Economy and Financial Markets
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Poland Economics View

Interventions to be less frequent

- **No interventions in January** – The National Bank of Poland repeatedly intervened in December, purchasing foreign currencies worth almost USD 5bn. However, the attempts to weaken the zloty faded more recently, and our analysis suggests that in January the NBP stayed out of the market.

- **NBP less active in 2021 –** January may be a harbinger of how the coming months will look in terms of FX purchases. Although sporadic interventions cannot be ruled out, we expect them to be significantly less frequent and not necessarily at the same levels as in December. The NBP is probably ready to accept zloty appreciation as long as it is gradual and does not threaten exporters.

- **Forget about FX floor –** The NBP is unlikely to defend any particular FX level and recent comments from central bank's officials confirm this view. Although Poland's move towards FX interventions was sometimes compared to the Czech FX floor from 2013-2017, we see more differences than similarities. Both banks had different motives, different communication strategies and simply chose very different FX arrangements.

- **Lasting impact on the market –** Interventions pushed implied yields to negative territory and led to the widening of the basis. This situation may last for weeks and in the case of repeated interventions, the low level of implied yields could be even more lasting.

- **Unconventional toolkit complete –** Interest rates may be at zero lower bound but the NBP has now a toolkit of unconventional measures. This includes asset purchases (quasi yield curve control), forward guidance and FX interventions. The NBP should now be able to support the economy without the need to cut policy rates to negative territory.

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Interventions to be less frequent

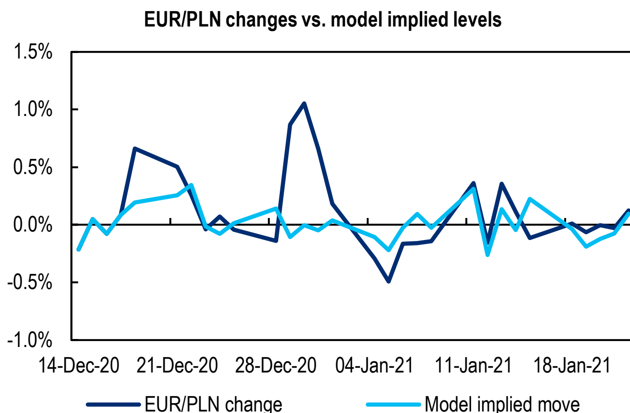
No interventions since December

In the final weeks of 2020 the central bank surprised the market by launching FX interventions and purchasing foreign currencies to weaken the zloty. There is little official data on this activity as the NBP does not reveal details of interventions, and therefore any conclusions need to be based on investigation of indirect indicators. However, our analysis suggests that the central bank purchased foreign currencies on four or five days in December. On these days the EUR/PLN increased significantly more than usual patterns would suggest (Figure 1-2), and simultaneously the banking sector noted a large increase in liquidity.

December intervention was likely larger than any past NBP intervention. Gross FX reserves rose in December by USD 8.9bn, but some of the increase was due to revaluation effects (approx. USD 1.8bn) or repo operation used by the central bank (USD 2.4bn). Adjusting for these factors, the size of intervention probably reached USD 4.7bn, or 0.9% of GDP[1]. An unprecedented scale of NBP activity in the FX market shows that the central bank was determined to weaken the currency and wanted to send a strong signal to market participants.

