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**Stabilization Policy in Poland
Challenges and Constraints**

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1. **New Hopes and Old Fears Across the Country**

In Poland change and talk of change are everywhere. The enactment of the Laws of Economic Activity and the Laws on Companies With Foreign Participation at the close of 1988, "Round-table" Talks and especially real political reforms followed in their wake in 1989 - these and other internal changes and transformation, - coupled with external ones - dominate the conversations of Poland's "political class". Some optimistically inclined started even professing that the new Poland emerging from its long reforming gestation will be as different as a butterfly is from a crawling caterpillar.

The truth is, however, that no one is certain about the shape of the new Poland or about exactly how it will function. But its evolution is already having an impact on the politics of various social groups and classes and on the imagination of Poles as well. In Poland, just as in some other socialist countries, reformers vie with old habits and attitudes for control of the future. The opportunity to win - or preserve - political prominence through the institutions of the new Poland is attracting creative ambitious political figures who are already busily trying to expand the scope of new developments. It goes without saying that such external developments as the parallel rapid democratization of Hungary's politics and the progressive openings of glasnost in the Soviet Union have raised hopes and stimulated democratic movements.

Now and again the question is being raised what about the vacuum left by the decline of old dogmatic ideas how to run a socialist economy. Obviously, apart from left-wing ideas and some new blends of socialist values and market mechanisms, into the vacuum certain other forces are moving, mostly of Western provenance. One is the free market capitalist economy. Another is science coloured by positivism. But it is interesting to note that in quite different quarters to another possibility the attention has drawn. It has been stated that other

ideas, perhaps more authentic, might be waiting to rise from Eastern lands (Gawronski, 1989).

Apart from this political and intellectual revival there is a wide spread feeling that economic problems are piling up faster than they are solved and, by many measures, time is running out. It is now clear that the Polish economy is moving into a new stage of development, for the current situation of the middle 1989 simply will not prevail for much longer. The outlines of this will be defined by choices made in the days, weeks and months immediately ahead. Circumstances - it is felt - call for major shifts on several economic (and political - to be sure - as well) fronts to restore so much needed equilibrium.

To conclude these sweeping remarks on the nature and pace of changes in Poland, one might ask whether recent development has contributed to the old question of reform's irreversibility.

Let us distinguish two aspects of this all-important question. First, to what extent the reformers have succeeded in creating a viable reform strategy (blueprint) and facts that cannot be shrugged off lightly by the future?

As to the reform blueprints or programs in circulation before their actual implementation, one should neither underestimate nor overestimate the impact of their existence before hand. So far history stands witness that the reality of the reforming countries never did and does not today correspond to any of the blueprints. J. Kornai duly reminded that "It is ironic to note ... that major transformation in centrally planned economies go on without being based on a central plan. There is a Chinese adage which talks of "crossing the river by touching the stone". The reform process in socialist economies conforms exactly to this image: whole societies have proceeded to cross the deep water without accurate knowledge about the final direction by a process of moving from one stone to another." He continues that "because of this lack of strategy, the reality of reform in socialist countries is characterised by historical compromises, by movements backwards as well

as by movements forwards, by periods of euphoria and of optimism alternating with periods of lost illusions and of frustrations". Two observations are relevant in this place: first, that we do not see any reason why this generalization should lose its predictive power with respect to future development in Poland and that J. Kornai rightly reformulates the question of ir - or - reversibility to the question "the limits of transformability of a society which can only be accurately gauged once one begins to transform it" (Kornai, 1989).

It should be added, however, that launching and carrying through on initiatives needed to safeguard reform drive is placing extraordinary demands on political leaders and on imaginative leadership.

With respect to the second part of the first aspect, the question arises in particular, how tangible is the spirit of business and profit as normal pursuits, with their own dynamics apart from political favour and privilege? It seems that this spirit of business has taken to some extent root in Polish economy. There is a new air of permanence about the move toward greater economic freedom and market efficiency. However, hope tempered with caution is the way to view this accelerating process.

Secondly, to what extent political changes actually under way create more solid basis for further consistent reforming activities within the economic domain? In short, how radical political changes might really undergird and revive once discredited reforming gradualism? It should be once again underlined that primo we are referring to reforming gradualism with the provision of "stable" context of radical political reform ensuring consistency in economic reforming drive, and secundo, that ultimately, in this new political context, responsibility for the future rests with individuals, providing an appropriate socio-political framework, and that their values, choices, and behaviours will shape social and political change.

2. Gaps and Challenges

It is well-understood today in Poland that a truly radical and comprehensive reform is one that affects the whole institutional framework that guides and controls the process of resource allocation. And that it should affect in particular:

- the decision-making system that defines the rights and responsibilities of the various socio-economic actors,
- the information system that links these actors to one another, and
- the incentive mechanism that motivates those actors to function within the system.

It is also widely perceived that a comprehensive reform to enhance the role of the market would radically increase the autonomy of the state enterprises and signal extension of non-state ownership, free the price system as to reflect shifts in supply and demand, give greater authority to the financial system to allocate credit and expand capital market; change the wage system so as to permit the labour market to operate more flexibly; overhaul the legal system to change economic actors rights and obligations, etc. The vital question of interconnections between the institutions of the economy and the sequencing issue have not been forgotten in the "Round Table" talks which tried to hammer out a "New Economic Order". One may say that meanwhile the Polish economy was steering indeed towards a mixed socialist economy whatever could be meant by this term. The intellectual search for new ways of transformation of the state ownership, new forms of non-state ownership and the real extension of small private business has been impressive. The last process has not been so far, however, up to Government's somewhat inflated expectations. Partly it has been due to the fact that the economic situation in 1989 is in many respects much more difficult than in the beginning of the decade, despite many attempts at its improvement made in the meantime. And this is the consequence of the inability of policies to cope with lingering and/or emerging socio-economic problems. One aspect of this inability, though admittedly disputable, is whether Poles have been conditioned into accepting the gravity of their situation. Not many politicians in Poland

have dared to take the President Menem stance who told the Argentine public that "those who in future will not be able to afford to run their cars, must take to riding bicycle".

Prospects for Poland and Polish task of radical reform depend upon how successfully numerous highly visible gaps will be dealt with. By a gap are meant differences between supply and demands (or necessary requirements) impeding an achievement of desired goals or partial or general equilibrium. The urgency of easing those gaps is even more pronounced when we recall that the opening to the outside world will almost certainly remain a primary goal for Poland. Quickly emerging Political Economy of the Transition from the old economic system to a new one suggests that there might be gaps of a quite different nature. Obviously, the theoretical content of papers dealing with the political economy of radical reform are building stone for a new emerging discipline.

Effective Power Centre Gap

The first gap more from within the realm of 'politics' than economics is the one related to the management of the radical reform. In Poland, just like throughout the centrally planned economies world, the issue now is how to manage the radical reform. The everyday management of radical reform is now most urgent priority on the Polish agenda.

The dilemma is: will it be done in chaos and further deterioration of the socio-economic situation with all its consequences or will it be done as a controlled process in which a new consensus will emerge on how to demolish the administrative system with a minimum of pain?

There has been, up to now, an acute sense of growing gap between urgency for effective management of radical reform and easily discernible disarray of policies meant to implement it.

Thus, in the months immediately ahead, Poland will confront two related problems of paramount importance - those of establishing effective leadership and new ways of forming socio-economic policy

fostering radical reform. This is, as we have already mentioned above, a realm of extremely intricate politics where "Nobody really knows how or where to start dismantling a Soviet-style economy, while keeping a minimum flow of essential foods and services flowing to the consumers" (Walker, 1989). In view of that, therefore, perhaps it does not sound so paradoxical an opinion one can hear that in most regards the preconditions for radical economic reform look much better than e.g. in the middle of 1988, because the economic situation deteriorated and illusions once more have faded away.

What a political economist can merely venture to suggest is that a new socio-economic way of policy forming should be based upon a socialist model of countervailing powers. It requires as a precondition, however, decisive in a real socio-political process clarification of interest groups and establishing new ways of their articulation. But that is, after all, what the whole modern political process is all about; it is meant, indeed, to avoid situation of many developing countries where the government remains a government of men, not of law.

Economic Resource Gaps

There are in Poland at least four economic resource gaps (ERG) whose "behaviour" can influence the complicated tasks of reform. Their single common feature is they are becoming more pronounced and interconnected. There is no need in case of Polish economy to apply special econometric apparatus to surface their existence or degree.

The saving gap, though has a long history (and which some estimate now up to one third of investment fund), it has become so acute in the 80s not because of the high level of social and personal consumption but because of the ossified industrial structure, protracted debt burden and low efficiency of investment process and highly effective de-incentive system to save.

The foreign exchange gap, though there exists a substantial current account's surplus, it stems from an increasing debt burden, limited export capacity mainly due to the obsolete industrial structure,

low level of labour productivity and quality of products. An absolute amount is equal up to \$3.0 - \$3.5 billion annually, according to governmental and "Solidarity" and international estimates.

Fiscal gap (which has been steadily growing) stems from the same structural sources plus a lax financial law and, above all, practice.

Energy gap, always looming but now rapidly growing in its importance, stems both from the same structural sources as any other above mentioned ERGs, consumers' rising cultural aspirations, and additionally from specific labour relations in Polish coal mining industry.

It is quite interesting to note: first that - in quantitative terms - most of ERGs, amount to approximately one third of the requirement, secondly that each one has had recently a discernible tendency to grow due to deepening of others. This multiplying effect of Polish gap's system presents policy makers with narrowing scope of manoeuvre and, at the same time, growing urgency to ease them.

The most obvious paths toward easing ERGs is a bold and radical restructuring of Polish economy, expansion of international cooperation and courageous stabilization attempts. All of them are, alas, full of painful consequences for the Polish people and immediate dangers for policy-makers.

A review of past attempts and problems involved in especially two last paths will be taken up in the following two parts of the paper.

Particular attention will be paid to the fact that the very market orientation of Polish reform "presents the authorities with the challenger of fashioning new instruments for microeconomic stabilization" (Wolf, 1989). It goes without saying that success of reforming socialist economies in meeting these challenges can, in turn, impact upon the sustainability and ultimate success of the reform process.

PART II ECONOMICS AND POLITICS OF STABILIZATION
Grzegorz W. Kolodko

1. Attempted Acceleration

Years spent on trying to stabilize the economy have failed to produce results and the process of macroeconomic reproduction is still suffering from a crisis. While the scale may differ from country to country, this statement is true for Poland, as well as for other socialist countries. This crisis, which can be called the general crisis of the socialist economy (Kolodko 1988b) to differentiate from the production crisis, consisting in the decline of the absolute output level, as was the case in Poland in the years 1979 - 82, is reflected in many negative phenomena and social and economic processes. Specifically, one can refer to slower economic growth (or even recession, sometimes), structural stagnation, disequilibrium and inflation, foreign debt, low competitiveness, lack of innovative propensity and ecological disequilibrium. Problems resulting therefrom are the fundamental growth challenges that contemporary socialist economies have to deal with.

Thus, stabilization policy should be viewed as a part of a broader social and economic policy. It is so, because we have a seriously destabilized economic system (but also a destabilized social and political system, which is largely a result of the former), where there are various interferences in the course of growth processes. This is why, keeping in mind the need for measures designed to achieve long-range economic and social effects, especially to ensure the best possible fulfilment of social needs and the creation of stable and durable premises for future growth, it is still necessary to implement appropriate short- and medium-term measures intended to stabilize the economy. This usually refers to steps taken to balance the economic system, both with regard to the external environment and - which is more important - internally.

At the present stage, the priorities of stabilization policy in the socialist economies are connected mostly with growing foreign debt and ever higher inflation. There are broad implications to that, as the

problem concerns both forms of inflation (open and repressed), as well as financial disequilibrium, un-institutionalized internal debt in the form of the inflationary overhang, the second economy, the parallel existence of two currencies and other related phenomena. There are some definite relationships between all these issues, though some of them are actually contradictions.

The late eighties brought a marked acceleration of the necessary adjustment processes in several socialist countries. It could be observed in the systemic, structural and political spheres, though structural changes within a given structure of productive assets are relatively insignificant, which is derived from insufficient systemic or political pressure on such transformations. It should be specifically referred to the conversion of a part of the productive capacities from the manufacture of the means of production to that of consumer products, that is to the curbing of the phenomenon of the so-called "self-eating economy", where a high proportion of the output is consumed for production purposes, and to convert a part of the productive capacities from military to consumer needs, especially to the production of consumer goods bought by the households. Certain symptoms of improvement with this respect could have been observed in Hungary, where it was announced that defense expenditure would be cut by about 14% and in Poland, where these cuts are to amount to about 4% in 1989 (in real terms). Major efforts aiming to speed up systemic and political changes were to be observed in the late eighties in Poland.

