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Poland's Quest for Economic Stabilisation, 1988–91: Interaction of Political Economy and Economics

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> This is perhaps the place to emphasise that, however much one may wish for a speedy return to a free economy, this cannot mean the removal at one stroke of most of the wartime restrictions. Nothing would discredit the system of free enterprise more than the acute, though probably short-lived, dislocation and instability such an attempt would produce.
>
> Hayek (1944, p. 209n)

> Both the economic logic and the political situation argue for a rapid and comprehensive process of transition. History in Eastern Europe has taught the profound shortcomings of a piecemeal approach, and economic logic suggests the feasibility of a rapid transition. Moreover, the macroeconomic situation is deteriorating in many countries, and therefore requires urgent attention.
>
> Lipton & Sachs (1990, p. 99)

POLAND'S JANUARY 1990 STABILISATION PROGRAMME has attracted widespread attention.[1] It is so far the boldest attempt to transform a socialist economy suffering from a high degree of instability (inflation and shortages) into a stable capitalist economy. It thus involves two separate components—macroeconomic stabilisation and systemic reform. In this paper we are concerned with the first component.

The 1990 Stabilisation Programme, however impressive, cannot be considered in isolation. Prior to January 1990 there were at least two years of intensive attempts at reform. Reforms failed, either because no minimal social consensus could be achieved or because they were badly designed. However, they hold lessons for other countries that may follow the same road as Poland. Their failure also paved the way for the much more ambitious project in January 1990.

This paper is organised in four sections. In the first two we examine respectively the Price and Income Operation of February 1988 (the so-called 'second stage of reform'), and the change in policy that ensued under the Rakowski government, including the removal of food subsidies, in August 1989. The third section discusses the January 1990 Stabilisation programme and the fourth presents conclusions.

The Failed Price and Income Operation
(November 1987–October 1988)

In the past 40 years Poland has experienced several attempts to reform its centrally planned economic system. They have all been at best no more than moderately successful and the system has shown a remarkable tendency, once the initial impetus of the reform movement slackened, to drift back to its old *modus operandi*. In the 1980s the reform effort commenced in 1982 and 1983 under the very difficult circumstances of the State of War. Since the economy, owing to intense shortages, was at that juncture in an almost chaotic situation, the first reflex action of the government was to increase central controls. Meanwhile, the government clearly expressed its view that recentralisation should only be temporary, and that its strategy remained a movement toward a more market-oriented system where enterprise decision making would be to a large extent free from state interference. Some important changes were implemented in these years, notably the slashing of subsidies and the price readjustment,[2] but the reform soon ground to a halt.

In October 1987, in an effort to inspire the reform movement with renewed energy, the Messner government, with strong economic guidance from the Deputy Prime Minister and Head of the Central Planning Commission, Professor Sadowski, inaugurated the so-called second stage of reform. It was complete with an ambitious and detailed timetable for administrative reorganisation as well as with legal and policy changes to be implemented.

The reform was supposed to deal with one of the perennial problems in all centrally planned economies—price distortions. It had a long list of predecessors, the major ones being the price reforms of 1970, 1976 and 1982. A number of prices in Poland were 'social prices', deliberately held below equilibrium levels in order to protect consumers. This was the case with food, agricultural inputs (fertilisers, pesticides), all types of energy inputs, transport and rents.

The government decided in the second half of 1987 that it needed to move decisively in the price area and, in order to enlist public support, it submitted to a popular referendum the plan on sharp price increases for most of the subsidised products. In the referendum held in November 1987 the proposal failed to gain the required 50% majority of all eligible voters, although among those who voted the proposal was accepted by a 2 to 1 margin. In the face of this result the government decided to scale down its initial plans and to proceed with a more cautious price reform.

Macroeconomic developments in 1988 were dominated by what became known as the Price and Income Operation. It not only represented the key plank in government economic strategy for the year, but the key element of the reform process as well. As we shall see, for a number of reasons the operation went awry and eventually failed. Yet its reverberations, and the developments to which it gave rise, dominated the economic scene in 1988 and, to some extent, all the period up to the Stabilisation Programme of January 1990.

The essential idea behind the Price and Income Operation launched in February 1988 was to raise prices of foodstuffs, household energy, rent, and alcohol and tobacco, and to compensate (most) workers for the increase in the price index net of the part due to alcohol and tobacco. The government tried to achieve several objectives:

(i) to tackle the sensitive issue of relative prices and to eliminate some of the most egregious disparities that have serious effects on allocation decisions in both consumption and production (e.g. low coal prices);
(ii) to impose a somewhat hidden reduction in real wages (by not compensating for the entire change in the price index), and thus to reduce excess aggregate demand; and
(iii) to improve its fiscal position by raising more taxes (via increased prices of alcohol and tobacco), and by lowering subsidies.

The Price and Income Operation, together with other government actions (creation of a commercial banking system, reorganisation of the state administration, reduction in the scope of central planning and liberalisation of the trade system), was supposed to restart the economic reform which had stalled in the period 1984–87.

In the event, the government failed to achieve its objectives. The main cause of the failure lay in inability to stem extremely high 'compensatory' wage demands which followed in the wake of raised prices. Vocal demands by workers, reinforced by strikes, led the government to allow substantial wage increases that by March 1988 were already running ahead of inflation. In March wages in the socialised sector, measured on a month-to-month basis (March 1988 to March 1987),[3] were 67% higher while prices (measured the same way) increased by 57%. The gap remained unchanged after strikes in May 1988, and then after a series of fresh strikes in August 1988 increased to more than 20 percentage points (see Figure 1).[4] In the last months of the year the gap grew further and by the end of 1988, wages had increased by 156% and retail prices by 73%.[5]

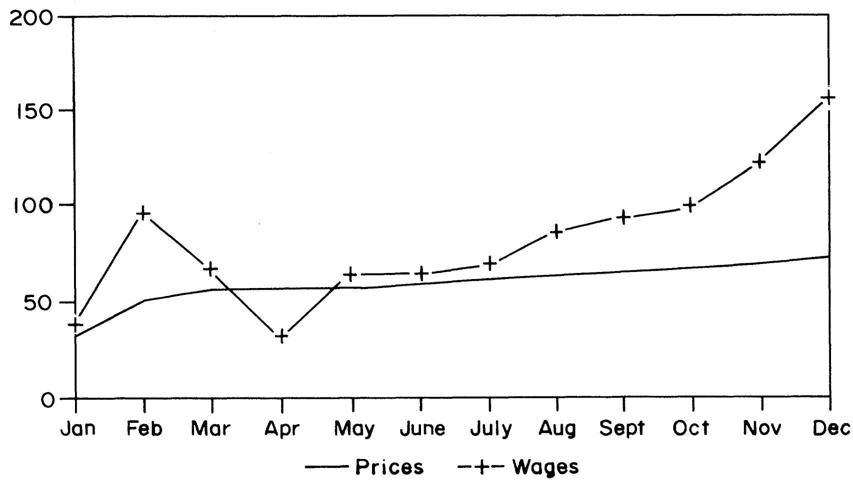

FIGURE 1. Rate of growth of wages and prices (month-on-month): 1988.

