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Poland Under "Solidarity" Rule

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The coalition cabinet in which Solidarity played a leading role, but which also included Communists and their allies, won Parliamentary approval on September 12, 1989. This coalition inherited from the Communists an economy in deep crisis: Inflation was raging, shortages of virtually all goods were rampant, the black market was all-pervasive. The new government pledged to restore the market economy, kindling hopes that the political victory would soon be followed by improvements in material well-being. Dramatic changes have taken place since then. The currency is stable and exchangeable. Queues and the black market have disappeared, and stores are decently stocked by East European standards.

Yet there is widespread dissatisfaction. Real incomes have declined. The official data indicate a 20 percent fall, but that is overstated. After all, consumers can now buy what they want, whereas a year and a half ago, after lengthy search, they had to buy what they could find.[1] Nevertheless, there are clear signs of impoverishment. For instance, food now takes up over 55 percent of the average consumer's budget, vs. less than 40 percent in the first half of 1989, and a larger proportion of the food expenditures now goes on inferior goods, such as bread and potatoes, and less on luxuries like meat.[2] Overall, real incomes probably have declined by as much as 12 percent. Unemployment has

[1] Product quality also improved, a point heavily emphasized by Lipton and Sachs (1991).
[2] Another sign of relative impoverishment: though in 1990 Poland's food production was somewhat lower than in 1989, in 1989 Poland was a net food importer, and in 1990 a net food exporter.

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reached 7 percent of the labor force, and it is mounting; for the first time in over 40 years, there is job insecurity.[3]

The new government came into power as inflation was turning into hyperinflation, as a final legacy from the Communist government. Soviet-type systems are inherently inflation-prone. To achieve full resource utilization prices are fixed at a level at which there is excess demand: that is, suppressed inflation. Moreover, if overall plan fulfillment is in danger, consumer goods are cut back, not producer goods. When this happens, wage payments exceed the production of wage goods, aggravating the shortages.

In Poland, policies reflecting the weakness and the unpopularity of the Communist party also contributed to the inflation. In contrast to the other East European countries, most of the Polish farm land remained in private hands, but the regime, fearing the rise of a "kulak" class, adopted policies that retarded modernization by keeping the farms artificially small. Food production increased more slowly than urban demand, causing shortages. Past attempts by authorities to raise prices triggered "bread and freedom" riots. The government would then "solve" the problem by rescinding the price increases, increasing food and animal feed imports, and by granting subsidies to farmers. Large subsidies were also given to the mining industry to keep down production and heating costs (coal being the main source of heat and of energy of Polish industry) and to housing. In fact, coal prices were so low that private gardeners profitably grew hothouse tropical flowers for export. The mounting subsidies were the cause of increasingly large fiscal deficits which were monetized. Reluctantly, the authorities had to raise prices lest all the goods disappear from the official outlet. To placate the workers, the government readily gave in to demands for higher wages. Enterprises that found themselves in financial trouble as a consequence were given subsidies.

The wage-price cycle was formalized in April 1989. In accordance with the Round Table agreement wages were to be automatically raised by a factor equal to 80 percent of the previous quarter's rise in the cost of living index. This addition was to come on the top of wage raises obtained through collective bargaining, which means that wages could rise faster than prices. In June 1989 the cost of living index rose by 6 percent, and in July by 10 percent. Wages soared, goods with controlled prices disappeared from the shelves. In August the government attempted a drastic reform: it cut farm subsidies and freed most of the food prices. Food prices rose by 80 percent, and the cost of living by 40 percent. The sudden price jump contributed to the seething popular discontent. Defeated at the polls, deprived of Soviet military support, unable to cope with the economic situation, the Party surrendered power.

[3]The unemployment figures should be interpreted with caution. They include a sizeable number of people who never held jobs and/or who work as street peddlers or do other unregistered work. On the other hand, the statistics do not take into account the number of workers put on compulsory unpaid leave or who work short hours.

Stabilization

During the closing months of 1989, the Solidarity-led government took important preparatory steps: it made drastic budgetary cuts to reduce inflation; it devalued the zloty by 75 percent in real terms, and it made important institutional changes that included the organization of an unemployment registration and relief system. Then, on January 1, 1990, the government introduced a multifaceted package of reforms backed by the IMF and World Bank.

One goal was to reduce the budgetary deficit from 7 percent of GNP in 1989 to 1 percent in 1990; in fact, 1990 ended with a slight budgetary surplus. A deep cut in coal subsidies was accompanied by a 500 percent increase in administered coal prices and a 200 percent increase in electricity and transport rates. Subsidies to individual enterprises were eliminated, and most price controls were swept away. With the consent of organized labor, wage indexation was converted from an instrument to preserve real wages to an instrument of wage restraint. After January 1, 1990, monthly wage raises were not to exceed a limit calculated as a given percentage of the increase in the cost of living (the limit was 30 percent for January and 20 percent for February and March, later on, it was raised to 60 percent). Enterprises which exceeded the limit were subject to heavy penalty taxes. Strict monetary and credit expansion limits were imposed. The Central Bank discount rate was set at a rate exceeding the expected rate of inflation. The zloty was further devalued by almost half, and it was made convertible on current account. Virtually all non-tariff barriers to trade were removed.

