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How to make it through the epidemic and prepare Poland's economy for rebuilding[1]

By Stefan Kawalec

How should we fight the epidemic, and limit its negative effects on the economy? Everyone is asking these two questions today - from politicians and CEOs of large companies, through the thousands of owners of small companies all around the world. The economist Stefan Kawalec analyzes the situation for 300Gospodarka.

The author is the president of the advisory firm Capital Strategy and a former deputy finance minister.

I. How to fight the epidemic

In Poland the effects of the epidemic, measured as the number of infected, the number with serious symptoms and number of deaths, are still statistically small. So in and of themselves they don't have a significant impact on economic life, nor do they seem large in comparison to the resources of the Polish health service. However, social and economic life in Poland, as well as the functioning of the health service, are deeply disrupted, and in many areas actually paralyzed as a result of actions taken to halt the coronavirus epidemic.

Actions should be taken to slow the spread of the virus, and as far as possible to prevent a situation where the number of infected people who require intensive medical care starts to exceed the health system's capacity. To put it as briefly as possible, the point is to keep the epidemic from breaking out of control, and prevent a situation in which people will die because they can't access ventilators.

[1] Translation of an article published on the 300gospodarka.pl website: http://300gospodarka.pl/analizy/2020/03/26/stefan-kawalec-jak-przejsc-przez-epidemie-i-przygotowac-gospodarke-do-odbudowy/

We must try to halt the development of the epidemic using actions with the smallest possible negative economic effects. Here an important starting point can be the experience of South Korea or Sweden, meaning the countries that are trying energetically to stop the spread of the epidemic, but are applying widespread restrictions, which paralyze public life, to a significantly lesser degree than other countries. An important element of such a strategy should be energetically monitoring the development of the epidemic by measuring the occurrence of symptoms of the disease, as well as testing in the places or groups that are more exposed to infection.

For example, South Korea hasn't completely closed foreign air travel, but it has imposed strong safety measures. Passengers on planes arriving from Europe are surveyed to check for the circumstances in which symptoms occur, and also given tests and made to wait for the results in special centers by the airport. People who make it through this first cordon are allowed in, but they're still required to submit to a 14-day quarantine in their place of residence.[2]

I give this example not to state that this precise solution should be applied in Poland today, but to illustrate the desired direction for our thinking and our actions. Properly targeted surveys and tests can in many cases provide an alternative to completely shutting down production and service facilities, or public institutions. Better monitoring of the epidemic can also enable more flexible application of broadly operating limitations on public life, specifically a controlled lifting of certain restrictions, while remaining ready to bring them back in the areas where surveys and tests indicate a dangerous acceleration of the epidemic.

II. A demand impulse won't revive economic activity halted by government decisions, and people can't eat money

Everything indicates that in 2020 we will experience a severe recession, both in the global economy and here in Poland. The obvious associations are with the great crises that the world economy suffered through in the 1930s, and most recently after 2008. But the experiences of those past crises seem to be a poor guide when seeking the proper government response to rescue the economy. Those historical crises resulted from a collapse of global demand, associated with a breakdown of liquidity in banking systems. At the time, the effective medicine was support by central banks and governments for commercial banks, to support money supply and prop up demand. This medicine was missing after the 1929 American stock market crash, which many economists believe contributed to the dramatic worldwide crisis that almost led to the collapse of the democratic world. The conclusions from the negative experiences of the Great Depression meant that in the face of the 2008 financial crisis, the Western world's governments and central banks performed a massive intervention, pumping huge amounts of money into the financial system. It is quite widely believed that this intervention prevented a repeat of the tragedy of the

[2] "Coronavirus testing to be done on all arrivals from Europe", *The Korea Herald*, March 20, 2020. http://www.koreaherald.com/view.php?ud=20200320000549&np=1&mp=1&fbclid=IwAR0O4fCxz7sMawy0pX1iSeeymgvsakWKp9A4pPRBxiJRkunSkA4K4patiO8

Great Depression, and as a result, after 2008 the West went through a relatively moderate recession. Somehow in spite of themselves, governments and central banks today refer back to those experiences from a decade ago, cutting interest rates and announcing billions of dollars of support for the economy.

