# The Frank E. Seidman Distinguished Award In Political Economy

Acceptance Paper By

Jeffrey Sachs

## The Economic Transformation of Eastern Europe: The Case of Poland

Award Bestowed September 26, 1991

RHODES COLLEGE
Memphis, Tennessee

# The Frank E. Seidman Distinguished Award In Political Economy

## Objective

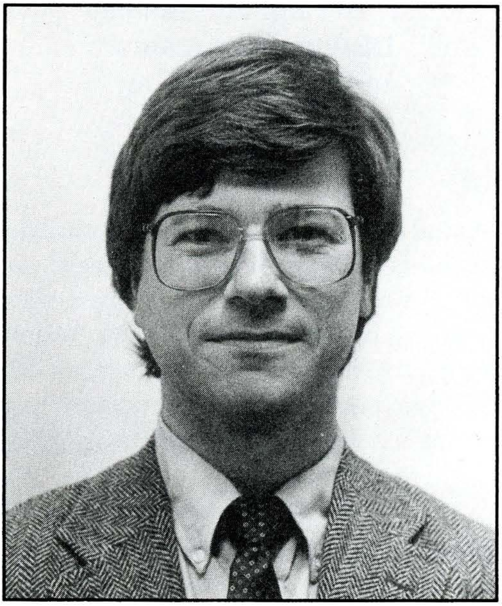
The Seidman Award recognizes distinguished contributions to Political Economy by economists or other political and social scientists who, by conventional and/or innovative approaches, have demonstrated their dedication to improving human conditions. The Award seeks to honor scholars who have advanced general understanding of the roles of democratic values, public institutions, government policies, private enterprises, and free markets in promoting economic well-being and social welfare.

## Selection Procedure

Each year nominations are solicited worldwide from the economics and social science professions. Following a defined process, the recipient is chosen by the Board of Trustees, acting upon recommendations of a Selection Committee composed of eminent economists appointed for limited terms. The Award is presented annually at a formal banquet hosted by the Award's Trustees and Rhodes College in Memphis, Tennessee.

The announcement of the recipient of the award will be made in the Spring by the Board of Trustees of the Award and by Rhodes College.

Mel G. Grinspan
Distinguished Service
Professor Emeritus
Award Director



**JEFFREY SACHS**
Recipient of 1991
Frank E. Seidman Distinguished Award
In Political Economy

# PRESENTATION OF THE AWARD
## BY AMARTYA SEN
## LAMONT UNIVERSITY PROFESSOR
## HARVARD UNIVERSITY

Jeffrey Sachs has not quite followed Henry Wadsworth Longfellow's vision of a good life: "Let us, then be up and doing,/With a heart for any fate;/ Still achieving, still pursuing,/ Learn to labour and to wait." There has been no shortage of "labour", nor any of "pursuing" and "achieving", in Sachs's life, but *waiting* has not been a particularly Sachsian virtue. He rushed through his studies rapidly, achieved a formidable academic reputation remarkably early, and when Harvard appointed him to a full Professorship at the tender age of 29, that University could almost be accused of harbouring child labour, if not cradle-snatching.

At the age of 32, Sachs was advising the President of Bolivia on how to curb their inflation rate of 40,000 per cent per year. It did fall to a more tenable 15% soon enough. Within a few years of that, Jeffrey Sachs produced a major study of the Third World debt problem in a 4-volume definitive work for the National Bureau of Economic Research. He then proceeded to help transform the economy of Poland (sponsored by the World Institute of Development Economics Research), and to give powerful advice to the political leaders of many lands, including Yugoslavia, Slovenia and Mongolia, and of course to Boris Yeltsin of Russia. He has developed a remarkable specialist expertise in helping centrally planned economies to marketize.

Sachs's advisory work is characterized by optimism, confidence and determination. There is an old game, which we used to play in school, that takes the form of having to decide which literary character *least* resembles a particular person. If that game were to be played with the dynamic and determined Jeffrey Sachs, a natural contrast would have been with Hamlet. Not for Jeffrey any "To be, or not to be". Rather, "To be, or definitely to be".

Jeffrey Sachs was born in 1954 in Detroit, Michigan (his parents are here tonight). He married his Harvard classmate, Dr. Sonia Ehrlich, a skilled and much-admired pediatrician, who is also present here (as are *her* parents). His student career at Harvard was brilliant and rapid, and after establishing his mark as a splendid economic theorist, Sachs soon developed a major reputation as an applied economist. His first book, *Economics of Worldwide Stagflation*, published in 1985, was written jointly with Dr. Michael Bruno (who was later the architect of inflation control in Israel and went on to become the Governor of the Bank of Israel). Their analysis of stagflation - the combined occurrence of stagnation and inflation - threw a good deal of light on the general nature of that beast and also on the economic problems actually faced by many industrial countries.

