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## Editors note

This Working-Paper consists of reprints of two papers by Grzegorz W. Kolodko.

The first one: *From Market Reforms to Transition to a Market Economy. The Case of Poland* was presented to the international conference on: *Rethinking of Gradualism: What China Can Learn from Early Reforms in Other Countries*, National Economic Research Institute, China Reform Foundation, Beijing, 21-22 August, 1997.

The second one *Exchange Rate Liberalization Policy and Growth in Transition Economies* was presented to the Policy Seminar on Financial Sector Development and Reform at Tashkent on December 4-6, 1997.

# I. FROM MARKET REFORMS TO TRANSITION TO A MARKET ECONOMY. THE CASE OF POLAND

## 1. Lessons from historical experience

The notion of "reforms" had been used for several occasions in the centrally planned economies in the course of their history. The common denominator of these reforms, whatever their features and characteristics have been, was an effort to sustain the system by its improvement through growing efficiency and better standard of living of the population. And always the reforms carried forward in the late 50's, and then in late 60's, and early 70's had delivered some improvement of economic performance, but it has not lasted for a longer period of time. The positive results of the systemic changes introduced under the subsequent reform attempts had been evaporating as the time was passing by. Ultimately, the next drive towards "new", or "just" reforms had been taken. It has happened so, because the reforms in each particular case were not able to solve the crucial problem, namely to secure the ability for fast, sustainable economic growth. After some initial improvement of the overall economic situation, the economy was slowing down its pace of growth and had been driven into another deterioration of economic equilibrium (Kolodko, 1986b). Again and again the shortage re–appeared and the repressed inflationary pressure re–emerged, with all accompanying inefficiencies. *The bigger was the disequilibrium the slower was the long–run rate of growth and the bigger were the shortages, the wider was the fluctuation of the rate of growth.* And this has been, although to different extent, the case of all socialist centrally planned economies of East Central Europe since 1950 until the end of the eighties (see Table 1).

Table 1

**Economic Growth Cycles in Centrally Planned Economies: 1950–88**

| Country | Periods<br>NMP growth rates (in percent) | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Bulgaria | ... | 1953–56 | 1957–59 | 1960–63 | 1964–67 | 1968–71 | 1972–75 | 1976–80 | 1981–85 | 1986–88 |
| | | 6.5 | 14.0 | 6.0 | 9.1 | 7.4 | 8.3 | 6.4 | 3.5 | 5.2 |
| | | − + | − + | − + | − − | + | | | | |
| Czecho-Slovakia | 1950–52 | 1953–56 | 1957–61 | 1962–65 | 1966–69 | 1970–75 | 1976–78 | 1979–84 | 1985–88 | |
| | 10.0 | 6.5 | 7.4 | 0.8 | 7.2 | 5.3 | 4.7 | 1.8 | 2.4 | |
| | | − + | − + | − − | − | + | | | | |
| GDR | 1950–52 | 1953–56 | 1957–59 | 1960–63 | 1964–69 | 1970–75 | 1976–86 | 1987–88 | | |
| | 18.0 | 6.7 | 8.7 | 2.2 | 5.0 | 5.7 | 4.4 | 3.3 | | |
| | | − + | − + | + | − − | | | | | |
| Hungary | 1951–53 | 1954–56 | 1957–60 | 1961–65 | 1966–69 | 1970–74 | 1975–78 | 1979–85 | 1986–88 | |
| | 9.3 | 2.0 | 11.0 | 5.4 | 7.2 | 6.2 | 5.0 | 0.9 | 1.6 | |
| | | − + | − + | − − | − + | | | | | |
| Poland | 1950–53 | 1954–57 | 1958–63 | 1964–68 | 1969–70 | 1971–75 | 1976–78 | 1979–82 | 1983–85 | 1986–88 |
| | 9.8 | 9.1 | 5.4 | 7.1 | 3.7 | 9.8 | 4.9 | −6.5 | 4.9 | 3.9 |
| | | − − | + | − + | − − | + | − | | | |
| Romania | 1951–53 | 1954–56 | 1957–59 | 1960–62 | 1963–66 | 1967–70 | 1971–76 | 1977–79 | 1980–84 | 1985–88 |
| | 17.0 | 5.0 | 10.6 | 7.6 | 10.5 | 7.0 | 11.5 | 7.7 | 4.0 | 5.4 |
| | | − + | − + | − + | − − | + | | | | |
| Soviet Union | 1950–51 | 1952–53 | 1954–56 | 1957–63 | 1964–68 | 1969–73 | 1974–78 | 1979–88 | | |
| | 16.0 | 8.2 | 11.6 | 6.0 | 8.2 | 6.5 | 5.0 | 3.3 | | |
| | | − + | − + | − − | − | | | | | |

NMP – Net Material Product, ... – data not available, "+" – acceleration, "–" – slowdown

*Source:* Statistical Yearbook, Central Statistical Office, Warsaw (different years), and author's estimates

In the case of Poland, which has happened to be a specific laboratory for the reforms of the socialist centrally planned economy and its ultimate failure, the general sequence of changes followed similar path, although there had been much more sound efforts to reform the traditional, Soviet–type socialist system than elsewhere. After the reform of late 50's, when there was an attempt to de–centralize the management of the state companies and exercise at a wider scale the workers' self–management, the reform of late 60's took place. However, it was inconsistent, lacking complexity and not supported enough by the political leadership to be carried forward in a successful way. Hence, after another serious economic and political crisis of 1970, the firm effort to reform the system was undertaken in the course of 70's. This time there had been a commitment to create a sort of socialist concerns and conglomerates to make the economy more competitive on the international scale and, first off all, to open it up for wider contacts and links with the world economy.

Contrary to the expectations, after some years of remarkable improvement (1971–74) *the economy had been driven again into big disequilibria and, what has been the beginning of the end, into unmanageable foreign debt.* The openness of the economy, which supposed to be a mean of its upgrading, owing to wrong policies had turned to cause growing burden of debt, which has started to strangle the whole economy. Ultimately, it has caused another severe economic crisis, which has brought the system close to collapse. As the aftermath of it, the reforms of the eighties had been launched, but the task this time was even more paramount than any time earlier, due the distorted economic relations not only domestically, but on the external side of the economy as well.

Despite all the merits, *the market oriented reforms did contribute – unfortunately, only to the degree and only for a short time – to higher rate of growth and growing competitiveness of the economy.* The new institutional arrangements, which were brought during the subsequent reforms, had make the economic entities, especially the state enterprises, a little bit more flexible and more able to respond positively to the market signals. On the other hand, the evident lack of other, crucial for sound economic development organizations and institutions, did cause repeatedly

various contradictions and tensions. And the logic of these processes had been such, *that the economic tensions had been transmitted – although with some time lag, but unavoidably – into the field of social and, ultimately, political relations.*

Hence, the pre–transition economic reforms implemented in the eighties in Poland – as well as in the other socialist countries – are hardly the first of such efforts. Actually, they have a long history[1]. First attempts at reforming socialist economies had been made back in 1956–1958. It was a reaction to the compromised, utterly bureaucratized, Stalinist system. Originally, this system had caused a number of changes in the economy. Among other things, it brought essential transformations in economic structure. In Poland this was expressed mostly in the rapid industrialization and the creation of the foundation for further industrial development, especially of heavy industries. The economic structure thus created and the mechanisms of economic operation, however, were increasingly inert and inflexible. They also failed to keep abreast with quickly rising and changing social aspirations. The need for far–reaching changes was becoming increasingly pressing. Efforts made in that period failed, because the leadership lacked the determination required to consistently carry out the reforms. At the same time, *the structures and institutions, which supposed to be changed mostly, were proving increasingly resistant.* Both, the system and social structure, which went along with it, proved exceedingly viable and adept at self–perpetuation. Several years went by, the reforms had been abandoned and not surprisingly they did collapse.

Later, Hungary tried to draw some conclusions from earlier Polish failures. In turn, this very country is frequently cited as an example for the Polish reform of the eighties. So, the process of learning by doing, including the conclusion drawn from the own ones as well as from the mistakes of somebody else, had taken place. Similarly as in Poland, in Hungary the firm drive towards market–oriented reforms had contributed to relatively better economic performance than elsewhere. It has to be

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[1] More on this issue see - among others - Wilczyński (1972), Wiles (1977), Zieliński (1978), Nove (1981), Kornai (1986), Brus (1988) and Poznański (1996).

stressed that the early reforms of the centrally planned regime have significantly contributed to the late transition to a market system. *The more the socialist economy had been reformed in the course of seventies and eighties, the easier the transition from the pervious system to the new one, following in the nineties, does go.*

## 2. Prerequisites for a successful reform

The history of the economic reforms, their results and failures in Poland and other socialist countries show that at least *four conditions must be simultaneously satisfied for any reform to succeed.* First, society must be willing to carry out the reform and to bear the inherent costs. Second, firm commitment and determination of the political authorities are necessary. Third, knowledge is required to provide a theoretical foundation of the new system, which is to be put in place. Lastly, reform needs resources, to facilitate the necessary changes by the opportunity to reach to the them at the time, when the "old" is no longer there and the "new" is not yet in place. One can hardly find until the end of the eighties an example satisfying all these conditions simultaneously.