Instead of a decline in real wages and reduced excess demand the very opposite situation ensued. Price disparities had remained more or less unchanged. The real amount of subsidies increased by 2% and the share of total subsidies remained at the high level of 15% of GDP. Among the subsidies, food subsidies, which were to be curtailed, increased by 56% in real terms.

The mismatch between the purchasing power of the population and the availability of goods, often at controlled prices,[6] resulted in growing shortages. The supply of consumer goods in particular could not keep pace with the increase in incomes: while retail sales increased by 3% in real terms, total incomes of the population (composed of wages, social benefits, agricultural incomes and non-agricultural private sector incomes) went up by almost 15%.

Since price controls were not removed, inflation was not allowed to mop up the entire amount of excess liquidity. Excess money balances found their outlet in the parallel market for foreign exchange. The parallel exchange rate of the zloty with respect to the dollar soared during the year by 160% (see Figure 2). The official exchange rate broadly kept pace with the increase in prices until August 1988 but then fell increasingly behind. The ratio between the parallel and the official rate, which during the previous year and a half fluctuated between 3.5 and 4.5, increased in August 1988 to 5, and reached almost 7 by the end of the year. Some devaluation of the parallel rate was due to political events and fear of instability at the time of each major strike movement. Most of the increase, however, was attributable to the rapid rise in incomes. With shortages of goods, few opportunities for private investment, and negative real interest rates on zloty deposits, foreign exchange proved to be the safest way to protect savings.[7] A simple regression for the period 1987–88 (on monthly data) shows that each percentage increase in real wages was associated with 0.9% real devaluation of the parallel exchange rate.[8] In normal circumstances the effect of the increase in real wages on the exchange rate would be only indirect: through an increase in domestic costs and worsening trade balance. In the Polish situation the impact was almost immediate since foreign exchange served as the main store of value.

Excess liquidity also exerted a negative impact on external equilibrium. In the last months of the year imports increased (partly as a result of a government decision to increase the supply of consumer goods in order to alleviate shortages) while export growth, owing to an easy home market and real appreciation of the official exchange rate, decelerated.[9]

In May 1988, faced with a situation that already seemed to be running out of control, the Sejm gave the government extraordinary powers. The principal objective of that move was to stem the accelerating rate of inflation. This was to be accomplished mostly by administrative means such as more difficult access to credit for enterprises that increased wages excessively, dismissal of managers by the government, expansion of the obligatory price increase notifications and lengthening of the approval period. These measures were the direct antithesis of the avowed aim of economic liberalisation. The government was yet again obliged to move in a vicious circle: starting with piecemeal liberalisation that should have been a prelude to a comprehensive liberalisation, it was led by events to a position where it needed to reassert its role in the hope of reversing negative trends in the

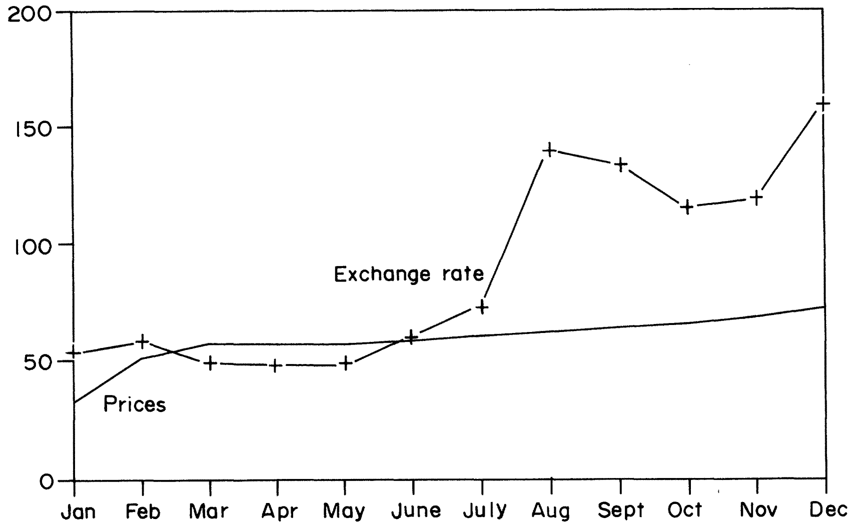

FIGURE 2. Rate of growth of prices and parallel exchange rate (month-on-month): 1988.

economy, and was thus undermining the original intent of the reform. Most of the extraordinary powers were never used, nor were government decisions always implemented. For example, viewing domestic disequilibrium with alarm, the government decided in May 1988 to press enterprises to increase their deliveries to the domestic market. It decided that only enterprises that kept their domestic deliveries at a level at least equal to that achieved in 1987 would enjoy export incentives. The measure originally created some stir among export-oriented firms, but was never seriously implemented. It was, in addition, in direct conflict with another objective of government policy—increasing convertible currency exports. Similarly, the existence of wage increase thresholds which were supposed to trigger punitive tax rates was quietly forgotten.

It seems that while originally the government had a relatively coherent policy in mind and tried to steer the economy in a definite direction, after May 1988, despite its enhanced powers on paper, it was mostly reacting to events, and to some extent drifting. This became even more obvious when the next round of strikes occurred in August 1988. The worsening economic situation led in October 1988 to the replacement of the Messner government and the resignation of the main architect of the Price and Income Operation, Professor Sadowski. The new government was led by Mieczyslaw Rakowski, previously Secretary-General of the party.

The failure of the Price and Income Operation can be traced to several causes, the relative importance of which is difficult to determine. It can be argued that the operation itself was bound to fail as it was not comprehensive; notably, the exchange rate issue was left practically untackled,[10] the trade regime was unchanged, price controls remained pervasive, and interest rates were strongly negative in real terms. The whole operation had a whiff of administrative tinkering about it.

On the other hand, it can be argued that the main cause of failure lay in inability to resist wage increases and in willingness to underwrite them through credit subsidisation of enterprises. The average interest rate charged on credits to socialised enterprises was 11%, that is minus 30% per annum in real terms. The room for burgeoning wage payments was thus created thanks to implicit subsidisation of credits.[11] Transfers through implicit interest rate subsidies were estimated at 10.3% of GDP (four percentage points higher than in 1987).[12] Responsibility for the interest rate policy lay with the National Bank of Poland (NBP), whose relations with the main architects of the reform were strained. Reformers were not able to control the policy of the NBP. Furthermore, enterprises continued to accumulate arrears against the banking sector and the amount of inter-enterprise credit increased by a quarter in real terms. The financial position of enterprises improved (gross profits increased by 10% in real terms). All this, plus inadequate depreciation allowances, allowed enterprises to raise wages without relation to productivity. This was all the easier because of the existence of significant *ex post* subsidies (and taxes) that tended to equalise the performance of profitable and unprofitable firms.[13]

Since negative interest rates entailed only minor *explicit* subsidisation by the government, the fiscal picture appeared good. The government deficit that amounted to 2.5% of GDP in 1987 was practically eliminated in 1988, thanks mostly to buoyant tax revenues (driven by increased profitability of enterprises).

