Seminar
LESSONS AND CHALLENGES IN TRANSITION

Conference Hall of the Czech National Bank, 22 September 2000

Marek Belka

Lessons from Polish Transition

After ten years of transition (or should we say, first ten years of transition) from socialist central planning to a market economy in Poland, enough experience has been accumulated to make us able to synthesize and draw conclusions for our own future and for other reforming countries of the region.

Poland has been frequently quoted, particularly in the last period, as an example of successful reforms. High economic growth rates and general consistency of economic policy earned us a reputation of one of the front-runners in the process of transition. Both statistical data and political facts, such as Poland's admission to the OECD in 1996, NATO membership in 1999 and the beginning of the accession negotiations with the EU confirm this positive assessment. More importantly, political and economic changes of the last years seem to have enjoyed broad support of the Polish society, as shown in virtually all opinion polls concerning its attitudes towards the market economy, democracy and Poland's integration with the Western institution. The more complicated economic and social situation in 1999 notwithstanding, transformation in Poland is an undisputable success. This is the general assumption of my forthcoming remarks.

10 years of transition - stylized facts

Starting point of reforms

The starting point for reforms was in many respects highly unfavourable. Polish economy suffered from all typical deficiencies of central planning - deeply distorted structures, including prices, pervasive shortages, massive misallocation of resources and lack of inventiveness of the state enterprises. On top of this, and contrary to most of its neighbours in the region, Poland inherited from the period of socialism a huge foreign debt and high inflation, approaching hyper-inflation levels in the late 1989. In sum, Poland entered transition not only as a stagnant, but also a destabilized country. Due to the unsuccessful reforms of the previous system, dating back to the mid-fifties, and repeated with

a surprising regularity every ten years, or so, economic policy of the government lost any credibility, demoralizing both the managers of the state firms and the workers. The task of economic reform appeared to be paralysingly difficult.

On the hand, the miserable state of economic affairs and the popular enthusiasm over the fall of communist rule created an unique opportunity for a redical change. The people were ready to take sacrifice and accept whatever the Solidarnoœæ-dominated government would propose. Political opposition was virtually absent, branch lobbies temporarily silenced, trade unions positioned out of their usual social role, external environment unequivocally positive. Courage,
determination and vision, coupled with a minimum initial knowledge of what in fact was never tried before by anyone, was provided by the team of reformers, led by Deputy PM Leszek Balcerowicz.

Thus, the golden opportunity was not lost, as it happened in some other countries, and as it may have happened in Poland.

Stabilization package of January 1990

The dual challenge of the New Economic Policy was to stabilize the economy and to start building institutions of a market society. The Stabilization Package of January 1990 is usually associated with what was later labelled as „shock treatment“ or the Polish „big bang“.

The package contained (a) liberalization measures, which in fact set the foundations of a market economy and (b) typical stabilization moves aimed at equilibriating the economy.

Most prices were immediately set free, rationing of goods and foreign exchange was eliminated, internal convertibility of the *z³oty* was introduced. Simultaneously, individual tax concessions (one of the most perverse characteristics of the late socialist economy) and most subsidies were done away with, budget expenditures reduced, monetary policy drammaticaly tightened. A restrictive tax on excess wage growth was designed to serve as a back-up measure to strengthen the fiscal austerity... and defend the embattled enterprises from the wage demands of their own workers.

An upfront 50% devaluation of *z³oty*, and foreign financial assisstance, put at the disposal of the Polish government were meant to support the fragile convertibility. The exchange rate was fixed and promised to be kept unchanged for half a year, to rebuild confidence in the national currency and strengthen credibility of the economic policy.

The main goal of these harsh measures was to reduce the extend of macroeconomic disequilibrium, as reflected in inflation and state budget deficit.

First two years, 1990-1991, were marked by falling output and national income, high „correction“ inflation, brought about by price liberalization. Real wages (as measured statistically) were reduced by more than 20%, and unemployment - a phenomenon unknown in a centrally-planned economy - appeared and quickly exceeded 10% of labour force. Kornai called it transformation recession.

These were extremely difficult years, as reality turned out to be much gloomier than rather optimistic official scenarios. Only later did we realize that Polish recession was mildest among all transition countries, and partially was a statistical illusion (elimination of redundant output, excessive inventories and overuse of energy, transportation services, etc.). High unemployment, however, was for real. So was high inflation that proved to be much more difficult to stem, than we all expected.

Most importantly, this first stage of transition produced extremely positive results in three respects. Firstly, basic price distortions have been eliminated, thus letting the market send correct signals to the firms and households. Three most crucial prices were set at a realistic level - i.e. interest rates, foreign exchange rate and prices of energy. All other duly adjusted. Sensible price relations allowed sensible decisions about allocation of resources. Secondly, convertibility of *z³oty* was introduced and maintained. A lengthy process of rebuilding the confidence in the national currency was initiated, the dominating position of the US dollar was undermined. This in fact was the real opening of the Polish economy, a factor stimulating an unprecedented growth of newly-established private enterprises. Thirdly, radical reduction of the scale of subsidizing coupled with the beginning of privatization changed the philosophy of doing business. Even though most big and medium-size companies were in the hands of the state at that time, their managers started to realize that without a proper adjustment, they cannot survive on the market.