Changing the economy to a market-type, under the conditions of current crisis, is a far more difficult task than would have been in times of a relatively stable and less unbalanced growth, e.g. in the early seventies in Poland. At that time, however, Poland did not meet all the requirements needed to implement such reforms (Kolodko 1988b).

Going ahead with market reforms in the economic and financial system calls for simultaneous progress in the democratization of the institutions of social and political life. This thesis is not only gaining increasingly widespread recognition in the countries which press

on with their reforms, but it is also being practically implemented, though to a still inadequate extent. Where does the need to democratize political life come from? The point is not only that it is a value on its own, a value even superior to the economy, but also a definite historical and international context in which these developments are taking place. After all, the world is advancing at an astonishing pace, also with regard to political evolution.

Another point is that the authorities wishing to carry out their projects of market reforms and implement the necessary stabilization and adjustment processes, must enforce various unpopular measures over a short period of time. These may consist in the temporary lowering of the living standards of some social groups, liquidation of loss-making companies or even whole industries, changes in the structure of prices and incomes, an overhaul of the tax system producing far reaching consequences in income redistribution, etc. We thus come to conflicting economic interests, in many complex planes, without being wholly aware of the directions and even less, of the intensity of redistribution in incomes and wealth. If wrong methods are used, or if the timing is wrong, these contradictions may be further antagonized, as vividly illustrated by the Polish crisis of the eighties.

Thus, the implementation of such unpopular, sometimes potentially antagonizing measures, designed to streamline the economic system and economic structure, may call for the canvassing of popular support. The authorities must secure at least the passive approval of various social and political forces which are beyond their control, for their stabilization policies. As it is known, implementing the necessary changes requires a strong government. One may say that the more sweeping the systemic and structural changes undertaken in the therapy of short-term stabilization and long-term adjustment, the stronger the government must be.

The strength of a government may be derived either from popular support or from efficient policing. Market reforms and democratization require the former. It is in this light that we should view the

political transformations in some of the socialist countries, especially in Yugoslavia, Poland and Hungary. What is required is agreement within the framework of mostly new institutions, in order to implement the necessary reforms as democratically as possible. The government facing further economic and social destabilization, and political anarchy, may prove strong even without such agreement, but its strength will not stem from popular support. Much as such developments would be undesirable, one cannot exclude this possibility. Thus, at the threshold of the nineties, the socialist countries (though not yet all of them) came to face the problem of working out their own solutions with respect to the institutions of political democracy. There is no doubt these solutions will not be as uniform as they used to be, since each country will make its own contribution. What we are witnessing now, is a great historical experiment, which will yield a variety of solutions, though with the same principal objectives.

2. The Shortageflation Dilemma

The shortageflation syndrome is one of the major problems facing stabilization policies in Poland and other socialist countries (Kolodko - McMahon 1987). What it called shortageflation is a phenomenon unknown to the market economy. This is not merely a simple sum of price (open) and repressed inflation, but a wholly new category. It is a very specific form of the coexistence of overall price growth and the accompanying redistribution of incomes and resources, with the permanent shortage of goods in the market.

The problem lies not only in the fact that prices soar while shortages persist and in the resulting choice between the scale of these two interconnected phenomena, but also in the fact that prices keep on rising while shortages grow ever more acute. In a way this is similar to stagflation, known to the market economy, while rising inflation is accompanied by rising unemployment. In the case of shortageflation the rates of price (open) and of repressed inflation are rising, the latter being reflected in increasingly massive shortages. This phenomenon is to be observed in all socialist economies undergoing reforms in the second

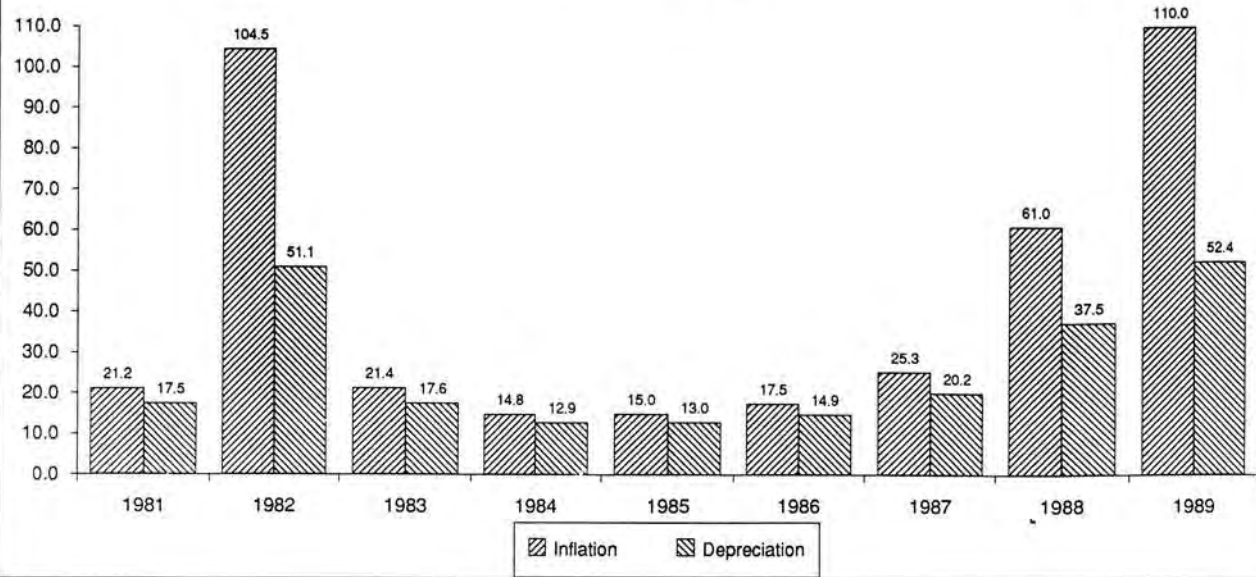
half of the eighties, but Poland's case is again the most spectacular (Kolodko 1988a).

The rate of price inflation showed a systematic decline between 1982 and 1985, falling from about 105% to about 15%. Then, it started rising again, and not only from year to year but, starting with the second quarter of 1988, from month to month. This was a predictable effect of the so-called "price and income operation" of February 1988. It was demonstrated once again, that instead of stabilizing effects promised by the economic policy, it actually led to a further destabilization. Thus, as price growth became faster, currency obviously also depreciated at a higher pace. This is illustrated in Fig. 1. What is striking, is the symmetry between the curbing of inflation in the years 1982-85 and its take-off in the years 1986-1989.

A 100 zlotys of the year 1980, which marked the beginning of the social and economic crisis, is now worth a little over 5 zlotys (Fig. 2). In other words, taking the 1980 price level as 100 and predicting 1989 inflation to reach 110%, we end up with a 20-fold increase in the level of prices (Fig. 3) and a corresponding decline in the purchasing power of the Polish zloty.

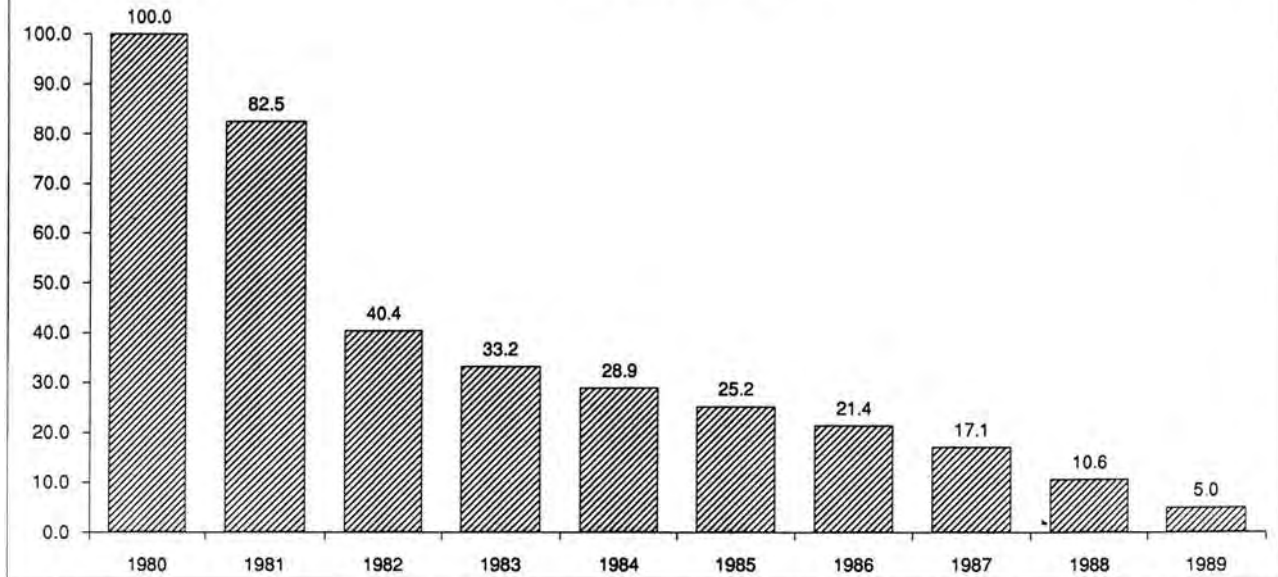
This purchasing power is actually even lower, since given the conditions of the economy of shortages, it must be measured not only with the amount of goods and services which can be bought for a nominal unit of currency, but also by the real changes to realize effective demand. And these chances are strongly limited due to parallel repressed inflation. Moreover, rising inflation in the eighties was accompanied by ever more acute shortages. There are no precise indices to measure repressed inflation, to match those used for price inflation, though there is already quite an extensive literature devoted to this problem (Nutti 1986a; Kolodko 1987; Miliuk 1989). All available estimates show that shortages became even more serious in that period. Among other things, it was reflected in the increased volume of the inflationary overhang, in shop stocks falling to levels which no longer guaranteed a

Figure 1
Inflation and Depreciation
(annual rates in %)



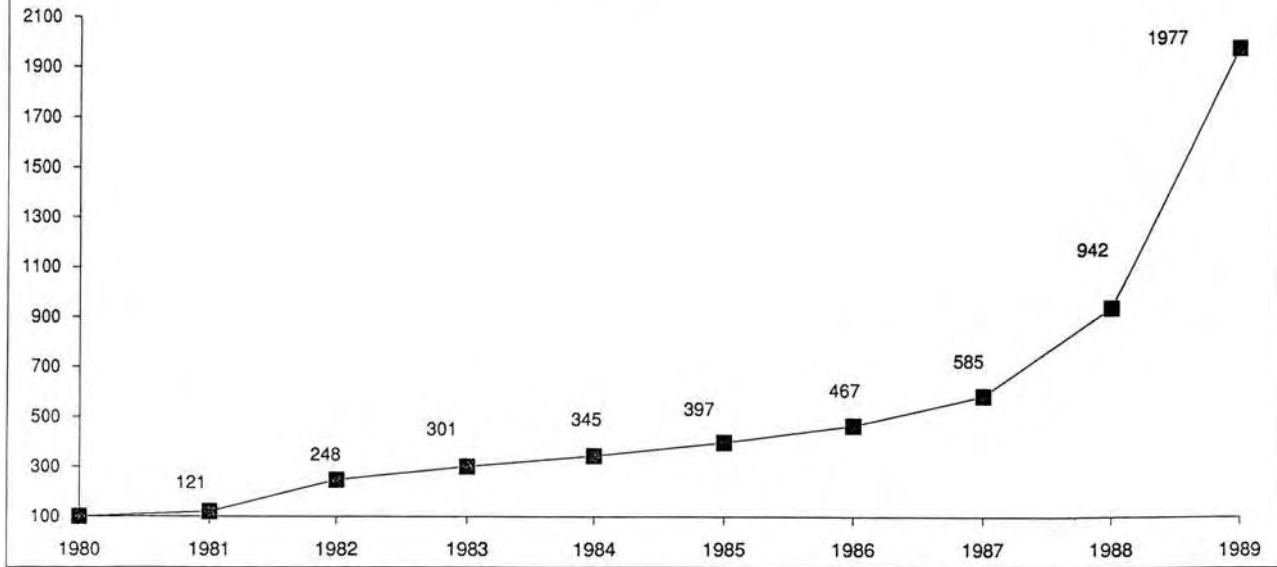
Source: National Bank of Poland and own calculations. Data for 1989 - own forecast.

