Monetary Policy Council

Medium-Term Strategy of Monetary Policy

(1999 - 2003)

Warsaw, September 1998

C O N T E N T S

I. INTRODUCTION

Marked progress in switching the Polish economy to a market model, coupled with development of market institutions (money, foreign exchange and capital markets) and liberalisation of foreign exchange regulations increase the vulnerability of economic entities to changing national and international financial markets and macro-economic policies. At the same time, economic decisions of market participants are subject to an extended time horizon. Given these conditions, the Monetary Policy Council has felt mandated to develop the Strategy presenting the Council intentions with regard to monetary policy going beyond a one year period, contributing in this way to better predictability of monetary policy.

The Strategy defines the approach to be taken by the Central Bank in pursuing its constitutional and statutory role over the medium-term. The ultimate goal of the central bank monetary policy will continue to be the process of reducing inflation, and consequently, over time, to ensure price stability. Achieving this objective will provide a solid foundation for sustained economic growth. Considering the ongoing transformation of the Polish economy into a mature market economy, the additional goal of the central bank is to support the institutional development of modern financial markets.

The Strategy outlines the most crucial efforts of the Council in pursuing these goals in the period 1999 - 2003. The time frame of the Strategy not only corresponds with the office term of the first Council, but it also coincides with Poland's preparations for integration with the European Union (EU) through 2002, and later, with the European Monetary Union (EMU). Specific monetary policy targets for any given year shall be presented in Monetary Policy Guidelines each preceding September for the coming year.

The Strategy will further enhance the transparency of monetary policy, allowing businesses and households to make more rational decisions, and contributing to the development of money and foreign exchange markets and their instruments.

Drafting the Strategy is further justified by the future integration with the European Union, since monetary policy will play a crucial role in the process of adjusting the Polish economy to EU and later, to EMU. Meeting the eligibility criteria for joining the monetary union directly depends on the monetary policy decisions.

Co-ordination of fiscal and monetary policy is critical for a sustained economic growth. It is particularly important in the case of Poland - a small, open economy in transition, pursuing integration with the European structures, and facing increasing globalisation and recurring crises in financial markets. Presentation of this Strategy by the Council should facilitate co-ordination of fiscal and monetary policies, making efforts to contain inflation more effective under conditions of high, sustained economic growth. Furthermore, it will contribute to early detection of possible conflicts between these two elements of macro-economic policy, setting the ground for their faster harmonisation.

II. MONETARY POLICY IN THE CONTEXT OF MACRO-ECONOMIC PROCESSES AND PROSPECTS FOR INTEGRATION WITH THE EUROPEAN UNION

The strategic goal of Poland is to integrate our economy with EU, and at a later time, with EMU. To accomplish this goal, the Polish economy will have to meet several macro-economic convergence criteria over the next few years. Some of them represent a serious challenge to monetary policy. The monetary convergence criteria relate to price, exchange rate and long-term interest rates stability. The price stability criterion implies that Poland will have to reduce inflation to the level not exceeding 3-4% annually in a relatively short time. Under the exchange rate criterion, a country aspiring to join the monetary union will have to be a part of the European Exchange Rate Mechanism (ERM2) for at least two years. Within this system, the Zloty will have to be pegged to the Euro. The market rate of the Zloty will be allowed to fluctuate around the fixed parity rate, probably within a plus-minus 15% band. The interest rate criterion calls for the spread of long-term interest rates to the reference rate of EMU not exceeding two percentage points. Early achievement of this goal under conditions of high and stable economic growth will be critical for minimising the social cost of integration.

Since 1989, Poland has scored major successes in building up a market system. Starting with 1992, the country entered a phase of rapid economic growth combined with decreasing inflation. Privatisation and restructuring of the economy was accompanied by the development of many segments and institutions of market economy. Since 1998, there has been an acceleration of systemic reforms to restructure the economy, aimed at decentralisation of administrative structures, public finance, the pension and health care systems.

