage, although conducive to boosting economic activity, might reduce the demand for less qualified workforce and expand the grey economy.

Fiscal policy developments in 2009-2010 will be an important factor affecting monetary policy in 2009. In accordance with the *Convergence Programme, Update 2007*, after the expected easing in 2008, the fiscal policy is supposed to be tightened in the subsequent years by 0.5 percentage point of GDP annually. In line with the *Draft Budget*

Act submitted by the Government, the budget deficit should decrease from PLN 22.9 billion in 2008 to PLN 18.2 billion in 2009, thus by 0.5 percentage point of GDP. Yet, the worsening balance of special purpose funds and local government entities in 2009, as anticipated by the Government, might prove an obstacle to meeting of the objective set out in the *Convergence Programme*. Wage demands from trade unions of public sector employees are also of considerable importance. Excessive wage growth in the public sector could be conducive to deepening the public sector deficit and boosting inflationary pressure.

Further growth in electricity prices will probably be the factor increasing inflation in 2009. Besides, developments of prices of natural gas, coal and other energy commodities as well as gradual pass through of high prices of those energy commodities to retail prices of energy products, will continue to be a risk factor for inflation. Another important factor increasing inflation in 2009 which is beyond the direct impact of the monetary policy, will be a rise in excise tax on some goods, resulting partly from the EU accession requirements.

In the first half of 2008 the Council continued the cycle of interest rate increases started in 2007. The same period was marked by the appreciation of the zloty exchange rate. The effected interest rate increases, coupled with considerable appreciation of the zloty exchange rate will be conducive to lower inflationary pressure in 2009. At the same time, due to the permanent nature of the consequences of price shocks in the global markets and the increase in administered prices in Poland, factors which boosted price growth, as well as taking into account time lags in the transmission of monetary policy, inflation is likely to be brought down to the target of 2.5% gradually.

In 2009 interest rates – as in the previous years – will be adjusted to the changing assessment of the probability of inflation running above or below the target of 2.5% in the medium term. Stabilising inflation at the target in the medium term is consistent with the monetary policy strategy of the National Bank of Poland and policy of other central banks pursuing the inflation targeting strategy.

If a binding decision is taken on the scheduled date of Poland joining the euro area, the Council will pursue monetary policy that will make it possible to meet the convergence criteria, and thus allow Poland’s adoption of the euro at a scheduled date.

An important factor favouring macroeconomic stability in the longer run, and thus ensuring the sustainable fulfilment of the Maastricht criteria, is the implementation of structural reforms, including public finance reform which would accelerate the long-term economic growth and, at the same time, curb the inflationary pressure. In the opinion of the Council, those reforms are necessary to take full advantage of the opportunities offered by the euro adoption.

In December 2008 the works conducted at the NBP on the *Report on Poland's full membership in the third stage of the Economic and Monetary Union* are to be finalised. The *Report* will be used in the development of the plan of actions connected with Poland’s joining the euro area.

An important element in achieving the inflation target is the communication of the central bank with its environment. As part of this communication, the Council presents its assessment of the present situation of the economy and future developments of economic processes. Major communication instruments in 2009 will continue to be the *Monetary Policy Council Press Releases* and press conferences held after the Monetary Policy Council meetings as well as the *Minutes of the Monetary Policy Council Decision-Making Meetings* and *Inflation Reports*.

If a binding decision is taken on the scheduled date of Poland joining the euro area, the Council will present a document describing the monetary policy strategy subordinated to the necessity of sustainable fulfilment of the convergence criteria in the period preceding the euro adoption. This document will be an update of the *Monetary Policy Strategy beyond 2003*.

3. Monetary policy instruments

Banking sector liquidity in 2009

The National Bank of Poland estimates that the average value of the issuance of the NBP bills with 7-day maturity in the 2008 will amount to approx. PLN 11 billion.

The increase in currency in circulation in 2009 will contribute to the decrease in the banking sector liquidity. In turn, the conversion of EU funds inflow into zlotys, conducted at the NBP, will be increasing the level of the banking sector liquidity.

The source of the State Treasury's foreign debt service will exert a considerable influence on the level of the banking sector liquidity. According to the NBP assumptions, the foreign currency sale by the central bank to the Ministry of Finance will result in the decrease in the banking sector liquidity.

Poland's possible participation in ERM II may also affect the level of the banking sector liquidity.

Depending on developments of the above mentioned autonomous factors, it is possible that the surplus liquidity will be maintained or that the liquidity shortage will appear in the banking sector in 2009.

Interest rates

The short-term interest rate is the principal instrument of monetary policy. 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 the overnight interest rate in the interbank market.

The NBP's reference rate determines the yield obtainable on the basic open market operations, influencing, at the same time, the level of the short-term market interest rates.

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

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

Open market operations

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

The central bank will use basic and fine-tuning operations to affect the liquidity conditions in the banking sector for the POLONIA rate to settle close to the NBP's reference rate.

Basic open market operations, typically with 7-day maturity, will as a rule be conducted on a regular weekly basis. A fixed rate at the level of the NBP's reference rate will be binding during tenders for the NBP bills.

Due to the possibility of a liquidity shortage in the banking sector occurring in 2009, the NBP will be able to conduct both liquidity-providing and liquidity-absorbing basic open market operations. When a liquidity surplus persists, the central bank will issue the NBP bills. When a liquidity shortage occurs, the NBP will provide liquidity to the banking sector in the form of repo transactions. They will be collateralised with securities accepted by the NBP.

Fine-tuning operations may be conducted in order to limit the impact of movements in the liquidity conditions in the banking sector on the level of short-term market interest rates. These operations may be both liquidity-absorbing (issuing the NBP bills, reverse repo transactions) and liquidity-providing (redemption of NBP bills before their maturity, repo transactions). Maturity, yield and the manner in which the operations will be conducted will depend on the situation in the banking sector.

Structural operations may be conducted in order to change the level of banking sector liquidity in the long-term. Should the need arise, the central bank may perform 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 stabilise the current liquidity conditions in the banking sector. The possibility of maintaining required reserves in the averaged system limits the volatility of shortest market interest rates.

Any possible changes in the required reserve ratio will depend on liquidity developments in the banking sector.

Standing facilities

Standing facilities are meant to limit the scale of fluctuations of the overnight market rate. 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. The interest on the facility constitutes the lower limit for the market rate quoted for this particular period.

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

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

Foreign exchange interventions

Foreign exchange interventions are another monetary policy instrument that may be used by the NBP. Exchange rate fluctuations exert a considerable impact on inflation, thus there may arise circumstances in which the Monetary Policy Council decides that it is necessary to intervene in the foreign exchange market in order to stabilise inflation.

Should Poland join ERM II, interventions in the foreign exchange market may also be used for stabilising the zloty exchange rate for the exchange rate stability criterion to be met.