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POLISH HYPERINFLATION AND STABILIZATION 1989–1990

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Polish Hyperinflation and stabilization 1989-1990

(Summary)

In the latter half of the eighties, inflationary processes in Poland were undergoing an ever greater intensification. Their characteristic feature was the parallel existence of both price (open) inflation and shortages. In the second half of 1989 it came to near-hyperinflation. The economic situation was extremely disequilibrated, a recession appeared, external debt was growing. Against this background - after the political breakthrough of summer 1989 - a successive economic program was developed consisting of two currents. The first one aimed at a radical acceleration of previously initiated market-oriented institutional changes. The second current consisted in a fundamental change in economic policy towards preponderance of fiscal and mometary instruments.

Basing on these premises, the Polish version of orthodox-type stabilization program was worked out and gained approval of the International Monetary Fund. After several-month preparations, its implementation was started at the beginning of 1990.

In this paper, some processes leading to the elaboration of the program, its assumptions and implementation as well as its hitherto obtained effects are discussed. They have been rather unfavourable. A high inflation rate still persists. The previously dominating trade off: inflation versus shortage, typical of the reformed socialist economies, has been replaced by another dilemma: inflation versus recession. The latter constitutes the greatest danger to the success of the stabilization package. Therefore, in this paper some necessary directions and instruments for a future modification of the stabilization program have been proposed.

1. Sources of inflation in Poland

1.1. Inflationary processes in the eighties

The origins of the intensified inflationary processes in Poland still date from the mid-seventies. The inefficient economic system and wrong policy, on the one hand, as well as external price shocks, on the other hand, led to an ever greater intensification of both cost and demand inflations. But till the end of the decade the inflation rate did not exceed one-digit level..

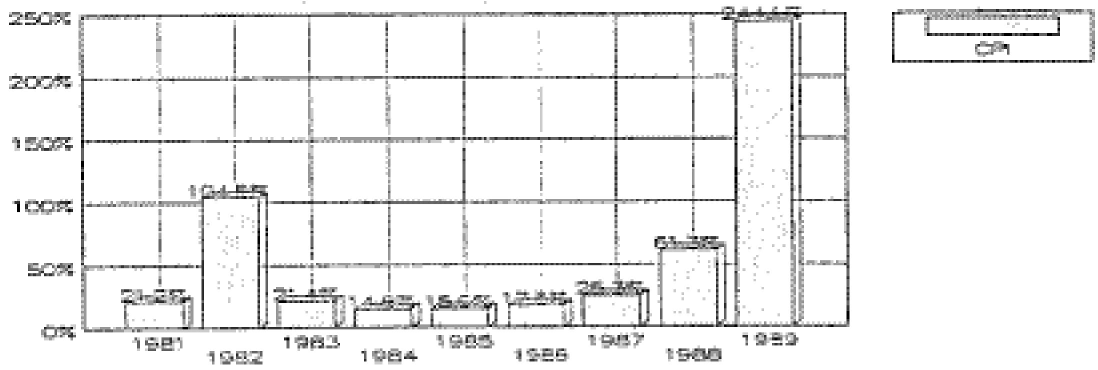
A well-marked acceleration of the inflation took place beginning with summer 1980 as a result of the simultaneous appearance of a dynamic wage rise and economic crisis. A particularly high inflation rate took place in 1982 afer which, in the following period, its rate gradually declined to less than 15 percent in 1985. It is also worth noting that the period after 1982 and till 1985/86 was characterized by a relatively high economic growth rate, though this growth rate was referred to the critical breakdown of 1979-1982, when the per-capita GDP had dropped by almost one third.

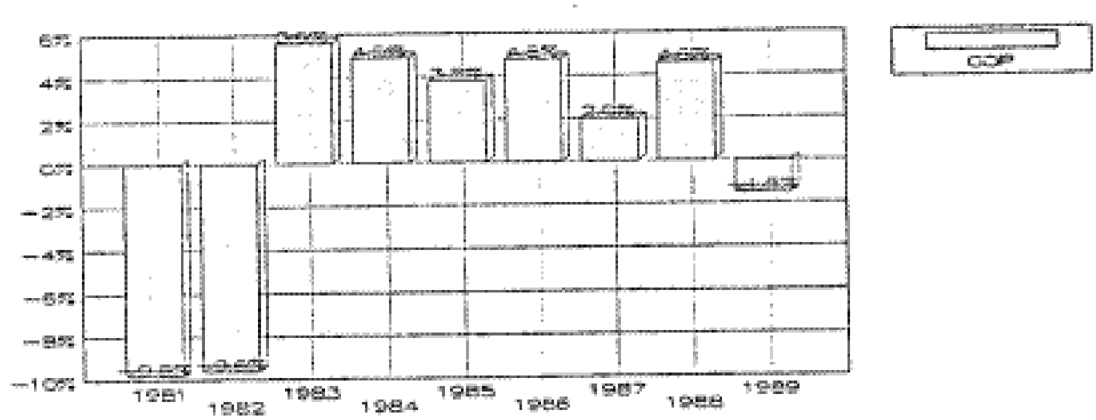
But in the latter half of the eighties inflationary processes were visibly accelerated once more. The price inflation (open inflation) rate went up from 15 percent in 1985 to 61 percent in 1988. At the same time, the economic growth was slowed-down. The trends of both these processes became stronger and stronger, this being particularly apparent in 1989 (see figure 1). This, among others, was the source of the mounting tide of social dissatisfaction leading not only to government resignation which took place in September 1988, but also to the fundamental institutional and political breakthrough in summer and autumn 1989.

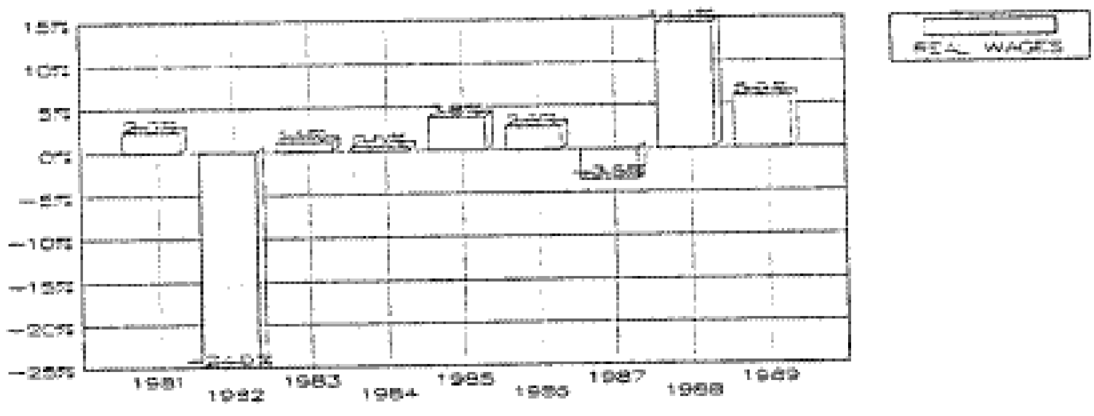
Thus, in the 80s, several different periods from the point of view of the dynamics of price inflation processes could be distinguished. The first one extended from summer 1980 till the end of 1981. Next, a shock price rise of February 1982 took place with consequences bearing on the whole year. Then, between 1983 and 1986 a gradual reduction in inflation

Figure 1

INFLATION, ECONOMIC GROWTH AND REAL WAGES IN 1981 – 1989







rate followed, after which we witnessed its renewed accelaration starting with 1986 and lasting till mid-1989[1].

1.2. Failed stabilization attempts

Over the whole past decade, a number of stabilization attempts were made. The most spectacular one was the 1982 reform which, among others, resulted in a fall in reall wages by as much as 25 percent. The general price level rose at one stroke by over 100 percent upon which some adjustment followed, mainly with regard to the household demand, real reduction in money reserves of the household sector and limitation of the excess liquidity of enterprises. But beginning with August, after a dramatic breakdown because of demand barriers in the preceding months, the economy managed to regain a growth trend. It started to grow once more and an inflation rate reduction process was initiated.

However, in the mid-80s, the reform process lost its original momentum. Institutional changes were insufficient and inconsistently implemented. Economic dis equilibrium intensified once more, additional inflationary factors appeared (in particular a permanent trade balance surplus since 1982) and social support for the reform was fading. Also, economic dynamics were running out which led to recession beginning with May 1989 (although, in the whole year's scale the decline in industrial production was still insignificant).

It was against this background that successive stabilization attempts and anti-inflationary measures were taken. In particular, the "Governmental Implementation Program for the Second Stage of the Economic Reform" as well as the "Program for Strengthening the Currency" were developed in autumn 1987. Especially the latter was a kind of stabilization package. However it was not fully consistent with the former which was being mainly focussed on institutional transformations. The insufficient coordination between both plans and particularly the difficulties in blocking the wage rise compensatory in relation to price rise led to the failure of these incoherent stabilization attempts. Planned at 44.5 percent for 1988, the inflation rate in reality exceeded 61 percent. The shortages were also

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[1] The literature devoted to inflation in socialist economies is getting ever more extensive. See i.a. Winiecki (1986), Kolodko (1987), Rosati and Michalski (1989), Rutkowski (1989) and Topiński (1989). From among the English-language literature it is Nuti's study (1985) that is worth quoting in the first place.

aggravating. In addition, the production dynamics continued to decline and the external debt level incessantly grew.

1.3. The shortageflation syndrome

A specific feature of inflation in the socialist economy has been its duality. The latter consists in simultaneous appearance of open and repressed inflations. While the former, typically of the socialist economies, finds expression in the rise of the general price level, the latter finds expression in shortages equally typical of the socialist economies. This phenomenon - called shortageflation (Kolodko-McMahon 1987) - has specific implications for the stabilization policy, since not only price stabilization, but also elimination of shortages must be sought in its course. So, the problem is more complex than in market-type economy where shortages do not appear.

The shortageflation syndrome can be interpreted in two ways. Firstly, a certain analogy emerges to the inflation-versus-unemployment alternative described by the Phillips curve. In the case of a centrally planned economy with full employment a similar dilemma regards the possibility (and scope) of the trade-off between the price rise scale and shortage level. However, this type of trade-off comes into play for short periods only and with regard to particular sub-markets. Since, over a longer period and on macroeconomic scale, the shortage will reproduce itself at an ever higer cost, income and price level. To block this specific process requires certain institutional changes (market-oriented restructuring of the economy and remonetization of economic ralations), as well as appropriate modifications in economic policy, especially by shifting its focuss from a "price-and-income" policy (here, its liberalization is also meant) towards a fiscal and monetary policy (Kolodko 1990).