These positive processes have been also accompanied by some negative developments, such as the rapid growth of domestic demand in relation to GDP since 1995/1996. This disproportion was induced by rapidly growing real wages, extensive lending and a relatively high fiscal deficit. As a result, the fast economic growth has generated rapidly growing trade and current account deficits. Continuation of high economic growth has become contingent on the ability to reduce the external imbalance.

In order to counteract these tendencies, the central bank has steadily tightened monetary policy, raising interest rates and the required reserve ratios since the fourth quarter of 1996. The delayed and insufficient support to monetary policy from the side of public finance resulted in a conflicting policy mix. Its continuation could undermine the process of stabilising the economy.

The institutional process of monetary policy decision-making was changed in the beginning of 1998. Under the new Constitution and the National Bank of Poland (NBP) Act, the Monetary Policy Council was instituted. The Council consists of the President of NBP and 9 other members appointed in equal numbers by the President of the Republic of Poland, the Sejm (lower chamber) and the Senate (upper chamber) of the Parliament. The Council determines the monetary policy guidelines for each year and on their basis it formulates decisions concerning the central bank key policy instruments: interest rates, required reserves ratios, open market operations, NBP loan and credit facilities and the exchange rate policy. At its initial meetings, the Council made very important decisions shaping the monetary policy directions. These crucial decisions included:

- widening the exchange rate band of the Zloty allowing the rate determination by the market within the band, thus eliminating much of the exchange rate rigidity and creating conditions for more effective monetary policy;
- reducing the „crawling devaluation” of Zloty, thus setting conditions for a continuous disinflation;
- shifting the emphasis from the monetary base to interest rates in the process of controlling the money supply;
- changing the rules of implementation of open market operations by adopting the rate on 28-day open market operations as the reference rate, thus shortening the maximum maturity of NBP money bills from 270 to 28 days.

A restrictive monetary policy supported by contractionary fiscal policy reduced the rate of growth of domestic demand to the level of GDP growth rate and it dampened the rate of growth of the current account deficit. This process took place under the circumstances of rapid economic growth and continuing disinflation. It will be a challenge for macro-economic policy, including monetary policy, to sustain these positive economic developments in the coming years.

III. DIRECT INFLATION TARGETING - THE UNDERLYING PRECEPT OF MONETARY POLICY FOR 1999-2003

The primary goal of the central bank is to maintain price stability. This can be accomplished by applying direct or indirect strategies to meet the inflation target.

The strategy to meet the inflation target indirectly assumes stable links between the aggregates which the central bank attempts to influence (intermediate targets) and inflation as the ultimate goal. There are two methods of the indirect strategy, one based on a stable rate of exchange between domestic currency and currency of a low inflation country, and the other one based on controlling the money supply growth.

Although the strategy of maintaining a stable exchange rate is easily understood by the economic environment, and it restrains excessively expansionary monetary policy of the central bank, it also has serious drawbacks:

- it is very difficult to determine the equilibrium exchange rate, particularly in the presence of external shocks, advancing liberalisation of foreign exchange transactions and accelerated structural changes in the economy;
- under the fixed exchange rate regime, monetary policy has a limited ability to cushion domestic market shocks;
- the economy becomes susceptible to adverse developments in the country to which the national currency is pegged;
- given the increasing openness of economies and the global nature of financial markets, the countries with fixed exchange rates are susceptible to major crises resulting in high volatility of exchange rates on a large scale. The adoption of such a system would be risky, given the extended convertibility of the Zloty along with increasing destabilisation of global financial markets.

A possible introduction of a fixed exchange rate would contradict the earlier logic of a gradual approach to a floating exchange rate of the Zloty and could inhibit a smooth transition of the Zloty to the ERM2 system. The entry to the ERM2 should take place at the equilibrium rate, difficult to determine without resorting to market forces. A fixed rate would offer little guarantee of attaining this goal.

