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Growing steadily in the midst of a recession: Poland's case

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This paper examines the major factors responsible for limited spread of 2008 recession to Poland, the only EU country that continuously experienced growth throughout the current crisis. The analysis reveals that in combination, low share of mortgages in bank assets, relatively small decline in real estate prices, fortuitous foreign exchange rates, modest levels of private and public debt, and proactive policies by foreign banks substantially buffered Poland's financial sector. At the same time, real economy was aided by a large domestic market, strong dependence on consumption, as opposed to exports, a favorable labor market structure, and timely financial assistance from the EU.

Field of Research: Business cycle, financial and macroeconomic crisis

1. Introduction

No Developed East[1] economy has been unscathed by the global financial crisis and those effects continue to be widely felt. In 2009 average GDP growth across the European Union ("EU") was negative 4.5 percent (Eurostat 2009), and Eastern Europe was particularly hard hit. Latvia's GDP, for example, declined by 16.7 percent, Lithuania's by 15.8 percent, and Estonia's by 12.9 percent, while the Czech Republic, Romania and Hungary registered 3.8, 6.6, and 6.7 percent GDP declines respectively (Trading Economics 2009). At the same time, unemployment in the EU averaged 8.3 percent at March 2009, ranging from 7.9 (Bulgaria) to 16.1 (Latvia) percent (Eurostat 2009). One exception is Poland, which (besides Cyprus) was the only EU country that experienced positive GDP in 2009, growing 1.7 percent (1.9 percent year over year) in March 2009, with an unemployment rate of 7.7 percent.

In this paper we explore two sets of circumstances that played a significant role in Poland's surprisingly positive economic performance. The first consists of the policies and role of foreign banks in Poland's financial sector. The second is a set of specific macroeconomic aspects that differentiate Poland from its neighbors. These analyses are presented in parts one and two of the paper. We conclude in part three that Poland, until recently an uncertain stepchild of the Developed West, serves as an unexpected reminder of a simple market truth. While untangling sophisticated financial systems from economic fundamentals can (and perhaps, inevitably will) destroy more than it creates, the converse is also true. That is, adherence to basic risk models matters, and can serve a national economy well.

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It is difficult to wrap the policy, financial, and market circumstances of any one country into neat bundles. That said, to the extent Poland's refusal to decouple economic fundamentals was purposeful, its economy may fairly be viewed trendsetter.

2. Literature Review

The severity of the recent worldwide economic turmoil has generated a substantial amount of literature on its general causes and effects, and will likely preoccupy researchers for decades to come. Country specific analyses, though, are still in relatively short supply, and most of those that have been completed focus on the US and EU based causes, such as reliance on highly leverage by financial markets, errant monetary policies, persistent real estate bubbles, and other factors that contributed to the crisis.

In US centric studies, much of the analysis centers on financial markets, potential Federal Reserve, policy errors, and the housing bubble. Within the broad category of "financial markets" as a root cause, poor risk management and corporate governance have been cited as key contributors (Lang 2010). Assessments of the Federal Reserve's role are still mixed (Bernstein 2010) and likely will remain so as it is difficult to separate out as discrete causative factors the boom and bust in the housing market, serious strains in financial markets, low interest rates on home prices, deregulation of mortgage finance, and aggressive lending by mortgage institutions and banks. The absence of any centralized - or well-coordinated regional - attempt in the United States to monitor asset prices, analyze the consequences of trends, and disseminate information about those analyses arguably lulled individual property owners into a sense of complacency during a period of rapid real estate price inflation, and regulators (if not investors) were slow to react to the dangers of the price and credit bubble (Muller 2010).

Other research is beginning to cover country specific problems outside the US that, various authors argue, contributed to the depth of the recession. Studies of Ireland (Ayi Gavriel 2010) and Iceland (Hayes 2010) - two countries hit particularly hard by the downturn - identify unique financial and housing markets conditions existing in those domestic markets that deepened the severity of the crisis. In addition, several works assess the role of government spending in exacerbating economic problems. For example, initial studies of Greece's fiscal policies (Siriopoulos 2010) point clearly to a persistent EU concern about excessive public spending in one member country having a negative spillover effect into all major markets.

