National Bank of Poland
Monetary Policy Council

Monetary Policy Guidelines for 2011

Warsaw, September 2010

In setting the *Monetary Policy Guidelines for 2011* the Monetary Policy Council fulfils the requirements of Article 227 of the Constitution of the Republic of Poland which obligates it to present monetary policy guidelines to the Sejm annually, concurrently with the submission of the draft Budget by the Council of Ministers. Pursuant to Article 53 of The Act on the National Bank of Poland, *Monetary Policy Guidelines* are published in the Official Gazette of the Republic of Poland "Monitor Polski".

The *Guidelines* present the basic elements of the monetary policy strategy pursued by the National Bank of Poland and an outline of macroeconomic conditions that may have an impact on this policy in 2011. In addition, the *Guidelines* comprise a description of monetary policy instruments.

Monetary Policy Guidelines for 2011 take into account information available up to 10 September 2010.

Monetary Policy Guidelines for 2011 is a translation of the National Bank of Poland's *Założenia polityki pieniężnej na rok 2011* in Polish. In case of discrepancies, the original prevails.

Content

Chapter 1.
Monetary policy strategy

According to Article 227 section 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 Article 3 section 1 that "the basic objective of NBP activity of 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 the pursuit of the basic objective of the NBP".

Nowadays central banks understand price stability in terms of inflation as low as not to negatively affect decisions taken by economic agents, including investment and savings decisions. 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. In pursuit of the task of maintaining price stability, central banks respond both to inflationary and deflationary threats.

Since 1998 the Monetary Policy Council, hereinafter "the Council", has based its monetary policy on inflation targeting (IT). Beginning 2004, the Council adopted a permanent inflation target of 2.5% with a symmetrical tolerance band for deviations of ± 1 percentage point. The Council pursues the strategy under a floating exchange rate regime. However, the floating exchange rate regime does not rule out foreign exchange interventions should they turn out necessary to ensure domestic macroeconomic and financial stability, which is conducive to meeting the inflation target in the medium term.

The experience of the National Bank of Poland, hereinafter "the NBP", and other central banks shows that IT is an effective way to ensure price stability. The global financial crisis has shown that in order to ensure long-term price stability factors related to financial system stability should play a more pronounced role in monetary policy than to date. Inflation targeting enables the pursuit of such a policy while providing support for the regulatory and supervisory policies addressed to the financial sector.

In pursuing monetary policy the Council is guided by the following principles, which – to a significant extent – remain unchanged of their hitherto understanding:

- 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 the use of quarterly and annual inflation indices is also justified, such as those applied in the NBP's inflation projection, in the state budget and in the statistics of the European Union, hereinafter "the EU", including the harmonized index of consumer prices – HICP. An important role in the assessment of inflationary pressure is also played by core inflation indices which make it easier to distinguish between temporary changes in the consumer price index from more sustained changes in inflation pressure.