Controlling the growth of money supply as a key monetary policy strategy is feasible when the link between the monetary aggregates and inflation is predictable, and when the central bank is able to exercise control over money supply, by applying the instruments at its disposal. These conditions are present in the Polish economy only to a very limited degree, since:

- the development of the financial markets and instruments alters the degree of monetisation of the economy;
- the present exchange rate mechanism does not guarantee control over money supply, mainly due to the impact of foreign capital inflows on money supply;
- the considerable excess liquidity of the banking sector spurred by the inherited structure of NBP assets and the institutional structure of the banking sector distorts the process of transmitting central bank signals to the economy.

Until 1998, the National Bank of Poland attempted to conduct a monetary policy by combining the elements of the two strategies. The intermediate target was to increase the money supply under conditions of crawling devaluation of the Zloty vis-à-vis the basket of currencies, with limited fluctuations of the real exchange rate within the permitted band. This strategy did not allow to meet the two intermediate targets in full, although initially, given the limited links between the Polish economy and the global financial market implying greater monetary policy sovereignty, it allowed for reducing inflation. An advancing integration of the Polish financial markets with the global markets coupled with relatively low investment risk in Poland prevented effective continuation of such a monetary policy strategy. The Council, by deciding to increase the float of the Polish Zloty within a widened band, reduced the conflict between the intermediate targets of monetary policy pursued earlier.

The Council does recognise that along with growing integration of the Polish and the global economy, and given the need of breaking through inflationary expectations which constitute one of the main obstacles in the process of steadily reducing inflation, the primary monetary policy precept for the years 1999 through 2003 should be a strategy of achieving the inflation target by direct measures.

The strategy of direct inflation targeting (DIT) assumes abandoning intermediate targets. The central bank will not focus on any single price index. Instead, it will react to any available information on factors which could jeopardise reaching the inflation target set for a given year. In pursuing this target, the central bank will apply available monetary policy instruments.

The choice of this monetary policy strategy can be supported by the following arguments:

- the monetary policy goal is explicit and understandable to economic agents;
- this system, by its openness, limits the ability of monetary authorities to implement short-term objectives in the real economy and it allows for public verification of monetary policy directions and the policy effectiveness, thereby enhancing the policy credibility;
- with the central bank credibility, this strategy allows for minimising the social cost of inflationary expectations, thus it permits to reconcile disinflation with high economic growth;
- the system allows for greater flexibility in applying monetary policy instruments, thus it minimises the shortcomings of a fixed exchange rate. It allows for the policy focus on domestic variables and it can periodically insulate the economy from external shocks and speculative attacks;
- a greater flexibility in applying monetary policy instruments enables the central bank to tailor its actions to the specific nature of the shock which could jeopardise achieving the inflation target;
- in contrast to the policy based on controlling aggregate money, DIT allows for flexible reactions to changing velocity of money.

Additional arguments for the application of DIT stem from the earlier cited shortcomings of the other two monetary policy strategies.

While choosing the DIT strategy, The Council is aware of the limitations of this approach to monetary policy, including:

- a limited accessibility of information (length of time series) required for the assessment of inflationary reactions to key monetary policy instruments;
- the problem of delayed reactions, which causes that the accuracy of monetary policy decisions can be assessed only with a considerable time lag;
- the need for closer co-ordination of fiscal and monetary policies in order to add credibility to the disinflation strategy.

Notwithstanding these limitations, the Council is convinced that, comparing with alternative strategies, direct inflation targeting is the best policy approach at the time preceding Poland's accession to the EU and the EMU.

IV. ACHIEVING THE DIRECT INFLATION TARGET

The Council has decided that the medium-term target of monetary policy will be to reduce inflation to below 4% by the year 2003.

Inflation targets for the period covered by the Strategy and the assessment of their implementation will focus on the Consumer Price Index, despite the fact that many countries apply the so-called "core inflation" index.

Comparing to CPI, core inflation excludes from the estimate certain goods and services subject to strong seasonal variations, administrative regulations or subject to temporary supply shocks. It is a more accurate measure of structural changes in the economy's price levels. A comparison of CPI and core inflation indexes enables to define the limits of central bank influence on inflationary processes taking place in the economy. For that reason, many central banks around the world monitor core inflation indexes. NBP has started the preparatory work for calculating the core inflation index and it has applied to the Central Statistical Office for the data base required for that purpose. Despite the choice of CPI, the impact of external factors not affecting core inflation will be commented in detail. The comments will be presented when specific policy decisions will seem to be inconsistent, at first sight, with the direction of the discrepancy between the inflationary target and the observed and/or the forecasted CPI level.