Given the short time since the onset of the crisis, most works are descriptive as researchers continue to sort through the data and await new developments before performing detailed analyses. This study presents the unique case of Poland, where some of the key ingredients responsible for this recession have been absent. We argue that Poland's case can be viewed as an affirmation that - historical factors aside - adherence to basic risk models matters, and can serve a national economy well.

3. The Role of Foreign Banks in Poland's Financial Sector

Broadly speaking, Swedish, Austrian, and Italian banks are critical players in the Developed East market, which they have further segmented by geographic sub-regions. Swedish banks predominate in the Baltic Republics. They have chosen a homogeneous business model that, in effect, extended uniform credit instruments, risk management tools, and credit strategies throughout that region. Austrian banks, which focused their activities in Czech Republic, Slovakia, Hungary (and, to a lesser degree, Bulgaria and Rumania) took a more country specific approach, modifying basic business activities to respond to particular conditions to accelerate borrowing. And UniCredit (an Italian Bank) - the predominant player in Poland – adopted a Pan-European bank strategy; that is, the formation of one integrated bank across national borders which maintained tight lending standards.

Undoubtedly, the shared goal of each of these institutions was, and is, to service rising incomes and savings in the host countries and (until recently) meet rising credit demand – particularly for mortgages – unleashed by transition, expansion of the EU, and global impact of loose U.S. monetary policies. To achieve that goal, each of these foreign banks deployed strategic and tactical objectives in varying regulatory regimes that, in general, did more or less to facilitate subprime lending or the proliferation of high risk financial products. Not, it should be emphasized, due to prescient government regulators, but rather as a natural consequence of history or, more precisely, the lack of it.

Having moved to market economies in the early 1990s, most Developed East populations are simply less accustomed to market risk than their western counterparts. This experiential gap, coupled with the inherently confusing and opaque nature of complex derivatives, has tended to keep down demand from local clients and their bankers for these products. But easy money and loose credit come in many variants and different bank strategies plainly impacted country specific indebtedness levels, and therefore risk. Because bank credit was new to Developed East economies reliance on it to fuel private domestic consumption and investment required facilitation. One way to generally assess the role of foreign banks as facilitators is to look to the indebtedness levels and credit/deposit ratios that they allowed private firms and households to carry.

By this measure, Swedish banks appear to have been the most aggressive, with private firm and household indebtedness reaching almost 500 percent of GDP and a permitted credit/deposit ratio of 150 percent in Estonia. In Latvia, household debt alone was 137 percent in 2008 (Bloomfield 2009), and the permitted credit/deposit ratio reached almost 200 percent. Austrian banks seem to have been more measured. For example, private firm and household indebtedness reached 32 percent of GDP in Bulgaria and 79 percent of GDP in Hungary (IMF 2008). And although credit/deposit ratio reached 150 percent in Hungary, it was 89 percent in the Czech Republic. In Poland,credit/deposit ratio was 120 percent, but private firm and household indebtedness was only 16 percent

of GDP – which was approximately half that of Bulgaria, and a mere 3.3 percent of the level reached in Estonia. (Forbes 2009).

The specifics of these bank policies are beyond the scope of this paper. The positive macroeconomic impact of particular bank practices is, however, well-illustrated by the mortgage policies of UniCredit, which were formed by (and in reaction to) market conditions. After decades of housing shortages, Poland's housing stock grew rapidly beginning in the 1990s. During that first decade of transition, virtually all housing purchases were acquired in cash with savings, for the simple reason that a market for mortgages and the legal and financial systems needed to support it did not yet exist, and were slow to develop.

