NBP Narodowy Bank Polski

Monetary Policy Council

Monetary Policy Guidelines for 2020

In setting the Monetary Policy Guidelines for 2020, 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 2020 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.

This version of the *Monetary Policy Guidelines for 2020* incorporates changes introduced by the Monetary Policy Council resolution of 8 April 2020, which extended the set of monetary policy instruments by including bill discount credit.

The *Monetary Policy Guidelines for 2020* is a translation of the publication of Narodowy Bank Polski entitled *Założenia polityki pieniężnej na rok 2020*. 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, of 2018, item 2243 and of 2019, item 371 and 730) 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 Council flexibly determines the desirable 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 stabilising 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 significant role in containing macroeconomic and financial imbalances. Owing to its capacity to selectively influence credit aggregates, macroprudential policy can stabilise 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 2020 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 2020

Determinants of monetary policy instruments

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

The forecast for 2020 foresees banking sector liquidity higher than maintained in 2019. 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 in 2020 will be the Ministry of Finance foreign currency sale to NBP. 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, as will the foreign currency purchase by the European Commission from NBP in relation 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 NBP's reference rate. This objective is achieved with the use of respective monetary policy instruments specified in *Monetary Policy Guidelines*.

NBP shall use monetary policy instruments flexibly in the case of disturbances in the financial markets. Changes in the way the instruments are used, 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 the NBP interest rates.

The main NBP interest rate is the 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 the NBP 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 2020, these operations will be carried out in the form of NBP bills issuance.

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

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 it (or repurchases) under a forward contract at a specified date.

Foreign exchange interventions

NBP may carry out interventions in the FX market.

Bill discount credit

NBP may offer bill discount credit aimed at refinancing loans granted to enterprises by banks. The interest rate applied to this credit is the discount rate.

Chapter 3. Monetary policy determinants in 2020

External determinants

In the first half of 2019, growth in the global economy declined compared to 2018, although economic conditions in individual countries and sectors varied. In particular, industrial activity growth declined sharply, while the situation in the service sector continued to be favourable.

In the euro area – Poland's main trading partner – annual GDP growth lowered markedly in the first half of 2019 compared to 2018. The decline in world trade growth amid escalating trade disputes, translating into a slowdown in industrial activity as well as structural problems of certain member countries had a negative impact on growth in the euro area. At the same time, growth in this economy was supported by rising household income – as reflected in the relatively good situation of the service sector – and the easing of fiscal policy in some euro area countries. Despite the end of asset purchases in December 2018, the European Central Bank's (ECB) still expansionary monetary policy worked in the same direction.

Significant uncertainty currently persists regarding the length of the slowdown in the euro area. However, according to available forecasts, GDP growth is expected to pick up in 2020 in the euro area, although it might still be considerably lower than in previous years.

According to current forecasts, the deterioration in economic conditions in the euro area in the first half of 2019 will translate with some lag into a slowdown in Central and Eastern European economies, although GDP growth in these economies will remain significantly higher than in Western Europe.

In the United States, economic activity growth was relatively high in the first half of 2019, yet it was lower than in 2018. On the one hand, it was supported by high private consumption growth, driven by rising employment and wages as well as high net worth of US households. On the other hand, the intensification of trade policy tensions, combined with the fading effect of fiscal loosening were the factors limiting GDP growth. Available forecasts indicate that in 2020 growth in this economy will slow down, although it will remain higher than in the euro area.

In the first half of 2019, GDP growth in the emerging market economies was somewhat lower than in 2018, though the situation of individual countries varied. Available forecasts point to a pick-up in economic activity growth in this group of countries in 2020. However, in China – which is the largest emerging market economy – forecasts indicate a likely continuation of the gradual slowdown in GDP growth.

Inflation in the external environment of the Polish economy remained at a moderate level in the first half of 2019, close to that of 2018. A significant increase in the prices of certain agricultural commodities, in particular, of pork and some vegetables, put upward pressure on inflation. The increase in pork prices was the result of a reduction in its supply following the African swine fever (ASF) epidemic in China, whereas the increase in vegetable prices was due to unfavourable weather conditions prevailing, in particular, in Europe. In turn, energy commodity prices – including oil prices – were lower on average than a year ago, which limited inflation. At the same time, core inflation in the major economies did not change significantly and in some of these economies, particularly in the euro area, it remained low. As a result, price growth slowed down somewhat in the advanced economies, while in the emerging market economies, which are more sensitive to changes in food prices, it accelerated. The available forecasts indicate that in 2020 global inflation will remain moderate, while price growth in the euro area will continue to be low.

