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### **Why has monetary policy proved unsuccessful? How to limit the spread of the crisis?**

The rate of spread of this economic crisis and the crisis of confidence are both very unsettling. The inter-bank market has practically ceased to exist, with institutions that ought to enjoy public trust not even trusting each other. The reputations of the largest banks in the world lie in ruins. The banks are not granting credits because borrowers are now seen as less reliable due to the global economic downturn. Emotions dominate the stock markets, and the market has stopped evaluating companies' real value. People's antipathies towards the banks are growing, as is anger towards foreign investors. At any moment social problems could start to dominate political decisions. Even if the new safety net financial security architecture in Europe and world-wide proves successful over the next few months, one will need to wait a little longer for the situation to be calmed and for a return to confidence in the markets.

It is worthwhile bearing in mind that under a classical economic cycle, a lowering of interest rates usually induces economic expansion, as the cost of borrowed money for companies is lower and at the same time people's willingness to take credits is higher, thus stimulating demand. As the banks expand credit, the quality of bank assets improves, credit policy is liberalised and credit sellers are rewarded in a commensurate system.

If economic expansion is excessive, which is usually evident in inflationary pressures, then raising interest rates is in turn a good instrument for cooling down the economy and curbing inflation.

In a period of economic slowdown, when prices of credit rise and the quality of banks' assets falls, credit procedures become more restrictive and as a consequence credit expansion undergoes a slowdown.

Classical monetary policy, if it well identifies the rising phase of the economic cycle and the economy's lagged reaction phase, can be an effective instrument in balanced economic growth. However, in Poland the current situation is different. The economic slowdown is imported from outside, and is also burdened by the infection of falling confidence. **The crisis**

**in Poland is not a classic financial or economic crisis.** Until recently, the credibility of renowned strategic investors in Polish banks enabled relatively cheap access to borrowed capital on the financial market and also for a financing of own expansion on the basis of loans from mother companies. This situation changed dramatically in the fourth quarter of 2008. The availability of credit on foreign financial markets after the fall of Lehman Brothers was reduced sharply. This caused severe difficulties on the domestic financial market in the host countries despite the universal belief that being owned by strategic investors in host countries meant that banks would be able to underpin the security of the financial sector. It is hard to expect daughter companies to garner much confidence on the local interbank market in a situation where the mother company has little confidence on the global market.

Currently in Poland (February/March 2009) on the credit-deposit market we are witnessing a mechanism that is typical for a shortage economy.

In Poland, the value of granted loans exceeds the value of deposits by about 15-20%. In conditions of limited access to external sources of financing, the banks are offering interest rates of 7-9% on the deposit market, against an official cost of money on the interbank market of 4-5%. The problem is that the price on the imperfect interbank market is not representative. Transactions on the inter-bank market have been replaced by repo type transactions, that is between the central bank and commercial banks. Market prices of money have been replaced by centrally planned prices. The NBP, as other central banks, instead of fulfilling its function as bank of last resort, has turned into a bank of only resort. The extreme cost of obtaining money by banks has for several months exceeded the price of previously borrowed corporate credits and mortgages, for which the WIBOR is the reference price. In such conditions one cannot be surprised that banks are not inclined to sign new credit agreements. Paradoxically, in this situation a further cut in interest rates by the MPC has the reverse effect to that intended. Rebuilding confidence in the interbank market has a fundamental importance for rationalising credit risk. In the current situation a further cut in interest rates by the MPC might have the opposite effect to those that would be intended.

In shortage conditions funds for financing credit activity have, moreover, changed banks' behaviour. Credit sellers have stopped being rewarded according to the quantity of their sales. They receive a set limit of funds for credit activities and the motivation system has been directed towards maximisation of benefits for the bank within these set credit limits.

Maximisation of fees and commission from the narrow limited pool of funds has replaced maximisation by volume of credits. The WIBOR has ceased in this situation to fulfill a price-setting function.

Further rate cuts in conditions of shortages of funds for financing credit activities will not lead to expansion, but may actually create problems for example in terms of a further depreciation of the zloty.

If we consider the effectiveness of monetary policy in a situation of a shortfall of funds for financing credit activities these conclusions would appear rather obvious. Only activity that lowers this shortfall can be effective. For example, there is no justification for Poland's level of reserve requirements to be higher than the level set by the ECB. In the current circumstances the level of reserve requirements in Poland should be close to zero.

The shortfall of funds for financing credit activities has two different causes. Firstly, from the objective external conditions of limited possibilities of obtaining funds and, secondly, from the beneficial (for banks) possibility of depositing their own funds at the NBP.

It may turn out that lowering interest rates on banks' deposits in NBP accounts is an effective way of limiting shortfalls on the credit market. This restriction would be a financial cushion for excessively cautious banks. Reducing deposit rates for *overnight* deposits appears to be urgently required.

It would also be important to consider introducing limits on banks' sales of bonds, which currently represent an easy access substitute instrument for credit activity.

Immediate preventative funds – which would restrict further importation of the crisis of confidence to the Polish banking sector - are also important.

Among those that do not reach into the taxpayer's pocket, it is important, firstly, to eliminate the evident conflict of interest of those institutions that regulate the credibility of market participants. We have in mind here in particular ratings and auditing firms, which provide information for market participants and are paid by those they rate and audit. In this situation the suspicion is aroused that one can buy a good rating for papers issued or a positive

evaluation for an audited report. It may be worthwhile entrusting the selection of an external auditor for a public trust institution, for example, to a supervisory organ and not to units of the banks. Moreover, in the current situation, which is without doubt untypical, it would be advisable to contract a financial market supervisory body whose function has to date been fulfilled by the ratings agencies. Supervisors in collaboration with central banks should vet the credibility of financial market players via a transparent publicised process, for example, a pointed evaluation of their financial credibility. This proposition will probably meet with opposition from supervisory bodies, as it would in effect increase their co-responsibility for the situation on the financial market. Publication of transparent and quantified evaluations of financial credibility by supervisory bodies would, however, be part of a preventative mission by the supervisory bodies and in any situation in which a ratings agency became compromised it could help restore market participants' confidence. It seems that in the current situation there is no way the supervisory institutions, paid for by market participants, could avoid responsibility for restoring confidence in the financial markets.

It is also important to suspend the auction of bank prices on the deposit market, this being connected with moral hazard stemming from the defence of deposits by the Guarantee Fund Bank (BFG). The simplest way to do this is by limiting defence of deposits to those whose annual interest rates do not exceed those set, for example, by the Finance Ministry maximising acceptable levels of interest rates on a yearly scale. The interest rate deposits above set by the Finance Ministry's level would not be necessary to defend. We would in this way avoid threats to financial stability resulting not only from a rise in the volume of expensive deposits in banks, who as a consequence of moral hazard would not be in a state to effectively manage them and they would become unprofitable, but would also limit cost pressure for a rise in credit prices for companies and individuals. Setting the maximum limit on deposit interest rates that would be defended by the FSO would, however, ultimately be necessary if other instruments and the FSO's own activities limited the auction price and moral hazard on the deposit market turned out to be ineffective.

The proposals outlined here are far from perfect and are certainly incomplete. It seems that their advantage lies in the possibility of their relatively fast introduction and the avoidance of using tax-payers' money. Indeed, before using tax-payers' money it is worthwhile weighing up if practically costless anti-crisis solutions are in fact possible at all.