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Lessons for the Emerging Markets from Poland's Great Change

Summary

It is widely assumed that the post-socialist transformation started in Poland. This is true, but only in part. Although it was indeed in Poland that various processes contributing to this dramatic change gained in the 1980s the greatest momentum, things were not at a standstill in other countries of Central and Eastern Europe, either. Another widespread assumption is that the post-socialist transformation was set in motion in 1989, when – first in Poland and then, through a chain reaction engulfing the entire region – ‘real socialism collapsed’ or, as others would prefer to put it, ‘communism was defeated’. There is no doubt that later on Poland has handled the challenges of the great transformation better in many respects than other countries. Hence, after over 15 years of an ongoing post-socialist transformation toward democratic polity, market economy and civil society, there must be certain lessons that other countries, especially the so-called emerging markets, can learn from the Polish experience. Hence it is worth to have a closer look at what works and why and what does not work and why.

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Lessons for the Emerging Markets from Poland's Great Change

It is widely assumed that the **post-socialist transformation started in Poland**. This is true, but only in part. Although it was indeed in Poland that various processes contributing to this dramatic change gained in the 1980s the greatest momentum, things were not at a standstill in other countries of Central and Eastern Europe, either. The winds of change also blew in Hungary or in the former Czechoslovakia. But it is true that Poland acted as a trailblazer and was the first to implement many of these changes, which was not an easy thing to do.

Another widespread assumption is that the **post-socialist transformation was set in motion in 1989**, when – first in Poland and then, through a chain reaction engulfing the entire region – ‘real socialism collapsed’ or, as others would prefer to put it, ‘communism was defeated’. Did then the previous system, prevailing for several decades in this part of Europe and in the vast expanses of Asia, simply **collapse** through an insufficient capacity to adapt to the changing internal and external conditions – not just economic, cultural and political, but also technological – or was it, rather, **defeated**, and if so, by whom: by internal forces alone, or by an external pressure? This is a separate question which still remains controversial. Maybe History will provide an unambiguous answer, although I doubt it. For real socialism *did* collapse and *was* defeated. One does not rule out the other. What is, on the other hand, an unquestionable fact for us is that History sees that very year – **1989** – as a turning point on the path of mankind. Even if it was not the actual beginning of that great change, whose roots went back to earlier reforms – particularly those implemented in Poland, Hungary, and also the former Yugoslavia – it did mark a major shift.

This **great post-socialist shift** consisted in giving up the earlier efforts to reform the old system (Kolodko and Nuti 1997; Kornai 2001). The attempts to increase the international competitiveness of the economy and give real socialism a more ‘human face’ had failed. The foundations of the old system thus became abandoned in a fairly radical manner. Rather than go on ‘reforming’ what had proved to be hardly reformable, the endeavor was made to reject the old system and build a new one in its place. This time it was to take the form of a capitalist market economy. Likewise, to be sure, with a ‘human face’.

It is a process which has been going on for 15 years, during which post-socialist countries have gone through many ups and downs, the latter, sadly, prevailing. Excluding China, the greatest economic success story in modern world (Lin, Cai and Li 2003), as well as

Vietnam, following in China's footsteps, in the majority of the 27 countries of Central and Eastern Europe and the former Soviet Union, with over 400 million inhabitants, the output and consumption levels in 2004 remain lower than they were 15 years ago. International statistics demonstrate unequivocally that the **proportion of people marginalized by social exclusion in post-socialist transforming economies has markedly increased** (Kolodko 2000b; Stiglitz 2002). The areas of poverty and destitution have also expanded, and in some countries life expectancy has dropped, too. Income disparities have increased everywhere, sometimes sharply, although once again to a varying degree. In the majority of societies of the post-Soviet region and the Balkans, the Human Development Index (HDI) as assessed under the United Nations Development Program (UNDP) is now lower than at the beginning of the transformation.

Quite understandably, the situation differs from country to country and, within each specific country, from region to region. Even in a seemingly homogenous country like Poland, per capita GDP in the richest region is about six times higher than in the poorest one. On the international scale, such differences within post-socialist countries are even greater. This is a consequence of both the inheritance of the past – including that of the centrally-planned socialist economy – and, especially, the course taken by the system transformation over the past 15 or so years. Some countries did better than others. Poland is quite universally included in the more successful group. Some commentators even speak about a 'Polish economic miracle'...