In this work as well as in all others (including his studies of Third World debt and radical reform), Sachs has shown a remarkable combination of good economic reasoning with excellent use of empirical understanding and common sense. The combination of analytical reach and sound common sense is, we have to admit, relatively rare in economics. In fact, in 1904, no less an economist than Alfred Marshall, one of the founders of modern economics, had complained in a letter to Knut Wicksell, another pioneer, that a newly arrived student at Cambridge had offended Marshall by telling him that "the founders of Economics of all nations were inferior in common sense to most children of ten." That was, I must insist, a slight exaggeration, but the ability to make intelligent use of common sense without losing sight of the lessons of economic theory is indeed a remarkable *uncommon* ability, and Sachs has proved himself to be a master of this genre of analysis. It is a great tribute to Sachs's standing as an economist that his expertise is so widely sought across the globe.

In his work on Third World debt problems, Jeffrey Sachs was particularly critical of the negative effects of the influence of commercial interest groups (including U.S. banks) on public policy.

In a well-publicized newspaper interview, Sachs had once accused James Baker at the Treasury of being "mainly attuned to the interests of U.S. commercial banks". In his present work on the reform of ex-communist regimes, his main adversaries have been state bureaucracies. He has been fearless in his criticism of what he has seen as the evil effects of vested interests, and assured and poised in his proposals to do away with those evils. His style of presentation is tremendously focused, identifying the principal enemy and going at it with hard-hitting aplomb.

There is an interesting story in the ancient Indian epic *Mahabharata*, in which some princes are tested for their skill in archery. The teacher asks each in turn to aim his arrow at an eye of a bird and then asks each what he can see. While all the princes except one describe the bird and the tree, Arjuna the great warrior - and the main hero of the epic - says that he cannot describe anything other than the eye of the bird because he cannot see anything else whatsoever. The winning prize is, then, awarded to Arjuna without a single arrow being shot. Jeffrey Sachs has something of that quality of concentration and focus in his present imperative work on marketization of centralized economies. He is not to be deflected from the main target by the complexities of the over-all picture. This is clearly an important ingredient of Sachs's success as a practical activist and a radical reformer.

When at leisure Jeffrey writes about all this, as he must do at some stage, I don't doubt that we would get from him a much broader analysis—with some account of the tree and of the other features of the bird. I mention this since the temptation to expect the same kind of diversity and catholicity in Sachs's counseling work as in his academic writing is bound to be disappointed.

We shall all await Jeffrey Sachs's more academic and more rounded analysis of the challenges of institutional reform. But meanwhile we can express our admiration for what we have already received so plentifully from him. We honour today the creative and innovative author of many far reaching contributions in political economy, all achieved in remarkably few years. It gives me great pleasure to be able to hand over to Jeffrey Sachs the much-deserved Frank E. Seidman Distinguished Award in Political Economy.

# THE ECONOMIC TRANSFORMATION OF EASTERN EUROPE: THE CASE OF POLAND

by Jeffrey Sachs

The East European economies are digging out from the rubble of 45 years of communist rule. In virtually every aspect of economic life, the communist legacy is adverse. Normal market institutions were destroyed by the communist rulers in the early post-war period, so that even the most basic categories of economic life in a market economy — corporations, bankruptcy law, securities trading, collective bargaining — must be painfully reconstructed. For four decades, capital spending was dictated by political fiat in a system that valued heavy industry to the neglect of basic consumer needs, and that ruthlessly reoriented trade from Western Europe to the Soviet Union.

The economic effects of the communist period are just now coming into clear view among analysts in the East and West, and the picture is even worse than expected. Living standards in Czechoslovakia, Hungary, and Poland are now estimated to be at the levels of the middle-income developing countries of Latin America, and far below the levels of even the poorer countries of the European Community.[1]

At the same time, the industrial structure seems even less suited to the requirements of competition in world markets than was hoped, and the ecological degradation caused by decades of reckless disregard for the environment constitutes another urgent and costly legacy of the previous regime.

The first two years of post-communist rule have been tumultuous for the average citizen, with high inflation, factory closings, and an end of the certainties of life in the communist era. But despite the deep anxieties which understandably grip the Eastern European societies, I believe that the new democratic leaders of these countries have already hit upon a broad strategy for economic reform that has a good chance of success. I have had the great honor to participate in the design of the reform strategy in Poland, as an unofficial advisor during 1989 to the leaders of Solidarity, and since the start of post-communist rule in Poland in August 1989, to senior Government officials and members of the Parliament.[2]

I will take this occasion to review Poland's economic strategy in the post-communist era and its economic prospects in the coming years.

