Poland's Economic Reform
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POLAND'S ECONOMIC REFORM

The leaders of Eastern Europe's democratic revolution describe their goal as a "Return to Europe." They seek to overcome the Cold War divisions of Europe as rapidly as possible by adopting the institutions of parliamentary democracy and a market economy and by joining the economic and political organizations of Western Europe. The new democratic governments of Poland, Hungary and Czechoslovakia have explicitly rejected the idea of experimenting with a "third way" between capitalism and state socialism, aiming instead to replicate the economic institutions of Western Europe. The basic economic questions facing East European governments are therefore not mainly about the desired ends of reform, but rather about the strategy for making the transition from state socialism to a market economy.

The transition is fraught with danger. The East European economies are not starting from a stable situation but from a deep and prolonged economic crisis. Moreover there are no comparable success stories to serve as clear road maps for reform. Previous reforms conducted under communist rule have backfired. Attempts to decentralize planned economies have tended to worsen financial instability, a pattern now evident in the Soviet Union and one that also occurred in the 1980s in Hungary, Poland and Yugoslavia.

Of course, the new democratic governments in the region have profound advantages over previous regimes in attempting the necessary reforms. Not only do the new governments command popular trust and support, but they also are not hampered by the ideological baggage and vested interests that weighed down the reform attempts of earlier years. Nonetheless the political situation in Eastern Europe remains fragile. If the reform programs of the new democratic governments fail,

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the meager living conditions in Eastern Europe will fall further, which could in turn provoke serious social conflict and even a breakdown of the new democratic institutions. But there are also profound possibilities for rapid improvements in living standards, if the East European countries can successfully make the transition from central planning to the market economy.

While there is enormous speculation on the correct strategy for reform, only Poland has so far launched a program of comprehensive reform under noncommunist rule.[1] Poland's pioneering effort, which began on January 1, 1990, is the culmination of a decade in which Poland's Solidarity movement led the region in organized opposition to communist rule, and then in forming a noncommunist government. When Solidarity's Tadeusz Mazowiecki became prime minister in September 1989, his new government was facing a financial crisis among the worst in the world—with inflation of about 40 percent per month and widespread shortages of basic goods. The Polish public was thoroughly demoralized by a long-term crisis of economic and ecological decline that had lasted in acute form since the late 1970s.

Under the leadership of Deputy Prime Minister Leszek Balcerowicz, the government's new economic team fashioned a program of comprehensive and rapid change, aimed at ending hyperinflation and shortages and at creating a market economy as rapidly as possible. The program has been described as an attempt to "leap to a market economy." More precisely, it aims to create during the course of 1990 the legal, economic, financial and administrative conditions needed for a market economy. Nonetheless many key steps, such as tax reform and the privatization of a large portion of state industry, will necessarily take longer. And the actual restructuring of economic activity, involving the rise of small and medium-size firms in the private sector and a shift of production from heavy industry to light industry, services and housing construction, will occur only in the course of the coming decade.

There is much to be learned from Poland's efforts, even at this early stage. Not surprisingly, economic reformers and politicians in the rest of Eastern Europe and in the Soviet

[1] A more technical discussion of Poland's economic crisis and reform strategy can be found in David Lipton and Jeffrey Sachs, "Creating a Market Economy in Eastern Europe: The Case of Poland," *Brookings Papers on Economic Activity*, 1990:1.

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Union are studying the Polish experience intently. From our vantage point as economic advisers to Solidarity, we will examine the logic of the Polish economic program, the results to date, the anticipated difficulties in the coming months and years and the lessons for other socialist economies. We will also describe the kinds of assistance from Western governments that would be most effective in supporting Poland's transition to a market economy.

II

The starting point for Poland's leap to the market economy is the country's Stalinist economic legacy. Most important, more than 90 percent of industry is state owned, with a strong bias toward heavy industry—long held by communist ideology to be the real source of growth in the economy—and a neglect of consumer goods production. Similarly, the service sector is seriously underrepresented. Only 35 percent of the Polish work force is in services, compared with an average of more than 50 percent for most of Western Europe. The emphasis on industrial growth has also been supported by a deliberate distortion of the pricing structure, aimed at keeping the prices for industrial inputs low, especially the price of energy. The "energy intensity of production" (energy use per unit of GNP) is far higher in Eastern Europe than in Western Europe, and this is one of the sources of environmental degradation in the region.

