

# NAVAL POSTGRADUATE SCHOOL MONTEREY, CALIFORNIA



## THESIS

**TRANSFORMING CENTRALLY-PLANNED  
ECONOMIES  
THE CASE OF POLAND**

by

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**TRANSFORMING CENTRALLY-PLANNED ECONOMIES  
THE CASE OF POLAND**

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Submitted in partial fulfillment  
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## ABSTRACT

The thesis analyzes the Polish experiences in the 1990s of the stabilization “shock therapy” implemented simultaneously with the set of system-transforming reforms. The primary research question was: is Poland on the right track to a market economy? The main thrust of the study is the critical evaluation of the efforts made by reformers of the Polish economy to lessen the gap between Poland and Western Europe. It presents the areas of success and failure, so that any reader could learn more about the significance and difficulties of economic transformation in Poland. The thesis starts with the analysis of the failure of the Soviet-type economy. However, the basic focus of the research is limited to evaluation of the period between 1989 and 1995 and to presentation of possible strategies for the last five years of the century. The thesis argues that the Polish experience of the first half of the 1990s has proved that traditional tools of macroeconomic stabilization can be a success in a largely socialist economy. Despite many problems and difficulties, today Poland enjoys the fastest economic growth in all of Europe. The Polish economy entered the 1990s as the weakest in Eastern Europe; it is heading for the new century with a good chance of emerging as the strongest.



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## I. INTRODUCTION

### A. THE UNIQUENESS OF TRANSITION FROM COMMUNISM TO CAPITALISM

Poland as well as the rest of Eastern Europe is currently in the middle of a unique process to transform her centrally-planned economy into a modern market system. The greatest challenge of the decade seems to be the question how to change from communism to capitalism. The basic goal is to achieve the kind of free market model that already exists in the wealthy countries of Western Europe.

Failure of central state planning to yield significant growth inspired social unrest and official policy reform in the early 1980s, but no real change occurred until the installation of a noncommunist government in the Summer of 1989. Poland was in the vanguard of political and economic upheaval that swept the communist system from most of Eastern Europe and set the members of the Soviet dominated Council for Mutual Economic Assistance (or Comecon) on the course of drastic political and economic reform. Poland needed, and in some areas still needs, to overcome the legacy of over forty years of generally misconceived economic policy. In reality, each postcommunist government in Eastern Europe had to deal with an immense economic restructuring as each country in the region has been seeking to find areas of comparative advantage.

There is no doubt that since 1989 Europe has been larger. That year Poland, as the first former Soviet satellite, began the process of profound, long lasting, and extremely difficult transition from the communist system to ... Yes, it seems to be a very challenging question - to what? What are the main targets of these fundamental changes? What were the first results? What are the fields

of success ? What kind of difficulties has the country have to manage ? What kind of economic adjustments still needs to be done to help bridge the gap between Poland and the developed economies of Western Europe.

The aim of the thesis is to suggest a way of understanding the process Poland has been experiencing since 1989. The author wants to introduce the reader to diverse aspects of contemporary Poland. Considering many geopolitical aspects and the role of pioneer in the whole region, the Polish case seems to be an especially good example of the broader trends taking place in previously centrally coordinated economies.

It is obviously too early to draw any general conclusions regarding to direction the Polish economy is heading. However, some aspects seem to be undeniable. First of all, the economic performance in the first three years of transition appeared to be far worse than expected. Secondly, supporters of the chosen strategy did not enjoy an early recovery as early as they had predicted. Even worse - the economic disappointments had a huge and destructive influence on political developments. What was unlikely few years ago - the reelection of former Communist-dominated government - did happen in 1995.

Poland's economic reform approach has had a significant influence in the rest of the region. After few years of Polish reforms many foreign observers remain convinced in the potential for successful economic reforms. As soon as economic liberties were established, ne entrepreneurs surged forward with increased energy and determination. Taking into account every pro and cons, the reformers must be able to maintain the direction of reform against the organized opposition, not only of adherents of the old order, but also of the great band of new populists who seek to gain power by playing on the public fears. One has to remember that there are still many people expressing

frustration and disenchantment with life after Communism.

Unfortunately, the new governments of "Solidarity" origin brought with them not only hope for better future, but also double-digit unemployment and a drastic drop in the standard of living. The radical and comprehensive character of the systemic transformation caused the gradual disappearance of welfare-state social programs - guaranteed employment, free health care, and free education - the so-called "social safety net" to which people had grown accustomed during 45 years of Communist utopia. The "shock therapy" also underlined how difficult is the issue of privatization, how hard for any postcommunist government is to make decisions about the state sector. After six years of hesitating attempts the problem of massive privatization remains to be solved.

## **B. ORDER OF THESIS**

The second chapter covers the heritage left from central planning. It presents the failure of the Soviet-type economy which was implemented in Poland after World War II. It briefly describes several reasons of the unsuccessful efforts undertaken by socialist governments. The third part takes a look at the principal objectives of the Polish economic transformation implemented in the beginning of 1990. It also discusses the most important tools applied to reform the economy. Chapter IV analyzes the process of economic transformation that Poland has been undertaking since January 1990. It focuses on the effects of the so-called "shock therapy" on the Polish economy to find areas of success and fields of failure. The last chapter presents the most possible outcomes for the Polish economy to be implemented in the near future.



## II. BACKGROUND

The chapter will present the failure of the Soviet-type economy which created the need for changes in the late 1980s. By looking in this chapter at Poland's economy before 1989, the reader will be better able to find out why was it necessary for Poland in 1989 to change radically the direction of unsuccessful attempts from the past. An examination of Poland's economy and its economic situation after more than 40 years of the socialist experiment reveals a dilemma common to a number of other states in the region (mainly such as Hungary or former Czechoslovakia). Although geographically Poland lies in the heart of Europe and historically it was linked more closely to the Roman Christian tradition of Western Europe than to the Byzantine system of Russia, Poland found itself, after the second World War, subsumed within the politically and economically defined conception of Eastern Europe .

After the war, the Polish economy was organized along the lines of the Soviet economic system. The first and most important movement was the nationalization of industry, banking, and trade. Using the historical background presented by Leszek Balcerowicz, it can be said that :

After World War II, Poland fell under Soviet domination, with two resulting fundamental changes in its institutional system: first, the establishment of an authoritarian political system of a party-state type centered around the Polish United Workers Party (PUWP), and second, the replacement of private property and the market by central planning and state ownership. One major exception to state ownership was agriculture, which after the attempt at forced collectivization in the first half of the 1950s remained largely private.<sup>1</sup>

The traditional Soviet-type economic system is best characterized as one of central planning,

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<sup>1</sup>Balcerowicz, L. (1994), "Poland" in "The Political Economy of Policy Reform" by Williamson, J. (ed.), Institute for International Economics, Washington, DC, p.153.

implemented administratively through the issuing of direct commands and extensive, detailed instructions. The salient characteristics for understanding the nature and performance of that type of economic systems can be concisely summarized as follows:

- 1) A hierarchical structure of authority in which all choices must be made and all conflicts resolved, in principle, at a level superior to all sides of the issue with sole vertical accountability for actions and outcomes;
- 2) Rigid, highly centralized planning of production and distribution;
- 3) A commitment to maximal resource utilization, implying tautness and pressure in planning;
- 4) Formal rationing - that is, administrative allocation in physical or quasi physical terms of producers' goods and services;
- 5) Exhaustive price control, yielding multiple and contradictory systems of centrally fixed, inflexible prices;
- 6) The lack of any liquidity or flexible response capability (either financial or physical) in the system, and in particular the lack of a true money;
- 7) The lack of legal alternatives to assigned economic relationships and the inability of any subordinate to alter any of these relationships legally;
- 8) Absolute and arbitrary control by superiors of the norms, indices, and parameters of plan assignment, performance evaluation, and rewards;
- 9) Incentives that are geared to meeting the plans and desires of evaluating superiors, and not to the economic consequences of decisions taken at levels below the very top.<sup>2</sup>

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<sup>2</sup> For more see Murrell, P. "Symposium on Economic transition in the Soviet Union and Eastern Europe", Journal of Economic Perspectives, Vol. 5, No. 4, Fall 1991, p.19.

As many authors underline, Poland was the least committed to communism. The system did not have the hold it had in other Eastern European countries for several reasons:

- 1) Poland had no tradition of communism before World War II;
- 2) There is a strong resentment of any outside power (Russia, Germany);
- 3) The Catholic Church has always been playing a viable role of the life of Poland and a bulwark against change ;
- 4) An aspect of the Polish national character is a romantic fatalism that has been created by many centuries of being a common battleground for foreign aggressors. Poles have revolted countless times against their aggressors, usually with disastrous results.<sup>3</sup>

Taking this into account, some leaders of brother communist states found it very difficult to situate the Polish nation in the community of the newly created communist countries. Joseph Stalin was to predict in 1944: "...Communism does not fit the Poles. They are too individualistic, too nationalistic. Poland's future economy should be based on private enterprise. Poland will be a capitalist state. ..."<sup>4</sup>

Many attempts were made in Poland over the years prior to the collapse of communism to improve the system's performance by introducing " reforms" meaning changes in the system of management while still retaining the essence of the existing structures. As Dariusz Rosati<sup>5</sup> underlines:

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<sup>3</sup> For more see "Eastern Europe: From Marx to Markets" in Schnitzer, M.C. (1994), "Comparative Economic Systems", South-Western Publishing Co., Cincinnati, Ohio, p. 205.

<sup>4</sup> The statement was to be said to Stanislaw Mikolajczyk, October 1944, quoted in Mikolajczyk's "The Rape of Poland : The Pattern of Soviet Aggression", New York, Whittlesley House, 1948, p. 100.

<sup>5</sup> Dariusz K. Rosati was Director of the Foreign Trade Research Institute in Warsaw and Associate Professor of Economics in the Foreign Trade Faculty at SGPiS. He acted as a consultant to many commercial and international organizations including Citibank, UNIDO, and the ILO. Main research interests include forecasting, foreign trade policy, investment appraisal,

The economic history of Poland after the Second World War is characterized by periods of accelerated growth (fueled by extensive investment programmes) implemented at the cost of stagnating (or declining) consumption, followed by rapidly growing disequilibria and social discontent. This usually prompted more or less articulated calls for essential economic reform and often led to leadership changes. However, new leaders, once firmly in power, typically became increasingly reluctant to keep promises, trying instead to solve emerging economic problems with the use of traditional measures, like temporary reductions in the rate of investment, diverting resources from traditional sectors (agriculture) to industry, borrowing from abroad or simply printing more money. In a sense, therefore, the economic history of post war Poland is the history of "relinquished reforms".<sup>6</sup>

Rosati mentions several reasons for these repeated failures. According to him, the most important was connected with the single-party/monocentric political system adopted in Poland in the late 1940s under pressure from the Soviet Union. It was characterized by centralized decision making and overwhelming state control over the economy, whereas the fundamental idea of systemic reforms was always decentralization. Another reason for the lack of progress was that reforms attempts suffered from numerous conceptual and operational weaknesses; reform ideas were often naive and simplistic. Finally, he underlines the importance of the international environment which had a great influence on the willingness and ability of successive governments to implement radical economic reforms. He blames the "Soviet factor" as playing a crucial role in slowing down the reform process in Poland, especially in the 1960s and 1970s (Rosati, p.21).

As many economists pointed out, the centralized economy of Poland, similar to that of other socialist countries, initially grew fast, mainly owing to the very low point from which it started and very high rates of investment:

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systemic reforms in planned economies, inflation and development economics. Now he works as Minister of Foreign Affairs in the Cimoszewicz government.

