

UNU World Institute for  
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## Research for Action 33

# **The Polish Alternative**

Old myths, Hard Facts and New Strategies  
in the Successful Transformation of the Polish Economy

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This study has been prepared within the UNU/WIDER project on the Transition Strategies, Alternatives and Outcomes, which is co-directed by Professor Giovanni Andrea Cornia and Professor Vladimir Popov.

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## FOREWORD

The transition to a market economy is taking place in about 30 countries of Eastern Europe, the Baltic States and the former Soviet Union. A great deal has been achieved so far but much still remains to be done. A common feature of the entire group of transition economies – although the progress in the introduction of the market economy varies significantly across the region – is the severe contraction accompanying the fundamental changes in economic structures, institutions and policies. By 1997 the GDP of the transition economies, on average, is still below 75 per cent of the pre-transition level achieved by 1989. Only in Poland, after eight years of sound changes, has production surpassed the 1989 level, while the Polish GDP in 1997 stands at 110 per cent of pre-transition level.

The impression that these remarkable results are due to a jump-start to the whole transition process, and a radical approach towards economic liberalization and stabilization in the early 1990s is naive. Complex, multidimensional processes of change during two widely different periods in the eight years of Polish economic transformation have been set in motion. First, often associated with the so-called 'shock therapy', and accompanying it, were severe recession and relatively high inflation, which lasted from late 1989 until mid-1993, and, second, there has been an advanced stage of transition associated with the *Strategy for Poland* development programme and the sound economic growth of late 1993-97.

This paper has been prepared by Professors Grzegorz W. Kolodko and D. Mario Nuti within the UNU/WIDER research project on Transition Strategies, Alternatives and Outcomes. Professor Kolodko, who was the Polish Minister of Finance and First Deputy Premier from April 1994 to February 1997, is currently the holder of the Sasakawa Distinguished Chair in Development Policy at UNU/WIDER, Helsinki. Professor D. Mario Nuti is Professor of Comparative Economic Systems at the Faculty of Economics, Rome University La Sapienza, and Visiting Professor at the London Business School.

While this publication is focused mainly on a discussion of the Polish case of the transition to a market economy and policies to sustain economic development, it draws a number of conclusions relevant for all countries involved in the great post-communist transformations. This study addresses the fundamental and still intriguing question: What works and what does not work in transition economies – and why? I warmly recommend this publication to all those who are interested in the complexity of the transition process.

Giovanni Andrea Cornia  
Director, UNU/WIDER  
March 1997

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## ABSTRACT

In 1994-97 Poland has recorded an outstanding economic performance in terms of GDP growth, simultaneous reduction of inflation and unemployment, fiscal balance, zloty real revaluation, capacity restructuring, private sector growth and institution building. The Polish success needed a market environment but is not and could not be, as it is often claimed, the delayed result of the so-called 'shock therapy' of the early 1990s.

This paper shows that initial shocks – e.g. in the foreign trade regime, exchange rate, credit and interest rate policies – were largely unnecessary or excessive. Therefore Polish stabilization and transition involved costs, often unduly belittled, which would have been and were subsequently reduced by the alternative policies adopted by post-1993 governments under the new *Strategy for Poland*.

The *Strategy* documents form an integrated and detailed package of medium to long term economic policies, characterized by a commitment to establish a modern and open market economy and by new and distinctive features. There is emphasis on the reform of central administration, on institution building through a participatory process, on parity between state and private enterprises; promotion of investment and growth; greater security in economic transactions. Strict fiscal austerity, with a lower and fairer tax burden and the drastic reform of the pension and social welfare system, is matched by reliance on monetary relaxation and by an anti-inflationary social pact on wages. Multi-track privatization is aimed at raising budgetary revenue and establishing corporate governance, accompanied by commercial management of the residual state sector. Industrial and agricultural policy guide restructuring, avoiding the softening of budgets constraints and direct or indirect favour for individual enterprises. Greater openness to trade integration, and to foreign direct investment, prepares an early Polish accession to the European Union with an option for possible membership of EMU.

Consistent implementation of these policies has allowed and promoted Polish success, which is judged to be economically sustainable. The *Strategy* ideas and policies, which were unfashionable and controversial at the time of their first formulation and implementation, have been gaining increasing acceptance and are now gradually forming a new consensus. Poland's successful experience provides an alternative paradigm to those post-communist countries whose transformation is still incomplete.



## I INTRODUCTION

The outstanding Polish economic performance of the last four years has been likened to that of the 'Four Tigers' (Hong Kong, Korea, Singapore, Taiwan) and other high-performing Asian economies. The June 1996 Rating Report by IBCA, raising Poland's standing to investment quality, was entitled *Transition Tiger*, and in March 1996 the Kleinwort Benson's Report *Wolves and Tigers* compared Poland favourably with these Asian economies and concluded that in the medium term Poland can match, or even exceed, Asian productivity gains as it catches up with the West. Kolodko (1996) contrasts Poland's 800 days of 'cold turkey' with its 1000 days as 'soaring eagle' when he was Minister of Finance and First Deputy Premier in charge of the economy.

Poland has the best performance to date of all the transition economies of central-eastern Europe. In 1994-97 the Polish economy went from strength to strength, speeding up economic growth and capacity restructuring, lowering simultaneously both inflation and unemployment, maintaining fiscal restraint and strengthening the currency (see Table 1 and section II for more detailed information). EBRD confirms that by 1996, 'The leading economic performer in the region was Poland' (1997: 7). This performance might be regarded as an economic miracle, except that in economics  *cudow nie ma*, as the Polish saying goes – there are no miracles, any more than free lunches.

A vision of Poland's recent development and economic future is embodied in two major policy documents, both prepared by Grzegorz W. Kolodko with a team of advisers which included Mario Nuti: *A Strategy for Poland*, whose first draft was available already in October 1993 and inspired government policy, and *Package 2000*. These documents, widely distributed and publicized, provided, at the same time, a sense of direction and focus for criticism; they were formally approved by government and Parliament, after wide ranging discussions, respectively in June 1994 and March 1996. A third document, *Euro 2006*, prolongs the time horizon to include Poland's prospective membership both of the European Union and the European Monetary Union; in January 1997 *Euro 2006* was approved by the Committee for Economic Integration.

These policy documents represented an integrated and detailed package of medium to long-term economic policies. They were neither forecasts nor central plans but firm policy commitments, internally consistent and feasible within the ordinary policy instruments commonly at the disposal of governments in any market democracy. By and large the ambitious targets set in *Strategy* have been implemented, often at a faster rate than originally envisaged (see section II below).

TABLE 1  
SUMMARY STATISTICS FOR POLAND, 1989-96

	1989	1990	1991	1992	1993	1994	1995	1996
Output and expenditure	<i>(percentage change)</i>							
GDP at constant prices	0.2	-11.6	-7	2.6	3.8	5.2	7.0	6.0
Private consumption at constant prices	-0.3	-15.3	6.3	2.3	5.2	4.3	4.5	8.2
Public consumption at constant prices	-4.6	0.5	10.2	6.4	3.8	2.8	2.9	3.4
Gross fixed investment at constant prices	-2.1	-10.6	-4.4	2.3	2.9	9.2	18.5	20.9
Exports of goods/services at constant prices	2.6	15.1	-1.7	10.8	3.2	13.1	18.4	11.2
Imports of goods/services at constant prices	4.3	-10.2	29.6	1.7	13.2	11.3	22.7	26.5
Industrial production	na	na	-8	2.8	6.4	12.1	9.7	8.5
Agricultural production	na	na	-1.6	-12.7	6.9	-9.3	10.7	0.3
Prices and wages								
Consumer prices (annual average)	251.1	585.8	70.3	43.0	35.3	32.2	27.8	19.9
Consumer prices (end-year)	639.6	249.3	60.4	44.3	37.6	29.5	21.6	18.5
Producer prices (annual average)	212.8	622.4	48.1	34.5	31.9	30.1	25.4	12.1
Wages and salaries (annual average)	291.8	398.0	70.6	38.9	34.8	34.5	31.6	26.4
Monetary sector <sup>1)</sup>								
Broad money (end-year)	526.5	150.0	36.9	57.5	38.0	38.2	34.9	29.4
Government sector	<i>(in percent of GDP)</i>							
General government balance <sup>2)</sup>	-7.4	2.8	-2.1	-4.9	-2.3	-2.2	-1.8	-2.5
General government outlays <sup>2)</sup>	48.8	45.1	45.8	50.0	49.9	50.5	49.7	48.9
State budget balance <sup>3)</sup>	-3.0	0.4	-3.8	-6.0	-2.8	-2.7	-2.6	-2.5
State budget outlays <sup>3)</sup>	28.5	34.6	29.9	33.2	32.2	32.7	31.9	30.0
External data in convertible currencies	<i>(in billions of US\$)</i>							
Current account balance <sup>4)</sup>	-1.4	0.7	-1.4	-0.3	-2.3	-0.9	-2.3	-8.5
"Adjusted" current account balance <sup>4)</sup>	na	na	na	na	na	2.3	5.5	-1.4
Trade balance <sup>4)</sup>	0.2	2.2	0.1	0.5	-2.3	-0.8	-1.8	-8.2
External debt	40.2	48.9	48.3	48.2	48.7	40.9	39.4	na
	<i>(percentage change in the US\$ value)</i>							
Exports (data from the balance of payments) <sup>4)</sup>	4.5	43.4	17.5	9.7	-2.9	24.8	35.0	6.7
Imports (data from the balance of payments) <sup>4)</sup>	16.3	17.9	46.8	6.1	17.7	12.0	38.9	31.9
Flow of foreign direct investment settled in cash	0.0	0.0	0.1	0.3	0.6	0.6	1.1	na
	<i>(in months of imports of goods and non-factor services)</i>							
Gross international reserves (end-year), excl. gold	3.6	5.5	3.3	3.4	3.0	3.7	6.5	6.0
Miscellaneous items	<i>(denominations as indicated)</i>							
Population (in millions)	38	38.2	38.3	38.4	38.5	38.6	38.8	38.64
Employment (percentage change, end-year)	-5.3	-10.6	-8.1	-4.8	-3.1	5.7	0.8	1.7
Unemployment (% of the labour force, end-year)	0.0	6.5	12.2	14.8	16.4	16.0	14.9	13.6
Exchange rate (zloty per US\$, end-year) <sup>5)</sup>	0.65	0.95	1.096	1.577	2.134	2.437	2.468	2.876
Exchange rate (zloty per US\$, average) <sup>5)</sup>	0.145	0.95	1.058	1.363	1.812	2.272	2.424	2.697
Interest rate (refinancing rate, end-period) <sup>6)</sup>	140	55	40.0	38.0	35.0	33.0	29.0	25.0
GDP (in billions of new zloties; current prices)	11.8	56.0	80.9	114.9	155.8	210.4	286.0	361.8
Private sector share of GDP (%)	28.6	30.9	42.1	45.4	47.5	53.0	62.0	70.0
The share of agriculture in GDP (%) <sup>7)</sup>	11.8	10.3	9.0	6.7	6.6	6.2	7.9	7.7
The share of industry in GDP (%) <sup>7)</sup>	44.1	44.9	40.3	34.0	32.9	32.2	32.0	31.5
GNP per capita (in US\$) at PPP exchange rate <sup>8)</sup>	na	na	na	na	na	5,380.0	6,200	7,000

Source: Data for 1989-95 are an EBRD summary of official data from national authorities, the IMF, the World Bank, OECD, PlanEcon and the Institute of International Finance (Transition Reports 1996), revised and updated to 1996 by the authors on the basis of the data from the Ministry of Finance.

Notes to Table 1 (previous page)

- 1) Beginning December 1991, data are based on a new system of accounts and an improved reporting system.
- 2) 'General government' includes the state, municipalities and extra-budgetary funds. The data are compiled on a commitment basis, except for external interest payments which are cash-based.
- 3) For the period 1988-90, the 'state budget' includes central government accounts and accounts of local and regional authorities. The state budget for 1991 and subsequent years includes the central government accounts, the accounts of regional authorities and accounts of several previous extra-budgetary funds. Flows are compiled on a commitment basis, except for external interest payments which are cash-based.
- 4) The unadjusted series is based on official trade data which are likely to understate exports very significantly. The 'adjusted' estimates take into account export revenues that flow through the so-called 'kantor' markets for small-scale foreign exchange transactions. Such flows are negligible prior to 1994.
- 5) Zloty values are expressed in the re-denominated units: given the elimination of four zeros on 1 January 1995, the figures given here should be multiplied by 10,000 to obtain actual pre-1995 values.
- 6) From 1996 Lombard rate.
- 7) At current prices.
- 8) PPP stands for purchasing power parity. The estimate quoted here stems from the *World Bank Atlas 1996*. In the computation of this estimate, the country's nominal GNP per capita in local currency was divided by the PPP, defined as the number of units of the country's currency required to buy the same amount of goods and services in the domestic market as one would buy in the United States.

Polish achievements are not, and could not be, the result of the mere activation of markets, which in the early days of transition was treated as a sufficient condition for recovery and growth. *Strategy for Poland* and *Package 2000* have added parallel institution building, necessary structural policies and a different mix of quantitative and qualitative instruments. This distinct policy switch defined a new, more developed and articulated Polish alternative; there is a tight connection between achievements, policies and instruments.

A number of myths, through cumulative and uncritical repetition, are ingrained both in general public opinion and, even, in professional circles. At the risk of oversimplification, the conventional wisdom is that Poland's outstanding success is due primarily, or even exclusively, to the so-called 'shock therapy' of January 1990 – a package of macroeconomic stabilization, price deregulation and reduction of subsidies, foreign trade liberalization and immediate convertibility. For instance, in mid-January 1996 a conference organized by CASE (Centre for Social and Economic Research, Warsaw) reportedly 'diagnosed Poland's economic situation – *thanks to its first reforms* – as good in comparison to other post-socialist countries'.<sup>1</sup> The initial deep recession which accompanied those policies is dismissed as either a statistical illusion (e.g. Berg 1992) or the inescapable cost of transformation (e.g. Gomulka 1996). In this perspective, the therapy's effects were reinforced by systemic changes – primarily privatization – and structural reforms implemented by successive governments until September 1993.

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<sup>1</sup> See *New Europe*. 26 January 1997: 8 (emphasis added).

The harvest was reaped instead by Poland's former communists. They changed their name to social democrat, adopted the 'Balcerowicz programme' as their own (sic!) and won the September 1993 general elections by promising to reduce the social costs of reforms. They then proceeded to maintain the budgetary restraint and the macroeconomic stability which have underpinned economic growth and pushed slowly ahead with privatization and other reform (Robinson 1997).

Post-1993 governments are credited at best with good luck, at worst with wilful delays and digressions which failed to reverse Polish progress, thanks only to the strength of previous achievements and of favourable external trends.

