NBP Narodowy Bank Polski

Monetary Policy Council

# Monetary Policy Guidelines for 2021

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Warsaw, 2020

In setting the *Monetary Policy Guidelines for 2021*, the Monetary Policy Council, hereinafter the "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 2021* the Council has maintained the monetary policy strategy pursued by Narodowy Bank Polski, hereinafter "NBP", 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 scope, manner and scale of using monetary policy instruments by NBP will take into account the determinants of monetary policy implementation, in particular economic consequences of the Covid-19 pandemic.

The *Monetary Policy Guidelines for 2021* is a translation of the publication of Narodowy Bank Polski entitled *Założenia polityki pieniężnej na rok 2021*. 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 2019, item 1810 and of 2020, item 568) 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 NBP laid down in the Constitution of the Republic of Poland and in the Act on Narodowy Bank Polski, 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 2.1%, 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 and market conditions. 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 a decision on monetary policy parameters 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.

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 (including real estate prices) and growth in lending. Given the free movement of capital and highly integrated financial markets, macroprudential policy plays a significant role in containing macroeconomic and financial imbalances as well as in stabilising lending growth.

Besides monetary and macroprudential policy, fiscal policy plays an important role in maintaining macroeconomic stability. A fiscal policy which mitigates the impact of economic shocks, while ensuring 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 press releases (*Information from the meeting of the Monetary Policy Council*), at the 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 2021 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 2021

**Determinants of monetary policy instruments**

As part of monetary policy easing in 2020, in response to the Covid-19 pandemic, NBP decided on a wider use of existing monetary policy instruments.

The measures taken by the central bank involved, among others, a reduction in the NBP interest rates, purchases of government securities and government-guaranteed debt securities in the secondary market, and a decrease in the required reserve ratio. NBP provided banks with a bill discount credit, thus allowing them to refinance bank loans granted to enterprises. At the same time, NBP stood ready to provide liquidity to the banking sector in the form of repo operations.

The changes in the scope of monetary policy instruments and in the way they are used, increased the banking sector's liquidity in 2020, largely through decreasing the required reserve ratio and purchasing of debt securities by the central bank. In 2020, the net purchase of foreign currencies by NBP supported the growth in banking sector liquidity. On the other hand, a substantial increase in the volume of currency in circulation, specifically in March and April 2020, i.e. at the initial stage of the spread of the Covid-19 epidemic in Poland, had the opposite effect.

NBP envisages that monetary policy instruments in 2021 will be used amid surplus of the banking sector liquidity. This will be affected by, among others, changes in the way monetary policy instruments are used, which NBP introduced in 2020. Moreover, in 2021 banking sector liquidity will be boosted by the purchase of foreign currencies from the Ministry of Finance. The NBP sale of foreign currencies to the European Commission, related to the currency conversion of the EU membership fee, and a rise in currency in circulation, will have a curbing effect on the level of banking sector liquidity.

In 2021, the scope, manner and scale of use of monetary policy instruments by NBP will take into account factors determining the conduct of monetary policy, in particular the economic fallout of the Covid-19 pandemic. As in 2020, monetary policy instruments may be used in a flexible manner to account for the changing macroeconomic and market conditions. In view of the above, depending on the direction and strength of the changes, it will be possible to either limit or broaden the scope of monetary policy instruments used in 2021 as compared to 2020.

The operational target of NBP's monetary policy in 2021 will be to keep the POLONIA rate running close to the NBP reference rate.

**Interest rates**

The key instrument of monetary policy in 2021 will be the NBP interest rates.

The main NBP interest rate is the reference rate, which will determine 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 will determine 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 will determine the interest rate on deposits, allowing to deposit funds with NBP on an overnight basis.

The discount rate will determine the interest rate on the bill discount credit.

**Open market operations**

Main operations will be the key instrument by means of which NBP will be striving to shape liquidity conditions in the banking sector, and consequently – the level of the POLONIA rate. These operations will normally be carried out on a regular basis, typically with a 7-day maturity. During tenders for main operations NBP will apply a fixed-rate tender procedure with the rate at the level of the NBP reference rate. Due to the expected liquidity surplus in the banking sector in 2021, these operations will be carried out in the form of NBP bills issuance. The way of conduction of main operations may be modified where justified by a change in market conditions or parameters of NBP's monetary policy.