<sup>6</sup>Rosati, D.K. (1991), "Poland : systemic reforms and economic policy in the 1980s" in Blazyca, G. and Rapacki, R. "Poland into the 1990s", St. Martin's Press, New York, p.20.

A persistent priority accorded the development of heavy industry beginning in the 1950s has succeeded in making Poland one of the world's 12 most industrialized nations. However, this was achieved at the expense of greatly reduced investment in agriculture and the light, consumer goods industrial sector. Serious shortages that arose from this policy resulted in major economic crises in 1956 and 1970 and demands for a reform of the planning system. Changes were made, or promised, in each instance. Within a comparatively short time after 1956, however, strong centralized control had been reestablished, and the emphasis on heavy industry continued.<sup>7</sup>

The agrarian reform was conducted from the very beginning with a possibility to eventual collectivization. Neutralization of the peasant masses during the most important stages of the communist takeover was intended to demonstrate the alleged absurdity of individual farming. The major objective of the communist propaganda was to boast the superiority of "socialist farming". The Six Year Plan 1950 -1955 was the inauguration of centralized economic planning. The plan not only called for accelerated development of heavy industry but also provided for forced collectivization of agriculture. It did not succeed, however, mainly because of strong peasant resistance. As Balcerowicz argues:

The centralized economy of Poland, similar to that of other socialist countries, initially grew fast, thanks to the very low point from which it started and very high rates of investment. However, as time went on, the efficiency of investment and of the economy as a whole continuously declined because of the decreasing ability of the centralized economic system to cope with progressively more complex economic problems. As the efficiency of the investment declined, there was a tendency to try and compensate for it by increasing the rate of investment. This in turn increased the complexity of the economy, and so on. The overall result of this vicious circle was declining rates of growth of national income and almost stagnant consumption, already witnessed as early as the late 1960s.(Balcerowicz, pp. 153-154).

Generally rapid growth in the 1950s was mainly created by newly built up industries and labor flowed out of agriculture, but a subsequent long-run tendency to decline. The reasonable success of the 1970s was accompanied by favorable terms for the import of Soviet raw materials.

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<sup>7</sup> Nelson, H.D. (1983) "Poland, a country study", Foreign Area Studies, The American University, p.165.

One has to remember, it was also thanks to openness to the West which ended up in huge borrowing to buy technology, however, much of the investment was misdirected and the country was left crippled by an enormous debt burden. From a level of \$ 1.1 billion in 1970, gross debt reached \$ 25.1 billion in 1980 with a debt service ratio of 101 per cent. This was the immediate cause of the depression from 1978 to 1982.<sup>8</sup>

Many authors point out the 1970s as the beginning of the problems of the Polish economy. The Soviet industrial model proved to be heavy burden for the Polish economic policy. New leader of the PUWP - Edward Gierek proposed a "New Development Strategy" based mainly on rapid increases in living standards, consumerism, and increased integration into the international economy, as the answer to Poland's economic troubles.

The reforms of the early 1970s included some liberalization of economic activities and a new approach to development that involved greatly increased investment for the modernization of industry. Large amounts of Western loans that were to be repaid through export receipts. Under the new policy the economy showed considerable improvement in the first years of the decade. But by the mid-1970s a disequilibrium had developed, in some degree stemming from the effects of increases in the price of oil and of raw materials imported for processing and in part because of the necessity to import larger and larger quantities of grain. The government had generally continued to ignore the development of agriculture throughout this time. Also a factor was the slowdown in productive investment that had occurred as a substantial proportion of new Western credits were used to purchase consumer goods. Moreover, the planning bureaucracy had managed by then to reimpose the highly inflexible centralized system of direct control from the top throughout the state economic sector.<sup>9</sup>

Once the imported capital and technology was in place, Poland's modernized factories and

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<sup>8</sup> See Myant, M. (1993), "Transforming Socialist Economies: The Case of Poland and Czechoslovakia", p. 8.

<sup>9</sup> "Poland: a country study" (1992), edited by G.E. Curtis, Federal Research Division, Library of Congress, pp. 165-166.

farms would be able to increase exports to the West, thus earning the hard currency required to pay off the debts incurred by the imports. Such an "import led growth" strategy did not seem inherently unreasonable, since other developing countries (such as South Korea) at that time have parlayed similar strategies into favorable economic results. Because this program promised to integrate Poland into the international economy, it did place a premium on the efficient allocation of imported investment goods and on improving hard currency export performance. Considering the investments in Western technology, Balcerowicz underlines :

The underlying assumption was that these investments would increase Poland's export potential to such an extent that the country would be able to service the debt and still achieve a higher level of GDP and consumption. However, this did not happen. The foreign borrowing proved excessive, and the related investments on the whole proved misdirected and inefficient, largely because they were undertaken within the framework of a basically unchanged centralized economic system. After rapid growth of the national income and consumption in 1971-78, Poland entered a long period of economic crisis with a huge and growing foreign debt. The drastic cuts in imports, due to the balance of payments difficulties, had brought about a decline in net material product of 27 percent between 1978 and 1982. (Balcerowicz, p.154)

Very similar and accurate diagnosis of the late 1970s is presented by many other observers. Among them - Ben Slay, who underlines that:

The Gierek regime and its corrupt *nomenklatura* were so blinded by the initial successes of the New Development Strategy that the long-term implications of its weaknesses, even signs of impending danger, were generally ignored. Investment projects and licences for foreign technology were forced on reluctant firms by the central authorities as the investment boom lost all sense of proportion. The realization that Poland's westernized industrial and agricultural base would, far into the future, demand a steady stream of raw materials, components, semi-finished products, and spare parts imported for hard currency seems not to have sunk in.<sup>10</sup>

On the other hand, James Brus argued that when the massive expansion got underway, no apparent

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<sup>10</sup> Slay, B. (1994), "The Polish economy. Crisis, reform, and transformation", Princeton University Press, p. 42.

provision was made for an adverse turn in events beyond the leadership's control, such as changes in Western markets or poor weather... The country was led into a state of euphoria, with sycophants among economists proclaiming as outdated and defeatist many interrelationships and constraints that were, in fact, vital.<sup>11</sup>

So, events of the late 1970s quickly disabused the optimists of the "real socialism" hopes. By that time shortage of consumer goods was acute. The overwhelming majority of Polish society had lost faith in the PUWP and viewed the vision of "democratic socialism" ambiguously offered by the Party as neither probable nor desirable.

Nominal income increases continued as a "money illusion" to minimize social discontent and provide a work incentive. This strategy increased the "inflationary overhang", the accumulated and unusable purchasing power in the hands of the population. At the same time, suppressed inflation spurred maladjustments and inequities in the production processes, further reducing the supply of goods. The deteriorating situation in the consumer goods market resulted in a series of watershed events: a wave of strikes that led to the formation of the Solidarity union in August 1980, a third enforced change in the communist leadership in September 1980, and the imposition of martial law in December 1981. Between 1978 and 1982, the NMP of Poland declined by 24 percent, and industrial production declined by 13,3 percent. The decline in production was followed by prolonged stagnation.<sup>12</sup>

Slay argues that the events of August 1980 proclaimed the final bankruptcy of Soviet style socialism in Poland. Even the PUWP understood the necessity of fundamental economic changes. However, at that time the most important questions remained: could the PUWP institute such changes? And would the Soviet Union permit them? (Slay, p. 49)

Economic policy in the 1980s can be basically characterized by a verbal commitment to

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<sup>11</sup>See Brus, W. (1983), "Politics and Economics: The Fatal Link" in "Poland: Genesis of a Revolution, ed. A. Brumberg, New York, Vintage Books, p. 38.

<sup>12</sup>For more see "Poland: a country study" (1992), pp. 128-129.

continue with the ideas developed and approved in the 1980-81 when the Solidarity union enjoyed a legal existence. As a result, political and international factors were decisive in determining the pace, scope and impact of the new wave of economic reforms in Poland. As Balcerowicz refers to the beginning of the decade:

An extraordinary change in Poland's sociopolitical system then occurred: after a wave of massive strikes in August 1980, the authorities agreed to the creation of an independent trade union, Solidarity... But Solidarity was a trade union only in name; in fact, it was a massive political movement for reform, which at its peak had 10 million members out of an adult population of 21 million. Despite this size, the presence of a common opponent (the authorities) and the common danger (Soviet invasion) produced a remarkable degree of unity and explained the self-limiting nature of Solidarity's demands, which may appear modest from today's perspective. In the area of economics, the principal demand was to replace central planning with market mechanisms without, however, privatizing the state enterprise (Balcerowicz, p. 154).

Developing this issue, Taras argues that the most general and most principle advocated by reformers associated with Solidarity was the so called "3-S" idea of the self-contained (or independent), self-financed, and self-managed economic enterprise. The main idea was to create greater managerial independence in matters of employment and output, and more active participation by the work force in determining the size and use of the social fund and to a lesser extent, output, pricing, and employment issue.<sup>13</sup> During the 1980s the Polish government progressively relaxed bureaucratic controls. The Jaruzelski's regime implemented a modified version of the "3-S" concept. To develop and coordinate the reform program, the general appointed a special Commission on Economic Reform. However, as Taras underlines, the government's zealotry in sponsoring reform measures was self defeating; the basis for government action ought to have rested in spontaneous, market factors rather than in administrative decrees. Taras concludes that the objectives and strategies

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<sup>13</sup> See Taras, R. (1986) "Poland: Socialist State, Rebellious Nation", Westview Press/Boulder and London, p. 111.

of the economic reform program of the 1980s were the last evidence we had yet that Solidarity's practical impact on many questions was more lasting than its autonomous organizational life. Those reforms suggested that the post-1981 leadership had in the economic sphere at least shown more reform-mindedness than many credited it with (Taras, pp. 110-113).

Some observers present a much more pessimistic point of view in evaluating the decade of the 1980s. Slay summarizes the period as follows:

The 1980s were more than the decade of Poland's economic collapse. Two sets of economic reforms (the so-called first and second stages) were attempted between 1981 and 1988, reforms that tested the boundaries of the Soviet-style economy. The martial-law crackdown on Solidarity in December 1981 was followed by a controlled attempt at gradual political reform from above, dubbed "normalization" by the PUWP leadership. The 1980s were also a decade rich in irony. Political and economic reforms that would have been inconceivable in the 1970s were introduced in the 1980s, but instead of improving economic performance and democratizing the political system they contributed to the ultimate collapse of Soviet-style socialism in Poland. In the process, the decade of reform made an important contribution to the creation of the socioeconomic infrastructure necessary for a market economy to function. Not only did the final bankruptcy of Soviet-style socialism in Poland, as well as the final attempts at reforming it, occur in the 1980s: by the end of the decade, the imperative of *transforming* authoritarian socialism into democratic capitalism had become widely accepted (Slay, p. 50).

Slay presents a number of factors that influenced the effectiveness of the first stage of economic reforms implemented in 1980-81. He suggests that they can be applied universally to attempts at economic in other socialist countries and can be described in general as follows:

1. The lack of competitive-market and entrepreneurial traditions.
2. Industrial-policy decisions made before the 1980s, favoring such sectors as shipbuilding, mining, and energy production, that created favored sectors with strong lobbies able to perpetuate industrial structures incompatible with emphases upon enterprise self-financing and profitability.
3. The lack of hard currency, which prevented the appearance of anything more than symbolic

import competition.

