

NBP

Narodowy Bank Polski

Monetary Policy Council

Monetary Policy Guidelines for 2015



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Warsaw, 2014

In setting the *Monetary Policy Guidelines for 2015* 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 on an annual basis, concurrently with the submission of the draft Budget Act by the Council of Ministers. Pursuant to Article 53 of the Act on the National Bank of Poland (Narodowy Bank Polski), the *Monetary Policy Guidelines* are published in the Official Gazette of the Republic of Poland *Monitor Polski*.

The *Guidelines* present the key elements of the monetary policy strategy pursued by Narodowy Bank Polski and an outline of macroeconomic conditions that may have an impact on this policy in 2015. In addition, the *Guidelines* comprise a description of monetary policy instruments.

The *Monetary Policy Guidelines for 2015* take into account information available up to 8 September 2014.

The *Monetary Policy Guidelines for 2015* is a translation of the publication of Narodowy Bank Polski entitled *Założenia polityki pieniężnej na rok 2015*. In case of discrepancies, the original prevails.

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Introduction

In line with expectations presented in the *Monetary Policy Guidelines for 2014*, global economic growth gradually accelerated in 2014. Yet, although seven years have passed since the onset of the financial crisis and the subsequent measures launched by the central banks of developed countries to stimulate growth, economic activity in many countries has still not returned to its pre-crisis levels. Past experience shows that where recessions are triggered by the collapse of unstable credit booms and the ensuing banking crises, it may take a relatively long time for output to return to its pre-crisis growth path. This is largely because economies of many countries recovered from the crisis with a huge burden of private and public debt. Therefore, global recovery is expected to continue at a relatively slow pace in 2015, which will affect monetary policy of central banks, including the NBP.

Uneven economic recovery abroad

In 2015, like in the current year, inflation developments worldwide – and hence also in Poland – are expected to be crucially affected by differences in growth trends in the global economy. Economic activity will probably rise faster in the United States than in the euro area as a consequence of both: (i) higher potential output growth in the US economy as compared with the euro area, and (ii) the fact that Europe – unlike the United States – has not yet fully recovered from the financial crisis. The ongoing deleveraging and the shifts in the structure of financing the banking sector adversely affect lending growth and domestic demand. This impact is further enhanced by the fact that the role of the banking sector in funding corporate investment is far more significant in Europe than in the United States, where capital market remains the primary source of financing.

In the United States, economic growth in the first half of 2014 reached approximately 2% y/y amidst falling unemployment. Also, balance sheets of households continued to strengthen, which should support further rise in consumption. In the euro area, in turn, economic activity remains very low. Domestic demand in the euro area economy is considerably curbed by huge public sector debt, which reduces opportunities for fiscal stimuli, the persistently unfavourable situation in the labour market and the relatively weaker condition of banks in those euro area countries which were the most hit by the recession. Access to lending is thus highly constrained in those euro area countries where households and firms are in the most urgent need for it. Moreover, demand for credit is dampened as the balance sheets of households and enterprises are being adjusted.

The divergent paths of economic growth in the United States and in the euro area translate into divergent monetary policy cycles of these economies. While the Federal Reserve (the Fed) is scaling down its asset purchase programmes and preparing market participants for gradual

interest rate increases, the European Central Bank (ECB) has further eased its monetary policy, by reducing the interest rates and announcing the launch of financial asset purchases as well as the extension of further long-term liquidity loans to banks¹.

In line with the divergent monetary policies of the Fed and the ECB, the former will probably return – as announced – to a conventional monetary policy, where adjustment of short-term central bank interest rates is the prime instrument to affect bank lending and the economy. The ECB, on the other hand, will probably – given, among others, the possible weak economic growth – have to continue its quantitative easing (asset purchase) programmes and to undertake attempts to stimulate the economy through conditional refinancing.

Low inflation and the risk of deflation

Besides the different pace of recovery and the resulting divergence in monetary policy cycles between the Fed and the ECB, another key external factor to influence the NBP monetary policy in 2015 will be low inflation in the world economy, particularly in the euro area. Slow price growth in the euro area countries will have an impact on inflation in Poland, given the large volume of trade between the Polish economy and those countries.

