Poland’s Transition to the Market: An Overview

Poland was one of the first of the former centrally planned economies to launch a comprehensive program of economic transformation in the late 1980s and early 1990s. The Polish experience of liberalization and reform, which is now over five years old, can provide useful lessons for other developing and transition economies that have undertaken, or are just embarking on similar reforms.

First, aside from the fact that it was one of the first efforts at stabilization and reform among the countries of Central and Eastern Europe and the states of the former Soviet Union, the Polish economic program attracted worldwide attention because of its radical and comprehensive approach. Several attempts to reform the centrally planned system in Poland in a gradual and piecemeal fashion undertaken during the 1980s were generally viewed as failures, in part because they were not comprehensive enough, and many believed that these efforts only compounded the imbalances associated with central planning. The Polish authorities therefore explicitly adopted a less gradual, more radical approach—the so-called “shock therapy” or “big bang” approach to economic reform. The success or failure of this approach was to be a decisive factor in the debate on the appropriate scope and speed of economic reform in transition economies.

Second, the Polish economic program was one of the first to be supported with IMF resources. At the request of the Polish authorities, the IMF collaborated closely with the policymakers in the design and monitoring of the program. The IMF also made available a stabilization fund of $1 billion to support Poland’s exchange rate policy (see below). The Polish program thus offers valuable insight into the IMF’s approach to financial programming in a transition economy.

Third, when the economic program was introduced at the beginning of 1990, many observers regarded it as an instance of the so-called “heterodox” approach to stabilization, which combines fiscal discipline with a (temporary) fixed exchange rate and a tax-based incomes policy that moderates wage behavior. The program’s reliance on the exchange rate “anchor” to brake emerging hyperinflationary expectations was a key feature of the approach and attracted much scrutiny and interest. The Polish reform program is a useful case study of the role of exchange rate policy in stabilization programs.

Finally, prior to stabilization, Poland faced macroeconomic and structural imbalances common to many transition economies. These included (i) emerging hyperinflation at the end of 1989; (ii) widespread “dollarization,” suggesting a serious loss of confidence in the local currency; (iii) a sharp fall in output in the early phases of the economic reform program; (iv) large fiscal imbalances, the result of declining tax revenues and pressures for higher spending; and (v) structural and institutional rigidities in the fiscal and financial sectors that made adjustment difficult. While the structural weaknesses and the need for fiscal consolidation continue to present challenges for Polish policymakers, the stabilization program succeeded in bringing down the rate of inflation, thereby restoring confidence in the zloty and the deregulation and liberalization measures helped foster a thriving private sector, leading to increased exports and economic growth.1 This success makes the Polish program particularly instructive.

The Decades Before 1990

The Decline in Output and the External Debt Buildup

After a period of economic growth in the 1950s and 1960s based on large-scale investment in heavy industry and the absorption of labor from the farm sector, Poland experienced a slump in the 1970s. In response, the authorities launched a massive investment effort financed by imported capital, which led to a surge in industrial output but also created large external current account deficits and heavy accumulation of external debt. The deficit peaked at about 10 percent of GDP in 1975, and external debt rose from practically zero in the early 1970s to 40 percent of GDP at the end of the decade.

The industrial boom collapsed when foreign capital dried up, and import volumes fell by 50 percent during the crisis years of 1979–82. A harsh adjustment was imposed in 1982 under a martial law regime, but growth resumed only at modest rates during 1983–88. On balance, the decade leading up to 1988 was marked by a dismal record of economic performance, with stagnating real output and rising repressed inflation. A notable feature of this period was the state industrial sector’s experience. Output and employment fell, but the consumption of energy and raw materials rose sharply, as did the capital stock, suggesting a rapidly rising capital-output ratio and increased energy-intensity in industry. The stagnating output was vividly reflected in the failure of exports to grow and generate the foreign receipts necessary to service the rising external debt.

