Stefan Kawalec[1]

November 5, 2008

How to safeguard the economy from the crisis[2]

The situation in which the Polish economy finds itself is anomalous and requires an unconventional response. The cost of ignoring the magnitude of the problem and of not implementing the necessary measures will be a more severe economic slowdown and higher unemployment.

Part I – What is the threat to the economy

In the USA and EU authorities are implementing unconventional measures to counteract the paralysis of the financial system

As a result of the crisis, the banking sector and financial markets in developed countries have been paralyzed to a large extent. Credit losses and the breakdown in mutual trust between financial institutions set off a panic reaction from banks. The mechanism of financial intermediary, which efficiently transfers capital from those in possession of savings to those that are capable of using these savings productively, suddenly failed. The economy, lacking access to capital, began to slow down.

In Western Europe and the USA, governments and central banks are implementing radical and unconventional measures to bolster confidence as well as unblock and revitalize the banking system. They are introducing successive recovery packages, pumping money into the banking system and providing guarantees. Proof of the determination of the American central bank (FED) is that in light of the standstill of existing funding channels it has begun to provide direct financing to companies by purchasing commercial paper from issuers.

In Poland there is a mistaken belief that we have not caught the "American disease"

The Polish government and regulators are, with good reason, emphasizing that Polish banks are in very good condition, have high solvency and profitability ratios, and that their portfolios do not have "toxic" assets associated with the risk of the American mortgage loan crisis.

This does not mean, however, that we have not caught the American illness. Polish banks are a part of the international financial system and are owned by large banks from countries affected by the

[1]/ The author is a former Deputy Minister of Finance. He is currently President of the Management Board of the consulting company Capital Strategy (www.capitalstrategy.pl).
[2] / An abridged version of the article was published by "Gazeta Wyborcza" on November 12, 2008.

crisis. Despite the health of our economy and of Polish banks, the Polish banking system is experiencing similar overreaction and "paralysis" seen in countries that are in the center of the crisis.

Statistical data will soon confirm that the economy is slowing down

In September 2008, the Polish economy experienced growth in industrial production (7% year to year), a fall in the unemployment rate and a large increase in retail sales. However, there are some disturbing signals. As a result of banks restricting the flow of loans to real estate developers and to potential buyers of housing, construction has considerably slowed down. Demand for construction steel has therefore plunged . Steel mills, which had record sales in the third quarter of 2008, have experienced a sudden lack of orders and some have been forced to extinguish furnaces. The automotive industry, one of the main sectors of Polish exports, is reeling from the dramatic fall in demand for cars in Europe. More and more companies are expected to begin group layoffs.

Data for the fourth quarter of 2008 will certainly show a less optimistic view of the economy. As a response to this data, analysts will revise their projections for economic growth and banks will further toughen lending criteria because of possible increased credit losses. Tightening credit policies will further slow the economy down.

If no action is taken economic growth in 2009 may fall to 1%

If the authorities do not take action, economic growth in 2009 may be significantly lower not only than forecasted in the budget (4.8%) but also below the forecasts of market analysts, who currently predict a growth rate in the range of 2.5 -4%. It is difficult to say how close the economy will come to a recession but a growth rate of 1%, or even lower, is completely realistic. In light of the fact that labor productivity is growing at a rate of 4% annually, GDP growth of 1% would result in a significant increase in unemployment.

Limited access to credit may become the main factor slowing the Polish economy down

Before I present a proposed plan of action, it is worth taking another look at the factors that will have a slowing effect on the Polish economy.

A significant factor is the global economic slowdown especially in the European Union, which is Poland's major export market. The consequences of a recession in export markets for Polish companies will be, however, partly balanced by the weakening of the zloty. The high price of the euro and the dollar will significantly increase the competitiveness of Polish products. It will also allow many exporters to achieve increased revenues in zlotys despite lower sales volumes.

The second factor slowing the Polish economy down will be the tightening of lending policies. The reason for this tightening is on the one hand, liquidity pressure resulting from the paralysis of the interbank market and financial markets and on the other hand, the huge aversion of banks to take on

further credit risk. There is no evidence of any automatic mechanisms that would weaken the effects of this factor in the near future.

The scale of liquidity pressure is higher than it may seem

In the European Union the value of bank loans is 40% higher than the value of deposits. In Poland the financing disparity or the value that loans exceed deposits is relatively much smaller. Taking into account the loans and deposits of national and local government entities as well as non-banking financial institutions, it amounted to PLN 44 billion or 8% of total deposits. Under normal conditions, banks would have no difficulty to finance this disparity by borrowing from their foreign parent companies, issuing commercial paper on the international market or borrowing from other Polish banks. All of these financing sources have basically dried up.