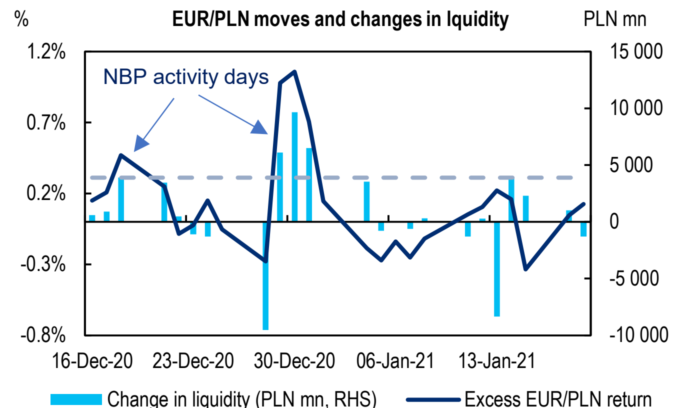
Recent EUR/PLN levels seem less worrying for the NBP. Our analysis suggests there have been no signs of central bank interventions in January. Both changes in the EUR/PLN rate, as well as fluctuations of banking sector liquidity, do not show any “abnormal” moves in first weeks of 2021 (Figure 2). This makes us convinced that if the central bank purchased any currencies in January (which we doubt), these were very small interventions with no material impact on the market.

Figure 1. On four-five days of December 2020 the zloty weakened excessively as compared to our model estimates



Source: Bloomberg, Citi Handlowy Research estimates. Note: In our model daily EUR/PLN returns are “explained” by changes in HUF, CZK, EUR/USD and SPX.

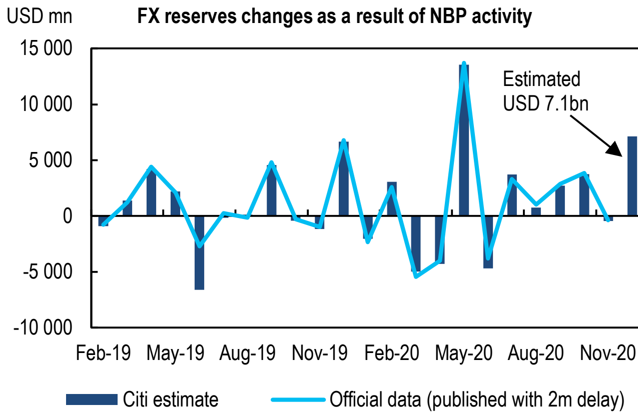
Figure 2. These days coincided with substantial increases in banking sector liquidity, suggesting these were dates of NBP interventions



Source: Citi Handlowy Research analysis based on NBP and Bloomberg data. Note: Changes in the liquidity of the banking sector are adjusted in order to take into account T+2 delay in reporting. Grey dotted line shows 1 standard deviation for excess PLN return forecast.

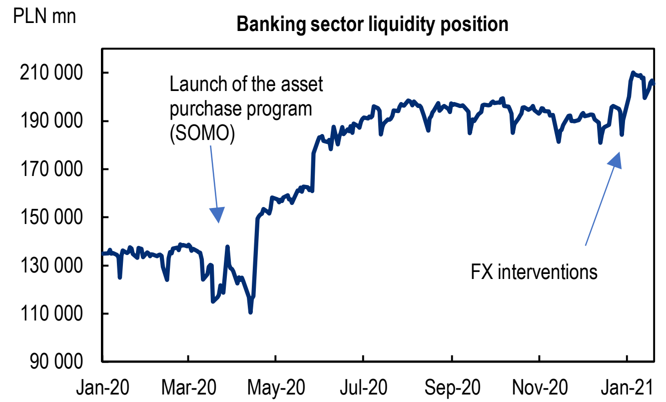
[1] Initially we estimated interventions at ~USD7bn but revised this estimate down after publication of data on liquid assets of the NBP, which allowed us to estimate the likely size of NBP repo/reverse repo operations in December 2020.

Figure 3. Our estimates show that FX reserves rose by around USD 7.1bn as a result of NBP operations (a combined impact of FX interventions as well as repo/reverse repo operations)



Source: NBP data, Citi Handlowy Research estimates. Note: NBP has not yet published its December data on FX reserve changes resulting from NBP activity. Figure shows Citi estimates for Dec 2020 as well as track record of our model in prior months.

