

NBP

Narodowy Bank Polski

Monetary Policy Council

Monetary Policy Guidelines for 2019



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In setting the Monetary Policy Guidelines for 2019, the Monetary Policy Council fulfils the requirements of Article 227 section 6 of the Constitution of the Republic of Poland, which obligates it to formulate monetary policy guidelines and present them to the Sejm on an annual basis.

In the Monetary Policy Guidelines for 2019 the Monetary Policy Council has maintained the monetary policy strategy pursued by Narodowy Bank Polski so far. Price stability remains the main statutory objective of monetary policy. At the same time, monetary policy will be conducted in a way that helps maintain sustainable economic growth and financial stability.

NBP will continue to pursue the strategy of a medium-term inflation target at 2.5%, with a symmetric band for deviations of +/-1 percentage point. NBP's interest rates will remain the principal instrument of monetary policy, and the operating objective will be to enable the POLONIA rate to run close to NBP's reference rate. Monetary policy will continue to be implemented under the floating exchange rate regime, which does not rule out interventions in the foreign exchange market.

The *Monetary Policy Guidelines for 2019* is a translation of the publication of Narodowy Bank Polski entitled *Założenia polityki pieniężnej na rok 2019*. In case of discrepancies, the original prevails.

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Chapter 1. Monetary policy strategy

According to Article 227 Section 1 of the Constitution of the Republic of Poland (Journal of Laws of 1997, item 483, as amended), “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 2017, item 1373) 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.”

Fulfilling the main obligations of Narodowy Bank Polski, hereinafter “NBP”, laid down in the Constitution of the Republic of Poland and in the Act on Narodowy Bank Polski, the Monetary Policy Council, hereinafter the “Council”, strives to maintain price stability. At the same time, monetary policy is conducted in a way that helps maintain sustainable economic growth and financial stability.

The Council has been pursuing the price stability objective by using 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. In countries pursuing inflation targeting strategy, inflation rate is lower than in other countries, on average. Since 2004 the average annual growth in CPI in Poland has been 2.0%, i.e. close to the NBP’s target.

The medium-term nature of inflation target means that due to macroeconomic and financial shocks, inflation may temporarily deviate from the target and even run outside the band for deviations from the target. The response of monetary policy to shocks is flexible and depends on their causes and the assessment of persistence of their consequences, including the impact on inflation developments. Each time inflation deviates from the target, the Monetary Policy Council flexibly determines the expected time necessary to bring it back to the target, as bringing inflation rapidly back to the target may entail significant costs to macroeconomic and financial stability.

The monetary policy strategy pursued by the Council assumes flexibility of the instruments applied. This means that the range of instruments used by NBP can be adapted to the nature of disturbances observed in the economy. The flexible use of monetary policy instruments is conducive to effective functioning of the transmission mechanism as well as macroeconomic and financial stability.

While taking monetary policy decisions, the Council considers the time lags in the transmission mechanism of monetary policy. The time lag between an interest rate decision and its peak impact on real variables (such as output or employment) and on inflation takes several quarters and may change over time. Moreover, monetary policy is conducted under uncertainty, in particular about future economic developments.

The experience of the global financial crisis shows that stabilizing inflation at a low level is an 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 by taking into account in its decisions the development of asset prices (especially real estate prices) and growth in lending. Given the free movement of capital and highly integrated financial markets, macroprudential policy should play a primary role in containing macroeconomic imbalances. Owing to its capacity to selectively influence credit aggregates, 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. A fiscal policy which ensures long-term stability of public finance is necessary to maintain macroeconomic stability.

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 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 in the Minutes of the Monetary Policy Council decision-making meetings, Inflation Reports, Monetary Policy Guidelines and the Report on Monetary Policy.

In line with the adopted strategy, in 2019 monetary policy parameters, including NBP interest rates, will be adjusted to the economic situation so as to ensure long-term price stability and, at the same time, support sustainable economic growth and financial stability.