Leaving miracles where they belong, it is nevertheless a legitimate question to ask **whether Poland is an economically successful country**. It all depends on the metric of success. After 15 years of transformation, per capita GDP is about 40 percent higher (Kolodko 2003). This is not much of a progress, not only in comparison with China, but also *vis-à-vis* Western Europe or the United States, that is, the richest countries, which have, on average, developed faster in those years, leaving Poland and other post-socialist countries even further behind. At the same time it is the greatest increase among all transforming economies. In this respect Poland has achieved more than any other country in the region – at least for the time being, as it will only be possible to speak of a true success (or lack thereof) after a longer period than a decade and a half. A final judgment can only be passed from the perspective of generations.

There is no doubt, however, that in many – but, sure enough, not all – respects, **Poland has handled the challenges of the great transformation better than other countries**. This merits reflection and scrutiny and invites comparisons across time and space.

Much has been said about it thus far, while many other things remain to be uncovered. But even a cursory analysis of the special case of Poland shows that its better macroeconomic indicators result from two factors.

The first was the **shortest duration of the transformational recession among all countries**. It lasted only for three years – from mid-1989 till mid-1992 – whereas in the extreme case of Ukraine, it evolved into a **great transformational depression** which went on for a whole 10 years. This was a consequence not so much of a sound strategy at the outset of the Polish transformation, which was missing as a result of the insane idea of a ‘shock therapy’, as of the positive effects of the market reforms implemented already in the days of socialism (Kolodko 2000a; Baka 2004). And this is the first lesson that follows from the Polish experience of the times of dramatic change.

LESSON ONE

Economic reforms that increase the flexibility of markets and at least partially contribute towards the building of institutions necessary for the efficient functioning and development of a market economy always come in handy when a bolder and more profound structural shift is subsequently made. Even if certain reasons – for instance, of political or cultural nature – prevent changing too much at one go, it makes sense to change things little by little, for in time this is likely to bring about the desired results. This is not to say that these partial reforms will gain due recognition later on. Most likely they will not, but that does not change the fact that they did take place and prove helpful for long-term development. Politically speaking, someone sows and someone else reaps the political benefits, but the most important thing is the gain for society, economy and state.

Second, the past 15 years has been a heterogeneous period in terms of not only the dynamics of growth, but also the distribution of its fruits (Tanzi, Chu and Gupta 1999) and **institution building** (World Bank 2002), which allowed growth to occur in Poland earlier than elsewhere. The years in question can be divided into four distinct episodes:

1. The initial **‘shock without therapy’ in 1989–93**, when a largely overshoot stabilization policy, disregard for market-economy institution building, excessive and too fast trade liberalization and neglect of the growth-stimulating functions of the state pushed the cost of the transformation well beyond the unavoidable minimum (which was also mentioned in the official documents), while the effects fell considerably below what was expected (and

attainable). The actions that led to **sub-optimal effects at an excessive cost were in blatant violation of the basic rules of pragmatism and rationality**. Consequently, the scale of the transformational recession was much larger than would have been the case had the government pursued an appropriate policy; unemployment reached massive proportions; inflation proved impossible to bring down to single digits and a structural budget deficit began to mount.

2. **‘Strategy for Poland’ in 1994–7**, when the economic institutions became substantially strengthened – allowing Poland to become associated with the European Union in 1994 and join the OECD in 1996 – and, most importantly, the economy entered a fast-growth path thanks to an appropriate policy of structural reform and development. During those four years, per capita GDP grew at an average rate of 6.4 percent a year, achieving a cumulative increase of as much as 28 percent, which is truly impressive compared to the overall 40-percent growth in the 15 post-socialist years. The increase of income disparities was curbed, as reflected by the Gini coefficient, which stabilized in 1996–7 at about 33 points. There is a lesson to be learned from the ‘Strategy for Poland’ episode:

LESSON TWO

Only a proper mix of two policies – a system change policy and a development policy oriented towards the accumulation and efficient allocation of capital – offers a chance for a rapid economic growth. Neglect of either of these components precludes good results. Apart from Poland, this is amply demonstrated in a negative sense by the Russian case and in a positive sense by China.

3. The period of **overcooling the economy in 1998–2001**. Indeed, the word ‘overkilling’ would be just as apt, as growth rate was brought down from more than 7 percent during the last quarters of the implementation of the ‘Strategy for Poland’ to a stagnant 0.2 percent in the 4th quarter of 2001. Such was the result of a doctrinaire approach to financial policy, viewed mostly in instrumental terms, as a tool to suppress inflation and reduce current account deficit. Such a policy could not have brought the expected stabilizing effects, while inevitably causing destruction in the real sphere by hampering growth and aggravating the unemployment problem. Hence the next lesson.