Production, moreover, was organized by state planners to facilitate central control rather than to instill any spirit of competition. Employment tends to be in very large enterprises, to the almost complete exclusion of small and medium-size firms. In all of Poland, there are only 982 enterprises in the state sector with 100 or fewer employees. The average number of employees per state-owned enterprise (excluding cooperatives) is 1,132, and per individual plant is 378. By contrast, there was an average of 66 workers per plant in a 1986 survey of Western economies.

Competition was further reduced by the closing off of domestic markets from imports from the West. In Poland and elsewhere in Eastern Europe, imports have been controlled by strict bureaucratic allocation of foreign exchange and by explicit quotas. In Poland, until the mid-1980s, almost all imports had to be centrally approved, although this system of central control was partially liberalized in the last years of the

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communist regime. In most cases, importing was carried out through a state trading bureaucracy, which limited the contact of individual state enterprises with the outside world. Individual firms were therefore cut off from the transfer of technology that would usually accompany the import of industrial goods from more technically advanced economies.

Under strict central planning, the flow of physical resources to individual enterprises was set in the central plan. By the early 1980s the deficiencies of this system were so evident that the regime embarked upon a gradual decentralization of production, even as political repression under martial law intensified. Between 1982 and 1989, the regime cut back significantly on the role of central planners, allowing individual firms much greater freedom in the choice of inputs and outputs.

As part of the decentralization and as an attempt to mollify a bitter population, a small measure of worker self-management was introduced into the enterprises during the 1980s. In a sense, this can be thought of as the communist regime's preferred response to the public's growing demands for political representation: no free elections, but a modest degree of worker representation. Workers' councils were given some powers of supervision over plant operations and over management. While this control was illusory in many instances and was easily manipulated by the communist authorities, it was substantial in other cases.

There were two ironic effects of this limited devolution of power to the plant level and to the workers' councils. First, as decentralization progressed, workers gained enough influence to push for higher and higher wages. This contributed to an explosion of wages during 1987–89, which rose far more quickly than official prices, and which in turn contributed to shortages, inflation and a rising budget deficit in the last years of the communist regime. The second effect was to instill in parts of the Solidarity movement a commitment to worker-managed enterprises, which is now complicating the government's desire to convert firms into joint-stock companies organized along Western lines.

The specific patterns of the Polish crisis should also be noted. During the 1970s, the regime of Edward Gierek tried to overcome the inherent shortcomings of the economy and to regain the support of a sullen population by the device of heavy foreign borrowing from the West. By the end of 1979, the economy had taken on $25 billion in foreign debt (since

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grown to over $40 billion as interest arrears have accumulated). The loans had been singularly poorly used, with almost no increase in export potential to show for the debt. At the end of the 1970s Poland was plunged into a deep foreign-debt crisis when the inflow of money stopped and when payments started to fall due. Living standards collapsed in the period 1979–82, prompting the rise of Solidarity and its brutal repression under martial law. According to the official data, the 1978 levels of per capita income were finally restored in 1988, but in fact is is likely that 1978 living standards have not yet been restored even today.

The regime responded to the deepening crisis by partially eliminating the central planning apparatus and giving more freedom to enterprises. The result was not the birth of a market economy, but rather an intensification of financial instability. There was still no real competition. Production remained highly monopolized, and international trade—which might have allowed for competition from abroad—remained centrally regulated. Some private firms were legalized, but they were hobbled by administrative and tax laws and unable to obtain adequate supplies from the state sector. Also, the state enterprises had the wrong incentives. Workers were able to push for higher wages, either because they actually controlled management or because the managers were given little incentive to resist workers' demands. Managers borrowed funds whenever they could; if an enterprise later got into trouble, the reasoning went, it would surely be bailed out. The regime pumped money into the economy at highly inflationary rates, partly to satisfy the enterprises' voracious appetite for investment funds, partly to bail out money-losing firms, and partly to subsidize consumer goods in a vain hope of calming a bitter population.

In effect the central plan was replaced not by markets but by an unending process of ad hoc negotiations between firms and the government. When an enterprise experienced difficulty, it would go to the finance ministry or the central bank for some combination of cheap credits, tax exemptions, subsidies, central allocations of a scarce good. Prices, credits, foreign exchange allocations and subsidies were all subject to intensive bargaining between enterprises and the government and among ministries. Rules changed rapidly—to the extent that they existed at all—and the economic environment became increasingly unpredictable.

