

NBP

Narodowy Bank Polski

Monetary Policy Council

Monetary Policy Guidelines for 2017



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Introduction

In setting the *Monetary Policy Guidelines for 2017*, hereinafter the *Guidelines*, the Monetary Policy Council fulfils the requirements of Article 227 of the Constitution of the Republic of Poland (Journal of Laws of 1997, item 483 as amended), which obligates it to formulate the *Guidelines* and present them to the Sejm on an annual basis. The *Guidelines* present the monetary policy strategy pursued by Narodowy Bank Polski, monetary policy instruments used by NBP and an outline of macroeconomic conditions that may have an impact on this policy in 2017.

In 2017 the basic objective of NBP's monetary policy will 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 NBP. While striving to maintain price stability, NBP will pursue the inflation targeting strategy. At the same time, monetary policy will be conducted in a way that fosters sustainable economic growth and financial stability. Therefore, NBP will be flexible in its response to shocks that cause a deviation of price growth from the target, factoring in the nature of those shocks and the way they affect inflation developments and economic activity.

A flexible approach to the inflation target is of special importance when price growth deviations from the target are mainly driven by a slump in global commodity prices, as has been the case in the past few years. Such negative price growth is driven by external factors and in the light of currently available information it does not adversely affect business activity and the economic situation of households in Poland. This does not mean that long-term deflation would be a tolerable phenomenon, should it trigger deflationary expectations and a marked slowdown in economic growth.

Amid low price growth, the adjustment of monetary policy parameters depends mainly on the assessment of the benefits of a fast return of price growth to the inflation target as compared to the economic costs and risks for macroeconomic and financial stability resulting from the conduct of monetary policy focused on a fast rise in inflation.

Therefore, in 2017 monetary policy parameters, including NBP interest rates, will be adjusted to the situation in the economy so as to ensure long-term price stability and at the same time support sustainable economic growth and financial stability.

Taking into account the external nature of shocks causing price growth to deviate from the inflation target, while not willing to allow a sustained decrease in long-term inflation expectations, which could enhance the risk of deflation persistence and, hence, its adverse macroeconomic effects becoming apparent, the Council decided to maintain the medium-term inflation target at 2.5%, with a symmetric band for deviations of +/-1 percentage point.

When formulating the *Monetary Policy Guidelines for 2017*, the Council emphasized that monetary policy would be conducted amid uncertainty. The possibility of a deterioration

in economic conditions in the environment of the Polish economy and the outlook for investment activity in Poland in the coming years are the major sources of uncertainty for the domestic monetary policy in 2017. At the same time, commodity prices in the global markets and the possibility of a slower than expected wage growth in Poland will remain important risk factors for price growth.

The *Monetary Policy Guidelines for 2017* take into account information available up to 6 September 2016.

Chapter 1.

Monetary policy strategy

According to Article 227 Section 1 of the Constitution of the Republic of Poland, “Narodowy Bank Polski shall be responsible for the value of Polish currency”. The Act on Narodowy Bank Polski of 29 August 1997 (Journal of Laws of 2013, item 908, as amended) states in Article 3 Section 1 that “the basic objective of the activity of 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 NBP”.

In 2017 – similarly to the previous years – the Monetary Policy Council will strive to maintain price stability. At the same time, monetary policy will be conducted in a way that helps maintain sustainable economic growth and financial stability. In doing so, the Council will fulfil the main obligation of Narodowy Bank Polski laid down in the Constitution of the Republic of Poland and in the Act on Narodowy Bank Polski.

Nowadays central banks define price stability as low, yet positive inflation, which does not adversely affect the decisions of economic agents, including those concerning investment and saving. So defined price stability may be threatened not only by excessive inflation, but also by long-lasting deflation, especially if it causes a marked slowdown in economic growth. Negative price growth has not yet adversely affected entrepreneurship in Poland.

The Monetary Policy Council has been pursuing the price stability objective under the inflation targeting strategy. Under this strategy, since 2004 the monetary policy objective has been to keep inflation – understood as the annual change in the consumer price index – at 2.5% with a symmetric band for deviations of +/-1 percentage point in the medium term.

Since 2004 the average annual growth in CPI in Poland has been 2.1%, and hence it was close to the NBP’s target, although in some years price growth was outside the band of deviations from the target. Yet, temporary deviations of inflation from the target, including the negative price growth observed in the past few years, have failed to give rise to deflationary expectations. At the same time, the pace of economic growth in the past few years has been relatively stable and close to the long-term trend, with no macroeconomic imbalances arising. This indicates the inflation targeting strategy has been effective in ensuring long-term price stability, while at the same time supporting sustainable economic growth.

The adopted inflation target is a medium-term target. This means that due to fluctuations in commodity prices or other macroeconomic and financial shocks, inflation may temporarily deviate from the target and even run outside the band for deviations from the target. Under such circumstances, the response of monetary policy to a shock depends on its causes, nature and the assessment of persistence of its consequences, including its impact on price developments and inflation expectations.