Chapter 2. Monetary policy instruments in 2019

Determinants of monetary policy instruments

Monetary policy is conducted under conditions of liquidity surplus in the banking sector.

The forecast for 2019 foresees banking sector liquidity higher than maintained in 2018. The level of liquidity 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. The main factor increasing banking sector liquidity surplus in 2019 will be the purchase of foreign currencies resulting from FX transactions, primarily from the Ministry of Finance. A steady rise in currency in circulation and in deposits, which are the basis for calculating the required reserve level, will have a curbing effect on the level of banking sector liquidity surplus, as will 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 operational target of monetary policy is to keep the POLONIA rate running close to the NBP reference rate. This objective is achieved with the use of respective monetary policy instruments specified in the *Monetary Policy Guidelines*.

NBP shall use monetary policy instruments flexibly in the case of disturbances in the financial markets. Changes in the way of using the instruments, if any, will be aimed at ensuring effective operation of the monetary policy transmission mechanism and macroeconomic and financial stability, supporting price stability in the long-term.

Interest rates

The principal instrument of monetary policy is NBP interest rates.

The main NBP interest rate is reference rate, which determines the yield obtainable on the main open market operations conducted by NBP, while at the same time affecting the level of short-term market interest rates.

The NBP lombard rate determines the interest rate on the lombard credit offered by NBP allowing to obtain funds from the central bank on an overnight basis. The NBP deposit rate, in turn, determines the interest rate on deposits, allowing to deposit funds with NBP on an overnight basis.

Open market operations

Open market operations are the main instrument used by NBP to pursue its monetary policy operational target. By using open market operations NBP influences liquidity conditions in the banking sector in a way enabling 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 the NBP reference rate is binding during tenders. Due to the forecast continued

liquidity surplus in the banking sector in 2019, these operations will be carried out in the form of issuance 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 (issuance of NBP bills, reverse repo transactions) or liquidity-providing operations (redemption of NBP bills before maturity, repo transactions). The maturity and yield of these operations as well as the manner in which they are carried out depend on the situation in the banking sector.

Structural operations may be conducted in order to change the 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.

Required reserve system

The required reserve system supports the pursuit of the operational target of monetary policy, contributing to the stability of short-term market interest rates. This is ensured by the averaged reserve requirement, which allows banks to determine the amount of funds held on the account with the central bank throughout the reserve maintenance period, provided the average level of holdings at NBP does not fall below the value of the required reserve. At the same time, the reserve requirement reduces the scale of NBP open market operations conducted to absorb liquidity surplus.

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.

An important parameter of the required reserve system is also remuneration of holdings of the required reserve.

Standing facilities

Standing facilities offered by NBP are designed to limit the scale of overnight market rate fluctuations by stabilizing liquidity conditions in the banking sector.

The standing credit facility (lombard credit) enables banks to obtain overnight credit from the central bank on each trading day. 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.

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

Foreign exchange swaps

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

Foreign exchange interventions

NBP may carry out interventions in the FX market.

Chapter 3. Monetary policy determinants in 2019

External determinants

In the first half of 2018, global economic conditions remained favourable. Available forecasts suggest that the global economic situation will continue to be good in 2019, although activity growth in the external environment of the Polish economy will probably slow down somewhat compared with this year.

In the euro area, Poland's most important trading partner, economic activity continued to be strong in the first half of 2018, despite slightly slower GDP growth than in 2017. Forecasts point to a further weakening of the euro area GDP growth in 2019 related to lower external demand due to the anticipated slowdown in global trade. However, economic activity growth in the region will continue to be supported by the improvement in labour market conditions, high consumer and business confidence, low cost of borrowing and the fiscal loosening in Germany. Forecasts indicate that lower GDP growth in the euro area in 2019 will entail a slight slowing of economic growth in most countries of Central and Eastern Europe.

In the United States, GDP in the first half of 2018 grew faster than in the previous year. Yet, available forecasts show that economic growth will lose some momentum in 2019, while staying above the euro area's rate. GDP growth in the United States will continue to be supported by very good labour market conditions, the wealth effects of high assets prices and the tax reform taking effect in 2018, which has reduced the tax burden of firms and households.