This means that there were two components to the failure of the February operation: (1) letting wages rise and (2) paying this higher wage bill out of implicit credit subsidies. This is very similar to the inflationary mechanism which by 1988 was quite common in Yugoslavia.[14] As a number of authors have argued (Pant & Lahiri, 1988; Mates, 1987; Rocha, 1989) these channels were inadequately understood until the Yugoslav Stabilisation Programme of December 1989. It seems that the IMF, which throughout most of the 1980s had stand-by programmes with Yugoslavia, was similarly unaware of the problem. Being concerned primarily with the objective of external equilibrium, the IMF might have emphasised devaluation without realising sufficiently its impact on implicit exchange rate subsidies and thus on inflation. In other words, in addition to the usual channels whereby devaluation causes inflation (cost-push), in Yugoslavia there was also the implicit subsidy element that proved an even more potent source of inflationary pressure. The question may be raised whether sufficient attention was being paid by the IMF to a similar mechanism operating via interest rate subsidies in Poland. It is difficult to determine conclusively whether it was or not. However, there is a marked contrast, in terms of the attention paid, between the need for external adjustment (achieving current account balance in convertible currencies) and the discussion of macro-economic mechanics at work. There is no evidence that the dangers of subsidisation that would ultimately derail the programme and undermine the objective of external adjustment were fully comprehended.

The programme definitely came unstuck in August 1988 following a series of strikes. The inability to resist the wage push was rooted in the government's lack of political strength; its fear of social disorder. Thus, the failure of the Operation was inevitable so long as workers were unwilling to accept a decline in real wages, and the government was too weak to hold the line.

The Decomposition of the System (October 1988–September 1989)

Significant changes in the economic system already started under the Messner government. They included phasing out of the central planning system, decentralisation of the banking system, introduction of the first drafts of laws that equalised treatment of all forms of property and allowed private individuals to purchase and issue bonds and shares and thus to create joint stock and limited liability companies. Most of these laws were adopted by the Sejm under the Rakowski government, often in a more liberal version. For example, the draft bill on 'Undertaking Economic Activity' at first limited private sector employment to 50 workers; under the Rakowski government the limit was removed. The draft law similarly envisaged a greater number of areas closed to the private sector. The number of 'forbidden areas' was later reduced (publishing, for example, was originally on the banned list).

The legacy of the Rakowski government is ambiguous. It is positive in the area of institutional change since almost all impediments to private sector development were then lifted. The three fundamental laws, on undertaking economic activity, on foreign investments and on banking, were passed during the Rakowski government. Limited internal convertibility of the zloty was introduced in March 1989. Purchases and sales of foreign exchange between citizens, which in the past had been legally prohibited even if tolerated, were legalised and private individuals were allowed to open foreign exchange offices. 'Spontaneous privatisations' also started in the first half of 1989. The importance of central allocation of inputs decreased. Central allocation now applied to only a handful of essential items (coal, coke, crude oil, paper pulp, etc.), in contrast to about 22–25% of total intermediate inputs in 1988. Finally, a major operation of lifting of food subsidies was also executed at the end of the government's tenure in August 1989. In the area of macroeconomic management, however, the legacy is almost entirely negative since the economic situation deteriorated markedly.

Macroeconomic instability became worse in the last months of 1988 and continued in 1989. Monthly increases in the retail price index that in 1988 oscillated between 3% and 7% (with the exception of February, when the Income and Price Operation was launched) accelerated to about 10% in the first half of 1989. Wages continued to outdistance prices and by July 1989 were about 25% higher in real terms than a year before (see Figure 3). The official exchange rate appreciated in real terms between January and September by 9% (see Figure 5 below). Real interest rates became even more negative: the *highest* interest rate charged on enterprise credits in the first half of the year was −36% per annum in real terms; the interest rate on credits to the government proper for financing the state budget was −53% per annum. The rate of growth of industrial output steadily declined and by mid-year reached zero.

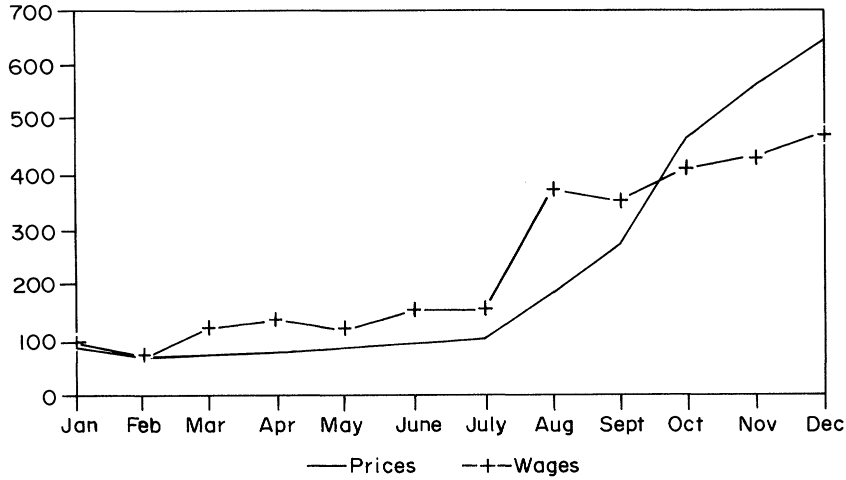

FIGURE 3. Rate of growth of wages and prices (month-on-month): 1989

The fiscal position of the government deteriorated sharply owing to several factors: (a) acceleration in inflation reduced real tax revenue;[15] (b) tax reform combined with stagnation of output generated lower revenue; and (c) expenditure increased as food subsidies snowballed owing to higher agricultural procurement prices.[16] The fiscal deficit, which in the first nine months of 1989 amounted to more than 10% of GDP (on an annualised basis), was financed mostly by National Bank lending to the government.

Shortages were exacerbated and the ratio between parallel and official exchange rate stayed between six and seven. Currency substitution, already present in 1988, became more widespread, with the result that two-thirds of broad money consisted of dollar-denominated deposits held by enterprises and the population.[17] The economy was exhibiting all the typical features of accelerating inflation (increasing velocity,[18] declining stock of real zloty) threatening to burst into hyperinflation. As output was stagnant, the gap between the purchasing power of the population and the supply of goods was increasing. This was the situation of *shortage–stagflation.*

The external position, which began to worsen in the last quarter of 1988, slipped further. The trade surplus with the convertible currency area was halved: from almost \$1.1 billion in the first ten months of 1988 to \$570 million for the same period a year later. The deterioration occurred in response to real appreciation of the official exchange rate, but was also due to the deliberate government policy of increasing imports in the months prior to the June 1989 elections (the first multi-party elections since 1947). Soaring imports of consumer goods were also supposed to mop up some of the excess liquidity.

The question arises why the Rakowski government allowed the economic situation to deteriorate in such an unambiguous fashion. Different views were advanced. In part, the government's hands were tied since the 'Round Table' talks between the government and the opposition that lasted throughout the first quarter of 1989 introduced the principle of wage indexation (at first at 80% of price increases). It was difficult for the government—which enjoyed no more popular support than its predecessor—to renege on that. Secondly, the government continued with the earlier strategy aimed at changing relative prices. This necessitated particularly sharp increases in prices of energy inputs (electricity, heating and fuels). It also proceeded to further price liberalisation, so that about 50% of retail prices were free.