And yet as former Monetary Policy Council member Professor Jan Czekaj points out, "In a situation where a significant proportion of companies, particularly service providers, have ceased operations based on a decree of the state, providing the economy with liquid, widely targeted funds won't help anything."[3] The current crisis directly affects the real economy, and is largely a supply crisis. Deutsche Bank analysts Oliver Harvey and Robin Winkler write that if governments are going to try to maintain spending at the level from before the introduction of limitations on demand, while simultaneously maintaining these restrictions, then more money will simply be spent on smaller amounts of goods, which will push up prices.[4] In the current situation, where supply is inelastic, governments can hand money out to people, but in and of itself this won't cause a resumption of flights or an increase of production in factories whose operations are curtailed during the epidemic. Harvey and Winkler also address the argument that there's no reason to fear inflation because in light of the gloomy prospects for the economy people will hold back on spending, keeping these payouts for a rainy day. They reply that people's behavior depends on their expectations. The moment people see that the prices of basic articles are starting to rise, they'll start to spend faster, which will drive inflation up further.

It's possible that for an epidemic, a more appropriate reference point than previous financial crises is what happens to economies in wartime, when a significant proportion of factories is shifted to production for the military. That makes the supply of sought-after consumer products inelastic, and a growing amount of money in consumers' hands leads only to price growth and the need to introduce rationing of basic goods.

III. Act so that the economy can rebuild quickly after the epidemic

Government policy while the epidemic lasts should concentrate on supporting the health service and other public services, and on ensuring all citizens have a minimum of social welfare, access to medical care and food. We have to protect the liquidity of the banking sector, and simultaneously monitor lenders' policies toward their clients, so that their actions don't contribute to a worsening of the economic and social situation.

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[3] Jan Czekaj, "Dwa kryzysy jedna recepta" (Two crises, one prescription), *Rzeczpospolita*, March 23 2020, https://www.rp.pl/Opinie/303229967-Dwa-kryzysy-jedna-recepta.html
[4] "Helicopter money would make the coronavirus a lot worse", https://www.zerohedge.com/markets/deutsche-bank-helicopter-money-will-be-disastrous-and-will-lead-hyperinflation-buy-gold

We must accept that if some companies stop operating, the level of economic activity will fall. Companies that can't operate normally must be given a simple way to suspend operations, during which they'll be able to stop meeting some of their obligations, particularly to banks, the government and their workers. Employees, both full-time and on temporary contracts, should receive government-financed welfare benefits, while for organizational reasons these payments could be made for a certain time through the employer, and refunded by employment offices.

The idea is not only that we survive the epidemic, but also that after it ends the economy will be able to rebuild itself and get onto a healthy growth path. However, this can be hindered by several negative developments that are likely to occur, and which we must try to avoid or minimize, namely:

1. A lasting collapse of international exchange
2. Corporate bankruptcies
3. Economic actors burdened by mutually unpaid debts and paralysis of the banking system
4. Public debt paralyzing the state and the economy
5. High inflation and currency destabilization

Ad 1. A lasting collapse of international exchange

A significant chunk of Polish industry is oriented toward export production; the overwhelming share of its output goes to EU markets. If these exports are frozen, only a small portion of this production could be absorbed by the domestic market. Export-dependent factories would then have to fundamentally curtail production and employment, and many of them would be liquidated. Simultaneously, demand created by these factories and their employees on the internal market would disappear, and there would be a significant drop in GDP.[5] In this context it's worth recalling the experience of the Second Polish Republic, when industrial centers in the area that had been occupied by the Russian and Prussian Empires were cut off from their former markets. The loss of traditional export markets was most likely the main reason why industrial production per capita in Poland in 1938 was almost 10% lower than in 1913.[6]

While the epidemic lasts, we must make all reasonable efforts to avoid creating unnecessary barriers in international trade. So it's very good that by reducing documentation requirements we have managed to eliminate the lines of trucks, tens of kilometers long, that had built up at the German border in the first days after Poland introduced border controls. The government should engage in actions through the EU aimed at bringing back conditions for the return of unhindered trade as soon as possible after the end of the epidemic.