As for the knowledge, it looks different from today's perspective, but in due time the knowledge in these matters was no doubt still limited. It expanded usually at the pace of an arithmetic series, while problems the economists and politicians had faced did soar in a geometric progression. Although *it has been known more and more about how to reform the economy*, the target system had never been clear enough and always the "unexpected" influenced the course of the changes rather in a negative than the positive manner, making them even more difficult to carry forward.

What concerns *the social support for the reforms* – sometimes quite difficult, if not thorny for the societies involved – the situation had varied, depend of the social strata interests and particular period of the implementation of the reforms. On the whole, while in the eighties the population of Poland display much interest and support for economic reform (although not as much as earlier, especially in 1956–58 and 1971–74), it also demonstrated a rising reluctance to bear the inevitable costs

of systemic and structural changes. This syndrome reflected in paying lip service to reforms, while passively (or sometimes actively) counteracting them when it came to concrete action entailing costs, resembles the situation when they want to have their cake and to eat it. In the eighties the public opinion polls had provided corroborating evidence supporting this observation, especially with the regard to price and income policies. Population regularly declared that they favour price levels and relations to be based upon market categories (so to say, they accepted an idea of bringing them to the market clearing level), but they did raise quite strong protests, the severe series of strikes notwithstanding, when the authorities raised the prices, or – because of the very deep sense of the reforms – allowed them the be fixed (of course, at the higher than previously level) by the very market.

The answer to the question on the *leadership's determination in the implementation of systemic reforms* is more complex. The leadership had not been always homogenous one, whatever was the impression of the outsiders, and the power elites reflected – although they did not express it openly in public – the same, or similar contradictions, which were present within different groups of the society. Of course, the approach of the authorities toward the reforms has not been the same all the time. But in the eighties – and it occurred to quite a degree due to the lessons learned from the historical experience – the Polish leadership, like never before, wished really to go ahead with market reforms. This determination was a function of many factors, but the most important one was the indeed deep conviction, that there can be no further efficient performance of the economy without a major overhaul. If the authorities sound commitment to the reforms is backed by the social support for them, the things are much easier to be implemented than otherwise.

So, *for the reforms to succeed it is necessary to create a proper compatibility between the authorities and society's interests in its implementation*, to establish a firm coalition working in favour of these changes. Such a compatibility can be a very strong factor stimulating reform process. In the Polish developments of the eighties it was not the case and it had happen rather for the political reasons, than purely

due to the economic ones. What's more, because of the political struggle, which had taken place, especially after the imposition of martial law at the end of 1981, the opposition followed destructive from an economic viewpoint approach "the worse, the better". It supposed to mean that the deterioration of the economic and social situation was contributing to growing chance of the political overhaul, along the line of the expectations of the political opposition. As the specific by–effect of such a bizarre political struggle, the economic situation indeed had started – after some improvement in 1983–85 – to deteriorate again, what was "better", according to this sort of logic. Despite some attempt to change the political institutions and practices did take place, the lack of adequate, deep political reforms, accompanying great efforts of the authorities to turnaround the economy, mitigated the ability of the leadership to enforce the necessary structural and institutional changes.

Coming to the fourth factor, which offers a chance – as we can at most speak of a chance – for a successful reform, that is *financial and material resources*, Poland has not been the best off. What has made the situation still more difficult to manage, that was the country heavy foreign debt, which had been a major burden imposed upon the economy during the reform efforts of the seventies and the eighties (Table 2). This debt very seriously limited the margin of freedom and scope of manoeuvre required for the successful implementation of the reforms. As the years had been passing by, *the narrower the field for manoeuvre was, the increasingly futile was the chance for the reforms to succeed.* The problem is that the most favourable conditions for the reforms are at the period, when the economy is in a good condition and is able to provide the resources to cover the costs of adjustment, but at this very time there is hardly a sound conviction that the reforms have to be executed at all. The question had been always raised under such circumstances: if the economic performance is a good one, why to change it?

Table 2

**Growth of Polish Foreign Debt in Convertible Currencies: 1971–1988**

in billion $

| Year | Gross Foreign Debt (year end) |
|---|---|
| 1971 | 1.3 |
| 1972 | 1.7 |
| 1973 | 3.1 |
| 1974 | 5.3 |
| 1975 | 8.4 |
| 1976 | 12.1 |
| 1977 | 15.4 |
| 1978 | 18.5 |
| 1979 | 21.9 |
| 1980 | 25.0 |
| 1981 | 25.5 |
| 1982 | 25.2 |
| 1983 | 26.4 |
| 1984 | 26.8 |
| 1985 | 29.3 |
| 1986 | 33.5 |
| 1987 | 39.2 |
| 1988 | 40.1 |

*Source:* Rocznik (1988).

## 3. Central planning and market

Economic reform concepts in Poland in the eighties had been based on a far broader introduction of market relations into the economy than considered ever before. Contrary to many past approaches, typical for the stage of command socialism, tied with bureaucratic centrally planning, the conscious did come that *over centralized management cannot cope with the optimal allocation of capital and labour.* This inability led to an ever greater complication of economic, commercial, financial, technological and other relations, and eventually to a relatively lower economic performance and labour productivity. The centralized management system of so–called "real socialism" was thus unable to cope with the allocation of limited material and human resources. In Poland, this system was generally referred to as directive–type, or more precisely, directively–distributory management, which was to emphasize the role of the central, bureaucratic rationing of scarce means of production. Hence, economic reform in Poland aimed at comprehensive introduction of market categories into the institutional set–up.

The role of money, prices, credit, interest rate, exchange rate and suchlike had been gradually, although significantly enhanced. The conviction that it was necessary to call upon these market categories had been derived from several premises. First, *the market was supposed to bring discipline into economic processes through putting a curb on the excessive expansion drive*, typical for the bureaucratized central management. This drive used to lead to over investment, with all the adverse consequences for economic performance, especially the growing imbalances and disequilibria. The earlier exercised passive role of money and market meant that their meaning had been only secondary to physical processes. The biggest units in any factory always had been the planning (in physical terms) and the procurement divisions and the smallest one was the marketing department. There was not at all problem to sell and always there was the great problem to purchase. So, the economic reforms were designed to inverse these relationships, that is to subordinate material processes to monetary processes, which should facilitate the balancing of the input and output in the economy and, therefore, through increasing competitiveness and equilibrium contribute to better efficiency and productivity.

Second, market categories and – most of all – resultant *dear money policies as well as hard budget constraints were intended to create the systemic premises enforcing necessary economic constraints vis–a–vis both, the firms as well as the households.* Before, only the households knew the hard budget constraints, while all attempts of applying them to state firms did fail, precisely because of too passive role of the market and money. *And this is the biggest of all failures of the socialist economies, including the reformed ones.* The points were, therefore, to enable the market competition through the ability of economic agents to make for them the free choice possible, but – by the same time – based upon the hard budget constraints, without any guarantee of the state subsidies in the case of loose.

And third, *the market is a mechanism whereby the output structure (in the short term) and the investment structure (in the long term) adapt themselves to social needs and demand.* Excluding certain strategic and infrastructure investment projects decided by the central government, central planning – despite major advances in planning methods and computing techniques – had been and remains unable to initiate processes balancing the volume and structure of supply and demand. This failure was especially visible with the regard to consumer goods market and social services provided by the public sector, with severe negative influence upon the social situation and support – or a lack of such a support, to be more precise – for economic reforms. Hence, the role of a market and its mechanism became the fundamental problem facing the theory and practice of systemic reforms under socialism. It was hardly a coincidence that the course of discussions on this subject was similar in all countries, which had experimented with the reforms and initiated them, sooner or later.