In sum, the biggest achievement of the first phase of transition was that the economy became manageable and people started to react to the instruments of economic policy in a predictable manner.

Reaction of enterprises

The success of the „shock treatment“ reform depended very much on the reaction of big state enterprises, on how fast and how deeply would they be able to adjust to the new situation. Many observers expressed concern that without an immediate privatization these companies would quickly degenerate, assets would be squandered on a massive scale and „business as usual“ altitude would be taken, with imminent collapse following very soon. At best, SOE’s would engage in barter trade, extending each other unofficial commercial credit, temporarily overcoming a liquidity crunch, making the ultimate industrial crisis

more serious or forcing the government to carry out a big bail-out operation. In consequence, the whole stabilization program would be derailed.

The microeconomic dimension of the early transition proved, however, to be quite different from expectations. January 1990 „big bang“ was indeed a huge blow for the existing companies. It came both from the demand and supply side. Particularly hit were traditional exporters to the USSR and Comecon markets, as the so-called protocol trade collapsed entirely.

On the whole, the enterprise sector managed to survive 1990 quite well. More surprisingly, companies registered record profits, due to the inflated value of their foreign currency deposits and artificially low (historical) value of inventories from previous years. This was reflected in an unexpectedly favourable tax revenues. These paper profits were not to last for long, but the situation may have been dangerous, as it could mislead the managers about the seriousness of the reform attempt of the government. One has to remember that the credibility of economic policy, particularly of any reform attempts, was still to be established.

The immediate reaction of most companies was to cut output and raise prices. Those who were able, tried to repay outstanding bank credits, because the level of interest rates became prohibitive overnight. Financial situation of most enterprises deteriorated by the end of 1990, and further administrative price increases of January 1991 together with the final collapse of Comecon markets delivered decisive blow. Industrial sector fell into a full-fledged crisis, with consumer goods producers, traditional suppliers of the Soviet market and companies with heavy credit burden from the past suffering most.

If not immediately, state enterprises began adjusting to the new situation relatively early. Virtually all aspects of their functioning underwent changes. Internal organization was modified - marketing and sales department were created and reinforced, redundant assets were disposed off gradually, unused machinery sold to the new private firms, free space rented out, social assets closed down or separated from the main activities, excess labour force laid off. Enterprises had to rebuild domestic distribution channels, as the state wholesale network was first to go bankrupt due to high interest rates.

One of most serious challenges was to deal with the accumulation of overdue payables and receivables, potentially leading to massive payment jams and barter economy. It is rightly believed that a consistent macroeconomic policy forced enterprises to control this issue and prevent it from reaching unmanageable proportions. In my opinion this was one of the most convincing pieces of evidence for meaningful restructuring taking place in the Polish state companies in that period. Another one was a successful reorientation of exports from the former Comecon to the EU countries. All in all, SOE’s did a lot to change from being producers and insatiable users of inputs (as in socialism) to become sellers and asset managers.

Restructuring was thus very broad, covering most dimmensions of the existing companies and a large majority of them. However, it was also rather shallow, not involving necessarily deep technological change and, by definition, change in ownership. Without privatization, state companies remained virtually uncapable of attracting sufficient external financing and indispensable flexibility. Restructuring was mostly of „defensive“ character, to use a term coined by W.Carlin, as opposed to strategic one, that would unable them to prosper in the longer time horizon.

One could legitimately ask, why in absence of massive privatization, did it happen at all. Two factors seem to have been decisive: consistent and increasingly credible macroeconomic policy and a promise to privatize state companies. The first reduced hope of an automatic bail-out, even for big state companies, which was illustrated by numerous near-bankrupcies in the textile sector. Without an effort to adjust to the new circumstances the chances for survival became limited. The second made the acting managers think about their reputation and its role for their future professional career. Thus a powerful mechanism of industrial restructuring was set in motion.

Banks in transition

An important dimension of microeconomic aspect of transformation was the evolution of bank behaviour. An important concern about the state banks - parallel to that refering to the state enterprises - was, that they would carelessly extend credit to the defunct companies, either due to the lack of expertise or even as a consequence of a certain kind of conspiracy of nomenklatura managers still dominating both in the banks and non-financial enterprises at the beginning of transition. No matter how exotic these allegations sound now, they seemed to pose a serious problem for the early reformers. To strengthen the control over credit, credit ceilings for individual banks were introduced and the MoF encouraged banks to concentrate on private sector. The latter measure proved to be rather naive as many newly-established, small private firms turned out to be too weak to repay their obligations and banks accumulated a large volume of bad loans not only related to the large SOE’s (as feared) but also to the new private enterprises.

Indeed, the situation in the banking sector deteriorated in 1990-1991 significantly. The share of irregular credits (lost and doubtful) in all bank credit outstanding climbed to 30-40% in some of the most important banks. A full-scale crisis was in sight. Moreover, some studies (most notably of B.Pinto, M.Belka and S.Krajewski) showed a negative correlation between firms’ dependence on bank credit and their profitability. „Good“ enterprises tried to

avoid external financing as too expensive, „bad“ enterprises had to „double the stakes“ to stay on the market. A massive market failure became most probable.