Regardless of the nature of the shocks in the economy, bringing inflation back to the target requires time because changes in monetary policy parameters affect the economy with a lag. The time lag between an interest rate decision and its peak impact on real variables (output, employment) and on inflation takes several quarters and may change over time. In such a situation, it may not be desirable to strive to bring inflation back to the target as soon as possible given the costs that it could generate for the economy. Therefore, each time inflation deviates from the target, the Monetary Policy Council flexibly determines the expected time necessary for inflation to return to the target. A fast return of inflation to the target may entail significant costs to macroeconomic and financial stability.

The experience of the global financial crisis shows that stabilizing inflation at a low level is a very important, yet insufficient condition to maintain balance in the economy which, in turn, supports price stability in the long term. Especially imbalances in the financial sector pose a threat to long-term price stability. Bearing this in mind, the Council conducts monetary policy in a way that supports the stability of the financial system and mitigates the risk of imbalances building up in the economy, taking into account in its decisions the development of asset prices (especially real estate prices) and growth in lending. Yet, the Council believes that given free movement of capital and highly integrated financial markets, macroprudential policy should support monetary policy in containing macroeconomic imbalances. Given its capacity to selectively influence credit aggregates, above all mortgage loans, macroprudential policy can stabilize lending growth with lower costs for economic growth than monetary policy.

Besides monetary and macroprudential policy, fiscal policy plays an important role in maintaining macroeconomic stability. Provided that it does not lead to excessive public debt, it should support sustainable economic growth.

The Council implements the inflation targeting strategy under the floating exchange rate regime. The floating exchange rate regime does not rule out interventions in the foreign exchange market whenever it is necessary to ensure the country's macroeconomic and financial stability.

Monetary policy communication is an important element of the Council's inflation targeting strategy. Thus, the Council's decisions together with their macroeconomic determinants are presented in the Monetary Policy Council's press releases (*Information from the meeting of the Monetary Policy Council*) and the accompanying press conferences, as well as the *Minutes of the Monetary Policy Council decision-making meetings*, *Inflation Reports*, *Monetary Policy Guidelines* and the *Report on Monetary Policy Implementation*.

Chapter 2.

Banking sector liquidity and monetary policy instruments in 2017

Banking sector liquidity in 2017

In 2017 monetary policy will continue to be conducted under conditions of liquidity surplus in the banking sector.

The level of the liquidity surplus in the banking sector will primarily be affected by the measures taken by the Ministry of Finance in relation to financing the borrowing needs of the state budget, foreign debt service and the use of EU funds.

It is expected that the reduction in the excess liquidity of the banking sector will continue in 2017.

The main factors reducing the amount of the banking sector's liquidity in 2017 will continue to be a further rise in currency in circulation and in deposits which are the basis for calculation of the required reserve level, as well as the sale of foreign currency by NBP for the needs of the European Commission in connection with the exchange of the currency of the membership fee. The purchase of foreign currencies resulting from FX transactions will have the opposite effect, namely increasing the surplus liquidity.

Monetary policy instruments in 2017

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 fluctuations in the overnight market rate.

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 by the central bank 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 so 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 continued liquidity surplus in the banking sector in 2017, 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 and the 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: issuance of bonds, and 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. The fact that banks hold balances on account 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 reserve 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 level of liquidity in the banking sector as well as the conditions prevailing in the interbank market.

Standing facilities

Standing facilities are designed to limit the scale of overnight market rate fluctuations. Banks use standing facilities at their own initiative.

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

The 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.

Foreign exchange swaps

NBP may carry out foreign exchange swaps. This is a transaction in which NBP purchases (or sells) Polish zloty against 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 2017 and its determinants

External determinants

Since the global financial crisis the world economy has been growing at a relatively low pace. This is mainly due to weaker investment growth in the advanced economies and the related slowdown in labour productivity growth in these countries. Another factor reducing global growth in recent years was a deterioration in economic conditions in the emerging market economies, above all in China. These trends will most likely continue in 2017.

Economic growth in Poland's main trading partners in the first half of 2016 was somewhat higher than in previous years, but – like in the majority of the economies – it was still lower than before the global financial crisis. Forecasts indicate that the moderate growth of economic activity in the environment of the Polish economy will continue in 2017, with significant uncertainty about its prospects.

In the European Union (EU), economic growth in the first half of 2016 was higher than in previous years and – in line with available forecasts – it will remain moderate in 2017, particularly in the euro area, Poland's most important trading partner. Internal demand continues to be the main growth driver in the euro area, supported by good labour market conditions, low cost of credit amid the ECB's strongly expansionary monetary policy and slower tightening of fiscal policy in some euro area countries. At the same time, economic conditions in the euro area will be contained by a relatively low pace of growth in the global economy, primarily in China. Moderate economic growth in the euro area should be accompanied by a recovery in the majority of the Central and Eastern European countries. In the United Kingdom, in turn, economic growth is likely to slow down in 2017 due to heightened uncertainty related to the perspective of this country's withdrawal from the EU.