This systemic restraint on demand tended to limit the growth rate of real property prices relative to those of other, less expensive, assets. At the same time, double digit inflation (which persisted throughout most of 1990s) and its' consequence - high interest rates - made mortgages denominated in domestic currency expensive as Poland's privatization driven domestic growth generated a steady foreign capital inflow, strengthening the value of Polish currency. That combination of factors persuaded a number of domestic banks to offer lower interest mortgages issued in such foreign currencies as Swiss francs. By late 2008, almost 70 percent of all mortgages in Poland were denominated in a foreign currency.

As the financial panic rippled through the Developed East, a common reaction of private investors was to flee from those emerging markets. The resulting currency depreciation then accelerated this poisonous circle, as increasing numbers of foreign investors abandoned their positions, causing yet more depreciation. Initially, Poland was hard hit by this cycle. Between September of 2008 and February of 2009, the Polish zloty lost 27 percent against the Euro, representing the biggest currency decline among emerging markets. This breathtaking drop put many Polish homeowners at risk as rapidly rising monthly mortgage payments threatened widespread defaults, and that threat would almost certainly have been realized, but for a series of key circumstances.

One was the relatively slow growth of Poland's overall mortgage market, in the face of persistent and sustained strong demand for housing. By 2008, mortgages still constituted only 10 percent of Poland's GDP, as compared to 18 percent of GDP in the Czech Republic, 20 percent in Hungary, and 70 percent in the United States (Global Property Guide 2009).[2] And subprime lending was virtually nonexistent. Another was the decision by UniCredit, which owns Poland's two largest banks, to issue mortgages exclusively in Polish zlotys. This buffered 30 percent of all Polish mortgages from short-term currency depreciation and, in so doing, helped diminish the level of domestic panic and the magnitude of capital outflows by investors from Poland. It also contributed to stabilizing real property values by allowing more Polish borrowers to remain timely on their loan payments, and incentivizing them to do so. Then, in February of 2009, the

Polish Finance Ministry began selling Euros from EU grants in earnest, and both the EBRD and World Banks earmarked new funds for UniCredit.

This confluence of factors helped persuade foreign investors, who initially failed to differentiate between East European markets, to reconsider Poland, and between February and September 2009 the zloty appreciated 19 percent and exceeded its pre-crisis dollar value (NBP 2009). The zloty appreciation rendered Swiss franc denominated mortgages more affordable, as persistent housing shortages made the subsequent correction in assets prices and tightening in credit conditions less deflationary to the Polish economy than elsewhere in the region.

Moreover, the same slow development of the mortgage market also characterized Poland's poorly developed foreclosure and bankruptcy procedures, which further shielded real estate values. Consequently, in the first quarter of 2009, the average decline in real estate prices ranged from between just 3 percent in Warsaw (the most expensive and fastest growing housing market in Poland) to approximately 9 percent in Krakow (Open Finance 2009). By contrast, the average decline in real estate prices exceeded 15 percent in the Czech Republic and almost 30 percent in Hungary (Global Property Guide 2009).

Together, these factors reduced loan defaults and strengthened the financial sector. The percentage of non-performing loans in Poland remained roughly stable between the summers of 2008 and 2009, accounting for only 4.5 percent of all loans in July 2009 (Cienski 2009), while regionally the number of non-performing loans, on average, more than doubled. In Estonia, the growth rate was 2.6 times, and in Latvia, the number of non-performing loans more than trebled (EBRD 2009)[3]. Poland's loan-to-deposit ratio of 120% in March 2009 was considered relatively safe compared with many other developed economies, and its loan/asset ratio of 56.0% matched the median number in that period for Western European countries (Banker 2009). At the same time, total deposits in Poland grew even in the midst of the crisis, averaging 18.6 percent between June 2008 and 2009, while banking capital adequacy ratio dropped only slightly from 11.5 to 11.1 percent by July 2009 (Urzad Komisjii 2009), allowing bank profitably to remain positive, averaging 8.4 percent in 2008 and 2.7 percent in the first quarter of 2009 (GUS 2009c).

