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Poland Economics Flash

Where is the money?

- **On Friday the central bank in its weekly open market operations sold only PLN 55.8bn of cash bills.** This signals a significant drop in the banking sector excess liquidity in recent months, especially as compared to PLN 101.7bn of cash absorbed in October (Figure 1). The market is reacting to tighter conditions by pushing the money market rates higher.
- **Is Finance Ministry hoarding zlotys in the NBP?** Over last two months the central bank increased its FX reserves by €8.5bn but this has not led to a corresponding increase in the zloty liquidity. The intuitive explanation is that the Finance Ministry has decided to keep the money at the deposit with the NBP, a decision that would effectively 'eliminate' the money from the banking system as it wouldn't be available for commercial banks. However, this is not a valid explanation in our view. According to our estimates the stock of government's zloty deposits at the central bank actually remained stable this year - the last data for April was 4bn and showed no increase despite rising FX reserves (Figure 3). Therefore there is no sign that the Finance Ministry was taking the zloty deposits from the banking sector to the central bank. However, the data shows also there was a substantial increase in government's FX deposits in April (by PLN 13bn to 22.7 bn) and most likely also in May. This suggests to us that at least until end of May the Finance Ministry did not convert EU funds into zlotys but kept them at the NBP, most likely preparing itself for possible interventions after UK referendum. If the Ministry is not converting EU funds into PLN, it is no surprise there is no corresponding increase in liquidity.
- **What happened to open market operations?** The fact the Finance Ministry refrained from converting EU funds may explain tight liquidity conditions in recent weeks but it is worth noting that the size of open market operations has been shrinking for some time already. In our view this is partly related to significant increase cash holdings by households and firms. Figure 5 shows that the increase in cash holdings fully explains the decrease in excess liquidity from Jan15 to May16 (and explains more than half of the decrease after October 2015). Low interest rates, lack of inflation and possibly the increase in grey economy contributed to a sharp rise in demand for cash, thus changing liquidity environment for banks.
- Obviously the central bank can simply ignore the trend and see the excess liquidity evaporate. This would have significant impact on how the money market operates and would mean an upward pressure on market rates. **If this is the case the NBP will need to be ready to provide liquidity to the market. Alternatively, the NBP could consider lowering of the reserve requirement.** Currently the required reserve ratio stands at relatively high level of 3.5% and its reduction by 1% point would release approximately PLN 10bn in liquidity in the banking sector.

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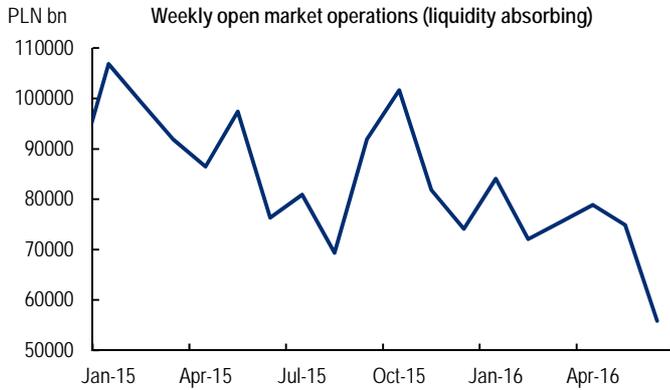
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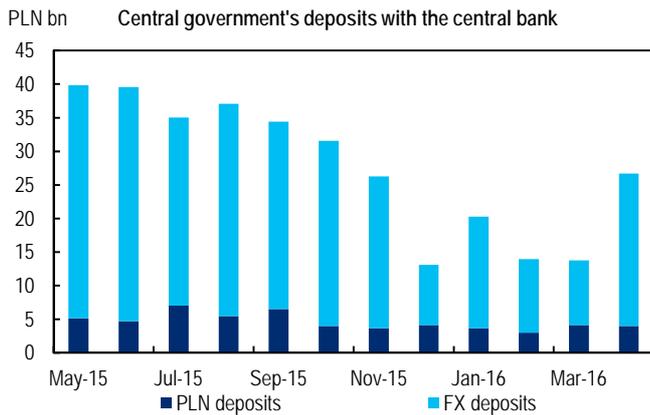
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Figure 1. Excess liquidity of the banking sector is shrinking rapidly



