I Overview

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Poland has received much attention recently as economic activity finally rebounded following a sharp collapse in output ushered in by the implementation in 1990 of a comprehensive program of economic transformation. The rebound has been widely viewed as indicating that the reform efforts of the past three years are at last bearing fruit. Since Poland embarked on its transformation program earlier than the other countries in Eastern and Central Europe, as well as before the countries of the former Soviet Union, this evidence of success, and Poland's experience more generally, are believed to contain valuable lessons for the countries that are following on the road to a market economy. The focus of this Occasional Paper is on describing the salient features of Poland's economic transformation with a view to highlighting the general characteristics of that process.

Background

The economic situation in Poland deteriorated in the late 1980s. The problems became particularly acute in 1989 as evidenced both by a rapid acceleration in inflation that by October had reached a monthly rate of 55 percent and by the emergence of a large fiscal deficit equivalent to about 7 percent of GDP. Indeed, the very credibility of the Government's financial policies had severely eroded; for example, dollar-denominated deposits had become so popular that the share of zloty-denominated money in total money had shrunk to 28 percent by December 1989.[1]

In the preceding years, there had been several attempts to reform the economic system to redress the emerging stresses associated with the inadequacies of Poland's centrally planned regime. However, the limited nature of those reforms appears, if anything, to have exacerbated the difficulties that were being experienced.[2] In particular, the measures reflected an ambiguous attitude on the part of the authorities about the role of the market—specifically, market forces were often viewed as facilitating the planning process rather than of value as signals for economic activity. As an example of a particular problem, the first attempts to decentralize a degree of decision making to the enterprise level took place without at the same time ensuring that new (market-based) instruments to enforce financial discipline would be introduced; this situation likely contributed to the macroeconomic imbalances that emerged by the end of the decade.

Accordingly, it became increasingly clear that a more fundamental break in the economic regime was warranted, and in 1990, Poland embarked on a program of reform with a view both to stabilizing the economy and to putting it on the transition path to a market economy.[3] In many respects, the financial performance under the program exceeded expectations, particularly as concerns the turnaround in the fiscal position, where a significant surplus was recorded rather than the broad balance that was envisaged, and in a related event, the balance of payments was much stronger than anticipated.

Nevertheless, the reform program was initially associated with a surprisingly sharp output drop, and Poland entered a severe depression. There is a large literature considering the factors that might explain the sharp decline in output. A discussion of this literature is beyond the scope of this overview, other than to note that the plunge likely reflected a combination of influences rather than a single precipitating force.[4] However, one element deserves highlighting given the focus of this Occasional Paper. Most commentators seriously underestimated the impact that the destruction of the institutions underpinning the

[1] See Gomulka (1993).

[2] Further details on the nature of earlier reform efforts and the events leading to the economic crisis in the late 1980s can be found in Lane (1991) and Wolf (1991).

[3] Some of the reforms associated with the 1990 program had in fact already occurred in 1989 (notably, the January 1989 introduction of a uniform tax on enterprise incomes, independent of whether the enterprise was in the private or public sector; the February 1989 separation of nine commercial banks from the central monobank; and the August 1989 initiatives to liberalize food prices).

[4] See Lane (1991) and Borensztein and Ostry (1992) for details on the debate concerning the source of the decline.

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centrally planned regime would have on economic organization in general and, moreover, were overly optimistic concerning the ease with which the institutional framework associated with a market economy could be put in place. (At the time, thinking appears to have reflected the perception that the inefficiencies associated with centrally planned regimes would place a floor on the level of economic activity.) Exacerbating these errors in judgment, and notwithstanding the creation of safety net mechanisms, the social costs associated with the transformation process have been large. Accordingly, there has been ongoing political pressure to slow down, and modify the thrust of, the reforms.

The severe disruption of the "information" channels for economic activity associated with the introduction of the transformation program had an impact beyond its implications for the depth of the downturn in activity. Specifically, as the transformation progressed, budgetary pressures emerged beyond those that might have been anticipated solely as a result of the decline in output. The traditional mainstay of the revenue base, taxes levied on state enterprises, collapsed as the financial base of state enterprises deteriorated. The revenue loss could not be quickly made up given the time-consuming nature of tax reform. On the expenditure side, while subsidies were rapidly reduced, transfer payments increased rapidly as a social safety net was put in place as a buffer against the social costs of economic transformation. Compounding these structural expenditure problems was the fact that it proved difficult to target the new transfer programs—for example, in the absence of suitable earnings histories, pensions had to be based on the most recent wage data, providing an obvious incentive to enterprises to grant generous wage rewards to those approaching retirement.

