JEFFREY SACHS

Poland's big bang after one year

Poland has led Eastern Europe's escape from communism. After one year of radical economic reforms — starting from a most severe macroeconomic crisis — Poland has proved that it is possible to take giant steps away from central planning towards a market economy.

The results so far are remarkable: hyperinflation is stopped, shortages eliminated, private traders has sprung up by the tens of thousands, and exports to the West have exploded. The reforms remain fragile, though, and the support from the West can be the decisive factor for the outcome.

Poland has led Eastern Europe's political and economic escape from communism. After Solidarity became the first anticommunist movement to gain power, in August 1989, the new Solidarity-led government was the first, at the start of 1990, to introduce radical economic reforms. After one year, Poland has proved that it is possible to take giant steps away from central planning, towards a market economy. Poland's example has encouraged other countries to follow the same path of radical reform. Nonetheless, Poland's work is only half done, and another year of heroic efforts — with high political risks — will be required if Poland is to pull itself irreversibly from the swamp left behind by communist rule.

Solidarity inherited the most severe macroeconomic crisis in the world. Shortages were rampant, as extensive as in the Soviet Union today. Prices were rising at a hyperinflationary rate. The trade balance was in large deficit and foreign-exchange reserves were nearly depleted. Factories, and even hospitals, were ceasing to function for lack of inputs.

The new Polish reformers, led by Deputy Prime Minister Leszek Balcerowicz, knew that half measures could not stabilize the situation, much less give Poland a chance to establish a market economy closely integrated with the West. Poland's own experience with "perestroika-style" half-measures at the end of the 1980s was proof enough of the need for a radical break with the past. Thus, the new government moved rapidly on several fronts at the beginning of 1990. First, it eliminated almost all price controls, thereby allowing price increases to rebalance supply and demand. It eliminated most subsidies in one swoop, thereby shifting the budget from large deficit to surplus. The National Bank of Poland eliminated subsidized credits to the state enterprises, and sharply raised interest rates on loans and deposits. The combination of tight fiscal and monetary policies ended the government's reliance on money printing, and thereby stopped the hyperinflation in its tracks.

At the same time, the economic team sharply devalued the exchange rate, ending the excess demand for dollars and allowing the government to end the rationing of foreign exchange. The Polish zloty, long a worthless currency, thereby became convertible overnight. In addition, trade barriers, including tariffs, quotas, and licensing requirements, were cut back or eliminated. The combination of currency convertibility and low trade barriers immediately thrust the Polish economy into the world market. Enterprises were suddenly encouraged to find new export markets in the West, while domestic firms were just as sud-
denly thrust into competition with newly available imports.

Finally, the government took up the cause of promoting the private sector. A legal overhaul has strengthened private property rights, company law, commercial codes, and investment codes. The government has encouraged new credits for new private enterprises. It began the process of selling or leasing small shops in the state sector. Perhaps most importantly, it began preparing for a massive and rapid privatization of the large industrial enterprises under state control. The Basic Privatization Law was passed by the parliament in July 1990.

The macroeconomic results during 1990 were dramatic. Shortages were eliminated almost overnight. By the second week of January 1990 the shops began to fill with goods, both domestic and imported. New private traders sprung up by the tens of thousands. Their ranks included farmers who brought their goods directly to market, and traders who carried goods from Western Europe to the major new markets of Poland in the boots of their cars. Prices jumped sharply upon the ending of subsidies and controls, almost doubling in the first two weeks of January 1990, but then the rapid ascent of prices halted, once supply and demand had come back into balance. The monthly inflation rates fell from 40—50 per cent per month at the end of 1989 to the rates of 4—5 per cent by mid-1990.

Contrary to widespread fears at the outset, the convertibility of the Polish złoty was not only maintained but the exchange value of the złoty against the dollar has remained stable since the reforms began. The new trade system promoted a veritable explosion of exports to the West. Export volumes rose by 45 per cent in 1990, and the trade surplus reached more than USD 4 billion, adding to the central bank’s foreign-exchange holdings. These accumulated reserves now provide a desperately needed cushion against the shocks ahead. The export increases came from a wide range of sectors, including food processing, metal products, electrical machinery, light industry, and chemicals, thus disproving the myth that Eastern Europe cannot compete in the West.

Why the reforms remain fragile

Despite the remarkable successes of Poland’s economic programme, the reforms remain precarious, for two main reasons. First, the gains have been balanced by short-run costs, and these costs (as well as exaggerated fears of future costs) could undermine the political support of the reforms. Second, the economy will remain inherently unstable as long as industry remains mostly owned by the state. Unless privatization occurs quickly and on a vast scale, it will be virtually impossible to maintain macroeconomic control in the medium term. Thus, the government is in a race against time. If privatization is delayed in Poland and the rest of Eastern Europe, the economic achievements to date will be threatened by a renewal of macroeconomic instability.