The reaction of the authorities was proper and timely. In late 1991 a program of state bank privatization was announced. Simultaneously, a bank restructuring scheme was conceived. It contained providing banks with additional capital in the form of special bonds and requiring them to clean up their assets portfolio in return. Banks were helped in establishing new departments dealing with these issues. They could sell the assets on the market, initiate bankruptcy procedure of an insolvent debtor or initiate a so-called bank conciliatory procedure, in the framework of which an embattled but prospectively viable enterprise could obtain cancellation or reschedulling of its debt upon presentation of a sensible and realistic restructuring program. The scheme have probably helped some number of manufacturing firms to survive the worst time, although the analysts differed in their opinions, as to its actual efficiency in this respect. However, nobody has ever denied that the Law on Financial Restructuring was beneficial for the banks. It helped increasing their capital base, add new expertise, and most important of all, change their attitude towards creditors. In fact, Polish banks earned a reputation of becoming overly conservative rather than lenient in their relations with enterprises. The result is, that the Polish banking sector after 10 years transition may still be undercapitalized, fragmented, not sufficiently modern and cost-efficient, but it is certainly not haunted by bad loans and intransparent ownership structures. In consequence, the privatization of state banks is proceeding smoothly and most prestigious financial institutions compete fiercely to acquire shares in their equity.

Institution building

The dominant position of **private ownership** - a mainstay of a market economy - was the first thing to be established and strengthened. The expansion of the new private sector was made possible by radical liberalization of business activity, that happened already in 1989, but was stimulated further by the abolition of state monopoly of foreign trade and convertibility of the *z³oty*. In fact, this grass-roots privatization became the most powerful engine of growth for the whole decade.
Privatization of state enterprises turned out to be much more difficult and time-consuming. Indeed, after 10 years, Poland remains still halfway in this process. To describe its main characteristics, we shall return to it in a special paragraph.

It was understood early, that the **system of financial intermediation** would be decisive for a proper functioning of the resource allocation. The pre-

transition mono-bank was broken down in 1988 already and the commercial banks were created. More important, independent bank supervision was established and located in the structure of the National Bank of Poland, whose independence from the Government was declared and gradually solidified (also in the new Constitution of 1997). Very soon, important auxiliary institutions, as for example clearing house, national register of collaterals, and many more were created.

In parallel, capital market was developped. Warsaw Stock Exchange was inaugurated in 1991, and the Securities Commission, a watchdog of the market, began to perform its duties. This paved the way for a stepwise, orderly expansion of the capital market, that became capable of absorbing new companies and new money market instruments. Rather tough regulatory framework might have at times slowed down its quantitative growth, but saved it many disruptions so characteristic for newly-born institutions of this kind.

Tax system in the command economy was based on a complicated turnover tax levied on the sales of (state) enterprises. It was entirely inconsistent with the exigencies of a market economy, due to its high degree of non-neutrality. The rates of turnover tax were randomly differentiated. It may have also been very sensitive to the swings in the economic activity.

In 1992-1993 a new system was introduced. Personal income tax (PIT) and Corporate income tax (CIT) were put in place in 1992 and a VAT in mid-1993.

Both income taxes were relatively simple, with moderate marginal rate of 40%, so that collection rate was high from the very beginning. Notably, the newly-introduced PIT was very comprehensive, standard deduction was minimal, the lowest rate rather high (20%) and virtually all incomes, including social benefits, were taxable. As a flat 20% wage tax, existing in the pre-transition time was replaced by a moderately progressive personal tax, the lower income people were protected from a net income reduction and the entire increase of tax burden was placed on the better-off. The PIT turned out thus to be easily acceptable by the people. The Poles, with a notable exception of farmers, became a tax-payers' society.

Privatisation

Privatisation was immediately declared one of the highest priorities of transition.

It could proceed through the so-called initial privatisation or expansion of the new private firms and through the disposal of state assets. Liberalization of economic activity, stabilization and convertibility of the domestic currency, accompanied by lifting of travel restrictions to the West created favourable

conditions for a real explosion of private entreneurship. Selling off state companies turned out to be much more difficult.

Already in mid-1990, the Law on Privatisation of state-owned enterprises has been passed, that provided for a broad spectrum of methods of ownership change. To win the support of trade unions, 10% (later increased to 15%) of equity stock would have to be distributed free of charge among the employees of the privatised company. SOE's could be sold to foreign and domestic investors, could be bought out by employees and management or could be subject of an IPO on the Warsaw Stock Exchange. The Law on Financial Restructuring of Banks and Enterprises of 1993 allowed firms' debts to be swaped for equity. Finally, in 1994 a limited program of coupon privatisation (National Investment Funds) was initiated.

State assets disposal proved to be a technically difficult and politically loaded process. On top of this, the demand for Polish companies on the part of foreign investors turned out to be low at the beginning of the decade. „Case by case" privatisation is always time-consuming, even in most favourable economic and political circumstances. In Poland, powerful labour unions often resisted an ownership change in „their" companies, political will to act vigorously was erratic and sometimes weak (particularly under the governments of Jan Olszewski in early 1992 and Waldemar Pawlak in 1993-1994). In sum, privatisation has been treated by many as fight for power.