Secondly, the shortageflation syndrome is to be interpreted as a process of simultaneous intensification of both the price and repressed inflations. As a result of maintaining soft budgetary constraints for economic agents (especially for the enterprise sector) there is a simultaneous increase in both shortage level and inflation rate. Processes of this kind have been in the latter half of the eighties typical of inflations in most socialist countries of which also in China and Soviet Union.

Since 1985, it has been exactly this type of processes that can be observed in Poland. After 1985, the price inflation rate has been rising (from 15 percent in 1985 to 244 percent in 1989) and at the same time, shortages have been intensified. This apparent paradox can be easily explained given the differetiated dynamics of nominal and real flows. Namely, in spite of an ever lower growth rate (and, in 1989, even an absolute decline) of production and supply, the nominal incomes (especially wages) were - except in 1987 - incessantly growing at a more rapid pace than the price level. In the face of the lack of capital market by which the excess demand flow could have been absorbed, the disequilibrium state was deepening in spite of an ever quicker price rise.

Of course, the above-described shortageflation syndrome must not be interpreted as if the economic policy were able to arbitrarily manipulate the price or resources inflation rate by alternately choosing now higher price level, now greater shortage, with all the implications in the sphere of goods, capital and labour allocation. But, on the other hand, there always have been some possibilities to control the mutual relation between the repressed and open inflations. However, an incorrect policy with this regard has finally led - because of existing systemic and structural conditions - to the growth of both forms of inflationary processes.

1.4. Induced Hyperinflation

The sources of hyperinflation[2] in Poland were accumulating since the beginning of 1988 already. The inflation was visibly accelerated by the so-called "price-and-income" operation of February 1988. It had to facilitate the execution of the "Implementation Program of the Second Stage of Economic Reform". However, this was not the case. Instead of the intended reduction in average real wage level by about 5-6 percent the latter rose by as much as 13 percent, while the supply was insufficient in

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[2] The use of the term "hyperinflation" in the context of the Polish 1989/1990 inflation is controversial, since it lasted seven months only and, on the average, amounted in that period to somewhat less than 40 percent monthly tantamount to about 5,500 percent yearly. Dornbush (1990) would call it "megainflation". Cagan (1956) - using very formal criteria - defines hyperinflation as a process of steady price rise in excess of 50 percent (why not, for example, 40 percent?) in every censecutive month. Whereas to overcome the hyperinflation requires, according to Cagan, reducing the inflation rate to less than 50 percent monthly throughout the following year at least. But in the light of the above discussion, I still propose to use the term "hyperinflation" here, keeping in mind however that, as will be shown below, in Poland it was of an indeced character. Hence its vehemence, irregularity (from 17.7 percent in December 1989 to 78.6 percent in January 1990) and short duration.

real terms. This led to a further destabilization and considerably strengthened the influence of the demand and cost inflations (excessive increase in labour costs). The price inflation was considerably accelerated; parallelly, shortages were growing, too. And the government began to an ever larger extent to loose control over inflationary processes.

Another strong impulse towards hyperinflation was the rapidly worsening condition of the state budget, among others because of the retroactive raise of state purchase prices for agricultural products. This evidently wrong decision was - like many other economic decisions in Polnad - mainly motivated by political considerations and strongly contributed to speed up inflation. Throughout 1989, the budget disequilibrium was deepening, and that for many reasons (see Report 1990). Inflationary budget expenditure was excessively growing, especially for subsidies to the ever more deficitary state sector production. On the other hand, because of the use of wrong systemic solutions and low fiscal discipline, budget revenues were (in real terms) lower than planned.

The Polish hyperinflation was mainly provoked by two decisions made as a result of the Round Table negotiations (Kolodko 1989a). Here the unprepared so-called "marketization" of the agriculture (in August 1989) and the "general wage and income indexation system" forced by the Solidarity for political reasons are meant. The "marketization" of agriculture almost exclusively consisted in the liberalization of retail prices for food and of profit margins in the food trade, without the necessary previous demonopolization measures in the area of the agricultural products trade and the supply of agriculture with production means. This operation largely contributed to the price rise in August by as much as 40 percent in comparison with July. The accelerated price inflation process was additionally fueled by the effects of the full indexation which gave an extremely powerful push to wage inflation and to current demand. First corrections to the faulty and destructive indexation system were made soon after the power take-over by the Solidarity.

Apart ot these - and some other - hyperinflation sources which can be called technical ones, there also were some wider causes. So, one may guess the hyperinflationary option was deliberately chosen for the following reasons.

First, the conviction that torment caused by hyperinflation would foster the population's readiness to bear the inevitable cost of a shock therapy for stabilization.

Second, the belief that exit from hyperinflation would be - under certain circumstances which presumably were met in Poland - relatively easier than from a galloping inflation combined with shortage.

Third, the hyperinflation had to facilitate (and this really happened) the depreciation of monetary resources accumulated by economic agents (particularly by households) and generally reduce the excessive financial liquidity of the economy.

Fourth, the justified conviction that in a hyperinflationary environment it would be easier to lower the real income level of households, although the implementation of this assumption was not equally spread over different months.

Finally, fifth, its premises we previously defined as technical ones having been fully met, the hyperinflation was a conscious choice for an interim period because of market-oriented systemic transformations. Since, on this occasion, some indispensable market options of economic policy could be initiated which otherwise would have been extremely difficult, if possible at all. Here, a reduction in the scale of subsidies and budgetary redistribution, the introduction of a partial currency convertibility, implementation of capital and labour market elements, initiation of the privatization process, etc. are meant.

To sum up, it is to be stated that the hyperinflation started in Poland in summer 1989 was to a large extent induced, since its technical causes alone - in spite of the price explosion in August already - could, still in September, have been got under control or at least radically neutralized. The choice of the definite way of curbing inflation by utilizing itself for this purpose was also promoted by the practical situation, especially by the time coincidence of government change and outbreak of rampant inflationary processes.

2. Economic disequilibrium

The steady worsening of the situation in the latter half of the 80s found its expression, among others, in a deepening economic disequilibrium which practically affected all the sectors of the economy. In spite of the ever higher inflation rate, disequilibrium was growing in the goods and consumption services market. In this case we had to do as well with a disequilibrium of flows (open inflationary gap being ex post "filled" with the increment in compulsory household savings) as with a resources disequilibrium in the shape of the so-called inflationary overhang i.e.

resources reflecting the excess liquidity of the household sector at the given time (with the given real supply, demand and price levels)[3].

Similary deeply disequilibrated were the investment and labour sectors. In both these areas, too, a surplus demand typical of the socialist economy existed which - in the face of the lack of an efficient market allocation - could not be equilibrated by the available supply of means of production.

A synthetic expression of the internal disequilibrium was the state budget deficit which - as stated above - almost led to budget breakdown in mid-1989. At the end of the last decade and in particular in 1989, the so-called Oliviera-Tanzi effect (Tanzi 1977) made appearance. It consists in the fact that, in the face of hyperinflationary trends, tax remittances by economic agents are more and more delayed and, at the same time, pressures for advanced disbursements from the budget, mainly for the public sector expenses, become ever more insistent (and often more effective). As a result, the budget deficit becomes deeper which, in turn, sends up the inflation rate. This fact must be particularly stressed, as in the course of elaboration of the stabilization package in Poland the debate strongly exposed the inflated and ever bigger budget deficit as one of the inflation sources, while neglecting the fact that there also was a very strong opposite relation. Namely, it was the galloping inflation turning into hyperinflation that led to the ever growing budget disequilibrium level.A unilateral approach to this problem and underestimation of the importance of the above-mentioned effect greatly influenced the final shape of the stabilization program in which the necessity of full budget equilibration was recognized to be one of the prime intermediate objectives in combatting the inflation and this equilibrium was to be achieved by a very high fiscal encumbrance of the enterprise sector (including private enterprises).

The economic disequilibrium has its external dimension too. The Polish foreign debt in convertible currencies was doubled in the 80s. It grew from about USD 20 billion in 1980 to more than USD 41 billion at the

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3 Some economists - e.g. Topiński (1990) - try to deny the applicability of the inflationary overhang notion to the resource disequilibrium analysis. I am also afraid that the incomplete understanding of the essense of the so-called overhang and an overestimation of its real volume was one of the reasons of the excessive drainage on monetary assets of the household sector in the first months of the implementation of the stabilization program.

end of 1989, and that in spite of repayments which amounted to about USD 20 billion over this period. It is to be stressed that this was possible owing to sustained trade balance surplus between 1982 and 1989 as well as to the positive transfer balance. However, the positive trade balance exerted, at the same time, an inflationary pressure. In 1990, it has to be negative again, at least as assumed by the government's economic program.

Apart from the dollar debt, also Polish debt expressed in transfer roubles considerably grew in the last decade. At the beginning of 1990 it was equal to Rb. 5.6 billion. This debt is almost entirely owed to the Soviet Union.

3. The orthodox shock - January 1990

3.1. New environment

The Polish economic stabilization program being implemented since the beginning of 1990 can be recognized as a more or less successful attempt to apply the orthodox methods of the International Monetary Fund to Polish conditions synthetically illustrated above. Numerous difficulties in the application of the IMF orthodoxy - this application being a prerequisite for signing a stand-by agreement with this organization which, in turn, influenced the whole sphere of Poland's financial relations with the West - mainly resulted from the need to allow for the existing deep disequilibrium, and in particular for the manifold shortages.

With all this, it must be stressed that the economic package presented by the new government was, to a large extent, a continuation of measures which had been already earlier taken. The basic difference consisted less in the economic side of the problem than it is political aspects; and that in both the internal and external dimensions, since the political situation had radically changed. What formerly was hardly conceivable has become possible now. The new authorities have an immense popular support at their disposal which makes the implementation of the difficult economic program possible, but, at the same time, creates the danger of its overheating by applying an excessively restrictive financial policy.

