

Macroeconomic Stabilisation in Central and Eastern Europe with Special Reference to Poland

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The collapse of the Soviet bloc has radically transformed the social and economic landscape of Eastern and Central Europe. Geoffrey Gill assesses both the theory behind, and the success of, the reforms implemented using Poland as a benchmark against which the general experience can be measured.

“In 1989 we had but one asset. That was the enthusiasm born of the newly-won freedom. And we invested that asset in economic reform.”¹

Central and Eastern Europe in the period 1989-90 was an unstable ship, in a sea of political turmoil. Its stabilisation required radical economic reform of an unprecedented scale of which economists had little prior experience of. What was needed was more than a mere rebalancing of the economy using standard policy instruments. Indeed, the policy instruments *themselves* had to be created. ‘Stabilisation’ must be seen as a simultaneous approach in restructuring and rebalancing the economy involving price and foreign trade liberalisation, and fiscal, monetary, exchange rate and incomes policies. Concurrent with this were the microeconomic changes involving property rights reform, privatisation and restructuring .

This paper will analyse macroeconomic stabilisation in the region since 1989 generally, and will consider the case of Poland with respect to each of the issues involved. The Polish economy is interesting in that its ‘big bang’ strategy of reform, with severe stabilisation methods employed, resulted in worryingly sharp effects with a severe output contraction, yet recently it has emerged with encouragingly strong growth rates. Firstly we shall briefly consider the initial conditions at the time of reform and question why there was a need for stabilisation measures. Then macroeconomic stabilisation will be considered generally, including a discussion of price and foreign trade liberalisation. We shall subsequently examine two potentially conflicting ‘models’ to gain insights on the reforming economies. Poland’s transition program mix will then be forwarded . We shall then move to consider the various policy options available, followed by the effects in Poland, particularly in terms of output and inflation. Of course, as alluded to earlier, microeconomic issues cannot be ignored, and it will be seen throughout that

¹ Bronislaw Geremek of Democratic Union, *Moscow News* 15-21 April 1994, p4 quoted in Jeffries (1996)

there is a severe limit to what can be achieved by macro policies alone.² Finally potential future issues will be addressed. This paper will adopt a general to specific methodology using Poland as a clarification mechanism.

The Initial Conditions

The countries of the CEE³ varied significantly in their pre-reform economic conditions (see Table 1). Czechoslovakia seemed to enjoy the most favourable internal and external macroeconomic balance with the highest GNP per capita, a low debt to GDP level and only a slight monetary overhang - developed later. We denote Money (M2) /GDP as a proxy for monetary overhang - this was 0.7 in Czechoslovakia - where Bruno (1992) considers 0.4 to be the 'norm'. Poland was possibly in one of the worst states with a large external debt overhang, practically no growth shown in the 1980s, the lowest GNP per capita level and a significant monetary overhang of 0.9. Indeed, it seemed that Poland experienced rapidly deteriorating macro conditions at the end of 1989 involving extreme disequilibria. Initial inflation ran at 259%. Although Poland always had a private agricultural sector, it did not undertake the gradual reform process that Hungary had undergone since the 1960s, which left Hungary better prepared on the institutional economic front.

Table 1: Post-Reform Economic Conditions

	Hungary	Poland	Czechoslovakia	Bulgaria	Romania
GNP per capita	2,5 90	1,790	3,450	2,320	2,2 90
GNP Growth*: 1970s	4.5%	5.5%	4.6%	7.0%	9.3%
1980s	0.5%	0.7%	1.4%	2.0%	1.8%
Money (M2)/GDP (1990)	0.4	0.9	0.7	1.3	0.6
External Debt / GDP (1990)	65%	80%	19%	50%	3%

* Average annual rate at constant prices. Adapted from Bruno, 1992

Clearly from the above, stabilisation seems to be a necessity, particularly in Poland. Blanchard et al (1993) cite three reasons why stabilisation and price liberalisation are preconditions for a successful reform process⁴:

² Bruno, 1992

³ Central and Eastern Europe: Hungary, Poland, Czechoslovakia, Bulgaria and Romania

⁴ Blanchard et al, 1993, Ch. 1

1. Political : the government had to send a clear signal that it was going to balance the budget, and that it was no longer committed to extending unlimited credit to loss making firms.
2. Macroeconomic : lacking stabilisation, inflation would turn to hyperinflation with its attendant large dislocations.
3. Microeconomic : for restructuring to proceed in the right direction, prices had to be right, and firms could not avoid market discipline.