**Poland's Goal of Economic Integration with Europe**

Poland's fundamental course, like that of other Eastern European countries, is to aim for the closest possible economic and political integration with Western Europe. Put succincity, and in the words of the favored slogan of the revolutions of 1989, the goal is to "return to Europe." Operationally, Poland is aiming to put in place a political and economic system similar to that of the European Community. There is to be no "third way." This point of view was precisely described by Minister Jacek Saryusz-Wolski, Poland's Plenipoteniary for Relations with the European Community:

> The most important thing will be to harmonize economic policy and legislation. Poland will try to take an enormous step forward in coordinating its economic and monetary policy with that of the EEC, followed by policies on industry, customs duties, commerce, company law, conditions for residence, and the pursuit of economic activity — taxation, social matters, regional issues, environmental protection, agriculture, energy, scientific research, the protection of intellectual property. And that is still not everything. We know that joining the EEC means adopting about 7,000 legal regulations. At the present time we are at the process of translating the EEC code of preferential product listings. We also have asked the Community to produce a list of norms that we would introduce right away, because they are of exceptional importance.

As a final step of this harmonization, Poland aims to become a full member of the European Community, to begin around the year 2000.

The urge to harmonize with and eventually join the EC has many deep roots. Most fundamentally, Poland desires to regain its place in the mainstream of European society and culture. Also, there is a near-unanimous admiration in Poland for the social and political accomplishments of postwar Western Europe, in creating wealthy and equitable societies based on private ownership, social welfare systems, and stable parliamentary democracies. Rather than experimenting with a new economic system, Poland has an attractive role model to guide its policy choices. By sticking closely to a role model, there are certainly fewer chances for large mistakes in the major changes ahead. As Poland's Deputy Prime Minister Leszek Balcerowicz has frequently put it, "Poland is too poor to experiment. We will therefore follow working models. Let the rich countries experiment if they want."

Another motivation for harmonization and integration with Western

Europe is the judgement, based on Western Europe's postwar economic history, that free trade and financial relations with the EC will directly help Poland to catch up with Western European living standards. During the post-war period, the poorer countries of Western Europe's periphery have tended to grow faster than the core economies, thereby narrowing the gap in living standards.[3] There is strong evidence that the high growth rates of the poorer countries have been spurred by their close trade and financial ties with the rest of Europe, as these ties have spurred financial capital inflows, foreign direct investment, and a general upgrading of technology in the poorer countries. As a more general matter, a considerable body of theory and evidence from developing countries supports the view that an outward-oriented trade regime encourages a more efficient specialization of production and more rapid economic growth.[4]

Yet another advantage for Poland of committing itself early to eventual membership in the EC is that Poland thereby signals to potential investors, both domestic and foreign, that its policies will not be thrown off course by domestic political demands for protectionism or other kinds of policies inimical to long-term growth. Given the amount of restructuring that must take place in Poland in future years, and the intense political resistance that is likely to accompany that restructuring, potential investors naturally fear that the reforms can be seriously thrown off course. By committing at the beginning of the reform process to a free-trade policy, especially in the context of treaty agreements with the EC, Poland can raise the confidence of would-be investors that it will not backtrack from its reforms at a later date.

## The Economic Reform Program in Poland

The deficiencies of Poland's economic structure are evident across the economy: an overgrown and inefficient heavy industrial sector completely protected from international competition; an underdeveloped light industrial sector; a neglected and undersized service and distribution sector; a particularly inefficient and underdeveloped financial sector; and a technologically backward agricultural sector, in which millions of poor farmer households work tiny plots of land.

Poland's economic reform strategy does not aim to address these problems mainly by direct intervention in these sectors, but rather through the generalized introduction of market forces which will guide most of the needed restructuring. For this reason, we have to think about Poland's economic transformation from two perspectives. The first is the timing and content of the *reforms*; the second is the timing and content of the actual *restructuring* that will take place as the result of the reforms. The reforms themselves can and should be introduced quickly, in three to five years. The restructuring, on the other hand, will necessarily last for a much longer period, presumably a decade or more, since there must be time enough for a substantial buildup of investments in new sectors of the economy in response to the newly introduced market signals.

Poland's comprehensive economic reform program has three main types of policies. *Economic liberalization* is the broad rubric for all of the legal and administrative changes needed to create the institutions of private property, and to introduce market competition. *Macroeconomic stabilization* involves measures to limit budget deficits, reduce the growth of the money supply, and establish a realistic and uniform exchange rate for the currency, in order to create a working monetary system based on a convertible currency and stable prices. *Privatization* includes the wide range of measures needed to transfer ownership of state property to the private sector. Note that there are two ways that the private sector will develop: through the formation of new firms made possible through economic liberalization, and through the privatization of existing state property.