Figure 2
Depreciation of Polish Zloty
(1980 = 100)



Source: as in Figure 1.

Figure 3
Inflation in Poland
(1980 = 100)



Source: as in Figure 1.

continuity of sales, the ever expanding scope of the second economy and the "dollarization" of the economy, etc. (Raport 1989).

Rising price inflation, paralleled by increasingly serious shortages testifies to the inefficiency of short-term stabilization measures and longer-term measures of adjustment to the changing conditions of macroeconomic reproduction. This appraisal holds for all three spheres: systemic reform, realignment of economic policy and structural transformations. This observation also leads to a certain conclusion. That the only variants of stabilization policy which can be recognized as politically viable are those which ensure a parallel lowering of both open and repressed inflation (Kolodko 1989a). Neither the assumptions, nor the implementation of the "price and income operation" of 1988 met these criteria. What is worse, currently enforced measures do not fulfil them either, as they actually lead to a further rise in price inflation.

3. Financial Policy

A systemic market reform would considerably enhance the role of financial policy. But already here, we should observe, that its instruments frequently have a limited impact or even - that they are grotesque in comparison with their equivalents in advanced market economies. This can be said for example of the attempts to set up a capital market in a situation of massive shortages (Czekaj 1989). The inefficiency of many of the instruments of financial policy is also partly attributable to the fact, that the national economy is now a hybrid: no longer centrally planned (actually, no longer planned at all) but hardly a market economy, as yet. This is why the impact of such instruments as prices, taxes, exchange rates or the interest rate is limited or distorted. Companies are nearly insensitive to the influence of some of these instruments or their use leads companies to adjust in quite different ways than in advanced market economies.

These statements are hardly meant to imply that we should not have an ever broader recourse to the instruments of active financial policy,

but on the contrary. However, we should be fully aware of the shortcomings of some of the instruments of this policy while balancing and stabilizing the economy (Nutti 1988b).

If we reject command-type, administrative methods of stabilization policy and go on with marketizing the economy and monetizing economic relations, major changes will be required also in the financial policy (Nutti, 1988a and Adam, 1989). Foremost amongst these changes should be shifting the emphasis from fiscal to monetary policies. This implies the enhancement of the role of the interest rate as an instrument designed to shape demand for money and regulate its flow to the economy. On the other hand, the regulation of financial flows with the use of fiscal policy instruments must be limited. Eventually, there would have to be less redistribution through the state budget, as this is what these postulates really come down to. State subsidies for unprofitable producers and company taxation must be cut. Thus, the argument about excessive fiscalism or excessive subsidies cannot be substantiated. What is justifiable is the conjunction of these two points of view, as the problem lies in too much redistribution through the state budget. One must add here, that limiting redistribution through the state budget will result in more redistribution through the market. Having said that, we must stress that the more balanced the economy becomes the less problems concerning redistribution we shall have.

In the light of this just postulate calling for the shifting of emphasis towards monetary policy, it is worthwhile to devote some attention to the issue of the so-called "real" interest rate. It is usually understood as an interest rate higher than the current inflation rate. This is not entirely accurate, because what it really means is a positive (in real and not nominal terms) rate, while a real interest rate actually means a rate which balances money demand and supply. Just as a real price is an equilibrium price (and not simply an unsubsidized one, though this approach seems to dominate in all discussions on the stabilizing functions of pricing policies), a real interest rate is not one which is simply higher than the overall inflation rate, but an equilibrium rate which balances the demand for money from all economic

sectors with its supply for the whole economy. In our further deliberations, however, we shall adopt the more widespread interpretation, of an interest rate higher than the inflation rate.

There is a common and sound postulate to reach a positive (in real terms) interest rate. The problem is that there is no way to establish what this rate should be. The market would take care of that in an advance market economy, but cannot do it in a destabilized, "post-planned" socialist economy. The monetary authorities cannot do it either, because it is an impossible task under ever higher inflation and persistent shortages. Given these circumstances, after a short period of adjustment, inflation would gain rise above the interest rate. This is connected to what might be called a specific balance of the anti-inflationary and inflationary effects of interest rate increases.

The anti-inflationary effects are connected with two processes. First, there is the decline (though, what must be emphasized, only temporary) in the demand for money from various sectors, especially from the companies. Companies opt for less liquidity, use more of their own funds as working capital and channel a higher proportion of their own funds into investment. Demand growth on the macroeconomic scale is lower, especially for capital goods, but consumer demand also falls, due to the indirect effects on the wages.

Second, there is the increase, though also only temporary, in the propensity to save. This effect concerns mostly the households. This adjustment process results again in a slower growth of demand, which has an anti-inflationary impact.

But these processes were to be observed on a certain scale in Poland in 1988, when the maximum interest rate was set at 30%. It was meant to be the so-called "real" interest rate, since it was three points higher than the inflation rate assumed in the Central Annual Plan (after the elimination of the lag effects from the previous year). The so-called "new" price growth was not to exceed 27%. Such calculations are obviously incorrect and are more of a manipulation designed to

produce short-term political effects. In reality, inflation rate was planned to be 45%. Eventually, it exceeded 61%, meaning that it was more than twice as high as the maximum interest rate, as the average interest rate on the deposits of the non-socialized sector was 22.5%, which resulted from the structure of the deposits of this sector of the national economy in the banking system.

These processes were even more apparent in 1989. There, attempts were made to correlate the interest rate directly with the inflation rate, setting the former as a ratio to the overall inflation rate assumed in the plan. The problem however was that, as was stressed before, that this is not a planned economy any longer. Projections set inflation at 55% (even in documents adopted by the Parliament as late as mid-February). Actually, inflation rate in the first half of 1989 was almost 80% in comparison with the corresponding period of the previous year and continues its rise. The monthly price growth is equal to about 8%, which gives an annual inflation rate in excess of 160%. Hence, the gap between the inflation and the interest rates kept on widening, instead of being nearly closed, which had been announced (with the usual fanfare) in statements on economic policy. Why was it so?

There is no doubt that rising inflation in Poland, and in other socialist economies, is affected by a whole set of relatively well-known and described causes (Adirim 1983, Nuti 1986a, Winiecki 1986, Kolodko 1987). There is no need for their broader presentation here. What must be stressed however, are the inflationary effects of the attempts to achieve a "real" interest rate. They are twofold.

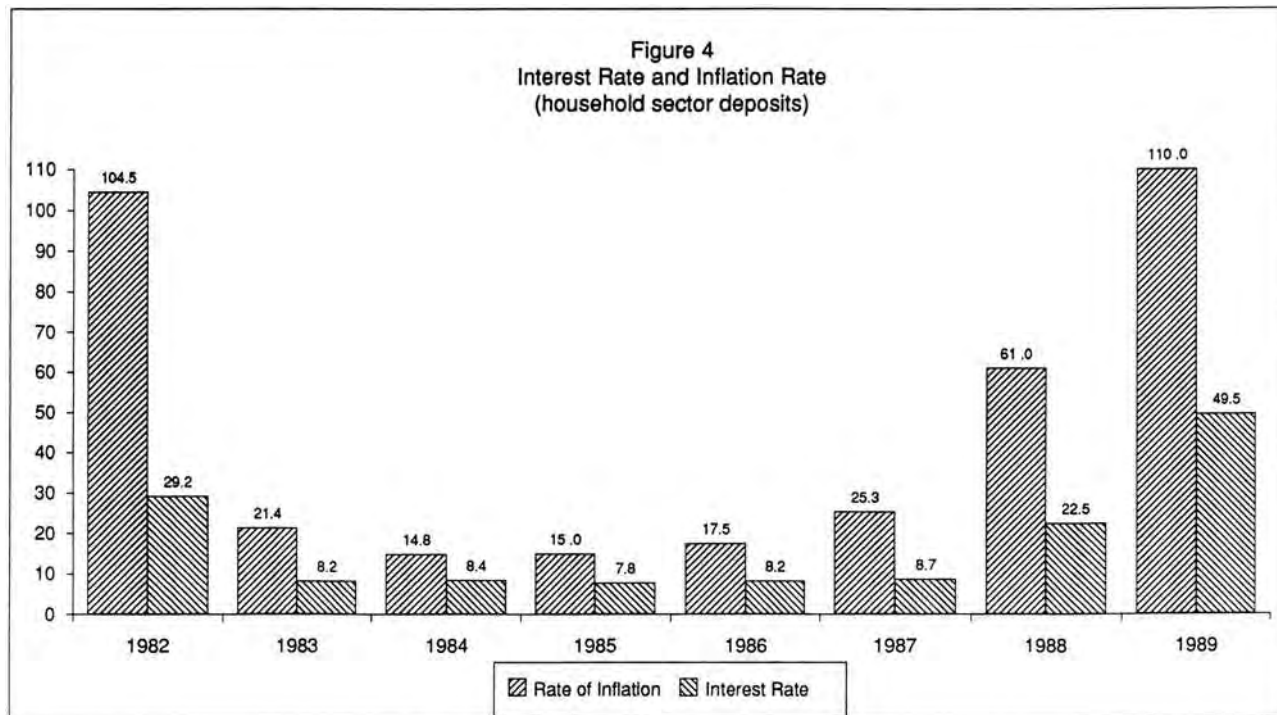
First, given the important (more than twofold, as the maximum rate had been set at 65% for 1989 and it will no doubt be revised upwards) increase in the interest rate paid on savings deposits, there will be an important growth in the incomes, especially of the households. This important source of additional demand, created solely by higher interest, will no doubt absorb a large proportion of the additional supply predicted for this year.

Second, bank credit is becoming increasingly expensive which, given the automatic inclusion of its cost in production costs and into prices, will send the overall price level still higher. After a slight drop in the demand for credits in early 1989, the inflationary character of adjustment processes led to recovery to at least the previous level. In other words, the publicly declared anti-inflationary effects of the attempts to achieve a "real" interest rate, actually fuelled inflation. Inflation still has the upper hand. Inflation and interest rate patterns are illustrated in Fig. 4.

Does that mean that raising the interest rate makes no sense? Of course not, since the smaller the gap between the inflation rate and the interest rate, the lower the losses of the depositors, the less redistribution via the banking system, shifting resources and incomes from those who save, to those who borrow. All I am trying to prove here, is only that such a policy will not ensure a lasting, long-term, positive (in real terms) interest rate and not even in the medium-term.

Attempts to achieve a positive (in real terms) interest rate can succeed only when inflation is falling. That was the case in Poland in the years 1982-85 (see Fig.1) and that was the time to take steps to set the interest rate on deposits and credits above the falling inflation rate. At that time, however, this postulate did not find the necessary support, was not espoused by the economic policy which, it might be believed, underlaid the inflationary take-off in the subsequent years.

It is in this light that we must formulate an economic principle which should be observed in the implementation of stabilization policies. Namely, that in an economy of shortage, attempts to achieve a "real" interest rate, by setting it higher than the inflation rate, will strengthen the current trend with regard to inflation. If, at a given time, the inflation rate is falling, then such adjustment of the interest rate will further curb inflation. And conversely, when such attempts are made while inflation is on the rise, a higher interest rate will send the overall price level still higher. Thus, an efficient stabilization policy must first lower the pace of price growth and only



Source: as in Figure 1.

then can it set the interest rate above the rate of price growth. It is therefore clear that the prime task of the stabilization policy must consist in reversing the coexistent trends of the accelerated price growth and of the ever more serious market disequilibrium.

Some of the postulates put forward in the "Position on Social and Economic Policy and on Systemic Reforms" worked out at the "Round Table" talks (Stanowisko 1989) seem to meet these requirements. While the whole set of measures proposed there seems to have an inflationary character, it does include a number of sound postulates concerning specific issues, especially those calling for the balancing of the demand and supply of capital goods, of the state budget and the adjustment of the overall company and household demand to the supply capacities of the economy. It is worthwhile to stress, in the light of earlier comments with this regard, that it is assumed that the automatic crediting of state budget deficits by the central bank will be abandoned. These deficits are to be financed by non-inflationary methods, among other ways, through the sale of some elements of state property and through the emission of securities, purchased by the companies and households.

