CURRENCY MARKET

Zloty Free at Last

The Polish złoty had a volatile start on its first day of free trading as dealers struggled to find a level for the currency after the central bank abolished the last restrictions on its movement.

The National Bank of Poland (NBP) late on April 11 scrapped the złoty's trading band and the parity rate which referenced its value to the dollar and the euro, finally leaving the market alone to judge the currency's worth.

The surprise removal of the guide mechanisms was initially greeted with enthusiasm, driving the złoty up from 4.158 against the dollar to a high of 4.065 before profit taking set in. By mid-afternoon April 12 the złoty had slipped to 4.1415 in cautious trade and was at 3.9655 against the euro. "The złoty should stabilize now, but where?" asked Piotr Konarski, senior dealer at Westdeutsche Landesbank in Warsaw. "Its not clear. It could go either way, down or up."

However, the change in values brought by the flotation was limited, since the trading band had been 30-percent wide and the monthly devaluation rate, which adjusted the currency for high domestic inflation, was only 0.3 percent. Analysts and dealers were digesting the wider implications of the float, which the central bank said would help its fight against inflation and was necessary to pave the way to membership in the European Union (EU) and eventually the Euro currency.

Dealers would have to rely more on technical analysis and economic indicators to guide trade, while the increased exposure to forex risk...
would lead to a gradual expansion of the Polish derivatives market, particularly for corporate clients.

The central bank says the greater exchange rate risk accompanying the float will help to stabilize the currency. And by removing any hint of an exchange rate target, the bank will be free to focus on the fight against inflation. "It was done to fulfill direct inflation targeting," NBP President Hanna Gronkiewicz-Waltz told reporters. "I'm not interested in the level of the exchange rate."

"Getting rid of the trading band frees their [Monetary Policy Council's (RPP)] hands," said James Owen, an economist at SG Bank in Warsaw. "They don't want to be tied by exchange rate commitments."

The central bank wants to cut inflation from an annual rate of 10.4 percent in February to 5.6-6.8 percent by December and has complained that exchange rate concerns have been a distraction in its overriding quest to limit price growth.

But the NBP's gamble that it can ignore the zloty's levels may not pay off. Analysts say the already strong currency may appreciate further, damaging exports and widening the already dangerously large current-account gap. The RPP has pushed up interest rates three times since September to try to force down domestic demand and limit inflation. This has increased yields on Polish debt and sharply boosted the zloty, hitting exports.

"In the longer term, after a period of volatility, macro-economic fundamentals will cool appreciation speculation, because the only effect of the float is an increased exchange rate risk," RPP member Boguslaw Grabowski told Reuters.

Asked if the council had floated the zloty with curbing the current-account gap in mind, Grabowski said, "Of course. One cannot shield foreign capital from the exchange rate risk-capital which is drawn by high interest rates kept high to meet the inflation target," Grabowski said. "We would be increasing the current account deficit if we were still protecting foreign investors from the exchange rate risk while implementing our policy of direct inflation targeting." Grabowski said the council was aware that despite the float, Poland's interest rate differential would keep attracting large amounts of speculative capital. "The government and parliament should be aware of this, because they effectively decide the level of interest rates by setting the level of budget deficit," he said.

"Looking at the tone and rhetoric of the central bank, the element of additional risk created by the flotation was underlined," said Krzysztof Rybinski, chief economist at ING Barings in Warsaw. "This suggests that they [the NBP, the RPP and the Ministry of Finance] would be very worried if the flotation was followed by a strong zloty rise. Over the last
three weeks we have counted seven verbal interventions against the zloty by RPP members."

Analysts said that despite the increased forex risk, Poland remains an island of high interest rates in Eastern Europe, with zloty-asset returns topping those of regionallleader Hungary by 600-700 basis points and the euro zone by 1,400 basis points. "The danger is that until Polish interest rates start to come down, you could get a self-fulfilling zloty bubble," said SG Bank's Owen.

Analysts also said the market may want to test the central bank's will to let the zloty rate be freely set by the market. "In the nearterm the float is positive for the zloty, as the carry has gone up and made the trade more attractive," said Bechara Madi, economist at Morgan Stanley in London. "Some of that attraction has been slightly offset by the implied increased risk in volatility, assuming that the central bank is firmly committed not to intervene on the market either. That commitment has yet to be tested."

The NBP has not intervened on the forex market to halt zloty swings for years, but the zloty had never hit the outer edge of its targeted band, which in itself kept down exchange rate volatility.

"As far as weakening the currency is concerned, the ball is in the government's court. They could either tighten fiscal policy, which is unlikely, or weaken the currency by diverting the sell-off inflows," Madi said.

The government has said it planned to keep at least $2 billion of this year's privatization inflows, now seen around $7 billion, in a special hard-currency account in the central bank, cutting the amount of dollars they have to exchange into zlotys. The rest of the privatization receipts will go to finance the budget deficit, especially the costly overhaul of Poland's social insurance system which started in 1999.

Polish Treasury bonds should be unaffected by the decision to fully float the zloty, Deputy Finance Minister Jaroslaw Bauc said. But debt prices rallied on news the zloty would be floated, depressing yields nearly half a point. "I do not expect investors to start buying Polish bonds rapidly just because the crawling peg has been eliminated," Bauc told reporters.

Analysts said they were surprised only by the timing of the move, not by its substance. "I did not expect this until the second half of the year when there should be signs of improvement in the export sector," said Zsolt Papp, emerging Europe economist at ABN AMRO in London. He noted that the total 30-percent range for the zloty had meant the currency had to all intents and purposes been floating. "In all, it will have very little impact, but it is a very strong vote of confidence in the monetary policy of the central bank," he said. Juliet Sampson,
emerging Europe currency analyst at Bank of America agreed the move would reinforce the benefits of the carry trade but said the implications were more psychological.

M. S. with Reuters