These myths are matched by counter-myths, namely that the cost of Polish stabilization could have been reduced by a more gradual approach, or that demand expansion funded by public sector deficits would have permanently contained unemployment without causing inflation. Both sets of arguments are often extended to explain the experience of other transition economies; often – rightly or wrongly – the poor performance of Russia, Ukraine or Belarus is attributed to a more gradual approach while, on the contrary, China and Vietnam are used to demonstrate the possibility of a gradual alternative accompanied by economic growth.<sup>2</sup>

Clearly Polish economic achievements to date could not have been obtained without the fundamental policy switch of September 1989, from a somewhat reformed socialist planned economy to a genuine market economy. However, first, this was a necessary but not a sufficient condition for the recent Polish achievements. Second, of course this does not imply that the switch to the market economy was well designed and well implemented: it is the quality of the transformation that is questionable, rather than its speed. Third, it is quite implausible that the Polish economic performance in 1994-97 should have been predetermined by earlier policies, let alone the January 1990 policy package on its own; there is no known instance in world economic history of such a combination of long lags and total invariance of economic performance with respect to current policies, as is implied in this reasoning. While other transition economies have enjoyed a comparable start and identical external conditions, they have been considerably less successful.

This essay presents a brief review of Polish economic performance in 1994-97 (section II) and seeks to discredit these myths by contrasting them with facts. The negative legacy of post-communist governments prior to September 1993 is illustrated (section III). We argue that the stabilization package of 1990, while putting the transformation on the right track, inflicted on the Polish economy more, and deeper, shocks than were necessary and led to overshooting (section IV); that the accompanying recession was real, not a statistical mirage (section V). We then stress the distinctive features of new strategies and ideas that have shaped Polish transformation in 1994-97 (section VI), in its macroeconomic, microeconomic and sectoral

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<sup>2</sup> Until 1996 China and Vietnam have experienced continued fast growth since the start of transition, respectively at 9.4 per cent since 1978 and 7.1 per cent since 1986.

aspects: respectively fiscal, monetary, exchange rate and trade policies (section VII), privatization and governance (section VIII), restructuring (section IX). Section X assesses positively the sustainability of Polish economic growth in the longer run, while stressing political obstacles. Issues raised by Polish accession to the European Union, including prospective membership of the European Monetary Union, are considered in section XI. The last section notes that these ideas and strategies, which were unfashionable and controversial at the time of their first formulation and implementation, have been gaining increasing acceptance and are now gradually forming a new consensus.

## II ECONOMIC PERFORMANCE 1994-97

In 1994-97, Polish GDP growth accelerated to an average of over 6 per cent, making Poland the first transition economy to overtake its 1989 real income (a summary of Polish economic indicators for 1989-96 is provided in Table 1).<sup>3</sup> This growth is rooted in investment and export growth, thus appearing sustainable. Unemployment, which in 1994 peaked at 16.9 per cent of the labour force, has been falling steadily to 13.3 per cent in December 1996, under the level of end-1992. The private sector has continued to grow, reaching nearly 65 per cent of GDP in 1996; there are over 2 million private enterprises, of which over 200,000 trade on the international market.

In 1994-97, the public sector deficit has been stabilized and maintained at well under 3 per cent of GDP; public debt has fallen from 86.9 per cent of GDP in 1993 to 53 per cent in 1996; it is forecast at 50 per cent in 1997. Thus both deficit and debt are below the Maastricht benchmark – a sure sign of fiscal convergence with Europe.<sup>4</sup> Inflation has steadily declined, down to 18.5 per cent in 1996. The zloty has continued to depreciate at a crawling peg, though at a falling rate (1 per cent a month in early 1997) and, since mid-May 1995, within a 7 per cent band either side of a crawling parity. However, the zloty has been appreciating in real terms, and occasionally even in nominal terms, thus rapidly lifting wages and incomes in dollar terms. This has not upset Polish competitiveness, thanks to exceptional labour productivity increases, due to restructuring, higher than wage growth. Both exports and imports have boomed, integrating Poland further into the European and world economies. An apparent trade deficit is reduced and sometimes offset by large scale border trade, especially with Germany; its order of magnitude is an amazing US\$6-7 billion. Foreign investment, which

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<sup>3</sup> De Melo *et al.* (1996) classify 28 transition economies in terms of their growth experience since the beginning of transition, into *growing* (China and Vietnam), *recovering*, *lagging*. Recovering economies are those that have experienced an initial drop in real GDP but register a positive growth rate in 1994-95: all central-eastern European countries, the Baltics, Slovenia, Mongolia, Armenia, Croatia. Lagging economies have declined and continue to decline in 1994-95: all the other former Soviet republics, FYR Macedonia.

Within the group of recovering economies, Poland ranks second after Slovenia with an identical initial drop of 16 per cent of GDP with respect to the transition base year (1989 for Poland and 1991 for Slovenia), and respectively an average yearly real GDP growth since the start of -0.6 per cent and 1.7 per cent. But this comparison glosses over Slovenian decline in 1989-91, and ignores that Poland was first in resuming growth in 1992 at a sustained and accelerated trend rate (the 1996 apparent slowdown follows exceptional agricultural growth in 1995). If 1989-95 is considered, the four Visegrad countries and Slovenia stand head and shoulders above the others in the 'recovering' group, with Poland at the top.

<sup>4</sup> Maastricht Treaty accounting conventions measure the deficit as the increase in government nominal debt + privatization revenue, which means that privatization revenues are excluded from budget revenue - a debatable asymmetry since government investment in productive assets is not excluded from the expenditure side. According to this stricter definition Poland would exceed the limit in 1996 but will be just over the 3 per cent limit in 1997. Government debt is also defined slightly differently from the Maastricht rules; for instance in Poland interest accrued but unpaid on public debt is not included. The difference is an underestimate of total debt of the order of 1.5-3 per cent, which does not affect Poland's observance of the 60 per cent limit.

until the end of 1993 represented only 7 per cent of the cumulative total inflow into the area, has accelerated: in 1994-95 it exceeded that which took place in 1989-93; on a cash basis it reached US\$14 billion in 1996; beside the booming automotive sector (US\$3 billion projects by General Motors, Fiat, Daewoo, another US\$1 billion in component plants, plus plans by Mercedes Benz and Isuzu). FDI has moved in sectors from home computers to retail networks. An emerging trade balance is manageable through the mobilization of reserves, justified not only by the large investment component of imports that lays the foundations for further growth, but also by the high cost incurred by the National Bank of Poland to sterilize much of its mounting foreign reserves (over US\$21.6 billion at the end of October 1996) equivalent to seven months' imports, i.e. well in excess of IMF-recognized prudential limits of three months (see below).

In other respects, and overall, Poland is a front runner jointly with the Czech Republic and Hungary, as confirmed by their common achievement of OECD membership. Thus, for instance, the Czech Republic boasts a larger share of private sector activities, and lower inflation, but at the cost of unchanged management and governance mechanisms, lack of restructuring and above all a weak banking sector. Hungary shares Poland's advantages while boasting a greater foreign presence in its privatization and higher cumulative foreign investment to date, but has a more unstable macroeconomic position (higher inflation, burden of foreign debt, lower growth).

Polish economic progress has entered general perceptions and expectations. Internally, Poland enjoys a widespread feel-good factor. In July 1996 opinion polls, a majority of families viewed their financial position as better than in July 1995 (57.2 per cent) and expected it to continue to improve in the following year (56.9 per cent), markedly reversing the previous balance.

International confidence has been growing.<sup>5</sup> In 1996 Standard & Poor's, Moody's and IBCA raised Poland's credit-rating giving investment quality to its sovereign debt. In July 1996 Poland borrowed DM 250 million at a fraction of only 65 per cent of one percentage point above the Bundesbank – better than Hungary. In November 1996, membership of the OECD gave Poland the stamp of approval as an open, advanced market economy, thus concluding a whole stage of transition. Poland's accession to the European Union, applied for in April 1994, is not in doubt; the only question is timing – whether it be by the year 2002 as claimed by bureaucrats given the technical delays of negotiation and ratification of treaties, or by the year 2000 as envisaged in September 1996 by President Chirac during his state visit to Warsaw.

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<sup>5</sup> In September 1994, an agreement with the London Club commercial creditors confirmed international confidence by slashing a US\$13.2 billion component of external debt by 42.5 per cent.

### III THE LEGACY OF 1989-93

The claims that Poland's successes of 1994-97 are rooted in the earlier policies of 1989-93 must necessarily imply that by September 1993 Polish 'fundamentals' were already poised for recovery and growth. On the contrary, while the previous post-communist governments (successively led by Mazowiecki, Bielecki, Olszewski, Suchocka) had successfully initiated the Polish transformation, they had left also an extremely heavy, negative legacy. The new governments (successively led by Pawlak, Oleksy, Cimoszewicz) have benefited from the switch to market economy, which they have sustained and consolidated, but have also had to contend with the aftermath of a drastic, excessive output contraction and mass unemployment, without the redeeming feature of capacity restructuring. Savings and investment had plummeted. Earlier, draconian monetary stringency had failed to control inflation, which in 1993 was still running at the yearly rate of 38 per cent; instead such policy had resulted in the accumulation of inter-enterprise payment arrears. The bad loans inherited by the banking system from the 1980s, wiped out by the rapid inflation of early transition, were replaced by new bad, or non-performing, loans.<sup>6</sup>

Privatization initiatives had brought neither badly needed budgetary revenue, nor the speedy transfer of ownership intended through mass privatization, which followed a cumbersome and overly centralized programme.

In the name of *laissez faire*, the state sector at best had been neglected, leading to complaints of 'state desertion' (Nuti and Portes 1993), with state firms operating under neither central guidance nor market discipline; incentives were weak and often perverse. At worst, the state sector was deliberately attacked through crippling taxation, discriminatory with respect to the private sector and therefore distortionary, and through the indiscriminate denial of investment credit regardless of economic viability. This process, which is part of what Jerzy Hausner (1996) calls 'transformation as victory', was welcomed as 'creative destruction' – a travesty of this Schumpeterian concept in the absence of the innovation, investment and competition necessarily associated with its creative component. Moreover, the necessity for creative destruction in the Polish and other transitions remains to be demonstrated; not all destruction is necessarily creative.

Paradoxically, drastic systemic changes were often implemented as a centrally planned form of institutional engineering, similar to that imposed by the Soviets in the transition to communism and condemned by Hayek (1992) as 'fatal conceit'; suffice to mention the unprecedented experiment of mass privatization. In other respects, the new institutions were expected to be generated directly by the new opportunities, as exemplified by Jeffrey Sachs's belief that '*markets spring up as soon as central planning bureaucrats vacate the field*' (1993: xii; emphasis added). By end-1993 not only had the massive task of institution building and

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<sup>6</sup> The programme for the financial restructuring of enterprises and banks, however, was initiated in early 1993.

consolidation not been completed; worse, earlier governments had acted as if it had, relying on supply responses which were not yet fully present.

Monetary policy had been at first more restrictive than actually intended by the government, due to anchoring nominal monetary targets to under-estimated inflation; then geared to an incoherent combination of high interest rates and above-target monetary expansion which, together with exchange rate policy, prevented a faster fall of inflation (see below, section VII).

Fiscal policy had been erratic, moving from an unwanted surplus in 1990 to a significant deficit: in 1989-93 budgetary subsidies had been cut by 9.6 per cent of GDP, but simultaneously social spending had been raised by 11 points from 10 to 21 per cent of GDP – the dead-weight cost of unemployment and above all pensions, used on a large scale as a social pacifier, with generous early retirement and invalidity pensions *in lieu* of redundancy payoffs. Failure to address this issue is a major area in which pre-1993 policies could have been improved; early warnings had been clearly and loudly given by the OECD country study of 1992 (pp. 75-7). By 1993 roughly 32 per cent of Polish adults were pensioners of some kind or another. The burden was set to rise because of the infelicitous switch, at a time of falling real wages in the early transition, from price to wage indexation of pensions, which predictably triggered off an excessive growth of real pensions once real wages resumed their growth. The reversal of this simple but devastating miscalculation was to become the most difficult task for the post-1993 governments to deal with.

Foreign trade policy had also been erratic, moving from the drastic devaluation of 1 January 1990 to rapid and significant real revaluation, and from an initial regime which, by any world standards, was exceptionally free to the subsequent rise of protectionism (see below).

The mixed nature of Polish economic performance can be summarized in a macroeconomic stabilization 'pentagon' drawn in terms of income growth, unemployment, inflation, fiscal stance and current account position (Kolodko 1993a). The pentagon area, rather than individual parameters, summarizes economic performance;<sup>7</sup> in the Polish case, progress in some directions was matched by excessive deterioration in others, showing that early Polish transition had not resolved the outstanding problems but simply transformed them into other problems and, what matters most, had underperformed.

Furthermore, by the end of 1993 the initial period during which the population was willing to accept sacrifices for the sake of transformation was already over. The new governments faced a disillusioned, frustrated and highly expectant public; reform fatigue; a hostile media, and a constitutional crisis due to Walesa's abuse of presidential vetos.

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<sup>7</sup> Of course, the pentagon area, like *any* synthetic quantitative measurement of *any* multi-dimensional phenomenon, is necessarily sensitive to the scale and origins adopted; the device is a way of illustrating precisely the multidimensional nature of economic performance, and of considering and assessing the trade-offs actually selected.

#### IV UNNECESSARY SHOCKS AND OVERSHOOTING

Polish stabilization and transformation did not begin on 1 January 1990 with the drastic policy package announced in September 1989 by the new Solidarity-led coalition headed by Tadeusz Mazowiecki. The package was meant to administer a shock therapy, a big bang, a cold turkey<sup>8</sup> treatment. But Poland, like Hungary and unlike other transition economies – including Romania and Bulgaria, Russia and especially other FSU republics right up to 1992 – had already benefited from a very great deal of price and trade liberalization and even the building of much of the infrastructure of the market economy. By the autumn of 1989, the stabilization and transformation of the Polish economy still had some way to go but did not actually need much of a shock.

Significant systemic changes had taken place in Poland long before 1990, even under martial law in 1982-83. By 1989 reform achievements were many and significant. Central planning had been replaced by 'government contracts'; the share of material inputs subject to central allocation, already relatively low in 1986 at 45 per cent, had fallen to 22 per cent by 1988. As in Hungary, branch ministries had been abolished and merged into a single Ministry of Industry. Wage payments had been liberalized, subject to progressive taxation on excess earnings. New legislation and agencies promoted joint and private enterprises, including 'agency' and leasing contracts involving the private redeployment of state assets, with a special role for Polish expatriates; there was a thriving private sector not only in agriculture, which had been decollectivized in Poland since the late 'fifties, but also in manufacturing, including high technology activities.<sup>9</sup> A two-tiers banking system (the lack of which delayed the CSFR transition by one year) was in position, together with an exceptionally independent central bank (already by January 1989, see below). The informal foreign exchange market had been legalized in February 1989, thus losing its 'black' status; currency retentions by exporters, transferable to other users, and currency auctions by the central bank, had enhanced *de facto* convertibility at the margin – in a 'dual-track' foreign exchange market. Thus by 1990 Polish producers were already subject to external competition and could bypass residual central controls through direct access to foreign trade on a significant scale (at least 20 per cent of their purchases). OECD could state that 'as a result of these reform efforts, Poland by 1989 was very far from the typical idea of a centrally planned economy' (1992: 12).

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<sup>8</sup> This is defined in the Oxford Dictionary as 'abrupt withdrawal from addictive drugs'.

<sup>9</sup> In 1989, private agriculture amounted to 75 per cent of the land, about 10 per cent of GDP and 21 per cent of employment (see Rapacki and Linz 1992); in the 1980s non-agricultural private activities trebled to about 10 per cent of GDP and employment, including manufacturing as well as traditionally private activities such as trade, catering, services.