In consequence, privatisation process was marked by following features:

- domination of **insider privatisation**, either in the form of employee leasing schemes in smaller and medium state companies or management-dominated buyouts of former foreign trade organisations, that were transformed into industrial conglomerates (see Elektrim, Impexmetal),
- small number of outside investors, especially foreign, in early privatisation,
- virtual lack of privatisation in „strategic" industries, due to political sensitivity, often ambivalent behaviour of managers, resistance of interest groups (i.e. in oil industry) and moderate interest of foreign investors in the early 90s.

Slow pace of privatisation, or more correctly, slower than needed and expected pace, resulted in more limited extend of microeconomic restructuring, sufficient to carry a rather brisk revival from the early transition recession, but leaving Polish enterprise sector vulnerable to external shocks and lagging in its efforts to adjust to the EU standards. This critical assessment should, however, be supplemented by the following observations:

- the temptation to use shortcuts, i.e. mass privatisation was largely avoided, thus leaving ownership and corporate governance structures relatively sound and transparent,
- properly conceived and regulated capital market could in many instances be used as a channel of ownership change, for employee-dominated companies

to go public and acquire new investors, for IPO-privatised SOEs to become controlled by outsiders, for NIF's to become full-fledged investment funds,

- the extend of actual privatisation is largely underestimated, because the majority of ailing SOEs, before the formal liquidation or bankruptcy, used to dispose much of their assets (space, machinery, labour) that stimulated the expansion of newly-established private firms.

Thus it is tenable to say, that Poland managed to avoid major mistakes in the privatisation process. We have lost many opportunities, but it is possible to accelerate it, when political and economic circumstances allow.

Economic cycle in transition?

Business activity after 1989 can roughly be divided into four phases: transformation recession in 1990-1992, early revival of mid-1992 to late 1994, acceleration between 1994 and mid-1998 and subsequent slowdown.

Transformation recession resulted from the introduction of stabilization package of 1990, followed by the collapse of protocol trade with the Comecon countries. Recorded GDP fell by ca 18%, which turned out to be the least in the region, but real wages (again statistically recorded) decreased by 30% and unemployment climbed from what was perceived as 0% to over 10%. Households were first to take a blow, enterprises felt the pinch with some delay as they used up their shallow reserves roughly within a year. Bank credit contracted drastically, investment was duly reduced. For many it seemed to be the end of the world, but also a beginning of painful, but frequently rewarding adjustment process. Ten years later I tend to consider that first 2 years a huge cleaning operation. Most price distortions were eliminated or reduced, but other structural imbalances survived, as some important industries managed to build institutional protection from market competition (recentralisation, import tariffs, softened budget constraints in the form of tax arrears, etc.).

Early revival started in the second quarter of 1992. Manufacturing industry rebounded first, followed by construction with a considerable lag. Almost nobody believed the revival was sustainable. Firstly, investment expenditure stagnated. Secondly, there was a fear that the growth was fuelled by expansion of inter-firm arrears, infamous „payment jams“. With the benefit of hindsight we can say that „stagnation“ in investment was in fact a sign of positive adjustment in the enterprise sector. The early growth was based on rearrangement af existing assets and some marginal new modernisations. It should be remembered that state companies entered transition with excess of largely redundant space, machinery and labour. The issue was thus how to get rid of them and not to expand. Conspicuously absent were investment outlays in new constructions. As to the inter-firm arrears, it turned out that credible macroeconomic policy convinced the state companies that bankruptcy, or at

least financial trouble and not an easy bail-out was a typical consequence of leniency towards unviable creditors. In result, the extend of the problem remained largely under control, never assuming a scale dangerous for the economy.

Acceleration of growth of 1995-1998 produced rates of GDP expansion in the range of 6-7% annually. Poland entered a phase of intensive modernization. Real investment outlays grew regularly at rates surpassing 20%, albeit from relatively low level. After the final resolution of the foregn debt rescheduling (London Club in 1994), FDI started flowing in. For the first time in decades, Poland regained a status of an attractive location of investment. It became classified as one of the most promising emerging markets in the world and assumed a position among the leaders of transformation. Growth was accompanied by falling inflation and unemployment. Rising consumption fuelled optimism. Success brought about a certain degree of complacency, as the urgency of tough restructuring effort and quick privatisation was somewhat overshadowed by the flow of good news.

This bright picture was spoiled a little by a widening trade deficit. Mitigated by a positive balance of cross-border trade, the current account deficit looked much better, but nevertheless reached a 4% of GDP level in the fourth quarter of 1996 (annually). Real appreciation of *z³oty* coupled with a strong demand for imported investment goods inevitably resulted in growing c/a deficit. Monetary restrictions and budgetary discipline helped arrest its growth to just 3.1% of GDP, but it expanded to almost 7% two years later. Clearly, the external disequillibrium has to be cured, as the whole situation becomes unsustainable.

Slowdown took place in late 1998, but the GDP for the whole year grew a healthy 4.8% and will further decelerate in 1999 to just under 4%. It is difficult to say, whether this was fully the consequence of the Russian crisis and the subsequent loss of export markets in the ruble-related area or whether the „cooling off“ macroeconomic policy was the reason. With the impact of Russia largely digested by late 1999, the Polish economy finds itself in a delicate position. Current account deficit is not decreasing and has to be tackled by means of macroeconomic management. Monetary restrictions are easy to use but may be self-defeating, as high interest rates attract portfolio investments, push the exchange rate of the domestic currency upwards and cause the c/a deficit to grow. Precisely the opposite what is needed. A proper response hinges on a fiscal adjustment, that is on strengthening budgetary discipline. This is, however close to impossible in a period of drammatic structural reforms reinforced by an equally sweeping tax reform.