According to a different view, the Rakowski government deliberately pursued the policy of high inflation. Because of the elections the government let wages increase even faster than was implied by the indexation formula[19] (thus, in June alone real wages increased by 9%). Also, the government might have held that only through inflation could it effect structural changes. Since it assumed that most prices were inflexible downward, it concluded that higher relative prices of some products inevitably required a generalised increase in the price level. It probably overlooked the point that in an inflation that so quickly threatens to degenerate into hyperinflation all signals about relative profitability are lost in a cacophony of rising prices, and relative price changes become undistinguishable from the changes in the overall price level.

The economic situation in July 1989 (after the electoral defeat of the communists) reached its nadir. Amid growing shortages (including those of food) the inflation rate, on a month-to-month basis, reached a three-digit level, for the first time since 1982, while the cumulative growth in industrial output was 0.2%.

The last decision of the Rakowski government was a courageous one. With very little to gain from it, the government decided in August 1989 to proceed with an action that had eluded all previous governments: to practically eliminate food and agricultural input subsidies in one fell swoop. The two were *quid pro quo*. Output prices could be liberalised only if farmers accepted that their input prices would be raised as well. The decision took place in conditions of food shortages and its immediate effect was a doubling of food prices and an increase in the rate of inflation (39.5% in August alone). It was ironic that a decision which eluded all previous communist governments and cost several of them office (after the disturbances in 1970, 1976 and 1980) was finally executed in the last month of communist rule in Poland. (On 16 September Mazowiecki became Prime Minister.

In the political arena, in particular, the legacy of the Rakowski government is subject to different interpretations. It can be argued that the lack of success of the Price and Income Operation, coupled with similar failures in the past, convinced the Rakowski government that it essentially had two options. Either it needed to define a new economic policy designed to stimulate private sector growth or it had to proceed with political liberalisation.

Under the first option, liberalisation would be limited to the economic sphere. Since most social groups were already alienated from the government, the nascent private sector would be the stratum on which the government could count. The idea found favour with economic liberals[20] even if the new policy were to benefit not only the legitimate private sector but, possibly even more, the *nomenklatura* which sought to convert its political clout into economic power. As Walicki (1989, p. 362) writes:

> [liberals] distinguish between the post-totalitarian economic system and the post-totalitarian ruling group, seeing the latter... as thoroughly de-ideologised, deeply disappointed with the existing system and no longer identifying their personal and group interests with its maintenance.

Liberals were ready to support consistent marketisation, holding (probably rightly) that it would quickly lead to depoliticisation of economic life and the re-emergence of the rule of law. The Krakow Industrial Society exemplified this attitude. Liberals also believed that the second option, immediate political democracy, was too risky and held a strong promise of populism. Following Hayek, they might also have thought that, if choice needed to be made between economic and political freedom, the former was more important because more fundamental and more relevant for everyday life.

It is one of the mysteries that remains for political scientists and historians to solve why this option failed despite strong support, based on a coincidence of interests, by the official circles of reformers, economic liberals, and one part of the opinion-forming elite. To many observers the Round Table talks, ending not only in legalisation of Solidarity but in partly free elections, foreshadowed the failure of this option since they ushered in political democracy that was incompatible with preservation of the communist party in power. But there are indications too that the communists thought that they would succeed in squeezing an honourable electoral result, thus allowing them (with rules giving them an almost instant majority in the Sejm) to retain power.[21]

To a spectator, it seemed at times that the communists viewed the Round Table talks and free elections as another manoeuvre in attempting to coopt society, without realising that they were actually putting their power at stake. Maybe their long period in power, punctuated by numerous 'carrot' and 'stick' operations, designed alternately to cajole and to menace the population, made the communist leaders almost impervious to the idea that power could be lost. Believing that they were involved in another of the periodic thaws, they effectively connived in surrendering power. When the outcome became clear, their demoralisation and 'fatigue of governing' prevented them from taking measures that they indubitably would have some 20 years earlier. The period of economic liberalisation had permitted one part of the *nomenklatura* to find relatively lucrative positions: they had less to fear from the change of system and thus less to defend.

The Rakowski government vacillated between the two options: economic liberalisation alone or democratisation. As Ryszard Bugaj recently put it, 'I wonder whether the Rakowski government opened the door to a new Poland or made the attempt, the last attempt, to prevent Poland's transformation'.[22] The bill on the responsibility of the Rakowski government for the marked deterioration in economic performance states essentially the same: 'Rakowski's government, in its short tenure, undertook efforts at partial modernisation of the social and economic system. However, attempts to modernise economic rules were not accompanied by social conditions facilitating economic change'. It seems that the

Rakowski government originally opted for the first solution (economic liberalisation alone) but was then, often reluctantly, pushed by the unfolding events towards the second option: democracy.

The Balcerowicz Stabilisation Programme (January 1990–January 1991)

The most important developments *prior* to the introduction of the Stabilisation Programme (that is, in the period September–December 1989) were the decline in real wages and real devaluation of the official exchange rate. During the last quarter of 1989, real wages decreased by about 16% (Figure 4), and about one-third of the eventual real wage reduction was already achieved by January 1990. The real (official) exchange rate was steeply devalued between October and December—from 1775 zloty per dollar in October to about 5200 zloty in December, so the number of zloty per dollar increased by a factor of three while the retail price index increased by 44%.

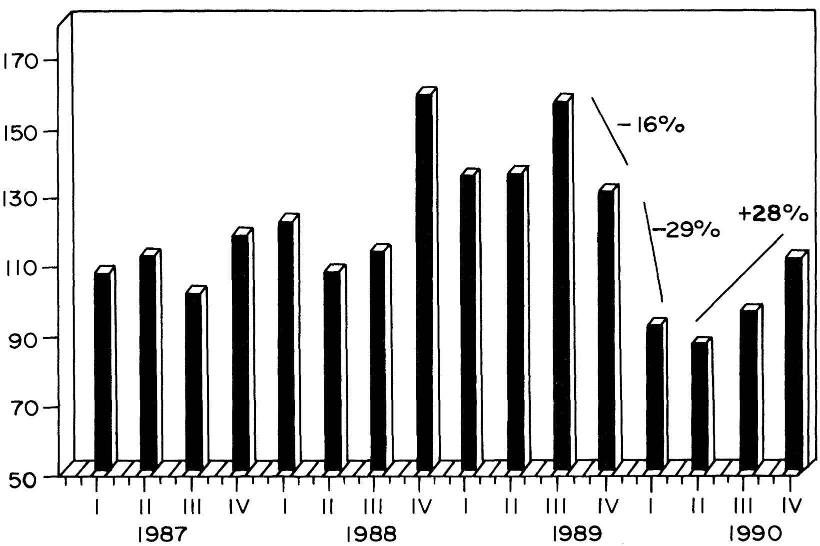

FIGURE 4. Real wage level (quarterly average).