The problem, however, is that unless more progress is achieved in curbing inflation, there will be little interest in purchasing such securities or in the development of the capital market, failing which one can hardly expect to balance supply and demand in the national economy. Hence, what we are facing here is a system of negative feedbacks, where once again inflation is the key factor. No major advances in stabilization can be expected unless there is some major breakthrough with respect to inflation.

4. Stabilization Measures versus Consumption and Wages

The need to lower the living standards of certain social groups may be one of the very unpopular elements of stabilization policies, especially in the short run. This issue merits more attention, as it often leads to various misunderstandings. We often hear the postulate - also advanced by Polish economists (Kleer 1989) - that the crisis cannot

be overcome without a further fall in the population's living standards. Here we shall treat this living standard at par with consumption from the national income, although this is methodologically incorrect, as the category of real consumption would be more appropriate. Real consumption covers more than consumption from current national distributed income (included foreign transfers), including also the value of consumption resources amassed in the past and the value of households' own production and services. It can happen in a crisis (understood as economic recession) that consumption in terms of the distributed national income may fall, while real consumption will still rise, or at least fall at a lower pace. M. Pohorille called this phenomenon the "lag principle" (Pohorille 1982). It no doubt occurred in Poland in the early eighties. However, we shall concern ourselves with another problem here. Namely, whether or not the implementation of proposed stabilization and adjustment measures really necessitates lowered consumption?

There is no such necessity, though there is a need to lower real personal incomes (including wages). These two statements are not as contradictory as they may appear, if the analysis is confined to the macroeconomic scale and/or considered in terms of averages. This ostensible paradox of a decline in real wages accompanied by rising consumption is possible only under the conditions of an economy of shortage, i.e. under inflationary disequilibrium. As it is known, the latter is the only type of disequilibrium inherent to the socialist economy. Let us focus on this issue and try to explain it drawing on recent Polish experiences.

In an economy which is experiencing strong, though partly repressed inflationary pressure, demand permanently exceeds the supply. In the long run, this leads to the creation of the so-called inflationary overhang (Herer-Sadowski 1981, Kolodko 1986, Nuti 1986a). Under such conditions, even when the overall pace of price growth (inflation rate) is higher than the growth rate of nominal personal incomes (wages), household consumption can still grow. After all, consumption is a function of production and of the supply of consumer

goods or, even more precisely - of their real sales - and not of the overall level of real incomes. Let us consider this on an example.

In year t_0 nominal household incomes were 100 units, whereof 95% was earmarked for consumer expenditure, while 5% for the increase in voluntary savings. The supply of goods (actually sold), however, was only 90 units, thus compulsory savings (i.e. imposed on the households by the shortage of goods) were also 5 units. In year t_1 nominal wages grew by 10%, achieving the nominal level of 110 units. Inflation rate at the same time was 14%, thus the price index was 114. This means that real wages fell by 3.5% (i.e. to 96.5%). The supply of goods to the market - which is a function of other variables - increased over this period by 2% (e.g. thanks to increased productivity), which means that supplies to the market were equal to 91.8 of the preceding year's level (in terms of volume) and to 104.6% in nominal terms. The propensity for voluntary savings remaining at 5%, the households would have saved 5,5 units from their incomes (which for our purposes we assume to be equal to wages). Effective demand was therefore 104.5 units (current nominal incomes less increase in money balance due to voluntary savings). This demand was met by a supply increased by 2% in real terms, in comparison with the preceding year, or 104.6% in nominal terms. The entire supply was sold and - assuming that households did not stockpile - consumed. Thus, consumption grew by 2%, for that was the growth in production (and also in supply, spending and lastly - consumption), even though real incomes had fallen by 3.5%. These figures more or less reflect the situation in Poland in 1987, when real wages fell by 3.5% on the average, while household consumption grew by about 3% (and about 2.4% per capita.)

Let us observe that on the macroeconomic scale the "cost" of this trend was the elimination of compulsory savings, which fell from 5% in year t_0 to zero per cent in year t_1 . To make the picture complete, we must add that the stocks of goods grew by 0.1% in year t_1 in current prices, which is due to a slight excess of supply (104.6%) over demand (104.5%) created by current incomes. This is precisely the desired stabilization effect which is to be sought in the lowering the level of

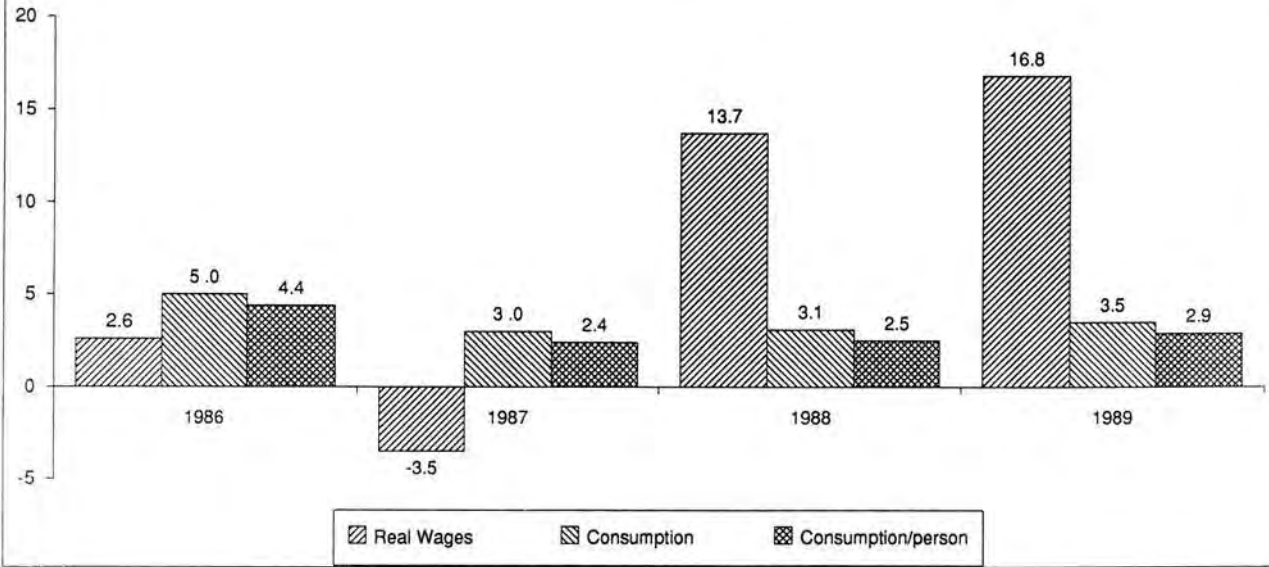
real incomes in an economy of shortage. Thus, this effect can be achieved without lowering the average consumption level, as long as it is possible to maintain an economic growth structure capable of keeping consumption on the rise.

Naturally, the inverse may also be true. It is possible to have an increase in real wages (in the statistical approach) accompanied by declining consumption, or even a disproportionately high increase of wages comparing to the actual growth of production and consumption. This was the case in Poland in 1988, when a 3.1% increase in consumption was accompanied by a nearly 14% rise in real wages! Recent patterns with this regard are illustrated in Fig. 5.

The core of the problem lies in the fact that the relationships discussed here apply to the macroeconomic scale and to averages. In the real-life social and economic mechanism, a 3.5% decline in real wages accompanied by a 2.4% rise in consumption, means only that it was how things were on the average. The higher the inflation rate, the more important are the deviations from this averaged picture. This is why stabilization policies calling for the lowering of real wages (without a decline in the average - and let's stress the word "average" - consumption level of the households) are all the more difficult to implement, insofar as social acceptance is concerned, the higher the inflation rate. And yet, it is then that this acceptance is needed most badly.

The situation in Poland is rendered still more complex by at least two factors. First, comes the widespread attitude, that no decline whatsoever in real wages is acceptable, that the Polish society had already paid dearly and enough for the crisis. This hinders constructive discussion which, among other things, should clearly point to the difference between real wages (in formal and statistical terms) and consumption. Let us make it clear, however, that this point is not the only one. We must remember that in our theoretical example, the households were left with nominal savings of 10 units in year t_0 , but half of that were compulsory savings induced by shortages. In year t_1 ,

Figure 5
Consumption and Real Wages
(annual rate of growth in %)



Source: Central Statistical Office and own calculations. Data for 1989 - own forecast.

they ended up with savings of 5.5 units, pointing to the stabilization in the real level of savings and there were no compulsory savings on the macroeconomic scale. I believe that this beneficial stabilizing effect is unwelcome from the microeconomic point of view of the households, due to the impression that they are losing money.

The second factor which complicated the situation with this respect, was the discontinuous nature of real income and wage growth in 1988. It has been negatively offset in the subsequent periods, unless some other outlet like, e.g. voluntary investment, is provided. It appears possible in view of the newly created opportunities for private enterprise and for private investment in productive activities. What is most important, however, is no longer to drain excessive financial resources from the households but to match supply to current personal incomes.

Keeping in mind economic, social and political constraints, it would appear that as far as the real growth of personal incomes (especially wages) and consumption are concerned, socialist countries suffering from high inflation should follow stabilization policies characterised by certain definite features.

First, they should stabilize real wages for at least several years or even - in extreme cases (Poland being one) - lower somewhat their average level.

Second, there should be a moderate growth in consumption in line with the growth of the distributed national income, that is after the necessary deductions for the service of a part of the foreign debt.

Third, stabilization should gradually reign in price inflation (insofar as practicable at a given stage of the adjustment process), to minimize wealth and income redistribution, i.e. to minimize deviations from the standard situation for all households.

Fourth and last, necessary protection ought to be given to the economically weakest groups, to avert an excessive lowering of living standards among these social strata. There is no doubt, that such lowering of living standards will be inevitable with regard to quite numerous groups of the population. That is the price of stabilization measures or rather the cost to be borne to overcome economic crisis.

5. Attempts at Stabilization - Political Aspects

Each country has its specific features. Apart from the generalities, even crisis, adjustment and growth have a number of specific traits. They sometimes decide on the rarity, or even exclusivity of some phenomena and processes, in other cases they only determine the specific forms in which certain general trends and patterns are manifested. It is the latter that we are most interested in. It is also in this context that one should view the successive attempts to bring the crisis of the Polish economy in the final years of this decade under control and to overcome what has been called the general crisis in the socialist economy in the final years of this decade. We specifically refer here to the "Plan for the Consolidation of the National Economy" (Plan 1989) and the deliberations and results of the "Round Table" (Porozumienia 1989).

The "Plan for the Consolidation of the National Economy" came into being as yet another initiative aimed at stabilizing the national economy after several successive failed attempts (or failures to even try - as was the case of the "Program for the Strengthening of the Currency" - [Program 1987]). Specifically, it was a reaction - and a very prompt one at that - to the catastrophic outcome of the price and income operation (sometimes referred to as "price-list and compensation" operation) of February 1988. As stressed before, the situation escaped control and rising open price inflation, which exceeded the planned 45% to reach 61%, was accompanied by a visibly stronger repressed inflation. Already massive shortages became even more dramatic. This was followed by stronger social discontent, leading to the staging of various protests and strikes. The beginning of the implementation of the so-

called "2nd stage of economic reform", designed to bring economic, social and political stabilization, produced quite the opposite effects. These developments led to the demise of the government - first time ever in the history of the socialist countries. It is worth stressing, that the motion calling for the resignation of the cabinet was put forward - publicly at least - by the so-called "official" trade unions.

The government resigned but the system remained. Problems waiting to be solved, more complex than ever, remained too. Rising inflation, ever stronger economic disequilibrium and growing foreign debt are the foremost. Wage disparities are also increasing, entailing all the obvious social and political consequences, while the definitely undesirable structure of prices is setting in. One may say that the situation in 1989 is much more difficult than in the beginning of the decade, despite many attempts at its improvement made in the meantime.

The "Plan for the Consolidation of the National Economy" put forward in August 1988 at the 7th Plenum of the Central Committee of the PUWP, which the Parliament adopted after much discussion and controversy in February 1989, was designed to change this state of things and of the negative trends it produced. Unfortunately, it proved to be yet another plan of wishful thinking. It concentrated on inflationary goals derived from social motivations, rather than on strict, stabilizing measures. High priority was given to the food industry, housing and environmental protection. Attempts to found the "Plan for the Consolidation..." on the otherwise sound assumptions of the "Program for the Strengthening of the Currency", which assumed a subordination of state economic policies to the challenges posed by the need to contain economic disequilibrium and inflation failed, because the mechanisms of negotiation and consultation - so desirable in principle, when our economic and political life is undergoing democratization, but which are not a substitute for democratization - often lead astray to rotten compromises. Instead of radical, consistent and - above all - comprehensive measures, it all came down again to attempts to conciliate incompatible postulates of economic policy.