Given the necessity of imposing macro stabilisation measures in order to establish government credibility, to fight endemic inflation and as part of the reform process as a whole, it is appropriate now to consider macro stabilisation generally.

The Stabilisation Process

When communism fell in 1989, the issue in most countries was not whether to go to a market economy but rather how to get there. The debate over this question was very compressed in time - the time constraint was biting - and earlier debate (pre-1989) had concentrated on hypothetical long-term issues rather than short-term and pragmatic issues.⁵ Bofinger (1994) stresses that there were no macroeconomic models that were tailored to the specific situation in transitional economies. Some have drawn comparisons with similar situations in history such as the Austro-Hungarian Empire collapse (Dornbusch, 1993) and Latin American stabilisation (Gros and Steinherr, 1995). Indeed, Balcerowicz - the architect of Polish economic reforms - commented that he believed that they should rely on 'proven models'. From this we may imply a standard IMF approach adapted to the Polish situation. The key question essentially was whether to choose a big bang or a gradualist approach in the move from pre-reform distorted equilibrium to the desired post-reform quasi-equilibrium⁶. According to Bruno "cumulative experience from episodes of hyperinflation and high inflation....only point to the clear advantage of taking the cold turkey approach at the inflation stabilisation stage." Given Poland's rapidly deteriorating macro conditions and initial disequilibria, to choose a gradualist approach for stabilisation and liberalisation would be doomed to failure. Balcerowicz describes the choice as between "an almost hopeless strategy and a risky strategy".⁷ The former implied delaying stabilisation to concentrate on transformation and privatisation as Russia did (and subsequently is suffering for). Thus a big bang approach was adopted in Poland and Yugoslavia in 1990 and they were followed by Czechoslovakia, Bulgaria and Romania in 1991. Reforms needed to be radical enough and pass a certain threshold of necessary changes in order

⁵ Gros and Steinherr, 1995, Ch.5

⁶ Bruno, 1992

⁷ Blejer and Coricelli, 1995

to be successful (and credible) i.e. they needed to achieve a certain 'critical mass' of change⁸

Concurrent and tied with the macro stabilisation policies was the need for the imposition of a rational price structure. This involved price liberalisation and foreign trade liberalisation. We will consider these in turn.

(i) Price Liberalisation

The liberalisation of prices is the foundation of all reforms. The necessary scarcity signals needed for an efficient economy can only be determined by market-determined prices. 90% of Poland's previously administered prices were liberalised with some foodstuffs, energy and housing exempted. Administered prices were set below the market clearing level in command economies, they were thus supply constrained and had excess demand (manifested in queues). Liberalising prices thus led in general to a price jump. After liberalisation in January 1990 Poland experienced a 130% initial price jump, and inflation in 1990 was 585%⁹, which greatly exceeded original estimates. This initial impact on the general price level can be attributed to:

a) Monetary Overhang

This manifests itself on a macro level as a mismatch between wages and the amount of goods available at the state-controlled price level. That is, the sum of wages in the economy is greater than the available supply of goods at the price level.¹⁰ Thus, the accounting real wage was excessive. 'Forced saving' is occurring,¹¹ in a sense. Prices will rise to eliminate the excess. It seems to have built up slowly over time, accelerating as perestroika proceeded in the USSR. Estimation of the effect of this is done using a Fisher equation ($MV=PQ$) approach.