Price increases in September and October were already at the hyperinflation stage, fueled to a large extent by removal of subsidies on food and agricultural inputs. However, shortages and explosive price increases of food subsided in November as the EEC food help became more abundant. Moderation in the growth of food prices[23] provided an important and possibly indispensable cushion for the stabilisation programme by protecting the standard of living of the urban poor. By early 1991 the combined impact of food aid and reduced domestic demand was so strong that continuation of foreign food aid triggered complaints by farmers, who saw their output prices depressed while input prices kept on increasing.

High inflation over the six months prior to the stabilisation programme reduced real money balances (inclusive of foreign exchange deposits, M2X) by more than 50% and practically eliminated the stock of excess liquidity. The presence of that stock had traditionally made stabilisation difficult even when money incomes could be controlled and their growth held below the rate of inflation. The control in effect pertained only to the flow, while the stock of existing involuntary zloty savings soaked up all the forthcoming supply of goods. A 'demand barrier', such that producers would cease to consider their market guaranteed and would have to compete for customers and reduce prices, was unlikely to appear so long as huge undesired monetary balances were held by the population. The Balcerowicz programme was thus greatly helped since inflation had practically wiped out the excess balances.

Finally, the fiscal position of the government improved in great part due to reduction of subsidies (after food, some energy subsidies were cut in October), and increases in prices of alcohol and tobacco, so that the year ended with a budget deficit of 6.8% of GDP (versus 10% of GDP by September).

It was against such a backdrop that the Balcerowicz Stabilisation Programme was officially launched in January 1990. It can be considered a heterodox programme since it included a fixed exchange rate (at the level of Zl 9500 per dollar, unified with the parallel rate) and an incomes policy.[24] Wage growth was to be controlled by under-indexing enterprises' wage bill. Using the wage bill rather than the average wage was motivated by the belief that this would give enterprises an incentive to shed labour and to increase wage differentiation (within enterprises) in order to retain their better workers. The effect of restrictive policies on output growth would thus, it was thought, be lessened. At the inception of the programme a number of energy prices were sharply raised: coal by between five and seven times, electricity and gas by four to five times, and central heating by five times. These prices and a few others (transport), as well as the exchange rate, were then fixed for at least six months. For the remaining prices (comprising 90% of GDP) price controls were lifted.

The programme included substantial fiscal adjustment. Subsidies were further streamlined,[25] with the objective of bringing them down to a level of some 5% of GDP (as against 15% and 12% respectively in 1988 and 1989). The total extent of planned fiscal adjustment was around 6% of GDP: from a deficit of 7% of GDP in 1989, the government aimed to achieve a deficit of only 1% in 1990. Aggregate demand was also reduced through the wealth effect. Unification of the official and parallel market rates produced an important real appreciation of the parallel rate (see Figure 5). The population (and enterprises), whose holdings of foreign exchange amounted to probably $7–8 billion, incurred substantial real capital losses[30] in terms of zloty purchasing power.

Interest rate policy was to be entirely overhauled. Net domestic assets of the banking system (the IMF performance criterion) were supposed to increase by 20% in nominal terms in the first quarter of 1990. As the price jump in January proved much stronger than expected (79%), monetary policy turned out even

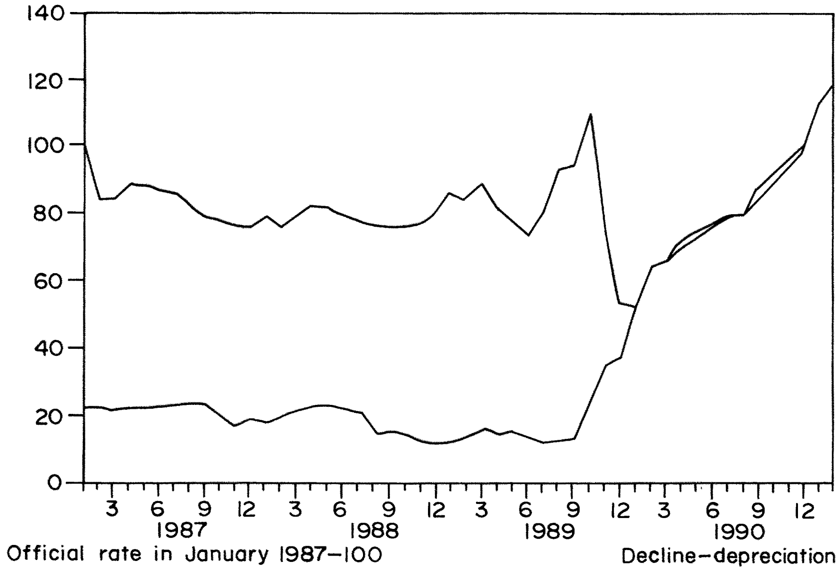

FIGURE 5. Official and parallel real exchange rate.

more restrictive than originally anticipated.[27] The real interest rate (measured by the discount rate) became positive from March 1990 (see Figure 6). From the beginning the intention was to reduce rates in nominal terms in line with the declining rate of inflation.

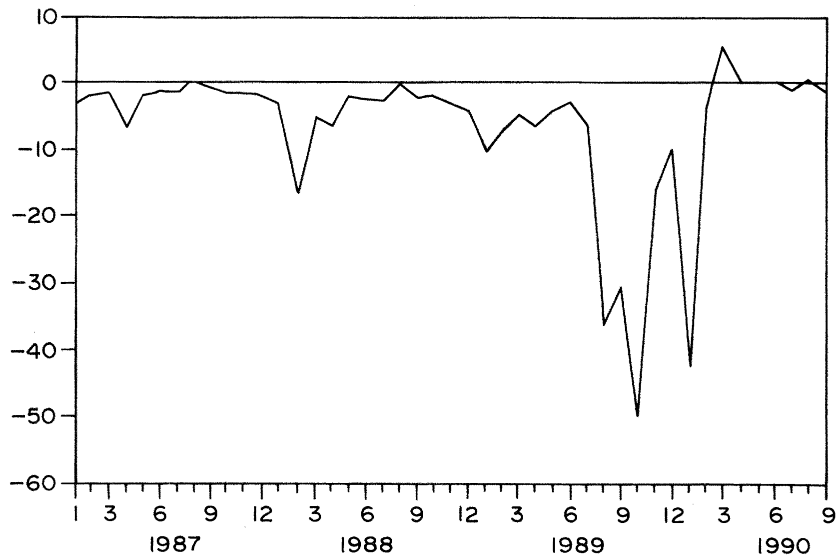

FIGURE 6. Real discount rate (per month).

