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Inaugural lecture

Credibility of anti-crisis policies

It is my great honour to deliver this inaugural lecture at the commencement of a new academic year, a ceremony that takes place in exceptional circumstances. These very circumstances are behind the choice of the subject of today's lecture. The central issue arising from them now concerns the economic consequences of the COVID crisis. There is no doubt that the economic consequences of this crisis for the global economy, including the Polish economy, will be comparable with the effects of the Great Depression of the first half of the 20th century, the global financial crisis of the beginning of this century, and given the possibility that the epidemic may have a recurrent nature, these effects may even exceed what we have experienced in the past.

Today, there is also no doubt that offsetting the effects of the crisis requires state intervention, an intervention on an unprecedented scale. Even the most radical advocates of economic liberalism are not calling for things to be left to sort themselves out. But given the scale of potential actions and costs of anti-crisis policies, the issue of credibility of government declarations and actions assumes extreme importance, as, in economic terms, only a credible anti-crisis policy can be effective. By taking various actions, the government must convince the public, domestic businesses and financial markets of the credibility, adequacy and effectiveness of the measures it has taken.

Therefore, a question may be asked as to what are the preconditions for the credibility of not just anti-crisis policies but of broad economic policy. In my opinion, these include:

1. the existence of an appropriate economic theory underlying economic policy,

2. the existence of appropriate institutional and legal solutions based on this theory,

3. the ability/propensity of state authorities to comply with the existing institutional and regulatory regime,

4. adequate communication with the public.

The theoretical foundations of macroeconomic policy, which, at least formally, is still being pursued in practice today, were developed and implemented in the last two decades of the 20th century. These foundations were based on:

- the Rational Expectations Theory,

- the Real Business Cycle Theory,

- the Effective Financial Markets Hypothesis.

These three important theories result in specific presumptions concerning institutional solutions and macroeconomic policy.

Firstly, in an economy in which rational economic agents operate, economic fluctuations are caused by factors of a real nature and financial markets appropriately value financial instruments, there is no need for government intervention in the course of economic processes. Indeed, by disrupting the functioning of the market mechanism, government interventionism may be a source of economic shocks, hence the suggestion of the most far-fetched economic liberalism.

Secondly, monetary policy should be the primary tool of macroeconomic policy. Fiscal policy should aim for a balanced budget, at least within the framework of the business cycle.

Thirdly, the only, or at least the most important, goal of the central bank is to maintain the value of the currency, i.e. ensure low and stable inflation, as such inflation constitutes the foundation of stable economic growth.

Fourthly, an interest rate policy aimed at determining the level of short-term interest rates on the interbank market which is consistent with the implementation of the inflation target is the primary instrument of central banks' policies.

This general concept underlying the construction of the macroeconomic policy mechanism should be augmented by additional measures ensuring that they are complied with in economic practice. These solutions include:

- the principle of central bank autonomy,

- legal regulations regarding budgetary discipline, e.g. by introducing limits on public sector debt and deficit, or so-called fiscal rules.

The last condition for credibility involves appropriate communication with the society, domestic businesses and financial markets on the part of institutions responsible for conducting macroeconomic policy. The central bank plays a pivotal role in this respect.

Such solutions were successively implemented in the 1990s in many countries, including Poland. The Constitution, adopted in 1997, laid down restrictions on public debt and introduced the principle of central bank independence, entrusting the bank with the task of maintaining the value of the currency. The latter measure was specified in 1998, when the Monetary Policy Council adopted the inflation target as the basis of monetary policy operations.

The economic policies conducted in accordance with the above principles brought about very good outcomes. The period from the late 1980s to the beginning of the financial crisis of the first decade of this century was a period of high growth, low unemployment and low inflation. Relevant literature dubbed it the Great Moderation, and many economists considered that the central problem of macroeconomics – the problem of economic fluctuations – had ultimately been resolved.