[5] Cf. Marek Rozkrut, "Czy konsumpcja jest głównym motorem wzrostu polskiej gospodarki?" (Is consumption the main driver of Polish economic growth?), EY Economic Analysis Team, Warsaw 2020.
[6] Cf. Stefan Kawalec, Ernest Pytlarczyk, *Paradoks Euro. Jak wyjść z pułapki wspólnej waluty?*, Wydawnictwo Poltext, Warsaw 2016, pp.243-256.

Ad 2. Corporate bankruptcies

We can't have any illusions that the disruptions connected with the epidemic won't cause an increased number of bankruptcies and closures of companies. We must try to limit this process primarily by offering companies convenient models for complete or partial suspension of operations – in such a way that they can pass through the period of reduced or missing income in a state of hibernation,[7] in which they won't build up debts to the government, the ZUS social insurance fund, banks or employees. At the moment the epidemic ends, those hibernating companies that haven't lost their raison d'être should renew operations, and if needed pass through a restructuring process. Meanwhile, those that have lost their reason to exist should undergo bankruptcy or liquidation.

Ad 3. Economic actors burdened by mutually unpaid debts and paralysis of the banking system

Despite the actions aimed at limiting the growth of obligations at companies with reduced incomes during the epidemic, the moment it ends we'll have to deal with the ballast of overdue obligations, as well as unpaid bank loans. We must prepare beforehand to conduct fast financial restructurings of companies and banks after the epidemic, so that overdue obligations don't paralyze the economy or slow the process of emerging from the recession. For this we may need special, temporary legal solutions (analogous to those introduced by the 1993 Act on Bank and Enterprise Restructuring). Such restructurings may impose significant costs on the government as a result of the need to cancel certain tax and social insurance obligations, and the possible need to support banks that are writing off unpaid loans.

Ad 4. Public debt paralyzing the state and the economy

Some economists argue that during an epidemic, we shouldn't worry about deficits and growing public debt. Arnaud Marès, Citibank's chief economist for Europe, says the entire epidemic-related decline in GDP should be absorbed by the government, which should compensate companies and households for their lost income. He argues that even a very serious deficit and growth in debt can be absorbed if the central bank keeps public borrowing costs under control.[8] And American economist Greg Mankiw writes: "There are times to worry about the growing

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[7] For a similar use of the term „hibernation" see "Marek Jakubiak: Prezydenta może wybrać koronawirus" (The next president may be elected by the coronavirus), interview with Jacek Nizinkiewicz, *Rzeczpospolita*, March 25 2020, https://www.rp.pl/Wywiady-i-rozmowy/200329447-Marek-Jakubiak-Prezydenta-moze-wybrac-koronawirus.html?cid

[8] European Economics View, by Arnaud Marès, Citi Chief European Economist, "Towards Full Fiscal Absorption (With ECB Support)", March 16 2020 (material provided by Professor Stanisław Gomułka as part of an online discussion)

government debt. This is not one of them."[9]

It's hard to agree completely with these views. It's true that today the priority is to counteract the epidemic. But that doesn't mean that the scale of growth in public debt is meaningless. We can refer once again to the analogy between fighting an epidemic, and war. It's true that during wartime, goals such as limiting deficits recede onto the back burner. Wars have often led to high growth in public debt. But the debt with which countries emerged from wars was significant for their later development prospects. In 1919 John Maynard Keynes, discussing the drastic budget situation of European countries after World War I, pointed out that the difference in their positions was caused in part by the differences in the direction and scale of their efforts to balance their budgets during the war. In contrast to Great Britain, which despite the war effort took action to balance its budget, France took a passive approach, tolerating a huge budget deficit.[10] The state of public finances France inherited after the war was one reason why in the first half of the 20th century, the French market suffered huge disruptions resulting from high inflation and currency crises.

If we want the Polish economy to be able to function normally and grow rapidly after the epidemic is over, we have to keep public finances under control. At the moment Poland has a certain limited potential for growth in public debt, but we should keep at least some of this in reserve for the period after the epidemic ends, for reasons including being able to perform the aforementioned financial restructurings of companies and banks.