LESSON THREE

Confusing means and ends in economic policy backfires, increasing the social costs of development and decreasing its attainable scale. This sin was rampant not only in Poland and was not restricted to specific periods: mixing up policy goals and instruments is a widespread phenomenon in modern world (seen, in particular, in the erroneous advice furnished by the International Monetary Fund and, worse still, its misguided practices). As the means become glorified, they sometimes come to be perceived as ultimate goals, as was the case in Poland in the late 1990s, driving the economy to stagnation. That effect occurred despite the progress in institution building, privatization efforts and the ongoing process of opening up the economy.

4. The **return to the path of rapid development and integration with the European Union in 2002–4** marks a fourth period, differing from the previous ones in the characteristics and dynamics of changes in the system and in the real sphere. A key role has been played therein by two factors of programmatic nature: profound reorganization attempts in the area of public finance, aimed at adjusting the system to the capacities of the state and requirements of a modern market economy, on the one hand, and European integration on the other. The principal policy document in this field was the ‘Public Finance Recovery Program’ (PNFR 2003), in which both the far-reaching restructuring of the public finance system, and the EU accession process were viewed in instrumental terms. Its main task – to restore rapid growth – has been fulfilled. The rate of GDP growth quickly climbed from 0.5 percent in early 2002 to 6.5 percent in the first half of 2004.²

It thus becomes apparent that the **success of the Polish transformation in 1989–2004 is made up of a peculiar mixture of ups and downs**. In this context, the abominable performance towards the end of the 1990s, in the real and the financial spheres alike, makes one pause to wonder. After all, the boom of 1994–7 – the years of the ‘Strategy for Poland’ – might have gone on but did not. In a different perspective, after the needless and harmful overcooling of the economy in 1998–2001, the economic misery of those years might have continued to this day, but did not, either.

What do such profound changes in growth dynamics depend upon? Surely, no significant external shocks occurred to account for the great acceleration of 1994–7 or for the great deceleration of 1998–2001. The impact of the Russian crisis of 1998–2001 on the Polish

² However, due to too restrictive monetary policy of the central bank (NBP), on the one hand, and discouraging capital formation and productivity growth politics during the election year, it has slowed down again, to about 4 percent in the first half of 2005.

economy was many times less serious than the Polish and foreign propaganda would have it in those days (some reminiscences of that way of thinking still linger on); likewise no other subsequent external shock (this time of a positive nature) occurred to dynamize the economy. In fact, during the four-year period 1994–7, the Russian economy was in a much poorer shape than in the next four years: 1998–2001, and yet no responsible person would have invoked this ‘argument’ to explain why things were not even better. On the other hand, in 1998–2001, the need was felt to explain away many things – namely, the above-mentioned **economic policy errors**. These observations give rise to our next conclusion:

LESSON FOUR

At the time of a great systemic transformation – in which the liberalization and opening up of the economy go hand in hand with its integration into the global system – institution building, that is, the creation of new rules of the market economic game and a legal and organizational framework for their implementation, is of a fundamental importance (North 1997 and 2002; Kolodko 2000a; Stiglitz 1998). But policy is also vital. Ever improving institutions do not by themselves entail – at least not in the short-term perspective – an ever improving policy. The latter may be, alas, steadily deteriorating, for it also depends on other factors, such as the economic doctrine, the dominant political set-up and the skills (or their lack) of those who run the economic policy. Institutions matter, but so does policy.

This is a situation which indeed occurred in Poland: despite the obvious institutional progress – also in connection with the EU integration – the economic policy deteriorated. Its particularly weak point was the poor coordination between fiscal and monetary, as well as industrial and trade policies. It only became possible to change this, partly, in mid-2002. It is small wonder then that soon afterwards the economy re-entered the path of a more rapid growth. This does not mean, however, that it will automatically stick to this path, as this will depend on the quality of the economic policy, which is an area where new threats emerge.

One would be hard pressed to give an example of an economic success based on investing other people’s savings. Only in a handful of special cases did foreign investments – especially direct ones, which in the modern world and the global economy are a principal vehicle promoting technology transfer, management quality improvement, the development of marketing abilities and a pro-export orientation in the economy – play a significant (but still not decisive) role in financing economic expansion. Such was the case in Ireland, which aptly utilized the incoming stream of investment, mostly from the Irish Diaspora in the United

States. Foreign direct investment also played a significant role in the accelerated growth in the south-east of China. Generally, however, **foreign investments only play a supplementary role vis-à-vis domestic savings**. It makes sense to count on the influx of foreign capital, but one should beware of too optimistic projections in this area. This is another lesson that emerges from the experience of the post-socialist Poland – not only for the Poles, but also for other ‘emerging markets’.