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By this route Poland had fallen into a remarkable combination of explosive inflation and massive shortages by the time Solidarity inherited the government in September 1989. Huge excess demand in the economy was being stoked by large wage increases, swollen budget deficits and cheap credits from the central bank; since official prices were continually held below market-clearing levels, shortages developed, and goods were available to consumers only after long waits in queues, by the paying of bribes or through the black market.

The inflation at the end of 1989 was further intensified by one of Solidarity's own actions. In the course of the historic roundtable negotiations in early 1989 that legalized Solidarity, and which set up the elections that soon brought Solidarity to power, the trade union movement pressed the government to introduce wage indexation as a defense against inflation. Indexation became a key transmission belt for inflation and quickly pushed monthly inflation to 54 percent in October 1989, thus breaching the 50 percent per month threshold that economists use to define hyperinflation.

Looking back at the 1980s, the failure of the piecemeal approach to reform attempted by Poland's communist regime (along with similar failures in Hungary, Yugoslavia and the Soviet Union under perestroika) seems clear. Ultimately the communist parties of Eastern Europe (and the Soviet Union to date) were unwilling and unable to carry out truly radical reforms to create a competitive, private market economy. Such a transformation was barred by ideology, by party elites intent on preserving power, by the distrust of the public and by the lack of foreign financial support from Western governments, which rightly doubted the commitment of the East European governments to the fundamental and necessary changes.

III

When the new Solidarity government began to define its strategy, its policymakers knew well the failure of piecemeal change. They recognized that thoroughgoing measures were needed. But at the same time, certain profound barriers stood in the way of comprehensive change. The trick was to find one's way out of the maze of dead ends and false turns left behind by the old system.

Consider, for example, the urgent problem of macroeconomic stabilization. Halting hyperinflation almost always requires an elimination of a large budget deficit and a tightening

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of monetary conditions by the central bank. Poland's situation presented no exception. At the same time, however, a monetary and fiscal squeeze almost always prompts some bankruptcies, especially of inefficient firms that are suddenly cut off from artificial subsidies and cheap credits. In a socialist economy like Poland's at the end of 1989, the price system is so distorted that there is simply no way to tell which firms should go bankrupt and which should be allowed to stay in operation. Without a realistic set of prices for industrial goods, it is impossible to sustain a tight macroeconomic policy without the risk of excessively high social costs.

This in turn suggests that macroeconomic stabilization measures must be carried out in conjunction with an end of price controls, so that prices can respond to supply and demand and thereby send accurate signals to the economy. But here the next conundrum arises. With the economy as monopolized as it is in Poland (and the rest of Eastern Europe), policymakers were rightly concerned that price deregulation would result in a new distortion: monopolistic pricing. Nor was the bureaucracy equipped to overcome that problem by administrative controls. The whole history of price setting by the bureaucracy in the 1980s had proven the impossibility of determining a rational set of prices by bureaucratic methods. Only shortages had resulted.

In turn, a demonopolization designed to precede macroeconomic adjustment presented another dead end. Not only was the macroeconomic situation spinning out of control, but demonopolization, like price liberalization, cannot really be carried out by bureaucratic fiat. The kinds of industrial restructuring that are necessary will only be learned in the context of actual market performance. Winners and losers cannot be selected a priori from among Poland's 7,800 industrial enterprises in the state sector. And, as is now evident, the type of production that individual enterprises will undertake in a market environment may be vastly different from that which they have traditionally conducted under a central plan.

A further apparent problem was that real market competition requires a real private sector. While liberalization of private sector activity would allow a new private sector to arise in the course of time, this natural process would be too slow to ensure a proper functioning of the economy in the meantime. Part of the process of building the private sector must therefore also include the privatization of state enterprises, mainly

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by selling firms to the public. But at what price? A reliable valuation of firms requires a reliable price structure for the inputs and outputs of the enterprises. This in turn requires market competition, which in turn requires an active private sector. How then to cut the Gordian knot?

The new Polish economic team chose several ways out of this dilemma. First and most important, they recognized that international trade would be the most effective means to instill competition in the economy. By allowing foreign firms to import freely into Poland (and Polish firms to export freely to the West), domestic state enterprises would immediately be subjected to intense competition from the world market. At least for goods that can be potentially traded (which includes most industrial and agricultural commodities), a decisive opening of Poland to world markets would immediately create domestic competition as well as a realistic structure of prices that would mimic that of Western Europe.