- Second, monetary policy is unequivocally focused on maintaining inflation as close as possible to the target of 2.5% and not just within the tolerance band. This is to facilitate the anchoring of inflation expectations and thus to allow the central bank to change monetary policy parameters less frequently in response to potential shocks affecting current inflation. It may also lead to lower volatility of long-term interest rates.
- Third, the occurrence of shocks in the economy is inevitable. Depending on the strength of the shock and the degree of inertia of inflation expectations, the scale and the duration of inflation deviation from the adopted target may differ. In countries with sustained low inflation, the central bank usually does not respond to deviations from the inflation target if it deems them temporary, even when inflation leaves the tolerance band. When assessing the need for response, the Council will, however, take into account the fact that in Poland low inflation expectations have not been sufficiently anchored. The extent to which inflation expectations are anchored affects the scale and persistence of the impact of supply and demand shocks on inflation. In the case of shocks which, in the Council's opinion, may lead to a relatively permanent increase in inflation expectations and, as a result, to the rise in inflation due to the emergence of the so-called second-round effects, the central bank will adjust its monetary policy parameters accordingly.
- Fourth, the monetary policy response to shocks also depends on their causes and nature. In the case of demand shocks inflation and output move in the same direction. An interest rate increase weakens economic activity in the short term and, subsequently, inflationary pressure. In the case of supply shocks output and inflation move in opposite directions. An attempt to fully neutralise the impact of a supply shock on inflation using monetary policy instruments may lead to an unnecessary plunge in output growth which is already lowered by the supply shock's negative impact on consumption and investment. On the other hand, an attempt to fully accommodate – by pursuing expansionary monetary policy – the real effects of a supply shock resulting in a rise in inflation and a decline in output growth usually leads to persistently higher inflation. This, in turn, requires far more restrictive monetary policy in subsequent periods. This leads to a stronger deceleration in economic growth than the monetary tightening that prevents inflation from being sustained at a heightened level . The response of the central bank to the shock should depend on the assessment of the persistence of the shock's effects, including the assessment of the risk of second-round effects.
- Fifth, because of the lags in the response of output and inflation to the monetary policy, the impact of monetary policy on the current inflation is limited. Current decisions of the monetary authorities affect price developments in the future just as the current inflation is influenced by interest rate changes made several quarters before. However, the the time lag between an interest rate decision and its strongest impact on real variables (output, employment) and then on inflation is not constant. It depends, to a large extent, on structural and institutional changes in the economy. Changes in the monetary transmission mechanism means that central banks can only approximately assess this time lag. Turmoil in the domestic and international financial system may constitute an additional factor disrupting the monetary transmission mechanism.
- Sixth, monetary policy should take into account the need to maintain financial stability which is indispensable to ensure price stability in the longer term and which enables effective functioning of the monetary policy transmission mechanism. In this context, when assessing the balance of risks to future inflation and economic growth, asset price developments are of particular importance. Excessive interest rates cuts and the long-lasting maintainging lowered interest rates amidst low inflation and simultaneous fast economic growth may lead to a rapid asset price growth, thus increasing the risk of the so-called speculative bubbles. Rapid asset price growth is accompanied by the growing likelihood of asset price deviation from the levels justified by fundamentals, which increases the risk of an abrupt and significant decline in asset

prices in the future. Rapid increase in asset prices, especially if it is accompanied by a fast rise in lending, poses a threat to the financial system stability, and consequently – in the longer term – to sustainable economic growth and price stability. Monetary policy supporting financial system stability is thus consistent, in the longer term, with the achievement of the basic objective of the central bank's activity i.e. ensuring price stability, although it may occasionally pose a risk of temporary deviation of inflation from the target. In order to maintain consistency between attempting to keep inflation at the target and supporting financial system stability, under certain conditions it may be necessary to lengthen the inflation target horizon.

- Seventh, in assessing the risk of turmoil in the financial system and the inflation outlook in the longer run, it is useful to analyse monetary and credit aggregates. A fast increase in these aggregates may lead to growing macroeconomic imbalances in the economy, including imbalances in the asset markets. Monetary policy decisions should take into account the risk connected with excessive increase in these aggregates. Regulatory and supervisory policies in the financial sector that have an impact on credit growth and its structure are an important factor influencing monetary policy.
- Eighth, in assessing the degree of monetary policy restrictiveness not only should the level of real interest rates 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. Ensuring price stability amids an overly expansive fiscal policy may require keeping interest rates at a higher level.
- Nineth, monetary policy is pursued under uncertainty which excludes strict control of economic processes. This uncertainty means that while taking decisions related to monetary policy it is necessary to take into account all available information relevant for inflation developments, rather than the results of inflation projection only. Models used by central banks to forecast inflation may be imperfect in adequately reproducing behaviour of the economy if only because of its ongoing structural changes. In addition, it is not possible to adopt a simple policy rule which could be known *ex ante* to market participants.
- Tenth, an important input into the monetary policy decision-making process is the balance of factors affecting the probabilities of future inflation running above or below the target. This balance is based on the assessment of the actual economic developments, including the inflation projection. While assessing the factors affecting future inflation, the Council takes into consideration the past inflation developments since they have a bearing on the anchoring of inflation expectations at the inflation target. In particular, the Council takes into account 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 decision is taken on Poland joining the ERM II, the Council will make all necessary adjustments to the monetary policy strategy and – in consultation with the Council of Ministers – to the exchange rate policy to conditions ensuing from the necessity of meeting the convergence criteria required for the euro adoption. In the Council's opinion, Poland's accession to ERM II and the euro area should take place at the earliest possible date after meeting all the required legal, economic and organizational conditions.