In 2003, at a meeting of the American Economic Association, Robert Lucas, one of the main fathers of the revolution of rational expectations, stated that macroeconomics should no longer deal with the business cycle, because its hitherto central problem of recession prevention had been practically resolved. A similar view was formulated in 2004 by Ben Bernanke, the later Fed chairman, who said that the problem of the business cycle, if not finally resolved, had been reduced to the realm of marginal issues that did not warrant special attention. Even in 2008, a few weeks before

the collapse of Lehman Brothers, Olivier Blanchard, the later chief economist of the International Monetary Fund, stated that while there were some imperfections or differences of opinion on some specific theoretical issues or practical solutions, macroeconomics was in good shape.

The global financial crisis of 2008 brutally refuted these views. On theoretical grounds, it turned out that the participants of economic life are by no means rational, financial markets are not effective and economic crises have their sources also, and even above all, outside the real economy.

On the other hand, economic practice saw a departure from the previously developed institutional solutions and previously pursued principles of macroeconomic policies, even if that was not accompanied by any formal declarations. The most significant changes include:

1. Departure from the policy of balanced budgets used as the main instrument of stability and stimulus policies, which led to a sharp increase in budget deficits and public debt in most countries.

2. Departure from previously developed principles of monetary policy through the use of unconventional tools, including in particular:

- the so-called quantitative easing, i.e. central banks' buying of securities not to control the level of banking system reserves, but to support governments and further to support selected areas of the economy,

- low/zero interest rate policy,

- using money issuance to finance public spending.

In the 10 plus years that passed since the outbreak of the global financial crisis, the macroeconomic policy of major world economies underwent some transformations, although formally speaking, the theoretical and institutional foundations of macroeconomic policy were not put into question. The only significant systemic change introduced in this period consisted in increasing the regulatory and supervisory functions of the state, especially with regard to the banking sector.

Attempts were also made to return to the original assumptions of macroeconomic policy, i.e. reduction in public sector debt and deficits, reduction in the so-called quantitative easing or occasional interest rate increases to signal the return of monetary policy to its primary goal, namely controlling inflation. Generally speaking, these attempts should be considered as unsuccessful.

More than 10 years after the crisis, basic macroeconomic relations were less favourable than prior to the crisis. First of all, on a global scale, public debt was much higher than it was before the crisis of the first decade of the 21st century. The public debt of the G-7 group swelled from 82.5% of GDP in 2006 to 118.7% in 2019, and from 68.3% to 84.1% in the Eurozone area. The public sector debt of developing countries also increased significantly from 36.7% to 53.2% of their GDP.

One of the most important innovations in macroeconomic policy during the crisis was the use of reserve money to support the public finance sector and to stimulate economic growth. As a result of the so-called quantitative easing,

the balance sheet totals of major central banks grew significantly. The Fed's balance sheet spiked from USD 870 billion in 2006 to USD 4,166 billion in 2019. At the same time, the ECB's balance sheet increased from EUR 1,150 billion to EUR 4,671 billion.

Despite the use of simultaneous fiscal and monetary stimuli on an unprecedented scale, economic performance was disappointing. The average annual GDP growth over the 11 years from the start of the 2008 crisis was lower in the G-7 countries by 45%, in the European Union by 57% and in the USA by 43% on the 11 years before the crisis.

The economic policy pursued for the last 10 years has no clearly defined theoretical foundations. We do not know what will be the long-term effects of an economic policy in which budget deficits and public debt have no caps, central banks pursue a policy of unlimited issuance of reserve money to directly finance public spending and apply zero or even negative interest rates. The only school of economics that could offer theoretical foundations for such a policy is the so-called Modern Monetary Theory, but its influence is limited.

