

National Bank of Poland
Monetary Policy Council

Monetary Policy Guidelines for 2012

Warsaw, August 2011

In setting the *Monetary Policy Guidelines for 2012* 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 2012. In addition, the *Guidelines* comprise a description of monetary policy instruments.

Monetary Policy Guidelines for 2012 take into account information available up to 9 August 2011.

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Chapter 1.

Monetary policy strategy

The Monetary Policy Council decided to maintain the key elements of the NBP monetary policy strategy that had been presented in the *Monetary Policy Guidelines for 2011*. In 2012 the monetary policy strategy will be pursued according to the following rules.

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 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 as inflation so low as not to negatively affect decisions taken by economic agents, including investment and savings decisions. Ensuring price stability is a fundamental way in which the central bank contributes 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. Therefore, monetary policy should aim at stabilising inflation at the target in the medium-term, while at the same time containing the risks of imbalances in the financial system. 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 still guided by the following principles:

- 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. While analysing 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. Moreover, core inflation indices make it easier to distinguish between impacts of supply or demand shocks on inflation.

- 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 and the direction 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. The dilemmas of monetary policy in such a case are as follows:
An attempt to neutralise the impact of a supply shock on inflation using monetary policy instruments may lead to even deeper plunge in output growth resulting from supply shock’s negative impact on consumption and investment.
On the other hand, an attempt to 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 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. Those changes mean 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 maintaining 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 amidst an overly expansionary fiscal policy may require a tight monetary policy, including keeping interest rates at a higher level.
- Ninth, monetary policy is pursued under uncertainty which excludes strict control of economic processes. This natural 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 should join the ERM II and the euro area at the earliest date possible, after meeting the necessary legal, economic and organizational conditions.

An important factor affecting the monetary policy is the situation of public finances. In order to maintain macroeconomic stability, including price stability, it is necessary to conduct fiscal policy ensuring the long-term stability of public finances. Such a policy will also enable compliance with the euro adoption criteria.

Chapter 2.

Monetary policy in 2012

The first half of 2011 saw continued recovery in the global economy. At the same time, the economic situation continued to differ markedly across countries: in major developed economies activity continued to be dampened by high unemployment, whereas emerging economies, especially in Asia, continued to record strong GDP growth accompanied by rising inflationary pressure. At the same time, a surge in commodity and food prices in the global markets, observed until 2011 Q2, led to a marked rise in inflation in most countries. Amidst high deficit and public debt levels in some peripheral countries of the euro area and in the United States, concerns about the solvency of some of those countries and about the outlook for global economic growth persisted, which triggered tensions in the global financial markets.

Amidst strong economic growth and rising inflation, central banks in the majority of emerging economies continued tightening monetary policy. Monetary policy was tightened also in some small open developed economies, whereas major developed economies maintained their expansionary monetary policy, although it started to differ slightly across countries. The Fed and the Bank of England maintained their interest rates at historically low levels, whereas the European Central Bank increased its interest rates in April and in July 2011 (each time by 0.25 percentage points, including the refinancing interest rate up to 1.50%) and the Bank of Japan eased its monetary policy further after a natural disaster had hit this country.

The sustained growth in external demand supported the growth in economic activity in Poland. Rising domestic demand, which has had a decisive share in GDP growth in the past few quarters, was mainly driven by higher private consumption and the rebuilding of firms' inventories. Since the second half of 2010, GDP growth has also been fuelled by gradually rising investment. However, in 2011 Q2 GDP growth probably declined as compared to the previous quarters.

Rising employment, which accompanied the recovery in economic activity, was observed amidst growing labour supply, which led to the unemployment rate remaining at a heightened level and curbed the wage pressure in the economy. Following a marked acceleration recorded in 2010 Q4, 2011 Q1 saw the wage increases slow down slightly.

Rising economic activity has so far been accompanied by moderate lending to non-financial corporations. The value of consumer loans extended to households continued on a downward trend, which might have been connected with the implementation of the T Recommendation. However, the relatively high rise in housing loans continued. Since the beginning of the year lending to enterprises has continued growing.