Whereas, in the external dimension, the Western attitude towards Poland has diametrically changed. The West has decidedly approved the direction and pace of the Polish reforms. What more, its attitude to the Polish debt service has also changed. In particular, the IMF has departed from the requirement of the two-year deadline for the equilibration of the current account balance, while accepting that higher priority must be given to internal equilibrium. In this connection, the situation with respect to external aid has also changed. Instead of the net negative capital transfer amounting to USD 1.5-2 billion yearly (as in the preceding years), a USD 2 billion net capital inflow can be expected in 1990.

In sum, the implementation of the hard economic program has encountered, on the one hand, social acceptance of a drastic therapy which reduces real wages and the living standard and, on the other hand, economic support by the West for the implementation of the new government's economic program. Under these circumstances, after several months' preparations, the implementation of the stabilization program was set in motion at the beginning of 1990.

3.2. Propositions of the stabilization program

3.2.1. State budget

The stabilization program assumes balancing of the state budget in 1990. It is to be mainly achieved through a radical limitation - and in many cases complete abolishment - of subsidies. There share in the state expenditure is to fall from about 38 percent in 1989 to about 14 percent in 1990. The state budget equilibrium is also to be helped by improved fiscal discipline, ban on contraction of interest non-interest bearing loans from the central bank (intermediate crediting on commercial terms must not exceed 4 percent of the budget in the first quarter of the year and 2 percent in the following quarters) and substantial reduction in or elimination of previously numerous tax exemptions. The institution of public debt is also introduced. An issue of government bonds amounting to Zl 4,1 trillion (as compared with Zl 197 trillion of the budget on both sides) has been planned. The bonds will be exchanged for shares in privatized state enterprises[4]. Also, emission of shortterm treasury bonds

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[4] The treatment of possible receipts from such bonds as budget revenues is controversial. However, because of the fact that the state is not obliged to redeem *these* bonds in financing this expenditure from budget resources but has to exchange them for equities of privatized enterprises, we do not have here to do with a conventional internal debt. So, in this connection, receipts from *this specific* bond issue can be considered to be budget revenue rather than budget debt contracted in the open market.

has been admitted for the case of insufficient budget revenues, but their amount must not exceed 4 percent of the total budget.

3.2.2. Prices

Prices have been to a large extent liberalized. However, at the beginning of 1990, 14 percent of prices (in value terms) were still directly set by the state. This mainly regarded the prices of energy, transportation, housing, medicaments, and the cheepest sort of milk. In addition, about 10 percent of prices are subject to a kind of indirect state control. It consists in the obligation to inform the tax authorities of intended price raises and the raises can be postponed, though for no longer than three months.

Particularly important from the economic point of view - but at the same time very painful from the social point of view - have been the corrective energy price adjustments. The retail price for coal rose overnight as much as sevenfold! The electric power price rose twofold, and prices for liquid fuels were doubled. The price move induced thereby is called *corrective inflation*. For January, it was planned to amount to 45 percent (in comparison with the average price level in December). As a matter of course, this inflation index had also to result from the general price liberalization as well as from other decisions made under the stabilization package, especially with respect to interest rate and exchange rate.

3.2.3. Monetary policy

It has been assumed that the budget equilibration measures and price liberalization will not lead to hyperinflation if the whole economic and financial system is adequately "anchored". Under the Polish stabilization program the following factors are of special importance as the so-called anchors (stabilizers): a) hard budgetary policy (both of the side of rigorous revenue enforcement and on the side of severe economical discipline with regard to expenditure); b) restrictive monetary policy; c) quasi-freeze of wages; and d) uniform and fixed exchange rate.

As to the monetary policy, the positive real interest rate has been assumed to be the practically sole control instrument of money supply to the national economy. At the same time, it was accepted this reality requirement would not apply to each individual month but, in the initial program implementation phase, to the first 1990 quarter as a whole. The interest rate is to be changed every month, being at the beginning kept as little as possible below the inflation rate and, later, somewhat above it. Thus, the following interest rates (basic interest rates on refinancing credits from the central bank) were adopted for the first three consecutive months: 36 percent for January, 20 percent for February and 10 percent for March. Of course, an inconsistency is immediately evident here because - given the interest rates having been adopted for these months - the averaged interest rate for the whole three-month period could not be really positive. This especially regards the deposits of the household sector. But another, more serious objection arises, since it is doubtful whether, under such circumstances a positive real interest rate is really needed. Because, under conditions of very high inflation and currency substitution, an interest rate high enough in comparison with the *expected* inflation rate would be quite sufficient to induce necessary reduction in credit demand on the one hand, and to maintain the propensity of economic agents for savings on the other hand.

3.2.4. Wage restrictions

After heated debates at the end of 1989, it was decided there would be neither a full wage freeze nor the use of compensatory indexation mechanism at the level of 0.8 of the living cost increase, as had been the case, with certain modifications, in the fourth quarter of the last year. It can be assumed that it was just as a result of a certain compromise between the requests of the trade unions and the expectations of international financial institutions that the principle of wage fund (and not individual wages) indexation by the inflation index multiplied by 0.3 in January, by 0.2 in the three following months and, later, by 0.6 was adopted.

The coefficients constructed in the above way permit to raise the wage fund in the enterprise (as far as allowed by its financial condition in the new economic environment) by the real inflation rate multiplied by an appropriate index. Thus, much depends on inflationary expectations and on the credibility of the inflation rate forecast by the government. Because, if the admissible wage fund increase is exceeded by not more than three percentage points, the enterprise will pay a penalty tax amounting to 200 percent of the excess payments; if the excess makes more than three percentage points over the admitted limit, the penalty taxation is equal to as much as 500 percent for each additional point of excess payments. In the Polish economic jargon this type of solution is usually called "wage quillotine". Such a solution permits either a greater rise in the wage fund than would result from the official forecast as to the inflation level (if the enterprise management can better foresee the general price level dynamics) or an appropriate ex post regulation (correction) when the real inflation index is already known. As easily noticeable, this kind of wage policy tool functions in the way that the higher the inflation rate the greater the reduction in the real wage level. In view of the very high inflation rate in the initial period of the stabilization program implementation, the extremely restrictive character of this mechanism is to be stressed.

3.2.5. Exchange rate

One of the main nominal anchors in the stabilization program is the exchange rate. For many years, the Polish economy was practically a two-currency economy and the US dollar still plays a very great role, especially with respect to households. They still keep (with the present exchange rate) more than one half of their money balances in hard currency. So, the scope of currency substitution is still very large. A specific feature of the economic and financial system was the extreme, rarely encountered difference between the market price of dollar (till March 1989 i.e. the start of the exchange rate liberalization policy it was black-market price) and the official one. On the long-term average their ratio usually was 4-5:1.

Still in September the official (bank) exchange rate was ZL 1,400 only and at the and of the year attained, because of galloping devaluation the 6,000 level. During this period the market exchange rate slightly rose first, was falling than, and at the end of the year fluctuated around ZL 9,500. That is why the official bank exchange rate was set at this level at the start of the anti-inflationary program, on assumption it should be stable for at least three months. If the parallel (market) rate declined from the bank rate by more than 10 percent over a period defined by "The Letter of Intent" addressed to the IMF as a "more-than-short period", the central bank would be obliged to intervene through an interest rate change.

It is to be added than the introduction of a uniform fixed exchange rate, also called "internal convertibility", was supplemented, on the one hand, with a further liberalization of external trade and, on the other hand, with the introduction of restrictive import duties and taxes on some goods (e.g. the duty on motor cars together with simultaneously collected turnover tax amounts in total to 44 percent of the foreign price). On this occasion, the foreign currency retention accounts (RODs) - expect the previously existing ones - for exporting enterprises were abolished and, in their place, an obligatory immediate resale of export receipts was introduced along with possibility to finance the imports with foreign currencies bought from commercial banks. The central bank, in turn, would guarantee by its reserves, supported with the USD 1 billion stabilization loan granted by the OECD countries specially for currency stabilization purposes, to meet the commercial banks' demand for foreign currencies.

3.3. Social dimension of the stabilization

In the case of the Polish stabilization we have to do with many specific features. With respect to the economic sphere, the abovedescribed shortageflation - and later even hypershortageflation - syndrome is meant here; since, in this case, we have to do not only with a classical-type highinflation but with shortages too. So, the stabilization program has been simultaneously aimed at both limiting or eliminating the shortages and stabilizing the price level. Therefore, as opposed to Latin American stabilizations (Bruno-Di Tella-Dornbush-Fisher 1988), in this case an additional problem of bringing the prices to a level which will clear the market is to be solved. This requires, first of all, a significant acceleration on inflationary processes in the first period, but such a policy can encounter social barriers if aimed at bringing prompt anti-inflationary effects.

And here, the immense patience and even more - social support for the implementation of the stabilization program is worth noting. To outside observers this may seem almost irrational, but at least two circumstances are to be kept in mind here. First, the very difficult economic program requiring sacrifices is being implemented after a fundamental political turn as a result of which the government has been taken over by the Solidarity movement which enjoys an immense political support. Secondly, the intensity of support for the new authorities is - as shown by opinion polls - proportional to the level of aversion and dislike to the former system and to policies carried out by its authorities. Therefore, this factor is intensly utilised by the propaganda which successfully brings home to the majority of public opinion that the former authorities are *totally* responsible for the *present* difficult situation (this being by no means true) and ascertains that there is *no alternative whatsoever* to the program being implemented at present (this also being not absolutely true).

But the fact remains that the immense social support is a function of political rather than economic factors and has strongly encouraged the new government's approach of the "now-or-never" or "all-or-nothing" type. Of course, both these alternatives are false but, as it appears, socially acceptable and politically viable. And this is just what counts most in politics.