4. Conflicts inherent in trying to reconcile greater enterprise autonomy and an emphasis on profitability with the bureaucratic nature of or Comecon trade.
5. The desire to prevent enterprise bankruptcy and the appearance of open unemployment.<sup>14</sup>

Evaluating the results of the "first stage", Slay argues that:

By the autumn of 1985, prospects for economic reform in Poland did not look very promising. The "first stage" legislation of 1981-1982 had created a new financial system for state enterprises, increased the importance of financial instruments, and partially reformed the intermediate layer; but the reassertion of the branch ministries' dominance, the rapid increase in money wages, the continued subsidization of large and inefficient firms, and increased structural concentration all violated the spirit (and frequently the letter) of the 1980-1981 blueprint (p.65).

Considering the military character of the Jaruzelski government, the first stage of economic reform consisted essentially of a flurry of legalization combined with military discipline. The decentralizing reforms were distorted by the constraints of martial law that had been imposed nationally in December 1981 and they failed to improve the economic situation. Internally inconsistent and insufficiently far-reaching, the reforms reduced central administrative control without establishing any of the fundamentals of an alternative market system. Thus, in effect, the economy operated from 1981 to 1989 in a systematic vacuum. After 1985 the foreign trade situation further complicated Poland's economic crisis.

In July 1986, to the surprise of many observers, the PUWP leadership commitment to reform seemed to be firmer. The Gorbachev's *perestrojka* and *glasnost* allowed the tenth PUWP congress to call for a "second stage" in the economic reform and authorized the consideration of proposals that

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<sup>14</sup>See Slay, p. 56.

had been beyond the realm of the possible since December 1981. The basic principles of the second stage were the following:

1. Establishment of the economic preconditions necessary for markets to function, including market equilibration, reduction of restrictions on free prices, reduction of rationing as well as of other barriers to resource reallocation between enterprises and sectors, and strict observance of the principle of enterprise self-finance, including the liquidation of unprofitable enterprises.
2. Emphasis on "socialist entrepreneurship" based on industrial deconcentration, antitrust policy, the creation of new enterprises, and relaxed restrictions on cooperation between enterprises with different forms of ownership.
3. Completion of the reform of the central administration begun in 1981-1982.
4. Support for worker and local government self-management.<sup>15</sup>

Analyzing the failure of the "second stage" of the reform, Rosati explains that:

The notion of a "second stage" of the reform was launched in late 1986 as a reaction to growing imbalances and slowdown in the Polish economy. The authorities realized that a major breakthrough was needed to reverse the downward trend. The emphasis was initially put on accelerating already scheduled reforms and reworking the 1982 blueprint.

The failure to break away from old management styles was demonstrated clearly during the preparation of the five-year plan for 1986-1990, where both targets and instruments were formulated in a traditional manner. The plan actually assumed the strengthening of central government controls over the economy, further expansion of heavy industries, especially coal mining and energy production, and a practical freeze on economic relations with the West. The plan did not propose any increased reliance on market mechanisms to improve resource allocation and economic efficiency (Rosati, p. 26).

Furthermore, Rosati underlines that the reformers did not succeed to eliminate the most important drawbacks of the original reform concept from 1982, despite another opportunity to accelerate the pace of reform in the mid 1980s. The new reform proposals did not include major market economy institutions to name only a capital or foreign exchange market. Also economic policy

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<sup>15</sup> See Slay, p. 66.

was based on a traditional approach, which was in favor of administrative measures and excessive fiscalism, and overlooked monetary and credit policy, as well as an exchange rate policy.

On the other hand, Slay - summarizing the decade of the 1980s - concludes:

In some respect, the second stage of economic reform was a failure. In economic terms, the second stage injected strong new inflationary pressures, as well as a fresh measure of organizational flux, into the Polish economy... On the other hand, important institutional changes were made in the central administration, the banking system, foreign trade, joint ventures and elsewhere. A dialogue with Western governments, the IMF, and the World Bank was reestablished. And the failure of the second stage convincingly demonstrated the futility of attempting far-reaching economic reforms without seeking some sort of accommodation with the political opposition (Slay p.70).

Looking at the Table 1.1. it seems to be obvious that the reforms of the decade left several difficult problems for the successors of the PUWP. The communist misleading rules helped to create a reform-weary society and a traumatized, suspicious economic administration. The economic growth ended in 1989, inflation increased to triple digit levels, inflationary expectations were rampant, and the hard- currency merchandise trade surpluses of 1982 to 1988 were deteriorating. Majority of Polish society did not believe the reform slogans, the whole concept had lost much of its usefulness and credibility as an answer to Poland's economic problems.

In general, Poland's experience in the 1980s demonstrated the infeasibility and unattractiveness of "market socialism" and "socialist democracy" as answers to Poland's troubles. As Slay points out, the feasibility of transition to market economy and pluralist democracy remained to be determined (p.85). Despite another opportunity to move forward in the mid 1980s, the last communist government did not succeed in eliminating the major drawbacks of the original reform concept from 1982. Reform proposals still lacked crucial market institutions such as capital or foreign exchange market. Moreover, economic policy was still dominated by the traditional approach, favoring administrative measures and excessive "fiscalism" and overlooking monetary and credit

policy, as well as exchange rate policy.<sup>16</sup>

Table 1.1.

Macroeconomic and External Trends, 1983-1989

	1983	1984	1985	1986	1987	1988	1989
National income produced (% change)	6.0	5.6	3.4	4.9	2.0	4.9	-0.2
Gross industrial sales (% change)	6.6	5.6	4.1	4.4	3.4	5.3	-0.5
Gross agricultural production (%change)	3.3	5.7	0.7	5.0	-2.3	1.2	1.5
Retail price inflation	21.4	14.8	15.0	17.5	25.3	61.3	243.8
Labor productivity (%change)	6.9	5.7	3.0	4.8	2.6	5.8	0.7
Hard currency merchandise trade							
balance (\$ billions)	1.44	1,53	1.06	1.07	1.23	1.01	0.77
Net hard currency debt (\$billions)	25.2	25.5	28.1	32.1	37.6	37.5	39.3
Net ruble debt (TR billions)	3.5	4.5	5.3	6.3	6.4	6.3	5.3

*Source: Roczniki Statystyczne 1985-1990*

*Note: Data in rows 1-3 are in constant prices*

In conclusion, it seems to be useful to cite the main foreign adviser of the Polish economic

<sup>16</sup> See Rosati, p. 26.

reform - Jeffrey Sachs, who summarizes the communists' efforts as follows:

Two features of the reforms ultimately doomed them. First, the communist reformers never really believed in competition, so that decentralization did not lead to functioning markets. Prices remained controlled; entry by new firms into existing markets was discouraged; international trade remained restricted so that the international market provided no real competition for domestic producers... In short, existing state enterprises were never put to the market test, despite being given more freedom of maneuver. Second, the communist reformers had no interest in privatizing industry. They completely neglected or misjudged, or simply tolerated, the enormous inefficiencies that came from the lack of proper ownership of the enterprises. They failed to realize that the "insiders" of the enterprises, the managers and workers, could seriously distort enterprise behavior to their own advantage. In essence, the communist reformers failed to understand the basic flaw of socialism, whether of a "market" variety or not: when there are no capitalists, there is nobody to represent the interests of capital.<sup>17</sup>

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<sup>17</sup> Sachs, J. (1994) "Poland's Jump to the Market Economy", MIT Press, Cambridge, Massachusetts, London, p. 29.



### III. AFTER THE FALL OF THE COMMUNIST SYSTEM

This chapter explains the basic assumptions of the "Polish experiment" which started after the collapse of the Communist bloc on the beginning of the 1990s. The author will try to answer the following questions: what were the principal objectives of the Polish economic transformation and what tools were used to make it successful. In general, the chapter will aim to show how the strategy was chosen and what were the hopes and expectations of its advocates.

As it was presented in the previous chapter, before 1990 Poland had no real capital markets or market based financial institutions. At the end of the decade of the 1980s knowledge of Western financial institutions and accounting practices was incredibly poor. It was the time, when there were no well-established cases or even fully developed theories which would be helpful to implement a conversion from socialism to capitalism. As Sachs mentions:

The emergence of noncommunist rule has been a fundamental watershed for real reform in Eastern Europe. But at the same time, the emergence of noncommunist governments in the region not only does not erase all existing political difficulties, but actually introduces new ones. The economic strategy must take cognizance of the new political context, which, in our view, argues overwhelmingly for a very rapid, straightforward, and sharp program of economic reform.<sup>18</sup>

There is no doubt that Poland faced very serious problems at the beginning of its economic transformation, however their nature was less severe than in some other postcommunist countries. As Balcerowicz points out, the dependence on the Russian market was less pronounced than in practically all the non-Russian republics of the former Soviet Union and Bulgaria. Moreover, the industrial structure was less distorted by the presence of the military industrial complex and heavy

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<sup>18</sup> Lipton, D. And Sachs, J. (1990) "Creating a Market Economy in Eastern Europe: The Case of Poland" in Brookings Papers on Economic Activity, Vol. 1, pp. 75.

industry, as it was in Russia, Ukraine, and Slovakia (Balcerowicz, p. 157).

As Balcerowicz suggests, the economic conditions of Poland in the fall of 1989 can be divided into those that were similar to the structural conditions prevailing in other socialist states and those that were specific to Poland at the time. The conditions comprising the economic legacy of the socialist state are summarized as follows:

- an economic structure with an oversized industry and underdeveloped service sector;
- a heavy industry concentration at the plant level, with many plants larger than optimum and some in poor locations;
- an industrial structure shaped during many years of import substitution;
- a heavy independence on the Soviet market for exports in such sectors as machinery, textiles, electronics, and pharmaceuticals;
- a destruction of the environment in regions with a concentration of heavy industry and mining (p.156)

Describing the main features of the Polish economic system, Balcerowicz underlines:

- domination of the state sector - this constituted the basic difference between the initial conditions of the postcommunist countries and those of other countries introducing market oriented reforms...;
- heavily distorted prices due to price subsidies and controls, and this included the regime of multiple exchange rates and sharply negative real interest rates;
- absence of, or underdevelopment of, institutions needed in the market economy, such as a competitive banking system (separation of the central bank from the commercial banks had occurred only a couple of months earlier), a stock exchange, a system of government bonds to finance the deficit, genuine local government, etc.;
- a weak public administration that specialized in activities that had to be curtailed (e.g. detailed state intervention) and was weak in areas important in the market economy (i.e. analytical skills, macro management, tax administration) but that nonetheless had to start the economic reform given the shortage of skilled bureaucrats;
- a "socialist welfare state", which was extensive relative to the level of economic development but increasingly inefficient and financially insupportable and which included, among other things, public provision of health services and education, relatively generous family benefits, easily obtainable disability pensions, long maternity leave, relatively long holidays, heavily subsidized sanatoria, access by the employees of larger state enterprises to holiday facilities for them, and summer camps for their children, largely financed by these enterprises (p.157).

Like many other economists, the main architect of the Polish economic transition realized that the most important specific feature of the initial Polish economic situation was the dramatic state of the macro economy. The main creator of the recovery program stresses that:

The economic strategy was designed to cure two economic illnesses: macroeconomic and structural. The macroeconomic problem was near-hyperinflation, combined with massive shortages. Stabilization and, to some extent, liberalization components of the economic program were the relevant cures. The structural problem was low and declining efficiency, which was responsible for the low standard of living. The relevant part of the economic program here was the transformation of the economic system, comprising the removal of unnecessary restrictions (liberalization) and fundamental institutional change - that is, building and rebuilding various institutional segments of the economy: enterprises (privatization), local government, financial sector, tax system, and so on (Balcerowicz, p. 160).