b) Elimination of Subsidies

There is a need to accompany price de-control by an elimination of producer subsidies and consumption taxes.

c) Initial Exchange Rate Devaluation¹²

With trade liberalisation, in order to keep Purchasing Power Parity, due to the devaluation the domestic price level must rise

⁸ Balcerowicz, quoted in Blejer and Coricelli, 1995

⁹ Gros and Steinherr, 1995, Ch.11; Winiecki, 1993; Jeffries, 1996; (Bruno, 1992 describes it as at 249%)

¹⁰ Gros and Steinherr, 1995, Ch. 5

¹¹ Although, at a micro level this may seem nonsensical due to the existence of a black market for many products

¹² Bruno, 1992

d) Monopolistic behaviour by State Owned Enterprises (SOEs)¹³

This is an attempt to capture increased profits by raising their mark-ups over costs

Price liberalisation *per se* should not be a cause for continuing inflation (which was seen). Indeed, Bruno points out that if the initial price shock is restricted to an existing monetary overhang, it would follow that a higher initial price jump would *save* the system from additional inflationary adjustments later on. Thus, there would be a positive trade-off between the initial shock and subsequent price stability. We shall explore the possible explanations for continuing inflation later on.

(ii) Foreign Trade Liberalisation

To liberalise prices without liberalising trade does not make sense in that it is a necessary condition to create a 'rational' price structure. Once trade liberalisation reveals the real pattern of comparative advantages, export expansion is expected to follow. Winiecki (1995) points out that theory predicts an import surge preceding export expansion due to the fact that it takes time to find export markets, unlike sending orders for (imported) goods that were previously not permitted. In fact, the reverse was the case in the CEE. This is even though the IMF provided funds for stabilisation to help withstand pressure on exchange reserves. In fact, export surges started quickly after transition. This can be explained by two factors: Firstly, according to Winiecki, hoarding of inputs was common in Soviet Type Economies, of which a substantial part are imports. Thus, after transition demand for imports fell. This heightens the relative effect of export increases. Secondly, the devaluation in Poland of the zloty would boost exports and decrease imports. Thus it is probable that when the effects on competitiveness were felt due to price rises, imports 'bounced back' (see Table 2).

Table 2

	Exports (as % of year before)	Imports (as % of year before)
1 st half of 1990	119.7%	54.1%
(Whole) 1990	140%	106.35
1 st 3 quarters of 1991	117.9%	196.5%

Source: Winiecki, 1993

Gros and Steinherr¹⁴ outline the practical steps for trade liberalisation:

¹³ Berg and Blanchard, 1994

- abolish the state monopoly on foreign trade
- unify the exchange rate so all exporters and importers transact at the same rate
- eliminate all quantitative restrictions
- moving to unrestricted foreign exchange convertibility for current account transactions

For trade liberalisation, unlike perhaps price liberalisation, one can make a good case for gradualism i.e. eliminate all quantitative restrictions but retain some tariffs. Although this is a second best solution it can be an important source of revenues and can provide a temporary source of protection for inefficient SOEs - thus preventing them from failing at the same time¹⁵. Of course credibility issues arise here, as it may lend itself to discretionary reversals by government. Bruno pinpoints its advantage in “the attenuation of the immediate output and employment costs, while the right price signals for long-term investment are nonetheless retained.”¹⁶

The most common approach, and that used by Poland, to stabilisation was a multiple anchors or *heterodox* approach in relation to pegging the exchange rate and adopting wage controls or incomes policies. In this, inflationary expectations as well as actual inflation are addressed.¹⁷ It is perhaps appropriate to point out here that stabilisation does not mean zero inflation must be achieved at any cost.¹⁸

Before considering Poland’s specific program and later discussing the available policies to stabilise the macroeconomy, it is worthwhile to try and develop briefly an appropriate macro-model for a typical CEE country in its post reform stage.

A Model?