The Failure of the Partial Reforms of the 1980s

The Polish authorities, responding to the balance of payments crisis of 1979–81, undertook a series of partial reforms in the 1980s intended to decentralize economic decision making in the areas of production and investment planning, wage setting, enterprise financing, and foreign trade. Attempts were made to give state enterprises progressively greater autonomy over production, investment, and financing decisions. While these decentralization measures probably facilitated the transformation process, they failed to address the issue of economic stagnation, mainly because they failed to create truly free markets where competition could flourish or to bring about the basic change in the structure of relative prices that was needed to reduce shortages.2

The decentralization of wage setting led to accelerating wage pressures that culminated in wage explosions during the early 1980s and again in 1987–89. Because these large real wage gains were not backed by gains in productivity, they merely created a huge amount of excess demand and intensified existing shortages. Indeed, they may have been accompanied by a fall rather than a rise in living standards.

Decentralization, in practice, only increased problems with the bureaucracy, as direct controls were replaced by a large number of arbitrarily implemented rules under which enterprises bargained for credits, subsidies, tax relief, and access to foreign exchange. These partial reforms proved to be a poor substitute for well-functioning markets. The lack of market discipline, absence of provisions for free entry to and exit from markets, the ongoing protection from foreign competition, and the absence of a capital market to regulate investment and wage decisions meant that efforts to instill discipline in state enterprises failed. Ultimately, the unwillingness of the nomenklatura to undertake real reform and the political illegitimacy of the regime led to the failure of this experiment with reform.

The Legacy of Central Planning

The primary legacy of Poland’s long period of central planning was the relative impoverishment of the country. By 1989, Poland lagged behind many developing countries in terms of per capita income. Its per capita GNP ($1,850) fell between the averages for low-income developing countries ($1,270) and high-income developing countries ($2,940). The legacy of central planning was also evident in the main structural characteristics of the Polish economy, which explain the reform strategy adopted in the late 1980s and the early results of the reforms. Poland’s economy was characterized by the following structural distortions:

- Overindustrialization. Poland, like other Eastern European countries, was highly industrialized, too much so for its level of overall economic development. The result was that other sectors, such as the service sector, were deprived of resources in favor of industry.
- A large, inefficient agriculture sector. Almost alone in Europe, Poland still had a large agri-

These attempts at partial reform in the 1980s are parallel to the reforms attempted under perestroika in the former Soviet Union. Both efforts ended with hyperinflation, intense shortage of goods and services, growing black markets, and falling output.
Emerging Hyperinflation in 1989

As the centrally planned economic structures disintegrated along with the communist system, the mechanisms for maintaining financial control over the budget, the banking system, and external finances collapsed in 1988-89. Despite repeated reschedulings of external debt, actual debt service payments remained large, forcing the authorities to restrict imports and squeeze domestic demand. An abortive austerity program in 1988 attempted to cut subsidies and liberalize prices, but in the absence of popular support resulted in a wage-price-exchange rate spiral. This spiral, in turn, pushed Poland into hyperinflation in the second half of 1989, with monthly inflation accelerating from about 9 percent in July to 55 percent in October. The movement toward hyperinflation was reinforced by three events. First, the legalization of the black market in foreign exchange supported the flight from zloty. Second, the adoption of a formal wage-indexing mechanism led to a sharp rise in real wages in the state industrial sector. Third, the sharp cut in food subsidies intensified the wage-price-exchange rate spiral. All in all, in October 1989 the Polish economy stood on the brink of hyperinflation and was further threatened with a collapse of output.

The Reform Strategy

The solidarity-led government that took office in September 1989 had as its principal economic goal a rapid move to a market economy. The authorities' strategy, called a leap to the market, involved rapid macroeconomic stabilization, the immediate liberalization of prices and international trade and payments, and a fixing of the exchange rate. Taken together, these steps were intended to reduce decisively inflation expectations and to introduce widespread competition from abroad as quickly as possible.

The new government's stabilization program was based on five mutually reinforcing policies aimed at reducing aggregate demand and anchoring the price level.

- First, the authorities cut subsidies and investment spending sharply to reduce the fiscal deficit.
- Second, they instituted tight controls on net domestic credit of the banking system, partly by raising interest rates.
- Third, they depreciated the exchange rate by 31 percent, pegged it at the new rate, and established current account convertibility.
- Fourth, they put in place a tax-based incomes policy that would limit the rate of growth of nominal wages.
- Finally, they liberalized prices in all but a few regulated sectors (such as public utilities), raising prices in these sectors in a one-time adjustment.