I should also stress that the steps of liberalization, stabilization, and privatization do not exhaust the range of key governmental actions over the economy. In addition, the government must make certain that there is a *social safety net* in place at the time of reforms in order to prevent the reform actions from gravely affecting the most vulnerable parts of the society. A rudimentary *social safety net* exists, though with low levels of benefits that reflect Poland's impoverished economy. The old regime had already in place many of the needed social measures. New measures, such as unemployment insurance were introduced at the outset of the program. Also, the government must oversee a *public investment program*, mainly for needed infrastructure, as a complement to the restructuring of the economy.

Poland's strategy has been to introduce the three main pillars of reform as rapidly as possible, an approach that is being emulated widely throughout Eastern Europe. Substantial steps towards liberalization and stabilization were introduced in a single package of measures, or "big bang," on January 1, 1990, directed by Deputy Prime Minister Leszek Balcerowicz, and now known as the Balcerowicz Plan. A privatization law was passed in June 1990 to set in motion the third leg of the reforms.

The motivation for comprehensiveness and speed in introducing the reforms is clear cut. Such an approach vastly cuts the uncertainties facing the public with regard to the new "rules of the game" in the economy. Rather than creating alot of turmoil, uncertainty, internal inconsistencies, and political resistance, through a gradual introduction of new measures, the goal is to set in place clear incentives for the new economic system as rapidly as possible. As one wit has put it, if the British were to shift from left-hand-side drive to right-hand-side drive, should they do it gradually ...say, by just shifting the trucks over to the other side in the first round?

If we examine the timing of reform actions more carefully, we note that many of the key steps of economic liberalization can be introduced very quickly, indeed virtually overnight by a well-prepared government. The crucial steps of establishing free trade, market pricing according to the forces of supply and demand, key aspects of commercial law and private property rights, and the end of state orders and central planning, were introduced in Poland in the space of a few weeks at the end of 1989 and the beginning of 1990.[5]

Macroeconomic stabilization can also be achieved relatively quickly, with key steps of eliminating the budget deficit and tightening monetary policy in Poland taken at the time of the "big bang." The need for quick macroeconomic action in Poland was particularly acute, since the weakness of the last communist government and the final breakdown of the old regime had led to an extraordinary financial destabilization that was capped by a brief period of hyperinflation at the end of 1989. The hyperinflation would surely have intensified save for the decisive actions of the new Solidarity-led government which came to office at the end of 1989.

On January 1, 1990, the new government took stringent macroeconomic measures, including large cuts in budget subsidies (which meant higher prices passed on to consumers), higher tax collections, wage controls, and a sharp devaluation of the currency. These measures, together with the elimination of most price controls as part of the economic liberalization, led to a large one-time jump in the price level, of nearly 100 percent in the month of January, 1990! But soon after this extraordinary one-shot jump in prices, the new economic environment brought a rapid end to the high inflation of the previous year, and even more remarkably, a rapid end to decades of chronic shortages and lines.

Without question, privatization is the most challenging and time-consuming of all of the steps of the reform program. Many countries around the world have sold state enterprises to private investors in recent years, but none has faced the magnitude of the challenge in Poland and the rest of Eastern Europe. Under the communist regime in Poland, more than 90 percent of industry, in roughly 3,000 industrial enterprises, was in state hands, and the share of state ownership was also very high in other parts of the non-agricultural economy.

To put the issue into perspective, consider the fact that under the aggressive privatization campaign of the Thatcher era, the U.K. succeeded in privatizing approximately 50 enterprises during the 1980s, roughly 5 firms per year. At the Thatcherite rate (which benefitted from a sophisticated capital market and a large private sector to absorb the state firms), the Polish task of privatization would take several hundred years! "British-style privatizations" cannot be the main answer for Eastern Europe.[6]

The basic framework law for privatization was put in place in mid-1990. Under this law, privatization has proceeded remarkably rapidly for small firms, such as retail shops, for which privatizations are mostly controlled by local and regional governments. Poland has succeeded in leasing or selling more than 40,000 shops to private operators by mid-1991. It is estimated that as a result of this "small-scale privatization," as well as the rapid growth of new private firms in the service sector, roughly 80 percent of retail trade is now carried out by the private sector! Privatization has also been very rapid in trucking, construction, and small industrial units, where privatization has occurred in part by auctions, and in part by leasing the enterprises to the workforce.

Unfortunately, privatization of large industrial enterprises has proceeded much more slowly, indeed far too slowly. It seems clear that new methods of privatization beyond those that have been used in the West will be needed to speed the process. After much debate and analysis, there are plans in Poland to privatize several hundred large enterprises by giving away their shares to the Polish population. Specifically, the plan is to freely distribute a portion of the shares of these large industrial enterprises into mutual funds, whose shares in turn will be distributed to the adult Polish citizens.[7] There is also some discussion of distributing shares into new private pension funds that would take over some of the burden of the state social security system.