The difficulty of postulating a model for a transitional economy *ex ante* cannot be overestimated - inherent uncertainties of outcomes undermine any attempts to do this. For this reason most countries, including Poland adopted an ‘IMF-type’ stabilisation strategy, augmented to the particular needs of the economies. It is thus that we attempt to find a model that will predict the outcome that did occur, such as the major output contraction across all countries, a decline in real wages (in Poland of 40%) and a large decrease of employment.

¹⁴ Gros and Steinherr, 1995, Ch.6

¹⁵ *ibid.*

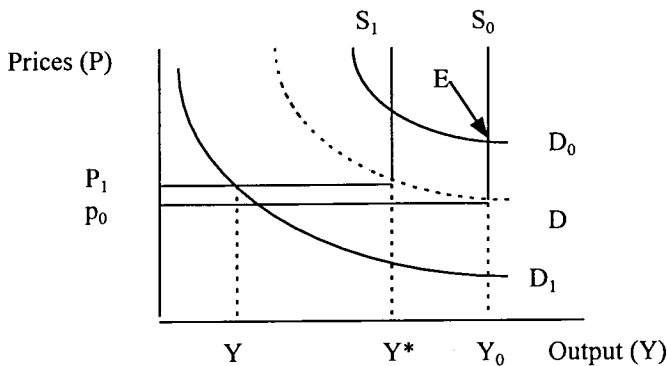
¹⁶ Bruno, 1992

¹⁷ Winiecki, 1993

¹⁸ Dornbusch, 1993, Ch.1

Gomulka (1992) argues the standard hypothesis - that during transition the economy switches from a supply-constrained to a demand-constrained regime. He contrasts the Structuralist view versus the Keynesian-type view of the cause of the recession. The former is allied to the Schumpeterian view of 'creative destruction', sharply rising input and output prices determining new relative prices but a slow microeconomic adjustment, implying an output loss. This, allied with the collapse of trade with the CMEA¹⁹, would explain the output fall. Pure Keynesians, conversely, might argue that the full employment output essentially remained unchanged but a major decrease in aggregate demand occurred. These are not mutually exclusive, though, but Gomulka argues that policy makers tended towards structuralist reasons, but accepted that government policies, given the monopolistic market structure, would have a major impact on aggregate demand. A simple diagram shows this.

(Fig. 1):



E: initial pre-reform short-term equilibrium. It is on the vertical part of S_0 showing presence of excess demand and inflation.

- Removal of subsidies and price liberalisation, thus S_0 goes to S_1 . This is as potential output falls from Y_0 to Y^* (supply shock).
- Ideally the demand shock would have shifted to D , but suppose that it fell further to D_1 . Thus $(Y^* - Y_1)$ is the output fall due to excessive fall of aggregate demand.

Y^* is not known, though, and only the aggregate outcome is observed.

¹⁹ Council of Mutual Economic Assistance

Bofinger (1994) argues that under the 'classical' conditions prevailing in all transitional economies, only a supply-side explanation is adequate. He finds difficulty, though, in finding a theoretical foundation for this, although Calvo and Coricelli²⁰ provide some (if faulted) hope in their 'credit crunch' hypothesis. He concludes that the direct effect of monetary policy is theoretically and empirically difficult to establish. Showing macroeconomic data for Czechoslovakia, Poland and Hungary, and the similarity in their output performances despite undergoing radically different stabilisation and reform processes, he argues that only a 'classical' interpretation can be suggested, i.e. one that is inconsistent with the demand-side view.