The epidemic will force the government to spend more, and simultaneously the drop in economic activity will reduce income from taxes and mandatory social insurance contributions. If we don't want to allow excessive debt growth, we must immediately introduce solutions that will limit the deficit. The recommendation by employers organization Pracodawcy RP, that we halt the planned 13th and 14th monthly pension payments, seems to be justified.[11] This is a serious budget expenditure, which goes to people who already have a steady source of income. What's more necessary in the current situation is to gather funds to support people who will lose their incomes when they lose steady jobs or opportunities for occasional work.

Ad 5. High inflation and currency destabilization

Poland has its own currency, which on the one hand has benefits, and on the other is connected with certain costs and risks. The main benefit is the automatic adjustment mechanism of the exchange rate, which operates countercyclically. When the economy's condition and prospects are good, the złoty strengthens, which slows the economic boom somewhat. And when there is a

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[9] Greg Mankiw, "Thoughts on the Pandemic", March 13 2020, https://gregmankiw.blogspot.com/2020/03/thoughts-on-pandemic.html?m=1&fbclid=IwAR02LwbQ_d1qB6v4kk5eFLGXaLD24nlk0JqnzR5uQFg65YY8Ed5KCRrHTOQ

[10] John Maynard Keynes, Fellow of King's College, Cambridge, *The Economic Consequences of the Peace*, 1919, pp. 174-175 (BiblioBazaar Reproduction Series edition)

[11] Pracodawcy RP (Employers of Poland) press release, "Konieczna przebudowa budżetu – albo 13-stki i 14-stki, albo katastrofa" (Budget restructuring essential: either 13th and 14th monthly payouts or catastrophe), Warsaw, March 21 2020.

serious worsening of the economic situation in Europe, capital flows out from Poland and the złoty weakens, as has happened in recent weeks (from the beginning of the year through March 25, the złoty weakened by about 6-7%). The weakening of the złoty, in conditions of low inflation, generally brings relief to the economy (it has a positive effect on exporters' earnings and contributes to a reduction in imports), but it worsens conditions for certain entities (including those who have borrowed in foreign currencies).

Having your own currency also means having your own central bank, and the ability – at least formally – to conduct independent, autonomous monetary policy. In the case of an economy that's small on the global scale, such as Poland's, if the central bank is overconfident in its ability to stimulate the economy and financing of the state budget, it can easily cause an explosion of inflation and a collapse of confidence in the currency. That could trigger a vicious cycle in which inflation and the weakening of the złoty are mutually reinforcing: inflation causes growth in the cost of foreign currency, i.e. a weakening of the złoty, and that increases the prices of imported goods, which drives inflation.

Inflation expectations are currently low, both in Poland and around the world. But we must remember that the conviction that the danger of inflation has been banished from the world economy is about as accurate as the statement about "the end of history" was in its time. Inflation and deflation are factors that can appear in any economy where the conditions for them are created.

In the situation of inelastic supply that we may be facing in conditions of the restrictions introduced during the epidemic (as discussed above), excessive monetary or fiscal expansion may cause a very rapid change in expectations, and an explosion of inflation. Rapid inflation during an epidemic would pose a threat to public health and safety. Rather than following social distancing rules, people would storm the shops, ATMs, banks and currency exchanges seeking products, cash and foreign currencies, which could be accompanied by violence and clashes with the police.

In the case of very high inflation, after the end of the epidemic, rather than the economy getting onto a stable growth path we'd be facing a stabilization operation that would mean a temporary slowing of economic growth.

IV. Don't harm ourselves, and bring back international trade

Referring once more to wartime experiences, it's worth pointing to the many examples of fast economic growth after wars end, despite the frequently enormous destruction of production assets and infrastructure.

In the case of the coronavirus epidemic, neither production assets nor physical infrastructure will be damaged, and so theoretically, after the restrictions are removed and fear of the virus subsides, the economy could very quickly return to its previous level of activity. As long as we don't harm ourselves, and international trade is rebuilt.