It must be emphasized that the "Program for the Consolidation of the National Economy" should have been correlated to the corresponding adjustment program negotiated with the International Monetary Fund. In a certain sense, it was to be its internal, domestic version. This however was not the case. Eventually, it came out that it was impossible to elaborate a single plan of stabilization measures, which would meet both the main criteria put forward by the international financial community and those of the population. A stabilization plan for Poland, and actually for many other countries, including Yugoslavia and Hungary, would have to reflect a certain compromise between these two contradictory positions. However, that the only measures which offer some chance of success are those which will be aimed at the gradual overcoming of the shortageinflation syndrome.

The consolidation plan does not offer such opportunities, because it is not really aimed at curbing inflation. Actually, this should not be a source of concern, since under the present systemic and political circumstances, such a plan cannot be viewed as a real instrument of macroeconomic policy, because one can fully support the earlier statement, that this is no longer a centrally planned, but not yet a market economy. Moreover, the life expectancy of the consolidation plan has been clearly shortened and its importance changed, following the results of the "Round Table" and the consequences that its settlements may have for the stabilization of the national economy and for its growth.

The idea of the "Round Table" came into being more or less simultaneously with that of the consolidation plan. Its sense consisted mostly in the political aspects, which cannot be underestimated. The very fact that people representing different ideologies and political convictions met and negotiated, merits praise and testifies to progress in democratization.

Some elements of the settlements achieved at the "Round Table" will no doubt have a positive impact on the systemic sphere. Settlements concerning the so-called "new economic order", which further develops

the correct assumptions on the marketization of the economy, are amongst the foremost. Despite differing rhetorics, the elements of new economic order are essentially a continuation - despite a somewhat different distribution of emphasis, an intensification of certain steps and a radicalization of certain solutions - of the guidelines adopted in the program for the implementation of the 2nd stage of economic reform and in the consolidation plan. It is no doubt an important step forward in the process of systemic transformations, which has been called the "triple D" (as an analogy to the already traditional "triple S"), referring to deregulation, demonopolization and democratization (Kolodko 1989b).

While settlements concerning the area of systemic adjustment raise rather less objections and doubts, the postulates concerning economic policy must lead to objections. Here again, politics dominated over economic rationality, with the sole difference that this time the opposition is to blame, rather than the government. The opposition was also guided by its short-term political interests, connected with its legalized renaissance in the enterprises. The suspension of strikes resulted in the forced settlement on a general system of wage indexation, which - facing inflation in the region of the psychological three-digit level and massive shortages - added another factor to the already very strong mechanism of the inflationary spiral. This reflects passive subordination to inflationary processes, resulting from the inability to stand up to it.

General and automatic indexation will further fuel inflationary processes, checking at the same the opportunities to introduce necessary changes in the structure of prices and incomes. This will prevent any efficient operation on the part of mechanisms designed to provide incentives for better work.

While attenuating - and only temporarily - the wage demands of some social and professional groups, the system of general indexation will only boost demands put forward by other groups and also - further weaken the impact of the new financial and economic mechanisms, which

are so difficult to set in motion under the conditions of rampant shortageinflation. Widespread and automatic indexation of wages and other incomes is justified only with regard to the sphere of non-productive services and some social benefits, especially disability and old-age pensions and scholarships. With regard to the productive sphere, it would put in question the whole set of stabilization measures, including those proposed in the "Round Table" settlements.

The idea which professedly underlies the postulate of generalized indexation is connected to naive faith in the appeasement of social attitudes. Actually, that is quite impossible, due, among other things, to the strength of social demands, the time lag between the adjustment of wages to rising living costs or - more precisely - to the important and hardly controllable differences in this time lag. Indexation in an economy of shortage can be hardly compared to the market economies. In the first case, the households form their expectations with respect to inflation and their demands basing on their subjective appraisal of price movements in the free markets (alternative, black, etc.), where these movements are much stronger, rather than on the average increases in the cost of living.

The adoption of automatic indexation, at the threshold of three-digit inflation and with major shortages, would be tantamount to a quantum leap into rampant inflation. This phenomenon should be understood as a scale of inflationary processes where wage movements are no longer connected or related in any way whatsoever with changes in the effectiveness of production or labour productivity, where savings lose their sense, while inflation turns against economic growth. Eventually, such developments must end in a monetary reform. The implementation of such reform, however, may prove incompatible with the further democratization of political life.

Given the existing set of circumstances, such an ill-considered decision on introducing generalized indexation, will produce a situation where monetary reform will be only a matter of time. It is likely that in the meantime we may have yet another unsuccessful stabilizing

operation, that is a freeze on wages and prices. Obviously, such a freeze will not cure the causes, nor the far-reaching consequences of inflationary processes, but will at least cut down the population's expectations of inflation and allow some time required to prepare further action. Actually, a freeze on wages and prices would have more sense under the present circumstances, much more than generalized indexation, which offers no positive solution to the situation. It seems, however, that political considerations had once again outweighed the economic reasons. Short-term political interest had once more triumphed over long-term economic interests. This time, however, the responsibility for this ill-considered economic policy is not only the government's, as before, but also of the opposition, though there is no doubt that the authorities will get all the blame. That is the cost to be paid for this late birth of democratic institutions in Poland.

PART III: FOREIGN ECONOMIC POLICY AND EXTERNAL BALANCE IN THE 1980s
by Dariusz Rosati

1. External accounts in the 1980s

The decade of the 1980s started with the rapid deterioration of economic and financial conditions at international markets. The Polish economy, plagued by an inefficient planning and management system, disastrous economic policy and growing social and political unrest, proved to be particularly vulnerable to external shocks (such as a deep recession in developed market economies, a two-fold oil price increase and soaring interest rates). In 1981 Poland asked for a rescheduling of its foreign debt, but still tried to maintain necessary levels of imports drawing on new credits from the Soviet Union. The situation sharply deteriorated after the imposition of martial law in December 1981 had led to credit and trade restrictions introduced by Western countries. Net Material Product (distributed) sunk by 10.5% in 1982, being lower by more than 27% than in 1978. Convertible currency exports decreased from 7.5 billion US\$ in 1980 to 5.7 billion US\$ in 1982, and convertible currency imports dropped from 8.5 billion US\$ to 4.3 billion US\$ over these two years. This tremendous 'supply-side' shock was partly absorbed by reduction of output and partly by massive price increases (the consumer price index went up by 102% in 1982). As a result consumption per capita decreased by almost 17% between 1980 and 1982.

Responding to the embargo on new credits imposed by the West, Poland suspended foreign debt service, channelling limited resources of foreign exchange for necessary imports in order to protect domestic output and employment. Deep cuts in investment and consumer imports together with the suspension of debt service and the unavoidable reduction of domestic output allowed for the first time to switch the trade balance from a permanent deficit to a surplus of 350 million US\$ in 1982. It must be remembered, however, that this was achieved through a very sharp decline of national income.

In an attempt to compensate for lost sources of supplies in the West, Poland tried to secure the inflow of necessary primary products from the Soviet Union. Financial assistance from the USSR allowed the avoidance of an even deeper collapse of production and industrial output, but added to the overall external indebtedness of Poland. Transferable rouble debt rose from less than 1 billion in 1979 to almost 6.5 billion at the end of 1988 (of which 94% to the USSR). In the longer run this geographical and political 'reorientation' of Polish foreign trade towards the East could not have produced the expected stability of supplies because the USSR had itself only limited capacities to produce more fuels and raw materials and also their quality and technical characteristics were different from those required by Polish industry, which in turn was largely based on Western technologies. As a result, hopes for 'reorientation' quickly faded and Poland had to undertake efforts to rebuild its export capabilities to the West.

A deep reduction of domestic consumption and even more drastic cuts of domestic investment allowed for sizeable increments of exports in 1982-84. Of special importance was of course, a recovery of coal exports, which first dropped dramatically from 41 million tons in 1979 to 15 million in 1981, and next increased gradually to 28 million tons in 1982, and almost to 43 million tons in 1984 (the highest level ever recorded). It must be stressed, however, that this initial export expansion was produced neither by a significant policy change towards export-oriented activities, nor by a result of radical market oriented and pro-efficiency reforms. Further developments proved that the growth of exports in 1982-84 was rather an outcome of elementary coordination of the national economy after the collapse in 1981-82 and no permanent basis for long-run export activities had been created. In 1985, hard currency exports declined by 3.2% and Poland, after having exploited superficial reserves (e.g., almost total absence of strikes, large unused production capacities in industry), entered a prolonged period of low dynamics of output and exports, gradually increasing imbalances and growing inflation. In the annual report of the World Economy Research Institute, a group of independent Polish economists warned in 1986:

"...There is considerable evidence, that symptoms of stagnation observed in the Polish economy in 1985 do not constitute only a short-term deviation from the growth trend followed in 1983-84...It is very likely that 1985 marks the beginning of a prolonged period of stagnation in Poland, and may even lead to a new, deep economic and civilization crisis..."(WERI, '1986, p.47).

From today's perspective it seems, that this opinion was by no means excessively pessimistic and that the year 1985 was accurately identified as the turning point. Another publication even predicted the timing of the new crisis:

"...An enormous effort is urgently necessary to make a qualitative breakthrough in economic processes to prevent the possibility - within the next 2-3 years - of a consecutive social crisis..." (Huebner, Rosati, 1986, p.402).

Erratic and inconclusive efforts by the Polish government to accelerate exports and to control the foreign debt without resorting to drastic restrictions on domestic demand did not produce the expected results. Bureaucratic and political resistance against radical market-oriented reforms strengthened considerably after Xth Party Congress in 1986, when conservatives had won majority. The government of prime minister Z. Messner, proved to be unable to go ahead with reforms, which would undoubtedly disturb vested interests of powerful industrial and administration lobbies. Economic policy became inconsistent and dominated by the short-term goals of political stability, the significance of achieving foreign balance was gradually losing ground to other domestic policy objectives and Poland was not able to continue with further improvements of the external equilibrium position. These phenomena were noticed with some concern also by the IMF (see IMF Survey, 1987).

Exports were growing at the average annual rate of 7.7%, but imports were growing much faster (9.70%) and the trade surplus (first achieved in 1982, due to drastic cuts on imports) after reaching a peak of 1456 million US\$ in 1984, has shown a declining tendency in recent years, coming down to 920 million US\$ in 1988 (see Table 1). Even together with the balance of private remittance, which grew steadily to 1.4 billion US\$ in 1988, Poland could not manage to meet debt service payments and was not servicing foreign debt in full. As a result, external convertible currency debt increased from 21.9 billion US\$ in 1979 to 39.3 billion US\$ at the end of 1988, which was almost entirely due to accumulated arrears and capitalized interest. In 1986, Poland opened up to foreign direct investment, but the inflow of funds from the West was below expectations (less than 120 million US\$ over three years) and obviously could not alleviate balance of payments difficulties.

2. System changes and policy in Polish foreign trade: The Recovery of 1982-84

Economic reforms introduced in 1982 changed the institutional environment of foreign trade activities, with the elimination of central command planning being probably the most important reformist decision. As traumatic as it might have been for political authorities and central administration, the removal of the central planning dogma was, however, not sufficient to create a viable market mechanism and to stimulate pro-efficiency structural changes. Economic reform had serious conceptual flaws in its initial framework and moreover, its implementation was very inconclusive, sluggish and lacking imagination. While laying foundations for the product market, the government clearly tried to avoid the creation of capital market, foreign exchange market and labour market - probably for ideological and political reasons. Although foreign exchange auctions started already in 1982, they sold only marginal amounts of foreign exchange (covering less than 0.1% of import needs) and until 1988 had no practical significance. Also a capital market has not been established as yet for various reasons, foremost among them being the lack of political decision to open doors to the privatization of state owned enterprises. These ideological fears are still strong,

Table 1.
Poland's Balance of Payments
(Convertible currency area, in USD million, 1981-1988).