Formally speaking, Poland is in a much better shape than many highly developed countries. The public-debt-to-GDP ratio in 2019 was similar to that in 2006 (around 46% of GDP). The situation of the National Bank of Poland changed only slightly. Although the NBP did not implement the so-called quantitative easing through the purchase of securities, yet its balance sheet total also increased notably, from PLN 155 billion in 2006 to PLN 509 billion in 2019 (3.3 times). However, the main factor behind the increase in its balance sheet total was an increase in foreign exchange reserves rather than the purchase of securities. Foreign exchange reserves rose from PLN 147 billion in 2006 to PLN 506 billion in 2019. The sources of the increase in the balance sheet total of the central bank are of significant importance - an increase in the balance sheet total of the central bank due to the accumulation of foreign exchange reserves is more favourable than an increase occasioned by the purchase of domestic securities. Moreover, prior to the beginning of the current crisis, the NBP pursued a conservative interest rate policy, maintaining positive real interest rates.

Over the last thirty years or so, the growth of the Polish economy has been not only relatively fast, but also sustainable. Overall, throughout the entire period in question, the Polish economy maintained internal and external equilibriums. The fast and sustainable economic growth was acknowledged by international financial institutions, which was duly reflected in the ever higher credit ratings assigned by rating agencies, which, in turn, had a significant impact on the availability of foreign financing and its cost.

Starting in 1995 when the major rating agencies made their first assessments, government securities advanced from a speculative level to an investment-grade level. The interest on the national debt was also falling. At the beginning of 2000, the interest rate on 10-year treasury bonds stood at 10.54% compared to 1.36% in September 2020, following a persistent downward path throughout the period. It is worth emphasizing that even during the most acute phase of the global financial crisis (2008-2009) and the subsequent crisis in the euro area, the interest rate on Polish bonds did not increase, but in fact decreased significantly from about 6.6% at the time of the collapse of Lehman Brothers to below 2% in early 2015. These trends resulted from the adoption of clear solutions in the field of fiscal policy (constitutional debt limits, the Stabilization Expenditure Rule), monetary policy (inflation target, central bank autonomy) and compliance with existing rules.

To recapitulate this part of the speech, I should like to state that hardly had the global economy managed to recover from the effects of the previous crisis, than it plunged into yet another crisis in 2020, the effects of which will probably exceed what happened during the previous crisis. The expenditure both declared and effectively incurred to counteract the effects of the crisis cause (will cause) a further significant deterioration of the fiscal situation of most countries, developed and developing alike. There will also be a further increase in the issuance of money by central banks by means of more intensive quantitative easing, mainly to support public sector spending. Data on public finances and central banks for the first half of this year fully corroborates this claim.

According to IMF estimates, the ratio of public debt to GDP in developed countries will rise from 105.2% in 2019 to 122.4% of GDP at the end of 2020, in the Eurozone from 84.1% to 97.4%, in the USA from 109% to 131.1 %, and in developing countries from 53.2% to 62%. Of course, actual debt may differ from these estimates depending on how the COVID-19 pandemic unfolds. However, these estimates predict a significant worsening of the situation.

We can already say today that there has been a sharp increase in the reserve money supply. During the first half of 2020, the Fed's balance sheet increased from USD 4.127 billion to USD 6.970 billion, i.e. by almost 70%. At the same time, the ECB's balance sheet rose from EUR 4,671 billion to EUR 6,351 billion, i.e. by 36%. Similar increases were reported by other important central banks (Bank of England or Bank of Japan). What is particularly important is the fact that these increases are mainly the result of central banks purchasing government securities – financing deficits of the public sector in the Eurozone or the US would not be possible on market terms, therefore central banks have resorted to money printing. While during the previous crisis, we also witnessed unprecedented increases in reserve money, it should be noted that the immediate reasons for the issuance were somewhat different. In the first place, the increase in money supply by central banks was aimed at resolving the liquidity crisis in the banking sector, whereas now the primary goal is to ensure the inflow of money into the public sector. As we can see, the bosses of the world's major economies decided to exploit central banks in a manner which is unprecedented in history, or to put it simply – to have them print money to mitigate the effects of the current crisis.