In case of unexpected slump in global economy, the near-zero inflation may turn into deflation. Deflation arising from weak demand would exacerbate downside risks for economic growth. Under current circumstances, with central bank interest rates close to zero, it would be difficult to prevent a further economic slowdown. The risk of such a scenario turning into reality is particularly high in the euro area.

The euro area economies are still fairly unlikely to slide into a period of prolonged deflation as such a development would have to be driven, primarily, by persistent and significant deterioration in the expectations of households and enterprises (as was the case in Japan at the beginning of the previous decade, after several years of stagnation). Nevertheless, it could also be triggered by other factors. Anyhow, the risk of deflation will probably have a bearing on the ECB's monetary policy. This is warranted by potential threats of deflation, especially those related to an increase in the real burden of private and public debt repayments, as known since the Great Depression of the 1930s and from Japan's experience of the last two decades².

¹ The *Targeted Long-Term Refinancing Operations* (TLTRO) are designed to stimulate lending growth. Under TLTROs, commercial banks can obtain liquidity support for a period of up to 4 years, with the ceiling tied to the amount of loans granted by them to the non-financial private sector.

² I. Fisher (1933), "Debt-Deflation Theory of Great Depression", *Econometrica* no. 1 vol. 4. pp. 337-357. On Japan's experience, see: H. Kuroda (2014), "Japan's economy - achieving 2 percent inflation", speech by the Bank of Japan's Governor at the Research Institute of Japan, 1 August 2014.

Consequences for the NBP

The above-described developments in the external environment of the Polish economy highlight two main risks for the NBP monetary policy in 2015. On the one hand, persistently weak economic growth and low inflation abroad (in particular, in the euro area) may influence inflation and economic growth in Poland. On the other hand, tapering of quantitative easing by the Fed and the concurrent easing of monetary policy by the ECB may – depending on the timing of the two processes – boost the volatility of portfolio capital flows, thus raising the volatility of prices in asset markets, including in the foreign exchange and sovereign bond market.

The *Monetary Policy Guidelines for 2015* have taken these risks into account, highlighting, in this context, the flexibility of inflation targeting and the necessity to include macroprudential policy in the range of instruments of the State's stabilisation policy.

It has also been emphasised that in 2015 the NBP monetary policy will continue to be geared toward the attainment of the medium-term inflation target. This means that monetary policy will continue to take account of the impact of any potential supply shocks, global factors or lags in the transmission mechanisms which may temporarily cause inflation to deviate from the NBP target. Flexibility of monetary policy strategy also means that the range of NBP instruments and the types of collateral used will be adjusted to the type of disturbances that may arise in the financial markets.

The *Guidelines* have also pointed out macroprudential policy as a necessary complement to the flexibly applied inflation targeting which helps to prevent credit booms in selected sectors of the economy (particularly in the mortgage loan market). As shown by the international experience, macroprudential policy, while striving to limit unstable sources of bank funding, may simultaneously curb short-term capital flows, including cross-border interbank loans.

An increasing number of countries have already in place institutions responsible for macroprudential policy. In most cases, the central bank plays a major role in this area. For this reason it is important to implement the recommendation of the European Systemic Risk Board on the establishment of an institution responsible for macroprudential policy at the national level and ensuring a key role for the central bank in pursuing this policy.

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 (Narodowy Bank Polski) of 29 August 1997 states in Article 3 section 1 that “the basic objective of the activity of the NBP shall be to maintain price stability, while supporting the economic policy of the Government, insofar as this does not constrain the pursuit of the basic objective of the NBP”. Nowadays central banks define price stability as low, yet positive inflation, i.e. one that does not affect adversely the decisions of economic agents, including investment and savings decisions. Against this background, price stability may be undermined not only by excessive inflation, but also by deflation construed as a lasting and across-the-board decline in price level, one that feeds through to the expectations of economic agents. Fulfilling the statutory obligation to ensure price stability is a fundamental way in which NBP contributes to achieving sustainable economic growth.

Since 1998, the Monetary Policy Council has attained the price stability objective within the inflation targeting framework. The essence of this framework consists in acknowledging price stability as the primary objective of monetary policy and a public announcement of a numerical target for inflation³.

Following a period of disinflation in the years 1998-2003, during which inflation targets were set annually with a view to bringing inflation below 4% by 2003⁴, a continuous medium-term inflation target at 2.5% was adopted from 2004, with a band for deviations of +/-1 percentage points.