Chapter 2.

Monetary policy in 2011

Following a strong decline in economic growth at the turn of 2008 and 2009, since the second half of 2009 the global economic activity has markedly improved. Yet, the scale of the recovery differed across countries. In the majority of developed economies – despite gradual acceleration of GDP growth – economic activity remained moderate, while in the majority of the biggest emerging economies GDP growth was strong. In view of moderate economic activity, high uncertainty about sustainability of economic recovery and limited inflationary pressure in major developed countries, central banks of those countries continued expansionary monetary policy. On the other hand, central banks in major emerging economies, where economic boom was accompanied by rising inflation, started to tighten their monetary policy.

In 2010 the external developments continued to have a strong impact on the situation in the Polish economy. On the one hand, economic recovery abroad strengthened positive trends in Poland's foreign trade and industrial production. On the other hand, the first half 2010 saw renewed turmoil in the financial markets and increased uncertainty connected with the financial crisis in Greece and persisting fiscal imbalances in many other countries. This turmoil and increased uncertainty found reflection in the gradual ceasing of appreciation of currencies of the Central and Eastern European countries, including of the zloty, observed since 2009 Q1.

In Poland, economic growth has gradually accelerated since 2009 Q2. In the first half of 2010 GDP increased, in real terms, by 3.2% y/y which was mainly driven by a rise in domestic demand connected with rebuilding of inventories and growing individual and public consumption. At the same time gross fixed capital formation continued to decline, yet the scale of this decline was lowered by growth in public investment.

The situation in the labour market improved. Both employment in the corporate sector and the number of the employed in the economy started to increase, and the registered unemployment rate started to decline. At the same time, wage growth in the economy continued to fall which helped to maintain growth of unit labour costs at a low level.

In 2010 the public finance sector continued to register a very high deficit.

Economic recovery and gradual easing of banks' lending policies (with the exception of lending policy related to consumer loans) supported cessation of decline in the growth of credit to non-financial sector. Yet, credit growth differed considerably across sectors – corporate debt decreased while household lending rose, mainly as a result of significant increase in mortgage lending.

Limited demand pressure, low growth in unit labour costs and the previously observed appreciation of the zloty exchange rate supported the fall in core inflation and – as a result – in

CPI inflation in the first half of 2010 close to the NBP inflation target. The decline of this measure of inflation (in y/y terms) in the first half of 2010 was also connected with negative base effects .

In the first half of 2010 – in view of declining inflation and moderate economic growth in Poland, as well as taking into consideration uncertainty about the situation in the external environment of the Polish economy – the Council kept the NBP interest rates unchanged – until August 2010 the reference rate amounted to 3.5%.

At the same time, amidst growing liquidity surplus in the banking sector in 2010 the NBP gradually limited the scale of non-standard monetary policy operations conducted in response to disturbances connected with the global financial crisis .

* * *

In 2011 the basic objective of the monetary policy will be 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 so as to support balanced economic growth.

Similarly to the previous years, monetary policy parameters, including the level of the NBP interest rates, will be adjusted to the changing situation in the economy and the ensuing assessment of the likelihood of inflation running above or below the inflation target of 2.5% in the medium term.

In its decisions, the Council will also take into account the situation in the financial sector which stability is the precondition to maintain price stability in the longer run.

* * *

Developments in the external environment will continue to be an important factor influencing the Polish economy in 2011. According to currently available forecasts, recovery in the global economy will continue in 2011. At the same time, in major developed economies inflationary pressure will probably remain limited. On the other hand, in major emerging economies – in view of gradual tightening of their macroeconomic policy – a decline in economic growth and lower inflationary pressure may be expected. Persisting high liquidity in the global financial markets may be a risk factor conducive to higher inflation abroad.

Due to Poland’s strong commercial and financial links with the euro area, economic situation in this region will be of major importance for economic growth in Poland. According to current forecasts, GDP growth in the euro area in 2011 may be expected to slightly accelerate; yet, the level of economic activity should differ significantly across euro area countries. An important source of uncertainty about the economic activity in the euro area are the consequences of high fiscal imbalance in many countries of the region, as well as its anticipated reduction.