In discussing market–oriented systemic reforms one should remember that *socialism was originally conceived as an anti–thesis, a negation as if it were, of the capitalist economy based on the market forces.* The "satisfaction of social needs" has been contradicted with the drive towards profits maximization; the planned coordination and "socialist co–operation" were to replaced the tough market competition; the administered price setting was to substitute the market clearing mechanism;

the bureaucratic allocation of the means of production was to swapped the spontaneous one conducted by supply and demand interactions; and – first of all – the state and co–operative ownership was to take over the private property rights. But the reforms were not targeted on simple reversal of this early and naive approach, but they were, in a sense, the effort to escape forward, a sort of negation of the negation. In another words, first the capitalism had been rejected and almost everything was going to be different one. Later, in turn, these very "different one" institutional arrangements and economic events had been challenged by the introduction of the elements of the market. And these were only of the elements of it, but definitely not the entire new (indeed new, not the old, previous one, since capitalism has changed in the meantime tremendously) institutional set–up.

*The reform driven attempts, including the ones carried forward in the eighties, were made to implant elements of the market economy into the socialist system, but certainly not to replace the latter with the market economy.* Everything what was going to be changed, was only to the extent, which supposed to perfect the new system, but whatsoever not to allow for the return of the old one. So, at that time – as it is still the case in China or Vietnam – the natural question had come. what are the limits to the market mechanisms and relations in reformed socialist economy? There have been conflicting views on this matter. In defining the extreme attitudes with this regard, Kornai (1986) referred to the ides of nearly complete introduction of market relations as the "socialist Friedmanism" and coined the term "Galbraith's socialism" for those advocating the active role of the state in economic processes to be maintained. While Kornai's observations made then were drawing mainly on the Hungarian experiences, they were not relevant for Poland and, I believe, also they were not true for other centrally planned economies, which were not engaged that much in a systemic reforms, as it was the case of Hungary and Poland.

The Polish debates of the eighties concerning these matters reveal an interesting evolution of the views. What makes it all the more interesting is the fact that *the evolution of theoretical views had been followed, with a certain, natural time lag, by the significant alterations in politicians' opinions and, eventually, in the policies of systemic and*

*institutional changes.* Initially, reform was to consist mostly in a narrower application of certain market elements. Then it was decided that the scope of market influence was to be extended, both about what we may call its scope and depth. This is how it came to the discussions about the overriding role of central strategic planning and a still auxiliary and corrective role of the market. Then came the further enhancement of the role played by the market. This was clearest – both, in theory and in certain practical solutions – in a further expansion of the reach of market categories: from the consumer market alone (this was to be reflected, among other things, in the relaxation of price controls by the state) to the means of production. In the next stage there was already more talk about the creation of money market and capital market and about a necessity to launch a sound labour market. It could be also heard that the range and power of the market mechanisms were to be still deeper, stronger and farther going, but still within the unpassable limits of socialism.

Hence, the market and accompanying it institutional arrangements were no longer discussed as a secondary, of a corrective nature only, to the paramount central planning instruments, but as an "equal partner" of the very central plan. *Economic processes were to be no longer guided exclusively by the visible hand of the central planner, but also, and step by step to an increasing degree, by the invisible hand of the market.* By the end of the eighties one could already anticipate that the next stage will inverse the stress and will put the emphasis on the examination of the essence and features of the market (first) and planned (second) model.

So, the entirely new quality change was closer and closer and the reformed socialist economies were thus approaching the stage of a complete reversal of the fundamental ideological and political options. Until that time, the market was supposed to correct – and only to some extent – the shortcomings and inconsistencies of a central planning. Under the new approach, emerging as an aftermath of both, the successes and the failures of the reforms, the central planning had been left only to correct the negative impact of powerful market influences. The driving force of economic growth has been shifted from plan, which was dying, to the market, which was only emerging. *The socialism ceased to*

*developed as the anti–thesis of capitalism and it started to evolve more and more by incorporating the institutional arrangements and behavioural aspects of a market economy.* It can be claimed that in the late eighties Poland was in a transition period from the model of planned and market–type socialism to the model of market–type and planned economy. Interestingly, the organizations and institutional arrangements have followed this path of developments. Already at the beginning of 1989 the mighty Planning Commission had been abandoned and replaced by more market compatible Central Planning Agency, based rather on the Japanese or French experiences with the indicative planning, than the early Soviet–type directive planning[2]. The logic of this historical process appeared to be quite clear. Similar observations could be made at that time with the respect to Hungary, Yugoslavia and, to the extent, to China[3].

Only such a broader context affords the comprehension of the processes connected with the organization of e.g. the capital market, calls for a true labour market (that is including unemployment), or the attempts to commercialize banking system. Thus, for example, only when the conviction about the indispensability of the capital market matured, banking reform was initiated. This reform would have no sense under the traditional arrangements, as it could not have produced any desirable effects. It was precisely under such circumstances that a network of commercial banks had been set up in Poland in 1987–1989[4]. In turn, the *commercialization of the banking system was an institutional and systemic measure designed to promote further marketization of economic*

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[2] It is worth to stress that only as late as in 1996 (when the author was as the First Deputy Premier and Minister of Finance of Poland in charge of economic policy) this quasi-ministry, within the implementation of the reform of the central administration, has been dismantled and replaced by the National Strategic Studies Centre, rather a think tank without any administrative prerogatives, than a bureaucratic body.

[3] On the economic reforms in the 1980s in China see - for instance - Ellman (1986), Feuchtwang and Hussain (1983), Fan (1997), Harding and Hewett (1988), Kosta (1987), Perkins (1988), Quaisser (1987) and Zhang (1989).

[4] On the structural reforms and institutional arrangements in the eighties in Poland see Kolodko (1989).

*relations*, especially capital allocation, the balancing of supply and demand. It also had aimed at the enhancement of economic performance in production and investment through the imposition of hard budget constraints upon the state and co–operative companies.

The creation of a *two–tier banking system*, however, had a deeper sense. It was, in fact, an *institutional confirmation of the increasing role of money and market relations in the socialist economy*, more and more led by the market forces than by the central planning allocation. It was possible only within such a banking system that money could play a more active role and influence the processes of production, trade and distribution. This background was also necessary for carrying out active monetary policies that, as mentioned before, had been previously subordinated to planning in physical units. This evolution in the approach of the management of economic processes in Poland was reflected in the transition from separated input–output planning in physical units and financial planning to an integrated system of material and financial planning, which had been expected to be introduced since 1989. The integrated material and financial plan were aiming at an acceleration of the transition from directive–type planning to the model of market–related planning. Radical systemic changes, as well as the changes in economic policies provided for in the programme for the implementation of so–called second stage of economic reform (Programme 1988), were the natural steps capable of bringing changes in this status quo.

The nation–wide referendum, which preceded the adoption of this programme, reflected the second fundamental feature of the systemic reform in Poland: the democratization of political relations. It was already generally accepted – in research papers, press statements and official party documents – that the *democratization of economic relations, expressed primarily in the introduction of market forces and mechanisms, is not possible without sound democratization in the broader, political sense.* Despite democracy is a value itself, it was obvious that it is also an essential mean of resistance against the particular interests of a number of lobbies, which otherwise were acting rather in an informal way. And it is well known that the market does not yield to the pressures of various groups of interests as the central command planning did.

Moreover, there is a great deal of evidence supporting one's claim that there had been some sort of inconsistency between the determination to enforce the market rules and liberalize – and once more only to the degree – the economic policies and the commitment to support these changes through appropriate political liberalization. So, *the first main cause of the failure of market reforms in Poland was the inconsistency and lack of complexity of executed reforms.* Lack of comprehensive approach and dearth of sound commitment to get entirely rid of the bureaucratic planning, did weaken the economic system instead of enforcing it, as it had been expected. The old did not actually work anymore, but the new one was too long in statu nascendi to overhaul mounting imbalances, inefficiencies and overall economic and social hardship. So, in a sense, the fruits of the reforms died before they were really born.

The so–called second stage of economic reform, implemented since 1986 after the defeat of an attempt to slow down the whole reform process, constituted a continuation of developments started in the years 1981–82 and it was de facto admission that many earlier attempted measures had failed to bring the anticipated breakthrough in overall economic performance in Poland. How, therefore, can one evaluate the effects achieved by this reforms of the economic system in Poland and what were the principal barriers to its implementation? It is indeed a truth, that the farthest reaching changes were implemented vis–a–vis institutional set–up. The system of the economy by the end of previous decade had differed significantly from the one that had led to the deep crisis in the late seventies. *By the late eighties economic system in Poland was dominated by indirect, indicative planning, making widespread use of numerous market categories and monetary policy instruments*[5]. Unfortunately, despite the whole reform efforts and despite the qualitative difference between the earlier and the later systems, it hardly happened that the economy was freed of her previous crisis–prone nature.

