



Features of the Transition to Inflation Targeting in Poland

Duskobilov Umidjon Sharofiddinovich

Department of Banking and investments, Tashkent State University of Economics, Uzbekistan

Abstract: The article examines the Polish experience of the transition to inflation targeting. In particular, the necessity and reasons for Poland's transition to this regime were analyzed. When regulating inflation expectations, the activities of the National Bank of Poland in cooperation with the government were considered. It was also initially investigated that due to structural problems in the economy, it was not possible to switch to full inflation targeting, and the Inflation Targeting Lite regime was chosen, while the exchange rate policy occupied a prominent place in this process. In addition, the activities of the Polish National Bank, such as "setting acceptable interest rates", "stabilizing the exchange rate", "regulating the liquidity of the banking system", "improving the efficiency of operations on the open market", "strengthening the status of independence", "meeting the criteria for joining the euro" were also analyzed.

Key words: monetary policy, inflation targeting, interest rate, National bank of Poland, full-fledged inflation targeting, Inflation Targeting Lite, exchange rate.

Introduction

During the research of the experience of countries that have switched to inflation targeting, it became known that the regime in question is improving, further strengthening the aspects in itself in accordance with the development trends of local and world markets. Initially, although the inflation targeting regime manifested itself as a monetary measure embodying a relatively simple goal of increasing the consumer ability of the population, over time it turned into an effective mode of implementing monetary policy. As a result, many countries have put on the agenda of their monetary policy the task of adapting the mechanism of functioning to inflation targeting, as well as a gradual transition to the regime under consideration[1]. Poland is considered one of the countries with a special experience of transition to the inflation targeting regime, and this is explained by frequent changes in the monetary policy regime of Poland. That is, over the past 30 years, the National Bank of Poland (NBP) has chosen several monetary policy regimes and strategies and, accordingly, has pursued monetary policy based on various goals.

Initially, the NBP chose the target exchange rate regime. "It was during this period that the role of the Polish zloty in payment relations increased, and the share of deposits in foreign currency in the banking sector decreased from 80 to 40 percent" [2, 2-p.]. As part of the reforms aimed at improving the stability of the Zloty, significant changes were made to the exchange rate regime. In particular, "in January 1990, under conditions of hyperinflation, the NBP switched to the regime of establishing a single fixed exchange rate of the zloty against the US dollar. On the other hand, an increase in the money supply (M2) has been identified as an intermediate objective of monetary policy"[3, 9-p.].

To date, it is worth noting that every country that has chosen an inflation targeting regime is switching to this regime with its own characteristics. In this case, the main aspect is explained by the scale of macroeconomic problems in the country and the directions of their solution. It is thanks to different approaches to solving similar problems that some countries managed to achieve the set

inflation target at the first stage, and others - at the second or third stage. In this regard, the study of the Polish experience as a country that has successfully passed inflation targeting, and the practical use of priority aspects in it are of significant practical importance for countries that are moving to inflation targeting at the current stage, and determine the need and relevance of conducting research on this issue.

Literature review

A number of studies were conducted on the processes of Poland's transition to inflation targeting, as well as the practice of using monetary policy instruments by the National Bank of Poland, some of which were discussed in the article.

Jerzy Pruski argued that the possibility of switching to a regime of "full-fledged inflation targeting" is small due to the presence of structural problems in the Polish economy, such as dependence on imports, as well as weak macroeconomic conditions. He claimed that in 1995 the Polish government chose a way to switch to the regime "Inflation Targeting Lite", given the difficult situation that had arisen. Jerzy Pruski believes that, although the transition to an incomplete regime, on the one hand, means a cautious approach by the government, in fact, the decision in question was made against the background of the inability of monetary and fiscal regulators to ease the growing inflationary pressure[2].

A new monetary policy strategy focused on inflation targeting in Poland was researched by Jan Gottschalk and David Moore. According to him, as part of the general requirements of the inflation targeting strategy, it is emphasized that Poland will reduce fiscal dominance and the need to tighten budget restrictions. In addition, scientists argue that exchange rate policy has played an important role in the successful transition to inflation targeting and that the relationship between the short-term interest rate and inflation remains uncertain. Given this uncertainty, those who have put forward a proposal to expand the inflation target range or expand the target horizon[3].