Figure 4. Adjusting for the size of NBP repo operations, the intervention can be estimated at around USD 4.7bn, in line with an increase in banking sector liquidity



Source: NBP, Citi Handlowy Research

This is not an FX floor

NBP interventions triggered discussions among market participants on whether the Polish central bank introduced an implicit or explicit FX floor arrangement. The discussion was fueled by comments from one of the Monetary Policy Council members, who suggested EUR/PLN at 4.5 was the “optimal level” (PAP, 30 Dec 2020). Yet in Poland decisions to intervene are taken by the NBP management board, not the MPC. Therefore, opinions of MPC members may not reflect all motives and considerations that were behind the central bank’s activity.

Recent comments from NBP management show that the central bank treats FX interventions as ordinary operations and has no intention to introduce an FX floor. In particular, on 15th January governor Glapiński said the NBP was not trying to defend any particular FX level and stated also that the central bank was sticking to a floating exchange rate regime. It seems to us there is no automaticity in intervention decisions and the central bank will respond flexibly to FX market developments.

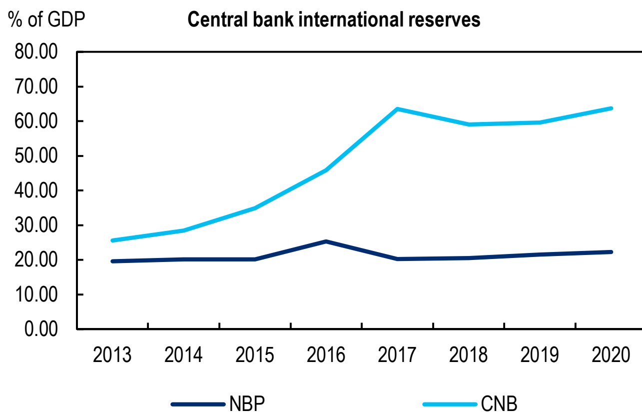
We expect the frequency of FX purchases to fall significantly in 2021 as compared to the last weeks of 2020. The apparent lack of interventions in early January, when EUR/PLN fluctuated below levels when the central bank intervened in December, reinforces this view. Our base case is that the NBP will refrain from activity in the FX market, accepting gradual strengthening of the currency, but may step in if the appreciation becomes too fast. Admittedly, there is no clear definition of “too fast” in this context but in our view 3-5% strengthening over one year should be acceptable to the NBP.

Very different from Czech case

Although commentators have tried to compare NBP activity to Czech FX interventions in 2013-2017, we think there are much more differences than similarities. Unlike the CNB, the Polish central bank did not commit itself to defending any particular FX level. The motives were also different. The

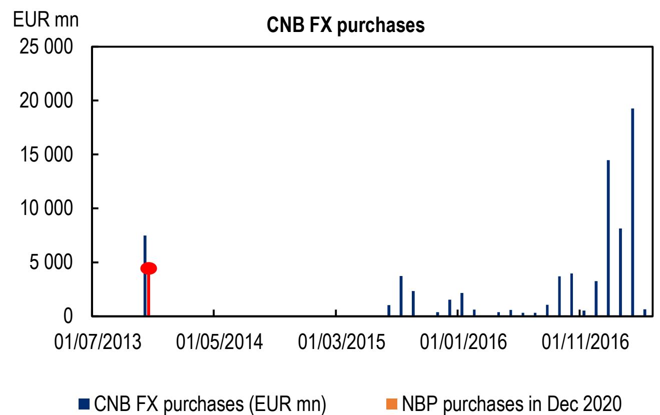
Czech central bank tried to minimize the risk of deflation, to shorten the period of undershooting its inflation target and to avoid negative policy interest rates. In contrast, Polish monetary authorities are more focused on growth impact. In particular NBP officials are concerned that potential future appreciation could lead to exports slowdown. Moreover, the undershooting of the inflation target is not a concern for the NBP. Its most recent projection shows inflation either close to or even above the 2.5% target during the whole two-year forecasting horizon.

