Leszek Balcerowicz, a key architect of Poland's economic and financial reforms, served as both Deputy Prime Minister and Minister of Finance of Poland from September 1989 to December 1991 and from October 1997 to June 2000.

Poland's Transformation

Poland has made considerable progress over the past decade in transforming its centrally planned economy into a market-oriented one, but challenges remain. How can it best complete this transformation and facilitate its integration into the European Union?

Leszek Balcerowicz

MORE THAN ten years ago, after breaking out of the Soviet-dominated communist bloc, Poland took a chance and decided to transform its inefficient centrally planned economy into a market economy. On January 1, 1990, the first postcommunist Polish government introduced an unprecedented economic reform plan known as the Economic Transformation Program. This plan was designed to stabilize the economy, promote structural reforms, and put the country on the right path to becoming a market economy. Poland benefited from the difficult but effective introduction of truly market-driven mechanisms into the economy and became the first country in the region to rebound from transformational recession and exceed GDP levels seen before postcommunist reforms. A moderate recovery during 1992–94 was followed by robust growth (the fastest in Central Europe) during 1995–99 that was driven by a rapid expansion of the new private sector. Poland's GDP was 20 percent larger in 1999 than in 1989.

The changes introduced have not only put Poland on the path to growth but also made its economy strong enough to sustain positive long-term trends in the more demanding external environment. As a result, Poland has shown itself to be relatively resilient with respect to international financial crises—compared with, for example, the Czech Republic, which suffered a currency crisis in 1997, and especially Russia, which experienced the collapse of August 1998. Poland's resilience can be attributed mainly to its balanced and consistent macroeconomic policy, structural reforms, and relatively strong and transparent financial system. However, the Russian crisis and an economic slowdown in the European Union (EU) dampened demand for Polish exports in 1999 and contributed to the growth of Poland's current account deficit. At the same time, the Polish economy has proved strong enough to withstand very tough times, and after GDP growth slowed to 1.7 percent in the first quarter of 1999 (as a result of the Russian crisis), it rebounded to more than 6 percent in the fourth quarter of 1999 and the first quarter of 2000.

Medium-term objectives

Poland has ambitious goals for the first decade of the twenty-first century. Its medium-term objective is to achieve high and sustainable growth—6 percent—to boost employment and narrow the gap between Poland and EU member states. The Budget Act for 2000 provides for real GDP growth of 5.2 percent (up from 4.1 percent in 1999), consumer price index inflation of 5.7 percent by the end of 2000, and a more prudent approach to Poland's fiscal and current account situations. By 2003, the general government's budget will be balanced and the inflation rate will drop below 4 percent.

International institutions offer a positive outlook for the Polish economy. For 2000 and 2001, the European Commission expects Poland to be among the fastest-growing countries that are candidates for EU membership. According to a medium-term scenario prepared by the Organization for Economic Cooperation and Development (OECD), Poland will be one of the two fastest-growing OECD members, and its inflation and unemployment rates will be visibly reduced. The Economist Intelligence Unit's projections up to 2004 provide for Polish GDP growth of about 5 percent annually, fueled primarily by exports and investments.

In the coming decade, Poland hopes to benefit from increasing globalization and liberalization. It will be increasingly integrated with the world economy and exposed to the external economic environment, which will create both opportunities and risks. The changed environment allows for a more efficient allocation of resources while providing the growing Polish economy with the capital it urgently needs to close the gap between investment and domestic savings. The inflow of long-term capital will contribute to an increase in productivity through such means as the transfer of technology and introduction of better management techniques. At the same time, the Polish economy will be exposed to the risks generated by the volatility of international capital flows and by specific features of Poland's own financial markets, such as distortions created by government loan guarantees, which increase the markets' vulnerability to reversals of financial flows; an asymmetric distribution of information; and herding behavior among investors.

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The effectiveness of Poland's response to these and other external shocks or risks will be determined by the quality of the government's macroeconomic, structural, and institutional frameworks for decision making. Responsible economic policies will allow benefits to be maximized and the risks associated with integration into the world economy to be reduced.

Economic strategy

Poland's medium-term economic strategy has four main components: macroeconomic stabilization, strengthening of the financial sector, structural reforms, and accession to the European Union.