By applying this strategy in the past ten years, the monetary authorities have succeeded in ensuring price stability (average annual CPI in Poland has been 2.7%, i.e. close to the target set by NBP), amidst relatively small volatility of interest rates and output gap. Thus, the experience of the past decade shows inflation targeting to be an effective strategy to maintain price stability, and indirectly – to ensure macroeconomic stability.

Yet, the second half of the past decade brought global financial crisis and the recession triggered by it. The huge cost of the banking crisis – and the ensuing recession in the economies of many countries – prompted central banks to modify their views on the conduct of monetary policy. In particular, it was recognised that stabilising inflation was an important, yet insufficient condition to keep economy in balance. To ensure macroeconomic stability, monetary policy has to be pursued in a manner which – while striving to stabilise inflation at the targeted level – simultaneously limits the risk of build-up of imbalances in the economy, including, in particular, in the financial system. Apart from monetary policy, fiscal and macroprudential policy should

³ G. Hammond (2012), “State of the art of inflation targeting”, *CCBS Handbook* no. 29.

⁴ NBP (1998), *Medium-Term Strategy of Monetary Policy (1999-2003)*, Warszawa.

play an important role in maintaining macroeconomic stability. In order to preserve price stability in the longer term, it is necessary to pursue a fiscal policy to safeguard the long-term stability of public finances and a macroprudential policy to mitigate the risk of imbalances building up in the economy.

Besides the evolution of the views on monetary policy and on its role in stabilization policy, the NBP monetary policy is being affected by the ongoing globalisation processes. Domestic monetary policy is also increasingly contingent on the decisions taken by major central banks, especially decisions on interest rates and quantitative easing programmes. These decisions may fuel the volatility of international capital flows, thus affecting the monetary impulse transmission mechanism and domestic economic developments.

The Council has decided to preserve the key elements of the current NBP monetary policy strategy. At the same time, the Council is taking into account the evolution of views on the role of monetary policy, provoked by the recent global banking crisis and the resulting recession as well as mounting influence of external developments on the situation in the Polish economy. Hence, when implementing monetary policy the Monetary Policy Council places increased emphasis on flexibility of the inflation targeting and the need to include macroprudential policy in the range of stabilisation instruments of the State. In 2015, the monetary policy strategy will be pursued within the following framework:

- First, the Council strives to achieve a medium-term inflation target of 2.5% with a symmetrical band of deviations of ± 1 percentage point. The medium-term orientation of the target means that although it refers to inflation as measured by the annual percentage change in the level of consumer prices in a given month, shocks affecting the economy may cause inflation to temporarily deviate from the target. Striving to keep inflation as close as possible to the target each month would require frequent and considerable changes in interest rates, which would entail significant costs for the real economy.
- Second, the monetary policy response to shocks and the resulting deviations of inflation from the target depend on the underlying cause and the character of these shocks and the assessment of the sustainability of their effects, including the impact on price developments and inflation expectations. The Council determines the time necessary for inflation to return the target in a flexible manner, depending on the character of the shock, its persistence and the overall assessment of risks posed by the shock both for price stability and broadly understood macroeconomic stability in the medium term. In particular, the central bank does not usually respond to deviations of inflation from the target, if it considers them to be temporary. This also applies to situations where deviations from the inflation target temporarily fail to fall within the band of deviations from the target.
- Third, the Council implements inflation targeting under the floating exchange rate regime. The floating exchange rate regime does not rule out intervention in the foreign exchange

market when they turn out necessary to ensure macroeconomic and financial stability of the country, which is conducive to meeting the inflation target in the medium-term.