The authorities' economic strategy recognized that macroeconomic stabilization and structural reform are interrelated and complementary processes on the road to a market economy. An effective system of price setting cannot be established until inflation falls and the currency is made convertible. Tighter fiscal policies will not result in real structural adjustment until state assets are sold off, the private sector is freed from regulation, bankruptcy procedures are established, a social safety net is in place, tax reforms are instituted, and the financial sector is overhauled. While recognizing that implementing all the institutional and legislative changes necessary to the structural reform process requires time, the Polish authorities initiated a limited number of structural reform measures.

Some further noteworthy features of the Polish reform program included:

- **The link between price liberalization and trade liberalization.** This link was a key element in the Polish reform strategy. Reformers in Poland and elsewhere had been reluctant to liberalize prices in economies dominated by monopolistic firms, fearing an explosion in monopoly profits. The rapid opening up of foreign trade provided the needed competi-
tion in the domestic market, solving the reformers' dilemma.

- A relatively low initial exchange rate. The decision to set the exchange rate slightly below the black-market rate raised inflation in the short term. A more appreciated rate would have resulted in less inflation, but the lower exchange rate was easier to defend and provided the needed competitive margin in the early period of reform.
- Tight monetary policy. The level of international reserves at the start of the program was very low, making it essential for the authorities to maintain a tight monetary policy. The new policy would force households and enterprises to convert some of their foreign exchange holdings back into zlotys in order to carry out domestic transactions. The return of confidence in the zloty also helped to boost official international reserves, as the central bank sold zlotys for dollars.
- External financial support. The reform program attracted strong support from the international financial community. Support for the balance of payments came in the form of an IMF stand-by loan, a Stabilization Fund administered by the IMF, and a bridging loan from the Bank for International Settlements. Moreover, creditor governments provided temporary relief from the burden of external debt servicing by agreeing to reschedule virtually all the principal and interest on Poland's debt through March 1991.

**Economic Performance**

Viewed in the light of recent history, the Polish big bang approach was basically successful and widely imitated. It succeeded in averting the risk of hyperinflation by bringing inflation down dramatically from over 1,000 percent on an annual basis to about 50 percent. The fiscal balance improved significantly in 1990 and, as a result of a surge in exports, the current account of the balance of payments showed a slight surplus. Nevertheless, the reforms were not fully successful. Inflation remained higher than targeted, and there was a sharp drop in output, reflecting a combination of influences. The impact of the destruction of existing institutions was underestimated and the speed of response of output to the new incentive structures was overestimated. The early phase of transition was marked by slower than expected fiscal adjustment and difficulties in financing the fiscal deficit because of the lack of public trust in the government—reflected in its inability to sell government securities and the phenomenon of dollarization. But by 1994, the government succeeded in significantly restoring public confidence in the currency, and the focus of financial policy shifted from fiscal adjustment to monetary and exchange rate management in order to contain the inflationary impact of external capital inflows. The specific aspects of economic performance are covered in more detail below.

**Inflation**

The strategy of using an exchange rate anchor supported by a tax-based incomes policy to reduce inflation achieved dramatic success. The inflation rate, measured by the consumer price index (CPI), fell from over 620 percent in 1989 to 250 percent in 1990 and to 60 percent in 1991. Although the rate was reduced slightly in 1992–93, it then remained in the 30 percent range from late 1993 until early 1995 (see Chart 1.1).

The initial upward shock to the price level at the beginning of the reform program was quite large. The exchange rate depreciation, price liberalization, and increases in administered prices produced a corrective burst of price hikes, so that average monthly inflation in January 1990 was more than 78 percent over the previous month. In subsequent months, the inflation rate fell sharply. The government's success in ensuring that the large corrective price increases did not feed into the underlying rate of inflation owed much to the tax-based wage policy, which kept inflation from being incorporated into wages. This heterodox policy, combined with monetary restraint, helped not only to support the nominal exchange rate peg, but, ultimately, to break the momentum of inflation expectations.