Looking at the experience of other successful transition countries, notably that of Hungary and the Czech Republic, one can notice certain similarities that

suggest a common pattern, a *sui generis* transition cycle. Market-oriented reforms in these countries have two linked but conceptually separate dimmensions: macroeconomic stabilisation and microeconomic adjustment. Both aspects of transformation are mutually reinforcing. Macrostability provides an environment of a hard budget constraint that is necessary to stimulate micro adjustment. Privatisation and restructuring of enterprises and institutional reform provides for economic dynamism and competitiveness. Lack of it can derail stabilisation efforts.

The key issue is to keep both developments time-consistent. It is difficult, as by nature microeconomic adjustment takes more time and always lags behind macrostabilisation. Even worse, the more successful a national economy is in terms of fighting inflation, restoring fiscal stability, etc. the more attractive it becomes for foreign investors, the more pronounced is the appreciation pressure on domestic currency. The pressure on domestic companies grows, the more efficient the macroeconomic management is, and paradoxically, the more efficient they are themselves in restructuring themselves. There is thus a constant disequilibriating force that acts to derail the transition process. No matter how fast we privatise, a setback may always occure. Hungary is a good example. This is, of course, not an argument against fast-track privatisation and restructuring, but a reminder that transition is not a smooth process. To attenuate a possible crisis two things should be avoided. Firstly, a realistic exchange rate policy, or more generally, realistic policy targets should be taken. Secondly, transparency in policy-making should be considered a highest priority. Hiding problems will always backfire (as in the Czech republic).

„Four reforms“

The end of the decade is marked by important reforms in the so far neglected sphere of social services financed predominantly from the budget. The so-called budgetary sector to a large extend survived as a non-market enclave, with its characteristic imminent inefficiency and stagnation. High cost and low quality of services, something that prevailed in the whole Polish economy before transition and what gradually has been forgotten in the „productive“ sector, largely dominate public **health service, education and social security**.

On top of this, a bold decision was made to advance **an administrative reform**, that provided for introducing a new level of local government, *a powiat* and promised a significant decentralisation of the functions of the state.

Reform of the pension system in Poland boils down in replacing a traditional state-run, monopolistic pay-as-you-go system by a multi-pillar system borrowing from best international experience, notably that of Sweden

and Chile. The reform was launched in 1999, following some years of preparatory work, during which the whole system was conceived, worked out and two sets of laws describing the new pension system were passed. It consists of a notional defined-contribution, pay-as-you-go first pillar, a mandatory defined contribution, privately-managed, funded second pillar, and a voluntary employee pension plans in the third pillar. Its introduction is accompanied by attempts to clean the existing system from sectorial priviledges and all sorts of special treatment, that was enjoyed by more that a third of the labour force in Poland.

The pension reform, it is hoped, will bring many positive consequences both for the insured and for the public finance. The nature of the labour market should change in some important respects, as a strong link between contributions and benefits is introduced. Capital market will also benefit by the establishement pension funds and, hopefully, by an increase in savings propensity, or at least by an increase in the supply of long-term saving.

The reform entails significant fiscal cost, as employees switching from the state system to the pension funds, divert part of their social security contribution to the latter institutions. The resultant deficit in the Social Insurance Fund (FUS) in the order of 1-1.5% of GDP throughout the first 10-12 years has to be covered from the state budget, although this deficit is not inflationary in the same sense as other public expenditures. The bulk of this will have to be financed from privatisation proceeds in the coming decade. All in all, pension reform seems to be very well conceived and should have a very positive impact on the overall functioning of the Polish economy.

On top of the expected cost (non-inflationary as I keep stressing), the implementation of the reform resulted in painful slippages. The state Social Insurance Office (ZUS), responsible for the first - now deeply reformed - first pillar of the system, was not able to introduce the new information scheme on time. In consequence it undercollected contributions in 1999 in the order of 1-1.5% of GDP, endangering the entire fiscal position of the public sector.

Health system in Poland has long suffered from many serious diseases - low quality of service, cost explosion, underfunding from public sources, waste and inefficiency, corruption. From the purely fiscal point of view, complete lack of discipline in managing public resources by medical units was probably most dangerous.

Looking only from a narrowly financial poit of view, the reform of health sector consists of two main elements. Firstly, most of the medical units were transferred (following cancellation of their accumulated past debts) under the authority of local government, that was supposed to take over control and responsibility for their future obligations. Secondly, regional health administration institutions were established (*kasa chorych* or *Krankenkassen* in

German) that are supposed to contract out medical services for the insured citizens. These institutions become thus intermediaries between the patients and health units. Their role is to distribute the scarce resources, coming from personal income taxes and supplementary budget funding in the most efficient way, among the most productive service-providers.

Health reform is certainly very difficult from a logistical point of view. Most problems arise however from its social consequences. If cost explosion is to be contained or slowed down, some hospitals should close down, redundant personnel should be reduced and carelessness in managing expenditures eradicated. The doctors and nurses are not happy at all, especially that resources are limited and wages cannot grow too much. Uncertainty prevails about what will happen with the newly emerging payment arrears, possible bankrupties of medical units and the future of imminent privatisation of health service.