If one compares the Balcerowicz programme with the Price and Income Operation of February 1988, it emerges that the Balcerowicz programme was both more comprehensive (e.g. foreign trade reform was hardly mentioned in 1988) and more consistent. It included a substantial initial real devaluation of the official exchange rate, which deliberately represented somewhat of an overshoot. This was done in order to avoid over-valuation later, as inflation would inevitably continue for a few months. Parallel and official exchange rates were unified (as current account convertibility of the zloty was introduced) almost exactly at the mid-point between the two rates (see Figure 5). The pegged rate of Zl 9500 per dollar was apparently well chosen: the country's foreign exchange reserves were not depleted. On the contrary, net reserves increased in the first half of 1990 by $3 billion and the parallel and the official rate did not diverge. In February 1988, in contrast, there was no real devaluation of the official exchange rate. Interest rates, as we have already seen, were made positive in real terms virtually from the beginning of the 1990 programme. Thus, one of the key channels through which inflationary pressures were allowed to propagate in 1988 was now closed off. Finally, price controls were lifted, allowing markets to function, while stringent fiscal and monetary policy were supposed to keep a lid on inflation. The designers of the Balcerowicz programmes were certainly aware that in the Price and Income Operation price controls were responsible for growing shortages.

In drawing positive parallels between the Balcerowicz programme and its predecessor, one must give due acknowledgement to differing political circumstances. We have argued above that possibly the key reason for the failure of the Price and Income Operation was political unwillingness (or impossibility) to resist wage increases, combined with inability of those who designed the programme to control the accommodating policy of the National Bank. The Balcerowicz programme was helped by (a) willingness to tolerate unemployment that inevitably appeared as restrictive fiscal and monetary policy began to take hold, (b) ability to extract real wage decreases, (c) existence of the $1 billion stabilisation fund to defend the zloty. In February 1988, the first two elements were politically unacceptable, and the third did not exist.[28]

The effects of the Stabilisation Programme began to be felt from the moment of its introduction. While inflation exploded in January following increases in prices of energy and infrastructure, the monthly rate then consistently fell, reaching less than 2% by August (see Figure 7). Wages, less than fully indexed, declined between January and August (when they reached the trough) by 36% in real terms. The share of foreign exchange deposits in money supply was sharply reduced, even if currency substitution was not reversed but only arrested.[29] A tight monetary stance was maintained as both M1 and M3 decreased in real amounts in the first half of the year. (The assumption is that demand for money increased owing to declining inflation.) Finally, budget revenues behaved even better than expected (the reversed Tanzi effect). In the first six months the budget registered a surplus of some 3% of GDP (at an annual rate) and remained in surplus for the year as a whole. Revenue increased thanks to higher turnover tax (the basic rate was raised from 15% to 20%), elimination of most tax reliefs, and better than expected financial performance of enterprises.[30]

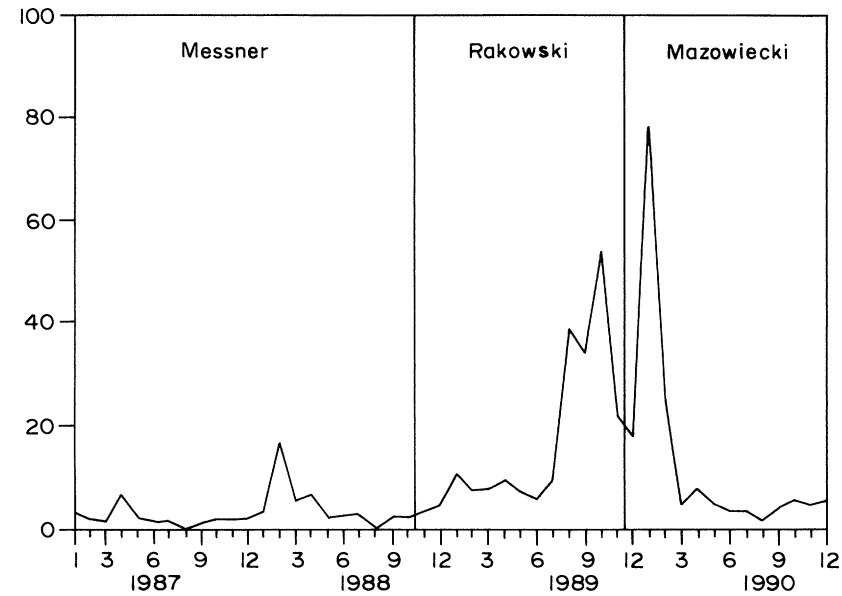

FIGURE 7. Monthly rate of inflation.

The two much-quoted negative effects of stabilisation are unemployment and a drop in industrial output. The number of unemployed reached 1.2 million by the end of 1990, three times as high as the government's original forecast. State sector industrial output dropped by about 25% (in comparison with 1989) immediately after the introduction of the programme and stayed more or less the same thereafter. Since employment in the socialised sector decreased by only about 10%, productivity per worker also declined.

While one part of the decline in output is statistical (the growing private sector is statistically poorly covered, retailers might have overreacted to initial decreases in demand by drawing down stocks and delaying new orders, etc.) or is irrelevant (a number of products were unwanted or of very bad quality), its severity was greater than anticipated. A possible explanation may lie in the monopolistic nature of the Polish economy, where cuts in output by one and often the only buyer or supplier affect a number of downstream and upstream enterprises, which must also reduce production. The massive trade liberalisation that was part of the stabilisation programme helped both by providing alternative sources of supply and by stimulating exports but the time left to domestic producers to adjust to foreign competition was probably too short. The output decline was most important in production of investment goods. This was due to weak investment demand: demand, in turn, was low because of high interest rates (at least relative to the past) and, more importantly, because of the unsettled question of industrial ownership. Workers and managers were understandably reluctant to invest since they could not be sure that assets might not be taken over by the state and sold to outside investors. Centralised state investment, owing to numerous earlier decentralisation measures, had become quite small (accounting for only 2% of GDP in

1989). Because of the fiscal situation, as well as the ideological preference of the new government, it was destined to remain so. Finally, new private investors were too few to make a big difference to overall investment demand (and they too were affected by uncertainty and high interest rates). The supply response that led to the 1990 real growth in convertible currency exports of 35% was probably the most successful feature of the stabilisation and contributed some five percentage points to the 1990 Polish GDP growth (which was nevertheless highly negative, estimated at -12%).

Rapid real wage decline, unemployment, and a drop in industrial output, juxtaposed to too optimistic promises of 'prosperity around the corner' made by some Solidarity leaders at the time of their assumption of power, had led by mid-1990 to the first open signs of dissatisfaction both in the media and among workers. The first strikes also appeared at that time. The rumblings of dissatisfaction, combined with Walesa's distancing himself from the Balcerowicz programme amid signs that a presidential campaign might be in the offing, might have persuaded the government to relax somewhat its monetary stance (increase in credits to the state sector) and allow larger wage increases.[31] Restrictions on wage growth were relaxed in July 1990. This did not take place through abandonment of the indexation formula itself, but by letting a number of enterprises increase their wage bill without punitive taxation. Enterprises that were allowed to do so were those that did not enjoy a monopoly position and had been converted into joint stock companies (even if they remained 100% state-owned), or private sector firms. Although the decision to release some enterprises from wage ceilings could be justified by pointing out that they could no longer automatically count on state bail-outs, and that the putative new owners (unclear though it was who they might be in state-owned firms) would have an incentive to keep wage growth on a short leash,[32] abandonment of tight incomes policies was also motivated by spreading workers' dissatisfaction and probably by the coming elections. By December 1990 real wages were 36% higher than in June (see Figure 4).