To implement a regime of free trade quickly requires a series of financial, economic and diplomatic steps. Financially the exchange rate must be made convertible on the trade account, meaning that domestic enterprises can freely buy foreign exchange, without rationing, at a given official price, and that exporters receive the same price in domestic currency for each dollar earned abroad. The government set a unified rate of 9,500 złotys per dollar on January 1, 1990, as the stable convertible rate for all of Poland's international trade with the West—a devaluation from 6,500 złotys per dollar at the end of 1989. Next, all sorts of trade barriers, including import quotas and high tariffs, had to be eliminated or at least sharply reduced. Finally, trade treaties with the United States and the European Community were needed to ensure Poland open access to Western markets.

Another way to attack the dilemma was to proceed as rapidly as possible on liberalization in conjunction with macroeconomic stabilization. As an example, farmers were allowed to bring food directly to the market themselves, thereby bypassing the monopolized food-processing industry. In a matter of weeks, farmers' markets sprung up all over Poland, breaking the monopoly power of the state food distribution sector.[2] The

[2] Poland has a decisive advantage in this regard relative to other East European countries. Most of Poland's agriculture remained in private hands after World War II. The private agricultural sector was terribly squeezed by the state, but it was allowed to survive. It is these private farmers that undertook their own marketing in the opening weeks of 1990.

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free market prices for food are generally lower now than in the official stores, though higher than the official prices that prevailed before the end of food subsidies. Another set of policies aimed to move swiftly to break up monopolies in specific sectors, such as coal, publishing and retail shops, mainly by dividing large, multiplant enterprises into several independent units, and by eliminating industry-wide cartel-like associations.

It was recognized that small-scale privatization—in which a state enterprise sells off a shop, or a piece of machinery—would also help to get thousands of small-scale entrepreneurs in business in a short period of time. On the other hand, large-scale privatization of major enterprises was recognized as something that must follow, rather than precede, the initial stage of stabilization and liberalization.

In the end, therefore, Poland's strategy for a "leap to the market" was based on the following precepts:

—The budget deficit and easy credit policies had to be ended, as the basis for eliminating shortages and halting rampant inflation;

—Prices had to be decontrolled and subsidies eliminated, in order to establish a demand-and-supply-driven system of price determination;

—A regime of free trade with the West had to be established by creating a convertible currency at the outset of the program and by eliminating almost all restrictions on international trade, thus allowing Poland to "import" a realistic price structure;

—Restrictions on the private sector had to be done away with as soon as possible and specific sectors targeted for rapid demonopolization;

—Privatization should proceed as rapidly as possible, recognizing that it would be a long process, involving many or most of the 7,800 industrial enterprises in the state sector.

These measures were to be undertaken rapidly. Even before the Solidarity-led government took office in September 1989, key leaders in Solidarity—such as the current minister of labor, Jacek Kuroń—were pressing hard to use Solidarity's public support to introduce decisive changes in the economy as quickly as possible. Mazowiecki and Balcerowicz shared this point of view. The crisis was clearly getting out of hand, but it was felt that the government would enjoy a vital freedom of action made possible by high public trust and the shared sense

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of national emergency. The public expected strong measures and the government had the political opportunity to implement them. It was known that many measures would be socially painful, and that the painful steps should not be stretched out in an unending social agony. As former Bolivian Planning Minister Gonzalo Sanchez de Lozada, who ended his country's hyperinflation in 1986, was fond of explaining: "If you are going to chop off a cat's tail, do it in one strike, not bit by bit."

IV

On the first day of 1990 the official exchange rate was devalued sharply and the złoty was made a stable, convertible currency. As was hoped, the fixed exchange rate has provided an effective "nominal anchor," stabilizing the prices of traded goods in złoty terms. The creation of a convertible currency was accompanied by the liberalization of international trade and the decontrol of domestic prices. Simultaneously most remaining subsidies were cut back sharply or entirely in order to eliminate the budget deficit.