The reduction in inflation was achieved despite the fiscal deficits, which needed considerable monetary financing. Key to this success was a sharp rise in the demand for broad money that reflected considerable confidence in the zloty. As the zloty gained favor, the share of private savings in domestic currency held in the form of bank deposits increased. With private savings rechanneled into the banking system, the authorities had some room to maneuver in their efforts to reduce monetary financing of the deficit. Chart 1.2 illustrates the sharp fall in the ve-
locity of złoty money during the period of disinflation in 1990-91.

Consumption, Output, and Unemployment

Real Incomes and Consumption

The official statistics suggesting that the cost of the stabilization effort in Poland has been high—a fall in real incomes of one-third—should be interpreted with caution. The fall in real wages—the index of real wages fell by over 30 percent during 1990—in part simply offset the large increases in real wages of 1987-89. More importantly, real wages do not correspond to living standards in an economy in which shortages are pervasive, because the official price index does not reflect the shortages, queues, or high black-market prices caused by excess demand. Thus, the real wage increases of 1987-89 did not make workers better off, and the fall in real wages in 1990 did not reflect a comparable fall in real consumption, since more and better consumer goods became available after 1990, reducing both queues and the importance of black markets. Data on household consumption expenditures in Poland strongly suggest that there was no sharp fall in living standards as a result of the 1990 price liberalization. Public opinion surveys also refute the notion that living standards declined in the early phases of reform.

Industrial Output

All the previously centrally planned economies of Central and Eastern Europe and the states of the former Soviet Union have experienced a fall in industrial output, irrespective of the pace of individual countries’ reform efforts. Poland’s fall in industrial output was among the smallest but was nevertheless substantial.

The fall in output of over 11 percent in 1990 reflected the impact of the fiscal balance’s sharp swing into surplus and the resultant squeeze on domestic demand; the dislocation brought on by the hyperinflationary period of 1989; the collapse of the central planning structure; and cutbacks in production by large “heavy” industries, which lacked customers. A further fall of 8 percent in 1991 was caused largely by the external shock of the collapse of the CMEA and the accompanying worsening of the terms of trade. Growth resumed in 1992 and accelerated to 4 percent in 1993, supported by a buoyant private sector and expansion of exports.

Other factors influenced the fall in industrial output. In all the transition economies, resources—in-
including workers—from the overdeveloped industrial sector were shifted to the service sectors, including wholesale and retail trade and finance. The resulting gains in the service sector's output, which in many transition economies were not reflected in official statistics, helped to offset the fall in industrial output. In fact, the decline was concentrated in the military-industrial complex, and the engineering and transport equipment sectors, while industries such as building materials and food processing registered healthy increases in output. There was also an explosion of new small, private businesses in the trade, services, and small-scale manufacturing sectors—activity the official statistics did not adequately reflect.

All in all, the economic statistics, properly interpreted and supplemented with other relevant information, suggest that a fundamental economic transformation has been occurring in Poland since 1991. While it is undeniable that there have been "losers" as well as "winners" in this process, the basic direction of change has been toward an economy able to provide far higher standards of living for everyone, on the basis of real productivity gains rather than the artificial stimulation of demand by the government. The hallmarks of this transformation have been the creation of large-scale private ownership of productive resources; a market system; a thriving export sector; an end to shortages; a decisive shift from heavy industry to consumer goods and services; and prospects for closer integration with the world economy.

**Unemployment**

One consequence of the reforms was an initial rise in unemployment. The unemployment rate rose from very low levels in 1990 to 13 percent at the end of 1991. Again, however, the data are suspect: a significant number of those counted as unemployed were working in the "second" economy or on farms while collecting unemployment compensation. For this reason, the pessimistic forecasts of a "catastrophic rise" in unemployment turned out to be wrong. The lesson of the Polish experience is that if firm wage restraint is maintained to prevent wage gains from exceeding productivity gains, and if the private sector is allowed to grow without restraints, then stabilization and restructuring are compatible with unchanged or even declining unemployment.

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**Chart 1.2. Poland: Velocity of Money**

Source: IMF Institute database.
1. Velocity is measured as nominal GDP divided by average of broad money or zloty money.
2. Zloty money comprises of currency and all zloty deposits.
3. Broad money comprises of currency, zloty deposits (demand, savings, and time), and foreign currency deposits.