The main political pressures against economic reform can be readily identified. Poland, like the rest of Eastern Europe, suffers from the Stalinist legacy of a greatly overgrown industrial sector and an extremely meagre service sector. Stalin was interested in steel mills, not in restaurants or travel agencies. The industrial sector was built up by the central bureaucracy, which directly requisitioned resources for industry against the overwhelming pull of market demand. Consumer markets were "equilibrated" only through pervasive shortages and queues. Now, with the introduction of resource allocation by market demand rather than by communist apparatchiks, heavy industry will decline, and resources will be freed to create a desperately needed service sector.

During 1989 and 1990, employment in the industrial sector declined sharply, by about 20 per cent. Most of the decline was apparently a result of attrition (voluntary quits and retirement) rather than of forced lay-offs, though a precise accounting has yet to be carried out by the Labour Ministry. According to the official data, only about 170,000 workers lost their jobs in “collective dismissals” (group lay-offs), while overall industrial employment in the state enterprises fell by about 1 million. A significant proportion of the workers found their way into the burgeoning wholesale and retail trade sectors, and into private industry.

Even though displaced workers in Poland are protected by unemployment insurance and
other social benefits, and even though most workers who have left or lost jobs in industry have readily found new jobs in the growing private sector, the decline in industrial employment still threatens to provoke a political backlash from workers in the overmanned industrial sector. The risk of a backlash is intensified by the exaggerated fears of industrial workers about imminent unemployment. During 1990, opinion surveys showed that around 40 per cent of industrial workers feared losing their jobs, even though the actual proportion turned out to be closer to 4 per cent of the industrial labour force. Similarly, while some economists and politicians were predicting 20 to 30 per cent unemployment rates in Poland, the unemployment rate in fact reached only 6.5 per cent by the end of 1990, a rate that is comparable to that of Western Europe.

Like the industrial workers, many of Poland’s small farmers will also experience financial pressures, now that agricultural subsidies have been eliminated. With almost 30 per cent of the labour force still in the agricultural sector, Poland has yet to undergo the basic demographic transition out of agriculture which is the rite of passage of advanced industrial economies. Hundreds of thousands of family farmers still work tiny plots of 5 hectares or less, at a time when efficient family farms in the West are often hundreds of hectares in size. The decline of agricultural employment will take place over a generation, not in a year or two. Nonetheless, as with the industrial workers, the family farmers are already a strong lobby for protection and renewed subsidies.

The fact that employment will fall in heavy industry and farming certainly does not imply that open unemployment must be very high. Rather, if economic policies are effective, new jobs will be created at a rapid rate in the service sector and in light industry. Workers will be drawn voluntarily into these new sectors by the higher wages that will be offered, rather than be pushed out of the old sectors by forced unemployment. It should be borne in mind that, in Western Europe in the 1950s and 1960s, the massive shift out of agriculture occurred during a period of unprecedentedly low unemployment rates.

Nonetheless, it is understandable that the first Solidarity government of Prime Minister Tadeusz Mazowiecki found itself on the defensive vis-à-vis key groups of workers in industry and farming, and without enough countervailing support from the small, but rapidly expanding new sectors of the economy. In a sense, the government was representing the “unborn” winners from the reform process, who had not yet emerged and were therefore unable to offer concrete political support to the programme. As a result of widespread economic fears, opposition in key social groups (especially miners and farmers), and Mazowiecki’s remarkably meagre campaign skills, the prime minister was ejected from office in the presidential elections just 11 months after the start of the reforms.

Of course, Poland is now led by Lech Walesa, certainly the most gifted and astute politician in the country. He has shown, just as he campaigned, that he is squarely behind a true “acceleration” of the reform programme, particularly in the area of spurring small private business and in privatizing large industrial enterprises. But even Walesa’s great political gifts will be challenged by the social pressures. It may be recalled that Ronald Reagan and Margaret Thatcher were both unpopular a year after the start of their anti-inflation programmes, and perhaps even more relevant, that Chancellor Adenauer just barely survived politically a full two years after the start of the German “economic miracle”. It was only understood to be a miracle after its effects had been felt for a full decade.

The pressures from workers and farmers would be politically challenging enough even without the profound structural weakness of macroeconomic control in the state-owned economy. The Achilles’ heel of macroeconomic control is wage pressure in the socialist industrial enterprises. In Poland’s socialist system inherited from the past, workers’ councils have effective control over key management decisions in the firm, including the hiring and firing of factory managers. The workers’ councils can therefore put enormous pressure on managers to raise wages.

Under communist rule, these pressures were usually held in check by direct and often brutal repression by the Communist Party, which
acted to suppress labour unrest. Even then, the wage pressures exploded at periodic intervals. Now that the communist repression has been lifted, the wage pressures from the firm level are unrelenting.