These were small improvements, however (from the immediate perspective of the population), and they proved insufficient to prevent Mazowiecki's convincing defeat in the November 1990 presidential election, which was widely seen as a referendum on the first post-Communist government, and in particular on its economic policy. Walesa, who has a reputation for sensing the swings in popular moods, probably judged rightly in laying emphasis on acceleration of systemic changes (including 'cleaning up' the former *nomenklatura* from their position of influence) and sounding some populistic economic themes. However, Walesa's later decision (after the elections) to keep the essential contours of the programme intact, as well as to keep its main architect as the Deputy Prime Minister, lends support to a different hypothesis; that his objective was not simply to take power, but to prolong the life of the programme by a somewhat tortuous strategy.

After Walesa's victory in the run-off election the Mazowiecki government continued as a caretaker government until the end of December, when Walesa proposed Bielecki to the Sejm as the new Prime Minister. Bielecki decided to keep Balcerowicz in his post of Deputy Prime Minister, thus indicating his desire to continue with a broadly unchanged stabilisation programme while accelerating privatisation.[33]

At the time of the induction of the Bielecki government, the 'integrity' of the 1990 Stabilisation Programme faced renewed pressures, both domestically and externally. On the domestic side, problems included a continued drop in industrial production, stubbornly persistent inflation oscillating between 4% and 5% per month (it rose to that level after the July 1990 monetary relaxation), slow privatisation, and increasing appreciation of the real exchange rate of the zloty (in February 1991 some 10% higher than the *official* rate at any time since 1987). This last point illustrates the importance of controlling inflation: if inflation continues the exchange rate becomes unsustainable; devaluation, however, leaves the programme without another nominal anchor (after the incomes policies were relaxed in the second half of 1990) and might usher in a fresh bout of inflation.

On the external side, the situation had substantially worsened in comparison to January 1990. Recession and disorder in the Soviet Union led to a decline in demand for Polish exports. These exports have very few alternative outlets, as some Polish enterprises had been exporting to the Soviet Union (and according to Soviet specifications) for years.[34] Furthermore, terms of trade with the USSR moved strongly against Poland in January 1991 when Polish–Soviet trade switched to convertible currencies. The Polish government expected that the switch to dollar trade would be preceded by several years of adjustment. It was estimated that the 1991 annual terms of trade loss for Poland would amount to $3 billion. German unification led to cancellation of deals already concluded between East German firms and Polish companies. Finally, the Gulf crisis had multiple negative effects on Poland. Iraq is a net debtor of Poland (owing some $400 million). Polish firms had been involved in construction works in Iraq; the increase in oil prices cost Poland an additional $300 million in 1990 alone. The only significant bright spot was forgiveness of some 30% (and possibly 50% if the IMF targets are observed) of Polish debt to official Western creditors. However, in cash terms, the current account improvement attributable to forgiveness is minimal since Poland was anyway servicing only a fraction of its debt. The key advantage of forgiveness is to facilitate new foreign lending investment.

The eventual fate of the Stabilisation Programme may hinge on political and external developments that are strictly speaking extraneous to the economic design of the programme, but one should not forget that all economic programmes take place within a political framework. Even the failure of the Income and Price Operation (whatever its design shortcomings) was ultimately due to political circumstances.

Conclusions

In the economic sphere the beginning of the end of communist rule in Poland probably started with the Income and Price Operation in February 1988. Even if this was a better thought out and a more comprehensive operation than the previous ones (1976, 1980, 1982), its eventual failure showed that the country could not be governed without an agreement with society. Significant changes of a systemic nature, both in economics and politics, were thus clearly seen as a *sine qua non* for the solution of the crisis. The Rakowski government was aware of this, and its approach was, it seems, two-pronged. In the economic arena, it proceeded to a number of deep institutional changes, virtually eliminating all limits on private sector activity; it began privatisation of state enterprises, introduced limited internal convertibility of the zloty, and created a two-tier banking system. In the political arena, its actions were more tentative, and it will doubtless be difficult, if not impossible, ever to determine how far Rakowski and the communist elite in power were willing to go in that direction. It can be argued that they were unaware exactly where their concession would ultimately lead them or even that they simply held too optimistic a view of their own popularity. In any event, the succession of events overtook those in power, and they had, however reluctantly, to surrender power. Rakowski's vow at the time of his induction as Prime Minister that, if he failed in his duties, he at least expected to 'fall from a tall horse', was fulfilled, although certainly not in the manner he envisaged.

The failure of the Price and Income Operation also had an effect on the economic thinking of policy makers. The main contours of a more ambitious programme that would later become associated with the new Polish Minister of Finance, Balcerowicz, were worked out under the Rakowski government. Despite critiques of its various aspects, the Stabilisation Programme launched in January 1990 survived its first year relatively well (the time when most stabilisation programmes fail).

At the time it was launched, the Balcerowicz programme enjoyed at least four facilitating conditions, all absent in 1988.

(1) Real wages declined by 16% between August 1989 and the launching of the programme; there was also willingness to let them slip further.
(2) Very high inflation, for about six months *prior* to the Stabilisation Programme, wiped out monetary overhang and made government policy easier since in order to control aggregate demand it was sufficient to concentrate on flows (nominal incomes and nominal supply of goods), without the need to be concerned with the stock of unwanted monetary balances.
(3) Substantial real devaluation of the zloty was achieved between October 1989 and January 1990. Unification of the official and parallel market rate was made easier. This resulted in a significant real appreciation in relation to the population's dollar holdings, thus producing a negative wealth effect and further restraining aggregate demand.
(4) Finally, the government was willing to tolerate the emergence of substantial open unemployment following enterprise restructuring and restrictive monetary and fiscal policies. This was possible only because the government felt sufficiently strong politically.

All the same, even if social conditions were at the root of the failure of the Price and Income Operation, the design of the stabilisation policies also markedly improved between 1988 and January 1990. There were at least three important differences.

(1) Increase in real interest rates up to positive levels (reached by March

1990—two months into the programme). This sealed off one of the key channels fueling wage increases and inflation in 1988.

(2) Almost complete price liberalisation. In 1988 price controls were responsible for shortages and high real devaluation of the parallel exchange rate, leading to an increase in the real money supply.

(3) Almost complete import liberalisation, which introduced the foreign competition needed to keep prices down.[35]

(4) Unification of the official and parallel exchange rates.

Turning now to the achievements and failures of the Balcerowicz Stabilisation Programme, let us consider the achievements first.

(1) Full and maintained current account convertibility of the zloty.
(2) An almost 35% increase in convertible currency exports, with the trade surplus reaching some 3.5% of GDP.
(3) Import liberalisation that is responsible for an incomparably better supply situation than in the past, and the emergence, for the first time since World War II, of a 'demand barrier', i.e. a buyer's market.
(4) Arrested hyperinflation, and budget surplus in 1990.

The programme, on the other hand, is criticised for:

(1) A sharp drop in industrial production (25% in one year).
(2) Persistent inflation (at 4–5% per month).
(3) High unemployment (rising from zero to more than a million in one year).
(4) Increased income disparities between successful private entrepreneurs and professionals and the bulk of workers and pensioners, whose real incomes dropped by about 30%.