In the current situation, it is not enough to look at the aggregate value by which loans exceed deposits to assess the scale of liquidity pressure because this would underestimate the problem. The paralysis of the interbank market means that any available funds that banks may have cannot be used for the permanent increase of credit because these funds are deposited in accounts in the National Bank of Poland (NBP) or because only short-term loans of one to seven days are offered. The amount of deposits "frozen" in this manner in banks with a surplus of funds is estimated to be PLN 65 billion but it may be even greater. This means that in the group of banks with loans exceeding deposits, the difference amounts to approximately PLN 109 billion zloty (the sum of PLN 44 billion disparity in the entire banking system and PLN 65 billion surplus of deposits in the group of banks with a surplus of funds). The total loan portfolios of banks amounted to PLN 579 billion at the end of September 2008. Making a simplified and hypothetical statistical simulation, it is possible to state that if every bank with more loans than deposits would adjust their lending policies to their deposit base then total loans in the banking system would decline by 19%. It is undeniably clear what kind of shock this would have on the economy and what social costs this would entail.

Risk aversion in Poland may be stronger than in countries of parent companies

A separate factor leading to tightened lending policies is aversion to risk.

In banks a typical consequence of extensive credit losses or of the belief in an impending economic crisis is that the influence of different organizational departments on lending policies significantly changes. In times of prosperity, the leading role is played by sales managers whose aim is to keep the bank's offer competitive in order to attract new clients and transactions. In times of crisis credit risk managers, responsible for minimizing the losses that a bank may incur given a pessimistic macroeconomic scenario, take control .

Over two-thirds of the assets of the Polish banking sector are owned by banks from countries seriously affected by the crisis. Many of these companies have suffered serious losses and have received public financial aid. The foreign headquarters of international banking groups present in the Polish market are currently headed by specialists in credit risk management. The main objective is to maintain liquidity and contain further losses. Banks are analyzing their existing portfolios, creating reserves for assets in jeopardy but mainly they are limiting their credit and off-balance sheet

exposure to certain market segments, industries and specific companies. As is often the case in times of uncertainty, lending policies are then overly tightened.

The paradox of the current situation is that in Poland where there have been no major credit losses and the condition of banks and the overall economy is good, lending policies may be tightened to a greater extent than in countries in which banks have suffered huge losses and the economy is going into recession.

One of the reasons for this paradox is the limits on exposure in specific foreign markets. The global financial crisis and the problems of other countries in our region (Hungary, Ukraine) have led many banking groups to lower exposure limits to Polish risk, thereby constraining activities of their affiliated companies in Poland. At the same time, these banking groups are not restricting their operations in their own countries because they usually do not establish limits on exposure to risk in their own countries.

The second reason for the paradox is the limits on exposure to risk in specific sectors and industries of the economy. The limit for a sector is established for the entire banking group and then divided into countries. If for a variety of reasons it is difficult to limit exposure in the parent country, exposure to this sector in foreign markets is limited to a greater extent. These decisions are in reality made by mid-level managers in the headquarters who do not always understand the Polish economy. The resolutions are then conveyed for implementation to the credit risk managers in Polish banks.

Self-fulfilling negative prognosis

A survey carried out by NBP at the end of September 2008, indicates that banks have already tightened and will continue to tighten their lending policies for both companies and individuals. It is therefore clear that irrespective of other factors, the widespread tightening of lending policies will result in payment difficulties for many companies[3]/. This knowledge will encourage banks to show even greater caution and further toughen lending criteria. If this self-fulfilling negative prognosis is not averted, it will have a devastating effect on the economy.

[3]/ „According to Mart King, a credit strategist at Citigroup, the single biggest factor influencing corporate default rates is banks' willingness to extend credit – as measured by the lending surveys of the Fed and the European Central Bank." (*The Economist*, March 15th 2008, p. 88)

Part II – What can we do?

Implement unconventional measures to preserve access to credit in the economy

In the described situation, in order to prevent the fulfillment of the negative scenario and to limit the severity of the economic slowdown, unconventional measures need to be implemented to maintain access to credit in the economy.