However, in the case of studies by Magda Pekala and other authors, the global financial and economic crisis highlighted the need to make some adjustments to the methods and regimes of monetary policy, in particular, to the inflation targeting regime. In this case, the consequences of the global financial and economic crisis were discussed in connection with the full 30-year experience of stimulating inflation. At this stage, the aspects of the problem related to the instruments of macroprudential and monetary policy were briefly discussed, since these scientists focus on the strategic elements of the structure[4].

In our opinion, it is necessary for any central bank to clearly define its obligations to determine and achieve the inflation target, in particular, the intermediate and strategic objectives of monetary policy. In this case, it is important that the communication channel regarding inflationary expectations of the population and economic entities regularly ensures efficiency.

Data and analysis

The thematic approach and views of several foreign economists were investigated. Based on the expression of the author's attitude to them, scientific and theoretical aspects of the article were formed. The content and essence of the article were also disclosed on the basis of macroeconomic conditions for the implementation of monetary policy during Poland's transition to inflation targeting, as well as an analysis of monetary policy conducted by the National Bank of Poland in this regard. In carrying out this study, methods of comparative evaluation and scientific abstraction, system analysis were used.

Since we will focus in more detail on the analysis, "the practice of introducing various regimes in Polish monetary policy was formed against the background of mitigating the negative effects of hyperinflation of 585.8 percent, which occurred in 1990 as a result of the liberalization of regulated prices in 1989-1990. At the same time, hyperinflation did not last long, and the indicator in question fell to 70.3 percent in 1991, to 43 percent in 1992 and to 27.9 percent in 1995"[5].

It should be noted that in 1990-1995, when the exchange rate regime was in effect, the main attention of the Polish government and the NBP was focused on mitigating the negative effects of hyperinflation, increasing the country's competitiveness in foreign trade and ensuring the stability of the real exchange rate relative to the country's main partner. Based on this, from the strictly defined course mode in the first years of this period, the controlled float was switched to the course mode, and this choice of NBP served to increase the flexibility of the zloty course.

The fixed exchange rate set by the NBP against the leading foreign currencies served as an anchor aimed at easing devaluation pressure by controlling the flow of capital in hyperinflation conditions. At the same time, the processes of transition to the inflation targeting regime were somewhat complicated due to the fact that the momentum of the impact on inflation through import prices of exchange rate changes in the transmission mechanism of monetary policy NBP has a high permeability (Figure 1).

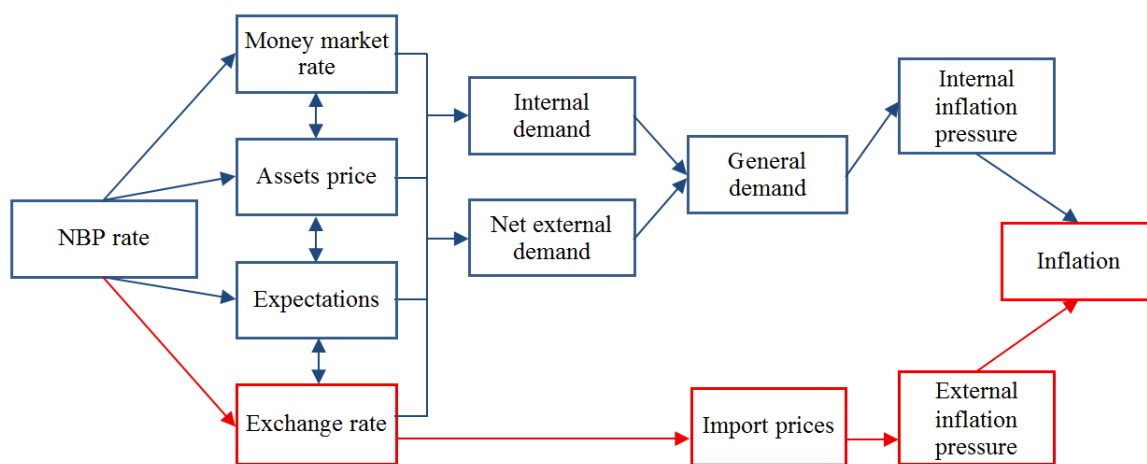


Figure 1. Transmission mechanism of the influence of the main channels of monetary policy of the National Bank of Poland on inflation¹.

It is known from international experience that the classic type of rigid inflation targeting has some negative features, as well as its positive aspects. For example, in the practice of countries with open economies, the operational mechanism of the inflation targeting policy is limited only by the exchange rate transmission channel. If, for one reason or another, the inflation rate at the national level increases in this situation, the government will try to change the prices of exports and imports in order to stabilize the dynamics of the consumer price index by changing the exchange rate[6].