These measures led to a corrective inflation: consumer prices were 78 percent higher on average in January than in December, according to the official price index. But this inflation was a one-time burst, which was quickly dissipated. From the beginning of February until the end of the month, prices rose by less than five percent, and then by about the same rate in March. To ensure that the corrective inflation would not be incorporated into a fruitless wage-price spiral, the government adopted a tax-based wage policy, which meant that wage increases would be held considerably below the increases in prices at the start of the government's program.[3]

From an economic point of view, it was impossible to compensate workers fully for the price increases. In part, the rise in prices resulted from the end of budget subsidies, which in turn was necessary to end the high inflation. Granting higher wages would have simply undone many of the budgetary savings. In addition, the higher prices resulted from the end of price controls under a situation of widespread excess demand for goods. Prices rose as shortages were eliminated.

[3] A wage norm was established under which the wage bill of enterprises could rise by 30 percent of the monthly inflation in January and 20 percent thereafter. Enterprises granting wage increases above the norm were subjected to very high rates of tax.

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While households might seem to have been hurt by the lower real wages, the fall in actual living standards is greatly overstated by the official statistics. Households now pay more for goods that they buy, but they also pay less in the form of the hidden "inflation tax," which had been reducing their purchasing power by steadily eroding the value of their currency holdings. Additionally, since the higher prices resulted in part from the elimination of shortages, households are compensated for the price increases by shorter lines, greater availability of goods and an end to the higher-priced black market. Indeed households that had previously been shopping on the black market for particular commodities might not even notice any actual price increases, even though the official statistics report a large jump in prices.

To guarantee that the excessive issuance of money would be firmly stopped, a fundamental adjustment of financial policies was undertaken. Legislation was approved by the parliament prohibiting the National Bank of Poland from extending any long-term credits to the government. At the same time, the budget called for the deficit to be reduced from more than nine percent of gross domestic product in 1989 to around one percent of GDP in 1990. The improvement will come mainly from a sharp reduction of subsidies and the elimination of various tax exemptions. Provision in the budget has been made for new social safety net programs (especially unemployment insurance), other forms of social spending and a fund to assist in the restructuring of industry. At the same time, the national bank has tightened the extension of new credits to the rest of the economy. Interest rates have been set well above the rate of inflation and the lending operations of the major commercial banks have been closely supervised.

The situation was further complicated by Poland's external debt. The debt in convertible currencies stood at $40.3 billion at the end of 1989, of which $27.7 billion was owed to Western governments, $9.2 billion to commercial banks and $2.1 billion to other socialist countries. The annual $3.6-billion interest bill on this debt consumes about 50 percent of the earnings on Poland's merchandise exports to the West.

Western governments provided two forms of financial assistance to Poland as the stabilization program was being launched. First, Poland's foreign exchange reserves were bolstered by balance-of-payments support loans from the International Monetary Fund and the Bank for International

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Settlements. In addition a special $1-billion stabilization fund was created by the Group of Seven leading industrialized nations, comprising a combination of grants, including $200 million from the United States, and loans from others of the G-7 governments.

Second, virtually all of the principal and interest falling due on Poland's debt to official creditors through March 1991 was rescheduled by Western governments. Poland also unilaterally limited interest payments to its commercial bank creditors, pending completion of negotiations for a deep reduction of its commercial bank debt burden to be arranged under the auspices of the U.S. Treasury's "Brady Plan." The Western governments, the IMF and World Bank have attested to Poland's need for commercial bank debt relief, and to Poland's inability to service its existing debt on a normal market basis.

These two forms of assistance provided a crucial underpinning for the Polish government's efforts to create a convertible currency, which was at the heart of the stabilization effort. The availability of balance-of-payments support made it possible for the financial authorities to contemplate the introduction of a stable, convertible currency, providing much-needed backing for the złoty. Similarly the rescheduling of debt service lessened the claims on export earnings and strengthened the ability of the authorities to make the złoty exchange rate defensible. As other East European countries prepare fundamental reform, these same two forms of financial assistance should be made available to permit the creation of stable, convertible currencies.

The initial goals of Poland's reform program are now within reach. The corrective inflation has passed and the excess demand in the economy—reflected in shortages and high inflation—has been brought under control. Shortages have been eliminated in almost all parts of the economy, both at the household and industrial level. Foreign consumer goods are now widely available.

Household incomes are down by about 30 percent after correcting for inflation, but we believe that this decrease overstates the actual decline in living standards, as we have noted. Public opinion surveys show that households believe that the economic situation and their own economic welfare are somewhat better in March 1990 than they were three months earlier, despite the large recorded decrease in the real wage. Evidently the end of inflation and shortages, and the

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wider availability of goods, has compensated the population for the higher but now fairly stable prices.