Key domestic factors that will influence monetary policy in 2011 will include: economic activity in Poland, situation in the labour market, fiscal policy and bank lending. Those factors may have a major impact on inflationary processes both in 2011 and in subsequent years.

In 2011 GDP growth in Poland may be expected to accelerate. As indicated by preliminary data for the first half of 2010 and forecasts for the second half of 2010, GDP growth will remain to be mainly supported by domestic demand. Acceleration of DGP growth of such a structure may be largely driven by continuing high growth of public investment (mainly infrastructural low-import-intensive investment) connected with the anticipated significant use of EU funds. Also stable rise in household consumption as well as possible revival in corporate investment are likely to support economic growth. It is expected that gradual improvement in economic activity of Poland's major trading partners will have a positive impact on the exports growth, yet, due to growing domestic demand in 2011 contribution of net exports to GDP will probably be negative.

Inflationary processes in 2011 will also be affected by the situation in the domestic labour market. It may be expected that due to limited decline in employment amidst lower labour demand at the time of economic slowdown, the situation in the labour market will most likely improve only gradually. This improvement may be conducive to growing wage pressure and rising unit labour costs.

Fiscal policy will be an important factor taken into account in the conduct of monetary policy in 2011. In line with the draft Budget Act, the state budget deficit is to remain at an elevated level (PLN 40.2 billion). At the same time, considerable deficits are likely to be registered in the finances of other public entities – i.e. local government entities, the Social Insurance Fund and the National Road Fund. This means that in 2011 public finance sector deficit is likely to remain at a very high level. The hitherto declared measures aimed at reducing the public finance imbalance do not guarantee that public debt does not exceed prudential thresholds provided for in the Public Finance Act and the limit set forth in the Constitution of the Republic of Poland.

The expected further improvement in the economic activity should support the increase in lending. At the same time, growth in lending may be limited by persisting uncertainty about macroeconomic situation, and – in the case of households' loans – also by the rules provided for in Recommendation T to be implemented by the end of 2010, adopted by the Polish Financial Supervisory Authority, and the already applicable provisions of Recommendation S II. These Recommendations will help to limit the risk of instability of the financial system which will be a factor facilitating the conduct of monetary policy aimed at maintaining price stability.

In 2011 an increase in the majority of VAT rates scheduled for the beginning of 2011 will be a factor likely to raise the annual inflation rate. Yet, the impact of this factor on inflation should be rather small. A risk factor for price growth are also possible rises in the prices of energy carriers as well as rises in the prices of public utility services, connected with difficult budgetary situation of local government entities.

An important factor influencing inflation in Poland will also be the zloty exchange rate. Exchange rate fluctuations are affected by both domestic developments and the situation in the external environment of the Polish economy.

* * *

Considering the scale, extent and duration of the global crisis, expectations about economic situation in 2011 are especially uncertain.

The developments in the economic situation abroad constitute an important uncertainty factor. The uncertainty mainly relates to the effects of the high fiscal imbalance in many countries and its planned reduction. It is also connected with the effects of an expansionary monetary policy, including non-standard operations carried out by central banks in response to the global crisis and its consequences.

Lower than expected GDP growth in the world may economy may hinder the planned reduction in public finance deficits in many countries. Delayed improvement in public finance could, in turn, lead to an increase in long-term interest rates and higher volatility of financial instruments, which would additionally contribute to lowering global economic growth. Economic growth will also have an impact on monetary policy, including the scale of non-standard operations carried out by central banks.

Global economic growth in 2011 and its impact on inflation will also be affected by a decline in the growth of potential output in many countries linked to the financial crisis. The scale of this decline is, however, unknown.

Lower than expected economic growth in the global economy may lead to a decline in GDP growth in Poland and lower inflationary pressure. In the developed countries, amidst marked decrease in demand growth and difficult situation in the labour market, deflationary tendencies cannot be excluded.

The developments regarding commodity prices in the world markets continue to be an important uncertainty factor. Amidst persisting liquidity surplus in the global financial markets and a potential occurrence of supply shocks in commodity markets there is a risk of significant increase in commodity prices. However, this risk depends on the developments in the global economic situation.