The difficulties experienced in establishing the institutions that are central to the efficient functioning of a market economy also affected the pace of ownership transformation. More generally, strengthening corporate governance so as to ensure the efficient allocation of resources proved particularly time-consuming and at times politically contentious. As a result, the economic performance of enterprises did not improve as rapidly as envisaged.

All of the above point to a close interrelationship between macroeconomic stabilization and structural reform. Indeed, at the risk of excessive simplification, one could characterize the underlying imperative of Polish economic policy since 1990 to be to move as rapidly as possible on the path of structural reform both with a view to Poland's becoming a market economy and so as to support financial policies. As the recent upturn in economic activity attests, the fruits of these efforts are more and more in evidence. The following sections confirm the increasingly beneficial impact of the sweeping changes that have occurred while, at the same time, indicating that the agenda for further action remains long.

Table 1-1. Main Economic Developments

	1990	1991	1992	1993
Real GDP (percent change)	−11.6	−7.6	1.5	4.0
Consumer prices (percent change)	585.8	70.3	43.0	35.3
General government balance (in percent of GDP)	3.1	−6.5	−6.7	−2.9
Current account (in billions of U.S. dollars)	0.7	−2.2	−0.3	−2.3

Sources: Polish authorities; and IMF staff estimates.

Economic Developments

Table 1-1 outlines the main economic developments in the period 1990–93 (see also Appendix Tables A1–A3).

The economic reform program introduced in 1990 has been characterized as a somewhat heterodox approach to stabilization (Lane (1991) and Lipton and Sachs (1990)). The financial policy component included a commitment to reduce the fiscal deficit sharply, the introduction of a temporary fixed exchange rate as a nominal anchor to break emerging hyperinflationary tendencies, and a tax-based incomes policy to restrain wage behavior. These policies were supplemented by the first steps to comprehensive structural reform with, as a practical matter, the greatest initial impact occurring through the liberalization of many prices (following initial moves in this direction in 1989) and international transactions.

As already mentioned, economic performance in 1990 subsequent to the introduction of the reform program was mixed. Inflation, after an unexpectedly large surge in early 1990 that likely in part reflected the initial choice of a fixed exchange rate at 9,500 zlotys to the U.S. dollar, retreated rapidly from the near hyperinflationary rates of late 1989 to reach a monthly rate of about 3 percent by midyear. The state budget recorded a surplus equivalent to about 4 percent of GDP (implying a general government surplus equivalent to 3 percent of GDP) in the first half of 1990 rather than an expected small deficit. This budgetary outcome in part was due to a one-off

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surge in revenues arising from the taxation of profits on nominal inventory valuation adjustments, taxation that contributed to the decapitalization of the state enterprise sector.[5] With incomes policy set in line with a level of projected inflation that in the event turned out to be an underestimate, real wages fell sharply in the initial months of 1990. Reflecting both this development and the fiscal outcome, domestic demand declined sharply in early 1990, and, in a related event, the balance of payments was much stronger than anticipated. Despite a midcourse correction involving a broad policy easing that was associated with a leveling out in economic activity, output for the year as a whole fell sharply, with measured GDP declining by about 12 percent.[6]

Instead of rebounding as generally anticipated, economic activity in Poland declined again in 1991, with GDP falling by almost a further 8 percent. The most important precipitating event in this further decline was the external shock arising from a collapse in trade among Council of Mutual Economic Assistance (CMEA) partners and the attendant worsening in the terms of trade. In addition, there was evidence of slow domestic adjustment to the new external reality; for example, real wages increased by 3 percent, probably reflecting in part the persistence of inappropriate incentive structures in the state enterprise sector. Moreover, the combination of a reluctance on the part of enterprises rapidly to shed labor in the face of real wage increases and declining demand led to a sharp fall in enterprise profitability. This development, in turn, contributed to a sharp decline in budgetary revenues even as pressures were increasingly being felt in the social expenditure programs. The uneven pace of structural reform, reflecting both unanticipated implementation difficulties and some political hesitation, contributed to the scale and persistence of the economic imbalances. For example, implementation of a value-added tax (VAT) to replace the turnover tax was postponed and the problems arising from the poor targeting of social expenditure programs became increasingly serious.

On balance, consumption gained at the expense of investment in 1991, and there was an associated significant deterioration in Poland's current account balance, with foreign exchange reserves falling by $2 billion and the real exchange rate appreciating sharply.[7] Nonetheless, the macroeconomic imbalances did not result in an acceleration in inflation. Although inflation in 1991 was a high 70 percent (consumer price index, or CPI, basis, annual average), this was a marked improvement over the 586 percent in 1990.