In addition, the combined effect of the austerity measures and the fixed and competitive złoty exchange rate has been a quick turnaround in Poland's external trade situation. The trade balance with the West in the first four months of 1990 totaled a surplus of $1.2 billion, which is more than twice the surplus for the full year 1989. In particular, exports have picked up significantly, reaching nearly $1 billion in March, almost 20 percent higher than a year earlier.

The surplus that has been achieved has several important implications. First, the export increase indicates that the Polish economy can be successfully integrated with Western Europe. Second, the stable exchange rate, which is key to price stability, is better assured because of the rise in foreign exchange reserves. And third, the sacrifices that the Polish public has endured are resulting in a financial cushion that will lessen the risks of further crisis and create a stable environment in which the economic transformation can proceed.

The new "demand barrier," in which enterprises find it difficult to sell their total output, has led enterprises and workers alike to reevalutate their behavior. The managers of Polish firms, now cut loose from the protection of the state, are struggling to produce goods that the public will buy at competitive prices. For the first time, enterprises are faced with the need to market their products actively at home and abroad, and to compete with importers who can also deliver goods to the domestic market. While state enterprises still are likely to be more lax in financial management than are private firms, tight credit conditions and restrained demand are forcing state enterprises to weigh cost considerations as never before.

The state enterprises will need Western management assistance to learn to function properly in a market environment. Polish firms have been more a part of the state bureaucracy than a part of the marketplace. Most enterprises have had few contacts with Western businesses, know little about the potential markets in the rest of the world, and do not produce to Western specifications. Management consultants in the West have the knowledge and experience that could greatly accelerate the insertion of Polish firms into normal market life.

At the same time, the reduction in aggregate demand has caused a cyclical recession in Poland. One effect of the recession is a rise in unemployment. The official data show 266,000

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registered unemployed at the end of March, or about 1.5 percent of the 18-million person labor force, in comparison with almost zero at the end of 1989. Note that despite the rise of unemployment in early 1990, the overall unemployment rate remains far below that of almost all market economies, including the United States (where the unemployment rate was 5.4 percent of the labor force in April 1990). It is expected, however, that unemployment will rise further in future months, perhaps to between five and ten percent of the labor force, not out of line with unemployment rates seen in Western Europe. Polish unemployment will probably grow to exceed West European rates at least temporarily, as the restructuring of the labor force takes place in the next year or two.

The rising risk of unemployment has greatly affected the behavior of workers. Poland's over-full employment has long meant that workers could find new jobs easily, while businesses had difficulty finding workers, combating absenteeism and motivating a strong work effort. Now, with employees worried about potential job losses, sick leave has dropped sharply according to government surveys, wage pressures have abated and strike activity is negligible.

Besides unemployment, the drop in domestic sales is the other indication of recession, and the main source of concern about the state of the economy. Data for January through March show that the percentage of Polish production sold by the state sector was about 30 percent lower than in the same months of 1989. While a recession is undoubtedly in progress, these data overstate the depth of the decline, as they do not include the fastest growing sector of the economy, the private and informal markets (for which little comprehensive data are as yet available).

V

The first phase of the Polish leap to a market economy is on schedule. Some basic institutional steps remain to be taken in the course of 1990 and 1991, which will be important in setting the proper incentives for the new private sector. These include tax reform, further antimonopoly measures, additional liberalization of private business activity, and changes in profit repatriation rules in order to spur foreign investment.

These changes will be easier than the other, much more profound, structural adjustments still ahead in Poland. The

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deeper structural adjustments involve both basic institutional change—mainly the privatization of much of state industry—and the reallocation of the work force and capital within the economy. It is really with these deeper changes that the ultimate test of the government and its economic policies will be made.

Privatization is already proving to be one of the most contentious and complex issues facing the country. Britain's prime minister, Margaret Thatcher, who may be regarded as the most fervent privatizer of the 1980s, has presided over some two dozen privatizations in the past decade, most of which were carried out by public offerings of shares of state companies. In Poland, however, there are over 7,000 state enterprises that are candidates for privatization. Poland must therefore find new privatization means that are administratively feasible, economically efficient and politically viable.