4. Indeed, the national accounts of these countries were still being compiled primarily on the basis of the central planning methodology (the Material Product System, or MPS), which did not count services but focused on the net material product.
Financial Policies

Strong fiscal adjustment efforts supported by a tight monetary policy was the key feature of the Polish authorities' stabilization program. The strength of the fiscal adjustment soon became evident in the turnaround in the government's fiscal position. The deficit disappeared, falling from 7.4 percent of GDP in 1989 to zero, and a surplus of 3.1 percent emerged in 1990. Most of this massive adjustment came from the large cuts in expenditures—over 7 percentage points of GDP—achieved through sharp cutbacks in subsidies on food and energy and restraint in raising government wages. Although this fiscal adjustment was reversed in 1991, in part because of the contraction in output attendant on the collapse of CMEA trade and in part because of large wage increases, the authorities managed to regain the momentum of the fiscal adjustment in 1992–93, stabilizing the general government deficit at about 3 percent of GDP.

Monetary policy, especially the peg to the U.S. dollar, supported fiscal restraint, especially in the early phases of the reforms. Despite heavy borrowing from the banking sector to finance the deficit, the authorities succeeded in reducing inflation. One factor in this decline was the rising demand for money as private savings moved into the banking system, attracted by positive real rates of interest on bank deposits. The loosening of interest rate regulation and the success in reducing inflation helped to keep interest rates on deposits broadly positive and to reduce dollarization in the initial stages of the stabilization program (Charts 1.3, 1.4, and 1.5).

Exchange Rate Policy

The Polish experience of exchange rate management offers a number of lessons for policymakers in liberalizing economies.

First, if it is supported by appropriate monetary and wage restraint, an exchange rate peg can provide a valuable instrument of disinflation.

Second, the level at which the rate is pegged is the major determinant of the peg's success in reconciling the objectives of lowering inflation and maintaining competitiveness and of its durability.

Third, the timing of the so-called "exit" from a peg to a more flexible exchange rate is important in preventing the crisis of confidence that can be brought about by speculative attacks on the pegged exchange rate.

Fourth, under a crawling exchange rate regime, a rate of crawl lower than the inflation differential can help reduce inflation without sacrificing competitiveness.
Fifth, a partial solution to the problem of monetary expansion fueled by capital inflows is a move to greater flexibility in the exchange rate (see below).

Trade Liberalization

In the prereform period, Poland traded almost exclusively with other CMEA countries. Trade was governed by bilateral barter and based on prices fixed by governments. The trading environment at the onset of reforms was burdened by administrative impediments, limited freedom of entry, high tariffs, numerous nontariff barriers, and a currency that was not convertible. The radical reforms announced in January 1990 involved sharply reducing or eliminating most tariffs and nontariff barriers, lifting import and export licensing requirements and making the zloty convertible for current account transactions at the new devalued exchange rate. At the beginning of 1990, the General Agreement on Tariffs and Trade (GATT; now the World Trade Organization, or WTO) declared the Polish trade regime to be one of the most liberal in Europe.

This trade liberalization was partially reversed in early 1991 in the face of a worsening current account deficit, and several tariffs were raised and some nontariff barriers reimposed. During 1992–93, Poland returned to the path of liberalization; however, in contrast to the unilateral decisions of 1990 that reduced both tariffs and nontariff barriers, the liberalization took place in the context of negotiations with Poland’s trading partners. The consultations culminated in free trade agreements with the countries of the European Union, the European Free Trade Area (EFTA), and the Central European Free Trade Area (CEFTA) covering industrial goods and raw materials. As the deep-seated anti-export bias of the old regime—reflected in an overvalued exchange rate, chronic excess domestic demand, and explicit trade barriers that included quantitative restrictions on exports—was removed, exports (especially to Western markets) boomed.

Recent Challenges to Macroeconomic Policy

Since 1993, Poland has experienced strong economic growth, sustained by gains in productivity and a positive export performance. In 1994, Poland’s economy expanded at an annual rate of 6 percent. Growth has not been hindered, as it often was in the past, by a balance of payments constraint. Indeed, taking into account estimated unrecorded
trade, the current account recorded a surplus of over 2 percent of GDP in 1994, and official reserves have continued to rise.

