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## THE POLISH RECIPE

*Twenty-six years ago the international community witnessed one of the most dramatic changes in economic systems. Naturally, the fall of communism in Eastern Europe and its consequences were events difficult to judge and anticipate in their immediate aftermath. Today, we have gained a much more coherent perspective on their meaning. The political liberalization of Poland in 1989 and its transition to the market economy was generally perceived as the most successful of all post-communist countries. From 1990 to 2013, Poland experienced the most outstanding economic growth within the former communist bloc. It doubled its GDP in real terms and became the only country to experience economic growth during the financial crisis of 2008-09. However, the Polish secret recipe lies in the "shock therapy" adopted at the beginning of the 90's. The aim of this paper is to examine the importance of the Balcerowicz's program in creating the basis for economic stability and growth through privatization, liberalization of foreign trade, monetary reform and an open economy. We will also review the impact of this unprecedented transformation in shaping a strong, market-oriented economy.*

**Key Words:** transition; shock-therapy; economic reforms, privatization; liberalisation.

**Introduction.** In the last twenty-six years, Eastern Europe's countries have experienced dramatic economic and political challenges in their transformation path – from centralized systems to market based ones. The intensity of these systemic changes was enormous and it affected millions of people [8, p. 35]. However, it wasn't an easy task for the new politicians to choose a development path, so different approaches were implemented and one can see the consequences even in these days. Today, it is rather obvious that the Polish recipe was the most successful when compared to other countries. Poland's post-communist economic development is certainly a unique experience. Regardless of the challenges it encountered in terms of economic, political and social democratization, today, Poland is a strong country and a developed nation that enjoys economic growth and European integration more than its closest peers – Ukraine, Romania and the Baltic countries [13].

Poland's economic transformation and development from 1990 to 2013 falls into several different periods: the post-communist transition (1990-2000), the global boom (2001-2007), the global financial crisis of 2008-2012) [4, p. 8]. This paper will focus mostly on the post-communist transition, because we believe that the basis of Poland's success lies in this period.

It is important to point out that Poland, at the beginning of the 90's, was, similar to the other countries from Eastern Europe, still influenced by the socialist ownership structure.

Within such structures the industrial production is usually above 90 % state owned, so is the service sector, and a high level of activity takes place on the black market. Agriculture is also state owned, planned and controlled in most of the Eastern European countries, except Poland where farmers managed to retain 77 % of total arable land after the World War II, though under repressive and restrictive conditions [11, p. 80]. By the end of the 1980's Poland's debt represented two thirds of its GDP [10, p. 21] and inflation had reached 250 percent by 1989 [7]. The fall of communism brought a newly democratic Poland which was forced to deal with its inherited Stalinist legacy. With the hyperinflation that seemed to lead to economic collapse and the decline of national income and productivity, Poland's new leaders were right to be concerned – how could Poland face these challenges and become a prosperous country? Their answer was articulated in the Balcerowicz Plan, a *shock therapy* meant to rapidly reform the economic structure of Poland and to create the basis for a privatized market economy [13].

The shock-therapy represented the shared belief that the economies of the former communist countries were performing so poorly that a radical, coherent liberal program of reforms would have been absolutely necessary [2, p. 6]. The supporters of shock therapy argued that this was the only way to ensure economic growth and a much higher level of employment, with low inflation [12, p. 89]. The architect of

this plan was Leszek Balcerowicz, who wrote a reform program based on privatization, liberalization of foreign trade, currency convertibility and an open economy in the spring of 1989 [3, p. 4]. Becoming Minister of Finance in September, he was effectively responsible with implementing economic reforms, so his plan was adopted.

While the ultimate goal of this program was liberalization, Poland's leaders decided to focus first on reducing not only hyperinflation but, also, excessive internal demand. More specifically the shock-therapy was based on 6 items meant to liberalize prices, reduce the inflation rate and open the economy [8, p. 36]:

1. The elimination of centrally established prices – 90% of the price controls were immediately abolished [10, p. 15];
2. Austerity measures – Sharply reducing government spending and the budget deficit;
3. Reducing the money supply and, thus, inflation by introducing a more restrictive credit policy;
4. Introduction of high real interest rates;
5. Reducing the role of state-owned industries in order to allow the Polish private sector to grow [13];
6. Convertibility of the national currency combined with its substantial devaluation.