The economic recovery in Poland was accompanied in 2010 by a deepening fiscal imbalance. The deficit of central and local government institutions in ESA95 terms grew from 7.3% of GDP in 2009 to 7.9% of GDP in 2010 against a decline to 6.9% assumed in the *Convergence Programme*.

2009 Update. The debt of this sector – also in ESA95 terms – increased from 50.9% in 2009 to 55.0% of GDP in 2010. Public deficit reduction has been planned to start in 2011. In line with the *Convergence Programme. 2011 Update*, the deficit reported by central and local government institutions is to be reduced in 2011 to 5.6% of GDP; the scale of fiscal tightening, as measured by a change in the primary structural deficit, is to stand at 2.3 percentage points of GDP, of which approx. 0.6 percentage points of GDP will be attributable to a reduction in the contribution paid to open pension funds (OFE) from 7.3% to 2.3% of the contribution calculation base.

The rebound in economic activity in the domestic market was accompanied by a widening of the deficit in the current account of the balance of payments. This resulted not only from a higher trade deficit but also from a larger negative income balance, and in 2011 Q1 also from a decline in the positive current transfers balance.

The surge in commodity prices in the world markets, observed since 2010, coupled with unfavourable supply conditions in some domestic food product markets contributed to an increase in inflation in Poland above the NBP inflation target in the first half of 2011. Growing food and energy prices were accompanied by a rise in core inflation, partly related to an increase in most VAT rates implemented on 1 January 2011.

In 2010, given limited inflationary and wage pressures in Poland and considerable uncertainty about the sustainability of the recovery in the global economy and of the acceleration in economic growth in Poland, as well as strong capital inflows to emerging economies, the Council kept the key NBP interest rates unchanged, including the reference rate at 3.5%. However, taking into account the fact that in 2010 the main reasons behind liquidity disturbances in the financial markets had ceased, in October 2010 the Council decided to increase the required reserve ratio by 0.5 percentage points from 3.0% to 3.5%, bringing it back to its pre-crisis level. The increase of the required reserve ratio was to be a sign of the Council's readiness to respond to growing inflationary pressure.

In the first half of 2011 the Council assessed that amidst a considerable rise in inflation, accompanied by growth in core inflation and rising inflation expectations as well as relatively fast economic growth, it was justified to tighten the monetary policy. The risk of the wage pressure mounting amidst significant employment growth also spoke in favour of increasing the NBP interest rates. In order to limit the risk of inflation running above the inflation target in the medium term, the Council increased the NBP interest rates in January, April, May and June, each time by 0.25 percentage points (i.e. by a total of 1 percentage point), and the reference rate to 4.5%.

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In 2012 the primary monetary policy objective will be to stabilize inflation at 2.5% in the medium term, which will 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 economic situation and the ensuing assessment of the likelihood of inflation running in the medium term at a level consistent with the inflation target.

In its decisions, the Council will also take into account the situation in the financial sector, whose stability is a precondition for maintaining price stability in the longer term.

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In 2012 developments in the global economy will continue to be an important factor affecting the Polish economy. According to current forecasts, growth in the global economy will remain stable in 2012, following a slow-down in 2011. However, the recently observed intensified tensions in

the financial markets and unfavourable data on the economic situation in the United States in the first half of 2011 add to the uncertainty about the outlook for global economic growth.

According to current forecasts, in 2012 inflation should decline, in most countries, following a temporary increase in 2011, largely fuelled by a surge in commodity prices in the global markets.

Due to Poland's strong trade and financial links with the euro area, economic growth in Poland will largely depend on economic developments in this region. According to current forecasts, economic growth in the euro area in the years 2011-2012 will be similar to that observed in 2010, with the level of economic activity differing significantly across individual euro area countries. Following relatively strong growth in 2010-2011, in 2012 GDP is expected to grow slightly more slowly in Germany, the main market for Polish exports. The ECB is expected to tighten its monetary policy in 2012.

