NBP Narodowy Bank Polski

Monetary Policy Council

Monetary Policy Guidelines for 2018

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Warsaw, 2017 r.

In setting the *Monetary Policy Guidelines for 2018*, 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 2018* the Monetary Policy Council has kept the monetary policy strategy pursued by NBP so far. Price stability remains the main statutory objective of the 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 2018* is a translation of the publication of Narodowy Bank Polski entitled *Założenia polityki pieniężnej na rok 2018*. 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, number 78, 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 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. In countries where the inflation targeting strategy is pursued inflation rate is lower than in other countries, on average.

Since 2004 the average annual growth in CPI in Poland has been 2.0%, and hence it has been close to the NBP's target, although in some years price growth was outside the band for deviations from the target. 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 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 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.

While taking monetary policy decisions, the Council considers the monetary transmission mechanism, including the fact that 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. 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 the most important 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 2018 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 2018

Determinants of monetary policy instruments

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

The forecast for 2018 foresees banking sector liquidity surplus at a level similar to 2017. The liquidity level in the banking sector will be primarily 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 factors reducing the amount of the banking sector's liquidity will be a rise in currency in circulation and in deposits which are the basis for calculating the required reserve level, as well as the sale of foreign currency by NBP, mainly for the needs of the European Commission in connection with the exchange of the currency of the membership fee. The purchase of foreign currencies, primarily from the Ministry of Finance, will have the opposite effect, namely of increasing the surplus liquidity.

The operational target of the 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 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 are NBP's interest rates.

The main NBP interest rate is NBP's 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.

NBP's 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. NBP's 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. 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 NBP's reference rate is binding during tenders. Due to the expected continued liquidity surplus in the banking sector in 2018, 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 the yield of these operations as well as the manner in which they are carried out depends 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 the 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's open market operations conducted to absorb liquidity surplus in the banking sector.

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 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 on the 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. Determinants of the monetary policy in 2018

External determinants

In the first half of 2017, economic growth worldwide, including in Poland's main trading partners, was faster than the year before, yet remained lower than in the period preceding the global financial crisis. Available forecasts point to stable activity growth in the external environment of the Polish economy in 2018, although uncertainty about the outlook persists.

In the European Union, hereinafter "the EU", economic growth in the first half of 2017 was stronger than the year before, and forecasts indicate further stable GDP growth in 2018. In particular, stable economic growth should continue in the euro area, which is Poland's major trading partner. Domestic demand will probably remain a key driver of GDP growth in this economy, supported by improving labour market conditions, strong consumer and business confidence as well as low cost of borrowing owing to the expansionary policy of the European Central Bank, hereinafter "the ECB”. Forecasts also point to stable economic growth in most Central and Eastern European countries, although in 2018 GDP growth in this region may be slightly weaker than in 2017.

In the United States, economic growth in the first half of 2017 was higher than in the previous year. Available forecasts show that recovery in this economy will continue into 2018. It will remain to be driven primarily by expanding domestic demand, supported by tight labour market and a recovery in investment.

In the largest emerging market economies being Poland's important trading partners, economic conditions improved somewhat in the first half of 2017 compared with 2016, while still remaining weaker than in the previous years. In China, economic growth stabilised after several years of slowdown, yet a renew weakening of the country's GDP growth is expected in 2018. Russia, in turn, has come out of recession, but forecasts imply the possibility of sluggish growth in this economy in 2018.

In the first half of 2017, global inflation was markedly higher than in recent years, supported by higher commodity prices as compared to the previous year. Yet, despite a significant acceleration, global inflation remained moderate. In advanced economies, higher levels of inflation compared with the previous year were underpinned – besides the rise in commodity prices – by economic recovery amid continued expansionary monetary policy of the major central banks. At the same time, price growth in many emerging market economies was contained by the appreciation of their currencies. In addition, global price growth was dampened by the gradually waning effects of the earlier increase in commodity prices. In 2018, according to available forecasts, global inflation will stabilise at a moderate level, and in some advanced economies, including the euro area, it will remain below the central banks' targets.

Against this background, the ECB maintained interest rates near zero in the first half of 2017, including the deposit rate below zero, while continuing financial asset purchases. The consolidation of the euro area recovery may incline the ECB to gradually scale down its monetary expansion in 2018, although this will probably be slow, as inflation is expected to persist below the level consistent with the ECB's definition of price stability. Consequently, in 2018 interest rates will probably remain very low.

The Federal Reserve, in turn, raised policy interest rates in the first half of 2017 and indicated it would continue interest rate increases in the following quarters, including in 2018. At the same time, the likely reduction in the scale of reinvestment of assets purchased by the Federal Reserve under the quantitative easing scheme may work towards tighter monetary conditions in 2018.

Domestic determinants

GDP growth in Poland accelerated markedly in the first half of 2017, following a temporary slowdown in 2016. Rising consumer demand remained the main driver of economic growth, supported by increasing employment and wages, disbursement of benefits and very strong consumer sentiment. At the same time, the investment growth rate was close to zero, which was associated with a smaller scale of the EU co-financed investment projects than in previous years and still low level of corporate investment.

Forecasts for 2018 point to a continuation of stable – albeit slightly slower than in 2017 – GDP growth. On the one hand, the investment activity is expected to be stronger than in 2017, mainly owing to an increase in the inflow of funds from the EU budget under the new 2014–2020 financial framework. Investment growth will also be supported by rising demand amid higher capacity utilisation, as well as strong financial performance of enterprises and high credit availability. On the other hand, consumption growth will probably slow down due to the waning statistical effects of child benefit payments. This notwithstanding, consumer demand growth will probably remain fairly robust due to very good labour market conditions, including expectations of further wage growth, and favourable consumer sentiment.

In the first half of 2017, the annual growth in the prices of consumer goods and services in Poland, following a marked rise, stabilised at a moderate level. The stabilisation results, on the one hand, from the fading effects of the past increase in global commodity prices, and in particular those of oil, and on the other hand, from the gradual rise in core inflation.

Available forecasts indicate that CPI inflation will remain moderate in 2018, although with core inflation probably higher than in 2017. Domestic consumer price growth will be constrained by the moderate inflation in the external environment of the Polish economy.

In the first half of 2017, most indicators confirmed a lack of significant macroeconomic imbalances in Poland. Taking into account available forecasts, also 2018 should see no major imbalances – either of external or internal nature.

Uncertainty factors

The above macroeconomic scenario is subject to several areas of uncertainty, relating primarily to the external environment of the Polish economy. In the United States, equity prices in the first half of 2017 were running at their historical highs, which might signal a heightened risk of their decline. This could have an adverse effect on economic conditions in this country. At the same time, a risk of stronger-than-expected slowdown in China persists, due to high levels of indebtedness in this economy – especially in the private sector – and mounting imbalances in the real estate market. A possible slowdown in the United States or China would negatively affect economic growth in the euro area, and hence also in Poland. There is also uncertainty over the future fiscal and monetary policy stance in the world's largest economies. Moreover, commodity and food price developments remain an important source of uncertainty in the external environment of the Polish economy.

In Poland, in turn, uncertainty persists as to the scale of the expected pick-up in investment growth rate. Another uncertainty factor is how strongly labour market recovery will impact inflation, in particular against the background of the present migration trends and changes in the demographic structure of the population, which have a bearing on labour supply.

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