Poznanski argues that since 1971 Poland had experienced

the relatively slow, often inconsequential, disintegration of the planning regime and the parallel re-emergence of capitalist markets. *Much of this systemic transition has been brought about unintentionally by the communist leadership responding to a variety of pressures coming from a disaffected society.* The mid-1989 negotiated relinquishment of political control by the communist party did not mark the end of this institutional transition, but it did accelerate it by opening additional avenues for reform (1996: 1; emphasis added). The transfer of power in mid-1989 was orderly and peaceful and, consequently, rather than seeing some momentous change in the aftermath of that transfer, one finds the post-communist economic system changing at a relatively slow pace, with many elements of the past still in place or just marginally altered (1996: 3).

Following Poznanski, the Polish reform appears as an evolutionary, almost 'random' process, rather than the intentional and prefigured development typical of Hungary.

Poland had also already made significant progress towards stabilization before 1990. In general, macroeconomic stabilization in a transition economy has three dimensions. First, the elimination of shortages and queues, which is a system-specific aspect of transition economies: the monetary 'overhang', due to excessively low prices relative to available supplies, must be eliminated; repressed inflation must be transformed into open price rises, up to a market-clearing level. Second, price subsidies must be reduced and prices fully deregulated. Third, open inflationary pressures must be brought down to the desired level. In this respect, as in the development of market institutions and private ownership, Poland had an immensely simpler task than any other transition economy – arguably including CSFR and Hungary, not to speak of FSU republics.

On the basis of econometric evidence for 1985-95 Nijssse and Sterken claim that, 'Contrary to the popular forced savings hypothesis, where money holdings are merely believed to be a passive residual of the central planning process, ... households in Poland had sufficient opportunities to adjust their money balances to the desired level' (1996: 22). This may or may not be an exaggeration but undoubtedly by August 1989, under the Rakowski government, repeated rises of both free and administered prices, including indeed especially food, had greatly brought down monetary overhang. Price subsidies had already been falling significantly in 1988-89, by some 3 per cent of GDP. Prices for about half of total transactions had been deregulated. In the course of 1989 several successive nominal devaluations had restored some competitiveness, with the dollar premium being driven primarily by speculation; in October-December 1989 monthly inflation fell drastically to 30 per cent. Therefore the first two dimensions of transitional stabilization indicated above – market clearing, deregulated prices at reduced subsidies – were already well within striking distance, before and without the shock therapy of January 1990.

The very announcement of a drastic stabilization plan – just as it happened in mid-1990 in the CSFR with the January 1991 stabilization plan pre-announced by Vaclav Klaus – predictably brought about immediate adverse effects. Inflationary expectations, leading to speculative purchases by households and firms, became self-fulfilling. Commentators have argued that in 1989 inventories were built up to the point of offsetting the tightness of monetary policy in the following year (Schaffer 1992). On the eve of the stabilization plan, generous wage settlements which anticipated the price rises that this would bring about actually exacerbated inflationary trends and recreated excess demand for goods and foreign exchange (see Nuti 1990).

The policy package of January 1990 delivered a shock to the economy, indeed several identifiable different shocks. Many of these were not at all therapeutic, or had bad side effects: the foreign trade regime shock, the exchange rate shock, the credit and interest rate shock. Whatever the therapy's merits, its dosage was demonstrably excessive, overshooting several targets: an initial budget surplus, a trade surplus and unintended accumulation of reserves, actual wages mostly below statutory guidelines for most of 1990. Moreover the promised early end to inflation and recession was not delivered.

The authorization for all economic agents – state or private, individuals or enterprises – to conduct foreign trade activities was clearly a necessary and most important component of the move to a market economy. It was also necessary to remove the earlier quantitative restrictions and licensing on both imports and exports. However, especially starting from a structure of productive capacity so far from equilibrium with respect to international trade opportunities, it was not necessary to remove almost entirely all forms of tariff protection to the point of establishing one of the most liberal trade regimes in the world. Higher (though still modest), non-discriminatory and temporary tariffs would have been still fully compatible with a market system and would have been tolerated by trade partners. With that alternative policy, some activities which were unprofitable without some tariff protection, but still yielded a positive value added, would have made a positive contribution to employment, consumption and net exports. As it was, sudden unrestricted trade opening amounted to a further shock: in 1990 Poland's average tariff (including agricultural goods) fell from 18.3 to 5.5 per cent. After significant real appreciation of the zloty, this regime soon had to be accommodated by tariff increases: by August 1991 tariffs were raised again to an average of 18.4 per cent, though spread more uniformly across products.<sup>10</sup> In January 1992 tariff suspensions were reversed; in December 1992 a 6 per cent 'temporary' import surcharge was established; it was lifted only in 1997 with the implementation of *Strategy for Poland*, though the inroads of subsidized EU exports into the Polish domestic market allowed by the 1990 measures continued to call for some countervailing measures even after 1993. Drastic trade opening, and subsequent reversals, at least partly cancelled out in the end, but they still represented separate, unsettling shocks.

The instant convertibility decreed in January 1990 could only be achieved at a grossly undervalued exchange rate – with respect to Purchasing Power Parity (with the US dollar at

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<sup>10</sup> OECD (1992: 134). Average weighted tariffs rose to 11 per cent on industrial goods and 18 per cent on agricultural goods (EBRD 1994: 115).

almost twenty times the PPP rate at the beginning of January 1990) and other measures of competitiveness; with respect to the level of domestic wages expressed in foreign currencies (about US\$50 in the month of January 1990) and to the experience of similar (but non-transitional) economies where the ratio is usually of the order of 2. The same thing also happened in other transition economies, due to the existence of monetary overhang, pent-up demand for foreign assets, over-caution on the part of authorities. But Poland's ratio between PPP and actual exchange rate was the highest outside the FSU, for additional reasons: the exceedingly liberal trade regime; the pitching of the new nominal exchange rate at the free-market level, higher than the equilibrium unified rate;<sup>11</sup> the use of the exchange rate as a nominal anchor in conditions of inflationary expectations.

Such gross undervaluation distorts the short-run profitability of foreign trade with respect to longer term opportunities. Therefore it provides no guidance for capacity restructuring; encourages distress exports (i.e. unprofitable in equilibrium) especially in association with restrictive monetary policy; disrupts patterns of production and trade which would be viable at a sustainable equilibrium rate. But the most damaging effect in the short run is its generation of inflationary pressures, under the guise of high profitability of exports and lack of competitiveness of imports: 'These sharp increases [in the ratio between actual and PPP exchange rates] surely exacerbated inflationary pressures ...' (de Melo *et al.* 1995: 23). Terms of trade worsened significantly as a result, by as much as 36 per cent in 1990. At undervalued rates, the threat of over-expensive imports is no substitute for the lack of internal competition; monopolistic behaviour is encouraged, also contributing to the first round of transitional inflation. Of course, real revaluation occurred fast, reversing the trend in terms of trade by 1991 with a 25 per cent improvement – which was as much a shock as their previous collapse. By 1996 the zloty rate to the dollar had fallen under twice the PPP rate. Due to NBP policy, however, the unstoppable real revaluation of the zloty occurred not through nominal revaluation or at least stability of the nominal rate, but through further nominal devaluations and differential inflation with respect to foreign currencies. As with trade policy, undervaluation followed by real revaluation also delivered some destabilizing jolts to the Polish economy.

Another unnecessary shock was due to credit and monetary targets being taken as nominal anchors for an expected inflation rate which was significantly lower than the actual rate – not least because of an undervalued exchange rate: therefore the unintended contraction of real credit and money gave a recessionary squeeze to the economy, in addition to the targeted high interest rate which was aimed at achieving a positive real rate (see Calvo and Coricelli 1993).<sup>12</sup> Such a squeeze played an important part in the Polish recession, at least in the first eight months of 1990.

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<sup>11</sup> It is well known (not least from post-war literature on price controls and black markets) that the high free price in a two-tiers price system is normally higher than a uniform equilibrium price at which the same total quantity is sold. Thus in 1990 the zloty was made cheaper than if it had been left to float. See also Nuti 1995 and Rosati (1996).

<sup>12</sup> Bofinger (1994) challenges the role of credit shocks because of the fairly uniform collapse in countries with different monetary policies, including, for instance, Russia and Ukraine where initially monetary policies were expansionary. However, this could be better explained by the lack of market institutions in these two countries, which may have prevented the operation of monetary stimulation.

Unnecessary shocks, plus a therapy overdose, led to overshooting with respect to important original targets such as the fiscal stance, the trade balance and the unplanned acquisition of reserves, wage levels.

The 1990 fiscal balance target was overshoot and a surplus obtained instead, of 3.5 per cent of GDP in the government budget and 0.7 per cent in the state budget. This was primarily due state enterprises being taxed on their paper profits; their tax liabilities rose by a factor of three, due to the zloty revaluation of their foreign assets and revenues, to windfall gains of stock revaluation in the face of huge inflation, and to the large profits of the banking system. This surplus created a temporary demand deficit, which in the first half of 1990 could have been eliminated by keynesian expansion. The output loss involved was not made any better by the following fiscal crisis, which arose with the drying up of these sources of revenue and the growth of social welfare expenditures, a phenomenon related to output collapse and unemployment (discussed in the next section).<sup>13</sup>

Another aspect of overshooting was the realization of trade surplus, partly due to the recession itself, partly to 'distress exports' (mentioned above) caused by illiquidity and undervaluation; these were detrimental to the domestic economy through low (if any) value added, and through supply lines disruption. The accompanying reserve accumulation of US\$2.2 billion in 1990 was also unintended and – in view of very high nominal interest in a currency stable in terms of the dollar (until May 1991) – ruinously expensive to sterilize.

These criticisms should not be confused with the calls for some kind of gradualism which have been put forward in the transition debate on Poland and on other countries by authors of the most diverse backgrounds; all have either never had any involvement in the transition, even as government advisers, or have lost a position of power. These include kaleckians/keynesians such as Amit Bhaduri and Kazimierz Laski (1993); 'social market' supporters such as John Gray (1994); anti-neoclassical writers such as Alice Amsden, Bogdan Kochanowski and Lance Taylor (1994); former advocates of reform in the old system and Third Way seekers like Nikolai Petrakov (former chief economic adviser to President Gorbachev) and Valtr Komarek (first Czechoslovak Deputy Prime Minister immediately after the Velvet Revolution); representatives of the state enterprise lobby such as Arkady Volsky in Russia in 1992.

For instance, Bhaduri and Laski (1992) claim that,

The economic disaster of pursuing the orthodox remedy of 'austerity only' is now far too apparent in East Europe ... By restricting demand in almost every possible way – through an extremely tight monetary policy, reduced government expenditure in an attempt to reduce budget deficit and restraint on wage – these economies have been precipitated in an economic depression

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<sup>13</sup> See Kolodko (1992) on what he calls the 'perverse effect of fiscal adjustment', or the deterioration of fiscal balance as a result of privatization and other aspects of systemic change.

which can only be compared to that of the 1930s in the capitalist world (1992: 5).

Apart from the fact that the 1930s saw neither structural problems nor systemic change, for Poland this argument only holds for the first eight months of 1990. Subsequently the only conceivable room for further keynesian expansion in Poland was of a Haavelmo type, i.e. through the balanced budget multiplier effects of both higher fiscal revenue and higher public expenditure.<sup>14</sup>

More generally, the juxtaposition of shock therapy versus gradualism is, to a very great extent, a false dilemma: the scope of choice is narrow and is further restricted by actual circumstances. The only country where undiluted shock therapy was possible is East Germany, by virtue of unique, unrepeatable circumstances (see Brezinski and Fritsch 1995). Everywhere else some shock therapy measures were undoubtedly necessary (e.g. price liberalization, stabilization, exchange rate unification, legalization and encouragement of private ownership and enterprise, etcetera), to an extent depending on earlier progress, e.g. low in Hungary and Poland, higher elsewhere. Most other measures – especially institutional developments – on the contrary necessarily take time; their effects can be brought forward by government announcements, provided these are consistent and credible. A time duration necessarily raises problems of optimum sequencing of policy measures. A major source of transitional costs has been the ignoring of the necessary slowness of many of the steps towards the target model – which is, however, *per se* a case for taking additional rather than alternative steps.

Very few measures could have been the object of choice between gradualism and speed, always involving, as they did, not absolute superiority of one over the other but a different trade-off between alternative objectives; arguably there are only four instances.

First, the more slowly subsidies are reduced the lower is the rate of inflation – at a corresponding budgetary cost which may be incompatible with other targets, or involve a trade-off between current and future inflation. Czechoslovakia had the budgetary resources to sustain subsidies for longer than was consistent with Vaclav Klaus' rhetoric; China reduced subsidies and price controls even more slowly, relying on its dual-track price system to reduce adverse effects on efficiency. Poland, like all other transition economies, had neither the time nor the resources to delay the reduction of subsidies. By 1989 the question of the optimal time scale for subsidy reduction and price deregulation, whether one or ten years, had become – in the absence of time travel facilities – largely irrelevant.

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<sup>14</sup> De Crombrugge and Lipton (1992) suggested a rise of budget revenues from 23.4 per cent of GDP in 1991 to 30 per cent, with current spending also up, from 24.9 per cent to 27 per cent of GDP, thus bringing government saving from -1.5 to 3 per cent, but raising investment from 1.9 to 6 per cent while lowering the deficit from 3.3 to 3 per cent of GDP. For plausible values of the parameters determining the multiplier this kind of fiscal manoeuvre could have been non-recessionary.

Second, the faster the privatization, the lower is its contribution to budgetary revenue and the weaker its impact on enterprise efficiency – due to the likely greater role of insiders – but the earlier that particular impact is felt. Third, the sooner convertibility is introduced, the faster is the reintegration into the world economy but the greater is the devaluation necessary to sustain it – regardless of the exchange rate regime adopted – with inflationary repercussions and adverse terms of trade trends. Fourth, the faster the lowering of trade barriers, the greater the impact on competition and the attraction for foreign investment, but the greater also the unemployment cost of destroying activities which – though loss-making at international prices – still yield some positive value added.<sup>15</sup> In these areas there is no obvious superiority of speedy or gradual change; the best choice depends both on trade-offs actually available and on government preferences.

Last but not least, the focus of the transition debate should move away from the comparison of an extreme approach down to the nitty gritty both of the programmes actually implemented (their small print, the unintended effects of a process which acquired an uncontrolled life of its own) and of the proposed alternatives – attempted in this evaluation of both major periods of Polish transition, before and after September 1993.

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<sup>15</sup> Williamson (1993) regards this as 'avoidable loss'.

## V A VERY REAL RECESSION

The policies launched in January 1990 were widely expected to bring instant relief from inflation and, in a matter of months, fast recovery and growth after a small output fall. Sachs expected a 1 per cent inflation in January 1990, instead of the recorded 45 per cent, and recovery after six months; Balcerowicz (1992) also expected a turnaround in a matter of months; Gomulka (1990) predicted GDP growth rates in 1991-93, respectively, of 4.7, 8.7 and 7.9 per cent. Contrary to these expectations, in Poland as in every other transition economy – outside China and Vietnam – stabilization was accompanied by a protracted, large-scale fall in recorded consumption, GDP and industrial production; the initial price flare was higher, and inflation fell much more slowly than was anticipated by the promoters (Table 1).

There has been a marked tendency for policy makers and their advisers to 'massage' official data and argue that much of the recession was a statistical illusion, while any unexplained residual was simply regarded as a legacy from the past, i.e. the necessary cost of the transformation.