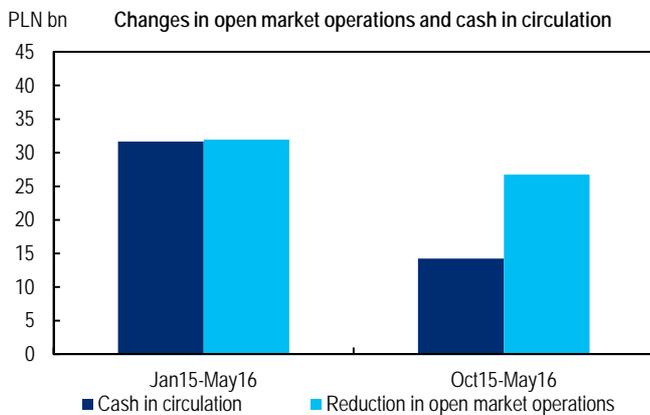
Source: NBP, Citi Handlowy Research

Figure 3. Finance Ministry has not increase its PLN deposits at the central bank



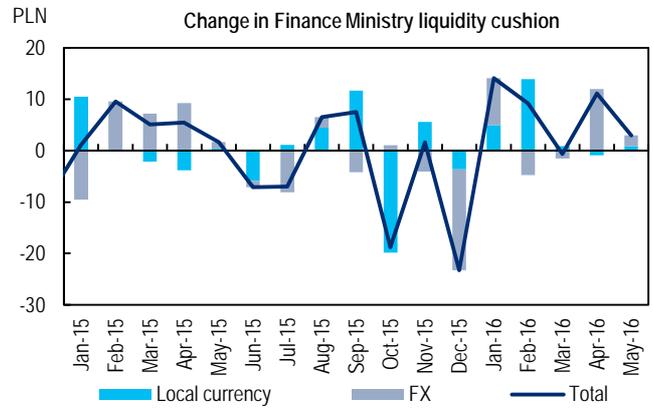
Source: NBP, Citi Handlowy Research

Figure 5. Rising cash holdings explain a deterioration in the banking sector's liquidity conditions



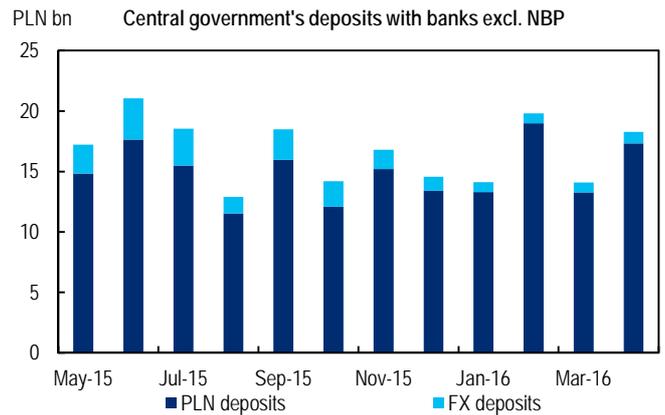
Source: NBP, Citi Handlowy Research

Figure 2. Finance Ministry saw its FX cushion rise in April and May but no significant increase in local currency liquidity buffer



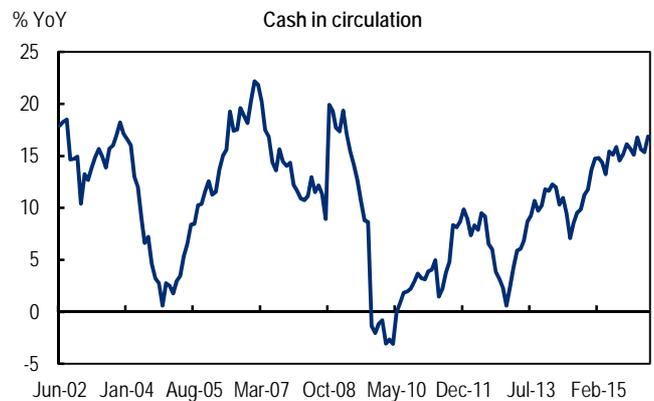
Source: MF, Citi Handlowy Research

Figure 4. There was only moderate increase in PLN deposits with commercial banks but this did not help the liquidity



Source: NBP, Citi Handlowy Research

Figure 6. Larger grey economy, low rates and lack of inflation contributed to an increase in cash holdings



Source: NBP, Citi Handlowy Research

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