Item	1981	1982	1983	1984	1985	1986	1987	1988
A. Current Account								
1. Merchandise trade:								
1.1. Exports	5482	4974	5402	5828	5768	6226	6920	7911
1.2. Imports	6233	4616	4317	4372	4594	5108	5878	6991
1.3. Trade balance	-751	358	1085	1456	1174	1118	1042	920
2. Services								
2.1. Inflows	814	577	800	735	753	812	968	1030
of it interest	169	86	161	183	168	183	212	280
2.2 Outflows	3849	3470	3500	3350	3214	3448	3809	3946
of it interest (due)	3345	3063	2893	2732	2612	2739	3016	3096
of it interest (paid)	2272	1862	1591	1248	1234	1152	924	954
2.3. Service balance	-3035	-2893	-2700	-2615	-2461	-2636	-2841	-2916
3. Transfers (balance)	645	318	375	462	764	944	1407	1433
B. Capital Account	-2546	-4948	-3677	-2802	-2155	-3852	-3232	-3930
4. Long-term capital	-1537	-5233	-3744	-2675	-2164	-3436	-3171	-3571
4.1. Foreign investment	1	-1	2	2	1	-5	2	-18
4.2. Lending	420	5	69	176	9	253	249	118
4.3. Net borrowing	-1118	-5227	-3677	-2501	-2156	-3178	-2924	-3435
of it repayments (due)	6037	6701	4242	2719	2417	3472	3241	3694
of it effective payments	1397	368	508	364	765	715	646	636
5. Short-term credit	-767	-6	4	54	159	83	9	1
6. Errors and omissions	-242	291	63	-181	-150	-499	-70	-360
C. Change in reserves	-35	-369	-119	-340	236	173	-797	-561
D. Restructured liabilities	2111	4358	1154	2427	13337	1688	7484	4700
E. Change in arrears	3602	3176	3882	1412	-10895	2565	-3063	354
F. Total foreign debt, hard currency, US\$. bill	25.9	26.3	26.4	26.9	29.3	33.5	39.2	39.2

Source: Compiled from data of National Bank of Poland.

although it seems that strategic clearance has been given at the 'round-table' debate to go ahead with large scale privatization through institutionalized capital market. Likewise, the creation of a genuine labour market has been continuously postponed.

Meanwhile, the 'half-reformed' economy displayed still a number of distortions, leading to increased disequilibria at many markets and gradually steered away from market regulation.

The foreign trade regime introduced in 1982 was an outcome of two conflicting tendencies, which dominated systemic changes through out the whole period of the 1980s. On the one hand, the government tried to implement indirect economic instruments to take advantage of emerging market mechanism in pursuing the policy objective of export expansion. Direct central planning was abolished, the state monopoly of foreign trade has been somewhat relaxed by creating legal possibilities for enterprises to obtain rights to enter foreign trade transactions, and a system of decentralized allocation of foreign exchange in the form of 'foreign exchange retention quotas' has been introduced for exporters. On the other hand, however, because the fears of loosing control over a depressed economy and facing strong political opposition, the government maintained a number of restrictions on the market mechanism, foremost among them being widespread price controls, unrealistic foreign exchange rate, coupled with an administrative price equalization system and lengthy bureaucratic procedures for capital transactions.

Statistical data seemed at first to suggest, that the new system worked fairly well during the recovery after a deep recession in 1982. Exports of coal, the main source of currency earnings, reached a record level of 43 million tons in 1984 (of it almost 60% to the convertible currency area), surpassing the highest pre-crisis level by 2.4% (in 1979). The level of capacity utilization in industry increased allowing for higher exports of manufacturing products. Yet these successes were shortlived. In 1985, symptoms of stagnation became more and more apparent, and reform-minded economists called for more radical changes in economic mechanisms and in economic policy. However, political

constraints did not allow for significant acceleration of the reform (Rosati, Mizsei, 1989).

The drop in hard currency exports in 1985 was caused not only by the lack of progress in systemic mechanism, but also by the anti-export orientation of economic policy, which was not initially properly recognized. Despite strong official rhetorics putting exports as one of the high priorities of economic policy, the actual structure of protection was, in fact, favouring import substitution. The main element of the anti-export bias was the overvalued exchange rate of Polish currency, coupled with widespread administrative restrictions on foreign trade transactions.

The foreign trade regime in Poland in 1982-1985 was still largely based on directives and administrative regulations. True, command planning ceased to exist formally, but foreign trade companies still followed the guidance of ministries in setting their planned targets, because 'informal' dependence was nevertheless quite strong. First of all, more than 80% of imports were financed through the central allocation of foreign exchange, administered by the Planning Commission. Second, individual careers of managers depended heavily not on the performance of their companies, but rather on good or bad relations with higher organs (ministries, 'founding organs', unions etc.). Finally, export did not initially enjoy strong financial preferences; tax relief on exports introduced for the first time in September 1982 were very small (3-4% of export value) and obviously did not compensate for the additional effort connected with exports to highly competitive Western markets.

It has been a common view, that the two strongest incentives for exports in the period 1982-85 were 'foreign exchange retention quotas', or RODs (rachunki odpisów dewizowych), and the legal possibility of obtaining foreign trade license ('koncesja'). RODs allowed exporters to retain certain proportion of export earnings for their own use. The stimulating power of this instrument was, however, limited, because the use of these funds was restricted to purchases of raw materials,

components and spare parts, and because ROD rates were quite small. Individual rates varied from 2-3% to 50%, but on the average they were below 20%. The share of RODs in total import financing was therefore small, rising from 6% in 1982 to 18% in 1983 and 19% in 1984. After having reached a certain level of hard currency earnings, securing necessary supplies, producers were not interested in further export expansion and preferred to produce for domestic markets where sales conditions were much easier than abroad. Another conceptual shortcoming of RODs was that they were based on import intensity of output, thus reducing willingness to eliminate redundant imports.

As to the licensing, contrary to earlier expectations, only a few enterprises displayed an interest in obtaining rights to trade directly. Conditions required to obtain a license were still quite restrictive (at least 1 billion zł. of exports or a 25% share of exports in total output plus so-called 'organizational' conditions assessed arbitrarily by the Ministry of Foreign Trade). By contrast, private companies were much more interested in licensing. The number of licensed enterprises increased from 164 in 1982 to 245 in 1983 and 330 in 1984, out of which more than 80% were private companies and individuals.

An overwhelming majority of foreign exchange was distributed through administrative procedures and this traditional system blocked effectively initiatives to develop new kinds of exports as long as it needed some imported inputs. Foreign exchange auctions, introduced in 1983, were organized only on an 'experimental' basis for negligible amounts of hard currency (over the period 1983-1986 only 2.5 million US\$ were sold, i.e., less than one promille of total import value).

One of the main reasons for the poor performance of the Polish economy in that period, and of the foreign trade sector in particular, was the exchange rate policy, dominated by domestic rather than external considerations. In the 1970s, Poland followed a very passive exchange rate policy, maintaining the level of US dollar rate close to the average cost of acquiring one dollar in commodity exports. In 1982 a new policy rule of the so-called 'sub-marginal' exchange rate was adopted,

recommended as appropriate in a new, reformed environment. The 'sub-marginal' rate was supposed to secure the profitability of 75-85% of exports and it was set as a basic guideline for exchange rate policy. But this rule has never been actually observed and the official rate was always kept at a lower level, securing profitability of 60-65% of exports, the remaining part being automatically subsidized directly from the budget.

A devaluation of the zloty by 79%, made at the beginning of 1982, was meant to close the gap between the average rate inherited from the 1970s, and the 'sub-marginal' rate. But potential benefits which might have stemmed from this bold operation were effectively neutralized by a parallel increase in the general price level by 102%. As a result, a real revaluation of the zloty took place instead, leading to a further weakening of incentive towards a possible expenditure switch from non-tradeables to tradeables. A similar, very careful and defensive foreign exchange rate policy has been followed throughout the whole period 1982-1988. As can be seen from Table 2, there was practically no real devaluation over that period.

Some interesting conclusions can be derived from the data presented in Table 2. Most striking is perhaps a stability of the relation between price changes and foreign exchange rate changes. Assuming 1980=100, the consumer price index rose to 936 in 1988, whereas the exchange rate index rose 972, which means that we had a 3.8% real devaluation over a nine year period - hardly a devaluation at all. If one takes into account increasing shortages and disequilibria, it becomes clear that the exchange rate policy was still very passive.

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Table 2

Real devaluation of zloty in Poland, 1980-88
(indices lower than 100 mean real revaluation)

Year	Consumer Price Index	Official (zł/\$)	US\$ rate (Index)	Real devaluation (4/2)
1	2	3	4	5
1980	100.00	44.3	100.00	-
1981	121.2	46.6	105.2	86.2
1982	204.5	83.4	179.0	87.5
1983	121.4	91.6	109.8	90.4
1984	114.8	113.7	124.1	108.1
1985	115.0	147.2	129.5	112.6
1986	117.5	175.2	119.0	101.3
1987	125.3	265.2	151.4	120.8
1988	160.0	430.6	162.4	101.5
1989 ^{a)}	140.0	632.0	146.8	104.9

a) Preliminary estimates for January-June, 1989.

Source: Compiled from data of Central Statistical Office and National Bank of Poland.

Next, it can be seen that in 1985 and in 1987 the government tried to devalue domestic currency more decisively, but each time this effort was shortlived and ineffective. At the same time, however, the government paid heavy subsidies to exporters, accepting in practice effective exchange rates 50-100% higher than the official rate.

The main reason for keeping an overvalued zloty rate was, of course, the belief that devaluation had a necessarily high inflationary

impact on domestic price levels without inducing an increase of exports and reduction of imports. A number of studies demonstrated conclusively that the effect of devaluation on price level is rather moderate and largely disappears after 0.5-1 year (0.2% of the increase in price level for 1% of devaluation - under the assumption of no monetary restriction), but within the government the so-called 'elasticity pessimism' prevailed (see e.g. Rosati, 1982; Ledworowski, Michalski, Piotrowski, 1984; Piotrowski, 1989).

Another original flaw, at the early stages of reform, was that domestic prices for primary products have been in 1982 calculated through conversion of average world market prices using 50 zl/dollar rate and not the official rate of 80 zl/dollar. This operation introduced very serious distortions in the price system and since then primary products have been always relatively cheap (and in the most, in short supply). Again, the reason was to keep inflation under control. This policy of fighting inflationary symptoms instead of sources, obviously backfired, producing constant shortages and repressed inflation (see Kolodko, 1989; Rosati, 1989).

3. Growing disequilibria and policy adjustments in 1985-1988

Declining hard currency export earnings in 1985 (by 3.2%) and growing inflationary pressures were alarming signs of insensitivity of the Polish economy to the policy measures applied in 1982-84. Responding to the challenge, the government tried to restore export expansion through fiscal incentives, and to put inflation under control through a restrictive foreign exchange rate policy. This package was obviously inconsistent because the two instruments contradicted each other. Fiscal reliefs from export activities went up from 2-3% of export earnings in the second half of 1982, to 3-6% in 1984 to 3-8% in 1986 and up to 12% in 1987 (with more processed exports enjoying higher rates). As a result, the total amount of fiscal benefits from exports (deducted from corporate income tax liabilities) increased from less than 2% of export value in 1982, to 4.4% in 1985 and to 10.2% in 1987 (see Table 4). Except for corporate income tax reliefs, exporters could have obtained a

special relief from Excess Wage Tax ('PPWW') and an exemption from domestic turnover tax. While the latter has always been rather insignificant (its annual value varying from 2 to 6 billion zl., i.e. 0.1-0.5% of exports), the former was considered quite important as the reliefs were directly paid out as bonuses and wage increases for workers employed in exporting enterprises. Unfortunately, no statistics are available on the amount of the Excess Wage tax reliefs, except for 1987 and 1988.

Another important export supporting measure was a package of incentives for export-oriented investment projects, including preferential interest rates and investment allowances reducing taxliabilities. The package, introduced in 1985, was however, too limited in terms of funds made available for export investments (10 billion zl. - less than 1% of total domestic investment) and obviously could not produce a massive reallocation of resources to export industries.

These export stimulating measures were, however, effectively counterbalanced by a number of other policy decisions, dominated by government anxieties about the internal market situation. Official zloty devaluation was practically stopped in the second half of 1985 and throughout the whole of 1986, reducing export profitability and putting more pressure on imports. The US dollar rate increased from 159 zl/dollar in June 1985 to 200 zl/dollar in December 1986, i.e. by 25.7% whereas consumer prices went up by almost 30% (see Table 2). At the same time, prices for primaries were kept at artificially low levels in a futile attempt to stop inflation through administrative controls. Differentials between international prices and domestic prices were equalized with subsidies and taxes from the Price Equalization Account (PEA), financed by the central budget. As can be seen from Table 4, a growing amount of equalization taxes and subsidies gives evidence of increasing price distortions at the domestic market. Since monetary expansion was still unrestricted (real interest rates were negative, budget expenditures were increasing faster than real output, and credit limits were notoriously surpassed with no sanctions), domestic demand

was rising fast, producing widespread shortages, putting strong pressure on prices and diverting resources from export activities.