The Polish economy, like the economies of almost all countries in the world, has been affected by the effects of the pandemic. As a result of the lockdown, as well as other effects of the pandemic, Poland's GDP in the second quarter of this year contracted by over 8% on the second quarter of the previous year. Clearly, such a decline in GDP must have had a significant impact on Poland's socio-economic situation, in particular the situation of the public finance sector. Financial non-returnable aid for businesses and citizens, coupled with a decline in the revenues going to the public finance sector due to the reduction of economic activity has had a significant impact on the situation of this sector. The increase in the debt and deficit of the public sector should be treated as an inevitable consequence of the crisis that hit the Polish economy. Of course, the scale of assistance, its manner and time of delivery, as well as the conditions under which this assistance is offered, are of significant importance, as they determine the effectiveness of the actions taken and their credibility.

We will be able to assess the effects of the anti-crisis policy of our country's authorities in a few quarters' time, when it will be known how the basic macroeconomic indicators including GDP, unemployment, budget deficit and

public debt have evolved. Today, however, we can try to answer the question of whether by taking measures to combat the crisis, the Polish government acted in a manner conducive to strengthening the credibility of the policy pursued, or whether these measures may undermine long-term credibility, which will be of significant importance for the course of important economic processes in the future, may favour strengthening of consumers', investors', financial markets' confidence, which, in turn, will affect the dynamics of economic growth, access to financial markets, costs of borrowing, etc.

It is imperative to answer two questions. Firstly, will the economic policy being pursued be conducive to maintaining the macroeconomic equilibrium or will it undermine the very foundations of this equilibrium? Secondly, will the policy be credible?

It is clear that in conditions of a severe economic downturn, the actions taken the government and the central bank must be unconventional. An increase in the budget deficit and public debt or an unconventional approach to monetary policy are not the main problem. The problem is how these actions are implemented, how they are communicated and whether there is a broad consensus on how to take them. From this point of view, the policy pursued by the government and the central bank is questionable.

Analysing the steps taken by the government, it is possible to identify several disturbing actions.

Firstly, the finance minister was absent from the debate on how to overcome the effects of the crisis, especially in its initial stages. One could have the impression that the competences of the minister of finance had been taken over by the president of the Polish Development Fund (*PFR*). Hence, there is a concern that decisions regarding the spending of public funds are, and will be, taken by bodies without appropriate constitutional prerogatives, which undermines the legality and credibility of the actions taken.

Secondly, the impact of anti-crisis measures on the situation of the public finance sector is unclear. On the one hand, the public is informed about the unusually high spendings to tackle the effects of the crisis, and on the other, the impact of these largely non-returnable funds on the public finance sector is downplayed. In the draft amendment to the 2020 budget, the deficit was fixed at PLN 109.3 billion (revenues lower by PLN 36.7 billion, and expenses higher by PLN 72.7 billion). Meanwhile, the mass media reported the cost of the crisis to total at least PLN 300 billion. In his interview for the *Rzeczpospolita* daily, Deputy Finance Minister Piotr Patkowski stated that the costs of tackling the crisis amounted to PLN 260 billion. This means that at least 2/3 of the costs of the crisis were hidden outside the state budget.

As a consequence, we do even not know what the real debt of the public finance sector is. In practice, there are two definitions of public debt: one domestic and one EU. In the draft budget act for 2021, public debt at the end of 2020, according to the national definition, is to amount to PLN 1,132 billion (50.7% of GDP), while according to the EU definition it stands at PLN 1,391 billion (62.2% of GDP). Even greater discrepancies concern the 2021 figure: according to the national definition, public debt is to amount to PLN 1,246.2 billion (51.6% of GDP), and according to the EU to PLN 1,523.8 billion (64.7% of GDP).