LESSON FIVE

The main source of development financing in all types of so-called emerging markets has been and is the domestic capital accumulation. Therefore, its formation should be given the priority it requires in the macroeconomic policy and in the system of microeconomic incentives. What is important, in particular, is the appropriate design of the financial – both fiscal and monetary – policy, which significantly affects the marginal propensity to save and thus has a fundamental influence on the overall rate of capital accumulation and the investment level and its dynamics. One can count on others to a limited degree only. It is best to count on oneself.

This should not be interpreted as an argument against attempts to attract as much foreign capital as possible (or, to use the correct globalization parlance, capital from other parts of the increasingly integrated world economy) – but not at any price. The experience of Poland (among other countries) serves as a dramatic reminder that the influx of foreign capital, if improperly controlled, may lead to excessive dependency on that capital (particularly in the financial services sector), which is not always beneficial for long-term growth. The resulting dependency levels are sometimes referred to as *dependent capitalism*.

Poland stands out as one of the few countries worldwide to have received a **vast infusion of external capital during a very difficult period, crucial for the success of the entire market transformation**. It took a highly peculiar form of forbearance from taking action that would otherwise necessitate a severe outflow of capital from Poland in connection with the repayment of a large foreign debt. However, in view of the political circumstances, half of Poland’s debt was cancelled – subject to some tough conditions, which were met. Few cases like this have ever occurred worldwide.

One should, nevertheless, hope that their number will increase. **Poor countries should persevere in their efforts to obtain the cancellation of the unrecoverable portion (which may in some cases be the full amount) of their debt to rich countries**. They ought to keep

trying until they succeed, as succeed they must. Only the imprudence, greed and shortsightedness of the richer countries prevent this from happening. And when it does happen, the capital flow from more developed to poorer economies will increase. However – and this is yet another significant lesson from Poland – debt cancellation must be combined with sound structural reforms, effective anti-corruption measures and an adequate macroeconomic policy. Debt reduction is sometimes simply inevitable, if a country is unable anyway to pay off its external liabilities. But it only makes economic sense if the consequences of the earlier economic policy errors (excessive debt) are removed along with their causes (faulty policy).

Politicians of the world have united. Not workers – as someone postulated a long time ago – but, of all people, politicians. At least when it comes to shifting the responsibility for their errors onto others, including – interestingly – other countries and *their* governments. This can be seen, for instance, in the powerful United States, whose trade deficit, of structural type though it is, is being blamed – by the Administration – on China and its policy of fixed exchange rate of the yuan, which, as it happens, has been pegged for years on end to the U.S. dollar. Less surprisingly, this trend also occurs in most poorer countries, such as Mali, where the mounting difficulties are attributed (not without reason, this time) to the discriminatory trade practices of the stronger partners from better-developed parts of the world, who subsidize their farmers (and voters), thus suppressing the price of cotton – a commodity of fundamental importance for many countries trying to break out of the vicious circle of poverty.

The countries of post-socialist transformation, including Poland, are no different. **Blaming one's own problems on others has become even easier now that the technological, commercial and financial links between various national economies are stronger than ever.** It is thus simpler (or so it seems to those who engage in such practices) to push the responsibility for the outcomes of one's own incompetence to 'foreign influence and interests'. In Poland, such a reaction was widespread in the aftermath of the erroneous and harmful policy after 1998, which overcooled the economy. The consequences of these errors were explained away by invoking the Russian crisis, which in reality affected Poland to a minimum degree only, due to the marginal importance of its trade with Russia.

Later on – and this tendency is certain to continue – blame for various hardships, which are never lacking, was put on the European Union, although it obviously offers the new member states more than it receives in return. This is not meant to conceal the fact that, in the course of the integration process, the post-socialist accession countries could have obtained

more at a lower cost but, alas, failed to take advantage of this opportunity during the accession negotiations. There is a lesson to be learnt here by the countries applying for accession to the EU in the future: Bulgaria, Croatia, Macedonia, Romania and also Turkey.

The general conclusion from all this is as follows: **globalization, which is an objectively inevitable process, presents to national economies new, additional opportunities and chances, but also additional risks and threats** (Kolodko 2002). The two go together. But ‘together’ does not mean ‘in a one-to-one proportion’. The additional benefits (those which would not have arisen save for globalization) may well outweigh the additional costs. But, unfortunately, the reverse is also possible. The whole point is to make apt use of these interrelations in the national strategy of socio-economic development. And this is yet another lesson to be learnt by all the emerging economies from all corners of the ever more strongly interconnected world, as they keep opening up to broad external contacts.