First, it has been argued that GDP statistics do not include the welfare increase from the elimination of shortages and of time-wasting queues, and from a broader scope for choice (Berg 1992). In 1991 an adviser to the Polish government, asked to name the greatest achievement of the stabilization programme, answered 'You can now buy kiwis in Warsaw streets'.

Second, it has been argued that earlier levels had been achieved only on paper, due to incentives to over-report economic performance. Thus real wages on the eve of the reform were much lower than 'statistical' real wages.<sup>16</sup> New private sector activities, on the other hand, were being under-recorded for several reasons, given both a fiscal incentive to keep a low profile and the poor coverage of small enterprises especially in the semi-legal 'grey' economy, where many workers officially unemployed are believed to be working (see Berg and Sachs 1992).<sup>17</sup> Moreover, index numbers underplayed quality improvements (Osband 1992). China's performance, on the contrary, was overstated by deflating money income growth by price indices which were not representative and underestimated inflation; in any case its special features bar generalizations.

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<sup>16</sup> 'Using consumer expenditure data, we found that the weighted volume of consumption fell in 1990 compared with 1989 by around 4 per cent, *not taking into account the rise in product variety, product quality, or the end of queuing time*' (Sachs 1993: 71, referring to Berg-Sachs 1992; emphasis in the original).

<sup>17</sup> See also Sachs (1993: 75) '... the statistical agencies did not report data on key parts of the nonindustrial economy ...'. 'The official index almost surely undercounts the contribution to production of new, small-scale, private industrial enterprises' (1993: 76).

The latest, determined attempt at revising Polish national income statistics in the earlier days of the transition is that of Czyzewski *et al.* 1996. According to this study, the 1989 GDP level usually taken as a starting point of pre/post transition comparisons was overestimated due to high inflation (at a yearly point-to-point rate of 549 per cent) which, according to the national income conventions of the time, had treated the value increase of inventories as income. When properly measured, Czyzewski *et al.* (1996) argue that the cumulative income decline in the early transition was 7 per cent, instead of 18 per cent.

These authors also introduce a novel methodology to evaluate the specific weight of factors contributing to changes in gross industrial output in Poland during 1989-91. Seven factors are considered: the Comecon effect; other export changes; import effects; the domestic spillover of Comecon effects (estimated by means of a 1990 input/output table elaborated by the main statistical office for 32 branches); domestic spillover of other net export effects and the effect of stabilization (both by means of input-output analysis). Finally, the unexplained residual is defined as a 'structural effect' – although quantitative structural changes are already fully accounted for in the analysis. Such structural effect, as it happens, in 1990 has a stronger negative weight than stabilization, which according to this study makes a positive contribution to average industrial output change by 1991.

While some of these arguments do not have real substance, others are vastly overplayed. The search for goods had been replaced by the search for jobs, with one giant queue of unemployed replacing the innumerable queues for goods, while the welfare of employed workers was worsened by job insecurity. Further, established national income conventions do not include consumers' surplus derived from sheer access to markets and the broadening of consumer choice.

Sachs' and Berg's calculations neglect the faster than average drop in public consumption in Poland, and seem to be the result of a certain amount of massaging of raw data (their first estimate of consumption fall was higher: see Nuti-Portes 1993). By the autumn of 1989 shortages in Poland had been virtually eliminated, i.e. real wage falls with respect to October 1989 cannot be entirely dismissed.

Much private sector growth consisted of existing, formerly illegal, activities surfacing. Private sector activity levels may well be underestimated, but their growth probably is not, due to a lower degree of under-recording of these activities under the new system (the Polish private sector, incidentally, was already large and had been rapidly growing even under the old system, with a million employees outside agriculture by 1989). On the contrary, Polish industrial output, being an index of sales, was probably inflated by the splitting of large state enterprises through the inclusion of formerly excluded infra-enterprise transactions now become inter-enterprise transactions. Rachael Walker (1996) applies to the Visegrad countries in 1990-93 the method devised by Gerschenkron (1947) for the verification of Soviet pre-War output indices. She finds that by that method 'the decline in industrial output in the transition may indeed be greater than is accounted for in the indices for industrial production' (see also Rosati 1994).

The so-called 'structural effect' is really a spurious concept which, like all unexplained residuals, is more likely to be evidence of the inadequacy of data and methodology than an estimate of anything. A transforming economy cannot perform like a market economy until all the necessary new institutions have been set up and are fully operational; it would be more plausible to interpret the structural effect discussed by Czyzewski *et al.* as the cost of implementing a stabilization package in a market vacuum.<sup>18</sup> Such a cost cannot possibly be separated from the overall cost of the selected stabilization policies.

Sample enquiries conducted by the World Bank confirmed that the unemployed were real. In any case the 'true' unemployment rate should have included those involuntarily withdrawn from the active population: the early retired and pseudo-invalids pensioned off instead of being sacked, plus those unemployed who, no longer being entitled to benefits, failed to register. Moreover per capita average data hid the drastic redistribution that had plunged below poverty levels – however measured – an increasing proportion of the population. According to World Bank (1996) the Gini coefficient of income inequality (ranging from zero for uniform income to 100 for a theoretical distribution of all of GDP to one person) in Poland rose from 25 in 1987-88 to 30 in 1993, higher than in Hungary (23), Slovenia (28) and the Czech Republic (27), though lower than in Bulgaria (34) or Russia (48). Over the same period the percentage of the population living below the poverty line – conventionally fixed at US\$120 per month throughout central eastern Europe – rose from 6 to 16 per cent, the highest among Visegrad countries. The poverty gap index, which indicates the average percentage of the poverty line reached by those below that line, is usually taken as a measurement inversely related to the depth of poverty; in Poland in 1993, this index was only 27. Sixty per cent of the poor in Poland are workers; during 1989-91 old age pensioners actually improved their relative position (see below on pension trends for an explanation) while the greatest losers have been children. Drastic income redistribution is the likely cause of the rapid growth in the consumption of luxuries and durables (VCRs, stereo tape recorders, colour TV sets, washing machines, freezers) which some observers mistake for signals of unrecorded income recovery in the early transition.

The original claim that the output loss involved in the January 1990 package had been overemphasized by official data, improbable but plausible at the time, was eventually transformed into a much stronger and totally implausible claim that 'There has been no significant fall in living standards. Real incomes did not plummet. Unemployment, while high, is not soaring to the levels that were feared' (Sachs 1993: 71), or 'Economic life remains hard in Poland. It always has been, and had been getting worse fast at the end of the 1980s. But it did not get still worse after 1989' (p. 78). These statements are contradicted by Sachs's own data; it has taken until 1993 for food consumption per capita to approach the 1989 level. At the beginning of 1990 Labour Minister Jacek Kuron anticipated one million unemployed by the end of 1990; his forecast was impressively accurate. Whether or not the unemployment levels actually reached were as high as feared, they still amounted to mass unemployment: if '... the transformation has not resulted in mass unemployment' (Sachs 1993: 73) one may well ask:

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<sup>18</sup> 'Market signals - such as there are - [are] covered by noise or echoing in a systemic vacuum...' (Eatwell *et al.* 1995).

where does mass unemployment begin? (for a critique of the denial of recession, see Kolodko 1992 and 1993b).

Mundell (1995) questions whether the underground economy in the transition is greater than under communism, whether under-reporting of new firms is on a sufficient scale to account for output collapse; he regards the share of industrial output produced by the private sector as too small, initially, to alter the recessionary picture even if it did grow more rapidly than recorded. Mundell concludes that in transition economies in general, 'The negative mirage theory is completely unconvincing'; indeed, in the whole history of the world, he regards the Black Death as the only appropriate comparison to the deep recession – except that in that case income per head did not fall.

To the extent that there was, at least at some time or in some sectors, a recognized fall in residual output or income, it is variously attributed to exogenous factors, to departures of stabilization measures from the recommended path, and most of all to the communist inheritance, i.e. the liquidation of negative value added activities. Thus the Comecon collapse and the Gulf War are taken as exogenous shocks; but the Comecon shock was self-inflicted by central-eastern European ex-members upon themselves, through a deliberate political choice; the Gulf War impact has been exaggerated. While the failure to implement mass privatization rapidly has been taken as the main explanation for that part of the Polish recession which is not explained away by other factors, former Hungarian Finance Minister Lajos Bokros on the contrary, regards the Polish delay in mass privatization as a 'blessing in disguise', which enabled Poland to reorganize and restructure state enterprises ahead of privatization and collect substantial revenue from their sales.<sup>19</sup> Another reason often given for the recession is western failure to adequately support the transition countries' efforts with financial aid and trade access – an obligation which paradoxically is associated with the kind of international solidarity of traditional former socialist ideals.

The inappropriate composition of supply at the start of transition is often regarded as the ultimate cause of output depressions; therefore '*Post-reform recessions are inevitable and, in terms of unemployment of labour, have to be deep and fairly long*' (Gomulka 1993, emphasis added). Does that mean that, insofar as there is a recession, it is all for the best, in the best of all possible worlds? First, in Poland as elsewhere, the initial industrial output fall was accompanied by little industrial restructuring, of a kind that should have occurred if output collapse had been caused by the elimination of negative value added activities. Second, such elimination must create unemployment in the short run, but supporters of this approach still have to come up with some explanation of how it is that cutting negative value added activities can at the same time reduce GDP, which is nothing but total nationwide value added.

Politically, if the Polish recession had been a statistical illusion, or if the sacrifices had been believed necessary, the 1993 elections should have brought the parties associated with the early transition policies back to power. But on the eve of the election the western financial

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<sup>19</sup> At a UNU/WIDER conference in Helsinki in November 1996.

press (for instance *The Financial Times*) reported extensively on the 'feel-bad factor' of the Polish electorate, and correctly predicted the forthcoming changes.

## VI THE NEW STRATEGY FOR POLAND

In September 1993, when the Polish electorate gave an absolute parliamentary majority to the reformed successors of the socialist and peasant parties that had ruled in 1989, there was widespread concern for the stability and continued transformation of the Polish economy. There were dismal predictions of 'creeping destruction' (former Finance Minister Balcerowicz) '300 per cent inflation within six months' (former Premier Bielecki), 'national catastrophe' (former EBRD Polish Director Winiecki). These fears were shown to be unfounded by the most impressive economic performance (illustrated above, section II).<sup>20</sup>

In the face of such an outstanding performance, the reactions of the critics went through three stages. At first it was claimed that the state of the economy was not as good as it looked and in any case what was good was due to earlier policies taking effect with a lag. Then there was talk of 'fool's luck', a Polish colloquial expression which here attributed success to international 'koniunktura'. More recently and happily there is increasing recognition that the Polish economic performance has been the joint product of both pre- and post-September 1993 transformation and policies.

The new strategy, as the then First Deputy Premier and Finance Minister stressed in a speech to the IMF annual meeting in Madrid in October 1994,

does not involve any change in target model, nor in transition speed, nor in fiscal stance.... The target remains a modern capitalist mixed economy, though with emphasis on equality and partnership between private and public sectors, rather than the previous discrimination and antagonism between the two. The speed of transition is, in some respects, accelerated.... In other respects, [it] continues to be dictated by the technical delays of effective institution-building.... The overall fiscal stance does not leave much scope for manoeuvre by any government. The differences are in actual policies, in the choice and calibration of policy instruments, in the trade-offs between alternative targets selected by the government in preference to other possible trade-offs – as is normally the case in the theory and practice of economic policy.

The new governments have continued the fundamental processes of transition and stabilization. They have been committed to fiscal restraint, which has steadied and tightened the public sector deficit; monetary restraint, while respecting the National Bank of Poland independence; trade and price liberalization, poised to achieve greater European integration; further building

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<sup>20</sup> The September 1993 elections caused a temporary dip in the Warsaw stock exchange which did not prevent record appreciation rates of over 1,000 per cent in dollar terms in a year by early March 1994. The April-November two-thirds collapse was due to a bursting speculative bubble after price/earnings ratios had reached Japanese levels.

of market institutions; privatization on all tracks, including the overdue implementation of mass privatization, and the resolution of pending claims for property restitution (or reprivatization); and the determined pursuit of greater price stability.

At the same time, *Strategy for Poland* and *Package 2000* have nevertheless included many significant changes with respect to the approach followed by previous governments. There have been differences in the choice of policy instruments and their actual quantitative parameters, as well as improvements and innovations. These changes are due partly to a different vision of the transformation, as a more participatory and more open-ended process; partly to different government preferences, attaching greater weight both to economic growth and to the social costs of stabilization and transformation; partly simply to learning from previous errors and mistakes.

*Package 2000* updates and extends to the end of the century the projections originally established to the year 1998 by *Strategy for Poland*; *Euro 2006* goes much further. These documents contain not only detailed positive propositions of economic policy but also a set of macroeconomic projections for a variety of important indicators, such as GDP, budgetary expenditure and revenue, investment, inflation, wage guidelines, unemployment, imports and exports, and so on.

TABLE 2  
THE ECONOMY IN *STRATEGY FOR POLAND*  
(YEARLY GROWTH RATES UNLESS OTHERWISE STATED)

	1994	1995	1996	1997	1997 (1993=100)
GDP real growth	4.5	5.0	5.2	5.5	121.8
Average earnings	1.5	2.8	3.0	3.1	110.8
Average pensions	6.5	1.4	3.1	1.0	112.5
Consumption	3.1	3.3	3.6	3.6	114.3
- of which: private	3.5	3.5	4.0	4.0	115.9
Investment	6.0	7.0	8.0	8.0	132.4
Investment share of GDP	21.3	22.1	23.2	44.4	
Exports (constant prices)	6.0	7.0	8.0	9.0	133.5
Imports (constant prices)	2.5	4.0	5.2	6.0	118.0
Consumer prices (XII/XII)	23.6	16.1	12.0	8.7	174.7
State budget revenues (constant prices, GDP deflator)	5.3	4.3	4.8	5.5	121.4
State budget expenditures (constant prices, GDP deflator)	8.0	8.4	1.8	2.1	121.7
Public debt (% of GDP)	77.7	76.9	74.1	72.4	
Unemployment rate (end-year)	17.2	6.7	15.6	14.0	
Current account balance (% of GDP)	-22.1	-1.7	-1.7	-1.5	

Source: Kolodko (1994).

*Strategy's* policies are summarized in Table 2. Taking 1993 as a base, by 1997 GDP was expected to rise by a cumulative 21.8 per cent, labour productivity 17.5 per cent, real wages

10.8 per cent, consumption 14.3 per cent (faster for private consumption) and investment 32.4 per cent – raising the share of investment in GDP from 20.9 per cent in 1993 to 24 per cent in 1997. Unemployment, expected to peak in 1994 to 17.2 per cent of the labour force, would gradually fall, down to 14 per cent in 1997. Inflation, cumulatively at 74.7 per cent in four years, would reach single digit rates by 1997; the budget deficit, after a slight rise to 3.7 per cent of GDP in 1994, would fall to 2.5 per cent in 1997. The Polish economy was being steered already in *Strategy* towards the convergence conditions required by the Maastricht Treaty for European monetary unification – a policy pursued further in the two subsequent policy documents *Package 2000* and *Euro 2006* (see Tables 3 and 4).