Bofinger shows the command economy to be characterised by an aggregate supply *point* not an AS curve as output and prices were exogenous (and the labour market did not clear). A dual equilibrium was present: excess employment caused a real disequilibrium pushing production levels higher than profitable; part of this was financed by issuing money, resulting in a nominal disequilibrium. The IS curve was vertical and with rigid interest rates the LM curve was horizontal. In the transitional economy employment is now determined in the labour market (which clears) with lower employment and thus a reduction in total output. With flexible prices the AS point becomes a vertical AS curve. Although simplistic, this model can explain 'stylised facts' of the transition process, notably:

- roughly similar output falls for all three countries as disequilibria had been similar in all three
- reduction in employment and real wages
- differences in macroeconomic policies are irrelevant due to a vertical AS curve

If we introduce a 'Keynesian' element of friction in the labour market, perhaps due to governments preventing real wage falls more than is politically acceptable, we can model the gradual reduction in excess employment and why the output decline lasted from early 1990 to the end of 1992.

The Polish Reforms

Leszek Balcerowicz, Minister of Finance of Poland 1989-91, led the Polish policy-making team in the introduction of the stabilisation plan. The main points of this consisted of:²¹

- Fiscal consolidation - sharp cutback in the budgetary deficit
- Price liberalisation and substantial decrease in subsidies

²⁰ Calvo and Coricelli, 1992

²¹ Berg and Blanchard, 1994; Gomulka, 1992

- Convertibility of the domestic currency (zloty) and expansion of international measures to protect internal convertibility, which must assume priority over price stability in the initial period
- Stabilisation of liberalised prices based on standard IMF approach - important role for nominal anchors assigned to tough incomes policy and fixed exchange rate as well as restrictive monetary policy
- Quick opening of the economy
- Structural reforms to create competitive markets, and decrease barriers to entry

The reforms were far-reaching, which the political climate at the time favoured, and it was seen as a race against time to create a new economic structure or else social support of the reforms would fade out²². Macroeconomic restraint was closely tied with the need for credibility especially in respect to disciplining agents accustomed to 'soft' budget constraints i.e. firms whose costs consistently exceed revenues, financed through bank credit and subsidies which ultimately leads to a budget deficit and thus inflationary pressure. External credibility was heightened in 1991 with The Paris Club reducing the Polish external debt of \$33 billion by 30% with reduction of the debt by a further 20% after three more years, conditional on the successful implementation of reforms.²³

It is now appropriate to discuss the four policy instruments available to transforming economies, notably fiscal policy, monetary policy, exchange rate policy and incomes policy. It is of interest to note that socialist economies felt that they had no need to use these instruments, thus once transition to a market economy occurred, such instruments had to be created and policy-makers had to learn how to use them.²⁴

Policy Instruments

1. Fiscal Policy

Balancing the budget is vital to the success of stabilisation. Due to the fact that many governments had large external debts (apart from Czechoslovakia and Romania) it is not possible to finance a deficit through external borrowing. Capital markets have not yet been developed, so there is no market for selling government bonds. Thus the only way to finance the deficit is by obtaining credit from the Central Bank i.e. seigniorage or printing money. This of course produces inflation. Thus it is vital to keep the deficit as small as possible. For fiscal adjustment, one needs a productive tax structure and expenditure reforms. A substantial permanent reduction in

²² Zielinski, 1993

²³ Gomulka, 1992

²⁴ Gros and Steinherr, 1995, Ch.7

government expenditure on subsidies was necessary and achieved, although political pressure for the retention of a social safety net was high, especially given the large percentage of pensioners.²⁵ Despite expectations to the contrary, Poland and Czechoslovakia ran a temporary budget surplus in the first few months after reform. This was due to a deep fall in real wages (cutting firms' costs) and the tendency for enterprises to keep large input inventories at the time of reform (bought at old prices). When prices rose, revenues increased, thus profits rose. The socialist economies relied heavily on the profit tax for revenues (15 - 20% of GDP typically), thus tax receipts were high. The profit tax element subsequently fell substantially once real wages rebounded and the temporary effects of low input costs for firms stopped, and profits were squeezed. Also, output fell generally thus reducing tax receipts. Thus a fiscal crisis emerged in Poland in 1991. Difficult expenditure cuts were needed, thus the 'residual' expenditure of investment in infrastructure suffered most (as political opposition is least), thus causing harmful long-term effects. In terms of inflation, Dornbusch argues that a tight monetary policy is not a substitute for a balanced budget.