Balcerowicz's programme was indeed a bold one and it did not come without short-term costs. The immediate consequence was a much deeper recession than the economic disruption imagined by the Polish leaders. One of the most evident costs was the rising level of unemployment, growing from 6.5 percent in 1990 to 12,2 percent in

1991. This huge employment decrease was due to a variety of factors. First of all, the liberalization of the economy revealed the inefficiency of the state-owned enterprises on a competitive market. Therefore, these enterprises lost almost 3 million jobs. On the other hand, large, privately owned enterprises lost almost a half of their workforce. This dramatic job loss contrasted sharply with the rise of the new created private sector. Data from the Central Statistical Office of Poland shows that by 1997, 90000 new firms were established which created 2,3 million jobs. These results show us that Poland's shock-therapy lead to the replacement of the old centralized economy with an entirely new one, rather than a transformation of the old one [10, p. 11]. Furthermore, the private sector developed greatly not by transforming existing enterprises but by creating new firms with entirely new perspectives.

Table 1 shows four basic macroeconomic indicators for the 1990–1994 period. It is obvious that the immediate consequence of these reforms was a substantial decline of economic activity. GDP per capita dropped to \$ 5873 in 1991, before starting to rise again in 1992. Inflation also dropped dramatically after 1990 – from 247,06 % to 29,1 % in 1994. Furthermore, the gross national income dropped in 1991 to \$ 38,7 billion, before returning to the 1990 level in 1993. Other specific macroeconomic indicators followed a similar pattern (Marvin, 2010). Output levels in agriculture and industry declined in the first year of the shock-therapy implementation, but then returned to positive growth at the end of 1992 [17, p. 35].

**Table 1. Selected macroeconomic indicators for Poland, 1989 through 1994**

Year	Unit	1990	1991	1992	1993	1994
Unemployment	%	6,5	12,2	14,3	16,4	16
GDP/capita	\$US	6,126	5,873	6,148	6,521	7,007
Gross National Income	\$US	41,6	38,7	39,6	41,1	43,3
Government budget deficit (% of GDP)	%	-3	0,4	-3,8	-6	-2,8
Inflation	%	247,06	61,02	44,74	37,45	29,1

Source: Central Statistical Office of Poland, OECD Statistics

**Privatization and employment.** In order to produce the expected results, these macroeconomic reforms were accompanied by stringed reforms at the microeconomic level. The purpose was to force state-owned enterprises to adapt their behavior in order to transfer existing resources into privately-owned new firms. At the beginning of 1990, 8441 large enterprises were eligible for privatization. Table 2 shows different methods of privatization. One interesting fact about Poland's transition lies in its ability to generate and grow entirely new enterprises. As a result of having low entry barriers, many firms started their activity, quickly creating a strong and viable private sector [1, p. 18]. By far, the most effective strategy was liquidation, especially for

small enterprises. Managers, workers or citizens, could all lease or buy the assets of the liquidated firms (shops mostly). The result was a very rapid dissolution of enterprises owned by the state. The Act of Mass Privatization was proposed in 1991 but passed only in 1996. This means that old private owned enterprises were liquidated and not necessarily transformed, and the assets went to completely new firms [10, p. 28]. With regards to the employment problem, the newly created private sector represented by far the greatest source of jobs. Almost 84 000 of domestic owned firms existed in 1997, employing around 2 million workers.

**Table 2. Firms in Privatization, 1993 and 1997**

Method	1993		1997	
	Entered	Completed	Entered	Completed
Direct Privatization	892	707	1,563	1,424
Liquidation	1,079	186	1,54	677
Capital Privatization	527	98	1,254	228
None	5,953		4,084	

Source: Jackson, E; Klich, J.; Poznanska; K. (2005)

Another great source of employment was represented by the foreign-owned firms which started to operate in Poland after 1990. Furthermore, FDI played a major role in revitalizing the Polish economy in the post-communist era. Although it encountered many challenges and difficulties, the Polish privatization process became one of the main

pillars of Poland's economic liberalization and prosperity. Nearly 6000 of this kind of firms were established after 1990, employing 266 000 people in 1997. Poland's success in attracting FDI was a result of several factors: first of all, its proximity to the other developed western European economies which have guaranteed a great demand for

Polish products. Being closer to Western Europe it managed to receive the highest foreign capital inflows [18, p. 126]. Also, despite the mismanagement of communist leaders, the Polish population represented a skilled, educated, literate workforce, unlike those from other Eastern Europe's countries. Poland also possessed a developed infrastructure, which was another important advantage in

attracting foreign direct investments. As Table 3 shows, the net inflows of FDI (% of GDP) started to rise significantly from 1990 to 2000, amounting to 5,44 % of GDP. The existing data on Poland's exports and FDI inflows suggests the existence of an important turning point in the Polish economy's internationalization, starting with the implementation of the 90's reforms [19, p. 177].