The government realized, of course, that economic reform could not be limited to liberalization and to stabilization. But structural reform, by its very nature, would take more time to design and to implement. Moreover, it was felt that the imposition of a strict macroeconomic discipline would, of itself, foster efficiency. In a shortage economy, enterprises could sell all they wanted; now they would have to compete for markets. Previously, thanks to generous subsidies, they could survive regardless of costs. Now they would have to trim their labor force and improve resource management to survive.

The price response to the macroeconomic measures was dramatic: in January the retail price index rose by 80 percent, by another 24 percent in February, but in March by only 4 percent. The hyperinflation was over, but until mid-1991, prices continued to rise at a two-digit annual level.[4]

What seems to explain the prolonged inflation is the push of periodic increases of the remaining administered prices, the main ones being housing, transport and public utilities, and the pull of foreign exchange overvaluation. The rate set on January 1, 1990—9,500 zlotys to the dollar—was lower than the then-prevailing free market rate which, itself, greatly understated the purchasing power parity of the Polish currency. The prices of Polish goods that

[4]The lowest monthly inflation rate (0.8 percent) was registered in July 1991.

were freely traded with the west adjusted quickly to world levels. But foreign trade plays a minor role in the Polish economy, largely because economic planners had tried to avoid interdependence with the west, and overall price adjustment has been slow. Quality differences are an obvious barrier to price equalization. For example, very few Poles could afford western cars in 1990. Polish cars were incomparably cheaper, but their low quality was an effective bar to exports.

The initial price surge was accompanied by a 26 percent decline in the output sold by public sector enterprises relative to the January 1989 level (a drop of more than 30 percent in relation to December 1989). There was a further slight fall in February, and then output stabilized at the lower level. Why the slump?

It is possible that the initial stabilization measures were too restrictive. Apparently, the forecast did not adequately take into account the effects of devaluation of the zloty and of administrative price increases (Frydman and Wellisz, 1990). Prices rose twice as fast as foreseen in the forecast used as a basis for the determination of the January-February 1990 volume of money and credit. The consequence was a severe credit squeeze. Though Polish wages were highly flexible, the fixed exchange rate made for downward price rigidity and output fell. In mid-August, credit conditions were eased, real interest rates turned negative, and there were some signs of the beginnings of recovery, but wages rose, and so did prices. The government found itself in violation of the conditions attached by the IMF to its stand-by loan, and controls were tightened once again.

A sharp decline in consumer demand contributed to the recession. When stabilization came, households dishoarded goods bought up as an inflation hedge, and they also attempted to rebuild their cash balances, whose real value declined at the time of inflation and of negative interest rates. Consumption expenditure declined more than in proportion to the fall in real household incomes. The consumer goods sector was the first to suffer from the recession which only gradually spread to the producer goods sector (Frydman and Wellisz, 1990).

The undervaluation of the zloty and the decline in domestic activity caused a sharp import reduction and export expansion. Current balance turned positive and remained so throughout 1990, leading to an unexpected increase in reserves. Though, by 1991, the rising internal prices caused the balance to turn negative. The government was able to maintain a fixed exchange rate until May 1991.[5]

The decline in employment was much more gradual than the decline in output. In January, in the face of the severe slump in sales, employment in the socialized sector declined by only 1.3 percent, and over the year as a whole by

[5]In May 1991, the zloty was devalued by 14 percent in relation to the dollar. At the same time it was de-linked from the dollar and linked, instead, to a trade-weighted currency basket.

17 percent. Thus, the austerity measures caused an initial drop in labor productivity. A year and a half into the program, output per worker has barely regained the pre-reform level.

In the closing years of their rule, the Communists gave the Workers' Councils the right to dismiss the managers, while union consent is required in the case of group dismissal. Therefore, it hardly comes as a surprise that attrition accounts for most of the decline in public sector employment, and that group layoffs are an act of last resort.

Amidst the uncertainty generated by the reforms, wage increases were initially much lower than permitted under the indexation rule. The government made it clear that, unlike in the past, it would not come to the rescue of financially troubled enterprises. The fear of bankruptcy and of loss of jobs was an important factor restraining wages. But as the situation stabilized, it became evident that most of the enterprises were in sound financial condition. Their indebtedness was low; in 1989 they purchased, at prices that were much lower than in 1990, inventories that were more than adequate given the reduced production, and they made paper profits through the revaluation of their dollar accounts. Moreover, the removal of price controls permitted many enterprises to improve their profit margins. In mid-year wages started rising.[6] Toward year-end, the statutory controls began to bite and, not surprisingly, they came under bitter attack. The controls remained, but the base rate used to compute the raises in 1991 was increased. The rationality of statutory wage limits is, at any rate, a matter of controversy. Those in favor maintain that in the absence of controls there could be a wage explosion and widespread unemployment. Critics point out that the wage structure inherited from the Communist regime leaves virtually no room to reward skills and performance, and that, until restraints are removed, there will be little incentive to increase productivity.