Generally speaking, the transfer of power to the new government made possible the introduction of radical economic reforms that the PUWP had previously been unable or unwilling to implement. According to Slay, the Polish program for economic recovery and transition to capitalism had to focus simultaneously on six interrelated but necessarily complementary tasks (p. 87):

1. *Macroeconomic stabilization.*

The gathering hyper inflationary firestorm had to be extinguished, in order to allow relative prices to provide accurate information to decision makers and to significantly reduce the extent of macroeconomic, microeconomic, and external disequilibria.

2. *Liberalization and deregulation.*

The price system, as well as traditional regulations on firms in all sectors, had to be liberalized, to afford enterprises the freedom to respond autonomously to market signals emanating both from the domestic economy and from abroad.

3. *Privatization.*

A credible program for encouraging the rapid growth of private enterprise had to be

designed, aimed at privatizing the bulk of some 7,000 state enterprises as well as encouraging the formation and development of new private firms.

4. *Increasing convertibility.*

Significantly increasing the degree of zloty convertibility was a necessary precondition for better integrating Poland into the international economy. Increased integration would mean import competition for hidebound domestic firms, increased foreign investment, and better access to technology and know-how, as well as increased export incentives.

5. *Constructing new legal, regulatory, and financial mechanisms.*

Private firms are unlikely to function in a socially desirable manner in the absence of appropriate legal and institutional constraints on rapacious practices. This meant in particular:

- creating markets for capital and corporate control,
- reforming the banking system,
- establishing regulatory agencies to oversee these new or reformed financial institutions,
- reforming the legal system in order to more clearly define and uphold property rights,
- establishing antitrust policies consistent with the development of market competition

6. *Providing a social safety nets.*

The transition to market capitalism was expected to exact high social costs in the form of unemployment, high (initial) rates of inflation, and reduction in state subsidies. This

required redirecting the welfare state away from programs that provided benefits to all, irrespective of socioeconomic position, and toward programs that would furnish aid to those groups most at risk during the transition.

Many economists underline the highly controversial character of the Balcerowicz economic program introduced in 1990-1991. As Slay points out, in general terms, discussions about the plan for economic transformation focused around the following aspects (p.89):

1. *Alternatives.*

Are American and Western European varieties of capitalism the only viable alternatives to Soviet socialism? How relevant are the experiences of the newly industrializing countries, particularly in Asia, to the postcommunist economic transition? Does some sort of viable "third road" between modern capitalism and Soviet socialism exist? If so, what is it?

2. *Sequencing.*

What is the appropriate sequence of the six elements of the transformation described above?

To what extent must stabilization and liberalization precede privatization and other structural changes? To what extent is the simultaneous introduction of all six elements feasible and desirable?

3. *Gradualism versus shock therapy.*

Is an attempt at rapid transformation - "shock therapy" - preferable to the more gradual introduction of market capitalism? Is shock therapy feasible from a social point of view?

4. *Industrial policy.*

Is it feasible to rely on market forces to bring about industrial and agriculture restructuring?

In addition, Slay admits that the Balcerowicz Plan proposed a relatively clear set of answers to the four issues mentioned above. Taking into account suggestions from the IMF and other Western advisors, the Solidarity governments led by Tadeusz Mazowiecki (and later by Jan Krzysztof Bielecki) realized that extinguishing the gathering inflation required shock therapy; any form of gradualism had to be rejected. There was no room for "third roads" which were dismissed as "experiments". The only possible and acceptable destination was to be Western-style capitalism. It

was the main goal to achieve it as soon as possible through the introduction of a new economic program mainly based on liberalism. Slay points out that the perceived need for a rapid transition and clean break with the past was accompanied by the rejection of industrial policy. He concludes that - in terms of sequencing - stabilization, liberalization, and convertibility received the most emphasis (Slay, pp.91-92)

A similar point of view is represented by other observers. For example Balcerowicz explains that:

The peculiar feature of the Polish economic program (and later that of other programs in the postcommunist countries) was that, in view of the initial economic system, the systematic transformation had to be far more comprehensive and radical than in any previous cases of market-oriented reform. Another characteristic of the Polish program was that the systemic change had to be combined with radical economic stabilization because of inherited hyperinflation and massive shortages. This distinguished the Polish situation from that of Czechoslovakia and Hungary, which were macro economically much more stable, and made it similar to the situation in some Latin American countries and to the initial conditions in the former Soviet Union as well as Bulgaria, Romania, and Albania two years later (p.160).

Moreover, the unprecedented character of the changes which were initiated during the "Round Table" talks in April 1989 is also underlined by other economists. D. Rosati argues that the new economic program was not a simple policy adjustment, but a fundamental systemic transformation of historical significance aimed to switch from a centrally planned economy to a competitive market economy, based on private ownership of capital and guided by efficiency criteria and the profit motive. He underlines two major elements of the plan:

- a stabilization package, which was intended to bring down inflation and to restore market equilibrium;
- an institutional (systemic) transformation, which was supposed to be the base for creating in Poland a modern market economy of the West type.

Rosati underlines that while the first part was intended to be short term, the latter constituted a comprehensive restructuring of the institutional framework of the Polish economy and was of necessity long term. He points out that the stabilization package was recognized by both domestic and international experts as radical and ambitious. Generally it consisted of five main components:

- the freeing, in January 1990, of almost all remaining administrative price controls, coupled with the increase of official coal and energy prices by 400 % to 600% and other fuel prices by roughly 100%;

- the so- called "internal convertibility" of the zloty (the Polish currency), that is, the unification of the market for foreign exchange for most current transactions, accompanied by a sharp official evaluation of the zloty by 32% from zl 6,500/\$ to zl 9,500/\$, with the aim (successfully achieved) of maintaining the fixed exchange rate for at least six months;

- the limitation of wage fund growth in enterprises to a small fraction of the price inflation (0.3 in January, 0.2 in February-April) through a very restrictive tax-based income indexation policy (also successfully implemented);

- the elimination of the budget deficit and attainment of approximate fiscal balance by the general government in 1990, through major cuts in food and commodity subsidies, reductions of public investment programs and defense and internal security expenditures, coupled with substantial increase of taxes, custom duties and other fiscal charges paid by enterprises;

- a major tightening of credit and monetary policy, through a strict limitation of the rate of domestic credit expansion to government and non-government sectors, together with a sharp increase of interest rates making them positive in real terms.

The most important parts of the systemic package ( some changes were implemented from the beginning of 1990, some during the next year) were:

- the rapid privatization of state-owned or co-operative enterprise, through competitive asset sales;
- breaking up existing monopolies and creating favorable conditions for unrestricted competition among enterprises, from both private and public sectors;
- liberalization of foreign trade and payments, removing most administrative restrictions on the licensing of foreign trade and establishing a foreign exchange market;
- liberalization of the land market;
- modernization of the financial sector through creation of two-tier banking system, with a network of strong and competitive commercial banks, applying modern technologies and techniques of banking operations;
- establishment of fully-fledged capital market, with a stock exchange;
- modification of the Labor Code to establish conditions for a labor market;
- upgrading the managerial and administration skills of the Polish business community, through extensive training programmes organized jointly with foreign institutions;
- a comprehensive reform of the tax system, aimed at the introduction of a broad-based individual income tax and replacement of differential turnover taxes with a value-added tax;
- a new joint-venture law, offering significant incentives for foreign investors.<sup>19</sup>

The general orientation of the program was neo-liberal and neo-monetarist in character. As Rosati underlines, the plan follow rather closely the standard IMF approach to macroeconomic

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<sup>19</sup> See Rosati, pp.28-30.

stabilization policy, and, not surprisingly, has been highly praised by IMF and World Bank officials. The key idea of the Balcerowicz Plan was to break decisively with the communist system, to end halfway reform efforts, as the Solidarity leaders used to say, to jump to the market economy. The program was introduced on January 1, 1990, and soon became known as "the big bang".



#### IV. POLAND'S TRANSITION TO A MARKET ECONOMY

The aim of this chapter is to analyze the process of economic transformation that Poland has been undertaking since January 1990. The author will concentrate on the effects of the so-called "shock therapy" on the Polish economy in the last six years. He will try to find areas of success and fields of failure. The main question is what was the Poland's economic position at the end of 1995 and what were the main factors that had the biggest influence on the present outcome.

The initial reforms in Poland have been especially far reaching and have been widely recognized as a model for the reforms in other parts of Eastern Europe and the former Soviet Union. Before talking about the performance of the Polish economy since 1990, it seems to be necessary to precise what the terms "success" and "failure" should mean - taking into account some specific circumstances Poland (as well as the other countries of the former Soviet bloc) had to face on the road to a market economy. As Jeffrey Sachs suggests:

Before speaking more about the chances for "success" or "failure" of the reforms, it is useful to be clear about what success would mean. Many people say, "How can Eastern Europe succeed? The industry is so old-fashioned; the workers don't have the right skills; the enterprises are so dilapidated; the environment is despoiled." If "success" were to be defined as solving these problems and elevating Eastern European living standards to Western levels in a period of ten years, then Eastern Europe surely cannot succeed. By Western European standards, these countries will remain poor for a generation or more.

The term "success" should therefore mean something more modest, though certainly challenging enough. At a minimum, success should mean the consolidation of democratic institutions and a well-functioning market economy. As for a practical standard of future economic performance, I would suggest that reforms will have been successful if these countries pull close enough in living standards to Western Europe in the next decade or two that they can comfortably be integrated into the European Community...

It is also useful to have clearly in mind what a failure of the reforms might mean, because the concept of "failure" can also be misunderstood. At a minimum, "failure" could simply mean a continuation of economic stagnation or economic growth too slow to raise living standards toward those in Western Europe along the timetable just spelled out. But what worse could happen? Failure

for Eastern Europe will not mean a reversion to communism... Failure, rather, means the inability to reach any new consistent system, and particularly the Western European system. The possibility of this kind of failure is very real because the political challenges of the Eastern European transformation are daunting, and indeed are far more complex than the economic challenges (Sachs 1993, pp. 6-7).

It is hard to disagree with the boundaries established in the way presented above. On the other hand, Balcerowicz argues that the specific nature of the transition from communism in Central and Eastern Europe becomes clear when we compare it with other major shifts from one stable state of society to another potentially stable state. By other types of transition he means :

1. classical transition - democratization in basically capitalist countries between 1860 and 1920,
2. neoclassical transition - democratization in basically capitalist countries after the Second World War,
3. market-oriented reform in non-communist countries,
4. Asian post-communist transition.<sup>20</sup>

Furthermore, a number of features can be presented that distinguishes the post communist transition in Central and European Europe:

1. The scope of change is exceptionally large which means that both physical and economic systems are affected, and changes in these systems in turn interact with changes in the social structure. In the types of transition mentioned above, there was either a focus on the political system while the economic system remained basically unchanged (as in classical and neoclassical transitions), or a focus on the economy while the political regime was unaffected (non-democratic cases). In the Polish case, the unprecedented huge scope of changes created an extreme information overload for top decision makers which made errors and delays hardly surprising. This becomes more understandable when we take into account the fact that decision makers from the beginning had to deal with a public

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<sup>20</sup>Balcerowicz, L. (1995), "Socialism, Capitalism, Transformation", Central European University Press, p.145.

administration largely inherited from the old regime.

2. Although the changes in the political and economic systems started at about the same time, it is highly misleading to speak of simultaneous transitions in post-communist Europe ( i.e. it takes more time to privatize the bulk of the state dominated economy than to organize free elections and at least some rudiments of political parties ). Given the largely simultaneous beginnings of the political and economic transitions, this asymmetry in speed produces a historically new sequence: mass democracy (or at least political pluralism) first, and market capitalism later.