TABLE 3  
MACROECONOMIC PATHS IN *PACKAGE 2000*

Yearly growth rates (per cent)	1995	1996	1997	1998	1999	2000	average 1996-2000
GDP	7.0	6.0	5.5	5.3	5.1	5.1	5.4
Consumption	4.4	4.5-4.7	3.2-3.6	3.2-3.6	3.1-3.6	3.1-3.6	3.5-3.8
Gross investment	19.0	10.5-13.0	9.5-14.0	9.5-12.5	10.0-10.5	10.0-10.5	9.9-12.1
Imports	21.1	11.5-13.6	8.0-13.0	7.0-10.3	6.5-8.6	6.5-8.3	7.7-10.5
Exports	17.0	13.4	12.4	10.0	8.4	8.3	10.5
Budget real outlays	3.6	2.3	1.8				2.0
Budget real revenue							
in percentage	3.5	2.3	1.9				2.3
Unemployment rate	14.9	13.6	13.1-13.4	12.0-12.4	10.7-11.3	9.4-10.2	
Inflation rate							
(end-year)	21.6	17.0	12.0	8.0-10.0	6.0-8.0	5.0-7.0	
Budget outlays/GDP	32.9	31.8	31.2			29.9	
Budget revenue/GDP	30.2	29.1	28.5			28.2	
Deficit/GDP	2.8	2.7	2.6			1.7	

Source: Kolodko (1996).

These projections were not an indicative plan because they were not broken down by sector and were not constructed through an iterative process. They were not a forecast; considerable room for manoeuvre was left to government policy within general guidelines; targets and instruments were not uniquely and rigidly predetermined. The documents were backed by an array of potential policy instruments and as such were the statement of government multiannual commitments for the medium and long term that were judged to be mutually consistent, feasible and commensurate with the range of instruments available within the confines of the open market economy and democratic consensus. Instruments under direct government control, such as tax policy and fiscal stance and the major components of public expenditure, were given in detail. Other instruments were not specifically quantified because they were not under the full control of the government or were subject to negotiations with groups or institutions; but as economic trends unfolded, these other aspects of government policy were to take shape, keeping the economy as close as possible to the course mapped in the documents.

TABLE 4  
EURO 2006: INFLATION AND FISCAL CRITERIA

	Budget deficit/GDP 1	Debt/GDP 2	Inflation rate 3
1991			60.4
1992	6.0	85.2	44.3
1993	2.8	86.0	37.6
1994	2.7	69.5	29.5
1995	2.6	56.2	21.6
1996	2.4	54.0	18.4
1997	2.7	49.8	13.0
1998	3.0	48.1	9.9
1999	2.9	46.9	7.8
2000	2.5	45.6	5.0
2001	2.3	44.5	4.5
2002	2.2	43.4	4.1
2003	2.1	42.4	3.7
2004	2.0	41.5	3.1
2005	2.2	40.7	2.6
2006	2.2	40.0	2.4

Source: Kolodko (1997).

- Notes: 1) Maastricht criterion: maximum 3 per cent of GDP  
 2) Maastricht criterion: maximum 60 per cent of GDP  
 3) Maastricht criterion: September 1996, maximum 2.6 per cent

Marek Belka, appointed Minister of Finance in February 1997, has stressed his commitment to *Strategy's* implementation. But it is significant that the three documents actually cover a period which goes beyond the time horizon of the 1993-97 legislature. This reflects the belief that future governments will be equally constrained by external factors and above all by the desire to maintain stability, sustain economic growth, move fast towards accession to the European Union, and enhance international credibility. Any new government should be persuaded, therefore, to continue along the same course, simply because the policies recommended are sound and have worked – of course without prejudice for the kind of policy changes associated with normal political alternations intermittently occurring in any democratic system. Rather than *Strategy* taking over the policies of the Solidarity-led governments, the opposite is now the case, as Balcerowicz 'admits that the SLD's economic policies and goals expressed by Marek Belka, the new Finance Minister, are virtually indistinguishable from those of UW'; (UW is the Union for Freedom Party; *Financial Times* 27 March 1997).

The details of the new strategy are discussed in the next three sections; its general features include, *inter alia*:

## 6.1 Interactive versus imperative transformation

The new approach could be labelled social democratic, as opposed to the earlier liberal, fundamentalist approach. This does not mean *etatist*, as is often suggested in Poland in public discussions, in the sense of direct state interference with the economic life of individual enterprises. Indeed, Jerzy Hausner, while Chief of Economic Advisers to the Minister of Finance, called himself 'anti-etatist', though 'not in the sense of being an enemy of an active role of the state in the economy: ...an extreme liberal project leads in practice to far-reaching state interference in the economy'. In Hausner's words, 'Most important is the choice between an imperative and an interactive mode of transformation' (1996: 7). The latter involves the recognition that there is a choice between alternative market systems; the shift from central to participatory building of institutions; the deliberate construction of a market system, instead of the passive expectation that it will establish itself once the old system is destroyed; the rejection of 'transformation as victory' and of so-called 'creative destruction' (see section III above).

## 6.2 Parity between private and public sectors

On the rebound from the old system, the early transition had deliberately grossly neglected the state sector, and penalized it with discriminatory and, therefore, inefficient taxation not levied on the private sector (see above, section III). There was, for instance, the dividend, a capital tax levied regardless of profitability and of reinvestment requirements. A heavy excess wage tax (PPWW or *popiwiek*) had the added function of enlisting employee support for privatization in the hope of higher wages. PPWW in particular was typical of what in the old system used to be called 'indirect or parametric centralization', i.e. the grading of policy parameters so as to induce the same result as would be obtained with direct controls. The ideal of early transition governments seemed to be a system of generalized markets for everything except labour. By 1993 these taxes had already come under criticism, for instance by Jerzy Osiatynski, who however had not dismantled them while Finance Minister. *Popiwiek* was abolished only by the new government, and the dividend was significantly reduced.

To establish parity between private and state enterprises, *Strategy for Poland* envisaged the commercialization of state enterprises, i.e. their corporatization, the conversion of self-management into employee part-ownership, the appointment of boards of independent directors and the enhancement of managers' functions, penalties and rewards; financial restructuring; assignment either to a state agency for subsequent privatization or to the Treasury for economic management. This 'commercialization' process was seen not as an alternative to privatization, but as the preparation of state enterprises for either a more efficient and faster privatization or a more efficient operation by the Treasury of those enterprises which were to remain in state hands. The Commercialization Law, vetoed by Walesa, was endorsed by President Kwasniewski in a new version with effect from April 1997. There are still areas in which state enterprises are in a favoured position (for instance, the ability to run substantial tax or social security payments arrears, in the railways and the coal mines); however these anomalies are recognized by the government which seeks to overcome them.

### 6.3 'Reform of the Centre'

A major element of *Strategy for Poland* is institution building, including the reform of central state administration to fully reflect the transformation from a centrally planned economy with dominant state ownership to a market economy with dominant private ownership and enterprise. An integral part of the *Strategy*, the reform of central administration followed urgently upon economic consolidation. In 1996 this policy was implemented by speeding through a dozen acts of Parliament; political debate concentrated on details but the general approach was unchallenged.

The reform involved the excising of the Central Office of Planning and other central or branch-oriented institutions. The new Treasury was set up as a Ministry responsible for state property, taking over the functions of the Ministry for Ownership Changes, also abolished, and responsibility for the improvement of governance and control of state assets. This approach encourages the further rapid progress of privatization, with some prior restructuring of state enterprises and overhauling of their management to ensure their profitability; thus the new Treasury is similar to the German Treuhandanstalt, except for its continued responsibility for running the residual state sector – much smaller and more commercially oriented than in the past. This delegation of governance functions to the Treasury leaves the Ministry of Finance with purely fiscal competency which, in state enterprises, involves benefiting from profits as well as taxes, without treating dividends as a fixed rate tax on capital as in the early transition.

Central administration reform also involves the decentralization of many central powers and budgets to regional and local authority (*voivodships* and counties – or *gmina*) level. A new Committee for European Integration has taken over all work for the preparation of and negotiations for Polish accession to the European Union.

## VII MACROECONOMIC POLICIES

*Strategy for Poland* aims at the consolidation of macroeconomic stability and the promotion of investment and growth. Fiscal policy seeks the reduction of expenditure and tax revenue as a share of GDP, the further reduction and stabilization of the deficit well under the limit of 3 per cent of GDP allowed by the Maastricht Treaty, and a more even redistribution of taxes and benefits. This policy involves a drastic reform of the social welfare system. In Poland monetary and exchange rate policies are under the independent responsibility of the National Bank, which is widely regarded as one of the most empowered central banking institutions in the world (in the words of an earlier NBP governor who presided over the early stage of transition, see Baka 1995). *Strategy* postulated a strict fiscal stance to be matched by a slightly more accommodating monetary policy than otherwise would have been necessary,<sup>21</sup> with an exchange rate policy dictated exclusively by the need to ensure the international competitiveness of Polish producers. The actual policies followed by NBP have been stricter than postulated in terms of interest rates, excessively accommodating in terms of monetary expansion, prone to implement a steady (and inflationary) nominal devaluation greater than needed, as proven by occasional nominal revaluations. Monetary and exchange rate policies have caused Poland to underperform with respect to both inflation and growth, but international constraints have contained NBP departure from the role postulated by *Strategy for Poland* (see below). Massive capital inflows, partly expensively sterilized, partly transformed into excess monetary expansion, have forced NBP to reduce both interest rates and zloty devaluation.

The combination of fiscal austerity, moderate monetary relaxation, a social pact on wages – together with the microeconomic and sectoral measures discussed in the next two sections – has enabled Poland to achieve the simultaneous reduction of both unemployment and inflation as postulated in the *Strategy for Poland*.

### 7.1 Fiscal policy

Within fiscal restraint, *Strategy for Poland* promotes investment and growth directly, through investment switching in government expenditures; and indirectly, through the tax regime, for instance through accelerated depreciation schemes for enterprises and profit tax reductions geared to reinvestment, and through incentives to housing investment for individuals (including restructuring of past housing debts, access to mortgages, a new Housing Fund, etcetera). It is mainly through growth acceleration, as well as through standard active labour policies, that unemployment can be brought down further.

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<sup>21</sup> This is the policy also advocated by David Currie (1993) for Finland, another country suffering from the external shocks typical of central-eastern European transition economies.

The share of public expenditure in GDP has been reduced from the earlier 32-34 per cent in 1993 to below 30 per cent in 1996. The reduced role of redistribution through the budget will help to bring down inflation. Personal income tax rates are being reduced from 21, 33 and 45 per cent to 19, 30 and 40 per cent in 1998, lowering the tax burden by about 1 per cent of GDP. Corporate tax at the 40 per cent flat rate is to be reduced by 2 percentage points yearly, partly compensated by other charges such as higher VAT on energy and a rise in excise duty (see *Poland 2000*). There is a commitment not to introduce a capital gains tax at least until the year 2000, in the interest of capital accumulation and growth. The rise in the disposable income of enterprises and households should raise their propensity to save and invest, thus promoting competitiveness and growth.

Parity between state and private sector involves necessarily a shift in fiscal burden reflecting their relative size; the replacement of the excess-wage tax in favour of performance related earnings; the absorption of the informal sector into the official economy so as to broaden the fiscal basis; and greater security in economic transactions.

Reductions in tax rates should encourage the surfacing of economic activities now submerged in the 'shadow economy', which is another important goal of the *Strategy*. The fairer contribution of the shadow economy – which in 1994 was estimated to be adding an unrecorded 18-20 per cent to official GDP<sup>22</sup> – should make possible the further reduction of the tax burden.

## 7.2 Social security and pensions

The maintenance of a fairly strict fiscal stance imposes a radical reform of social security and above all pensions. Throughout OECD countries, not only in Poland, the pension system's mounting liabilities appear to be a veritable time bomb; with the difference that in Poland the bomb has a short fuse. No other country – except for Italy perhaps – presents such an adverse combination of an ageing population, a falling activity ratio, a high proportion of invalids and retirees, a high unemployment, for an exceptionally high average pension relative to the average wage. The present system is far from self-financing and represents an unbearable burden on the state budget, while at the same time it raises labour costs by at least one third. With 15 per cent of GDP, Poland already has one of the highest levels of public pensions expenditure in Europe. Without reform, further increases are projected which would immediately clash with the maintenance of fiscal restraint. Previous governments have not confronted this problem successfully; their attempts at income and pension cuts in the public sector were later declared unconstitutional by the Constitutional Court.

The reform of the system as envisaged by *Strategy for Poland* is an absolute precondition of sustaining – let alone improving – the country's fiscal integrity. Following *Strategy* principles, in

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<sup>22</sup> Kaufmann and Kaliberda (1995) estimate that the Polish share of the unofficial economy is 19 per cent, i.e. GDP is  $19/(100-19) = 23.5$  per cent higher than actually reported. This compares with 17 per cent in the Czech Republic and 29 per cent in Hungary.

1995 the government presented a draft proposal for drastic reform, moving from a pay-as-you-go to a fully capitalized pension system. More precisely, the new pension system would consist of three-tiers:

- i) a basic state pension available to all,
- ii) a compulsory earnings-related contribution system, and
- iii) voluntary contributions to pension funds.

This system should enhance the level of savings and the provision of funds for company investment. In addition, it is planned to earmark a significant fraction of state assets, still to be privatized, for the endowment of additional funds which would invest their income in the purchase of government bonds. This would be a relatively painless way to finance the cost of shifting from the old to the new pension system, usually regarded as the main drawback of this type of pension reform (as in the Chilean example).

A number of painful but necessary decisions, also from the viewpoint of overall fairness, involve the move to indexation to prices instead of wages, the increase of retiring age for women, a more stringent regulation of invalidity pensions, and the reduction of pensions granted in the past on the occasion of plant closures.

Together with pensions, the reform of social security is also essential to prevent open-ended commitments which would easily jeopardize any attempt at containing public expenditure, and to ensure the targeting of public funds to the neediest recipients. For both pensions and social security reforms the achievement of a very broad social consensus is essential.

In spite of these austerity measures, the implementation of *Strategy* has gone hand in hand with the reversal of previous trends in income distribution and poverty. While in 1990-93 the rich got richer and the poor poorer, 1994-97 has seen a generalized income per head growth across the board. The Gini coefficient peaked in mid-1994 but then began to decline together with other measures of inequality such as the decile ratio (between the average income of the ten per cent top recipients and that of the bottom ten per cent) as well as within income groups (see OECD 1997: 84-90).

### **7.3 Monetary policy**

The new governments' policy has been one of respect for central bank independence – despite the NBP Governor's political involvement as a presidential candidate in the autumn of 1995 – but of transparent debate on targets and instruments. In normal market economies there is a frequent, though by no means universal, support for Central Bank independence, in order to constrain government ability to raise employment through inflationary fiscal deficits and domestic currency devaluations. This involves a division of targets and instruments between the Central Bank – restraining monetary expansion in order to achieve low inflation and supporting

the domestic currency's international strength – and government aiming at employment targets through fiscal policy.

In the early transition there was considerable cooperation between the Ministry of Finance and the independent National Bank of Poland. Under the new governments there seems to have been a certain reversal of roles between the two. The NBP appeared to be particularly concerned with supporting the international competitiveness of Polish exports – and therefore employment – through the steady crawling nominal devaluation of the zloty, a major inflationary factor especially in view of the necessary real revaluation that the zloty had to undertake in order to reverse the gross excessive undervaluation of 1990. The NBP pushed this policy too far as, during 1995, it had to reverse the effects of crawling by allowing significant nominal revaluations, thus missing the opportunity of reducing inflationary expectations and inflation through a fixed or more slowly crawling rate.