In China and Russia, economic growth in the first half of 2018 remained close to the previous year's levels. According to forecasts for 2019, GDP growth in both countries will slow down slightly. In China, this is to result from the tightening of the financial sector regulations, coupled with the expected slowdown in global trade.

Global inflation, notwithstanding a slight rise, remained moderate in the first half of 2018. The increase in inflation indices was mainly driven by substantially higher energy commodity prices than a year ago, in particular, oil prices. In many emerging market economies, price growth was additionally enhanced by depreciation of national currencies. At the same time, the rise in global inflation was dragged by the relatively low core inflation in some major economies, including the euro area. Available forecasts for 2019 point to a slightly higher, yet still moderate global inflation, with relatively stable price growth in the euro area.

In the first half of 2018, the European Central Bank, hereinafter the "ECB", maintained interest rates close to zero, including the deposit rate below zero, while continuing financial asset purchases. Simultaneously, the ECB announced a reduction in the scale of asset purchases starting from October 2018, and the termination of the programme at the end of the year. At the same time

– in line with the ECB's current signals – interest rates in the euro area will remain at their present levels at least through the summer of 2019.

In turn, the Federal Reserve of the United States raised interest rates in the first half of 2018 and indicated it would continue the increases in the following quarters, including in 2019.

Domestic determinants

In Poland, robust economic growth continued in the first half of 2018. Rising consumer demand remained the main driver of GDP growth, supported by increasing employment and wages, disbursement of benefits and very strong consumer sentiment. This was accompanied by a gradual recovery in investment, driven, to a significant degree, by a strong rise in public investment. Amid continued high domestic demand and the simultaneous weakening of export sales, net exports made a slightly negative contribution to GDP growth.

According to available forecasts, favourable economic conditions will continue into 2019, although GDP growth will be somewhat lower than in 2018. Consumption growth will probably persist at relatively high rates – notwithstanding a minor flattening – supported by further employment and wage growth coupled with very strong household sentiment. At the same time, due to the expected weakening in the growth of spending co-financed with European Union funds, public investment growth rate is forecasted to decline. Yet the impact of this weakening on gross fixed capital formation will probably be mitigated by the expected pickup in corporate investment growth, which should benefit from the sound financial performance of enterprises amid high production capacity utilisation.

In the first half of 2018, the annual growth of consumer prices continued at a moderate pace, driven by the consistently low domestic demand pressure and moderate inflation in Poland's major trading partners. At the same time, the rising global prices of energy commodities, coupled with zloty depreciation, had a boosting effect on the consumer price index. In turn, food price growth decelerated compared to 2017.

Available forecasts suggest that inflation will rise slightly in 2019 while remaining close to the NBP inflation target. The anticipated pickup in price growth is to be driven by an increase in core inflation amid persistently strong economic conditions and rising unit labour costs. In turn, a curbing effect on inflation will come from price growth in the external environment of the Polish economy, which remains moderate.

In the first half of 2018, most indicators in the Polish economy confirmed a lack of significant macroeconomic imbalances. Available forecasts do not point to a material risk of imbalances mounting in 2019.

Uncertainty factors

The materialisation of the above macroeconomic scenario is subject to uncertainty, relating primarily to the external environment of the Polish economy. The main risk factor is the potential

aggravation of trade tensions between the world's largest economies. This could result in a more marked slowdown in international trade, which, particularly if leading to a significant weakening in the euro area's export sales, would probably have an adverse effect on economic growth in Poland. Also the impact of the ongoing monetary policy tightening in the United States on global asset prices and economic conditions remains a source of uncertainty. Another major uncertainty factor relating to the outlook for both economic activity and prices in the external environment of the Polish economy is the future level of energy commodity prices – in particular, prices of oil. In the domestic economy, in turn, uncertainty persists about the impact of labour market conditions on wage growth as well as the scale and speed of price adjustments to the rising labour costs.

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