3. The sequence implies that market oriented reforms (exceptionally comprehensive in character owing to the socialist economic legacy) have to be launched under democratic, or at least pluralistic, political arrangements. Balcerowicz argues that it is hard to find any former case of economic transition that both approached the comprehensive of what occurred in post-communist Europe and was carried out under a democratic regime.

4. The non-violent nature of transition ( in the form of a tacit political pact) in Poland has had important implications for other aspects of transition. The old ruling elites remained intact and ready to gain profits from the dissatisfaction of a part of society; on the other hand the newly emerging capitalist class is likely to include many of the former elites, an aspect that reduces the legitimacy of the whole capitalist transition and fuels conflicts on the opposition side.<sup>21</sup>

Many authors find the Polish case as an economic wonder. Someone may treat such evaluations as a bit exaggeration, but it definitely helps to support the theory that the last six years (1990-1995) were the time of outstanding efforts of the Polish governments to break out of the socialist system by launching the process of radical economic transformation.

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<sup>21</sup> For more see Balcerowicz (1995), pp. 145-151.

Six years ago Poland was an eastern European basket case, suffering hyperinflation, defaulting on its international debts, and seemingly on the brink of starvation. Yet today, the Polish economy is the most dynamic in Europe with a growth rate of 7 per cent a year. How could this economic wonder have happened ?<sup>22</sup>

So, to find the possible answer to the Aslund's question it is necessary to come back to the starting point of 1990. As it was underlined in the second chapter, the turning point was the "Balcerowicz program" implemented in January 1990 by the Poland's first non-socialist postwar government. The main architect of the plan - Leszek Balcerowicz, minister of finance and deputy prime minister - later became known as the "father of shock therapy" as a result of the program's immediate effects on the Polish economy. The crucial steps of the Polish *big bang* were implemented as planned:

...a sharp cut in consumer and producer subsidies; an end to almost all price controls; an elimination of central planning; a devaluation of the zloty-dollar exchange rate, followed by a pegged rate at the new level; an opening of foreign trade, including a suspension of licensing and quotas, and fully convertibility of the currency for current account transactions; the introduction of the *popiwiek* (tax on excessive wage increases); and the introduction of various legal changes designed to encourage new entry of private firms, competition, and demonopolization. Privatization of industry was to have started early in 1990, but it was not until June that the framework privatization law was passed. Even before the passage of the law, however, small shops began to be privatized by local governments through auctions and leases (Sachs 1993, p.57).

## A. INITIAL RESULTS

The results of the first few months can be best described by reference to the most important goals of the program, that means: ending hyperinflation and shortages, making the transition to a market economy and encouraging a structural change from heavy industry to light industry and services. Within few weeks stores were well stocked and the long queues in front of them disappeared. However, postcommunist economic reform initially brought both positive and negative

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<sup>22</sup> Aslund, A. "A shock therapist's radical prescription" in Financial Times, Feb. 29, 1996, p.10.

results in the key areas of price control, productivity, inflation, and wages. The common perception was that individual budget limitations rather than the availability of goods and services became the primary determinant of buying patterns.

The dramatic changes started on the first days of the program, with an enormous jolt to the economy that was quickly christened "shock therapy". With the elimination of price controls, the inflationary pressure that had been building up for years was suddenly released. The average price level jumped by about 80 percent in the first two weeks of January. It was a gut-wrenching experience for the public and the reformers alike... The results of the first few days were unimpressive to say the least. The farmers hoarded the grain and meat in expectation of still higher prices. Many economic pundits in the country commented in the press how horribly wrong the neoclassical Western economists were - they just did not understand anything about Poland. In Poland, the pundits asserted, when prices go up, shortages intensify. The program was attacked as "shock without therapy" (Sachs 1993, pp.58-59).

Table 4.1

A comparison of initial macroeconomic conditions of the East European countries\*

	Poland	Czechoslovakia	Hungary	Bulgaria	Romania
1) Broad money (end-year, %)					
1988	63.0	-	-	-	-
1989	526.5	3.5	13.8	10.6	5.3
1990	-	0.5	29.2	16.6	22.0
2) CPI inflation (end-year, %)					
1988	73.9	-	-	-	-
1989	640.0	1.5	18.9	10.0	0.6
1990	-	18.4	33.4	72.5	37.7
3) Fiscal balance (GDP %, last Pre-reform year)					
	-7.4	0.1	0.5	-12.7	1.2

\* The last pre-reform year for Poland is 1989, for the other countries 1990.

Source: *Transition Report (1994)*, European Bank of Reconstruction and Development.

To better understand the dramatic state of the Polish macro economy it seems to be useful to present the macroeconomic imbalance in Poland during the last two pre-reform years in comparison with the other states of the former Soviet bloc. Table 4.1. proves that Poland was in fact the only postcommunist economy which started its economic transition from a position of hyperinflation and massive shortages. The collapse of or Comecon only worsened the situation. It put all former member countries in a state of economic crisis by completely changing the terms of trade among them.

Table 4.2  
Macroeconomic indicators, 1989-1992

Year/ month	Real wage (1985 = 100)	Inflation (monthly rate)	Unemployment rate	Industrial production (1989 = 100)
1	2	3	4	5
1989: 1	102	9.6		110
2	121	8.8		99
3	148	8.1		110
4	130	9.2		101
5	118	6.8		104
6	128	6.1	0.0	109
7	125	10.3		86
8	179	39.5		92
9	135	34.2		99
10	109	54.8		101
11	116	22.4		94
12	142	18.3		96
Average	129	19.0	0.0	100

Table 4.2 - continued

	1	2	3	4	5
1990:	1	82	77.3	0.3	78
	2	82	15.8	0.9	69
	3	107	4.5	1.5	76
	4	92	6.7	2.0	70
	5	84	4.5	2.5	74
	6	81	3.8	3.2	74
	7	85	4.9	3.9	70
	8	87	1.8	4.6	75
	9	89	4.6	5.2	75
	10	95	5.7	5.7	83
	11	108	4.9	6.1	79
	12	101	5.9	6.3	73
Average		91	11.7	3.5	75
1991	1	87	17.2	6.8	72
	2	91	6.7	7.0	64
	3	89	4.5	7.3	69
	4	85	2.6	7.5	63
	5	79	2.7	7.9	61
	6	76	4.9	8.6	62
	7	81	0.1	9.6	59
	8	79	0.7	10.1	59
	9	78	4.3	10.7	60
	10	81	3.2	11.1	65
	11	88	3.2	11.4	59
	12	90	3.1	11.8	59
Average		84	4.4	9.2	63
1992	1	79	7.5	12.1	61
	2	77	1.8	12.4	58
	3	83	2.0	12.1	69
	4	81	3.7	12.2	65
	5	73	4.0	12.3	63
	6	73	1.6	12.6	67
	7	78	1.4	13.1	65
	8	75	2.7	13.4	63
	9	75	5.3	13.6	68
	10	77	3.0	13.5	71
	11	85	2.3	13.5	na

Table 4.2 - continued

1	2	3	4	5
1992 - average	78	3.2	12.8	65

Source: *IMF - International Financial Statistics (2), (3), and (5)*  
*Biuletyn Statystyczny, various issues (4).*

Table 4.2 shows the success of price stabilization in 1990 and the following years. The new government moved quickly to douse the inflationary fires. The rapidly introduced short term policies quickly and fundamentally changed the workings of the Polish economy; however, a view spread that the costs to living standards had been very high. Comparing the end of 1989 with January 1990 it appears that the program cut real wages very drastically.

Critics have pointed to numerous shortcomings of the plan and its implementation. They underlined that the *big bang* had started a remarkable process of change and an end of shortages, but at a fearful cost of falling living standards. Many have charged that the plan was too dogmatic and inflexible, inappropriate for Poland's specific conditions, or that it was introduced prematurely, before a more developed groundwork for a market economy was in place. On the other hand, the opposite side criticized Balcerowicz of being too willing to abandon monetary and fiscal rigor in the second half of 1990, in order to deliver on the promise of an "improvement" after the first six months of shock therapy (Slay 1994, pp.93-94). This explains the increase in real wages and inflation in the last four month of 1990. Moreover, ex post disparities between projected and actual macroeconomic performance (Table 4.3) provided more arguments for the criticizing side.

Table 4.3

## Projected and actual macroeconomic indicators in 1990

	Projected	Actual
Consumer price inflation (%)	267.6	352.2
GDP (% change)	-3.1	-11.6
Industrial output (% change)	-5.0	-24.2
Unemployment rate (%)	2.0	6.1
Merchandise trade balance		
In dollars (billions)	-0.8	3.8
In transferable rubles (billions)	0.5	4.4
Consumption (%change)	-1.0	-11.7
Real wages (% change)	-20.0	-22.3

Source : *Slay 1994, p.94*

Taking into account the data presented above, the first and the most difficult year of economic transition can be summarized using the evaluation presented by Slay:

In any case, except for inflation, Poland in 1990 met and often surpassed the stabilization targets agreed on with the IMF. The \$668 million current account surplus recorded in 1990 - the first since the 1960s - was particularly impressive and boded well for the reestablishment of Poland's creditworthiness. This occurred in spite of the fact that Poland's energy imports increased by some \$1 billion in 1990 as a result of higher oil prices (and shrinking deliveries from the Soviet Union) and despite the economy's loss of another \$2.9 billion as a result of the country's participation in the international embargo against Iraq. Although the government suspended debt servicing in February 1990, Poland became the darling of the international financial community and the IMF and the World Bank agreed to aid programs totaling some \$2.5 billion. This paved the way for a landmark agreement concluded in April 1991 with the Paris Club of creditor governments. According to this agreement, 50 per cent of Poland's publicly-held foreign debt would be forgiven, provided that economic development in Poland continued along the path begun in 1990, debt servicing was renewed, and targets in the IMF agreements were met (Slay 1994, pp.96-97).

In addition, the stabilization program's accomplishments were accompanied by progress in a number of other important sectors of the transformation, i.e. the implementation of competition

policy to break up monopolies in the extractive and cooperative sector, external liberalization, the passage of landmark privatization legislation, and the introduction of unemployment programs. According to many observers from Western Europe, a more promising start for Poland's economic reform could hardly have been imagined, particularly when someone takes into consideration the previous track record of unsuccessful reform attempts before 1990.

One of the most significant achievements of the initial period of transition was a successful change in the area of so-called "small business". Hundreds of thousands of new private businesses were initiated in the wake of the reforms. Table 4.4. presents the increasing trend in the area observed in the early 1990s. Liberalization of law made it very easy to let people try their chance in the private sector.

Table 4.4

Private business registered in 1989-1992 (in 000s, at year end)

Year	Commercial law partnerships	Joint Ventures	Individual proprietorships
1989	11.6	0.4	813.5
1990	29.6	1.6	1,135.5
1991	45.1	4.8	1,420.0
1992 (mid-year)	51.2	7.6	1,523.4

Source: *Sachs 1993, p.63*

Sachs evaluates that the increase in small business owners represented around 4 per cent of the working population:

Total employment in these small businesses rose from 1,475,000 to 2,800,400, an increase of more

than 7 per cent of the total labor force. As of larger enterprises, the number of private commercial law partnerships (partnerships, limited liability companies, and joint stock companies) rose from 11,693 at the end of 1989 to 51,174 by mid-1992 (Sachs 1994, p.63).

