

**The  
Global Long-term  
Economic Growth  
and the  
Economic Transformation  
of Poland  
and Eastern Europe**



# **The Global Long-term Economic Growth**

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Economic Transformation  
of Poland  
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**STANISŁAW GOMUŁKA**



SCHOLAR Publishing House  
Warsaw 2023

Editor: Bogdan Baran  
Cover design: Katarzyna Juras  
Editorial coordinator: Lidia Męzińska

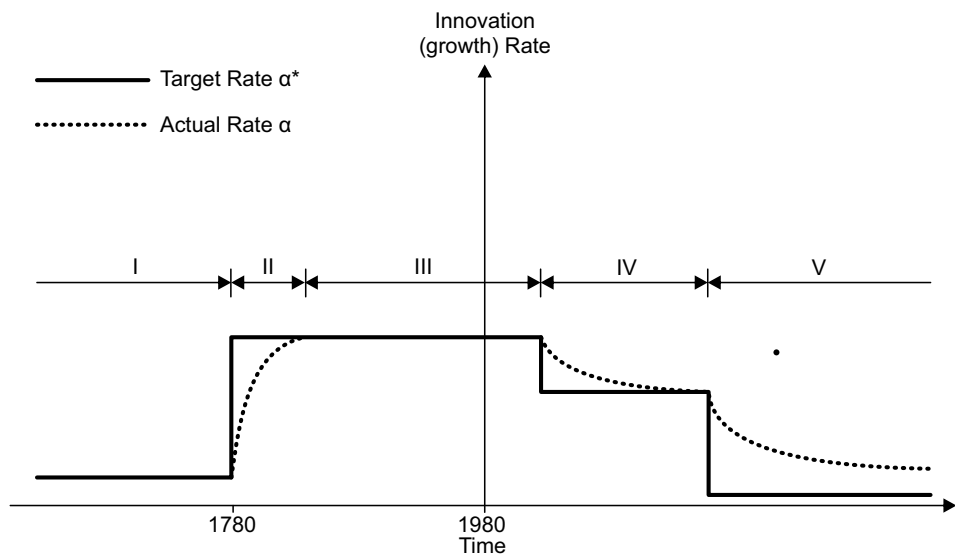
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ISBN 978-83-67450-11-9

eBook edition available:  
eISBN 978-83-67450-23-2  
doi 10.7366/9788367450232

Scholar Publishing House  
ul. Oboźna 1  
00-340 Warszawa  
tel. 22 826 59 21; 22 692 41 18  
email: [info@scholar.com.pl](mailto:info@scholar.com.pl)  
[www.scholar.com.pl](http://www.scholar.com.pl)

First edition  
Printed in Poland



**The target and actual innovation rates over time in the Technology Frontier Area (TFA). The dates and magnitudes are chosen for illustrative purposes**

The Five Periods of the global innovation rate  $\alpha$ , the growth rate of the world population  $n$ , the growth rate of employment in the global sector producing conventional goods  $n_1$ , the growth rate of global capital in the sector producing qualitative changes,  $n_1 + \alpha$ , the growth rate of global employment in the sector producing qualitative changes,  $n_2$ , the growth rate of global Gross Domestic Product per manhour,  $g$ :

- (I)  $n$ ,  $n_1$  and  $n_2$  are all very low. So are  $\alpha$  and  $g$ .
- (II)  $(n_1, n_2) \gg n$  and  $n$  is high. The rates  $\alpha$  and  $g$  are increasing.
- (III)  $(n_1, n_2) \gg n$ , but  $\alpha$  and  $g$  are high and stable.
- (IV)  $n_1 = n_2 = n$ , but  $n$  is still high.
- (V)  $n_1 = n_2 = n = 0$ ,  $\alpha$  and  $g$  are declining.



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# Introduction

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Economic activity can be divided into a “sector I”, producing conventional goods, and a “sector II”, producing qualitative changes, mainly technological innovations, institutional improvements and upgrading human skills. Until about two centuries ago, the long-term economic growth rate in the global GDP per capita had been about 0.05% per year (Angus Maddison) – that is, close to zero. During that period, sector I of the economic activity was almost totally dominant. However, by the end of the 18<sup>th</sup> and the beginning of the 19<sup>th</sup> century, within a small portion – let’s call it “part A” – of the world economy (essentially, Western Europe – especially England), sector II started to grow at a much higher rate than sector I, and that higher rate continued during the last two centuries. For much of the 19<sup>th</sup> century, however, this did not occur in the remaining “part B”. There have been two important implications of these developments. One was that, by the end of the 19<sup>th</sup> century and the first half of the 20<sup>th</sup>, part A of the world economy became much more developed technologically than part B, and another was that the former represented a much bigger share of the global GDP.

In the course of the last half a century or so, we have been observing a certain new phenomenon: a vast international transfer of technology and skills from part A to part B, reducing the income gap between the two parts of the world economy. Moreover, in the course of this century the unbalanced growth between sectors I and II worldwide must come to an end. I also assume that the global population growth will come to an end this century.

In chapter 1, the key “stylised facts” concerning long-term economic growth are formulated: two common for all countries, three for the A category and two for the B category. In chapter 2, a theory is developed, expanding significantly upon an original model by Phelps (1966), to explain these stylized facts. An earlier version of this theory is chapter 10 of my book *The Theory of Technological Change and Economic Growth* (Routledge, 1990).

The theory yields a thesis, new in the literature, that the world’s technological revolution is going to be an innovation superfluctuation, or superwave, – implying that the rate of global per capita GDP growth will eventually return to the historically standard very low level. This theory also assumes that the world will continue to avoid two potential catastrophes: a global nuclear war and a climate disaster.

One of the characteristic facts concerning the “catching-up countries” is the exceptionally large variation in their per capita annual rate of growth, from about zero to about 10%. The papers published in this monograph show that this rate is strongly dependent on the rate of investment, the quality of the labour force and the quality of institutions. The rate of investment is, in turn, dependent on the rate of domestic savings. In Poland, domestic savings are shown to have been and continue to be very low by international standards. The trend rate of growth of about 3.7% has been about 2 pp. higher than that of the most developed economies, mainly thanks to the development of modern market institutions and a new private sector, and partly thanks to foreign direct investments and a significant inflow of finance from the European Union (EU). The data also show that by far the least successful transformation in Eastern Europe has taken place in Ukraine.

In 1979–82 Poland suffered a large recession, a 24% drop in GDP, and in February 1981 it declared bankruptcy in servicing a large portion of its public foreign debt. Several chapters in this monograph discuss the institutional transformation in 1989–1990 and the reasons for policies adopted in that crucial period, as well as in later years. One of the chapters specifically discusses the role of the IMF in Poland (and Russia).

Two chapters discuss the economic and political significance of the euro as a common currency in Europe and of the European Central Bank as a key institution for the EU, especially for the eurozone countries. One of these chapters attempts to evaluate the costs for Poland if it remains outside the eurozone. This particular chapter, as well as chapter 20, last in the book, are written in Polish, as they are addressed only to Polish readers. What is novel in chapter 20 is the discussion of the forthcoming new “special circumstances” in Poland, which will significantly reduce the country’s rate of economic growth after 2030. The most important of these are negative population growth and the end of the catching-up process. The latter factor will reduce the annual trend rate of the GDP per capita growth to about 1.5%.

In the EU, fiscal policies are decided by the member countries (the EU budget represents about 1% of the EU GDP, whereas the national budgets represent about 40-50% of national GDPs). A separate chapter 19 discusses the fiscal policy reasons for the large recession in Greece in 2009-12, with its GDP falling by 25%. The analysis is intended partly as a warning for Poland and other candidates for eurozone membership, that a poor quality fiscal policy may cost more than the benefits stemming from eurozone membership.

# 1. The global economy in the 21<sup>st</sup> century: Will the trends of the 20<sup>th</sup> century continue?<sup>\*1</sup>

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**Abstract:** This paper compares three lists of basic ‘stylized facts’ of global economic growth and proposes a list of five ‘stylized trends’ that describe the main developments of the global economy in the 20<sup>th</sup> century. The author’s main purpose is to answer the question whether, in the light of the contemporary growth theory and demographic forecasts, these trends are likely to continue in the 21<sup>st</sup> century. Considering this theory, it is argued that the global economy rate of growth of the per capita gross domestic product (GDP) is likely to continue to be high in the first half of the current century, but decline significantly in the second half. This paper offers forecasts for the average growth rates during this century, and the levels by its end, of the per capita GDP for the technology frontier area (TFA) of the world, and for the countries outside the TFA. According to these forecasts, the strong divergence trend of the 19<sup>th</sup> and 20<sup>th</sup> centuries will be replaced by a strong convergence between the TFA and the other countries during the 21<sup>st</sup> century.

**Keywords:** global economic trends; 20<sup>th</sup> and 21<sup>st</sup> centuries; convergence; divergence.

**JEL Codes:** F01, O00, O47

## 1. Introduction

Angus Maddison’s *Contours of the World Economy, 1-2030 AD* (2007) is perhaps the best world economic history work. Steve Hanke summarized it as the history of three “distinct epochs of economic growth: the Middle Ages 1000-1500, when the world *per capita* GDP rose by 0.05% per year; the protocapitalistic

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\* *Central European Economic Journal*, 2017, 2(49): 62-72.

<sup>1</sup> Polish Academy of Sciences and London School of Economics 1970-2005 . E-mail: Gomulka@rubikon.pl. This paper is a much extended version of the article published in Polish in *Studia Ekonomiczne* (4, 2015), and *Nauka* (1, 2016). I wish to thank the referees and the Editor for their helpful comments. I am also grateful to Krzysztof Malaga, Ryszard Rapacki and Nicholas Stern for helpful suggestions.

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epoch, 1500-1820, when it grew by 0.07% a year; and the capitalist epoch, 1820-2000, when the rate of growth was 17 times higher than it was in the preceding epoch” (Hanke, 2008, x).

The neoclassical theory of economic growth, dominant in the economic literature until the 1960s and 1970s, treated investment in fixed assets and employment as crucial growth determining factors. Growth models were empirically tested mostly on 20<sup>th</sup> century data for developed economies. However, the last few decades have witnessed a big change in economic growth theory. There are some important reasons behind this change.

First, the following two assumptions about production functions at the national economy level are now seen as realistic:

1. Whilst the elasticity of substitution between capital and labour may differ widely across sectors and specific production outlets, the technological progress and other qualitative changes are generally labour-augmenting.
2. Returns to scale are (nearly) constant.

These assumptions imply that, in the long run, the growth rate of GDP per working hour is determined by qualitative changes. To see this, let  $Y$  stand for the GDP,  $L$  for labour hours,  $K$  for fixed capital and  $Q$  for the index of quality of  $K$  and  $L$ . By assumption (1), the relationship between  $Y$  and inputs  $K$  and  $L$  would have the form:  $Y=F(K,QL)$ , and this by assumption (2) can be written as:

$$Y = QL * F(K/QL, 1) = QL * F((K/Y) * (Y/QL), 1).$$

Solving for  $Y/QL$ , we get that

$$Y/QL = f(K/Y).$$

In the long run, assuming that the investment/GDP ratio remains fixed, the  $K/Y$  ratio would be constant, so  $Y/L$  would indeed be proportional to  $Q$ . The growth rate of GDP per working hour is therefore a good proxy for the pace of these qualitative changes, which I shall call the innovation rate. These changes are determined directly by technological progress and improvements in human capital, and indirectly by economic policies and institutional changes. In initial neoclassical models, both technological progress and institutional changes were exogenously given.

Secondly, empirical studies have recently been extended to practically all countries of the world and over the last millennium. These studies have resulted in a near consensus that the two types of changes, technological and institutional, are the key determinants of systematic economic growth, with institutional

changes being particularly fundamental in situations when they affect, ease or hamper technological changes.

Thirdly, the mechanisms of technological progress in the most developed countries, forming the *technology frontier area* (TFA), are quite different than in non-TFA countries, including the catching-up countries, known also as *emerging economies*.

Before attempting to answer the question asked in the title of the paper, I shall first note and briefly discuss the basic stylized facts about economic growth worldwide, as proposed by Easterly and Levine (2001), Jones and Romer (2009), and in my own work (Gomułka, 1971; 1990; 2009).

## 2. Basic stylized facts

The statistical data on economic growth have certain fundamental characteristics, termed “stylized facts”, which the growth theory must explain first and foremost. Formulations relating to these facts have undergone an important evolution.

### 2.1. The facts according to Easterly and Levine (2001)

Their facts are as follows:

- 1. It is not differences in capital accumulation (physical or human), but differences in the productivity growth of these two kinds of capital (total factor productivity – TFP) that explain almost completely the differences in the growth rate of GDP per capita.**

This formulation assumes **implicitly** that capital accumulation and TFP are independent factors. In my interpretation of growth mechanisms, such an assumption is justified only in relation to TFA countries. In non-TFA countries, however, the import and absorption of technology from outside is usually correlated with physical and human capital accumulation.

- 2. There are huge and growing differences in GDP per capita; divergence – not conditional convergence – is the big story.**

Such an approach is a polemic against the traditional Solow-Swan growth model, in which qualitative changes are given by assumption. Fact (2) is compatible with a description that emphasizes a high increase in the degree of duality of the world economy over most of the past 200 years, but is at variance with data for the last 30-40 years.

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**3. Growth is not persistent over time, but capital accumulation is.**

By this formulation, the authors probably want to stress the large role in economic growth, especially in the short term, played by factors other than capital accumulation.

**4. All factors of production flow to the same places, suggesting important positive externalities.**

The observed significant variation in the level of development between places within the same countries is an indication of a substantial role of concentration, and sometimes also of climate and geography. However, such factors do not influence the trend (long-term) growth rate of *per capita* GDP.

**5. National policies influence long-term growth.**

The influence of economic policy on long-term growth is relatively limited in TFA countries, but large in non-TFA countries. The decision by Easterly and Levine is not to differentiate between these two groups of countries.

## **2.2. The ‘new Kaldor’ facts according to Jones and Romer (2009)**

In 1961, Nicholas Kaldor summarized in six statements what he thought at that time to be the most fundamental features of world economic growth. However, he limited his observations to modern times and a group of well-developed countries. The result of these limitations was that five of his stylized facts were about stability over time: in the growth both of labour productivity and capital per worker; in the real interest rate and the return on capital; in the capital/output ratio; and in the shares of capital and labour in national income. Only one fact noted significant cross-country variation in the trend rate of growth.

Jones and Romer, nearly half a century later, took note of Kaldor’s facts, but proposed a very different list of six stylized facts. Their five facts are about changes and differences, and only one concerns stability.

**1. Increased flows of goods, ideas, finance and people – via globalization and urbanization – have increased the extent of the market for workers, producers and consumers.**

**2. Growth at the global level in both population and per capita GDP has accelerated, especially during the last two centuries.**

**3. The variation in the rate of growth of per capita GDP increases with the distance from the technology frontier.**

**4. Differences in measured inputs explain less than half of the enormous cross-country differences in per capita GDP.**

**5. Human capital per worker is rising dramatically throughout the world.**

**6. Relative wages of skilled and unskilled labour have been stable, not reflecting relative quantities of human capital.**

These are, the authors write, the ‘new stylized facts’ that growth models should explain. The facts (1), (3), (4) and (5) have strong support in the evidence. However, the important statement (2) does not have that kind of support. As Maddison (2007) estimated, and Figure 2 of their paper shows, there was high stability in the global *per capita* GDP growth rate in the period 1500-1820, at a very low level of 0.07% per year, and then stability again in the period 1820-2000, at 17 times higher. Thus, a big acceleration in the growth rate took place towards the end of the first period and at the beginning of the second one, not throughout the five centuries. The authors note that most of their facts can be explained by partial models, but they would like economists to develop a single general equilibrium model that explains all the facts simultaneously.

### **2.3. The alternative new stylized facts by this author (2009)**

The first two of my proposed seven facts apply to all countries, but the other five apply either to the TFA or to the non-TFA countries.

**1. The great acceleration in the growth rate of world GDP per capita, and still more per working hour, took place some two centuries ago, and a historically exceptionally high growth rate has since continued.**

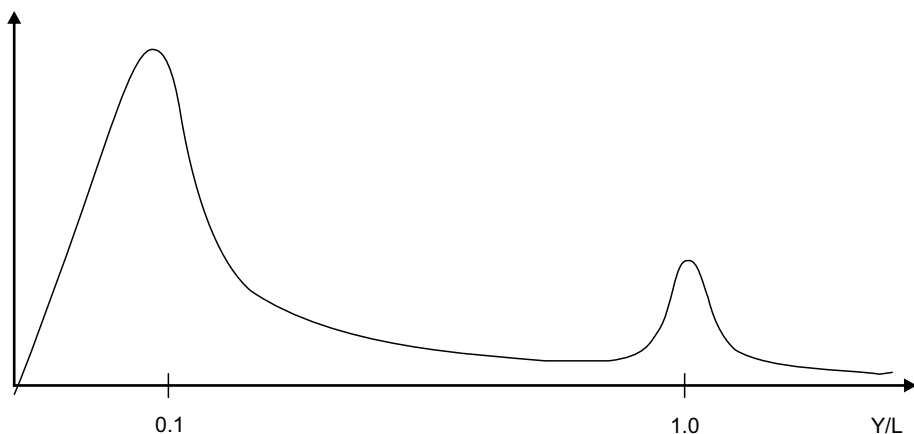
The evidence is largely that provided by Maddison (2007). An explanation of this by now well-established fact is required, and – in the light of this explanation – an answer is needed to the question as to if and when such a fast growth may begin to decelerate, and eventually possibly die away.

**2. Over the past two centuries there has been a large variation in the rate of per capita growth between countries, leading to the very high degree of duality of the world economy observed by the end of the 20<sup>th</sup> century.**

This fact is well-documented and widely accepted; it is essentially the same as Easterly and Levin’s fact (2) and Jones and Romer’s fact (4). The information on high duality is best provided by density of the distribution of global employment according to the level of value-added per working hour,  $Y/L$ . This distribution for the 20<sup>th</sup> century and, so far, this century, has been not only two-humped, but also strongly dual, as the distance between the humps is large (Figure 1). The hump around a certain high labour productivity level, taken to be unity, refers mainly to economic activities in the most developed countries. Activities with such high

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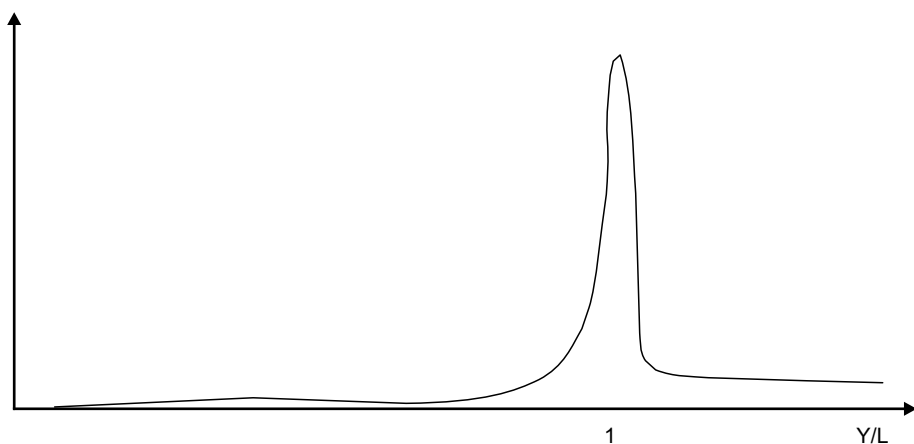
productivity form the **technology frontier area (TFA)**. Today this area consists of the USA, western Europe, Japan, Canada and South Korea, but includes also high productivity islands in all other countries. Employment in this area now amounts to around 15% of global employment. The hump around a certain low productivity level relates largely to activities in the ‘developing countries’.



**Figure 1.** Density of the distribution of global employment according to the level of value-added per working hour, schematic diagram.

Note: The area below the diagram is total global employment.

Source: Author's own elaboration.



**Figure 2.** Density of the distribution of internationally registered patents with respect to value-added per working hour in the countries of origin of the patents, schematic diagram.

Note: The area below the diagram represents global number of important patents per year.

Source: Author's own elaboration.



We need to provide the reasons for this large duality, and an answer to the question if and when there will take place convergence of the levels of GDP per working hour on the global scale.

In my interpretation of worldwide economic growth mechanisms, another figure is crucial. Figure 2 shows the density function of internationally registered patents *versus* labour productivity ( $Y/L$ ); the area below the graph of this function represents 100% of the total world innovation output in any given period.

These two distributions reflect the exceptionally strong duality of the world economy at the end of the 20<sup>th</sup> and the beginning of the 21<sup>st</sup> centuries. In the creation of new important innovations, the TFA countries dominate, with a share in internationally recognized patents accounting for some 90-95% of the world total. This strong duality in inventive activity means that in the TFA and non-TFA countries the sources and mechanisms of technological progress are substantially different. Because of this difference, I propose other stylized facts to relate to each of these two groups separately.

In relation to the TFA countries:

**3. During the past two to three centuries, there has been a far more rapid growth of inputs of labour and capital in the sector producing qualitative changes than the growth of inputs in the sector producing conventional goods.**

Let  $K$  and  $N$  be the inputs of capital and labour in the conventional goods producing sector and  $M$  and  $R$  the corresponding inputs in the innovative and educational sector, producing qualitative changes. Two to three centuries ago, the sector of qualitative changes was a tiny part – perhaps 1% – of the entire economy. Today, this sector constitutes about 10% of the economy. In the last 200-300 years the ratios  $M/K$  and  $R/N$  in the TFA have, therefore, been systematically and rapidly increasing.

**4. The growth rates of inputs in both sectors have been stable over time. Likewise, the growth rate of the ratio  $Y/L$  has been stable, although very much higher (an order of magnitude greater) than during the many centuries that preceded it.**

**5. The rate of growth of the ratio  $Y/L$  has been and is stable over time, and differs only to a small extent between countries as it depends only slightly on the ratio of investment to the gross domestic product (GDP).**

The innovation rate in individual TFA countries depends on the size of the total TFA inventive activity. Given this direction of causality, national investments respond to the supply of opportunities created by this common activity.

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With respect to the non-TFA countries, the principal stylized facts are the following:

**6. The rate of growth of Y/L varies strongly over time and between countries.**

**7. The growth rate of Y/L is strongly dependent on the level of investment as a fraction of the GDP.**

Qualitative changes have been particularly fast in several East Asia countries, correlated with exceptionally high savings and investment ratios (IMF, 2017).

	1981–2000	2001–2015
<b>China:</b> savings, % GDP	35–43	39–52
GDP annual growth, %	9.9	8.6
<b>India:</b> savings, % GDP	20–28	28–41
GDP annual growth, %	5.6	7.3
<b>Korea:</b> savings, % PKB	26–40–34	34
Annual growth, GDP, %	8.5	4.0

In catching-up countries, the rate of innovation depends on absorptive capacity, which varies from country to country and may vary also over time.

The strong variation of the trend rate of growth of Y/L between non-TFA countries is evidence, now widely noted, of the influence on this growth rate of the institutional factors and economic policy in the catching-up countries. This dependence relates to the factors influencing the diffusion of technology from the TFA countries and its effective absorption in the non-TFA countries.

During the 20<sup>th</sup> century, the global economy became increasingly dualized in terms of technological level and *per capita* income. In other words, we have witnessed a divergence between the TFA and all other economies. This divergence trend was a continuation of a similar development observed in the 19<sup>th</sup> century. However, in the second half of the 20<sup>th</sup> century some important countries, such as China, the former USSR and India, implemented crucial institutional reforms. In China and the former USSR these included privatization of land and state companies, and the acceptance of foreign direct investments. The model of a centrally planned (and state-governed) economy was accepted to underperform the market economy model, in which the role of the state is limited largely to law making, law enforcement and income redistribution. All these changes decreased the role of politicians in current economic management and in investment decisions, and

increased the role of innovators and entrepreneurs. As a result, a growing divergence was globally replaced by a growing convergence.

### 3. The role of institutions in economic growth according to Acemoglu and Robinson

There is a rich body of literature about the role of institutions in economic growth (IMF, 2003; Balcerowicz, 2008). Recently, this role has been examined in a series of articles and books by Daron Acemoglu and James A. Robinson. In 2012, they published an extensive monograph: *Why Nations Fail: The Origins of Power, Prosperity and Poverty*.

The main message of this book is that: “The most common reason why nations fail today (and why they failed also in the past – note by the author) is because they have economic and political extractive institutions” (Acemoglu and Robinson 2012, p. 368-369). The authors focus their discussion on some extreme situations, when political elites create legal instruments, or even take illegal actions, to seize a significant part of the wealth created by innovators and entrepreneurs. This lowers the incentive of potential innovators and entrepreneurs to create and introduce new important qualitative changes, such as new or improved products and more efficient methods of their production and distribution. This, in turn, translates into a slow pace of growth or even a long-term stagnation or recession.

Acemoglu and Robinson extensively studied the functioning of such development-blocking institutions over the last decades in the case of a few drastic examples: Zimbabwe after Mugabe coming to power; Egypt under the rule of Mubarak; and Uzbekistan under the rule of Karimov. It is evident that in those countries at least, **degenerated institutions**, or **extractive institutions**, as described by Acemoglu and Robinson, tend to be persistent. The examples above can be supplemented by some republics of the former USSR, such as Ukraine. In 2015, the GDP *per capita* in Ukraine, in purchasing power parity terms (PPP), was equal, according to the World Bank data, to 14.1% of the US GDP *per capita* and 29.3% of the Polish one, the latter equal to 48.1% of the US level. In 1989, the Ukrainian level was slightly higher than in 2015 as a proportion of the US level and, more remarkably, somewhat higher than the level in Poland. For comparison, the German GDP *per capita* in 2015 amounted to 85.6% of the corresponding US level.

The authors also focus on several crucial reforms, which reduced or even completely removed progress-blocking institutions. Above all, these include the

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1688 political revolution in England, whose social and educational consequences triggered, they maintain, the start of an industrial revolution in England and the USA a century later. Reforms in continental Europe after the 1789 French revolution, and in Japan after the 1868 Meiji revolution (which introduced a parliament and a constitution, and stripped 250 regional oligarchs of power) were also fundamental. More recent examples are the 1979 political revolution in China, after the death of Mao and under the leadership of Deng Xiaoping, which triggered an economic boom of exceptional strength, and the transformation of political and economic systems in Central Europe and in the former USSR, which started in 1989 in Poland.

A comparison of situations before and after such fundamental changes makes it possible to identify and compare economic consequences of **inclusive** and **extractive political institutions**. Acemoglu and Robinson conclude that **inclusive institutions**, particularly political institutions, are necessary, although clearly not sufficient, to achieve economic success. **Inclusive institutions** are, according to Acemoglu and Robinson, the links in the cause-effect chains between innovation, economic growth and socially optimal wealth distribution. Acemoglu and Robinson's theory concentrates on the cause and effect relationship between political and economic institutions, and between institutions and economic growth.

Such a direction of causality is indeed often observed. However, there is also sometimes a reverse relationship in action. This reversed causality was in fact present in the former USSR, as well as in Central and Eastern Europe, for several decades before 1990. Despite central planning, predominant state ownership of enterprises and authoritative one-party political systems, it was possible to achieve marked technological progress, rapid development of education and a high degree of urbanization. Accumulation of these changes sparked, in turn, a strong social demand for political change, which led to fundamental shifts in economic and political institutions and policies.

Acemoglu and Robinson focus on rather extreme cases of extractive institutions in which there is limited interest on the part of the state, and underpinning elites, to develop innovation and investment incentives in the private economy. The extensive empirical study by Besley and Persson (2014, p. 930) suggest that there have been situations in which "governments have the knowledge about good policies and the will to implement them, but lack the ability – i.e., the state capacity – to carry them out". However, if there is the will, such capacities can be slowly developed. The point Acemoglu and Robinson are making is that there have often been situations in which there is no such will because interest groups can create institutions and methods of governments that allow them to meet their wealth requirements through extraction. In those cases, there would be

little incentive for such groups to develop economic institutions and policies that produce widespread benefits at a high rate. The statistical evidence on economic growth can be interpreted to support the view that since the start of industrial revolution in Europe by the end of the 18th century there were no such strong incentives present in most African countries until recently, and in most Asian countries until the middle of the 20<sup>th</sup> century.

#### 4. Qualitative changes: the Phelps model with extensions

One of the first attempts to model economic growth based on a division into the conventional and innovative sectors was that of Phelps (1966). I generalized it in several directions (Gomułka 1970, 1971), and for the conditions under stylized fact (3) (Gomułka 1990). This theory, as well as the present day endogenous growth models, assumes that institutions are those of a competitive market economy. Moreover, the original Phelps model applied only to the TFA.

The equations of this model are:

$$Y = F(K, TN) \quad (1)$$

$$\dot{T} = H(E, T) \quad (2)$$

$$E = E(M, TV) \quad (3)$$

$$V = R^\lambda L^{1-\lambda}, \quad 0 < \lambda < 1 \quad (4)$$

$$L = N + R = L_0 \exp(nt), \quad n \geq 0 \quad (5)$$

where  $\dot{T}$  in equation (2) is the change in  $T$  per unit of time, as a result of research and education effort  $E$ . In the original model  $T$  represents technological innovations. In my adaptation of this model  $T$  is a measure of quality, denoted earlier in this paper by  $Q$ , of the fixed capital  $K$  and work-force  $N$  in the conventional sector, and of the fixed capital  $M$  and work-force  $R$  (more precisely, of the innovative capital  $V$ ) in the sector producing qualitative changes. Therefore,  $R$  denotes not only the number of researchers, as in the original model, but also teachers. The total workforce  $L$  grows at a constant rate.

The production functions  $F$  and  $H$  are assumed linear with respect to scale, but the function  $E$  has the scale elasticity  $\epsilon$ , where  $\epsilon < 1$ . Phelps only considered balanced growth paths and set out to answer two questions:

1. The global economy in the 21<sup>st</sup> century: Will the trends of the 20<sup>th</sup> century continue?

1. What should be the optimal division of capital and labour between the two sectors, conventional and innovative?
2. What will be the growth rate of Y/L on the optimal path?

The answer to both these questions provided by Phelps applies only to a situation of balanced growth. However, during the last two centuries, as we know from empirical data,

$$G_M \gg G_K \text{ and } G_R \gg G_N \quad (6)$$

where G denotes the growth rate of the variable indicated by the subscript. If (6) applies, the ratios M/K and R/N increase towards their optimal levels. Since their initial levels differ considerably from the optimal ones, their approach to the optimal state extends over a fairly long period. During that period, we have an exceptional situation, one of technological revolution. The data show that for the current TFA about two centuries were needed to reach the optimal levels. However, globally inequalities (6) still apply, so we continue to be in the period of slow convergence to the optimal state.

This extended model explains the exceptionally high growth rate of *per capita* GDP within the TFA over the past 200 years by three circumstances: the initially large growth reserve in the form of the low use of the stock of potential innovative talent of the population; the public policies and market institutions that have been developed to make gradually effective use of that reserve; and the high rate of population growth.

All these factors are, however, transitory since after a certain time, probably during the present century, we shall reach a situation of total use of the world talent pool, which must mean a fall in the growth rate of R to the level n. The growth rate of the fixed capital M in the research and development (R&D) and educational sectors will also fall to the level of the growth rate of K (and Y). One must also expect stabilization of the world population at some stage, possibly sometime this century, which means n will fall to zero.

In general, this should mean, and certainly this is so for the (extended) Phelps model, a slow and prolonged decrease in the growth rate of qualitative changes in the TFA, the rate in that model decreasing asymptotically to zero. Thus, according to this theory, the period of some 300-400 years of an unusually fast growth will be something in the nature of a huge fluctuation in the history of civilization. The growth rate of *per capita* GDP would return with time to the (very) low level before the technological revolution. My proposed term “hat-shaped relationship” (Gomulka, 1971; 1990) can be used to describe this superfluctuation.

## 5. Hat-Shaped Relationship for non-TFA countries

As observed by all the authors of the stylized facts listed above, in non-TFA countries we have a strong variation of the *per capita* GDP growth rate, both over time and between countries. In these countries, much depends on a potentially very large number of factors, which have an influence on the transfer and absorption of technology from outside. Two factors are of fundamental importance. One of them is the technological gap, or more generally the qualitative gap, since the greater this gap the greater the growth **reserve** and the greater the number of innovations ready for possible use. Another factor is the absorption capacity itself. When the development gap is large, the absorption capacities are typically undeveloped. On the other hand, when the development gap is already small, these capacities are typically large but the number of innovations that can be made available by transfer is also smaller than before. Thus, even without theoretical inspiration, one may **expect** that countries will develop most rapidly at the intermediate stage between the very undeveloped and developed stages. Hence, the expectation is that the growth rate of GDP per working hour for all non-TFA countries at any given time and for individual countries over time will also form a hat-shaped relationship (Gomułka, 1971; 1990).

In the hat-shaped dependence of the growth rate of GDP per working hour on **the** development gap, the gap is measured by the ratio of  $Y/L$  in the TFA to  $Y/L$  in **each** country. Such a dependence is specific to each country. Its variation between countries arises from the fact that countries with similar development levels may, and generally do, have significantly different institutions and/or economic policies, in addition to different natural resources. The empirical data confirm that the variation of the growth rate of GDP per working hour for countries with a similar level of development may be great. The importance of international diffusion for the development was noted first by economic historians (e.g., Veblen, 1915; Gerschenkron, 1962; Abramovitz, 1979; 1993).

## 6. Trends of the 20<sup>th</sup> century

Recently, ten economists attempted to answer the question asked in the title of this paper: will the main trends of the 20<sup>th</sup> century continue in the 21<sup>st</sup> century? Their analysis was published in a book edited by Ignacio Palacios-Huerta (2013). Possibly the most extensive answer was proposed by the Massachusetts Institute of Technology economist Daron Acemoglu. He organized his analysis around ten (social, economic, technological and political) trends of the 20<sup>th</sup> century.

## 1. The global economy in the 21<sup>st</sup> century: Will the trends of the 20<sup>th</sup> century continue?

As the focus of this paper is long-term economic growth, I shall make use of only three of Acemoglu's trends. These are numbered (1)-(3) below. Moreover, I shall somewhat redefine them, and complement with two more trends of my own. The aim is to assess whether all of them, or which of them, will continue into the 21<sup>st</sup> century.

Thus, selected key 'stylized trends' concerning global economic development in the 20<sup>th</sup> century are as follows:

- 1. GDP growth per capita in the most technologically advanced economies was highly volatile in the 20<sup>th</sup> century, but the fluctuations took place around an extraordinarily stable growth trend. This trend was common for all economies from this group, hence it was almost unrelated to economic policies conducted by the countries concerned.**
- 2. In less technologically advanced economies, GDP growth per capita was not only strongly diversified between countries, but also, in many cases, unstable over time; thus, it was strongly dependent on economic policies.**
- 3. The world's population was rising at a fast pace and had quadrupled, increasing from 1.5bn in 1900 to 6.0bn in 2000.**
- 4. The most technologically advanced countries accounted for almost the total global output of significant innovations. In those countries, the labour and capital inputs in R&D and education of all types, i.e., in the sector producing qualitative changes, rose during the 19<sup>th</sup> and 20<sup>th</sup> centuries much (5-10 times) faster than the labour and capital inputs in the sector producing conventional goods, triggering the so-called technological revolution.**
- 5. The 20<sup>th</sup> century saw a strongly rising dualism of the global economy, i.e., a significant divergence between the most technologically advanced economies and all the other economies. This trend was a continuation of a similar phenomenon witnessed in the 19<sup>th</sup> century.**

## 7. Trends in 21<sup>st</sup> century

The five trends of the 20<sup>th</sup> century listed above are also largely applicable to the 19<sup>th</sup> century, so they are essentially valid for the last 200 years. Earlier, in the Middle Ages and the protocapitalistic epoch, the sector producing qualitative changes was both very small and expanding very slowly, which translated into a very low pace of economic growth *per capita*. The variation between countries in labour productivity was also low. The five trends represent the capitalist epoch. The key characteristic of this epoch is an exceptionally fast growth of the sector producing qualitative changes, in terms of inputs several times faster than the



growth of the sector producing conventional goods and services. The economic growth has thus been highly unbalanced in this epoch. In the TFA, the innovative talent pool, initially almost wasted, started to be employed more and more over time. Today that talent pool may be fully employed in the technologically most advanced countries. However, at the global level there is yet a large reserve of innovative talent still unemployed in the area outside the TFA. That reserve is large enough to support a fast growth of GDP *per capita* for much of the 21<sup>st</sup> century. But once the total global innovative talent is fully employed, which should happen before the end of this century, a new epoch should start, one of gradual deceleration of economic growth.

My detailed answers to the question whether the 20<sup>th</sup> century five trends will continue in the 21<sup>st</sup> century are therefore as follows:

In the case of trend (1), we will see its continuation for the reasons presented above.

The same will happen to trend (2), but in this case, some of the non-TFA countries today will join the group of developed economies and thus will be governed by trend (1).

According to demographic projections, the world population will rise rapidly in the first half of the 21<sup>st</sup> century, whereas in the second half it is likely to stabilize. According to the French Institute of Demographic Studies (INED), the population of China, now 1,412 millions, will decline to 1,317 millions in 2050 and, more significantly, to 771 millions in the year 2100. This will bring a major change in trend (3). The implication of this change will be a stabilization during the second half of the 21<sup>st</sup> century of the size of the global innovation talent pool.

Trend (4) has already begun to change substantially. As I mentioned earlier, by the end of the 20<sup>th</sup> century, the developed economies had already fully exhausted their potential innovation pool. A situation typical to the early 20<sup>th</sup> century in the TFA can still be observed in the emerging economies, which are still far from full use of their innovative potential. Increasing engagement of this resource will underpin the global GDP *per capita* growth close to the current levels for the better part of the 21<sup>st</sup> century. Hence my comment about trend (1).

Trend (5) concerning the global economy dualism will change dramatically in the 21<sup>st</sup> century; this conclusion is supported by the empirical works of academic economists as well as by the extensive reports of international institutions over the last 20-30 years. The growing divergence of the 20<sup>th</sup> century has already started to be replaced by a growing convergence. However, the convergence between developed and developing countries need not be complete. Large regional differences in GDP *per capita* are present, and can be persistent, within technologically advanced countries.

1. The global economy in the 21<sup>st</sup> century: Will the trends of the 20<sup>th</sup> century continue?

**Table 1.** Key changes in the 21<sup>st</sup> century

	2000	2100
<b>Population (bn)</b>		
TFA	1	2
Non-TFA	5	8
<b>GDP per capita, index (TFA in 2000 = 1)</b>		
TFA	1	4
Non-TFA	0.2	2.4
Total	0.3	2.7
<b>Total GDP, index (TFA in 2000 = 1)</b>		
TFA	1	8
Non-TFA	1	19

Note: gross domestic product (GDP) according to purchasing power parity (PPP).

TFA: technology frontier area.

Source: Author's own elaboration.

To present the effects of the convergence process on the global GDP at the end of the 21<sup>st</sup> century, I shall resort to a simple numerical exercise, based in part on two assumptions:

1. Total populations of the TFA and non-TFA regions in 2100 will be, respectively, 2 bn and 8 bn.
2. The ratio of the *per capita* GDP in non-TFA countries to that in TFA countries was 20% in 2000 and will be 60% in 2100.

The results of the exercise are shown in Table 1. The assumed doubling of the TFA population is mostly due to the geographical expansion of this region.

The results of the exercise imply that the global GDP will rise by 11-12 times in the current century, with the average growth rate slightly over 2.6%. The global *per capita* GDP will rise by nine times, with the average growth rate of 2.2%. Exceptionally high growth rates will be witnessed in the first half of the 21<sup>st</sup> century.

## 8. Geopolitical consequences until 2050

Because of the outstandingly fast economic growth in China since 2000, in 2015 its GDP in PPP terms was equal to (international) USD 20,253 bn. This means that it was 10% higher than that of the USA and six times higher than that of the Russian Federation (RF). However, the USA are still significantly outperforming in terms of the GDP *per capita* (USA = 100.0; China = 25.8; RF = 43.6). I assume

that in the years to come these differences will narrow, but will never vanish. In the forecast presented above, I have assumed that the convergence progress will halt when the GDP *per capita* in China and the RF reach 60% of the US level. It cannot be known when such an equilibrium will be reached, but the international comparisons suggest that 2050 may be quite a good guess. Moreover, I assume annual population growth rates at  $-0.5\%$  in the RF, and  $0.5\%$  in both China and the USA.

Given the above, in 2050 national GDP in China will be 2.5 times higher than in the USA and 14 times higher than in the RF. The population of China will still be four times higher than in the USA, but about 14 times higher than in the RF.

However, the geopolitical position of a country depends not only on GDP and population, but also on the achieved level of technology and science. Bearing this in mind, the current technological leaders (USA, European Union, Japan, Canada) are likely to maintain their dominant position; however, they are also likely to be put under pressure by China and other countries of the “new world”. Anticipation of growing economic and technological strength of China may be viewed by the current military superpowers, USA and RF, as a threat to their presently dominant position in the military area. However, the numbers shown above suggest that the RF may feel more threatened than the USA and the European Union.

## 9. Final remarks

The above-mentioned forecasts neglect two global megarisks: nuclear world war and large adverse climate changes. There is also a considerable risk that the global population will increase during the century significantly above the 10 bn assumed in our forecast exercise. However, if cataclysms of this kind do not materialize, then the 21<sup>st</sup> century will witness a large leap of the present world economy towards a global market economy with a stable population and a fairly low, eventually even very low, rate of economic growth. Moreover, by the end of the 21<sup>st</sup> century the average *per capita* GDP will be some nine times higher than in the year 2000, the global economic integration will be (probably) much deeper than at present and the distribution of income and (especially) wealth will be more equal. However, in terms of the GDP and population growth, the world economy after the 21<sup>st</sup> century would resemble the one before the technological revolution of the last 200 years.

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## 2. A theory of global economic growth in the very long-run: Is a grand innovation slowdown inevitable?\*

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**Abstract:** The paper shows how the original semi endogenous and balanced growth model of Phelps (1966), and my extended version of it (Gomulka, 1990), could be useful in explaining the key ‘stylized facts’ of global long-term growth so far, and in predicting its dynamics in the future. During the last two centuries the sector of R&D and education, producing qualitative changes, has been expanding in the world’s most developed countries much faster than the sector producing conventional goods. The extended model is used to explore and evaluate the consequences for the global long-term growth of the end of this unbalanced growth, of the completion of the catching up by most of the world’s less developed countries, and of the expected eventual stabilization of the size of the world population. The theory yields a thesis, new in the literature, that the rate of global per capita GDP growth will eventually return to the historically standard very low level, thus implying that the world’s technological revolution is going to be an innovation super-fluctuation.

**Keywords:** Endogenous growth theory, Phelps, Hat-shaped relationship, Long-term global growth slowdown, Key growth trends, Key growth stylized facts

**JEL Codes:** F01, O33, O41, O47

### 1. Introduction

Angus Maddison in his *Contours of the World Economy, 1-2030 AD* (2007) shows that there was a high stability in the global per capita GDP trend growth rate in the Middle Ages 1000-1500, at a very low level of 0.05% per year, to be followed by only slightly higher rate of 0.07% a year in the protocapitalistic epoch 1500-1820. But during the capitalistic epoch 1820-2000 the trend rate

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\* *Central European Economic Journal*, 2019, 6(53): 174-88.

exploded to a level about 17 times higher than in the preceding period. Under the two assumptions economists now usually make, constant returns to scale and labour-augmenting technological (and other qualitative) changes, the growth rate of GDP per unit of labour is, in the long term, determined fully by qualitative changes. These changes are produced by the R&D inventive activity, the educational activity, and by institutional reforms.

The key stylized fact of the long-term growth of the world economy is, therefore, that about two centuries ago a remarkably large acceleration in the percentage rate of technological and other qualitative changes started, and the new exceptionally high rate of these changes has since continued.

Following the empirical studies by economic historians and development economists, in my earlier publications (Gomułka, 1970; 1971; 1990), I accepted that the mechanisms of technological progress in the most developed countries, forming the *technology frontier area* (TFA), are quite different than in non-TFA countries, known also as *emerging economies*.

For the purposes in hand it will be useful to regard the TFA as a single economy. I shall also assume that the inventive activity of that imagined economy is the only factor capable of moving the world technological frontier outwards. The inventive activity of the firms operating behind the frontier will thus be ignored. As an approximation we can think of the United Kingdom and parts of continental Europe as the TFA for most of the nineteenth century, and of the United States, parts of Western Europe and Japan as the TFA for most of the twentieth century.

A family of macroeconomic models of innovation and growth, the so-called endogenous growth theory, was created in the second half of last century. Their primary purpose was to explain changes in the joint factor productivity, and to find the rates of GDP growth which would obtain when resources of labour and capital are distributed in an optimal manner between sector I, of conventional production, and sector II, mainly R&D and education, producing qualitative changes. As interpreted by Grossman and Helpman (1991) and noted by Jones (1995), in many initial models of that theory, and the model discussed in this paper does not belong to that category, permanent changes in certain policy variables have permanent effects on the rate of economic growth. According to Jones, such permanent changes have taken place, but „growth rates of GDP per capita show little or no persistent increase”(p. 495). During the last 20-25 years a second generation of endogenous growth models were developed, beginning with, among others, Peretto (IER 1996, JEG Dec 1998), Dinopoulos and Thompson (JEG 1998), Young (JPE 1998) and Howitt (JPE 1999). These models appear to perform better in empirical tests. Still, it remains to explain the causes and the consequences of the central feature of the world economy in general, and of its



TFA part in particular, namely that during the last two centuries there has been an unbalanced growth: an expansion of sector II. much faster than that of sector I.

Two centuries is a relatively short period of time by historical standards. The unusually high innovation rate, supported by an unusually high growth rate of the world population during that period, is therefore still an exception in the history of humanity. Since the growth of the world population and much faster growth of sector II than sector I must eventually both come to an end, probably in the course of this century, there is a possibility that the exceptionally high rate of technological innovations, and of other qualitative changes, of the last two centuries will be followed by a declining rate. Such an innovation slowdown would have rendered the technological revolution to be at once a transitory phenomenon and one which would forever be seen as a huge innovation outburst or an innovation super-fluctuation.

The primary purpose of this paper is to investigate this prospect in order to identify the key assumptions and parameters which are to affect its likelihood and the time-scale. The analysis represents a development of the ideas by Edmund Phelps (1966). This in three directions. One is to strengthen the theoretical and empirical foundations of the model. The second is to consider the dynamics of growth in the TFA over the last two centuries, when sector II has been and still is expanding (much) faster than sector I. And the third is to note the future implications for the global growth rate of the *per capita* GDP of the expected stabilization of the size of the world population and of the substantial disappearance of the presently still strong duality of the world economy, as the per capita GDP and wealth in the TFA countries are yet much higher than in the non-TFA countries.

## 2. The key stylized facts of economic growth

The statistical data on global long-term economic growth have certain fundamental characteristics, termed ‘stylized facts’, which the growth theory must explain first and foremost. Possibly the best known such ‘facts’ were originally those of Kaldor (1961). Now we have also five ‘facts’ of Easterly and Levine (2001) and six of Jones and Romer (2009). In (Gomułka, 2017) I present and discuss these much different two lists, adding to them one of my own (Gomułka, 2009). This particular list consists of seven ‘facts’. These are as follows:

*With respect to all countries:*

1. The great acceleration in the growth rate of world GDP per capita, and still more per working hour, took place some two centuries ago, and a historically exceptionally high growth rate has since continued;

2. A theory of global economic growth in the very long-run...

2. Over the past two centuries there has been a large variation in the rate of per capita growth between countries, leading to the very high degree of duality of the world economy by the end of the 20<sup>th</sup> century.

*With respect to the TFA countries:*

3. During the past two to three centuries, there has been a far more rapid growth of inputs of labour and capital in the sector producing qualitative changes than the growth of inputs in the sector producing conventional goods;
4. The growth rates of inputs in both sectors have been stable over time. Likewise, the growth rate of the ratio  $Y/L$ , output per man hour, has been stable, although very much higher (an order of magnitude greater) than during the many centuries that preceded it;
5. The rate of growth of the ratio  $Y/L$  has been and is relatively stable over time, differs to a small extent between countries, and depends weakly on the ratio of investment to the gross domestic product (GDP).

*With respect to non-TFA countries:*

6. The rate of growth of  $Y/L$  varies strongly over time and between countries;
7. The growth rate of  $Y/L$  is strongly dependent on the level of investment as a fraction of the GDP.

At the level of firms in the TFA countries we observe a huge variation in the ratio of R&D expenditures to sales and a huge variation in the rate of return on such expenditures. This makes it difficult to provide microeconomic foundations to a macro growth theory. However,, as noted in facts 3 to 5, during the last two centuries there has been little variation over time and across countries in respect to some key macro variables. This suggests that a macroeconomic approach to a theory of long-term growth for the TFA should be successfully attempted. In non-TFA countries we have a completely different set of data: a large variation over time and across countries in respect to key macro variables and a marginal contribution of their own inventive activity to the world inventive output. This suggests a fundamental role there of factors determining international technology transfer from the TFA, hence the key role in those countries of institutions and economic policy, to explain economic growth.

Since Phelps's model is a point of departure for this analysis, I shall begin by presenting it in some detail. However, it should be stressed from the outset that that model and its optimal growth path apply only to the TFA, and only to a future target situation of balanced growth. The model does not say anything about the growth path for the global economy during the transitional period of some probably three-four centuries, during which a gradual adjustment takes place of the distribution of global resources of capital and labour between sectors I and II,

from their very low, highly suboptimal levels in sector II about two centuries ago to much higher, optimal ones, in a century or two.

The pace of this redistribution of resources has been so far quite stable (stylized facts 3 and 4). The purpose of my extended model is to study the growth dynamics during the adjustment period, assuming that the pace of redistribution will continue unchanged. As no attempt is made to explain this pace of redistribution, the model is not fully endogenous. Phelps' model of the end-point economy is neoclassical, but my growth model of the transition to that endpoint state is, using the Nelson-Winter terminology, evolutionary. Still, I assume in my extended model that the technology function which Phelps proposed applies during the entire adjustment process.

### 3. The Phelps model of innovation and balanced growth

The key equations of the model are as follows:

$$Y = F(K, TN) \quad (1)$$

$$\dot{T} = H(E, T) \quad (2)$$

$$E = M^\beta R^\mu L^\gamma \quad (3)$$

$$L = N + R = L_0 \exp(nt) \quad (4)$$

According to (1), the net output  $Y$  of the conventional sector is dependent on the capital stock  $K$  and the 'effective' labour  $TN$ , where  $T$  represents an index of the quality of capital and labour, and  $N$  represents labour input in terms of man-hours. Qualitative changes are thus assumed to be purely labour-saving (or labour-augmenting). Equations (2) and (3) represent an embedded two-level production function for the output of sector II, where in (2) the dot over  $T$  denotes the time derivative. In the original model, sector II is limited to the production of new technology,  $E$  is the amount of research produced when researchers  $R$  are equipped with capital  $M$  and selected from a total labour force  $L$ . This research, in turn, brings new technology  $\Delta T$ , and in (2) this addition is assumed to be influenced positively by  $T$  itself. The reason is that innovation also builds on accumulated past research.

In this paper I shall continue to use the term „technology” for the index of all qualitative changes, which apart from technological innovations include also improvements in human capital and in institutions. Therefore, persons  $R$  shall include also teachers.

In (1) and (2) constant returns to scale are assumed, but the elasticities of substitution between  $K$  and  $N$  and between  $E$  and  $T$  need be neither unitary nor

constant. In (3) the partial elasticities with respect to inputs  $R$  and  $M$  are constant and, to be consistent with the optimal macro conditions (8) and (9) implied by the model, the sum of these elasticities need be less than 1 (See also equation (15) and the comment on that equation). This particular feature of the theory means that the productivities of these two inputs decline as their size increases. The empirical evidence reported and discussed recently in a paper by Bloom *et al.* (2017), fully supports this important feature.

The elasticity of substitution between any two of the three ‘factors’ in (3) was assumed by Phelps to be unitary. This assumption is highly restrictive and it will be dispensed with later *in the chapter*.

Let the partial elasticity of the function  $F$  with respect to  $K$  be denoted by  $a$ , and the partial elasticity of the function  $H$  with respect to  $E$  by  $b$ . The assumption of constant returns to scale implies that:

$$a = a(K/TN), b = b(E/T), \text{ and } 0 < a, b < 1$$

The Phelps technology production function has two important and intuitively appealing properties. One is that the same research effort will be more productive if it is spread evenly over a longer period of time rather than being concentrated in a short period. To see this, consider a variable period  $\Delta t$ , a steady research flow  $E$ , and a constant total research effort  $E\Delta t$ . Denoting the latter by  $c$ , we have that  $E = c/\Delta t$  and  $\Delta T = H(c/\Delta t, T) \Delta t$ . Hence  $\partial \Delta T / \partial \Delta t = (1 - b) H > 0$ , which confirms that  $\Delta T$  increases with  $\Delta t$ , given  $c$ . An implication of this property is that research effort allocated evenly over a period of time is assumed to be more productive than an equivalent total research effort which proceeds in fits and starts.

Another important property of the Phelps technology function is that it attempts to capture the inherent heterogeneity of people with respect to their inventive ability. If we assume that in the inventive activity most inventive persons are employed first, the research capability of a given number of such persons can be expected to increase as the total pool from which they are selected increases. This is the reason why  $L$  is an argument in the  $E$  function. Specification (3) is rather *ad hoc*, but we shall provide its theoretical justification.

### 3.1. The optimum research intensity and the equilibrium innovation rate

Empirical evidence tells us that in the past two centuries or so the technology-producing sector has usually been expanding much faster than the conventional sector. It is instructive, however, to consider first the case of balanced growth. Accordingly, suppose that  $Y$ ,  $K$ , and  $M$  all change at a common constant growth

rate, to be denoted by  $g$ , and that  $L$ ,  $N$ , and  $R$  change at another constant rate  $n$ . From (1) we have:

$$g = \alpha + n \quad (5)$$

where  $\alpha = T'$  the growth rate of all qualitative changes, in short the innovation rate. Thus indeed in the long run the *per capita* GDP growth rate is determined fully by this innovation rate.

*Important notation:* Here and throughout the paper the upper-case comma denotes the time derivative of the indicated variable divided by the variable itself, or the growth rate of that variable.

Given the assumption of constant returns to scale, it follows from (2) that  $\alpha = H(E/T, 1)$ . Thus the rate  $\alpha$  is constant, a requirement of balanced growth, only if  $T$  is proportional to  $E$ , say  $T = \eta E$ .

We also note that under balanced growth, gross investment in fixed capital equals  $\dot{K} + \delta K + \dot{M} + \delta M$ , or  $(g + \delta)(K + M)$ , where  $\delta$  is the depreciation rate. Therefore the level of consumption is as follows:

$$C = F\{K, \eta E(M, L - N, L)N\} - (g + \delta)(K + M) \quad (6)$$

This level is at a maximum if the inputs  $K$ ,  $M$ , and  $N$  are chosen to meet these first-order optimality conditions:

$$F_K = g + \delta \quad (7)$$

$$\frac{M}{K} = \frac{1-a}{a} \beta \quad (8)$$

$$\frac{R}{N} = \mu \quad (9)$$

Condition (7) gives the optimal capital intensity in the conventional sector, while (8) and (9) give the optimal sectoral distribution of the two resources, capital and labour. Using these conditions we can find gross capital investment in each sector. We can also find the optimal (balanced-growth) research intensity, i.e. the expenditure on wages and investment in the technology sector as a proportion of the conventional output. Gross investment is, in the conventional sector:

$$(g + \delta)K = F_K K = \left( F_K \frac{K}{Y} \right) Y = aY$$

and, in the technology sector:

$$(g + \delta)M = (g + \delta)\frac{M}{K}K = (1 - a)\beta Y$$

Subtracting total investment from output gives consumption. Now, suppose that consumption is the same as the total wage income and that wage rates are the same in both sectors. Condition (9) enables us to find the wage income in each sector. Thus we have obtained both the investment and the wage element of the R&D expenditure. The research intensity  $i$  – the share of total conventional output devoted to the technology sector – is in this case:

$$i = (1 - a)\left\{\beta + \frac{\mu}{1 + \mu}(1 - \beta)\right\} \quad (10)$$

Since, in this model,  $a$  is the share of gross investment in the conventional sector, it can be expected to be less than 0.5. If presently observed values of  $M/K$  and  $R/N$  in the TFA are any indication of their optimal values, then by (8) and (9) both  $\mu$  and  $\beta$  are small and, consequently, both  $1 + \mu$  and  $1 - \beta$  are close to unity. The optimal research intensity can therefore be approximated as follows:

$$i \approx (1 - a)(\beta + \mu)$$

Of central interest, however, is the magnitude of the equilibrium innovation rate  $\alpha$ . We obtain it by recalling that  $T = \eta E$ , from which it follows that  $\alpha = T' = E'$ . From (3) we have in turn that  $E' = \beta M' + (\mu + \gamma)n$ . However, according to (5),  $M' = \alpha + n$ . Therefore  $\alpha = \beta(\alpha + n) + (\mu + \gamma)n$  which gives:

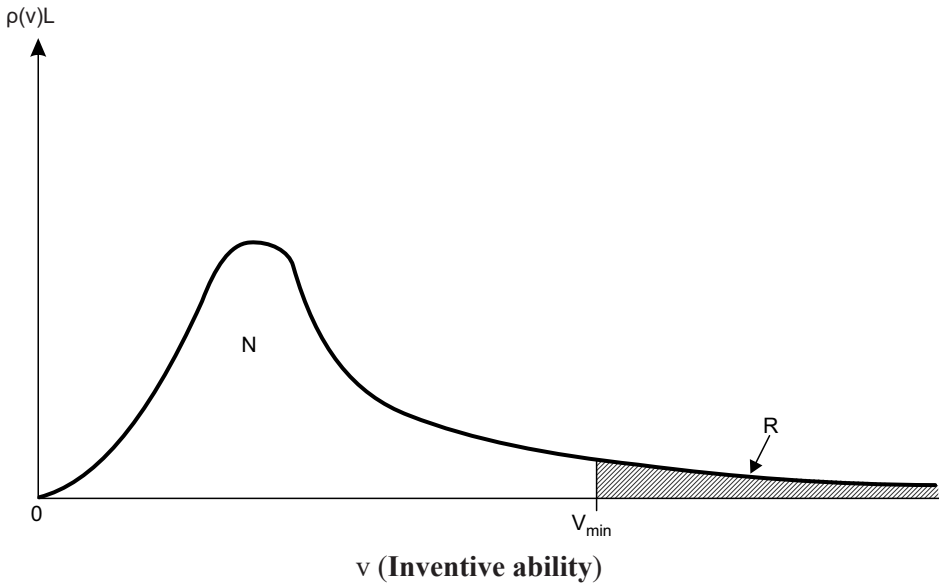
$$\alpha = \frac{\beta + \mu + \gamma}{1 - \beta}n = \alpha^* \quad (11)$$

The asterisk indicates that this is the equilibrium rate.

Two important implications of the result (11) can be noted immediately. One is that if  $\beta$  and  $\mu$  are significantly less than unity, and there are indeed good grounds to place them between zero and 0.1, then the heterogeneity of the labour force with respect to inventive ability, represented by  $\gamma$ , may be a key factor determining the innovation rate. The other implication is that if the population of the TFA ceases to grow, so that  $n = 0$ , the innovation rate would be still positive at any finite time, but it would be falling continuously and be zero in plus infinity. So, in this case a long-term equilibrium does not exist.

## 4. Human inventive and innovative heterogeneity and technological progress in the technology sector itself: two generalizations

Inventive ability is known to differ substantially between individuals. Figure 1 shows a possible distribution of the working population with respect to this ability  $v$ . What matters for us is not the innate or natural inventive ability but the actual inventive ability, given possible environmental influences such as quality of schooling, family circumstances, and attitudes to learning, as well as the system of incentives and values encouraging potential inventors to make use of their potential. If the ‘screening methods’ of the ‘appointments committees’ are appropriate, the research workers would be represented by the shaded area in Figure 1 below the upper tail of the distribution  $L\rho(v)$ .



**Figure 1:** The Distribution of the total working population  $N$  and  $R$  with respect to inventive ability  $v$

Our first substantial modification of the Phelps model is to assume that this tail is a Pareto-type function, an assumption often adopted in economics (for example, to describe the upper tail of the distribution of income or wealth). In this case,  $R/L = \text{prob}(v > v_{\min}) = C_1(v_{\min})^{-\lambda}$  where  $\lambda > 1$  and  $C_1$  is a positive constant. It follows that, for  $v > v_{\min}$ , the underlying density distribution is  $\rho(v) = \lambda C_1 v^{-\lambda-1}$ . The total inventive ability of our  $R$  researchers can now be calculated:

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$$V = L \int_{v_{\min}}^{\infty} v \rho(v) dv = C_2 R^{1-1/\lambda} L^{1/\lambda} \quad (12)$$

where  $C_2 = \{\lambda / (\lambda - 1)\} C_1^{1/\lambda}$ . This result justifies specification (3). Moreover, writing (3) as  $E = C^{\mu} M^{\beta} V^{\nu}$  we have that  $\mu = \nu(1-1/\lambda)$  and  $\gamma = \nu / \lambda$ . Consequently, in this case  $\mu + \gamma$  in expression (11) for  $\alpha^*$  would be equal to  $\nu$ ; the innovation rate  $\alpha^*$  would thus be independent of the ability variation parameter  $\lambda$ .

Our second modification of the Phelps model is to regard  $T$  as an index of quality of the standard inputs, labour and capital, and to extend the R&D sector by the educational activities, to form a  $Q$  sector. When the labour input in the quality producing sector  $II$  is expressed in units of ability-hours, as in (12), rather than in man-hours, as in the original Phelps model, then the  $E$  function need not be of the very restrictive Cobb-Douglas form to permit balanced growth. The least restrictive specification that would still be satisfactory is:

$$E = E(M, TV) \quad (13)$$

where  $V$  is multiplied by  $T$  to account for technological change also enhancing the research and education capability of the researchers and teachers themselves. Equation (13) is our third modification of the model. Specifications (1) and (13) are now symmetric. Consequently, the elasticity of substitution between  $M$  and  $V$ , as between  $K$  and  $L$  in (1), need to be neither unitary nor constant. Parameter  $\beta$  continues to be the elasticity of  $E$  with respect to  $M$ , and  $\nu$  now stands for the elasticity of  $E$  with respect to  $TV$ .

It is interesting to note the implication of replacing (3) by (13) for the magnitude of  $\alpha^*$ , the key variable of the model. Let  $\varepsilon$  be the scale elasticity, assumed constant, of the  $E$  function. Hence:

$$E = T^{\varepsilon} V^{\varepsilon} E(M/TV, 1) = T^{\varepsilon} V^{\varepsilon} e(m) \quad (14)$$

where  $m = M/TV$ . On a balanced growth path  $m$  is a constant and therefore  $E' = \varepsilon (T' + V')$ . However,  $E' = T'$  and  $V' = n$ . Hence the balanced growth innovation rate would be:

$$\alpha^* = \frac{\varepsilon}{1 - \varepsilon} n = \frac{\beta + \nu}{1 - \beta - \nu} n \quad (15)$$

This result is similar to (11) where, incidentally,  $\beta + \mu + \gamma$  is the same as  $\varepsilon$  in (15). In particular, despite allowing for (labour-saving) technological change in the  $Q$  sector, the equilibrium innovation rate still remains proportional to the population



growth rate. Conditions (7)-(9) for the optimal distribution of capital and labour between the two sectors, conventional production and quality enhancing, also remain unchanged. However, for (15) to make economic sense, research activity must be subject to diminishing returns to scale ( $\varepsilon < 1$ ).

## 5. Price's two laws and the 'technological revolution': the case of unbalanced growth

The term 'technological revolution' is one of those which are used often without being defined precisely. The term seems intuitively clear enough; it means a period of 'unusually' rapid innovation in a particular sector, country, or the world as a whole. Some authors distinguish major bursts of world innovative activity, such as that based on the steam engine and consequent mechanization, or electrical power and its applications, or inventions in electronics and telecommunication, or, recently, microelectronics and the use of robots. They refer to these bursts of innovations as technological revolutions – first, second, and so forth – in their own right. Such distinctions are sometimes useful to a social scientist by their virtue as indicators of the changing content of the innovation flow, with its implications for changes in the skills required, social stratification, social mobility, and the rate of spread of information and ideas. However, for the economist it is the rate of innovation flow as such, rather than the flow's specific content, which is of central interest.

What is meant, then, by an 'unusually' high rate of innovation? It must be a rate which cannot be sustained 'forever', i.e. an innovation rate which is greater than the balanced-growth innovation rate, or  $\alpha^*$  in (15). In terms of our two-sector economy, technological revolution can therefore be defined as a prolonged period of economic growth in which the technology sector is expanding faster than the conventional sector. Such unbalanced growth cannot be sustained for ever, but as long as it lasts it does give rise to  $\alpha > \alpha^*$ .

A convenient measure of the expansion of any sector of economic activity is a weighted sum of the growth rates of the inputs employed in that sector – labour and capital in the case of our present model. The data on the growth rates of these two inputs in the technology sector vary in quality among countries and between different periods. However, such records as we have indicate that, over the last two to three centuries, the world Q sector II has been expanding (i) nearly exponentially and (ii) much faster than the conventional sector I. The empirical propositions (i) and (ii) are among the key stylized facts concerning technological change and long-term growth that have been (relatively) well established. According to the science historian, Derek de Solla Price:

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many numerical indicators of the various fields and aspects of science ... show with impressive consistency and regularity that if any sufficiently large segment of science is measured in any reasonable way, the normal mode of growth is exponential. (Price, 1963, p. 4-5)

Price suggests that this steady exponential growth of the size of world science has been maintained for the past two to three centuries. Because of this long period of validity, he calls it the 'fundamental law of any analysis of science' (*ibidem*, p. 5). We shall refer to it as Price's first empirical law. His second empirical law is as follows:

depending on what one measures and how, the crude size of science in manpower or in publications tends to double within a period of 10 to 15 years. The 10-year period emerges from the catch all measures that do not distinguish low-grade work from high but adopts a basic, minimal definition of science; the 15-year period results when one is more selective, counting only on some more stringent definition of published scientific work and those who produce it. (*ibidem*, p. 6)

The steady doubling every 10 to 15 years gives the growth rate of the world scientific membership as between 4.7 and 7.2 percent per annum. Judging from the detailed country data for the past 50 years or so, the total labour input in both research and development has been increasing about as rapidly as the number of scientists alone. These data also indicate that the non-personnel (real) expenditure on R&D has been expanding somewhat faster than the R&D personnel. These two growth rates in the period 1750-1975 have apparently been much higher than the growth rates of labour and capital in the conventional sector, which were roughly 0.7 percent (the growth rate of the world population) and 1.7 percent (the growth rate of the world GDP) respectively. It is this wide disparity in the sectoral growth rates, in favour of the technology sector, which above all underlines the phenomenon of 'technological revolution'. Such a disparity cannot be maintained for ever; in fact there has already been a significant slow-down in world R&D growth since about 1970. The balanced-growth solution of the previous section is relevant only with reference to an equilibrium configuration that was present in the distant past and will emerge in the (possibly less distant) future. However, the past two or three centuries represent a period of highly unbalanced growth that needs separate consideration. We shall do this in this section.

We retain the model specifications (1)-(4) of the previous section, except that (3) is replaced by (13). We also retain the assumption that the capital-to-output

ratio in the conventional sector is constant. However, neither the savings ratio nor the growth rates of total output and its components need be constant. Let  $n$  with subscript 1 be the number of workers engaged in producing capital goods for the quality enhancing sector. The assumption that the capital-to-output ratio is constant implies that, as in the previous section, the productivity of these workers is proportional to the aggregate level of technology  $T$ . Hence the growth rate of capital employed in the quality enhancing sector is

$$M' = \alpha + n_1 \quad (16)$$

The growth rate of the labour input in the quality enhancing sector is

$$R' = n_2$$

Price's two empirical laws are

- (i) that  $n_1$  and  $n_2$  have both been significantly greater than  $n$ , and
- (ii) that they have been approximately constant.

Given  $n_1$  and  $n_2$ , we can now obtain the innovation rate from (2) and (13).

Assume  $H(E, T) = E^b T^{1-b}$  and  $E(M, TV) = M^\beta (TV)^\nu$  where  $V$  is given by (12) and the elasticities  $\beta$ ,  $b$ , and  $\nu$  are all constant. With these specifications the system determining  $\alpha$  is as follows:

$$\alpha' + b\alpha = bE' \quad (18)$$

$$E' = \beta M' + \nu(\alpha + V') \quad (19)$$

$$V' = \frac{\lambda - 1}{\lambda} R' + \frac{1}{\lambda} n \quad (20)$$

The growth rate of research effort is, in (18), the propelling force that determines the dynamics of the innovation rate. This growth rate is in turn determined by the growth rates of Q inputs, the measure of the labour input taking due account of the variation in inventive ability, and the effect of innovation on efficiency in the Q sector itself.

Superimposing the stylized facts (16) and (17) on the system (18)-(20) yields the following differential equation for  $\alpha(t)$ :

$$(1 - \beta - \nu)\alpha + \frac{1}{b}\alpha' = \beta n_1 + \left\{ \frac{1}{\lambda} n + \left( 1 - \frac{1}{\lambda} \right) n_2 \right\} \nu \quad (21)$$

Hence

$$\alpha' = b(1 - \beta - \nu)(\alpha_{TR}^* - \alpha) \quad (22)$$

where

$$\alpha_{TR}^* = \frac{\beta n_1 + \nu \{ (1/\lambda)n + (1 - 1/\lambda)n_2 \}}{1 - \beta - \nu} \quad (23)$$

From (22) it follows that  $\alpha(t)$  approaches  $\alpha_{TR}^*$  with time. This  $\alpha_{TR}^*$  stands for the 'equilibrium' component of the innovation rate in the course of the technological revolution. Equation (22) can be solved numerically to give  $\alpha$  as a function of time:

$$\alpha(t) \text{ increasing if } \alpha < \alpha_{TR}^* \text{ and declining if } \alpha > \alpha_{TR}^* \quad (24)$$

A growth slow-down in Q activity has taken place in the TFA during the last half a century. If the slow-down means that the optimal ratios of  $R/N$  and  $M/K$  are about to be or have already been achieved in the TFA, we can use the optimality conditions (8) and (9) for estimating the values of the parameters that appear in (23). These conditions are that  $\nu(1 - 1/\lambda) = R/N$  and  $\beta(1/a - 1) = M/K$ . Guided by empirical evidence we also assume that  $R/N = M/K$  and  $n_1 = n_2$ . Consequently, the following relationship can be obtained:

$$\alpha_{TR}^* = \frac{(\lambda - 1)n_1 + (1 - a)n}{(\lambda - 1)(1 - a)(N/R) - (\lambda - 1)a - \lambda(1 - a)} \quad (25)$$

**Table 1.** The values of  $\lambda$  as implied by (25), given  $\alpha_{TR}^*$ ,  $n_1$ , and  $R/N$ , and assuming that  $a = 0.2$  and  $n = 0.7$  percent

$\alpha_{TR}^*$ (%)	$n_1$ (%)	$\lambda$				
		$R/N=0.01$	$R/N=0.02$	$R/N=0.03$	$R/N=0.04$	$R/N=0.05$
1	4	1.02	1.04	1.06	1.09	1.13
	6	1.02	1.04	1.07	1.11	1.15
	8	1.02	1.04	1.07	1.12	1.19
2	4	1.01	1.03	1.05	1.06	1.08
	6	1.01	1.03	1.05	1.07	1.08
	8	1.01	1.03	1.05	1.07	1.10
3	4	1.01	1.02	1.04	1.05	1.07
	6	1.01	1.02	1.04	1.06	1.08
	8	1.01	1.02	1.04	1.06	1.09

Note: The values of  $\lambda$  are rounded to two decimal places.

It should be noted that the higher is the value of  $\lambda$  the lower would be the proportion of highly innovative individuals; the case of  $\lambda = \infty$  is the limiting situation where no very innovative talent is present.

According to Price, the rate  $n_1$  has been somewhere in the range 4-8 percent. Given this range, it is instructive to find the values of  $\lambda$  for which the rate  $\alpha_{TR}^*$ , as given by (25), would be approximately equal to the innovation rate actually observed. These values are presented in Table 1. Since our knowledge of the optimal ratio  $R/N$  is uncertain, the table provides the values of  $\lambda$  for a range of  $R/N$  from 1 to 5 percent.

## 6. A consistency test of the model and Lotka's law

The instructive point of this numerical example is the result that, for the probable values of  $\alpha_{TR}$  and  $R/N$ , the model we discuss predicts  $\lambda$  to be only somewhat greater than unity. If there was independent evidence indicating that the  $\lambda$  actually observed is in fact not far from unity, the model would pass an important empirical test.

The trend growth rate of GDP per man-hour, which can be taken as a measure of  $\alpha$ , was 2.3 percent per annum in the United States in the period 1870-1970 (Maddison, 1979). Since the growth rate was fairly stable during that period, it can also be taken as a measure of  $\alpha_{TR}^*$ .

An indication of the value of  $\lambda$  is provided by studies of the frequency distribution of scientific productivity. A pioneer investigation of this type was made by Lotka (1926). The result of his investigation, later repeated and confirmed by several others, is the finding that the number of scientists producing  $m$  papers within their lifetime is approximately proportional to  $1/m^2$ . The number of publications or the number of inventions is, of course, only one of several possible measures of inventive power. The measure may be a poor guide for judging the weight of the contribution to science or technology of any particular individual, but a good guide for the 'representative' scientist (inventor).

If we take  $m$  as a measure of the inventive ability, denoted by  $v$  in equation (12), Lotka's law asserts that our frequency distribution  $p(v)$ , the distribution specified in (12) as  $C_1 v^{-\lambda-1}$ , is proportional to  $v^{-2}$ , implying that  $\lambda = 1$ . Several other investigators have since repeated such publication counts. According to Price, they all confirm Lotka's result, 'which does not seem to depend upon the type of science or the date of the index volume' (Price, 1963, p. 43). Moreover, Lotka's law is known to overestimate somewhat the proportion of researchers with a high  $m$  (*ibidem*, p. 46-9). This in turn implies that the 'true empirical'  $\lambda$  is in fact somewhat greater than unity. It is interesting, indeed remarkable, that such

values of  $\lambda$  also happen to be the requirement of the theoretical model discussed in the previous section. Lotka's law thus seems to provide empirical support for this particular theory of technological change and economic growth.

## 7. The Hat-Shape Relationship and the hypothesis of innovation limits to growth

The story of technological change and growth that is told by the theory of this paper is one in which the technological revolution is a phenomenon of the TFA when the key resource ratios  $R/N$  and  $M/K$  are rising fairly fast to reach their optimum levels, and when the key growth rates  $n_1$ ,  $n_2$  and  $\alpha$  are temporarily significantly higher than their balanced growth magnitudes  $n$  and  $\alpha^*$ . The last two centuries are not the only ones when inventive activity, in terms of the inputs used, has been expanding faster than conventional activity. The history of science and technology provides ample evidence of significant bursts of inventive and innovative work in Europe in the Middle Ages, as well as in the ancient civilizations of the Middle East, China, and the Mediterranean. However, what makes the present technological revolution qualitatively quite unique is the circumstance that the growth rates  $n$ ,  $n_1$ , and  $n_2$  have apparently all been much higher than ever before over a prolonged period, giving rise to a correspondingly much higher innovation rate with profound implications for the pace of economic and social change in much of the world.

In the past century or two the relative size of sector II has been rising rapidly, but this change of size apparently did not influence the innovation rate very much, which remained fairly stable in the TFA. This stylized empirical fact agrees well with our equations (22) and (23), since the growth rates of inputs in that sector, rather than their levels, influence the innovation rate. In equation (23), these levels could influence  $\alpha$  only through the parameters  $\beta$  and  $v$ . Therefore, we can deduce that these parameters have been almost independent of the ratios  $M/K$  and  $R/N$  respectively and that the actual  $\alpha$  was near to  $\alpha_{TR}^*$ .

Given the apparent stability of  $\beta$  and  $v$  so far, it is fair to assume that the two parameters will remain in future about the same as they were in the past. However, the future will bring about two important new phenomena: (i) an inevitable fall in the employment growth rates  $n_1$  and  $n_2$  to about  $n$ , as the technology sector ceases to claim an increasing share of resources, and (ii) an equally inevitable fall of the rate  $n$  itself to about zero as the size of the world population must eventually stabilize. It is interesting, in the light of our theory, to find what the impact of these two phenomena on the innovation rate in the TFA will be.

### 7.1. Case (i): end of the faster growth of the technology sector

From (23) it follows that for  $n_1 = n_2 = n$  the target innovation rate would be

$$\alpha^* = \frac{\beta + \nu}{1 - \beta - \nu} n \quad (26)$$

The actual rate  $\alpha(t)$  would be falling from  $\alpha_{TR}^*$  to  $\alpha^*$ . Let us express  $\alpha^*$  in terms of  $\alpha_{TR}^*$ :

$$\alpha^* = \frac{(\beta + \nu)n}{n_1 + \nu\{(1/\lambda)n + (1 - 1/\lambda)n_2\}} \alpha_{TR}^* \quad (27)$$

To illustrate the possible size of the fall, suppose that on a balanced growth path  $M/K = R/N = \text{constant}$ . Suppose also that in the past  $n_1 = n_2$ ,  $n = 0.7$  percent, and  $a = 0.2$ . On using the optimality conditions, namely that  $\beta = \{a/(1 - a)\} M/K$  and  $\nu = \{\lambda/(\lambda - 1)\} R/N$ , expression (27) implies that:

$$\alpha^* = \frac{\lambda + \{(\lambda - 1)/(1 - a)\}an}{1 + \{(\lambda - 1)/(1 - a)\}n_1/n} \alpha_{TR}^* \quad (28)$$

Lotka's law suggests that the value of  $\lambda$  is not much greater than unity; suppose that it is at most 1.2. The ratio  $n_1/n$  is unlikely to have been greater than 10. Substituting these two numbers into (28) gives the lower limit for  $\alpha^*$ , which turns out to be about  $0.35\alpha_{TR}^*$ . Thus, the upper limit for the innovation slow-down is from  $\alpha_{TR}^*$  down to  $0.35\alpha_{TR}^*$ . The size of the slow-down is sensitive to the value of  $\lambda$ . Taking  $\lambda = 1.1$  and retaining the values of the other parameters gives  $\alpha^* = 0.49\alpha_{TR}^*$ .

### 7.2. Case (ii): end of the world population growth

Should the population of the TFA cease to grow, the model predicts that while the innovation rate would be positive at any finite time, it would be falling continuously from  $\alpha_{TR}^*$  to near zero after a sufficiently long period. This is clearly an interesting prediction, especially since an end to population growth in the TFA, and eventually in the whole world, may not be far off. It is therefore important to discuss the model's implications for the innovation rate and economic growth in this case.

If the population is constant and a constant proportion of it is engaged in Q-type activities, our variable  $V$ , denoting the total number of researchers and teachers corrected for their inventive and educational ability, is also constant. The index of quality is nevertheless increasing. This is because technological progress still takes place, increasing not only the output of the conventional sector, and therefore investment  $M$ , but also the productivity of inputs  $M$  and  $V$  in the Q sector. Both  $M$  and  $TV$  are in fact rising at a common rate equal to  $\alpha$ . However, the scale elasticity  $\beta + \nu$  of

the  $E$  function must be less than unity if equation (23) is to make economic sense. However, if  $\beta + \nu < 1$ , the research output would grow at a rate less than  $\alpha$ . The ratio  $E/T$  would therefore be declining. Hence  $\alpha = H(E/T)$  would also be declining.

It should be noted that absolute annual additions to the technology level, if following the rule that  $\Delta T = H(E, T)$ , would continue to be increasing with time. However, these additions would be increasing at a falling percentage rate, to become eventually nearly constant. Total conventional output, capital stock, and consumption would all also continue to increase. However, instead of increasing at a nearly geometric rate, as they did when the technology sector II itself had been expanding nearly exponentially, they would be increasing at a nearly arithmetic rate. The innovation limits to growth should therefore be understood to mean a very long-term growth slow-down, both technological and economic, but not necessarily an end to economic growth. The model does not imply that there is any finite upper limit to the level of technology or conventional output; such a limit is known to arise if some essential inputs were both non-reproducible and difficult to substitute for by reproducible inputs, with the relevant elasticities of substitution being less than unity. In our model the labour input is the only natural resource, but it is one which is reproducing itself; it is not non-reproducible.

It seems obvious, or at least possible, that if the world is finite, everything is finite, including the scientific and technological knowledge that is still to be discovered. In the model the innovation limits of this ultimate kind are implicitly assumed to be so distant as to have no impact on the inventive productivity of our researchers. However, this factor may be expected to reinforce the innovation slow-down in due course.

### 7.3. The Hat-Shape Relationship

In (Gomułka, 1990) I discussed the variation of innovation rates among countries at different levels of development in any relatively short period of time, such as a decade. I noted that such a cross-country variation tends to form a hat-shaped pattern, with the medium-developed countries tending to experience faster innovation than both the least and the most developed countries.

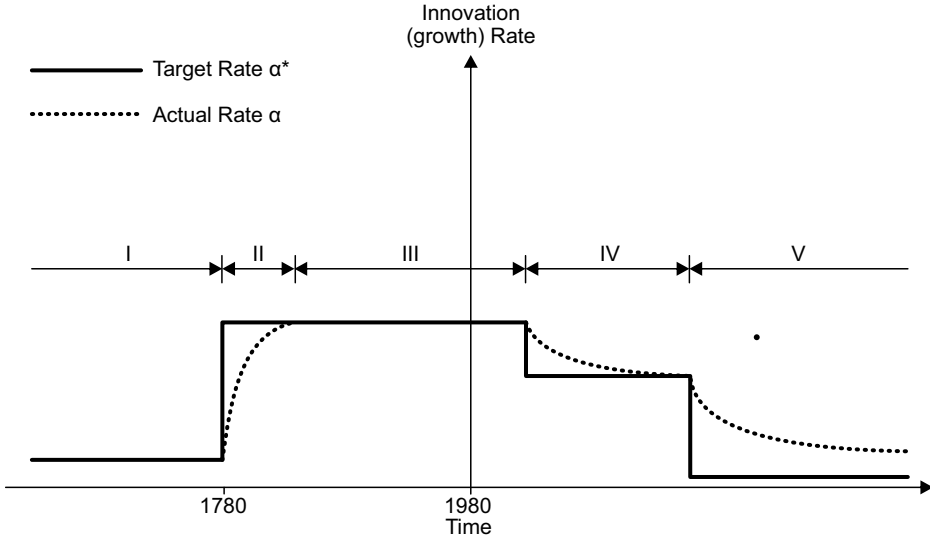
Our discussion in this paper is limited to the TFA of the world. The central question is how the area's innovation rate changes over time in the course of centuries. This is thus 'one-country' dynamic analysis. This analysis indicates that the pattern of change of the innovation rate over time may also be eventually hat-shaped. The First Hat-Shape Relationship is an empirical law that is given a theoretical interpretation. The Second Hat-Shape Relationship seen in Figure 2 is in part a prediction based on a particular model of innovation and growth.



Its acceleration and steady growth segments correspond well to the past reality. However, its slowdown part is yet to be tested.

The five periods distinguished in Figure 2 have the following characteristics:

- (i) The growth rates  $n_1$ ,  $n_2$ , and  $n$  are all very low, close to zero. Consequently the innovation rate is also low.
- (ii)  $(n_1, n_2) \gg n$ , and the population growth rate  $n$  is high. The actual innovation rate increases from the very low level of the previous period, approaching the target innovation rate  $\alpha_{TR}^*$  at the end of period (ii).
- (iii)  $(n_1, n_2) \gg n$ , and  $\alpha = \alpha_{TR}^*$ : This is a period of balanced growth in the sense that the trend growth rate of per capita GDP is fairly stable, but it is unbalanced in the sense that the sector upgrading the quality of the labour and producible material inputs is expanding much faster than the conventional sector.
- (iv)  $n_1 = n_2 = n$ , but  $n$  is still high. In those circumstances the target innovation rate may continue to be high, though lower than in periods (ii) and (iii). The actual rate is higher than the target rate, but approaches gradually the latter, triggering off a global innovational slowdown.
- (v)  $n_1 = n_2 = n = 0$ : The target rate drops to zero, strengthening the slowdown.



**Figure 2:** The target and actual innovation rates over time in the TFA. The dates and magnitudes are chosen for illustrative purposes.

In periods (ii) and (iii) the sector producing qualitative changes is expanding much faster than does the conventional sector. This is the time of the technological revolution. In (iv) the two sectors expand at a common growth rate, which is itself falling. Period (v) is the same as (iv), except that the labour force ceases to grow.

## 8. The plausibility of the innovation slow-down hypothesis

Econometric estimates of production functions for national economies and major conventional sectors suggest that slower growth of inputs virtually always causes slower growth of outputs. A slowdown in the trend growth of research inputs, especially labour, is clearly inevitable. Since the late 1960s there has been a marked fall in growth rates of the industrial R&D expenditure and the employment of labour in OECD countries. But is the link between the growth rates of inputs and outputs in the technology sector similar to that apparently observed in the conventional sector? Moreover, even if some innovation slowdown already occurs or will occur, how plausible is it that it will be of the kind suggested by the theory discussed in this paper?

The answer to the second question cannot be definitive. Our growth data and econometric estimates are not precise enough to be otherwise.. But it is interesting that the proposed model is capable of generating the type of innovation and growth pattern that has been observed in the past. In particular, the model appears consistent with Price's two laws of growth of science, Lotka's law concerning the distribution of inventive ability, and the stylized facts of economic growth in the TFA. Such a broad agreement with key facts relating to innovation and growth over a period of centuries suggests that the theory has passed a test important enough to be taken seriously both as a plausible interpretation of economic growth in the past and as a useful vehicle for making predictions about the growth in the future. The recent evidence discussed by Bloom *et al.* (2017), provides additional support for this theory.

## 9. Remarks concerning 21<sup>st</sup> c. growth

Recently, ten economists attempted to answer the question related to the global economy in the 21<sup>st</sup> c., will the trends of the 20<sup>th</sup> c. continue? Their answers were published in a book edited by Ignacio Huerta (2013). Among the five trends of the 20<sup>th</sup> c. which I discuss elsewhere (Gomułka, 2017), there are three those of Daron Acemoglu (2013), one of the ten economists. To these I added two. One concerns the dynamics of the sector II producing qualitative changes. By the end of the 20<sup>th</sup> c. the most developed economies have already (nearly) fully employed their potential innovation pool, so their strongly unbalanced growth during the 19<sup>th</sup> and 20<sup>th</sup> centuries – sector II expanding much faster than the conventional sector I – came essentially to an end.

A situation typical to the early 20<sup>th</sup> c. in the TFA can be observed now in the emerging economies, which are still far from full use of their innovative potential. According to the theory presented in this paper, increasing engagement of that resource has the potential to underpin the global GDP *per capita* growth rate close to its current level for the better part of 21<sup>st</sup> c. The growing divergence in terms of the per capita GDP (PPP) between the TFA countries and the non-TFA countries, observed during the 20<sup>th</sup> c., has started to be replaced by a growing convergence. This dramatic new trend gives support to this prediction. The key players in that process are China and India.

## Acknowledgement

I wish to thank Mark Schaffer, Oded Stark and participants in several seminars for helpful comments and criticism. My special thanks go to two referees of this paper and to the Editors of this journal. In the paper I make use of segments of chapter 10 of my book, 1990. I would like to thank Routledge, the book's publisher, for granting their permission to make that use.

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### **3. On the design of economic policy: The challenge of Eastern Europe\***

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The attention of policy designers and policy-makers in Eastern and Central Europe is gradually switching from short-term crisis measures following the breakdown of the “communist” system, to policies designed to help stimulate recovery. The primary purpose of this paper is to define the starting conditions which appear necessary to ensure that any such recovery is not short-lived, but is rather the start of a sustained process of economic growth. The second purpose is to discuss further reforms, in addition to the liberalization and stabilization measures already implemented, with which to obtain these conditions so that these countries can begin to pursue their strategic aim: to achieve the living standards and productivity levels of the “capitalist West.”

In the beginning of the paper, a brief description of the volatile growth paths of the two Europes, Western and Eastern, is offered, by a way of comparison with the more stable growth path of the US economy. This comparison of 20<sup>th</sup>-century growth patterns assists us in forming a view about the possible course of the catching-up process in the post-communist countries in the first half of the 21<sup>st</sup> century. The paper also discusses the recessionary impact of liberalization and stabilization policies in the short run and the complex impact of the recession on the ability of these countries to initiate recovery in the medium term.

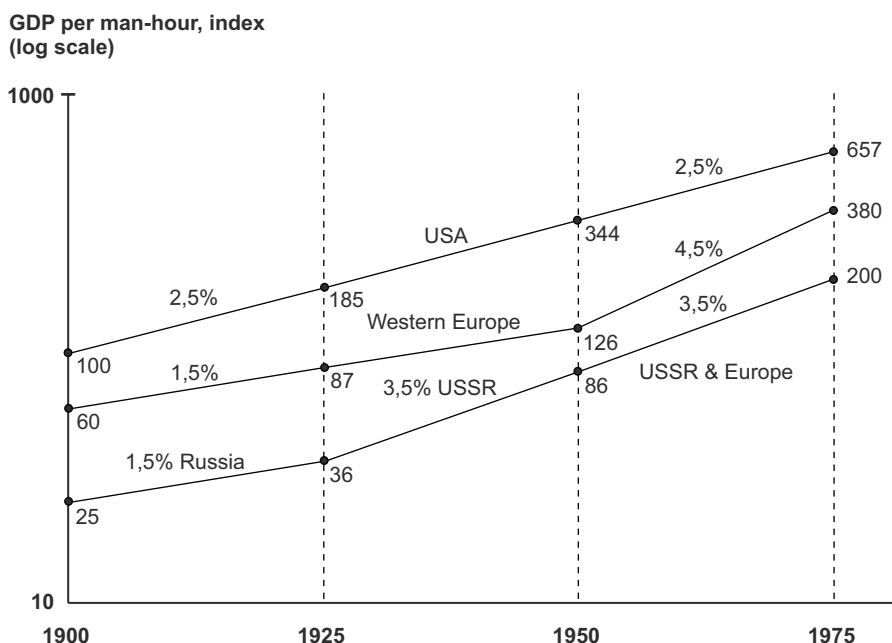
#### **1. Stylized growth paths of the 20<sup>th</sup>-century USA and the two Europes, Western and Eastern**

Figures 1 and 2 [next pages] portray three stylized (or trend) growth paths of the economies of the USA, Western Europe (OECD except USA), and Russia (USSR) and Eastern (central) Europe. They indicate key dates at which at least one of the trend rates changes, the magnitudes of the trend rates, and the absolute and relative levels of development. I take gross domestic product (GDP) per man-hour as a measure of such levels. I also assume that, in the long run, both returns to scale and capital/output ratios are approximately constant. Changes in

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\* In: H. Siebert (ed.), *Economic Growth in the World Economy*, Tübingen: J.C.B. Mohr (Paul Siebeck), 1993.

the measures come then only, or largely, as a result of technological innovation and other qualitative changes. For that reason I also take the measure to reflect the level of “technological advance.” In the period 1925-50 the USSR appeared to improve its relative position somewhat vis-a-vis the USA and significantly vis-a-vis Western Europe. Fairly high Soviet (and East European) growth rates continued in the period 1950-75, although the trend rate of growth of the Western European economy was, in that period, probably higher still. However, since about the middle of the 1970s the socialist economies began to behave as if their growth potential was exhausted. By the end of the 1970s, a period of stagnation began, leading to crisis and a near collapse a decade later.

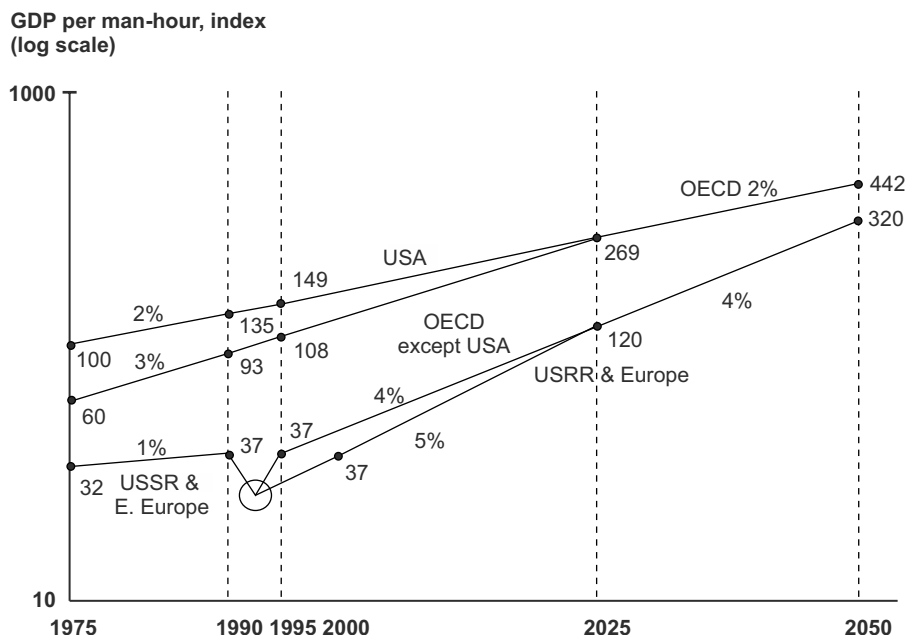


**Figure 1.** Stylized growth paths: USA, Western Europe, and USSR and Eastern Europe, 1900-75

Source: Gomulka (1991b).

## 2. Four phases of development in Central Europe and the former USSR

The intertemporal and international growth comparisons presented in Figures 1 and 2 suggest that 4 distinct phases of development of the countries of the (former)



**Figure 2.** Stylized growth paths: USA, Non-US OECD, and USSR and Eastern Europe, 1975-2050

Source: Gomułka (1991b).

USSR and Central Europe can be distinguished. The first 2 of these phases refer to their socialist past, the third to current developments, and the fourth to the post-transition period. The phases are as follows:

- (i) Fast or Fairly Fast Growth. For the former USSR this phase relates to the half-century period, 1925-75. For Central Europe this was the period 1945-75.
- (ii) Slowdown and Stagnation. Both the USSR and Central Europe entered into this phase at about the same time, the second half of the 1970s, and stayed in it throughout the 1980s.

Limited exports to dollar markets imposed a constraint on the size of imports of Western technology. In the case of the Soviet Union, these imports were also constrained by large food imports, this being the combined effect of low food prices, an underdeveloped food processing industry and a failed policy to improve Soviet agriculture through massive investments in state-owned farms. The Central European socialist countries also faced the reality of declining Soviet supplies of energy and the prospect of having to obtain oil in the dollar market. Low innovation rates and poor exports were again emerging as binding constraints, threatening to halt or indeed already halting further development.

(iii) *Collapse and Transition*. A high synchronization of crisis developments throughout the region of Central Europe and the Soviet Union is a remarkable feature of this phase. The depth of collapse and the spread of transition from a planned, state-dominated economy to one driven by competitive markets and private ownership are bound to vary considerably between the countries. Yet the major part of the drama is likely to be played out in all of them at about the same time, namely the first half of the 1990s.

The analysis of supply and demand shocks during the transition to a market economy is a separate subject. (My brief and preliminary treatment of it is offered in: Gomułka, 1991a.) But whatever analysis one can offer, cumulative losses in GDP are likely to be in the region between 15 percent and 35 percent, which would make them comparable to the losses suffered by Western Economies during the Great Depression of the 1930s<sup>1</sup>.

(iv) *Recovery and Resumed Catching-Up*. In the 1995-2000 period the relative position of Central Europe and the former USSR vis-a-vis Western Europe, in terms of GDP per man-hour, will be, according to data underlying Figure 2, about the same as was the relative position of Western Europe vis-a-vis the USA in 1950. If the transition to a market economy progresses sufficiently far by that time, the conditions would then exist for the region to resume development at a rate of growth similar to that enjoyed by Western Europe in the years 1950-1990. This resumption of catching-up to the Technology Frontier Area would be based, ultimately, on a massive transfer of technologies and skills from the OECD countries, this transfer to be aided and supplemented, especially at a later stage, by the region's own R&D and innovative activity. Market competition, private ownership, and an increasing integration of the region with the world economy through international trade should provide the necessary environment of incentives to workers and investors for this massive technology transfer to take place. Having said that, the 4 to 5 percent growth path in Figure 2 is not a forecast, but merely a potential path that it may well prove difficult to achieve.

## 2.1. Presentation of the four phases: the productivity growth loop

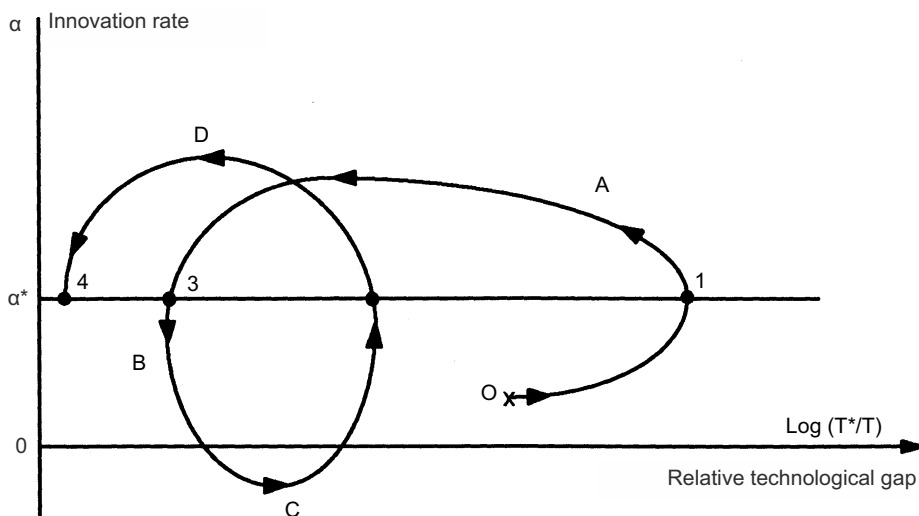
It may be useful, for purposes both of presentation and interpretation, to show the four phases as segments of the growth path representing the relationship between the innovation rate and the (relative) technological gap. This I do in Figure 3. In it  $T^*$  represents the technology level in the Technology Frontier Area

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<sup>1</sup> See Table 1 further on in the text. The official statistics appear to overstate somewhat the losses. One of the reasons for the bias is an expansion of the un(der)reported economy. The size of the bias is, however, unlikely to be more than 5 percentage points.



(TFA) and  $T$  is the technology level in the former USSR and Central Europe. Both  $T^*$  and  $T$  are, measured in terms of GDP per man-hour,  $a^*$  and  $a$  are the growth rates of  $T^*$  and  $T$ , respectively. So long as the magnitude of the international technology transfer is related causally to a range of factors, social and economic, which themselves are related positively to the ratio  $T^*/T$ , the innovation rate  $a$  is “explained” by that ratio. In the typical case a less developed economy travels along a growth path that in Figure 3 begins at point 0, where  $a$  is low and  $T^*/T$  is high, moves to point 1, from which a real catching-up begins, and moves on to point 3, where the catching-up ends. This path is what I call the (first) Hat-Shaped Relationship (Gomułka, 1990 chap. 9)<sup>2</sup>. However, the equilibrium technological gap  $x^*$  at point 3 should typically be small, if there is any gap at all. If that gap is still fairly large, as it turned out to be the case for our group of socialist countries, a social revolution may take place, as it is now doing, with the aim of producing systemic (political and economic) changes that would permit the countries to move closer to the TFA.



**Figure 3.** Four Phases of Development and the Productivity Growth Loop: Russia (USSR) and Eastern Europe, 1900-2050

Source: Gomułka (1991b).

<sup>2</sup> This relationship was first discussed, in terms of both data and theory, in Gomułka (1971). A brief survey of related literature is provided in my entry on “Catching-up” in *The Palgrave: A Dictionary of Economic Theory and Doctrine* (1987). A more extended discussion of the topic is provided in Gomułka (1990).

During the transition itself, a post-communist economy suffers from large supply and demand shocks that temporarily reduce productivity levels. Consequently, the economy moves backwards from point 3 to point 2 in Figure 3. This movement has the same purpose as the earlier travel from point 0 to point 1. On both occasions preconditions for a subsequent take-off are being created. The preconditions during the third phase involve, apart from developing market institutions and strong incentives, also actual destruction of a significant part of the economy fairly quickly. The Schumpeterian “creative destruction” phenomenon, one which takes place in any innovating economy, is intensified during transition in response to sudden and deep changes of relative prices, much easier access to imports, collapse of the CMEA and interrepublican trade, and a sharp shrinkage of the defence sector.