In conditions of high inflation, the rapid increase in imports compared to exports caused an increase in the devaluation of the zloty against the background of a reduction in foreign exchange earnings. This also led to an increase in the share of import inflation in total inflation due to increased import costs. As a result, the emergence of a currency deficit while ensuring the proportionality of supply and demand for foreign currency in a floating exchange rate regime sharply reduced the chances of containing inflation. Based on this, the NBP has begun to explore the possibilities of switching to an inflation targeting regime. However, due to the presence of structural problems in the economy, such as dependence on imports, as well as weak macroeconomic conditions “full-fledged inflation targeting”, it was not possible to switch to this regime.

In 1995, the Polish government decided to switch to the regime “Inflation Targeting Lite”, given the difficult situation that had arisen. Although the transition to an incomplete regime, on the one hand, meant a cautious approach by the government, in fact, the decision in question was made against the background of the inability of monetary and fiscal regulators to ease the growing inflationary pressure.

“In May 1995, the NBP, relying on its resources, expanded the range of fluctuations in the zloty exchange rate from ± 2 percent to ± 7 percent. As a result, in December 1995, the zloty exchange

¹ <https://nbp.pl/en> – Developed by the author based on data from the official website of the National Bank of Poland.

rate was revalued by 6%. This caused the official gold-currency reserve to rise from US \$ 5.8 billion to US \$ 15 billion during 1995”[7]. However, in conditions where the influence of non-monetary factors on inflation in the “Inflation Targeting Lite” regime remains high, the NBP faced some problems in ensuring the stability of the zloty rate. In particular, inflation has failed to effectively implement interest rate policy, which is considered the main channel of monetary policy within the target indicator. In their study, Frömmel, Schobert[8] and Vasicek[9] argued that “the central bank has an indirect influence on ensuring a certain level of the exchange rate by changing the interest rate. But this does not apply to Poland. Because they claim that the momentum of influence between interest rates and exchange rate changes in Poland is very weak”.

The transition to “Inflation Targeting Lite” regime was considered by the NBP as a medium-term strategy, and an additional scenario was developed that provided for the transition to a full-fledged regime in the future due to the easing of tension in the economy. As a result, the "Monetary Policy Council" of the NBP was established in February 1998, and the corresponding council decided to switch to a full inflation targeting regime in September 1998.

As we know, in the inflation targeting mode, there are such types of target settings as “corridor”, “range” and “single point”[10]. Considering the evolution of countries' transition to an inflationary regime, it can be noted that Poland became one of the few countries that chose this regime back in the 20th century. The first countries to switch to inflation targeting were New Zealand and Australia with the corridor, Canada and the Czech range with the United Kingdom choosing a single-point Target Indicator. Poland, on the other hand, became the first country in 5 years to use all three types of targeting. In particular, in 1998 a single-point target of 9.5 percent was designated by the NBP, and in 1999, 2001, 2003 a type of target with a corridor. In addition, in 2002, the target inflation rate was chosen in the range of 5 ± 1 percent in 2004 2.5 ± 1 percent, and it remains unchanged to this day (Figure 2).