## The Early Effects of Poland's Reforms

Even in the first two years of economic reform, the combination of liberalization, stabilization, and privatization measures has had a profound and beneficial effect on the Polish economy. In the first few weeks of Poland's "big bang," Poles were startled to see the end of the shortages which had wracked Poland for decades, as well as the appearance of many new imported consumer goods on the market. Hundreds of thousands of new small businesses started operations in 1990, creating in a matter of months an incredible network of new shops and service establishments, and firms engaged in international trade, construction, and trucking. The development of the service and trade sectors was particularly dramatic in an economy that had long been starved of these sectors.

The economy also quickly adjusted to the opening of markets to international trade. Polish exports to the West surged in 1990, as enterprises took advantage of the new convertibility of the currency and the newly attractive exchange rate following the devaluation and unification of the exchange rate at the start of 1990. The surge in exports continued in 1991, and has helped to pay for a sharp rise in imports as well. The import boom reflects, in part, the eager purchases by Polish households of Western durables goods that were long unavailable, and in part, a substantial increase in machinery imports.

The overall effect in the first two years of the economic changes on the average Polish households is hard to assess. Despite the new availability of goods since the start of 1990, many Poles have complained bitterly about the new higher prices. The evidence suggests that *on average*, Poles are now consuming somewhat more meats, fruits, and consumer durables than they were before the reforms, so that greater availability of goods has, on average, more than compensated for higher prices. For some other goods, though, average consumption has probably declined. On a weighted-average basis, there seems to have been a slight decline in average consumption. But even that slight decline has probably been offset by the increase in the quality and variety of goods available, and the savings of millions of hours per week that used to be wasted in long queues for scarce goods.

But, of course, average levels of consumption tell only one part of the story. There are surely important groups in the population that have lost ground in the first two years of the reforms. These groups include, for example, the hundreds of thousands of farmers working on tiny and inefficient farms, who have lost the production subsidies that used to help them stay in operation. Similarly, there are hundreds of industrial enterprises, with hundreds of thousands of workers, that are unable to compete under the new market conditions. As a result, there has been a sharp loss of jobs in industrial firms, which has contributed to a sharp increase of the unemployment rate, which has risen to nearly 10 percent in mid-1991.

Not all of the rise of unemployment is due to the reforms, however. Some was always present, but was simply unrecorded by the previous regime, under which unemployment was a crime and not a circumstance meriting compensation. Also, the collapse of the Soviet economy, and the breakdown of trade relations with the Soviet Union, has led to an enormous and rapid decline in exports from Eastern Europe to the Soviet Union. Hundreds of enterprises in Poland and the rest of Eastern Europe are being forced to close their doors, or at least to cut back dramatically on production, as a direct result of the Soviet crisis. The economic reforms in Poland have in fact helped to ease this shock, by creating conditions in which enterprises can shift their exports from the Soviet Union to Western markets. Nonetheless, the loss of national income and employment due to the Soviet crisis is widely attributed by the Polish public to the economic reforms themselves.

The dominant mood in Poland may be described as a grudging acceptance of the need for the reforms, and an appreciation for the achievements to date in ending inflation and shortages, and in promoting the private sector. At the same time, however, there is a deep anxiety over rising unemployment and a profound uncertainty about the future. In a recent opinion survey, more than 60 percent of the Poles said that they feared losing their jobs in the near future. While such fears are almost surely exaggerated, the fears themselves are real, and they contribute to a pall that hangs over the country.

## The Need for a Breakthrough on Privatization

Poland has made it more than half-way through the reform process needed to transform itself into a market economy. The price system now works according to supply and demand; international trade is free, and as hoped, both exports and imports are rising; new private firms are forming and growing at a rapid rate. Indeed, Poland already can be considered to have a market economy, but one that still has an overwhelming state-ownership of large industrial firms. Poland has so far achieved a form of "market socialism."

This is surely not where Poland wants to remain. Market socialism is not only inefficient, but if continued would almost surely lead to a return of profound macroeconomic instability. The problem is that in the absence of real owners of the industrial assets, the enterprises lack clear goals, and are not subject to any effective corporate governance. In the West, enterprise managers are governed by a board of directors that is legally obliged to govern the firm on behalf of the owners, with the goal of maximizing the firm's value. While this system poses serious problems of how to make sure that managers and board directors in fact operate on behalf of the owners, at least the legal responsibilities and basic incentives of corporate enterprises are clear.

Under the communist regime, governance was provided by a system of commands from the state adminstration and the Communist Party, backed up by terror or its threat. With the merciful collapse of communist terror, governance of the industrial sector has also collapsed, with striking and pathological effects. Now, enterprise managers operate on their own behalf, or under the control of a workers' council within the firm. In a small minority of firms, a Supervisory Board has been appointed by the government to represent the interests of the Treasury as the legal owner of the enterprises. In these cases, the workers' council role is eliminated, and the enterprise is made subject to normal commercial law for corporations, a process known in Poland as "commercialization."