LESSON SIX

Globalization creates additional development opportunities and additional development threats to everyone (Stiglitz 2002). Therefore, the art of economic policy-making consists today in the apt handling of the dilemmas that crop up under the new circumstances. The mini-max rule should be followed: minimize threats, maximize opportunities – or, more precisely, reduce the inevitable costs of participation in the global economic game and increase the benefits thereof.

The Polish case is highly illustrative in this context. The reduction of the foreign debt by half; the structural shift in the geographic distribution of foreign trade towards the most highly developed economies, abounding in free capital resources (potentially allocable in Poland) and modern (likewise absorbable) technologies; the influx of a sizable stream of foreign direct investments that reinforce the desired microeconomic restructuring and boost the international competitiveness of enterprises; finally, integration with the European Union – these are just the most significant benefits that Poland has skillfully taken advantage of.

On the other hand, **the exorbitant price paid by Poland for the inrush of short-term speculative capital** during some episodes of its opening up to the world has been (and still is) an additional cost to pay. Too bad, indeed, the price is so steep, but the guilty party is not globalization or capital (greedy by its very nature and ‘speculative’ by definition), but an **erroneous policy of the central bank** (NBP), whose dismal handling of internal interest rates creates international rate differentials that amount to inviting ‘foreign speculative capital’ to

wreak havoc in Poland. This entails losses in the order of billions of dollars, which would be perfectly avoidable. There are countries which have solved this problem, in a variety of ways, including Chile or Malaysia, to say nothing of China and India. **The Polish experience thus indicates not only the right and proper course of action, but also things to steer clear from.** It is best to avoid errors that someone has already committed at some place and time. For instance, in Poland at the beginning and then again towards the end of the 1990s.

The momentous changes in Poland at the turn of the 20th century also teach us quite a few lessons on the borderline between economics and politics. This is a compulsory curriculum for all, since everyone has to learn the hard way the interrelationships described above. Even so, it would be unreasonable not to examine the experiences of others. The Poles have learned a great deal, too, analyzing other ‘interesting cases’ (although, perhaps, not *as* interesting as the case of Poland – the most fascinating of all), but some persons in charge of the government could have done better in this respect. In particular, each of the four stages of the Polish transformation of 1989–2004 enumerated above demonstrates that in order to attain economic success, **it is necessary to combine a technocratic and a social approach.**

Economic policy requires a great deal of professionalism. When ‘everything depends on everything else’, it is very difficult to state competently what really depends on what in the tangle of events. One needs to understand this and make use of extensive professional knowledge and technocratic ability to manage huge resources and capital streams.

But this is not enough. An economy does not consist solely of financial and material resources and streams. It is also – indeed, mainly – made up of social capital, people and the relationships that unite them (or divide, as the case may be). Therefore, political activity in the field of economy inevitably entails an involvement in the sphere of social relationships, especially those which arise through economic interaction. In economic policy, ‘to be right’ in the technocratic sense is not enough. One also has to be right in social terms (Sen 2000). Which means that the **principal social groups should have a general understanding of the government’s intentions behind its financial, industrial, commercial, regional or investment policies.** Furthermore, even if these groups do not actively support measures intended to put the government program into practice, they should at least give their passive consent for their implementation. Otherwise, the politicians – *qua* technocrats – may still be right (for instance, when trying to reduce the scope of tax exemptions or to verify the system of social transfers), but society may also be right to reject their ideas. A situation when both sides are right is likely to stir controversy for all. And when both sides stubbornly stick to their respective rights, an open political and social conflict ensues.

LESSON SEVEN

Economic policy is at the same time a technocratic and social endeavor. The neglect of either of these aspects automatically decreases the effectiveness of the policy. It is not enough that narrow circles of experts know what to do: this knowledge must be shared by broad circles of society, although it then becomes a different knowledge. Therefore, the best results in economic policy are provided by an appropriate mix of financial and social engineering, technocratic macroeconomic governance and genuine social dialog, professional pragmatism and social sensitivity.

The past 15 years of market transformation in Poland and its intermittent ups and downs clearly indicate that the economy was doing better when the two above-mentioned approaches were consistently combined. Any deficiency in this respect badly affected the effectiveness of the economic policy. How is this effectiveness measured? The answer follows from one of our lessons, admonishing us not to confuse means and ends: the appropriate measure is invariably the socio-economic dynamics – the pace of financially, economically, socially and ecologically sustainable growth. In those periods when we made sure our homework was done, growth was faster, and *vice versa*. Obviously, the actor to learn the most from these experiences was Poland – although, regrettably, not all Poles. After all, ignoramuses – whether in politics or at school – are never in short supply. And whereas the Polish transformation has indeed been largely successful, there was most certainly no such thing as a Polish miracle. For there are no miracles. Not even in Poland.

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