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High inflation in Poland is caused by the Monetary Policy Council

A slight decrease in inflation measured by the CPI (Consumer Price Index) at the end of 2022 should be treated with great caution because it is accompanied by an increase in core inflation, which is calculated by excluding food and energy prices from the market basket.

CPI and core inflation in Poland, Q4 2022

	CPI	Core inflation
October	17,9%	11,0%
November	17,5%	11,4%
December	16,6%	11,5%

Source: GUS and NBP

CPI is the most widely known and used indicator by central banks as an measure in which the inflation target is expressed (in Poland it is 2.5%, plus or minus 1 p.p.).

Inflation, however, must also be looked at through the so-called core inflation, which is calculated excluding food and energy prices from the CPI. This is due to the fact that in the food industry and on the energy market there are often disturbances called "supply shocks", which mainly occur on global markets: increases or decreases in the prices of crude oil or wheat, sugar or coffee can significantly affect CPI changes in individual countries, although the internal demand pressure in the economies of these countries does not change. It may remain at a stable level, while the rising energy or food price on the global market raise the domestic CPI. Equally, falling energy and food prices in global markets may drive down the domestic CPI even as domestic demand pressure increase. Unlike the CPI, the core inflation index can be treated as free from the impact of external fluctuations. Core inflation more strongly than CPI reflects the impact of domestic factors, including domestic inflationary pressure.

CPI fluctuations resulting from sudden, unexpected price changes in global food and energy markets are not directly influenced by monetary policy, and this may justify a solution of simply waiting for the "supply shock" to wear off. The issue of reacting to changes in core inflation looks different:

monetary policy is able to slow down its growth by raising the reference interest rate. And it should respond to a sufficiently deep decline in core inflation by lowering the rate. Such policy to be effective requires accurate prediction of core inflation determinants and adjusting the monetary policy response to these predictions (forward-looking approach), as well as an appropriate timing.

Core inflation in Poland in December 2022 was 11.5%, while the average in the European Union was 5.97%, and in the euro zone alone it was 5.2%. These huge differences in core inflation prove that the Polish monetary policy was pro-inflationary. These pro-inflationary mistakes had to be made mainly in 2020-2021.

Already in 2019, core inflation was significantly growing month by month (from 0.8% in January to 3.1% in December), and at the end of the first quarter of 2020 it already reached 3.6%. In the same period, an elevated CPI level: 4.6% at the end of the first quarter of 2020 was observed. From April 2020, there was a significant change in both of the indicators and their mutual relationship: core inflation remained at 3.6%, and increased in subsequent months, while the CPI decreased to 3.4%, to continue to decline in subsequent months (in December 2020 to 2.4%). Thus, the CPI was below the core inflation, and for the next period of nearly a year the excess of the core inflation over the CPI was increasing.

The reason for the CPI reduction at the beginning of 2020 can be found in the outbreak of the COVID-19 pandemic and the decline in prices on global markets. The price of North Sea Brent crude fell from nearly $70 to just over $20 per barrel during that period, the price of a bushel of wheat fluctuated in the moderate $400-500 range, and the FAO Food Price Index fell from 100 to 90 points.

The situation on the global markets and the opposite directions of shifting CPI and core inflation in Poland (CPI down, core inflation up) signaled that the domestic demand pressure was growing, and only external impulses masked its true scale to some extent. However, the Monetary Policy Council acted as if it did not notice these facts. In the statement after the meeting of March 3-4, 2020, there was an optimistic sentence that "on the horizon of impact of the monetary policy, price growth will run close to the inflation target" (!!!). Moreover, at an urgent meeting on March 17, the reference rate was reduced by 0.5 percentage point (from 1.5% to 1.0%) for the first time in five years. At the same time, the obligatory reserve ratio was significantly reduced (from 3.5% to 0.5%) and its interest rate was slightly raised (from 0.5% to 1.0%). The required reserve ratio dictates commercial banks what part of the collected deposits they should pay to the NBP, so its lowering made it possible to allocate more funds to loans. Additionally, it should be remembered that the low rate of the required reserve combined with its low interest rate leads to lower interest on deposits and term deposits in commercial banks, so their customers' tendency to save decreases.

On April 8, the Monetary Policy Council lowered the reference rate by another 0.5 percentage point (to 0.5%), and on May 28 to 0.1%, that is virtually to zero. These decisions were the root causes of the subsequent rise in inflation

In addition, from March 2020, imitating the "quantitative easing" conducted by the world's largest central banks, NBP began to buy financial assets under the so-called structural open market operations. Only in the first four months of this program, until mid-2020, NBP bought securities (Treasury bonds, as well as those issued by Bank Gospodarstwa Krajowego and the Polish Development Fund) for over 100 billion PLN, that is the equivalent of approx. 4% of GDP. This mass of money was additionally pumped into the economy!

Strong loosening of monetary policy in the period from March to May 2020 is the first of the fundamental pro-inflation mistakes of the MPC.