One might say that the *system established in the eighties was a hybrid* and thus not always a comprehensible one. This system combines

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[5] More on these features see Poznański (1996) and Kolodko and Nuti (1997).

the relics of the old arrangements with the elements of the new one. It interweaves the components of central, bureaucratic rationing of scarce means with market allocation methods. Solutions typical of wartime economy criss–crossed with market mechanisms. One may therefore advance that heterogeneity and the incoherence of certain solutions, brought into the economy by the introduction of the reform, were amongst the fundamental features of the performance of the economic system. Obviously, this had an adverse impact on the real processes and renders possible many ill–conceived actions in economic policy, especially regarding economic stabilization and vis–a–vis the curbing of inflation.

The low starting point in 1982, due to recession of 1979–1982, was not in itself a satisfactory explanation of the still low degree of social satisfaction resulting from the fruits of economic reforms implemented during the eighties. Thus, the answer must be sought elsewhere. It would appear that two sets of psychological factors were essential with this regard. First, there is a big periodically growing (which makes things still worse) gap between social aspirations and the degree of their satisfaction. The point is that the population feels that economic situation is deteriorating, whenever the gap between consumer expectations and the real consumption expands, even if the absolute level of consumption had statistically increased. This situation, which I elsewhere (Kolodko 1987) called the paradox of the lower degree of satisfaction of the needs at a higher consumption level, could be diagnosed in Poland between 1983 and 1988, despite an absolute growth in the real income of households sectors as well as in their consumption standard, the growth of GDP notwithstanding (see Table 3).

This was reflected in a situation where the population claimed that they are "worse and worse off", while the leadership made futile attempts at convincing the society that "things are on the mend". And this is the second fundamental cause of the failure of market reforms under socialism. The growing gap between the expectations and economic ability to meet them drives out the remaining support for the reforms, so they have to collapse, together with the old system.

Table 3

**Economic Growth in Poland: 1983–1988**

(in %)

| | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 |
|---|---|---|---|---|---|---|
| Net National Income | 6.0 | 5.6 | 3.4 | 4.9 | 1.7 | 3.8 |
| National Income Distributed | 5.6 | 5.0 | 3.8 | 5.0 | 1.6 | 3.3 |
| Investment | 9.5 | 12.3 | 4.9 | 5.9 | 5.1 | 4.1 |
| Consumption | 5.8 | 4.4 | 2.9 | 4.8 | 2.9 | 2.9 |
| Industrial Output | 6.0 | 5.6 | 4.1 | 4.4 | 3.5 | 4.0 |
| Export | 10.3 | 9.5 | 1.3 | 4.9 | 4.8 | 5.5 |
| Import | 5.5 | 8.6 | 7.9 | 4.9 | 4.5 | 4.0 |

*Source:* Rocznik (1988a).

## 4. Inflationary constraints

The declining support for market reform in Poland had been strongly linked with accompanying it inflationary pressure. The inflation was expressed in her both forms typical for centrally planned economies in periods of market oriented reforms, that is open (price) inflation and repressed inflation[6]. Facing high inflation, the population tends to evaluate their economic situation in the light of the real purchasing power of their nominal income, rather than by the indicators that illustrate actual rate of economic growth. Inflation invariably entails depreciation and in a country like Poland in the course of the eighties, with a weak and inconvertible currency, also far–reaching devaluation. (Table 4).

[6] The term "repressed" inflation (to distinguish it from "open" inflation) applies to inflation reflected in persisting shortages, various rationing schemes, forced substitution and parallel, unofficial markets, contrary to the price rise, typical for the open inflation. Emphasis is laid on the consequences of this process, as it results in involuntary savings of the households, due to the shortages of consumer goods, and not necessarily in the growth of the price level. Portes (1981), (1984), Kolodko (1986a) and Nuti (1989).

Table 4

**Inflation, Depreciation and Devaluation of Polish Zloty 1981–88**

in %

| | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 |
|---|---|---|---|---|---|---|---|---|
| Inflation (CPI) | 24.4 | 101.5 | 23.0 | 15.0 | 15.1 | 17.7 | 25.7 | 60.0 |
| Depreciation | 17.5 | 51.1 | 17.6 | 12.9 | 13.1 | 15.0 | 20.5 | 37.5 |
| Devaluation | 23.7 | 55.0 | 13.8 | 28.3 | 17.2 | 33.6 | 59.7 | 61.6 |

*Source:* National statistics and author's own calculations.

Given these strong inflationary processes, there was a little wonder that the population had a sceptical, or even clearly negative attitude towards economic reforms and other complementary stabilization measures. *Inflation had become one of the most painful barriers, effectively obstructing the introduction of new systemic solutions provided for by the economic reforms.* Initially, the process of the opening of inflation (being an unavoidable one in the economy with severe shortages, when the price liberalization had taken place) was one of the major conditions facilitating the implementation of economic reforms. The object was to balance the market by enforcing the market clearing prices. It was of a vital importance to eliminate acute shortages, and not only in the consumer market.

Given, however, the strong inflationary influence of structural and systemic factors, it took on a lasting character. Eventually, certain newly introduced elements of the new economic and financial mechanisms also proved inflationary. Hence, *the process of opening inflation, which was one of the premises required for the implementation of economic reform, became a fundamental barrier and probably the most difficult to overcome.* This statement is all the more important, because of the whole complex of new systemic solutions has been conceived for a balanced economy, since it is only in a balanced environment that the market mechanism can operate efficiently. What is more, a two–digit inflation[7]

[7] Its rate in Poland in the years 1981-1988 was 35% on the average. See also Table 3 on the resulting depreciation of the currency.

effectively can kill all economic and financial incentives and one can hardly expect the reforms to succeed under such the circumstances.

So, the persisting, or even growing periodically disequilibria were the fundamental obstacles in the broader application of the "triple S" formula associated with the Polish economic reforms of the eighties. So–called triple S stood for self–management, self–dependence and self–financing of the state companies. However, despite these commitments and aims of the institutional changes, *the burden of the structure of the real economy did cause continuously strong pressure for the government to transfer the resources form more efficient enterprises to the less profitable ones*. Therefore, the economic performance still featured a high share of grants and subsidies for unprofitable production as well as a strong dose of fiscalism, expressed in relatively heavy taxation of the enterprises. One must note here that taxes imposed on the households had played at that time no major role[8].

During the eighties, despite the reform drive, there still was a fair proportion *of unprofitable products, which imposed a big burden on the state budget.* The budget for many years had been running deficits (although a limited one, especially if compared with the deficits of the later period of transition in early nineties), due to taxes being insufficient to balance growing budgetary expenditures. Budget deficit, an important contributor to the demand induced inflation, had been running at 3% to 5% of the overall state expenditures (Kolodko, 1992). However, given that there were no government bonds and the public debt was not managed on the market foundation, this gap was automatically filled by the central bank credits provided to the government.

Of course, *this clearly inflationary policy was not able to solve the problem of financing the government outlays on the long–run.* As an outcome, the permanently faster growing aggregated demand than aggregated supply did cause still more severe inflationary pressures. Together with the reform driven effort to liberalize the prices (at least

[8] Except indirect taxes included in the retail prices of several consumer goods in the form of the turnover tax. The VAT has been introduced only in 1993, already during the transition to a market economy (see Kolodko, Nuti, 1997).

to the degree), it had brought higher and higher price (open) inflation. This very *acceleration of inflation had contributed tremendously to the process of evaporation of the political support for the reforms.* Even under the circumstances of relatively (in international standards) high rate of growth and despite the increasing consumption of the households, the population did not appreciate the changes being introduced and has started to turn against this course of the reforms.

Poland's stabilization policy, especially regarding the reform of prices, involved sharp contradictions. On the one hand, it was necessary to further liberalize the rules of price setting. But, on the other hand, it accelerated the rate of open price–wage inflation. After three years lasting period of falling down inflation (from over 100% in 1982 to about 15% in 1985) the CPI rose again to over 60% by 1988 and up to 160% in the first semester of 1989. Pricing policies are very politically sensitive issue under any circumstances, especially, however, when the open inflation is accompanied by the repressed one. This was precisely the Polish case of the eighties, what – using the language of the housewives – had led to the *nightmare of the situation, where everything was getting increasingly expensive and nothing was there to be bought without queuing, or special rationing coupons.* The parallel existence of the open and repressed inflation is known as so–called shortageflation (Kolodko and McMahon 1997). *The shortageflation syndrome eroded the efficiency of the centrally planned economy to the limits and caused the ultimate lack of its ability to compete at the world markets and to expand. And this is the third key factor behind the collapse of the socialist system – as well as the failure of the whole series of efforts to reform it – in Poland and elsewhere.*

Against such a background, the attempts made for the sake of adjusting the price structure towards the structure of long–run costs and market demand, had failed to yield the desired effects. *The price structure still differed considerably from the structure of social production costs* and thus it could not properly inform producers and consumers about the real scarcity of particular goods and services. This also prevented a part of the input from being allocated according to the allocative efficiency requirements.