The decision to use CPI for setting the inflation target and for monitoring the adherence to the target has stemmed from a number of factors. The key supporting factor is that CPI has been extensively used in Poland as measure of inflation since the beginning of the economic transformation, thus it is deeply rooted in the public perception as the underlying measure of inflation.

Due to its composition incorporating the real structure of household consumer spending as determined by the Central Statistical Office, the CPI index provides accurate information about aggregate changes in price levels of consumer goods and services. The selection of CPI for the purpose of setting and monitoring the inflationary targets over the next several years has been further determined by the combination of factors that have contributed to price increases in the Polish economy, including a large share of prices subject to seasonal fluctuations and prices directly or indirectly administered by the state. Application of core inflation as the official policy target would require eliminating from CPI the prices of goods and services that strongly influence the public perception of inflationary developments. Alternative measures of core inflation based on specific statistical formulas developed by the central bank would be probably too complex for the adequate public perception of an inflationary target. An additional argument supporting CPI is the independent from the NBP assessment and publication of this index by the Central Statistical Office.

The inflationary target for any given year will be defined as a range. The tolerance band cannot be too narrow, because it would entail a considerable risk and require frequent adjustments of monetary policy parameters that could ultimately generate serious disturbances in the real economy. A wider tolerance band provides greater flexibility of monetary policy responses to various types of shocks that may occur in the Polish economy in the coming years. Monetary policy has a shorter impact lag (can more quickly correct economic disturbances) than fiscal policy, particularly in view of the decision-making system in force. Absorption of shocks via monetary policy adjustments shall not contribute to the erosion of determination to reach the inflation target. In view of this, the tolerance band cannot be too wide, since businesses could perceive it as not credible.

The Council has decided to set the 1999 target in the range of 8% to 8.5%. The tolerance band may be seen as relatively narrow considering comparable approaches of other countries. The main reason for choosing the narrow band is the nature of the prevailing in Poland public perception of monetary targets defined until 1998 as fixed points. A possible application of a wider band would imply a weaker commitment of the Council to reduce inflation. Given the above arguments, the Council believes that in the coming years the tolerance band should be gradually widened.

The Council has also decided that the time span for which targets will be set is to be one year. This time horizon takes into consideration the impact lag (the time of economic reactions to central bank actions) and it also provides monetary policy with the possibility of altering the disinflation scenario in a longer perspective in response to potential shocks destabilising the economy. Since monetary policy impact time lags are expected to get longer with lower inflation and development of financial markets, the time horizon of the monetary policy target may be extended in the future (e.g. instead of December to December, achieving the target over a longer period).

The strategy of direct inflation targeting calls for modifying the role of the NBP public information policy This strategy allows for flexible responses to the challenges and threats of the disinflation process in the short- and the long-run by allowing application of all available instruments to a much wider extent than the alternative monetary policy strategies would allow. Nonetheless, the implementation of DIT may induce in the short-run some public doubts whether the adopted disinflation path is realistic. In order to avoid this situation, the NBP public information policy should be now aimed at convincing the public about the central bank commitment to achieve the declared target.

The public information will have to focus on diminishing the uncertainty of economic agents about central bank reactions to various shocks. This can be accomplished through a transparent commitment and public announcement of: long-term targets, the means of their implementation and the interpretation of the country's economic situation. The public information policy will be particularly instrumental for lowering inflationary expectations. An effective information policy should allow for minimising the consequences of disinflation policy for the real economy. Since credibility of the central bank monetary policy will be crucial for diminishing inflation expectations, a detailed explanation of specific policy decisions and their impact on the target fulfilment will have to be provided.

The main analytical document for the Council will be the Inflation Report. The Report will initially be published semi-annually and, in the future, on a quarterly basis. Under the terms of the National Bank of Poland Act, the Court & Economic Monitor will publish information about the voting by each Council member.