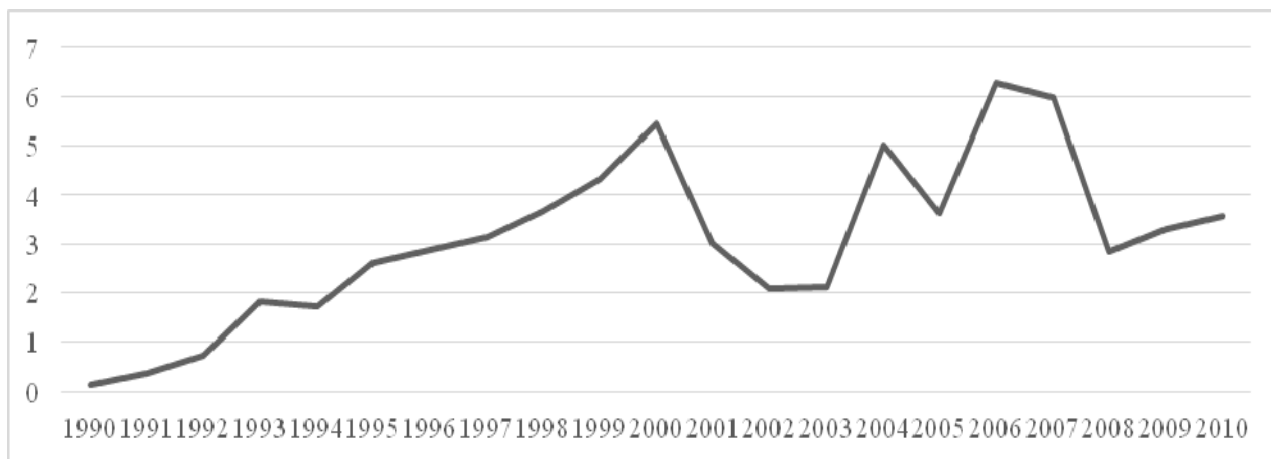


Fig. 1. Foreign direct investment, net inflows (% of GDP) in Poland from 1990 to 2010

Source: World Bank

A specific characteristic of the Polish recipe was precisely this *creative destruction* represented in the first part by the elimination of old state-owned enterprises and implicitly, of a great amount of jobs and replacing them with newly private-owned firms established in different and more specialized sectors [10, p. 34]. This measure was combined with the similarly radical option which permitted anybody to sell anything at any price. This radical liberalization gave the market an enormous initial incentive – "As a result, the central squares in Warsaw and other big cities were flooded with people who started selling whatever they wanted to get rid of and soon these informal trade stands were transformed into ordinary enterprises" [4, p. 12].

Between 1990 to 2012 it became quite clear that the private sector had become the dominant one in Poland's economy. In 2002 the private sector in the economy represented more than 77 % by comparison with the year of 1989 when it represented below 30 % [5]. If we take a look at the specific fields, we see that the most impressive rise of the private sector appeared in exports – from less than 10 % in the 80's to 83,6 % in 2001 [20, p. 5].

Although before starting the transition, the Polish economy was considered to be in really bad shape, Poland managed to turn itself around quickly and to become a model for other economies from the former communist bloc. Its initial status represented, without any doubt, a considerable advantage. Unlike its closest peers, Poland already had a functional private sector, comprising about 25% of the economy. Reforms started early in Poland and they managed to break down obstacles to foreign trade.

Furthermore, a lot of Poland's external debt was annulled, so it started became even more attractive for FDI.

**Exports.** In 1990 the trade balance between Poland and the former Soviet Union amounted to 4,4 billion rubles. Even if the fall of the Soviet Union was imminent, Poland decided to continue the export of goods and services inside the ex-communist bloc. The consequences were tremendous considering the fact that Poland received only \$20 million in payment in the first quarter of 1991, despite the fact that the total amount of exports was about \$130 million. The collapse of Comecon in 1990 increased Poland's need to redirect its exports [6].

As mentioned before, Poland experienced long term growth between 1991 and 1997, driven mostly by exports. Poland managed to quickly find new trading partners, especially in Western Europe, after the drastic limitation of domestic demand, along with the devaluation of its national currency by 32 % and the liberalization of foreign trade by private firms. Soon after that Poland's exports to EU amounted to 70 % [1, p. 19]. In 1990 hard-currency exports increased by 6,3 % to over 17\$ billion. As Table 4 shows, in the period from 1990 to 1997 Polish exports grew almost constantly, reaching an amount of \$42 billion in 1998 (more than double).