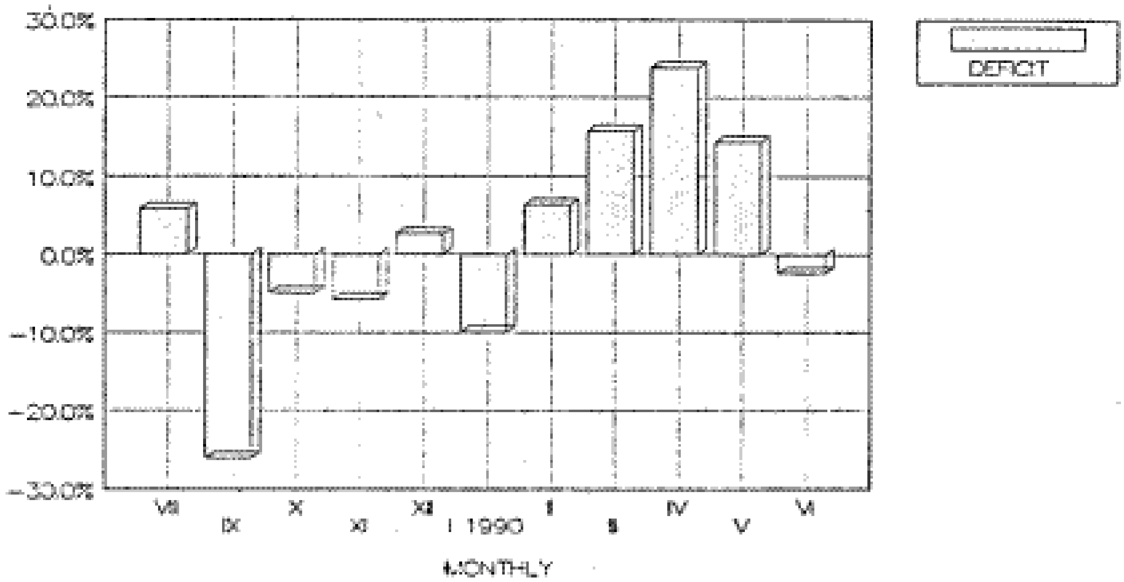
4. Implementation of the program

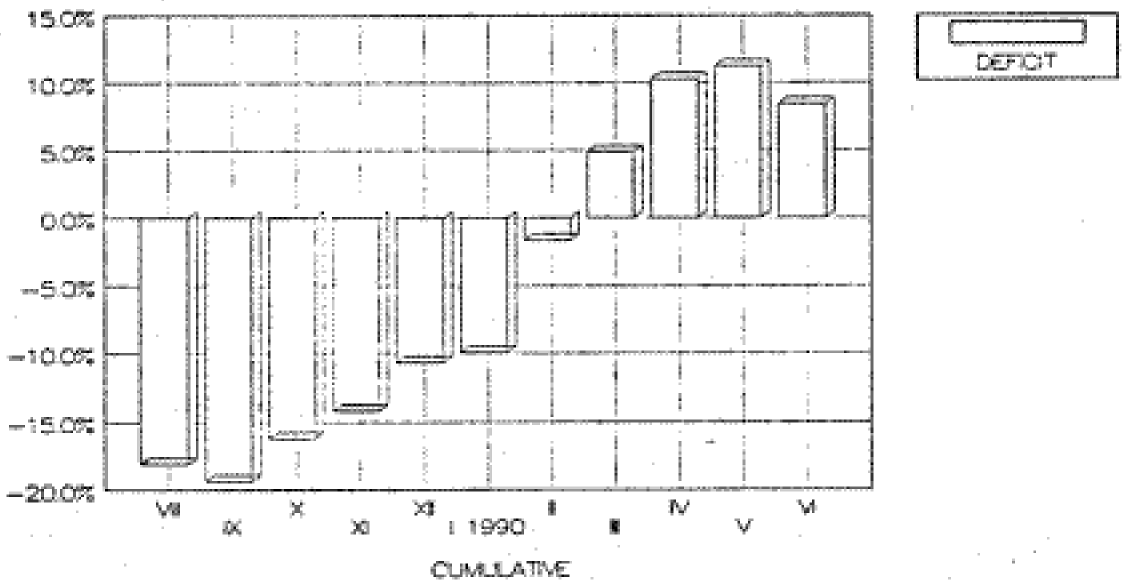
4.1. Budget

At the beginning of January, the shock therapy was applied. As far as the budget was concerned, subsidies to deficitary production, in particular subventions to energy prices, were substantially reduced. Also, many arbitrary tax exemptions and reductions were abolished and the collection of budgetary revenues was disciplined. There also was a delay in the execution of a part of payments which had to compensate the public sector and its workers for the inflationary price rise. However, it is difficult to evaluate the state budget performance in the perspective of the short period of a few months only. Nevertheless, the fact stands, that over the first five months of 1990 the budget was not only equilibrated but a certain surplus of revenues over expenses persisted (figure 2). However, it is to remembered that, in the Polish financial system, the three first months of the year have always been somewhat specific. In January, many distortions appear resulting from the settlement of outstanding dues and obligations from the preceding year. In February, so-called "compensation-taxes" on high personal incomes are paid. In February and March special remunerations (so-called "thirteenth pays" and "profit shares") are payed which temporarily raise the level of the household sector incomes. Nevertheless, it can be stated that: first, budgetary subventions have been substantially cut; second, fiscal discipline has been improved; third, no substantial savings in the public sector expenditure have been achieved; fourth, the scale of income redistribution through the

Figure 2

STATE BUDGET DEFICIT





budget has been reduced; fifth, the budget has been practically equilibrated throughout the early half of the year.

I mentioned above that the 1990 budget assumed the state would sell long-term bonds (convertible into shares in privatized enterprises) for the amounth of over Zl 4,1 trillion. But because of bad organization of the operation and as a resutl of the excessive drainage of the population's financial resources and its genaral pauperization the government managed to sell, during the first half of the year, bonds for not more than 1 percent of the proposed amount, this fact creating a threat to budget revenues and to the fragile budgey equilibrium.

But a still greater threat comes from the huge economic recession. It was assumed that: a) industrial production would fall by 5 percent (during the whole 1990 in comparison with 1989); b) the GDP would be reduced by 3,1 percent only; whereas c) consumption - by 1 percent only. Such optimistic assumptions might well be a remnant of the wishful thinking typical of the central planning period, since they were not backed by any reliable and convincing economic calculation.

The resutling threats to the budget and the inflationary implications are twofold. First, revenues from income taxes will be less because the economic activity is very much weakened. The decline in industrial production (measured by the sale of production of the socialized sector) in the January-June period by as much as 30 percent must be considered to be *very drastic* indeed. This is an unnecessary cost of the excessively restrictive monetary and wage policy[5].

Second, the unemployment resulting from such a deep recession can prove much mere costly for the budget in augmenting its expenditure much over the planned level; since, in the budget resources were reserved for covering the costs of the expected unemployment level of about 400,000 persons. In July, the unemployment has been already in excess of the level of half milion persons. And the unemployment is bound to rapidly grow in the latter half of the year because of the *lag effect* i.e. a time-shifted employment adjustment to the level of demand for labour corresponding with recession. In other words, while in the recession phase the industrial output fell by as much as 30 percent, the employment diminished by "mere"

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5 Some economists use farther-reaching definitions in this context. Rosati (1990) righty remarks that the simultaneous use of a certain combination of financial, moneatry and wage restrictions brings the economy outright to ruin.

7 percent. But in the depression phase (which has been practically lasting from February following the January breakdown), with production decline practocally stopped in absolute terms, the employment level will further decline.

In other areas - especially in the agriculture having a very large share in total production (over 15 percent) and employment (about 28 percent), building and transport - the scale of recession caused by the implementation of the stabilization program and by the critical situation as a whole is more difficult to be assessed because of their seasonal character. In my opinion, these side effects of the anti-inflationary shock therapy, though inavoidable, could have been less if the level of different anchors (stabilizers) in particular the interest rate and real wage reduction coefficients, were more aptly chosen. But the fear these coefficients might prove insufficiently restrictive and hence ineffective induced the authorities to exaggeration in the opposite direction. And it is just in this sense that the program has been overshooted.

4.2. Prices

At the beginning of January 1990, the greatest price shock in Poland's postwar history took place. The far-reaching price liberalization, on the one hand, and central corrective price rises, on the other hand, provoked a price explosion by nearly 80 percent in comparison with December. And it is to be stressed that since October 1989 the inflation index was gradually falling (see figure 3) amouting in the consecutive months of the last quarter of that year 55, 22 and 17 percent respectively (in comparison with the preceding month).

As equally alarming must be recognized the fact that progress toward price structure improvement has been less than originally assumed (Frydman, Kolodko, Wellisz 1990). The higher -than-expected price rise has caused that real energy prices did not grow so much as assumed in the program - with all the resulting consequences including the need for repeated corrective raises[6], since the stabilization program assumed the