Education reform is probably least spectacular, but equally important for the country's future. It aims at improving the curricula, adjusting the education path to the changing situation on the labour market (particularly replacing the traditional vocational secondary schools with more generally-orientated educational institutions), lowering the obligatory school age from 7 to 6, and introducing incentives into the teachers' pay scale. The immediate budgetary impact of educational reform is limited, so I shall not elaborate it further. What has to be observed however is that, as in the health sector, the changes here aim at bringing the labour relations closer to the exigencies of a market system, at stimulating rationality and innovation. Social tensions are thus a natural and inevitable consequence.

Decentralization of the state begun in Poland as early as 1990, when first-level local government units, the communes or *gminas* were created. Later, numerous functions (for example administration of primary education) were added to their responsibilities, along with additional funding and big cities were entrusted with certain autonomy. In 1999, two other local government levels, *powiat* and *województwo*, or county and region, were created. They received certain financial resources, mainly as shares in general tax revenues, and precisely defined responsibilies.

The tendency to strengthen local government is very favourable for the activisation of local communities (important particularly in view of the future membership in the EU), expansion of civil society, solidifying of democracy and political stabilisation in general. It is also hoped, that decentralisation will eventually result in more efficient use of public resources and better quality of public service. In the shorter run it may, however cause serious problems for the financial discipline in the country. Local governments are desperately short of money (if only in their subjective assessment) and will try to acquire new funds,

either through incurring debts on the capital market or/and by squeezing more resources from the central budget.

Administrative reform, very much as other institutional changes initiated in the recent years, is a good investment in the future of Poland but its financial cost carries a destabilising potential for the fiscal equilibrium in the economy. The financial consequences of „4 reforms“ (there are more of them, i.e. coal mining, railways restructuring, reform of the judiciary and many others) are serious and pose difficult a dilemna that the government(s) will have to face in the coming years. This is a **necessity to reconsile the need to maintain, or rather continuously strengthen the financial discipline, as reflected in a reduced deficit of the public sector and find resources to co-finance a comprehensive modernisation effort, as reflected in the above described institutional reforms**.

Sources of relative success

Poland remains a poor country, at least compared to the EU. Per capita GDP does not exceed 40% of the average West European level (measured at PPP). International competitiveness of Polish firms is low, although growing. Export potential is limited. Infrastructure is catching up, but still under-developped in many respects. More than a quarter of working population is employed in agriculture. Ten years of rapid change cannot undo decades, or even centuries of turbulent history, backwardness and poverty.

On the other hand, resolute reform efforts and clear EU membership prospects make Poland one of the more promising „emerging markets“, attractive location for foreign investments and even an increasingly more important regional player. Beyond doubt, it is one of the most successful transition countries. The success is relative as it is more and more frequently measured against the achievements of the more recent EU entrants, like Portugal, Spain, Greece or Ireland. From „class transition“ Poland graduated to „class EU prospects“, and further progress will be verified not by the distance from slow-reforming countries of Eastern Europe but by the smoothness of the integration with the EU.

The success of transition is, in my opinion, due to five main factors. First to mention is the famous **„shock therapy“ of 1990**, or the early stabilisation package implemented by Leszek Balcerowicz. For most commentators this has been the key source of subsequent positive developments in the Polish economy. I share this view entirely, but let me elaborate on what was its

significance. Firstly, it was a huge cleaning operation. Most price distortions were eliminated and the rules of economic game were abruptly changed. Secondly, it was an attempt to begin restoring credibility of economic policy, or more broadly, of the state itself. One must remember that Poland entered transition as a highly destabilised economy which resulted, among others, from numerous failed attempts to reform the socialist system. In consequence, managers of state enterprises learned how to survive „reforms“ in the past and nothing short of a „shock“ could convince them about the seriousness of the government. Thirdly, the package of 1990 set forth a very forceful and comprehensive agenda of market reforms, that nobody after dared to challenge, let alone to reverse. Thus, from the very onset of transition, Polish reformers did not loose time looking for a „third way“, instead introducing measures and solutions tried in advanced countries.

The relations of the IFIs and the Polish Government were very good thoughout the whole period of transition. Poland was always considered to be the „best pupil“ in the class, a faithful follower of the IMF-tailored stabilisation program, and eventually one of the few examples of IMF's success. It is beyond doubt, that international assisstance and policy advise played a significant and positive role in the implementation of Polish reforms. It must be added, however, that the most **simplistic foreign advise**, sometimes ascribed to the IMF, the famous *„privatise, liberalise and fight inflation/ the rest will be taken care off by market mechanism recipe*“ **was largely ignored**. Mass privatization was reduced to a manageable scale, capital flows liberalisation was phased in gradually and an overly ambitious policy of fixed exchange rate was early replaced by a pre-announced crawling peg. Instead, carefully sequenced process of institution building was initiated. As a result, the newly-emerging market structures got some time to mature and the embattled companies some time to adjust to the new situation.