There is also uncertainty relating to the direction and scale of international capital flows, which is heightened by the persisting liquidity surplus in the global financial markets and changing expectations as to the global economic growth. Changes in risk aversion related to the above may have a bearing on the developments in financial instrument prices, including exchange rates.

An important domestic risk factor is the impact of economic growth on the incomes of the public finance sector. If the growth of those incomes proves slower than assumed by the government in the draft Budget Law for 2011, the ratio of public debt to GDP may exceed 55% which would contribute to a relative deterioration in the perception of the Polish economy and – as a result – would lead to a larger exchange rate volatility and an increase in long-term interest rates. This could be conductive to the worsening of funding conditions, both of the public and the private sector.

* * *

In achieving the inflation target the communication of the central bank with the public is of key importance. As part of this communication, the Council presents its assessment of the current and future economic developments. *Monetary Policy Council Press Releases* and press conferences held after the Council meetings as well as the *Minutes of the Monetary Policy Council Decision-Making Meetings*, *Inflation Reports* and *Report on Monetary Policy Implementation* will continue to be the major communication instruments in 2011. In the *Report on Monetary Policy Implementation* the Council will present the assessment of possible deviations from the inflation target.

Chapter 3.

Monetary policy instruments

Banking sector liquidity in 2011

The year 2011, similarly to the years 2009-2010, is expected to see rising liquidity surplus in the domestic banking sector. Its level may exceed an annual average of PLN 100 billion. The main factor conducive to raising the level of liquidity surplus will be the inflow of EU funds to Poland and their exchange at the NBP. Moreover, liquidity may also be increased by the NBP purchasing from the Ministry of Finance foreign currency stemming from credits granted by international financial institutions and from issuance of treasury bonds to foreign markets. In turn, the increase in currency in circulation will be a factor lowering the level of liquidity surplus.

The manner of financing foreign debt servicing of the Treasury will be of significant importance for the liquidity of the banking sector. Purchase of foreign currency at the NBP by the Ministry of Finance in order to service foreign debt will limit liquidity surplus of the banking sector.

Interest rates

The principal instrument of monetary policy is the short-term interest rate, i.e. the NBP's reference rate. Changes in this rate result from the direction of the pursued monetary policy. The NBP's deposit and lombard rates set the corridor for fluctuations of overnight interest rate in the interbank market.

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

The NBP's lombard rate determines the marginal cost of funds obtainable 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 floor for the fluctuations of the overnight market rate.

Open market operations

Open market operations are used by the central bank to influence liquidity in the banking sector in a way allowing it to maintain the short-term interest rates at a level consistent with the NBP's reference rate set by the Council. In particular, the central bank will conduct open market operations on such a scale as to enable the level of the POLONIA rate to settle close to the NBP's reference rate.

Main 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. Due to the expected persistance of liquidity surplus in the banking sector in 2011 these operations will be conducted in the form of issuance of NBP bills.

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 interbank interest rates. These operations may be both liquidity-absorbing (issuance of 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 are conducted will be dependent on the situation in the banking sector.

Structural operations may be conducted in order to change the structure of banking sector liquidity in the long term. Should the need arise, the central bank may execute the structural operations by issuing bonds, purchasing and selling securities on the secondary market.

Reserve requirement

The basic function of the reserve requirement is to stabilise the liquidity level in the banking sector. Possibility to maintain required reserves in the averaged system limits fluctuations of short-term interest rates.

Changes in the reserve ratio depend on changes in the liquidity conditions in the banking sector.

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.

Standing deposit facility enables banks to deposit their liquidity surpluses on an overnight basis with the central bank. The interest on this facility constitutes the lower limit for the overnight market rate.

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

Intraday credit facility, i.e. 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 are non-interest bearing loans, collateralised with securities accepted by the central bank.

Foreign exchange swaps

In case of the need for providing the banking sector with foreign currency, the NBP may use foreign exchange swaps. The foreign exchange swap consists in that the NBP purchases (or sells) the zloty for foreign currencies in the spot market and, at the same time, it resells (or repurchases) it on a forward transaction basis on a specified date.

Foreign exchange interventions

The monetary policy instrument that may be used by the NBP are foreign exchange interventions.

Should Poland join the 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.