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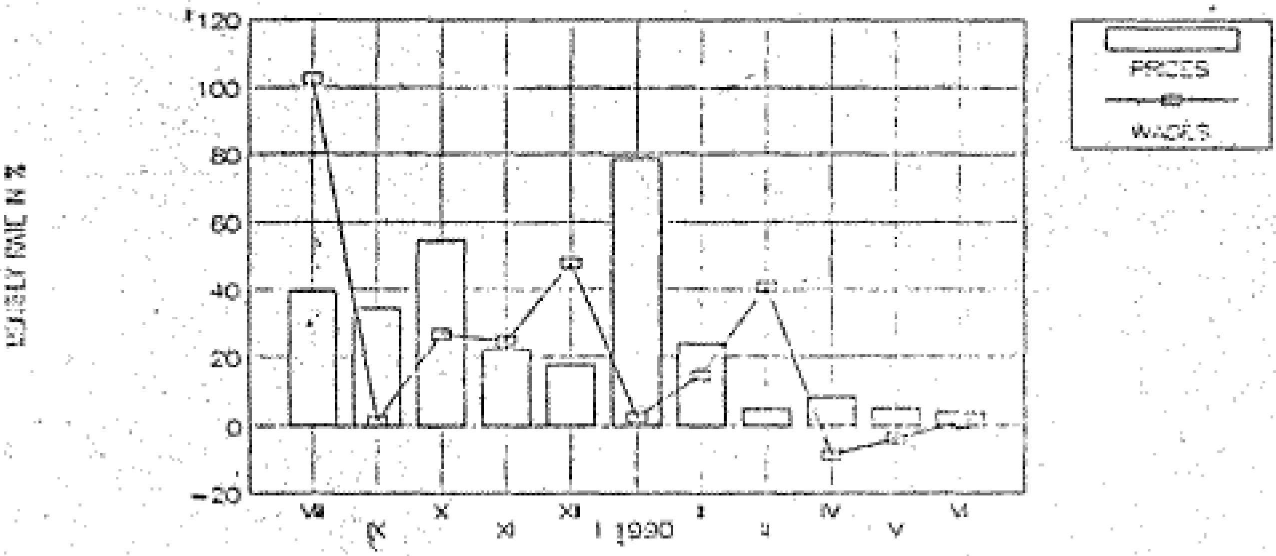
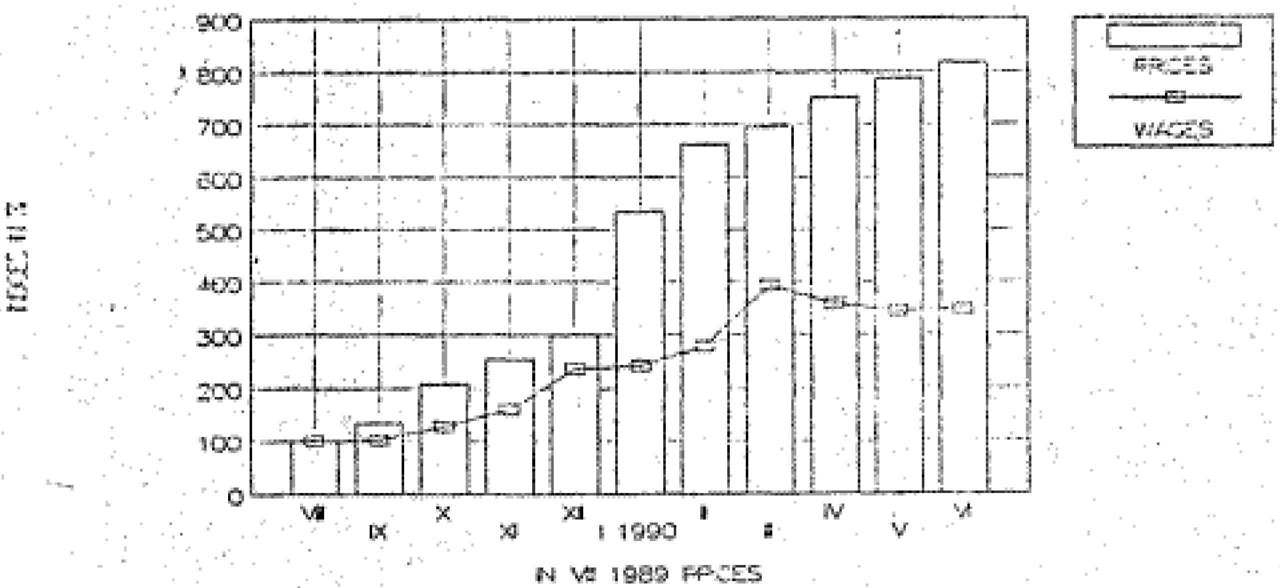
[6] They were partly performed in May already, mainly through liberalization of trade margins and by shifting the transportation costs on the buyers. The price as such were on the average raised by about 5 percent. But from the buyers' point of view - and also as implication for production costs - the raise in really paid coal prices was considerably more. The coal prices were liberalized entirely since July 1990.

Figure 3

PRICES AND WAGES RATE OF INFLATION





real price rises for coal and other fuels should be sufficiently high to anticipate the increase in costs which would follow the general price level growth that, however, was expected to attain 45 percent only. But, in reality, it proved to be by 80 percent higher.

Neither can the remaining changes in the price structure be favourably evaluated, since in the initial phase of the program implementation almost all proces were still formed according to the cost-based pricing formula rather than the demand/supply-based formula, this anyway having been foreseen. Finally, the impact of price changes on the real economy sphere too can not be favourably judged since, from the very beginning, negative adjustments in the shape of production reductions (because of the demand barrier) took place instead of positive real adjustments in the shape of production cost reduction, employment streamlining, quality improvements, etc.

After the price explosion of January, the price dynamics were visibly dying out in the following months. The inflation rate measured by the CPI amounted to 23.9 percent in February and to 4.7 percent in March[7]. Unfortunately, in April it was dynamized once more - up to 8.1 percent monthly i.e. to as much as 155 percent yearly, in May the inflation rate was 5.0 percent, and in June close to 4 percent. One to expect that the monthly rate of inflation in July will be around 8 percent, although the government target has been 5.5 percent. In my opinion, the reversal of the several weeks' favourable trend towards inflation suppression resulted from several factors.

First, a very high statistical increase in real wages in March as a result of the existing wage policy rules and its false sequencing in the initial period of the implementation of the stabilization program. Since, just as there was no need for such a drastic reduction in real wages as was the case in January, there also was no need to "make up" in March.

Second, the use of the US dollar exchange rate as nominal anchor has brought about an increase in the cost of imports paid in other currencies which were appreciated during this period. As a result, this factor, too, constituted a certain cost-push inflation impulse.

Third, the enterprises continued to use - of course in the framework

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[7] Here, mean monthly levels in comparison with each preceding month are meant. The so-called "point-to-point" indices i.e. end-of-month-to-end-of-month indices are presented in figure 3.

of a radically reduced demand - the so called cost-plus pricing formula wherever possible.

Finally, fourth - and this is the most important conclusion here - inflation can not be got under control by an exclusive use regulative tools. Recession in itself is - through an abrupt reduction in real supply - the strongest inflationary factor, the more so because in our case it has overproportionally affected the consumption industry branches.

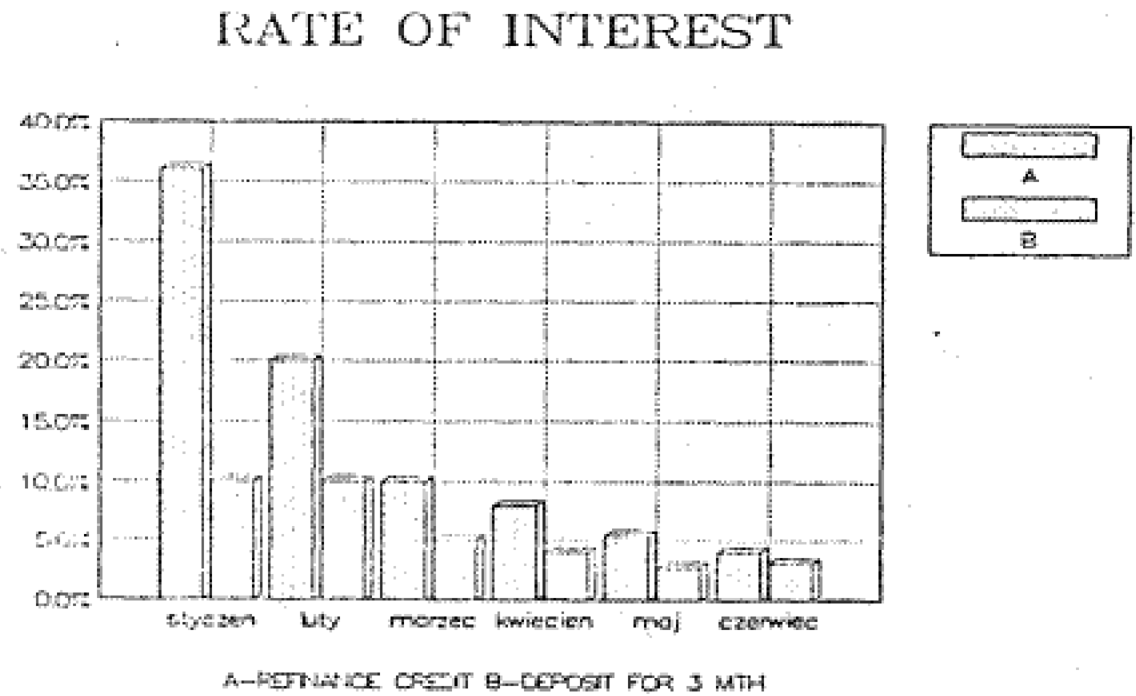
4.3. Interest rate

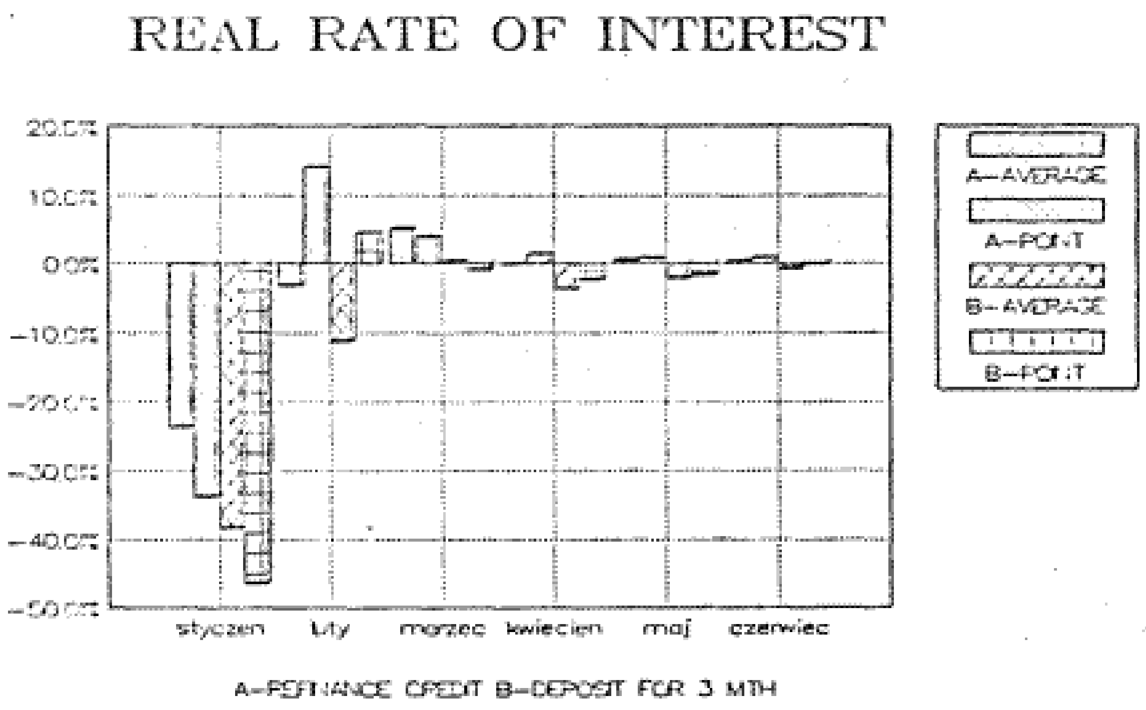
Interest rate has been one of basic instruments of the stabilization program implementation. It was assumed it should, in the scale of the first three-month period, come as near as possible to a really positive rate. However, a very large deviation took place in January. The basic interest rate was set at 36 percent (monthly) being, of course, appropriately differentiated for different credit and deposit categories (fig. 4).

