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Should Polish monetary policy go long?

Abstract

This essay discusses the optimal shape of monetary policy in Poland as the Polish economy faces the COVID-19 pandemic. It starts by discussing possible scenarios for GDP and inflation dynamics in 2020, and next it focuses on monetary policy. It reviews recent moves as taken by the Monetary Policy Council in March and April 2020, and then analyses the possibility of monetary policy in Poland going long by allowing interest rates on long-term repo operations to be lower than the reference rate. In doing so it uses, among others, the idea of reversal interest rate. Although this paper generally supports the idea of Polish monetary policy going long, it also underlines some potential risks of implementing non-standard instruments of monetary policy.

Key words: COVID-19 pandemic, monetary policy, repo operations, reversal interest rate, yield curve control strategy

JEL: E42, E52, E58

Czy polska polityka pieniężna powinna kontrolować długoterminowe stopy procentowe?

Streszczenie

Esej traktuje o optymalizacji polityki pieniężnej w Polsce w warunkach kryzysu gospodarczego wywołanego pandemią COVID-19. Początkowo rozważane są możliwe warianty wzrostu PKB i inflacji w 2020 r., a następnie skoncentrowano się na polityce pieniężnej. W szczególności omówiono decyzje Rady Polityki Pieniężnej z marca i kwietnia 2020 r., a następnie przeanalizowano możliwości wydłużenia horyzontu tej polityki, w szczególności dzięki utrzymywaniu stóp procentowych długoterminowych operacji repo na niższym poziomie niż stopa referencyjna. W tekście wykorzystano koncepcję reversal interest rate. Mimo, że generalnie Autor popiera wydłużanie horyzontu polskiej polityki pieniężnej, to akcentuje ryzyka związane z wdrażaniem niestandardowych instrumentów tej polityki.

Słowa kluczowe: pandemia COVID-19, polityka pieniężna, operacje repo, reversal interest rate, strategia kontroli krzywej dochodowości

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1. Setting the stage

The Polish economy is facing unprecedented challenges resulting from the COVID-19 pandemic, and hence there is a need for an appropriate economic policy reaction. What is clear and relatively uncontroversial is that we need both fiscal and monetary expansion. Such an approach is now dominant in nearly all countries where central banks are breaking successive taboos in monetary policy, e.g., by opening up the possibility of nearly unrestricted debt purchases, and where fiscal policies often suspend spending rules. This begs the question, how should economic policy be crafted in Poland? In general, this essay focuses solely on monetary policy and asks how monetary expansion should be carried out in Poland.

In 2020, a recession in Poland is inevitable, although the GDP decline should be lower than in many other European countries. Nevertheless, unemployment is expected to rise, and a huge jump in uncertainty is certain to hit investments and private consumption. The future inflation path is less clear. On the one hand, inflation will be constrained by a strong decline in economic activity together with rising unemployment, not to mention low fuel prices. However, on the other hand, all sorts of rumors about the definitive death of inflation should not be taken for granted, since consumers' inflation expectations are still high, food prices are rising as well as prices of basic necessities, global supply chains are interrupted, and thus access to the global product market is limited. Last but not least interest rates are historically low, and fiscal policy is to be more expansionary. As far as inflation is concerned, it should be taken into account that what matters for its level is not only price dynamics but also the structure of the so-called inflation basket. If consumers are now buying more food and less services, and if food prices are on the rise, then real inflation may already be much higher than the one reported by the Central Statistical Office, which reviews the structure of inflation basket only annually. This, of course, has a redistributive dimension because inflation is always more painful for the less well-off, which in the case of Poland is reinforced by a largely degressive income tax. Thus, the economic situation of a huge share of Polish households is likely to worsen in 2020. Therefore, three decades of continuous economic growth have, it seems, come to an end and Polish economic policy has to change its course.