The outlook as Poland entered 1992 was for a prolonged period of pronounced adjustment, and commentators at the time hoped that output in that year would at best fall no further. In the event, the economy experienced a fairly sharp turnaround early in the year. In particular, industrial production rebounded, rising by 4.2 percent in 1992 after a cumulative decline of 42 percent during 1989–91. The recovery was broad based and reflected mainly favorable domestic supply factors, assisted in part by increased access to European Community (now Union) markets, a devaluation in February 1992, and gains in competitiveness. The private sector played a prominent role in the recovery—in industry, output of the private sector increased by 32 percent, while in the state-owned sector, it declined by 5 percent; as a result, the share of industrial output in private hands increased from a fourth in 1991 to almost a third in 1992. Underlying this was the growing impact of success with individual routes to ownership transformation, even as the target date for implementation of the mass privatization program once again slipped. Also, there was evidence that a growing number of enterprises still within the state sector were adjusting to the realities of hard budget constraints, implying a general strengthening of corporate governance (Pinto and others (1993)). Output, as measured by GDP, increased by 1.5 percent in 1992.

While the robust upturn in private sector activity thus attested to the progress that was being made in transforming the economy, the process of reform continued in some respects to be slower than anticipated. In particular, despite attempts to rein it in and the relatively buoyant economy, the fiscal balance deteriorated further in 1992, largely reflecting the persistence of the underlying structural problems in the budget and difficulties in the implementation of structural reforms on both the revenue and expenditure side—the introduction of a comprehensive tax on personal incomes in January 1992 was a notable exception. The state budget deficit for the year was the equivalent of 6.8 percent of GDP.

[5]For further elaboration on the impact of the interaction between a nominally based capital income tax and inflation in the Polish case, see, for example, Schaffer (1992).

[6]The actual decline in output could have been less for a number of reasons. For instance, the sharp fall in output of state enterprises might have been partially offset by growth in the new private sector that was not fully captured in official statistics. See Berg (1993).

[7]As regards exchange rate developments, in May 1991, the peg for the zloty was switched from the U.S. dollar to a basket of currencies and at the same time the zloty was devalued by about 14½ percent. In October 1991, the fixed exchange rate arrangement was turned into a crawling peg arrangement with a preannounced rate of crawl.

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Nevertheless, the balance of payments strengthened considerably in the year, as exports grew steadily and a major restructuring agreement with Poland's Paris Club creditors reduced debt-servicing requirements significantly. The growth in exports owed much to Poland's improved competitiveness reflecting steady productivity increases as industrial output recovered and enterprises reduced employment. Underpinning the improved trade situation was a surprisingly robust level of private savings. Price performance also improved—the annual average inflation rate slowed to 43 percent in 1992 from the 70 percent in 1991.

Official projections for 1993 assumed that real GDP would rise by 2 percent. In the event, the turnaround in activity already in evidence gained momentum, especially in the first half of the year—for example, industrial production in mid-1993 (June–July) was up about 8½ percent over a year earlier. Although there was a pause in the upswing in the third quarter, the latest data point to further strength toward the end of the year, with the prospect for real GDP growth perhaps a little above 4 percent. Moreover, the unemployment rate tended to stabilize as the year progressed.

However, the increase in demand in 1993 outstripped that of supply, and the savings-investment balance deteriorated by some 4 percentage points of GDP (owing both to a surge in consumption, notably consumer durables, and to increased investment). Reflecting an associated sharp deterioration in the trade balance, particularly at midyear, the current account balance deteriorated from a deficit of 0.3 percent of GDP in 1992 to about 2.7 percent of GDP in 1993, though the magnitude of the deficit is overstated due to unrecorded exports. Price performance continued to improve in 1993—the 12-month rate of inflation (CPI basis) was about 35 percent for the year.

Financial policies in 1993 in general had a conservative cast. In particular, the state budget cash outturn for the year—a deficit equivalent to about 3 percent of GDP—was significantly less than the planned deficit equivalent to 5 percent of GDP. This better result reflected in large part the buoyancy of revenues arising from the stronger than expected rebound in activity and the successful introduction of a VAT to replace the system of turnover taxes. The deterioration in the trade balance that raised concerns in some quarters about Poland's international competitiveness influenced the decision to devalue the zloty by 7.4 percent against a basket of currencies in August 1993. At the same time, it was announced that the rate of crawl would be reduced from 1.8 percent per month to 1.6 percent per month.

As regards structural measures in 1993, in addition to the successful introduction of the VAT, there was progress with a major initiative simultaneously to recapitalize commercial banks and restructure many state enterprises. Mass privatization continued to move forward with the prospect finally of implementation in 1994. Privatization by other routes, notably case-by-case privatizations, continued. In addition, there was a boom on the Warsaw Stock Exchange that indicated strong interest in investing in Poland's emerging private sector. This interest was further evidenced by a large oversubscription in late 1993 for shares in Bank Slaski, the second commercial bank to be privatized of the nine state-owned commercial banks that were created on the establishment of a two-tier banking system.