2. Monetary Policy

Generally, restrictive monetary policy is needed to try and keep the growth rate of the money supply within reasonable limits and it must be in tandem with fiscal policy. The money supply *can* act as a nominal anchor for the economy, but severe difficulties arise with monetary policy due to the existence of soft budget constraints²⁶. Borrowing inertia by SOEs is a serious problem, as they expect to be bailed out by the state if their finances are in crisis. Equally, lending inertia by banks with poor lending policies, and with creditworthiness and risk assessment abilities very poor, make the effect of monetary restraint perverse.²⁷ Indeed, restrictive monetary policy may lead to adverse selection, according to Winiecki, where the least efficient survive (usually the largest) who can borrow almost limitlessly, and the demise of more efficient (smaller) enterprises with reduced access to credit. There is a need to create an independent Central Bank as it is difficult to resist pressure from the government to monetize the deficit.

Calvo and Coricelli (1992) take the view that a 'credit crunch' occurred in Poland in the first quarter of 1990:

²⁵ Bruno, 1992

²⁶ Bofinger, 1994

²⁷ Winiecki, 1993

“Firms need liquidity in their daily operations....Insufficient liquidity/credit levels prevent firms from operating at full capacity and output is lost”²⁸

Thus, firms are forced to move on their production function towards the origin. As a result the AS is shifted to the left. This correspond with Bofinger’s Classical model with a supply constrained economy discussed earlier. This hypothesis is undermined by the common assertion that firms did not operate under a binding credit constraint and could counteract monetary austerity by increasing inter-enterprise credits²⁹. We may conclude from this that in transitional economies monetary policy is much less powerful than in a market environment. Indeed, Bofinger goes on to assert that there is no convincing evidence for a significant real sector impact of monetary policy in the period 1990-1992 in Poland. Zielinski also comes to this conclusion in assessing whether restrictive monetary policy throttled internal demand. Additional money injections should revitalise domestic demand but tests do not show this. Gertler, though, in a comment on the Calvo and Coricelli paper, believes the ‘credit crunch’ hypothesis is complementary to the adverse demand shock story advanced by Berg and Blanchard and also Gomulka. He asserts that credit market friction’s help propagate demand shocks in making both firms and household spending sensitive to current cash flows.

3. Exchange Rate Policy

Bruno states that given the instability of money demand, preference should be given to the exchange rate as a nominal anchor. Initial pegging of the Polish zloty to the dollar was helped by the devaluation of the dollar against all major OECD currencies during 1990.³⁰ The zloty was devalued by 65% to promote exports and limit imports. The Polish nominal exchange rate remained constant for 17 months from January 1990 till May 1991. If inflation persists there is pressure for the nominal exchange rate (e) to fall to retain purchasing power parity.

Thus, with domestic inflation, in order to retain competitiveness ‘ e ’ must fall. As a result of this it is necessary eventually to shift to a crawling peg tied to a weighted basket of currencies. Dornbusch points out that overvaluation is a grave risk, as although it may help to cool inflation, it invariably leads to a real and financial crisis³¹. This ‘second stage’ was adopted in Poland in May 1991. The decision to abandon the fixed rate is difficult, Dornbusch argues,

²⁸ Calvo and Coricelli, 1992

²⁹ Bofinger, 1994

³⁰ Gomulka, 1992

³¹ Dornbusch, 1993, Ch.9

because it signals the government's acceptance of inflation as something inevitable.