Figure 5. Czech FX reserves rose dynamically as a result of interventions, especially in final months before the FX floor was abandoned



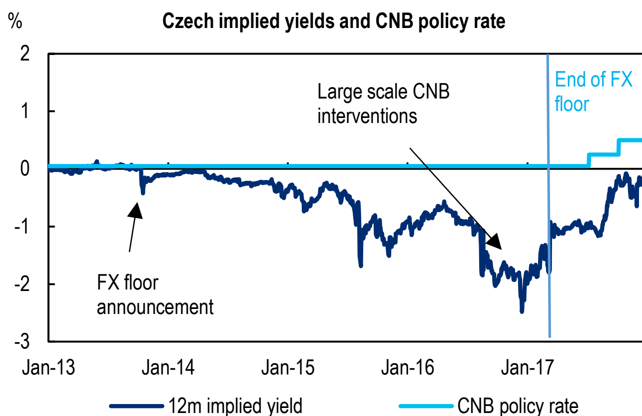
Source: CNB, NBP, Eurostat, Citi Handlowy Research

Figure 6. Initial CNB intervention was larger than the NBP one



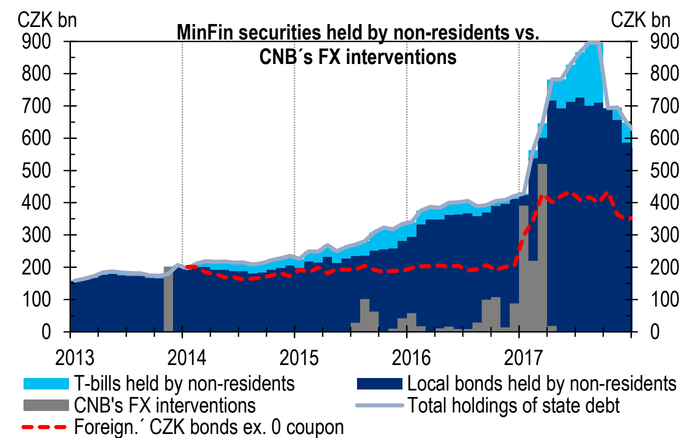
Source: CNB, Citi Handlowy Research estimates

Figure 7. CNB interventions pushed implied yields lower, well into negative territory



Source: Bloomberg, Citi Handlowy Research

Figure 8. Foreigners initially focused on t-bills, followed by zero coupon bonds in 2015-16, while the inflow in early 2017 partly reflected CZ GB inclusion into the JPM GBI-EM (announced on 22 Feb 2017)



Source: Haver Analytics (MinFin), CNB, Citi Research calculation. Note: "Foreigners´ CZK bonds ex. 0 IR (red dashed line)" excludes the zero coupon bonds (issued during the FX interventions) from foreigners' holding of CZK bonds (dark blue columns).

The lack of clear commitment by the NBP to defend any particular level also has implications for the size of interventions. Although our estimates of NBP FX purchases in December are relatively large (~USD 5bn or EUR 4bn), they pale in comparison with CNB interventions immediately after the announcement of the FX floor (EUR 7.5bn in November 2013). In the months following the first intervention the CNB did not have to purchase FX but eventually the large inflow of foreign capital led to larger

interventions. For example in March 2017, the last full month before the abandoning of the FX floor, the CNB purchased EUR 19.3bn. As long as the NBP keeps its flexible approach and does not defend any particular level, there should be no need for large interventions comparable to those taken by the CNB.

Another important difference between Polish and Czech intervention is in communication strategy. The Czech central bank clearly communicated possible changes in its toolkit more than one year in advance of the first interventions. CNB also continued to publish the 10-day balance sheet and monthly data on the size of its FX trading operations, showing the split between its own activity (FX interventions) as well as operations conducted for its clients. Overall, the CNB intended to use the EURCZK floor as the fully-fledged monetary policy tool after the interest rate policy could not be utilized anymore. The NBP chose a different communication approach, leaving the size and timing of its operations in the shadows. Information about motives of FX purchases were published only after 2-3 days of interventions, while detailed explanation was provided in mid-January. This approach is in line with the view that the Polish central bank aims to use FX interventions only sporadically.