A specific feature of the socialist centrally planned economies, including the Polish price system still dominating during the period of reforms of the eighties, was the *relatively low level of prices of subsistence goods and services as food, some types of clothing, housing rents, public transport, medical services, etc. Attempts to increase these prices in order to cut back the subsidies (which contributed to the growing income redistribution through the state budget) run into strong social opposition, including strikes, and entailed almost automatic compensation for any increase in the cost of living due to this price rise*. That was the case, e.g. in 1988, when – following another exercise targeted at major changes in the level and structure of prices – the inflation spiral was wounded once again. Only in the first half of 1988 the average price of consumer goods level was increased by about 49% and average nominal wages were indexed almost automatically, and increased by about 53%. Parallel to that, there was an increase in social transfers provided to the households by the state budget, without matching it growth on thr revenue side, hence it had brought again the inflationary results. The changes accomplished within the prices' structure were only modest, but the significant one was the result of the income redistribution. So, the whole undertaking went without any longer lasting deflationary consequences.

## 5. The political economy of reforms

As for the social consciousness and popular support of the market reforms, it must be stressed that the Polish population was by the late eighties already tired with both – the persistent structural crisis and the ways the very reforms had been tried to be implemented by the authorities, or the way the necessary reforms have been neglected or mismanaged. So, it was a "catch 22" situation, when the reforms were not good, but a lack of them was even worse. *The population associated more and more the reforms with the most painful of its symptoms, e.g. the continues price hikes. Inflation, which has clearly accompanied these reforms, entailed an important redistribution of incomes, which – in turn – did produce a situation, where despite the growth of the average consumption level, many social groups and households had been*

*suffering continuos decline in their consumption for several consecutive years.* It is for these reasons that many households – due to growing, despite price rise acceleration, shortages – preferred, for example, meat rationing rather than more realistic pricing, i.e. meat prices increased to a level, which would balance the supply and demand.

It must be emphasized that under the conditions of disequilibrium, typical for the Polish economy in the previous decade, an increase in the prices would not be automatically and entirely equivalent to the lowering of the average consumption level, but to a redistribution of incomes. For instance, *the real wage had decreased* in 1987 by 3.7 per cent on the average, *while the consumption (in fixed prices) had went up* by 2.0 per cent. This is the effect of containing the excessive liquidity of the households sector, or the removal of the shoratges. So, in some specific situations, it could happen, that the official statistical data suggested the fall of the real income (in money terms), but the consumption actually did not deacreas at the same period of time. It was also possible that the statistics showed the growth of the real income, or salary, but de facto consumption at the very same period did not expand, due to the effect of elimination of shortages from market.

As long as the politically sensitive groups were unwilling to accept such redistribution (and it is badly required for the introduction of market mechanisms) this remained an objective barrier in the implementation of necessary structural, institutional and political changes, what the reform is indeed all about. One must remember, that *it had not been (and still is not) rationality or theoretical accuracy that makes any given system or adjustment programmes enforceable, but the actual balance of social and political forces interested – or not interested – in the implementation of particular set of changes.* This balance in Poland only at the turn of eighties and nineties has started to be favourable one, but by the late eighties there still was hardly an agreement for the required reform measures, without prior, or at least parallel, but guaranteed political changes.

In this light also the issue of the ability towards the external adjustment of the Polish economy had to be raised. It was obvious already after the crisis of 1979–82 that Poland will not be able to pay her entire

foreign debt. So, the more obvious it was by the late eighties. On the other hand, it was also increasingly clear that there was not going to be any important foreign debt reduction, restructuring and rescheduling without launching sound systemic reforms, including the political one, and putting them on the irreversible track. From this perspective, it is true, that *in the case of Poland unmanageable burden of the foreign outstanding debt did contribute to the fiasco of market reforms in the eighties. So, the fourth key reason for the breakdown of market reforms was the burden of foreign debt.*

This was also a case, to the extent, in the instance of Hungary. So, paradoxically, the two most reformed socialist economies of East Central Europe were affected most by the dependence on the pressure stemming from their due obligations to the world economy, especially to the international creditors. In case of Poland, contrary to the Hungarian experience, the major part of the foreign debt was owned to the Western governments, so their ability to persuade some institutional changes behind the "iron curtain", which indeed was already a fiction by that time, were higher. Of course, *the insistence for far going liberalization and privatization for the sake of being able to meet the financial obligations was a tremendous one, including the persistent political pressure from the West.* On the other hand, the necessity to serve the foreign debt in the long–run was one among various important factors, which ultimately have triggered off the transition to a market.

This is why Poland attached already by the mid–eighties so much *importance to a proper collaboration with the World Bank and the International Monetary Fund,* becoming again the member of these Bretton Wood organizations as early as in 1986[9]. It was connected with the implementation of the economic stabilization and structural adjustment programmes, including the sound desire on the behalf of the political leadership to execute the reforms of institutional arrangements. These international organizations could, on the one hand, provide assistance in the preparation of the substantive adjustment measures and, on the

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[9] Poland was the member of the Bretton Wood institutions already in the late 1940s, but it left them soon after the introduction of the centrally planned regime.

other, supply some financial relief and aid. And by the late eighties it was already very well known that unless such an assistance was secured, even the most ambitious and relevant reform scenarios would under perform.

## 6. Conclusions

So, there has been a set of causes of the failure of market reforms in Poland. By the late eighties the economy was already seriously involved in so-called "growth fatigue" (Poznanski 1996) and *not only the society was tired with repeated but futile reform attempts, yet the political leadership was ready to give it up as well.* The lack of comprehensive approach towards the economic and social challenges, the neglect of supporting the economic overhaul political measures, growing shortageflation syndrome and expanding gap between the expectations and the results of economic development, and – last but in the case of Poland definitely not least – the unbearable burden of foreign debt, these are the factors through prism of which one should see the failure of reforms.

*The people were more and more dissatisfied in all social rules they play in the active, public lives.* They have been *disappointed as the producers*, because of mismanagement they witnessed on the microeconomic level. They were *disappointed as the consumers*, due to the persistent shortageflation and accompanying it waste of time for queuing and deteriorating quality of live, despite some progress in the quantity of output and real consumption. And they were *disappointed as the citizens*, owing to the negligence of their opinions about the ways the economy performed and the expectations how it supposed to be improved.

Ultimately, instead of another attempt to reform the socialist centrally planned economy, the time has come to transform it into another system. *The transition to a social market economy has been launched at the turn of the eighties and nineties* (see Kolodko 1989 and 1996). Of course, there would be not this historical turn around, if not the earlier market reforms. The farther they went at that time, the easier it is now

Table 5

**Recession and growth in transition economies, 1990–1997**

| Countries | number of years of GDP decline | did GDP fell again after recovery? | 1990-93 | 1994-97 | 1990-97 | 1997 GDP index (1989 =100) | Ranking |
|---|---|---|---|---|---|---|---|
| | | | Average annual rate of GDP growth | | | | |
| Poland | 2 | no | –3,1 | 6,4 | 1,7 | 112,2 | 1 |
| Slovenia | 3 | no | –3,9 | 4,1 | 0,1 | 99,8 | 2 |
| Slovakia | 4 | no | –6,8 | 6,0 | –0,4 | 94,7 | 3 |
| Croatia | 3 | yes | –4,2 | 3,1 | –0,6 | 92,5 | 4 |
| Czech Republic | 4 | no | –5,5 | 3,2 | –1,1 | 89,9 | 5 |
| Hungary | 4 | no | –4,8 | 1,9 | –1,5 | 88,1 | 6 |
| Romania | 4 | yes | –6,5 | 3,2 | –1,7 | 85,8 | 7 |
| Uzbekistan | 5 | no | –3,1 | –0,7 | –1,9 | 85,3 | 8 |
| Albania | 4 | yes | –8,8 | 5,3 | –1,8 | 80,7 | 9 |
| Estonia | 5 | no | –9,7 | 1,9 | –3,9 | 71,5 | 10 |
| Bulgaria | 6 | yes | –7,6 | –3,2 | –5,4 | 63,5 | 11 |
| Belarus | 7 | yes | –6,1 | –5,2 | –5,7 | 62,0 | 12 |
| Turkmenistan | 6 | no | –4,5 | –7,3 | –5,9 | 60,1 | 13 |
| Macedonia | 6 | no | –12,9 | 0,6 | –6,1 | 58,5 | 14 |
| Kyrgyzstan | 4 | no | –9,3 | –3,0 | –6,1 | 56,4 | 15 |
| Latvia | 4 | yes | –14,1 | 1,3 | –6,4 | 54,3 | 16 |
| Russia | 8 | no recovery | –10,1 | –5,7 | –7,9 | 51,3 | 17 |
| Kazakstan | 6 | no | –9,9 | –7,4 | –8,6 | 46,7 | 18 |
| Lithuania | 4 | no | –20,1 | 2,8 | –8,7 | 43,3 | 19 |
| Armenia | 4 | no | –21,4 | 6,0 | –7,7 | 42,2 | 20 |
| Ukraine | 8 | no recovery | –9,1 | –11,5 | –10,3 | 41,2 | 21 |
| Azerbaijan | 6 | no | –14,5 | –5,8 | –10,2 | 40,1 | 22 |
| Moldova | 7 | no | –12,5 | –9,3 | –10,9 | 36,6 | 23 |
| Tajikistan | 8 | no recovery | –12,2 | –11,0 | –11,6 | 35,8 | 24 |
| Georgia | 5 | no | –24,1 | 2,9 | –10,6 | 34,3 | 25 |