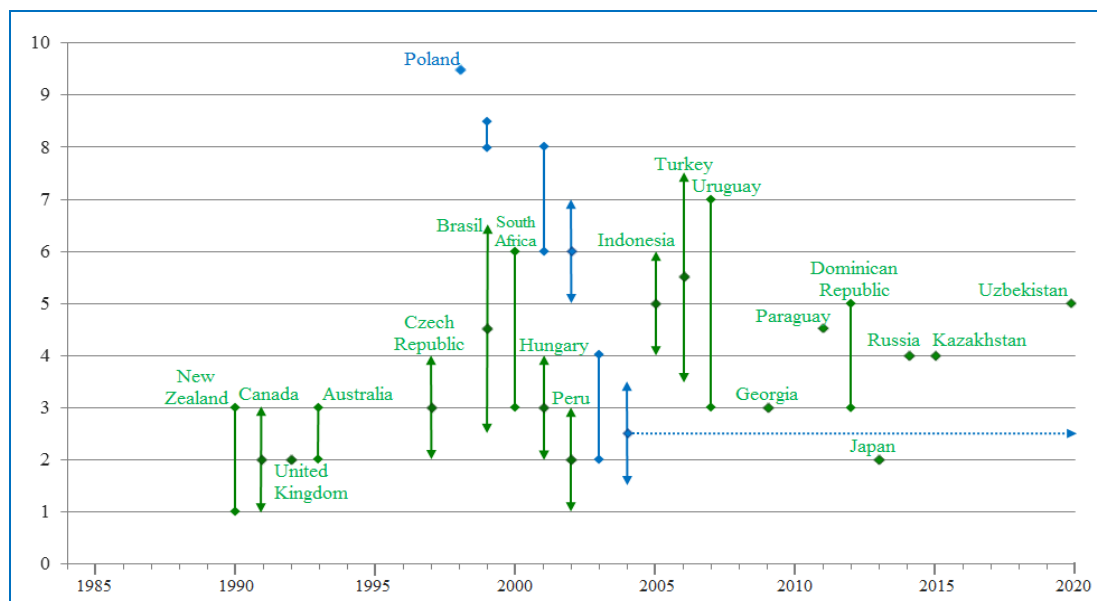


Figure 2. The level of target indicators of countries at the time of choosing the target inflation rate regime, as a percentage².

It can be seen from the graphical data that in the period up to 2007, countries mainly determined the inflation target in a corridor or range, while in the last 10 years they preferred to determine the inflation target in one point. In our opinion, the experience of countries that have chosen the types of corridor, range and single-point inflation targeting shows that no type of targeting is able to achieve particular effectiveness. And positive results are achieved mainly against the background of the peculiarities of the economic and financial systems of countries. It follows from this that the monetary regulator of the countries chooses a single-point type of targeting to tighten monetary policy and increase the accuracy of achieving its goal.

² Developed by the author on the basis of data from the International Monetary Fund.

“The NBP has set the following short- and medium-term goals aimed at reducing the annual inflation rate to 3-4 percent, based on the Maastricht convergence criteria for inflation, the exchange rate and the interaction of medium-term interest rates in the implementation of monetary policy:

- ✓ lowering the inflation rate below 4% in 2003;
- ✓ to ensure inflation in 1999 was in the 8-8.5 percent range;
- ✓ introduction of a one-year inflation target period;
- ✓ to print an inflation report every half year;
- ✓ converting the “CB rate” to the basic monetary instrument in the space of;
- ✓ focusing on the official CPI when setting inflation target”[3, 12-p].

Results

Despite the transition to “full inflation targeting” in 1998, Poland still had a corridor exchange rate. Based on the requirements for the transition to the inflation targeting regime, “in April 2000, the Monetary Policy Council of the NBP announced a gradual transition from a corridor exchange rate to a free-floating exchange rate. This was achieved by lowering the interest rate and expanding the range of exchange rates”[2, 5-p.]. At the same time, the establishment of short- and long-term inflation targets for 1 and 6 years and the announcement of a short-term interest rate as the main instrument laid the foundation for combining the directions and strategies of monetary policy within a single goal.

During the transition to inflation targeting, the NBP paid special attention to defining the objectives of monetary policy, ensuring transparency in the selection and use of its instruments. In addition, the impact on interbank money market rates by changing the base interest rate based on the results of the assessment of inflation expectations of individuals and legal entities, as well as the liberalization of the exchange rate, contributed to the improvement of monetary conditions.

Setting optimal interest rates. The NBP has decided to keep the base rates, pawn rates, re-discount rates and deposit rates unchanged in 2015-2020. This decision of the NBP cannot be justified, given the regular changes in economic growth, inflation and other similar indicators. Because, it was in 2015 that the inflation rate increased, and in 2020 inflation reached the upper limit of the target range (Figure 3).