### **3. The conditions following the implementation of the reforms**

The content of initial reforms and their cost in terms of recession vary substantially, depending – it seems – above all on prereform initial conditions rather than reform policies themselves<sup>3</sup>. The recession is deeper whenever the initial price distortions are larger, the inflation rate is higher, the private sector is smaller, the defence sector is larger, intra-CMEA trade accounts for a larger proportion of GDP, and the opening of the economy to Western competition is faster. It is therefore not surprising that the lowest cumulative postreform fall in GDP has been in Hungary, followed by Poland (see Table 1). The reformers exercise a large degree of control mainly over the speed with which prices are corrected, inflation brought under control, and international competition imposed on the producers of tradeables. Since typically a substantial increase of international reserves is required in order to support convertibility, the exchange rate policy has to ensure that imports are not excessive. This concern imposes a limit on the level of external competition. Nevertheless, dollar wages and consumer imports tend to increase sharply, displacing a significant part of the domestic manufacturing sector.

A fairly fast improvement of the price system is both possible and necessary. This implies in particular large reductions in subsidies and sharp increases in interest rates, energy prices, and exchange rates. The new much changed relative prices and resulting demand shifts require a correspondingly large change in the

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<sup>3</sup> Former East Germany is an exception to this proposition for well-known reasons. But the so called shock therapy in Poland, while forceful, has in any case proven to be far more gradual than the initial policies might have indicated.

**Table 1.** Gross Domestic Product (I) or Net Material Product, and Gross Investment (I) (1988 = 100)

	GDP or NMP				I
	1989	1990	1991	1992 <sup>a</sup>	1991
Bulgaria	100	82	61	52	43
Czechoslovakia	101	99	80	73	74
E. Germany (1)	102	87	58	61	125
Hungary (1)	100	97	87	83	85
Poland (1)	100	89	82	83	84
Romania	92	83	72	61	43
USSR (CIS)	102	98	89	70(?)	93
Yugoslavia (1)	101	92	78	65(?)	

<sup>a</sup> Expected values.

Source: United Nations (1992 pp. 26 and 28).

entire product composition of the supply side. Superimposed on these are demand shifts related to the shrinkage of the defence sector and CMEA trade. But owing to the presence of various rigidities, substantial resources become useless or, at any rate, have to remain idle until redeployed to produce what, under new prices, is in demand and profitable<sup>4</sup>.

Since all these micro adjustments are large and necessary, the post-reform recessions are inevitable and, in terms of unemployment of labour, have to be deep and fairly long.

Such a J-curve pattern of postreform responses<sup>5</sup> necessitates the application of macroeconomic policies which ensure that aggregate demand falls a great deal, and falls quickly, to the level of the initially much reduced sustainable aggregate supply. The structural causes of these recessions also imply that they cannot be reversed in a Keynesian way, through an expansion of aggregate demand. The reversal can come only gradually, through a simultaneous increase of supply and demand, at a rate of growth depending on the speed of technological adjustment of the capital stock, skill adjustment of the labour force, and institutional adjustment of the economy.

The concern about avoiding a catastrophe of the East German type (large-scale bankruptcies and large-scale unemployment at the start of the reform) dictates a course of action, such as a restrictive monetary and wage policy, that results in a large fall of real wages in the first year of reform. Low wages help to

<sup>4</sup> That contribution of rigidities in the mobility of resources, particularly capital assets, to the recession is highlighted in Gomulka and Lane (1993).

<sup>5</sup> A phrase introduced in Siebert (1991) and Brada and King (1992).

maintain high profitability of the enterprise sector despite recession. This in turn ensures high revenue for the state budget and low expenditure on salaries in the budget-funded sector of the economy. High profitability is also helped, at least initially, by a large up-front devaluation of the local currency, designed to promote net exports and maintain the stability of the new exchange rate.

The concern about reducing inflation requires, in turn, the phasing out of the wage indexation of pensions and other benefits. A failure to do so may reintroduce, as it did in Poland and Hungary in 1991 and 1992, the stabilization problem via a quickly increasing budget deficit. This threat to stability has three sources: the declining profitability of enterprises, the smaller size of the postreform economy, and the rapidly increasing numbers of pensioners and unemployed. To meet the threat, a strict continuation of the wage policy in the state sector is required, one sufficiently effective to ensure that most state enterprises continue to be (at least just) profitable. In addition, an effective tax system is needed, one capable of keeping the budget deficit under control whatever the depth of the recession happens to be.

The data in Table 1 indicate that a reform-induced recession lasts about 2 to 3 years. Following this, the East European economies enter a *consolidation phase* that should evolve gradually into a *recovery phase*. In the consolidation phase the level of activity is stable, inflation is high but declining, and unemployment is high and increasing. Choice, accessibility, and the quality of goods and services are all much improved. The readjustment of foreign trade away from the former CMEA over to the EC area is completed. The quality of the price system is close to EC standards. The levels of international reserves are sufficient to support current account convertibility of local currencies at unified and fairly stable rates. And a substantial share of the GDP, typically between a quarter and a half, is produced by the private sector, and this share continues to increase rapidly.

## 4. How to initiate recovery

What is needed is to initiate a virtuous cycle whereby existing savings finance new innovations that reduce unit costs and/or increase demand, which in turn increases profits that, augmented by bank loans, are used to finance further investment. For this to happen, these savings should be available to the right investors, these savings should be substantial, the right investors should be numerous, and they should have strong incentives to undertake the effort to search for innovations and implement investment projects despite the associated risks.

The typical ways for policy-makers to assist the process are by creating a stable macroeconomic environment, and by low direct taxation of personal incomes

and profits. These, I think, are also very important in Eastern Europe. Low nominal interest rates are, in fact, essential to stimulate investment in larger investment projects.<sup>6</sup> They are also needed to create demand for private housing. Increased housing construction has the potential to provide a major stimulus for an overall recovery. However, the main problem is the fact that due to the fall of profits and the shrinkage of the economy, total savings are rather small. Moreover, in the postreform economy a significant part of these savings is (or will be) used to finance the government budget deficit (in effect, to finance public consumption). To stimulate savings, real interest rates should therefore be significantly positive. In order to safeguard savings for investment purposes, the authorities must strive to restrict public consumption to a level that can be financed by taxes alone.

Nominal interest rates can be low only if inflation is low, and this in turn is related to the growth of wages and the size of the budget deficit. A restrictive, tax-based wage policy in state-owned enterprises and a prudent fiscal policy are therefore necessary to achieve low nominal interest rates. The policy should also help the managements of these enterprises to make profits for restructuring purposes. The scope and restrictiveness of the policy can be reduced with the progress of commercialization and privatization of state enterprises and the increase of unemployment.

A very important macro instrument to be used for the purpose of initiating recovery is, of course, the exchange rate. Initially, the exchange rate is typically set at a highly depreciated level. During the liberalization and stabilization phases of transition, the dollar wage increases rapidly, stimulating imports of manufactured consumer goods. In Poland, for example, these imports increased about threefold during 1990-1991, alone causing a reduction of industrial output by some 10 percent. The fixed exchange rate serves as a nominal anchor during the initial part of this period, and there is a strong temptation for policy-makers (and the IMF) to overburden the rate with that role, which was the case for Poland in 1991.

The temptation should be resisted. The prime nominal anchors should be the wage policy and the supply of money, while the exchange rate should be used primarily to achieve a desired outcome in the balance of payments. Eastern Europe is not and should not be expected to be placed yet, nor for a considerable while, under the strict discipline of the Exchange Rate Mechanism. Liberalization of trade is likely to lead to an increase of both exports to, and imports from, the convertible currencies area. But exchange rate policy should strive to achieve a sizeable trade surplus, in line with the export-led growth

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<sup>6</sup> In Poland commercial nominal interest rates were, in 1991-1992, typically in the 60 to 80 percent range. By "low" I mean rates below 20 percent.

strategy. The surplus would be a reflection of the current recession (low imports of intermediate inputs), would limit the depth of the recession, and is needed to build and maintain adequate international reserves of the region while servicing its large foreign debt<sup>7</sup>.

The experience of Western Europe, Germany in particular, suggests that the success of the transformation may hinge on a rapid expansion of the sector comprising small and medium-sized firms. There are already hundreds of thousands of such firms in Central Europe, most of them in the private sector. They form the testing ground for a wide spectrum of innovations. The most successful of these firms can become the basis for the flexibility and dynamism of the region's economies.

The problem seems to be that, so far, "the growth is mostly in very small firms, mostly in non-tradeables, and mostly outside of manufacturing" (Berg and Blanchard, 1992, p. 28). An implication of this is that "private sector growth cannot, in the short or medium term, substitute for the restructuring of state firms" (*ibid.*). One of the reasons is that "as the non-tradeable sector grows and the tradeable sector stagnates or shrinks, pressure from a growing trade deficit will require either steady real depreciation, or a further contraction" (*ibid.*).

One should recognize, however, that privatization and restructuring have their own sequencing. They occur first in the sectors, such as trade and construction, in which the transaction cost of privatization is small and where the investment cost of restructuring is manageable for the (new) private owner. (In Poland, this phase has been nearly completed in the first two years of reform.) The trade sector then becomes a major innovative force for the entire economy. Private traders identify the products that are in demand and transmit this information to domestic producers. They also import higher quality goods, thereby putting pressure on domestic firms, most of which are still state-owned, to upgrade their own products and stand up to external competition. In the second phase, therefore, many state-owned firms also begin to wake up, starting to restructure and innovate. (In Poland this phase, it seems, began recently in key consumer goods sectors – such as food processing, leather products, and textiles – leading to a considerable recovery in these sectors in terms of output and financial indicators, as well as to a strong export performance.) In the meantime the privatization process continues, beginning to embrace medium-sized state enterprises, through either employee and/or management buyouts or the liquidation and sale of assets. To use the Polish example again, this route was the main channel of privatization

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<sup>7</sup> If and when Eastern Europe attracts large direct foreign investment, then external capital would finance some of the imports, particularly investment imports. The need for a trade surplus would be then lessened; even a trade deficit may then be acceptable.

in 1991, involving about 1,000 enterprises. The total pool of enterprises in this category is still about 6,000, out of a total of about 8,000.

Another potential problem is the behaviour of banks in their choice of firms and investment projects that they are willing to support. Profit-maximizing banks may have a perverse incentive to finance less efficient projects of the firms that are in debt in preference to more efficient projects of the debt-free private or state firms. The reason is that the banks calculate that new money to old firms should also improve the chance of recovering some or all of the under or non-performing old debt, while if they lend to debt-free firms this additional potential benefit is absent (Perotti 1992 develops a formal model that leads to this proposition). Banks also show a limited willingness to lend to new entrepreneurs with no proven reputation of business success and limited collateral. In this situation, as Svejnar (1991, p. 133) suggests, "there is strong economic justification for government to step in and provide credit insurance or other measures to stimulate bank lending to this sector."

The bad debt problem is the most serious matter to be addressed in the consolidation phase. (In Russia and other former Soviet republics, the debt of the enterprise sector was large already at the start of the liberalization and a near hyperinflation during this phase, coupled with higher negative interest rates, is assisting in reducing its real value.) As reform progresses, profitability tends to decline and the proportion of state enterprises that are loss-making and therefore no longer creditworthy increases. (In Poland this proportion reached a maximum of about 50 percent in early 1992.) The reformers respond by implementing programmes that involve the closure of some of the state enterprises, compensation of some bank losses by the treasury, and greater participation of banks (also through the acquisition of shares) in the restructuring of enterprises regarded as still viable. The financial position of state enterprises depends on the ability of managements to withstand pressure to increase wages. Commercialization, incomes policy, and the credibility of the threat of closure are the key instruments with which to strengthen that ability. If these instruments are strong and work, then lowering external competition by devaluation may also be used to improve profitability. If wage earners declines sharply, while the number of pensioners and unemployed increases sharply. The reform governments may however fall victim to the legislative inertia fuelled by the political pressure of the interest groups. In Poland, for example, the number of pensioners and unemployed increased from 6.8 in 1989 to 10.7 in 1992, while nonagricultural employment declined from 12.6 million to 11.0 million in the same period. The total expenditure on pensions and benefits increased from 9.1 percent of GDP in 1989 to 15.8 percent of GDP in 1991, and is expected to reach 20.9 percent of GDP in 1992.



These developments had a devastating impact on public finances, forcing a sharp diversion of government expenditure from infrastructure investments in particular to the funding of pensions and therefore consumption. A large fall of revenue from profit taxes is also causing the Central Europe governments to reduce expenditure on research and development, education, and restructuring investment.

## 5. How to sustain recovery

There are various important “structural” reforms which the post-communist countries started to implement and with which they need to progress much further in order to develop a solid basis for a sustained growth. The programme of these reforms includes above all privatization of financial institutions and production enterprises, and privatization of the housing stock in order to increase labour mobility. However, one politically sensitive area that requires determined policy action is public finance.

Some of the countries concerned, such as Czechoslovakia and Hungary, entered the transition with the total public expenditure claiming more than 50 percent of GDP. As I noted earlier, reform governments continue to keep direct taxation low in order to have an incentive system that encourages effort. For the same reason the welfare benefits and pensions should not be high in relation to wages. The full wage indexation of these benefits and pensions cannot be maintained during transition. The reason is that the revenue of the social security system is a proportion of wages, and the number of wage earners declines sharply, while the number of pensioners and unemployed increases sharply. The reform governments may however fall victim to the legislative inertia fuelled by the political pressure of the interest groups. In Poland, for example, the number of pensioners and unemployed increased from 6.8 in 1989 to 10.7 in 1992, while nonagricultural employment declined from 12.6 million to 11.0 million in the same period. The total expenditure on pensions and benefits increased from 9.1 percent of GDP in 1989 to 15.8 percent of GDP in 1991, and is expected to reach 20.9 percent of GDP in 1992. These developments had a devastating impact on public finances, forcing a sharp diversion of government expenditure from infrastructure investments in particular to the funding of pensions and therefore consumption. A large fall of revenue from profit taxes is also causing the Central Europe governments to reduce expenditure on research and development, education, and restructuring investment.

It seems therefore that a greater mobilization of savings than at present will be necessary for sustaining recovery at a growth rate compatible with “full



employment.” The size of the savings deficiency is still difficult to estimate. In the immediate aftermath of the reform, the savings ratio is likely to range between 15 and 20 percent of GDP, depending on the country. If the post-1950 experience of Western Europe is to be a model to follow for Central Europe now, this ratio should be between 25 and 30 percent.

## 6. The growth bottlenecks and western assistance

A major governmental concern in Central Europe is to make the area more attractive to investors, domestic and foreign, by reducing the growth bottlenecks in the technical infrastructure. Programmes have been devised to build, during the next 10 to 15 years, a network of highways, to upgrade the railway system, to link up with the Western European network of oil and gas pipelines, to build several modern international airports and to improve port facilities. Of immediate concern is the telecommunications system, which is already expanding rapidly. In Poland alone these essential infrastructure investments during the next 10 to 15 years are to cost about \$50 billion. The financing of these projects is not yet secured. In view of the tense fiscal constraints, Central Europe is searching for external finance.

Reform governments have, in 1992, a more realistic view about the probable size and forms of Western assistance. Most Western governments' credits are available to finance only imports and only from the creditor countries. Such credits, in the period of recession, are of extremely limited value to Central Europe, and they remain largely unused. Lending by the EBRD and the Luxembourg-based European Investment Bank are yet to be of any significance. The European Community would like to be more helpful, provided however that this assistance does not embrace what for Central Europe is perhaps most important: free access to Community markets. The recent Association Agreements between the EC and Czechoslovakia, Hungary, and Poland mark a change of policy, though the removal of quotas and other restrictions is to be slow and incomplete. The World Bank is, so far, the most active development agency, both in terms of lending and technical assistance.

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## 4. Economic and political constraints during transition<sup>\*1</sup>

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Following the collapse of the old political (communist) system, the overall strategy of transition and *initial* reform policies appear to be influenced above all by the inherited economic and institutional constraints and the long-term political and economic aims of the reforms, rather than by the usual short-term concern to gain and preserve political power. Many of the constraints are systemic and therefore common to all countries undergoing the transition. This article primarily discusses the influence of these constraints, both common and country-specific, on the choice of reform strategy, as well as on the choice of specific economic policies.

Economic, institutional and political reforms during transition have a feedback effect on the inherited constraints. They also activate or modify current political constraints. The article notes positive outcomes of reforms, which tend to relax some of the constraints, and discusses the effect of negative outcomes, such as severe recessions and grave fiscal problems, which tend to produce new economic and political constraints. The second aim is therefore to discuss how these changes of constraints may lead to modifications of initial reform policies in the course of transition.

### 1. Interactions between politics and economics in transition

We begin by formulating several propositions about the sequence of broad interactions between politics and economics just before and during transition. The first of these propositions is as follows:

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\* *Europe-Asia Studies*, 1994, 1(46).

<sup>1</sup> The author has been Economic Adviser to Poland's successive Finance Ministers since September 1989. As a member of the Balcerowicz Group he advised the Polish Government on the elaboration and implementation of the 1990-91 reform. He also advised the Russian government on the liberalisation policies in the second half of 1991. He takes sole responsibility for the contents of this article. Comments on the first draft by Margot Light and George Schopflin have been most helpful. The article also benefited from comments by Mark Schaffer and by an anonymous referee.

#### 4. Economic and political constraints during transition

(i) The pre-transition economic stagnation led to limited reforms, destabilising economic policies and an ideological crisis, and eventually in most countries to an open and sharp economic and political crisis.

This pattern was particularly strong in Poland and the former Soviet Union (FSU). The fundamental reasons for the economic stagnation were, however, systemic and therefore common to all the former communist countries once they reached a fairly high level of development (Gomułka, 1986, 1991b). Some countries attempted to respond to the growth slowdown by introducing limited economic reforms. But the reforms were too marginal substantially to change the essence or improve the performance of the old system.

Another response to the slowdown was to increase investment imports from the West on credit terms. Larger investment imports improved growth performance and raised consumption levels in the 1970s but, as is well known, led in turn to large debts, import cuts and output falls in the 1980s.

The third notable policy response during the growth slowdown was the relaxation of fiscal, incomes and monetary policies. This was especially in evidence in the FSU, Poland and Yugoslavia in the 1980s. Under mounting social and political pressure, caused in large part by the growth stagnation, the authorities increased consumer subsidies while keeping prices and taxes under control. This led to suppressed inflation and a rapid aggravation of the standard economic problems – monetary overhang, market disequilibria, forced substitution, and hoarding of shortage goods.

The new aggravation and the old stagnation amounted, in the late 1980s, to a widely held perception of general economic crisis. The crisis caused demoralisation of the communist elite, prompting gradual reconciliation of many of its prominent members to the view that the failure of the historical ‘socialist experiment’ was imminent and inevitable, and that a radical change of the system, if and when demanded by the people, should not be opposed or should even be promoted.<sup>2</sup> Hence our second proposition:

(ii) The pre-transition economic crisis softened and eventually removed ideological and political constraints to a radical change, indeed abandonment, of the communist system. It legitimised reform programmes aimed at imitating the ‘proven solutions’ of market-based capitalist economies of the West European type. The ideological and political crises have in turn required that such

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<sup>2</sup> Commenting on this point, George Schopflin suggested that, at a political level, ‘the economic crisis and the mounting evidence of other disfunctions of the old system resulted not merely in a legitimisation crisis but also in the loss of self-legitimation. The communist elite concluded that it was incapable of governing by the previous elite-legitimising myths and conceded power’ (personal communication).

programmes be implemented fast. They also swept to power liberal, non-socialist reformers ready to design and implement the programmes.

Sociological studies appear to suggest that, in the 1980s, rejection of the non-democratic (communist) political system was increasingly popular, becoming in some countries of Central Europe widespread and intense. However, the rejection of the state-dominated economic system was still uncertain. Even in Poland the attitude to medium and large-scale private businesses remained hostile (Kolarska-Bobińska, p. 163). Pre-1984 Poland was a country in which, according to Kolarska-Bobińska, only the myth of the free market developed. The institution itself was accepted only in so far as it was a rejection of the existing misery (usually exaggerated) and a symbol of good things to be found or thought to exist elsewhere; the necessary implications in terms of private ownership, job insecurity and hard work attitudes were yet to be considered and absorbed. The pre-transition crises served to initiate and accelerate this learning process throughout the countries of Central Europe and the FSU.

By the time the communist system was about to collapse, popular support for a variant of the capitalist system was high. But the new, post-communist political elites had typically only a vague idea of what economic reforms to introduce and in what sequence to introduce them. In the virtual absence of political parties, they tended to hand over the task of designing the reforms to a small group of economic experts, typically academics.<sup>3</sup> Given the pressure of crisis circumstances, these experts demanded, and usually obtained, an unusual amount of power. Legitimacy of that power probably came mainly from the evident collapse of the old economic system. The nations and their new political elites had in any case no option but to trust the ability of their economic experts to lead the post-communist countries out of the crisis through the transformation to a Western-type economy. Moreover, as I argue below, the total crisis had the further implication of effectively ruling out a gradual implementation of the transformation reforms, by which I mean a Chinese-type strategy.

However, many of the experts and probably most of the people were initially unaware of the necessarily large social and economic costs of the transformation. Hence my third proposition:

(iii) The initial transition reforms – in particular, liberalisation, stabilisation and re-arrangement of international trade – bring about a reform-related economic crisis.

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<sup>3</sup> The change of system requires the introduction of many new laws. These laws have to be designed by experts. Hence, from society's angle, the reforms may have appeared remote and technocratic, formulated in inaccessible language. According to George Schopflin, this feature 'reproduced some of the sentiments that greeted communist technocracy' (personal communication). Even so, the purpose this time was not to build something completely new, so the main thrust of reforms was transparent to most ordinary people.

The associated economic and social costs differentiate social attitudes, split the reform movements and increase political tensions during the main transition phase.

The reforms are revolutionary in that they bring about fast and exceptionally large changes in the economic and social circumstances and opportunities of individuals and businesses. The changes for the better are large enough to sustain broad public support for the reform process, as the high popularity ratings of many of the new political leaders showed. Set against the benefits of reforms, however, there are also large costs, which we shall discuss in greater detail below. Both the benefits and the costs influence the political process.<sup>4</sup> Hence our fourth proposition:

(iv) The changing political support for the initial reforms and reformers in turn influences the content and may moderate the speed of implementation of subsequent reform policies, without (much) changing their overall direction.

In Poland popular support for the Balcerowicz Plan declined steadily, from about 45% in favour and 10% against in October 1989 to about 20% in favour and 40% against in October 1991 (CBOS, *BS457*, November 1991). Despite massive external support, the original enthusiasm in East Germany gave way to apathy. Radical reformers became less popular in the FSU, notably in Russia and the Baltic republics, and have yet to gain power in Belarus and Ukraine. Even highly pragmatic reformers in Hungary lost much of their initial popular support (Mizsei, 1993). It seems that only in the Czech Republic have the radical reformers remained comfortably in power. Political inexperience, the small number of top reformers, and the need to concentrate on details in view of the poor quality of the civil service have also contributed to problems for reform governments. There was, initially, little effort to explain to ordinary people the details of reform programmes, and the reasons for various measures (Jacek Kuroń, Minister for labour and social policy in Poland, was a notable exception). The importance of ‘selling’ the reform and explaining how current hardship would bring later benefit was appreciated only later, when the need for selling became more apparent and the hardships more evident.

However, and this is the main point, the modifications of the original reform policies have been, so far, relatively modest. The strategic aims of the reforms – political democracy, private ownership and market economy – remain unchanged. The April 1993 referendum results in Russia confirm that this is so also in that post-communist country. The judgment of people about the horrors of the old system is probably still fresh. The demonstration effect of Western economies

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<sup>4</sup> What matters are perceptions of these costs and benefits over longer periods of time. Hence the crucial role of expectations. These expectations are probably formed uniquely on the basis of evidence of performance of developed market economies and success of some of the newly industrialised countries.

must still be convincing. The attractions of personal and political freedoms must also be difficult to resist for the largely modern, well educated post-communist societies. The main effects of the harsher post-reform reality seem to be that the original myths about the immediate effects of reform are disappearing and that, in their place, the nations concerned are beginning to form more realistic expectations concerning the effort and the time needed to close the gap with Western developed countries. The apparent rise of anti-market, anti-Western currents of nationalistic populism must, in view of the referendum results in Russia, be judged to be more a reflection of political differentiation and a defensive reaction to reforms by extreme political groups rather than the dominant judgment of mainstream opinion.<sup>5</sup>

## 2. Inherited constraints and reform strategy

A change of economic system of the kind we are discussing requires major structural shifts in terms of institutions, ownership, modes of interpersonal behaviour, attitudes to work, and laws. Some institutions have to be closed down (communist party committees, Warsaw Pact and CMEA organisations, mass media censorship, central and intermediate planning organisations) or cut in size (ministries and industrial associations, security and military establishments, central international trade bodies, central bureaucracy of the various cooperatives). At the same time new institutions have to be created (stock exchanges, securities commission, ministry of privatisation, investment and pension funds, unemployment offices, foreign exchange dealers, building societies; all these in addition to new political parties and the new mass media). Other institutions have to be expanded (banks, business schools, customs and other tax offices, business consulting). These institutional changes are superimposed on large changes in the pattern of prices and foreign trade relations, both of which imply major shifts in the required composition of output. In particular, exports to the former CMEA area were to fall dramatically, from between 40% and 60% of total exports to, typically, between 10% and 20%. The earlier emphasis on economic activities producing energy, materials, investment and defence goods led to industry and mining accounting for a disproportionately high proportion of GDP, between 45% and 60% (Marer *et al.*, Table 8.4, p. 74). During transition this proportion needs to

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<sup>5</sup> Leszek Balcerowicz (1993), in a wide-ranging lecture, identifies the following three major features of global transformation: their broad range (simultaneous change of both the political and economic systems), the peaceful method of changes despite their revolutionary content, and their a-historical sequence: mass democracy first, capitalism later.



fall to about 30-40%. On the other hand, the share of trade and financial services, which accounted for about 10% of GDP before reforms, should increase, judging by the experience of market economies, to about 20-30%.

In terms of institutions, skills, prices and products (and possibly some other economic characteristics), there is therefore a large distance between the initial point, where a post-communist economy finds itself just before the reforms, and the end point of its intended transition. Reform strategy is about the speed and sequence of reforms to effect the transition. The distance between the two points represents a measure of inherited constraints.

A policy designer, in proposing a broad reform strategy and specific policies, has also to take into account particular economic circumstances, as well as political constraints. These circumstances relate to the size of internal disequilibrium (monetary overhang, budgetary deficit, inflation rate), the size of external disequilibrium (foreign debt, balance of payments position, international reserves), and the possible extent of external assistance.

From this description of inherited constraints it is already clear that they fall into two categories, common and country-specific. The common part dominates and ensures that the reform policies and transition paths exhibit some basic similarities among countries. Nevertheless, the variation in country-specific inherited constraints and circumstances is substantial enough to have an impact on the choice of overall reform strategy as well as specific policies. The strategy may be discussed in terms of five components – micro-liberalisation, macro-stabilisation, structural changes (including ownership and other institutional changes), safety net and external assistance. Of these the first three are the crucial components of any reform package. In particular, external assistance is typically very small and therefore of limited impact, even though its significance is exaggerated for political reasons by both donors and recipients.

Micro-liberalisation applies not only to prices but also to regulations and policies concerning the private sector, foreign trade and foreign investment, monopolisation and competition, labour mobility and wage bargaining, financial institutions and intermediation. The policy choice concerns the speed with which to increase administrative prices to either world levels or subsidy-free levels; the extent of price regulation through subsidies, the level of protection of domestic producers through tax privileges, tariffs, quotas and/or the exchange rate; the size of budgetary resources devoted to other forms of industrial and/or microeconomic involvement of state authorities, such as investment grants, tax exemptions, credit guarantees or subsidised loans. Of particular importance are consumer subsidies and energy prices. At the start of transition, consumer subsidies are typically about 10% of GDP and energy prices about 10% of world levels.



Four broad reform strategies may be distinguished – (A) shock, (B) controlled shock, (C) semi-gradual and (D) gradual. (A) was applied only in East Germany, where Western prices were imposed from one day to the next. Although subsidies remained in place, the monetary union meant that local producers were offered no protection against West German competition. The outcome is well known; drastic collapse of industrial output, massive unemployment and external assistance of some \$100 billion per year. Although this strategy offers the potential for a fast reallocation of resources, it is far too costly in the short and medium term to be of interest to any other post-communist country. Strategy (D) has been pursued successfully by China since the late 1970s. This option, however, had already been tried in Central Europe, especially in Hungary and Poland, though with less vigour and poorer results than in China. The real choice for the FSU and Central Europe was therefore between (B) and (C). Option (B) was adopted by Poland and Czecho-Slovakia, and option (C) by Hungary. Other countries adopted either some combination of (B) and (C) or – in the case of some republics of the FSU – possibly combinations of (C) and (D).

If initial economic conditions are those of a severe crisis, policy makers tend to enjoy a greater political freedom to act decisively. Forceful actions are also called upon to remedy the situation. This was the case of Poland towards the end of 1989 and, to some extent, the case of Russia two years later. In the former Czecho-Slovakia there was no open crisis in 1989, and so the case for a shock reform strategy was less strong. However, the abortive reforms of 1968 and the dark years of ‘normalisation’ which followed contributed to the nation’s feeling of defeat and humiliating lagging behind (Svejnar, 1993). Radical reformers asked for and received, in 1990 and 1991, the necessary political support to take the country and the economy rapidly to a West European standard, even at a large cost in the medium term. Hungary’s moderately successful reforms of the 1970s and 1980s prepared the country for a more gradual transition. However, a truly gradual transition strategy would take, as in China, several decades to implement. Such a strategy involves a gradual change in ownership structure of the non-agricultural economy, through natural growth of the existing private sector rather than a rapid privatisation of the existing state enterprises. As mentioned above, neither Hungary nor apparently any other post-communist country is prepared to accept such a gradual privatisation policy.

The rapid dismantling of the CMEA and a nearly instant dollarisation of all intraCMEA trade, both major factors contributing to post-reform recession, were events over which Hungary and the other Central European countries exercised no control. These external shocks were large and had to be absorbed quickly by all, Hungary included. The country’s strategy of gradualism was therefore limited

to a somewhat slower pace of price liberalisation – possible in view of the high quality of the Hungarian price system to begin with – a more gentle reduction of subsidies and a more guarded approach to convertibility of the currency.

### 3. Specific policies and constraints

In this section we note the variation among countries in the choice of specific policies and the influence on the choice of some of the inherited constraints.

*Exchange rate policy.* Once the central allocation of foreign exchange was abandoned, an exchange rate was needed that would roughly equilibrate the demand for and the supply of the local currency. Convertibility for at least current account purposes was also needed to reduce the impact on prices of the monopolised market structure. A floating exchange rate policy was a possible option. However, the stabilisation of liberalised prices would be helped, by the impact on expectations, if the exchange rate were fixed for a period of time following the ‘zero hour’ when prices were liberalised. To sustain such a policy, the authorities require some international reserves and the ability to conduct a restrictive monetary policy. The latter was difficult unless there was also in place, at least initially, a highly restrictive incomes policy.

The important inherited constraint here is the size of international reserves. These were modest in Central European countries, but large enough not to exclude the possibility of introducing convertibility at a unified rate and using the exchange rate as a nominal anchor. In the event, the policy of fixed exchange rates with the possibility of discrete devaluations was adopted by most of these countries. Russia and other republics of the FSU, however, turned out to have virtually no international reserves. In such circumstances, a floating exchange rate policy for the ruble became necessary.

In most republics of the FSU, particularly in Russia, the exchange rate policy was also influenced by the debate about the shape of inter-republic economic relations. Gaidar and his group, when submitting their economic programme to President El'tsin at the beginning of November 1991, already took the view that all republics were likely to end up with their own currencies and independent economic policies. The alternative view, promoted at that time by Silaev, Yavlinsky and Shatalin, gave rise to the proposal to form a ‘Common Economic Zone’. The zone was to comprise the FSU and be open to other countries of the former CMEA. The countries were to be served by either a single currency and a single central bank or, alternatively, by their own currencies with fixed exchange rates between them. In this and most other respects (labour mobility, single market,

coordination of fiscal policies), the zone was to be the Eastern equivalent of the European Community if and when it adopts the European Monetary System.

The Gaidar group noted the main attraction of the proposed zone: that it would limit disruption in inter-republic trade and thus reduce the depth of the transition-related recession. However, it considered as naive the implicit assumption that the newly independent countries would be prepared to coordinate their fiscal and monetary policies sufficiently to maintain fixed exchange rates and to balance inter-republic payments. The point was that the projected locking of internal prices to world prices for tradeables meant that Russia was about to inflict terms-of-trade losses upon most of the republics. The fear was that these republics would then attempt to use the zone as an instrument of 'exploitation' of Russia, by running trade deficits and demanding that Russia finance these deficits in order to preserve the fixed exchange rates.

Initially, the IMF supported the single currency concept, hoping that – apart from reducing recession – it would also help its stabilisation efforts by providing a reason to impose a macroeconomic discipline on the member countries. However, the IMF proved unable to influence macroeconomic policies in much of the FSU in the course of 1992. Consequently, it accepted the inevitability of separate currencies and independent exchange rate policies in all the republics. In the meantime, a ruble zone has been maintained as a short-term facility intended to limit the trade disruption. As a goodwill gesture towards the other republics, Russia has also accepted the principles of gradual lifting of energy prices to world levels and gradual dismantling of direct subsidies.

*Wage policy.* Restrictive (tax-based) incomes policies (TIPs) or administrative wage controls were already in place before transition in all the countries concerned. The policies were unpopular, but the Central European reformers retained and enforced them in the state sector during the initial years of transition. TIPs played the role of nominal anchors in Czecho-Slovakia, Hungary and Poland in 1990-92. However, in November 1991 the top Russian political authorities took the view that price liberalisation could be accepted by the population at large only if all wage restrictions, including a highly restrictive TIP, were lifted. Effectively, wage liberalisation was seen as a price necessary to obtain popular consent, as well as the support of the Russian Parliament, for a general price liberalisation.

The Russian Parliament was, in 1992, an assembly of members elected before the dissolution of the USSR and the CPSU. This inherited institution was prepared to support some market-orientated reforms, but on many occasions proved unprepared to accept the full implications of the failure of the old system. Effectively, it represented an inherited political constraint on reforms. Its actions in the fiscal, monetary and incomes policy areas had contributed to the result that

the initial corrective inflation in January and February 1992 led, in the course of 1992, to a wage-price inflationary spiral.

An argument can be made that TIPs proved to be not particularly important nominal anchors in Czecho-Slovakia, Hungary and Poland, and that the wage-price inflationary spiral in Russia and other countries of the ruble zone was caused by large fiscal deficits and the granting of excessive credits to enterprises, rather than by the absence of a strong incomes policy. Indeed, economic theory tells us that restrictive fiscal and monetary policies are sufficient to control the growth of wages and prices. The purpose of an incomes policy is only to play a supporting role: to help to achieve a given inflation rate with a less restrictive monetary policy and hence a smaller recession. In Poland in 1990, and Czecho-Slovakia in 1991, monetary policies were initially so restrictive that incomes policies were not binding in most enterprises. As I discuss elsewhere, the 'war at the top' of the Solidarity movement induced the Polish government to relax significantly all macroeconomic policies, except the exchange rate, but including the incomes policy, in the summer of 1990 (Gomułka, 1993).

The result was a sizeable inflation rate and a large fiscal deficit in 1991-93. In sharp contrast, the stronger parliamentary base of the Czecho-Slovak reformers, combined with weak unions, enabled the government there to conduct policies which rapidly brought the inflation rate down to about 1% a month and which have since kept the public finances under control.

To sum up, the speed of disinflation and the rate at which inflation settles down following price liberalisation are good measures, above all, of the *political ability* of reform governments to conduct their macroeconomic policies during transition.

*Monetary policy.* The ability to control the money supply is essential in any stabilisation policy. There was concern that the poor quality of the banking system, an inheritance from the past, could seriously undermine this ability. In most of Central Europe high interest rates, in addition to reserve ratios and administrative credit limits, have been used quite successfully to control demand for credit. Inter-enterprise involuntary credit increased sharply but not disastrously. However, in Russia and most other republics of the FSU the conduct of a proper monetary policy proved impossible in 1992, the first year of radical reforms. The institutional and inherited political constraints stood in the way. A monetary union was initially proposed (Minsk Agreement of January 1992), with one Central Bank and a single currency for the entire ruble area. But, as noted above, individual republics wished to pursue independent fiscal policies, and to be able to run budget deficits and finance them by bank credit. The republics controlled banks on their territory and were thus able to codetermine the supply of credit to their enterprises. Moreover, some of the republics issued money substitutes or even

their own second currencies to meet the demand for money. At the Central Bank itself, strong and effective political pressure was applied by local interest groups, through the Russian parliament and the Russian government, to validate wage increases by means of an accommodating monetary policy.

Apart from validating wage increases, there was also the question of taking the political responsibility for possible large-scale closures of enterprises in the absence of subsidised credit. In Russia in 1992-93 the politically dependent Central Bank became concerned not merely with the inflation rate but also, and occasionally above all, with the level of economic activity, typically the domain of governments. Consequently there came about a reversal of roles, the government being forced to care more about inflation than recession. The Central Bank, on the other hand, wished the government to pursue an industrial policy which would, for example, take care of the military-industrial complex, and a fiscal policy which would eliminate the budget deficit. It also wanted the government to impose an incomes policy to control wage increases. If all these happened, the Central Bank argued, it would be in a position to reduce the supply of credit to enterprises and the government, and the inflation rate would fall. The Russian government, however, doubted its ability to administer an incomes policy and was politically too weak, in 1992, to avoid a large budget deficit.

*The CMEA trade links.* For Central Europe, the FSU represented a large captive market for poorly made but expensive manufactured goods. It also was the major supplier of cheap energy and other natural resources. The implicit Soviet subsidy may be estimated to have reached between \$10 billion and \$15 billion annually, or some 3% of Central Europe's GDP. With the end of Soviet domination in Central Europe, the case for the subsidy disappeared. The subsidy and the overblown trade links now became inherited constraints on reforms. To overcome these constraints, Central European countries had to absorb terms-of-trade losses and a near total loss of the FSU market. Both factors contributed to large falls in GDP at the start of transition. The collapse of the CMEA also prompted reformers to take strong measures to promote exports to Western markets, so that the countries would have the hard currency to pay for energy imports.

*Privatisation policy.* The classical (Western) methods of privatisation rely on the presence of financial institutions to effect the sale of state assets, and on the availability of private capital and capitalists to buy and manage these assets. None of these are available in post-communist countries in numbers necessary to meet the requirements of the task. These inherited constraints forced reformers to be innovative in their choice of simple and politically attractive methods that would nevertheless be effective. Tax incentives also have been and are being used to promote privatisation through autonomous growth of the old private sector.

An important political dilemma concerned the choice of a method of giving away state assets to citizens. The issue of coupons to all is politically attractive in the short term, but runs the risk that most coupon holders would sell them immediately in secondary markets for cash. The market prices of coupons would then collapse to a small fraction of their face value. Local capitalists and foreigners may then buy most of the assets at very low prices. This possible outcome haunted Polish reformers in 1990 on the grounds that the majority would feel robbed and turn against reforms. Alternative privatisation methods have been devised which met this concern to some extent, but which also prolonged the privatisation process (Gomułka & Jasinski, 1993). However, the risk was thought to be negligible by the top reformers in Russia and the former Czecho-Slovakia.

*The underdeveloped trade sector* In order to ensure that price liberalisation was effective in eliminating shortages, the authorities initially allowed private street traders to operate on a large scale, even though the traders were not paying any taxes. With rapid development of the organised trade sector, street trade has been gradually phased out, by means of regulations and taxes.

*Fiscal policy.* During earlier reforms, Hungary introduced a VAT of the Western type and personal taxation. The two taxes provided a good proportion of all revenues to the state budget during transition. On 1 January 1992 a VAT was also introduced in the FSU. The other countries had to rely to a great extent on the taxation of enterprise profits. A collapse of these profits in the course of transition therefore had a sizeable effect on the state of public finances, a topic to which we return below.

## 4. Economic outcomes of reforms and new constraints

As we noted at the beginning of this article, the initial economic and political reforms during transition have certain economic outcomes which in turn influence the social and political environment, and hence further reforms. In this section we identify the major outcomes and discuss their feedback effects. Although we begin by listing beneficial effects of early reforms, our main concern will be the severe recessions and grave fiscal problems, and their powerful effects on the course of transition.

### 4.1. Positive outcomes

Before discussing the serious new problems which develop during transition, it is important not to lose sight of the major achievements of the countries

concerned during the first stages of the transition process. A selection of these, not necessarily in order of importance, would be as follows:

(i) Disappearance of shortages as a result of price liberalisation.

One of the remarkable outcomes of the reforms so far has been the very high speed at which microeconomic equilibria were restored once administrative price controls were lifted. Kornai's well known thesis that shortages are an imminent feature of any economy with a predominant state sector subject to soft budget constraints, whatever the price regime, has apparently turned out to be wrong. A further consequence has been the disappearance of various shortage-related phenomena: forced substitution in consumption and production (replacement of shortage goods by those available), monetary overhang, forced saving, excessive inventories, the humiliation and cost of long queues, and shortage-related bribes.

(ii) Wider choice, higher dollar wages and better access to imports.

With the switchover from a shortage economy to a demand-constrained one there has already been an improvement in the choice and quality of the domestically produced goods and services. Although real wages declined, the reforms have typically brought an increase in the dollar wage and, consequently, improved access of consumers to foreign goods.

(iii) Better access to foreign know-how.

Convertibility, higher dollar purchasing power and increased foreign direct investment have ensured the countries' access to foreign technology and skills. Large benefits from this access are already notable in telecommunications, banking, trade and the mass media.

(iv) Improved incentives.

The incentives to acquire or improve the right skills and work hard have become much stronger. There is consequently a better use of the latent entrepreneurial talent, especially in the private sector.

(v) Improved product composition.

The structure of the transition economies' output, in terms both of the broad sectoral pattern and of products within sectors, has changed substantially in the required direction.

(vi) Increased external creditworthiness.

Most of the countries concerned have increased international reserves and lowered their debt/export ratios. An exceptionally large debt reduction package was offered to Poland, partly in recognition of the pioneering role the country has played in bringing about the fall of the communist system and in charting the subsequent transformation. The reduction represented also, on the part of Western creditors, a realistic estimate of Poland's ability to service the unusually large inherited debt.



The combined impact of the benefits listed above varies between the post-communist countries. The largest impact may well be observed in Poland. As a result of a rapid growth of the private sector, in 1992 Poland also became the first country in transition to experience a sizeable recovery in industrial output.

### 4.2. The output collapse

Cumulative losses in GDP are likely to be in the region between 10% and 40%, which would make them comparable to the output losses suffered by Western economies during the Great Depression of the 1930s.

There are two main competing theories of the output collapse. One asserts that while the time profile of the GDP fall varies with the choice of reform strategy, the cumulative fall is related mainly to the inherited economic constraints (Gomułka, 1992). Given the weight and commonality of the constraints, the recession has inevitably to be deep everywhere. The recession is nevertheless deeper whenever: the initial price distortions are larger; inflation is higher; the private sector is smaller; the defence sector is larger; intra-CMEA trade accounts for a larger proportion of GDP; and the opening to Western competition in domestic markets is faster. Price liberalisation itself contributes to recession by virtue of the fact that prices increase faster than wages. This fall of real purchasing power is necessary in order to eliminate 'suppressed inflation' and the forced buying of goods (forced substitution). Price liberalisation results also in changed relative prices, which require changes in the entire product composition of the supply side. As relative prices of energy and other inputs increase a great deal, some production processes become loss-making and have to be discontinued. Superimposed on these changes are demand shifts related to the shrinkage of the defence sector and the CMEA trade. Owing to the presence of various rigidities, substantial resources become permanently useless or idle until redeployed and/or improved to produce what, under new prices and new trade links, is in demand and profitable. Since all these micro adjustments are large and necessary, the post-reform recessions are inevitable and, in terms of unemployment of labour, have to be deep and fairly long.

The implication of this theory is that post-reform sustainable supplies form J-curve patterns. These patterns necessitate the application of macroeconomic policies which ensure that aggregate demand falls a great deal, and falls quickly, to the level of much reduced sustainable aggregate supply. In other words, the essentially structural causes of these recessions imply that they cannot be reversed in a Keynesian way, through an expansion of aggregate demand (Gomułka, 1991; 1992; Siebert, 1991; Kornai, 1993). The recessions are created on the demand side, but must be solved on the supply side (Kastberg, 1991).



The other, rival theory relates the collapse mainly to reform policies themselves, stressing in particular government-induced ‘excessive’ reductions in aggregate demand, ‘excessive’ opening of domestic markets to foreign competition and absence of government assistance to restructure state enterprises. A strong criticism of economic policies in Central Europe on such Keynesian-Kaleckian grounds was recently offered by Bhaduri & Laski (1993). They note that the ‘paradox of thrift’ is nowadays often forgotten and that ‘some multilateral institutions recommend indiscriminately austerity, especially in government spending, both for developing countries in balance of payments difficulties and for the former command economies trying to make a transition to the market system’. In their view, ‘the economic disaster of pursuing the orthodox remedy of “austerity only” is now far too apparent in Eastern 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 wages – these economies have been precipitated into an economic depression which can be compared only with the Great Depression of the 1930s in the capitalist world’ (p. 5). They continue to remind us that ‘several democracies could not survive that economic debacle’, warn that ‘it will be unwarranted optimism to believe that all the fragile democracies of Eastern Europe can survive an economic depression of his magnitude, if it lasts much longer’, and quote: ‘Those who do not remember history are condemned to repeat it’ (p. 5).

Neither theory has been properly tested against the empirical evidence. Political parties and interest groups critical of the initial reforms do, however, make extensive use of the latter theory, while the reformers would typically think and act in terms of the former.

An analysis of the causes of output falls is clearly important for policy makers in their deliberations to formulate a proper policy response. The inevitable debate about this response leads typically to sharp divisions within governments, parliaments, the reform movements and the nations in general. The mixture of remarkable improvements for the better in some respects (and for some people) and large economic changes for the worse (often for the same people) has given rise to genuine confusion and anxiety among the population and a loss of confidence within the political elites as to what the next reform steps should be. This manifests itself in the ‘drop-out syndrome’ of the electorate (low participation rates in parliamentary and local elections) and in the split of the reform movements into a large number of political parties and factions within parties.

In many post-communist countries, particularly Russia and Poland, these postreform difficulties have produced a state of near-paralysis in parliaments and,

consequently, the governments are often unable to obtain approval of their proposed legislation. In the meantime unemployment rates have been and continue to be increasing. The recessions have also reduced the tax base while inducing an increase of pensions and other social security payments (see the next section). These developments pose a new threat – large budget deficits – and open a new political battlefield when governments respond to the threat by increasing taxes and reducing public expenditure. The problem is that, in fact, the scope for safe anti-recessionary policies, both macro and micro, is extremely limited and that the policy corrections needed to deal with actual or potential crisis in public finance are costly in social and political terms.

Recessions increase pressure on the authorities to make a number of modifications to their initial stabilisation policies. These are: to pursue an active industrial policy in order to assist state enterprises in their restructuring; to soften (or, better, eliminate) any tax-based incomes policy; to lower real interest rates and increase bank credit to enterprises; to slow privatisation of state enterprises in order to reduce the upward trend in unemployment; to promote exports and investment; to increase protection of local producers from imports by tariffs and devaluations. Some modifications are possible and have been or are being made, but these modifications are usually marginal compared with the demands of the situation and the expectations of interest groups.

The idea of conducting a really active industrial policy, apart from going against the principles of systemic reforms, is simply unrealistic in the initial phases of transition. For, in the new circumstances, the central authorities have neither the human nor the financial resources that such a policy requires. Such resources as exist are in the hands of enterprises themselves and banks. Crisis in public finance is forcing the governments to reduce badly needed public investment. Financing the budget deficit, if and when such a deficit appears, is in turn forcing banks to reduce (in real terms) lending to enterprises. This reduction in lending is also caused, in some countries, by the proliferation of bad debts and lower profitability of enterprises. This gives rise to an industrial policy by default (Gomułka, 1993). The need to use private savings to finance public consumption reduces the amount of savings available for non-government investment and keeps up interest rates.

The anti-recessionary policies that are possible concern mainly the exchange rate policy, tariffs and wage policy. The large appetite of consumers for imported goods, it needs to be recognised, represents a serious threat to local industries. External competition is important, but its level should be chosen with care. An active exchange rate policy should therefore replace, in the course of transition, the initial fixed exchange rate policy. Discrete or pre-announced gradual devaluations are needed to ensure that dollar wages remain low. In Poland, tariffs were

lowered in the first year of transition, but increased in the second and third years. Moreover, on 17 December 1992 a special import surcharge was imposed as part of a package of measures to deal with the budget deficit problem. The measure is also intended to protect domestic producers. This higher level of protection is temporary, and should be reduced again with progress in industrial restructuring, privatisation and a greater inflow of foreign direct investment. Wage policy is another candidate for modifications. A wage policy of some kind continues to be needed for macroeconomic reasons, but it should become more flexible in the course of transition to facilitate microeconomic adjustments. A restrictive wage policy is also a conveniently visible target for trade unions and opposition political parties. Attacks on this target are popular and therefore politically costly. With a fall in inflation and an expansion of the private sector, this cost can at some point exceed the gains from the policy in higher employment and lower rate of inflation.

Output tends to fall over a period of about two to three years. Following this *recession phase*, the transition economies enter a *consolidation phase* which should evolve gradually into a *recovery phase*. In the consolidation phase the level of activity is stable, inflation is high but declining, and unemployment is high and still increasing. Choice, accessibility and quality of goods and services are all much improved. The readjustment of foreign trade away from the former CMEA to the EC area is completed. The quality of the price system is close to EC standards. The levels of international reserves are sufficient to support current account convertibility of local currencies. A substantial share of the GDP, typically between a quarter and a half, is produced by the private sector, and the share continues to increase rapidly.

### 4.3. The crisis of public finances

Whatever the health of public finances just before the start of transition reforms, post-communist economies tend to develop a fiscal crisis in the course of transition. In 1992 the important countries which experienced the problem were Hungary, Poland and Russia. Despite massive efforts to raise revenue and cut expenditure, these countries' budget deficits (of the general government) were in the range between 5% and 10% of GDP. Moreover, the three countries announced further strong fiscal measures for 1993 in order merely to keep the deficits within the same range (Poland 5.1%, Hungary 6%, Russia 8%). In some cases and over some periods (Ukraine 1992) the deficits were much higher.

In Poland the tax revenue of the central government fell by 10% of GDP in 1991 and has remained low since then. This fall can be traced mainly to the collapse of enterprise profits. (For causes of this, see Schaffer, 1992.) The new

profitability is typical of the levels observed in competitive market economies and therefore cannot be expected to improve much. But since subsidies also declined by about 10% of GDP, the fiscal problem should have not appeared. It did in fact appear because of another reform-related development: a sharp increase in the budgetary transfer to two pension funds and to the unemployment fund, from 4% of GDP in 1987 to 8% in 1990-91. The cost of unemployment benefit is a relatively minor burden. The main cause of the fiscal crisis has been the meteoric rise of expenditure on pensions (Gomułka, 1993).

In Hungary combined tax revenues of the general government represented, in 1990, 51.8% of GDP (Revesz & Zalai, 1992, Table 2), compared with 42% in Poland. Hungary's stronger revenue position was due mainly to higher taxes on goods and services (VAT, excise and import duties), which yielded 20.3% of the GDP, about twice the Polish share.

The 'dramatic deterioration', the phrase used by Revesz & Zalai (p. 17), of Hungarian public finances in 1991 occurred as a result of lower than planned tax revenues rather than higher expenditure. Both the VAT and payroll taxes of employees have yielded, in Hungary as well as in Russia, significantly lower revenues than planned. There is apparently evidence that, in Hungary as well as other countries in the course of transition, it becomes increasingly difficult for the authorities to enforce the tax laws.

We may summarise this discussion as follows: the major cause of the fall in the real value of tax revenue has been the recession. However, revenue tends to decline more sharply than GDP, while expenditure tends to decline less than GDP. The two tendencies lead to the budget deficit, and this is so despite sharp reductions in subsidies and public investment.

The two key questions for reform governments are the following: what measures to take to contain and reduce budget deficits, and how to get approval of the measures in parliaments, as well as some minimum support for them from the general public. Economic and social considerations influence the answer to the first question, while political considerations affect the answer to the second question. In practice, proposed measures would already have taken political constraints into account.

To discuss these questions let us consider the example of the package of measures which the Polish policy designers came up with in the latter part of 1992 for implementation in 1993. The total package represented about 6% of expected GDP in 1993. The size of the package was the initial crucial policy decision. This decision was motivated by the desire to bring the inflation rate below 40%, that is, somewhat lower than in 1992. The second crucial decision concerned the broad composition of the package: increased taxes versus reduced expenditure.

The detailed composition of the package was as follows (the effect of each measure in terms of % of GDP is given in parenthesis):

*Revenue:* An increase in the statutory turnover tax rates (1.5%); a temporary import surcharge (0.9%); freezing personal income tax brackets (0.5%); and freezing the depreciation allowance for investments made before 1990 (0.3%).

*Expenditure:* Lowering the base on which pension benefits are calculated (1.5%, about 1% in 1993); reducing wage bill allocations in real terms in the budgetary sphere (0.7%); and reducing current non-wage expenditure in the budgetary sphere (0.8%).

The package hit everyone, but its composition was designed to distribute the pain in a manner that had a chance of being seen in parliament and by the public as fair.

There was also the question of opportunity costs, that is, the costs associated with the inflation tax, higher interest rates and lower attractiveness of Poland to foreign investors, that could have been incurred in the absence of the package; or alternative costs, if other measures were taken instead.

## 5. Lack of experience with democratic politics

We end with a few observations about politics in transition, a subject which is outside the scope of the article but upon which we have touched in the course of our discussion. The socially very costly phase of transition comes at a time when democratic institutions are in their infancy. Moreover, the inherited constitutions and other basic laws are not fully suitable in the new circumstances. In particular, the division of power between the main central institutions is often unclear.

Democratic government is founded on broadly based trust, which is renewed through elections and daily democratic politics. But this renewal of trust is difficult when there are too many small parties with ill defined policies and when most politicians lack experience of efficient communication with the electorate. Such circumstances often produce confusion and political instability, which of course hinder the process of economic reforms and pose a continual threat to democratic politics. The result "of this so far has been frequent changes of governments and, at later stages of transition, legislative near-paralysis.

Frequent changes of government also provide an opportunity to employ the political capital and the professional standing of a large pool of politicians in the interest of the transformation during the crucial phases of reform. This capital and that standing are assets which burn quickly under the crisis conditions of the transition. Changes of government can therefore be interpreted as an indication that reformers, in designing their policies, have the long-term interests of their countries in mind rather than the preservation of their own short-term power.

The large number of political parties which now operate in most of these countries can make it difficult to form a majority government. The introduction of electoral systems with high thresholds is clearly needed. However, it may be inappropriate to set the thresholds too high too early. For, initially, none of the parties has a record and they are therefore unknown quantities to the electorate. The large pool is therefore an asset in the sense that it enhances political competition, promotes tolerance and offers small parties the chance of becoming winners. Perhaps more importantly, it also reduces the risk of political alienation by large sections of the electorate, the risk of groups under-represented in parliaments seeking to influence the political process through extra-parliamentary means. The political reformers face here a trade-off between instability of governments and instability of countries.

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## 5. The IMF-supported programs of Poland and Russia, 1990-1994: Principles, errors, and results<sup>\*1</sup>

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**Abstract:** The paper discusses four IMF-supported adjustment programs in Poland, 1990-5, and two in Russia, 1992-4, in terms of the underlying theory, policy objectives, assumptions, policies, errors, and results. The paper suggests that the role of the IMF and the World Bank has been helpful and significant but, compared to the influence of domestic factors and local reformers, relatively modest. Transition - related features of the programs are the focus of the analysis. The specific topics include the choice of nominal anchors, the speed of disinflation, the choice of performance criteria, and the role of foreign economic assistance.

*Journal of Economic Literature* Classification Numbers: E63, E65, P41.

The primary objective of this paper is to discuss the IMF-supported adjustment programs of Poland and Russia in terms of the underlying theory, policy objectives, explicit and implicit assumptions, proposed policies, major errors in assumptions and policies, and actual results. Throughout this discussion, the intention is to identify the influence of systemic features and transition circumstances. The analysis suggests that the roles of the IMF and the World Bank have been helpful and significant but more modest than generally presumed.

Part I of the paper provides a discussion of the broad policy objectives, common and separate, of the authorities of Poland, Russia, and the two Bretton Woods institutions, the IMF and the World Bank. Part II outlines the theory underlying the standard IMF adjustment programs. Part III collects and discusses what, according to this author, have been the major errors in assumptions and policies.

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\* *Journal of Comparative Economics*, 1995, 20(3): 316-46.

<sup>1</sup> Presented at the conference on the Role of International Financial Institutions in Eastern Europe, Munich, April 12-14, 1994. The paper benefited much from criticisms by conference discussants Lothar Altman, Wolfgang Quaisser, and Ben Slay, as well as from extensive and helpful comments by Leszek Balcerowicz, Peter Boone, Josef Brada, Marek Dąbrowski, Stefan Kawalec, Richard Portes, Markus Rodlauer, and Mark Schaffer. Many drafts of this paper have been word-processed patiently and skillfully by Pat Nutt and Nadine Moles.

The aim is to identify the origins and the implications of those errors. Part IV provides an analysis of the actual adjustment programs. The major feature of this analysis is the discussion of aims and results of the various programs. Finally, Part V addresses the issue of the role of foreign financial assistance in transition economies.

## **1. Broad policy objectives**

The main economic actors whose policy objectives I consider in this paper are the local reformers in Poland and Russia, the IMF, and the World Bank. The local reformers include above all the successive finance ministers and presidents of the central banks who are the main negotiating partners for the two Bretton Woods institutions (BWIs) and, often, actual policymakers. They and their aides and advisors are also the key policy designers. The governments, including the President in Russia, and the parliaments are the key institutional partners and formal policy makers. The immediate analytical problem, especially evident with respect to Russia, is the wide variation in views among reformers at any time and the considerable changes in their views over time. Some changes of objectives have also occurred on the part of the IMF and the World Bank. Nevertheless, at a very broad level, both local reformers and these two institutions have important policy objectives that have been common and stable. In terms of specific issues, there have also been distinct differences between the objectives of the IMF and the World Bank, and between these two institutions and the local reformers. Because I wish to comment on reform programs in terms of success and failure, and such an evaluation depends critically on the objectives of the program designers, the nature of these objectives is important.

### **1.1. Differences in policy objectives**

At the level of broad and long-term objectives, the approaches of local reformers and the Bretton Woods institutions have been similar. These are expressed well by the first Polish letter of intent: “the sustained growth of output and living standards and the strengthening of our external position over the medium term ... are the ultimate goals of our efforts” (December 22, 1989, p. 1). The proposed strategy to achieve these goals had the familiar three, generally accepted, components: extensive and rapid liberalization of prices and trade, macroeconomic discipline, and market-oriented structural and institutional reforms, particularly privatization. Safety nets and external assistance were additional, supportive

features. Most reformers, especially in Poland but probably also in Russia, would even agree with the IMF that “it has taken us far too long to shake off two dangerous misconceptions of the 1970s: first, that monetary stability and growth are at odds with one another; and second, that external financing – borrowing – is the best path to growth” (Camdessus, July 11, 1990). To meet popular criticisms, the Director of the IMF also explained that we are striving to improve the design of our programs to ensure a better blend of adjustment, growth and equity, ... we encourage governments to avoid raising taxes on the basic staples ... and to protect critical social expenditures” (p. 4).

However, the traditional and central concern of the IMF has been neither economic growth as such nor equity but macroeconomic stability in the short and medium term. Its main role is that of the major global regulator of economic policy, acting on behalf of the common interests of all member states, particularly of the G-7 group, to assist in maintaining a proper international economic order. Its services are called upon when that order is endangered, and Fund programs are designed specifically to assist in removing danger and restoring order. Hence, the core policy concerns of such programs are the restoration and sustainability related to external and internal macroeconomic equilibria. The policy objectives and the performance criteria are related to these concerns. The recipients of the IMF funds are typically central banks, not governments or enterprises, because the primary purpose of such loans is to strengthen the external position of a country during the adjustment period.

While the IMF is concerned mainly with creating the right macroeconomic conditions for growth, the World Bank is a development agency concerned with the promotion and financing of economic growth itself (Table 1, next page). To fulfill this role, the World Bank aims to create the right economy-wide microeconomic conditions for growth, largely by promoting the liberalization of prices and trade, the removal of subsidies and excessive import tariffs, market competition, and privatization.

The coordination of policies for transition economies between the two sister organizations, however, became somewhat of a problem. Institutional and other structural reforms are the core of the transformation, and they are neither macro nor microeconomic. In principle, these reforms were supposed to be the province of the World Bank, but the immediate problems in Poland, 1989-90, and in Russia, 1992-4, were those of stabilization. This initial primacy of macroeconomic issues gave the IMF the leading role in formulating conditions for all Western assistance, including that of the World Bank. The policy interest of the IMF has consequently expanded over time to cover all economy-wide market-oriented structural reforms. Except on the occasion of negotiating the so-called Structural

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Adjustment Loan in Poland, in spring 1990, the role of the World Bank has been reduced to discussing sectoral adjustments and specific, government-supported investment projects.

**Table 1.** Poland: credit lines of the world bank and their utilization until 31 January 1994

Name	Receiving institutions	Approval date	Sum in million \$US	Utilization in million \$US				Cumulative utilization 1.01.1990-31.01.1994	
				1990	1991	1992	1993	In millions	In %
Ind. export develop.	NBP	6.II.90	260	10.1	17.7	12.0	20.4	60.2	23
Agricult. export develop.	NBP	6.II.90	100	14.9	9.1	32.4	15.0	71.4	71
Environmental management	G	24.V.90	18	0.5	0.4	6.5	3.0	10.5	58
Transport general	E	1.V.90	4.75		1.0	0.6	1.4	3.0	63
Transport railways	E	1.V.90	145		16.0	18.5	20.6	57.3	39
Energy resource develop.	G	5.VI.90	250		32.2	46.6	81.1	161.0	64
SAL	G	31.VII.90	300	28.4	270.9	0.7		300.0	100
Telecommunications	G	23.IV.90	120		24.3	23.2	1.8	49.2	41
Employment promotion	G	23.VI.91	100		2.0	3.1	0.1	5.2	5
Financial inst. develop.	G	11.VI.91	200			75.1	7.2	82.3	41
Privatization restruct.	G	11.VI.91	280		0.1	74.6	8.2	82.9	30
Agricultural develop.	G	11.VI.91	100			1.0	4.7	5.7	6
Heat supply restruct.	E	26.VI.91	285			47.5	25.3	73.2	14
Health	G	7.V.92	130						
Private enterprise develop.	E	7.VI.92	60						
Housing	G	25.VI.92	200				4.6	4.6	3
Roads	G	9.III.93	150						
EFSAL	G	4.V.93	450				27.7	100.0	33
ASAL	G	4.V.93	300				4.7	4.9	3
Forestry	G	29.VII.93	146						
TOTAL	Poland		3598.75					1071.3	30

Source. Poland's Ministry of Finance.

Note. NBP = National Bank of Poland, G = Government, E = Economy

Since September 1989, the Polish authorities have taken the view that the two institutions' long-term objectives coincide with the ultimate interests of Polish

reforms so much that the success of those reforms could become for them an important policy objective in itself.<sup>2</sup>

A special problem for Poland was its large foreign debt. A very important and distinctive aim of the Polish reformers was therefore to enlist the international authority of the BWIs in supporting the case for a deep reduction of Poland's foreign debt, which was seen as a precondition of long-term external viability and growth. The eventual reduction of Poland's debt by about US\$20 billion has been by far the dominant form of external financial assistance. The intermediary role of the BWIs, and especially of the IMF, in obtaining the reduction has been significant.

The first common objective of the governments of Poland and Russia was to gain the IMF's support in order to obtain international credibility for their proposed reforms. The second common objective was that of the central reform groups, based largely in the finance ministries and the central banks. It was to enlist the professional authority of the BWIs in supporting their policies within the government, above all, and to some extent also in the parliament and the country in general, in order to obtain internal credibility for the reforms. For this purpose, it was useful for the groups to stress, even exaggerate, to domestic audiences the importance of external assistance and the influence of the BWIs among Western governments, banks, and private investors. The third common objective was to secure new credits (Table 2). Finally, the missions of the BWIs represented international think tanks of highly professional experts who have been providing Polish and Russian reformers with systematic analysis of the two economies, helping them to identify major economic problems and to formulate specific policy responses. The fourth common objective was therefore to secure and benefit from the BWIs', and particularly the IMF's, know-how.

## 1.2. Policy arguments and controversies

Policy controversies in Poland between the BWIs and reformers concerned important issues such as energy pricing; the role of expectations in formulating the exchangerate policy in 1990 (see footnote 9); the level of interest rates in early 1990; the methods for the financial restructuring of banks and enterprises in 1991/1992 (Kawalec *et al.*, 1994b); the form of wage policy in 1990; the choice of nominal anchors in 1991-3 (see Section 2.2 of part 2); the speed of state-led commercialization and privatization, in particular the mass corporatization

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<sup>2</sup> As in other countries, in Poland and Russia there were, of course, policymakers and legislators who were deeply suspicious of the BWIs' intentions.

program in 1990/1991 and the mass privatization program in 1990-4; the ideal level of subsidies; and the level of tariff protection.

However, most of the disagreements were either relatively minor or on relatively minor issues, and they were usually resolved by the BWIs accepting the Polish view.<sup>3</sup> Of overriding importance has been the agreement, initially much stronger in Poland than in Russia, that quick policy actions are required to liberalize prices and foreign trade, to impose a restrictive macroeconomic policy to discipline enterprises and stabilize liberalized prices, and to establish a process for fast privatization. Following the Polish experience, the common ground in Russia also included the acceptance of the view that a large fall in output might be an unavoidable consequence of the accumulation of inherited structural problems and a necessarily rapid pace of system transformation following the sudden collapse of the old political system.

Perhaps the most controversial issue has been the initially great emphasis placed by the IMF on a very rapid reduction of the inflation rate during transition. The IMF's view on that matter has been changing somewhat, but the initial position was that low inflation, while not sufficient, is nearly necessary to effect a transformation to a market economy successfully. A low-inflation environment was taken by the IMF to be a monthly inflation rate of less than 1%. It was deemed essential that this rate be achieved within one year of the stabilization effort. This particular policy aim was adopted by Poland for the end of 1990, and later for 1991. This initial view is the main reason that despite the large amount of progress in liberalization and privatization reforms in Russia, the IMF was most reluctant to support the reforms financially in 1992-3. In hindsight, it is fairly clear that inflation need not be low for a system transformation to be successful.

The IMF is an institutional guardian of low inflation, and its credibility worldwide depends on how well that role is discharged. It may therefore have developed an institutional bias toward attributing excessive resource costs to high inflation and refusing to accept that, in conditions of extraordinary falls in output, which are a specifically transitional feature, welfare benefits arising from income redistribution from rich to poor, among both households and enterprises through the inflation tax may be sizeable and socially important. But it is an exaggeration to maintain, as Portes (1994b) does, that "[t]he main trap ... was in

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<sup>3</sup> The IMF's technical expertise was still important in providing a critical consistency analysis of the Polish programs, particularly the stabilization program for 1990. The macroeconomic assumptions underlying the state budgets, the budgets themselves, and the policies to implement the programs were, with few exceptions, of Polish origin. Therefore the credit and blame for the results of the programs should go largely to Polish reformers rather than Fund experts. By and large the same applies with respect to Russia.

the over-emphasis on macroeconomic policy itself.” Portes goes on to argue that it was wrong for the non-Fund agencies, e.g., G7, G24, the EC, and the World Bank, to make aid “conditional on agreement to a stabilization programme with the Fund and thereby to put its priorities at the top of policy-makers’ agendas” (p. 1184). Even if one accepts this assessment, as I am inclined to do with reference to the IMF advice for Poland in the years 1989-91, macroeconomic stabilization is still an important aim to achieve fairly quickly. The destructive impact of high inflation is particularly high when inflation is caused by large subsidized credits to enterprises. A loose macroeconomic policy then interferes with needed structural adjustment, as was the case in Russia in 1992-4<sup>4</sup>.

**Table 2.** Poland: credit lines from institutions other than the world bank, until 31 dec. 1993

Credit given	Credit taken	Credit	Equity capital	Utilization (%)
EBRD <sup>a</sup>	Private sector	264.0	75.5	7
IFCD	Private sector	158.1	32.6	7
EIB <sup>b</sup>	Economy	303.0	-	45
EBRD <sup>a</sup>	Government	165.5	-	1
IMF <sup>c</sup>	NBP			
(i) Standby 20.11.9014.11.91		545 (about \$710)		60
(ii) EFF IV.91-V.93		1828.6 (about \$2500)		16
(iii) Standby MI.93-IV.94		475 (about \$600)		80
G-24	Government	1000 (stabilization fund)		100

Source. Poland's Ministry of Finance, "Information concerning the utilization of foreign credits," mimeo, 23 February 1994.

<sup>a</sup> Million US dollars.

<sup>b</sup> Million ECU.

<sup>c</sup> Million SDR.

Still, in transition economies, relative prices need to undergo exceptionally large changes, and these are easier to accommodate when the inflation rate is fairly high, or at least moderate, for a while (Balcerowicz and Gelb, 1994). There may, therefore, be a case, in transition economies, for a more gradual disinflation path than the one the IMF so strongly insisted upon initially, a path of the type actually followed by Poland or one somewhat steeper: 3000% in 1989, the last five months of the year, on an annual basis; 249% in 1990; 60% in 1991; 44% in 1992; 38% in 1993; 30% in 1994; and about 25% expected in 1995, measured by within-year changes of the consumer price index. This view has recently been given

<sup>4</sup> When inflation is not fully anticipated, which may have been the case in Russia in 1992, subsidies to enterprises financed by central bank credit creation tend to raise real purchasing power and therefore help to sustain old output (Kierzkowski *et al.*, 1994, p. 33).

support by several economists (Bruno, 1993; Dornbusch and Fischer, 1993; and Layard, 1994). Initial proposals for instant stabilization of liberalized prices also overlooked that, in the course of transition, a serious budget deficit problem tends to develop for good, transition-related reasons: a smaller tax base as economic activity shrinks, initially inappropriate tax systems, poor tax administration, and the growth of a shadow economy. In market-based economies, the cases of successful gradual disinflation from very high inflation rates have been rare, but Poland in 1989 and Russia in 1991-4 did not belong to the category of true hyperinflation cases. The Polish and Russian experience suggests that the reasonable aim of stabilization policy should be to ensure that the annual inflation rate falls to some 20 to 40% in the medium term, during a period of falling output, and to below 10% during the recovery period. In 1994, Poland adopted the latter objective for 1997, primarily in order to reduce interest rates and stimulate investment but also to facilitate negotiations concerning Poland joining the European Union. For Poland to actually join the Union it will have to achieve a further reduction of inflation, probably to about 3% per year.\

## 2. The conceptualization of policies and performance criteria

The standard IMF program has five interconnected components: fiscal, monetary, external balance, incomes, and structural and institutional changes. It sets principal policy aims and formulates policies in all five areas to achieve its aims. Given initial conditions and some behavioral and other assumptions, it also formulates performance criteria for the purpose of monitoring the program's implementation.

### 2.1. The macroeconomic consistency conditions

Using standard notation, a demand-driven macroeconomic model may be written in the form of ten equations,

$$Y = C(Y_d, M/p) + I(\Pi/p, r) + G + X(p_q) - p_q Q(p_q, Y), \quad (1)$$

where  $p_q = ep^*/p$ , the ratio of foreign to domestic prices,  $e$  is the exchange rate,  $r$  is the interest rate,  $\Pi$  is profits,  $F_d$  is disposable income,  $I$  is investment,  $X$  is exports, and  $Q$  is imports, all in real terms;

$$Y_d = Y_d(Y, T/p, r) \quad (2)$$



$$T = T(pY, IT, \text{tax rates}) - \text{transfers} \quad (3)$$

$$\Pi = pY - wL(Y) \quad (4)$$

$$M_d = V(r, i^e)pY \quad (5)$$

$$M_s = eR + \int (pG - T)dt + K(r), \quad (6)$$

where  $T$  is net government revenue,  $w$  is the wage rate,  $L$  is employment,  $R$  is the stock of net international reserves,  $K$  is the stock of bank credit to the nonfinancial sector of the economy, and  $i^e$  is the expected inflation rate; and

$$M_d = M \quad (7)$$

$$X - p_q Q + NCF = \Delta R \quad (8)$$

$$p = p(w, e, r) \quad (9)$$

$$w = w(p - 1, p^e, u, \dots), \quad \text{or} \quad pMP_L = w, \quad \text{or} \quad w = \bar{w}, \quad (10)$$

where  $NCF$  is the net capital flow,  $p^e$  is the expected price level,  $w$  is the unemployment rate, and  $MP_L$  is the marginal product of labor.

The ten endogenous variables in this model are  $Y$ ,  $Y_d$ ,  $n$ ,  $T$ ,  $M_d$ ,  $M_s$ ,  $p$ ,  $w$ ,  $r$ , and either  $e$ , under the floating exchange rate regime, or  $R$ , if the exchange rate is exogenously fixed. In the system above, the variables influenced strongly by expectations,  $p^e$  and  $i^e$ , are regarded as given parameters.

In terms of our four macro components of the program, the relevant variables are:

fiscal:	the budget deficit, $BD = pG - T$
monetary:	$r$
external:	$e$ and $R$
incomes:	$w$ .

The quantity of money is endogenously determined:

$$M = eR + \int BDdt + K(r).$$

In order to stabilize quickly, the wage rate,  $w$ , is sometimes fixed or subjected to an incomes policy. In this case, under the fixed exchange regime,  $w$  and  $e$  are exogenously given and all the other variables of the model are functions of the two variables. In particular, given  $G$ , the rates  $w$  and  $e$  would determine the price level as well as the interest rate, the budget deficit, NIR (net international reserves), and the demand for credit,  $K$ , and for money,  $M$ .

## 2.2. The Question of Nominal Anchors

The preferred IMF approach in 1989-91 was to have both  $e$  and  $w$  serve as nominal anchors of a stabilization program, as was the case in Poland in 1990. Therefore, the IMF felt at a loss in Russia in late 1991 when neither of the two variables could serve as an anchor. Given the virtual non-existence of international reserves in Russia at the start of the transition in 1992, a floating exchange rate policy was accepted by the IMF as inevitable and superior to a fixed exchange rate combined with rationing of the foreign exchange by central authorities.

The budget deficit outcome is conditional on meeting the revenue target,  $T$ , and choosing the level of government spending,  $G$ . In transition economies, and especially in periods of high inflation, both taxes and government spending undergo large changes and it is they, rather than the exchange rate or the level of international reserves, that are under direct government influence. In such circumstances, the evolution of  $BD$ , bank credit to enterprises and households, and possibly of  $w$  decides the level of prices and the rate of inflation. In this case, the policy instruments remaining under the formal control of the Central Bank, such as the money supply, the nominal exchange rate, and the nominal interest rate, are decided to a large extent by developments that are outside of the Central Bank's control.

The argument in favor of using a fixed nominal exchange rate as the policy instrument for bringing the rate of inflation down rests mainly on the proposition that once the authorities are publicly and strongly committed to the policy, they would judge it politically less costly to make the required adjustments to fiscal policy, with an aim of reducing bank credit to the government, or to interest rate policy, in order to reduce credit to enterprises and households, rather than to devalue the exchange rate.

It is safe to adopt policies based on this proposition only when reformers enjoy considerable freedom of action, as they did in Poland at the end of 1989 and the beginning of 1990. In most transition economies and most of the time the political conditions are volatile and the freedom to act is limited. This author therefore promoted the doctrine that exchange rate policy in Poland should be subordinated to the needs of securing and maintaining external equilibrium, while fiscal, monetary, and incomes policies should address the inflation problem. The implication of this separation principle has been that the real exchange rate should be set at a competitive level, though not excessively competitive, and should be stable. This has indeed been the policy in Poland since late 1991 (see also footnotes 5 and 9). The stability of the real exchange rate was achieved through the very transparent instrument of daily devaluations at a preannounced rate linked to anticipated inflation, with the exchange rate being corrected further when necessary

by additional small and infrequent devaluations linked to past inflation. The policy has been adopted and maintained despite considerable and, given its primary responsibility for external equilibrium, somewhat unexpected misgivings by the IMF, which wished it to play a more active role in reducing inflation.

Portes (1994b) notes that, with respect to the exchange rate policy, “the trap was not early convertibility or fixed nominal exchange rates where these were implemented, but rather over-devaluation” (p. 1184). However, a large upfront devaluation in Poland and other countries brought about important benefits that Portes and other critics of the exchange rate policy actually adopted tend to overlook or undervalue: it protected domestic producers from excessive imports in the vital initial stage of transformation, and it stimulated exports at a time when domestic demand fell sharply and international reserves were low. A significant over-devaluation does have a major drawback in that it opens up a gap between world prices and domestic prices for tradeables. The consequence is that external competition can not help arrest a rapid increase in domestic prices in the period following devaluation, despite the fact that the nominal exchange rate remains constant (Williamson, 1991; Gomułka, 1993). For the exchange rate to be a truly effective nominal anchor, the magnitude of its undervaluation should not be excessive. If it is, there is either no solid anchor in place or that role is played by the money supply. In Poland, the money supply was a solid anchor only in the first quarter of 1990, while the exchange rate played the role of anchoring the price structure strongly only in early 1991. From that perspective, the upfront devaluation in Poland was clearly excessive, and it was even more excessive in Czechoslovakia and the former Soviet Union. However, the anchoring role is, in the initial phase of transition, less important than the benefits of a low real exchange rate mentioned earlier (see also footnote 5).

Portes also states that “there was insufficient clarity regarding the exchange-rate regime.” In fact, it was assumed already in the autumn of 1989, though not stated in official documents, that a form of crawl might have to, and probably would, follow the peg once the real exchange rate appreciated to an appropriate long-run level.

When the central authorities set the interest rate at a level too low to bring the market for credit into equilibrium, which is often the case in transition economies, credit to enterprises is subject to an administrative limit imposed by the central bank. In this case, this credit limit, in addition to direct or indirect central bank financing of the budget deficit, is the second main nominal variable influencing prices and is in this sense a sort of nominal anchor. This has been the case in Poland in 1990-1 and Russia throughout 1992-4, where, however, both anchors were highly flexible.

### 2.3. Hazards in the choice of macroeconomic and other assumptions

The starting point for a macroeconomic program designer is usually the price path, specified in terms of the monthly inflation rate, in the course of the period covered by the Fund-supported program. Achieving the targeted price path is typically a principal short-term policy aim of the program. If it is a stabilization program, that price path would show a strong disinflation. Already at this stage of program design, the problem is to estimate correctly the unavoidable cost-push impact on prices of intended policy actions. This impact is largest at the start of transition and, as I discussed earlier, this is also the time when the choice of disinflation path represents the greatest hazard.

The second major step in designing a program involves the use of the Fisher equation to determine the quarterly changes in the quantity of money that are consistent with the targeted price path, Eq. (5) above. At this stage, assumptions have to be made about the level of real GDP and the velocity of money circulation. Again, in a period of systemic transformation, the risk is that the assumptions adopted are seriously wrong, as in Poland in 1990 and 1991 and in Russia in 1992.

The third step is to divide the available money increase between credit to the government, credit to the nonfinancial sector of the economy, and a change in the NIR, Eq. (6). The money increase thus represents a budget constraint. In order to decide on the uses of new money, it is essential to know the size of the budget deficit that would have occurred under the existing legislation, the likely net inflow of foreign capital, and the size of the so-called directed credit to economic units. During systemic transformation, major revenue and expenditure reforms take place, the level of economic activity changes rapidly, and fiscal discipline is difficult to maintain. Assumptions underlying the government budget are consequently often wrong by wide margins, as in Poland in 1990-1 and in Russia in 1992-4.

The fourth step is the consideration of detailed policy measures that appear to be needed to bridge the gaps between the targets implied by the three-way division made at the third stage of the permissible money increase and the likely outcomes in the absence of such measures. By the nature of things, these measures are focused on public finances.

To achieve consistency, the analytical framework cannot be a linear sequence of steps as outlined above but must be of a general equilibrium type. In particular, the original assumption concerning the targeted inflation path may be altered in view of the necessary policy measures implied by the analysis at stage four, and this may lead to the next round of program design.

## **2.4. The inherent tension between strict quantitative criteria and loose quantitative analysis**

The choice of performance criteria by the B WIs reflects the strongly macro-economic and short-term orientation of the IMF and the microeconomic and mediumterm orientation of the World Bank. The IMF criteria are typically few, quantitative, and quarterly. The interesting feature of these programs is that the inflation rate is a policy objective rather than a binding target. This is in recognition of the fact that policymakers do not control inflation directly, and their indirect control is imprecise (IMF, 1986, p. 16). The key criteria are as follows:

- (a) the upper limit for the cumulative change in net credit of the banking system to the general government;
- (b) the upper limit for the cumulative deficit of the general government;
- (c) the upper limit for the cumulative change in the net domestic assets of the banking system; and
- (d) the lower limit for the cumulative change in NIR in convertible currencies of the banking system.

There may also be a limit for changes in average wages or wage funds in the socialized sector, and a limit on the contracting or guaranteeing of new external debt.

These criteria are not different in conception from those of the standard IMF program; they are, in fact, the same. This underscores my earlier point that, despite substantial interest in, and intensive policy discussions about, systemic transformation reforms, the inflation rate and the external position, and not these reforms as such, remain effectively the central focus of IMF programs for transition economies. The only significant concession for transition concerns the quality of programs as reflected in the reduced tightness of criteria. Of the three types of programs, the Extended Fund Facility, the Stand-By Agreement, and the Systemic Transformation Facility, the first is the most demanding and the last is the least demanding. Fund programs for economies in transition are usually of the latter two categories. The credibility of the IMF requires that it treats the agreed quantitative targets seriously. While waivers may be granted, the programs are usually suspended if limits are breached by significant margins.

## **3. Major errors in assumptions and policies**

Part 4 of the paper discusses actual programs and their outcomes. However, it will be useful to collect and discuss briefly in this section the major errors in assumptions and policies. It will be evident that these errors are related mainly

to the exceptional complexity of the transformation process, the influence that difficult to predict political developments have on economic policies, the presence of large uncertainties, and the limited experience of the program designers at the start of the process. In these circumstances the forecasting errors were virtually inevitable and these in turn influenced policies. Some errors (4, 7, and 9 listed below), however, were in policy design and implementation. Despite those errors, the Polish stand-by program for 1990 was successful on its own terms, but errors contributed to the failure of the Fund-supported program for Poland in 1991 and for Russia in 1992-3. The third Polish program, for 1993, was almost error-free and exceptionally successful. An important difference between Poland and Russia was that Polish programs were negotiated by authorities with the political will to implement them. Most programs for Russia, especially in the years 1992-3, were proposed and accepted by the Russian authorities without adequate commitment to implement them.

## Poland

*Error 1.* Assumptions concerning GDP growth:

–3.5% in 1990 against the actual –11.4%, and

+3.5% in 1991 against the actual –7.4%.

The so-called actual numbers above are, in fact, the official estimates of measured changes in GDP. The actual GDP declines were significantly lower than officially stated (Zienkowski, 1992). Nevertheless, these forecasting errors were probably large, especially for 1991, when the size of the collapse of the CMEA and the impact of that collapse and of the dollarization of trade on the former CMEA area were grossly underestimated. In the program for 1990, little attention was given to the other two phenomena that deepen the fall of output: the destocking of inventories and high savings of households. While these assumptions on GDP growth were made by the Polish Finance Ministry, they were accepted by the IMF.

*Error 2.* The assumptions concerning corrective inflation in the consumer price index, following price corrections and price liberalization, compared to the average prices of December 1989: 45% against the actual 79.6% in January 1990, and 75% in Q1, 1990 against the actual 133%.

The IMF team produced estimates, dated December 5, 1989, that predicted the following monthly inflation rates: 42.6% in January, 16.6% in February, and 4.9% in March, 1990. This prediction formed the basis for the choice of the disinflation path in the course of 1990 and the choice of the exchange rate in the Polish stabilization program for 1990. In view of the fact that both choices were

very important and both have subsequently attracted strong criticism, it may be useful to give more details of the underlying analysis. The estimates of the IMF team were based on the following assumptions:

The Q1, 1990 price effect of excess liquidity was to be 20%, the excess being absorbed by coal and other energy price increases, 12% in January, 5.4% in February, and 1.7% in March.

The coal price increase would be 500% and the gas increase 200% in January; these were approximately the actual increases.

The January wage increase would be equal to inflation minus the impact of exchange rate adjustment. Wage levels would remain fixed in February-April and then would be indexed on inflation of the same month with the 70% coefficient from May. This assumption was approximately correct, except for January, when the wage increase was much lower (see footnote 9).

The new exchange rate would be 9706 zloty to the dollar, the result of adding up the December unification level of 5888, export incentives due to be removed, 430, the effect of January inflation, 2505, and a 10% safety margin of 882 zloty. The actual rate chosen was 9500.

The wage increase was assumed to be 26.5% in January, but its contribution to inflation would be only 4.3%, and then 2.1% in February and 0.7% in March.

The cumulative Q1, 1990 price impact of devaluation was thought to be 24%, 14.4% in January, 6.3% in February, and 2% in March.

At the request of the Polish authorities, I discussed these projections with the IMF's team on December 6, 1989. My notes show that I proposed corrections, including the price impact of wage increases that were three times higher, energy price increases that were twice as high, no impact of the stock excess demand, which I assumed to be already nonexistent, but an impact of the flow excess demand of 10% in January, which implied the following inflation rates: 70% in January, 30% in February, and 10% in March. The actual rates were 79% in January, 24% in February, and 4.7% in March. My projection for Q1, 1990, was therefore close to the actual outcome, 143% against the actual 133%. The actual wage increases were lower than assumed by both sides in these discussions, while neither side took full account of the cost-push impact of sharp increases in interest rates and depreciation rates or the December 1989 devaluations. It is quite clear that both sets of estimates were little more than educated guesses, but the IMF showed a strong tendency to come up with low estimates for corrective inflation.

The much lower IMF-projected inflation rates were seen by the Polish side as probably unrealistic, but they were accepted nevertheless as a built-in safety margin of the program. The point was that some expenditures of the government budget and money supply targets of the Central Bank would have to be increased



if the projected inflation rate were also increased. The actual fiscal and monetary policies were consequently, in the first half of 1990, much tighter than in the program, and so helped to increase exports and achieve the targeted disinflation path, though probably at some cost in the form of reduced output (IMF, 1990b; Gomułka, 1991b).<sup>5</sup>

*Error 3.* The misinterpretation of the reasons for large taxable statistical profits in 1989 and 1990, the consequent large underestimation of holding gains during that period, and a large overestimation of taxable profits in 1991.

These matters are discussed best in Schaffer (1993). The presence of holding gains was known in principle, but the absence of good data on inventories prevented the Polish/IMF program designers from coming up with a credible estimate of any gains or their impact on profits and budget revenue. In the absence of such estimates, a popular hypothesis in 1990, later abandoned, was that very high profit margins and sharper-than-assumed output falls reflected the monopolized market structure.<sup>6</sup>

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<sup>5</sup> On December 7, 1989, the IMF team produced the so-called Alternative 2 projection, in which the impact of price liberalization, including energy price rises, was increased from 20% to 40% in Q1, 1990. The impact of wage rises was also increased somewhat, in this scenario, prices would rise 53% in January, 21% in February, and 6.6% in March, giving a total increase, in Q1, of 97% and an exchange rate of 10,385 zł to the US\$. That alternative was eventually dropped as too pessimistic. The Polish program was later often criticized for adopting an excessive devaluation of the zloty. The Polish Ministry of Finance, on the strong advice of the Ministry for External Trade and with the support of the Central Bank, assumed initially that the new exchange rate would be 10,500 zł and that it would be fixed until April 1990 and then progressively increased to 14,500 zł. by the end of 1990. In a note to Leszek Balcerowicz, dated December 4, 1989, Michael Bruno, at that time Governor of the Bank of Israel on a visit to Poland, suggested that there may be no need to devalue, or there may be a need for only a small correction, at the launching of the stabilization program. The suggestion would imply a rate of about 6500-7000 zloty per US dollar. The note influenced the correction of the Polish original intention and the choice of 9500 zł as the rate, which happened to be also the IMF's original suggestion: their Alternative 1. Bruno's suggested rate would probably have been sustainable for much of 1990, and may possibly have been a superior choice, although the actual choice was in my view justified by the urgent need to increase international reserves and to provide a safety margin for the program. In December 1989 about 2/3 of broadly defined money was in the form of dollar deposits and the macroeconomic credibility of the authorities was poor. In these circumstances dollar reserves and the safety margin were far more important considerations than the inflationary or even recessionary impact of a potentially excessive devaluation; the latter was stressed much, but without evidence or estimates, by several critics of the chosen exchange rate (Kolodko, 1992; Lutkowski, 1994; Portes, 1994b; and Rosati, 1994). For further discussion, see Sections 2.2 and 4.1.

<sup>6</sup> This view was particularly popular at the IMF as well as among the domestic critics of the government program. According to Camdessus (1991), "The decision to free prices (at a stage in the reform process when large state enterprises had not yet been either privatised or split up into



*Error 4.* The reforms of the pension system in 1990-1 which led to an explosion of social transfers in 1991-4.

It was overlooked that a backward-looking indexation rule, linking current changes in transfers to past changes in wages, would result in a sharp increase in the ratio of benefits to wages with the progress of stabilization. Also, the criteria for early retirement and disability pensions are too liberal, and this resulted in a sharp increase in the number of pensioners (Gomułka, 1993; Barbone, 1994).

Errors 3 and 4 were large enough to set the stage for the fiscal crisis in 1991-2, the collapse of the EFF programme in the middle of 1991, and severe fiscal problems in 1992-4.

*Error 5.* The targets for state-driven privatization were initially excessively optimistic.

However, an explosive growth of the original private sector has largely neutralized the negative impact of that particular error on the assumed growth of the private sector (Rostowski, 1993; Gomułka and Jasiński, 1994).

*Error 6.* The Extended Fund Facility (EFF) program for 1991-3 assumed a hugely optimistic growth rate of 15% per year for the level of investment activity.

In 1990 the perception was that the recovery in output would be led by investment and net exports (Gomułka, 1990; Republic of Poland, 1991). It was overlooked that after large falls in output and real incomes, recovery is likely to be consumption led. The Polish government programs for each year of the period 1991-3 continued to call for a redistribution of expenditure from private consumption to investment and net exports, but the actual developments had each year moved in the opposite direction. This changed only in 1994, when the classical model of recovery and growth began to apply.

*Errors 7 & 8.* The exchange rate was kept fixed for several months longer than needed and import tariffs were increased in August 1991, instead of at the beginning of 1991 as initially planned.

These two policies may not have been errors in the long term since they promoted competition and structural changes. Nevertheless, in 1991, they must have accentuated the fall in output and contributed to the budget deficit.

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competitive units) may have allowed some state enterprises to exercise the monopoly power they already had." This statement is probably correct but Camdessus goes on to claim that "[t]his may explain why prices rose more than expected in 1990, despite tight monetary policy," which appears to regard the monopolized market structure as the principal reason for the error.

## Russia

Most errors in Russia were in implementation rather than in design. The Russian IMF team from late 1991 on included several experienced members of the earlier Polish IMF teams, but the IMF's impact on policy implementation in Russia, especially in the years 1992-3, was clearly less substantial than in Poland. This changed in late 1993 and in 1994.

*Error 1.* An initial error of the Gaidar Plan was again a vast underestimation of corrective inflation in January, 1992, which was assumed to be 100% against the actual 245%.

The assumption was influenced by the advice of the IMF team, which itself was influenced by the analysis of Mario Blejer (1991, p. 5). The analysis appeared to be careful, with many caveats, but it concluded that "the initial rise in the price level needed to restore *stock* balance to the money market should not exceed 70-75 percent." The IMF team suggested that the increase would be 50%. An internal estimate by the Russian Economics Ministry, based on unit cost analysis, was of an increase of about 200%. This appeared vastly excessive and was rejected in a written directive to the Budget Group of the Finance Ministry by Gaidar himself. The error was not fatal by any means, but it was large enough to undermine significantly the credibility of the first Gaidar budget for Q1, 1992.

*Error 2.* The IMF's initial support for a common currency and a monetary union spanning most of the FSU was a policy mistake that betrayed a technocratic bias and political naiveté or insensitivity.

The proposal was intended to limit the inflation rate by providing "a set of rules for a coordinated monetary policy" (Hernandez-Cata, 1994). An additional outcome of the proposal, if adopted, would have been a lower trade shock and a lower fall in output. However, the proposal could not be accepted by Russia without its central bank controlling fully the credit expansion by the non-Russian members of the ruble zone, and such control would be at variance with the aspirations for independence of most of those members (Odling-Smee, 1992). The prolonged existence of the ruble zone did probably limit the trade shock, but it also contributed to the budgetary problems of Russia.<sup>7</sup>

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<sup>7</sup> On July 1, 1992 Russia discontinued the automatic extension of CBR credit to other central banks of the FSU. This accelerated the introduction of separate currencies. The CBR's withdrawal of the pre-1993 ruble notes in July 1993 and the elimination of subsidies from the Russian Government to other republics in the second half of 1993 led to the end of the ruble area.

*Error 3.* As mentioned earlier, strong emphasis by the IMF, bordering on single-minded concern, was placed initially on inflation and macroeconomic policies, while little recognition in the terms of the formal performance criteria, as opposed to policy interest, was given to key transformation-related reforms in liberalization, institutional change, and privatization.

Even the major improvement in the external position of the country was not recognized early enough or properly. The IMF's 1993 Systemic Transformation Facility of US\$4 billion was a financial innovation intended essentially to redress the imbalance.<sup>8</sup>

## 4. Programs and outcomes

This section discusses briefly six IMF-supported programs, four for Poland and two for Russia, in order to identify their distinct features and purposes.

### 4.1. The Polish stand-by program for 1990: a conditional success?

This program, which was extremely important for both Poland and the IMF, had a number of unusual features (Republic of Poland, 1989). They were directly linked to the launching of a radical reform in crisis circumstances and the absence of any similar experiences for policy designers. The main paradoxical feature of the program was that many of its important assumptions and policy aims were missed by wide margins, yet all of its six performance criteria were comfortably met during most of 1990, allowing Poland to draw three tranches of the total support granted out of the four available. Compared to the initial assumptions, the output fall was much larger, yet the fiscal out-turn of the general government, including extrabudgetary funds, was much better, resulting in a 3.1% GDP surplus instead of 0.6% GDP deficit; the surplus was particularly large and clearly excessive, about 8% of GDP, in the first half of 1990. The exchange rate had held throughout the period yet consumer prices increased by 250% rather than the assumed 94%, and despite the large appreciation of the zloty, the trade surplus was much higher than assumed (Table 3). All these developments have good ex post explanations but were wholly surprising for the program designers, both Polish and IMF. Another surprise was that two major concerns of the designers

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<sup>8</sup> Supporting the G-7 proposal for an exceptional program of assistance to Russia, the World Bank has an Accelerated Program of lending which also amounts to US\$ 4 billion. The Bank's Rehabilitation Loan of US\$ 0.6 billion, approved in 1992, belongs in the same category.

proved to be misplaced. These were the rules for indexing the wage norm in the first six months of the program, particularly in the first month, and whether a public and binding commitment could be made by the Polish authorities to defend the exchange rate at a fixed level for a specific period of time, e.g., 3, 6, or a full 12 months.<sup>9</sup> For the IMF, a satisfactory agreement about these two matters was seen as crucial for the success of the entire program. Discussions of these issues, especially the exchange rate policy, were therefore both intense and time consuming. In any event, the much tighter than planned actual fiscal and monetary policies, largely the automatic result of Errors 2 and 3, and a deeper than expected fall in output, rendered the two issues irrelevant for the critical first half of 1990.

In retrospect, given the novelty of the systemic circumstances and the initial crisis conditions, the program served its role of a clear and broadly consistent

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<sup>9</sup> Under the terms of the incomes policy operating in 1990, most enterprises paid a large penalty if the average wage or the total wage costs exceeded the enterprise-specific wage norm. The effectiveness of the policy in bringing inflation down depended crucially on the choice of the coefficient linking changes of wage norms to inflation. The lower the coefficient, the lower would be the scope for compensating workers for past inflation, and therefore also a faster rate of disinflation. Two broad options were considered by the government. The initial option assumed the coefficient to be close to 1 in the first month of the stabilization program and 0.7 thereafter. The subsequently preferred option assumed the coefficient to be close to 0.5 in the first month (0.3 was in fact chosen) and 0.2 in the next three months, followed by 0.6 thereafter. The IMF was prepared to accept at most 0.5 for the first few months of the program. The Polish second proposal was therefore wholly acceptable to them and became part of the program.

Although the setting up of a \$1 billion stabilization fund by the G-24 was proposed already in September 1989, both the Polish Government and the IMF were uncertain that it would actually be set up. It was set up only at the end of January 1990 from contributions by 10 countries. Nevertheless the IMF was insisting very strongly during the October-to-December 1989 negotiations that, in order to break the inflationary expectations of the population, the exchange rate should be fixed for a period of at least 3 and possibly up to 12 months, and a public commitment to defend the rate should be made by the Polish authorities. The Polish side argued that a mere public announcement by the government carries little weight in Poland, and that the fate of the exchange rate will be decided instead by the actual fiscal, monetary, and incomes policies. Despite large uncertainties, the intended policies seemed strong enough and the initial devaluation seemed large enough for the Polish negotiators to accept, as a policy aim, the preservation of the fixed exchange rate for (at least) the first three months.

<sup>1</sup> The pressure for correction came mainly from within the Government and the Central Bank. Among top advisers, only this author argued for a controlled relaxation. In the event, relaxation proved stronger than desirable, partly because of the impact of the presidential election in December 1990 on wages. This forced the authorities to tighten monetary policy sharply at the end of 1990 and the beginning of 1991, which in turn may have accentuated somewhat the recessionary impact of the CMEA collapse in the first half of 1991. The IMF was not consulted about these policy changes.

declaration of intentions remarkably well with respect to the transition policies. The built-in safeguards and errors of the program resulted in a stop-go sequence of policies that proved more pronounced than desirable, but this feature was secondary compared to the large achievements (IMF, 1991; Gomułka, 1991, 1992, 1993a; Rosati, 1993). Some critics of the actual policies conducted in 1990, notably Kołodko (1993), stress excessive overshooting in the first half of 1990. However, some overshooting should be an important feature of any good stabilization program. Poland's overshooting in the first few months of 1990 was probably excessive. This was recognized by the end of April 1990 when the reasons for a large overfulfillment of all the performance criteria for Q1, 1990, were discussed by Balcerowicz and his top advisers on the Polish side and the IMF. A correction of the policies was subsequently made for the second half of 1990.<sup>1</sup> Industrial output in the second half of 1990 was about 15% higher than in the first half, but part of the increase was due to seasonal factors. Pointing to the large welfare costs of the first Polish program therefore seems wrong, especially in view of the still larger output falls that occurred in the postcommunist countries that adopted a much more gradual approach in their macroeconomic policies, including Hungary and most of the FSU.

## **4.2. The Polish EFF program for 1991-3: a failure that served a purpose?**

This three-year program was meant to be a successful follow-up of the first standby (Republic of Poland, 1991). However, the Errors 2, 3, and 4 discussed in Part I, Section 3 led to its suspension only a few months after approval on April 18, 1991<sup>10</sup>.

In early 1991, the flaws in the program were already apparent, but there was no time to renegotiate it because, on March 18, 1991, the Paris Club offered Poland an immediate 30% debt reduction, conditional only on its having a Fund-supported economic program. The condition was met on April 18, 1991, and the reduction was granted on April 19, 1991. The EFF therefore served an important purpose.

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<sup>10</sup> Poland had already breached the criteria for June 1991. The negotiations of new criteria for the second half of 1991 and 1992 were not successful. However, the financial assistance by the World Bank was not halted. Moreover, Poland did not need the IMF's money during those two years. The IMF's tough stand in 1991 enhanced its credibility and helped to negotiate and implement sensible policies for 1993.