2. Monetary policy reaction

The above has major implications for monetary policy and this essay puts emphasis on that very issue. Here the question is not whether monetary policy should be more expansionary, because certainly it should, but how it should be changed. In other words, monetary expansion can be realised in many different ways. Nevertheless, its goal should be always the one defined by a strategy of medium-term inflation targeting as it is described in the Monetary Policy Guidelines for 2020. The Monetary Policy Council should also take care of macroeconomic and financial stability, in addition to the proper functioning of monetary transmission channels. Thus, now that we are facing such unprecedented economic shock as the one provoked by the COVID-19 pandemic, the National Bank of Poland should use all necessary tools to help the Polish economy. Its tools consist of interest rates, open market operations, required reserve system, standing facilities, foreign exchange swaps, foreign exchange interventions, and bill discount credit. What composition of these instruments should be used by the NBP in the current circumstances? This is the question which should be debated now.

Firstly, the reference interest rate needed to be lowered but not to the extent as it was decided in March and April. We should not forget that what matters for quantity of credit in the economy is not only demand for credit but also its supply, and such a massive interest rate cut strongly reduced the ability of banks to offer new credits. For sure, however, an interest rate cut of 100 basis points helps consumers and businesses to repay loans they already have. However, if a given consumer is to lose their job, or if a given enterprise is to go into bankruptcy, then such "help" does make any difference. What is needed is to strongly support businesses by offering them the so-called "credit vacations" and giving them access to cheap, long-term financing.

Secondly, the NBP has to lower tensions in the financial markets, for instance, by providing liquidity to the banking sector, and hence the decision to lower the required reserve ratio from 3.5% to 0.5%. It could have been lowered even more sharply. A necessary step was also to give the NBP the green light to purchase government bonds on the secondary market as part of the structural operations that change the long-term liquidity structure in the banking sector and contribute to maintaining liquidity in the government bond secondary market. Furthermore, the NBP decided to offer bill discount credit aimed at refinancing new loans granted to economic entities by banks. Lastly, during its April meeting, the MCP made the much needed decision to purchase government securities and government-guaranteed debt securities on the secondary market as part of the structural operations. Apart from these measures, the NBP uses repo transactions to provide liquidity to the banking sector. An important rationale for such operations is to ensure proper functioning of the monetary transmission channels.

3. Going long and not (only) short?

Now, why such a scepticism towards cutting the short-term interest rate by 100 basis points? Here two points need to be raised. Firstly, a nominal reference rate of 0.5%, with the specificities of the Polish banking sector in min, is dangerously close to the so-called reversal interest rate, namely "the rate at which accommodative monetary policy reverses its intended effect and becomes contractionary for lending. […] the reversal interest rate is not necessarily zero"[1]. Again, in the Polish

[1] M. Brunnermeier, Y. Koby, *The Reversal Interest Rate*, NBER Working Paper Series, 2018, no 25406, p. 1.

context it is above zero. To simplify a bit, the phenomenon of reversal interest rate is partially due to the negative impact interest rate cuts have on banking sector's profitability. Secondly, the goal of any given central bank is to impact the structure of interest rates in such a way so as to maximise the probability of achieving the bank's objectives. In normal times this was done by impacting a short end of yield curve, e.g., by cutting interest rates. However, once a nominal rate is close to zero, or even below, as is the case now in many countries, then controlling the yield curve by impacting its short end only ceased to be easily achieved. Now, effective zero lower bound may in fact be above zero and, for instance, close to the reversal interest rate. Therefore, many central banks have started to be more sympathetic to the so-called yield curve control strategies, and in particular they introduced non-standard instruments in order to directly impact longer interest rates. As J. Yellen once put it:

"The increased relevance of the zero lower bound reflects the fact that the neutral real rate of interest looks to have declined considerably in recent decades […]. I will instead focus on an approach I consider promising – one that is evolutionary, practical, and has the potential to significantly mitigate the adverse effects of the zero lower bound. I believe the FOMC should seriously consider pursuing a lower-for-longer or makeup strategy for setting short rates when the zero lower bound binds and should articulate its intention to do so before the next zero lower bound episode"[2].