At the same time the NBP targeted real interest rates comparable to those of the currencies entering the basket to which the exchange rate is related. The combination of competitive real interest rates and real revaluation made the return on financial investment in Poland particularly attractive, driving up capital inflows. As well, a zloty still undervalued with respect to PPP encouraged a large turnover and surplus in border trade. Whether due to capital inflows or to border trade, in 1994-96 the NBP acquired large, unplanned hard currency reserves. In 1995 net international reserves rose by about US\$9 billion, reaching US\$20.4 billion, and had risen further, to US\$22.1 billion, by the end of 1996.

Such rapid accumulation of reserves was partly sterilized at great cost for NBP, equivalent to the excess interest differential over zloty devaluation; such cost is revealed by the NBP profit contributions to the state budget rapidly falling in 1995 and 1996 and being poised to reach actual losses. To the extent that additional reserves were not sterilized, they led to monetary expansion at a faster rate than originally targeted – and therefore higher inflation – at the same time forcing a decline in interest rates.

External factors finally forced the NBP to adopt a more accommodating policy than it had intended, both in terms of interest rates and monetary expansion. Such a policy, consistent with *Strategy* postulates, was forced upon a fully independent National Bank of Poland not by the government but by international markets. The NBP policy, however, involved an unnecessary, wasteful, and immense cost (for a full account of monetary and exchange rate policy in Poland in 1994-96 see Nuti 1996).

The NBP policy-mix has clearly been sub-optimal. Less inflation could have been achieved at lower interest rates and a steadier zloty exchange rate, i.e. avoiding intermittent nominal revaluations on top of crawling nominal devaluation. The sterilization of reserve increases – which in 1995-96 cost the state budget something in the order of 1 per cent of GDP due to the NBP open market operations, could then have been much cheaper even on a larger scale. Lower interest rates would have killed two birds with one stone, i.e. reduced both capital inflows and the cost of their sterilization. They would have also lowered inflationary

expectations, thus aiding dis-inflation. However, given the institutional and political constraints faced by the government, the policy actually implemented has turned out to be a workable compromise between policy targets and alternative instruments; it is inefficient but broadly in line with the original premise of *Strategy for Poland*.

#### **7.4 A social pact**

Beside containing the budget level and deficit, the government has sought to fight cost side inflation, without resorting to direct or indirect controls, such as the old-style punitive taxation of excess wages over central guidelines (which was applicable exclusively in the public sector). Indeed such taxation was completely abolished in 1995, restoring a genuine labour market; it was replaced by a consensus approach based on social partnership, through a national Tripartite Commission for Socio-economic Affairs that sets quarterly target maxima for wage increases chargeable as costs. These procedures are designed to reduce strife, to contain wage settlements in line with inflationary targets, to replace the earlier direct confrontation between enterprises and workers, often directed against a government which was powerless to intervene in the private sector. This economy-wide negotiating mechanism has not yet been fully implemented; and although railway strikes, for example, are difficult to handle without the new structure, the machinery is in position and is becoming increasingly effective.

Such negotiating structure while reminiscent of former Labour Minister Jacek Kuron's 'enterprise pact', goes much further, because it embraces entire sectors and the whole economy (and in any case Kuron's initiative was not part of the early transition liberal design but a social-democratic appendage). These labour market policies are also particularly close to European Union policy, which promotes partnership relations between labour and capital (the Social Chapter, profit sharing, etc.).

The microeconomic and sectoral policies implemented under *Strategy for Poland* are also markedly different from those of early transition, as will be seen in the next two sections on privatization – including governance – and sectoral restructuring.

## VIII PRIVATIZATION AND GOVERNANCE

Before *Strategy*, Polish privatization had followed a multi-track course, not by policy as by default, i.e. through the increasing adoption of new methods to overcome unexpected difficulties as they arose (see Table 5 on the progress of ownership transfer 1990-95). Initially the dominant method was to be a western style 'indirect' or 'capital' privatization, involving open sales of shares and the search for a strategic outside investor; this proved to be slower, costlier and harder than anticipated. To speed up the process and resolve the problems of lack of liquid savings – pulverized by high inflation at the inception of the Polish transformation – and of asset valuation, a mass privatization scheme was devised, which technically is another form of 'capital' privatization. This track was held up by political and technical delays resulting from the approach originally selected, which – unlike the Czechoslovak approach – placed complex and controversial procedural burdens on the government, such as setting up National Investment Funds, selecting Fund managers, negotiating reward formulas, and allocating enterprises (see Nuti 1995). Thus, by September 1993, four successive governments had failed to implement mass privatization. Meanwhile, many insolvent state enterprises were being closed down and sold off to private buyers, as a whole or in bits and pieces, according to Article 19 of the old, September 1981, Law on State Enterprises. Other, economically viable, state enterprises were being sold or leased, also as a whole or in parts, to private buyers and consortia of buyers, with priority granted to new companies formed with employee participation; this was allowed by the 1990 Privatization Law, Article 37. Both processes involved enterprise 'liquidation' in the literal technical sense of their cancellation by the Tribunal from the registry of state enterprises; the resulting dominance of employee ownership, if not actually against government policy, was not at all part of it.

*Strategy for Poland* promotes privatization on all tracks as a matter of policy; emphasis is placed on *de novo* private activities, while in the privatization of state assets a dominant role is given to sales by the newly established Treasury, with a move from mass privatization to raising revenue or funding pension reform.

Past commitments to mass privatization have been honoured, after an initial delay due to Premier Pawlak's qualms about national control of crucial sectors. By the closing date of 22 November 1996, as many as 25.7 million Poles, or 95 per cent of those eligible, have claimed their privatization vouchers; a year earlier only one in ten Poles said they would claim, while the government expected only 10 million participants. Vouchers were distributed by the state bank PKO at zł 20 fee (US\$7), selling for as much as ten times that fee on the Stock Exchange; in March 1997 they were exchanged for shares in 15 National Investment Funds (NIFs), controlling 512 companies formerly in state ownership, covering a cross section of industry. NIF shares, tradable beginning in June 1997, should massively enhance the capitalization of the Warsaw Stock Exchange.

TABLE 5  
PROGRESS OF OWNERSHIP TRANSFER IN POLAND, 1990-95  
(CUMULATIVE NUMBER OF ENTERPRISES AT THE END OF EACH YEAR)

	1990	1991	1992	1993	1994	1995
Total number of state-owned enterprises	8453	8228	7245	5924	4955	4563
Liquidation						
Started	49	989	1576	1999	2287	2507
Completed	0	201	561	893	1248	1450
Article 19 of the SOE Law						
Started	18	540	857	1082	1845	1358
Completed	0	19	86	186	303	396
Article 37 of the Privatization Law						
Started	31	449	719	917	1042	1149
Completed	0	182	475	707	945	1054
Converted into joint-stock companies	38	260	480	527	723	958
Capital privatization	6	27	51	99	134	160
Public offerings	5	11	12	15	19	22
Trade sales	1	16	39	81	110	132
Mixed methods	0	0	0	3	5	6
Total: Started	93	1276	2107	2625	3144	3625
Completed	6	228	612	992	1382	1610
Income from privatization (flows, mn zł.)		170.9	484.4	780.4	1594.8	2641.7
Leasing and sale of liquidated assets		46.4	171.8	287.0	322.9	406.2
Capital privatization		124.5	308.7	439.4	846.7	1714.2
Bank privatization		0.0	3.9	54.0	425.2	521.3

Source: Ministry of Ownership Transformation (1996).

Note: Zloty figures are expressed in re-denominated zlotys, i.e. pre-1995 zlotys should be multiplied by 10,000 for conversion to old units. 'Liquidation' of viable enterprises took place under Art. 37 of the July 1990 Law (restructuring privatization) and for non-viable enterprises under Art. 19 of the old Law on state enterprises of September 1981.

The private sector has continued to grow, necessarily raising its share at a slower rate which however is still faster than income growth, reaching almost 70 per cent of GDP in 1996 and an even higher share of employment. Many of the *de novo* activities which dominate this growth would not have been possible without asset privatization, i.e. the private re-deployment of chunks of productive assets which has accompanied state enterprise liquidation (see above). The new *Strategy*, however, involves what can be called *managed* privatization – managed, that is, in such a way as to raise sale revenue; improve governance mechanisms through the commercialization of state enterprises (see above), instead of focusing on the purely nominal transfer of ownership; ease distribution effects – favouring old age pensioners and employees (see above on the use of state assets to fund the pension reform); reorganize entire sectors in

order to strengthen international competitiveness of enterprises. Thus, for instance, in 1995 'capital' privatizations involved only 26 firms, compared to 48 firms in 1993 – a natural slowdown once the share of privatized assets rises – but 1.7 billion zlotys were obtained by the budget in sales revenue compared to 200 million zlotys in 1993.

Commercialization of state enterprises, involving their generalized transformation into joint stock companies regardless of their privatization prospects (see above), could and should have been the first step in the transformation of post-communist economies, and could have been achieved even before stabilization.

Another feature of the new policy of privatization is concern for consensus at the enterprise level, and the associated powers of initiative attributed to management and employees – which may sometimes slow down slightly the privatization process but certainly enhance its smooth implementation. Employee ownership, which previously happened spontaneously, becomes part of the new policy; the adverse side-effects predicted by economic theory (excess labour earnings and employment, low investment) have not actually materialized in the Polish case, confirming the soundness of this policy (see Nuti 1997).<sup>23</sup>

TABLE 6  
A CORPORATE GOVERNANCE SCORECARD

	Poland	Hungary	Czech Republic	Russia
Disclosure	****	**	*	*
How strong are requirements making investors reveal large shareholdings?				
Transparency	****	***	**	*
How well do listed share prices reflect actual market activities?				
Corporate results	****	***	***	*
How good are reporting requirements for corporate earnings?				
Protection	***	**	**	*
How well are small shareholders protected from abuses by majority owners?				
Insider trading	***	**	**	*
How free is the market from insider dealing?				
Key: Excellent **** Good *** Passable ** Shoddy *				

Source: Assorted brokerages and fund managers, EBRD, London, from *Central European Review* IV: 2. March 1996.

The achievements of the new approach to privatization and governance are clear from Table 6 above, illustrating an independent assessment of relative progress of corporate governance in

<sup>23</sup> Nuti (1997) shows that such side-effects depend on share distribution among employees, which in Poland was probably sufficiently concentrated to avoid them.

Poland, Hungary, the Czech Republic and Russia, with Poland obtaining the highest score (from the *Central European Review* March 1996). New impetus has been gained by privatization in 1997 with the prospective privatization of telecommunications, tobacco and major new banks (such as Bank Handlowy). Further acceleration should also be gained from the final resolution of pending reprivatization claims, left unresolved in the early stages of Polish transition.

## IX RESTRUCTURING

The structure of the Polish economy inherited from both the old-style system and the early transition was inappropriate from various viewpoints: e.g. enterprise capacity, sectoral and regional patterns, trade orientation.

### 9.1 Capacity restructuring

There has been, especially over the last two-three years, considerable restructuring of productive capacity. This is shown by three major indicators. First, industrial output has been growing faster than income, which – especially when occurring after industrial output fell faster than income in 1990 to early 1992 – is a clear sign of structural adjustment. Second, empirical studies (such as one by Jo Brada and I. J. Singh, forthcoming in a World Bank publication) have shown that output has been growing faster in those sectors where labour productivity is either higher or has increased faster. Third, labour productivity growth (17 per cent in 1994) is far in excess of the kind of rates which can be attributed to technical progress alone; (by contrast, in 1991-95 labour productivity in the Czech Republic has had an average negative rate). Even Polish shipbuilding has turned around, though with local difficulties, with the three largest shipyards exporting nearly US\$1 billion in 1995 and boasting orders for 100 new ships, the fourth largest order book in the world.

With growth acceleration in 1994-97, expansion has become increasingly broad-based: from 1994 onwards the state sector, which had been contracting until 1993, bounced back and – once allowance is made for privatization – continued to expand (OECD 1997). Leaving agriculture aside which is subject to large scale fluctuations, differential growth in the various sectors has continued to favour services – especially financial intermediation, construction and industry; within the industrial sector an increasing number of branches has participated in the overall expansion: out of 62 major products the number of those for which output was still declining dropped from 36 in 1992 to 16 in 1994-95, with the fastest growth in manufacturing (13 per cent in 1994, 12 per cent in 1995). High technology such as electronics, telecommunications equipment, and precision instruments and machinery are included among the more dynamic industries (see OECD 1997).

In spite of such restructuring, which is still largely to come in the other Visegrad economies except for Hungary, labour unemployment has been falling significantly from the peak of nearly 17 per cent reached in early 1994 (see above), owing as well to the acceleration of investment growth (from 2.8 and 2.9 per cent in 1992 and 1993, respectively, to an average 10 per cent in 1994-96, accelerating further in 1997).

## 9.2 Industrial policy

In 1990 Tadeusz Syryjczyk, Minister for Industry and Trade in the Mazowiecki government, quipped that 'the best industrial policy is no industrial policy'. But even the *least* industrial policy possible and efficient may actually amount to quite a bit, while *no* industrial policy simply means a residual industrial policy by default, implicit in other policy choices. Thus the industrial policy implicit in the governments of the early transition consisted of unrestricted free trade, high interest rates and nominal credit targets amounting to the unintended squeeze of real credit (because of underestimated inflation), grossly undervalued exchange rates rapidly appreciating in real terms, and discriminatory penalization of the state sector – a recipe for fast and deep recession only partly offset by reliance on privatization. Syryjczyk's successor in the Bielecki government, Andrzej Zawislak, decided to resign rather than preside – as he claimed – over the 'destruction of Polish industry' (see also Poznanski 1996).

The kind of industrial policy that should be avoided – and was by and large avoided by the new governments – is one of direct or indirect favour or disfavour for individual enterprises, or of general loosening of budgetary constraints. Otherwise, there is a great deal of scope for 'an active role of the state in the economy' or indeed in industry: for instance in promoting investment, especially in sectors characterized by price-elastic and income-elastic international demand, or by faster growing labour productivity; in improving access to credit for small and medium size enterprises and generally favouring their formation and growth; in encouraging innovation; in promoting marketing; in insuring exports through new institutions of export credit guarantee; in introducing and protecting standards; in reclaiming and protecting the environment. In *Strategy for Poland* such a state role is seen as strengthening a market economy and its growth, as in the experience of all fast growing economies, whether today or in a recent or distant past. The lesson of the 'developmental state' success in the Pacific area is not lost in the *Strategy* approach; nor is the commitment expressed to the UK Parliament by Michael Heseltine as President of the Board of Trade, 'I will intervene before breakfast, before lunch, before tea ...'.

In the same spirit the reorganization, financial and capacity restructuring of enterprises and banks has been begun, in place of the earlier so-called 'creative destruction' of the state sector (and all that there was before), so dear to the early promoters of transition. Occasionally enterprise and bank restructuring has been by consolidation and mergers, a process sometimes interpreted – wrongly – as threatening privatization and competition. For instance, seven state-owned oil refineries and the main petrol distribution network have been merged into a holding company, precisely in order to raise efficiency and help the industry to stand up to western competition, with a view to prospective privatization. The refineries and the distribution network will maintain their identities as separate companies and will begin to be privatized within a year, while the holding company will be privatized after two years. Similarly, bank mergers are a means to facilitate restructuring while speeding up privatization by dealing with a single larger unit.