V. MOVING TOWARD THE FLOATING EXCHANGE RATE

The direct inflation targeting strategy will be accompanied by the expanded exchange rate flexibility. One of the conditions of Poland's accession to the EMU will be the inclusion of the Zloty in the ERM2 system for at least two years. This, as already noted, should be preceded by a period of freely floating exchange rate. This arrangement will help to bring the market rate closer to the equilibrium rate, prior to its renewed fixing within the ERM2. The floating exchange rate system will be introduced following a period of the gradual expansion of the band of permitted exchange rate fluctuations and the gradual reduction the crawling devaluation within the framework of the present exchange rate system.

Until the introduction of the fully floating Zloty exchange rate, the central parity rate will be set against a basket of currencies. The structure of the reference basket will be changed as of 1 January, 1999. The Council has accepted that the new reference basket should be based on the Euro and the US Dollar.

The deadline for the introduction of the fully floating exchange rate will depend on the actual developments in foreign exchange markets and on the progress in capital account liberalisation. Both within the present exchange rate system and after the introduction of a fully floating rate, the National Bank of Poland will maintain the right to intervene in foreign exchange markets when it recognises a need to do so for monetary policy reasons.

Along with the advancing exchange rate flexibility, businesses and financial institutions will be exposed to growing exchange rate risk. The public pronouncement of exchange rate policy directions will be essential for better adaptation of businesses to the expected changes, and for an accelerated development of instruments hedging the exchange rate risk.

VI. MONETARY POLICY INSTRUMENTS

Within the framework of the adopted Strategy, the central bank will be using all the available information and will apply a suitable mix of monetary policy instruments to reach the pre-determined inflationary target. The weight assigned to individual instruments at any time juncture will depend on the nature of challenges faced by the central bank in the disinflation process. Greater flexibility in selecting monetary policy instruments will also reflect the changes to the present exchange rate regime.

The lombard rate and the re-discount rate will remain the key interest rates of the central bank. The lombard rate will determine the ceiling (the upper limit) of inter-bank market interest rates and it will reflect the general direction of monetary policy adjustments.

The reference rate, as an indicator of monetary policy general directions, will remain to serve as the rate of interest on short-term open market operations. It will also serve as the floor (the lowest permitted rate) for inter-bank deposits with maturities similar to those of NBP open market operations. It will be subject to more frequent adjustments than the prime lending rates.

Open market operations will continue as the main instrument of adjustments of the banking system reserves by the NBP. A proper selection of instruments used in such operations will depend on the specific prevailing market conditions. The Council intends to develop the environment where long-term interest rates are determined by the market. Consistently, the NBP will generally concentrate on short-term operations.

The Council does not foresee major changes in the rules of bank refinancing.

Experiences of central bank indicate that the structural absence of excess liquidity in the banking sector is one of the premises for effective transmission of monetary policy signals from the central bank to the banking sector and for an early and appropriate scale of reverse reaction. At the present time, NBP is experiencing a sub-optimal situation. Excess liquidity of the banking system is reflected in the corresponding scale of open market operations. Under these circumstances, NBP will present a proposal to the government to restructure the public sector liabilities to the central bank and to permit their securitisation. This would allow for reducing the role of NBP money bills, as NBP liabilities, in carrying out open market operations. By making these adjustments, NBP should gain a better control over the banking sector liquidity, using its securitised assets. This operation would also give NBP a more active role in developing the financial market in Poland.

The Council foresees the necessity of gradual modification of the system of reserve requirements in the direction incorporating the actual needs of monetary policy and in bringing the system closer to the arrangements adopted by the European Central Bank.

VII. CO-ORDINATION OF MONETARY, FISCAL AND INCOME POLICIES

Under the system of direct inflation targeting, the efficient co-ordination of monetary, income and fiscal policies becomes particularly critical. A possible inconsistency between these policies could undermine the credibility of the planned pace of disinflation. Using fiscal policy instruments and administrative price and wage adjustments, the government can exert a significant impact on inflation.