But the real inflation rate in January was much higher than originally assumed; it attained as much as 78.6 percent, this being the world's highest level for that month (along with similar inflation rate in Argentina). So, the real interest rate in the first month - according to the program authors, the key one for the success of the entire operation - was decidedly negative. But despite the intentions, it was a good thing, since the interest rate was high enough - even more than enough - to radically reduce the demand for credits from both the enterprise and household sectors and to encourage the trend to locate free monetary resources in domestic currency accounts rather than in hard currencies. The interest rate on the latter has not been changed (it amounts to 3-10 percent annually in dependence on deposit category). A still higher nominal interest rate level would not bring any additional advantages while leading to a still deeper and longer-lasting recession.

In February - in the face of expected inflation rate of 20-25 percent order - the basic interest rate was set at 20 percent. This time, already, its real level was much less negative, since the real price rise index amounted to 23.9 percent. Whereas, if measured by the point-to-point method, the real interest would prove substantially positive (see fig.4). However, the restrictive monetary policy sheltered by such a high interest rate contributed to sustained recessionary trends.

Figure 4


RATE OF INTEREST
40.0%
35.0%
30.0%
25.0%
20.0%
15.0%
10.0%
5.0%
0.0%
styczen
luty
marzec
kwiecien
maj
czerwiec
A
B
A-REFINANCE CREDIT B-DEPOSIT FOR 3 MTH


REAL RATE OF INTEREST
20.0%
10.0%
0.0%
-10.0%
-20.0%
-30.0%
-40.0%
-50.0%
styczen
luty
marzec
kwiecien
maj
czerwiec
A-AVERAGE
A-POINT
B-AVERAGE
B-POINT
A-REFINANCE CREDIT B-DEPOSIT FOR 3 MTH

In the third month of program implementation, after a certain suppression of the inflationary processes, the basic interest rate was reduced to 10 percent which already secured - for the first time since a long time - its positive real level; since, in March, the inflation amounted to 4.7 percent only. April, in turn, already brought a visible deterioration. Im comparison with the repeated growth of the inflation rate to 8.1 percent, the interest rate on most deposits of the household sector (except on two- and three-year ones) was once more substantially negative in real terms. This situation does not foster the most desirable way of demand reduction - i.e. through increased savings. In May, the situation has been similar; the basic interest rate is 5.5 percent i.e. not more than the price rise rate. Since, July the discount rate of central bank has been fixed on yearly basis at the level of 34 percent.

So, when evaluating the impact of the restrictive monetary policy on the implementation of the stabilization program, it can be statet that: first, it has brought the expected results in the area of demand reduction for goods and, at the same time, strengthened the demand for Zloty in comparison with demand for hard currency assets. Second, it has led to a huge, not necessarily needed on such a scale, recession in the real sphere. Third, money balances of the household sector have been subject to a steady deep depreciation, this having further, this time already negative, repercussions in the sphere of excessive demand restraints including a shortage of financial resources needed for the implementation of the privatization program.

In the light of the above considerations, some more general conclusions and recommendations with respect to the *sequencing of the interest rate policy steps* under conditions of fighting the (hyper)shortageflation syndrome can be drawn. Here, four distinct phases must be distinguished. The first one is characterized by a high inflation accompanied by vast shortages and soft budgetary restraints, the latter being institutionally connected with the two former phenomena. Under such circumstances, the following economic law is functioning: *In a shortage economy, any attempt to decree a nominal interest rate above the inflation rate (i.e. at a positive real level) strengthens the existing trends with respect to the price inflation rate. If, in the given period, this rate is growing, any rise in the interest rate will still intensify the inflationary processes - and vice versa.* Therefore, the so-called "making the interest rate real" would have been justified after the 1982 stabilization, especially in 1983-1985, while being pro-inflationary in the later period (Kolodko 1989a). Also, a really positive interest rate was to be more actively sought in the fourth quarter of the last year, when a descending trend of monthly inflation rates had been successfully achieved. However, this was not done and monetary balances of the households were intentionally depreciated and severly wiped-out on the eve of the shock therapy which was delayed till the beginning of the next year.

In the second phase i.e. the corrective inflation phase - being, by its very nature, of short duration - the positive interest rate principle does not apply. This rate must only be sufficiently high to radically and abruptly reduce the demand for money from all economy sectors and to prevent the destabilizing effects of currency substitution. In Poland, January and the early part of February 1990 corresponded with this phase.

In the third phase - and in Poland this phase is still going on and will last till the end of the third quarter at least - positive real interest rates must be used, while the interest rate on loans (granted in the first place to enterprises of the socialized sector) must be lower than interest rate on deposits (this particularly applies to the deposits of household sector). A policy of this type will be anti-inflationary as it contributes to a reduction in recession scale, strengthens the propensity for savings and stimulates investment. Whereas the differences in interest rates are to be financed through low interest rates on the sight deposits and zero-interest on current accounts of the enterprise sector. So, in this phase, the following relations must function:

$$r_d > r_c > p$$

where:

r_d - interest rate on household deposits,

r_c - interest rate on credits,

p - inflation rate.

Finally, in the fourth phase, when stabilization effects begin to assume a more permanent character, transition to the interest policy typical of market economies is necessary, where:

$$r_c > r_d > p$$

It is evident that neither the months preceding the stabilization programm nor its hitherto implementation have been subordinated to the above sequencing, and that is why the desirable stabilizing effects could hardly be expected.

4.4. Wages

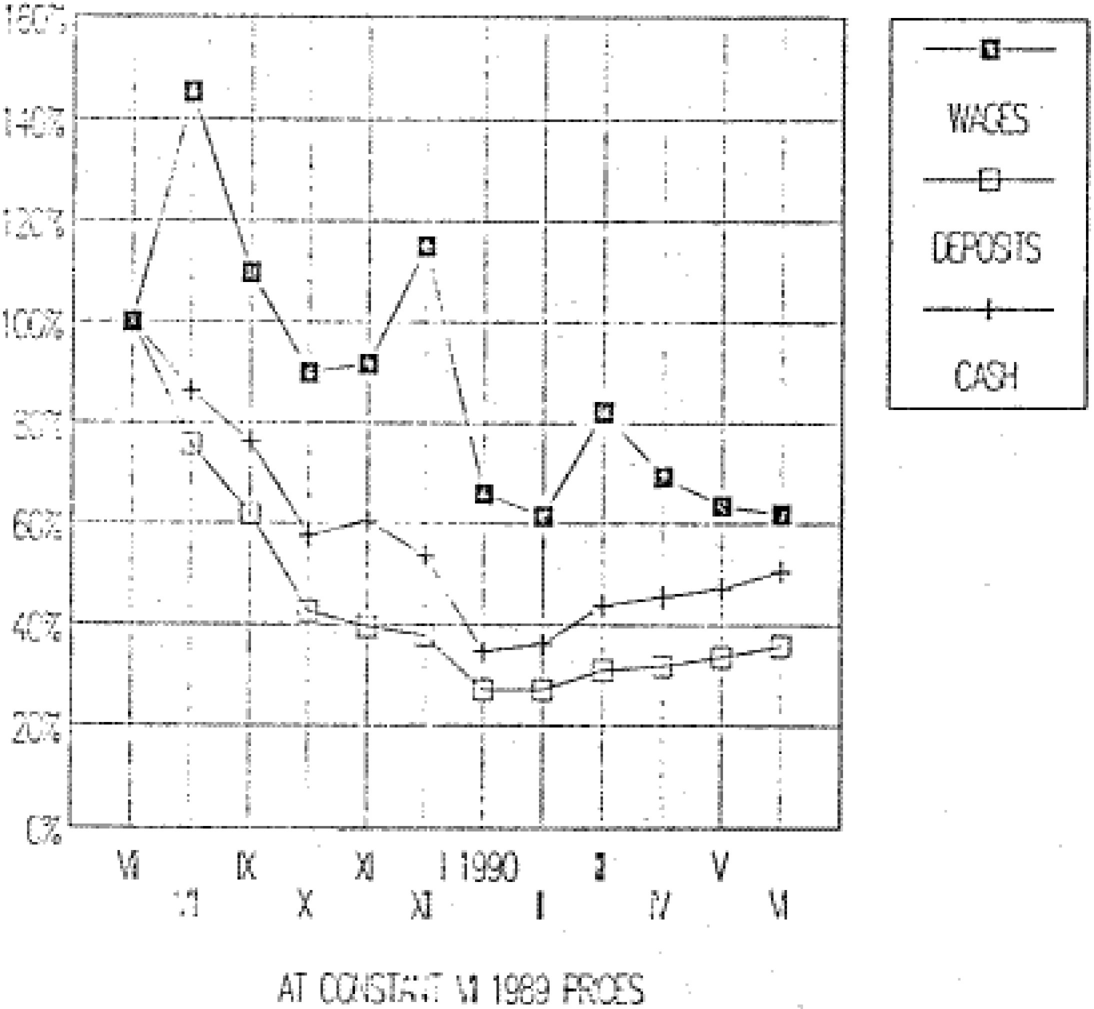
The wage indexation system being in force in the course of the program implementation undoubtedly is of a very restrictive, deflationary character. Its short-term impact is unquestionably anti-inflationary and stabilizing. But, in the longer run, its influence is demotivating and supply-reducing hence pro-inflationary. In addition, its important drawback consists in a practically equal treatment of all enterprises irrespective of their production trends. Worse still, the restrictive wage policy has, in the first place, affected the enterprises which deliver goods to relatively equilibrated partial markets, since it has been there that the demand barrier has appeared first, in limiting the production which so far has been profitable and well selling.

In January, the demand reduction caused by fiscal and monetary measures was so deep that, in many cases, the enterprises did not raise the wages even by the admissible (free of penalty tax) coefficients. They simply lacked the necessary liquidity. Thus, the wages grew by 1.3 percent only, this being tantamount to their monstrous fall by as much as over 45 percent in real terms. But already in February these indicators looked quite differently, a part of February payments constituting a delayed partial compensation for the inflationary rise in the cost of living in January. With a lower than in January price rise, the rise in wages was substantially greater. In March, in turn, a considerable increase in real wages took place, mainly resulting from so-called profit-share payments. Whereas in April real wages fell by 14.5 percent (see fig.5). But, as already pointed out, the sequencing of cost of living movements as well as of both nominal and real wage changes was controversial.