The main barrier to privatization, and potentially the ultimate sticking point, is a heated political debate over who really owns the firms. The government is asserting its clear juridical title to the companies. The workers in many enterprises, on the other hand, are asserting a de facto if not de jure claim, and are arguing that shares should be turned over to the workers or held in trust in a form of worker self-management. The government is opposed to this solution on grounds of both equity and efficiency. It is not fair, the government asserts, to give away the majority of shares to current workers when the industrial work force is a mere third of the total work force, and when some workers happen to work in highly profitable enterprises while others work in firms near bankruptcy. The government has instead proposed that a limited (and minority) proportion of shares of an enterprise be sold cheaply to its workers.

The government is also correct, in our view, to oppose worker ownership of firms on efficiency grounds. Not only has the practical experience with worker self-management been dismal in Yugoslavia (the only country where it has been tried on a large scale), but there are compelling theoretical arguments against it. First, workers would be unwise to keep both their financial capital and their labor earning power (human capital) tied up in a single firm. It is better for workers to own (through pension funds, for example) the shares of enterprises other than their own. Second, worker-managed firms tend to be cut off from outside capital markets. As long as

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workers' councils are the management bodies, and therefore get to decide how much of a company's income stream will be categorized as "wages" versus "profits," the firm will have a difficult time attracting outside investors.

Another barrier to effective and rapid privatization will be the logistical problems. Poland's financial markets are very limited in scope, and the financial purchasing power of households is also very limited. Thus the government will have to come up with ways to sell the firms at very low prices, or will actually have to give shares away through one mechanism or another (e.g., share distributions as a form of employee bonus or retirement benefit). Various innovative schemes for transferring blocs of shares to local governments, state banks or new holding companies are also under intensive study.

In the short term, the government can likely maintain macroeconomic equilibrium even while the industrial sector remains largely in state hands. But privatization must proceed rapidly if the Polish government is to avoid a renewed financial crisis in a few years. Historical experience teaches that public enterprises around the world have been prone to repeated financial crises, through overinvestment and overly generous compensation of employees. Thus, in Latin America (where state ownership often reaches 50 percent of the industrial sector), financial crises in the state enterprises have been commonplace. Even in Western Europe, state firms have been unusually prone to financial embarrassment.

The second, and equally divisive, structural challenge is to close down parts of loss-making heavy industry and to reorient the economy toward light industry, housing construction and services. Declining industrial sectors, such as the coal industry in Britain or the steel sector in the United States, almost always provoke heated political battles in which vested interests in the declining sector lobby the government to slow down the process of decline. The results can be very expensive if protectionism and subsidies are used to keep old and failing industries alive. Poland and other East European economies face special risks in that regard, since it is likely that much of the heavy industrial sector should be cut back in scale and some enterprises should be closed down entirely. A rise in unemployment is inevitable, even in the long run after restructuring is completed, as some workers lose their jobs in declining industries.

This will present not only an economic challenge to the new

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government, but also a political challenge. It will be vital to have a strong social safety net in place, including unemployment insurance and job retraining and relocation programs. In addition, the government should actively support the formation of new small businesses to absorb the unemployed and to fill in the gaps in services, light industry and housing construction left by the previous system. It can do this with special credit programs directed toward small businesses, and with technical assistance.

Poland has good reason to endure the ongoing recession and persist in its efforts to transform the economy, because the long-run economic prospects are promising. The land is well-endowed with natural and human resources and in close geographic proximity to Western Europe. There is every reason to believe that economic and political integration with Western Europe will enable Poland to raise its living standards decisively, if market forces are allowed to guide the transformation. Although Polish workers currently earn only a small fraction of what their counterparts make in the West, the narrowing of this gap will come naturally through increased trade, transfers of technology and capital inflows aimed at modernizing Polish industry and taking advantage of Poland's low wages.

The long-run promise of Poland will certainly remain unfulfilled, however, if political barriers impede the transformation process. The most immediate risk is that economists and policymakers, misled by faulty data or spurred by populist politics, might attempt to arrest the recession through a renewal of inflationary policies. If Poland were to succumb to the temptation to reactivate the economy artificially at this early stage, the initial gains would be lost, and a resurgence of inflation and a balance-of-payments crisis would not be far off. The second risk is a paralyzing debate over privatization.

The third risk is a descent into protectionism, if coalitions of workers, managers and bureaucrats tied to declining sectors wage a successful lobbying battle to preserve their jobs in the face of adverse market forces. Argentina's fate in the past thirty years—when entrenched special interests frustrated desperately needed structural reforms—represents Poland's potential nightmare in the future. Poland and the rest of Eastern Europe, with their legacy of powerful state enterprises, bureaucratic entrenchment and monopolistic industrial organization, may be especially prone to this tragic denoue-

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ment, unless political leaders act bravely and decisively to fend off protectionist pressures.