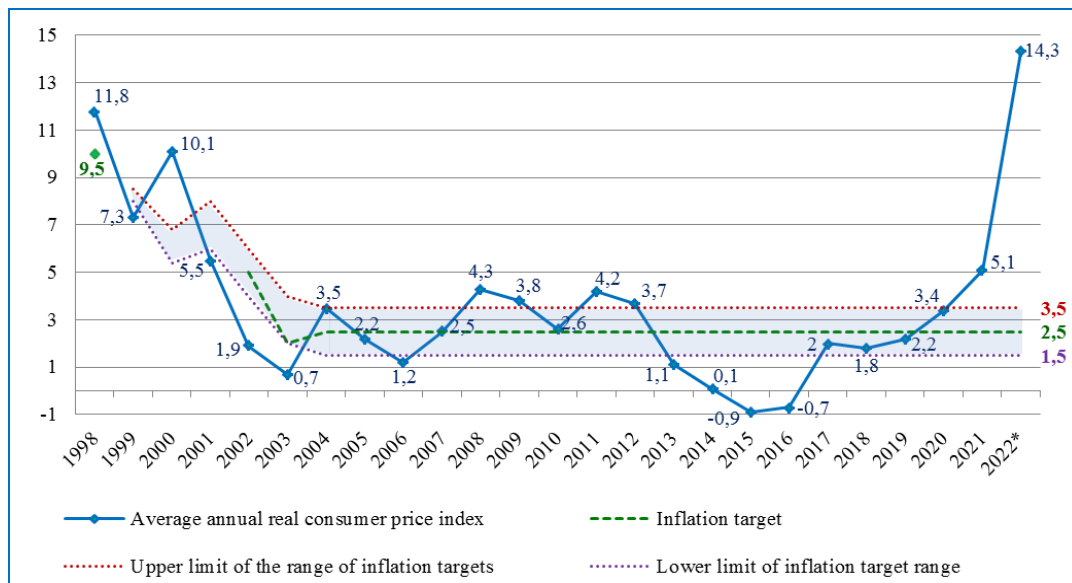


Figure 3. Dynamics of changes in the target inflation rate and consumer price index in Poland for 1998-2022³.

³ Developed by the author on the basis of data from the International Monetary Fund (<https://www.imf.org/en/Countries/POL>) and the National Bank of Poland (<https://nbp.pl/en>).

In this situation, an increase in interest rates was expected. However, the NBP made concessions to the government's policy aimed at restoring the economy after the complications of the pandemic, and decided to lower all interest rates. In 2021, against the background of stabilization of macroeconomic conditions in the country, interest rates were raised upward at the initial level. However, interest rates were further increased in order to reduce demand inflation, which was formed in the conditions of cheap money, as well as to mitigate the consequences of geopolitical external shocks in 2022. In this case, the main problem is the growing level of inflation, despite the increase in interest rates, as well as the increased risk of production falling into the "trap of cyclical fluctuations".

In 2015-2020, the constant dynamics of interest rates weakened the desire to influence inflation, taking into account internal and external factors. As a result, inflation rates became more active even during and after the pandemic. In particular, in 2022, the actual consumer price index was 14.3 percent, increasing from the upper range of the inflation target to 10.8 percentage points.

Exchange rate stabilization. Under the influence of the weakening of foreign economic conditions in 2020-2022, the zloty devalued against the leading foreign currencies. In this situation, the NBP had a hand in the first currency intervention in the last 25 years and explained this by the fact that the program of "Quantitative easing" was carried out in order to strengthen the impact on economic growth. However, devaluation continued and in 2022 EUR/PLN was 4.69 (4.59 in 2021), USD/PLN was 4.37 (4.06 in 2021). It is worth noting that as a result of the increase in interest rates, it is possible to predict a slowdown in production in the near future. It was during this period that the unfavorable foreign economic and political conjuncture, the shortage of raw materials on the world markets were caused by the risk of an increase in prices for imported goods, negatively affecting the current balance of foreign trade relations. This may have contributed to an increase in the cost of imports and, ultimately, increased inflationary pressure under the influence of the depreciation of the national currency.

Regulation of the liquidity of the banking system. The withdrawal of excess liquidity in the banking system from circulation after the transition to inflation targeting has become one of the main tasks of the NBP. In particular, in 2020, the volume of excess liquidity in the banking system amounted to 184 million zlotys, which is 2 times more than in the previous year.

The following factors can be assessed as factors that increase liquidity:

- acquisition of securities by the NBP through structured transactions on the open market in order to develop the secondary market;
- issuance of new loans to individuals and legal entities;
- purchase of foreign currency from the Ministry of Finance.

Against the background of increased liquidity in the banking system, the average balance on short-term transactions also increased. In general, as a result of the analysis, it is possible to predict an increase in liquidity in the banking system. The main negative aspect of this is that the instruments used by the NBP to attract excess liquidity do not give the expected effect. It is on this basis that the NBP has recently advocated the activation of cash transactions in payment relations.

Improving the efficiency of open-market operations. The NBP has issued securities on the primary market in order to regulate liquidity in the banking system. It also guaranteed the repurchase of securities on the secondary market in order to increase the interest of participants in this activity and encourage them. It was the purchase of securities on the basis of a guarantee issued by the NBP that led to an increase in their value on the secondary market. This reduced the yield of securities on the secondary market, the main function of which was to attract liquidity. It should be noted that these emerging unfavorable conditions require the NBP to strengthen control over short- and long-term interest rates. However, the establishment of control over interest rates reduces real interest rates and increases the impact of inflation on economic processes.