In the face of these pressures, the Government's medium-term strategy is clear: privatize the enterprises as rapidly as possible to put real owners in control of the firm. After that, wages can be determined by normal wage negotiations between workers and owners who care about the bottom line. Until an industrial firm is privatized, however, it is vital to maintain wage controls at all costs. The government has therefore implemented a tax-based incomes policy, in which wage increases about a specified norm subject the enterprise to high rates of taxation. The so-called excess wage tax applies only to the socialized sector, while private firms are free to determine wages as they see fit.

The excess wage tax is a growing focal point of political protest by industrial workers, populist politicians, and even some free-market economists (who apparently fail to recognize that real market behaviour inside the firm requires a real owner of the firm's capital). But the government knows that the result of prematurely easing the wage controls would be an explosion of wages and a collapse of profits, which would lead to an inflationary burst of demand, a sharp increase in unemployment (as thousands of firms would fall into the red) and a sharp decline in budget revenues (as tax collections depend importantly on enterprise profits). Thus, the government is in a race against time: privatize before the wage policy becomes unstuck. If privatization is delayed, the incomes policy will surely collapse, leading to a renewed round of intense macroeconomic instability.

The government is now devising mechanisms for mass privatization, in order to turn thousands of enterprises to private hands in the next few years. These methods include a free distribution of the government’s shares in the enterprises to newly created mutual funds, pension funds, state commercial banks, and the workers within the firms (who would receive a modest fraction of the shares in their own enterprises). Since there are more than 3,000 state industrial enterprises, the government correctly understands that mass privatization must depend on a wide-scale free distribution of shares to the public (largely through intermediaries), rather than the public sale of enterprises as in British-style privatizations. The political and logistical problems facing the privatization programme are awesome, but so too are the risks in further delay.

The role of the West

Many in the West are sitting in suspense wondering whether Poland can beat the odds—by creating enough new jobs in the service sectors and light industry to absorb the lay-offs in the state sector, and by privatizing industry before macroeconomic instability returns. What these observers typically fail to recognize is that the West itself can be the decisive factor in the success or failure of the reforms. Two actions by Western governments can make the difference.

The first is deep debt reduction for Poland. Right now, Poland's foreign debt of USD 48 billion (of which about USD 32 billion is owed to governments, USD 10 billion to banks, and USD 6 billion to other creditors) is a fundamental barrier to the new foreign investments in the country that are needed to create the new jobs in services and light industry, and to upgrade the desperately inadequate infrastructure. The creditors, both banks and governments, recognize that Poland cannot service its external debts. This has been clear for most of the past decade, during which time the creditors have been capitalizing unpaid interest. As the unpaid interest has mounted, the debt has grown mechanically from around USD 27 billion in the late 1970s to its current level.

It is clearly no solution for Poland to have the old creditors continuing to capitalize the unpaid interest. New foreign investors will shy away from Poland, knowing rightly that the country will continue to be subject to a balance of payments crisis, and that the old creditors will have the first lien on any future surpluses produced by Poland. With insufficient job creation to absorb the workers released from the declining sectors, the political pressures will surely tilt back towards protectionism, subsidies, and a generalized pressure to reverse the market reforms. For these reasons, Poland has called upon its creditors for a cancellation of 80
per cent of the debt, based on a hard-headed assessment of its balance of payments prospects for the next decade. This amount of reduction may seem large, but it is readily justified. After all, Germany is pumping up to USD 60 billion per year into East Germany to overcome the communist legacy of economic mismanagement in that country. How, then, could Poland be expected to pay money out in order to service its old debts? The debt relief should, however, be phased in over time, perhaps over three years, in order to provide the incentive for Poland to stay the course on reform. Each new tranche of relief would be made contingent on Poland's progress on reforms, though the overall amount of the debt relief would be committed at the beginning of the process. The most important conditions for debt reduction should be progress on privatization and maintenance of macroeconomic discipline.

The prospects for sufficient relief remain clouded, however, by the stubbornness of several governments, which recognize Poland's financial needs, but have worried out loud that, despite these needs, the precedent of deep debt relief for Poland might be dangerous for other countries. These concerns over precedent make a mockery of the much vaunted "case by case" strategy of debt relief, in which each country is to be judged on the merits of its needs and the strengths of its reforms.

The second fundamental step by the West should be a clear commitment by the European Community that Poland (as well as Czechoslovakia and Hungary) will gain full membership of the EC within a decade by persevering with the politically difficult reforms. The EC has so far been shockingly coy on the issue of future membership of the Eastern European countries. Western governments do not seem to recognize that a commitment to future membership of these countries—conditioned on maintenance of rapid reforms—could provide exactly the political spur within the reforming countries to keep them running boldly towards their long-term goal of "returning to Europe".