Define a minimum objective

The government and NBP should clearly state that the objective is to ensure a defined minimum level of loans to companies and households in 2009. In the 12 months ending in September 2008, credit growth amounted to approximately 30%. It is not a question of maintaining such a high rate of growth but of avoiding an overly severe slowdown or the very likely scenario of a fall in credit levels. It is safe to assume that to maintain a real rate of GDP growth of 3% with a 3% inflation rate, credit growth cannot be lower than 11%. This would mean a 5 percentage point higher rate of growth than nominal GDP growth, which seems to be a safe assumption given the constant increase of monetization of the economy. At the same time, the government and NBP should declare what actions will be taken to meet this objective.

Provide liquidity and increase funding stability

The NBP and Ministry of Finance should introduce the already declared forms of support for banks. However, in order to achieve a decisive effect and changes in expectations, further reaching action is needed.

In order to restore liquidity and increase funding stability, the NBP should provide banks with access to financing for a period longer than three months and should expand the list of eligible collaterals.

A significant factor may be the provision of guarantees for deposits on the interbank market in the amount of approximately PLN 70 billion. This limit should be administered by the NBP and proportionately divided according to the credit portfolio of banks. This would mean that each bank would have the possibility to finance 10-12% of its loan portfolio through borrowing from other banks under the protection of the government guarantee. This guarantee plan should be introduced independently of the already confirmed individual guarantees, which will be approved on an individual basis. It should be available to all banks automatically. The fee should be uniform and paid not for availability of funds but for funds actually borrowed. The fees should be set at a reasonable level comparable to the market costs of guarantees for a stable bank operating in a calm market.

The universality of the guarantee and its reasonable fee structure are indispensible if the plan is to have any effect on meeting the authorities' objective of increased credit growth in the banking system. Banks making use of the guarantee should therefore not be punished image wise by the requirement of filing individual applications nor should they be required to pay high fees discouraging the use of the guarantee. The risk that the guarantee will provide funds to banks not

meeting security requirements should be eliminated by banking supervision. I will elaborate on this subject later on.

In light of the significant amount of the proposed guarantee, there is a question of what risks and costs the State Treasury faces. In the current situation of a dramatic lack of trust, it seems obvious that irrespective of any formal plan, the authorities cannot allow the bankruptcy of any bank and losses of its creditors. The conclusion is that the authorities will never allow the occurrence of a situation, which would lead to payment of the guarantee provided.

Supervision of solvency and measures for individual banks in trouble

Banking supervision should monitor the solvency and liquidity of banks so that banks not meeting security requirements would not be able to increase the scale of their operations using public support. If a bank has problems, which threaten its operations it should be acquired by another bank or public funds should be used to support the bank against shares taken over by the State Treasury.

Controlling settlement of accounts with parent companies

It is necessary for the NBP and the Polish Financial Supervision Authority (KNF) to monitor the settlement of accounts between banks and their foreign owners. This would prevent a situation in which banks would utilize public aid in order to decrease their debt to the foreign parent company or even provide a loan to their headquarters.

Liberate banks from the panicked instructions of foreign head offices

The KNF should remind banks and their major shareholders that it is illegal to outsource the formulation of lending policies – that is, to delegate to other entities the key task of assessing credit risk and making loan decisions. The majority of large banks in Poland are publicly traded companies with minority stakeholders. The main shareholder – even if it is a bank – cannot provide a bank that is licensed in Poland with instructions regarding lending policies and a Polish bank is not allowed to base its operations on such instructions. It is not a question of preventing shareholder control over a bank. Decisions should be made by management boards appointed by shareholders. Management must represent the interests of the company and all of its shareholders. Directors should demonstrate that their decisions are based on analysis and assessment of the Polish economy and of individual clients. Decisions made without the necessary rationalization and analysis should lead to excluding these decision makers from being approved for management positions in financial institutions by the KNF. In situations in which a bank continues to outsource their lending policy decisions, sanctions should be imposed by banking supervision. It is unacceptable for lending policies to be determined by panicked e-mails sent from foreign head offices.

There is a need for regular communication between Polish authorities (Ministry of Finance, NBP and KNF) and bank managements and their foreign owners on the subject of the condition and prospects of the Polish economy as well as the planned actions and intentions of authorities so that banks would have additional data in shaping their lending policies. Also needed is a line of communication

between the KNF and the supervisory bodies of foreign parent companies of Polish banks in order to ensure their cooperation.

Direct support for companies

The measures presented above may not be sufficient to meet the objective of increased lending. It is therefore advisable that a more direct intervention in which the State Treasury takes on the credit risk of companies be instituted.