Fine-tuning operations may be conducted to limit the volatility of short-term market interest rates. The reason why they may be employed may also be the provision of liquidity to the banking sector or the absorption of liquidity for longer terms. As part of liquidity-providing operations, NBP may offer repo transactions and redeem NBP bills before maturity. In the case of liquidity-absorbing operations, the central bank may issue NBP bills or offer reverse repo operations. The maturity and yield of these operations as well as the way in which they are carried out will be adapted to the purpose of their application.

Structural operations may be conducted in order to change the long-term liquidity structure in the banking sector as well as, like in the case of such operations carried out in 2020, in order to ensure the liquidity of the secondary market of purchased securities and strengthen the monetary transmission mechanism.

In 2021, NBP may continue to use structural open market operations involving the purchase of debt securities in the secondary market. Moreover, if required, the central bank may use other types of structural operations, i.e. sale of debt securities in the secondary market or bonds issuance.

**Required reserve system**

The main objective of the required reserve system will be to enhance 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 that 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 and a remuneration on the required reserve will depend on the conditions in which monetary policy will be pursued in 2021.

**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) will enable banks to obtain overnight credit from the central bank on each trading day. This credit is collateralised with assets accepted by the central bank (including government 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 will act as a ceiling for the overnight market rate.

The overnight deposit facility will allow banks to deposit their liquidity surpluses with the central bank on an overnight basis on each trading day. The interest on overnight deposit will fix the floor for the market rate determined for this term.

**Bill discount credit**

NBP may offer the bill discount credit aimed at refinancing loans granted to enterprises by banks.

**Foreign exchange swaps**

NBP may carry out foreign exchange swaps. A foreign exchange swap is a transaction in which NBP purchases (or sells) the Polish zloty against a 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 intervene in the FX market.

# Chapter 3. Monetary policy determinants in 2021

**External determinants**

In the first half of 2020, the Covid-19 pandemic and the containment measures aimed at limiting its spread triggered the collapse of the global economy and the pronounced deterioration in consumer and corporate sentiment. The strong economic fallout from the pandemic hit many of Poland's important trading partners, including the euro area where GDP declined markedly. In the United States, economic activity also slumped, albeit less severely than in the euro area.

The fall in global demand in the first half of 2020 and the deterioration of global economic outlook were reflected in lower prices of fuels – mainly crude oil – and agricultural commodities. Together with the global slump in economic activity, this put a downward pressure on price dynamics in the environment of the Polish economy which fell to the lowest level since the global financial crisis.

Facing the negative impact of the pandemic, a number of countries took policy measures protecting and stimulating economic capacity. Fiscal packages were introduced with the aim of cushioning the negative bearing of the pandemic on the financial situation of households and businesses, especially from the sectors hardest hit by the restrictions. Alongside that, central banks of both developed and emerging market economies loosened their monetary policies in an unprecedented way. In numerous countries, interest rates were either lowered or kept at historically low levels, and asset purchase programmes were either launched or extended; also, other measures to increase liquidity in the banking sector were taken.

While keeping the deposit facility rate below zero, the European Central Bank (ECB) expanded the existing asset purchase programme and started a new one, which will be carried out until at least mid-2021. The US Federal Reserve, in turn, from early 2020 cut its interest rates by 1.5 percentage points to close to zero and launched a series of asset purchase programmes on a large scale.

Along with easing of the restrictions, in many economies activity resumed, although the pace of the recovery varied across countries. Available forecasts point to a further improvement in economic conditions in the second half of 2020 and the continued rebound in global GDP in 2021. These developments will likely be accompanied by inflation remaining at a relatively low level, despite its potential increase. However, macroeconomic developments in 2021, especially the sustainability and pace of the recovery, as well as the accompanying changes in inflation are highly uncertain, which is largely driven by the further evolution of the pandemic and its impact on the sentiment and decisions of economic agents.