Throughout the state sector and particularly in the vast majority of firms that have not been commercialized, there are incessant wage pressures that are not kept in check by managers who represent real owners of the firms. Managers are in fact all-to-ready to pay out enterprise profits in the form of higher wages. In the absence of centralized wage controls, therefore, there is the tendency towards a wage explosion of the sort that has occurred in East Germany (where wage controls were not imposed).[8] Therefore, wages are now kept somewhat under control in Poland by highly unpopular centralized incomes policies, which are both economically inefficient and politically debilitating for the government.

Also, in the non-commercialized enterprises, there are reports of widespread self-dealing and conflict of interest by state managers. Managers have been reported to engage in the following kinds of activities: intentionally bankrupting firms to buy them back cheaply; establishing private firms to do business, in sweetheart deals, with the state enterprises that they manage; accepting unfavorable joint venture and takeover offers that provide personal benefits for the manager, while rejecting favorable offers that put the manager's personal position at risk.[9]

Finally, there are "zombie" enterprises, in which incompetent managers simply run down the bank balances and other capital of the enterprise, while failing to adjust in a satisfactory way to the new market conditions. In the case of many Polish firms that were hit by the collapse of the Soviet market, enterprises simply continued to produce the normal output levels and build up inventories, waiting for a miracle of some sort. Finally, in mid-1991, the bank balances have run out, and a politically and economically troubling spate of insolvencies has hit the country. Once again, the absence of a capital market (in which a takeover might occur), and the lack of corporate governance, has contributed to these profound managerial failures.

The proper long-term solution for the industrial sector problems is clear. The enterprises should be privatized, and then restructured or liquidated once under private control. The case for privatizing the firms quickly is overwhelming. The onus on the government for restructuring will be greatly reduced; the pressures from the firms for subsidies and protection will be easier to resist[10]; and, presumably, the private owners will do a better job of saving the viable parts of industry and sloughing off the unviable parts. As mentioned earlier, novel approaches to privatization — based on a free-distribution of shares of industrial enterprises — are probably vital to speeding the privatization process. Nonetheless, these novel methods remain controversial and subject to criticisms by various groups, such as managers intent on keeping control over their enterprises.

Before privatization is complete, there is an urgent need to widen the use of commercialization, to bring the enterprises under the governance of Supervisory Boards. While this step does not establish private owners, it does help to establish some modicum of oversight of managerial behavior, and it does subject the enterprise to normal corporate law. Even this step, however, is controversial and slow to be applied in Poland. Some policymakers underestimate the importance of establishing a clear legal framework for the enterprises, while others point to the real, but surmountable, logistical difficulties of finding qualified individuals to sit on the Supervisory Boards. Still other critics of commercialization worry that if the process is abused, it could lead to a recentralization of governmental power over the enterprises.

**Economic Restructuring in the Medium Term**

The economic reforms will set in motion a sustained process of economic restructuring. Of particular importance will be the pressures of international competition on Polish industrial pressures of international competition on Polish industrial enterprises. While we cannot make accurate predictions about the precise long-term consequences of this restructuring, especially as regards which industrial sectors will survive and flourish, and which will decline, we can make some useful predictions about the basic trends that are likely to emerge.

Under communist rule, Poland's economy was heavily skewed towards industry and away from services. This bias was cruelly felt in everyday life, in the form of a shortage of shops and restaurants, miserably inefficient banks, and virtually unobtainable personal services.[11] Once market forces are unleashed, there should be a strong pull of resources into the previously neglected sectors, and out of the overextended industrial sectors. Even in the first year-and-one-half of the reforms, such trends have been clearly evident. Industrial employment has fallen sharply, perhaps by around one-fourth in the state-owned industrial enterprises. At the same time, hundreds of thousands of new private businesses have emerged in trade, service, and residential construction. While Poland is sometimes described as being in a sharp recession, this characterization in fact applies only to the industrial sector. The economy is actually booming in many of the previously neglected sectors, especially through the formation of new small businesses.

Agriculture is another area where we should expect major restructuring. Poland has a large and inefficient agricultural sector made up of hundreds of thousands of tiny farms. As mentioned earlier, these small farms were sustained despite very low productivity by large subsidies granted by the communist regime to keep social peace in the countryside. Poland, therefore, has not yet completed the great demographic shift of employment from agriculture to industry and services that has been traversed by nearly every advanced industrial country. As a result of the sharp cuts in subsidies to agriculture in the past two years, many small-scale farmers are now under financial pressure. It should be expected that many small farmer households will sell their farms in the coming decade or two, so that farmlands will be consolidated over time into a much smaller number of larger farms.