In view of the deteriorating economic conditions and low inflation in the euro area in the first quarters of 2019, the ECB has kept interest rates close to zero, including a negative deposit rate, while signalling a stabilisation of interest rates at the current or lower level until at least the first half of 2020. At the same time, after the end of the asset purchase programme in 2018, the ECB continued to reinvest the whole of the principal payments from the maturing securities and signalled that it would continue this process for a longer time. In addition, the ECB has announced a third series of its targeted longer-term refinancing operations to be launched since September 2019. In the second half of 2019, an easing of the ECB's monetary policy is expected, including a possible reduction in interest rates and a restarting of the asset purchase programme. As a result, in 2020 a continuation of the ECB's expansionary monetary policy is likely.

In turn, in July 2019, the Fed lowered interest rates after a period of interest rate increases and gradual balance sheet reduction that lasted several years. At the same time, in 2019 it halted the process of reducing its balance sheet. Market expectations suggest that further monetary policy easing by the Fed is possible in the coming quarters, including in 2020.

Domestic determinants

In Poland, relatively robust economic growth continued in the first half of 2019, although GDP growth was lower than in 2018. Rising consumer demand, supported by increasing employment and wages, disbursement of benefits and very strong consumer sentiment, remained the main driver of GDP growth. This was accompanied by strong growth in investment activity, particularly corporate investment. Despite economic slowdown in Poland's main trading partners, foreign sales of Polish enterprises continued to rise significantly.

In the coming quarters, including in 2020, the robust domestic economic conditions are expected to continue, although a further weakening of GDP growth is likely. The scale of the slowdown in the domestic activity depends, to a large extent, on how long the downturn in the external environment of the Polish economy, including in the euro area, will last, and on the strength of its impact on the situation in Poland. At the same time, economic conditions in Poland will continue to benefit from rising domestic demand. Further growth in domestic consumption will be supported by still favourable, from the point of view of employees, labour market conditions, and changes in fiscal policy, which increase household disposable income, as well as very good consumer sentiment. Concurrently, gross fixed capital formation will continue to rise, although probably at a lower rate due to the expected slower growth in expenditures co-financed with European Union funds. However, the high capacity utilisation in enterprises amid relatively strong domestic demand should be a factor limiting the scale of the expected slowdown in investment.

In the first half of 2019, annual growth in prices of consumer goods and services was gradually rising, largely as a result of a marked increase in food prices, but also due to higher core inflation. This was mainly related to the limited supply of some agricultural commodities in Poland and abroad, owing to unfavourable weather conditions in Europe and the ASF epidemic in China. The systematic growth in consumer demand amid rising wages also contributed to higher inflation. At the same time, energy price growth was low, mainly as a result of the freezing of electricity prices for end-users. The moderate inflation in Poland’s main trading partners also had a dampening effect on price growth in Poland. Consequently, despite increasing, inflation remained at a moderate level.

Available forecasts suggest that inflation might be higher in 2020 than in 2019. According to current expectations, after a temporary rise in 2020 Q1, price growth will decline and will run close to the NBP inflation target. The anticipated pick-up in inflation will be driven primarily by the expected rise in energy prices resulting from staggering the effect of higher electricity production costs over time. Concurrently, core inflation might also be slightly higher. The curbing effects on inflation will come from moderate price growth in the external environment of the Polish economy as well as the expected slowdown in domestic economic growth.

In the first half of 2019, the levels of most indicators of external and internal balance of the Polish economy indicated a lack of significant macroeconomic imbalances. Available forecasts do not point to a material risk of imbalances mounting in 2020.

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 for domestic economic conditions and developments in prices is the scale and duration of the global economic slowdown. In this context, an important issue is the possible escalation of trade tensions between the world’s largest economies, which could lead to a sharper decline in international trade and softer global growth. The transmission of the current downturn in industry to other sectors of the economy, including services and construction, is also a source of uncertainty. The terms on which the United Kingdom leaves the European Union could also have an impact on economic conditions, particularly in Europe.

Future developments in global asset prices, including exchange rates, are another source of uncertainty, particularly in view of the likely further deterioration in global economic conditions and changes in monetary policy of the major central banks.

Uncertainty about future global price growth continues to stem also from prices which are difficult to forecast, like energy commodity prices, including oil prices, as well as prices of agricultural products, in particular due to the changing supply conditions in these markets. In Poland, additional sources of uncertainty include the possible changes to national regulations on electricity prices and the scale of the impact of weaker economic growth on inflationary pressure.

At the same time, uncertainty persists in the domestic economy regarding the situation in the labour market, including future wage growth. In this context, migration flows, which are dependent on economic conditions in Poland and abroad as well as on changes in immigration policy of European Union countries, including Germany, might be of significance. The labour market situation will also depend on the scale of the expected slowdown in economic growth in Poland and its possible impact on labour demand.

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