- Fourth, the Council conducts monetary policy in such a way as to support the stability of the financial system, which is necessary to ensure price stability in the longer term and enable smooth functioning of the monetary policy transmission mechanism. Therefore, the Council in its decisions will take into account the prices of assets, especially the prices of real estate, and growth in lending. As confirmed by the recent experience of a number of countries, lending booms, particularly in the mortgage markets, pose a serious threat to financial stability, sustainable economic growth and price stability in the longer term. Monetary policy promoting the stability of the financial system is therefore consistent with the long-term implementation of the basic objective of the central bank's activities, i.e. ensuring price stability, although it can sometimes cause a temporary deviation from the inflation target. In order to support the stability of the financial system it may be - under certain conditions - necessary to lengthen the horizon of achieving the inflation target.
- Fifth, macroprudential policy is also of considerable importance for financial stability and the need to limit the risk of economic imbalances. One of its features is the possibility to selectively influence certain credit aggregates, e.g. housing loans. This advantage is particularly important in the light of international experience of the last decade. During this period, the feedback between the growth in lending and the rise in real estate prices was the most considerable and common threat to financial stability. An effective use of macroprudential policy to curb unstable booms in the mortgage market could help to reduce the scale of the necessary monetary policy tightening, and thus decrease the overall cost of conducting the counter-cyclical policy. Under certain conditions, macroprudential policy may turn out to be a more effective tool of reducing macroeconomic imbalances than monetary policy. The need to use macroprudential policy instruments, as part of stabilization policy, is suggested, among other things, by empirical studies demonstrating that financial cycles can be much longer than business cycles, to which monetary policy responds.⁵
- Sixth, flexibility of the monetary policy strategy pursued by the Council means that the NBP instruments and types of collaterals used will be adjusted to the character of disturbances that may occur in the financial markets. Flexibility of monetary policy instruments supports an effective operation of the transmission mechanism and macroeconomic and financial stability, which are necessary to ensure price stability in the longer term.
- Seventh, in assessing the degree of monetary policy restrictiveness not only the level of real interest rates (i.e. adjusted for inflation expectations) should be considered, but also the level of the real exchange rate (i.e. adjusted for the price level at home and abroad). The restrictiveness of monetary policy is connected with the implemented fiscal and

⁵ C. Borio (2012), "The financial cycle and macroeconomics: What have we learnt", *BIS Working Papers* nr 395.

macroprudential policy; these in combination determine the degree of restrictiveness of macroeconomic policy.

- Eighth, due to lags in the transmission mechanism, the impact of the currently pursued monetary policy on current inflation is limited. Therefore, the current decisions of the monetary authorities affect the future price developments, while current inflation is influenced by interest rate decisions taken 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 assess this time lag only approximately. Turmoil in the domestic and international financial system may constitute an additional factor disrupting the monetary transmission mechanism.
- Ninth, monetary policy is pursued under uncertainty, which means that economic processes cannot be precisely managed. As a result, when taking monetary policy decisions it is necessary to consider the largest possible set of information relevant for inflation developments.

Since joining the EU, Poland has been obliged to strive for full participation in the third stage of the Economic and Monetary Union (EMU), which has to be preceded by joining the ERM II. If a decision is taken on Poland's membership in the ERM II, the Council will make all necessary adjustments in the monetary policy strategy and – in consultation with the Council of Ministers – in the exchange rate regime to comply with the conditions necessary to meet the convergence criteria required for the euro adoption. In the opinion of the Council, Poland's participation in the ERM II and the euro area should be considered under conditions that would allow for the maximization of benefits offered by currency integration and minimization of its risks.

Chapter 2. Banking sector liquidity and monetary policy instruments in 2015

Implementation of monetary policy amidst liquidity surplus in the banking sector

Besides the inflation targeting strategy presented in Chapter 1, monetary policy conduct in Poland is largely affected by the persistent liquidity surplus in the banking sector, observed since mid-1990s. Its direct consequence is the need for NBP to conduct sterilising open market operations.

High volume and rapid changes in the level of liquidity surplus may impair the effectiveness of central bank steering of short-term market interest rates. Yet, as shown by NBP's experience in the pursuit of inflation targeting strategy, the persistent liquidity surplus in the national banking sector observed in this period has not posed a major obstacle to an effective monetary policy implementation. The adjustments in NBP's operating system of monetary policy have helped to maintain the effectiveness of the monetary policy transmission mechanism, including the interest rate channel. Since 2010, although the banking sector liquidity surplus has hit its historical levels (in 2013, the amount was close to PLN 130bn), the deviations in the POLONIA rate from NBP reference rate have been narrowed down considerably, to levels observed before the financial crisis.

The persistent liquidity surplus in the banking sector generates costs of its sterilisation. On the other hand, it has a stabilising effect on the domestic banking sector, as it absorbs the impact of crisis developments originating in foreign markets. Such an effect was observed directly upon the collapse of the Lehman Brothers, when the liquidity buffers held by banks eased the potential strains stemming from the disruptions in functioning of the interbank markets.