The fate of the programme will depend, as before, on social acceptance of the policies, the speed of privatisation and restructuring (an issue that was not addressed in this paper) and on the impact that the deteriorating external environment will have on the fragile Polish economy. Lack of social acceptance of policies could be translated into another increase in real wages and/or an increase in credit to mitigate the decline of industrial production.

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[1] To mention only two excellent papers: Lipton & Sachs (1990); Rocha & Coricelli (1990).

[2] In 1982 a number of retail prices were raised in an attempt to mop up excess liquidity. The relative price of energy inputs was also increased. Inflation reached 105% and the real incomes of the population declined by 20%.

[3] This measure is used in order to adjust for fluctuations due to uneven monthly payments of bonuses.

[4] To make matters worse, agricultural procurement prices were raised in July in order to maintain parity between rural and urban incomes.

[5] On an average yearly basis, the gap is somewhat less: real wages increased some 15%. The conventionally calculated increase in real wages, however, overstates the real improvement in the standard of living because shortages became more acute in 1988. The same effect, but in reverse, reappeared during the stabilisation in 1990.

[6] There were three types of prices at that time: official, fixed by the government; contract, which were supposed to reflect supply and demand but for which the government either set a limit or imposed obligatory notification before an increase; and free prices. The proportions of output sold at these different prices were respectively 45%, 35% and 20%.

[7] The average interest rate paid on household deposits was 22%: with an average annual inflation of 60% this yields a real interest rate of about −24%. The yield differential between the zloty and foreign exchange was startling: real annual yield on the US dollar was +28% (valued at the parallel rate).

[8] The equation is:

$$\log PER = \underset{(0.00)}{8.789} - \underset{(0.00)}{0.898} \log W$$

with $\bar{R}^2 = 0.553$, where PER = real parallel exchange rate and W = real wage. Values under the coefficients show the significance level at which null hypothesis is rejected.

[9] In the last quarter of 1988 (compared with the same period of 1987) convertible currency imports of foodstuffs increased by 38%; imports of medicines and other consumer goods by 51% and 133% respectively. Convertible currency trade was in balance, compared with a $226 million surplus in 1987.

[10] There were some modest attempts to increase the percentage of foreign exchange kept by enterprises and to broaden the scope of foreign exchange auctions at which enterprises could freely sell and buy foreign exchange.

[11] At times enterprises used working capital loans to pay higher wages.

[12] See 'Poland: economic management for a new era', *The World Bank Report*, No. 7999-POL, p. 8.

[13] While pre-tax (and pre-subsidy) profit rates of socialist enterprises may be widely different, negotiated subsidy and tax settlements considerably narrow this range, and often turn money losers into profitable firms. See Kornai (1986) and Schaffer (1990).

[14] The difference, however, is that in Yugoslavia subsidisation of the enterprise sector took place through coverage of the exchange rate risk.

[15] The tax burden of the socialised sector decreased from 30.8% of GDP in 1988 to 20.1% in 1989.

[16] As the then Deputy Prime Minister, Sekula, explained in a recent testimony to the Sejm, procurement prices were raised to avert farmers' strikes. Quoted from Dryll (1990).

[17] Dollar deposits are converted into zloty at the parallel exchange rate (for household deposits) and the auction rate (for enterprise deposits). The stock of foreign exchange deposits kept on increasing continuously: from about $4 billion in 1987 to $6 billion by mid-1989. But even more important for boosting money balances was real devaluation of the parallel exchange rate.

[18] Income velocity of zloty held by the population increased from a stable level of 2.4 in the 1980s to 3.4 in 1988 and 4.75 by September 1989.

[19] The whole dispute about the indexation formula at that time had a slightly surreal touch. Arguments whether the coefficient should be less than or equal to 1 raged while real wages were clearly rising and the government was manifestly unwilling to restrain them.

[20] The word 'liberal' is used in its traditional (European) meaning: favouring extension of private sector freedoms and a minimal role for the government.

[21] There are at least two signs that can be interpreted to mean that the communists assessed their position relatively favourably: they argued for the majority voting system, even if it distinctly penalises small parties; and in the summer 1989, after the overwhelming electoral defeat, General Kiszczak was still seriously considering forming a new government, not doubting that the communists' erstwhile allies (the Peasants' Party and the Democrats) would change sides.

[22] Quoted in Dryll (1990).

[23] After November 1989 food prices increased less than the overall retail price index.

[24] A special stabilisation fund of $1 billion, provided by Western governments, was established to 'defend' the pegged exchange rate.

[25] The most important measures were the halving of medicine subsidies, reduction of subsidies to loss-making enterprises, a nominal freeze on subsidies to coal mines and elimination of non-CMEA export subsidies.

[26] Foreign exchange deposits in banks amounted to about $6 billion in December 1989, four-fifths of which were owned by the population. It was estimated that, in addition, between one and two billion were kept at home (see Krzyzkiewicz (1989, p. 29)). Between January 1990 and December 1990 the price level increased by 95% while the parallel exchange rate (now equal to

the official rate) fell by about 4%. The real loss to foreign exchange holders (measured in domestic currency) was thus between \$3.3 billion and \$3.8 billion (about 6% of GDP).

[27] See Rocha & Coricelli (1990, p. 14).

[28] Since the origin of the third was also political, it could be argued that all three elements were practically political.

[29] The share of foreign exchange in M3 decreased from 69% in December 1989 to 42% in June 1990. Data from Rocha & Coricelli (1990, p. 19).

[30] Their debts were practically wiped out in real terms during the hyperinflation period in the second half of 1989, and their profits soared. Profitability declined in the first half of 1990, but less than was anticipated. Enterprises were also able to evade tight monetary policies to some extent through inter-firm credit. See Gelb, Jorgensen & Singh (1991).

[31] According to many analysts (including Professor S. Gomulka, government economic adviser) there is an intimate relationship between monetary and wage policy. In socialist economies, both restrictive monetary policy and incomes policy may be needed to curb wage growth.

[32] A further argument was that freedom to increase wages would accelerate the process of corporatisation of state enterprises and their eventual privatisation.

[33] The nomination to the Ministry of Privatisation of Lewandowski, who belongs to the same liberal circle as Bielecki and who is well known as the author, together with Szomburg, of the first Polish proposal (Lewandowski & Szomburg, 1989) for a massive voucher-based privatisation scheme, attests to the desire to accelerate privatisation.

[34] In one case a motor engine company had been exporting to the USSR only, with few technological improvements, for 40 years.

[35] We do not include monetary and fiscal policy directly here. Zloty monetary policy (as distinct from interest rate policy) was not expansionary in 1988. Growth of broad real money was due to growth of foreign exchange deposits and, in particular, devaluation of the parallel rate (at which these deposits are valued). Fiscal policy, as reflected in the budget, was not at the outset of the 1990 programme more restrictive than in 1988: both aimed at budget deficits of about 1% of GDP. The better result in 1990 is probably due to an underestimate of the Tanzi effect.

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