One of the most binding constraints on export development was the traditional system of allocation of foreign exchange, based mainly on administrative rationing. ROD accounts, developing fast in 1982-83, were practically stabilized in the following years, leaving limited possibilities for exporters to take advantage of increased export earnings. Moreover, the liquidity crisis in 1985-1986 led to a suspension of payments from ROD accounts, placing many enterprises in a critical condition, because of sudden shortages of imported inputs. As can be seen from Table 3, the central allocation of foreign exchange still dominated over decentralized imports. The share of RODs in total import financing, after jumping from 6.2% in 1982 to 18% in 1983, grew only by 6 percentage points over the next five years.

Table 3

**Sources of foreign exchange financing of convertible
currency imports, 1982-1988 (in %)**

Source	1982	1983	1984	1985	1986	1987	1988
Central allocation	-	-	70.1	67.8	64.2	64.9	61.2
ROD accounts	6.2	18.3	19.4	20.6	23.5	23.5	24.7
Other decentralized sources (like credits, auctions, barter transactions, 'Pewex' quotas etc.)	-	-	10.5	11.6	12.2	16.0	14.1

Source: Compiled from data of Central Statistical Office and of the National Bank of Poland.

In 1986, pressures from the deteriorating situation in the current account balance intensified. The trade surplus was gradually shrinking, credit and financial restrictions imposed by Western countries in 1982 still continued, the supply of traditional export commodities could not

be further expanded (coal exports declined to 34 million tons in 1986 and to 31 million tons in 1987), and manufacturing industries proved unable to fill this gap. Poland decided to open up to foreign direct investment in the form of joint capital ventures. A new law offered 2 years tax holidays, preferential tax rate (50% as compared to 65% for national companies) and the possibility to transfer 75-85% of foreign exchange earnings from exports abroad. But again, as in the case of other measures, these encouraging conditions were offset by other important restrictions, foremost among them the condition of maximum foreign participation limited to 49% and the right to Polish nationals to occupy keyposts in a joint venture company. Moreover, the unrealistic official rate made foreign investment rather expensive in terms of foreign currency, and also cumbersome, bureaucratic procedures of registration scared many potential investors. Last but not least, lack of political stability and growing imbalances in the domestic market, effectively discouraged foreign capital from taking advantage of the new regulations.

As a result, the inflow of capital was rather insignificant and fell short of the expectations of the Polish government. Over the first 2.5 years (until the end of 1988) only 31 joint-venture companies were established in Poland with an estimated total capital of ca.100 million US\$, and 21 more projects passed the registration procedure. The value of planned investment over the next 3-5 years, is estimated at 120 billion zl. (at 1988 prices), which is less than 2% of total investment in 1988. Recognizing the need to strengthen economic incentives for foreign investors, in order to offset the unstable political and economic environment, the government enacted a new law on foreign investment in 1989, removing a large part of those regulations which were most criticized by foreign investors.

A very important innovation in the foreign trade regime introduced in 1987, was foreign exchange auctions, organized by the newly established Export Development Bank. The government, being under pressure from enterprises to open possibilities for acquiring foreign exchange through commercial channels, decided - not without strong

resistance from bureaucrats representing the *ancien régime* - to launch long awaited foreign exchange auctions, but still on an experimental scale. From May to December 1987 only 8.5 million US\$ were sold (mostly surpluses from ROD accounts), with the dollar rate varying from 873 zl/dollar to 1085 zl/dollar, i.e. 3.3-4.1 times higher than the official rate. In 1988 the amount auctioned rose tenfold to 85.9 million US\$, with the dollar price gradually increasing from 985 zl/dollar in January to 1420 zl/dollar in April-May and to 1865 zl/dollar in December, i.e. surpassing the official rate 3.1-3.8 times.

As limited and imperfect as they were, foreign exchange auctions undoubtedly constituted a very important step towards a regular foreign exchange market. Although they could not alter the predominantly administrative character of the foreign exchange allocation in Poland, they certainly paved the way to a much more far reaching liberalization of foreign exchange transactions in 1989. In 1988 their share in import financing was very tiny (1.2% of convertible currency imports), but in the first quarter of 1989 more than 102 million US\$ were sold and the share of the auctions in import financing rose to 6%.

4. Structure of protection and anti-export bias of economic policy in Poland in 1982-88

Export expansion was repeatedly stressed by the Polish government as one of the most important economic objectives after 1982. However, the economic policy actually pursued by the government was, in fact, consistently anti-export oriented. The analysis of the structure of protection reveals, that despite official rhetorics, import-competing industries enjoyed stronger incentives than export-oriented ones. As a result, Polish producers were throughout the whole period 1982-88 inclined to favour the domestic market rather than exports.

Table 4 presents the amount of direct taxes and subsidies paid in connection with foreign trade transactions. The biggest share is taken by price differential transfer payments from the Price Equalization Account, administered by the Ministry of Foreign Economic Relations. The

role of these transfers (taxes and subsidies to exports and imports) is to cover differentials between foreign trade transaction prices and domestic controlled prices. The PEA was the most important source of price distortions, effectively insulating domestic producers and consumers from the price signals coming from international markets. Other elements of direct protection included custom duties on imports, turnover tax exemptions and the reimbursement of custom duties for exporters. As can be seen from Table 4, the significance of the two latter measures was rather symbolic, as they gradually diminished from 0.8% in 1983 to nil in 1988. Of much greater importance, however, was the income tax relief for exporters, which rose gradually from 1.8% of total exports in 1982 to 10.2% in 1987 and suddenly plunged in 1988 to 4.7% of the total export value.

Two more important observations can be drawn from Table 4. First, that direct nominal export promotion was stronger than direct nominal import protection. As illustrated by Row E. export promotion measures were higher by 64-141% than import protection measures, except for 1982, when they were lower by 21%. This fact was frequently used in Poland by many economists as an argument against aggressive export incentives, and has been instrumental in the reduction of fiscal reliefs for exporters in 1988. Second, it can be observed that domestic price distortions caused by the PEA taxes and subsidies (now F), were relatively high until 1986, and diminished sharply in 1987-88, which can be interpreted as symptoms of the gradually eroding power of the PEA in insulating domestic prices from international prices.

However, direct tools of trade policy cannot be relied on in determining the structure of actual protection in economies with partly administered prices. Probably the single most important instrument of protection is foreign exchange controls, connected with a highly overvalued exchange rate of domestic currency (Rosati, Mizsei, 1989, UNDP/World Bank, 1989). The official rate of exchange of the US dollar was permanently kept at artificially low levels for many reasons, common for all countries with balance of payments problems and with limited or no convertibility of national currency. Foremost among these

Table 4.

Direct measures of export promotion and import protection, 1982-1988
(in billion zł, current prices).

Item	1982	1983	1984	1985	1986	1987	1988
A. EXPORTS							
1. Total value	951	1060	1338	1691	2116	3237	6012
2. Subsidies from PEA	84	154	232	284	348	356	520
3. Taxes to PEA	63	55	66	101	102	38	31
4. Custom duty reimbursement	1	2	1	3	4	6	-
5. Turnover tax relief	4	6	6	12	2	-	-
6. Income tax relief	17	31	56	74	116	328	284
7. Excess Wage Tax relief d)	-	-	-	-	-	45	60
B. IMPORTS							
1. Total Value	869	992	1249	1595	1964	2876	5437
2. Subsidies from PEA	56	48	61	83	55	68	130
3. Taxes to PEA	81	93	109	133	179	250	334
4. Custom Duties	26	29	41	65	84	131	235
C. Average subsidy rate to exports (in %) a)	4.5	13.0	17.1	15.2	17.4	21.5	13.9
D. Average tax rate on imports (in %) b)	5.9	7.5	7.1	7.2	10.6	10.9	8.1
E. Relation C/D	0.76	1.73	2.41	2.11	1.64	1.97	1.72
F. Domestic price distortion through PEA (in %) c)	17.0	18.5	19.7	19.5	18.8	13.8	10.9

a) PEA subsidies plus tax reliefs plus custom duties reimbursements minus PEA taxes, divided by the value of exports;

b) PEA taxes plus custom duties minus PEA subsidies, divided by the value of imports;

c) The value of all PEA subsidies and taxes plus custom duties, divided by the total value of exports and imports;

d) Own estimates based on data from the Ministry of Foreign Economic Relations;

Source: Compiled from data of the Ministry of Foreign Economic Relations and of National Bank of Poland.

considerations was fear of the inflationary effect of devaluation and the 'elasticity pessimism'. As a result, the official dollar rate was, in Poland, 3-6 times lower than the unofficial rate (or 'black market' rate). The low price of foreign exchange leads always to the outflow of reserves and, sooner or later, to exchange controls. In Poland widespread foreign exchange restrictions existed practically until 1987, when public enterprises were allowed, for the first time, to sell and buy ROD surpluses at a parallel or unofficial rate. In 1989 also the private sector was allowed to enter free market transactions with foreign exchange, although prevailing proportions are still allocated through the central rationing system.

Exchange controls and limited access to foreign exchange are among the most effective barriers against import competition. One of its inevitable consequences is that it allows for a substantial premium on all imports because of the limited availability of foreign exchange. Since foreign exchange is allocated in an administrative way and not through competitive auctioning, the premiums increase not only profitability of direct importers, but also profitability of all, even potential, import-substitution activities.

Foreign exchange premium can be expressed as a relative differential between a hypothetical equilibrium rate and the official rate. It is very difficult to assess the actual level of the premium in a centrally controlled economy. Some rather crude estimates put the premium at 200% in the case of Poland (Rosati, Mizsei, 1989, p.65-66). A study by the World Bank puts the premium between 211% and 344% within the period 1985-88 (UNDP/World Bank, 1989, p.92).

The equilibrium rate can be approximated by calculating the weighted average of the official rate and the parallel rate, the weights being respective shares in total import financing. This simple approach can serve only as a starting point for more refined estimates. Using the data from Table 3, the following equilibrium rate estimates have been obtained for the period 1984-1988 (see Table 5).

Several observations can be made. First, that the extent of undervaluation of the official dollar rate was gradually diminishing, coming down from 440% in 1984 to 200% in 1988 for the relation between official and parallel rates, and from 133% in 1984 to 78% in 1988 for the relation between official and equilibrium rates. The declining tendency was mostly a result of the liberalization of foreign exchange transactions from ROD accounts in 1985-86 and of the extension of foreign exchange auctions in 1987-88. Second, the foreign exchange premium, shown in column 7 of Table 5, although systematically shrinking since 1984, was still quite high in absolute terms, coming down below 100% only recently (78% in 1988).

Table 5

Estimates of the equilibrium foreign exchange rates (zł/US\$), 1984-88

Year	Official rate (zł/\$)	Share of central-ized imports	Parallel rate a) (zł/\$)	Share of decentral-ized imports (%)	Equil-ibrium rate (zł/\$)	Premium (6/2)
1	2	3	4	5	6	7
1984	113.7	70.1	620	29.9	265	2.33
1985	147.2	67.8	650	32.2	309	2.10
1986	175.2	64.2	700	35.8	365	2.08
1987	265.2	64.9	1030	35.1	534	2.01
1988	430.6	61.2	1294	38.8	765	1.78

a) Black market rates of PEKAO coupons for 1984-1987, and average selling price for US dollar at auctions organized by the Export Development Bank and the Ministry of Foreign Economic Relations

Preliminary data for the first six months of 1989 reveal, however, an increasing tendency again (with the average official rate at 632 zł/US\$, parallel rate varying from 1800 to 4000 zł/US\$, depending on the type of auction, and the share of decentralized imports approaching 50%, the equilibrium rate was around 1700 zł/US\$, and the premium - 2.69, i.e.169%).

The foreign exchange premiums increased the level of actual protection of the domestic market against import competition, as they

represent the implicit surplus of domestic prices over international prices converted at official rates. Therefore, in 1982-86 the premiums worked as strong incentives for import-substitution. Since 1987, when the first foreign exchange auctions were introduced, the premiums started to work also as incentives for exports, but the export impact was limited as only a fraction of foreign exchange earnings from export (ROD retention quotas) could have been traded freely by exporters at a parallel rate. Adding up direct protection measures for exports and imports from Table 4, rows C and D, and foreign exchange premiums from Table 5 (in %), one eventually obtains the following structure of real protection in Poland (Table 6). As can be seen from Table 6 (row 8), the total protection level for import-substitution activities in Poland was 25-38% higher than export promotion level, measured by direct and indirect subsidies. It demonstrates conclusively, that economic policy which followed in Poland in 1984-88, displayed a strong anti-export bias, and that the most important component of this bias was an undervalued official exchange rate.