## 5. The IMF-supported programs of Poland and Russia, 1990-1994: Principles, errors, and results

**Table 3.** Poland: selected economic indicators, 1988-94 (percentage change unless otherwise indicated)<sup>a</sup>

	1988	1989	1990	1991	1992	1993	1994
Domestic indicators (in real terms)							
Gross domestic product (SNA basis)	4.1	0.2	-11.6	-7.6	2.6	3.8	5.0
Consumption (SNA basis)	2.6	6.1	-11.7	3.3	3.5	4.6	3.1
Gross fixed investment	6.1	-2.1	-10.6	-4.5	2.8	2.9	6.0
Consumer prices (period average)	60.2	251.1	585.8	70.3	43.0	35.3	32.2
Consumer prices (12 months increase)	72.9	639.7	249.3	60.4	44.4	37.6	29.5
Average monthly wages (period average)							
nominal	81.9	291.8	398.0	70.6	39.2	33.6	36.3
Fiscal indicators (in percent of GDP)							
State Budget revenue	35.6	30.8	33.3	25.7	27.0	29.6	29.7
State budget expenditure <sup>b</sup>	37.0	36.9	32.7	32.7	33.9	32.9	32.4
State budget balance <sup>b</sup>	-1.4	-6.1	0.7	-7.0	-6.9	-3.4	-2.7
General government balance <sup>b</sup>	—	-7.4	3.1	-6.5	-6.7	-2.9	-2.5
Monetary indicators (end of period)							
Net domestic assets <sup>c</sup>	127.3	192.3	38.4	142.0	35.6	21.7	22.5
Money and quasi-money	133.0	236.0	121.9	47.4	57.5	36.0	37.6
External indicators in convertible currencies (in terms of U.S. dollars)							
Exports <sup>de</sup>	17.6	4.5	43.4	17.5	9.7	-2.9	25.0
Imports <sup>de</sup>	23.1	16.3	17.9	46.9	6.1	17.7	11.0
Trade balance							
In billions of dollars	0.9	0.2	2.2	0.1	0.5	-2.3	-0.8'
In percentage of GDP <sup>f</sup>	1.4	0.4	3.6	0.1	0.6	-2.7	-0.9
Current account							
In billions of dollars	-0.6	-1.8	0.7	-2.2	-0.3	-2.3	-0.9
In percent of DGP	-0.8	-2.7	1.1	-2.9	-0.3	-2.7	-1.0
External debt (end of period) <sup>g</sup>							
In billions of US dollars	39.1	40.2	48.9	48.3	47.6	48.7	46.2
Ratio to exports of goods and nonfactor							
services in convertible currencies		4.8	4.0	3.3	3.1	3.2	2.4
External debt services ratio <sup>h</sup>							
Due	85.0	61.6	56.3	71.5	20.0	21.5	14.0
Paid	20.0	16.0	6.9	6.6	9.9	11.2	—

Sources: Central Statistical Office, *Rocznik Statystyczny*, data provided by the authorities, and Fund estimates.

<sup>a</sup> In the five main areas of the socialized sector through 1990; thereafter in the six main areas of the economy.

<sup>b</sup> On a commitment basis, except external interest, which is on a cash basis.

<sup>c</sup> In relation to broad money at the end of the previous year. <sup>d</sup> Balance of payment basis.

<sup>e</sup> Including transactions with former CMEA area for 1991 and 1992.

<sup>f</sup> Gross domestic product in zloty terms is converted into US dollars at the commercial exchange rate.

<sup>g</sup> Including arrears in the Fund.

<sup>h</sup> In percent of exports of goods and nonfactor services in convertible currencies, including the Fund.

<sup>i</sup> If unrecorded trade is included, the trade balance in 1994 was probably positive.

### 4.3. The Polish stand-by for 1993: a model of success?

Errors 2, 3, and 4 mentioned above led not only to the suspension of the EFF program, they also produced a threat to the progress of stabilization in the form of a large budget deficit. Despite corrective measures, the deficit of the general government reached 6% of GDP in 1991 and 7% in 1992 (Table 4). The deficits were financed to a large extent by monetary expansion and, by 1992, became the main source of inflation. In the meantime, the Paris Club accepted that Poland would qualify for a further 20% reduction of the official debt if it ran a successful Fund-supported program in 1993. Reaching an implementable agreement with the Fund therefore became essential. This was made easier by the more flexible position displayed by the IMF in 1992. Influenced probably by the course of events in Hungary and elsewhere in eastern and central Europe, the IMF increased its tolerance level for the budget deficit and the inflation rate. Moreover, to ease the deficit problem, the organization offered to support the Polish case for an import surcharge. However, a package of strong fiscal measures, amounting to about 5% of GDP of new tax revenues and expenditure cuts, was proposed by Polish authorities, not the IMF. The package reflected the outcome of an internal policy debate within the government and the country about the potential net costs and risks associated with a large budget deficit.<sup>11</sup> To increase the chance of success, the program for 1993 was based on conservative fiscal assumptions (Republic of Poland, 1992). Its success was also aided by an economic recovery that was stronger than assumed. In any event, all performance criteria were met comfortably and in a manner that should help the progress of recovery and stabilization in the postprogram years.

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<sup>11</sup> A first draft of the package was written by this author in August 1992. The package was then, with some modifications, adopted by the Board of the Finance Ministry and incorporated into the Budget for 1993. It was approved by the Government in December 1992 and by the Parliament in February 1993. The critical role in pushing the package through was played by Jerzy Osiatynski, the Finance Minister. For details of the package, consult Republic of Poland (1992) or Gomułka (1994a).

## 5. The IMF-supported programs of Poland and Russia, 1990-1994: Principles, errors, and results

**Table 4.** Poland: Consolidated revenue and expenditure of the general government<sup>a</sup> (in % of GDP)

	1989	1990	1991	1992	1993	1994	1995
Total revenue	41.4	43.0	42.3	43.8	47.6	46.5	47.7
Tax revenue	35.5	37.2	35.3	36.4	39.1	39.5	39.4
Personal income tax	3.4	3.0	2.9	7.1	9.0	9.5	9.7
Social security contributions	9.1	9.0	9.8	9.7	9.4	10.0	9.8
Profit tax	9.7	14.0	7.3	4.4	4.2	3.3	3.1
Popiwek	1.8	1.5	3.4	1.5	0.6	0.2	—
Turnover, VAT, excises	8.8	6.3	7.6	9.0	11.4	11.5	13.0
Import duties	—	0.6	2.1	2.3	2.8	2.3	2.0
Nontax revenue							
Dividend	1.7	2.2	1.6	0.7	0.4	0.3	0.5
Central bank transfer			0.8	0.9	0.9	1.1	1.3
Capital revenue	—	—	0.2	0.4	0.8	0.9	1.2
General government total expenditure <sup>b</sup>	48.9	39.8	48.9	50.4	50.5	49.0	50.7
Current expenditure	38.9	33.2	45.3	47.0	47.3	45.9	47.7
Subsidies to enterprises			5.1	3.2	2.3	2.0	1.8
Transfers to households <sup>c</sup>			17.4	19.9	20.6	21.3	22.4
Interest payments	—	0.4	1.6	3.2	3.4	4.0	5.3
Other current expenditure <sup>d</sup>	—	—	21.3	20.6	21.0	18.5	18.2
Overall balance	-7.5	3.1	-6.7	-6.6	-2.9	-2.5	-3.1
Financing	5.4	-2.8	6.7	6.6	2.9	2.5	3.1
Domestic	5.6	-2.7	5.2	7.1	3.0	2.9	3.4
Banking system	5.2	-2.8	5.1	6.6	2.3	2.1	2.8
Nonbank	-0.4	—	0.1	0.5	0.7	0.8	0.7
Foreign	-0.3	-0.7	-0.1	-0.2	-0.4	-0.5	-0.4
Increase in arrears, net <sup>e</sup>	2.0	-0.3	1.6	-0.6	0.3	0.1	—
Other	0.1	0.6	—	0.4	—	—	—

Sources: Polish authorities and Spring 1995 Fund staff estimates. Data for 1994 are preliminary, for 1995, from budget projection.

<sup>a</sup> Comprising the state budget, extrabudgetary operations, and local government operations. <sup>b</sup> On a commitment basis except for external interest payments, which are on a cash basis. <sup>c</sup> About three quarters of these transfers are pensions. <sup>d</sup> Included in other current noninterest expenditures for 1989.

<sup>e</sup> Expenditure arrears to the bank and nonbank public that were not converted into treasury bills.



#### **4.4. The Polish stand-by for 1994-5: a macroeconomic success but a structural failure?**

The fourth Polish/IMF agreement was for an 18-month program to run from July 1994 to December 1995 (Republic of Poland, 1994). It was also linked to a debt-reduction agreement, but this time with private banks represented by the London Club. To implement it, on 27 October, 1994, Poland needed \$1.9 billion, of which \$0.9 billion was provided by the IMF and \$0.4 billion by the World Bank.

The program itself was innovative in that it placed strong emphasis on several structural and systemic reforms. Two such reforms were considered particularly important: implementation of the long-delayed mass privatization program for 444 large enterprises and a politically sensitive change of the pension indexation rule, linking periodic adjustments to a consumer price index rather than to wage developments. Positive government decisions on both reforms were given the status of “specific benchmarks against which progress in implementing the stand-by arrangement would be assessed at the time of the first review” (Republic of Poland, 1994).

Although the Polish Government accepted the arrangement, the implementation of the two politically sensitive reforms was held up in 1994.<sup>12</sup> This put the credibility of both the Government’s ‘Strategy for Poland’ and the IMF’s qualitative conditions to the test. The noncompliance with these conditions on time was overlooked, the IMF falling back once again on the usual five quantitative criteria, which were all met in 1994, and on public assurances by the government that the two reforms would eventually be implemented.

#### **4.5. The Russian experience: a macroeconomic failure but a transformation success?**

There has been much confusion about what kind of strategy Russia has followed and much discussion about policies that the country should follow – less shock and more therapy? or more shock and more therapy? Was the strategy excessively gradual? With respect to macroeconomic policies, why have they been so inflationary? Were they irrational?

From the perspective of a student of systemic transformation, there is much evidence in favor of the view that Russia in its own chaotic manner has followed

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<sup>12</sup> The mass privatization reform became politically sensitive once it assumed a leading role for foreign management groups. That role had been proposed already in 1990 (Frydman and Rapaczynski, 1990) and accepted by the Polish Parliament in 1993, subject to modifications. It was possible for the Prime Minister to delay the implementation of the reform on, effectively, national security grounds.

a very radical reform, as documented in IMF (1994d). The main components of that reform have apparently been implemented. A fast liberalization of most prices, at least at the federal level, has permitted the replacement of central planning by market coordination. The liberalization of the foreign exchange market and internal convertibility of the ruble improved the mobility of resources and the quality of prices. A considerable foreign trade liberalization has led to large shifts in the geographical and product composition of trade. The size of the initially overblown defense sector has been much reduced. A large progress in privatization and other systemic, structural, and institutional changes have also taken place. A deep fall in industrial output, by some 50%, may be taken as indirect evidence of the substantial volume of painful reforms that have been implemented, although a longer and deeper recession than that experienced in Poland is also related to a much smaller private sector at the start of transition (Goldman, 1994). Moreover, the floating exchange rate policy led to an extremely deep real devaluation, and this in turn has produced a fairly strong improvement in the external position of the country.

Russia's reforms have been gradual, elusive, and controversial, mainly with respect to inflation (Hernandez-Cata, 1994). The country's inflation crisis has been due almost entirely to the monetization of large budget deficits and even larger subsidized credits to enterprises (Easterly and Cunha, 1993). In this respect, the sharp differences in public spending between Poland and Russia in 1992 are worth noting: much higher spending in Russia on defense, 6% versus 2%; producer and import subsidies, 10% versus 3.2%; subsidies to the former republics of the FSU, 5% versus 0%; but much lower spending on social transfers, particularly pensions, 8% versus 20%.<sup>13</sup> The large subsidies to enterprises have also slowed down the pace of restructuring. It is clear that the authorities in Russia and most of the FSU have retained the main prereform concerns: production by enterprises, foreign policy, and defense, while Polish authorities have developed concerns, arguably excessive, about consumption by individuals, particularly pensioners.

The distinctive feature of the Gaidar stabilization plan was that neither the wage rate nor the exchange rate would serve as a nominal anchor.<sup>14</sup> This feature had already caused concern for the IMF by the end of 1991. However, a strict

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<sup>13</sup> The estimates of subsidies and social transfers in Russia are highly imprecise but are hoped to indicate the orders of magnitude involved.

<sup>14</sup> The original document which Gaidar presented to President Yeltsin in early November 1991, on the basis of which he was appointed to lead the Russian reform effort, had "stabilization plan" in its title. However, the body of the document was concerned mainly with liberalization, privatization, and institutional reforms, and not at all with detailed stabilization policies.

monetary policy probably could have controlled nominal wage increases. Real wages fell sharply in 1992, as required by the stabilization objectives. The problem was the failure of the government to eliminate the need for the domestic bank financing of the budget deficit of 6% of GDP in 1992 (IMF 1993, Table 5) and an excessive flow of much-subsidized credit to enterprises and former republics of the FSU by the authorities.

The first Fund-supported program for Russia, in June 1992, was of a standby type.<sup>15</sup> It expired on January 4 1993. During that period, the inflation rate was supposed to decline to below 5% a month. Instead, it increased from about 10% a month in the second quarter of 1992 to about 25% a month in the fourth quarter of 1992 and remained at that high level for much of 1993. In terms of this particular indicator of performance, so central for the IMF, the program was a failure.<sup>16</sup> The second program was of the STF type. It started in June 1993 and is still continuing. Again, the chief aim of the program in 1993, reducing the monthly rate of inflation to single-digit levels by the end of 1993, was not reached. However, in 1994, Russia is showing an unexpected determination to bring the rate of inflation down.

## 5. Foreign assistance in a broader perspective

In his address to the Group of Thirty at its Spring 1993 planning meeting in Vienna, Mr. Klaus, the Prime Minister of the Czech Republic, summarized his experiences as a reformer in the form of “Ten Commandments” for what he calls profound, fundamental, structural reforms. One of the Commandments asserts that the role of foreign aid in these reforms is marginal. This also happens to be my view with respect to most transition countries of the region. The reason is self-evident. Using purchasing power parities, per capita GDP in the FSU and central Europe was, just before the reforms, some US\$5,000 and, therefore, the total GDP of all the transition countries was about 2000 billion US dollars. The average fall of measured GDP during the contraction phase of transition has been about 40% or \$800 billion in flow terms. Even if the actual fall was much smaller, say \$400 billion, the investment needed to restructure the region’s capital stock so that at least the prereform level of GDP is regained must be several times the lost output, that is, some \$1000 billion. The combined resources of international

<sup>15</sup> Russia formally rejoined the BWIs in June 1992.

<sup>16</sup> Russia applied to G-24 for a \$6 billion stabilization fund in December 1991. The Fund was potentially available in the years 1991-4 but it was not activated because “the appropriate conditions were not in place” (IMF, 1994e p. 78).

financial institutions are clearly too small by comparison to make a sizeable contribution to such an investment effort. The resources can, in any case, be provided only on a commercial basis, rather than as development aid, and are therefore subject to strict conditions that transition economies cannot easily meet. In the initial period of transition, there is, in addition, a low capacity to use large foreign capital effectively.

The argument above flies against the widespread perception of the large role that foreign assistance does or should play.<sup>17</sup> That perception may be based in part on a fairly large actual role of the international financial institutions, particularly the IMF, in providing the expertise and policy guidance for economic stabilization and institutional development, and on confusion concerning the motivations guiding the cooperation between transition countries and multinational institutions. An extreme view could be held, and it has been expressed at times, that the West has been attempting to impose specific reforms and policies that reflect its own values and interests rather than the needs of the reforming countries. Consequently, vast Western assistance has been provided, or should be offered, to transition countries as an incentive, or indeed as a form of compensation, to encourage the countries to adopt the capitalist system and specific policies. One of the reasons for the reluctance of Western governments to offer sizeable foreign assistance to transition countries may have been the concern not to lend credence to such a view.

Some economists have based their arguments in favor of foreign assistance on the apparent bankruptcy of the state in transition countries, dangerous for international security, on a drastic downgrading of the size of transition economies, and on a correspondingly vast exaggeration of the potential economic impact of such assistance (Sachs, 1993, 1994; for a different view, see Dąbrowski, 1995). Extreme devaluations of local currencies have, for some periods, reduced wages in most transition economies to some 20 US dollars a month and the region's GDP to about \$200 billion. By this account, Russia's GDP in 1992 was a mere \$100 billion, or about the size of West German annual assistance to the former GDR. It would therefore appear possible to stabilize the Russian economy by providing a relatively small amount of external aid, some \$10 billion a year, to the government budget and the enterprise sector. However, such a stabilization plan would soon fail, as the inevitable rapid appreciation of the exchange rate, following stabilization, would reduce quickly the ruble value of the aid, opening up the budget deficit gap again.

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<sup>17</sup> The IMF and the G-7 group were using quite effectively the method of ill-specified promises of substantial aid. The promises were costless for the western taxpayers but often served to help local reformers in persuading the governments and the parliaments concerned to adopt reforms.

## 6. Concluding remarks

The impact of foreign assistance can be substantial, even vital, only on a few occasions, especially when it is in the form of grants and debt reductions linked to performance. Most postcommunist economies are simply too large and their transitions to capitalism too costly for foreign assistance to have more than a marginal impact. Some of these economies are already heavily indebted, and this gives them little room for contracting new debt. A far more important foreign impact may come from the inflow of Western private investment and know-how. However, internal reform efforts rather than external financial assistance are needed for this inflow to take place.

International financial organizations, especially the BWIs, have been helpful for Russia and Poland by providing local reformers with modern analysis and expert policy advice. They were also most helpful in pressing Western creditors for a sizeable reduction of the Polish debt and a fast removal of trade barriers to West European markets. However, the sequence of reforms, their content, and the speed of transition have been decided largely by the initial circumstances, the new long-term goals of the countries concerned, and the various internal political and institutional factors during transition, rather than by the advice of the two institutions.

The major problem in the design of IMF programs for both countries has been the nearly exclusive choice of standard, purely macroeconomic and stabilization-related performance criteria. The key transformation reforms were recognized from the start, in the Polish program for 1990, as central for the success of long-term economic strategy, including the achievement of macroeconomic stability, but while these reforms were discussed with officials and incorporated in the program documents, they were not covered by formal performance criteria. This paper suggests that this was probably a mistake.

However, in the later IMF-supported programs, the initially strong emphasis on rapid stabilization has been reduced, and progress with structural reforms has been given more weight in the evaluation of performance. The difference between Poland and Russia has been mainly in the conduct of macroeconomic policy and not in the core of transformation reforms. Errors in forecasting, analysis, and policies have been made, some of them quite major, but in the crisis circumstances of the two countries, the main body of reforms, especially in Poland, has probably been about right.

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## 6. Macroeconomic policies and achievements in transition economies, 1989-99<sup>\*1</sup>

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### 1. Introduction

The primary purpose of this paper is to consider and answer the following questions:

- How far have the transition economies of central Europe and the former Soviet Union been able to establish the macroeconomic framework needed for sustaining investment and economic growth?
- What distinguishes the more successful from the less successful: initial conditions, the political environment, the state of institutions?
- How far have weak or missing institutions hampered effectual policy-making?
- Have macroeconomic policy dilemmas been intensified by weak institutions?
- Has too much emphasis been placed on lowering inflation – or reducing it too rapidly – at the expense of economic growth?
- What lessons can be drawn for those transition economies which are still struggling to achieve macroeconomic stability and economic growth?
- Under the emerging economic system, what is the potential contribution to growth of the technological convergence (catching-up) factor?

These specific questions are addressed in section 3 of the paper.<sup>2</sup> The wider issues of reform strategy and the content of the main macroeconomic policies are discussed in section 2. The transition countries covered in this survey are listed in table 1. They are divided into two groups: 13 central European and Baltic

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\* In: *Economic Survey of Europe*, 2000, no. 3, Economic Commission of Europe, UN, Geneva and New York.

<sup>1</sup> The author wishes to acknowledge the debt to the organizers of the UN/ECE Spring Seminar, especially to Paul Rayment, for proposing the theme and the main questions of this paper. The final version benefited from the discussion at the seminar's meeting. I am particularly grateful to the four official discussants, George Kopits, Silvana Malle, Jože Mencinger and Leonid Grigoriev, and to Zdenek Drabek and Vincent Koen for their stimulating comments.

<sup>2</sup> All except the final question were formulated by Paul Rayment, Director of the Economic Analysis Division of the United Nations Economic Commission for Europe, on behalf of the Seminar's organizers.

countries and 12 members of the Commonwealth of Independent States (CIS). This division is motivated, in part, by similarities in the choice of reform strategies made by the countries in each group. Table 1 also gives two GDP estimates for each country in 1998, one based on market exchange rates and the other based on purchasing power parity (PPP) exchange rates. The latter estimates are used to obtain each country's weighting. These weightings are then used in section 3 of the paper to produce weighted averages and absolute mean deviations for the main macroeconomic variables, as well as weighted econometric estimates of the correlation coefficients between output falls and inflation rates, all for the years 1991-8.

The PPP estimates of GDP imply that, in 1998, the combined weighting of the CIS region was 3.7 percent of the world economy and that of the central European and Baltic countries 2.4 percent.

## 2. An overview of reforms and policies

### 2.1. Reform strategy

The reform of the economic system which occurred in Central Europe and the former Soviet Union in the 1990s has been fundamental, involving major changes of institutions, types of ownership, corporate governance, laws, modes of interpersonal behaviour and attitudes to work. Some institutions were cut in size or closed down, others expanded or created. These institutional changes were superimposed on massive changes in relative prices and the pattern of foreign trade; the latter changes caused, in turn, major shifts in the composition of output. In terms of institutions, skills, prices and products, there was therefore a large distance between the initial point (where a given post-socialist economy found itself just before the reform) and the end point of its intended transition. Reform strategies have addressed the content, the sequence and the speed of reforms required to effect this transition.

In adopting a broad reform strategy and specific policies, a transition country had to take into account its particular economic circumstances and political constraints. Such a strategy had typically six major components: *micro-liberalization* (especially with regard to prices, trade and entry), *macro-stabilization* (especially with regard to inflation, public finances and foreign debt), *structural changes* (especially privatization and international trade), *new market institutions* (especially with regard to commercial codes, property rights and the financial/capital markets sector), *safety nets* and *external assistance*. The first four were crucial

**Table 1.** Population and GDP data for 25 transition economies of central Europe, the Baltic states and the CIS, 1994 and 1998

	1994	1998			
	Popula- tion (millions)	GDP per cap. (thous. PPP\$)	GDP (billion PPP\$)	GDP (billion \$)	PPP\$/\$
Albania	3.4	2.9	9.9	3.2	3.1
Bulgaria	8.4	4.8	40.3	10.9	3.7
Croatia	4.5	6.8	30.6	21.9	1.4
Czech Republic	10.3	12.5	129.0	56.0	2.3
Estonia	1.5	7.6	11.4	5.4	2.1
The former Yugoslav Rep. of Macedonia	2.1	4.4	9.2	3.3	2.8
Hungary	10.3	10.2	105.0	47.8	2.2
Latvia	2.6	5.6	14.6	6.9	2.1
Lithuania	3.7	6.4	23.7	10.8	2.2
Poland	38.5	7.7	296.0	148.0	2.0
Romania	22.7	5.6	127.0	38.5	3.3
Slovakia	5.4	9.8	52.9	20.4	2.6
Slovenia	2.0	14.3	28.6	19.1	1.5
CIS					
Armenia	3.6	2.2	7.9	1.8	4.3
Azerbaijan	7.5	2.2	16.5	4.0	4.1
Belarus	10.4	6.1	63.4	14.4	4.4
Georgia	5.5	3.3	18.2	5.3	3.4
Kazakhstan	17.0	4.3	73.1	25.2	2.9
Kyrgyzstan	4.6	2.3	10.6	1.6	6.5
Republic of Moldova	4.4	1.9	8.4	1.9	4.4
Russian Federation	148.0	6.5	962.0	275.0	3.5
Tajikistan	5.8	0.9	5.2	1.2	4.2
Turkmenistan	4.0	3.2	12.8	1.7	7.6
Ukraine	51.9	3.2	166.0	43.7	3.8
Uzbekistan	22.4	2.1	47.0	13.1	3.6

**Source:** GDP per capita in PPP\$ terms from IMF, *World Economic Outlook* (Washington DC), October 1999. GDP (1998) levels in \$ at market exchange rates are from EBRD, *Transition Report* (London), 1999.

components of any reform package. Soaring unemployment and the elimination of most subsidies to households required a complete remodelling of the welfare system. With the exception of the former German Democratic Republic (GDR), and to some extent also Bulgaria, Poland and parts of the former Yugoslavia (Bosnia, Kosovo) external assistance was typically small and of limited impact.

The inherited circumstances fall into two categories, common and country-specific. As the reform policies and transition paths have exhibited some basic

similarities among countries, the common category would seem to have dominated. Nevertheless, the variations in country-specific circumstances were substantial enough to have a major impact on the choice of overall reform strategy as well as specific policies.

The similarities were possibly greatest with respect to micro-liberalization and certain important structural changes, notably reorientation of foreign trade and privatization. Somewhat unexpectedly, the greatest differences initially emerged in the area of macroeconomic policy. These differences, however, narrowed in the second half of the 1990s.

Three broad reform strategies may be distinguished: “shock therapy”, rapid adjustment and gradual change. The shock therapy approach was only really applied in the former GDR. Although this strategy offered the potential for a fast reallocation of resources, it proved far too costly in the short and medium term to be of interest to any other post-communist country.”<sup>3</sup> At the other end of the spectrum is a gradual strategy. This has been pursued successfully by China since the late 1970s. However, in conditions of a total (economic, institutional and political) crisis, virtually the only choice open to the former Soviet Union and central Europe was a form of rapid adjustment. A *strong* variant of it (variant S below) was adopted by some countries, e.g. Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia, and a *weak* variant (variant W) by most other countries, particularly Russia and Ukraine. The differences between the two variants have been substantial, especially during the first few years of transition.

#### **(a) Rapid adjustment: the stronger variant (variant S, most central European and Baltic countries)**

One way of defining this variant was formulated by V. Klaus, the then Prime Minister of the Czech Rep., in the shape of 10 commandments.<sup>4</sup> They are as follows:

(i) Reforms in post-communist countries are the outcome of a complex social and political process, and cannot therefore be pre-planned or socially engineered by any one person or centre;

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<sup>3</sup> J. Kornai, Ten Years After *The Road to a Free Economy* (the author’s self-evaluation), paper presented at the World Bank’s Annual Conference on Development Economics (Washington DC), 18-20 April 2000, suggests that, in the early 1990s, “many participants in the post-socialist transformation suffered from an obsession with speed”, and notes that “excessive emphasis on speed leads to impatience, aggressiveness and arrogance”. He uses mass-privatization programmes in the Czech Republic and Russia as examples. However, the actual policies of many reformers were often much less radical than their rhetoric. This applies also to possibly the most influential reformers of the region: Balcerowicz, Gaidar and Klaus.

<sup>4</sup> V. Klaus, The Ten Commandments of Systemic Reform, Group of Thirty Occasional Paper. No. 43 (Washington DC), 1993.

- (ii) The role of foreign aid is marginal;
- (iii) An economic shock, meaning a large fall in output, is inevitable;
- (iv) Dramatic actions are required to impose a restrictive macroeconomic policy, liberalize prices and foreign trade and establish a process for privatization;
- (v) A restrictive macroeconomic policy must be sustained;
- (vi) The price shock resulting from price liberalization must be vigorously defended and must survive;
- (vii) Economic restructuring requires comprehensive privatization;
- (viii) Transformation costs must be widely shared;
- (ix) Successful transformation requires the opening of markets to foreign goods and the free flow of peoples and ideas;
- (x) Successful transformation requires successful politicians.

These commandments well encapsulate the views of a substantial body of reformers – both decision-makers and their advisers, in the early 1990s. However, actual developments provide the basis for significant modifications to this original formulation.

The choice of reforms, while certainly the outcome of a political process, has been limited by the overriding goal of imitating or even replicating the well-known solutions, in terms of both institutions and policies, of market-based capitalist economies. Moreover, reformers can have, should have and usually do have specific reform blueprints for achieving this goal. These blueprints have been useful even if the timetable, the sequencing and the methods of their implementation may have changed under the weight of political pressures.

With respect to foreign aid, the main reason for its marginal role for most countries has been the size of their economies. Using the 1998 PPP exchange rates, the combined GDP of the former Soviet Union and central Europe, on the eve of the reforms, was some \$3,500 billion (the data in table 1 imply that it was \$2,300 billion in 1998). The investment needed to restructure economies of that size, so as to regain the pre-reform level of GDP, is probably of the same order of magnitude. The combined resources of the *IMF*, the World Bank and the EBRD available to transition countries, by comparison, are small and, in any case, can be provided only on a commercial basis, and therefore are subject to performance conditions which economies in transition cannot easily meet. Only transfers to the former GDR have been really large in relation to its GDP and, indeed, have been several times larger than the total aid extended to all other transition countries. However, the impact on economic recovery has been moderate. Moreover, in the case of Russia, it was not an extension of external financing but its discontinuation, following the crisis of August 1998, that forced the adjustments

in domestic policies which accelerated the reform process. Still, there are a few countries, e.g. Bulgaria and Poland, in which foreign aid, especially in the form of partial debt cancellations, has been important and helpful.

Commandments four to seven formed the core of reform efforts. Short-term gains (if any) arising from conducting a loose macroeconomic policy turned out to be small, while medium and long-term gains from establishing a stable macroeconomic environment are commonly thought to be large. Initially, the main objective of a stabilization policy may, and possibly should, be moderate inflation rather than stable prices. But once a country has moved from transformation to recovery and sustainable growth, a high quality macroeconomic stability becomes essential. This requirement applies, above all, to the candidate members of the European Union. A similar caveat can be made with respect to Klaus's seventh commandment, concerning the need for rapid privatization. In Poland, state-driven privatization has been slow. But a rapid autonomous growth of the original private sector has ensured that the total private sector accounted, in 1999, for about 65 percent of GDP. Privatization of state owned enterprises (SOEs), while usually helpful, may thus not be as necessary as some reformers initially believed. The quality of privatization has proved to be very important, and there is a trade-off between speed and quality.

The tenth commandment has also proved to be an overstatement. Successful politicians can be helpful, but not necessary for a successful transformation. Reform must be legitimized through a democratic political process. This is vital. But the initial legitimization was provided by the collapse of the communist system. This collapse offered a window of opportunity, the Balcerowicz period of "extraordinary politics", to initiate the kind of reforms which could not be easily reversed under the more hostile political conditions which prevailed later on. The socially costly phase of transition took place at a time when democratic institutions were in their early infancy. Consequently there were (and in most cases, still are) typically too many small parties with ill-defined policies, the division of power between the main central institutions has often been unclear and many politicians lack experience of efficient communication with the electorate. Such circumstances can produce confusion and political instability, which hinder the process of economic reform and pose a continual threat to democratic politics. The result has been frequent changes of government and, in many cases, legislation slowdowns. However, such frequent changes have also provided an opportunity to employ, in the cause of reform, the combined political capital of a large pool of politicians during the socially most costly phase of transformation.

From today's perspective, it is also noticeable that Klaus's formulation understates the importance of the task of creating a new legal and institutional



environment and a new culture of habits and attitudes, which a modern market economy requires. This task has been particularly important in the countries of the former Soviet Union.

The more successful transitions of the central European and Baltic countries are associated with the S-variant of the rapid adjustment model. One of the most successful countries has been Poland, where real GDP in 1999 was one quarter higher than at the beginning of the transition in 1989 – by far the best result in the region. After a contraction of about 15 percent in 1990 and 1991, the economy has grown at an average rate of 5 percent per annum. Estonia, Hungary Latvia, Lithuania, Slovakia and Slovenia have also experienced rapid growth in the last few years.

The Polish model of transition consisted of five main elements:<sup>5</sup>

- complete liberalization of *de novo* private sector entry into almost all areas of economic activity (January 1989 and January 1990);
- adoption of the pre-1939 commercial code (1982) and abolition of communist party organizations in SOEs, which gave real power to the workers' councils that had formally exercised it since 1981 (until end 1989);
- very rapid price liberalization (during 1989 the share of freely determined prices rose from 25 to 90 percent);
- introduction of hard budget constraints on SOEs and a sharp reduction of inflation to a moderate level, through fiscal, monetary and wages policies (January 1990), followed by gradual disinflation;
- current account convertibility of the currency and almost complete foreign trade liberalization (January 1990).

The Polish programme was gradual in many important respects: it took 10 years to reduce inflation to below 1 percent a month, mass privatization was limited mainly to small enterprises, social transfers have been large (pensions increased substantially in relation to wages) and budget deficits remained significant throughout the 1990s. The results of the programme were, on the positive side: the fast introduction of market prices based on relative scarcity and world prices for traded goods; a financial squeeze on SOEs, which forced them to

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<sup>5</sup> This description of the programme and the model follows that given by M. Dąbrowski, S. Gomułka and J. Rostowski in: Whence reform? A critique of the Stiglitz perspective, London School of Economics and the Central European University, 2000, mimeo (this paper was published in *Policy Reform*, 2001, vol. 4: 291-324). More details of the model may be found in S. Gomułka, The Polish model of transformation and growth. *The Economics of Transition* 6, 1, March 1998: 163-71, and in M. Dąbrowski, Ten years of the Polish economic transition 1989-1999, paper presented at the Fifth Dubrovnik Conference on Transition Economies: Ten years of transition: What have we learned and what lies ahead (Dubrovnik), 23-25 June 1999.

rapidly release excess labour *and* physical capital (known as *asset privatization*); the maintenance of a minimum tolerable level of effective corporate governance in SOEs (due in part to the workers' councils); and the very rapid development of the *de novo* private sector. On the negative side, the restructuring of public services and public finances has been inadequate, limiting the growth of domestic savings and investments.

The Hungarian model has been similar. The same five main elements of reform were introduced as enacted and implemented in Poland, although their implementation was somewhat more gradual and workers councils had little importance. However, the bankruptcy law that was enacted and implemented has been possibly the most radical in central Europe. Also the growth of the domestic *de novo* private sector tended to be in services rather than in manufacturing, where there was a fairly rapid development due to foreign direct investment (FDI). A larger external debt burden and poorer macroeconomic policies meant that stabilization of the GDP contraction took longer than in Poland and – more significantly – the start of rapid growth was delayed by five years (until 1997).

Slovenia was also somewhat of an exception on two counts: earlier, pre-transition reforms had been more substantial than elsewhere in central Europe and the initial crisis was much more limited. Hence a more gradual transformation was feasible and, indeed, adopted in the early 1990s.

Following the adoption of such programmes, the experience of successful transitions indicate that growth can resume quickly and can proceed at a rapid pace. This growth has been driven almost entirely by *de novo* private sector development, rather than through the restructuring of SOEs, privatized or otherwise.<sup>6</sup> *De novo* private activity was at first predominantly domestic and concentrated in services. But as time went on, in all successful countries it came to involve significant foreign direct investment and to expand into manufacturing industry.

The experience of the central European and Baltic countries demonstrates the following: the usefulness of pre-existing rules and institutions (workers' councils, a commercial code, a legal system); the importance of macroeconomic stabilization and the accompanying imposition of hard budget constraints; and the importance of the liberalization of prices, trade and entry for growth of new private enterprise.

### **(b) Rapid adjustment: the weaker variant (variant W, most CIS countries)**

In Russia, the 1992 attempt at sharp budget hardening, disinflation and full liberalization of prices, trade and entry, the Gaidar plan, failed. This meant that

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<sup>6</sup> J. Rostowski, *Private Sector Development, Structural Changes and Macroeconomic Stabilization: The Case of Poland 1989-93*, London School of Economics, Centre for Economic Performance, Discussion Paper, No. 159, 1993, and S. Gomułka, *op. cit.*

enterprises were subsequently under less pressure to divest physical assets and to shed labour they did not need, thus effectively denying *de novo* private firms the resources they needed for their development. The failure to liberalize thoroughly kept the setup costs for new firms high. For several years large subsidized credits and entry barriers undermined the credibility of the strategy, inducing capital flight, creating opportunities for tax avoidance and criminal asset stripping, as well as slowing down the restructuring of old firms. The Russian reform was nevertheless radical, since by and large prices and wages were liberalized quickly. As a result, markets started to develop, taking over from the planners the informational and coordination roles. A large-scale privatization programme was also initiated early on and implemented quickly. This embarking on privatization before full liberalization (involving not just product prices, exchange rates and interest rates but also trade and entry terms), and before the hardening of budget constraints for enterprises and disinflation, was the key characteristic of the reform strategy adopted by Russia and most other CIS countries in the first few years of transition. However, these differences between variants S and W have narrowed in the late 1990s.

## 2.2. Was the output collapse inevitable?

The phenomenon of large falls in output in the economies of Central Europe and the former Soviet Union during their systemic transformation in the 1990s is one of the most researched – yet one of the most controversial. Kornai proposed the term “transformational recession” to indicate that these falls were directly related to the change of the economic system rather than to transition policies. However, these falls occurred against a background of rapid growth in China and Viet Nam, which had also been introducing fundamental changes in their economic systems. This may indicate that the falls were related not merely to the systemic transformation as such, but also to its speed. Stiglitz, among others, argues that the speed of transition was a choice variable, and that choosing high speed was a major error.<sup>7</sup> In a recent survey of evidence and interpretations of the recession, the present author suggested that, unlike in China and Viet Nam, in the countries of central Europe and the former Soviet Union (and Mongolia) the rapid speed was forced principally by the initial conditions of their deep and all-embracing (economic, institutional and political)

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<sup>7</sup> J. Stiglitz, Whither Reform, paper presented at the World Bank Annual Bank Conference in Development Economics (Washington, D.C.), 1999, and Quis Custodiet Ipsos Custodies?, paper presented at the World Bank Annual Bank Conference on Development Economics – Europe (Paris), 1999.

crisis.<sup>8</sup> In the survey, I identified four classes of specific causes of output falls: 1) massive and rapid changes in relative prices in conditions of limited resource mobility; 2) the elimination of excessive real aggregate demand to establish buyers' markets; 3) the collapse of captive markets within the former CMEA area; and 4) the collapse of the arms industry and of state financed investments in housing, energy, agriculture and the infrastructure. Relative prices changed mainly as a result of rapid price and trade liberalization, sharp increases in interest rates, large up-front devaluations and considerable harmonizations of turnover and border tax rates.

A sharp price liberalization caused large supply-side and demand-side shocks that reduced outputs and increased prices. However, the high speed of price liberalization was in part a consequence of the collapse of central planning institutions, since this collapse created the need to establish immediately a market-based coordination mechanism, of which market-clearing (free) prices were an essential part. A fairly rapid liberalization of prices, trade and entry was also needed to enhance competition and initiate structural changes

In the initial period of transition, economic developments in the former Soviet Union and central Europe reflected not so much the quality of current reforms, but the pre-reform crisis conditions, which had led to the collapse of the Soviet style economic, military and political system. In Russia, because of this crisis, industrial output had already started to fall sharply in 1991, still under the old system. Whether reform had taken place or not, this fall would have presumably continued as the system unwound, as the experience of slow and/or late reformers would indicate, e.g. Belarus, Bulgaria and Romania. The collapse of the Warsaw Pact (and the associated contraction of the defence industry), the CMEA (and the associated contraction of trade) and the USSR itself (and the associated disruption of intra-Soviet production links), were all the largely inevitable consequences of earlier events in Russia and elsewhere. The reduction in the output of the defence and defence-related industries alone, according to one knowledgeable source, accounts for 60 percent of the fall in industrial production in Russia.<sup>9</sup>

In his forceful challenge to the merits of fast liberalization and stabilization, Stiglitz accepts that, according to economic theory, reducing price distortions through price and trade liberalization and price stabilization, should, in addition to improving incentives through privatization, "have moved countries closer to

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<sup>8</sup> S. Gomulka, Output: Causes of the decline and the recovery. In: P. Boone, S. Gomulka and R. Layard (eds.), *Emerging from Communism: Lessons from Russia, China and Eastern Europe*. Cambridge, MA: MIT Press, 1998.

<sup>9</sup> Y Yassin, Defeat or retreat? Russia's reforms and the financial crisis (Moscow), 1999, mimeo.

their production possibilities curve”.<sup>10</sup> The problem for him is that “output should have soared – instead it plummeted” Much of his challenge to the conventional theory is motivated by this apparent contradiction. However, Stiglitz ignores the arguments which associate output falls in the initial phase of transition mainly with unusually large inherited (structural and price) distortions and with the institutional crises which forced the tempo of price liberalization. Despite wide differences in reform policies, the cumulative falls in industrial output, at 40-60 percent, were not just large but also similar between countries. He also ignores the fact that, as Aslund, Boone and Johnson first showed,<sup>11</sup> the speed of macroeconomic stabilization had a significant effect on the time profile of decline, but had little impact upon the magnitude of the cumulative fall of output. These falls tended to be larger in the countries that were slow in bringing inflation to moderate levels, say to below 40 percent per annum. The evidence is too weak to suggest the presence of causality from higher inflation to larger cumulative output falls. It is probably more likely that the countries (mainly within the former Soviet Union) which were subjected to larger supply-side and demand-side shocks also experienced larger output falls and, simultaneously, higher inflation. (I shall return to this point in section 3(v).) Nevertheless, apart from increasing inflation, the main effect of a loose macroeconomic policy would appear to have been, in most cases, to reduce the rate of fall and, therefore, to extend the length of the transformational recession.<sup>12</sup> However, as the EBRD, *Transition Reports 1995-1999* note, the evidence goes to support the proposition that, in the countries which liberalized and stabilized to a greater extent, output not only stopped falling earlier, but also started to recover faster. (I shall return to this last point in section 3.)

The medium-term purpose of the reforms is to restructure transition economies in favour of activities producing more value added per unit of primary inputs (of labour and capital). If restructuring needs had been small, real wages highly flexible and labour and capital resources easily moveable, then large output falls would have been unnecessary to effect such a restructuring. However, restructuring needs were, in fact, exceptionally large and the mobility of resources was quite limited. In such circumstances unemployment, although it does involve short-term costs, performs a positive signaling role, by making it clear to people that they have to either change skills and move to higher productivity work or accept lower real incomes. Therefore, the welfare cost associated with a temporary rise in unemployment can be thought of as a form of investment needed to

<sup>10</sup> J. Stiglitz, *op. cit.*

<sup>11</sup> A. Aslund, P. Boone and S. Johnson, How to stabilize: Lessons from post-communist countries, *Brookings Papers on Economic Activity* 81(1) (Washington DC), 1996: 217-315.

<sup>12</sup> On this point, see also EBRD, *Transition Report 1999* (London).

achieve a permanent welfare gain from a better allocation of labour and other resources.

### **2.3. Money has been the key nominal anchor**

In most countries of central and eastern Europe it was assumed that the stabilization of liberalized prices must be based on the standard International Monetary Fund approach, with an important role as nominal anchors assigned to an incomes policy and – when feasible – a fixed exchange rate, in addition to restrictive fiscal and monetary policies. In the event, however, the supply of credit to governments and enterprises proved by far the dominant nominal anchor, with the exchange rate and the incomes policy playing only supportive roles.

Two related broad conclusions can be drawn from the evidence regarding the experience of disinflation in transition economies. One is that fiscal fundamentals, that is, the size of the budget deficit of general government and the way it was financed, have been the key to disinflation (tables 2 and 3). The other is that the policy of a fixed nominal exchange rate was helpful but not essential, and that, in any case, its survival was strictly conditional on a sound fiscal policy.<sup>13</sup> Also, “the transition record suggests that innovative exchange rate arrangements can provide only a brief interval during which sound fiscal discipline needs to be put in place for controlling inflation”.<sup>14</sup> With respect to the exchange rate, low levels of international reserves and the poor credibility of macroeconomic policies just before the start of transition, forced large up-front devaluations in all countries except Hungary. The result was that, initially, world prices offered little discipline for domestic prices. A restrictive incomes policy was intended to achieve a targeted inflation rate with other policies being less restrictive and, hence, a somewhat smaller recession. However, given the large changes and uncertainties, it has proved difficult to coordinate incomes policy with the main (fiscal and monetary) macroeconomic policies. In Poland in 1990 and Czechoslovakia in 1991, for instance, those main policies were initially so restrictive that in most enterprises incomes policies were not binding. In the former Soviet Union the authorities took the view that a restrictive incomes policy could not be implemented for political reasons. In the CIS countries the politically dependent central banks, in their credit policy for enterprises, were initially concerned above all with the

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<sup>13</sup> D. Begg, Disinflation in Central and Eastern Europe, and S. Gomulka, Comment on Begg. In: C. Cottarelli and G. Szepary (eds.), *Moderate Inflation: The Experience of Transition Economies*. Washington DC: IMF and National Bank of Hungary, 1998.

<sup>14</sup> P. Desai, Macroeconomic fragility and exchange rate vulnerability: A cautionary record of transition economies. *Journal of Comparative Economics*, vol. 26, no. 4, 1998: 621-41.

level of economic activity, typically the chief domain of governments. As noted earlier, in the first few years of transition, the CIS governments ran large budget deficits which were monetized (table 2). The consequence was wage-price inflationary spirals and (near) hyperinflations.

**Table 2.** Key macroeconomic indicators for the central European and Baltic economies, 1991-8

	1991	1992	1993	1994	1995	1996	1997	1998
GDP growth (percent)								
GDP-weighted averages	-10.7	-4.1	-0.3	3.7	5.6	3.9	2.7	1.8
GDP-weighted absolute mean deviations	2.9	5.0	3.2	1.6	1.9	2.1	4.6	3.9
Inflation, CPI (percent)								
GDP-weighted averages	109.9	183.0	115.0	29.9	24.2	21.3	46.1	12.0
GDP-weighted absolute mean deviations	77.0	208.0	131.0	14.0	11.7	11.4	54.1	8.3
General government budget balance (percent of GDP)								
GDP-weighted averages	-3.2	-4.8	-3.4	-3.2	-3.0	-3.2	-3.1	-3.1
GDP-weighted absolute mean deviations	3.8	2.6	2.9	1.9	1.3	1.3	0.9	1.1
General government expenditures (percent of GDP)								
GDP-weighted averages		47.3	45.7	44.7	43.8	43.4	43.1	43.1
GDP-weighted absolute mean deviations		4.9	6.5	5.2	4.5	4.7	5.2	3.0
Gross reserves (months of current account expenditures)								
GDP-weighted averages	1.9	2.1	2.5	3.0	4.4	3.9	4.1	4.5
GDP-weighted absolute mean deviations	0.9	1.0	0.8	0.9	2.0	1.7	1.4	1.8
Broad money (percent of GDP)								
GDP-weighted averages		47.2	44.7	44.6	44.8	45.7	44.5	43.8
GDP-weighted absolute mean deviations		15.5	16.8	16.6	15.2	14.5	12.4	11.7
Lending rate (percent)								
GDP-weighted averages		141	45.9	35.7	27.7	45.9	25.4	24.4
GDP-weighted absolute mean deviations		196.0	26.3	16.4	9.3	42.2	9.4	10.0

Source: Author's calculations based on official data, as reported in EBRD, *Transition Report 1999* (London). The GDP weights are from table 1, using the PPP GDP estimates.

Note: Inflation is the within-year change (December to December). General government: central, local and extra-budgetary funds. Broad money includes cash in circulation, current deposits and time deposits, in both domestic and foreign currencies.



**Table 3.** Key macroeconomic indicators for CIS economies, 1991-8

	1991	1992	1993	1994	1995	1996	1997	1998
GDP growth (percent)								
GDP-weighted averages	-6.2	-14.3	-9.6	-13.7	-5.3	-3.3	1.0	-2.9
GDP-weighted absolute mean deviations	2.7	2.1	2.0	2.6	2.5	2.1	1.7	2.4
Inflation, CPI (percent)								
GDP-weighted averages	155.0	2391.0	2431.0	514.0	151	30.2	15.1	70.6
GDP-weighted absolute mean deviations	10.5	303.0	2435.0	471.0	51	13.2	8.1	29.4
General government budget balance (percent of GDP)								
GDP-weighted averages	-36.5	-15.9	-10.4	-6.4	-7.6	-6.8	-5.1	-5.3
GDP-weighted absolute mean deviations	10.2	3.0	2.6	1.1	2.2	1.9	0.8	1.3
General government expenditures (percent of GDP)								
GDP-weighted averages	—	64.8	45.2	44.0	35.6	37.1	38.2	35.0
GDP-weighted absolute mean deviations	—	9.1	4.0	3.5	3.3	5.2	4.4	4.0
Gross reserves (months of current account ex penditures)								
GDP-weighted averages	—	—	—	1.6	2.6	2.5	2.6	2.0
GDP-weighted absolute mean deviations	—	—	—	0.8	0.7	1.0	1.0	0.6
Broad money (percent of GDP)								
GDP-weighted averages	—	39.3	25.4	19.2	13.7	12.8	13.9	16.6
GDP-weighted absolute mean deviations	—	3.3	6.4	5.8	0.9	1.1	0.9	1.9
Lending rate (percent)								
GDP-weighted averages	—	—	—	—	191.0	65.2	36.6	39.6
GDP-weighted absolute mean deviations	—	—	—	—	49.0	5.3	4.2	3.9

Source: As for table 2.

Note: As for table 2;

In the initial years some central banks made successful use of the instrument of credit limits. Deploying this instrument means that real interest rates need not be high – although they should not have been as negative as they were in most of the former Soviet Union. These rates may have to be higher in the intermediate stages of transition when credit limits are lifted and the real exchange rate has had the time to appreciate. During that stage high interest rates became the key policy instrument for protecting bank savings and restraining wage inflation. However,



in the advanced stage of transition, higher credibility and capital account liberalization have resulted in increased international capital mobility. This in turn forces some convergence of high domestic interest rates to low world interest rates.

## 2.4. The exchange rate policy

The freedom to set the exchange rate was initially tightly constrained by low levels of international reserves and an urgent need to win credibility for the new policy of full current account convertibility at a uniform rate. It was desirable to have a regime of a fixed nominal exchange rate in order for the rate to serve as an anchor for domestic prices, thus reducing inflationary expectations and inflation itself. However, the countries which adopted such a regime had to strongly devalue up-front to ensure a sufficiently competitive rate, so that reserves would increase. As I have already noted, such devaluations opened up large gaps between domestic and foreign prices, thereby undermining the role of the exchange rate as an anchor. In Russia (and many other CIS countries) international reserves were too low and monetary and fiscal policies too lax to contemplate nominal exchange rate pegging. A floating exchange rate regime was therefore adopted. However, the need to build up reserves meant that Russia and other floaters could not adopt a pure float. Once the reserves become sufficiently large as a result of interventions in the exchange market, the case for a pure float is stronger. A broad generalization would be that, at the (early) stabilization stage of transition, a concern with disinflation favoured nominal exchange rate pegging, while at the (later) advanced stage, when inflation was already low, the need to limit the destabilizing effects of capital inflows favoured a more flexible exchange rate regime, including a pure float as an extreme option. Between these two stages, both the inflation rate and the level of reserves would be moderate, and the concern to remain competitive favoured the adoption of an exchange rate regime that combined some flexibility in nominal terms with some stability in real terms. The regime chosen for this intermediate stage was typically a crawling band, with the pre-announced rate of crawl linked to anticipated inflation. This rate would therefore decline as disinflation progressed, while the band would be narrow initially and widen over time to a maximum of the ERM-2 size of  $\pm 15$  percent. To limit the domestic cost of any external shock, it was also desirable to peg to a basket of currencies, reflecting the composition of trade flows, rather than to any single currency.

Exchange rate movements in all transition economies, with the notable exception of Hungary, have followed a similar path, with a sharp depreciation at the start of transition followed by gradual real appreciation. Such a path is hardly

surprising given the initial conditions: low levels of international reserves, large risks associated with transition, inexperienced policy makers, no record of convertibility and typically poor credibility of policies.<sup>15</sup>

Several countries adopted a currency board, under which nominal pegging is combined with full backing of the base money by international reserves. The key benefit of such an arrangement is a sizeable instant gain in credibility. This lowers immediately inflationary expectations, which in turn reduce market interest rates, both nominal and real. As the experience of the Baltic states in the early 1990s and Bulgaria in 1997 showed, falls in interest rates could be large and rapid. In the short term, lower interest rates reduce the cost of servicing debt, both private and public, which in turn reduces both the stock of under-performing assets of the banking sector and the budget deficit of the government, thus further improving credibility. A currency board also helps to instil confidence among investors and hence supports recovery of the enterprise sector.

However, the strait-jacket of the currency board deprives the macroeconomic framework of any flexibility with respect to the exchange rate. This, and indeed any fixed nominal exchange rate regime, may mislead the private sector into believing that the exchange rate risk is completely absent. The result is an in-built tendency to contract a large foreign debt, which was the case not only in South-East Asia but also in the Czech Republic. This tendency is particularly strong in countries with weak financial institutions, to which category most transition countries still belong.<sup>16</sup> Such a debt, whether public or private, in turn produces a risk of an attack on the currency, which, if successful, leads to sharp devaluation and stagflation.

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<sup>15</sup> Economic and other factors which underlie exchange rate movements in transition economies are discussed by L. Halpern and C. Wyplosz, *Equilibrium real exchange rates in transition economies*, *IMF Staff Papers*, vol. 44, no. 4 (Washington DC), 1997: 430-60 and by the Symposium on Exchange Rates, *Journal of Comparative Economics*, vol. 26, no. 4, December 1998. The main reason for Hungary being the exception was, probably, the country's high standing among foreign investors at the start of transition. Specific issues with respect to the exchange rate policy of the transition economies which are candidates for membership of the European Monetary Union (EMU) are discussed among others, in: G. Kopits, *Implications of EMU for Exchange Rate Policy in Central and Eastern Europe*, IMF Working Paper WP/99/9 (Washington DC), January 1999.

<sup>16</sup> S. Fries, M. Raiser and N. Stern, *Stress test for reforms: transition and east Asia 'contagion'*, *The Economics of Transition*, vol. 7, no. 2, July 1999: 535-67, find that the transition countries with large public or private sector imbalances and low reserve cover of short-term debt are more vulnerable to contagion and that these weak fundamentals have their origin in inadequate structural and institutional reforms. A good comparative discussion of risk indicators for the banking sector in six transition economies of central and eastern Europe is provided in: S. Kawalec, *Banking sector systemic risk in selected European countries*, CASE Report No. 23 (Warsaw), 1999.

### 3. A detailed discussion of specific issues

#### 3.1. The macroeconomic framework: what progress?

To be conducive to investment and growth, the macroeconomic environment has to meet several criteria. I shall first articulate these criteria and then use them for an evaluation of the progress which the 25 transition countries have made during the 1990s.

The criteria that, I suggest, would be desirable to meet are as follows:

(i) The inflation rate to be in the moderate range of 10 to 40 percent, with a good prospect of it falling below 10 percent and remaining in the 0 to 10 percent range;

(ii) The general government budget deficit to be reduced from the initial 5 to 30 percent of GDP for most countries to a level below 3 percent of GDP, with a high premium given to a policy of a budget surplus;

(iii) The public debt to be stable at a level significantly below 60 percent of GDP;

(iv) General government expenditure to be reduced from its pre-transition level of some 50 to 60 percent of GDP to a level in the range of 30 to 40 percent of GDP;

(v) Official reserves of foreign exchange to equal at least four months of imports of goods and services, exceed total (public and private) short-term foreign debt, and be equal to at least one third of public foreign debt;

(vi) Direct taxes (especially profit taxes) to be low, together with social insurance contributions providing revenues of less than, say, 20 percent of GDP;

(vii) The monetization of the economy to be substantial, equal at least to 30 percent of GDP;

(viii) The lending rate to be below 20 percent in nominal terms and below 10 percent in real terms.

The first three criteria are those of the Maastricht treaty. They are not independent. If  $D$  is public debt,  $Y$  is GDP,  $P$  is the price level and  $\Delta D$  is the budget deficit, fiscal sustainability requires that the ratio  $D/PY$  be constant, which implies that:

$$\Delta D/PY = (\pi + g) D/PY \quad (1)$$

where  $\pi$  is the rate of inflation and  $g$  is the growth rate of GDP. The left hand side of (1) is the budget deficit as a proportion of GDP, and  $D/PY$  on the right hand

side is the targeted debt-to-GDP ratio. For most of the EU member countries, the rate  $g$  is expected to be low, say 3 percent. The maximum budget deficit of 3 percent is thus consistent with the maximum debt of 60 percent only if the inflation rate is maintained, in this case, at 2 percent. Transition economies are expected to grow at a rate (significantly) higher than 3 percent. Those countries which intend to join the EMU will need to meet the Maastricht criteria on inflation and the budget deficit, hence equation (1) implies that they will have to keep public debt at a level (significantly) lower than 60 percent of their GDP.<sup>17</sup> Criteria (ii), (iv) and (vi) are also related. Their common motivation is to increase national savings and improve the incentives for work and investment. Criterion (v) is intended to reduce the exchange rate risk and criterion (vii) serves to indicate that the banking sector has developed sufficiently to intermediate effectively between savers (mainly households) and investors (mainly enterprises).

The differences between the two groups of countries can be noted in tables 2 and 3. Compared with the central European and Baltic countries, in the CIS countries both inflation and budget deficits have been much higher, but public expenditures have declined more sharply. Gross reserves have increased to adequate levels in the central European countries, but still remain very low in the CIS region. The ratios of broad money to nominal GDP have been remarkably stable, at moderately high levels, in the central European and Baltic countries, but they declined sharply, as one would expect, during the high inflation period in the CIS region where they now stand at very low levels. Despite these significant differences, a considerable convergence has taken place in macroeconomic conditions between and within the two groups, together with a sharp improvement over time in both.

In terms of the eight macroeconomic criteria, the central European and Baltic countries are close to meeting the criteria with respect to the variables in table 2. The data on public debt and taxes also indicate compliance with the criteria for these two additional indicators. For the CIS region, the macroeconomic balance is still fragile, and the macroeconomic environment, while no longer as hostile to growth as it was in the early 1990s, needs to be significantly improved to become growth-friendly. The financial crisis of August 1998 revealed the extent of Russia's macroeconomic imbalance. However, following this crisis, policy adjustments in Russia and elsewhere in the CIS have contained its destabilizing effects, restored equilibrium and, consequently, reduced further the gap in performance between this group and the central European and Baltic countries.

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<sup>17</sup> Fiscal sustainability in transition economies has been discussed recently by several authors, e.g. W. Buiter, *Aspects of Fiscal Policy in Some Transition Economies under Fund-Supported Programs*, IMF Working Paper WP/97/31 (Washington DC), April 1997.

### 3.2. What distinguishes the more successful from the less successful countries?

I propose to measure the success of reforms in the transition countries by their ability to recreate the (institutional, legal and economic) conditions for rapid and sustainable growth. This ability is indicated by the increase in output since the start of recovery. It is this yardstick which differentiates strongly the Baltic states from, for example, Russia and Ukraine within the former Soviet Union, and much of central Europe from much of the former Soviet Union. It is natural to ask about the factors underlying these differences: are they initial conditions, the state of institutions or the political environment?

The cumulative changes in output between 1989 and 1998, and between its lowest point and its level in 1998, are shown in table 4 (next page), where the countries are also graded according to their commitment to liberalization and stabilization. Several countries achieved significant recoveries in GDP growth, but some of them are not reform related. Internal conflicts led to very deep recessions in Albania, Armenia, Azerbaijan and Georgia; subsequent improvements in political stability would have contributed much to the recovery of their economies. There are also two countries, Belarus and Kyrgyzstan, where substantial recoveries may have been artificial, as they reflect in part the postponement of the needed structural changes.<sup>18</sup>

There are a substantial number of empirical studies which attempt to explain the wide variation in the rate and length of recovery. These studies fall into two broad groups, one based on macroeconomic data and the other on enterprise data. One of the latest comprehensive studies in the first group, using a general-to-specific modeling approach, finds some evidence in support of “the pre-eminence of structural reforms over both initial conditions and macroeconomic variables in explaining cross-country differences in performance and the timing of the recovery.”<sup>19</sup> In particular, more liberalized economies grow faster. However, as the periods of recovery have been short for most countries, econometric results are not yet stable. The wide differences in performance within countries suggest that initial conditions might be more potent than indicated by aggregate data. Indeed, another recent empirical study, using a somewhat different statistical method,

<sup>18</sup> According to the Belarus Minister of Economy, economic growth “during the second half of the 1990s was substantially initiated by additional loading of old manufacturing facilities and was boosted ... by emission credits [which] allowed Belarus to preserve her manufacturing potentials and to solve some important social problems” (V. Shimov, report presented at the UN/ECE Spring Seminar, Geneva, 2 May 2000).

<sup>19</sup> A. Berg, E. Borensztein, R. Sahay and J. Zettlmyer, *The Evolution of Output in Transition Economies: Explaining the Differences*, IMF Working Paper WP/99/73 (Washington DC), May 1999.

**Table 4.** GDP growth and reforms in the Central-European, Baltic and CIS economies (percent, index)

	Growth (percent)		Reforms (index)	
	1998 from lowest level	1989-98	Liberalization	Stabilization
Albania	43.1	-14	3	5
Bulgaria	3.5	-34	3	5
Croatia	20.6	-22	3	5
Czech Republic	12.7	-5	5	5
Estonia	25.7	-24	5	5
The former Yugoslav Republic of Macedonia	5.3	-28	3	3
Hungary	16.2	-5	5	5
Latvia	14.0	-41	3	5
Lithuania	19.8	-35	3	5
Poland	42.5	17	5	5
Romania	1.8	-24	3	5
Slovakia	32.9	—	5	5
Slovenia	25.7	4	5	5
CIS				
Armenia	31.8	-59	3	3
Azerbaijan	.. 17.9	-56	1	3
Belarus	.. 22.6	-22	1	3
Georgia	.. 29.2	-67	3	3
Kazakhstan	—	-39	3	3
Kyrgyzstan	.. 20.4	-40	3	5
Republic of Moldova		-68	3	5
Russian Federation	—	-45	3	3
Tajikistan	.. 5.8	-58	1	3
Turkmenistan	4.2	-56	1	3
Ukraine	—	-63	1	3
Uzbekistan	6.1	-10	1	3

Source: EBRD, Transition Report 1999 (London).

Note: Early liberalizers are given grade 5. They are defined as countries that had achieved "complete price liberalization, full current account convertability and almost complete small-scale privatization". Late liberalizers achieved these thresholds after 1993. They are given grade 3. The remaining countries are given grade 1. With respect to stabilization, countries are divided into early stabilizers, those which stabilized before the end of 1993, and late stabilizers (all other countries). The grades given are, respectively, 5 and 3.

finds that growth performance during the 1990s was “substantially determined by initial conditions, both directly and indirectly through their impact on structural reform.”<sup>20</sup>

The periods of positive growth have been short for most countries, but especially for the three main CIS countries – Kazakhstan, Russia and Ukraine, and for Bulgaria and Romania in south-east Europe. These five countries (together with the Republic of Moldova) are clearly the least successful of all the 25 transition countries in table 4. Recovery in both the Czech Republic (1997-9) and Hungary (1995-6) has suffered from unexpected macroeconomic instabilities. The long pause in recovery in the Czech Republic has prompted a reappraisal of the virtues of rapid voucher-type privatization. It is this negative experience of the Czech Republic and the much better growth performance of Poland, Estonia and, more recently, Hungary, which has led to the “new wisdom”, namely that the success of transition depends above all on a rapid creation of conditions – institutional, legal, microeconomic and macroeconomic – which are conducive to the development and growth of a new private sector (including FDI). From this perspective, it is clear that with the exception of some authors, notably Kornai,<sup>21</sup> the early conventional view overestimated the positive impact on performance of a fast privatization of SOEs and, by the same token, failed to appreciate sufficiently the key role that a completely new private sector would play in the recovery and growth.

Given the central role of the new private sector in recovery and post-transition growth, it is worth noting the presence of wide international differences in the domestic/foreign composition of that sector, with Hungary and Poland at the extremes and Estonia somewhere in between. In these three countries, strong liberalization policies with respect to prices, trade and entry were adopted early, and in conjunction with a policy of harder budget constraints and increased competitive pressures on SOEs. Poland was also helped by the presence of a sizeable private sector outside agriculture at the beginning of transition.

### **3.3. How far have weak or missing institutions hampered effectual policy-making?**

In the first decade of the transformation, the institutional deficiency was severe, and this added an additional dimension of difficulty to policy-making. Macroeconomic management was particularly difficult in the new countries of

<sup>20</sup> E. Falcetti, M. Raiser and P. Sanfey, *Defying the odds: initial conditions, reforms and growth in the first decade of transition*, London School of Economics and EBRD (London), May 2000, mimeo.

<sup>21</sup> J. Kornai, *The Road to a Free Economy*. New York and London: Norton & Co, 1990.

the former Soviet Union, which initially lacked their own currencies and central banks and where international reserves were almost nonexistent. With the exceptions of Hungary and Slovenia, the introduction of personal taxes and the replacement of turnover taxes by a proper VAT could not take place at the start of the transition. The capital market was initially almost non-existent and its development has been slow. The result of these two types of deficiency was that budget deficits were larger and their financing was to a greater extent achieved by outright monetization than would otherwise have been the case. Large or hyperinflations wiped out most bank savings in all but a few transition countries, thus limiting the role of the banking sector in economic restructuring. Politically independent bank supervision did not exist under the old system, and its necessarily gradual establishment during the transition meant that in many countries it was too weak to prevent bank failures. High rates of inflation and poor banking practice must have been major factors underlying low bank savings, the flight from domestic money, and the use of parallel currencies (especially dollars and deutsche marks).

Given these extreme initial circumstances, it is remarkable that it took the new countries of the former Soviet Union only some four to five years to establish the basic institutional framework needed to conduct a reasonable macroeconomic policy – by creating central banks, new currencies, bank supervision, international payments systems, new taxes and tax collection systems, stock exchanges, securities commissions, labour exchanges and new social benefit systems. The result has been a vast improvement in the macroeconomic environment of those countries in the second half of the 1990s. Nevertheless, the new central institutions still lack high quality personnel, and they have yet to establish a tradition of trust and behaviour based on transparent and stable rules, consistent with long-term public interest and market principles.

The ultimate success of transition will depend on the establishment of appropriate market institutions supporting macroeconomic stability, entrepreneurship and competition. Such institutional changes are inherently slow and depend on the political commitment to reform of governments and parliaments, and on their practical effectiveness in implementing reforms and policies. This commitment was clearly stronger and its effectiveness probably greater in the central European and Baltic countries than in the CIS. This difference reflects not only the longer and stricter socialist central planning in the CIS, but also a much stronger influence of the European Union in the central European and Baltic countries, including (in contrast to the CIS) the pull of the strategic aim of membership of the European Union.



### 3.4. Have policy dilemmas been intensified by weak institutions?

In several instances, weak institutions led to a renewal of macroeconomic instability or to a serious threat of such an instability. A clear case was Albania in 1996, when the rapid growth of a pyramid system led to a general crisis of confidence and almost to civil war. Another, and more important, example was the case of Bulgaria in 1997, when poor banking supervision led to a sharp growth of underperforming assets. This in turn forced interest rates to such high levels that the cost of servicing Bulgaria's public debt became unsustainable. There were two policy options for Bulgaria (and the IMF). One was to inflate away this debt by a non-equivalent currency change or by printing a great deal of money, and then introduce a stabilization programme. The other was, effectively, to abolish the central bank and introduce a currency board in its place. Such an institutional reform meant replacing domestic monetary control by nominal exchange rate targeting and depriving the government of the option of monetizing its budget deficit. The currency board option was, in fact, adopted on the assumption that the gain in credibility would be large enough to bring about sharp falls in both inflation and interest rates. This assumption was vindicated by actual developments. Currency boards had been adopted earlier by the Baltic states for similar reasons. However, the most spectacular institutional failure was in Russia. There, poor cooperation between the executive and the legislative branches of government, the weakness of the tax administration and lax expenditure controls led to excessive short-term foreign borrowing in 1997-8, and resulted in a financial crisis in August 1998. In Poland, during the early stage of transition the central bank operated a system of credit limits for commercial banks, a practice which was discontinued only with the development of an interbank money market.

The performance of transition economies and, indirectly, the conduct of macroeconomic policies, were also influenced by weak corporate governance and uncertainties with respect to enforcement of contracts, including those concerning property rights. These factors have probably contributed to the phenomenon of capital flight from Russia and may account for the limited amount of foreign direct investment in most countries of the CIS. The recent prolonged recession in the Czech Republic (1997-9) is also difficult to explain without reference to the quality of the corporate governance of the country's enterprises, following its coupon privatization programme. Finally, banking supervision may have been inadequate to prevent the growth of underperforming loans in many countries, including the Czech Republic and Romania. This in turn required repeated and expensive recapitalizations of state owned banks by governments.

### 3.5. Has too much emphasis been placed on lowering inflation – or reducing it too rapidly at the expense of economic growth?

As I discussed elsewhere, the first IMF-supported programmes for Poland and Russia placed much emphasis on a swift disinflation.<sup>22</sup> But these programmes tended also to underestimate the severity of the supply and demand shocks associated with the institutional crisis and price liberalization, and did not sufficiently appreciate the fact that such shocks would at the same time sharply reduce output and be highly inflationary. For the years 1992-8 and for all the 25 transition countries listed in tables 2 and 3, there is a fairly strong association between the fall in output and the inflation rate, as shown in the following equation (t-ratios in parentheses):

$$g_{Y,t}^i = 15.5 - 4.5 \log_{10}(1 + \pi_{t-1}^i) - 7.80 \log_{10}(1 + \pi_t^i) \quad (2)$$

(3.6)(-4.6)                      (-7.9)                      ...

N = 175, R<sup>2</sup> = 0.61, i = 1, 2, ..., 25

$$\log_{10}(1 + \pi_t^i) = 1.4 - 0.01 g_{Y,t-1}^i - 0.04 g_{Y,t}^i \quad (3)$$

(5.3)(-2.2)                      (-9.2)                      ...

N = 200, R<sup>2</sup> = 0.53, i = 1, 2, ..., 25

In these two equations,  $g_{Y,t}^i$  is the percentage change of GDP in year t and  $\pi_t$  is the percentage inflation rate, divided by 100, in year t. N is the number of observations and i the number of the country. For the purpose of estimation, both  $g_{Y,t}^i$  and  $\pi_t^i$  have been weighted by the square root of the countries' share in total GDP, expressed in terms of PPP dollars.<sup>23</sup> These estimates indicate that last-year's inflation reduces current growth and last-year's fall in output increases current inflation. However, the tightest association is between current output falls and current inflation. This evidence supports the view of the transformational recession as being essentially of the stagflation type, whereby both output falls and inflation increases had to a significant extent common causes.

The policy mix required to achieve disinflation under such circumstances is one of a tight fiscal policy combined with an accommodating monetary policy. The disinflation process may also have to be gradual to accommodate more easily

<sup>22</sup> S. Gomulka, The IMF-supported programs of Poland and Russia, 1990-1994: Principles, errors and results. *Journal of Comparative Economics*, 1995, 20(3): 316-46.

<sup>23</sup> For a linear system of the form:  $y_i = \sum a_j x_{ij} + e_j$  the standard ordinary least squares (OLS) estimates of the parameters  $a_1, a_2, \dots, a$ , minimize  $\sum (y_i - \sum a_j x_{ij})^2$ . Weighted OLS estimates minimize  $\sum w_i (y_i - \sum a_j x_{ij})^2$  or  $\sum (w_i y_i - \sum a_j w_i x_{ij})^2$ , where  $\sum w_i = 1$ . This is equivalent to estimating a system in which the original variables are rescaled by the square roots of their respective weightings.

large changes in relative prices. In practice, disinflation was swift only in Croatia. In the central European and Baltic countries – with the exception of Romania in 1993 and 1997 and Bulgaria in 1997, which experienced strong inflation reversals – the disinflation process has been more or less gradual. However, most CIS countries failed to keep their budget deficits under control and, consequently, experienced periods of very high inflation, even hyperinflation. As already noted in section 2, in those countries the recession has been prolonged and the recovery either has been modest or has not yet materialized. Thus, in practice, the clear failure of macroeconomic policy was limited mainly to the CIS countries in the years 1992-4 (in Tajikistan and Turkmenistan this continued in 1995).

At the advanced stage of transition, the rate of disinflation is constrained by international capital mobility, which limits the freedom of central banks to set and maintain interest rates much above the world level. The attendant dilemmas are well known. If the exchange rate is fixed, a restrictive monetary policy induces capital inflows, as borrowers substitute foreign for domestic debt and foreign investors buy domestic assets. The sterilization of such inflows is possible but expensive, and therefore has its limits. If the exchange rate is floating, capital inflows induce an appreciation of the domestic currency. This helps to reduce inflation in the short term, but may also lead to a large current account deficit and, therefore, increases the risk of a sudden devaluation and higher inflation in the medium term. Borrowers in transition economies have little experience in estimating the exchange rate risk. Misjudgments are especially likely when expectations are being formed during prolonged periods of real effective appreciation. The appreciation trend is a feature of transition and is sustained by several factors, the two crucial ones being depressed exchange rates at the starting point and rapid improvements in productivity and rates of return during the subsequent transition. Productivity improvements are particularly rapid in countries where reforms have been successful. Such countries are also credible candidates for membership of the European Union and, for that reason, attract more FDI than others, giving further support to the appreciation. Such circumstances call for an interest rate policy that is not very restrictive, and place an even bigger burden on governments to conduct a restrictive fiscal policy. However, if such a fiscal policy is not adopted, any attempt to disinflate quickly by means of highly restrictive monetary and exchange rate policies, may easily backfire, as it would cause a large current account deficit which may at some point trigger a crisis of confidence and result in stagflation. A short-term gain in the rate of disinflation is then obtained at the cost of an increased risk of macroeconomic instability. During the run up to EU membership, short-term foreign debt tends to increase rapidly. It is therefore prudent during this period to keep international reserves

high and increasing, even if this concern about stability causes a certain slowing down of the rate of disinflation.<sup>24</sup>

### **3.6. What lessons can be drawn for those transition economies still struggling to achieve macroeconomic stability and economic growth?**

The lessons which I propose to draw from these 10 years of transition are as follows:

(i) Most former SOEs, especially the large ones, have suffered from the British Leyland/Rover syndrome: the accumulation of structural problems of such magnitude that they are not amenable to significant “strategic” restructuring nor capable of rapid growth whatever their new ownership and regulatory framework. Given the financial, managerial and other constraints, and poor positive incentives, such enterprises – unless taken over by large foreign investors – are mainly capable of only “defensive” restructuring;

(ii) The success of transition depends above all on the rapid creation of conditions – institutional, legal, microeconomic and macroeconomic – which are conducive to the development and growth of a new private sector, domestic and/or foreign;

(iii) This development of this new sector is facilitated by increased competition through price liberalization, permitting SOEs to sell capital assets, imposing hard budget constraints on them, encouraging FDI and lowering the entry barriers to new businesses. The number of these businesses outside of agriculture should be about 0.5 million per 10 million of the population, and the small and medium-size enterprises should eventually account for some 50 to 60 percent of GDP;

(iv) The inflation rate need not, and initially should not, be very low, but it must not be high (not more than 40 percent per annum), and it should be seen to be converging to the EU level;

(v) A disinflation policy should involve all the key macroeconomic components: fiscal, monetary, the exchange rate and (when applicable) wages and benefits. Given the close link between budget deficits and money growth in transition countries, a tight fiscal policy is necessary. But it may not be sufficient, and other policies should be used in supporting roles. The cost of disinflation is lower if the monetary authorities are politically independent. Although an extreme solution, currency boards can be useful;

(vi) The choice of an exchange rate regime is not very important from the point of view of an anti-inflation policy, but it helps to have, at some point, a

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<sup>24</sup> These issues are discussed comprehensively by several authors in Z. Drabek and S. Griffith-Jones (eds.), *Managing Capital Flows in Turbulent Times: The Experience of Europe's Emerging Economies in Global Perspective*. Armonk, NY: M. E. Sharpe, 1999.

moderately or even fully flexible regime, in order to provide the private sector with better information about the exchange rate risk and so establish a better defence against speculative capital inflows and an excessive growth of private foreign debt;

(vii) The essential institutional basis for a stable macroeconomic environment includes, apart from an independent central bank, a solid regulatory framework for financial institutions: banks, insurance and pension funds and stock exchanges;

(viii) To attract foreign direct investment and eliminate capital flight, external credibility is vital. In order to build up this credibility, the exchange rate should be competitive most of the time to ensure that international reserves are high in relation to imports and foreign debt, especially short-term debt;

(ix) Fiscal policy, in order to be consistent with the stability objective, should aim to meet the Maastricht criteria with respect to the general government budget deficit and public debt. However, if the policy is also to serve developmental objectives, it should additionally aim to keep taxes (and therefore public expenditures) low in relation to GDP and, within public expenditures, should favour spending on education and infrastructure at the expense of social transfers, defence and subsidies;

(x) The high rate of structural unemployment requires changes in the labour code to increase flexibility of labour markets, e.g. by reducing hiring and firing costs. It also requires an active role of governments in education and training.

These 10 lessons overlap with the following conclusions reached by Wyplosz in his own recent survey: it has paid to start early and move fast; macro-stabilization is a prerequisite for growth; the exchange rate regime is largely irrelevant for disinflation; and microeconomic foundations/structural reforms are important for both stability and growth.<sup>25</sup> But the additional matters that I am emphasizing are the links between policies and the growth of the new private sector, and the importance of the exchange rate policy for competitiveness, credibility and stability.

Recent comparative empirical studies of enterprise performance, in CIS countries on the one hand and in the more successful countries on the other, attempt to identify the key underlying factors. According to Johnson, McMillan and Woodruff, macroeconomic stability is not sufficient for private sector growth, and an essential institutional feature for entrepreneurship to develop is the presence of a legal system sufficiently strong to secure property rights.<sup>26</sup> Such a feature, howev-

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<sup>25</sup> C. Wyplosz, *The Ten Years of Transformation: Macroeconomic Lessons*, CEPR Discussion Paper, No. 2254 (London), March 2000.

<sup>26</sup> S. Johnson, J. McMillan and C. Woodruff, *Entrepreneurs and the ordering of institutional reform: Poland, Slovakia, Romania, Russia and Ukraine compared*. *The Economics of Transition*, vol. 8, no. 1, March 2000: 1-36.

er, is probably only one of several necessary conditions. After all, the legal system is the same throughout Hungary or Poland, but private sector development is still weak in the countryside and small towns, and heavily concentrated in the capitals and major cities where the supply of labour skills and infrastructure facilities is high and where there are more individuals with entrepreneurial abilities.

### 3.7. What are the long-term growth prospects for transition economies?

In most of these countries, the institutional reforms of the 1990s have created a microeconomic and institutional environment conducive to the effective use of their entrepreneurial capital. In such countries, the magnitude of international technology transfer can be assumed to be related positively to both capital accumulation and the development gap. This transfer may also be expected to be greater in countries that have succeeded in creating and maintaining a stable macroeconomic environment.

Elsewhere I have reported the results of an empirical test of such propositions, using the post-Second World War data for 20 countries in western Europe, Latin America and the Pacific rim.<sup>27</sup> These regression results are as follows:

$$g_y = -2.22 + 0.195(I/Y) + 5.63 \log_{10}(y^{US}/y) - 5.92 \log_{10}(1 + g_p) \quad (4)$$

(-3.6) (7.9) (14.5) (-6.8) ...

where t-ratios are indicated in parentheses, and where  $R^2 = 0.80$ . In this relationship, the time unit is a 10-year period, and  $g_y$  is the percentage growth rate of GDP,  $I/Y$  is the gross investment/GDP ratio,  $y$  is the per capita GDP at purchasing power parities, and  $g_p$  is the percentage rate of inflation (of the GDP deflator) divided by 100, all variables being 10-year averages.

In the regression equation (4),  $\log(1 + g_p)$  equals approximately  $g_p$  (expressed as a fraction of 100), so it tells us that an increase in the trend rate of inflation by a percentage point reduces the trend growth rate of GDP by 0.06 percent. The inflation rate is strongly correlated with the inflation variance, so the latter may also serve as an instrumental variable for instability factors.

For those transition economies which are EU candidates, the ratio  $y^{US}/y$  equals about 4, and  $\log_{10} 4 = 0.6$ . Thus, according to this Gomułka-Dumas equation, the catching-up factor could contribute about 3.4 percentage points to their current growth of GDP. For a EU candidate country with an  $I/Y$  ratio in the range of 20 to 25 percent and an inflation rate of 10 to 15 percent, the growth equation predicts a

<sup>27</sup> S. Gomułka, Growth convergence: A comment on Warner, London School of Economics, 1999, mimeo (forthcoming in a book edited by L. Orlowski, to be published by Elgar).

GDP growth rate ranging from 4.7 percent (for  $I/Y$  equal to 20 percent and  $g_p = 15$  percent) to 5.8 percent (for  $I/Y$  equal to 25 percent and  $g_p = 10$  percent). A further increase of the  $I/Y$  ratio by 5 percentage points, to 30 percent, would raise the growth rate to 6.8 percent and a reduction of the inflation rate by 7 percentage points, to 3 percent, would raise it further to 6.9 percent. However, after a decade of growth at between 5 to 7 percent, the ratio  $y^{US}/y$  would decline from the present level of 4 to about 3, reducing the contribution of the catching-up factor by 0.7 percentage points, and reducing the growth rate from 6.9 percent to 6.2 percent, by the year 2010.

This exercise is not intended to provide precise estimates of the growth rate for specific time periods and specific countries. The purpose is rather to estimate the potential trend growth rate on the basis of the broad and long-term experience of a group of countries thought to be representative of medium-developed and market-based economies.

The estimates reported in table 5 should be interpreted in this spirit, as an indication of the possible growth rate for the countries listed over the next 50 years, given the declining role of the “advantages of backwardness” factor. Policy options are represented by two savings ratios.

The important role of capital accumulation in this growth projection is indicated by an implicit assumption that international technology transfer is proportional to investment. This assumption may be realistic when the technological gap is large, in the first 20-30 years of the projection. In the closing years of the period, declining returns to capital must set in, so the projection in table 5 is then less realistic.

After the first decade of transition, domestic savings tend to be low in most transition countries. This is so, essentially, for two reasons: the inherited policies of large social transfers and the negative effect on incomes of the transformational recession. Following the first wave of reforms (liberalization, stabilization and privatization), the transition countries can turn to implementing reforms and policies intended specifically to promote savings. These include pension reforms, whereby state pensions are sharply reduced and private pension schemes established, and tax reforms intended to lower sharply both subsidies and direct taxes on individuals and companies.

The European Union candidates should also be able to attract foreign direct investments in volumes that are significant in relation to GDP. The macroeconomic risks to investors could be reduced further, and substantially, once the new EU members become a part of Euroland. When this happens, and only then, domestic savings should no longer be a constraint on investment, and hence no longer a constraint on growth.



Public investments have a significant contribution to make in promoting growth in all those areas in which positive externalities are present. These include, typically, physical infrastructure, research and education. Public spending in these areas has been radically curtailed during the first decade of the transition. A reduction of social transfers is also needed for the purpose of reversing this trend.

**Table 5.** GDP growth and relative GDP per capita for selected transition economies (United States GDP per capita = 1)

	s = 20						s = 30					
	0	10	20	30	40	50	0	10	20	30	40	50
Russia												
$g_y$	—	4.66	4.09	3.65	3.29	3.02	—	6.24	5.34	4.63	4.07	3.63
$y_t/(1.02)^t$	0.22	0.29	0.36	0.43	0.50	0.55	0.22	0.34	0.49	0.65	0.81	0.96
Poland												
$g_y$	—	4.33	3.83	3.44	3.13	2.89	—	5.91	5.08	4.42	3.91	3.50
$y_t/(1.02)^t$	0.26	0.33	0.40	0.47	0.53	0.58	0.26	0.39	0.54	0.70	0.86	1.01
Ukraine												
$g_y$	—	6.03	5.17	4.50	3.97	3.55	—	7.61	6.43	5.49	4.75	4.16
$y_t/(1.02)^t$	0.11	0.17	0.23	0.31	0.38	0.45	0.11	0.20	0.31	0.46	0.62	0.78
Czech Rep.												
$g_y$	—	3.37	3.07	2.84	2.66	2.52	—	4.94	4.32	3.82	3.43	3.13
$y_t/(1.02)^t$	0.41	0.48	0.54	0.59	0.64	0.68	0.41	0.57	0.73	0.89	1.04	1.18
Hungary												
$g_y$	—	3.77	3.39	3.09	2.86	2.67	—	5.34	4.63	4.07	3.63	3.28
$y_t/(1.02)^t$	0.34	0.41	0.48	0.54	0.59	0.64	0.34	0.49	0.65	0.81	0.96	1.11

Source: Author's estimates on the basis of equation (4), and under the assumption that the United States GDP per capita will be increasing at a constant rate of 2 percent per annum.

Note: 1998 is the initial year, t denotes years from 1998, s is the investment/GDP ratio in percent.

### 3.8. Concluding remarks

In all the transition countries covered by this paper, the liberalization and stabilization measures of the 1990s have been fundamental in helping to foster a rapid expansion of the new private sector, a contraction and restructuring of the state sector, and a profound reorientation and rapid growth of international trade. In most of these countries, GDP per capita was about 15 to 30 percent of the level in the United States at the beginning of the twentieth century, and is still at about the same level at the end of the century. The economic transformation of the last



decade has contributed significantly to meeting the strategic aim of creating an economic system that should enable these countries to make substantial progress in closing this income gap in the 21<sup>st</sup> century.

Dramatic macroeconomic imbalances and extraordinarily large structural distortions have been the key problems that the 25 post-socialist countries of central Europe and the former Soviet Union inherited and have had to face and solve during the first decade of their transition. The reform packages which most central European and Baltic countries have adopted, broadly corresponded to the severity of the macroeconomic crisis and the magnitude of these inherited structural problems. They aimed at regaining macroeconomic stability quickly, rapidly liberalizing prices, trade and entry, and establishing an infrastructure of institutions and laws capable of servicing a well-functioning, competitive market economy. The reform strategy adopted by most of the CIS countries embraced considerable, but less extensive PTE liberalizations, and placed rapid privatization before macroeconomic stabilization. In those countries structural distortions were initially larger, private sectors smaller, and earlier market reforms more limited. These more hostile initial conditions had a major impact on reforms, policies and the progress of transition. However, the differences in reform strategies between the two groups of countries and within each group narrowed considerably in the second half of the 1990s.



## 7. The causes of recession following stabilization\*

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### 1. Introduction

The primary and partially contradictory economic policy aims of the reforming governments in Eastern Europe and the USSR during their first months in office are price liberalization and price stabilization. They are also preliminary aims, the purpose of which is to remove economic distortions and thus prepare the ground for the next and more difficult stage of institutional changes and other 'structural' reforms.

These two stages involve a series of shocks to the economy. The shocks may be divided into those arising on and directly affecting the supply side and those originating from the demand side. There are several types of supply-side shocks to be discussed later in the paper, of which possibly the most important takes the form of large changes in relative prices. There are also several reasons why aggregate demand may be significantly reduced and the composition of the purchasing power between households, enterprises and the government sharply changed.

Such shocks are bound to reduce activity. A weakening of economic activity is therefore in part the inevitable price of, and in part a condition for, the adjustment of the economy to the new rules of resource allocations and the new price environment.

In Poland, corrective recession of this type was expected and was looked at as a part of the program for 1990-1, just as the corrective inflation in January 1990 was part of the program of stabilizing prices since February 1990. Nevertheless, this recession seems to be, in 1990-1, much deeper than what most Polish policy makers and the IMF experts were predicting in November and December 1989 when the details of the January 1990 package of measures were worked out. The surprises of the stabilization period also apply to the behavior of a number of other important macroeconomic variables, in addition to output.

In this paper we shall describe and interpret only some of these surprises. The focus of attention will remain the recession, for it has become evident that the depth of this recession, not only in Poland but throughout Eastern Europe and

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\* *Comparative Economic Studies*, 33 (2), Summer 1991.

the USSR, is, or is going to be, truly large, comparable to the Great Depression of the 1930s. The debate that is now raging among policy makers, their advisors, institutional experts and academic economists, attempts to establish the contributions to that recession of the liberalizing supply-side shocks and of the stabilizing measures in the form of contractionary fiscal, incomes and monetary policies.

If the supply-side contribution is dominant, then the recession represents Schumpeterian creative destruction, designed to release resources locked in unproductive or insufficiently productive uses, for their future use elsewhere. If the demand-side contribution is large, then the recession is in part a price to be paid for regaining macroeconomic control. In this case, there is also the possibility to be considered that the demand contraction has been excessive.

## **2. Aims and effects of the stabilization policy in Poland 1990**

The stabilization policy had three principle aims:

- reduction of inflation from between 20 to 50 percent per month in August-December 1989 to about 5 percent in March 1990, and about 1-2 percent per month in the second half of 1990;
- transition from a producers' to a consumers' market and, as a result, a general strengthening of budgetary constraints on enterprises; and
- a substantial reduction of the share of dollar currency in the total money supply.

The first aim was to be attained with the aid of three nominal „anchors”: an almost total wage freeze, limited expansion of money supply, and a fixed rate of exchange. The second aim was to be reached through a balanced budget of the government and price liberalization, and the third by a bank interest for zloty savings considerably higher than that for dollar savings.

The aims so formulated were broadly attained in the stipulated time period. (The only exception was the inflation rate, which increased to about 5 percent a month in the second half of 1990.) In that sense, the realization of the stabilization policy in its central part was a success. On the one hand, the original program and the policy to implement it may also be judged in terms of the six performance criteria adopted by the International Monetary Fund (IMF) to monitor the performance under a Stand-By Agreement with the Polish government (see Table 1). These criteria may be supplemented by four additional measures: the cumulative price increase, the fall in economic activity, the increase in real total money supply, representing the sum of the changes in the international reserves of the banking systems and in net domestic assets (NDA), and change in real credit to non-government.

Comparison of the program figures and actual performance shows that the realization of the stabilization program differed substantially from expectations in the case of several such measures.

In general, the monetary and budgetary policies were much more restrictive than the program had envisaged, and despite this the inflation rate was much higher than anticipated. The economic recession is likewise deeper than had been originally foreseen. Some of the surprises have been of the welcome category. They included above all: (1) a comfortable budget surplus, (2) an extraordinary stability of the exchange rate, (3) a high effectiveness of the monetary policy, and (4) a high speed of structural changes driven by a rapid growth of the private sector and a fast growth of exports to Western markets. I shall comment on these developments briefly later in the paper. (For a more detailed discussion, consult Gomulka, 1991.)

However, two surprises have been of the unwelcome variety: a much faster price inflation and a much deeper recession.

**Table 1.** Poland: performance under the Stand-By Arrangement, first half of 1990 and the whole of 1990

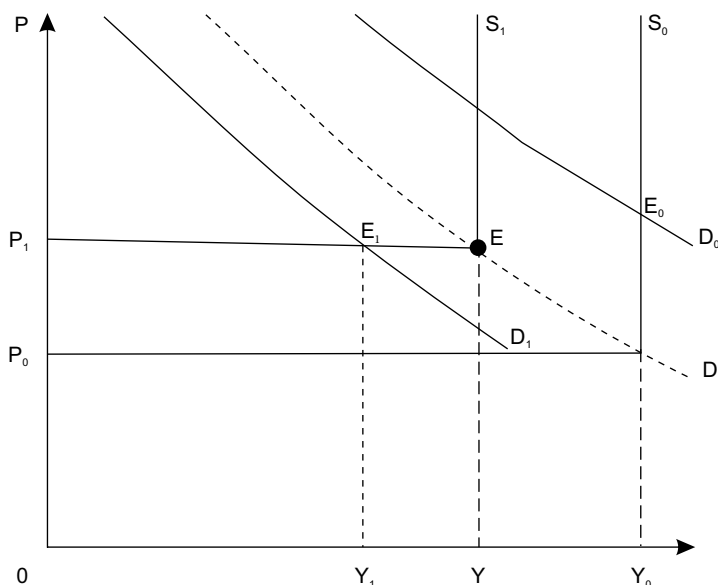
	First half 1990		1990	
	Program <sup>a</sup>	Actual	Program	Actual
<b>A. IMF Criteria</b>				
1. Change in real wages, 5 main sectors (in %, 1989 = 100) <sup>b</sup>	-18	-38	-31	-31
2. Credit to the general government (percent of GDP)	0.7	-0.8	0.0	-1.4
3. Deficit of 'core' general government (percent of GDP)	1.6	-10.0	-0.1	3.0
4. Change in real NDA (in percent)	-28	-58	-24	-51
5. Change in net international reserves of the banking system (in ml. USD)	-165	3,100	245	2,650
6. Contracting new short-term debt (in ml USD)	400	183	700	
<b>B. Additional Criteria (percent)</b>				
7. Change in GDP	—	-15	-5	-12
8. Change in real money supply	-25	-42	-5	-42
9. Change in real credit to non-government	0	-18	20	0
10. Increase of the consumer price index (within the period)	75	-172	94	250

<sup>a</sup> The 'program' numbers refer to agreed upper limits or are implied by such limits and the targeted increase in the consumer price index.

<sup>b</sup> Actual criteria 1 and 4 were formulated in terms of nominal magnitudes. The numbers in the table are implied by these magnitudes and the price increases specified in row 10.

Note: The nominal GNP is taken to be 597 trillions for the whole of 1990 and 220 trillions for its first half.

Sources: Data provided by the Polish authorities and/or the IMF (1990a) and (1990b).



**Figure I.** Shifts in aggregate supply and demand functions following stabilization and liberalization measures

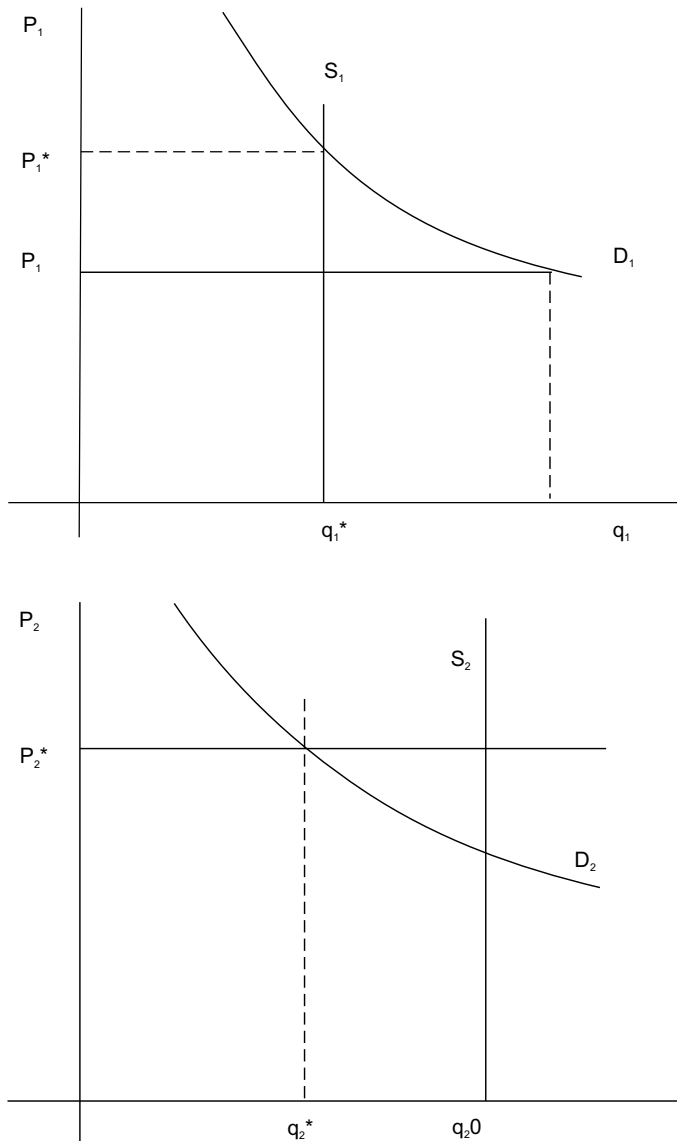
### 3. Diagrammatic presentation of the economy's response to the 1990 policies

In Figure 1, the short-term equilibrium of the Polish economy is represented by point  $E_0$  just before and by point  $E_1$  after the January 1, 1990, measures were taken.

In Figure 1, point  $E_0$  lies on the vertical segment of the initial supply curve  $S_0$  to indicate the presence of excessive demand and inflation. The price liberalization does two things to it: it shifts the horizontal part of the supply curve upwards and it reduces the (maximum) potential output from  $Y_0$  to  $Y$ , the difference  $Y_0 - Y$  representing the impact of the supply shock. Ideally, the demand curve should be shifted only from  $D_0$  to  $D$ , so that, at new prices, demand is still sufficient to buy the new potential output. Suppose, however, that demand is shifted further, from  $D_0$  to  $D_1$ . The difference  $Y - Y_1$  would then be attributed to an excessive contraction of aggregate demand. The problem is that  $Y$  is not known, and only the aggregate outcome of the two effects is observed. Still, it may be useful to discuss in some detail the factors which must have contributed to each of these two effects.

## 4. The causes of the supply contraction

Forced substitution increases potential output before the reform and the immobility of resources reduces it after the reform. The effect of forced substitution is shown in Figure 2.



**Figure 2.** Forced substitution and potential output

Before the reform, prices of two substitutable goods, 1 and 2, are  $p_1$  and  $p_2$ . At these prices, there is a shortage of good 1 and a surplus of good 2. The unsatisfied consumers respond by buying what is available, removing, as a result, the surplus of good 2. After the reform, price  $p_1$  moves upwards to equilibrate demand and supply in that market. But price  $p_2$  is set at the unit cost level and is, I assume, downward-inflexible. Consequently, output of good 2 must drop to  $q_2^*$ .

Potentially even more potent may be the effect of the asymmetry between the first, large change in the composition of demand in response to large changes in incomes and relative prices and the slow capacity of the supply side to make corresponding adjustments in the composition of outputs. Demand tends to move away from more expensive to less expensive goods and from less essential to more essential ones. While the supplies of the goods in greater demand usually cannot be increased easily, the supplies of the less demanded goods must be and are reduced quickly. This produces an overall fall in output immediately. The fall reduces incomes and may have a further contractionary effect on output.

In Poland, in the initial aftermath of the January 1, 1990, reform, purchasing power was shifted from durable consumer goods to foodstuffs. Food prices increased sharply, but food consumption remained almost unaffected. Domestic sales of textiles and other consumer goods deemed less essential fell drastically. Their producers could have increased their exports, but largely failed to do so. In a study of 94 groups of industrial products, compared to 1989, output in 1990 declined by more than 25 percent in 36 cases, it declined by less than 25 percent in 49 cases, and it increased in 8 cases (CUP, 1991). This large change in the composition of output is indicative of the power of this 'structural factor,' or the supply shock.

## 5. The contraction of aggregate demand: was it excessive?

Given the switch on January 1, 1990, to a demand-constrained regime, the standard IS/LM analysis may be used to discuss the shift of the aggregate demand function caused by the reform package. The two key equations are as follows:

$$Y = I(r) + C(Y^d, M/p) + G + X(Y, e/p)$$

$$M/p = L(Y, r)$$

where  $C(Y^d, M/p)$  is consumption as a function of disposable income  $Y^d$  and monetary wealth  $M/p$ ;  $X$  is net export as a function of income  $Y$  and the real rate of exchange of the zloty  $e/p$ , and  $L(Y, r)$  is the demand for money. Assuming  $G$  is constant, a fall in real money holdings  $M/p$  generates or requires a rise in the interest rate  $r$  and a



fall in income  $Y$ . The magnitude of the fall in income depends on the elasticities of the four functions:  $I$ ,  $C$ ,  $X$  and  $L$ , with respect to appropriate variables.

It is interesting that despite a large increase in  $r$ , total real fixed investment declined only by 9 percent. The policy of low wages secured large profits, and these profits not only improved the finances of the government but also helped to sustain investment activity of state enterprises as well as reduce bankruptcies and unemployment.

The original intention of policy makers was to use a tax-based incomes policy as an instrument to control price inflation. The chief reason was uncertainty about how effective monetary policy alone would be as an instrument to control wages. Indeed, it was feared that, in Polish and indeed East European conditions, a monetary policy in order to be really effective would have to be extremely contractionary. In the event, price inflation in the first quarter of 1990 was much higher than assumed, but the authorities decided, for fear of even larger inflation, to stick to the original monetary targets in nominal terms. Consequently, real money balances declined more sharply than anticipated and the enterprise sector experienced an unprecedented liquidity squeeze. The result was that during the first six months of 1990, wages remained well below the ceiling levels specified by the incomes policy. Only in June 1990, when the authorities decided to relax somewhat fiscal and monetary policies, did the liquidity position of enterprises begin to improve rapidly, enabling them to increase wages to the full limit permitted under the incomes policy. The wage increase reserve accumulated in the first half of 1990 was so large, however, that the policy started to be a binding constraint, for the majority of enterprises, only in November and December of 1990. In the meantime, real wages increased to levels undermining the international competitiveness of enterprises, increasing inflation from a low of 2-3 percent a month in June-August to 5-6 percent a month in October-December, and threatening the fixed exchange rate.

The movements in prices and wages in the second half of 1990 have taught Polish policy makers a lesson in the intricacies of the right coordination of monetary, fiscal and incomes policies. Macro-control has been maintained, but there has arisen also a need for a contractionary correction of the monetary policy at the end of 1990 and the beginning of 1991 to keep in check the pressures that threaten to break the incomes policy.

Having said that, it remains as an indisputable fact that the monetary and fiscal policies in the first half of 1990, and especially in the first quarter of 1990, were much more restrictive than the IMF-sponsored program had assumed.