Nor did this wage policy contribute to a wage structure improvement. During the implementation of the stabilization program all wages were changing in converging directions and at similar pace. Thus, neither in intergroup nor interbranch relations, the desired change took place and adjustments with this respect which will be necessary in future will once more exercice inflationary pressures.

Figure 5

REAL WAGES AND STOCK OF MONEY IN HOUSEHOLDS



4.5. Exchange rate

The exchange rate policy in the early month of 1990 can be considered to be successful. In spite of the controversial choice of the US dollar as the nominal anchor, since in Poland's case it would be better to use a currency basket the composition of which would correspond with the share of different currencies in the Polish foreign trade, the exchange rate level was correctly anticipated. Although, in this case, it was not a matter of anticipation precision, because in reality it was a devaluation of the Zloty to the level of the then actual market rate (i.e. to the level of Zl. 9.500 for one US dollar) that was carried out on January 1st 1990. The synchronous introduction of a high nominal interest rate on bank deposits denominated in Zloty and of prohibitive - may be even excessively high and sometimes harmful - import taxes as well as the selling out of previously accumulated dollar assets by the pauperized population and of currencies kept on the above-mentioned ROD accounts by enterprises, where the factors which contributed to the maintenance of a stable and uniform exchange rate. On the one hand, they reduced the demand for dollars and, on the other hand, increased their supply.

In the early six months of the program implementation, the parallel (market) exchange rate only slightly deviated from the bank (official) exchange rate, the deviation not exceeding 3 percent (fig. 6). It was assumed a change in the official exchange rate would be necessary after the first quarter of 1990 only, but such a need did not appear. For the sake of price stabilization, the stand-by agreement with the IMF provided that in the case of an excessive exchange rate divergence an intervention through interest rate adjustment should be used first, but thus far no intervention has been necessary. The objective of stabilizing the exchange rate for a protracted period is to make this rate one of the nominal anchors, although in the case of ther Polish economy the importance of this factor is less than in developped market economies.

Also, the utmost psychological importance of a stable, uniform exchange rate is worth stressing. Since, for the great majority of the Polish population this is an entirely new situation. On the other hand, it is to be noted that the radical change in the market-to-official exchange rate ratio directly affects many households, as at least every fourth of them owns a foreign currency assets. In Poland the number alone of bank accounts denominated in hard currency is over 4 million. Their owners have been deprived of the premium resulting from the exchange rate difference

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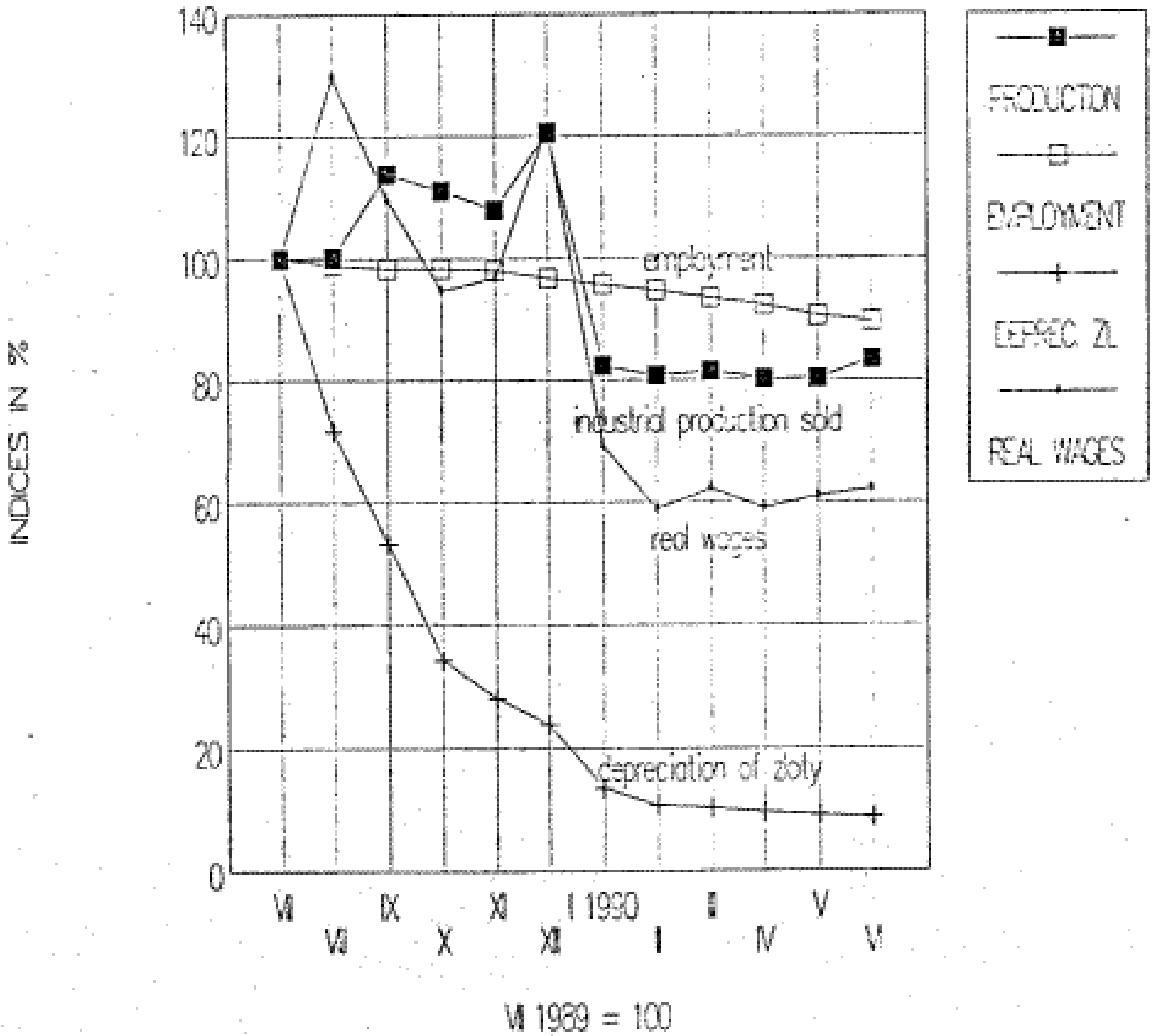
Figure 7

HYPERINFLATION AND RECESION



margin and, consequently, many have become poorer. Wealth accumulated in hard currencies has considerably shrunk. For the first time under the long-lasting Polish inflation dating from the latter half of the seventies and throughout the eighties, considerable economic losses were suffered by households fleeing from Zloty to US dollar.

What more, in the course of the program implementation we also have to do with a high inflation in the market served by convertible currencies. This augments the scale of inflationary processes in the economy as a whole, since an estimated 20 percent (in value terms) of all transactions are carried out in US dollars. Only in June the prices in so-called dollar shops have increased by additional 20-30 percent.

5. Evaluation attempt

It results from the above examination that the implementation of the economic program can hardly be favourably evaluated (see figure 7). In spite of the lapse of more than ten months with respect to systemic changes and seven months with respect to the implementation of the stabilization program, the condition of the economy is far from both social expectations and policy promises, the former being, by the way, to a large extent provoked by the latter. In particular, the following areas must be pointed out in which the program implementation has failed.

First, basic objectives of the systemic part of the economic program are being implemented with very great delay. In particular, the ownership transformation program has not yet been started and the chances of the so-called little privatization have been to a large extent diminished by the excessive reduction of incomes and money resources of the household sector. The excess liquidity of this sector of the economy was largely reduced in 1989 already; but its complete elimination could have been better achieved by the sale of different small assets than by the inflationary seizure of a considerable portion of the population's monetary balances (see fig.5). Moreover, because of erroneous solutions the chance has been missed to institutionalize public debt. It previously existed in the form of the so-called inflationary overhang which, in reality, was a certain, though "uncivilized", kind of internal public debt and constituted rather compulsory than voluntary savings of the households. The problem could have been partly solved through an internal exchange of surplus monetary balances of the population for shares in privatized enterprises. Such exactly was the purpose of issuing government bonds convertible into shares in privatized enterprises (bonds with privatization option or a sort of internal debt-for equity-swaps), but as a result of the lack of secondary market, uncertainty as to real possibilities of equity acquisition in the near future and the prospect of a lottery redemption of outstanding bonds after 1994 only, people did not show interest in these bonds in spite of their most advantageous interest rate in comparison with any other investments in the arising financial market[8].

Second, the stabilization policy missed the opportunities resulting from the decsending trend of both inflation forms which showed up in the fourth quarter of 1989. At that time, both open and represses inflations (see figure 3) were visibly slowing down (surplus liquidity of the enterprise and household sectors diminished and shortages were reduced).

Third, that fact was neglected that adjustments by economic agents (especially by production enterprises) would initially almost exclusively be of non-market nature i.e. the processes would be dominated, on the one hand, by the so-called cost-based pricing formula and, on the other hand, by a reduction in production volume because of the decline in real demand. In the face of such negative adjustment processes the objectives assumed by the government for the economic program as a whole, and the stabilization program in particular, simply could not be achieved. Above all, objectives such as 1 percent inflation rate to be achieved in June 1990, 5 percent fall in individual production, 3.1 percent decline in GDP and 1 percent in per-capita consumption with a 20 percent reduction in real wages, were from the very beginning considered to be illusory. In the light of facts it is only the latter indicator that can - and should - continue to be the goal of economic policy.

Fourth, the much higher than expected so-called corrective inflation in January and February, as well as its echo in April and May, resulted in much greater effects with respect to inflationary wealth and income redistibution (see figure 5) than originally assumed by the government, on the one hand, and than necessary from the point of view of the stabilization processes, on the other hand.

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[8] A million Zloty of the end of the last year represented at the end of the first quarter of 1990 the following nominal values (taking into account the exchange rate changes, nominal interest rates and premium in the case of bonds): 2.496 million if invested in bonds, 1.06 million in case of bank deposit in US dollars, and 1.277 million in case of three-month deposit at the National Savings Bank (PKO).