*Source:* National statistics, international organizations and author's own calculations.

to manage the process of fundamental changes of the whole set of institutional arrangements, and the sooner it is possible to put the economy on the path of sustainable development. In the case of Poland – contrary to a number of other economies in transition in East Central Europe and the former Soviet Union (see Table 5) – it seems already to be the case.

The lessons have been learned, at least to the extent. Was it done on time or too late, it is not relevant anymore, as it is not relevant to reconsider now was it possible to succeed with the reforms carried forward in the past? One may say, that if it would be possible, it should happen, but it occurred not to be the case. Consequently, Poland – as the first country among the late socialist centrally planned economies – in a definite and irreversible way has shifted from the series of reforms of the old system to the development of the new one. *The first stage of this very transition has been initiated together with the "round table" negotiations hold at the spring of 1989 and was completed already by summer of 1996, when Poland has become the 28–th member of the Organization for Economic Co–operation and Development – OECD.* By mid–1997 Poland – together with four other East Central European economies in transition to a market, the Czech Republic, Estonia, Hungary and Slovenia – has been invited to start the accession negotiations with the European Union, considering the future membership in this organization.

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# II. EXCHANGE RATE LIBERALIZATION POLICY AND GROWTH IN TRANSITION ECONOMIES

*The management of the exchange rate and the introduction of convertibility have brought mixed results in different countries in transition to a market economy.* In some of them the devaluation of domestic currency had been significantly overshot, for instance in Poland at the beginning of 1990, in another the effort to use the exchange rate as a nominal anchor of stabilisation programmes has failed, for example in the former Yugoslavia (Kolodko–Kozierkiewicz–Paczek, 1992). Later, after the process of transformation has been more matured in the whole region of Eastern Europe and the former Soviet Union, there have been significant diversification of the currency regimes, although all of them were aiming towards more or less gradual liberalisation.

The essential aspect of systemic transformation and economic restructuring was the move from centrally planned foreign trade conducted by foreign trade enterprises, state owned and specialising in the import–export of commodity groups in conditions of monopoly, within the framework of the former Council for Mutual Economic Assistance (CMEA) trade block, to *free and unrestricted trade undertaken by any enterprise and individual, and the reintegration of these economies into world trade.*

Later, all transition economies have joined the Bretton Woods organisations, i.e. the International Monetary Fund (IMF) and the World Bank, some of them are already the members of the World Trade Organisation (WTO), the most advanced in transition have been admitted to the Organisation of Economic Co–operation and Development (OECD) and are expecting to start next year their accession negotiations with the European Union (Table 1).

This process, which has involved the re–structuring and re–direction of trade flows, requires not only the *dismantling of foreign trade monopoly*, i.e. dismantling of foreign trade organisations and the legalisation of foreign trade activities undertaken by all state and non–state organisations, but also *market access to foreign exchange* needed for imports and the free disposal of all currency earnings originating in exports.

In other words, the gaining of the trade benefits necessarily requires *internal convertibility, i.e. the convertibility of domestic currency by residents for current account purposes.* That much convertibility is simply a corollary of an open market economy. In the old system, on the contrary, money was not freely convertible into goods – given endemic shortages at administered prices, even at times of inflation, given the frequent coexistence of shortages and inflation, or shortageflation (Kolodko, 1992) – let alone into foreign currencies, which like material goods were underpriced. Hence, the domestic currency was overvalued, scarce and directly allocated to strictly authorised users according to the plan.

In its simplest form, *internal convertibility can be achieved easily by legalising the black market for foreign exchange*, as Poland had already done in February 1989 before the transition got under way, or as Russia did at the beginning of January 1992. In this case the exchange rate is a freely floating market–determined rate, there is no need of foreign currency reserves to back a pre–fixed exchange rate, trade competitiveness is automatically maintained by devaluing the currency as required and the convertibility can be speedily introduced.

The main disadvantage of such a solution was gross undervaluation of domestic currency, due to inflationary expectations generated by simultaneous price liberalisation (Kolodko–Nuti, 1997). *This kind of undervaluation in turn could cause further inflation.* Indeed relatively high, if not very high inflation has been persisting in a number of countries in transition until now (Table 2).

If convertibility is introduced less hastily, once inflationary expectations have been lowered, and in the presence of significant central reserves, a pre–fixed exchange rate level or bands can be aimed at, with

potential advantages for price stability. Here the *danger is an erosion of international competitiveness unless unit wage costs can be contained by means of productivity growth or wage restraint, or both.* So, the crucial factor for sustained growth is both the liberalisation and stabilisation, what depends on sound attempt for market institutional re–design and fashionable development policy (Stern and Stiglitz, 1997; Kolodko, 1998).

The real issue therefore is not whether internal convertibility should or should not be introduced – as it is part and parcel of the market economy – but at what exchange rate level and exchange rate regime. *The choice between fixed and floating exchange rates is one roughly between fighting inflation or unemployment,* with mixed policies representing a compromise between the two evils.

The *exchange rate regimes at which convertibility has been introduced in the transition vary enormously:* from the floating rate of Russia (January 1992) to the fixed rate of Poland (January 1990 – May 1991) with intermittent devaluations (May and November 1991), to the theoretically permanently fixed exchange rate of the currency boards (Lithuania 1992, Bulgaria 1997), with intermediate regimes of sliding crawling pegs (Poland November 1991 – May 1995), crawling bands (Poland May 1995 to date), fixed bands (Russia, 1996).

Regardless of the exchange rate regime, the transition experience has followed a fairly common pattern: *initial severe undervaluation of the domestic currency with respect to purchasing power parities and other measures of competitiveness, accompanied by trade surpluses, followed by real revaluation achieved mostly through inflation differentials, often accompanied by trade balances deterioration* unless – as in Poland – competitiveness was enhanced by large productivity increases higher than wage growth, and/or real revaluation was contained by nominal devaluations (Kolodko and Nuti, 1997).

Inflationary cost of the undervaluation, associated with early convertibility, should be set against the advantages of rapid trade re–direction and expansion and of greater attraction for foreign investment. It has been argued that *an initial modest tariff protection, temporary and non discriminatory, might have mitigated the amount of devaluation*

*required by convertibility* and even raised government revenues alleviating the fiscal crisis (Tanzi, 1997). The fiscal stance vary from country to country and has changed in favour of more balanced public finance system in the countries that were able to go further with institutional reforms supporting overall liberalisation, including the liberalisation of the exchange rate regime (Table 3).

The broad international integration of transition economies in the global one requires the achievement of *capital account convertibility* as well. In its full form internal convertibility is defined by Article VIII of the International Monetary Fund general agreement. However – as demonstrated by the Czech koruna crisis of June 1997 – *capital account convertibility involves a greater vulnerability to speculative flows*, especially by the hedge funds (Roubini and Wachtel, 1997, EBRD, 1997). In some countries where exchange rate policy has been quite liberalised – as in the Czech Republic, Estonia, Latvia, Poland and Slovakia the current account balance significantly deteriorated in 1996–97, although due to sound export–led growth the situation seems to be still sustainable (Table 4).

So, the general conclusion that follows is that in the sequencing of transition reforms such a *fuller convertibility should come only after stabilisation has been consolidated into stability, government policies have established international credibility and enterprise restructuring – financial and real – have been broadly achieved.* Unfortunately, it has not been yet the case in all countries involved with important consequences for the real processes, contraction and growth notwithstanding (Table 5).