The program would have been much different if its authors had known that the administrative price increases would trigger an increase in the consumer price

index (CPI), during 1990, by 250 percent and not by 94 percent as assumed (and nearly 80 percent rather than 45 percent in January alone). The problem with this Polish (and indeed other IMF-sponsored) stabilization program is that they are quite literally hostages to a priori assumptions on future price paths. The path is difficult to predict under any circumstances, but it is exceptionally difficult to guess in a situation, such as in Poland in December 1989, in which really large price changes were planned. The IMF has what may be called a „built-in institutional bias” to predict lower inflation and then to work hard with officials to incorporate this prediction into the monetary program. Once the program is in place, it is difficult to adjust it to changing circumstances. It must be said, however, that the Polish monetary authorities reacted to higher-than-anticipated inflation with a monetary policy not less but even more restrictive than planned. In the first quarter of 1990, net credits to the economy could have been increased by a much larger amount without breaking the agreed limit. To achieve this, the base interest rates in February and March should have been lower, as should have been the interest spreads charged by commercial banks. Net exporters had the option, which they used immediately, of selling their accumulated dollar savings at the new, very high exchange rate, to improve their liquidity positions, but net importers had no such option. Their poor liquidity position might have led them to reduce imports and outputs or withhold payment obligations to suppliers.

A „liquidity crunch” is a situation when output is reduced despite the presence of demand and merely because of insufficient liquidity in the economy. Indeed, Calvo and Corecelli (1990) suggest that a crunch of this type did develop and was a major reason why the recession in the first half of 1990 was exceptionally deep. The size of the separate contribution of this factor, however, is difficult to assess.

As indicated above, the primary reason behind the exceptionally large fall in real supply of money in the first quarter of 1990 was the unexpectedly large increase in prices. Initially it was thought that the monopolistic market structure enabled enterprises to take advantage of the price liberalization by increasing profit margins and reducing output. However, much of the price liberalization took place already in 1989, and profit margins reached a maximum in the fourth quarter of 1989. The margins were declining in the course of 1990. It seems that, simply, the policy designers underestimated the impact on unit costs of the administratively imposed price increases. One particular factor that was missed in estimations of the likely price increase was the impact of the new interest rates. In December 1989 the reformers had outdated (too low) estimates of the share of interest payments in total unit costs in industry. The approximately five-fold increase in these payments had in fact a major impact, though differentiated by sector, and yet to be precisely estimated.

Sometimes it is suggested that the exchange devaluation was excessive and, by raising prices, contributed significantly to the fall in  $M/p$ . However, it must be noted that dollar holdings of enterprises and households represented, in December 1989, a large proportion of the total supply of money. Therefore, the zloty devaluation increased the money supply substantially. In fact, since the share of the imports in total GDP was lower than the share of dollars in the total money supply, the zloty devaluation increased the ratio  $M/p$ .

## **6. Was the macroeconomic policy excessively contractionary?**

The question still remains: what hard evidence is there to suggest that, with less restrictive policies, the recession would have been significantly less costly in terms of activity in the short run, without any significant delaying impact on the speed of adjustment in the medium and long term? The evidence which has been or may be used is the following:

1) In March and April 1990 nominal incomes of the population increased sharply, as the payments of bonuses in the material sphere coincided with compensatory payments in the budget and social spheres. Yet the level of activity in the months April-June 1990 remained unchanged. Additional spending increased, instead, the monthly inflation rate, from 4.3 percent in March to 7.5 percent in April and 4.6 percent in May. The policy makers tended to interpret this disappointing response of the economy as a warning against any Keynesian-type relaxation. However, there was at that time a mitigating circumstance, the Easter holidays. Much of the additional spending power of the population went to buy food and food products. The supply of these goods is nearly fixed in the short run, and so it was food prices which increased above all. (The proportion of household money incomes spent on food increased, in the first half of 1990, from the usual 40 percent or so to nearly 60 percent.)

2) In May and June 1990 it became clear that the government budget was heading for a large surplus. Analysis of the unusually large „over-achievement” of the government in meeting most of the six IMF performance criteria for the first quarter of 1990 provided a stimulus for a discussion on the direction of economic policy in the second half of 1990. The government continued to emphasize that macroeconomic control was still fragile and that economic improvement had to come from the supply side rather than from the demand side. But the supply side was responding too slowly for comfort, and in any case there appeared to exist a demand slack ready to be activated by suitable government policy. Here are the

origins of an experiment in controlled relaxation of monetary and fiscal policies for the second half of 1990. The relaxation was decided in early June 1990, this time without consultation with the IMF. Although the new policies and the arguments in their favor met with skepticism at the IMF, they were incorporated in the Letter of Intent for the second half of 1990, prepared by the IMF staff and Polish government negotiators during the consultations in late June and July 1990.

The relaxation of the fiscal stand proved to be as targeted. The monetary expansion, however, went further than intended, especially in the third quarter of 1990. A re-monetization of the economy advanced and the liquidity position of enterprises improved. The impact of these developments on wages, both nominal and real, was discussed in Section 5.

What were the main results of this experiment? Both real output and inflation increased. Industrial sales in the second half of 1990 were 8.5 percent higher than in the first half (CUP, 1991). The increase is probably substantial enough to justify the new policy, provided of course that the increase and the policy were closely connected. Moreover, sales increased despite the fact that housing and other construction activity declined further, by 9.6 percent, in the second half of 1990. This decline was probably a delayed effect of the contraction of aggregate demand in the first half of the year, i.e., the decline in the second half would have been higher without the change in policy.

Unfortunately, the new supply-side shocks in January 1991 – following the dollarization of trade with the former CMEA trading partners – and a new dose of contractionary incomes and monetary policies to reduce inflation, have brought the level of industrial activity in early 1991 to 3-5 percent less than what it was in early 1990.

3) A comparison may also be made between the stabilization programs of Poland and Yugoslavia, both launched at approximately the same time (December 18, 1989, in Yugoslavia and January 1, 1990, in Poland). Both programs reduced inflation and contracted economic activity, but in Yugoslavia, at least in the first few months, the reduction of inflation was deeper and the contraction of activity smaller. Taking the level of industrial output in the years 1986-7 for 100, in 1990 the level in Yugoslavia dropped to about 90 and in Poland to about 80. It may be argued that the smaller recession in Yugoslavia is related to the fact that the real supply of money was reduced much less in Yugoslavia than in Poland, whatever definition of money one is using.

The problem with this evidence is that the purity of the price system in Yugoslavia was probably much superior to the one before the start of the program in Poland. The Polish program involved also price liberalization, in addition to price stabilization. Hence the supply-side shock and its contractionary impact,

the result of changing relative prices, must have been greater in Poland. There was also another factor at work in Poland: enforced dollarization of trade with the Soviet Union, the result of reduced supplies of oil and other raw materials. The consequent losses in terms of trade, in 1990, I estimate to have been about 3 percent of GDP.

What is the conclusion to be drawn from this evidence? The original expectations of Polish policy making, concerning the required fall in output, were surely excessively optimistic. Yet, with a more refined set of policies, a fall in industrial GDP could have probably been smaller, limited perhaps to 15 percent instead of the actual 20 percent. But the right policies are much easier to define with the benefit of hindsight. In the spring of 1990, Polish policy makers were inclined, when in doubt, to err on the side of caution, which in the circumstances meant to stick to certain, restricted policies rather than go for an uncertain gain in output. The relaxation of policy in the second half of 1990 shows them to have been flexible, prepared to switch attention to the real sphere, even at a significant expense to macroeconomic control.

## **7. Stabilization versus growth: a false dichotomy?**

The great emphasis placed by the Polish program, indeed any stabilization program, on reducing inflation and on contractionary measures deemed necessary to achieve this aim, can produce the impression that a fundamental conflict exists between stabilization policies and growth-oriented policies. This impression has also affected the writings of economists critical of the Polish government program. Consequently, the alternative doctrines have emerged about how to get Poland out of the present recession.

The doctrine of the Balcerowicz Plan regards fast economic development as, ultimately, the primary aim of reforms, but it also sees stabilization of prices and systemic rules as an environment conducive to such development. The Memorandum of the Government of Poland on Economic Reform and Medium-Term Policies for 1991-3, negotiated with the IMF in early 1991, predicts that gross investment "will have to rise by about 12-15 percent per year in real terms during 1991-93." Low nominal interest rates are needed to stimulate such a substantial upsurge in investment activity and positive or at least non-negative interest rates are needed to stimulate large private saving to finance this activity. This implies the need to have stable or nearly stable prices. Low inflation would also enable the linking of the zloty with the U.S. dollar or, better still, with the ecu, by means of a fixed exchange rate. Such price and exchange rate stability, in addition

to stable tax and other financial and systemic rules, would in turn attract private foreign investment, in a volume commensurate with the size of the restructuring needs. Given the size of the public sector, the government's investment in infrastructure and the independent investment activity of state-owned enterprises would continue to be very important. To ensure sufficient revenue to the government and investment finance to state-owned enterprises, profits, according to this doctrine, must be protected by a tax-based incomes policy. The latter policy would, however, become redundant with the progress of privatization.

The alternative doctrine suggests increasing the scope of government investment activity immediately. It also recommends a reduction in taxes, especially in the private sector, a reduction of nominal interest rates and the abolishment of any legal restrictions on wages. The budget deficit would emerge, to be financed by monetary expansion. This in turn would lead to a high inflation and negative real interest rates. The savers would therefore be the losers, and they would be called upon effectively to subsidize the investment activity. The high inflation may discourage foreign investment, but that investment according to this doctrine is unlikely to be substantial anyway.

Both doctrines are internally consistent and have their own merits as well as disadvantages. The doctrine of the Balcerowicz Plan seeks to make Poland not unlike the rest of Europe and to base economic development on tested and reliable policies of developed Western economies. The alternative doctrine would appear to be extremely adventurous, offering the prospect of short-term improvement in activity at a high risk of backsliding into hyperinflation and general economic instability. Programs based on such a doctrine are unlikely to have the cooperation of the international financial institutions, particularly the IMF and the World Bank, nor of the EEC institutions. They are therefore also likely to ensure that Poland would not qualify for the 20 percent debt reduction offered by the Paris Club in three years time.<sup>1</sup>

An intermediate doctrine between the two suggests abolishing the income policy immediately and leaving to highly restrictive monetary and fiscal policies the task of maintaining macroeconomic control. Here the risk is that policies based on such a doctrine, in a situation when the public sector still dominates, can work only in the presence of very high unemployment and that they will fail to stimulate economic growth. There is also the possibility that if the government, for political reasons, is unable to impose a restrictive incomes policy, so would the authorities of the central bank be unable to impose a restrictive monetary policy.

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<sup>1</sup> On March 13, 1991, the Paris Club agreed to forgive Poland about half the \$33 billion owed to Western governments. *The New York Times*, March 15, 1991.

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## **8. Polish economic reform, 1990-91: Principles, policies and outcomes<sup>\*1</sup>**

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The primary aim of this paper is to discuss the economic ideas and other motivations underlying the choice of particular reform principles and policies in Poland during its dramatic transition to a market economy in the years 1990-1. The paper suggests that, in the first year of the reform, achieving price stability was, in fact, secondary to the following three other aims: a substantial increase of international reserves (large up-front devaluation required), a drastic reduction of the share of dollar currency in the total money supply (large monetary expansion required) and a major improvement of the quality of the price system (price liberalisation and drastic increases of some administrative prices needed). It is argued that, contrary to the stabilisation plan, the quantity of money supplied was virtually the only nominal anchor in the first year of the reform, and that the exchange rate and the incomes policy became important nominal anchors only in the second year of the reform. The causes and consequences of this deviation from the plan are discussed. The paper also offers an interpretation of the causes of recession and of the newly emerging large fiscal imbalance. Finally, it identifies the presence, in Poland 1990-2, of the relationship between the quality of macroeconomic control and the pace of structural change.

### **1. Reform principles**

#### **1.1. The overall aims of the reform**

It is often emphasised, quite correctly, that in contrast to the economic reforms of the 1960s, 1970s and early 1980s, the long-term purpose of this present wave

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<sup>\*</sup> *Cambridge Journal of Economics*, September 1992, 16: 355–72.

<sup>1</sup> London School of Economics. An earlier version of this paper was presented at a conference on ‘Whither Socialist Society’, 8-11 April, 1991, Hebrew University in Jerusalem. Financial support from the Leverhulme Trust is gratefully acknowledged. The paper was produced as part of the LSE’s Centre for Economic Performance (CEP) Programme on Post-Communist Reform. The Centre is financed by the Economic and Social Research Council. Most helpful in preparing the final version were the comments by two referees of this journal, as well as those by Marek Dąbrowski of the Polish Academy and Mark Schaffer of the CEP. The author advised the Polish Government on the elaboration and implementation of the 1990-1 reform. He takes the sole responsibility for the contents of the paper.

of reforms in Eastern Europe is no longer the marketisation of Soviet-type socialism but the embrace of Western (welfare state) capitalism, and that therefore the reforms involve not merely a change within a system, but a change of the system itself. Such a dramatic change requires extensive re-modelling of institutions, skills and attitudes, and it must therefore be a process extending over a number of years. In this process, privatisation of ownership is in fact the dominant concern. However, in the initial phases of the reform the public sector continues to dominate. Since central planning and management are already limited or no longer exist, the immediate aim of reformers is to put into place a market-based price system. The system would take over the traditional role of planners in guiding economic agents, in particular state-owned enterprises, about their allocative choices. The transformation, in this first stage, may be described as one from a modified (indirectly) centrally regulated economy of the Hungarian type, 1968-89, to a market-oriented socialist economy, the latter to be changed, within the 1990s, into a fully fledged market economy of the Western type.

In the autumn of 1989, the new Polish reform government faced another urgent problem: the restoration of the internal and external credibility of its macroeconomic policies. Internal credibility was severely eroded in 1988 and, especially, in 1989, when massive subsidies led to large budget deficits and near hyperinflation. External credibility was low and declining further with the rapid rise of international debts.

An official policy memorandum defines the aims of the Polish reform in the following way:

At the beginning of 1990, the Government of Poland launched a far-reaching program to stabilize the economy and transform it progressively to a market system. The underlying aim is to improve efficiency in an equitable and environmentally compatible manner, to raise living standards on a sustainable basis, and to restore external credit-worthiness. During 1990, the principal focus of policy was directed toward stabilization objectives and, in particular, to achieving a sharp drop in the underlying rate of inflation. At the same time, however, important steps were taken toward reducing structural rigidities and developing the legal, institutional, and regulatory framework for further systemic reforms. The Government of Poland is determined to build on this progress and, in particular, to accelerate the implementation of structural and systemic change. This memorandum outlines our objectives and policies for the period 1991-3 (Republic of Poland, 1991). (A summary of these objectives and policies is given in the Appendix to this paper.)

## 1.2. The sequencing problem

It is useful, perhaps even essential, for the reformers to formulate a ‘game plan’. The plan should identify the main reform measures to be taken and the sequence in which they would be implemented. Polish reformers of the Mazowiecki Government faced this task in September 1989, and they came up with the Balcerowicz Plan. The principles of the Plan that I would regard as crucial were the following (Gomułka, 1990):

(a) Price liberalisation, substantial reduction of subsidies and internal convertibility of the domestic currency must come first, before privatisation and other major structural reforms are initiated.

(b) To protect internal convertibility, expansion of international reserves must assume priority over price stability in the initial period of the reform. Large up-front devaluation and high ‘corrective’ inflation are therefore necessary.

(c) Stabilisation of the liberalised prices must be based, at least during the first year or so, on the standard International Monetary Fund (IMF) approach, with an important role for nominal anchors assigned to a tough incomes policy and a fixed exchange rate, in addition to a restrictive monetary policy.

(d) Structural reforms must involve a radical increase in the number of independent enterprises, by breaking up existing large firms and lowering the entry barriers to new firms, and an ownership reform, with the dual aim of creating competitive markets and a large, ultimately dominant, private sector within a period of several years.

(e) International assistance for the reform programme should include the recognition, both by Western private banks and governments, that radical reforms call for large sacrifices and that, given the large size of the Polish debt, a substantial part of it cannot be repaid without putting the reform programme at serious risk. In particular, balance-of-payments considerations must be secondary in any initial stand-by agreement with the IMF.

The principles above represented the common ground within the inner ‘reform group’ of the Mazowiecki Government.<sup>2</sup> These principles also define what

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<sup>2</sup> The group was headed by Leszek Balcerowicz, Deputy Prime Minister and Finance Minister, and included above all Marek Dąbrowski and Stefan Kawalec, Deputy Finance Ministers, and Alfred Bieć, Under-Secretary of State in the Council of Ministers. Important allies of the group were Jacek Kuroń, Minister of Labour, and Waldemar Kuczyński, Undersecretary of State and the main economic adviser of Tadeusz Mazowiecki, the Prime Minister. In the first year, top political support was provided by Lech Wałęsa, leader of Solidarity (and later the President of Poland), Bronisław Geremek, Leader of the Solidarity caucus in the Parliament, and the Prime Minister himself. Although the reform programme was essentially of Polish origin, the role of the IMF was important in the choice of technical details and performance criteria. The programme and its implementation

is usually termed the sequencing of the reforms. In that respect principle (a) is particularly crucial. The urgency to stabilise prices arose from the fact that near hyper-inflation had been raging since the beginning of August 1989. However, it might have been and was argued that price liberalisation should wait until the big monopolies were dismantled. The problem with this argument was that proper demonopolisation would take a long time. In the meantime, given the poor quality of the price system, shortages would persist. Moreover, it would not have been possible to know which enterprises were really profitable and which were not. It was recognised that some price regulation could remain, but that the key price signals should be provided by markets as soon as possible, so that structural changes – including the closure or restructuring of loss-making and really hopeless activities – could start in spring 1990, and be conducted on a sound economic basis. But to reduce the impact of a monopolised market structure, convertibility became essential. In this respect, the experience with auctions and legalised (since March 1989) free dollar market for households became helpful in providing information as to the appropriate level of the unified exchange rate. Apart from easing foreign trade, convertibility was also very important in its own right: as a psychological signal to enterprises and the public that this reform is qualitatively different from those in the past, and as an economic instrument to improve the mobility of resources between net exporters and net importers.

The anti-inflationary programme did not involve any new economic theory. The principles of it were well known. But it did involve the necessity for (statistical) real wages to drop sharply, something which can be implemented only by a strong government.

Under (d), privatisation, labour market and competition policies are the key reforms. Placing price liberalisation before privatisation is partly deliberate and partly inevitable. Principle (e) is based on the view that Western creditors might eventually recognise that the success of reforms in Eastern Europe is in their long-term interest, whether or not the debts are repaid. The debts and the large burden of their servicing payments have helped to expose the severe economic weaknesses of the Soviet-type socialist system, and have thereby helped to bring about its downfall. In that respect, the debt has already provided the West with an important strategic benefit: it has in that sense already been repaid.

The distinct emphasis of the Plan on regaining and maintaining macroeconomic control had important microeconomic implications (initially not fully anticipated by the reform designers: see Section 2.5 below). There were few

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were also influenced by advisers to Mr. Balcerowicz, *de facto* members of the group, particularly S. Gomułka, K. Lutkowski, J. Rostowski and J. Sachs, of whom Karol Lutkowski became briefly the successor to L. Balcerowicz as Finance Minister by the end of 1991.

bankruptcies and, with the exception of exports, a slow pace of structural adjustment in 1990. Macroeconomic concerns dictated a course of action that resulted in a large fall in (statistical) real wages. Low wages maintained the high profitability of enterprises despite a recession. This in turn ensured high revenue for the government budget and low expenditure on salaries in the budget-funded sector of the economy. High profitability was also helped, in 1990, by a series of upfront devaluations of the *zloty*, designed to promote net exports and maintain the stability of the exchange rate. This exchange rate policy sharply improved the external position of the country. The policy was inflationary in two ways, by increasing the cost of imports and by contributing to monetary expansion through the balance of trade surplus; but it was also helping the budget and reducing recession. Another outcome of this macro policy was that inefficient enterprises continued to be profitable, and therefore not subject to the immediate necessity of undertaking any drastic, cost-cutting measures.

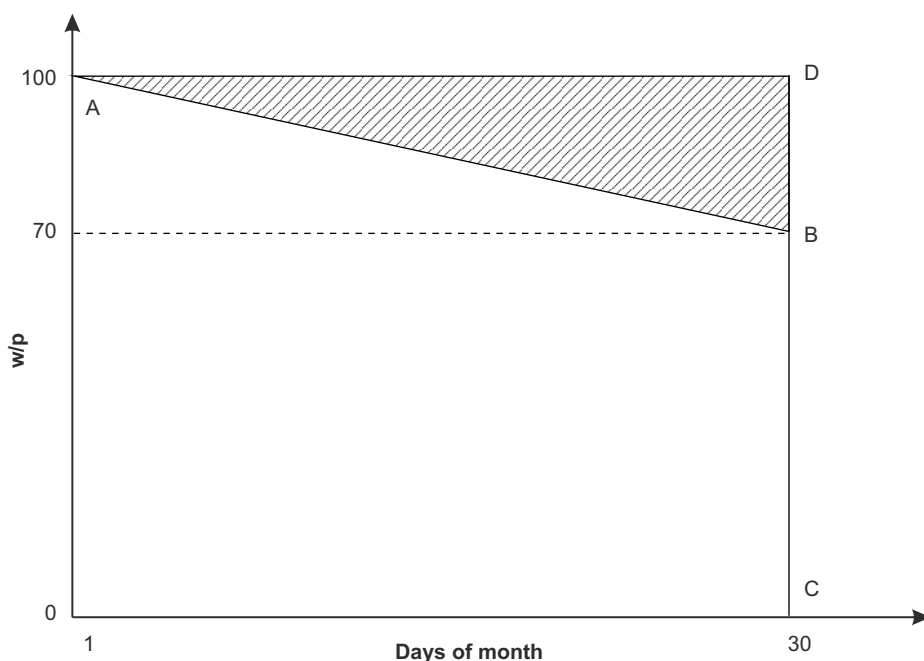
The strategy itself was deliberate, even if it went too far in the first half of 1990. It was motivated by the desire to avoid a catastrophe of the East German type: large scale bankruptcies and large-scale unemployment at the start of the reform. The implicit choice of sequencing was, after all, to deal first with macro problems, such as the budget deficit, inflation, international reserves and foreign debt, and only later with the more fundamental, difficult and time-consuming problem of microeconomic inefficiency.

### 1.3. How fast? Gradualism versus a big bang

Structural adjustment can be slower or faster, but it must always be gradual. (So far the only exception to this rule is East Germany, where jumping all at once into a completely open system with highly competitive markets has destroyed much of the existing economic structure. However, the large human and capital resources of West Germany are available there rapidly to create a new system in its place and, in the meantime, to provide adequate social safety nets.) In contrast to such structural adjustment, stabilisation and liberalisation measures are easy to devise and implement. Moreover, a case can be made for introducing the measures all at once (Gomułka, 1989; Dornbusch, 1990). The case is particularly strong if initial conditions are those of a crisis, such as the situation of Poland in the second half of 1989. Strong measures are then needed anyway to avoid a collapse. The population is, in conditions of crisis, also more inclined to accept a large dose of sacrifice in exchange for a prospect, however distant and unclear, of an improvement.

The Polish package of measures was implemented on 1 January, 1990. It represented a distinct discontinuity in the process of reform. The package was also

a strong psychological signal to the population that the Government was taking charge of the crisis situation and that the reform about to be implemented might this time be real. (I shall return to the gradualism versus big-bang question in Section 2.5.)



**Figure 1.** The area OABC represents the real wage. The shaded area ABD represents the inflation tax

On 1 January 1990 Poland also suspended, unilaterally, servicing the medium and long-term debt to commercial banks. Despite this measure, on 5 February 1990 the Executive Board of the IMF approved a Stand-By Arrangement with Poland for a period of 13 months. This support from the IMF opened the way for a wide range of other forms of Western assistance, among them substantial loans from the World Bank, a Stabilisation Fund, and grants and loans from the European Economic Community.

On 18 April 1991 the Board of the IMF approved a three-year Extended Fund Facility (EFF) arrangement to the amount of SDR 1,224 million. On 19 April 1991 The Paris Club reduced the Polish debt of 33 billion by 30%, or \$10 billion, with reduction of the debt by a further 20% in three years time, conditional upon successful implementation of the EFF arrangement. This and some other debt reduction measures would appear to make the servicing of the

Polish debt manageable.<sup>3</sup> The consequent gain of external credibility may open the way to closer economic relations between Poland and the Western community and thus provide a potentially vital long-term support for the reform process.

## 1.4. The initial conditions

The budget deficit was much reduced in the closing months of 1989, but the government budget was still overburdened with large subsidies. Price distortions were large, e.g. the price of coal was about 10% of the world price. Interest rates were sharply increased in December 1989, but still remained strongly negative in real terms. The official exchange rate was also increased sharply in November and December 1989, but still remained much below the free market rate, making rationing of the foreign exchange necessary.

In 1989 the statistical economy-wide real wage (with bonuses) was 24% higher than in 1987. A large fall in the wage, following liberalisation and stabilisation was thus necessary. In 1990 the real wage (also with bonuses) was 17% lower than in 1987, the fall reflecting lower productivity as output declined more than employment.

## 1.5. The war of economic ideas

Modern economies are so complex that, even if uncertainty were not present, which it is in large measure, no one can predict all the economic implications of any policy decision. In addition to this technical difficulty, the same economic outcomes have different welfare and political implications to different policymakers. Throughout the decision process judgments on all these matters have to be made. In making these judgments policymakers are helped by analytical discussions which are in turn informed by empirical evidence, including the experience of other countries, and by theoretical considerations. Before discussing specific macroeconomic policies in Part 2 of the paper, it may therefore be useful to discuss first, if only briefly, the major economic ideas which played a part in motivating the choice of these policies in the period from September 1989 until the end of 1991.

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<sup>3</sup> The reduction by 30% will permit a reduction of the stock of debt by \$4 billion and an 80% reduction in interest payments for three years. The Paris Club agreement stipulates that Poland would negotiate a comparable debt reduction agreement with commercial banks. The comparability clause is binding for Poland in her current negotiations with the banks.

### **1.5.1. Keynesian-type versus structural causes of recession**

This was perhaps the most fundamental debate, affecting policies on wages, budget deficits and monetary expansion. The structuralists are those who in the particular circumstances of post-communist countries during transition regard large changes in the microeconomic environment of enterprises as the primary reason for recession. In particular, sharply raising some input prices has made the production of specific goods unprofitable and sharply raising some output prices had reduced specific demands. The new relative prices required that a corresponding change in the whole product composition of the economy's supply side took place. But because of the presence of various rigidities, some resources had to become unemployed before they could be redeployed to produce what, with new prices, is in demand and is profitable. The output loss of this micro-adjustment of the supply side was augmented by the disappearance of the forced buying of goods, so-called forced substitution. The collapse of trade with the former CMEA area was another important factor in the same category. Since all these adjustments are large and necessary, structuralists expected the East European recession to be deep, long and inevitable (Gomułka, 1989; 1991; Dąbrowski, 1991; Kastberg, 1991; Lane, 1991; Siebert, 1991). They therefore regarded it as the Schumpeterian 'creative destruction' phenomenon, similar in type (though larger in scale) to the Western recession of the early 1980s, following the oil shock of 1979.

Pure Keynesians, on the other hand, conducted their analysis in aggregate terms only and emphasised the negative impact on economic activity of policies which were reducing aggregate demand (Laski, 1990; Caselli and Pastrello, 1991). The implicit assumption of their analysis was that 'full employment output' has remained essentially unchanged, despite the dramatic change of the micro-environment.

Polish policy makers were divided as to the weight of aggregate versus micro factors in influencing the level of activity. However, the main thrust of their policy was as if the structuralist analysis was the dominating doctrine. At the same time, it was accepted that the choice of government policies, given the monopolistic market structure and limited price flexibility, would have a major impact on aggregate demand. The concern was therefore not to deflate more than necessary. As I explain elsewhere (Gomułka, 1991), in practice, given the presence of large uncertainties about the potential impact of the reform measures on activity, the tendency was to be more rather than less restrictive in the first few months following the big bang, which in turn led to an excessively expansionary policy in the second half of 1990 (see Section 2.5 for further discussion).



### 1.5.2. Demand-pull versus cost-push causes of inflation

This relates to the question of the assumptions about price formation underlying Polish economic policy: were short-period prices believed to be demand determined or of 'cost-plus' nature and, if the latter was the case, how did this belief affect macro financial policies?

The short answer to these questions is that, following price liberalisation, most prices were assumed to follow the cost-plus principle, with supplies being adjusted to demand at these prices. The anti-inflationary policy therefore aimed to restrict the growth of unit nominal costs, in particular wage costs. The incomes policy was the primary instrument for controlling wages, especially in the state sector. However, the belief was that this policy instrument would not survive for long unless supported by the full combination of other (monetary, fiscal and exchange rate) policies. The purpose of the support was to harden the budget constraint of enterprises and to increase competition. Profit margins did vary significantly among enterprises and whole sectors, as well as over time, indicating that demand factors and market structure were also important. The view that a relaxation of financial policies would increase wages, prices and imports rather than domestic output was tested in the second half of 1990 and the results of the test were interpreted as supporting that view (to be discussed further in Part 2)<sup>4</sup>.

### 1.5.3. Market-driven versus state-driven industrial restructuring

Past experience of excessive state intervention has prompted key policy-makers to leave largely to enterprises themselves the task of re-organising their activities. The idea of formulating an active industrial policy was rejected. However, the central authorities in any case did not have the human and material resources that an active industrial policy required. Such resources as existed were in the hands of enterprises and banks. Still, selective industrial policy was pursued through direct subsidies and new institutions created for that purpose<sup>5</sup>. Another instrument of restructuring was privatisation, and this was mainly in the hands of central and local authorities. It was also hoped that increased financial discipline, elimination of the central allocation of inputs and increased

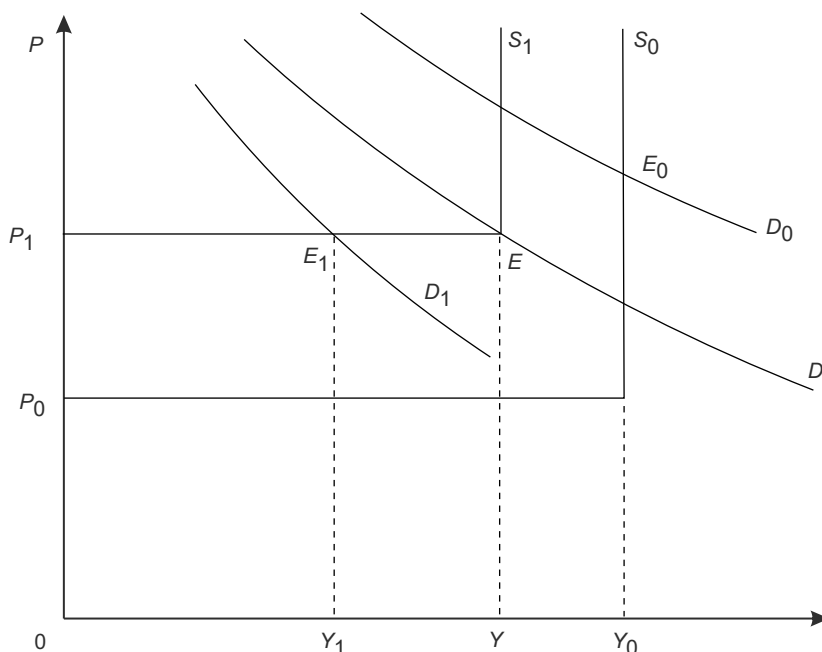
<sup>4</sup> One of the referees of this paper offered a view that acceptance of 'cost-plus' pricing behaviour is inconsistent with the policy of positive real interest rates on the grounds that such policy 'rather added to inflation than restricted it', and restriction of inflation was a major policy objective. This view was also expressed by many Polish critics of the reform package. The critics would prefer the use of tough administrative credit rationing rather than positive real interest rates to control inflation. The criticism overlooks the point that the policy of positive interest rates was needed above all to prevent any massive transfer of money from zloty to dollar accounts and to encourage savings. The former was necessary to protect convertibility and the latter to fund investment activity, net exports and, since 1991, budget deficits. I shall return to these points later in the paper.

<sup>5</sup> Exports to CMEA in 1990, for example, attracted subsidies of about 1% of GDP.

competition would prompt state enterprises to get on with the job of restructuring more vigorously. While concern to avoid large-scale bankruptcies was paramount, there was also the desire to allow some closures to underpin the break with the old paternalistic attitudes.

## 2. Macroeconomic policies

In Figure 2, the short-term equilibrium of the Polish economy is represented by point  $E_0$  just before, and by point  $E_1$  just after, the 1 January 1990 measures were taken. Point  $E_0$  lies on the vertical segment of the initial supply curve  $S_0$  in order to indicate the presence of excessive demand and inflation. The removal of subsidies and the price liberalisation shifted the horizontal part of the supply curve upwards and it reduced the (maximum) potential output from  $Y_0$  to  $Y$ . The difference  $Y_0 - Y$  represents the impact of the supply shock arising from the sharp change in the composition of demand in response to changes in relative prices (see Gomułka, 1991 for a further discussion of this impact). Ideally, the demand



**Figure 2.** Shifts in aggregate supply and demand functions following stabilisation and liberalisation measures.  $Y_0 - Y$ , the effect of supply-side shocks;  $Y - Y_1$ , the effect of excessively restrictive policies.

curve should have been shifted only from  $D_0$  to  $D$  so that, at new prices, aggregate demand is still sufficient to buy the new (reduced) maximum output. Suppose, however, that the demand curve was shifted further, from  $D_0$  to  $D_1$ . The difference  $Y - Y_1$  would then be attributed to an excessive contraction of aggregate demand. The problem is that  $Y$  is not known, and only the aggregate outcome of the two effects, supply shock and demand contraction, is observed.

Given the switch on 1 January 1990 to a demand-constrained regime, the standard IS/LM analysis may be used to discuss the shift of the aggregate demand function caused by the reform package. The two key equations are as follows:

$$Y = I(r) + C(Y^d, M/p) + G + X(Y, e/p);$$

$$M/p = L(Y, r),$$

where  $C(Y^d, M/p)$  is consumption as a function of disposable income  $Y^d$  and monetary wealth  $M/p$ ;  $X$  is net export as a function of income  $Y$  and the real rate of exchange of the zloty  $e/p$ , and  $L(y, r)$  is the demand for money. Assuming  $G$  is constant, a fall in the real money holdings  $M/p$  generates or requires a rise in the interest rate  $r$  and a fall in output  $Y$ . The magnitude of the fall in income depends on the elasticities of the four functions:  $I$ ,  $C$ ,  $X$  and  $L$  with respect to appropriate variables.

The key policy instruments used in an attempt to stabilise prices and improve external equilibrium were the standard four: interest rate, exchange rate, the budget and a tax on excessive wages. I shall discuss briefly the policies and motivations of the policy makers in making their particular choices.

### 2.1. Interest rates

The structure of interest rates is largely determined by the base rate (in Poland called the refinance rate). The central bank (National Bank of Poland, NBP) is the institution with the authority to decide that rate. The NBP is formally independent of the Government. Its governor is appointed by Parliament at the recommendation of the country's President. In practice the dependence of the NBP on government authorities had until the end of 1991 been strong. The policies on interest rates and exchange rates since September 1989 have been decided as a result of discussions between the Ministry of Finances and the NBP, with the Prime Minister and the IMF being consulted once the consensus view was reached. (The only exception to this rule was the decision of the NBP to set the base rate for February 1990 at 20%, five percentage points above the rate suggested by the Finance Minister. The role of the IMF in that decision, and generally during the first half of 1990, was important.)

Active interest rates policy was designed to perform three main functions: (a) to control demand for credit by enterprises and households; (b) to induce transfer of savings from dollar accounts to zloty accounts, and in this way support convertibility of the zloty at the set exchange rate; and (c) to provide correct information to economic agents about the cost of financial capital. Let us discuss these functions in turn.

(a) The ability to mount tough monetary policy was essential in the Government's attempt to reduce price inflation. High interest rates, reserve ratios, administrative credit limits and informal persuasion of the central bank have been used, quite successfully, to control demand for credit. There was concern that, if banking credit were limited too much, inter-enterprise involuntary credit could escalate. The latter credit did increase sharply in the first half of 1990, and again in the first half of 1991, but credit of this type is an illiquid monetary asset and therefore of limited danger to the effectiveness of the overall monetary policy.

(b) The share of zloty-denominated money in total money was, in December 1989, a mere 28% (foreign currency deposits valued at the exchange rate of 2 January 1990). If valued at the average official December rate of 5235 zl to the dollar, the share was still a modest 41%.) A substantial increase in the share was essential and, indeed, has been a major policy objective of the stabilisation programme. The credit squeeze prompted enterprises, in early 1990, to sell most of their foreign currency deposits to the central bank. The household sector, which was the major holder of these deposits, has however continued to keep its foreign exchange, even though its purchasing power was much better protected if moved into zloty-denominated deposits. This behaviour was clearly evidence of the limited confidence of private dollar holders in the success of the stabilisation programme throughout 1990. This interest rate policy was nevertheless successful in persuading the households to keep all new savings in a zloty-denominated form. Consequently, by the end of 1990, the share of zloty-denominated money in total money was 59%; it increased to 75% by the end of 1991.

(c) Interest rate policy was also guided by the idea that real interest rates on longterm deposits should be positive. The money markets are being developed with the aim of providing a more precise guide for policy makers about the right levels of interest rates.

## 2.2. The exchange rate

The internal convertibility of the *zloty* and the stability of the exchange rate are two major achievements of the reform so far. The unexpected durability of the initial exchange rate is yet to be fully understood. In setting the rate policy

makers were largely guided by the following two considerations: the rate should withstand the expected increase in domestic prices in the first quarter of 1990 of 75%, and the rate should remain unchanged during at least that first quarter despite the very low international reserves. The large uncertainty as to what the right choice should be prompted the Government negotiators to resist the suggestion of making the stability of the exchange rate a performance criterion under a standby arrangement with the IMF.

**Table 1.** The purchasing power parity (PPP), in zloty per the US Dollar, and the (relative) real exchange rate, 1985-90

	PPP	Exchange rate PPP (PPP = 1)
1985	71.6	2.05
1986	82.7	2.12
1987	99.9	2.66
1988	153.7	2.80
1989	505.0	2.85
1989, XII	1269.0	4.11
1990, I	2228.0	4.26
1990, II	2734.0	3.46
1990, III	2872.0	3.31
1990, IV	3081.0	3.08
1990, V	3217.0	2.95
1990, VI	3310.0	2.86
1990, XII	4200.0	2.26

Source: Marczewski (1991).

The stability of the exchange rate may seem remarkable in view of the fact that the increase in prices in 1990 was about 250% rather than 94% assumed in the programme. The pegging of the *zloty* to the US dollar was helped by the devaluation of the latter against all major OECD currencies during 1990. The liberalisation of exports and the deep recession must have also been important factors behind the stability of the zloty/dollar exchange rate and the large increase in dollar exports in the course of 1990. However, the key factor was a succession of devaluations of the real exchange rate in December 1989 and on 2 January 1990. A good indicator of the (relative) real exchange rate is the ratio of the official exchange rate to the rate implied by the purchasing power parity (PPP). If we use the parities provided for Poland by the International Comparison Project, this (relative) real exchange rate had been as given in Table 1. In the light of these statistics and the fact that the exchange rate has remained constant for

much longer than planned, the large devaluation of the *zloty* on 2 January 1990 by 65%, may appear to be excessive for the purposes the policy makers wished to achieve. The devaluation was the result of mistrust in the official exchange rate. This derived from the estimate that some 20% of Polish exports were in the past unprofitable, and from the fact that the market exchange rate used to be much higher than the official exchange rate. (The state of mind of the Polish reform group may be illustrated by the fact that it expected the average exchange rate in 1990 to be 14,500 zł, despite the expected inflation rate of 94% compared with the actual rate of 250%.)

Polish experience in 1990 appears to suggest that purchasing power parity should be taken seriously in gauging the proper exchange rate under a regime with internal convertibility. Having said that, I am not proposing to accept that the January devaluation was also 'excessive' in the sense that it contributed to recession and was therefore a mistake.

The link with recession is often made on the grounds that before any devaluation has a chance to stimulate exports, it increases prices and therefore reduces the real money balances in the economy, and so is equivalent to a contractionary monetary policy. This argument, however, does not hold in the particular circumstances of Poland where, in December 1989, nearly 60% of the total money supply was dollar-denominated. The share is much greater than the share of imports in GDP and, therefore, the January 1990 devaluation increased money supply much more than it increased prices<sup>6</sup>. (To be more precise, the dollars held by households should be converted into *zlotys* at the market rather than the official exchange rate. With this correction, the increase in the nominal money supply caused by the January 1990 devaluation was about 25%, while the direct inflationary impact of the devaluation was about 15%.)

Any substantial up-front devaluation risks a large gap opening up between international and domestic prices for tradeables. In the presence of such a gap, the convertibility of the currency and the opening of the economy to the world market cannot serve the purpose of enhancing competition and restraining inflation. On the contrary, domestic producers would have obtained a green light to pass any cost increases into prices.

However, in the Polish case the large dollar deposits of households, and the much lower official reserves of the Central Bank, represented both immediate and grave threats to the sustainability of the convertibility of the currency, and thus to the reform programme itself. The policy of high initial devaluation was

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<sup>6</sup> Any devaluation also redistributes real income from the consumers of imported goods to net exporters. Excessive devaluation may cause sharp changes in the composition of demand and these may lower activity in the short run.

designed to promote exports, limit imports and consequently quickly improve the balance of payments position. The high interest rate policy was in turn designed to discourage households from using their *zloty* savings to buy foreign exchange in the open market. The purpose of both policies was to preserve, and preferably increase, the international reserves of the banking sector. This policy objective had, in 1990, a priority over price stability (see again p. 361, n. 1).

The fixed exchange rate began to act as a nominal anchor by the end of 1990. The evidence in support of this view is provided by the sharp deterioration of the trade balance and some reduction of the profit margins, despite an improvement in the level of economic activity. In view of the continuing high inflation, there was a need to change the exchange rate policy at some point from the fixed peg to a crawling peg. The timing of this change became a major policy problem at the end of 1990 and during 1991<sup>7</sup>. Since the official reserves had improved substantially, it was feasible to make the reduction of inflation a primary concern. Accordingly, the exchange rate continued to be fixed for most of 1991. This policy soon came under extreme pressure, since it contributed to the collapse of enterprise profits and the consequent crisis of the state budget. On the other hand, the collapse of profits helped to relieve the pressure of the trade unions on the government to suspend the incomes policy in the state sector of the economy. As explained earlier (Section 1.5), the preservation of this incomes policy was seen as crucial in reducing inflation.

### 2.3. Pricing, subsidies and fiscal policy

The shares of agricultural producer, industrial producer and consumer prices that are, in the early 1991, freely determined amount to 100%, 88% and 83%, respectively (Republic of Poland, 1991). Administered prices apply only in the case of alcohol, electricity, gas, heating and hot water, rents in the state housing sector, postal services and telecommunication, and state rail and road transportation.

This price liberalisation enabled the government to reduce subsidies; as a proportion of GDP, they were reduced from 15% in 1989 to 6% in 1990. Government finances were also improved by a nearly total elimination of tax exemptions for enterprises. Another major and unexpected factor that gave strength to the fiscal position was the high profitability of state-owned enterprises, owing to factors which we already discussed (Section 1.2). The purpose of fiscal policy was to

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<sup>7</sup> In May 1991, the *zloty* was devalued by 17% and the peg was changed from the US dollar to a basket of five currencies (45% US dollar, 35% German mark, 10% British pound, and 5% each French and Swiss franc). A pre-announced crawling peg to this basket was introduced on 14 October, 1991.

have just a balanced budget. The programme for 1990, in fact, allowed for a budget deficit in the first half of the year, to be followed by a budget surplus in the second half. The actual developments were very much the other way round, owing largely to the fact that real wages followed quite a different path than had been assumed in the programme (see the next section).

## **2.4. The incomes policy**

The original intention of policy makers had been to use a tax-based incomes policy as an instrument to defend profits and therefore revenue for the budget and investment finance for enterprises themselves. The chief reason was uncertainty about how effective monetary policy alone would be as an instrument to control wages. It was feared that, in Polish and indeed any East European conditions, a monetary policy, in order to be really effective, would have to be extremely contractionary. Although corrective inflation in the first quarter of 1990 was much higher than assumed, the authorities decided, for fear of even larger inflation, to stick to the original monetary targets in nominal terms. Consequently, real money balances declined much more sharply than planned and the enterprise sector experienced an unprecedented liquidity squeeze. This and the general uncertainty about future sales had the result that during the first six months of 1990 wages remained significantly below the ceiling levels specified by the tax incomes policy. As already explained, in June 1990 the authorities decided somewhat to relax fiscal and monetary policies for the second half of the year. In practice the relaxation proved greater than intended. The liquidity position of enterprises and the business outlook began to improve significantly, enabling them to increase wages above the ceiling levels specified by the incomes policy for the second half of 1990. The wage increase reserve accumulated in the first half of 1990 was so large, however, that the policy started to be a binding constraint only in the latter part of the year.

The continuing application of the policy meant that it was necessary for enterprises to reduce nominal wages at the start of 1991, just at a time when inflation accelerated owing to a new wave of increases in administrative prices. This coincidence caused, as mentioned earlier, a near-mass revolt against the policy.

Its survival in the early part of 1991 was helped again by a substantial deterioration in the liquidity position of state-owned enterprises. The deterioration was caused in part by a new supply-side shock, in the form of a massive loss of exports to the former CMEA area and a large increase in prices for imports from this area. The continuing fixed exchange rate has given rise to two additional factors: the lower profitability of exports to Western markets and the much higher



competitiveness of Western imports. Finally, the concern rapidly to reduce inflation prompted the authorities to conduct a non-accommodating monetary policy. These new pro-recessionary developments on both the supply and the demand side are, this time, causing grave problem for the budget. But they are also bound to accelerate structural adjustment, albeit at a cost in the form of bankruptcies and increased unemployment.

## 2.5. The pace of reform, recession and structural change

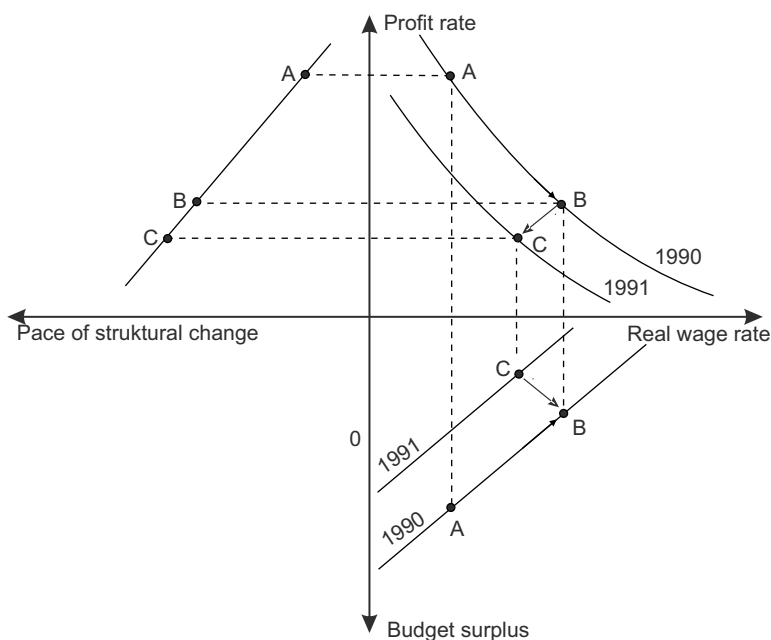
One conclusion of our discussion so far is that, during transition, there are two important relationships at work: (A) between the speed of stabilisation and the scale of recession; and (B) between the pace of structural changes and the quality of macroeconomic control. In order to minimise recession in the initial phase of the reform, it makes sense to limit the size of the price shock. This outcome is obtained most effectively if upward correction of administrative prices and convertibility are separated. The separation, with price correction coming first and convertibility later, allows one to introduce the policy of positive real interest rates, necessary to defend convertibility, only after the very high corrective inflation is gone. In the absence of such separation, as in the Polish case, nominal interest charges are huge and are passed on to prices. This point is particularly important when the debt of the enterprise sector is large (which is, for instance, the case of Russian and other republics; the debt was fortunately of a moderate size in Poland). To reduce recession through price shock, one needs also to avoid any sharp upward re-pricing of the capital stock, in order to keep depreciation costs low.

Another important implication of large price increases is the appearance of inflation-induced, extraordinary profits of enterprises. If reformers underestimate them, as they did in Poland, then the immediate result is a large budget surplus and, again, excessive recession. The risk of this happening is thus particularly high when price liberalisation, price correction and convertibility are all combined in one package. (For an estimate of extraordinary profits and effective tax rates in Poland consult Schaffer, 1991.)

A large part of the price shock comes from the correction of the administrative prices of key inputs, such as fuels, metals and foreign exchange. The estimates produced recently by Hare and Hughes (1991) suggest that the immediate adoption of world prices for tradeables by the countries in transition would result in a significant part of their manufacturing sector producing negative value added. The proportion is about 20% for Poland, Czechoslovakia and Hungary, and about 30% for the former USSR. It is not clear how much of the contraction of

industrial output in Poland has, in fact, been due to this supply-side shock. The Hare-Hughes evidence, if true, may be taken to suggest the need to adopt world prices gradually. The wisdom of this policy depends on whether and how fast producers would switch, if given a chance, to products and processes which economise the use of newly-expensive inputs. On the other hand, a gradual transition to world prices risks allowing social resistance to emerge and, consequently, it may never progress sufficiently.

The Polish experience of transition during the years 1990-1 is also instructive in giving support to the relationship (B) depicted in Figure 3 (and described more fully in Sokolowska, 1991). In the first half of 1990, the central budget was in surplus and international reserves had increased sharply. In terms of these two crucial indicators, the quality of macro-economic control was high. Indeed, in Gomulka (1991) I argue that the contractionary measures were excessive; this was the so-called stop phase of the transition. This control was achieved through



**Figure 3.** Summary presentation of the Polish sequence of policies in 1990-1: from 'stop' (A, first half of 1990) to 'go' (B, second half of 1990) to 'stop' again (C, 1991).

*Notes:* The relation between the profit rate and the real wage rate is the standard factor price frontier. Government's budget is in surplus when wages are low because expenditures in the government sector are then low and corporate taxes are high (personal income taxes and payroll taxes were low in 1990-1). The pace of structural change is low when the threat of bankruptcy is low (the profit rate is high). The shifts of the first two relationships were caused by the collapse of trade with the former CMEA area and the terms-of-trade losses with Russia, following 'dollarisation' of trade.

initially excessively restrictive monetary policy and the large real depreciation of the *zloty*, both of which secured low real wages for workers and high profitability for enterprises (point A in Figure 3). The bankruptcy rate was as a result exceedingly low. There was also little pressure for enterprises to change their ways of doing business. This changed dramatically in 1991 following a sharp increase in real wages in the second half of 1990 (the go phase of the transition). The large real appreciation of the domestic currency, the collapse of CMEA trade and terms-of-trade losses led to much reduced profitability, with about one-third of all state enterprises becoming loss-making<sup>8</sup>. The threat of bankruptcy became real, forcing many businesses, both private and state-owned, to quicken the tempo of 'structural' adaptations. Nearly 10% of state-owned enterprises, historically an unusually large proportion, were liquidated for financial reasons. This acceleration of structural changes was gained, however, at a cost in terms of macroeconomic control. In particular, the international reserves declined and the collapse of profits led to a fairly large budget deficit.

This deterioration of macroeconomic control and the widespread loss-making of enterprises induced the Polish reformers to adopt 'corrective measures' in the course of 1991. Savings in government expenditures were imposed, amounting to about 5% of GDP. Still, a budget deficit of about 4% of GDP, financed by monetary expansion, had to be accepted. This in turn made any further reduction of the inflation rate impossible. Since this rate, at about 3% per month, is very high by West European standards, it became necessary to change the exchange rate policy (see p. 365, no. 2). In order to help the enterprise sector real interest rates were also reduced. Finally, given the poor budget position, substantial limitation of the 'giving-away' component of the mass privatisation programme has been proposed.

### 3. Surprises and policy disputes

I have already alluded to instances when policy makers made wrong forecasts or wrong assumptions and were surprised by subsequent developments. (Of course, not all policy makers or their advisers were truly surprised.) Some of the forecasts, e.g. on prices and output, were made under the pressure of policy convenience, in order to generate an outcome more desirable than would have been possible otherwise. Some of the other surprises were both positive and genuine, e.g. the exceptionally strong budget stance in the first half of 1990, the unusual export boom in 1990 and the longevity of the fixed exchange rate. But if I were

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<sup>8</sup> The much reduced inflation-related profits was however also a major factor in this collapse of officially reported profitability (in Schaffer, 1991).

to name major negative surprises – not just for many policy makers, but also for economists and possibly for the general public – they would be the following: (1) deeper and longer recession, (2) higher unemployment and inflation, (3) a slower pace of re-structuring and (4) lower foreign investment.

These negative surprises have given rise to major policy disputes. They are centred, among others, around the following questions. Is a stabilisation policy a precondition for sustained growth or a hindrance to it? Is controlled macroeconomic relaxation, such as the one in the second half of 1990, insufficient or an unnecessary blunder? Is an incomes policy a lesser evil or a socially divisive and avoidable hindrance to efficiency and structural adjustment? Given the underdeveloped condition of many markets and the slow pace of privatisation, should not the economic policy of the government assume, for some time yet, a more active role in enterprise management and resource allocation?

Let me discuss very briefly three of the surprises.

### **3.1. Deeper and longer recession**

If the latest official statistics are to be believed, in 1990 (in 1984 prices) Polish GDP fell by 11.6%, industrial GDP by 22%, domestic expenditure by 15.4% and total (private and public) consumption by 11.7%. The level of economic activity in 1991 was again substantially lower than a year ago. Instead of the anticipated recovery in GDP, on a year-to-year basis by some 3-4%, there was a further fall of some 7% in 1991. This and the likely spread of bankruptcies are accelerating the increase in unemployment, which reached about 12% of the total labour force and 16% of the non-agricultural labour force by the end of 1991. The crucial factor is the muted reaction of state-owned enterprises to the harsher Financial environment. The usual inertia of these enterprises is compounded by the prospect of privatisation, which increases uncertainty to both managers and workers, providing them with even less incentive to think long-term. But large-scale privatisation seems to be the quickest way to establish a concentrated private ownership, and thus an incentive structure promoting efficiency and sustainable growth. In the short run, however, higher efficiency is likely to imply more unemployment and more recession.

### **3.2. Higher unemployment and inflation**

Much higher unemployment, reaching 20% of the non-agricultural labour force or more in 1992, is likely. In enterprises threatened with partial or complete closure, the workers may prefer lower real wages to unemployment. There is

already evidence to this effect. Lower real wages may reduce the threat of bankruptcies and therefore slow down restructuring, but they should keep unemployment and inflation in check and thereby allow the reform process to survive. Such a fall in real wages would also apply to the budget-funded sector and therefore help to keep the government budget deficit under control.

The reform would be blown off course by any strong resistance to lower real wages, in the face of lower output and productivity. Such strong resistance cannot however be excluded. If it happens and if the monetary authorities accommodate it, an acceleration of both unemployment and inflation would be the inevitable result.

### **3.3. Slower pace of restructuring**

Really fast restructuring, which is the East German solution, is a policy likely to be socially and politically suicidal in the other post-communist countries. Small-scale privatisation involves lower transition costs and therefore is and should be promoted. The privatisation of large enterprises begins with their commercialisation, a step that has a chance to improve the performance somewhat, by clarifying the role of managers as industrial leaders. Their subsequent privatisation has to be well-prepared if it is not to risk large social costs.

## **4. Concluding remarks**

The cost of the Polish reform so far, if measured by fall in GDP in the years 1990-1, is about 18% of the pre-reform GDP. The second year of the reform proved to be substantially more difficult than the first one, seriously straining social support for the reform process. However, activity has probably reached a low point, and macroeconomic equilibrium has been regained. International reserves have been increased substantially and a fifth of the total international debt has been cancelled, with the prospect of a further fifth of the debt being cancelled within the next three years. The costly readjustment of foreign trade away from the former CMEA area to, mainly, Western Europe has been completed. The convertibility of the currency at a unified rate has been maintained without much difficulty. The inflation rate has been brought down (from about 30% per month in the second half of 1989 to about 3% per month in the second half of 1991). The quality of the price system has been radically improved and small-scale privatisation has been nearly completed.

In terms of macroeconomic policies, the authorities were thus largely successful in attaining their initial objectives. However, they failed to avoid the costly

stop-go-stop sequence of policies (the cost of which is however often exaggerated, as it is likely to be only a small fraction of the total cost of transition). The most controversial were the excessively restrictive monetary and fiscal policies in early 1990 and a massive use of the exchange rate and low tariffs to reduce inflation during most of 1991. The major threats to further progress of reform developed in the course of 1991, in the form of a large budget deficit and high unemployment. These are likely to be common features of most transition economies, straining political support for reform and threatening the reappearance of social and economic destabilisation.

Structural changes of large state enterprises, including their privatisation, represent disturbances which may cause further falls in output. A return to the pre-reform level of GDP is therefore unlikely before 1995.

At the end of 1991, a new (third post-communist) government came to power in Poland. This and subsequent governments have the difficult task of arresting the recessionary tendency and continuing the privatisation reform while defending the substantial stabilisation gains of the last two years, all these in the circumstances of rising concern on the part of the population about the social costs of the transition.

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## **Appendix. Poland: summary of intended structural adjustment policies, 1991-3**

### **(1) Privatisation, commercialisation and enterprise restructuring**

- 1991 Commercialise about 1,000 enterprises; privatise 150 large enterprises; reduce size of state enterprise sector by 15%; complete major sector restructuring studies
- 1992-1993 Reduce size of state enterprise sector to 50% of its 1990 level through privatisation; accelerate restructuring

### **(2) Competition policy**

- 1991 Activate private wholesale trade; demonopolise grain processing; create new smaller dairy processing units
- 1992-1993 Increase competition in agricultural inputs supply, road haulage, the power industry and steel industry

### **(3) Rural policies**

- 1991 Begin privatisation of state farms, transformation of agricultural co-operatives; create favourable conditions for land concentration
- 1992-1993 Develop services, trade and small and medium-sized industry in rural areas; accelerate the restructuring and modernisation of agriculture and related activities

### **(4) Pricing and subsidies**

- 1991 Free coal prices and abolish coal export duty; reduce State budget subsidies from 6% of GDP to 5% of GDP
- 1992-1993 Begin to phase out housing and transportation subsidies; increase share of freely-determined industrial producer and consumer prices; reduce state budget subsidies to about 3% of GDP

### **(5) Wages and employment**

- 1991 Introduce more flexible wage controls; introduce instruments to improve the labour market
- 1992-1993 Reduce the scope of wage control in line with commercialisation and privatisation; promote a more efficient and absorptive labour market by liberalising the housing market, improving information flows, retraining programmes and support for new businesses

### **(6) Fiscal reform**

- 1991 Improve expenditure monitoring and reporting, cash management and budgetary planning; review public investment programme



1992-1993 Implement value-added tax and personal income tax; develop domestic and external debt management systems

(7) Financial sector reform

1991 Introduce Accounting Plan for banks; establish system of prudential regulation; develop plans for bank restructuring; commercialise state-owned banks; reform NBP refinance system and introduce flexible, more market-determined interest rates; limit growth of subsidised credit

1992-1993 Privatising a substantial part of the state-owned banking sector; strengthen competition in the banking sector, particularly in the rural economy; reorganise activities of NBP

(8) External policies

1991 Liberalise regulations governing foreign investment in Poland; reduce number of commodities requiring export licenses; modify foreign exchange surrender system; establish export credit guarantee agency

1992-1993 Abolish most remaining export license requirements; reform tariff structure

(9) Environmental policies

1991 Launch an investment programme in the field of environmental protection; revise the environmental protection laws and regulations; continue the enforcement of the environmental protection laws (including the elimination of environmentally hazardous technologies)

1992-1993 Broaden the size of environmental investment; continue strict enforcement of environmental protection laws; register an initial improvement of the environment in the most polluted areas.



## 9. Kornai's road to a free economy in light of Polish experience\*

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Janos Kornai, *The Road to a Free Economy: Shifting from a Socialist System. The Example of Hungary*. New York: Norton, 1990. 160 pp.

It was a year ago when the Editor of this Journal asked me to review Kornai's *The Road to a Free Economy*. He added, however, that I should discuss Kornai's suggestions concerning economic policy during transition in light of the Polish experience. The task has since been frequently on my mind, but I felt unable to discharge it properly. The problem was that only in the course of 1991, the second year of the Polish reform program, were many of the original policies really tested, in some cases the tests forcing significant revaluations and changes. Only now, after 2 years of reforms, do I feel able to write about the Polish experience with any confidence. (For a comprehensive discussion of the experience, see Gomułka, 1991).

As Kornai explains, his book was originally written in the summer of 1989 as a contribution to policy debate in Hungary. The title of the original Hungarian publication is accordingly: *A Passionate Pamphlet in the Cause of Economic Transition in Hungary*. The Hungarian origin is also indicated in the subtitle of the English version: *Shifting from a Socialist System*. However, there is very little in the book that is specifically Hungarian. The bulk of his discourse is meant to apply to all post-communist countries in the first few years after the collapse of communist power. The book may thus be read as a sequel to Hayek's *The Road to Serfdom*, an inference that Kornai himself encourages the reader to make in his Introduction.

The Western reader of the book may take the view that the generality of its policy discussion makes much of it neither original nor controversial. After all, the specific long-term recommendations amount to adopting time-tested institutions and policies of developed Western countries. The book is also, however, in some parts even mainly, about the transition, hence also about the sequencing of reforms and the influence on economic policies of the peculiar point of departure: a dominant state sector, underdeveloped markets, chaotic bureaucracy, and

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\* *Journal of Comparative Economics*, June 1992, 16.

widespread attitudes of the “homo sovieticus” type. The difficulty Kornai faced was that, at the time of writing the book, there was no real-life experience with transition. He had no choice but to speculate, openly or implicitly, about the possible virtues of adopting one sequence rather than another and about the impact of initial circumstances on the content and effectiveness of the various policies along the transition path.

The book covers the familiar five topics: (1) macro-stabilization, (2) micro-liberalization, (3) privatization, (4) external economic relations, and (5) internal politics. The policies in those areas are interrelated, and there is a degree of overlapping in the timing of their implementation. I discuss them in turn, except topic (5), which I omit.

## **1. Macroeconomic stabilization**

This was less of a problem in Hungary, but was one to be dealt with urgently in Poland and Yugoslavia in 1989-90, and is again a problem in the former USSR in 1991-2. In all three countries the reformers confronted simultaneously a large budget deficit, grossly inadequate international reserves, and unserviceable external debt. Kornai (1990) suggests that “stabilization measures must be taken in one stroke” (p. 102). But he interprets this in an uncharacteristically soft way, by meaning that stabilization “surgery” must merely begin on a stated day, and “ought to be completed within two years of the new government’s inauguration” (p. 102). To obtain this outcome, he is in favor of a tight monetary policy (positive real interest rates), restrictive incomes policy, and a fiscal restraint (no budget deficit).

These text-book prescriptions are, of course, correct. However, his general discussion overlooks the potential complexity of the problem in some of the countries concerned. In Poland, the government budget was improved radically and quickly. But the low level of international reserves prompted reformers to impose large devaluations within the first few months of the reform. As a result, competition in domestic markets was initially limited and enterprises were able to lift domestic prices and wages quite fast. Despite very high interest rates, demand for money was high. Given the recessionary conditions, the monetary authorities accommodated the wage increases, as long as they were consistent with the government wage policy. The inflationary impact of correcting administrative prices has also been high, as was the impact of dollarization of trade with the USSR. The combined result was a 250 percent inflation in 1990.

In early 1991 the authorities decided to step up the fight against inflation by the combination of a major appreciation of the exchange rate, low tariffs, and

restrictive incomes and monetary policies. What were the results? Real wages did decline sharply, but so did profit margins and economic activity in general. Despite strong measures to reduce expenditure, resulting in savings of about 5 percent of GDP in 1991, a significant budget deficit of about 4 percent of GDP has emerged. This deficit had to be financed by a banking credit, fuelling monetary expansion. Even though incomes policy has survived and unemployment reached 15 percent of the non-agricultural labor force, inflation was still about 3 percent a month at the end of 1991.

After 2 years of reform there is, in Poland and possibly in some of the other countries of Eastern Europe and the former USSR, a real danger of the following cycle developing: near hyperinflation (1989), stabilization program (1990), recession (1990-2), budget deficit (1991-), large public debt (1993-), large budget deficit, near hyperinflation again.

In Hungary there was no near hyperinflation to begin with, and the price corrections were smaller than in Poland. Consequently the recession has been less deep and the implications for the health of public finances less threatening. However, large falls in GDP, exceeding even 20 percent, as in Poland 1990-1 where the cumulative fall was, according to official statistics, close to 20 percent, are likely to be common during transition. Kornai conveniently but unrealistically assumes, "for the sake of making exposition simpler" (p. 113), no fall in GDP.

On the other hand, his intention to be realistic led him to think that the state banking system may not be able to restrict credit to state enterprises. This fortunately was neither the Polish experience in 1990-1, nor, I understand, has been the Hungarian experience during the same period. In Poland, quarterly limits on credit expansion to enterprises and households were set by central authorities, and a host of instruments has been used by the Central Bank to ensure that the limits are observed by commercial banks. The allocation of credit may have been inefficient but the control over the volume of credit has been, so far, effective. The recession and a fall in profits in 1991 also created the problem of bad debts. This latter problem may in due course, if the fall persists, become a grave threat to the effectiveness of the credit control policy and to the viability of the banking sector itself.

It is thus evident, once again, that recession, in part induced by stabilization, may at some point become a major threat to a successful completion of stabilization. To meet the threat, not only is a strict wage policy required, one sufficiently effective to ensure that most enterprises continue to be profitable, but also an effective tax system is needed, one capable of keeping the budget balanced whatever the depth of the recession happens to be.

## 2. Micro-liberalization

This applies not only to prices but also to regulations concerning the private sector, foreign trade, and foreign investment. Kornai's suggestions in these areas are, in my view, neither particularly surprising nor controversial. There are, however, topics that Kornai does not discuss, but that, in practice, cause controversy. They are: the speed with which to increase administrative prices of certain goods, such as fuels, transport and telecommunication services, central heating and hot water, rents and electrical energy, to either world levels or subsidy-free levels; the extent of price regulation through subsidies for agricultural products; and the level of protection of domestic producers through tariffs or the exchange rate. The estimates produced recently by Hare and Hughes (1991) suggest that the immediate adoption of world prices for tradeables by the countries in transition would result in a significant part of their manufacturing sector, some 20 to 40 percent, producing negative value-added. It is not clear to me how much of the contraction of industrial output in Poland has in fact been due to this supply-side shock. The Hare-Hughes evidence, even if it were correct only approximately, is stunning. The evidence may be taken to suggest the need to adopt world prices gradually, in order to give the enterprises a chance to respond. On the other hand, a slow transition to world prices is not only potentially wasteful, but also risks creating a chance for social resistance to emerge and, consequently, preventing the transition from being carried through to its conclusion.

I also read Kornai's discussion of the virtues of price liberalization with an interest to find what, if anything, has remained of his earlier theory of the shortage phenomenon. The theory links most shortages to the necessarily soft budget constraint of state-owned enterprises and insists that price liberalization alone, without large-scale privatization, would be incapable of eliminating such shortages. A few years ago Kornai still defended this view in a response to my challenge of the theory (Gomułka, 1985; Kornai, 1985). On this occasion, however, I have no cause for any disagreement, though I am not sure if this really implies, as it would appear to do, an effective abandonment of the theory. In any case, the East European experience seems to vindicate my view that, following price liberalization, most shortages would disappear almost immediately.

As already indicated, I also find myself in full agreement with Kornai on the need to maintain a strict wage discipline (p. 145) in the state sector. During the initial period of transition this is particularly important in the sector of the economy benefiting from large increases in administrative prices and the liberalization of foreign trade. This sector may be small but, without any tax-based incomes policy, wages in it could increase many-fold and quite quickly, providing a strong

demonstration effect throughout the entire economy. A highly restrictive monetary policy alone may also keep nominal wages in check, as it did in Poland in the first half of 1990. However, after the initial shock is over, the pressure on wages builds up. If the monetary authorities refuse to accommodate wage increases, this would cause the collapse of profits and widespread bankruptcies. An incomes policy is thus a partial substitute for unemployment to achieve macroeconomic stabilization. Past incomes policies had often failed in Eastern Europe. This is because they could not be enforced by politically weak governments. In Poland, post 1990, the incomes policy has by and large worked. However, it would probably not have survived for long on its own, without the support of the full combination of monetary, fiscal, and exchange rate policies. The purpose of the support was to harden somewhat the budget constraint of enterprises and to increase competition.

The incomes policy could be gradually phased out with the increase of unemployment and the progress of privatization.

### 3. Privatization

The basic and well-recognized microeconomic problem during transition is that socialist ownership still predominates and that, without a strong and self-interested advocate for profits and capital within an enterprise, the incentives continue to be to increase the short-term income of the workforce rather than the long-term net worth of the enterprise. But how are we to find entrepreneurial owners where there are only few capitalists, and in what socially acceptable manner to hand over to them the state assets where there is only little private capital?

Kornai has distinctive and well-argued answers to these key questions. They are derived from his strong, Schumpeterian-type belief in the overriding value of entrepreneurial talent as the main source of economic wealth and from a deep mistrust of any institutional owners who are not subject to the competitive discipline of the market. Since entrepreneurial talent is rare, he accepts a high concentration of share ownership as an avoidable feature of “real capitalism.” For example, in the United States, the richest 1 percent own apparently 80 percent of the shares, and the richest 0.1 percent own 40 percent of the shares. He is therefore against “people’s capitalism,” and regards turning all citizens into shareholders by a large-scale free distribution of shares as artificial and “quite alien to the real development of capitalism” (Kornai, 1991, p. 38). He is also strongly against the use of large state institutions, such as banks, insurance companies, or newly formed mutual funds, as shareholders. But private insurance companies and private pension funds would qualify as legitimate buyers of state shares; they may even be given some of the shares free of charge (Kornai, 1991; this represents a

modification of his position in the book). In Eastern Europe these private institutions however, are unlikely to be formed and become large players quickly. What therefore remains as a main privatization route is leasing capital assets or selling shares to individual private owners. Potential buyers can be offered privatization credits at a reduced interest rate, but a significant proportion of the price of assets must be paid in cash.

Kornai accepts that his proposals are bound to lengthen the process of privatizing the existing state enterprises. A rapid privatization of the economy is, in his view, still possible, but mainly through a fast expansion of the existing private firms and the entry of new firms.

Kornai's policy suggestions may be said to be truly liberal, in contrast to what he calls, after the Polish economist Tadeusz Kowalik, the school of statist liberalism, which, in order to accelerate privatization, envisages a large role of governments in setting-up investment funds and a massive giving away of their shares or the shares of individual enterprises to the population.

The privatisation of small enterprises can be carried out quickly using Kornai's organic methods, and it has been nearly accomplished in Poland. The problem is with the privatization of medium and large-scale enterprises. Private capitalists are simply too few and too poor to buy these enterprises on commercial terms. Selling these enterprises to the highest bidder at giveaway prices is the only financially feasible solution, but also one that is considered to be highly unpopular and therefore not really a possibility. The Polish liberal reformers were initially also against the so-called commercialization of enterprises and the establishment by the state of investment funds to serve as intermediaries. The reasons were similar to those of Kornai. The position changed in the course of 1990 in the face of evidence that the traditional methods of privatization are ineffective for large enterprises and that the growth of the original private sector is too slow to make an impact on the whole economy. As the recession in the state sector deepened, the pressure has been mounting to accelerate enterprise restructuring. Such restructuring typically requires concentrated ownership, one capable of providing leadership and attracting capital. It is hoped, perhaps unrealistically, that the funds, some of them run by foreign management groups, will be able to do both for a substantial number of Polish large enterprises.

## **4. External economic relations**

The external component of Kornai's reform program is fairly comprehensive. It includes relations with Bretton-Woods institutions, economic aid from Western



governments, policies to attract foreign private investment, trade policy, and the question of servicing foreign debt. As might be expected, Kornai is especially keen to promote foreign private investment, but is against the usual incentives, tax concessions, protective tariffs, and any insurance against exchange rate risk. Apparently Hungary has been by far the most successful in Eastern Europe in attracting foreign capital, despite the presence of a large foreign debt. The Hungarian policy of avoiding a restructuring of the debt and servicing it fully must have been an important underlying factor. This is also the policy that Kornai advised Hungary to follow.

## 5. Concluding remarks

Janos Kornai's wide-ranging and sometimes passionate analysis of the transition process is both wise and comprehensive. Actual reforms in Eastern Europe have been, so far, close to his boldly liberal proposals. However, devastating declines in economic activity and high unemployment are changing the political climate in favor of populism and activist government policies. These policies may have to come and be tested before a proper balance of market liberalism and state intervention is found.

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## 10. Poland: Glass half full\*

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The primary purpose of this paper is to offer a policy-oriented overview of the current state of Poland's economic transformation, taking into account its starting point, the progress of reforms so far, policy errors in 1990-1, major economic, social and political problems in 1991 and 1992, and policy aims for 1993. The economic issues and policies are considered in their own right as well as in the broad social and political context. The paper has the following structure: section 1 – broad interactions between politics and economics in the process of transition; section 2 – macro stabilization; section 3 – micro liberalization; section 4 – privatization and other structural changes; and section 5 – major problems in 1991-2 and aims in 1993.

### 1. Broad interactions between politics and economics in the process of transition

It may be useful to address immediately the question of the mutual interplay between economic reforms and their political environment. In the case of Poland, the following sequence of powerful interactions has been at work:

(1) The pre-reform economic crisis of 1979-81, renewed in 1988-9 (crisis no. 1), led to the rise and survival of Solidarity, to the collapse of the limited reforms of the communist-led governments and, in the spring of 1989, to Round Table negotiations on power sharing and gradual dismantling of communist rule in Poland.

(2) These revolutionary political changes in Poland and the parallel political changes in the USSR in turn led, in September 1989, to the assumption of extraordinary power over the economy by radical liberal reformers, Solidarity experts, and the launching by them of economic reforms aimed at rapidly creating a mixed capitalist economy of the West European type.

(3) These historical reforms have brought large improvements, but also inflicted large costs – the transition-related economic crisis (crisis no. 2).

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\* In: R. Portes (ed.), *Economic Transformation in Central Europe: A Progress Report*. London: CEPR, 1993.

(4) This economic crisis has changed attitudes to reforms and reformers and has shaped the new political parties and their transition politics.

(5) This transition political process has gradually imposed a degree of control over the liberal reformers, forcing changes to the pace and substance of reforms, while maintaining then overall direction.

Sociological studies appear to suggest that, in the decade 1979-89, rejection of the political system was widespread and intense. Rejection of the state-dominated economic system, however, was still uncertain. In 1982-8, while some 60-80% of adults were in favour of introducing the laws of the market and free competition into the economy, the attitude to medium and large-scale private business remained hostile (Kolarska-Bobińska, 1990, p. 163). Pre-1989 Poland was a country in which, according to Kolarska-Bobińska, only the myth of the free market developed. The institution itself was accepted only insofar as it was a rejection of the existing misery and a symbol of good things to be found elsewhere; the necessary implications in terms of ownership, job insecurity and work attitudes were yet to be considered and absorbed. The 1989 crisis served to initiate and accelerate this learning process.

By the time the Solidarity-led government came to power, in September 1989, popular support for a variant of the capitalist system was apparently high. The Solidarity-led political coalition had only a vague idea of what to do with power in the economy. It therefore handed over the task of designing the reform programme and conducting the transition to a small group of experts. In the virtual absence of political parties and under the pressure of crisis circumstances, these experts, led by Leszek Balcerowicz, assumed an unusual degree of power. Its legitimacy came above all from the evident collapse of the old economic system and the proven performance of the system about to be introduced. It also came from the trust of the nation and the new political elite in the knowledge of the experts to lead the country out of the crisis through the transformation to a Western-type economy.

Many of the experts and probably most of the population were, however, unaware of the necessarily large social and economic costs of the transformation. Instead of the expected rapid improvement in the standard of living, there came a shocking realization that Poland was entering into a prolonged period of massive recession. Accordingly, in the course of the reforms popular support for the Balcerowicz Plan declined steadily, from about 45% in favour and 10% against in October 1989 to about 20% in favour and 40% against in October 1991 (CBOS, BS 457, November 1991). The reforms have also brought about large changes for the better, enough to sustain broad support for the continuation of the reform process, as evidenced in high popularity ratings of the top political leaders. This

mixture of large economic changes for the worse in some respects and remarkable improvements for the better in other respects has given rise to confusion and anxiety among the population, including the political elite, and a loss of confidence as regards what the next reform steps should be. This manifests itself in the ‘withdrawal syndrome’ of the electorate (42% participation in parliamentary elections in October 1991) and the split of the reform movement into a large number of political parties and factions within parties. This situation produced statements such as President Wałęsa’s “I am in favour of this reform but also against it” or, by a Solidarity union leader in January 1992, “We strike not against the government but against the situation.”

These reform-related economic difficulties produced, in 1991 and 1992, a state of political near paralysis in the parliament, a weak presidency and governments unable to get most of their proposed legislation through parliament. In the meantime, a large budget deficit developed and the danger arose that this deficit would lead to a return of hyperinflation.

An effective government with a strong political base in parliament, one capable of taking unpopular decisions, was clearly needed to deal with these grave threats. On its transition path Poland arrived, in early 1992, at a crossroads of sorts. After a turbulent first half of the year, when Poland saw a government and two prime ministers appointed and dismissed, the fairly strong government of Miss Suchocka, which was committed to reform, came to power in the summer of 1992.

## **2. Macro-stabilization**

### **2.1. Initial conditions**

The domestic credibility of the Polish government’s macroeconomic policies was severely eroded in 1989 when massive subsidies led to a large budget deficit in the first half and resulted in near hyperinflation in the second half. External credibility was low and declining further with the rapid rise of international debts. International reserves were low, but the dollar deposits were so high that the share of zloty-denominated money in total money was, in December 1989, a mere 28%. The inflation rate of some 30% a month served two useful purposes: it eliminated the monetary overhang and it reduced drastically the real debt of the enterprise sector. A system of extensive price indexation of wages and benefits, however, worked to reproduce excessive purchasing power and high inflation. Food prices were already liberalized, but otherwise the quality of the price system was poor.

In particular, interest rates were highly negative, energy prices were about a tenth of world prices, and the official exchange rate was, in September 1989, a seventh of the market exchange rate. Polish industry was highly material-intensive, and the whole economy was strongly dependent on supplies of energy and other inputs from the USSR, obtained largely in exchange for poor-quality Polish manufactured goods.

## 2.2. Sequencing

This has been discussed in a number of papers, e.g. Fischer and Gelb (1991), Dornbusch (1991), Gomułka (1990, 1992a), Nuti (1991), Portes (1992), and Wellisz et al. (1991). Here it suffices to note that the immediate steps, made in preparation for the 'Big Bang' of 1 January 1990, were designed above all to eliminate the budget deficit and to reduce drastically, through a series of devaluations, the gap between the market and the official exchange rates.

## 2.3. The 'big bang'

The operation aimed above all to improve radically and permanently the quality of prices, including the interest rate and the exchange rate, and to stabilize the liberalized prices gradually through the application of three anchors: the money supply, the exchange rate and an incomes policy. Given the initial conditions, achieving price stability was, in 1990, secondary to two other aims: a substantial increase in international reserves (which required a large up-front devaluation) and a major improvement in the quality of the price system (price liberalization and drastic increases of some administered prices during 1990 and early 1991). Large induced inflation justified in turn large monetary expansion, which helped to achieve the third aim: a severe reduction in the share of dollar currency in the total money supply.

Macroeconomic concerns dictated a course of action that resulted in a large initial price increase and hence a large fall in (statistical) real wages. Low wages helped to maintain high profitability of enterprises despite recession. This in turn ensured high revenue for the government budget and low expenditure on salaries in the budget-funded sector of the economy. High profitability was also helped, in 1990, by a large up-front devaluation of the zloty, designed to promote net exports and maintain stability of the exchange rate. This exchange rate policy sharply unproved the external position of the country. The policy was inflationary in two ways, by increasing the cost of imports and by contributing to monetary expansion through the balance of trade surplus; but it also contributed to the budget and helped

reduce recession. The microeconomic outcome of this macro policy was, however, that inefficient enterprises continued to be profitable, and therefore were not faced with the immediate necessity of undertaking any harsh cost-cutting measures.

The strategy itself was deliberate, even if it went too far in the first half of 1990. It was motivated by the desire to avoid a catastrophe of the East German type – large scale bankruptcies and large-scale unemployment at the start of the reform. The implicit choice of sequencing was after all to deal first with macro problems, such as the budget deficit, inflation, international reserves and foreign debt, and only later with the more fundamental, difficult and time-consuming problem of microeconomic inefficiency.

## **2.4. The stop-go sequence of macroeconomic policies**

The initial aims were achieved fairly quickly; in particular, the near hyperinflation that was raging in 1989 was eliminated by the spring of 1990. Nonetheless, inflationary pressures were still high throughout 1990 and 1991. In the second half of 1990, the inflationary pressures increased. This was linked to the unintended stop-go sequence of policies adopted in Poland.

In the first half of 1990, policies were highly contractionary, in fact much more so than originally intended. Particularly restrictive were fiscal and monetary policies. The combined budget surplus of the total government sector, including special parabetgetary funds, was of the order of 8% of GDP in the first half of 1990. Since the budget was in deficit for a similar amount in 1989, the change in the fiscal position was unprecedented in magnitude, and it was achieved within a very short period of time. Monetary policy was also highly contractionary. Output immediately declined a great deal, especially in the sector producing non-essential consumer goods.

By the middle of 1990, the government had introduced policies intended to promote economic activity and to open domestic markets to foreign competition. In order to stimulate activity, the authorities reduced interest rates, increased credit to enterprises and increased government expenditure, but on a scale larger than initially intended. In the second half of 1990, wage increases were consequently large, nearly 10% a month, and inflation increased to about 5% per month. After a fairly sharp fall in the purchasing power of household incomes in the first half of 1990, by about 35-40%, there was thus a very rapid recovery in real incomes and consumption in the second half of 1990. Real wages in fact reached levels that began to undermine the international competitiveness of Polish exports as, in dollar terms, they exceeded the levels then prevailing in Czechoslovakia and Hungary. The level of economic activity did increase, especially in branches

producing food products and consumer durables. There was also, however, an exceptionally large increase in consumer imports, turning a healthy trade surplus during the first three quarters of 1990 into a deficit in the fourth quarter of 1990. In response to all this, by the end of 1990 the central authorities modified monetary policy with a view to regaining macroeconomic control. This led to a new phase of 'stop' policies in the first half of 1991.

In early 1991, Poland was thus *in* a 'stop' phase of its reform path. The two dominant developments were: a continuing effort to regain macroeconomic control after it was seriously eroded during the last months of 1990, and a new supply-side shock in the form of the switchover to dollar prices within the CMEA area from 1 January 1991 and the consequent sharp fall in Polish exports to this area. The impact of the dollarization on Poland's inflation, terms of trade and recession was larger than anticipated. The price index increased by 15% in January, and industrial output declined by 15%. A further decline by about 10% from April 1991 brought the level of industrial activity in 1991 down to about 65% of its pre-reform level. I estimate the overall (direct and indirect) impact of the CMEA collapse to be about 5% of GDP in 1991. The terms-of-trade losses during 1990-1 amounted to a further 3% of GDP.

## **2.5. The nominal anchors: money, incomes and the exchange rate**

A highly restrictive monetary policy during the first quarter of 1990 and the general uncertainty about future sales had the result that during the first half of 1990 wages remained significantly below the ceiling levels specified by the tax-based incomes policy. The policy started to be binding only towards the end of 1990 and has since been the principal nominal anchor. In 1990 the policy restricted the growth rate of the wage fund in nearly all enterprises and, since January 1991, it has restricted the growth rate of average nominal wages in state-owned enterprises.

The basic problem with the Polish stabilization effort was that two nominal anchors, money and incomes, were too flexible during the second half of 1990 and most of 1991 to serve as proper anchors. In 1990 and 1991 monetary policy, with the exception of a few short periods (in particular, the beginning of 1990 and the turn of 1990 and 1991), accommodated price increases and, with the exception of the first four months of the year, the effective price indexation of wage norms was nearly 100%. The excessive and financially unsustainable wage indexation of benefits was in operation throughout this period.

There was already a clear need in the summer of 1990 to introduce an incomes policy with little or no price indexation of wage norms. The judgment was made, however, that for political reasons this was not possible. What the authorities did



instead was to keep the exchange rate fixed in 1990, despite the 250% price increase, and continue to appreciate it in real terms in 1991 (when the rate of appreciation against the dollar was 28%). In this way the exchange rate became a major nominal anchor from the latter part of 1990. The result of this combination of a soft incomes policy, an accommodating monetary policy and a hard exchange rate policy was a sharp increase in imports, especially of consumer goods, and the disappearance of the trade surplus starting in the fourth quarter of 1990. This in turn led to a fall in international reserves and possibly excessive recession.

The economic policy implemented in 1992 and intended for 1993 aims to restore policy coordination by substantially changing the incomes policy, hardening the monetary policy and allowing some depreciation of the real exchange rate (Council of Ministers [CM], 1992a). The new incomes policy for wages in state enterprises is designed to meet the following criteria: allow a small increase in real wages when inflation is low and a fall in real wages when inflation is high; help managers of loss-making enterprises to reduce wage costs significantly; provide an incentive for exports, commercialization and privatization; and define a path for the gradual withdrawal of the policy along with the progress of privatization and the rise in unemployment. Moreover, the policy discontinued the practice of automatically linking wages in the government sector to other wages. It also aims to reduce the ratio of pensions to wages.

## **2.6. Public finances: deterioration in 1991 and crisis in 1992**

Whatever the health of public finances just before the start of transition reforms, post-socialist economies appear invariably to develop a fiscal crisis in the course of transition. The causes of this tendency are well understood, and I shall discuss them only briefly. Less clear but vital for policy-makers are the implications of such deficits for the inflation path, given the servicing requirements of the accumulating public debt and the credit requirements of the economy.

In the first year of reform, the budget deficit is typically low but the inflation rate is high, much of it due to corrective price increases. In the second and third years of reform, the deficit/GDP ratio tends to increase sharply, while the inflation rate declines. There comes a point, however, when the deficit is large enough to arrest and then to reverse the downward trend of inflation.

## **2.7. Causes of the fiscal problem**

In Poland, fiscal developments in aggregate terms have been and are expected to be as shown in Table 1. Inspection of the table shows that the share of general

government expenditure in GDP has been reasonably stable. The primary cause of the newly emerging fiscal gap has been on the revenue side. The central government was even able to reduce its expenditures by some 4% of GDP in 1991-2, compared with the levels in the years 1987-90. State revenues, however, fell by about 10% of GDP in 1991 and have remained low. This fall can be traced mainly to the collapse of enterprise profits, but also in part to a fall in turnover taxes as industrial output fell much more than the GDP. This suggests that the primary remedy for the budget deficit problem must be found also on the revenue side, probably through an increase in indirect taxes.

However, the expenditure side is also interesting to look at because of large shifts in its composition. Perhaps the most reform-related expenditure items are subsidies. Their pre-reform composition – about two-thirds of the total going to the household sector and about one-third to the enterprise sector – has remained virtually unchanged. But their total sum has fallen dramatically, from about 16% of GDP in 1987-8 to 12.9% in 1989, 8.2% in 1990 and 4.8% in 1991. On the other hand, the budgetary transfer to pension funds and the Labour Fund increased from 4% of GDP in 1987 to about 8% in 1990-1. The cost of unemployment benefits is still a relatively minor burden, less than 1% of GDP in 1991.

**Table 1.** Fiscal indicators in Poland, 1987-93 (as % of GDP)

Indicator	Pre-reform			Transition				
	1987	1988	1989	1990	1991	1992 <sup>1</sup>	1992 <sup>2</sup>	1993 <sup>3</sup>
State budget:								
Revenues	34.2	35.5	30.8	37.4	26.5	26.7	25.0	27.2
Expenditures <sup>4</sup>	37.7	37.0	36.9	36.7	33.0	32.8	35.0	32.3
Balance <sup>4</sup>	-3.5	-1.4	-6.1	0.7	-6.5	-6.1	-10.0	-5.1
General government:								
Revenues	47.0	48.0	41.4	48.3	42.3	42.0	41.0	42.5
Expenditure	47.8	48.0	48.8	44.8	48.5	48.2	50.0	47.5
Balance <sup>4</sup>	-0.8	0.0	-7.4	3.5	-6.2	-5.8	-10.0	-5.0

Notes:

<sup>1</sup> Expected outcome as of December 1992 (CM, 1992b).

<sup>2</sup> Expected outcome in the absence of corrective measures.

<sup>3</sup> Expected outcome if measures proposed in the state budget for 1993 (CM, 1992b) are adopted.

<sup>4</sup> On a commitment basis, except external interest which is on a cash basis.

*Definitions:* 'State budget' is the budget of the central government. 'General government' includes central government, local authorities and extra-budgetary funds.

*Sources:* IMF (1992b) for 1987-91, Polish Ministry of Finance for 1992-3.

The main problem on the expenditure side has been the meteoric rise of expenditure on pensions and other social insurance items. This occasioned the need to transfer resources from the state budget to the main three extra-budgetary

funds: FUS (mainly workers' pensions), KRUS (mainly farmers' pensions) and the Labour Fund (mainly unemployment benefits) (see Table 2). Total expenditures of the three funds increased from 11% of GDP in 1987 to 18% in 1991, and were expected to reach 21.6% in 1992. Pensions alone accounted for 6.6% of GDP in 1987, but 11.1% in 1991 and 13.5% in 1992. As subsidies to the household sector were reduced, the authorities apparently felt compelled to increase the ratio of the average pension to the average wage rate from about half before the reform to about two-thirds in 1992.

A fortunate aspect of the Polish fiscal position so far has been the light burden, about 1% of GDP, of servicing the external debt. The agreement with the Paris Club of March 1991 on about US\$30 billion of sovereign debt gave Poland three years during which 80% of interest payments due would be forgiven. Poland also continues not to service the bulk of the US\$13 billion of commercial debt. It may therefore be expected that in 1994 and thereafter the burden of servicing the external debt will greatly increase, possibly to about 4% of GDP. This will still be lower than the Hungarian burden now, which, at some 6-8% of GDP, is a major cause of the weak fiscal position in that country.

**Table 2.** Transfers to social insurance funds in Poland, 1988-92

	1988	1989	1990	1991	1992
To FUS:					
% of state budget	2.0	4.2	4.5	10.5	15.8
% of FUS's expenditures	8.0	12.5	16.3	9.2	26.2
To KRUS:					
% of state budget	1.9	3.5	3.8	6.5	7.9
% of KRUS 's expenditures	75.0	99.7	96.8	87.3	94.2

Source: Polish Ministry of Finance.

About 90-100% of the deficit is financed by the banking sector, and about half to two-thirds of this is financed by the central bank. The difficulties in reducing the budget deficit are related to insufficient political cooperation between the government and the parliament, reflecting in part the rising national concern over the social costs of the transition.

The situation has arisen in part because of inadequate understanding of the reasons for a large budget improvement at the beginning of the reform, in the fourth quarter of 1989 and the first quarter of 1990. During that period of very high inflation, the nominal (zloty) value of two capital assets of the enterprise sector, foreign exchange deposits and inventories of materials, semi-finished and finished goods, increased rapidly. In line with the Polish accounting system, the

consequent capital gains were counted as profits. However, insofar as they do not reflect any change in the volume of these two assets, the gains are 'paper profits'. The existence of these profits was well known, but their large impact on total profit and corporate income tax was never properly estimated. An attempt at such an estimate was made recently by Mark Schaffer (1992a). It appears that these paper profits significantly exceeded 'true profits' in the periods in question (fourth quarter of 1989 and first quarter of 1990), increasing the tax burden of the enterprise sector by a factor of 3.

This automatic anti-inflationary stabilizer had already helped to eliminate the budget deficit in November and December 1989. It also accounts for the fact that, in 1990, corporate income tax and dividend tax represented about 16% of GDP and half of the total budget expenditure, compared with about 11% in (say) 1985 and 7.8% in 1982, which was less than one-third of the total expenditure.

It is now clear that the government made two major errors in the fiscal field. It overestimated the size of the corporate and dividend taxes for 1991 by 6.5% of GDP, and it failed to increase indirect taxes sufficiently to compensate quickly for the shortfall in the direct enterprise taxes. In view of the technical difficulties in introducing the VAT system, the government could and should have sharply increased the turnover tax by broadening its base and raising tax rates. The fiscal situation would also have been helped by a stricter wage policy. Such a policy would have increased profits and therefore budget revenue, and it would have reduced wages in the budget sphere as well as wage-indexed welfare benefits, and therefore budget expenditure. These income measures would have required, however, close cooperation between the government and parliament, and this was singularly lacking in 1991 and continued to be insufficient in 1992.

**Table 3.** Budgetary costs of pensions and unemployment benefits, 1989-93

	1989	1990	1991	1992	1993
Pensions:					
No. (million)	6.8	7.4	8.0	8.5	8.9
Cost (% of GDP)	7.2	9.4	11.4	12.8	13.3
Unemployment benefits:					
No. (million)	0.0	0.5	1.4	1.4	1.2
Cost (% of GDP)	0.0	0.5	1.0	1.1	1.0
Total cost (% of GDP)	7.2	9.9	12.4	13.8	14.3

*Note:* Cost is net of personal taxes; numbers are averages for the year. Pensions are of three categories: old age, early retirement and disability. The first two categories represent about 60% of the total. The average unemployment benefit is about 32% of the average wage and about 50% of the average pension, the latter now being equal to about 65% of the average wage.

*Sources:* Author's estimates based on Poland's Ministry of Finance data for 1989-92 and projections for 1993.

Cooperation was and continues to be vital in implementing a programme of budget savings. These are necessary in view of the development portrayed in Table 2. Underlying that table are the data shown in Table 3. Inspection of these figures and of Table 2 above shows that the crisis of public finances is also the result of a sharp increase in welfare expenditures. The cost of unemployment benefits is as yet insignificant compared with the cost of pensions, which is the result of a large increase in both the number of pensioners and the real value of the average pension.

To conclude this discussion of public finances, it is worth noting two circumstances that are important and common to nearly all transition economies and that complicate the policy-makers' task of reducing the budget deficit. One is the poor quality of bank assets and the other is widespread private sector evasion of taxes. The two factors influence public finance policy in the following way.

The banking sector seeks to improve its portfolio of assets by lending more to the government and less to economic units. Given that, in Poland, about 50-60% of all enterprise debt is not being serviced, and that the government debt is fully serviced, the ability of the banking system to pay reasonable interest on deposits is enhanced with the persistence of a large budget deficit. The deficit is thus a way of providing a safety net for the banking system. In the course of time, the poor-quality debt will be a declining share of all banking assets, and therefore the significance of this factor should also decline.

The tax collection problem is in turn inducing the members of parliament representing taxpayers (who are the majority of the electorate) to impose an inflation tax in preference to other taxes. The reason is that, because it is difficult to evade, inflation tax is paid by those operating in the black economy.

### **3. Micro-liberalization**

Liberalization applies not only to prices but also to regulations and policies concerning the private sector, foreign trade and foreign investment; demonopolization and competition; labour mobility and wage-bargaining; financial institutions and intermediation. There are few issues in this area that arouse controversy. Those that do include: the speed at which to increase administered prices to either world levels or subsidy-free levels; the extent of price regulation through subsidies for agricultural produce; the level of protection of domestic producers through tariffs, quotas and/or the exchange rate; and privileged treatment of the private sector.

**Table 4.** Percentage of transactions at free prices, by market sector, 1989-92<sup>1</sup>

	1989	1990	1991	1992
Agricultural produce	41	100	100	100
Intermediate inputs	65	77	88	88 <sup>2</sup>
Market supplies	26	73	85	85 <sup>3</sup>

Notes:

<sup>1</sup> Shares at 1 January of each year.

<sup>2</sup> The share is 97% if prices whose changes are subject to reporting restrictions and can be delayed by up to three months are included as free. The 3% share of administered prices applies only to natural gas and electricity.

<sup>3</sup> 89% if prices whose changes must be reported and can be delayed by up to three months are included. The 11% share of administered prices applies to basic medicines and health services, household gas and electricity, alcoholic beverages (except imports), housing rents and passenger mass transportation tariffs.

Source: Economic Committee of the Council of Ministers (1991b), pp. 51-2.

### 3.1. Price liberalization and the new price structure

From the beginning of 1990, foreign exchange and intermediate inputs were no longer subject to any central allocation.

The policy on most administered prices is governed by an agreement with the World Bank in connection with its Structural Adjustment Loan. The agreement committed Poland to freeze nominal subsidies to coal mines and liberalize domestic coal prices by 1 July 1990; to eliminate subsidies and the export tax on coal by the end of 1992; to bring prices of other forms of energy to industrial consumers into the same relationship with domestic coal prices as is typically observed in the West European economies by the end of 1991; to increase energy prices to household consumers to 50% of prices paid by industrial users by the end of 1990 and to 100% by the end of 1991; and to reduce substantially housing and transportation subsidies in the years 1991-3 (Memorandum of Development Policy, No. 16, June 1990). Poland has remained faithful to the terms of this agreement.

Budget outlays on price-related subsidies are expected still to be about 5% of GDP in 1992, of which nearly 4% of GDP are housing subsidies (on operation and maintenance, rents, central heating and hot water, gas and electricity and interest payments). These housing subsidies and increased household bills have absorbed not only the original coal subsidy, but also a part of the Soviet subsidy implicit in the originally extremely low prices of natural gas and oil. The share of household expenditure on energy increased from about 3% of total household expenditure in 1989 to about 15% in 1992.

To conclude, it would appear that the extent of price liberalization and the quality of the price structure have already more or less reached EC standards.

### 3.2. Demonopolization, competition policy and foreign investment

Progress so far has been substantial in increasing competition, marked in demonopolization and negligible in attracting foreign investment. The decentralization of foreign trade, a five-fold increase in the dollar purchasing power of the average wage (compared with 1985-8) and low tariffs have combined to expose domestic producers of tradeables to foreign competition on a really large scale. Domestic competition has also been enhanced by a rapid expansion of the private sector, the breaking up, in 1989-91, of 290 large state enterprises into 996 enterprises, and the activities of the Anti-Monopoly Office and its eight regional offices. The industrial landscape still continues to be dominated by large-scale enterprises. Employment (and output) of them is tending to decline rapidly, however, while the number of small and medium-sized businesses, employing 5-200, is increasing fast.

The scale of foreign direct investment in Poland in the period January 1989 to October 1991 has been put by a government source at US\$684 million (ECCM, 1991b, p. 43). Foreign capital had also invested about US\$100 million in privatization ventures and about US\$50 million in the financial sector in the years 1990-1 (*ibid.*, p. 43). To promote such investment, in June 1991 parliament passed a new foreign investment law, described by the OECD as 'quite liberal and comparable to FDI regimes in most OECD countries' (Schaffer, 1992c, p. 25). However, to make an impact commensurate with restructuring needs, foreign direct investment would have to be much larger, of the order of US\$50 billion within the next 10 years. To achieve this objective Poland would have to reduce substantially the risk of political and economic destabilization. A second important condition is to reach an agreement with the London Club on the reduction and full servicing of the post-reduction commercial debt.

The World Bank is the largest and most enthusiastic institutional investor in Poland, committing about US\$1 billion per year in support of the post-1990 reform. The absorption of this and other institutional and government credit lines has been: US\$226 million in 1989, US\$428 million in 1990 and US\$800 million in 1991 (ECCM, 1991b, p. 22).

### 3.3. The banking sector

The state banking sector – the central bank, nine commercial banks and six specialized banks – accounts for about 95% of all banking operations. In October 1991, the nine commercial banks were transformed into joint stock companies in preparation for their privatization in 1992-5. There also operate or are about to operate some 70 private domestic and foreign banks.

In 1990 the financial health of banks improved, as bad debts were few and interest margins exceptionally high. This position changed radically for the worse in 1991. The main cause of the change was a sharp increase in the proportion of loans regarded as under or non-performing (loans doubtful or lost). About one-third of all state enterprises are no longer considered creditworthy by banks (as of end 1991), and loans to state enterprises represent about 90% of the loan portfolio of the commercial banks. Profit margins also fell with the general decline of interest rates and increased competition among banks.

The privatization programme of the banking sector is now in danger of collapsing unless the financial position of the banks is clarified and unproved. A particular threat is the so-called old debts, which were extended to state enterprises before February 1989 by the central bank, and for which the commercial banks, financially independent only since then, do not feel responsible.