Polish early reformers, with Leszek Balcerowicz, rightly earned a reputation of being liberal and consistently pursuing free market solutions. They avoided any suggestion to look for a „third-way“ and never used the argument of „unique conditions“ of Poland. At the same time, the **policies applied were quite frequently much more pragmatic that one could expect from their ultra-liberal rethorics**. Credit ceilings were installed in 1990, as nobody believed that (state) commercial banks would immediately start applying efficiency criteria to their credit activity, tax on excessive growth of wages (*popiwek*) was introduced to shelter the companies from fast growing labour costs, Law on Financial Restructuring of Banks and Enterprises was prepared and passed in early 1993, when it became evident that without help from the state a widespread banking crisis was in sight. These were measures that could

not be considered in line with liberal orthodoxy, but helped to stregthen the implementation of a liberal strategy. Policies are always more pragmatic than programs and declarations, so my observation looks almost banal. However, pragmatism can sometimes be danderous, particularly when the policy agenda remains vague and the politicians unconvinced and unconvincing. Then, pragmatism can degenerate into opportunism. This was not the case in Poland, where clear vision and pragmatic daily attitude gave a blend of policies that worked.

Shock therapy applied in 1990 brought severe hardships on the population. Diminishing job security and falling real wages were only partially compensated by better supply of goods and services of higher quality. Particularly hit were people approaching retirement age and workers inhabitating „one-company towns“ and rural areas. Early transition is often described, particularly by its critics, as totally ignoring the social consequences of reforms and complete disregard of the precarious situation of the poor and weak. Patience and restrains showed by the Polish people is thus explained only by the unique political circumstances after the fall of communism. This story does not capture, in my opinion, one important factor, which I call the „**Jacek Kuroñ factor**“.

Jacek Kuroñ, a legendary figure of anticommunist opposition, became minister of Labour in the first Solidarity-dominated government. Understanding the hardships of transformation he managed to introduce some measures soothing them, notably the early retirement benefits and more generous indexation of social security benefits. In fact, when we look at statistical records of the 90s, we find that the share of social expenditures in the state budget increased sharply at the beginning of the decade. Equally important, he was skilful in using media to communicate with the society, explaining the essence of the changes and trying to project the prospects of better life in a market-oriented, democratic society. His policies often diluted the necessary budget discipline that Balcerowicz was adamant to keep. No wonder, he was not a favourite of the „economists“ in the team of reformers. With the benefit of hindsight, and looking at the bad experience of some countries in the region, this **consideration for social needs**, that Kuroñ added to the transformation process in Poland might have strengthened (and not weakened) the reform process. This factor is almost uniformly overlooked in the assessments of Polish reforms.

From the very beginning of transition Poland declared her strategic goal to become a member of the European Union. An association agreement, called European Agreement was signed as early as 1991 (ratified in 1993). It provided, among others for an asymetric trade liberalisation, a modest financial assistance

in the form of PHARE, and - most important - for an obligation of Poland to adjust all new legal regulations to the EU standards. No matter how naive it sounded to our Western partners, we considered it a first step towards membership. All political elites and a vast majority of the population stood firmly behind the idea of joining the Union possibly early.

The reasons of that clear orientation were more geopolitical (national security) and, what I would describe as instinctive, than purely economic. We wanted to be a part of a stable, democratic and prosperous world. The question of the accession to the unified market was secondary. So was the perspective of financial assisstance. Of course, the priorities change over time, the understanding of the consequences of EU membership deepens, and the popular support dwindles somewhat as the evident costs become visible.

After 10 years of transition this **pro-European orientation emerges as one of the key sources of success, key engines for positive evolution of the system.** Firstly, the association agreement, with all its aquis communautaire-related provisions, reduced the national sovereignity in economic policy, but also our freedom to commit serious mistakes. It has served as a guideline for reforms. Secondly, it mobilised political will to reform, helped stem natural resistance to change, increased the level of policy discourse in the country. Thirdly, intensified contacts with the EU provided a massive inflow of policy-related know-how. Last, but not the least, the association status finally (after some years of hesitation) resulted in a not insignificant increase inflow of FDI into Poland.

Lessons from transition- some nonorthodox remarks

The experience of last decade, both in Poland and in other countries in the region shows that **transition is an inherently unstable process**. This is not only an exercise in building and rebuilding institutions, in changing our behaviour and our mindset, but also in catching-up with the most advanced societies. A technically and socially difficult reform process has thus to be accompanied by fast economic growth. I have previously pointed to the complex linkage between the macroeconomic and microeconomic dimmensions of transition, between the exigencies of equilibrium and dynamics. We have therefore to be prepared for setbacks and recurrent imbalances, we should not expect a smooth process of transformation.

Having this in mind we have to avoid setting overambitious targets, underestimate difficulties and desperately look for shortcut solutions. In terms of policy-making, we have to be bold but **cautious, even conservative** in planning. Unrealistic exchange rate policies, budgets built upon overoptimistic assumptioms do not serve well the ultimate goal of transition - catching-up with the best.

Transparency is important to avoid misperceptions. Covering up problems and diminishing the extent of difficulties is counterproductive on two accounts. Firstly, it makes people expect too much and eventually become bitterly disappointed. Secondly, there is a danger that foreign investors are induced to behave in a more erratic way. Both can result in detrimental instabilities, either social or financial.