There is general agreement, however, that the current system of enterprise governance does not foster efficient resource use. Enterprises have a high degree of autonomy, but managers are beholden to labor, and no one acts as the owner who is interested in maximizing the return on capital. Now that stability is within sight, privatization has become a matter of great urgency to the government.

Restoration of Private Enterprise

One of the first acts of the Solidarity-led government was to remove all barriers to private ownership of the means of production. Yet from the very start, the authorities realized that, paradoxical as it may seem, laissez-faire is not the right policy to re-establish laissez-faire. Spontaneous "nomenklatura

[6]Frydman and Wellisz (1990) argue that the wage increases that occurred in the latter part of 1990 reflect the easing of credit.

privatization" was taking place even prior to the transfer of power. Company insiders, many with strong Party ties, formed private businesses and stripped the assets of the public sector enterprises. This process was unacceptable to the new regime. The idea of turning enterprises over to the workers was also rejected as being socially inequitable and unlikely to foster efficiency.

There is, of course, the possibility of returning property to former owners. But during the past 40 years, much of the property has been transformed and its legal status is often murky. A decision was made not to return properties that were expropriated in accordance with the nationalization laws passed under Communist rule. This includes country estates that were divided under the land reform law and industrial enterprises with 50 or more workers. Claimants may, however, be granted partial compensation in the form of privatization bonds, exchangeable for shares of privatized companies.

Thus, outright return of property is to be limited to small, illegally seized enterprises, such as mills and brickworks. Even there in most of these cases there are no legitimate claimants, and the small-scale enterprises and/or the facilities they occupy are being put up for sale or for long-term lease. To date about 80 percent of retail stores and hundreds of other small businesses have been privatized.

There remains the problem of some 5000 large and medium-size firms. Many of the smaller ones are being liquidated. In accordance with the law their assets may then be leased, with purchase option, to a newly formed company that has to include, among its owners, the majority of the workers of the enterprise that was liquidated. Selected large and medium enterprises (fewer than a dozen so far) are being privatized in the classical fashion; after careful appraisal and issuance of a prospectus shares are offered to the public, and then listed on the newly re-opened Warsaw Stock Exchange. But the total value of savings of the Polish population is estimated at no more than $9 billion—a tenth of the estimated value of the property to be transferred. Moreover, the appraisal procedure is slow and costly. To speed up privatization, the government decided in June 1991 to launch a Mass Privatization Scheme under which shares of 400 large enterprises are to be transferred to Privatization Funds. The Funds' shares would, in turn, be freely distributed to the entire adult population. The people are thus to become indirect owners of industry. The Funds, supervised by Polish boards of directors but managed by foreign investment banks, will be given incentive to restructure, to modernize, and, ultimately to sell the enterprises under their control. The privatization process is, as it were, to be privatized (Frydman and Rapaczynski, 1990).

Meanwhile, an enormous institutional task has to be accomplished (Wellisz, 1991). Under Communist rule the civil code fell into desuetude. Banks were transformed into agencies for disbursement of planned credits. There were no securities, and thus no rules concerning their trading, and no stock exchange. These institutions are rapidly being rebuilt. But the problem of human capital is the most difficult of all. Work in a bureaucratized Polish enterprise is no

preparation for a future businessman. Also, the Communist system created a mentality of entitlement. Now people are asked to give up what is "owed" to them and accept the opportunity to become self-reliant, but most do not know, or do not want to take advantage of such an opportunity.

Frustrations mount with the passage of time, and the new government is increasingly blamed for the economic hardships. Private enterprise has been growing, but not fast enough to absorb all the new entrants into the labor force. With the continued rise in domestic costs and prices, foreign competition has become more intense, especially in consumers goods. The dissolution of the COMECOM with its bilateral clearing arrangements aggravated the situation. Factories that produced for the Soviet Union lost their long-established markets, and now face the difficult task of readjustment. Increasing foreign competition and the loss of the Soviet market caused a sharp decline of enterprise profits. But profit taxes and turnover taxes are the two major sources of budgetary revenues which plunged precipitously. An August 1991 revision of the 1991 budget brought deep cuts in expenditures and new taxes, including higher import duties. Yet a large deficit is forecast for the remaining quarter of the year. There is a threat of renewed inflation, just at a time when pressures are mounting for measures to revive the economy.

The program of the Solidarity-led government was a bold experiment. Never before has an attempt been made to liberalize and to stabilize a post-socialist economy on such a scale. For all the hardships it wrought, the program looked like success. But now it is in danger. The COMECON dissolution shock aggravated the recession and unbalanced the fiscal budget. Moreover, as is now amply evident, the imposition of a market discipline failed to improve the performance of public sector enterprises. The remedy that has now been decided upon is mass privatization, another unprecedented bold experiment, which may, however, come too late to rescue the stabilization.

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