4. Incomes Policy

Incomes policy has been in effect since Dec. 1989 in which each firm is subject to a wage norm which initially was roughly equal to the prestabilisation wage. This has increased over time, though, due to partial indexation to inflation and the fact that the norm has been in relation to the wage bill, thus when employment decreases further proportional increases in the wage itself are allowed.³² Incomes policy is not an absolute constraint on firms; rather, excess of wages above the norm are taxed at very high rates. This tax applies to the excess of the wage bill for the whole year above the norm, therefore if the firm pays a lower than the norm early in the year, it can pay a wage above the norm later in the year.³³ According to Berg and Blanchard, by the end of 1990, roughly two thirds of the firms in industry were willing to pay the excess wage in order to transfer some of the profits to workers. This shows clearly the power of workers' councils even after reforms.

The main justification for maintaining a wage ceiling, even though wage controls are clearly distortive, is as a support for the exchange rate anchor in combating inflation.³⁴ Wage-push inflation is a serious problem - especially in SOEs where managers do not have an incentive to keep wage increases below increases in productivity as they do not have to observe a hard budget constraint. It is clear then that alongside incomes policies is a need to harden the budget constraint and increase competition. Gomulka (1993) cites that the basic problem with the Polish stabilisation effort was that the two nominal anchors, money and incomes, were too flexible during the second half of 1990 and most of 1991 to serve as proper nominal anchors. With the exception of the first four months of the year, the effective price indexation of wage norms was nearly 100%.³⁵ For political reasons it was not possible to introduce an incomes policy with little or no price indexation of wage norms. Bruno offers an alternative to distortive wage controls to be a social compact on incomes policy between the major sectors (government, employers and workers' unions) - of the kind used in Scandinavia. Clearly the above four policy instruments were key to the macroeconomic stabilisation efforts, yet the effects, especially initially were not altogether inspiring, thus stabilisation may

³² Berg and Blanchard, 1994

³³ *ibid.*

³⁴ Bruno, 1992

³⁵ Gomulka, 1993

not be categorised as a complete success. The severe and long-lasting output decline and the continued persistence of inflation are testament to this.

Effects in Poland

1. The output decline

Contractions in output were severe across the CEE Table 3 shows this, with the largest fall occurring in Czechoslovakia in 1991 - the first year of its stabilisation program.

The main reasons proposed for the decline can be summarised as:

- Mismeasurement - figures only include enterprises of 100+ employees; fledgling private sector omitted³⁶
- Anticipation of a sharp price increase stimulates hoarding which is immediately followed by a sharp decrease in demand³⁷
- 'J-Curve hypothesis' - severe deterioration of economic performance due to restructuring and public-sector cuts, followed by an equally rapid and sustained improvement.³⁸ Portes (1993) describes this as trivially correct, though.
- Real wage and real monetary squeeze - throttled internal demand³⁹
- Credit squeeze reduced firms' output - Calvo and Coricelli
- Foreign trade shock - collapse of the CMEA

Table 3: Annual rate of change of real GDP in %

	1988	1989	1990	1991
Czechoslovakia	2.6	1.3	-0.4	-16.4
Hungary	-0.1	-0.2	-4.0	-(7-9)
Poland	4.1	0.2	-11.6	-8.0

Source: Winiecki, 1993

Microfoundations e.g. 'management shock' - transformed environment where they have to make their own decisions; adopt a wait-and-see approach

2. Inflation

The causes of the initial price shock in post-reform Eastern Europe were discussed earlier, including monetary overhang, elimination of subsidies, initial exchange rate devaluation etc.. These, though do *not* explain the persistence of inflation which occurred as shown in Table 4. Inflation erodes the information conveyed by prices. It erodes the real value of taxation if

³⁶ Winiecki, 1993

³⁷ Bruno, 1992

³⁸ Brada and King, 1993

³⁹ Bruno, 1992

there is any delay between accrual and payment of taxes.⁴⁰ Dornbusch discusses how when inflation accelerates, contracts shorten, which in itself causes inflation to accelerate as there is always some group of wage earners who are still lagging behind price increases. Incomes policies can help combat this inertia.