## **B. MACROECONOMIC INDICATORS FOR 1991-1993**

The performance of the Polish economy in the next three years of its transformation proved that the adjustment to a market economy would require more time and that policy makers would face greater social discomfort than it was predicted at the end of 1989. It appeared to be necessary to reorganize legal and institutional framework of the new model of economy:

Financial institutions, capital and labor markets, the taxation system, and contract laws required revision. Establishing systems for protection of consumers and of the environment was another priority. For these institutional changes, legislation had to be prepared, considered, and enacted by the government; then key personnel had to be trained to gradually bring the system to full efficiency. Because many flaws in new legislation or regulations were only detectable after implementation, policy making took on unstable, trial-and-error quality.<sup>23</sup>

What is even more important to underline, the economic program was implemented under complicated political circumstances:

Frequent election campaigns gave occasions for displays of populism, which must have unfavorably affected the expectations and consequently the actions of economic agents; this resulted in renewed wage pressure and in the reduced inclination of state enterprises to take difficult restructuring decisions. With strong and rather aggressive trade unions, frequent elections and a fragmented party system, Poland had a much more difficult political environment for economic reform than Hungary or the Czech Republic.

Another group of conditions which could influence the economic transition were the external

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<sup>23</sup> For more see "Poland, a country study" (1992), pp.132-133.

economic developments. In the case of Poland there was much difficulty, because of the collapse of Polish exports to the former Soviet Union and a sharp deterioration in terms of trade. The shock is estimated to have cost Poland between 3.5 and 5 per cent of its GDP in 1991 (Balcerowicz 1995, p.322).

Table 4.5  
Macroeconomic and external trends, 1990-1991

	1990	1991
GDP (% change)	-11.6	-7.4
Industrial production (%change)	-24.2	-11.9
Consumer price inflation (%)	352.2	70.3
Unemployment (%)	6.1	11.8
Consumption (% change)	-11.7	0.5
Merchandise trade balance (convertible currencies)	\$ 2.2 billion	\$ 51 million
Current account balance (convertible currencies)	\$ 716 million	-\$ 1.36 billion
Gross investment (%change)	-10.1	-4.4
Real wages (% change)	-20.0	2.0

Source: *Roczniki Statystyczne 1991-1992*, various issues.

The second Solidarity government led by Jan Krzysztof Bielecki continued the economic policy of its predecessors. However, as it is shown in Table 4.5., the outcome was far beyond expectations. The main areas of failure were: still the unsatisfactory rate of inflation (approximately double the anticipated level), no sign of the GDP growth, and the rate of unemployment - almost double increase in comparison with the last year's percentage. Also investment spending - despite an anticipated increase of 20 per cent in real terms - fell by another 4.4 per cent. Most disquieting was the appearance and rapid growth of the government budget deficit, reaching some 30 trillion zloty (approximately \$2.7 billion), a sum comprising approximately 15 per cent of budgetary expenditures and 4 per cent of GDP. (Slay 1994, pp.98-99)

Some observers saw part of the problem in the government policy of fiscal discrimination against state firms, the policy directed to promote the development of the private initiatives:

While levying the *popiwek* wage tax and *dywidenda* asset charge on state but not private firms can be justified on microeconomic grounds, fiscal discrimination against the state sector had the effect of closely linking budgetary revenues to state enterprise liquidity - too closely, as it turned out. The recession that decimated state enterprise finances left the budget without viable alternative revenue sources. As much as 23 trillion of the 30 trillion zloty budget deficit that had developed by November 1991 could be accounted for by outstanding tax payments owed by state firms (Slay 1994, p.100).

Despite the negative trends mentioned above, Balcerowicz points out that the years 1991 and 1992 marked a visible political change and made a progress in law adjustment:

The institutional reforms in 1991 included a new securities law and the establishment of a stock exchange, a new liberal foreign investment law, a law on comprehensive income tax, and a new budgetary law. The growth of the private sector and the related privatization of state enterprises assets continued to be very rapid, but the privatization of larger state enterprises was rather slow, due mostly to political complications. On the macroeconomic front, in May 1991 the zloty was devalued and pegged to a basket of currencies instead of previous peg to the US dollar. In October a crawling peg was introduced. Other changes included modification in the wage control mechanism, which was attacked by the trade unions but maintained (Balcerowicz 1995, p.321).

Not surprisingly some authors find it very difficult to judge fairly and in a simple way the first two years of the economic transition:

...definitive judgements on the stabilization program in 1990-1991 are difficult to make. Recession had afflicted all the postcommunist economies, and the declines in volumes and terms of trade certainly were factors beyond Poland's control. The experience of many countries indicates that high rates of inflation are virtually never reduced without significant declines in employment, incomes, and output. Questions about sins of omission and commission in macro policy during 1990 and 1991 - whether these mistakes were avoidable and whether an alternative program (or the same program "better implemented") would have been more effective - are so fraught with technical and normative issues as to identify simple answers. In this author's view, however, given the desperate economic situation in which Poland found itself in late 1989, the results of stabilization program during 1990 and 1991 were generally favorable, and certainly more so than most specialists had expected (Slay 1994, p.102).

Table 4.6  
Macroeconomic and external trends, 1991-1992

	1991	1992
GDP (%change)	-7.4	1.0
Industrial production (%change)	-11.9	4.2
Consumer price inflation (%)	70.3	43.0
Unemployment rate (%)	11.8	13.6
Gross investment (% change)	-4.4	0.0
Merchandise trade balance (convertible currencies)	\$ 51 million	\$ 734 million
Current account balance (convertible currencies)	-\$ 1.36 billion	-\$ 36 million
Real wages (% change)	2.0	-7.6

Source: *Roczniki Statystyczne, various issues*

Note : data in rows 1,2,5,and 8 are in constant prices.

Table 4.6. shows that - despite the political instability of the period - a real economic recovery began in Poland during 1992 and (as will be shown later) continued in 1993. The Olszewski government and then the government under Prime Minister Hanna Suchocka maintained the overall framework of the macroeconomic stabilization largely in place. During 1992 industrial production increased significantly. The government succeeded in lowering the rate of inflation and in keeping the budget deficit within the 5 per cent limit agreed on with the IMF. By tightening eligibility requirements it helped to stabilize the unemployment rate. The improvement in the balance of merchandise trade and the current account was also significant. There were also some optimistic indicators that at least some state enterprises were beginning to restructure themselves and adopt to the new environment. The Suchocka government's most important policy contributions came in the microeconomic arena, however, including the passage of Poland's long delayed mass-privatization legislation, the approval of a landmark bill on enterprise debt restructuring and the recapitalization

of the banking system, and particularly the introduction of a new approach to labor relations in the state sector (Slay, p.117).

At this point it seems to be useful to present Poland's macroeconomic achievements during the first four years of reform in comparison with other post-socialist economies. The data presented in Table 4.7 show clearly that - in the Polish case - the combination of stabilization and liberalization policies resulted in rapid disinflation and elimination of shortages. It was accompanied with the lowest cumulative declines in GDP and consumption.

Table 4.7  
Poland's macroeconomic developments in a comparative perspective, 1990-1993

	Poland		Chech Republic		Hungary		Bulgaria		Romania	
	End-year	Average.	E.y.	Av.	E.y.	Av.	E.y.	Av.	E.y.	Av.
	1		2		3		4		5	
1) CPI inflation (%)										
1989	640.0	251.0	1.5	2.3	18.9	17.0	10.0	6.4	0.6	1.1
1990	249.0	585.6	18.4	10.8	33.4	28.9	72.5	23.9	37.6	5.1
1991	60.4	70.3	52.0	56.7	32.2	35.0	339.0	334.0	222.8	174.5
1992	44.3	43.0	12.7	11.1	21.6	23.0	79.0	82.0	199.2	10.9
1993	37.6	35.3	18.2	20.8	21.1	22.5	64.0	73.0	295.5	256.1
Disinflation*	0.06	0.14	1.0	2.0	0.64	0.74	0.9	3.0	7.5	50.0
2) GDP (%)										
1990		-11.6		-1.2		-3.3		-9.1		-8.2
1991		-7.6		-14.2		-11.9		-11.7		-13.7
1992		1.5		-7.1		-5.0		-7.7		-15.4
1993		4.0		-0.5		-2.0		-6.0		1.0
Cumulative*		-13.8		-21.6		-20.7		-30.4		-32.3

Table 4.7 - continued

	1	2	3	4	5
3) Consumption** (%)					
1990	-11.7	2.4	-3.5	-0.6	9.0
1991	3.3	-7.2	-5.3	-8.3	-11.6
1992	5.0	-7.1	-2.0	-7.7	-8.5
1993	5.3	2.2	0-2	-	1.1
Cumulative*	0.8	-8.8	-8.7 to -10.4	-	-10.8

Source: *Balcerowicz 1995*, (1) based on *The Transition Report 1994*, EBRD ;  
(2) and (3) based on *Economic Survey of Europe in 1993 -1994*.

Note: \* calculated by linking the annual indices of GDP (with previous year = 100) from 1990 to 1993.

\*\* measured by the ratio of 1993 inflation to the rate of inflation in the last pre-reform year (1989 for Poland, 1990 for other countries)

The positive economic results of 1993 surprised many observers from Western Europe. They started to recognize Poland as a leader in economic recovery among Central and East European countries:

The numbers are improbably good. GDP was 3.9% higher in the first six months of this year than in the first half of 1992. Industrial output soared by 9.4%. Inflation (though still in double figures) is dropping. The stock exchange index has doubled since April. Some Asian tiger? No, Poland. Poland is leading Eastern Europe's transition from central planning to the market. It is Europe's only post-communist country that is growing fast indeed, Europe's only country to do so (and not just because much of the rest of the continent is in recession).<sup>24</sup>

Poland's effort to reshape its economy are working - but not always in the way the reformers intended(..) Although disaster is still possible, Poland appears to have turned the corner. Its neighbors should draw lessons from its experience. Not, though, because the Polish reform worked perfectly. It did not. On the contrary, Poland provides an excellent example of how reform work when politicians are weak. Much of what happened did not go according to plan; muddle and spontaneity have shaped the progress of reform just as much as careful planning.<sup>25</sup>

Since the second half of 1993, the question for many economists has been not so much

<sup>24</sup> For more see "Europe's tiger: Poland", *The Economist*, August 28, 1993, v.328, p.48.

<sup>25</sup> For more see "If it works, you've fixed it: Poland's economic reforms", *The Economist*, January 23, 1993, v.326, p.21.

whether Poland has been succeeding - it clearly has been - but whether it could continue to do so, especially in the context of the outcome of general elections on September 19 in 1993, when the leftist government emerged on the political arena. Despite many threats, the new government - consisted mainly of post-communists - did not leave the path of reform. The Polish economy maintained the status of the most progressive in Eastern Europe. Despite remaining problems (still unsatisfactorily high rate of inflation and unemployment), structural reform has been steadily taking place.<sup>26</sup>

Table 4.8  
Macroeconomic indicators in 1994-1995

	1994	1995*
Real GDP growth (%)	5.2	6.5
GDP per head (\$)	2,478	3,167
Annual average growth in:		
Consumer prices (%)	33.3	28.2
Industrial output (%)	11.9	11.0
Agricultural output (%)	-10.0	9.0
Gross fixed investment (%)	8.2	10.0
Unemployment (recorded % of labor force)	16.6	16.2
Reserves minus gold (\$bn)**	5.8	14.2
Stock market index (annual % change)**	-39.92	1.51
Public sector deficit	-2.8	-2.8
Total external debt (% GDP)	46.1	36.7
Merchandise exports (\$MN)	17,121	20,716
Merchandise imports (\$MN)	-18,930	23,095

Source: *Financial Times*, March 27, 1996.

Note: \* Estimates unless otherwise stated

\*\* End period.