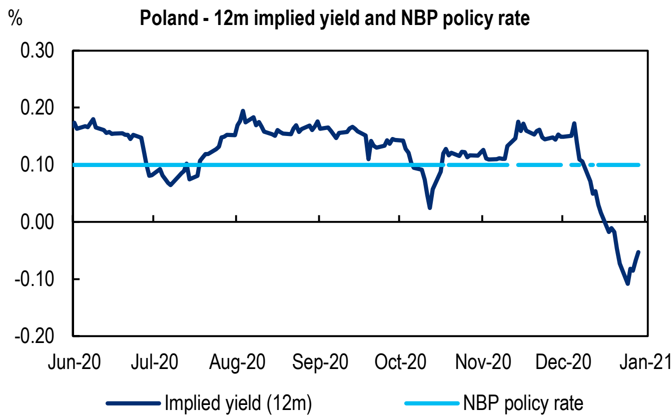
Lasting impact on the market

The mechanics of FX interventions suggest the excess liquidity will stay in the system for a very long time. The central bank purchases foreign currencies and simultaneously creates new PLN liquidity that is added to commercial banks' accounts with NBP. Commercial banks can hold this money on deposit with the central bank or can buy weekly cash bills offered by the NBP but they are not able to reduce the liquidity in the system. Using this liquidity to purchase bonds or foreign exchange would only move the funds from one bank to another, but would not change the overall liquidity position of the banking sector.

The only way for liquidity to fall to pre-intervention levels would be if the central bank decided to absorb it via long-term operations, by issuing special bonds. However, we think the central bank will not take this step as this would be a de facto sterilization, and sterilized interventions are less effective than unsterilized ones. Furthermore, absorbing liquidity would diminish effectiveness of the NBP asset purchase program (QE) that was launched in March 2020 (Figure 4).

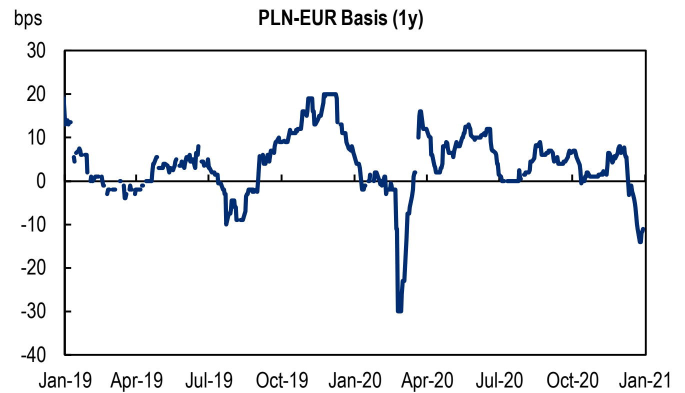
Interventions changed the balance between foreign exchange and zloty held by banks. The NBP de facto decreased supply of euros on nostro accounts of Polish banks and substantially increased the supply of PLN in the system. This was reflected in a noticeable drop in implied yields and the widening of the EUR/PLN basis (Figure 10), which shows that funding in foreign currencies is now relatively more expensive than in PLN, as compared to the situation preceding interventions. This also directly affects the cost of FX hedging, making the exporters' FX hedging less favourable via negative forward points that eventually may lead to larger share of natural FX hedging via larger share of foreign-denominated borrowing.

Figure 9. NBP interventions pushed 12m implied yields lower but less than in Czech case…



Source: Bloomberg, Citi Handlowy Research

Figure 10. … and the NBP activity made funding in foreign currencies relatively more expensive



Source: Bloomberg, Citi Handlowy Research

Over time the scarcity of FX will be eliminated by continued foreign trade surplus or increased inflow of portfolio capital, lured by the weakness of the zloty. Yet this process may take weeks or months and in the case of repeated interventions the low level of implied yields could be even more lasting, as was the case in the Czech Republic (Figure 7). The only easy way to quickly increase "the supply of euros" would be if the Finance Ministry decided to exchange incoming EU funds in the market, rather than in the central bank. However, this would be inconsistent with its past actions and would work against the NBP.