Banking sector liquidity in 2015

In 2015, monetary policy will be conducted under the conditions of surplus liquidity in the banking sector.

The level of surplus liquidity in the banking sector will be primarily affected by the measures taken by the Ministry of Finance, relating to the financing of the state budget borrowing requirement, the servicing of the foreign sovereign debt as well as the use of EU funds. The use of EU funds in the domestic currency entails the need to exchange the currency. The place where the exchange takes place is of prime importance for the level of banking sector liquidity. If the foreign currencies are purchased by the central bank, the banking sector liquidity surplus of the increases. The exchange of EU-derived funds directly in the interbank market remains neutral for surplus liquidity levels.

The servicing of Poland's external debt through drawing on the Ministry of Finance's foreign currency accounts held with NBP, and credited mainly with the proceeds from the issue of bonds in the foreign markets, is neutral in terms of banking sector liquidity. Should, on the other hand, the Ministry of Finance obtain foreign currency for the debt service through the purchase of foreign currency at NBP, the liquidity surplus in the banking sector will diminish.

It is expected that in 2015 the liquidity surplus in the banking sector will be approximately at the current year's level. Factors which may limit liquidity level include an increase in cash in circulation and in bank deposits which constitute the calculation base for the reserve requirement. Net purchases of foreign currency resulting from foreign exchange transactions conducted with the Ministry of Finance will have an opposite effect of similar scale.

Monetary policy instruments in 2015

Interest rate

The principal instrument of monetary policy is the short-term interest rate – NBP's reference rate. Changes in its level result from the direction of the implemented monetary policy.

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 market interest rates.

NBP's lombard rate determines the cost of obtaining liquidity at NBP. It sets the ceiling for the overnight market rate. At the same time, its four-fold amount denotes the ceiling for the so-called maximum interest.

NBP's deposit rate determines the interest on deposits made with NBP. It provides the floor for fluctuations of the overnight market rate.

The levels of the NBP deposit and lombard rates set the corridor for overnight interest rate fluctuations in the interbank market.

Open market operations

Open market operations are used to influence liquidity conditions in the banking sector in a way which allows to keep short-term market interest rates at a level consistent with the inflation target set by the Monetary Policy Council. In particular, the central bank conducts open market operations on such a scale as to enable the POLONIA rate to run close to NBP's reference rate.

Main operations are carried out on a regular weekly basis, typically with a 7-day maturity. A fixed rate at the level of NBP's reference rate is binding during tenders. Due to the expected persistence of liquidity surplus in the banking sector in 2015 these operations will be carried out in the form of issue of NBP bills.

Fine-tuning operations may be conducted in order to limit the volatility of short-term market interest rates. They may involve liquidity-absorbing operations (issue of NBP bills, reverse repo

transactions) or liquidity-providing operations (redemption of NBP bills before maturity, repo transactions). The maturity of and yield of these operations as well as the exact manner in which they are carried out depends on the situation in the banking sector.

Structural operations may be conducted in order to influence long-term liquidity structure in the banking sector. If required, the central bank may carry out the following structural operations: bond issue or purchase or sale of securities in 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 hold balances on accounts with NBP means that during each business day they have funds readily available to facilitate mutual settlements. At the same time, the averaged reserve requirement system allows banks to determine the amount of funds held on the current account with the central bank throughout the maintenance period.

The reserve requirement also reduces the amount of surplus funds at banks' disposal. This means that the reserve requirement – amidst liquidity surplus in the banking sector – contributes to lower volume of the liquidity-absorbing open market operations.

Changes in the required reserve ratio depend on the liquidity level in the banking sector as well as the conditions prevailing in the interbank market.

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 bank on an overnight basis. The interest on the facility constitutes the floor for the market rate quoted for this period.

Standing credit facility (lombard credit) enables banks to obtain overnight credit. The lombard credit is collateralised with assets accepted by the central bank (including Treasury securities, securities issued by NBP, municipal bonds, covered bonds and corporate bonds with a high credit rating). The interest on this credit determines the marginal cost of obtaining funds from the central bank, which constitutes the ceiling for the overnight market rate.