<sup>26</sup> See Blanchard, O.J. (1994) "Transition in Poland", *Economic Journal*, September 1994, v.104, n.426, p.1169.

As it is shown in table 4.8, the last year (1995) was the best in the whole period of transformation. It looks like the painful course of shock therapy is paying off. Tough fiscal policy of the finance minister Grzegorz Kolodko resulted in recognizing Poland as a rising star among new market economies of Central Europe:

Now Poland's economy is the healthiest in Central Europe, with 5% growth expected both this year and next. Already around 60% of gross national product comes from the private sector. Deutsche Bank, a level-headed German giant not known for its flights of fancy, has been moved to compare Poland with the Asian "tiger" economies. Inflation has come down by leaps and bounds, though at 20-30% it remains high. Unemployment too is falling after a sharp climb that went with the shock therapy. At about 12%, it is now roughly the same as in France, and a great deal lower than in Spain (...) Ironically, now that former communists are back in control, the Polish government has acquired a more solid look that bodes well for continued reform.<sup>27</sup>

The government realizes that to catch up with OECD countries - the economy must grow by 7% a year for next decades. Even Western economists admit that this is not impossible. Nicholas Stern, chief economist at the European Bank for Reconstruction and Development foresees medium-term GDP growth for Central Europe of 5.7 %, rivaling the rates of Asia's tiger economies. "The resumption of growth has been remarkably rapid", he says.<sup>28</sup>

Although Poland has been succeeding in general results of reform, to complete the picture of the Polish economy at the present stage, it is necessary to point out the main issues in which the government did not achieved the effects as it had expected. From the most important pillars of economic transition there is still a great need and a lot of room for improvement in the following areas:

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<sup>27</sup> For more see "A wobbly giant", in a survey of Central Europe, *The Economist*, November 18, 1995, p.11.

<sup>28</sup> See "Micro chasm: transition economies", *The Economist*, November 4, 1995, p.81.

1. Privatization of state enterprises and restructurization of loss-making branches of industry.
2. Reform of the social security and pension system.
3. Budget deficit reduction.
4. Foreign direct investment.

In the context of expected membership in the Organization for Economic Co-operation and Development and later in the European Union, the slow pace of privatization is particularly worrisome. The process of privatization has lagged behind, though the new private sector has thrived. The warnings expressed by foreign economists few years ago are still alive:

Poland must begin a rapid process of privatization of state firms, not only to assure efficient resource use in the future, but to prevent the collapse of the stabilization itself in the medium term. Experience around the world, plus the logic of the soft budget constraint, strongly suggests that it will be difficult to maintain the financial discipline of the state enterprises beyond the short run, especially if the state enterprise sector remains the dominant part of the economy. Eventually, wage pressures and lax investment decisions are likely to undermine the financial health of the state firms.<sup>29</sup>

Moreover, in many cases the newly privatized state enterprises do not perform better than before privatization (mainly due to lack of experienced management and because of insufficient capital). Dynamic development of the private sector supports the conviction that privatization of the remained 4000 state enterprises would reduce significantly political pressure on the government's decision-making. Connected with this is also a great need for implementation of the plan to cut loss-making branches of industry, with the particular emphasis on coal production.

With general elections due in the summer of 1997, the pressure from opposition camps to raise spending is growing and cutting taxes and spending will not be possible unless the government, after six years of unsuccessful efforts, grasps the crucial political nettle - a reform of the social

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<sup>29</sup> Lipton and Sachs (1990), p.127.

security system to put pensions on a self-financing basis. The scale of the problem will be better understood when we take into account that Poland's 9 million-plus pensioners make up about 25 per cent of the whole population. Their pensions are linked to average incomes and past attempts made by the government and the Parliament to freeze payments or link pensions to inflation rates rather than wages have been challenged in the courts and have left a legacy of outstanding payment commitments of around \$2.8 bn.<sup>30</sup>

Although the treasury has managed to keep the public sector deficit below 3 per cent of GDP for the past two years, it is also an element of pressure for further privatization because it badly needs higher revenue to keep overall spending and the budget under control.

Foreign capital has been interested to invest in Poland, however, willingness is one thing and the level of actual investment is quite another. Political instability, delays in the legislative process, and low financial credibility have been so far the most important factors discouraging foreign investors from making business in Poland. The positive climate for investing improved significantly in the period of last 2-3 years:

Foreign direct investment, now approaching \$7 bn and rising fast, is starting to play an increasingly important role in modernizing the economy and integrating Poland with global markets. But this means that competition is increasing - and with the temptation for politicians to listen to calls for the protection of local capital rather than press ahead with open markets and transparent rules for all.<sup>31</sup>

Stanislaw Gomulka foresees that foreign investment may increase to about \$15 bn in the following five years. No doubt, the possible membership in the EU would significantly affect the number of

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<sup>30</sup> See Robinson, A. (1996) "Tough challenge for radical" in the Financial Times Survey of Poland, FT, March 27, 1996, p.2.

<sup>31</sup> See the Financial Times Survey (1996), p.2.

foreign investors. However Gomulka concludes that investment at the level of 2-3 per cent of GDP will be always only a supplement, not a substitute for domestic investment efforts.<sup>32</sup>

In conclusion, the Polish experience of the first half of the 1990s has proved that traditional tools of macroeconomic stabilization can be a success in a largely socialist economy. The country took the unique opportunity to reorient the path of economic development from socialism to capitalism. Despite the inevitable mistakes during the transition and the burden of heavily indebted postcommunist economy, Poland did make a remarkable progress on the long and difficult way to a market economy. However, the continuation of tough fiscal policy seems to be a must, if Poland wants to complete the complex process of political and economic transformation. If all the reform's premisses are put in place - if stabilization and liberalization continue; if the process of privatization moves forward; and if a new social safety net meets people's expectations - the following prediction will inevitably come true: "the Polish economy entered the 1990s as the weakest in central Europe; it is heading for the new millennium with a good chance of emerging as the strongest".<sup>33</sup>

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<sup>32</sup> For more see Gomulka, S. (1995) "Potrzebna swiadomosc zagrozen" in Rzeczpospolita, October 31-November 1, 1995, n.253, p.13.

<sup>33</sup> Robinson, A. (1996) The Financial Times Survey of Poland, p.2.



## V. FUTURE PERSPECTIVES

This chapter will try to answer the question: what is the possible direction of economic reforms in Poland during the second half of the 1990s. It will analyze the latest proposals of the government, the proposals which are intended to shape the economic image of Poland in the near future. One of the most important strategic targets of the country's economic policy is to tighten our relations with Western Europe. The priority is integration with Western Europe to provide the Poles with a better way of life and higher living standards. After getting OECD membership<sup>34</sup>, the next goal will be to join the EU around the beginning of the next century. Membership of the EU is the basis of the kind of society Poland is already turning into. So, the question remains: what needs to be done to make it happen? In other words - what is the government strategy to convince the gentlemen from Brussels that Poland is ready to enlarge the EU to the east. For the moment, the EU cannot afford to let in Poland and the other applicants from Central and Eastern Europe. The time of waiting for future membership should be spent effectively. The decisions made by the government should help to strengthen the market oriented economy. Poland can be treated as a serious candidate only with a healthy and growing model of economy. On the following pages the author will present nine key programs which concentrate on the macro-economic and macro-social approach. Generally, they seem to be problem oriented and quite functional in nature. The programs are an integral part of the Strategy for Poland<sup>35</sup>:

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<sup>34</sup>The government predicts it will happen in July 1996.

<sup>35</sup>The following programs are included in Kolodko, G.W. (1994) "*Strategia dla Polski*", Poltext, Warsaw. The author also used other governmental data available at that time.

- reforming the social security system,
- improvement in management of state assets and ownership transformation process,
- increasing international competitiveness of the polish economy,
- preventing unemployment,
- investing in human capital,
- creating partner-like labor relations and a negotiating pay regulation mechanism,
- developing and reforming the financial sector,
- improvement of the agrarian structure,
- progress in the security of economic turnover and reduction of the "gray zone",

#### **A. REFORMING THE SOCIAL SECURITY SYSTEM**

After six years of unsuccessful efforts, it seems to be an absolute necessity to carry out a comprehensive reform of the social security system, which should be recognized as social insurance, health services, and protection against the effects of unemployment. The most important targets to be implemented by the government are as follows:

- significant improvement in the efficiency of the system (self-financing, rationalization of the amount and range of benefits, raising the quality of health services),
- greater commitment of extra-budgetary means.

The social security system should be geared to the objective of a gradual modification of a largely distributor system, based on the funding of benefits from current payments and budget donations, and of giving the system the form of insurance which structure and funding are to be established on business practices and procedures followed by insurance companies. The main goal of the reform is

to achieve a situation wherein the system will incorporate mutually supplementary sub-systems:

- a basic sub-system with the amount of benefits made dependent on the amount and time frame of payment of premiums,
- an additional system to be based on individual and group savings, on participation in pension funds, and on commercial insurance available on the market,
- health insurance,
- unemployment insurance.

All of the sub-systems mentioned above will make up a system ensuring a comprehensive and internally cohesive social security system.

## **B. IMPROVEMENT IN MANAGEMENT OF STATE AND OWNERSHIP**

### **TRANSFORMATION PROCESSES**

The government's intention is to go ahead with the process of ownership transformations and strive to make a distinct improvement in the management of enterprises in the state sector. The continuation of privatization will consist in starting up National Investment Funds as the main instrument of the Mass Privatization Programme: thereafter, in the implementation of the "Stability-Restructuring-Privatization" program which is to be applied with the collaboration of the European Bank for Reconstruction and Development; in enterprise and bank financial adjustments; and in giving effect to long-term financial, property, and organizational adjustments in the economic branches. Along with this, the government plans to support the use of various privatization techniques, recognizing the principle of decentralization of ownership transformation decision-making. The State Treasury is the institution which will be set up to achieve improvement in the

management of the state sector. The commercialization of state enterprises will be implemented on a large scale, and conditions will be provided to help state enterprises and State Treasury companies to recover. With regard to enterprises where recovery measures have failed to produce positive results, additional steps will be taken to manage their assets in a proper way.

### **C. INCREASING INTERNATIONAL COMPETITIVENESS OF THE POLISH ECONOMY**

Helping the economy to be more competitive on the international market will ultimately answer the question whether the development plans underlined in the "Strategy for Poland" appear to be successful or not. The government's goal in this area will be to stimulate economic growth and provide the means to service the foreign debt by increasing the volume of export significantly. This is intended to be achieved through stabilization of a realistic currency exchange rate, increased productivity, and pro-effective production adjustments. The government is not going to confine itself merely to the use of market mechanisms to make allocations and stimulate the attainment of this objective. Instead, it will try to facilitate these processes by consistently adhering to the timetable for implementation of pro-export policies, by increasing the capacity of the economy to absorb outside capital, by expanding the promotional activities of exports, and by carrying out the adjustment program designed to integrate the Polish economy into European institutions. Also a great effort should be made to give Polish-made goods better access to foreign markets, to protect the domestic market against unfair competition, and to give investment goods a greater share of imports. An export credit reinsurance and guarantee system will be put in place to energize the growth of Poland' foreign trade.

#### **D. PREVENTING UNEMPLOYMENT**

The government has been implementing an active policy to fight unemployment, also intended to stimulate the creation of new jobs. Investment programs will get under way to upgrade the country's technical infrastructure, while the sectoral restructuring programs will be related more closely with the labor market situation, with retraining of redundant employees and occupational adjustment projects. Job protection will get priority and will be put at the center of privatization programs. There should be also a more rigid approach to the criteria under which local markets are identified as ones threatened with high unemployment, and in parallel to this, instruments stimulating the growth of employment will be strengthened and project-oriented. Moreover, action packages will be applied to stimulate economic growth in regions showing the collapse of non-agricultural economic sectors, the dominance of socialized farming or of traditional and declining industries.