### **9.3 Agriculture**

Like industry, in the course of early transition agriculture was characterized by an adverse implicit policy, consisting of high – retroactive – interest rates on existing as well as new loans (January 1990); drastic deterioration in rural input/output terms of trade; exposure to the competition of EC subsidized exports both in domestic and in traditional export markets – all resulting in a significant rural income fall relatively to urban levels (in place of the earlier policy of rural/urban parity). In Polish agriculture the destructive tendencies of the early transition governments manifest themselves in identifying modernization with the destruction of the rural cooperative movement, as well as family farming, thus weakening the supply response of the whole sector.

*Strategy for Poland* has focused on the reorganization and rationalization of agriculture, with better opportunities for non-agricultural employment in rural areas. After some temporary price support, fractional with respect to European CAP and provoked by the inroads of subsidized European food into the Polish market, *Strategy* provides far greater expenditure on agriculture, and emphasis on multi-track growth of rural areas, which importantly corresponds to the latest European Union 'integrated rural policy'. These policies are linked both with regional development policies and crucially with environmental protection.

Polish agriculture is characterized by an exceedingly large number of small productive units below 2 hectares, which in 1988 were almost as numerous as in the European Community of twelve; recently some restructuring has taken place, with the growth both of new, medium-large size units and of new, small but highly productive and specialized, market gardening units. GUS latest agricultural census, conducted in 1996, shows that since the earlier census of 1988 the number of individual farms has fallen by 130,000 to 2,038,000, in spite of privatization. The public sector area has fallen from 4.1 to 1.6 million ha, with private ownership now covering 90.4 per cent of the land. The average private acreage has increased by 0.35 ha to 7.93 ha, larger in the northern provinces averaging 15 ha, biggest in Szczecin and Olsztyn averaging 20 ha, but still low by international standards especially considering the tail end of small productive units of under 2 ha.

### **9.4 Regional development promotion**

In place of a regional policy of budgetary transfers, *Strategy for Poland* promotes regional growth through regional self-determination and a degree of financial autonomy. This approach mobilizes local entrepreneurship and other resources, establishes local control over economic processes and, by both means, is expected to raise economic efficiency and self-reliance. An example of this approach is the regional restructuring contract negotiated for Silesia. These policies follow closely the EU approach, which also promotes initiative from below, and integrated approaches, as well as far deeper interventions by 'regional development planning'.

While in 1992 gross industrial output was rising in less than two-thirds of Poland's 49 voivodships, by 1994 it rose in all voivodships except one; the dispersion of regional growth

rates declined; the proportion of voivodships experiencing double digit growth surged from one quarter to two thirds (OECD 1997).

## 9.5 Trade orientation

As envisaged in *Strategy*, foreign trade expansion has been the driving force for growth. In 1993-95 the volume of exports and imports of goods and non-factor services rose by 34 and 37 per cent respectively (including the border trade discussed above), against a real GDP growth of about 12.5 per cent. An increasing share of foreign trade has been accounted for by *outward processing* – through which Poland's competitive advantage of low labour costs is being realized: the importation of inputs processed in Poland and then re-exported reached 24 per cent of exports and 12 per cent of imports (respectively 82 and 62 per cent in light industry). Together with the dominant weight of intermediate and investment goods, this puts a reassuring complexion on the otherwise worrying recent surge of imports.

TABLE 7  
GEOGRAPHIC DISTRIBUTION OF TRADE (TOTAL = 100)

	1985	1989	1990	1991	1992	1993	1994	1995
<b>Exports</b>								
EU	28.1	32.1	31.5	33.7	32.1	39.4	46.0	53.2
CEFTA	8.5	8.4	7.3	5.7	3.7	3.1	4.2	3.1
Rest of the world	65.3	62.6	61.2	60.6	64.2	57.5	49.8	43.7
- of which: FSU	21.4	21.4	25.2	23.0	13.9	9.1	6.6	5.8
<b>Imports</b>								
EU	24.2	33.8	42.5	49.9	50.7	57.3	57.5	65.7
CEFTA	8.1	7.3	4.5	4.2	4.1	3.6	4.3	5.6
Rest of the world	77.0	82.5	70.4	67.8	57.1	73.9	60.8	45.1
- of which: FSU	22.4	35.5	23.6	17.0	14.5	21.8	17.9	18.3

Source: Drabek (1997).

Based on Direction of Trade Statistics (IMF) and national statistics. Note: European Union consists of the current 15 member states throughout the period. FSU stands for Former Soviet Union.

Trade structure has increasingly shifted towards the European Union, though through differential growth rather than through the decline of trade with other areas. With respect to 1993 the share of the 15 present member states of the EU in 1995 had risen from 39.4 per cent to 53.2 per cent of Polish exports, and from 57.3 to 65.7 per cent of Polish imports (see Table 7 above). Another favourable aspect of Polish trade structure is the increasing share of intra-industrial trade in overall trade, the so-called Grubel-Lloyd index which is regarded as evidence of progress from dependence on primary products to a deeper and more mature degree of integration related to technological relationships rather than natural endowments. By 1992 the Polish Grubel-Lloyd index had regained the 1989 level of 0.42, rising to 0.45 in 1993 and 0.48 in 1995 (see Baldone *et al.* 1996; Krzesniak and Maciejewski 1996).

## X SUSTAINABLE GROWTH

The successful implementation of *Strategy for Poland* raises naturally two fundamental questions. First, what are the main sources of Poland's growth and how is it related to *Strategy's* policies? Second, how far, and how confidently, can Polish performance to date be extrapolated into the future?

The dissection of growth sources by any method is always fairly dependent on somewhat arbitrary assumptions. On the demand side, Polish economic growth has been led first by exports and then by investment; in 1996-7 consumption has also contributed to demand growth. Supply factors, however, have been dominant: investment – including FDI – started growing again only in response to export-led income growth, which in turn would not have been possible without both exceptional productivity growth enhancing competitiveness and a greater responsiveness of supply to the new opportunities. Productivity has been undoubtedly enhanced by *Strategy's* policies for encouraging new small and medium private enterprises, improving corporate control of state companies (rather than the earlier 'creative destruction' discussed above), establishing a positive feedback between labour productivity and earnings (against the adverse motivation induced by *popiwek*), following a strict and consistent fiscal policy which has forced upon a reluctant NBP a fall in interest rates; and redirecting public expenditure towards investment – directly and indirectly through fiscal incentives. A major source of productivity increases has been enterprise restructuring (Brada and Singh, quoted above); further, a part of the unnecessary decline generated by early transition policies has been more easily recovered in the new climate of 1994-97. The fact that until recently Polish growth was not dependent on FDI is now an element of strength, and bound to be an important factor in its sustainability.

Until now Poland has not faced the external and domestic imbalances that usually constrain emerging economies. The external constraint has been eased by the dramatic increase in foreign investment. Possible worries about the trade balance are eased first by the still significant contribution of a surplus in border trade, then by fact that the current account imbalance is contained, exports are growing faster than GDP, and there is a high investment component in imports. With hindsight, the foreign trade postulates of *Strategy* and *Package 2000* were both overly pessimistic in their belief that a trade surplus was needed to drive growth, and overoptimistic in the belief that such a trade surplus was possible.

Can Poland's vibrant economy replicate the Asian Tigers' success? Like the high performers of South East Asia, Poland – now a member of the OECD and WTO and an associate member of the EU – has a highly educated labour force, proximity to rich markets and strategic investors, openness to investment and trade. Relative endowments of natural resources are comparable, better than Korea, not as good as Thailand or Malaysia. Poland no longer has difficult relations with a 'big brother', such as that the South East Asian countries still have with China. The Polish labour force grows more slowly – also reducing investment requirements without affecting relative prospects of future income per capita.

Wages in Poland are relatively low by European standards, but considerably higher than those in Asia. Aspirations of consumption catching up with richer neighbours make wages harder to

contain and account for much lower, though rising, saving ratios than those in both Europe and Asia – a handicap with respect to Asian high performing economies (World Bank 1994).

In the short-medium, though, Poland still has some underutilized capital and infrastructure, and great potential for productivity growth from underutilized technology and know-how. In the longer run, having regained and overtaken historical consumption levels, and with continued stability and growth of capital markets, savings ought to take off. While in 1993 Poland had a saving ratio of 15.5 per cent, the net effect of a domestic rate of 16.5 per cent and a foreign rate of -1 per cent, in 1996 these rates have risen respectively to 20.6, 18 and 2.6 per cent, and in 1997 are poised to rise to 22.2, 18.4 and 3.8 per cent. The reduction in the share of government revenue and expenditure in GDP, postulated in *Strategy* and being implemented in the 1997 budget, should gradually shorten the distance from the standards of high growth Asian countries, leaving greater room for private domestic saving and investment. Foreign investment, which could never have kick-started a recovery and the resumption of growth, nevertheless has been responding very rapidly to growth acceleration during 1994-97; government projections of cumulative FDI growing from US\$14 billion in 1996 to an order of magnitude of US\$30 billion by the year 2000 are close to the US\$27 billion expected by the Economist Intelligence Unit.

Higher domestic and foreign savings do not need a policy of artificially high real interest rates, which only attract financial investment (with the drawbacks discussed above) and discourage investment in capacity expansion and new technology. Domestic and foreign savings and investment are best driven by improved prospects of domestic growth and increased integration into the European and the world economy (see next section).

The extraordinary increase in foreign assets held by the National Bank of Poland and other financial institutions – which, as noted above, are well above IMF prudential norms – should enable Poland to meet, without difficulty, balance of payments constraints, at least in the medium term.

The main obstacles to sustained economic progress in Poland are – as they have been in the past – mainly political. The government coalition, in spite – indeed paradoxically because – of the lack of alternatives, indulges in frequent disputes. Electoral concerns, populist promises, uncooperative strategies, all make it more difficult to steer a steady course. In the discussion of *Package 2000* and the 1997 budget, the proposal to reduce income tax from the old rates of 21, 33 and 45 per cent to 20, 31 and 43 per cent in 1997 and 20, 30 and 40 as of 1998 was amended by *Sejm* into a much greater reduction, to 17, 20, 33 per cent, while leaving the highest rate unchanged at 45 per cent. This would have significantly worsened the budgetary deficit. The amendment was passed with the vote of the Union for Freedom (UW), despite its proclaimed support for market reform, and of the peasant party, the PSL, a government coalition party. The vote was fortunately reversed by the Senate, thanks to the determined efforts of the Minister of Finance, but is indicative of the nature of the threats to financial stability.

Paradoxically, the very resumption and acceleration of growth – which should have made it easier to satisfy rival claims – have reawakened those pent-up aspirations and claims which at a time of deep crisis are, at least partly, set aside. Populist temptations have slowed down the reform of social security and pensions, which is the greatest long-term problem for Poland, caught in the scissors of a rising average pension now at 64 per cent of the average wage and a falling number of contributors per pensioner (by one-third in the last ten years). In early 1997, however, the reform programme prepared within *Strategy for Poland* was provisionally accepted by the partners of the Tripartite Commission for Socio-economic Affairs – government, employees and employers.

Despite considerable capacity restructuring there are still great difficulties, especially in coalmining, agriculture and banking. In the coal industry it is still necessary to close down a number of mines, modernize the others, dismiss and redeploy 80,000-100,000 workers, at a total cost of the order of US\$2-3 billion. In the banking sector Poland has already executed a successful financial restructuring of enterprises and banks, but further, slow and expensive, consolidation is needed and is proceeding; the banks' already high share in stock exchange capitalization is an obstacle to their faster privatization.

It is now widely recognized, even by the Bretton Woods institutions, that, in transition economies, moderate inflation of the order of 20 per cent per year is difficult and costly to reduce, and is therefore tolerable if it is falling. Here Polish prospects depend on the National Bank of Poland's ability to restrain monetary expansion. The combination of the NBP's high interest rates, exchange rate crawling within a falling band and real revaluation, and acquisition of net reserves, have involved both expensive sterilization and excess monetary expansion. An independent NBP will have to give much greater consideration to the international implications of its policies.

Two conclusions can be drawn from these reflections. First, the question is not whether Poland can rival South East Asian performance, but whether it can do it for the next twenty years or only for another ten. Second, the obstacles on the way to sustainable growth are technically manageable but politically serious; ultimately, the continuation and permanence of success is subject to the wisdom and determination of Polish political leaders.

The need to fulfil the preconditions discussed above already maps out the long-term evolution of the Polish economy, or rather rules out a number of alternative models. Clearly Poland must avoid turning into a 'precociously mature welfare market economy', with a stable and open macroeconomy but with low investment and growth, higher open unemployment, and higher welfare and pension costs than economies with comparable GDP per capita levels. While aiming at a sustained growth performance, Poland cannot simply imitate the Asian tigers due to the differences stressed above; in particular it cannot be guided by a benign developmental state, but be guided rather by what Jerzy Hausner calls the 'facilitating' state and by the mobilization of local initiatives.

The model explicitly and implicitly targeted by *Strategy* is rather a modern, mixed, West-European market economy, shaped partly by policies already underway, partly by the growing process of European integration and preparation for membership in the European Union and European Monetary Union.

## XI EUROPEAN INTEGRATION

Poland, with the other signatories of the Visegrad Treaty of February 1991, led the way in the gradual rapprochement with the European Union. The closer contacts already obtained on the eve of transition with a new generation of trade and cooperation agreements, and with the extension of the System of General Preferences previously applicable only to developing countries, were followed by the stipulation and implementation of Association Agreements.<sup>24</sup> These acknowledged Poland's and other members' unilateral wish to join the Community (as it then was), without reciprocation, until the June 1993 Copenhagen summit which stated EU readiness to consider all Associates as potential members. Accession was subject to three main conditions: implementation of a market economy and pluralist democracy; capacity to cope with competitive pressure and market forces within the Union, and the willingness and ability to take on all the obligations of membership, the so-called *acquis communautaire*. In April 1994 Poland applied for membership in the European Union, together with Hungary and ahead of all other Eastern applicants.

*Strategy for Poland* reaffirmed and strengthened Polish commitment to re-integrate into Europe, not only through openness to trade and investment but through progressive implementation of the conditions for formal and full membership of the EU, including the option to join the planned European Monetary System in due course.