Here J. Yellen just claims that monetary policy authority should keep short rates lower for longer than the rule, e.g., the Taylor rule, would recommend. But what if a given central bank does not have time to wait till such a strategy impacts the whole yield curve in a desired way? In such a situation, it should influence it more directly by introducing instruments which impact the longer cost of money and financial instruments. Here, quantitative easing, including TLTRO by the ECB and bond purchases by FED, serve as good examples. Again as J. Yellen put it: "[…] the Committee turned to asset purchases to help make up for the shortfall by putting additional downward pressure on longer-term interest rates"[3]. Asset purchases by the NBP are going in a same direction. Even if the current recession period in Poland ends, uncertainty will stay with us for years and thus business entities will need cheap financing for the long term. Thus, should the NBP offer banks the same once they use it to provide financial assistance (credit lines) to businesses affected by the COVID-19 pandemic? For instance, why not consider long repo operations, say with maturity of two years and longer, but with a price lower than the one defined by the reference rate? As in the case of TLTRO by ECB, a given bank's access to such operations should be limited by its activity on the credit market. The proposed scheme should be just the credit market for companies and not households. Such long repo operations would be less non-standard than TLTRO operations, since repo measures need collaterals and TLTRO operations do not. Overall, in the current situation, monetary policy by

2 J. Yellen, *Comments on Monetary Policy at the Effective Lower Bound*, Brookings Papers on Economic Activity 2018, Sept. 13–14.

3 J. Yellen, *The Economic Outlook and the Conduct of Monetary Policy*, Speech at the Stanford Institute for Economic Policy Research, Stanford University, Stanford, California, on January 19, 2017.

the NBP should be more non-standard, but at the same time with the reference rate higher than the one we have after the March and April cuts. What should be debated also, including in the Polish academic community, is whether we have the following dilemma: due to the fact that the Polish economy is still relatively small and open, its monetary policy cannot be at the same time hugely non-standard and characterised by a reference rate close to effective zero lower bound.

Considering Polish monetary policy going long raises the question of potential dangers of such a move. One risk is that "setting more than one interest rate independently would potentially create arbitrage opportunities across the yield curve"[4]. Here two solutions emerge. First, moving a set of interest rates in tandem would definitely reduce arbitrage opportunities. Second, some additional regulatory measures may be introduced to lower the risk of arbitrage. Nevertheless, lowering long rates by flattening the yield curve may stimulate investments, which, in the presence of the post-COVID19 trauma of uncertainty, will be very much needed. However, via the Philips curve, such a change in the shape of the yield curve may stimulate inflation, but since the Philips curve is relatively flat in the Polish economy we should not be afraid of such a possibility[5]. But still, the NBP should not forget about its main goal, namely keeping inflation under control. All in all, once strong inflation pressure reappears, we should not hesitate to act appropriately.

4. Some concluding remarks

There is, however, one point which should be raised while considering the NBP going long, namely, as the MPC, we should be clear that we would like to go back to normal as soon as possible. In other words, our most normal world is the one in which we do not buy bonds, and we do not use other non-standard instruments. In other words, any signs of the NBP accepting its non-standard instruments as permanent without communicating the conditions of withdrawal from these initiatives may provoke a debate about the independence of the NBP, which in turn may negatively impact the yield curve the NBP is trying to influence. The above is even more urgent keeping in mind the failed attempt to raise rates in January when inflation was well above 4% and other conditions for monetary policy tightening seemed to be met. We do hope that we will be able to go back to normal at the NBP, since a return to everyday, stable monetary policy is a signal that the Polish economy is going back to its pre-COVID-19 growth path. One way of going back to normal may be first to raise the reference rate, and only later to withdraw from asset purchases. Also, a raise in the reference rate can be accompanied by a temporal and conditional introduction of a lower rate for the long-term repo operations described above. On the whole, a debate on whether monetary policy should go long in Poland is much needed.

4 R. Reis, *Central Banks Going Long*, CESifo Working Papers, 2018, no 6998, p. 28.

5 Cf. K. Szafranek, '*Flattening of the New Keynesian Phillips Curve: Evidence for an Emerging, Small Open Economy*, Economic Modelling 2017, vol. 63, pp. 334–348.

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