In 2012 Poland may be expected to see slower GDP growth than that observed in the years 2010-2011, due to moderate economic growth in the euro area, completed rebuilding of inventories of enterprises, measures undertaken to lower the general government deficit, as well as the possible effects of monetary policy tightening in 2011.

Inflationary processes in 2012 will also be significantly affected by the situation in the domestic labour market. In particular, a further rise in labour demand amidst probable slower growth in labour supply should lead to a gradual fall in unemployment. As a result, the situation in the labour market may be conducive to growing wage pressure and rising unit labour costs.

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

Fiscal policy developments will be an important consideration in the conduct of monetary policy in 2012. In line with the draft Budget Act and the *Convergence Programme. 2011 Update* adopted by the government, the process of reducing the public finance imbalance, commenced in 2011, is to be continued in 2012. In accordance with this *Programme*, the deficit of the central and local government units should be reduced further in 2012 by 2.7 percentage points of GDP, of which 0.5 percentage points will be the result of a cutback, implemented in May 2011, in contributions paid to open pension funds. The scale of fiscal tightening in 2012, as measured by a change in the primary structural deficit, is expected to stand at 2.6 percentage points of GDP. However, in light of the already presented consolidation measures and the planned slight reduction in the state budget deficit, the achievement of the scale of fiscal adjustment planned for 2012 is subject to uncertainty.

The year 2012 is expected to see a further increase in lending. At the same time, potential measures undertaken by the Polish Financial Supervision Authority in order to limit the risk of financial system instability might temporarily curb lending to particular sectors. From the point of view of financial system stability, it is of particular importance to narrow access to foreign currency denominated loans. Although the share of foreign currency lending to households in the total number of newly granted mortgage loans is markedly lower than before the global crisis, in order to ensure macroeconomic stability it is important to undertake supervisory measures aimed at limiting the supply of mortgage credit. These measures may also contribute to boosting the effectiveness of the monetary transmission mechanism.

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Expectations about the economic situation in 2012 are subject to uncertainty, similarly to the previous years. An important uncertainty factor are economic developments abroad (particularly in Germany), including the consequences of the persistently severe public finance imbalances in

many countries. The effects of fiscal policy tightening in some of those countries are also a risk factor for global economic growth.

Among the uncertainty factors concerning economic activity and inflation in the global markets one should also include the consequences of expansionary monetary policy pursued by major central banks in the past few years. The persisting liquidity surplus in the global financial markets may have a destabilizing effect on the price developments of commodities and financial assets, as well as on exchange rates.

The political situation in oil-exporting countries and the regulatory policy governing the use of commodities in biofuels production are another source of uncertainty about the developments in commodity prices, and, consequently, about their impact on global economic activity and inflation.

A risk factor for the domestic economy is the extent of the rebound in corporate investment, given that a sound financial condition of corporations and growing production capacity utilization are accompanied by forecasts of lower demand growth after 2011. The scale of economic migration, fuelled by the opening of the German, Austrian and Swiss labour markets to Polish citizens in May 2011, is an uncertainty factor for the labour market in Poland, including the labour supply, the unemployment rate and wage growth. Another uncertainty factor is the unknown degree of fiscal tightening in 2012.

A factor that may affect inflation in Poland in 2012 is a likely further increase in the excise tax charged on tobacco products in 2012. Possible energy price increases are another risk factor for price growth. In particular, due to the high degree of concentration in the electricity market, the announced liberalization of prices of electricity sold to households may constitute a risk factor affecting the price growth.

Potential output growth in Poland and abroad, in particular given the difficulties in assessing to what extent it has been affected by the global financial crisis, is a risk factor for the conduct of monetary policy.

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In achieving the inflation target, the central bank's communication with the public is of key importance. As part of this communication, the Monetary Policy Council presents its assessment of 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 the *Report on Monetary Policy Implementation* will continue to be the major communication instruments in 2012. In the *Report on Monetary Policy Implementation* the Council will present the assessment of the reasons for inflation's possible deviations from the target.

Chapter 3.