The government should provide the bank BGK with a capital injection in the amount of approximately PLN 1 billion aimed at launching a credit program for companies that are unable to obtain necessary financing from commercial banks but have reasonable adjustment plans. This capital should be provided to the BGK in the form of treasury bonds and the actual amount should be determined by the organizational capabilities of this state-owned bank. The NBP should supply BGK with a refinancing loan, which would allow the bank to provide loans worth several times more than the capital received. This form of intervention as the others proposed here should be of a short-term nature. Once the financial system recovers its ability to increase credit, BGK should sell off the loan portfolio created during the recovery plan and its capital base could be then partially reduced.

As a parallel measure, I propose to apportion approximately PLN 5 billion to guarantee loans extended to companies by commercial banks in situations similar to those described in the BGK program. The guarantee fund could be divided between the interested banks with the criteria for distribution being a bank's willingness to increase loans not covered by the guarantee program above the level on September 30, 2008 as well as the value of loans partially guaranteed that the bank will provide under the guarantee program using one zloty of the guarantee obtained.

The return of young emigrants from EU countries may significantly stimulate growth

The recession in Western Europe will result in the return of many Polish nationals who left Poland in search of work following our accession to the European Union. These are people with above average entrepreneurial spirit, new professional and business experience and some accumulated savings. Their return to Poland should be taken advantage of to stimulate growth. It is essential that we create an environment that would attract the return of the best people. They need to be convinced that their best opportunity to take advantage of the experience and business ideas gained abroad lies in Poland. They need to have incentive to set up new businesses and purchase housing. Many will not have permanent positions upon their return, which would make it impossible to receive a mortgage loan. A fund should be established that would allow them to get a mortgage loan and purchase housing if they have a down payment. At the same time, people possessing the start-up funds for a business should be given the possibility to supplement their savings with a preferential loan or a grant.

Protect budget expenditures on infrastructure investment and EU programs

The projected budget for 2009 is based on the unrealistic forecasted GDP growth rate of 4.8%. According to Professor Stanislaw Gomulka, assuming a 3-3.5% GDP growth rate, budget revenues will

be approximately PLN 15 billion lower than projected. In case of a 1% GDP rate of growth, budget revenues could be lower than projected by PLN 26 billion. Budget expenditures will inevitably have to be cut in next year's budget.

To limit the extent of the economic slowdown, it is essential to completely protect all infrastructure investment and EU program co-financing in any revision of the budget as well as in its implementation.

The situation is irregular and the right measures must be implemented

The measures proposed above, in particular the authorities' defining of the objective of increasing credit in the economy require a significant departure from the way monetary policy has been implemented in recent years. The proposal to take such unconventional actions for a certain period of time comes from the belief that we are dealing with a highly irregular situation. The reasons that we can safely assume that the situation is unusual include:

- The threat of tightened lending policies is not a result of imbalance in the Polish economy but a consequence of the paralyzing aversion to risk resulting from losses experienced by banks in the USA and Western Europe.
- Most of the assets in the Polish banking sector are owned by banking groups with headquarters in countries directly affected by the crisis. If the authorities fail to act, lending policies will be tightened not only to a greater extent than is warranted by the condition of the Polish economy and Polish banks but also more than in the markets of the foreign banking groups.
- The paralysis of the banking system caused by aversion to risk means that implementing only traditional monetary policy instruments such as interest rate cuts may be insufficient.

It is clear that there are some risks associated with implementing the proposed measures. The biggest risk is that the unconventional instruments implemented in an extreme but short-term situation will not be revoked once the reasons for their use disappear. Therefore, it should be stipulated at the outset that the proposed measures would be fully available until the end of 2009 and then gradually withdrawn.

A convincing recovery plan must be implemented to change the expectations of market participants

Every one of the proposed actions may raise doubts and fear in specific public institutions, politicians and public servants. The key to the success of the proposed measures is convincing market participants that the authorities are determined, have a clear objective and possess effective and practical instruments. Only this type of package can change the expectations of market participants and convince financial institutions that the government will meet its goal of a minimum increase in credit. If the banks are convinced then their assessment of risk will diminish and the stated goal will not be difficult to achieve.

How much will this cost?

The proposed measures will entail budget expenditures in the amount of approximately several billion zloty. However, if this would allow the economy to note a 3% GDP rate of growth instead of 1%, then public revenues (taxes and social insurance contributions) will be PLN 11 billion higher and furthermore several hundred thousand jobs will be saved. It can therefore be stated that the costs and risks involved in implementing the proposed program are much smaller than the costs and risks of failing to do so.