Strengthening the independence status of the NBP. The risks and complications of the global pandemic have increased the need for the central bank to strengthen its cooperation with the government. At the same time, it is important that the central bank maintains its independence status and does not cross the border when talking about cooperation with the government. However, the Monetary Policy Council of the NBP came under the influence of a political party and was unable to ensure the stability of the exchange rate and solve some similar problems. Today it is necessary to carry out structural reforms in the activities of the Monetary Policy Council of the NBP. Because as a result of the study, it became known that recently the council made weak decisions regarding the impact on the activation of economic growth, stabilization of the balance of payments and the creation of employment opportunities, which did not have the expected effect. This was due to the fact that macroeconomic processes as a result of long periods of unchanged interest rates are tied to the trajectory of formation in conditions free from the influence of interest rates.

Compliance with Euro membership criteria. As we know, Poland applied for the transition to the euro in 2003 and signed an accession agreement. However, the transition to the euro requires the fulfillment of six convergence criteria established by the European Commission. According to data for 2020, Poland met only three convergence criteria (budget deficit-to-GDP ratio, public debt-to-GDP ratio, long-term interest rates). The remaining indicators did not meet the criteria (compliance of inflation with the harmonized CPI in the European Union, exchange rate, compliance of legislation in the industry with the legislative framework of the European Union).

The growing level of inflation has recently made it increasingly difficult to meet the requirements of this criterion. In our opinion, the deterioration of the external economic situation may increase the distrust of developing countries in relation to the financial market. This may lead to the fact that in the near future the flow of capital in the financial market will move towards developed markets. If such a situation arises, there may be a sharp decline in the Polish securities market and there may be a decrease in demand for this market. In addition, this situation reduces the efficiency of securities trading to compensate for the budget deficit. In general, the development of the above indicators to the level of the requirements of the convergence criteria established by the European Commission will continue to be relevant as a medium-term strategy of the NBP.

Conclusion

As a result of the research of the monetary policy of the NBP, the following proposals and interpretations were developed on the application of some of the priority aspects in them in the practice of Uzbekistan.

Firstly, during the transition to inflation targeting, the Central Bank, as an absolutely independent body, should not obey the government's fiscal rule. That is, it is necessary that the central bank does not assume strict obligations to ensure a stable level or dynamics of nominal variables, such as the nominal exchange rate, wages of the population. Because this leads to the fact that these indicators are formed in such a way that they do not correspond to the inflation target.

Secondly, it is necessary that the central bank clearly defines the main goal pursued on the open market and does not fall under the influence of government trading on the securities market, which are observed in certain periods. That is, the guarantee of a repeat purchase of securities by the central bank as part of the development of the secondary securities market will also cause an increase in securities prices, while increasing investor interest in this market. As a result, the central bank may be isolated from an effective instrument for attracting excess liquidity. Because, the increase in the price of securities in the secondary market reduces the profitability of this instrument attracting liquidity.

Thirdly, the use of mandatory reserve requirements is permissible in order to stabilize short-term interest rates. Because the impact on the excessive liquidity of the banking system primarily affects short-term interest rates on the interbank money market. In our opinion, the central bank should not set a limit on the level of mandatory reserves set by each commercial bank so that it is above the average coefficient. Because the fact that the volume of mandatory reserves allocated by any commercial bank exceeds the average level indicates that this bank carried out active depository

activities and, accordingly, assumed large obligations to customers. It is these obligations that negate the restrictions on deviations from the averaging level.

Fourth, when determining the target inflation rate, it is necessary that the central bank can determine the exact direction of the influence of the inflationary factor. Foreign experiments show that in recent years, central banks of countries that have switched to inflation targeting are trying to move away from the strategy of the Ministry of Finance and rethink the main goal of monetary policy. That is, the central banks of the countries that have chosen the inflation targeting regime note that instead of targeting the nominal inflation rate, when the inflation target is reached, priority is given to the real value of money and the stability of the financial system. This makes it necessary to revise the concept of monetary policy and make institutional changes in its implementation in countries that have chosen the inflation targeting regime.

In general, today the International Monetary Fund recommends using a number of aspects of the Polish experience as one of the countries that have successfully switched to the inflation targeting regime. This serves to further increase the importance of research within this facility.

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