In the United States, economic growth in the first half of 2016 was weaker than in the previous year. In 2017 GDP growth in the US economy should accelerate somewhat as a result of further growth in consumer demand and increased investment. However, low oil prices, which reduce investment growth in the oil extraction industry, as well as ongoing uncertainty about economic conditions in the environment of the US economy may limit GDP growth in the United States.

In the majority of the main emerging market economies, domestic conditions were still weak in the first half of 2016. In China, GDP growth slowed down further and adverse economic conditions will probably continue into 2017. At the same time, the country's high debt level, particularly of the private sector, poses a risk for the stability of the Chinese financial system,

and for economic growth as a result. Russia and Brazil were still in recession in the first half of 2016, which – in line with available forecasts – is expected to end in the second half of 2016 and in 2017 respectively. Despite this, economic growth in these countries will probably stay low. In India, in turn, economic conditions are better than in other major emerging market economies, and stable economic growth is expected also in 2017.

In the first half of 2016, oil prices increased slightly, but were still lower than in 2015. The relatively weak global economic growth, coupled with the high level of oil stocks, has an adverse effect on oil prices. Prices of other energy and agricultural commodities also remained low. As a result, global inflation was very low in 2016. In the majority of advanced economies, including in the euro area, price growth was close to zero.

Along with the expected acceleration of global economic growth and the subsiding impact of the earlier fall in commodity prices on price growth, inflation in the environment of the Polish economy should rise in 2017. Despite this, it will probably remain below the inflation targets of the central banks in the majority of the most important advanced economies, including in the euro area. A significant risk factor for global inflation is the possibility of a deterioration in global economic conditions, which could translate into weaker demand pressure and another fall in commodity prices.

Under these conditions, the ECB maintains interest rates close to zero, including a negative deposit rate. At the same time, it is continuing financial asset purchases. Amid still low inflation, the ECB will probably continue to conduct a highly accommodative monetary policy, and may even ease it further.

In the United States, the interest rates have been kept unchanged since their increase in December 2015. At the same time, the Fed has been reinvesting the principal payments from government bonds purchased during the successive rounds of quantitative easing, which has an indirect stabilising effect on long-term interest rates. Increases in interest rates are likely in the second half of 2016 and in 2017, but uncertainty about the scale and the timing of these interest rate increases remains significant.

The uncertainty about the outlook for the global economic conditions and the Fed's monetary policy is an important risk factor for global financial asset prices, in particular the emerging market currencies. At the same time, the ECB's expansionary monetary policy is conducive to an improvement in financial market sentiment in European countries, including Poland.

Domestic determinants

In Poland, stable economic growth continued in the first half of 2016, although GDP growth was slightly lower than in the previous year. The main source of the growth in economic activity was a rise in consumer demand amid improving labour market conditions, an increase in the lending growth rate and the launch of the new child benefits under the “Family 500 plus” programme. Stable consumer growth rate was accompanied by relatively low investment growth rate. This was associated with a smaller scale of implementation of

projects financed from EU funds and heightened uncertainty, including in the Polish economy and its environment.

In 2017, GDP growth is expected to remain stable, with private consumption continuing as a main source of GDP growth. Private consumption will be supported by further improvement in the labour market conditions, translating into a gradual increase in wage growth and higher household income, also associated with the new child benefits. It can be expected that investment growth rate will increase in 2017, albeit to lower level than in previous years. Investment growth should be supported by good financial standing of enterprises, high capacity utilisation, stable growth in demand and the increase in the EU funds absorption. However, growth in investment, particularly that of enterprises, might still be contained by uncertainty.

In the first half of 2016, consumer price growth rate was still negative. The main reasons behind the decrease in consumer prices were external and included the earlier sharp fall in global energy prices and the weak global economic activity, which contains growth of the remaining prices in the environment of the Polish economy. The fall in global energy prices translated into lower domestic energy prices, which – along with the absence of demand and cost pressures – contributed to a decline in prices of other goods and services. The available forecasts indicate that in 2017 price growth will be higher than in 2016, supported by the fading impact of the earlier fall in commodity prices and the expected acceleration in wage growth. This notwithstanding, price growth will most likely be modest, as the output gap will be closing slowly and global price growth will remain low.

In Poland, most macroeconomic indicators confirm a lack of significant macroeconomic imbalances. Taking into account available forecasts, 2017 should see no significant imbalances – either of external or internal nature.

A number of areas of uncertainty remain around the above macroeconomic scenario. The most important of these are associated with the possibility of a stronger slowdown in the emerging market economies, particularly in China, which – along with heightened uncertainty related to the United Kingdom's perspective of withdrawal from the EU – could result in slower economic growth in the euro area. The elevated uncertainty about the economic growth outlook in the environment of the Polish economy might also lead to an increase in volatility in financial asset prices and exchange rates. Apart from external factors of uncertainty, there are also domestic ones, in particular lower absorption of funds from the new EU financial framework, which could contain investment growth. Other risk factors for price growth in Poland are developments in the global commodity prices and slower than expected growth in domestic wages.

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