Notably, PeKaO SA, Poland's second largest bank and a member of the UniCredit Group, fared even better than other Polish banks. By the third quarter of 2009 its non-performing loans had grown by only of 1 percent (as compared to an overall sectoral growth of 11 percent), operating profits increased by 3.4 percent for the quarter and 18 percent for the year, and the provision coverage ratio was 77.5 percent at a time when the sectoral average was 59.4 percent (Bank PeKaO SA 2009).

4. Macroeconomic factors

In addition to the resilience of Poland's financial sector, a number of structural factors in the real economy helped limit the effects of the worldwide recession. One is the low negative impact of Polish exports on the overall economy – itself the result of several related circumstances.

First, Poland's exports represent a relatively small share of its output – approximately 28 percent in 2008, as compared to 59 percent for the Czech Republic, 40 percent for Germany, and 63 percent for Hungary (CIA 2009). Second, Polish exports are more diversified than those of other Developed East countries – the heavy concentration in the Czech Republic and Slovakia, for example, on auto exports left those countries particularly vulnerable to external demand shifts. Polish exporters, by contrast, have less exposure to recessionary forces because much of exports involve manufacturing products that are cheaper to import than to produce in their target markets. A third factor is Poland's floating exchange rate regime, which allowed initial significant nominal and real depreciation of the zloty positively affecting net exports.

The structure of the Polish labor market has also helped to shield it from the global recession. More than 25 percent of Poles are employed in the relatively recession proof agro-industrial sector and farming, which continue to receive significant EU subsidies. That high share of labor linked to agriculture can be contrasted with 5 percent or less percent in Hungary, the Czech, and Slovak Republics, and undoubtedly protected incomes, jobs, and consumption for a meaningful segment of Polish workers. This same positive effect was likely realized by public sector employees, who account for approximately 27 percent of Poland's labor force and are largely immune from unemployment (Maly Rocznik Statystyczny 2008). Together, these two labor market segments represent more than half of all Polish workers.

Active fiscal policies (e.g., increasing public sector salaries by 2.5 percent in real terms in early 2009, as well as pensions and benefits by 1 percent) also protected incomes. In fact, Poland's nominal and real wage growth averaged 6.8 and 3 percent, respectively, in the first quarter of 2009, as compared to nominal wage rate declines of 1.8 percent in Hungary and 1 percent in the Slovak Republic. The erosion in savings and wealth has also been less severe in Poland than in other Developed East countries, at least for assets invested in equity securities. Through much of the last decade the Polish stock market's performance has been strong, with annual growth rates of Poland's WIG registering gains of 45 percent in 2003, 28 percent in 2004, 34 percent in 2005, 42 percent in 2006 and 10 percent in 2007. Unsurprisingly, the WIG declined by 51 percent decline in 2008 but, as of early 2010, had regained its April 2008 level, aided by key firms included in the index, such as KGHM (copper), which rose by 200 percent, and two key development companies, Immoeast and JW Construction, that rose by 316 and 177 percent, respectively. By January 2010, the Hungarian BUX, by contrast, remains 18 percent below its April 2008 level, and the Czech PX is 40 percent below its April 2008 level.

These factors, along with Poland's relatively low consumer debt, helped fuel a 7.1 percent[4] growth for 2008 (GUS 2009a) in that country's real consumption spending, which has historically been funded primarily from savings, and more recently, limited credit. Consumer debt in Poland during 2008 equaled 40 percent of income, as contrasted with 90 percent in Bulgaria, 87 percent in Hungary, 150 percent in the United Kingdom, 137 percent in the United States, and 115 percent in Spain (Polityka, 2009). Moreover, most of this debt (70 percent) is in the form of mortgages, which (as previously noted) account for less than 10 percent of Polish GDP[5], and are tied to an asset class (real property) that has declined less in Poland than in most EU markets. Improved real consumption spending is significant in all market economies, but particularly so for Poland. There, the share of private consumption as a share of Polish GDP averages 65 percent. Equivalent numbers for Germany, Hungary, and the Czech Republic in 2007 were 54, 45, and 40 percent, respectively (Economist Fact Book 2008).