The Ministry of Finance and the central bank have recently proposed a 'Programme for Restructuring the Banking Sector in Poland' (MF, 1992a), the primary initial purpose of which is to deal with the bad debts problem.

The implementation of the programme will lead to the closure of some of the state enterprises, compensation of some bank losses by the Treasury, and greater involvement of banks, including through the acquisition of shares, in the restructuring of enterprises regarded as still viable. The programme has been influenced by the strong criticism of and proposed remedies for the financial relations between state banks and state enterprises by Beksiak et al. (1991).

## 4. Privatization and other structural changes

At the end of 1989, 8.3 million people, 47% of the workforce, were active in the non-state sector. However, about half of this employment was in private agriculture and much of the other half was in the semi-state 'cooperative sector'. In industry and services, state sector domination was overwhelming.

It is useful to distinguish the following routes to privatization (for recent extensive discussions of techniques, dilemmas, problems and results, consult Frydman et al., 1993, and Gomułka and Jasiński, 1993):

(1) Self-transformation of the cooperative sector by the removal both of central bureaucracy and of central allocation of inputs.

(2) 'Small privatization', through the sale or leasing of small portions of state-owned assets, e.g. shops.

(3) Medium-sized privatizations of small and medium state enterprises employing typically 100-500 people, using either:



(a) the Act of Privatization of State Enterprises – essentially employee and/or management buy-outs, a popular means of ‘privatization from below’, or

(b) the liquidation process under the State Enterprise Act, the enterprises being closed and their assets auctioned off.

(4) ‘Classical privatization’ along Western lines – auctions of enterprise shares, with special purchase rights reserved for the employees, and sales to foreign investors.

(5) ‘Mass privatization’, in Poland through the allocation of 60% of shares of large-scale enterprises to some 20-50 ‘National Investment Funds’, which are essentially investment trusts, and then the sale to, or free distribution of the shares of these funds among, a large number of small investors. The remaining 40% of shares would be divided between the Treasury (30%) and employees (10%).

(6) ‘Organic’ or ‘growth privatization’, through the natural contraction of the state sector and the organic growth of the private sector under the new competitive conditions.

In Poland, routes (1) and (2) were put into effect immediately after the Solidarity-led coalition assumed power in September 1989, and became the most effective means of privatization in 1990. Route (3) was the main channel of privatization in 1991, involving about 400 enterprises through subroute (a) and about 500 enterprises through subroute (b). The total pool of enterprises of this medium-sized category is still about 6,000, out of a total of about 8,000. The organizational and other transaction costs are small with routes (1) and (2) and moderate with route (3). Only 22 enterprises were privatized, in 1990-1, through the classical method (4). These privatizations led, however, to the emergence of the share market and the establishment of the Stock Exchange in April 1991. Mass privatization is not to be in full swing until 1994. The necessary institutional preparations are under way and expected to be completed in 1993. Organic privatization has been taking place all along. Although there are no reliable measures of its progress and importance, the spectacular growth of the private sector has elevated this form of privatization.

A separate programme has been set up to privatize the state agricultural sector, which comprises 2,300 farms (about 20% of the country’s total agricultural land), about 0.6 million households. The programme is run by a financially independent Agency for State-Owned Agriculture. The intention is to privatize 600-800 farms in 1992 (Ministry of Ownership Changes, 1992, P-21).

#### **4.1. Restitution**

This problem is still unsolved, and continues to represent a considerable obstacle to privatization. A new draft Law on Re-privatization is to be presented to

parliament before summer 1993. The intention was legally to separate the two processes of privatization and restitution by the device of the Treasury taking over any claims of previous owners, and settling such claims through the use of shares generated by the mass privatization programme.

## 4.2. Commercialization of state enterprises

The commercialization programme started in autumn 1990 in response to a perceived large-scale shift of power in enterprises from managements to unions and workers' councils. The shift was thought to be capable of paralysing management efforts to initiate and implement cost-cutting restructuring programmes. In 1991, 350 enterprises were given supervisory boards with powers to act on behalf of the state owner. In 1992 an additional 400 such boards were to be created. Progress has been slow partly because the Ministry of Ownership Changes was not enthusiastic about the programme. Moreover, there is apparently no compelling evidence of an improvement in performance following commercialization.

## 4.3. Privatization and the composition of employment

Inspection of Table 5 reveals a spectacular growth during 1990-2 of the non-cooperative 'private sector outside agriculture, where the increase in employment was 2.3 million. Nearly all of this growth took place in the trade sector, however, largely at the expense of the cooperative sector. Still, private activity in industry did not shrink, and it positively expanded in construction and transport. On the other hand, there has been a very rapid decline in employment in the state sector, mainly under the impact of severe supply and demand shocks.

**Table 5.** Poland: employment by economic sector and ownership category, 1989-92

	1989	1990	1991	1992
(a) Levels (millions, end-year)				
Non-agriculture	12.8	11.8	11.3	11.3
State	8.9	7.6	6.5	6.0
Private	3.9	4.2	4.8	5.3
Old private	1.8	2.3	3.0	4.1
Cooperatives, etc.	2.1	1.9	1.8	1.2
Agriculture	4.8	4.7	4.6	4.5
State	0.6	0.5	0.4	0.4
Private	4.1	4.1	4.1	4.1

<b>Table 5 cont.</b>	<b>1989</b>	<b>1990</b>	<b>1991</b>	<b>1992</b>
(b) Private sector (old private and cooperatives) share of employment (% , end-year)				
Trade	72.7	82.2	88.3	90.5
Industry	29.1	31.2	35.8	41.9
Construction	37.4	42.1	59.5	71.8
Transport	14.3	15.2	26.0	23.1
Communal services	29.9	30.0	40.3	44.4
Total economy				
outside private agriculture	31.2	33.6	40.3	44.4
Total economy	45.5	50.3	56.0	59.1

Source: Central Statistical Office, *Informacja o sytuacji społeczno-gospodarczej kraju. Rok 1992*, Warszawa, 28 January 1993, p. 51.

In 1992 the output growth trends seen recently have changed. The shocks had already been absorbed, and therefore the recession-related contraction of the state sector should have slowed down, at least in terms of output. The privatization of the trade sector was nearly completed, and therefore the spectacular growth of the private trade sector should also have come to a halt.

#### 4.4. Labour market, housing and social safety net

During transition there is a distinct discontinuity in the demand for labour: large falls for most skill categories and sharp increases for some others. Although the influence of workers' councils has increased, and their primary concern is probably the preservation of employment, it is interesting that the sharp increase in overall unemployment has been caused by heavy shedding of employment across the entire mass of state enterprises and budget-funded institutions rather than through the closure of enterprises or a large influx of new labour. It is apparent that neither the traditional softness of the state enterprise budget constraint nor the shift of power to labour are factors strong enough to slow down considerably, let alone prevent, fairly rapid adjustment of employment to the demand for output. The unemployment increase has been uneven within the country. Lehmann et al. (1991) distinguish three types of regions: *modern*, where heavy industry is not dominant, the service sector is strong, and the supply of and the demand for labour are highly diversified with respect to skill; *heavily industrialized*, where large firms dominate, the service sector is weak and the private sector not substantial; and *agricultural*, where services and technical infrastructure are poorly developed and skill levels are low. The authors show that the unemployment/vacancy ratios are increasing to reach 'long-term levels' that vary between the three types in proportions 1:2:3.

The wage rate has long been perceived to be determined by political rather than market forces. To change this perception, the post-communist governments have tried to withdraw from wage negotiations completely. These negotiations are now decentralized to the enterprise level, where typically two enterprise-specific unions operate. The unions have a hierarchical structure, but there are no industry-wide or country-wide wage settlements. Despite unemployment, upward pressure on wages remains high. Management is *in* a weak position to resist the pressure. It also has no strong incentive to do so, since the prospect of commercialization and privatization has increased uncertainty for managers as well.

The government has taken a number of policy initiatives to provide a social safety net and to combat unemployment. Effective active labour policies, however, such as public works and large-scale retraining, are costly and have therefore been put on ice. The main function of the government has been to provide money: unemployment benefits, housing subsidies, 'free soup' for the poor, early retirement pensions, family support benefit, etc. The programme appears to have been successful in containing the growth of extreme poverty, and this containment has been and continues to be the overriding concern of the government's social policy.

To facilitate labour mobility, stronger policy action is needed to establish a properly functioning housing market. One possible move would be to impose a legal obligation on local authorities to sell or give away then housing stock to its present occupiers within a short period of time. Another move would be to release more land for housing construction. The result of the policy would be an increased release to the market of under-used accommodation, a faster market-driven reallocation of accommodation, and increased housing construction.

#### **4.5. Major income redistribution**

Who are the losers and who are the winners during the transformation so far? Considerable light is shed on this question by the household surveys of the Polish Central Statistical Office. A summary table has recently been compiled by Bywalec (1993).

Table 6 provides startling evidence of a large-scale redistribution of incomes away from workers and farmers and in favour of pensioners and entrepreneurs. The original aim of the reformers was indeed to protect the poor and the rich. This policy aim has been clearly implemented. It may well be that the redistribution has been even larger than intended and desirable. The table also indicates that the overall level of real personal incomes has been quite stable. The propensity to save out of this income did increase sharply, contributing to a fall in the level

of personal consumption. It is also to be noted that the fall in wage incomes is in part explained by a fall in the number of wage-earners. Some of the former wage-earners have become pensioners, unemployed or entrepreneurs.

**Table 6.** The level and composition of personal real incomes in Poland, 1985-91

Source of income	Level (1985 = 100)			Composition (%)		
	1988	1990	1991	1988	1990	1991
All income	113.6	102.7	108.8	100.0	100.0	100.0
Wages	111.5	75.5	73.4	46.3	38.2	35.1
Private agriculture	124.4	70.7	57.5	12.7	6.6	5.1
Other private activity	118.8	157.4	170.0	25.6	37.9	38.6
Welfare payments	111.5	95.6	124.0	15.4	17.3	21.2

Source: Bywalec (1993)

## 5. Major problems in 1991-2 and aims in 1993

Before discussing the serious problems that developed in 1991-2 and are confronting Poland in 1993, it is important not to lose sight of the major achievements of the transition process so far. A selection of these, not necessarily in the order of importance, would be as follows.

Despite the high cost of the reform in terms of GDP, consumption and unemployment, extreme poverty has been largely avoided, and both the democratic process and respect for law have been preserved. Choice, accessibility and quality of goods and services have improved vastly. The costly readjustment of foreign trade away from the former CMEA area mainly to the EC area has been completed. International reserves have increased substantially, and a fifth of the total international debt has been cancelled, with the prospect of a further fifth of the debt being cancelled within the next three years. Consequently, confidence in the zloty has been established and maintained, and its internal convertibility at a unified rate has been preserved without difficulty. The inflation rate has been brought down substantially, from about 30% a month in the second half of 1989 to about 3% a month now. The quality of the price system has been improved radically, and small-scale privatization has been nearly completed.

At the end of 1991, the first post-Balcerowicz government came to power in Poland. It had the difficult task of counteracting the continuing recessionary tendency and promoting the privatization reform while at the same time defending the substantial stabilization gains of the previous two years – all this in

circumstances of rising concern among the population over the social costs of the transition and a highly divided parliament.

In January and February 1992 the government took stock of the situation and considered policy corrections for 1992. The starting point was to note the adverse developments in 1991, which I have discussed already in section 2 of the paper, and which may be summed up as follows:

(1) High price indexation of wage norms and wage indexation of welfare benefits, and an accommodating monetary policy, led to the inflation rate continuing to be very high, despite a big appreciation of the real exchange rate and high unemployment.

(2) Delays in increasing indirect taxes and excessive rises in pensions and other benefits led to a crisis of public finances.

(3) The use of the exchange rate as a key nominal anchor, while incomes policy and monetary policy were lax, and delays in introducing higher import tariffs have led – through the large appreciation of the real exchange rate – to a spectacular rise in consumer imports and the disappearance of the trade surplus.

(4) While the collapse of CMEA markets was the main cause of recession in 1991, the influx of imports was also a factor in a rapid increase in the number of enterprises that became loss-making and ceased to service debt. This development has threatened a financial crisis in the banking sector.

(5) Despite a large fall in GDP, private consumption, especially of imported luxury goods, has increased significantly, while investment in fixed capital declined further.

(6) The financial support of the IMF for the Polish programme was suspended in autumn 1991, after Poland failed to meet the performance criteria on the budget deficit and the expansion of credit for the second and third quarters. This support is crucial for the debt reduction programme and the flow of Western credit and direct private investment.

Excessive criticism of the policies in 1990-1, often for the wrong reasons, was unfortunately the intellectual starting point of the new parliament and the new government of Mr Jan Olszewski. It soon became apparent, however, that the necessary policy corrections would be costly in social and political terms, and that the scope for safe anti-recessionary policies, both macro and micro, is extremely limited. The government guidelines (CM, 1992a) were an attempt to meet the problems (1) to (6) by calling for a tougher incomes policy (I have already noted this in section 2 with respect to wages in state enterprises), a larger turnover tax, a real depreciation of the exchange rate and large reductions in some welfare benefits. Specific tax increases and benefit reductions were proposed in the state budget for 1992.

The broad macroeconomic aims of the new programme were to limit the budget deficit to 5% of GDP, to reduce the inflation rate from 60% in 1991 to about 45% in 1992, and to initiate a modest recovery (or to limit a further fall in GDP) through a trade surplus and possibly higher investment.

Since the new government inherited the prospect of a budget deficit of some 10-13% of GDP, the guidelines in effect called for a package of tax increases and spending cuts equivalent to about 5-8% of GDP. The increases had to be concentrated on indirect taxes and the cuts on material expenditure in the budget sphere and on pensions and other welfare benefits. Meeting the 5% limit on the budget deficit in 1992 was also an essential part of the government's anti-inflationary policy.

The Olszewski government did not have sufficient parliamentary support to implement its proposed welfare cuts. Where it could have acted, as in the case of indirect taxes, it moved slowly. Its fall in June 1992 created an opportunity to form a new government, headed by Miss Hanna Suchocka, with a stronger parliamentary base and a stronger commitment to the original reform principles.

The Suchocka government, while still a minority one, was prepared to accept the political risk associated with taking the measures needed to deal with the crisis of public finances. A package of such measures was proposed in August 1992, and incorporated in the state budget for 1993, which was submitted to parliament for approval in November 1992.

The measures include imposing a temporary import surcharge of 6% in 1993 and 3% in 1994, freezing thresholds in personal income tax and depreciation allowances in corporate income tax (for investments made before 1990), reducing the ratio of pensions to wages and, above all, increasing indirect taxes. The combined size of the measures is about 5% of GDP. Despite these measures, the projected budget deficit for 1993 is also about 5% of GDP. Armed with these budget proposals, the government was able to negotiate a standby agreement with the IMF, the implementation of which is linked with the second phase of the Paris Club debt reduction agreement.

By the beginning of 1993, the following four important pieces of the Polish reform jigsaw had therefore fallen into place: (1) the government's political base in parliament enlarged, (2) the crisis of public finances brought under control, (3) an agreement with the IMF reached, and (4) a new (temporary) Constitution adopted, clarifying the division of power between the government, the president and parliament. Moreover, in the course of 1992, a considerable recovery in industrial activity got under way (see Table 7). This recovery appears to be driven mainly by exports and the private sector, so it is probably part of a sustainable upward trend.

**Table 7.** Poland's post-reform recession 1990-91 and recovery 1992 (1990 = 100)

	Pre-reform	1991		1992			
		H1	H2	Q1	Q2	Q3	Q4
Industry	131.9	92.1	84.1	85.0	85.1	88.9	96.4
Mining	135.1	96.6	92.6	99.5	89.7	92.4	92.4
Fuel & power	128.4	92.9	90.5	102.4	82.3	87.7	94.8
Metallurgical	124.6	86.8	68.4	72.7	77.7	68.1	77.4
Electro-engineering	128.2	84.9	70.5	67.1	72.9	74.1	89.9
Chemical	132.6	91.2	81.8	85.5	84.9	89.1	97.0
Mineral	127.5	100.5	94.5	79.7	100.4	113.3	106.2
Wood & paper	132.2	100.7	96.5	103.0	101.3	111.7	125.5
Light	151.0	95.6	78.4	78.1	75.5	81.9	91.4
Food processing	131.1	98.8	102.8	94.5	106.1	115.2	112.5
Construction	121.3	108.9		83.9	93.2	100.2	111.3

Note: The activity indexes are those of gross output. Data seasonally unadjusted.

Source: *Statistical Bulletin*, Central Statistical Office, Warsaw, January 1993, p. 21.

Looking ahead, the risks of political and economic instability are still high. These risks will be much reduced only when a new election law is adopted and a new less politically fragmented parliament is returned by a more mature electorate. Until this happens, a good working relationship between the government and parliament will remain a problem capable of seriously disrupting the economic transformation at almost any time.

## Note

The author has been and continues to be Economic Adviser to Poland's successive Finance Ministers since September 1989. As a member of the Balcerowicz Group he advised the Polish government on the elaboration and implementation of the 1990-1 reform. He takes sole responsibility for the contents of the paper. Research support funded by the Leverhulme Trust is gratefully acknowledged.

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# 11. The financial situation of enterprises and its impact on fiscal and monetary policies: Poland 1992-3<sup>\*1</sup>

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## 1. Introduction

This is the first detailed study of enterprise finances in a country of Central and Eastern Europe during transition. It is based on enterprise data collected monthly by the Polish Central Statistical Office. Its primary purpose is to provide answers to questions about the size of enterprise debt, particularly bad debt, to banks, other enterprises, and the government; about its distributions by sector of activity and type of ownership; and about its evolution over time.

The central findings are, firstly, that the bad debt is a large proportion of total debt, both to banks and enterprises, and, secondly, that it is highly concentrated. The study identifies enterprises, in terms of sales (and possibly employment) representing about a tenth of the whole enterprise sector, whose debt in relation to the total income of these enterprises is particularly large. In terms of financial situation and the softness of the budget constraint, these enterprises have been (and are) distinctly different from most other enterprises, forming effectively a 'black hole' in the economy. The Polish enterprise sector has thus been found to have, in 1992-3, a heavily pronounced dual structure: about 90% of it is almost debt-free while about 10% of it has accumulated large debts to banks, the government and other enterprises.

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\* *Economics of Transition*, 1994, 2(2).

<sup>1</sup> All computations needed to compile the various tables were performed by the Computer Department of the Polish Ministry of Finance at the request and under the direction of the author. Econometric computations were performed by Joanna Gomułka and Anna Kucharska and diagrams were prepared by Gilles Alfandari. The paper benefited much from suggestions by Jacek Rostowski of the School of Slavonic and Eastern European Studies, London University, Mark Schaffer of the Centre for Economic Performance at the London School of Economics, and from comments by an anonymous referee for this journal. Skilful secretarial assistance was provided by Pat Nutt. The study was prepared when the author was Economic Adviser to Jerzy Osiatyński, the Polish Finance Minister. An earlier version was presented to a number of academic and policy-making groups in Poland, as well as seminars at the London School of Economics and Oxford University. The Warsaw-based Centre for Social & Economic Research (CASE) distributed the paper as working paper No. 6 of its Studies and Analyses series.

The paper also discusses the implications of these findings for the conduct of fiscal and monetary policies of the central authorities and for the lending policy of commercial banks. For the purpose of disciplining both state banks and enterprises, it advocates an initially incomplete re-capitalization of banks and the use of banks for financial and physical restructuring of indebted enterprises.

## 2. Data

The Polish Central Statistical Office (CSO) divides all enterprises (legal persons), irrespective of ownership, into three categories: large (L), medium (M) and small (S).

Those of the L category employ 51 or more in industry and construction and 21 or more elsewhere (domestic and foreign trade, transport, communications, agriculture services, forestry, and communal housing services). The whole enterprise sector accounted, in 1992, for about 70% of the economy's total employment outside agriculture, and for about 70% of the country's Gross Domestic Product (GDP).

Enterprises of the M category employ between 6 and 50 (but 20 outside industry and construction), and those of the S category employ between 1 and 5. In 1992-3, there were about 20 to 25 thousand L-type enterprises, about 50 to 60 thousand M-type enterprises, and some 1 to 2 million businesses of the smallest category. The CSO collects monthly some key data from all enterprises of the L category (except state farms) and from a sample of 10% of those of the M category, using the so-called FO-1 form. It is this data set which we use in this paper.

## 3. Indicators of financial situation

We shall use two indicators to describe the financial situation of each enterprise. One of these is the ratio of the stock of net financial assets, to be denoted by  $F$ , to quarterly gross sales and other income,  $S$ . The other is the ratio of a measure of gross profits,  $Z$ , to  $S$ , both quarterly. The  $F$  indicator is defined as follows:

$$F = \text{own money} + (\text{receivables} - \text{payables}) - (\text{credits and loans}) \quad (1)$$

Own money is either cash or, more often, deposits with banks. Receivables are payments due from customers, mainly other enterprises. Payables include tax obligations to the government, central and local, and to parabudgetary funds. However, most payables are payments due to other enterprises for goods and

services provided. Credits represent the borrowing from banks which is agreed by banks, while loans stand for non-bank borrowing.

Until the beginning of 1993, there had been no automatic capitalization of the interest due but unpaid. The interest of this kind on 'directed credit' (e.g. to housing cooperatives and farms) was and is automatically capitalized. However, on any other credit the unpaid interest was typically not capitalized until the beginning of 1993, but has been capitalized since then. The amounts involved were, according to internal data of the NBP for 1992, 22.5 trn zł for directed credit and about 15 trn zł for other credit (Trn stands for trillion, or  $10^{12}$ ). These numbers may be compared with the GDP in 1992 of 1140 trn zł. and with the total bank debt of non-financial economic units of 237 trn zł. at the end of 1992.

In this paper we take the entry 'credits and loans' of the FO-1 form to be a good approximation of the total bank debt. To obtain bank debt precisely, the data on 'credits and loans' should be augmented by unpaid non-capitalized interest and reduced by non-bank credits and loans. Taking into account what we know about the magnitudes of loans and unpaid interest, our procedure possibly underestimates somewhat the true debt position in 1992.

The financial situation of an enterprise depends not on the amount of debt, but on the ability to meet its debt payments obligations. We take the ratio

$$f = F / S \quad (2)$$

as a measure of that ability, where S stands for an average quarterly gross income from the start of the year. We calculate f for each quarter. For example, to compute a 2nd quarter f, any year, we take F as it was at the end of the 2nd quarter, while S is half of the gross income during the year's first two quarters.

The financial situation of an enterprise depends also on its ability to cover current production costs in the medium to long-term. We take as a measure of that ability the ratio

$$z = Z / S \quad (3)$$

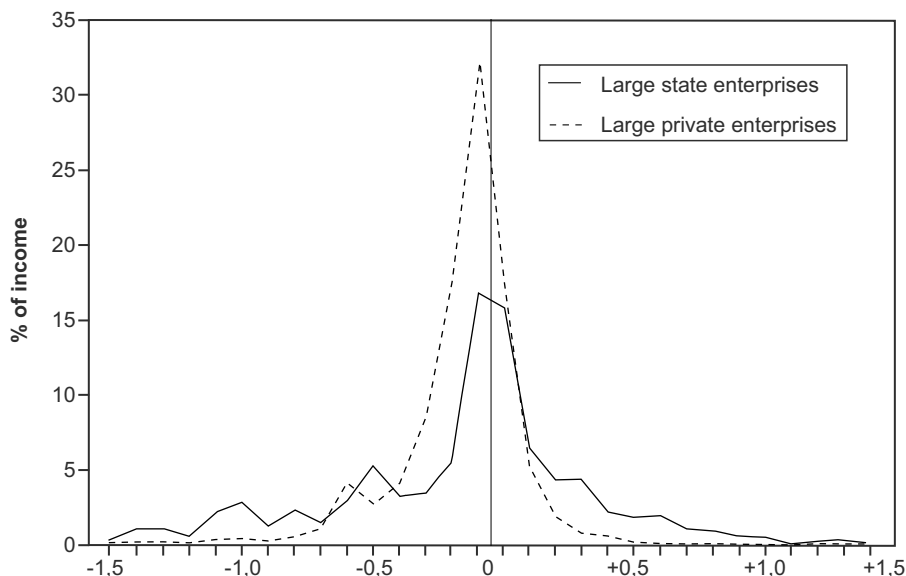
where Z represents the so-called gross financial result augmented by amortization (the depreciation allowance)<sup>2</sup>.

Our intention is to divide the enterprise sector into groups characterized by similar values of f, and then subdivide each group further according to the value of z. The procedure aims, as a first step, to identify the enterprises which have both a highly negative f and a negative z.

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<sup>2</sup> Note that cash flow equals  $Z - \text{inventories} - \text{receivables} + \text{payables}$ . If inventories and receivables do not increase, but payables continue to increase, the cash flow position is better than that indicated by Z.

#### 4. The distribution of L-enterprises in terms of f



**Figure 1.** Large state and private Polish enterprises: distribution of sales and other incomes, end September 1992

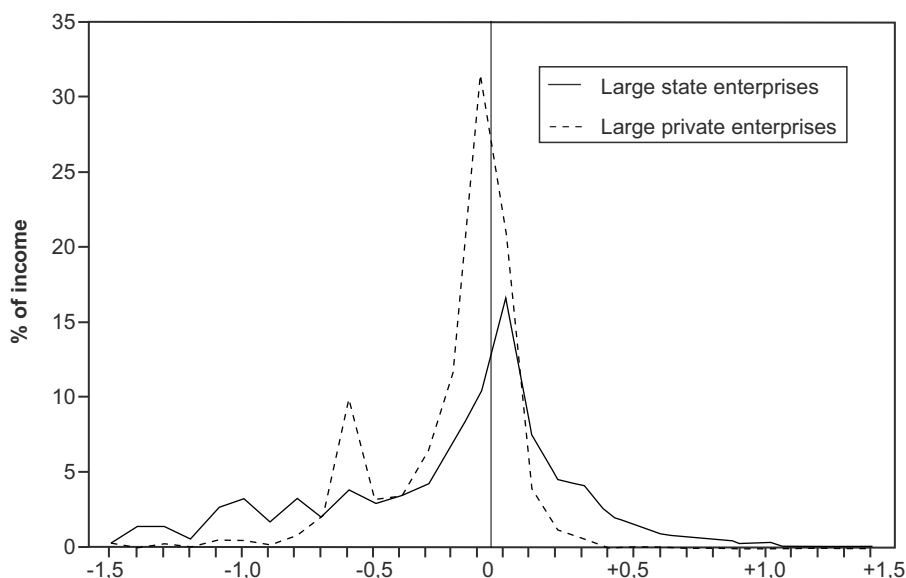
Most enterprises of whatever size turn out to have  $f$  in the range between  $-1.5$  and  $+1.5$ . We divide this range into 30 equal subranges, each of the length 0.1. To each such subrange there corresponds a subgroup of enterprises. The gross income of any such subgroup is then computed as a proportion of the gross income of the total population of our L enterprises. In this way we arrive at an income-weighted distribution of enterprises in terms of  $f$  (Table 1). The diagrams in Figures 1 and 2 are such distributions for quarter III, 1992.

It turns out that the distribution, for this and any other of the five quarters investigated, is of the bell-shape type, with a heavy concentration of enterprises near  $f=0$ . Guided by this finding, and in order to facilitate analysis, we divide all enterprises into five groups according to their financial state as indicated by the ratio  $f$ :

very bad,	if $f < -1.5$ ,
bad,	if $-1.5 < f < -0.5$ ,
satisfactory,	if $-0.5 < f < 0.5$ ,
good,	if $0.5 < f < 1.5$ ,
very good,	if $f > 1.5$ .

The choice of values of  $f$  separating these groups is essentially arbitrary. Nevertheless, the choice has been made to ensure that the central group, the one





**Figure 2.** Large state and private industrial Polish enterprises: distribution of sales and other incomes, end September 1992

near  $f = 0$ , comprises enterprises accounting for about half of the gross income of the total population of our L enterprises. The division of the range of the variable  $f$  from  $-1.5$  to  $+1.5$  into three equal parts has enabled us to cut out such a central group. Two neighbouring groups have been thereby defined: of financially 'bad' and financially 'good' enterprises.

All enterprises which fall outside the range  $(-1.5, +1.5)$  are regarded as outliers. They form the remaining two groups. Of particular interest to us in this study are enterprises of the 'very bad' and 'bad' categories.

## 5. L-type enterprises of the 'very bad' category, end 1992

Tables 2 to 5 give the distributions of all L-type enterprises by the end of 1992, in terms of the above five groups, by sector of activity and the type of ownership. Similar tables have been compiled for the three earlier quarters of 1992 and the 1st quarter of 1993. This sequence of tables enables us to monitor the shifts in all these distributions over that period.

The first interesting feature of these data is that very bad enterprises account for a smaller proportion of the total income of the enterprise sector than the proportion of the total number of enterprises. A typical very bad enterprise is thus

smaller than the average. One of the main reasons may well be that their poor financial situation has been forcing many of them to contract activity<sup>3</sup>.

However, the most interesting feature of the data is the unusually large concentration of net debt of each of the three categories: to banks, other enterprises and the government. In particular, the 'very bad' group accounted, by the end of 1992, for 61.6% of the bank debt of all the L-type enterprises. The group's combined net debt of all three categories equalled its gross income for about 13 months.

### **5.1. The distribution of 'very bad' enterprises by financial result**

We may now use the  $z$  indicator of financial situation to form a view about the viability of these 'very bad' enterprises. We also have data which indicate the extent to which bank credits remain unserviced.

The cost of financial operations (line 4 of Table 6) is nearly exclusively the interest due on most bank credits<sup>4</sup>. The bank credits of these very bad enterprises increased in the course of 1992 from about 100 trn zł to 115 trn zł. With interest rates typically in the range between 45% and 60%, the interest that would have been due under standard scheduling arrangements would probably have been about 60 trn zł. The interest actually due by the group was, in 1992, about 20 trn, probably because of rescheduling arrangements or government subsidies. The interest actually paid would have been less still. Since the group's bank credit represented about 50% of the total enterprise bank credit, about 33% or more of the total was either effectively unserviced or would have been unserviced in the absence of government subsidy. The total amount of bad (unserviced by enterprises concerned) debt is somewhat greater still, as unserviced debt is also a part of the remaining 50% of the credit (see section 7).

Table 6 also reveals that despite the large underpayment of interest, for most enterprises of the group the profitability indicator  $z$  was negative. It would thus appear that most of the 'very bad' enterprises cannot stay in business for long unless they continue failing to service their debt, and to accumulate tax obligations to the government and payments obligations to other enterprises. (In the case of housing cooperatives, continued survival depends largely on continued government subsidies; see also section 5.3).

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<sup>3</sup> A primary example of this is a private company called "Art B", which at some point employed about 15 thousand people, but which now is a small business with bank debt outstanding of hundreds of millions of US dollars.

<sup>4</sup> It also includes: net purchases of stocks and securities, discounts on sold debts, the effects of changes in exchange rates, and interest on bonds.

## 5.2. The distribution of 'very bad' enterprises by sector of activity and type of ownership

It follows from Table 3 that about half of the financially 'very bad' enterprises were industrial. The sector 'other' includes housing cooperatives, most of which belong to our first group. The two sectors also account for the bulk of the bank credit of the group (Table 4).

The distribution of the 'very bad' enterprises by the type of ownership reveals in turn that, of their total bank credit, nearly half was owned by state enterprises and an additional 30% by cooperatives.

## 5.3. Bank credit, enterprise size and investment

This section is based on data pertaining to 3rd quarter, 1992. Of the 2725 'very bad' enterprises, we select the largest 150 bank debtors. Their combined debt represented, by the end of September 1992, 62.5% of the group's total debt. This suggests a considerable degree of concentration of bank debt within the 'very bad' category. We divide this group of 150 into three subgroups: (a) the top debtor, now nearly extinct; (b) 58 housing cooperatives and (c) the remaining 91 enterprises. We wish to find out how much variation in bank debt can be explained by variation in size, measured by  $S$ , and the level of investment activity in the first three quarters of 1992. The results are as follows (subscript  $i$  refers to enterprises,  $u_i$  is the error term and the numbers in parentheses are standard errors).

Subgroups (b) and (c) combined:

$$D_i = 0.156 + 0.876 S_i + 0.804 I_i + u_i \quad (4)$$

(0.092) (0.084)

$R^2 = 0.904$ , the number of observations  $N = 149$ .

Subgroup (b):

$$D_i = 0.104 + 0.464 S_i + 1.019 I_i + u_i \quad (5)$$

(0.579) (0.207)

$R^2 = 0.374$ ,  $N = 58$ .

Subgroup (c):

$$D_i = 0.191 + 0.783 S_i + 0.871 I_i + u_i \quad (6)$$

(0.125) (0.111)

$R^2 = 0.908$ ,  $N = 91$ .

In the case of housing cooperatives (subgroup (b)), sales income is small and weakly correlated with bank debt. But these cooperatives have been parabudgetary units rather than typical enterprises. Hence the linear correlation (6) is more

interesting. The relationship turns out to be exceptionally strong and the confidence intervals for the correlation coefficients to be quite tight. The relationship would be encouraging if not for the fact that the magnitude of the constant term in (6) is large, equal to nearly half of the mean of D.

## 6. L-type enterprises of the 'bad' category

The number and gross income of these enterprises are similar to those of the 'very bad' category. However, their net financial debt equals approximately only a fourth of that for the latter group. Table 3 shows that about one third of these enterprises were industrial. State industrial enterprises tend to be large and they accounted, in 1992, for most of the group's bank debt.

Using data for 3<sup>rd</sup> quarter, 1992, we select 150 enterprises with the largest bank debt. The subgroup accounted for 68% of the group's total bank debt, confirming the high concentration of the debt within the group. We may then test the power of the variables S and I in explaining debt. The correlation is as follows:

$$D_i = 0.061 + 0.254 S_i - 0.093 I_i + u_i, \quad (7)$$

(0.022)    (0.165)

$$R^2 = 0.520, N = 150.$$

This time the correlation between D and I breaks down.

As before, we may also in this case use the z indicator of financial situation to form a view about the viability of these enterprises. We should also like to know the extent to which bank credits remain unserved.

Since Z stands for gross financial result (profit) augmented by the depreciation allowance, a negative z indicates the potential for cash-flow problems. Lines 1 and 2 of Table 7 show that the proportions of enterprises, in terms of N and S, which were in that financially extremely poor position, are quite large.

Another potential problem is the serviceability of bank debt. The interest due in 1992 was probably about 15 trn zł, which is quite close to the cost of financial operations shown in line 4. We may conclude therefore that most of the bank debt was and possibly remains serviced by the group. In this respect there is thus a large difference between this group and enterprises of the 'very bad' category.

## 7. Changes in the financial situation of L-type enterprises over time

In this section we compare key enterprise financial data for end of March, 1992 with those of end of March, 1993. The period between the two dates was also the first year of post-reform recovery. The results of the comparison are displayed in Table 8.

For most financial variables changes in the distribution of enterprises between our five groups were, during the year in question, relatively small. The size of both outlier groups, 'very bad' and 'very good', had increased. This may suggest the presence of a trend for increasing polarization in the fortunes of enterprises. Very good enterprises are free of bank debt and, although accounting for less than 2% of total sales, have accumulated nearly 20% of total cash deposits. Therefore these enterprises probably represent the top growth area of the economy. Most existing members of the 'very bad' group would be doing the opposite: contracting activity and, at some point, ceasing operations. The group is, however, constantly resupplied by failures from the bad and satisfactory groups. Consequently, it may also expand, as it did in the period in question.

It may also be useful to compare the distributions of the 'very bad' enterprises alone on these two dates in terms of our  $z$  indicator (Table 9).

## 8. The $f$ distribution of M-type enterprises

To recall, M-type enterprises are those which employ between 6 and 50 in industry and construction and between 6 and 20 elsewhere. The data are for the end of September 1992. As before we divide the whole sample of enterprises into 32 classes using the indicator  $f$  and calculate the proportion of sales and other gross income for each class (see Table 10). The resulting  $f$  distribution also turns out to be of the bellshape type, with the average  $f$  equal to  $-0.38$  and a high concentration of enterprises in the range of  $f$  between  $-0.3$  and  $+0.3$  (see Figure 3). We then form five  $f$ -categories of enterprises. Compared to those of L-type, the main significant difference is an even greater concentration of debt (to banks, enterprises and the government) in the 'very bad' category. For example, in the case of bank debt, the category accounted for 74% of the total, as against 60% for the L-type group, on September 30, 1992.

If two-thirds of this 74% is unserviced, such bad debt would amount to about 5% of the total bank credit to the economy. The combined bad debt for both categories of enterprises, L and M-type, would therefore appear to be, by

September 1992, about 38% of the total bank credit to the non-financial sector of the economy.

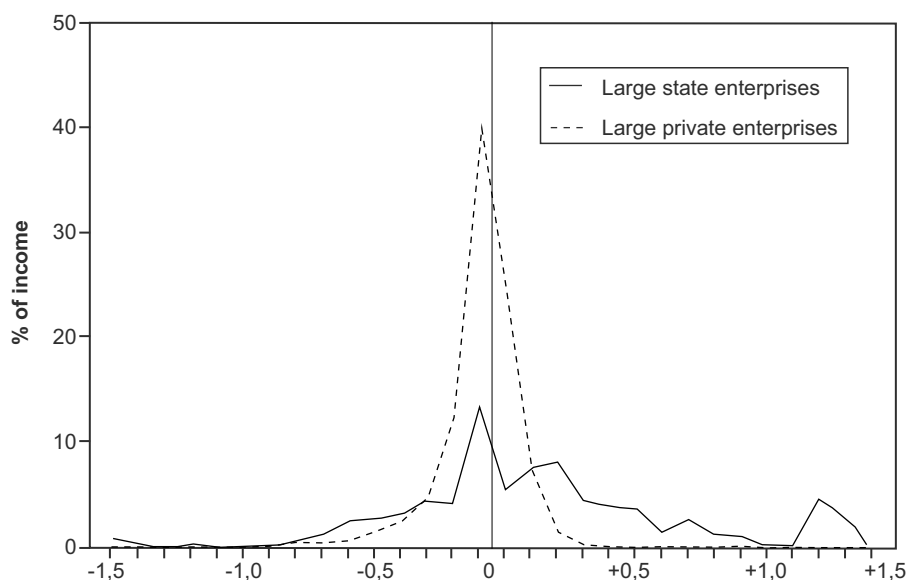


Figure 3. Medium state and private Polish enterprises: distribution of sales and other incomes, end September 1992

To arrive at an estimate for the total stock of bad debt, one needs to know the quality of bank credits given to farms, both private and state, and to other small businesses employing up to 5 persons. This sector accounts for about 20% of the total bank credit. If the quality of that credit is not much different than that of the other 80%, the total bad debt was, in 1992 and probably continues to be in 1993, in the range between 45 and 50% of outstanding bank credit. An early internal audit of nine state commercial banks found the share of bad debts, on 30.06.1991, to range between 9% and 79%, with 42% being the weighted average (Poland's Ministry of Finance, June 1992, p. 4). Subsequent audits have shown the shares to change little.

Aggregate NBP data on total capitalized interest (on directed credit according to set rules and as a result of rescheduling arrangements) and interest due but unpaid and not re-negotiated show an increase during 1993 by about 30 trn zł. This is despite a direct budget subsidy to creditors (housing cooperatives) of some 10 trn zł. The total mid-year bank debt of non-financial economic units was 286 trn zł. These numbers allow one to come up with an estimate of the share of bad debts. Note that, given the market interest rates-lying in the range 40 to 50% in 1993, the interest payments due were in the range of 115 to 143 trn, the unpaid

interest (40 trn zł) thus representing some 28 to 35% of the total payments. This range is on the low side of my estimate above.

However, the interest rates offered by banks after re-negotiations may be lower than the market rates. Hence the NBP data may underestimate the size of the problem.

## 9. Implications for fiscal and monetary policies

In view of the large size of bad bank debts, they appear to be a very serious problem for the banking sector. However, their heavy concentration in about a tenth of the enterprise sector means also that the remaining 90% of the enterprise sector is almost debt-free. This heavily pronounced financial duality has implications for economic policies of the government and the Central Bank, and the lending policy of commercial banks. It also has an influence on the pace of economic recovery.

The immediate effect is that banks have to maintain a large interest spread, thus increasing the cost of borrowing to good enterprises and the government, and lowering the incentive to save. With the cost of servicing public debt higher, we have one or more of the following: (i) a higher budget deficit, (ii) cuts in other public expenditures, or (iii) higher taxation. Option (i) is welcomed by banks, as it offers them an opportunity to buy government bonds and thereby improve the quality of their assets. However, such a deficit is effectively dis-saving. It also implies a higher inflation rate and, therefore, higher nominal interest rates and lower investment activity. The budget position is affected adversely also on the revenue side. The reason is poorer profits of banks, as provisions are made against bad debts. The provisions are built up gradually, and it could take – it will take in Poland – several years before they are adequate.

During such a period, therefore, there is a tendency for changing the composition of demand for new bank credit: away from the economy and in favour of the government. The real interest rates are too high in that period for most good enterprises and the access to new credit for most poor enterprises is blocked by the now more cautious banks.

In Poland the velocity of money circulation is several times higher than it is in developed market economies (as well as in Hungary and the Czech Republic). Moreover, the share of foreign currency deposits in the total stock of money is high. These two factors imply that a given budget deficit which is financed by credit expansion is also several times more inflationary. High nominal and high real interest rates are the result. The problem of a large bad debt, therefore, is that

it contributes to creating an economic environment which, while perhaps not a major threat, is not at all conducive to recovery.

One should of course separate out the debt issue as an inherited macroeconomic problem adversely affecting good enterprises and taxpayers from the question of the future viability or otherwise of the debt-ridden enterprises. These enterprises need not be closed down, and those which would make a gross profit when not servicing the debt should not be closed down.

The separation is best achieved by adopting a form of shock therapy: cancellation of all bad debt and the issue of government paper to banks in the same amount (Begg and Portes, 1992). However, the therapy would have the effect of lifting the pressure from our 'very bad' enterprises to meet at least some of the debt servicing cost. Even more importantly, it would reduce the disciplining function of bad debts for banks in their credit policy. The bad debt problem could then re-appear quickly.

Polish authorities also rejected the standard, less radical approach to the bank financial restructuring, one which was, according to senior Ministry of Finance officials, advocated for Poland by the international financial institutions (Kawalec, *et al.*, 1993). It proposes to transfer bad loans to a specially created loan-recovery institution and to replace them with interest-bearing treasury bonds. In the circumstances of Central and Eastern Europe this second approach may however differ little from the first one. As Kawalec *et al.* (1993) explain:

"we did not believe that a centralised, government-sponsored agency can vigorously and effectively recover bad debts. We did not believe in our ability to create, within a reasonable time period, a strong institution in terms of high quality of its staff and internal organisation. Neither did we believe in the possibility of devising an adequate incentive system that would ensure that institution's active approach toward the indebted enterprises. We also did not believe that such an institution could be made to resist the political pressure. By painlessly removing the burden of bad debt from the banks, the centralised approach creates a danger that the bad loan portfolio will re-emerge in a near future".

An evolutionary strategy seems, in this case, more appropriate. The government may recapitalize banks with its paper, and possibly cash, by a large fraction but not by the full amount of the bad debt. The level of such partial recapitalization should be sufficient to reduce substantially the risk of bankruptcy for banks in order to create adequate provisions against bad loans. But the banks should also be encouraged, through financial incentives and administrative means, to engage in drawing up financial and business restructuring plans for enterprises with bad debts. The Polish Law on Financial Restructuring of Enterprises and Banks envisages that conciliation procedures may take place between creditors



holding at least 50% of the claims and debtors, leading to agreements about how to implement such plans. The agreements may lead to a full or, more often, a partial recovery of the bank loan. They were supposed to be reached before March 1994, but the deadline has been moved to end of April 1994. If they cannot be reached, one of the following has to take place instead: bankruptcy is declared by the court, liquidation of the debtor's business is initiated, or creditworthiness of the debtor is regained by servicing the debt for at least a three-month period. The banks also have the options of selling the debt on the market for cash or swapping it for equity.

This decentralized approach to bad loans is expected to limit somewhat the magnitude of the direct call on state resources, while stimulating supply-side restructuring, privatization and good banking management.

However, this present study suggests that the Polish authorities have initially probably underestimated the size of the bad debts and, therefore, the amount of recapitalization eventually needed. This has been partly recognized already in the budget for 1994 by increasing the amount from 23 trn to 39 trn zł. The cost to the budget of operating the so-called subsidiary government intervention to help important enterprises is also likely to be high. Tax losses resulting from the obligation for banks to make increased provisions against bad debt will probably be much higher than initially anticipated.

## Tables

**Table 1.** Polish enterprises, end September 1992 Distribution (in %) of sales and other incomes in terms of  $f$  and various types of enterprises

	Large state	Large private	Large state industrial	Large private industrial	Medium state	Medium private
Number of enterprises $f$ range	6281	3853	3151	1817	2640	32600
Less than -1.5	7.85	1.56	10.54	1.44	8.63	0.81
(average $f$ )	(-4.14)	(-5.73)	(-4.35)	(-3.85)	(-11.53)	(-3.77)
From -1.5 to -1.4	0.44	0.14	0.62	0.41	1.03	0.12
-1.4 to -1.3	1.01	0.11	1.48	0.07	0.63	0.08
-1.3 to -1.2	1.00	0.17	1.48	0.37	0.00	0.15
-1.2 to -1.1	0.51	0.09	0.69	0.08	0.57	0.12
-1.1 to -1.0	2.11	0.31	2.67	0.62	0.00	0.24
-1.0 to -0.9	2.78	0.35	3.33	0.62	0.00	0.11

## 11. The financial situation of enterprises and its impact on fiscal and monetary policies...

<b>Table 1 cont.</b>	<b>Large state</b>	<b>Large private</b>	<b>Large state industrial</b>	<b>Large private industrial</b>	<b>Medium state</b>	<b>Medium private</b>
−0.9 to −0.8	1.24	0.22	1.79	0.30	0.32	0.29
−0.8 to −0.7	2.27	0.50	3.33	0.89	0.72	0.62
−0.7 to −0.6	1.42	1.01	2.02	2.18	1.40	0.62
−0.6 to −0.5	2.92	4.10	3.93	9.96	2.76	0.86
−0.5 to −0.4	5.21	2.67	2.94	3.20	2.96	1.79
−0.4 to −0.3	3.21	4.03	3.44	3.43	3.45	2.69
−0.3 to −0.2	3.40	8.55	4.23	6.45	4.57	4.95
−0.2 to −0.1	5.42	17.67	6.94	11.68	4.32	12.47
−0.1 to 0.0	16.83	32.23	10.13	31.37	13.62	39.94
0.0 to 0.1	15.81	17.54	16.59	20.74	5.66	24.20
0.1 to 0.2	6.46	5.22	7.46	3.91	7.70	7.34
0.2 to 0.3	4.28	1.86	4.48	1.22	8.26	1.62
0.3 to 0.4	4.37	0.76	4.16	0.65	4.77	0.50
0.4 to 0.5	2.16	0.57	2.17	0.01	4.06	0.15
0.5 to 0.6	1.78	0.14	1.42	0.09	3.96	0.16
0.6 to 0.7	1.98	0.04	0.94	0.05	1.64	0.06
0.7 to 0.8	1.10	0.01	0.82	0.00	2.89	0.00
0.8 to 0.9	0.90	0.05	0.70	0.12	1.57	0.00
0.9 to 1.0	0.56	0.02	0.38	0.00	1.25	0.02
1.0 to 1.1	0.47	0.00	0.50	0.01	0.41	0.01
1.1 to 1.2	0.09	0.00	0.05	0.01	0.36	0.00
1.2 to 1.3	0.22	0.03	0.16	0.09	4.92	0.00
1.3 to 1.4	0.36	0.00	0.09	0.04	3.25	0.05
1.4 to 1.5	0.06	0.00	0.00	0.00	0.24	0.00
More than 1.5	1.76	0.06	0.52	0.02	4.08	0.03
(average f )	(+2.10)	(+6.62)	(+1.94)	(+4.19)	(+6.18)	(+4.06)

**Table 2.** Polish large enterprises: end of 1992. Summary data (monetary totals in trn zł)

	Levels	Shares in percent				
	Total	Very bad f <sub>s</sub> < -1.5	Bad f(-1.5, -0.5]	Satisfactory f(-0.5, +0.5]	Good f(+0.5, +1.5]	Very good f > +1.5
1. Number of enterprises	21824	14.2	13.6	59.2	10.5	2.4
2. Revenue <i>per</i> quarter	461.3	10.8	13.6	65.9	7.9	1.8
3. Credits and loans	186.6	61.6	15.3	21.4	1.4	0.6
4. Payables-receivables	109.3	98.2	31.4	-.03	-14.2	-15.4
5. Payables	410.7	38.0	18.4	33.2	7.1	3.3
6. Payables to government	71.8	42.9	20.8	30.9	3.1	2.3
7. Receivables	301.5	16.1	13.7	45.3	14.8	10.1
8. Own money	73.8	11.5	7.8	40.2	24.2	16.2
9. f = F/S	-.48	-4.29	-.91	-.03	.85	3.29

**Table 3.** Polish large enterprises: end of 1992. Distribution in percent. N – number of enterprises; S – of the revenues

Type of activity	Very bad f < -1.5		Bad -1.5 < f < -0.5		Satisfactory -0.5 < f < 0.5		Good -0.5 < f < 1.5		Very good f > 1.5		Total	
	N	S	N	S	N	S	N	S	N	S	N	S
Total	14.4	10.9	13.8	13.9	59.8	65.7	10.7	7.9	2.4	1.8	100.0	100.0
Industry	6.7	8.2	5.5	10.0	16.0	27.9	2.0	2.0	0.3	0.2	30.5	48.3
Construction	1.1	0.2	1.6	0.7	7.6	3.2	2.0	1.0	0.3	0.1	12.6	5.2
Agriculture services	0.9	0.0	1.1	0.1	4.9	0.4	1.2	0.1	0.2	0.0	8.3	0.6
Forestry	0.1	0.0	0.0	0.0	0.2	0.5	0.0	0.1	0.0	0.0	0.3	0.5
Transport	0.5	0.6	0.6	0.1	3.6	3.3	1.1	0.3	0.1	0.1	5.9	4.6
Communications	0.0	0.0	0.0	0.0	0.1	1.0	0.0	0.3	0.0	0.0	0.1	1.4
Communal services	0.1	0.2	0.2	0.0	3.1	1.6	1.3	0.6	0.2	0.1	4.9	2.3
Trade	1.8	3.5	3.5	2.2	17.9	20.7	0.7	1.6	0.3	0.6	24.2	25.6
Foreign trade	0.1	0.1	0.2	0.3	0.6	5.3	0.1	1.0	0.1	0.5	1.1	7.2
Other	3.1	1.1	1.1	0.5	5.8	1.9	2.3	0.8	0.9	0.2	13.2	4.5
	14.2	10.8	13.6	13.6	59.2	65.9	10.5	7.9	2.4	1.8	99.9	100.0

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**Table 4.** Polish large enterprises: end of 1992. Distribution of banking debt D by activity and f category

Type of activity	Total		Very bad f < -1.5		Bad -1.5 < f < -0.5		Satisfactory -0.5 < f < 0.5		Good 0.5 < f < 1.5		Very good f > 1.5	
	f	D	f	D	f	D	f	D	f	D	f	D
Total	-0.5	186.6	-4.3	115.0	-0.9	28.6	-0.0	39.4	-0.8	2.5	3.3	1.1
Industry	-0.7	106.0	-3.7	62.1	-0.9	22.2	-0.0	20.6	0.7	0.8	3.2	0.3
Construction	0.0	3.8	-3.0	0.7	-0.9	1.0	0.1	1.6	0.8	0.5	3.3	0.1
Agricult. serv.	-0.3	1.0	-3.8	0.3	-0.9	0.5	0.0	0.2	0.8	0.0	4.3	0.0
Forestry	-0.1	0.7	-6.8	0.4	-0.7	0.0	0.1	0.3	0.6	0.0		0.0
Transport	-0.3	5.7	-2.4	4.2	-0.8	0.2	-0.2	1.2	0.8	0.0	2.3	0.1
Communica- tions	-0.0	4.7	-7.4	0.1	-0.6	0.0	-0.5	4.5	1.1	0.0	24.8	0.0
Communal services	0.2	2.5	-3.8	1.3	-0.8	0.1	0.1	0.7	0.9	0.5	2.5	0.0
Trade	0.0	18.4	-4.3	5.4	-0.8	2.7	-0.0	9.2	0.9	0.6	3.5	0.6
Foreign trade	0.5	5.0	-3.6	1.1	-0.9	0.4	0.1	2.5	0.9	0.5	3.7	0.5
Other	-2.0	43.7	-10.1	40.5	-0.8	1.9	0.0	1.1	1.0	0.1	3.2	0.0

**Table 5.** Polish large enterprises: end of 1992. Distribution of N, S and D by type of ownership and f categories. (N and S in percent, D in trn zł.)

Type of ownership	Totals				Very bad f < = -1.5				Bad f (-1.5, -0.5)			
	N	S	f	D	N	S	f	D	N	S	f	D
1. Total	100.0	100.0	-5	186.6	14.2	10.8	-4.3	115.0	13.6	13.6	-9	28.6
2. State	32.9	66.5	-5	105.2	5.8	8.1	-3.6	54.6	4.6	9.4	-9	20.2
3. Communal	4.4	1.5	.2	1.2	.2	.0	-4.6	.3	.3	.1	-8	.1
4. Cooperatives	35.0	12.1	-1.0	40.9	4.5	1.2	-8.9	34.4	3.7	.8	-8	1.8
5. Social organizations	.8	.1	.2	.0	.0	.0	-3.0	.0	.0	.0	-8	.0
6. Foreign	1.9	1.3	-.6	2.7	.3	.1	-4.2	1.7	.4	.4	-9	.8
7. Private Polish	18.4	8.9	-.7	22.5	2.4	.8	-4.8	16.9	3.7	1.9	-8	2.3
8. Mixed ownership	6.5	9.7	.1	14.0	.9	.5	-4.4	7.1	.9	1.1	-9	3.5

Type of ownership	Satisfactory f (-0.5, +0.5)				Good f (+0.5, +1.5)				Very good f > +1.5			
	N	S	f	D	N	S	f	D	N	S	f	D
1. Total	59.2	65.9	-.0	39.4	10.5	7.9	.8	2.5	2.4	1.8	3.3	1.1
2. State	16.5	42.4	-.0	28.6	4.9	5.4	.8	1.3	1.2	1.1	3.0	.5
3. Communal	2.8	1.0	.1	.4	.9	.3	.7	.4	.2	.0	2.1	.0

Table 5 cont.	Satisfactory $f(-.5, +.5)$				Good $f(+.5, +1.5)$				Very good $f > +1.5$			
	N	S	f	D	N	S	f	D	N	S	f	D
4. Cooperatives	23.5	9.6	-.1	4.6	2.9	.4	.8	.1	.5	.1	5.3	.0
5. Social organizations	.4	.0	.0	.0	.2	.0	.9	.0	.1	.0	2.7	.0
6. Foreign	1.0	.8	-.1	.2	.2	.1	.7	.0	.0	.0	2.0	.0
7. Private Polish	11.1	5.9	-.1	3.2	1.0	.3	.8	-.1	.2	.0	2.8	.0
8. Mixed ownership	3.8	6.1	.1	2.3	.6	1.3	.9	.5	.3	.6	3.7	.5

**Table 6.** The Breakdown of L-type enterprises with  $f < -1.5$  by profitability<sup>1</sup>, end of 1992

Category	All	$z < -0.1$	$-0.1 < z$	$0 < z < 0.1$	$z > 0.1$
N, in %	100.0	58.2	10.0	24.9	7.0
S <sup>2</sup>	49.8	24.4	8.7	11.1	5.7
Z <sup>3</sup>	-8.3	-9.6	-0.5	0.4	1.3
Cost of financial operations <sup>3</sup>	19.2	13.4	1.8	2.5	1.5
D <sup>4</sup>	115.0	46.6	15.2	40.4	12.8
Average $z^3$	-0.17	-0.4	-0.06	0.04	0.24
Average $f^3$	-4.3	-4.2	-4.0	-5.4	-3.0
Receivables <sup>4</sup>	48.6	28.4	6.1	8.8	5.3
Payables <sup>4</sup>	156.0	86.1	26.7	31.8	11.3
Payables to government <sup>4</sup>	30.8	21.4	3.5	4.0	1.8

1. Except in rows 1, 6 and 7, the numbers denote trillions zł (1 trn = 1,000,000 millions)

2. Average quarterly and other income in 1992

3. Annual, 1992

4. End of 1992

*NB* At the average official rate in 1992, 1 trn zł equaled 63.4 mln USD. Measured GDP in 1992 was, in current prices, 1140 trn zł.

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**Table 7.** The breakdown of L-type enterprises with  $-1.5 < f < -0.5$  by profitability<sup>1</sup>, end of 1992

Category	All	$z < -0.1$	$-0.1 < z < 0$	$0 < z < 0.1$	$z > 0.1$
N, in %	100.0	26.5	27.1	34.5	11.9
S <sup>2</sup>	62.9	7.6	14.7	27.0	13.6
Z <sup>3</sup>	2.0	-1.4	-0.6	1.3	2.6
Cost of financial operations <sup>3</sup>	13.7	1.3	4.0	5.0	3.4
D <sup>4</sup>	28.6	2.2	5.1	11.5	9.8
Average z <sup>3</sup>	0.03	-0.19	-0.04	0.05	0.19
Average f <sup>3</sup>	-0.9	-1.1	-0.9	-0.9	-0.9
Receivables <sup>4</sup>	41.3	5.8	9.9	16.4	9.2
Payables <sup>4</sup>	75.5	12.5	19.6	29.8	13.6
Payables to government <sup>4</sup>	15.0	3.5	2.7	6.1	2.7

1. Except in rows 1, 6 and 7, the numbers denote trillions zł.

2. Average quarterly and other income in 1992

3. Annual, 1992

4. End of 1992

**Table 8.** Distributions of financial assets and liabilities of enterprises by f-category, end of March (A) 1992 and (B) 1993

Category	Total		Very bad		Bad		Satisfactory		Good		Very good	
	Absolute levels		in percent									
	A	B	A	B	A	B	A	B	A	B	A	B
N	20130	18021	12.0	15.1	14.0	15.0	59.3	58.3	10.8	8.9	3.3	2.8
S	388.6	496.9	6.9	11.2	15.6	12.9	68.6	67.0	7.6	7.3	1.3	1.6
Bank debt (D)	169.7	195.3	60.9	62.3	17.4	13.7	19.6	22.2	1.4	1.2	0.7	0.6
Own cash (M)	53.6	67.1	13.3	10.3	11.3	7.8	38.7	40.6	21.7	23.5	14.9	17.7
Receivables	275.1	310.2	10.7	17.2	16.1	12.6	47.9	49.1	16.7	11.6	8.5	9.5
Payables (P)	304.6	420.5	24.2	38.8	23.9	17.6	38.8	35.2	10.4	5.0	2.8	3.3
Payables to government (PG)	48.8	82.2	26.9	45.5	32.3	19.1	34.5	30.2	4.9	3.3	1.4	1.9
Average f	−0.4	−0.5	−5.3	−4.0	−0.9	−0.9	0.0	0.0	0.8	0.8	4.2	3.3

As before, S stands for average quarterly gross income from sales and other sources.

**Table 9.** The breakdown of L-type enterprises with  $f < -1.5$  by profitability, end of March, (A) 1992 and (B) 1993

Category	Total		z < -0.1		-0.1 < z < 0		0 < z < 0.1		z > 0.1	
	Absolute levels		in percent							
	A	B	A	B	A	B	A	B	A	B
N	2428	2716	57.9	50.1	10.5	14.2	22.2	28.7	9.4	7.0
S	26.6	55.6	32.1	26.7	28.5	31.3	27.4	31.2	12.0	10.9
z	-3.4	-4.2	115	131	9.5	9.6	-6.0	-14.1	-18.4	-27.1
D	103.3	121.6	20.5	34.0	14.2	21.2	58.0	32.3	7.3	12.5
R	29.5	53.5	45.5	38.6	19.5	25.0	23.3	24.4	11.6	12.0
P	73.6	163.2	46.1	38.8	26.2	24.1	18.8	28.7	8.9	8.4
PG	13.1	37.4	58.0	43.8	18.3	16.2	15.2	32.1	8.5	7.9
Z	-0.13	-0.08		-0.37	-0.04	0.02	0.03	0.03	0.2	0.19
f	-5.3	-4.0		-5.5	-3.6	-2.9	-8.5	-4.1	-3.2	-3.5

As before, S stands for average quarterly gross income from sales and other sources. The value unit of account is trn zł.

**Table 10.** Summary results for M-type enterprises, end of March 1992

	N	S	D	Payables	Receivables
Total group	53,450	106.4	39.2	65.1	47.1
Private	29,390	65.3	14.0	31.9	32.4
All „very bad”	6,640	5.9	29.1	19.7	6.4
Private	2,890	2.6	7.1	7.1	2.7
State	700	0.4	1.8	3.0	0.8

1. Except those in column N, all numbers are trillions of zł.

2. Original data concern a 10% sample of M-type enterprises. Data in Table 10 above are these original data multiplied by 10.

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## 12. Privatization in Poland 1989-93: Policies, methods, and results<sup>\*1</sup>

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An ownership reform intended to transform an economy based on predominantly state ownership and central coordination to one based largely on private ownership and market coordination is an economic and social process of the most fundamental nature. Our principal concern in this chapter will be privatization in the narrow sense, defined as the transfer from state to private owners of full ownership rights. In Poland from 1989 to 1993, such a transfer has been a significant, but not yet the dominant cause, of the observed fast increase in the share of the private sector in total GDP, a principal measure of privatization in the broad sense. An endogenous growth of the private sector, commercialization of the co-operative sector, and mass leasing of small businesses have so far been the main causes of the share's increase. A discussion of these causes will be our second major concern.

The chapter starts with a brief overview of the changes in the ownership structure of the Polish economy. The next two sections describe briefly the ownership changes that preceded the Act on the Privatization of State-owned Enterprises of 13 July 1990. These sections also summarize the ideas underlying the competing privatization blueprints proposed in 1989 and 1990. Sections 4 and 5 are the core of the chapter. They report on the process of implementation of this Act, discussing various forms and methods of privatization. Section 6 discusses the privatization plans for 1994-5, involving above all mass privatization of large enterprises and privatization implications of the Pact on Enterprises. Implementation of these plans is expected to accelerate the privatization process so much as probably to ensure that Poland's ownership structure will be similar to that of the European Community before the end of the 1990s. Section 7 discusses constraints to

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\* With P. Jasiński, in: *Privatization in Central and Eastern Europe*, S. Estrin (ed.). London: Longman, 1994.

<sup>1</sup> The critical comments and positive suggestions by a number of readers of earlier drafts of this chapter have proved most useful in preparing the final version. The authors wish to thank in particular Leszek Balcerowicz of the Warsaw School of Economics, Saul Estrin of the London Business School, Władysław W. Jermakowicz of the School of Business, University of Southern Indiana, and Mark Schaffer of the Centre for Economic Performance at the London School of Economics.

privatization. Section 8 concludes with a tentative assessment of the results of efforts undertaken so far.

## 1. Growth of the private sector

Like the other countries of Central and Eastern Europe, Poland started the process of systemic transformation when its economy was dominated by state-owned enterprises (SOEs) and enterprises indirectly controlled by the state (mostly co-operatives). The political control over such enterprises was fairly tight, exercised ultimately by the Communist Party. However, the share of the GDP produced by the socialized sector peaked long before Tadeusz Mazowiecki formed his Solidarity-led government in September 1989. The share of the GDP produced by the private sector outside agriculture started to increase in the late 1970s and has grown more or less continuously since then.<sup>2</sup> The private sector consisted mainly of unincorporated businesses in crafts, services, and retail trading. In 1976 the so-called Polonia partnerships were allowed, i.e. firms owned by Poles or people of Polish origin not resident in Poland. In 1977 the first three firms were registered; by the end of 1980 their number had increased to only 46, employing 1560 people.<sup>3</sup> In 1985 a major legal reform took place: the Commercial Code of 1934 was returned into force. The real turning point for the private sector was, however, the 1988 Act on Economic Activities, introduced by the Rakowski government. Under the Mazowiecki government (September 1989 to December 1990), the growth of the private sector rapidly accelerated (Table 1). By the end of 1993 the private sector already employed about 60 percent of those in work, compared with 44 percent in 1989, and, in 1993, produced 50 percent of GDP,<sup>4</sup> compared with 28.6 percent in 1989 (Table 2).

By far the most important element so far in privatizing the Polish economy has been what is known as *organie privatization* (Gomułka, 1993a), which is one form of *privatization from below* (Kawalec, 1989). Organic privatization involves setting up new private businesses, either incorporated or unincorporated, by both

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<sup>2</sup> Efforts to collectivize Polish agriculture never really succeeded; what was collectivized in the period of stalinism was reversed after 1956. This meant that some 80 percent of arable land was in the private sector. Activities of farmers were still controlled by means of compulsory deliveries of products, fixed prices, centralized distribution of material supplies and rationing of mechanized equipment.

<sup>3</sup> By 1989 their number had increased to 841 and they were employing 100,240 people, less than 1 percent of the workforce.

<sup>4</sup> These figures do not include the parallel or under-reported sector of the private economy. It is widely presumed that this sector has been growing since 1989.

**Table 1.** Growth of the private sector in Poland, 1980-93

	1980	1989	1990	1991	1992	1993
% of the GDP						
Private sector		28.6	30.9	42.1	45.0	50.0
Private sector proper	17.5	19.2	23.0	n.a.	n.a.	n.a.
State sector	82.5*	71.4	69.1	57.9	55.0	50.0
Number of registered firms in the private sector						
All private firms	460,333 (1981)	857,430	1,201,933	1,493,701	1,719,304	1,901,704
Cooperatives (excl. banks)	n.a.	16,691	16,650	17,374	18,284	n.a.
Domestic incorporated firms	—	15,681	33,239	47,690	58,218	66,457
Foreign incorporated firms	—	429	1645	-4796	10,131	15,053
Polonia companies	46	841	862	787	716	n.a.
Unincorporated businesses	481,000	826,533	1,135,492	1,420,002	1,630,800	1,783,900

Source: Central Statistical Office, Ciechocińska (1992), and own calculations.

\* Includes co-operatives

**Table 2.** Poland, employment by economic sector and ownership category, 1989-93

	1989	1990	1991	1992	1993
LEVEL (MILLIONS, END-YEAR)					
Non-agriculture	13.5	12.4	11.8	11.4	11.4
State	9.6	8.2	7.3	6.6	6.1
Private	3.9	4.2	4.5	4.8	5.3
Private sector proper	1.8	2.3	3.0	4.1	n.a.
Cooperatives, etc	2.1	1.9	1.5	1.2	n.a.
Agriculture	4.8	4.7	4.6	4.5	4.5
State	0.6	0.5	0.4	0.4	0.4
Private, incl. cooperatives	4.2	4.2	4.2	4.2	4.2
PRIVATE SECTOR (PRIVATE AND CO-OPERATIVES) SHARE OF EMPLOYMENT (% , END-YEAR)					
Total economy outside private agriculture	31.2	33.6	40.3	44.4	46.2
Total economy	44.3	49.1	53.0	56.6	60.0
Trade	72.7	82.2	88.3	90.7	92.5
Industry	29.1	31.2	35.8	40.5	46.9
Construction	37.4	42.1	59.5	71.9	80.9
Transport	14.3	15.2	26.0	25.4	28.5
Communal services	29.9	30.0	40.3	44.4	n.a.

Source: Central Statistical Office, in particular Informacja o sytuacji społeczno-gospodarczej kraju. Rok 1993, Warsaw, 28 January 1994.

Polish and foreign investors, and the autonomous growth of existing private businesses. This privatization is in part fuelled by *asset privatization*, whereby some unused inventories and fixed assets of state enterprises are sold very cheaply to private owners. Second in importance was mass leasing of state and cooperative assets by small private businesses, also a form of privatization from below. Third in importance was what one could call *statutory privatization*. Following the dissolution of their central administration, cooperatives have been commercialized and are now considered to belong to the private sector (Section 4.2). Fourth, by the end of 1993, 977 nonagriculture SOEs were privatized (Section 5).

## 2. The privatization debate and developments before September 1989

In November 1988, a conference was held at the Central School of Planning and Statistics in Warsaw, entitled ‘Proposed Transformations of the Polish Economy’. That conference marked the first serious academic discussion on privatization in a Polish context, during which some rather specific, and in those days revolutionary, proposals were put forward. Stefan Kawalec proposed turning state-owned firms into joint stock companies, and selling shares in these companies to the public. By contrast, Janusz Lewandowski and Jan Szomburg advocated a free distribution of shares of state-owned enterprises.<sup>5</sup> The dilemma as to whether the state-owned assets should be sold or distributed free of charge became subsequently a permanent feature of both theoretical and policy discussions.

These discussions, initially purely theoretical, were already accompanied by ‘spontaneous privatization’ (the polite Hungarian term) or ‘nomenklatura’ privatization (*uwłaszczenie nomenklatury*, the apt Polish term). This privatization was a consequence both of a deepening economic crisis and of an ideological and a discipline crisis within the Communist Party.

Two kinds of actions were particularly popular. The first involved a low valuation of assets contributed by the state enterprise and a high valuation of the contributions in kind made by the private partner(s).<sup>6</sup> The second route of

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<sup>5</sup> Kawalec (1989) and Lewandowski and Szomburg (1989), later modified in Lewandowski and Szomburg (1990, 1991). For a critical assessment of the two models of privatisation see Jasiński (1990). It is worth noting that other speakers at the same conference either preferred reorganization of SOEs (Święcicki, 1988) or still advocated self-management (Dąbrowski, 1988).

<sup>6</sup> When the partner was a foreign investor, this kind of ‘sweetheart deal’ would often involve giving the foreign partner a stake in the enterprise and, in return, the manager would be appointed to an attractive position in the new venture (Gruszecki, 1990).

*nomenklatura* privatization was based on contractual relationships between old state enterprises and the newly established '*nomenklatura joint-stock companies*,'<sup>7</sup> in which state managers would have personal stakes. The manager might then lease the plant and machinery of the state enterprise at highly favourable terms to such a *private* company, allowing it to earn exceptionally high rates of return. The profits of the state enterprise could be also transferred to the private firm by way of giving it exclusive rights on selling the SOE's output. The best way to bias such a contract in favour of the private firm was to use highly favourable transfer prices (Winiecki, 1992).

The *nomenklatura* privatization led to public outrage, following reports in the mass media. However, it would appear that the process consisted above all in exploiting legal gaps. Irregularities could and in some cases most likely did occur in evaluating the assets as well as in what can be labelled 'conflicts of interest', but their illegality was very difficult to prove and very few deals were in fact declared null and void. Even though *nomenklatura* privatization had some positive aspects (Ciechocińska, 1992; Mizsei, 1992), this route to capitalism proved politically unacceptable and was blocked by the Mazowiecki government in late 1989 and early 1990.

### 3. Policy controversies and the privatization act of 1990

Soon after Tadeusz Mazowiecki formed his Solidarity-led coalition government, an economic programme was announced. In clear break with the Round Table agreement of April 1989, the programme proclaimed a return to capitalism as its ultimate goal.

Though a key player in bringing the communist rule in Central and Eastern Europe to an end, Solidarity was above all a trade union and, as such, could not and did not have the return to full blooded capitalism as its principal objective. Things were additionally complicated by the earlier attempts to reform the Polish economy, which in the 1980s went almost unequivocally in the direction of self-management. At the same time, the demise of the Communist Party

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<sup>7</sup> Socialized institutions (state enterprise, cooperative, association, administrative agency acting on behalf of the Treasury) which establish connections with the manager of such an entity, the manager having the status of a partner in the company. These persons – managers, presidents, directors – are members of the *nomenklatura*. There were also 'weaker' forms of *nomenklatura* companies, in which the president, manager or director do not become formally partners, but are members of the supervisory board or are additionally employed in the company's management, deriving various benefits from such an arrangement (Gruszecki, 1990).

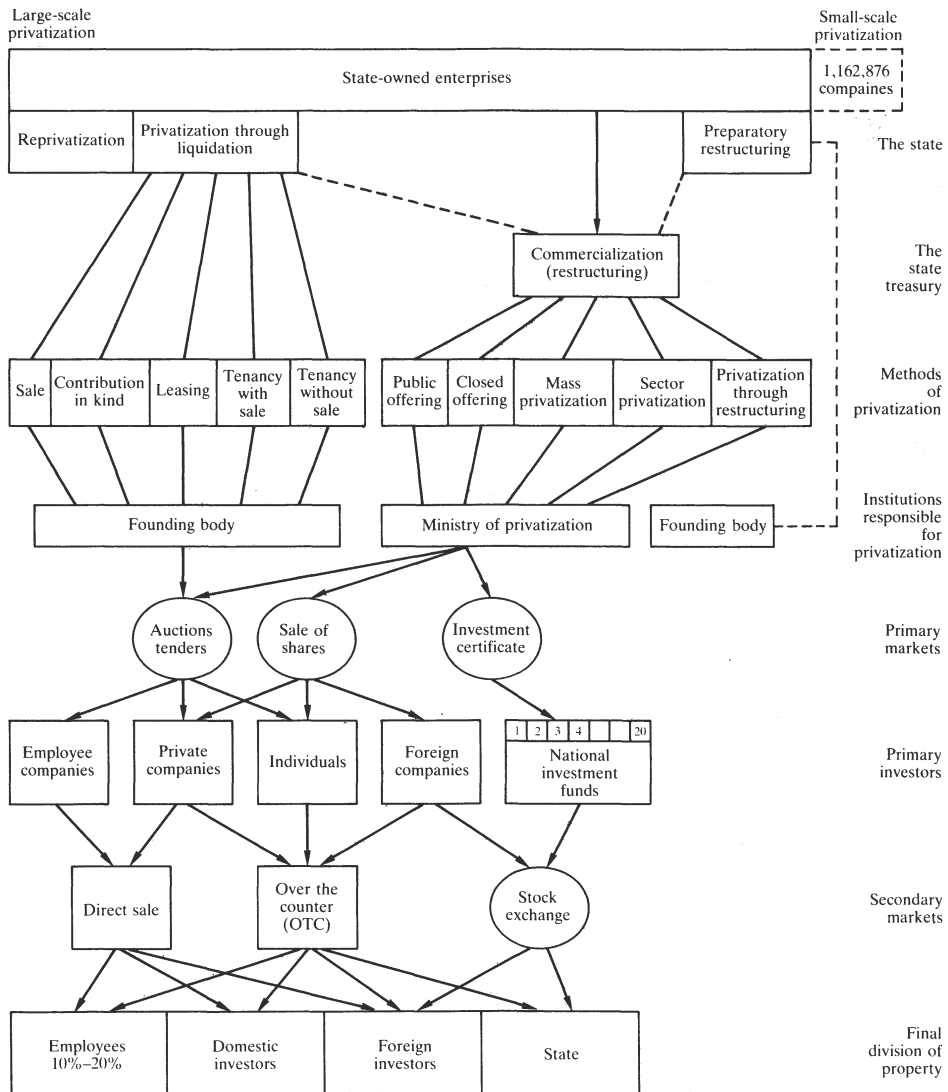
deprived members of the old *nomenklatura* of effective power and created at the enterprise level a vacuum which was filled by a triumvirate of the management, the workers' council, and the trade unions. In many cases the Solidarity union controlled the workers' council and the council controlled the management, making it difficult for the latter to propose and implement adjustment programmes which were costly in the short run. This legitimized the opinion that enterprises *de facto* belonged to their employees and therefore the formal property rights should also be transferred to them or, at least, that they should have a decisive say in designing and implementing the privatization policy. The Balcerowicz team, in charge of economic policy, became scared of the prospect of Poland choosing the 'third way' by default. Convinced that workers' ownership is inferior, the team confronted the self-management activists and their exaggerated ownership claims. However, the Act on state-owned enterprises of 25 September 1981 was still in force and it was not considered politically feasible for the Solidarity-led government to repeal it. Instead the legal powers of workers' councils had to be taken into account in designing privatization techniques.

### 3.1. The early proposals

The Mazowiecki government was already in 1989 presented with two privatization proposals, which this time had a real chance of being implemented. First Gomułka (1990; 1992) suggested that all the SOEs should be turned immediately into joint stock companies and that the government should create a network of intermediaries, which he called investment banks, but which would effectively be open-ended mutual investment funds. To avoid the valuation problem, the shares of the companies taking part in that scheme would be distributed equally among funds, with 10 to 20 percent to be retained by workers. The shares could be swapped among funds, but they were to be gradually sold at a speed decided by the authorities. The funds themselves were eventually to be privatized. Soon afterwards Beksiak and three other Polish economists (Beksiak *et al.*, 1990) presented an all-embracing programme of economic transformation, of which privatization was an integral part. At the start of the privatization process, employees would be given 20 percent of shares. In this way a clearly identifiable group of shareholders would emerge from the start to reduce the costs of control over management. The State Treasury would own the remaining 80 percent but without voting rights. Over time, as the remaining shares are sold or distributed free of charge, new controlling shareholder groups would emerge.

In the spring of 1990 it became clear, however, that the formation of many new intermediaries was beyond the capabilities of the government. The lack of suitable

### 3. Policy controversies and the privatization act of 1990



**Figure 1.** The model of privatization in Poland

Source: Jermakowicz (1992)

personnel and facilities was the stumbling block. In response to this formidable constraint, a programme was born based on two principles: (1) many paths, particularly for small and medium size firms and (2) use of some of the existing institutions and new domestic and foreign management groups for the purpose of mass privatization programme for large enterprises.

Already in October 1989, the Government Plenipotentiary for Ownership Transformation, Krzysztof Lis, was appointed at the Ministry of Finance to propose the necessary initial legislation. This would provide a general framework, and not be specific as to the methods of privatization. The work on selecting the enterprises for a UK-type privatization began almost at the same time.

In March 1990 the proposed text of the Act on the Privatization of State-owned Enterprises was approved by the Council of Ministers and sent to the *Sejm*, where a special committee was formed and met every day for three months to discuss the law. The main opponents, not so much of privatization as of the government proposals, were MPs involved in the self-management movement, who at the same time presented their own draft of the act.<sup>8</sup>

The Act on the Privatization of State-owned Enterprises and the Office of the Minister of Privatization Act<sup>9</sup> were finally passed by the *Sejm* on 13 July 1990 and came into force on 1 August 1990.<sup>10</sup> Figure 1 illustrates the overall structure of the privatization processes. Their description and an assessment of the results achieved will be given in section 5.

### 3.2. The war of privatization blueprints, summer 1990

The slow supply response of state enterprises in 1990 reinforced the point that the liberalization and stabilization policies of the Polish government rest on soft microeconomic foundations and may not be sustainable for long. Strong and self-interested advocates for profits and long-term net worth of state enterprises continued to be absent and, instead, incentives to increase the short-term income of the workforces became stronger. The Privatization Act of 1990 was very pluralistic and could be a legal basis for many policies. Reform designers and policy makers became convinced of an urgent need for a privatization strategy that could produce quickly, within five years or so, certainly before the end of the 1990s, private owners for most state property, ones who would have entrepreneurial

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<sup>8</sup> The main differences between the two projects were: "the scope of legislation, the institutional framework of the privatization process, including political control over its progress; the choice of procedures for privatization, and the role and importance of employee shareholding and other legal and financial measures intended to ensure private ownership" (Błaszczuk and Gruszecki, 1991, p. 24). The *Sejm* decided to use the government proposal as their basis for discussion but the final version contained solutions from both documents.

<sup>9</sup> For full texts of both documents see Economic Commission for Europe (1992), p. 115-30, and for the detailed structure of the MOP see Frydman *et al.* (1993).

<sup>10</sup> They were made operational by seven instructions of enactment, issued by the Council of Ministers and the Minister of Privatization (initially Ownership Changes) in October and November 1990 (Błaszczuk and Gruszecki, 1991: 51-6).



talent and possibly also financial capital needed for restructuring. But then the questions were, first, how to find such owners where there are only a few successful domestic capitalists and, second, in what socially acceptable manner to hand over to them the state assets, where there is little private capital. The various policy blueprints which were proposed in the summer of 1990 differed above all in the way they sought to answer these two questions, especially with reference to medium and large enterprises.

The initial privatizers, led by Krzysztof Lis, were keen to rely on classical (Western) methods of privatization. They proposed mass-scale commercialization of state enterprises, rapid establishment of the stock exchange, careful valuation of enterprises and their sale through auctions and public offers. Similarly to Hungarian privatizers, the Lis group was essentially against vouchers and investment funds. The strategy had already encountered a difficulty in December 1989 when, in order not to antagonize trade unions and workers' councils, the mass commercialization proposal was rejected by the government. Instead, incentives were created to induce state enterprises to accept voluntary commercialization, and compulsory commercialization was left as an option to be used rarely. However, the main objection to Lis's strategy was that the pace of privatization using classical methods would be much too slow. In the summer of 1990, this led Leszek Balcerowicz and his key advisers to seek novel ways of accelerating the privatization process. An acceleration was also demanded by Lech Wałęsa in his presidential campaign during that time.

The hottest debate concerned the privatization of large enterprises (URM 1990). The use of vouchers was accepted as necessary for providing access to state assets to all (adult) citizens, and therefore gaining vital political support for the entire privatization programme. There remained the question of whether the vouchers should be named, in order to avoid their early sale in secondary markets and a collapse of share prices, or not named, in order to facilitate the creation of a capital market and a rapid concentration of shareholding. In both cases, to provide effective oversight for enterprise managements on behalf of the millions of shareholders, it became necessary to propose setting up intermediaries. But various blueprints differed as to the minimum number of these institutions, whether they should be state or market created, which if any of the existing institutions (banks, pension funds) could play such a role, what should be the rules for distributing the enterprise shares between intermediaries, and what role to offer to foreign management funds. Creating a small number of holding companies in the role of such intermediaries was administratively attractive, but could make them similar to old ministries or production associations, capable of engaging in monopolistic practices. Since the bankruptcy of such a holding company would

be inconceivable, there was also the danger that the soft budget constraint that has long bedevilled the socialist economies might be recreated in a different guise.

The involvement of government in creating the intermediaries would help in terms of resources, supervision and trust, but care should be taken not to make them excessively bureaucratic. Western experts, particularly the British privatization advisers Warburg (1990), noted that mutual funds in Western countries act typically as passive investors. Poland needed active investors who would take control of the restructuring activities. This led to the idea of selecting one fund for each enterprise as a dominant shareholder.

Finally, there was the delicate matter of the extent and forms of involvement of foreign ownership and management. Already in early 1990 it was proposed and broadly accepted as a long-term aim that the economy-wide foreign ownership be substantial but possibly not more than 20 percent (Gomułka, 1990a). It was also hoped that there would be a considerable direct foreign investment; a target of 50 billion US\$ was thought feasible for the total inflow of foreign capital in the 1990s. Instead of selling state assets cheaply to foreigners, it was proposed to involve Western management companies in running the intermediaries (Frydman and Rapaczyński, 1990, 1991). These companies, it was argued, have the standing necessary to attract foreign credits for restructuring and the know-how necessary to arrange production of attractive goods at competitive prices. Following such restructuring, the market value of Polish enterprises would increase sharply and, according to this argument, it would then be the right time for Polish shareholders to exercise the option of selling their stock to foreign buyers. These ideas influenced the scheme for 'mass privatization' of large enterprises (section 6).

The blueprints also differed with respect to a number of technical (rather than policy) issues. These included the specification of incentives for managements of the intermediaries; the appointment procedures for these managements; the rules for selecting enterprises; who and how would be selling enterprise shares to intermediaries and the shares of intermediaries to the public for privatization coupons; what other state property, apart from large enterprises in the mass privatization programme, could be bought for coupons; the precise rights of shareholders and the duties of intermediaries. One of the more controversial issues turned out to be the use of 'special' credit to augment the coupon capital. Some proposed to link the size of the credit in a fixed ratio to investor's own capital (Gomułka, 1990a). Others proposed to offer such credit to all adults (Wałęsa's proposal of '10,000 US\$ for everyone' was also made in the summer of 1990 during his presidential campaign), or to no-one (this was essentially the position of Balcerowicz). This particular issue was again hotly debated in 1993 and by the end of that year was still awaiting a clear resolution.

## 4. Mass privatization of small-scale businesses

Two important forms of privatization, especially in the early stages of the process, have been *municipal privatization* and the transformation of co-operatives. Both involved small-scale businesses and were therefore called *small privatization*. Analysis of these forms is, however, very difficult because reliable data are exceptionally scarce and dispersed. It also runs into similar conceptual problems as privatization in general on account of being sometimes mixed up with the organic growth of the private sector.

### 4.1. Municipal privatization

Most municipal privatizations concern retail trade. They were made possible by the Act on Economic Activities of December 1988 and the Act regulating the rental of trade premises, as amended in June 1990. Most of these premises belonged to municipal authorities and almost all of them changed their users but not their owners. The state and municipally owned retail and wholesale trade firms or nominal cooperatives, previously occupying the municipally owned trading premises, lost them, in a more or less competitive process, to private entrepreneurs, at the same time losing their workforces.<sup>11</sup> By the end of 1991, 33,786 premises owned by local councils moved from public to private users (Tamowicz *et al.*, 1992), but only 1074 (3.2 percent) of them were actually sold. It has led to a form of privatization from below of retail and wholesale trade, based on leasing arrangements.<sup>12</sup> The previously dominating firms, which are being privatized using techniques described in section 5, continue to trade on the premises which they actually owned.

In the first half of 1990, only 9 percent of rent contracts, signed with the local councils and cooperatives, were based on open auctions and within the next 12 months this share fell to 4 percent<sup>13</sup>. In all other cases some more or less transparent administrative procedures were applied and those who worked previously on the premises involved were offered preferential financial terms.

<sup>11</sup> A similar process went on in crafts and services, and there is no doubt that in manufacturing 'small privatization' was substantially helped by the provisions and implementation of the act on the privatization of SOEs (Bednarski, 1991).

<sup>12</sup> "Under the existing rules, the sale of such premises is not possible, because the rules do not permit the sale of shop space which constitutes a part of a larger building. And it is in large buildings where most shops are found" (Bednarski, 1991, p. 11). On the other hand, however, there are ways of dealing with the uncertainty allegedly faced by shopkeepers because of such an arrangement.

<sup>13</sup> A similar picture emerges from the survey reported in Tamowicz *et al.* (1992). The authors analyzed decisions taken by 24 urban local councils (*gminy miejskie*) and only one of them decided to go for a market solution based on open auctions.

The legislation introduced in the spring of 1990 gave the local authorities the right to hold property. The ownership rights of some SOEs and state budgetary entities were transferred to local authorities on the territory of which they were located. Most of them were either public services or public utilities. Local authorities, in turn, were obliged to decide till the end of 1992 whether these enterprises were to be joint-stock companies, fully owned by the local council and with councillors acting as board directors, or budgetary units.<sup>14</sup> Both legal forms, however, could become transitory stages on the way towards privatization. Since privatization usually demands more expertise than most local authorities have at their disposal, once the necessary decision is taken, they are allowed to sign a contract with the MOP to have privatization services provided by the Ministry's officials and experts.

## 4.2. Cooperatives

Under the communist regime, cooperatives had in fact very little to do with group ownership; they were *de facto* – and not only from the point of view of the statistical classification used – a part of the public sector. At the same time they constituted a large<sup>15</sup> and very diversified class of economic agents, embracing housing cooperatives, labour cooperatives, dairy cooperatives, agricultural production cooperatives, cooperatives for the disabled, and cooperative banks. What is even more important, there existed cooperatives of legal persons as well as of natural persons. All of them were highly centralized and it was only in the 1980s that some genuine small cooperatives were set up.

This state of affairs provoked a quick reaction from the Mazowiecki government. The Cooperative Law was already amended in January 1990 in order to restructure and democratize the cooperative sector of the Polish economy. The amendments brought forward the election of new member representatives and liquidated all cooperative bureaucracy at the regional and national levels (Bandyk 1991). Other legislative changes intended to provide a legal basis for ownership changes in this sector, particularly for the transformation of cooperatives into companies registered under the Commercial Code, were still being debated in 1993, and new amendments to the Cooperative Law are expected in 1994.<sup>16</sup>

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<sup>14</sup> On the one hand, local councils are liable for any debts incurred or damages caused by budgetary units. On the other hand, budgetary units were not subject to the *popiwek* regulations, i.e. to the tax on above norm increases of wages, still in force at the beginning of 1994.

<sup>15</sup> In 1989 they employed 2.203 m people.

<sup>16</sup> The most important problems which have to be solved follow from the indivisibility of most of a cooperative's assets and from the typically huge discrepancy between the original share fund and the actual share capital.

## 5. Methods and results of privatization in the narrow sense

The methods and techniques of proper privatization which have been used in Poland include: capital privatization, privatization through liquidation using either the Privatization Act or the law on state-owned enterprises, the ‘privatization express’, sectoral (branch) privatization and privatization through restructuring. This section discusses all of these as well as privatization of banks and insurance companies and privatization in agriculture, which constitute special cases.

### 5.1. Capital privatization

Capital privatization usually starts with the decision of the Ministry of Privatization (MOP, in Polish called the Ministry of Ownership Changes), to transform an SOE into a joint stock company with the state as single shareholder. In exceptional cases such a decision can be taken unilaterally by the Prime Minister,<sup>17</sup> but normally the initiative belongs either to the SOE concerned, i.e. to its executive director and the employee council (after having obtained the opinion of the general assembly of the employees (delegates) as well as the opinion of its Founding Body), or to its Founding Body – typically a minister – with the consent of the SOE (Article 5 of the Privatization Act).

Initially a company emerging from such a transformation remains exclusively owned by the State Treasury. It assumes all the rights and duties of the transformed SOE and the Commercial Code applies (Articles 7 and 8). Yet privatization implies that shares are disposed to third parties and the MOP is given two years to do it, assuming that proper asset valuation has been completed and the legal status of a company’s assets determined. It can choose one of the following three possibilities: an auction, a public offer, and negotiation after a public invitation (Article 23, para. 1).<sup>18</sup>

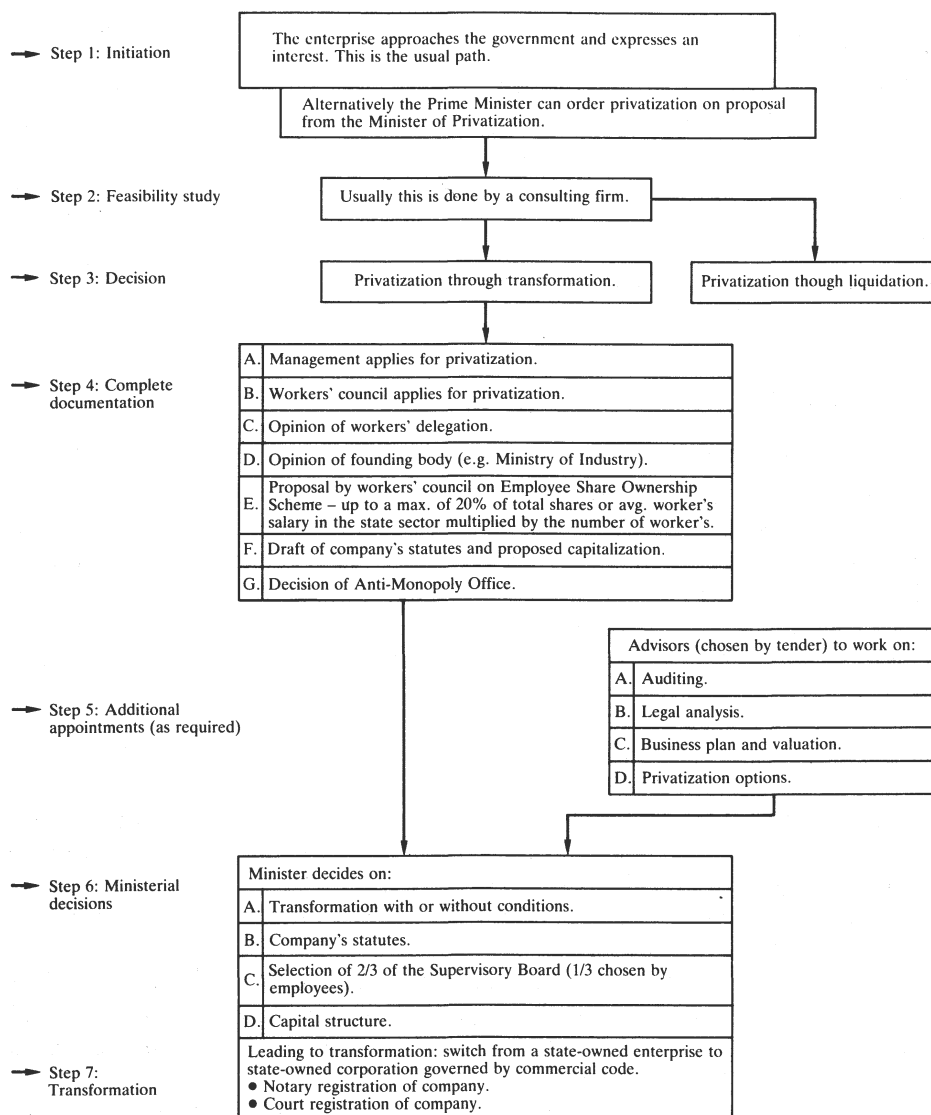
The subscription for the first public offer started on 30 November 1990. Part of the shares in five companies – 4.33 million out of the total of 6.5 million shares – were offered to the private sector (because state legal persons had to have special permission to purchase privatization shares).<sup>19</sup> From then until the end of 1993 this method of finding buyers for all or some shares in privatized companies

<sup>17</sup> Until the end of 1993 such decisions were taken only in respect to SOEs which are to take part in the mass privatization programme.

<sup>18</sup> Article 23, para. 2 reads as follows: ‘In specific cases, the Council of Ministers, on a motion of the Minister of Privatization, can permit State Treasury shares to be sold in a different manner from those specified in para. 1’.

<sup>19</sup> According to the Privatization Act employees are entitled to buy up to 20 percent of shares at a 50 percent discount, subject to the total value of the discount not exceeding one year’s wages.

## 12. Privatization in Poland 1989-93: Policies, methods, and results



**Figure 2.** Privatization through transformation Source: Jermakowicz (1992)

was used in 18 cases (but only in one case in 1992) and their shares are traded, together with those in four other companies, on the Warsaw Stock Exchange, which began trading on 16 April 1991.<sup>20</sup>

<sup>20</sup> It may be of interest to notice that, in real terms, expressed as a ratio of the price of 15 December 1992, to the subscription price of December 1990, adjusted for inflation (128 percent),

Far more successful, especially more recently and from the point of view of state revenue, were trade sales, especially those in which foreign investors were the buyers, and leveraged buy-outs (LBOs).<sup>21</sup>

Altogether, by the end of 1993, 98 cases of ‘individual capital privatizations’ were completed (see Table 3). The sum total of payments received by the Treasury from ‘individual capital privatizations’ until then was equal to about \$520 mln.

## 5.2. Privatization through liquidation using the privatization act

The space devoted in the Act – 26 articles on ‘capital privatization’ against only 6 on ‘liquidation privatization’ – reflected the priorities and expectations of the official privatizers in the early 1990. These priorities were challenged within the government in the summer 1990. The developments which followed passing the Act have reflected the new approach, stressing techniques which were capable of accelerating the process (see section 3 above). In terms of the number of privatized medium-size SOEs, privatization through liquidation has proved to be the most effective technique, and leasing the most popular procedure of its implementation.<sup>22</sup>

The very name ‘liquidation privatization’ is misleading insofar as the SOEs privatized in this way are in fact in a relatively good financial position. Under this procedure, a given enterprise is dissolved or wound up as a SOE,<sup>23</sup> and its former employees set up a new company, with or without the participation of outside investors. This new company then takes control over all or some<sup>24</sup> of the assets of the liquidated enterprise. More precisely, to quote the Act, a Founding Body, after obtaining the consent of the Minister of Privatization, may rule that a SOE be wound up in order to:

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share prices of the first five companies privatized by public offer were as follows: Exbud 1.11; Próchnik 0.38; Kable 0.23; Krosno 0.21; Tonsil 0.15. These results were hardly encouraging for the purchase of shares of privatized companies. An extraordinary boom on the Warsaw Stock Exchange, in these and all other shares, however, took place in the course of 1993.

<sup>21</sup> In fact, the very first privatization, the meat processing company Zakłady Mięsne in Inowrocław, was a leveraged buy-out. Makowski (1990) gives a very detailed account of this pioneering enterprise.

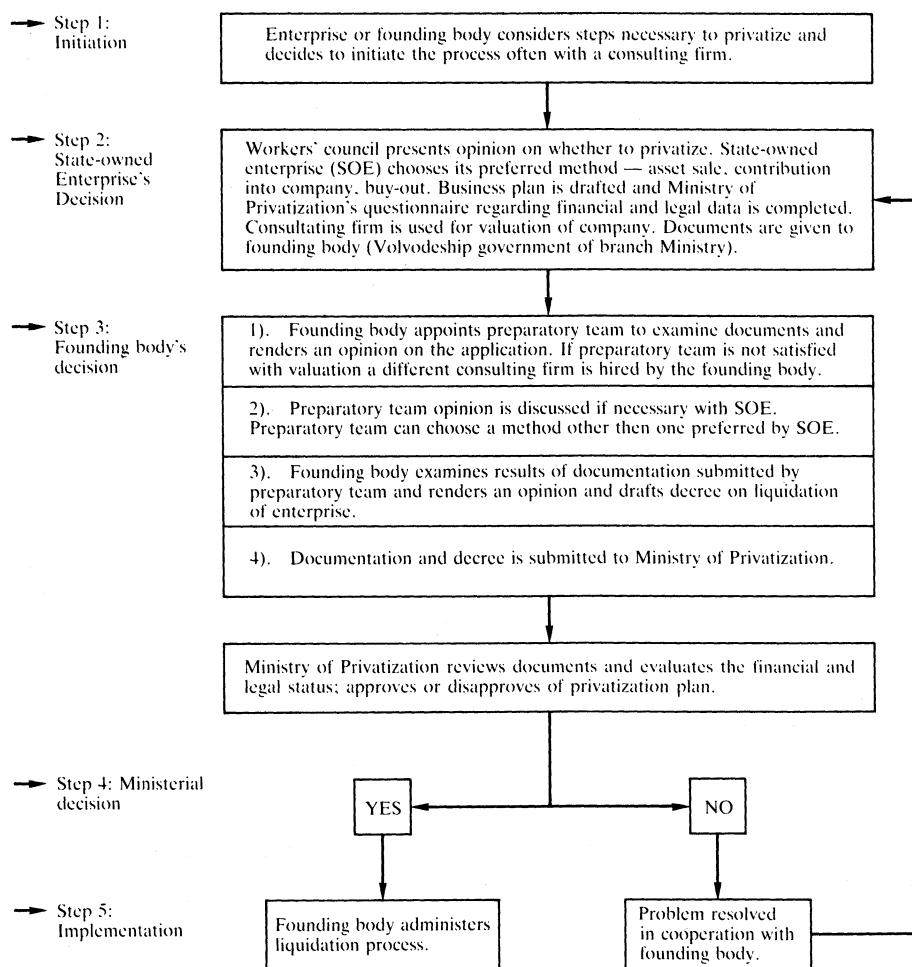
<sup>22</sup> In the case of leasing ownership rights can, but do not have to, be transferred to the lessees at the end of the contract. Nevertheless, since control rights are fully transferred from the very beginning, it seems appropriate to treat this as real privatization. What is more, the planned amendments to the Pact on privatization envisage changing leasing into deferred payments once 30 or 40 percent of payments have been made.

<sup>23</sup> Strictly speaking, from the legal point of view privatization of SOEs as SOEs was impossible: an SOE could neither sell itself nor be sold as a whole, and any revenue from selling its assets had to stay in the given SOE, preserving in this way its value. That is why, to be privatised, a SOE had to be either transformed into a company (commercialized) or liquidated (Gruszecki 1990).

<sup>24</sup> They have to constitute at least 20 percent of the book value of the liquidated enterprise.



- sell its assets, or integrated parts of the enterprise's assets,
- use the enterprise's assets or integrated parts of its assets as a contribution to a company,
- allow the enterprise's assets or integrated parts of its assets to be let against payment for a specified time (Article 37, para. 1).



**Figure 3.** Privatization through liquidation *Source:* Jermakowicz (1992)

Until the end of 1993, this technique was applied in 917 SOEs, 73.5 percent of which were to use leasing, and the process was completed in 707 of them.

The popularity of this type of privatization among employees stems from two reasons: they are treated preferentially in terms of access to assets, and only some



money must be paid out of their own pockets<sup>25</sup>. On the other hand, unlike cases in which the techniques described in the previous and the next sub-section were used, this kind of privatization is usually accompanied by a far reaching restructuring, both before and after ownership transformation. That is, this procedure is usually undertaken with a prepared business plan. From this point of view it is a pity that, because of limited access to credit, the size of liquidated SOEs is usually the most important factor limiting more frequent use of this technique. Further developments will, however, depend on the extent to which the present tendency to restrict trade in stocks and shares is overcome, thus allowing more dynamic growth of these companies.