Therefore, a consistency between the fiscal stance and the inflationary target used by NBP will be the main criterion applied by the Council in the formulation of the opinion on the national budget. In order to foster the credibility of disinflation policy, the Council will make efforts ensuring a greater consistency between the information policies of the government and the central bank.

VIII. STRUCTURAL CONSTRAINTS OF THE MONETARY STRATEGY

The coming years will bring many important developments affecting the conditions of the monetary policy implementation.

The Polish economy will be increasingly integrated with the global economic system, and this integration may impede monetary policy implementation particularly in the presence of repeated disturbances in world financial and foreign exchange markets. After the year 2000, a free market international exchange of goods, services and capital between Poland and its major foreign partners will result from Poland’s membership obligations in WTO, OECD and, for the time being, from the candidacy for accession to the EU. The fact that the Polish economy is already an integral part of the global economic system, with all the benefits and shortcomings, places significant constraints and greater responsibility on the entire financial policy. Lack of cohesion or inconsistency with predetermined policy guidelines may induce increasingly severe, penalising reactions of foreign markets.

The increasing sensitivity of the Polish economy to the developments in international financial markets requires its stronger resilience, which, in turn, will influence the effectiveness of monetary policy. As a result, it will be necessary to maintain sufficiently large foreign exchange reserves. These reserves ought to stabilise the Zloty exchange rate in the event of significant disturbances in the foreign exchange market and to facilitate the rapidly expanding convertibility of the Zloty and the increased debt repayments anticipated in the near future.

The inception of the Euro zone may lead to significant structural changes in international financial markets and to changes in parity rates among the leading world currencies. For Poland, the common European currency may imply a higher demand for the Zloty as the international investors will be willing to diversify the currency composition of their asset portfolios, facing a reduced number of European currencies.

Liberalisation of foreign exchange transactions and the expanded convertibility of the Zloty will contribute to the development of financial markets. However, these processes may destabilise demand for money and they may change its established trend. The growth of market capitalisation and financial intermediation will be accompanied by the pension system reform which will probably increase the propensity to save, possibly levelling off the growth of term deposits. The development of payment-servicing systems will consequently reduce demand for cash.

Within the internal ramifications, the prevailing situation in the public finance sector in conjunction with the projected structural and institutional reforms will play a critical role for the determination of the scope of uncertainty in the business environment.

From the beginning of 1999, the primary focus of the government fiscal policy will be to finance the reforms of the administrative system, social security, health service and education while maintaining a low budget deficit, essential for macro-economic stability. At the same time, deregulation of administrative structures and the subsequent decentralisation of public finance may add uncertainty to fiscal policy in the initial phase of fiscal reform. The reform is imperative for establishing favourable conditions for more effective use of budgetary resources.

Implementation of the reforms in a manner inconsistent with government expectations and the accumulation of their costs in a short-time will present a grave threat to public finance and, consequently, to achieving the inflation target and/or to keeping the current account deficit at a safe level.

Changes in the system of indirect taxes, accumulated in a short-time may pose a serious challenge to meeting the annual inflation targets within the period covered by this medium-term monetary strategy. Raising the VAT and excise taxes in order to adjust them to EU levels may lead to a temporary increase in CPI which will not denote inefficiency of monetary policy.

The degree if inertial inflation in the Polish economy will be an important monetary policy constrain in the coming years. After experiencing an extended period of high inflation, businesses and households formulate their inflationary expectations primarily on the basis of past experiences. Their behaviour may thus become a significant factor enduring the climate of price increases. Monetary policy credibility will play a significant role in effective breaking of inflationary expectations. At the same time this policy could be more effective in reducing inflation at a lower cost to the real economy if the scope of systemic indexation mechanisms was curtailed, particularly with respect to wages and salaries.

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The presented Strategy is not definite. Some of its precepts can be subject to modifications and adjustments to current economic conditions, in response to regular outcome and applicability assessments always disclosed to the public. It shall be emphasised that the Strategy represents the position of the Monetary Policy Council which in certain areas (for instance decisions regarding the exchange rate system) will require government endorsement.