Another prerequisite of Poland's success, which seems to be forgotten, was the willingness of European countries to open their markets to Polish exports. Poland signed an Association Agreement with the EU, along with Hungary and Czechoslovakia, on 16 December 1991, which helped to further expand its exports.

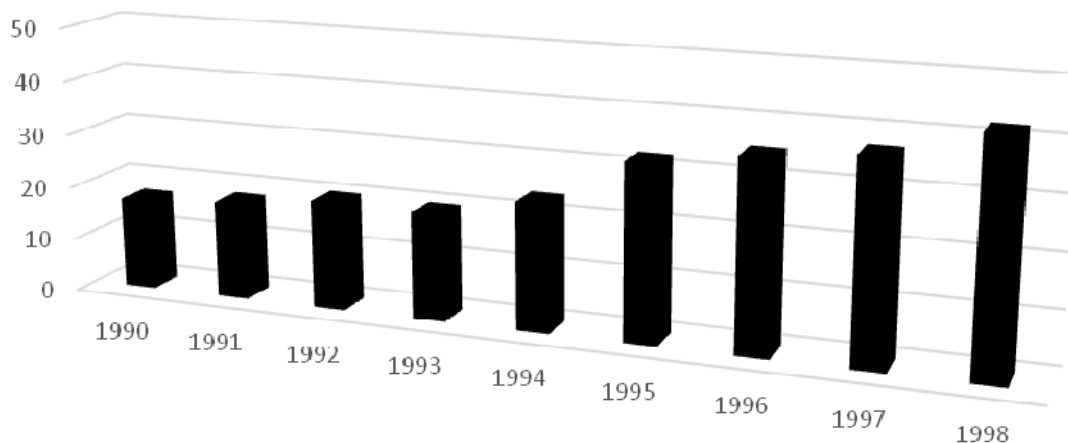


Fig. 2. Exports of goods and services 1990-1998 (billion \$US)

Source: World Bank national accounts data, and OECD National Accounts data files

The difference between Poland and its neighbours was, on one hand, the prescription of early, radical and comprehensive reforms, and on the other hand its timing – the simultaneous implementation of the four tenets (macroeconomic stabilization, deregulation, privatization and the reinforcement of the social safety net). Poland succeeded in taking advantage of the early democratization's window of opportunity [3, p. 4].

**International assistance.** Another pillar of Poland's success in its transition to a free market was its access to international assistance. The West's consensus on the Polish recovery within the G24 Forum, where it was decided to finance a stabilization fund as well, along with the IMF's standby program of US \$720 million, had a major impact on helping Poland to get on its feet very quickly [3, p. 14]. The G24 and international financial institutions committed a total of \$US 36 billion to assisting Poland. Additionally, the US provided \$US 700 million in Overseas Private Investment Corporation financing and insurance for US businesses willing to invest in Poland, and \$US 355 million in Eximbank loan guarantees and investment credits. A total of \$US 2.4 billion of Poland's debts were also forgiven by its international creditors [22, p. 256].

**Exchange rate policy.** Poland's competitive exchange rate policy was related to its access to international assistance. In 1989 the Polish national currency – the Zloty, fluctuated simultaneously with the US dollar, which started to function as an informal currency in Poland. On January 1<sup>st</sup> the exchange rate was depreciated from 6,500 Zloty/dollar to 9,500 zloty/dollar and currency convertibility was introduced. The existing system based on multiple exchange rates was replaced by the government with a single, fixed rate. The result was that exporters could exchange their foreign currency proceeds at a single exchange rate and importers had unrestricted access to foreign currency at the same official rate [11, p. 113]. Because of the international assistance and the stabilization fund, Polish financial institutions successfully pegged the exchange rate of the Zloty to the US dollar. The peg also represented a major pillar for price stabilization. Even in May 1991, when Poland was forced to devalue its currency, Polish leaders adopted a 'crawling peg' which permitted its exchange rate to stay competitive and allowed exports to expand. By comparison with the Czech Republic and Slovakia, Poland avoided having a period of overvalued exchange rates [4, p. 15].

The depreciation of the exchange rate was accompanied by price adjustments, as a result of price liberalization. On January 1<sup>st</sup> almost all of the remaining price controls on consumer and producer goods were eliminated, leaving only 5 % of the prices subject to control [11, p. 113].