There are the efforts to follow this sequence, but the arrival of the full convertibility is not yet on the present agenda even in the countries most advanced into transition, like the post–socialist OECD members, i.e. the Czech Republic, Hungary and Poland. The impact upon overall economic activity and therefore the size of the real output, resulting from currencies' different regimes and policies, is also different. If these policies were well balanced and carried forward gradually, with the proper care being taken over accompanying institutional arrangements,

they would have contributed to faster growing trade and could attract an additional inflow of foreign direct investment.

Hence, they would facilitate a growth in the medium–term as well. But, as some examples have shown, including the case of the Czech Republic and Estonia in 1997, if the wrong sequence of foreign exchange regime liberalisation goes together with the negligence of management of the state sector and/or mismanagement of the privatisation of state assets through inadequate corporate governance, it can hamper the ability to grow.

Table 1

**Membership of transition economies in international economic and financial organizations**

| Country | Organization | | | | | |
|---|---|---|---|---|---|---|
| | IMF & WB | WTO | Association with EU | OECD | Invitation to join EU | Ranking by stars |
| Albania | * | | | | | * |
| Armenia | * | | | | | * |
| Azerbaijan | * | | | | | * |
| Belarus | * | | | | | * |
| Bulgaria | * | * | * | | | *** |
| Croatia | * | | | | | * |
| Czech Republic | * | * | * | * | * | ***** |
| Estonia | * | | * | | * | *** |
| FYR Macedonia | * | | | | | * |
| Georgia | * | | | | | * |
| Hungary | * | * | * | * | * | ***** |
| Kazakstan | * | | | | | * |
| Kyrgyzstan | * | | | | | * |
| Latvia * | | * | | | ** | |
| Lithuania | * | | * | | | ** |
| Moldova | * | | | | | * |
| Poland | * | * | * | * | * | ***** |
| Romania | * | * | * | | | *** |
| Russia | * | | | | | * |
| Slovakia | * | * | * | | | *** |
| Slovenia | * | * | * | | * | **** |
| Tajikistan | * | | | | | * |
| Turkmenistan | * | | | | | * |
| Ukraine | * | | | | | * |
| Uzbekistan | * | | | | | * |

*Source:* Author's own compilation on the basis of data from various international organizations.

Table 2

**Inflation in eastern Europe, the Baltics and the CIS (change in the year-end retail/consumer price level, in per cent)**

| Country | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 Estimate | 1997 Projection |
|---|---|---|---|---|---|---|---|
| Albania | 104 | 237 | 31 | 16 | 6 | 17 | 42 |
| Bulgaria | 339 | 79 | 64 | 122 | 33 | 311 | 592 |
| Croatia | 250 | 938 | 1 149 | -3 | 4 | 3 | 4 |
| Czech Republic | 52 | 13 | 18 | 10 | 8 | 9 | 9 |
| Estonia | 304 | 954 | 36 | 42 | 29 | 15 | 12 |
| FYR Macedonia | 230 | 1 925 | 230 | 55 | 9 | 0 | 8 |
| Hungary | 32 | 22 | 21 | 21 | 28 | 20 | 17 |
| Latvia | 262 | 959 | 35 | 26 | 23 | 13 | 8 |
| Lithuania | 345 | 1 161 | 189 | 45 | 36 | 13 | 10 |
| Poland | 60 | 44 | 38 | 29 | 22 | 19 | 15 |
| Romania | 223 | 199 | 296 | 62 | 28 | 57 | 116 |
| Slovak Republic | 58 | 9 | 25 | 12 | 7 | 5 | 7 |
| Slovenia | 247 | 93 | 23 | 18 | 9 | 9 | 9 |
| Eastern Europe and the Baltic States[a] | 193 | 510 | 166 | 35 | 19 | 38 | 65 |
| Armenia | 25 | 1 341 | 10 896 | 1 885 | 32 | 6 | 19 |
| Azerbaijan | 126 | 1 395 | 1 294 | 1 788 | 85 | 7 | 7 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Belarus | 93 | 1 558 | 1 994 | 1 900 | 243 | 40 | 99 |
| Georgia | 131 | 1 177 | 7 488 | 6 473 | 57 | 14 | 9 |
| Kazakhstan | 137 | 2 984 | 2 169 | 1 160 | 60 | 29 | 12 |
| Kyrgyzstan | 170 | 1 259 | 1 363 | 96 | 32 | 35 | 24 |
| Moldova | 151 | 2 198 | 837 | 116 | 24 | 15 | 11 |
| Russia | 144 | 2 501 | 837 | 217 | 132 | 22 | 14 |
| Tajikistan | 204 | 1 364 | 7 344 | 1 | 2 132 | 41 | 105 |
| Turkmenistan | 155 | 644 | 9 750 | 1 328 | 1 262 | 446 | 44 |
| Ukraine | 161 | 2 730 | 10 155 | 401 | 182 | 40 | 15 |
| Uzbekistan | 169 | 910 | 885 | 1 281 | 117 | 64 | 40 |
| The Commonwealth of Independent States[b] | 139 | 1 672 | 4 584 | 1 387 | 363 | 63 | 33 |

Notes:

Data for 1990-95 represent the most recent official estimates of results as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Data for 1996 are preliminary actuals, mostly official government estimates. Data for 1997 represent EBRD projections. Figure for Albania for 1997 is based on the information from parts of the country where data collection was possible.

[a] Unweighted average for Albania, Bulgaria, Croatia, the Czech Republic, Estonia, FYR Macedonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia.

[b] Unweighted average for all countries of the former Soviet Union, except Estonia, Latvia and Lithuania.

*Source:* EBRD 1997.

Table 3

**General government balances in eastern Europe, the Baltics and the CIS (in per cent of GDP)**

| Country | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 Estimate | Change 1995-96 |
|---|---|---|---|---|---|---|---|---|
| Albania | -15.0 | -31.0 | -22.0 | -15.0 | -12.0 | -10.0 | -12.0 | -2.0 |
| Bulgaria | na | na | -5.2 | -10.9 | -5.8 | -6.4 | -13.4 | -7.0 |
| Croatia | na | na | -4.0 | -0.8 | 1.7 | -0.9 | -0.5 | 0.4 |
| Czech Republic | na | na | na | 2.7 | 0.8 | 0.4 | -0.2 | -0.6 |
| Estonia | na | 5.2 | -0.3 | -0.7 | 1.3 | -1.2 | -1.5 | -0.3 |
| FYR Macedonia | na | na | -9.6 | -13.6 | -3.2 | -1.3 | -0.4 | 0.9 |
| Hungary | 0.4 | -2.2 | -5.5 | -6.8 | -8.2 | -6.5 | -3.5 | 3.0 |
| Latvia na | na | -0.8 | 0.6 | -4.1 | -3.5 | -1.4 | 2.1 | |
| Lithuania | 5.4 | 2.7 | 0.8 | -3.1 | -4.2 | -3.3 | -3.6 | -0.3 |
| Poland | 3.1 | -6.7 | -6.6 | -3.4 | -2.8 | -3.6 | -3.1 | 0.5 |
| Romania | 1.0 | 3.3 | -4.6 | -0.4 | -1.9 | -2.6 | -3.9 | -1.3 |
| Slovak Republic | na | na | na | -7.0 | -1.3 | 0.1 | -1.2 | -1.3 |
| Slovenia | -0.3 | 2.6 | 0.2 | 0.3 | -0.2 | 0.0 | 0.3 | 0.3 |
| Eastern Europe and the Baltic States[a] | -- | -- | -- | -4.5 | -3.1 | -3.0 | -3.4 | -0.4 |
| Armenia | na | -1.8 | -8.1 | -56.1 | -16.5 | -11.1 | -9.3 | 1.8 |
| Azerbaijan | na | na | 2.8 | -12.7 | -11.4 | -4.2 | -2.6 | 1.6 |
| Belarus | na | na | na | -1.9 | -2.6 | -1.9 | -1.6 | 0.3 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Georgia | na | -3.0 | -25.4 | -26.2 | -7.4 | -4.5 | -4.4 | 0.1 |
| Kazakhstan | 1.4 | -7.9 | -7.3 | -1.3 | -7.2 | -2.0 | -2.5 | -0.5 |
| Kyrgyzstan | 0.3 | 4.6 | -17.4 | -14.2 | -7.7 | -13.5 | -6.4 | 7.1 |
| Moldova | na | 0.0 | -26.2 | -7.4 | -8.7 | -5.7 | -6.7 | -1.0 |
| Russia | na | na | -21.6 | -7.2 | -10.4 | -5.5 | -8.3 | -2.8 |
| Tajikistan | na | -16.4 | -31.2 | -25.0 | -10.5 | -11.2 | -5.3 | 5.9 |
| Turkmenistan | 1.2 | 2.5 | 13.2 | -0.5 | -1.4 | -1.6 | -0.2 | 1.4 |
| Ukraine | na | na | -25.4 | -16.2 | -7.8 | -4.9 | -3.2 | 1.7 |
| Uzbekistan | -1.1 | -3.6 | -18.4 | -10.4 | -6.1 | -4.1 | -7.3 | -3.2 |
| The Commonwealth of Independent States[b] | -- | -- | -- | -11.2 | -7.4 | -5.4 | -4.4 | 1.0 |