This pro-inflation policy of the MPC was continued in the following months of the second half of 2020, until the beginning of 2021: the reference rate remained at a record low level of 0.1%, the CPI index fluctuated gently within the upper level of deviations from the inflation target, and core inflation remained at a level approx. 1 percentage point higher.

In April 2021, the CPI increased to 4.3% and thus was well above the upper level of deviations from the inflation target, and at the same time exceeded an already high core inflation of 3.9% for the first time in a year. It was a real wake-up call! The price of Brent crude oil exceeded 60 USD per barrel, the price of a bushel of wheat moved to the range of 600-700 USD, the FAO food price index exceeded 120 points, and core inflation remained high, close to the 4% level reached in a year before. Thus, an immediate tightening of monetary policy became a necessity!

In March 2021, at a press conference after the MPC meeting, statements were made that interest rates in market transactions were rising. Therefore, MPC was asked whether maintaining an ultra-low reference rate by the MPC was justified. The response of the President of the National Bank of Poland, Adam Glapiński, was extremely decisive: “The probability of interest rate hikes during this term of the MPC is still zero. The market is wrong." (!!!)

In the following months of 2021, the CPI remains above 4%, and then exceeds 5%, core inflation stabilizes at a level close to 4%. Meanwhile, the MPC led by President Glapiński does not take any anti-inflationary measures. What is worse, the NBP continues to buy bonds and adds another nearly 40 billion PLN to the 100 billion by which it increased its assets in 2020.

In September 2021, the CPI reaches 5.9% - level not recorded in Poland for 20 years, and the core inflation is 4.2%. Meanwhile, President Glapiński assures: “The current increase in prices in Poland and in the world is temporary. We also have the effect of postponed demand, but the increase in inflation results from the increase in prices of raw materials and freight, as well as supply problems. (...) The central bank should not react to negative supply shocks by raising interest rates. This would be a rookie mistake, leading only to lower economic growth, or even to growth suppression. Those who are urging us to raise the rates want us to stagnate." It was another rookie pro-inflationary mistake of the NBP president.

The first reaction of monetary policy to the heightened inflation takes place only in October 2021, but it is very weak: the reference rate is raised from 0.1% to 0.5%. At the same time, the obligatory reserve ratio is increased to 2%. However, the recent assurances about the temporary nature of elevated inflation disappear from the statement after the meeting, and in its place, there is a thesis that "inflation may remain at an elevated level longer than previously expected".

In November 2021, the MPC increases the reference rate by 0.75 percentage point, to 1.25%. At that moment, the CPI was 6.8% and the core inflation was 4.5%. The statement after the meeting finally acknowledges: "a clear increase in average wages in the enterprise sector" and "demand stimulated by an increase in household income".

Before the December (2021) meeting, President Glapiński performs another verbal flip. He declares: “I am changing the rhetoric. Inflation is temporary, but within two years, and even that is unknown, although we see it that way now.” The temporary nature of inflation with a horizon of two years or more and burdened with additional uncertainty is undoubtedly the president's contribution to the language of central banking messages.

More than six months' delay in tightening the monetary policy, which took place between March and November 2021, is the second major mistake made by the MPC.

From November 2021 to September 2022, the MPC carries out nine consecutive increases in the reference rate, to the level of 6.75%. This level was in effect in Poland for the last time from November 2002 to March 2003. However, the CPI did not reach 1% at that time, and core inflation slightly exceeded 1%; the real interest rate was clearly positive. With the current CPI level of 16.6% and core inflation of 11.5%, the real interest rate in both indicators remains deeply negative. An effective anti-inflationary measure would require raising the reference rate to such level that the rate resulting from the relation to core inflation would be positive (that means approx. 12%).

The ECB seems to be aiming at a positive real interest rate - in relation to core inflation. The Governing Council started the policy tightening cycle in July 2022 by raising rates by 50 bp. In September, it increased the scale of hikes to 75 bp and made a similar move in October. The fourth increase – by 50 bp – took place in December and as a result, the interest rate on the main refinancing operations was at the level of 2.5%. At the same time, the December statement specified that "interest rates will have to increase significantly at a steady pace, to levels restrictive enough to ensure a rapid return of inflation to the target level of 2% in the medium term." In environment of core inflation close to 5%, this may mean reaching a positive value of the real rate in relation to it in the near future.

Stopping the cycle of reference rate increases in September is clearly leading the MPC to commit the third significant error in a row. As a result, the period of increased inflation may be extended not only to 2023, but also to the following years. In reference to the ECB's decision and statement, it should also be emphasized that the task of the central bank is not to reduce inflation in any way or bring it to a single-digit level, but to return to the inflation target in the medium term. The fact that in such period inflation will fall to 10% or even slightly lower should in no way be treated and shown as a success! The effect of the MPC's actions should be a return to the inflation target in the medium term, and the current policy of the interest rate frozen from September 2022 does not ensure it.

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