The buildup of international reserves, which reflected the sizable capital inflows of early 1995, caused the money supply to expand faster than planned. The monetary authorities' efforts to sterilize the inflows met with only partial success, and the rapid monetary expansion contributed to the persistent inflation that hovered at about 30 percent a year. The authorities, concerned about the inflationary impact of the capital inflows, first reacted by reducing the rate of the exchange rate crawl from 1.4 percent to 1.2 percent a month in February 1995. When this step did not ease the pressure on monetary expansion, in May 1995, the authorities announced the move to a managed float, which allowed the exchange rate to fluctuate within a band of ±7 percent on either side of the official rate. The zloty has been allowed to appreciate by 5 percent within the band, helping to put downward pressure on inflation. Despite these policy adaptations, the goal of reducing inflation to less than 20 percent a year has proved difficult to achieve.

The fiscal policy stance has been broadly supportive of the macroeconomic adjustment, although too, the pace of adjustment has slowed in recent years. The general government deficit, which stood at about 6.5 percent of GDP in 1991–92, was reduced to under 3 percent of GDP by 1993–94, but further reductions have proved harder to achieve. The downward trend in national saving, which have declined as a proportion of GDP from 20 percent in 1991 to about 15 percent in 1993 (in current prices), highlights the need to increase private saving. The fall in saving may in part reflect a sharp rise in consumption after several years of repressed demand for consumer goods. Should the downward trend continue, however, it could pose a challenge to macroeconomic policy in Poland, as there is a continuing need for noninflationary financing of the fiscal deficits and access to foreign saving may be limited.

The persistence of inflation in Poland reflects a challenge to economic policy confronting a number of countries in transition. The challenge is how to move from moderate to low inflation at an acceptable cost in lost output. It is now well understood that besides the monetary causes of inflation dis-

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cussed above, some "real" factors such as relative price adjustment, indexation mechanisms, and enterprise restructuring also play a key role in the inflation process in the transition economies.

The necessity of large relative price adjustments creates an inflationary bias in these economies, because while firms and sectors facing large shocks raise their prices, there are no offsetting decreases in prices elsewhere in the economy. The impact on inflation is also exacerbated by the existence of wage and price indexation. The resulting inflexibility in prices forces the monetary authorities to accommodate inflation to a greater extent than they would otherwise prefer to do, because of the high output costs of nonaccommodation. The authorities are also concerned that the burden of a tight monetary policy should not be borne disproportionately by the emerging private sector. To avoid this risk, a faster restructuring of traditionally dominant industries and the imposition of a hard budget constraint on state enterprises are essential. Thus, the ideal anti-inflationary strategy would combine a tight monetary policy with faster restructuring and gradual elimination of indexation, in order to make the needed relative price adjustment compatible with progress from moderate to low inflation.

Goals and Strategies of Transition

With the collapse of central planning throughout Central and Eastern Europe and the states of the former Soviet Union, a number of countries besides Poland embarked on programs of economic reform that would lead to market-based regimes. The economic strategies these countries employed had several interrelated objectives that would support the overall goal of making a successful transition from central planning to a market economy, including macroeconomic stabilization, structural reform, and the liberalization of prices and the trade regime. Each country's strategy was influenced by the degree of emphasis the government placed on the individual objectives, which in turn was dictated by initial conditions, existing economic structures, the severity of the macroeconomic imbalances confronting the authorities, and any broad social and political objectives. The case of Poland illustrates how an individual country's transition strategies are shaped by its own history, institutions, and wider sociopolitical conditions and objectives.

The desire to make the transition to a mode of economic organization based on market signals rather than on central directives reflects the recent worldwide consensus that a market-based economy is the more efficient and dynamic way of generating and allocating resources. Centrally planned economies are handicapped by perverse incentives, a lack of information, bureaucratization, and the associated risks of corruption and the abuse of power. While it is widely recognized that markets can fail and that there are circumstances in which government intervention is justified, on balance the market allocates an economy's resources to alternative activities far more efficiently than the government. Moreover, a market economy provides individuals with certain rights—to choose an occupation, consume the goods and services one prefers, and take risks—which are widely seen as fundamental not only to a desirable standard of living, but also, to individual liberty.