Berg and Blanchard argue that there is no single cause for persistence of inflation in Poland - that there is no stickiness of inflation, just many shocks along the way such as the catching up of wage at the end of 1990. We can distil some significant causes, though:

- 1) Fiscal deficit: can only be financed through printing money
- 2) Wage-price spiral: due to the indexation of wages, especially if pressure for wage increases are greater than productivity increases
- 3) Soft budget constraint for firms - firms avoiding imposition of rational price structure

The continuation of incomes policies, tight monetary policy and fiscal restraint should help to further whittle down inflation, as will, paradoxically, the reintroduction of indexation, according to Dornbusch. Although this is seen as responsible for inflation, it can in fact help reintroduce inertia and help establish expectations of low inflation.

*Table 4: Inflation in Central and Eastern Europe (and Russia) since 1991
Retail/consumer prices (end-year) - percentage change*

	1991	1992	1993	1994 (est.)	1995*	1996*
Czech Republic	52	13	18	<u>10</u>	<u>8</u>	7
Hungary	32	22	21	21	28	22
Poland	60	44	38	29	22	19
Romania	223	199	296	62	28	20
Russia	144	2318	841	203	131	45

**Projected*

Source: Hare, 1996, Table 2

Current and Future Issues: Stabilisation to Growth

Poland experienced positive GDP growth in 1992 and it was the first transitional economy to achieve this. Since then growth rates have been remarkable: 6% in 1994, 7% estimated in 1995 and 6% projected for 1996. It is expected to be the first transitional economy to reach the same level of real

⁴⁰ Dornbusch, 1993, Ch.1

GDP as it had in 1989 by 1996.⁴¹ Unemployment, though, was 16% at the end of 1994 and inflation 29% (although expected to be below 20% in 1996 - see Table 4). Net direct foreign investment has risen from \$88m in 1990 to well over \$600m in 1996.⁴²

Emerging unemployment, the elimination of shortages and the restoration of basic monetary equilibrium are all symptoms of transforming from a supply-constrained to a demand-constrained economy.⁴³ A shift in the macroeconomic balance according to Gomulka is still occurring, which should imply a shift in the macroeconomic targets from anti-inflation to anti-recession - opening the way for a transition from stabilisation to recovery and growth. Thus, policy balance should shift more emphasis onto institutional reforms especially in the banking sector and financial regulation as well as structural policies e.g. privatisation - which is slow and costly.⁴⁴

To sustain growth, there is a need to achieve high rates of investment, and so far foreign investment has been modest, so high rates of domestic savings are vital. Hare goes on to estimate that to sustain a nominal growth rate of 4% it would require domestic investment at a rate of about 20% of GDP. Accession to the EU is very important and 10 Eastern European countries (except Albania) are classed as 'Associated States', and are all actively preparing for membership.⁴⁵ There has been an increase in the region's penetration of the EU market from 2-3% in pre-reform days to 7-8% of trade flows according to Hare.

Conclusion

The central issue in Central and Eastern Europe, and particularly in Poland, has shifted away from that of stabilisation to that of policies to increase/sustain growth. The persistence of inflation and the underlying processes generating it is a problem though, and requires stabilisation-type measures. Priorities are moving from the macroeconomic to the microeconomic, which are no less and possibly more important. There is a limit as to what macro policies can do unilaterally without underlying 'grass-root' changes. Stabilisation has though in general been achieved in Poland, in really a remarkably short space of time given the titanic political and economic changes that have occurred. Poland has been seen to be a leader in economic reform, and is currently leading the charge in the drive towards growth, prosperity and a stable market structure

⁴¹ Hare, 1996

⁴² Jeffries, 1996, Ch.24

⁴³ Gomulka, 1993

⁴⁴ *ibid.*

⁴⁵ Hare, 1996

and ultimately to the fortress of the European Union. Dornbusch recognises the interdependence between countries in the region - there are spillover effects in economic and political confidence- thus it is in the countries' interests to co-operate together. Then foreign investment will be generated which will ultimately lead to the export-oriented economy the Poles are looking for.

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