There are three main obstacles to Polish membership of the EU – which are also true in the case of most other transition economies. First there is the cost of extending to Polish agriculture the full support of the EU Common Agricultural Policy (CAP). The cost of extending to the present ten central eastern European candidates (CEEC-10) the provisions of CAP in its present form, which already absorbs almost 60 per cent of the EU budget, has been calculated by the European Commission to be of the order of 12 billion ECU per year 'after a period of transition and adjustment' (European Commission 1995), on the assumption of enlargement in the year 2000. Others have estimated a much higher cost (37 billion ECU per year according to Baldwin 1994), which presumably includes the costs of such 'transition and adjustment'. Moreover the extension of CAP to the CEEC-10 would add, say, some 20 per cent to their consumer price index and raise the overall average food surplus in the enlarged EU. For Poland this difficulty implies the need for significant consolidation and restructuring of its agricultural sector – of the kind outlined in *Strategy for Poland*. On the part of the EU this calls for an early radical reform of CAP, which is already under increasing pressure not only for the otherwise prohibitive cost of EU enlargement to the east but also for

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<sup>24</sup> These were labelled 'Europe' Agreements to distinguish them from the looser association agreements already existing, for instance, with Cyprus and Malta.

the next round of negotiations for world trade liberalization. Alternatively, an inordinately long transition period could be envisaged for extending CAP to new members.<sup>25</sup>

Second, there is the cost of extending to the new members the budgetary transfers for which they would qualify under structural funds, cohesion funds and other headings. Central eastern European countries – and Poland in particular – are both populous and relatively poor: in 1993 they represented only 8.6 per cent of total GDP in the Union of twelve (at purchasing power parities i.e. even without the downwards bias of undervalued exchange rates) against a proportion of 29.4 per cent for their population (Barta and Richter 1996). Therefore the cost of regional transfers would also be substantial; together with that of the CAP, this would represent an additional burden of the order of 1-1.5 per cent of the Union's GDP; hence, the particular importance of accelerating the growth of income per capita as postulated in the three *Strategy* documents and implemented since 1994. In dollar terms at purchasing power parity rates, during 1994-97 Polish GDP per capita has increased by as much as one third, to around US\$7,000, thus reducing the gap with the EU average. An early catching up will depend on a continued significantly higher growth rate, as envisaged in the *Strategy* programmes.

Finally, EU enlargement raises the question – only too easily neglected – of the new members' readiness to be exposed to the full blast of EU competition, in view of the sheer institutional and structural fragility of economies with inherited structural problems and a still 'immature' economic system (see Eatwell *et al.* 1997). The microeconomic and sectoral policies envisaged by the *Strategy* documents (reviewed above in sections VIII and IX) are designed to prepare Poland to meet these challenges.

The EU has preferred not to diversify its approach among the eastern candidates for accession, treating them all equally for the time being. Simultaneous eastern accessions, however, are no more plausible than the earlier presumption that all the countries of the Soviet bloc would simultaneously reach the stage of full communism. On current trends a number of countries such as Albania, Bulgaria, Romania, are visibly and progressively diverging from the fulfilment of the Copenhagen criteria for accession, not to speak of the Maastricht criteria for EMU membership. By following the course mapped in *Euro 2006* Poland can confidently expect to be among the first to join the EU, at a date that can be realistically placed around 2002.

Joining the EU – in the Copenhagen declaration of June 1993 – involves readiness to join the European Monetary System. Once Poland is fully integrated into the European economy both in its trade and in factor movements including labour, monetary integration is a relatively small step, especially for a government that has already relinquished any direct control over

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<sup>25</sup> In practice, this is happening already, with European Commission proposals for the enlargement (by 50 per cent) of tariff quotas and the further abatement (to 10 per cent) of such tariffs. As long as the CAP is in force, access to the EU market simply displaces EU domestic sales; as tariffs tend to zero and tariff quotas stop biting, ultimately the costs of this policy tend to be just as high as those of the full extension of the CAP to those countries.

monetary and exchange rate policies and that would benefit from lower interest rates and a more stable currency. *Euro 2006* postulates Poland's commitment to be a full member of the Union, including EMU, but there is no need to pre-empt the decision on when, and on what terms, Poland should join. 'If Poland wants to fully benefit from membership of the European Union, at the same time it must attempt to become a member of the deepest form of its internal integration, which will be the Monetary Union' (emphasis in the text). Thus *Euro 2006* prepares Poland's option to join the European Monetary System – whenever and in whatever form it will be realized – as soon as feasible which seems to be around the year 2006. By that time Poland will be in a position to take a final decision – on the condition that its experience with the first seven years or so of EMU operation, and the terms negotiated by Poland, should be positively judged by the Polish people.

Lack of readiness on the part of either the EU, Poland or other new members, may demand a particularly long period of transition to accession, for both the EU and especially EMU, but the possibility of early and full membership is the main concern of *Euro 2006*. There is no conceivable merit, for instance, for Poland to opt out of the Social Charter in return for agreeing to a postponement of the free mobility of labour (as suggested by Sachs and Warner 1996): from the stance taken by *Strategy* and *Euro 2006* both opt-outs are disadvantageous to Poland.

The experience of the first round of EMU foundation-laying indicates the exceedingly high cost of forcing the pace of monetary unification, with individual efforts to meet Maastricht's stringent criteria leading to a deep competitive recession; hence the gradual preparations and soft landing envisaged by *Euro 2006*.

Poland is already meeting the Maastricht criteria for fiscal convergence: budget deficit under 3 per cent of GDP over a year, public (domestic and external) debt under 60 per cent of a year's GDP.<sup>26</sup> Poland is still far from meeting the criteria for monetary convergence, under which interest and inflation rates are to be kept within strict bounds of the average rates of the three Union members with the most stable prices, and of a stable exchange rate (which involves joining the European Monetary Mechanism and staying for two years within its maximum bounds of variation). By the end of 1996 this would have required an inflation rate of 2.6 per cent (1.5 per cent over the average rate of Finland, Holland and Germany) and an interest rate of 8.7 per cent (2 per cent over that of the same countries) instead of over 20 per cent. The zloty's crawling band exchange rate regime is far from the fixed band of the ERM, though for a narrower band of variation (7 per cent either way instead of the 15 per cent applicable to ERM members – except Germany and Holland who are committed to a mere 2.25 per cent).

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<sup>26</sup> The Maastricht Treaty allows the fiscal thresholds to be exceeded for a short and even for a longer period as long as the deficit is falling in a clear and regular manner. The Stabilization and Growth Pact recently signed in Dublin defines the conditions under which a departure from these thresholds is acceptable (automatically for a drop in GDP larger than 2 per cent, subject to negotiation for a drop of GDP within the range 0.75-2 per cent) and penalties otherwise applicable.

Table 4 maps out a process of continued satisfaction and eventual improvement of the fiscal criteria, and of the steady deceleration of inflation down to below today's admissible threshold of 2.6 per cent. Such a performance for the rate of inflation postulates the full cooperation of the National Bank of Poland and, in turn, given the fiscal stance, should allow the NBP to fulfil the interest and exchange rate conditions.

A major question for all prospective EU members from central eastern Europe, is

the extent to which adoption of the European Union's body of legislation and case law – the *acquis* – will stunt Eastern growth and raise unemployment rates. After all, the EU's rules were designed for rich social democracies with extensive social security systems. They are thus unlikely to be appropriate for poorer but rapidly growing Eastern nations.... Quantifying such costs [of enlargement for the East] is important but seemingly impossible (Baldwin *et al.* 1997).

The Polish *Strategy* postulates that any such costs can be contained and offset by parallel gains. Containment can be obtained by a variety of means: transitional dilution; scaling down commitments to Poland's income per head; placing caps on public outlays geared to the *acquis*; catching up with richer but much more slowly growing members – a process which is already under way; last but not least, the net transfers from other member states, rooted not only in solidarity but in their enlightened self-interest. Estimates of central-eastern new members net gains from EU accession vary from large to very large, but are not in doubt. According to Baldwin *et al.* (1997), for the 10 prospective members long-term gains range between 2.5 billion and 30 billion ECUs, plus farm and structural funds transfers between 23 billion and 50 billion ECUs: Poland's fair share of both the costs and benefits of accession is still bound to represent an exceptionally attractive rate of return.

Finally, the very need to meet the membership criteria and adopt the EU's *acquis* 'has helped all central European government to resist special interest calls for bad policy' (Baldwin *et al.*). The prospect of accession is, therefore, a major factor in the implementation of *Strategy*-type policies not only by the present government but also by its successors, even in the legislature due to begin in 1997.

## XII TOWARDS A NEW CONSENSUS

When the strategies and ideas expounded in this paper were formulated and implemented in Poland, they were undoubtedly unfashionable and controversial, in contrast with the so-called 'Washington consensus' policies of conventional shock therapy. By 1997 there are widespread signs that a new consensus is emerging, even in official international circles, which is based precisely on the ideas implemented in Poland in 1994-96.

On the early recession, a dispassionate and authoritative source such as Bob Mundell states unambiguously that 'early denials that the contractions were occurring have proven to be incorrect', and that in general these contractions were due to 'a bungle of economic policy on an unprecedented scale' (1995). Even an early supporter of the 1990 policy package, Stanislaw Gomulka, by 1996 recognizes that, 'The percentage falls in total measured output in most transition economies ... are much smaller but still remain formidable after reasonable corrections of the official data are made'; Poland is not claimed to be an exception.

On the relatively minor importance of privatization of state assets, relatively to the 'organic' growth of the private sector, even Gomulka now accepts that, 'The single most important factor underlying the considerable variation in the pace of recovery in the few countries which experienced it by 1995-96 has been, on the supply side, the initial size and the subsequent growth of the *de novo* private sector...' (1996). Konings *et al.* (1996) also find that Polish *de novo* private firms account for the major share of employment creation although they represent a small fraction of existing employment. In this respect Poland has imitated a pattern familiar from Chinese and Vietnamese experience. Why then the earlier rush to 'creatively' destroy the state sector and to give it away? Thanks to its multi-track approach, Poland is now recognized to have avoided the adverse experience of other transition economies, such as the Czech Republic and Russia, which have 'ended up with cloudy, crony-dominated systems in which banks and company bosses keep each other comfortable, but create little value for shareholders' (*The Economist* 15 February 1997).

The earlier approach to institution building, documented above (section III), has given way to much more informed and considered views. After central planners move out, street traders may move in, establishing those markets which Mancur Olson (1996) calls 'self-enforcing' elementary markets – basically characterized by nonrecurring spot exchange. But those markets associated with economic growth, involving long-term contracts and a transfer of resources to risk-taking entrepreneurs, are different. These take both time and active government policies, and a new role for the state: 'There cannot be private property without government' (Olson 1996). 'No-one measured the true depth of the collapse of all administrative structures, the decomposition of the state which accompanied the collapse of the communist system' (IMF Managing Director Michel Camdessus, referring to Russia; *Financial Times* 10 January 1997). Yet Eatwell *et al.* (1995: ch. 2) had given ample and

prominent space to that issue. These propositions presume not just *less* government at any cost, but *better* government.

The EBRD Chief Economist, Nicholas Stern, also recognizes that,

The building of institutions takes time. Clear examples are the financial and legal institutions. Banks depend on special skills including accounting, credit analysis and the like. These depend on the establishment of relationships, track records and working methods. Legal systems have to be first established and then implemented. The analysis (ch. 6) of the Transition Report for 1995 shows that the implementation has been much weaker than the setting of legal structures themselves. Similar considerations apply to competition policy and, more generally, to the changing role of the state ... (Stern 1996).

The latest EBRD *Transition Report Update* stresses that, 'Strengthening of existing institutions and policies, augmented by behavioural changes of private agents and authorities, is essential to yield sustained improvements in the investment climate of the region' (EBRD 1997: 23; emphasis added).

The importance of corporate governance – as opposed to the sheer transfer of property titles – is now being recognized even by the early supporters and practitioners of mass privatization, such as Frydman and Rapaczynski (1994). Estrin (1996) reports that in Poland, as in Hungary, the Czech Republic and Russia, there is no clear evidence that privatized enterprises perform better than state enterprises which have not yet been privatized. 'For enterprises, effective corporate governance will take time to establish.' ... 'Restructuring itself will be a major and fundamental task involving investment, hard decisions and dislocation. It will be much less painful if economic growth, effective corporate governance and well-functioning safety nets are established' (Stern 1996). Konings *et al.* (1996) argue that good corporate governance is essential for recovery.

After the extreme *laissez-faire* of the early transition, values of cooperation and solidarity are being rediscovered. By January 1997, the billionaire financier George Soros, who played a significant role in financially supporting the transformation of communist into open societies, writes,

Although I have made a fortune in the financial markets, I now fear that the untrammelled intensification of *laissez-faire* capitalism and the spread of market values into all areas of life is endangering our open and democratic society. ... Too much competition and too little cooperation can cause intolerable inequities and instability (Soros 1997).

In the 1996 *World Development Report*, devoted to the transition, the World Bank now emphasizes very strongly the need for social consensus, 'Establishing a social consensus will be crucial for the long-term success of transition – cross-country analyses suggest that societies

that are very unequal in terms of income or assets tend to be politically and socially less stable and to have lower rates of investment and growth'.

Initial fiscal overshooting had long been recognized even by the IMF: 'In some eastern European countries there were substantial budget and current account surpluses in the early stages of the reform programs, which might, *ex post*, suggest that macroeconomic policies could have been less restrictive'; (1992: 46; but there had been abundant *ex ante* warnings, recalled by Kolodko 1992).

It is now widely accepted (for instance, in the World Bank 1996) that, in economies – like the Polish economy – which are still affected by structural rigidities, such as formal and informal indexation, and sluggish supply response, once inflation has fallen well below a threshold of about 40 per cent, attempts at speeding up disinflation would have had significant, perhaps intolerable costs, in any case higher than those of the moderate and falling inflation actually experienced by Poland in the last years. What counts is that inflation should continue to fall steadily and noticeably, without ever accelerating again.

The need to target a positive real interest rate, an unwarranted dogma in the early transition and a ruinous policy especially when held during the later necessary stage of real revaluation, is now forgotten as a determinant of savings in favour of more important factors such as demographic trends, national pensions (retirement) policy, and overall fiscal and regulatory policies. A considerate neglect of real interest rates is displayed by Buiters *et al.* (1996) who stress the importance of the permanent income and life-cycle hypothesis.<sup>27</sup> Equally the 1996 EBRD *Transition Report*, which is actually devoted to infrastructure and savings, stresses the role of raising government savings (especially through the overhauling and reform of social security and pension systems, and more broadly based taxation at lower rates) and the development of contractual savings and life insurance. In this perspective, the early (and later) transition stress on high and positive real interest rates is grossly misplaced, with respect to the more appropriate macroeconomic policy framework developed in *Strategy for Poland*.

Recently the fiscal and quasi-fiscal activities of central banks, notably in emerging economies and especially in post-communist economies, have attracted considerable attention (Fry 1993). In particular, the costs of sterilization policies, which are the results of excessive interest rate differentials and/or of undervalued currencies, have recently come to the fore – for instance in the OECD country study of the Czech Republic (1996). It turns out that for a considerable time the central banks of both Poland and the Czech Republic have wasted about 1 per cent of GDP in their unfortunate sterilization policies (Nuti 1996; OECD 1996). Thus what may have appeared to outside observers as a challenge to the National Bank of Poland's independence on the part of the Polish Ministry of Finance turns out to be a well

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<sup>27</sup> Within this framework, it is plausible for some 'target' savers to respond negatively to a higher interest rate, which allows them to achieve a given consumption transfer to the future at the cost of lower current sacrifice; indeed this may be likely in an ageing economy like Poland. With higher real incomes and the further fall in inflation, the real rate required to raise savings is bound to fall considerably.

founded disagreement about both targets (inflation versus unemployment) and instruments (interest rate versus monetary aggregates; exchange rate policy).

All these propositions are now widely accepted. They are often offered as theoretical propositions, while Poland has had and offers the advantage of direct operational experience. Poland has now a great deal to give to other post-communist and emerging economies; an initiative for setting up a 'Polish Know-how Fund' has already attracted international attention and support.

Myths may help men to bear and accept uncontrollable natural adversities, but successful strategies and experience – such as Poland clearly has today – are essential to avoid, control and overcome man-made adversities such as the avoidable costs of systemic transformations which are still taking place elsewhere, and to make these transformations equally successful.

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