Macroeconomic stabilization is concerned with macroeconomic variables such as output, employment, inflation, the balance of payments, and public debt. Since many transition economies have suffered from severe macroeconomic imbalances that have manifested themselves in high inflation and falling output, stabilization has been a high priority among economic policymakers. Progress in macroeconomic stabilization—particularly in bringing down the rate of inflation—is often a precondition for the structural reforms that will support the successful transition to a market economy.

The process of transition to the market encompasses three sets of reforms:

- Stabilization needs to be accompanied by freeing of prices, trade, and entry to markets. Liberalization is a precondition for realizing the other benefits of structural and institutional reforms.
- Clarification of property rights and privatization are essential if individuals and businesses are to respond efficiently to market forces.
- Reshaping of social services and the social safety net with a view to ease the pain of transition is the third critical aspect of the reform process. It is the key to sustaining popular support for the reform process over the long run.

Economic Agents and the Transition to a Market Economy

The transition to an open market-based economy entails changes in virtually all areas of the economy.
and significantly alters the activities of the key economic players. The new roles are outlined briefly below.

- In a market economy, the government's role is not eliminated, but it is drastically transformed from what it was under central planning. Rather than allocating resources and setting quotas for output, the state provides certain "public" goods and services, such as national defense, law enforcement, environmental protection, and social safety nets for vulnerable sections of the population. It ensures that markets function properly and enforces the rules governing economic operations. Enforcing the rules involves supervising the behavior of enterprises and financial institutions and maintaining legal structures that ensure property rights, regulate private contracts, and promote the smooth functioning of markets.

- The principal productive activities in any free market economy are carried out by privately owned enterprises whose owners seek to maximize their profits. Because the search for profits constitutes the main driving force in the economy, the share of total output the private sector generates is often regarded as the key indicator of progress in the transition to a free market. Similarly, privatizing the previously state-owned enterprises is a major element in policies aimed at making a successful transition.

- For an economy to operate efficiently, markets must perform their role in a transparent and legitimate fashion. Well-functioning markets are characterized by free trade in a range of goods and services; clear information about prices and quality; flexible prices; and, most importantly, competition, which is ensured if new firms can easily gain entry. Many of the benefits a market economy offers in terms of efficiency and innovation hinge on the existence of competitive markets. Opening the economy to international trade is often the surest means of ensuring competition in domestic markets.

- Financial institutions play a pivotal role in a market economy by channeling saving and investment. Financial markets allocate and assess risks, provide a payments mechanism, and ensure that enterprises maintain financial discipline. Fostering a private financial sector that can offer intermediation services in the saving-investment process is therefore a key part of making the transition to the market. But profit-oriented financial institutions are central to a transition economy for another reason. Under central planning, banks were required to provide credit to public enterprises operating under a "soft" budget constraint. The result was an increasing number of "bad" bank loans. Financial institutions must be able to act autonomously and to enforce a "hard" budget constraint on enterprises (with the ultimate sanction of bankruptcy).

Economic Strategies for Transition Economies

The experiences of countries in different parts of the world suggest that there is no one "right" path for making a successful market economy. The sequencing of reforms and the speed with which they are implemented depend largely on country-specific factors such as initial conditions, political constraints, and institutional history. Nevertheless, there is growing consensus on the main points. It is clear from the available evidence on transition economies in Central and Eastern Europe and the states of the former Soviet Union that those countries which have enjoyed the most success have pressed ahead on several fronts, including stabilization, liberalization, privatization, and restructuring. Not only have they made relatively rapid gains in their move to a market-based economy, but they have also seen a rapid reduction in inflation and a more moderate decline in output. In some sectors, however, the pace of change is necessarily slower and requires a gradual approach. Overhauling legislation, legal and judicial structures, and related institutions, for instance, takes time. Gradualism in such areas is effective if the country's overall transition strategy succeeds in gaining (and maintaining) credibility among domestic and international investors. Thus, the authorities must be committed not just to the reform process; they must also be willing to build popular coalitions in support of a consensus on economic reforms.