Monetary policy instruments

Banking sector liquidity in 2012

It is foreseen that in 2012 monetary policy will be conducted in conditions of liquidity surplus in the banking sector.

The level of the liquidity surplus will be mostly affected by the Ministry of Finance's budget policy, with respect to funding the borrowing requirement of the budget, financing its external debt and use of EU funds.

With a view to continued inflow of EU funds to Poland, it will be of key significance the place where these funds are exchanged into the domestic currency. If the NBP purchases the inflowing foreign currency, the liquidity surplus in the banking sector will increase, whereas a direct exchange of currency from EU funds in the interbank market by the Ministry of Finance will have no impact on the level of the liquidity surplus.

The level of the liquidity surplus in the banking sector will be also depended on the way of servicing the Poland's external public debt. If the Ministry of Finance uses the currency held on account with the NBP, there will be no effect on excess liquidity. If, on the other hand, the Ministry of Finance undertakes to obtain the required foreign currency through the purchase with the NBP, it will work towards reducing the liquidity surplus.

Interest rate

The principal instrument of monetary policy is the short-term interest rate - the NBP's reference rate. Changes in the level of this rate result from the course of the monetary policy implemented. The levels of NBP deposit and lombard rates set the corridor for overnight interest rate fluctuations in the interbank market.

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

The NBP's lombard rate determines the cost of liquidity obtainable at the NBP. It sets the ceiling for the overnight market rate.

The NBP's deposit rate determines the interest on 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 conditions in the banking in a way allowing it to maintain short-term market interest rates at a level consistent with a binding inflation target as set by the Monetary Policy Council. In particular, the central bank will conduct open market operations on such a scale as to enable the POLONIA rate to settle close to the NBP's reference rate.

Main operations will be carried out on a regular weekly basis and will typically with a 7-day maturity. A fixed rate at the level of the NBP's reference rate will be binding during tenders. Due to the expected persistence of liquidity surplus in the banking sector in 2012, these operations will be carried out in the form of issuance of NBP bills.

Fine-tuning operations may be conducted with the aim for limiting the volatility of short-term market interest rates. They may involve liquidity-absorbing operations (issuance of NBP bills, *reverse repo* transactions) or liquidity-providing ones (redemption of NBP bills before maturity, *repo* transactions). The maturity and yield of these operations as well as the exact manner in which they are carried out will be dependent on the situation in the banking sector.

Structural operations may be conducted in order to affect long-term liquidity structure in the banking sector. If required, the central bank may carry out the following structural operations: bond issue, purchase or sale of securities on the secondary market.

Reserve requirement

The system of required reserves contributes to the stability of the shortest-term market interest rates in the reserve maintenance periods. The fact that banks are required to maintain reserve holdings under the arrangement facilitates interbank settlements, as they always have the necessary funds at their disposal. At the same time, the averaged reserve requirement system allows banks to determine the amount of funds held on current account with the central bank over the maintenance period.

Moreover, the obligation to maintain the required reserve limits the amount of surplus funds at the disposal of banks. Thus, under prevailing excess liquidity, the reserve requirement system enables the central bank to reduce the scale of its liquidity-absorbing open market operations.

The changes in the reserve requirement ratios depend on the liquidity conditions in the banking sector.

Standing facilities

Standing facilities are aimed at limiting the scale of overnight market rate fluctuations. Banks participate in these facilities at their own initiative.

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

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 loan expresses the marginal cost of obtaining funds from the central bank, which constitutes the upper limit for the overnight rate.

Intraday credit facility involving both zloty- and euro- denominated non-interest bearing loans offered by the NBP is an important element of the NBP settlement system, as the source of funds to be obtained **during the trading day**. These loans are collateralised with securities accepted by the central bank.

Foreign exchange swaps

The NBP may carry out foreign exchange swap transactions. A foreign exchange swap involves a purchase (or sale) by the NBP of zloty for foreign currency in the spot market, with a simultaneous sale (repurchase) under a specified-date forward transaction.

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 in order to meet the currency stability requirement.