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

Foreign exchange swaps

NBP may carry out foreign exchange swaps. This is a transaction in which NBP purchases (or sells) Polish zloty for foreign currency in the spot market and, at the same time, resells it (or repurchases) under a forward contract at a specified date.

Foreign exchange interventions

Foreign exchange interventions are another monetary policy instrument which may be used by NBP.

Chapter 3. Monetary policy in 2015 and its determinants

Stabilization of inflation at $2.5\% \pm 1$ percentage points in the medium-term, which fosters sustainable economic growth, will remain the primary objective of the NBP monetary policy in 2015. Monetary policy parameters, including the NBP interest rates, will be flexibly adjusted to the changing conditions of the economy, so as to ensure price stability in the medium term, in line with the guidelines on monetary policy strategy as presented in Chapter 1. In 2015, as in the previous years, the Council's monetary policy decisions and assessment of the current state of the economy and future economic developments will be presented in the *Information from the meetings of the Monetary Policy Council*, and at press conferences held after meetings of the Council, as well as in the *Minutes from the Monetary Policy Council decision-making meetings*, *Inflation Reports*, *Monetary Policy Guidelines and Report on monetary policy implementation*.

Global determinants of monetary policy in 2015

In the past few quarters, a moderate recovery in the global economy continued with growth rates varying across the major economies. In the United States economic activity accelerated markedly in 2014 Q2, whereas the euro area remained in stagnation. It should be assumed that the recovery in the global economy might continue to be relatively slow and uneven. Such an assumption stems from the fact that many economies are recovering from recessions caused by banking crises, after which – as shown by historical experience⁶ – it takes long for GDP growth to return to its pre-crisis path. One of the main reasons for this pattern is that households and enterprises of countries hit by a collapse of a long-term credit boom repay their debt from current income (balance sheet recession). The need for the private and public sectors to reduce their debt dampens domestic demand in the countries previously affected by the banking crisis. Although global economic growth in 2015 may be expected to pick-up gradually, with debt repayment - especially in the euro area - still in its early stage, in many countries it is likely to run below the long-term average observed before the financial crisis. Moreover, demand growth in developed countries may be weakened by structural factors, such as demographic changes or slow wage growth and the resulting reduction in the wage income share in GDP.

The moderate recovery in global economy will be conducive to stabilizing energy and food prices in the world markets. Growth in the prices of commodities may, however, be driven by the escalation of geopolitical tensions, particularly in Ukraine and the Middle East. Over the next few

⁶ See C. M. Reinhart, K. S. Rogoff (2009), „This Time is Different. Eight Centuries of Financial Folly”, Princeton University Press, Oxford. Ò. Jordà, M. Schularick and A. Taylor (2013), “When credit bites back”, *Journal of Money, Credit and Banking*, volume 45.

quarters, the impact of the two risks – weak growth and geopolitical tensions – seems to be relatively balanced, which should contribute to keeping relatively low inflation in 2015.

As regards the major developed economies, the most favourable outlook for growth is seen in the United States, where, according to available forecasts, GDP growth is expected to pick up to 3.0% in 2015, i.e. slightly below the long-term average before the crisis. Improved economic outlook in the United States is accompanied by a fall in unemployment, which, however, is partly the consequence of declining activity rates and favorable changes in the structure of household balance sheets which allow a further increase in consumption and contribute to improving business and consumer sentiment. Under these circumstances, the Fed is scaling down its asset purchase programme and is preparing market participants for the termination of the quantitative easing scheme to take place already in 2014. It also plans to increase interest rates, which – according to current expectations of the majority of the FOMC members – could take place as soon as 2015.

The situation in the euro area seems less favourable. According to available forecasts, in the coming quarters GDP growth in the euro area will remain well below the long-term average observed before the crisis. Bleak prospects for growth in the euro area are driven by unfavorable condition of the labour market and the continuing adjustments in the balance sheets of the private sector. Growth is also dragged down by the fragmentation of the euro area financial system, hindering access to credit and impairing the recovery of domestic demand in some of the euro area countries. The economic activity in the euro area may also be negatively impacted by the consequences of Russian-Ukrainian conflict. Under these conditions, inflation, which in the euro area has been declining gradually since the end of 2011 is likely to remain low also in 2015. Low inflation will additionally be supported by structural reforms in some euro area countries, aimed at reducing rigidities in labour and product markets.