5. Liberalization attempts in 1989

The Polish economy entered 1989 with rapidly growing inflation, spreading shortages and political turmoil. The government of Mr. Rakowski seemed to be determined to speed up the process of market-oriented reforms, and introduced a package of important institutional and policy measures, which strongly affected foreign trade and the external balance. However, mostly due to a disastrous monetary and budget policy, these measures failed to improve the situation, and the balance of payments position of Poland became critical in April 1989, because of serious liquidity problems. As it has been stressed earlier (see Part II), the applied policies were extremely inconsistent: lacking financial and monetary discipline, they were at the same time oriented for achieving short-term political stability objectives instead of achieving medium-term economic equilibrium.

For the first six months of 1989 convertible currency exports have grown by 6.5%, but the actual inflow of hard currency increased only by

Table 6

Direct and indirect protection in Polish economy, 1984-1988

Item	1984	1985	1986	1987	1988
1. Average, uniform subsidy rate to exports (in %)	17.1	15.2	17.4	21.5	13.9
2. Effective exchange rate for exports a), z/\$	210.1	250.8	298.5	444.9	643.9
3. Foreign exchange rate premium on export b), (in %)	(85) d)	(70) d)	(70) d)	68	50
4. Total export preferences (rows 1+3), in %	102.1	85.2	87.4	89.5	63.9
5. Average, uniform tax rate on imports, (in %)	7.1	7.2	10.6	10.9	8.1
6. Foreign exchange premium on imports substitution c)	133	110	108	101	78
7. Total domestic protection (rows 5+6)	140.1	117.2	118.6	111.9	87.1
8. Anti-export bias of economic policy (ratio of total export preference to total domestic protection (rows 4:7)	0.729	0.727	0.737	0.800	0.734

a) Calculated as weighted average of the official rate and the parallel rate, the weight for the latter being average ROD rate from Table 3;

b) Calculated as percentage difference between the effective rate on exports and the official rate;

c) Calculated as percentage difference between the equilibrium rate (from Table 5) and the official rate;

d) Theoretical values, as official foreign exchange trading was not permitted.

Source: Own calculations.

1.0% as compared within the respective period of 1988, because a growing number of transactions were concluded at barter, non-currency terms. Imports in turn have grown by 14.3%, (but the free currency purchases by 18.9%), and as a result a trade surplus with convertible currency area, declined to 448 million US\$. The actual payments surplus was, however, only 167 million US\$, because of a growing proportion of credit sales on exports. At the same time, we have observed much lower rates of growth of industrial output (only 2.5%) and services. The tendencies remind us strongly of the pre-crisis situation in 1980 and there is a considerable risk of a new recession in the near future.

The foreign trade regime in 1989 was characterized by a further reduction of administrative measures, but potential benefits were largely neutralized by very 'soft' monetary policy. Three important changes have been introduced in 1989: (a) law on free entrepreneurship, (b) a new law on joint-ventures, and (c) new regulations of the foreign exchange regime. The first one assured formal equality of the private and public sector and removed administrative barriers for establishing and expanding private business activities. However, many other bureaucratic obstacles at lower (regional and local) levels still remain, hampering genuine initiative.

Amendments to joint-venture law, enlarged significantly, privileges for foreign investors as compared with local companies. Tax 'holidays' have been extended to 3 years, the income tax rate has been reduced to 40% and compulsory selling quotas of foreign exchange have been lowered from 25% to 15% (a provision strongly criticized by domestic public enterprises facing compulsory quotas from 50% to 90%). Moreover, the limit of 49% of foreign capital participation has been removed as well as the legal requirement to nominate a Polish national as managing director of joint-venture companies. More than 80 new j.v. companies have been established during the first six months of 1989 - a substantial increase from the previous year. However, a large majority of them are small scale companies, with limited equity capital and concentrating, in most cases, in trade and simple processing sectors.

Hopes for large inflows of funds and new technologies are still unfulfilled.

Probably the most important change has to do with the new system of foreign exchange allocation, being part of a new foreign exchange law. Not only private individuals have been allowed to carry out foreign exchange transactions, but also enterprises have been permitted to sell and buy foreign exchange at market prices. Five uniform ROD rates have been introduced for exporters (10,20,30,40,50%), depending on the degree of processing of exported goods. Surpluses or unused amounts from RODs can be freely traded at market rate auctions organized by the Export Development Bank. What is more important, a large part of hitherto centrally allocated foreign exchange funds for the so-called centrally financed imports are now being sold at special 'target' auctions, organized every two weeks by Bank Handlowy, S.A. According to Central Annual Plan, more than 1.6 billion US\$ should be sold this year at these auctions to enterprises for imports of 52 main commodity groups. This means that the central allocation system has been considerably reduced, probably to less than 50% of total imports.

The application of a free market rate to a larger proportion of import purchases had to increase inflationary pressures, because the free market rate was 3-5 times higher than the official rate and the higher cost of imported inputs was immediately passed on to prices of finished goods. This was the argument raised frequently against the system of auctions. Proponents of the system argue, however, that inflation is caused mainly by passive monetary policy, accommodating money supply to transaction demand, and that the segmented foreign exchange market should soon be replaced by a uniform market, where equilibrium exchange rate would be much lower because of a much larger supply of foreign currency. This point is certainly valid if some kind of restraint is put on monetary expenditures - otherwise 'creeping' devaluation is effectively offset by printing more money with little or no effect on expenditure reduction or switching. Thus, a restrictive monetary policy is a necessary condition of efficient devaluation. Other conditions include the removal of administrative barriers to import,

existence of efficient capital and labour markets and elimination of domestic price controls.

6. External aspects by G. Kolodko

The foregoing discussion focused on domestic policy measures aimed at achieving external balance. We tried to emphasize that radical steps are still to be done in order to transform generally inward-oriented attitudes of Polish producers into export-oriented ones. However, the outcome of even the most ambitious programmes on the domestic side may still be amplified or dampened by more or less favourable developments at international markets.

Perhaps the most important aspect of the external implications of adjustment processes in Poland, but also in other socialist countries, concerns the worldwide debt crisis. Efforts undertaken by Poland to stabilize the foreign debt are as yet unsuccessful, and, taking into consideration the proportions of debt, as compared with the GNP and hard currency export potential, it seems unrealistic to assume that Poland can repay or even service the foreign debt in the foreseeable future (see e.g. Montagnon 1989). There is a need for an innovative plan of action, which would restore the internal equilibrium, significantly broadening the export base, thus creating solid grounds for recovering Western money in longer perspective. Recent declarations by top officials of the G-7 group, made in the wake and in recognition of the political reforms process unfolding rapidly in Poland, offer some hope for a constructive solution.

The current situation with regard to worldwide debt cannot last. The existing debts simply cannot be paid back, even if we consider the so-called 'unconventional' methods of debt service and repayment, in the form of a secondary debt market, swaps or transactions involving the writing off of a part of the debts for environmental protection. Major changes can be expected as far as the approach of creditors towards their debtors is concerned. Such changes are already taking place with regard to some developing countries. This is not only a humanitarian

concern. It is also common sense, since it is obvious that these debts cannot be repaid anyway. The debts of some of the poorest African states are being written off, while the proposals of the new American administration, presented by Nicholas Brady, the Treasury Secretary, actually imply the relinquishment of the major part of Latin American debt to American commercial banks.

Then comes the question about the relationship this would have to the indebtedness of the socialist countries, already in excess of 120 billion dollars. It would appear that such a relationship can be noticed in the case of Yugoslavia, Hungary and Poland. Their foreign debt amounts to 22 plus, 18 and 39 billion US dollars, respectively. Given their structurally limited export capacities and internal problems, none is able to assure full debt service, which is why their debts are piling up. Yugoslavia and Poland had repaid over the last two decades more or less the same amounts they still owe to the richest countries. Moreover, as it was stressed before, there is no solution which would simultaneously solve the problems of internal and external equilibrium. Such a situation cannot last. Thus, major changes with this regard can be expected and they are likely to be connected with political changes which these countries have initiated and which are already in progress.

Thus, potential changes in the external determinants of economic growth, resulting from a new approach by the creditors, can facilitate and help in accelerating the stabilization and adjustment processes. There are obvious feedbacks between the foreign debt burden and the capacity of the economy to finance the necessary structural transformations, failing which even the farthest-reaching changes and a realignment of economic policies, and of policy in general, cannot produce the desired effects nor create the premises for long-term social and economic development.

Accelerated West European integration, leading to the formation of a single market after 1992, is another important factor bearing on the external determinants of economic growth in the socialist countries, especially in the small and medium East European states. This market

will be second only to North America, and not only for goods, but also for services, capital and labour. Leaving aside a number of issues which West European countries must still solve on their way to integration, one must remember that this is a major challenge for other states and it is a factor to be reckoned with in the elaboration of their growth strategies.

Theoretically speaking, there are four possible scenarios for the development of the mutual relations of the European socialist countries with integrated Western Europe. The first is a scenario of continuity, consisting of the persistence of present trends, with only minor changes. This would be reflected in efforts aimed at 'the further strengthening and streamlining of socialist integration' in the framework of the Council of Mutual Economic Assistance (CMEA), embracing also the Soviet Union and three non-European member states: Cuba, Mongolia and Vietnam (Roca, 1989 and Goodman 1989). This scenario would mean that East and West European countries would grow increasingly different and any chances for a major future rapprochement would be eliminated. This scenario seems to be advocated by the bureaucrats connected with the existing patterns of bilateral trade which, under the cover of the CMEA, had actually dominated over multilateral contacts.

The second scenario could consist of the strengthening of the real integration processes within the CMEA, especially amongst its European members, founded on reformed market economies and a common convertible currency. Such a community as a whole, would grow closer to West European economies through dynamically expanding commercial and financial contacts, as well as the transfer of people, capital and information.

The third scenario could be the dissolution of the CMEA in its present form and the members would look for their own solutions in the new situation. This scenario is an unlikely as the second.

The fourth scenario is one of diversification. Some economies will evolve more rapidly towards economic integration with Western Europe,

while others will remain in the framework of their present economic relations. An increasing economic rapprochement to integrated Western Europe does not imply the severance of ties with other socialist states. These contacts are often beneficial and appear rather durable, though the dominance of competitive economic structures over complementary structures, reflected in the likeness of these countries' economic structures is a barrier to more modern and advanced forms of economic cooperation.

The fourth scenario is also the most likely. Actually, its implementation is to some extent already under way. Some countries have already concluded agreements on collaboration with the EEC (Czechoslovakia, Hungary and Romania), others - including Poland - are striving to intensify economic ties with the EEC. Yugoslavia - though not a member of the CMEA and not a member of the Warsaw pact, which has a special importance in this context - is in the most advantageous position in this respect and has the best chances to become an associate member of the EEC. Hungary and Poland appear to have the opportunity to be second and third. Here, however, we come once again to the dominance of politics over economy, this time on the international scale.

The reply to the question about the pace at which the socialist economies will grow nearer an integrated Western Europe, while maintaining strong and parallel integration ties with other socialist states, will depend mostly on the success of their reformatory efforts. Success in the market realignment of their economies, monetization of economic relations and democratization of public life institutions may, though not necessarily, make this rapprochement nearer. On the other hand, given the overall nature and patterns of change the contemporary socialist economies, a certain acceleration in the creation of more advantageous conditions of commercial, financial, technical and capital collaboration with West European countries should be a catalyst for adjustment processes in the socialist economy. However, this factor will come into play only when the societies and authorities of the countries concerned effectively implement the necessary changes. These changes will have to cover the set of indispensable, radical and consistent

measures with regard to the operation of the national economy (economic reform), appropriate market structural transformations and a realignment of economic policy. Action along these lines will also call for further and substantial progress in the democratization of social and political life, while averting the risks of anarchization which unfortunately, cannot be excluded. If this is the case, Poland can face the alternative: 'Marshall Plan' or 'martial law'... And it is only the process of adjustment in the socialist economy, understood as explained above, that offers the chance to overcome its general crisis and the creation of premises for a durable social and economic development in the future.

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