**Conclusions.** Was the shock-therapy a success? Without any doubt Poland strongly benefited from its transition to a free market economy, but, unfortunately these gains did not come without a cost. However, no drastic economic revolution ever succeeded without any expense. In 1989 Poland's economy was in really bad shape, but its leaders decided to break every tie with the old system, to create a plan and stick to it. The Balcerowicz Plan may have had its flaws, contributing to the economic recession that soon followed the reforms and caused high levels of unemployment. Nonetheless, by anticipating and accepting the short-term costs, Poland's leaders managed to ensure that the gains of a liberalized market economy wouldn't be lost on future Poland.

It is hard to determine whether the Polish experience could be a replicable model for developing countries. The shock-therapy represented a long-term success mainly because Poland was already a developed nation with a viable private sector, regardless of its mismanagement [13]. With an educated and skilled workforce, functional infrastructure and established, though largely corrupt, institutions, Poland possessed the basic assets to create a new political and economic order. Nonetheless, the Polish recipe was a successful one not just because it proposed a package of reforms meant to liberalize and open the economy, but primarily because the reforms were determined, radical, coherent and quickly implemented. Criticized by many economists, the shock-therapy permitted immediate gains and widespread access to many products which would remain unavailable to other countries from Eastern Europe for significantly longer periods of time. Filled shelves in previously empty shops, after half a century of economic shortages, would help alleviate the psychological impact of the downsides of shock-therapy. Another pillar of Poland's success was the rapid expansion of entrepreneurship which certainly had a major contribution to the revival and growth of the private sector.

The reforms prescribed by the shock-therapy were, without any doubt, an important pillar of Poland's economic revival, but a few other pre-existing assets were also vital. Maybe shock-therapy wasn't entirely responsible for the Polish growth miracle, but it certainly eliminated many of

the old political, social and economic handicaps that stood in the way of Poland's path to a free market.

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### ПОЛЬСЬКИЙ РЕЦЕПТ

Двадцять шість років тому міжнародне співтовариство стало свідком однієї з найдраматичніших змін в економічних системах. Природно, що падіння комунізму у Східній Європі і його наслідки було важко оцінити і, тим паче, передбачити. Нині ми отримали набагато послідовніші точки зору на зміст тих подій. Політична лібералізація Польщі в 1989 р. і перехід до ринкової економіки загалом сприймається як найуспішніший з усіх посткомуністичних країн. З 1990 по 2013 рр., Польща пережила найвидатніше економічне зростання серед країн колишнього радянського блоку. Вона подвоїла ВВП в реальному вираженні і стала єдиною країною з досвідом економічного зростання під час фінансової кризи 2008–2009 рр. Проте польський секретний рецепт полягає в "шоковій терапії", прийнятій на початку 90-х рр. XX ст. Метою зазначеної роботи є вивчення важливості програми Бальцеровича у створенні основи для економічної стабільності та зростання за рахунок приватизації, лібералізації зовнішньої торгівлі, грошової реформи і відкритої економіки. Ми також розглянули вплив цієї безпрецедентної трансформації на формування сильної ринкової економіки.

Ключові слова: перехідний період; "шокова терапія"; економічні реформи, приватизація; лібералізація.

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### ПОЛЬСЬКИЙ РЕЦЕПТ

Двадцать шесть лет назад международное сообщество стало свидетелем одного из самых драматических изменений в экономических системах. Естественно, что падение коммунизма в Восточной Европе и его последствия было трудно оценить и, тем более, предсказать. Сегодня мы получили гораздо более последовательные точки зрения на содержание тех событий. Политическая либерализация Польши в 1989 г. и переход к рыночной экономике в целом воспринимается как успешный из всех посткоммунистических стран. С 1990 по 2013 гг., Польша пережила выдающийся экономический рост среди стран бывшего советского блока. Она удвоила ВВП в реальном выражении и стала единственной страной с опытом экономического роста во время финансового кризиса 2008–2009 гг. Однако польский секретный рецепт заключается в "шоковой терапии", принятой в начале 90-х гг. XX ст. Целью данной работы является изучение важности программы Бальцеровича в создании основы для экономической стабильности и роста за счет приватизации, либерализации внешней торговли, денежной реформы и открытой экономики. Мы также рассмотрели влияние этой беспрецедентной трансформации на формирование сильной рыночной экономики.

Ключевые слова: переходный период; "шоковая терапия"; экономические реформы, приватизация; либерализация.

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