Thirdly, regulations aimed at ensuring public finance discipline are being dismantled. The act suspending the Stabilizing Expenditure Rule was passed. The Minister of Finance said that there was no point in maintaining artificial regulations in the form of a limit on the debt of the public finance sector in relation to GDP. While understanding the complexity of the current situation in the public finance sector, one cannot agree to treat constitutional and statutory restrictions as something that can be eliminated in the face of emerging difficulties. It should be emphasized that a discussion on these topics is possible and even desirable. Changes to the constitutional limits of debt require concerted action by the country's main political forces. Any change (suspension) of constitutional provisions relating to public debt would have to be accompanied by solutions that would not allow for their complete elimination from Polish law.

Monetary policy has also undergone significant changes. The National Bank of Poland (NBP), following the example of other central banks, began implementing an unconventional monetary policy, also violating the existing legal regulations.

Firstly, the NBP President openly and unequivocally stated that the central bank would buy government securities without restrictions, thus breaking the constitutional ban on financing state budget expenditures by issuing money. It is not a problem when sovereign debt is bought on the secondary market. The NBP is permitted to buy securities, especially government securities, on the secondary market, but for the purposes of conducting monetary policy, i.e. shaping banking system's reserves in a way that will enable the interest rate on the interbank market to be maintained at the level of the reference rate. Meanwhile, the banking sector has been experiencing excess liquidity for many years, which increased from around PLN 100 billion to around PLN 200 billion after the NBP became involved in buying government securities. The purchase of treasury securities by NBP is not intended to combat the lack of liquidity in the banking sector, as such liquidity is adequate or even excessive.

Secondly, the NBP launched a policy not aimed at controlling inflation, but at achieving other goals (supporting the government, supporting the economy by directly influencing selected segments of the economy or generally by influencing the so-called yield curve), which is contrary to the provisions of the constitution.

Thirdly, the NBP joined the league of central banks which pursue a policy of low (zero) interest rates. This means that practically speaking, the possibilities of exploiting interest rates to stimulate economic activity and pursuing an anti-deflation policy have been exhausted.

Fourthly, conditions were created for using the central bank to absorb, either temporarily or permanently, part of the budget deficit. The structure of the Polish Development Fund's bond issue and trading mechanism enables such activities, which would allow for a kind of "parking" of the debt with the NBP and thus a formal reduction in the debt-to-GDP ratio below the constitutional limits.

The above-mentioned actions of the government and the central bank led to the dismantling of the macroeconomic policy mechanism, which over the last twenty years has brought positive outcomes, favoured the achievement of high growth rates and made it possible to gain credibility among foreign partners and domestic participants of the economic life.

Coming back to the issue of pre-conditions of the credibility of macroeconomic policy formulated at the beginning of this presentation, it can be said that they have been practically dismantled. Today we do not know:

- what the theoretical foundations of macroeconomic policy are,

- what formally binding institutional and legal solutions constitute the basis for actions taken by the government and the central bank,

- to what extent state authorities are willing to comply with the existing institutional and regulatory regime,

- to what extent the real economic situation of the country, especially the situation of the public finance sector, is communicated to the society.

I am aware that nowadays, not only in Poland, but on the global scale, there are no clear answers to these important questions. It will probably be many years before the economic theory deals with these problems and, consequently, appropriate institutional solutions are developed. This does not mean, however, that in the meantime the economic policy allows the use of *any* solutions. In our country, we have to acknowledge that in real terms the constitutional limits of debt will be exceeded. We can, of course, ignore this obvious fact and, resorting to creative accounting, create any virtual reality. As long as, even in real terms, Polish public debt in relation to GDP is at a moderate level, the discrepancy between the reality and the fiction created will not be of great importance for the assessment of Poland's credibility. However if certain, although difficult to clearly define, limits of the real debt are exceeded, then the official data on these ratios will not matter in the least. The history of the last few decades provides many cases of a painful clash between reality and fiction, a fact that should be borne in mind when conducting macroeconomic policy.

Thank you.