### 5.3. Privatization through liquidation using the law on state-owned enterprises

A sharply increased level of international and domestic competition in 1991, the second year of transition, has led to a rapid deterioration in the financial position of many SOEs.<sup>26</sup> This situation had to be taken into account in designing privatization policy. The bankruptcy of an SOE, triggered for example by not paying the so-called dividend tax, did not imply that some or even all of its assets could not be used profitably, especially if they were to be transferred to the private sector. Such a transfer is a form of privatization, but the legal instrument used is the Act on state-owned enterprises of 25 September 1981, with later amendments, not the Privatization Act.

In practice things are organized in the following way. The Act under consideration, Article 20, foresees the following situations in which an SOE can be liquidated:

1. The after-tax profits are not high enough to pay the 'dividend';<sup>27</sup>
2. The court or the administrative authorities banned all previous activities of the given SOE and no new activities had been started;
3. The government-appointed receiver proposes liquidation;
4. Stocks, shares and/or bonds plus assets leased or rented constitute more than a half of all assets of the given SOEs.<sup>28</sup>

<sup>25</sup> Preferential treatment enjoyed by employees consists in that Art. 37, para. 1.3 can be used only if most employees become stakeholders in the new company to which the enterprise's assets or integrated parts of its assets [are] to be let against payment for a specified time.

<sup>26</sup> On the behaviour of Polish SOEs since 1989 see, *inter alia*, Schaffer (1992, 1993), Dąbrowski *et al.* (1990, 1991a and b, 1992a), Maj (1991), Mayhew and Seabright (1992), Wawrzyniak (1992), Pinto *et al.* (1992, 1993).

<sup>27</sup> Under the Pact on Enterprise, to be implemented in the second half of 1994 (see section 8), the dividend tax is to be discontinued.

<sup>28</sup> *Inter alia*, this is to avoid creating empty shell-type SOEs after they set up a joint venture.

If any of these situations happens, the founding ministry may decide, either on its own or when solicited by the managers, to liquidate the enterprise.<sup>29</sup> Out of 1082 enterprises liquidated in this way until 31 December 1993, 87 were declared bankrupt and their assets and liabilities were taken care of by the courts. In other cases a liquidator is appointed to decide what to do with the assets, which may either be auctioned off or become a contribution in kind to a new company, set up, for example, by former employees. However, by the end of 1993 only 15.1 per cent of the liquidations in question, i.e. 172 out of 1082, ended up in striking the enterprise off the SOE register (see Table 3). This outcome indicates that it is easier to liquidate an enterprise than to find alternative uses for its assets. Recession and excess supply of second-hand capital goods are possible explanations for this state of affairs. At the same time cases of selling a (bankrupt) enterprise for a symbolic price are still sporadic. The authorities are aware that waiting too long for a buyer willing to pay a higher price may result in a rapid depreciation of assets, even to the point that nobody would be ready to accept them as a gift. But they often prefer to risk this rather than be accused of colluding with the buyer at the public expense.

**Table 3.** Number of privatized state-owned enterprises

	Total	Capital privatization	Mass privatization	Liquidation	Privatization
				Art. 19	Art. 37
31.12.1990	6 (130)	6 (58)	0	0 (28)	0 (44)
30.06.1991	113 (505)	13 (162)	0	21 (173)	79 (170)
31.12.1991	188 (1258)	30 (244)	0 (64)	44 (534)	114 (416)
30.06.1992	385 (1724)	36 (286)	0 (178)	78 (708)	271 (542)
31.12.1992	570 (2052)	53 (301)	0 (183)	118 (853)	399 (715)
30.06.1993	781 (2265)	77 (316)	0 (185)	123 (967)	581 (797)
31.12.1993	977 (2521)	98 (336)	0 (186)	172 (1082)	707 (917)

Source: Central Statistical Office, *Dynamika Prywatyzacji*, various issues; own calculations.

Note: Figures in brackets refer to the number of enterprises qualified to take part in the privatization programme.

#### 5.4. 'Privatization express'

The sections above described the standard privatization techniques adopted in Poland. However, within a limited legal framework provided by the Privatization Act and the Enterprise Act, more imaginative approaches are also possible, and

<sup>29</sup> An approval from the MOP is also necessary, this was only a formality and not a single case has been rejected up until now.

the MOP has been trying to make use of at least some of them. The most relevant initiatives are presented below.

‘Privatization express’ is a form of liquidation privatization’ aiming to speed up the sales of small and medium size SOEs (employing up to 500 people) to Polish investors.<sup>30</sup>

It works as follows.<sup>31</sup> Founding bodies propose which firms they would like to be sold in this way, but each of their choices has to be approved by the MOP. When all necessary documents are ready, the sale of an enterprise is announced and after two weeks a commission staffed by people from the founding ministry negotiates the sale, taking into account prices offered,<sup>32</sup> structure of payments, level and structure of employment, and investment potential of the buyer (Latuch and Głogowski, 1992).

By the end of 1992 the ‘express’ sales of 103 firms were announced, 45 of them were completed, and negotiations are still going on in 23 cases. This may appear slightly disappointing, but an important conclusion to be drawn from this experience is that various forms of auctions, very attractive from the theoretical point of view,<sup>33</sup> are likely to fail if too many conditions, the lowest acceptable price included, are imposed.

## 5.5. Sectoral (branch) privatization

In principle, a sectoral (branch) privatization may be either capital privatization or liquidation privatization. What makes it a distinct form of privatization is an attempt to exploit economies of scale, to the extent that problems faced by all enterprises in the given (sector of) industry are common or similar. For the MOP it is also easier, under the sectoral approach, to shape the future market and ownership structure of these industries, taking into account the requirements of competition policy and capital investment. In other words, sectoral (branch) privatizations combine ownership transformation with restructuring and with industrial policy.

Sectoral (branch) privatizations are to be based on detailed industrial studies of 34 sectors, ranging from petrochemicals and paper to sugar and beer. These are commissioned by the MOP from domestic and foreign consulting firms and

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<sup>30</sup> Foreign investors purchase only those enterprises which are located in regions particularly affected by unemployment. More generally, in those regions the rules of ‘express privatization’ are much more liberal (Latuch and Głogowski, 1992).

<sup>31</sup> The legal basis for this procedure is provided by the Act on the Privatization of State-owned Enterprises (Article 37, para. 1) and by the Act on State-owned Enterprises (Article 18a, para. 2 and 3).

<sup>32</sup> It is usually equal to three year profits, but not less than 75 percent of the book value, adjusted for the value of the land.

<sup>33</sup> See, e.g., Maskin (1992), Bolton and Roland (1992).

investment banks. Authors of the studies are supposed to participate actively in subsequent privatizations, among others helping to find core investors.

So far now there has been one clear success story, the detergent products industry. Since privatization the industry includes several international producers.<sup>34</sup> Another example of a successfully completed sectoral privatization is the car industry, with Fiat, General Motors, Peugeot and Volkswagen participating. Unfortunately, sectoral (branch) privatizations were considerably slowed down in the first half of 1992 under the Olszewski's Premiership, which resulted in many sectoral studies that were already prepared becoming out of date.

A special case concerns foreign trade companies. These are a remnant of the old system, when foreign trade was monopolized by the state. Some of them have nevertheless managed to adjust well to the new reality.<sup>35</sup> Out of 54 such companies, by the end of 1992 11 had already been privatized, 7 were being sold, and 5 were undergoing liquidation. Restructuring had started in four of them, and the rest were at various preparatory stages.

## **5.6. Banks and insurance companies**

Banks and insurance companies constitute a special case, firstly because their founding organ is the Finance Ministry and, secondly because their privatization is considered to be an opportunity to restructure these two crucial areas for creating the institutional framework of the nascent capital market in Poland.

Under the old system Poland, like all the other Soviet-type economies (STEs), had the so-called monobank and a few specialized banks. In 1988 the former was divided, along regional lines, into nine commercial banks.<sup>36</sup> Despite the fact that since 1988 scores of new banks have been created, their combined market share is still less than 5 percent.

The decision of the Council of Ministers of 14 May 1991 made possible the transformation of the nine commercial banks into joint stock companies, with

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<sup>34</sup> The most important producers are Unilever, Henkle and Benckiser. Another important company in this industry, Procter and Gamble, preferred initially to import its products, but in the late 1992 it began constructing a new plant.

<sup>35</sup> Most of them were already joint-stock companies and their privatization was much easier because it was enough to diminish the proportion of shares owned by the Treasury by simply issuing new shares and selling them exclusively to private firms and/or the public. In fact, precisely this method was used in the case of Universal, which had most of its shares in private hands already under the Rakowski government.

<sup>36</sup> The establishment of an investment bank in 1993, to conduct the remaining NBP commercial activities, would complete the process of separating commercial from regulatory functions of the central bank.

the Treasury the single shareholder.<sup>37</sup> Their subsequent privatization is expected to take place within the next three to five years. Public offers of the first two – Bank Śląski in Katowice and Wielkopolski Bank Kredytowy in Poznań – have taken place in 1993. To help the process along, the end result of which is to be an efficient banking system of West European quality, seven of the nine commercial banks were paired with various banks from the EC. The government intends to retain the majority of the bank shares in Polish ownership, while encouraging some of the foreign banks to buy shares of their supervisees.<sup>38</sup> To proceed with these privatizations, two fundamental problems have to be solved first: undercapitalization of banks and bad debts of enterprises. The new Act on Financial Restructuring of Banks and Enterprises, dated 19 December 1992, aims to deal with these two related problems. In particular, it allows for debt-for-equity swaps and an injection of capital from the budget, the World Bank and the G-24 Stabilization Fund.

Despite the fact that many new insurance companies have been created in the years 1990-3, this market is still dominated by two firms: PZU SA and TUiR Warta SA, controlling respectively 70 and 16 percent.<sup>39</sup> The main problem to be solved is the division of the PZU SA. The document presented by the government in December 1992<sup>40</sup> proposed that two nation-wide companies would be created, both having 50 percent of shares in all regional branches.<sup>41</sup> The restructuring process is to be finished by the end of 1994. Privatization by a public offer should take place in 1995. In the case of the TUiR Warta SA, the aim of having the majority of its shares in private hands will be achieved by issuing new shares, offered to the public. Eventually the shares now held by the Treasury will also be sold.

As insurance companies are usually important institutional investors, privatization of the PZU and Warta is expected to help in speeding up the process of

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<sup>37</sup> The cases of other state owned banks, BGZ, PKO, BP, PKO SA and Bank Handlowy etc. are too complicated for any realistic scenario to be proposed at the present time.

<sup>38</sup> An agreement on the debt repayment with the London Club – commercial banks whom Poland owes about 13 billion US\$ – would help the process along. The negotiations restarted in February 1993 and an outline agreement was reached in March 1994.

<sup>39</sup> PZU is still fully owned by the Treasury, while a new issue of shares in TUiR Warta reduced the proportion of shares held by the Treasury to 48.5 percent. The main private contestants Westa and Westa-Life, which won almost 10 percent of the insurance market in Poland, had their licences withdrawn in the autumn of 1992 and went into receivership, which further complicates the prospects for increasing competition, as foreign firms' entry will be severely restricted until 1999.

<sup>40</sup> 38. CM (1992a). See also *Rzeczpospolita*, 306 (3344), 31.12.1992-1.01.1993.

<sup>41</sup> An alternative and most likely cheaper proposal, put forward by PZU's management, advocates setting up one nation-wide company, taking over 50 percent of the present structure, and five smaller companies based on regional branches.

privatization of other companies and the development of capital markets, particularly the stock exchange.

### 5.7. Privatization with restructuring

This privatization technique was prompted by the increasing number of small and medium SOEs which were considered viable in the medium and long term, but for various reasons were currently in deep trouble. To meet the problem, in summer 1991 a restructuring team was created under the leadership of W. Jermakowicz and T. Stankiewicz. It developed a new technique which combines privatization with restructuring (Stankiewicz and Jermakowicz 1991). Management teams – individuals and/or institutions, domestic and/or foreign – would be invited to compete with each other in terms of restructuring plans and assessments of how much a given enterprise is worth. Restructuring would be carried out by the management team which wins the competition and the ultimate goal is to sell the restructured enterprise.

Although legally an enterprise under such restructuring remains, until the moment of its sale, owned by the State Treasury, this technique was designed to assure the best possible incentive structure for the winning management team. Apart from salaries, the managers would receive the share of after tax profits which corresponds to their own contribution to the capital of the company as well as, after the contract has been implemented, a share of the revenue from selling the enterprise. The share is 70 percent of the increase in enterprise value resulting from the restructuring effort of the management team. Both shares are parts of the contract.

In the autumn of 1992 the first 15 SOEs were selected to participate in the programme, which is organized by Deloitte and Touche.<sup>42</sup> First contracts were awarded in 1993. Whether it works in practice remains to be seen, but financial restrictions imposed on the possible participants as well as fears of dysfunctional or collusive behaviour seem to be the most important obstacles to more extensive use of this method.

### 5.8. Privatization in agriculture

In 1989 71.7 percent of agricultural land was in private hands, while 3.9 percent was cultivated by cooperatives. The rest was owned by the state and organized in state-owned farms, known as PGRs. At that time 959 PGRs<sup>43</sup> owned 3.507 million hectares of land and employed 441,000 people. The systemic reforms

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<sup>42</sup> For the list of selected enterprises, see *Prywatyzacja*, 1992, 12: 3-4.

<sup>43</sup> By the end of 1991 the number of PGRs increased to 1409.

of 1989-90 led most of them to the verge of bankruptcy in 1991 and 1992. To solve the ownership problem in this sector of the economy, a special Agency of the State Treasury (*Agencja Własności Rolnej Skarbu Państwa* – AWRSP) was created. Its main task is to take over all PGRs, and find for them either outright buyers or leasees. By the end of 1993, 1557 PGRs became ‘treasury farms’. Only 58,600 hectares were actually sold.<sup>44</sup> It seems that limited outside demand for land is emerging as an important barrier. Therefore it was proposed that each employee should be given a 0.4 hectare plot free of charge. This would help them to survive the most difficult period, and would in the process dispose of 100,000 hectares.

Despite the AWRSP’s effectiveness in taking over the PGRs and despite high expectations, the process of ownership changes in agriculture will be long and complicated. The main barrier is financial; the PGRs are heavily indebted, their assets are often over-valued, and the price of credit is still very high. The unsolved reprivatization problems and gaps in legal documentation further slow down any progress. Finally, the whole process is causing serious social problems and the attitudes to privatization of those involved is often highly emotional (Olko-Bagieńska *et al.* 1992).

## 6. Privatization in 1993 and prospects for 1994-5

Some of the plans of the Polish government in general and of the MOP in particular have already been mentioned in this chapter. All of them were listed and summarized in two documents: the *Memorandum of the Government of Poland on Economic Policy* (CM 1992b), prepared for the IMF in December 1992, and in the *Proposals for the privatization in 1993* (CM 1992a), sent for approval to Parliament in the same month.<sup>45</sup> Their implementation will be strongly affected by the Pact on Enterprises, a product of negotiations between the government, trade unions and employers. This Pact includes, *inter alia*, amendments to the Act of 13 July 1990.

All approaches to privatization, described above, continued in 1993. It is envisaged that in the years 1993-4 1500-2000 SOEs, of about 7000 still remaining, will be commercialized and that privatization with restructuring will finally commence. Thirteen sectoral (branch) privatizations will also continue. ‘Privatization express’ should transfer to the private sector about 40 SOEs and debt-for-equity

<sup>44</sup> Central Statistical Office, *Informacje* 1993; p. 70, Warsaw, 27 January 1994.

<sup>45</sup> The Act on the Privatization of SOEs (art. 2, para. 2) requires that the government’s plans for and reports on the progress of privatization are presented to the Sejm for approval.



swaps will be encouraged, but initially limited to domestic banks and investors. Classical 'capital privatization' will result in only 8 to 10 public offers. Some 400 SOEs will take part in 'liquidation privatization' of the first type, i.e. they will be wound up in order to be privatized. The assets of almost 90 percent of them will be leased using liberalized procedures compared to those in 1992. Bankruptcy liquidation will affect an additional 200 SOEs.

The most important issues in 1993 were, however, mass privatization of large SOEs, and reprivatization.

## 6.1. Mass privatization

Mass privatization is typically understood as (almost) free distribution of shares of a large number of state-owned enterprises, usually medium and large-scale, directly or through intermediaries in the form of mutual investment funds, banks, pension funds or holdings. In the West it was once advocated by Milton Friedman and Samuel Brittan, but never really tried in practice. In the context of the SOEs it was first proposed, as has been mentioned, by Lewandowski and Szomburg.<sup>46</sup> Despite many objections formulated by the critics of their proposal, it slowly gained political currency. Among other things, the Act of 13 July 1990 contains a clause, inserted at the very late stage of the parliamentary debate, which reads as follows:

The Parliament, on a motion of the Council of Ministers, shall pass a resolution regarding the issue and value of Privatization Coupons which can be used to pay for:

- a. acquiring shares issued as a result of the transformation of an SOE;
- b. acquiring title to participation in financial institutions (Mutual Investment Funds) which will have at their disposal shares created as a result of the transformation of SOEs;
- c. acquiring enterprises or integrated parts of the assets of SOEs.

The Privatization Coupons issued ... will be distributed free of charge in equal volume among all citizens of the Republic of Poland resident in the country. (Article 25, para. 1 and 2).

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<sup>46</sup> Gomulka (1989) can be also interpreted in this way. The papers by Balcerowicz (1990a and b), Olex (1990) Kawalec (1990a), Bieć and Gomulka (1990), Sachs and Berg (1990), Lipton and Sachs (1990) represent somewhat different variations of the same central proposal. Suggestions by Hinds (1991), Frydman and Rapaczyński (1991), Tirole (1991, 1992), and Blanchard *et al.* (1991) belong to the same family. All these schemes, different as they were, expected financial intermediaries, either holdings, banks or mutual investment funds, to play a key role in solving the agency problem. Technical papers by EBRD (1990 and 1991) and Warburg (1990), among others, have been useful early inputs in the formulation of the policy.



The initially slow pace of ownership changes and the slow adaptation of SOEs to the new economic environment won support for mass privatization from three key figures: Lech Wałęsa, Tadeusz Mazowiecki and Leszek Balcerowicz. Once Janusz Lewandowski became Minister of Privatization in the Bielecki government (end of 1990 until end of 1991), an acceleration of privatization along this route seemed likely. In the event this apparently simple idea proved to be a logistic nightmare. What is more, all attempts to translate it into law which would make the general provisions of the Act specific and operational suffered from continuous political turbulence. The parliamentary election of 27 October 1991 made any serious discussion impossible, not to mention drafting the necessary legislation. Tomasz Gruszecki, responsible for ownership changes in the Olszewski government (December 1991-June 1992), restarted work on the draft but finished it only in June 1992, when the government fell. It was therefore Janusz Lewandowski again, returned to office in July 1992, whose task it was in 1993 to win the approval of the Polish Parliament for mass privatization of this kind. He achieved this objective in April and May 1993, when, respectively, the Sejm and the Senate approved the Law on National Investment Funds and their privatization.

The implementation of the mass privatization programme will be organized as follows. The key intermediary institutions are to be the National Investment Funds (NIFs). There are to be about 30 of them (initially 20) and they are supposed to combine the activities of three different financial institutions known in the West: venture capital/turn around agencies, holding companies, and closed-end funds (Jermakowicz and Jermakowicz, 1992). Each fund is to have a board of directors, a majority of them Polish citizens, appointed by a special selection committee.<sup>47</sup> These boards will supervise fund managers, who in turn will play the role of effective owners with respect to companies taking part in mass privatization. They are supposed to maximize the long-term worth of assets managed by their funds on behalf of the millions of small individual owners, and will be remunerated accordingly.<sup>48</sup>

The NIFs will receive 60 percent of shares in participating companies, but only 27 percent of them will be distributed equally among all NIFs. The remaining 33 percent will be bid for, and will go to one NIF, so that each NIF becomes a core investor (or dominant shareholder) in about 10 to 20 companies.<sup>49</sup> Employees of

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<sup>47</sup> Members of the selection committee were to be appointed by the Parliament (4 by Sejm and 1 by Senate), 2 by nationwide trade unions (one by each of them) and by the Council of Ministers (12).

<sup>48</sup> Out of about 200 firms which were offered the possibility of providing the executive teams, 35 expressed their readiness to participate in the selection process by submitting detailed offers. The authors of best offers will be awarded contracts to run NIFs. Obviously, no contract can be signed before the final legal framework is ready and binding.

<sup>49</sup> Of the remaining 40 percent of shares, 15 percent will be given free of charge to the employees, who at present are entitled to buy 20 percent of shares at a 50 percent discount, and 30 percent

the participating enterprises will be given 15 percent of shares in their enterprises (Art. 46.2).

The NIFs will themselves be joint stock companies owned by Polish citizens who will exchange their participation certificates for shares of the NIFs, once they become quoted by the Warsaw Stock Exchange. These certificates will be distributed at a nominal registration fee of 10 percent of the average monthly wage to all eligible people who choose to participate in the programme.<sup>50</sup> The exchange of certificates for shares will however be possible only after one full year of working of the scheme, when first company reports will be ready for assessment. In the meantime, secondary trading in certificates among citizens (sales of certificates for cash) and in the shares of privatized companies among funds (swaps of shares for shares) will be allowed.

The government objectives of this programme are as follows: (1) accelerating restructuring of the enterprises involved, (2) further developing capital markets, (3) lessening the pressure on wages and subsidies, (4) attracting higher foreign investment, (5) increasing the long-term worth of the enterprises and job security for the employees (MOP 1992b). It remains to be seen whether all these objectives will be achieved. The energy of the MOP has so far concentrated, perhaps excessively, on perfecting the legal framework within which the NIFs are supposed to operate, creating in consequence a system which is quite complicated for a society with, until recently, almost no experience of capital markets. Another important question mark is raised by the possibility that the NIFs may constitute a powerful pressure group vis-a-vis the government. However, the really central question is whether the few funds will be capable of providing efficient oversight. This is related to the incentives for, and the control of, the managers of such funds. An incentive structure chosen is to supplement a management fee with stocks: 1 percent for each year and 5 percent at the end of the 10 year period (MOP 1993).

The first SOEs to be privatized in this way were selected as early as autumn 1991 and transformed into joint stock companies fully owned by the Treasury. The process has continued since then and, in early 1994, about 400 out of the envisaged 600 were selected for the programme and transformed into such companies. The sales of the 400 account for about 20 percent of total public enterprise sector sales. According to the Law on National Investment Funds and their privatization these 400 enterprises will constitute the first tranche. The other 200 enterprises

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will be kept by the Treasury (18 percent of these shares will be used to pay pensions and salaries of state employees).

<sup>50</sup> It is estimated that if 10 million people pay for their certificates, the cost of organizing mass privatization in Poland will not exceed \$20 million, while the registration fees paid in would amount to \$200 million. The estimated book value of assets per certificate would be about \$500.

are to follow, depending on decisions of the enterprises themselves regarding whether or not they want to participate. The fact that the Pact on Enterprises is to force SOEs to decide about the method of their privatization within a fairly short period of time after the Pact comes into force, has already influenced many SOEs to join the mass privatization programme. The mere prospect of inevitable privatization is also accelerating the process of adjustment and restructuring.

## 6.2. The Pact on Enterprises

The Pact on Enterprises, was proposed by Jacek Kuroń, Minister for Labour and Social Security in the Suchocka government, in July 1992. Negotiations between the government, almost all trade unions and the representatives of employers took place from October to December of that year. The tripartite Pact was signed on 22 February 1993 and is the first agreement of that kind in the post-communist countries. The Pact has been codified in 13 pieces of proposed parliamentary legislation, to be considered in 1994.

The Pact has three parts regarding labour issues, financial matters and privatization. In order to speed up privatization, workers are to be given a period of time, yet to be specified, to choose a form of it. If they fail to do so, the MOP will be free, and indeed obliged, to take the decision. Financial terms for leasing agreements under liquidation privatization will be eased. What is more, ownership rights will be transferred before all payments are made, giving enterprises better access to bank credit. Instead of being entitled to purchase 20 percent of shares at a 50 percent discount, workers will be given 15 percent of shares free of charge. The right of employees to elect some members of the supervisory board will be a permanent one. Finally, the excess-wage and 'dividenda' taxes<sup>51</sup> will be phased out and a new tripartite commission will be set up to negotiate nationwide pay agreements.

## 7. Constraints to privatization

Bolton and Roland (1992) divide all major constraints to privatization into five categories: stock-flow, fiscal, informational, administrative and political. This is a useful categorization and in this section we shall briefly comment on these constraints and discuss their impact in Poland.

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<sup>51</sup> The former is a highly progressive tax on excess wages, the latter is a tax levied on a certain category of capital assets.

The *stock-flow constraint* has already been mentioned. It denotes the fact that the stock of assets to be sold is large compared to the flow of new savings of households or the flow of future profits of enterprises. Since excessive lengthening of the period of privatization was not acceptable to Polish reformers, there remained two other options: selling to foreigners at full prices and to domestic investors at give-away prices.

The *fiscal constraint* is typically a serious problem during transition. As the economy shrinks, social expenditures increase, and enterprises profits fall, a large budget deficit tends to emerge. One way of reducing the deficit could be to sell much of state assets at 'reasonable' prices. This would require slowing down the pace of privatization. Keeping the deficit low is needed to achieve macroeconomic stability, while privatization is needed to speed up microeconomic restructuring. Therefore the fiscal constraint considerations may imply that there exists a tradeoff between macroeconomic stability and privatization. An additional support for the presence of such a trade-off is derived from the evidence of a relatively large incidence of tax avoidance in the private sector.

These arguments are, however, easy to overstate. The tax avoidance is serious only in the sector of very small private enterprises, those employing less than five workers. Such enterprises are typically new ventures rather than the products of state-driven privatization. A major cause of the fiscal problem is also 'tax strikes' by powerful state enterprises. Privatization of these may in fact help to meet the problem. Some larger private firms, especially with foreign participation, are offered tax incentives. But the incentives operate for a short period of time, and their purpose is to induce greater investment and therefore to increase future tax revenue. Selling state enterprises to poor domestic investors at full prices, for cash or against future profits (no-cash bids, advocated by Bolton and Roland, 1992), has the disadvantage of reducing private resources needed for restructuring of the privatized enterprises. The strategy would amount to making use of scarce private savings for the purpose of financing public consumption.

The fiscal implications were considered by the Polish reformers in the summer of 1990, when privatization policies were formulated, and again in 1991-3, when budget deficits became a problem. The policy chosen was that efficient and speedy privatization rather than large revenue from privatization from domestic investors should be the dominant concern of the MOP. At the same time it was decided to reduce the scale of tax privileges to joint ventures and to strengthen tax discipline in the private sector. The introduction of VAT in July 1993 was also intended to achieve the latter end. At the same time the government was ready to meet some categories of budgetary obligations with the shares of state enterprises. Already in 1990 the London Club of creditors was informed that

stock-debt swaps could be one of the debt reduction instruments. In 1992 the parliament offered the government to settle with shares outstanding pay obligations to the employees of budgetary units and some categories of pensioners. The first tranche of nearly 400 large state enterprises under the mass privatization programme of 1993, worth about \$4 billion, is to be used in part for this purpose. The state shares will also be used to compensate former owners for nationalization of their property. A wider use of shares as a way of payment to pensioners was considered in 1991, but rejected on the grounds that it would be opposed by pensioners themselves.

The *informational constraint* relates to limited ability to value enterprises in the new (market) environment. This is less of a problem if assets are given away or auctioned off. In those situations it was accepted that the book value can be a rough guide.

Ascribing excessive importance to the concept of book value or, alternatively, stressing the need to provide independent assessments of the value of assets has nevertheless proved time consuming. Repeated controls by the NIK, a state audit office, caused central privatizers to become over-cautious. This was particularly damaging because privatization in Poland has from the very beginning been highly centralized,<sup>52</sup> partly because of bad experiences with *nomenklatura* privatization.

*Administrative constraints* have caused a serious bottleneck. The constraints favoured the choice of simple privatization techniques and forced the use of outside consultants, some of them foreigners. In order to make better use of local resources many privatization offices were set up throughout the country.

The category of *political constraint* brings us to the problem of the attitudes of Polish society towards privatization. Paradoxically, public support for privatization had been at its strongest before the process of systemic transformation started. A CBOS survey of spring 1989 showed that 97.9 percent of workers and 99.2 percent of managers favoured privatization in the handicraft sector, retail trading and small-scale industrial enterprises, while privatization of large industrial enterprises, the least favourably viewed, was supported by, respectively, 58.9 and 56.6 percent of the members of the two groups. In February 1990 those accepting the view that privatization was necessary in Poland still outnumbered its opponents by a ratio of 5:1 (56.3 percent against 11 percent of respondents), but only 14.7 percent were prepared to invest their savings in shares of privatized companies.

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<sup>52</sup> The MOP has 13 regional offices, but their role in the process is almost exclusively subsidiary. The central privatizers numbered less than 30 for most of 1990. The staff of the MOC increased during 1991-2 to reach about 200, still a very small number by the East German standards.

Two and a half years after the Privatization Act was passed, privatization is still perceived as something unavoidable, but, again according to CBOS, between January 1991 and December 1992 the proportion of people thinking that privatization is good for the Polish economy diminished from 47 percent to 32 percent and the share of people rejecting this view increased from 5 percent to 19 percent.<sup>53</sup> On the other hand, only 4 percent of those surveyed wanted to work in a privatized firm and only 14 percent were prepared to view the privatization of their own firm with hope rather than with fears.<sup>54</sup> The following are the primary concerns:

1. the distribution of state assets, in the form of shares or the revenue from their sales, may not be 'just';
2. high unemployment may be a by-product of privatization; and
3. too large a share of the economy may become foreign-owned or otherwise come under the control of foreigners.

Concern (3) was particularly strong at the start of the reform. However, it became subsequently evident that foreign capital is not eager to invade Poland. Advantages of attracting foreign capital and foreign management services to improve competitiveness and save employment have also been noted. Consequently this particular concern ceased to be a major factor, though it influenced somewhat the content of the mass privatization bill (see section 6).

Privatization in Poland, looked at as an exercise in the redistribution of wealth, does not present a clear picture. It is still too early to identify those who gain most. Slogans on the need to create a middle class are used often. But in practice the first move belongs typically to the workers and not to prospective investors. The desire to cushion the possible negative effects of privatization, the fears of which so far proved unfounded, often takes precedence over the efforts to create opportunities for entrepreneurship. The distrust, and even fear, which found their expression in the CBOS surveys quoted above, are quite understandable, but they were reinforced by political in-fighting, especially during the presidential election campaign of November and December 1990 and prior to the parliamentary elections of 27 October 1991 and 19 September 1993. The three elections resulted in many changes of government. As a consequence, apart from Krzysztof Lis who set up the privatization bureaucracy in 1989 and 1990 but never became cabinet minister, ministers in charge of privatization were Waldemar Kuczyński (autumn 1990), Janusz Lewandowski (twice: 1991 and from July 1992 to September 1993), Tomasz Gruszecki (the first half of 1992) and Wiesław Kaczmarek (from

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<sup>53</sup> In August 1991, the respective ratios were equal to 25 and 27 percent.

<sup>54</sup> This mixture of general support and of the desire not to be affected by this kind of change seems to be consistent with what the Polish public opinion thinks about market economy in general (Kolarska-Bobińska, 1990).

October 1993). This lack of continuity at the top was accompanied by many changes at lower levels of the ministerial hierarchy. Also important have been legislative delays, illustrated best by the fate of the laws on mass privatization and reprivatization.

## 8. A tentative assessment: concluding remarks

The measures typically used to assess the progress of privatization are the shares of the private sector in employment, capital ownership, output and investment. If we take the share of the GDP produced by the private sector, 50 percent in 1993, or the share of the private sector employment, 60 percent in 1993, it is evident that a very considerable success has been achieved. But if we compare the result with expectations as reflected in successive government programmes, some disappointment would be justified.

The question of whether privatization improves economic efficiency is now easy to answer for whole economies in the long run, but can be difficult with respect to particular enterprises in the short run, and be so even in relatively stable economies like the UK one (Yarrow 1989). The very process of fast systemic transformation as well as the sheer scale and complexity of the East European undertaking makes the comparison task virtually impossible. Higher consumer satisfaction from the wider range and higher quality of products and the much improved performance of the trade sector is in good measure due to privatization. But this improvement is probably not captured fully by the official statistics.

Three studies deserve attention. For 1991 Dąbrowski *et al.* (1992b) investigated 20 enterprises and for the period ending on 30 June 1992 the sample was increased to 55 enterprises (Dąbrowski *et al.*, 1992c), all of them at different stages of the ownership transformation process. The researchers were interested in almost all aspects of privatization, beginning with the question of who initiated the procedure and ending with the present distribution of shares. Although the profitability of privatized companies declined over the investigated period of time, this decline was smaller than for the economy as a whole. This is particularly true for those enterprises that underwent capital privatization. The two reports confirm that the main problem of privatization in Poland is politics and the state administration. But what makes their overall assessment relatively optimistic are efforts undertaken by many privatized companies to reorganize themselves, to introduce production modifications and to extend the scope of their activities. The third study is by Maciejka (1993). It reports the results of a survey in which 55 companies privatized by liquidation took part. The founding body for all of



them was the Ministry of Industry and Trade. Unlike Dąbrowski *et al.* (1992b and 1992c), Macieja's study is much more critical about liquidation privatization. He even comes to the view that management and worker buy-outs do not improve economic efficiency of privatized companies. It seems, however, that this disturbing conclusion does not really follow from the data presented by the author. He fails to compare the results from the sample with those for the economy as a whole and for the relevant sectors, in consequence ignoring the fact that the business environment was quite different in 1991 and 1992. Moreover, the very fact of privatization liberates the privatized enterprises from *popiwek* and therefore the management may initially accommodate demands for a wage increase.

These remarks are not supposed to imply that the picture is in fact a very rosy one. There are, in particular, problems with sufficient cash flow to finance large investment programmes necessary to compete with high quality imports. Initially it was common to be excessively optimistic about future profits stream. The fact that the leased assets could not be used as a collateral for bank credit made these problems more troublesome, but changes envisaged in the Pact on Enterprises should help to solve them (section 6).

The pace of Polish privatization, through the application of a wide variety of routes described in this chapter, is nevertheless extraordinary by Western experience, as it is revolutionary by historical experience of the country and the region.

This fast privatization has on the supply side been the primary factor accounting for the recovery in Polish GDP, 1.5 percent growth in 1992 and 4 percent growth in 1993. Much of this growth has taken place in the industrial private sector, as Table 4 portrays.

During 1992-3, privatization proper – in the form of direct transfer of ownership – is, in Poland, at best able to explain the fall of output of the state industry. The key source of industrial recovery, the largest in Central and Eastern Europe so far, has clearly been the very fast organic growth of the private sector. The explanation of its success lies not in the high volume of investment, but in the good choice of investment projects which have been typically extremely capital-saving. Labour productivity, wages and profit margins are about the same in both sectors, but the capital/output ratios – both average and marginal – appear to be many times lower in the private sector. Consequently, the profitability of investment is also many times higher in the private sector.

Although privatization aims to limit politicians' interference with day-to-day running of the economy at the microeconomic level, the process itself can be implemented only by state institutions through political means. The very concept of private property is sometimes ambiguous and embodied in various legal arrangements. This indeterminacy is made worse by transition-related shocks,



which increase uncertainty and social anxiety. Consequently many advise against a new shock which rapid privatization may cause.

**Table 4.** Poland: Industrial sales 1991-3, constant prices

	1991	1992	1993
LEVEL (total 1991 = 100)			
State	74.4	71.9	67.2
Private	25.6	32.0	43.1
Total	100.0	103.9	110.3
GROWTH RATE (in %)			
State		-3.3	-6.5
Private		23.4	34.7
Total		3.9	6.2

Source: Central Statistical Office, *Informacja. Rok 1993*, p. 81, Warszawa, 27 January 1994

The early dilemma as to whether to privatize or to liberalize and stabilize the economy first was, in 1989, decided in favour of liberalization and stabilization. The recession which followed became an important background which had an impact on privatization policies and their implementation. The effects can be observed at both the micro and macro levels.

At a microeconomic level, the phenomenon of so-called soft budget constraint survived the 'controlled shock therapy' of January 1990. However, it is much less pervasive than it was, being limited largely to tax arrears, and is heavily concentrated (Gomułka, 1993b; Jasiński, 1993). The debts and liabilities make the purchase of a state firm less attractive. But any financial restructuring, usually a necessary precondition for the transaction, is usually complex and time consuming. Also, to the extent that the persistence of the soft budget constraint translates into a poor macroeconomic environment, investors' response to offers put forward by the MOP may be affected.

The as yet unsatisfactory structure of the privatization law is best illustrated by the issue of reprivatization. As many as five drafts of the Reprivatization Act have already been proposed, both by the government and the MPs. The real cause of delays seems to be the lack of political will to solve the problem.<sup>55</sup> The

<sup>55</sup> In principle, when the act of taking away the property violated the then existing law, no new regulation is necessary and the matter can be settled by administrative decisions of respective ministers. From 1 January 1992 till the end of August 1992, 552 decisions were declared null and void. Nevertheless, even though this procedure proved in some cases relatively straightforward and successful, many other claims have to go through numerous appeals, which takes a lot of time and is very costly. That is why even in these cases there is a need for an overall legal regulation.

main controversy revolves around the problem of the form and extent of compensation<sup>56</sup>. This is, however, a political problem *par excellence*, which brings us back to the tangled issue of the relationship between politics and privatization in Poland.

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<sup>56</sup> *Rzeczpospolita*, 91 (34-35), 19.04.1993: I. It is worth noting that the whole problem has also an international aspect: 73.6 percent of claims refer to property on the territory of the former Soviet Union, for which, according to the agreement signed between the government of Poland and the USSR, the claimants were to be compensated by the Polish government. On the other hand, 149 claims were put forward by people currently living abroad, mostly in Germany (MOP 1992a).

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## 13. The Polish conflict\*

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The resolution of the ongoing dispute between the National Bank of Poland (NBP) – the country's central bank, and the government of Poland – supported in parliament by the government coalition and most of the opposition parties, is of considerable importance for Poland's economic development, both current and long term. It is also of significant interest for the European Union, which Poland hopes to join in 2004, and for other countries, especially post-communist and developing ones, that have adopted a model of central bank independence.

What is the background to this dispute? How did it develop into such an open and intense conflict? Has the NBP's monetary policy council (RPP in Polish) been too hawkish in its bid to demonstrate credibility or have the last two governments been too populist in their bid to maintain political power? What have been the consequences for the central bank, the governments and the Polish economy of the policies adopted and of the dispute itself? What have been the major issues and flash points? This article attempts to answer these questions.

### **Institutional set up**

On August 29 1997, Poland adopted the Law on the National Bank of Poland that established a new key institution, the monetary policy council. The ten council members were elected in February 1998, all for a period of six years. The intention was to make the NBP fully independent using the model of the European Central Bank. The council was given the power to set official interest rates, reserve requirements for commercial banks and to co-determine, together with the government, the exchange rate policy. Not just this parliamentary act, but also the country's constitution, specified that "the basic objective of NBP's activity shall be to maintain price stability". This was interpreted to give the council the power also to determine the inflation targets along the disinflation path, from the initial point of some 15% inflation in 1997 until price stability, interpreted as inflation of about 2% or less, is reached.

Compared to the UK's monetary policy committee, which was established at about the same time, Poland's monetary council is thus more powerful and more

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\* *Quarterly Journal: Central Banking*, XIII (1), August 2002.

independent. Unlike in the United Kingdom, inflation targets in Poland are set by the RPP, and council members cannot be dismissed. Moreover, in Poland all except one are external members, of which three are appointed by the country's president, while six others are elected by parliament (three by the *Sejm*, the lower house, and three by the Senate, the upper house). The council is chaired by the governor, the tenth member, who is elected by the *Sejm* at the invitation of the president. These procedures were intended to give the RPP a high degree of political legitimacy and full independence from political parties, as well as some powers over the permanent staff of the central bank itself.

### **A politicized council**

Council members were supposed to be outstanding experts on banking and finance. But the election rules favoured the choice of experts who commanded the trust of the political leaders. This trust would be gained for services rendered to the main political parties or the president. Of the ten members elected or appointed in 1998, one was previously a presidential candidate, three were members of parliament, one was a cabinet minister and one was the chief economist of the then dominant political party, later also a candidate of that party for the prime minister. The present governor is a former minister and the leader of a political party. Most council members have thus also got strong political and communication skills. It was perhaps natural and inevitable that these skills would continue to be used by those people while in their new positions of central bankers. The result was that not just the governor, but also most council members, have been unusually active in mass media, sharing their views on all aspects of economic policy, including those reserved for the government, with the public. Indeed, many of these views have been (highly) critical of government policy. The RPP has in effect become, as far as economic policy is concerned, a shadow government.

From the perspective of the RPP there are and have been good reasons for such extended public activity. In September 1997 a parliamentary election brought to power a party, AWS, that was dominated by trade union leaders. Some reforms were allowed by those leaders (privatisation, pensions, taxation, local government), but many important reforms were blocked (labour code) or diluted (health, red tape, education, restructuring of State enterprises), and some non-reform legislation adopted (increased social transfers, shorter working week). The main conflict between the government and the RPP, however, was not about the policies of the government, but about the monetary and exchange rate policies of the RPP.

## Monetary policy too tight

Inflation during the economic transformation in Poland has gradually but systematically dropped from 250% in 1990 to 13.2% in 1997. In each year of that period the rate of inflation was about four-fifths of the level of the previous year. That rate of disinflation proved to be consistent with a high and stable rate of economic growth of about 5% a year. The RPP set the annual inflation targets for the years 1999-2002 that implied, more or less, the continuation of the earlier disinflation trend. In particular, the inflation target for 2001 was set at 7%, and for 2002 at 5%. However, the actual monetary policy has proved to be much tighter than needed to achieve these targets (See Table 1). The outcome has been a much faster disinflation than in earlier years, as the actual inflation rate fell to 3.6% in 2001 and to below 2% by the middle of 2002. In these two years the targets of the RPP have thus been undershot by large margins. The target for 2003 was initially set at 4%; it was reached two years earlier. Instead of relaxing policies appropriately in response to such an outcome, in the middle of 2002 the RPP merely lowered the target for 2002, from 5% to 3%, and the target for 2003, from 4% to 3%.

**Table 1.** Poland: key macroeconomic variables since the establishment of the RPP.

Category	1998	1999	2000	2001	2002	2003
CPI inflation (within year, %)	8.6	9.8	8.5	3.6	3.0	2.5
Inflation target %	9.5	8.0-8.5	5.4-6.8	7.0	5.0	4.0
GDP growth, %	4.8	4.1	4.0	1.0	1.0	3.1
Growth of domestic demand, %	6.4	4.8	2.8	-1.9	0.7	3.1
Unemployment rate, end period, %	10.4	13.0	15.1	17.4	19.6	20.0
Exchange rate (average) zl/€		4.23	4.01	3.67	3.77	3.86
zl/\$	3.49	3.97	4.35	4.09	4.14	4.09
Current account balance, % PKB	-4.4	-7.5	-6.3	4.0	4.5	-5.2
WIBOR (Warsaw interbank offered rate), 3-month, average, %	21.3	14.7	18.8	16.1	10.0	7.5
Budget deficit public sector, % of GDP	3.2	3.3	2.7	5.5	6.1	5.5

Note: Data for 1998-2001 are official Polish, for 2002-3 are as forecast by the Polish Finance Ministry.

The sudden tightening of monetary (including exchange rate) policy occurred in the second part of 1999, nearly two years after the RPP's appointment. The consequences of this change for the real sphere – a sharp reduction of both the domestic demand and the overall economic growth, and a sharp increase of unemployment – have occurred since the middle of 2000 (Table 1).

It might be helpful to present these causes from the perspective of the two governments, which have been in power during the last two years and, separately, from the perspective of the RPP itself.

### **Government: an irrational bank**

Although a change of government took place in October 2001, following parliamentary elections in September 2001, the government perspective has remained largely unchanged throughout this two-year period. It has been dictated by the predictably large negative effects of the sharp slowdown in growth (open recession in industry and construction) on public finances and unemployment. These effects are thought to be caused primarily by a sharp appreciation of the real exchange rate and very high real interest rates. The budget deficit increased in the years 2001-2, by some three percentage points, to about 6% of GDP, despite significant cuts in certain areas of public expenditure. The unemployment rate increased over the last two years by some six percentage points. Nominal interest rates have been reduced substantially since March 2001. However real (*ex post*) interest rates have been maintained at very high levels, despite the sharp fall of inflation to levels much below target, and despite the increase of unemployment that keeps nominal wage increases very low, hence future inflation is also low. Thus from the government's perspective the policy of the central bank was in part irrational, since it has been at the same time, both undermining to the credibility of the bank, and also unnecessarily costly to the country. The recent changes of the inflation targets are seen as a part of the same pattern.

### **RPP: legitimate reasons...**

The voting on interest rates since March 2001 shows the RPP to be Split 5:5 on many occasions. However, the near recession in 2001 and 2002 was brought about mainly by the policy decisions in the year 2000, and these were supported by almost all ten RPP members. From their perspective, the shift towards a sharp tightening of monetary conditions in that year had a number of legitimate reasons.

Firstly, in the second half of 1999 and the first half of 2000 there was a sharp increase in the inflation rate. The increase was caused primarily by an external shock, namely a three-fold increase of the price of oil. Although this external shock was short-lived, it was strong enough to stimulate wage inflation and inflationary expectations, causing concern that the earlier disinflation gains might be lost, and consequently the inflation targets for 2001-3 badly overshoot.

Secondly, in the years 1999 and 2000 there was a sharp increase in the current account deficit. The increase had good causes; not a fall of domestic savings or an unsustainable increase of domestic demand, but the loss of the Russian market (following the financial crisis of August 1998), a large privatisation programme in the year 2000 (a large surplus on Capital account) and the imposition by the RPP of the new policy of no intervention in the foreign exchange market. Nevertheless, there was a concern that once the privatisation programme came to an end, as it almost did in the years 2001 and 2002, there would be a sharp devaluation of the zloty that would make the attainment of inflation targets impossible. Thirdly, the domestic reforms which would underpin the disinflation process and rapid growth, were announced by the government but many were not implemented. As a result the labour market continued to be highly inflexible. Social transfers were excessive and domestic savings insufficient to sustain macroeconomic stability in conditions of (rapid) growth at a rate necessary to keep unemployment low.

### **...but it has a problem**

The economic case of each of the two sides appears to be quite strong. Nevertheless, the RPP has a problem: how to explain that actual inflation rates have been so much below their own targets. Moreover, this happened not just in one quarter or even one year, but over the period of two years, 2001-2, and may well happen also in the year 2003. During this period the RPP's forecasts of developments, in terms of both nominal and real variables, have proved – systematically and by a wide margin – to be wrong.

### **The weak euro**

The factor that possibly most complicated the task of the RPP in evaluating the various risks and making good forecasts was the unexpectedly strong and prolonged devaluation of the euro against nearly all currencies from its launch at the beginning of 1999 until 2002. Most central banks outside the eurozone responded to the implied tightening of monetary conditions in their countries by lowering interest rates. But in Poland the extensive sale of assets to foreigners by the government and the policy of very high interest rates by the RPP have caused the zloty to appreciate strongly against the euro, in some periods to appreciate even against the US dollar. The consequent massive increase of euro-wages sharply reduced the Polish exporters' profit margins, inflicting losses in many cases and forcing large reductions in employment and investment. Polish exporters could

have absorbed a moderate appreciation, but not apparently the 20-30% of the actual appreciation which took place within a fairly short period of time.

The RPP was apparently surprised, along with most other policymakers as well as market makers, by the depth and persistence of the euro weakness and the zloty strength. Moreover, while the direct disinflationary impact of such an appreciation is easy to estimate, the indirect impact – through the labour market and expectations – must have been more difficult to gauge. Even so, the inflation rate and the rate of economic growth started to decline sharply in the second half of the year 2000. It was therefore dearly a mistake to impose a massive increase in interest rates in September 2000, and to begin reduction of interest rates only in March 2001. Moreover, the reductions were gentle, and therefore made under constant market pressure. During that time the RPP decisions were backward-looking, causing speculative Capital inflows which continued to provide strong support for the zloty. This prolonged the period of stagnation.

### **Exchange rate conflict**

In early 2002, the government proposed to the RPP a modification of the exchange rate policy, one that would replace the present regime of unrestricted floating with a float within a band anchored to a central rate for a euro-dollar basket, in which the euro's weight would equal 75%. The proposal was rejected by the RPP, which wants to enter into the "ERM2" without any intermediary regime and only after Poland joins the European Union. This rejection represented a defeat for the finance minister, who resigned on July 2 2002, and a setback for the country's president, who attempted to mediate between the RPP and the government. The parliament is now considering a number of changes to the act on the NBP. One of these would increase the head count of the RPP with the appointment of six new members. Another change under consideration is addition of concern for economic development as a separate goal for the RPP along with stable prices. If adopted, these proposed changes are likely to be contested by the president and the European Union. Their legality is also likely to be considered by the Constitutional Tribunal.

### **A currency board solution?**

The appointment of the new finance minister, on July 6 2002, is likely to have a major impact on the course of the parliamentary debate on the NBP. The reason is his support for a radical institutional change, the replacement of the RPP by a currency board. This would peg the zloty to the euro and abolish official

interest rates. Real market interest rates would probably fall significantly, probably mainly through an increase of the inflation rate. It is interesting that such an institutional reform was proposed earlier by two Polish economists, Andrzej Bratkowski and Jacek Rostowski, of whom one is at present a deputy governor of the NBP and the other is an adviser to the NBP's governor. The reform would be acceptable to the European Commission, but would require a change in the constitution. In the present tense economic and political circumstances in Poland, the change may have sufficient parliamentary support.

### **A lack of experience**

The conduct of monetary policy and the proper coordination of monetary, fiscal and structural policies are difficult in any country. But in emerging economies of the post-communist countries there are additional difficulties. The decision makers may be well-educated and well-motivated, but they typically lack experience of evaluating and managing macroeconomic risks. Moreover, the risks themselves are high, as these economies are less stable and more vulnerable to shocks than developed economies. The monetary and exchange rate policies, which Poland adopted in the first eight years of the economic transformation (1990-7), were simple, even simplistic, and the independence of the central bank was not full. But the outcome was an extraordinary success in securing a working coordination of macroeconomic policies. This led to a stable rate of disinflation without the need to inflict shocks to the real economy by the central bank or the government. When the political system is immature, market institutions are weak, and policymakers are inexperienced, the full (instrument and goal) independence of the central bank may still enhance the ability of the authorities to reach and maintain low inflation, but it also increases the risk of political confrontations and economic instabilities.

The Polish experience strengthens the case for the abolition of the national central banks and early accession for the post-communist countries of Central and Eastern Europe into the European economic and monetary union.





## 14. Perspectives for the eurozone, short term and long term<sup>\*1</sup>

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### 1. Introduction

For a common currency area to be fully successful over a long period of time, it must meet several economic, institutional and political conditions. From the day the euro was introduced on 1 January 1999, it was widely recognised that there might, and even certainly would be problems in meeting all these conditions in the euro area. Still, until the arrival of the world Financial crisis in the summer of 2008, the euro monetary union had functioned quite well, perhaps even better than might have been expected.<sup>2</sup>

The current crisis has a number of causes. Perhaps the three most important are excessive public debt in some eurozone countries, excessive wage increases that resulted in the loss of competitiveness by those same countries or other eurozone States, and excessive risk-taking by some segments of the banking sector, which resulted in excessive private debt in some of the member countries.<sup>3</sup>

A significant part of the confusion in the debate concerning the present crisis in the eurozone and the needed responses to it comes from the uncertainty about the weight of the external shock in causing the crisis versus the weight of the

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\* *The Polish Quarterly of International Affairs*, 2012, no. 2.

<sup>1</sup> This paper has been written at the invitation of Dr Marcin Zaborowski, Director of the Polish Institute of International Affairs and Editor-in-Chief of this Quarterly. I would like to thank Alberto Chilosi, Marek Dąbrowski, Stefan Kawalec, Kazimierz Marcinkiewicz, Andrzej Olechowski, Dariusz Rosati, Adam Szyszka, Paweł Wojciechowski and Cezary Wójcik for their helpful comments on earlier drafts of the paper. I also wish to acknowledge with thanks suggestions concerning grammar and style by Kacper Rękawek, Brien Barnett and Michael S. Gomułka.

<sup>2</sup> See: J. Bourrinet, P. Vigneron, *Paradoksy strefy euro*. Poznań: Uniwersytet Ekonomiczny, 2011, for a comprehensive review of the area's performance before the financial crisis in 2008 and during the current euro crisis.

<sup>3</sup> Much of that excessive private debt was related to the housing bubble, and this in turn, at least in the USA, was apparently caused mainly by institutional and policy measures of the U.S. government. See: P. Dobrowolski, A. Kondratowicz, *Unreliable Markets, Bad Economists, and Good Politicians: The Sources of the 2007-2009 Financial Crisis in the USA*, in: M. Guzek (ed.), *Ekonomia i polityka w kryzysie*. Warszawa: Uczelnia Łazarskiego, 2012, for an excellent statistical and econometric evidence in support of that view.

long-standing internal problems of the eurozone itself. After clarifying somewhat the relative weights of the two causes, I shall discuss possible remedies for these internal problems. This discussion falls into two parts. The first concerns changes that need to be introduced urgently in order to contain the crisis. Here, the controversial policy aspect relates to the need for international solidarity versus the concern about moral hazards, and therefore the necessity for national fiscal and banking discipline. All these should take into account limitations imposed by the present political realities. I also will highlight the important informational and disciplinary role played by financial markets. The second part deals with the longer term and the Identification of reforms needed to reduce substantially the risk of a similar crisis in the future.

Last, I shall discuss some of the implications of the crisis for Poland and other prospective members of the eurozone. These implications concern entry conditions to the eurozone – whether they should be much more severe; and also the likely gains from entry – how much they differ from those estimated in the last report by the National Bank of Poland (Narodowy Bank Polski, or NBP). Given the limited space and focus of the paper on the eurozone crisis, I am going to discuss only the former, and only briefly.<sup>4</sup>

This paper does not discuss the option of the so-called controlled decomposition of the eurozone.<sup>5</sup> The main reason is that while uncontrolled decomposition of the eurozone is possible at some, hopefully rather distant point in the future, controlled decomposition is in my view not an option likely to happen, neither now nor in the future.

## **2. The intended integration roles, political and economic, of the euro for the European Union**

The founding fathers of the European Union (EU) project were fundamentally vague about its ultimate institutional and political shape. However, they were quite clear about its needed direction of integration for changes in the area of markets of all kinds, especially those for internationally traded goods

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<sup>4</sup> See: R. Mundell, The European fiscal reform and the plight of the euro. *Poznań University of Economics Review*, 2011, vol. II, no. 1 and A. Torój, *et al.*, EMU: the (Post-)Crisis Perspective. Literature survey and implications for the euro candidates, Poland's Ministry of Finance, Working Paper; no 11, March 2012 for discussions of benefits and costs of joining the eurozone by Poland in the light of the world financial crisis 2008-9 and the euro crisis 2010-11.

<sup>5</sup> See: S. Kawalec, E. Pytlarczyk, Kontrolowana dekompozycja strefy euro aby uratować Unię Europejską i jednolity rynek, 11 April 2011, [www.liberte.pl](http://www.liberte.pl).

and financial products, as well as for labour. But at some point, it was realised that a common currency, while itself not a necessary pillar of a common market, could, and if successful would assist in the process of the economic and political integration of the EU. The inspiration may have come from economists such as Robert A. Mundell, whose work (for which he was awarded a Nobel Prize) indicated that the project to set up a common monetary system based on a single currency is institutionally feasible and, under some conditions (the most principal of which was the ability to have national fiscal policies sufficiently flexible and stability-oriented), would be economically beneficial. The elimination of the exchange rate risk would stimulate trade and investment within the currency area and, therefore, increase market competition and economic efficiency. The actual developments since 1999 have been in line with these expectations.

For the political leaders of Europe, seeking to establish an economic and political order conducive to permanent peace after two exceptionally barbaric and destructive wars, the social and political implications of this increased economic integration might have been even more important. Integration would enhance the interdependence of the nations of the EU, and this would strengthen the spirit of political cooperation across borders and weaken the incentive for military competition among States. Moreover, a common currency, if it were to help economic integration, would also begin to form a common European identity, which over generations could provide the necessary glue to cultural integration, helping with political cooperation, and leading in time, perhaps, to a political integration of some kind. Developments since 1999 have by and large also been in line with these expectations.

From the Polish perspective, it is interesting that the less-developed member countries of the monetary union were expected to benefit more strongly – those which economists call emerging or catching-up countries. Poland and other new members of the EU, as well as prospective members, such as Turkey and Ukraine, belong to that category. These countries enjoy what U.S. economic historian Alexander Gerschenkron half a century ago called “advantages of backwardness.”<sup>6</sup> These advantages are potent only when the countries in question are capable of generating or bringing about an international transfer of new products and technologies from their more developed partners. Such transfers are typically proportional to investments in technology-intensive projects. Membership in the monetary union stimulates foreign direct investments and gives domestic firms easier access to foreign savings at lower interest rates. The result should be a higher growth rate and therefore faster real convergence of less-developed

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<sup>6</sup> See: A. Gerschenkron, *Economic Backwardness in Historical Perspective*. Cambridge, MA: Harvard University Press, 1962.

member countries with the most-developed ones. Developments since 1999 have shown that these gains may be illusive, that is, they are possible but not certain. Indeed, lower interest rates may also stimulate consumption or investment in housing rather than technology-intensive projects, leading in some circumstances to bubbles and excessive (private and public) debts.

Bubbles or excessive debts can produce instability. When combined, they are capable of causing a particularly severe illness. It has become evident that this illness is a problem, one among several, against which some new measures must be developed if the stability of the eurozone is not to suffer again in the future.

### 3. The causes of the current crisis

A currency crisis is usually understood to be a sudden decline in confidence in a given currency, resulting in its substantial depreciation against the world's leading currencies. Nothing like that has happened with the euro so far. However, the concern is that, given the political and institutional constraints, the exceptionally large accumulation of public and private debt in some countries in the eurozone will cause a financial crisis in those countries that will spread to engulf the whole area, leading at some point to a large decline in confidence in the euro. Right now, we have therefore only a severe fiscal crisis in some eurozone countries and a potential euro crisis.

Given the exceptionally destabilising role of Greece to the eurozone, I shall discuss this particular cause of the eurozone crisis separately. It may be useful to first discuss several causes of the crisis of a general nature.

**The problems as defined by David Cameron and George Soros: incorrect evaluations or serious errors in the institutional architecture.** David Cameron, the British prime minister, argued recently in Davos that successful currency unions had vital features in common: a lender of last resort for the State, economic integration and flexibility to deal with shocks, fiscal transfers and collective debt. He said: "Currently it's not that the eurozone doesn't have all of these; it's that it doesn't have any of these."<sup>7</sup>

The European Central Bank (ECB) is indeed not supposed to be a lender of last resort for the State. This is partly because there is no federal State since the eurozone is essentially a collection of independent States. The credibility of the central bank in any country is in normal times enhanced by a clear separation of responsibilities for macroeconomic stability between it and the government or

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<sup>7</sup> See: 1789 and all that, *The Economist*, 11-17 February 2012.

parliament. This is the kind of separation Poland also enjoys. If the ECB were a lender of last resort for all the eurozone Member States, its ability to keep inflation low at relatively low interest rates would be seriously undermined; it probably would just not be possible. This is because both the Member States and financial markets would know that the constraint to keep national budget deficits low would be less binding, and it would be possible in many cases and often to have a condition in which a soft budget constraint would arise. This type of danger is less potent if fiscal matters are in the hands of a single State, but with many independent States and with the ECB as a lender of last resort, the responsibility for fiscal stability in the entire eurozone would be diffused, leading to a potentially gigantic freerider problem and, hence, increasing substantially the risk of massive macro-financial instabilities.

During the last two years of the euro crisis, the ECB has nevertheless acted from time to time to limit the cost of servicing public debt.<sup>8</sup> In principle, it may act in liquidity crises, but not in real solvency crises. Thus, the ECB can be a lender of last resort, but as an exception and in circumstances it deems appropriate, and only, or mainly indirectly, by lending money at favourable rates to commercial banks. There is no need to change this important pillar of the present institutional arrangement. Still, there may be the need to clarify the ECB mandate for this aspect in its Charter.

The second apparent weakness, according to Cameron, concerns economic integration and flexibility, that is, whether a monetary union is sufficiently developed in these two respects to absorb large price and quantity shocks at low cost. The eurozone essentially meets the requirement of high economic integration, but several (if not most) member countries have not met the flexibility requirement. Indeed, to compensate for the absence of exchange rate flexibility, more flexibility is required in the two other core policy areas: public finance and the labour market. If budgets are to be in deficit during a recession, they should, given near stability of the long-term EU GDP and the need to lower the debt/GDP ratios, be in surplus during a boom. That is what was supposed to happen under the provisions of the Stability and Growth Pact, but did not happen in practice. In turn, larger flexibility in the labour market is needed to keep the growth of unit labour

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<sup>8</sup> Since May 2010 the ECB operates so-called Securities Market Programme. Under this programme, it buys, from time to time, typically in the secondary market, government bonds of the Member countries which happen to be under exceptionally large pressure from financial markets to offer these bonds at very high interest rates, unsustainable for those countries in the longer term. According to the Polish PM's Economic Council Bulletin of 5 June 2012, total purchases of such bonds under this programme from its start until 1 June 2012 amounted to 212 billion euros. The ECB also occasionally accepts such bonds from banks as collateral in its attempt to save banks from ill-effects of, effectively, junk securities.

costs at a similar pace in all countries of the eurozone and, therefore, international product competitiveness at a similar level. Once that competitiveness is lost on a large scale in any particular country, it is difficult to regain it under a fixed exchange rate regime, leading to a large external debt or prolonged recession in that country. This loss of competitiveness is what apparently happened in several countries of the eurozone in the period 2000-8, well before the start of the world financial crisis in the summer of 2008 and the start of the eurozone crisis in 2010.

Fiscal and labour market policies have been, and for many years will remain, the responsibility of national governments and national parliaments. National budgets represent typically about 50% of national GDPs,<sup>9</sup> while the common EU budget is just about 1% of EU GDP. Misguided national macroeconomic policies have had negative external effects on the entire eurozone. But they are also costly for individual countries. It is important that Member States have no incentive to deviate from policies required for stability of their countries and, consequently, that of the eurozone as a whole. Any arrangement concerning international fiscal transfers and collective debt, the lack of which Cameron lists as another problem, must be subordinated to that central requirement.<sup>10</sup>

The problems listed by George Soros are similar to those discussed above, along with insufficient regard to incentives for all Member States to care about short-term stability and long-term sustainability. Soros makes the judgment that “the euro crisis is a direct consequence of the crash of 2008”, after which “the entire financial system ... had to be put on artificial life support.” However, Germany declared that guaranties to financial institutions, offered by European finance ministers as early as November 2008, should be “exercised by each European State individually, not by the EU or the eurozone acting as a whole.” According to Soros, this “sowed the seeds of the euro crisis because it revealed and activated a hidden weakness in the construction of the euro: the lack of a common treasury.” He notes that an equivalent to some mortgages in the U.S. subprime crisis has been another apparently riskless asset, namely the bonds issued by some European governments. Soros would like the newly created institutions – the European Financial Stability Facility (EFSF, created in May 2010) and its successor, the European Stability Mechanism (ESM, after 2013) – “to provide a safety net for the eurozone as a whole.” This would require their transformation into “a full-fledged European treasury, ... with the power to tax and therefore to

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<sup>9</sup> These are so called general government or public sector budgets, which include also local governments and social security and health funds. Central government budgets are typically much smaller, some 20-40% of GDP.

<sup>10</sup> More on that in the later part of the article.

borrow.”<sup>11</sup> This would imply transferring national economic competences to the EU level, a step nobody is apparently yet ready to accept.

This Soros recommendation, if implemented, would probably be effective in returning confidence to the financial markets for suspect government bonds – those for which high risk premiums are demanded. But his recommendation is unlikely to be implemented for rather obvious political reasons. Moreover, and equally important, if his plan were to succeed in the long run, all fiscal affairs of the eurozone member countries would have to be taken over by the new treasury. This would require another miracle: the creation now, or quite soon, of a single federal eurostate, possibly along the U.S. model.

**The exceptional case of Greece.** As noted previously, the euro crisis that erupted in 2010 was ignited by the wider Financial sector crisis that occurred outside the eurozone in 2008-9, mainly in the U.S. and the UK. However, it erupted only in some countries of the eurozone, and mainly in response to the accumulation of large debts, both public and private, over several years before 2008. In the years 2007-8 there were two groups of countries in Europe on the brink of macro-financial instability, defined as an excessive, unsustainable fiscal deficit and/or debt, or private debt, or current account deficit, or some combination of these. One group was outside the eurozone altogether: the three Baltic countries, Bulgaria, Hungary and Romania. The other group was the GIIPS countries: Greece, Ireland, Italy, Portugal and Spain. However, during the period since 2008, the Baltic countries and Bulgaria responded to their crises with exceptionally strong measures. They have consequently regained market confidence. One of them (Estonia) was even able to join the eurozone from the beginning of 2011. In the eurozone itself, Germany and several other “strong” member countries have retained the full confidence of world financial markets. Consequently, the euro has so far remained a strong currency, and interest rates on government bonds of these “strong” countries have not increased but have fallen to historically very low levels.

Of all the countries in distress, Greece is exceptional. The country adopted the euro on 1 January 2001, though the ratio of public debt to GDP in 2001, at 103.7%, was already far in excess of the 60% Maastricht limit. During the last few years, it has been the only country with both large public and private debts in relation to GDP, the consequences of a large government budget and large balance of payments deficits over many years. Moreover, in the period 2001-8, exceptionally rapid increases in nominal wages led to a substantial loss of international competitiveness, and one much worse than elsewhere in Europe.

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<sup>11</sup> G. Soros, Does the euro have a future? *The New York Review of Books*, 12 October 2011.



Across the whole Greek economy, these wage increases were financed to a significant extent by foreign credit. A clear institutional failure on the part of the EU institutions and banks was in allowing Greece to run up such large foreign debts, not to mention turning a blind eye to Greece's persistent falsification of its public accounts.

## 4. How to limit the risk of a possible chain reaction disintegration of the monetary union?

Whatever the causes of Greece's present predicament, the question remains about what the economically right and politically feasible policy response to it is now – a policy that would be well designed to both help Greece and reduce the risk of a destabilising chain reaction. There is also the question about the right institutional response, one that would hopefully strengthen the eurozone by reducing the risk of a similar crisis in the future.

**Short-term responses to the crisis: solidarity versus discipline in the eurozone.** A reference to solidarity has in Poland positive political connotations, associated with the birth of the Solidarity movement in 1980 and the subsequent peaceful revolution. In Germany, this particular term must by now be associated mainly with something completely different, namely with the so-called solidarity tax, imposed on West Germans to finance the reconstruction of East Germany, following the collapse of the Berlin Wall in late 1989. That tax financed transfers to East Germany that have been quite substantial, some €2 trillion since 1990.<sup>12</sup>

However, the eurozone is not a nation State and Greece is not East Germany. The demand of a large transfer of resources from Germany to Greece on the principle of European solidarity cannot be politically popular in Germany and may even be seen, quite correctly, as economically irrational and morally unacceptable. The irrationality argument is founded on the premise that if Greece is rewarded for its past policy of overspending and overborrowing, then this could be seen by some other countries as an incentive to conduct similar policies. Such an incentive would therefore have the potential for moral hazards on a scale large enough to lead to the total and uncontrolled decomposition of the eurozone.

In weaker countries in the EU, including Poland, it is popular among policy makers to refer, perhaps for internal political reasons, to the notion of solidarity in order to motivate proposals that would alleviate the fiscal problems of Greece and other heavily indebted countries at the cost of other, stronger countries. But

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<sup>12</sup> Author's own estimate.



#### 4. How to limit the risk of a possible chain reaction disintegration of the monetary union?

what may be good politics on national grounds is, in this case, a dangerous populism for the EU.

If Greece and the other eurozone countries in distress had not been helped, they would have already been in no position to service their public debt. A disorderly bankruptcy would follow, one probably extremely costly for the countries in question and also possibly capable of triggering a fairly large-scale recession in the EU. The assistance provided to Greece by the ECB, some members of the eurozone, and the International Monetary Fund (IMF) is keeping these countries afloat, therefore limiting the social and political costs of the present crisis.

But in order to avoid the development of a potentially highly destabilising moral hazard mechanism, such assistance must be quite limited and, moreover, would make economic sense only if the countries in trouble themselves adopt sufficiently strong measures to deal with their excessive debts and low competitiveness. This should have been the message of Poland when it held the EU presidency and it should, in my view, be its policy now.

As for Greece, an orderly default has already taken place; about half of the country's public debt to private Financial institutions, the equivalent of some 40% of GDP, has been written off. The contractionary fiscal measures adopted by Greece, partly as a condition of external assistance, are expected to bring about a fall in the country's GDP by some 20%. The unemployment rate is likely to stay at 20-25% for several years. These socially costly developments will, however, also have several desired long-term effects: regaining competitiveness through lower wage costs, increasing net exports, and instilling in the memory of the nation and its political elite concern for financial responsibility. Important also are the internal measures on the supply side, limiting wasteful rents on positional goods and modernising the fiscal administration in order to reduce corruption and tax avoidance.

The golden rule for external assistance during such a crisis is (in my interpretation) the well-tested IMF principle: the assistance should be large enough to induce substantial reforms by distressed countries while avoiding deep recessions, but low enough to be politically acceptable to donor countries and incapable of encouraging the development and spread of destabilising moral hazards.

The countries of the eurozone, together with the ECB and the IMF, are essentially following this golden rule. Leaving the euro would probably make it easier for Greece and Portugal to regain competitiveness fast. This radical alternative option is open to them. But it would be very costly to these countries,<sup>13</sup> there-

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<sup>13</sup> In the case of Greece, the recent approximate estimate of the country's central bank is that the further fall of GDP resulting from the exit from the euro would be some 20-25%, bringing the cumulative fall of GDP and the effective unemployment rate to some 35-40%.

fore unlikely to be willingly embraced. However, while the countries in distress apparently much prefer to stay in the eurozone, some of them, notably Greece, may refuse to implement the conditions on which the external assistance has been offered and is being provided. This raises the prospect, with respect to Greece, of the discontinuation of such assistance and the forced withdrawal from the eurozone. If this were to happen, it should by now have probably quite limited negative impact on the eurozone in the short run and rather positive impact in the long term.

The creation of the European Stability Mechanism (ESM), with Capital now of €500 billion and ultimately of €800 billion, has been the key stabilising response of the eurozone for the medium and long terms. The ESM should, from the beginning of 2013, take over from the ECB the role of principal partner of the IMF in providing conditional assistance to the countries in distress.

**What long-term repairs are needed?** In the economic behaviour of States and nations, decisions are often taken on the basis of short-term considerations, and as a result are irrational, sometimes even self-destructive, in the medium or long terms. Rules and incentives are needed to remove this inconsistency in favour of longer-term interests and against short-term temptations. Since States are independent, the realistic aim is not to remove completely short-term behaviour, but rather to reduce the likelihood of such behaviour.

In the case of the eurozone, the key question from the start was whether a common monetary policy and a single currency can be sustained without a common fiscal policy decided by the European Parliament or another single political authority, or, alternatively, whether the agreed Maastricht criteria would be a sufficient constraint on national fiscal policies to insure good coordination and stability at the EU level. The history of the eurozone so far suggests that despite some 60 cases when the criteria were breached, by and large they were met sufficiently for the coordination of the two types of policies, monetary and fiscal, to have been effective most of the time.<sup>14</sup> However, it is still legitimate to ask whether in light of recent experience the present Maastricht criteria need to be changed, and also whether the disciplinary system to ensure compliance has been sufficiently strong.

The case of Greece, and to an extent also some other countries, shows that the present stability-oriented coordination and disciplinary system needs to undergo significant repairs. This need has been recognised by EU leaders. Their response

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<sup>14</sup> One may also argue, as does Alberto Chilesi in a comment on an earlier version of this paper, that the “destruction of Maastricht discipline by Schroeder and Chirac in 2003-2005, with the collaboration of the Italian government, has been crucial in producing the present crisis.”

#### 4. How to limit the risk of a possible chain reaction disintegration of the monetary union?

so far has been the so-called fiscal pact. Among the changes in the Maastricht and EU Treaties that, to me, seem warranted are as follows:

1. Two new stability conditions should be considered, one with respect to total (public and private) external debt and the other to the current account balance, both in relation to GDP. Alternatively, the TARGET instrument of the ECB should be reformed along the U.S. model.<sup>15</sup> The new EU initiative, the Excessive Imbalance Procedure (EIP), meets this problem to some extent, but may not be sufficient.

2. The European Commission, in cooperation with the European Court of Justice, should have the power to penalise countries that do not meet some or all of the Maastricht criteria. The penalties should be nearly automatic, and maximum penalties should be substantial and may include lowering or even stopping transfers from the EU budget to the country.

3. The European Union Treaty should be amended to include the extreme possibility that if Maastricht stability criteria are violated fairly systematically and strongly, a country may be expelled from the eurozone. The exit rules should be clearly specified so that the removal threat is credible, in which case the likelihood of such exits would be small. As Rosati noted in a personal comment on an earlier version of this paper, this exit possibility would be needed “if the monetary union implies a commonly financed stability mechanism.”<sup>16</sup> Alternatively, and perhaps as a first step in that direction, the possibility should exist to suspend the voting rights of such a country in the Council of Ministers and the ECB.<sup>17</sup>

4. The EU budget should be gradually, but eventually substantially, increased in relation to the EU’s GDP, from the present level of about 1%. This change would be mainly in order to finance Europe-wide investment projects in such areas as infrastructure, energy, research, defence, and environment. At the same time, in order to gain political acceptability for a larger EU budget, some limits should be imposed on the size of member countries’ net transfers to the EU common budget.

With respect to the first reform, it would recognise the fact that not only public (domestic and foreign) debt but also total external debt, when excessive, can be a source of macroeconomic instability. Under the present system, balance of payments deficits are not limited by any criterion. By summer 2011, the G11PS

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<sup>15</sup> The term TARGET is an acronym that stands for Trans-European Automated Real-Time Gross Settlement Express Transfer. This refers to the eurozone transaction settlement system through which commercial banks of one member country make payments to commercial banks of another member country.

<sup>16</sup> Author’s private communication with Dariusz Rosati.

<sup>17</sup> See: A. Chilosì, The EU and its neighbours: Everything but institutions? *The European Journal of Comparative Economics*, 2007, vol. 4, no. 1: 25-38.

countries accumulated liabilities of €404 billion.<sup>18</sup> Technically these liabilities represent a part of gross government debt, but they are not officially counted as such. This would not be the case if the banks were under strict ECB, rather than national supervision. In August 2011, this hidden debt amounted to 76% of GDP for Ireland, 44% for Greece, and 35% for Portugal. These are big numbers, capable of influencing the evaluation by financial markets of a country's debt repayment ability, hence their credibility. Since imports are done largely by the private sector, there are good economic reasons for treating these liabilities as a separate category of national debt rather than simply as a part of public debt. A large current account deficit should be a signal for the government that either incomes of the population are excessive or government expenditure is too large (or taxes are insufficient), and should induce it to take some corrective measures.

As for the second reform, it is important that the disciplinary mechanism of enforcement is strong. The practice under the present system was one of virtually no penalties for even serious and persistent violations of members' treaty obligations.

With the third reform, it is important to correct the present situation when the welfare of the entire eurozone depends on the goodwill of each and every member, including those willing to misbehave. The membership of the eurozone, at 17, is already quite large and expected to be much larger, possibly up to 25. Since member countries are politically independent, the practice has shown that one or two of them may sooner or later decide not to meet important treaty obligations and yet insist on membership.

Finally, the fourth reform means that increasing the integration of the economies of the EU provides economic justification for an eventually much bigger role for the EU budget. But for this to happen, net transfers amongst countries should be subjected to clear and politically acceptable limits. This budget should still be a small fraction of national public spending, and therefore cannot play any significant role as a fiscal (automatic or not) stabiliser.

## **5. Questions about the timing and distribution of repair costs**

The assets and liabilities of the eurozone financial system are so intermingled on the basis of a common currency that a "breakdown of the euro would cause a

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<sup>18</sup> H. W. Sinn, T. Wollmershaeuser, Target Loans, Current Account Balances and Capital Flows: The ECB's Rescue Facility, NBER Working Paper, No. 17626, Cambridge, MA, November 2011, p. 2.

meltdown beyond the capacity of the authorities to contain [it].”<sup>19</sup> In the recent study “Euro break-up: The consequences,” three UBS economists estimated the economic cost of a euro break-up to be in the first year about 40-50% of GDP for a country in the GIIPS group and some 20-25% of GDP for a strong country such as Germany.<sup>20</sup> These estimates may well be exaggerated but it needs to be accepted that the costs would most certainly be exceptionally large. Since this appears to be a consensus view, the reform option is widely seen as socially superior to a break-up. Most repairs have to be done in GIIPS countries. This suggests they should take most of the necessary action and absorb most of the economic, social and political costs of such reforms. External assistance can be large, but mainly conditional and in the form of credits rather than outright transfers. However, the resistance (in the short-run) to costly reforms in weak countries and the need to take swift stabilising measures puts pressure on strong countries to contribute more than is rational given long-term considerations. A Russian roulette situation has developed. Soros warns that if EU authorities persist in their current course of trying to buy time, “this will have incalculable political consequences.” But, in his view, “the path that leads to a solution has to be found in Germany, which, as the EU’s largest and highest-rated creditor country, has been thrust into the position of deciding the future of Europe.”<sup>21</sup>

However, the arguments underlying the “golden rule” suggest that Germany and other so-called strong countries may be right in resisting short-term political pressures, and in insisting on introducing what is economically rational in the long-term. This German/European Commission strategy is more time consuming, so it would have to be safeguarded by the technical ability and actual willingness of the ECB to stabilise financial markets as quickly and as strongly as might be required in the short term. The ECB did this in 2011, mainly by providing a large amount of liquidity to the eurozone financial sector at a very low interest rate. There is, however, a second pillar to this strategy. That is, to prepare for the possibility of a voluntary or forced exit of Greece and possibly Portugal from the eurozone. Such an exit need not take place, and probably will not take place with respect to Portugal, but the probability of it taking place with respect to Greece is high, perhaps its exit is inevitable.

The main targets of such a strategy are Italy and Spain. Their financial position is much better than Greece, and the pressure on them to reform must be maintained in order to firmly establish important behavioral rules for the future

<sup>19</sup> G. Soros, Does the euro have a future?, *op. cit.*

<sup>20</sup> S. Deo, P. Donovan, L. Hatheway, Euro break-up – the consequences. *UBS Global Economic Research*, London, 6 September 2011.

<sup>21</sup> *Ibidem.*

stability of the entire eurozone. These two countries and their national debts are so big anyway that, given the political and institutional constraints that prevent large inter-Member State transfers, they must take on themselves the main burden of adjustment if the entire euro project is to survive.

Therefore, while the keys to success in removing the present fiscal difficulties lie in all countries of the eurozone, the most important ones are in Rome and Madrid rather than in Berlin. The strong call by Polish Foreign Minister Radosław Sikorski in his Berlin lecture for Germany to assume a more active leadership role in the EU is therefore somewhat double edged. It may be interpreted as full and unmitigated acceptance by Poland of Germany's much-enhanced position within the EU<sup>22</sup>. But it may also be interpreted as a demand to transfer much more resources from Germany to countries in distress. The policy as seen under this second, probably intended, interpretation is neither realistic nor quite what is needed.

Also open to criticism have been public statements by Jacek Rostowski, Poland's finance minister, who called in the European Parliament and on other occasions for the ECB (and for the Polish national bank) to assist countries in distress by direct and sufficiently large purchases of their debts. The ECB can and should help in order to give States the time needed to implement necessary reforms, but this assistance must be at the ECB's own initiative and limited in size in order to maintain pressure on governments and preserve the ECB's credibility.

As I noted in the introduction, a major cause of the 2008-9 world financial crisis and the 2010-11 euro crisis, has been the unusually large blunders committed by the private sector, especially by banks and rating agencies, in the evaluation of risk. Private owners and investors must pay a large share of the implied costs for these blunders. It is therefore also important to limit to a necessary minimum the transfers of resources from the public sector to the private sector.

## **6. The U.S. experience with a monetary union and its implications for the eurozone**

The German economists H. W. Sinn and T. Wollmershaeuser argue that "Europe might wish to think about adopting the U.S. rules about running a monetary union. After all, these rules have been distilled from a long historical trial-

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<sup>22</sup> R. Sikorski, Polska a przyszłość Unii Europejskiej, November 2011, [www.msz.gov.pl](http://www.msz.gov.pl).

and-error process, and have been shown to function. It is not always necessary to re-invent the wheel.”<sup>23</sup> The institutional structure and methods of the ECB’s operation can indeed be improved by borrowing from the U.S. system of 12 Federal Reserve districts. Specific proposals have been made by these two economists with respect to the TARGET facility, and by Willem Buiter<sup>24</sup> with respect to the conduct of the common monetary, credit, and liquidity policy of the ECB and its 17 national central banks.

However, given the key causes of the current crisis, I am concerned mainly about how to defend against the potentially destabilising impact on monetary developments of the absence of a single treasury and a single political authority. The U.S. is a federation of States, but it also has a strong federal government. In 1913, the Federal Reserve was set up to act as lender of last resort. *The Economist* notes that “The 1930’s slump led to much-expanded federal spending under Roosevelt. American States are now constrained by balanced budget rules, but the federal government borrows hugely to bolster demand.” It comments that “The eurozone has, in effect, tried to create America’s no bail-out doctrine of 1940 with neither Hamilton’s federal structure nor Roosevelt’s counter-cyclical tools. Euro members are walking on a wobbly tightrope without a safety net. When the storm has blown, they have found themselves tied together by the Financial markets, meaning that if one were to fall, all would risk doing so.”<sup>25</sup>

In the eurozone there is, of course, no strong central government and virtually no central budget. However, active fiscal policies can be, and are conducted by individual Member States. Their budgets are large and need not be balanced every year. Fiscal limitations apply only to structural deficits and cumulative public debts. The U.S. federal government can borrow from the Federal Reserve, but in practice it borrows mainly in domestic and international Financial markets, similar to what the EU governments do.<sup>26</sup> Therefore, while institutional differences between the U.S. and EU are indeed quite large, they are not so potent for the conduct of stability-friendly Fiscal and monetary policies.

But since fiscal limitations in the EU are somewhat soft, and have proved too soft until now, the country risk may vary strongly. Taxes and expenditures are decided by national parliaments, not by the European Parliament. Therefore,

<sup>23</sup> H. W. Sinn, T. Wollmershaeuser, Target Loans..., *op. cit.*, p. 29.

<sup>24</sup> W. Buiter, Is the eurozone at risk of turning into the rouble zone? *Citigroup Global Markets*, 13 February 2012.

<sup>25</sup> 1789 and all that, *op. cit.*

<sup>26</sup> The proportion of the U.S. government bonds held by the Federal Reserve by the end of September 2011 varied between 6% and 27% depending on maturity. See: H. Hannoun, Monetary policy in the crisis: Testing the limits of monetary policy, Bank for International Settlements, Speech at Governors’ Conference, Seoul, 13-14 February 2012.



the responsibility for debt servicing and debt repayment must be, and is taken wholly by individual member countries. This gives Financial markets a very important independent role to play in disciplining the conduct of Member State Fiscal policies. This role is more than merely supplementary to that conducted by the European Commission, and is in fact fundamental. That is true even though financial markets react sometimes quite erratically. But public institutions may meet this problem by providing timely and good quality information to market participants.

## 7. The Fiscal Pact on Coordination and Governance

A new treaty on stability, coordination and governance, proposed on 31 January 2012, and an earlier “six-pack” package have been so far the main institutional responses of the political leaders of the EU to the present euro crisis. In a follow-up document, the European Commission explains the motivations behind these responses. It begins with a diagnosis that “fiscal imbalances and competitiveness divergences (have) developed in certain euro area countries (because) the EU relied largely on more or less voluntary coordination of policies.”<sup>27</sup>

The studies of all major monetary unions show that a necessary condition for the success of such unions is solid fiscal discipline.<sup>28</sup> The moral obligations of governments in the eurozone failed to provide that discipline. It is in fact somewhat surprising that these moral obligations were almost sufficient for so long. In the absence of the world financial crisis, the explosive material of excessive debt would be much smaller and may not have been ignited for some time.

On 7 September 2010, the EU Economic and Financial Affairs Council (ECOFIN) introduced the European Semester, which brought together the coordination processes of both the Stability and Growth Pact and the Broad Economic Guidelines under a single institutional framework. It is likely that “this initiative may help in strengthening ex-ante peer review mechanisms at the early stages of national budget planning.”<sup>29</sup> The governance “six-pack” initiative, adopted by the European Parliament (EP) in October 2011, is intended to insure expanded surveillance by the EC of the economic policies of all Member States, and also impose tougher and automatic Financial sanctions in response to non-compliance

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<sup>27</sup> Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, [www.european-council.europa.eu](http://www.european-council.europa.eu).

<sup>28</sup> C. Wójcik, *Reforma Unii pilnie potrzebna. Rzeczpospolita*, 27 January 2011.

<sup>29</sup> M. Dąbrowski, *Macroeconomic surveillance within the EU, CASE Network E-briefs*, November 2010, no. 13.



with the Maastricht criteria. Two new measures are important. One is that an Excessive Deficit Procedure can be launched, even if a deficit is below 3% of GDP, when the debt-to-GDP ratio exceeds 60%. The other measure is that when a euro-area Member State is in breach of the fiscal deficit criterion, the European Court of Justice can impose financial sanction of up to 0.1% of GDP. However, the risk is that the culprits are not going to pay. Freezing the payment from the EU budget would have more bite.

Are these measures sufficient to ensure fiscal discipline? Is there a risk of the EC turning into some kind of Central Planning Commission, a bureaucratic power restricting excessively the policy flexibility at the national level and the political rights of national parliaments?

We do not know the answer to the first question and the answer to the second question is almost certainly in the negative. Given the fact that the EU is and will continue to be a collection of essentially independent States, specific decisions on taxes and expenditures are, and will be taken at the national level. The roles of the EC and the EP in fiscal matters will continue to be largely informational and advisory. Whilst it is true that “euro adoption will be associated with giving up more sovereignty than it has previously been expected,”<sup>30</sup> the required shift in that direction probably will be fairly limited. The EU’s centre is going to have much stronger teeth, mainly in matters concerning compliance with stability criteria. The key provision is the obligation to put EU fiscal rules into the national legal framework, preferably at a constitutional level. This is how it should be. The centre will also have bigger financial resources for the purpose of intervening in financial markets in order to assist Member States in distress. However, the non-federalist structure of the EU rules out significant international transfers. This “fact of life” should become an unquestionable principle of intra-EU politics, ingrained in the thinking of political leaders as well as the EU population in general.

On January 1, 2011 three new EU institutions were established: the European Banking Authority for bank supervision, the European Securities and Markets Authority for the supervision of Capital markets, and the European Insurance and Occupational Pensions Authority, to deal with insurance supervision. In addition, since November 2010 the European Systemic Risk Board has been in place. The EC has also informed in various Communications that it intends to make credit ratings more reliable, to tighten rules on hedge funds, to curb banking pay practices that encourage recklessness, and to reform audit.

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<sup>30</sup> A. Torój *et al.*, EMU: The (post-)crisis perspective..., *op. cit.*

## 8. The global context: the build-up of competitive pressures from China and India

The recent emergence of China and India as large economic powers is beginning to change the world distribution of political power, eventually probably quite fundamentally and with substantial consequences for the conduct of international affairs. These changes are bound to have an impact on economic and political developments in Europe and will tend to provide a new incentive for stronger economic and political cooperation within the EU. How much time does the EU have to prepare itself to meet head-on the competition from these new world powers?

It may be useful to think of the most-developed countries at present, that is the old world (OW), as one entity. Belonging to that entity are the EU, the U.S., Japan, and Canada. Their combined population in 2010 was about 920 million people. The populations of China (1.34 billion) and India (1.2 billion) are of a similar order of magnitude. In terms of world GDP, in terms of purchasing power parity, the shares of the three entities in 2010 were approximately: 47.4% for the OW, 13.2% for China, and 5.5% for India.<sup>31</sup> However, the OW still dominates almost completely in the production of internationally registered patents and the financial markets.<sup>32</sup>

These relative positions are likely to change substantially by 2030, and fairly radically by 2050. China and India are so-called emerging countries – their economies growing for some time at rates in the range 6-10% per year.<sup>33</sup> The worldwide experience of catching up suggests that these kind of rates could be maintained for another 10-20 years for China and for some 20-30 years for India, at which time the rates begin falling gradually, perhaps even rapidly, to some 1-2% in terms of GDP per head, which is the range for the O W. Consequently, the (very) approximate shares of world GDP will be, in 2030: 35% for the OW, 25% for China and 10% for India, and in 2050: 25% for the OW, 20% for China and 15% for India. Given these shares, the countries of the OW would maintain

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<sup>31</sup> See: World Development Indicators database, <http://data.worldbank.org/indicator>.

<sup>32</sup> In 2010, the EU accounted for 22% of the world GDP. This compares with 19% of the USA and 5.7% of Japan. While the productivity growth rate is likely to be about the same in the EU, USA and Japan, about 1-2% per annum, the GDP growth rate in the USA will be higher by some 1% on account of faster population growth.

<sup>33</sup> See: J. Y. Lin, China and the Global Economy: Remarks at the 20<sup>th</sup> Anniversary of the University of Science and Technology, Hong Kong, 23 March 2011, for an excellent account and analysis of the current relative position of China in the world economy and its catching-up progress.

global dominance in technological research and financial markets until 2030 but would see that lead much eroded by 2050.<sup>34</sup>

Given this forecast, the build-up of competitive pressures from China and India on Europe will be fairly gradual, though ultimately very substantial. This gives us ample time to modernise the institutional architecture of the EU. But as the Polish foreign affairs minister recently noted in Berlin: “we must not stay idle when the world around us changes and new competitors come into play.”<sup>35</sup>

By 2050, the less-developed countries of Central and Eastern Europe should also progress in their modernisation drive, to a level of technological and civilisation standard possibly not much lower than that of Western Europe.

## 9. The euro strategy for Poland

An EU with a common market can prosper without a common currency; it did so until 1999. However, the return to national currencies now would be extremely costly economically for several years for all EU countries, especially those in the eurozone. It is therefore reasonable to assume that the eurozone will eventually come out of the present crisis strengthened.

The EU is also a political project, and the common currency is to promote international political cooperation. The principal motivation for such cooperation has been, and is, to prevent the occurrence of wars from which Europe suffered so much for centuries. In the second half of the 20<sup>th</sup> century, among the EU countries it was Poland and Germany which suffered most, much more than other important countries. Perhaps for that reason the popular support for the EU, including a further integration within it, is rather strong in those two countries. It is not surprising that Sikorski in his Berlin lecture declared that in the years to come, “the biggest threat to the security and welfare of Poland would be the collapse of the eurozone.”<sup>36</sup>

The appropriate euro strategy for Poland must have two clear objectives. In the short term, the country should take a clear stand on how to deal with the present euro crisis. In the medium term, the country should conduct fiscal and monetary policies that would enable it to join the eurozone relatively quickly, and as a strong member. It is now quite risky to suggest any timetable. But it would be sensible to assume that the eurozone will be ready for expansion in some 2-3

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<sup>34</sup> As for the year 2020, it is reasonable to assume that the world shares of the EU and USA will be about the same, somewhat less than 20%, and about the same as the share of China.

<sup>35</sup> R. Sikorski, *Polska...*, *op. cit.*

<sup>36</sup> *Ibidem.*

years. It may well take about that same time for Poland to be ready to enter the Exchange Rate Mechanism (ERM). It would thus appear that the earliest entry date is 2016 or 2017, possibly not later than 2020.

For both economic and political reasons it is, I think, important for Poland that Ukraine joins the EU. Ukraine is right now far from meeting membership criteria. But even when it meets the criteria, an expansion of this kind could be seen as somewhat destabilising. However, the balance of risk would change in favour of stability if Poland itself becomes a solid example.

This exemplary role should apply not just to the medium term, when Poland is attempting to meet the Maastricht and other criteria of entry into the eurozone, but also, perhaps even more importantly, to the long term, after the entry point. The conduct of policies after this point, and the institutional reforms needed to support them, should therefore become an important part of the country's entire strategy of eurozone membership. This post-entry part should focus specifically on public finances, structural reforms, and the labour market, with the aim to maintain enhanced flexibilities more or less permanently, and on the financial sector, with the aim to insure against credit-financed demand bubbles in response to permanently lower nominal and, especially, real interest rates.

In the area of public finance, Poland (and the EU) has an excellent model to study and possibly adopt (at least some parts of it) – the Swedish fiscal policy of the last two decades. In the Polish labour market, there is a question about how to respond to the threat to stability from an expected large fall in the supply of new labour. The various pension reforms proposed recently by the government should help to meet this threat. Another policy response would be an activation of the still large labour reserve lying idle in the countryside, especially in the poorer parts of Poland. If these two responses proved to be insufficient, then another possibility to consider would be to open Poland somewhat more widely than it is at present to immigration from our eastern neighbours: Belarus and Ukraine. That kind of policy may also have beneficial implications in international foreign affairs by fostering closer cooperation and integration – economic, cultural, and political – in Central and Eastern Europe.

## 10. Conclusions

The large potential costs of a break-up of the eurozone are probably now large enough to induce policies and institutional reforms at both the national and EU levels that are needed to heal and strengthen the monetary union. Most of the needed reforms are at the national level in GIIPS countries. The reforms proposed

so far at the EU level are a significant step in the right direction, but are probably insufficient. In particular, they do not prevent excessive growth of total, public plus private, foreign debt. I have suggested that in order to meet that threat, open limits on inter-country transfers of resources are needed. These would enhance stability and allow for an enlargement of the EU budget. Limits to such transfers may be safely relaxed only with the progress of political integration, which at this stage must be expected to be very slow. As for the monetary union, there is also the need to reform the TARGET instrument, possibly along the U.S. model, and to integrate more fully the national central banks with the ECB in the conduct of common monetary, credit, and liquidity policy.



# **15. Poland's economic and social transformation 1989-2014 and contemporary challenges\***

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## **1. Introduction**

The transformation of the economic and social system in Poland and other Central European and former USSR countries began when both the governed and governors of these countries almost commonly accepted that the economic system based on central management and state ownership lost in the competition with the system based on private property and individual entrepreneurship, market competition, coordinating role of prices and regulatory role of law.

In this way, the biggest experiment of the 20<sup>th</sup> century which tested in practice the quality and social usefulness of two globally dominating, and completely different, economic theories has come to an end.

In 1989 the level of macroeconomic destabilisation of the Polish economy was much bigger than that of the economies of other countries of real socialism. It was only Poland that did not service majority of its foreign debt and only in Poland inflation approached the hyperinflation level, undermining the confidence of citizens to its own currency so seriously that in August 1989 the average monthly pay, according to the market exchange rate, declined to 20 US dollars.

In this situation, the restoration of a sustainable macroeconomic equilibrium had to become an urgent priority goal.

The reformers' second key goal was to fully liberalise prices and foreign trade so as to promptly get rid of shortages and queues. In the new economic system the prices of products and services were to play an important informational role about the real production costs. Thus, they had to be free from severe deformation made by large subsidies and product specific taxes.

The third key goal was to restore the development capacity of the economy to a level enabling Poland the start of a process of gradual bridging, and in a few decades possibly the elimination, of a serious and long-lasting civilisation gap in relation to Western Europe that has arisen in the past few centuries.

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\* *Central Bank Review*, 2016 (16): 19-23.

Statistical data show that already during the first few years of transformation Poland, to a large extent, managed to achieve these three goals.

## **2. The impact of collapse of the former economic system on the course of transformation**

The scholarly literature points to a great similarity of economic systems in nearly all countries of real socialism and to large differences in the ways the transformation was conducted in the Central European countries and the former USSR on the one hand and in China on the other.

One of these differences resulted from the fact that in all the countries but China big systemic reforms were adopted after a few decades of change suppression, but when they finally began, they were fast and in majority of cases radical. In China big systemic changes began in 1979, i.e. 10 years earlier, but they were limited almost entirely to the economic area and except for the initial revolutionary liquidation of communes have been gradual in the last 35 years. The second important difference concerns the state financial (fiscal, exchange rate and monetary) policy, which in China was to a large extent subordinated to the achievement of a very rapid economic growth, and also a very high employment growth rate.

However, despite these differences in the course of transformation, the basic systemic reforms were conducted in all countries in response to serious economic failures. In China it was the so-called Cultural Revolution, which lasted for 6 years and was quite destructive. In the USSR and Central Europe it was a significant economic growth slowdown which began about 1975, mass shortages on the domestic market as well as a growing inflation pressure. In Poland it was also a deep recession in the period 1980 – 1981 and a formal bankruptcy in the foreign financial relations from 1981.

A low level of urbanisation in China enabled the authorities to isolate the economic from political reforms. Inefficient communal agriculture and a dynamic population growth forced the authorities to shift to individual farming already at the end of the 1970s. In much more developed countries of the former USSR and Central Europe the strategy of maintaining a high degree of state control over the economy meant that the social and economic crisis had to become critical to force the authorities to accept the overall transformation of the economic system. However, in the meantime the structural deformation of economies in these countries went very far.

In such circumstances, a fast introduction of market prices together with the elimination of most subsidies and the liberalisation of imports and exports meant a rapid and deep change in the composition of the domestic demand, particularly



### 3. General evaluation of the 25-year period. What are the effects of the economic transformation?

a considerable decline in the demand for a large number of goods produced domestically. And the collapse of the CMEA trading bloc and a shift to world prices necessitated a quick and in-depth reorientation of foreign trade. Moreover, in the former Soviet Union there was a big decline in its well-developed and large armaments manufacturing. In this situation, from the Elbe to Kamchatka the industrial output had to decline, in certain cases very considerably, giving rise to the so-called transformational recession (Kornai, 1994; Gomułka and Lane, 2001).

Transformational recession, measured in percentages of the decline in industrial output or the whole GDP in the transformation first few years, was smaller in Poland than elsewhere (apart from Slovenia). Also the Polish economy regained its growth capacity sooner than others. Why did it? The extensive literature does not offer a satisfactory theoretical explanation of these two phenomena. The authors (for example Blanchard, 1997; Gomułka, 1998) point to a positive role of reforms before 1989, as a result of which the private sector in 1989 represented a much bigger share in the economy than elsewhere, and to more profound liberalising reforms in the initial period of transformation, which resulted in an extremely dynamic growth of the new private sector.

### **3. General evaluation of the 25-year period. What are the effects of the economic transformation?**

Economists are primarily interested in the indicator of the relative economic level, measured in terms of GDP per capita as a percentage of GDP per capita in the most developed countries. In 1992 – 2013 GDP per capita in Poland grew twice as fast as in the most developed EU countries. As a consequence, this indicator of the relative level of the Polish economy grew from about 30% in 1988 up to about 50% in 2013. Table 1 shows the relative economic level data with reference to the USA for all the countries which went through the social and economic transformation, also for Germany at the beginning and end of the transformation period.

For Poland in 2014 the level of the former Federal Republic of Germany or southern England, not to mention the United States, is still very distant. The country is at the level of Hungary and Greece, and is approaching the level of Portugal. However, the improvement in the relative economic level indicator is so large that it justifies to call the period of the last 25 years a golden quarter century of the last three centuries of the Polish history. This positive assessment is based on GDP per capita, but it may be additionally supported by data on a substantial improvement in ecological indicators, much improved access of households and

companies to the latest technologies for processing information, mass scale of travelling of Poles all over the world and a rise of life expectancy by about 10%. In recent years the quality of housing and public infrastructure has also been much improved. All these mean a substantial progress in bridging the civilisation gap in relation to the world's best developed countries.

## **4. Issues which raise argument in public debate on economic transformation**

The publicly circulated evaluation of the Polish transformation has always been and still is much diversified. Some critical approaches concern important questions and are well-documented.

Thus, on about 1/3 of the Polish territory, that less urbanised, the unemployment rate is excessive, often amounting to more than 20%.

As a consequence, labour migration has been considerable; the number of emigrants is presently estimated to be about 2 million, or about 10% of the potential labour force. In several important areas, such as health service, public administration, higher education as well as basic research and innovative activity, the progress is notable but the distance to well developed countries still remains substantial.

The level of diversification of incomes and wealth per capita is not as dramatically big as for example in China, Russia or the United States, but the scope of poverty is conspicuous. In 2013, according to data published recently by GUS (the Central Statistical Office of Poland), about 12% of people were eligible to social security support, and about 7% of people had incomes below the official level of subsistence.