The third major trend that we should expect is a complete restructuring within the industrial sector, from energy-intensive heavy industry to more labor-intensive and skill-intensive industries that can compete on world markets. Poland enjoys low-cost skilled labor, particularly in engineering, that should make Poland an attractive place to produce industrial goods for exports to Western Europe. Over time, Western firms, mainly from Western Europe, are likely to set up operations in Poland for the sake of export production, in the same way that European firms are investing in Spain, or American firms are investing in Mexico, or Japanese firms are investing in Korea, Taiwan, and the rest of Southeast Asia. So far, foreign direct investment has been modest, since foreign investors remain concerned about the lack of clarity in property rights, and about the political sustainability of Poland's reforms. Assuming that the reforms are in fact sustained, the rate of foreign direct investment should increase markedly in the coming years.

**Sustaining the Reforms: the Role of the West[12]**

Despite Poland's great accomplishments in reforms to this date, the situation remains decidedly fragile. Average citizens are probably less aware of the fact that the burgeoning of new firms promises economic growth down the road than they are of the fact that many large industrial enterprises are currently going bust. While they appreciate the end of shortages and queues that plagued daily life for decades, they are also worried about making their low monthly earnings cover the new and higher market prices. And most of all, many are confused — failing to understand why the end of Communism did not bring immediate prosperity; why they have both markets and low living standards at the same time; why economic reform is bringing in a wave of unemployment.

Reformers don't always fare well in this kind of environment. Ludwig Erhard, the father of the post-war German economic miracle, was not hailed as the creator of prosperity until several years after the start of his free-market reforms. Two years into those reforms, in 1950, Erhard was widely attacked in Germany as the creator of high unemployment rather than high living standards. The Adenauer government, of which Erhard was a part, just barely survived politically in the difficult first years, and in large part because of the generous Marshall Plan funds that were flowing into the country.

In Poland, Leszek Balcerowicz will be remembered as the father of his country's economic miracle, *but only if the reforms are given the time to work.* And time may be very scarce indeed, given the sullen attitudes of the population; the fertile ground for populism; the powerful political forces supporting protection and subsidization of failing industries; and the potential for political stalemate or worse.

The greatest risk in Poland is that populism, confusion of property rights, and a splintering of political power in the parliament, will lead to weak governments unable to take the last decisive step to private ownership. In that case, the economic situation will almost surely deteriorate, macroeconomic instability will rise, and as in Latin America, democracy itself could be put at risk. The risk is heightened by the fact that Poland has adopted proportional representation as the basis for parliamentary representation. This voting system surely increases the likelihood of weak, splintered political parties, and a government that is dependent on fragile, multi-party coalitions. Twenty seven political parties are putting forward nationwide slates, and no less than 62 parties are fielding at least one candidate, in the parliamentary elections in October 1991!

The key fact about economic reform is that several years must pass before the fruits of reform are widely evident. The intervening period has been called a "valley of tears," and it may be observed in nearly every country that has undergone a radical economic transformation, from post-War Germany and Japan, to Chile and Mexico in the 1980s. The time in the valley depends on the consistency and boldness of the reforms. If there is wavering or inconsistency in economic measures, it is easy to get lost in the valley. Argentina has been lost for forty-five years.

Passing through the valley of tears requires first, and foremost, political leadership, and second, enough social consensus to sustain a stable set of policies. But even Moses and the Israelites would not have made it through the wilderness without some manna from heaven. External assistance can be vital in the perilous first years of change. And Moses did not face re-election for forty years (though he certainly faced a leadership challenge at the base of Mt. Sinai).

The glue holding together the reforms is the basic social consensus that success will be achieved by "returning to Europe." But if Western Europe shows that it doesn't really want Poland (and the rest of Eastern Europe) to "return," then the consensus will break apart, and the intense pressures already facing the governments of the region are likely to undermine the reforms. Worse yet, given the stingy attitude of the West to date, and the undoubted cases of rapacious Western investors intent on profiteering from the gaps in adequate legal structure in Eastern Europe, there is already evident a risk of xenophobic backlash among part of the Eastern European population.

The key step would be for the European Community to signal Poland that it can indeed return, in the concrete sense that the Poland can expect to become a member of the European Community after it passes the key hurdles of economic reform. Nothing would so much channel the energies and political passions in Poland as a clear track to membership in the EC. But, alas, there seems to be as much fear as welcome of eventual membership for Poland and other Eastern European countries. In the critical negotiations between the EC and Poland on Associate Membership, the EC has so far made no concessions on the critical issue of agricultural trade, and limited concessions on textiles, and it has remained vague on the question of eventual membership.

In addition to EC membership, there is also the need for greater financial assistance during the period of restructuring. Poland will need large sums of money to invest in a modernization of infrastructure. Once again, the West could play a crucial role in helping to assure that greatly needed financial resources are available during this most delicate period of economic transformation.