Fifth, the "side" effect of the stabilization measures in the shape of real processes, especially of an exceptionally deep recession, must be univocally negatively evaluated. The decline in industrial production by about 30 percent over the first half of 1990 would be a hardly acceptable cost even if the stabilization policy were successful. It proves all the more failed as the recession has been to a large extent unfruitful. This results from the fact that the production fall has not been accompanied by the elimination of the most inefficient enterprises nor by the desirable restructuring, but on the contrary, the recession has most severely affected the enterprises which supply the needs of household consumption. So, it is not that production which constitutes the heaviest burden on the budget, the balance of poyment and the economy as a whole which is being eliminated from the market, but in many cases production is being reduced in the maintenance of which we are interested (this mainly regards some branches of the food-processing and consumption goods industries, e.g. the textile industry)

Sixth, the primary objective of the stabilization policy i.e. the reduction of the inflation rate to 1 percent monthly till the middle of the year was not achieved because, under the existing structural and systemic conditions, it could not be achieved. Simply, this goal was to boldly set. In the initial debate phase, I defined such optimistic visions of inflation being curbed within a very short period as an expression of lack of imagination and responsibility[9], unless, in one of the succesive phases, refuge was to be taken to some freezing measures, the latter being however, as is well-known, inconsistent with the philosophy of the new systemic and political principles. Still worse, the price inflation has been stabilized at a level being the highest in Europe and much has to be done in order to make this stabilization as short as possible, since the mean montly inflation rate for the March - July 1990 period amounted to as much as about 6 percent, this being tantamount to a yearly inflation level of 100 percent. It is worth adding that in April and in July the inflation level was similar to that of the early half of 1989 (8.1 in April in comparison with 8.3 percent). But there is a difference consisting in the fact that, now, the industrial production is by 30 percent lower.

Seventh, these negative facts must be, however, perceived against a

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[9] On this subject see i.a. arguments set forth at the XVth Congress of the Polish Economic Society in Łódź in November 1989 (Kolodko 1989b) as well as in the debate with Jeffrey Sachs (Kolodko, Sachs 1989).

background of the favourable phenomenon that, as a result of the stabilization program and systemic transformations, shortages have been radically reduced, though not fully eliminated. And that in all the markets, because it regards as well the consumption goods market as the procurement goods and investment goods markets.

Eight, a very favourable effect from the point of view of the stabilization goal has been the maintenance of the fixed bank (official) dollar exchange rate over seven consecutive months, with the market exchange rate only slightly deviating from the official one (see fig.6). Although its impact on different economic activity spheres - especially on foreign trade, trade balance and transfer level - is different, there is no doubt that the exchange rate stabilization contributes to lower the inflationary expectations of economic agents and, hence, supports the process of stabilizing the whole social and economic system.

To sum up, the hitherto implementation of the economic program in Poland shows that within the alternative: "cold turkey" therapy (not to be confused with shock therapy) versus gradual approach, the choice should be the gradual approach. At the same time, I insist, and that since a long time, that the graduality does not exclude a shock blow at some sore points of the system structure and economic agents' behaviour. But it is not possible to solve - as proposed by some people - too many problems simultaneously or within a too short period. Anyhow, the life itself and the experience of the last few months irrefutably show that there is a need for a second push - being, may be, only one of many successive moves - towards stabilization and simultaneous transformation of the economy into a market one. But it is to be regretted that this conclusion has to be drawn a new at a high social cost the scale of which could have been much less.

6. Elements of the "second gear" of the stabilization

In the light of past experience and the resulting conclusions it is evident that the economy must "shift the gear" in which it is running, though by no means change the fundamental direction of the market-oriented institutional (systemic) structural and political transformation of the whole economy. The essence of this "second gear" must be an active interventionist state policy oriented towards supply-inducing structural transformations; since, other wise, if it does not resume its growth capability, the economy will stay in the condition of protracted depression without likelihood of permanent stabilization. We cannot continue to be steeped in illusion the problems of structural changes and economic recovery will be solved by the market itself. And that for two fundamental reasons. First, it has not yet been achieved by market being not supported by the state sound policy in the modern world anywhere, even in very developed and mature economies. Second, in Poland's case we still have to do with market mechanisms which are only just coming to life and must be (and sometimes - even contrary to official declarations - already is) supported by an enlightened state interventionism.

The particular difficulty of the stabilization policy in its "second gear" consists in the need to solve a sharp contradiction between recession and inflation. The trade-off: open (price) inflation versus repressed inflation (shortages) typical of the economy in the preceding period has now been - and this is an important achievement of the economic policy - replaced by the dilemma: how to stimulate economic growth while preventing depression (or even a further recession) without a repeated acceleration of price inflation (or reproduction of schortages)? Against the background of this question, I would like to formulate some proposals.

First, while running in "the second gear" of the strabilization policy and continuing the sustemic and structural changes intrinsically couples with this policy, one should not lay down any too far-reaching objectives with regard to the scale of inflation rate reduction.

It seems that curbing the inflation rate to about 2 percent monthly (i.e. 26.8 percent yearly) while keeping up the trend to form market-clearing (shortage-eliminating) prices is sufficient at this phase of inflation fighting. Because otherwise - e.g. if a goal of the order of 1 percent monthly is laid down, the policy must be much more restrictive, thus sustaining the recessionary trends in the real economy sphere and threatening it with further destruction[10].

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[10] Rudiger Dornbusch (1990) thinks that goals of the zero-inflation type for countries trying to extricate themselves from mega- or hyper-type inflation are unrealistic. Because they can just lead to such a deep recession that the latter will, in turn, become a pro-inflationary factor and destroy the whole stabilization effort. I would only like to add that, like in Poland, also in Yugoslavia unrealistic goals as to the expected inflation rate were adopted. In Yugoslavia, it was assumed to amount to 1 percent monthly on the average throughtout the year. In reality, it amounted in the consecutive months of the first quarter to 17, 8.4 and 2.6 percent respectively, but in second quartes it was brought down to zero (after the hyperinflationary index of 64 percent in December 1989). In Vietnam, the goal was more realistically set, namely as 2 percent monthly. And in Mexico which already finds itself at a much more advanced

Second, the economic recovery must be mainly induced by stimulating the investments, since only investments can contribute to structural changes of anti-inflationary character. Without new investments an economic growth trend can not be permanently sustained. Investments must be stimulated, among others, by a less restrictive fiscal policy, especially in combining it with ownership transformations.

Third, the monetary policy must, as to date, remain - because of its restrictivity - the main element of continued stabilization effort. But for an intermediate period, until a permanent stabilization is achieved, the interest rate on household deposits must be higher than that on loans, since that is the third phase in the above-described interest policy sequence. Only under such conditions - and not with a negative interest rate on a part of deposits (see figure 4) - a substantial increase in the households' propensity for savings can be expected without which a non-inflationary growth of effective investments will hardly be imaginable, the more so because foreign aid with this respect can be expected to a limited extend only. In my opinion, particularly important in this area is a perceptible positive real interest rate on short- and middle-term deposits. One of serious errors of the hitherto applied interest rate policy has been the defiance of three- and six-month deposits. *Under conditions of aggressive stabilization measures, three months and all the more so six months make a long period.* The refinancing credit rate must catch up with the interest rate on households' deposits not in the case of 12-month deposits only but with respect to three-month deposits already. Such measures will, of course, contribute to a relative reduction in the households' demand (without necessity to limit their real incomes) and, at the same time, to a *non-inflationary growth of the investment demand,* thus oriented towards a long-term production increase. It is later only that the fourth interest rate policy phase must be initiated during which both interest rates must be really positive, with credit prices exceeding the interest rate on deposits.

Fourth, owing to the increase in the households' propensity for savings it will be possible - in keeping up the restrictive fiscal and monetary policy - to unlock the anti-motivational wage limitations and eliminate the pathologies which sometimes result from these limitations, e.g. making impossible to employ in the private sector workers dismissed

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stabilization phase the inflation rate for 1990 has been set at 15.3 percent i.e., on the average, 1.2 percent monthly.

from the state sector. At present, the maintenance of wage rise limitations mainly leads to recession and further decline in the real wage level rather than to curbing of inflationary processes. The wage policy needs a radical flexibilization through its liberalization which should exert, if the conditions I have mentioned above are met, a supply-promoting influence.

Fifth, price liberalization must be gradually continued. The fundamental problem consists in the requirement the prices should rise as slowly as possible and, at the same time, be kept at a market-clearing level. Only next, the still existing subsidies should be eliminated; as long as the budget is equilibrated, subsidies will nor necessarily nourish inflation.

Sixth, the exchange rate policy must be made more flexible, too. I think that the high, still persistent inflation results, to a certain extent, from the fact that the fixed uniform exchange rate has been anchored in the US dollar. In view of the exchange rate risk, the structure of the Polish external trade and the balance of payment, I think it would be better - on occasion of a possibly indispensable exchange rate correction - to anchor the exchange rate in a currency basket (e.g. ECU) better reflecting our external trade relations. At the same time, this will to a lesser extent stimulate the import-induced cost inflation.

Seventh, one should constantly strive after creation of a competitive environment. Cordoning off the economy by restrictive import tariffs serves, in reality, opposite situations. Domestic producers often continue to avail themselves of the comfort of monopolistic positions not disturbed by competitive imports. Here, the most classical examples are our automotive and electronic durables industries. In this connection, a radical reduction, and in most cases even abolishment of import duties and a further liberalization of foreign trade seems to be justified, since it is under such conditions only that positive effects of the supply-inducing outwardly open policy will be attainable. The fear of a cumulated foreign currency flow out of the country which could presumably lead to a failure of the nominal anchor represented by the fixed exchange rate seems exaggerated. This view is based on assumption that, under conditions of a greater extrernal trade liberalization, it is the foreign currency *turnover* and not necessarily the foreign currency outflow that will be accelerated. The resultant of all adjustment processes which could be set in motion should, in this case, be advantageous to building-up nominal foreign currency balances, especially those of the household sector. This is also corroborated by the experience of many other countries which have taken measures to stabilize and reduce the scale of currency substitution (Pinto 1990).

So, in the light of the ensemble of the above considerations, it can be well seen which indispensable systemic, political and structural measures should jointly form what I call the "second gear" of stabilization. In my opinion, the economic situation is sufficiently complicated - and *destabilized* - to justify concentrated anti-inflationary and equilibrating measures to be taken just now. The fact of the matter is that economic processes are, by their very nature, continuous and this can not be changed by even most radical approach of the "now-or-never" or "everything-or-nothing" type. The point is that it is certainly now, but surely not everything. Since, the present stabilization policy is, on the one hand, a continuation of measures having been already earlier taken and, on the other hand, an initiation of processes we will have to struggle with in future.

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