In view of the persistently poor growth prospects and low inflation in the euro area, the ECB has recently continued to ease its monetary policy. In particular, the ECB has decreased interest rates – including the deposit rate to -0.2% – and announced the launching of the asset-backed securities purchase programme for the non-financial sector. The long-term liquidity-providing operations, whose size will depend on the scale of lending to the non-financial private sector, will be an additional instrument to stimulate lending in the euro area. The aim of the introduced measures is to stimulate lending and demand in the euro area. The possible improvement in the condition of the euro area economy should, in turn, have a positive impact on the situation in Poland and other countries of Central and Eastern Europe, which are closely integrated with the euro area economy, mainly through participation in international production networks.

In this context, the following global determinants of the Polish monetary policy in 2015 may be highlighted. First, weak growth and low inflation abroad, and, in particular, economic stagnation in the euro area may curb inflation and drag down economic activity in Poland. Second, the diversified growth rates in the United States and the euro area will lead to divergence of monetary policy cycles between these economies. This divergence – depending on the timing of

individual actions by the Fed and the ECB – may contribute to increased volatility in the financial markets, which, in turn, may hinder the conduct of monetary policy especially in small open economies. Finally, geopolitical risk resulting primarily from the conflict between Russia and Ukraine, as well as the situation in the Middle East, is likely to be an important determinant of monetary policy in 2015. Growth in the global geopolitical risk leads to rising uncertainty, which may adversely affect the business and consumer sentiment. Moreover, economic and trade sanctions imposed as a result of the conflict between Russia and Ukraine can have a direct impact on economic activity and inflationary processes in Europe, including in Poland.

Domestic determinants of monetary policy in 2015

Following a few quarters of accelerating growth in Poland, recently economic recovery has slowed down somewhat. In 2014 Q2, GDP growth was slightly lower than in the previous quarter, which was driven by a negative contribution of net exports and a reduction in investment growth. On the other hand, GDP growth was boosted by a slight acceleration in consumption supported by a moderate improvement in the labour market.

The coming quarters are expected to see economic growth stabilizing at a level similar to that observed in 2014 H1. Rising consumer demand, supposed to be supported by a relatively favourable situation in the labour market, translating into faster growth in household disposable income, will continue to act as a key driver of economic growth in 2015. Housing investment may be expected to rebound gradually on the back of improving financial situation of households, although somewhat deteriorating sentiment observed recently may drag down expenditure growth. Also growth of public investment is expected to gain momentum, which will be supported by the planned use of EU funds under the EU financial perspective 2014-2020. At the same time, until the end of 2015, public consumption growth should remain moderate as wage freeze in the public sector is expected to continue. As a result, the overall impact of fiscal policy on domestic macroeconomic conditions in 2015 should be close to neutral.

Despite stable economic growth in 2014 H1, CPI inflation – in line with the trends observed worldwide – remained very low, to fall slightly below zero in July 2014. This was driven – apart from the absence of demand pressures – by favourable weather conditions affecting supply in agricultural market, stable energy commodity prices and a decline in agricultural commodity prices in the global markets as well as the bans on Polish exports associated with the conflict in Eastern Europe.

In the subsequent quarters, continuing growth in economic activity and the accompanying relatively favourable labour market condition should be conducive to a gradual increase in inflation. Yet, amidst low demand pressure, persistently low inflation in the euro area and stabilization of commodity prices in the world markets, inflation in Poland is likely to be low.

The macroeconomic scenario outlined above is, however, subject to considerable uncertainty associated with a possible downturn in the euro area and the escalation of geopolitical tensions, including, in particular, further intensification of the Russian-Ukrainian conflict, as well as the

risk of a sudden deterioration in sentiment and fall in asset prices in the global financial markets. Constraints on trade and increased uncertainty, which may lead to lower investment and economic activity, may be a downside risk for Poland's economic performance. These factors may negatively affect economic growth and, consequently, inflation⁷.

⁷ N. Bloom, M. Floetotto, N. Jaimovich, I. Saporta-Eksten, S. Terry, (2012), "Really Uncertain Business Cycles," *NBER Working Paper* no. 18245. M. A. Kose, M. E. Terrones (2012), "How Does Uncertainty Affect Economic Performance?" *World Economic Outlook* Box 1.3, pp. 49–53, International Monetary Fund, October 2012.

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