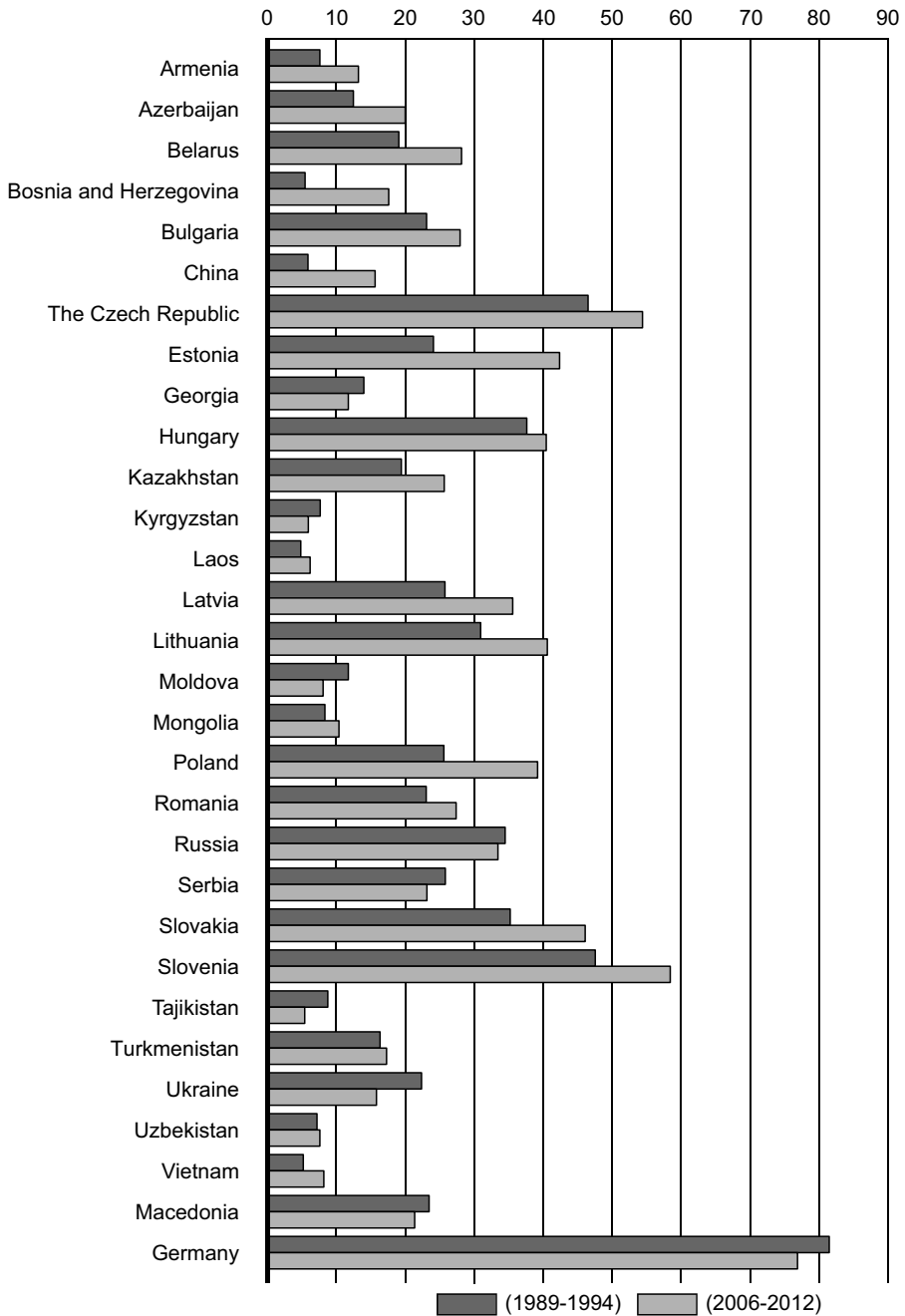
What is controversial or simply incomprehensible is the appearance on a large scale of opinions which are extremely critical and ill-founded.

Let me present four of them from among the most popular and the most extreme:

### **4.1. The initial so-called shock therapy was truly a “shock without therapy”**

This assessment is not based on facts. The liberalisation of prices had to be implemented quickly, but it did not include all prices; about 10% of prices remained regulated. The rate of inflation was reduced gradually; the initial goal – 1% or less per month at the end of 1990 was not achieved until 10 years later. The fiscal policy was not restrictive either. All throughout the transformation, except

#### 4. Issues which raise argument in public debate on economic transformation



**Figure 1.** GDP per capita (current purchasing power parity with reference to the USA).

for 1990, budget deficits have been substantial and in a few years (2009 and 2010) very big. Social transfers were for many years very high and privatisation slow.

Some critics, when talking about the “shock”, refer to a big decline in real wages in 1990. Indeed, according to GUS data, they were 26.7% lower in comparison with the level in 1989. However, 1988 saw an excessive increase in real wages. In comparison with their level in 1987, the decline amounted only to 7.7%.

#### **4.2. Economic policy of the 25-year period was to a large extent excessively liberal and insufficiently solidarity minded**

This assessment is not based on facts either. The basic facts include a high, and in the first years even very high, relation of old age and disability pensions to average wages, and an initially large and later fast growing number of old age and disability pensioners. The average pension within the Social Insurance Fund (FUS) system rose in relation to the average wage from about 50% before 1989 up to 65% in 1990 and to 75,6% in 1991. This relation remained at the level of 70-73% in the period of 1992-4, and gradually declined to the level of 65% in 1998. In the period of transformation Poland introduced on a large scale the so-called bridging pensions, pensions for farmers and sickness pensions. Moreover, in practice a low retirement age was retained. As a result, a joint number of old age and disability pensioners of all kinds rose from the level of about 7 million in 1989 to about 9.5 million 10 years later. GUS research confirms that the lowest standard of living is experienced not by the old age and disability pensioners but by young families, in particular those with many children.

#### **4.3. Privatisation was accompanied by scams, primarily in favour of people privileged by the former communist party**

This assessment ignores the facts which positively differentiate Poland from such countries as Russia or Ukraine. The state sector really shrank quickly, but primarily due to the decline in employment and production of companies, and not as a result of bankruptcy or privatisation of these companies. Empirical research proves that the privatisation of large companies was slow and, as a rule, transparent, usually through public auctions. As I have already remarked, in Poland there was a unique phenomenon, not to be found in the other countries undergoing the transformation: a very rapid increase in the number and size of brand new private companies. This explains one of the paradoxes of the Polish transformation,

namely fast privatisation of the economy despite slow privatisation of companies (Dąbrowski et al., 2001).

#### **4.4. Transformation destroyed a large part of the Polish industry**

This assessment is correct with regard to the period 1990-1. In 2013 the industrial output (manufacturing and mining) in constant prices was 2.5 times higher than in 1989, and about 3.7 times higher than in 1991. There was a change in the composition of industrial production in the right direction: the extraction of raw materials shrank while the production and export of processed goods, including high tech goods, grew many times.

### **5. Special achievements**

From among many achievements mentioned, I would consider two to be the most important: firstly the creation, nearly from scratch and relatively quickly, of a thriving sector of new private companies and, secondly, the introduction of legal and institutional reforms of the market economy, which together with other things, enabled Poland to join the European Union in 2004.

A large success of the economic policy includes also the avoidance of a crisis in the financial sector (banks, investment and pension funds, insurance companies and stock exchanges) and no open crisis in public finance. Poland belongs to a small group of countries which have managed to avoid such crises in the last 25 years. A considerable success in the real sphere has been the attraction of foreign direct investment to the export sector (processing industry) and to services (banks, large retail business, telecommunications and hotel industry). . These investments were relatively modest, as in the period 1995-2008 they accounted for about 10% of all investments. However, due to their large concentration in the formerly neglected economic sectors, their impact on the development of exports and the quality of services has been crucial.

The local government reform also proved to be a great success. As expected, it released a large capital of entrepreneurship at a regional level. Probably partly due to this reform, since 2004 the absorption of EU funds has been relatively high for infrastructure investments, which is an essential area for the development of the country. Finally, thanks to a strong expansion of higher education, there was a rise in the number of specialists with new qualifications in deficit areas, such as management, linguistics, finance or information technology.

## **6. Making up for the development backwardness: why only moderately fast?**

According to the OECD estimates, in 2013 Poland's GDP was 2.3 times higher than in 1989. The average GDP growth rate in Poland in the years 1989-2013, of about 4% annually, is not particularly high in comparison with the rate achieved by emerging markets in South-East Asia since 1950. A few Polish governments formulated the achievement of a GDP growth rate up to 6% annually as their strategic goal. The implementation of such a goal would require a considerable rise in Poles' employment activity, which at present is about 10% lower than in the most developed part of EU, as well as an increase in the investment rate by about 10% of GDP from the present level of about 20%. Economists know what economic policy (social policy, taxation policy, euro adoption) is necessary to achieve such changes in the value of these two key parameters. However, attempts made by some governments to conduct such policies have not been successful. Possibly, the necessary reforms would have not been supported by the electorate.

## **7. The paradox of high innovativeness of the Polish economy and the middle-income trap**

Poland has still a number of serious problems to solve and many important reforms to introduce. The general goal of these reforms should be to sustain the capability of further erosion of the income and wealth gaps in relation to the world's most developed countries. A satisfactory progress in bridging these gaps depends on the economic growth rate in the next 20-30 years being 3-5% annually, not below 3% annually.

It is necessary to present, in this context, a short theoretical commentary on the mechanism of economic growth in the long run. The economic growth rate in the short run depends on a number of factors, e.g. on aggregate demand. A long-term economic growth rate per capita depends nearly entirely on the rate of qualitative changes, such as technological and institutional innovations as well as employees' skills. In well developed countries these changes result primarily from the innovativeness of the entire world sector of R&D (research and development) and the national level of education. In less developed countries, that is the group of so-called catching-up countries to which Poland belongs, their own innovative activity is marginal and will be insignificant for yet a number of years, while the access to the latest innovation will continue to be strongly

limited. Technological changes in economy within this group depend nearly entirely on the absorption of foreign innovations, primarily those easily accessible. This absorption occurs mainly through the channel of investment activity. In the case of high investment in relation to GDP, technological changes in the catching-up countries, in percentages terms, may be for a certain period of time even several times bigger than in the most developed countries. In Poland, as a result of transformation, the access to the world resources of knowledge and technology of older generations as well as the absorption capacity of the economy have considerably increased. This explains the paradox of a high innovativeness of the Polish economy and a low innovativeness of the Polish R&D. However, with the GDP per capita at a level of 50-70% of the most developed countries, further fast technological progress of a catching-up country is becoming more difficult, as access to technologies of newer generations becomes necessary. At this level of development the process of catching-up may be stopped. Economists speak about the so-called middle-development trap or middle-income trap. Further progress in gap bridging is possible, but the pace of catching up as a rule becomes slower.

This pace may be sustained or the pace of the growth slowdown may be reduced in two ways. One way is to strongly raise the country's own innovation and absorption capacity, especially directly by companies. The other is to care more about the factors which increase the attractiveness of the country for investors from the most developed countries. These factors include for example a good quality infrastructure, high quality vocational and university education, stable and entrepreneur-friendly legal and financial system, low political and exchange rate risk, low interest rates and low inflation.

A document concerning Poland issued on 2 July 2014 by the European Commission includes a detailed list of challenges and a long list of necessary reforms. Let me just quote the assessment of Poland's research and innovativeness:

Poland is among the EU countries with the lowest level of R&D expenditure and is one of the worst performers in broader innovation indicators. Private R&D expenditure is especially low. Low R&D spending is coupled with weak research and innovation activity by companies and an insufficiently innovation-friendly business environment. The innovation support system in Poland has been risk-averse, based mostly on grants, supporting technology absorption and transfer without a big impact on genuinely new innovation. Existing tax incentives for R&D are ineffective in promoting internal R&D by the private sector and are used only by big companies.

Economic integration favours the diffusion of everything that contributes to a fast economic growth. Poland's escape from the middle-growth trap will therefore also depend on the progress of technological integration within the European Union. Meanwhile, in recent years the risk of collapse of the best integrated EU part, i.e. the euro zone, though not big so far, has grown. It is a worrying phenomenon, particularly if as a result of this collapse the Union itself becomes weak too. Such a weakening would result in the rise in national competition and different kinds of barriers between countries with regard to the flow of goods, people, capital and technology.

A stronger defence of national identity in the EU countries comes in part in response to the integration progress perceived sometimes as too rapid. In order to avoid the collapse of the euro zone, there have to be reforms in the area of public finance and banking. But the integration processes in the EU will certainly be slow in the nearest future, as they have to include what is called the European identity, i.e. an extremely complex social and cultural sphere. An essential until now internal motive behind the development of a strong economic integration, which is the avoidance of war in Europe, is probably still valid. In the next decades this motive may be reinforced by a growing trade competition, and perhaps even the pressure arising from threats of different kind from two new global economic and military superpowers: China and India, the countries whose own populations are much bigger than the EU, the USA, Canada and Japan jointly.

In its national interest, Poland should be active in the search of recipes for the reduction of the risk of EU collapse down to zero, or close to zero, and it should also itself, in cooperation with others, undertake activities in favour of further economic integration.

## 8. Acknowledgements

While working on this article I made use of many interesting substantive and stylistic suggestions made by professor Krzysztof Malaga of Poznań University.

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## 16. Poland's economic performance in global and long-term perspective: Surprises so far and risks in the years ahead\*

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**Abstract:** The paper is focused on economic and institutional developments in Poland during the last 30 years of transition from its centrally planned socialist economy to a market-based capitalist economy. The main purposes of the paper are three. One is to identify and explain the developments that were either surprising or specifically Polish. The second purpose is to note and explain the differences between the rate of growth of the Polish economy and that of the other emerging economies, in particular to explain 'the green island' phenomenon during the global financial crisis 2008-9. The third purpose is to note and discuss the new risks that may prevent Poland to reduce further the development gap to technologically most advanced economies.

**Keywords:** transition economies, Poland's performance surprises, global growth trends, Polish policy risks

**JEL Codes:** P16, P27, P51

### Acknowledgement

I wish to thank Mark Schaffer of Heriot-Watt university for suggesting improvements in style and wording and for helpful substantive comments. The final version gained from critical comments by two referees and by Łukasz Hardt, the Editor. An earlier version of this paper was presented on 6 September 2018 as a keynote lecture at the 15<sup>th</sup> Biannual Conference of the European Association for Comparative Economic Studies.

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\* *Central European Economic Journal*, 2018: 109-17.

## 1. Introduction

Much of this paper are comments on, and interpretations of, the institutional reforms during the last few decades in the formerly centrally planned economies, especially in Poland.

Major Institutional changes started in China in the years 1978-80, to be followed by similarly large changes in the countries of Central Europe and the former USSR in the years 1989-91, Their revolutionary economic and social systems, based on central management, state ownership, and dominant role of central preferences, then started to be replaced by the original ones, based on individual entrepreneurship and preferences, market competition and private ownership.

In this way, the biggest institutional experiment of the 20<sup>th</sup> century, which tested in practice the theories underlying two globally competing systems – market capitalism and state socialism – came to an end.

This 20<sup>th</sup> century global economic and social experiment tested in particular two key ideas, one due to Karl Marx and the other to Joseph Schumpeter. Elsewhere I commented on these ideas in the following way (Gomułka, 1990):

Both Marx and Schumpeter argued that capitalism would give way to socialism. Although their arguments were quite different, they rested on assumptions concerning the innovation process and its effects. Innovations have been largely labour saving, as Marx assumed, but, contrary to his expectations, they have not caused the increasing and eventually massive unemployment which was supposed to lead to a supereconomic crisis and, eventually, to the overthrow of the capitalist system... Marx clearly underestimated, or simply overlooked, the positive effect of innovations on (average) wage increases and, in turn, the positive effect of increasing (average) wages on the (aggregate) demand for goods and the (total) employment of labour.

For Schumpeter the truly capitalist economic system was one in which the individual initiative of the entrepreneur, rather than the collective efforts of organizations, was central to insure success. However, his economies-of-scale argument led Schumpeter to believe that small firms, in their inventive and innovative activity, would be at a disadvantage compared with large firms, and so the latter would eventually dominate. In his theory firms would eventually be so large and complex that they have to be run by hierarchical organizations. A bureaucratized economic system would emerge, which in his words would be ‘an order of things which it will be

merely a matter of taste and terminology to call Socialism or not' (Schumpeter, 1928). He argued, therefore, that such a system could in due course become less innovative than the initial entrepreneurial capitalist system.

As we know by now, Schumpeter was wrong in his prediction of the diminishing, eventually marginal, role of small and medium sized firms under a capitalist system. But he was correct in his characterization of economies under a socialist system as far more bureaucratic and much less innovative than those under a capitalist system.

In China, the biggest impulse to change substantially, and perhaps even to abandon, the state socialist economic system was provided by the political and economic crisis in the 1970s. That crisis resulted in the dissolution of communes in 1979, followed by gradual marketization and privatization. In Central Europe, the initial impulse to radical reforms was provided by the economic and political crises in Poland in the 1980s, which resulted in the adoption of a democratic and fully capitalist economic system in the 1990s. In the USSR, doubts about the quality of the socialist system were ignited by the post-1975 growth slowdown. Nevertheless, resistance to market-oriented reforms was strong until late 1980s. The start of the transformation in late 1991 reflected the final and widespread acceptance by its communist elites of the results of the global experiment in economic system.

The key long term economic purpose of the transition in all formerly socialist countries has been to reduce substantially, perhaps even to eliminate completely, the "civilization gap", and more specifically the per capita income and wealth gaps, vis-a-vis western Europe and the United States.

With respect to the transformation in Poland,<sup>1</sup> I propose to divide the economic developments since 1989 into two groups, those largely typical for countries in transition, and those which have been rather specifically Polish, some of them unexpected. The purpose in the first part of my paper is to list and discuss these two classes of developments. The purpose in the second part is to list and discuss the risks that are present now and likely to remain in the years ahead

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<sup>1</sup> The literature on Polish transformation is too extensive to be reviewed. But I should note that there are three large volumes of government documents, all in their original languages, on internal policy discussions, the IMF advice, key new laws and policy decisions, and debt reduction negotiations, published by WN Scholar: vol. I, 2010, with reference largely to 1989, edited by T. Kowalik, vol. II, 2011, with reference to 1990, edited by S. Gomułka and T. Kowalik, and vol. III, 2013, with reference largely to 1991–1993, edited by S. Gomułka. Volume I is available both in paper and electronic versions, and volumes II and III are accessible on the Research Gate. Included in the volumes are also my 25 journal articles on various aspects of the Polish transformation.

which, if they come about, will slowdown the catching up process and may keep Poland significantly and permanently behind western Europe.

## **2. Developments in Poland that were typical and expected in transition countries**

A key initial development in all transition countries was price liberalization. A fast introduction of market prices at the start of transition eliminated quickly, within about three months, shortages and queues. This development in Poland produced the first important social improvement in the early 1990.

This particular success disproved the theory, developed by Janos Kornai, that the necessary condition for the elimination of shortages is an earlier imposition of hard budget constraints on enterprises, and that such imposition would require privatization of state enterprises. I questioned that theory before the transition started. A debate took place between Kornai and myself concerning that theory on the pages of the journal *Economics of Planning*, October 1985.

Price liberalization and elimination of most product specific price distortions also resulted, in almost all countries in transition, in exceptionally large changes in relative prices, causing deep and fast changes in the composition of the domestic demand. Given the restricted mobility of labour and other resources, and a dramatic reorientation in foreign trade, large falls of outputs of many industrial products in the initial period of transition became inevitable. So the second important initial development was the so-called transformational recession (Kornai 1994; Gomulka and Lane, 2001). This recession produced a large social cost in most transition countries, in the form of high unemployment and islands of poverty, over a prolonged period.

The third important and almost common development was a supply-side defensive response by old and new firms, initially in the form of lower production of some products, followed by the introduction of less costly methods of production and new or improved products. These responses led eventually to an increase in the rate of growth of per capita GDP, substantial enough to resume the process of catching up with the per capita GDP levels of the technologically advanced economies.

## **3. The unexpected developments in Poland**

During the last 25 years the rate of growth of per capita GDP in Poland was about twice as high as in the part of the world economy which I call the Technology

Frontier Area (TFA). The TFA includes, above all, western Europe, the USA and Japan. As a result of this much better growth performance, despite the costly transformational recession in the years 1990-1, the level of per capita GDP (PPP) in Poland increased, according to the IMF, from 30,1% of the US level in 1989 to 49,6% in 2017. Compared to Germany, the increase was from 35,7% in 1989 to 58,5% in 2017 (in 1989 without Eastern Germany). Such a large and relatively fast improvement in this aggregate measure of the relative level of development was indeed hoped for, even expected.

However, in the process of this overall large improvement several developments in Poland were unexpected.

1. The transformational recession in Poland was smaller in size and shorter in length than in nearly all other European and the USSR countries in transition. Given the exceptionally deep financial crisis in 1989, this was a surprise. The subsequent growth of the per capita GDP has been in Poland fairly fast among the countries of Central Europe and the former USSR, but moderately fast among all countries outside the TFA, and much slower than that in China.
2. The expansion of output and employment in the new private sector was exceptionally fast in the first few years of transition, with an annual rate in the range of 20-30%. This development was a surprise as the expansion was much faster than in any other country undergoing transformation. .... My explanation of this surprise is based on data showing a large inflow from abroad of many Polish workers and their significant savings in the initial phase of transformation. Due to some economic liberalization before 1990, much larger than elsewhere in Eastern Europe, the number of such workers was also exceptionally large. Apparently the economic and political program of the first post-communist government of Tadeusz Mazowiecki, with Leszek Balcerowicz its key policy maker in the economic area, was sufficiently convincing for the Poles with entrepreneurial talent to invest their savings in new businesses in Poland.
3. Poland and Bulgaria were the only countries in transition which were offered large (by 50%) foreign debt reductions by western governments and private banks. But only in Poland did the initially small foreign reserves start to increase very early and fast. That development was also a surprise; This particular surprise has the same explanation as that of surprise no 2.
4. There has been no significant crisis in the financial sector, and so there was never, not even during the world financial crisis 2008-9, any need to use significant public resources to capitalize banks and other financial institutions (a recapitalization of some banks in the early 1990s was relatively small). In order to win the 50% foreign debt reduction, Poland needed the support of

- the IMF. This gave that institution a significant role in the conduct of macroeconomic policy in the first few years of transformation.<sup>2</sup> That enhanced role helped the minister of finance and the governor of the central bank to win the parliamentary support for a more sensible financial policy in those years.
5. Social transfers in the first fifteen years of transition, at levels in the range 20-25% of the GDP, were exceptionally high. In the first 5 years of transition, pensions of people outside agriculture, with the average pension at a level of 60-75% of the average wage, were also exceptionally high. These facts are at variance with the often strong criticism of the economic social policy in early period of transformation.
  6. The reduction of inflation from near-hyperinflation levels in the first few months of transition to the world standard level was systematic, but also gradual, spread over some 12 years. The surprise was how long it took.
  7. The privatization of state-owned enterprises was, in comparison with other European and USSR countries in transition, exceptionally gradual, but nevertheless the size of the private sector in terms of output and employment soon became high.<sup>3</sup> This development took place for three reasons: rapid reduction of outputs and employments in many state enterprises, exceptionally rapid expansion of the new private sector, and a fairly large private sector at the start of transition, much larger than elsewhere.
  8. Domestic savings have been persistently exceptionally low, due to very low savings by households and always negative savings by the general government. Consequently, domestic private investment, usually around 12-15% of the GDP, has also been exceptionally low. Here we have a sharp difference between Poland and China.
  9. Employment in the low productivity agricultural sector was initially exceptionally high, and while declining, continues to be high. Employment of people age 50+ has been and remains low by Scandinavian and western European standards.
  10. There were three cases of significant growth slowdowns over the last 25 years (2001-2, 2009, 2012), with significant recessions in industry and construction, but there has been no case of economy-wide recession. The absence of such economy-wide recession in 2009, the worst year of world financial crisis, was in the European Union an exceptional development, often considered a big positive surprise.

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<sup>2</sup> S. Gomulka, The IMF-supported programmes of Poland and Russia, 1990–1994: Principles, errors and results. *Journal of Comparative Economics*. 1995, 20, July: 316–46.

<sup>3</sup> S. Gomulka and P. Jasinski, Privatization in Poland 1989–1993: Policies, methods and results. In: S. Estrin (ed.), London: Longman, 1994.



11. The consistency of Polish economic policy making has been high despite many changes of government. This may be attributed to the unusual consensus of the economic elite on what needed to be done and what was and wasn't good economic policy.

Some of these facts have been noted and discussed in the Polish and international literature of comparative studies. In my own recent studies I discuss at some length facts 1, 4 and 10, largely from the perspective of long term and global developments (Gomułka 2016, 2017 and 2018). Let me note and discuss two misunderstandings which I often find in this literature.

One concerns the sources of economic growth: what are the key differences between the TFA countries and the catching up countries ?. Economists recognize that in the long run the per capita GDP is determined fully, or nearly fully, by qualitative changes, in particular by technological innovations and improvements in the human capital embodied in workers. In the TFA countries new technological changes are produced by the global R&D sector. The growth of that sector has been exceptionally fast and stable over the last two centuries. Consequently the trend innovation rate has been fairly stable over time during those two centuries, similar across countries and almost independent of national economic policies, in particular nearly independent of the rate of investment.

However, in the catching up countries the mechanism generating qualitative changes is quite different. For, most technological changes that are taking place there at the enterprise level come about as a result of transfers from the TFA, where they were invented some time earlier. The rate of absorption of such innovations depends strongly on the national absorption ability, in particular on the rate of investment. This rate varies strongly among countries, as does the rate of qualitative changes and the rate of economic growth (Gomułka, 2017). That rate can easily be, and often is, much higher than that prevailing in the TFA. This was also the case in Poland since 1990.

This difference in the mechanism of economic growth is often disregarded, with excessive weight being placed on the low number of newly patented domestic innovations as a key obstacle to technological and productivity changes, and on the low wages as a key advantage.

## 4. The green island phenomenon

The second misunderstanding concerns the original Polish official interpretation of the so-called “green island” phenomenon, which refers to the absence

of an economy-wide recession in Poland during the recent worldwide financial crisis. In the year 2009 the GDP of the EU declined by 4.4% from the level in 2008, and by about 6% from the trend. Poland's GDP in 2009 increased by 1.7%, declining from the trend by only 2%. This official interpretation claimed government credit for that much better performance.

In my interpretation this much better performance of the Polish economy in 2009 was caused mainly by the following three factors:

1. Excessively expansionary monetary policy in the USA, where the crisis originated, and in most member countries of the EU, including transition countries except Poland and Slovakia, in the period 2002-8. According to the IMF data, bank credits to the private sector as proportion of GDP increased in that period as follows: in Bulgaria from 26.0% to 66.7%, in Romania from 7.1% to 37.0%, in Estonia from 36.1% to 90.2%, in Latvia from 19.0% to 85.8%, in Lithuania from 13.1% to 61.9%. Baltic countries and Bulgaria operated at that time a fixed exchange rate regime with no own central banking, with the domestic money supply decided by the size of the foreign exchange reserves. Just before the summer of 2008 these reserves were increasing fast, so was the money supply, forcing market interest rates strongly down.
2. According to the World Bank data, monetary policy in Poland was tight in the years 1999-2000, causing deep contraction of the construction sector and a recession in industry, but it was moderately expansionary in the years 2001-7. In relation to GDP, domestic credit to the private sector fell sharply in the years 1999-2000 – stood at 26.5% in 2000 and only 37.1% in 2007.<sup>4</sup> Moreover, domestic credit fell in countries around Poland in the years 2009-10, but in Poland it stood at 47.0% in 2009 and 48.8% in 2010, so it was expanding.
3. A highly expansionary fiscal policy was adopted in Poland not in response to, but just one year before the start of the crisis, when the financial crisis was not even anticipated. That policy, of the size of about 3% of GDP, was implemented in the years 2008 and 2009, increasing the fiscal deficit in the years 2009 and 2010 to nearly 8% of the GDP, the highest level during the entire transformation.

Given these large differences in the conduct of monetary and fiscal policies between Poland and other EU countries in period I (2001-8) just before the financial

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<sup>4</sup> I provide a detailed discussion of the monetary policy in Poland in the years 1999–2000, conducted by the newly established Monetary Policy Council, in the paper: The Polish conflict. (*Quarterly Journal*) *Central Banking*, vol. XIII, no. 1, August 2002.

crisis in 2008 and in the subsequent period II (2009-15) just after the crisis, it is more accurate to compare the economic performance of Poland with that of these other countries in the period I + II. This I do in Table 1. Moreover, since the monetary policy of Poland was much different within period I, that comparison is made in Table I also for subperiods IA (2001-4) and IB (2005-8).

It turns out that in period IA the GDP increase in Poland was lowest among the eight transition countries of Central and Northern Europe. It is interesting that in the period 2001-15, the leaders in economic growth in that part of Europe were Slovakia and Lithuania. Bulgaria, Latvia and Romania also achieved better results than did Poland. A clear outsider was Hungary. With respect to period II, what differentiated Poland most was the absence of a banking crisis.

**Table 1.** GDP increases in the periods indicated as percentages of initial levels

Country	IA	IB	I	II	I + II
	2001-2004	2005-2008	2001-2008	2009-2015	2001-2015
Lithuania	34,0	31,9	76,7	4,1	83,9
Slovakia	19,8	35,6	62,4	12,3	82,4
Latvia	33,9	32,2	77,0	-1,9	73,6
Romania	27,0	30,6	65,9	3,9	72,4
Bulgaria	23,7	30,2	61,1	5,4	69,8
Poland	12,4	22,2	37,4	22,7	67,9
Estonia	28,8	23,4	58,9	5,2	67,2
Hungary	18,1	10,0	29,8	3,0	33,7
EU	8,2	9,2	18,2	-1,2	16,7

Source: Calculated by the author on the basis of latest IMF data.

The key reason of that was low level of underperforming bank loans to households and enterprises.

But a large increase of public debt in the years 2009-11 forced the government to adopt a contractionary fiscal policy in the years 2012-14. Moreover, the government was forced to take over half of the resources, about 8% of GDP, accumulated since the year 2000 in the second pillar of the pension system, consisting of privately managed open retirement funds. That transfer was officially misinterpreted as a 'needed correction of an error' in the original legislation concerning these funds, introduced by the Buzek government in 1998. That error was said to be in allowing pension funds to invest in Polish government securities (!).

## 5. Global long-term trends

The long-term risks which Poland is likely to face in the years ahead are more clear when discussed in the context of likely developments in the world economy. Historically the most striking development of this kind was noted and documented by Angus Maddison (2007), namely that the world per capita GDP rose on average by only 0.5% per decade during the Middle Ages 1000-1500, by 0,7% per decade, so only marginally faster, in the protocapitalistic epoch 1500-1820, but 17 times faster, 1.2% per year, in the period 1820-2000.

In a recently published paper (Gomułka, 2017), chapter 1 in this book, I review and discuss several lists of 'stylized facts' and 'stylized trends' of the world economy in the 20<sup>th</sup> century, and attempt to answer the question, whether and which of these facts and trends are likely to continue in the 21<sup>st</sup> century. Fundamental among them is the emergence, in the course of the 19<sup>th</sup> and most of the 20<sup>th</sup> centuries, of a very large gap in per capita GDP between the TFA countries and all the other countries.

However, during the last 40 years this particular feature of the world economy is undergoing a dramatic change, from a strong divergence to a strong convergence. Moreover, that convergence is expected to continue for some time at a fairly rapid rate. As a result, the world per capita GDP growth rate is likely to be significantly higher in the years to come, especially during the first half of this century, than the 1.2% trend rate of the 19<sup>th</sup> and 20<sup>th</sup> centuries

In a discussion about the place of the Polish economy in the years ahead, it is important to note and accept that this world per capita GDP growth rate, recently at a historically exceptionally high level of about 3%, is likely to remain at that level for some time, at least during the next 30-40 years.

Growth convergence is in part a product of technological integration of national economies into a single world economy. That process of integration has progressed particularly forcefully in Europe during the last 50 years. There have been institutional implications of that forceful technological integration. One of them is the creation of the European Union, European Central Bank and euro as the common currency for almost all EU countries. Before the euro was adopted the countries of southern Europe didn't care as much about inflation as postwar Germany did. Consequently the governments in those countries had the option of adopting expansionary fiscal policy to win popular support and choosing devaluation later on to restore competitiveness. Germany suffered hyperinflation in the early 1920s, and the social cost of that experience was apparently so powerful that it changed political culture in Germany and the neighbouring countries. As a result, these northern European countries have become more responsible in

their fiscal policies, so much so that exchange rates of their currencies tended to appreciate.

Technological integration of countries within the EU has meant that exporting firms as a group are now also big importers, and exports and imports are large proportions of GDP. Moreover, financial integration meant that much private and public debt became denominated in foreign currencies.

In such circumstances the potential benefit of having national currency for the purpose of keeping available the option of devaluation, has declined for all EU member countries. This created the economic conditions in the entire EU far more conducive than before to introduce and keep a common currency. In 2008, but just before the eruption of world financial crisis, the Polish zloty was strong against foreign currencies, much stronger than it is now. Yet most Polish exporting firms were comfortably profitable then, almost as much as they are now. But the key condition to meet before adopting the euro is to have low public debt, therefore the average budget deficit to be close to zero. That condition was not met by several member countries of the EU, in particular by Greece, and is not yet met by Poland.

Much research in comparative economics has been so far about the role of institutions in economic development. Given the central role of the rate of technological innovation in determining the rate of development, in the focus of this research was essentially the causal relationship between institutions and the rate of innovations. Less attention has been given to the reverse relationship, one between cumulative technological changes and institutional changes. The volume of technological changes increases exponentially, and over the last two centuries it has been increasing at a high rate. Consequently, increases in that volume per unit of time are now much bigger than they were a century ago, or even a few decades ago. Their potential to cause institutional changes is proportionately also much higher than it was in the distant past.

## **6. Long-term trends in Poland which cause concern**

With respect to risks for Poland's development in the years ahead, the facts which cause particular concern are the following:

1. A large gross emigration of workers of about 2.5 million, and still significant net emigration, of about 1,5 million, representing about 10% of the working population;
2. A new demographic trend that just started and is expected to continue, which implies that the population of Poland will fall until the year 2050 by about 5 million, or about 13%;

3. The effective retirement age is low and, in response to recent lowering of official retirement ages, will probably decline further. Consequently the number of pensioners, already large, will be increasing;
4. The domestic savings rate is exceptionally low and this is likely to continue. Consequently the domestic investment rate is also likely to be low, and, as a further consequence, the innovation rate and growth rate of GDP per worker will be lower;
5. The net inflow of foreign savings is likely to decline, certainly from the UE budget and probably also from private investors.

The combined effect of these developments will be a declining population and, probably, a strongly declining trend rate of growth of the per capita GDP, from about 3.5% per year during the transition so far to about 2% in the next 10-20 years, and lower still later on. In the absence of defensive policy measures, a significant catching up of Poland's per capita income and wealth with those of the TFA countries may well continue only for the next 10 years or so. Under this scenario, my own tentative forecast is that the catching up would (nearly) stop when the per capita GDP(PPP) in Poland will reach about 70% of the corresponding level in Germany and about 60% of that in the USA. That would be about twice the relative level prevailing during the last two centuries, but probably below the aspirations of the people living in Poland.

What is important for the quality of life is not only the average level and distribution of income per person, but also the average level and distribution of wealth per person, the quality of public sector (non-market) services and the quality of the environment. In these three aspects the distance between most developed countries of the EU and Poland may well yet be much higher than that in terms of the per capita GDP.

## **7. Poland's controversial and risky policy responses**

During the last three years an unusual confrontation of economic and institutional ideas and policies has been taking place in Poland. Several competing strategies have been proposed: a single Strategy A of the government and several non-government strategies. It is interesting that the central long-term aim is the same in all strategies: to avoid the middle-income trap. Also the same are the proposed two key economic policy instruments: substantial increases in the rate of domestic saving and in the rate of total investment in fixed assets. But, the government, as part of Strategy A, has also proposed to increase substantially social

transfers, reduce significantly retirement ages, reduce foreign direct investments, increase the size of the state sector, and increase the role of state preferences in important investment decisions.

Implementation of some initially proposed components of Strategy A has been abandoned. This reduced the risk of a crisis in public finances. Still, the rate of investment remains low, one of the lowest in the EU, and is likely to remain low. A tight labor market started to produce a wage pressure that should in due course increase inflation. Despite an exceptionally high rate of growth of tax revenues and the presence of fairly large one-off revenues, the budget deficit of the general government has continued to be close to the upper limit of 3% of the GDP. This produces the risk that the expansion of public debt will accelerate in the years of slower growth, and as a consequence of promised much higher public expenditures on health, pensions and defense. If this risk comes about, the cost of servicing public debt would also increase.

But the most controversial, even revolutionary, are the institutional changes introduced already during the last three years. 2016-18. They include the imposition of a strict political control over the public radio and television, civil service and, most importantly, an attempt to impose such a control over the whole judiciary system, including the Constitutional Tribunal, the National Judiciary Council and the Supreme Court. The original program of the governing Law and Justice party accepts with only considerable difficulties the ideas of competitive market capitalism and the values underlying the common principles of the European Union. It is also strongly, even emotionally, critical of the economic, institutional and political transformation since 1989 until 2015. Consequently, the prospect of a system has suddenly emerged in which one and the same political party will be in power for long. In the meantime, an unusually rapid remodeling of the rules-based liberal order is under way.

But some important differences compared with the pre-1989 system are yet present. They include acceptance by the present government of a large private sector, (formal) acceptance of the membership of the European Union, active presence of the political opposition and an important role for the private mass media. These differences are probably still sufficiently large to keep the prospect alive of Poland remaining a fully democratic country and an influential member of the European Union. However it is rather certain that membership of the euro-zone remains now a distant possibility.

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## 17. Ekonomiczne i polityczne implikacje pozostawania Polski poza strefą euro\*

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### Economic and political implications for Poland remaining outside the Eurozone

**Abstract.** In the Accession Treaty of 16 April 2003, Poland agreed to adopt euro as its national currency, but the date of this adoption was not specified. The financial crisis in several countries of the eurozone, in response to the world financial crisis in 2008, reduced drastically the public support in Poland for the replacement of the zloty by the euro. This article has two objectives. One is to assess the net costs, economic and political, for Poland remaining long outside the eurozone. In this assessment the analysis includes also two official reports by National Bank of Poland, the country's central bank, published in 2009 and 2014. The other objective is to note and assess the reforms which have been undertaken by member states of the eurozone in response to this crisis, in order to maintain and enhance financial stability and economic effectiveness of the rules adopted at the start of the eurozone on 1 January 1999. The author suggests to consider and adopt additional reforms. Discussed is also the USA experience with its own monetary union, and the potential influence on policy developments in the EU of increasing global competitive pressures from China and India.

**Key words:** Poland, eurozone, stability conditions, institutional reforms

### 1. Wprowadzenie

Kryzys finansowy, jaki w 2008 r. wybuchł w Stanach Zjednoczonych i Wielkiej Brytanii, czyli w krajach znajdujących się poza strefą euro, nie obniżył na świecie zaufania ani do amerykańskiego dolara, ani do euro. Te dwie waluty zostały nawet początkowo wzmocnione. Kapitał zaufania do Stanów Zjednoczonych i głównych krajów strefy euro był bowiem, i pozostaje, na tyle duży, że dolar i euro są nadal podstawowymi walutami rezerwowymi banków centralnych oraz

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\* *Nauka*, 2019, 1: 7-30.

walutami w obiegu na światowych rynkach finansowych. Na skutek wzrostu ryzyka makroekonomicznego w skali globalnej uległy natomiast osłabieniu waluty krajów z niewielkim lub umiarkowanym kapitałem zaufania. Między innymi mieliśmy przez wiele lat, i nadal częściowo mamy, do czynienia z dość silnym osłabieniem złotego w stosunku do poziomu w roku 2007.

Niemniej jednak spadło drastycznie poparcie Polaków dla idei szybkiego wejścia Polski do strefy euro. Stało się tak, mimo że w strefie euro kryzys dotyczył tylko niektórych krajów i pojawił się w nich z różnych powodów. W Irlandii, na Cyprze oraz w Hiszpanii były to problemy bankowe, natomiast nadmierny dług publiczny i duży dług zagraniczny przyczynił się do sytuacji kryzysowej w Grecji, po części także w Portugalii, Hiszpanii i we Włoszech. W krajach strefy euro, także w krajach objętych kryzysem, akceptacja i zaufanie dla wspólnej waluty przez ludność tych krajów pozostaje po roku 2008 stabilne na przedkryzysowym wysokim poziomie 60–70%. Dla Polaków ważny wydawał się być fakt, że przynależność do strefy euro nie uchroniła tych krajów od silnego wzrostu ryzyka bankructwa. To początkowo silnie negatywne nastawienie zaczyna się jednak zmienić na umiarkowanie negatywne w miarę stabilizacji strefy euro w wyniku reform podjętych w krajach w stanie kryzysu lub zagrożenia kryzysem oraz rosnącej świadomości tego, jakie koszty ekonomiczne i polityczne niesie ze sobą pozostawanie Polski poza strefą euro.

Aby strefa euro mogła skutecznie funkcjonować w długim okresie, musi spełniać szereg warunków ekonomicznych, instytucjonalnych i politycznych. Już pierwszego dnia obowiązywania wspólnej waluty, czyli 1 stycznia 1999 r., można było przypuszczać, że niemal na pewno będą problemy ze spełnianiem tych warunków w strefie euro. Niemniej do lata 2008 r., czyli do wybuchu globalnego kryzysu finansowego, europejska unia monetarna funkcjonowała całkiem sprawnie, może nawet lepiej niż początkowo zakładano.

Z dzisiejszej perspektywy wiemy, że do trzech najważniejszych przyczyn kryzysu w kilku krajach strefy euro należały: nadmierne zadłużenie publiczne, nadmierny wzrost płac, skutkujący spadkiem konkurencyjności, oraz akceptowanie nadmiernego ryzyka przez duże segmenty sektora bankowego.

Istotna część kontrowersji w debacie poświęconej problemom strefy euro oraz niezbędnym działaniom naprawczym wynikała z niepewności co do skuteczności polityki międzypaństwowej solidarności z racji obawy przed zjawiskiem *moral hazards* (pokusy nadużycia).

W artykule omówię implikacje kryzysu dla reform podjętych w strefie euro dla poprawy stabilności oraz implikacje dla realizacji podjętego przez Polskę i inne kraje zobowiązania o wejściu do tej strefy. Przedstawię również wpływ dotychczasowych doświadczeń państw strefy euro na nową ocenę korzyści netto,

ekonomicznych i politycznych, płynących z przyjęcia przez Polskę wspólnej waluty.

## 2. Reformy w strefie euro

Kryzysy finansowe pojawiały się w przeszłości na świecie dość często, ale przed 1 stycznia 1999 r. (data utworzenia strefy euro) występowały tylko w krajach z walutą narodową oraz własnym bankiem centralnym. W rezultacie analiz tych kryzysów wzrosła wiedza o ich przyczynach, co z kolei doprowadziło do zwiększenia roli nadzoru finansowego i ostrożniejszej polityki fiskalnej rządów oraz monetarnej banków centralnych. W przypadku strefy euro, obok kryteriów stabilizacyjnych z Maastricht, istnieje ponadnarodowy ośrodek decyzyjny, w skład którego wchodzi: Europejski Bank Centralny, Komisja Europejska oraz spotkania ministrów finansów krajów strefy euro.

Teoria optymalnych obszarów walutowych Roberta Mundella koncentrowała się na stopniu zgodności przebiegu cykli koniunkturalnych. Tymczasem najważniejszą kwestią dla stabilności strefy euro okazała się zdolność krajów członkowskich do utrzymywania jednostkowych kosztów pracy na mniej więcej tym samym poziomie, czyli podobnego stopnia zdolności konkurencyjnej. Można ją uzyskać przede wszystkim, utrzymując wysoką, wyższą niż w państwach narodowych, dyscyplinę polityki fiskalnej oraz wysoką elastyczność rynku pracy. Znacznie większa niż przed 2008 r. jest też obecnie rola rynków finansowych w utrzymaniu dyscypliny fiskalnej w strefie euro przez różnicowanie rentowności między krajami strefy euro. Inwestorzy prywatni zauważyli bowiem, że kryteria z Maastricht nie są na tyle silnymi instrumentami, aby doprowadzić do zniwelowania poważnych różnic w poziomie ryzyka niewypłacalności między krajami strefy euro. Zrozumieli również, że transfery finansowe między krajami są możliwe tylko na niewielką skalę.

Obecna polityka Europejskiego Banku Centralnego jest ostrożniejsza niż polityka amerykańskiego Systemu Rezerwy Federalnej, banku centralnego Japonii czy Banku Anglii. Jest ona nakierowana głównie, obok realizacji celu inflacyjnego, na stabilizowanie sytuacji w systemie bankowym strefy euro. Skupowanie przez EBC papierów skarbowych krajów, które znalazły się w kłopotach, mają dodatkowo zmniejszyć ryzyko ich bankructwa, ale jednocześnie jest na tyle ograniczone, aby podtrzymać presję na kontynuację przez te kraje reform fiskalnych. O tym, że polityka realizowana przez Europejski Bank Centralny odniosła sukces, świadczy odnotowywana w strefie euro niska inflacja, niskie stopy procentowe oraz stabilny kurs euro wobec dolara, w 2018 r.

wręcz zbliżony do kursu początkowego, wynoszącego 1 stycznia 1999 r. 1,17 dolara za euro. Nowy Traktat w sprawie stabilności, koordynacji i zarządzania (The Treaty on Stability, Coordination and Governance in the Economic and Monetary Union), zaproponowany 30 stycznia 2012 r., podpisany 2 marca 2012 r. przez 25 państw członkowskich UE, wszystkich, z wyjątkiem Wielkiej Brytanii oraz Czech, a także wprowadzony 8 listopada 2011 r. pakiet regulacji nazywany „sześciopakiem”, stanowią jak dotąd podstawowe działania instytucjonalne podjęte przez politycznych liderów UE w odpowiedzi na napięcia w strefie euro. Komisja Europejska, wyjaśniając powody, dla których zostały podjęte te działania, rozpoczyna od diagnozy, zgodnie z którą „w części krajów należących do strefy euro doszło do powstania nierównowagi fiskalnej oraz różnic w konkurencyjności dlatego, że UE w dużej mierze polegała na mniej lub bardziej dobrowolnej koordynacji polityk w tym obszarze” (Treaty on Stability..., 2012).

Badania wykazują, że warunkiem koniecznym dla sprawnego funkcjonowania polityki monetarnej opartej na sztywnym kursie walutowym jest ścisła dyscyplina fiskalna (Wójcik, 2011). Nieomal zaskakujące wydaje się, że wspomniane tu zobowiązania moralne okazywały się skuteczne aż tak długo. 7 września 2010 r. Rada ds. Gospodarczych i Finansowych UE (ECOFIN) wprowadziła procedurę Semestru europejskiego, która umożliwiła połączenie w jednym modelu instytucjonalnym procesów koordynacyjnych przewidzianych w *Pakcie stabilności i wzrostu* oraz w *Ogólnych wytycznych polityki gospodarczej*. Należy uznać za prawdopodobne, że „ta inicjatywa może pomóc we wzmocnieniu mechanizmów oceny *ex ante* na wczesnych etapach planowania budżetów krajowych” [Dąbrowski, 2010]. Inicjatywa nazywana „sześciopakiem”, przyjęta przez Parlament Europejski w październiku 2011 r., powinna gwarantować sze-roki nadzór KE nad polityką gospodarczą wszystkich państw członkowskich, a także wprowadzić ostrzejsze i automatyczne sankcje finansowe za naruszanie kryteriów z Maastricht. Warto zwrócić uwagę na dwa nowe narzędzia. Pierwsze z nich przewiduje możliwość uruchomienia procedury nadmiernego deficytu, nawet jeśli jest on niższy niż 3%

PKB, gdy stosunek długu publicznego do PKB wynosi więcej niż 60%. Drugie narzędzie pozwala Europejskiemu Trybunałowi Sprawiedliwości nałożyć sankcje finansowe do wysokości 0,1% PKB na ten kraj członkowski strefy euro, który naruszyłby kryterium deficytu fiskalnego. Oczywiście pojawia się tu ryzyko, że winowajca postanowi kary nie płacić. Skuteczniejszym środkiem nacisku byłoby zamrożenie wypłaty z budżetu unijnego. To narzędzie jest dostępne i może być silne w odniesieniu do krajów takich jak Polska, będących beneficjentami netto budżetu UE.

Czy są to środki wystarczające do zagwarantowania dyscypliny fiskalnej? Jeden z wybitnych makroekonomistów pyta też: „Czy istnieje ryzyko, że KE zmieni się w coś na kształt Komisji Centralnego Planowania, biurokratycznej władzy nadmiernie ograniczającej elastyczność prowadzenia polityki fiskalnej na szczeblu krajowym oraz prawa polityczne parlamentów narodowych?” (Buiter, 2012).

Odpowiedzi na pierwsze pytanie nie znamy, natomiast odpowiedź na pytanie drugie jest niemal na pewno przecząca. UE jest – i zapewne pozostanie jeszcze przez wiele lat, może zawsze – zbiorem w dużej mierze niezależnych państw, więc konkretne decyzje dotyczące podatków i wydatków publicznych będą podejmowane nadal na szczeblu krajowym. Rola Komisji Europejskiej (KE) i Parlamentu Europejskiego (PE) w kwestiach fiskalnych ma i będzie mieć w dużej mierze charakter informacyjny i doradczy. Chociaż „przyjęcie euro będzie kojarzone z większą utratą suwerenności, niż początkowo zakładano” [Torój i in., 2012], to jednak związane z tym zmiany będą prawdopodobnie dość ograniczone. Unia Europejska będzie miała skuteczniejsze narzędzia nacisku, głównie w kwestii przestrzegania kryteriów stabilności, być może także praworządności. Podstawowym jest tu obowiązek uwzględnienia unijnych zasad prowadzenia polityki fiskalnej w krajowym systemie prawnym, najlepiej na szczeblu konstytucyjnym. UE będzie dysponować również całkiem dużymi zasobami finansowymi przeznaczonymi na niesienie pomocy w postaci kredytów przyznawanych państwom członkowskim znajdującym się w trudnej sytuacji finansowej. Trzeba jednak podkreślić, że niefederalna struktura UE wyklucza większe międzynarodowe transfery środków. Ten „niezaprzeczalny fakt” powinien stać się niekwestionowaną zasadą wewnątrzunijnej polityki, zakorzenioną w mentalności polityków oraz całej społeczności mieszkańców Unii Europejskiej.

1 stycznia 2011 r. powołano do życia trzy nowe instytucje unijne: Europejski Urząd Nadzoru Bankowego, Europejski Urząd Nadzoru Giełd i Papierów Wartościowych, sprawujący nadzór nad rynkami kapitałowymi, oraz Europejski Urząd Nadzoru Ubezpieczeń i Pracowniczych Programów Emerytalnych, sprawujący nadzór ubezpieczeniowy.

Oprócz tego w listopadzie 2010 r. utworzono Europejską Radę ds. Ryzyka Systemowego. Komisja Europejska informowała również w licznych materiałach, że będzie dążyć do zwiększenia wiarygodności ratingów kredytowych, zacieśnienia reguł prowadzenia funduszy hedgingowych, ograniczenia wypłacania wynagrodzeń skłaniających do nierozsądnych zachowań w sektorze bankowym oraz do zreformowania systemu audytowania.

### **3. Koszty ekonomiczne pozostawania przez Polskę poza strefą euro**

Suma eksportu i importu dóbr i usług wynosi obecnie w Polsce już prawie 100% PKB, i ma tendencję rosnącą. Ceny większości dóbr i usług są podawane w euro, więc ryzyko kursowe jest w tej sytuacji dużym i rosnącym kosztem dla polskich importerów oraz eksporterów. Pozostawanie poza strefą euro sprawia również, że międzynarodowe rynki finansowe postrzegają polską gospodarkę jako obszar podwyższonego ryzyka makroekonomicznego, co przekłada się na wyższe niż w strefie euro realne stopy procentowe od kredytów zagranicznych oraz na mniejszy napływ bezpośrednich inwestycji zagranicznych. Z kolei wyższe stopy procentowe zmniejszają skłonność do inwestowania również krajowych przedsiębiorców. Podwyższają też koszt obsługi zadłużenia (publicznego i prywatnego), który mierzony rentownościami skarbowych papierów wartościowych i tak jest w Polsce znacznie wyższy niż w krajach unijnych pozostających poza strefą euro, ale postrzeganych jako wiarygodne, takich jak Czechy, Szwecja, Dania czy Wielka Brytania.

Ryzyko kursowe jest w Polsce dobrze znane tym gospodarstwom domowym, które zaciągnęły kredyty mieszkaniowe denominowane w SF. Ryzyko to znane jest także przedsiębiorcom, zwłaszcza dużym (w relacji do własnej produkcji) eksporterom i importerom. Dla eksporterów problemem jest silny złoty, a dla importerów słaby złoty. Kryzys finansowy wybuchł w roku 2008 w Stanach Zjednoczonych i Wielkiej Brytanii, więc w krajach spoza strefy euro, a w strefie euro dotknął głównie sektor bankowy, z powodów niemających nic wspólnego z samą wspólną walutą. Niemniej jednak pojawiła się błędna interpretacja w sferze publicznej, jakoby problemem była właśnie wspólna waluta, euro. Tylko jeden kraj – mała Grecja – stanęła na skraju niewypłacalności, czyli bankructwa, z powodu własnej rozrzutności. W Stanach Zjednoczonych też mamy przypadki bankructwa miast, a nawet całych stanów, zresztą z tego samego powodu nadmiernej rozrzutności. Nikt jednak nie proponuje, aby np. Kalifornia czy Detroit wprowadziły swoje własne waluty, aby następnie – przez ich silną dewaluację wobec dolara – poprawiały konkurencyjność swoich produktów i usług.

W debacie publicznej pojawia się często problem daty wejścia Polski do strefy euro. Dla przedsiębiorców i wielu zwykłych obywateli to ważna kwestia. Choć Polska w roku 2003 zobowiązała się wejść do strefy euro i zobowiązanie to zostało zaakceptowane dużą większością w referendum, to data nie została określona. Główną przeszkodą jest to, że Polska nie spełnia dwóch podstawowych warunków wejścia. W dodatku nie wiadomo, kiedy będzie je spełniać. Te dwa warunki to, po pierwsze, istnienie większości konstytucyjnej, czyli ponad 2/3

ogólnej liczby posłanek i posłów za wejściem do strefy euro, oraz, po drugie, trwała poprawa o ok. 3–4% PKB wyniku sektora finansów publicznych. Taka poprawa wymaga jednak zmian ustawowych, które spowodowałyby uelastycznienie wydatków publicznych, czego dotąd nie proponuje żadna z dwóch dominujących partii politycznych.

Argumenty części przeciwników wejścia Polski do strefy euro są ideologiczne, ponieważ integrację polityczną w ramach UE traktują jako zagrożenie dla narodowej tożsamości. Przeciwno wejściu do strefy euro te osoby pozostaną zatem w każdych okolicznościach. W argumentacji przeciwko wejściu używa się także mitu głoszącego nieunikniony znaczny wzrost cen w momencie przyjęcia euro. Utrata niezależności polityki pieniężnej Polski z chwilą wejścia do strefy euro jest zwykle traktowana jako najpoważniejszy koszt włączenia kraju do wspólnego obszaru walutowego. Ale polska gospodarka jest mała w porównaniu ze strefą euro, a po wejściu do Unii jest dodatkowo całkowicie otwarta na przepływy kapitałowe z tą strefą. Według standardowej teorii ekonomicznej, w sytuacji zliberalizowanych przepływów kapitału i silnie zintegrowanych rynków pieniężnych faktyczny zakres niezależności jest niewielki. Łukasz Goczek i Dagmara Mycielska podjęli próbę oszacowania faktycznego stopnia niezależności w latach 2001–2013 [Goczek, Mycielska, 2014]. We wnioskach piszą, że „skutkiem integracji walutowej Polski nie będzie istotne ograniczenie swobody prowadzenia polityki pieniężnej, ponieważ prawdopodobnie już teraz (...) nasza polityka pieniężna jest silnie skorelowana z działaniami EBC. (...) Uzyskane wyniki wskazują na występowanie długookresowej jednostronnej zależności między stopami procentowymi, przy czym nie można wykluczyć pełnego dostosowania” (*ibidem*, s. 278). Przykładem takiej jednostronnej zależności jest Dania, która formalnie nie należy do strefy euro, ale utrzymuje kursy swojej waluty w stosunku do euro na niemal dokładnie stałym poziomie.

W przestrzeni publicznej pojawiła się też sugestia, aby wejść do strefy euro dopiero wtedy, gdy różnica w płacach i innych dochodach, wyrażonych w euro, między Polską a krajami starej UE będzie niewielka. To stanowisko może mieć uzasadnienie psychologiczne i polityczne, ale ignoruje wiele istotnych argumentów ekonomicznych. Po pierwsze, korzyści gospodarcze przejścia na euro maleją wraz ze spadkiem luki rozwojowej między Polską a starą Unią. Po drugie, różnice w dochodach nominalnych wyrażonych w euro, chociaż niekoniecznie w sile nabywczej, będą duże jeszcze przez dziesięciolecia, być może nigdy nie będą małe. Po trzecie, pozytywna decyzja o wejściu wzmacnia walutę krajową i tym samym redukuje wyrażone w euro nominalne różnice w dochodach. Po czwarte, z racji tego, że polski sektor eksportowy jest zdominowany przez duże



firmy, (jednocześnie eksportujące i importujące) oraz w około 45–50% przez kapitał zagraniczny, z łatwym dostępem do rynków światowych, to konkurencyjność tego sektora jest mało wrażliwa na kurs złotego. Kurs złotego wobec euro w 2019 r. mógłby być silniejszy, niż jest obecnie, nawet o 10–20%. To oznaczałoby wzrost wyrażonych w euro dochodów w Polsce o taki sam procent, więc byłoby ewidentną i znaczną korzyścią dla gospodarstw domowych.

Kurs złotego przy wejściu do strefy euro nie może być jednak zbyt „mocny”, np. 1 euro = 1 złoty. Taki kurs byłby bardzo atrakcyjny na przykład dla rencistów i emerytów, ale prowadziłby natychmiast do masowych bankructw przedsiębiorstw i do masowego bezrobocia. Przy okazji zjednoczenia Niemiec w 1990 r. zdecydowano się na kurs 1:1 marki zachodnioniemieckiej i wschodnioniemieckiej. Rezultatem była głęboka recesja na obszarze byłej NRD i konieczność dofinansowania tej części Niemiec w wysokości około 100 mld euro rocznie przez około 20 lat.

W Europie kontynentalnej wartości narodowe nie kojarzą się z dumną tradycją, jak to jest w przypadku Wielkiej Brytanii, ale z dwiema światowymi wojnami pierwszej połowy XX w. Dla wielu z nich wspólna waluta i wspólny bank centralny są bardzo ważne, mogą bowiem pomóc w ograniczeniu ryzyka kolejnej wojny w Europie przez promocję współpracy gospodarczej i politycznej oraz wzrost poczucia przynależności do jednej wspólnoty, opartej na podobnych wartościach. Te polityczne korzyści są dla wielu indywidualnych ludzi być może ważniejsze nawet niż korzyści czysto gospodarcze. W Europie dwa kraje, Polska i Niemcy, poniosły w pierwszej połowie XX w. – i mogą ponieść w przyszłości – największe koszty narodowych rywalizacji, powinny więc być teraz szczególnie zainteresowane integracją gospodarczą i polityczną w Unii Europejskiej, której to integracji ważną częścią jest wspólna waluta.

#### **4. Ostatni raport NBP o strefie euro i polskiej drodze do euro**

W przeszłości Narodowy Bank Polski przygotował i opublikował już trzy obszernie raporty na temat wszystkiego, co wiąże się z przyjęciem przez Polskę euro jako waluty krajowej. Drugi z tych raportów był opublikowany w roku 2009, na podstawie prac przygotowanych w większości jeszcze przed wybuchem światowego kryzysu finansowego latem 2008 r. Główny wniosek tego opracowania był następujący: „Bilans korzyści i kosztów przyjęcia przez Polskę euro pokazuje, że korzyści zdecydowanie przewyższają koszty zarówno w krótkim, jak i długim okresie” (Raport na temat pełnego uczestnictwa..., 2009). Wpływ



korzyści netto autorzy tego raportu oszacowali na 7% PKB rocznie po dziesięciu latach pobytu w strefie euro.

Trzeci dokument NBP (Ekonomiczne wyzwania integracji..., 2014) na ten sam temat jest nie tyle nowym całościowym raportem, ile bardzo obszernym – ma blisko 200 stron – dodatkiem do raportu z 2009 r. Został przygotowany przez duży zespół analityków NBP na podstawie szczegółowej analizy doświadczeń i działań krajów strefy euro i Polski, jakie nastąpiły w trakcie oraz w konsekwencji światowego kryzysu.

Autorzy koncentrują się na przeglądzie i ocenach reform instytucjonalnych, dotyczących głównie polityki fiskalnej i sektora bankowego, podjętych przez kraje strefy euro w odpowiedzi na ten kryzys. W ocenach tych chodzi głównie o to, czy podjęte działania zmniejszają w sposób istotny ryzyko podobnych kryzysowych zjawisk w przyszłości.

W podsumowaniu autorzy nie kwestionują głównego wniosku wynikającego z poprzedniego raportu, ale wobec licznych i nieuniknionych wątpliwości piszą ostrożnie, że wejście Polski do strefy euro daje raczej szansę niż pewność znacznych korzyści ekonomicznych, a może i politycznych – którymi się zresztą nie zajmują. Głównym motywem opracowania jest, jak się wydaje, poszukiwanie odpowiedzi na pytanie, co trzeba zrobić w Polsce, by w świetle działań podejmowanych w związku z przystąpieniem do strefy euro tę szansę dobrze wykorzystać.

Niemniej jednak główna część dokumentu nie jest poświęcona temu, co trzeba zrobić w Polsce, ale ocenie zmian w samej strefie euro. Kierunek tych zmian autorzy uważają za właściwy, a w przypadku integracji finansowej nawet za zadowalający.

Jednocześnie autorzy dokumentu twierdzą, że zmiany w koordynacji polityki fiskalnej i ogólnie gospodarczej wprowadzone dotąd w strefie euro „nie likwidują istotnych słabości” tej strefy. Ich zdaniem wzmacnia to potrzebę silniejszych reform w Polsce na rzecz poprawy „konkurencyjności strukturalnej” przed przyjęciem euro.

Autorzy zauważają bardzo ważną zmianę w stopniu dyscyplinowania „rządów rozrzutnych” przez rynki finansowe. Przed rokiem 2008 rentowności skarbowych papierów wartościowych krajów strefy euro były podobne i kształtowały się na niskim poziomie. Tymczasem jakość polityki fiskalnej była między krajami bardzo zróżnicowana.

Kryteria z Maastricht dotyczące długu publicznego i deficytu sektora finansów publicznych były przed rokiem 2008 lekceważone nie tylko przez rządy, lecz także przez inwestorów prywatnych na rynku papierów skarbowych. Jednocześnie transfery środków budżetowych między krajami strefy euro były niemal niemożliwe. Te fakty przestały być ignorowane po 2008 r.

W sektorze bankowym poprawa bezpieczeństwa nastąpiła nie tylko w rezultacie działań związanych z unią bankową, lecz także pod wpływem wymogów ostrożnościowych narzuconych przez tzw. Bazyleę III. Autorzy dokumentu piszą o czterech filarach obecnej rządowej strategii integracji Polski ze strefą euro: filar (1) trwałe wypełnianie kryteriów z Maastricht, dotyczących wyniku sektora finansów publicznych i długu publicznego; (2) wzmocnienie potencjału polskiej gospodarki; (3) dobre przygotowanie techniczno-organizacyjne; (4) wzmocnienie instytucjonalne samej strefy euro. Ale raport koncentruje się tylko na filarze drugim. Tymczasem najważniejszy i najtrudniejszy do realizacji wydaje się być filar pierwszy. W latach 2000–2012 dług publiczny Polski był zwykle na poziomie 50–60% PKB, więc przekraczał o 20–30 pp. pożądany poziom ok. 30–40% PKB, a deficyt strukturalny finansów publicznych przekraczał pożądany średni poziom ok. 0% PKB o średnio 3–4% PKB. W latach dobrej koniunktury powinniśmy mieć nadwyżkę budżetową ok. 2–3% PKB, zamiast odnotowywać deficyt w wysokości 2–3% PKB, jak to było dotąd i jak jest nadal. Poprawa w tym obszarze ma duże znaczenie dla stabilności i wysokości tempa wzrostu gospodarczego kraju w każdych okolicznościach, także wtedy, gdy jesteśmy poza strefą euro.

Autorzy raportu poświęcają wiele uwagi kwestii zbudowania fiskalnych mechanizmów stabilizacyjnych w stosunku do wybranych krajów oraz całej strefy. Autorzy omawiają dość szczegółowo kilka propozycji tego rodzaju, takich jak budżet strefy euro, specjalny fundusz na trudne czasy, wspólny system zasiłków dla krótkookresowych bezrobotnych oraz zabezpieczenie fiskalne dla unii bankowej.

Autorzy podkreślają w tej dyskusji wysokie ryzyko zjawiska *moral hazards* z racji niskiej jeszcze skali integracji politycznej, w rezultacie dużą trudność w implementacji proponowanych przez KE mechanizmów. W związku z tym, że to budżety narodowe są i będą przez kolejne dziesięciolecia podstawowym instrumentem polityki fiskalnej, narodowe powinny być także główne mechanizmy stabilizacyjne.

Autorzy podkreślają również, że transfery środków budżetowych między krajami strefy euro mogą mieć tylko bardzo ograniczony charakter, ponadto powinny być przeprowadzane według z góry określonych reguł, takich jak ustalone niskie pułapy wspólnego zadłużenia oraz limity takiego zadłużenia dla poszczególnych krajów.

W dokumencie autorzy omawiają także propozycję „wspólnotowienia” (termin używany przez autorów) części narodowych długów publicznych, czyli przejęcia odpowiedzialności za część długów narodowych przez całą strefę euro, oraz propozycję euro-obligacji. Zwracają uwagę, że tego typu instrumenty fiskalne

mają szansę akceptacji tylko wtedy, gdy zapewni się brak wystąpienia trwałych jednokierunkowych transferów między krajami strefy euro. Uważają wręcz za „kluczowe przywrócenie wiarygodności klauzuli *no bailout* lub zwiększenia uprawnień kontrolnych instytucji centralnych nad krajową polityką fiskalną” (*ibidem*, s. 100).

Autorzy poświęcają też dużo uwagi propozycjom inspirowania i koordynacji reform przez Komisję Europejską. Oceniają że „jest mało prawdopodobne, by wdrożenie koordynacji *ex ante* planów najważniejszych reform przyniosło istotne pozytywne korzyści z punktu widzenia działania strefy euro” (*ibidem*, s. 60). Zróżnicowanie jakości rządów i polityki gospodarczej między krajami jest bowiem obecnie duże i takie zapewne pozostanie.

Ekonomiści zwracają uwagę politykom, że brak elastyczności kursowej ma dobrą stronę w postaci eliminacji ryzyka kursowego, ale ten brak trzeba kompensować wzrostem elastyczności w innych obszarach, zwłaszcza fiskalnym, usług publicznych na rzecz przedsiębiorców oraz na rynku pracy. Autorzy dokumentu NBP też ten aspekt podkreślają.

Elastyczność rynku pracy jest w Polsce stosunkowo wysoka. W dużych aglomeracjach miejskich stopa bezrobocia jest niska, a mimo to presja płacowa jest umiarkowana. Problemem jest niska mobilność pracowników z obszarów o wysokim bezrobociu do miejscowości o niskim bezrobociu. Dużą barierą takiej mobilności jest to, że niemal nie ma tanich mieszkań na wynajem. Na tę barierę omawiany dokument również zwraca uwagę, podkreślając, że należy ją usuwać jak najszybciej. Usunięcie tej bariery nie jest jednak warunkiem wejścia Polski do strefy euro.

Po wejściu do strefy euro nominalne stopy procentowe byłyby niższe o ok. 2%, a stopa inflacji nieco wyższa niż obecnie. W rezultacie więc realne stopy procentowe byłyby znacząco niższe. Dokument NBP zwraca uwagę, że długotrwałe utrzymywanie się realnej stopy procentowej na niskim poziomie „zwiększa ryzyko nadmiernej ekspansji kredytowej oraz powstania bańki na rynku nieruchomości” (*ibidem*, s. 10). Ale autorzy przyznają, że w ograniczaniu ryzyka narastania bańki na rynku nieruchomości zastosowane mogą być limity narzucone przez nadzór bankowy dotyczące wskaźników *loan-to-value* i *debt-to income*.

Realne rynkowe stopy procentowe powinny być zbliżone do tempa wzrostu PKB. To reguła teoretyczna, orientacyjna. W praktyce problemy zaczynają się wtedy, gdy odstępstwo od tej reguły jest duże i długotrwałe. W dokumencie NBP brak analizy ilościowej tego potencjalnego problemu. W dodatku instrumenty ostrożnościowe stosowane przez banki oraz nadzór bankowy mogą w przypadku Polski okazać się wystarczające do zapewnienia stabilności na rynku finansowym.

W Polsce mamy wysoką innowacyjność gospodarki opartą na transferze z zewnątrz zarówno nowych produktów, jak i technologii ich wytwarzania. Wejście do strefy euro powinno zwiększyć dopływ bezpośrednich inwestycji zagranicznych i wymianę handlową. Kanały te ułatwiają dopływ innowacji z zewnątrz, podnosząc konkurencyjność i zmieniając w dobrym kierunku strukturę gospodarki. Opierając się na tej argumentacji, należy zatem raczej przyspieszyć niż opóźniać wejście Polski do strefy euro.

## 5. Polityczne i ekonomiczne funkcje integracyjne euro

Ojcowie założyciele Unii Europejskiej (UE) nie nakreślili jej precyzyjnych kształtów politycznych czy instytucjonalnych. Dość szczegółowo mówili natomiast o przyszłym kierunku niezbędnej integracji, która miała obejmować zmiany na wszelkiego rodzaju rynkach, ale ze szczególnym uwzględnieniem międzynarodowej wymiany handlowej oraz produktów finansowych, także stopniową integrację rynku pracy. Politycy doszli do wniosku, że wspólna waluta – sama w sobie niestanowiąca warunku koniecznego dla dobrego funkcjonowania wspólnych rynków – może wspierać proces integracji gospodarczej i politycznej w obrębie Unii Europejskiej. Inspiracją do podjęcia tego typu działań mógł być dorobek ekonomistów, takich jak Robert A. Mundell (1969), który twierdził, że projekt stworzenia jednolitego systemu monetarnego opartego na wspólnej walucie jest instytucjonalnie możliwy do zrealizowania, a w pewnych okolicznościach (najważniejsze z nich to prowadzenie przez państwa członkowskie elastycznej i stabilnej polityki fiskalnej) nawet ekonomicznie korzystny. Eliminacja ryzyka kursowego korzystnie wpłynęłaby na wymianę handlową i inwestycje w obrębie unii walutowej, zwiększyłaby konkurencję na rynku towarów i ogólną efektywność gospodarki. Rozwój wydarzeń od roku 1999 pokrywał się z tymi oczekiwaniami.

Dla politycznych liderów Europy, chcących zaprowadzić ład gospodarczy i polityczny sprzyjający trwałemu utrzymaniu pokoju po dwóch wyjątkowo barbarzyńskich i niszczycielskich wojnach, polityczne i społeczne skutki ściślejszej integracji gospodarczej mogły być nawet ważniejsze niż korzyści czysto gospodarcze. Integracja gospodarcza zwiększyłaby współzależność państw tworzących UE, a to wzmocniłoby ducha transgranicznej współpracy politycznej, co zniechęciłoby państwa członkowskie do rywalizacji militarnej. Co więcej, wspólna waluta wspomogłaby proces tworzenia wspólnej tożsamości europejskiej, która wraz z przyjściem kolejnych pokoleń stałaby się spoiwem niezbędnym do integracji kulturowej, pomogłaby we współpracy politycznej,

a z czasem być może doprowadziłaby do jakiejś formy integracji politycznej. Rozwój wydarzeń od roku 1999 w dużej mierze pokrywał się również z tymi oczekiwaniami.

Dla Polski duże znaczenie mają oczekiwania, że unia monetarna może przynieść korzyści krajom słabiej rozwiniętym, doganiającymi wysoko rozwinięty Zachód. Do tej kategorii zaliczyć należy Polskę i inne kraje Europy Środkowej. Kraje te doświadczają efektu, który Alexander Gerschenkron, amerykański historyk gospodarczy, mniej więcej przed sześćdziesięciu laty nazwał „korzyściami zacofania” (Gerschenkron, 1962). Korzyści te są osiągalne wyłącznie pod warunkiem, że polityka gospodarcza kraju doganiającego sprzyja transferowi od swoich bardziej rozwiniętych partnerów i absorpcji w kraju nowych produktów i technologii. Tego rodzaju transfery i absorpcje są zwykle wprost proporcjonalne do wydatków na inwestycje w projekty o charakterze technologicznym.

Członkostwo w unii monetarnej stymuluje zagraniczne inwestycje bezpośrednie oraz daje krajowym firmom łatwiejszy dostęp do zagranicznych oszczędności po niskim koszcie. W rezultacie kraje słabiej rozwinięte mają szansę osiągać szybszy wzrost gospodarczy, co w ujęciu realnym oznacza szybsze doganianie krajów lepiej rozwiniętych. Sytuacja po 1999 r. skłania do przyjęcia poglądu, że tego rodzaju korzyści, choć możliwe do osiągnięcia, nie są jednak gwarantowane. Niższe stopy procentowe mogą bowiem w praktyce stymulować konsumpcję lub inwestycje w rynek nieruchomości mieszkalnych, zamiast rozwoju projektów o charakterze technologicznym. W niektórych okolicznościach może to prowadzić do cenowych baniek spekulacyjnych oraz nadmiernego zadłużenia (zarówno prywatnego, jak i publicznego), które z kolei mogą być źródłem destabilizacji. Czynniki te, występując wspólnie, mogą poważnie zaszkodzić kondycji gospodarki. Dzisiaj wiemy, że jest to problem, przeciw wystąpieniu którego istnieją jednak środki zaradcze.

Europejski Bank Centralny (EBC) formalnie nie pełni roli pożyczkodawcy ostatniej instancji dla państw członkowskich. Powodem jest to, że państwa członkowskie nie tworzą federacji, lecz tylko zbiór niezależnych krajów. Wiarogodność banku centralnego każdego kraju wynika z jasnego podziału obowiązków związanych z zapewnianiem stabilności makroekonomicznej między tym bankiem a władzą wykonawczą lub ustawodawczą. O tego rodzaju podziale można mówić również w przypadku Polski. Gdyby EBC pełnił funkcję pożyczkodawcy ostatniej instancji dla wszystkich państw wchodzących w skład strefy euro, wówczas znacznie ograniczałoby to jego możliwości w zakresie utrzymywania niskiej inflacji. Wynika to stąd, że kraje członkowskie oraz rynki finansowe wiedziałyby, iż rygor wymuszający utrzymywanie niskiego deficytu finansów publicznych nie jest zbyt ostry. W wielu przypadkach mielibyśmy

zatem do czynienia z rozluźnieniem polityki fiskalnej. Tego rodzaju zagrożenie jest wyraźnie mniejsze w sytuacji, w której polityka fiskalna pozostaje w rękach jednego państwa. Gdyby EBC pełnił funkcję pożyczkodawcy ostatniej instancji dla państw członkowskich, doszłoby do rozproszenia odpowiedzialności za stabilność fiskalną całej strefy euro. W ten sposób mielibyśmy do czynienia z potencjalnie olbrzymim efektem gapowicza, znacznie zwiększającym ryzyko występowania przypadków destabilizacji makroekonomicznej.

Mimo to w okresie po roku 2008 EBC podejmował okresowe działania na rzecz obniżenia kosztów obsługi długu publicznego. Co do zasady EBC może reagować w przypadku problemów z płynnością w systemie bankowym strefy euro, natomiast w przypadku faktycznych kryzysów wypłacalności banków i państw już nie powinien. Oznacza to, że EBC może pełnić funkcję pożyczkodawcy ostatniej instancji tylko wyjątkowo, w okolicznościach, które sam uzna za stosowne. Co więcej, może podejmować przede wszystkim działania pośrednie, sprowadzające się do pożyczania pieniędzy bankom komercyjnym na korzystny procent. Nie ma potrzeby modyfikowania tego istotnego filaru bieżącego ładu instytucjonalnego, choć niewykluczone, że warto byłoby doprecyzować mandat EBC w zakresie podejmowania takich działań, wprowadzając odpowiednie zapisy w jego statucie.

Strefa euro spełnia warunek pomocnego instrumentu w budowie daleko posuniętej integracji gospodarczej. Ale wobec usztywnienia kursów wymiany walut narodowych konieczna jest kompensata w postaci większej elastyczności w dwóch innych podstawowych obszarach polityki ekonomicznej, mianowicie w finansach publicznych i na rynku pracy. Jeżeli w trakcie recesji poszczególne państwa mogą mieć deficyt budżetowy, to w okresach gospodarczego boomu powinny utrzymywać nadwyżkę budżetową. Właśnie ten cel miał zostać osiągnięty dzięki podpisaniu *Paktu stabilności i wzrostu*.

W ostatnich kilku latach dobrej koniunktury większość krajów UE, w tym kraje strefy euro, istotnie mają nadwyżki budżetowe. Większa elastyczność narodowych rynków pracy jest, z kolei, niezbędna w celu utrzymania we wszystkich krajach członkowskich stopy wzrostu jednostkowych kosztów pracy na zbliżonym poziomie. Jest to warunek utrzymywania zbliżonego poziomu międzynarodowej konkurencyjności produktów. Duża utrata tej konkurencyjności w którymś z państw tworzących strefę euro okazuje się w warunkach sztywnego kursu walutowego – trudna do odzyskania, a to przekłada się na wysokie zadłużenie zewnętrzne lub długotrwałą recesję w tym kraju. Najwyraźniej tego rodzaju utrata konkurencyjności nastąpiła w kilku krajach strefy euro w latach 2000–2008, czyli na długo przed wybuchem globalnego kryzysu finansowego (lato 2008) oraz kryzysu w strefie euro (2010). Polityka fiskalna i polityka zarządzania pracą



pozostają w gestii władz krajów członkowskich i ich parlamentów. Budżet krajów członkowskich stanowi średnio ok. 50% ich PKB, natomiast budżet Unii Europejskiej – zaledwie ok. 1% PKB całej Unii. Niewłaściwa polityka makroekonomiczna poszczególnych krajów jest na dłuższą metę kosztowna dla nich samych, ale ma także negatywny wpływ na sytuację całej strefy euro. Ważne jest więc, aby kraje członkowskie były karane za odchodzenie od polityki gwarantującej własną makrofinansową stabilność, a w rezultacie stabilność całej strefy euro.

George Soros wskazuje na niewystarczającą uwagę poświęcaną w UE czynnikom motywującym państwa członkowskie do dbania o krótkoterminową stabilność i długoterminową równowagę. Formułuje diagnozę, zgodnie z którą „kryzys euro (w latach 2010–2011) stanowi bezpośredni skutek krachu finansowego z 2008 r.”, po którym „cały system finansowy (...) trzeba było podłączyć do aparatury sztucznie podtrzymującej go przy życiu” (Soros, 2011). Mimo to Niemcy obwieściły, że ich zdaniem gwarancje dla instytucji finansowych, zaoferowane przez ministrów finansów państw członkowskich już w listopadzie 2008 r., powinny być „realizowane przez poszczególne kraje członkowskie, a nie przez Unię Europejską czy strefę euro jako całość” (*ibidem*). Zdaniem Sorosa deklaracja ta „położyła podwaliny pod kryzys euro, ponieważ ujawniła i aktywowała ukryty dotąd słaby punkt konstrukcyjny wspólnej waluty: brak wspólnego ministerstwa finansów i wspólnej polityki fiskalnej” (*ibidem*). Zauważa też, że odpowiednikami niektórych kredytów hipotecznych z amerykańskiego rynku *subprime*, które przyczyniły się do wybuchu kryzysu w USA, są rzekomo pozbawione ryzyka aktywa, a mianowicie obligacje emitowane przez niektóre kraje europejskie. Soros życzyłby sobie, aby nowo utworzone instytucje – Europejski Fundusz Stabilizacji Finansowej (EFSF, założony w maju 2010 r.) i jego następca, Europejski Mechanizm Stabilności (ESM, założony po 2013 r.) – „stanowiły siatkę bezpieczeństwa dla całej strefy euro”. Wymagałoby to ich przekształcenia w „pełnoprawny skarb europejski, (...) z prawem nakładania podatków, a zatem także z prawem zapożyczania się” (*ibidem*).

Oznaczałoby to konieczność przekazania krajowych kompetencji fiskalnych na szczebel unijny, czego dzisiaj najwyraźniej nikt w UE nie jest gotów zaakceptować. Gdyby rekomendacja Sorosa została zrealizowana, prawdopodobnie pozwoliłaby przywrócić zaufanie rynków finansowych do podejrzanych obligacji niektórych państw członkowskich, których emitenci muszą wypłacać wysoką premię za ryzyko. Rekomendacja Sorosa nie została zrealizowana z dość oczywistych powodów politycznych. Bowiem kraje należące do strefy euro musiałyby zrzec się kompetencji w zakresie prowadzenia polityki fiskalnej i przekazać je Komisji Europejskiej oraz Parlamentowi Europejskiemu. Wymagałoby to

względnie szybkiego utworzenia europejskiego państwa federalnego, Stanów Zjednoczonych Europy.

Doświadczenia ostatnich kilku lat pokazują jednak, że rekomendacje George'a Sorosa są zbyt daleko idące, były i są warunkiem dostatecznym, ale nie koniecznym utrzymania makrofinansowej stabilności strefy euro. Przyjęte rozwiązanie polegało na przejęciu przez EBC roli stabilizatora na rynku obligacji skarbowych.

## 6. Solidarność a dyscyplina w strefie euro

Słowo „solidarność” budzi w Polsce pozytywne skojarzenia polityczne związane z narodzinami ruchu „Solidarność” na początku lat osiemdziesiątych XX w. i z późniejszą pokojową rewolucją. W Niemczech to samo słowo jest zapewne kojarzone z tzw. podatkiem solidarnościowym, nałożonym na Niemcy Zachodnie w celu sfinansowania odbudowy Niemiec Wschodnich po upadku Muru Berlińskiego pod koniec 1989 r. Z tego podatku sfinansowano transfery pieniężne do Niemiec Wschodnich na łączną kwotę ok. 2 bilionów euro od 1990 roku.

Strefa euro nie jest jednak jednolitym podmiotem państwowym, a Grecja to nie Niemcy Wschodnie. Oczekiwanie dużego i długotrwałego transferu środków pieniężnych z Niemiec do Grecji w imię europejskiej solidarności nie mogło spotkać się w Niemczech z polityczną przychylnością, a może być wręcz postrzegane jako nieracjonalne ekonomicznie i nieakceptowalne moralnie. Argument o nieracjonalności ekonomicznej takiego działania opiera się na założeniu, że gdyby Grecja została nagrodzona za swoją rozrzutność oraz nadmierne zadłużanie się, w innych krajach mogłoby to zostać odebrane jako zachęta do prowadzenia podobnej polityki. Pojawiłaby się zatem pokusa nadużycia na tak wielką skalę, że mogłoby to doprowadzić do całkowitej i niekontrolowanej dekompozycji strefy euro.

W słabszych krajach Unii Europejskiej, w tym w Polsce, politycy stosunkowo chętnie odwołują się do zasady solidarności, którą interpretują jako obowiązek rozwiązania problemów Grecji i innych wysoko zadłużonych krajów przez najsilniejsze gospodarczo państwa. Gdyby Grecja i inne zadłużone kraje strefy euro nie otrzymały znacznej pomocy finansowej, to nie byłyby w stanie obsłużyć swojego długu publicznego. Doszłoby wówczas do niekontrolowanych bankructw, które okazałyby się zapewne niezwykle kosztowne dla tych krajów, a mogłyby również wywołać dużą recesję w całej UE. Pomoc świadczona Grecji przez EBC, niektóre kraje członkowskie oraz Międzynarodowy Fundusz Walutowy (MFW)



po 2008 r. umożliwiła temu państwu utrzymanie wypłacalności, tym samym ograniczając społeczne i polityczne koszty kryzysu.

Aby uniknąć powstania potencjalnie destabilizujących mechanizmów związanych z pokusą nadużycia, tego rodzaju pomoc musi mieć ograniczony charakter. Co więcej, taka pomoc ma sens jedynie pod warunkiem, że jej beneficjenci sami wdrożą odpowiednio skuteczne środki radzenia sobie z nadmiernym zadłużeniem i niską konkurencyjnością.

Złotą zasadą przyświecającą udzielaniu pomocy zewnętrznej w przypadku tego rodzaju kryzysu jak w Grecji powinna być sprawdzona zasada MFW: udzielana pomoc powinna być na tyle duża, aby umożliwić wprowadzenie istotnych reform w kraju zmagającym się z problemami, a jednocześnie na tyle mała, aby była akceptowalna dla krajów tę pomoc finansujących oraz aby nie upowszechniała destabilizującej pokusy nadużycia.

Kraje strefy euro oraz EBC i MFW w dużej mierze trzymają się tej złotej zasady. Odejście od euro prawdopodobnie ułatwiłoby Grecji szybkie odzyskanie konkurencyjności. To radykalne rozwiązanie alternatywne, z którego kraj ten mógł skorzystać. Byłoby ono dla Grecji jednak bardzo kosztowne, więc Grecy je odrzucili. Głównym narzędziem, za pomocą którego strefa euro zareagowała na bieżące wyzwania z myślą o średnim i długim okresie, było utworzenie Europejskiego Mechanizmu Stabilności z kapitałem w wysokości 500 mld euro, a docelowo 800 mld euro. Europejski Mechanizm Stabilności z początkiem 2013 r. miał przejąć od EBC rolę głównego partnera MFW w świadczeniu warunkowej pomocy krajom strefy euro zmagającym się z trudnościami w obsłudze swych zagranicznych zobowiązań.

## 7. Długoterminowe środki naprawcze

Decyzje ekonomiczne państw i społeczeństw są często podejmowane na podstawie względów krótkoterminowych, przez co w rezultacie w średnim i długim okresie mogą być decyzjami nieracjonalnymi. Eliminacja krótkoterminowych pokus wymaga stosowania odpowiednich reguł oraz zachęt na rzecz brania pod uwagę względów długoterminowych. Państwa w strefie euro są niezależne, należy więc myśleć realistycznie i nie zakładać całkowitej eliminacji ich nieracjonalnych zachowań, lecz raczej zabiegać o ograniczenie prawdopodobieństwa ich występowania.

W przypadku strefy euro od samego początku zastanawiano się, czy kryteria z Maastricht będą wystarczającym ograniczeniem krajowych polityk fiskalnych, aby zapewnić właściwą koordynację i stabilność na poziomie UE. Dotychczasowa

historia strefy euro pozwala wyprowadzić wniosek, że – mimo bardzo wielu przypadków naruszenia kryteriów z Maastricht – kryteria te były wypełniane w wystarczającym stopniu, aby w większości przypadków możliwa była skuteczna koordynacja dwóch kluczowych polityk: monetarnej i fiskalnej. Zupełnie uzasadnione wydaje się jednak pytanie, czy w świetle najnowszych doświadczeń nie należałoby zmienić dotychczasowych kryteriów z Maastricht oraz czy system dyscyplinujący, mający wymuszać stosowanie się do tych kryteriów, jest wystarczająco skuteczny.

Przypadek Grecji i kilku innych krajów dowodzi, że bieżący system dyscyplinowania i koordynacji powinien prawdopodobnie zostać poddany działaniom naprawczym. Do traktatu z Maastricht i traktatów europejskich warto byłoby wprowadzić następujące zmiany.

Należałoby rozważyć wprowadzenie dwóch nowych warunków stabilności: jednego – dotyczącego całkowitego zadłużenia zewnętrznego kraju (czyli zadłużenia publicznego i prywatnego), oraz drugiego – dotyczącego rachunku bieżącego bilansu płatniczego, przy czym oba te kryteria należałoby rozpatrywać w odniesieniu do PKB. Alternatywnie należałoby zreformować na modłę amerykańską stosowany przez EBC instrument TARGET (skrót od ang. Trans-European Automated Real Time Gross Settlement Express Transfer, system rozliczania transakcji w obrębie strefy euro, w ramach którego banki komercyjne jednego państwa członkowskiego mogą dokonywać transferów do banków komercyjnych innego państwa członkowskiego). Problem ten został częściowo rozwiązany w nowej inicjatywie unijnej, czyli w procedurze nadmiernego deficytu, jednak środki te mogą okazać się niewystarczające.

Komisja Europejska, we współpracy z Trybunałem Sprawiedliwości UE, powinna otrzymać kompetencje w zakresie nakładania kar na kraje niespełniające części lub wszystkich kryteriów z Maastricht. Kary te powinny być nakładane w sposób niemal automatyczny. Wśród nich mogłoby się znaleźć ograniczanie lub wręcz wstrzymywanie transferu środków z budżetu unijnego do danego kraju. Propozycja ta powinna zostać wprowadzona w życie w odniesieniu do nadmiernego deficytu i zasad praworządności.

Traktat o Unii Europejskiej powinien zostać zmieniony w taki sposób, aby uwzględniał skrajną możliwość usunięcia ze strefy euro takiego państwa członkowskiego, które systematycznie i znacząco naruszałoby kryteria stabilności z Maastricht. Należałoby dokładnie sprecyzować zasady opuszczania strefy euro, aby groźba usunięcia państwa z tej strefy była realna, co – zmniejszyłoby prawdopodobieństwo wystąpienia takiej sytuacji. Możliwość wyjścia ze strefy euro byłaby potrzebna w sytuacji, w której unia monetarna oznacza m.in. funkcjonowanie finansowanego wspólnie mechanizmu stabilizującego.

Budżet UE należałoby stopniowo, ale znacząco zwiększać w stosunku do PKB całej Unii. Dzisiaj stanowi on zaledwie 1% PKB UE. Zmiana ta miałaby na celu umożliwienie finansowania ogólnoeuropejskich projektów inwestycyjnych w takich obszarach, jak: infrastruktura, energetyka, badania i rozwój, obronność czy ochrona środowiska, radzenie sobie ze skutkami globalnego ocieplenia klimatu.

Przedstawiona wyżej pierwsza reforma oznaczałaby uznanie, że nie tylko dług publiczny (krajowy i zagraniczny), lecz również całkowite zadłużenie zewnętrzne w nadmiernej wysokości może okazać się źródłem destabilizacji makroekonomicznej. W ramach obecnego reżimu nie istnieje ani jedno kryterium ograniczające deficyt na rachunku bieżącym bilansu płatniczego. Z technicznego punktu widzenia zobowiązania te stanowią element zadłużenia publicznego brutto, jednak oficjalnie się ich w ten sposób nie liczy. Gdyby krajowe banki komercyjne znajdowały się pod nadzorem EBC, a nie poszczególnych państw członkowskich, sytuacja ta kształtowałaby się inaczej. Import jest prowadzony głównie przez sektor prywatny, istnieją zatem ekonomiczne podstawy, aby traktować te zobowiązania jako osobną kategorię zadłużenia narodowego, a nie jako jeden z elementów długu publicznego. Duży deficyt na rachunku bieżącym bilansu płatniczego powinien być z kolei sygnałem dla władz państwa, że albo mieszkańcy osiągają zbyt duże dochody, albo za wysokie są wydatki publiczne (ewentualnie podatki zbyt niskie). Sygnał ten powinien skłonić władze do podjęcia odpowiednich działań.

Jeśli chodzi o drugą reformę, ważny jest skuteczny mechanizm dyscyplinowania krajów członkowskich. W ramach dotychczasowego systemu nie obowiązywały żadne automatyczne kary, nawet za poważne i konsekwentne naruszenia zobowiązań traktatowych.

Zadaniem trzeciej reformy jest uzdrowienie bieżącej sytuacji, w której dobro całej strefy euro spoczywa w rękach każdego z państw członkowskich, a więc również tych krajów, które są skłonne łamać postanowienia traktatowe. Kraje członkowskie zachowują polityczną niezależność, a doświadczenie z Grecją w sprawach fiskalnych oraz Węgier i Polski w kwestii praworządności uczy, że jeden lub dwa z nich prędzej czy później postanowią nie wywiązywać się z podstawowych obowiązków wynikających z podpisanych traktatów, a mimo to będą nalegać na pozostanie w UE i strefie euro. Zaproponowane przez KE powiązanie wypłat z budżetu UE w perspektywie 2020–2025 z przestrzeganiem zasad praworządności jest zgodne z tą propozycją.

Czwarta reforma nawiązuje do coraz większej integracji gospodarek krajów tworzących UE, która to integracja uzasadnia uchwalanie znacznie większego budżetu unijnego. Aby to było możliwe, wpłaty netto krajów członkowskich

do tego budżetu powinny zostać obłożone jasnymi i politycznie akceptowanymi limitami. Budżet unijny nadal powinien stanowić niewielką część wydatków publicznych krajów członkowskich, a zatem nie może odgrywać istotnej roli jako narzędzie (automatyczne bądź nie) stabilizacji fiskalnej.

Rozpad strefy euro spowodowałby głęboki kryzys gospodarczy i polityczny w Europie, więc koszty tego zdarzenia byłyby wyjątkowo wysokie. Dlatego też społecznie korzystniejszym rozwiązaniem jest reforma strefy euro, nawet dość głęboka, a nie jej rozpad. Większość reform jest wprowadzana w krajach PIIGS (Portugal, Ireland, Italy, Greece, Spain). Bo to one powinny podjąć większość działań i to one powinny wziąć na siebie znaczną część gospodarczych, społecznych i politycznych kosztów tych reform. Pomoc zewnętrzna może być duża, winna być jednak świadczona na określonych warunkach i przybierać raczej postać kredytów niż bezzwrotnych transferów. Taka też jest dotychczasowa praktyka.

## **8. Doświadczenia Stanów Zjednoczonych z unią monetarną i ich implikacje dla strefy euro**

Ekonomiści H.W. Sinn i T. Wollmershauser twierdzą, że „Europa powinna rozważyć przyjęcie amerykańskich zasad funkcjonowania unii walutowej. Zasady te zostały przecież opracowane w długim historycznym procesie prób i błędów, a ich skuteczność została dowiedziona. Nie zawsze trzeba na nowo wynajdować koło” (Sinn, Wollmershauser, 2011, s. 29). Struktura instytucjonalna oraz metody działania EBC rzeczywiście można by było usprawnić, zapożyczając gotowe rozwiązania z amerykańskiego Systemu Rezerwy Federalnej, który dzieli się na 12 okręgów. Dwaj wspomniani wyżej ekonomiści sformułowali konkretne propozycje dotyczące mechanizmu TARGET, a Willem Buiters (2012) sformułował szczegółowe propozycje rozwiązań dotyczących prowadzenia wspólnej polityki monetarnej, kredytowej i płynności przez EBC i 17 (19 od 2015 r.) krajowych banków centralnych.

Z uwagi jednak na podstawowe przyczyny kryzysu skoncentruję się przede wszystkim na tym, w jaki sposób strefa euro może się bronić przed potencjalnie destabilizującym oddziaływaniem braku wspólnego organu politycznego i wspólnej władzy finansowej na politykę monetarną. Stany Zjednoczone to federacja stanów dysponująca jednak silnym rządem federalnym. W 1913 r. utworzono System Rezerwy Federalnej, mający pełnić funkcję pożyczkodawcy ostatniej instancji. „The Economist” pisał, że „spowolnienie gospodarcze z lat trzydziestych doprowadziło do rozdęcia wydatków publicznych za prezydentury Roosevelta. Stany są teraz ograniczone obowiązkiem równoważenia budżetu,

jednak to rząd federalny istotnie się zapożycza w celu kreowania popytu”. Dalej w tym samym tekście pojawia się uwaga, że „strefa euro usiłuje *de facto* kopiować amerykańską strategię nieratowania dłużników z lat czterdziestych, nie dysponuje jednak ani strukturą federalną stworzoną przez Hamiltona, ani narzędziami antycyklicznymi Roosevelta. Członkowie strefy euro balansują na cienkiej linie bez żadnego zabezpieczenia. Gdy przyszło zmierzyć się z burzą, okazało się, że wszystkie kraje członkowskie są ze sobą powiązane za pośrednictwem rynków finansowych. Gdyby jeden z nich miał upaść, to samo może grozić pozostałym” (*The Economist*, 2012).

Strefa euro nie dysponuje centralnymi władzami, praktycznie nie ma też centralnego budżetu. Poszczególne kraje członkowskie prowadzą aktywną politykę fiskalną. Ich budżety są duże i z roku na rok nie muszą się bilansować. Ograniczenia fiskalne z Maastricht dotyczą tylko deficytów strukturalnych oraz skumulowanego długu publicznego. Amerykański rząd federalny może pożyczać od Systemu Rezerwy Federalnej, w praktyce jednak pożycza głównie na krajowych i międzynarodowych rynkach finansowych, czyli postępuje podobnie, jak rządy krajów UE. Różnice instytucjonalne między Stanami Zjednoczonymi a Unią Europejską są bardzo duże, jednak w kontekście prowadzenia sprzyjającej stabilności polityki fiskalnej i monetarnej nie są już aż tak wyraźne. Ograniczenia fiskalne w UE są jednak raczej łagodne, jak dotąd nawet zbyt łagodne, bardzo zróżnicowane jest zatem ryzyko inwestycyjne prezentowane przez poszczególne kraje. O podatkach i wydatkach publicznych decydują parlamenty krajowe, a nie Parlament Europejski, dlatego też odpowiedzialność za obsługę i spłatę zadłużenia musi spoczywać w całości na poszczególnych państwach członkowskich – tak też się dzieje. Powoduje to, że rynki finansowe pełnią funkcję bardzo ważnego, niezależnego czynnika dyscyplinującego politykę fiskalną poszczególnych państw członkowskich. Nie można mówić, aby była to rola jedynie uzupełniająca względem działań Komisji Europejskiej – oddziaływanie rynków finansowych ma znaczenie fundamentalne, nawet jeśli rynki te czasami reagują dość niekonsekwentnie.

## 9. Kontekst globalny – wzrost presji konkurencyjnej ze strony Chin i Indii

Szybki wzrost znaczenia Chin i Indii jako potęg gospodarczych zaczyna przekładać się na zmiany w globalnym rozkładzie sił politycznych. Prędzej czy później zmiany te będą prawdopodobnie miały charakter fundamentalny i przyniosą doniosłe skutki dla stosunków międzynarodowych. Zmiany te muszą odbić

się także na gospodarczej i politycznej przyszłości Europy. Prawdopodobnie będą stanowić dodatkową zachętę do zacieśnienia współpracy gospodarczej i politycznej w ramach UE. Ile czasu ma UE, aby przygotować się do bezpośredniej rywalizacji z tymi dwiema nowymi globalnymi potęgami?

W tym kontekście proponuję rozpatrywać najbardziej rozwinięte obecnie kraje, czyli tzw. Stary Świat, jako jeden podmiot. W jego skład wchodzi UE, Stany Zjednoczone, Japonia i Kanada. Łączna liczba ludności zamieszkującej ten obszar wynosiła w 2017 r. około 950 mln. Podobnie ludne są Chiny (1,4 mld mieszkańców) i Indie (1,2 mld). Jeśli chodzi natomiast o ich udziały w światowym PKB liczonym według parytetu siły nabywczej, to w 2017 r. mieliśmy następujący stan rzeczy: Stary Świat – 37,3%; Chiny – 18,3%; Indie – 7,4%. Stary Świat zachowuje jeszcze niemal całkowitą dominację w dziedzinie patentów chronionych na skalę międzynarodową oraz – w mniejszym stopniu – na globalnych rynkach finansowych.

Należy się jednak spodziewać, że te wartości udziałów do 2030 r. ulegną istotnej, a do 2050 r. radykalnej zmianie (Gomułka, 2017). Chiny i Indie to tzw. kraje wschodzące, których gospodarki rozwijają się w tempie 5–7% rocznie. Ogólnoświatowe doświadczenia związane z doganianiem innych każą wysnuć wnioski, że Chiny będą zdolne utrzymać takie tempo wzrostu jeszcze przez jakieś 10–20 lat, a Indie przez 20–30 lat. Później stopa wzrostu zacznie stopniowo, a może nawet gwałtownie spadać do poziomu 1–2% PKB *per capita*, czyli do poziomu notowanego obecnie w Starym Świecie. W rezultacie (bardzo) szacunkowe wartości udziału w światowym PKB w 2050 r. byłyby następujące: Stary Świat – 23%; Chiny – 19%, Indie – 14%. Ta prognoza sugeruje również, że do roku 2030 kraje Starego Świata raczej utrzymają dominację w badaniach technologicznych oraz na rynkach finansowych, jednak do 2050 roku ich przewaga także na tych polach znacząco zmaleje.