Notes:

Data for 1990-95 represent the most recent official estimates of results as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Data for 1996 are preliminary actuals, mostly IMF estimates. Change in fiscal balances in 1995-96 represents the difference between the ratios of fiscal balances to GDP in the respective years. General government includes the state, municipalities and extrabudgetary funds. Balances reported on cash basis expect for Albania and Poland. 1996 figure for Albania refers to the first half of 1996. Data for Armenia refer to the consolidated state government, for Croatia refer to the consolidated central government and for Uzbekistan refer to the state and extrabudgetary funds.

[a] Unweighted average for Albania, Bulgaria, Croatia, the Czech Republic, Estonia, FYR Macedonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia.

[b] Unweighted average for all countries of the former Soviet Union except Estonia, Latvia and Lithuania

*Source:* EBRD 1997.

Table 4

**Current account and trade balances in eastern Europe, the Baltics and the CIS**

| | Current trade balance 1996 | Merchandise account balance 1996 | Current account balance 1996 | Merchandise trade balance 1996 | Change in current account balance 1995-96 | Change in merchandise trade balance 1995-96 |
|---|---|---|---|---|---|---|
| | In million US dollars | | in % of GDP | | Change in GDP-share in % | |
| Albania | -123 | -692 | -4.7 | -26.7 | 2.7 | -7.1 |
| Bulgaria | 117 | 209 | 1.3 | 2.4 | 1.8 | 1.5 |
| Croatia | -1 452 | -3 276 | -7.6 | -17.2 | 1.8 | -1.2 |
| Czech Republic | -4 476 | -5 972 | -8.1 | -10.9 | -5.3 | -3.4 |
| Estonia | -448 | -1 058 | -10.3 | -24.2 | -5.6 | -6.2 |
| FYR Macedonia | -288 | -317 | -7.8 | -8.6 | -1.7 | -2.4 |
| Hungary | -1 700 | -2 600 | -3.8 | -5.9 | 1.9 | -0.4 |
| Latvia | -361 | -929 | -7.2 | -18.5 | -3.5 | -7.0 |
| Lithuania | -440 | -631 | -4.4 | 6.3 | 0.0 | 0.0 |
| Poland | -1 352 | -8 154 | -1.0 | -6.1 | -5.7 | -4.6 |
| Romania | -2 336 | -2 130 | -5.9 | -4.6 | -1.0 | -0.1 |
| Slovak Republic | -1 941 | 2 106 | -10.2 | -11.1 | -8.0 | -9.8 |
| Slovenia | 47 | -853 | 0.3 | -4.6 | 0.5 | -0.1 |
| Eastern Europe and the Baltic States[a] | -- | -- | -5.3 | -10.9 | -1.7 | -3.1 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Armenia[b] | -424 | -436 | -26.6 | -27.4 | 10.9 | 3.9 |
| Azerbaijan | -811 | -549 | -23.6 | -8.0 | -12.1 | 1.9 |
| Belarus | -909 | -1 335 | -6.7 | -9.9 | -4.3 | -4.8 |
| Georgia | -222 | -295 | -4.9 | -6.5 | 3.4 | 5.2 |
| Kazakhstan | -700 | -300 | -3.4 | -1.4 | 0.6 | -0.3 |
| Kyrgyzstan | -414 | -373 | -23.7 | -21.4 | -4.4 | -3.7 |
| Moldova | -250 | -234 | -13.1 | -12.2 | -4.5 | -9.0 |
| Russia | 9 600 | 23 100 | 2.2 | 5.2 | 0.9 | 0.3 |
| Tajikistan | -110 | -50 | -10.9 | -5.0 | -11.1 | -9.5 |
| Turkmenistan | 43 | 159 | 1.7 | 6.1 | 1.4 | 1.6 |
| Ukraine | -1 184 | -4 296 | -2.7 | -9.8 | 1.5 | -3.5 |
| Uzbekistan | -1 075 | -931 | -7.9 | -6.8 | -7.4 | -8.9 |
| The Commonwealth of Independent States[c] | -- | -- | 10.0 | -8.1 | -2.1 | -2.2 |

Notes:

Data are the most recent official estimates of results as reflected in publications from the national authorities, the IMF, the World Bank, the OECD, PlanEcon and the Institute of International Finance. Change in current account and merchandise trade balances in 1995-96 represents the difference between the ratios of current account and merchandise trade balances to GDP in respective years.

[a] Unweighted average for Albania, Bulgaria, Croatia, the Czech Republic, Estonia, FYR Macedonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia.

[b] The current account balance for Armenia excludes transfers.

[c] Unweighted average for all countries of the former Soviet Union, except Armenia, Estonia, Latvia and Lithuania.

*Source:* EBRD 1997.

Table 5

**Recession and growth in transition economiec, 1990-1997**

| Countries | Number of years of GDP decline | Did GDP fell again after recovery? | 1990--1993 | 1994--1997 | 1990--1997 | 1997 GDP index (1989==100) | Ranking |
|---|---|---|---|---|---|---|---|
| | | | (average annual rate of GDP growth) | | | | |
| Poland | 2 | no | -3.1 | 6.4 | 1.7 | 112.2 | 1 |
| Slovenia | 3 | no | -3.9 | 4.1 | 0.1 | 99.8 | 2 |
| Slovakia | 4 | no | -6.8 | 6.0 | -0.4 | 94.7 | 3 |
| Croatia | 3 | yes | -4.2 | 3.1 | -0.6 | 92.5 | 4 |
| Czech Republic | 4 | no | -5.5 | 3.2 | -1.1 | 89.9 | 5 |
| Hungary | 4 | no | -4.8 | 1.9 | -1.5 | 88.1 | 6 |
| Romania | 4 | yes | -6.5 | 3.2 | -1.7 | 85.8 | 7 |
| Uzbekistan | 5 | no | -3.1 | -0.7 | -1.9 | 85.3 | 8 |
| Albania | 4 | yes | -8.8 | 5.3 | -1.8 | 80.7 | 9 |
| Estonia | 5 | no | -9.7 | 1.9 | -3.9 | 71.5 | 10 |
| Bulgaria | 6 | yes | -7.6 | -3.2 | -5.4 | 63.5 | 11 |
| Belarus | 7 | yes | -6.1 | -5.2 | -5.7 | 62.0 | 12 |
| Turkmenistan | 6 | no | -4.5 | -7.3 | -5.9 | 60.1 | 13 |
| Macedonia | 6 | no | -12.9 | 0.6 | -6.1 | 58.5 | 14 |
| Kyrgyzstan | 4 | no | -9.3 | -3.0 | -6.1 | 56.4 | 15 |
| Latvia | 4 | yes | -14.1 | 1.3 | -6.4 | 54.3 | 16 |
| Russia | 8 | no recovery | -10.1 | -5.7 | -7.9 | 51.3 | 17 |
| Kazakstan | 6 | no | -9.9 | -7.4 | -8.6 | 46.7 | 18 |
| Lithuania | 4 | no | -20.1 | 2.8 | -8.7 | 43.3 | 19 |
| Armenia | 4 | no | -21.4 | 6.0 | -7.7 | 42.2 | 20 |
| Ukraine | 8 | no recovery | -9.1 | -11.5 | -10.3 | 41.2 | 21 |
| Azerbaijan | 6 | no | -14.5 | -5.8 | -10.2 | 40.1 | 22 |
| Moldova | 7 | no | -12.5 | -9.3 | -10.9 | 36.6 | 23 |
| Tajikistan | 8 | no recovery | -12.2 | -11.0 | -11.6 | 35.8 | 24 |
| Georgia | 5 | no | -24.1 | 2.9 | -10.6 | 34.3 | 25 |

*Source:* National statistics, international organizations and author's own calculations.

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