Developments toward the end of 1993 and into the early part of 1994, notably a marked reversal in the deterioration in the trade balance and a strengthened international reserve position, indicate that excess demand pressures had significantly abated. Indeed, the balance of concern was shifting to the possible emergence of cost-push pressures. In particular, consumer price inflation accelerated late in the year—the average monthly rate of increase in November and December was about 5 percent. In addition, wage increases, which are typically high at year-end, may have been somewhat larger than expected, possibly reflecting an anticipation of a more relaxed attitude on the part of the incoming Government as regards incomes policy. Balancing these concerns, much of the spurt in consumer price inflation can be traced to one-off increases in meat prices due to supply disruptions; inflation moderated to more typical levels in January and February 1994.

Assessment

With all the developments that have occurred over the past four years, it is important not to lose sight of the major accomplishments that have been achieved as Poland progresses on the transition path to a market economy. Specifically:

- The 1990 transformation program was introduced in difficult circumstances and, in particular, against the background of large and growing macroeconomic imbalances. The combination of policies has succeeded in dramatically reducing and containing those imbalances.
- An indicator of the success at the aggregate level has been the sharp reduction that has occurred in inflation from the near hyperinflationary levels of 1989 to about 35 percent a year in 1993. Reflecting this development, confidence in the zloty is being restored and the economy has begun to remonetize.
- Reflecting the impact of comprehensive liber-

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alization, the shortages and queues of the 1980s have vanished, and the range and quality of goods available have dramatically improved.

- Poland has acquired a vibrant and growing private sector, with about 50 percent of output generated outside the public sector. In addition, the financial performance of many state enterprises has greatly improved in advance of their privatization.
- The liberalization of Poland's trade regime has resulted in an outward-oriented economy that is looking to exports for growth.
- Finally, and most obviously, economic activity in Poland has been expanding for more than two years.

Future Agenda

While the policies pursued so far in Poland's transition to a market economy have had major positive results, it is clear that much remains to be done. Although the specifics may change, the tensions intrinsic to the transformation program remain. The momentum of structural reform needs to be sustained, both because it is important in its own right and because the ultimate success of stabilization policies depends on continued progress with such reform; however, the social costs of transformation remain high, triggering legitimate demands that policies alleviate the burden of the transition.

Against that background, and considering the agenda for further reform, two aspects stand out. First, to ensure that the economy will continue on a path of sustained growth, the focus increasingly should be on encouraging an increase in national savings in general, and private savings and financial intermediation more specifically. Such a focus indicates the urgency, among other things, of pension reform and of reforms that would work to improve the efficiency of financial intermediation. At the same time, the authorities have indicated the need to target existing transfer programs more efficiently so as to facilitate assisting those most in need and to strengthen administration to ensure that the tax system is effectively extended to all groups in society, notably including those in the private sector.

Second, despite the evident progress on the supply side, including the improved financial performance of many state enterprises, serious problems remain in some of the core industries of the Polish economy. In particular, certain sectors, for example, the coal and defense industries, still face the need for major adjustment. At the same time, it must also be recognized that the process of ownership transformation still has a long way to run.

* * *

The sections that follow cover a range of topics selected to highlight the issues that have arisen as the Polish economy moves from a centrally planned regime to a fully functioning market economy. The first sections focus on issues associated with macroeconomic stabilization. Section II discusses all the reforms that have been implemented to put the state budget on a sound basis and documents in particular the success Poland has had in implementing a modern tax system. Section III considers the parallel developments that have influenced the conduct of monetary policy, describing, in particular, the increased sophistication of Poland's financial markets while at the same time outlining the structural problems that remain. Section IV describes the role played by exchange rate policy, bringing out the tension between the use of the crawling peg exchange rate regime as an instrument of monetary policy to reduce inflation and the desire to maintain Poland's international competitiveness.

The next sections focus more on the microeconomic foundations of the supply response in Poland. Specifically, Section V reviews the rapid pace of domestic market reforms, including price liberalization and progress with ownership transformation. The section also documents the actual trends in the various sectors of the Polish economy. Section VI describes developments in Poland's external accounts and, in particular, stresses that while Poland's trade has developed very rapidly, progress as regards integration into international capital markets has been much less.

A final section addresses the question of the social costs of transformation and, in particular, discusses the merits of the various indicators being used to gauge the impact of the reform process and to identify those most adversely affected.

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