Z prognoz tych wynika także, że wzrost presji konkurencyjnej ze strony Chin i Indii będzie w Europie raczej stopniowy, w pewnym momencie presja ta stanie się jednak bardzo silna. Mamy zatem wystarczająco dużo czasu na zmodernizowanie struktury instytucjonalnej UE. Do 2050 r. postępy modernizacyjne powinny poczynić też kraje rozwijające się z Europy Środkowej i Wschodniej, osiągając standard cywilizacyjny i technologiczny być może tylko nieznacznie niższy niż w Europie Zachodniej.

## 10. Strategia dla Polski i strefy euro: uwagi końcowe

Unia Europejska może funkcjonować bez wspólnej waluty, w końcu funkcjonowała w ten sposób aż do 1999 r. Ale powrót do walut krajowych byłby



niezwykle kosztowny. Koszty gospodarcze takiej decyzji przez kilka lat odczuwałyby wszystkie kraje członkowskie UE, nie tylko te, które należą do strefy euro. Ponadto mamy korzyści gospodarcze dalszej integracji monetarnej. Można zatem bezpiecznie założyć, że strefa euro będzie nadal się reformować i umacniać.

UE to również projekt polityczny, a zadaniem wspólnej waluty jest także wspieranie tego projektu. Podstawowym celem podejmowania tych działań było – i nadal jest – zapobieganie wybuchom wojen, które przez stulecia nękały Europę. W drugiej połowie XX w. ze wszystkich państw członkowskich UE najczęściej wycierpiałą Polska i Niemcy – znacznie więcej niż inne ważne kraje wspólnoty. Być może właśnie dlatego poparcie dla Unii, a także dla jej dalszej integracji, jest w tych dwóch krajach duże. Nic dziwnego, że polski minister spraw zagranicznych zadeklarował kilka lat temu w Berlinie, iż w nadchodzących latach „największym zagrożeniem dla bezpieczeństwa i dobrobytu Polski będzie ewentualny upadek strefy euro” (Sikorski, 2011).

Powstanie UE nastąpiło nie tylko w odpowiedzi na II wojnę światową, ale także jako efekt procesu globalizacji pod presją zmian technologicznych. Te zmiany nadal zachodzą, są nawet teraz silniejsze niż w przeszłości, a tym samym podtrzymują potrzebę kontynuacji procesu integracji gospodarczej i politycznej w ramach UE, w tym przede wszystkim w ramach strefy euro.

Interesujące jest jednak to, dlaczego pojawiła się różnica w przestrzeganiu kryteriów z Maastricht dotyczących kluczowej kwestii finansów publicznych między południową a północną częścią UE. Już przed przyjęciem euro jako wspólnej waluty kraje południowej Europy, także Francja, nie przywiązywały dużego znaczenia do utrzymania niskiej inflacji. W tych krajach akceptowano w rezultacie opcję dużego deficytu budżetowego i silnego wzrostu nominalnych płac jako ceny za krótkoterminową poprawę koniunktury i politycznej popularności rządzących, a dewaluację jako akceptowalny środek na odzyskanie konkurencyjności. Niemcy doświadczyły hiperinflacji w pierwszej połowie lat 20. XX wieku. Koszt społeczny tego doświadczenia był prawdopodobnie tak duży, że zmienił na kilka generacji polityczną kulturę w Niemczech i krajach sąsiednich w odniesieniu do polityki gospodarczej.

Odpowiednia strategia przyjęcia przez Polskę wspólnej waluty powinna jasno precyzować dwa cele. W krótkim okresie Polska powinna zająć zdecydowane stanowisko w kwestii sposobów wzmocnienia strefy euro. W średnim okresie powinna prowadzić taką politykę monetarną i fiskalną, która umożliwiłaby względnie szybkie wejście do strefy euro w roli jej silnego członka. Podawanie dzisiaj jakiegokolwiek terminów jest dość ryzykowne, można jednak założyć, że za kilka lat Polska mogłaby być gotowa do wejścia do ERM, Mechanizmu Kursów Walutowych. Problemem dzisiaj nie jest „stan zdrowia” strefy euro,

ale brak wystarczającej akceptacji politycznej w Polsce na wejście Polski do strefy euro.

Ścisłe spełnianie kryterium fiskalnego leży w interesie kraju już teraz, więc od potrzebnych zmian w polityce fiskalnej należy zacząć. Polska (i cała Unia) ma w krajach sąsiednich: Szwecji, Czechach i Słowacji, także w Niemczech, znakomite wzory do naśladowania. Na polskim rynku pracy pojawia się też problem reakcji na zagrożenia wynikające z oczekiwanego dużego spadku podaży pracy. W rozwiązaniu tego problemu mogłyby pomóc reformy systemu emerytalnego, wprowadzane w życie we wszystkich krajach UE. Tymczasem Polska od 1.10.2017 obniżyła minimalny wiek emerytalny (do 60 lat dla kobiet i 65 lat dla mężczyzn). Kolejnym sposobem na zażegnanie tego zagrożenia byłaby aktywizacja dużych jeszcze rezerw pracy znajdujących się na wsi, zwłaszcza w uboższych regionach Polski. Środkiem na krótką i średnią metę jest wprowadzone w życie otwarcie Polski na imigrantów z Ukrainy i Białorusi.

Reformy dotąd wprowadzone w krajach PIIGS oraz na szczeblu unijnym stanowią istotny krok we właściwym kierunku, ale mogą okazać się niewystarczające. Przede wszystkim nie zapobiegają one nadmiernemu narastaniu całkowitego – publicznego i prywatnego – długu zagranicznego. Rozwiązaniem pozwalającym zażegnać to zagrożenie byłoby rozluźnienie ograniczeń transferu zasobów między państwami. Ale ograniczenia tego typu transferów można by było bezpiecznie rozluźnić tylko w warunkach ściślejszej integracji politycznej, a ta na obecnym etapie będzie przebiegać bardzo powoli. Jeśli chodzi o unię monetarną, konieczna wydaje się również reforma instrumentu TARGET, być może na wzór amerykański. Celem powinno być pełniejsze zintegrowanie krajowych banków centralnych z EBC w obszarze prowadzenia wspólnej polityki monetarnej, kredytowej i płynności.

**Podziękowania.** Praca powstała na zaproszenie redakcji czasopisma *Revue internationale des économistes de langue française*. Przy pisaniu tej pracy wykorzystałem trzy rozdziały swojej książki (Gomułka, 2016), opublikowanej przez PWN. Chciałbym podziękować Wydawcy, Pani Dorocie Siudowskiej-Mieszkowskiej, za wyrażenie zgody na to wykorzystanie. Chciałbym też podziękować za pomocne uwagi do wcześniejszej wersji pracy przesłane mi przez Alberta Chilosi, Marka Dąbrowskiego, Stefana Kawalca, Krzysztofa Malagę, Andrzeja Olechowskiego, Dariusza Rosatiego, Pawła Wojciechowskiego oraz Cezarego Wójcika.



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## 18. Poland's transformation: Facts and myths about the period 1990-2020 and the country's chances of attaining the economic level of the USA and Germany after 2020\*

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**Abstract:** This paper studies path-breaking economic developments in Poland following the start of the systemic transformation in 1989. Three groups of countries are used for comparative analysis: those economically most advanced, those less developed but striving to catch up during the last 30–40 years, and as a subgroup of the latter, the transition economies. The paper has three objectives. The first is to show that many opinions regarding major aspects of the Polish transformation are at variance with the plain statistical facts. The second is to evaluate the pace and the extent of the progress so far in the effort to narrow the income and wealth gaps between Poland and most developed countries, particularly pre-2004 members of the European Union. The third consists of a discussion of factors which are likely to impede the pace of Poland's economic development in the years to come.

**Key words:** Poland 1989–2019, European Union, political aspects, long term growth forecasts

**JEL classification codes:** O52, O57, P52

### 1. Introduction: Three revolutionary economic changes in the world

Around 1990, the world witnessed the arrival of two major changes that could be described as revolutionary. One of these changes occurred in the countries of “real socialism” and involved the collapse of the economic system that had been

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\* *Nauka*, 2020, 4: 55–73.

based on the state bureaucracy playing a central role in deciding what should be produced, how, and for whom. As a result of systemic transformations, these countries transitioned in a very short time to a largely competitive, free-market economy. In the political sphere, Europe also experienced surprisingly rapid and fundamental change: the breakup of the Union of Soviet Socialist Republics (USSR) and the Warsaw Pact, the unification of Germany, and democratization in Central and Eastern Europe. In the second part of the paper, I will compare certain myths about how this transformation played out in Poland against the facts.

The second crucially important change involved much faster rates of growth in GDP *per capita* than before in countries that had been poorly developed until 1990 and, which taken together, accounted for around 85% of the world's population. These countries included China and India.

In highly developed countries, growth in GDP *per capita* (or strictly speaking, per working hour), depends almost entirely on the pace of growth in the sector driving technological change and improving the skills of the workforce. Over the past two centuries, the trends regarding the pace of development in those countries have been fairly stable over time and similar, with the annual growth in GDP *per capita* hovering around 1.2-1.5%.

In what are sometimes referred to as “catching-up countries,” the pace of economic growth depends above all on their volume of technology transfer from highly developed countries, and this volume depends on their economic policies, in particular the level of investment in relation to GDP, the quality of institutions, and workforce skills. As a result of this, the pace of catching up varies widely across countries and over time – as demonstrated by data from the World Bank and the International Monetary Fund (IMF) – with growth in GDP *per capita* usually falling within the wide range of 1-10% a year (Gomułka, 2017).

In the 19<sup>th</sup> and 20<sup>th</sup> centuries, the percentage income gap between those countries and highly developed countries had continually risen, as had the civilization gap in general. As a result of the second of the two crucial changes mentioned above, however, around 30–40 years ago these two gaps rapidly started to narrow. The countries affected by this transition – from divergence to convergence – also include Poland.

The past 40–50 years have also witnessed a revolutionary institutional and political change in Europe, namely the establishment and development of the European Union (EU) along with the economic, developmental, and political consequences that this has brought for the member states and for the globe. Economic and political changes brought by the first revolution also facilitated the EU's enlargement. Poland did not join the EU until as recently as in 2004.

Over the past four years, Poland has encountered problems with fully accepting the consequences of membership (Wilkin, 2019). In this paper, I will list some of these problems.

Development means not only growth in GDP *per capita* or in wealth *per capita* but also changes in all other factors that impact significantly on the quality of life. In the third part of the paper, I will restrict myself to only four fields of such changes in Poland: the quality of political democracy, the level of income and wealth inequality, demographic changes, and the quality of the natural environment against the backdrop of other countries, chiefly the EU member states.

In the fourth part of the paper, I will present Poland's position in the process of bridging the development gap in relation to the United States and the economically and institutionally most developed countries of the EU. I will touch upon the issue of further possibilities of narrowing the gap with respect to GDP *per capita* in the next 20–30 years, depending on strategic choices in economic policy. In this context, I will address the following issues:

- 1) Reasons behind the high rate of growth in 2016–2019;
- 2) Forecasts of GDP growth and the condition of public finance in the next few years;
- 3) Adjustments in economic policy needed in the next 10–30 years;
- 4) Long-term forecasts of GDP *per capita* in several scenarios;
- 5) The costs and directions of fundamental transformations needed in the energy sector.

## 2. Facts and myths about the transformation in Poland

The key reforms launched in late 1989 and during the 1990s still sometimes come under criticism, including on the part of influential politicians. Did Poland have an evidently better modernization alternative? In order to answer this question in a reliable way, we must first point out several important facts.

A good lead-in to the key reforms of late 1989 and early 1990 was provided by the following measures: “Wilczek’s reform”, which liberalized business activity (the Business Activity Act of 23 December 1988), the National Bank of Poland (NBP) Act and the Banking Law of 31 January 1989, which allowed for the operation of private banks, and the establishment of nine regional commercial banks based on some 400 outlets of the NBP. Other important reforms involved allowing for the emergence of the foreign exchange market based on around 20,000 private foreign currency exchange offices in the first half of 1989, and far-reaching liberalization of food prices in August 1989. These important market-oriented

measures were taken partially in response to the IMF's recommendations, made at the request of the Polish government in 1985<sup>1</sup>. Those recommendations were initially ignored by the Polish authorities, but they started to be taken into account when the Rakowski government was formed on 27 September 1988.

However, those market-oriented measures also revealed the dangerously large scale of macroeconomic disequilibrium shortly before the appointment of the Mazowiecki government on 12 September 1989. In August 1989, the market price of the dollar reached such a high level that a monthly wage was equivalent to around USD 20, and the inflation rate in that month alone was estimated at around 50%. The foreign exchange reserves of the NBP and commercial banks were very low – slightly under USD 2 billion. In turn, the formal dollar deposits held by households in banks totalled around USD 5 billion and those held by businesses amounted to nearly USD 3 billion. Poland's foreign debt to the members of the Paris Club was not being serviced, and the state's budget deficit was being financed through money printing. In August 1989, Poland was therefore in the state of an exceptionally profound economic and financial crisis whose scale was significantly greater than the situations faced by the other European countries of "real socialism".

Despite that profound crisis, however, the transformational recession – inevitable in response of the necessary liberalization of prices and the breakup of the rouble based trading bloc (the Council for Mutual Economic Assistance, COMECON) in 1991 – in Poland (and Slovenia) was smaller in scale and lasted shorter than elsewhere in the Eastern bloc countries. In turn, the increase of the GDP *per capita* measured in terms of purchasing power parity (PPP) was exceptionally large in the 30-year-period under discussion: from 30-40% of the level reported in Western Europe and in the United States in 1989 to 50-60% in 2019, in other words to a level much higher than had been seen over the past two or three centuries (Piątkowski, 2018).

One of the several most important reasons behind this historic success was the fact that the new domestic private sector outside agriculture expanded exceptionally rapidly only in Poland (Dąbrowski, Gomułka and Rostowski, 2001). A substantial role in that expansion after 1988 was played by the country's opening up to the West in 1971–1981 and in 1984–1989, which had led to robust growth in private financial and human capital in Poland. However, most probably it chiefly resulted from a handful of reforms (legislative acts) launched by the

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<sup>1</sup> As the IMF's chief adviser on Polish affairs in 1985-1987 and the author of a special report commissioned by the IMF in 1985 (Kowalik, 2010, Document No. 175), I was one of the formulators of those recommendations (I forwarded the report directly to several economists in Poland, including Leszek Balcerowicz and Władysław Baka, who then served as governor of the NBP).

Table 1. GDP *per capita* with reference to the United States: comparison between Poland and other post-socialist countries at the beginning of the transformation and in 2018

Country	Initial year	Level in initial year	Level in 2018
<b>Central Europe and Russia</b>			
Poland	1989	30.1	50.0
Bulgaria	1990	35.0	35.1
Czech Republic	1995	48.0	63.4
Estonia	1993	28.0	56.6
Lithuania	1995	24.0	56.4
Latvia	1992	23.0	49.0
Germany	1990	86.7	85.8
Russia	1992	24.0	43.3
Romania	1990	30.8	45.0
Slovakia	1993	31.0	54.1
Slovenia	1992	44.0	61.0
Ukraine	1992	24.0	14.7
Hungary	1990	46.0	49.0
<b>Central Asia and China</b>			
China	1990	4.1	29.1
Armenia	1992	6.0	16.5
Azerbaijan	1992	7.0	28.8
Georgia	1994	6.0	18.2
Kazakhstan	1992	28.0	44.1
Kyrgyzstan	1992	7.0	6.2
Tajikistan	1992	5.0	5.5
Turkmenistan	1992	12.0	30.8
Uzbekistan	1992	7.0	11.2

Source: World Bank, the most recent database, gives GDP per capita, PPP as percent of the US level (constant 2011 international \$)

Mazowiecki government at the beginning of 1990, with a crucial role in the drafting and implementing of those reforms being played by Leszek Balcerowicz and his associates, as well as from the economic policy pursued by that government and the following cabinets and parliaments as well as consecutive governors of the NBP (Gomułka, 1998).

Before 1989, the share of the private sector in total employment was relatively large (32% in 1970, 26.6% in 1980, and 30.9% in 1989), but the share of the private sector outside agriculture was very low – 2.9% in 1970, 3.6% in 1980, and 7% in 1988 (Jarosz-Nojszewska, Morawski and Zawistowski, 2017).

The success of Poland's economic policy in the transformation period is evidenced by the fact that since 1992 Poland has not experienced any recession on an economy-wide scale, nor any banking crisis. Fiscal policy, though not exemplary, did not play a strongly destabilizing role. Monetary policy was focused on gradually reducing inflation for the first 10 years, then on maintaining price stability for the past 20 years. The creation of a competent system of banking supervision has been a considerable success.

It is astounding how many critics of Poland's transformation strategy, not only politicians and journalists but also academics, formulate opinions that are at variance with these and other important and generally indisputable facts. I will adduce several such opinions.

## **2.1. Wages, prices, and pensions**

The view that the year 1990 witnessed "an extremely large" decline in real wages is mistaken. It ignores the excessive increase in average real wages in the previous two years: by 13.6% in 1988 and by 26% in 1989. In 1990, real wages fell by 26.7% compared with the level in 1989, but only by 7.7% compared with the situation in 1987.

Another mistaken view holds that old age and disability pensioners were hard-hit in the initial period of the transformation. In 1990, their pensions were adjusted every quarter. As a result of the adjustment by nearly 31% in January 1991, the average pension rose in relation to the average wage from 64.1% in 1990 to 75.6% in 1991, the highest level in the whole of the 30-year period. Such strong growth complicated the situation of the state budget in 1991–1992 to a considerable extent.

Another myth is a view that has been propagated for many years and holds that the reformers were too focused on lowering inflation. Indeed, the plan for 1990 did call for bringing annual inflation below the level of 10% as early as at the end of the year. In reality, however, inflation was reduced gradually, and it took 12 years to lower inflation from 250% in 1990 to below 10% a year.

## **2.2. Privatization**

Another myth is that privatization was carried out too hastily and without securing public interests to a sufficient degree. In reality, already at the end of 1989, the Council of Ministers issued a regulation prohibiting workers' councils from appointing individuals who were owners of private companies as members of the management boards of the Treasury-owned companies. The regulation cut the flow of profits from the public sector to the private sector. The state-owned



enterprises in Poland were privatized exceptionally slowly in comparison with other European countries of “real socialism.” This was because the Polish reformers rejected the kind of mass voucher privatization that was carried out in the former Soviet countries and Czechoslovakia, and the government of the Democratic Left Alliance (SLD) and the Polish People’s Party (PSL), headed by Waldemar Pawlak, limited voucher privatization through national investment funds to slightly over 400 medium-sized enterprises, which employed a total of around 200,000 staff. Unfortunately, “reprivatization” (property restitution) was likewise too slow, partially for reasons related to its considerable costs for public finance.

Poland’s economy was privatized relatively quickly, with the share of the private sector in GDP rising rapidly from 9.7% in 1988 outside agriculture and from the general level of 19.2%. However, political assessments and commentaries often fail to mention the reasons behind this situation: fast growth in the new domestic private sector, a large inflow of private foreign direct investments (FDIs), and a steep decline in production in most of the state-owned enterprises and cooperatives that witnessed a drop in demand for their products and services in the new price and trading conditions. Even now, the share of the public sector in Poland’s GDP remains among the largest in the EU countries (Błaszczuk, 2017) and currently poses a burden for the economy. This pertains in particular to the energy sector.

The first four years of the transformation witnessed a substantial rise in the registered unemployment rate: from 0% in 1989 to 6.3% in 1990, 11.8% in 1991, 13.6% in 1992, and 16.4% in 1993. In 1994-9, the registered unemployment rate stood at an average of around 12%. In that period, many potentially unemployed individuals decided to take advantage of the possibility of going into retirement. Unemployment benefits were introduced, and they were initially high. In 2001-4, the registered unemployment rate again rose to a very high level, namely around 19%. In turn, Poland’s accession to the EU in 2004 immediately opened up access to the labour markets in the UK and Ireland, which was an important reason behind a significant decline in unemployment in 2005-10.

In addition, it is sometimes claimed that the IMF played too great a role. Even in the initial period of the transformation, however, the IMF’s role in the Polish authorities’ economic policy was advisory, largely due to the similarity of views. It was nonetheless very helpful in reducing by half the high debt to countries (30% in 1991 and 20% in 1994) and Western banks (1994). In January 1990, the IMF approved a credit line for Poland, but no drawings were made under that arrangement<sup>2</sup>.

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<sup>2</sup> A key role in the decision to provide that assistance to Poland was played by the G-7 countries. Documents related to that and other debt reduction decisions can be found in vol. 2 and 3 of *Transformacja polska: dokumenty i analizy* (“The Polish Transformation: Documents and Analyses”) (2011, 2013).

The main reforms were drafted by the Polish side (12 acts of legislation adopted at the end of 1989 are included in vol. 1 of the *Transformacja polska* series, Kowalik, 2010). This pertained not only to “Balcerowicz’s Plan” for the fourth quarter of 1989 and 1990 but also to the Suchocka government’s important stability-focused fiscal policy in the fourth quarter of 1992 and 1993 (when Jerzy Osiatyński held office as finance minister), which made it possible to reduce the public finance deficit by 5 percentage points of the GDP and to lower the foreign debt to the members of the Paris Club by a further 20% and to private banks from the London Club by 50%.

### 2.3. Industry

In the transformation period of 1990-2018, the share of industry in GDP creation fell substantially from 25% to 22%. This statistical fact helped give rise to another two myths: one held that a period of de-industrialization actually occurred, and the other that this decline was caused by the displacement of industrial production by services. The former myth remains quite popular among critics of Poland’s transformation strategy. But what are the facts?

If we take the value of GDP at constant prices in 1990 as 100, then in 2018 this figure was 276 according to the Central Statistical Office of Poland (GUS). In turn, sold industrial production at constant prices rose from the level of 100 in 1990 to 412 in 2018. Over these same 28 years, the average rate of GDP growth was 3.6% a year (or 3.3% over 1989-2018), while industrial production grew at an average rate of 5% a year. We can only speak of a phenomenon of de-industrialization in the context of 1990, when industrial production declined by 24.2%, and 1991, characterized by a drop of 8%. However, declines such as those reported in those two years largely actually should have taken, or indeed had to take place, because existing industrial products were ill adjusted to market demand or because the unit costs of production were too high.

But what was the reason for the decline in the share of industry in GDP at current prices over the whole of the transformation period? This drop was – and still is – mainly caused by the fact that the prices of industrial products rise at a systematically slower pace than the prices of services, due to systematically faster growth in labour productivity in industry than in services. These differences in the pace of growth in labour productivity and in prices are a general global phenomenon.

### **3. Civilization development: trends in Europe and problems in Poland**

#### **3.1. Political democracy**

One of the most important components of civilization development is the quality of political democracy. The Economist Intelligence Unit compiled an index measuring the condition of political democracy in all 40 European countries in 2016 (Madej, 2017). It is based on five categories, each rated on a scale from zero to 10: electoral process and pluralism, functioning of government, political participation, political culture, and civil liberties. The index distinguishes between four types of regimes: full democracy, flawed democracy, authoritarian regime, and hybrid regime. According to the authors of the ranking, the only authoritarian regimes in 2016 were Russia and Belarus. Five countries were classified as hybrid regimes, only one of them being significant, namely Ukraine. Fourteen countries were classified as full democracies. Among this group Switzerland and four large countries, namely Germany, the UK, Spain, and the Netherlands. Other Western European countries score only slightly worse than those countries, whereas the Baltics and the Czech Republic and Slovakia are somewhat farther down in the ranking. In the countries described as flawed democracies, the category “electoral process and pluralism” has high scores. Another category that scores quite well is “civil liberties.”

In Poland’s case, the category “political culture” has an exceptionally low score. “Government functioning” also scores low, and “political participation” is also rather low. Consequently, the EIU concluded that the quality of political democracy in Poland in 2016 was among the lowest in the EU.

In 2017-19, Poland’s score was declining, a view confirmed by the Economist democracy index for 2019. This is because the executive took political control of the prosecution service and the public media, the civil service, the Constitutional Tribunal, and the National Council of the Judiciary (KRS) and attempted to take over control of courts, including the Supreme Court. This has created threats not only to democratic processes and in the political sphere, which resulted in the lower quality of legislation, but also to actual respect for civil rights in the civil and economic area.

A low level of political culture among voters had a considerable influence over the economic platforms of the parties that ran for parliament in 2019. Proposals were made that were aimed at making substantial improvements in people’s financial situation in a short time, despite having a considerable destabilization potential in the long term. This included such pledges as: to increase radically the minimum wage in 2020-3; to increase rapidly and substantially public spending

on health care in relation to GDP without raising health care contributions; and to introduce so-called “13<sup>th</sup> pensions” and “14<sup>th</sup> pensions” (extra annual payouts to pensioners) without raising pension contributions and formal retirement ages, or offering tax incentives for those who want to continue working after reaching the retirement age. In the campaign preceding the parliamentary elections, almost all parties failed to support such proposals as: private co-payments for public health-care services and education; public co-payments for private health-care services and private schools; equal retirement ages for men and women; reduced pension privileges; the lifting of the prohibition on terminating a worker’s employment contract for four years before they reach the formal retirement age; the presentation of ways to achieve and maintain an average zero or near-zero deficit in public finance; the presentation of ways to finance swift reductions in carbon dioxide emissions; or setting an approximate date for Poland’s accession to the euro zone.

During the parliamentary campaign, some political leaders argued that the proposed very large and rapid raise in the minimum wage was a good method for “reaching the European pay levels quickly.” In the short term, such a populist idea trumps politically the arguments raised by economists, who say that in the long run real wages are always determined by labour productivity, which in turn depends on skills and technology, which in turn depend on investment expenditures, the quality of education, good institutions, as well as the talents of innovators and entrepreneurs.

### **3.2. Income and wealth inequality**

In his review article Michał Brzeziński (2017) draws the following conclusions:

- Income inequality remains high, and over the past several decades it has shown a tendency to grow in most countries, even in Denmark and Sweden. Based on income data from tax returns, inequality estimates have been recently adjusted upward, revealing a level of inequality significantly higher than survey-based estimates.
- After these adjustments, the actual Gini coefficient for Poland may be as high as 0.55, not around 0.30-0.40, as was previously believed. Such a result places Poland among the countries with the highest level of inequality in the world.
- Two other important gauges of income inequality are: (A) the percentage share of people who live below the subsistence level; and (B) the percentage share of people who live in extreme poverty – those who are legally entitled to social benefits and claim them. According to the most recent figures from the GUS, the indicator labelled “A” reached 5.6% in 2008, rose to 7.4% in 2014, and then fell to 4.3% in 2017. Surprisingly, it rose to 5.4% in 2018. However, the

indicator labelled “B” rose even more rapidly – from 10.4% in 2017 to 14.1% in 2018. These data prove that labour and skills play an important role in eliminating poverty, whereas the role of social transfers remains limited.

- The level of wealth inequality is significantly higher than income inequality practically everywhere. In Poland, however, it is lower than in highly developed countries.
- A significant level of income and wealth inequality may impact positively on the pace of economic growth, but if it is too high, it may play a socially and politically destabilizing role and therefore impact negatively also on the pace of economic growth. What poses a problem are not income levels among members of the middle class, but a very high level of wealth held by a small percentage share of people.

Importantly, the tax system and social transfers as well as spending on health care and education in every country should as a matter of principle be targeted towards reducing poverty and utilizing the creative talents of people to the fullest possible extent. In Poland, the economic policy in the period of transformation remained under the influence of that principle, known as the “social market economy” paradigm, dominant in the EU countries.

### **3.3. Demographic trends**

Over the past 30-40 years, Europe has experienced three types of demographic changes: large-scale immigration, a low rate of natural population increase, and growth in average life expectancy. The impact of immigration applies in particular to Germany, France, the UK, and Sweden, and it has been large enough to introduce a visible cultural, national, and religious diversity into the fabric of society but also sufficiently moderate and gradual to make this diversity acceptable to and appreciated by local communities. In turn, growth in average life expectancy has brought acceptance for longer employment activity as something natural and appropriate.

In Poland, such demographic changes started after the country joined the EU in 2004. Initially, they were mainly related to increased emigration. According to estimates, there are around 2.5 million Polish nationals who have the status of emigrants – those who have lived in other EU countries for at least three months. The number of foreign nationals who live in Poland and have a similar status is estimated at around 1.5 million. Increased immigration in the past several years appears societally acceptable, but this may be because it has mainly involved individuals who are close to the Poles in terms of their national, linguistic, and religious characteristics.

Over the past 30 years, Poland has likewise witnessed a considerable rise in average life expectancy – by eight years for men (to 74 years, still five years less than the EU average) and by 6.5 years for women (to 81.8 years, only two years less than the EU average). As yet, however, this longer life expectancy has not been coupled with public acceptance for higher formal retirement ages and longer periods of employment activity.

Likewise, Poland has been characterized by growing acceptance of equal treatment for men and women, yet probably on a much smaller scale than in the old EU countries. Finally, despite the formal separation of church and state, the political role of the institutional Catholic Church as a clearly dominant religion remains large. Although this role is probably dwindling, it will remain much greater than in the old EU countries for the next several decades, perhaps even several generations.

Integration trends in Europe apply not only to the economic and political sphere but also to the linguistic, legal, and moral sphere, or in other words, to what is generally referred to as culture. These trends became visibly stronger when Poland and other Central European countries joined the EU. However, it will be some time before English becomes the second language used on a mass scale in Poland and the Constitution and the International Bill of Human Rights become commonly accepted laws.

### **3.4. Trends in the improvement of the quality of the natural environment in Poland and in the old EU countries**

Nicholas Stern, a prominent British economist, formulated this opinion on the occasion of the Climate Change Conference in Katowice in December 2018:

The transition to a zero-carbon economy is the inclusive growth story of the twenty first century. It needs to be managed with effective and cohesive policies, whilst recognizing that sustainable development, inclusive growth and climate action are interwoven and mutually supportive. (Stern, 2019)

The shift away from a carbon-based economy started in the UK and France in the 1970s, with trends towards nuclear energy becoming significantly stronger in the 1980s. Over the past 30 years (1990-2019), the EU has witnessed the emergence of a new and increasingly important component in this trend, namely renewable energy sources (RES). The UK is expected to phase out all coal-based power plants by 2025. As a result of technological progress, the years 2009-18

witnessed a marked drop in the unit costs of electricity production in the RES segment. On the other hand, total unit costs of the production of coal and oil-based energy are growing. Likewise, the abandonment of traditional energy sources has been substantiated with important environmental and climate-related reasons as well as the depletion of natural resources, inevitable by the end of this century. In 2018 and 2019, Poland imported around 25% of its demand for coal and around 10% of its demand for electricity. Identified coal deposits are large, but the costs of building new underground mines are so high that the exploitation of such deposits is usually unprofitable. Consequently, even official government forecasts warn of the possibility of a major energy crisis around 2030.

On the scale of the globe, alarming fundamental environmental quality parameters include: rapidly growing greenhouse gas production, a considerable rise in temperatures in vast areas of the globe and the related sea level rise as well as growing instability in the supply of water to plants, animals, and people. The EU has responded to this situation with what is referred to as the European Green Deal. The EU accounts for only around 10% of the world's net production of carbon dioxide, but *per capita* emissions are still above the world's average. The EU's strategic goal now involves reducing this share to zero by 2050, which means reducing the emissions of carbon dioxide by humans and animals to the level of its absorption by trees and plants. Efforts to implement this goal are helped by what are important and essentially revolutionary technological innovations in the field of renewable energy sources and means of transport propelled by electric motors. Animal farming for meat production accounts apparently for around 20% of the world's greenhouse gas emissions. Recent years have witnessed the arrival of a new technology also in this field: the production of cultured meat, with a culture of animal stem cells being grown with the use of plant-based culture medium. Over the past 20 years, the measures taken by Poland in the RES field were a lot less intensive than in the EU. Over this period, Poland and the EU have started to move in diverging directions in the field of energy policy. Consequently, the trends that prevail in Poland include a high death rate and the more common occurrence of diseases caused by low and worsening air quality, growing costs of carbon dioxide emissions permits, a growing risk of draughts, floods, and periodical water supply crises as well as the risk of rapidly growing energy prices and, after 2030, the prospect of energy shutoffs on a significant scale. These adverse trends and risks persist despite a strong reduction in the role of coal in the economy (electricity, heating, and the metallurgical sector) in 1990–2000 as a result of the systemic transformation. In 2017, according to EC data (2018), the carbon dioxide emissions *per capita* in Poland (8.48 metric tons) were nonetheless higher than the EU average (6.97 metric tons) and much higher than the world's average (4.91 metric tons).



Achieving the goal set forth by EU for 2050 will require major and swift changes in the country's economic policy: opting out of creating new brown coal opencast mines and coal-fired power plants, shutting down existing coal mines and gradually phasing out most coal-fired power plants, in addition to the construction of a distributed network of water reservoirs by local governments, the modernization of power grids by the state (in order to reduce what are currently considerable losses), and the complete elimination of heating with the use of old polluting coal-fired stoves. As a part of a new strategic policy, we also need to leave the production of electricity mainly to the private sector<sup>3</sup>.

## 4. The Polish economy's chances for reaching the Western levels of the GDP and wealth per capita

In 1989, Poland's GDP *per capita* (PPP) was 30.1% of the US level, compared with 84.2% in Germany (without East Germany), according to the IMF's figures. A radical change in the economic and political system and a profound reorientation of economic and technological links have drastically reduced the barriers limiting Poland's access to technological innovation. Poland became one of the "catching-up" countries. The success of its efforts is evidenced by the fact that according to the IMF, Poland's GDP *per capita* (PPP) in 2019 reached 51.4% of the US level and 60.9% of the level reported in Germany (together with the former East Germany).

Another important gauge of a country's economic condition is wealth *per capita*. In Poland, this is still only one-sixth of the levels reported in the United States and Germany. As a result of low domestic savings in relation to the GDP, the reduction of this very wide gap is only possible to a limited extent in the next 30 years.

Hence the proposed forecast that Poland stands a chance of (almost) reaching the level of the GDP *per capita* in the West by 2050, but the difference in terms of wealth *per capita* will remain (very) large for much longer.

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<sup>3</sup> The actual energy mix in 2019: 75% coal, 11% renewables, 8% natural gas, 6% other. The energy mix proposed by the current government in 2040 calls for 50% coal, 20% nuclear power, 20% renewables, and 10% natural gas. Given the costs of energy production and the climate objectives, a reasonably good mix for this year would envision 50% renewables, 30% coal, 10% nuclear power and 10% natural gas, while a good mix for 2050 would be 70% renewables, 20% nuclear power, and 10% natural gas. By comparison, Germany aims to produce already in 2030 65% energy from renewables, and in 2040 no energy from coal.



### 4.1. Interpretation of the rapid pace of growth in Poland's GDP in 2016–9

In 2016-9, the GDP rose at a much faster pace than the long-term trend in the 30-year period between 1989 and 2019, namely 3.3%. There were many reasons behind this exceptionally good economic situation. Here, I will list four particularly important ones:

- the economic situation in the EU was better than average, which stimulated Poland's exports and increased the level of domestic capacity utilization;
- private consumption grew rapidly, stimulated by higher social transfers and a rapid raise in income levels, which also increased the level of capacity utilization;
- many people immigrated from Ukraine and Belarus in search of jobs, which made it possible to increase employment;
- there was a high level of investments funded by foreign, private and EU funds.

Developments after 2019 are likely to be quite different than during the last 30 years. Due to a health-related global recession in 2020, the GDP in Poland is expected to remain in 2021 at the level in 2019. After 2021 the trend rate of growth of the GDP per capita should fall significantly below the level in 2016-9. The reasons for this are as follows:

- a lower pace of growth in the EU's GDP, around 1-1.5% instead of 2-3% in 2016-8, and – as a result of this lower pace of growth and problems in global trade – a lower rate of growth in the EU's exports, which will translate into a lower growth in Poland's exports to the EU;
- a substantial decline in the Polish working-age population and a low, perhaps even dwindling level of employment activity;
- an inevitable decline in the EU investments in Poland after 2022;
- in the years after 2021 the most important thing will be that as “catching-up countries” near the level of the GDP *per capita* in the most developed countries, the rate of GDP growth in each such “catching-up” country, including Poland, falls automatically, eventually reaching the level of 1-1,5% a year.

### 4.2. Forecasts for the next several years

In 2020 the global economy found itself unexpectedly in the state of a significant recession, caused by restrictive government measures intended to reduce the human cost of a large world-wide coronavirus epidemic. The GDP is expected to fall by some 3-5% globally, and by some 5-10% in the EU and the USA. To limit that recession in the course of 2020 and to initiate a recovery in 2021, very

expansionary monetary and fiscal policies have been adopted. The expected outcome is that the total change of global GDP will be close to zero in the period 2020-1. Developments in Poland are likely to imitate those in the world. These developments are expected to increase sharply the public debt and reduce private investment for several years after 2021, but to have a limited impact on the trend rate of growth in the long term.

Already in 2017, the IMF pointed out to three phenomena in Poland: since 2012, the working-age population in the country had been dwindling at a rate of 1% a year, investments in fixed assets made by Polish private-owned companies accounted for a mere 11% of the GDP in 2004-16, and the pace of growth in the total productivity of the main production factors, namely labour and capital, fell from 2.4% in 2003-7 to 1% in 2013-6.

The proposals included in the incumbent government's economic program are quite detailed on two important issues. If implemented consistently, these proposals could pose a problem in the long run. They are:

1. *A change in the pension system that involves introducing additional pension payouts (13th and 14th pension) financed from the state budget.*
2. *A radical increase in the administratively determined minimum wage, much faster than the rise in labour productivity.*

The proposed large increase of the minimum wage, if implemented, would create the illusion that real wages are determined by politicians, rather than by investments and technology, and so by businesses and employees. The very large increase of public debt in 2020 may force the government to abandon the implementation of proposals 1 and 2.

After Poland's accession to the EU in 2004, the EU's funding of nearly half of public investments played an important modernization role in the country, especially in the field of infrastructure (CASE, 2019). After 2022, this funding will be reduced significantly. From 1994 to 2018, an important role in the development of the export sector and the technological innovation was played by foreign investments: an average of 3.3% of the GDP a year, around 15% of all investments. However, the political doctrine pursued by the governing Law and Justice (PiS) party considers them a threat to national sovereignty. This may reduce the inflow of FDI.

### **4.3. Adjustments needed in Poland's economic policy**

In the long run, the pace of economic growth is determined by two factors: a percentage change in the number of people who work and the pace of qualitative change in such fields as technology, employees' skills, and the quality of

institutions. The number of people who work is influenced positively by considerable net immigration and negatively by the dwindling number of the Poles of working age – according to the GUS, this number will decrease in 2020 by 484,000 compared with 2018 and by 1.2 million compared with 2015. In the future, the number of people who work will be affected negatively by two factors: Poland's shrinking population and the growing share of pensioners in this population. In turn, the pace of qualitative changes in “catching-up” countries, which include Poland, is mainly influenced by the share of investments in the GDP, because investments largely determine a country's ability to absorb innovation. Since the share of the EU-originated savings and investments in the GDP of Poland will almost certainly decrease, measures are needed that will increase domestic savings and investments.

The negative impact of the lower statutory retirement ages on labour supply is estimated at around 700,000 people. Also, Poland is entering a period of a demographic decline. So far, these two developments have been compensated by the inflow of workers from Ukraine and other countries as well as the flow of workforce away from agriculture.

In the highly developed countries, the expected long-term pace of GDP growth *per capita* in the coming decades is 1.2-1.5% a year. However, there are considerable differences in this respect within specific countries despite the same economic policy and the same institutions: between the South vs the North in the UK and in Italy, between the West and South vs the East in Germany, and between California and states in the East vs the central states in the United States. Usually, these are differences of 1 : 2, sometimes even 1 : 5.

The existing differences result from considerable variations in the level of human and physical capital. In the EU, there are highly developed countries with a high level of the GDP *per capita* (group A countries) and countries with visibly lower GDP levels (group B countries). Group A chiefly comprises Germany (without the former East Germany), the UK, the Netherlands, Belgium, Scandinavia, and Ireland, whereas group B comprises Italy, Spain, the former East Germany, perhaps also Greece, Slovenia, the Czech Republic, and Portugal.

*I propose to adopt the assumption that Poland, given the consumption and investment preferences of its inhabitants, may be capable of joining group B.*

#### 4.4. Four scenarios of economic growth in 2020-40

In the main scenario for Poland, I propose assuming that the average rate of growth in the GDP *per capita* will be 2.5% until 2030 and 2% in 2030-40. This scenario is based on the assumption that Poland will join the group B countries

in 2040, when the *per capita* income gap between Poland and Spain and Italy is closed. In the optimistic scenario, the rate of growth until 2030 would be higher by 0.5 percentage point, which means 3% a year. In the pessimistic scenario, it would be lower by 0.5 percentage point, which means 2% a year. Let us call these Scenario One (the optimistic scenario), Scenario Two (the standard scenario), and Scenario Three (the pessimistic scenario).

If we adopt these assumptions, Poland's position would be as follows: in Scenario Three, the development gap between Poland and wealthy countries would stop narrowing in 10-15 years, with the average income *per capita* reaching the level of around 65% of the income *per capita* in Germany (without the former German Democratic Republic). In Scenarios One and Two, the narrowing of the income gap would continue until 2040, when the average income in Poland would reach 70-75% of the average income in Germany (without the former German Democratic Republic) in Scenario Two and 80-85% in Scenario One. Each scenario is related to a different economic policy.

In Scenario One, economic policy would aim at maintaining a stable number of people employed in the non-agricultural sector, lowering considerably the number of those working in agriculture and low-productivity enterprises, maintaining solid public finance (with an average deficit near zero), and a large share of investments in fixed assets in national income (more like 20-25% of the GDP than 15-20%).

## **5. Concluding remarks: slower trend rate of economic growth and growing tension in public finance**

The government's economic policy implemented in 2016-9 favoured consumption more than investments. Total investments in fixed assets in relation to the GDP reached 20.1% in 2015, but fell to 17.7% in 2017 and 18.2% in 2018. This happened despite the fact that Prime Minister Mateusz Morawiecki stressed the importance of investments, especially domestic investments, for economic development. In addition, the lowering of the formal retirement ages will mean a strong decline in the number of people who work (700,000 over 5-10 years). It also means the risk of strong growth in budgetary subsidies for the pension system. In such a situation, it would be more difficult to cope with the budgetary criteria for accession to the euro zone.

The coronavirus-related recession in 2020 poses a considerable risk to economic developments in Poland in the early 2020s. According to official forecasts the Polish government's policy response to this recession will cause the public

debt to increase to about 62% of the GDP by the end of 2020 and about 64% by the end of 2021, thus exceeding the constitutional threshold of 60% of the GDP. If fiscal and monetary policies continue to be highly expansionary also after 2021 we could witness developments worse than Scenario Three, which we can describe as an extremely pessimistic Scenario Four. It could even include the materialization of certain alarming forecasts anticipating a public debt crisis and many years of stagflation (Gronicki and Hausner, 2019).

For many years, Poland's public finance has been characterized by an excessive deficit and an excessive level of public debt in relation to the GDP, too close to the constitutional threshold of 60% (instead of below 40%, as is the case in the Czech Republic). In years characterized by rapid economic growth, for example in the period of 2017-9, Poland should have reported a substantial budget surplus, while in fact it recorded a deficit.

In this respect, Poland differs from most of the EU countries. We owe the relatively comfortable situation in public finance in the period 2017-9 chiefly to the "positive shocks" described above, several considerable one-off revenues to the state budget, and the government's withdrawal from several campaign promises.

In the coming years, we will witness two important changes. First is a significant reduction in the trend rate of per capita economic growth, resulting in an end of the catching-up process. Second is a growing pressure towards the worsening of the state of public finances for reasons related to a drop in the pace of GDP growth and the promised considerable growth in spending on social transfers, health care, national defence, environmental protection, and the pension system. According to the authors of a balanced development index, "Poland seems to be moving towards the category of emotional countries, such as Greece, with all the related dangers incoming" (Koźmiński *et al.*, 2020). Even though this is more of a warning rather than a firm prediction, it should be taken seriously by the Polish electorate, and by Poland's intellectual and political leaders.

**Acknowledgments.** I am thankful for the helpful comments from Leszek Balcerowicz, Marian Gorynia, Andrzej Koźmiński, Roman Kuźniar, Ryszard Pazdan, Aleksander Smolar, Oded Stark and Jerzy Wilkin. Helpful comments on the analysis of the transformation in 1989-2019 were likewise made during discussions at the Poland' Stefan Batory Foundation and at the Macroeconomics Congress in the Warsaw School of Economics (SGH). Translation from Polish into English is by Daniel J. Sax and from English into French by the Editor of RIELF, professor Krzysztof Malaga. An earlier version of this paper was published in Polish in *Rocznik Strategiczny* (Annual Strategy) 2019/20, 2020, Roman Kuźniar (ed.), Wydawnictwo Naukowe Scholar, Warszawa.

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## 19. The comparative analysis of Poland and Greece: Short-term policy errors versus longer-term rationality\*

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**Abstract.** This article has three objectives. The first one is to compare and interpret the economic growth that was seen over the period of 2000-2018 (partly in reaction to the world financial crisis of 2008-2009) by two exceptional EU Member States: Greece, which saw the greatest decline in GDP, and Poland, which suffered the smallest costs of the crisis. The second objective is to analyse the risks to the pace and stability of Poland's economic growth and the state of public finances following 2018. It is argued that Poland, despite these risks, is not likely to become a second Greece. The third objective is to note that the presence of strong persistent factors, such as globalisation and climate changes, tends to foster longer-term rationality in economic policies of the EU institutions, and that this may have an important positive impact on national policies and economic performance of the member countries of the EU, including Poland.

**Key words:** Poland 2000-2020, Greece 2000-2020, institutional factors in development, macroeconomic stability risks

### 1. Introduction

The per-capita GDP of Greece in 2000 was nearly 70% higher than that of Poland. In 2000-10 that difference was almost entirely eliminated, and by 2019 Poland's per-capita GDP was 9% higher (Figure 5). The elimination of this very large difference in per-capita GDP between Greece and Poland in 2000 was caused by the fact that the Greek government was forced to respond to the rapid increase in the cost of servicing public debt in 2008-9 and the prospect of the bankruptcy of the state, by taking defensive measures, such as lowering salaries and pensions in the public sector and raising taxes. However, those stability

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\* *Myśl Ekonomiczna i Polityczna*, 2021, 1(71): 31-50.

measures were belated and very costly, causing a drop in the GDP by 25% and a surge in unemployment.

The impact of any unforeseen shock is influenced by countries' internal ability to absorb such a shock, hence by their earlier macroeconomic policies, particularly monetary and fiscal. That ability is a form of capital. Accumulation of that capital serves to meet long term stability ends, but reduces the chances to win and preserve the short-term political power. The comparison between Greece and Poland informs about the choices made by those in power in these two countries in the period 2000-20.

Although this downturn in Greece in 2000-19 was much more unfavourable than what happened in Poland in the crisis year of 2020 and what is being forecast to happen in the following years, it may be treated as a warning for Poland for the coming 15-20 years. This is in view of certain actual and projected similarities: excessive growth in the number of pensioners, declining investments in relation to the national income, the worsening financial performance of businesses (including banks), and large state budget deficits, actual for 2020-1 and projected for the following years, causing public debt to grow significantly in relation to the GDP (Gomułka, 2020).

Figure 1 and 5, Statistical appendix

## 2. Institutional differences

Poland is not, and in fact cannot be in the near future, close to being a second Greece on account of several reasons, among them two institutional differences. The first one is that Greece has been a member of the euro zone since 1 January 2001. Greece ignored the financial criteria of eurozone membership and – with a public debt of around 100% of the GDP – did not meet those requirements even on the day of its accession. The European Central Bank (ECB) and the eurozone countries nevertheless agreed to Greece's membership – under the circumstances, their decision was the first serious mistake. From 2001 onwards, however, a decisive majority of citizens did not want to return to the country's national currency, and neither did consecutive governments.

The second difference pertains to compliance with rule-of-law requirements. Unlike Poland, Greece did not have, and does not have, problems in this respect. This particular difference has worked and continues to work in Greece's favour.

As a result of Greece's eurozone membership, the yield on Greek government securities in the years preceding the outbreak of the global financial crisis in 2008 was very low, close to the yields on German or Dutch securities and lower

than they should have been. This encouraged the Greek authorities to pursue a populist fiscal policy that was politically motivated in the short term. In addition, businesses and households were encouraged to take out large bank loans.

Figure 2. Statistical appendix

### **3. Mistaken decisions by financial investors, their correction, the risk of Greece's bankruptcy and conditional assistance**

The financial markets made a mistake before 2008-9 by assuming that all the EU member states, especially the eurozone members, would comply at least approximately with the Maastricht criteria regarding fiscal policy. For Greece, however, non-compliance became a rule, on a large scale at that.

Figure 3. Statistical appendix

Moreover, the Greek authorities made another mistake that was very costly for the country: they assumed that the investors operating in the financial markets would not correct the mistake that they had made by ignoring considerable differences in investment risk between the eurozone countries depending on each country's fiscal policy. Such corrections were not made until 2008-9, but in response to the world financial crises they were very rapid and very costly for Greece.

Figure 4. Statistical appendix

The debt servicing costs rose so considerably that Greece was certain to go bankrupt without help from the ECB (the purchase of Greek securities to reduce their yield to below 7% a year) and from the International Monetary Fund (IMF), as well as directly and indirectly from other eurozone countries.

The help that was offered needed to be great in scale and spread out over many years, so it had to be – and was – conditional. Greece was forced to agree to cut employment and salaries in the public sector as well as most pensions and to increase budgetary revenue also by selling off some of the state's assets. Actual measures had to be, and ultimately were, significant enough to lead to a nearly zero deficit in the public finance sector and even to a budget surplus for several years.

Remaining in the eurozone entailed, and continues to entail, such benefits as low inflation, low costs of loans for businesses, and above all avoidance of likely mass bankruptcies of indebted companies and households. The costs of the Greek government's mistaken policy included a deep recession that continued for many years and was coupled with a large rise in unemployment and considerable emigration. Nevertheless, the very large public debt of around 200% of the GDP still remains a problem. In such a situation, maintaining credibility in the financial markets now

demands that Greece continue, with the exception of the short period of the pandemic, a policy of maintaining its public finance sector deficit at more or less zero.

## **4. Poland's case**

### **4.1. Effects of avoiding a bank crisis**

In 2008-9, Poland benefited from the prudent policies adopted by its Monetary Policy Council (RPP) in 2001-7, the aims of which included preventing the explosion of “bad debts” in the financial sector (Gomułka, 2016; 2018). As Poland did not make the same mistake that was made by the governments and financial authorities in the United States, the UK, Ireland, and the Baltic countries, it was consequently the only country in the EU not to experience a crisis in its banking sector. After 2007, Poland's fiscal policy was rather expansionary yet aimed at keeping the public debt below the constitutional limit of 60% of the GDP and the costs of servicing this debt below 2% of the GDP. The effect of those two policies, the monetary policy and the fiscal policy, was that although many businesses were hard-hit and the state budget took over half of the funds in the Open Pension Funds (OFE), Poland avoided recession on the scale of the whole economy and was indeed a “green island” of positive growth against the “red map” of the EU. In turn, Poland's accession to the EU in 2004 had opened up the job market for the Poles in several EU countries, making it possible to reduce the unemployment rate in a significant way.

### **4.2. Effects of the pandemic and two questions**

However, the global health crisis in 2020-1 has created threats for the global economy that are greater than those caused by the financial crisis in 2008-9. This time, Poland is not only experiencing a major recession, but also an exceptional surge in the public debt in relation to the officially projected level of over 60% of the GDP in 2020 and 2021 (calculated using the EU methodology). Moreover, we can expect the coming years to bring a combination that may be dangerous to macro-financial stability: rising public expenditures in relation to the GDP and a slowdown in economic growth, which also translates into lower growth in budgetary revenue. Significant surges in the ratio of public spending to the GDP should be expected primarily in two fields: healthcare, from around 4% of the GDP now to around 8% in 10-20 years' time, and minimal pensions, assuming that current statutory retirement age is maintained at 60 years for women and 65 for men, from around 1.5% of the GDP now to around 4.5% in 20-30 years.

Hence, we arrive at two questions:

1. Given the causes and the size of the Greece's crisis: What consequences might this dangerous combination entail for Poland?
2. How will these consequences be influenced by the two differences between Poland and Greece, namely: (A) the fact that Poland is not a member of the euro zone and (B) Poland's conflict with the EU against the backdrop of the country's worsening compliance, or rather growing non-compliance, with the principles of the rule of law enshrined in treaties?

We still do not know the full answer to the first question, although it is crucial to have it for forecasts for development of the situation over the next 20-30 years (Gomułka, 2020). Consequently, I will restrict myself to a proximate answer to the first question, and attempt to provide an answer to the second.

## **5. Effects of Poland being outside the eurozone**

The main consequence of the fact that Poland remains outside the eurozone is the country's reduced credibility as a debtor in the capital markets. As a result of such lower credibility, the yields on the Polish government securities required by investors are several times higher than yields on German, Slovak, or Dutch securities. Such lower credibility also results from the fact that per-capita wealth in Poland is only around one-sixth of the levels reported in such countries as the United States, Japan, and Germany. Poland's foreign debt, both public and private, is not very large in relation to its GDP, but compared to those countries it is relatively high in relation to the whole of financial and physical wealth. Growth in national wealth depends on how savings-focused the behaviour of households, the public authorities, and companies are. In Poland, the propensity to save on the part of households is exceptionally low, and on the part of the public sector it has been and will likely remain systematically negative. As a result, national savings are low, and so the ratio of national wealth to the GDP will remain on a relatively low level for many years.

High risks for the stability of an emerging economy such as Poland become particularly visible in periods of heightened uncertainty in the global financial markets. We are seeing such uncertainty during the time of the global pandemic, 2020-1. The response by foreign investors to this uncertainty in 2020 (one of several such responses) was to sell shares in Polish corporations and Polish government securities. The WIG20 index has fallen from around 2,500 in 2018 to around 1,600-1,800 in the second half of 2020. Capital outflow has been so large that the zloty has weakened despite a significant surplus in the current account.

Under the circumstances, if the supply of government securities increases significantly, we may witness a large rise in the cost of servicing public debt.

In addition, rising pay levels, financed partly through money-printing, and the depreciation of the zloty could lead in general to a (considerable) surge in the inflation rate and therefore also to an increase in interest rates. We are already observing such a course of events in Turkey. High inflation, high interest rates, and uncertainty about the zloty exchange rate would increase investment risk and therefore reduce investment, which means that it could generally lead to near stagflation (Gronicki, Hausner, 2019). The likelihood of such a course of events in Poland's economic situation may not be great, but in view of the potentially high social costs it should be treated as unacceptable already at the level of a 5% or higher chance.

## **6. Conflict with the EU and Polish businesses**

A proposal was recently made by the EU authorities and net donor countries to increase significantly, by 750 bn euros, of which nearly half in the form of grants, the pool of the EU budgetary funds for Member States most affected by the coronavirus health crisis and climatic changes. The countries that would benefit most from this new Reconstruction Fund (RF) are Spain, Italy and Poland. This exceptionally large assistance would be disbursed in the next three to five years on the condition that they observe the principles of the rule of law applicable in the EU. In response to this proposal, the governments of Poland and Hungary have initially warned that they might veto the EU budget for 2021-7 if the condition is not effectively dropped altogether or at least substantially weakened.

The proposed link between the disbursement of EU funds, both budgetary and the RF, and the observance of the principles of the EU rules of law has been strongly supported by the European Parliament, and in July 2020 accepted by the EU Council. Following this important, legally binding decision, the governments of Hungary and Poland demanded, under the threat of veto of the EU budget for the perspective 2021-7 and the RF for the years 2022-5, and in the end obtained a partial, but not full, acceptance by the Council on 10 December 2020 of the rules of implementation for this proposed link of the mechanism to the disbursement of EU payments to Member States. The legal, political and, especially, economic consequences of the July and December Council decisions, both immediate and long-term, are nevertheless still likely to be strongly supportive of the EU project.

The formal acceptance of the original interpretation of the condition has strengthened the view that the long-term aim of the present government of Poland is not a British-style Polexit, but a Polexit from some important institutional and

policy parts of the EU project. These concerns have been articulated by a former member of the Poland's Monetary Policy Council in the following way: "Polexit means taking a sequence of steps that would transform an emerging market economy into a re-emerging state economy, which may lead to an economy in state of emergency" (Wojtyna, 2020). A similar concern is noted and discussed by the authors of the Polish Academy of Sciences Report (Wilkin, 2019) and supported by an empirical study (Kowalski, 2021).

The central attention of the EU institutions to rational long-term concerns and policies aims to reduce the risk of such costly consequences.

## 7. The key stylised facts of economic growth

The statistical data on global long-term economic growth have certain fundamental characteristics, termed 'stylised facts'. In Gomulka (2017), chapter 1 of this book, I present and discuss my proposed list of such facts. These are 2 facts with respect to all countries, 3 with respect to the most developed countries, forming the world's Technology Frontier Area (TFA), and 2 with respect to non-TFA countries. Both Greece and Poland have been and still are catching up, so they belong to the non-TFA. In this paper we make comparisons of the two countries with the most developed countries. My stylised facts for these two groups are as follows:

*With respect to the Technology Frontier Area (TFA) countries:*

1. During the past two to three centuries, there has been a far more rapid growth of inputs of labour and capital in the sector producing qualitative changes than the growth of inputs in the sector producing conventional goods;
2. The trend growth rates of inputs in both sectors have been during that period stable over time. Likewise, the growth rate of the ratio  $Y/L$ , output per man-hour, has been stable, although very much higher (an order of magnitude greater) than during the many centuries that preceded it;
3. The trend rate of growth of the ratio  $Y/L$  has during the last two centuries been and is relatively stable over time, differs to a small extent between countries, and depends weakly on the ratio of investment to the gross domestic product (GDP).

*With respect to non-TFA countries:*

4. The trend rate of growth of  $Y/L$  varies strongly over time and between countries;
5. The growth rate of  $Y/L$  is strongly dependent on the level of investment as a fraction of the GDP.

As noted in facts 1 to 3, during the last two centuries there has been little variation over time and across TFA countries in respect of some key macro variables. In non-TFA countries we have a completely different set of data: a large variation over time and across countries in respect of key macro variables and a marginal contribution of their own inventive activity to the world inventive output. This suggests a fundamental role of factors determining international technology transfer from the TFA, hence the key role in those countries of institutions and economic policy, to determine the rate of economic growth.

## **8. Various categories of shocks: What kind is the current shock? What is the main objective of the central authorities' economic policy?**

In general, shocks typically have major positive or negative consequences in the short term, but little impact in the long run. Over the past century, there have been several major fluctuations that had primarily short-term effects, including two world wars, the Spanish flu epidemic in 1918-20, and the global economic crisis of 1929-31. In recent years, such events have included what proved to be an almost global financial crisis in 2008-9 and the current global health crisis caused by the COVID-19 epidemic.

In the case of the ongoing health crisis there is a novel destabilising development, as the main public measures taken initially have the nature of administrative restrictions that reduce the number of deaths at the expense of employment and GDP levels in the medium term. The purpose of the state's policy in the course of the epidemic is to minimise total costs, not just the economic ones. Under the circumstances, it is extremely hard for the authorities to find a (nearly) optimal policy. The goal is rather or seems to be to avoid making major mistakes. But the second round responses of governments and central banks to initial large economic costs are quite similar to those taken during the financial crisis in 2008-9.

It is interesting that China and several countries of Southeast Asia have reported far fewer COVID-19 cases and deaths per 100,000 inhabitants than the European countries, including Poland, and the United States, and far lower economic costs measured as percentages of GDP. The reasons for this disparity remain poorly studied.



## 9. Past errors and new risks for Poland

Poland also suffered a major financial and economic crisis in modern times. This happened in the years 1979-82, with the GDP falling by 24% and the foreign debt to countries ceasing to be serviced in 1981 (until 1991). That crisis, similar in size to that of Greece's, was caused also by the government policy of a large expansion of both investment and consumption at the same time (in the years 1971-6), financed to a significant extent by foreign borrowing. In both cases the short-term motivation for the government was the same: to gain and maintain popular support and political power.

As noted earlier in the paper, Poland avoided mistakes of many other countries in the years 2000-7. However, after 2007 problems started to appear and accumulate in the energy sector, water supplies, environment qualities, and in the pension system. In most countries of the EU financially and politically costly reforms started a long time ago to address similar problems in order to meet rational long-term objectives. However, in Poland the energy sector, for short-term political gains of the government, has continued to be dependent almost entirely on coal. Two reforms of the pension system were initiated at a political cost, but one of them, on the retirement ages, for short-term political gains, was reversed in 2017.

The consequences of these mistaken short-term policies are now becoming socially apparent and economically large. Poland has become a major importer of coal and electricity, the coal industry is strongly loss making, unit energy costs are internationally high and increasing, the air pollution is killing apparently some 50 thousand people a year, future pensions are expected to be either very low or heavily subsidised, posing in the latter case a threat to public finances.

Circumstances hindering the pursuit of sound fiscal and monetary policies can be summed up as follows:

1. Poland has only a moderate credit rating, because it is not a member of the euro zone and is not expected to become one soon.

The country's financial and physical wealth per capita remains low, in relation to GDP only about 1/6 of the levels in the USA, Germany or Japan. Budget deficits of the general government are a rule, not an exception. In the Accession Treaty of 16 April 2003, Poland agreed to adopt euro as its national currency, but the date of this adoption was not specified. The world financial crisis in 2008 started in the USA and the UK, but it affected also severely several countries of the eurozone. The absence of the banking sector crisis in Poland also served to strengthen the confidence of the population in the Polish currency and the national Central Bank. All these reduced drastically

the public support for the early replacement of the zloty by the euro. A large increase in the budget deficit, to about 8% of GDP in the years 2009 and 2010, reduced also the initial enthusiasm of the government to adopt the euro, as that adoption required a considerable tightening of the fiscal policy. During the last 5 years there are no longer banking problems in the eurozone, but in 2015 a fairly Eurosceptic government came to power in Poland, with a message to financial investors that an early entry of the country into the eurozone is out of the question.

2. Low domestic savings in relation to the GDP, caused chiefly by the very low propensity of households to save.

Under the old socialist system people had no good reason to save money. The unemployment rate was close to zero, housing and pensions were provided by the state, and private businesses were discouraged. Under the present capitalist system most households continue to have either little reason to save or small incomes from which to do so. Total bank deposits by households are now in Poland only about 40% of the GDP.

3. Low domestic private investments.

Small domestic savings are a constraint on domestic private investments, which at about 10-15% of the GDP are in consequence low by international standards, and very low by the standards of South-East Asia countries. Private investments are relatively sensitive to the quality and independence of the judicial system, which in Poland has been deteriorating since 2015. This factor and the pro-consumption fiscal policy of the government have had a powerful impact on the ratio of gross private – domestic and foreign – investments in GDP since the end of 2015. The ratio was 15.2% in 2015, but declined to 13.3% in 2016, 12.2% in 2017, 11.7% in 2018, 12.1% in 2019 and 8.6% in 2020.

In these circumstances exceptionally important roles are played by investments financed by the EU and the state budget (about 45-46% of the GDP).

4. A projected considerable rise in public expenditures in relation to the GDP (chiefly on health and pensions).

Public expenditures on health in Poland (at about 4.5% of the GDP) are relatively modest by the standards of other countries of the EU; they are expected to go up within the next 10-20 years to about 8% of the GDP. The minimum pension is set at 20% of the average wage. To keep this pension at that level costs the budget now 1.5% of the GDP, but is expected to cost about 4% of the GDP in 20-30 years. To increase incomes of all (nearly 10 m) pensioners the government introduced recently the 13<sup>th</sup> and 14<sup>th</sup> pensions, with a total cost of about 1% of the GDP

5. No public approval of any increase in the formal retirement ages coupled with the destabilising effects of the actual lowering, three years ago, of the formal retirement ages to 60 for women and 65 for men.

As with time people live longer, in most countries of the EU obligatory retirement ages have been increased. Poland is an exception, the consequence of which is a steep increase in the number of low-income pensioners and, consequently, a significant increase in the public debt.

6. In the next 10-20 years, Poland will not avoid a drop in the trend rate of GDP growth per person employed from around 3.5% over the past 30 years to around 1-1.5%.

This inevitable decline in the rate of growth is associated with the ending of the catching up process (Gomułka, 2018; 2020).

In view of the factors listed above, we can realistically expect the coming years to bring a combination that may be dangerous to Poland's macrofinancial stability: growing public expenditure in relation to the GDP and a slowdown in economic growth, which also translates into slower growth in budgetary revenue.

## **10. Longer term and global factors and concerns for the EU, their impact on short-term policies**

### **10.1. The energy sector and the quality of the environment**

The shift away from a carbon-based economy started in the UK and France in the 1970s, with trends towards nuclear energy becoming significantly stronger in the 1980s. The EU has witnessed the emergence of a new and increasingly important component in this trend, namely renewable energy sources (RES), over the past 30 years (1990-2019). The UK is expected to phase out all coal-based power plants by 2025. As a result of technological progress, the years 2009-18 witnessed a marked drop in the unit costs of electricity production in the RES segment. On the other hand, total unit costs of the production of coal and oil-based energy are growing. Likewise, the abandonment of traditional energy sources has been substantiated with important environmental and climate-related reasons as well as the depletion of natural resources, inevitable by the end of this century. In 2018 and 2019, Poland imported around 25% of its demand for coal and around 10% of its demand for electricity. Identified coal deposits are large, but the costs of building new underground mines are so high that the exploitation of such deposits is usually unprofitable. Consequently, even official government forecasts warn of the possibility of a major energy crisis around 2030.

On the global scale, alarming fundamental environmental quality parameters include: rapidly growing greenhouse gas production, a considerable rise in temperatures in vast areas of the globe and the related sea level rise as well as growing instability in the supply of water to plants, animals, and people. The EU has responded to this situation with what is referred to as the European Green Deal. The EU accounts for only around 10% of the world's net production of carbon dioxide, but per capita emissions are still above the world's average. The EU's strategic goal now involves reducing this share to zero by 2050, which means reducing the emissions of carbon dioxide by humans and animals to the level of its absorption by trees and plants. Efforts to implement this goal are helped by what are important and essentially revolutionary technological innovations in the field of renewable energy sources and means of transport propelled by electric motors and hydrogen.

Over the past 20 years, the measures taken by Poland in the RES field have been a lot less intensive than in the EU. Over this period, Poland and the EU have started to move in diverging directions in the field of energy policy. Consequently, the trends that prevail in Poland include a high death rate and the more common occurrence of diseases caused by low and worsening air quality, growing costs of carbon dioxide emissions permits, a growing risk of draughts, floods, and periodical water supply crises as well as the risk of rapidly growing energy prices and, after 2030, the prospect of energy cutoffs on a significant scale. These adverse trends and risks persist despite a strong reduction in the role of coal in the economy in 1990-2000 as a result of the systemic transformation. In 2017, according to EC data (2018), the carbon dioxide emissions per capita in Poland (8.48 metric tons) were nonetheless higher than the EU average (6.97 metric tons) and much higher than the world's average (4.91 metric tons). Achieving the goal set forth by the EU for 2050 will require major and swift changes in the country's economic policy: opting out of creating new brown coal opencast mines and coal-fired power plants, shutting down existing coal mines and gradually phasing out most coal-fired power plants, in addition to the construction of a distributed network of water reservoirs by local governments, the modernisation of power grids by the state (in order to reduce what constitutes currently considerable losses), and the complete elimination of heating with the use of old polluting coal-fired stoves, which still number several millions. As a part of a new strategic policy, Poland also needs to leave the production of electricity mainly to the private sector.

The actual energy mix in 2019 for the production of electrical energy was 75% coal, 11% renewables, 8% natural gas, 6% other. The energy mix just proposed by the current government for 2040 calls, approximately, for 30% coal,

15% nuclear power, 40% renewables, and 15% natural gas. Given the costs of energy production and the climate objectives, a reasonably good mix for this year would envision 50% renewables, 30% coal, 10% nuclear power and 10% natural gas, while a good mix for 2050 would be 70% renewables, 20% nuclear power and 10% natural gas.

## **10.2. Climatic changes and long-term economic and geopolitical trends induce integration within the EU**

The ECB is now the key central economic institution for all members of the UE in the area of monetary policy. Fiscal policies continue to be decided almost completely by national governments. However, this may gradually change in the course of this century, partly under the impact of climatic changes, which are already significant and accelerating. These changes may prove to be within the next few decades large enough to require, even force, a closer cooperation of the Member States of the EU in order to meet the costs of possibly large defensive investments. There will likely be a need to have EU budgets much larger in relation to the EU's GDP than the present 1% proportion. The European Parliament has already proposed a substantial increase of that proportion. The new initiative of the EU, the Reconstruction Fund of 750bn euros for the years 2021-3, has been accepted by the key donor countries. It may well be only a first step in a process establishing for the EU institutions a larger, though not dominant, role also in the area of fiscal policy.

## **10.3. The impact of global developments on the EU**

The current policies of Member States of the EU are likely to be also under the impact of rapid changes in the distribution of global economic activity. Climate changes will gradually make the large empty space of Siberia attractive to peoples of China and Central Asia. The population of China alone is about 10 times higher than that of the Russian Federation (RF). In Europe, Ukraine and Belarus may at some point be closely associated economically with the EU, may even become its new member states. In the circumstances it would be natural for the RF to be also closely associated economically and politically with the EU. A more democratic and economically friendly RF would be then no longer seen as a threat, and in fact no longer be one, to the EU countries. Diffusion of businesses between the UE, the USA and the UK is likely to be increasing, continue to be stronger than between Europe (or the USA) and China or India. These are new global tendencies under the impact of which the integration of the EU is likely to continue.

## 11. Concluding remarks

The remarkably large difference in economic performance between Poland and Greece in the period 2000-19 demonstrates the power of economic policies and institutions of the countries concerned. In particular, it gives a strong support for the presence of a constitutional limit on the public debt-to-GDP ratio. The impact of global markets and the economic policies of key global players, i.e. the United States and the European Union, has been shown in this comparison to be substantial but much less important.

Greece and Poland are now, and likely to remain in the years to come, at the same level of development, significantly lower than that of the technologically most advanced and economically richest countries. Certain advantages of underdevelopment should therefore operate in both countries, as well as in other countries of similar level of development. Whether they are in fact effective, will continue to depend on the quality of economic policies and institutions. In case of Poland the important risks discussed in this paper may limit the rate of economic growth and harm its stability. In particular, keeping the public debt-to-GDP ratio below 60% may be impossible in the near future.

The main and perhaps politically realistic goal should be to keep the structural budget deficit below 3% of the GDP and the costs of servicing public debt below a predetermined rational level, say 2-3% of the GDP, or generally a level that keeps the risk of default near zero. However, given the large risks, this would probably be a second-best objective. The best fiscal policy for the general government would continue to be a near balanced structural budget, with the average public debt-to-GDP ratio around or below 40%.

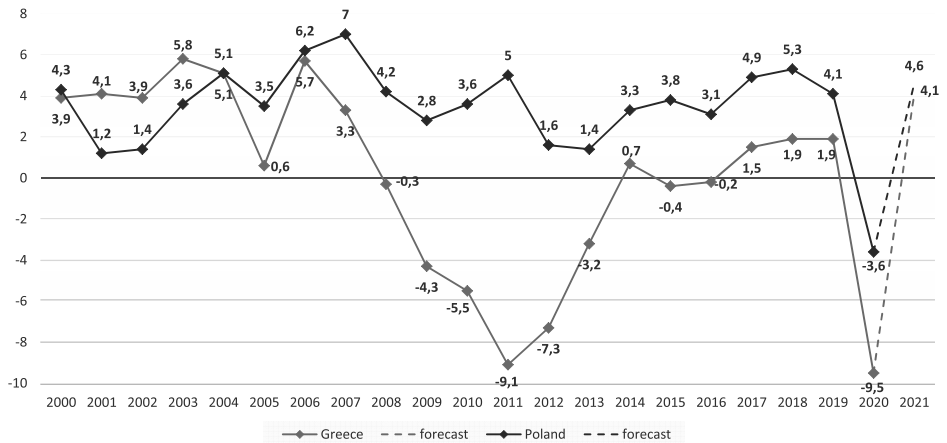
From the perspective of all the countries of the EU, the globalisation tendency, continuing integration of markets and businesses, increasing rapidly human links, and possibly large climatic changes are forcing a constant redefinition of the common EU interests in the long term, and a constant adaptation of short-term national interests and policies to those common. While the EU is likely to continue for some, probably quite a long time, to remain a union of largely independent states, the impact of these common interests is likely to be increasing.

**Acknowledgments.** The statistical annex was compiled by A. Piekutowska, PhD, of Białystok University. Translation from Polish into English of an early version of the paper is by Daniel J. Sax. I am thankful for the helpful comments from the participants of a seminar on the implications of the present health crisis for Poland's public finances and from Robert C. Hancke of the LSE's European Institute, two referees and Adrian Chojan, the Editor of this quarterly.

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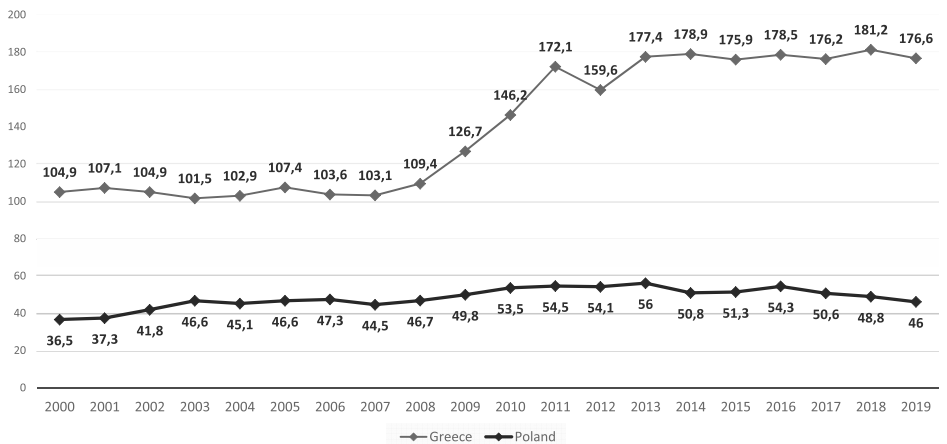
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Statistical appendix



**Figure 1.** Annual percentage growth in real Gross Domestic Product (GDP) for Greece and Poland, 2000-20 plus a forecast for 2021

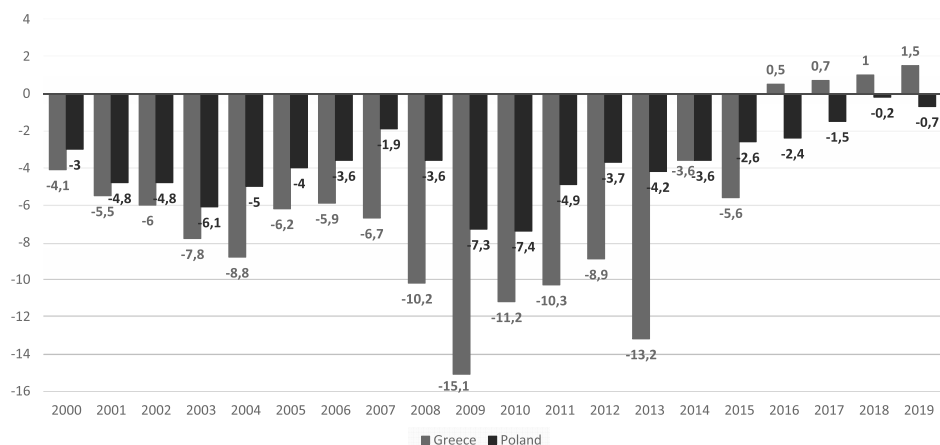
Source: IMF, DataMapper [https://www.imf.org/external/datamapper/NGDP\\_RPCH@\\_WEO/OEMDC/ADVEC/WEOWORLD](https://www.imf.org/external/datamapper/NGDP_RPCH@_WEO/OEMDC/ADVEC/WEOWORLD)



**Figure 2.** Public debt as a percentage of the GDP for Greece and Poland, 2000-19

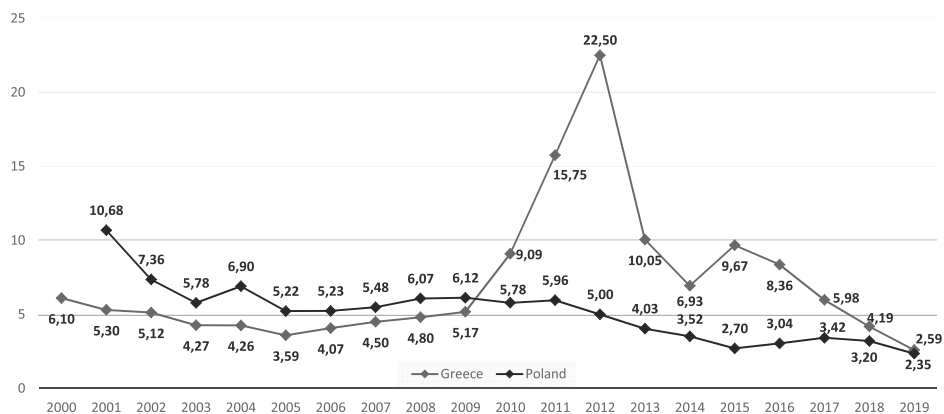
Source: Eurostat <https://ec.europa.eu/eurostat>





**Figure 3.** Deficit/surplus of the general government budget as a percentage of the GDP for Greece and Poland, 2000-19

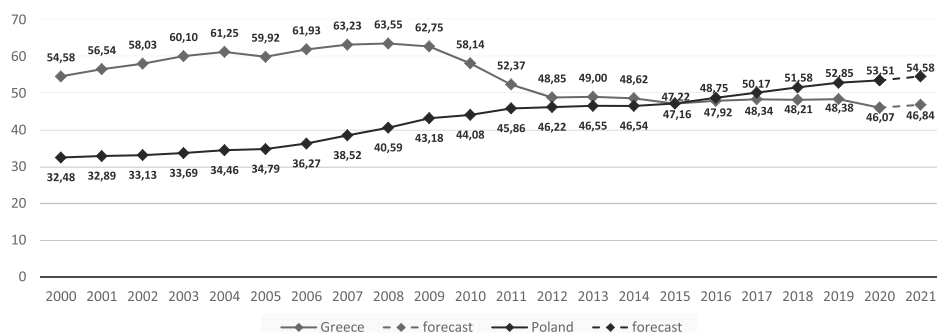
Source: Eurostat <https://ec.europa.eu/eurostat> [21.10.2020]



**Figure 4.** Annual average 10-Year Bond Yields for Greece and Poland, 2000-19

Source: EBC, <https://sdw.ecb.europa.eu/>

## 19. The comparative analysis of Poland and Greece...



**Figure 5.** Per capita (PPP) GDP for Greece and Poland for 2000-19, forecasts for 2020 and 2021, as percentages of the US level

Source: IMF, <https://www.imf.org/external/datamapper/PPPPC@WEO/GRC/POL/USA>

## 20. Finanse publiczne w Polsce: bardzo zmienna polityka w latach 1970–1990, obecne i przyszłe zagrożenia, jaka racjonalna polityka w latach 2023–2050<sup>\*1</sup>

**Abstract.** This article has three objectives. The first one is to compare and interpret the exceptionally large social and economic costs of policy errors by central authorities in Greece 2000-10, Poland 1970-80 and the G-7 countries 2000-10. The second objective is to analyse the risks to the pace and stability of Poland's economic growth and the state of public finances after 2020. The third objective is to propose policy adjustments in responses to these risks in the period 2023-30.

**Key words:** Poland 1970-2020, Greece 2000-2010, the impact of new „special circumstances” in Poland 2020-2040

### 1. Wstęp

W pracy pod tytułem *The comparative analysis of Poland and Greece: short-term policy errors versus longer-term rationality* (2021) odnotowałem kilka sytuacji w ostatnich kilkudziesięciu latach w Grecji i Polsce, także globalnie, kiedy miały miejsce kosztowne kryzysy gospodarcze spowodowane błędami władz publicznych. W przypadku Grecji w latach 2009–2013 doszło do kilkuletniej recesji, z kumulatywnym spadkiem PKB o 25%, wzrostem długu publicznego z około 100% PKB do 180%. Jako rezultat polityki fiskalnej silnie stymulującej konsumpcję prywatną, polityki finansowanej w dużym stopniu zadłużeniem zagranicznym, pojawiła się pewność bankructwa w skali masowej: kraju, banków i kredytobiorców. Aby jej uniknąć, Grecja przyjęła, bo przyjęć

<sup>\*</sup> *Nauka*, 2022, 3: 17–24.

<sup>1</sup> Artykuł na kanwie wykładu przygotowanego na Konferencję Polskich Katedr Finansów, Uniwersytet Wrocławski, key-note wykład, 15.09.2022

musiała, kosztowny społecznie program stabilizacyjny, zaproponowany przez Międzynarodowy Fundusz Walutowy (MFW), Europejski Bank Centralny (EBC) oraz kraje członkowskie strefy euro.

W przypadku Polski mieliśmy w latach 1971–1976 również szybko rosnące zadłużenie zagraniczne, finansujące szybki wzrost równocześnie inwestycji publicznych i konsumpcji prywatnej. Błąd ówczesnego rządu polegał na przyjęciu założenia, że mimo ograniczeń charakterystycznych dla gospodarki centralnie planowanej nowe inwestycje zwiększą zdolności eksportowe na tyle, aby spłacić we właściwym czasie zagraniczne kredyty. Rezultatem krótkoterminowym tego błędu był też bardzo duży spadek PKB w latach 1979–1982, o 24%, a w roku 1981 zawieszenie na 10 lat obsługi większości zagranicznego długu publicznego, wreszcie w roku 1989 bardzo wysoka inflacja. Program stabilizacyjny pojawił się dopiero w latach 1990–1993 w postaci zmiany systemu gospodarczego na wolnorynkowy, zacieśnienia polityki fiskalnej i monetarnej oraz darowania Polsce połowy zadłużenia zagranicznego.

Błędy popełniały także kraje wysokorozwinięte z gospodarką wolnorynkową. Duży kryzys bankowy wybuchł niespodziewanie w roku 2008 po obu stronach Atlantyku, w konsekwencji miała miejsce recesja gospodarcza i duże wzrosty długów publicznych w wielu krajach. Ten kryzys był wynikiem głównie nadmiernie ekspansywnej polityki kredytowej banków komercyjnych oraz monetarnej kluczowych banków centralnych w latach 2002–2007.

Polska tym razem uniknęła recesji, była w UE „zieloną wyspą”. Przyczyną tego relatywnego sukcesu była ostrożna polityka monetarna i fiskalna w latach 2002–2007, dzięki której nie doszło do faktycznych bankructw, ani nawet wzrostu ryzyka bankructw, w polskim sektorze bankowym w kolejnych latach.

Jenakże polityka fiskalna i monetarna w Polsce w ostatnich siedmiu latach jest raczej ryzykowna aniżeli ostrożna, motywowana przez decydentów w dużym stopniu troską o umocnienie władzy politycznej, podobnie jak w Polsce w pierwszej połowie lat 70. oraz w Grecji w pierwszej połowie lat 80. ubiegłego wieku. Ponadto niewielka, ale bardzo eurosceptyczna, wręcz otwarcie antyunijna, część rządowej koalicji sejmowej narzuca Polsce kosztowną gospodarczo, prawnie i politycznie „wojnę” z Unią Europejską (UE). Rezultatem jest blokada w roku 2022 dopływu do Polski oferowanych dużych środków UE (58 mld euro) na finansowanie Krajowego Planu Odbudowy, niskie inwestycje prywatne w środki trwałe, rosnący koszt obsługi długu publicznego oraz dwukrotnie wyższa niż średnio w strefie euro inflacja cen konsumpcyjnych, z rosnącym ryzykiem wysokiej inflacji i niskiego wzrostu gospodarczego w najbliższych latach.

Biorąc pod uwagę te zagraniczne i własne doświadczenia w przeszłości oraz zagrożenia krajowe w przyszłości, zasadnicze pytanie brzmi: **jaka powinna być**

**racjonalna polityka makroekonomiczna Polski, w szczególności polityka fiskalna rządu, w ciągu najbliższych 20–30 lat?** Poszukiwanie odpowiedzi trzeba zacząć od odnotowania głównych bieżących problemów w polskim systemie finansów publicznych oraz zwiększających ryzyka dla stabilności finansów publicznych „specjalnych okoliczności” w polskiej gospodarce w najbliższych latach.

## **2. Problemy w polskim systemie finansów publicznych teraz oraz nowe „specjalne okoliczności” polskiej gospodarki w najbliższych latach**

Stabilność wzrostu gospodarczego zależy w dużym stopniu od uniknięcia problemów w systemie finansów publicznych. W porównaniu z większością krajów na świecie, dług publiczny w relacji do PKB jest w Polsce umiarkowanie wysoki. Ale bankructwo w latach 80. ubiegłego wieku, bardzo niski poziom nagromadzonego bogactwa na mieszkańca oraz bardzo niejasna perspektywa wejścia Polski do strefy euro podtrzymują ryzyko niewypłacalności, co podnosi wymagane przez inwestorów rentowności polskich skarbowych papierów wartościowych. Te rentowności są już teraz i mogą być w przyszłości nawet kilkakrotnie wyższe niż w krajach strefy euro czy w Stanach Zjednoczonych. W konsekwencji w przypadku przekroczenia przez dług publiczny konstytucyjnego progu 60% PKB może pojawić się ryzyko silnego wzrostu kosztu obsługi długu publicznego.

Wysokie ryzyko otwartego kryzysu w finansach publicznych w najbliższych 20–30 latach może się pojawić także z racji zapowiadanego dużego wzrostu wydatków w relacji do PKB na publiczną ochronę zdrowotną, obronę narodową, budownictwo socjalne, dofinansowanie systemu emerytalnego oraz wzrostu inwestycji publicznych celem obniżenia do zera emisji netto CO<sub>2</sub>.

Masowe stosowanie w Polsce niskich stawek opodatkowania VAT obniżyło wagę tego podatku w ogólnych dochodach budżetowych państwa, co utrudnia podejmowanie stabilizacyjnych działań obronnych.

Dodatkowym problemem jest fakt, że ustawy podatkowe dotyczące CIT (podatek od zysków), PIT (podatek od dochodów z pracy) i VAT (podatek od wartości dodanej) są w wielu segmentach mało precyzyjne, więc podatne na wadę zróżnicowanej interpretacji, co podwyższa niepewność dotyczącą przyszłych obciążeń podatkowych przedsiębiorstw, zniechęcając do inwestycji.

Tę listę problemów uzupełnić trzeba o **ważne nowe okoliczności** utrudniające utrzymanie dobrej kondycji finansów publicznych w najbliższych latach:

- 1) W porównaniu nie tylko z krajami Dalekiego Wschodu, ale także z krajami UE, bardzo niskie są w Polsce oszczędności krajowe, szczególnie oszczędności gospodarstw domowych. W rezultacie niskie są krajowe inwestycje w środki trwałe i niski jest krajowy popyt na dług publiczny.
- 2) Niska jest także aktywność zawodowa osób powyżej 50 lat, co bez dużej imigracji (obecna z Ukrainy jest raczej wyjątkiem) i przy oczekiwanym silnie ujemnym przyroście naturalnym musi oznaczać znaczny spadek zatrudnienia i duży wzrost liczby emerytów.
- 3) Wyczerpywanie się korzyści z racji procesu doganiania krajów wysoko rozwiniętych w najbliższych 10–20 latach oznacza, że nieunikniony będzie wkrótce duży spadek średniorocznego tempa wzrostu PKB na mieszkańca, z około 3,5% przez ostatnie 30 lat do około 1,5%, poziomu zbliżonego do tempa wzrostu gospodarczego wysoko rozwiniętych krajów.
- 4) Od roku 2028 Polska przestanie być dużym beneficjentem netto środków z budżetu UE, szczególnie jeśli członkiem UE zostanie Ukraina.

Z racji wymienionych powyżej okoliczności 1 do 4 wzrasta ryzyko niestabilności w obszarze polskich finansów publicznych. Rośnie też prawdopodobieństwo, że Polska jeszcze przez wiele lat nie będzie spełniać kryteriów, w szczególności kryterium fiskalnego, warunkujących wejście do strefy euro. Oznaczać to będzie brak korzyści z racji takiego członkostwa, m.in. mniejszego kosztu oprocentowania długu publicznego.

W świetle starych problemów i nowych specjalnych okoliczności chciałbym zaproponować wybór głównego celu polityki finansowej państwa na najbliższe 20–30 lat.

### **3. Wybór głównego celu na najbliższe 20–30 lat: (niemal) eliminacja deficytu sektora finansów publicznych**

Od roku 1991 mieliśmy w Polsce wiele zmian w systemie podatkowym, ale jedna rzecz była niezmienna: wynik sektora finansów publicznych był zawsze deficytem, w przedziale od blisko 2% PKB do nieco ponad 7% PKB, średniorocznie około 4%. Tak znaczny deficyt stał się więc jedną z głównych zasad dotychczasowej polityki fiskalnej państwa. Duże negatywne konsekwencje stosowania tej zasady były i nadal są następujące:

- 1) Obniżanie oszczędności krajowych, tym samym obniżanie możliwości finansowania inwestycji krajowych;

- 2) Istnienie systematycznej presji w górę na wielkość długu publicznego w relacji do PKB, co wymusza od czasu do czasu kryzysowe działania obronne, takie jak renegocjacja długu zagranicznego w latach 1991–1994 (w konsekwencji podobnej polityki prowadzonej w latach 1970 i 1980) oraz przejęcie przez budżet państwa połowy środków OFE w ostatnich kilku latach;
- 3) Niespełnianie przez Polskę wymagań Paktu Stabilności i Wzrostu, co blokuje wejście Polski do strefy euro, w konsekwencji podnosi koszt obsługi długu publicznego. Wysoka inflacja, więc duży podatek inflacyjny oraz stosunkowo wysokie tempo wzrostu PKB w latach 90. powodowały, że nominalny PKB rósł bardzo szybko, co powstrzymywało wzrost relacji długu do PKB. W najbliższych 20 latach będziemy mieć pod tym względem zasadniczo inną sytuację, bo zarówno inflacja, jak i wzrost realnego PKB będą w najbliższych latach dużo niższe niż średnio w ostatnich 30 latach.

W tej nowej sytuacji wynik sektora finansów publicznych powinien być **w przedziale od nadwyżki około 0–2% PKB w okresie dobrej koniunktury do deficytu 2–4% w okresie recesji. Oznacza to konieczność zbudowania trwałej poprawy średniorocznego wyniku o około 3 pp. PKB, z poziomu około 4% deficytu do poziomu około 1% deficytu.**

Osiągnięcie tego celu to warunek konieczny, a zarazem dostateczny, stabilności finansów publicznych. To także warunek konieczny, chociaż niedostateczny, wejścia Polski do strefy euro oraz podtrzymania rozwoju gospodarczego w tempie umożliwiającym dalsze, choć wolniejsze niż dotąd, zmniejszanie luki rozwojowej wobec Niemiec, innych krajów starej UE oraz Stanów Zjednoczonych i Japonii.

Z racji tych fundamentalnych powodów proponuję uznać **niemal eliminację deficytu sektora finansów publicznych za cel podstawowy polityki fiskalnej w najbliższych 20 latach.**

Przy średniorocznym deficycie bliskim zeru możliwe byłoby systematyczne obniżanie relacji długu publicznego do PKB z obecnej bliskiej maksymalnie dopuszczalnego przez Konstytucję pułapu 60% **do poniżej 40% za 20 lat.**

**Obniżanie tej relacji jest szczególnie potrzebne w najbliższych latach, aby stworzyć rezerwę makro finansowej stabilności Polski przed wejściem kraju do strefy euro.**

Przez sformułowanie i realizację takiego głównego celu polityki fiskalnej Polska przyłączyłaby się do grupy krajów UE w naszym regionie (Szwecja, Dania, Czechy, Słowacja, kraje bałtyckie), które od szeregu lat tego rodzaju politykę prowadzą, albo jak Niemcy, które od kilku lat zaczęły ją prowadzić.

## 4. Inne cele

Wybór innych celów powinien być podporządkowany dwóm kryteriom: zasadzie pomocniczości w realizacji celu głównego oraz zasadzie minimalizowania skutków ujemnych systemu podatkowego dla rozwoju gospodarczego. System podatkowy jest po części instrumentem realizacji polityki społecznej, ale podtrzymanie zaufania wymaga stabilności tego systemu, więc cele redystrybucyjne i inwestycyjne polityki społecznej powinny być realizowane przede wszystkim poprzez zmiany w strukturze wydatków.

Realizacji celu głównego sprzyjałyby działania na rzecz zmniejszenia deficytu systemu emerytalnego oraz na rzecz uszczelnienia systemu podatkowego. W każdym z tych obszarów realistycznymi celami powinno być polepszenie wyniku w skali około 2–3 pp. PKB.

Wprowadzone od IV kwartału 2017 roku obniżenie ustawowego wieku emerytalnego pogorszyło wynik finansów publicznych natychmiast o ok. 2 pp. PKB rocznie, a z czasem obniży ten wynik nawet o 1/2 pp. PKB rocznie. **Zmiana ewidentnie błędnej polityki gospodarczej w tym obszarze będzie konieczna.**

Sytuację na rynku pracy pogorszyła duża emigracja z Polski po 2004 r., wynosząca około 2 mln osób. Mimo dużej imigracji z Ukrainy stopa bezrobocia jest teraz już w pobliżu poziomu minimalnego. Polityka podatkowa powinna więc **zachęcać do zwiększenia aktywności zawodowej oraz do ograniczenia tempa depopulacji kraju poprzez inwestycje w żłobki i przedszkola.**

## 5. Proponowane działania

W przypadku usług zdrowotnych pełne finansowanie ze środków publicznych mogłoby dotyczyć tylko tych kategorii usług, na które nie ma dużych kolejek. W Polsce płatnikami netto na publiczną służbę zdrowia są osoby z wysokimi dochodami, bo ich składki zdrowotne są wysokie, a korzystają z usług prywatnej służby zdrowia. Składki zdrowotne osób z niskimi dochodami są niewielkie. Dotyczy to szczególnie rolników i ich rodzin. Jeśli jednak potrzebne współfinansowanie nie będzie możliwe, to jedynym wyjściem musiałoby być albo podwyższenie składki zdrowotnej, albo kontrola popytu na usługi, jak dotąd, przez kolejki.

W obszarze emerytalnym problemem jest **ograniczona racjonalność obywateli**. Ustawowy wiek emerytalny jest wszędzie na świecie ważnym instrumentem wpływającym na efektywny wiek emerytalny. Przy pełnej racjonalności obywateli ustawowy wiek emerytalny mógłby być całkowicie zniesiony, a nie



tylko obniżony. Aby zachęcić do większej racjonalności, państwo ma szereg innych, oprócz ustawowego wieku, instrumentów do dyspozycji.

Jednym z nich byłoby powiązanie emerytury minimalnej z emeryturą średnią, a nie ze średnią płacą. Efektem takiego powiązania byłby spadek emerytury minimalnej w relacji do średniej płacy z obecnego poziomu 20% do około 15%. Inny możliwy instrument to obniżenie oprocentowania kapitału na kontach emerytalnych w ZUS. Trzeci instrument to rozszerzenie zasad emerytalnych obowiązujących w systemie ZUS na wszystkich zatrudnionych, z wyjątkiem osób powyżej ustawowego wieku emerytalnego. W przypadku emerytur rolniczych oznaczałoby to albo podwyższenie składek emerytalnych, albo obniżenie emerytur, albo też jakąś kombinację obu tych konsekwencji. Tego typu skutki sprzyjałyby zmniejszeniu liczby pracujących w rolnictwie, która teraz jest w Polsce ciągle bardzo wysoka; wynosi około 8–10%, a z czasem zapewne spadnie do około 3% ogólnej liczby pracujących w gospodarce.

Rozwiązanie w postaci wyższych niż obecnie obowiązkowych składek emerytalnych osób w systemie ZUS zmniejszyłoby deficyt w sektorze emerytalnym, ale sprzyałoby utrzymaniu wysokiej aktywności zawodowej w szarej strefie.

W Polsce dużym problemem społecznym są niskie emerytury kobiet. Tak jest z trzech powodów: niższych płac, niższego okresu pracy i znacznie dłuższego okresu życia po przejściu na emeryturę. Potrzebne jest przynajmniej zrównanie formalnego wieku emerytalnego kobiet i mężczyzn, prawdopodobnie w większości zawodów na poziomie między 60 a 68 lat. Takie zrównanie może być społecznie akceptowalne.

## 6. Druga zasada podatkowa

Oprócz zasady zerowego przeciętnego deficytu sektora finansów publicznych, drugą zasadą podatkową powinno być **ograniczenie obciążania podatkami pracy i przyrostu kapitału kosztem opodatkowania wydatków konsumpcyjnych**. Taka zasada zachęca do pracy i oszczędzania, czyli do stabilności i rozwoju na szczeblu zarówno rodziny, jak i państwa. Wpływy z podatków PIT i CIT są w Polsce umiarkowane, bo finansują tylko około 1/10 wszystkich wydatków publicznych, wynoszących teraz w Polsce około 44% PKB.

Podatek CIT w relacji do zysków w okresie transformacji znacząco obniżono. Wiele krajów obniża ten podatek przez obniżanie podstawy do opodatkowania. Ale w UE mamy też kilka krajów z wyjątkowo niską stawką tego podatku. Sztandarowym przykładem jest Irlandia ze stawką 12%. Niska skala zachęca do pokazywania prawdziwych zysków i nie musi prowadzić do dużego obniżenia

wpływów z tego podatku. Przedsiębiorcy obciążeni są także podatkiem od dywidendy, który wynosi w Polsce 19%. Tymczasem suma stawek podatkowych CIT oraz od dywidendy powinna być równa stawce 32% podatku PIT. Obecny system podatkowy nie spełnia tej reguły. Istnieje przestrzeń do obniżenia podatku CIT do poziomu 12%. Z kolei w przypadku podatku PIT jego rola mogłaby zmaleć, gdyby wynosił zero dla osób powyżej ustawowego wieku emerytalnego. Potrzebna jest także eliminacja tzw. podatku Belki od oprocentowania oszczędności bankowych gospodarstw domowych, bo te są w Polsce bardzo niskie.

Największymi pozycjami po stronie dochodów publicznych są składki emerytalne pracowników i pracodawców, składka zdrowotna oraz podatki pośrednie (VAT + akcyza). Składki emerytalne są jednak przeznaczone na określony cel, przyszłe emerytury płacących składki (składki płacone formalnie przez pracodawców są faktycznie płacone także przez pracowników), są więc raczej wymuszonymi prawem celowymi oszczędnościami niż podatkiem. Podatki pośrednie obciążają konsumpcję, więc zgodnie z moją drugą zasadą podatkową odgrywały w ostatnich 30 latach bardzo ważną rolę. Utrzymanie dużego zróżnicowania stawek VAT i akcyzy było i nadal jest motywowane względami polityki socjalnej, potrzebą stosowania zasady progresywności. Ale wydatki na żywność odgrywają już niewielką rolę, mniejszą niż 30%, w budżetach rodzinnych większości Polaków, a będą odgrywać jeszcze mniejszą w najbliższych 20–30 latach.

W swoich rocznych rekomendacjach dla Polski Komisja Europejska systematycznie zauważa, że „Poland made no progress in limiting the extensive use of reduced VAT rates, which have an adverse impact on VAT revenue and are not an effective social policy instrument”. Istotnie, niskie stawki VAT powinny być z czasem wyjątkiem od reguły, a nie regułą.

## 7. Uwagi końcowe

Zmniejszenie roli podatków PIT i CIT, niemal eliminacja deficytu sektora finansów publicznych oraz konieczność znacznego podniesienia płac dla niektórych pracowników sektora publicznego może wymagać zwiększenia roli podatków pośrednich, w szczególności podatku VAT. Może też być konieczne wprowadzenie nowych obciążeń podatkowych. W Stanach Zjednoczonych podatek od sprzedaży detalicznej zasila budżety władz stanowych. W Polsce taki podatek mógłby być wprowadzany przez sejmiki wojewódzkie. W Wielkiej Brytanii nie ma podatku od sprzedaży, ale w dyspozycji władz lokalnych jest podatek od mieszkań i domów. W Polsce taki podatek mogłyby wprowadzać

miasta. Możliwe są też podatki ekologiczne, zachęcające do korzystania z transportu publicznego w centralnych częściach miast, do rezygnacji z domowych ciepłowni, czy zniechęcające do korzystania ze szczególnie szkodliwych dla zdrowia surowców energetycznych.

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