## Endnotes

1 According to World Bank estimates of dollar GNP for the year 1989, we find: Czechoslovakia, $3,450; Hungary, $2,590; Poland, $1,790. This compares with Portugal, $4,250; Greece, $5,350; Ireland, $8,710; and Spain, $9,300; and in Latin America, with Brazil, $2,540; Uruguay, $2,620; and Venezuela, $2,450. (World Bank, *World Development Report*, 1991 Appendix Table 1, p.205).

2 During 1989, my work in Poland was supported by the Stefan Batory Foundation, and during 1990-1991, by the World Institute of Development Economics Research (WIDER), a Helsinki-based branch of the United Nations University.

3 For evidence on this point, and a detailed discussion of economic convergence, with an extensive bibliography as well, see Robert Barro and Xavier Sala-i-Martin, "Convergence across States and Regions," *Brookings Papers on Economic Activity*, 1991:1, 107-182.

4 For a recent discussion of the evidence, see the *World's Bank World Development Report, 1991*, chapter 5.

5 Before Poland's big bang, there had been great concerns about liberalizing prices in the face of a highly monopolized industrial structure. Many economists had insisted that price liberalization could only be accomplished after a substantial and time-consuming demonopolization of the economy. But this view was basically mistaken, since the immediate introduction of free trade was a quicker and more effective means of instilling competition in Poland's markets than an attempt at administratively guided demonopolization.

6 The British privatizations typically followed a pattern in which the firm was "prepared" for privatization through an internal restructuring; the firm was "valued" by one or more investment banks, to get a base price for an initial public offering (IPO); the IPO was widely advertised and promoted; and then the IPO was carried out several months later. The whole process could take a year or more.

7 For a detailed discussion of the concept and motivations for a free distribution of shares, see J. Sachs and D. Lipton, "Privatization in Eastern Europe: the Case of Poland," *Brookings Papers on Economic*

*Activity*, 1900:2, and J. Sachs, "Accelerating Privatization in Eastern Europe: the Case of Poland," prepared for the World Bank Annual Conference on Development Economics, May 1991.

8 The wage explosion in East Germany has had devastating consequences, for it has led to the virtual bankruptcy of the entire East German industrial sector. Most enterprises continue to operate only by virtue of large-scale subsidies from the government. Wages have risen to around 50 to 60 percent of West German levels, even though productivity is perhaps only 20 to 30 percent of West German levels. The wage explosion resulted from a variety of factors: the lack of wage controls; the East German public's belief that they "deserved" West German wage levels; the unwillingness of politicians in West Germany to speak out on behalf of rational wage policies; and the pressure of West German unions to help raise East German wages, lest the lower wages in the East undermine the wages in the West.

9 By favorable or unfavorable I refer to the value of the offer compared to the value of the capital that is being sold to the foreign bidder. Of course, the issue of self-dealing by managers in the face of hostile takeover bids is familiar in American capitalism as well, but the managers are limited in egregious behavior by the boards of directors, which are themselves bound by corporate law to consider the interests of the shareholders as paramount in the event of a takeover bid.

10 Protectionist pressures will also be easier to resist if the East European countries are successful in signing Associate Membership Agreements with the European Community. These agreements should presumably guarantee open markets on both sides, and therefore bind the East European countries to free-trade policies. See below for further discussion.

11 The shortage of services was the butt of many jokes. One story tells of a man putting down on the counter his bags of zloties to buy a car. He is told by the clerk that he car will be delivered ten years from that day. He calmly asks whether the car will be delivered in the morning or afternoon. The clerk is incredulous. "Ten years from today, I said. Morning or Afternoon? What difference could it possibly make?" "Oh, it makes alot of difference,"says the buyer. "The plumber is coming in the morning!"

12 This section draws upon my article, "Crossing the Valley of Tears," in *Challenge Magazine*, September-October 1991.

## 1991 Board of Trustees
## The Frank E. Seidman Distinguished Award in Political Economy

## 1991 Selection Committee
## The Frank E. Seidman Distinguished Award in Political Economy

| | |
|---|---|
| ALAN S. BLINDER | Gordon S. Rentschler<br>Memorial Professor of Economics<br>Chairman, Department of Economics<br>Princeton, University<br>Princeton, New Jersey |
| A.J. KONDONASSIS | President, International Executive Board,<br>Omicron Delta Epsilon<br>David Ross Boyd<br>Professor of Economics<br>The University of Oklahoma<br>Norman, Oklahoma |
| FRANCO MODIGLIANI | Nobel Laureate in Economics<br>Institute Professor Emeritus,<br>Massachusetts Institute of Technology |
| PAUL CRAIG ROBERTS | Professor, Political Economy<br>Center for Strategic and<br>International Studies,<br>Georgetown University<br>Washington D.C. |
| AMARTYA SEN | 1986 Award Recipient<br>Lamont University Professor,<br>Harvard University<br>Cambridge, Massachusetts |