Macroeconomic stabilization depends to a large extent on the consistency of economic policy. Achieving a proper mix between fiscal and monetary policies and exchange rate policies remains relevant. Reducing current account and inflationary pressures is a priority. Poland's sizable current account deficit, which amounted to 7.6 percent of GDP in 1999, will continue to be a source of vulnerability. Any tightening of Poland's monetary policy in response to rising inflation will therefore have to be weighed carefully against the likely effects on the exchange rate and the current account. Poland's current account deficit is financed largely by foreign direct investment, and its gross reserves currently cover seven months of imports and 400 percent of short-term debt. The weakness of the country's exports will nevertheless have to be addressed. The prospects for external demand are bright, with both recovery of EU markets and improvements in eastern markets expected. Poland's efforts to strengthen its exports include microeconomic reforms (aimed at, among others things, increasing deregulation and labor market flexibility) designed to improve the competitiveness of Polish products in the medium term.

Fiscal consolidation is crucial to increasing domestic saving, decreasing the current account deficit, and reducing the latter's impact on inflation. The government's Strategy for Public Finance and Economic Development 2000–10 anticipates a balanced budget for the general government by 2003, increased efficiency of both taxes and expenditures, and a reduction of the fiscal burden through lower direct taxes, a stable and transparent tax system, and redirection of expenditure toward development-oriented outlays.

Poland's fully floating exchange rate regime should increase the risks for short-term investors and permit a more accurate fix of the zloty against the euro. Stabilization is expected to be achieved through Poland's participation in the ERM2 (exchange rate mechanism of the European Monetary System) upon accession to the European Union.

Poland will continue an orderly and cautious liberalization of capital flows. The limited number of restrictions remaining on short-term capital flows will be abolished after the current account is stabilized, and capital flows will be fully liberalized within 30 months of Poland's planned EU accession.

The *financial system* was strengthened following the government's adoption in 1993 of a restructuring program for the banking sector that included the recapitalization of banks. This restructuring paved the way for the privatization of banks, which will be completed in coming years. Poland's regulatory and supervisory systems compare favorably with those of other countries in Central Europe. At the same time, its financial transparency is constantly being improved. Poland was among the first countries that subscribed to the IMF's Special Data Dissemination Standard. The Institute of International Finance's most recent *Data Release Practices of Emerging Market Economies* ranked Poland fifth among the 27 countries examined. To improve its position, Poland should issue data on public sector accounts and international reserves more frequently, provide data on the disposition of reserves, and supply regular data on debt-amortization schedules.

As the key component in increasing the Polish economy's competitiveness, important *structural reforms* have been carried out in privatization, social security, health care, education, and local governments.

Up to 75 percent of existing state-owned assets are to be privatized by 2001, and the proportion is expected to increase to 90 percent by 2005. State ownership will be limited mostly to minority stakes in strategic sectors. Key projects scheduled for 2000 and 2001 include privatizations in the telecommunications, power-generation, petrochemical, and steel-processing sectors. A start will also be made on privatizing the traditionally difficult coal-mining sector.

Structural reforms begun in 1999 will have a profound and beneficial impact on the long-term sustainability of public finances and on the efficiency achieved in delivering public goods. Social security system reform will involve a transition from a pay-as-you-go public pension system to a fully funded individual-retirement-account system, which should help reduce social transfers, develop the capital market, and increase domestic savings and investment.

Reform of the health care system—providing for budgetary financing of medical services currently paid for out of health care funds independent of the national budget—will be financed by 7.5 percent of revenues from Poland's personal income tax. Education reform should increase economic efficiency, and reform of local governments will decentralize expenditure and improve regional efficiency.

Job creation will be enhanced by structural reforms as well as by development of a strategy designed to reduce the social costs of restructuring and facilitate the absorption of a large inflow of new entrants into the labor force. Labor market flexibility will be increased by adoption of a sound wage policy, trade liberalization, and the simplification of tax structures.

One of the major goals of Poland's economic program is to facilitate the country's integration into the European Union. This will be Poland's next step, after joining the OECD in 1996 and the North Atlantic Treaty Organization (NATO) in 1999, toward full integration into the global economy. As part of its program for EU accession, the Polish government will tackle several challenges, including achieving compatibility between Poland's legislation and that of the European Union; meeting the remaining economic convergence criteria for membership in European Economic and Monetary Union (EMU); meeting the increased competition faced by Polish products in the European Union owing to the improved transparency brought about by EMU; and creating new jobs (for new entrants and workers leaving the agricultural sector and ailing industries) to assuage EU fears of massive emigration from Poland to (other) EU countries.

Some changes in EU economic policies would also be helpful—for example, institutional reform bringing the Common Agricultural Policy closer to market determination of prices for agricultural products and the design and implementation of social and labor-market reforms aimed at reducing structural unemployment.

By joining EMU, Poland will complete its transformation to a market-driven economy, successfully achieving the goal it set for itself more than ten years ago. F&D