VI

Success in Poland's transition to a market economy will require financial support from Western governments during the period of transition, as well as the determination of the West to welcome Poland as a full partner in the political and economic institutions of the Western nations. If support from the West is timely and on an adequate scale, and if Poland remains steadfast in its reform efforts, the transition period will be brief, and so too will be the period in which financial aid is needed.

The initial phase of Poland's transition to a market economy has already been assisted by the loans and debt relief extended to the Polish government. The $1-billion stabilization fund, the IMF standby loan and the export credits granted by several governments gave the Polish government the financial backing it needed to take the major steps of currency convertibility and price liberalization.

One clear lesson from the case of Poland is that the West should be preparing similar packages of lending and debt-service relief for other East European countries, to be made available, quickly and on an adequate scale, to governments that choose to undertake the key steps of currency convertibility and price decontrol. Holding out the promise of sufficient financial assistance would greatly bolster the new governments of Hungary and Czechoslovakia as they consider the case for making a decisive "leap" to the market.

Poland's state enterprises now face a much harsher economic environment than they did under communism. Without an urgent effort to bring technical assistance to Poland's state firms, much of Poland's state sector will perform poorly, deepening the recession unnecessarily and slowing down the process of privatization (as healthy firms are much easier to privatize than distressed firms). Potentially viable enterprises might slide into bankruptcy before their managements learned how to cope with the competitive forces that have been unleashed. This could put the economic program at political as well as economic risk.

Recognizing the urgency of this problem, Deputy Prime Minister Balcerowicz has called for the creation of a "Minister's Fund," supported by contributions from the West, which

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would provide individual enterprises with the management assistance that they need in the immediate future. Polish enterprises wishing to acquire Western expertise would be eligible to draw upon the fund, provided that they put up counterpart funds from their own resources. The fund would be administered in a decentralized fashion, with enterprises themselves arranging to receive the services of Western management consultants, marketing experts, accountants, auditors, investment bankers and lawyers.

Poland's most fundamental financial need is for a deep and permanent reduction of its external debt burden. Otherwise, the debt burden will remain as a profound barrier to economic recovery. So far, Western governments have agreed that Poland can participate in the Brady Plan, under which Poland will negotiate a reduction of its debt to commercial banks. The Brady Plan, however, would cover only $10 billion of Poland's $40-billion debt, since the remaining $30 billion is owed to governments rather than to banks. The G-7 governments have not, so far, committed to a policy of debt reduction on Poland's government-to-government debt.

A reduction of debt to commercial banks is certainly needed and should be arranged swiftly, with the assistance of the leading creditor governments and the international financial institutions. The debt could most effectively be reduced through a single, comprehensive "buyback"—agreed to by Poland and the banks—at the price of Poland's debt in the secondary capital markets, between 15 and 20 cents per dollar. With $8 billion of medium- and long-term debt owed to commercial creditors, roughly $1.5 billion would be required to consummate the deal. These funds could easily be raised from the resources allotted for this purpose at the International Monetary Fund and the World Bank, combined with the resources of the $1-billion stabilization fund and loans and grants from friendly governments and the new European Bank for Reconstruction and Development.

In order to arrange for such a simple and straightforward deal, Poland will require the clear backing of the creditor governments, which (as in all debt reduction deals under the Brady Plan) must work with their countries' banks to put such a deal in place. Without official debt relief, Poland will be stuck with an enormous debt overhang, which in turn will frustrate the flow of private funds into Poland that are so vitally needed for the growth of private economic activity.

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The case for official debt reduction should be plainly evident to Poland's leading creditor, the Federal Republic of Germany, for no country's history in the twentieth century makes as clear the case for a timely reduction of an unpayable foreign obligation. After World War I, Germany's unpayable reparations bill put forward by the allies helped to create the chaotic economic conditions that eased the rise of Hitler.

After World War II, the allied powers were far wiser. Not only did the United States lend generously to Germany under the Marshall Plan, but it also led a successful effort to cut Germany's debt burden significantly, in order to give that country a fresh start. Now, it is time for a democratic and prosperous Germany to lead a multilateral effort to provide Poland with the same kind of assistance today.

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