NBP interventions have had little or no meaningful impact on POLGBs, but this may change depending on the size of FX activity. Czech experience offers an interesting lesson in this respect as large and lasting interventions in the Czech Republic led to significant inflows to the bond market. Foreign investors who sold euros to the CNB were using CZK to buy Czech government bonds as the implied yields from deposits were negative. This helped to keep bond yields at a very low level. As compared to the CNB, Polish interventions are too small to matter but if they continue for longer, the short and middle part of the yield curve would be pushed lower. In this case interventions and QE operations of the NBP would work in the same direction, reinforcing each other.

What would need to be done for FX floor to work

If the NBP really wanted to introduce an FX floor (which we think is unlikely), this would require some additional changes in its operations. We think the NBP would need to put much more emphasis on communications with markets, describing new exchange rate arrangements and signaling that the FX floor will stay for long. The latter appears an important point as the prospect of a long period of weak currency would allow exporters to adjust their strategic decisions accordingly. Without this knowledge in advance, the weakness of the currency would be probably used only to hedge near-term payments and therefore the impact on longer-term export performance would be limited.

In FX floor arrangements not just the nominal exchange rate, but also the real exchange rate, needs to be considered. The stronger the commitment to the FX floor and the longer the FX floor period, the larger the exchange rate pass-through into consumer prices. This could eventually lead to an

earlier and probably stronger acceleration of the consumer price growth. This would also lead to an earlier and stronger real appreciation of the Polish zloty (thus reducing its potential to nominally appreciate after the FX floor exit).

There are also other considerations the NBP would need to take into account. FX floors may encourage large inflows of foreign capital, especially when the arrangement is temporary and the local currency is weaker than the "fair value" perceived by market participants (as it is now). To minimize such inflows, the NBP would need to coordinate its actions with the Finance Ministry and the latter might need to limit issuances to limit available "investable" assets for foreign investors. Taking into account the large scale of fiscal easing in response to the pandemic shock, a reduction of issuances in the near term seems unlikely, at least for now.

The NBP would also need to be ready to consider a system of tiered interest rates in order to discourage inflows. In such a system, a limited pool of liquidity could be placed at the central bank at a standard deposit rate, while amounts above this threshold would be covered by a negative rate. At the moment such an arrangement is not necessary, but it might be useful if the NBP really wanted to introduce an FX floor and make it effective.

An unconventional toolkit completed

The decision to start FX interventions expanded the unconventional policy toolkit. In March 2020 the National Bank of Poland announced the launch of an asset purchase program (QE), which aimed to change the structure of long-term liquidity in the banking sector, improve liquidity in the secondary market of purchased bonds and strengthen the monetary transmission mechanism. The central bank did not commit to any particular QE envelope and adjusts asset purchases in response to changes in market conditions. This makes the asset purchase program look more like a yield curve control than quantitative easing. Furthermore, in recent quarters NBP governor has actively used forward guidance, announcing that rates will remain low at least until the end of his term (mid-2022). Finally, the FX interventions that were started in December 2020 show the NBP is ready to enter the FX market in order to ensure loose monetary conditions or achieve other policy goals.

All the above changes allow the NBP to have a more significant impact on monetary conditions in the period when nominal rates are already at a zero lower bound. Some of the tools may not be regularly used (FX interventions) or may be used to a much smaller extent than in the past (QE), but they offer the central bank flexibility to respond to potential shocks. In these circumstances the NBP should be able to avoid further interest rate cuts that would push the policy rate below zero.

The clear message from recent policy actions is that monetary policy will remain accommodative for long. We expect the policy interest rate to stay unchanged (0.1%) at least until mid-2022 and, if anything, in this period rate cuts seem more likely than rate hikes. First hikes might be delivered only in late 2022, but even this scenario is strongly conditional on future growth and inflation trends. Should the growth disappoint, the period of low rates could be significantly longer than is currently expected.

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