**Domestic determinants**

In early 2020, economic conditions in Poland continued to be relatively good. At the same time, in March when the first cases of Covid-19 were reported, a number of restrictions were put in place. They involved social distancing and business restrictions aimed at reducing the spread of the virus. The restrictions and the related strong deterioration in consumer and corporate sentiment were conducive to a deep contraction of economic activity, particularly strong in the services sectors. Along with the economic downturn in the environment of the Polish economy, which reduced foreign sales, this translated into a marked decline in GDP in the first half of 2020. At the same time, the situation in the labour market worsened, which was reflected in a fall in employment, rise in unemployment and a slowdown in wage growth.

At the beginning of 2020, the CPI inflation rate in Poland rose temporarily, driven by regulatory and supply-side factors that remain outside the scope of domestic monetary policy, including among others an increase in electricity prices, higher fuel prices and rising food prices. At the same time growth rates of service prices and administered prices were elevated. In the subsequent months inflation declined as the prices of many raw materials in the international markets fell.

A number of large-scale anti-crisis actions were taken to mitigate the negative impact of the pandemic and the related containment measures on economic activity. These actions were primarily targeted at limiting the adverse bearing of the pandemic on the financial and liquidity position of businesses as well as households' budgets, especially through job protection. Under the Anti-Crisis Shield scheme, the government reduced social contributions for small businesses, offered loans to microenterprises and subsidised labour costs. Enterprises, especially micro-, small and medium-sized ones, were also offered substantial support in the form of subsidies under the so-called Financial Shield.

At the same time, the Monetary Policy Council cut the NBP interest rates, including the NBP reference rate from 1.5% to 0.1%. NBP also conducted purchases of government securities and government-guaranteed debt securities in order to change the long-term liquidity structure in the banking sector, ensure liquidity in the secondary markets for the purchased securities and enhance the impact of the NBP interest rate cuts on the economy, i.e. strengthen the monetary policy transmission mechanism. Moreover, the required reserve ratio was decreased by 3 percentage points to 0.5%. NBP also offered banks the possibility of obtaining funds under repo transactions and of refinancing loans granted to enterprises in the form of bill discount credit.

From May 2020, with easing of the containment measures, sentiment gradually improved and economic activity recovered in Poland. Economic conditions are expected to improve further in the second half of 2020 and in 2021, although according to the current forecasts GDP may remain lower than before the pandemic. The rebound in activity will be supported by economic policy measures and the expected improvement in economic conditions in the environment of the Polish economy.

At the same time, the persisting uncertainty over the future course and impact of the epidemic, coupled with weaker household and business sentiment than in previous years, may have a curbing effect on the scale and pace of the recovery. Amid only a gradual rebound of economic activity both domestically and globally, as well as a likely low inflationary pressure abroad, the CPI inflation rate is expected to decline in 2021.

**Uncertainty factors**

The evolution of the Covid-19 pandemic around the world and in Poland is the main uncertainty factor for domestic economic conditions and price developments. In particular, if the epidemic situation worsens, it is possible that restrictions will be tightened again and sentiment of economic agents will subdue. In such circumstances, global and domestic activity might decline further, and it would take longer to restore it. In turn, the permanent fall in the number of new infections and development of an effective vaccine against the coronavirus could accelerate global and domestic GDP's return to the levels observed prior to the pandemic outbreak.

Uncertainty concerns also the further scope and the sustainability of economic policy measures used so far to mitigate the fallout of the pandemic. Especially, the phase-out of protection and stimulus programmes may weaken the recovery of economic activity, if the negative impact of the pandemic on consumers and investment continues.

Potential structural changes in the economy are another risk factor. The experience gained during the pandemic and the prolonged period of uncertainty over its evolution may result in changes in economic behaviour of households and businesses, and – as a consequence – in a revision of the structure and scale of their expenditures. Structural changes may also affect linkages in the global economy, including global supply chains and globalisation developments in the future. In this context, the trade policies of major economies, in particular those of the United States and China, are also an uncertainty factor. If economic disputes around the world are aggravated, this may hamper global trade revival.

The future developments in prices of many assets and commodities are also an uncertainty factor. Uncertainty may particularly stem from price developments of fuels, mainly crude oil, and agricultural commodities, which are both difficult to predict. In the case of food prices, changes in meteorological and agricultural conditions in Poland and abroad, which are hard to foresee, pose a substantial risk.

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