Additionally, educational and retraining programs and educational system changes will be used to increase the mobility of the unemployed and to prevent further unemployment. The system of social protection of the unemployed will be modified to increase its effectiveness and to reduce its anti-motivational and dependence-producing effects. The basic goal is to achieve a step-by-step reduction in the rate of unemployment, to prevent chronic joblessness and its adverse effects, as well as to bring down the rate of unemployment among young people.

#### **E. INVESTING IN HUMAN CAPITAL**

Expenditures on human capital, especially on education, science, culture, health care, and the environment are an investment of the highest social effectiveness, without which it is impossible to

ensure long-term economic and civilizational growth of the country. Spending should grow in these branches of the national economy and in the use of economic and financial instruments to make corporations and private individuals more interested in investing in human capital. The most important area of interest will be the following:

- tax preferences to investment projects designed to achieve innovative and technical progress, to education, science, culture, and health services,
- donations from corporations and some individual spending on investments in human capital to be excluded from the tax assessment basis,
- incentives for corporations to establish new charities or to support existing ones in the fields of education, science, culture, and health services,
- support to spending on manager and staff training, introduction of an educational credit cancellation system, and of a preference system to reward prominent innovators, scientists, people from the world of culture and art.

Through pursuing such policies, the government wants to enlarge the scope of education for young people at secondary and higher levels, to stimulate the interest of corporations in funding research and development and in investing in human capital, to increase the recruitment of young people to scientific and research-and-development units, and to stop the emigration of educated and creative people.

## **F. CREATION OF PARTNER-LIKE LABOR RELATIONS**

One of the most important strategic objectives of the government in the near future seems to be the establishment of partner-like labor relations measuring up to European standards and provided

with a negotiating mechanism to settle conflicts of interests. The State should be a mediator, not a party, in disputes arising against the background of labor relations and the level of wages. The Trilateral Commission for Social and Economic Affairs<sup>36</sup> is intended to be the general decision maker in this area. Labor legislation is intended to provide only a legal framework and guarantees for the basic interests of employees. All particular norms will be a matter of negotiation between employers and employees. Labor law will be gradually modernized to fit the changing environment. All crucial issues connected with job performance and wages are supposed to be solved by collective bargaining. Generally, every aspect related to this area should be achieved in accordance with the standards of the European Union.

#### **G. DEVELOPING AND REFORMING THE FINANCIAL SECTOR**

All activities in this area should be extended to embrace all elements of the financial sector, that is banks, insurance and the capital market. The development strategy should take account of the need to enlarge the extent of services provided, to improve organizational structures, and to bring property relations in line with the requirements of effectiveness. The goal is to raise the effectiveness of the sector to European standards. The point is to release means in the banking system and in the budget to allow the economy to grow at the rate not lower than 5% per annum and to get inflation down to 10% in 1997. The mobilization of national savings and better credit capacity in banks should help to cut interest rates.

Till 1998 the banking sector will have to undergo consolidation and privatization. The banks

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<sup>36</sup> The Commission consists of the delegates representing the government, employers, and employees (trade unions).

which survive the operation will increase their independence from direct intervention by administrative authorities. Institutions such as the Bank Guarantee Fund will be set up in order to reduce the costs of bank services. The National Bank of Poland should gain more independence to play the role of a bank of issue for the State and of a financial agent for the government.

In the insurance sector, the most important goals are: to provide support for the integration of small-size insurance companies, to establish an independent Insurance Audit Board, and to start and support the creation of new insurance firms of the pension fund type.

The capital market should be supported by new institutions such as trust funds, pension funds, insurance companies, and risk-taking funds. The Warsaw Stock Exchange should significantly diversify its forms and scope of operations. The role of the government should be to give additional impulses and encouragement to support further development of the capital market institutions.

## **H. IMPROVEMENT OF THE AGRARIAN STRUCTURE**

Another fundamental goal of the government is to achieve a multi-functional growth of rural areas. This should inspire the activation of non-agricultural businesses towards food processing, trade, services and infra structural expansion in villages and farming. State interventionism in agriculture should be oriented so as to support modernization processes and to improve the agrarian structures.

State assistance (including funding) should be given to specific farmsteads and agricultural producers who are capable of farming on the highest standard and of making the most effective use of means made available to them. Multi-directional actions in farming and in villages will be adjusted to regional needs while simultaneously promoting horizontal integration, in particular on the basis

of its simpler form, that means the system of contract deliveries. The whole idea of multi-functional rural development is a path along which Polish farmers may gradually move towards European standards at the least social costs.

## **I. PROGRESS IN THE SECURITY OF ECONOMIC TURNOVER AND REDUCTION OF THE "GRAY ZONE"**

It is obviously true that economic growth is more achievable in stable and clear business conditions, when unreported transactions and adverse effects are eliminated from business and social life. Once this state is achieved, it will increase the commitment of Polish and foreign entrepreneurs and will raise budget revenues from taxation without having to raise taxes. One of the government priorities should be to provide stable business conditions and to trim the size of the "gray zone". The main areas where improvement is needed are as follows: money settlements, the tax system, execution of the sums due, registration of business activities, and cooperation with foreign countries. Also a lot of job will have to be done to adjust the law to European standards, to make the prosecution of improper conduct and business frauds more effective and to provide appropriate conditions for the conduct of honest, reliable and serious activities.

In conclusion, the Strategy for Poland opens a new phase of the Polish transition. At the present level of economic development Poland needs a longer-term perspective. A strategic concept of balanced and permanent development should have three priorities: a fast rate of economic growth, a system and macro-economic stabilization, and improvement of living conditions. Future legislative activities and economic policy will decide how big will be the economic growth. To maintain positive trends in the Polish economy, in the first quarter of 1996 the government approved additional set of

sectoral and ministerial programmes, known as "Package 2000"<sup>37</sup>. It serves as an important supplement to the Strategy and it presents the governmental action and predicted outcomes of the Polish economy in the second half of the 1990 from two perspectives: macro-economic policy and fiscal policy. The 5 -year time horizon is the result of the government's optimistic assumption that around the year 2000 Poland will join the European Union. As it was said, the level and pace of economic growth will be a decisive factor whether it happens or not. For this reason, implementation of stable and tough rules of macroeconomic and fiscal policies is considered as a must, not only to obtain EU membership, but also to ensure a relatively strong position inside the organization. The position which would be the result of a stable and dynamic economy, that would be able to compete with the strongest economies of Europe.

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<sup>37</sup> See "Rzeczpospolita", January 31, 1996, n.26, p.12.

## VI. CONCLUSION

Compared to other postcommunist economies, Poland was a pioneer in macroeconomic stabilization and adjustment, the expansion of the private sector, and domestic and external liberalization. Since 1989, the Polish experience has been taken as a hopeful one for reformers in other postcommunist economies. Based on data presented in the previous chapters, it can be said that Poland's efforts to reshape its economy are working. The country has made decisive and irreversible progress on constructing a market economy since the start of its reforms. The Polish case proves that despite inevitable mistakes made during transition, a heavily indebted postcommunist economy can retreat from the brink of hyperinflation and may experience the beginnings of recovery within two or three years.

Although some kind of disaster is still possible, Poland appears to have turned the corner. However, the early stage of Polish transformation proved more difficult, more painful, and took longer than expected. The country has been providing an excellent example of how reforms works when politicians are weak. As it was suggested in the previous chapters, much of what happened did not go according to the plan; muddle and spontaneity have shaped the progress of reform just as much as has careful planning.

Nevertheless, the last six years is characterized by a number of significant achievements:

- elimination of shortages in the domestic consumers' markets,
- huge reduction in the rate of inflation,
- considerable increases in the private share of economic activity,
- the quick dismantling of the mechanisms of the command economy,

- growing marketization and liberalization of economic life,
- the creation of some of the legal and institutional framework fundamental to a market economy,
- successful internal convertibility of currency exports which allowed to an impressive expansion in hard-currency exports.

On the other hand, the macroeconomic reforms did not affect all parts of the economy in the same way. While they created new opportunities for small private business, they made life very difficult for large state enterprises. The economy split into two tiers: a fast growing private sector and ailing state industry. As a result, the new democratically elected governments brought with them large-scale unemployment and a drastic drop in living standards. This included the gradual reduction of welfare-state social benefits, free health care, free education, and guaranteed employment. All of them created so-called "social safety net" to which people had grown accustomed during 45 years of Communism. In this context, lack of increase in quality of life seemed to be the main reason for the reemergence of former Communists in Eastern Europe.

Of all the changes that reform requires, transferring ownership from the state to a totally inexperienced, ill-prepared private sector seems to be the most difficult task to get accomplished successfully. For example, the rapid transition from a state - run economy to a market economy brought with it massive firings of workers in government-owned steel mills and shipyards. At the same time, the free market had no time to create new jobs. The level of difficulty was aptly summed up by Lech Walesa: " It is easy to turn an aquarium into fish soup, but not so easy to turn fish soup back into an aquarium ".

Looking at the economic outcome of 1995, the Polish economy shows signs of becoming an

open modern industrial system that could ensure a reasonable standard of living for its population. Despite many problems and difficulties, the current recovery and enormous economic and social changes show that the basic promise of the big bang strategy is being fulfilled. Courage in implementing painful measures up-front is being rewarded with growth and increased welfare. Today Poland enjoys the fastest economic growth in all of Europe. Although the new wealth does not benefit the bulk of society, President Aleksander Kwasniewski and his fellow ex-communists seem to have no intention of dropping Balcerowicz 's shock therapy reforms, including such tough challenges like an accelerated privatization of state enterprises. The present government still faces a menacing accumulation of social problems, including stubborn unemployment and inadequate payments to retirees, who represent one-quarter of the country's population. These problems must be addressed and solved as soon as possible if Poland is to avoid internal confrontations and a slowing of its economy.

Furthermore, economic harmonization with Western Europe and eventual membership in the European Union seem to be another fundamental goals of the Polish government in the near future. Poland must take a great step forward in order to coordinate its economic and monetary policy with that of the EU, especially addressing such crucial issues like policies on industry, customs duties, commerce, company law, taxation, environmental protection, agriculture, scientific research, and social matters. The introductory stage of the reform seems to be done, so the key to success now depends on the ability to find the common language between the West and the East:

If Eastern Europe is indeed trying to return to Western Europe, an obvious implication is that success in the economic transformation will depend not only on the East, but quite fundamentally on the West as well. It will take actions on both sides for Eastern Europe to "return to Europe". Therein lies a whole range of problems related to the willingness of Western Europe to act with the vision necessary to open its borders - not only to industrial goods but also to agriculture, and not only to

commodities but also to people from the East - so that all of Europe can be a unified and integrated region. Thus the West cannot escape responsibility for the changes ahead. In the absence of a generous and visionary approach by the West, however, it will prove impossible to achieve success in the reforms - no matter how resolute Eastern Europe is with its own actions.<sup>38</sup>

Finally, it is obvious to all those who continue to follow economic developments in Poland that adequate economic support for the economic transformation is in the West's direct strategic interest as well as its moral responsibility. In the middle of 1996, there is no sufficient evidence that would persuade the author of the thesis to abandon his own deep conviction that Poland will continue the process of political and economic reforms targeted to live under democratic government and to work in a free market economy.

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<sup>38</sup> Sachs, J. (1994) p. 6.

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