In general, the positive impact of these factors on Polish consumers also extended to private firms. Their overall credit load in 2006 (18 percent of GDP) was low relative to the EU average of 35 percent. In the Czech Republic and Hungary, this figure exceeded 30 percent, and was over 40 percent in Latvia, Bulgaria and Romania (Balazs 2007). Poland's government and international debt ratios were also relatively low; the former approximating 45 percent (as compared to an EU average of 60 percent) and the latter 60 percent, a large part of which includes debt acquired by Polish subsidiaries of foreign banks. These manageable debt levels permitted the government to increase consumption in the first quarter 2009 by 6.1% on year, which was down from the remarkable 14.1% year-on-year growth in the fourth quarter (perhaps explaining some of the resilience in private consumption in the first place), but well above the 5.1% growth posted in the first quarter of 2008.

While domestic factors have been the most relevant in cushioning Poland from the world financial crisis, external forces also played a positive role. We have already noted EBRD and World Bank funds provided to UniCredit. A third – EU funding earmarked for a number of specific projects and as agricultural subsidies, have also facilitated Poland's ability to spend and grow. For example, a decision to accelerate 6 billion euro in EU funded investments, which was originally to be disbursed between 2007 and 2013, expedited the creation of additional jobs and income. Poland has not, however, escaped all damage. The unemployment rate, by way of example, rose from 6.7 in December 2008 to 8.3 percent in the summer of 2009 (GUS 2009b). It is noteworthy, though, that even this sharp increase in the unemployment rate leaves Poland below the EU average, and is also rather low by recent Polish standards. For instance, in first quarter of 2009 unemployment reached 17.4 percent in Latvia, 15.6 percent in Estonia, and 10.2 percent in Hungary. Likely contributors to this relatively positive result are the limited decline in macroeconomic growth, increased consumption, and a scarcity of skilled labor which may have made Polish companies more reluctant to shed workers.

5. Conclusion

It might seem counterintuitive that a country still undergoing transition would be better positioned to weather the current financial crisis than its Developed East contemporaries, and the EU as a whole. And yet that is the case in Poland. The economic reasons why – being inherently diffuse and interrelated – defy precise description. An overarching rationale for this surprising result can, however, is found in the very nature of the crisis itself. To the extent that the financial system failure is a tied to fundamental market risk, economic performance is, in part, an outcome of risk tolerance. Those countries that fully embraced poorly understood financial instruments and unsustainable leverage have suffered. Those which hesitated to do so suffered less. And Poland, through a happy confluence of relatively conservative bank practices, government fiscal policy, labor market segmentation, and widely followed personal consumption norms has fared best of all.

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[1] The term "Developed East" is not commonly used in the literature. We employ it here to denote those East European countries of the former Soviet bloc that generally share certain attributes highly relevant to a market economy; specifically, a demonstrated commitment to marketization, financial privatization, and a functioning democratically based political system. In this paper, the term Developed East refers to Poland, the Czech Republic, Slovakia, Bulgaria, Romania, and Hungary. It excludes Ukraine, Belo-Russia, and Russia.

[2] . The lack of mortgages also contributes to Poland's relatively low consumer debt.

[3] Unfortunately, it is still too early to fully assess the causes of these diverse growth rates. They may reflect procrastination strategy among banks to roll-over dubious loans, or an upgrading of risk-management systems by foreign parent banks.

[4] Poland's real consumption spending remained positive in the first quarter of 2009, increasing by another 3.3 percent. (GUS2009b).

[5] Equivalent ratios are 80 percent for Great Britain, 45 percent for Spain, and 53 percent for Sweden (Foreign Policy 2009).

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