Transition is a holistic process. To succeed, no important element of it can be ignored. It is not enough to proceed on one field, say in stabilisation of currency and neglect structural reforms. It is not enough to introduce a modern tax system, if restructuring of troubled sectors is hopelessly slow. Even more, an unbalanced mix of reforms, consisting of advanced, ambitious measures is some dimmensions and complete failure on other accounts, can be particularly harmful for the sustainability of the reform process. This means that you do not need to be perfect in all respects, but what is important is to **avoid major mistakes**. In fact, a detailed analysis of the Polish developments in the 90s could lead someone to a conclusion, that it has been a streak of failures or, at best, very limited success. Privatisation was too slow and dominated by insiders, inflation permanently higher than in other successful transition countries, restructuring of coal mining delayed, agricultural polies inconsistent. Nevertheless, Poland succeeded in building-up a reasonably well-functioning market economy, because the main elements of this process - consistent and carefully sequenced macroeconomic policy, gradual microeconomic adjustment and basic institutions, were not neglected.

One of key premises of success in reforms is **political stability**. This should not, however, be mixed up with a lack of changes on the political scene. What really counts is the continuity that results from a broad consensus over the main goals. Looking at Poland (and Hungary) one may even say that frequent changes in power may, under certain circumstances speed up reforms. More parties take part in the policy-making process, developing necessary expertise and sense of responsibility, at the same time the inevitable political costs of transformation are more evenly spread over the whole spectrum of parties. A highly petrified structure of power (as in the Czech Republic for many years) leaves the opposition alienated from the realities of painful decisions and largely unprepared to continue necessary policies. We mest remember however that a high turnover at the steering wheel of the economy does not turn into chaos only if a broad consensus over the general course of reforms is secured. In Poland, as I mentioned before, this was provided by the widely shared European orientation of the political elites.

The unfinished business. Tough choices for the future.

The coming decade will not bring relief to the economic policy-makers. On the contrary, it seems that the challenges ahead are equally formidable. How to combine a successful integration to the EU with consolidation of reforms and, probably most important, with a high rate of growth, necessary to close the gap between Poland and her West European partners?

The main dilemna is how to reconcile high rate of growth with both economic and social equilibrium. In other words it is **how to reconcile fiscal discipline with the need to co-finance modernisation effort and how to maintain some degree of social cohesion.**

We dwelled extensively on the issue of inherent instability of transition process. Fiscal restraint is one of very few short-run instruments in the hands of the authorities to reduce the gap between savings and investments. As long as we do not build up institutions stimulating private saving, which is a time-consuming process linked to the recently initiated social security reform and as long as the wave of investment does not produce more exports, there will always be a strong pressure to reduce budget deficit or, indeed, to build up a surplus.

At the same time, public funds have to be provided to co-finance industrial restructuring (mining, steel, agriculture), modernising technical infrastructure (highways) and improving natural environment. Also, structural funds from the EU have to be partially matched by domestic component.

Fundamental reforms of the expenditure side of the budget coupled with drastic cuts in non-essentials are the only way, how these two exigencies can be reconciled. Recent experience shows, however, that when you undertake a deep reform, as it happened with health sector or local government, prospective gains in efficiency are preceded by increased costs. You have to invest first, and only later you can reap the benefits.

Fast growth does not automatically solve acute social problems. Excessive income disparities, regional differences and poverty have to be tackled, or the situation may get out of hand. Fiscal austerity makes it all but impossible to try to build a generous welfare-state-type social policy. On the contrary, there will always be a pressure to better streamline expenditures, eliminate „waste“ and restrict the spending programs to the very basic level.

Such prudence may be salutary, as poverty and social exclusion has never been properly addressed, let alone solved, by careless spending behaviour. However, intelligent methods of fighting poverty have to be used. These are, in my opinion, **massive investment in education**, particularly in rural areas and **support for small and medium enterprises**. Poverty is linked to

unemployment, and jobs are created almost exclusively in the SME sector. Lack of education makes people unemployable, even if demand for labour is rising. Thus, the recipe seems obvious. It requires certain budgetary support and knowledge how to spend public money in a most efficient way.

In the shorter run, sustainable growth is jeopardised by an **inconsistent macro policy mix**. A constant need to keep the economy from overheating and current account deficit from widening too much leads the central bank to monetary restrictions. High interest policy - necessary to stimulate savings and curb domestic demand - may become a self-defeating policy, when an interest rate differential attracts excessive inflows of foreign portfolio capital. This results in appreciation of domestic currency and higher trade deficit - exactly opposite what was aimed by the central bank.

Theoretically, this inconsistency can be solved, if fiscal policy is sufficiently tight. However, as has been mentioned above, a too drammatic shift in the budget may be impossible, not only due to political ramifications, but also due to economic exigencies. This is another dimmension of what I call an inherently unstable character of transition.

Summing up, transition has so far brought great achievements. Unprecedented success for some, justified hopes for many others, but also disappointment for the least fortunate. And yet, transition is far from over. Reconstruction of the whole agricultural sector, further restructuring of sunset industries, reform of the labour market and judiciary are among some of the most difficult challenges facing Poland in her drive to join European Union.

So far, success was largely due to a broad consensus concerning the strategic goals prevailing in the political elites, and indeed, in the society at large. As long as this consensus is strengthened by common sense in the policy-implementation process we can look into the future with optimism.